Vol.-I & II
Unit-I , II, III, IV & V

+3 Commerce

CORPORATE ACCOUNTING

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We wish you happy reading.

SPPani

(S.P. Pani)
DIRECTOR

Content

1.	Unit I	Share Capital and Loan Capital	1
2.	Unit II	Financial Statement	159
3.	Unit III	Valuation of Goodwill	197
4.	Unit IV	Accounting for Amalgamation of companies	229
5.	Unit V	Funds flow statement	274

UNIT – I

LESSON – I

SHARE CAPITAL AND LOAN CAPITAL

Objectives of this lesson :

When you complete this lesson you will be able to –

Define company

Meaning of company

Types of company

Brief discussion of formation of a company

Statutory records of a company

Capital of a company

Types of share capital

Issue of share capital

Forfeiture of share capital

Re-issue of forfeited shares

Redemption of preference shares

Meaning of debentures

Types of debentures

Issue of debentures

Redemption of debentures

After going through this lesson in detail, turn to the end of this lesson and take the 'self test'. If you are ready to begin with the next lesson.

LESSON OVER VIEW

INTRODUCTION :

The objective of company account is to know methods of preparing the books of accounts of the corporate houses to determine the net income and financial position of the organization

Definition of Company –

Section 3(1)(i) of the companies Act 1956 defines a company as "company formed and registered under this Act or an existing company". An existing company means a company formed and registered under any of the former companies Acts.

Meaning of a company –

A company is an association of persons with capital contributed by them to carry out a common purpose i.e., to earn profit out of it. The capital of a company is divided into numerous transferable shares. It enjoys perpetual succession, a common seal and legal entity different from its members.

CHARACTERISTICS OF A COMPANY :

To have a clear idea regarding status of a company let us discuss the characteristics of a company as follows.

1.2 The basic characteristics of a company are as follows :

- **Separate Legal Entity :** A company enjoys a separate legal entity distinct from its members. It is treated as a separate legal person having duties and rights distinct from those of its members. The scope of its activities and the working of the company is regulated by its Memorandum of Association, Articles of Association, provisions of the Companies Act and SEBI guidelines. It can own properties, enter into contracts, etc. in his own name. It is held responsible for the acts of the company.

- **Common - seal :** A company, being an artificial legal person, acts through natural persons. These natural persons act on behalf of the company and sign on behalf of the company under the common-seal of the company.

- **Limited Liability :** Liability of the members is limited to the contribution promised by them. In a company limited by shares, members (also called shareholders) are liable to contribute the value of shares held by them. In case a company is limited by guarantee, members are liable to contribute the guaranteed amount only. For academic purposes, a company can have members with unlimited liability. These companies are called unlimited companies.

- **Separation of Ownership and Management :** As the number of shareholders is very large, management is entrusted to a select few. They elect their representatives in shareholders meeting to direct the affairs of the company. Elected representatives are called Directors and the group of directors is termed as 'Board of Directors'. Board of Directors manage the affairs of the company and for certain crucial decisions they again come to the body of shareholders. In shareholders meeting, decisions are taken by passing a resolution. Resolution passed with simple majority is called 'Ordinary Resolution' and if it is to be passed with three-fourth majority, it is referred to as 'Special Resolution'.

- **Perpetual Succession :** Company being an artificial legal person, is not affected by the death, insolvency, lunacy, etc. of its members. It is created by law and comes to end only by the process of law.

- **Transferability of Shares :** Member of a company can transfer his interest or share in the company without the concurrence of other members. It provides liquidity of investment. Facility of transfer of shares, alongwith limited liability has made company form of organization very popular.

- **Registered Association of persons :** Company is an association of persons for some common object formed and registered under the Companies Act, 1956. Sometimes people associate together not for making profits but for promoting art, science, religion, charity or any other useful object. These associations, registered under the Act may be termed as 'Associations not-for-profit. Generally, a number of individuals get united for business and normally form a 'Company Limited by Shares'.

TYPES OF COMPANY :

Types of companies may be as follows :

1. **Chartered company :** A company formed through a royal charter is called as chartered company. Now a days such type of companies are not existing. For example – East India Company, South Sea House etc.

2. **Statutory Companies :** Statutory companies are formed by the special Act passed by the central or state legislature. For example-Reserve Bank of India, Life Insurance corporation, state Finance corporation etc.

3. **Registered Companies :** Companies registered under the companies Act are known as registered companies. For example-public limited company.

4. **Private Limited Company :** According to sec. (3(i)(iii) a private company means a company which has been formed without issuing the share to collect the capital from the public.

5. **Public Limited Company :** A company which has been formed by collecting capital through issue of share capital is called as public limited company.

6. **Limited Company :** A company limited by share or guarantee is called limited company.

7. **Company Limited by Shares :** A company in which the liability of the members is limited to the amount of shares he has agreed to contribute is called as company limited by shares.

8. **Company Limited by Guarantee :** A company in which the liability of the members is limited to the guarantee fixed by the memorandum is called as company limited by guarantee.

9. **Government Company :** According to sec.617, a company, if which not less than 51% of the paid up share capital is held by the central government or by any state Government or party by central government and partly by state Government or a company which is a subsidiary of a government company.

Difference between public ltd company and private limited company

	Basis of difference	Private company	Public company
1.	Minimum number of members	Two	Seven
2.	Maximum number of members	Fifty	Unlimited
3.	Issue of prospectus	A private company does not issue the prospectus as it can't issue shares or debentures to the public	A public limited company must issue a prospectus or a statement in issue of prospectus.
4.	Transfer of shares	Shares are not transferable	Shares are freely transferable
5.	Commencement of business	A private company can start its business after getting certificate of incorporation	A public company can start its business only after obtaining the certificate of commencement of business.
6.	No. of directors	At least two directory	At least 3 directors.
7.	Quorum for meeting	At least two persons are required	At least five members are requirements

8.	Membership	Membership of private company is restricted to friends	Membership of a public company is not confined within the friends.
9.	Restriction regarding managerial remuneration	No restriction	It can be paid upto a maximum limit of 11%.
10.	Use of the word limited	The word 'private Ltd" is used at the end of the name of private company	The word Ltd is used at the end of the name of public company.

HOW A COMPNAY IS FORMED :

After knowing the types of company let us discuss how a company is formed. As you know a company is an artificial person which is created by law and closed down or liquidated by law. A company is formed as discussed in the following paragraph.

After having examined the future prospects of the company and after having ascertained from the registrar of companies that the proposed name of the company is available, the promoter makes himself busy with the preparation and registration of memorandum of association, articles of association and many other documents. He finds the first directors of the company accumulates funds and arranges for its advertisement. Thus formation of a company involves three important stages as follows :

(i) preparation and filling of necessary documents

(ii) payment of necessary fees and

(iii) registration of a company and obtaining the certificate of incorporation.

After obtaining the certificate of incorporation a company is said to be formed. So a private limited company can starts its business after obtaining a certificate of incorporation. But a public limited company can start its business after obtaining the certificate of commencement.

BOOKS OF ACCOUNTS AND PREPARATION OF FINAL ACCOUNT :

Section 209 of the Indian Companies Act. 1956 prescribes the books of account to be maintained by a company as follows :

(a) Such books as are necessary to give a true and fair view of the state of affairs of the company and to explain its transactions, are kept on accrual basis and according to the double-entry system of book keeping.

(b) Every company maintains proper books of account with respect to ;

(i) All sums of money received and expanded by the company and the matters in respect of which receipts and expenditure takes place;

(ii) All sales and purchases of goods by the company;

(iii) All assets and liabilities of the company and;

(iv) Utilization of material or labour or other items of costs in cost accounting records in case of manufacturing company.

Section 211 along with schedule VI of the companies Act, 1956 deals with the preparation and presentation of profit and loss account and the balance sheet to give a true and fair view of the state of affairs of the company.

Further, it requires that every profit and loss account and balance sheet of the companies shall comply with the accounting standards issued by the ICAI and prescribed by the central government in consolation with the national advisory committee on accounting standards established under section 210 of the companies Act, 1956.

STATUTORY BOOKS AND RECORDS MAINTAINED BY A COMPANY:

Statutory Books -

These are those books which a company is required to keep under the law. Non-maintenance of these books involves penalties for the management of the company. Every company must maintain the following subsidiary books.

1. Register of investments made by the company not held in its own name [section 49 (7)]
2. Register of fixed deposits [Section 58 (A)]
3. Copy of every instrument creating any charge requiring registration [Section – 136]
4. Register of mortgages charges [Section – 143 (1)]
5. Register of members [Section – 150 (1)]
6. Index of members, if the company has more than 50 members unless the Register of members is in such a form as will in itself constitute an index [Section 151 (1)]
7. Register and index of debenture holders [section – 152]
8. Foreign register of members and debentured holders and their duplicates [Section – 157 and 158]
9. Minutes books [Section – 193]
10. Register of contracts with companies and firms in which directors are interested directly or indirectly [Section – 301]

11. Register of directors, managing directors, manager and secretary [section – 303]

12. Register of directors share holdings [section – 307]

13. Register of loans guarantees etc. to or investments in shares or debentures of companies in the same group [Section 370 and 372]

14. Register of renewed and duplicate certificates [Rule 7 of the Companies (Issue of share certificate) Rules 1960.

In addition to the above statutory books, there are many other books which are generally maintained by companies and are called statistical or non-statutory books. The following statistical books are generally maintained by companies.

1. Share application and allotment register
2. Share call register
3. Debenture application and allotment register
4. Debenture calls register
5. Register of share certificates
6. Register of share warrants
7. Register of share transfers.
8. debenture holders interest register
9. Share holders dividend book
10. Debentures transfer register
11. Register of certification and balance tickets.
12. Register of probates
13. Register of dividend mandates
14. Agenda book
15. Register of sealed documents
16. Register of powers of attorney
17. Directors attendance book

SOURCES OF CAPITAL OF A COMPNAY :

A company requires funds for various purposes some funds are required to make long term investments such as purchase of land, building, plant and machinery etc some funds are needed to meet short-term-needs such as working capital. Some funds may be required to meet medium term needs too, e.g., overhauling of machinery, heavy expenditure, and on a sustained programme of advertisement, etc. The sources of funds are decided with reference to the type or requirements for finance, long-term and medium-term needs are met by issue of shares and debentures and by raising long-term loans. Working capital needs can be meet by raising short-term loans from commercial banks etc.

SHARES :

Total capital of the company is divided into units of small denomination. The units into which the capital of the company is divided is called a share. For example the total capital of a company is Rs.1,00,000 divided into 10,000 shares of Rs.10 each then such unit of Rs.10 is called as share of Rs.10 each.

According to sec.246 of the companies Act-1956 the term share is defined as a share in the share capital of the company; and includes stock except where a distinction between stock and shares is expressed or implied. Shares must be numbered so that they may be identified; they are moveable property and are transferable in the manner provided by the Articles of Association.

TYPES OF SHARES :

Companies issue three classes of shares as follows :

(i) Equity shares

(ii) Preference shares

(iii) Deferred shares

Equity Shares –

As per companies Act. 1956 an equity share is one which is not a preference share. These are normally risk bearing shares. The dividend is paid to the equity shareholders out of the balance of the profit available after paying the dividend to the preference share holders. Similarly at the time of liquidation of a company equity shareholders are paid out of the surplus assets available after paying to the creditors and preference share holders.

Preference Share –

As per the companies Act 1956 share having preferential rights over the equity shares in respect of payment of dividend out of the profits earned by the company and repayment of capital at the time of liquidation of a company.

Classes of preference shares -

The preference shares are of following types :

(i) *Cumulative preference shares* – A preference share is said to be cumulative when the arrears of dividend are cumulative and such arrears are paid before paying any dividend to equity shareholders. Suppose a company has 10000 8% preference shares of Rs.100 each. The dividends for 1987 and 1988 have not been paid so far. The directors before they can pay the dividend to equity shareholders for the year 1989, must pay the pref. dividends of Rs.2,40,000 i.e. for the year 1987, 1988 and 1989 before making any payment of dividend to equity shareholders for the year 1989.

(ii) *Non-cumulative preference shares* – In the case of non-cumulative preference shares, the dividend is only payable out of the net profits of each year. If there are no profits in any year, the arrears of dividend cannot be claimed in the subsequent years. If the dividend on the preference shares is not paid by the company during a particular year, it lapses. Preference shares are presumed to be cumulative unless expressly described as non-cumulative.

(iii) *Participating Preference shares* – Are those shares which are entitled in addition to preference dividend at a fixed rate, to participate in the balance of profits with equity shareholders after they get a fixed rate of dividend on their shares. The participating preference shares may also have the right to share in the surplus assets of the company on its winding up. Such a right may be expressly provided in the memorandum or articles of association of the company.

(iv) *Non-participating preference shares* - Non-participating preference shares are entitled only to a fixed rate of dividend and do not share in the surplus profits. The preference shares are presumed to be non-participating, unless expressly provided in the memorandum or the articles or the terms of issue.

(v) *Convertible preference shares* – Convertible preference shares are those shares which can be converted into equity shares within a certain period.

(vi) *Non-convertible preference share* – These are those shares which do not carry the right of conversion into equity shares.

(vii) *Redeemable preference shares* – A company limited by shares, may if so suthorised by its articles issue preference shares which are redeemable as per the provisions laid down in Section 80. Shares may be redeemed either after a fixed period or earlier at the option of the company.

(viii) *Guaranteed preference shares* – Are those shares which carry the right to a fixed dividend even if the company makes no or insufficient profits.

Difference between equity shares and preference shares –

The following are the points of distinction between preference shares and equity shares.

1. Preference shares are entitled to a fixed rate of dividend. The rate of dividend on equity shares depends upon the amount of profits available.

2. Dividend on preference shares is paid in priority to equity shares. In other words the dividend on equity shares is paid only after the preference dividend has been paid.

3. The preference shares have preference s to capital and the equity shares rank behind the preference shares for repayment of capital on winding up.

4. The voting rights of preference shareholders are usually restricted. An equity shareholder can vote on all matters affecting the company but preference shareholder can vote only when their special rights are being varied or their dividend is in arrear.

5. Redeemable preference shares may be redeemed or paid back by the company but equity shareholders cannot be paid back except under a scheme involving reduction of capital.

6. If the preference shares are cumulative, the dividend not paid in any year are accumulated and until such arrears of dividend are paid, the equity shareholders are not paid any dividend.

Capital –

The word 'capital' used in connection with a company has several different meanings

(i) *Authorised, registered or nominal capital*– This is the amount of capital with which the company intends to get itself registered. This is the amount of share capital which a company is authorized to issue. Nominal capital is divided into shares of a fixed amount. It must be set out in the memorandum of association. It can be increased or decreased by following the prescribed procedure.

(ii) *Issued capital* – It is that part of the nominal capital which is actually issued by the company for public subscription. A company need not issue the entire authorized capital at once. It goes on raising the capital as and when the need for additional funds is felt. The difference between the nominal and the issued capital is known as 'unissued capital'. Where the whole of authorized capital is offered to the public, the authorized and issued capital will be the same.

(iii) *Subscribed capital* – It is that amount of the nominal value of shares which have actually been taken up by the public. It is that part of the nominal capital which has actually been taken up by shareholders who have agreed to give consideration in kind or in cash for shares issued to them. Where shares issued for subscription are wholly subscribed for, issued capital would mean the same thing as 'subscribed capital'.

(iv) *Called up capital* – The amount due on the shares subscribed may be collected from the shareholders in instalments at different intervals. Called up capital is that amount of the nominal value of shares subscribed for which the company has asked its shareholders to pay by means of calls or otherwise. If 10,000 shares of Rs.100 each, have been subscribed by the public, and the company has asked the shareholders to pay Rs.10 on application, Rs.20 on allotment and Rs.30 on first call, then the called up capital of the company would be Rs. 6,00,000 The remaining amount i.e., Rs. 40 per share on 10,000 shares i.e. Rs. 4,00,000 would be the uncalled capital of the company.

(v) *Paid up capital* – That part of the called up capital which is actually paid up by the members is known as the paid up capital. In other words, paid up capital represents the total payments made by the shareholders to the company in response to the calls made by the company. Paid up capital of the company is calculated by deducting the calls in arrears from the called up capital. If in the above example, out of 10,000 shares of Rs.100 each, on which Rs.60 has been called by the company from the shareholders, one shareholder, holding 100 shares, fails to pay the first call of Rs.30 per share on his shares, the paid up capital of the company would be Rs. 6,00,000 – Rs. 3,000 i.e. rs.5,97,000.

Reserve Capital –

According to Section 99 of the Indian Companies Act 1956. It is the capital, which has not been called up by the company and it has decided, not to call the uncalled capital, except, on its winding up, by passing a special resolution. So the reserve portion of the subscribed capital becomes reserve capital and it will be available only to the creditors in case of liquidation of the Company.

DIFFERENCE BETWEEN SHARE AND STOCK

	Shares		Stock
1.	Shares can be partly paid or fully paid	1.	A stock will only be fully paid
2.	The shares have a nominal value	2.	A stock has no nominal value
3.	Shares are transferable only in nominal value	3.	A stock can be transferred in parts or in fraction.
4.	The shares are given a distinct number	4.	The stock has no distinct number
5.	A company can issue shares at the first instance	5.	The stock cannot be issued at first instance
6.	The shares can be issued for public subscription	6.	The stock cannot be issued for public subscription
7.	Any type of company can issue shares	7.	Only companies limited by shares can issue stock

ISSUE OF SHARES :

A public company issues a prospectus inviting general public to subscribe for its shares on the basis of prospectus, applications are deposited in a scheduled bank by the interested parties along with the amount payable at the time of application known as application money. Application money cannot be less than 5% of the face value of shares. After the closing date of the issue (i.e., the last date for filing the applications) company decides about allotment of shares in consultation with the SEBI and stock exchange concerned.

The company reserves the right to reject or accept an application fully or partially successful applicants become shareholders of the company and are required to pay the second installment known as allotment money and unsuccessful applicants get back their money. The issue price of shares is generally received by the company in installments as follows :

Fist installment	-	Application money
Second installment	-	Allotment money
Third installment	-	1st call money
Fourth installment	-	Second and final call money.

Four example – A company issued 1000 shares of Rs.10 each at Rs.10 each as follows:

Share application money – Rs.2

Share allotment money – Rs.3

Share 1st call money – Rs.2

Share 2nd call money – Rs.3

JOURNAL ENTRIES FOR ISSUE OF SHARE CAPITAL :

We have already discussed the meaning of shares, types of shares and how the share capital is issued by a company. Now we will discuss the journal entries to be passed for shares issued by a company.

(1) on receipt of application money :

Bank A/c Dr

To share application A/c

(Being the application money on .... shares @ Rs......... per share receive)

(2) on allotment of shares :

(a) First the application money on allotted shares is transferred to share capital account as follows :

Share Application A/c Dr

To share capital A/c

(Being the share application money transferred to share capital A/c).

(b) The applicants to whom the shares could not be allotted, their application money will be returned. The following journal entry is passed :

Share Application A/c Dr

To Bank A/c

(Being the application money of shares returned)

(3) On allotment of shares the allotment money becomes due to the company. For this the following journal entry is passed :

Share allotment account Dr

To share capital Account

(Being the share allotment money due on ...... shares

@ Rs....... Per shares)

(4) When allotment money is received

Bank account Dr

To share allotment account

(being the share allotment money received)

(5) On making the first call money due from shareholders the entry is :

Share first call account Dr

To share capital account

(being the first call money due on .... Shares @ Rs.......... Per shares)

(6) On receipt of the first call money the entry is :

Bank account Dr

To share first call account

(being share first call money ...... shares @ Rs. Per share received)

NB : Similar entries will be passed for second call, third and final call, if any.

Example – 1

Binary ltd issued 10,000 equity shares of Rs.1000 each payable Rs.20 on application, Rs.40 on allotment and Rs.20 on first call, Rs.20 on 2nd and final call. All the shares are subscribed and amounts duly received pass the journal entries and give a Balance sheet.

Solution –

1. Bank account Dr. 2,00,000 to share application account 200000 (for application money for 10000 shares @ Rs. 20 each received)

2. Equity share application account Dr. 200000 To equity share capital account 200000 (for share application money transferred to share capital account)

3. Equity share allotment account Dr 400000 to equity share capital account 400000 (for share allotment money due on 10000 shares @ Rs. 40 per shares)

4. Bank account Dr. 400000 To share allotment account 400000 (for share allotment money received)

5. Equity share 1st call account dr. 200000 to equity share capital account 200000 (for share 1st call money due on 10000 shares @ Rs.20 per share)

6. Bank account Dr. 200000 to share 1st call account 200000 (for share 1st call money received on 10000 shares @ Rs. 20 each)

7. Equity share 2nd and final call account Dr 200000 to equity share capital account 200000 (for second and final call money due on 10000 shares @ rs.20 each.

8. Bank account Dr. 200000 to share 2nd and final call account 200000 (for share 2nd final call money received on 10000 shares @ Rs.20).

BALANCE SHEET OF BINARY LTD as on.

Liabilities	Amount	Assets	Amount
Issued subscribed and paid up capital 10,000 equity share of Rs.100 each fully called up and paid up	1000000	Cash at Bank	
	1000000		1000000

WHEN BOTH PREFERENCE AND EQUITY SHARES ARE ISSUED

If a company issued both preference and equity shares then it is desirable that the entries for application money, allotment money and calls money should be separately passed for each type of share capital.

Example – 2

ABC Ltd issued 1000 equity shares of Rs.10 each and 2000 preference shares of Rs.100 each on equity shares Rs.2 on application Rs.3 on allotment, Rs.2 on share 1st call and Rs.3 on share second call on preference share Rs.20 on 1st call and Rs.30 on 2nd and final call. All the shares were subscribed and amounts duly received.

Solution –

1. Bank account Dr. 20000 to equity share application account (For application money received on 1000 equity shares @ Rs. Each.
2. Equity share application Account Dr. 2000 to equity share capital account 2000 (For application money on 1000 equity shares @ Rs.2 each was transferred to equity share capital)
3. Bank account Dr. 40000 to preference share application account 40000 (For application money on 2000 preference share Rs.20 was received)
4. Preference share application account Dr. 400000 to preference share capital account 40000 (for application money on preference share was transferred to preference share capital account)
5. Equity share allotment account Dr. 3000 to equity share capital account 3000 (For allotment money on 1000 equity shares @ Rs. 3 was due.
6. Bank account Dr. 3000 to equity share allotment account 3000 (For allotment money on 1000 equity shares @ Rs.3 was received)
7. Preference share allotment account dr. 60000 to preference share capital account 60000 (For allotment money on 2000 preference share @ Rs.30 was due)
8. Bank account 60000 to preference share allotment account 60000 (allotment money on 2000 preference shares @ Rs.30 per share was received)
9. Equity share 1st call account Dr. 2000 to equity share capital account 2000 (For 1st call money on 1000 equity share @ Rs.2 each was due)
10. Bank account Dr. 2000 to equity share 1st call account 2000 (For equity share 1st call money on 1000 shares @ rs.2 each was received)
11. Preference share 1st call account dr. 40000 to preference share capital account 40000 (For 1st call money on 2000 preference shares @ Rs. 20 each was due)
12. Bank account Dr. 40000 to preference share 1st call account 40000 (For 1st call money on 2000 preference share @ Rs. 20 each was received)

13. Equity share 2nd call account Dr. 3000 to equity share capital account 3000 (For equity share 2nd call money due on 1000 shares @ Rs.3 each.

14. Bank account Dr. 3000 to equity share 2nd call account 3000 (being equity share 2nd call money received on 1000 shares @ Rs.3 each)

15. Preference share 2nd call account Dr. 6000 to preference share capital account 60000 (For preference share 2nd call money due on 2000 preference shares of Rs.30 each)

16. Bank account Dr. 60000 to preference share 2nd call account 60000 (For preference share 2nd call money received on 2000 shares @ Rs.30 each)

ISSUE OF SHARES FOR PURCHASE OF ASSETS :

If the shares have been allotted to any person or firm from whom the company has purchased any asset. Then the journal entry will be :

Asset account Dr to share capital account (For shares issued in consideration of purchase of an asset for the company)

ISSUE OF SHARES AT PREMIUM :

If a company issued shares at a price above the face value of shares then the shares are said to be issued at premium, premium so collected shall be credited to a separate account called securities premium account.

Journal Entries -

1. If the premium is paid with application money :

(a) Bank account Dr
To share application A/c
(For share application money along with premium received)

(b) Share application account Dr
To share capital account
To share premium A/c
(For share application money transferred to share capital and share premium A/c)

2. If the premium is collected with the share allotment money then:

(a) share allotment A/c Dr
To share capital A/c
To share premium A/c
(For share allotment and share premium received)

(b) Bank account Dr
To share allotment A/c
(For share allotment money received).

3. If the securities premium is received alongwith the allotment money, then the following entries will be passed :

(a) Share allotment A/c Dr
To share capital A/c
To share premium A/c
(For share allotment and share premium money due on .... Shares).

(b) Bank account Dr
To share allotment A/c
(For the allotment money received)

Example – 3

Alpha Ltd issued 5000 preference shares of Rs. 10 each at a premium of Rs. 4 per share payable Rs.1 per share on application, Rs. 6 per share on allotment (including premium), Rs.3 on first call and the balance on final call. The shares were all subscribed all money due was received except the first call money on 1000 shares and the final call money on 1500 shares.

Give the cash book and journal entries to record the above the transactions.

Solution –

CASH BOOK

Receipts	Amount (Rs.)	Payments	Amount (Rs.)
To preference share application (being preference share application money received on 5000 share of Rs.1 per share)	5000		61000
To preference share allotment (preference share allotment money received on 5000 shares @ Rs.6 per share)	30000		
To preference share 1st call (For 1st call money received on 4000 share)	12000		
To preference share final call (For final call money received on 3500 shares)	14000	By bal c/d	61000
	61000		61000

JOURNAL ENTRIES

1.	Preference share application A/c	Dr.	5000
	To preference share capital A/c		
	(for preference share application money transferred to preference share capital A/c).		
2.	Preference share allotment A/c	Dr.	30000
	To preference share capital A/c		10000
	To share premium A/c		20000
	(for preference share allotment money due on 5000 share Rs.6 per share)		
3.	Preference share 1st call A/c	Dr.	15000
	To preference share capital A/c		15000
	(for preference share 1st call money due on 5000 shares @ Rs.3 per share)		
4.	Preference share final call A/c	Dr.	20000
	To preference share capital A/c		20000
	(for preference share final call due on 5000 shares @ Rs.4 per share)		

ISSUE OF SHARES AT DISCOUNT :

The share issued at a price below the face value is called as shares issued at discount For example if a share of Rs.10 each was issued at Rs.8 per share, then it is said that shares were issued at a discount of Rs.2

A company can issue shares at a discount subject to the following conditions.

i) The issue of shares at a discount is authorized by a resolution passed by the company in general meeting and sanctioned by the central government.

ii) The resolution must specify the maximum rate of discount which should not exceed 10% of the nominal value of shares of such higher percentage as the central government May permit.

iii) One year must have been elapsed since the date at which the company was a allowed to commence business.

iv) Issue must take place within two months after the date of the section by the court.

Journal Entry –

The following journal entry is passed on the issue of shares at a discount at the time of allotment.

Share allotment A/c	Dr	
Discount on issue of shares A/c	Dr	
To share capital A/c		
(For shares issued at discount)		

Discount on issue of shares is shown in assets side of Balance sheet till it is written off completely.

Example – 4

Beta Ltd issued 10000 shares of Rs.10 each at a discount of 6% payable as follows : on application Rs 2.50, on allotment Rs.3.40 and on 1st and final call rs.3.50.

The application received were for 90000 shares and all of these were accepted. All money due was received except the first and final call on 1000 shares.

Pass necessary journal entries and Balance sheet of Beta Ltd.

Solution –

				Rs.
1.	Bank A/c	Dr	225000	
	To share application A/c			225000
	(For share application money received on 90000 shares @ Rs.2.50 each).			
2.	Share application A/c	Dr	225000	
	To share capital A/c			225000
	(For share application money on 90000 shares @ Rs.2.50 per share)			
3.	Share allotment A/c	Dr	306000	
	Discount on shares A/c	Dr	54000	
	To share capital A/c			360000
	(For share allotment money due on 90000 shares @ Rs.3.40 per share and discount @ Rs.0.60 per share).			
4.	Bank A/c	Dr	306000	
	To share allotment A/c			306000
	(For allotment money received on 90000 shares @ Rs.3.40 per share)			
5.	Share first and final call A/c	Dr	315000	
	To share capital A/d			315000
	(For share 1st and final call money due on 90000 shares @ Rs.3.50 per share)			
6.	Bank A/c	Dr	311500	
	To share 1st and final call A/c			311500
	(For share first a final call money received on 89000 shares @ Rs.3.50 per share).			

Balance sheet of Beta Ltd. As on

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Issued capital 100000 share @ Rs.10 per share	1000000	Cash at Bank Discount on issue of shares	842500
Subscribed capital 90000 shares @ Rs.10 per shares	900000		54000
Paid up capital 90000 shares @ Rs.10 per shares 900000 less calls in arear 3500	896500		
	896500		896500

ADJUSTMENT OF EXCESS MONEY TOWARDS THE AMOUNT DUE ON ALLOTMENT AND CALLS

In case of oversubscription of shares the allotment is either made of less number of shares or on prorate basis. If the company decides not to allot the shares to any applicant then the company will return their application money. If the company decides to allot the share to all the applicants then the company will allot the shares on prorate basis. The excess application money will be adjusted against the share allotment money and share 1st cal money.

Example –

Mukesh company Ltd issued 10000 shares of Rs.10 each but application for 20000 shares were received by company. The directors refused to applicants of 5000 shares and applicants of 15000 shares were allotment the 10000 shares on prorate basis. In this case the ratio of allotment of shares to applications is $\frac{10000}{15000} = \frac{2}{3}$ i.e. shares will be allotted for every 3 applications received and excess application money will be adjusted against the shares allotment and on calls.

Example – 5

A company issued 500000 shares of Rs.10 each at a premium of Rs.4 per share, payable as under :

On Application Re. 1 per share; On allotment Rs.4 per share and Rs.2 premium; On Final payment Rs.5 per share and Rs.2 premium.

Over-payments on application were to be applied towards sum due on allotment and final call. Where no allotment was made, application money was to be returned in full. The issue was oversubscribed to the extent of 13,000 shares. Applicants for 12,000 shares were allotted only 1,000 and applicants for 2,000 were sent letters of regret. All money due on allotment and final call was duly received. Make the necessary entries in company's books

Solution –

JOURNAL ENTRIES

		Rs.	Rs.
Bank A/c	Dr.	63,000	
To Share Application A/c			63,000
(Being Share Application money received on 63,000 shares @ Re. 1 per share)			
Share Application A/c	Dr.	50,000	
To Share Capital A/c			50,000
(Being transfer of Share Application money on 50,00 shares @ Re.1 each to Share Capital A/c)			
Share Application A/c	Dr.	13,000	
To Share Allotment A/c			6,000
To Calls in Advance A/c			5,000
To Bank A/c			2,000
(Being the surplus amount received on Share Application transferred to Share Allotment and Share Call and the balance returned)			
Share Allotment A/c	Dr.	3,00,000	
To Share Capital A/c			2,00,000
To Securities Premium A/c			1,00,000
(Being Share Allotment money due on 50,000 Shares @ Rs.4 per share and premium @ Rs.2 per share)			
Bank A/c	Dr.	2,94,000	
To Share Allotment A/c			2,94,000
(Being receipt of Share Allotment money)			
Share First & Final Call A/c	Dr.	3,50,000	
To Share Capital A/c			2,50,000
To Securities Premium A/c			1,00,000
(Being Share First & Final Call money due on 50,000 shares @ Rs.5 per share and premium @ Rs. 2 per share)			
Bank A/c	Dr.	3,45,000	
Calls in Advance	Dr.	5,000	
To Share First & Final Call A/c			3,50,000
(Being receipt of share First & Final Call money, less Rs.5,000 received in advance)			

Illustration – 8

A company made an issue of 30,000 shares of Rs.10 each payable Rs.3 on application, Rs.5 on allotment and Rs.2 on call

93,200 share were applied for and owing to this heavy over-subscription allotments were made as follows:

Applicants for 21,500 (in respect of applications for 2,000 or more) received 10,200 shares.

Applicants for 50,600 (in respect of applications for 1,000 or more but less than 2,000) received 12,600 shares.

Applicants for 21,100 (in respect of applications for less than 1,000 shares) received 7,200 shares.

Cash then received after satisfying amount due on application was applied towards allotment and call money and balance was then returned. All money due on allotment and call were realized.

Write up the relevant ledger accounts relating to this issue of shares in the books of the company.

Solution –

Excess application money received on account of heavy oversubscription is utilized as follows :

	Lot – I (who applied for 2,000 shares or more)	Lot – II (who applied for 1,000 shares or more but less or more but less than 2,000)	Lot – III (who applied for less than 1,000 shares)	Total
Shares applied for	21,500	50,600	21,100	93,200
Shares allotted	10,200	12,600	7,200	30,000
Excess shares applied for	11,300	38,000	13,900	63,200
	Rs.	Rs.	Rs.	Rs.
Excess application money	33,900 (11,300 x 3)	1,14,000 (38,000 x 3)	41,700 (13,900 x 3)	1,89,600 (63,200 x 3)
Retained towards allotment	33,900	63,000 (12,600 x 5)	36,000 (7,200 x 5)	1,32,900
Retained towards call		25,200 (12,600 x 2)	5,700	30,900
Returned to applicants		25,800		25,800
	33,900	1,14,000	41,700	1,89,600

Ledger Accounts
CASH ACCOUNT

	Rs.		Rs.
To Share Application money on 93,200 shares @ Rs.3)	2,79,600	By share application A/c (Amount refunded to applicants)	25,800
To Share Allotment A/c (Allotment money on 30,000 shares @ Rs.5 per share less Rs.1,32,900 retained towards allotment)	17,100	By Balance c/d	3,00,000
To Share first and Final Call Account (Call money on 30,000 share @ Rs.2 per share less Rs.30,900 retained towards call)	29,100		
	3,25,800		3,25,800
To Balance b/d	3,00,000		

SHARE APPLICATION ACCOUNT

	Rs.		Rs.
To Share Capital Account	90,000	By Cash Account	2,79,600
To Share allotment Account	1,32,900		
To Share First and Final Call Account	30,900		
To Cash Account	25,800		
	2,79,600		2,79,000

SHARE ALLOTMENT ACCOUNT

	Rs.		Rs.
To Share Capital Account	1,50,000	By Share Application Account	1,32,900
		By cash Account	17,100
	1,50,000		1,50,000

SHARE FIRST AND FINAL CALL ACCOUNT

	Rs.		Rs.
To share Capital Account	60,000	By Share Application Account	30,900
		By Cash Account	29,100
	60,000		60,000

SHARE CAPITAL ACCOUNT

	Rs.		Rs.
To Balance c/d	3,00,000	By Share Application Account	90,000
		By Share Allotment Account	1,50,000
		By Share First and Final Call A/c	60,000
	3,00,000	By Balance b/d	3,00,000

CALLS IN ARREAR

If any amount has been called by the company either as allotment or call money and a shareholder has not paid that money, then the unpaid calls are called as calls in arrear.

Interest on calls in Arrears :

If there is a provision in the articles of association, the company can charge interest @ 5% p.a. on calls in arrear for the period for which such amount remained in arrear from the share-holders. The journal entry will be :

Bank A/c Dr

To int. on calls in arrear A/c

(For interest on calls in arrear received)

calls in arrear amount is deducted from called up A/c in the liabilities side of the balance sheet.

CALL IN ADVANCE :

If a share holder pays the uncalled money in advance alongwith a particular call money, then such amount will be called as calls in advance and will be credited to a separate account known as calls in advance as follows :

Bank A/c Dr.

To calls in advance A/c

(For call in advance received)

Calls in advance A/c is shown in the liabilities side of balance sheet.

If the articles of association provides then interest on calls in advance will be paid @ 6% p.a. for the period for which the company received the calls in advance amount. The journal entry will be :

call in advance A/c Dr.

To Bank A/c.

Illustration – 9

On 1st March, 1998 X Ltd. Makes an issue of 20,000 equity shares of Rs.10 each payable as below ;

On application Rs.2; on allotment Rs.3 and on first and final call Rs.6 (three months after allotment).

Applications were received for 26,000 shares and directors made allotment in full to the applicants demanding ten or more shares and returned money to the applicants for 6,000 shares. One shareholder who was allotted 40 share paid first and final call with allotment money and another shareholder allotted 60 shares did not pay allotment money on his shares, but which he paid with the first and final call. Directors have decided to charge and allow interest, as the case may be, on calls in arrears and calls in advance respectively according to the provisions of Table A. Give the necessary journal entries in the books of the company.

Solution –

Journal entries

1998		.	Rs.	Rs.
March 1	Bank Account To Share Application Account (For Application money received on 26,000 share @ Rs.2 per share)	Dr	52,000	 52,000
	Share Application Account To Share Capital Account To Bank A/c (For application money of 20,000 shares transferred to share capital account and application money of 6,000 shares refunded)	Dr	52,000	 40,000 12,000
March 1	Share Allotment A/c To Share Capital A/c To Securities Premium A/c (For allotment money and Securities Premium due on 20,000 shares @ Rs.2 and Re.1 per share respectively as per resolution of the Board of Directors dated ....)	Dr	60,000	 40,000 20,000
	Bank Account To share Allotment A/c To Calls in Advance Account (For the receipt of allotment money @ Rs.3 on 19,940 shares and advance call money on 40 shares @ Rs.6 each)	Dr	60,060	 59,820 240
June 1	Share first and final Call A/c To share Capital A/c (For the amount due in respect of first and final call on 20,000 shares @ Rs.6 per share as per resolution of the Board or Directors dated ....)	Dr	1,20,000	 1,20,000

FORFEITURE OF SHARES :

If a shareholder defaults in payment of allotment money or any call money called by the company, the board of directors may decide to forfeit the shares held by the defaulting shareholder by following the procedure given in Articles of association of the company. After the forfeiture, the defaulting shareholder will have no claim on the company.

Accounting treatment on forfeitures of shares is discussed under three heads as under.

(1) Forfeiture of shares issued at par

(2) Forfeiture of shares issued at premium

(3) Forfeiture of shares issued at discount.

Forfeiture of shares Issued at Par :

On forfeiture of shares of a shareholder, he ceases to be the member and his name is removed from the Register of Members. Total amount called on forfeited shares is debited to 'Share Capital Account'. Amount called by the company is either paid or not paid by the shareholder. Amount called and paid is forfeited and recorded in 'Share forfeited (or forfeiture) Account'. Amount called but not paid is credited to respective installments accounts to cancel the amount in arrears. The journal entry is as follows :

Share Capital A/c	Dr. (Amount called up on shares forfeited)
To Particular Call A/c (or Calls-in-Arrears A/c)	(Amount called but not received0
To Share Forfeiture A/c	(Amount called and received)

Illustration – 19

(a) A share of Rs.50 each fully called up is forfeited for non-payment of final call @ Rs.10 per share. Assume calls-in-arrears accounts is not opened.

(b) 100 shares of Rs.20 fully called up are forfeited for non-payment of final call @ Rs.4 per share. Assume calls-in-arrears account is opened.

(c) A share of Rs.40 each, Rs.30 called up, is forfeited for non-payment of first call @ Rs.10 per share. Assume calls-in-arrears account is opened.

(d) 500 shares of Rs.60 each, Rs.50 called up, are forfeited for non-payment of allotment, first call and second call @ Rs.15, Rs.15 and Rs. 10 per share respectively.

Journal

a.	Share Capital A/c To Share Final Call A/c To share forfeiture A/c (For forfeiture of a share for non-payment of final call @ Rs.10)	Dr	50	10 40
b.	Share Capital A/c To Calls-in-Arrears A/c To Share Forfeiture A/c (For forfeiture of 100 shares for non-payment of final call @ Rs.4 per share)	Dr	2,000	400 1,600
c.	Share Capital A/c To Calls-in-Arrears A/c To Share Forfeiture A/c (For forfeiture of a partly called up share for non-payment of first call @ Rs.10)	Dr	30	10 20
	ISSUE AND FORFEITURE OF SHARES			
d.	Share Capital A/c To Share Allotment A/c To share first call A/c To share forfeiture A/c (For forfeiture of 500 partly called up shares on which only application money is received)	Dr	25,000	7,500 7,500 5,000 5,000

Forfeiture of shares Issued at Premium –

According to section 78 of the Companies Act, securities full premium can be utilized only for four specified purposes. It means securities premium received by the company cannot be cancelled at the time of forfeiture of shares. Thus, the journal entry for forfeiture remains as under :

Share Capital A/c	Dr. (Amount called up on account of share capital)
To Share Forfeiture A/c	(Amount received on account of share capital)
To Respective Calls A/c	(Amount not paid on account of installments demanded)

However, when the amount of premium is called by the company, but not paid by the shareholder, its treatment depends upon its recording as follows:

(i) Receipt Basis : If premium is recorded on receipt basis, then non-payment of oremium will not affect the entry for forfeiture of shares.

(ii) Due Basis : If premium is transferred to securities premium account when it is due, then non-payment of premium amount affects the entry for forfeiture of shares. Premium amount recorded in securities premium account and not received by the company is cancelled at the time of forfeiture of shares by passing following entry :

Share Capital A/c	Dr.(Amount called up on account of share capital)
Securities Premium A/c	Dr. (premium recorded but not received)
To Respective Calls A/c	(Amount recorded as due but not received)
To Share Forfeiture A/c	(Amount received on account of share capital)

Illustration – 20

Pass journal entries in the following cases :

(a) A share of Rs.50 each issued at Rs.60 is forfeited for non-payment of second and final call @ Rs.15 per share.

(b) A share of R.100 each is forfeited for non-payment of allotment money rs.50 (including premium rs.20) and first and final call Rs.20.

(c) A company invited application for equity shares of Rs.40 each payable as follows :

	Rs.
On application	20 (including premium)
On allotment	20
On first call	10

Mr. X holding 500 shares failed to pay allotment money and his shares were forfeited before the first call was made.

(d) X Ltd. Issued shares of Rs. 100 each payable as under :

	Rs.
On application	40 (including Rs.15 premium)
On allotment	40 (including balance of premium)
On first call	40

Mr.X holding 100 shares failed to pay allotment and on his subsequent failure to pay first call his shares were forfeited.

Journal

a.	Share capital A/c	Dr.	50	
	To share second & final call A/c			15
	To share forfeiture A/c			35
	(for forfeiture of share due to non-payment of final call and forfeiture of amount paid on account of share capital)			
b.	Share Capital A/c	Dr.	100	
	Securities premium A/c	Dr.	20	
	To share Allotment A/c			50
	To first & final call A/c			20
	To share forfeiture A/c			50
	(for forfeiture of a share for non-payment of allotment (including premium) and call money)			
c.	Share Capital A/c	Dr.	15,000	
	To share allotment A/c			10,000
	To share forfeiture A/c			5,000
	(for forfeiture of partly called up share and forfeiture of amount paid on account of share capital)			
d.	Share capital A/c	Dr.	10,000	
	Securities premium A/c	Dr.	500	
	To share allotment A/c			4,000
	To share first & final call A/c			4,000
	To share forfeiture A/c			2,500
	(for forfeiture of 100 shares, cancellation of premium recorded and not received and forfeiture of amount received on account of share capital)			
	Alternatively, if premium is recorded on receipt basis, the entry is :	Dr.	10,000	
	Share capital A/c			
	To share allotment A/c			3,500
	To share first & final call A/c			4,000
	To share forfeiture A/c			2,500

Forfeiture of Shares Issued at Discount –

If shares issued at discount are forfeited for non-payment of installments called by the company, the amount of discount allowed on forfeited shares is cancelled at the time of forfeiture by crediting 'Discount on Issue of Shares Account'. It is worth noting that amount called up on forfeited shares is debited to share capital account and it includes, besides the amount of installments payable by the shareholders, the amount of discount. Entry is as under :

Share Capital A/c	Dr. (Amount called up including discount)
To Respective Call A/c	(Amount called but not received)
To Discount on Issue of shares A/c	(Amount of discount)
To Share Forfeiture A/c	(Amount called and received)

ISSUE AND FORFEITURE OF SHARES

Illustration – 21

Pass journal entries in the following cases :

(a) A share of Rs.10 each issued as 10% discount is forfeited for non-payment of first and final call @ Rs.3 per share.

(b) 500 shares of Rs.20 each issued at 5% discount are forfeited for non-payment of allotment and final call money @ Rs.9 and Rs. 5 respectively.

(c) A share of Rs.50 each issued at 10% discount is forfeited for non-payment of first call of Rs.10 per share before the second and final call of rs.10 is made.

(d) 100 shares of Rs.1000 each issued at 5% discount are forfeited for non-payment of allotment money @ Rs.20 per share and first call money @ Rs.20 per share. Second and final call payable @ Rs.20 per share has not been made till the forfeiture of shares

a.	Share capital A/c To Share first & final cal A/c To Discount on Issue of Shares A/c To share forfeiture A/c (For forfeiture of a share for non-payment of final call and cancellation of discount)	Dr.	10	 3 1 6
b.	Share Capital A/c To Share allotment A/c To share fist call A/c To discount on issue of shares A/c To share forfeiture A/c (for forfeiture of a partly called share issued at discount)	Dr.	10000	 4500 2500 500 2500

c.	Share Capital A/c To Share first call A/c To discount on Issue of share A/c To share forfeiture A/c (for forfeiture of a partly called share issued at discount)	Dr.	40	 10 5 25
d.	Share capital A/c To share allotment A/c To share First call A/c To discount on issue of shares A/c To forfeiture of share A/c (For forfeiture of partly called up shares originally issued at 5% discount)	Dr.	8000	 2000 2000 500 3500

'Share Forfeited A/c' in Balance Sheet –

Share forfeited account balance is added to paid up capital and aggregate figure is shown in the balance sheet. Alternatively, it may be shown as separate items after paid up capital as shown below :

Balance Sheet

Share Capital Called and paid up capital : ....shares of Rs.....each Rs.......per share called up Les instalment in arrears Share Forfeiture A/c			

Illustration – 10

A Ltd. Issued 1,000 Equity shares of Rs. 100 each payable as follows :

Rs. 20 on application : Rs.25 on allotment ; Rs.20 on first call; Rs.30 on final call.

900 shares were applied for and allotted. All moneys were received with the exception of the first and final calls on 20 Equity shares held by Bose. Theses shares were forfeited by the Directors of the company.

Give the Journal and Cash Book entries in the books of the company to record the above transactions.

Solution –

CASH BOOK

	Rs.		Rs.
To Equity share application (Being receipt of App. Money on 900 shares @ Rs.25 per share)	22,500		89,000
To Equity share allotment (Being allotment money received)	22,500		
To Equity share first call A/c (Being first cal money Received on 880 share @ Rs.20 per share)	17,600		
To Equity share 2nd & final Call A/c (Being 2nd & final call Money received on 880 Shares@Rs.30per share.)	26,400	By Balance c/d	89,000
To Balance b/d	89,000		89,000

JOURNAL ENTRIES

		Rs.	Rs.
Equity share application A/c To Equity share capital A/c (being transfer of Application money to equity share capital A/c)	Dr.	22,500	22,500
Equity share allotment A/c To Equity share capital A/c (Being allotment money due on 900 shares @ Rs. 25 per share)	Dr.	22,500	22,500
Equity share first Call A/c To Equity share capital A/c (being share 2nd & final call money due on 900 shares @ Rs.20 per share)	Dr.	18,000	18,000

Equity share 2nd & final call A/c To equity share capital A/c (Being share 2nd & final call money due on 900 snares @Rs.30 per share)	Dr.	27,000	27,000
Share capital A/c To share first call A/c To share 2nd & final call A/c To share forfeited A/c (being forfeiture of 20 shares on which first call @ Rs.20 per share and 2nd & final call @ Rs.30 per share was outstanding as per the resolution of the Board of Directors)	Dr.	2,000	4000 600 1,000

RE-ISSUE OF FORFEITED SHARES :

After forfeiture of shares company may decide to reissue the forfeited shares. Share can be reissued at par, at premium or at discount. For reissue of shares at par or premium, journal entries discussed earlier for issue of shares are passed. However reissue of shares at discount, maximum discount is restricted to the amount forfeited on these shares plus the original discount, if any. So reissue price should not be less than the amount credited to share capital as called up and paid up, on reissued shares less the amount forfeited on those shares and the original discount if any.

Journal Entry for reissue of forfeited shares –

Bank A/c Dr
Discount on issue of shares A/c Dr
Share forfeited A/c Dr (for discount on reissue of forfeited shares)
To share capital A/c
To share premium A/c (premium on reissue)

Transfer to Capital Reserve –

After re-issue of forfeited shares the balance of share forfeited A/c (i.e the difference between credit balance of share forfeited A/c found at the time of forfeiture of shares and the debit balance of share forfeited A/c found at the time of re-issue of forfeited shares) is a net gain on forfeiture and reissue of shares is a capital profit and is transferred to capital reserve as follows : share forfeited A/c Dr.

To Capital Reserve A/c

(for closing the share forfeiture A/c.)

Illustration – 22

Give journal entries in the following cases :

(a) A share of Rs.50 each forfeited for non-payment of final call of Rs.10 per share is reissued for Rs.50.

(b) A share of Rs.50 each forfeited for non-payment of final call of Rs.10 per share is reissued for Rs.40. credited as Rs.40 called & paid up.

(c) A share of Rs.20 each forfeited for non-payment of allotment and final call @ Rs 1[illegible] and Rs.5 per share respectively, is reissued for Rs.25.

(d) A share of Rs.20 each forfeited before final call of Rs.5 for non-payment of first call o[illegible] Rs.5 reissued for Rs.20 credited as Rs.15 paid up.

(e) A share of Rs.100 each issued at 10% discount is forfeited for non-payment of first [illegible] final call of Rs.20 and is reissued for Rs.80 credited as fully paid up.

Journal

a.	Share capital A/c To final call A/c To share forfeiture A/c (for forfeiture of share)	Dr.	50	 10 40
	Bank A/c To share capital A/c (For reissue of share at par)	Dr.	50	 50
	Share forfeiture A/c To capital reserve A/c (for transfer of net gain toc apital reserve)	Dr.	40	 40
b.	Share capital A/c To share final Call A/c To share forfeiture A/c (For forfeited of a share due to non-payment of final call)	Dr.	50	 10 40
	Bank A/c To share capital A/c (For reissue of forfeited share at par and partly called up)	Dr.	40	 40
	Share forfeiture A/c To Capital reserve A/c (For transfer of gain on forfeited and reissued share to capital reserve)	Dr.	40	 40
c.	Share capital A/c To share allotment A/c To share first and final call A/c To share forfeiture A/c (for forfeiture of a share)	Dr.	20	 10 5 5

	Bank A/c To share capital A/c To securities premium A/c (for reissue of a share at premium)	Dr.	25	20 5
	Share forfeiture A/c To capital reserve A/c (for transfer of net gain to capital reserve)	Dr.	5	5
d.	Share capital A/c To share first call A/c To share forfeiture A/c (For forfeiture of partly called share)	Dr.	15	 5 10
	Bank A/c To share capital A/c To securities premium A/c (for reissue of a share as partly paid up and at a premium)	Dr.	20	 15 5
	Share forfeiture A/c To capital reserve A/c (for transfer of net gain to capital reserve)	Dr.	10	10
e.	Share capital A/c To discount on issue of share A/c To first and final call A/c To share forfeiture A/c (for forfeiture of share issued at discount)	Dr.	100	 10 20 70
	Bank A/c Discount on issue of shares A/c Share forfeited A/c (Balancing Figure) To share capital A/c (for reissue of share involving reinstatement of original discount)	Dr.	80 10 10	 100
	Share forfeiture A/c To capital reserve A/c (For transfer of net gain (70-10) to capital reserve)	Dr.	60	 60

Partial Reissue of Shares –

Sometimes, all the forfeited shares are not reissued in one lot. If the number of shares reissued are less than the number of shares forfeited, it is known as partial reissue of shares. In case of partial reissue of shares, amount of net gain to be transferred to capital reserve is calculated as under :

Amount to be transferred to Capital Reserve =

Proportionate Amount Forfeited on Reissued Shares	Amount of Discount on Reissue debited to share Forfeited A/c

For example, if 100 shares of Rs.10 each are forfeited for non-payment of final call of Rs.2 per share and only 40 shares are reissued for Rs.280, amount to be transferred to capital reserve is calculated as follows:

Amount forfeited on 100 shares	= 100 x 8
Proportionate amount forfeited on 40 shares	= (40/100 x 800)
Discount on Reissue of 40 shares	= (40 x 10 – 280)
Net Gain on Forfeiture and reissue of 40 shares (transferred to capital reserve)	

Note that the amount forfeited on remaining 60 shares (60/100 x 800, i.e., Rs.480) shall remain in share forfeited account till these shares are reissued. At the time of reissue of these shares, net gain on these shares shall be calculated and transferred to capital reserve account.

Sometimes, shares held by more than one shareholder are forfeited and reissued. To calculate gain in case of partial reissue of such shares, shares to be reissued are taken in the order in which they are forfeited. Suppose, a company forfeits shares held by Mr. X and subsequently shares held by Mr.

Illustration – 25

X Ltd. Issued for public subscription 60,000 shares of Rs.10 each at a premium of rs.2 per share payable as under :

	Rs.
On application	2
On allotment	5 (including premium)
On first call	2
On second call	3

Applications were received for 90,000 shares. Allotment was made pro-rata to the application for 72,000 shares. The remaining applicants were refused allotment. Excess money received on application was adjusted against allotment money.

X to whom 3,000 shares were allotted failed to pay both calls. These shares were subsequently forfeited and 2,000 shares out of forfeited shares were reissued to Z as fully paid up at Rs.7 per share. Pass journal entries.

Journal

Bank A/c To share application A/c (For application money received on 90,000 shares applied)	Dr.	1,80,000	1,80,000
Share Application A/c To share capital A/c To share allotment A/c To Bank A/c (For disposition of application money received)	Dr.	1,80,000	1,20,000 24,000 36,000
Share Allotment A/c To Share Capital A/c To securities premium A/c (For allotment money due including premium)	Dr.	3,00,000	1,80,000 1,20,000
Bank A/c To share allotment A/c (For allotment money received 3,00,000 – 24,000)	Dr.	2,76,000	2,76,000
Share first call A/c To share capital A/c (For first cal money due)	Dr.	1,20,000	1,20,000
Bank A/c Call-in-Arrears A/c To share first call A/c (For first call money received and arrear of all money)	Dr. Dr.	1,14,000 6,000	1,20,000
Share second and final call A/c To share capital A/c (For second call money due)	Dr.	1,80,000	1,80,000
Bank A/c Calls- in-Arrears A/c To share second and final call A/c (for second call money received and arrears of cal money)	Dr. Dr.	1,71,000 9,000	1,80,000
Share capital A/c To calls-in-Arrears A/c To share forfeited A/c (For forfeiture of 3,000 shares)	Dr.	30,000	15,000 15,000
Bank A/c Share forfeited A/c To share capital A/c (for issue of 2,000 shares @ Rs.7 per share)	Dr. Dr.	14,000 6,000	20,000
Share forfeited A/c To capital reserve A/c (For transfer of net gain on forfeiture and reissue of 2,000 shares)	Dr.	4,000	4,000

Amount forfeited on 3,000 share = Rs.15,000	
Proportionate amount forfeited on 2,000 share	$\frac{2,000}{3,000} \times 15,000 = 10,000$
Less : discount on reissue of 2,000 shares	6,000
Gain on forfeiture and reissue of 2,000 shares	Rs. 4,000

Illustration – 26

PQ Ltd. Invited application for 20,000 shares of Rs.20 each payable as follows :

	Rs.
On application	10 (including Rs.6 premium)
On allotment	10 (including Rs.4 premium)
On first call	5
On second call	5

Mr. X holding 1,000 shares failed to pay allotment money on his subsequent failure to pay calls his shares were forfeited. Another shareholders, Mr. Y, to whom 500 shares were allotted, failed to pay both calls and his shares were also forfeited. Out of the forfeited shares, 1,200 shares were reissued @ Rs.18 per share credited as fully paid up.

Pass journal entries for forfeiture and reissue.

ISSUE AND FORFEITURE OF SHARES
Journal

Share Capital A/c	Dr.	2,000	
Share premium A/c	Dr.	4,000	
To share allotment A/c			10,000
To share first call A/c			5,000
To share second call A/c			5,000
To share forfeiture A/c			4,000
Share capital A/c	Dr.	10,000	
To calls-in-Arrears A/c			5,000
(First call Rs.2500 and second call Rs.2500			
To share forfeited A/c			15,000
(for forfeiture of 3,000 shares)			
Bank A/c	Dr.	21,600	
Share forfeited A/c	Dr.	2,400	
To share capital A/c			24,000
(For issue of 2,000 share @ Rs.7 per share)			
Share forfeited A/c	Dr.	3,600	
To capital reserve A/c			3,600
(For transfer of net gain on forfeiture and reissue of 2,000 shares).			

	Rs.
Amount forfeited on :	
1,000 shares of Mr.X	4,000
500 shares of Mr. Y	5,000
Discount on Reissue of 1,200 shares	2,400
Proportionate amount forfeited on 1,200 shares reissued :	
On 1,000 shares of Mr. X	4,000
On 200 shares of Mr. Y $\left(\frac{200}{500} \times 5{,}000\right)$	2,000
	6,000

Net Gain on Forfeiture and Reissue of 1,200 shares = 6,000 – 2,400 = Rs.3,600

Sometimes, excess application money transferred to share allotment account is less than the amount due on allotment, including premium. In that case, it is suggested that excess is adjusted towards amount due on account of share capital and any excess left thereafter is applied towards premium payable on allotment. Alternatively, surplus may be applied first towards premium due and then against amount due on account of share capital.

REISSUE OF FORFEITED SHARES :

Illustration – 27

20,000 shares issued on pro-rata basis to applicants for 50,000 shares of Rs.10 each payable as follows :

	Rs.
On application	3
On allotment	6
On call	3

A shareholder who has applied for 50 shares failed to pay allotment and on his subsequent failure to pay call money his shares were forfeited.

Pass a journal entry for forfeiture of shares.

Working Notes :

A. *Calculation of Amount Not Paid on Allotment*

Share applied	50
Application money paid	50 x 3 =Rs.150

Shares allotted	$50 \times \frac{20,000}{50,000} = 20$
Application money on allotted shares	20 x 3 = Rs.60
Adjusted against allotment	150 x 60 = Rs.90
Allotment money due	= 20 x 6 = Rs.120
Less adjusted	90
Allotment money not received (120-90)	Rs. 30

B. *Adjustment of Excess Application Money*

Amount in arrear on account of allotment (Rs.30) is less than the amount of premium due on twenty shares (Rs.40). It means premium to the extent of Rs.10 (Rs.40 – Rs.30) is already received and cannot be cancelled. Out of Rs.150 paid alongwith application only Rs.140 (20 x 93 + 4) is adjusted against share capital and the balance Rs.150 – Rs.140, i.e. Rs. 10 is adjusted towards premium due. Thus, at the time of forfeiture amount received against share capital is forfeited and the amount of premium not received (Rs.40 – Rs. 10) is cancelled as under :

Share Capital A/c	Dr.	200	
Securities premium A/c	Dr.	30	
To share allotment A/c			30
To share first and final call A/c			60
To share forfeited A/c			140
(For forfeiture of 20 shares and cancellation of premium recorded but not received)			

*Alternatively, it may be assumed that excess application money rs.90 is first adjusted against premium due (Rs.40) and the balance (Rs.50) is applied towards share capital instalment due at the time of allotment. In that case, the journal entry for forfeiture is all follows :

Share Capital A/c	Dr.	200	
To share allotment A/c			30
To share first and final call A/c			60
To share forfeited A/c			110
(For forfeiture of 20 shares and forfeiture of amount paid and applied towards share capital, i.e., Rs.60 + Rs.50)			

PRACTICAL PROBLEMS

Issue of Shares

1. X, Y, Ltd. Was registered with an authorized capital of 2,00,000 shares of Rs. 10 each. 1,40,000 shares were issued to the public. The public subscribed for 1,00,000 shares. The company called up Rs. 7 per share. All the money called up was duly received. Show the amounts of various types of share capital.

   Ans. [Authorised Capital Rs.20,00,000; Issued Capital Rs.14,00,000; Subscribed Capital Rs.10,00,000 and Paid up Capital Rs.7,00,000].

2. A company was formed with a capital of Rs.15,00,000 in shares of Rs.10 each. It offered to the public 1,00,000 shares payable Re.1 per share on application, Rs.2 per share on allotment and Rs.3 per share on first call. The balance of R.4 per share to be called only in case of necessity. Applications were received for 90,000 shares and the shares were accordingly allotted. All the money was duly received with the exception of allotment money on 200 shares and first call on 500 shares.

   Journalise the transactions and prepare the Balance Sheet.

   Ans. [Calls in Arrears Rs.1,900 ; B/S Total Rs.5,38,100].

3. The Green Revolution Company issues 1,000 Equity Shares of Rs.100 each and 2,000 Preference Share of Rs. 100 each. The share capital was to be collected as under :

	Rs.	Rs.
On application	25	20
On allotment	20	30
First call	30	20
Final call	25	30

   All these shares were subscribed. The first call and final call on 160 Equity Shares and 240 preference shares were not received. Enter the transactions in the books of the company. Ledger Accounts are not required.

4. A company with an authorized capital of Rs.30,00,000 invited applications for 2,00,000 shares of Rs.10 each at a premium of Re.1. The shares are payable as follows :

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

   There was oversubscription and applications were received for 3,60,000 shares. Allotment of shares was made as under :

To applicants of 1,50,000 shares	1,50,000 shares
To applicants of 25,000 shares	Nil
To applicants of 1,85,000 shares	50,000 shares

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

Give journal entries, ledger accounts and Balance Sheet.

Ans. [B/S Total Rs.22,00,000].

5. Yellow Limited offered for subscription 3,000 12% preference shares of Rs.100 each at a premium of 20% on 1st January, 1998. The amount was payable as follows :

On Application	Rs.20
On Allotment	Rs.40 (including premium – due on 1st Feb.)
On First call .	Rs.30 due on 1st March
On Second call	Rs.30 due on 1st May

All the shares were subscribed by the public and subscription list was closed on 25th January, 1998. Money due on allotment and calls payable 15 days after the due dates. All the amounts were duly received in time except the second call on 200 shares

Prepare Journal and Cash Book in the books of the company and show them in the Balance Sheet.

Ans. [B/S Total Rs.3,54,000]

6. The authorized capital of Janata Company Limited was divided in 5,000 equity shares of Rs.100 each. The company had issued 4,000 equity shares in the year 1993. On 1st January, 1998 the directors of the company have decided to issue the remaining shares at 10% discount. Issue is to be made in the following manner :

On Application	Rs.25. Last date of closing the list 25th January.
On Allotment	Rs.25.Due date 1st February and date of receipt 15th February.
On First Call	Rs.20.Due date 1st April and date of receipt 15th April
On Second Call	Rs.20 due date 1st June and date of receipt 15th June.

Shri Dinesh to whom 100 shares were allotted, paid allotment and first call money with second call. Other shareholders paid their dues at appropriate time. As per Articles of association, company charges interest at 5% p.a. on calls-in-arrears.

Give necessary journal entries and show the relevant accounts in the Balance Sheet of the company.

Ans. [Interest on Call-in-Arrears Rs.58.33; B/S Total Rs.5,00,058.33].

Forfeiture of Shares and Re-issue of Forfeited Shares –

7. Give journal entries for the forfeiture and re-issue of shares :

(a) X Ltd. Forfeited 20 shares of Rs.10 each Rs.7 called up, on which M had paid application and allotment money of Rs.5 per share. Out of these 15 shares were reissued to N as fully paid up for Rs.6 per share.

(b) X Ltd, forfeited 10 shares of Rs.10 each (Rs.6 called up), issued at a discount of 10% to n on which he had paid Rs.2 per share. Of these 8 shares were re-issued to M as Rs.8 called up, for Rs.6 per share.

(c) X Ltd. Forfeited 30 shares of Rs.10 each fully called up, held by K, for non-payment of allotment money of Rs.3 per share. These shares were reissued to S for Rs.8 per share.

(d) Grewal Ltd. Forfeited 100 equity shares of Rs.10 each issued at discount of 10% held by Ranjit Kaur on 15.1.1991 for non-payment at the first call of Rs.2 per share and the final call of Rs.3 per share.

Out of these, 60 share were reissued to Ajit Kaur at Rs. 8 per share 9as fully paid). Pass necessary journal entries.

Ans. [Amount transferred to Capital Reserve (a) Rs.15; (b)Rs.8; (c) Rs.30 (d) Rs.180].

8. The Hindustan Manufacturing Limited had a total subscribed capital of Rs.10,00,000 in equity shares of Rs.10 each of which Rs.7.50 were called up. A final call of Rs.2.50 was made and all amounts paid except the two calls of Rs.2.50 each in respect of 100 shares held by D.Roy. These shares were forfeited and re-issued at Rs.8 per share

Make the journal entries (including that of cash) necessary to record transactions of final cal, forfeiture of shares and reissue of forfeited shares.

Ans. [Amount transferred to Capital Reserve Rs.300].

9. A ltd. Invited applications for 10,000 shares of Rs.100 each at a discount of 5 per cent payable as follows :

On application Rs.25; On allotment Rs.34; On first call and final call Rs.36.

The applications received were for 9,000 shares and all of these were accepted. All moneys due were received except the first and final call on 200 shares which were forfeited. 100 shares were reissued @ rs.90 as fully paid.

You are required to pas entries in the Cash Book and Journal of the company Also show how these transactions will be reflected in the company's Balance Sheet.

Ans. [Cash Balance Rs.8,56,800; B/S Total Rs.9,01,300; Amount transferred to Capital reserve Rs.5,400]

10. On 1st April, 1997 the directors of ABC Ltd. Issued 1,00,000 equity shares of Rs.10 each at Rs.12 per share payable as to Rs.5 on application, rs.4 on allotment and the balance on 1st July, 1997.

The lists closed on 12th April, 1997, by which date applications for 1,40,000 shares had been received. Of the cash received, Rs.80,000 was returned and Rs.1,20,000 was applied to the amount due on allotment the balance of which was paid on 19th April, 1997. All shareholders paid the call due on 1st July 1997, with the exception of one allotted for 1,000 shares. These shares were forfeited on 30th November and reissued as fully paid at Rs.8 per share on 2nd January 1998.

