KLE LAW ACADEMY BELAGAVI

(Constituent Colleges: KLE Society's Law College, Bengaluru, Gurusiddappa Kotambri Law College, Hubballi, S.A. Manvi Law College, Gadag, KLE Society's B.V. Bellad Law College, Belagavi, KLE Law College, Chikodi, and KLE College of Law, Kalamboli, Navi Mumbai)

STUDY MATERIAL

for

CORPORATE ACCOUNTING

Prepared as per the syllabus prescribed by Karnataka State Law University (KSLU), Hubballi

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CORPORATE ACCOUNTING
SYLLABUS

Unit 1 Underwriting of share

Meaning - underwriting Commission- underwriter - functions - advantages of underwriting, types of underwriting - marked and unmarked applications problems.

Unit 2 issue of shares

Meaning of shares, types of shares -preference shares and equity shares - debentures - issue of shares at par, at premium, at discount, pro-rate allotment-journal entries and bank account - preparation of balance sheet in the vertical form

Unit 3 profit prior to Incorporation

Meaning - calculation of sales ratio - time ratio - weighted ratio- treatment of capital and revenue expenditure - ascertainment of Pre-incorporation and post-incorporation profits by preparing profit and loss account and balance sheet in the vertical form.

Unit 4 valuation of goodwill and shares

Meaning- circumstances of valuation of goodwill - factors influencing the value of goodwill - methods of value of goodwill: average profit method, super profit method, capitalisation of average profit method, capitalisation of super profit method and annuity method -problems.

Meaning of valuation of shares- need for valuation - factors affecting valuation - methods of valuation: intrinsic value method, yield method, earning capacity method, fair value of shares.

Unit 5 company final accounts

Statutory provisions regarding preparation of company final accounts -treatment of special items - tax deduction at source - advance payment of tax - provision for tax - depreciation - interest on debentures - dividends - rules regarding payment of dividends - transfer to reserve - preparation of profit and loss account and balance sheet in vertical form (as per 2011 revised format).

CONTENT

UNIT – 1

UNDERWRITING OF SHARES

1. INTRODUCTION UNDERWRITING OF SHARES:

Underwriting an issue of shares or debentures involves entering into a contract with a person known as underwriter, who may be an individual, partnership or company, undertaking that in the event of the shares or debentures not being subscribed by the public or only a part of them being subscribed, he shall take up the balance. In view of the magnitude of such an obligation, issues of shares or debentures are rarely underwritten by one person. They are either underwritten by two or more persons jointly or only a part of the issue is underwritten and, in respect of rest, the company takes the risk of the capital being not subscribed by the public.

2. UNDERWRITING COMMISSION

The function of an underwriter has great economic significance. It provides an assurance to the company that it would be able to raise the stipulated amount of capital by the issue of shares or debentures and, on the basis of such an assurance; company can proceed to draw up its investment programme. The Central Government has recently set up a number of financial institutions for helping companies to raise capital. One of the forms in which such a help is rendered is by underwriting the issues of shares and debentures, made by the companies. The prominent institutions that render this service are: Industrial Finance Corporation, Industrial Credit and Investment Corporation of India and Life Insurance Corporation of India.

In consideration of such a service, the underwriter is paid a commission. The Companies Act, 2013 places certain restrictions on the rate of commission and the conditions under which it can be paid. It provides that commission only at a rate authorized by the Articles, not exceeding 2½% of the issue price of debentures and 5% of issue price of shares, can be paid. No commission can be paid in respect of shares or debentures which have not been offered to the general public for subscription.

3. PROVISIONS IN THE COMPANIES ACT AFFECTING THE UNDERWRITING:

Disclosure in the Prospectus - According the Companies Act, it is necessary that when any issue of shares or debentures is underwritten, the names of the underwriters and the opinion of the directors that the resources of the underwriters are sufficient to discharge their obligations should be stated.

Disclosure in the Statutory Report - According to clause (6) of the Form prescribed for such a report, a brief description of each underwritten contract should be given and, if any contract has not been carried out fully, the extent to which it has not been carried out and reasons therefore should be stated. In addition, particulars of any commission paid or payable to any Director, Manager, or their associates should be disclosed.

TWO TYPES OF UNDERWRITING CONTRACT:

Normal Underwriting

Firm Underwriting

2.4.1.3 Determination of liability where the whole or part of the issue has been underwritten by two or more underwriters: In the case in which whole or only part of an issue has been underwritten by a number of underwriters, a difficulty may arise in determining the liability of each of the underwriters; such a difficulty may arise in deciding the basis on which the unmarked applications, *i.e.* the applications which have directly flowed to the company should be allocated among the different underwriters. Marked applications are those

applications which are received through an underwriter and such applications are to his credit against his overall obligations.

The allocation of unmarked applications to the underwriters can be done in any one of the two ways: according to one method, the unmarked applications are allotted in the proportion of gross amount of capital underwritten; alternatively these are allocated in proportion to the gross amount of capital underwritten as reduced by the marked applications. How the liability of underwriters is determined by following one or the other method, is explained below :

Elahi Buksh & Co. Ltd. issued 10,000 equity shares. These were underwritten as follows:

A	40%	B	35%	C	25%

In all, applications for 8,000 shares were received; applications for 2,000 shares have the stamp of A; those for 1,000 shares that of B, and those for 2,000 shares that of C. There were thus applications for 3,000 shares which did not bear any stamp or which were unmarked. If credit for unmarked applications is given to A, B and C in proportion to their gross liability, the liability of each of the underwriters will be as shown below:

	A	B	C
Gross liability as underwritten	4,000	3,500	2,500
Less: Unmarked applications			
3,000 shares in the ratio of 40:35:25	(1,200)	(1,050)	(750)
Gross Liability of underwriters	2,800	2,450	1,750
Marked applications	2,000	1,000	2,000
Balance	800	1,450	(250)
Credit to A and B for C's surplus (ratio 40:35)	(133)	(117)	250
Actual liability	667	1,333	—

If however, the other view is taken that unmarked applications should be credited to different underwriters in the ratio of liability after credit for marked applications has been given - the position will be as follows :

If however, the other view is taken that unmarked applications should be credited to different underwriters in the ratio of liability after credit for marked applications has been given - the position will be as follows :

	A	B	C
Gross liability	4,000	3,500	2,500
Less: marked applications	(2,000)	(1,000)	(2,000)
Liability net of marked applications	2,000	2,500	500
Less: Unmarked applications	(1,200)	(1,500)	(300)
(Shares in ratio of 20:25:5)			
Net liability	800	1,000	200

The liability in this case could also be determined by simply apportioning the total number of shares yet to be subscribed (2,000 in the above case) in the proportion of the balance of the liability after credit for marked forms has been given. Since the liability of each underwriter

If credit of marked application is

- **Given to individual underwriter**
  - **Then unmarked application will be distributed in Gross Liability Less marked application ratio**
- **Not given to individual underwriter**
  - **Then unmarked application will be distributed in Gross Liability ratio**

In case the information as regards the number of applications that are marked and those that are unmarked is not available in the given question, it should be assumed that out of the total number of applications received, a number proportionate to the value of the issue underwritten has been received through the underwriters.

The surplus shown by the particular underwriters is to be credited to the other underwriters in same proportion as for unmarked applications.

Illustration 1

Newton Limited incorporated on 1st January, 2013 issued a prospectus inviting applications for 20,000 equity shares of ₹ 10 each. The whole issue was fully underwritten by Adams, Benzamin and Clayton as follows:

Adams	*10,000 shares*
Benzamin	*6,000 shares*
Clayton	*4,000 shares*

Applications were received for 16,000 shares, of which marked applications were as follows:

Adams	*8,000 shares*
Benzamin	*2,850 shares*
Clayton	*4,150 shares*

You are required to find out the liabilities of individual underwriters.

Statement of Net Liability of Underwriters

	Gross liability	Marked appli-cations	Number of Unmarked applications in the ratio of gross liability	Shares Total (2) + (3)	Surplus of Clayton in the ratio of 10:6	Total (4)+(5)	Net liability (1)- 6)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Adams	10,000	8,000	500	8,500	219	8,719	1,281
Benzamin	6,000	2,850	300	3,150	131	3,281	2,719
Clayton	4,000	4,150	200	4,350	-350	4,000	-
	20,000	15,000	1,000	16,000	-	16,000	4,000

Note: The applications are for 16,000 shares out of which 15,000 are marked. Hence unmarked applications are for 1,000 shares.

2.4.2 Firm Underwriting

It signifies a definite commitment to take up a specified number of shares irrespective of the number of shares subscribed for by the public. In such a case, unless it has been otherwise agreed, the underwriter's liability is determined without taking into account the number of shares taken up 'firm' by him that is to say, the underwriter is obliged to take up :

(*i*) The number of shares he has applied for 'firm'; and

(*ii*) The number of shares he is obliged to take up on the basis of the underwriting agreement.

In other words, in such cases the obligation or liability of the underwriter is the aggregate of shares to be taken up under firm commitment and the shares as per underwriting commitment.

Let us say, A underwrites 60% of an issue of 10,000 shares and besides applies for 1,000 shares, 'firm'. In case there are marked applications for 4,800 shares he will have to take 2,200 shares, *i.e.* 1,000 shares for which he applied 'firm' and 1,200 shares to meet his liability of underwriting contract. If, on the other hand, the underwriting contract has provided that abatement would be allowed in respect of shares taken up 'firm' the liability of A in the above-mentioned case would only be for 1,200 shares in total.

2.4.2.1 When the Issue is Fully Underwritten [with Firm Underwriting]

There are two alternative ways:

(i) The benefit of firm underwriting is not given to individual underwriter, or

(ii) The benefit of firm underwriting is given to individual underwriter.

(i) The benefit of firm underwriting is not given to individual Underwriter:

For determining the liability of individual underwriter, the following steps are followed:

Step 1 Compute gross liability in the usual manner (if it has not been given).

Step 2 Subtract marked applications (excluding firm underwriting) from gross liability of respective underwriters. If some of the resultant figures are found negative, then add all negative figures and divide the resultant in the ratio of gross liability.

Step 3 Determine the number of unmarked applications as follows:

Total subscriptions (excluding firm underwriting)	******
Less: Marked applications (excluding firm underwriting)	******
Unmarked applications by public	******
Add: Applications under firm underwriting	******
Total unmarked applications	******

Divide the above calculated unmarked applications in the ratio of **gross liability.**

If the resultant figures of Step 3 are all positive or zero, then it represents **net liability** as per agreement. After this step, go to Step 5 (skip Step 4).

If some of the resultant figures are negative, then continue to Step 4.

Step 4 Add all the negative figures and divide the resultant between the underwriters having positive figures in the ratio of **gross liability.** Repeat Step 4 unless all figures are non-negative. Now these figures represent the **net liability** as per agreement. After this step, to Step 5.

Step 5 Add firm underwriting with the **net liability** as per agreement. The resultant figures represent **total liability.**

Here,

(1) Firm underwriting is treated as unmarked applications and divided in the ratio of gross liability.

(2) The liability of underwriter consists of:

(a) Net liability as per agreement; and

(b) Firm underwriting.

(ii) The benefit of firm underwriting is given to individual underwriter

For determining the liability of individual underwriter, the following steps are followed:

Step 1 Compute gross liability in the usual manner (if it has not been given).

Step 2 Subtract marked applications (excluding firm underwriting) from gross liability of respective underwriters. If some of the resultant figures are found negative, then add all negative figures and divide their sum in the ratio of gross liability.

Step 3 Determine the number of unmarked applications as follows:

Total subscriptions (excluding firm underwriting)	******
Less: Marked applications (excluding firm underwriting)	******
Unmarked applications by public	******

Divide the above calculated unmarked application in the **ratio of gross liability.**

Step 4 Subtract "firm underwriting" of individual underwriter from the respective figures of Step 3.

If the resultant figures of Step 4 are all positive or zero, then that represents net liability as per agreement. After this step, go to Step 6 (skip Step 5).

If some of the resultant figures are negative, then continue to Step 5.

Step 5 Add all negative figures and divide it between the underwriters having positive figures in the ratio of gross liability. Repeat Step 5 unless all figures are non-negative. Now these figures represent the net liability as per agreement. After this step, go to Step 6.

Step 6 Add firm underwriting with the net liability as per agreement. The resultant figures represent total liability.

Here,

(1) Firm underwriting is not treated as unmarked applications.

(2) Firm underwriting is credited to individual underwriters separately.

(3) The liability of Underwriter consists of:

(a) Net liability as per agreement; and

(b) Firm underwriting.

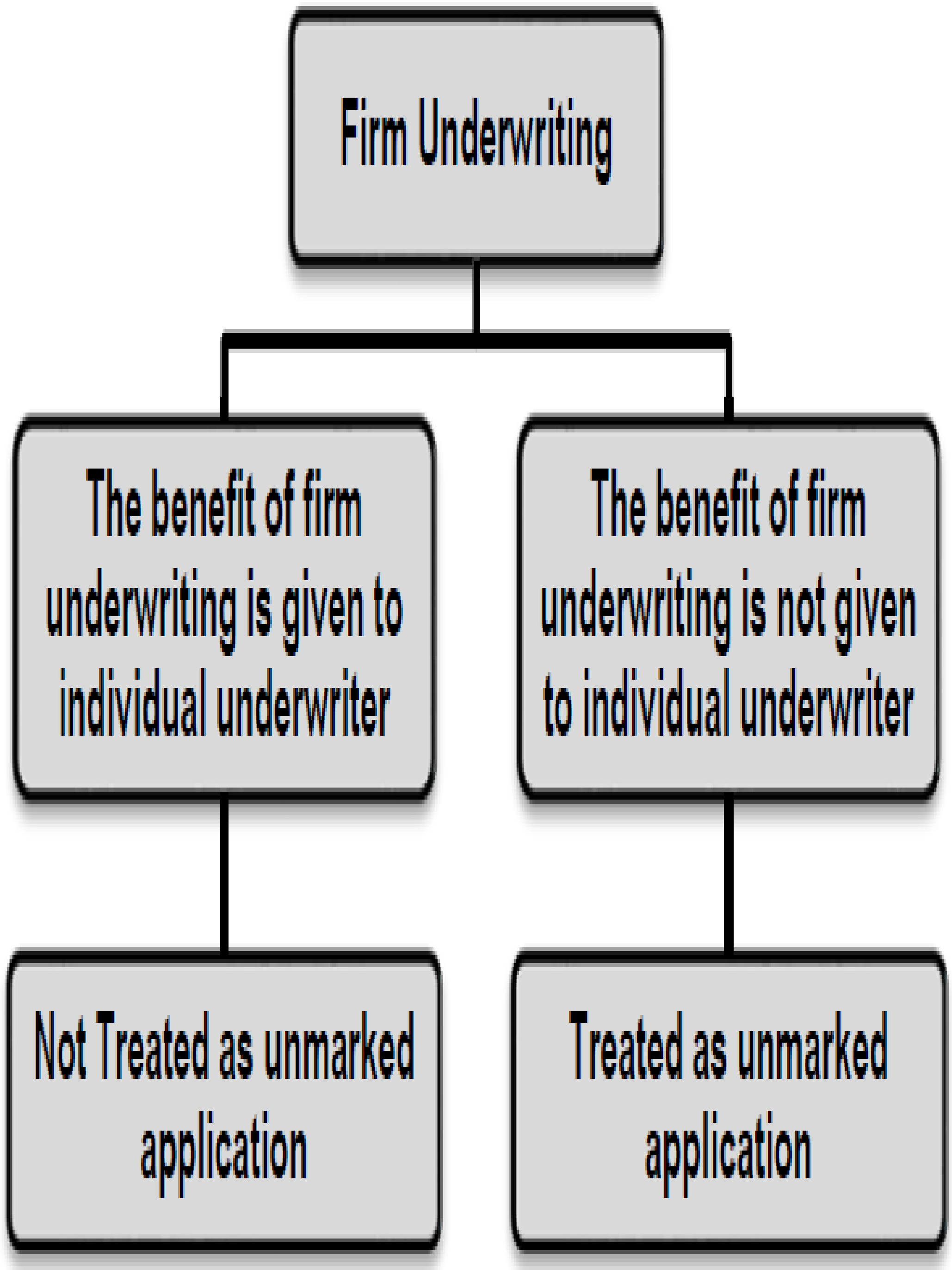
Firm Underwriting
The benefit of firm underwriting is given to individual underwriter
The benefit of firm underwriting is not given to individual underwriter
Not Treated as unmarked application
Treated as unmarked application

Illustration 2

Rosy Ltd. made a public issue of 4,00,000 equity shares of ₹ 10 each, ₹ 2 payable on application. The entire issue was underwritten by five underwriters as follows: A: 25%, B: 25%, C: 25%, D: 10% and E: 15%. Under the underwriting terms, a commission of 2% was payable on the amount underwritten. Further, the underwriter was at liberty to apply, during the tenure of public issue, for any number of shares in which case he was entitled to a brokerage equal to 1/2% of the par value of shares so applied for.

Applications received were to be analyzed on the basis of rubber stamp of the underwriter, who was to be given credit for the number of applications received bearing his rubber stamp. Applications received which did not bear any rubber stamp were considered as "direct applications" to be credited to all the underwriters in the ratio of their respective underwriting commitment. If, any such credit being given a "surplus" was to result in respect of any underwriter, as compared to his commitment, such surplus was to be distributed amongst the remaining underwriters in the ratio of their respective underwriting commitments.

