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CORPORATE ACCOUNTING

DISCIPLINE SPECIFIC CORE (DSC-4)

SEMESTER - II COURSE CREDIT - 4

DEPARTMENT OF DISTANCE AND CONTINUING EDUCATION
UNIVERSITY OF DELHI

AS PER THE UGCF-2022 AND NATIONAL EDUCATION POLICY 2020

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ISBN: 978-81-19169-34-4

1st Edition: 2023

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Published by:
Department of Distance and Continuing Education
Campus of Open Learning/School of Open Learning,
University of Delhi, Delhi-110007

Printed by:
School of Open Learning, University of Delhi

This Study Material is duly recommended in the meeting of Standing Committee held on 08/05/2023 and approved in Academic Council meeting held on 26/05/2023 Vide item no. 1014 and subsequently Executive Council Meeting held on 09/06/2023 vide item no. 14 {14-1(14-1-11)}

- **Unit I-IV are edited versions of study material prepared for the courses under Annual & CBCS Mode and Unit V written afresh.**
- **Corrections/Modifications/Suggestions proposed by Statutory Body, DU/ Stakeholder/s in the Self Learning Material (SLM) will be incorporated in the next edition. However, these corrections/modifications/suggestions will be uploaded on the website https://sol.du.ac.in. Any feedback or suggestions may be sent at the email- feedbackslm@col.du.ac.in**

Printed at: **Taxmann Publications Pvt. Ltd., 21/35, West Punjabi Bagh, New Delhi - 110026 (15000 Copies, 2023)**

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UNIT - I

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LESSON

1

Issue, Forfeiture and Reissue of Forfeited Shares

Dr. Saima
Assistant Professor
Zakir Husain Delhi College

STRUCTURE

1.1 *Learning Objectives*
1.2 *Concept of Share Issue*
1.3 *Procedure of Issue of Shares*
1.4 *Modes of Issue of Shares*
1.5 *Issue of Shares at Premium [(Sec. 52)]*
1.6 *Issue of Shares at Discount*
1.7 *Surrender & Forfeiture of Shares*
1.8 *Reissue of Forfeited Shares*
1.9 *Issue of Right Shares and Bonus Shares*
1.10 *Employee Stock Option Plan*
1.11 *Book Building*
1.12 *Underwriting and Brokerage*
1.13 *Summary*
1.14 *Questions for Practice*

1.1 Learning Objectives

This Chapter will assist you to:

- Know procedure of issue of shares.
- Understand modes of issue of shares.
- Understand Sections 52 and 53 related to issue of shares at premium and discount.
- Learn meaning and application of *pro rata* allotment.

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- Surrender & forfeiture of shares.
- Apply the accounting procedure of reissue of forfeited shares.
- Understand meaning and valuation of right shares.
- Learn the concept of employee stock option plan.

1.2 Concept of Share Issue

The Capital of the company is divided into small units called shares. If a company has total Capital of Rs. 50,00,000 divided into 50,000 units, the value (face value) of each unit (share) will be Rs. 100 (50,00,000/50,000 units). Thus, the company will have share capital divided into shares of Rs. 100 each. No trading concern can run without capital. However, the companies limited by guarantee or unlimited companies need not to have share capital.

Distinction between Shares and Stock:

1. **Paid up amount:** Shares may be fully or partly paid up. Where as Stock is always fully paid up.
2. **Issue:** Shares may be issued directly to the public after incorporation. Stock cannot be issued directly and just after incorporation.
3. **Transfer:** Shares cannot be transferred in fraction because a share is not divisible. Stock may be transferred in fraction.
4. **Nominal Value:** Shares are of equal denomination (nominal value). Stock may be dividend into unequal nominal value.
5. **Number:** Shares are always serially numbered. Stock is not numbered.
6. **Registration:** Shares are always registered. Stock may be registered or unregistered both.

Types of Shares

Companies usually issue two types of shares (Section 43) as authorised and permitted by Companies Act, 2013. These are preference shares and equity shares which are also known as ordinary shares:

1. **Preference Shares:** As the term itself suggests that these are the shares which enjoy preferential rights as regards payment of dividend during the life time of the company and repayment of capital in the event of liquidation. However, preference shareholders cannot

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compel or force a company to pay dividend except in case where company has already paid equity dividend. This simply means that preference shares carry a right of dividend at a fixed rate before any dividend is paid on equity shares. These shares do not carry any voting right.

The preference shares are classified into following categories:

(*i*) **Cumulative Preference Shares:** Preference shares are always deemed to be cumulative unless otherwise stated in the Articles. In case of cumulative preference shares dividends accumulate if not paid due to inadequacy of the profits or otherwise. The dividend payable on these shares go on accumulating till it is fully paid off. The arrears of dividend have to be paid before any divided is paid to equity shareholders. However, in case of winding up of a company the arrears of dividend are payable only if it is expressly stated in the Articles.

(*ii*) **Non-Cumulative Preference Shares:** Such shares do not enjoy right to claim arrears of dividend if not declared and paid in any of the year due to inadequacy of profit. The right to claim dividend lapses and shareholders cannot claim arrears of dividends of any year out of the profit of subsequent years.

(*iii*) **Participating Preference Shares:** Such type of preference shares are entitled to a dividend at a given rate and a share in the profits (residual) left after paying preference, and equity dividend at a specified rate. The right to participate may also extend to surplus assets if available after satisfying the claims of equity shareholders in the event of liquidation.

(*iv*) **Non-Participating Preference Shares:** These preference shares carry a right to claim dividend at a given rate only. Holders of such shares are not entitled to share either the surplus profits or surplus assets. All preference shares are deemed to be non-participating unless otherwise expressly stated in the Articles.

(*v*) **Redeemable Preference Shares:** Redeemable Preference Shares are those shares which can be redeemed after a specified period of time in accordance with the terms of issue. That

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is, the preference shareholders are entitled to get their money back during the lifetime of the company.

(*vi*) **Irredeemable Preference Shares:** Such shares are not redeemable during the lifetime of the company but on winding up. However, Companies Amendment Act, 1988 expressly prohibits issue of irredeemable shares. Now, no company can issue such type of shares.

(*vii*) **Convertible Preference Shares:** Such shares can be converted into equity shares as per the terms of issue within the stipulated period of time.

(*viii*) **Non-Convertible Preference Shares:** The holder of such shares does not enjoy the right to get their preference shares converted into equity shares.

2. **Equity Shares:** Equity Shares are of two types:
   1. Equity shares issued by a company limited by shares to public or its members (section 43)
   2. Sweat Equity Shares [section 2(88)]

According to section 43 "an equity share is one which is not a preference share." Such shares do not enjoy any preferential rights as regards to payment of dividend or refund of capital. That's why these are known as ordinary shares. The equity shareholders are the last to claim in the assets of the company and entitled to residual surplus left after meeting the claims of Debenture holders, Creditors and Preference shareholders. However, these shares carry voting rights.

Issue of Sweat Equity Shares

Sweat Equity Shares are issued by a company to its employees, officers or whole-time directors either at a discount or for consideration other than cash, for providing know-how or, making available rights in the nature of intellectual property rights or value addition, by whatever name called. According to section 2(88), Sweat equity shares means equity shares which are issued by the company to its employees or its directors either at a discount or for consideration other than cash, for providing their know-how or making available rights in the nature of patents or other value additions (*e.g:* for bringing in new technology in order to reward them to feel motivated, Trade mark, Industrial design etc.).

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Conditions:

(*i*) The issue of Sweat equity shares is authorised by special resolution passed by the company in the general meeting.

(*ii*) The resolution specifies the number of shares, current market price and the consideration if any, being paid along with the class of employees, officers and directors to whom sweat equity shares are to be issued.

(*iii*) Not less than one year has elapsed since the date on which the company was entitled to commence business.

(*iv*) SEBI's guidelines shall be applicable in case of a listed company issuing sweat-equity shares. In case of unlisted company, in accordance with guidelines as prescribed.

(*v*) Sweat-Equity shares must be of a class of shares already issued by the company.

Rule 8 of Companies (Share Capital and Debentures) Rules, 2014, provides that a company shall not issue sweat equity shares for more than 15% of the existing paid-up capital in a year or for shares of the value of Rs. 5 crores, whichever is higher.

Accounting Treatment

Issue of sweat equity shares to directors at discount

Bank Account	Dr. (with the cash received)
Discount on issue of Shares Account	Dr. (with the amount of discount)
To Equity Share Capital (Sweat Equity) Account	

(*vi*) Issue of Sweat Equity Shares for Technical know-how or Intellectual Property Rights :

Technical know-how or	Dr.
Intellectual Property Rights Accounts	Dr.
To Equity Share Capital (Sweat Equity) Account	

Distinction between Preference Share & Equity Share

1. **Right to claim dividend:** A preference shareholder has the right to receive dividend before any dividend is paid to equity shareholders. Equity shareholders don't have any preferential right with regards to dividend payment. In this case dividend is a residuary decision.

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2. **Rate of dividend:** Preference Shares carry pre-determined dividend rate which is fixed at the time of issue. Rate of dividend may vary year after year. The rate depends upon availability of divisible profits and the management policy.
3. **Arrears of dividend:** Preference shareholders have the right to claim arrears of dividend except when it is provided otherwise in the Articles. *i.e.* preference shares are non-cumulative. Question of arrears of dividend does not arise in case of equity shares.
4. **Right to vote & participation in management:** Usually, preference shares do not carry any voting right except in special circumstances and thus have no say in management. Equity shares always enjoy voting rights and have their say in managerial affairs.
5. **Capital structure:** A company cannot have only preference shares in its capital structure. Hence a company cannot be formed with preference shares only. A company may have only equity shares in its capital structure and it can be formed with equity shares alone.
6. **Redemption:** Preference shares are redeemable on or before the stipulated period of time as per terms of issue. The stipulated period cannot exceed ten years in any case. Equity shares are always irredeemable. However, on liquidation they are entitled to surplus or residuary assets of the company.

1.3 Procedure of issue of shares

A registered company follows the following procedure to collect money from the general public by way of issuing shares:

Step 1 - Issue of prospectus

Step 2 - To receive application

Step 3 - Allotments of shares

Step 4 - To make calls on shares

Step 5 - Issue of share certificate

When a Public company intends to raise capital by offering (selling) its shares to the public, it invites the public through a document called ‘Prospectus’. After analysing prospectus if the investors are satisfied

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and interest; they may apply for purchase of shares. Section 39(1) of Companies Act, 2013 provides that a company cannot allot any security to the public unless the amount stated in the prospectus as the minimum amount has been subscribed. The minimum amount is called the minimum subscription and is required to be stated in the prospectus. Company may ask for the full price of the shares at the time of application stage itself or it may be demanded in different instalments referred as allotment and calls. Section 39(3) provides for refunds of application money, if the minimum subscription is not received within 30 days from the date of issue of prospectus or such other period as may be specified by SEBI.

After getting application along with the required amount from the investors; company scrutinizes the applications and after completing necessary formalities shares are allotted. Amount left after payment of application and allotment money is demanded from the investors in different instalments known as calls *e.g.* 'First Call' and 'Second Call' and so on. Generally 'Final' word is added with the last call e.g. second and final call.

A share certificate contains two important statements namely: (*i*) the member was, at the date of the issue of the certificates, the holder of a certain number of shares and (*ii*) the extent to which they are paid up *i.e.,* paid up amount of the shares.

1.4 Modes of Issue of Shares

The accounting entries for the issues of shares are related to the format of the issue price namely:

(*i*) Issue of shares at par.

(*ii*) Issue of shares at premium.

Then shares may be issued for cash or for consideration other than cash in all the foregoing cases.

Issue of shares at par

When a share is issued at its nominal or face value, it is an issue of shares at par *e.g.,* a share of the nominal value of Rs. 200 issued at Rs. 200. Thus, the par value of a share is its face or nominal value. In

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case the nominal or par value is payable in instalments, the investors (purchasers of shares) have to pay application money, allotment money and call money.

1. On receipt of application money:

   Bank A/c Dr.... including premium
   To Share Application A/c

2. Transfer of application money to share capital account:

   Share Application Account Dr. [With the application money on allotted shares only]
   To Share Capital Account

3. Transfer of excess application money towards allotment money:

   Share Application Account Dr. [With the application money retained as allotment money]
   To Share Allotment Account

4. Refund of application money:

   Share Application Account Dr. [With the amount refunded]
   To Bank Account

5. Calls in Advance:

   The company may transfer the surplus to a newly opened account, namely, Calls-in-Advance Account if following two conditions are satisfied:

   (*a*) The articles of the company provide for the acceptance of calls-in-advance.

   (*b*) The consent of the applicant(s) has been taken either by a separate letter or by inserting a clause in company's prospectus or application form

   Share Application Account Dr.
   To Calls-in-Advance Account

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6. Allotment money becoming due:

   Share Allotment Account Dr.
   To Share Capital Account

7. On receipt of Allotment money:

   Bank Account Dr.
   To Share Allotment Account

8. Calls on shares:

   (*a*) When the first call money becomes due

   Share First Call Account Dr. [With the amount due on first call]
   To Share Capital Account

   (*b*) When the first call money is received

   Bank Account Dr. [With amount is actual received on first call]
   To Share First Call Account

Note: The above two entries (*a*) and (*b*) are repeated for subsequent calls, that is, second call, third call and so on. All the entries will be same for preference shares.

Under-subscription

When the number of shares applied for is less than the number of shares offered to the public for subscription, the issue is termed as under subscribed. For example, ABC Ltd. offers 12,50,000 equity shares for subscription but the public applies for only 10,40,000 shares. It is a case of under-subscription. In this too, the company must raise the minimum subscription before it (the company) proceeds to allot the shares.

Over-subscription

When the number of shares applied for is more than the number of shares offered to the public, the issue is said to be over-subscribed. In such a situation the directors allot shares on some reasonable basis. The procedure adopted may be outlined as under:

First alternative: To reject some applications because of some technical defects *e.g.,* insufficient application money and allot in full to the other applicants.

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Second alternative: To make *pro rata* allotment to all the eligible applicants. second alternative is as follows:

(*i*) Acceptance (or allotment) of some applications in full *i.e.* full allotment.

(*ii*) Allotment to the remaining applicants on *pro rata* basis.

The *pro rata* allotment is made on the basis of following formula:

Total No. of Shares Allotted × No. of Shares Applied by the Applicant

Total No. of Shares Applied for

Distinction between Over-subscription and Under-subscription

1. **No. of shares Applied for:** Number of shares applied by the public is more than invitation to offer for the shares in case of over subscription. Number of shares applied for is less than the invitation to offer for the shares in case of under subscription.
2. **Acceptance of Application:** All the application (or offers) for shares are not accepted in full in case of over-subscription. All the applications (or offers) for shares are accepted in full in case of under-subscription.
3. **Minimum Subscription:** The problem of minimum subscriptions does not arise as the commitment for money is always more than required in case of over-subscription. Whereas, the problem of minimum subscription may arise as the response may be less than the minimum subscription in case of under subscription.
4. **Refund of Money:** In case of over subscription Money will have to be refunded where some applications are totally rejected or where excess application money is more than what is due on allotment. On the other hand, no question of any refund in case of under subscription.

Illustration 1: X Ltd. issued 1,000 Equity Shares of Rs. 10 each payable as follows – Rs. 3 on application, Rs. 4 on allotment and Rs. 3 on first and final call. Company got applications for 1,100 shares. 100 shares were rejected and money returned in due time. Company got all the amounts with exception to Rs. 150 on final call. Pass necessary journal entries.

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Solution:

Journal Entries in the Books of X Ltd.

Particulars	Debit (Rs.)	Credit (Rs.)
Bank A/c Dr.	3,300	
To Share Application A/c		3,300
(Being application money received on 1,100 shares @ Rs. 3)		
Share Application A/c Dr.	3,300	
To Share Capital A/c		3,000
To Bank A/c		300
(Being application money transferred to share capital account)		
Share Allotment A/c Dr.	4,000	
To Share Capital A/c		4,000
(Being share allotment money due on 1,000 shares @ Rs. 4)		
Bank A/c Dr.	4,000	
To Share Allotment A/c		4,000
(Being allotment money received)		
Share First and Final Call A/c Dr.	3,000	
To Share Capital A/c		3,000
(Being amount on share first and final call due @ Rs. 3)		
Bank A/c Dr.	2,850	
To Share First and Final Call A/c		2,850
(Being share first and final call received on 950 shares)		

1.5 Issue of Shares at Premium [Section 52]

When a company issues shares (securities) at a price higher than its face value, it is said to be issue of shares at premium. *i.e.* Excess amount received by a company over and above the face value of shares is known as premium. For example, if a company issues shares of Rs. 20 each at Rs. 25 per share, then Rs. 5 will be treated as securities premium. According to section 52(1) of the Companies Act, 2013, the

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premium collected on shares must be credited to Securities Premium Account. The company, accordingly, may use the premium for the following purposes:

(1) For paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

(2) For writing off preliminary expenses of the company.

(3) For writing off the expenses or commission paid or discount allowed on any issue of shares, or debentures of the company.

(4) For providing for any premium payable on redemption of preference shares or debentures or for buy back purposes as per section 68 of Companies Act, 2013.

Advantages of Securities Premium:

(*i*) It is a permanent source of fund like equity share capital.

(*ii*) As the premium is a part of 'Reserves and Surplus', it increases the existing reserves, thereby raising the reputation (goodwill) of the company.

(*iii*) Section 52(2) permits the utilization of the premium for certain purpose helpful to the functioning of the company.

Accounting Treatment:

(*a*) If premium is to be collected on Application.

(1) Bank A/c	Dr.... including premium
To Share Application A/c	
(2) Share Application A/c	Dr.... Amount received
To Share Capital A/c	... transfer to share capital
To Securities Premium A/c	... transfer to securities premium

(*b*) If premium is to be collected on Allotment.

Share Allotment A/c	Dr.... Amount due
To Share Capital A/c	... transfer to share capital
To Securities Premium A/c	... transfer to securities premium
Bank A/c	Dr.
To Share Allotment A/c	

Illustration 2: Y Ltd. issued 1,000 shares of Rs. 10 each at a premium of Rs. 5 payable as : Rs. 6 on application, Rs. 7 on allotment (including

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premium) and balance on first & final call, company got application for 950 shares only. You are required to show entries w.r.t. allotment only.

Solution:

Journal Entries in the Books of X Ltd.

Particulars	Debit	Credit
Share Allotment A/c Dr.	6,650	
To Share Capital A/c		1,900
To Securities Premium A/c		4,750
(Being allotment money due on 950 shares @ Rs. 7)		
Bank A/c Dr.	6,650	
To Share Allotment A/c		6,650
(Being allotment money received along with premium of Rs. 5)		

1.6 Issue of Shares at Discount

"At discount" means at a price less than the nominal value. Thus, when the company issues shares at a price which is less than the face value (or nominal value or par value) of the share, it is said that shares have been issued at discount. Where a company issues shares at a price lower or less than its face value, the shares are said to be issued at discount. For example, if a company issues shares of Rs. 100 each at Rs. 90 each, the shares are issued at a discount of Rs. 10 per share. Thus, the discount on issue of shares represents the excess of face value over the issue price. Where shares are issued at a price lower than the market price but not below the nominal value of the shares, such an issue is not an issue at discount.

Section 53 of the Companies Act, 2013 prohibits the issue of shares other than sweat equity shares at discount. Except as provided in Section 54, a Company shall not issue shares at discount. Any share issued by a company at a discounted price shall be void.

Accounting Treatment

Share discount is usually allowed on allotment, hence the following entry will be recorded on allotment which is different from the situation when shares are issued at par or premium. All other entries will be recorded as usual.

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Share Allotment A/c	Dr.	(with the amount due on allotment)
Discount on Issue of Shares A/c	Dr.	(with the amount of discount)
To Share Capital A/c		(with the total)

1.7 Surrender & Forfeiture of Shares

Forfeiture of shares: When a shareholder fails to pay money due on allotment, first call or any other call *i.e.* on any due date, the company may sue the defaulting shareholder or forfeit the shares. Generally, the company follows the second approach. The Articles of Association of the Company usually authorises the directors to forfeit the shares of a member on non-payment of any call or calls on or before the due date. However, a proper notice must be served to the holder.

Surrender of Shares: It means the voluntary return of shares by the shareholders to the company. There is no provision in the Companies Act or Table F regarding surrender of shares. However, Articles of Association may allow surrender of shares. A company, if authorized by the Articles of Association, can accept surrender of shares under conditions and limitations under which shares can be forfeited. Thus, surrender of shares may take place in respect of partly paid-up shares when a shareholder is not able or willing to pay the unpaid call. It is a short cut to the long procedure of forfeiture of shares. Surrendered shares may be reissued in the same way as the forfeited shares. The accounting entries to be made on surrender of shares are very much similar to those made on forfeiture of shares.

Accounting Treatment: The effect of forfeiture reduces the share capital & hence it is debited with the called up value and amount due but not paid (either on allotment or on calls) is credited to respective account and amount actually paid by holder is credited to "Share forfeited" Account. The forfeiture entry is passed on the following grounds:

1. When shares were issued at Par

Share Capital A/c Dr. — (No. of shares × Amount called up per share)

To Share Allotment A/c — Amount due & not paid

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To Share First Call A/c — Amount due & not paid

To Share Final Call A/c* — Amount due & not paid

To Share Forfeited A/c — Amount paid by holder

(Being ... shares forfeited for non-payment of allotment, first call & final call money as per the directors resolution No... dated...]

In case the amount due on call or calls has been transferred to "Calls-in-Arrears" A/c, the following entry will be recorded in forfeiture:

Share Capital A/c Dr. (No. of Shares × Amount called up per share)

To Calls-in-Arrears A/c — [Amount due]

To Share Forfeited A/c — [Amount paid by holder]

*If final call is not made then it will not be credited.

2. Forfeiture of Shares Originally Issued At Premium

(*a*) ***Premium already received on forfeited shares:*** When the shares are issued at premium and the money was duly received on the shares forfeited, it would remain in the 'Securities Premium Account'. And cannot be cancelled at the time of forfeiture of shares because of:

(*i*) Section 52 imposes restrictions on the utilisation or application of securities premium money;

(*ii*) the premium is not a payment for the shares themselves but a payment for the right to acquire the shares.

Accounting Treatment:

Share Capital Account	Dr. (Total number of shares forfeited × called up amount per share)
Securities Premium A/c	Dr. (with the amount of premium money unpaid on the forfeited shares)
To Shares Forfeited Account	(With the amount already paid on the forfeited shares)
To Share Allotment Account	(with the unpaid amount on allotment, if any)
To Share First Call Account	(with the unpaid amount on first call, if any)

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When the premium money has not been received on forfeited shares:

Share Capital Account	Dr. (Total number of shares forfeited × called up amount per share)
Securities Premium Account	Dr. (with the premium money unpaid on the forfeited shares)
To Shares Forfeited Account	(With the amount already forfeited)
To Calls-in-Arrears Account	(With the unpaid amount on various instalments)

1.8 Reissue of Forfeited Shares

Forfeited shares become the property of the company and the directors of the company have an authority to re-issue the shares in accordance with the provisions contained in Articles of Association. The price fixed for the forfeited share should not be lower than the amount of the call(s) due and unpaid on the share at the time of forfeiture *i.e.* the amount of discount on forfeited shares cannot exceed the amount actually paid by the original shareholder (on these forfeited shares).

Accounting Treatment

The Directors may reissue the Forfeited shares at par, at premium or at a discount. Accounting Entries are as follows :

(*a*) Re-issue at par :

Bank A/c	Dr. (Amount received)
To Share Capital A/c (Amount credited as paid up)	

(*b*) Re-issue at Discount:

Bank A/c	Dr.
Share Forfeited A/c	Dr. (Discount allowed on re-issue)
To Share Capital A/c	

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(*c*) Reissue at Premium:

Bank A/c Dr.
To Share Capital A/c
To Securities premium A/c (Premium received)

Any profit on reissue of Forfeited Shares represents Capital Profit & hence it should be transferred to Capital Reserve through the following entry:

Share Forfeiture A/c Dr.
To Capital Reserve A/c

Illustration 3: A Ltd. invited applications for 4,000 shares of Rs. 10 each at a premium of Rs. 2 per share, payable as Rs. 2 on application, Rs. 5 on allotment (including premium), Rs. 3 on 1st call and Rs. 2 on 2nd and final call. 6,000 applications were received and allotment was made *pro rata* to the applicants of 4,800 shares. Ram to whom 80 shares were allotted only paid application money. His shares were forfeited after his failure to pay 1st call. Rahim the holder of 120 shares, failed to pay the two calls and his shares were forfeited after his failure to pay the second call of the forfeited shares 160 were reissued @ Rs. 9 per share as fully paid, the whole of Ram's share included. Expenses paid with respect to issue of share Rs. 4,000.

Show journal entries and cash book. You are also required to prepare Balance Sheet with respect to the above transactions.

Solution:

Cash Book (Bank Column only)

Date	Particulars	(Rs.)	Date	Particulars	(Rs.)
	To Share Application A/c	12,000		By Share Application A/c	2,400
	To Share Allotment A/c	18,032		By Share Issue Expenses A/c	4,000
	To Share First Call A/c	11,400			
	To Share Final Call A/c	7,600		By Balance c/d	44,072
	To Share Capital A/c	1,440			
		50,472			50,472

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Journal Entries

No.	Particulars	Debit (Rs.)	Credit (Rs.)
	Share Application A/c Dr.	9,600	
	To Share Capital A/c		8,000
	To Share Allotment A/c		1,600
	(For allotment of 4,800 shares proportionately, and adjustment of excess amount on allotment)		
	Share Allotment A/c Dr.	20,000	
	To Share Capital A/c		12,000
	To Securities Premium A/c		8,000
	(For allotment money becoming due on 4,000 shares @ Rs. 5)		
	Share First Call A/c Dr.		
	To Share Capital A/c	12,000	
	(For First call money becoming due on 4,000 shares @ Rs. 3)		12,000
	Share Capital A/c (80 × 8) Dr.	640	
	Securities Premium A/c (80 × 2) Dr.	160	
	To Share Allotment A/c		368
	To Share First Calls A/c		240
	To Share Forfeiture A/c		192
	(For forfeiture of 80 shares for non-payment of allotment and first call)		
	Share Final Call A/c Dr.		
	To Share Capital A/c	7,840	
	(For Final call money becoming due on 3,920 shares @ Rs. 2)		7,840
	Share Capital A/c (120 × 10) Dr.	1,200	
	To Share First Calls A/c (120 × 3)		360
	To Share Final Calls A/c (120 × 2)		240
	To Share Forfeiture A/c		600

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No.	Particulars	Debit (Rs.)	Credit (Rs.)
	(For forfeiture of 120 shares for non-payment of first and final call)		
	Share Forfeited A/c Dr. To Share Capital A/c (for allowing discount on re-issue of shares)	160	160
	Share Forfeiture A/c Dr. To Capital Reserve A/c (for transfer of profit on reissue of 160 shares)	432	432
	Securities Premium A/c Dr. To Share Issue Expenses A/c (For writing off Share Issue Expenses of Rs. 4,000 against Securities Premium)	4,000	4,000

Balance Sheet of A Ltd. as at......

Particulars	Note No.	(Rs.)
Equity and Liabilities		
1. Shareholder's Fund	1	39,800
Share Capital Reserves & Surplus	2	4,272
Share Application Money Pending Allotment		
Non-Current Liabilities		
Current Liabilities		
Total		44,072
Assets		
1. Non-Current Assets		
2. Current Assets		
Cash & Cash Equivalents	3	44,072
Total		44,072

Notes to Accounts

Particulars	Rs.
1. Share Capital	
Authorised	
..... Shares of Rs. 10 each	***

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Particulars		Rs.
Issued and Subscribed		
3,960 shares of Rs. 10 each fully paid	39,600	
Share Forfeited	200	39,800
2. Reserves & Surplus	3,840	
Securities Premium Rs. (7,840 - 4,000) Capital Reserve	432	4,272
3. Cash & Cash Equivalents [Please refer Cash Book]		44,072

Illustration 4:

S Ltd. has an authorised capital of Rs. 20,00,000 divided into equity shares of Rs. 10 each. Out of this, 1,00,000 shares were issued at par fully paid to vendors for purchasing the building. For the balance, the company invited public subscription. They were issued at a premium of 5%. The amount payable was as follows: Application Rs. 2.50, Allotment Rs. 3.50, and First and Final Call Rs. 4.50.

Applications were received for 1,00,000 shares. All the money due were received except final call on 1,000 shares which were forfeited. Out of the forfeited shares 500 shares were re issued at Rs. 9 per share, fully paid.

Give journal entries.

Journal Entries in the Books of S Ltd.

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
	Building A/c Dr.	10,00,000	
	To Vendor A/c		10,00,000
	(Being building purchased)		
	Vendor A/c Dr.	10,00,000	
	To Equity Share Capital A/c		10,00,000
	(Being 1,00,000 equity shares of Rs. 10 each issued to vendors in satisfaction of their claim)		
	Bank A/c Dr.	2,50,000	
	To Equity Share Application A/c		2,50,000
	(Being application money received on 1,00,000 equity shares @ Rs. 2.50 each)		

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Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
	Equity Share Application A/c Dr. To Equity Share Capital A/c (Being application money transferred to share capital account)	2,50,000	2,50,000
	Equity Share Allotment A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being allotment money due on 1,00,000 shares @ Rs. 3.50 including securities premium @ Rs. 0.50 per share.)	3,50,000	3,00,000 50,000
	Bank A/c Dr. To Equity Share Allotment A/c (Being allotment money received on 1,00,000 shares @ Rs. 3.50 including securities premium @ Rs. 0.50 per share.)	3,50,000	3,50,000
	Equity Share First and Final A/c Dr. To Equity Share Capital A/c (Being Share First and Final money due on 1,00,000 shares @ Rs. 4.5 per share)	4,50,000	4,50,000
	Bank A/c Dr. To Equity Share First and Final A/c (Being Share First and Final money received on 99,000 shares @ Rs. 4.5 per share)	4,45,500	4,45,500
	Share Capital A/c [1,000 @ Rs. 10] Dr. To Share First & Final Call A/c To Share Forfeiture A/c (For forfeiture of 1,000 shares for non-payment of first and final call)	10,000	4,500 5,500
	Bank A/c Dr. Share Forfeited A/c Dr. To Share Capital A/c (Being 500 shares reissued @ Rs. 9 per share)	4,500 500	5,000
	Share Forfeiture A/c Dr. To Capital Reserve A/c (Being profit on reissue of forfeited shares represents Capital Profit & hence transferred to capital reserve account)	2,250	2,250

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Notes

1.9 Issue of Right Shares and Bonus Shares

Right Issue

Shares which are offered to the existing members are called "Rights Shares", and the right of members to be so offered is called "Right of Pre-emption." In other words, Rights Issue is an invitation to existing shareholders to purchase additional new shares in the company at a discount to the market price on a stated future date.

In a Rights Issue, a company gives shares only to existing shareholders at a certain ratio to the number of shares they already own. For example, one right share may be given for every five shares owned. In rights issue, a cut-off date is fixed which is known as the record date. Rights shares are given only to those shareholders who own the company's shares on the record date. Those who buys the shares of the company after the record date, will not be entitled to rights shares despite the fact that the rights shares will be issued after that date.

Usually a company offers rights issue at a price which is lower than the market price of the shares so that existing shareholders may get the monetary benefit of their association with the company. As per sec. 62(1) of Companies Act, 2013 where at any time, a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares shall be offered—

(*a*) to persons who, at the date of the offer, are holders of equity shares of the company in proportion, as nearly as circumstances admit, to the paid-up share capital on those shares by Sending a letter of offer subject to the following conditions, namely:—

(*i*) the offer shall be made by notice specifying the number of shares offered and limiting a time not being less than 15 days and not exceeding 30 days counted from the date of the offer within which the offer, if not accepted, shall be deemed to have been declined;

(*ii*) unless the articles of the company otherwise provide, the offer aforesaid shall be deemed to include a right exercisable by the person concerned to renounce the shares offered to him or any of them in favour of any other person; and the notice referred to in clause (*i*) shall contain a statement of this right;

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(*iii*) if the existing shareholder declines to accept the shares offered, the Board of Directors may dispose them in such manner which is not dis-advantageous to the shareholders and the company.

This right can be calculated as follows:

Step 1: Calculate the market value of these shares [*i.e.*, price required to be paid get fresh shares] = M

Step 2: Find the price required to be paid by existing shareholder for one share = S Now Find M + S

Step 3: Find the average price of the above two *i.e.* [of existing shares and fresh shares] = ***M+S***

Number of Shares

Step 4: Now average price of the share should be deducted from the market price and the Result will be value of Right.

Example: 1

X Ltd. makes a right issue of **one** share for every **three** share held. The market value of existing shares is Rs. 25 (face value Rs. 10 per share). The issue price of right share is Rs. 15 per share. Calculate value of right.

Solution:

Total market price of three existing shares = 25 × 3 = 75

The issue price of right share is = 15

Total for 4 shares = 90 i.e. [75+15]

Average Price per share = 75+15/4 = 90/4 = Rs. 22.50

Value of Right = 25 : 22.50 = Rs. 2.50

Bonus Issue

When a company has large accumulated reserves which cannot be distributed as dividends in cash either because of legal restrictions or accounting principle of prudence (or conservatism), it converts this surplus into capital (by process of capitalising the surplus) and divides the capital among the existing shareholders in proportion to the (share) capital held by them by issuing fully paid bonus shares. The shareholders to whom these shares are allotted have to pay nothing *i.e.* Bonus issue is made to the existing members free of charge.

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The basic characteristics of bonus shares are:

(*i*) Bonus shares are issued to the existing members,

(*ii*) Bonus shares are always fully paid, and

(*iii*) Right to renunciation is not available in respect of bonus shares.

Conditions for bonus issue or capitalising reserves under section 63(2) as given below:

(*a*) It is authorised by its articles.

(*b*) It has, on the recommendation of the Board, been authorised in the general meeting of the company.

(*c*) It has not defaulted in the payment of interest or principal in respect of fixed deposits or debt securities issue by it.

(*d*) It has not defaulted in respect of the payments of statutory dues of the employees such as, contribution provident fund, gratuity and bonus.

(*e*) The partly paid-up shares, if any, outstanding at the date of allotment must be made fully paid-up.

(*f*) It complies with such other conditions as may be prescribed.

The bonus shares shall not be issued in lieu of dividend [Section 63(3)].

Rule 14 of the Companies (Share Capital and Debentures) Rules, 2014 provides that once a company announce decisions of the Board recommending bonus issue, it cannot withdraw such decision subsequently:

(*i*) It is a simple method of expanding the capital base of the company.

(*ii*) It helps the company to retain the cash.

(*iii*) It adds to the reputation or goodwill of the company.

(*iv*) Initially the market value of the share will decline on the issue of bonus shares. This trend lead to more trading volume in shares in stock market.

(*v*) By issue of bonus share, the paid-up capital reflects the actual capital employed by the company.

Advantages:

- Liquidity position improves as no cash dividends are paid.
- Reduces the chances of any takeover bid.

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- More security to creditors.
- Retains cash required for operating activities.

Disadvantages:

- Rate of return per share would decline as the number of shares outstanding increased.
- Encourage more speculative dealings.
- Lengthy and cumbersome procedure for obtaining approval from SEBI.

Distinction between Rights Issue and Bonus Issue:

(*i*) **Price:** Rights shares are issued for a price while bonus shares are issued to the existing members free of charge.

(*ii*) **Partly paid:** Rights shares may be partly paid while bonus shares are always fully paid.

(*iii*) **Minimum subscription:** In the case of Rights Issue, if the company does not receive a minimum subscription, the entire money received shall be returned; there is no such requirement regarding bonus issue.

(*iv*) **Separate bank account:** For rights issue, the amount received must be kept in a separate bank concerned stock exchange approves the allotment. But this is not relevant to bonus issues since no money is to be received by the company.

(*v*) **Right to renounce:** Rights issue may be renounced by a member in favour of his nominee. But no such facility is available in respect of bonus issue.

(*vi*) **Provision in the Companies Act:** Section 62 of the Companies Act governs the issue of rights share guidelines also apply. On the other hand, bonus shares can be issued only when there is an express provision in the articles of association under section 63 of the Companies Act, 2013 and Rule 14 (Share Capital and Debentures) regulate the issue of bonus shares. The guidelines issued by SEBI have also to be strictly.

(*vii*) **Purpose:** Rights issue is made for raising funds for the company. Bonus issue is made to capitalized undistributed profits.

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(*viii*) **Cash:** Rights share bring cash to the company; Bonus shares are free and hence do not add to the cash of the company.

1.10 Employee Stock Option Plan

Employee Stock Option Plan is a plan under which the company grants rights to its employees to purchase shares of the company at a stated price at the time of public issue or otherwise. Here the term 'employee' includes a director of the enterprise, whether whole time or not for the purpose of Employee Share - based payments. The objective of this scheme is to encourage employees to have a higher participation in the company. Here, it is important to note that Employee Stock Option Plan is a contract that gives the employees the right, but not the obligation, for a specified period of time to purchase or subscribe to the shares of the company at a fixed price.

Accounting Treatment

1. Fair Value Method:

(*i*) Employee Compensation Expense Account Dr.

To Employee Stock option outstanding account

(Being compensation expenses recognized in respect of the ESOP)

(*ii*) Statement of Profit and Loss Account Dr.

To Employee Compensation Expense Account

(Being employee compensation expenses adjusted against Profit and Loss Account)

At the time of exercising the options by the employee following entries are required to be passed:

(*i*) For receipt of exercise price from the employee:

Bank Account Dr. (No. of options × exercise price)

To Employee Stock option outstanding account

(Being receipt of exercise price from the employees)

(*ii*) For issue of shares:

Employee Stock option outstanding account Dr. (No. of options × Fair value of shares)

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To Share Capital Account (No. of option × Face value of shares)

To Securities Premium Reserve Account (Balancing Figure)

For Cancellation of Options Lapsed:

Employee Stock Option Outstanding Account Dr. (No. of options lapsed × Fair value of each option)

To General Reserve Account

(Being the fair value of options lapsed at the end of exercise period transferred to General Reserve Account)

2. Intrinsic Value Method

It is the excess of the market price of the share under ESOS over the exercise price the option. Any excess of the intrinsic value over the nominal price of shares is to be transferred to 'Securities Premium Reserve Account'. The accounting entries are passed in same way as passed in fair value method.