Pass journal entries in the books of the company recording the above transactions.

Ans [Amount transferred to Capital Reserve Rs.5,000].

11. M Limited invited applications for 1,000 shares of Rs.100 each at Rs.120, payable as to Rs.55 (including premium) on application, Rs.40 on allotment, and the balance by way of call.

Applications for 1,200 shares were received. The Board of Directors allotted (i) in full to applicants for 700 shares, and (ii) the balance of the shares pro-rata to the remaining applicants.

The Board also utilized the excess application money, if any, towards the allotment money.

X to whom 60 shares were allotted on pro-rata basis, faield to pay the allotment and call moneys. After complying with the necessary procedures, his shares were forfeited. these were subsequently reissued at Rs.110 each.

Show the necessary ledger accounts to record the above.

Ans. [Amount transferred to Capital reserve Rs.4,300; Cash Balance Rs.1,24,900].

12. A Ltd. Company issued 3,000 equity shares of Rs.10 each at a discount of 10%. On the shares payments are to be made as follows :

Rs.2 on application, Rs.3 on allotment and Rs.5 on first and final call. Mohan, who is holder of 800 shares has not paid the first and final call, hence, his shares have been forfeited and have been reissued at a discount of 5%. Pass the necessary journal entries, cash book entries and the Balance Sheet.

Ans. [Amount transferred to Capital Reserve Rs.3,200; balance Sheet Total Rs.33,200].

13. A Limited Company ahs a nominal capital of Rs.2,50,000 in Rs.10 shares. Of these, 4,000 shares were issued as fully paid in payment of buildings purchased; 8,000 shares were subscribed for by the public, and during the first year Rs.5 per share were called up, payable Rs.2 on application, Re.1 on allotment, Re.1 on first call and Re.1 on second call. The amounts received in respect of these shares were as follows :

On 6,000 shares the full amount called.

On 1,250 shares Rs. 4 per share.

On 500 share Rs.3 per share

On 250 shares Rs.2 per share.

These shares were subsequently reissued at Rs.3 per share.

Give journal entries for the above transactions and prepare the Company's Balance Sheet.

Ans. [Amount transferred to Capital Reserve Rs.500; B/S total Rs.79,250]

14. Rama Krishna Ltd. Issued equity shares of Rs.100 each on the following terms ;

On Application Rs.20 per share ; On Allotment Rs.40 per share; On First Call Rs.20 per share; On Second and Final Call Rs.20 per share.

Mehta to whom 300 shares were allotted, failed to pay the allotment and on his subsequent failure to pay the first call, his shares were forfeited. Gupta, the holder of 100 shares failed to pay the first call, and his shares were forfeited. The forfeited shares were reissued subsequently for Rs.110 per share as fully paid. Journalise the transactions.

Ans. [Rs.12,000 transferred to Capital Reserve].

15. M. Khaitan Ltd. Was formed with an authorized capital of 20,000 equity shares of Rs.10 each to purchase the business of M.Khaitan for Rs.1,00,000 by the allotment of fully paid shares.

On 1st January, 1997 the purchase consideration was satisfied and 9,000 shares were subscribed for by the public at par, Rs.2 per share being payable on application and Re.1 per share on allotment. A first call of Rs.2.50 per share was due on 1st March and a second call of Rs.2 per share on 1st may.

On 31st December, 1997, position as regard to shares subscribed by the public was as follows :

No. of shares	Amount paid per share
	Rs.P
8,900	7.50
60	5.50
30	3.00
10	2.00

On 31st December, 1997 all shares on which less than Rs.5.50 per share had been paid were forfeited.

On 28th February, 1998 the arrears on shares were collected.

On 1st March, 1998 the forfeited shares were reissued to Goenka at the price of Rs.8.50 per share. The shares were reissued as fully paid up.

On 1st April, 1998 the directors made a final call of Rs.2.50 per share, payable on 1st June. The amount was duly received.

Draft Journal entries to record all the above transactions. Cash transactions are to be passed through Cash book.

Ans. [Rs.50 transferred to Capital Reserve; Cash Balance Rs.90,050].

16. A Ltd. Co. had its Issued Capital comprising of 20,000 Equity Shares of Rs.10 each payable as :

Rs.2 on Application; Rs.3 on Allotment (including Prem.); Rs.3 on 1st Call and Rs.3 on Final Call.

The shares were called upto the 1st call stage. All the share money was received except from A, holding 300 shares, who paid only upto Application and except from B, holding 400 shares, who paid upto Allotment. All these shares are forfeited. Out of these forfeited shares. 400 shares (whole of A's holdings and balance of B's holdings) were re-issued to C, on payment of Rs.6 per share and as paid up to the same extent as other shares.

Journalise the entries for forfeiture and re-issue only.

Ans. [Amount transferred to Capital reserve Rs.600].

REDEMPTION OF PREFERENCE SHARES

Meaning of preference share –

The shares having preferential rights over the equity share in respect of payment of dividend and refund of capital at the time of liquidation of the company.

Meaning of redemption –

Redemption of preference shares means returning the preference share capital to the preference share holders either at a fined date or after a certain time period during the life time of the company as per the provisions given under section 100 of the companies Act, 1956.

Under section 100 of the Companies Act, a company is not allowed to return to its shareholders the share money without the permission of the Court. But permission of the court is not necessary, if the refund is to be made to the preference shareholders.

When the capital is raised by issuing redeemable preference shares, it is to be paid back by the company to such shareholders after the expiry of stipulated period whether the company is to be wound up or not. Ordinarily, the amount of such shares will be paid back during the life time of company either out of the profits or proceeds of the issue of fresh shares. The following important provisions regarding the redemption of preference shares are given under section 80 of the Companies Act.

(i) Such shares cannot be redeemed unless they are fully paid up. In other words partly paid-up shares cannot be redeemed. This provision is made in order to protect the interest of the creditors.

(ii) Such shares can be redeemed either out of profits which would be available for dividend or out of the proceeds of a fresh issue of shares made with the object of redemption. These shares cannot be redeemed out of the proceeds of fresh issue of debentures or out of the ale proceeds of any property of the company as it will lead to erosion of available security to the creditors. Capital profits such as shares forfeited account, development rebate account, capital redemption reserve account, securities premium account, profit prior to incorporation, capital reserve are not available for dividend. If shares are to be redeemed at premium, then such premium must be provided either out of the accumulated profits of the company or out of the company's securities premium account, profit prior to incorporation, capital reserve are not available for dividend. If shares are to be redeemed at premium, then such premium must be provided either out of the accumulated profits of the company or out of the company's securities premium account. The word 'proceeds' implies the amount received excluding the amount of securities premium if the shares are issued at premium but the net amount if the shares are issued either at a par or at a discount. This clause is inserted in order to protect the interest of the creditors.

(iii) When shares are redeemed out of profits available for distribution for dividend, a sum equal to the nominal amount of the shares so redeemed must be transferred out of profits to a reserve account to be called '*Capital Redemption reserve Account*'. This provision is made in order to *immobilize profits from being used for any other purpose* such as declaration of dividend, redemption of debentures, etc.

(iv) Such reserve can be used for issuing fully paid bonus shares to the shareholders. This account cannot be reduced except in accordance with the sanction of the court relating to reduction of share capital.

(v) Redemption of preference shares should *not be regarded as a reduction of the authorized capital* of the company and as such the reduced shares should remain part of the authorized capital and must be shown in the Balance Sheet.

The purpose of the all legal restrictions on redemption of preference shares is not to allow redemption of preference shares which may adversely affect the security available to the creditors of company. The purpose is to keep the security intact which is available to the creditors even after the preference shares are redeemed. Section 80 of the Companies Act provides that redemption of preference shares can be made either out of the profits of the company which would be available for dividend or out of the proceeds of a fresh issue of shares. If redemption is carried out in any other manner such as out of borrowing or by sale of available assets, it will reduce the amount of available security to the creditors. It is not the case when redemption is made out of profits because creditors are not affected as the increase in profit would result in an increase in the available assets of the company. Similarly, when redemption is carried out of fresh issue of shares, it results in an increase in the available assets and amount of security available to the creditors will not be affected after the redemption of shares is made.

Another objective of legal restrictions on redemption of preference shares is that there should be no reduction of share capital. It has been ensured by the following provisions of Section 80 of the Companies Act.

(a) Preference shares can be redeemed either out of the proceeds of the fresh issue of shares or out of profits available for dividend purposes. If preference shares are redeemed out of the proceeds of fresh issue of shares, capital provided by fresh issue of shares will be substituted by the capital which will be reduced by redemption of preference shares.

(b) If preference shares are redeemed out of revenue profits available for dividend purposes, nominal value of shares so redeemed must be transferred to Capital Redemption Reserve Account. Capital Redemption Reserve Account is just like capital because it can only be used for issue of fully paid-up bonus shares. Hence, redemption of preference shares will not amount to reduction of capital.

Nominal value of preference shares to be redeemed must be equal to or less than the paid up value (deducting discount on issue of fresh shares if any) of fresh issue of shares and Capital Redemption Reserve Account i.e., total *of paid up value of fresh issue of shares and capital redemption reserve account* (if redemption is carried out of profits available for dividend purposes) *must not be in any case less than the nominal value of preference shares to be redeemed.*

Profits available for redemption of preference shares		Profits not available for redemption of preference shares	
1.	Reserves	1.	Share premium A/c
2.	General reserves	2.	Share forfeited A/c
3.	Reserve fund	3.	Profit prior to incorporation
4.	Dividend equalization fund	4.	Capital reserve
5.	Insurance fund	5.	Development rebate reserves
6.	Workmen's compensation fund,		
7.	Workmen's accident fund		
8.	Voluntary debenture redemption A/c		
9.	Debenture sinking fund A/c		
10.	Profit and loss A/C(cr)		

. **Accounting Entries or Procedure for Solving Problem –**

1. First you see whether the redeemable preference shares are fully paid up or partly paid up. If partly paid up make them fully paid up as partly paid up preference shares cannot be redeemed.

(a) Preference share final call A/c Dr.

To preference share capital A/c

(For preference share final call due)

(b) Bank A/c Dr.

To preference share final call A/c

(For preference share final call money received)

2. Amount due to preference shareholders on redemption :
Redeemable preference share capital A/c Dr. (with face value)
Premium on redemption A/c Dr. (with premium on redemption)
To preference shareholders A/c (Amount to be paid on redemption).

3. It equity shares is issued for the purpose of redemption of preferences shares :
Bank A/c Dr. (with amount actually redemption)
Discount on issue of shares All Dr. (if shares are issued at discount)
To equity share capital (face value)
To share premium (if issued at premium)

4. Premium on redemption of preferences shares is provided out of share premium A/c, or profit and loss A/c or general reserve.

Share premium A/c Dr.
Profit and loss A/c Dr.
General reserve A/c Dr.
To premium on redemption.

5. Sufficient amount from profit and loss A/c or General reserve or any other reserve available for the distribution of dividend should be transferred to capital redemption reserve A/c required for the redemption of preference shares :

Profit and loss A/c Dr.
General reserve A/c Dr.
To capital redemption reserve A/c.

6. If sufficient cash and bank balance is not available for making payment to preference shareholders on redemption then either current assets may be sold by the company or bank loan may be arranged. The entries will be as follows :

(a) If current asset is sold
Bank A/c Dr.
Profit and loss A/c Dr. (less on sale of current asset)
To current Asset
To profit and loss A/c (profit on sale of current assets)

(b) If bank loan is obtained for redemption
Bank A/c Dr.
To Bank loan A/c

7. If redemption of preferences shares is made by conversion of some other shares, then preference share capital A/c. Dr.

8. If payment is made to preference share holders
Preference share holder A/c Dr.
To Bank A/c

Example – 1

10,000, 7% Redeemable preference shares of Rs.10 each fully paid are outstanding on 1st January 1997 in a company. The company decided to redeem these shares on 1st March, 1997 at Rs.13 per share. To provide for redemption the company decided to issue 5000 equity shares of Rs.10 each at Rs.14 each payable in full on 20th February 1997. The profit and loss A/c showing a credit balance of Rs.100000.

			Rs.	Rs.
Ans. (1)	Preference share capital A/c	Dr.	1,00,000/-	
	Premium on redemption A/c	Dr.	30,000/-	
	To preference share holders A/c			1,30,000/-
	(for Amount due to preference share holders on redemption)			
(2)	Bank A/c	Dr.	70,000/-	
	To equity share capital A/c			50,000/-
	To securities premium A/c			20,000/-
	(for issue of 5000 equity shares at Rs.14 each)			
(3)	Securities premium A/c	Dr.	20,000/-	
	Profit and loss A/c	Dr.	10,000/-	
	To premium on redemption A/c			30,000/-
	(for adjustment of premium on redemption against the share premium and profit and loss A/c).			
4)	Profit and loss A/c	Dr	50,000/-	
	To capital redemption reserve A/c			50,000/-
	(for capital redemption reserve created for the redemption of preference shares)			
(5)	Preference share holders A/c	Dr.	1,30,000/-	
	To Bank A/c			1,30,000/-
	(for payment made to preference share holders)			

Example – 3

(Where number of shares of fresh issue are not given). Exchange Ltd. Has an issued share Capital of 650 7% Redeemable Preference Shares of Rs.100 each and 4,500 Equity Shares of Rs.50 each. The Preference Shares are redeemable at premium of 7½ on April 1, 1997. The Company's Balance Sheet as on 31st March, 1997 was as follows :

Liabilities	Rs.	Assts	Rs.
Share Capital		Fixed Assets	3,45,000
Issued 650 7% redeemable		Investments	18,500
Preference Shares of Rs.100		Balance at Bank	31,000
Each fully paid	65,000		
4,500 Equity Shares of Rs.50 each fully pad	2,25,000		
	2,90,000		
Profit and loss account	48,000		
Sundry creditors	56,500		
	3,94,500		3,94,500

In order to facilitate the redemption of the preference shares, the company decided (a) to sell all the investments for Rs.16,000; (b) to finance part of the redemption from company's funds, subject to leaving a balance of Rs.12,000 in the profit and loss account, and (c) to issue sufficient equity shares of Rs.50 each at a premium of Rs.13 per share to raise the balance of funds required.

The preference shares were redeemed on the due date and the issue of equity shares was fully subscribed.

You are required to prepare – (i) the necessary Journal entries to record the above transactions (including cash) and (ii) the Balance sheet as on completion.

Solution

Exchange Ltd.

Journal

		Rs.	Rs.
Bank A/c Profit and loss A/c To investments A/c (Being the investments sold at Rs.16,000 and loss debited to profit and loss account)	Dr. Dr.	16,000 2,500	 18,500
7% Red. Preference share capital A/c Premium on redemption A/c To preference shareholders A/c (Being the amount payable on redemption of 650 preference shares transferred to preference shareholders A/c)	Dr. Dr.	65,000 4,875	 69,875
Bank Account To equity share application & allotment A/c 9Being the application money received on 630 equity shares of Rs. 50 each at a premium of Rs. 13 per share)	Dr.	39,690	 39,690

Equity shares applicatipn and allotment A/c To equity share capital A/c To securities premium A/c (Being the allotment of 630 equity shares of 50 each at a premium of rs.13 per share vide Board Resolution dated ....)	Dr.	39,690	 31,500 8,190
Profit and loss account To capital redemption reserve A/c (being the amount transferred out of profits equal to nominal value of shares redeemed otherwise than out of proceeds of fresh issue)	Dr.	33,500	 33,500
Securities premium A/c To premium on redemption A/c (Being the premium payable on redemption of preference shares charged to securities premium account)	Dr.	4,875	 4,875
Preference shareholders A/c To Bank (Being to payment made on redemption of preference shares at a premium of 7½%)	Dr.	69,875	 69,875

Balance sheet of exchange Ltd. As on 1st April, 1997

Liabilities	Rs.	Assts	Rs.
Share capital : Authorised ....shares of rs...... each Illued, subscribed and paid up : 5,130 equity shares of rs.50 each fully paid	2,56,500	Fixed Assets	3,45,000
Reserve and surplus		Investments	-
Capital redemption reserve	33,500	Current Assets:	
Securities premium A/c	3,315	Cash at Bank	16,815
Profit and loss A/c	12,000		
Secured loans	-		
Unsecured loans	-		
Current liabilities and provisions :			
Sundry creditors	56,500		
	3,61,815		3,61,815

Working notes

(1) Calculation of Number of Equity Shares to be issued balance of profit and loss account	Rs.	Rs. 48,000
Less: loss on sale of investment	2,500	
Amount to be retained as balance	12,000	14,500
Amount available for transfer to Capital Redemption reserve		33,500
Nominal value of Equity shares to be issued (65,000 – 33,500)		
No of equity shares = $\frac{31,500}{50}$ = 630 shares.		31,500

(2)Calculation of Balance at bank

Bank Account

Liabilities	Rs.	Assets	Rs.
To Balance b/d	31,000	By preference shares	
To Investments	16,000	Redemption A/c	69,875
To share application & Allotment A/c	39,690	By balance c/d	16,815
	86,690		86,690

Illustration – 4

Where forfeiture and reissue of shares is to be done before redemption). The following is the Balance Sheet of a Ltd. Company as at 31st March, 1998.

Balance Sheet

Liabilities		Rs.	Assts	Rs.
Equity share capital (Fully paid)		18,00,000	Fixed assets	27,00,000
9% redeemable preference shares of			Investment (against reserve)	2,00,000
Rs.100 each fully	Rs.		Current assets	11,00,000
Called	1,80,000			
Less : Calls in arears	2,000			
		1,78,000		
Revenue reserve		13,50,000		
Current liabilities		4,50,000		
Provisions		2,22,000		
		40,00,000		40,00,000

100 preference shares on which the last call of rs.20 was not paid, were forfeited by the Board of Directors on 30th April, 1998.

The Directors redeemed the remaining preference shares at a premium of 10% on 30Th September, 1998. For this purpose 10,000 equity shares of rs.10 each were issued at a premium of 10% and were fully paid up within 30th July, 1998. Current assets before redemption of preference shares included Rs.2,00,000 in Current Account with Bankers. The Company closes its accounts on 31st March, every year.

Pass necessary journal entries and prepare Balance Sheet after redemption of preference shares.

Solution

Journal entries

Date	Particulars		Dr.	Cr.
1998			Rs.	Rs.
April 30	9% redeemable preference share capital A/c	Dr.	10,000	
	To calls in arrears A/c			2,000
	To forfeited shares A/c			8,000
	(Being forfeiture of 100 preference shares of Rs.100 each for non payment of final call of Rs.20 as per Board's resolution No..... Dated.......)			
July 30	Bank A/c	Dr.	1,10,000	
	To equity shares capital A/c			1,00,000
	To securities premium A/c			10,000
	(Being issue of 10,000 equity shares of Rs. 10 each at a premium of 10% for redeeming preference shares as per Board's resolution No......... Dated ....)			
Sept.30	9% Redeemable preference share capital A/c	Dr.	1,70,000	
	Premium on redemption of preference shares A/c	Dr.	17,000	
	To preference shareholders A/c			1,87,000
	(Being amount due to preference shareholders on redemption of 1,700 preference shares of Rs.100 each at a premium of 10%)			
Sept.30	Securities premium A/c	Dr.	10,000	
	Revenue reserve A/c	Dr.	7,000	17,000
	To premium on Redemption of preference shares A/c			
	(Being premium on redemption of preference shares provided out of securities premium A/c and revenue reserve A/c)			

Sept.30	Revenue reserve A/c To capital redemption reserve A/c (Being transfer of requisite amount from revenue reserve A/c to capital redemption reserve A/c for redemption of preference shares)	Dr.	70,000	70,000
Sept.30	Forfeited shares account To capital reserve A/c (Being balance of forfeited shares A/c transferred to capital reserve A/c)	Dr.	8,000	8,000
Sept.30	Preference shareholders A/c To Bank A/c (Being payment of amount due to preference shareholders)	Dr.	1,87,000	1,87,000

Balance sheet of ...... as at September 30, 1998

Liabilities	Rs.	Assets	Rs.
Equity share capital (fully paid)	19,00,000	Fixed Assets	27,00,000
Capital redemption reserve	70,000	Investment(against reserve)	2,00,000
Capital reserve	8,000	Current assets (including cash at Bank Rs.1,23,000 i.e., Rs. (2,00,000 – 1,87,000 + 1,10,000)	10,23,000
Revenue reserve (Rs.13,50,000 – Rs.77,000)	12,73,000		
Current liabilities	4,50,000		
Provisions	2,22,000		
	39,23,000		39,23,000

REVIEW EXERCISES

(i) Redemption of preference shares amount to reduction in the capital of the company.

(ii) The nominal value of the shares can be redeemed from the sale of fixed assets.

(iii) Distributable profits means profits which would otherwise be available for dividends.

(iv) Premium on redemption of preference shares can be paid out of capital reserves resulting from profit on revaluation of fixed assets.

(v) Debenture premium can be utilized to pay premium on redemption of preference shares.

(vi) Proceeds means the realized amount when shares are issued at a discount.

(vii) The logic behind the creation of the capital redemption reserve is to maintain the capital structure of the company intact after redemption.

(viii) Capital redemption reserve account can be utilized to pay dividend after obtaining the necessary of the company law board.

Ans. ——————

Indicate the correct answers :

(a) Capital Redemption Reserve Account is created :

i. Out of securities premium account

ii. Out of share forfeited account.

iii. To meet legal requirements.

iv. Voluntarily.

(b) Preference shares can be redeemed :

i. If they are fully paid up

ii. If they are partly paid up

(c) Preference shares can be redeemed out of :

i. The proceeds of issue of debentures

ii. Share forfeited account

iii. The proceeds of a fresh issue of shares

(d) Capital Redemption Reserve Account can be utilized :

i. For writing past losses

ii. For declaring bonus to employees

iii. For writing of capital losses

iv. For issuing partly paid bonus shares

v. For issuing fully paid bonus shares

Ans. [(a) (iii); (b) (i); (c) (iii); (d) (v)].

Short Answer Type –

1. What are redeemable preference shares ?
2. Can partly paid up redeemable preference shares be redeemed ?
3. What are the two sources of redemption of preference shares?
4. Can preference shares be redeemed out of fresh issue of debentures or amount realized

from the sale of fixed assets?

5. Give the journal entries when

   i. Partly paid shares are made fully paid up by nonus issue.

   ii. Fully paid bonus shares are issued to existing shareholders in a certain proportion.

Long Answer Type –

1. Discuss the provisions of law with regard to redemption of redeemable preference shares as laid down in section 80 of the companies Act.

2. Under what conditions may a company issue redeemable preference shares and in what manner they may be redeemed ?

3. Explain in brief the procedure (along with journal entries) for solving problems on redemption of preference shares.

4. What do you mean by capital redemption reserve account ? How is it created? How can it be utilized ?

5. Under which section of the companies Act, preferénce shares can be redeemed? Can partly paid-up preference shares be redeemed?

PRACTICAL PROBLEMS

1. (Redemption out of Divisible Profits). The following balances are appearing in the Ledger of the company as on 31.3.97 :

	Rs.
Share capital – equity shares (fully paid up)	6,00,000
Preferences shares (fully paid	3,00,000
General reserve	2,00,000
Profit and loss account (Cr. Balance)	1,25,000
Securities premium account	50,000

The company decided to redeem the preference shares at a premium of 10 per cent out of its general reserve and undistributed profit.

Give journal entries relating to the redemption of the preferences hares.

2. (Redemption by fresh issue and out of profits). A company wishes to redeem its preference shares amounting to Rs.1,00,000 at a premium of 5% and for this purpose

issues 5,000 equity shares of Rs.10 each at a premium of 5%. The company has also a balance of Rs.1,00,000 in General Reserve and Rs.50,000 in profit and loss account. Give the journal entries to record the above transactions.

3. (Redemption out of profits and by fresh issue). A company, in a series of operations :

   (1) Issues at par 40,000 redeemable preferences hares of Rs.10 each, redeemable at premium of 5 per cent.

   (2) Redeems 15,000 of the redeemable preferences hares out of the profits of the company.

   (3) Issues for cash 30,000 equity shares of Rs.10 each at a premium of Re.1 per share and out of the proceeds, redeems the balance of the redeemable preference shares.

   Journalize these transactions.

4. (Where ledger accounts are to be prepared). The summarized balance sheet of sterling Ltd. As on 31st March, 1996 was as follows :

	Rs.		Rs.
Share capital		Sundry assets	34,00,000
Issue & paid-up		Cash	6,00,000
10,000 8% redeemable	10,00,000		
Preferences shares of			
Rs.1000 each			
1,00,000 Equity shares	10,00,000		
Of Rs. 10 each	5,00,000		
Capital reserves	2,00,000		
General reserves	9,50,000		
Profit & loss account	3,50,000		
Creditors	40,00,000		40,00,000

The preferences hares were redeemable on 30th June, 1996 at a premium of 25%; for the purpose, the company decided to issue 50,000 equity shares of Rs.10 each at a premium of Rs.4 per share payable in full on 15th June, 1996.

Show the necessary ledger accounts.

1. (Where balance sheet is to be prepared after redemption). X and company issued 50,000 equity shares of Rs.10 each and 3,000 redeemable preference shares of Rs.100 each, all shares being fully called and paid up. On 31st March, 1996 profit and loss account showed an undistributed profit of Rs.50,000 and General reserve account stood

at Rs.1,20,000. on 2nd April, 1996 the directors decided to issue 1,500% preference shares of Rs.100 each for cash and to redeem the existing preference shares at Rs.105 utilizing as much profits as would be required for the purpose.

Show the journal entries to record these transactions. Prepare also a summarized balance sheet showing the position of the company on completion of the redemption. On 31st March, 1996 the cash balance amounted to Rs.1,85,000 and sundry creditors stood at Rs.87,000.

Ans. [Bank Balance Rs. 20,000; Amount transferred from profit and loss account to capital redemption reserve account rs.45,000].

2. (Where bank loan is taken for payment to shareholders). The balance sheet of Grey Ltd. As at 31st March, 1997 was as follows :

Liabilities	Rs.	Assets	Rs.
Share capital (shares of Rs.100 each, fully paid) :		Fixed Assets	8,00,000
		Investments	1,00,000
Equity	5,00,000	Cash	2,00,000
7% redeemable preference	3,00,000	Other current assets	5,00,000
Securities premium	50,000		
Capital reserve	1,00,000		
Revenue reserve	2,00,000		
6 per cent debentures	3,00,000		
Creditors	1,50,000		
	16,00,000		16,00,000

Both the redeemable preference shares and debentures were due for the redemption on 1st April, 1997. Grey Ltd. Took the following in this respect :

(1) It issued 2,000 equity shares of Rs.100 each at a premium of 10 per cent, the shares were fully subscribed and paid for.

(2) It sold the investments for Rs.90,000

(3) It arranged a bank loan to the extent necessary.

The redemption was duly carried out. Prepare the balance sheet of the company immediately afterwords.

Ans. [B/C Total Rs.13,00,000; Bank Overdraft Rs.90,000]

1. (Where no. of shares to be issued is not given) Spotlight Limited has issued share capital of 60,000,8% redeemable cumulative preference shares of Rs.20 each and

4,00,000 equity shares of Rs.10 each. The preference shares are redeemable at a premium of 5% on 1st April, 1996.

As at 31st March, 1996 the company's balance sheet showed the following position :

Liabilities and capital	Rs.	Assets	Rs.
Issued share capital ;		Plant and machinery	25,00,000
60,000 8% redeemable		Furniture & fixtures	9,00,000
Cumulative preference		Stock	15,00,000
Shares of Rs.20 each, fully paid		Debtors Investments	14,00,000
4,00,000 equity shares of Rs. 10 each	12,00,000	Balance at bank	3,50,000
fully paid	40,00,000		3,50,000
Profit and loss A/c	7,00,000		
Sundry creditors	11,00,000		
	70,00,000		70,00,000

In order to facilitate the redemption of preference shares it was decided :

(a) to sell the investments for rS.3,00,000

(b) to finance part of the redemption from company funds subject to leaving a balance on profit and loss account of Rs.2,00,000.

(c) to issue sufficient equity shares of Rs.10 each at a premium of Rs.2 per share to raise the balance of funds required.

The preference shares were redeemed on due date and equity shares were fully subscribed.

You are required to prepare :

(i) Journal entries to record the above transactions.

(j) A memorandum balance sheet as on completion of redemption.

Ans. [B/S Total Rs.65,90,000, No of shares to be issued is 75,000; Bank balance rs.2,90,000].

1. (Where scheme of redemption is drawn up). The balance sheet of happy private limited as at March 31, 1995 was as follows:

Liabilities	Rs.	Rs.
Share capital		
18,000 – 9.5% cumulative redeemable preference Shares of Rs.100 each	18,00,000	
40,000 equity shares of Rs.100 each fully paid up	40,00,000	58,00,000
Reserves :		
Securities premium	5,00,000	
General reserve	9,00,000	14,00,000
Secured loans from institutions		18,00,000
Current liabilities and provisions		16,00,000
		1,06,00,000

The Board of Directors decided to redeem the preference shares both by issue of fresh capital and by utilization of reserves but without any further borrowings. You are required to advise them the scheme for redemption and draw up the balance sheet after redemption along with journal entries.

Ans. [B/S Total Rs. 97,00,000]

(Where final call is to be made and balance sheet is to prepared after redemption of preference shares). The balance sheet of a ltd. As on 31st March, 1997 is as follows :

	Rs.		Rs.
Share capital		Sundry assets	2,80,000
20,000 Equity shares of Rs.10 each	2,00,000	Investments	30,000
10,000 12% redeemable Preference shares of Rs.10 each Rs.8 paid up	80,000	Cash at Bank	70,000
Sundry creditors	42,000		
Profit and loss account	58,000		
	3,80,000		3,80,000

The directors have given notice to redeem the preference shares at a premium of 5% as provided in the Articles of Association. Investments have been sold for Rs.25,000.

Make journal entries and a summarized balance sheet after redemption.

Ans. [B/S Total Rs. 3,42,000]

Hints :

(1) Final call of Rs.2 per share called to make partly paid preference shares as fully paid up because only fully paid preference shares can be redeemed as per section 80 of the companies Act, 1956.

UNIT - I

LESSON – 2

ACCOUNTING FOR DEBENTURE

Students till now we have discussed the issue of shares and redemption of preference shares. But there is another vital security like debentures which is issued to raise funds in the form of a debt which is widely used in practice.

1. Meaning of debenture
2. Types of debenture
3. Issue of debentures
4. Interest on debenture
5. Redemption of debenture
6. Review exercise.

MEANING OF DEBENTRUE – A debenture is a written acknowledgement of debt by a company under its common seal. Interest is paid to debenture holders at a fixed rate at regular intervals.

TYPES OF DEBENTURES – Debentures may be classified from different point of view :

(1) From security point of view : debentures may be classified as

(a) Naked or simple debentures

(b) Mortgage debentures

Naked or simple debentures : The debentures which do not carry any security in respect of payment of interest or repayment of principal amount is called as naked or simple debentures.

Mortgage debentures : The debentures which are secured by a charge on the assets or properties of the company are called as mortgage debentures. The debenture holders have the right to recover their principal amount as well as unpaid interest out of the assets mortgaged by the company.

(2) From permanence point of view : from this point of view the debentures may be classified as :

(a) Redeemable debentures

(b) Irredeemable debentures

Redeemable debentures : These debentures provide for the payment of principal amount on the expiry of a certain period. Redeemable debentures can be reissued even after they have been redeemed until they have been cancelled.

Irredeemable debentures : these debentures are retained as a part of the permanent capital structure of the company. They are also known as perpetual debentures. They are not refundable during the lifetime of the company. Such debt becomes due for payment only when the company goes into liquidation or when the payment of interest is not made regularly. The company has the option of canceling its liability to the debenture holders at any time by giving due notice to them.

(3) From priority point of view : The debentures may be classified as

(a) First debentures

(b) Second debentures

First debentures : The debentures which are paid first before any payment is made to another type of debentures are known as first type debentures.

Second debentures : The debentures which are paid after making the payment of first debentures is known as second debentures.

(4) From recording point of view : Debentures maybe classified as

(a) Bearer debentures

(b) Registered debentures

Bearer debentures –

The debentures, which are transferable to another bearer without endorsement and they are just, like bearer cheques or government currency notes are called as bearer debentures.

Registered debentures –

The debentures, which are transferable to another bearer with endorsement and following some legal formalities, are known as registered debentures.

DISTINCTION BETWEEN DEBENTURES AND SHARE

	DEBENTRUE		SHARE
1.	A person investing money in debentures is called debenture holder.	1.	A person investing money in shares is called shareholders.
2.	Debenture holder is a creditor of the company.	2.	Shareholder is a owner of a company.
3.	A debenture holder cannot participate in the management of the company.	3.	A shareholder has costing power so he can participate in the management of the company.
4.	A debenture holder gets interest on debenture and is paid in all circumstances whether there is profit or less.	4.	A shareholder gets dividend on shares and is paid if there is any profit.
5.	Debentures can be converted into shares.	5.	Shares cannot be converted into debentures.
6.	Debenture holders will get priority in getting the money back at the time of liquidation.	6.	Share holders are paid after satisfying to the debenture holders.
7.	There are no restriction on issue of debentures at a discount.	7.	The share can be issued at a discount only after fulfilling certain legal formalities.
8.	There can be mortgaged debentures.	8.	Btu there can be no mortgaged shares.
9.	Debentures can be issued as collateral security by a company.	9.	Shares cannot be issued as collateral security by a company.
10	Debentures are generally redeemed within a fixed period of time.	10.	Share cannot be redeemed during the life period of the company.

Distinction between debentures and debenture stock

1.	Debentures need net be fully paid up	1.	Debenture stock must be fully paid up.
2.	Debenture can be transferred wholly but not in fraction	2.	Debenture stock can be transferred in fraction also.
3.	Debentures are identified by their distinct numbers	3.	Debenture stock is not identified by any distinct number.

STATES FOR DEBENTURE :

The following are the main stages of issuing debentures :

(i) Issue of debentures

(ii) Creation of issue for redemption of debentures

(iii) Redemption of debentures.

ISSUE OF DEBENTURES :

Debentures may be issued from different point of view :

1. Debentures issued for consideration
2. Debentures issued for price
3. Debentures issued from redemption point of view :

From consideration angle the debentures can be issued

(a) For cash

(b) In consideration other than cash

(c) Issued as collateral security

Debenture issued fro cash

The debentures may be issued at par, at a premium, or at a discount. The following entries are passed in connection with the issue of debentures :

1.	On receipt of application money Bank A/c To debenture application A/c (Being application money received on ......debentures @ Rs. per debentures	 Dr.
2.	On allotment the application money on debentures allotted is transferred to debentures account : Debenture application A/c To debentures A/c (For the transfer of application money on debentures allotted to debentures account)	 Dr.
3.	Refund application money on rejected applications Debenture application A/c To Bank A/c (For refund of the application money on rejected application)	 Dr.
4.	Transfer of excess application money to debenture allotment account : Debenture application A/c To debenture allotment A/c (For transfer of excess application money to debenture allotment A/c)	 Dr.
5.	Amount due on allotment money Debenture allotment A/c To debentures A/c (For allotment money due on .... Debentures Rs. per debenture)	 Dr.
6.	Receipt of allotment money : Bank A/c To debenture allotment A/c (For debenture allotment money received)	 Dr.

7.	For debenture 1st call money due Debenture 1st call A/c To debenture A/c (For debenture 1st call money due)	Dr.	
8.	For debenture 1st call money received : Bank A/c To debenture 1st call money (For debenture 1st call money received).	Dr.	

Entries similar to 1st entries will be passed for the debenture second call money due and debenture 2nd call money actually received.

ISSUE OF DEBENTURES FROM POINT OF VIEW OF PRICE :

From this point of view there are three different situations :

(a) Debentures issued at par

(b) Debentures issued at discount

(c) Debentures issued at premium

Debentures issued at pair

Debentures are said to be issued at par when the amount collected for it is equal to the nominal value (face value0 of the debentures, for example the debentures of Rs.100 each issued at R.100.

Illustration – 1

X Ltd. issued 20,000 12% Debentures of Rs.100 each payable :

Rs.20 on application; Rs.40 on allotment; and the balance two months after allotment. The public applied for 28,000 debentures. Applications of 18,000 debentures were accepted in full; applicants for 4,000 debentures were allotted 2,000 debentures and the remaining applications were rejected. All money was duly received. Journalize the transactions.

Solution :

Particulars		L.F.	Dr.(Rs.)	Cr.(Rs.)
Bank A/c To debenture application A/c (Receipt of application money on 28,000 debentures)	Dr.		5,60,000	5,60,000
Debentures Application A/c To 12% Debentures A/c To debenture Allotment A/c To Bank A/c (Transfer of application money on 20,000 debentures (allotted) to debentures Account. Surplus application money on 2,000 debentures transferred to debenture allotment account. Application money on rejected applications refunded.)	Dr.		5,60,000	4,00,000 1,20,000 40,000

Debenture allotment A/c To 12% debentures A/c (Amount due on allotment on 20,000 debentures)	Dr.		8,000,000	8,00,000
Bank A/c To debenture allotment A/c (Balance of the amount due on allotment received)	Dr.		7,60,000	7,60,000
Debenture call A/c To 12% debentures A/c (Amount due on call)	Dr.		8,00,000	8,00,000
Bank A/c To debenture Call A/c (Amount due on all received)	Dr.		8,00,000	8,00,000

ISSUE OF DEBENTRUES AT DISCOUNT

When debentures are issued by company at a price less than its nominal value (face value) it is said to be issued at discount. For example, if a debenture of Rs.1,000 is offered to public at Rs.950, it is issue at a discount. Here Rs.50 on each debenture is loss to the company. As a principle of equity, it is desirable to write off this loss. It is a capital loss and until it is written off completely, it is shown on the asset side of balance sheet, under the heading 'Miscellaneous Expenditures', as a fictitious asset. Discount on issue of debentures account is supposed to be allowed on allotment, unless, otherwise, mentioned.

There is no legal restriction on issuing debentures at a discount. The requisite entry to be passed is

(a)	**When allotment money becomes due** Debenture allotment A/c Discount on issue of debenture A/c To debentures A/c	Dr. Dr.	(Amount receivable) (Amount of discount) (Total amount)
(b)	**When allotment money is received** Bank A/c To debenture allotment A/c	Dr.	(With actual amount received on allotment)

The working of issue of debentures at a discount is well explained by the following illustration

Illustration – 2 (Issue of debentures at discount)

XYZ Ltd; issued 2,000 14% debentures of Rs.50 each at a discount of 10% on April 1,199
payable as follows :

Rs.30 on application; Rs.10 on allotment (discount to be adjusted with allotment) an
Rs.5 on first and final call. The issue was fully subscribed and all money was received in fu
Give journal entries; ledger accounts and balance sheet (extract only).

Solution

1998			Dr. Rs.	Cr. Rs.
	Bank account To Debenture application account (Being application money on 2,000 debentures received)	Dr.	60,000	60,000
	Debenture application account To 14% debentures account (Being allotment of debentures vide board's resolution)	Dr	60,000	60,000
	Debenture allotment account Discount on issue of debentures account To debentures allotment account (Being allotment money due and discount adjusted)	Dr Dr	20,000 10,000	30,000
	Bank account To debenture allotment account (Being allotment amount received)	Dr	20,000	20,000
	Debenture final call account To 14% debentures account (Being first and final call due @ Rs.5 per debenture)	Dr	10,000	10,000
	Bank account To debenture final call account (Being final and final call due @ Rs.5 per debenture received)	Dr	10,000	10,000

14% DEBENTURES ACCOUNT

Dr.	Rs.		Cr.
To Balance c/d	1,00,000	By debentures application account	60,000
		By debenture allotment account	20,000
		BY discount on issue of debentures	10,000
		By debenture final call account	10,000
	1,00,000		1,00,000

DISCOUNT ON ISSUE OF DEBENTURES ACCOUNT

Dr.			Cr.
To 14% debentures account	Rs. 10,000	By balance c/d	Rs. 10,000

BANK ACCOUNT

Dr.			Cr.
	Rs.		Rs.
To debenture application account	60,000	By balance c/d	90,000
To debenture allotment account	20,000		
To debenture final call account	10,000		
	90,000		90,000

BALANCE SHEET (Extract only)

Liabilities		Assets	
Secured loans :	1,00,000	Bank	90,000
2,000,14% debentures @ Rs.50 each	1,00,000	Discount on issue of debentures	10,000 1,00,000

Illustration – 3

A limited company made an issue, which was fully subscribed, of 1,000 debentures of Rs.100 each at Rs.97. The debentures were allotted on 31st July 2001, subscriptions being payable 10 per cent on application, 40 per cent on allotment, 25 per cent on 30th September and the balance on 30th November 2001.

Under the terms of the issue, payment could be made in fully on 31st July, 2001, interest on any amounts prepaid being allowable at the rate of 10 per cent per annum; such interest was not deductible from the subscriber's payment, but was payable by the company on 30th November 2001. The allotted of 300 debentures took advantages of the prepayment terms, while others paid on the due dated. Journalize the entries to be made in the company's books; (Ignore Debenture Interest)

[C.B.S.E. 1992 (Delhi) (C)]

Solution : **Journal**

Date	Particulars		L.F.	Dr.(Rs.)	Cr.(Rs.)
2001	Bank A/c To debenture Application money received fro 1,000 (Being the application money received for 1,000 debentures at the rate of Rs. 10 per debenture)	Dr.		10,000	

	Debenture Application A/c	Dr.		10,000	
	To debenture A/c				
	(Being the transfer of application money)				
July, 31	Debenture Allotment A/c	Dr.		40,000	
	Discount on Issue of Debentures A/c	Dr.		03,000	
	To Debenture A/c				43,000
	(Being the allotment money due on 1,000 debentures @ Rs.40 each and Rs.3 per share allows as discount)				
	Bank A/c	Dr.		54,100	
	To Debenture Allotment A/c				40,000
	To Calls-in-Advance A/c				14,100
	(Being the amount received on allotment and also received of call in advance on 300 debentures @ Rs.47 per debenture)				
Sept. 30	Debentures First Call A/c	Dr.		25,000	
	To Debentures A/c				25,000
	(Being the amount due on first call on 1,000 debentures @Rs.25 per debenture)				
Sept. 30	Bank A/c	Dr.		17,500	
	Calls-in-Advance A/c	Dr.		07,500	
	To Debentures First Call A/c				25,000
	(Being the amount received on first call and calls in Advance A/c is adjusted to the extent of Rs.7,500)				
Nov. 30	Debenture Second and Final Call A/c	Dr.		22,000	
	To Debenture A/c				22,000

Working Note :

Calculation of Interest on Calls-in-Advance

$$\text{Rs.}7{,}500 \times \frac{2}{12} \times \frac{10}{100} = \text{Rs.}125$$

$$\text{Rs }6{,}600 \times \frac{4}{12} \times \frac{10}{100} = \text{Rs.}220$$

ISSUE OF DEBENTURES AT PREMIUM

If debentures are issued at a price more than its nominal value (face alue) such as issue is called issue at a premium. For example, if a debenture of Rs.1000 is offered at 1,050, it is a case of issue of debentures at premium. The excess of issue price over face value is premium. The premium is a capital gain for company so it is to be credited to 'premium on issue of debentures account'. Like discount on issue of debentures, premium on issue of debentures is also realized at the time of allotment, if nothing to the contrary is provided. Premium on issue is a capital gain, so it is shown on the liabilities side of balance sheet under the head 'Reserves and Surplus'.

The entries relating to premium will be :

(i)	When instalment containing premium is made due : Debenture allotment a/c To Debentures a/c To Premium on issue of debentures (Being allotment money due on – debentures @ Rs.- each including premium)	Dr.	(Total due) (Amount of debenture only) (Amount of premium)
(ii)	When debenture allotment money is received Bank a/c To Debenture allotment a/c (Being allotment money received on ... debentures)	Dr.	With total amount received on allotment

Nowhere in the companies Act have been provided the conditions regarding the utilization of amount of premium on debentures. Still the amount of premium on debentures should not be transferred to profit and loss account because it is not a profit arising from the normal operations of the company.

The amount of debenture premium may be used for writing off debenture issue expenses, discount on issue of shares etc. or alternatively it may be credited to Debenture redemption fund (if any).

Issue of debentures at premium

Illustration 4

A company issued, 1,000 6% debentures of Rs.100 each at Rs.110 payable as follows:

Rs.30 on application (including premium Rs.5)

Rs.30 on allotment including premium Rs.5)

Rs.50 on first and final call.

All the debentures were applied for and allotted. All money due was received, except final call on 20 debentures.

Pass journal entries for the above.

SOLUTION : **JOURNAL**

Particulars		L.F.	Debit	Credit
			Rs.	Rs.
Bank a/c	Dr.		30,000	
To Debentures application a/c				30,000
(Being application money received)				
Debenture application a/c	Dr.		30,000	
To 6% Debentures a/c				25,000
To Premium on debentures a/c				05,000
(Being application money transferred to debentures account, together with premium @Rs.5)				
Debenture allotment a/c	Dr.		30,000	
To 6% Debentures a/c				25,000
To Premium on debentures a/c				05,000
(Being allotment money due together with premium @Rs.5 per debenture)				
Bank a/c	Dr.		30,000	
To 6% Debentures allotment a/c				30,000
(Being allotment money received0				
Debenture first and final call a/c	Dr.		50,000	
To 6% Debentures a/c				50,000
(Being call money due on debentures)				
Bank a/c	Dr.		49,000	
To Debenture first and final call a/c				49,000
(Being call money received on 980 debentures)				

Illustration – 5 (Issue of debentures for a lump sum)

Journalise the followings :

(a) Issued 5,000 7% debentures of Rs. 100 each, at par.

(b) Issued 5,000 7% debentures of Rs. 100 each at 10% premium.

(c) Issued 5,000 7% debentures of Rs. 100 each at 10% discount.

All the debentures are redeemable at par.

SOLUTION : **JOURNAL**

	Particulars	L.F.	Debit	Credit
			Rs.	Rs.
(a)	Issue at par Bank a/c To debenture application & allotment a/c (Being application money received on 5,000 debentures @ Rs. 100 each)	Dr.	5,00,000	5,00,000
	Debenture application & allotment a/c To 7% debentures a/c (Being application money transferred to debentures account)	Dr.	5,00,000	5,00,000
(b)	Issue at premium Bank a/c To debenture application and allotment a/c (Being application money received)	Dr.	5,50,000	5,50,000
	Debentrues application and allotment a/c To 7% debentures a/c (Being application money transferred to debentures and debenture premium a/c)	Dr.	5,50,000	5,00,000 50,000
(c)	Issue at a discount Bank a/c To debenture application & allotment a/c (Being application money received)	Dr.	4,50,000	4,50,000
	Debenture application and allotment a/c Discount on debentures a/c To 7% debentures a/c (Being application money transferred to debenture a/c)	Dr. Dr.	4,50,000 50,000	5,00,000

DEBENTURES ISSUED IN CONSIDERATION OTHER THAN CASH

Sometimes a company purchases a running business (assets and liabilities) and issues to vendor, debentures as consideration. It is called issue of debentures in consideration other than cash. In such situation following entries are recorded.

I. When agreement of purchase of business is signed.

Business purchase a/c	Dr.	with amount of
Sundry assets a/c	Dr.	purchase
To Vendor's a/c		
(Being sundry assets purchased)		

II. When purchase consideration is paid to vendors in the form of debentures.

Vendor's a/c	Dr.	with amount of
To debentures a/c		purchase consideration
(Being debentures issued as consideration for assets purchased)		

Note : When debentures are issued in consideration other than cash they can be issued either at par, at premium or at discount. If they are issued at premium the amount of premium will be credited to 'premium on issue of debentures account' and if issued at a discount, the discount will be debited to 'discount on issue of debentures account'.

As per rule purchase consideration (amount to be paid for assets purchased) should be equal to net assets (Assets purchased-liabilities assumed) value. But in practice sometimes it is more than the value of net assets and sometimes it is less than the value of net assets.

Extra payment made over and above the value of net assets is treated as goodwill, which can be calculated as follow :

Goodwill = purchase consideration – Net assets

Where Net assets = Assets purchased – Liablities assumed

In case the purchase consideration to be paid by company is less than the value of net assets, the excess of net assets over purchase consideration is a capital gain, which is transferred to capital reserve account.

Illustration – 6

(Debenture issued in consideration other than cash)

Z Ltd purchased building for Rs.2,20,000. Half of the payment was made in cash and the remaining half by the issue of 12% debentures at a premium of 10%. Pass the necessary journal entires. (C.B.S.E. 1995)

SOLUTION **JOURNAL – Z LTD.**

Building account To vendor (Being purchase of building)	Dr.	Dr. Rs. 2,20,000	Cr. Rs. 2,20,000
Vendor To bank account To 12% debentures account To debenture premium account (Being payment made and debentures issued in satisfaction of consideration)	Dr.	2,20,000	1,10,000 1,00,000 10,000

Working note :

Calculation of debentures to be issued :

	Rs.
One half of amount payable in debentures	1,10,000
Debenture price being Rs. 100 + 10% premium	110
No. of debentures = 1,10,000 ÷ 110 = 1,000	
∴ Nominal value of debentures and debentures premium (being 10%)	1,00,000 10,000

Illustration – 7 (Calculation of goodwill)

Star Automobiles Ltd. took over assets of Rs. 2,35,000 and liabilities of RS.40,000 of Ashoka Automobiles Ltd. for the purchase consideration of Rs. 2,20,000. Purchase consideration was payable by issuing debentures of Rs. 100 at 10% premium. Give journal entries in the books of Star Automobiles Ltd.

SOLUTION **JOURNAL**

Particulars		L.F.	Debit	Credit
Sundry assets a/c Goodwill a/c To Sundry liabilities a/c To Ashoka automobiles ltd. (Being purchase of assets and liabilities of Ashoka automobiles letd).	Dr. Dr.		Rs. 2,35,000 25,000	Rs. 40,000 2,20,000

Ashoka automobiles Ltd.	Dr.		2,20,000	
To debentures a/c				2,00,000
To premium on issue of debenture a/c				20,000
(Being debentures issued as consideration for purchase of business at 10% premium)				

Working notes

The purchase consideration is Rs.2,20,000 against net assets being valued (2,35,000 – 40,000) Rs. 1,95,000. The difference of Rs. 25,000 is goodwill.

When debentures are issued as a collateral security there are two ways of treatment in the accounting books.

(i) No journal entry is made in the account books at the time of issue of such debentures. A note is appended below the loan on the liabilities side of the balance sheet to the fact that they have been secured by the issued of debentures. This will be shown in the balance sheet as follows :

BALANCE SHEET (EXTRACTS)

		Rs.
(i)	Liabilities Debentures (In addition, debentures for Rs...... have been issued as collateral security) Loan (Secured by the issue of debentures of Rs...... as collateral security)	
(ii)	Sometimes issue of debentures as collateral security is recorded by making journal entry as follows : Debentures suspense a/c Dr. To debentures a/c (With nominal value of debentures)	

The debentures suspense account will appear on the assets side of the balance sheet and debentures on the liabilities side. When the loan is re-paid the entry is reversed in order to cancel it.

Illustration – 10 (debentures issued as collateral security)

A company had Rs.5,00,000 6% debentures outstanding on 1st January, 1993. During the year company took a loan of Rs.1,00,000 from bank for which the company placed with bank, debentures for Rs.1,20,000 as collateral security. Pass journal entries, if any. Also show how the Debentures and Bank Loan will appear in company's Balance Sheet.

Solution : First Method :

No entry will be passed for issue of debentures as collateral security. Only the entry for bank loan will be passed i.e.

Bank a/c Dr. 1,00,000 1,00,000

To Bank loan a/c(Being loan obtained from bank)

BALANCE SHEET (Extract only)

Liabilities	Details Rs.	Amount Rs.
6% debentures (In addition, debentures worth Rs. 1,20,000 given to bank as collateral security) Bank loan (Secured against debentures worth Rs. 1,20,000 given as collateral security)		5,00,000
Second Method In addition to entry fro bank loan following entry should also be passed :		
Debenture suspense a/c Dr. To 6% debentures a/c (For the issue of Rs.1,20,000 debentures as collateral security for a loan of Rs. 1,00,000 from the bank).	1,20,000	1,20,000

BALANCE SHEET

Liabilities	Rs.	Assets	Rs
6% debentures (Including debentures for Rs.1,20,000 issued as collateral security)	6,20,000	Debentures suspense a/c	1,20,000
Bank loan (Secured against debentures worth Rs.1,20,000)	1,00,000		

Illustration – 11

A Ltd. secured a loan of Rs.1,80,000 from the Canara Bank by issuing 2,000, 1 debentures of Rs. 100 each as collateral security. How will you treat the issue of s debentures ?

[C.B.S.C. (Foreign) 1991 (C)]

Solution

1. First Method (when no entries are passed in the books)

AN EXTRACT OF BALANCE SHEET OF A LTS. AS AT...

Liabilities	**Rs.**	**Assets**	**Rs.**
Secured Loans : Loan from Canara bank (Secured by the issue of 2,000, 15% Debenture of Rs. 100 each as Collateral security	1,80,000		

II.Second Method (when entries for debentures are passed)

JOURNAL OF A LTD

Particulars	**L.F.**	**Dr. (Rs.)**	**Cr. (Rs.)**
Debentures Suspense A/c Dr. To 15% debentures A/c (Being the issue of 2,000, 15% debentures of Rs.100 each as collateral security for a loan from a bank as per board's resolution dated....)		2,00,000	2,00,000

AN EXRACT OF BALANCE SHEET OF A LTD. AS AT ...,

Liabilities	**Rs.**	**Assets**	**Rs.**
Second Loans : 2,000, 15% Debentures of Rs. 100 each (issued as collateral security)	2,00,000	Miscellaneous Expenditure: Debenture Suspense A/c	2,00,000
Loan from Canara Bank (Secured by the issue of 2,000, 15% debentures of Rs.100 each as collateral security)	1,80,000		

Illustration – 12

A Ltd. issued 5,000, 13% debentures of Rs.100 each at part and raised a loan of Rs.80,000 from bank, collaterally secured by Rs.1,00,000 13% debentures. How will you show the debentures in the Balance sheet of the company assuming that the company ahs recorded the issue of debentures as collateral security in the books. [C.B.S.E. (Foreign) 1992 (C)]

Solution

AN EXTRACT OF BALANCE SHEET

Liabilities	Rs.	Assets	Rs.
Secured loans:	5,00,000	Current Assets :	5,80,000
5,000 13% debentures of RS.100 each issued at par		Bank	
		Miscellaneous expenditure	1,00,000
1,000 13% debentures of Rs. 100 each (issued as collateral security)	1,00,000	Debentures Suspense Account	
Loan from bank (Secured by the issue of 1,000 debentures of Rs.100 each)	80,000		

CLASSIFICATION FROM 'CONDITIONS OF REDEMPTION" POINT OF VEIW

Like issue of debentures at part, premium or discount the redemption of debentures can also be :

(a) Redemption at par

(b) Redemption at premium

(c) Redemption at discount

Thus following sets of cases can be formed :

(i) Issue at par, redeemable at par
(ii) Issue at discount, redeemable at par
(iii) Issue at premium, redeemable at par
(iv) Issue at par, redeemable at premium
(v) Issue at discount, redeemable at premium
(vi) Issue at premium, redeemable at premium

The study of above sets clarifies that debentures are redeemable wither at part or premium. How the debentures are to be redeemed in future is provided in the prospect issued by the company at the time of issue. Sometimes a company can also redeem its debentures by purchase from open market. Generally in such cases it is normally seen that company buys them at below the par value, thus making profit on redemption.

Journal entries for issued at part and redeemable at par

(i)	When debentures are issued at par and redeemable at par			
	(a)	Bank a/c To Debenture application and allotment a/c	Dr.	
	(b)	Debenture application and allotment a/c To debentures a/c	Dr.	
(ii)	When debentures are issued at discount and redeemable at par			
	(a)	Bank a/c To Debenture application and allotment a/c	Dr. Dr.	
	(b)	Debenture application and allotment a/c Discount on issue of debentures a/c To Debentures a/c	Dr.	
(iii)	When debentures are issued at premium and redeemable at par			
	(a)	Bank a/c To Debenture application and allotment a/c	Dr.	
	(b)	Debenture application and allotment a/c To Debentures account To premium on issue of debentures a/c	Dr.	
(iv)	When issued at par and redeemable at premium			
	(a)	Bank a/c To Debenture application and allotment a/c	Dr.	With nominal value
	(b)	Debenture application and allotment a/c Loss on issue of debentures a/c To Debentures a/c To premium on redemption of debentures a/c	Dr.	(Nominal value) Difference in issue and redemption price) (Nominal value) (amount of premium)

(v)	When issued at discount redeemable at premium			
	(a)	Bank a/c To Debenture application and allotment a/c	Dr.	With actual amount received
	(b)	Debenture application and allotment a/c Loss on issue of debentures a/c To Debentures a/c To premium on redemption of debentures a/c	Dr. Dr.	(Actual receipt) (Difference in issue and redemption price) (Face value) With premium)

The point to note is that premium on redemption is a personal account because it represent the extra liability which is to be discharged when debentures are redeemed. It is recorded o the liability side of the balance sheet until it is paid off. Since company promises to pay mor at the time of redemption, therefore, there is loss of equal amount which is debited to "los on issue of debentures a/c". This loss on issue of debentures is written off gradually eve year during the life of the debentures. The unwritten off portion appears on the assets side he balance sheet under the head 'Miscellaneous Expenditure" as a fictitious asset.

The mechanism can be explained with the help of following illustrations :

Illustration – 13

Journalise the following transactions :

(i) A debentures issued at Rs. 95 repayable at Rs. 100.
(ii) A debenture issued at Rs. 95 repayable at Rs. 105.
(iii) A debenture issued at Rs. 100 repayable at Rs. 105.
(iv) A debenture issued at Rs. 105 repayable at Rs. 100.

Note : The face value of each debenture is Rs. 100. [C.B.S.E. (Delhi set II]

Solution

Journal

Date	Particulars		L.F.	Debit. Amount Rs.	Credit amount Rs.
(i)	Bank account Discount on issue of debentures a/c To debentures account (Being the issue of a debenture of Rs.100 at a discount of 5%)	Dr. Dr.		95 5	10[illegible]

(ii)	Bank account Loss on issue of debentures account To debentures account To premium on redemption of debentures account (Being the issue of debentures of Rs. 100 at a discount of 5% repayable at a premium of 5%)	Dr. Dr.		95 10	100 5
(iii)	Bank account Loss on issue of debentures account To debentures account To premium on redemption of debentures account (Being the issue of debentures of Rs. 100 at a discount of 5% repayable at a premium of 5%)	Dr. Dr.		100 5	100 5
(iv)	Bank account To debentures account (Being the issue of a debenture of Rs.100 at a premium of 5% repayable at par)	Dr.		105	100 5

Illustration – 14 (Issue at discount redeemed at premium)

P.Ltd., issues 7,000 debentures of rs.100 each at a discount of 10% with the condition that these shall be redeemed at a premium of 5% after the expiry of three years.

Pass the necessary journal entries for the issue and redemption of these debentures after the expiry of three years. (C.B.S.E. 1993)

Solution **Journal of P Ltd.**

		Dr. Rs	Cr. Rs
Bank account To debentures application and Allotment A/c (Being the issue of 7,000 debentures of Rs.100 each at a discount of 10%)	Dr	6,30,000	6,30,000
Debenture Application and Allotment A/c Loss on issue of debentures A/c To debentures A/c The premium on redemption A/c	Dr. Dr.	6,30,000 1,05,000	7,00,000 35,000

Debentures account To premium on redemption of debentures account To debenture-holders account (Being amount due on redemption to debenture-holders).	Dr. Dr.	7,00,000 35,000	7,35,000
Debenture-holders account To Bank account (Being amount due on redemption paid to debenture-holders)	Dr.	7,35,000	7,35,000

Working Note :	Rs.
Loss on issue of debentures	70,000
Discount on issue	35,000
Add: - premium or redemption	1,05,000

Illustration – 15

A company issued Rs., 1,00,000, 15% Debentures at a discount of 5% redeemable after 10 years at premium of 10%. Pass journal entry.

[C.B.S.E. 1991 (Delhi)]

Solution journal

		L.F.	Dr.Rs.	Cr. Rs.
Bank A/c Loss on issue of debentures A/c To 15% debentures To premium payable on redemption of debentures A/c (Being the issue of debentures at discount of 5% and redeemable at a premium of 10%)	Dr. Dr.		95,000 15,000	1,00,000 10,000

Illustration – 16

Journalize the following transactions :

(a) X Ltd. issues Rs. 2,00,000, 12% Debentures at discount of 5% redeemable at pa

(b) Y Ltd. issues Rs. 5,00,000 Debentures at a discount of 5% redeemable at a premiu of 7% [C.B.S.E. 1993 (Delhi) III]

Solution **Journal of X Ltd.**

	Particulars		L.F	Dr.Rs.	Cr.Rs.
(a)	Bank A/c	Dr.		1,90,000	2,00,000
	Discount on issue of debentures A/c	Dr.		10,000	
	To 12% Debentures A/c				
	(Being the issue of 12% Debentures at a discount of 5% redeemable at par)				

Journal of X Ltd.

	Particulars		L.F.	Dr.Rs.	Cr.Rs.
(b)	Bank A/c	Dr.		4,75,000	5,00,000
	Loss on issue of debentures A/c	Dr.		60,000	35,000
	To debentures A/c				
	To premium on redemption of debentures A/c				
	(Being the issue of debentures at discount of 5% and redeemable at a premium of 7%)				

Illustration – 17

You are required to show by means of journal entries how to record the following issues :

(i) A company issued 14,000 debentures of rs.100 each at a discount of 5% to be repaid at par at the end of 5 years.

(ii) A company issued 5,000 debentures of Rs.100 each at a discount of 5% repayable at a premium of 10% at the end of 5 years. [C.B.S.E. (Outside Delhi) (C) 1996]

Solution **Journal**

	Particulars		**L.F.**	**Dr.Rs.**	**Cr.Rs.**
(i)	Bank A/c	Dr.		13,30,000	14,00,000
	Discount on issue of debentures A/c	Dr.		70,000	
	To debentures A/c				
	(Issue of debentures at 5% discount)				
(ii)	Bank A/c	Dr.		4,75,000	5,00,000
	Loss on issue of debentures A/c	Dr.		75,000	50,000
	To debentures A/c				
	To premium on redemption of debentures A/c				
	(Issue of debentures at 5% discount and 10% premium on redemption)				

Illustration – 18 (Issue of debentures – different terms of issue)

Record journal entries in following cases :

(a) Issued Rs. 1,00,000 12% Debentures at par, redeemable at par.

(b) Issued Rs. 1,00,000 12% Debentures at discount of 10%, redeemable at par.

(c) Issued Rs. 1,00,000 12% Debentures at a premium of 5%, redeemable at par.

(d) Issued Rs. 1,00,000 12% Debentures at par, redeemable at 10% premium.

(e) Issued Rs. 1,00,000 12% Debentures at a discount of 5%, redeemable at 5% premium

Also state how you will treat the loss on issue of debentures in books of accounts.

Solution

	Particulars		L.F.	Debit.Rs.	Credit.Rs.
a	Issued at par, redemption at par Bank a/c To debentures application & allotment a/c (Being application money received on debentures)	Dr.		1,00,000	1,00,000
	Debenture application & allotment a/c To 12% debentures a/c (Being application money transferred to debentures account)	Dr.		1,00,000	1,00,000
b	Issued at discount, redemption at par Bank a/c To debentures application & allotment a/c (Being application money received on debentures)	Dr.		90,000	90,000
	Debenture application & allotment a/c Discount on debentures a/c To 12% debentures a/c (Being application money transferred to debentures account and discount charged)	Dr. Dr.		90,000 10,000	1,00,000

c	Issued at premium, redemption at par Bank a/c To debentures application & allotment a/c (Being application money received on debentures)	Dr.		1,05,000	1,05,000
	Debenture application & allotment a/c To 12% debentures a/c To premium on issue of debentures a/c (Being application money transferred to debentures and premium account)	Dr.		1,05,000	1,00,000 5,000
d	Issued at par, redemption at Premium. Bank a/c To debentures application & allotment a/c (Being application money received on debentures)	Dr.		1,00,000	1,00,000
	Debenture application & allotment a/c Loss on issue of debentures a/c To 12% debentures a/c To premium on redemption a/c (Being application money transferred)	Dr. Dr.		1,00,000 10,000	1,00,000 10,000
e	Issued at discount, redemption at premium Bank a/c To debentures application & allotment a/c (Being application money received)	Dr.		95,000	95,000
	Debenture application & allotment a/c Loss on issue of debentures a/c To 12% debentures a/c To premium on redemption a/c (Being application money transferred to debentures account)	Dr. Dr.		95,000 10,000	1,00,000 5,000

Note : Loss on issue of debenture consists of discount on issue and premium payable on redemption. It is a capital loss and will be shown on the asset side on Balance Sheet. It will be written off over a number of years. The balance will continue to appear in Balance sheet.

Interest on Debentures

Interest on debentures is charged to the profit and loss account. While paying the interest on debentures, it is the obligation of the company concerned to deduct the income tax before making payment of interest to debenture-holder. The following journal entries are passed in this connection :

(i)	When interest on debentures is due: Debit interest on debentures A/c Credit income tax account Credit debenture-holders A/c	(with gross amount) (with income tax) (with net amount)
(ii)	When net amount due is paid : Debit debenture-holders Account Credit Bank Account	

Interest on debentures is transferred to the debit side of profit and loss account. Th credit balance of income tax account is shown on the liabilities side of the balance sheet. A and when it is paid to the government this account is debited and bank account will b credited.

Debenture interest given in the tribal balance

The treatment of debentures interest while preparing final accounts must be not carefully especially when it is given less tax at a specified rate. For example, if the tr balance shows "half year's debenture interest less tax at 42% rs.5,800" then the profit a loss account will be debited with the gross amount Rs. 10,000 $\left(i.e., 5{,}8000 \times \frac{100}{58}\right)$ and I 4,200 $\left(i.e., \frac{42}{100} \times 10{,}000\right)$ will be shown in the balance sheet as liability under the head income tax payable account.

Redemption of Debentures

Redemption of debentures refers to the discharge of liability on account of debentu The following three problems require attention when a company wants to redeem debentures.