As a result of the issue the following applications were received:

As a result of the issue the following applications were received:

Bearing rubber stamp of	*A*	*1,02,000 shares*
-Do-	*B*	*95,000 shares*
-Do-	*C*	*60,000 shares*
-Do-	*D*	*32,000 shares*
-Do-	*E*	*51,000 shares*
Not bearing any stamp		*10,000 shares*
		3,50,000 shares

Included in the number of applications mentioned against D in the above table was an application made by D himself for 10,000 shares. The underwriters were informed of the amounts due to or from them, the amounts were duly received or paid.

Show, with the aid of necessary workings, the entries to record the amount so received or paid.

Journal Entry

		Dr. ₹	Cr. ₹
Bank A/c	Dr.	57,500	
Underwriting commission A/c	Dr.	80,000	
Brokerage on shares A/c	Dr.	500	
To Equity Shares applications A/c			1,00,000
To Bank A/c			38,000

Working Notes: (for description of the columns see below)

Name	1	2	3	4	5	6	7	8	9	10	11	12
A.	1,00,000	1,02,000	2,500	1,04,500	–4,500	1,00,000	–	–	20,000	–	–	20,000
B.	1,00,000	95,000	2,500	97,500	1,500	99,000	1,000	2,000	20,000	–	–	18,000
C.	1,00,000	60,000	2,500	62,500	1,500	64,000	36,000	72,000	20,000	–	52,000	–
D.	40,000	32,000	1,000	33,000	600	33,600	6,400	12,800	8,000	500	4,300	–
E.	60,000	51,000	1,500	52,500	900	53,400	6,600	13,200	12,000	–	1,200	–
	4,00,000	3,40,000	10,000	3,50,000	–	3,50,000	50,000	1,00,000	80,000	500	57,500	38,000

Column No.

(1) Commitment—No. of Shares

(2) Marked Applications

(3) Additional proportionate no. of direct applications or unmarked applicaitons

(4) Total (2) + (3)

(5) Allocation of surplus – done in the ratio of underwriting i.e 25:25:10:15 (B, C, D & E)

(6) Total (4)+(5) – this will be the total credited applications

(7) Final Deficit (1)—(6): Commitment – Total Credited Applicaitons

(8) Amount Receivable from underwriters due @ ₹ 2 per share.

(9) Underwriting Commission due @ 2 % nominal value.

(10) Brokerage due @ 1/2%: Only payable to D for 10,000/- shares applied by him on par value of the shares i.e on Rs 100,000

(11) Due from underwriters.

(12) Due to underwriters.

Illustration 3

Libra Ltd. came up with an issue of 20,00,000 equity shares of ₹ 10 each at par. 5,00,000 shares were issued to the promoters and the balance offered to the public was underwritten by three underwriters Anand, Vijay and Ashok - equally with firm underwriting of 50,000 shares each. Subscriptions totalled 12,97,000 shares including the marked forms which were :

Anand	*4,25,000 shares*
Vijay	*4,50,000 shares*
Ashok	*3,50,000 shares*

The underwriters had applied for the number of shares covered by firm underwriting. The amounts payable on application and allotment were ₹ 2.50 and ₹ 2.00 respectively. The agreed commission was 5%.

Pass summary journal entries for —

(a) The allotment of shares to the underwriters;

(b) The commission due to each of them; and

(c) The net cash paid and or received.

Note: *Unmarked applications are to be credited to underwriters equally. Benefit of firm underwriting is given to individual underwriter.*

Libra Ltd.
Journal

		Dr. ₹	Cr. ₹
Bank A/c	Dr.	3,75,000	
To Share Application A/c			3,75,000
(Application money received on firm applications for 50,000 each @ ₹ 2.50 per share from Anand, Vijay & Ashok)			
Anand	Dr.	1,00,000	
Vijay	Dr.	1,00,000	
Ashok	Dr.	3,38,500	
Share Application A/c	Dr.	3,75,000	
To Share Capital A/c			9,13,500
(Allotment of shares to underwriters 50,000 to Anand; 50,000 to Vijay and 1,03,000 to Ashok; application and allotment money credited to share capital)			
Underwriting Commission A/c	Dr.	7,50,000	
To Anand			2,50,000
To Vijay			2,50,000

To Ashok (Amount of underwriting commission payable to Anand, Vijay and Ashok @ 5% on the amount of shares underwritten.)		2,50,000
Bank A/c Dr. To Ashok (Amount received from Ashok on shares allotted less underwriting commission)	88,500	88,500
Anand Dr. Vijay Dr. To Bank A/c (Amount paid to Anand & Vijay in final settlement of underwriting commission due less amount payable on shares allotted payable to him.)	1,50,000 1,50,000	3,00,000

Working Notes :

(1) Calculation of Liability of Underwriters

	Anand	Vijay	Ashok
Gross Liability (No. of shares)	5,00,000	5,00,000	5,00,000
Less : Marked Applications(excluding firm underwriting)	(4,25,000)	(4,50,000)	(3,50,000)
	75,000	50,000	1,50,000
Less : Unmarked Applications (equally)	(24,000)	(24,000)	(24,000)
	51,000	26,000	1,26,000
Less : Firm Underwriting	(50,000)	(50,000)	(50,000)
	1,000	(24,000)	76,000
Surplus of Vijay distributed between Anand & Ashok equally	(12,000)	24,000	(12,000)
	(11,000)	-	64,000-
Surplus of Anand allocated to Ashok totally	11,000	—	(11,000)
	11,000	—	64,000
Less : Adjustment of Anand's surplus	(11,000)	—	(11,000)
Net liability, excluding firm underwriting	—	—	53,000
Add: Firm underwriting	50,000	50,000	50,000
Total liability of underwriters	50,000	50,000	1,03,000

(2) Calculation of Amounts Payable by Underwriters

	Anand	Vijay	Ashok
Liability (No. of shares)	50,000	50,000	1,03,000
Amount payable @ ₹ 4.50 per share	2,25,000	2,25,000	4,63,500
Less : Amount paid on Firm Applications of 50,000 each @ ₹ 2.50	(1,25,000)	(1,25,000)	(1,25,000)

Balance payable	1,00,000	1,00,000	3,38,500
Underwriting Commission Receivable	2,50,000	2,50,000	2,50,000
Amount Paid	1,50,000	1,50,000	–
Amount received by the Co.	–	–	88,500

Illustration 4

A company made a public issue of 1,25,000 equity shares of ₹ 100 each, ₹ 50 payable on application. The entire issue was underwritten by four parties: A, B, C, and D in the proportion of 30% and 25%, 25% and 20% respectively. Under the terms agreed upon, a commission of 2% was payable on the amounts underwritten.

A, B, C, and D also agreed on 'firm'; underwriting of 4,000, 6,000, Nil and 15,000 shares respectively.

The total subscriptions, excluding firm underwriting, including marked applications were for 90,000 shares. Marked applications received were as under :

A 24,000 C 12,000 B 20,000 D 24,000

Ascertain the liability of the individual underwriters and also show the journal entries that you would make in the books of the company. All workings should form part of your answer.

Solution:

When the benefit of firm underwriting is given to individual underwriters.

(i) Total marked applications:

A	B	C	D	
24,000	+20,000	+12,000	+24,000	= 80,000

(ii) Shares subscribed excluding firm underwriting

Total applications	90,000	shares
Less : Marked applications	(80,000)	shares
Unmarked	10,000	

(iii) Statement showing Liability of underwriters

	A	*B*	*C*	*D*	*Total*
Gross liability (30:25:25:20)	37,500	31,250	31,250	25,000	1,25,000
Less : Marked applications	(24,000)	(20,000)	(12,000)	(24,000)	(80,000)
	13,500	11,250	19,250	1,000	45,000
Less : Unmarked (in Gross Ratio)	(3,000)	(2,500)	(2,500)	(2,000)	(10,000)

Less : Firm underwriting	(4,000)	(6,000)	–	(15,000)	(25,000)
	6,500	2,750	16,750	–16,000	10,000

Less : Surplus of 'D'allotted to A, B & C (30:25:25)	(6,000)	(5,000)	(5,000)	–	–
	500	(2,250)	11,750	–	10,000
Surplus of 'B' allotted	500	–	1,750	–	–
Net liability	–	–	10,000	–	10,000

v) Statement of underwriters' liability

Firm	4,000	6,000	–	15,000	25,000
Others	–	–	10,000	–	10,000
	4,000	6,000	10,000	15,000	35,000

) Amounts due from underwriters

	A	B	C	D	Total
Shares to be subscribed as per (iv) above	4,000	6,000	10,000	15,000	35,000
Amount due @ ₹ 50 per share	2,00,000	3,00,000	5,00,000	7,50,000	17,50,000
Less : Commission due of shares underwritten	(75,000)	(62,500)	(62,500)	(50,000)	(2,50,000)
	1,25,000	2,37,500	4,37,500	7,00,000	15,00,000

When the benefit of firm underwriting is not given to individual underwriter:

(i) Total marked applications = 24,000+20,000+12,000+24,000 = 80,000

(ii) Shares subscribed excluding 'Firm' underwriting but including

Marked applications	90,000	shares
Add: 'Firm' underwriting	25,000	shares
Total subscription	1,15,000	shares
Less: Marked Applications	(80,000)	shares
Balance being unmarked	35,000	shares

) **Check:**

(a)	Taken by public - unmarked applications	10,000	shares
(b)	Public through underwriters - marked	80,000	shares
(c)	By underwriters - under agreement	35,000	shares
		1,25,000	shares

Journal Entry

		₹	₹
Bank A/c	Dr	60,00,000	
Underwriting Commission A/c	Dr	2,50,000	
Equity share Application A/c			62,50,000

UNIT – 2

ISSUE OF SHARES

Shares refer to the units into which the total share capital of a company is divided. Thus, a share is a fractional part of the share capital and forms the basis of ownership interest in a company. The persons who contribute money through shares are called shareholders.

TYPES OF SHARES

Preference shares

According to Section 43 of The Companies Act, 2013, a preference share is one, which fulfils the following conditions :

That it carries a preferential right to dividend to be paid either as a fixed amount payable to preference shareholders or an amount calculated by a fixed rate of the nominal value of each share before any dividend is paid to the equity shareholders.

That with respect to capital it carries or will carry, on the winding up of the company, the preferential right to the repayment of capital before anything is paid to equity shareholders.

Equity Shares:

According to Section 43 of The Companies Act, 2013, an equity share is a share which is not a preference share. In other words, shares which do not enjoy any preferential right in the payment of dividend or repayment of capital, are termed as equity/ordinary shares. The equity shareholders are entitled to share the distributable profits of the company after satisfying the dividend rights of the preference share holders. The dividend on equity shares is not fixed and it may vary from year to year depending upon the amount of profits available for distribution. The equity share capital may be (i) with voting rights; or (ii) with differential rights as to voting, dividend or otherwise in accordance with such rules and subject to such conditions as may be prescribed.

SHARE CAPITAL OF A COMPANY:

A company, being an artificial person, cannot generate its own capital which has necessarily to be collected from several persons. These persons are known as shareholders and the amount contributed by them is called share capital. Since the number of shareholders is very large, a separate capital account cannot be opened for each one of them. Hence, innumerable streams of capital contribution merge their identities in a common capital account called as 'Share Capital Account'.

CATEGORIES OF SHARE CAPITAL:

From accounting point of view the share capital of the company can be classified as follows:

• Authorised Capital: Authorised capital is the amount of share capital which a company is authorised to issue by its Memorandum of Association. The company cannot raise more than the amount of capital as specified in the Memorandum of Association. It is also called Nominal or Registered capital. The authorised capital can be increased or decreased as per the procedure laid down in the Companies Act. It should be noted that the company need not issue the entire authorised capital for public subscription at a time. Depending upon its requirement, it may issue share capital but in any case, it should not be more than the amount of authorized capital.

• Issued Capital: It is that part of the authorised capital which is actually issued to the public for subscription including the shares allotted to vendors and the signatories to the company's memorandum. The authorised capital which is not offered for public subscription is known as 'unissued capital'. Unissued capital may be offered for public subscription at a later date.

• Subscribed Capital: It is that part of the issued capital which has been actually subscribed by the public. When the shares offered for public subscription are subscribed fully by the public the issued capital and subscribed capital would be the same. It may be noted that ultimately, the subscribed capital and issued capital are the same because if the number of share, subscribed is less than what is offered, the company allot only the number of shares for which subscription has been received. In case it is higher than what is offered, the allotment will be equal to the offer. In other words, the fact of over subscription is not reflected in the books.

• Called up Capital: It is that part of the subscribed capital which has been called up on the shares. The company may decide to call the entire amount or part of the face value of the shares. For example, if the face value (also called nominal value) of a share allotted is Rs. 10 and the company has called up only Rs. 7 per share, in that scenario, the called up capital is Rs. 7 per share. The remaining Rs. 3 may be collected from its shareholders as and when needed.

• Paid up Capital: It is that portion of the called up capital which has been actually received from the shareholders. When the shareholders have paid all the call amount, the called up capital is the same to the paid up capital. If any of the shareholders has not paid amount on calls, such an amount may be called as 'calls in arrears'. Therefore, paid up capital is equal to the called-up capital minus call in arrears.

• Uncalled Capital: That portion of the subscribed capital which has not yet been called up. As stated earlier, the company may collect this amount any time when it needs further funds.

Reserve Capital: A company may reserve a portion of its uncalled capital to be called only in the event of winding up of the company. Such uncalled amount is called 'Reserve Capital' of the company. It is available only for the creditors on winding up of the company.

Issue of Shares

A salient characteristic of the capital of a company is that the amount on its shares can be gradually collected in easy instalments spread over a period of time depending upon its growing financial requirement. The first instalment is collected along with application and is thus, known as application money, the second on allotment (termed as allotment money), and the remaining instalment are termed as first call, second call and so on.

The important steps in the procedure of share issue are :

• Issue of Prospectus: The company first issues the prospectus to the public. Prospectus is an invitation to the public that a new company has come into existence and it needs funds for doing business. It contains complete information about the company and the manner in which the money is to be collected from the prospective investors.

Receipt of Applications: When prospectus is issued to the public, prospective investors intending to subscribe the share capital of the company would make an application along with the application money and deposit the same with a scheduled bank as specified in the prospectus. The company has to get minimum subscription within 120 days from the date of the issue of the prospectus. If the company fails to receive the same within the said period, the company cannot proceed for the allotment of shares and application money should be returned within 130 days of the date of issue of prospectus.

Allotment of Shares: If minimum subscription has been received the company may proceed for the allotment of shares after fulfilling certain other legal formalities. Letters of allotment are sent to those whom the shares have been alloted, and letters of regret to those to whom no allotment has been made. When allotment is made, it results in a valid contract between the company and the applicants who now became the shareholders of the company

Accounting Treatment

On application :

The amount of money paid with various instalment represents the contribution to share capital and should ultimately be credited to share capital. However, for the sake of convenience, initially individual accounts are opened for each instalment. All money received along with application is deposited with a scheduled bank in a separate account opened for the purpose. The journal entry is as follows:

Bank A/c Dr.

To Share Application A/c

(Amount received on application for — shares @ Rs. ______ per share)

On allotment :

When minimum subscription has been received and certain legal formalities on the allotment of shares have been duly compiled with, the directors of the company proceed to make the allotment of shares.The allotment of shares implies a contract between the company and the applicants who now become the allottees and assume the status of shareholders or members.

The journal entries with regard to allotment of shares are as follows:

1.For Transfer of Application Money

Share Application A/c Dr.

To Share Capital A/c

(Application money on _____ Shares allotted/

transferred to Share Capital)

2. For Money Refunded on Rejected Application

Share Application A/c Dr.

To Bank A/c

(Application money returned on rejected application for ___shares)

For Amount Due on Allotment

Share Allotment A/c Dr.

To Share Capital A/c

For Adjustment of Excess Application Money

Share Application A/c Dr.

To Share Allotment A/c

(Application Money on __Shares @ Rs__per shares

adjusted to the amount due on allotment).

5. For Receipt of Allotment Money

Bank A/c Dr.

To Share Allotment A/c

(Allotment money received on ___Shares @

Rs. — per share Combined Account)

For Receipt of Application and Allotment

Bank A/c Dr.

To Share Application and Allotment A/c

(Money received on applications for shares

@ Rs. _____ per share).

For Transfer of Application Money and Allotment Amount Due

Share Application and Allotment A/c Dr.

To Share Capital A/c

(Transfer of application money to Share Capital Account for amount due or allotment of — Share @ Rs. _____ per share)

For Money Refunded on Rejected Applications

Share Application and Allotment A/c Dr.

To Bank A/c

(Application money returned on rejected application

for ___ shares)

On Receipt of Allotment Amount

Bank A/c Dr.

To Share Application and Allotment A/c

(Balance of Allotment Money Received)

Problem 1

Mona Earth Mover Limited decided to issue 12,000 shares of Rs.100 each payable at Rs.30 on application, Rs.40 on allotment, Rs.20 on first call and balance on second and final call. Applications were received for 13,000 shares.The directors decided to reject application of 1,000 shares and their application oney being refunded in full. The allotment money was duly received on all the shares, and all sums due on calls are received except on 100 shares. Record the transactions in the books of Mona Earth Movers Limited.