1.11 Book Building

Book building was one such important mechanism recognized by SEBI. Under the traditional fixed price method of pricing public issues, the issue price is determined around 60-70 days before the opening of the issue and the issuer has no clear idea about the market perception of the price determined. As a result, majority of the public issues coming through the fixed price method are either underpriced or over-priced. Moreover, public offers in fixed price methods involved a pre-issue cost of 2-3% and carry the risk of failure if it does not receive 90% of the total subscription. In book building such cost and risks can be avoided because the issuer company can withdraw from the market if demand for the security does not exist. Thus, Book-building involves the collection of bids based on an indicative price range (normally the price band cannot exceed 20% of floor price). Investors place their bids at different prices and ultimately that price and quantum which has maximum demand is selected.

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Steps of Book Building Process

The main parties who are directly associated with book-building process are the issuer company, the Book Runner Lead manager (Book Runner or Merchant banker) and the syndicate members. The Book Runner Lead Manager (*i.e.,* Merchant Banker) and the syndicate members who are the intermediaries are both eligible to act as underwriters. The steps which are usually followed in the book building process can be summarized below:

(*i*) The issuer company proposing IPO appoints a lead merchant banker as Book Runner.

(*ii*) Initially the issuer company consults with the Book Runner in drawing up a draft prospectus (*i.e.* offer document) which does not mention the price of the issues, but includes other details about the size of the issue, past history of the company, and a price band. The securities available to the public are separately identified as "net offer to the public."

(*iii*) The draft prospectus is filed with SEBI which gives it a legal standing.

(*iv*) A definite period is fixed as the bid period and Book Runner conducts awareness campaigns like advertisement, road shows, etc.

(*v*) The Book Runner appoints a syndicate member, a SEBI registered intermediary to underwrite the issues to the extent of "net offer to the public."

(*vi*) The copy of the draft prospectus may be circulated by the Book Runner to the institutional investors as well as to the syndicate members.

(*vii*) The syndicate members create demand and ask each investor for the number of shares and the offer price.

(*viii*) The prospective investors may revise their bids at any time during the bid period.

(*ix*) The Book Runner on receipt of the feedback from the syndicate members about the bid price and the quantity of shares applied, has to build up an order book the demand for the shares of the company at prices. The syndicate members must also maintain a

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record book for orders received from institutional for subscribing to the issue out of the placement portion.

(*x*) On receipt of the above information, the Book Runner and the issuer company determine the issue price. This known as the market clearing price.

(*xi*) The Book Runner then closes the book in consultation with the issuer company and determines the issue (*a*) placement portion and (*b*) public offer portion.

(*xii*) Once the final price is determined the allocation of securities should be made by the Book Runner based on prior commitment, investor's quality, price aggression and earliness of bids. The bid of an institutional bidder, even if he has paid full amounts may be rejected without being assigned any reasons as the Book Building portion of institutional investors is left entirely at the discretion of the issuer company and the Book Runner.

(*xiii*) The final prospectus is filed with registrar of companies within 2 days of determination of issue price and receives the acknowledgement card from SEBI.

(*xiv*) The Book Running Lead Manager must certify that the disclosures made in the offer document are in conformity with the SEBI (Disclosure and Investor Protection) Guidelines.

(*xv*) The allotment for the private placement portion shall be made on the 2nd day from the closure of the issue and the private placement portion is ready to be listed.

(*xvi*) The allotment and listing of issues under the public portion (*i.e.* fixed price portion) must be as per the existing statutory requirements.

(*xvii*) Finally, the SEBI has the right to inspect such records and books which are maintained by the Book Runner and other intermediaries involved in the Book Building Process.

The book building process offers the following **advantages**:

(*i*) The cost of issue is considerably minimized because of limited number of investors;

(*ii*) The funds are collected easily and quickly at least to the extent of private placement;

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(*iii*) The success of the issue of shares is ensured because of full subscription by underwriters and brokers. There are minimum chances of over-subscription;

(*iv*) The issue price of the shares is realistic in the sense that it is fixed just one or two weeks before the opening of the issue;

(*v*) Since the issue price is based on the actual offers made by different investors, it tends to be closer to the real one and hence, it is fair one;

(*vi*) The intrinsic worth of the securities and credibility of the company can be easily evaluated in the book building process.

Limitations of Book Building

(*i*) Book building is most suitable in the case of mega issues only;

(*ii*) The issuer company must be financially sound and well known to the investors (*e.g.*: issue of shares by Maruti Udyog Limited;

(*iii*) For the success of book building process, the existence of well-organized stock exchanges is necessary. The investors are made available the necessary information affecting the movement of share prices.

There is a possibility of price rigging on listing of securities as promoters may try to help or bail out syndicate members.

1.12 Underwriting and Brokerage

Underwriting is an agreement with or without conditions, to the securities of a body corporate when the existing shareholders of such body corporate or the public do not subscribe to the securities offered to them (SEBI Regulations, 2009).

Rule 13 of the Companies Rules, 2014 provides that a company may pay commission to any person in connection with the subscription or procurement of subscription to its securities, whether absolute or conditional, subject to the following conditions:

- The payment of such commission shall be authorized in the company's articles of association.
- The commission may be paid out of the proceeds of the issue or the profits of the company or both.

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- The rate of commission shall not exceed in case of shares, 5% of the price at which the shares are issued, or as specified in the company's articles, whichever is less.
- There shall not be paid commission to any underwriter on securities which are not offered to the public for subscription.

1.13 Summary

A company may arrange finance through investment of its own savings, by taking loans from commercial banks and financial institutions, by inviting public deposit, or by issue of shares/debentures. When a Public company intends to raise capital by offering (selling) its shares to the public, it invites the public through a document called 'Prospectus'. A company can issue shares in two ways *i.e.* issue of shares for cash and issue of shares for consideration other than cash. Further shares may be issued at its face value or at premium. Section 52 of Companies Act, 2013 deals with issue of shares at premium whereas section 53 provides guidelines w.r.t. issue of shares at discount.

Over Subscription is a situation when number of share applied for exceeds the number of share issued. Directors of the company make the allotment of shares on the basis of some reasonable basis in case of over-subscription. They may decide total rejection of some application; or acceptance of some application in full; and allotment of remaining applicants on *pro rata* basis.

If any shareholder fails to pay the calls made on him, the board has the right to forfeit those shares. Forfeiture will lead to removal of the name of the member from the Register of Members and the amount paid by him will not be refunded to him. Forfeiture means termination of membership. Forfeited shares become the property of the company and the directors of the company have an authority to reissue the shares in accordance with the provisions contained in Articles of Association.

Whenever a company plans to issue new shares then its existing shareholders must be given a chance to apply for these shares at first instance. Provision of this chance may be considered as a right for the shareholders and the issue may be named as 'Issue of Right Shares'. Employee Stock Option Plan is a plan under which the company grants

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rights to its employees to purchase shares of the company at a stated price at the time of public issue or otherwise. Book-building involves the collection of bids based on an indicative price range (normally the price band cannot exceed 20% of floor price). Investors place their bids at different prices and ultimately that price and quantum which has maximum demand is selected. Underwriting is an agreement with or without conditions, to the securities of a body corporate when the existing shareholders of such body corporate or the public do not subscribe to the securities offered to them.

1.14 Questions for Practice

Exercise 1: Very Short Answer Type Questions

1. What do you mean by issue of shares at premium?
2. What is over-subscription of shares?
3. What is the purpose of *pro rata* allotment?
4. Give suitable journal entry for forfeiture of share with necessary narration?

Exercise 2: Descriptive Questions

1. What do you mean by the term 'share'? Discuss the type of shares, which can be issued under the Companies Act, as amended to date.
2. Describe the purposes for which a company can use the amount of Securities Premium as per section 52 of Companies Act, 2013?
3. Companies are prohibited from issuing shares at a discount. Comment in the light of section 53 of Companies Act, 2013.
4. Explain the term 'Forfeiture of Shares' and give the accounting treatment on forfeiture.
5. Write a short note on Book Building.
6. Distinguish between Rights issue and Bonus issue.

Exercise 3: Multiple Choice Questions Select the correct alternative:

(*a*) Share Allotment Account is a:

(*i*) Nominal Account

(*ii*) Personal Account

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(*iii*) Both (*i*) & (*ii*)

(*iv*) Real Account

(*b*) The balance of the forfeited shares account after reissue of forfeited shares is transferred to:

(*i*) Capital Reserve Account

(*ii*) Share Capital Account

(*iii*) Profit and Loss Account

(*iv*) Revenue Reserve

(*c*) When shares are forfeited, the shares capital account is debited by:

(*i*) Called up amount

(*ii*) Paid-up amount

(*iii*) Nominal value of shares

(*iv*) None of the above

Ans.: (*a*) (*ii*) Personal Account

(*b*) (*i*) Capital Reserve Account

(*c*) (*i*) Called up amount

Exercise 4: Fill in the blanks:

(*i*) Balance in share forfeited account is shown in the balance sheet under the head ________.

(*ii*) Securities Premium is presented under the head ________while preparing financial statements.

(*iii*) Companies Act ________a company to issue shares at discount.

Ans.: (*i*) Shareholders fund (Share Capital)

(*ii*) Reserve and Surplus

(*iii*) Prohibits

Exercise 5: True and False:

State with reason whether the following are true or false:

(*i*) Company is free to use Securities Premium amount for any of the purposes.

(*ii*) Shares of a company can't be issued for consideration other than cash.

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(*iii*) From accounting point of view forfeiture and surrender of shares are different.

(*iv*) Any profit on reissue of Forfeited Shares represents Capital Profit & hence it should be transferred to Capital Reserve through the following entry :

Share Forfeiture A/c Dr.
To Capital Reserve A/c

Ans.: (*i*) False (*ii*) False (*iii*) False (*iv*) True

Exercise 6: Practical Question

X Ltd. Co. invited applications for 10,000 shares of Rs. 10 each at a Premium of Rs. 5 per share payable as follows:

On application Rs. 3 per share, on allotment Rs. 6 per share (including premium) and the balance by two calls of equal amount.

Applications were received for 18,000 shares and allotment was made on applications of 15,000 shares at the rate of two shares for every three applied for. Som failed to pay the allotment money for the forty (40) shares allotted to him and these shares were forfeited when he failed to pay the first call.

Bakshi failed to pay the calls in respect of 120 shares allotted to him and these shares were forfeited after the second call. 40 shares allotted to Som originally and another 40 shares allotted to Bakshi were later issued to Goswami as fully paid on payment of Rs. 9 per share.

Show Journal entries in the books of company.

Ans.: Share Forfeiture A/c (Cr.) Sam's share = Rs. 180; Share Forfeiture A/c (Cr.) Bakshi's share = Rs. 480; Amount Transferred to Capital Reserve Rs. 260.

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L E S S O N

2

Redemption of Preference Shares

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STRUCTURE

2.1 *Learning Objectives*
2.2 *Meaning of Redemption*
2.3 *Legal Provisions for Redemption of Preference Share*
2.4 *Accounting Treatment*
2.5 *Redemption of Preference Shares by Conversion*
2.6 *Use of Algebraic Equation*
2.7 *Summary*
2.8 *Questions for Practice*

2.1 Learning Objectives

This Chapter will assist you to:

- Understand the meaning of redemption of preference shares under section 55.
- Legal provisions for redemption of preference share.
- Apply the accounting procedure in redemption of preference shares.

2.2 Meaning of Redemption

To redeem means to repay. Redemption of preference shares means the repayment or return of preference share capital to the preference shareholders. Section 55 of the Companies Act, 2013 permits the redemption of preference shares provided the certain conditions are satisfied. Redemption may be at par or at premium. The conditions are:

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(*i*) **Redemption of fully paid shares only:** Only fully paid preference shares at the time of redemption, can be redeemed. If the shares are partly paid, they must be made fully paid by making final call on the shareholders; the reason is that section 55 is intended to replace only the nominal value of shares and not the paid-up value.

(*ii*) Redemption only out of divisible profits or out of proceeds of a fresh issue of share capital. Divisible profits means profits which would otherwise be available for distribution as dividend. If profits are not available for dividend, they cannot be used for redemption of preference shares.

Example of divisible profits are: Positive balance in the Surplus Account (Profit and Loss Account), General Reserves, Dividend Equalisation Reserve, Reserve Fund, Insurance Fund, Workmen, Compensation Fund (to the extent it is in excess of the required provision), Workmen' Accident Fund (to the extent in excess of required provision). Contingency reserve (in excess of required provision), profit on sale of investment though it is a part of surplus Account.

Development Rebate Reserve Account and Investment Allowance Reserve can be used only when specifically mentioned in the examination problem. Here also only specific amount stated in the problem is available for redemption purpose.

Profits prior to incorporation is capital profit and not available for dividend distribution; hence not available for redemption purpose.

(*iii*) Redemption out of the proceeds of the fresh issue of equity shares or preference shares made for the purpose of redemption. The term proceeds means, the nominal value of new shares when issued either at par or at a premium. Securities Premium Account cannot be used for redemption of preference shares

It may be emphasised that a company can use divisible profits and proceeds from the fresh issue of shares simultaneously as sources for redemption purpose. In other words' a company can redeem a part of the preference shares out of the proceeds of fresh issue of share capital and the balance out of the divisible profits.

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(*iv*) **Transfer to capital redemption reserve account:** When preference shares are redeemed out of profits which would otherwise be available for dividend distribution, a sum equal to the nominal value of the shares redeemed (out of divisible profits) must be transferred to Capital Redemption Reserve Account from the divisible profits [No such transfer to capital redemption reserve account is made when the redemption is done out of proceeds of the fresh issue of equity or preference shares or both]

(*v*) **Utilisation of capital redemption reserve account:** Capital Redemptions Reserve Account can be used only for the purpose of issuing fully paid bonus shares.

(*vi*) **Premium on redemption:** Premium payable on redemption of any preference shares issued must be provided out of the profits of the company or out of the Securities Premium Account before such shares are redeemed. Profits for this purpose include capital profit also. But revaluation reserve cannot be used to pay premium on redemption.

Under the Companies Act, 2013, such class of companies as may be prescribed whose financial statements comply with Accounting standards prescribed for such class of companies cannot utilize securities premium account for providing premium payable on redemption of preference shares or debentures.

2.3 Legal Provisions for Redemption of Preference Share

Section 55 of the Companies Act, 2013 deals with the issue and redemption of redeemable preference shares. Its provisions are summarised as under:

(*i*) **Only redeemable preference shares:** It means that no company can issue irredeemable preference shares.

(*ii*) **Authorised by articles:** The issue of redeemable preference shares must be authorised by the articles of association.

(*iii*) **Period of redemption:** Preference shares shall be redeemed after the expiry of 20 years from the date of its issue. However, a company may issue preference shares for a period exceeding 20 years for infrastructure.

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Rule 10 of the Companies (Share Capital and Debentures) Rules, 2014 provides that a company engaged in infrastructure projects may issue preference shares for a period exceeding 20 years but not exceeding 30 years. In such a case, at least 10% of the preference shares per year from 21st year onward or earlier, on proportionate basis, at the option of the preference shareholders have to be redeemed.

(*iv*) **Other conditions:** Rule 9 of Companies (Share Capital and Debentures) Rules, 2014 mentions two more conditions for the issue of preference shares:

(*a*) The issue of preference shares must have been authorised by passing a special resolution in the general meeting.

(*b*) The company, at the time of such issue of preference shares has no subsisting default in the redemption of preference shares or in the payment of dividend on preference shares.

(*v*) **Sources of redemption:** The nominal or face or par value of redeemable preference shares can be redeemed either:

(*a*) out of distributable or divisible or free profits; or

(*b*) out of the proceeds of a fresh issue of shares (equity or preference or both) made for the purpose of redemption only; or

(*c*) out of a combination of both, that is, partly out of fresh issue of shares and partly out of the divisible or distributable or free profits.

(*vi*) **Premium on redemption:** A company can redeem preference shares either at par or at premium. If preference shares are redeemed at a premium, the premium must be provided, before the shares are redeemed, either : (*a*) out of company's securities premium account or (*b*) out of the profits of the company.

(*vii*) **Capital redemption reserve:** When redeemable preference shares (only nominal value) are redeemed out of divisible profits of the company, an amount equal to the nominal value of shares so redeemed must be transferred from divisible profits to the Capital Redemption Reserve Account.

(*viii*) **Use of capital redemption reserve :** The capital redemption reserve can be used only for issuing fully paid bonus shares to the equity

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shareholders. It means, that it cannot be used for making partly paid shares as fully paid.

(*ix*) **No reduction in capital :** When preference shares are redeemed, it does not amount to reduction of authorised capital of the company. Similarly, there is no reduction of actual capital because either new shares are issued for redemption or capital redemption reserve account is used to issue bonus shares leading to new share capital.

(*x*) There is no increase in authorised capital if new preferences shares are issued by company in lieu of redemption of preference shares.

2.4 Accounting Treatment

1. For Making Partly Paid Redeemable Preference Shares as Fully Paid

(*a*) Share Final Call Account Dr. [With the call money due]
  To Redeemable Preference Share Capital Account

(*b*) Bank Account Dr. (On receipt of final call money)
  To Share Final Call Account

(*c*) Money received on calls-in-arrears:
Bank Account Dr. [With the amount received]
  To Calls-in-Arrears Account

2. Forfeiture of Shares

Redeemable Preference Share Capital Account Dr.
  To Shares Forfeited Account
  To Calls-in Arrears Account

3. Reissue of Forfeited Shares

(*a*) Bank Account Dr.
  Shares Forfeited Account (if any) Dr.
  To Share Capital Account

(*b*) Profit or gain on forfeiture Dr.
  Shares Forfeited Account
  To Capital Reserve Account

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4. Sale of Fixed Assets, Investments etc. to Provide Cash for Payment

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

Any profit or loss on sale must be transferred to the Profit and Loss Statement

5. Issue of New Shares

When the new shares are issued, for the redemption out of proceeds of the fresh issue made for the purpose redemption, the following entries are made.

Issue and Redemption of Preference Shares

(*i*) When new shares are issued at par

(*a*) Bank Account Dr.
To Share Application and Allotment Account

(*b*) Share Application and Allotment Account Dr.
To Share Capital Account

(*ii*) When new shares are issued at a discount

Section 53 of the Companies Act Prohibits the issue of shares at discount.

(*iii*) When new shares are issued at premium

(*a*) Bank Account Dr.
To Share Application and Allotment Account

(*b*) Share Application and Allotment Account Dr.
To Share Capital Account
To Securities Premium Account

6. Transferring the Claims OR Amount Payable on Redemption:

(*a*) When redemption is at par Dr.
Redeemable Preference Share Capital Account
To Preference Shareholders Account

(*b*) When redemption is at premium
Redeemable preference Share Capital Account Dr.
Premium on Redemption of Preference Shares Dr.
To Preference Shares Account

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Issue and Redemption of Preference Shares

(*i*) When new shares are issued at par

(*a*) Bank Account Dr.
    To Share Application and Allotment Account
(*b*) Share Application and Allotment Account Dr.
    To Share Capital Account
    Premium on Redemption of Preference Shares Account Dr.
    To Preference Shareholders Account

7. Adjustment for (or Writing Off) the Premium on Redemption

Securities Premium Account Dr.
Capital Profit Account Dr.
General Reserve Account Dr.
Surplus Account Dr.
    To Premium on Redemption of Preference Shares Account

8. Creation of Capital Redemption Reserve

When the company redeems preference shares, wholly or partly, out of divisible profits, it has to transfer nominal value of shares redeemed out of such profits to a new reserve account called Capital Redemption Reserve Account. The entry is:

Surplus Account Dr.
Any other Revenue Reserve Account Dr.
    To Capital Redemption Reserve Account

Note: All appropriations of profit are done in the Balance Sheet under the head “Reserves and Surplus” (Schedule III of Companies Act, 2013).

CRR Account = Nominal Value of Preference Shares to be redeemed – Proceeds from the fresh issue of shares.

Settlement of Claims or Payment on Redemption: The entry of the settlement of claim of (or payment to) preference shareholders is:

Preference Shareholders Account Dr.
    To Bank Account

Payment of Expenses on Fresh Issue of Shares or Debentures

Expenses on Fresh issue of Shares or Debentures Account Dr.
    To Bank Account

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2.5 Redemption of Preference Shares by Conversion

The redemption of preference shares can be affected by payment in cash unless the terms of issue of the shares provide for an option of conversion into equity shares. Such preference shares are known convertible preference shares. Any scheme of conversion will require the compliance of section 62 (Further issue of Share Capital) section 48 (Variation of shareholders' rights), section 230 (Power to compromise or make arrangements with creditors and members), section 231 (Power of Tribunal to enforce Compromises and Arrangements). The accounting treatment or the scheme of journal entries would depend upon the fact whether the equity shares are issued at par, or premium on redemption by conversion.

The journal entries are:

(*i*) Amount payable to preference shares on redemption

Preference Share Capital Account	Dr.
Premium on Redemption (if any) Account	Dr.
To Preference Shareholders Account	

(*ii*) Issue of equity shares at par

Preference Shareholders Account	Dr.
To Equity Share Capital Account	

(*iii*) Issue of equity shares at premium

Preference Shareholders Account	Dr.
To Equity Share Capital Account	
To Securities Premium Account	

Calls-in-arrears

According to section 55 of the Companies Act, only fully paid preference shares can be redeemed. It means that if there are calls-in-arrears in respect of certain preference shares, such shares can be redeemed only when the calls are paid by the defaulting shareholders who hold these shares. In an examination problem, the students should not redeem such shares unless there is actual receipt of money on these calls-in-arrears. The company should keep sufficient balance in divisible profits to redeem these shares in future when call-in-arrears will be paid. The journal entry for recording the realisation or receipt of calls-in-arrears is:

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Bank Account Dr.
To Calls-in-Arrears Account

2.6 Use of Algebraic Equation

Sometimes the examination problem requires the determination of the minimum possible amount of fresh issue and nothing more than required, for the purpose of redemption. The difficulty arises especially when:

(*i*) The preference shares are to be redeemed at a premium,

(*ii*) The fresh issue is to be made at premium, and

(*iii*) The given amount of premium in the securities premium account (in the balance sheet) plus the amount of premium to be obtained from the fresh issue is not sufficient to pay off premium on redemption of preference shares.

In order to solve the problem under discussion, it is suggested to use the following algebraic equation:

Let us assume the fresh issue is equal to 'n'.

(*a*) When the fresh issue is to be made at premium

[Preference Share Capital + Securities Premium Account] = [Balance in the Securities Premium Account in the Balance sheet] + [Divisible or Free Profits] + n+ [n X Percentage of Rate of premium on fresh issue]

(*b*) When the fresh issue is to be made at discount

[Redeemable Preference Share Capital + Premium on Redemption] = [balance in the Securities Premium Account in Balance Sheet] + [Divisible or Free Profits] + n+ [-n X percentage of Premium]

Note: Section 53 prohibits issue of shares at discount.

Illustration 1:

Tarun Ltd. had part of its share capital in 4,000 Preference Shares of Rs. 10 each fully paid-up; these have become due for redemption. The preference share capital was to be redeemed out of a fresh issue of equity shares of Rs. 10 each (at par) made particularly for this purpose. General reserve of the company stood at Rs. 95,000.

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Show the journal entries for the above.

Solution:

Journal Entries in the Books of Tarun Ltd.

No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
1.	Preference Share Capital Dr.	40,000	
	To Preference Shareholders A/c		40,000
	(Being amount due on redemption transferred to preference shareholders account)		
2.	Bank A/c Dr.	40,000	
	To Equity Share Capital A/c		40,000
	(Being 4,000 equity shares @ Rs. 10 each for redemption)		
3.	Preference Shareholders A/c Dr.	40,000	
	To Bank A/c		40,000
	(Being payment made to preference shareholders on redemption)		

Illustration 2:

A company decides to redeem at par 20,000 redeemable preference shares of Rs. 100 each. A general reserve of Rs. 12,50,000 had already been built up for this purpose. For the purpose of redemption, 75,000 equity shares of Rs. 10 each were offered to the public at a premium of Rs. 5 each, payable on full on application. The new issue was fully subscribed and money received in time. Preference shares were redeemed following prescribed guidelines in the Companies Act.

Journalise the above.

Solution:

Journal Entries

Sl. No.	Particulars	Debit (Rs.)	Credit (Rs.)
1.	Bank A/c Dr.	11,25,000	
	To Equity Share Application and Allotment A/c		11,25,000
	(Being application money on 75,000 equity shares @ Rs. 15 each received)		

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Sl. No.	Particulars	Debit (Rs.)	Credit (Rs.)
2.	Equity Share Application and Allotment A/c Dr.	11,25,000	
	To Equity Share Capital A/c		7,50,000
	To Securities Premium A/c		3,75,000
	(Being application money transferred to share capital and amount transferred to securities premium account)		
3.	Preference Share Capital A/c Dr.	20,00,000	
	To Preference Shareholders A/c		20,00,000
	(Being amount due on redemption transferred to preference shareholders account)		
4.	Preference Shareholders A/c Dr.	20,00,000	
	To Bank A/c		20,00,000
	(Being payment made to preference shareholders on redemption)		
5.	General Reserve A/c Dr.	12,50,000	
	To Capital Redemption Reserve A/c		12,50,000
	(Being amount of general reserve transferred to capital redemption reserve account)		

Illustration 3:

Ayan Ltd. had 50,000 Equity Shares of Rs. 10 each and 3,000, 10% Preference Shares of Rs. 100 each, Rs. 90 paid. On 31.03.2014, Profit and Loss A/c showed an undistributed profit of Rs. 50,000 and General Reserve Account stood at Rs. 1,20,000. On 01.04.2014, the directors decided to issue 1,500, 6% Preference Shares of Rs. 100 each for cash and to redeem the existing preference shares at Rs. 105 utilising as much reserve as would be required for the purpose. Show the journal entries to record the transactions.

Solution:

Journal entries in the Books of Ayan Ltd.

Sl. No.	Particulars	Dr.	Cr.
1.	Share Final Call A/c Dr.	30,000	
	To Redeemable Preference Share Capital A/c		30,000
	(Being calls invited to make the shares fully paid up)		

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Sl. No.	Particulars	Dr.	Cr.
2.	Bank A/c Dr.	30,000	
	To Share Call A/c		30,000
	(Being amount received from preference shareholders)		
3.	10% Preference Share Capital A/c Dr.	3,00,000	
	Premium on Redemption of Preference Shares A/c Dr.	15,000	
	To Preference Shareholders A/c		3,15,000
	(Being amount due on redemption of preference shares)		
4.	Bank A/c Dr.	1,50,000	
	To Preference Share Capital A/c		1,50,000
	(Being 6% preference shares issued for the purpose of redemption)		
5.	General Reserve A/c Dr.	15,000	
	To Premium on Redemption of Preference shares A/c		15,000
	(Being premium payable on redemption written off against general reserve)		
6.	General Reserve A/c Dr.	1,05,000	
	Profit & Loss A/c Dr.	45,000	
	To Capital Redemption Reserve A/c		1,50,000
	(Being capital redemption reserve account created by transferring requisite amount from general reserve and profit and loss account)		
7.	Preference Shareholders A/c Dr.	3,15,000	
	To Bank A/c		3,15,000
	(Being payment made to pref. shareholders on redemption)		

Illustration 4:

S Ltd. has an authorised capital of Rs. 8,00,000 divided into : 10,000; 6% Preference Shares of Rs. 10 each

20,000; 7% Preference Shares of Rs. 10 each and

50,000; Equity Shares of Rs. 10 each

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(*i*) On 1st January, 2015, the whole of the two classes of preference shares and 15,000 of equity shares were fully paid. On that date, Securities Premium Account showed a balance of Rs. 20,000 and Profit and Loss Account had a balance of Rs. 32,000.

(*ii*) On 1st July, 2015, it was decided to redeem the whole of 6% Preference Shares at a Premium of Rs. 1 per share and for this purpose, company issued for cash 8,000 equity shares of Rs. 10 each at a premium of Rs. 2 each, payable full on allotment. All these shares were taken up.

(*iii*) Cost of issue of shares amounted to Rs. 3,000.

Solution:

Journal Entries in the Books of S Ltd.

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
2015	6% Preference Share Capital A/c Dr.	1,00,000	
July 1	Premium on Redemption of Preference Shares Dr.	10,000	
	To Preference Shareholders A/c		1,10,000
	(Being amount due on redemption transferred to preference shareholders account)		
	Bank A/c Dr.	96,000	
	To Equity Share Application and Allotment A/c		96,000
	(Being application money on 8,000 equity shares @ Rs. 2 received, including a premium of Rs. 2 per share)		
	Equity Share Application and Allotment A/c Dr.	96,000	
	To Equity Share Capital A/c		80,000
	To Securities Premium A/c		16,000
	(Being application money transferred to share capital and amount transferred to securities premium account)		
	Expenses on Issue of Shares A/c Dr.	3,000	
	To Bank A/c		3,000
	(Being cost on issue of shares paid)		
	Preference Shareholders A/c Dr.	1,10,000	
	To Bank A/c		1,10,000
	(Being payment made to preference shareholders on redemption of preference shares)		

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Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
	Securities Premium A/c Dr.	13,000	
	To Premium of Redemption Preference Share A/c		10,000
	To Expenses on Issue of Shares A/c		3,000
	(Being required entry for Adjustment of Premium on Redemption passed)		
	Profit and Loss A/c [Surplus A/c] Dr.	20,000	
	To Capital Redemption Reserve A/c		20,000
	(Being amount transferred to capital redemption reserve account) Rs. [1,00,000 - 80,000]		

Calculation of Minimum Number of Fresh Shares to be issued

Sometimes, problem does not specify the minimum number of shares to be issued for the purpose of redemption of Preference Share and at the same time it is required to ensure compliance of section 55 of the Companies Act, 2013.

Following equation is used for ascertaining the required minimum number of shares to be issued:

Nominal value of Redeemable Preference Shares + Premium payable on Redemption of Preference Share = Maximum amount of Reserve and Surplus available (i.e. available Divisible Profit) + Available Securities Premium + Amount from Fresh Issue of Shares.

Example 1:

Nominal value of Redeemable Preference Shares = 5,00,000

Premium payable on Redemption = 10%

Profit and Loss A/c Balance [free Reserve]

Securities Premium = 3,72,000

= 13,000

Company wants to issue minimum number of equity shares of Rs. 10 each at a premium of 10%. At the same time compliance of section 55 of Companies Act must be ensured.

Solution: Let nominal value of equity shares to be issued = x

Securities premium on issue @ 10% will be [10% of x] = x/10

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Total amount to be received on this issue = x + x/10 = 11x/10

Now by applying the above equation:

Nominal value of Redeemable Preference Shares + Premium payable on Redemption of Preference Share = Maximum amount of Reserve and Surplus available (*i.e.* available Divisible Profit) + Available Securities Premium + Amount from Fresh Issue of Shares.

i.e. 5,00,000 + 50,000 = 3,72,000 + 13,000 + 11x/10

or, 11x/10 = 1,65,000

Nominal value of equity shares to be issued (*x*) = 1,50,000

Securities premium on issue (x/10) = Rs. 15,000

Verification:

1. Amount Payable	2. Amount arranged through fresh issue	3. Arrangement of Balance
Capital Part: Rs. 5,00,000	Shares Capital : Rs. 1,50,000	From General Reserve: Rs. 3,50,000
Premium Part: Rs. 50,000	Securities Premium: Rs. 15,000 (New)	Securities Premium: Rs. 15,000 (New) Securities Premium: Rs. 13,000 (Old) Profit and Loss A/c: Rs. 22,000

2.7 Summary

To redeem means to repay; redemption is the process of repaying an obligation as per terms and conditions specified at the time of issue of securities (preference Shares or Debentures). Preference Shares can be redeemed through the proceeds of a fresh issue of Equity I Preference Shares or through capitalization of undistributed profit. Under the Indian Companies Act, a company cannot issue irredeemable preference shares. A company can't start redemption proceeding for those shares which are partly paid-up.

Convertible preference share possesses the right of conversion into common stock at a set rate after a fixed period of time. Non-convertible Preference shares do not carry the right of conversion. Conversion may take place at par, premium or discount; *i.e.* as per the terms specified at the time of issue.

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2.8 Questions for Practice

Exercise 1: Very Short Answer Type Questions:

(*a*) What is redemption?

(*b*) Write a note on Capital Redemption Reserve Account?

Exercise 2: Descriptive Questions:

1. Explain Legal provisions for Redemption of Preference Share in brief. [As per section 55 of Companies Act, 2013]
2. What do you mean by Capital Redemption Reserve Account with respect to Redemption of Preference Shares? Explain relevant accounting treatment.

Exercise 3: Fill in the blanks:

(*a*) Shares having preferential rights w.r.t. dividend and repayment of capital are termed as _________.

(*b*) Shares which are not equity shares are called as _______.

(*c*) The preference shares on which unpaid dividend keeps on accumulating is termed as __________.

(*d*) If the preference shares are redeemed out of accumulated profit, then it is a must to transfer an amount equal to the amount utilised from this source to __________ Account.

Ans.: (*a*) Preference Shares (*b*) Preference Shares (*c*) Cumulative Preference Shares (*d*) Capital Redemption Reserve

Exercise 4: True and False:

State with reason whether the following are true or false:

(*a*) Under the Indian Companies Act, a company cannot issue irredeemable preference shares.

(*b*) A company can't start redemption proceeding for those shares which are partly paid up.

(*c*) CRR A/c [Sec. 55(4)] and Securities Premium Account [Sec. 52] are never used for issuing bonus shares.

Ans.: (*a*) True (*b*) True (*c*) False

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LESSON

3

Buy-Back of Shares

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STRUCTURE

3.1 *Learning Objectives*
3.2 *Concept of Buy-back*
3.3 *Sources of Buy-back [Section 68]*
3.4 *Legal Provisions of Buy-back*
3.5 *Methods of Buy-back*
3.6 *Accounting Treatment [Section 68 of the Companies Act, 2013]*
3.7 *Summary*
3.8 *Questions for Practice*

3.1 Learning Objectives

This Chapter will assist you to:

- Understand meaning of buy-back of shares.
- Know sources of buy-back of shares.
- Legal provisions w.r.t. buy-back of shares.
- Apply the accounting procedure in buy-back of shares.

3.2 Concept of Buy-back

Buy-back of shares means the repurchase of its own shares by the company. When a company has sufficient cash resources, it may like to buy its own equity shares from the market, particularly when the prevailing rate of its equity shares in the market is much lower than the face value. The shares thus bought back have to be cancelled.

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Buy-back of equity shares may be done for the following objectives or reasons:

(*i*) Enables the company to utilise its surplus cash.

(*ii*) Generally, increase the earnings per share provided there is no fall or reduction in future profitability.

(*iii*) Increase intrinsic value of shares because lesser number of shares have claims on the net assets.

(*iv*) Prevents the takeover of the companies by the competitors.

(*v*) Increases the shareholding of the promoters.

(*vi*) Enables the company to achieve internal reconstruction by making the share capital compatible with the real value of the assets through the process of reducing the share capital.

(*vii*) Prevents the downward trend or fall in the value of shares.

Advantages:

(*i*) It utilizes its surplus.

(*ii*) It improves the Return on Capital (RoC), net profitability and also earning per share.

(*iii*) It enables the settlement with dissatisfied or dissenting members of the company.

(*iv*) It enables the company to buy the shares of the retiring employees.

(*v*) The existing promoters or managements can keep their control over the company because of less shares available for sale in the market. In other words, it makes difficult the hostile takeover attempts.

(*vi*) The remaining shareholders are kept happy because of more amount of dividend and increase in the value of their shares in the long run provided the company is making steady progress market.

(*vii*) Fractional share-holdings and odd lots can be avoided since the company encourages the shareholders to sell odd lot shares.

(*viii*) It brings liquidity in the hands of the investors.

(*ix*) It rationalises the capital structure of the company.

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Dangers associated with Buy-back:

(*i*) It will provide an ample opportunity for inside trading.

(*ii*) Buy-back may lead to artificial manipulations of stock prices.

(*iii*) The position of the minority shareholders is weakened as buy-back enables the management to their control over the company.

3.3 Sources of Buy-back [Section 68]

A company may purchase its own shares or other specified securities out of:

(*i*) Its free reserves; or

(*ii*) The securities premium account; or

(*iii*) The proceeds of any shares or any other securities. However, it must be clarified that:

(*a*) No buy-back shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

(*b*) When a company purchases its own shares out of free reserves, Section 69 requires that a sum equal to the nominal value of the shares so purchased shall be transferred to Capital Redemption Reserve Account. Capital Redemption Reserve Account can be used only to issue fully paid bonus shares.

Important Note: Free reserves means such reserves, which as per the latest audited balance sheet of the company are available for distribution as dividend [Section 2(*43*)]

For buy-back of shares. 'Free Reserves' includes, securities premium account (*Explanation II* to section 68).

Examples of Free Reserves:

(*i*) Surplus/profit as shown by profit and Loss Statement

(*ii*) General Reserve

(*iii*) Dividend Equalization Reserve

(*iv*) Various Funds (after deducting, liability, if any) such as Workmen' Compensation Fund, Insurance Fund and so on

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(*v*) Sinking Fund

(*vi*) Investment Fluctuation Reserve

Examples of Reserves Not available for Buy-back:

(*i*) Revaluation Reserve

(*ii*) Capital Redemption Reserve

(*iii*) Debenture Redemption Reserve

(*iv*) Shares Forfeited Account

(*v*) profits Prior to Incorporation

(*vi*) Statutory Reserves created under income tax

3.4 Legal Provisions of Buy-back

Section 68(2) provides that a company must fulfil the following conditions before it can purchase its own shares other specified securities:

(*i*) The buy-back is authorised by its Articles of Association.

(*ii*) A special resolution has been passed in the general meeting of the company authorizing the company to purchase its own shares. The notice of the meeting at which the special resolution is proposed to be passed should be accompanied by an explanatory statement stating:

(*a*) a full and complete disclosure of all material facts;

(*b*) the necessity for the buy-back;

(*c*) the class of shares or securities intended to be purchased under the buy-back;

(*d*) the amount to be invested under the buy-back; and

(*e*) the time limit for completing of buy-back.