(a) **Time of redemption of debentures.** Generally debentures are redeemed a expiry of their period by making the payment of the amount promised fro sometimes company may reserve the right in the articles of association to rec the debentures even before the date of redemption either by installments o purchasing them in the open market. Payment of debentures by installment is nc but redemption of debentures by drawing a lot. Sometimes a company does not to serve a notice with the debenture-holders and wants to redeem the deber before the date of redemption. This is possible by purchasing out own debentu the open market. Thus debentures can be redeemed either at the expiry of pe debentures or before the expiry of the period by drawing a lot or by purchasing in the open market before the expiry of the period of debentures.

(b) **Amount to be paid on redemption.** The amount to be paid on redemption of debentures depends on the circumstances of each case. If the debentures are redeemed on the expiry of the period or only during a lot, then the amount to be paid can be either at premium or at par as promised by the company. If the debentures are redeemed by purchasing them in the open market, then the amount to be paid depends on the market quotation, i.e., either at par or at a discount or at a premium. Generally, the companies purchase their own debentures from the market when the debentures are quoted below face value to take the advantages of depressed prices.

(c) **Sources of Finance.** The major sources wherefrom the debentures can be redeemed may be (i) out of profits, (ii) out of capital, 9iii) out of provisions made for redemption and (iv) by converting them into shares or new debentures.

(i) Redemption out of profits

When debentures are redeemed out of profits, the following journal entries will be passed.

(a) Entry for amount paid on redemption

Debit debentures account

Credit Bank

(b) Entry for transfer of profit

Debit profit & loss appropriation account

Credit debenture redemption reserve A/c

(c) When balance of D.R.R. A/c is not required for redemption and is transferred to General Reserve Account

Debit debenture redemption reserve account.

Credit general reserve.

The balance of general reserve is a free reserve and will be available for all purposes.

The effect of redemption of debentures out of profits is that the company withholds a part of the divisible profits from distribution as dividend which may be retained in the business itself as a source of internal financing.

Illustration – 7

On 1st January, 1997, a company issued Rs.20,00,000 14% debentures at 5% discount repayable in five years at par. The company reserved the right to redeem to the extent of Rs.2,00,000 in any year by purchase in the open market. The interest was payable half yearly on 30th June and 31st December and the same was duly paid.

On 31st December, 1997, the company purchased Rs.2,00,000 debentures at a cost of Rs.1,91,000. Pass necessary journal entries in the books of the company upto 31st December, 1997 including closing entries on that date if the above redemption was out of profit. (Adapted B.Com., Madurai)

Solution **Journal entries**

1997			Rs.	Rs.
Jan.1	Bank Account Discount on debentures account To 14% debentures account (Being issue of 14% debentures at 5% discount)			
June 30	Interest on debentures account To bank account (Being interest paid for half year on Rs.20,00,000 debentures @ 14% p.a. for half year)			
Dec.31	Interest on debentures account To bank account (Being alf year on Rs.20,00,000 debentures @ 14% p.a. for half year)			
Dec.31				
Dec.31				
Dec.31				
Dec.31				

(ii) Redemption out of Capital

If debentures are redeemed out of capital, no amount of divisible profit is kept aside for redeeming debentures. Profits are not utilized for redemption of debentures and may go to the shareholders by way of dividends. Redemption out of capital reduces the liquid resources available to the company. Therefore, a company may adopt this method only when it has sufficient funds.

According to the guidelines issued by SEBI, a company has to create Debenture Redemption Reserve equivalent to 50% of the amount of debenture issue before redemption of debenture commences. Thus, according to this provision redemption of debentures wholly out of capital is now not possible. However, creation of debenture Redemption Reserve is not required in the following cases:

(i) Debentures with a maturity of 18 months or less.

(ii) Fully convertible debentures. Incase of partly convertible debentures, Debenture Redemption Reserve is to be created for the non-convertible part in the same way as applicable for fully non-convertible debentures.

When debentures are redeemed out of capital the following journal entry is made:

Debit Debentures Account

Credit Bank.

When debentures are reduced out of capital, nominal value of debenture redeemed is not transferred from profit and Loss Appropriation Account or Debenture Redemption Reserve Account to General Reserve.

Sometimes instead of passing one entry given above, the following two entries are passed:

(a) Debit Debentures Account
Credit Debenture-holders

(b) Debit Debenture-holders A/c
Credit Bank.

This method is preferable, as it does not mix up the amount unpaid to debenture-holders with the debentures account.

Illustration – 8

A Company on 31st December 1996 redeemed Rs. 10,000 6% debentures out of capital by drawing a lot. Similarly, the company on 31st December 1997 redeemed Rs. 15,000 6% debentures out of profits by drawing a lot. You are required to pass journal entries in the books of a company.

Solution

Journal entries

			Rs.	Rs.
1996 Dec.31	6% debentures account To Bank Account (Being the redemption of debentures out of capital)	Dr.	10,000	10,000
1997 Dec.31	6% debentures account To Bank Account (Being the redemption of debentures out of profit)	Dr.	15,000	15,000
	Profit & loss appropriation account To debenture redemption reserve account (Being the transfer of profit to debenture redemption reserve account)	Dr.	15,000	15,000

Illustration – 9

On 1st April, 1994, a company issued 1,000 6% debentures of Rs. 1,000 each at Rs.950. Terms of issue provided that beginning with 31st March, 1997 Rs.50,000 of debentures should be redeemed either by drawings at part or by purchase in eh market every year. The expenses of the issue amounted to Rs.3,000 which were written off on 31st March, 1995. The company wrote off Rs.10,000 from the discount on debentures every year. On 31st March, 1997 the debentures to be redeemed were repaid at the end of the year by drawings. On 31st March, 1998 the company purchased fro cancellation 50 debentures at the ruling price o rs.980, the expenses being Rs.100. Interest is payable yearly, Ignore income-tax.

Give Journal entries and the Balance sheet (as far as it relates to debentures) on 31st march, 1998.

Solution

Journal entries

			Rs.	Rs.
1994 April 1	Bank A/c Discount on debentures A/c To 6% debentures A/c (issue of 1,000 6% debentures of Rs.1,000 each at Rs.950)	Dr. Dr.	9,50,000 50,000	10,00,000
April 1	Debentures Issue expenses A/c To Bank Account (Rs.3,000 incurred on the issue of debentures)	Dr.	3,000	3,00
1995 Mr.31	Profit % loss account To debenture issue expenses A/c To discount on debentures A/c (Being the debenture issue expenses and discount on debentures written off)	Dr.	13,000	3,00 10,00
Mar.31	Interest on debentures A/c To Bank (Interest due on debentures for one year paid)	Dr.	60,000	60,0
1996 Mar.31	Interest on debentures A/c To Bank (Interest on debentures due for one year paid)	Dr.	60,000	60,0

Mar.31	Profit & loss A/c To discount on debentures A/c (Amount written off of discount on debentures)	Dr.	10,000	10,000
1997 Mar.31	Interest on debentures A/c To Bank (Interest on debentures due for own year paid)	Dr.	60,000	60,000
Mar.31	*Profit & loss Account* To discount on debenture A/c	Dr.	*10,000*	*10,000*
Mar.31	6% debentures A/c To Bank (Redemption of debentures worth Rs.50,000 by drawing at par)	Dr.	50,000	50,000
1998 Mar.31	6% debentures A/c To profit on redemption of debentures A/c To Bank (for the purchase of 50 debentures in the market at Rs.980 plus Rs.100 for expenses)	Dr.	50,000	900 49,100
Mar.31	Interest on debentures A/c To Bank (Interest @ 6% on Rs.950,000 for one year)	Dr.	57,000	57,000
Mar.31	Profit on redemption of debentures A/c Profit and loss account To discount on debentures A/c (The writing off Rs.10,000 out of debentures discount and also utilization of profit for the same purspose)	Dr. Dr.	900 10,000	10,000

Balance sheet as on March 31, 1998

900 6% debentures of Rs.1,000 each	Rs. 9,00,000	Discount on debentures	Rs. 9,100

Illustration – 10

On 1st April 1996 Naveen Ltd. made an issue of 50,000 12% debentures of Rs.1,000 each at Rs.980 per debenture. The terms of issue provided for the redemption of Rs.50,00,000 debentures every year commencing from 1997-98 either by purchase or by drawing lots at part, at the company's option. Profit on redemption, if any, is to be transferred to capital reserve account. The company's accounting year ends on 31st March. Interest on debentures is payable on 30th September and 31st March.

During the year 1997-98, the company wrote off Rs.1,00,000 from debentures discount account. During the same financial year, the company purchased fro cancellation debentures of the face value of:

(i) Rs.30,00,000 at Rs.960 per debenture on 30.09.1997.

(ii) Rs.20,00,000 at Rs.970 per debenture on 31.03.1998.

Show how these items will appear in the financial statements for the year ending 31st March 1998. Also show corresponding figures for the previous year ending 31st March 1997.

Solution. Some Basic Calculations

(1) Interest on debentures for the year ending 31st March 1997

On 50,000 debentures of Rs.1,000 each i.e., Rs.50,00,000 face value debentures @ 12% p.a. = Rs.60,00,000

(2) Interest on debentures for the year ending 31st March 1998

On Rs.50,00,000 debenture @ 12% p.a. for 6 months ending 30 September, 1997 Rs.30,00,000

On Rs.4,70,00,000 @ 12% p.a. for 6 months ending

31st March, 1998 Rs.28,20,000

Interest for the financial year 1997-97 Rs.58,20,000

(3) Calculation of profit on cancellation of debentures

On Rs.30,00,000 @ Rs.40, per

Rs. 1,000 $i.e. 30,00,000 \times \frac{40}{1,000}$ 1,20,000

On Rs.20,00,000 @ Rs.30 per

Rs.1,000 $i.e. 20,00,000 \times \frac{30}{1,000}$ 60,000

Total profit on cancellation of debentures 1,80,000

(4) Discount on issue of 50,000 debentures @ Rs.20 10,00,000

Balance sheet of Naveen Ltd. as on 31st March, 1998 (Extracts)

31.3.97	Liabilities	31.3.98	31.3.97	Assets	31.3.98
Rs.	Reserves & surplus Capital reserve secured loans 12% debentures	Rs.	Rs.	Miscellaneous Expenditure (to the extent not written off) Discount on Issue of Debentures	Rs.
5,00,00,000		1,80,000 4,50,00,000	10,00,000		9,00,000

Profit and loss account of Naveen Ltd for the year ending 31st March 1998 (Extracts)

1996-97		1997-98	1996-97		1997-98
Rs.	To interest on debentures	Rs.	Rs.		Rs.
60,00,000		58,20,000			

(iii) Redemption by conversion

Sometimes the debenture-holders of a company are given the option to convert their debentures into the shares or new debentures within a stipulated period. Such option is exercised by the debenture-holders only when they are very sure about the progress of the company. The new shares or debentures can be issued either at part or at a premium of at a discount. The following entry will be made :

Debit old debentures account

Debit discount on the issue of share/debentures

Credit new share capital/debentures account

Credit premium on the issue of share/debentures.

Illustration – 11

On 1st April, 1997, Y Ltd. issued 800 12% debentures of rs.1,000 each at Rs.950 each. Debenture-holders had an option to convert their holdings into 6% preference shares of Rs.100 each at a premium of Rs.25 per share. On 31st March, 1998, one year's interest had accrued on these Debentures which was not paid. A holder of 50 debentures notified his intention to convert his holding into 13% preference shares.

Journalise the above transactions and draw the company's Balance sheet as at 31st March, 1998.

Solution

Journal entries

			Rs.	Rs.
1997 Apr.1	Bank A/c Discount on issue of Debentures A/c To 12% debentures A/c (Issue of 800, 12% debentures of RS.1,00 at Rs.950 each)	Dr.	7,60,000 40,000	8,00,000
1998 Mar.31	Interest on debentures A/c To sundry debenture-holders of the year ended 31.31998	Dr.	96,000	96,000
	12% debentures A/c To 13% preference share capital A/c To securities premium A/c (Conversion of 50 debentures to 400 13% preference shares of Rs.100 each at a premium of Rs.25 per share)	Dr.	50,000	40,000 10,000
	Sundry debenture-holders A/c To Bank A/c (Interest on 50,12% debentures paid on conversion)	Dr.	6,000	6,000
	Profit & loss A/c To interest on debentures A/c (Interest on debenture transferred to p. % l. A/c)	Dr.	96,000	96,000

Balance sheet as on 31st March, 1998

Liabilities	Rs.	Assets	Rs.
Share capital :		Bank (7,60,000 – 6,000	7,54,000
400 13% preference		Discount on issue of debentures	40,000
Shares of Rs. 100 each	40,000	Profit & loss account	96,000
750 12% debentures of Rs.1,000 each	7,50,000		
Sundry debenture-holders	90,000		
Securities premium	10,000		
	8,90,000		8,90,000

Illustration – 12

The summarized Balance sheet of X Ltd. as on 31st March, 2000 was as follows :

Liabilities	Rs.	Asses	Rs.
Share Capital		Goodwill	40,00,000
40,000 13% redeemable		Fixed assets	82,60,000
Preference shares of		Stock	90,00,000
Rs.100 each fully paid	40,000	Sundry debtors	43,00,000
Up redeemable at par		Discount on debentures	2,40,000
8,00,000 Equity shares of	80,00,000		
Rs. 10 each fully paid up	1,20,00,000		
12% debentures			
(Redeemable at par)	60,00,000		
Profit & loss A/c	50,00,000		
Bank loan	.10,00,000		
Sundry creditors	18,00,000		
	2,58,00,000		2,58,00,000

The company decided to redeem the preference shares and debentures and in due course offered to the preference shareholders and debenture-holders the option to convert their holdings into equity shares which are to be treated as worth Rs.12.50 each. One half of the preference shareholders and one third of the debenture-holders (in value) agreed to accept the offer.

The company issued 6,00,000 equity shares of Rs.10 each @ Rs.12.50 to the public for cash and with the proceeds of such issue, paid off the bank loan and redeemed the remaining preference shares and debentures.

Solution

In the books of X Ltd.

Journal entries

2000	12% debentures A/c	Dr.	Rs.	Rs.
March 31	To 12% debenture-holders A/c		60,00,000	60,00,000
	(Being amount payable n redemption of 12% debentures)			

	13% Redeemable preference share capital A/c to 13% Redeemable preference shareholders A/c (Being amount payable on redemption of 13% preference shares)	Dr.	40,00,000	40,00,000
	12% debenture-holders A/c 13% preference shareholders A/c To equity share capital A/c To securities premium A/c (Being the conversion of Rs.20,00,000 debentures and Rs.20,00,000 preference shares into equity shares of Rs.10 each issued at a premium of Rs.2.50 per share)	Dr. Dr.	20,00,000 20,00,000	32,00,000 8,00,000

(iv) Redemption out of provision

It si always a wise policy for the company to made arrangements in advance to rep the known liability for redemption of debentures. This can be done by making provisi otherwise it will be difficult for the company to arrange lumpsum to repay debts. This possible by adopting either the sinking fund method or insurance policy method.

Sinking Fund for redemption of debentures

Debentures are to be paid on a specified date. It si desirable to make some arrangem for their redemption otherwise it will be very difficult for the company to pay the lumpsum the time when the redemption is due. The best method is to create sinking fund for purpose. This method resembles with that of depreciation fund method.

To recapitulate, the following entries will be passed :

At the end of the 1st Year

(i) For the amount set aside every year

Profit & loss appropriation account Dr.

To Sinking fund account

Or

Debenture redemption fund account

(ii) For amount kept aside for redemption invested in securities

Sinking fund investment account Dr.

Or

Debenture redemption fund investment account Dr.

To Bank.

At the end of 2nd and Subsequent Year

(i) For interest received on investment

Bank Account Dr.

To interest on Sinking fund investment A/c

(ii) For interest transferred to Sinking fund

Interest on Sinking fund investment account Dr.

To Sinking fund account

(iii) For annual amount set aside

Profit & Loss appropriation account

To Sinking fund account

(iv) For annual instalment plus interest invested in securities

Sinking fund investment A/c Dr.

To Bank

At the end of last year (when debentures are to be redeemed)

All the entries except entry (iv) in second and subsequent year should be passed. Entry (iv) is not passed as debentures are to be redeemed so no investment will be made rather the securities will be sold.

(i) For amount realized on the sale of securities

Bank A/c Dr.

To Sinking Fund investment A/c

(ii) For profit on sale of investment
Sinking Fund investment A/c Dr.
To Sinking fund account

Note. Reserve entry will be made if there is a loss on sale of investment.

(iii) For amount paid to debentureholders to redeem the debentures
Debentures A/c Dr.
To Bank

(iv) For balance of Sinking fund transferred to
general reserve account Sinking fund A/c Dr.
To general reserve

Illustration – 15

On 1st April, 1993, Metal products Ltd. issued debentures for Rs. 1,00,000 redeema at part at the end of 5 years and it was resolved that a Sinking fund should be formed a invested in tax-fee securities.

Give journal entries for 5 years, assuming that the interest received on the investme was at the rate of 5 per cent on cost, that the interest was received yearly and immediat invested and that the investments were realized at a loss of Rs.300 at the end of five yea

Reference to the Sinking fund table shows that Re.0.180975 invested at the end year at 5% compound interest will produce Re. 1 at the end of 5 years.

Solution

For one rupee, the annual amount required is Re.0.180975

∴ For Rs. 1,00,000, the annual amount required is, 180975 x Rs.1,00,000 = Rs.18,098 (near rupee).

Journal

1993			Rs.	Rs.
April.1	Bank Account To debentures account (Being issue of rs.1,00,000 debentures at par)	Dr.	1,00,000	1,00,00
1994 Mar.31	Profit and loss appropriation account To sinking fund account (Being the annual sum required to provide for the redemption of debentures).	Dr.	18,098	18,098
Mar.31	Sinking fund investment account To bank account (Being amount invested in tax-free securities to the nearest hundred rupees)	Dr.	18,100	18,100
1995 Mar.31	Bank Account To interest on sinking fund Investment A/c (Being interest received on investments Rs.18,100 @ 5% p.a. for one year)	Dr.	905	905

Mar.31	Interest on sinking fund investment account To sinking fund account (Being transfer of interest to sinking fund)	Dr.	905	905
Mar.31	Profit and loss appropriation account To sinking fund account (Being provision of annual installment for redemption of debentures)	Dr.	18,098	18,098
Mar.31	Sinking fund investment account To Bank Account (Being annual installment Rs.18,098 plus interest Rs.905 invested in securities to the nearest hundred rupees)	Dr.	19,000	19,000
1996 Mar.31	Bank Account To interest on sinking fund investment A/c (Being interest received on investment Rs.18,100 + Rs.19,000@ 5% for year)	Dr.	1,855	1,855
Mar.31	Interest on Sinking fund investment A/c To sinking fund account (Being interest on investment transferred)	Dr.	1,855	1,855
Mar.31	Profit and loss appropriation account To sinking fund account (Being provision of annual installment for redemption of debentures)	Dr.	18,098	18,098
Mar.31	Sinking fund investment Account To bank Account (Being annual installment Rs.18,098 plus interest Rs.1,855 invested in securities to the interest hundred rupees)	Dr.	20,000	20,000
1997 Mar:31	Bank account To interest on sinking fund Investment A/c (Being interest received on investments Rs.18,100	Dr.	2,855	2,855

Mar.31	Interest on sinking fund investment account To sinking fund account (Being interest on investment transferred)	Dr.	2,855	2,855
Mar.31	Profit and loss appropriation account To sinking fund account (Being provision of annual sum for redemption of debentures.	Dr.	18,098	18,098
Mar.31	Sinking fund investment account To Bank account (Being annual investment Rs.18,098 plus interest Rs.2,855 invested in securities to the nearest hundred rupees)	Dr.	21,000	21,000
1998 Mar.31	Bank Account To interest on sinking fund investment A/c (Being interest received on investments 9Rs.18,100 + Rs.19,000 + Rs.20,000 + Rs. 21,000 =Rs.78,100) @ 5% for one year)	Dr.	3,905	3,905
Mar.31	Interest on sinking fund investment account To sinking fund account (Being transfer of interest on investments)	Dr.	3,905	3,905
Mar.31	Profit and loss appropriation account To sinking fund account (Being provision of annual installment for redemption of debentures)	Dr.	18,098	18,09
Mar.31	Bank Account To sinking fund investment Account (Being amount realized on sale of investment – Rs. 78,100 – Rs.300 loss = Rs.77,800	Dr.	77,800	77,80
Mar.31	Sinking fund account To sinking fund investment account (Being loss on sale of investments transferred)	Dr.	300	300

Mar.31	Debentures Account To Bank Account (Being redemption of Rs.1,00,000 debentures at par)	Dr.	1,00,000	1,00,000
Mar.31	Sinking fund account To general reserve (Being balance of sinking fund transferred to general reserve on redemption of debentures)	Dr.	99,710	99,710

Note It is assumed that investments have been made in multiples of hundred.

Insurance policy method

Sinking fund insurance policy can also be taken to make provision for redemption of debentures. Under this method a fixed amount of premium is paid every year to the insurance company which in turn agrees to pay the necessary amount for redemption of debentures at the end of a specific period.

Journal Entries

First year

(i) For amount of premium appropriated from profit and loss account

Profit and loss appropriation account Dr.

To debentures redemption fund A/c

(ii) For amount of premium paid to insurance company

Debenture redemption fund policy A/c Dr.

To Bank

Note. These entries will be passed every year including the last year also.

The following entries will also be passed at the end of the specific period on realization of the policy :

(i) For the amount received from insurance Co.

Bank account Dr.

To redemption fund policy A/c

(ii) For he balance of debenture redemption fund policy account (excess amount received) – transferred to debenture redemption fund account

Debenture redemption fund policy A/c Dr.

To debenture redemption fund A/c

(iii) For amount paid to debenture-holders
Debentures A/c Dr.
To Bank

(iv) For balance of debenture redemption of und account transferred to general reserve
Debenture redemption fund account Dr.
To general reserve

Illustration – 18

A limited company has made an issue of Rs.5,00,000 9% debentures on 1st Ap 1996, the terms of which include that the company must take a 4 years Sinking fund insurar policy for the redemption of debentures at a premium of 5%. The annual premium Rs.1,15,000. The value of the policy increases each year by 6%.

Give the necessary Ledger Accounts to record the above transactions for 4 year.

Solution

Sinking fund account

1997		Rs.	1997		Rs.
Mar.31	To balance c/d	1,21,900	Mar.31	By profit & loss app. Account	1,15,000
			Mar.31	By sinking fund insurance policy account	
				$\left(1,15,000 \times \frac{6}{100}\right)$	6,900
		1,21,900			1,21,900
1998		Rs.	1997		Rs.
Mar.31	To balance c/d	1,51,114	April 1	By Balance b/d	1,21,000
			1998		
			Mar.31	By profit & loss App. Account	1,15,000
			Mar.31	By sinking fund insurance policy account (Int.)	
				$\left(2,36,900 \times \frac{6}{100}\right)$	14,214

		1,21,900			1,51,114
1999			1998		
Mar.31	To Balance c/d	3,88,081	April 1	By Balance b/d	2,51,114
			1999		
			Mar.31	By profit & loss App. Account	
			Mar.31	By sinking fund insurance policy account (Int.)	
				$\left(3,66,114 \times \frac{6}{100}\right)$	21,967
		3,88,081			3,88,081
2000			1999		
Mar.31	To premium on Redemption of Debenture A/c		April 1 2000 Mar.31	By Balance b/d By profit & loss App. Account.	
	$\left(5,00,000 \times \frac{5}{100}\right)$	25,000	Mar.31	By Sinking fund Insurance policy account (Int.)	
Mar.31	To General reserve A/c	5,08,266 5,33,266		$\left(5,03,081 \times \frac{6}{100}\right)$	30,185 5,33,266

Sinking fund insurance policy account

1996		Rs.	1997		Rs.
April 1	To Bank Account	1,15,000	Mar.31	By Balance c/d	1,21,900
1997					
Mar.31	To sinking fund Account (Int.)	6,900			
		1,21,900			1,21,900
1997			1998		
April 1	To Balance b/d	1,21,900	Mar.31	By Balance c/d	2,51,114

April 1	To Balance b/d	1,21,900	Mar.31	By Balance c/d	2,51,11
April 1	To Bank Account	1,15,000			
1998					
Mar.31	To sinking fund A/c (Int.)	14,214			
		2,51,114			2,51,11
1998			1999		
April 1	To Balance b/d	2,51,114	Mar.31	By Balance c/c	3,88,08
April 1	To Bank Account	1,15,000			
1999					
Mar.31	To sinking fund Account (Int.)	21,967			
		3,88,081			3,88,08
1999			2000		
April 1	To Balance b/d	3,88,081	Mar.31	By bank Account	5,33,26
April 1	To Bank Account	1,15,000			
2000					
Mar.31	To sinking fund account (Int.)	30,185			
		5,33,266			5,33,26

6% debenture account

2000		Rs.	1996		Rs.
Mar.31	To Bank Account	5,00,000	April 1	By Bank Account	5,00,000

Premium on redemption of debentures account

2000		Rs.	2000		Rs.
Mar. 31	To Bank Account	25,000	Mar. 31	By sinking fund A/c	25,0

QUESTIONS

1. Which of the following statements are correct :

(a) A debenture-holder is an owner of the company.

(b) Debenture-holders get their money back only on the liquidation fo the company.

(c) Debenture-holders will be entitled to get interest even if there is loss to the company.

(d) Debenture need not be fully paid whereas debenture stock must be fully paid.

(e) Debentures can be issued at a discount and can be redeemed at a premium.

(f) Premium on debentures and premium on redemption of debentures convey the same meaning.

Ans. [Correct : (c); (d); (e)].

2. State whether the following statements are true or false :

(a) After the redemption of all debentures, the balance in the sinking fund is transferred to general reserve.

(b) Profit on sale of sinking fund investments is to credited to debentures account.

(c) Interest on debentures is payable only when a company makes profits.

(d) Interest on sinking fund investment is credited to profit and loss account.

(e) Own debentures account will appear on the assets side of the balance sheet.

(f) If debentures are redeemed out of capital, entry for the transfer of profits to debenture redemption reserve account is not passed in the books.

(g) First debentures are those which are repaid before other debentures are paid out.

(h) Registered debentures are those, which are transferable by mere delivery.

(i) A company cannot buy its own debentures.

(j) In case of debentures if the quotation is cum-interest it means that it is with interest and for recording purpose interest is added to the total price paid.

Ans. [True : (a); (e); (f); (g), False: (b); (c; (d);(h); (i); (j)].

3. What do you understand by a debentrure ? Describe briefly the different types of debentures.

4. What is debenture stock /

5. Distinguish between : (i) a debenture and a share, and (ii) debenture and debenture stock.

6. Give different considerations for which debentures may be issued.

7. Write notes on : (i) Debentures Discount, (ii) Debentures as Collateral Security, Interest on Debentures, (iv) Ex-interest nad Cum-interest, (v) Own Debentures.

8. Discuss the various journal entries which are passed in the books of a company w provision is made through sinking fund or insurance policy for the redemptio debentures.

9. What are the various methods of redemption of debentures?

10. What are the alternatives available for making the provision for redeeming debentur Is it necessary to make such provision ?

11. Explain (i) redemption of debentures out of capital and (ii) redemption of debentu out of profit.

PRACTICAL PROBLEMS

1. A limited company issued 1,000 debenture bonds of rs.100 each at a premium o per cent repayable at part at the end of the 10th year. The debenture bonds w payable 25 per cent on application, 35 per cent on allotment (including the premi and the balance on first and final call. All the moneys were received by the comp in due course.

   You are asked to journalise the above transactions in the books of the company.

2. A limited company issued Rs.1,00,000 debentures, which were issued as follows

		Rs.
1.	To sundry persons for cash at 90 per cent	50,000 nominal
2.	To a creditor for rs.20,000 capital expenditure in satisfaction of his claim	25,000 nominal
3.	To bankers as collateral security	25,000 nominal

The issue (1) and (2) are redeemable at the end of 10 years at par. How should debentures be dealt with in preparing the balance sheet of the company ?

1. Naveen Ltd. Issued Rs.1,00,000 10 per cent debentures on 1st January, 1994 at disc of 5 per cent repayable in annual drawings of rs.25,000 commencing from December following. The company's year ends on 31st December. Journalize the ab transactions for four years ending 31st December 1997, assuming that the comp decided to write off debenture discount account during the life of the debentures

Ans. [Debenture Discount A/c written off : 1994 Rs.2,000; 1995; 1996 rs. 1,000; 1997 Rs.5

2. A company issues Rs.1,00,000 10 per cent debentures on 1st April, 1994 at a disc of 5 percent repayable in annual drawings of Rs.25,000 each on 31st March e year. Calculate the amount of discount to be written off each year. The financial of the company ends on 31st December each year.

3. (a) A limited co. issued 2,000 10% debentures of Rs.100 each at Rs.95 on 1.1.91. As per the terms of issue, debentures are to be redeemed at the end of 5 years. Show the amount of the discount to be written off to the profit and loss account every year.

(b)A company purchases assets of Rs.2,60.000 and liabilities of Rs.50,000 for a sum of Rs.2,00,000. The purchase consideration is satisfied by the issue of 9% debentures of Rs.100 each at par. Journalize.

(a) A company issued 20,000 10% debentures of Rs.100 each at a discount of 5% repayable after 10 years at a premium of 5%. Pass necessary journal entries.

Ans. [(a) rs.2,000; (b) Capital Reserve Rs.10,000; (c0 Loss on issue of debentures rS.2,00,000]

4. A company issued 5,000 debentures of Rs.100 each at par on 1st January 1995 redeemable at par on 31st December 1999. a sinking fund was established for the purpose. It was expected that investments would earn 5% net. Sinking fund tables show that Re.0.180975 amount to Re.1 at the end of 5 years @ 5%. On 31st December, 1999 the investments realized Rs.3,90,000. On that date the company's bank balance stood at Rs.1,45,600. The debentures were duly redeemed. Give the necessary journal entries, ledger accounts and assume that the investments were made to the nearest Rs.10.

5. In the Balance Sheet of a company, the discount on debentures shows a debit balance of Rs.15,000. Every year Rs.5,000 is charged off to profit and loss account. How will you show the discount on debentures account at the end of the first year and second year in the balance sheet of the company ?

Ans. [Discount on Debentures account balance at the end of: 1st year Rs.10,000; 2nd year rs.5,000 to be shown on the Assets side under the heading of Miscellaneous expenditure (to the extent not written off)]

6. On 1st January, 1994, a company made an issue of 5,000 5% debentures of Rs.100 each at Rs.90 per debenture. The terms of issue provided for redemption of Rs. 20,000 debentures every year commencing from 1995 either by purchase or by drawing at part or at the company's option. Rs.5,000 was written off the debenture discount account in 1994 and 1995. During the year 1995, the company purchased for cancellation debentures of the face value of rs.6,000 at Rs.94 per debenture and rs.14,000 at Rs.92 debenture. Pass journal entries.

7. A limited issues 10,000 14% debentures of rS.100 each at 98 on January 1, 1992. Under the terms of issue (a) debenture interest is annually payable on 31st December every year, and (b) one fifth of the debentures are annually redeemable by drawings, the first redemption occurring on 31st December, 1993.

Ans. [Balance in debentures account on 31.12.94 Rs.6,00,000; Balance in discount on issue of debentures account on 31.12.94 Rs.6,000; Interest on debentures:1992

Rs.1,40,000; 1993 Rs.1,40,000; 1994 Rs.1,12,000; discount on issue of debentures writt
off: 1992 Rs.5,000; 1993 Rs.5,000; 1994 Rs.4,000].

8. A company issued Rs.2,00,000 6% debentures of rs.1000 each at par, repayable the end of 5 years at a premium of 5%. In terms of the trust deed, a sinking fund wa to be created for the purpose of accumulating sufficient fund for the purpos Investments were made yielding 5% interest received at the end of each year. investments, including reinvestments of interest received, were made at the end the year.

   You are required to show, for 5 years, the –

   (a) Sinking Fund Account; and

   (b) Sinking Fund Investment Account

Note. [Rs.2,71462 invested at the end of each year at 5 per cent compound interest w amount to Rs.15 at the end of 5 years].

9. The debenture redemption fund account of a limited company stood at Rs.1,60,00 represented by rs.2,00,000 (nominal) investments. The debentures stood Rs.5,00,000 and the company sold Rs.24,000 investments at Rs.85 for the purpos of redeeming Rs.20,000 debentures at 102.

   Show ledger accounts ignoring interest etc.

Ans. [Profit on Sale of Investments Rs.1,200].

10. On 31st March, 1995, the Alka Trading Company Ltd. had a debenture redemptic fund of rs.5,00,000 represented by the investment amounting to Rs.5,90,000. Th company has bank balance on 30th September, 1995 of rs.60,000. The debenture amounting to rs.5,00,000 were paid off on 30th September 1995. The security wa sold for this purpose and realized 83% net and the proceeds were banked on 30 September 1995. Record the above transactions in company's ledger.

Ans. [Balance in Bank A/c Rs.49,700/-].

11. A company had rs.8,00,000 5% debentures outstanding as on 1st January, 199 redeemable on 31st December, 1995. On that day, sinking fund was Rs.7,49,00 represented by Rs.1,00,000 own debentures purchased at the average price of rs.9 and Rs.6,60,000 3% stock. The annual installment was Rs.28,400.

    On 31st December, 1995, investments were realized at Rs.98 and the debenture were redeemed.

    You are required to write up the accounts for the year 1995.

    Ans. [Profit on Cancellation of own Debentures Rs.1,000; Loss on Sale of 3 Stock Rs.3,200,k Balance of Sinking Fund Account transferred to General Reser Rs.7,99,000].

UNIT - I
LESSON – 2
ACCOUNTING FOR DEBENTURE

Students till now we have discussed the issue of shares and redemption of preference shares. But there is another vital security like debentures which is issued to raise funds in the form of a debt which is widely used in practice.

1. Meaning of debenture
2. Types of debenture
3. Issue of debentures
4. Interest on debenture
5. Redemption of debenture
6. Review exercise.

MEANING OF DEBENTRUE – A debenture is a written acknowledgement of debt by a company under its common seal. Interest is paid to debenture holders at a fixed rate at regular intervals.

TYPES OF DEBENTURES – Debentures may be classified from different point of view :

(1) From security point of view : debentures may be classified as

 (a) Naked or simple debentures

 (b) Mortgage debentures

Naked or simple debentures : The debentures which do not carry any security in respect of payment of interest or repayment of principal amount is called as naked or simple debentures.

Mortgage debentures : The debentures which are secured by a charge on the assets or properties of the company are called as mortgage debentures. The debenture holders have the right to recover their principal amount as well as unpaid interest out of the assets mortgaged by the company.

(2) From permanence point of view : from this point of view the debentures may be classified as :

 (a) Redeemable debentures

 (b) Irredeemable debentures

Redeemable debentures : These debentures provide for the payment of principal amount on the expiry of a certain period. Redeemable debentures can be reissued even after they have been redeemed until they have been cancelled.

Irredeemable debentures : these debentures are retained as a part of the permanent capital structure of the company. They are also known as perpetual debentures. They are not refundable during the lifetime of the company. Such debt becomes due for payment only when the company goes into liquidation or when the payment of interest is not made regularly. The company has the option of canceling its liability to the debenture holders at any time by giving due notice to them.

(3) From priority point of view : The debentures may be classified as

(a) First debentures

(b) Second debentures

First debentures : The debentures which are paid first before any payment is made to another type of debentures are known as first type debentures.

Second debentures : The debentures which are paid after making the payment of firs debentures is known as second debentures.

(4) From recording point of view : Debentures maybe classified as

(a) Bearer debentures

(b) Registered debentures

Bearer debentures –

The debentures, which are transferable to another bearer without endorsement ar they are just, like bearer cheques or government currency notes are called as beare debentures.

Registered debentures –

The debentures, which are transferable to another bearer with endorsement and followi some legal formalities, are known as registered debentures.

DISTINCTION BETWEEN DEBENTURES AND SHARE

	DEBENTRUE		SHARE
1.	A person investing money in debentures is called debenture holder.	1.	A person investing money in shares is called shareholders.
2.	Debenture holder is a creditor of the company.	2.	Shareholder is a owner of a company.
3.	A debenture holder cannot participate in the management of the company.	3.	A shareholder has costing power so he can participate in the management of the company.
4.	A debenture holder gets interest on debenture and is paid in all circumstances whether there is profit or less.	4.	A shareholder gets dividend on shares and is paid if there is any profit.
5.	Debentures can be converted into shares.	5.	Shares cannot be converted into debentures.
6.	Debenture holders will get priority in getting the money back at the time of liquidation.	6.	Share holders are paid after satisfying to the debenture holders.
7.	There are no restriction on issue of debentures at a discount.	7.	The share can be issued at a discount only after fulfilling certain legal formalities.
8.	There can be mortgaged debentures.	8.	Btu there can be no mortgaged shares.
9.	Debentures can be issued as collateral security by a company.	9.	Shares cannot be issued as collateral security by a company.
10	Debentures are generally redeemed within a fixed period of time.	10.	Share cannot be redeemed during the life period of the company.

Distinction between debentures and debenture stock

1.	Debentures need net be fully paid up	1.	Debenture stock must be fully paid up.
2.	Debenture can be transferred wholly but not in fraction	2.	Debenture stock can be transferred in fraction also.
3.	Debentures are identified by their distinct numbers	3.	Debenture stock is not identified by any distinct number.

STATES FOR DEBENTURE :

The following are the main stages of issuing debentures :

(i) Issue of debentures

(ii) Creation of issue for redemption of debentures

(iii) Redemption of debentures.

ISSUE OF DEBENTURES :

Debentures may be issued from different point of view :

1. Debentures issued for consideration
2. Debentures issued for price
3. Debentures issued from redemption point of view :

From consideration angle the debentures can be issued

(a) For cash

(b) In consideration other than cash

(c) Issued as collateral security

Debenture issued fro cash

The debentures may be issued at par, at a premium, or at a discount. The followin entries are passed in connection with the issue of debentures :

1.	On receipt of application money Bank A/c To debenture application A/c (Being application money received on ......debentures @ Rs. per debentures	Dr.
2.	On allotment the application money on debentures allotted is transferred to debentures account : Debenture application A/c To debentures A/c (For the transfer of application money on debentures allotted to debentures account)	Dr.
3.	Refund application money on rejected applications Debenture application A/c To Bank A/c (For refund of the application money on rejected application)	Dr.

4.	Transfer of excess application money to debenture allotment account : Debenture application A/c To debenture allotment A/c (For transfer of excess application money to debenture allotment A/c)	Dr.
5.	Amount due on allotment money Debenture allotment A/c To debentures A/c (For allotment money due on .... Debentures Rs. per debenture)	Dr.
6.	Receipt of allotment money : Bank A/c To debenture allotment A/c (For debenture allotment money received)	Dr.
7.	For debenture 1st call money due Debenture 1st call A/c To debenture A/c (For debenture 1st call money due)	Dr.
8.	For debenture 1st call money received : Bank A/c To debenture 1st call money (For debenture 1st call money received).	Dr.

Entries similar to 1st entries will be passed for the debenture second call money due and debenture 2nd call money actually received.

ISSUE OF DEBENTURES FROM POINT OF VIEW OF PRICE :

From this point of view there are three different situations :

(a) Debentures issued at par

(b) Debentures issued at discount

(c) Debentures issued at premium

Debentures issued at pair

Debentures are said to be issued at par when the amount collected for it is equal to the nominal value (face value0 of the debentures, for example the debentures of Rs.100 each issued at R.100.

Illustration – 1

X Ltd. issued 20,000 12% Debentures of Rs.100 each payable :

Rs.20 on application; Rs.40 on allotment; and the balance two months after allotment.

The public applied for 28,000 debentures. Applications of 18,000 debentures were accepted in full; applicants for 4,000 debentures were allotted 2,000 debentures and the remaining applications were rejected. All money was duly received. Journalize the transactions.

Solution :

Journal

Particulars		**L.F.**	**Dr.(Rs.)**	**Cr.(Rs.)**
Bank A/c To debenture application A/c (Receipt of application money on 28,000 debentures)	Dr.		5,60,000	 5,60,000
Debentures Application A/c To 12% Debentures A/c To debenture Allotment A/c To Bank A/c (Transfer of application money on 20,000 debentures (allotted) to debentures Account. Surplus application money on 2,000 debentures transferred to debenture allotment account. Application money on rejected applications refunded.)	Dr.		5,60,000	 4,00,000 1,20,000 40,000
Debenture allotment A/c To 12% debentures A/c (Amount due on allotment on 20,000 debentures)	Dr.		8,000,000	 8,00,000
Bank A/c To debenture allotment A/c (Balance of the amount due on allotment received)	Dr.		7,60,000	 7,60,000
Debenture call A/c To 12% debentures A/c (Amount due on call)	Dr.		8,00,000	 8,00,000
Bank A/c To debenture Call A/c (Amount due on all received)	Dr.		8,00,000	 8,00,000

ISSUE OF DEBENTRUES AT DISCOUNT

When debentures are issued by company at a price less than its nominal value (face value) it is said to be issued at discount. For example, if a debenture of Rs.1,000 is offered to public at Rs.950, it is issue at a discount. Here Rs.50 on each debenture is loss to the company. As a principle of equity, it is desirable to write off this loss. It is a capital loss and until it is written off completely, it is shown on the asset side of balance sheet, under the heading 'Miscellaneous Expenditures', as a fictitious asset. Discount on issue of debentures account is supposed to be allowed on allotment, unless, otherwise, mentioned.

There is no legal restriction on issuing debentures at a discount. The requisite entry to be passed is

(a)	**When allotment money becomes due** Debenture allotment A/c Discount on issue of debenture A/c To debentures A/c	Dr. Dr.	(Amount receivable) (Amount of discount) (Total amount)
(b)	**When allotment money is received** Bank A/c To debenture allotment A/c	Dr.	(With actual amount received on allotment)

The working of issue of debentures at a discount is well explained by the following illustration:

Illustration – 2 (Issue of debentures at discount)

XYZ Ltd; issued 2,000 14% debentures of Rs.50 each at a discount of 10% on April 1,1998 payable as follows :-

Rs.30 on application; Rs.10 on allotment (discount to be adjusted with allotment) and Rs.5 on first and final call. The issue was fully subscribed and all money was received in full. Give journal entries; ledger accounts and balance sheet (extract only).

1998			Dr. Rs.	Cr. Rs.
	Bank account To Debenture application account (Being application money on 2,000 debentures received)	Dr.	60,000	60,000
	Debenture application account To 14% debentures account (Being allotment of debentures vide board's resolution)	Dr	60,000	60,000

	Debenture allotment account Discount on issue of debentures account To debentures allotment account (Being allotment money due and discount adjusted)	Dr Dr	20,000 10,000	30,000
	Bank account To debenture allotment account (Being allotment amount received)	Dr	20,000	20,000
	Debenture final call account To 14% debentures account (Being first and final call due @ Rs.5 per debenture)	Dr	10,000	10,000
	Bank account To debenture final call account (Being final and final call due @ Rs.5 per debenture received)	Dr	10,000	10,000

14% DEBENTURES ACCOUNT

Dr.	Rs.		Cr.
To Balance c/d	1,00,000	By debentures application account	60,000
		By debenture allotment account	20,000
		BY discount on issue of debentures	10,000
		By debenture final call account	10,000
	1,00,000		1,00,000

DISCOUNT ON ISSUE OF DEBENTURES ACCOUNT

Dr.			Cr.
To 14% debentures account	Rs. 10,000	By balance c/d	Rs. 10,000

BANK ACCOUNT

Dr.			Cr.
	Rs.		Rs.
To debenture application account	60,000	By balance c/d	90,000
To debenture allotment account	20,000		
To debenture final call account	10,000		
	90,000		90,000

BALANCE SHEET (Extract only)

Liabilities		Assets	
Secured loans :	1,00,000	Bank	90,000
2,000,14% debentures @ Rs.50 each	1,00,000	Discount on issue of debentures	10,000 1,00,000

Illustration – 3

A limited company made an issue, which was fully subscribed, of 1,000 debentures of Rs.100 each at Rs.97. The debentures were allotted on 31st July 2001, subscriptions being payable 10 per cent on application, 40 per cent on allotment, 25 per cent on 30th September and the balance on 30th November 2001.

Under the terms of the issue, payment could be made in fully on 31st July, 2001, interest on any amounts prepaid being allowable at the rate of 10 per cent per annum; such interest was not deductible from the subscriber's payment, but was payable by the company on 30th November 2001. The allotted of 300 debentures took advantages of the prepayment terms, while others paid on the due dated. Journalize the entries to be made in the company's books; (Ignore Debenture Interest)

[C.B.S.E. 1992 (Delhi) (C)]

Solution : **Journal**

Date	Particulars		L.F.	Dr.(Rs.)	Cr.(Rs.)
2001	Bank A/c To debenture Application money received fro 1,000 (Being the application money received for 1,000 debentures at the rate of Rs. 10 per debenture)	Dr.		10,000	
	Debenture Application A/c To debenture A/c (Being the transfer of application money)	Dr.		10,000	
July, 31	Debenture Allotment A/c Discount on Issue of Debentures A/c To Debenture A/c (Being the allotment money due on 1,000 debentures @ Rs.40 each and Rs.3 per share allows as discount)	Dr. Dr.		40,000 03,000	 43,000

	Bank A/c To Debenture Allotment A/c To Calls-in-Advance A/c (Being the amount received on allotment and also received of call in advance on 300 debentures @ Rs.47 per debenture)	Dr.		54,100	 40,000 14,100
Sept. 30	Debentures First Call A/c To Debentures A/c (Being the amount due on first call on 1,000 debentures @Rs.25 per debenture)	Dr.		25,000	 25,000
Sept. 30	Bank A/c Calls-in-Advance A/c To Debentures First Call A/c (Being the amount received on first call and calls in Advance A/c is adjusted to the extent of Rs.7,500)	Dr. Dr.		17,500 07,500	 25,000
Nov. 30	Debenture Second and Final Call A/c To Debenture A/c (Beign the amount due on final call on 1,000 debentures @Rs.22 per debenture)	Dr.		22,000	 22,000
Nov. 30	Bank A/c Call-in-Advance A/c To Debenture Second and Final Call A/c (Being the amount of second call received on 700 debentures and Calls-in-Advance A/c adjusted0	Dr. Dr.		15,400 06,600	 22,000
Nov. 30	Interest on Calls-in-Advance A/c To bank A/c 9Being two months interest on Rs.7,500 and 4 months' interest on Rs.6,600 @10% per annum)	Dr.		345	 345

Working Note :

Calculation of Interest on Calls-in-Advance

$$Rs.7,500 \times \frac{2}{12} \times \frac{10}{100} = Rs.125$$

$$Rs.6,600 \times \frac{4}{12} \times \frac{10}{100} = Rs.220$$

ISSUE OF DEBENTURES AT PREMIUM

If debentures are issued at a price more than its nominal value (face alue) such as issue is called issue at a premium. For example, if a debenture of Rs.1000 is offered at 1,050, it is a case of issue of debentures at premium. The excess of issue price over face value is premium. The premium is a capital gain for company so it is to be credited to 'premium on issue of debentures account'. Like discount on issue of debentures, premium on issue of debentures is also realized at the time of allotment, if nothing to the contrary is provided. Premium on issue is a capital gain, so it is shown on the liabilities side of balance sheet under the head 'Reserves and Surplus'.

The entries relating to premium will be :

(i)	When instalment containing premium is made due : Debenture allotment a/c To Debentures a/c To Premium on issue of debentures (Being allotment money due on – debentures @ Rs.- each including premium)	Dr.	(Total due) (Amount of debenture only) (Amount of premium)
(ii)	When debenture allotment money is received Bank a/c To Debenture allotment a/c (Being allotment money received on ... debentures)	Dr.	With total amount received on allotment

Nowhere in the companies Act have been provided the conditions regarding the utilization of amount of premium on debentures. Still the amount of premium on debentures should not be transferred to profit and loss account because it is not a profit arising from the normal operations of the company.

The amount of debenture premium may be used for writing off debenture issue expenses, discount on issue of shares etc. or alternatively it may be credited to Debenture redemption fund (if any).

Issue of debentures at premium

Illustration 4

A company issued, 1,000 6% debentures of Rs.100 each at Rs.110 payable as follows:

Rs.30 on application (including premium Rs.5)

Rs.30 on allotment including premium Rs.5)

Rs.50 on first and final call.

All the debentures were applied for and allotted. All money due was received, except final call on 20 debentures.

Pass journal entries for the above.

SOLUTION : **JOURNAL**

Particulars		L.F.	Debit	Credit
			Rs.	Rs.
Bank a/c To Debentures application a/c (Being application money received)	Dr.		30,000	 30,000
Debenture application a/c To 6% Debentures a/c To Premium on debentures a/c (Being application money transferred to debentures account, together with premium @Rs.5)	Dr.		30,000	 25,000 05,000
Debenture allotment a/c To 6% Debentures a/c To Premium on debentures a/c (Being allotment money due together with premium @Rs.5 per debenture)	Dr.		30,000	 25,000 05,000
Bank a/c To 6% Debentures allotment a/c (Being allotment money received0	Dr.		30,000	 30,000
Debenture first and final call a/c To 6% Debentures a/c (Being call money due on debentures)	Dr.		50,000	 50,000
Bank a/c To Debenture first and final call a/c (Being call money received on 980 debentures)	Dr.		49,000	 49,000

Illustration – 5 (Issue of debentures for a lump sum)

Journalise the followings :

(a) Issued 5,000 7% debentures of Rs. 100 each, at par.

(b) Issued 5,000 7% debentures of Rs. 100 each at 10% premium.

(c) Issued 5,000 7% debentures of Rs. 100 each at 10% discount.

All the debentures are redeemable at par.

SOLUTION : JOURNAL

	Particulars	L.F.	Debit	Credit
(a)	Issue at par Bank a/c To debenture application & allotment a/c (Being application money received on 5,000 debentures @ Rs. 100 each)	Dr.	Rs. 5,00,000	Rs. 5,00,000
	Debenture application & allotment a/c To 7% debentures a/c (Being application money transferred to debentures account)	Dr.	5,00,000	5,00,000
(b)	Issue at premium Bank a/c To debenture application and allotment a/c (Being application money received)	Dr.	5,50,000	5,50,000
	Debentrues application and allotment a/c To 7% debentures a/c (Being application money transferred to debentures and debenture premium a/c)	Dr.	5,50,000	5,00,000 50,000
(c)	Issue at a discount Bank a/c To debenture application & allotment a/c (Being application money received)	Dr.	4,50,000	4,50,000
	Debenture application and allotment a/c Discount on debentures a/c To 7% debentures a/c (Being application money transferred to debenture a/c)	Dr. Dr.	4,50,000 50,000	5,00,000

DEBENTURES ISSUED IN CONSIDERATION OTHER THAN CASH

Sometimes a company purchases a running business (assets and liabilities) and issues to vendor, debentures as consideration. It is called issue of debentures in consideration other than cash. In such situation following entries are recorded.

I. When agreement of purchase of business is signed.

Business purchase a/c	Dr.	with amount of
Sundry assets a/c	Dr.	purchase
To Vendor's a/c		
(Being sundry assets purchased)		

II. When purchase consideration is paid to vendors in the form of debentures.

Vendor's a/c	Dr.	with amount of
To debentures a/c		purchase consideration
(Being debentures issued as consideration for assets purchased)		

Note : When debentures are issued in consideration other than cash they can be issued either at par, at premium or at discount. If they are issued at premium the amount of premium will be credited to 'premium on issue of debentures account' and if issued at a discount, the discount will be debited to 'discount on issue of debentures account'.

As per rule purchase consideration (amount to be paid for assets purchased) should be equal to net assets (Assets purchased-liabilities assumed) value. But in practice sometimes it is more than the value of net assets and sometimes it is less than the value of net assets.

Extra payment made over and above the value of net assets is treated as goodwill which can be calculated as follow :

Goodwill = purchase consideration – Net assets

Where Net assets = Assets purchased – Liablities assumed

In case the purchase consideration to be paid by company is less than the value of net assets, the excess of net assets over purchase consideration is a capital gain, which is transferred to capital reserve account.

Illustration – 6

(Debenture issued in consideration other than cash)

Z Ltd purchased building for Rs.2,20,000. Half of the payment was made in cash and the remaining half by the issue of 12% debentures at a premium of 10%. Pass the necessary journal entires. (C.B.S.E. 1995)

SOLUTION **JOURNAL – Z LTD.**

Building account To vendor (Being purchase of building)	Dr.	Dr. Rs. 2,20,000	Cr. Rs. 2,20,000
Vendor To bank account To 12% debentures account To debenture premium account (Being payment made and debentures issued in satisfaction of consideration)	Dr.	2,20,000	1,10,000 1,00,000 10,000

Working note :

Calculation of debentures to be issued :

	Rs.
	1,10,000
One half of amount payable in debentures	110
Debenture price being Rs. 100 + 10% premium	
No. of debentures = 1,10,000 ÷ 110 = 1,000	1,00,000
∴ Nominal value of debentures and debentures premium (being 10%)	10,000

Illustration – 7 (Calculation of goodwill)

Star Automobiles Ltd. took over assets of Rs. 2,35,000 and liabilities of RS.40,000 of Ashoka Automobiles Ltd. for the purchase consideration of Rs. 2,20,000. Purchase consideration was payable by issuing debentures of Rs. 100 at 10% premium. Give journal entries in the books of Star Automobiles Ltd.

SOLUTION **JOURNAL**

Particulars		L.F.	Debit Rs.	Credit Rs.
Sundry assets a/c Goodwill a/c To Sundry liabilities a/c To Ashoka automobiles ltd. (Being purchase of assets and liabilities of Ashoka automobiles letd).	Dr. Dr.		2,35,000 25,000	40,000 2,20,000
Ashoka automobiles Ltd. To debentures a/c To premium on issue of debenture a/c (Being debentures issued as consideration for purchase of business at 10% premium)	Dr.		2,20,000	2,00,000 20,000

Working notes

The purchase consideration is Rs.2,20,000 against net assets being valued (2,35,000 – 40,000) Rs. 1,95,000. The difference of Rs. 25,000 is goodwill.

When debentures are issued as a collateral security there are two ways of treatment in the accounting books.

(i) No journal entry is made in the account books at the time of issue of such debentures. A note is appended below the loan on the liabilities side of the balance sheet to the fact that they have been secured by the issued of debentures. This will be shown in the balance sheet as follows :

BALANCE SHEET (EXTRACTS)

(i)	Liabilities Debentures (In addition, debentures for Rs...... have been issued as collateral security) Loan (Secured by the issue of debentures of Rs...... as collateral security)	Rs.
(ii)	Sometimes issue of debentures as collateral security is recorded by making journal entry as follows : Debentures suspense a/c Dr. To debentures a/c (With nominal value of debentures)	

The debentures suspense account will appear on the assets side of the balance sheet and debentures on the liabilities side. When the loan is re-paid the entry is reversed in order to cancel it.

Illustration – 10 (debentures issued as collateral security)

A company had Rs.5,00,000 6% debentures outstanding on 1st January, 1993. During the year company took a loan of Rs.1,00,000 from bank for which the company placed with bank, debentures for Rs.1,20,000 as collateral security. Pass journal entries, if any. Also show how the Debentures and Bank Loan will appear in company's Balance Sheet.

Solution : First Method :

No entry will be passed for issue of debentures as collateral security. Only the entry for bank loan will be passed i.e.

Bank a/c	Dr.	1,00,000	1,00,000
To Bank loan a/c(Being loan obtained from bank)			

BALANCE SHEET (Extract only)

Liabilities	Details Rs.	Amount Rs.
6% debentures (In addition, debentures worth Rs. 1,20,000 given to bank as collateral security) Bank loan (Secured against debentures worth Rs. 1,20,000 given as collateral security)		5,00,000
Second Method In addition to entry fro bank loan following entry should also be passed :		
Debenture suspense a/c Dr. To 6% debentures a/c (For the issue of Rs.1,20,000 debentures as collateral security for a loan of Rs. 1,00,000 from the bank).	1,20,000	1,20,000

BALANCE SHEET

Liabilities	Rs.	Assets	Rs
6% debentures (Including debentures for Rs.1,20,000 issued as collateral security)	6,20,000	Debentures suspense a/c	1,20,000
Bank loan (Secured against debentures worth Rs.1,20,000)	1,00,000		

Illustration – 11

A Ltd. secured a loan of Rs.1,80,000 from the Canara Bank by issuing 2,000, 15% debentures of Rs. 100 each as collateral security. How will you treat the issue of such debentures ?

[C.B.S.C. (Foreign) 1991 (C)]

Solution

1. First Method (when no entries are passed in the books)

AN EXTRACT OF BALANCE SHEET OF A LTS. AS AT...

Liabilities	Rs.	Assets	Rs.
Secured Loans : Loan from Canara bank (Secured by the issue of 2,000, 15% Debenture of Rs. 100 each as Collateral security	1,80,000		

II. Second Method (when entries for debentures are passed)

JOURNAL OF A LTD

Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
Debentures Suspense A/c Dr. To 15% debentures A/c (Being the issue of 2,000, 15% debentures of Rs.100 each as collateral security for a loan from a bank as per board's resolution dated....)		2,00,000	2,00,000

AN EXRACT OF BALANCE SHEET OF A LTD. AS AT ...

Liabilities	Rs.	Assets	Rs.
Second Loans : 2,000, 15% Debentures of Rs. 100 each (issued as collateral security)	2,00,000	Miscellaneous Expenditure: Debenture Suspense A/c	2,00,000
Loan from Canara Bank (Secured by the issue of 2,000, 15% debentures of Rs.100 each as collateral security)	1,80,000		

Illustration – 12

A Ltd. issued 5,000, 13% debentures of Rs.100 each at part and raised a loan of Rs.80,000 from bank, collaterally secured by Rs.1,00,000 13% debentures. How will you show the debentures in the Balance sheet of the company assuming that the company ahs recorded the issue of debentures as collateral security in the books. [C.B.S.E. (Foreign) 1992 (C)]

Solution

AN EXTRACT OF BALANCE SHEET

Liabilities	Rs.	Assets	Rs.
Secured loans:	5,00,000	Current Assets :	5,80,000
5,000 13% debentures of RS.100 each issued at par		Bank	
		Miscellaneous expenditure	1,00,000
1,000 13% debentures of Rs. 100 each (issued as collateral security)	1,00,000	Debentures Suspense Account	
Loan from bank (Secured by the issue of 1,000 debentures of Rs.100 each)	80,000		

CLASSIFICATION FROM 'CONDITIONS OF REDEMPTION" POINT OF VEIW

Like issue of debentures at part, premium or discount the redemption of debentures can also be :

(a) Redemption at par

(b) Redemption at premium

(c) Redemption at discount

Thus following sets of cases can be formed :

(i) Issue at par, redeemable at par

(ii) Issue at discount, redeemable at par

(iii) Issue at premium, redeemable at par

(iv) Issue at par, redeemable at premium

(v) Issue at discount, redeemable at premium

(vi) Issue at premium, redeemable at premium

The study of above sets clarifies that debentures are redeemable wither at part or at premium. How the debentures are to be redeemed in future is provided in the prospectus issued by the company at the time of issue. Sometimes a company can also redeem its debentures by purchase from open market. Generally in such cases it is normally seen that company buys them at below the par value, thus making profit on redemption.

Journal entries for issued at part and redeemable at par

(i)	When debentures are issued at par and redeemable at par			
	(a)	Bank a/c To Debenture application and allotment a/c	Dr.	
	(b)	Debenture application and allotment a/c To debentures a/c	Dr.	
(ii)	When debentures are issued at discount and redeemable at par			
	(a)	Bank a/c To Debenture application and allotment a/c	Dr.	
	(b)	Debenture application and allotment a/c Discount on issue of debentures a/c To Debentures a/c	Dr. Dr.	
(iii)	When debentures are issued at premium and redeemable at par			
	(a)	Bank a/c To Debenture application and allotment a/c	Dr.	
	(b)	Debenture application and allotment a/c To Debentures account To premium on issue of debentures a/c	Dr.	
(iv)	When issued at par and redeemable at premium			
	(a)	Bank a/c To Debenture application and allotment a/c	Dr.	With nominal value
	(b)	Debenture application and allotment a/c Loss on issue of debentures a/c To Debentures a/c To premium on redemption of debentures a/c	Dr.	(Nominal value) Difference in issue and redemption price) (Nominal value) (amount of premium)
(v)	When issued at discount redeemable at premium			
	(a)	Bank a/c To Debenture application and allotment a/c	Dr.	With actual amount received
	(b)	Debenture application and allotment a/c Loss on issue of debentures a/c To Debentures a/c To premium on redemption of debentures a/c	Dr. Dr.	(Actual receipt) (Difference in issue and redemption price) (Face value) With premium)

The point to note is that premium on redemption is a personal account because it represents the extra liability which is to be discharged when debentures are redeemed. It is recorded on the liability side of the balance sheet until it is paid off. Since company promises to pay more at the time of redemption, therefore, there is loss of equal amount which is debited to "loss on issue of debentures a/c". This loss on issue of debentures is written off gradually every year during the life of the debentures. The unwritten off portion appears on the assets side of he balance sheet under the head 'Miscellaneous Expenditure" as a fictitious asset.

The mechanism can be explained with the help of following illustrations

Illustration – 13

Journalise the following transactions :

(i) A debentures issued at Rs. 95 repayable at Rs. 100.

(ii) A debenture issued at Rs. 95 repayable at Rs. 105.

(iii) A debenture issued at Rs. 100 repayable at Rs. 105.

(iv) A debenture issued at Rs. 105 repayable at Rs. 100.

Note :

The face value of each debenture is Rs. 100. [C.B.S.E. (Delhi set II]

Solution

Journal

Date	Particulars		L.F.	Debit Amount Rs.	Credit amount Rs.
(i)	Bank account Discount on issue of debentures a/c To debentures account (Being the issue of a debenture of Rs.100 at a discount of 5%)	Dr. Dr.		95 5	100
(ii)	Bank account Loss on issue of debentures account To debentures account To premium on redemption of debentures account (Being the issue of debentures of Rs. 100 at a discount of 5% repayable at a premium of 5%)	Dr. Dr.		95 10	100 5
(iii)	Bank account Loss on issue of debentures account To debentures account To premium on redemption of debentures account (Being the issue of debentures of Rs. 100 at a discount of 5% repayable at a premium of 5%)	Dr. Dr.		100 5	100 5
(iv)	Bank account To debentures account (Being the issue of a debenture of Rs.100 at a premium of 5% repayable at par)	Dr.		105	100 5

Illustration – 14 (Issue at discount redeemed at premium)

P.Ltd., issues 7,000 debentures of rs.100 each at a discount of 10% with the condition that these shall be redeemed at a premium of 5% after the expiry of three years.

Pass the necessary journal entries for the issue and redemption of these debentures after the expiry of three years. (C.B.S.E. 1993)

Solution **Journal of P Ltd.**

		Dr.Rs.	Cr.Rs.
Bank account To debentures application and Allotment A/c (Being the issue of 7,000 debentures of Rs.100 each at a discount of 10%)	Dr.	6,30,000	6,30,000
Debenture Application and Allotment A/c Loss on issue of debentures A/c To debentures A/c The premium on redemption A/c	Dr. Dr.	6,30,000 1,05,000	7,00,000 35,000
Debentures account To premium on redemption of debentures account To debenture-holders account (Being amount due on redemption to debenture-holders).	Dr. Dr.	7,00,000 35,000	7,35,000
Debenture-holders account To Bank account (Being amount due on redemption paid to debenture-holders)	Dr.	7,35,000	7,35,000

Working Note :	Rs.
Loss on issue of debentures	70,000
Discount on issue	35,000
Add: - premium or redemption	1,05,000

Illustration – 15

A company issued Rs., 1,00,000, 15% Debentures at a discount of 5% redeemable after 10 years at premium of 10%. Pass journal entry.

[C.B.S.E. 1991 (Delhi)]

on		L.F.	Dr.Rs.	Cr. Rs.
... A/c	Dr.		95,000	1,00,000
... on issue of debentures A/c	Dr.		15,000	10,000
...5% debentures				
... premium payable on redemption of debentures A/c				
...ing the issue of debentures at discount of 5% and ...eemable at a premium of 10%)				

...stration – 16

...rnalize the following transactions :

(a) X Ltd. issues Rs. 2,00,000, 12% Debentures at discount of 5% redeemable at par.

(b) Y Ltd. issues Rs. 5,00,000 Debentures at a discount of 5% redeemable at a premium of 7% [C.B.S.E. 1993 (Delhi) III]

...olution

Journal of X Ltd.

	Particulars		L.F	Dr.Rs.	Cr.Rs.
(a)	Bank A/c	Dr.		1,90,000	2,00,000
	Discount on issue of debentures A/c	Dr.		10,000	
	To 12% Debentures A/c				
	(Being the issue of 12% Debentures at a discount, of 5% redeemable at par)				

Journal of X Ltd.

	Particulars		L.F.	Dr.Rs.	Cr.Rs.
(b)	Bank A/c	Dr.		4,75,000	5,00,000
	Loss on issue of debentures A/c	Dr.		60,000	35,000
	To debentures A/c				
	To premium on redemption of debentures A/c				
	(Being the issue of debentures at discount of 5% and redeemable at a premium of 7%)				

Illustration – 17

You are required to show by means of journal entries how to record the following issues :

(i) A company issued 14,000 debentures of rs.100 each at a discount of 5% to be repaid at par at the end of 5 years.

(ii) A company issued 5,000 debentures of Rs.100 each at a discount of 5% repayable at a premium of 10% at the end of 5 years. [C.B.S.E. (Outside Delhi) (C) 1996]

Solution

Journal

	Particulars		L.F.	Dr.Rs.	Cr.Rs.
(i)	Bank A/c	Dr.		13,30,000	14,00,000
	Discount on issue of debentures A/c	Dr.		70,000	
	To debentures A/c				
	(Issue of debentures at 5% discount)				
(ii)	Bank A/c	Dr.		4,75,000	5,00,000
	Loss on issue of debentures A/c	Dr.		75,000	50,000
	To debentures A/c				
	To premium on redemption of debentures A/c				
	(Issue of debentures at 5% discount and 10% premium on redemption)				

Illustration – 18 (Issue of debentures – different terms of issue)

Record journal entries in following cases :

(a) Issued Rs. 1,00,000 12% Debentures at par, redeemable at par.