Solution :

Books of Mona Earth Mover Limited
Journal

Date	*Particulars*	*L.F.*	*Debit Amount (Rs.)*	*Credit Amount (Rs.)*
	Bank A/c Dr. To Share Application A/c (Application money on 13,000 shares @ Rs.30 per share received)		3,90,000	3,90,000
	Share Application A/c Dr. To Share Capital A/c (Application money transferred to share capital)		3,60,000	3,60,000

	Share Application A/c Dr. To Bank A/c (Application money on 1,000 shares returned]		30,000	30,000
	Share Allotment A/c Dr. To Share Capital A/c (Money due on allotment of 12,000 shares @ Rs. 40 per share)		4,80,000	4,80,000
	Bank A/c Dr. To Share Allotment A/c (Money received on 12,000 shares @ Rs. 40 per share on allotment)		4,80,000	4,80,000
	Share First Call A/c Dr. To Share Capital A/c (Money due on 12,000 shares @ Rs. 20 per share on first Call)		2,40,000	2,40,000
	Bank A/c Dr. To Share First Call A/c (First Call money received except for 100 shares)		2,38,000	2,38,000
	Share Second and Final Call A/c Dr. To Share Capital A/c (Money due on 12,000 shares @ Rs. 10 per share on Second and final Call)		1,20,000	1,20,000
	Bank A/c Dr. To Share Second and Final Call A/c (Second and final call money received except for 100 shares)		1,19,000	1,19,000

Calls in Arrears

It may happen that shareholders do not pay the call amount on due date. When any shareholder fails to pay the amount due on allotment or on any of the calls, such amount is known as 'Calls in Arrears'/'Unpaid Calls'. Calls in Arrears represent the debit balance of all the calls account. Such amount shall appear as 'Note to Accounts (Refer Chapter 3). However, where a company maintains

'Calls in Arrears' Account, it needs to pass the following additional journal entry:

Calls in Arrears A/c Dr.

To Share First Call Account A/c

To Share Second and Final Call Account A/c

(Calls in arrears brought into account)

On receipt of the call amount together with interest, the amount of interest shall be credited to interest account while call money shall be credited to the respective call account or to calls in arrears account. When the shareholder makes the payment of calls in arrears together with interest, the entry will be as follows:

Bank A/c Dr.

To Calls in Arrears A/c

To Interest A/c

(Calls in arrears received with interest)

Calls in Advance

Sometimes shareholders pay a part or the whole of the amount of the calls not yet made. The amount so received from the shareholders is known as “Calls in Advance”. The amount received in advance is a liability of the company and should be credited to ‘Call in Advance Account.” The amount received will be adjusted towards the payment of calls as and when they becomes due. Table F of the Companies Act provides for the payment of interest on calls in advance at

a rate not exceeding 12% per annum. The following journal entry is recorded for the amount of calls received in advance.

Bank A/c Dr.

To Calls in Advance A/c

(Amount received on call in advance)

On the due date of the calls, the amount of ‘Calls in Advance’ is adjusted by the

following entry :

Calls in Advance A/c Dr.

To Particular Call A/c

(Calls in advance adjusted with the call money due)

The balance in 'Calls in Advance' account is shown as a separate item under the title Equity and Liabilities in the company's balance sheet under the head 'current liabilities', as sub-head 'others current liabilities'. It is not added to the amount of paid-up capital.

The accounting treatment of interest on Calls in Advance is as follows:

1. For Payment of Interest

Interest on Calls in Advance A/c Dr.

To Bank A/c

(Interest paid on Calls in Advance)

Or

2.(a) For Interest due

Interest on Calls in Advance A/c Dr.

To Sundry Shareholder's A/c

(Interest paid on Calls in Advance)

2.(b) For Interest Paid

Sundry Shareholder's A/c Dr.

To Bank A/c

Illustration 5

Unique Pictures Limited was registered with an authorised capital of Rs. 5,00,000 divided into 20,000, 5% preference shares of Rs. 10 each and 30,000 equity shares of Rs. 10 each. The company issued 10,000 preference and 15,000 equity shares for public subscription. Calls on shares were made as under

	Equity Shares (Rs.)	*Preference Shares (Rs.)*
Application	2	2
Allotment	3	3
First Call	2.50	2.50
Second and Final Call	2.50	2.50

All these shares were fully subscribed. All the dues were received except the second and final call on 100 equity shares and on 200 preference shares. Record these transactions in the journal. You are also required to prepare the cash book and balance sheet.

Solution

Books of Unique Pictures Limited
Journal

Date	*Particulars*		*L.F.*	*Debit Amount (Rs.)*	*Credit Amount (Rs.)*
	Equity Share Application A/c	Dr.		30,000	
	5% Preference Share Application A/c	Dr.		20,000	
	To Equity Share Capital A/c				30,000
	To 5% Preference Share Capital A/c				20,000
	(Transfer of application money)				
	Equity Share Allotment A/c	Dr.		45,000	
	5% Preference Share Allotment A/c	Dr.		30,000	
	To Equity Share Capital A/c				45,000
	To 5% Preference Share Capital A/c				30,000
	(Amount due on allotment)				
	Equity Share First Call A/c	Dr.		37,500	
	5% Preference Share First Call A/c	Dr.		25,000	
	To Equity Share Capital A/c				37,500
	To 5% Preference Share Capital A/c				25,000
	(First call money due)				

Date	Particulars	L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
	Equity Share Second and Final Call A/c Dr.		37,500	
	5% Preference Share Second and final Call A/cDr.		25,000	
	To Equity Share Capital A/c			37,500
	To 5% Preference Share Capital A/c			25,000
	(First call money due)			
	Call in Arrears A/c Dr.		750	
	To Equity Share Second and Final Call A/c			250
	To 5% Preference Share Final Call A/c			500
	(For Calls in Arrears)			

Cash Book (Bank Column)

Dr. *Cr.*

Date	*Receipts*	*L.F.*	*Amount (Rs.)*	*Date*	*Payments*	*L.F.*	*Amount (Rs.)*
	Equity Share Application		30,000		Balance c/d		2,49,250
	5% Preference Share Application		20,000				
	Equity Share Allotment		45,000				
	5% Preference Share Allotment		30,000				
	Equity Share First Call		37,500				
	5% Preference Share First Call		25,000				
	Equity Share Second and Final Call		37,250				
	5% Preference Share Second and Final Call		24,500				
			2,49,250				**2,49,250**

Balance Sheet of unique pictures as at . . . . .

Particulars	Note No.	Amount (Rs.)
I. Equity and Liabilities		
1. Shareholders' Funds		
a) Share capital	1	2,49,250
		2,49,250
II. Assets		
1. Current assets		
a) Cash and Cash Equivalents	2	2,49,250
		2,49,250

Notes to Accounts

1. Share Capital		
Authorised Capital		
30,000 Equity Shares of Rs. 10 each		3,00,000
20,000 5% Preference Shares of Rs. 10 each		2,00,000
		5,00,000
Issued Capital		
15,000 Equity Shares of Rs. 10 each		1,50,000
10,000 5% Preference Shares of Rs. 10 each		1,00,000
		2,50,000
Subscribed Capital		
Subscribed and fully paid-up		
14,900 Equity Shares of Rs. 10 each	1,49,000	
9,800, 5% Preference Shares of Rs. 10 each	98,000	
		2,47,000
Subscribed but not fully paid-up		
100 Equity Shares of Rs. 10 each	1,000	
Less: Calls in Arreras	-250	750
200, 5% Preference Shares of Rs. 10 each	2,000	
Less : Calls in Arrers	-500	1,500
		2,49,250

Forfeiture of Shares:

It may happen that some shareholders fail to pay one or more instalments, viz. allotment money and/or call money. In such circumstances, the company can forfeit their shares, i.e. cancel their allotment and treat the amount already received thereon as forfeited to the company within the framework of the provisions in its articles. These provisions are usually based on Table F which authorise the directors to forefeit the shares for non-payment of calls made. For this purpose, they have to strictly follow the procedure laid down in this regard. Following is the accounting treatment of shares issued at par, premium or at a discount. When shares are forefeited all entries relating to the shares forfeited except those relating to premium, already recorded in the accounting records must be reversed. Accordingly, share capital account is debited with the amount called-up in respect of shares are forfeited and crediting the respective unpaid calls accounts's or calls in arrears account with the amount already received.

Forfeiture of Shares issued at Par:

Share Capital A/c..........(Called up amount) Dr.

To Share Forfeiture A/c...........(Paid up amount)

To Share Allotment A/c

To Share Calls A/c (individually)

(..... shares forfeited for non-payment of allotment money and calls made)

It may be noted here that when the shares are forfeited, all entries relating to the forfeited shares must be reversed except the entry relating to share premium received, if any. Accordingly, the share capital is debited to the extent to called-up capital and credited to (i) respective unpaid calls account i.e., calls in arrears and (ii) share forfeiture account with the amount already received on shares.

The balance of shares forfeited account is shown as an addition to the total paid-up capital of the company under the head ‘Share Capital’ under title ‘Equity and Liabilities’ of the Balance Sheet till the forfeited shares are reissued.

Illustration 10

Honda Limited issued 10,000 equity shares of 100 each payable as follows: Rs. 20 on application, Rs. 30 on allotment, Rs. 20 on first call and Rs. 30 on second and final calls 10,000 shares were applied for and allotted. All money due was received with the exception of both calls on 300 shares held by Supriya. These shares were forfeited. Give necessary journal entries.

Journal

Date	Particulars	L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
	Bank A/c Dr. To Share Application A/c (Application money on 10,000 shares @Rs.20 per share received)		2,00,000	 2,00,000
	Share Application A/c Dr. To Share Capital A/c (Application money transferred to share capital)		2,00,000	 2,00,000
	Share Allotment A/c Dr. To Share Capital A/c (Money due on allotment of 10,000 shares @Rs. 30 per share)		3,00,000	 3,00,000
	Bank A/c Dr. To Share Allotment A/c (Allotment Money received on 10,000 shares @ Rs. 30 per share on)		3,00,000	 3,00,000
	Bank A/c Dr. To Share Allotment A/c (Allotment Money received on 10,000 shares @ Rs. 30 per share on)		3,00,000	 3,00,000
	Share First Call A/c Dr. To Share Capital A/c (Money due on 10,000 shares @ Rs. 20 per share on Ist Call)		2,00,000	 2,00,000
	Bank A/c Dr. To Share First Call A/c (First call money received except for 300 shares)		1,94,000	 1,94,000
	Share Second and Final Call A/c Dr. To Share Capital A/c (Money due on 10,000 shares @ Rs. 30 per share on Second and Final Call)		3,00,000	 3,00,000
	Bank A/c Dr. To Share Second and Final Call A/c (Second and Final Call money received except for 300 shares)		2,91,000	 2,91,000
	Share Capital A/c Dr. To Share First Call A/c To Share Second and Final Call A/c To Share Forfeiture A/c (300 shares Forfeited)		30,000	 6,000 9,000 15,000

ILLUSTRATION:

Ashok Limited issued 3,00,000 equity shares of Rs. 10 each at a premium of Rs. 2 per share, payable as Rs. 3 on application, Rs. 5 on allotment (including premium) and the balance in two calls of equal amount. Applications were received for 4,00,000 shares and pro-rata allotment was

made to all the applicants. The excess application money was adjusted towards allotment. Mukesh who was allotted 800 shares failed to pay both the calls and his shares were forfeited after the second call. Record necessary journal entries in the books of Ashok Limited and also show the balance sheet:

Solution:

Books of Ashok Limited
Journal

Date	*Particulars*		*L.F.*	*Debit Amount (Rs.)*	*Credit Amount (Rs.)*
	Bank A/c	Dr.		12,00,000	
	To Equity Share Application A/c				12,00,000
	(Application money received on 4,00,000 shares)				
	Equity Share Application A/c	Dr.		12,00,000	
	To Equity Share Capital A/c				9,00,000
	To Equity Share Allotment A/c				3,00,000
	(Application money on 3,00,000 shares transferred to share capital account and the excess amount adjusted to share allotment account)				
	Equity Share Allotment A/c	Dr.		15,00,000	
	To Equity Share Capital A/c				9,00,000
	To Securities Premium Reserve A/c				6,00,000
	(Allotment money due on 3,00,000 shares)				
	Bank A/c	Dr.		12,00,000	
	To Equity Share Allotment Reserve A/c				12,00,000
	(Allotment amount received after adjusting excess money received with application)				
	Equity Share First Call A/c	Dr.		6,00,000	
	To Equity Share Capital A/c				6,00,000
	(First Call amount due on 3,00,000 shares)				
	Bank A/c	Dr.		5,98,400	
	Calls in Arrears A/c	Dr.		1,600	
	To Equity Share First Call A/c				6,00,000
	(First Call amount received on 2,99,200 shares)				

Bank A/c Dr.		5,98,400	
Calls in Arrears A/c Dr.		1,600	
To Equity Share Second and Final Call A/c			6,00,000
(Amount on 2,99,200 shares received)			
Equity Share Capital A/c Dr.		8,000	
To Share Forfeiture A/c			4,800
To Call in Arrears A/c			3,200
(Forfeiture of 800 shares)			

Balance Sheet of Ashok Limited as on ....

Particulars	*Note No.*	*Amount (Rs.)*
I EQUITY AND LIABILITIES		
1. Shareholders' Funds		
(a) Share Capital	1	29,96,800
(b) Reserves and Surplus	2	6,00,000
		35,96,800
II ASSETS		
1. Current Assets		
Cash and Cash Equivalents	3	35,96,800
		35,96,800

Notes to Accounts

1. *Share Capital*		*Rs.*
Authorised Capital		
... Equity shares of Rs. 10 each		
Issued Capital		
3,00,000 Equity shares of Rs. 10 each		**30,00,000**
Subscribed Capital		
Subscribed and Fully Paid-up		
2,99,200 Equity shares of Rs. 10 each		29,92,000
Add: Share forfeiture accounts		4,800
		29,96,800
2. *Reserves and Surplus*		
Securities Premium Reserve		**6,00,000**
3. *Cash and Cash Equivalents*		
Cash at bank		**35,96,800**

Problem

Janta Papers Limited invited applications for 1,00,000 equity shares of Rs. 25 each payable as under:

On Application Rs. 5.00 per share

On Allotment Rs. 7.50 per share

On First Call Rs. 7.50 per share

(due two months after allotment)

On Second and Final Call Rs. 5.00 per share (due two months after First Call)

Applications were received for 4,00,000 shares on January 01, 2017 and allotment was made on February 01, 2017.

Record journal entries in the books of the company to record these share capital transactions under each of the following circumstances:

1 The directors decide to allot 1,00,000 shares in full to selected applicants and the applications for the remaining 3,00,000 shares were rejected outright.

2 The directors decide to make a pro-rata allotment of 25 per cent of the shares applied for to every applicant; to apply the balance of application money towards amount due on allotment; and to refund the amount remaining thereafter.

3 The directors totally reject applications for 2,00,000 shares, accept full applications for 80,000 shares and make a pro-rata allotment of the 20,000 shares to remaining applicants and the excess application money is to be adjusted towards allotment and calls to be made.