(*iii*) Over-all buy-back limit in a financial year:

(*a*) Buy-back can be made up to 25% of the paid up capital and free reserves. It means that it may be less than 25% of the total paid up capital and free reserves of the company but not more than 25%.

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(*b*) In respect of the buy-back of equity shares in any financial year, the reference to 25% restriction would mean 25% of the total paid up equity capital in that financial year.

(*c*) The ratio of the aggregate secured and unsecured debts owed by the company after the buy-back is not more than twice the paid up capital and its free reserves.

Please Note: debt-equity ratio should not be more than 2:1

(*iv*) **Fully paid up:** All the shares or other specified securities for buy-back must be fully paid up.

(*v*) The buy-back of the shares or other specified securities listed on any recognized stock exchange must be within the regulations made by Security and Exchange Board of India (SEBI) in this behalf.

(*vi*) The buy-back in respect of any company not listed on any recognized stock exchange must be in accordance with the rules as may be prescribed.

Rule 17 of the Companies (Share Capital and Debentures) Rules, 2014 deals with the buy-back of shares and other specified securities.

(*vii*) **Completion of buy-back:** Every buy-back must be completed within a period of one year (12 months) from the date of passing of special resolution or Board of Directors' resolution, as the case may be.

(*viii*) **Methods of buy-back:** The buy-back may be:

(*a*) from the existing shareholders or security holders on a proportionate basis;

(*b*) from the open market;

(*c*) by purchasing the securities issued to employees of the company in pursuant to a scheme of stock option or sweat equity.

(*ix*) **Declaration of solvency:** Before making the buy-back, the company is required to file with the Registrar and in the case of listed company with the Securities and Exchange Board of India (SEBI) also a declaration of solvency in Form No. SH8 (Unlisted company) and Form No. SH9 (Listed company) and verified by an affidavit to the effect that the Board of Directors of the company.

(*x*) **Physical Destruction of Securities bought-back:** A company shall extinguish and physically destroy the securities so bought back with 7 days of the completion of buy-back [Section 68(7)].

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(*xi*) **Filing of returns:** After the completion of the buy-back, a company shall file with the registrar and SEBI a return (details) containing such particulars relating to the buy-back within 30 days of such completion as may be prescribed.

(*xii*) **Maintenance of register of buy-back:** A company shall maintain a register of the shares or securities bought back, the consideration paid, the date of cancellation of shares or securities, the date of extinguishing and physically destroying the shares and securities.

(*xiii*) **No further issue of same kind of securities:** Where a company completes a buy-back of its shares or other specified securities, it shall not be permitted to make further issue of same kind of shares or other specified securities within a period of 6 months except:

(*a*) by way of bonus shares, or

(*b*) conversion of warrants, stock option scheme, sweat-equity, or

(*c*) conversion of preference shares or debentures into equity shares.

(*xiv*) **Prohibition of Buy Back:** Section 70 of the Companies Act, 2013 prohibits company from buying its own shares or other specified:

(*a*) through any subsidiary company including its own subsidiary companies; or

(*b*) through any investment company or group of investment companies; or

(*c*) if a default is made in repayment of deposits or interest due thereon, redemption of debentures or preference shares or payment of dividend or repayment of any term loan or interest thereon to any financial.

It is further provided that a company cannot purchase its own shares or other specified securities in the following cases as well:

(*a*) Not filing of annual returns, preparation of annual accounts, or whose accounts do not view (Section 92)

(*b*) Non-payment of dividend within 30 days of declaration (Section 123)

(*c*) Failure to distribute dividend (Section 127)

(*d*) Non-preparation of Balance Sheet and Statement of Profit and Loss as per Schedule III.

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3.5 Methods of Buy-back

Section 68(5) of the Companies Act, 2013 provides that the buy-back may be:

(*a*) from existing shareholders or security holders on a proportionate basis (Tender method);

(*b*) from the open market.

Buy-back through tender offer: Under this method the company fixes a price at which it wishes to buy-back a specified number of shares from its shareholders. If the number of shares offered for buy-back at the stated price is more than the number of shares to be bought-back, then the shares are bought-back from each shareholder proportionately.

Buy-back through Open-market purchases or operations

Under this method buy-back is done:

(*a*) through stock exchanges

(*b*) through book-building process

Through stock exchanges: Under this method the company buy-back shares through the stock exchange at the prevailing market price till it purchases the pre-determined number of shares it had originally decided to buy-back and the market price does not exceed the pre-determined maximum price for buy-back. SEBI guidelines provide that in case of buy-back of shares through the stock market route, the purchases shall not be made from the promotors or persons in control of the company and the buy-back of shares shall be made only on stock exchange with electronic trading facility.

Through stock book-building process: In this method, a company makes an offer to buy-back a specified number of shares to the shareholders at a specified price rate. The shareholders are invited to make a bid quoting a price within the price range and the number of shares offered for buy-back. After receiving the bids, the company selects the offered price from the lowest price onwards at which the cumulative number of shares offered equals or exceeds the maximum number of shares the company proposes to buy-back. The company fixes the buy-back price with in the range of minimum offer price and the highest price

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accepted which shall be paid to all the shareholders whose shares are accepted for buy-back.

Note: SEBI Guidelines do not permit the buy-back through negotiated deals, spot transactions and private placements.

3.6 Accounting Treatment [Section 68 of the Companies Act, 2013]

1. Only fully paid equity shares and other specified securities:

   (*i*) Share Final Call Account Dr. (with the amount of final call)
   To Equity/Preference Share Capital Account

   (*ii*) Bank Account Dr.
   To Share Final Call Account

2. Proceeds from fresh issue of shares (other kind)

   (*i*) Issued at Par:

   (*a*) Bank Account Dr.
   To Share Application and Allotment Account

   (*b*) Share Application and Allotment Account Dr.
   To (Relevant) Share Capital Account

   (*ii*) Issued at premium:

   (*a*) Bank Account (with the total amount) Dr.
   To Share Application and Allotment Account

   (*b*) Share Application and Allotment Account Dr.
   To (Relevant) Share Capital Account
   To Securities Premium Account

3. Sale of Assets/Investment:

   Bank Account Dr. (Sale proceeds)
   Profit and Loss Account Dr. (Loss on Sale, if any)
   To (Relevant) Asset/Investment Account (Book value)
   To Profit and Loss Account (Profit on sale, if any)

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4. Issue of Debentures:

(*a*) At Par

Bank Account	Dr.	(Amount Received)
To Debentures Account		(Face Value)

(*b*) At Discount

Bank Account	Dr.	(Amount Received)
Discount on Issue of Debentures Account	Dr.	(Amount of Discount)
To Debentures Account		(Face Value)

(*c*) At Premium

Bank Account	Dr.	(Amount Received)
To Debentures Account	Dr.	(Face Value)
To Securities Premium Account		(Amount of premium)

5. Buy-back from free reserves and security premium: creation of Capital Redemption Reserve Account If there is no earlier fresh issue of shares (or other securities) or the company intends to buy-back partially fully out of free reserves and securities premium account.

Securities Premium Account	Dr.
Surplus Account	Dr.
General Reserve Account	Dr.
Any other Divisible Profit Account	Dr.
To Capital Redemption Reserve Account	

6. Recording the Amount Payable on Buy-Back:

(*i*) Buy-back is at par

Equity Share Capital Account	Dr.	(Face Value)
To Equity Shareholders Account		(Face Value)

(*ii*) When buy-back is at premium

Equity Share Capital Account	Dr.	(Face Value)
Premium Payable on Buy-Back Account	Dr.	(Premium)
To Equity Shareholders Account		(Total Claim)

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(*iii*) When buy-back is at discount

Equity Share Capital Account Dr. (Face Value)

To Equity Shareholders Account (Net Amount Payable)

To Capital Reserve Account (Discount)

As per Rule 17(8) of the Companies (Share Capital and Debentures) Rules, 2014, the payment (on account of buy-back of share) shall be made through a separate bank account opened for the purpose.

(*iv*) For opening separate Bank Account, namely: Buy-back Bank Account

Buy-Back Bank Account Dr.

To Bank Account

(Being the opening of buy-back bank account for buy-back of shares)

(*v*) Payment to Equity Share holder

Equity Shareholders Account Dr.

To Buy-Back Bank Account

(*vi*) Adjustment of Premium Payable

Securities Premium Account Dr.

General Reserve Account Dr.

Profit and Loss Account Dr.

To Premium Payable on Buy-Back A/c

(*vii*) Payment of buy-back expenses

Buy-Back Expenses Account Dr.

To Bank Account

(*viii*) Adjustment of buy-back expenses

Profit and Loss Account Dr.

To Buy-back Expenses Account

Illustration 1: X Ltd. had Rs. 2,00,000 in Securities Premium Account and Rs. 50,00,000 in General Reserve. The Company decided to buy-back 1,00,000 shares of Rs. 10 each at Rs. 8 per share. The company had issued 2,00,000, 10% Preference Shares one month back for this purpose of re-purchase. Journalise.

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Solution:

Journal Entries in the Books of Bharat Ltd.

Sl. No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
1.	Equity Share Capital A/c Dr.	10,00,000	
	To Equity Shareholders A/c		8,00,000
	To Capital Reserve A/c		2,00,000
	(Being the amount due on buy back of 1,00,000 shares of Rs. 8 each transferred to shareholders A/c)		
2.	Securities Premium A/c Dr.	2,00,000	
	General Reserve A/c Dr.	6,00,000	
	To Capital Redemption Reserve A/c		8,00,000
	(Being entry passed for transfer of Nominal Value of shares purchased out of Free Reserves and Securities Premium A/c to Capital Redemption Reserve A/c *i.e.* entry to be passed for creation of Capital Redemption Reserve A/c)		
3.	Equity Shareholders A/c Dr.	8,00,000	
	To Bank A/c		8,00,000
	(Being amount due paid to shareholders)		

Illustration 2: (Buy back at par, out of fresh issue of Preference shares)

Bharat Ltd. decides to buy back 40,000 Equity Shares of Rs. 10 each; for this purpose the company issues 10% Preference Shares of Rs. 100 each of the equivalent amount. Assume that the buy-back is carried out actually on the legally permissible terms. Pass necessary Journal entries.

Solution:

Journal Entries in the Books of Bharat Ltd.

Sl. No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
1.	Bank A/c Dr.	4,00,000	
	To 10% Pref. Share Cap. A/c [4000 @ Rs. 100]		4,00,000
	(Being 4,000, 10% preference shares issued for the purpose of buy back of equity shares)		

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Sl. No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
2.	Equity Share Capital A/c Dr.	4,00,000	
	To Equity Shareholders A/c		4,00,000
	(Being amount due on buy-back of 40,000 equity shares transferred to equity shareholders account)		
3.	Equity Shareholders A/c Dr.	4,00,000	
	To Bank A/c		4,00,000
	(Being payment made to equity shareholders)		

Illustration 3: (Buy-back at premium)

Ladli Ltd. decided to buy-back 20,000 Equity Shares of Rs. 20 each at Rs. 5 premium per share. Assume that there is sufficient balance in Securities Premium and Profit and Loss account. Pass journal entries.

Solution:

Journal Entries in the Books of Ladli Ltd.

Sl. No.	Particulars	Dr. (Rs.)	Dr. (Rs.)
1.	Equity Share Capital A/c Dr.	4,00,000	
	Premium on buy back of shares Dr.	1,00,000	
	To Equity Shareholders A/c		5,00,000
	(Being amount due on buy back of 20,000 equity shares @ Rs. 25 per shares including premium of Rs. 5)		
2.	Securities Premium A/c Dr.	1,00,000	
	To Premium on Buy Back of Share A/c		1,00,000
	(Being entry passed for adjusting Premium paid on Buy Back out of securities premium A/c)		
3.	Profit & Loss A/c Dr.	4,00,000	
	To Capital Redemption Reserve A/c		4,00,000
	(Being entry passed for transfer of Nominal Value of shares purchased out of Free Reserve to Capital Redemption Reserve A/c)		
4.	Equity Shareholders A/c Dr.	5,00,000	
	To Bank A/c		5,00,000
	(Being payment made to equity shareholders on buy back)		

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Illustration 4: (Buy-back out of divisible profits)

A company buy-back 12,000 Equity shares of Rs. 10 each at Rs. 40 per share. The reserves of the company are as follows:

Security Premium Rs. 10,00,000 General Reserve Rs. 15,00,000 Profit & Loss A/c Rs. 1,00,000.

The company sold investment for Rs. 8,25,000 at 10% profit. Pass necessary entries in the books of company for the above.

Solution:

Journal Entries in the Books of .... Ltd.

Sl. No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
1.	Bank A/c Dr.	8,25,000	
	To Investment A/c		7,50,000
	To Profit & Loss A/c		75,000
	(Being Investments are sold at profit to provide cash for buy back)		
2.	Equity Share Capital A/c Dr.	1,20,000	
	Premium on buy back of shares A/c Dr.	3,60,000	
	To Equity Shareholders A/c		4,80,000
	(Being amount due on buy-back of equity shares *i.e.* cancellation of shares)		
3.	General Reserve A/c Dr.	1,20,000	
	To Capital Redemption Reserve A/c		1,20,000
	(Being entry passed for creation of capital redemption reserve out of general reserve A/c)		
4.	Securities Premium A/c Dr.	3,60,000	
	To Premium on Buy Back of Share A/c		3,60,000
	(Being entry passed for adjusting premium payable on Buy-Back of equity shares)		
5.	Equity Shareholders A/c Dr.	4,80,000	
	To Bank A/c		4,80,000
	(Being equity share holders paid on buy back)		

Working Notes :

(*a*) Investment were sold at 10% profit so cost of investment = 8,25,000 × 100/110 = 7,50,000

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3.7 Summary

Buy-Back is a corporate action through which a company buy-backs its own shares from the existing shareholders usually at a price higher than market price. Through buy-back company cancels its shares and returns a part of share capital to its Shareholders. It may be done at par, premium or discount.

Subject to the provisions of Companies Act, 2013 Section 68(2), a company may purchase its own shares or other specified securities referred to as buy-back out of - its free reserves; the securities premium account; or the proceeds of the issue of any shares or other specified securities.

Section 68(2) of Companies Act, 2013 puts restrictions on Buy-back of shares. As per section 68(4) of Companies Act, 2013 every buy-back shall be completed within a period of one year from the date of passing of the special resolution. As per Section 68(7) of the Act - where a company buys back its own shares or other specified securities, it shall extinguish and physically destroy the shares or securities so bought back within seven days of the last date of completion of buy-back.

The buy-back may be done from the existing shareholders or security holders on a proportionate basis; or from the open market; or by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity. Section 69(1) makes it compulsory to create a capital redemption reserve account for the purpose of buy-back of securities. The capital redemption reserve account may be applied by the company, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

3.8 Questions for Practice

Exercise 1: Very Short Answer Type Questions

(*a*) Write a note on extinguishment of share certificate.

(*b*) What are the resources of buy-back of shares.

(*c*) Give required entry for buy-back of shares at premium.

(*d*) Give required entry for buy-back of shares at discount.

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Exercise 2: Descriptive Questions

1. What do you mean by buy-back of shares?
2. What are the different sources of funds for buy-back of shares as per Section 68 of Companies Act, 2013?
3. Explain the accounting entries for buy-back of shares.

Exercise 3: Practical Question

Max Ltd. decided to buy-back 40,000 of its equity shares of Rs.10 each at a premium of 20%.

For this, it issues 3,000, 6% Preference Shares of Rs. 100 each at par. The company has Rs. 70,000 in General Reserve,

Rs. 80,000 in Profit & Loss A/c (Cr.),

Rs. 50,000 in Capital Reserve,

Rs. 35,000 in Exports Profits Reserve and

Rs. 65,000 in Securities Premium Account.

It decides to utilise profits and reserves also.

Give the Journal entries assuming that the transactions have been duly carried out.

Ans. : Amount to be transferred to Capital Redemption Reserve Account Rs. 1,00,000 from General Reserve Rs. 70,000 & profit and Loss Account Rs. 30,000

Exercise 4: Fill in the blanks:

(*i*) As per section 68(4) of Companies Act, 2013 every buy-back shall be completed within a period of ________from the date of passing of the special resolution.

(*ii*) Required entry to be passed for creation of Capital Redemption Reserve A/c is –

Securities Premium A/c Dr.

Profit and Loss A/c Dr.

General Reserve A/c Dr.

To……………………………………………………A/c

(*iii*) As per section 68(7) of the Act - where a company buys back its own shares or other specified securities, it shall extinguish and

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physically destroy the shares or securities so bought back within .... days of the last date of completion of buy-back.

Ans. : (*i*) one year (*ii*) Capital Redemption Reserve Account (*iii*) Seven days

Exercise 5: True and False

State with reason, whether the following statements are true or false:

(*a*) Section 69(1) makes it compulsory to create a capital redemption reserve account for the purpose of buy back of securities.

(*b*) The capital redemption reserve account may be applied by the company, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

Ans.: (*a*) True (*b*) True

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L E S S O N

4

Issue of Debenture

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STRUCTURE

4.1 *Learning Objectives*
4.2 *Concept of Debenture*
4.3 *Difference Between Share and Debentures*
4.4 *Types/Kinds of Debentures*
4.5 *Accounting for Issue of Debentures*
4.6 *Issue of Debentures Considering the Terms of Redemption*
4.7 *Writing off Discount/Loss on Issue of Debentures*
4.8 *Debenture Interest*
4.9 *Summary*
4.10 *Questions for Practice*

4.1 Learning Objectives

This Chapter will assist you to:

- Learn meaning, definition and concept of debentures.
- Differentiate between share and debentures.
- Know kinds of debentures.
- Understand the meaning of debenture trust deed.
- Underwriting and Brokerage of Debentures.
- Accounting for issue of debentures at par, premium and discount.
- Understand meaning of issue of debentures issued as a collateral security and its accounting.

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- Accounting treatment of debentures interest.
- Know the method writing off discount/loss on issue of debentures.

4.2 Concept of Debenture

A company can collect its capital from the public by issuing share as well as debenture. Shares are considered as owned and permanent capital of the company on the other hand Debenture is a loan capital or borrowed capital for the company. Company pays fixed interest to debenture holders at stipulated time. Payment of interest to debenture holders is a fixed obligation for the company *i.e.* interest is paid whether there is a profit or loss.

Debentures are debt for the company so, the amount of debenture is returned to the debenture holders at the end of pre-determined time known as maturity period.

Debenture-holders are creditors of the company. They have **no voting right** for the affair of company, but their claims rank prior to preference shareholders and equity shareholders.

4.2.1 *Definition*

As per Section 2(*30*) of the Companies Act, 2013 : *"debenture includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not.*"

The Companies Act, 2013 gives inclusive definition of debentures. When a debenture is issues as one mass it is called debenture stock. A bond is a debt instrument issued for a period more than one year with the purpose of raising money by borrowing. Debentures also includes any other instrument evidencing debt. Thus, debenture is a wide term.

Charge means an interest or right which a lender or creditor obtains in the property of the company by way of security that the company will pay back the debt.

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4.2.2 *Features of Debentures*

Following are the features of debentures:

- Each debenture has fixed face value or par value.
- Debenture holders are the creditors of the company and not the owners.
- Debenture is redeemable/re-payable at the fixed and specific time.
- Debentures are generally secured.
- Return of debentures *i.e.* interest is predetermined.
- Debentures are very risky from company's point of view but less risky for debenture holders.
- Debenture does not carry any voting rights.

4.3 Difference Between Share and Debentures

Shares are uniform parts of the share capital whereas debentures are uniform part of the loan capital of a company. The following are the main difference between a share and debenture:—

1. **Nature :** Share is a part of owned capital; and shareholders are considered as owners of the company. Debenture is a part of loan/ borrowed capital; and debenture holders are considered as creditors of the company.
2. **Return :** Shareholder will get a portion of the profits as dividend which depends on the profits of the company. Debenture holders will get interest on debentures and it will be paid to them in all circumstances.
3. **Stability of Return :** Return of shareholders keep fluctuating because change in profit earned by company. Rate of interest on debenture is always fixed.
4. **Security :** Assets of the company cannot be mortgaged in favour of shareholders, so shares are not secured. Assets of the company can be mortgaged in favour of debenture holders.
5. **Claim :** A shareholder has a claim over accumulated profits of the company and they can be rewarded with bonus shares. Debenture holder can't claim anything over their interest.

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6. **Proposal in annual General Meeting :** Dividend is paid only when the proposal to pay dividend is passed by the shareholders at the AGM of the company. There is no need of any approval in case of payment of interest on debentures.
7. **Issue at Discount :** Shares can't be issued at discount [Sec. 53 of Companies Act, 2013] There are no restriction on issue of debentures at a discount.
8. **Conversion :** Shares cannot be converted into debentures. Debentures can be converted into shares.
9. **Voting Right :** A person holding the shares is called shareholder and they enjoy voting right. A person having the debentures is called debenture holder they never enjoy voting right.

4.4 Types/Kinds of Debentures

Debentures differ on the basis of terms and conditions on which they are issued. Debentures may be classified as under—

4.4.1 *On the Basis of Security*

(*i*) **Secured Debentures**

(*ii*) **Unsecured Debentures**

Secured debentures or mortgage debentures are those debentures which are secured against the assets of the company which means in case of closure of the business, the assets will be sold and the debenture holders will realize their money. Unsecured debentures have no security against the assets of the company. Holders of such debentures are considered as unsecured creditors. Unsecured debentures are not common and attractive; unless otherwise stated debentures are assumed to be secured.

4.4.2 *On the Basis of Tenure*

(*i*) **Redeemable Debentures**

(*ii*) **Irredeemable Debentures**

Debentures which have to be repaid on expiry of fixed period of time either in lump-sum, or by annual drawing or by purchasing own debentures

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from the open market depending upon the terms of issue is known as redeemable debenture. Debentures which can't be redeemed during the life time of the company is considered as irredeemable debenture. Debentures are usually redeemable. Section 71 of the Companies Act, 2013 does not make any reference to irredeemable debentures.

4.4.3 *On the Basis of Registration/Record*

(*i*) Registered debenture

(*ii*) Bearer debenture

Registered debentures are those which are repayable to the person whose names are shown in the register of Debenture holders. In this case the company maintains a Register of Debenture holders wherein the names, address and holdings of all the debenture holders are recorded. Interest is paid to registered debenture holders. Registered debentures are transferred by executing a transfer deed. Bearer debentures are like a bearer cheque, it can be considered as negotiable instrument. These can be transferred by mere delivery. Company does not keep records for the debenture holders. Interest is payable to the person who produces the interest coupons attached to the debentures.

4.4.4 *On the Basis of Convertibility*

(*i*) Fully convertible debentures

(*ii*) Partly convertible debenture

(*iii*) Non-convertible debenture

As per section 71(1) of Companies Act, 2013 matters related to such conversion shall be approved by a special resolution passed at a general meeting.

Fully convertible debentures are those debentures which can be converted into equity shares or preference share at the option of debenture holders at the stated rate of exchange after a certain period. So, this type of debenture enables its holders to change their status from lender to shareholder.

When only a pre-specified part of debentures can be converted into equity or preference share of the company; it is termed as partly convertible debenture.

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Non-convertible Debentures are those debentures which cannot be converted either into equity shares or preference shares it means debenture holder remains debenture holder till its redemption.

4.4.5 *On the Basis of Priority*

(*i*) First debenture

(*ii*) Second debentures

This type of debenture suggests the priority of one debenture over the other. The debenture which is repaid before other debentures are known as first debenture. Just opposite of it the debenture which will be repaid after the first debentures are redeemed are known as second debenture.

4.5 Accounting for Issue of Debentures

The process of issue of debentures by a company is similar to that of the issue of shares. In case of debenture also company issues a prospectus through which applications are invited, and letters of allotment are issued. On rejection of applications, application money is refunded whereas in case of partial allotment, excess application money may be adjusted towards subsequent calls in the same manner.

From accounting point of view treatment of shares and debentures are almost the same the only difference is that here the word 'Debenture' will substitute 'Share'.

Underwriting and Brokerage

Underwriting is an agreement with or without conditions, to the securities of a body corporate when the existing shareholders of such body corporate or the public do not subscribe to the securities offered to them (SEBI Regulations, 2009).

Rule 13 of the Companies Rules, 2014 provides that a company may pay commission to any person in connection with the subscription or procurement of subscription to its securities, whether absolute or conditional, subject to the following conditions:

- The payment of such commission shall be authorized in the company's articles of association.

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- The commission may be paid out of the proceeds of the issue or the profits of the company or both.
- The rate of commission shall not exceed in case of debentures, $2_{1/2}$% of the price at which the debentures are issued, or as specified in the company's articles, whichever is less.
- There shall not be paid commission to any underwriter on securities which are not offered to the public for subscription.

Debentures may be issued in the following ways:

- Issue of Debentures for Cash
- Issue of Debentures for Consideration other than Cash
- Issue of Debentures as a Collateral Security

4.5.1 *Issue of Debentures for Cash*

As in case of shares, debentures may be issued (*i*) at par, (*ii*) at premium or, (*iii*) at discount.

(*i*) Issue of Debentures for Cash at Par

Debentures are said to have been issued at par when the issue price is equal to the nominal or face value of the debentures. The accounting entries are as follows:

(*a*) *When full amount is payable in one lump sum*

1. On receipt of application money

   Bank A/c Dr.

   To Debenture Application and Allotment A/c

2. On making allotment

   Debenture Application and Allotment A/c Dr.

   To ……% Debentures A/c

(*b*) *When amount is payable in instalment*

1. On receipt of application money

   Bank A/c Dr.

   To Debenture Application A/c

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2. On allotment of debentures

   Debentures Application A/c Dr.

   To …..% Debentures A/c

3. On transfer of surplus money after adjustment and refund of money on rejected applications

   Debentures Application A/c Dr.

   To Bank A/c

4. On adjustment of excess application money

   Debenture Application A/c Dr.

   To Debenture Allotment A/c

5. On making the allotment money due

   Debenture Allotment A/c Dr.

   To ….% Debentures A/c

6. On receipt of allotment money

   Bank A/c Dr.

   To Debenture Allotment A/c

7. On making the first call money due

   Debenture First Call A/c Dr.

   To ….% Debentures A/c

8. On receipt of first call money

   Bank A/c Dr.

   To Debenture First Call A/c

Note: If there are more than one call, separate entries for each case will be passed as done in case of shares.

Illustration 1:

X Ltd. issued 1000, 8% Debentures of Rs. 10 each payable as follows- Rs. 3 on application, Rs. 4 on allotment and Rs. 3 on first and final call. Company got applications for 950 debentures. Company got all the amounts in due time. Pass necessary journal entries.

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Solution:

Books of X Ltd.

Cash Book (Bank Column Only)

Particulars	Amount	Particulars	Amount
To Debenture Application A/c	2,850	By Bal c/d	9,500
To Debenture Allotment A/c	3,800		
To Debenture First and Final Call A/c	2,850		
	9,500		9,500

Journal Entries in the Books of X Ltd.

Particulars	Debit (Rs.)	Credit (Rs.)
Debenture Application A/c Dr.	2,850	
To 8% Debentures A/c		2,850
(Being entry passed for transfer of Application money to 8% Deb. A/c)		
Debenture Allotment A/c Dr.	3,800	
To 8% Debentures A/c		3,800
(Being allotment money due)		
Debenture First and Final Call A/c Dr.	2,850	
To 8% Debentures A/c		2,850
(Being First and Final call due)		

(*ii*) *Issue of Debentures for Cash at Premium*

Debentures are said to have been issued at premium when they are issued at more than their face value. For example, if a debenture of Rs. 100 is issued at Rs. 110, Rs. 10 is the premium on issue of debenture. Debentures are rarely issued at premium. Premium on issue of debentures will be credited to a separate account called Securities Premium Account. This account will be shown in Notes to Accounts in the Balance Sheet under the line item 'Reserves and Surplus'. It can be used, *inter alia,* to write off (*i*) discount on issue of shares and debentures, (*ii*) premium on redemption of shares or debentures, (*iii*) preliminary expenses, (*iv*) underwriting commission. It can also be used for buy-back of shares.

Illustration 2:

A company has issued 1,000 9% Debentures of Rs. 10 each at a premium of 10% payable as Rs. 4 on application Rs. 7 on allotment (including

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premium). All the debentures were subscribed for and money was duly received. Make journal entries.

Show how the amounts will appear in the balance sheet.

Solution:

Journal Entries in the Books of ....Ltd.

S.No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
1.	Bank A/cv Dr.	4,000	
	To Debenture Application A/c		4,000
	(Being debenture application money received)		
2.	Debenture Application A/c Dr.	4,000	
	To 9% Debentures A/c		4,000
	(Being application money transferred to 9% debentures account)		
3.	Debenture Allotment A/c Dr.	7,000	
	To 9% Debentures A/c		6,000
	To Securities Premium A/c		1,000
	(Being allotment money due on 1000 9% debentures @ Rs. 7/- debenture including Rs. 1 debenture for premium)		
4.	Bank A/c Dr.	7,000	
	To Debenture Allotment A/c		7,000
	(Being allotment money received)		

Balance Sheet of …….. as at …….

Particulars	Note No.	Rs.
Equity and Liabilities		
Shareholder's Fund		
Reserves and Surplus	1	1,000
Non-Current Liabilities		
Long-term Borrowings	2	10,000
Current Liabilities		
Total		**11,000**
Assets		
Non-Current Assets		
Current Assets		
Cash & Cash Equivalents	3	11,000
Total		**11,000**

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Note to Accounts [Balance Sheet]

	Particulars	Rs.
1.	**Reserves and Surplus**	
	Securities Premium (on 1000, 9% debentures @ Rs. 1)	1,000
2.	**Long-term Borrowings**	
	9% Debentures (1000 @ Rs. 10/- per debentures)	10,000
3.	**Cash & Cash Equivalents**	
	Cash at Bank	11,000

(*iii*) *Issue of debenture for cash at discount*

When debentures are issued at a price less than their par/face value; it is said to be issue of debenture at discount. Issuing the debentures at discount means accepting a price which is less than the face value of debentures *e.g.* if a debenture of Rs.10 is issued at Rs. 9, it is said that the share has been issued at discount of Rs. 1 *i.e.* [Face value Less Issue price] (Rs. 10 – Rs. 9). The Companies Act, 2013 does not prescribe any restrictions on issue of debentures at discount.

Amount of discount is written-off either by debiting it to Profit & Loss A/C or out of the Securities Premium, Capital Profits, if any, during the life time of debentures through following entry –

Securities Premium A/c Dr.

Profit & Loss A/c Dr.

To Discount on Issue of Debentures A/c

The unwritten off portion of discount on issue of debentures was used to be shown in the Balance Sheet on the assets side under the head 'Miscellaneous Expenditure' as per the Old Schedule VI to the Companies Act, 1956. The Schedule III of the Companies Act, 2013 does not contain any specific disclosure requirement for the unamortized portion of the expense items such as share issue expenses, discount on issue of debentures. Keeping in view, the Guidance Note on the Revised Schedule VI to the Companies Act, 1956 (now Schedule III of the Companies Act, 2013) issued by the ICAI, suggest that an entity can disclose the unamortized portion of such expenses, as "Unamortized Expenses", under the head "Other Current Assets" and/or "Other Non-Current Assets" depending on whether the amount will be written off or amortized in the next 12 months or thereafter.

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Illustration 3:

Raj Ltd. has issued 1,000 9% debentures of Rs. 10 each at a discount of 10% payable as Rs. 4 on application Rs. 5 on allotment. Pass necessary journal entries. You are further required to show the Balance Sheet.

Solution:

Journal Entries in the Books of Raj Ltd.

Sl. No.	Particulars	Dr.	Cr.
1.	Bank A/c Dr.	4,000	
	To Debenture Application A/c		4,000
	(Being debenture application money received)		
2.	Debenture Application A/c Dr.	4,000	
	To 9% Debentures A/c		4,000
	(Being application money transferred to 9% debenture account)		
3.	Debenture Allotment A/c Dr.	5,000	
	Discount on Issue of Debenture A/c Dr.	1,000	
	To 9% Debentures A/c		6,000
	(Being allotment money due on 1000 9% debentures)		
4.	Bank A/c Dr.	5,000	
	To Debenture Allotment A/c (Being allotment money received)		5,000

Balance Sheet of ...... as at ....

Particulars	Note No.	Rs.
1. Equity and Liabilities		
Shareholder's Fund		
Non-Current Liabilities		
Long-term Borrowings	1	10,000
Current Liabilities		
Total		10,000
Assets		
Non-Current Assets Current Assets:	2	9,000
Cash & Cash Equivalents	3	1,000
Other Current Assets		
Total		10,000

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Notes to Account (Balance Sheet)

	Particulars	Rs.
1.	Long-term Borrowings :	
	9% Debentures (1,000 @ Rs. 10)	10,000
2.	Cash & Cash Equivalents:	
	Cash at Bank	9,000
3.	Other Current Assets:	
	Discount on issue of 9% Debentures	1,000

4.5.2 *Issue of Debentures for Consideration other than Cash*

When a company purchases a business or some assets from the vendor and instead of paying the vendor in cash, the company may issue debentures to discharge the purchase price. In such a case, issue of debentures is called issue of debentures for consideration other than cash. The debentures may be issued at par, at premium or at discount. In this case, the following entries are passed:

(1) On purchase of business

Sundry Assets A/c Dr.

*Goodwill A/c Dr. (Excess of purchase price over net assets)

To Sundry Liabilities A/c

To Vendor's A/c (Purchase Price)

To *Capital Reserve A/c (Excess of purchase price over net assets)

*Either of the two may appear

(2) On issue of debentures

(*a*) When issued at par

Vendor's A/c Dr.

To .....% Debentures A/c

(*b*) When issued at premium

Vendor's A/c Dr.

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To …..% Debentures A/c

To Securities Premium A/c

(*c*) When issued at discount

Vendor's A/c Dr.

Discount on Issue of Debentures A/c Dr.

To …..% Debentures A/c

Note : Following simple formula is used to ascertain No. of debentures to be issued in satisfaction of the purchase consideration :

No. of Debentures = Purchase Price/ Issue Price Per Debenture

Illustration 4:

X Ltd. purchased a machine from Y Ltd. for Rs. 9,90,000. As per the terms, purchase consideration of Rs. 90,000 is to be paid by way of issuing a cheque and balance will be paid by way of 8% Debentures of Rs. 10 (face value) each issued at a discount of 10%. Pass required entries for this.

Solution:

In the Books of X Ltd.

Journal Entries	Debit (Rs.)	Credit (Rs.)
On Purchase of Machinery :		
Machinery A/c Dr.	9,90,000	
To Y Ltd.		9,00,000
To Bank A/C		90,000
On Issue of 1,00,000 Debentures at a discount of Rs. 1		
Y Ltd. A/c Dr.	9,00,000	
Discount on Issue of Debentures A/c Dr.	1,00,000	
To 8% Debentures A/c		10,00,000

4.5.3 *Issue of Debentures as Collateral Security for Loan*

Issue of debentures as collateral security means issue of debentures as an additional or secondary security against the loan in addition to the

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principal or main security. The lender to whom such debentures are issued will not be entitled to any interest on them. The additional or secondary security is to be realized only when the principal security is not sufficient to pay the amount of loan or interest thereon.

Debentures issued as collateral security can be dealt with in the following two ways:

First Method (When entry for issue of debentures as collateral security is not passed).

Under this method, journal entry for taking the loan is passed but no entry is passed in the books of the company at the time of issue of such debentures. In the Balance Sheet, a note is appended below the loan that the loan is secured by issue of debentures as collateral security. At the time of repayment of loan, entry for payment of loan is passed. In case of default in payment of loan the following entry is passed:

Loan A/c Dr.
  To …..% Debentures A/c

Second Method (When entry for issue of debentures as collateral security is passed).

Under this method apart from entry for loan taken, the following entry is passed to record the issue of debentures as collateral security:

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

Debenture Suspense Account will be shown under "Other Current Assets"/"Other Non-Current Assets" depending upon whether loan is payable within 12 months or thereafter. Alternatively, it can be shown by way of deduction from debentures. At the time of repayment of loan, *i.e.,* at maturity this entry is reversed and the entry for repayment of loan will also be passed.

In case of default by the company in repayment of loan the following entry is passed:

Loan A/c Dr.
  To Debenture Suspense A/c

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Illustration 5:

A company presently had Rs. 10,00,000, 12% Debentures outstanding redeemable after four years. During the current year, it took a loan of Rs. 5,00,000 from ICICI Bank payable seven years from now, giving as collateral security Rs. 8,00,000, 14% Debentures. Pass journal entries, if any, and show how the Debentures and Bank Loan will appear in the Balance Sheet of the company.

Solution:

First Method

Journal Entries in the books of ..... Ltd.

S.No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
	Bank A/c Dr.	5,00,000	
	To ICICI Bank Loan A/c		5,00,000
	(Being the loan taken from ICICI Bank and Rs. 8,00,000, 14% Debentures issued as collateral security)		

Balance Sheet as on ……………………..

Particulars	Notes	Amount (Rs.)
Equity and Liabilities		
Non-current Liabilities		
Long-term Borrowings	1	15,00,000

Notes to Accounts

Particulars	Amount (Rs.)
1. Long-term Borrowings	
12% Debentures (redeemable in four years)	10,00,000
Loan from ICICI Bank	5,00,000
(Collaterally secured by issue of Rs. 8,00,000 14% Debentures)	

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Second Method

Journal Entries in the books of ..... Ltd.

S.No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
	Bank A/c Dr.	5,00,000	
	To ICICI Bank Loan A/c		5,00,000
	(Being the loan taken from ICICI Bank and Rs. 8,00,000, 14% Debentures issued as collateral security)		
	Debenture Suspense A/c Dr.	8,00,000	
	To 14% Debentures A/c		8,00,000
	(Being the issue of Rs. 8,00,000 debentures as collateral security for loan of Rs. 5,00,000 as per the Board's resolution number…….. dated……)		

Balance Sheet as on ……………………..

Particulars	Notes	Amount (Rs.)
Equity and Liabilities		
Non-current Liabilities		
Long-term Borrowings	1	23,00,000
Total		23,00,000
Assets		
Non-current Assets	2	8,00,000

Notes to Accounts

Particulars	Amount (Rs.)
1. Long-term Borrowings	
12% Debentures (redeemable in four years)	10,00,000
14% Debentures	8,00,000
(Issued as collateral security for loan payable in seven years)	5,00,000
Loan from ICICI Bank	
(Collaterally secured by issue of Rs. 8,00,000 14% Debentures)	23,00,000
2. Non-Current Assets	
Debenture Suspense Account	8,00,000

Alternatively, Debenture Suspense A/c can be shown by way of deduction from 14% Debentures.