(b) Issued Rs. 1,00,000 12% Debentures at discount of 10%, redeemable at par.

(c) Issued Rs. 1,00,000 12% Debentures at a premium of 5%, redeemable at par.

(d) Issued Rs. 1,00,000 12% Debentures at par, redeemable at 10% premium.

(e) Issued Rs. 1,00,000 12% Debentures at a discount of 5%, redeemable at 5% premium.

Also state how you will treat the loss on issue of debentures in books of accounts.

	Particulars		L.F.	Debit.Rs.	Credit.Rs.
a	Issued at par, redemption at par Bank a/c To debentures application & allotment a/c (Being application money received on debentures)	Dr.		1,00,000	1,00,000
	Debenture application & allotment a/c To 12% debentures a/c (Being application money transferred to debentures account)	Dr.		1,00,000	1,00,000
b	Issued at discount, redemption at par Bank a/c To debentures application & allotment a/c (Being application money received on debentures)	Dr.		90,000	90,000
	Debenture application & allotment a/c Discount on debentures a/c To 12% debentures a/c (Being application money transferred to debentures account and discount charged)	Dr. Dr.		90,000 10,000	1,00,000
c	Issued at premium, redemption at par Bank a/c To debentures application & allotment a/c (Being application money received on debentures)	Dr.		1,05,000	1,05,000
	Debenture application & allotment a/c To 12% debentures a/c To premium on issue of debentures a/c (Being application money transferred to debentures and premium account)	Dr.		1,05,000	1,00,000 5,000
d	Issued at par, redemption at Premium. Bank a/c To debentures application & allotment a/c (Being application money received on debentures)	Dr.		1,00,000	1,00,000
	Debenture application & allotment a/c Loss on issue of debentures a/c To 12% debentures a/c To premium on redemption a/c (Being application money transferred)	Dr. Dr.		1,00,000 10,000	1,00,000 10,000

e	Issued at discount, redemption at premium Bank a/c To debentures application & allotment a/c (Being application money received)	Dr.		95,000	95,000
	Debenture application & allotment a/c Loss on issue of debentures a/c To 12% debentures a/c To premium on redemption a/c (Being application money transferred to debentures account)	Dr. Dr.		95,000 10,000	1,00,000 5,000

Note : Loss on issue of debenture consists of discount on issue and premium payable on redemption. It is a capital loss and will be shown on the asset side on Balance Sheet. It will be written off over a number of years. The balance will continue to appear in Balance sheet.

Interest on Debentures

Interest on debentures is charged to the profit and loss account. While paying the interest on debentures, it is the obligation of the company concerned to deduct the income tax before making payment of interest to debenture-holder. The following journal entries are passed in this connection :

(i)	When interest on debentures is due: Debit interest on debentures A/c Credit income tax account Credit debenture-holders A/c	 (with gross amount) (with income tax) (with net amount)
(ii)	When net amount due is paid : Debit debenture-holders Account Credit Bank Account	

Interest on debentures is transferred to the debit side of profit and loss account. The credit balance of Income tax account is shown on the liabilities side of the balance sheet. As and when it is paid to the government this account is debited and bank account will be credited.

Debenture Interest given in the tribal balance

The treatment of debentures interest while preparing final accounts must be noted carefully especially when it is given less tax at a specified rate. For example, if the trial balance shows "half year's debenture interest less tax at 42% rs.5,800" then the profit and loss account will be debited with the gross amount Rs. 10,000 $\left(i.e., 5{,}8000 \times \frac{100}{58}\right)$ and Rs.

₹200 $\left(i.e., \frac{42}{100} \times 10{,}000\right)$ will be shown in the balance sheet as liability under the heading Income tax payable account.

Redemption of Debentures

Redemption of debentures refers to the discharge of liability on account of debentures. The following three problems require attention when a company wants to redeem the debentures.

(a) **Time of redemption of debentures.** Generally debentures are redeemed at the expiry of their period by making the payment of the amount promised fro. But sometimes company may reserve the right in the articles of association to redeem the debentures even before the date of redemption either by installments or by purchasing them in the open market. Payment of debentures by installment is nothing but redemption of debentures by drawing a lot. Sometimes a company does not want to serve a notice with the debenture-holders and wants to redeem the debentures before the date of redemption. This is possible by purchasing out own debentures in the open market. Thus debentures can be redeemed either at the expiry of period of debentures or before the expiry of the period by drawing a lot or by purchasing in the open market before the expiry of the period of debentures.

(b) **Amount to be paid on redemption.** The amount to be paid on redemption of debentures depends on the circumstances of each case. If the debentures are redeemed on the expiry of the period or only during a lot, then the amount to be paid can be either at premium or at par as promised by the company. If the debentures are redeemed by purchasing them in the open market, then the amount to be paid depends on the market quotation, i.e., either at par or at a discount or at a premium. Generally, the companies purchase their own debentures from the market when the debentures are quoted below face value to take the advantages of depressed prices.

(c) **Sources of Finance.** The major sources wherefrom the debentures can be redeemed may be (i) out of profits, (ii) out of capital, 9iii) out of provisions made for redemption and (iv) by converting them into shares or new debentures.

(i) *Redemption out of profits*

When debentures are redeemed out of profits, the following journal entries will be passed.

(a) Entry for amount paid on redemption
Debit debentures account
Credit Bank

(b) Entry for transfer of profit
Debit profit & loss appropriation account
Credit debenture redemption reserve A/c

(c) When balance of D.R.R. A/c is not required for redemption and is transferred to General Reserve Account

Debit debenture redemption reserve account.

Credit general reserve.

The balance of general reserve is a free reserve and will be available for all purposes.

The effect of redemption of debentures out of profits is that the company withholds a part of the divisible profits from distribution as dividend which may be retained in the business itself as a source of internal financing.

Illustration – 7

On 1st January, 1997, a company issued Rs.20,00,000 14% debentures at 5% discount repayable in five years at par. The company reserved the right to redeem to the extent of Rs.2,00,000 in any year by purchase in the open market. The interest was payable half yearly on 30th June and 31st December and the same was duly paid.

On 31st December, 1997, the company purchased Rs.2,00,000 debentures at a cost of Rs.1,91,000. Pass necessary journal entries in the books of the company upto 31st December, 1997 including closing entries on that date if the above redemption was out of profit. (Adapted B.Com., Madurai)

Solution

Journal entries

			Rs.	Rs.
1997				
Jan.1	Bank Account Discount on debentures account To 14% debentures account (Being issue of 14% debentures at 5% discount)			
June 30	Interest on debentures account To bank account (Being interest paid for half year on Rs.20,00,000 debentures @ 14% p.a. for half year)			
Dec.31	Interest on debentures account To bank account (Being alf year on Rs.20,00,000 debentures @ 14% p.a. for half year)			
Dec.31				
Dec.31				
Dec.31				
Dec.31				

mption out of Capital

debentures are redeemed out of capital, no amount of divisible profit is kept aside leming debentures. Profits are not utilized for redemption of debentures and may go hareholders by way of dividends. Redemption out of capital reduces the liquid resources le to the company. Therefore, a company may adopt this method only when it has nt funds.

According to the guidelines issued by SEBI, a company has to create Debenture nption Reserve equivalent to 50% of the amount of debenture issue before redemption enture commences. Thus, according to this provision redemption of debentures wholly capital is now not possible. However, creation of debenture Redemption Reserve is quired in the following cases:

(i) Debentures with a maturity of 18 months or less.

(ii) Fully convertible debentures. Incase of partly convertible debentures, Debenture emption Reserve is to be created for the non-convertible part in the same way as applicable ully non-convertible debentures.

When debentures are redeemed out of capital the following journal entry is made:

Debit Debentures Account

Credit Bank.

When debentures are reduced out of capital, nominal value of debenture redeemed not transferred from profit and Loss Appropriation Account or Debenture Redemption eserve Account to General Reserve.

Sometimes instead of passing one entry given above, the following two entries are assed:

(a) Debit Debentures Account

Credit Debenture-holders

(b) Debit Debenture-holders A/c

Credit Bank.

This method is preferable, as it does not mix up the amount unpaid to debenture-holders with the debentures account.

Illustration – 8

A Company on 31st December 1996 redeemed Rs. 10,000 6% debentures out of capital by drawing a lot. Similarly, the company on 31st December 1997 redeemed Rs. 15,000 6% debentures out of profits by drawing a lot. You are required to pass journal entries in the books of a company.

Solution

Journal entries

			Rs.	Rs.
1996 Dec.31	6% debentures account To Bank Account (Being the redemption of debentures out of capital)	Dr.	10,000	10,000
1997 Dec.31	6% debentures account To Bank Account (Being the redemption of debentures out of profit)	Dr.	15,000	15,000
	Profit & loss appropriation account To debenture redemption reserve account (Being the transfer of profit to debenture redemption reserve account)	Dr.	15,000	15,000

Illustration – 9

On 1st April, 1994, a company issued 1,000 6% debentures of Rs. 1,000 each at Rs.950. Terms of issue provided that beginning with 31st March, 1997 Rs.50,000 of debentures should be redeemed either by drawings at part or by purchase in eh market every year. The expenses of the issue amounted to Rs.3,000 which were written off on 31st March, 1995. The company wrote off Rs.10,000 from the discount on debentures every year. On 31st March. 1997 the debentures to be redeemed were repaid at the end of the year by drawings. On 31st March, 1998 the company purchased fro cancellation 50 debentures at the ruling price of rs.980, the expenses being Rs.100. interest is payable yearly, Ignore income-tax.

Give Journal entries and the Balance sheet (as far as it relates to debentures) on 31st march. 1998.

Solution

Journal entries

			Rs.	Rs.
1994 April 1	Bank A/c Discount on debentures A/c To 6% debentures A/c (issue of 1,000 6% debentures of Rs.1,000 each at Rs.950)	Dr. Dr.	9,50,000 50,000	10,00,000
April 1	Debentures Issue expenses A/c To Bank Account (Rs.3,000 incurred on the issue of debentures)	Dr.	3,000	3,000

	Profit % loss account To debenture issue expenses A/c To discount on debentures A/c (Being the debenture issue expenses and discount on debentures written off)	Dr.	13,000	3,000 10,000
.1	Interest on debentures A/c To Bank (Interest due on debentures for one year paid)	Dr.	60,000	60,000
31	Interest on debentures A/c To Bank (Interest on debentures due for one year paid)	Dr.	60,000	60,000
.31	Profit & loss A/c To discount on debentures A/c (Amount written off of discount on debentures)	Dr.	10,000	10,000
7 r.31	Interest on debentures A/c To Bank (Interest on debentures due for own year paid)	Dr.	60,000	60,000
r.31	Profit & loss Account To discount on debenture A/c	Dr.	10,000	10,000
ar.31	6% debentures A/c To Bank (Redemption of debentures worth Rs.50,000 by drawing at par)	Dr.	50,000	50,000
998 Mar.31	6% debentures A/c To profit on redemption of debentures A/c To Bank (for the purchase of 50 debentures in the market at Rs.980 plus Rs.100 for expenses)	Dr.	50,000	900 49,100
Mar.31	Interest on debentures A/c To Bank (Interest @ 6% on Rs.950,000 for one year)	Dr.	57,000	57,000
Mar.31	Profit on redemption of debentures A/c Profit and loss account To discount on debentures A/c (The writing off Rs.10,000 out of debentures discount and also utilization of profit for the same purspose)	Dr. Dr.	900 10,000	10,000

Balance sheet as on March 31, 1998

900 6% debentures of Rs.1,000 each	Rs. 9,00,000	Discount on debentures	Rs. 9,100

Illustration – 10

On 1st April 1996 Naveen Ltd. made an issue of 50,000 12% debentures of Rs.1,000 each at Rs.980 per debenture. The terms of issue provided for the redemption of Rs.50,00,000 debentures every year commencing from 1997-98 either by purchase or by drawing lots at part, at the company's option. Profit on redemption, if any, is to be transferred to capital reserve account. The company's accounting year ends on 31st March. Interest on debentures is payable on 30th September and 31st March.

During the year 1997-98, the company wrote off Rs.1,00,000 from debentures discount account. During the same financial year, the company purchased fro cancellation debentures of the face value of;

(i)Rs.30,00,000 at Rs.960 per debenture on 30.09.1997.

(ii)Rs.20,00,000 at Rs.970 per debenture on 31.03.1998.

Show how these items will appear in the financial statements for the year ending 31st March 1998. Also show corresponding figures for the previous year ending 31st March 1997.

Solution. Some Basic Calculations

(1) Interest on debentures for the year ending 31st March 1997

On 50,000 debentures of Rs.1,000 each i.e., Rs.50,00,000 face value debentures @ 12% p.a. = Rs.60,00,000

(2) Interest on debentures for the year ending 31st March 1998

On Rs.50,00,000 debenture @ 12% p.a. for 6 months ending 30 September, 1997 Rs.30,00,000

On Rs.4,70,00,000 @ 12% p.a. for 6 months ending 31st March, 1998 Rs.28,20,000

Interest for the financial year 1997-97 Rs.58,20,000

(3) Calculation of profit on cancellation of debentures

On Rs.30,00,000 @ Rs.40, per Rs. 1,000 $i.e., 30,00,000 \times \frac{40}{1,000}$ 1,20,000

On Rs.20,00,000 @ Rs.30 per Rs.1,000 $i.e., 20,00,000 \times \frac{30}{1,000}$ 60,000

Total profit on cancellation of debentures 1,80,000

(4) Discount on issue of 50,000 debentures @ Rs.20 10,00,000

Balance sheet of Naveen Ltd. as on 31st March, 1998 (Extracts)

31.3.97	Liabilities	31.3.98	31.3.97	Assets	31.3.98
Rs.	Reserves & surplus Capital reserve secured loans 12% debentures	Rs. 1,80,000	Rs.	Miscellaneous Expenditure (to the extent not written off) Discount on Issue of Debentures	Rs.
5,00,00,000		4,50,00,000	10,00,000		9,00,000

Profit and loss account of Naveen Ltd for the year ending 31st March 1998 (Extracts)

1996-97		1997-98	1996-97		1997-98
Rs.	To interest on debentures	Rs.	Rs.		Rs.
60,00,000		58,20,000			

(iii) Redemption by conversion

Sometimes the debenture-holders of a company are given the option to convert their debentures into the shares or new debentures within a stipulated period. Such option is exercised by the debenture-holders only when they are very sure about the progress of the company. The new shares or debentures can be issued either at part or at a premium of at a discount. The following entry will be made :

Debit old debentures account

Debit discount on the issue of share/debentures

Credit new share capital/debentures account

Credit premium on the issue of share/debentures.

Illustration – 11

On 1st April, 1997, Y Ltd. issued 800 12% debentures of rs.1,000 each at Rs.950 each. Debenture-holders had an option to convert their holdings into 6% preference shares of Rs.100 each at a premium of Rs.25 per share. On 31st March, 1998, one year's interest had accrued on these Debentures which was not paid. A holder of 50 debentures notified his intention to convert his holding into 13% preference shares.

Journalise the above transactions and draw the company's Balance sheet as at 31st March, 1998.

Solution

Journal entries

			Rs.	Rs.
1997 Apr.1	Bank A/c Discount on issue of Debentures A/c To 12% debentures A/c (Issue of 800, 12% debentures of RS.1,00 at Rs.950 each)	Dr.	7,60,000 40,000	8,00,000
1998 Mar.31	Interest on debentures A/c To sundry debenture-holders of the year ended 31.31998	Dr.	96,000	96,000
	12% debentures A/c To 13% preference share capital A/c To securities premium A/c (Conversion of 50 debentures to 400 13% preference shares of Rs.100 each at a premium of Rs.25 per share)	Dr.	50,000	40,000 10,000
	Sundry debenture-holders A/c To Bank A/c (Interest on 50,12% debentures paid on conversion)	Dr.	6,000	6,000
	Profit & loss A/c To interest on debentures A/c (Interest on debenture transferred to p. % l. A/c)	Dr.	96,000	96,000

Balance sheet as on 31st March, 1998

Liabilities	Rs.	Assets	Rs.
Share capital :		Bank (7,60,000 – 6,000	7,54,000
400 13% preference Shares of Rs. 100 each	40,000	Discount on issue of debentures	40,000
750 12% debentures of Rs.1,000 each	7,50,000	Profit & loss account	96,000
Sundry debenture-holders	90,000		
Securities premium	10,000		
	8,90,000		8,90,000

Illustration – 12

The summarized Balance sheet of X Ltd. as on 31st March, 2000 was as follows:

Liabilities	Rs.	Asses	Rs.
Share Capital		Goodwill	40,00,000
40,000 13% redeemable		Fixed assets	82,60,000
Preference shares of		Stock	90,00,000
Rs.100 each fully paid	40,000	Sundry debtors	43,00,000
Up redeemable at par		Discount on debentures	2,40,000
8,00,000 Equity shares of	80,00,000		
Rs. 10 each fully paid up	1,20,00,000		
12% debentures			
(Redeemable at par)	60,00,000		
Profit & loss A/c	50,00,000		
Bank loan	10,00,000		
Sundry creditors	18,00,000		2,58,00,000
	2,58,00,000		

The company decided to redeem the preference shares and debentures and in due course offered to the preference shareholders and debenture-holders the option to convert their holdings into equity shares which are to be treated as worth Rs.12.50 each. One half of the preference shareholders and one third of the debenture-holders (in value) agreed to accept the offer.

The company issued 6,00,000 equity shares of Rs.10 each @ Rs.12.50 to the public for cash and with the proceeds of such issue, paid off the bank loan and redeemed the remaining preference shares and debentures.

Solution

In the books of X Ltd.

Journal entries

		Dr.	Rs.	Rs.
2000 March 31	12% debentures A/c To 12% debenture-holders A/c (Being amount payable n redemption of 12% debentures)		60,00,000	60,00,000

	13% Redeemable preference share capital A/c to 13% Redeemable preference shareholders A/c (Being amount payable on redemption of 13% preference shares)	Dr.	40,00,000	40,00,000
	12% debenture-holders A/c 13% preference shareholders A/c To equity share capital A/c To securities premium A/c (Being the conversion of Rs.20,00,000 debentures and Rs.20,00,000 preference shares into equity shares of Rs.10 each issued at a premium of Rs.2.50 per share)	Dr. Dr.	20,00,000 20,00,000	32,00,000 8,00,000

(iv) Redemption out of provision

It si always a wise policy for the company to made arrangements in advance to repay the known liability for redemption of debentures. This can be done by making provision otherwise it will be difficult for the company to arrange lumpsum to repay debts. This is possible by adopting either the sinking fund method or insurance policy method.

Sinking Fund for redemption of debentures

Debentures are to be paid on a specified date. It si desirable to make some arrangement for their redemption otherwise it will be very difficult for the company to pay the lumpsum at the time when the redemption is due. The best method is to create sinking fund for this purpose. This method resembles with that of depreciation fund method.

To recapitulate, the following entries will be passed :

At the end of the 1st Year

(i) For the amount set aside every year

Profit & loss appropriation account Dr.

To Sinking fund account

Or

Debenture redemption fund account

(ii) For amount kept aside for redemption invested in securities

Sinking fund investment account Dr.

Or

Debenture redemption fund investment account Dr.

To Bank.

At the end of 2nd and Subsequent Year

(i) For interest received on investment

Bank Account Dr.

To interest on Sinking fund investment A/c

(ii) For interest transferred to Sinking fund

Interest on Sinking fund investment account Dr.

To Sinking fund account

(iii) For annual amount set aside

Profit & Loss appropriation account

To Sinking fund account

(iv) For annual instalment plus interest invested in securities

Sinking fund investment A/c Dr.

To Bank

At the end of last year (when debentures are to be redeemed)

All the entries except entry (iv) in second and subsequent year should be passed. Entry (iv) is not passed as debentures are to be redeemed s r) investment will be made rather the securities will be sold.

(i) For amount realized on the sale of securities

Bank A/c

To Sinking Fund investment A/c

(ii) For profit on sale of investment

Sinking Fund investment A/c Dr.

To Sinking fund account

Note. Reserve entry will be made if there is a loss on sale of investment.

(iii) For amount paid to debentureholders to redeem the debentures

Debentures A/c Dr.

To Bank

(iv) For balance of Sinking fund transferred to general reserve account Sinking fund A/c Dr.
To general reserve

Illustration – 15

On 1st April, 1993, Metal products Ltd. issued debentures for Rs. 1,00,000 redeemable at part at the end of 5 years and it was resolved that a Sinking fund should be formed and invested in tax-fee securities.

Give journal entries for 5 years, assuming that the interest received on the investments was at the rate of 5 per cent on cost, that the interest was received yearly and immediately invested and that the investments were realized at a loss of Rs.300 at the end of five years.

Reference to the Sinking fund table shows that Re.0.180975 invested at the end of year at 5% compound interest will produce Re. 1 at the end of 5 years.

Solution

For one rupee, the annual amount required is Re.0.180975

∴ For Rs. 1,00,000, the annual amount required is, 180975 x Rs.1,00,000 = Rs.18,098 (nearest rupee).

Journal

			Rs.	Rs.
1993 April.1	Bank Account To debentures account (Being issue of rs.1,00,000 debentures at par)	Dr.	1,00,000	1,00,000
1994 Mar.31	Profit and loss appropriation account To sinking fund account (Being the annual sum required to provide for the redemption of debentures).	Dr.	18,098	18,098
Mar.31	Sinking fund investment account To bank account (Being amount invested in tax-free securities to the nearest hundred rupees)	Dr.	18,100	18,100
1995 Mar.31	Bank Account To interest on sinking fund Investment A/c (Being interest received on investments Rs.18,100 @ 5% p.a. for one year)	Dr.	905	905

Mar.31	Interest on sinking fund investment account To sinking fund account (Being transfer of interest to sinking fund)	Dr.	905	905
Mar.31	Profit and loss appropriation account To sinking fund account (Being provision of annual installment for redemption of debentures)	Dr.	18,098	18,098
Mar.31	Sinking fund investment account To Bank Account (Being annual installment Rs.18,098 plus interest Rs.905 invested in securities to the nearest hundred rupees)	Dr.	19,000	19,000
1996 Mar.31	Bank Account To interest on sinking fund investment A/c (Being interest received on investment Rs.18,100 + Rs.19,000@ 5% for year)	Dr.	1,855	1,855
Mar.31	Interest on Sinking fund investment A/c To sinking fund account (Being interest on investment transferred)	Dr.	1,855	1,855
Mar.31	Profit and loss appropriation account To sinking fund account (Being provision of annual installment for redemption of debentures)	Dr.	18,098	18,098
Mar.31	Sinking fund investment Account To bank Account (Being annual installment Rs.18,098 plus interest Rs.1,855 invested in securities to the interest hundred rupees)	Dr.	20,000	20,000
1997 Mar.31	Bank account To interest on sinking fund Investment A/c (Being interest received on investments Rs.18,100 + Rs.19,000 +RS.20,000 @ 5% for one year)	Dr.	2,855	2,855

Mar.31	Interest on sinking fund investment account To sinking fund account (Being interest on investment transferred)	Dr.	2,855	2,855
Mar.31	Profit and loss appropriation account To sinking fund account (Being provision of annual sum for redemption of debentures.	Dr.	18,098	18,098
Mar.31	Sinking fund investment account To Bank account (Being annual investment Rs.18,098 plus interest Rs.2,855 invested in securities to the nearest hundred rupees)	Dr.	21,000	21,000
1998 Mar.31	Bank Account To interest on sinking fund Investment A/c (Being interest received on investments 9Rs.18,100 + Rs.19,000 + Rs.20,000 + Rs. 21,000 =Rs.78,100) @ 5% for one year)	Dr.	3,905	3,905
Mar.31	Interest on sinking fund investment account To sinking fund account (Being transfer of interest on investments)	Dr.	3,905	3,905
Mar.31	Profit and loss appropriation account To sinking fund account (Being provision of annual installment for redemption of debentures)	Dr.	18,098	18,098
Mar.31	Bank Account To sinking fund investment Account (Being amount realized on sale of investment – Rs. 78,100 – Rs.300 loss = Rs.77,800	Dr.	77,800	77,800
Mar.31	Sinking fund account To sinking fund investment account (Being loss on sale of investments transferred)	Dr.	300	300
Mar.31	Debentures Account To Bank Account (Being redemption of Rs.1,00,000 debentures at par)	Dr.	1,00,000	1,00,000
Mar.31	Sinking fund account To general reserve (Being balance of sinking fund transferred to general reserve on redemption of debentures)	Dr.	99,710	99,710

Note It is assumed that investments have been made in multiples of hundred.

Insurance policy method

Sinking fund insurance policy can also be taken to make provision for redemption of debentures. Under this method a fixed amount of premium is paid every year to the insurance company which in turn agrees to pay the necessary amount for redemption of debentures at the end of a specific period.

Journal Entries

First year

(i) For amount of premium appropriated from profit and loss account
Profit and loss appropriation account Dr.
To debentures redemption fund A/c

(ii) For amount of premium paid to insurance company
Debenture redemption fund policy A/c Dr.
To Bank

Note. These entries will be passed every year including the last year also.

The following entries will also be passed at the end of the specific period on realization of the policy :

(i) For the amount received from insurance Co.
Bank account Dr.
To redemption fund policy A/c

(ii) For he balance of debenture redemption fund policy account (excess amount received) – transferred to debenture redemption fund account
Debenture redemption fund policy A/c Dr.
To debenture redemption fund A/c

(iii) For amount paid to debenture-holders
Debentures A/c Dr.
To Bank

(iv) For balance of debenture redemption of und account transferred to general reserve
Debenture redemption fund account Dr.
To general reserve

Illustration – 18

A limited company has made an issue of Rs.5,00,000 9% debentures on 1st April, 1996, the terms of which include that the company must take a 4 years Sinking fund insurance policy for the redemption of debentures at a premium of 5%. The annual premium is Rs.1,15,000. The value of the policy increases each year by 6%.

Give the necessary Ledger Accounts to record the above transactions for 4 year.

Note It is assumed that investments have been made in multiples of hundred.

Insurance policy method

Sinking fund insurance policy can also be taken to make provision for redemption of debentures. Under this method a fixed amount of premium is paid every year to the insurance company which in turn agrees to pay the necessary amount for redemption of debentures at the end of a specific period.

Journal Entries

First year

(i) For amount of premium appropriated from profit and loss account
Profit and loss appropriation account Dr.
To debentures redemption fund A/c

(ii) For amount of premium paid to insurance company
Debenture redemption fund policy A/c Dr.
To Bank

Note. These entries will be passed every year including the last year also.

The following entries will also be passed at the end of the specific period on realization of the policy :

(i) For the amount received from insurance Co.
Bank account Dr.
To redemption fund policy A/c

(ii) For he balance of debenture redemption fund policy account (excess amount received) – transferred to debenture redemption fund account
Debenture redemption fund policy A/c Dr.
To debenture redemption fund A/c

(iii) For amount paid to debenture-holders
Debentures A/c Dr.
To Bank

(iv) For balance of debenture redemption of und account transferred to general reserve
Debenture redemption fund account Dr.
To general reserve

Illustration – 18

A limited company has made an issue of Rs.5,00,000 9% debentures on 1st April, 1996, the terms of which include that the company must take a 4 years Sinking fund insurance policy for the redemption of debentures at a premium of 5%. The annual premium is Rs.1,15,000. The value of the policy increases each year by 6%.

Give the necessary Ledger Accounts to record the above transactions for 4 year.

Solution

Sinking fund account

1997		Rs.	1997		Rs.
Mar.31	To balance c/d	1,21,900	Mar.31	By profit & loss app. Account	1,15,000
			Mar.31	By sinking fund insurance policy account $\left(1,15,000\times\frac{6}{100}\right)$	6,900
					1,21,900
		1,21,900			Rs.
1998		Rs.	1997 April 1	By Balance b/d	1,21,000
Mar.31	To balance c/d	1,51,114			
			1998 Mar.31	By profit & loss App. Account	1,15,000
			Mar.31	By sinking fund insurance policy account (Int.) $\left(2,36,900\times\frac{6}{100}\right)$	14,214
					1,51,114
		1,21,900	1998		
1999			April 1	By Balance b/d	2,51,114
Mar.31	To Balance c/d	3,88,081			
			1999 Mar.31	By profit & loss App. Account	
			Mar.31	By sinking fund insurance policy account (Int.) $\left(3,66,114\times\frac{6}{100}\right)$	21,967
					3,88,081
		3,88,081	1999		
2000			April 1 2000 Mar.31	By Balance b/d By profit & loss App. Account.	
Mar.31	To premium on Redemption of Debenture A/c $\left(5,00,000\times\frac{5}{100}\right)$	25,000	Mar.31	By Sinking fund Insurance policy account (Int.) $\left(5,03,081\times\frac{6}{100}\right)$	30,185 5,33,26
Mar.31	To General reserve A/c	5,08,266 5,33,266			

Sinking fund insurance policy account

1996		Rs.	1997		Rs.
April 1	To Bank Account	1,15,000	Mar.31	By Balance c/d	1,21,900
1997					
Mar.31	To sinking fund Account (Int.)	6,900			
		1,21,900			1,21,900
1997			1998		
April 1	To Balance b/d	1,21,900	Mar.31	By Balance c/d	2,51,114
April 1	To Bank Account	1,15,000			
1998					
Mar.31	To sinking fund A/c (Int.)	14,214			
		2,51,114			2,51,114
1998			1999		
April 1	To Balance b/d	2,51,114	Mar.31	By Balance c/c	3,88,081
April 1	To Bank Account	1,15,000			
1999					
Mar.31	To sinking fund Account (Int.)	21,967			
		3,88,081			3,88,081
1999			2000		
April 1	To Balance b/d	3,88,081	Mar.31	By bank Account	5,33,266
April 1	To Bank Account	1,15,000			
2000					
Mar.31	To sinking fund account (Int.)	30,185			
		5,33,266			5,33,266

6% debenture account

2000		Rs.	1996		Rs.
Mar.31	To Bank Account	5,00,000	April 1	By Bank Account	5,00,000

Premium on redemption of debentures account

2000		Rs.	2000		Rs.
Mar. 31	To Bank Account	25,000	Mar. 31	By sinking fund A/c	25,000

QUESTIONS

1. Which of the following statements are correct :
   (a) A debenture-holder is an owner of the company.
   (b) Debenture-holders get their money back only on the liquidation fo the comp
   (c) Debenture-holders will be entitled to get interest even if there is loss to the comp
   (d) Debenture need not be fully paid whereas debenture stock must be fully pa
   (e) Debentures can be issued at a discount and can be redeemed at a premiu
   (f) Premium on debentures and premium on redemption of debentures conve same meaning.

Ans. [Correct : (c); (d); (e)].

2. State whether the following statements are true or false :
   (a) After the redemption of all debentures, the balance in the sinking fund is trans to general reserve.
   (b) Profit on sale of sinking fund investments is to credited to debentures acc
   (c) Interest on debentures is payable only when a company makes profits.
   (d) Interest on sinking fund investment is credited to profit and loss account.
   (e) Own debentures account will appear on the assets side of the balance sh
   (f) If debentures are redeemed out of capital, entry for the transfer of pr debenture redemption reserve account is not passed in the books.
   (g) First debentures are those which are repaid before other debentures are p
   (h) Registered debentures are those, which are transferable by mere deliver

(i) A company cannot buy its own debentures.

(j) In case of debentures if the quotation is cum-interest it means that it is with interest and for recording purpose interest is added to the total price paid.

Ans. [True : (a); (e); (f); (g), False: (b); (c; (d);(h); (i); (j)].

3. What do you understand by a debentrure ? Describe briefly the different types of debentures.

4. What is debenture stock /

5. Distinguish between : (i) a debenture and a share, and (ii) debenture and debenture stock.

6. Give different considerations for which debentures may be issued.

7. Write notes on : (i) Debentures Discount, (ii) Debentures as Collateral Security, (iii) Interest on Debentures, (iv) Ex-interest nad Cum-interest, (v) Own Debentures.

8. Discuss the various journal entries which are passed in the books of a company when provision is made through sinking fund or insurance policy for the redemption of debentures.

9. What are the various methods of redemption of debentures?

10. What are the alternatives available for making the provision for redeeming debentures? Is it necessary to make such provision ?

11. Explain (i) redemption of debentures out of capital and (ii) redemption of debentures out of profit.

PRACTICAL PROBLEMS

1. A limited company issued 1,000 debenture bonds of rs.100 each at a premium of 10 per cent repayable at part at the end of the 10th year. The debenture bonds were payable 25 per cent on application, 35 per cent on allotment (including the premium) and the balance on first and final call. All the moneys were received by the company in due course.

   You are asked to journalise the above transactions in the books of the company.

2. A limited company issued Rs.1,00,000 debentures, which were issued as follows :

1.	To sundry persons for cash at 90 per cent	Rs. 50,000 nominal
2.	To a creditor for Rs.20,000 capital expenditure in satisfaction of his claim	Rs. 25,000 nominal
3.	To bankers as collateral security	25,000 nominal

The Issue (1) and (2) are redeemable at the end of 10 years at par. How shou the debentures be dealt with in preparing the balance sheet of the company ?

3. Naveen Ltd. Issued Rs.1,00,000 10 per cent debentures on 1st January, 1994 at discou of 5 per cent repayable in annual drawings of rs.25,000 commencing from 31st Decemb following. The company's year ends on 31st December.

Journalize the above transactions for four years ending 31st December 1997, assumi that the company decided to write off debenture discount account during the life of debentures.

Ans. [Debenture Discount A/c written off : 1994 Rs.2,000; 1995; 1996 rs. 1,000; 1997 Rs.50

4. A company issues Rs.1,00,000 10 per cent debentures on 1st April, 1994 at a discou of 5 percent repayable in annual drawings of Rs.25,000 each on 31st March every ye Calculate the amount of discount to be written off each year. The financial year of t company ends on 31st December each year.

5. (a) A limited co. issued 2,000 10% debentures of Rs.100 each at Rs.95 on 1.1.91. per the terms of issue, debentures are to be redeemed at the end of 5 yea Show the amount of the discount to be written off to the profit and loss accou every year.

(b) A company purchases assets of Rs.2,60.000 and liabilities of Rs.50,000 fo sum of Rs.2,00,000. The purchase consideration is satisfied by the issue of debentures of Rs.100 each at par. Journalize.

(a) A company issued 20,000 10% debentures of Rs.100 each at a discount of repayable after 10 years at a premium of 5%. Pass necessary journal entries

Ans. [(a) rs.2,000; (b) Capital Reserve Rs.10,000; (c0 Loss on issue of debentures rS.2,00,0

6. A company issued 5,000 debentures of Rs.100 each at par on 1st January 19 redeemable at par on 31st December 1999. a sinking fund was established for purpose. It was expected that investments would earn 5% net. Sinking fund tab show that Re.0.180975 amount to Re.1 at the end of 5 years @ 5%. On 31st Decem 1999 the investments realized Rs.3,90,000. On that date the company's bank bala stood at Rs.1,45,600. The debentures were duly redeemed. Give the necessary jou entries, ledger accounts and assume that the investments were made to the nea Rs.10.

7. In the Balance Sheet of a company, the discount on debentures shows a debit bala of Rs.15,000. Every year Rs.5,000 is charged off to profit and loss account. How you show the discount on debentures account at the end of the first year and sec year in the balance sheet of the company ?

Ans. [Discount on Debentures account balance at the end of: 1st year Rs.10,000; 2nd year rs.5,000 to be shown on the Assets side under the heading of Miscellaneous expenditure (to the extent not written off)]

8. On 1st January, 1994, a company made an issue of 5,000 5% debentures of Rs.100 each at Rs.90 per debenture. The terms of issue provided for redemption of Rs. 20,000 debentures every year commencing from 1995 either by purchase or by drawing at part or at the company's option. Rs.5,000 was written off the debenture discount account in 1994 and 1995. During the year 1995, the company purchased for cancellation debentures of the face value of rs.6,000 at Rs.94 per debenture and rs.14,000 at Rs.92 debenture. Pass journal entries.

9. A limited issues 10,000 14% debentures of rS.100 each at 98 on January 1, 1992. Under the terms of issue (a) debenture interest is annually payable on 31st December every year, and (b) one fifth of the debentures are annually redeemable by drawings, the first redemption occurring on 31st December, 1993.

Ans. [Balance in debentures account on 31.12.94 Rs.6,00,000; Balance in discount on issue of debentures account on 31.12.94 Rs.6,000; interest on debentures:1992 Rs.1,40,000; 1993 Rs.1,40,000; 1994 Rs.1,12,000; discount on issue of debentures written off: 1992 Rs.5,000; 1993 Rs.5,000; 1994 Rs.4,000].

10. A company issued Rs.2,00,000 6% debentures of rs.1000 each at par, repayable at the end of 5 years at a premium of 5%. In terms of the trust deed, a sinking fund was to be created for the purpose of accumulating sufficient fund for the purpose. Investments were made yielding 5% interest received at the end of each year. All investments, including reinvestments of interest received, were made at the end of the year.

You are required to show, for 5 years, the –

(a) Sinking Fund Account; and

(b) Sinking Fund Investment Account

Note. [Rs.2,71462 invested at the end of each year at 5 per cent compound interest will amount to Rs.15 at the end of 5 years].

11. The debenture redemption fund account of a limited company stood at Rs.1,60,000 represented by rs.2,00,000 (nominal) investments. The debentures stood at Rs.5,00,000 and the company sold Rs.24,000 investments at Rs.85 for the purpose of redeeming Rs.20,000 debentures at 102.

Show ledger accounts ignoring interest etc.

Ans. [Profit on Sale of Investments Rs.1,200].

12. On 31st March, 1995, the Alka Trading Company Ltd. had a debenture redemption of rs.5,00,000 represented by the investment amounting to Rs.5,90,000. The com has bank balance on 30th September, 1995 of rs.60,000. The debentures amounti rs.5,00,000 were paid off on 30th September 1995. The security was sold for this pu and realized 83% net and the proceeds were banked on 30th September 1995. R the above transactions in company's ledger.

Ans. [Balance in Bank A/c Rs.49,700/-].

13. A company had rs.8,00,000 5% debentures outstanding as on 1st January, redeemable on 31st December, 1995. On that day, sinking fund was Rs.7.4 represented by Rs.1,00,000 own debentures purchased at the average price o and Rs.6,60,000 3% stock. The annual installment was Rs.28,400.

On 31st December, 1995, investments were realized at Rs.98 and the debentures redeemed.

You are required to write up the accounts for the year 1995.

Ans. [Profit on Cancellation of own Debentures Rs.1,000; Loss on Sale of 3% Stock Rs. Balance of Sinking Fund Account transferred to General Reserve Rs.7,99,000]

UNIT – II

COMPANY ACCOUNTS – FINANCIAL STATEMENTS

OBJECTIVES

In this chapter we will see how the final A/c of a corporate house is prepared we will proceed as fellows :

1. Introduction
2. Objectives of financial statement
3. Need for regulation of financial statement
4. Parts of financial statement
5. Balance sheet of a company
6. Items of balance sheet
7. Profit and loss A/c
8. Items in profit and loss A/c
9. Miscellaneous Examples

INTRODUCTION

In this chapter we will discuss the preparation of company financial statements, namely, the profit and loss account, balance sheet and notes to the accounts. Notes to the accounts comprise relevant data and information which needed by the users but which cannot be presented in the financial statements.

OBJECTIVES OF FINANCIAL STATEMENTS

The objectives of preparing the financial statements are as follows :

1. To provide financial information that is useful in making rational investment, credit and similar decisions.
2. To provide financial information to enable users to predict cash flows to the business and subsequently to themselves.
3. To provide financial information about business resources (assets), claims to these resources (liabilities and owners equity) and changes in these resources and claims.

NEED FOR REGULATION OF FINANCIAL STATEEMNTS

Financial statements are least helpful to the users if they are not drawn up properly and do not disclose the much needed information. So the following legal framework may be discussed :

1. The board of directors must present at every annual general meeting the followi
2. A balance sheet at the end of the financial year to show the financial position o company.
3. A profit and less A/c for that period to show the performance of the business.

Section – 210

A financial year may be more or less than a calendar year but it should not excee months. With special permission from registrar it may extend to 18 months companies nor prepare their accounts for the financial year ending with 31st March every year.

Section – 209

The profit and loss account and the balance sheet are prepared with the help of b of account maintained kept by the company. Such books are required to be kept on ac basis and according to the double entry system of accounting.

Part – I of schedule VI of companies Act 1956 say that every balance shee company, must give a true and fair view of the state of affairs of the company and conform to either the horizontal or vertical form.

Part – II of schedule VI of companies Act 1956 says that every profit and loss ac must give a true and fair view of the profit and loss of the company for the financial y

Financial statement must be prepared in accordance with accounting standards. standards are prepared by the institute of chartered accountants of India (ICAI) a prescribed by the central government.

Every balance sheet and profit and loss A/c of a company must be authentica its manager or secretary and by not less than two directors one of whom must be ma director.

The financial statements must be accompanied by the report of the statutory to the shareholders as required by the manufacturing and other companies (auditor's order (MAOCAR) 1988 issued by the central government.

Every balance sheet laid by the company at the annual general meeting m accompanied by a report of the board of directors as per sec. 217 and auditor's rep

As pert he companies Act 1956 the financial statements should give a true view of the books of accounts maintained.

MEANING OF TRUE AND FAIR VIEW

True and fair does not mean conforming to the forms prescribed by the Act. T fair view cannot be obtained only if the accounts are prepared in a defined manne down by various accounting standards and in conforming with the generally a accounting principles (GAAP).

The term true and fair view has not been defined in law nor is defined by any accounting standard. However it may be presumed that the financial statements reflect a "true and fair view" if the following requirements are met:

(a) The statements are drawn in accordance with the requirements of parts I and II of schedule VI of the companies Act.

(b) Proper books of accounts are maintained on double entry principles followed by accrual basis of accounting.

(c) Accounts are drawn conforming to GAAP and the requirements of accounting standards.

(d) Financial statements reflect substance of transactions and events that took place during the year.

(e) Accounts disclose all information as required by the statutory auditor although some information may not be strictly required by low.

ACCRUAL BASIS

It is mandatory under the companies Act for all companies to maintain their accounts on accrual basis and according to double entry system of accounting. Accrual basis as distinguished from cash basis recognizes revenues in the period earned even if such revenues are not received in cash. Similarly expenses are recognized in the period incurred in the process of generating revenues even if such expenses have not been paid.

PARTS OF FINANCIAL STATEMENT

The financial statement of company must consist of

(i) Balance sheet

(ii) Profit and loss A/c

(iii) Cash flow statement

(iv) A report on corporate governance

(v) Management discussion and analysis

But in the present chapter we will discuss how the balance sheet and profit and loss A/c of a company is prepared.

BALANCE SHEET

MEANING

Balance sheet is a statement of Assets, liabilities and capital which is prepared to know the financial position of a company on a particular date i.e., at the end of the year.

Balance sheet of a corporate house must be prepared in the prescribed form a[...] part-I of schedule-VI of the companies Act (sec.211) 1956. But this form does not ap[...] banking, insurance, and electricity companies which are governed by special statute[...] the formats for financial statements are prescribed therein.

Horizontal Balance sheet OF M/S________ as on 31st March ________

Fig.for pre. Yr.	Liabilities	Fig.for current Yr.	Fig.for pre. Yr.	Assets	Fi[...] c[...] Y[...]
	Share capital			**Fixed Assets**	
	Authorised share capital (......shares of Rs........)			(a) Goodwill (b) Land	
	Issued share capital (......shares of Rs........)			(c) Buildings (d) Leaseholds	
	Subscribed share capital (......shares of Rs........)			(e) Railway siding (f) Plant & Machinery	
	Called up share capital (......shares of Rs........)			(g) Furniture & fittings (h) Development of property	
	Paid up share capital			(i) Patents, trademarks and designs (j) Livestock, vehicles etc.	
	Less calls in Arear			**Investments**	
	Calls in Advance			1. Investment in Govt. or trust securities 2. Investment in shares, debentures or bonds.	
	Reserves & Surplus			**Current assets, loans and advances** **(A) Current Assets**	

	1. Capital Reserves 2. Capital redemption reserve 3. Share premium A/c 4. Profit & Loss (cr) 5. Sinking fund.			1. Interest accrued on investment. 2. Stores & spare parts 3. Loose tools 4. Stock-in-trade 5. Work in progress.	
				6. Sundry debtors:	
				(a) Debtors outstanding for a period exceeding six months. (b) Other debts. Less provision. 7. Cash in hand Cash at Bank	
	Secured Loans			**Loans & Advances**	
	1. Debentures 2. Loans & advances from bank 3. Loans & advances from subsidiaries 4. other loans & advances			8. Advances & loans to subsidiaries 9. Bill of exchange 10. Advances recoverable in cash or in kind. 11. Balances with customs, part trust etc.	
	Unsecured loans			**Miscellaneous Exp.**	
	1. Fixed deposits 2. Loans & advances from subsidiaries 3. Short-term loans and advances (a) From banks (b) From others 4. Other loans & Advances (a) From banks (b) From others			1. Preliminary exp. 2. expenses on underwriting 3. Discount on issue of shares or debentures. 4. Interest paid out of capital during construction 5. development exp. Profit & loss A/c (Dr)	

	Current Liabilities & Provision **Current liabilities**				
	1. Acceptances 2. Sundry creditors 3. Subsidiary companies 4. Unclaimed dividends 5. Other liabilities 6. Accrued interest on loans.				
	Provisions				
	7. Provisions for taxation 8. Proposed dividends 9. For contingencies 10. For provident fund scheme 11. For pension, insurance and similar staff benefits 12. Other provisions				

NB – Contingent liabilities

VERTICAL FORM OF BALANCE SHEET

		Schedule no.	Figs. As at the end of current financial year	Figs. the e… previo… financ…
I	**Source of funds**			
	1. Shareholders (a) Capital (b) reserve & Surplus 2. Loan funds (a) Secured loans (b) Unsecured loans			

	Total			
II	**Application of funds**			
	1. Fixed Assets (a) Gross block (b) Less depreciation (c) Net block (d) Capital work-in-progress 2. Investments 3. Current Assets, loans & advances (a) Inventories (b) Sundry debtors (c) Cash and bank balances (d) Other current assets (e) Loans & Advances			
	Less : current liabilities & provision			
	(a) liabilities (b) Provisions			
	Net current assets			
	4. (a) miscellaneous expenditure (b) Profit and loss A/c			
	1. Contingent liabilities			

DETAILS IN THE BALANCE SHEET ITEMS

Share capital

(i) Details of authorized, issued, subscribed and, called-up capital must be given separately with respect to preference and equity shares, the two types of shares, companies are permitted to issue.

(ii) From the called-up capital 'call in arrears' must be deducted to arrive at paid-up capital calls in arrears must be separately shown for directors and others.

(iii) Forfeited shares balance, if any, after transferring profit on reissue to capital reserve, should be added to paid-up capital.

(iv) Shares allotted for consideration other than cash such as shares allotted to vendor companies in mergers and acquisitions in pursuance of takeover agreements must be disclosed by way of information under this head.

(v) Similarly particulars of bonus shares issued must be given. Sources from which bonus shares are issued e.g., capitalization of profits or reserves or from share premium account, must also be stated.

(vi) Terms and conditions of redemption/ conversion of preference shares along wi earliest date of redemption or conversion must be given particulars of any option issued share capital must be specified.

(vii) When a public issue is made, any money received will become part of share only after the allotment is made. Therefore share application moneys and ca advance must be shown separately. However, excess application moneys re must be shown under current liabilities as these have to be repaid within a short p

Reserves and surplus

(i) Under this heading are shown the items reserves and surplus. Surplus refers credit balance in the profit and loss accounts after providing for appropriations s dividends and any write-offs which the company may decide. Reserves are of two namely capital and revenue reserves. Capital reserves are built up by approp capital profits such as profits on sale of investments, assets on reissue of fo shares etc. on the other hand revenue reserves are built up by appropriating r receipts or profits.

(ii) All additions and deductions from any reserves and surplus since the last b sheet must be shown under each of the specified heads.

(iii) A reserve is to be distinguished from reserve fund.

(iv) If the profit and loss account is a credit balance it would be shown as surplus ur heading on the other hand, if it is a debit balance the same should be deduct the reserves.

(v) In the case of the item share premium account all details of utilization in the provided under sec-78 of the companies Act must be shown in the year of util

(vi) Debenture redemption reserve created as per SEBI guidelines must be show liabilities side of the B/S under the head specific revenue reserve.

SECURED LOANS

(i) Under this heading fully secured loan are shown. A fully secured loan is one w market value of the security is more than the amount of loan. If the value f the is less them the loan amount, the loan becomes partly secured. Unsecured pa loan has to be shown under the next heading unsecured loans.

(ii) Interest accrued on loans should be included under the appropriate item u head. If it relates to debentures under debentures and similarly for other item

(iii) If the loans are guaranteed by the directors or managers, details must be dis loans are from directors it should be shown separately.

(iv) Nature of security in each case is to be specified.

(v) Terms of redemption or conversion of debentures and earliest date of redemption to be stated

(vi) If the assets are mortgaged in favour of a third party who had guaranteed the loan, such loan should also be classified as secured loan. The fact of mortgaging the assets in favour of guarantor instead of the lender should be stated.

(vii) Future installments payable under hire-purchase agreements should be shown under secured loans as a separate item.

(viii) Debentures guaranteed by government is not a secured loan as no asset has been mortgaged against such a loan.

(ix) Application moneys received against a debenture issue pending allotment should be shown as short-term deposits.

UNSECURED LOANS

(i) These are loans for which no security has been provided for. In the case of partly secured loans that portion of the loan which is not covered by the security will also appear under this heading. There are four items under this heading namely (1) fixed deposits (20 loans and advances, (3) short-term loans and advances and (40 other loans and advances.

(ii) Short-term loans and advances are those which are due for payment within one year from the date of balance sheet. Normally such items are shown under current liabilities.

CURRENT LIABILITIES

(i) As per ICAI guidelines current liability includes loans, deposits, bank overdraft which falls due for payment in a relatively short period, not more than twelve months. However schedule-VI of the companies Act requires showing of short-term secured and unsecured loans under the appropriate heads and not under current liabilities. Further interest accrued and due with respect to secured and unsecured loans are also not shown under current liabilities but shown under the respective heads.

(ii) This heading provides for seven items. Acceptances are bills accepted by the enterprise and pending payment on the balance sheet date. The items sundry creditor include all to liabilities arising out of the trading activities of the company and any other current liabilities fall under items (6) 'other liabilities' (if any).

(iii) The item 'subsidiary company' is to be used to reveal liabilities to a subsidiary for purchase of goods and services etc.

(iv) Advance payments include any payment received in advance against which goods are to be supplied or services are to be rendered in short run. Advances from custo dealers etc. fall under this category.

(v) Unclaimed dividends are the dividends in respect of which warrants have been i to the shareholders but not yet encased by the shareholders. But unpaid dividend r the dividends have been declared but not paid or the warrants and cheques in re of which have not yet been issued. Both unclaimed dividends and unpaid dividen to be shown as current liabilities.

(vi) Interest accrued on loans but not due should be shown under current liabilitie happens when interest dates and balance sheet date do not coincide with each

PROVISIONS

(i) Part – III of schedule VI defines a provision as any amount written off or retained of providing for depreciation, renewals or diminution in value of assets or retai way of providing for any known liability of which the amount cannot be determin substantial accuracy. For example provision for taxation, proposed dividends, pr for contingencies etc.

(ii) Inc se of contingencies losses should be provided and mentioned under the h provision for contingencies.

CONTINGENT LIABILITIES

(1) According to ICAI guidelines contingent liability means "an obligation relatin existing condition or situation which may arise in future depending on the occurr non-occurrence of one or more uncertain future events. For example a legal case in a court against the company relating to the compensation to a worker w injured due to an accident occurred in factory. If the case goes against the c then the company will be called upon to pay otherwise not.

(2) Schedule VI classifies contingent liabilities under the following heads :

(i) claims against the company not acknowledged as debts

(ii) uncalled liability on shares partly paid.

(iii) Arrears of fixed cumulative dividend.

(iv) Estimated amount of contracts remaining to be executed on capital acc provided for; and

(v) Other money for which the company is contingently liable.

Under this heading is to be shown the amount of any guarantees given by the on behalf of directors or other officers of the company.

Generally the contingent liabilities are shown at the foot note of the balance sheet.

FIXED ASSETS

(1) As per As – 10 'Accounting for Fixed Assets' a fixed asset is an "asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business. Even assets which are not legally owned but are held for the production of goods or services for example leasehold premises or asset purchased under hire-purchase agreements are also shown under this heading.

(2) Under this heading there are eleven categories starting with good will and ending with vehicles etc. under each head the original cost, and additions thereto and deductions there from during the year and the total depreciation written off or provided to the end of the year are to be stated. It would be clumsy to show all the details in the balance sheet itself and therefore a separate schedule will provide such details.

(3) In ascertaining the cost of an asset all expenditure incurred in bringing it to present location and put it to working condition should be included.

(4) In every case where the original cost of the asset cannot be ascertained without unreasonable expense or delay, the valuation shown by the books can be given. For this purpose, such valuation shall be the net amount at which an asset stood in the company's books at the commencement of this Act after deduction of the amounts previously provided or written off by way of depreciation, and where such an asset is sold, the amount of sale proceeds shall be shown as a deduction.

INVESTMENTS

(1) As – 13 defines investments as assets held by an enterprise for earning income by way of dividends, interests, and rentals for capital appreciation, or for other benefits to the investing enterprise. Investments represents capital invested outside by on enterprise and they may be long term or current investments current investments by its nature are readily realizable and are intended to be held for not more than one year. Investments other than current are considered to be long-term.

(2) Schedule VI of companies Act requires investments to be shown under the following categories :

(i) Government or trust securities

(ii) Shares, debentures or bonds

(iii) Immovable properties

(iv) Capital of partnership firms

(3) Shares, debentures and bonds held in subsidiary company must be separately show

(4) Company should disclose the nature of investment and the mode of valuation.

(5) The first two categories must be subdivided into quoted and unquoted and mar value of quoted investments must be given.

(6) In the case of shares etc. details of fully-paid and partly-paid must be given.

(7) A statement of investments separately classifying trade investments and oth investments should be annexed to the balance sheet.

(8) In the case of investments in partnership firms, the names of the firms, the names of the partners the total capital, and the shares of each partner must be given.

Current Assets and Loans and Advances :

(1) This is a common heading to (A) current Assets, and (B) Loans and Advances. To there are 12 items. 7 under current assets and 5 under loans and advances.

(2) Cash and other assets that are expected to be converted into cash or consumed in production of goods or rendering of services in the normal course of business as def as current Assets current assets are usually valued at lower of cost and net realiz value.

(3) With respect to sundry debtors the following details must be shown :

(i) Showing debts outstanding for a period of more than six months and other d

(ii) Classification based on security and recoverability :

(a) Debtors considered good in respect of which the company is fully sec

(b) Debts considered good for which the company holds no security othe the debtor personal security.

(c) Debts considered doubtful or bad.

(iii) It is required to deduct provision for bad and doubtful debts from the sundry de The provision should not exceed the amount considered doubtful or ba surplus provision already created should be shown as reserve for bad and d debts under the head reserves and surplus.

(4) Bank balances are primarily classified into balances with scheduled banks, an banks with respect to balances with scheduled banks details of current accou accounts and deposit accounts should be given. With respect to other banks, th of the banks together with nature of accounts should be given. If the directors relatives have interest in the non-scheduled banks where in bank balanc

maintained the same should be disclosed. If the balance is a overdraft the same should be included under sundry creditors alongwith a disclosure by way of a note that sundry creditors include bank overdraft amounting to Rs......

(5) Loans and advances are classified as :

(A) Advances and loans to subsidiaries

(B) Advances and loans to partnership firms in which the company or its subsidiary is a partner.

(C) Bills of Exchange

(D) Advances recoverable in cash or kind or for value to be recovered.

(E) Balance with customers. Port trusts etc (where payable on demand).

Disclosure requirements of loans and advances are similar to that of sundry debtors.

Miscellaneous Expenditure

(1) The amount are shown to the extent not written off or adjusted. The first item under this head is preliminary expenses. These are also known as formation expenses and include legal costs in drafting the memorandum nd Articles, capital duty and other fees on registration, cost of printing memorandum, articles and the statutory books of the company and any other expenses associated with the formation of the company. These are normally written off against profits over a period of time. Until it is fully written off, the amount not written off appears under this head.

(2) Expenses associated with the issue of shares and debentures such as issue expenses, brokerage paid to brokers, under writing commission paid to under-writers appears under this head. These can also be capitalized instead of showing as miscellaneous expenditure when share and debentures are issued at discount, the liability on account of share capital and debentures will appear at par value. However cash received will be short of such liability and the difference being discount appears under this heading. Financial prudence requires such amount to be written of over a period.

(3) Interest paid out of capital during construction can either be capitalized or shown as miscellaneous expenditure. Most of the items coming under miscellaneous expenditure deferred revenue expenses which must be written off over the period for which benefit is available. For example debenture discount and issue expenses can be written of over the maximum period for which the debentures would be outstanding. The fact that the amount spent is large does not make expenditure a deferred revenue expenditure. Such expenditure should benefit future period.

PROFIT AND LOSS ACCOUNT

According to sec-211 of the companies Act 1956 every profit and loss accoun company should give a 'true and fair' view of the net profit or net loss of the company

Requirements as to profit and loss A/c

The profit and loss A/c shall be made so that it can clearly disclose the result working of the company during the period covered by the account; and shall disclose material feature, including credits or receipts and debits or expenses in respect of non-re transactions or transactions of an exceptional nature.

The profit and loss account shall set out the various items relating to the incom expenditure of the company arranged under the most convenient heads, and in par shall disclose the following information in respect of the period covered by the accou

(a) The turnover that is the aggregate amount for which sales are affected by the co

(b) Commission paid to selling agents

(c) Brokerage and discount on sales, other than the usual trade discount.

A- In the case of manufacturing companies : -

(1) The value of the raw materials consumed, giving item-wise break-up and indica quantities thereof.

(2) The opening and closing stocks of goods produced, giving break up in respect class of goods and indicating the quantities thereof.

B- In case of trading companies, the purchases made and the opening and closing giving break up in respect of each class of goods traded in by the company and in the quanties thereof.

C- In the case of companies rendering or supplying services the gross income from services rendered or supplied.

D- In the case of al concerns having works in progress, the amounts for which su have been completed at the commencement and at the end of the accountin

(1) The amount provided for depreciation, renewals or diminution in value of fixe

If no provision is made for depreciation, the fact that no provision has been m be stated and the quantum of arrears of depreciation computed in accordance – 205(2) of the Act shall be disclosed by way of a note.

(2) The amount of interest on the company's debentures and other fixed loans if or payable to the managing director and the manager, if any.

(3) The amount of charge for Indian income-tax and other Indian taxation on profits paid or payable.

(4) Expenditure incurred on each of the following item, separately for each item : -

(5) (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.

(6) (a) Profit or loss on sale of investments

(b) Miscellaneous income

(7) (a) Dividends from subsidiary company

(b) Provision for losses of subsidiary company.

(8) The aggregate amount of the dividends paid, and proposed, and stating whether such amounts are subject to deduction of income tax or not.

E- The profit and loss account shall contain the following payments provided or made during the financial year to the directors including managing directors or manger, if any by the company, the subsidiaries of the company and any other person;

(i) Managerial remuneration under sec – 198 of the Act paid or payable during the financial year to the directors if any;

(ii) Any other perquisites or benefits in cash or in kind

(iii) Pensions, gratuities etc.

The profit and loss A/c shall contain or give by way of a note a statement showing the computations of net profits in accordance with sec-349 of the Act. With relevant details of the calculation of the commissions payable by way of percentage of such profits to the directors including managing directors, or manager (if any);

The profit and loss A/c 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 –

(a) As auditor

(b) As adviser, or in any other capacity, in respect of –

i. Taxation matters

ii. Company law matters

iii. Management services; and

(c) In any other manner.

In the case of manufacturing companies, the profit and loss account shall also contain, by way of a note in respect each class of goods manufactured.

PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED – 31ST MARCH 2005

	Schedule	Current yr.	Previous yr.
Income			
Sales Other income Increase/ decrease in W-i-progress/ finished stocks			
Total			
Expenditure			
Cost of Raw materials and spares. Excise duty Employees remuneration & Benefits Other expenses Interest Depreciation			
Total			
Profit before taxation & extraordinary items			
Extraordinary items Profit for the current year Profit period adjustments Profit before taxation Provision for taxation Profit after tax			
Balance B/C from the previous year			
Total available for appropriations			
Proposed dividend Corporate dividend on taxes Debenture redemption reserve General reserve Any other statutory reserves			
Balance c/f to next year			
Total of Appropriations and c/f.			

Notes to the profits and loss account : -

(1) Profit and loss account schedules are numbered after the schedules or balance sheet, and therefore start with higher numbers.

(2) In some annual reports adjustments relating to work-in-progress and finished stocks are carried to materials consumed.

(3) Under other expenses there can be more classifications such as manufacturing expenses, administration expenses, selling and distribution expenses etc.

(4) Each schedule gives more details as the income statement avoids showing such details. For example sales may give details of sales by product and/ or territory.

(5) The schedule of other income will show such items as profits on sale of fixed assets or investments and such other items.

(6) It may be noted that both extraordinary items and prior period items from part of current profits but they are shown separately so that the users can understand the impact of such items on current profit.

(7) In the preparation of profit and loss account each enterprise has a choice in accounting policies with respect to revenue recognition, inventory valuation, depreciation, valuation of investments etc.

(8) The change in any accounting policy and its impact on current profit will be mentioned only in the notes to accounts and will not be shown in the income statement.

SOME ADJUSTMENTS

(1) Calls in arrear : This item generally appears in the trial balance. It represents the amount not paid by the shareholders in the calls made on them by the company. This is shown in the balance sheet on the liability side by deducting the amount from the called-up amount. If this item appears in the adjustment then the trial balance shows paid-up capital (not-called-up capital0. The amount is first added to paid-up capital to make the paid up capital as called-up capital and then deducted again.

(2) Unclaimed dividend : This always appears on the credit side of trial balance. This represents dividend not collected by the shareholders. It is shown on the liability side of the balance sheet under the heading current liabilities.

(3) Interim dividend : This item always appears in the trial balance and it represents dividend paid by the company before the Annual General Meeting and mostly based on half yearly Accounts. This is an appropriation of profit and is shown on the debit side of appropriation section of profit and loss account. The appropriation section of the profit and loss account is usually called profit and loss appropriation A/c

(4) Final dividend appearing in the trial balance : This item is shown in the debit side profit and loss appropriation account.

(5) Final dividend for the previous year appearing in the trial balance : If trial balance sho the dividend for the previous year then it is shown on the debit side of profit and lo appropriation account.

(6) Proposed dividend : The item is generally given under adjustment. This is shown on debit side of profit and loss appropriation account and on the liability side of bala sheet under the heading provisions.

(7) Dividends received : These are dividends received on investments made in share other companies, and represent income on investment. The amount of dividend rece is the net amount of dividend received, i.e. dividend after tax so gross amount of divid is to be found out. The gross figures of dividends received will appear on the credit of the trial balance and tax deducted at source will appear on the debit side of balance.

(8) Interest received : This is the income being interest on money lent or on bank depo The interest received as given in the question is the net amount of interest receive interest due less tax deducted at source. So the gross amount of interest recei found out and shown on credit side of the profit and loss account.

(9) Interest paid on money borrowed for construction : This is a capital expenditure captalised by adjusted, it is shown in the balance sheet on the assets side und heading miscellaneous expenditure.

(10) Interest on debentures : The company disbursing interest on debentures h responsibility of deducting tax at source. The company is to deduct the tax amount of interest due on debentures. The tax so deducted is shown as a liabilit liability side of the balance sheet until it is paid. So the journal entry for inte debentures will be : interest on debentures A/c Dr.

To Bank A/c

To income tax payable A/c

(11) Discount and cost of issue of debentures : This includes discount, commiss other expenses on the issue of debentures. This appears on the assets side of sheet under the heading miscellaneous expenditure. This expense is writte prudently as possible out in no case should it be allowed to stand in the books life of debentures. The amount written off is shown in the debit side of profit account and the balance portion is shown in the balance sheet under the "miscellaneous expenditure".

(12) Forfeited shares account : This appears on the credit side of trial balance and is shown on the liability side of the balance sheet by adding to the paid up capital under the heading subscribed capital.

(13) Securities premium account : This is shown in the liabilities side of the balance sheet under the heading reserves and surplus

(14) Tax adjustments : In relation to corporate taxation, a student will come across the following items :

(a) Tax deducted at source

(b) Advance payment of tax

(c) Income tax (corporate tax)

(d) Provision for taxation

(e) Deferred tax.

The accounting treatment of the above points are discussed below:-

(a) Tax deducted at source : As per section 194 of the income Tax Act, 1961, tax is to be deducted at source from interest on securities before they are paid. For example, if the gross interest is Rs.1000 then the company will pay only rs.790 after deducting tax at source at 21%. The following entry is made by the investor company on the receipt of this amount :

Bank A/c	Dr	790
Tax deducted at source	Dr	210
To interest A/c		1000

So the item 'Tax deducted at source' will appear on the debit side of the trial balance. The amount so deducted can later be adjusted towards income tax payable after the assessment is over.

(b) Advance payment of tax : Under sec – 207 of the Income tax Act assesses are liable to pay advance tax when the income exceeds a certain limit and the limit is Rs.2500 for companies. When the tax is so paid the following entry is made :

Advance payment of tax A/c Dr

To bank A/c

This amount also appears on the debit side of a trial balance and is in the nature of a prepaid item. Advance payment of tax can alter be adjusted towards income-tad payable after the assessment is over.

(c) Income tax : Tax payable on the assessed income is debited to income tax account Necessary adjustment is made for the income tax paid in advance and tax deducted a source. For example if tax payable on assessed income is Rs.100000 and it has alread paid in advance Rs.60,000 the company now pays Rs.40000 only.

The entry will be :

Income tax account	Dr	100000	
To advance payment of tax			60000
To Bank			40000

If the assessment is not completed both advance payment of tax and tax deducted source remain unadjusted and would appear in the balance sheet under the headir current Assets, loan and advances etc.

(d) Provision for taxation : Since it would take quite some time for the company to get income assessed, it is usual to provide some amount for income-tax on profits at curre rats of taxation. Such provision is debited to the profit and loss account and credited provision for taxation account which appears on the balance sheet under the he current liabilities and provisions.