Books of Janta Papers Limited
Journal

First Alternative

Date	Particulars		L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
2017 January 01	Bank A/c	Dr.		20,00,000	
	To Equity Share Application A/c				20,00,000
	(Money received on applications for 4,00,000 shares @ Rs. 5 per share)				
February 01	Equity Share Application A/c	Dr.		20,00,000	
	To Equity Share Capital A/c				5,00,000
	To Bank A/c				15,00,000
	(Transfer of application money on 1,00,000 shares to share capital and money refunded on rejected applications)				
February 01	Equity Share Allotment A/c	Dr.		7,50,000	
	To Equity Share Capital A/c				7,50,000
	(Amount due on the allotment of 1,00,000 shares @ Rs 7.50 per share)				
	Bank A/c	Dr.		7,50,000	
	To Equity Share Allotment A/c				7,50,000
	(Allotment money received)				
April 01	Equity Share First Call A/c	Dr.		7,50,000	
	To Equity Share Capital A/c				7,50,000
	(First call money due on 1,00,000 shares @ Rs. 7.50 per share)				
April 01	Bank A/c	Dr.		7,50,000	
	To Equity Share First Call A/c				7,50,000
	(First call money received)				
June 01	Equity Share Second and Final Call A/c	Dr.		5,00,000	
	To Equity Share Capital A/c				5,00,000
	(Final Call money due on 1,00,000 shares @ Rs. 5 per share)				
June 01	Bank A/c	Dr.		5,00,000	
	To Equity Share Second and Final Call A/c				5,00,000
	(Final call money received)				

Second Alternative

Date	Particulars	L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
2017 January 01	Bank A/c Dr.		20,00,000	
	To Equity Share Application A/c			20,00,000
	(Money received on applications for 4,00,000 shares @ Rs. 5 per share)			
February 01	Equity Share Application A/c Dr.		20,00,000	
	To Equity Share Capital A/c			5,00,000
	To Equity Share Allotment A/c			7,50,000
	To Bank A/c			7,50,000
	(Transfer of application money on Shares allotted to share capital, excess application amount credited to allotment account and money refunded on rejected applications)			
February 01	Equity Share Allotment A/c Dr.		7,50,000	
	To Equity Share Capital A/c			7,50,000
	(Amount due on the allotment of Rs. 1,00,000 shares @ Rs 7.50 per share)			

Third Alternative

Date	Particulars	L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
2017 January 01	Bank A/c Dr.		20,00,000	
	To Equity Share Application A/c			20,00,000
	(Money received on applications for 4,00,000 shares @ Rs. 5 per share)			

February 01	Equity Share Application A/c Dr.		20,00,000	
	To Equity Share Capital A/c			5,00,000
	To Equity Share Allotment A/c			1,50,000
	To Calls-in-Advance A/c			2,50,000
	To Bank A/c			11,00,000
	(Amount on share application adjusted to share capital, share allotment and calls in advance and the balance refunded including the money on rejected applications)			
February 01	Equity Share Allotment A/c Dr.		7,50,000	
	To Equity Share Capital A/c			7,50,000
	(Transfer of application money on shares allotted to share capital and amount due on the allotment of 1,00,000 shares @ Rs. 7.50 per share)			
	Bank A/c Dr.		6,00,000	
	To Equity Share Allotment A/c			6,00,000
	(Allotment money received)			
April 01	Equity Share First Call A/c Dr.		7,50,000	
	To Equity Share Capital A/c			7,50,000
	(First Call money due on 1,00,000 shares @ Rs. 7.50 per share)			

April 01	Bank A/c Dr. Calls in Advance A/c Dr. To Equity Share First Call A/c (Calls-in-advance adjusted against first call and the balance money on call received)		6,00,000 1,50,000	 7,50,000
June 01	Equity Share Second and Final Call A/c Dr. To Equity Share Capital A/c (Final Call money due on 1,00,000 shares @ Rs. 5 per share)		5,00,000	 5,00,000
June 01	Bank A/c Dr. Calls in Advance A/c Dr. To Equity Share Second and Final Call A/c (Calls-in-advance adjusted against final call and the balance money on call received)		4,00,000 1,00,000	 5,00,000

Working Notes:

	(Rs.)	(Rs.)
Excess Application Money		15,00,000
Less Transfers :		
Share Allotment —		
20,000 shares @ Rs. 7.50	1,50,000	
Share Calls —		
20,000 shares @ Rs. 12.50	2,50,000	4,00,000[1]
Amount to be refunded (including that on the rejected applications)		11,00,000

Problem

Mona Earth Mover Limited decided to issue 12,000 shares of Rs.100 each payable at Rs.30 on application, Rs.40 on allotment, Rs.20 on first call and balance on second and final call. Applications were received for 13,000 shares. The directors decided to reject application of 1,000 shares and their application money being refunded in full. The allotment money was duly received on all the shares, and all sums due on calls are received except on 100 shares.

Record the transactions in the books of Mona Earth Movers Limited

Solution

Books of Mona Earth Mover Limited

Journal

Date	*Particulars*	*L.F.*	*Debit Amount (Rs.)*	*Credit Amount (Rs.)*
	Bank A/c Dr.		3,90,000	
	To Share Application A/c			3,90,000
	(Application money on 13,000 shares @ Rs.30 per share received)			
	Share Application A/c Dr.		3,60,000	
	To Share Capital A/c			3,60,000
	(Application money transferred to share capital)			
	Share Application A/c Dr.		30,000	
	To Bank A/c			30,000
	(Application money on 1,000 shares returned]			
	Share Allotment A/c Dr.		4,80,000	
	To Share Capital A/c			4,80,000
	(Money due on allotment of 12,000 shares @ Rs. 40 per share)			
	Bank A/c Dr.		4,80,000	
	To Share Allotment A/c			4,80,000
	(Money received on 12,000 shares @ Rs. 40 per share on allotment)			

	Share First Call A/c Dr.		2,40,000	
	To Share Capital A/c			2,40,000
	(Money due on 12,000 shares @ Rs. 20 per share on first Call)			
	Bank A/c Dr.		2,38,000	
	To Share First Call A/c			2,38,000
	(First Call money received except for 100 shares)			
	Share Second and Final Call A/c Dr.		1,20,000	
	To Share Capital A/c			1,20,000
	(Money due on 12,000 shares @ Rs. 10 per share on Second and final Call)			
	Bank A/c Dr.		1,19,000	
	To Share Second and Final Call A/c			1,19,000
	(Second and final call money received except for 100 shares)			

UNIT – 3

PROFIT PRIOR TO INCORPORATION

INTRODUCTION AND MEANING:

When a running business is taken over by the promoters of a company, as at a date prior to the date of incorporation of company, the amount of profit or loss of such a business for the period prior to the date the company came into existence is referred to as pre-incorporation profits or losses. Such profits or losses, though belonging to the company or payable by it, are of capital nature; it is necessary to disclose them separately from trading profits or losses. The general practice in this regard is that:

i. If there is a loss,

(a)it is either written off by debit to the Profit and Loss Account or to a special account described as "Loss Prior to Incorporation" and show as an "asset" in the Balance Sheet,

(b)Alternatively, it may be debited to the Goodwill Account.

ii. On the other hand, if a profit has been earned by business prior to the same being taken over and the same is not fully absorbed by any interest payable for the period, it is credited to Capital Reserve Account or to the Goodwill Account, if any goodwill has been adjusted as an asset. The profit will not be available for distribution as a dividend among the members of the company.

APPORTIONMENT BETWEEN PRE AND POST INCORPORATION PERIOD

Item	***Basis of Apportionment between pre and Post incorporation period***
Gross Profit or Gross Loss	Sales Ratio-On the basis of turnover in the respective periods (first preference) Or On the basis of cost of goods sold in the respective periods in the absence of any information regarding turnover (second preference) Or Time Ratio-On the basis of time in the respective periods in the absence of any information regarding turnover and cost of goods sold (third preference)
Variable expenses linked with Turnover [e.g. Carriage/Cartage	Sales Ratio

outward, Selling and distribution expenses, Commission to selling agents/travelling agents, advertisement expenses, Bad debts, Brokerage, Sales Promotion]	
Fixed Common charges [e.g., Salaries, Office and Administration Expenses, Rent, Rates and Taxes, Printing and Stationery, Telephone, Telegram and Postage, Depreciation, Miscellaneous Expenses]	Time Ratio
Expenses exclusively relating to pre-Incorporation period [e.g. Interest on Vendor's Capital]	Charge to pre-incorporation period (but if the purchase consideration is not paid on taking over of business, interest for the subsequent period is charged to post incorporation period)
Expenses exclusively relating to post-incorporation period [e.g. Formation expenses, interest on debentures, director's fees, Directors' remuneration, Preliminary Expenses, Share issue Expenses, Underwriting commission, Discount on issue of securities.	Charge to Post-incorporation period

Audit Fees	
(i) For Company's Audit under the Companies Act.	Charge to Post-incorporation period
(ii) For Tax Audit under section 44AB of the Income tax Act, 1961	On the basis of turnover in the respective periods
Interest on purchase consideration to vendor:	
(i) For the period from the date of acquisition of business to date of incorporation.	Charge to Pre-incorporation period
(ii) From the date of incorporation	Charge to Post-incorporation period

Calculation of time ratio and sales ratio

Example

Lion Ltd. was incorporated on 1.8.20X1 to take over the running business of M/s Happy with assets from 1.4.20X1. The accounts of the company were closed on 31.3.20X2.

The average monthly sales during the first four months of the year (20X1-X2) was twice the average monthly sales during each of the remaining eight months.

Calculate time ratio and sales ratio for pre and post incorporation periods.

Solution

Time ratio:

Pre-incorporation period (1.4.20X1 to 1.8.20X1)	=	4 months
Post incorporation period (1.8.20X1 to 31.3.20X2)	=	8 months
Time ratio	=	4 : 8 or 1 : 2

Sales ratio:

Average monthly sale before incorporation was twice the average sale per month of the post incorporation period. If weightage for each post-incorporation month is x, then

Weighted sales ratio = 4 × 2x : 8 × 1x = 8x : 8x or 1 : 1

ILLUSTRATION - 1:

Rama Udyog Limited was incorporated on August 1, 20X1. It had acquired a running business of Rama & Co. with effect from April 1, 20X1. During the year 20X1-X2, the total sales were ₹ 36,00,000. The sales per month in the first half year were half of what they were in the later half year. The net profit of the company, ₹ 2,00,000 was worked out after charging the following expenses:

(i) Depreciation ₹ 1,23,000, (ii) Directors' fees ₹ 50,000, (iii) Preliminary expenses ₹ 12,000, (iv) Office expenses ₹ 78,000, (v) Selling expenses ₹ 72,000 and (vi) Interest to vendors upto August 31, 20 X1 ₹ 5,000.

Please ascertain pre-incorporation and post-incorporation profit for the year ended 31st March, 20X2.

Solution

Statement showing pre and post incorporation profit for the year ended 31st March, 20X2

Particulars	*Total Amount* ₹	*Basis of Allocation*	*Pre-incorporation* ₹	*Post-Incorporation* ₹
Gross Profit (W.N.3)	5,40,000	2:7	1,20,000	4,20,000
Less: Depreciation	1,23,000	1:2	41,000	82,000
Director's Fees	50,000	Post	-	50,000
Preliminary Expenses	12,000	Post	-	12,000
Office Expenses	78,000	1:2	26,000	52,000
Selling Expenses	72,000	2:7	16,000	56,000
Interest to vendors	5,000	Actual	4,000	1,000
Net Profit (₹ 33,000 being pre-incorporation profit is transferred to capital reserve Account)	2,00,000		33,000	1,67,000

Working Notes:

1. Sales ratio

The sales per month in the first half year were half of what they were in the later half year. If in the later half year, sales per month is x then it should be .5 x per month in the first half year. So sales for the first four months (i.e. from 1st April, 20X1 to 31st July, 20X1) will be 4 × .50 = ₹ 2 and for the last eight months (i.e. from 1st August, 20 X1 to 31st March, 20X2) will be (2 × .50 + 6 × 1) = ₹ 7. Thus sales ratio is 2:7.

2. Time ratio

1st April, 20X1 to 31st July, 20X1 : 1st August, 20X1 to 31st March, 20X2

= 4 months: 8 months = 1:2

Thus, time ratio is 1:2.

3. Gross profit

Gross profit = Net profit + All expenses

= ₹ 2,00,000 + ₹ (1,23,000+50,000+12,000+78,000+72,000+5,000)

= ₹ 2,00,000 +₹ 3,40,000 = ₹ 5,40,000.

Illustration 2

The promoters of Glorious Ltd. took over on behalf of the company a running business with effect from 1st April, 20X1. The company got incorporated on 1st August, 20X1. The annual accounts were made up to 31st March, 20X2 which revealed that the sales for the whole year totalled ₹ 1,600 lakhs out of which sales till 31st July, 20X1 were for ₹ 400 lakhs. Gross profit ratio was 25%.

The expenses from 1st April 20X1, till 31st March, 20X2 were as follows:

	(₹ in lakhs)
Salaries	*69*
Rent, Rates and Insurance	*24*
Sundry Office Expenses	*66*
Travellers' Commission	*16*
Discount Allowed	*12*

Bad Debts	*4*
Directors' Fee	*25*
Tax Audit Fee	*9*
Depreciation on Tangible Assets	*12*
Debenture Interest	*11*

Prepare a statement showing the calculation of Profits for the pre-incorporation and post-incorporation periods.

Solution

Statement showing the calculation of Profits for the pre-incorporation and post-incorporation periods

Particulars	***Total Amount***	***Basis of Allocation***	***Pre-incorporation***	***Post-incorporation***
	(₹ in lakhs)		***(₹ in lakhs)***	***(₹ in lakhs)***
Gross Profit (25% of ₹ 1,600)	400	Sales	100	300
Less: Salaries	69	Time	23	46
Rent, rates and Insurance	24	Time	8	16
Sundry office expenses	66	Time	22	44
Travellers' commission	16	Sales	4	12
Discount allowed	12	Sales	3	9
Bad debts	4	Sales	1	3
Directors' fee	25	Post	-	25
Tax Audit Fees	9	Sales	2.25	6.75
Depreciation on tangible assets	12	Time	4	8
Debenture interest	11	Post	-	11
Net profit	152		32.75	119.25

Working Notes:

1. Sales ratio

	(₹ in lakh)
Sales for the whole year	1,600
Sales up to 31st July, 20X1	400
Therefore, sales for the period from 1st August, 20X1 to 31st March, 20X2	1,200

Thus, sale ratio = 400:1200 = 1:3

2. Time ratio

1st April, 20X1 to 31st July, 20X1 : 1st August, 20X1 to 31st March, 20X2

= 4 months: 8 months = 1:2

Thus, time ratio is 1:2.

Illustration 3

Inder and Vishnu, working in partnership registered a joint stock company under the name of Fellow Travellers Ltd. on May 31, 20X1 to take over their existing business. It was agreed that they would take over the assets of the partnership from January 1st, 20X1 for a sum of ₹ 3,00,000 and that until the amount was discharged they would pay interest on the amount at the rate of 6% per annum. The amount was paid on June 30, 20X1. To discharge the purchase consideration, the company issued 20,000 equity shares of ₹ 10 each at a premium of ₹ 1 each and allotted 7% Debentures of the face value of ₹ 1,50,000 to the vendors at par.

The summarised Profit and Loss Account of the "Fellow Travellers Ltd." for the year ended 31st December, 20X1 was as follows:

		₹			₹
To	*Purchase, including Inventory*	*1,40,000*	*By*	*Sales:*	
To	*Freight and carriage*	*5,000*		*1st January to 31st May 20X1*	*60,000*
To	*Gross Profit c/d*	*60,000*		*1st June to 31st Dec., 20X1*	*1,20,000*
			By	*Inventory in hand*	*25,000*
		2,05,000			*2,05,000*

To Salaries and Wages	*10,000*	*By Gross profit b/d*	*60,000*
To Debenture Interest	*5,250*		
To Depreciation	*1,000*		
To Interest on purchase Consideration (up to 30-6-20X1)	*9,000*		
To Selling commission	*9,000*		
To Directors' Fee	*600*		
To Preliminary expenses	*900*		
To Provision for taxes (entirely related with company)	*6,000*		
To Dividend paid on equity shares @ 5%	*5,000*		
To Balance c/d	*13,250*		
	60,000		*60,000*

Prepare statement apportioning the expenses and calculate profits/losses for the 'post' and 'pre-incorporation' periods and also show how these figures would appear in the Balance Sheet of the company.

Solution

Fellow Travellers Ltd.

Statement showing calculation of profit /losses for pre and post incorporation periods

		Ratio	Pre-incorporation	Post-incorporation
Gross profit allocated on the basis of sale		1:2	20,000	40,000
Less: Administrative Expenses allocated				
On time basis:				
(*i*) Salaries and wages	10,000			
(*ii*) Depreciation	1,000			
	11,000	5:7	4,583	6,417

Selling Commission on the basis of sales		1:2	3,000	6,000
Interest on Purchase Consideration (Time basis)		5:1	7,500	1,500
Expenses applicable wholly to the Post-incorporation period:				
Debenture Interest (1,50,000 x 7% x 6/12)	5,250			
Director's Fee	600			5,850
Preliminary expenses				900
Provision for taxes				6,000
Balance c/d to Balance Sheet			4,917	13,333

Time Ratio

Pre incorporation period = 1 January 20X1 to 31 May 20X1 = 5 months

Post incorporation period = 1 June 20X1 to 31 December 20X1 = 7 months

Time ratio = 5: 7

Sales Ratio

Sales in pre incorporation period (1 January 20X1 to 31 May 20X1) = ₹ 60,000

Sales in post incorporation period (1 June 20X1 to 31 December 20X1) = ₹ 1,20,000

Sales ratio = 1:2

Fellow Travellers Ltd.

Extract from the Balance Sheet as on 31st Dec., 20X1

		Particulars	*Notes*	₹
		Equity and Liabilities		
1		**Shareholders' funds**		
	a	Share capital	1	2,00,000
	b	Reserves and Surplus	2	33,250
2		**Non-current liabilities**		
	a	Long-term borrowings	3	1,50,000

3		**Current liabilities**		
	a	Short term provisions	4	6,000
		Total		3,89,250

Notes to accounts

			₹
1.	**Share Capital**		
	20,000 equity shares of ₹ 10 each fully paid		2,00,000
2.	**Reserves and Surplus**		
	Profit Prior to Incorporation		4,917
	Securities Premium Account		20,000
	Profit and loss Account	13,333	
	Less: Dividend on equity share	(5,000)	8,333
	Total		33,250
3.	**Long term borrowings**		
	Secured		
	7% Debentures		1,50,000
4.	**Other Current liabilities**		
	Provision for Taxes		6,000

Illustration 12 (Problem with Fluctuations in Sales and Rent)

X. Ltd., which was incorporated on May 1, 2012, acquired a business on January 1, 2012. The first accounts were closed on September 30, 2012.

The Gross Profit for the period was ₹ 42,000. S.R

Details of other expenses : general expenses (T.R) ₹ 7,200; directors' remuneration (Post) ₹ 12,000; and preliminary expenses (Post) ₹ 2,000.

Rent up to June 30 was ₹ 6,000 per annum after which it was increased by 40%.

Salary of the manager, who on formation of the Company had become a wholetime director and whose remuneration has been given above, was agreed at ₹ 5,100 per annum.

The Company earned a uniform Gross Profit. The sales up to September 2012 were ₹ 98,000. The monthly average of sales for the first four months of the year was one-half of the remaining period.