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4.6 Issue of Debentures Considering the Terms of Redemption

Depending upon the terms and conditions of issue and redemption of debentures, the following six situations are commonly found in practice:

(*i*) Issued at par redeemable at par

(*ii*) Issued at premium redeemable at par

(*iii*) Issued at discount redeemable at par

(*iv*) Issued at par redeemable at premium

(*v*) Issued at discount redeemable at premium

(*vi*) Issued at premium redeemable at premium

Note: In the above cases the difference between face value & redeemable value is considered as loss. Recording of loss at the time of issue is based on 'Principle of Prudence' which suggests to anticipate, record and provide for the losses which may take place in future.

The following journal entries are passed

(i) Issued at par redeemable at par

Bank A/c	Dr.
To Debenture Application and Allotment A/c	
Debenture Application and Allotment A/c	Dr.
To …..% Debentures A/c	

(ii) Issued at premium redeemable at par

Bank A/c	Dr.
To Debenture Application and Allotment A/c	
Debenture Application and Allotment A/c	Dr.
To …..% Debentures A/c	
To Securities Premium A/c	

(iii) Issued at discount redeemable at par

Bank A/c	Dr.
To Debenture Application and Allotment A/c	

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Debenture Application and Allotment A/c Dr.
Discount on issue of Debentures A/c Dr.
    To …..% Debentures A/c

(iv) *Issued at par redeemable at premium*

Bank A/c Dr.
    To Debenture Application and Allotment A/c

Debenture Application and Allotment A/c Dr.
Loss on issue of Debentures A/c Dr.
    To …..% Debentures A/c
    To Premium on Redemption of Debentures A/c

(v) *Issued at discount redeemable at premium*

Bank A/c Dr.
    To Debenture Application and Allotment A/c

Debenture Application and Allotment A/c Dr.
Discount on issue of Debentures A/c Dr.
Loss on issue of Debentures A/c Dr.
    To …..% Debentures A/c
    To Premium on Redemption of Debentures A/c

Or

Debenture Application and Allotment A/c Dr.
Loss on issue of Debentures A/c Dr. (discount and loss combined)
    To …..% Debentures A/c
    To Premium on Redemption of Debentures A/c

(vi) *Issued at premium redeemable at premium*

Bank A/c Dr.
    To Debenture Application and Allotment A/c

Debenture Application and Allotment A/c Dr.
Loss on issue of Debentures A/c Dr.

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To …..% Debentures A/c

To Securities Premium A/c

To Premium on Redemption of Debentures A/c

Note: Securities Premium Account is a nominal account but Premium on Redemption of Debentures Account is a personal account representing the portion of capital loss on issue of debentures. Similarly, discount on issue of debentures is also a capital loss. They are written off either through securities premium or gradually through the Statement of Profit and Loss over the life of the debentures. Unwritten off portion may be shown in the Balance Sheet as part of "Other Current Assets" and/or "Other Non-current Assets" depending on whether the amount will be written off in the next 12 months or thereafter.

Illustration 6:

Pass necessary journal entries in the following cases for issue of 8% Debentures—

(*a*) 5,000 debentures of Rs. 100 each at discount of 5%, redeemable at the end of 5 years at par.

(*b*) 5,000 debentures of Rs. 100 each at par, redeemable at the end of 5 years at a premium of 5%.

(*c*) 5,000 debentures of Rs. 100 each at discount of 5%, redeemable at the end of 5 years at a premium of 5%.

(*d*) 5,000 debentures of Rs. 100 each at Rs. 105, redeemable at the end of 5 years at Rs. 107 per debenture.

(*e*) 5,000 debentures of Rs. 100 each at Rs. 105 redeemable at the end of 5 years at Rs. 94 per debenture.

Solution:

(*a*) Journal Entries

S.No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
	Bank A/c Dr.	4,75,000	
	To 8% Debenture Application and Allotment A/c		4,75,000
	(Being application received for 5,000 debentures)		

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S.No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
	8% Debenture Application and Allotment A/c Dr.	4,75,000	
	Discount on Issue of Debentures A/c Dr.	25,000	
	To 8% Debentures A/c		5,00,000
	(Being the issue of 5,000 debentures of Rs. 100 each at a discount of 5% redeemable at par)		

(*b*) **Journal Entries**

S.No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
	Bank A/c Dr.	5,00,000	
	To 8% Debenture Application and Allotment A/c		5,00,000
	(Being application received for 5,000 debentures)		
	8% Debenture Application and Allotment A/c Dr.	5,00,000	
	Discount on Issue of Debentures A/c Dr.	25,000	
	To 8% Debentures A/c		5,25,000
	(Being the issue of 5,000 debentures of Rs. 100 each at par redeemable at a discount of 5%)		

(*c*) **Journal Entries**

S.No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
	Bank A/c Dr.	4,75,000	
	To 8% Debenture Application and Allotment A/c		4,75,000
	(Being application received for 5,000 debentures)		
	8% Debenture Application and Allotment A/c Dr.	4,75,000	
	Discount on Issue of Debentures A/c Dr.	25,000	
	Loss on Issue of Debentures A/c Dr.	25,000	
	To 8% Debentures A/c		5,00,000
	To Premium on Redemption of Debentures A/c		25,000
	(Being the issue of 5,000 debentures of Rs. 100 each at a discount of 5% redeemable at premium of 5%)		

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(*d*) **Journal Entries**

S.No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
	Bank A/c Dr.	5,25,000	
	To 8% Debenture Application and Allotment A/c		5,25,000
	(Being application received for 5,000 debentures)		
	8% Debenture Application and Allotment A/c Dr.	5,25,000	
	Loss on Issue of Debentures A/c Dr.	35,000	
	To 8% Debentures A/c		5,00,000
	To Securities Premium A/c		25,000
	To Premium on Redemption of Debentures A/c		35,000
	(Being the issue of 5,000 debentures of Rs. 100 each at Rs. 105 redeemable at Rs. 107)		

(*e*) **Journal Entries**

S.No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
	Bank A/c Dr.	5,25,000	
	To 8% Debenture Application and Allotment A/c		5,25,000
	(Being application received for 5,000 debentures)		
	8% Debenture Application and Allotment A/c Dr.	5,25,000	
	To 8% Debentures A/c		5,00,000
	To Securities Premium A/c		25,000
	(Being the issue of 5,000 debentures of Rs. 100 each at 5% premium, redeemable at Rs. 94)		

Note: As per the prudence concept, the profit for repayment will be booked at the time of repayment of debentures by passing the following entry:

8% Debentures A/c	Dr.	5,00,000	
To Bank A/c			4,70,000
To Profit on Redemption of Debentures A/c			30,000

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4.7 Writing off Discount/Loss on Issue of Debentures

The discount/loss on issue of debentures is a capital loss [fictitious asset] and, therefore, must be written-off during the life time of debentures. The method of writing off discount/loss on issue of debenture depends upon the method of redeeming debentures, adopted by the company.

Section 52 of the Companies Act, 2013 permits the utilization of 'Securities Premium Ale' and other capital profits for writing off the discount/loss on issue of debentures. In case, however, there are no capital profits or if the capital profits are not adequate, the amount of such discount/loss may be written-off against the Revenue Profits every year by passing the following journal entry:

Securities Premium A/c Dr.

To Discount on Issue of Debentures A/c

Or

Profit and Loss A/c Dr.

To Discount on Issue of Debentures A/c

Illustration 7:

On 1st January 2015, A Ltd. issued 8% Rs. 1,00,000 debentures at a discount of 12% repayable at 31st December 2018. Find amount of 'Discount on Issue of Debenture Account that will be written off in these 4 years.

Solution:

Here in the given case A Ltd. is utilizing equal amount *i.e.* Rs. 1,00,000 in all the five years *i.e.* 2015, 2016, 2017 & 2018. So, total discount of 12,000 must be divided equally *i.e.* 1:1:1:1 in these years *i.e.* Rs. 3,000 per year through the following entry:

Profit and Loss A/c Dr. 3,000

To Discount on Issue of Debentures A/c 3.000

Illustration 8:

On 1st January 2015, Ellora Ltd. issued 8% Rs. 1,00,000 debentures at a discount of 10% repayable by annual drawings of Rs. 25,000 commencing from the end of the 1st year at a premium of 10%. Find the amount of loss to be written off for these 4 years.

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Solution:

Here in the above case Ellora Ltd. has used Rs. 1,00,000 in 2015, Rs. 75,000 in 2016, Rs. 50,000 in 2017 and Rs. 25,000 in the year 2018.

So total loss of Rs. 20,000 must be divided in the ratio 4:3:2:1 *i.e.* ratio of amount outstanding after each repayment at the end of every year. So, it is Rs. 8,000, Rs. 6,000, Rs. 4,000, and Rs. 2,000 respectively for these four years.

4.8 Debenture Interest

Debentures interest is a charge against the profit & it is payable as an when interest is due whether there is a profit or loss. Generally, interest on debenture is paid after expiry of a period of six months. Companies are required to deduct TDS (at prescribed rate) on Gross Interest. The following journal entries are passed:

(a) *When debenture interest is due—*

Debenture Interest A/c   Dr.

To Tax Deducted at Source A/c

To Debenture Holders A/c

(b) *When net amount due is paid to debenture holders—*

Debenture Holders A/c   Dr.

To Bank A/c

(c) *For deposit of TDS amount with government authorities—*

Tax Deducted at Source A/c   Dr.

To Bank A/c

(d) *At the end of the year balance in debenture interest account is transferred to Profit and Loss Account—*

Profit and Loss A/c   Dr.

To Debenture Interest A/c

Notes:

(1) Until the company deposits the at deducted at source with the Government it will be shown under the line item "Other Current Liabilities". In the Notes to Accounts and as a part of Current Liabilities which is shown on the face of the Balance Sheet.

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(2) While transferring debenture interest to Profit and Loss A/C, and now to Statement of Profit and Loss as per Schedule III of Companies Act, 2013, at the end of the year, interest for full period for which accounts are being prepared should be transferred after taking into consideration outstanding or accrued interest on debentures, if any.

(3) If the company has issued tax-free debentures, tax will be paid by the company as a company cannot really issue tax-free debentures. The interest paid on debentures has to be grossed up.

4.9 Summary

A company can collect its capital from the public by issuing share as well as debenture. Debenture is a loan capital or borrowed capital for the company. Company pays fixed interest to debenture holders at stipulated time. Debentures are debt for the company so, the amount of debenture is returned to the debenture holders at the end of pre-determined time known as maturity period. As per Section 2(30) of the Companies Act, 2013 : "debenture includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not."

Debentures differ on the basis of terms and conditions on which they are issued. Debentures may be classified as under:

(*i*) Secured Debentures & Unsecured Debentures

(*ii*) Redeemable Debentures & Irredeemable Debentures

(*iii*) Registered debenture & Bearer debenture

(*iv*) Fully convertible debenture & Partly convertible debenture and Non-convertible debenture

(*v*) On the basis of priority, it may be called as First debenture & Second debentures.

The process of issue of debentures by a company is similar to that of the issue of shares. Debentures may be issued for Cash; for Consideration other than Cash or it may be issued as a Collateral Security. When debentures are issued at a price less than their par/face value; it is said to be issue of debenture at discount. The discount/loss on issue of debentures is a capital loss [fictitious asset] and, therefore, must be

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written-off during the life time of debentures. The method of writing off discount/loss on issue of debenture depends upon the method of redeeming debentures, adopted by the company. When debentures are issued at a price more than their par/face value; it is said to be issue of debenture at premium. The amount of premium must be transferred to an account titled 'Securities Premium Account'.

4.10 Questions for Practice

Exercise 1: Very Short Answer Type Questions

(*a*) Define Debentures.

(*b*) Write any two basic differences between debenture and a share.

(*c*) What are convertible debentures?

Exercise 2: Descriptive Questions

(*i*) Explain the meaning and accounting treatment of 'Debenture Issued as Collateral Security'.

(*ii*) What is loss on issue of debenture? How will you calculate the amount off loss to be written off each year?

(*iii*) What is the nature of 'Interest on Debentures' Give journal entries to record:

(1) When interest becomes due

(2) When interest is paid

(*iv*) Give journal entries both at the time of issue of debentures- Issue of Rs. 1,00,000. 9% Debenture at a discount of 5% but redeemable at a premium of 5%.

(*v*) Give journal entries both at the time of issue of debentures- Issue of Rs. 1,00,000. 9% Debenture at a premium of 5% but redeemable at a premium of 15%.

Exercise 3: Practical Questions

A. Pass required entries at the time of issue of debentures in the following cases:—

(*a*) Akash Ltd. issued 1,000, 15% Debentures of Rs.100 each at par but redeemable at 5% premium at the end of 4 years.

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(*b*) Raj Ltd. issued Rs.1,00,000, 15% Debentures at a discount of 5% but redeemable at a premium of 5% at the end of 4 years.

(*c*) Yes Ltd. issued Rs.1,00,000, 15% Debentures of Rs. 100 each at a premium of 5-% but redeemable at 110% at the end of 4 years.

Ans.: Refer illustration 6

B. Yoyo Ltd. issued 10,000 9% Debentures of Rs. 100 each payable as follows- Rs. 30 on application, Rs.40 on allotment and Rs. 30 on first and final call. Company got applications for 9,500 debentures. Company got all the amounts in due time. Pass necessary journal entries.

Ans.: Pass entries w.r.t. receipt of Rs. 2,85,000, Rs. 3,80,000 and Rs. 2,85,000 respectively on application, allotment and call.

C. A Ltd. purchased a machine from B Ltd. for Rs. 18,50,000. As per the terms, purchase consideration of Rs.50,000 is to be paid by way of issuing a cheque and balance will be paid by way of 9% Debentures of Rs. 100 (face value) each issued at a discount of 10%. Pass required entries for this.

Ans.: 20,000 Debentures having a face value of Rs. 100 will be issued at a discount of 10%

Exercise 4: True and False

State whether the following statements are true or false:

(*a*) Debenture holders are owners of the company.

(*b*) A company can't issue its debentures at discount.

(*c*) Interest on debentures payable only if there is sufficient profit.

(*d*) Interest on debentures keeps on fluctuating with amount of profit earned by the company.

(*e*) Companies Act, 2013 has made it compulsory for the companies to appoint Debenture Trustees.

(*f*) Debentures interest is a charge against the profit & it is payable as an when interest is due whether there is a profit or loss.

Ans.: (*a*) False (*b*) False (*c*) False (*d*) False (*e*) True (*f*) True

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Exercise 5 : Fill in the blanks:

(*i*) Debentures are shown in the balance sheet of a company under the head __________.

(*ii*) 12% debentures means a debenture will carry interest @ ______%.

(*iii*) Debenture holders are __________ of the company.

(*iv*) As per Section 2(30) of the Companies Act, 2013 : "debenture includes debenture ________, _________ or any other instrument of a company evidencing a debt, whether constituting a _________on the assets of the company or not."

Ans.: (*i*) Major head - Non-current Liability Sub-head- Long-term Borrowings, (*ii*) 12%, (*iii*) Loan providers (Creditors), (*iv*) Stock, bonds/ charge

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LESSON

5

Redemption of Debentures

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STRUCTURE

5.1 *Learning Objectives*
5.2 *Concept of Redemption*
5.3 *Sources of Redemption of Debentures*
5.4 *Redemption of Debentures by Purchase in the Open Market*
5.5 *Treatment of Debenture Interest and Interest on Own Debenture*
5.6 *Summary*
5.7 *Questions for Practice*

5.1 Learning Objectives

This chapter will assist you to:

- Know meaning and terms of redemption of debentures.
- Know sources of redemption of debentures.
- Apply the rule w.r.t. creation of debenture redemption reserve account.
- Know meaning of redemption by conversion and its accounting.
- Know the concept of sinking fund and its application in redemption of debentures.
- Understand the meaning of purchase of own debentures for immediate cancellation and investments and its accounting.
- Apply treatment of debenture interest and interest on own debentures.

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5.2 Concept of Redemption

Redemption of debentures means discharge of liability on account of debentures issued by a company. In other words, redemption of debentures means repayment to the debenture holders. Debenture holders are usually paid in cash. They may be paid by issue of shares or debentures if the terms of redemption permit the same. As per Section 71(8) of the Companies Act, 2013, a company shall pay interest and redeem the debentures in accordance with the terms and conditions of their issue. When a company proposes to redeem the debentures, it has to decide the method of redemption and sources of redemption of debentures.

Methods of Redemption of Debentures

A company can redeem the debentures in the following four ways:

1. Redemption in cash at the expiry of a specified period in one lump sum.
2. Redemption in cash within a specified period in instalments by drawing lots.
3. Redemption in cash by purchase of own debentures in the open market.
4. Redemption by conversion.

5.3 Sources of Redemption of Debentures

Company needs huge amount of money at the time of redemption of debentures so financial planners of the company must take into consideration the time as well as amount aspect involved in redemption. Redemption of debentures may be done out of the proceeds of fresh issue of shares/ debentures at par/premium/discount. Other than this source; other source available for the company are as follows:

A. Out of the proceeds of fresh issue of shares

B. Out of capital

C. Out of profit

D. By conversion in other securities as per terms of issue

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5.3.1 *Redemption of Debentures Out of Proceeds of Fresh Issue of Securities: [Specifically Issued for this Purpose*]

By adopting this method company can simply replace the loan capital by own capital and keep its working capital intact. Here just one security is replaced by another security as company is not using any other internal source for redemption purpose.

5.3.2 *Redemption Out of Capital*

Debentures are said to be redeemed out of capital, if no amount is set aside out of profits for redemption of debentures. In this case profits are not appropriated out of Profit and Loss Account. Section 71(4) of the Companies Act, 2013, provides that the company shall create a debenture redemption reserve account out of profits of the company available for payment of dividend and the amount credited to such account shall not be utilized by the company except for the redemption of debentures. As per rule 18(7) of the Companies Rules, 2014, only All India Financial Institutions regulated by the Reserve Bank of India and Banking Companies are exempt from creation of Debenture Redemption Reserve. Thus, in the case of companies covered by these two categories, debentures may be fully redeemed out of capital.

5.3.3 *Redemption Out of Profits*

Redemption of debentures is said to be out of profits if the company retains profit earned for redemption of debentures. One of the methods of doing this is to transfer adequate amount from Profit and Loss Account to Debenture Redemption Reserve Account. The effect of such a transfer is that it reduces the profit available for dividend.

Debenture Redemption Reserve (DRR)

As stated earlier, Section 71(4) of the Companies Act, 2013, provides that where debentures are issued by a company, the company shall create a debenture redemption reserve out of profits of the company available for payment of dividend. It further provides that the amount credited to such account shall not be utilized by the company except for the redemption of debentures.

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According to Rule 18(7) of the Companies Rules, 2014, the company shall create Debenture Redemption Reserve for the purpose of redemption of debentures, in accordance with the conditions given below:

(*a*) The Debenture Redemption Reserve shall be created out of profits of the company available for payment of dividend.

(*b*) The company shall create DRR in accordance with the following conditions:

(*i*) No DRR is required for debentures issued by All India Financial Institutions regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures.

(*ii*) For other financial institutions within the meaning of Section 2(*72*) of the Companies Act, 2013, and for Housing Finance Companies registered with National Housing Bank the adequacy of DRR will be 25% of the value of debentures issued through public issue and no DRR is required in case of privately placed debentures.

(*iii*) For other companies including manufacturing and infrastructure companies the adequacy of DRR will be 25% of the value of debentures issued through public and private issue. For unlisted companies issuing debentures on private placement basis, the DRR will be 25% of the value of debentures.

(*c*) Every company required to create DRR shall on or before 30th day of April in each year, invest or deposit, as the case may be, a sum which shall not be less than 15% of the amount of its debentures maturing during the year ending on 31st day of March of that year.

(*d*) In case of partly convertible debentures, DRR shall be created in respect of non-convertible portion of debenture issue.

(*e*) The amount credited to the DRR shall not be utilized by the company except for the purpose of redemption of debentures.

Journal Entries

1. For creation of Debenture Redemption Reserve

Surplus A/c (Profit and Loss A/c) Dr.

To Debenture Redemption Reserve A/c

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2. For investment or deposit

   Debenture Redemption Reserve Investment A/c Dr.

   To Bank A/c

3. For making amount due on redemption of debentures

   (*a*) If redemption at par

   Debentures A/c Dr.

   To Debenture-holders A/c

   (*b*) If redemption at premium

   Debentures A/c Dr.

   Premium on Redemption of Debentures A/c Dr.

   To Debenture-holders A/c

   (*c*) If redemption at discount

   Debentures A/c Dr.

   To Debenture-holders A/c

   To Gain on Redemption of Debentures A/c

4. For realization of investment or deposit

   Bank A/c Dr.

   To Debenture Redemption Reserve Investment A/c

   To Interest on DRR Investment A/c

5. For payment

   Debenture-holders A/c Dr.

   To Bank A/c

6. For transfer of DRR to General Reserve on redemption of all debentures

   Debenture Redemption Reserve A/c Dr.

   To General Reserve A/c

Illustration 1: A company issued Rs. 10,00,000 12% debentures at par on April 1, 2014 redeemable at par in two equal instalments on March 31, 2018 and March 31, 2019. The company decided to transfer to Debenture Redemption Reserve minimum amount as required by the by

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law on March 31, 2015. The company made the required investment on April 30, 2017 and April 16, 2018 respectively. The company sold the investment on March 31, 2018 and March 31, 2019 respectively and redeemed the debentures on the due dates. Pass journal entries, except for interest on debentures, assuming rate of interest on investments is 8% per annum.

Solution:

Journal Entries

Date	Particular	Dr. (Rs.)	Cr. (Rs.)
2014 April 1	Bank A/c Dr.	10,00,000	
	To Debenture Application & Allotment A/c		10,00,000
	(Being the debenture application money received)		
	Debenture Application & Allotment A/c Dr.	10,00,000	
	To 12% Debentures A/c		10,00,000
	(Being the allotment of debentures)		
2015 March 31	Surplus A/c (Profit and Loss A/c) Dr.	2,50,000	
	To Debenture Redemption Reserve A/c		2,50,000
	(Being transfer of 25% of Rs. 10,00,000 to debenture redemption reserve)		
2017 April 30	Debenture Redemption Reserve Investment A/c Dr.	75,000	
	To Bank A/c		75,000
	(Being investment of 15% of Rs. 5,00,000 as required by Rule 18(7) of the Companies Rules, 2014)		
2018 March 30	Bank A/c Dr.	80,500	
	To Debenture Redemption Reserve Investment A/c		75,000
	To Interest on DRR Investment A/c		5,500
	(Being realization of DRR investment along with interest for 11 months)		

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Date	Particular	Dr. (Rs.)	Cr. (Rs.)
	12% Debentures A/c Dr. To Debenture-holders A/c (Being amount due to debenture holders)	5,00,000	 5,00,000
	Debenture-holders A/c Dr. To Bank A/c (Being amount paid to debenture holders)	5,00,000	 5,00,000
	Interest on DRR Investment A/c Dr. To Profit and Loss A/c (Being the transfer of interest income)	5,500	 5,500
2018 April 16	Debenture Redemption Reserve Investment A/c Dr. To Bank A/c (Being investment made in specified securities equal to 15% of Rs. 5,00,000)	75,000	 75,000
2019 March 31	Bank A/c Dr. To Debenture Redemption Reserve Investment A/c (Being realization of DRR investment along with interest for 11.5 months)	80,750	 75,000 5.750
	12% Debentures A/c Dr. To Debenture-holders A/c (Being amount due to debenture holders)	5,00,000	 5,00,000
	Debenture-holders A/c Dr. To Bank A/c (Being amount paid to debenture holders)	5,00,000	 5,00,000
	Interest on DRR Investment A/c Dr. To Profit and Loss A/c (Being transfer of interest income)	5,750	 5,750
	Debenture Redemption Reserve A/c Dr. To General Reserve A/c (Being transfer of DRR to general reserve)	2,50,000	 2,50,000

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Sinking Fund or Debenture Redemption Fund for Debentures

Amount required for redemption is generally large and it is required at the end of a specified period. To meet this requirement, company may decide to set aside a fixed amount every year out of its divisible profit in a separate fund called 'Sinking Fund' or 'Debenture Redemption Fund'. An appropriate amount is calculated by referring to Sinking Fund Table depending upon the rate of return on investments and the number of years for which investments are made.

The amount thus ascertained is transferred from profits to Debenture Redemption Fund every year and its investment is termed as Debenture Redemption Fund Investment. This investment earns certain amount of income (call it interest) which is reinvested together with the fixed appropriated amount for the purpose in subsequent years.

In last year, the interest earned and the appropriated amount is not invested. In fact, at this stage the Debenture Redemption Fund Investments are en-cashed and the amount so obtained is used for the redemption of debentures. Any profit or loss made on the encashment of Debenture Redemption Fund Investments is also transferred to Debenture Redemption Fund A/C.

Procedure:

1. Calculate the amount of profit to be set-aside annually with the help of sinking fund table.

   Annual Appropriation =Amount payable at the Time of Redemption [Including Premium if any] X Relevant Sinking Fund Table value
2. At the end of the year, calculated sum is appropriated from divisible profits and credited to Debenture Redemption Fund A/c or Sinking Fund A/c.
3. Investments are made outside the business in good marketable securities equivalent to the amount appropriated. Investments amounting to a sum less than 15% of the nominal value of the debentures must be made as per Rule 18(7) of the Companies Rules, 2014.
4. The interest received on the investments is also credited to the Debenture Redemption Fund A/c or Sinking Fund A/c.
5. In the second and subsequent years, amount appropriated as well as interest received are invested. In this manner, debenture redemption

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fund or sinking fund accumulates to an amount required for redemption of debentures.

6. In the year of redemption *i.e.,* last year, the amount is appropriated as usual but no investment is made.
7. The investments are sold.
8. Profit/loss on sale of investment should be transferred to Profit and Loss Account as per AS-13, but practice it is transferred to Debenture Redemption Fund or Sinking Fund.
9. The proceeds are utilized for payment to the debenture holders.
10. Gain or profit on redemption of debentures is of capital nature, therefore it is transferred to Capital Reserve.
11. The balance in the Debenture Redemption Fund or Sinking Fund is transferred to Debenture Redemption Reserve and from Debenture Redemption Reserve to General Reserve. Alternatively, balance in Debenture Redemption Fund or Sinking Fund may be transferred directly to General Reserve.

Journal Entries

At the end of first year

(*a*) For annual appropriation for the purpose of redemption of Debentures

Surplus A/c (Profit and Loss A/c) Dr.

To Sinking Fund A/c

(or Debenture Redemption Fund (DRF) A/c)

(*b*) For investment of the annual appropriation

Sinking Fund Investment A/c Dr.

(or Debenture Redemption Fund Investment A/c)

To Bank A/c

At the end of second and subsequent years

(*a*) For receipt of interest on Sinking Fund (or DRF) investments

Bank A/c Dr.

To Interest on Sinking Fund (or DRF) Investments A/c

Note: Interest is calculated on the paid-up value or face value of investments as the case may be and not on cost of investments.

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(*b*) For transfer of interest to Sinking Fund (or DRF)

Interest on Sinking Fund (or DRF) Investments A/c Dr.

To Sinking Fund (or DRF) A/c

Alternatively, a combined entry may be passed for these two entries as under:

Bank A/c Dr.

To Sinking Fund (or DRF) A/c

(*c*) For annual appropriation for the purpose of redemption of debentures

Surplus A/c (Profit and Loss A/c) Dr.

To Sinking Fund (or DRF) A/c

(*d*) For investments of the annual appropriation along with interest received on sinking fund investments

Sinking Fund (or RDF) Investments A/c Dr.

To Bank A/c

Note: Investments should be made keeping in mind the provisions of Section 71 and Rule 18(7).

At the end of last year i.e., *the year of redemption*

(*a*) For receipt of interest on sinking fund (or DRF) investments

Bank A/c Dr.

To Interest on Sinking Fund (or DRF) Investments A/c

(*b*) For transfer of interest to sinking fund (or DRF)

Interest on Sinking Fund (or DRF) Investments A/c Dr.

To Sinking Fund (or DRF) A/c

(*c*) For annual appropriation for the purpose of redemption of debentures

Surplus A/c (Profit and Loss A/c) Dr.

To Sinking Fund (or DRF) A/c

(*d*) For sale of sinking fund investments

Bank A/c Dr.

To Sinking Fund (or DRF) Investments A/c

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(*e*) For profit or loss on sale of sinking fund (or DRF) investments

(*i*) In case of profit

Sinking Fund (or DRF) Investments A/c Dr.

To Sinking Fund (or DRF) A/c

(*ii*) In case of loss

Sinking Fund (or DRF) A/c Dr.

To Sinking Fund (or DRF) Investments A/c

Note: 'AS-13: Accounting for Investments' requires that profit or loss on sale of investments should be transferred to Profit and Loss Account.

(*f*) For making the amount due on redemption of debentures

(*i*) If redemption is at par

Debentures A/c Dr.

To Debenture-holders A/c

(*ii*) If redemption is at premium

Debentures A/c Dr.

Premium on Redemption of Debentures A/c Dr.

To Debenture-holders A/c

(*g*) For payment to debenture holders

Debenture-holders A/c Dr.

To Bank A/c

(*h*) For premium payable on redemption

If Loss on Issue of Debentures A/c was not debited for premium payable on redemption at the time of passing the entry for issue of debentures, then the following entry will be passed:

Sinking Fund (or DRF) A/c Dr.

To Premium on Redemption of Debentures A/c

If Loss on Issue of Debentures A/c was debited for premium payable on redemption of debentures and it has not been written off, then the following entry will be passed:

Sinking Fund (or DRF) A/c Dr.

To Loss on Issue of Debentures A/c

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(*i*) For transfer of Sinking Fund (or DRF) to general reserve

Sinking Fund (or DRF) A/c Dr.

To General Reserve A/c

Illustration 2:

On lst April 2015, SDE Ltd. issued 1,000, 8% Debentures of Rs. 100 each repayable at the end of four years at a premium of 10%. It was decided to create a sinking fund for the purpose; the investment is expected to yield 5% net. Sinking Fund table shows that 0.232012 invested annually amounts to Rs. 1 at 5% in four years. Investments were made in multiples of Rs. 100 only. On 31st March, 2019 the Balance at the Bank was Rs. 45,000 and the Investment realized Rs. 85,000 the debentures were paid off.

Give journal entries and show Sinking Fund account and Sinking Fund Investment Account; except for debentures interest.

Solution:

Journal Entries in the Books of SDE Ltd.

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
01.04.15	Bank A/c Dr.	1,00,000	
	To Debenture Application & Allotment A/c		1,00,000
	(Being debenture application money received on 1,000 debentures @ Rs. 100 each)		
01.04.15	Debenture Application & Allotment A/c Dr.	1,00,000	
	Loss on Issue of Debentures A/c Dr.	10,000	
	To 8% Debentures A/c		1,00,000
	To Premium on Redemption of Debenture A/c		10,000
	(Being application money transferred to 8% debenture a A/c and Premium payable on Redemption of Debenture transferred to Loss on Issue of Debentures A/c)		

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Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31.03.16	Surplus A/c (Profit and Loss A/c) Dr.	25,521	
	To Debenture Redemption Fund A/c		25,521
	(Being annual appropriation made to provide for redemption of 8% debentures)		
31.03.16	Debenture Redemption Fund Investment A/c Dr.	25,500	
	To Bank A/c		25,500
	(Being the amount appropriated from P/L Appropriation A/c invested in multiples of Rs. 100)		
31.03.17	Bank A/c Dr.	1,275	
	To Interest on Debenture Redemption Fund Investment A/c		1,275
	(Being interest received @ *5%* on Rs. 25,500)		
31.03.17	Interest on Debenture Redemption Fund Investment A/c Dr.	1,275	
	To Debenture Redemption Fund A/c		1,275
31.03.17	Surplus A/c (Profit and Loss A/c) Dr.	25,521	
	To Debenture Redemption Fund A/c		25,521
	(Being annual appropriation made to provide for redemption of 8% debentures)		
31.03.17	Debenture Redemption Fund Investment A/c Dr.	26,800	
	To Bank A/c		26,800
	(Being the amount appropriated from P/L Appropriation A/C along with interest invested in multiples of Rs. 100)		
31.03.18	Bank A/c Dr.	2,615	
	To Interest on Deb. Redemption Fund Investment A/c		2,615
	(Being interest received @ *5%* on Rs. 52,300)		

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Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31.03.18	Interest on Debenture Redemption Fund Investment A/c Dr. To Debenture Redemption Fund A/c (Being interest transferred to DRF A/c)	2,615	2,615
31.03.18	Surplus A/c (Profit and Loss A/c) Dr. To Debenture Redemption Fund A/c (Being annual appropriation made to provide for redemption of 8% debentures)	25,521	25,521
31.03.18	Debenture Redemption Fund Investment A/c Dr. To Bank A/c (Being the amount appropriated from P/L Appropriation A/c along with interest invested in multiples of Rs. 100)	28,100	28,100
31.03.19	Bank A/c Dr. To Interest on Debenture Redemption Fund Investment A/c (Being interest received @5% on Rs. 80,400)	4,020	4,020
31.03.19	Interest on Debenture Redemption Fund Investment A/c Dr. To Debenture Redemption Fund A/c (Being interest transferred to DRF A/c)	4,020	4,020
31.03.19	Surplus A/c (Profit and Loss A/c) Dr. To Debenture Redemption Fund A/c (Being annual appropriation made to provide for redemption of 8% debentures)	25,521	25,521
31.03.19	Bank A/c Dr. To Debenture Redemption Fund Investment A/c (Being DRF Investment sold)	85,000	85,000

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Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31.03.19	Debenture Redemption Fund Investment A/c Dr.	4,600	
	To Debenture Redemption Fund A/c		4,600
	(Being profit on realization of Debenture Redemption Fund Investments transferred to DRF A/c)		
31.03.19	Debenture A/c Dr.	1,00,000	
	Premium on Redemption of Debenture A/c Dr.	10,000	
	To Debenture-holders A/c		1,10,000
	(Being amount due to debenture-holders on redemption at premium)		
31.03.19	Debenture-Holders A/c Dr.	1,10,000	
	To Bank A/c		1,10,000
	(Being payment made to debenture-holders)		
31.03.19	Debenture Redemption Fund A/c Dr.	10,000	
	To Loss on Issue of Debenture A/c		10,000
	(Being Loss on Issue of Debenture written off on the assumption that it was not written off earlier)		
31.03.19	Debenture Redemption Fund A/c Dr.	1,04,594	
	To General Reserve A/c		1,04,594
	(Being balance in DRF A/c transferred to general reserve account)		

Note:

1. Annual appropriation = Rs. 1,10,000 x 0.232012 =Rs. 25,521.
2. It is instructed to invest in multiples of 100 only. In the first year required investment was Rs. 25,521 but Rs. 25,500 was invested similarly in the second year required investment was Rs. 26,796 but Rs. 26,800 was invested, in third year also Rs. 28,100 was invested against Rs. 28,136.

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Debenture Redemption Fund A/c

Dr. (Sinking Fund A/c) Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
31-03-16	To Balance c/d	25,521	31-03-16	By Surplus A/c	25,521
31-03-17	To Balance c/d	52,317	01-04-16	By Balance b/d	25,521
			31-03-17	By Interest on DRFI A/c	1,275
			31-03-17	By Surplus A/c	25,521
		52,317			52,317
31-03-18	To Balance c/d	80,453	01-04-17	By Balance b/d	52,317
			31-03-18	By Interest on DRFI A/c	2,615
			31-03-18	By Surplus A/c	25,521
		80,453			80,453
31-03-19	To Loss on Issue of Debentures A/c	10,000	01-04-18	By Balance b/d	80,453
31-03-19	To General Reserve A/c	1,04594	31-03-19	By Interest on DRFI A/c	4,020
			31-03-19	By Surplus A/c	25,521
			31-03-19	By DRFI A/c	4,600
		1,14,594			1,14,594

Debenture Redemption Fund Investment A/c

Dr. (Sinking Fund Investment A/c) Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
31-03-16	To Bank A/c	25,500	31-03-16	By Balance c/d	25,500
01-04-16	To Balance b/d	25,500	31-03-17	By Balance c/d	52,300
31-03-17	To Bank A/c	26,800			
		52,300			52,317
01-04-17	To Balance b/d	52,300	31-03-18	By Balance c/d	80,400
31-03-17	To Bank A/c	28,100			
		80,400			80,400
01-04-18	To Balance c/d	80,400	31-03-19	By Bank A/c	85,000
31-03-19	To Debenture Redemption Fund A/c	4,600			
		85,000			85,000

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5.3.4 *Redemption by Conversion*

Conversion means an act of changing one thing in another. If company has issued convertible debentures then these are redeemed by converting them into shares or new class of debentures [at par/at premium/or at discount].

As per Sec. 71(1) of Companies Act, 2013 *"A company may issue debentures with an option to convert such debenture into shares, either wholly or partly at the time of redemption: Provided that the issue of debentures with an option to convert such debentures into shares, wholly or partly, shall be approved by a special resolution passed at a general meeting".*

Rule 18(7) of the Companies Rules, 2014, provides that in case of partly convertible debentures, debenture redemption reserve shall be created in respect of non-convertible portion of the debenture issue. It implies that, in case of fully convertible debentures, debenture redemption reserve is not required.

Where the debenture originally issued at discount are converted before the redemption date into equity shares, the number of shares to be issued should be calculated on the basis of actual amount received from the debenture-holders at the time of issue of the debentures, otherwise it would amount to issue of shares at discount which is prohibited by the Companies Act, 2013 except when sweat equity shares are issued. However, if the conversion is done at or after the redemption date, amount due on redemption will be taken into consideration for calculating the number of shares to be issued.