Just as provision is made in the current year, provision would have been made in t previous year and such provision is called as "old provision which would appear in t trial balance on the credit side. When such a provision exists income-tax paid must debited to the provision account and not to the profit and loss account. It the old provis is in excess of the income tax paid, such surplus provision should be shown on credit side of the profit and loss account. Likewise if the old provision not sufficie further debit is made to the profit and loss account. These adjustments are sho below the line so that the current profits may not be affected due to these items.

Illustration – 1

From the following trial balance and the adjustment given there under show how items would figure in the relevant accounts.

Particulars	Debit Amount Rs.	Credit amount Rs.
Income-tax (98-99)	60000	
Provision for Taxation (98-99)		68000

Solution

Adjustment – provide Rs. 80,000 by way of provision for taxation for the year 1999-2000.

Dr **Provision for Taxation (98-99)** **Cr**

Particulars	Amount	Particulars	Amount
To income-tax (98-99)	60000	By bal b/d	68000
To profit & loss A/c	8000		
	68000		68000

Dr **Provision for taxation (1999-2000)** **Cr**

Particulars	Amount	Particulars	Amount
To Balance c/d	80,000	By profit and loss account (above the line) By Balance b/c	80,000 80,000
	80,000		80,000
		By Balance b/c	80,000

Profit and loss account

For the year ended 31st March, 2000

	Rs.		Rs.
To provision for taxation (New)	80,000	By provision for taxation (old)	8,000

Balance sheet as on 31st March, 2000

Liabilities	Rs.	Assts	Rs.
Current liabilities and provisions : Provision for taxation	80,000		

Illustration – 2

The trial balance of complex tax. As at 31st March 1998 shows the following items.

Items	Debit (Rs.)	Credit (Rs.)
Advance payment of income-tax	2,20,000	
Provision for taxation for the year ended 31-3-1997		1,20,000

The following further information is given :

(i) Advance payment of income tax includes Rs. 1,40,000 for 1996-97.

(ii) Actual tax liability for 1996-97 amounts to Rs.1,52,000. No effect for th far been given in the accounts.

(iii) Provisions for income-tax has to be made for 1997-98 for Rs.1,60,000.

You are required to pass the necessary journal entries and show the relevant accounts. A show how these items will appear in the profit and loss account and balance sheet for year 1998.

(C.A.Inter, Nov., 19

Solution

Journal

Date	Particulars		Debit Rupees	Credit Rupees
31.3.98	Income-tax account	Dr.	1,52,000	
	To advance payment of income-tax			140000
	To tax payable account			12000
	(Being the tax liability for 96-97 and the tax payable after adjusting advance payment of tax.)			
31.3.98	Provision for taxation (96-97) A/c	Dr.	1,20,000	
	Profit and loss appropriation A/c	Dr.	32,000	
	To income-tax account			1,52,00
	(Being the tax for 96-97 adjusted against the provision for 96-97 and tax in excess of provision debited to profit and loss account below the line.)			
31.3.98	Profit and loss account	Dr.	1,60,000	
	To provision for taxation account (97-98)			1,60,00

Illustration – 6

The following are the balances of Johri A. Ltd. as on 31st March, 2001:

Credit	Amount	Debit	Amount
Share capital	40,00,000	Premises	30,72,000
12% debentures	30,00,000	Plant	33,00,000
Profit and loss account	2,62,500	Stock	7,50,000
Bills Payable	3,70,000	Debtors	8,70,000
Creditors	4,00,000	Goodwill	2,50,000
Sales	41,50,000	Cash and Bank	4,06,500
General reserve	2,50,000	Calls-in-Arrear	75,000
		Interim Dividend paid	3,92,500
Bad Debt. Provision on (1.4.2000)	35,000	Purchases	18,50,000
		Preliminary expenses	50,000
		Wages	9,79,800
		Gen. Exp.	68,350
		Salaries	2,02,250
		Bad debts	21,100
		Debenture Int. paid	1,80,000
	1,24,67,5000		1,24,67,500

Additional Information :

(a) Depreciate plant by 15%

(b) Write off Rs.5,000 from preliminary expenses.

(c) Half year's debenture interest due.

(d) Create 5% provision on debtors for doubtful debts.

(e) Provide for income tax @ 50%

(f) Stock on 31st march 2001 was Rs.9,50,000

(g) A claim of Rs.25,000 for workmen's compensation is being disputed by the company.

(h) Ignore corporate dividend tax.

Prepare Final Accounts of the Company.

[B.Com, Delhi-Adapted]

Profit and loss account for the year ended 31st March, 2001

Dr. **Cr.**

Particulars	Amount	Particulars	Amount
To Stock	7,50,000	By sales	41,50,000
To Purchases	18,50,000	By stock	9,50,000
To Wages	9,79,800		
To Gross Profit c/d	15,20,200		
	51,00,000		51,00,000

To Preliminary expenses	5,000	By gross profit b/d	15,20
To general expenses	68,350		
To salaries	2,02,250		
To debenture interest (1,80,000 + 1,80,000)	3,60,000		
To bad debts	21,100		
To provision for doubtful debts	8,500		
To depreciation on plant	4,95,000		
To provision for tax	1,80,000		
To profit and loss appropriation A/c	1,80,000		
	15,20,200		15,2

Profit and loss appropriation account

Dr. **Cr.**

Particulars	Amount	Particulars	Amou
To interim dividend To balance c/d	3,92,500	By balance b/d By profit & loss A/c (Net Profit)	2,62 1,80
	4,42,500		4,42

Balance sheet as at 31-3-2001

Liabilities		Amount	Assets	Amount
Share capital			Fixed Assets :	
Called -up capital	40,00,000		Goodwill	2,50,000
Less: calls-in-arrears	75,000	39,25,000	Premises	30,72,000
Reserves & surplus :			Plant (33,00,000 – 4,95,000)	28,05,000
General reserve		2,50,000	Current Assets loans and advances	
Profit & loss A/c		50,000	Current assets :	
Secured loan :			Stock	9,50,000
12% debentures	30,00,000		Debtors (8,70,000 = 43,500)	
O/S interest	1,80,000	31,80,000		8,26,500
Current liabilities and provisions :			Cash & Bank	4,06,500
Current liabilities :			Miscellaneous Expenditure:	
Creditors		4,00,000	Preliminary expenses	45,000
B/P		3,70,000		
Provision :				
Provision for Tax		1,80,000		
		83,55,000		83,55,000

Note : There is a contingent liability of Rs.25,000 for workmen's compensation.

Illustration – 7

The auto parts manufacturing co-ltd. was registered with an authorized capital of Rs.10,00,000 divided into shares of Rs.10 each of which 40,000 shares had been issued and fully paid.

The following is the Trial Balance extracted on 31st March, 2001 :

Particulars	Debit	Credit
Stock (1st April, 2000)	1,86,420	
Purchase and sales	7,18,210	11,69,900
Returns	12,680	9,850
Manufacturing wages	1,09,740	
Sundry manufacturing expenses	19,240	
Carriage inwards	4,910	
18% Bank loan (Secured)	-	50,000
Interest on Bank Loan	4,500	
Office Salaries and expenses	17,870	
Auditors' fees	8,600	
Director's remuneration	26,250	
Preliminary expenses	6,000	
Free-hold premises	1,64,210	
Plant and machinery	1,28,400	
Furniture	5,000	
Loose Tools	12,500	
Debtors and Creditors	1,05,400	62,220
Cash in hand	19,530	
Cash at Bank	96,860	
Advance payment of tax	84,290	
Profit and loss A/c on 1st April, 2000	-	38,640
Share capital	-	4,00,000
	17,30,610	17,30,610

You are required to prepare Trading and Profit and Loss Account for the year ende March, 2001 and a Balance sheet as at that date after taking into consideration the fol adjustments :

(i) On 31st March, 2001, outstanding Manufacturing Wages and outstanding Office S stood at rs.1,890 and Rs.1,200 respectively. On the same date, stock was val Rs.1,24,840 and loose tools at Rs.10,000.

(ii) Provide for interest on Bank Loan for 6 months.

(iii) Depreciation on plant and machinery is to be provided @ 15% while on Office Furniture it is to be @ 10%

(iv) Write off one-third of balance of preliminary expenses.

(v) Make a provision for income-tax @ 50%.

(vi) The directors recommended a maiden (first) dividend @ 15% for the year ending 31st March, 2001 after statutory transfer to general reserve. Assume 10% dividend Tax

[B.Com., Delhi – Modified]

Trading and profit and loss account

Dr.				Cr.
To opening stock		1,86,420	By sales	11,69,900
To purchases	7,18,210		Less : return	12,680
Less : Returns	9,850	7,08,360		1157220
To manufacturing Wages	1,09,740		By closing stock	124840
ADD. Accrued wages	1,890	1,11,630		
To manufacturing expenses		19,240		
To carriage inwards		4,910		
To Gross profit c/d		2,51,500		
		12,82,060		12,82,060
To interest (4,500+4,500)		9,000	By gross profit b/d	2,51,500
To office expenses (17,870+1,200)		19,070		
To audit fees		8,600		
To directors' remuneration		26,250		
To preliminary expenses		2,000		
To depreciation plant		19,260		
Furniture		500		
Loose Tools		2,500		
To provision for income-tax		82,160		
To profit & loss appropriation A/c (Net profit)		82,160		
		2,51,500		2,51,500

Profit and Loss Appropriation A/c

Dr. Cr.

Particulars	Amount	Particulars	Amount
To general reserve 95% of Rs.82,160)	4,108	By balance b/c	38,640
To proposed dividend	60,000	By profit & loss A/c (Net profit)	82,160
To dividend tax	6,000		
To balance c/d	50,692		
	1,20,800		1,20,800

Balance sheet as at 31.03.2001

Liabilities	Amount	Assets	Amount
Share capital :		Fixed Assets	
Authorised issued and subscribed		Freehold premises	1,64,210
Capital fully paid 40,000 shares of Rs. 10 each	4,00,000	Plant & machinery (1,28,400-19,260)	1,09,140
		Furniture (5,000-500)	4,500
Reserves & Surplus		Current Assets, loans & advances	
		(A) current assets :	
General Reserve	4,108	Loose Tools	10,00
Profit & loss A/c	50,692	Stock	1,24,84
Secured Loan		Debtors	1,05,40
18% Bank loan	50,000	Cash	19,53
Current liabilities & provisions		Bank.	96,86
(A) Current liabilities			
Creditors	62,220		
Outstanding expenses			
Wages	1890		
Salary	1,200		
Interest	4,500	(B) Loans & Advances	
(B) Provisions		Advances tax 84,290	
		Less provisions for	
		Income tax 82,160	
		Miscellaneous expenditure	
Provision to dividend tax	6,000	Preliminary expenses 6,000	
		Less written off 2,000	4
Proposed dividend	60,000		6,40
	6,40,610		

Illustration – 8

The trial balance of X limited, having an authorized capital of Rs.8,00,000 as at 31st December 2001 was as under.

Particulars	Debit	Credit
Share capital (Shares of rs.100 each fully paid)		5,00,000
Securities premium		50,000
Land and building (Cost Rs.3,00,000)	2,50,000	
Plant and machinery (Cost Rs.4,00,000)	3,00,000	
Livestock	20,000	
Gross profit earned during 2001		1,30,000
General reserve		2,00,000
6% debentures (issued on 1st January, 1994 secured by mortgage on land and redeemable on 31.12.2001		1,00,000
Sundry debtors and creditors	60,000	30,000
Stocks as at 31.12.2001, at cost or market value, whichever is lower	50,000	
Salaries	19,000	
Directors' fees	10,000	
General expenses	15,000	
Cash at bank	6,400	
Cash in hand	600	
Bills receivable	20,000	
Discount on issue of debentures	4,000	
Profit & Loss Account		10,000
Investment [4% Government securities, face value Rs.1,00,000 purchased on 1.1.2001	95,000	
Investments in equity shares [10,000 shares of Rs.25 each, Rs.20 paid up]	1,70,000	
	10,20,000	10,20,000

Further Information :

(1) of the shares allotted, 2,000 shares worth Rs.2,00,000 were allotted as fully paid to vendor from whom a running business was acquired.

(2) Of the debtors, Rs.10,000 were outstanding but are considered good except a debt of Rs.5,000 doubtful to be provided.

(3) A provision of Rs.25,000 is to be made for income-tax.

(4) The market value of government securities on the date of the balance sheet wa Rs.93,000 and that of equity shares was Rs.1,60,000. Assume that these are long ter investments.

(5) Auditor's fee Rs.3,000 should be provided for. Included in general expenses is s months insurance Rs.1,500 paid for the year to end on 30th June 2002.

(6) Interest on debentures issued and on investment in government securities should taken into account.

(7) Depreciation is to been provided for @ 6% original cost of machinery and 2% on original cost of land and building.

(8) Provide for a dividend of 5% of shares. Ignore corporate dividend tax.

Prepare profit and loss account profit and loss appropriation account and the bal sheet as on 31.12.2001.

[ICWA – Modified]

Profit and loss account for the year ended 31.12.2001

Dr. Cr.

Particulars	Amount	Particulars	Am
To salaries	19,000	By gross profit b/d	1,3
To director's fees	10,000	By interest on govt. securities	
To general expenses 15,000			
Less prepaid insurance 750	14,250		
To provision for doubtful debt	5,000		
To interest on debenture	6,000		
To depreciation on			
Plant and machinery 24,000			
Land and building 6,000	30,000		
To audit fees	3,000		
To provision for tax	25,000		
To net profit c/d	21,750		
	1,34,000		

Profit and loss adjustment account for the year ended 31.03.1996

To proposed dividend	25,000	By balance b/d	10,000
To balance c/d	6,750	By net profit b/d	21,750
	31,750		31,750

Balance sheet as at 31.12.2001

Liabilities	Amount	Assets	Amount
Share capital		Fixed Assets	
Authorised capital		Land & building (cost Rs.3,00,000)	2,44,000
8,000 equity shares @ Rs.100 each	8,00,000	Plant & machinery (cost Rs.4,00,000)	2,76,000
Issued, subscribed & paid up capital		Livestock	20000
5,000 equity shares @ 100 each fully paid	5,00,000	Investments	
		Investment 4% Govt. securities (face value Rs.1,00,000)	95,000
Reserves & surplus			
General reserve	2,00,000	Investment in shares	1,70,000
Profit and loss	**6,750**	**Current assets, loans & advances**	
Securities premium	50,000	A. current assets	
Secured loan		Stock-in-trade	50,000
6% debenture (mortgage on land)	1,00,000	Debtors more than 6 months 10,000 Others 50,000 60,000	
Current liabilities & provisions		Less provision for doubtful debts 5,000	55,000
		55000	55000
A. current liabilities			
Sundry creditors	30,000	Cash in hand	600
Interest on debentures	6,000	Cash at bank	6,400
Auditor's fees	3,000	Bills receivable	20,000

		B. Loans and advances	
B. provisions		Interest on Govt. securities	4,000
Proposed dividend	25,000	Prepaid insurance	750
Provision for tax	25,000	Miscollaneous expenditures :	
		Discount on debentures	4,000
			9,45,[illegible]
	9,45,750		

QUESTIONS

1. Mention whether the following statements are right or wrong :

   (a) Shareholders can increase the rate of dividend recommended by the Boa directors, if they think it too low.

   (b) . Advance payment of tax should be shown on the assets side of the balance s

   (c) No dividend is payable on calls in advance

   (d) Requirements given in part-II of schedule VI apply to the balance sheet.

   (e) Ordinarily capital profits are not available for the distribution of dividend.

   (f) Dividend paid or declared are subject to corporate dividend tax @ 10% w 1st June 1997.

Ans. [Right (b), (c) , (e) and (f), wrong (a) and (d).

2. Fill in the blanks

   (a) Capital redemption reserve account and securities premium account can be only for issuing fully paid bonus shares and not for making partly paid sh

   (b) The difference between gross dividend receivable and dividend received is to ...

   (c) Dividend declared between two annual general meetings is known as ..

   (d) Interest out of capital during construction can be paid under section companies act.

Ans. (a) Fully paid shares; (b) Tax deducted at source A/c; (c0 Interim dividend, (d

3. Who is responsible for maintenance of books of account ? Briefly explain the p of company low regarding maintenance of proper books of account.

4. Explain and illustrate how the following items are to be shown in the balance sheet of a company to comply with requirements of the companies Act 1956.

   (a) Share capital

   (b) Secured loans

   (c) Fixed capital expenditures

   (d) Current liabilities

5. How will you deal with the following matters when preparing the annual accounts of a company in accordance the requirements of schedule VI to the companies Act 1956, amended upto date.

   (a) Bonus shares issued

   (b) Balance of forfeited shares account after the reissue of forfeited shares

   (c) Securities premium account

   (d) Payment to auditors.

6. What do you mean by contingent liabilities. How are these liabilities shown in the balance sheet of a company?

7. Write short notes on :

   (a) Corporate dividend tax

   (b) Provisions for taxation and dividends

   (c) Miscellaneous expenditure to the extent not written off.

8. Give a specimen form of balance sheet and profit and loss A/c of a company according to companies Act.

9. Give an imaginary form of the profit and loss appropriation account of a limited company.

10. Prepare a summarized form of the balance sheet of a company as per companies Act 1956, taking imaginary figures.

11. How do you calculate profits for the purpose of the calculation of the managerial remuneration? What are the maximum rates of remuneration allowable under the companies Act to (i0 directors 9ii) managing director and (iii) manager ? is there any provision for the payment of the minimum managerial remuneration ?

12. Indicate the correct answers :

   (a) Assets in the balance sheet of a limited company are arranged in the order of :

i. Permanence

ii. Liquidity

(b) Calls in arrear is shown on the liabilities side of the balance sheet: by deducting the amount from the called up capital.

(c) Fictitious assets are shown on the assets side of the balance sheet of a company under the heading :

(d) Goodwill in case of a joint stock company is shown on the assets side under the heading of :

(e) Share forfeited account is shown on the liabilities side of the balance sheet.

(f) Unclaimed dividend is shown on the liabilities side of the balance sheet under the heading ;

i. Reserve and surplus ;

ii. Current liabilities and provisions.

Ans [(a); (b) (ii); (c) (iii); (d) (i); (e) (i); (f) (ii)]

PRACTICAL PROBLEMS

1. Due to inadequacy of profit during the year the company proposes to declare divi[illegible] out of general reserves. From the following particulars you are to ascertain the am[illegible] that can be drawn applying the companies (Declaration of Dividend out of res[illegible] rules, 1975:

	Rs.
5,000 8% preferences shares of Rs.100 each fully paid	5,0[illegible]
2,00,000 equity shares of Rs. 100 each fully paid	20,0[illegible]
General reserve	6,[illegible]
Capital reserve on revaluation of assets	1[illegible]
Securities premium	1[illegible]
Profit and loss A/c – credit balance	
Net profit for the year	
Average rate of dividend during the last five year : 15%.	

Ans. [rs.1,20,000 can be safely drawn from General Reserve ; Maximum rate of Dividend 10% on Paid up Capital].

1. The accounts of the Ludhiana Ltd. Showed an amount of rs.1,00,000 to the credit of profit and Loss Account on 31st March, 1998 out of which the Directors decided to place rs.20,000 to General reserve and Rs.5,000 to debenture Redemption Fund. At the annual general meeting held on 15th June, 2000, it was decided to place rs.10,000 to a development Reserve and to pay a bonus of 2 ½% of the profit to the Directors as additional remuneration. The payment of the half-yearly dividends on Rs.2,50,000 5% cumulative preference shares on September 30, 1997 and March 31, 1998 was confirmed, and a dividend at the rate of 10% was declared on the equity share capital of the face value of Rs.3,00,000; the balance of profit and loss Account to be carried forward to next year.

Make out profit and loss appropriation account showing the above arrangements.

Ans. [Surplus carried to B/S Rs.15,750].

Hint. Corporate dividend tax @ 10% on Rs.42,500 dividend rs.4,250.

2. For the year ended 31st March, 1998; the profit of Krebs Ltd. Before charging depreciation on fixed assets and managerial commission amounted to Rs.3,00,000. Depreciation for the year amounted to Rs.60,000 and a commission of 10 percent of the profits (before charging such commission) was payable to the Manager.

The paid-up capital of the company consisted of Rs.10,00,000 divided into 5,000, 6 per cent preference shares of rs.100 each and 50,000 equity shares of rS.10 each. Interim dividend at 50 p. per share was paid during the year. There was credit balance of rs.35,000 in the profit and loss account brought from the previous year. The following appropriations were proposed by the board of directors and subsequently passed at the annual general meeting of the company :

(a) to pay the year's dividend on preference shares.

(b) To pay a final dividend on equity shares at 50 p. per share to make a total dividend of re. 1 per share for the year.

(c) To provide for taxation @ 50 per cent on the net profit.

(d) To transfer rs.25,000 to the general reserve.

(e) To carry forward the balance.

You are required to show the profit and loss appropriation account.

Ans. [Net profit before provision for taxation rs.2,16,000; surplus carried to B/S Rs.3...

Hint. Corporate dividend tax of rs.8,000 has been provided because dividend paid re...
a period which is after to 1.6.1997.

3. A limited company was registered with an authorized capital of Rs.30,00,000 ...
shares of Rs.10 each. The following is the list of balances extracted from its boo...
31.3.2000 :

	Rs.		Rs.
Purchases	9,25,000	General expenses	
Wages	4,24,325	Stock on 1.4.1999	
Manufacturing expenses	65,575	Goodwill	
Salaries	70,000	Cash in hand	
Bad debts	10,550	Cash at bank	
Directors fees	31,125	Subscribed and fully paid	
Debentures interest paid	45,000	capital	
Preliminary expenses	25,000	Profit and loss account	
Calls in arrear	37,500	(Credit balance)	
Plant and machinery	15,00,000	6% debentures	
Premises	16,50,000	Sundry creditors	
Interim dividend paid	1,87,500	Bills payable	
Furniture and fixtures	35,000	Sales	
Sundry debtors	4,36,000	General reserve	

You are required to prepare trading and profit and loss account for the year ...
March, 1998 and the balance sheet as at that date, after making the ...
adjustments:

Depreciate plant and machinery by 10% provide half year's interest on de...
Also write off rs.2,500 from preliminary expenses and make the provision ...
doubtful debts rs.4,250 on sundry debtors. Stock on 31st March, 2000 was ...
provide corporate dividend tax rs.18,750].

1. The following balances were extracted from the books of E. Chandra Ltd. F...
ended 31st March, 2000 :

	Rs.
Buildings	6,00,000
Furniture	60,000
Motor vehicles	60,000
Equity shares of companies	4,00,000
Stock-in-trade at cost.	4,00,000
Sundry debtors, unsecured considered good	2,80,000
Cash at bank	1,72,000
Advance against construction of building	1,30,000
Share capital	
10,000 equity shares of rs.100 each	10,00,000
Sundry creditors	3,50,000
Profit and loss account (credit balance)	20,000
Gross profit	10,00,000
Dividend received on investments	10,000
Salaries and wages	2,20,000
Directors' fees	8,000
Electricity charges	25,000
Rent, taxes and insurance	10,000
Auditors fees	15,000

Prepare the profit and loss account of the company for the year ended 31st March, 2000 and balance sheet as at that date after the following adjustments :

(i) Provide 10% depreciation p.a.

(ii) Stock has been revalued as Rs.3,60,000. This has not been considered as yet.

(iii) Debts more than 6 months are Rs.80,000.

(iv) Ignore tax provision.

Ans. [Net profit for the year Rs.6,20,000; B/S Total rs.19,90,000].

2. Big & Co. Ltd., is a company with an authorized capital of Rs.5,00,000 divided into 5,000 Equity shares of Rs.100 each. On 31.3.2000 2,500 shares were fully called up.

	Rs.		Rs.
Stock	50,000	Advertising	14,300
Sales	4,25,000	Debtors	38,700
Purchases	3,00,000	Creditors	35,200
Wages (productive)	70,000	Plant and machinery	80,500
Discount Allowed	4,200	Furniture	17,100
Discount received	3,150	Cash and bank	1,34,700
Insurance upto 30,6,2000	6,720	Reserve	25,000
Salaries	18,500	Loan from managing director	15,700
Rent	6,000	Bad debts	3,200
General expenses	8,950	Calls in arrears	5,000
Profit and loss account	6,220		
Printing and stationery	2,400		

You are required to prepare Trading and profit and loss account for the year end 31.3.2000 and the balance sheet as on that date of the company. The following fur information is given :

(1) Closing stock – Rs.91,500.

(2) Depreciation to be charged on plant and machinery and furniture at 15% and 1 respectively.

(3) Outstanding liabilities – wages - Rs. 5,200, Salary – Rs.1,200 and Rent- Rs.

(4) Dividend @ 5% on paid up share capital is to be provided.

(5) Corporate dividend tax @ 10% is to be provided.

Ans. [Gross profit Rs.91,300; Net profit rs.16,275; surplus carried to B/S Rs.9,020; B/s rs.3,50,395].

UNIT – III

LESSON – 1

VALUATION OF GOODWILL

In this unit we will see how the goodwill is valued :

1. Definition of goodwill
2. Meaning of goodwill
3. Features of goodwill
4. Factor affecting valuation of good will
5. Need for valuation of goodwill
6. Methods of valuation of goodwill
7. Miscellaneous examples
8. Review exercises
9. Prescribed books

LESSON – 2

VALUATION OF SHARES

In this lesson we will discuss how the shares of a company is valued :

1. Meaning of share
2. Need for valuation of shares
3. Factors affecting valuation of shares
4. Miscellaneous examples
5. Review exercises
6. Prescribed books

<u>VALUATION OF GOODWILL</u>

...oodwill is valued :

13. Factor affecting valuation of good will
14. Need for valuation of goodwill
15. Methods of valuation of goodwill
16. Miscellaneous examples
17. Review exercises
18. Prescribed books

DEFINITION OF GOODWILL

According to Spicer & Pegler : Goodwill may be said to be that element arising from the reputation, connection or other advantage possessed by a business which enables it to earn greater profits than the return, normally to be expected on the capital represented by the tangible assets employed in the business. According to SSAP – 22- U.K. Goodwill is the difference between the value of a business as a whole and the aggregate of the fair values of its separable net assets.

MEANING OF GOODWILL

Goodwill is the reputation of a business. Goodwill is the represent value of the future anticipated excess earnings. Goodwill is an intangible real asset.

FEATURES OF GOODWILL

Goodwill has certain peculiar features which distinguish it from other assets and it is worthwhile considering them here

(1) Good will may be positive value or negative value. It is positive when the value of business is more than the value of its net separable assets and negative when the value of the business is less than the value of its net separable assets.

(2) It is not possible to separately value each of the intangible factors contributing to goodwill.

(3) The value of goodwill has no relation to the amount invested and costs incurred in order to build it.

(4) The value of goodwill fluctuates from time to time due to changing circumstances which are internal and external to business.

(5) There can be no objective valuation of goodwill. It is subjective and it differs from estimator to estimator.

(6) Goodwill may be purchases or inherent in the business. When a business co

purchased and the purchase consideration is in excess of the fair value of the separable net assets acquired, such excess is recorded as goodwill. However, goodwill is recorded only when an amalgamation is in the nature of purchase and is not a merger. In the case of merger, pooling of interests method is followed and goodwill is not recorded.

FACTORS AFFECTING VALUE OF GOODWILL

There are several factors which contribute to the goodwill of the business and the important ones are listed below :

(1) Demand of the product in the market

(2) Productivity levels of the workers.

(3) Research and development efforts.

(4) Good industrial relations.

(5) Locational factors of the business

(6) Popularity of products in terms of quality and effective after sales service.

(7) Customers' favourable attitude and customer satisfaction.

(8) The profit or earning capacity of the business over the years

(9) Technical collaboration with established companies.

NEED FOR VALUATION OF GOODWILL

The need for valuation of goodwill depends on the form of business organization. In case of a sole trader, it is usually valued at the time of selling the business, so as to determine the amount payable by the buyer towards goodwill. In case of partnership there are several circumstances when goodwill has to be valued. They are :

(a) When a new partner is admitted

(b) When a partner retires or dies

(c) When there is a change in the ratio of profit – sharing, and

(d) When there is dissolution either by sale to a company or amalgamation with another firm.

In the case of limited companies :

(a) When two or more companies amalgamate

(b) When one company takes over another

(c) When a company wants to acquire controlling interest in another company, and

(d) When government takes over the business.

METHOD OF VALUING GOODWILL

There are various methods of valuation of goodwill as follows :

(1) By an arbitrary assessment

(2) By a capitalization of expected net profits or earnings (or capitalization method)

(3) By a certain number of years' purchase of past average profits or earning.

(4) By super profits or earnings

a. Purchase of super profit

b. Annuity method

c. Capitalization of super profit method.

Arbitrary Assessment :

The valuation of goodwill is arrived at by making valuation by one of the parties vendor or purchaser to which the other agrees. IN absence of the required information profits earned during the period depending on which the goodwill is to be value the pa may together estimate the value of goodwill arbitrarily. There is no method for the arbi assessment of goodwill.

Capitalization of expected future net profits (or capitalization method) :

The following are the main steps to be taken in computing goodwill by this metho

(a) Ascertain the average net profit which it is expected will be earned in future.

(b) Capital life this net profit at the rate which is considered a suitable return on c invested in a business of the type uner consideration.

(c) Find the value of the net tangible assets used in the business i.e., assets less o liabilities including the preference capital.

(d) Deduct the net tangible assets as per (c) from the capitalized profit obtained in (the difference is goodwill.

Past adjusted profits generally provide the basis for ascertaining the average ne which is expected to be earned in future. A reduction is made for remuneration of prop (if that has not already been done) and in the case of a limited company, income tax p on such profit. Further the recurring expenses not yet deducted is to be deducted and the non-recurring expenses already deducted is to be added back to the profit to get the adjusted profit. The main difficulty in valuing goodwill by this method is arriving at what return on capital is deemed appropriated to the particular business concerned.

While making the estimate of future maintainable profit on the basis of past profits, the following points are to be taken into consideration :

(1) All unusual working expenses should be excluded. Interest on debentures and depreciation on all fixed assets should be excluded. If fixed assets are revalued for goodwill purpose, depreciation should be based on the revalued figures of fixed assets.

(2) Non-trading assets such as non-trading investments should be excluded from the capital employed and income derived from such assets should also be excluded from profit.

(3) All necessary provisions for liabilities such as provision for taxation should be made. But appropriations of profits such as amount transferred to general reserves, sinking fund for redemption of a liability and dividend equalization reserve should not be taken into consideration.

(4) Preference dividend should be deducted.

(5) While calculating average profits, profits for the past for or five years during which conditions have remained normal should be considered.

(6) Effects of developments which have already taken place but whose results are likely to come in the future should also be considered.

(7) If the profits of the past four or five years have been increasing or decreasing in a significant manner, it will be better to give more importance to the profits of the last year and least importance to the profits of the first year. This can be taken care of by taking weighted average profit by assigning weights as 1,2,3,4, and 5 to the profits of 1st year, 2nd year, 3rd year, 4th year and 5th year respectively. The practice is not to be followed if there is consistent decline of profits. In that case, profits for the future should be lower than the profits for the latest year.

Illustration – I (Capitalization Method) :

A company desirous of selling its business to another company has earned an average profit in the past of Rs. 50000 per annum. It is considered that such average profit fairly represents the profit likely to be earned, in the future except that :

(a) Director's fees Rs. 10000 charged against such profit will not be payable by the purchasing company whose existing board can easily cope with the additional administrative work at present fees payable to the directors.

(b) Rent of Rs.20000 per annum which had been paid by the vendor company will not be a charge in the future, since the purchasing company owns its own premises and ca supply the accommodation necessary for the staff and the equipment of the vend company.

The value of the net tangible assets of the vendor company at the proposed date sale was Rs.1500000 and it was considered, that a reasonable return on capital invested this type of commodity, was 10%.

The profit of the vendor company would in no way be affected by the sale of its busin to the purchasing company and goodwill existed and was to be paid for on the basis that vendor company was a continuing enterprise. Calculate the value of goodwill by capitaliza of expected future net profits.

Solution :

Calculation of the value of goodwill

Average net profit		Rs.15000
Add non-recurring charges for :		
Director's fees	Rs.10000	
Rent	Rs.20000	30
Estimated future maintainable profit		180
Future profit capitalized at 10% i.e.	$\frac{180000 \times 100}{10}$	Rs.180
		Rs.150
Less net tangible assets		30
Goodwill		

Illustration – 2 (Capitalisation method by following simple average method)

Ascertain the value of goodwill of PCO ltd carrying on business as retail tra the following information :

Balance Sheet as on 31st December 1997

Liabilities	Rs.	Assets	Rs.
Paid up capital :		Goodwill	
2500 shares of Rs. 100 each	250000	Land and building at cost	
Profit and loss account	56650	Plant and machinery at cost less depreciation.	
Bank overdraft	58350	Stock at cost	
Sundry creditors	90500	Bad debts less	
Provision for taxation	19500	Provision for doubtful debts	
	475000		

The company commenced operations in 1993 with a paid up capital as aforesaid of Rs. 250000. The profits earned, before providing for taxation, have been as :

Year	1993	1994	1995	1996	1997
Rs.	61000	64000	71500	78000	85000

You may assume that income tax at the rate of 50% has been payable on these profits.

The average dividend paid by the company for the four years is 10% which is taken as reasonable return expected on the capital invested in the business.

Solution :

Profit for 5 years (Rs.61000 + Rs.64000 + Rs.71500 + Rs. 78000 + Rs.85000)

= Rs.3,59,500

Less income tax @ 50% Rs.1,79,750

Rs. 1,79,750

Average profit (Rs.179750/5) = Rs. 35,950

Future profits capitalized at 10% = $\frac{Rs.35950 \times 100}{10}$ = Rs. 359500

Total Assets Rs. 4,75,000

Less Goodwill Rs.25,000

Less liabilities

(58350 + 90500 + 19500) Rs.1,68,350 = Rs. 193350

Net tangible assets Rs. 2,81,650

Capitalized profit Rs.3,59,500

Less net tangible assets Rs. 2,81,650

Goodwill = 77,850

Purchase of past Average profits :

This method of valuing goodwill is commonly met with in practice and probably is the one most generally understood. It is calculated on the following basis :

(i) The profit (gross or net) for an agreed number of years preceding valuation are averaged so as to arrive at the average annual profit earned during that period. Average used may be simple avegarge or weighted average.

(ii) The goodwill is then estimated to be worth so many years purchase of such average profit. The number of eyars selected is presumed to bear relation to the number of benefit to be derived from past association.

This method is generally adopted when a partner dies or retires and a clause to this effect is frequently found in partnership agreements.

The number of years over which the profits are averaged and the number of years purchase applied, may considerably vary in practice but generally fall between one and five years. This method suffers from two defects as follows :

(i) The uncertainty as to the number of years purchase of profits

(ii) The capital to be employed in the business is not considered.

This method is adopted for valuing the goodwill of the professional persons or firms such as chartered or cost accountants, Doctors, Advocates etc. It ignores the amount of capital employed for earning the profit.

Illustration – 3

(purchase of simple/ weighted average profits) PLTC proposed to purchase the business carried on by Shri C goodwill for this purpose is agreed to be valued at tree years' purchase of the (i) Simple average profits and (ii) Weighted average profits of the past four years. The appropriate weights to be used are :

1994 – 1, 1995 – 2, 1996 – 3, 1997 – 4.

The profits for these years are 1994 Rs. 101000, 1995 Rs. 124000, 1996 Rs. 10000 and 1997 Rs. 150000. on a scrutiny of the accounts the following mattes are revealed.

(a) On 1st September, 1996 a major repair was made in respect of the plant incurring R 30000 which amount was charged to revenue. The said sum is agreed to be capitaliz for goodwill calculation subject to adjustment of depreciation at 10% per annum reducing balance method.

(b) The closing stock for the year 1995 was over valued by Rs. 12000.

(c) To cover management an annual charged of Rs. 24000 should be made for the purp of goodwill valuation.

Compute the value of the goodwill of the firm.

Solution :

Calculation of Adjusted profits

Profits : 1994		101000
Less management expenses		24000
Adjusted profit 1994		77000
Profit : 1995		124000
Less over valuation of closing stock	12000	
Management expenses	24000	36000
Adjusted profit 1995		88000
Profits 1996		100000
Add : over – valuation of opening stock	12000	
Major repairs of plant to be	30000	42000
		142000
Less depreciation on capital expenditure		142000
@10% per annum for 4 months from September 1996 to December 31 1996		$\left(30000\times\frac{10}{100}\times\frac{4}{12}\right)$ 1000 = 141000
Less management expenses		24000
Adjusted profits – 1996		117000
Profit – 1997		150000
Less 10% depreciation on Rs.29000 (book value Rs.30000-Rs.1000) exp		2900 147100
Profits – 1997		150000
Less 10% depreciation on Rs.29000 (book value Rs.30000 – Rs. 1000) capital expenditure		2900 147100
Less management Expenses Adjusted profits – 1997		24000 123100

(i) Simple average profit method

Total of adjusted profits

(Rs.77000 + Rs.88000 + Rs. 117000 + Rs.123100)= Rs.405100

average profit= Rs.101275

Value of goodwill = Rs.101275 x 3 = Rs.303825

(ii) Calculation of weighted average profits

Year	Profit	Weight	Product
1994	77000	1	77000
1995	88000	2	176000
1996	117000	3	351000
1997	123100	4	492400
		10	1096400

Average weighted profit = Rs.1096400 . 10 = Rs.109640 Goodwill at three years purchase
Rs.109640 x 3 = Rs.328920

(4) Super profits

It is the excess of the average profits over the normal profits based on normal rate return for representative firm in industry. For computation of super profit, the following th factors are required:

(i) Normal rate of return : This is the rate of profit or return which an investor expects on investment in a particular type of industry. It may be aggregate of pure rate of re (i.e., return on risk free securities) and risk rate of return.

(ii) Capital employed : - It may be calculated on the basis of assets side items or liabi side items.

Proceeding from assets side capital employed = Fixed Assets + Trade investments + cu Assets – Debentures – current liabilities proceeding from liabilities side :

Capital employed = paid up equity and preference share capital + accumulated balan capital reserves, general reserves and credit balance in profit and loss account ± revalu profits (or loss) – Fictious assets – Nontrading assets.

A refinement in the figure of capital employed can be average capital employed. A capital employed can be calculated as follows :

Average capital Employed

= ½ (capital employed at the beginning + capital employed at the end of the y average capital employed

= Capital employed at the end of the year - ½ of current year's profit after tax

= Capital employed at the beginning of the year +½ of current year's profit aft

(iii) Normal profit : It is calculated by multiplying the normal rate of return with capital e or average capital employed as the case may be.

Super profit method had three variations i.e.

(a) Purchase of super profit

(b) Annuity method

(c) Capitalization of super profit.

Purchase of super profits :

It this method of valuing goodwill, attention is focused upon super profits which are those profits remaining after deducting from the estimated annual future profit,

(a) Reasonable remuneration of proprietors and management, and

(b) An amount considered to be a reasonable return on the amount of capital invested in the tangible assets.

While averaging the past profits it is desirable to cover a span of year, in such a way as to include all possible seasonal changes and fluctuations. Allowance should be made for expenses emerged against pat profits which are not likely to recur and also for expenses which are likely to recur in the future. The next step is to reduce this by amount which is considered to be reasonable in respect of the services of the proprietors. This reduction would only be made where there had been no such charge for management against the average profit selected. The matter at taxation may also require to be considered from the purchaser's point of view.

There must also be deducted and amount, which is calculated to be a reasonable return on the capital invested in tangible assets. The reasonable return differs from business to business.

This percentage is then applied to the capital invested and the resulting figure deducted from the already reduced average profit, the final result giving the average annual super profit. On this basis the goodwill is to be calculated, say five years' purchase of super profits, then it will be arrived at by multiplying the average annual super profits referred to above by five. If the super profits are large, a large number of years' purchase is allowed for calculating the value of goodwill. In case of professional people, goodwill is usually valued on the basis of one year's purchase of gross fees earned because in case of a profession personal skill of the professional will play a very important role in earning the income.

Illustration-1

The XYZ Ltd is to be absorbed by the India Ltd. In order to determine he purchase consideration, the two companies considered it necessary to value the goodwill attaching to the business of the Asia Ltd. it is agreed that basis of the calculation of the goodwill shall be three years' purchase of the average annual super profits, the profits being average over 5 years.

... of the XYZ Ltd for the last 5 years before charging income tax at 50% are ... Rs.60000 and Rs.432000 for each of the

Two of the directors of the XYZ Ltd will be appointed to the Board of India Ltd on absorption and it is considered that their services have been worth Rs.48000 each per annum. It the past no charge was made against the profits of XYZ Ltd. for the services of the directors concerned.

The average capital invested in net tangible assets over the period is Rs.10,96,000. The normal return to be expected from the particular type of business carried on by the XYZ Ltd is 10% calculate the value of goodwill of XYZ Ltd based on the above information.

Solution

Total profits = Rs.400000 + Rs.496000 + Rs.352000 + Rs.560000 + Rs.432000 = Rs.2240000.

Average profit = $\frac{2240000}{5} = Rs.448000$

Average profit	Rs. 448000
Less directors service changes (Rs.48000 x 2	Rs. 96000
	Rs. 352000
Less Income tax @ 50%	Rs. 176000
Profit after tax	Rs. 176000
Less normal rate of return (1096000 x $\frac{10}{100}$)	Rs. 109600
Super profit	Rs. 66400

Goodwill = Super profit x no of year = Rs.66400 x 3 = Rs.199200

Illustration – 2

The balance sheet of Vishnu Ltd is as follows :

Balance sheet as on 31 – 3 – 1998

Liabilities		Amount	Assets		Amount
Equity share capital shares of Rs.100 each	1500	150000	Goodwill		1500
			Land and Building		950
Capital Reserve		30000	Machinary		600
Profit and loss account		13000	Stock		575
creditors		63000	Debtors	49000	
Depreciation fund:			Less BDR	1500	475
Land and building	7500		Cash and Bank balances		35
Plant & machinery.	15000	22500			
		278500			2785

This company's business is to be purchased by Shiv Limited. Your are required to value the goodwill of the company, after taking into account, the following information :

(1) The reasonable return on capital employed in the class of business done by the company is 12%.

(2) The company's average profits of the last five years after making 50% provision for taxation, amounted to Rs.47500.

(3) The present market value of the land and building is Rs.1,10,000.

(4) The other assets are to be taken at their book-values.

(5) The directors of Vishnu limited (two in numbers) are to be appointed on the board of directors of shiv limited. The worth of their services is (and will be in future), Rs.5000 p.a for each of the directors, but no charge has been made, regarding this against the profits of the Vishnu limited.

(6) The good will of the business of Vishnu Ltd is to be taken at four years' purchase of super profits of the company.

(7) Depreciation on increased value of Land and Building may be ignored.

Solution

Calculation of capital employed

Land and Building		Rs.110000
Machinary		Rs. 60000
Stock		Rs 47500
Debtors less BDR		Rs. 47500
Cash and Bank Balance		Rs. 3500
		Rs.278500
Less creditors	Rs.63000	
Depreciation fund	Rs.22500	Rs.85500
Capital employed		Rs.193000

Calculation of super profit

Average profits of last 5 years after tax (given) Rs.47500

Average profit before 50% tax (47500 x $\frac{100}{50}$) = Rs.95000

Less directors remuneration (2 x 5000) = Rs.10000

Average profits (in future) Rs.85000

Less 50% tax Rs.42500

Average profits (after tax in future) Rs.42500

Less reasonable return @ 12% on Rs.193000

Capital at employed Rs.23160

Super profits Rs.19340

Calculation of goodwill

Good will at 4 years purchase of super profits (Rs.19340 x 4) = 77,360.

ANNUITY METHOD

This method is similar to that of super profit method except that super profit w arrived at is not multiplied by a figure representing a certain number of years' purchas such super profits. The value of good will is calculated by finding the present worth o annuity paying the super profit (per year) over the estimated period discounted a appropriate rate of interest.

We have to ascertain the amount of cash it is necessary to pay out now in orde

It is on this principle that the annuity method of calculation of goodwill is base the present worth of an annuity of Rs.1 for n years at r per cent is obtained from the foll formula :

$$Q = \frac{1 - \left(1 + \frac{r}{100}\right)^{n}}{\frac{r}{100}}$$

Where Q = The present value of an annuity of Rs.1 for n year at percent.

r = The rate per cent per annum

n = The number of years.

(c) Capitalization of super profit method

Under this method, the value of good will is calculated by capitalizing the sup at the normal rate of return. This method attempts to determine the amount of capital needed for earning super profit. The value of goodwill is calculated by the following formula :

Value of goodwill $\frac{\text{Average Annual super profit}}{\text{Normal Rate of Return}} x100$

Suppose the super profit is Rs.20000 the normal rate of profit is 15%, the value of goodwill as per capitalization of super profit method is

$\frac{Rs.20000}{15\%} = Rs.300000$

Illustration – 3

(Calculation of super profit)

From the following information calculate the value of good will by capitalization of super profit method :

(i) Average capital employed in the business – Rs.700000

(ii) Net trading profit of the firm for the past three years@ are Rs.147600, Rs.148100 and Rs.152500

(iii) Rate of interest expected from capital having regard to the risk involved – 18%.

(iv) For remuneration to the partners for their services – Rs.12000 per annum.

(v) Sundry Assets (excluding goodwill) of the firm Rs.754762 sundry liabilities Rs.31,329.

Solution

Years	Given profits Rs.	Adjusted profits after remuneration
I	1,47,600	1,35,600
II	1,48,100	1,36,100
III	1,52,500	1,40,500
Total profits		4,12,200
Average profits		137400
Less normal expected return on capital (18% on 700000 p.a)		126000
Super profit		11400
Goodwill by capitalization of super profit method		$\frac{\text{super profit} \times 100}{\text{Normal Rate of Return}}$ $\frac{11,400 \times 100}{18} = 63,333(APP)$

Illustration - 4

The net profits of company after providing for taxation for the post five years are rs.78000; Rs.82000, Rs.88000; Rs.93000; And Rs.99,000. The capital employed in the business is Rs.800000 on which a reasonable rate of return of 10% as expected. It is expected that he company will be able to maintain its super profits for the next five years.

(i) Calculate the value of the goodwill of the business on the basis of an annuity of super profits, taking the present value of an annuity of one rupee for the five years at 10% interest is Rs.3.78.

(ii) How would year answer difference if the goodwill is valued by capitalizing the excess of the annual overage profits over the reasonable return on capital employed on the basis of the same return of 10%.

Solution

Profits for past 5 years (Rs.78000 +82000+88000 +93000 +99000)	Rs.440000
Annual average profit (Rs.440000 ÷ 5)	88000
Less 10% return on capital employed (i.e., Rs.800000) super profit	80000
	8000
(i) Good will = super profit X annuity reference = Rs.8000 X 3.78 =Rs.30,240	
(ii) Goodwill on the basis of capitalized value of super profits @ 10% = $\frac{\text{super profit}}{10\%} = Rs.8000 \times \frac{100}{10} = Rs.80000$	

Goodwill calculated on the basis of annuity method is most reliable and is very fa comparison to the valuation based on capitalization of super profits. Calculation of goodw under super profit method gives maximum value of goodwill, which is not desirable for th purchaser of the business.

EXERCISES

LONG QUESTIONS :

1. What do you understand by goodwill ? Under what circumstances does it arise ? Expl and illustrate the different methods of calculating goodwill.

2. Enumerate the factors that should be considered in valuing goodwill; briefly expl their importance in this regard.

3. Would you consider the annuity system of valuing goodwill superior to other metho If so why ?

4. What is goodwill ? How is it generally valued ? Explain and illustrate at least three important methods of its valuation.

Practical Problems

Questions

1. (Purchase of Average Profits) X,Y and Z are partners sharing profits and lasses in the ratio of 2:2:1. It was provided in the partnership agreement that on the death or retirement of a partner, goodwill should be calculated on the basis of four years purchase of the average net profits for the preceding seven years. Z retires on 30th June 1997. Calculate the amount of goodwill due to Z. Net profits for the seven years on 30th June of every year are as follows:

Year	Rs.
1991	32000
1992	40000
1993	72000
1994	64000
1995	32000
1996	80000
1997	72000

Ans. – [Rs/44.800].

1. (Purchase of Average Profits) X and co-decided to purchase a business for Rs.80,000. Its profits for the last 4 years are 2001 – Rs.20000, 2002 – Rs.25000, 2003 – Rs.24000, 2004 – Rs.23000. The business was looked after by the management. Remuneration from alternative employment, if not engaged in he buşiness, for the managemnt comes to Rs.3000 p.a.

   Find out the amount of goodwill if it is valued on the basis of 3 years purchase of the average net profits for the last four years.

   Ans. [Rs.60,000]

2. (Purchase of Average Profits) The following particulars are available in respect of the business carried on by bankey lal.

(a) Profits earned by X:1995 – Rs.50000; 1996- Rs.48,000 and 1997- Rs.52000.

(b) Profits of 1996 is reduced by rs.5000 due to stock destroyed by fire and profits of 1995 included a non-recurring income of rs.3000.

(c) Profits of 1997 include Rs.2000 income on investment.

(d) The stock is not insured and it is thought prudent to insure the stock in future. The insurance premium is estimated at Rs.500 pa.

(e) Fair remuneration to the proprietor (not taken in the calculation of profits) is Rs.1000 p.e.

Your are required to compute the value of goodwill on the basis of 2 years' purchase of average profits of the last [Rs.79000].

3. [Calculation of super profit] Mr Mital has invested a sum of Rs.200000 in his own business which is a very profitable one. The annual profit earned from his business is Rs.4500 which includes a sum of rs.10000 received as compensation of a part of his business premises.

As an alternative to his engagement in his business, he could have invested the mon in long-term deposit with Bank earning a normal rate of interest of 10% and also cou engage himself in employment thereby getting an annual salary income of rs.7200.

Considering 2% of fair compensation for the risk involved in the business calculate t value of goodwill of his business on capitalization of super profits at the normal rate of inter ignore the corporate tax.

Ans. [Rs.38000].

LESSON – 2

VALUATION OF SHARES

Dear students after covering this lesson you will be able to know the followings.

1. Meaning of valuation of shares
2. Need for valuation
3. Factors affecting valuation of shares
4. Methods of valuation of shares

Meaning of valuation of shares –

The value of shares means the price at which the shares are purchased and sold in stock market known as stock exchange. He shares are valued due to two reasons :

(i) Where there is no market price as in the case of a proprietary company.

(ii) Where for special reasons, the market price does not reflect the true or intrinsic value of the shares.

Need for valuation of shares –

The need for valuation of shares arise in the following circumstances.

(i) Where companies amalgamate or are similarly reconstructed, it may be necessarily to arrive at the value of the shares held by the members of the company being observed or taken over. This may also be necessary to protect the rights of dissenting shareholders under the provisions of the companies act, 1956.

(ii) Where shares are held by the partners jointly in a company and dissolution of the firm takes place; it becomes necessary to value the shares for proper distribution of the partnership property among the partners.

(iii) Where a portion of the shares is to be given by a member of proprietary company to another member as the member cannot sell it in the open market, it becomes necessary to certify the fair price of these shares by an auditory or accountant.

(iv) When a loan is advanced on the security of shares, it becomes necessary to know the value of shares on the basis of which loan has been advanced.

(v) When preference shares or debentures are converted into equity shares, it becomes necessary to value the equity shares for ascertaining the number of equity shares required to be issued for debentures or preferences shares which are to be converted

(vi) When equity shareholders are to be compensated on the acquisition of their shares by the government under a scheme of nationalization, then it becomes necessary to value the equity shares for reasonable compensation to be given to the holders.

Factors Affecting Valuation of shares –

Valuation of shares of a company depends upon the following factors

(a) Purpose of valuation.

(b) Nature of the business of the company concerned

(c) Demand and supply for shares,

(d) The government policy

(e) Past performance of the company

(f) Growth prospects of the company

(g) The management of the company

(h) The economic climate

(i) Accumulated reserves of the company.

(j) Prospects of bonus or rights issue

(k) Dividends declared by the directors and many other related factors.

The basic factors factor (or principle) in he valuation of shares is the dividend yield the investor expects to get as compared to the normal rate prevailing in the market in same industry. For example – for small investors, rate of dividend declared by the direc plays an important role in the valuation of shares whereas investors holding bulk of sh (say 15% to 30%) would be able to affect the dividend rate, therefore for them total profit earning capacity) play an important role in the valuation of shares.

METHODS OF VALUATION :

The different methods of valuing shares may be classified as follows :

1. Net asset basis (or intrinsic value method)
2. Earning capacity (or yield method or market value method.
3. Dual or fair value method.

Net Assets Basis

This method is concerned with the assets backing per share and may be based either:

(a) on the view that the company is a going concern.

(b) On the fact that the company is being liquidated.

(c) Company as a going concern. If this view is accepted, there are two approaches :

i. To value the shares on the net tangible assets basis (excluding the goodwill)

ii. To value the shares on the net tangible assets plus an amount of goodwill.

Net Tangible Assets Basis (Excluding the Goodwill)

Under this method, it is necessary to estimate net tangible assets of the company (Net Tangible Assets – Assets-liabilities) in order to value the shares. In valuing the figures by this method, care must be exercised to ensure that the figures representing the assets are sound, i.e., intangible assets and preliminary expenses are eliminated and all liabilities (whether in books or not) are deducted from the value of the tangible assets. Non-Trading assets are also included in the assets and the assets are taken at their market value i.e. replacement value.

Where both types of shares are issued by accompany, the shares would be valued as under :

(1) If preference shares have priority as to capital and dividend, then the preference shares are to be valued at par.

(2) After the preference shareholders are paid the net tangible assets are to be divided by the number of equity shares to calculate the value of each share. If at the time of valuation there is an uncalled capital, then the uncalled equity share capital will be added with the net tangible assets in order to value the shares fully paid up. The valuation of shares for the shareholders who have call on arrears with be valued as a percentage on their paid up value with the nominal value of shares. It the company has equity shares of varying face value, the total replacement value of assets left after deducting the paid up value of preference shares is first apportioned to different categories of equity shares on the basis of paid up value of such categories. The amount so arrived at would be divided by the number of shares in each of such categories to get the value of each share of such categories.

(3) It the preference shares are participating and rank equally with the equity shares, then the value per share would be in proportion to the paid up value of preference shares and equity shares.

Illustration – 1

The following is the balance sheet of X company as on 31st March 2005

Liabilities	Amount	Assets	Amount
Share capital : 10000 5% preference shares of Rs.100 each fully paid	1000000	Fixed assets	380000
200000 equity shares of Rs.10 each fully paid	2000000	Investments current assets :	10,25,00
Reserves and surplus :	1500000	Stock in trade sundry debtors	57200
General reserve profit and loss A/c(or)	1200000	Less provision	12,780
Secured loans: 6% debentures current liabilities :	800000	Cash and bank balances	2250
Creditors Liabilities for expenses	275000 125000		
	6900000		69000

For the purpose of valuation of shares, fixed assets are to be depreciated by 10% investments are to be revalued at Rs.10,80,000. Debtors will realize Rs.12,14,100.

Interests on debentures is accrued for 9 months and preference dividend for the ending 31st March 2005 is also due; neither of these has been provided for in the bal sheet calculate the value of each equity share.

Solution

Valuation of shares of X co Ltd. by the Net Asses Method

Fixed Assets		3420
Investments as per revaluation		1080
Stock in trade		572
Sundry debtors		1214
Cash and bank balances		225
Total Assets		6511
Less liabilities :		
6% debentures	800000	
Sundry creditors	275000	
Liabilities for expenses	125000	
Interest on debentures (accrued for 9 months	36000	123

		527500
Less : preference share capital	1000000	
Preferences share dividend	50000	
(@ 5% on Rs.10,00000)		1050000
Value of 2,00000 equity shares		4225100
Value of I equity share $\frac{4225100}{200000} = Rs.21.13(app)$		

In many cases goodwill may be worth the figure at which it is stated in the balance sheet or if there is no book value for goodwill, it may nevertheless exist. Further even it there is a book value, the actual value of goodwill may be considerable higher then the book value. It is generally considered that the value of fixed assets of the company depends on their ability to earn profits i.e., on the goodwill attaching to them. In such a case, goodwill should be included with other tangible assets for valuation purposes.

Illustration – 2

(Net Asset Basis method including goodwill)

The summarized balance sheet of B.K. Ltd as at 31st March 2005 is as follows :

Balance sheet

Liabilities	Amounts	Assets	Amount
30000 equity shares of Rs.10 each fully paid up	3,00,000	Good will	70000
		Other fixed assets	450000
10,000 equity shares of Rs.10 each Rs.8 paid up	80,000	Current assets	220000
		Preliminary exp.	10000
Reserves	180000		
11% debentures	100000		
Current liabilities	90000		
	750000		750000

The goodwill is independently valued at Rs.50000 and other fixed assets at Rs.420000. There was a contingent liability of Rs.200000 which has become payable. Determine the value of both the shares under net asset method.

Solution

Valuation of shares by net assets method

Assets :	Rs.
Goodwill	50000
Other fixed assets	420000
Current Assets	220000
Notional calls	20000
	(A) 710000
Less outside liabilities	
Debentures	100000
Current liabilities	90000
Contingent liability	20000
	(B) 210000
Net assets available for equity shares (A-B)	500000
Value per (fully paid) equity share $\frac{500000}{40000} = Rs.12.50$	
Value of (partly paid) equity shares = Rs.12.50 – Rs.2= Rs.10.50	

Illustration

(net assets basis method)

Your client intends to invest not more than Rs.15000 in equity shares of iron foundry Ltd. and wants you to advise him the maximum number of shares he can expect to acquire with the said amount on the basis of the following information available to him.

Issued and paid up capital :

6% preference shares of Rs.100 each	Rs.500000
Equity shares of Rs.10 each	<u>Rs.300000</u>
	Rs.800000

Average net profits of the business is Rs.57000. Expected normal field is 7% in case of such equity shares.

Total Tangible Assets (other them goodwill) are Rs.949,000 and total outside liabilities are Rs.95000

Goodwill is to be calculated at 5 year's purchase of the super profits, if any show your working in detail. Ignore income tax.

Solution

Calculation of goodwill :

Total Tangible Assets (other then goodwill) 9,49,000

Less outside liabilities	95000
Net Assets	854000
Less preference capital	500000
Amount belonging to equity shareholders	354000
Average net profit	57000
Less preference dividend @ 6% on Rs.500000	30000
	27000
Less normal return @ 7% on Rs.354000	24780
Super profit	2220
Value of goodwill at 5 years purchase of super	
Profit (2220 x 5)	11100
Calculation of value of equity share	
Net assets available for equity shareholder	354000
Add goodwill	11100
Total funds available for equity shareholders	365100
No of equity shares of the company is	30000

Value per equity share 9Rs.3,65,100 ,30000) = Rs.12.17

Calculation of no of shares to be acquired by the client for Rs.15000

No of shares which can be acquired = $\frac{15000}{12.17}$ = 1200 (App)

(iii) Assets backing where company is being liquidated

Assets backing method is sound if liquidation is contemplated though realizable value should be taken into account. When realization is imminent it is desirable to construct statement of affairs supported, by independent valuation f the fixed assets such as land and buildings, plant and goodwill provision should also be made for the cost of liquidation and so some indication may be obtained as to how much per share may be payable to members.

Net assets basis of valuation of shares is generally recommended for only those companies where no realistic idea of the earning capacity is possible because of highly uneven past profits and when a large block of shares is to be transferred or when the company is in winding up valuation on this basis is not desirable for growing company. This me valuation is also suitable for a company, which has been trading at a loss in the pa there are no prospects of earning any profit in the near future. This method of valua acceptable for statutory valuation particularly the wealth tax rules provide for assets b valuation of shares.

The practical difficulty in this method of valuation of shares is the estimation of r value of assets. There is lot of subjectivity in ascertaining the realizable value of a which may give erroneous valuation of shares.

Earning capacity (or yield basis or market value) method

This method of valuation of shares may do valuation by any of the following two

(i) Valuation based on rate of return

(ii) Valuation based on productivity factor.

(a)Valuation based on rate of return : The term rate of return here means a return a shareholder earns on his investment. The rate of return can further be classified as (a of dividend (b) rate of earning (c) price earning ratio.

(a)Valuation based on rate of dividend : This method of valuation of shares is su for small blocks of shares because small shareholders are usually interested in divide

The value of a share according to this methods is ascertained as follows :

$$\text{Value of share } \frac{\text{Possible rate of dividend}}{\text{Normal rate of dividend}} \times \text{Paid up value of share}$$

(b)Valuation based on rate of earning : This method of valuation f share is partic suitable in case of big investors because they are more interested in company's ear rather than what the company distributes in the form of dividends. The value of a shar be determined as follows :

$$\text{Value of share} = \frac{\text{Possible earning rate}}{\text{Normal earning rate}} \times \text{Paid up value of share}$$

Rate of return basis of valuation of share is the method, which is to be used in a exceptional cases. Under this method, the valuation depends upon he comparison c company's earning capacity and the normal rate of profits or dividend that is curre outside investment. To ascertain the value of share based on profits earning capacity, f maintainable profits and normal rate of profits or dividend at which the profits are t capitalized must be fixed. In arriving at the profits to show the normal earning capacity gen the following adjustments are made:

(i) Non-recurring items should be allowed for

Journal

a.	Share Capital A/c To Share Final Call A/c To share forfeiture A/c (For forfeiture of a share for non-payment of final call @ Rs.10)	Dr	50	10 40
b.	Share Capital A/c To Calls-in-Arrears A/c To Share Forfeiture A/c (For forfeiture of 100 shares for non-payment of final call @ Rs.4 per share)	Dr	2,000	400 1,600
c.	Share Capital A/c To Calls-in-Arrears A/c To Share Forfeiture A/c (For forfeiture of a partly called up share for non-payment of first call @ Rs.10)	Dr	30	10 20
	ISSUE AND FORFEITURE OF SHARES			
d.	Share Capital A/c To Share Allotment A/c To share first call A/c To share forfeiture A/c (For forfeiture of 500 partly called up shares on which only application money is received)	Dr	25,000	7,500 7,500 5,000 5,000

Forfeiture of shares issued at Premium –

According to section 78 of the Companies Act, securities full premium can be utilized only for four specified purposes. It means securities premium received by the company cannot be cancelled at the time of forfeiture of shares. Thus, the journal entry for forfeiture remains as under :

Share Capital A/c	Dr. (Amount called up on account of share capital)
To Share Forfeiture A/c	(Amount received on account of share capital)
To Respective Calls A/c	(Amount not paid on account of installments demanded)

However, when the amount of premium is called by the company, but not paid by the shareholder, its treatment depends upon its recording as follows:

$$\text{Expected rate of return} = \frac{50000}{200000\,(\text{i.e., equity capital})} \times 100 = 25\%$$

$$\text{Value per equity share } \frac{\text{Expected Return}}{\text{Normal retrun}} \times \text{Paid up value of equity share}$$

$$= \frac{25\%}{10\%} \times 10 = 25$$

Illustration – 2 (Valuation of preference shares & equity shares by rate of dividend)

The share capital of XY Ltd., consists of 10000 equity share of Rs.100 each, rs.50 paid and 2500 8% cumulative preference shares of Rs.100 each fully paid.

The balance sheet of XY Ltd shows assets (exclusive of goodwill) Rs.15,000000; liabilities Rs.400000, reserves Rs.350000 and paid up capital Rs.750000. The profits before tax of XY Ltd. for the previous five years were Rs.100000, Rs.300000, Rs.5000, Rs.200000 and Rs.445000 Rate of tax is 50%.

The assets and liabilities are accepted at balance sheet figures and there are no arrears of dividends on preference shares, which in similar business yield a return of 6% under current market conditions. The normal yield on capital employed in similar business is 10% and goodwill is valued at five times the purchase price of the super profit.

You are asked to value the preference shares and the equity shares of XY Ltd.

Solution

$$\text{Valuation of preference share} = \frac{\text{Possible rate of dividend}}{\text{Normal rate of dividend}}$$

$$= \frac{8\%}{6\%} \times 100 = 133.33$$

Calculation of goodwill

$$\text{Average profit of 4 years} = \frac{\text{Rs.}100000 + 300000 + 200000 + 445000}{4}$$

$$\frac{1045000}{4} = 261250$$

Profit of 3rd year being abnormal not considered. It was a small amount of Rs.5000 & it has been treated as abnormal.

Average profit	261,250	Rs. 261250
Less tax @ 50%	130625	Rs. 130625
		Rs. 130625

Less normal return @ 10% on Rs. 1100000

Capital invested (i.e., 1500000 assets – Rs.400000 liabilities) Rs. 110000

Super profit	Rs. 20625

Goodwill = 5 years purchase of super profit = Rs. 20625 x 5 = Rs103125

Calculation of value of equity share

Assets excluding goodwill as per balance sheet	Rs. 1500000
Add goodwill	Rs. 103125
	Rs. 1603125
Less liabilities	Rs. 400000
	Rs. 1203125
Less preference share capital	Rs. 250000
Assets available for equity shareholders	Rs. 953125

Number of equity shares = 10000

$$\text{Value of equity shares} = \frac{\text{Rs. } 953125}{\text{Rs. } 10000} = \text{Rs. } 95.31$$

EXERCISES

Essay type questions :

1. Describe two methods of shares and discuss which method, in your view, is most appropriate in valuing a minority and a majority holding.
2. What are the factors that influence the valuation of shares for the purpose of amalgamation of companies? Discuss with illustrations.
3. Explain the circumstances under which valuation of shares is essential and discuss the various methods of valuation.
4. Indicate briefly the steps involved in valuing shares under each of the following methods:

(a) Earning basis (b), net assets basis, (c) dual basis

Critically examine the merits and demerits of the methods and also indicate the circumstances of applicability of each method.

5. Explain with suitable examples the various methods of valuation of equity shares. Whic will be an appropriate method and under what situations ?

Practical problems :

1. (Net assets basis including goodwill) From the following information, find out the valu of each share :

BALANCE SHEET OF X LTD.