Show the Profit and Loss Account and indicate how you would deal with the pre-incorporation results.

(C.A.)

Solution:

Dr. Profit and Loss Account for the period from January 1, 2002 to September 30, 2012

Particular	*Ratio*	*Pre-incorporation* ₹	*Post-incorporation* ₹	*Particular*	*Ratio*	*Pre-incorporation* ₹	*Post-incorporation* ₹
To General expenses	4:5	3,200	4,000	By Gross Profit	2:5	12,000	30,000
To Directors' remuneration(Post)		—	12,000				
To Preliminary expenses(Post)		—	2,000				
To Rent (Note)		2,000	3,100				
To Manager's salary (Note)		1,700	—				
To Net Profit transfered to:							
— Capital reserve A/c		5,100					
— Profit & Loss App. A/c		—	8,900				
		12,000	**30,000**			**12,000**	**30,000**

Notes:

	Pre-incorporation		*Post-incorporation*
1. ***Time Ratio***	Jan. 1,'02 to April 30, '02	:	May 1, '02 to Sept. 30, '02
	4	:	5

2. ***Sales Ratio*** : Let the average sales for the first 4 months be X

∴ The average sales for the next 5 months be 2X

First 4 months' sales = 4 × X=4X

Next 5 months' sales = 5 × 2X=10X

Sales Ratio = 4X : 10X

= 2X : 5X

= 2 : 5

3. ***Rent*** up to May 1, 2012, is at ₹ 500, *i.e.*, 500 × 4 = **₹ 2,000**

Rent for May and June — 500 × 2 = ₹ 1,000

July, August and September — 700 × 3 = ₹ 2,100 **= ₹ 3,100**

4. ***Salary to the manager*** for the first 4 months being 5,100 × 4/12 = **₹ 1,700.**

5. Pre-incorporation profit is a capital profit — dividends cannot be paid out of it. It can be used by the directors to write off expenses and commission on the issue of shares or debentures, preliminary expenses, etc.

Illustration 13 (Calculation of Cost of Sales to findout Gross Profit)

Sarvottam Ltd., was incorporated on January 1, 2012, with an authorised capital of ₹ 50,000 and took over the running business of Uttam Bros. as from October 1, 2011. The following is the summarised Profit and Loss Account for the year ended September 30, 2012.

	₹	₹
Sales		
Oct. 1, 2011, to Dec. 31, 2011	60,000	
Jan. 1, 2012, to Sept. 30, 2012	1,90,000	2,50,000
Cost of sales for the year	1,54,000	
Administrative expenses T.R	17,680	
Selling commission S.R	8,750	
Goodwill written off P of	2,000	
Interest to vendors (loan repaid on Feb. 1, 2012) T.R	3,730	

Illustration 14 (Problem with Profit and Loss Account and Balance Sheet)

Parinitha Ltd., incorporated on April 1, 2011, with a capital of ₹ 50,000 in equity shares of ₹ 10 each took over the running business of Parinitha as from January 1, 2011. The purchase price ₹ 20,000 was settled on July 1, 2011, together with interest at 10% per annum by fully paid shares for ₹ 17,500 and the balance by cheque.

The Company's Trial Balance as on December 31, 2011, was as below :

	₹	₹
Cash and Bank balances (Cash ₹ 180)	4,860	
Share capital		22,500
Land and buildings	8,000	
Fixtures	750	
Cycles	1,000	
Salaries	1,200	
Purchases	48,500	
Sales		45,000
Debtors and creditors	4,500	3,000
Rent from tenants		600
Rent, rates and taxes	300	
Building upkeep	150	
Directors' fees	720	
Sundry charges	120	
Interest to vendor	1,000	
	71,100	71,100

Prepare the final accounts for the year ending December 31, 2011, considering the following additional details:

(1) Stock at end ₹ 14,000.

(2) Bad debts ₹ 200 (including ₹ 50 on debtors taken over from vendor) to be written off.

(3) Sales above include sales up to April 1, 2011, ₹ 7,500.

(4) Provide for doubtful debts ₹ 250.

(5) Depreciate buildings 5% and cycles 20%.

(A.C.S.)

Notes: (1) Time Ratio 3:9 = 1:3

(2) Sales Ratio 7,500 : 37,500 = 1 : 5

(3) Revised Time ratio

Pre-incorporation period - 3 months

Post-incorporation period - 3 months

∴ Revised time ration = 3 : 3 or 1 : 1

Solution:

Dr. Trading and Profit and Loss Account for the year ended December 31, 2011 Cr.

	₹		₹
To Purchases	48,500	By Sales	45,000
To Gross Profit c/d	10,500	By Closing Stock	14,000
	59,000		59,000

Dr. Cr.

Particular	*Ratio*	*Pre-incorporation* ₹	*Post-incorporation* ₹	*Particular*	*Ratio*	*Pre-incorporation* ₹	*Post-incorporation* ₹
To Salaries	1:3	300	900	By Gross Profit b/d	1:5	1,750	8,750
To Rent, rates	1:3	75	225	By Rent from tenants	1:3	150	450
To Building upkeep	1:3	38	112.				
To Directors' fees	post	—	720				
To Sundry charges	1:3	30	90				
To Interest to vendors	1:1	500	500				
To Bad debts	1:3	50	150				
To Provision for doubtful debts		—	250				
To Depreciation:	post						
Building 400							
Cycles 200							
600	1:3	150	450				
To Net Profit transferred to							
Capital Reserve		757					
P/L Appropriation Account			5,803				
		1,900	**9,200**			**1,900**	**9,200**

Balance Sheet of Parinitha Ltd. as on December 31, 2001

Liabilities	₹	₹	*Assets*	₹	₹
Share capital		22,500	Fixed Assets:		
Reserves and surplus:			Land and buildings	8,000	
Capital reserve		757	*Less*: Depreciation 5% p.a	400	7,600
Profit and Loss Account		5,803			
Current liabilities and provisions:			Fixtures		750
			Cycles	1,000	
Sundry creditors		3,000	*Less*: Depreciation 20%	200	800
			Investments		Nil
			Current assets, loans and advances:		
			Stock		14,000
			Sundry Debtros (4,500 – 200)	4,300	
			Less: Provision for bad debts	250	4,050
			Bank [4,860 - 180]		4,680
			Cash		180
			Miscellaneous expenditure		nil
		32,060			32,060

UNIT – 4

VALUATION OF GOODWILL AND VALUATION OF SHARES

DEFINITION:

According to SSAP-22, UK Accounting Standard on Accounting for Goodwill, "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."

If time value is taken into consideration , Goodwill may be defined as Present value of firms anticipated excess earnings.

DISTINGUISHING FEATURES OF GOODWILL:

1. Goodwill is an intangible asset. It is non-visible but it is not a fictitious asset.

2. It cannot be separated from the business and therefore cannot be sold like other identifiable and separable assets, without disposing off the business as a whole.

3. The value of goodwill has no relation to the amount invested or cost incurred in order to build it.

4. Valuation of goodwill is subjective and is highly dependent on the judgment of the valuer.

5. Goodwill is subject to fluctuations. The value of goodwill may fluctuate widely according to internal and external factors of business.

FACTORS AFFECTING GOODWILL:

1. Outstanding quality of products/services.

2. Locational factors—If a business is located at a favorable place; it enhances the value of goodwill.

3. The period for which the business has been in business.

4. Special advantages—A company that enjoys special advantages such as favourable contracts, assured supply of raw material at low rates, possession of trademarks, patents, copyrights, technical knowhow and research and development, well known collaborators etc. contribute to higher value of goodwill.

5. Nature of Business—A business having stable continuous demand for its products such as consumer goods is able to earn more profits and hence has more goodwill. If the business is risky, profits will be uncertain. The monopoly condition or limited competition enables the enterprise to earn higher profits which leads to higher value of goodwill.

6. Good relations with customers, suppliers, labour and government.

7. Efficiency of Management—A firm having efficient management enjoys advantages of high productivity and cost of efficiency. This leads to higher profits which in turn increases the value of goodwill.

8. Capital Required—If two businesses have same rate of profit, the business which requires lesser amount of capital tends to enjoy more goodwill.

NEED FOR VALUATION OF GOODWILL:

a) In the Case of a Sole-Proprietorship Firm:

(i) If the firm is sold to another person;

(ii) If it takes any person as a partner and

(iii) If it is converted into a company.

(b) In the Case of a Partnership Firm:

(i) If any new partner is taken;

(ii) If any old partner retires from the firm;

(iii) If there is any change in profit-sharing ratio among the partners;

(iv) If any partner dies;

(v) If different partnership firms are amalgamated;

(vi) If any firm is sold and

(vii) If any firm is converted into a company.

(c) In the Case of a Company:

(i) If the goodwill has already been written-off in the past but value of the same is to be recorded further in the books of accounts.

(ii) If an existing company is being taken with or amalgamated with another existing company;

(iii) If the Stock Exchange Quotation of the value of shares of the company is not available in order to compute gift tax, wealth tax etc.; and

(iv) If the shares are valued on the basis of intrinsic values, market value or fair value methods.

METHODS OF VALUATION OF GOODWILL :

Simple average Profit Method : Under this method , average profit for last few years and fixes the value of goodwill as to many years purchase of this amount . at the first average profit is calculated on the basis of past few years profits , at the time of calculating average profit ,precaution must be taken in respect of any abnormal items of profit or loss which may affect the future profit . after calculating the average profit , it s multiplied by number as agreed . The product will be value of goodwill .

Simple Average Vs. Weighted Average

While averaging past profits, an attempt must be made to arrive at a realistic figure. It is possible only when we know the trend of profits earned in the past. It is easy to calculate average profits when there are no wide fluctuations in the profits earned for the period under consideration. Under such a situation the simple average profit will give a realistic figure. However, if there are wide fluctuations from year to year, a simple average will fail to ascertain the future trend. Thus, to arrive at a true figure of future maintainable profits, the weighted average must be applied. Under this method the profits are arranged chronologically and multiplied by their respective number *i.e.* 1, 2, 3, 4, 5 & so on giving highest weightage to the most recent past year's profits and the least weightage to the earliest year's profits.

Thus to calculate goodwill, following steps are required.

(A) For simple average

1. Find out the actual profits of the past years. Take the average.
2. Make necessary adjustments with reference to past and provide for the future events and adjustments having a bearing on future profits to ascertain future maintainable profits.
3. Multiply by the number of year's purchase, as required in the question.
4. Resultant is the value of goodwill.

(B) For Weighted Average

(1) Fund out the past years' actual profits.

(2) Make necessary adjustment in respective year's of profits with reference to past events.

(3) Provide for the future adjustments.

(4) Calculate average profit by giving weightage in chronological order.

(5) Find out the weighted Average

(6) Multiply by the number of years' purchase as required in the question.

(7) Resultant is the value of goodwill.

Illustration 1

A Ltd. agreed to purchase business of a sole trader. For that purpose, goodwill is to be valued at 3 year's purchase of the average profits of last 5 years.

Profits for these years are :

2000 — Rs 40,000; 2001 — Rs 45,000; 2002 — Rs 36,000; 2003 — Rs 46,000; 2004 — Rs 50,000.

Solution

$$\text{Average Profit} = \frac{\text{Rs } 40{,}000 + \text{Rs } 45{,}000 + \text{Rs } 36{,}000 + \text{Rs } 46{,}000 + \text{Rs } 50{,}000}{5} = \text{Rs } 2{,}17{,}000 \div 5 = \text{Rs } 43{,}400.$$

Goodwill = 3 years' purchase of average profit of last 5 years = Rs 43,400 × 3 = Rs 1,30,200.

Illustration (1) (Simple Average Method)

X Ltd. purchased a running business of Mr. Y on 1st January 2006. The profits earned by Mr. Y for the last four years were as under.

	Rs.
Year ending 31st December, 2002	2,20,000
Year ending 31st December, 2003	2,10,000
Year ending 31st December, 2004	2,30,000
Year ending 31st December, 2005	2,40,000

Additional Information

(i) Included in the profits of the year 2005, a non-recurring item of profit of Rs. 25,000.

(ii) Profit for the year ending 31st December 2003 are affected by loss by fire of Rs. 20,000.

(iii) The closing stock for the year ending 31st December 2004 was over-valued by Rs. 10,000.

(iv) Acquisition of this business will require replacement of existing manager who was getting a salary of Rs. 10,000 p.m. The new manager is to be employed at a monthly salary of Rs. 12,000.

(v) Additional insurance premium is required to be made at Rs. 500 p.m.

Calculate goodwill at 2 year's purchase of average profit.

Solution:

			Rs.
	Profits for the year 2002		2,20,000
	Profits for the year 2003	2,10,000	
Add	Abnormal Loss (Loss by fire)	20,000	2,30,000
	Profits for the year 2004	2,30,000	
Less	Over Valuation of closing stock	(10,000)	2,20,000
	Profits for the year 2005	2,40,000	
Add	Under Valuation of opening stock	10,000	
		2,50,000	
Less	Non-recurring profits (Non-operating)	(25,000)	2,25,000
		Total profits	8,95,000
	Average Profits (8,95,000 ÷ 4)		2,23,750
Less	Additional Remuneration of the Manager (Rs. 2,000 × 12)		(24,000)
Less	Additional Insurance Premium (Rs. 500 × 12)		(6,000)
	Future Maintainable Profits		1,93,750
	Goodwill at 2 year's Purchase (Rs. 1,93,750 × 2)		3,87,500

Illustration (3) (Weighted Average Method)

On 1st April, 2006 A Ltd. proposed to purchase the business of B Ltd. Goodwill for this purpose is agreed to be valued at three years' purchase of the weighted average profits of the past four years. The appropriate weights were as under :

Year	Weight	Profit Rs.
2002-03	1	1,01,000
2003-04	2	1,24,000
2004-05	3	1,00,000
2005-06	4	1,40,000

On scrutiny of the accounts, the following facts were revealed.

(i) On 1st December, 2004, a major repair was made in respect of the plant incurring Rs. 30,000 which was charged to revenue. The said sum is agreed to be capitalised for goodwill calculation subject to adjustment of depreciation of 10% p.a. on reducing balancing method.

(ii) Closing stock for the year 2003-04 was over-valued by Rs. 12,000.

(iii) To cover the management cost, an annual charge of Rs. 24,000 should be made for the purpose of valuation of goodwill.

Compute Value of goodwill

Solution :

	Computation of Adjusted Profits	Rs.
2002-03	Profits as reported	1,01,000
Less	Managerial Cost	(24,000)
		77,000
2003-04	Profits as reported	1,24,000
Less	Over Valuation of Stock	(12,000)
Less	Managerial Cost	(24,000)
		88,000
2004-05	Profits as reported	1,00,000
Add	Over Valuation of Opening Stock	12,000
Add	Repairs to be Capitalised	30,000
		1,42,000
Less	Depreciation on Capitalised amount @ 10% p.a. for 4 months.	(1,000)
Less	Managerial Cost	(24,000)
		1,17,000
2005-06	Profits as reported	1,40,000
Less	Depreciation @ 10% on Rs. 29,000 (being W.D.V. of capitalised repair)	(2,900)
Less	Managerial Cost	(24,000)
		1,13,100

CALCULATION OF WEIGHTED AVERAGE PROFITS

Year	Adjusted Profits Rs.	Weightage	Amount Rs.
2002-03	77,000	1	77,000
2003-04	88,000	2	1,76,000
2004-05	1,17,000	3	3,51,000
2005-06	1,13,100	4	4,52,400
		10	10,56,400

Weighted Average Profits = (10,56,400 ÷ 10) = 1,05,640

Goodwill at 3 year's Purchase = (1,05,640 × 3) = 3,16,920

II SUPER PROFIT METHOD

Super profit refers to excess of adjusted average profit (Future Maintainable profit) over the normal profit. Normal profit represents profits based on normal rate of return (NRR) and the normal rate of return (NRR) is the rate of earnings which investors in general expect on their investments in any given industry. The NRR differs from industry to industry and depends upon many factors such as bank rate general economic conditions prevailing in the country, degree of risk attached to the investment and the duration or period of investment. To get normal profit the average capital employed is multiplied by the normal rate of return (NRR).

Thus remember :

Super Profit = Adjusted Average Profit – Normal Profit, and Normal Profit = Average Capital Employed × NRR. Adjusted Average Profits = Future Maintainable Profits

Illustration 10

The net profit of a company after providing for taxation for the past five years are :

Rs 40,000; Rs 50,000; Rs 30,000; Rs 70,000 and Rs 80,000.

The net tangible assets in the business is Rs 4,00,000 on which the normal rate of return is expected to be 10%. It is also expected that the company will be able to maintain its super profits for next five years.

Calculate the value of goodwill of the business on the basis of an annuity of super profits, taking the present value of an annuity of one rupee for five years at 10% interest is Rs 3.78.