I. When debenture redeemable at par are converted into equity shares before maturity

Debentures A/c	Dr.	(with nominal value)
To Discount on Issue of Debentures A/c		(with discount not yet written off)
To Profit and Loss A/c		(with discount already written off)
To Equity Share Capital A/c		(with paid-up value of shares)

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II. When debentured are converted, at maturity, into equity shares at premium, assuming that debentures are redeemable at premium

(*a*)	Debentures A/c Dr.	(with nominal value)
	Premium on Redemption of Deb. A/c Dr.	(with premium payable on redemption)
	To Debenture-holders A/c	(with the amount due on redemption)
(*b*)	Debenture-holders A/c Dr.	
	To Equity Share Capital A/c	
	To Securities Premium A/c	

Note:

$$\text{Number of shares/debentures to be issued} = \frac{\text{Amount Due to debenture holders}}{\text{Issue price of the shares or new debentures}}$$

Illustration 3: (Debenture issued at par and converted into shares issued at par)

Swarnim Ltd. issued Rs. 90,000, 6% debenture of Rs. 100 each on 1st April 2015 redeemable at the end of the 4th year by converting them into equity shares of Rs. 10 each. Record journal entries for issue and redemption of debenture. Ignore entries for payment of interest.

Solution:

Journal Entries in the Books of Swarnim Ltd.

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
2015 April 1	Bank A/c Dr. To Debenture Application and Allotment A/c (Being application money received)	90,000	90,000
2015 April 1	Debenture Application and Allotment A/c Dr. To 6% Debenture A/c (Being application money transferred to 6% debenture A/c)	90,000	90,000

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Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
2019 March 31	6% Debenture A/c Dr. To Debenture-holders A/c (Being amount payable to debenture-holders recorded)	90,000	 90,000
2019 March 31	Debenture-holders A/c Dr. To Equity Share Capital A/c (Being issue of 9,000 equity shares to debenture-holders)	90,000	 90,000

Illustration 4: (Debenture issued at par converted into shares issued at premium)

Judo Ltd. issued 88,000, 8 % debenture of Rs. 50 each at a premium of 5% on March 31, 2014 redeemable at par by conversion of debenture into shares of Rs. 20 each at a premium of Rs. 2 per share on June 30, 2019. Record necessary entries for redemption of debenture only.

Solution:

Journal Entries in the Books of Judo Ltd.

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
2019 June 30	Debentures A/c Dr. To Debenture Holders A/c (Being amount payable to Debenture Holders recorded)	44,00,000	 44,00,000
2019 June 30	Debenture Holders A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being entry passed for issue of equity share to Debenture holders)	44,00,000	 40,00,000 4,00,000

Working Notes:

1. No of equity shares to be issued = (Amount Due)/(Face Value of Shares + Premium) = 2,00,000
2. Equity Share Capital = 2,00,000 × Rs. 20 = Rs. 40,00,000
3. Securities Premium = 2,00,000 × Rs. 2 = Rs. 4,00,000

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5.4 Redemption of Debentures by Purchase in the Open Market

A company if authorized by its Articles, Debenture Deed etc.; can buy its own debentures in the open market, which were issued to public earlier. This method of redemption is also known as redemption of debenture through open market operation. Company uses this method of redemption only when they are available from the market at cheap rate. The debentures may be so purchased for the following purposes:

1. Purchase of debentures for immediate cancellation.
2. Purchase of debentures as investment.

Purchase of Debentures for Immediate Cancellation

At the time of cancellation of Own Debentures, Debentures Account should be debited and "Own Debentures Account" credited. The Debentures Account should be debited with the face value of cancelled debentures any difference between this end the value of "Own Debentures" being debited to "Loss on Redemption of Debentures account" (if it is a loss) or credited, if it is a profit, to "Profit on Redemption of Debentures Account". It is to be remembered that profit and loss on redemption of Debentures arises only on cancellation of debentures.

Accounting entries to be passed are as follows:

1. For sale of sinking fund investments

   Bank A/c Dr.

   To Sinking Fund Investment A/c

2. For transfer of profit or loss on sale of sinking fund investments

   (*a*) In case of Profit

   Sinking Fund Investment A/c Dr.

   To Sinking Fund A/c

   (*b*) In case of loss

   Sinking Fund A/c Dr.

   To Sinking Fund Investment A/c

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3. For purchase and cancellation of debentures payable at nominal value

   (*a*) When purchased at nominal value

   Debentures A/c Dr.

   To Bank A/c

   (*b*) When purchased at less than the nominal value

   Debentures A/c Dr.

   To Bank A/c

   To Profit on Redemption of Debentures A/c

   (*c*) When purchased at more than nominal value

   Debentures A/c Dr.

   Loss on Cancellation or Redemption of Debentures A/c Dr.

   To Bank A/c

4. For profit or loss on redemption of debentures

   (*a*) In case of profit

   Profit on Cancellation or Redemption of Debentures A/c Dr.

   To Sinking Fund A/c

   Sinking Fund A/c Dr.

   To Capital Reserve A/c

   (*b*) In case of loss

   Sinking Fund A/c Dr.

   To Profit on Cancellation or Redemption of Debentures A/c

5. For transfer of sinking fund to general reserve

   Sinking Fund A/c Dr.

   To General Reserve A/c

Illustration 5:

The following balances appeared in the books of AB Ltd. on April 1, 2018:

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12% Debentures (Face value Rs. 100 each)	Rs. 4,00,000
Debenture Sinking Fund	Rs. 2,50,000
Debenture Sinking Fund Investment	Rs. 2,50,000

(In 8% Government Bonds of the face value of Rs. 3,00,000)

Interest on debentures was payable on 30th September and 31st March and interest on Government Bonds was receivable on the same dates. On April 1, 2018, the company purchased for immediate cancellation 500 debentures in the market at Rs. 96 each. The amount required for this was raised by selling 8% Government Bonds of the face value of Rs. 60,000. On March 31, 2019, Rs. 41,600 was appropriated for debenture sinking fund and on same date 8% Government Bonds were acquired for the amount plus interest for the year on debenture sinking fund investments. The face value of the bonds acquired was Rs. 76,000. You are required to show the necessary ledger accounts.

Solution:

Dr. 12% Debentures A/c Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
01-04-18	To Bank A/c	48,000	01-04-18	By Balance b/d	4,00,000
01-04-18	To Profit on Redemption of Debentures A/c	2,000			
31-03-19	To Balance c/d	3,50,000			
		4,00,000			4,00,000

Dr. Debentures Sinking Fund Investments A/c Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
01-04-18	To Balance b/d	2,50,000	01-04-18	By Bank A/c	48,000
31-03-19	To Bank A/c	60,800	31-03-19	By Loss on Sale of Debenture Sinking Fund Investment A/c	2,000
			31-03-19	By Balance c/d	2,60,800
		4,00,000			4,00,000

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Dr. Debentures Sinking Fund A/c Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
01-04-18	To Loss on Sale of Debenture Sinking Fund Investment A/c	2,000	01-04-18	By Balance b/d	2,50,000
01-04-18	To General Reserve A/c	50,000	01-04-18	By Profit on Redemption of Debenture A/c	2,000
01-04-18	To Capital Reserve A/c	2,000	30-09-18	By Interest on Debenture Sinking Fund Investment A/c	9,600
			31-03-19	By Interest on Debenture Sinking Fund Investment A/c	9,600
			31-03-19	By Surplus A/c	41,600
		4,00,000			4,00,000

Working Notes:

1. Calculation of loss on sale of debenture sinking fund investments

Funds required for purchase of debentures	=	500 × 96
	=	Rs. 48,000
Face value of the Government Bonds sold	=	Rs. 60,000
Cost of the Government Bonds sold	=	60,000 × (2,50,000 / 3,00,000)
	=	Rs. 50,000
Loss on sale	=	50,000 – 48,000
	=	Rs. 2,000

2. Calculation of profit on redemption or cancellation of debentures

Face value of debentures purchased for immediate cancellation	=	500 × 100
	=	Rs. 50,000
Purchase price of debentures	=	500 × 96
	=	Rs. 48,000

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Profit on cancellation of debentures	=	50,000 – 48,000
	=	Rs. 2,000

Purchase of Own Debentures as an Investments

Debentures when purchased for investments are popularly known as "Own Debentures." "Investment in Own Debentures" till the date of sale or cancellation it is shown as a part of assets under the head 'Investments' in the balance sheet.

Purchased of Own Debentures by a company is treated like purchase of any other Investment only difference is that instead of debiting Investment A/c, it is debited to Investment in Own Debentures A/c or Own Debenture account at cost (*i.e.* purchase price).

Note: The debentures so purchased may either be kept as investment or it may be cancelled or re-sold in the open market.

Journal Entries:

1. For sale of sinking fund investments

- At Profit

Bank A/c Dr. (with amount realized)

  To Debenture Redemption Fund Investments A/c (with cost)

  To Debenture Redemption Fund A/c (with profit)

- At Loss

Bank A/c Dr. (with amount realized)

Debenture Redemption Fund A/c Dr. (with loss)

  To Debenture Redemption Fund Investments A/c (with cost)

2. For purchase of own debentures as investment

Own Debentures A/c Dr.

  To Bank A/c

3. For interest paid to outside debenture-holders and for interest on own debentures

Debenture Interest A/c Dr.

  To Bank A/c

  To Interest on Own Debentures A/c

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4. For transfer of interest on own debentures to sinking fund

   Interest on Own Debentures A/c Dr.

   To Debenture Redemption Fund A/c

5. For cancellation of own debentures payable at par

- In case of profit

  Debentures A/c Dr.

  To Own Debentures A/c

  To Debenture Redemption Fund A/c

- In case of Loss

  Debentures A/c Dr.

  Debenture Redemption Fund A/c Dr.

  To Own Debentures A/c

6. For transfer of profit on redemption to capital reserve

   Debenture Redemption Fund A/c Dr.

   To Capital Reserve A/c

7. For transfer of Debenture Redemption Fund first to Debenture Redemption Reserve and the from Debenture Redemption Reserve to General Reserve. Alternatively, amount may be transferred directly to general reserve.

- When entry is passed through DRR

  Debenture Redemption Fund A/c Dr.

  To Debenture Redemption Reserve A/c

  Debenture Redemption Reserve A/c Dr.

  To General Reserve A/c

- When direct entry is passed

  Debenture Redemption Fund A/c Dr.

  To General Reserve A/c

Illustration 6:

Sagar Ltd. has an outstanding balance of 4,00,000, 8% debenture of Rs. 100 each and sufficient funds in Debenture Redemption Reserve to meet legal requirements. The Board of Directors decided to purchase 1,00,000 debentures at a price of Rs. 96 for investments purpose. But

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after few months they took decision to sell them @ Rs. 99 in the market. Record necessary entries to show above transactions.

Solution:

Journal Entries in the Books of Sagar Ltd.

Sl. No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
1.	Investment in Own Debenture A/c Dr.	96,00,000	
	To Bank A/c		96,00,000
	(Being 1,00,000 8% own debentures purchased @ Rs. 96)		
2.	Bank A/c Dr.	99,00,000	
	To Investment in Own Debentures A/c		96,00,000
	To Debenture Redemption Fund A/c		3,00,000
	(Being own debentures re-sold (@ Rs. 99)		
3.	Debenture Redemption Fund A/c Dr.	3,00,000	
	To Capital Reserve A/c		3,00,000
	(Being profit on sale of investment transferred to capital reserve account)		

5.5 Treatment of Debenture Interest and Interest on Own Debenture

1. Interest on Own Debentures held as Investment is credited to Interest on Own Debentures Account; as it is an income for the company. The income so earned by way of interest is credited to Profit & Loss Account.
2. If Own Debentures are resold by the company then interest from date of sale till interest date will be payable to outsiders and up to the date of sale it is income for the company so credited to interest on Own Debentures Account.
3. If debentures are cancelled then Interest on Own Debentures is recorded only up to date of cancellation.

Purchase of debentures on a day other than the due date of interest and treatment of Cum-Interest and Ex-Interest

It is not necessary that the debentures are purchased on the date on which interest on it is due. So, the question arises, whether the purchase price

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includes the interest or not. If it includes this interest, it is called as cum-interest. However, if interest is to be paid in addition to purchase price, it is known as ex-interest.

Note:

If quotation price does not mention about cum or ex-interest, in the given problem. It is assumed that quotation price is ex-interest and suitable note should be given.

Illustration 7:

Pass necessary journal entries to record the following:

On 1st November, 2018 Z Ltd. purchase Own 12% Debentures for Rs. 11,900 cum-interest (face value Rs. 10,000). Its due date of payment of interest on 12% Debentures is 31st December every year.

Solution:

Own Debentures A/c	Dr.	10,900
Debenture Interest A/c	Dr.	1,000
To Bank A/c		11,900
Interest Accrued	=	10,000 x 12% x 10/12
	=	Rs. 1,000
Therefore, Cost of Own Debentures	=	11,900 – 1,000
	=	Rs. 10,900

Illustration 8:

Pass necessary journal entries to record the following:

On 1st November, 2018, Z Ltd. purchased own 12% Debentures for Rs. 11,900 ex-interest (face value Rs. 10,000). Its due date of payment of interest on 12% Debentures is 31st December every year.

Solution:

Own Debentures A/c	Dr.	11,900
Debenture Interest A/c	Dr.	1,000
To Bank A/c		12,900

Amount paid by Z Ltd. = 11,900 + 1,000

= Rs. 12,900

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Illustration 9:

A Ltd. had 1,000, 9% Debentures of Rs. 100 each as on 01-01-2019. The company made the following purchases in the open market.

(*a*) 31.03.2019 : 200 Debentures cum-interest at Rs. 97

(*b*) 01.10.2019 : 500 Debentures cum-interest at Rs. 102

(*c*) 01-11.2019 : 150 Debentures ex-interest at Rs. 98.50

All the debentures purchased were immediately cancelled except those purchased on 31.03.2019, which the company has not yet cancelled. Interest is payable on 30th June and 31st December.

Journalize the transactions. (*Ignore narrations*)

Solution:

Journal Entries in the Books of A Ltd.

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31.03.2019	On purchase of own debenture :		
	Own Debenture A/c Dr.	18,950	
	Debenture Interest A/c Dr.	450	
	To Bank A/c [200 @ Rs. 97][Refer: WN 1]		19,400
30.06.2019	For Half Yearly Interest :		
	Debenture Interest A/c Dr.	4,050	
	To Debenture-holders A/c [on 800 debentures]		3,600
	To Interest on Own Debenture A/c		450
	For Payment of Interest to Debenture holders–		
	Debenture holder A/c Dr.	3,600	
	To Bank A/c		3,600
01.10.2019	On purchase of own debenture–		
	Own Debenture A/c Dr.	49,875	
	Debenture Interest A/c [Refer: WN 2] Dr.	1,125	
	To Bank A/c [500 @ Rs. 102]		51,000

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Notes

	On cancellation of Debenture 9% Debenture A/c Dr. To Own Debenture A/c To Debenture Redemption Fund A/c	50,000	 49,875 125
	For transferring Gain on cancellation of Debenture to capital reserve– Debenture Redemption Fund A/c Dr. To Capital Reserve A/c	125	 125
01.11.2019	On purchase of own debenture– Own Debenture A/c Dr. Debenture Interest A/c [Refer: WN 3] Dr. To Bank A/c	 14,775 450	 15,225
	On cancellation of Debenture 9% Debenture A/c Dr. To Own Debenture A/c To Debenture Redemption Fund A/c	15,000	 14,775 225
	For transferring Gain on cancellation of Debenture to capital reserve– Debenture Redemption Fund A/c Dr. To Capital Reserve A/c		225
31.12.2019	For Half Yearly Interest– Debenture Interest A/c Dr. To Debenture-holders A/c To Interest on Own Debenture A/c [Refer: WN 4 & 5]	1,575	 675 900
	For Payment of Interest to Debenture holders Debenture-holders A/c Dr. To Bank A/c	675	 675
	For transferring interest on debenture A/c to Profit and Loss A/c– Profit and Loss A/c Dr. To Debenture Interest A/c Note – Rs. [450 + 4,050 + 1,125 + 450 + 1,575]		7,650

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	For transferring interest on own debenture A/c to Profit and Loss A/c- Interest on Own Debenture A/c Dr. To Profit and Loss A/c Rs. [450+900]	1,350	1,350

Working Notes :

1. Rs. 20,000 × 9% × 3/12 = Rs. 450
2. Rs. 50,000 × 9% × 3/12 = Rs. 1,125
3. Rs. 15,000 × 9% × 4/12 = Rs. 450
4. Rs. 15,000 × 9% × 6/12 = Rs. 675
5. Rs. 20,000 × 9% × 6/12 = Rs. 900
6. It is assumed that company has made adequate provision with respect to Debenture Redemption Reserve Account.

5.6 Summary

The refund of money to debenture holders is called redemption of debentures. Redemption is basically reduction, elimination or cancellation of debentures to the extent they have been redeemed. The debentures may be redeemed at Par, Premium or at Discount.

Debentures may be redeemed fully in one lump sum at a given time or in instalment/by drawing lots or by purchase in the open market or by conversion. Company needs huge amount of money at the time of redemption of debentures so financial planners of the company must take into consideration the time as well as amount aspect involved in redemption. Redemption of debentures may be done out of the proceeds of fresh issue of shares or out of profit or by conversion in other securities as per terms of issue.

As per recent guidelines issued by MCA a company is required to create DRR equal to 25% of the value of debentures. Further, the Rules requires that companies that are required to create DRR should also set aside 15% of the amount of debentures maturing during the financial year in bank deposits or certain other specified securities. The said amount to be invested before 30th April of the financial year.

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A company may decide to create a sinking fund; also termed as debenture redemption fund for redemption of debentures. Under this method an appropriate amount is calculated by referring to Sinking Fund Table depending upon the rate of return on investments and the number of years for which investments are made. The amount thus ascertained is transferred from profits to Debenture Redemption Fund every year and its investment is termed as Debenture Redemption Fund Investment. This investment earns certain amount of income (call it interest) which is reinvested together with the fixed appropriated amount for the purpose in subsequent years. At the end investment is realized and the proceeds are used to redeem the debentures.

A company if authorized by its Articles, Debenture Deed etc.; can buy its own debentures in the open market, which were issued to public earlier. The debentures so purchased may be cancelled immediately or may be held as investment. This method of redemption is also known as redemption of debenture through open market operation.

5.7 Questions for Practice

Exercise 1: Very Short Answer Type Questions

(*a*) Name the sources available for redemption of debentures?

(*b*) Pass required entry for writing off premium payable on redemption of debenture?

(*c*) What do you mean by debenture redemption reserve account?

(*d*) Explain cum-interest and ex-interest debentures with example.

Exercise 2: Descriptive Questions

(*a*) What is meant by redemption of Debenture?

(*b*) What do you mean by 'Debenture Redemption Reserve Account' is mandatory under the act to create it on redemption of debentures?

(*c*) Explain briefly the use of Sinking Fund Method for redemption of Debenture.

Exercise 3 : Practical Questions

(*a*) Pass required entries at the time of issue & redemption in the following cases—

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(*i*) Natasha Ltd. issued Rs. 1,00,000, 15% Debentures at a discount of 5% but redeemable at a premium of 5% at the end of 4 years. The Board of Directors decided to transfer the minimum required amount to Debenture Redemption Reserve Account at the time of redemption.

(*ii*) Rasna Ltd. issued Rs. 1,00,000, 15% Debentures of Rs. 100 each at a premium of 5% but redeemable at 110% at the end of 4 years. The Board of Directors decided to transfer the minimum required amount to Debenture Redemption Reserve Account at the time of redemption.

Ans.: Amount required to be transferred to Debenture Redemption Reserve Accounting both the above cases Rs. 25,000.

1. B Ltd. Issued on 01-01-2012 Rs. 10,000, 6% debentures of 100 each at par repayable at the end of 4 years at a premium of 10%. It was decided to create a sinking fund for redemption of debentures. Investments are expected to earn interest @ 5% p.a.

   Reference to the sinking fund table shows that 0.232012 invested annually at 5% compound interest amounts to 1 at the end of 4 years. Investments were made in multiples of 100 only. On 31-12-2015 investments were sold for Rs. 8,05,000 and the debentures were redeemed.

   Give journal entries and show necessary ledger accounts, accounts are closed on 31st December.

   Ans.: Annual Appropriation Rs. 11,00,000 × 0.232012 = Rs. 2,55,213
   Profit on sale of Investment – Rs. 400

Exercise 4: True and False

State following statements are true or false:

(*a*) Cum-interest price is higher than ex-interest price.

(*b*) A company may purchase its own debentures for immediate cancellation only.

(*c*) Premium payable on redemption of debentures is in the nature of personal account.

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(*d*) The creation of DRR is obligatory only for non-convertible debentures and non-convertible portion of partly convertible debentures.

Ans.: (*a*) False (*b*) False (*c*) True (*d*) True

Exercise 5: Fill in the blanks:

(*a*) Following entry will be passed if redemption of debentures is taking place at Premium –

Debentures A/c Dr.

______________________________ A/c Dr.

To Debenture Holders A/c

(*b*) When company transfers adequate profits from Surplus A/c to the ______________________________ A/c before the redemption of Debenture, then such redemption is known as redemption out of profits.

(*c*) Number of shares/debentures to be issued at the time of conversion of debentures into new securities may be calculated by applying following formula :

____

Issue price of the shares or *new debentures*

Ans.:

(*a*) Premium on Redemption of Debenture

(*b*) Debenture Redemption Reserve A/c

(*c*) Amount payable

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UNIT - II

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L E S S O N

1

Financial Statements of a Company

Revised By:
Sufiya
Assistant Professor
Zakir Husain Delhi College

STRUCTURE

1.1 *Learning Objectives*
1.2 *Concept of Financial Statement*
1.3 *Legal Requirements related to Financial Statements as provided in Section 129*
1.4 *General Instructions for preparation of Financial Statements of a Company*
1.5 *General Instructions for Preparation of Balance Sheet*
1.6 *General Instructions for Preparation of Statement of Profit and Loss*
1.7 *Divisible Profits*
1.8 *Dividend and its Accounting Treatment*
1.9 *Division II-Ind AS Schedule II*
1.10 *Summary*
1.11 *Questions for Practice*

1.1 Learning Objectives

This Chapter will assist you to:

- Understand the meaning of financial statements of a company.
- Learn some relevant terms for preparing financial statements of companies.
- Acquired knowledge regarding general instructions given to prepare financial statements of a company.
- Know various aspects of dividend such as meaning, concept and accounting.
- Know the prescribed accounting treatment of tax and or provision for tax.

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1.2 Concept of Financial Statement

Meaning of Financial Statement

According to section 2(*40*) of Companies Act, 2013, financial statement in relation to a company, includes—

(*i*) a balance sheet as at the end of the financial year;

(*ii*) a profit and loss account, or in case of a company carrying on any activity not for profit, an income and expenditure account for the financial year;

(*iii*) cash flow statement for the financial year; and

(*iv*) any explanatory notes annexed to, or forming part of, any document referred to in sub-clause (*i*) to sub-clause (*iii*).

However, the financial statement, with respect to One Person Company, small company and dormant company (Section 455) may not include cash flow statement.

Meaning of Financial Year

According to section 2(*41*), financial year, in relation to any company or body corporate, means the period ending on 31st day of March of every year. Where a company has been incorporated on after 1st day of January of a year, the first financial year will end on 31st day of March of the following year.

If a company or body corporate which is a holding company or a subsidiary or associate company of a company incorporated outside India and is required to follow a different financial year for consolidation of its accounts outside India, the Tribunal may, if it is satisfied, allow any period as its financial year, whether or not that period is a year.

1.3 Legal Requirements related to Financial Statements as provided in section 129

Sections 128 to 138 to deal with financial requirements. The following are the legal requirements as provided in sections 129.

Section 129(*1*) of the Companies Act, 2013 provides that the financial statements—

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(*i*) shall give a true and fair view of the state of affairs of the company or companies,

(*ii*) comply with the accounting standards notified under section 133,

(*iii*) shall be in the form or forms as may be provided for different class or classes of companies in Schedule III, and

(*iv*) the items contained in such financial statements shall be in accordance with the accounting standards.

However, the aforesaid provisions of section 129(1) shall not apply to any insurance or banking company or any company engaged in the generation of or supply of electricity, or to any other class of company for which form of financial statement has been specified in or under the Act governing such class of company.

Section 129(2) provides that every general meeting of a company, the Board of Directors of the company shall lay before such meeting financial statements for the financial year.

Section 129(3), provides that every general meeting of a company has one or subsidiaries or associate companies, it shall, in addition to standalone financial statement provided in section 129(2), prepare a consolidated financial statement of a company and of all the subsidiaries and associate companies. The consolidated financial statement shall be prepared by the company in the same form and manner as that of its own and in accordance with applicable standards. The consolidated financial statement shall also be laid before the annual general meeting of the company along with the laying of its standalone financial statement.

Section 129(4) states that the provisions of the Act applicable to the preparation, adoption and audit of the financial statements of a holding company shall, *mutatis mutandis,* apply to the consolidated financial statements referred in section 129(3).

Section 129(5) provides that where the financial statements of a company do not comply with the accounting standards referred to in section 129(1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reason for such deviation and the financial effects, if any, arising out of such deviation.

Section 129(6) empowers the Central Government to exempt any class or classes of companies from complying with any of the requirements

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of section 129 or rules made thereunder, if it is considered necessary to grant such exemption in the public interest.

The Central Government may, by notification, constitute a National Financial Reporting Authority to provide the matters relating to accounting and auditing standards under the Companies Act, 2013 (Section 132).

The Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority (Section 133).

1.4 General Instructions for Preparation of Financial Statements of a Company

1. Rules regarding preparation of Financial Statements hereafter are discussed in accordance with Division I - Schedule III of Companies Act, 2013. Division I is applicable on companies which are required to comply with the Companies Rules, 2006 (Accounting Standards).
2. Where compliance with the requirements of the Act including Accounting Standards as applicable to the companies require any change in treatment or disclosure including addition, amendment, substitution or deletion in the head or sub-head or any changes, *inter se,* in the financial statements or statements forming part thereof, the same shall be made and the requirements of this Schedule shall stand modified accordingly.
3. The disclosure requirements specified in this Schedule III are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 2013. Additional disclosures specified in the Accounting Standards shall be made in the notes to accounts or by way of additional statement unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act shall be made in the notes to accounts in addition to the requirements set out in this Schedule.
4. Notes to Accounts—

   Following points must be taken into consideration while referring notes to accounts, to any of the items in the financial statements—

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(*i*) Notes to accounts shall contain information in addition to that presented in the Financial Statements and shall provide where required (*a*) narrative descriptions or disaggregation of items recognized in those statements; and (*b*) information about items that do not qualify for recognition in those statements.

(*ii*) Each item on the face of the Balance Sheet and Statement of Profit and Loss shall be cross-referenced to any related information in the notes to accounts. In preparing the Financial Statements including the notes to accounts, a balance shall be maintained between providing excessive detail that may not assist users of financial statements and not providing important information as a result of too much aggregation.

5. (*i*) Depending upon the turnover of the company, the figures appearing in the Financial Statements may be rounded off as given below:—

Turnover	Rounding off
(*a*) Less than one hundred crore rupees	To the nearest hundreds, thousands, lakhs or millions, or decimals thereof.
(*b*) One hundred crore rupees or more	To the nearest lakhs, millions or crores, or decimals thereof.
Note: Once a unit of measurement is used, it shall be used uniformly in the Financial Statements.	

(*ii*) Except in the case of the first Financial Statements laid before the Company (after its incorporation) the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statements including notes shall also be given.

(*iii*) For the purpose of this Schedule, the terms used herein shall be as per the applicable Accounting Standards.

Note: This part of Schedule sets out the minimum requirements for disclosure on the face of the Balance Sheet, and the Statement of Profit and Loss (hereinafter referred to as "Financial Statements" for the purpose of this Schedule) and Notes. Line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant to

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an understanding of the company's financial position or performance or to cater to industry/sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act or under the Accounting Standards.

PART I

Balance Sheet

Name of the Company ……………….

Balance Sheet as at …………………..

(Rupees in…)

Particulars	Note No.	Figures as at the end of current year	Figures as at the end of previous year
1	2	3	4
I. Equity and Liabilities:			
(1) Shareholders' Fund:			
(*a*) Share Capital			
(*b*) Reserves and Surplus			
(*c*) Money received against Share Warrants			
(2) Share application money pending allotment			
(3) Non-current Liabilities:			
(*a*) Long-term borrowings			
(*b*) Deferred tax liabilities (net)			
(*c*) Other Long-term Liabilities			
(*d*) Long-term provisions			
(4) Current Liabilities:			
(*a*) Short-term borrowings			
(*b*) Trade payables			
(*c*) Other current liabilities			
(*d*) Short-term provisions			
Total		**xxxx**	**xxxx**

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Particulars	Note No.	Figures as at the end of current year	Figures as at the end of previous year
1	2	3	4
II. Assets			
(1) Non-current Assets:			
(*a*) Property, Plant and Equipment			
(*b*) Intangible Assets			
(*c*) Capital work-in-progress			
(*d*) Intangible assets under development			
(*e*) Non-current investments			
(*f*) Deferred tax assets (net)			
(*g*) Long-term loans and advances			
(*h*) Other non-current assets			
(2) Current Assets:			
(*a*) Current investments			
(*b*) Inventories			
(*c*) Trade receivables			
(*d*) Cash and cash equivalents			
(*e*) Short-term loans and advances			
(*f*) Other current assets			
Total		**xxxx**	**xxxx**

1.5 General Instructions for Preparation of Balance Sheet

1. Current Assets: An asset shall be classified as current when it satisfies any of the following criteria:

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I. it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;

II. it is held primarily for the purpose of being traded;

III. it is expected to be realized within twelve months after the reporting date; or

IV. it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

Note: All other assets shall be classified as non-current assets.

2. Operating Cycle: An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of twelve months.

3. Current Liabilities: A liability shall be classified as current when it satisfies any of the following criteria:

(*a*) it is expected to be settled in the company's normal operating cycle;

(*b*) it is held primarily for the purpose of being traded;

(*c*) it is due to be settled within twelve months after the reporting date; or

(*d*) the company does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

Note: All other liabilities shall be classified as non-current liability.

4. Trade Receivable: A receivable shall be classified as a "trade receivable" if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.

5. Trade Payables: A payable shall be classified as a ''trade payable" if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.

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6. A company shall disclose the following in the notes to accounts:

A. Share Capital:

For each class of share capital (different classes of preference shares to be treated separately):

(*a*) the number and amount of shares authorized;

(*b*) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;

(*c*) par value per share;

(*d*) a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;

(*e*) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;

(*f*) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;

(*g*) shares in the company held by each shareholder holding more than 5 per cent shares specifying the number of shares held;

(*h*) shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;

(*i*) for the period of five years immediately preceding the date as at which the Balance Sheet is prepared:

- Aggregate number and class of shares allotted as fully paid-up pursuant to contract(s) without payment being received in cash.
- Aggregate number and class of shares allotted as fully paid-up by way of bonus shares.
- Aggregate number and class of shares bought back.

(*j*) terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date;

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(*k*) calls unpaid (showing aggregate value of calls unpaid by directors and officers);

(*l*) forfeited shares (amount originally paid-up).

B. Reserves and Surplus:

(*i*) Reserves and Surplus shall be classified as:

(*a*) Capital Reserves;

(*b*) Capital Redemption Reserve;

(*c*) Securities Premium Reserve;

(*d*) Debenture Redemption Reserve;

(*e*) Revaluation Reserve;

(*f*) Share Options Outstanding Account;

(*g*) Other Reserves-specify the nature and purpose of each reserve and the amount in respect thereof;

(*h*) Surplus *i.e.,* balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves, etc.;

Note:

1. Additions and deductions since last balance sheet to be shown under each of the specified heads;
2. Fund - A reserve specifically represented by earmarked investments shall be termed as a "fund".
3. Presentation of Debit balance Profit and Loss - Debit balance of statement of profit and loss shall be shown as a negative figure under the head "Surplus". Similarly, the balance of "Reserves and Surplus", after adjusting negative balance of surplus, if any, shall be shown under the head "Reserves and Surplus" even if the resulting figure is in the negative.

C. Long-Term Borrowings:

(*i*) Long-term borrowings shall be classified as:

(*a*) Bonds/debentures;

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(*b*) Term loans:
- from banks,
- from other parties.

(*c*) Deferred payment liabilities;

(*d*) Deposits;

(*e*) Loans and advances from related parties;

(*f*) Long term maturities of finance lease obligations;

(*g*) Other loans and advances (specify nature).

(*ii*) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(*iii*) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(*iv*) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/ debentures are redeemable by instalments, the date of maturity for this purpose must be reckoned as the date on which the first instalment becomes due.

(*v*) Particulars of any redeemed bonds/debentures which the company has power to reissue shall be disclosed.

(*vi*) Terms of repayment of term loans and other loans shall be stated.

(*vii*) Period and amount of continuing default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.

D. Other Long-term Liabilities

Other Long-term Liabilities shall be classified as:

(*i*) Trade Payables;

(*ii*) Others.

E. Long-term Provisions

The amounts shall be classified as:

(*i*) Provision for employee benefits;

(*ii*) Others (specify nature).

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F. Short-term Borrowings

(*i*) Short-term borrowings shall be classified as:

(*a*) Loans repayable on demand;

- from banks,
- from other parties.

(*b*) Loans and advances from related parties;

(*c*) Deposits;

(*d*) Other loans and advances (specify nature).

(*ii*) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(*iii*) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(*iv*) Period and amount of default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.

G. Other Current Liabilities

The amounts w.r.t. Other Current Liabilities shall be classified as:

(*a*) Current maturities of long-term debt;

(*b*) Current maturities of finance lease obligations;

(*c*) Interest accrued but not due on borrowings;

(*d*) Interest accrued and due on borrowings;

(*e*) Income received in advance;

(*f*) Unpaid dividends;

(*g*) Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorized capital to cover the share capital amount resulting from allotment of shares out of such share application money.

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Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable, *i.e.,* the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under "other current liabilities";

(*h*) Unpaid matured deposits and interest accrued thereon;

(*i*) Unpaid matured debentures and interest accrued thereon;

(*j*) Other payables (specify nature).

H. Short-term Provisions

The amounts shall be classified as:

(*a*) Provision for employee benefits.

(*b*) Others (specify nature).

I. Property, Plant and Equipment

(*i*) Classification shall be given as:

- (*a*) Land;
- (*b*) Buildings;
- (*c*) Plant and Equipment;
- (*d*) Furniture and Fixtures;
- (*e*) Vehicles;
- (*f*) Office equipment;
- (*g*) Others (specify nature).

(*ii*) Assets under lease shall be separately specified under each class of asset.

(*iii*) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

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(*iv*) Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

J. Intangible Assets

(*i*) Classification of Intangible Assets shall be given as:

(*a*) Goodwill;

(*b*) Brands/trademarks;

(*c*) Computer software;

(*d*) Mastheads and publishing titles;

(*e*) Mining rights;

(*f*) Copyrights, and patents and other intellectual property rights, services and operating rights;

(*g*) Recipes, formulae, models, designs and prototypes;

(*h*) Licenses and franchise:

(*i*) Others (specify nature).

(*ii*) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses/reversals shall be disclosed separately.

(*iii*) Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

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K. Non-current Investments

(*i*) Non-current investments shall be classified as trade investments and other investments and further classified as:

(*a*) Investment property;

(*b*) Investments in Equity Instruments;

(*c*) Investments in preference shares;

(*d*) Investments in Government or trust securities;

(*e*) Investments in debentures or bonds;

(*f*) Investments in Mutual Funds;

(*g*) Investments in partnership firms;

(*h*) Other non-current investments (specify nature).

Note: Under each classification, details shall be given of names of the bodies corporate indicating separately whether such bodies are (*i*) subsidiaries, (*ii*) associates, (*iii*) joint ventures, or (*iv*) controlled special purpose entities in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(*ii*) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof;

(*iii*) The following shall also be disclosed:

(*a*) Aggregate amount of quoted investments and market value thereof;

(*b*) Aggregate amount of unquoted investments;

(*c*) Aggregate provision for diminution in value of investments.

L. Long-term loans and advances

(*i*) Long-term loans and advances shall be classified as:

(*a*) Capital Advances;

(*b*) Security Deposits;

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(*c*) Loans and advances to related parties (giving details thereof);

(*d*) Other loans and advances (specify nature).

(*ii*) The above shall also be separately sub-classified as:

(*a*) Secured, considered good;

(*b*) Unsecured, considered good;

(*c*) Doubtful.

(*iii*) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(*iv*) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

M. Other non-current assets

Other non-current assets shall be classified as:

(*i*) Long-term Trade Receivables (including trade receivables on deferred credit terms);

(*ii*) Others (specify nature);

(*iii*) Long term Trade Receivables, shall be sub-classified as:

(1) (*a*) Secured, considered good;

(*b*) Unsecured, considered good;

(*c*) Doubtful.

(2) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(3) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

N. Current Investments

(*i*) Current investments shall be classified as:

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(*a*) Investments in Equity Instruments;

(*b*) Investment in Preference Shares;

(*c*) Investments in Government or trust securities;

(*d*) Investments in debentures or bonds;

(*e*) Investments in Mutual Funds;

(*f*) Investments in partnership firms;

(*g*) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate [indicating separately whether such bodies are: (*i*) subsidiaries, (*ii*) associates, (*iii*) joint ventures, or (*iv*) controlled special purpose entities] in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(*ii*) The following shall also be disclosed:

(*a*) The basis of valuation of individual investments;

(*b*) Aggregate amount of quoted investments and market value thereof;

(*c*) Aggregate amount of unquoted investments;

(*d*) Aggregate provision made for diminution in value of investments.

O. Inventories

(*i*) Inventories shall be classified as:

(*a*) Raw materials;

(*b*) Work-in-progress;

(*c*) Finished goods;

(*d*) Stock-in-trade (in respect of goods acquired for trading);

(*e*) Stores and spares;

(*f*) Loose tools;

(*g*) Others (specify nature).

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(*ii*) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

(*iii*) Mode of valuation shall be stated.

P. Trade Receivables

(*i*) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the date they are due for payment should be separately stated.

(*ii*) Trade receivables shall be sub-classified as:

(*a*) Secured, considered good;

(*b*) Unsecured, considered good;

(*c*) Doubtful.

(*iii*) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(*iv*) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Q. Cash and cash equivalents

(*i*) Cash and cash equivalents shall be classified as:

(*a*) Balances with banks;

(*b*) Cheques, drafts on hand;

(*c*) Cash on hand;

(*d*) Others (specify nature).

(*ii*) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(*iii*) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(*iv*) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(*v*) Bank deposits with more than twelve months maturity shall be disclosed separately.