Liabilities	Amount	Assets	Amount
Share capital :	200000	Fixed assets :	190000
20000 equity shares of Rs. 10 each		Goodwill	
Reserves and surplus:	250000	Investment current assets,	300000
Reserves		Loans and advances :	
Profit and less A/c	30000	(a) Current assets	50000
Unsecured loans	80000	(b) Loans & advances	30000
Current liabilities	20000	(c) misc. expenses	10000
	580000		580000

For the purpose of valuation of shares goodwill shall be taken at two years purchase of the average profit of the last five years. The profits for the last five year are Rs.60,000, Rs.70,000, Rs.40,000 Rs.50,000 and Rs.50,000 (Ans – Rs.19.40).

2.(Net assets basis/yield method) on 31st March, 1998, the balance sheet of a limited company disclosed the following positions :

Liabilities	Amount	Assets	Amount
Issued capital in Rs.10 shares	400000	Fixed assets	500000
Reserves	90000	Current assets	00000
Profit and loss account	20000	Goodwill	40000
5% debentures	100000		
Current liabilities	130000		
	740000		740000

On 31st March 1998 the fixed assets were independently valued at Rs.350000 and the goodwill at Rs50,000. The net profits for the three years where : 1995 – 96 Rs.51,600, 1996-97 Rs.52000, and 1997-98 Rs.51,650.

Of which 20% was placed to reserve this proportion being considered reasonable in the industry in which the company is engaged and where a fair investment return may be taken at 10%.

Compute the value of the company's shares by

(a)the assets methods and (b)the yield method

Ans [(a) Rs.9.25; (b) Rs.10.35]

3. [Net assets basis/ yield method]

Mr. Ram Nath intends to invest Rs.66000 in equity shares of a limited company and seeks your advice as to the maximum number of shares he can expect to acquire based on

(i) intrinsic value including goodwill

(ii) intrinsic value excluding goodwill and

(iii) yield basis.

The following information is available :

Issued and paid up capital : 6% preference shares of Rs.100 each	
	1100000
Equity shares of Rs.10 each	700000
	1800000

Average net profit of the business is Rs.1,50,000. Expected normal yield is 8% in case of such equity shares. It is observed that net assets on revaluation are worth Rs.1,40,000 more than the amount of which they are stated in the books. Goodwill is to be calculated at 5 years purchase of super profits, if any , ignore taxation.

Ans [(i) No of shares to be purchased 5,000 on intrinsic value including goodwill.

(ii)No. of shares to be purchased 5,500 on intrinsic value excluding goodwill

(iii)On yield basis 4,400 shares]

4. [Net assets basis/yield method]

The following particulars are available in relation to I Ltd:

(i) capital :450 6% preference shares of Rs.100 each fully paid, and 4500 equity shares of Rs.10 each fully paid.

(ii) Reserved liabilities rs.7500

(iii) Reserves and surplus Rs.3500

(iv) The average expected profit (after taxation) earned by the company Rs.8500.

(v) The normal profit earned on the market value of equity shares (fully paid) of the same time companies is 9%

(vi) 10% of the profits after tax each year are transferred to reserves.

Calculate the intrinsic value per equity share and the value per equity share according to dividend yield basis. Assume that out of total assets, assets worth Rs.350 are factious

[Ans: - Intrinsic value per equity share Rs.10.70; value per share on dividend yield basis rS.12.22]

5. [Yield method]

Mr. Ramson holds 12000 equity shares in Bharat Ltd, the normal and paid up capital of which consists of

(i) 40000 equity shares of Rs.1 each

(ii) 25000 8% preference shares of Rs.1 each.

The preference shares do not participate in profits. It is ascertained:

(a) The normal annual net profits of such a company is rs.12000 and (b) the normal return by way of dividend on this paid up value of equity share capital for the type of business carried out by the company is 15%.

Mr. Ramson requires you to value the share holding based upon the above figures.

Ans. [Rs.20,000].

6. [Net Assets basis method]

The following is the balance sheet of a company Ltd as on March 31,2005. Find out the value of equity shares.

Liabilities	Amount	Assets	Amount
3000 equity shares of Rs.100 each	300000	Cash in hand	2000
		Cash at bank	20000
1500 8% preference shares of Rs.100 each	150000	Sundry debtors	80000
		Stock-in-trade	140000
General reserve	40000	Land and building	205000
Profit and loss account	10000	Furniture	30000
Bank loan	50000	Goodwill	70000
Sundry creditors	15000	Discounts on shares	18000
	565000		5,65,000

The value of assets is assessed as follows :

1. Furniture to be depreciated at 10%
2. Value of stock in trade, land and building and goodwill is estimated at rs.1,2000 Rs.250000, and Rs.80000 respectively.
3. Debtors are expected to realize 80% of book value.

UNIT – IV

LESSON – 1

ACCOUNTING FOR AMALGAMATION OF COMPANIES

Objectives

Till now we have discussed how a company is formed and how the final A/c of a company is prepared. So in this lesson we will discuss how two companies are amalgamated and a new company is formed. What is reconstruction of a company and its new balance sheet.

1. Meaning of Amalgamation
2. Purchase consideration
3. Accounting Entries for Amalgamation Absorption and External reconstruction.
4. Meaning of Reconstruction.
5. External reconstruction
6. Accounting Entries for external reconstruction
7. Miscellaneous Examples
8. Review exercises
9. Prescribed books.

LESSON – 2 .

INTERNAL RECONSTRUCTION

1. Meaning of Internal Reconstruction
2. Reduction of share capital
3. Reduction of liabilities
4. reduction of Assets
5. Miscellaneous Examples
6. Review exercises
7. Prescribed books.

ACCOUNTING FOR AMALGAMATION OF COMPANIES

Lesson plan

In this unit we will see how the corporate houses are merged with each other and h a corporate house is re-organized.

1. Meaning of Amalgamation
2. Purchase consideration
3. Accounting entry for Amalgamation and External Reconstuction
4. Examples
5. Review exercises.
6. Prescribed books.

MEANING OF AMALGAMATION

Amalgamation refers to combining of business of two or more existing companie Accounting for amalgamation is governed by AS-14 issued by the institute of chartere accountants of India. This standard is mandatory in nature and is applicable for accountin period beginning on or after 1.4.1995.

Amalgamation involves at least two existing companies who decide to blend the business to avoid competition and enjoy economies of scale. Section 394 of the companie Act 1956 facilitates amalgamation of companies by transfer of property and liabilities to th transferee company as per the orders of the Court. Transferee company means the compan into which a transferor company is amalgamated and the transferor company means th company which is amalgamated into another company. Thus at least two companies ar necessary for amalgamation.

TYPES OF AMALGAMATION

It may take place in anyone of the following two ways as per AS-14 prescribed by ICAI

(i) A new company is formed to take over the business of two or more existing companies. In this case all exiting companies lose their identity and are known by the name of a new company. It may be called pure amalgamation.

(ii) One of the existing companies takes over (or absorbs) the business of another existing company. It does not involve formation of a new company. In this case all, except one, of the existing companies lose their identity and are known by the name of the existing company who takes over their business. This form of amalgamation is also known as Absorption.

RECONSTRUCTION

It refers to reorganization of an over capitalized company with accumulated losses but whose future is very bright. In involves only one existing company as against amalgamation which requires at least two existing companies. For this purpose, company makes compromise or arrangement with its creditors and members. Section 391 of the companies Act 1956 allows the companies to make compromise or arrangement with its creditors and members provided, it is within the powers of the company as per its Articles of association and it is also sanctioned by the Court of law.

RYPES OF RECONSTRUCTION

Reconstruction of a company may take place in one of the following two ways : -

1. **External Reconstruction –** The existing company is liquidated and its business is taken over by a new company specially formed to takeover the business of the company being reconstructed. This form of reconstruction is known as External Reconstruction. It involves liquidation of existing company and formation of a new company.

2. **Internal Reconstruction –** Under this the existing company is reorganized by using provisions relating to reduction of capital as contained in sections 100 to 105 of the companies Act 1956. This form of reconstruction is known as Internal Reconstruction and it involves less procedural formalities, as winding up of the existing company and formation of a new company is not required.

Amalgamation (including absorption) and external reconstruction are although different in nature but involve similar accounting treatment. These involve closing of books of the transferor company which is being amalgamated/ absorbed/ reconstructed and recording of entries on acquisition of business by the transferee company which may be one of the existing companies (in case of absorption) or a new company (in case of amalgamation and external reconstruction).

Purchase Consideration

Purchase consideration is the amount which is paid by the transferee company for the purchase of the business of the transferor company. In other words consideration for amalgamation means the aggregate of the shares and other securities issued and payment in cash or other assets by the transferee company to the shareholders of the transferor company. It should not include the amount of liabilities taken over by the transferee company, which will be paid directly by this company. *Payments made to debenture-holders should not be considered as part of purchase consideration.* While determining the amount of purchase consideration special care should be given to the valuation of assets and liabilities of the transferor company. The calculation of purchase consideration is very important and may be calculated in the following ways:

(I) *Lump Sum Method.* When the transferee company agrees to pay a fixed sum to th transferor company, it is called a lump sum payment of purchase consideration. F example, if X Ltd. Purchases the business of Y Ltd. And agrees to pay Rs.25,00,000 all, it is an example of lump sum payment.

(II) *Net Worth (or Net Assets) Method.* According to this method, the purchase consideratio is calculated by calculating the net worth of the assets taken over by the Transfere company. The net worth is arrived at by adding the agreed value of assets taken ov by the transferee company minus agreed value of liabilities to be assumed by th transferee company. While calculating purchase consideration under this method th following points merit attention :

a. The term 'Assets' will always include cash in hand and cash at bank unless otherwis specified but shall not include factious assets as preliminary expenses, discount on th issue of shares or debentures, underwriting commission, debit balance of profit ar loss account etc.

b. If a particular asset is not taken over by the transferee company, it should not be include in the purchase consideration.

c. The term '*Liabilities*' will mean all liabilities to third parties (ie.. excluding company ar shareholders).

d. The term '*trade liabilities*' will include trade creditors and bills payable. It will exclud other liabilities to third party as bank overdraft, debentures, outstanding expenses, ta liability etc.

e. If a fund or portion of a fund denotes liability to third parties, the same must be include in the liability as staff provident fund, workmen's savings bank account, workmen' profit sharing fund, workmen's compensation fund (upto the amount of claim, if any).

f. The 'term liabilities' will not include past accumulated profits or reserves such as genera reserve, dividend equalization fund, reserve funds, sinking fund, capital reserve, shar premium account, capital redemption reserve account, profit and loss account etc. a these are payable to shareholders and not to third parties.

g. The term 'business' will always mean both the assets and the liabilities.

h. If any liability is not taken over by the transferee company, the same should not b included in the purchase consideration.

i. Goodwilll (being an intangible assets value agreed to be paid by the transferee compan is added in the purchase consideration.

j. The consideration for the amalgamation should include any non-cash element at fair value. In case of issue of securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up. Where the market value of the assets given up cannot be reliably assessed, such assets may be valued at their respective net book values.

k. Where the scheme of the amalgamation provides for an adjustment to the consideration contingent on one or more future events, the amount of the additional payment should be included in the consideration if payment is probable and a reasonable estimate of the amount can be made. In all other cases, the adjustment should be recognized as soon as the amount is determinable [see Accounting Standard (AS)4, Contingencies and Events Occurring After the Balance Sheet Date].

Treatment of Reserves Specified in a Scheme of Amalgamation. Where the scheme of amalgamation sanctioned under a statue prescribes the treatment to be given to the reserves of the transferor company after amalgamation, the same should be followed. Calculation f the purchase consideration by the net worth method may be made clear by the following example :

BALANCE SHEET OF A CO. LETD. as on ....

Liabilities	Rs.	Assets	Rs.
Share capital		Goodwill	28,000
6,000 equity shares of Rs. 10 each	60,000	Land and buildings	16,000
5% debentures	10,000	Plant and Machinery	28,000
Sundry creditors	6,000	Stock	16,000
General reserve	4,000	Debtors	8,000
Profit and loss account	20,000	Cash	2,000
		Preliminary expenses	2,000
	1,00,000		1,00,000

Suppose (i) Company B takes over the business of company A; (ii) The value agreed for various assets is : Goodwill Rs. 22,000, Land and Buildings rs.25,000, Plant and Machinery Rs.24,000, Stock Rs. 13,000 and Debtors Rs.8,000; (iii) B Company does not take over cash but agrees to assume the liability of Sundry creditors at Rs.5,000.

The calculation of purchase consideration will be as follows :

Value of assets taken over by B company :

	Rs.
Goodwill Land and buildings Plant and machinery Stock Debtors	22,000 25,000 24,000 13,000 8,000
	92,000
Less: Sundry creditors taken over by B company	5,000
Purchase consideration	87,000

(III) *Net Payment Method.* Under this method purchase consideration is calculated by adding the various payments in the form of shares, securities, cash etc. made by the transferee company. *No amount of liabilities is deducted even if these are assumed by the purchasing company.* Thus purchase consideration is the total of all the payments whether in shares, securities or cash. Suppose in the example given (on page 3) B Co. Ltd. Also agrees to pay rs.15,000 cash to discharge the creditors.

The purchase consideration will be *calculated as* under :

Share-holders of A Co. Ltd. Will get :	Rs.
$6,000 \times \frac{15}{10}$ =9,000 shares of rs.10 each, Rs. 8 paid up	72,000
Cash paid to discharge creditors	15,000
Purchase consideration	87,000

The following points should be taken into account while calculating purchase consideration under this method :

(a) The assets and liabilities taken over by the transferee company are not to be considered.

(b) The payments made by the transferee company for shareholders, whether in cash or shares must be taken into account.

(c) If creditors and debentures are taken over by the transferee company and subsequently discharged then such amount should not be added to the purchase consideration.

(d) When liabilities are not taken over by the transferee company, they are neither added or deducted to the amount of purchase consideration.

(e) Any payments made by the transferee company to some other party on behalf of the transferor company are to be ignored.

(f) If the liquidation expenses of the transferor company are to be borne by the transferee company, these should not be added to the purchase consideration.

(IV) *Shares Exchange Method.* Under this method purchase consideration is required to be calculated on the basis of intrinsic value of shares. The intrinsic value of a share is calculated by dividing the net assets available for equity shareholders by the number of equity shares. This value determines the ratio of exchange of the shares between the transferee and transferor companies. In some cases the agreed values of the shares of both the companies are given. In that case the purchase consideration is calculated with reference to the value of shares of two companies involved. Suppose X Ltd. And y Ltd. are two companies carrying on business in the same line of activity. Their capital is Rs.6,00,000 and Rs.2,00,000 (value of each share, Rs.10). The two companies decided to amalgamate in XY Ltd. If each share of X Ltd. And Y Ltd. is valued at Rs.15 and rs.25 respectively for the purpose of amalgamation, then purchase consideration will be as under :

	X Ltd.	Y Ltd.
	Rs.	Rs.
60,000 share @ Rs.15 each	9,00,000	5,00,000
20,000 shares @ Rs.25 each		5,00,000

Note: While issuing shares to individual shareholders of the selling company, these may be in fractions. A company cannot issue shares in fractions but it can issue fractional certificates or coupons or pay cash for the fractions.

Reconstruction. It means reconstruction of a company's financial structure. It may take place either with or without the liquidation of the company. If the company going into reconstruction is liquidated then the reconstruction is called as 'external reconstruction', otherwise it is called 'Internal Reconstruction'. The two types of Reconstructions thus are:

(i) *External Reconstruction.* When a new company is formed with the same name in order to take over the business of an existing company, it is called external reconstruction. This is generally resorted to in case of a company having accumulated past losses, the book value of assets are not shown at their true value. For example, National Company Ltd. was taken over by the New National Co. Ltd. Then the former company will be a transferor company being wound up and the latter company will be a transferee company.

(ii) *Internal Reconstruction.* This is generally resorted to by a company which is being reorganized internally. A scheme of re-organization is prepared in which all parties sacrifice. The sacrifice are made in this order-equity shareholders, preference shareholders, unsecured creditors and partially secured creditors. Under this scheme the existing company continues in its legal entity form and can take advantage of carry forward and set off of the past losses. This will be discussed in detail in next chapter.

With the sanction of a special resolution of the company, the liquidator is permitted to accept shares and securities etc. of the transferee company for distribution among th members of the transferor company. Thus a company that goes into liquidation can b purchased by some other company and the purchase price may be paid, fully or partly, b issuing shares or securities in the purchasing company. The members of the transferc company who do not like to purchase the shares of the transferee company have the right c requiring the liquidator to purchase their shares at a price to be determined by agreement o in default by arbitration.

From the above discussion it is clear that there are two types of companies i.e. transfere company and the transferor company companies in case of amalgamation, and externa reconstruction; so accounting entries which are to be passed in the books of transfere company and transferor company/ companies will be the same in case of amalgamation an external reconstruction.

AMALGAMATION AND EXTERNAL RECONSTRUCTION

Accounting Entries in the Books of the Transferor Company

The books of the transferor company being wound up will be closed in the same as th books of a partnership firm being dissolved. The following entries are made :

(1) *For transferring assets taken over by the transferee company.*

Realization Account Dr.

To Various Assets (individually) (at book value)

Note. Assets which are not taken over by the purchasing company as cash, bank balanc will not be transferred to Realization Account. Fictitious assets like preliminary expenses discount or commission or expenses on issue of shares or debentures, debit balance o profit and loss account are not to be transferred to realization account. Assets on whic some provision has been made are to be transferred to realization account at their gros figures and provisions made should be transferred along with liabilities.

(2) *For transferring liabilities taken over by the transferee company*

Various Liabilities (Individually) Dr. (at book value)

To Realization Account

Note. Only those liabilities are to be transferred which have been assumed by the transferee company. Accumulated profits like credit balance of profit and loss account, general reserve dividend equalization reserve, sinking fund, capital reserve are not transferred to realizatior account. If there is any fund which partially represents liability and partially undistributec profit, then that portion which represents liability should be transferred to realization account

(3) *For purchase consideration*

Transferee company's A/c Dr.

To Realization A/c

(4) *For receiving purchase consideration from the transferee company*

Bank A/c Dr.

Shares in Transferee Company A/c Dr.

To Transferee Company's A/c

(5) *For assets sold by the transferor company not taken over by the transferee company.*

Bank A/c Dr.

Realization A/c (If loss on sale of assets)

To assets A/c

To Realization A/c (If profit on sale of assets)

(6) *For liquidation expenses*

(a)*If the expenses are to be met by the transferor company*

Realization A/c Dr.

To Bank A/c

(b)*If the expenses are to be met by the transferee company*, there are two alternatives:

First Alternative – No entry.

Second Alternative – The following two entries will be passed :

(i)Transferee Co,'s A/c Dr.

To Bank

(ii)Bank A/c Dr.

To Transferee Co.'s A/c

(7) *For liabilities not taken over by the transferee company when paid by the transferor company*

Various Liabilities A/c Dr. Realization A/c (If excess payment is made) Dr. To Bank Account or Shares in Transferee Co. A/c

To Realization Account (if less payment is made)

(8) *For Closing Realization Account*

(a) *If Profit*

Realization A/c Dr.

To Equity Shareholders A/c

(b)*If Loss*

Equity Shareholders A/c Dr.

To Realization A/c

(9) *For transferring Preferences Share Capital*

Preference Share Capital A/c Dr.

To Preference Shareholders A/c

Note. If arrears of dividend are to be paid to preference shareholders, then such exces amount should be debited to realization account and credited to Preference Shareholde Account. If the preference shareholders have agreed to get less than the amount of capita then reverse entry is to be passed.

(10) *For transferring equity share capital and accumulated profit :*

Equity Share Capital A/c Dr.

General Reserve A/c Dr.

Debenture Redemption Fund Dr.

Dividend Equalization Reserve Dr.

Securities premium A/c Dr.

Profit & Loss A/c Dr.

Accident compensation Fund Dr.

(to the extent it does not denote liability)

Shares Forfeited A/c Dr.

Profit Prior to incorporation

Any Other Reserve or Fund A/c Dr.

To Equity shareholders A/c

(11) *For transferring accumulated losses and expenses not written-off*

Equity Shareholders A/c Dr.

To Profit & Loss A/c (Debit Balance)

To Discount or Expenses on Issues of Shares or debentures

To Preliminary expenses

To Underwriting Commission

(12) *For paying shareholders*

Preference Shareholders A/c Dr.

Equity Shareholders A/c Dr.

To Bank or Shares in Transferee Company

Accounting in the books of the Transferee Company

Accounting in the books of the transferee company is to be done with reference to Accounting Standard (AS)-14. The accounting procedure will differ depending upon the type of amalgamation. There are two main methods of accounting for amalgamation in the books of the transferee company :

(a) The Pooling of Interests Method, and

(b) The Purchasing Method.

(a) The Pooling of Interests Method

This method is applicable in case of amalgamation in the nature of merger. In this case, the amalgamation is accounted for as if separate businesses of amalgamated companies were intended to be carried on by the transferee company. That is why only minimum changes are made in aggregating the individual financial statements of the transferor companies. The following factors are taken into consideration while making entries in this method :

(i) In preparing the transferee company's financial statements, the assets, liabilities, and reserves (whether capital or revenue or 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 the amalgamation unless any adjustment is required due to different accounting

policies. The balance of the Profit and Loss Account of the transferor company sho
be transferred to the General Reserve, if any.

(ii) The difference between the amount recorded as share capital issued (plus any additio consideration in the form of cash or other assets) and the amount of share capital of transferor company should be adjusted in reserves. *In case there is no balance in Reserve Account in the Balance Sheet of the transferee company to offset the de balance in the reserve Account arising as a result of the difference between the purcha consideration and the amount of share capital of the transferor company should debited to Profit and Loss Account instead of debiting Reserve Account. It is so becau Reserve Account is never shown as a debit balance.*

(iii) If, at the time of amalgamation, the transferor and the transferee companies ha conflicting accounting policies, a uniform set of accounting policies should be adop following the amalgamation. The effects on the financial statements of any change accounting policies should be reported in accordance with Accounting Standard (A 5, 'Prior Period and Extraordinary Items and Changes in Accounting Policies.

The following journal entries are to be passed in the books of the transferee comp for incorporating the financial statements of the transferor company.

(1) *On amalgamation of business*

Business Purchase A/c	Dr.	(with the amount of
To Liquidators of the Transferor Co.		purchase consideration)

(2) *For recording assets and liabilities taken over*

Sundry assets (individually)	with book value
To Sundry Liabilities (Individually)	(With book value)
To reserve A/c	"
To Business Purchase A/c	"

The difference between debits and credits is adjusted in the reserves of the transfe company.

Note. As per para 33 of AS-14, the balance of the Profit and Loss A/c of the transf Company in transferred to General reserve, if any.

(3) *For making payment to the liquidator of the transferor company.*

Liquidators of the Transferor Co A/c

To Bank/ Share Capital/ Securities Premium (if any)

(4) *If liquidation expenses are paid by the transferee company*

General reserve or Profit & Loss A/c Dr.

If there is no General Reserve

To Bank A/c

(5) *For the formation expenses of the transferee company*

Preliminary Expenses A/c Dr.

To Bank A/c

Illustration – 1

A Ltd. and B Ltd. were amalgamated on and from 1st April, 1999. A new company AB Ltd. was formed to take over the business of existing companies. The balance sheets of A Ltd. and B Ltd. as on 31st March, 1999 are given below :

(figures in thousands)

	A Ltd.	B Ltd.		A Ltd.	B Ltd.
Share Capital			Fixed Assets	4,800	3,200
Equity shares of Rs.10 each	2,400	1,600	Less : Depn.	800	600
12% preference shares of Rs. 100 each	1,200	800		4,000	2,600
Reserve and Surplus :			Investments	1,600	600
Capital Reserve	800	600	Current Assets :		
General Reserve	1,200	600	Stock	1,200	600
Profit and loss A/c	400	200	Debtors	1,600	800
Secured loans	1,600	800	Cash & Bank Balance	1,200	600
Trade Creditors	1,200	400			
Tax provision	800	200			
	9,600	5,200		9,600	5,200

Other Information :

(i) Preference shareholders of the two companies are issued equivalent number of 15% preference shares of AB Ltd. at an issue price of Rs.125 per share.

(ii) AB Ltd. will issue one equity share of Rs.10 each for every share of A Ltd. and B Ltd. the shares are issued at a premium of Rs.5 per share. Prepare the balance sheet of AB Ltd. on the assumption that the amalgamation is in the nature of merger.

Solution

(1) CALCULATION OF PURCHASE CONSIDERATION

	A Ltd.	B Ltd.
	Rs.'000	Rs.'000
(a) Preference shareholders 12,000 shares at Rs.125 each 8,00 shares at Rs.125 each	1500	 1000
(b) Equity Shareholders 2,40,000 shares of rs.15 each 1,60,000 shares of rs.15 each	3600	2400
Total Purchase Consideration	5100	3400

(2) AMOUNT TO BE ADJUSTED AGAINST THE RESERVES

	A Ltd.	B Ltd.
Share capital of transferor companies	Rs.'000	Rs.'00
Equity share capital	2,400	1,60
Preference share capital	1,200	80
	3,600	2,40
Purchase consideration (as per working (i))	5,100	3,40
Difference to be adjusted against reserves	1,500	1,00

The total difference of rs.25,00,000 should be adjusted in the balance sheet of AB Ltd. against reserves as shown below :

	A Ltd.	B Ltd.	Total	Adjustment	Balanc
Capital reserve	800	600	1,400	1,400	Ni
General Reserve	1,200	600	1,800	1,100	70
	2,000	1,200	3,200	2,500	70

AB Ltd.
BALANCE SHEET as on 1.4.1999

Liabilities	Rs. (in '000)	Assets	Rs. (in '000)
Share capital :		Fixed assets :	8,000
20,000 Pref. shares of Rs.100 each	2,000	Less : depreciation	1,400
4,00,000 Equity shares of rs.10 each	4,000		6,600
Reserves & Surplus :		Investments	2,200
Share premium [25 x 20000 + 5x400000 = 2500000	2,500	Current assets	
General Reserve	700	Stock	1,800
Profit and Loss A/c	600	Debtors	2,400
Secured loans	2,400	Cash & Bank balances	1,800
Trade creditors	1,600		
Tax provision	1,000		
	14,800		14,800

(b) *Purchase Method*

This method of accounting is applicable for amalgamation in the nature of purchase. The following factors should be considered while making accounting entries under this method:

(i) In preparing the transferee company's financial statements, 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.

(ii) The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company.

(iii) An excess of the amount of the consideration over the net assets of the transferor company acquired by the transferee company should be recognized in the transferee company's financial statements as goodwill arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital reserve.

(iv) The goodwill arising on amalgamation should be amortized to income on a systematic basis over tits useful life. The amortization period should not exceed five years unless a somewhat longer period can be justified.

(v) Where the requirements of the relevant statute for recording the statutory reserves such as Development Allowance Reserve, Investment Allowance reserve etc. in the books of the transferee company are complied with, statutory reserves of the transferor company should be recorded in the financial statements of the transferee company by debiting 'Amalgamation Adjustment Account'.

(vi) The Amalgamation Adjustment Account should be disclosed as a part of "miscellaneous expenditure" or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and aforesaid account should be reversed.

The following journal entries are passed in the books of transferee company for incorporation of the financial statement of the transferor company :

(1) *For purchase of business from the Transferor Company :*

Business Purchase A/c Dr. (For Purchase consideration)

To Liquidator of the Transferor Company

(2) *For recording assets and liabilities taken over*

Various Assets A/c Dr.

(at revised values if any, otherwise at book values)

To various Liabilities (with the figures at which they are taken over)

To Business Purchase A/c

If (1) and (2) are combined, then the following one entry can also be passed :

Various assets A/c Dr.

(at revised values if any, otherwise at book values)

To Various Liabilities A/c (with the figures at which they are taken over)

To Business Purchase A/c

Note. (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 Accou

(3) *For making payment to the liquidator of the vendor company :*

Liquidator of the transferor Company Dr.

To Bank A/c

To Share Capital A/c

To Share Premium A/c (if any)

(4) *When statutory reserve is maintained*

Amalgamation adjustment A/c Dr.

To Statutory Reserves A/c

(5) *If liquidation expenses are paid by the transferee company :*

Goodwill A/c Dr.

To Bank

(6) *For formation expenses of the transferee company if any*

Preliminary Expenses A/c

To Bank

Less : Adjusted in reserve Fund and Profit loss A/c Balance of A Ltd. and B Ltd.

1,50,000

Reserve Fund and Profit and Loss A/c to be shown in B/ S of AB Ltd. Nil

Illustration – 3

A Ltd. acquired the undertaking of B Ltd. on 31.3.1999 for a purchase consideration of Rs.2,50,00,000 to be paid by fully paid equity shares of Rs.10 each. The Balance Sheets of the two companies on the date of acquisition were as follows :

	A Ltd.	B Ltd.		A Ltd.	B Ltd.
Share Capital	Rs.	Rs.	Fixed assets	Rs.	Rs.
Equity shares of Rs.10 each fully paid up	2,50,00,000	1,50,00,000	Land & buildings	1,20,00,000	80,00,000
Reserves & Surplus			Plant & Machinery	2,00,00,000	1,80,000
General reserve	1,20,00,000	18,00,000	Furniture & fixtures	10,00,000	20,00,000
Profit & loss A/c	10,00,000	53,00,000	Current assets		
Development rebate reserve	10,00,000	37,00,000	Stock	55,00,000	40,00,000
Workers' compensation fund	15,00,000	24,00,000	Debtors	45,00,000	40,00,000
Current liabilities	45,00,000	95,00,000		20,00,000	17,00,000
	4,50,00,000	3,77,00,000		4,50,00,000	3,77,00,000

Pass the necessary journal entries in the books of A Ltd. when amalgamation is in the nature of (i) merger and (ii) by way of purchase. Also prepare the Balance Sheet of A Ltd. after amalgamation assuming that Development Rebate Reserve and Workers' Compensation Fund of B Ltd. are required to be continued in the books of A Ltd.

Solution

(i)*When Amalgamation is in the Nature of Merger*

Books of A Ltd.

JOURNAL ENTRIES

			Rs.	Rs.
Business purchase A/c To liquidators of B Ltd. (being purchase of business of B Ltd.)	Dr.		2,50,00,000	2,50,00,00
Land & buildings A/c	Dr.		80,00,000	
Plant & machinery A/c	Dr.		1,80,000	
Furniture & fixtures A/c	Dr.		20,00,000	
Stock A/c	Dr.		40,00,000	
Debtors A/c	Dr.		40,00,000	
Bank A/c	Dr.		17,00,000	
General reserve A/c (balancing figure)	Dr.		29,00,000	
To current liabilities				95,00,000
To development rebate reserve A/c				37,00,000
To workers' compensation fund A/c				24,00,000
To business purchase A/c (being merger of assets, liabilities and reserves of B Ltd. with A Ltd. and difference transferred to General Reserve A/c)				2,00,000
Liquidators of B Ltd. To equity share capital A/c (being payment of purchase price by issue or 25,00,000 equity shares of rs.10 each	Dr.		2,50,000	2,50,00,00

BALANCE SHEET OF A LTD. (After Amalgamation) as on 31.3.1999

Liabilities	Rs.	Assets	Rs.
Share Capital 50,00,000 equity shares of Rs.10 each, fully paid up (of the above 25,00,000 shares of Rs.10 each issued for purchase of business of B Ltd.	5,00,00,000	Fixed assets	
Reserves & Surplus		Land & Buildings	2,00,00,00
General reserve	91,00,000	Plant & machinery	3,80,00,00
Profit & loss A/c	10,00,000	Furniture & fixtures	30,00,000
Development rebate reserve	47,00,000	Current assets	
Workers compensation fund	39,00,000	Stock	95,00,000
Current liabilities	1,40,00,000	Debtors	85,00,000
		Bank balance	37,00,000
	8,27,00,000		8,27,00,00

(ii) *When Amalgamation is by way of purchase*

JOURNAL ENTRIES

		Rs.	Rs.
Business purchase A/c To liquidators of B Ltd. (being purchase of business of B Ltd.	Dr.	2,50,00,000	2,50,00,000
Land & Buildings A/c	Dr.	80,00,000	
Plant & Machinery A/c	Dr.	1,80,00,000	
Furniture & fixtures A/c	Dr.	20,00,000	
Stock A/c	Dr.	40,00,000	
Debtors A/c	Dr.	40,00,000	
Bank A/c	Dr.	17,00,000	
To current liabilities			95,00,000
To business purchase			2,50,00,000
To capital reserve A/c (balancing figure) (being assets and liabilities taken over)			32,00,000
B Ltd. To equity share capital A/c (being payment of purchase price by issue of 25,00,000 shares of Rs.10 each)	Dr.	2,50,00,000	2,50,00,000
Amalgamation adjustment A/c	Dr.	61,00,000	
To development rebate reserve A/c			37,00,000
To Workers' compensation fund A/c (Being carrying forward of reserves of B Ltd.)			24,00,000

BALANCE SHEET OF B LTD (After Amalgamation) as on 31.3.1999

	Rs.		Rs.
Share Capital 50,00,000 equity shares of Rs.10 each, fully paid up (of the above 25,00,000 shares of Rs.10 each issued for purchase of business).	5,00,00,000	Fixed assets	
		Land & Buildings	2,00,00,000
		Plant & machinery	3,80,00,000
		Furniture & fixtures	30,00,000
Reserves & Surplus		Current assets	95,00,000
Capital reserve		Stock	85,00,000
General reserve		Debtors	37,00,000
Profit & Loss A/c	32,00,000	Bank balance	
Development rebate reserve	1,20,00,000	Miscellaneous expenditure (to the extent not written off or adjusted)	
Workers compensation fund	10,00,000		
Current liabilities	47,00,000		
	39,00,000		
	1,40,00,000	Amalgamation adjustment A/c	61,00,000
	8,88,00,000		8,88,00,000

Illustration – 4

A Ltd. and B Ltd. agreed to amalgamate by transferring their undertakings to a n company, AB Ltd., formed for that purpose. On the date of the amalgamation Balance She of the companies were as under.

Liabilities	A ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
	Rs.	Rs.		Rs.	Rs.
Authorized and issued capital			Sundry assets	4,80,000	3,22,000
Equity shares of Rs.10 each	5,00,000	3,00,000	Freehold property	2,00,000	1,00,000
5% debentures	2,00,000	1,00,000	Investments	50,000	20,000
Reserve fund		50,000	Debtors	2,50,000	1,50,000
Profit & loss A/c	30,000	20,000	Preliminary expenses	20,000	8,000
Mortgage loan secured on freehold property	50,000				
Sundry creditors	2,20,000	1,30,000			
	10,00,000	6,00,000		10,00,000	6,00,000

The purchase consideration consisted of :

(a) the assumption of the liabilities of both companies ; and

(b) the issue of shares at a premium of Rs.2 per share of equity shares of Rs.10 each AB Ltd.

For the purpose of the amalgamation, the assets are to be revalued as under :

	A Ltd. Rs.	B 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

Journalize the above transaction in the books of A Ltd., B Ltd., and AB Ltd. Indicate t basis on which the shares in AB Ltd. will be distributed among the shareholders of A Ltd. a B Ltd. respectively.

Solution

As per accounting standard 14, amalgamation is not in the nature of merger but it is the nature of purchase because assets of the transferor companies A Ltd. and B Ltd. have not been taken over by the transferee company at their existing values.

CALCULATION OF PURCHASE CONSIDERATION

	A Ltd.		B Ltd.	
	Rs.	Rs.	Rs.	Rs.
Assets taken over				
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
		10,46,000		6,50,000
Less : liabilities taken over				
5% debentures	2,00,000		1,00,000	
Mortgage loan	50,000			
Sundry creditors	2,20,000		1,30,000	
		4,70,000		2,30,000
		5,76,000		4,20,000

Purchases consideration to be discharged :

Issue of shares of rs.10 each at a

Premium of Rs. 2 per share Rs. 5,76,000 Rs.4,20,000

Number of shares issued $\frac{5,76,000}{12} = 48,000$ $\frac{4,20,000}{12} = 48,000$

Nominal value of shares issued

48,000 x Rs.10 = Rs.4,80,000 35,000 x Rs. 10=Rs.3,50,000

Shareholders of A Ltd. will get 48,000 shares for 50,000 shares held

Shareholders of A Ltd. will get 48 shares for every 50 shares held

Shareholders of B Ltd. will get 35,000 shares for 30,000 shares held

Shareholders of B Ltd. will get 7 shares for every 6 shares held

JOURNAL ENTERIES IN THE BOOKS OF A LTD

			Rs.	Rs.
Realization Account To Sundry assets account To freehold property account To investments account To debtors account (Being assets taken over by AB Ltd. transferred to realization account)	Dr.		9,80,000	 4,80,000 2,00,000 50,000 2,50,000
Mortgage Loan account Sundry Creditors account 5% debentures account To realization account (Being liabilities taken over by AB Ltd. transferred to realization account)	Dr. Dr. Dr.		50,000 2,20,000 2,00,000	 4,70,000
AB Ltd. To Realization account (Being purchase consideration agreed to be paid by AB Ltd.)	Dr.		5,76,000	 5,76,000
Equity shares in AB Ltd. To AB Ltd. (Being the receipt of the purchase price)	Dr.		5,76,000	 5,76,000
Realization Account To shareholders Account (Being profit on realization transferred)	Dr.		66,000	 66,000
Shareholders account To preliminary expenses account (Being transfer of preliminary expenses)	Dr.		20,000	 20,000
Equity share capital account Profit and loss account To equity shareholders account (Being balances transferred to equity shareholders)	Dr. Dr.		5,00,000 30,000	 5,30,000
Equity shareholders account To equity shares in AB Ltd. (Being payment made to equity shareholders)	Dr.		5,76,000	 5,76,000

JOURNAL ENTRIES IN THE BOOKS OF B LTD

	Dr.		Cr. Rs.	Rs.
Realization Account To Sundry assets account To freehold property To investments To debtors (Being assets taken over by AB Ltd. transferred to realization account)	Dr.		5,92,000	 3,22,000 1,00,000 20,000 1,50,000
Sundry Creditors account 5% debentures account To realization account (Being creditors taken over by AB Ltd. transferred to realization account)	Dr.		1,30,000 1,00,000	 2,30,000
AB Ltd. To Realization account (Being purchase consideration payable by AB Ltd.)	Dr.		 4,20,000	 4,20,000
Equity shares in AB Ltd. To AB Ltd. (Being purchase consideration received)	Dr.		 4,20,000	 4,20,000
Realization Account To shareholders Account (Being transfer of profit on realization)	Dr.		 58,000	 58,000
Equity Shareholders account To preliminary expenses account (Being transfer of preliminary expenses)	Dr.		 8,000	 8,000
Equity shareholders account Reserve fund Profit and loss account To equity shareholders accouts (Being balances transferred to equity shareholders)	Dr. Dr. Dt.		3,00,000 50,000 20,000	 3,70,000

JOURNAL ENTRIES IN THE BOOKS OF AB LTD

			Dr.	Cr.
			Rs.	Rs.
Business purchase account To liquidators of A Ltd. (Being the purchase price payable on the purchase of the business of A Ltd.)	Dr.		5,76,000	5,76,000
Goodwill Account Sundry Assets account Freehold property account Investment account Debtors Account To Mortgage loan account To Sundry creditors account 5% debentures account To business purchase account (Being assets and liabilities taken over)	Dr. Dr. Dr. Dr. Dr.		1,00,000 4,10,000 2,60,000 51,000 2,25,000	50,000 2,20,000 2,00,000 5,76,000
Liquidators of A Ltd. To Equity share capital account To securities premium account (being issue of 48,000 equity share of Rs. 10 each at a premium of rs.2 per share in settlement of the purchase price)	Dr.		5,76,000	4,80,000 96,000
Business purchase account To liquidators of B Ltd. (being purchase price payable to the liquidators of B Ltd. for the purchase of the business of B Ltd.	Dr.		4,20,000	4,20,000

Y CO. LTD.

	Rs.		Rs.
To realization account	1,50,000	By cash account By shares in Y Co. ltd.	60,000 90,000
	1,50,000		1,50,000

CASH ACCOUNT

	Rs.		Rs.
To y Co.Ltd.	60,000	By Sundry creditors account By bank overdraft account By Realization account	30,000 28,000 2,000
	60,000		60,000

SHARES IN Y CO. LTD

To Y Co. Ltd.	Rs. 90,000	By shareholders Account	Rs. 1,20,000

SHAREHOLDERS ACCOUNT

	Rs.		Rs.
To realization account (loss)	29,000	By share capital account	1,20,000
To profit and loss account	1,000		
To shares in Y co. Ltd.	90,000		
	1,20,000		1,20,000

JOURNAL ENTRIES IN THE BOOKS OF Y CO.LTD.

			Rs.	Rs.
Business purchase account Dr.			1,50,000	
To Liquidators of X Co. Ltd.				1,50,000
(Being purchase consideration agreed to be paid to the liquidators of X Co. Ltd.)				
Land and Buildings account Dr.			90,000	
Machinery account Dr.			50,000	
Stock account Dr.			17,000	
Sundry debtors Dr.			20,000	
To business purchase account				1,50,000
To capital reserve account				27,000
(Being various assets taken over at book value and the excess of value of assets over purchase price credited to capital reserve account being capital profit)				
Liquidators of X Co.Ltd. Dr.			1,5υ,000	
To share capital account				90,000
To cash account				60,000
(Being issue of 12,000 shares of Rs.10 each, Rs.7.50 paid up and Rs.60,000 cash paid to the liquidators of X Ltd. in settlement of the purchase price)				

Illustration – 6

X Ltd. and Y Ltd. are two companies carrying on business in the same line of activity. Their balance sheets as on 31.3.99 are given below :

	X Ltd. Rs.	Y Ltd. Rs.		X Ltd. Rs.	Y Ltd. Rs.
Fully paid up equity Shares of Rs.10 each	6,00,000	2,00,000	Land & buildings	1,00,000	-
General reserves	4,00,000	2,00,000	Plant & Machinery	7,00,000	3,00,000
Secured Loan	6,00,000	1,00,000	Investments	1,00,000	-
Current liabilities	6,00,000	4,00,000	Stock	9,00,000	4,00,000
	22,00,000	9,00,000	Debtors	3,00,000	1,00,000
			Cash at bank	1,00,000	1,00,000
				22,00,000	9,00,00

The two companies decide to amalgamate in the nature of purchase into XY Ltd. The following further information is given :

(1) X Ltd. holds 8,000 shares in Y Ltd. @ rs.12.50 each.

(2) All assets and liabilities of the two companies, except investments are taken over b Ltd.

(3) Each share in Y Ltd. is valued @ Rs.25 for the purpose of amalgamation.

(4) Shareholders in X Ltd. and Y Ltd. are paid off by issuing to them sufficient numb equity shares of Rs.10 each in XY Ltd. as fully paid up at par.

(5) Each share in X Ltd. is valued @ Rs.15 for the purpose of the amalgamation.

Show journal entries to close the books of both the companies.

Solution

JOURNAL (X LTD.)

Realization A/c Dr.		Rs.	
To land & buildings A/c		21,00,000	
To plant and machinery A/c			1,00,0
To stock A/c			7,00,0
To debtors A/c			9,00,0
To cash at bank			3,00,0
(Being assets taken over by XY Ltd. transferred to Realization Account)			1,00,0
Secured loan A/c Dr.		6,00,000	
Current liabilities A/c Dr.		6,00,000	12,00,0
To realization A/c			
(Being the liabilities taken over by XY Ltd. transferred to Realization Account)			
XY Ltd. Dr.		9,00,000	
To realization A/c			9,00,0
(Being purchase consideration agreed to be paid by XY Ltd.)			
Shares in XY Ltd. Dr.			
To investment A/c		2,00,000	
To sundry shareholders A/c			1,00,0
(Being the receipt of shares in XY Ltd. on liquidation of Y Ltd. and profit transferred to sundry shareholders A/c)			1,00,0
Shares in XY Ltd. A/c Dr.			
To XY Ltd.			
(By the receipt of shares from XY Ltd. on account of purchase consideration)		9,00,000	9,00,0
Share capital A/c Dr.			
General reserve A/c Dr.			
To sundry shareholders A/c		6,00,000	
(Being the transfer of share capital and general reserve to sundry shareholders account)		4,00,000	10,00,0
Sundry Shareholders A/c Dr.			
To shares in XY Ltd. A/c			
(Being the distribution of shares in XY Ltd. among the shareholders)		11,00,000	11,00,0

JOURNAL (Y LTD)

		Rs.	Rs.
Realization A/c Dr.		9,00,000	3,00,000
To plant & machinery A/c			4,00,000
To Stock A/c			1,00,000
To Debtors A/c			1,00,000
To Cash A/c			
(Being the assets taken over by XY Ltd. transferred to realization account)			
Secured Loan A/c Dr.		1,00,000	
Current liabilities A/c Dr.		4,00,000	
To realization A/c			5,00,000
(Being the liabilities taken over by XY Ltd. transferred to realization account)			
XY Ltd. Dr.		5,00,000	
To realization A/c			5,00,000
(Being purchase consideration agreed to be paid by XY Ltd.)			
Share capital A/c Dr.			
General Reserve A/c Dr.		2,00,000	
Realization A/c Dr.		2,00,000	
To sundry shareholders A/c		1,00,000	
(Being the share capital, general reserve and profit on realization transferred to sundry shareholders account)			5,00,000
Shares in XY Ltd. A/c Dr.			
To XY Ltd.			
(Being the receipt of shares from XY Ltd. on account of purchase consideration)		5,00,000	5,00,000
Sundry shareholders A/c Dr.			
To shares in XY Ltd.			
(Being the receipt of share from XY ltd. on account of purchase consideration)		5,00,000	5,00,000

Note

	X Ltd Rs.	Y Ltd. Rs.
Amount of purchase consideration		
60,000 shares @ rs.15 per share	9,00,000	-
20,000 shares @ Rs.25 per share	-	5,00,000

Illustration – 7

A Ltd. and B Ltd. were amalgamated on and from 1st April, 1999. A new company C Ltd. was formed to take over the business of the existing companies. The Balance Sheets of a Ltd. and B Ltd. as on 31st March, 1999 are given below :

(Rs. In lakh

Liabilities	A Ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
Share capital of Rs. 100 each	800	750	Fixed assets Land & building	550	400
12% preference shares of Rs. 100 each	300	200	Plant & Machinery	350	250
Reserves and surplus :			Investments	150	50
Revaluation reserve	150	100	Loans and advances		
General reserve	170	150	Stock	350	250
Investment allowance reserve	50	50	Sundry debtors	250	300
P & L Account	50	30	Bills receivable	50	50
Secured loans 105 debentures (Rs. 100 each)	60	30	Cash and bank	300	200
Current liabilities and provisions					
Sundry creditors	270	120			
Bills payable	150	70			
	2,000	1,500		2,000	1,500

Additional Informations

(1) 10% Debentureholders of A Ltd. and B Ltd. are discharged by C Ltd. issuing suc number of its 15% debentures of rs.100 each so as to maintain the same amount c interest.

(2) Preference shareholders of the two companies are issued equivalent number of 15% preference shares of C Ltd. at a price of rs.150 per share (face value rs.100).

(3) C Ltd. will issue 5 equity shares for each equity share of A Ltd. and 4 equity shares fo each equity share of B Ltd. the shares are to be issued @ rs.30 each, having a face value of Rs. 10 per share.

(4) Investment allowance reserve is to be maintained for 4 more years.

Prepare the Balance Sheet of C Ltd. as on 1st April, 1999 after the amalgamation has been carried out on the basis of amalgamation in the nature of purchase.

Solution

(1) Calculation of Purchase Consideration

(Rs. In lakhs)

	A Ltd.	B Ltd.
Preference shareholders to get 15% Pref. shares :		
$\frac{Rs.3,00,00,000}{Rs.100}$ i.e., 3,00,000 shares @ Rs. 150 each	450	
$\frac{Rs.3,00,00,000}{Rs.100}$ i.e., 2,00,000 shares @ Rs. 150 each		
Equity shareholders to get equity shares		
$\frac{Rs.8,00,00,000}{Rs.100}$ x 5 i.e., 40,00,000 shares @ Rs. 30	1,200	
$\frac{Rs.7,50,00,000}{Rs.100}$ x 4 i.e., 30,00,000 shares @ Rs. 30		900
Amount of purchases consideration (Lakhs Rs.)	1,650	1,200

(2) *Net Assets Taken Over*

(Rs. In lakhs)

	A Ltd.	B Ltd.	Total
Land and Building	550	400	950
Plant and Machinery	350	250	600
Investments	150	50	200
Stock	350	250	600
Sundry debtors	250	300	550
Bills receivable	50	50	100
Cash and Bank	300	200	500
Total assets	2,000	1,500	3,500
Less : liabilities taken over : debentures	(40)	(20)	(60)
9all debentures are not taken over because taking over of $\frac{2}{3}$ of 10% debentures will be able to get same amount of interest by issuing 15% debentures)	($60 \times \frac{2}{3}$)	($30 \times \frac{2}{3}$)	
Sundry creditors	(270)	(120)	(3900
Bills payable	(150)	(70)	(220)
Net assets taken over	1540	1290	2830
Less : purchase consideration	1650	1200	2850
	110	90	20
	(Goodwill	(Capital Reserve)	(Goodwill)

(3) As it is given that investment allowance reserve is to be maintained for 4 more years, it should be carried forward by a corresponding debit to amalgamation adjustment account in accordance with accounting standard 14.

BALANCE SHEET OF C Ltd. as on 1st April, 1999

(All figures in Rs. Lakhs

Liabilities		Assets	
Share capital		Fixed Assets	
70,00,000 equity shares of Rs.10 each		Goodwill	20
5,00,000 15% preference shares of	700	Land and Building	950
Rs.100 each		Plant and Machinery	600
(All the above shares are allotted as	500	Investments –	200
fully paid up pursuant to contracts		(A)Current Assets	
without payment being received in		Stock	600
cash)		Sundry Debtors	550
Reserve and surplus		Cash and Bank	500
Shares premium account			
(On 5,00,000 preference shares @ Rs.		(B) Loans and Advances	
50 each + On 70,00,000	1650	Bills Receivable	
Equity shares @ Rs.20 each)		Miscellaneous expenditure	100
Investment allowance reserve		(to the extent not written off or	
Secured loans		adjusted)	
15% debentures		Amalgamation adjustment	
Unsecured loans		Account	
(A)Current liabilities	100		100
Bills payable			
Sundry creditors			
(B) Provisions	60		
	Nil		
	220		
	390		
	Nil		
	2,620		3,620

Illustration – 8

The balance sheets as on 31st March, 1999 of X Ltd. and Y Ltd. are as under :

Liabilities	Rs.	Assets	Rs.
60,000 Equity shares of Rs. 100 each	60,00,000	Buildings	20,00,000
fully paid	8,00,000	Machinery	26,00,000
General reserve	4,80,000	Furniture	40,000
Profit and loss account'	9,60,000	Stock	16,00,000
Creditors		Debtors	9,20,000
		Cash in hand	2,80,000
		Bank	8,00,000
	82,40,000		82,40,000

Y Ltd.

Liabilities	Rs.	Assets	Rs.
20,000 Equity Shares of Rs. 100 each fully paid	20,00,000	Goodwill	4,00,000
		Machinery	16,80,000
Capital Reserve	2,00,000	Furniture	20,000
General Reserve	1,00,000	Stock	7,20,000
Profit and loss account	1,40,000	Debtors	7,20,000
12% debentures	12,00,000	Cash in hand	20,000
Creditors	3,80,000	Bank	1,60,000
		Expenditure on New project	3,00,000
	40,20,000		40,20,000

Y ltd. was absorbed by X Ltd. on 1st April, 1999 on the following terms :

(i) Fixed assets other than goodwill to be valued at Rs. 20,00,000 including Rs. 24,000 for furniture.

(ii) Stock to be reduced by Rs.80,000 and debtors by 5%

(iii) X Ltd. to assume liabilities and to discharge the 12% debentures by issue of 11% debentures of the same value and in addition a premium of 6% was paid in cash.

(iv) The new project to be valued at Rs.3,80,000.

(v) The shareholders of y Ltd. to receive cash payment of Rs.30 per share plus four equity shares in X Ltd. for every five shares held in Y Ltd.

(vi) Both the companies to declare and pay dividend of 6% prior to absorption.

(vii) Expenses of liquidation of Y Ltd. are to be reimbursed by X Ltd. to the extent of Rs.20,000.

The actual expenses amounted to Rs.24,000.

Draft journal entries in the books of X Ltd. and Y Ltd. and prepare the balance sheet of X Ltd. after absorption assuming that X's authorized capital in Rs.80,00,000.

Solution

It si a case of amalgamation in the nature of purhase because adjustments are intended to be made to the book values of assets of the transferor company when they are incorporated in the financial statements of the transferee company. As per AS-14, payment made to debenture holders and the cost of absorption agreed to be paid are not to be a part of the purchase consideration.

Calculation of Purchase Consideration

	Rs.	
Shareholders of Y Ltd. to get :		
Cash for 20,000 shares @ Rs.30	6,00,000	(Cash)
Equity shares @ 4 shares in X Ltd. for every 5 shares in Y Led. 20,000 x $\frac{4}{5}$ x Rs.100	16,00,000	(Shares)
Purchase consideration	22,00,000	

In the Books of Y Ltd.
JOURNAL ENTRIES

			Rs.	Rs
1979 April 1	Profit and loss account Dr. To dividend payable Account (Being dividend @ 6% payable on Rs. 20,00,000 share capital)		1,20,000	1,20,00
	Dividend payable account To bank account (Being payment of dividend)		1,20,000	1,20,00
	Realization account Dr. To goodwill account To machinery account To furniture account To stock account To debtors account To cash account To bank account (1,60,000 – 1,20,000 – 4,000) To new project account (Being transfer of assets to realization A/c)		38,96,000	 4,00,00 16,80,00 20,00 7,20,00 7,20,00 36,00 3,00,00
	12% debentures account Creditors account To realization account (Being liabilities agreed to be paid by X Ltd. transferred to realization account)		12,00,000 3,80,000	15,80,00
	X Ltd. Dr. To realization account (Being purchase consideration agreed to be paid by X Ltd.)		22,00,000	22,00,00
	Bank account Dr. Equity shares in X Ltd. Account To X Ltd. (Being receipt of purchase consideration)		6,00,000 16,00,00	22,00,00
	Realization account Dr. To bank A/c (Being payment of realization expenses not reimbursed by X Ltd).		4,000	4,00
	Equity shareholders account Dr. To realization account (Being loss on realization transferred to equity shareholders account)			

	Equity share capital account Dr.			
	Capital reserve account Dr.		1,20,000	
	General reserve account Dr.			1,20,000
	Profit and loss account			
	(1,40,000 – 1,20,000 dividend) Dr.			
	To equity shareholders account		20,00,000	
	(Being transfer of equity share capital and reserves to shareholders A/c)		2,00,000	
	Equity shareholders Account Dr.		1,00,000	
	To equity shares in X Ltd.		20,000	
	To bank A/c			
	(Being payment of amount due to shareholders)			23,20,000
			22,000,000	
				16,00,000
				6,00,000

In the Books of X Ltd.
JOURNAL ENTRIES

			Rs.	Rs.
1999 April 1	Business purchase account Dr.		22,00,000	22,00,000
	To liquidators of Y Ltd.			
	(Being purchase consideration agreed to be paid for purchase of business of Y Ltd.)			
	Machinery account Dr.			
	Furniture account Dr.		19,76,000	
	Stock account Dr.		24,000	
	Debtors account Dr.		6,40,000	
	Cash account Dr.		7,20,000	
	Bank account Dr.		20,000	
	New project account Dr.		36,000	
	Goodwill account		3,80,000	
	(Balancing figure) Dr.		20,000	
	To provision for doubtful debts account			36,000
	To 12% debentures account			1,20,000
	To creditors account			3,80,000
	To business purchase account			22,00,000
	(Being assets and liabilities of Y Ltd. taken over)			
	12% Debentures account Dr.			
	Goodwill account Dr.			
	To 11% debentures account			
	To bank account		12,00,000	
	(Being payment of 12% debentures at a premium of 6%, premium debited to Goodwill account)		72,000	12,00,000
	Goodwill account Dr.			72,000
	To bank account			
	(Being payment of cost of liquidation debited to Goodwill Account)			

	Liquidators of Y Ltd. Dr. To equity share capital account To bank account (Being payment of the purchase price)		20,000	20,000
	Profit and loss account Dr. To dividend payable account (Being 6% dividend payable on Rs.60,00,000 share capital)		22,00,000	16,00,000 6,00,000
	Dividend payable account Dr. To bank account (Being payment of dividend)		3,60,000	3,60,000

Balance Sheet of X Ltd.
as on 1st April, 1999

Liabilities	Rs.	Assets	Rs.
Share capital		Fixed Assets	
Authorised		Goodwill	1,12,000
80,000 equity shares of Rs. 100 each		Buildings	20,00,000
Issued and subscribed	80,00,000	Machinery	45,76,000
76,000 equity shares of Rs. 100 each fully paid		Furniture	64,000
		New project	3,80,000
(Of the above 16,000 shares issued for purchase of Y Ltd.)	76,00,000	Current assets	
		Stock	22,40,000
Reserve & surplus		Debtors 16,40,000	
General reserve		Less :	
Profit & loss account		provision for	
Secured loans		doubtful	
11% debentures		debts 36,000	
Current liabilities	8,00,000		16,04,000
Creditors	1,20,000	Cash and Bank balance	84,000
	12,00,000		
	13,40,000		
	1,10,60,000		1,10,60,000

Illustration – 9

A Ltd. and B Ltd. agreed to amalgamate and form a new company, C ltd., which will take over all the assets and liabilities of the two companies on the basis on amalgamation in the nature of purchase.

In the case of A Ltd. the assets and liabilities are to be taken over at book value for shares in C Ltd. at the rate of 5 shares in C Ltd. at 10% premium (i.e. Rs. 11 per share) for every four shares in A Ltd.

In the case of B Ltd. :

(i) The debentures of B Ltd. would be paid off by the issue of an equal number of debentures in C Ltd. at a discount of 10%.

(ii) The holders of 10% preference shares of B Ltd. would be allotted four 12% preference shares of Rs.100 each in C Ltd. for every five preference shares in B Ltd.

(iii) The equity shareholders would be allotted sufficient shares in C ltd. to cover the balance on their accounts after adjusting asset values by reducing plant and machinery by 10% and providing 55 on sundry debtors.

The summarized balance sheets of the two companies just prior to amalgamation were as follows :

Liabilities	A Ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
	Rs.	Rs.		Rs.	Rs.
Equity share capital shares of Rs.10 each			Plant & Machinery	8,00,000	8,00,000
10% pref. shares of Rs.100 each	4,00,000	5,00,000	Stock	65,000	60,000
			Debtors	95,000	50,000
14% debentures	-	3,00,000	Profit & loss A/c	-	1,40,000
Profit & loss A/c	-	2,00,000	Bank		
Contingency reserve	5,00,000	-		65,000	40,000
Creditors	50,000	-			
	75,000	90,000			
	10,25,000	10,90,000		10,25,000	10,90,000

Show the journal entries in the books of A Ltd. and B Ltd. show the Balance sheet of C ltd.

Solution

Calculation of Purchase consideration for A Ltd.

Shareholders of A Ltd. are to get 5 shares in C Ltd. @ Rs. 11 per share for every 4 shares in A Ltd.

A Ltd. has 40,000 shares ; so shareholders of A Ltd. will get 50,000 (i.e. 5/4 x 40,000) share @ Rs. 11 per share.

Thus purchase consideration is Rs.5,50,000 (i.e. 50,000 x 11).

Calculation of Purchase Consideration for B Ltd.

			Rs.
Value of assets taken over by C Ltd.			
Plant and Machinery (8,00,000 less : 10%)			7,20,00
Stock			60,00
Debtors (Rs.50,000 Less : 5% provision for Bad debts)			47,50
Bank			40,00
			8,67,50
Less : Creditors taken over		Rs.90,000	
Debentures taken over to be paid by C Ltd. at a discount of 10%		Rs.1,80,000	
			2,70,00
Purchase consideration			5,97,50
The purchase consideration is discharged as follows :			
Mode of payment			Amount
10% preference shareholders to get	12% preference share @ 4 preference shares for every 5 preference shares in B Ltd., (3,000 x 4/5), i.e., 2,400 shares of rs.100 each		2,40,00
Equity shareholders to get	35,750 equity shares of Rs.10 each i.e. balance of purchase consideration		3,57,50
			5,97,500

To provision for bad debts To debentures A/c (2,00,000 – 30,000) To sundry creditors A/c To Business purchase A/c To debentures in Y Co. Ltd. To Shares in Y co. Ltd. To capital reserve A/c (Bal. Fig) (Being various assets and liabilities taken over for 20,000 from Y Co. Ltd.)			10,000 1,70,000 2,00,000 20,000 30,000 13,065 8,935
Share Capital A/c (partly paid up) Dr. Liquidator of y Co.Ltd. A/c To share capital A/c (Being issue of 1,000 shares as fully paid to Y Co. ltd. and making partly paid up shares already held by that company fully paid)		10,000 20,000	30,000

BALANCE SHEET OF X CO. LTD.

as on 1st April, 1999 (after absorption)

Liabilities	Rs.	Assets	Rs.
Share capital :		Fixed assets :	
98,000 equity shares of		Investments (80,000	
Rs. 10 each Rs. 5 per share called up		– 20,000 – 30,000)	4,00,000
4,90,000		Current assets	30,000
3,000 equity		Stock-in-trade	
shares of		Book Debts less	
Rs. 10 each fully		provision 3,00,000–	4,70,000
Paid for consideration	5,20,000	10,000)	
Other than cash 30,000		Cash at bank	
Reserves & surplus :	8,935		2,90,000
Capital reserve			70,000
Profit & loss A/c	13,065		
(1.13.065 – 1,00,000)			
Secured loans :	1,70,000		
debentures (2,00,000 – 30,000)			
current liabilities & provisions current liabilities			
Sundry trade creditors			
(3,00,000 + 2,00,000 – 50,000)			
Equity dividend payable	4,50,000		
(1,00,000 – 2,000)			
	98,000		
	12,60,000		12,60,000

Working Notes :

Calculation of purchase consideration

No of shares in Y Co. Ltd. by outsiders $\frac{80,000-20,000}{500}$ =120

Number of shares to be issued to outsiders @ shares for any 2 shares $\frac{120x50}{2}$ =3,000

Shares already held by Y co. Ltd. 2,000 (i.e., rs.10,000 in shares of Rs. 5 each). Therefore, only 1,000 (i.e., 3,000 – 2,000) shares have to be issued.

Calculation of purchases consideration	Rs.
1,000 shares issued as fully paid up	10,000
Add : Additional amount on 2,000 partly paid up shares @ Rs. 5 to make them fully paid up Rs. 10 shares	10,000
Purchase consideration	20,000

Questions

Objective Type

1. State whether the following statements are True or False :

(a) When two or more companies go into liquidation and a new company is formed to t over their business, it is called absorption.

(b) The net worth is arrived at by adding the agreed value of assets taken over by purchasing company minus agreed value of the liabilities assumed by the purchas company.

(c) External reconstruction means reduction of capital of a company which is to reconstructed.

(d) Under net payment method, purchase consideration is calculated by adding the vari payments made by the purchasing company.

(e) Accident compensation fund is a liability and should be closed by transferring i realization account.

Ans. (True : (b), (d), False : (a), (c) and (e).

2. Fill in the blanks :

(a) When an existing company takes over the business of one or more existing compan it is called ....

(b) .... is the amount which is paid by the purchasing company for the purchase of business of the vendor company.

(c) Cost of liquidation of the vendor company agreed to be paid by the purchasing comp is debited to .... in the books of the latter company.

(d) Accumulated losses in the vendor company should be transferred to ....

Ans. [(a) absorption; (b) purchase consideration; (c) goodwill or Capital Reserve Account; Equity shareholders account].

Short Answer Type

1. What do you mean by amalgamation in the nature of merger?
2. What is the difference between internal reconstruction and external reconstruction
3. Give the names of various methods of calculating purchase consideration.
4. What is the journal entry to be passed by the purchasing company for making paym of liquidation expenses of the vendor company ?
5. What do you mean by inter company Owings ?
6. When the purchase price exceeds the net value of the business taken over hov difference dealt with /
7. How are accumulated losses in the vendor company treated?

8. If a company is purchased for a price which is less then net value, how will you deal with the difference?

9. How are reserves of the transferor company treated in the books of the transferee company in case of amalgamation in the nature of merger.

Long Answer Type

1. Define amalgamation. What entries are passed by a company to close its books when it is amalgamated by another company?

2. What entries should be passed in the books of a company that goes into liquidation for the purpose of amalgamation ?

3. What do you mean by the value of business ? If a concern is purchased for a price which is less than net value how will you deal with the difference ?

4. If the purchasing company issues fully paid shares to the liquidating company at a premium, how will they be dealt with / Explain and give the necessary journal entries.

5. Explain pooling interest method of amalgamation.

6. Give clearly the difference between amalgamation in the nature of merger and amalgamation in the nature of purchase.

7. what entries should be passed in the books of a transferee company in the case of an amalgamation in the nature of purchase.

PRACTICAL PROBLEMS

Amalgamation

1. The following are the abridged balance sheets of A Ltd. and B Ltd. as at 31st March 200–

Liabilities	A Ltd.	B. Ltd.	Assets	A Ltd.	B Ltd.
	Rs.'000	Rs.'000		Rs.'000	Rs.'000
Equity share capital (Rs.10 each)	24,000	9,000	Fixed assets	33,000	14,190
12% pref. share capital (Rs. 100 each)	-	3,000	Current assets	12,000	5,910
General Reserve	13,830	2,940			
Statutory reserve	1,170	375			
Profit and loss A/c	1,689	1,065			
13% debentures	-	750			
Current liabilities	4,311	2,970			
	45,000	20,100		45,000	20,100

On 1st April, 2000 A takes over b Ltd. on the following terms :

(i) A Ltd. will issue 10,50,000 equity shares of Rs.10 each at part to the equity shareholde of B Ltd.

(ii) A Ltd. will issue 33,000 12% preference shares of Rs.100 each at part to the pref4erenc shareholders of B Ltd.

(iii) The debentures of B Ltd will be converted into equal number of 14% debentures of th same denomination.

You are informed that the statutory reserves of B Ltd are to be maintained for two mor years. You are required to show the balance sheet of A Ltd. immediately after the abov mentioned scheme of amalgamation has been implemented assuming that :

(a) the amalgamation is in the nature of merger and

(b) the amalgamation is in the nature of purchase.