Solution

Calculation of Average Profits

Particulars	Rs
1st Year	40,000
2nd Year	50,000
3rd Year	30,000
4th Year	70,000
5th Year	80,000
Total Profit	2,70,000
Average Profits = Rs 2,70,000 / 5 = Rs 54,000	

Calculation of Super Profits

Particulars	Rs
Average Profits	54,000
Less: Normal return on capital employed	
(10% of Rs 4,00,000)	40,000
Super Profits	14,000

Goodwill = Super Profit x Value of an annuity

Goodwill = Rs 14,000 × 3.78 = **Rs 52,920.**

Illustration (4) (Super Profit Method)

From the following particulars, calculate value of goodwill on the basis of three years' purchase of super profit. The actual profits for the last four years were as under :

		Rs.
2002-03	Profit	1,83,000
2003-04	Profit	2,25,000
2004-05	Loss	(30,000)
2005-06	Profit	3,15,000

Other information

(i) Capital employed (Average) Rs. 7,50,000

(ii) Market rate of return on investment 8%

(iii) Rate of risk attached to such investment 2%

(iv) Remuneration from alternative employment of the proprietor, if not engaged in business, Rs. 90,000 p.a.

(v) Salary of manager who is not required in new set up. Rs. 60,000 p.a.

Solution:

CALCULATION OF AVERAGE ADJUSTED PROFITS OR SAY FUTURE MAINTAINABLE PROFITS

Profits of the last four years :

		Rs.
	2002-03	1,82,000
	2003-04	2,25,000
	2004-05	– (30,000)
	2005-06	3,15,000
		6,92,000
	Average Profits (6,92,000 ÷ 4)	1,73,000
Less	Proprietor's salary from alternative employment	(90,000)
		83,000
Add	Manager's salary not to be paid in new set-up	60,000
	Future Maintainable Profits	1,43,000

Normal Profits :

8% + 2% = 10% of Rs. 7,50,000	75,000
Super Profits = 1,43,000 – 75,000 =	68,000
Goodwill at 3 years' purchase of Super profits = 68,000 × 3 =	2,04,000

III CAPITALISATION METHOD

There are two methods of calculating value of goodwill by capitalisation method.

(a) Capitalisation of super Profit

(b) Capitalisation of Average Profits.

Under capitalisation of super profit method goodwill is calculated by ascertaining the capitalised value of the super profit on the basis of normal rate of return. This method is based on the assumption that the business so acquired will continue to yield constant return.

$$\text{Thus value of goodwill} = \frac{\text{SuperProfit}}{\text{NRR}} \times 100$$

Assuming super profits of Rs. 12,500 and normal rate of return at 10%, the value of goodwill will be = $\left(\frac{12{,}500 \times 100}{10}\right)$ = Rs. 1,25,000

However, under **Capitalisation of Average Profits**, the value of goodwill is calculated by taking the difference between **capitalised value of adjusted average profits** (future maintainable profits) and **actual capital employed** in that business.

Goodwill = Normal Capital Employed – Actual Capital employed

Capital Employed

There are two approaches for calculating the amount of capital employed :

(i) ***Net Assets Approach***

Under this the capital employed is worked out by adding the current values of assets except :

- Non-trading (Non-business) assets such as investments made outside business.
- Goodwill appearing in the Balance Sheet or otherwise including Patents, copyrights & Trademarks.
- Fictitious Assets-such as debit balance of Profit & Loss A/c, Discount on Issue of shares/ debentures and Preliminary Expenses and deducting therefrom:
- All liabilities due to outsiders, long term or short term loans & current liabilities.

Average Capital Employed

Average capital employed means capital employed throughout the year which can be obtained by averaging the opening and closing capitals.

$$\text{Average capital Employed} = \frac{\text{Opening Capital} + \text{Closing Capital}}{2}$$

In other words the average capital employed is calculated by adding capital employed in the beginning of the year and capital employed at the end of the year and by dividing the total by two.

In case the opening capital of any year is not given, the Average capital Employed can be ascertained by deducting half of the current year's profit from the closing balance of capital employed. This is done on the presumption that profit has been earned uniformly throughout the year. It is to be noted that Normal Profits should be ascertained by multiplying the Average capital Employed by the Normal Rate of Return.

Illustration (6) (Capitalisation Method)

The following is the Balance Sheet of Addu & Somu Ltd. as on 31st March 2006

		Rs.
Liabilities:		
	9% Preference Shares of Rs. 100 each	2,50,000
	Equity Share Capital - Shares of Rs. 10 each	5,00,000
	General Reserve	3,00,000
	Profit & Loss Appropriation A/c	1,50,000
	9% Debentures	2,00,000
	Provision for taxation	50,000
	Accounts Payable	1,75,000
		16,25,000
Assets		
	Goodwill	50,000
	Net Blocks	9,00,000
	6% Government Securities	1,00,000
	Stock	2,70,000
	Debtors	1,95,000
	Cash & Bank balance	35,000
	Preliminary Expenses	55,000
	Discount on Issue of Debentures	20,000
		16,25,000

16,25,000

Additional Information:

1. Net Blocks are considered worth Rs. 10,00,000
2. The average profits of the company are estimated to be Rs. 1,56,000. The normal rate of return of the industry is 10%. Calculate the value of goodwill by
   (a) Capitalisation of average profit and
   (b) Capitalisation of super-profit.

Solution:

CALCULATION OF AVERAGE CAPITAL EMPLOYED

			Rs.
	Net Blocks		10,00,000
	Stock		2,70,000
	Debtors		1,95,000
	Cash & Bank balance		35,000
			15,00,000
Less	Liabilities		
	9% Debentures	2,00,000	
	Provision for Taxation	50,000	
	Accounts Payable	1,75,000	(4,25,000)
	Actual Capital Employed		10,75,000

	Balance d/d	10,75,000
Less	Half of the Profit of the current year 1/2 (Rs. 1,56,000 – 6,000)	75,000
	Average Capital Employed	10,00,000
	Normal Profits (Rs. 10,00,000 × NRR)	1,00,000
	Adjusted Average Profit	1,50,000
	Super profit	50,000
	(Average Adjusted Profits – Normal Profits)	

(a) Goodwill by Capitalisation of Average Profit – Capitalised Value of Average Profit.

$$= \frac{1,50,000 \times 100}{NRR}$$

$$= \frac{1,50,000 \times 100}{10} \qquad = 15,00,000$$

Average Capital Employed = 10,00,000

Value of Goodwill = 5,00,000

(Capital Value of Average Profits – Actual Capital employed)

(b) Goodwill by Capitalisation of Super Profit

$$= \text{Super Profit} \times \frac{100}{NRR} = 50,000 \times \frac{100}{10} \qquad = 5,00,000$$

(IV) ANNUITY METHOD

Goodwill is always paid in anticipation of earning excess (additional/abnormal) profits in future which are termed as 'Super Profit'. The goodwill as per annuity method is calculated by multiplying the super profit by the 'Reference to Annuity Table. It means value of goodwill is the present value of an annuity of the annual super profit which the purchaser will recover over a period of time gradually. Since payment of goodwill is made immediately in lumpsum in anticipation of future super profits, the purchaser bears the loss of interest. Hence goodwill is considered equal to present value of future returns. In other words goodwill is the discounted value of the total amount calculated as per purchase method. The expected extra (super) profits are discounted at normal rate of return. In the absence of reference to Annuity Table, the following formula should be applied for the purpose of calculating value of goodwill.

Illustration (7) (Annuity Method)

From the following particulars calculate the value of goodwill by Annuity Method.

(i) Net profits after tax for the last five years – Rs. 1,60,000, Rs. 1,66,000, Rs. 1,80,000, Rs. 1,94,000 and Rs. 2,10,000.

(ii) Capital employed in the business Rs. 10,00,000

(iii) Normal rate of return 10%

(iv) Present value of annuity for Re. 1 for five years at 10% interest is 3.78

The profits include interest on investments in Government Bonds on an average basis of Rs. 7,000.

Solution:

Average Profits for the last five years

$$= \frac{\text{Rs. } 1{,}60{,}000 + 1{,}66{,}000 + 1{,}80{,}000 + 1{,}94{,}000 + 2{,}10{,}000}{5}$$

$= 9{,}10{,}000 \div 5$

	Average Profits	= 1,82,000
Less	Non-business income	(7,000)
	Average Adjusted Profits	1,75,000

Normal Profits = Capital Employed × NRR

= Rs. 10,00,000 10%

= 1,00,000

Super Profit = Adjusted Profits – Normal Profit

= Rs. 1,75,000 – 1,00,000

= Rs. 75,000

Value of Goodwill $=$ Super Profit Reference to Annuity Table

$= 75{,}000 \times 3.78$

$=$ Rs. 2,83,500

VALUATION OF SHARES

INTRODUCTION AND MEANING OF VALUATION OF SHARES:

Shares are traded in the stock exchange where forces of demand and supply determine the price of various securities. The prices at which transactions take place are recorded and made public in the form of market quotations which help the investors and other to know current market prices of shares. But this information is available only in respect of public limited companies whose shares are listed in any stock exchange. The private limited companies shares however, cannot be quoted in the stock exchange. Further, stock exchange quotations do not hold good for a very large lot. In addition to this, the valuation of shares is required under following situations :

1. In case of amalgamation, acquisition absorption or reconstruction etc.
2. In case of purchase or sale of shares of a private company.
3. Acquisition of controlling interest in the company.
4. Conversion of debentures/preference shares into equity shares
5. On pledging the shares as collateral security.
6. On assessment of estate duty or wealth tax.
7. For ascertaining payment to any dissentient shareholders under any scheme of takeover or reconstruction.
8. For ascertaining compensation to shareholders under the scheme of nationalisation.
9. In case of trust finance or investment trust finance companies.

As stated earlier the price quoted in the stock exchange does not represent the actual worth or true value of shares. The prevailing price is not the conclusive proof of efficiency or inefficiency of the concerned company. The net worth or net assets value of (NAV) cannot be worked out with the help of stock exchange price. All authorities agree that the price mechanism does not function purely on the basis of fundamentals but greatly affected by speculative forces, rumours and unhealthy practices. Therefore, the stock market quotation cannot form a fair, equitable or rational basis of valuation of shares.

FACTORS AFFECTING THE VALUATION OF SHARES:

1. Stock exchange prices of the shares of the two companies before the commencement of negotiations or the announcement of the bid.
2. The dividends presently paid on the shares of the two companies. It is often difficult to induce a shareholder, particularly an institution to agree to a share to share bid if it involves a reduction in dividend income.
3. The relative growth prospects of the two companies.
4. The cover (ratio of after tax earnings to dividends paid during the year) for the present dividends of the two companies. The fact that dividend of one company is better covered than that of the other is a factor that has to be compensated for, at least, to some extent.
5. In the case of equity shares the relative gearing of the shares of the two companies. The gearing of an ordinary share is the ratio of borrowings to the equity capital.
6. The values of net assets of the two companies. Where the transaction is a thorough going merger, this may be more of a talking point rather than a matter of substance, since what is relevant is the relative values of the two undertakings as going concerns.
7. The voting strength in the merged enterprise of the shareholders of the two companies.
8. Past history of the prices of the shares of the two companies.

METHODS OF VALUATION OF SHARES:

(I) Net Assets Value (NAV) Method

This method is also called Intrinsic value Method or Break up Value Method or Asset Backing Method. Under this method the net assets (Assets – liabilities) are calculated and divided by the number of shares to get the "net assets value" per share. Efforts must be made to find out a more realistic NAV (Net Assets Value). For this purpose adjustments must be made for adherence to accounting policies, provision for adequate depreciation, gratuity liability and other employee related payments etc. as also a realistic values of all assets and liabilities including receivables and payables and contingent liabilities. Further the value of intangibles such as goodwill, patents, trademarks, & copyrights has to be considered in a realistic valuation. In short the following should be taken into account.

1. Fixed assets to be taken at realisable values (In case market values cannot be ascertained) then adequate provision for depreciation must be made out of book values)
2. The value of intangible assets such as goodwill, copyrights, patents and trademarks must properly be valued. In case these are considered worthless, the same should be ignored.
3. Investments in shares or debentures (whether trading or non-trading) should be taken at their market values.
4. Stock of finished goods to be valued at market value, whereas stock of raw-material be valued at cost.
5. Debtors and other receivables at their realisable values i.e. after providing for reasonable amount for bad and doubtful debts.
6. Contingent assets, if any, be valued on a conservative basis, such as claims for damages/ insurance.
7. All fictitious assets are to be be ignored.
8. Ascertain the amount payable to outsiders such as Debentureholders, creditors, provision for taxation and outstanding expenses.

Proposed Dividend should be treated as a liability for Ex-dividend value of equity shares while it should be excluded from liabilities for cum-dividend value of equity share.

9. The difference between the total assets and the total liabilities so arrived at represent "Net Assets" available for Preference share holders and Equity shareholders.

Illustration: (1) (Net Assets Method)

The following is the Balance Sheet of X Ltd. as on 31st March, 2006.

Liabilities	Rs.	Assets	Rs.
50,000 Equity Shares		Goodwill	70,000
of Rs. 10 each	5,00,000	Land & Building	3,30,000
9% Preference Shares		Plant & Machinery	1,70,000
of Rs. 100 each	2,50,000	Computers	70,000
General Reserve	75,000	Motor Vehicles	60,000
Profit & Loss A/c	25,000	Stock	1,80,000
9% Debentures	1,00,000	Debtors	80,000
S. Creditors	50,000	Cash & Bank	20,000
		Preliminary Expenses	20,000
	10,00,000		10,00,000

Additional Information:

(1) The value of Land & Building and Stock to be taken at Rs. 5,00,000 and Rs. 2,00,000 respectively.

(2) Plant & Machinery, Computers and Motor Vehicles subject to 10% depreciation.

(3) Debtors : Good Rs. 70,000

Doubtful Rs. 10,000

(50% likely to realise)

(4) Goodwill is valued at Rs. 1,00,000.

(5) Preference dividend has not been paid for last two years.

(6) The liability for bills discounted likely to arise is estimated at Rs. 15,000.

Calculate value of equity shares by Net Assets Method.

Solution :

Calculation of Net Assets

Sundry Assets:			**Rs.**
	Goodwill		1,00,000
	Land & Building		5,00,000
	Plant & Machinery	1,70,000	
	Computers	70,000	
	Motor Vehicles	60,000	
		3,00,000	
Less	10%	(30,000)	2,70,000
	Stock		2,00,000
	Debtors (Good)	70,000	
	50% of Rs. 10,000	5,000	75,000
	Cash & Bank		20,000
	Total Assets		11,65,000
***Less* Liabilities:**			
	9% Debentures	1,00,000	
	S. Creditors	50,000	1,50,000
			10,15,000
Less	Liability for Bills discounted		(15,000)
	Net Assets		10,00,000
Less	Claims of Preference Shareholders		(2,50,000)
	Net Assets available for Equity Shareholders		7,50,000

$$\text{Value of Equity Share} = \frac{\text{Rs. } 7{,}50{,}000}{50{,}000 \text{ Shares}}$$

Rs. 15 per share

YIELD METHOD:

This method takes into account future prospects in terms of return on investment . Yield means possible the possible return an investor expect from his investment. Under this method valuation of shares done on the basis of expected rate of return which is calculated from the future maintainable profit or by taking average of last 4 or 5 years of dividend declared by the company .

The formula for calculating value of share

Value of shares = Expected rate of dividend * Paid up value of share

Normal Rate of Return

The expected rate of dividend can be computed as follows :

1.calculate future maintainable profit as explained under valuation of Goodwill

2. Provide for tax

3. Transfer to general reserve

4.Transfer to debenture redemption fund or any other statutory transfers

5.provide for preference dividend

The balance available treated as profits available for equity shareholders. Thus expected rate of dividend will be calculated as follows :

$$ERR = \frac{\text{Profit available for equity shareholder} * 100}{\text{Equity shares capital}}$$

Illustration (5) (Yield Method)

From the following information calculate value of share by Yield Method.

	Rs.
50,000 Equity Shares of Rs. 10 each	5,00,000
10% Preference Shares of Rs. 100 each	2,00,000

The company transfers 20% of profits to General Reserve. If the future maintainable profits before tax are Rs. 2,50,000 and the rate of tax is 40%, calculate value of equity share. The normal rate of return may be taken at 15%.

Solution :

		Rs.
	Future maintainable profits	2,50,000
Less	Tax @ 40%	(1,00,000)
		1,50,000
Less	Transfer to General Reserve @ 20%	(30,000)
		1,20,000
Less	Preference dividend	(20,000)
	Profits available for equity shareholders	1,00,000

$$\text{Expected Rate of Return} = \frac{1,00,000}{5,00,000} \times 100 = 20\%$$

$$\text{Value of Equity Share} = \frac{\text{Expected Rate of Return}}{\text{Normal Rate of Return}} \times \text{Paid up Value}$$

$$= \frac{20}{15} \times 100 = \text{Rs. } 150$$

III Earning Capacity Method

The yield method is considered inappropriate for valuing large lots of equity shares i.e. for acquiring controlling interest.

This method takes into account the earnings potentials of a company rather than the return of shareholders. A company with high potential earnings may not be able to declare high rate of dividend due to prudent and shrewd policy. It is quite possible that a large amount of earnings have gone to wipe out outstanding balance of losses.

Further, it is quite possible a large amount has been transferred to general reserve and thus leaving a small amount of profits for equity share holders. Usually growing and expanding companies do resort to ploughing back of profits. Hence, shares valued under other methods may not reflect the actual worth (market value).

Thus Earning Capacity Method takes into account total earnings of the company before any appropriations. This method involves the following steps.

1. Calculation of future maintainable profits
2. Calculation of Capital employed.
3. Ascertaining the rate of earnings
4. Determining the normal rate of return.
5. Determination of value of shares.