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R. Short-term loans and advances

(*i*) Short-term loans and advances shall be classified as:

(*a*) Loans and advances to related parties (giving details thereof);

(*b*) Others (specify nature).

(*ii*) The above shall also be sub-classified as:

(*a*) Secured, considered good;

(*b*) Unsecured, considered good;

(*c*) Doubtful.

(*iii*) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(*iv*) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

S. Other current assets (specify nature)

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

T. Contingent liabilities and commitments

(to the extent not provided for)

(*i*) Contingent liabilities shall be classified as:

(*a*) Claims against the company not acknowledged as debt;

(*b*) Guarantees;

(*c*) Other money for which the company is contingently liable.

(*ii*) Commitments shall be classified as:

(*a*) Estimated amount of contracts remaining to be executed on capital account and not provided for;

(*b*) Uncalled liability on shares and other investments partly paid;

(*c*) Other commitments (specify nature).

U. Disclosure of Dividend

The amount of dividends proposed to be distributed to equity and

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preference shareholders for the period and the related amount per share shall be disclosed separately. Arrears of fixed cumulative dividends on preference shares shall also be disclosed separately.

V. Where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the balance sheet date, there shall be indicated by way of note how such unutilized amounts have been used or invested.

W. If, in the opinion of the Board, any of the assets other than fixed assets and non-current investments do not have a value on realization in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion, shall be stated.

PART II

Statement of Profit and Loss

Name of the Company.........................

Profit and loss statement for the year ended ....

(Rupees in.....)

	Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
	1	2	3	4
I	Revenue from operations			
II	Other income			
III	Total Revenue (I + II)			
IV	**Expenses:** Cost of materials consumed Purchases of Stock-in-Trade Changes in inventories of finished goods work-in-progress and Stock-in-Trade			

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	Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
	1	2	3	4
	Employee benefits expense Finance costs Depreciation and amortization expense Other expenses Total expenses			
V	Profit before exceptional and extraordinary items and tax (III-IV)			
VI	Exceptional items			
VII	Profit before extraordinary items and tax (V-VI)			
VIII	Extraordinary items			
IX	Profit before tax (VII-VIII)			
X	Tax expense: (1) Current Tax (2) Deferred tax			
XI	Profit (Loss) for the period from continuing operations (VII-VIII)			
XII	Profit/(loss) from discontinuing operations			
XIII	Tax expense of discontinuing operations			

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	Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
	1	2	3	4
XIV	Profit/(loss) from Discontinuing operations (after tax) (XII-XIII)			
XV	Profit (Loss) for the period (XI + XIV)			
XVI	Earnings per equity share: (1) Basic (2) Diluted			

1.6 General Instructions for Preparation of Statement of Profit and Loss

1. The provisions of this Part shall apply to the income and expenditure account in the same manner as they apply to a statement of profit and loss.
2. Calculation of Revenue from Operations

(A) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from—

Calculation of Revenue from Operations	
(*a*) Sale of products; (*b*) Sale of services; (*c*) Other operating revenues; Less: (*d*) Excise duty.	xxxx xxxx xxxx xxxx
Revenue from Operations	xxxx

(B) In respect of a finance company, revenue from operations shall include revenue from—

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(*a*) Interest; and

(*b*) Other financial services.

Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable.

3. Finance Costs: Finance costs shall be classified as:

(*a*) Interest expense;

(*b*) Other borrowing costs;

(*c*) Applicable net gain/loss on foreign currency transactions and translation.

4. Other Income: Other income shall be classified as:

(*a*) Interest Income (in case of a company other than a finance company);

(*b*) Dividend Income;

(*c*) Net gain/loss on sale of investments;

(*d*) Other non-operating income (net of expenses directly attributable to such income).

5. Additional Information: A Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:

(*i*) (*a*) **Employee Benefits Expense** showing separately, the following items —

- salaries and wages,
- contribution to provident and other funds,
- expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP),
- staff welfare expenses.

(*b*) Depreciation and amortization expense;

(*c*) Any item of income or expenditure which exceeds 1% of the revenue from operations or 1,00,000, whichever is higher;

(*d*) Interest Income;

(*e*) Interest expense;

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(*f*) Dividend income;

(*g*) Net gain/loss on sale of investments;

(*h*) Adjustments to the carrying amount of investments;

(*i*) Net gain or loss on foreign currency transaction & translation (other than considered as finance cost);

(*j*) Payments to the auditor as-

(*a*) auditor; (*b*) for taxation matters; (*c*) for company law matters; (*d*) for management services; (*e*) for other services; and (*f*) for reimbursement of expenses;

(*k*) In case of Companies covered under section 135, amount of expenditure incurred on corporate social responsibility activities;

(*l*) Details of items of exceptional and extraordinary nature;

(*m*) Prior period items;

(*ii*) (*a*) In the case of manufacturing companies:

(1) Raw materials under broad heads.

(2) goods purchased under broad heads.

(*b*) In the case of trading companies, purchases in respect of goods traded in by the company under broad heads.

(*c*) In the case of companies rendering or supplying services, gross income derived from services rendered or supplied under broad heads.

(*d*) In the case of a company, which falls under more than one of the categories mentioned in (*a*), (*b*) and (*c*) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered is shown under broad heads.

(*e*) In the case of other companies, gross income derived under broad heads.

(*iii*) In the case of all concerns having works in progress, works-in-progress under broad heads.

(*vi*) (*a*) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve, but not including provisions made to meet any specific liability, contingency or commitment

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known to exist at the date as to which the balance sheet is made up.

(*b*) The aggregate, if material, of any amounts withdrawn from such reserves.

(*v*) (*a*) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments.

(*b*) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.

(*vi*) Expenditure incurred on each of the following items, separately for each item:

(*a*) Consumption of stores and spare parts;

(*b*) Power and fuel;

(*c*) Rent;

(*d*) Repairs to buildings;

(*e*) Repairs to machinery; Insurance;

(*f*) Rates and taxes, excluding, taxes on income;

(*g*) Miscellaneous expenses.

(*vii*) (*a*) Dividends from subsidiary companies.

(*b*) Provisions for losses of subsidiary companies.

(*viii*) The profit and loss account shall also contain by way of a note the following information, namely:

(*a*) Value of imports calculated on C.I.F basis by the company during the financial year in respect of—

I. Raw materials;

II. Components and spare parts;

III. Capital goods.

(*b*) Expenditure in foreign currency during the financial year on account of royalty, know how, professional and consultation fees, interest, and other matters;

(*c*) Total value if all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and

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components similarly consumed and the percentage of each to the total consumption;

(*d*) The amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related;

(*e*) Earnings in foreign exchange classified under the following heads, namely:

Export of goods calculated on F.O.B. basis;

I. Royalty, know-how, professional and consultation fees;

II. Interest and dividend;

III. Other income, indicating the nature thereof.

Note: Broad heads shall be decided taking into account the concept of materiality and presentation of true and fair view of financial statements.

1.7 Divisible Profits

Profits available to shareholders for dividends are called divisible profits. In normal course, profits are distributed as dividend only when they remain after meeting all expenses, losses, depreciation on fixed assets, taxation, past losses, and transferring a reasonable sum to reserves. The profits available for dividend should not include profits arising out of revaluation of fixed assets and other capital profits. No dividend can be paid or declared out of capital.

1.8 Dividend and its Accounting Treatment

Dividend means the profit of a company, which is not retained in the business and is distributed among shareholders in proportion to their shareholding. As per section 2(*35*) of Companies Act, 2013 the term "dividend" includes any interim dividend.

Dividend is a share of the profits of a company, the profit being divided among the shareholders.

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The legal provisions relating to payment of dividends are:

(*i*) Dividend is calculated at the prescribed rate on the paid-up value of a share. Thus, if a company declares a dividend of 5% on 20,000 Equity Shares of Rs. 10 each, Rs. 8 paid up, then the amount of dividend is [(1,60,000 × 5)/100] Rs. 8,000.

(*ii*) No dividend is paid on calls in advance.

(*iii*) The company may, before the declaration of any dividend in any financial year, transfer such percentage of its profits for that financial year as it may consider appropriate to the reserves of the company.

(*iv*) Share issue expenses, discount on issue of shares (in case of issue of sweat equity shares only) or on issue of debentures can be written off through securities premium account. Alternatively, they can be written off through Profit and Loss Account over a certain number of years. The amount so written off in a certain year will be shown in the Statement of Profit and Loss of that year and the unamortised portion of these expenses will be shown in the Balance Sheet under the head "Other non-current assets" if they are to be amortised over more than 12 months. If the unamortised portion is to be written off within a period of 12 months, then disclosure will be made in under the head "Other current assets".

(*v*) As per AS-26 preliminary expenses should be written off in the year in which they have been incurred.

(*vi*) If there are calls in arrears, then dividend is paid on the amount actually paid by shareholders. The company is, however, authorized to make provision in the articles prohibiting payment of dividend on shares having calls in arrears.

(*vii*) Dividends are calculated proportionately after taking into consideration the date of issue of shares. For example, if a company has issued 10,000 shares of 10 each on January 1, 2019, and 20,000 shares of Rs. 5 each on July 1, 2019 and it paid a dividend of 10% p.a. on 31st December 2019, then total dividend will be:

On 10,000 shares for one-year	Rs. 10,000
On 20,000 shares for six months	Rs. 5,000
Total Dividend	Rs. 15,000

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Proposed Dividend:

The dividends recommended by the Board of Directors are known as proposed dividends. As per AS-4 (Revised), Contingencies and events after the Balance Sheet Date, "If an enterprise declares dividends to shareholders after the Balance Sheet date, the enterprise should not recognize those dividends as a liability at the balance sheet date unless a statute requires otherwise." This amendment was made on 30-3-2016 effective from the financial year 2016-17. As per revised AS-4, the company cannot create provision for dividend proposed/declared unless a statute requires otherwise. Rather, the company will need to disclose the same in Notes to Accounts. No journal will be passed for proposed dividend. The **Journal entries for declaration and payment of dividend will be:**

1. Profit and Loss Appropriation or Surplus A/c Dr.
   To Dividend Payable A/c
   To Corporate Dividend Tax Payable A/c
2. Corporate Dividend Tax Payable A/c Dr.
   To Bank A/c
3. Dividend Bank A/c Dr.
   To Bank A/c
4. Dividend Payable A/c Dr.
   To Dividend Bank A/c

Interim Dividend:

Interim dividend is the dividend which is declared between two Annual General Meetings. It does not require approval of the shareholders. According to section 123(3) the Board of Directors of a company may declare interim dividend during any financial year out of—

- the surplus in the profit and loss account, and
- out of profits of the financial year in which such interim dividend is sought to be declared.

Accounting Treatment of Interim Dividend

1. On declaration of interim dividend
   (*a*) Interim Dividend A/c Dr.
   To Interim Dividend Payable A/c
   (*b*) Corporate Dividend Tax A/c Dr.
   To Corporate Dividend Tax Payable A/c

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2. On opening separate dividend bank account
    Dividend Bank A/c Dr.
        To Bank A/c
3. On payment of corporate dividend tax
    Corporate Dividend Tax Payable A/c Dr.
        To Bank A/c
4. On payment of interim dividend
    Interim Dividend Payable A/c Dr.
        To Dividend Bank A/c
5. For transfer of interim dividend and corporate dividend tax
    Profit & Loss A/c or Surplus A/c Dr.
        To Interim Dividend A/c
        To Corporate Dividend Tax A/c

Final Dividend:

Final dividend is proposed by the directors and declared by the shareholders in the Annual General Meeting of the company. Shareholders are empowered to approve or lower the dividend proposed by the directors; but in no case they can increase it.

Preference Dividend:

Preference shareholders are entitled to get dividend at the fixed rate. Preference dividend is paid before payment of the equity dividend. Preference shares may be—

- Cumulative or Non-Cumulative Preference shares
- Participating or Non-Participating Preference shares

Note: All preference shares are assumed to be cumulative and non-participating unless otherwise clearly stated.

Sources out of which Dividend may be paid

As per section 123(1) No dividend shall be declared or paid by a company for any financial year except out of—

I. current year profit [after providing for depreciation]; or
II. profits of the previous year/years [arrived at after providing for depreciation] and remaining undistributed; or

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III. out of money provided by the Central Government or a State Government for the payment of dividend by the company in pursuance of a guarantee given by that Government.

Opening of a Separate Bank Account for Dividend Purpose

The amount of the dividend, including interim dividend, shall be deposited in a scheduled bank in a separate account within 5 days from the date of declaration of such dividend. [Section 123(4)]

Unpaid Dividend Account

Where a dividend has been declared by a company but has not been paid or claimed within 30 days from the date of the declaration to any shareholder entitled to the payment of the dividend, the company shall, within 7 days from the date of expiry of the said period of 30 days, transfer the total amount of dividend which remains unpaid or unclaimed to a special account to be opened by the company in that behalf in any scheduled bank to be called the Unpaid Dividend Account. [Section 124(1)]. Following entry may be passed for this–

Unpaid Dividend Bank A/c Dr.
    To Dividend Bank A/c

Any money transferred to the Unpaid Dividend Account of a company which remains unpaid or unclaimed for a period of 7 years from the date of such transfer shall be transferred by the company along with interest accrued, if any, Investor Education and Protection Fund along with a statement containing such details as may be prescribed. [Section 124(5) & 124(6) of Companies Act, 2013].

***Corporate Dividend Tax* [*Dividend Distribution Tax*]**

A domestic company, in addition to the income tax payable on its total income, shall pay tax on income distributed, declared or paid by way of dividends to its investors/shareholders. Such dividends include Interim Dividends also. The Present rate of CDT is 17.65% with a surcharge of 12% + 3% Education-Cess making an effective rate of 20.36%.

Accounting Treatment of Tax/Provision for Tax

Provision for Tax:

This is the amount that needs to be set aside to pay any income taxes for a certain year. Provision for tax to be created for current year is

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Debited in Statement of Profit and Loss. It is calculated by applying certain percentage (given in the question) on profit before tax. Provision is always made for the coming year so the provision which was made in the previous year will be utilized in the present year. Provision for tax, if given in the trial balance represents provision created for the previous year/years. Following entry is passed to create provision for tax–

Profit and Loss A/c Dr.
To Provision for Tax A/c

Advance Tax:

As the name suggests, Advance tax or self-assessment taxes refers to paying a part of yearly taxes in advance. So advance tax is the tax paid in advance (In between the financial year) in respect of the estimated income for the whole year. It's like paying tax in instalments following entry is passed for its payment—

Advance Tax A/c Dr.
To Bank A/c

Provision for taxation is debited to Profit and Loss Account and it appears on the liability side of the balance sheet under the head 'Provisions'. On completion of the assessment, provision for tax will be compared with actual tax liability. If actual tax liability is more than the provision made in the previous year, the excess has to be shown on the debit side of Profit and Loss Appropriation Account. If the assessed tax is less than the opening provision, such excess provision should be credited to the Profit and Loss Appropriation Account. Let's learn the whole system in following steps—

STEP I:

Entry for making provision for the current year on the basis of current income and prevailing rate of tax—

Profit and Loss A/c Dr.
To Provision for Tax A/c

STEP II:

At the completion of the assessment provision already created is compared with the actual tax liability; here there may be two situations—

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A. Short Provision [Provision < Actual Tax Liability] so it is required to make more provision—

Profit and Loss A/c Dr.
To Provision for Tax A/c

B. Excess Provision [Provision > Actual Tax Liability)

Provision for Tax A/c Dr.
To Profit and Loss A/c

STEP III:

After second step we will get Actual Tax Liability = Total Provision for Tax. Now we should compare Advance Tax paid (along with TDS if any) in the previous year with Actual Tax Liability. There may be three situations—

1. If the self-assessed tax i.e. advance tax and tax as per assessment of income tax department is same. It means –

Provision for Taxation A/c Dr.
To Advance Tax A/c

2. If Company has already paid more tax than required in the form of advance tax; then Refund will be claimed from Tax Authorities. Following entry is passed for settlement—

Provision for Taxation A/c Dr.
Tax Refund Due A/c Dr. [Balancing Figure]
To Advance Tax A/c

On receipt of Tax Refund —
Bank A/c Dr.
To Tax Refund Due A/c

3. Following entry is passed if Actual Liability is more than the amount of Advance Tax paid—

Provision for Taxation A/c Dr.
To Advance Tax A/c
To Tax Payable A/c [Balancing Figure]

On making the Payment - Tax Payable A/c
To Bank A/c
Dr.

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Illustration 1:

The following extract from the Trial Balance of X Ltd. on 31st March 2019

Particulars	Dr.	Cr.
Provision for Taxation (2017-18)		2,00,000
Advance Tax paid for (2017-18)	1,80,000	
Advance Tax paid for (2018-19)	1,00,000	
Tax deducted at Source (2018-19)	10,000	
Surplus A/c (2017-18)		2,00,000

The assessment for the year 2017-18 was finalized during the year 2018-19. The total tax liability for that year was fixed at 2,20,000. The net profit earned by the company during 2018-19 before tax amounts to 4,00,000. The company is in 35% tax bracket (inclusive of any surcharge and cess).

Pass necessary journal entries to show effect of the above.

Solution:

Journal Entries in the Books of X Ltd.

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
2019 March 31	Profit and Loss A/c Dr.	20,000	
	To Provision for Tax A/c		20,000
	(Being additional Rs. 20,000 transferred to provision for tax account)		
March 31	Provision for Taxation A/c Dr.	2,20,000	
	To Advance Tax		1,80,000
	A/c to Bank A/c		40,000
	(Being balance of income-tax for 2017-18 paid)		
March 31	Profit and Loss A/c Dr.	1,40,000	
	To Provision for Tax A/c		1,40,000
	(Being provision for tax created for 2018-19 @ 35% on Rs. 4,00,000)		

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Earnings Per Share Ratio

Earnings Per Share Ratio earning capacity of the concern from the owner's point of view. It is calculated to find out overall profitability of the organization on per equity share basis.

Earnings Per Share may be calculated as

$$= \frac{\text{Earnings Available to Equity Shareholders}}{\text{Number of Equity Shares}}$$

Basic EPS only takes into account the number of shares outstanding at the time. So, if the net profit of a company is Rs. 1,00,000 and the No. of shares outstanding are 2,000 the EPS of the company is Rs. 1,00,000/2,000 = Rs. 50.

1.9 Division II-Ind AS Schedule II

Financial statements for a company whose financial statements are drawn up in compliance of the Companies (Indian Accounting Standards) Rules, 2015. Every company to which Ind AS is applicable shall prepare its financial statements in accordance with Ind AS Schedule III or with such modifications as may be required under certain circumstances. Financial statements includes:

- Balance Sheet,
- Statement of changes in equity for the period,
- Statement of Profit and Loss for the period, and
- Notes.

Cash Flow Statement shall be prepared in accordance with the requirements of the relevant Ind AS.

Where compliance with the requirements of the Act including Indian Accounting Standards as applicable to the companies require any change in treatment or disclosure including addition, amendment, substitution or deletion in the head or sub-head or any changes, *inter se,* in the financial statements or statements forming part thereof, the same shall be made and the requirements of this Schedule shall stand modified accordingly. The disclosure requirements specified in this Schedule are

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in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 2013.

Illustration 2:

From the following particulars of EXE Ltd., prepare the balance sheet as at 31st March 2019 as required by Part I of Schedule III of the Companies Act, 2013:

Particulars	Dr. (Rs.)	Cr. (Rs.)
Equity Share Capital (Face value Rs. 100 each)	-	50,00,000
Calls-in-Arrears	5000	-
Land and Building	27,50,000	-
Plant and Machinery	26,25,000	-
Furniture	2,50,000	-
General Reserve	-	10,50,000
Loan from state Financial Corporation	-	7,50,000
Stock:	12,50,000	-
Raw Material 2,50,000		3,40,000
Finished Goods 10,00,000		-
Provision for Taxation	10,00,000	-
Sundry Debtors	2,13,500	5,00,000
Advances	-	-
Profit and Loss Account		
Cash in Hand	1,50,000	-
Cash in Bank	12,35,000	-
Total	**95,45,000**	**95,45,000**

The following additional information is provided:

(*i*) Preliminary expenses included Rs. 25,000 Audit Fees and Rs. 3,500 for out of pocket expenses.

(*ii*) 10,000 equity shares were issued for consideration other than cash.

(*iii*) Debtors of Rs. 2,60,000 are due for more than 6 months.

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(*iv*) The cost of the assets were:

Building Rs. 30,00,000;

Plant and Machinery Rs. 35,00,000 and Furniture Rs. 3,12,500

(*v*) The balance of Rs. 7,50,000 in the loan account with State Financial Corporation is inclusive of Rs. 37,500 for Interest Accrued but not due. The loan is secured by hypothecation of Plant and Land Machinery.

(*vi*) Balance at Bank includes Rs. 10,000 with Idea Bank Ltd. which is not a Scheduled Bank.

Solution:

EXE Ltd.

Balance Sheet as at 31-03-2019

Particulars	Note No.	Amount Rs.
1	**2**	**3**
III. Equity and Liabilities		
(1) Shareholders' Funds		
(*a*) Share Capital	1	49,95,000
(*b*) Reserves and Surplus	2	14,83,500
(2) Share application money pending Allotment		
(3) Non-current Liabilities		
Long-term borrowings	3	16,17,500
(4) Current Liabilities		
(*a*) Trade Payables		10,00,000
(*b*) Other Current Liabilities	4	37,500
(*c*) Short-term Provisions	5	3,40,000
TOTAL		94,73,500
IV. Assets		
(1) Non-current Assets		
(*a*) Property, Plant & Equipment	6	56,25,000

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Particulars	Note No.	Amount Rs.
1	2	3
(2) Current Assets		
(*a*) Inventories	7	12,50,000
(*b*) Trade Receivables	8	10,00,000
(*c*) Cash and Cash Equivalents	9	13,85,000
(*d*) Short-term Loans and Advances		2,13,500
TOTAL		94,73,500

Notes to Accounts: (Balance Sheet)

Particulars	Rs.	Rs.
1. Share Capital		
Equity Share Capital		
Issued Subscribed and called up 50,000 Equity Shares of Rs. 100 each (of the above 10,000 shares have been issued for consideration other than cash)	50,00,000	
Less: Calls in Arrears	(5,000)	49,95,000
2. Reserves and Surplus		
General Reserve		10,50,000
Surplus (Profit and Loss Account)	5,00,000	
Less: Preliminary Expenses	(66,500)	4,33,500
		14,83,500
3. Long-term Borrowings		
Secured Loan Rs. (7,50,000 – 37,500)		7,12,500
(Secured by hypothecation of Plant and Machinery)		
Unsecured Loan		9,05,000
		16,17,500
4. Other Current Liabilities		
Interest Accrued but not due on loans (SFC)		37,500
5. Short-term Provisions		
Provision for Taxation		3,40,000
6. Tangible Assets		
Land & Building	30,00,000	

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Particulars	Rs.	Rs.
Less: Depreciation	(2,50,000)	27,50,000
Plant and Machinery	35,00,000	
Less: Depreciation	(8,75,000)	26,25,000
Furniture and Fittings	3,12,500	
Less: Depreciation	(62,500)	2,50,000
		56,25,000
7. Inventories		
Raw Materials	2,50,000	
Finished Goods	10,00,000	12,50,000
8. Trade Receivables		
Outstanding for a period exceeding 6 months	2,60,000	
Other Amounts	7,40,000	10,00,000
9. Cash and Cash Equivalents		
Cash with Bank:		
With Scheduled Banks	12,25,000	
With other Banks (Idea Bank Ltd.)	10,000	
Cash in Hand	1,50,000	13,85,000

Note: As per Para 56 of A-26, Preliminary Expenses are not shown in the Balance Sheet, thus, they are written off. The amount of Rs. 25,000 as Audit fee and out of pocket expenses paid to auditors amounting to Rs. 3,500 have been included in the amount of Rs. 66,500. The combined figure of Rs. 66,500 has been deducted from surplus in the given solution.

Illustration 3:

The following balances appeared in the books of Mera Bharat Mahan Ltd. as on 31st March, 2019:

Debit Balances	Rs.	Credit Balances	Rs.
Building at Cost	1,50,000	Equity Share Capital (fully paid shares of Rs. 10 each)	6,00,000
Purchases	5,00,900		
Manufacturing Expenses	3,59,000	General Reserve	2,50,000
(Salaries and Wages)		Unclaimed Dividend	6,520
Establishment Charges	26,810	Trade Creditors	36,880

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Debit Balances	Rs.	Credit Balances	Rs.
General Charges	31,090	Sales	10,83,940
Machinery at Cost	2,00,000	Provision for Depreciation	71,000
Motor Vehicles at Cost	30,000	Interest on Investment	8,540
Furniture at Cost	5,000	Surplus A/c (1-4-2018)	16,840
Opening Stock	1,72,050	Staff Provident Fund	37,500
Book Debts	2,23,380		
Investments	2,88,950		
Advance Payment of Tax	50,000		
Cash Balances	72,240		
Directors' Fees	1,800		
	21,11,220		21,11,220

From these balances and the following information, prepare the company's Balance Sheet as on 31st March, 2019 and its Statement of Profit and Loss for the year ended on that date:

(*a*) Stock on 31st March, 2019 was valued at Rs. 1,48,680

(*b*) Provide Rs. 10,000 for Depreciation on Fixed Assets, Rs. 1,800 for Managing Directors' remuneration and Rs. 6,200 for the company's contribution to Staff Provident Fund.

(*c*) Interest accrued on Investment amounted to Rs. 2,750.

(*d*) A provision of Rs. 50,000 for taxes in respect of profit for 2018-19 considered necessary.

(*e*) The Board of Directors propose a final dividend @ 8%. Ignore Corporate Dividend Tax.

(*f*) A claim of Rs. 2,500 for workmen's compensation is being disputed by the company.

(*g*) Authorized Capital is 80,000 equity shares of 10 each. The company had issued 60,000 shares of Rs. 10 each. Also prepare notes to the financial statement.

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Notes

Solution:

In the Books of Mera Bharat Mahan Ltd.

Balance Sheet as on 31-3-2019

Particulars	Note No.	Amount (Rs.)
Equity and Liabilities		
1. Shareholders' Fund:		
(*a*) Share Capital	1	6,00,000
(*b*) Reserves and Surplus	2	3,51,100
2. Share application money pending allotment		
3. Non-current Liabilities		
Long-term Provisions	3	43,700
4. Current Liabilities		
(*a*) Trade Payables (Trade Creditors)		36,880
(*b*) Other Current Liabilities	4	8,320
(*c*) Short-term Provisions	5	50,000
Total		**10,90,000**
Assets		
1. Non-current Assets		
(*a*) Property, Plant & Equipment	6	3,04,000
(*b*) Long-term Investment		2,88,950
2. Current Assets		
(*a*) Inventories (Stock-in-trade on 31-3-2019)		1,48,680
(*b*) Trade Receivables (Book Debts)		2,23,380
(*c*) Cash and Cash Equivalents	7	72,240
(*d*) Short-term Loans and Advances	8	50,000
(*e*) Other Current Assets	9	2,750
Total		**10,90,000**

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In the Book of Mera Bharat Mahan Ltd.

Statement of Profit and Loss for the year ended 31-3-2019

Particulars	Note No.	Rs.
Revenue from Operations	10	10,83,940
Other income	11	11,290
Total Revenue (I+ II)		10,95,230
Expenses:		
Purchase		5,00,900
Change in Inventory	12	23,370
Employee Benefit Expenses	13	3,65,200
Depreciation and Amortization expenses	14	10,000
Other Expenses	15	61,500
Total Expenses		9,60,970
Profit before tax		1,34,260
Tax Expenses: [Current Tax]		50,000
Profit after tax		84,260
Earnings Per Share [Nominal Value UO]		
Basic and Diluted [84,260/60,000]		1.40

Notes to Accounts: [Balance Sheet]

Particulars	Rs.	Rs.
1. Share Capital		
Authorized (80,000 Equity Shares of Rs. 10 each)		8,00,000
Issued Subscribed and Fully Paid-up		
(60,000 Equity Shares of Rs. 10 each)		6,00,000
2. Reserves and Surplus		
General Reserve – Opening Balance		2,50,000
Surplus – Opening Balance	16,840	
Add: Net Profit for the Year	84,260	1,01,100
		3,51,100
3. Long-term Provisions		
Provision for Employee Benefits (Staff Provident Fund)		
Opening Balance	37,500	
Additions during the year	6,200	43,700

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Particulars	Rs.	Rs.
4. Other Current Liabilities		
Unclaimed Dividend	6,520	
Managing Directors' Remuneration	1,800	8,320
5. Short-term Provisions		
Provision for Tax		50,000
6. Intangible Assets		
Buildings	1,50,000	
Machinery	2,00,000	
Motor Vehicles	30,000	
Furniture	5,000	
	3,85,000	
Less: Accumulated Depreciation	81,000	3,04,000
7. Cash and Cash Equivalents		
Cash-in-hand		72,240
8. Short-term Loans and Advances		
Advance Payment of Tax		50,000
9. Other Current Assets		
Interest Accrued on Long-term Investments		2,750
9A. Proposed Dividend		
Proposed Dividend @ 8% in Equity Shares		48,000

Notes to Accounts: [Statement of Profit and Loss]

Particulars	Rs.	Rs.
10. Reserves and Surplus		
Sales		10,83,940
11. Other Income		
Interest on Investments	8,540	
Add: Accrued Interest on Investments	2,750	11,290
12. Change in Inventory (Decrease in Stock)		
Opening Stock	1,72,050	
Less: Closing Stock	(1,46,680)	23,370
13. Employee Benefit Expenses		
Manufacturing Expenses (Salaries and Wages)	3,59,000	
Contribution to Staff Provident Fund	6,200	3,65,200

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Particulars	Rs.	Rs.
14. Depreciation and Amortization Expenses		
Depreciation on Fixed Assets		10,000
15. Other Expenses		
Establishment Charges	26,810	
General Charges	31,000	
Directors' Fees	1,800	
Managing Directors' Commission (Outstanding)	1,800	61,500
16. Contingent Liabilities and Commitments		
Contingent Liabilities: Claim against the company for workmen's compensation not acknowledged as debt.		2,500

1.10 Summary

A financial statement has two parts- Balance Sheet and Income statement. The balance sheet is a statement of assets, liabilities and net worth at given point of time. In a balance we always get Assets = Liabilities + Net Worth. The income statement, also known as the Profit and Loss Account or Statement of Profit and Loss, includes all incomes and expense accounts over a period of time. As per section 129(1) of 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 accounting standards notified and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III.

As per section 134(7) of Companies Act, 2013 a signed copy of every financial statement, including consolidated financial statement, if any, shall be issued, circulated or published along with a copy each of- any notes annexed to or forming part of such financial statement; the auditor's report; and the Board's report.

Schedule III prescribes only the vertical format for presentation of financial statements. Thus, a company will now not have an option to use horizontal format for the presentation of financial statements as prescribed in the New Schedule. Along with statement of profit and loss and balance sheet; notes to account is also prepared under this

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Notes

schedule. Notes to accounts shall contain information in addition to that presented in the Financial Statements and shall provide where required (*a*) narrative descriptions or disaggregation of items recognized in those statements; and (*b*) information about items that do not qualify for recognition in those statements.

As per prescribed format all items of assets and liabilities are to be bifurcated between current and non-current portions and they must be presented separately on the face of the Balance Sheet. For example, Land and Building is Non-Current Asset whereas Inventories is Current Asset. Care must be taken w.r.t. current maturities of a long-term borrowing; they will have to be classified under the head "Other current liabilities".

Dividend means the profit of a company, which is not retained in the business and is distributed among shareholders in proportion to their shareholding. Every company has the inherent power to distribute its profit among its shareholders in the form of dividend. However, the manner in which the dividends are to be paid may be regulated by Articles. As per section 2(*35*) of Companies Act, 2013 the term "dividend" includes any interim dividend.

1.11 Questions for Practice

Exercise 1: Very Short Answer Type Questions:

(*a*) Define financial year.

(*b*) What do you mean by books and accounts?

(*c*) Explain the term trade receivable and trade payable.

(*d*) What do you mean by notes to accounts?

(*e*) What is operating cycle?

(*f*) What are the components of shareholders fund?

Exercise 2: Descriptive Questions:

1. What do you mean by Financial Statement of a Company?
2. Explain Corporate Dividend Tax and its accounting treatment.
3. Differentiate between Interim Dividend and final Dividend?
4. Write short notes on the following —

    (*a*) Provision for Taxation

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(*b*) Contingent Liabilities

(*c*) Provision and Reserves

Exercise 3: Fill in the blanks:

(*a*) A financial statement has two parts - Balance sheet & ________.

(*b*) A receivable shall be classified as a "________" if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.

(*c*) A payable shall be classified as a "________" if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.

(*d*) A reserve specifically represented by earmarked investments shall be termed as a "________".

Ans.: (*a*) Income Statement (*b*) Trade Receivable (*c*) Trade Payable (*d*) Fund.

Exercise 4: True and False State True or False:

(*a*) Wages paid to workers is shown in the statement of profit and loss under - other expenses.

(*b*) Debentures are shown in the Balance Sheet under the head of - current liability.

(*c*) Profit on sale of fixed asset by a financial company is shown in statement of profit and loss as - other income.

(*d*) Share application money pending allotment is shown as current liability.

Ans.: (*a*) False (*b*) False (*c*) True (*d*) False

Exercise 5: Practical Questions

1. The following is the trial balance of PK Ltd. as at 31st March, 2019:

Debit Balances	Rs.	Credit Balances	Rs.
Opening Stock	1,50,000	Share Capital [@ Rs. 10]	5,00,000
Purchases	3,80,000	Purchase Return	10,000
Wages	60,000	Sales	11,50,000
Carriage	2,000	Discount	6,300

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Debit Balances	Rs.	Credit Balances	Rs.
Furniture	25,000	Profit and Loss Account	1,70,000
Salary	12,000	Sundry Creditors	33,700
Rent	15,000	General Reserves	82,000
Trade Expenses	11,000	Bills Payables	13,000
Sundry Debtors	54,000	Provisions for Doubtful Debts	3,000
Plant And Machinery	12,00,000		
Cash			
At Bank	21,500		
Patents	9,000		
Bills Receivables	14,000		
Bad Debts	6,500		
Discount Allowed	8,000		
	19,68,000		19,68,000

Additional Information—

1. Stock on 31st March, 2019 Rs. 2,00,000.
2. Depreciate Plant and Machinery at 12%, Furniture at 10% and Patents @ 20%.
3. Further Bad Debts amounted to Rs. 4,000.
4. Provide 5% on Debtors for bad debts.
5. Provide for Income Tax @ 35% and for Corporate Dividend Tax 17.65%.
6. The Board of Directors recommended a dividend of 25%.
7. Transfer 10% of profit to General Reserve.

Prepare Statement of Profit and Loss for the year ended 31st March, 2019 and Balance Sheet as on that date.

Ans.: Profit after tax Rs. 3,70,500 Balance Sheet Total – Rs.13,68,700.

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UNIT - III

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L E S S O N

1

Valuation of Internal Assets and Share

Revised By:
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INTRODUCTION

1.1 *Learning Objectives*
1.2 *Concept of Goodwill*
1.3 *Accounting Standards and Goodwill*
1.4 *Need for Valuation of Goodwill*
1.5 *Factors Affecting the Valuation of Goodwill*
1.6 *Classification of Goodwill*
1.7 *Methods of Valuation of Goodwill*
1.8 *Summary of the Chapter*
1.9 *Questions for Practice*

1.1 Learning Objectives

This Chapter will assist you to:

- Know the meaning and concept of goodwill.
- Learn factors affecting the valuation of goodwill.
- Know different methods of valuation of goodwill and its calculation.

1.2 Concept of Goodwill

Goodwill is an intangible asset. It is very easy to understand the term "Goodwill", but very difficult to define it. Goodwill is the present value of the firm's anticipated

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excess earnings. The Institute of Chartered Accountants of India defines goodwill as 'an intangible asset arising from business connections or trade name or reputation of an enterprise'.

Goodwill is related to the earning capacity of a business. If a business is able to return a higher income on its investment than it is normally earned in similar businesses, the firm may be assumed to possess goodwill, the reason for such higher profit may be due to technical knowledge and experience, near monopoly position etc. Thus goodwill may be described as the extra saleable value attaching to a prosperous business beyond the intrinsic worth of the net assets.

Definition

Walton defines goodwill as "The element of an established business which makes the business as a going concern worth more than its book value, that is, its net worth as shown by the books".

"Goodwill is an intangible asset compounded from a variety of successful business ingredients – competent and energetic management, customer acceptance, a favourable location, a quality and profitable product, efficient production methods, an outstanding reputation, plus the expectation that these ingredients will continue to produce an above – normal rate of return for an indefinite period of time." - **Braden and Allyn**

"The present value of a firm's anticipated excess earnings".: **Dr. Canning**

Characteristics of Goodwill:

(*a*) Goodwill has the ability to generate additional income for the business.

(*b*) Goodwill is an intangible fixed asset and not a fictitious asset.

(*c*) Valuation and existence of goodwill depends upon the subjective judgment of the valuer.

(*d*) Presence of goodwill helps in earning excess profits *i.e.* super profits.

(*e*) Goodwill is generally inseparable from a business and can fetch a price only if a business is sold on a going concern basis.

(*f*) Goodwill generally does not appear in the accounts of a company except where the company has actually paid for it when purchasing a business.

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(*g*) Goodwill comes into existence and depends upon several factors and forces such as favourable location, market standing etc.

(*h*) Presence and value of goodwill distinguishes an old and well established business from the new business.

1.3 Accounting Standards and Goodwill

1. Accounting Standard 10 issued by the Institute of Chartered Accountants of India on 'Accounting for fixed Assets' has prescribed that goodwill for which no money is paid, should not be recorded. The standard has not prescribed any procedure for valuation of goodwill. It has stated that goodwill should be recorded in the books of account only when some consideration in money or money's worth has been paid for it. When a business is acquired for a price which is in excess of the value of net asset of the business taken over, the excess should be termed as "goodwill".
2. As per Para 35 of AS-26 *"Internally generated goodwill should not be recognised as an asset"*. Para 36 explains the reason for not recognising it as an asset – *"Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost"*.