Ans. [(a) B/S Total (Rs. '000) 65,100; (b) B/S Total (Rs. '000) 65,475]

1. X Ltd. and Y Ltd. decided to amalgamate and new company viz. XY Ltd. is formed to o the Companies as on that date :

Liabilities	X Ltd. (Rs. In lakhs)	Y Ltd. (Rs. In lakhs)	Assets	X Ltd. (Rs. In lakhs)	Y Ltd. (Rs. In lakhs)
Share capital of Rs.10 fully paid	50	30	Goodwill	10	8.00
Reserve fund	20	15	Land & Building	25	19.00
Profit & loss a/c	3	5	Plant & Machinery	20	25.50
Div. Equalization fund	-	10	Patents & Trade mark	-	5.25
Workmen's compensation fund	2	-	Stock	20	15.00
Bank overdraft	-	5	Sundry debtors	10	5.00
Sundry Creditors	10	12	B/R	-	2.00
Bills payable	5	3	Cash at Bank	5	.25
	80	80		90	80

Show how the amount payable to each company is arrived at and prepare the amalgamated balance sheet of DY Ltd assuming amalgamation is done in the nature of purchase.

Ans. [Purchase consideration X Ltd. Rs.75 lakhs, Y Ltd. Rs. 60 lakhs, B/S total of XY Ltd. Rs. 170 Lakhs] .

1. The following are the balance sheets of G Ltd. and H Ltd.

Liabilities	G Ltd. Rs.	H Ltd. Rs.	Assets	G Ltd. Rs.	H Ltd. Rs.
Equity share capital (Rs.10 each)	50,00,000	20,00,000	Land & building	29,00,000	12,00,000
Pref. Share capital (Rs.100 each)	20,00,000	10,00,000	Plant & machinery	45,00,000	18,00,000
General reserve	8,00,000	2,00,000	Furniture	5,00,000	2,00,000
Investment allowance Reserve	7,00,000	3,00,000	Stock	15,00,000	5,00,000
Profit & loss A/c	10,00,000	5,00,000	Debtors	10,00,000	7,00,000
12% debentures (Rs.100 each)	5,00,000	2,00,000	Cash at bank	5,00,000	3,00,000
Trade creditors	5,00,000	3,00,000			
Other current liabilities	4,00,000	2,00,000			
	1,09,00,000	47,00,000		1,09,00,000	47,00,000

G Ltd. takes over H Ltd. as on April 1,2000. G Ltd. discharges the purchase consideration as follows :

(i) Issued 2,00,000 equity shares of Rs.10 each at Rs.12.50 to the equity shareholders of H Ltd.

(ii) Issued 15% preference shares of Rs.100 each to discharge the preference shares of H Ltd. at par.

The debentures of H Ltd. will be converted into equivalent number of debentures of G Ltd.

The investment allowance reserve of H ltd. is to be maintained for two more years. The fair value of plant & machinery of H Ltd. is Rs.15,00,000. Make entries in the books of G Ltd. and show the balance sheet of G Ltd. after amalgamation assuming that :

(i) The amalgamation is in the nature of merger,

(ii) The amalgamation is in the nature of purchase.

Ans [Total of balance sheet in (i) & (ii) rs.1,56,00,000]

1. Deva Ltd., and Asura Ltd., carrying on similar business agreed to amalgamate by transferring their undertaking to a new company, Devasura Ltd.

The terms of agreement were as follows :

(a) The purchase consideration consisted of :

(i)The assumption of liabilities of both the companies : ;(ii) the discharger of the debentures in Asura Ltd., at a premium of 5% by Devasura Ltd. by the issue of 7% debentures ; (iii) the issue of 10 equity shares of rs.10 each at a premium of Rs.2 per share for each preference share held in both the companies; (iv0 the issue of 10 equity shares of Rs. 10 each at a premium of rs.2 per share and rs.22 in cash for each equity share in Deva Ltd., and 5 equity shares of rs.10 each at a premium of Rs.2 per share and Rs.80 in cash for very equity share in Asura Ltd.

(b) All the assets and liabilities of the two companies were taken over at their book values except that a provision @ 5% to be raised on debtors.

(c) In order to raise working capital and to pay the purchase consideration, Devasura Ltd. decided to issue 30,000 equity shares of rs.10 each at a premium of Rs.2.50 per share.

Your are required to :

(i) pass journal entries in the books of Deva Ltd., to close its accounts, and

(ii) Show the opening balance sheet of Devasura Ltd. assuming amalgamation has been done in the nature of purchase.

	Deva Ltd. Rs.	Asura Ltd. Rs.
Ans. [purchase consideration :	13,10,000	7,20,000
Value of goodwill (taken over)		
Loss on Realization	52,900	48,230
Balance Sheet Total of Devasura Ltd. Rs. 22,07,000]	49,900	

5. Following is the balance sheet of M/s Desai Bros. as on 31st March, 2000.

Liabilities	Rs	Assets	Rs.
Capital	42,500	Freehold premises	25,000
Bank loan	20,000	Furniture	3,500
Bills payable	6,700	Motor Van	12,800
Creditors	10,800	Stock	13,200
		Bills receivable	5,400
		Debtors	18,700
		Cash	1,400
	80,000		80,000

On the above date the entire business was taken over by Ding Dong Bell Ltd. The purchase consideration was paid as under:

(i) 3,000 fully paid Rs.10 shares.

(ii) The balance in cash.

While recording the assets, the company valued the premises and stock at 10% and 20% above their book value respectively. Find out purchase consideration and pass necessary entries in the books of the Ding Dong Bell ltd., and show its balance sheet after take over of the business.

Ans [Purchase consideration rs.47,640 : B/S total Rs.83,740].

1. The following is the balance sheet or Beta Company limited as at 31st March, 1995 :

Liabilities	Rs.	Assets	Rs.
Share capital : 24,000 shares of Rs.10 each fully paid Sundry creditors Bank loan	 2,40,000 60,000 52,000	Buildings Plant & Machinery Stock of Goods Sundry debtors	2,00,000 80,000 30,000 42,000
	3,52,000		3,52,000

The company went into liquidation and the assets were sold to Alpha company Ltd. for Rs.2,94,000. The consideration was payable as follows :

Rs. 1,14,000 in cash (which sufficed to discharge the liabilities and to pay the cost of winding up rs.2,000) and the balance Rs.1,80,000 by the allotment of 24,000 shares of Rs.10 each, rs.7.50 per share paid up to the shareholders of Beta Company Ltd.

Close the books of Beta Company limited and give necessary entries for recording the transactions in the books of Alpha Company Limited.

Ans. [Loss on Realization Rs.60,000l; Capital reserve rs.58,000].

1. The Board of Directors of Lucky Ltd. decided to amalgamation the Unlucky Ltd. the Balance Sheet of the two companies as on 31st March, 2000 are given below :

Liabilities	Lucky Ltd.	Unlucky Ltd.	Assets	Lucky Ltd.	Unlucky Ltd.
	Rs.	Rs.		Rs.	Rs.
Share capital : 5% preference shares of Re. 1 each Equity shares of Re. 1 each Capital reserve General reserve Creditors Overdraft	 - 63,000 30,000 30,000 2,000 -	 10,000 20,000 - - 10,000 10,000	Goodwill Copy Rights Land & Buildings Plant Debtors Closing Stock Cash in Hand Profit & Loss A/c	10,000 5,000 25,000 35,000 10,000 10,000 30,000 -	10,000 - 15,000 - 10,000 5,000 - 10,000
	1,25,000	50,000		1,25,000	50,000

The terms of sales are as follows :

(i) Lucky Ltd. takes over both assets and liabilities of unlucky ltd.

LESSON – 2

INTERNAL RECONTRUCTION

Meaning

In internal reconstruction, the objective of reorganization is achieved without going into the process of l9iquidatiohn. For this purpose, provisions of the companies Act, 1956 relating to alternation of share capital (sections 94 to 97) and reduction of share capital (section 100 to 105) are utilized.

The process of internal reconstruction, sometimes involves the alternation of share capital sections 94 to 97 of the Act deals with alteration of Capital. It may take the form of fresh issue of shares, consolidation of existing shares, sub division of existing shares, conversion of fully paid shares into stock and cancellation of unissued capital. As alteration of capital does not have for reaching effect, it can be carried on by passing an ordinary resolution provided the articles of association of the company do not prohibit such alternation

REDUCTION OF SHARE CAPITAL

17.3Reduction of share capital may take the following forms :

1. *Reducing the uncalled capital* – Inc se of partly paid up shares, the decision may be taken to write off uncalled capital. This reduces the liability of members and thus, affect the rights of external stakeholders as the security cover available to external stakeholders depend upon paid up capital as well as uncalled capital which can be demanded by the company a any time during its lifetime. The decision to write off uncalled capital have no effect on paid up capital but it reduces the par value of shares.

Illustration – 1

The paid-up capital of a company is Rs.8,00,000 consisting of 10,000 equity shares o rs.100 each, Rs.80 called up. The company passes a special resolution for reducing it share capital by canceling its uncalled capital. Pas a journal entry to give effect to the above assuming that such reduction is permitted by the articles of association of the company and the resolution is confirmed by the court.

Share Capital (Rs. 10 each) A/c Dr. To share capital (Rs.80 each) A/c (For conversion of partly paid up shares of Rs.100 each into fully paid up shares of Rs. 80 each by cancellation of the uncalled capital).		8,00,000	8,00,000

2. *Return of paid up capital* – If a company feels that it has capital which is in excess of its requirement, it may decide to return paid up capital to its members. It reduces paid up capital and generally involves reduction in face value of shares.

Illustration – 2

The paid up capital of a company is Rs.8,00,000 consisting of 80,000 shares of rs.10 each fully paid up. The company finds tht it has excess cash funds amounting to Rs.2,00,000 and resolves to refund this amount to shareholders. Pass journal entries assuming that necessary formalities are complied with.

Share capital (Rs.10 each) A/c Dr. To share capital (Rs.7.50 each) A/c (For reduction in paid up capital by Rs.2,00,000 by conversion of rs.10 shares into Rs.750 share and refund of the amount to shareholders)		8,00,000		6,00,000 2,00,000
Shareholder A/c Dr. To bank A/c (for amount refunded to shareholders)		2,00,000		2,00,000

3. *Writing off paid up capital* — In this case, the paid up capital is reduced but the amount of reduction is not refunded to shareholders and is made available to the company for reorganization of its financial position. t/his form of capital reduction is most important from the point of view of internal reconstruction. The company has two options :

UNIT – V

LESSON – 1

FUNDS FLOW STATEMENT

In this lesson we will discuss how funds flow statement of a company is prepares

1. Introduction
2. Meaning and concept of fund
3. Meaning of flow of fund
4. Meaning of fund flow statement
5. Significance of funds flow statement
6. Schedule of changes in working capital
7. Funds from operation
8. Preparation of funds flow statement
9. Review exercises
10. Prescribed books.

LESSON – 2

In this less we will discuss how to prepare the cash flow statement of a company –

1. Introduction
2. Definition of cash flow statement
3. Procedure for preparing cash flow statement
4. Comparison between fund flow and cash flow statement
5. Uses and significance of cash flow statement.
6. Limitations of cash flow statement
7. Cash from operation
8. Preparation of cash flow statement
9. Miscellaneous examples

10. Review exercises

11. Prescribed books.

LESSON – 1

FUNDS FLOW STATEMENT

Lesson Plan :

In this unit we will discuss what is fund what are the sources and applications of fund for a business. How a funds flow statement is prepared.

1. Introduction
2. Meaning and concept of fund
3. Meaning of flow of fund
4. Meaning of fund flow statement
5. Significance of funds flow statement
6. Limitation of funds flow statement
7. Schedule of changes in working capital
8. Funds from operation
9. Funds flow statement

INTRODUCTION

As per As-3 the funds flow statement is defined as a statement that summarizes for the period covered by it, the changes in financial position including the sources from which funds were obtained by the enterprise and the specific uses to which such funds were applied.

The statement of changes in financial position is a broad term which includes both the funds flow and cash flow statements. Where the statement is prepared to ascertain the increase in working capital the statement is generally referred to as funds flow statement.

The funds flow statement gives a meaningful link between the balance sheets at the beginning and at the end of the period and the profit and loss account of the period.

The funds flow statement is a statement which shows the movement of funds and is a report of financial operations of the business undertaking. It indicates various means by which funds were obtained during a particular period and the ways in which these funds were employed. In simple words, it is a statement of sources and application of funds.

MEANING AND CONCEPT OF FUNDS

The term 'funds' has been defined in a number of ways.

(a) **In a narrow sense** – it means cash only and a funds flow statement prepared on th basis is called a cash flow statement such a statement enumerates net effects of t various business transactions on cash and takes into account receipts and disbursemer of cash.

(b) **In a broader sense** – the term 'funds' refers to money values form it may exist. He 'funds' means all financial resources, used in business whether in the form of mea material, money, machinery and others.

(c) **In a popular sense** – the term 'funds' means working capital, the excess of curre assets over current liabilities. The working capital funds has emerged due to the fa that total resources of a business are invested partly in fixed asserts in the form of fixe capital and partly kept in form of liquid or near liquid form of working capital.

However, the concept of funds is known as working capital in the most popular and this chapter we shall refer to 'funds' as working capital and a funds flow statement as statement of sources and application of funds.

MEANING AND CONCEPT OF 'FLOW OF FUNDS'

The term 'flow' means movement and included both 'inflow' and 'outflow'. The ter 'flow of funds' mean transfer of economic values from one assert of equity to another. Flow funds is said to have taken place when any transaction makes changes in the amount funds available before happening of the transaction. If the effect of transaction results in th increase of funds, it is called as a source of funds and if it results in the decrease of funds, is known as an application of funds. Further, in case the transaction does not charge fund it is said to have not resulted in the flow of funds. According to the working capital concep of funds, the term 'flow of funds' refers to the movement of funds in the working capital. If ar transaction results in the increase in working capital it is said to be an application or inflow funds and if it results in the decrease of working capital, it is said a source or out flow funds.

Rule

The flow of funds occurs when a transaction changes on the one hand a non-curre account and the other a current account and vice-versa.

When a change in non-current account e.g., fixed asserts long-term liabilities, reserve and surplus, factious asserts, etc., is followed by a change in another non-current account, does not amount to flow of funds. This is because of the fact that in such cases neither th working capital increases nor decreases. Similarly when a change in one current account results in a change in another current account, it does not affect funds. Funds move from non-current to current transaction affects (i) a current assert and a fixed assert, or (ii) a fixed and a current liability or (iii) a current assert and a fixed liability, (iv) a fixed liability and current liability, and funds do not move when the transaction affects fixed assets and fixed liability or current assets and current liabilities.

LIST OF CURRENT OR WORKING CAPITAL ACCOUNT

	Current liabilities		Current Assets.
1	Bills payable	1	Cash in hand
2.	Sunday creditors or accounts payable.	2.	Cash of Bank
3.	Accrued or outstanding expenses	3.	Bills receivable
4.	Dividends payable	4.	Sundry debtors or accounts receivable
5.	Bank overdraft	5.	Short term loans and advances
6.	Short-term loans advances and deposits.	6.	Temporary or marketable investments
7.	Provision against current assets.	7.	Inventions or stock such as (a) Raw materials (b) Works in process (c) Stores and spares (d) Finished goods.
8.	Provision for taxation, if it does not amount to appropriation of profits.	8.	Prepaid expenses
9.	Proposed dividend (May be a current or a non-current liability)	9.	Accrued incomes

LIST OF NON-CURRENT OR PERMANENT CAPITAL ACCOUNTS

	Non-current or permanent liabilities		Non –current or permanent Assets
1	Equity share capital	1	Goodwill
2.	Preference share capital	2.	Land
3.	Redeemable preference share capital	3.	Building
4.	Debentures	4.	Plant and machinery
5.	Long-term loans.	5.	Furniture and fittings
6.	Share premium account	6.	Trade marks
7.	Share forfeited account.	7.	Potent rights
8.	Profit and loss account (balance of profit credit balance)	8.	Long-term investment

9.	Capital reserve	9.	Debit balance of profit and lo account
10.	Capital redemption reserve	10.	Discount on issue of shares
11.	Provision for depreciation against fixed assets.	11.	Discount on issue of debentures
12.	Appropriation of profits.	12.	Preliminary expenses
	(a) General reserve (b) Dividend equalization fund (c) Insurance fund (d) Composition fund (e) Sinking fund (f) Investment fluctuation fund (g) Provision for taxation (h) Proposed dividend.	13.	Other deferred expenses

PROCEDURE FOR KNOWING WHETHER A TRANSACTION RESULTS IN THE FL OF FUNDS OR NOT

1. Analyse the transaction and find out the two accounts involved.
2. Make journal entry of the transaction.
3. Determine whether the accounts involved in the transaction are current or non-curre
4. If both the accounts involved are current i.e. either current assets or current liabilities does not result in the flow of funds.
5. If both the account involved are non-current, i.e., either permanent asserts or perman liabilities, it still does not result in the flow of funds.
6. If the account involved are such that one is a current account while the other is a n current account, i.e. current assert and permanent assert liability, or current assert a fixed assert, or current liability and fixed assert, or current liability and permanent liabi then it results in the flow of funds.

EXAMPLES

A- Transactions which involve only the current accounts and hence do not result the flow of funds :

1. Cash collected from debtors
2. Bill receivables realized
3. Cash paid to creditors.
4. Payment or discharge of bills payable.

5. Issued bills payable to trade creditors
6. Received acceptance from customers
7. Raising of short-term loans
8. Sale of temporary or marketable investments
9. Goods purchased for cash or credit.

B. Transaction which involved only non-current account and hence do not result in the flow of funds.

1. Purchase of one new machine in exchange of two old machines
2. Purchase of building or furniture in exchange of land
3. Conversion of debentures into shares.
4. Redemption of preference shares in exchange of debentures.
5. Transfers to general reserves, etc.
6. Payment of bonus in the form of shares.
7. Purchase of fixed assets in exchange of shares, debentures bonds or long-term loans.
8. Writing off of fictitious assets.
9. Writing off of accumulated losses or discount on issue of shares, etc.

C. Transactions which involve both current and non-current account and hence result in the flow of funds.

1. Issue of shares for cash.
2. Issue of debentures for cash.
3. Rising of long-term loans.
4. Sale of fixed assets on cash or credit.
5. Sale of trade investments.
6. Redemption of preference shares.
7. Redemption of debentures.
8. Purchase of fixed assets on cash or credit
9. Purchase of long-term trade investments.
10. Payment of bonus in cash.
11. Repayment of long-term loans.
12. Issue of shares against purchase of stock in trade.

MEANING AND DEFINITON OF FUDNS FLOW STATEMENT

I.C.W.A in Glossary of management accounting terms defines funds flow statement as 'a statement either prospective or retrospective, setting out the sources and applications of the funds of an enterprise. The purpose of the statement is to indicate clearly the requirement of funds and how they are proposed to be raised and the efficient utilization and application of the same".

Thus funds flow statement is a statement which indicates various means by which the funds have been obtained during a certain period and the ways to which these funds have been used during that period. The term 'funds' used here means working capital, i.e., the excess of current assets over current liabilities.

Funds flow statement is called by various names such as sources and application of funds. Statement of changes in financial positions, sources and cases of funds, used here means working capital, i.e., the excess of current assets over current liabilities.

Funds flow statement is called by various names such as sources and application of funds, statement of charges in financial positions, sources and uses of funds, summary of financial operations. Where come in and where gone out statement. Where got, where gone statement. Movement of working capital statement. Movement of funds statement. Funds received and Disbursed statement funds general and expended statement, sources of increase and application of decrease, funds statement etc.

DIFFERENCE BETWEEN FUNDS FLOW STATEEMNT AND INCOME STATEMENT

	Funds flow statement		Income statement
(1)	It highlights the changes in the financial position of a business and indicates the various means by which funds were obtained during particular period and the ways to which these funds were employed.	(1)	It does not reveal the inflows and outflows of funds but depicts the items of expenses and income arrive at the figure of profit or loss.
(2)	It is complementary to income statement income statement helps the preparation of funds flow statement.	(2)	Income statement is not prepared from funds flow statement.
(3)	While preparing funds flow statement both capital and revenue items are considered.	(3)	Only revenue items are considered.
(4)	There is no prescribed formal for preparing a funds flow statement.	(4)	It is prepared in a prescribed format.

DIFFERENCE BETWEEN FUNDS FLOW STATEEMNT AND BALANCE SHEET

	Funds flow statement		Balance sheet
(1)	It is a statement of changes in financial position and hence is dynamic in nature.	(1)	It is a statement o financial position on a particular date and hence is static in nature.
(2)	It shows the sources and uses of funds in a particular period of time.	(2)	It depicts the asserts and liabilities of a particular point of time.
(3)	It is a tool of management for financial analysis and helps in making decisions.	(3)	It is not of much help to management in making decisions.
(4)	Usually, schedule of changes in working capital has to be prepared before preparing funds flow statement.	(4)	No such schedule of changes in working capital is required. Rather profit and loss account is prepared.

Uses, significance and importance of funds flow statement

The significance or importance of funds flow statement can be well followed from its various uses given below.

(1) It helps in the analysis of financial operations - The financial statement revel the net effect of various transactions on the operational and financial position of a concern. The balance sheet gives a static view of the resources of a business and the uses to which these resources have been put at a certain point of time. But it does not disclose the causes for changes in the asserts and liabilities between two different points of time. The funds flow statement explains causes for such charges and also the effect of these changes on the liquidity position of the company. Some times a concern may operate profitably and yet its cash position may become more and more worse. The funds flow statement gives a clear answer to such a situation explaining what has happened to the profits of the firm.

(2) It throws light on many perplexing questions of general interest – Which otherwise may be difficult to be answered, such as –

(a) Why were the net current assets lesser inspite of higher profits and vice-versa.

(b) Why more dividends could not be declared inspite of available profits ?

(c) How was it possible to distribute more dividends than the present earnings ?

(d) What happened to the net profit ? Where did they go ?

(e) What happened to the proceeds of sale of fined assets or issue of shares debentures etc.

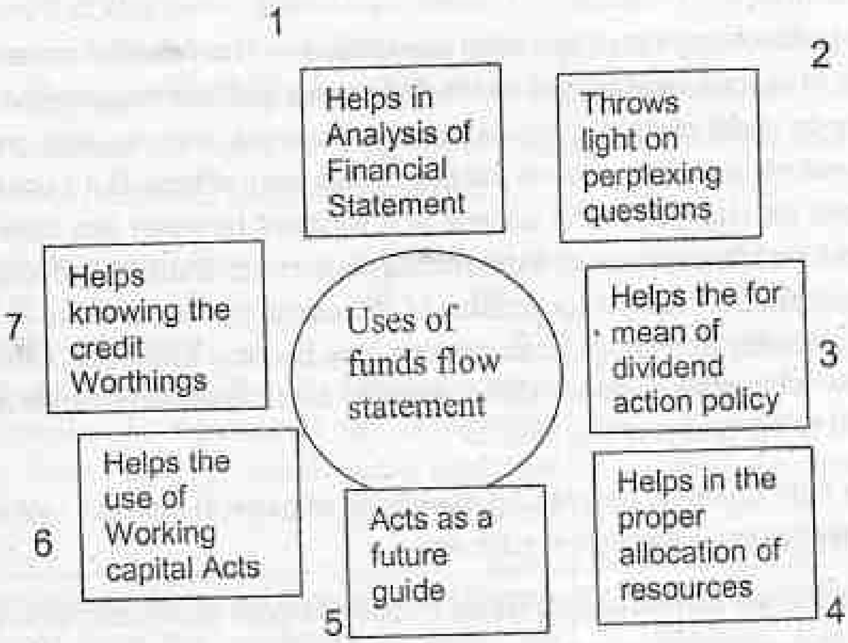
(f) What are the sources of the repayment of debt?

(g) How was the increase in working capital financial and how will be financed in future.

(3) **It helps in the formation of a realistic dividend policy** – Sometimes a firm has sufficie profits available for distribution as dividend but yet it may not be advisable to distribu dividend for lack of liquid or cash resources. In such cases, a funds flow stateme helps in the formation of a realistic dividend policy.

(4) **In helps in the proper allocation of resources** – The resources of a concern a always limited and it wants to make the best use of these resources. A projected fun flow statement constructed for the future helps in making managerial decisions. T firms can plan the deployment of its resources and allocate them among vario applications.

It acts as à future guide – A projected funds flow statement also out as a guide future to the management. The management can come to know the various proble it is going to face in near future for want of funds. The firms' future needs of funds c be projected well in advance and also the timing of these needs. The firm can arra to finance these needs more effectively and avoid future problems.



(6) **It helps in appraising the use of working capital** – A funds flow statement help explaining how efficiently the management has used its working capital and also sugg way to improve working capital position of the firm.

(7) **It helps knowing the overall credit worthiness of a firm** – the financial institut

and banks such as state financial institutions, Industrial Development Corporation, Industrial Finance Corporation of India, Industrial development bank of India, etc. all ask for funds flow statement constructed for a number of years before granting loans to know the credit worthiness and paying capacity of the firm. Hence a firm seeking financial assistance from these institutions has no alternative but to prepare funds flow statements.

LIMITATIONS OF FUNDS FLOW STATEMENT

The funds flow statement has a number of uses however it has certain limitations also, which are listed below.

1. It should be remembered that a funds flow statement is no a substitute of an income statement of a balance sheet. It provides only some additional information as regards changes in working capital.
2. In cannot revel continuous changes.
3. It is not an original statement but simply are – arrangement of data give in the financial statements.
4. It is essentially historic in nature and projected funds flow statement cannot be prepared with much accuracy.
5. Changes in cash are more important and revelant for financial management than the working capital.

PROCEDURE FOR PREPARING A FUNDS FLOW STATEMENT

Funds flow statement is a method by which we study changes in the financial position of a business enterprise between beginning and ending financial statements dates. Here, the funds flow statement is prepared by comparing two balance sheets and with help of such other information derived from the accounts as may be needed. Broadly speaking, the preparation of a funds flow statement consists of two parts.

1. Statement of schedule of charges in working capital.
2. Statement of sources and application of funds.

(1) STATEMENT OR SCHEDULE OF CHANGES IN WORKING CAPITAL

As, working capital = current assets – current liabilities.

So, (i) An increase in current asserts increases working capital.

(ii) A decrease in current assets decreases, working capital.

(iii) An increase in current liabilities decreases working capital and ,

(iv) A decrease in current liabilities increases working capital statement or schedu of changes in working capital.

Particulars	Previous year	Current year	Effect on working capital	
Current Assets			Increase	Decrease
Cash in hand				
Cash at bank				
Bills receivable				
Sundry debtors				
Temporary investments				
Stock/Inventories				
Prepaid expenses				
Acquired incomes				
Total current assets				
Current liability				
Bills payable				
Sundry creditors				
Outstanding expenses				
Bank overdraft				
Short-term advances				
Dividend payable				
Proposed dividends				
Provision for taxation				
Total current liabilities				
Working capital (CA – CL)				
Net increase or decrease in working capital				

Illustration – 1

Prepare a statement of changes in working, capital from the following balance sheets Manjit and company limited.

BALANCE SHEETS as at December 31

Liabilities	1994 Rs.	1995 Rs.	Asserts	1994 Rs.	1995 Rs.
Equity capital	5,00,000	5,00,000	Fixed assets	6,00,000	7,00,00
Debentures	3,70,000	4,50,000	Long-term		
Tax payable	77,000	43,000	Investments	200,000	1,00,00
Account payable	96,000	1,92,000	Work-in-progress	80,000	90,00
Interest payable	37,000	45,000	Stock-in-trade	1,50,000	2,25,00
Dividend payable	50,000	35,000	Accounts receivable	70,000	1,40,00
			cash	30,000	10,00
	11,30,000	12,65,000		11,30,000	12,65,00

Solution

STATEMENT OF CHANGES IN WORKING CAPITAL

Particulars	1994 Rs.	1995 Rs.	Effect on working capital	
Current Assets			Increase Rs.	Decreases Rs.
Cash	30,000	10,000		20,000
Account receivable	70,000	1,40,000	70,000	
Stock-in-trade	1,50,000	2,25,000	75,000	
Work-in-progress	80,000	90,000	10,000	
	3,30,000	4,65,000		
Current liabilities				
Tax payable	77,000	43,000	34,000	
Account payable	96,000	1,92,000		96,000
Interest payable	37,000	45,000		8,000
Dividend payable	50,000	35,000	15,000	
	2,60,000	3,15,0000		
Working capital (CA – CL)	70,000	1,50,000		
Net increase in working capital	80,000			80,000
	1,50,000	1,50,000	2,04,000	2,04,000

Try yourself :

From the following two balance sheets as on 31st December 1994 and 1995, you are required to prepare a schedule of changes in working capital for 1995 :

	Dec. 31, 1994	Dec.31 1995
Assets	Rs.	Rs.
Cash	60,000	94,000
Debtors	2,40,000	2,30,000
Stock-in-trade	1,60,000	1,80,000
Land	1,00,000	1,32,000
	5,60,000	6,36,000
Capital and liabilities		
Share capital	4,00,000	5,00,000
Trade creditors	1,40,000	90,000
Retained earnings	20,000	46,000
	5,60,000	6,36,000

[Ans. Net increase in Working Capital Rs.94,000]

(2) Statement of Sources and Application of Funds

Funds flow statement is a statement which funds (working capital) have been obtaine during a certain period and the uses or applications to which these funds have been p during that period. Generally, this statement is prepared in two formats :

(a) Report form

(b) T form or an account form or self-balancing Type.

SPECIMEN OF REPORT FORM OF FUNDS FLOW STATEMENT

Sources of funds	Rs
Funds from operations Issue of share capital Raising of long-term loans Receipts from partly paid shares, called up Sales of non current (fixed) assets Non-trading receipts, such as dividends received Sale of investment (long-term) Decrease in Working Capital (as per schedule of changes in Working Capital)	
Total	
Applications or uses of funds	
Funds lost in operations Redemption of preference shares capital Redemption of Debentures Repayment of long-term loans Purchase of non-current (fixed) assets Purchase of long-term investments Non-trading payments Payments of dividends* Payment of tad* Increase in Working capital (as per schedule of changes in Working capital)	
Total	

T form an account form or self-balancing type funds flow statement (for the year ended....)

Sources	Rs.	Applications	Rs.
Funds from operations		Funds lost in operations	
Issue of share capital		Redemption of preference	
Issue of debentures		Share capital	
Raising of long-term loans		Redemption of debentures	
Receipts from partly paid shares, called up		Repayment of long-term loans	
Sale of non-current (fixed) assets		Purchase of non-current (fixed) assets	
Non-trading receipts such as dividends		Purchase of long-term Investment	
Sales of long-term investments		Non-trading payments	
Net decrease in working capital		Payment of Dividends*	
		Payment of tax*	
		Net increase in working capital	

*Note. Payment of dividend and tax will appear as an application of funds only when these items are appropriations of profits and not current liabilities.

SOURCES OF FUNDS

The following are the sources from which funds generally flow (come), into the business:

(1) Funds from operations or Trading Profits

Trading profits or the profits from operations of the business is the most important and major source of funds. Sales are the main source of inflow of funds into the business as they increase current assets (cash, debtors or bills receivable) but at the same time funds flow out of business for expenses and cost of goods sold. Thus, the net effect of operations will be a source of funds if inflow from sales exceeds the outflow for expenses and cost of goods sold and vice-versa. But it must be remembered that funds from operations do not necessarily mean the profit as shown by the profit and loss account of a firm, because there are many non-fund or non-operating items which may have been either debited or credited to profit and loss account. The examples of such items on the debit side of a profit and loss account are : Amortization of fictitious and intangible assets such as goodwill, preliminary, expenses and discount on issue of shares and debenture written off; appropriation of retained earnings, such as transfers to reserves, etc., depreciation and depletion loss on sale of fixed assets; payment of dividend, etc. The non-fund items are those, which may be operational expenses but they do not affect funds of the business, e.g., for depreciation charged to profit and loss account, funds really do not move out of business. Non-operating items are those which although may result in the outflow of funds but are not related to the trading operations of t business, such as loss on sale of machinery or payment of dividends. The methods calculating funds from operations have been discussed in the following pages.

Basically, there are two methods of calculating funds from operations :

(a) The first method is to prepare the profit and loss account afresh by taking in consideration only fund and operational items which involve funds and are related the normal operations of the business. The balancing figure in this case will be eith funds generated from operations or funds lost in operations depending upon wheth the income or credit side of profit and loss account exceeds the expense or debit si of profit and loss account or vice-versa.

(b) The second method (which is generally used) is to proceed from the figure of net pro or net loss as arrived at from the profit and loss account already prepared. Funds fro operations by this method can be calculated as under :

(a) **CALCULATION OF FUNDS FROM OPERATION**	
	Rs
Closing Balance of P & L A/c or Retained Earnings (as given in the balance sheet)	
Add. Non-fund and non-operating items which have been already debited to P & L A/c :	
(i) Depreciation and depletion	
(ii) Amortization of fictitious and intangible assets such as :	
(a) Goodwill (b) Patents (c) Trade marks (d) Preliminary Expenses (e) Discount on Issue of shares, etc.	
(iii)Appropriation of Retained earnings, such as :	
(a) Transfer to General reserve (b) Dividend Equalization fund (c) Transfer to sinking fund (d) Contingency Reserve, etc.	
(iv)Loss on sale of any non-current (fixed) assets such as :	
(a) Interim Dividend (b) Proposed Dividend (if it is an appropriation of profits and not taken as current liability)	
(vi) Provision for Taxation (if it is not taken as Current liability)	
(vii) Any other non-fund/non-operating items which have been debited to P/L	
Total (A)	

Less Non-fund or non-operating items which have already been credited to P & L A/c	
(i) Profit or gain from the sale of non-current (fixed) assets such as :	
(a) Profit on sale of land and building (b) Profit on sale of plant & machinery (c) Profit on sale of long-term investments, etc.	
(ii) Appreciation in the value of fixed assets, such as increase in the value of land if it has been credited to P/L A/c	
(iii) Dividends Received	

(b) Funds from operations can also be calculated by preparing adjusted profit and loss account as follows :

ADJUSTED PROFIT AND LOSS ACCOUNT			
	Rs.		Rs.
To Depreciation & depletion or amortization of fictitious and intangible assets, such as : Goodwill, Patents, trade Marks, Preliminary Expenses etc.		By Opening Balance (of P & L A/c)	
To Appropriation of Retained Earnings, such as : Transfers to General Reserve, dividend Equalization Fund, Sinking Fund, etc.		By Transfers from excess provisions	
To loss on Sales of any non-current or fixed asset.		By Appreciation in the value of fixed assets	
To Dividends (including interim dividend)		By dividends received	
To Proposed Dividend (if not taken as a current liability)		By Profit on sale of fixed or non-current assets	
To Provision for taxation (if not taken as a current liability)		By *Funds from Operations* (balancing figure in case debit side exceeds credit side)	
To closing balance (of P & L A/c)			
To *Funds lost in Operations* (balancing figure, in case credit side exceeds the debit side)			

Illustration – 3

B.M. Company presents the following information and you are required to calculate funds from operations :

PROFIT AND LOSS ACCOUNT			
	Rs.		Rs.
To expenses :			
Operation	1,00,000	By gross profit	2,00,000
Depreciation	40,000	By gain on sale of plant	20,000
To loss on sale of building	10,000		
To advertisement suspense A/c	5,000		
To discount (allowed to customers)	500		
To discount on issue of shares written off	500		
To Goodwill	12,000		
Net Profit	52,000		
	2,20,000		2,20,000

Solution

CALCULATION OF FUNDS FROM OPERATIONS		
Net Profit (as given)	Rs.	Rs.
Add: Non-fund or non-operating items which have been debited to P/L A/c		52,000
Depreciation	40,000	
Loss on sale of building	10,000	
Advertisement written off	5,000	
Discount on issue of shares written off	500	
Goodwill written off	12,000	67,500
		1,19,500
Less : Non-fund or non-operating itesm which have been credit to P/L A/c :		
Gain on sale of Plant	20,000	
		20,000
Funds from Operations		99,500

Alternatively :

ADJUSTED PROFIT AND LOSS ACCOUNT			
	Rs.		Rs.
To depreciation	40,000	By opening balance	
To loss on sale of building	10,000	By Gain on sale of plant	20,000
To advertisement suspense A/c	5,000	By funds from operations (balancing figure)	99,500
To discount on issue of shares	500		
To goodwill	12,000		
To closing balance	52,000		
	1,19,500		1,19,500

Try yourself – 3

Calculate funds from operations from the following income statement.

INCOME STATEMENT

	Rs.		Rs.
To Rent paid	25,000	By Gross Income	5,00,000
To salaries paid	1,00,000	By profit on sale of vehicle	3,000
To provision for depreciation	50,000	By Refund of tax	2,000
To commission paid	5,000	By dividend received	10,000
To provision for taxation	1,50,000		
To general Reserve	3,000		
To loss on sale of investments	10,000		
To cost of issue of shares written off	2,000		
To provision for legal damages	5,000		
To net income	1,65,000		
	5,15,000		5,15,000

[Ans. Funds from operation = Rs.3,70,000]

Hints.

(1) Provision for legal damages is a non-fun item.

(2) Refund of Tax is a non-operating income.

Illustration – 4

Calculate 'Funds from operations from the information given below as on 31st March, 1995.

(i) Net profit for the year ended 31st March 1995, Rs.6,50,000

(ii) Gain on the sale of building Rs.35,500.

(iii) Goodwill appears in the books at Rs.1,80,000 out of that 10 percent has been written off during they year.

(iv) Old machinery worth Rs.8,000 has been sold for Rs.6,500 during the year.

(v) Rs.1,25,000 have been transferred to the general reserve fund.

(vi) Depreciation has been provided during the year on machinery and furniture at 20% whose total cost is Rs.6,50,000.

Solution

		Rs.
Net profit for the year (as given)		6,50,000
Add: Non-fund and non-operating items which have been debited to P/L A/c:		
Goodwill written off	18,000	
Los on sale of machinery (Rs.8,000-6,500)	1,500	
Transfer to general reserve fund	1,25,000	
Depreciation @ 20% on 6,50,000	1,30,000	2,74,500
Less : ;non-fund and non-operating items which have been credited to P/L A/c:		9,24,500
Gain on sale of building	35,500	35,500
Funds from operations		8,89,000

Alternatively :

ADJUSTED PROFIT AND LOSS ACCOUNT			
	Rs.		Rs.
To goodwill	18,000	By opening balance	
To loss on sale of machinery	1,500	By gain on sale of building	35,500
To transfer to general reserve fund	1,25,000	By funds from operations (balancing figure)	8,89,000
To depreciation	1,30,000		
To closing balance	6,50,000		
	9,24,500		9,24,500

Try Yourself – 4

Extracts from the balance sheets :

	31st Dec.94	31st Dec. 95
	Rs.	Rs.
Balance of profit and loss A/c	1,00,000	1,50,000
Additional information		
(i) Depreciation charged on assets		10,000
(ii) Preliminary expenses written off		5,000
(iii) Amount transferred to dividend equalization fund		15,000
(iv) A plant having a book value of Rs. 60,000 was sold for		65,000
(v) Interim dividend paid Rs.10,000 calculate funds from operations.		

[Ans. Funds from operation = Rs. 85,000]

Illustration – 5

From the following balance sheets and additional information given, you are required to calculate funds from operations for the year ended 1994.

Liabilities	1993	1994	Assets	1993	1994
	Rs.	Rs.		Rs.	Rs.
Share Capital	1,00,000	1,50,000	Land & Buildings	1,00,000	95,000
General reserve	30,000	30,000	Plant & Machinery	80,000	90,000
Profit & Loss A/c	20,000	22,000	Stocks	70,000	1,10,000
6% Debentures	80,000	80,000	Debtors	20,000	25,000
Creditors	65,000	58,000	Investments	-	10,000
Provision for tax	5,000	10,000	Cash	10,000	10,000
			Goodwill	20,000	10,000
	3,00,000	3,50,000		3,00,000	3,50,000

Additional information's :

1. During 1994, dividends of Rs.15,000 were paid.
2. Depreciation written off plant and machinery amounted to Rs.6,000 and no depreciation has been charged on land and buildings.
3. Provision for tax made during the year Rs.5,000
4. Profit on sale of machinery rs.2,000.

Solution

CALCULATION OF FUNDS FROM OPERATIONS

		Rs.
Closing balance of P/L A/c given in the B/S		22,000
Add : Non-fund or non-operating items already debited to P/L A/c :		
Depreciation	6,000	
Dividends	15,000	
Provision for tax	5,000	
Goodwill	10,000	36,000
		58,000
Less : non-fund or non-operating items already credited to P/L A/c :		
Profit on sale of machinery	2,000	
Opening balance of P/L A/c (given in B/S)	20,000	22,000
Funds from operations		36,000

1. Provision for tax has been treated as a non-current liability.

2. Goodwill written off during the year is :

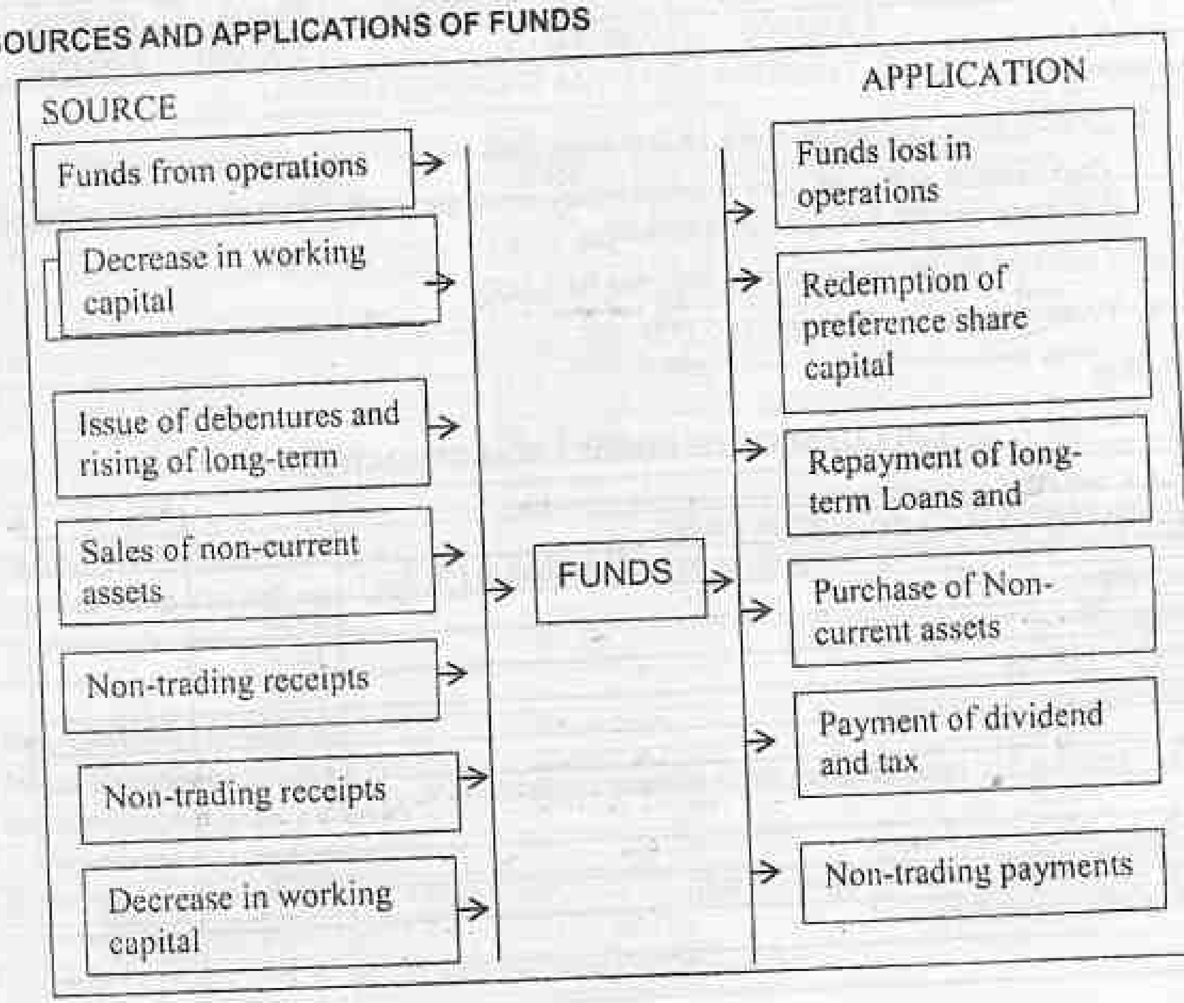
Rs.20,000 – Rs. 10,000 = Rs.10,000

Alternatively

ADJUSTED PROFIT AND LOSS ACCOUNT

	Rs.		Rs.
To depreciation	6,000	By opening balance	20,000
To dividends	15,000	By profit on sale of machinery	2,000
To provision for tax	5,000	By funds from operations (balancing figure)	36,000
To goodwill	10,000		
To Closing balance	22,000		
	58,000		58,000

SOURCES AND APPLICATIONS OF FUNDS



Try Yourself – 5

From the following Balance sheets and the additional information given, you are required to calculate funds from operations for the year ended 31st March, 1996.

Liabilities	31st March 1996 Rs.	31st March 1995 Rs.		31st March 1996 Rs.	31st March 1995 Rs.
Share capital	1,30,000	1,00,000	Fixed Assets	1,46,000	89,500
Retained Earnings	34,000	29,500	Less : depreciation		
Mortgages	30,000	20,000	Goodwill		10,000
Trade creditors	58,000	62,000	Investments		10,000
Short-term liabilities	27,000	35,000	(Marketable)		
Accrued expenses	19,000	13,000	Closing stock	80,000	70,000
			Debtors	54,000	50,000
			Cash	18,000	30,000
	2,98,000	2,59,500		2,98,000	2,59,500

Additional information :

1. Depreciation provided during the year amounted to Rs.13.500.
2. Dividends paid in 95-96 amounted to Rs.7,000
3. Goodwill was written off during the year out of retained earnings.

[Ans. Funds from operations = Rs.35,000]

(2) Issue of Share Capital

If during the year there is any increase in the share capital, whether preference or equity, it means capital has been raised during the year. Issue of shares is a source of funds, as it constitutes inflow of funds. Even the calls received from partly paid shares constitute an inflow of furans. It should also be remembered that it is the net proceeds from the issue of share capital which amounts to a source of funds and hence in case shares are issued at premium, even the amount of premium collected shall become a source of funds. The same is true when shares are issued at discount; it will not be the nominal value of shares but the actual realization after deducting discount that shall amount to inflow of funds. But sometimes shares are issued otherwise than in cash, the following rules must be followed :

(i) Issue of shares or making of partly paid shares as fully paid out of accumulated profits in the form of bonus shares is not a source of funds.

(ii) Issues of shares for consideration other than current assets such as against purchase of land, machines, etc. does not amount to inflow of funds.

(iii) Conversion of debentures or loans into shares also does not amount to inflow of funds.

In all the three cases mentioned above, both the amounts involved are non-current and do not involve any current assets or funds.

(3) Issue of debentures and raising of loans, etc.

Issue of debentures or raising of loans (long-term), whether secured or unsecured results in the flow of funds into the business. The inflow of funds is the actual proceeds from the issue of such debentures or raising of loans, i.e., including the amount of premium or excluding discount, if any. However, loans raised for consideration other than a current asset such as for purchase of building, will not constitute inflow of funds because in that case the accounts involved are only fixed or non-current.

(4) Sale of fixed (non-current assets) and long-term or trade investments

When any fixed or non-current asset like land, building, plaint and machinery, furniture, long-term investments, etc. are sold it generates funds and becomes a source of funds. However, it must be remembered that if one fixed asset is exchanged for another fixed asset, it does not constitute an inflow of funds because no current assets are involved.

(5) Non-trading Receipts

Any non-trading receipt like dividend received, refund of tax, rent received, etc. also increases funds and is treated as a sources of funds because such an income is not included in the funds from operations.

(6) Decrease in working capital

If the working capital decrease during the current period as compared to the previous period, it means that there has been a release of funds from working capital and it constitutes a source of funds.

APPLICATION OR USES OF FUNDS

(1) Funds lost in operations

Sometimes the result of trading in a certain year is a loss and some funds are lost during that period in trading operations. Such loss of funds in trading amounts to an outflow of funds and is treated as an application of funds.

(2) Redemption of preference share capital

If during the year any preference shares are redeemed, it will result in the outflow of funds and is taken as an application of funds. When the shares are redeemed at premium or discount, it is the net amount paid (including premium or excluding discount, as the case may be). However, if shares are redeemed in exchanges of some other type of shares or debentures, it does not constitute an outflow of funds as no current account is involved in that case.

(3) Repayment of loans or redemption of debentures, etc.

In the same way as redemption of preference share capital, redemption of debentures or repayment of loans also constitute an application of funds.

(4) Purchase of any non-current or fixed asset

When any fixed or non-current asset like land, building, plant and machinery, furniture, long-term investments, etc. are purchased, funds outflow from the business. However, if fixed assets are purchased for a consideration of issue of shares or debentures or if some fixed asset is exchanged for another, it does not involve any funds and hence not an application of funds.

(5) Payments of Dividends and Tax

Payments of dividends and tax are also applications of funds. It is the actual payment of dividend (may be interim dividend) and tax which should be taken as an outflow of funds and not the mere declaration of dividend or creating of a provision for taxation.

(6) Any other non-trading payment

Any payment or expense not related to the trading operations of the business amounts to outflow of funds and is taken as an application of funds. The examples could be drawings in case of sole trader or partnership firms, loss of cash, etc.

SOME TYPICAL ITEMS, WHICH REQUIRE PARTICULAR CARE

The following items require particular care while preparing a funds flow statement.

(1) Digging out Hidden Information

While preparing a funds flow statement, one has to analyse the given balance sheets. Items relating to current accounts, i.e., current assets and current liabilities have to be shown in the schedule of changes in working capital. But the non-current assets and non-current liabilities have to be further analysed to find out the hidden information in regard to sale or purchase of non-current assets, issue or redemption of share capital, raising or repayment of long-term loans, transfers to reserves and provisions, etc.

The hidden information can be digged out either by preparing working notes in the statement form or preparing concerned accounts of non-current assets and non-current liabilities. Both of these methods have been clarified in the following illustrations :

Illustration – 6

The following information has been extracted from the Balance sheets of a company

	31st Dec. 1993	31st Dec. 1994
	Rs.	Rs.
Machinery	80,000	2,00,000
Accumulated depreciation	30,000	35,000
Profit and loss account	25,000	40,000

The following additional information is also available :

(i) A machine costing Rs.20,000 was purchased during the year by issue of equity shares

(ii) On January, 1994, a machine costing Rs.15.000 (with an accumulated depreciation of Rs.5,000) was sold for Rs.7,000.

Find out sources/ application of funds.

Solution

ACCUMULATED DEPRECIATIONS A/c

	Rs.		Rs
To machinery A/c	5,000	By balance b/d	30,000
To balance c/d	35,000	By adjusted P/L A/c (balancing figure)	10,000
	40,000		40,000

8% PREFERENCE SHARE CAPTIAL A/c

	Rs.		Rs
To cash (application)	1,00,000	By balance b/d	2,00,000
To balance c/d	1,50,000	By cash-issue (balancing figure source)	50,000
	2,50,000		2,50,000

1. Issue of equity shares against purchased of machinery is neither a source nor application of funds.
2. Issue of shares worth Rs.50.000 for cash is a source of funds.
3. Redemption of reference shares worth Rs.1,00,000 is an application of funds.
4. Issue of preference shares of rs.50,000 is a source of funds.

Try yourself – 7

Extracts from Balance Sheets

	As on 30.6.1995	As on 30.6.1996
Equity share capital	2,00,000	3,00,000
Share premium A/c	20,000	30,000
9% debentures	1,00,000	1,50,000

Additional Information

9% debentures worth Rs.30,000 were redeemed during the year.

Prepare necessary accounts to find out sources/ applications of funds.

[Ans.(i) Issue of equity shares of Rs. Rs.1,00,000 is a sources of funds.

(ii) Sharc premium of Rs.10,000 is a source of funds.

(i) Redemption of debentures worth Rs.30,000 is an application of funds.

(ii) Issue of debentures for Rs.80,000 is a source of funds].

2. Investments

The treatment of investments while preparing funds flow statement depends upon their nature, i.e., whether they are current assets or fixed (long-term) or non-current assets. If the investments represent surplus funds temporarily invested in marketable or short-term securities, they are to be treated as current assets. But if investments are long-term, permanent or trade investments, these should be treated as fixed assets.

(a) Temporary Investments. When the surplus funds are temporarily invested in marketable securities, they are treated as current assets and hence shown in the schedule of changes in Working Capital. Temporary investments do not require any further treatment while preparing funds flow statement like all other current assets.

(b) Long-term, permanent or Non-current Investments. If the investments are of non-current nature, these should not be shown in the schedule of changes in working capital because they are not current assets. However, in this case, an investment account should be prepared as it is prepared in the books of accounts to find out the cost of investments purchased or sold during the year and the profit or loss on sale of such investments, if any. Sometimes, the investments are purchased-cum-dividend and the pre-acquisition dividend received is credited to the investment account. If there is a loss on sale of such investments and it has been debited to P/L A/c, it should be added back while finding funds from operations or shown on the debit side of adjusted profit and loss account (depending upon which method is followed) for the reason that such loss is not an operating loss. However, for the same reason, if a profit on sale of such investments has been credited to profit and loss account, it should be deducted while finding funds from operations or shown on the credit side of adjusted profit and loss account as the case may be.

The purchase of non-current or trade investments is an application of funds while the proceeds realized from the sale of such investments are a source of funds.

Illustration – 8

The extracts of a balance sheet reveal that there is an opening balance of trade investments amounting to Rs.20,000 and a closing balance of Rs.30,000, Rs.3,000 by way of dividends have been received during the year including Rs.1,000 from pre-acquisition profits which have been credited to Investments Account. You are required to find out the cost of Investments purchased during the year to be shown as application of funds.

Solution

INVESTMENTS ACCOUNT

	Rs.		Rs.
To balance b/d (opening balance)	20,000	By dividend A/c (Pre-acquisition)	1,000
To cash (purchases during the year-balancing figure)	11,000	By balance c/d (closing balance)	30,000
	31,000		31,000

Alternatively :

Calculation of purchase of investments

	Rs.
Opening balance	20,000
Less : dividend being pre-acquisition credited to	1,000
Investments A/c	19,000
Closing balance	30,000
Purchase of Investments during the year (balancing figures)	11,000

Try yourself – 8

Extracts of a balance sheet :	1994	1995
	Rs.	Rs.
Trade Investments	50,000	70,000

Additional Information :

(i) Rs.5,000 by way of dividend has been received during the year including rs.2,000 from pre-acquisition profits which have been credited to investments A/c.

(ii) Investments costing Rs.10,000 have been sold during the year for Rs.10,000.

Find out sources/ applications of funds.

[Ans.

(i) Dividend of Rs.5,000 received on trade investments is a source of funds.

(ii) Rs.10,000 realized from sale of trade investments is a source of funds.

(iii) Investments purchased during the year for Rs.32,000 is an application of funds].

3. Provision for Taxation

There are two ways of dealing with provision for taxation :

(i) As a current liability. Provision for taxation may be treated as a current liability as it, generally, represents an immediate obligation of the company to pay tax to the Government. When it is treated as a current liability, provision for taxation will appear in the schedule of changes in working capital like all other current liabilities and no further treatment is required while preparing the funds flow statement. In this case, there is no need to prepare the provision for Taxation account and the payment of tax made during the year shall not be shown as an application of funds because in that case both the accounts involved for the payment of tax shall be current accounts, e.g., the entry for taxes paid during the year shall be :

Provision for taxation A/c	Dr.	(already taken as Current Liability)
To cash A/c		(Current Asset)

It is clear from the above entry that only the current accounts are involved and hence there is no movement of funs (Working Capital).

(ii) As on appropriation of profits. When the provision for taxation is treated as an appropriation of profits and not as a current liability, then it shall not appear in the schedule of changes in working capital. Provision for taxation made during the year then shall be the appropriation of profits made during the year and will have to be added back while finding funds from operations being a non-fund item. If an adjusted profits and loss account is prepared, provision for taxation made during the year shall appear on the debit side for the same reasons. Moreover, the taxes paid during the year shall be an application of funds (not being a current liability) and will have to be shown in the funds few statements on the application side.

A provision for taxation account may have also to be prepared in case of hidden information, i.e., when the provision for taxation made during the year or the taxes paid during the year are not given.

However, the students may note that it is preferable to assume provision for taxation as a current liability as generally it is an immediate obligation of the company to pay it and it rarely represents an appropriation of profits.

Illustration – 9

The opening balance in the provision for taxation account as on 1st January 1995 was Rs.30,000 and the closing balance on 31st December 1995 was Rs.40,000. The taxes paid during the year amounted to Rs.25,000. How will you deal with this item in the funds flow statement?

SCHEDULE OF CHANGES IN WORKING CAPITAL

	1.1.1995	31.12.1995	Increase in working capital	Decrease in working capital
Current liabilities	Rs.	Rs.	Rs.	Rs.
Provision for taxation	30,000	40,000		10,000

(B)When provision for taxation is treated as an appropriation of profits ;

(1) It will not be shown in the schedule of changes in working capital.

(2) Taxes paid during the year i.e., Rs.25,000 is an application of funds and will appear on the application side of funds flow statements.

FUNDS FLOW STATEMENT

for the year ended 31.12.1995

Sources	Rs.	Application	Rs.
		Payment of tax	25,000

(3) Provision for taxation made during the year i.e., Rs.35,000 shall have to be calculated as below and it will be added back (or shall be shown on the debit side of adjusted profit and loss account) while finding funds from operations.

Calculation of provision for taxation made during the year.

	Rs.
Opening balance of provision for tax on 1.1.1995	30,000
Less : taxes paid during the year	25,000
	5,000
Closing balance of provision on 31.12.1995	40,000
Provision made during the year	35,000

OR

PROVISION FOR TAXATION A/c

	Rs.		Rs.
To cash (tax paid)	25,000	By balance b/d	30,000
To balance c/d	40,000	By adjusted P/L A/c (provision made balancing figures)	35,000
	65,000		65,000

Try yourself – 9

Extracts from the balance sheets

	30.6.95	30.6.96
	Rs.	Rs.
Provision for taxation (non-current)	50,000	75,000
Profit and loss A/c (Cr.)	2,00,000	3,00,000

Additional Information :

Tax paid during the year is Rs.30,000

Find out sources and applications of funds.

[Ans. (i) tax paid of Rs.30,000 is an application of funds.

(ii) Funds from operations of Rs.1,55,000 is a source of funds].

4. Proposed Dividends

Proposed dividend though shown on the liabilities side of a Balance sheet is not a liability in real sense unit it is formally declared to be paid to the shareholders in the annual general meeting of the company. Till such declaration of dividends, it simply represents an appropriation of profits and is like a reserve or surplus. But generally, declarations of dividends proposed by the directors are accepted in the shareholders meeting. In that case, proposed dividend cannot be said to be and appropriation of profits as these become payable within a short time after they are proposed. So there are two alternatives to deal with this item in the same way as that of provision for taxation ;

(i) As a current liability. When proposed dividend is treated as a current liability it represents an obligation of the company which is payable in a short period. Hence, it is shown in the schedule of changes in working capital as a current liability and it requires no further treatment in the funds flow statement.

(ii) As an appropriation of profits. When proposed dividend is treated as an appropriation of profits it is not a current liability and hence will not be shown in the schedule of changes in working capital. In this case, dividends proposed during they year, being an appropriation, are added back (or shown on the debit side of adjusted profit and loss account) while finding funds from operations. Thus, dividends paid during the year represent an application of funds and have to be shown on the application side of funds flow statement. In the absence of any information, proposed dividend for the previous year may be assumed to be paid during the year and taken as an application of funds while the proposed dividend of the current year, being an appropriation, may be added while finding funds from operations.

In any case, the students may note that the treatment of proposed dividend is much similar to the provision for taxation and it is also preferable to treat proposed dividend as a current liability because generally the dividends proposed by the directors are accepted by the shareholders in the Annual General Meeting and these become payable within a short period.

5. Interim Dividend

The expression 'interim dividend' denotes a dividend paid to the members of the company during a financial year, before the finalization of annual accounts. The dividend paid or declared in between the two Annual General Meetings, i.e., interim dividend should be added back (or debited in the adjusted profit and loss account) while calculating funds from operations. However, if the figure of profit is taken prior to the debit of interim dividend this adjustment is not required. The interim dividend is also an application of funds and has to appear on the application side of funds flow statement.

Illustration – 10

Extracts from the balance sheets

	30.6.95	30.6.96
	Rs.	Rs.
Proposed dividend	50,000	75,000
Profit and loss A/c (Cr.)	2,00,000	3,00,000

Additional information

Dividend paid during the year is Rs.50,000.

Find out sources and applications of funds.

Solution

PROPOSED DIVIDEND A/c

	Rs.		Rs.
To cash-dividend paid	50,000	By balance b/d	50,000
To balance c/d	70,000	By adjusted P/L A/c (balancing figure)	70,000
	1,20,000		1,20,000

ADJUSTED P/L A/c

	Rs.		Rs.
To Proposed dividend	70,000	By balance b/d	2,00,000
To balance c/d	3,00,000	By adjusted P/L A/c (balancing figure)	1,70,000
	3,70,000		3,70,000

(i) Dividend paid Rs.50,000 is an application of funds.

(ii) Funds from operations of rs.1,70,000 is a source of funds from operations.

Note. in case proposed, dividend is taken as a current liability and shown in the schedule of changes in working capital payment of dividend of Rs.50,000 is not an application of funds and no adjustment is required to calculate funds from operations.

Try yourself – 10

Extracts from balance sheets

	1994	1995
Proposed dividend	80,000	1,00,000
Retained Earnings	30,000	4,00,000

Additional information

Dividend proposed during the year and debited to retained Earnings A/c is Rs.1,00,000.

Prepare proposed dividend A/c and adjusted profits ant loss account to find out sources and applications of funds.

[Ans. (i) Dividend paid during the year Rs.80,000 is an application of funds.

(ii)Funds from operations of Rs.2,00,000 is a source of funds].

6. Provision against current assets

Provision against current assets, such as, provision for bad and doubtful debts, provision for loss on stock, etc. may be treated by any of the following methods :

(a) The opening and closing balance of provision against current assets should be deducted from the respective opening and closing balance of the concerned asset. The net amount of the current assets should then be shown in the schedule of changes in working capital. It does not require any further treatment in the funds flow statement.

(b) The amount of the opening and closing balance of the current assets may be taken as gross in the schedule of changes in working capital, i.e., without deducting the amount of provision. But, then, the opening and closing balance of the provision against current assets shall have to be taken as a current liability in the schedule of changes in working capital an it will not need any further treatment in the funds statement.

(c) If excess provision has been created, it may be treated as an appropriation of profits and should be added while calculating funds from operations. The amount of the excess provision will not be shown in the schedule of changes in working capital.

DEPRECIATION AS A SOURCE OF FUNDS

Depreciation may be regarded as the capital cost of an assets allocated over the lif the asset. In simple language, it means the gradual decrease in the value of an asset du wear and tear, use and passage of time. In real sense, depreciation is simply a book e having the effect of reducing the book value of the asset and the profits of the current yea the same amount. It does not affect current assets or current liabilities and does not resu the flow of funds or to say more precisely it is a non-fund item. Hence, although deprecia is an operating cost there is no actual outflow of cash and so the amount of the deprecia charged during the year is added back to profits while finding funds from operations. E then, is depreciation a source of funds?

There cannot be any definite answer in 'yes' or 'no' to this question as there differences of opinion on this important point. But it can be said with certainty that depreciati directly at least does not amount to a source of funds. However, under certain circumstanc depreciation helps a business concern to effect savings in payment of tax and dividends a amounts to withholding a part of the funds generated as an indirect source of funds. Howev it is not even an indirect source of funds under all circumstances. Say, for example, a compa is running into losses and there are no profits, then any amount of depreciation chargec profit and loss account will neither affect tax liability nor any payment of dividends, as th are no profits. In this case, depreciation does not amount to withholding of funds and her is not a source fo funds at all. On the other hand, if a concern earns sufficient profit amount of depreciation charged to profit and loss account will affect savings in the paym of tax as well as dividend and shall help in the generation of funds. In case a concern ea huge profit and excessive depreciation than permitted under the income tax Act is chargec profit and loss account, it shall still result in the generation of funds through savings in payment of dividends.

To conclude, it may be said that to the extent depreciation helps in effecting savings the payment of tax and dividends, it may be regarded as a source of funds.

COMPREHENSIVE ILLUSTRATIONS

(A)When only Balance Sheets are given

Illustration – 11

From the following balance sheets of the company for the ending 31st December 19 and 31st December 1994, prepare schedule of changes in working capital and a stateme showing sources and application of funds.