The computation of "Future Maintainable Profits" has already been discussed under the valuation of goodwill.

$$\text{Rate of Earnings} = \frac{\text{Profits after interest, tax \& Preference dividend}}{\text{Equity Capital Employed}} \times 100$$

$$\text{Value of Equity Share} = \frac{\text{Earning Rate}}{\text{Normal Rate of Return}} \times \text{Paid up Value}$$

Illustration (7) (Earning Capacity and Yield Method)

From the following particulars calculate the value of a equity share of Rs. 10 under:

(a) Earning Capacity Method

(b) Yield Method.

Year	Capital Employed Rs.	Profits after Tax Rs.	Dividend %
2001-02	5,00,000	80,000	12
2002-03	8,00,000	1,60,000	15
2003-04	10,00,000	2,20,000	18
2004-05	15,00,000	3,75,000	20

The normal rate of return is 10%

Solution: (a) (Earning Capacity Mathod)

Year		Rate of Earnings
2001-02	$\frac{80{,}000}{5{,}00{,}000} \times 100$	= 16%
2002-03	$\frac{1{,}60{,}000}{8{,}00{,}000} \times 100$	= 20%
2003-04	$\frac{2{,}20{,}000}{10{,}00{,}000} \times 100$	= 22%
2004-05	$\frac{3{,}75{,}000}{15{,}00{,}000} \times 100$	= 25%

$$\text{Average Earning rate*} = \frac{16 + 20 + 22 + 25}{4} \times 20.75\%$$

Hence Future maintainable earning rate = 20.75

$$\text{Value of Share} = \frac{\text{Expected Rate of Earning}}{\text{Normal Rate of Return}} \times \text{Paid up Value}$$

$$= \frac{20.75}{10} \times 10 = \text{Rs. } 20.75$$

(b) Yield Method

$$\text{Average rate of dividend} = \frac{12 + 15 + 18 + 20}{4}$$

Expected rate of dividend = 16.25%

$$\text{Value of Share} = \frac{\text{Expected Rate of Return}}{\text{Normal Rate of Return}} \times \text{Paidup Value}$$

$$= \frac{16.25}{10} \times 10 = \text{Rs. } 16.25$$

(V) Fair Value Method

In order to overcome the shortcomings of any one single method of valuation of shares, the Fair Value Method of valuation of shares is considered as the most appropriate method Fair value is simply an average of 'Intrinsic Value' and Yield Value or Earning Capacity method. For valuing shares of investment companies for wealth tax purposes, the fair value method has been recognised by the Government. It is suited to manufacturing and other organisations. The Fair value can be worked out as under :

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

$$\text{or} = \frac{\text{Intrinsic Value} + \text{Capitalised Value / Earning Capicity}}{2}$$

Illustration (9) (Fair Value Method)

From the following particulars calculate value of equity share by "Fair Value Method".

	Rs.
10% 50,000 Preference Shares of Rs. 10 each	5,00,000
1,00,000 Equity shares of Rs. 10 each	10,00,000
Reserves & Surplus	4,50,000
Liability to outsiders	2,50,000
Fictitious Assets	1,50,000
Average normal profits after tax	8,50,000
Normal profit earned on the market value of fully paid equity shares of similar companies	16%
Transfer to General Reserve	10%

[C.S. (I) June 2001 - Adapted]

Solution:

Solution:

CALCULATION OF INTRINSIC VALUE OF SHARES

Calculation of Gross Assets

Liabilities	Rs.	Assets	Rs.
10% 50,000 Pref. Shares	5,00,000	S. Assets (B.F.)	20,50,000
1,00,000 Equity Shares	10,00,000	Fictitious-Assets	1,50,000
Reserves & Surplus	4,50,000		
Liabilities	2,50,000		
	22,00,000		22,00,000

	Gross Assets	20,50,000
Less	Liabilities	(2,50,000)
	Assets available for Equity & Preference S/H	18,00,000
Less	Preference Share Capital	(5,00,000)
	Amount available for Equity shareholders	13,00,000

$$\text{Intrinsic Value} = \frac{13,00,000}{1,00,000} = \text{Rs. } 13$$

Yield Method

		Rs.
	Average Profits	5,00,000
Less	Transfer to General Reserve @ 10% on 5,00,000	(50,000)
		4,50,000
Less	Preference dividend	(50,000)
	Profits available for Equity Shareholders	4,00,000

$$\text{Expected Rate of Return} = \frac{4,00,000 \times 100}{1,00,000} = 40\%$$

$$\text{Value of Share} = \frac{\text{Expected Rate of Return}}{\text{Normal Rate of Return}} = \text{Paid up Value} = \frac{40}{16} \times 10 = \text{Rs. } 25$$

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

$$= \frac{13 + 25}{2} = \frac{38}{2} = \text{Rs. } 19$$

UNIT – 5

COMPANY FINAL ACCOUNTS

INTRODUCTION:

The word 'Company', in everyday usage, implies an assemblage of persons for social purpose, companionship or fellowship. As a form of organisation, the word 'company' implies a group of people who voluntarily agree to form a company.

The word 'company' is derived from the Latin word 'com' i.e. with or together and 'panis' i.e. bread. Originally the word referred to an association of persons or merchant men discussing matters and taking food together. However, in law 'company' is termed as company which is formed and incorporated under the Companies Act, 2013 or an existing company formed and registered under any of the previous company laws. As per this denition of law, there must be group of persons who agree to form a company under the law and once so formed; it becomes a separate legal entity having perpetual succession with a distinct name of its own and a common seal. Its existence is not affected by the change of members.

STATUTORY PROVISIONS REGARDING PREPARATION OF COMPANY FINANCIAL STATEMENT:

The books of accounts showing true and fair financial statements and relevant papers shall be kept at the registered address of the company.

The books shall be kept on accrual basis and according double entry system of accounting.

The books of accounts and relevant papers may be kept at other place in India as BOD may decide.

A seven days' notice shall be given to ROC for communication of new address. The accounts can be kept in electronic mode.

The books of accounts shall be open for director's inspection at registered office or other place during business hours. The copies of financial information maintained outside India shall be produced for inspection. The inspection of subsidiary can be done only after authorization from BOD.

The books of accounts of the company shall be kept in good order for a period of 8 FYs and in case investigations ordered by CG it may direct a longer period.

MAINTENANCE OF BOOKS OF ACCOUNT

As per Section 128 of the Companies Act, 2013, every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting: Provided further that the company may keep such books of account or other relevant papers in electronic mode in such manner as may be prescribed.

FINANCIAL STATEMENTS (SECTION 129)

Under Section 129 of the Companies Act, 2013, the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the notified accounting standards and shall be in the form or forms as may be provided for different class or classes of companies, as prescribed in Schedule III. The Board of Directors of the company shall lay financial statements at every annual general meeting of a company. Financial Statements as per Section 2(40) of the Companies Act, 2013, inter-alia include -i.

A balance sheet as at the end of thefinancial year;

A prot and loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year.

cash flow statement for the financial year;

A statement of changes in equity, if applicable; and

(any explanatory note annexed to, or forming part of, any document referred to in sub-clause (i) to sub-clause (iv):

Provided that the financial statement, with respect to One Person Company, small company and dormant company, may not include the cash flow statement.

Requisites of Financial Statements. It shall give a true and fair view of the state of affairs of the company as at the end of the Financial year.

Provisions Applicable

(1) Specie Act is Applicable For instance, any (a) Insurance company

(b) Banking company or (c) Any company engaged in generation or supply of electricity* or (d) Any other class of company for which a Form of balance sheet or Profit and loss account has been prescribed under the Act governing such class of company.

(2) In case of all other companies:

Balance Sheet as per Form set out in Part I of Schedule III and Statement of Prot and Loss as per Part II of Schedule III:

(3) Compliance with Accounting Standards As per Section 129 of the Companies Act, it is mandatory to comply with accounting standards notified by the Central Government from time to time.

(4) Schedule III of the Companies Act, 2013

As per Section 129 of the Companies Act, 2013, Financial statements shall give a true and fair view of the state of affairs of the company or companies and comply with the accounting standards notified under Section133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III under the Act.

Shall be laid before AGM by BOD along with the consolidated financials (prepared on the basis of same principles of standalone) in case of subsidiary, associate and JV.

If do not comply with accounting standards, shall disclose the deviation, reasons and financial effect.

Contravention of the provisions of this section; MD, CFO and such other person charged by the BOD with compliance of this section and in the absence of any such officers all the directors shall be punishable with imprisonment for maximum 1 year or with fine

Financial Statements, board's report etc.

FS including CFS (if any) shall be approved by BOD. FS shall be signed at least by the chairperson of the company or by two directors out of which one shall be MD and CEO if he is director, CFO and CS of the company. Auditors' report shall be attached with FS

FS and board's report shall be laid before the company in AGM. Board's report shall include:

Number of meetings of the board

Company's policy on directors' remuneration

Particulars of loans, guarantees or investments under section 186

Amounts proposed to be carried forward to reserves

Recommended dividend

Material changes and commitments affecting the financial position

Details of CSR policy developed & implemented

Board report shall be attached to FS. Board report shall be signed by Chairperson if authorised by board otherwise by at least two directors.

Copy of FS to be filed with Registrar (Section 137)

The financial statements including consolidated financial statements shall be filed with Registrar within 30 days from the date of AGM.

Right of the member to copies of audited financial statement (Section 136)

Financial Statements including Consolidated Financial Statements, auditors' report and other documents which are to be laid down before AGM shall be sent to every member and trustee of debenture holder and all other required persons at least before 21 days of AGM. In case of listed company these documents can be kept for inspection at least before 21 days of AGM.

Corporate Social Responsibility (CSR) (Section 135)

Company having net worth Rs. 500 crores or more, turnover Rs. 1000 crores or more net profit of Rs. 5 crores or more during any financial year shall constitute a CSR Committee of the board consisting of 3 or more directors, one shall be independent director.

PART I – Form of BALANCE SHEET

Name of the Company……………………..

Balance Sheet as at………………………

(₹ in………..)

Particulars			Notes No.	Figures as at end of the current reporting period	Figures as at end of the previous reporting period
	EQUITY AND LIABILITIES				
1.	**Shareholders' funds**				
	a.	Share capital (A)		xxx	xxx
	b.	Reserves and Surplus (B)		xxx	xxx
	c.	Money received against share warrants		xxx	xxx
2.	**Share application money pending allotment**			xxx	xxx
3.	**Non-current liabilities**				
	a.	Long-term borrowings (C)		xxx	xxx
	b.	Deferred tax liabilities (Net)		xxx	xxx
	c.	Other long term liabilities		xxx	xxx
	d.	Long-term provisions (D)		xxx	xxx
4.	**Current liabilities**				
	a.	Short-term borrowings (E)		xxx	xxx
	b.	Trade Payables		xxx	xxx
	c.	Other current liabilities (F)		xxx	xxx
	d.	Short-term provisions		xxx	xxx
	Total			xxx	xxx

	ASSETS			
1.	**Non-current assets**			
	a. Property, Plant and Equipment			
	i. Tangible assets (G)		xxx	xxx
	ii. Intangible assets (H)		xxx	xxx
	iii. Capital Work-in-progress		xxx	xxx
	iv. Intangible assets under development		xxx	xxx
	b. Non-current investments (I)		xxx	xxx
	c. Deferred tax assets (Net)		xxx	xxx
	d. Long-term loans and advances (J)		xxx	xxx
	e. Other non-current assets		xxx	xxx
2.	**Current assets**			
	a. Current investments (K)		xxx	xxx
	b. Inventories (L)		xxx	xxx
	c. Trade receivables		xxx	xxx
	d. Cash and cash equivalents (M)		xxx	xxx
	e. Short-term loans and advances		xxx	xxx
	f. Other current assets		xxx	xxx
	Total		xxx	xxx

Some items are to be explained as follows:

A. SHARE CAPITAL

For each class of share capital following points is to be kept in mind:

i. The number and amount of shares authorised.

ii. The number of shares which are issued, subscribed and fully paid and which are issued, subscribed but not fully paid.

iii. The par value per share.

iv. Shares outstanding at the beginning and at the end of the reporting period should be reconciled.

v. Calls unpaid.

vi. Forfeited shares.

B. RESERVES AND SURPLUS

Reserves and surplus can be distributed among the following sub-heads:

i. Capital reserves

ii. Capital redemption reserves

iii. Securities Premium

iv. Debenture Redemption reserve

v. Revaluation reserve

vi. Surplus; the balance as per profit and loss statement

vii. Other reserves (specify the nature and purpose)

C. LONG TERM BORROWINGS

Long term borrowings can be classified under the following sub-heads:

i. Bonds/Debentures

ii. Term loans

iii. Deferred payment liabilities

iv. Deposits

v. Long term maturities of finance lease obligations

vi. Loans and advances from related parties

vii. Other loans and advances (specify nature)

D. LONG TERM PROVISIONS

This can be classified as follows:

i. Employee benefits provision like gratuity, provident fund etc.

G. TANGIBLE ASSETS

Tangible assets can be classified as follows:

i. Land

ii. Buildings

iii. Plant and Equipments

iv. Furniture and Fixtures

v. Vehicles

vi. Office equipments

vii. Others (specify the nature)

A detailed report showing additions, disposals, acquisitions through business combinations and other adjustments and amount related to depreciation, impairment losses, revaluation etc. should be provided for each class of asset.

H. INTANGIBLE ASSETS

Intangible assets can be classified as follows:

i. Goodwill

ii. Brands/trademarks

iii. Computer software

iv. Mining rights

v. Publishing titles

vi. Copyrights, patents and other intellectual property rights, services and operating rights.

vii. Licence and franchise

viii. Recipes, models, designs, formulae and prototypes

ix. Others (specify the nature)

A detailed report showing additions, disposals, acquisitions through business combinations and other adjustments and amount related to depreciation, impairment losses, revaluation etc. should be provided for each class of asset.

I. NON-CURRENT INVESTMENTS

Investments can be classified as under:

i. Investments in property

ii. Investments in equity instruments

iii. Investments in preference shares

iv. Investments in governments or trust securities

v. Investments in debentures or bonds

vi. Investments in mutual funds

vii. Investments in partnership firms

viii. Other non-current investments (specify the nature)

J. LONG TERM LOANS AND ADVANCES

It can be classified under the following sub-groups:

i. Capital advances

ii. Security deposits

iii. Loans and advances to related parties

iv. Other loans and advances (specify nature)

The above shall also be sub-classified as follows:

i. Secured, considered goods

ii. Unsecured, considered goods

iii. Doubtful

K. CURRENT INVESTMENTS

It can be classified as follows:

i. Investments in equity instruments

ii. Investments in preference shares

iii. Investments in government or trust securities

iv. Investments in bonds or debentures

v. Investments in mutual funds

vi. Investments in partnership firms

vii. Other investments (specify the nature)

L. INVENTORIES

Inventories can be classified as:

i. Raw materials

ii. Work-in-progress

iii. Stores and spares

iv. Finished goods

v. Loose tools

vi. Stock in trade

vii. Goods in transit

viii. Others (specify the nature)

M. CASH AND CASH EQUIVALENTS

The following head can be classified as follows:

i. Balances with banks

ii. Cheques, drafts in hand

iii. Cash in hand

iv. Others (specify the nature)

ITEMS PECULIAR TO CORPORATE FINANCIAL STATEMENTS

A-Balance Sheet

(1) "Share Capital"

Under this head following details are required to be disclosed —

(i) Details of Authorised, Issued and Subscribed Capital along with number and nominal value of the shares with respect to preference and equity shares.

(ii) Calls-in-Arrears must be deducted from Called-up Capital. However, Calls-in-arrears on shares held by directors are to be shown separately. Similarly Calls-in-Advance should be treated as a separate item and shown accordingly.

(iii) Forfeited shares Account, if any, should be added to Paid-up Capital which forms the part of total of Balance Sheet. It is to be noted that the Authorised, Issued and Subscribed Capital. are not considered for the purpose of total of Balance Sheet.

(iv) Shares issued for consideration other than cash-must be disclosed such as

- shares allotted to transferor company under the agreement of takeover/merger.
- Issue of bonus shares and the source there of

(v) If preference shares have been issued, the terms of redemption or conversion along with the earliest date of redemption/conversion must be specified.

(vi) Excess application money on account of over-subscription not requiring any adjustment, should be refunded. If not, the money refundable must be shown as part of current liabilities.

(2) Reserves & Surplus

This may be in the following forms.

(i) **Capital Reserves**— It refers to those profits which are not earned from normal business operations. Such profits are not available for the purpose of distribution as dividend. It is created out of profit on sale of fixed assets or investments held as asset, profit on reissue of forfeited shares, pre-incorporation profit, profit on revaluation of fixed assets, profit on, purchase/acquisition of asset or business (excess of net assets over purchase price)

(ii) **Capital Redemption Reserve**— It is created when fully paid preference shares are redeemed out of divisible profits of the company. This reserve may be utilised for the purpose of issuing fully paid bonus shares to the members of the company.

(iii) **Securities Premium**— When a company issues shares/or debentures at a price which is more than it's face value, it is said to have issued shares/debentures at a premium. The premium so received is transferred to "Securities Premium Account. According to section 78 of Companies Act, the premium may be utilised for

- Issuing fully paid bonus shares
- Writing off preliminary expenses, discount on issue of shares or debentures
- Providing premium on redemption of preference shares or debentures.