1.4 Need for Valuation of Goodwill

In case of partnership firms, the necessity of valuing goodwill arises in connection with the following:–

1. When there is change in profit sharing ratio among the partners;
2. When a new partner is admitted;
3. When a partner retires or dies;
4. When a firm sells its business to a company or converts itself into a company;
5. When a firm is amalgamated with another firm.

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In case of a Joint Stock Company, the need for valuation of goodwill may arise when –

(*a*) The business of the company is to be sold to another company, or when the company is to be amalgamated with another company;

(*b*) Stock exchange quotations are not being available, shares have to be valued for taxation purpose, estate duty, gift tax etc.;

(*c*) Such a large block of shares as to enable the holder to exercise control over the company concerned has to bought or sold.

1.5 Factors Affecting the Valuation of Goodwill

Several factors contribute to create the goodwill like competent management, qualified, committed and skilled work force, favourable location, quality product, good relations with customers and employees and managerial efficiency etc. It takes time for a firm to become well established and earn a name for it. Like other assets, goodwill also facilitates to earn income; hence it is regarded as an asset. Goodwill is influenced by many factors. These are mentioned below:

1. **Profitability:** Profitability of a concern is the chief factor in valuation of goodwill. The profits that are expected to be earned in future are important for valuation of goodwill. The following are the important factors that have a bearing on future profits and, therefore, the value of goodwill:

   (*i*) Personal skill in management;

   (*ii*) Nature of business;

   (*iii*) Favourable location;

   (*iv*) Access to supplies;

   (*v*) Patent and trade mark protection;

   (*vi*) Exceptionally favourable contracts; and

   (*vii*) Capital requirements and arrangement of capital.

2. General reputation which the firm or the company and its management is enjoying.

3. Yield expected by investors in industry to which the firm or company belongs.

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4. Profits expected to be earned by the firm and the amount of capital employed to earn such profits.
5. Acceptance of the firm's product or service by the customers.
6. Price and quality of the product or service along with after sale service provided by the firm.

1.6 Classification of Goodwill

From accounting point of view goodwill of a business may be divided into two categories *i.e.*:

1. Purchased Goodwill.
2. Non-Purchased Goodwill or Raised Goodwill or Self-generated Goodwill.

Purchased Goodwill

This type of goodwill arises only when a business is acquired by another business as a going concern and the price paid (either in cash, shares or otherwise) is more than the net asset acquired, such goodwill is recognised and is shown in the balance sheet as an asset.

Non-Purchased/Self-generated

This goodwill arises only when a business generates its own goodwill (image/reputation) over a period of time. So this goodwill is internally generated and depends upon the subjective judgment of the valuer. It is not shown in the balance sheet as no price is paid for it. As per AS-26, internally generated goodwill is not recognised as an asset, *i.e.*, is not to be recorded in the books.

1.7 Methods of Valuation of Goodwill

There are various methods of valuation of goodwill. These are:

1. Average Profit Method:
   - (*a*) Simple Average Profit Method.
   - (*b*) Weighted Average Profit Method.
2. Super Profit Method:
   - (*a*) Purchase of Super Profit Method.

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(*b*) Annuity Method.

(*c*) Capitalisation of Average Profit Method.

Goodwill is generally valued on the basis of certain number of years' purchase of profits of past few years. After adjustment of the profits, the problem that arises is "how many years purchase price" should be taken into account to calculate the value of goodwill. There is no hard and fast rule for this. This depends upon the agreement between the seller and the buyer. Generally, in most cases 2 or 3 years' purchase price is considered.

Note : Number of years' purchase is the number of year in which value of goodwill is to be recovered.

Average Profit Method:

This method is also known as simple profit method. Under this method the average profits of the business is calculated on the basis of last two or 3 years of adjusted profit. This method is based on the basic assumption that a new business can't earn profit during the first year of its start.

Simple Average Profit Method:

Under this method, first the average profit is calculated. The average profit is multiplied by the numbers of years of purchase. The amount so calculated will be the value of goodwill.

Goodwill = Average Adjusted Profit × No. of year's purchase.

Illustration 1:

A purchased B's business with effect from 1st January 2015. It was agreed between the parties that the firm's goodwill is to be valued at two year's purchase of normal average profit of the last two years. The profits of B's business for the last three years were –

2012 - Rs. 1,60,000 including an abnormal gain of Rs. 20,000.

2013 - Rs. 2,00,000 after charging an abnormal loss of Rs. 40,000.

2014 - Rs. 1,80,000 excluding Rs. 20,000 as insurance premium required for firm's property. (It is now required to be insured).

Calculate value of firm's goodwill.

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Solution:

Calculation of Average Maintainable Profit:

Profit for 2012	Rs. 1,60,000 – Rs. 20,000	=	Rs. 1,40,000
Profit for 2013	Rs. 2,00,000 + Rs. 40,000	=	Rs. 2,40,000
Profit for 2014	Rs. 1,80,000 – Rs. 20,000	=	Rs. 1,60,000
		=	Rs. 5,40,000

Normal Average Profit = $\frac{\text{Rs. } 5,40,000}{3}$ = Rs. 1,80,000

Goodwill = Rs. 1,80,000 × 2 = Rs. 3,60,000

***Weighted Average Profit Method*:**

Weighted average profit method tries to eliminate the inherent limitations of simple average method. In simple average method equal importance is given to profits of all the years which is quite unreasonable.

If there is no stability in the profits of the years selected for calculating average profit, the average profit can be calculated on the basis of Weighted Average Method. Under this method, a specified weight is allotted to the profits of different years which are to be averaged. While assigning weight, the profit that can be earned in future, is given more importance. If the profits of different past years show an increasing trend, the profit of the first year is given the least weight and profit of the last year is given the maximum weight.

The profits of different years are multiplied with the relevant weights and thus the products are calculated. Then the total of the products so calculated is divided by total of weights. The figure thus arrived at is the weighted average profit. The weighted average profit is multiplied by the number of year's purchase, in order to find out the value of goodwill.

$$\text{Weighted Average Profit} = \frac{\text{Sum of Weighted Profits}}{\text{Sum of Weights}}$$

So Goodwill = Weighted average Profit × Number of the Years Purchase.

Illustration 2:

The profits of a firm for the year ended 31st March for the last five years are as follows–

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Notes

Year	2011	2012	2013	2014	2015
Profits (Rs.)	48,000	56,000	62,000	64,000	70,000

Calculate value of goodwill on the basis of three year's purchase of the weighted average profit after assigning weights 1, 2, 3, 4 & 5 respectively to the profits from year 2011 to 2015.

Solution:

Calculation of Weighted Average Profit

Years (31st March) 1	Profits (Rs.) 2	Weights 3	Product (Rs.) 4 = 2 × 3
2011	48,000	1	48,000
2012	56,000	2	1,12,000
2013	62,000	3	1,86,000
2014	64,000	4	2,56,000
2015	70,000	5	3,50,000
Total		15	9,52,000

$$\text{Weighted Average Profit} = \frac{\text{Rs. } 9{,}52{,}000}{15} = \text{Rs. } 63{,}467$$

Goodwill = Rs. 63,467 = Rs. 1,90,401

Illustration 3: (Valuation of Goodwill - Weighted Average Method).

The profits of last five years of a partnership firm were 2010 - Rs. 32,000; 2011- Rs. 21,000; 2012 - Rs. 28,000; 2013 - Rs. 26,000, 2014-Rs. 25,000. The weights assigned to each year are – 2010 - 1, 2011 - 2; 2012 - 3; 2013 – 4 and 2014 - 5.

You are further informed that:

(*i*) On October 1, 2014 a Parking Lot was constructed for Rs. 40,000. The same was charged to revenue. Depreciation @ 10% p.a. was not charged on this asset.

(*ii*) The closing stock for the year 2013 was undervalued by Rs. 3,000.

(*iii*) An annual insurance premium of Rs. 5,000 has not been taken into account during any of the years. The same should be taken into consideration for the purpose of valuation of goodwill.

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(*iv*) You are required to calculate the goodwill of this firm on the basis of three year's purchase of the weighted average profits of the last five year's.

Solution:

Calculation of Goodwill:

Calculation of Adjusted Profits	2010 (Rs.)	2011 (Rs.)	2012 (Rs.)	2013 (Rs.)	2014 (Rs.)
Profit before Adjustments	32,000	21,000	28,000	26,000	25,000
Less: Insurance Premiums	(6,000)	(6,000)	(6,000)	(6,000)	(6,000)
Add: Capital Expenditure, which has been charged to Revenue	26,000	15,000	22,000	20,000	19,000
	--	--	--	--	40,000
	26,000	15,000	22,000	20,000	59,000
Less: Dep. @10% p.a. (3 months)	--	--	--	--	(1,000)
	26,000	15,000	22,000	20,000	58,000
Add: Undervaluation of Closing Stock	--	--	--	3,000	--
Less: Undervaluation of Opening Stock	26,000	15,000	22,000	23,000	58,000
	--	--	--	--	(3,000)
Adjusted Profits	26,000	15,000	22,000	23,000	55,000

Calculation of Weighted Average Profit:

Years	Profits (Rs.) (A)	Weights (Rs.) (B)	Product (A × B)
2010	26,000	1	26,000
2011	15,000	2	30,000
2012	22,000	3	66,000
2013	23,000	4	92,000
2014	55,000	5	2,75,000
	Total	15	4,89,000

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Weighted Average Profit = $\frac{4,89,000}{15}$ = Rs. 32,600

Goodwill = Rs. 32,600 × 3 = Rs. 97,800

Super Profits Methods: An enterprise may possess some advantages or expertise which enables it to earn extra profits over and above the normal profit; known as super profit. In accounting we measure super profit as the excess of the average profits over the normal profits based on normal rate of return for representative firm in industry. The goodwill under this method is ascertained by multiplying the super profits by certain number of year's purchase.

For computation of super profit, the following components are required :

(*i*) ***Normal Rate of Return*:** Normal rate of return is the rate of return/ profit which an investor expects on his investment in a particular type of industry. It is calculated by applying a simple formula *i.e.*

Normal Profit = Capital Employed × Normal Rate of Return.

(*ii*) ***Capital Employed*:** Capital employed may be calculated on the basis of assets side items or liabilities side items of the balance sheet.

Capital Employed = Fixed Assets + Trade Investments + Current Assets – Current Liabilities *i.e.* Total Asset – Current Liabilities.

Or

Capital Employed = Paid up Equity and Preference Share Capital + Accumulated Balance of Capital Reserves, General Reserves and Credit Balance in Profit and Loss ± Revaluation Profits/Loss – Fictitious Assets – Non-Trading Assets.

(*iii*) *Super Profit* = Average Maintainable Profits – Normal Profits.

So Goodwill under Super Profit Method = Super Profit × No. of Years Purchase.

Illustration 4:

Akash and Bhanu earned an average profit of Rs. 80,000. Their capital employed in the firm is Rs. 1,40,000. It is expected that the average rate of profit is 15% on the capital. Calculate amount of Goodwill, if goodwill is valued at 2 year's purchase of Super Profits.

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Solution:

Average Profit = Rs. 80,000

Normal Profit = Capital Employed × Normal Rate of Return

= Rs. 1,40,000 × 15% = Rs. 21,000

Super Profit = Average Maintainable Profits – Normal Profits

= Rs. 80,000 – Rs. 21,000 = Rs. 59,000

Goodwill under Super Profit Method = Super Profit × No. of Years Purchase

= Rs. 59,000 × 2 = Rs. 1,18,000

Annuity Method: Under this method the value of goodwill is calculated by finding the present worth of an annuity paying the super profit (per year) over the estimated period discounted at the appropriate rate of interest. Goodwill under this method is calculated by applying simple formula *i.e.* Goodwill = Super Profits × Value of an Annuity.

Payment for goodwill under super profit method is based on the assumption that the payer will be able to recoup the amount paid for goodwill within the stipulated time of number of years purchase. Number of years purchase refers to the period during which the purchaser is expected to recoup the amount paid for goodwill. In doing so, he has to pay the agreed amount for goodwill on advances and then recoup it in future years. Thus, he has to suffer a loss on account of interest which he could have earned on the amount paid for goodwill if he had invested it elsewhere. Therefore, sometimes goodwill is calculated according to annuity method. This method shows the discounted value of goodwill amount and the payer is saved from loss of interest on that amount. Under this method the value of annuity is calculated taking into account the number of years purchase and the figure so arrived at is multiplied by super profit. The resultant figure is taken to be the value of goodwill. The value of annuity can be extracted from the annuity table. However, if the annuity table is not available it can be calculated with the help of following formula:—

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$$\text{Annuity Value} = 1 - \frac{\left(1+\frac{r}{100}\right)^n}{\frac{r}{100}} \text{ OR } \frac{1-\left(\frac{100}{100+r}\right)^n}{\frac{r}{100}}$$

Where r = Rate of interest expected to be carried on investment.

N = Number of years purchase.

Illustration 5:

From the following information, calculate the value of goodwill of a business based on Annuity Method at three years' purchase assuming the expected rate of interest on investment to 8%—

Average Capital Employed	Rs. 5,00,000
Normal Rate of Return	10%
Actual Profit earned	Rs. 65,000

How would your answer differ if goodwill is calculated on the basis of Super Profit Method?

Solution:

1. Calculation of Normal Profit –

   Normal Profit = Capital Employed × Normal Rate of Return

   = Rs. 5,00,000 × 10% = Rs. 50,000

2. Calculation of Super Profit:

   Super Profit = Average Maintainable Profits – Normal Profits

   = Rs. 65,000 – Rs. 50,000 = Rs. 15,000

3. So Goodwill under Super Profit Method = Super Profit × No. of Years Purchase = Rs. 15,000 × 3 = Rs. 45,000

   $$\text{Annuity Value} = 1 - \frac{(1+\frac{r}{100})^n}{\frac{r}{100}} \text{ OR } 1 - \frac{(\frac{100}{100+r})^n}{\frac{r}{100}}$$

   Where r = Rate of interest expected to be carried on investment = 8%

   N = Number of years purchase = 3

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So Annuity Value =

$$\frac{1-\left(\frac{100}{100+8}\right)^{8}}{\frac{8}{100}} = \frac{1-\frac{10,00,000}{12,59,712}}{\frac{8}{100}} = \frac{\frac{12,59,712-10,00,000}{12,59,712}}{\frac{8}{100}}$$

$$= \frac{\frac{2,59,712}{12,59,712}}{\frac{8}{100}} = \frac{2,59,712}{12,59,712} \times \frac{100}{8} = \text{Rs. } 2.5771$$

4. Goodwill based on Annuity Method:

   Goodwill = Super Profits × Value of an Annuity

   = Rs. 15,000 × Rs. 2.5771

   = Rs. 38,656.50

   So Goodwill under Super Profit Method = Rs. 45,000

   Goodwill based on Annuity Method = Rs. 38,657

Capitalisation Method: Under Capitalisation Method, Goodwill can be valued in two ways –

1. Capitalisation of Average Profit Method.
2. Capitalisation of Super Profit Method.

This method is based on the assumption that sufficient capital must be invested in the concern to earn the desired extra profit or super profit at a reasonable normal rate of return. For this purpose, the capitalised value of super profit is calculated and is taken to be the value of goodwill. Capitalised value of super profit is calculated as follows:

$$\text{Goodwill} = \frac{\text{Super Profit}}{\text{Normal Rate of Return}} \times 100$$

For example, if normal rate of return is 10% and super profit is Rs. 25,000 the value of goodwill be $\frac{25,000}{10} \times 100$ = Rs. 2,50,000

The value of goodwill under this method is, generally much higher than that calculated according to other methods. In the above example, the amount of extra profit expected to be earned is Rs. 25,000. At this

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rate, the payment of Rs. 2,50,000 for goodwill mean that the payer shall be able to recoup the amount in 10 years @ Rs. 25,000 p.a. Any new started business, manages to increase its profitability within a few years and, therefore no one will like to pay such a huge amount for goodwill. Thus, this method seems to be quite unreasonable and not a safe one to follow.

Under Capitalisation of Average Profit Method, goodwill is calculated by deducting Net Assets out of Capitalised Value of the Business.

Illustration 6:

A firm earns Rs. 1,20,000 as its annual profit, the normal rate of profit being 10%. Assets of the firm are Rs. 14,40,000 (excluding Goodwill) and Liabilities are Rs. 4,80,000. Find value of goodwill as per Capitalisation of Average Profit Method.

Solution:

Total Capitalised Value of the Business = $\frac{\text{Average Profit} \times 100}{\text{Normal Rate of Profits}}$

$$= \frac{\text{Rs. } 1{,}20{,}000 \times 100}{10} = \text{Rs. } 1{,}20{,}000$$

Net Assets = Total Assets – Liabilities

= Rs. 14,40,000 – Rs. 4,80,000 =Rs. 9,60,000

Goodwill = Total Capitalised Value of the Business - Net Assets

= Rs. 12,00,000 - Rs. 9,60,000 = Rs. 2,40,000

Illustration 7:

A business has earned average profits of Rs. 2,00,000 during the last few years and the normal rate of return in similar business is 10%. Find out the value of goodwill by:

(*i*) Capitalisation of Super Profit Method.

(*ii*) Super Profit Method if the goodwill is valued at 3 years purchase of super profits. The assets of the business were Rs. 20,00,000 and its external liabilities Rs. 3,60,000.

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Solution:

Capital Employed = Assets – External Liabilities

= Rs. 20,00,000 – Rs. 3,60,000

= Rs. 16,40,000

Normal Profit = Capital Employed × 10/100 = Rs. 16,40,000 × 10/100

= Rs. 1,64,000

Super Profit = Average Profit – Normal Profit

= Rs. 2,00,000 – Rs. 1,64,000 = Rs. 36,000

(*i*) Goodwill by Capitalisation of Super Profits:

$$\text{Goodwill} = \text{Super Profit} \times \frac{100}{\text{Normal Rate of Return}}$$

$$= \text{Rs. } 36{,}000 \times \frac{100}{10} = \text{Rs. } 3{,}60{,}000$$

(*ii*) Goodwill at 3 years purchase of Super Profit:

Goodwill = Super Profit × No. of years Purchase

= Rs. 36,000 × 3 = Rs. 1,08,000

Illustration 8:

The net profit of a company after providing for taxation, for the past five years, are Rs. 50,000, Rs. 52,000, Rs. 55,000, Rs. 56,000, Rs. 57,000. The Capital employed in the business is Rs. 5,00,000 on which return of 10% is expected. It is expected that the company will be able to maintain its super profits for the next five years:

(*a*) Calculate the value of goodwill of the business on the basis of annuity of super profits taking the present value of annuity of Rs. 1 for five years @ 10% interest as Rs. 3.78.

(*b*) How would your answer differ if the value of goodwill is calculated by capitalising the excess of annual average distributable profit over the reasonable return on capital employed on the basis of the same return of 10%.

(*c*) Calculate goodwill on 5 year's purchase of super Profits.

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Solution:

1. **Calculation of Average Profit:**

   Total profit of the last 5 years = Rs. 50,000 + Rs. 52,000 + Rs. 55,000 + Rs. 56,000 + Rs. 57,000

   = Rs. 2,70,000

   $$\text{Average profit} = \frac{\text{Rs. } 2{,}70{,}000}{5} = \text{Rs. } 54{,}000$$

2. **Calculation of Normal Profit:**

   Normal Profit = Capital Employed × Normal Rate of Return

   = Rs. 5,00,000 × 10% = Rs. 50,000

3. **Calculation of Super Profit:**

   Super Profit = Average Maintainable Profits – Normal Profits

   = Rs. 54,000 – Rs. 50,000 = Rs. 4,000

4. **Goodwill based on Annuity Method:**

   Goodwill = Super Profits × Value of an Annuity

   = Rs. 4,000 × Rs. 3.78

   = Rs. 15,120

5. **Calculation of Goodwill as per Capitalisation Method:**

   $$\text{Goodwill} = \frac{\text{Super Profit}}{\text{Normal Rate of Return}} \times 100$$

   $$= \frac{\text{Rs. } 4{,}000}{10} \times 100 = \text{Rs. } 40{,}000$$

6. **Calculation of Goodwill under Super Profit Method:**

   Goodwill = Super Profit × No. of Years Purchase

   = Rs. 4,000 × 5 = Rs. 20,000

1.8 Summary of the Chapter

Goodwill is an intangible asset. It is related to the earning capacity of a business. If a business is able to return a higher income on its

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investment than it is normally earned in similar businesses, the firm may be assumed to possess goodwill, the reason for such higher profit may be due to technical knowledge and experience, near monopoly position etc. **Walton** defines goodwill as ''The element of an established business which makes the business as a going concern worth more than its book value, that is, its net worth as shown by the books''.

Goodwill has the ability to generate additional income for the business. Valuation and existence of goodwill depends upon the subjective judgment of the valuer. Goodwill is generally inseparable from a business and can fetch a price only if a business is sold on a going concern basis. Several factors contribute to create the goodwill like competent management, qualified, committed and skilled work force, favourable location, quality product, good relations with customers and employees and managerial efficiency etc. It takes time for a firm to become well established and earn a name for it. Like other assets, goodwill also facilitates to earn income; hence it is regarded as an asset.

Accounting Standard 10 issued by the Institute of Chartered Accountants of India on 'Accounting for fixed Assets' has prescribed that goodwill for which no money is paid, should not be recorded. From accounting point of view goodwill of a business may be divided into two categories *i.e.* purchased goodwill and non-purchased goodwill or self-generated goodwill. There are various methods of valuation of goodwill such as Simple Average Profit Method, Weighted Average Profit Method, Purchase of Super Profit Method, Annuity Method, and Capitalisation of Average Profit Method.

1.9 Questions for Practice

Exercise 1: Very Short Answer Type Questions

(*a*) Define goodwill.

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(*b*) Write any four features of goodwill.

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(*c*) Non-purchased goodwill should not be recorded in the books. Do you agree?

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(*d*) What is annuity method of valuation of goodwill?

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Exercise 2: Descriptive Questions

1. What is meant by the term 'Goodwill'.

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2. Give any four factors affecting goodwill of a firm.

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3. Distinguish between average profit method and super profit method of valuation of goodwill.

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4. Explain the capitalisation method of valuation of goodwill.

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Exercise 3: Practical Question

1. A partnership firm earned net profit during the last three years as follows:

Years	Net Profit (Rs.)
2011-12	1,90,000
2012-13	2,20,000
2013-14	2,50,000

   The capital employed in the firm throughout the abovementioned period has been Rs. 4,00,000. Having regard to the risk involved, 15% is considered to be a fair return on the capital. The remuneration of all the partners during this period is estimated to be Rs. 1,00,000 per annum.

   Calculate the value of goodwill on the basis of—

   (*a*) Two years' purchase of super profits earned on average basis during the abovementioned three years; and

   (*b*) By Capitalisation Method.

Ans.: (*a*) Average profit Rs. 2,20,000, Super Profit – Rs. 60,000, Goodwill – Rs. 1,20,000.

(*b*) value of goodwill by Capitalisation Method – Rs. 4,00,000.

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Exercise 4: Fill in the Blanks :

(*a*) Goodwill is an __________ asset.

(*b*) Goodwill is an intangible __________current asset and not a fictitious asset.

(*c*) __________________goodwill arises only when a business is acquired by another business as a going concern and the price paid is more than the net asset acquired.

(*d*) Weighted Average Profit $= \dfrac{\text{Sum of Weighted Profits}}{\text{..........................}}$

(*e*) *Super Profit* = Average Maintainable Profits – ....

Ans.: (*a*) Intangible

(*b*) Non-current

(*c*) Purchased Goodwill

(*d*) Sum of Weights

(*e*) Normal Profits.

Exercise 5: True and False

State True or False:

(*a*) Goodwill helps to earn more than normal profit.

(*b*) It is difficult to ascertain exact value of goodwill.

(*c*) Self-generated goodwill is recorded in the business.

(*d*) According to capitalisation of average profit method of goodwill : Goodwill = Capitalised Value – Net Assets.

Ans.: (*a*) True (*b*) True (*c*) False (*d*) True

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LESSON

2

Valuation of Shares

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STRUCTURE

2.1 *Learning Objectives*
2.2 *Concept of Valuation of Shares*
2.3 *Interrelationship Between Valuation of Goodwill and Valuation of Shares*
2.4 *Factors Affecting Valuation of Shares*
2.5 *Different Values of Shares*
2.6 *Methods of Valuation of Shares*
2.7 *Summary of Chapter*
2.8 *Questions for Practice*

2.1 Learning Objectives

This Chapter will assist you to:

- Understand meaning of valuation of shares.
- Learn factors affecting valuation of shares.
- Understand and distinguish between different values of shares.
- Understand and calculate value of shares by applying different methods.

2.2 Concept of Valuation of Shares

Valuation of shares refers to that value of shares on which shares are purchased, sold, transferred and tax is levied. Usually the shares are transacted on the basis of stock-exchange quotations. But sometimes, the quotations prove to be inadequate. In such cases as well as, when the unlisted shares are required to be sold/purchased, the accountant

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is asked to place a value on the shares of a company. The mode of valuation of shares depends on the purpose for which the valuation is being made. The following are the particular instances, where the need of valuation of shares may arise:

1. At the time of amalgamation, absorption and reconstruction of companies value of shares need to be calculated to find purchase consideration and to adjust the right of dissenting shareholders.
2. When unquoted shares are to be bought or sold.
3. At the time of conversion of preference shares or debentures into equity shares.
4. At the time of assessment by the income tax authorities for the purpose of estate duty, capital gain, wealth tax and gift tax.
5. For calculating compensation payable by the government at the time of nationalisation of a company.
6. When a company acquires majority shares of another company for the purpose of acquiring a controlling interest in another company.
7. When shares are pledged as a security against a long term loan.

2.3 Interrelationship between Valuation of Goodwill and Valuation of Shares

The valuation of shares and valuation of goodwill are interrelated to each other. It is because the factors like Earning Capacity, Normal Rate of Return and Capital Employed which affect the value of goodwill, also affect the valuation of shares. These factors are calculated in the same way as in case of valuation of goodwill.

2.4 Factors Affecting Valuation of Shares

Share value of two different companies working in the same industry may differ significantly. Following are some of the basic factors which affect valuation of shares –

I. Performance of the company.

II. Growth prospects of the company.

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III. Dividend policy of the company *i.e.* conservative dividend policy or liberal dividend policy.

IV. Financial strength of the company and its accumulated reserves.

V. Government Policies w.r.t. company's business.

VI. Demand and supply of shares.

VII. The nature and size of the business of the company concerned.

VIII. Net asset position of the company.

IX. Management of the company and its composition.

X. Prospects of bonus or right issue.

XI. Political factors and government's attitude towards the industry.

2.5 Different Values of Shares

Value of shares may be of following types:

1. Par value or face value
2. Book value
3. Market value
4. Intrinsic value
5. Fair value
6. Purchase value or cost value
7. Capitalised value

Par value or face value of shares is found in the Memorandum of a company. A company may issue its shares above the par value *i.e.* at premium. Book value may be calculated by dividing shareholders fund by number of shares; here shareholders fund is calculated after adjusting net reserves and surpluses with paid up capital of the company. The price at which shares are purchased and sold in the stock exchange is called market value. By dividing net assets of the company by number of shares we may have intrinsic value of shares. Fair value is the average of intrinsic value and market value. The price at which a shareholder purchases the shares is the cost value. Brokerage, commission, service tax paid on acquiring the shares is added with the market price of the

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shares to calculate the cost value. Capitalised value is calculated by taking reference of earning capacity of company and the normal rate of return or capital employed. Capitalised value of shares is divided by number of shares to arrive per share value.

2.6 Methods of Valuation of Shares

The mode of valuation of shares depends on the purpose for which the valuation is being made. No method of valuation of shares is given in the Companies Act, though a company may make provision w.r.t. valuation of shares for some specified purposes in its articles of Association. The different methods of valuing shares may be broadly classified as follows –

1. Net Assets Method or Intrinsic Value or Net Worth Method.
2. Yield Method or Earning Capacity or Market Value Method.
3. Earnings Capacity Method.

(1) Net Assets or Intrinsic Value method:

Under this method the value of shares is calculated assuming that what amount would be paid to equity shareholders in case the company goes into liquidation. For this purpose, the realisable value of various assets is estimated and various liabilities are deducted therefrom including the preference share capital. The amount thus available is known as the intrinsic value of the assets or net assets. The value per share is calculated by dividing the net assets by the number of shares. It means,

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

Net Assets may be calculated as follows –

Particulars	Rs.	Rs.
Sundry Assets (at market value)		
Goodwill*		--
Land and Building		--
Plant and Machinery		--

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Particulars	Rs.	Rs.
Furniture and fittings		--
Stock		--
Debtors		--
Bills Receivables		--
Cash in Hand/Bank etc.		--
Total value of estimated assets :		***
Less : **Sundry Liabilities**		
Sundry Creditors		
Bills Payable		
x% Debentures	---	
Interest on Debentures	--	
Preference Share Capital etc.	--	(---)
	--	
Net Assets or Intrinsic value or amount available for equity shareholders		*****

Alternatively Net Assets may be calculated as follows :

Net Assets = Equity Share Capital + General Reserve + Accumulated Profits + Profit on Revaluation of Assets – Loss on Revaluation of Assets

Difficulties in Asset Valuation Method

The first requirement of this method is to find value of an asset; there may be many type of values e.g., replacement value, market value, break-up value etc. Likewise, at a given point of time it is tough to ascertain the amount of all the liabilities and its payable amount with accuracy. Some of the contingent liabilities may also materialise in the meantime. So a valuer must be careful while valuing assets and liabilities.

Illustration 1:

The following is the summarised Balance Sheet of M/s. Zee Limited as on 31st March, 2015.

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Liabilities	Rs.	Assets	Rs.
3,000 Equity Shares of Rs. 100 each, fully paid	3,00,000	Goodwill	70,000
		Other Fixed Assets	4,50,000
1,000 Equity Shares of Rs. 100 each, 80 paid up	80,000	Current Assets	2,20,000
Reserves		Preliminary Expenses	10,000
11% Debentures	1,80,000		
Current Liabilities	1,00,000		
	90,000		
	7,50,000		7,50,000

The goodwill is independently valued at Rs. 50,000 and other fixed assets at Rs. 4,20,000. There was a contingent liability of Rs. 20,000 which has become payable. Determine the value of both the shares under net assets method.

Solution :

(*i*) Calculation of Net Assets:

Particulars		Rs.
Sundry Assets:		
Goodwill		50,000
Other Fixed Assets		4,20,000
Current Assets		2,20,000
		6,90,000
Less: Liabilities and Provisions:		
11% Debentures	1,00,000	
Current Liabilities	90,000	
Contingent Liabilities (now payable)	20,000	(2,10,000)
Net assets available to equity shareholders (before Notional Call)		4,80,000
Add: Notional Call (1,000 @ 20)		20,000
		5,00,000

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$$\text{Value of Shares of Rs. 100 each fully paid} = \frac{\text{Net Assets}}{\text{Number of Equity Shares}}$$

$$= \frac{\text{Rs. } 5,00,000}{4,000} = \text{Rs. } 125$$

Intrinsic value per Rs. 100, Rs. 80 paid up share = Rs. (125 - 20) = Rs. 105 per share.

Illustration 2:

From the following information relating to a company, calculate the value of its equity shares as per intrinsic value method:

Issued Equity Share Capital - 10,000 shares of Rs. 10 each, Rs. 8 paid up

8% Preference Share Capital - 10,000 shares of Rs. 10 each, fully paid up

Rate of Tax	50%
Expected profit (before tax)	Rs. 2,00,000
Annual transfer to General Reserve	20%
Reserves and Surpluses	2,50,000
Normal rate of dividend	20%
Fictitious Assets	Rs. 20,000

Solution:

(*i*) Calculation of Net Assets:

Particulars	Rs.
Equity Share Capital - 10,000 shares of Rs. 10 each, Rs. 8 paid up	80,000
8% Preference Share Capital - 10,000 shares of Rs. 10 each, fully paid up	1,00,000
Add: Reserves and Surpluses	2,50,000
	4,30,000
Less: Fictitious Assets	(20,000)
Net Asset available for equity and preference shareholders	4,10,000
Less: Preference Share Capital	1,00,000
	3,10,000

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$$\text{Intrinsic Value of Shares of Rs. 10 each} = \frac{\text{Net Assets for equity shareholders}}{\text{Number of Equity Shares}}$$

$$= \frac{\text{Rs. 3,10,000}}{\text{10,000}} = \text{Rs. 31}$$

Yield Method or Market Value Method:

This method of share valuation takes into account the profitability of the concern. The value of shares depends to a great extent on its demand and supply also. If an organisation is declaring dividend at a higher rate, the demand for its shares would be comparatively more as every investor wants to get maximum return on its investments. Therefore, the size of the income determines the price which they will be willing to pay for its shares. Therefore to calculate the value of shares, under this method amount expected to be available to equity shareholders in future dividend is ascertained by adjusting the profits of the previous years (as has been explained under the valuation of goodwill). The expected rate of profit is arrived as follows:

$$\frac{\text{Profit available for Equity shareholders}}{\text{Paid up equity share capital}} \times 100$$

Taking into account the expected rate of profit value per share is calculated as follows:

$$\text{Value Per Share} = \frac{\text{Expected rate of Profit}}{\text{Normal Rate of Return}} \times \text{Paid up amount per Share}$$

Yield method is considered as a realistic method because under this method value of share is based on its income (yield); which is the basic purpose for which an investor invests in a particular share.

Illustration 3:

X Ltd. has 10,000 equity shares of Rs. 10 each, Rs. 8 paid and 1,00,000 6% preference shares of Rs. 10 each fully paid. The company has a practice of transferring 20% of the profit to general reserve every year. If the expected profit (based on past year's) performance before tax is Rs. 2,00,000 and the rate of Tax is 50%. You are required to

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calculate the value of equity shares. It may be assumed that normal rate of dividend is 20%.

Solution:

1. Calculation of profit available for equity shareholders

Particulars	Rs.
Expected Profit	2,00,000
Less : Tax @ 50%	1,00,000
Profit after Tax	1,00,000
Less : transfer to general reserve @ 20%	20,000
Profit after transfer to general reserve	80,000
Less : Preference Dividend (6% of Rs. 10,00,000)	60,000
Profit available to equity shareholders	20,000

2. Calculation of expected rate of profit

$$\text{Expected Rate} = \frac{\text{Profit available for Equity Shareholders}}{\text{Paid up Equity Share Capital}} \times 100$$

$$= \frac{20,000}{80,000} \times 100 = 25\%$$

3. Calculation of value per share

$$\text{Value Per share} = \frac{\text{Expected Rate of Profit}}{\text{Normal Rate of Return}} \times \text{Paid up amount per share}$$

$$= \frac{25}{20} \times 8 = \text{Rs. } 10 \text{ per share}$$

***Earning Capacity Method*:** Generally dividend paid by a company is much less than it's earning having regard to its capital employed. Earning of a company refers to the profits earned by it before providing for income tax, interest on debentures, preference dividend and transfer to general reserve. Sometimes shares are valued on the basis of the earning capacity of the company. For this purpose, the rate of earning is calculated as follows:

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$$\text{Rate of Earning} = \frac{\text{Profit Earned}}{\text{Average Capital Employed}} \times 100$$

Where,

Profit Earned = Profit earned after tax but before debenture interest, preference dividend, and transfer to general reserve less income from non-trading assets.

$$\text{Average Capital Employed} = \frac{\text{Capital Employed in the beginning + Capital Employed at the end}}{2} \textbf{ or}$$

Capital Employed at the end – ½ Profit of the year

After completing the above we may have **Value Per Share**

$$= \frac{\text{Rate of Earning}}{\text{Normal Rate of Return}} \times \text{Paid amount per share}$$

Fair Value Method**:** While taking investment decision the investors have two main objects in mind, *i.e.:*

(*i*) Maximum Return, &

(*ii*) Security of Investment.

None of the method of valuing shares fulfils both the objectives. By 'Net Assets' method we estimate the security of investments and by "Yield Method" we can estimate maximum probable return. Fair value of shares fulfils both the objects. By fair value of shares we mean the average of the value of share by net asset method and value by yield method. Fair value method is combination of two methods so it is termed as Dual Method.

$$\text{Fair Value of Shares} = \frac{\text{Value as per (Net Asset Method + Yield Method)}}{2}$$

Illustration 4:

The following is the summarised balance sheet of Ms. Victory Machines as on 31st March 2014 –

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Liabilities		Rs.	Assets	Rs.
Share Capital:			*Fixed Assets :*	
30,000 Equity Shares of Rs. 10 each, fully paid		3,00,000	Freehold Property	1,20,000
Reserve and Surplus :			Plant and Machinery	50,000
General Reserve	1,20,000		*Current Assets :*	
Capital Reserve	40,000		Stock	3,10,000
Profit and Loss A/c	1,20,000		Debtors	2,13,000
		2,80,000	Bank	1,07,000
Current Liabilities and Provisions:			Cash	1,700
Sundry Creditors	93,700			
Income tax payable	11,500			
Proposed dividend	34,000			
Provision for tax	82,500			
		2,21,700		
		8,01,700		8,01,700

Net profit (before taxation) for the past three years ended –

31st March, 2012	Rs. 1,38,000
31st March, 2013	Rs. 1,83,000
31st March, 2014	Rs. 1,97,000

Freehold Property was valued in 2014 at Rs. 1,80,000 and Plant and Machinery at Rs. 80,000.

Average yield in this type of business is 15% on capital employed. Goodwill of the company is Rs. 1,00,000. The company transfers 20% of net profit to general reserve. Rate of Tax is 50%.

You are required to find value of each equity shares on the basis of abovementioned facts. Also determine the fair value of the shares.