	31st December			31st December	
	1993	1994		1993	1994
Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Share capital sundry	3,00,000	4,00,000	Plant & Machinery	50,000	60,000
Creditors	1,00,000	70,000	Furniture & fixtures	10,000	15,000
P/L A/c	15,000	30,000	Stock-in-trade	85,000	1,05,000
			Debtors	1,60,000	1,50,000
			Cash	1,10,000	1,70,000
	4,15,000	5,00,000		4,15,000	5,00,000

Solution

SCHEDULE OF CHANGES IN WORKING CAPITAL

	1993	1994	Effect on working capital	
			Increase	Decrease
	Rs.	Rs.	Rs.	Rs.
Current Assets				
Cash	1,10,000	1,70,000	60,000	
Debtors	1,60,000	1,50,000		10,000
Stock-in-trade	85,000	1,05,000	20,000	
	3,55,000	4,25,000		
Current liabilities				
Sundry creditors	1,00,000	70,000	30,000	
	2,55,000	3,55,000		
Working Capital Net Increase in working capital	1,00,000			1,00,000
	3,55,000	3,55,000	1,10,000	1,10,000

STATEMENT OF SOURCE AND APPLICATION OF FUNDS
for the year ended 31.12.1994

Sources	Rs.	Applications	Rs.
Issue of share capital	1,00,000	Purchase of plant & machinery (60,000-50,000)	10,000
Funds from operations	15,000	Purchase of furniture & fixtures (15,000-10,000)	5,000
		Net increase in working capital	1,00,000
	1,15,000		1,15,000

Funds from operations	**Rs.**
Balance of P/L A/c 1994	30,000
Less Balance of P/L A/c in the beginning	
Of the year	15,000
Funds from operations	15,000

Illustration – 12

From the following two balance sheets as on 31st December 1994 and 1995, you are required to prepare statement showing flow of funds :

	December 31	
	1994	1995
	Rs.	Rs.
Cash	30,000	47,000
Debtors	1,20,000	1,15,000
Stock-in-trade	80,000	90,000
Land	50,000	6,000
	2,80,000	3,18,000
Capital and liabilities		
Share capital	2,00,000	2,50,000
Trade creditors	70,000	45,000
Retained Earnings	10,000	23,000
	2,80,000	3,18,000

Solution

SCHEDULE OF CHANGES IN WORKING CAPITAL
for the year ended 31.12.1995

	1994	1995	Increase in working capital	Decrease in working capital
Current assets	Rs.	Rs.	Rs.	Rs.
Cash	30,000	47,000	17,000	
Debtors	1,20,000	1,15,000		
Stock-in-trade	80,000	90,000	10,000	5,000
	2,30,000	2,52,000		
Current liabilities				
Trade creditors	70,000	45,000	25,000	
	70,000	45,000		
Working capital	1,60,000	2,07,000		
Net increase in working capital	47,000			47,000
	2,07,000	2,07,000	52,000	52,000

STATEMENT OF SOURCES AND APPLICATION OF FUNDS
for the year ended 31.12.1995

Source	Rs.	Applications	Rs.
Issue of share capital	50,000	Purchase of land	16,000
Funds from operations	13,000	Net increase in working capital	47,000
	63,000		63,000

Working Notes :

1. Funds from operations :	Rs.
Retained earnings in 1995	23,000
Less : Balance of retained earnings in 1994	10,000
Funds from operations	13,000
2. Purchase of land :	
Opening balance	50,000
Closing balance	66,000
Purchased during the year	16,000

Illustration – 13

From the following balance sheet of Mr. A, prepare a schedule of changes in working capital and funds flow statement

Liabilities	1993	1994	Assets	1993	1994
	Rs.	Rs.		Rs.	Rs.
Capital	63,000	1,00,000	Cash	15,000	20,000
Long-term borrowings	50,000	60,000	debtors	30,000	28,000
Trade creditors	42,000	39,000	Stock-in-trade	55,000	72,000
Bank overdraft	35,000	25,000	Land and buildings	80,000	1,00,000
Outstanding Expenses	5,000	6,000	Furniture	15,000	10,000
	1,95,000	2,30,000		1,95,999	2,30,000

Solution

SCHEDULE OF CHANGS IN WORKING CAPITAL

	1993	1994	Effect on working capital	
	Rs.	Rs.	Rs.	Rs.
Current Assets				
Cash	15,000	20,000	5,000	
Debtors	30,000	28,000		2,000

Stock-in trade	55,000	72,000	17,000	
	1,00,000	1,20,000		
Current liabilities				
Trade creditors	42,000	39,000	3,000	
Bank overdraft	35,000	25,000	10,000	
Outstanding expenses	5,000	6,000		1,000
	82,000	70,000		
Working capital (C.A.-C.L.)	18,000	50,000		
Net increases in working capital	32,000	50,000	35,000	35,000

FUND FLOW STATEMENT

Sources	Rs.	Applications	Rs.
Raising of long-term borrowings (60,000-50,000)	10,000	Purchase of land & building (1,00,000-80,000)	20,000
Sales of furniture (15,000-10,000)	5,000	Net increase in working capital	32,000
Funds from operations	37,000		
	52,000		52,000

Working Notes :

1. LONG-TERM BORROWINGS A/c

	Rs.		Rs.
To balance c/d	60,000	By balance b/d	50,000
		By cash (balancing figure)	10,000
	60,000		60,000

2. FURNITRUES A/c

	Rs.		Rs.
To balance b/d	15,000	By cash-sale (balancing figure)	5,000
		By balance c/d	10,000
	15,000		15,000

3. LAND AND BUILDING A/c

	Rs.		Rs.
To balance b/d	80,000		
To cash-purchases (balancing figure)	20,000	By balance c/d	1,00,000
	1,00,000		1,00,000

4. CAPITAL A/c

	Rs.		Rs.
To balance c/d	1,00,000	By balance b/d	63,000
		By profit (balancing figure)	37,000
	1,00,000		1,00,000

5. In the case of an individual the difference in capital A/c in the beginning and at the end of the year is on account of profit or loss made during the year as no other information as regards to drawings, etc. is given in the problem.

6 As there is no information as regards non-fund and non-operation items, the profit made during the year Rs.37,000 amounts to funds from operations.

Illustration – 14

Prepare a fund flow statement from the following balance sheet of Indian XL Ltd.

Liabilities	1994	1993	Assets	1994	1993
Share capital	545	545	Fixed assets	4,933	3,994
Reserves	2,459	1,660	Less : depreciation	1,927	1,651
	3,004	2,205		3,006	2,343
Loan funds	2,796	2,295			
	5,800	4,500	Investments (long-term)	62	62
Current liabilities	1,241	1,533			
Provisions	434	327	Inventories	2,075	1,804
			Debtors	1,157	687
			Cash & Bank balance	512	844
			Loans & advances	663	620
	7,475	6,360		7,475	6,360

Solution

SCHEDULE OF CHANGES IN WORIGN CAPTIAL

	1993	1994	Increase in working capital	Decrease in working capital
Current assets				
Inventories	1,804	2,075	271	
Debtors	687	1,157	470	
Cash & Bank balances	844	512		332
Loans and advances (assumed to be short-term	620	663	43	
	3,955	4,407		
Current liabilities :				
Current liabilities provisions	1,533	1,241	292	
(Assumed to be current liabilities)	327	434		107
	1,860	1,675		
Working capital (CA-CL)	2,095	2,732		
Net increase in W.C.	637			
				637
	2,732	2,732	1,076	1,076

FUNDS FLOW STATEMENT

(Rs.in lakhs)

Sources	Amount	Application	Amount
	Rs.		Rs.
Raising of loans	501	Purchase of fixed assets	939
Funds from operations	1,075	Increase in working capital	637
	1,576		1,576

Working notes :

(1) Calculation of raising of loans	
Loan funds in the beginning of 1994	2,295
Loan funds at the end of 1994	2,796
Loans raised during the year (balancing figure, i.e, 2,796-2,295)	501
(2) Calculation of funds from operations	
Reserves in the beginning of 1994	1,660
Reserves at the end of 1994	2,459
Profit for the year (2,459-1,660)	799
Add: Depreciation (1,927-1,1,651)	276
	1,075

OR

RESERVES A/c

	Rs.		Rs.
To depreciation (1927-1651)	276	By balance b/d	1,660
To balance c/d	2,459	By funds from operations (balancing figure)	1,075
	2,735		2,735

(e) CASH AND BANK A/c

	Rs.		Rs.
To balance b/d	54,375	By bank overdraft	24,000
To debtors	8,99,390	By sundry creditors	7,02,172
		By expenses	81,295
		By fixed assets	40,000
		By balance c/d	1,06,298
	9,53,765		9,53,765

ISSUE OF DEBENTRUES AT DISCOUNT

When debentures are issued by company at a price less than its nominal value (face value) it is said to be issued at discount. For example, if a debenture of Rs.1,000 is offered to public at Rs.950, it is issue at a discount. Here Rs.50 on each debenture is loss to the company. As a principle of equity, it is desirable to write off this loss. It is a capital loss and until it is written off completely, it is shown on the asset side of balance sheet, under the heading 'Miscellaneous Expenditures', as a fictitious asset. Discount on issue of debentures account is supposed to be allowed on allotment, unless, otherwise, mentioned.

There is no legal restriction on issuing debentures at a discount. The requisite entry to be passed is

(a)	**When allotment money becomes due** Debenture allotment A/c Discount on issue of debenture A/c To debentures A/c	Dr. Dr.	(Amount receivable) (Amount of discount) (Total amount)
(b)	**When allotment money is received** Bank A/c To debenture allotment A/c	Dr.	(With actual amount received on allotment)

The working of issue of debentures at a discount is well explained by the following illustration:

Illustration – 2 (Issue of debentures at discount)

XYZ Ltd; issued 2,000 14% debentures of Rs.50 each at a discount of 10% on April 1,1998 payable as follows :

Rs.30 on application; Rs.10 on allotment (discount to be adjusted with allotment) and Rs.5 on first and final call. The issue was fully subscribed and all money was received in full. Give journal entries; ledger accounts and balance sheet (extract only).

1998			Dr. Rs.	Cr. Rs.
	Bank account To Debenture application account (Being application money on 2,000 debentures received)	Dr.	60,000	60,000
	Debenture application account To 14% debentures account (Being allotment of debentures vide board's resolution)	Dr	60,000	60,000

	Debenture allotment account Discount on issue of debentures account To debentures allotment account (Being allotment money due and discount adjusted)	Dr Dr	20,000 10,000	30,000
	Bank account To debenture allotment account (Being allotment amount received)	Dr	20,000	20,000
	Debenture final call account To 14% debentures account (Being first and final call due @ Rs.5 per debenture)	Dr	10,000	10,000
	Bank account To debenture final call account (Being final and final call due @ Rs.5 per debenture received)	Dr	10,000	10,000

14% DEBENTURES ACCOUNT

Dr.	Rs.		Cr.
To Balance c/d	1,00,000	By debentures application account	60,000
		By debenture allotment account	20,000
		BY discount on issue of debentures	10,000
		By debenture final call account	10,000
	1,00,000		1,00,000

DISCOUNT ON ISSUE OF DEBENTURES ACCOUNT

Dr.			Cr.
To 14% debentures account	Rs. 10,000	By balance c/d	Rs. 10,000

BANK ACCOUNT

Dr.			Cr.
	Rs.		Rs.
To debenture application account	60,000	By balance c/d	90,000
To debenture allotment account	20,000		
To debenture final call account	10,000		
	90,000		90,000

BALANCE SHEET (Extract only)

Liabilities		Assets	
Secured loans :	1,00,000	Bank	90,000
2,000,14% debentures @ Rs.50 each	1,00,000	Discount on issue of debentures	10,000 1,00,000

Illustration – 3

A limited company made an issue, which was fully subscribed, of 1,000 debentures of Rs.100 each at Rs.97. The debentures were allotted on 31st July 2001, subscriptions being payable 10 per cent on application, 40 per cent on allotment, 25 per cent on 30th September and the balance on 30th November 2001.

Under the terms of the issue, payment could be made in fully on 31st July, 2001, interest on any amounts prepaid being allowable at the rate of 10 per cent per annum; such interest was not deductible from the subscriber's payment, but was payable by the company on 30th November 2001. The allotted of 300 debentures took advantages of the prepayment terms, while others paid on the due dated. Journalize the entries to be made in the company's books; (Ignore Debenture Interest)

[C.B.S.E. 1992 (Delhi) (C)]

Solution : **Journal**

Date	Particulars		L.F.	Dr.(Rs.)	Cr.(Rs.)
2001	Bank A/c To debenture Application money received fro 1,000 (Being the application money received for 1,000 debentures at the rate of Rs. 10 per debenture)	Dr.		10,000	
	Debenture Application A/c To debenture A/c (Being the transfer of application money)	Dr.		10,000	
July, 31	Debenture Allotment A/c Discount on Issue of Debentures A/c To Debenture A/c (Being the allotment money due on 1,000 debentures @ Rs.40 each and Rs.3 per share allows as discount)	Dr. Dr.		40,000 03,000	43,000

	Bank A/c To Debenture Allotment A/c To Calls-in-Advance A/c (Being the amount received on allotment and also received of call in advance on 300 debentures @ Rs.47 per debenture)	Dr.		54,100	 40,000 14,100
Sept. 30	Debentures First Call A/c To Debentures A/c (Being the amount due on first call on 1,000 debentures @Rs.25 per debenture)	Dr.		25,000	 25,000
Sept. 30	Bank A/c Calls-in-Advance A/c To Debentures First Call A/c (Being the amount received on first call and calls in Advance A/c is adjusted to the extent of Rs.7,500)	Dr. Dr.		17,500 07,500	 25,000
Nov. 30	Debenture Second and Final Call A/c To Debenture A/c (Beign the amount due on final call on 1,000 debentures @Rs.22 per debenture)	Dr.		22,000	 22,000
Nov. 30	Bank A/c Call-in-Advance A/c To Debenture Second and Final Call A/c (Being the amount of second call received on 700 debentures and Calls-in-Advance A/c adjusted0	Dr. Dr.		15,400 06,600	 22,000
Nov. 30	Interest on Calls-in-Advance A/c To bank A/c 9Being two months Interest on Rs.7,500 and 4 months' interest on Rs.6,600 @10% per annum)	Dr.		345	 345

Working Note :

Calculation of Interest on Calls-in-Advance

$$Rs.7,500 \times \frac{2}{12} \times \frac{10}{100} = Rs.125$$

$$Rs.6,600 \times \frac{4}{12} \times \frac{10}{100} = Rs.220$$

ISSUE OF DEBENTURES AT PREMIUM

If debentures are issued at a price more than its nominal value (face alue) such as issue is called issue at a premium. For example, if a debenture of Rs.1000 is offered at 1,050, it is a case of issue of debentures at premium. The excess of issue price over face value is premium. The premium is a capital gain for company so it is to be credited to 'premium on issue of debentures account'. Like discount on issue of debentures, premium on issue of debentures is also realized at the time of allotment, if nothing to the contrary is provided. Premium on issue is a capital gain, so it is shown on the liabilities side of balance sheet under the head 'Reserves and Surplus'.

The entries relating to premium will be :

(i)	When instalment containing premium is made due : Debenture allotment a/c To Debentures a/c To Premium on issue of debentures (Being allotment money due on – debentures @ Rs.- each including premium)	Dr.	(Total due) (Amount of debenture only) (Amount of premium)
(ii)	When debenture allotment money is received Bank a/c To Debenture allotment a/c (Being allotment money received on ... debentures)	Dr.	With total amount received on allotment

Nowhere in the companies Act have been provided the conditions regarding the utilization of amount of premium on debentures. Still the amount of premium on debentures should not be transferred to profit and loss account because it is not a profit arising from the normal operations of the company.

The amount of debenture premium may be used for writing off debenture issue expenses, discount on issue of shares etc. or alternatively it may be credited to Debenture redemption fund (if any).

Issue of debentures at premium

Illustration 4

A company issued, 1,000 6% debentures of Rs.100 each at Rs.110 payable as follows:

Rs.30 on application (including premium Rs.5)

Rs.30 on allotment including premium Rs.5)

Rs.50 on first and final call.

All the debentures were applied for and allotted. All money due was received, except final call on 20 debentures.

Pass journal entries for the above.

SOLUTION : JOURNAL

Particulars		L.F.	Debit Rs.	Credit Rs.
Bank a/c To Debentures application a/c (Being application money received)	Dr.		30,000	30,000
Debenture application a/c To 6% Debentures a/c To Premium on debentures a/c (Being application money transferred to debentures account, together with premium @Rs.5)	Dr.		30,000	25,000 05,000
Debenture allotment a/c To 6% Debentures a/c To Premium on debentures a/c (Being allotment money due together with premium @Rs.5 per debenture)	Dr.		30,000	25,000 05,000
Bank a/c To 6% Debentures allotment a/c (Being allotment money received0	Dr.		30,000	30,000
Debenture first and final call a/c To 6% Debentures a/c (Being call money due on debentures)	Dr.		50,000	50,000
Bank a/c To Debenture first and final call a/c (Being call money received on 980 debentures)	Dr.		49,000	49,000

Illustration – 5 (Issue of debentures for a lump sum)

Journalise the followings :

(a) Issued 5,000 7% debentures of Rs. 100 each, at par.

(b) Issued 5,000 7% debentures of Rs. 100 each at 10% premium.

(c) Issued 5,000 7% debentures of Rs. 100 each at 10% discount.

All the debentures are redeemable at par.

SOLUTION : **JOURNAL**

	Particulars	L.F.	Debit Rs.	Credit Rs.
(a)	Issue at par Bank a/c To debenture application & allotment a/c (Being application money received on 5,000 debentures @ Rs. 100 each)	Dr.	5,00.000	5,00,000
	Debenture application & allotment a/c To 7% debentures a/c (Being application money transferred to debentures account)	Dr.	5,00,000	5,00,000
(b)	Issue at premium Bank a/c To debenture application and allotment a/c (Being application money received)	Dr.	5,50,000	5,50,000
	Debentrues application and allotment a/c To 7% debentures a/c (Being application money transferred to debentures and debenture premium a/c)	Dr.	5,50,000	5.00.000 50,000
(c)	Issue at a discount Bank a/c To debenture application & allotment a/c (Being application money received)	Dr.	4,50,000	4,50,000
	Debenture application and allotment a/c Discount on debentures a/c To 7% debentures a/c (Being application money transferred to debenture a/c)	Dr. Dr.	4,50,000 50,000	5,00,000

DEBENTURES ISSUED IN CONSIDERATION OTHER THAN CASH

Sometimes a company purchases a running business (assets and liabilities) and issues to vendor, debentures as consideration. It is called issue of debentures in consideration, other than cash. In such situation following entries are recorded.

I. When agreement of purchase of business is signed.

Business purchase a/c	Dr.	with amount of
Sundry assets a/c	Dr.	purchase
To Vendor's a/c		
(Being sundry assets purchased)		

II. When purchase consideration is paid to vendors in the form of debentures.

Vendor's a/c	Dr.	with amount of
To debentures a/c		purchase consideration
(Being debentures issued as consideration for assets purchased)		

Note : When debentures are issued in consideration other than cash they can be issued either at par, at premium or at discount. If they are issued at premium the amount of premium will be credited to 'premium on issue of debentures account' and if issued at a discount, the discount will be debited to 'discount on issue of debentures account'.

As per rule purchase consideration (amount to be paid for assets purchased) should be equal to net assets (Assets purchased-liabilities assumed) value. But in practice sometimes it is more than the value of net assets and sometimes it is less than the value of net assets.

Extra payment made over and above the value of net assets is treated as goodwill, which can be calculated as follow :

Goodwill = purchase consideration – Net assets

Where Net assets = Assets purchased – Liablities assumed

In case the purchase consideration to be paid by company is less than the value of net assets, the excess of net assets over purchase consideration is a capital gain, which is transferred to capital reserve account.

Illustration – 6

(Debenture issued in consideration other than cash)

Z Ltd purchased building for Rs.2,20,000. Half of the payment was made in cash and the remaining half by the issue of 12% debentures at a premium of 10%. Pass the necessary journal entires. (C.B.S.E. 1995)

SOLUTION **JOURNAL – Z LTD.**

Building account To vendor (Being purchase of building)	Dr.	Dr. Rs. 2,20,000	Cr. Rs. 2,20,000
Vendor To bank account To 12% debentures account To debenture premium account (Being payment made and debentures issued in satisfaction of consideration)	Dr.	2,20,000	1,10,000 1,00,000 10,000

Working note :

Calculation of debentures to be issued : .

	Rs.
One half of amount payable in debentures	1,10,000
Debenture price being Rs. 100 + 10% premium	110
No. of debentures = 1,10,000 ÷ 110 = 1,000	
∴Nominal value of debentures and debentures premium (being 10%)	1,00,000 10,000

Illustration – 7 (Calculation of goodwill)

Star Automobiles Ltd. took over assets of Rs. 2,35,000 and liabilities of RS.40,000 of Ashoka Automobiles Ltd. for the purchase consideration of Rs. 2,20,000. Purchase consideration was payable by issuing debentures of Rs. 100 at 10% premium. Give journal entries in the books of Star Automobiles Ltd.

SOLUTION **JOURNAL**

Particulars		L.F.	Debit Rs.	Credit Rs.
Sundry assets a/c Goodwill a/c To Sundry liabilities a/c To Ashoka automobiles ltd. (Being purchase of assets and liabilities of Ashoka automobiles letd).	Dr. Dr.		2,35,000 25,000	40,000 2,20,000
Ashoka automobiles Ltd. To debentures a/c To premium on issue of debenture a/c (Being debentures issued as consideration for purchase of business at 10% premium)	Dr.		2,20,000	2,00,000 20,000

Working notes

The purchase consideration is Rs.2,20,000 against net assets being valued (2,35,000 – 40,000) Rs. 1,95,000. The difference of Rs. 25,000 is goodwill.

When debentures are issued as a collateral security there are two ways of treatment in the accounting books.

(i) No journal entry is made in the account books at the time of issue of such debentures. A note is appended below the loan on the liabilities side of the balance sheet to the fact that they have been secured by the issued of debentures. This will be shown in the balance sheet as follows :

BALANCE SHEET (EXTRACTS)

		Rs.
(i)	Liabilities Debentures (In addition, debentures for Rs...... have been issued as collateral security) Loan (Secured by the issue of debentures of Rs...... as collateral security)	
(ii)	Sometimes issue of debentures as collateral security is recorded by making journal entry as follows : Debentures suspense a/c Dr. To debentures a/c (With nominal value of debentures)	

The debentures suspense account will appear on the assets side of the balance sheet and debentures on the liabilities side. When the loan is re-paid the entry is reversed in order to cancel it.

Illustration – 10 (debentures issued as collateral security)

A company had Rs.5,00,000 6% debentures outstanding on 1st January, 1993. During the year company took a loan of Rs.1,00,000 from bank for which the company placed with bank, debentures for Rs.1,20,000 as collateral security. Pass journal entries, if any. Also show how the Debentures and Bank Loan will appear in company's Balance Sheet.

Solution : First Method :

No entry will be passed for issue of debentures as collateral security. Only the entry for bank loan will be passed i.e.

Bank a/c	Dr.	1,00,000	1,00,000
To Bank loan a/c(Being loan obtained from bank)			

BALANCE SHEET (Extract only)

Liabilities	Details Rs.	Amount Rs.
6% debentures (In addition, debentures worth Rs. 1,20,000 given to bank as collateral security) Bank loan (Secured against debentures worth Rs. 1,20,000 given as collateral security)		5,00,000
Second Method In addition to entry fro bank loan following entry should also be passed :		
Debenture suspense a/c Dr. To 6% debentures a/c (For the issue of Rs.1,20,000 debentures as collateral security for a loan of Rs. 1,00,000 from the bank).	1,20,000	1,20,000

BALANCE SHEET

Liabilities	Rs.	Assets	Rs
6% debentures (Including debentures for Rs.1,20,000 issued as collateral security)	6,20,000	Debentures suspense a/c	1,20,000
Bank loan (Secured against debentures worth Rs.1,20,000)	1,00,000		

Illustration – 11

A Ltd. secured a loan of Rs.1,80,000 from the Canara Bank by issuing 2,000, 15% debentures of Rs. 100 each as collateral security. How will you treat the issue of such debentures ?

[C.B.S.C. (Foreign) 1991 (C)]

Solution

1. First Method (when no entries are passed in the books)

AN EXTRACT OF BALANCE SHEET OF A LTS. AS AT...

Liabilities	Rs.	Assets	Rs.
Secured Loans : Loan from Canara bank (Secured by the issue of 2,000, 15% Debenture of Rs. 100 each as Collateral security	1,80,000		

II. Second Method (when entries for debentures are passed)

JOURNAL OF A LTD

Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
Debentures Suspense A/c Dr. To 15% debentures A/c (Being the issue of 2,000, 15% debentures of Rs.100 each as collateral security for a loan from a bank as per board's resolution dated....)		2,00,000	2,00,000

AN EXRACT OF BALANCE SHEET OF A LTD. AS AT ...

Liabilities	Rs.	Assets	Rs.
Second Loans : 2,000, 15% Debentures of Rs. 100 each (issued as collateral security)	2,00,000	Miscellaneous Expenditure: Debenture Suspense A/c	2,00,000
Loan from Canara Bank (Secured by the issue of 2,000, 15% debentures of Rs.100 each as collateral security)	1,80,000		

Illustration – 12

A Ltd. issued 5,000, 13% debentures of Rs.100 each at part and raised a loan of Rs.80,000 from bank, collaterally secured by Rs.1,00,000 13% debentures. How will you show the debentures in the Balance sheet of the company assuming that the company ahs recorded the issue of debentures as collateral security in the books. [C.B.S.E. (Foreign) 1992 (C)]

Solution

AN EXTRACT OF BALANCE SHEET

Liabilities	Rs.	Assets	Rs.
Secured loans: 5,000 13% debentures of RS.100 each issued at par	5,00,000	Current Assets : Bank	5,80,000
1,000 13% debentures of Rs. 100 each (issued as collateral security) Loan from bank (Secured by the issue of 1,000 debentures of Rs.100 each)	1,00,000 80,000	Miscellaneous expenditure Debentures Suspense Account	1,00,000

CLASSIFICATION FROM 'CONDITIONS OF REDEMPTION" POINT OF VEIW

Like issue of debentures at part, premium or discount the redemption of debentures can also be :

(a) Redemption at par

(b) Redemption at premium

(c) Redemption at discount

Thus following sets of cases can be formed :

(i) Issue at par, redeemable at par

(ii) Issue at discount, redeemable at par

(iii) Issue at premium, redeemable at par

(iv) Issue at par, redeemable at premium

(v) Issue at discount, redeemable at premium

(vi) Issue at premium, redeemable at premium

The study of above sets clarifies that debentures are redeemable wither at part or at premium. How the debentures are to be redeemed in future is provided in the prospectus issued by the company at the time of issue. Sometimes a company can also redeem its debentures by purchase from open market. Generally in such cases it is normally seen that company buys them at below the par value, thus making profit on redemption.

Journal entries for issued at part and redeemable at par

(i)	When debentures are issued at par and redeemable at par			
	(a)	Bank a/c To Debenture application and allotment a/c	Dr.	
	(b)	Debenture application and allotment a/c To debentures a/c	Dr.	
(ii)	When debentures are issued at discount and redeemable at par			
	(a)	Bank a/c To Debenture application and allotment a/c	Dr.	
	(b)	Debenture application and allotment a/c Discount on issue of debentures a/c To Debentures a/c	Dr. Dr.	
(iii)	When debentures are issued at premium and redeemable at par			
	(a)	Bank a/c To Debenture application and allotment a/c	Dr.	
	(b)	Debenture application and allotment a/c To Debentures account To premium on issue of debentures a/c	Dr.	
(iv)	When issued at par and redeemable at premium			
	(a)	Bank a/c To Debenture application and allotment a/c	Dr.	With nominal value .
	(b)	Debenture application and allotment a/c Loss on issue of debentures a/c To Debentures a/c To premium on redemption of debentures a/c	Dr.	(Nominal value) Difference in issue and redemption price) (Nominal value) (amount of premium)
(v)	When issued at discount redeemable at premium			
	(a)	Bank a/c To Debenture application and allotment a/c	Dr.	With actua amount received
	(b)	Debenture application and allotment a/c Loss on issue of debentures a/c To Debentures a/c To premium on redemption of debentures a/c	Dr. Dr.	(Actual receipt) (Difference i issue an redemption price) (Face value) With premium)

The point to note is that premium on redemption is a personal account because it represents the extra liability which is to be discharged when debentures are redeemed. It is recorded on the liability side of the balance sheet until it is paid off. Since company promises to pay more at the time of redemption, therefore, there is loss of equal amount which is debited to "loss on issue of debentures a/c". This loss on issue of debentures is written off gradually every year during the life of the debentures. The unwritten off portion appears on the assets side of he balance sheet under the head 'Miscellaneous Expenditure" as a fictitious asset.

The mechanism can be explained with the help of following illustrations :

Illustration – 13

Journalise the following transactions :

(i) A debentures issued at Rs. 95 repayable at Rs. 100.

(ii) A debenture issued at Rs. 95 repayable at Rs. 105.

(iii) A debenture issued at Rs. 100 repayable at Rs. 105.

(iv) A debenture issued at Rs. 105 repayable at Rs. 100.

Note :

The face value of each debenture is Rs. 100. [C.B.S.E. (Delhi set II]

Solution **Journal**

Date	Particulars		L.F.	Debit. Amount Rs.	Credit amount Rs.
(i)	Bank account Discount on issue of debentures a/c To debentures account (Being the issue of a debenture of Rs.100 at a discount of 5%)	Dr. Dr.		95 5	100
(ii)	Bank account Loss on issue of debentures account To debentures account To premium on redemption of debentures account (Being the issue of debentures of Rs. 100 at a discount of 5% repayable at a premium of 5%)	Dr. Dr.		95 10	100 5
(iii)	Bank account Loss on issue of debentures account To debentures account To premium on redemption of debentures account (Being the issue of debentures of Rs. 100 at a discount of 5% repayable at a premium of 5%)	Dr. Dr.		100 5	100 5
(iv)	Bank account To debentures account (Being the issue of a debenture of Rs.100 at a premium of 5% repayable at par)	Dr.		105	100 5

Illustration – 14 (Issue at discount redeemed at premium)

P.Ltd., issues 7,000 debentures of rs.100 each at a discount of 10% with the condition that these shall be redeemed at a premium of 5% after the expiry of three years.

Pass the necessary journal entries for the issue and redemption of these debentures after the expiry of three years. (C.B.S.E. 1993)

Solution **Journal of P Ltd.**

		Dr.Rs.	Cr.Rs.
Bank account To debentures application and Allotment A/c (Being the issue of 7,000 debentures of Rs.100 each at a discount of 10%)	Dr.	6,30,000	6,30,000
Debenture Application and Allotment A/c Loss on issue of debentures A/c To debentures A/c The premium on redemption A/c	Dr. Dr.	6,30,000 1,05,000	7,00,000 35,000
Debentures account To premium on redemption of debentures account To debenture-holders account (Being amount due on redemption to debenture-holders).	Dr. Dr.	7,00,000 35,000	7,35,000
Debenture-holders account To Bank account (Being amount due on redemption paid to debenture-holders)	Dr.	7,35,000	7,35,000

Working Note :	Rs.
Loss on issue of debentures	70,000
Discount on issue	35,000
Add: - premium or redemption	1,05,000

Illustration – 15

A company issued Rs., 1,00,000, 15% Debentures at a discount of 5% redeemable after 10 years at premium of 10%. Pass journal entry.

[C.B.S.E. 1991 (Delhi)]

Solution Journal

		L.F.	Dr.Rs.	Cr. Rs.
Bank A/c	Dr.		95,000	1,00,000
Loss on issue of debentures A/c	Dr.		15,000	10,000
To 15% debentures				
To premium payable on redemption of debentures A/c				
(Being the issue of debentures at discount of 5% and redeemable at a premium of 10%)				

Illustration – 16

Journalize the following transactions :

(a) X Ltd. issues Rs. 2,00,000, 12% Debentures at discount of 5% redeemable at par.

(b) Y Ltd. issues Rs. 5,00,000 Debentures at a discount of 5% redeemable at a premium of 7% [C.B.S.E. 1993 (Delhi) III]

Solution - **Journal of X Ltd.**

	Particulars		L.F	Dr.Rs.	Cr.Rs.
(a)	Bank A/c	Dr.		1,90,000	2,00,000
	Discount on issue of debentures A/c	Dr.		10,000	
	To 12% Debentures A/c				
	(Being the issue of 12% Debentures at a discount of 5% redeemable at par)				

Journal of X Ltd.

	Particulars		L.F.	Dr.Rs.	Cr.Rs.
(b)	Bank A/c	Dr.		4,75,000	5,00,000
	Loss on issue of debentures A/c	Dr.		60,000	35,000
	To debentures A/c				
	To premium on redemption of debentures A/c				
	(Being the issue of debentures at discount of 5% and redeemable at a premium of 7%)				

Illustration – 17

You are required to show by means of journal entries how to record the following issues :

(i) A company issued 14,000 debentures of rs.100 each at a discount of 5% to be repaid at par at the end of 5 years.

(ii) A company issued 5,000 debentures of Rs.100 each at a discount of 5% repayable at a premium of 10% at the end of 5 years. [C.B.S.E. (Outside Delhi) (C) 1996]

Solution

Journal

	Particulars		L.F.	Dr.Rs.	Cr.Rs.
(i)	Bank A/c	Dr.		13,30,000	14,00,000
	Discount on issue of debentures A/c	Dr.		70,000	
	To debentures A/c				
	(Issue of debentures at 5% discount)				
(ii)	Bank A/c	Dr.		4,75,000	5,00,000
	Loss on issue of debentures A/c	Dr.		75,000	50,000
	To debentures A/c				
	To premium on redemption of debentures A/c				
	(Issue of debentures at 5% discount and 10% premium on redemption)				

Illustration – 18 (Issue of debentures – different terms of issue)

Record journal entries in following cases :

(a) Issued Rs. 1,00,000 12% Debentures at par, redeemable at par.

(b) Issued Rs. 1,00,000 12% Debentures at discount of 10%, redeemable at par.

(c) Issued Rs. 1,00,000 12% Debentures at a premium of 5%, redeemable at par.

(d) Issued Rs. 1,00,000 12% Debentures at par, redeemable at 10% premium.

(e) Issued Rs. 1,00,000 12% Debentures at a discount of 5%, redeemable at 5% premiu

Also state how you will treat the loss on issue of debentures in books of accounts.

	Particulars		L.F.	Debit.Rs.	Credit.Rs.
a	Issued at par, redemption at par Bank a/c To debentures application & allotment a/c (Being application money received on debentures)	Dr.		1,00,000	1,00,000
	Debenture application & allotment a/c To 12% debentures a/c (Being application money transferred to debentures account)	Dr.		1,00,000	1,00,000
b	Issued at discount, redemption at par Bank a/c To debentures application & allotment a/c (Being application money received on debentures)	Dr.		90,000	90,000
	Debenture application & allotment a/c Discount on debentures a/c To 12% debentures a/c (Being application money transferred to debentures account and discount charged)	Dr. Dr.		90,000 10,000	1,00,000
c	Issued at premium, redemption at par Bank a/c To debentures application & allotment a/c (Being application money received on debentures)	Dr.		1,05,000	1,05,000
	Debenture application & allotment a/c To 12% debentures a/c To premium on issue of debentures a/c (Being application money transferred to debentures and premium account)	Dr.		1,05,000	1,00,000 5,000
d	Issued at par, redemption at Premium. Bank a/c To debentures application & allotment a/c (Being application money received on debentures)	Dr.		1,00,000	1,00,000
	Debenture application & allotment a/c Loss on issue of debentures a/c To 12% debentures a/c To premium on redemption a/c (Being application money transferred)	Dr. Dr.		1,00,000 10,000	1,00,000 10,000

e	Issued at discount, redemption at premium Bank a/c To debentures application & allotment a/c (Being application money received)	Dr.		95,000	95,000
	Debenture application & allotment a/c Loss on issue of debentures a/c To 12% debentures a/c To premium on redemption a/c (Being application money transferred to debentures account)	Dr. Dr.		95,000 10,000	1,00,000 5,000

Note : Loss on issue of debenture consists of discount on issue and premium payable on redemption. It is a capital loss and will be shown on the asset side on Balance Sheet. It will be written off over a number of years. The balance will continue to appear in Balance sheet.

Interest on Debentures

Interest on debentures is charged to the profit and loss account. While paying the interest on debentures, it is the obligation of the company concerned to deduct the income tax before making payment of interest to debenture-holder. The following journal entries are passed in this connection :

(i)	When interest on debentures is due: Debit interest on debentures A/c Credit income tax account Credit debenture-holders A/c	 (with gross amount) (with income tax) (with net amount)
(ii)	When net amount due is paid : Debit debenture-holders Account Credit Bank Account	

Interest on debentures is transferred to the debit side of profit and loss account. The credit balance of Income tax account is shown on the liabilities side of the balance sheet. As and when it is paid to the government this account is debited and bank account will be credited.

Debenture interest given in the tribal balance

The treatment of debentures interest while preparing final accounts must be noted carefully especially when it is given less tax at a specified rate. For example, if the trial balance shows "half year's debenture interest less tax at 42% rs.5,800" then the profit and loss account will be debited with the gross amount Rs. 10,000 $\left(i.e.,5,8000 \times \frac{100}{58}\right)$ and Rs.

4,200 $\left(i.e., \frac{42}{100} \times 10{,}000\right)$ will be shown in the balance sheet as liability under the heading income tax payable account.

Redemption of Debentures

Redemption of debentures refers to the discharge of liability on account of debentures. The following three problems require attention when a company wants to redeem the debentures.

(a) Time of redemption of debentures. Generally debentures are redeemed at the expiry of their period by making the payment of the amount promised fro. But sometimes company may reserve the right in the articles of association to redeem the debentures even before the date of redemption either by installments or by purchasing them in the open market. Payment of debentures by installment is nothing but redemption of debentures by drawing a lot. Sometimes a company does not want to serve a notice with the debenture-holders and wants to redeem the debentures before the date of redemption. This is possible by purchasing out own debentures in the open market. Thus debentures can be redeemed either at the expiry of period of debentures or before the expiry of the period by drawing a lot or by purchasing in the open market before the expiry of the period of debentures.

(b) Amount to be paid on redemption. The amount to be paid on redemption of debentures depends on the circumstances of each case. If the debentures are redeemed on the expiry of the period or only during a lot, then the amount to be paid can be either at premium or at par as promised by the company. If the debentures are redeemed by purchasing them in the open market, then the amount to be paid depends on the market quotation, i.e., either at par or at a discount or at a premium. Generally, the companies purchase their own debentures from the market when the debentures are quoted below face value to take the advantages of depressed prices.

(c) Sources of Finance. The major sources wherefrom the debentures can be redeemed may be (i) out of profits, (ii) out of capital, 9iii) out of provisions made for redemption and (iv) by converting them into shares or new debentures.

(i) Redemption out of profits

When debentures are redeemed out of profits, the following journal entries will be passed.

(a) Entry for amount paid on redemption
Debit debentures account
Credit Bank

(b) Entry for transfer of profit
Debit profit & loss appropriation account
Credit debenture redemption reserve A/c

(c) When balance of D.R.R. A/c is not required for redemption and is transferred to General Reserve Account

Debit debenture redemption reserve account.

Credit general reserve.

The balance of general reserve is a free reserve and will be available for all purposes.

The effect of redemption of debentures out of profits is that the company withholds a part of the divisible profits from distribution as dividend which may be retained in the business itself as a source of internal financing.

Illustration – 7

On 1st January, 1997, a company issued Rs.20,00,000 14% debentures at 5% discount repayable in five years at par. The company reserved the right to redeem to the extent of Rs.2,00,000 in any year by purchase in the open market. The interest was payable half yearly on 30th June and 31st December and the same was duly paid.

On 31st December, 1997, the company purchased Rs.2,00,000 debentures at a cost of Rs.1,91,000. Pass necessary journal entries in the books of the company upto 31st December, 1997 including closing entries on that date if the above redemption was out of profit. (Adapted B.Com., Madurai)

Solution

Journal entries

			Rs.	Rs.
1997				
Jan.1	Bank Account Discount on debentures account To 14% debentures account (Being issue of 14% debentures at 5% discount)			
June 30	Interest on debentures account To bank account (Being interest paid for half year on Rs.20,00,000 debentures @ 14% p.a. for half year)			
Dec.31	Interest on debentures account To bank account (Being alf year on Rs.20,00,000 debentures @ 14% p.a. for half year)			
Dec.31				
Dec.31				
Dec.31				
Dec.31				

(ii)Redemption out of Capital

If debentures are redeemed out of capital, no amount of divisible profit is kept aside for redeeming debentures. Profits are not utilized for redemption of debentures and may go to the shareholders by way of dividends. Redemption out of capital reduces the liquid resources available to the company. Therefore, a company may adopt this method only when it has sufficient funds.

According to the guidelines issued by SEBI, a company has to create Debenture Redemption Reserve equivalent to 50% of the amount of debenture issue before redemption of debenture commences. Thus, according to this provision redemption of debentures wholly out of capital is now not possible. However, creation of debenture Redemption Reserve is not required in the following cases:

(i) Debentures with a maturity of 18 months or less.

(ii) Fully convertible debentures. Incase of partly convertible debentures, Debenture Redemption Reserve is to be created for the non-convertible part in the same way as applicable for fully non-convertible debentures.

When debentures are redeemed out of capital the following journal entry is made:

Debit Debentures Account

Credit Bank.

When debentures are reduced out of capital, nominal value of debenture redeemed is not transferred from profit and Loss Appropriation Account or Debenture Redemption Reserve Account to General Reserve.

Sometimes instead of passing one entry given above, the following two entries are passed:

(a) Debit Debentures Account

Credit Debenture-holders

(b) Debit Debenture-holders A/c

Credit Bank.

This method is preferable, as it does not mix up the amount unpaid to debenture-holders with the debentures account.

Illustration – 8

A Company on 31st December 1996 redeemed Rs. 10,000 6% debentures out of capital by drawing a lot. Similarly, the company on 31st December 1997 redeemed Rs. 15,000 6% debentures out of profits by drawing a lot. You are required to pass journal entries in the books of a company.

Solution

Journal entries

			Rs.	Rs.
1996 Dec.31	6% debentures account To Bank Account (Being the redemption of debentures out of capital)	Dr.	10,000	10,000
1997 Dec.31	6% debentures account To Bank Account (Being the redemption of debentures out of profit)	Dr.	15,000	15,000
	Profit & loss appropriation account To debenture redemption reserve account (Being the transfer of profit to debenture redemption reserve account)	Dr.	15,000	15,000

Illustration – 9

On 1st April, 1994, a company issued 1,000 6% debentures of Rs. 1,000 each at Rs.950. Terms of issue provided that beginning with 31st March, 1997 Rs.50,000 of debentures should be redeemed either by drawings at part or by purchase in eh market every year. The expenses of the issue amounted to Rs.3,000 which were written off on 31st March, 1995. The company wrote off Rs.10,000 from the discount on debentures every year. On 31st March. 1997 the debentures to be redeemed were repaid at the end of the year by drawings. On 31st March, 1998 the company purchased fro cancellation 50 debentures at the ruling price of rs.980, the expenses being Rs.100. interest is payable yearly, Ignore income-tax.

Give Journal entries and the Balance sheet (as far as it relates to debentures) on 31st march. 1998.

Solution

Journal entries

			Rs.	Rs.
1994 April 1	Bank A/c Discount on debentures A/c To 6% debentures A/c (issue of 1,000 6% debentures of Rs.1,000 each at Rs.950)	Dr. Dr.	9,50,000 50,000	10,00,000
April 1	Debentures Issue expenses A/c To Bank Account (Rs.3,000 incurred on the issue of debentures)	Dr.	3,000	3,000

1995 Mr.31	Profit % loss account To debenture issue expenses A/c To discount on debentures A/c (Being the debenture issue expenses and discount on debentures written off)	Dr.	13,000	3,000 10,000
Mar.31	Interest on debentures A/c To Bank (Interest due on debentures for one year paid)	Dr.	60,000	60,000
1996 Mar.31	Interest on debentures A/c To Bank (Interest on debentures due for one year paid)	Dr.	60,000	60,000
Mar.31	Profit & loss A/c To discount on debentures A/c (Amount written off of discount on debentures)	Dr.	10,000	10,000
1997 Mar.31	Interest on debentures A/c To Bank (Interest on debentures due for own year paid)	Dr.	60,000	60,000
Mar.31	Profit & loss Account To discount on debenture A/c	Dr.	10,000	10,000
Mar.31	6% debentures A/c To Bank (Redemption of debentures worth Rs.50,000 by drawing at par)	Dr.	50,000	50,000
1998 Mar.31	6% debentures A/c To profit on redemption of debentures A/c To Bank (for the purchase of 50 debentures in the market at Rs.980 plus Rs.100 for expenses)	Dr.	50,000	900 49,100
Mar.31	Interest on debentures A/c To Bank (Interest @ 6% on Rs.950,000 for one year)	Dr.	57,000	57,000
Mar.31	Profit on redemption of debentures A/c Profit and loss account To discount on debentures A/c (The writing off Rs.10,000 out of debentures discount and also utilization of profit for the same purspose)	Dr. Dr.	900 10,000	10,000

Balance sheet as on March 31, 1998

900 6% debentures of Rs.1,000 each	Rs. 9,00,000	Discount on debentures	Rs. 9,100

Illustration – 10

On 1st April 1996 Naveen Ltd. made an issue of 50,000 12% debentures of Rs.1,000 each at Rs.980 per debenture. The terms of issue provided for the redemption of Rs.50,00,000 debentures every year commencing from 1997-98 either by purchase or by drawing lots at part, at the company's option. Profit on redemption, if any, is to be transferred to capital reserve account. The company's accounting year ends on 31st March, Interest on debentures is payable on 30th September and 31st March.

During the year 1997-98, the company wrote off Rs.1,00,000 from debentures discount account. During the same financial year, the company purchased fro cancellation debentures of the face value of:

(i)Rs.30,00,000 at Rs.960 per debenture on 30.09.1997.

(ii)Rs.20,00,000 at Rs.970 per debenture on 31.03.1998.

Show how these items will appear in the financial statements for the year ending 31 March 1998. Also show corresponding figures for the previous year ending 31st March 1997

Solution. Some Basic Calculations

(1) Interest on debentures for the year ending 31st March 1997

On 50,000 debentures of Rs.1,000 each i.e., Rs.50,00,000 face value debentures @ 12% p.a. = Rs.60,00,000

(2) Interest on debentures for the year ending 31st March 1998

On Rs.50,00,000 debenture @ 12% p.a. for 6 months ending 30 September, 1997 Rs.30,00,000

On Rs.4,70,00,000 @ 12% p.a. for 6 months ending

31st March, 1998 Rs.28,20,000

Interest for the financial year 1997-97 Rs.58,20,000

(3) Calculation of profit on cancellation of debentures

On Rs.30,00,000 @ Rs.40, per

Rs. 1,000 $i.e., 30,00,000 \times \frac{40}{1,000}$ 1,20,000

On Rs.20,00,000 @ Rs.30 per

Rs.1,000 $i.e., 20,00,000 \times \frac{30}{1,000}$ 60,000

Total profit on cancellation of debentures 1,80,000

(4) Discount on issue of 50,000 debentures @ Rs.20 10,00,000

Balance sheet of Naveen Ltd. as on 31st March, 1998 (Extracts)

31.3.97	Liabilities	31.3.98	31.3.97	Assets	31.3.98
Rs.	Reserves & surplus	Rs.	Rs.	Miscellaneous Expenditure	Rs.
	Capital reserve secured loans	1,80,000		(to the extent not written off)	
5,00,00,000	12% debentures	4,50,00,000		Discount on Issue of Debentures	
			10,00,000		9,00,000

Profit and loss account of Naveen Ltd for the year ending 31st March 1998 (Extracts)

1996-97		1997-98	1996-97		1997-98
Rs.	To interest on debentures	Rs.	Rs.		Rs.
60,00,000		58,20,000			

(iii) Redemption by conversion

Sometimes the debenture-holders of a company are given the option to convert their debentures into the shares or new debentures within a stipulated period. Such option is exercised by the debenture-holders only when they are very sure about the progress of the company. The new shares or debentures can be issued either at part or at a premium of at a discount. The following entry will be made :

Debit old debentures account

Debit discount on the issue of share/debentures

Credit new share capital/debentures account

Credit premium on the issue of share/debentures.

Illustration – 11

On 1st April, 1997, Y Ltd. issued 800 12% debentures of rs.1,000 each at Rs.950 each. Debenture-holders had an option to convert their holdings into 6% preference shares of Rs.100 each at a premium of Rs.25 per share. On 31st March, 1998, one year's interest had accrued on these Debentures which was not paid. A holder of 50 debentures notified his intention to convert his holding into 13% preference shares.

Journalise the above transactions and draw the company's Balance sheet as at 31st March, 1998.

Solution

Journal entries

			Rs.	Rs.
1997 Apr.1	Bank A/c Discount on issue of Debentures A/c To 12% debentures A/c (Issue of 800, 12% debentures of RS.1,00 at Rs.950 each)	Dr.	7,60,000 40,000	8,00,000
1998 Mar.31	Interest on debentures A/c To sundry debenture-holders of the year ended 31.31998	Dr.	96,000	96,000
	12% debentures A/c To 13% preference share capital A/c To securities premium A/c (Conversion of 50 debentures to 400 13% preference shares of Rs.100 each at a premium of Rs.25 per share)	Dr.	50,000	40,000 10,000
	Sundry debenture-holders A/c To Bank A/c (Interest on 50,12% debentures paid on conversion)	Dr.	6,000	6,000
	Profit & loss A/c To interest on debentures A/c (Interest on debenture transferred to p. % l. A/c)	Dr.	96,000	96,000

Balance sheet as on 31st March, 1998

Liabilities	Rs.	Assets	Rs.
Share capital :		Bank (7,60,000 – 6,000	7,54,000
400 13% preference		Discount on issue of debentures	40,000
Shares of Rs. 100 each	40,000	Profit & loss account	96,000
750 12% debentures of Rs.1,000 each	7,50,000		
Sundry debenture-holders	90,000		
Securities premium	10,000		
	8,90,000		8,90,000

Illustration – 12

The summarized Balance sheet of X Ltd. as on 31st March, 2000 was as follows:

Liabilities	Rs.	Asses	Rs.
Share Capital		Goodwill	40,00,000
40,000 13% redeemable		Fixed assets	82,60,000
Preference shares of		Stock	90,00,000
Rs.100 each fully paid	40,000	Sundry debtors	43,00,000
Up redeemable at par		Discount on debentures	2,40,000
8,00,000 Equity shares of	80,00,000		
Rs. 10 each fully paid up	1,20,00,000		
12% debentures			
(Redeemable at par)	60,00,000		
Profit & loss A/c	50,00,000		
Bank loan	10,00,000		
Sundry creditors	18,00,000		
	2,58,00,000		2,58,00,000

The company decided to redeem the preference shares and debentures and in due course offered to the preference shareholders and debenture-holders the option to convert their holdings into equity shares which are to be treated as worth Rs.12.50 each. One half of the preference shareholders and one third of the debenture-holders (in value) agreed to accept the offer.

The company issued 6,00,000 equity shares of Rs.10 each @ Rs.12.50 to the public for cash and with the proceeds of such issue, paid off the bank loan and redeemed the remaining preference shares and debentures.

Solution

In the books of X Ltd.

Journal entries

			Rs.	Rs.
2000	12% debentures A/c	Dr.		
March 31	To 12% debenture-holders A/c		60,00,000	60,00,000
	(Being amount payable n redemption of 12% debentures)			

	13% Redeemable preference share capital A/c to 13% Redeemable preference shareholders A/c (Being amount payable on redemption of 13% preference shares)	Dr.	40,00,000	40,00,000
	12% debenture-holders A/c 13% preference shareholders A/c To equity share capital A/c To securities premium A/c (Being the conversion of Rs.20,00,000 debentures and Rs.20,00,000 preference shares into equity shares of Rs.10 each issued at a premium of Rs.2.50 per share)	Dr. Dr.	20,00,000 20,00,000	32,00,000 8,00,000

(iv) Redemption out of provision

It si always a wise policy for the company to made arrangements in advance to repay the known liability for redemption of debentures. This can be done by making provision otherwise it will be difficult for the company to arrange lumpsum to repay debts. This is possible by adopting either the sinking fund method or insurance policy method.

Sinking Fund for redemption of debentures

Debentures are to be paid on a specified date. It si desirable to make some arrangement for their redemption otherwise it will be very difficult for the company to pay the lumpsum at the time when the redemption is due. The best method is to create sinking fund for this purpose. This method resembles with that of depreciation fund method.

To recapitulate, the following entries will be passed :

At the end of the 1st Year

(i) For the amount set aside every year

Profit & loss appropriation account Dr.

To Sinking fund account

Or

Debenture redemption fund account

(ii) For amount kept aside for redemption invested in securities

Sinking fund investment account Dr.

Or

Debenture redemption fund investment account Dr.

To Bank.

At the end of 2nd and Subsequent Year

(i) For interest received on investment

Bank Account Dr.

To interest on Sinking fund investment A/c

(ii) For interest transferred to Sinking fund

Interest on Sinking fund investment account Dr.

To Sinking fund account

(iii) For annual amount set aside

Profit & Loss appropriation account

To Sinking fund account

(iv) For annual instalment plus interest invested in securities

Sinking fund investment A/c Dr.

To Bank

At the end of last year (when debentures are to be redeemed)

All the entries except entry (iv) in second and subsequent year should be passed. Entry (iv) is not passed as debentures are to be redeemed so no investment will be made rather the securities will be sold.

(i) For amount realized on the sale of securities

Bank A/c Dr.

To Sinking Fund investment A/c

(ii) For profit on sale of investment

Sinking Fund investment A/c Dr.

To Sinking fund account

Note. Reserve entry will be made if there is a loss on sale of investment.

(iii) For amount paid to debentureholders to redeem the debentures

Debentures A/c Dr.

To Bank

(iv) For balance of Sinking fund transferred to general reserve account Sinking fund A/c Dr.
To general reserve

Illustration – 15

On 1st April, 1993, Metal products Ltd. issued debentures for Rs. 1,00,000 redeemable at part at the end of 5 years and it was resolved that a Sinking fund should be formed and invested in tax-fee securities.

Give journal entries for 5 years, assuming that the interest received on the investments was at the rate of 5 per cent on cost, that the interest was received yearly and immediately invested and that the investments were realized at a loss of Rs.300 at the end of five years.

Reference to the Sinking fund table shows that Re.0.180975 invested at the end of year at 5% compound interest will produce Re. 1 at the end of 5 years.

Solution

For one rupee, the annual amount required is Re.0.180975

∴ For Rs. 1,00,000, the annual amount required is, 180975 x Rs.1,00,000 = Rs.18,098 (nearest rupee).

Journal

			Rs.	Rs.
1993 April.1	Bank Account To debentures account (Being issue of rs.1,00,000 debentures at par)	Dr.	1,00,000	1,00,000
1994 Mar.31	Profit and loss appropriation account To sinking fund account (Being the annual sum required to provide for the redemption of debentures).	Dr.	18,098	18,098
Mar.31	Sinking fund investment account To bank account (Being amount invested in tax-free securities to the nearest hundred rupees)	Dr.	18,100	18,100
1995 Mar.31	Bank Account To interest on sinking fund Investment A/c (Being interest received on investments Rs.18,100 @ 5% p.a. for one year)	Dr.	905	905

Mar.31	Interest on sinking fund investment account To sinking fund account (Being transfer of interest to sinking fund)	Dr.	905	905
Mar.31	Profit and loss appropriation account To sinking fund account (Being provision of annual installment for redemption of debentures)	Dr.	18,098	18,098
Mar.31	Sinking fund investment account To Bank Account (Being annual installment Rs.18,098 plus interest Rs.905 invested in securities to the nearest hundred rupees)	Dr.	19,000	19,000
1996 Mar.31	Bank Account To interest on sinking fund investment A/c (Being interest received on investment Rs.18,100 + Rs.19,000@ 5% for year)	Dr.	1,855	1,855
Mar.31	Interest on Sinking fund investment A/c To sinking fund account (Being interest on investment transferred)	Dr.	1,855	1,855
Mar.31	Profit and loss appropriation account To sinking fund account (Being provision of annual installment for redemption of debentures)	Dr.	18,098	18,098
Mar.31	Sinking fund investment Account To bank Account (Being annual installment Rs.18,098 plus interest Rs.1,855 invested in securities to the interest hundred rupees)	Dr.	20,000	20,000
1997 Mar.31	Bank account To interest on sinking fund Investment A/c (Being interest received on investments Rs.18,100 + Rs.19,000 +RS.20,000 @ 5% for one year)	Dr.	2,855	2,855

Mar.31	Interest on sinking fund investment account To sinking fund account (Being interest on investment transferred)	Dr.	2,855	2,855
Mar.31	Profit and loss appropriation account To sinking fund account (Being provision of annual sum for redemption of debentures.	Dr.	18,098	18,098
Mar.31	Sinking fund investment account To Bank account (Being annual investment Rs.18,098 plus interest Rs.2,855 invested in securities to the nearest hundred rupees)	Dr.	21,000	21,000
1998 Mar.31	Bank Account To interest on sinking fund Investment A/c (Being interest received on investments 9Rs.18,100 + Rs.19,000 + Rs.20,000 + Rs. 21,000 =Rs.78,100) @ 5% for one year)	Dr.	3,905	3,905
Mar.31	Interest on sinking fund investment account To sinking fund account (Being transfer of interest on investments)	Dr.	3,905	3,905
Mar.31	Profit and loss appropriation account To sinking fund account (Being provision of annual installment for redemption of debentures)	Dr.	18,098	18,098
Mar.31	Bank Account To sinking fund investment Account (Being amount realized on sale of investment – Rs. 78,100 – Rs.300 loss = Rs.77,800	Dr.	77,800	77,800
Mar.31	Sinking fund account To sinking fund investment account (Being loss on sale of investments transferred)	Dr.	300	300
Mar.31	Debentures Account To Bank Account (Being redemption of Rs.1,00,000 debentures at par)	Dr.	1,00,000	1,00,0
Mar.31	Sinking fund account To general reserve (Being balance of sinking fund transferred to general reserve on redemption of debentures)	Dr.	99,710	99,71

Note It is assumed that investments have been made in multiples of hundred.

Insurance policy method

Sinking fund insurance policy can also be taken to make provision for redemption of debentures. Under this method a fixed amount of premium is paid every year to the insurance company which in turn agrees to pay the necessary amount for redemption of debentures at the end of a specific period.

Journal Entries

First year

(i) For amount of premium appropriated from profit and loss account
Profit and loss appropriation account Dr.
To debentures redemption fund A/c

(ii) For amount of premium paid to insurance company
Debenture redemption fund policy A/c Dr.
To Bank

Note. These entries will be passed every year including the last year also.

The following entries will also be passed at the end of the specific period on realization of the policy :

(i) For the amount received from insurance Co.
Bank account Dr.
To redemption fund policy A/c

(ii) For he balance of debenture redemption fund policy account (excess amount received) – transferred to debenture redemption fund account
Debenture redemption fund policy A/c Dr.
To debenture redemption fund A/c

(iii) For amount paid to debenture-holders
Debentures A/c Dr.
To Bank

(iv) For balance of debenture redemption of und account transferred to general reserve
Debenture redemption fund account Dr.
To general reserve

Illustration – 18

A limited company has made an issue of Rs.5,00,000 9% debentures on 1st April, 1996, the terms of which include that the company must take a 4 years Sinking fund insurance policy for the redemption of debentures at a premium of 5%. The annual premium is Rs.1,15,000. The value of the policy increases each year by 6%.

Give the necessary Ledger Accounts to record the above transactions for 4 year.

Solution

Sinking fund account

1997		Rs.	1997		Rs.
Mar.31	To balance c/d	1,21,900	Mar.31	By profit & loss app. Account	1,15,000
			Mar.31	By sinking fund insurance policy account	
				$\left(1,15,000 \times \frac{6}{100}\right)$	6,900
		1,21,900			1,21,900
1998		Rs.	1997		Rs.
Mar.31	To balance c/d	1,51,114	April 1	By Balance b/d	1,21,000
			1998		
			Mar.31	By profit & loss App. Account	1,15,000
			Mar.31	By sinking fund insurance policy account (Int.)	
				$\left(2,36,900 \times \frac{6}{100}\right)$	14,214
		1,21,900			1,51,114
1999			1998		
Mar.31	To Balance c/d	3,88,081	April 1	By Balance b/d	2,51,114
			1999		
			Mar.31	By profit & loss App. Account	
			Mar.31	By sinking fund insurance policy account (Int.)	
				$\left(3,66,114 \times \frac{6}{100}\right)$	21,967
		3,88,081			3,88,081
2000			1999		
Mar.31	To premium on Redemption of Debenture A/c		April 1 2000 Mar.31	By Balance b/d By profit & loss App. Account	
	$\left(5,00,000 \times \frac{5}{100}\right)$	25,000	Mar.31	By Sinking fund Insurance policy account (Int.)	
Mar.31	To General reserve A/c	5,08,266 5,33,266		$\left(5,03,081 \times \frac{6}{100}\right)$	30,185 5,33,266

Sinking fund insurance policy account

1996		Rs.	1997		Rs.
April 1	To Bank Account	1,15,000	Mar.31	By Balance c/d	1,21,900
1997					
Mar.31	To sinking fund Account (Int.)	6,900			
		1,21,900			1,21,900
1997			1998		
April 1	To Balance b/d	1,21,900	Mar.31	By Balance c/d	2,51,114
April 1	To Bank Account	1,15,000			
1998					
Mar.31	To sinking fund A/c (Int.)	14,214			
		2,51,114			2,51,114
1998			1999		
April 1	To Balance b/d	2,51,114	Mar.31	By Balance c/c	3,88,081
April 1	To Bank Account	1,15,000			
1999					
Mar.31	To sinking fund Account (Int.)	21,967			
		3,88,081			3,88,081
1999			2000		
April 1	To Balance b/d	3,88,081	Mar.31	By bank Account	5,33,266
April 1	To Bank Account	1,15,000			
2000					
Mar.31	To sinking fund account (Int.)	30,185			
		5,33,266			5,33,266

6% debenture account

2000		Rs.	1996		Rs.
Mar.31	To Bank Account	5,00,000	April 1	By Bank Account	5,00,000

Premium on redemption of debentures account

2000		Rs.	2000		Rs.
Mar. 31	To Bank Account	25,000	Mar. 31	By sinking fund A/c	25,000

QUESTIONS

1. Which of the following statements are correct :
   (a) A debenture-holder is an owner of the company.
   (b) Debenture-holders get their money back only on the liquidation fo the company.
   (c) Debenture-holders will be entitled to get interest even if there is loss to the company.
   (d) Debenture need not be fully paid whereas debenture stock must be fully paid.
   (e) Debentures can be issued at a discount and can be redeemed at a premium.
   (f) Premium on debentures and premium on redemption of debentures convey the same meaning.

Ans. [Correct : (c); (d); (e)].

2. State whether the following statements are true or false :
   (a) After the redemption of all debentures, the balance in the sinking fund is transferred to general reserve.
   (b) Profit on sale of sinking fund investments is to credited to debentures account.
   (c) Interest on debentures is payable only when a company makes profits.
   (d) Interest on sinking fund investment is credited to profit and loss account.
   (e) Own debentures account will appear on the assets side of the balance sheet.
   (f) If debentures are redeemed out of capital, entry for the transfer of profits to debenture redemption reserve account is not passed in the books.
   (g) First debentures are those which are repaid before other debentures are paid out.
   (h) Registered debentures are those, which are transferable by mere delivery.

(i) A company cannot buy its own debentures.

(j) In case of debentures if the quotation is cum-interest it means that it is with interest and for recording purpose interest is added to the total price paid.

Ans. [True : (a); (e); (f); (g), False: (b); (c; (d);(h); (i); (j)].

3. What do you understand by a debentrure ? Describe briefly the different types of debentures.

4. What is debenture stock /

5. Distinguish between : (i) a debenture and a share, and (ii) debenture and debenture stock.

6. Give different considerations for which debentures may be issued.

7. Write notes on : (i) Debentures Discount, (ii) Debentures as Collateral Security, (iii) Interest on Debentures, (iv) Ex-interest nad Cum-interest, (v) Own Debentures.

8. Discuss the various journal entries which are passed in the books of a company when provision is made through sinking fund or insurance policy for the redemption of debentures.

9. What are the various methods of redemption of debentures?

10. What are the alternatives available for making the provision for redeeming debentures? Is it necessary to make such provision ?

11. Explain (i) redemption of debentures out of capital and (ii) redemption of debentures out of profit.

PRACTICAL PROBLEMS

1. A limited company issued 1,000 debenture bonds of rs.100 each at a premium of 10 per cent repayable at part at the end of the 10^{th} year. The debenture bonds were payable 25 per cent on application, 35 per cent on allotment (including the premium) and the balance on first and final call. All the moneys were received by the company in due course.

   You are asked to journalise the above transactions in the books of the company.

2. A limited company issued Rs.1,00,000 debentures, which were issued as follows :

1.	To sundry persons for cash at 90 per cent	Rs. 50,000 nominal
2.	To a creditor for Rs.20,000 capital expenditure in satisfaction of his claim	Rs. 25,000 nominal
3.	To bankers as collateral security	25,000 nominal

The issue (1) and (2) are redeemable at the end of 10 years at par. How should the debentures be dealt with in preparing the balance sheet of the company ?

3. Naveen Ltd. Issued Rs.1,00,000 10 per cent debentures on 1st January, 1994 at discount of 5 per cent repayable in annual drawings of rs.25,000 commencing from 31st December following. The company's year ends on 31st December.

   Journalize the above transactions for four years ending 31st December 1997, assuming that the company decided to write off debenture discount account during the life of the debentures.

Ans. [Debenture Discount A/c written off : 1994 Rs.2,000; 1995; 1996 rs. 1,000; 1997 Rs.500]

4. A company issues Rs.1,00,000 10 per cent debentures on 1st April, 1994 at a discount of 5 percent repayable in annual drawings of Rs.25,000 each on 31st March every year. Calculate the amount of discount to be written off each year. The financial year of the company ends on 31st December each year.

5. (a) A limited co. issued 2,000 10% debentures of Rs.100 each at Rs.95 on 1.1.91. As per the terms of issue, debentures are to be redeemed at the end of 5 years. Show the amount of the discount to be written off to the profit and loss account every year.

   (b) A company purchases assets of Rs.2,60,000 and liabilities of Rs.50,000 for a sum of Rs.2,00,000. The purchase consideration is satisfied by the issue of 9% debentures of Rs.100 each at par. Journalize.

   (a) A company issued 20,000 10% debentures of Rs.100 each at a discount of 5% repayable after 10 years at a premium of 5%. Pass necessary journal entries.

Ans. [(a) rs.2,000; (b) Capital Reserve Rs.10,000; (c0 Loss on issue of debentures rS.2,00,000]

6. A company issued 5,000 debentures of Rs.100 each at par on 1st January 1995 redeemable at par on 31st December 1999. a sinking fund was established for the purpose. It was expected that investments would earn 5% net. Sinking fund tables show that Re.0.180975 amount to Re.1 at the end of 5 years @ 5%. On 31st December, 1999 the investments realized Rs.3,90,000. On that date the company's bank balance stood at Rs.1,45,600. The debentures were duly redeemed. Give the necessary journal entries, ledger accounts and assume that the investments were made to the nearest Rs.10.

7. In the Balance Sheet of a company, the discount on debentures shows a debit balance of Rs.15,000. Every year Rs.5,000 is charged off to profit and loss account. How will you show the discount on debentures account at the end of the first year and second year in the balance sheet of the company ?