(iv) **Revenue Reserves**— These may be in the form of specific reserves or free reserves and are created out of revenue profits of the company. Usually such reserves are formed from annual appropriation.

Specific reserves are created for specific purpose. For example Dividend Equalisation Reserve is created to meet the short fall in the divisible profits if the company intends to follow a stable dividend policy, or to redeem the debentures a sinking fund or a debenture redemption reserve may be created. Other specific reserves are Development Rebate Reserve, Investment Allowance Reserve, Export Incentive Reserve.

The term "Fund" is used when the money earmarked for any specific purpose is invested in outside securities. For example if money appropriated for the purpose of redemption of debentures is invested outside the business is termed as Debenture Redemption Fund, if not invested outside but retained or ploughed back in the business, it is called Debenture Redemption Reserve

Surplus

The Credit balance of Profit & Loss Account or P & L Appropriation Account (*i.e.* after making necessary transfer to reserves, & appropriating for proposed, interim or final dividend including bonus, if any) is shown under the heading as surplus. If a company has a debit balance of Profit & Loss Account, the same should be adjusted under this head.

(3) Secured Loans

This refers to mortgaged loan or other loans, which are fully secured either by a fixed or floating charge on the assets of the company. It includes loans from banks, financial institutions or from other companies provided these are secured against the specific or all assets of the company. Debentures are assumed to have first floating charge on the assets of the company. It is to be noted that interest accrued and due on secured loans is to be treated as and shown under Secured Loans. Loan from or guaranteed by directors should be disclosed and shown separately. In case of debentures the terms of redemption/conversion and it's earliest date of redemption/conversion be stated.

(4) Unsecured Loans

These are the loans against which no security stands as pledged or mortgaged. It also includes amount not covered by the value of security provided in respect of partly secured loans. It covers all loans which are not at all secured such as

- Fixed Deposits from public
- Loans and Advances from Subsidiaries
- Short-Term loans & Advances from Banks & others
- Other Loans & Advances.

It may include creditors for purchase of an asset.

(5) Current Liabilities and Provisions

This heading is split in two sub-headings

(A) *Current Liabilities*

It refers to those liabilities which are to be paid or payable with in a period of twelve months. It includes

- Sundry Creditors
- Bills Payable
- Outstanding Expenses
- Income Received in Advance
- Amount payable to subsidiaries

> It is to be noted that short-term loans and Interest o/s thereon are to be shown under "Secured" or "Unsecured Loans" to which these relate to as the case may be and not under Current Liabilities."

(B) *Provisions*

Such provisions are shown separately from Current Liabilities. This includes

- Proposed Dividend
- Provision for Taxation
- Provision for Depreciation, Repairs & Renewals.
- Provision for Doubtful Debts
- Investment Fluctuation Reserve

- Provident Fund
- Pension Fund

*Provision for Depreciation and Provision for Doubtful Debts may be shown on the 'Assets' side as deduction from the asset concerned.

Contingent liabilities

As explained earlier, these liabilities are shown as foot note and include

- Liability for bills discounted
- Claims against the company not acknowledged as debt
- Uncalled liability on partly paid shares
- Arrears of fixed cumulative preference dividends
- Guarantee given by the company on behalf of directors or other officers of the company
- Estimated amount of contracts remaining to be executed on capital account not provided for and
- Other money for which company is contingently liable :

> It is to be noted that if any provision is made against any contingent liability, the same is to be shown under the head provisions.

(6) Fixed Assets

Under this head there are eleven types of fixed assets* starting from goodwill to vehicles. According to AS-10 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 held for the purpose of production are treated and shown under this head. These include assets acquired under hire-purchase agreement and assets taken on lease. Valuation of fixed asses is made at cost less depreciation after considering the addition & disposal if any.

> It is worth remembering that "goodwill" should be shown in the books only when it is acquired for some consideration. According to AS - 26 internally generated goodwill should not be recognised as an asset.

***As per Schedule VI the fixed assets are classified as follows:**

1. Goodwill
2. Land
3. Building
4. Leasehold
5. Railway Slidings
6. Plant & Machinery
7. Furniture & Fittings
8. Development of property
9. Patents, Trade-marks & Designs
10. Live Stock
11. Vehicles

In case of revaluation of fixed assets, every Balance Sheet subsequent to such revaluation must show the revised figures with the date of increase or decrease in place of original cost.

In ascertaining the cost of an asset all expenditures incurred in bringing the asset to it's working condition should be included. This includes costs of transportation expenditure on trial runs. In case of Land & Building stamp duty, registration fee & architects fee should be capitalised.

(7) Investments

As per AS - 13 (Accounting for Investments), " Investments are assets held by an enterprise for earning income by way of dividends, interest and rental, for capital appreciation or for other benefits to the investing enterprise". Assets held as stock-in-trade are not investments. Money invested outside business is termed as investments which may be long-term, current investment or an investment property.

According to AS-13, a "Current investment by it's nature are readily realisable is intended to be held for not more than one year, where as an investment property is an investment in land or buildings that are not intended to be occupied substantially for use by the enterprise. Schedule VI requires investments to be shown as follows—

(i) Investments in Government or Trust Securities

(ii) Investments in shares, debentures or bonds, fully paid up & partly paid up and also different classes of shares.

(iii) Immovable properties.

(iv) Investments in the Capital of partnership firms.

The following details must be given :

1. Nature of Investment
2. Mode of valuation of Investments
3. Aggregate amount of company's quoted investments and it's market value
4. Aggregate amount of company's unquoted investments
5. Amount of fully paid and partly paid shares.
6. Investment in subsidiary companies.

(8) Current Assets, Loans and Advances

This is subdivided in two sub-headings :

(a) *Current Assets*

As per the Guidance note issued by ICAI, "Current assets means cash and other assets that are expected to be converted into cash or consumed in the production of goods or rendering of services in the normal course of business and include.

(1) *Stock-in-trade* (inventories of raw-materials, work-in-progress finished goods, stores and spare parts to be shown separately) including mode of valuation. Debtors should show the age-wise, and security-wise classification such as.

- Debts outstanding for a period of more than six-months and other debts
- Debts considered good in respect of which the company is fully secured
- Debts considered good in respect of which company holds no security other than the debtor's personal security.

- Debts considered doubtful or bad.
- Debts due by directors or other officers
- Debts due from other companies (subsidiaries)
- Maximum amount due by directors or other officers of the company (through footnote)
- Provision for doubtful debts is required to be deducted from sundry debtors. Provision should not exceed the amount considered doubtful or bad. Any excess provision be shown under "Reserve & Surplus".

(iii) *Cash and Bank balance should be shown separately.* Bank balances should be classified into balances with scheduled banks and other banks along with details of current account, saving bank and fixed deposits. Bank Overdraft, if any, should be shown under sundry creditors. This information of inclusion be disclosed in a footnote that the sundry creditors include bank overdraft amounting to Rs. ——————.

(B) *Loans & Advances*

The disclosing rules which are applicable to sundry debtors, the same should be applied to "Loans and Advances". *i.e.* These should be shown in age-wise security wise and realisability wise classification. In addition the following should be shown.

- Advances and loans to subsidiaries.
- Advances and Loans to partnership firms in which the company or subsidiary is a partner
- Bills of Exchange
- Advances recoverable in cash or kind or for value (Rent, Rates & Insurance)
- Balance with customers, port trust etc. which are payable on demand.

(9) Miscellaneous Expenditure

These are the expenses incurred in earlier years but not written off. These include.

(i) Preliminary Expenses (Formation expenses incurred on preparation of Memorandum and Articles of Association, legal fees, registration fee etc.

(ii) Shares & Debentures issue expenses such as brokerage, underwriting commission, discount on issue of shares and debentures

(iii) Interest paid out of capital during construction

Such miscellaneous expenditure is written off over a period for which benefit is available.

(10) Profit and Loss Account (Debit balance)

This represents past unwritten off losses. These are adjusted and written off against the free reserves (divisible profits/revenue profits) to the available extent. Unabsorbed amount is shown under this head.

PART II – Form of STATEMENT OF PROFIT AND LOSS

Name of the Company……………………

Profit and Loss Statement for the year ended ………………………

(₹ in…………)

Particulars		Note No.	Figures for the current reporting period	Figures for the previous reporting period
I.	Revenue from operations		xxx	xxx
II.	Other income		xxx	xxx
III.	Total Revenue (I + II)		xxx	xxx
IV.	Expenses:		xxx	xxx
	Cost of materials consumed		xxx	xxx
	Purchases of Stock-in-Trade		xxx	xxx
	Changes in inventories of finished goods Work-in-Progress and Stock-in-Trade		xxx	xxx
	Employee benefits expense		xxx	xxx
	Finance costs		xxx	xxx
	Depreciation and amortization expense		xxx	xxx
	Other expenses		xxx	xxx

Total expenses				xxx		xxx
V.	Profit before exceptional and extraordinary items and tax (III-IV)			xxx		xxx
VI.	Exceptional items			xxx		xxx
VII.	Profit before extraordinary items and tax (V-VI)			xxx		xxx
VIII.	Extraordinary Items			xxx		xxx
IX.	Profit before tax (VII-VIII)			xxx		xxx
X.	Tax expense:					
	(1) Current tax		xxx		xxx	
	(2) Deferred tax		xxx	xxx	xxx	xxx
XI.	Profit (Loss) for the period from continuing operations (VII-VIII)			xxx		xxx
XII.	Profit/(Loss) from discontinuing operations			xxx		xxx
XIII.	Tax expense of discontinuing operations			xxx		xxx
XIV.	Profit/(Loss) from discontinuing operations (after tax) (XII-XIII)			xxx		xxx
XV.	Profit (Loss) for the period (XI + XIV)			xxx		xxx
XVI.	Earnings per equity share:					
	(1) Basic			xxx		xxx
	(2) Diluted			xxx		xxx

B- INCOME STATEMENT/PROFIT & LOSS ACCOUNT

Salient features

Though the procedure and the process of preparation of "Income Statement" of a company and that of non-corporate entities are similar in principles yet, there are some differences in the method of presentation and some additional items which form the part of a corporate Income Statement. These differences are as under :

1. **Heading :** Non-corporate entities name income statement as "Trading and Profit and Loss Account, while companies call it "Income Statement" or Profit and Loss Account only. The items of Trading Account become the part of "Income Statement " No separate Trading Account is prepared.
2. **Appropriations :** Sole Trader does not prepare any appropriation account, while partnership firms and Companies do. A company 's Profit and Loss Account is split up in to two parts - "above the line" and "below the line". All items of appropriations are shown "below the line" and the remaining balance is transferred to the liabilities side of the Balance Sheet. A Partnership firm prepares a separate Profit & Loss Appropriation Account.
3. **As per AS - 5 extraordinary items** (abnormal nature) **prior period items** are shown separately where as in case of non-corporate entities such items are stated along with the normal and routine items.
4. **Requirements :** The Profit & Loss Account of a company should confirm to the requirements of schedule VI of Companies Act 1956 and adhere to AS - 1; AS-4 & AS - 5 recommendations, where as non-corporate enterprises are not required to do so.
5. **Income Tax** is treated as an expense for the companies while for firms and sole trade enterprise, it is treated as drawings.
6. Companies Profit & Loss Account should disclose the figures for the previous year along with the current year's where as non-company enterprises are not required to show figures relating to previous year.

TREATMENT OF SPECIAL ITEMS OF PROFIT & LOSS ACCOUNT

1. Interest on Debentures and Loans

This item includes interest paid and payable for the financial period for which accounts are prepared and shown to the debit side of Profit and Loss Account. Likewise, interest due but remaining outstanding is taken to the liability side of the Balance Sheet. Interest on Debentures and interest on secured loans outstanding if any, is shown under the heading "Secured Loans" whereas interest O/s on unsecured loan is shown under "unsecured loans".

It is to be noted that interest on loan for the construction period should be capitalised and added to the cost of the asset concerned.

2. Tax on interest on Debentures

As per the Income Tax Act 1961, every company must deduct tax at source (TDS) while paying interest to the debenture holders. The amount so deducted shall be deposited with the Government treasury. The current rate for TDS are as follows.

Debentures (listed)	10.2% including Education cess
Debentures (unlisted)	20.4% including Education cess

If A Ltd. has to pay interest on it's 9% debentures (listed) of the face value of Rs. 5,00,000 then gross interest will be Rs. 45,000 while tax deducted at source Rs. 4,590 and balance shall be paid to the Debentureholder Rs. 40,410. The following entry is recorded :

Interest on Debentures A/c	Dr.	45,000	
To Debenture holders A/c			40,410
To Income Tax Payable A/c			4,590

Income tax deducted but not deposited with the Government is to be shown in the Balance Sheet under the heading "Current Liabilities".

It should be remembered that Profit and Loss Account will always be debited with the gross amount of interest.

3. Discount on Debentures/ Loss on Issue/ Debenture Issue Expenses.

Discount on issue of debentures, debenture issue expenses such as commission, brokerage etc. or premium payable on redemption (treated as loss on issue which may include discount also) are to be written off as early as possible, or over the life span of the debentures, depending upon the policy of the company. In the absence of any specific instructions in the question, such amount should be written off on the basis of debentures outstanding. The unwritten off balance is to be shown on the assets side of the Balance Sheet under the heading of "Miscellaneous Expenditure".

Note : Only written off * amount is charged to Profit and Loss Account.

4. Preliminary Expenses

As already explained under Balance Sheet items, it appears on the assets side of the Balance Sheet under the heading "Miscellaneous Expenditure" as long as it is not written off. The amount written off* is charged to Profit and Loss Account. If there is no specific instruction relating to the amount to be written off, then the entire amount should be shown in the Balance Sheet.

5. Corporate Income Tax

This is shown under three stages.

(I) ***Advance Income Tax***

As per Income Tax Act 1961, the companies are required to pay income tax on the profits earned. They have to deposit advance tax under PAYE (Pay As You Earn) scheme on specific dates during the financial year. The advance tax so paid is adjusted against income tax liability. The unadjusted amount of advance income tax is shown as an asset under the heading Current Assets, Loans and Advances.

(ii) *Provision for Taxation*

While preparing Profit and Loss Account, a provision for income tax is created on the basis of current year's profit to meet the actual tax liability. The amount so provided depends on the prevailing tax rate. The Current rate of corporate tax is 30% plus 10% surcharge and 2 % education less for domestic companies and 40% plus 2.5% surcharge and 2% education cess for foreign companies. The following entry is recorded.

Profit & Loss Account Dr.

To Provision for Taxation A/c

AS-22 "Accounting for Taxes on Income" recommends that the net balance i.e. excess of "Advance Tax" over "Provision for Taxation" or excess of "Provision for Taxation" over Advance Tax" may be shown on the assets side or liabilities side of the Balance Sheet as the case may be, till the final assessment is made and actual tax liability determined by the tax authorities.

(iii) *Determination of actual tax liability*

As per Income Tax rules, Income (Profits) for the previous year is assessed and taxed in the assessment year. When the assessment is completed the provision for taxation so created may either fall short of actual tax liability or may exceed the tax liability. Such a shortfall or excess is treated as prior period item (AS-5) and therefore it's adjustment is made in the Profit and Loss Account but "below the line", either to the debit side (for short fall) or to the credit side (for excess).

On the other hand, the actual tax liability is compered with advance income tax paid. In case actual tax liability is more than the amount of advance tax paid the same may be paid or shown as a current liability in the Balance Sheet and if advance tax paid exceeds, the difference being refund should be stated under "Current Assets" loans and Advances in the Balance Sheet.

Example (1)

EXTRACTS FROM A TRIAL BALANCE OF A COMPANY
As on 31st March, 2003

	Dr. (Rs.)	Cr. (Rs.)
Provision for Taxation (2001-02)		2,50,000
Advance Income Tax (for 2001-02)	2,60,000	
Advance Income Tax (for 2002-03)	3,00,000	

Additional Information

(i) The actual tax liability for the year 2001-02 amounted to Rs. 2,75,000.

(ii) Provision for Taxation for the year 2002-03 of Rs. 2,85,000 is required to be made.

Show the relevant information in the relevant ledgers.

PROFIT AND LOSS ACCOUNT (EXTRACTS)
for the year ended 31st March 2003

	Rs.		
To Provision for Taxation (2002-03)	2,85,000	above the line	
To Provision for Taxation (2001-02) (Rs. 2,75,000 – 2,50,000) Tax liability – Provision	25,000	below the line	

BALANCE SHEET (EXTRACTS)
As on 31st March 2003

(Liabilities)	Rs.	(Assets)	Rs.
Income Tax Payable	15,000	Loans & Advances	
(Tax liability – Advance Tax)		Advance Tax (Current year) 3,00,000	
for 2001-02		Provision for Taxation	
2,75,000 – 2,60,000		Current Year 2,85,000	15,000

PROVISION FOR TAXATION (2001-02)

	Rs.		Rs.
To Income Tax (Tax liability)	2,75,000	By Balance b/d	2,50,000
		By Profit & Loss A/c (below the line)	25,000
	2,75,000		2,75,000

PROVISION FOR TAXATION (2002-03)

	Rs.		Rs.
To Balance c/d	2,85,000	By Profit and Loss A/c (above the line)	2,85,000
	2,85,000		2,85,000

Bibliography:

ICAI – IPCC – Advance accounting study material

Corporate accounting By Naseem Ahmad

Corporate accounting By V K Goyal and Ruchi Goyal

Corporate accounting By S.N Maheswari