Solution:

(*a*) Value of shares as per net assets method:

(i) *Calculation of Net Assets:*

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Particulars	Rs.
Goodwill	1,00,000
Freehold Property at Market value	1,80,000
Plant and Machinery	80,000
Stock	3,10,000
Debtors	2,13,000
Bank	1,07,000
Cash	1,700
	9,91,700
Less: Current Liabilities and Provisions	(2,21,700)
Net assets available to equity shareholders	7,70,000

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

$$= \frac{\text{Rs. } 7,70,000}{30,000} = \text{Rs. } 25.67 \text{ per share}$$

(*b*) **Value per share as per Yield Method:**

Average profit based on weighted average basis –

Calculation of Weighted Average Profit

Years (31st March) 1	Profits (Rs.) 2	Weights 3	Product (Rs.) 4 = 2 × 3
2012	1,38,000	1	1,38,000
2013	1,83,000	2	3,66,000
2014	1,97,000	3	5,91,000
Total		6	10,95,000

Note: Profits are showing increasing trend so weighted average basis has been used.

$$\text{Weighted Average Profit (before tax)} = \frac{\text{Sum of Weighted Profits}}{\textit{Sum of Weights}}$$

$$= \frac{\text{Rs. } 10,95,000}{5} = \text{Rs. } 1,82,000$$

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Now, Expected profit available to equity shareholders =

Weighted Average Profit (before tax)	Rs. 1,82,000
Less : Income Tax @ 50%	Rs. 91,250
	Rs. 91,250
Less : transfer to general reserve	Rs. 18,250
Expected profit available to equity shareholders	Rs. 73,000

Calculation of expected rate of profit:

$$\text{Expected Rate of Profit} = \frac{\text{Profit available for Equity Shareholders}}{\text{Paid up Equity Shares Capital}} \times 100$$

$$= \frac{73{,}000}{3{,}00{,}000} \times 100 = 24.33\%$$

Calculation of Yield Value per share:

$$\text{Value Per share} = \frac{\text{Expected Rate of Profit}}{\text{Normal Rate of Return}} \times \text{Paid up amount per share}$$

$$= \frac{24.33}{15} \times 10 = \text{Rs. } 16.22 \text{ per share}$$

(*c*) **Calculation of fair value of shares:**

$$\text{Fair Value of Shares} = \frac{\text{Value as per (Net Asset Method + Yield Method)}}{2}$$

$$= \frac{\text{Rs. } (25.67 + 16.22)}{2} = \text{Rs. } 20.95$$

Illustration 5:

The following is the Balance Sheet of M/s. Z Limited as on 31st March, 2014.

Liabilities	Rs.	Assets	Rs.
3,000, 8% Preference Shares of Rs. 100 each, fully paid	3,00,000	Fixed Assets	6,00,000
		Current Assets	3,72,000
4,500 Equity shares of Rs. 100 each, fully paid	4,50,000	Preliminary expenses	15,000
		Profit & Loss A/c	48,000

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Liabilities	Rs.	Assets	Rs.
General Reserve	7,500		
Debenture Redemption Fund	37,500		
Investment Fluctuation Fund	15,000		
6% Debenture	75,000		
Depreciation fund	15,000		
Sundry Creditors	1,35,000		
	10,35,000		10,35,000

Current assets included investments Rs. 75,000 market price of which is Rs. 72,000. Debtors included in current assets doubtful to the extent of Rs. 7,500 for which no provision has been made so far. Stock at the end did not include return of Rs. 1,500 though transaction was properly recorded and posted. Debenture interest is owing for one year and preference dividends are in arrear for two years. Assuming other assets are worth book values, you are required to value the share if:

(*a*) Preference shares have priority as to payment of capital and arrears of dividend;

(*b*) Preference shares have priority as to the payment of capital only;

(*c*) Preference shares have priority as to payment of dividend only;

(*d*) Preference shares have no priority at all.

Solution:

Calculation of Net Assets:

Particulars	Rs.	Rs.
Fixed Assets		6,00,000
Current Assets	3,72,000	
Add: Increase in the value of closing stock	(1,500)	3,73,500
		9,73,500
Less: Depreciation on fixed assets	15,000	
Fall in value of investment	3,000	
Doubtful debts	7,500	(25,500)
Less: **Liabilities**		
Creditors	1,35,000	

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Particulars	Rs.	Rs.
6% Debentures	75,000	
Interest on Debentures	4,500	(2,14,500)
Net Assets		7,33,500

Calculation of value of shares:

(*a*) When Preference Share have priority as to repayment of capital and dividend

Net Assets (as per (1) above)		Rs. 7,33,500
Less: Preference Share Capital	Rs. 3,00,000	
Preference dividend (for 2 years)	Rs. 48,000	Rs. (3,48,000)
Net Assets		Rs. 3,85,500

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

$$= \frac{\text{Rs. } 3,85,500}{4,500} = \text{Rs. } 85.67$$

(*b*) When Preference Shares have priority as to the repayment of capital only

Net Assets (as per (1) above)	Rs. 7,33,500
Less: Preference Share Capital	Rs. (3,00,000)
Net Assets	Rs. 4,33,500

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

$$= \frac{\text{Rs. } 4,33,500}{4,500} = \text{Rs. } 96.34$$

(*c*) When Preference Shares have priority as to repayment of dividend only

Net Assets (as per (1) above)	Rs. 7,33,500
Less: Preference Dividends for 2 years	Rs. (48,000)
Net Assets	Rs. 6,85,500

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$$\text{Value of Shares} = \frac{\text{Rs. } 6{,}85{,}500}{4{,}500 + 3{,}000} = \text{Rs. } 91.40$$

(*d*) When Preference Shares have no priority at all

$$\text{Value of Shares} = \frac{\text{Rs. } 7{,}33{,}500}{4{,}500 + 3{,}000} = \text{Rs. } 97.80$$

Note:

(*i*) In case (*c*) & (*d*) No. of shares = (Equity + Preference) Share.

(*ii*) In case (*d*) Rs. 7,33,500 is the net asset value taken from above.

Illustration 6:

It is provided in the articles of association that at the death of the shareholder his share will be purchased by the remaining shareholders at a price to be settled on the basis of the last balance sheet. It is further provided that goodwill will be valued on the basis of three years purchase of the average annual profits for the last five years. On the of death of a shareholder (who was holding 200 shares) the last Balance Sheet of the company stood as follows:

Liabilities	Rs.	Assets	Rs.
2,000 equity shares of Rs. 100 each	2,00,000	Goodwill	2,00,000
General Reserve	2,00,000	Investment	3,00,000
Workmen's Saving Fund	2,00,000	(market value Rs. 2,50,000)	
Employees Prov. Fund	1,00,000	Stock	5,00,000
Creditors	6,00,000	Debtors	4,00,000
Profit and Loss A/c	1,70,000	Bank	70,000
	14,70,000		14,70,000

The profit of the last five years were – Rs. 25,000, Rs. 30,000, Rs. 35,000, Rs. 40,000 and Rs. 45,000. Calculate price to be paid for each share and for the total shares on the basis of net assets method.

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Solution:

Calculation of Weighted Average Profit

Years 1	Profits (Rs.) 2	Weights 3	Product (Rs.) 4 = 2 × 3
1	25,000	1	25,000
2	30,000	2	60,000
3	35,000	3	1,05,000
4	40,000	4	1,60,000
5	45,000	5	2,25,000
Total		15	5,75,000

Note: profits are showing increasing trend so weighted average basis has been used.

$$\text{Weighted Average Profit (before tax)} = \frac{\text{Sum of Weighted Profits}}{\text{Sum of Weights}}$$

$$= \frac{\text{Rs. } 5{,}75{,}000}{15} = \text{Rs. } 38{,}333.33$$

Goodwill at 3 years' purchase of weighted average profit:

Goodwill = Weighted Average Profit × No. of Years purchase

= Rs. 38,333.33 × 3 = Rs. 1,15,000

Calculation of Net Assets:

Particulars	Rs.	Rs.
Goodwill	1,15,000	
Investment (Market value)	2,50,000	
Stock	5,00,000	
Debtors	4,00,000	
Bank	70,000	13,35,000
Less: Sundry Liabilities		
Workmen's Saving Fund	2,00,000	
Employees Prov. Fund	1,00,000	
Creditors	6,00,000	
		(9,00,000)
Net Assets		4,35,000

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

$$= \frac{\text{Rs. } 4,35,000}{2,000} = \text{Rs. } 217.50 \text{ per share}$$

Value of 200 shares = Rs. 217.50 × 200 = Rs. 43,500

2.7 Summary of Chapter

Valuation of shares refers to that value of shares on which shares are purchased, sold, transferred and tax is levied. The mode of valuation of shares depends on the purpose for which the valuation is being made. The need of valuation of shares may arise: at the time of amalgamation, absorption and reconstruction of companies value of shares need to be calculated to find purchase consideration and to adjust the right of dissenting shareholders, at the time of conversion of preference shares or debentures into equity shares, at the time of assessment by the income tax authorities for the purpose of estate duty, capital gain, wealth tax and gift tax etc.

Some of the basic factors which affect valuation of shares are - performance of the company, growth prospects of the company, dividend policy of the company, financial strength of the company, government policies w.r.t. company's business, the nature and size of the business of the company concerned, net asset position of the company.

The mode of valuation of shares depends on the purpose for which the valuation is being made. No method of valuation of shares is given in the Companies Act, though a company may make provision w.r.t. valuation of shares for some specified purposes in its articles of Association. The different methods of valuing shares may be broadly classified as – Net Assets Method or Intrinsic Value or Net Worth Method, Yield Method or Earning Capacity or Market Value Method and Earnings Capacity Method.

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2.8 Questions for Practice

Exercise 1: Very Short Answer Type Questions

(*a*) What do you mean by face value of shares?

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(*b*) Is there any relation exists between valuation of shares and valuation of goodwill.

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(*c*) How will you calculate market value of shares?

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(*d*) Name any three methods which can be applied in valuation of shares.

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Exercise 2: Descriptive Questions

1. What do you understand by share valuation?

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2. Describe the different methods of valuation of shares?

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3. Discuss the various factors that affect value of goodwill.

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4. What is the need for valuation of share? State the factors affecting valuation of shares?

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Exercise 3: True and False

State True or False:

(*a*) Par value or face value of shares is found in the Memorandum of a company.

(*b*) The price at which shares are purchased and sold in the stock exchange is called market value.

(*c*) The majority of shareholders in a company are interested in dividend.

(*d*) Brokerage, commission, service tax paid on acquiring the shares is added with the market price of the shares to calculate the cost value.

(*e*) Goodwill is a fictitious asset.

(*f*) Stock exchange quotations provide reliable basis of valuation of shares.

Ans.: (*a*) True (*b*) True (*c*) True (*d*) True (*e*) False (*f*) False

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Exercise 4: Fill in the Blanks:

(*a*) Fair Value of Shares = $\dfrac{\text{Value as per (.......................... + yield Method)}}{2}$

(*b*) Net Assets = Equity …………+ General Reserve + Accumulated Profits + Profit on Revaluation of Assets – Loss on Revaluation of Assets

(*c*) A company may issue its shares above the par value *i.e.* at ……………………....

(*d*) **…………….** = $\dfrac{\text{Capital Employed in the beginning + Capital Employed at the end}}{2}$

Ans.: (*a*) Net asset Method

(*b*) Equity Share Capital

(*c*) Premium

(*d*) Average Capital Employed

Exercise 5: Practical Question

1. The following is the Balance Sheet of Jina Limited as on 31st March, 2014.

Liabilities	Rs.	Assets	Rs.
Share Capital :		*Fixed Assets*	
50,000 Equity Shares of Rs. 00 each, fully paid	5,00,000	Goodwill	1,00,000
Reserve and Surplus	7,50,000	Buildings	6,70,000
Profit and Loss A/c	90,000	Machinery	5,00,000
Unsecured Loans	3,40,000	Investments	2,00,000
Current Liabilities	60,000	Current Assets	1,50,000
		Loans and Advances	90,000
		Preliminary Expenses	30,000
	17,40,000		17,40,000

Buildings and Investment were valued at Rs. 7,00,000 and Rs. 1,90,000 on 31st March, 2014. For the purpose of valuation of shares, Goodwill

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shall be taken at two years' purchase of the average profits of the last three years. Profits for the last three years are Rs. 1,30,000, Rs. 1,40,000 and 1,80,000. Calculate the intrinsic value of shares.

Ans.: Rs. 30.60

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UNIT - IV

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LESSON

1

Amalgamation of Limited Companies

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STRUCTURE

1.1 *Learning Objectives*
1.2 *Concept of Amalgamation*
1.3 *Accounting Standard-14 Amalgamation of Companies*
1.4 *Purchase Consideration*
1.5 *Accounting Procedure in the Books of Purchasing Company*
1.6 *Accounting Treatment in the Books of Transferee Company Pooling of Interest Method*
1.7 *Accounting Procedure in the Books of Transferor/Vendor Company*
1.8 *Dissenting Shareholders*
1.9 *Summary*
1.10 *Questions for Practice*

1.1 Learning Objectives

This Chapter will assist you to:

- Meaning, definition and terms related to amalgamation as per AS-14.
- Differentiate between Amalgamation, Absorption and Reconstruction.
- Understand types of amalgamation *i.e.* Amalgamation in the nature of Merger.
- Purchase as per AS-14.
- Understand the meaning and calculation of Purchase Consideration.
- Apply accounting treatment to be followed by the transferor and transferee company while dealing with the amalgamation process.

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1.2 Concept of Amalgamation

To 'Amalgamate' means to join or unite to form a larger organisation or group. It simply means taking over by a new company of two or more existing companies. Companies which are taken over go into liquidation and a new company is formed to take over business of these companies e.g., a company XY Ltd. is formed to take over X Ltd. and Y Ltd. Absorption, on the other hand, takes place when an existing company (or companies) takes over the business of existing Companies. When X Ltd. takes over the business of Y Ltd. Resulting in liquidation of Y Ltd., it is a case of absorption.

Reconstruction is resorted to tide over the difficulties arising out of accumulated past losses or financial stringencies. It is of two types – External and Internal. External reconstruction takes place when a new company is floated to take over an existing company. The latter company is wound up. A Ltd. is formed to take over the business of B Ltd.; in this case B Ltd. will wound up and shareholders of B Ltd. will become the shareholder of A Ltd. and it is a case of external reconstruction.

Internal reconstruction means the reduction of capital without going into liquidation. Thus in internal reconstruction, neither any company goes into liquidation nor a new company is formed.

The next chapter discusses about internal reconstruction.

According to Accounting Standard 14 - *Amalgamation means an amalgamation pursuant to the provision of the Companies Act, 1956 or any other statute which may be applicable to the Companies, Amalgamation involves acquisition of one company by another. After Amalgamation, the acquired company is dissolved and ceases to exist.* In the above definition two companies are involved in the whole process –

(*i*) Transferor Company and

(*ii*) Transferee Company

(***i***) **Transferor Company:** Means a company, which is amalgamated into another company. The company selling its business is also called "Vendor Company". In the above example X Ltd. and Y Ltd. is Transferor Company.

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(*ii*) **Transferee Company:** Transferee Company means the Company into which a transferor Company is amalgamated (purchasing company). In the above example XY Ltd. is Transferee Company.

In amalgamation, two or more companies join hands to take the advantage of various economic issues like diversification, expansion, modernisation, elimination of competition, avoidance of duplication of activities, tax saving, cost saving in various activities like transport, communication and so on. There may be three situations through which a new company may be formed:

(*a*) **Amalgamation:** Here two or more than two existing companies come together and form a new company to take over their business e.g. a new company AB Ltd. may be formed for the purpose of taking over the business of A Ltd. and B Ltd.

(*b*) **Absorption:** Absorption is a process through a company tries to increase its strength by eliminating the rivals. Here one existing company takes over the business of another existing company e.g. A Ltd. an existing company takes over B Ltd. another existing company.

(*c*) **External Reconstruction:** In case of external reconstruction one company is formed especially for the purpose of taking over the business of another existing company. For example A (New) Ltd. is formed to take over the business of A Ltd. which is a loss making company.

1.3 Accounting Standard-14 Amalgamation of Companies

The I.C.A.I. has issued Accounting Standard 14 governing the procedure and accounting of Amalgamation of companies. This standard is effective since the accounting period beginning on or after 01.04.1995 and is mandatory in nature. AS-14 does not make any difference between an amalgamation and absorption. It only recognizes two types of amalgamation that is—

1. Amalgamation in the nature of Merger, and
2. Amalgamation in the nature of Purchase.

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So absorption is also treated as a form of amalgamation. Accounting Standard-14 only recognizes Pooling of Interest Method for 'Merger' and Purchase Method in case of 'Purchase'.

1. As per standard, an amalgamation should be considered to be an "amalgamation in the nature of merger" when all the following conditions are satisfied:
   (*a*) All assets and liabilities of the transferor company become, after amalgamation, the assets, and liabilities of the transferee company.
   (*b*) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before amalgamation by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of amalgamation.
   (*c*) The consideration is discharged by the transferee company wholly by the issue of equity shares only, except that cash may be paid in respect of any fractional shares.
   (*d*) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.
   (*e*) No adjustment is intended to be made to the book value of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

Amalgamation in the nature of purchase: If Amalgamation does not satisfy anyone of the above five conditions then it will be regarded as Amalgamation in the nature of purchase.

Pooling of Interest Method v. Purchase Method

Basis for Comparison	Pooling of Interest Method	Purchase Method
Meaning	Pooling of Interest Method of accounting is one in which the assets, liabilities and reserves are combined and shown at their historical values, as of the date of amalgamation.	Purchase Method, is an accounting method, wherein the assets and liabilities of the transferor company are shown at their market value in the books of the transferee company, as of the date of amalgamation.

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Basis for Comparison	Pooling of Interest Method	Purchase Method
Applicability	Merger	Acquisition
Assets and liabilities	Appear at book values	Appear at fair market values
Recording	All the assets and liabilities of the companies undergoing merger are aggregated.	Only those assets and liabilities are recorded in the books of transferee company, which are taken over by it.
Reserves	The identity of transferor company's reserves is kept intact.	The identity of the transferor company's reserves except statutory reserves is not kept intact.
Purchase Consideration	Difference in the amount of purchase consideration and share capital is adjusted with reserves.	Surplus of deficit of purchase consideration over the net asset acquired, should be credited or debited, as capital reserves or goodwill.

1.4 Purchase Consideration

Purchase Consideration is the sale price of the business agreed mutually between the two parties, the transferor (Selling Co.) and the transferee (Purchasing Co.). AS-14 defines the Purchase Consideration as—

> *"the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the "Shareholders of the Transferor Company".*

Methods of Purchase Consideration:

(*i*) Lumpsum Method

(*ii*) Net Payment Method

(*iii*) Net Assets Method

(*iv*) Exchange of Shares Method/Intrinsic Value Method

(*i*) *Lumpsum Method:* When the purchasing company agrees to pay a fixed sum in consideration of acquiring the vendor company it is considered as lumpsum method e.g. A Ltd. agrees to take over B Ltd. for a sum of Rs. 10 lakhs. Payment made to third parties and cost of winding up is not to be included in purchase consideration.

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(*ii*) ***Net Payment Method:*** Under this method purchase consideration is equal to total of the Payments made by the transferee company in the form of shares, debentures and cash.

Here purchase consideration is arrived at by adding up cash paid and the agreed values of securities issued by the transferee company to shareholders of transferor company in discharge of the purchase consideration.

Example 1:

X Ltd. takes over business of Y Ltd. and agrees to pay the purchase consideration as follows: Issue of 10,000 equity shares of Rs. 10 each at Rs. 12 each, 5,000 preference shares of no each and cash Rs. 30,000.

Here the purchase consideration:

10,000 Equity Shares of Rs. 10 each at Rs. 12 each	Rs. 1,20,000
5,000 Preference Shares@ Rs. 10	Rs. 50,000
Cash	Rs. 30,000
Purchase Consideration	**Rs. 2,00,000**

(*iii*) ***Net Assets Method:*** Net asset is the aggregate of the assets taken over at agreed values less liabilities taken over at agreed values. In absence of agreed values of assets and liabilities, book values should be taken. If a particular asset is not taken over by the transferee company, it should not be included in the purchase consideration.

Particulars	**Amount**	**Amount**
Assets taken over at agreed values	***	
(excluding Fictitious Assets)	***	
Goodwill	***	
Land/Building/Plant/Machine/Furniture	***	
Investments	***	
Motor vehicles	***	
Stock	***	
Debtors	***	
Cash and bank balances	***	***
Less: Liabilities Taken over at Agreed Value		

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Particulars	Amount	Amount
Creditors	(***)	
Bills Payables	(***)	
Bank Overdraft	(***)	
Debentures	(***)	(***)
Purchase Consideration (Net Assets)		***

Take care of the following points while calculating Purchase Consideration :

(*a*) The term 'Business' will always mean both the assets and the liabilities.

(*b*) Term assets include all assets except fictitious assets.

(*c*) Liabilities mean outside liability it never includes Equity Share Capital, Preference Capital and Reserve and Surplus.

Illustration 1:

X Ltd. Purchased the business of Y Ltd. whose summarised Balance Sheet as on 31st March, 2019 was as follows:

Liabilities	Amount	Assets	Amount
38,000 Equity Shares of Rs. 10 each, fully paid	3,80,000	Goodwill	70,000
		Other Fixed Assets	4,50,000
Reserves	1,80,000	Current Assets	2,20,000
11% Debentures	1,00,000	Preliminary Expenses	10,000
Current Liabilities	90,000		
	7,50,000		7,50,000

The goodwill is independently valued at Rs. 50,000 and other fixed assets at Rs. 4,20,000. There was a contingent liability of Rs. 20,000 which has become payable. Determine the amount of purchase consideration under net assets method.

Solution:

Calculation of Purchase Consideration through Net Asset Method:

Particulars	Amount
Sundry Assets:	50,000
Goodwill	4,20,000
Other Fixed Assets	2,20,000
Current Assets	6,90,000

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Particulars		Amount
Less: Liabilities and Provisions:		
11% Debentures	1,00,000	
Current Liabilities	90,000	
Contingent Liabilities (now payable)	20,000	(2,10,000)
Value of Net Assets (Purchase Consideration)		4,80,000

(*iv*) Exchange of Shares Method/Intrinsic Value Method: Under this method the intrinsic value of the shares of both the companies is calculated and then the transferor company issues shares to the transferee company on the basis of these values. For the purpose of finding out Intrinsic Value of shares the realisable value of Total Net Assets is divided by the number of Shares Outstanding.

$$\text{Intrinsic Value} = \frac{\text{Value of Net Assets}}{\text{No. of Shares}}$$

Value of Net Assets = Net Releasable Value of Assets - Payable value of Liabilities - Payable to Preference Shareholders

Note: Students may refer - Valuation of Shares for further explanation of intrinsic value method.

1.5 Accounting Procedure in the Books of Purchasing Company

In case of amalgamation, Transferor company loses its identity and its assets and liabilities becomes assets and liabilities of the Transferee company and these are presented in the financial statements of the transferee company, prepared subsequent to the date of amalgamation.

Accounting treatment in the books of Transferee Company will be different in two types of amalgamation *i.e.* Amalgamation in the nature of Merger (Pooling of interest Method) and Amalgamation in the nature of Purchase (The purchase Method).

Amalgamation in the nature of Purchase - The Purchase Method

An amalgamation is considered to be in the nature of purchase when anyone or more of the five conditions specified for amalgamations in

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the nature of merger as stated is not satisfied. In case of 'amalgamation in the nature of purchase' Purchase Method is applied.

If the amalgamation is an 'Amalgamation in the nature of Purchase', the identity of the reserves, other than the statutory reserves is not preserved. [AS 14 Para 17]. The Act requires that the identity of statutory reserves should be preserved for a specified period. Such reserves retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, so long as their identity is required to be maintained to comply with the relevant statute.

Finding the Value of goodwill on amalgamation:

The amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company to find goodwill or capital reserve as the case is. It may be simplified as follows

If Purchase Consideration > Net Assets Taken Over = Goodwill (Dr.)

If Purchase Consideration < Net Assets Taken Over = Capital Reserve (Cr.)

Accounting Entries in the books of Transferee Company

1. **For purchase consideration becoming due:**

Business Purchase A/c	Dr.
To Liquidator of Transferor Company A/c	

2. **For taking over assets and liabilities of transferor company:**

Sundry Assets A/c	Dr.
Goodwill A/c*	Dr.
To Sundry Liabilities A/c	(Individually) [fair/agreed value if given]
To Business Purchase A/c	[Purchase Consideration]
To Capital Reserve A/c	

Notes:

(*i*) If the total of the liabilities taken over at a revised values + purchase consideration exceeds the total of the assets taken over (except goodwill) at revised values - Goodwill A/c is debited with the

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difference. In opposite case Capital Reserve A/c is credited with the difference amount.

(*ii*) If goodwill and Capital Reserve appears simultaneously in the balance sheet, then following entry should be passed to set-off –

Capital Reserve A/c Dr.
  To Goodwill A/c

3. For payment of purchase consideration to Vendor Company:

Liquidator of Transferor Co. A/c Dr. [Purchase Consideration]
  To Equity Share Capital A/c
  To Preference Share Capital A/c
  To Securities Premium A/c
  To Bank A/c

4. Treatment of liquidation expenses:

(*i*) If borne by the transferor/vendor company - No entry

(*ii*) If borne and paid by the transferee company:

Goodwill A/c Dr.
  To Cash/Bank A/c

(*iii*) If liquidation expenses are first paid by the transferor company and then it is reimbursed by the transferee company (same entry as above, *i.e.* (*ii*) above)

Goodwill A/c Dr.
  To Cash/Bank A/c

Note: Alternatively we may pass the following two entries instead of the above entry No. (*iii*)

(*a*) Goodwill A/c Dr.
  To Liquidator of Transferor Company A/c

(*b*) Liquidator of Transferor Company A/c Dr.
  To Cash/Bank A/c

5. For issuing debentures to discharge liability w.r.t. existing debenture holders:

Debentures in Transferor Co. A/c Dr.
  To X % Debentures A/c [Debentures in Purchasing Company]

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6. **For recording Statutory Reserves:**

Amalgamation Adjustment A/c Dr.
 To Statutory Reserve A/c [Individually]

Notes:

(*a*) Reserve created under law generally for obtaining tax benefits such as – Development Rebate Reserve, Investment Allowance Reserve, Foreign Project Reserve etc. are known as Statutory Reserves.

(*b*) Statutory Reserve is shown as a part of Reserves and Surplus in the Balance Sheet, details will be shown in notes to accounts.

(*c*) Amalgamation Adjustment A/c is shown under the Sub-heading - Other Non-Current Assets. The Main Heading will be Non-Current Assets.

(*d*) This entry is reversed when statutory reserve is net required to be maintained.

7. **For the formation expenses of the transferee company:**

Preliminary Expenses A/c Dr.
 To Bank A/c

1.6 Accounting Treatment in the Books of Transferee Company Pooling of Interest Method

This method is used for amalgamation in the nature of merger. As per Para 16 of AS-14 if the amalgamation is an 'amalgamation in the nature of merger', the identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company *i.e.* after amalgamation General Reserve of the transferor company becomes the General Reserve of the transferee Company, the Capital Reserve of the transferor company becomes the Capital Reserve of the transferee company and the Revaluation Reserve of the transferor company becomes the Revaluation Reserve of the transferee company and so on.

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Entries in the Books of Transferee/Purchasing Company :

1. For purchase consideration becoming due on merger :

   Business Merger A/c Dr.
   To Liquidator of Transferor Company A/c

2. For taking over assets and liabilities of transferor company :

   Sundry Assets A/c Dr. (Individually) [at book value]
   To Sundry Liabilities A/c (Individually) [at book value]
   To Securities Premium A/c
   To Statutory Reserves A/c (Individually) [at book value]
   To Other Reserves and Provisions A/c (Individually) [at book value]
   To Profit and Loss or Surplus A/c
   To General Reserve A/c*
   To Business Merger A/c [Purchase Consideration]

   Note: Difference between Purchase Consideration and Share Capital *i.e.* [Equity + Preference Share] is adjusted against reserves.

3. For payment to Vendor company- [at Par/Premium/Discount]

(*a*) For issue of shares:

   Liquidator of Transferor Co. A/c Dr. [Purchase consideration]
   To Equity Share Capital A/c
   To Preference Share Capital A/c
   To Bank A/c [If any]

   Note: Premium or Discount on Issue of Securities will be Credited and Debited accordingly in the above entry.

4. For issuing debentures to discharge liability w.r.t. existing debenture holders :

   Debentures in Transferor Co. A/c Dr.
   To x % Debentures A/c [Debentures in Purchasing company]

5. Treatment of liquidation expenses :

   (*i*) If borne by the transferor company - No entry

   (*ii*) If borne and paid by the transferee company :

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A. For payment of expenses —

Liquidation Expenses A/c Dr.

To Bank

B. For adjusting Liquidation Expenses against General Reserve/ Profit and Loss/Surplus A/c:

General Reserve/Profit and Loss/Surplus A/c Dr.

To Liquidation Expenses A/c

Note: A combined entry to give effect to the above entry may be passed. *i.e.*

Profit and Loss A/c/Surplus A/c Dr.

To Bank A/c

6. For formation expenses of the transferee company:

Preliminary Expenses A/c Dr.

To Bank A/c

Note: Preliminary expenses must be written off against General Reserve/ surplus A/c otherwise it will appear in the Balance Sheet of transferee Company as Other Current Assets.

Illustration 2:

X Ltd. takes over the business of Y Ltd. for a consideration of Rs. 2,00,000 to be discharged in the form of fully paid equity shares of Rs. 10 each. Their balance sheet on the date of acquisition were as follows:

Balance Sheet As on 31st March, 2019

[amount in '000]

Liabilities	X Ltd.	Y Ltd.	Assets	X Ltd.	Y Ltd.
Equity Shares of Rs. 10 each	200	125	Building	200	100
General Reserve	75	15	Machinery	200	100
Export Profit Reserve	45	25	Stock	30	40
Profit and Loss A/c	60	45	Debtors	30	40
Creditors	100	80	Bank	20	10
	480	290		480	290

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Notes

Journalise the transactions in the Books of X Ltd. when amalgamation is by way of:

(*a*) Merger

(*b*) Purchase

Also prepare Balance Sheet of X Ltd.

Solution:

Amalgamation by way of Merger –

In the books of X Ltd.

Particulars		Dr. (Rs.)	Cr. (Rs.)
Business Merger A/c	Dr.	2,00,000	
To Liquidator of Y Ltd. A/c			2,00,000
(Being purchase consideration payable as per scheme of amalgamation)			
Building A/c	Dr.	1,00,000	‘
Machinery A/c	Dr.	1,00,000	
Stock A/c	Dr.	40,000	
Debtors A/c	Dr.	40,000	
Bank A/c	Dr.	10,000	
General Reserve A/c	Dr.	15,000	
To Export Profit Reserve A/c			25,000
To Creditors A/c			80,000
To Business Merger A/c			2,00,000
(Being assets and liabilities taken over from Y Ltd. and also for recording accumulated profit, capital loss on merger adjusted with general reserve and profit and loss account)			
Liquidator of Y Ltd. A/c	Dr.	2,00,000	
To Equity Share Capital A/c			2,00,000
(Being payment of purchase consideration by way of issue of equity shares)			

Note: Here amount of purchase consideration is > Equity Share Capital

Difference of Rs. 75,000 will be adjusted against General Reserve if amount of general reserve is not adequate then it may be adjusted against balance of profit and loss account.

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Balance Sheet of X Ltd. as at 31st March, 2019

Particulars	Note No.	Amount
Equity and Liabilities		
1. Shareholder's Fund		
Share Capital	1	4,00,000
Reserves & Surplus	2	1,90,000
2. Non-Current Liabilities		
3. Current Liabilities		
Trade Payables (Sundry Creditors)	3	1,80,000
Total		**7,70,000**
Assets		
Non-Current Assets		
1. Fixed Assets		
Tangible Assets	4	6,00,000
2. Current Assets		
Inventories	5	70,000
Trade Receivables	6	70,000
Cash & Cash Equivalents	7	30,000
Total		**7,70,000**

Notes to Accounts: [Balance Sheet]

Particulars	Amount
1. Share Capital	
Issued, subscribed, called up and paid up 40,000 Equity shares of Rs. 10 each	4,00,000
[includes 20,000 equity shares issues as purchase consideration to Y Ltd.]	
2. Reserves & Surplus	
General Reserve [Rs. 75,000 – Rs. 15,000]	60,000
Export Profit Reserve (X Ltd. + Y Ltd.)	70,000
Profit and Loss A/c (X Ltd. + Y Ltd.)	60,000
	1,90,000
3. Trade Payables	1,80,000
Sundry Creditors (X Ltd. + Y Ltd.)	

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Particulars	Amount
4. Tangible Assets	
Building	3,00,000
Machinery	3,00,000
	6,00,000
5. Inventories (Stock)	70,000
6. Trade Receivables (Debtors)	70,000
7. Cash & Cash Equivalents (Bank)	30,000

Amalgamation by way of Purchase:

In the books of X Ltd.

Particulars		Dr. (Rs.)	Cr. (Rs.)
Business Purchase A/c	Dr.	2,00,000	
To Liquidator of Y Ltd. A/c			2,00,000
(Being purchase consideration payable as per scheme of amalgamation)			
Building A/c	Dr.	1,00,000	
Machinery A/c	Dr.	1,00,000	
Stock A/c	Dr.	40,000	
Debtors A/c	Dr.	40,000	
Bank A/c	Dr.	10,000	
To Creditors A/c			80,000
To Business Purchase A/c			2,00,000
To Capital Reserve A/c [Balancing fig.]			10,000
(Being assets and liabilities taken over from Y Ltd. and also for recording excess of net assets over purchase consideration in Capital Reserve A/c)			
Liquidator of Y Ltd. A/c	Dr.	2,00,000	
To Equity Share Capital A/c			2,00,000
(Being payment of purchase consideration by way of issue of equity shares)			
Amalgamation Adjustment A/c	Dr.	25,000	
To Export Profit Reserve A/c			25,000
(Being statutory reserve carried forwarded)			

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Balance Sheet of X Ltd. as at 31st March, 2019

Particulars	Note No.	Amount
Equity and Liabilities		
1. Shareholder's Fund		
Share Capital	1	4,00,000
Reserves & Surplus	2	2,15,000
2. Non-Current Liabilities		
3. Current Liabilities		
Trade Payables	3	1,80,000
Total		**7,95,000**
Assets		
Non-Current Assets		
1. Fixed Assets		
Tangible Assets	4	**6,00,000**
2. Other Non-Current Assets	5	**25,000**
3. Current Assets		
Inventories	6	**70,000**
Trade Receivables	7	**70,000**
Cash & Cash Equivalents	8	**30,0000**
Total		**7,95,000**

Notes to Accounts: [Balance Sheet]

Particulars	Amount
1. Share Capital	
Issued, subscribed, called up and paid up 40,000 Equity shares of Rs. 10 each	4,00,000
[includes 20,000 equity shares issues as purchase consideration to Y Ltd.]	
2. Reserves & Surplus	
General Reserve [Rs. 75,000 – Rs. 15,000]	60,000
Export Profit Reserve (X Ltd. + Y Ltd.)	70,000
Profit and Loss A/c (X Ltd. + Y Ltd.)	60,000
	1,90,000

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Notes

Particulars	Amount
3. Trade Payables	
Sundry Creditors (X Ltd. + Y Ltd.)	1,80,000
4. Other Non-Current Asset [Amalgamation Adjustment A/c]	25,000
5. Tangible Assets	
Building	3,00,000
Machinery	3,00,000
	6,00,000
6. Inventories (Stock)	70,000
7. Trade Receivables (Debtors)	70,000
8. Cash & Cash Equivalents (Bank)	30,000

1.7 Accounting Procedure in the Books of Transferor/ Vendor Company

Journal Entries

1. **For transfer of all assets to Realization A/c:**

   Realisation A/c Dr.

   To Sundry Assets A/c [Individually]

   Note:

   (*a*) Fictitious assets should not be transferred to Realization A/c these are directly transferred to Shareholders A/c.

   (*b*) Debtors and Reserve for Doubtful Debts should be treated as separate Accounts.

2. **For transfer of all external liabilities to Credit side of Realization A/c:**

   Sundry Liabilities A/c Dr. [Individually]

   To Realization A/c

   Note:

   Entry to be passed for discharge of the liabilities [recorded/unrecorded/ contingent] not taken over by the Transferee Company :

   Realisation A/c Dr.

   To Bank A/c [Actual payment]

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3. Entry to record the sale of business *i.e.* for consideration due:

Transferee Company A/c Dr.

To Realization A/c (with amount of Purchase Consideration)

4. Treatment of Realisation Expenses in different cases:

(*a*) If borne and paid by Transferor Company:

Realisation A/c Dr.

To Bank A/c

(*b*) If borne and paid by Transferee Company : No Entry

(*c*) If paid by Transferor Company and then it is Fully or Partially Reimbursed by the Transferee Company :

(*i*) Realisation A/c Dr. [Payment by Transferor Company]

To Bank A/c

(*ii*) Bank A/c Dr. [Reimbursement by Transferee Company]

To Realization A/c

5. For closing Preference Share Capital A/c:

Amount payable to Preference Shareholders [at Par]

Preference Share Capital A/c Dr. [Face value]

To Preference Shareholders A/c

Amount payable to Preference Shareholders [at Premium]

Preference Share Capital A/c Dr. [Face value]

Realisation A/c Dr. [Premium payable]

To Preference Shareholders A/c

Amount payable to Preference Shareholders [at Discount]

Preference Share Capital A/c Dr. [Face value]

To Preference Shareholders A/c

To Realisation A/c [Discount]

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6. **To settle the claim of Preference shareholders:**

   Preference Shareholders A/c Dr.

   To Equity Shares in Transferee Co. A/c

   To Preference Shares in Transferee Co. A/c

   To Cash/Bank A/c

7. **For Receiving purchase consideration from transferee company:**

   Equity shares in transferee Company A/c Dr.

   Preference shares in transferee Company A/c Dr.

   Cash/Bank A/c Dr.

   To Transferee Company A/c

8. **For closing the Realisation A/c and transfer of profit/loss on Realisation to Equity Shareholders A/c:**

   (*a*) **If Profit :**

   Realisation A/c Dr.

   To Equity Shareholders A/c

   (*b*) **If Loss:**

   Equity Shareholders A/c Dr.

   To Realisation A/c

9. **For transfer of Equity Share Capital & other Reserves to Equity Shareholders A/c:**

   Equity Share Capital A/c Dr.

   Securities Premium A/c Dr.

   General Reserve A/c Dr.

   Profit & Loss A/c Dr.

   Capital Reserve A/c Dr.

   To Equity Shareholders A/c

10. **For transferring accumulated losses & fictitious assets to Equity Shareholders A/c:**

    Equity Shareholders A/c Dr.

    To Profit and Loss A/c

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To Preliminary Expenses A/c

To Exp. on issue of shares/debentures A/c

To Discount On issue of shares/debentures A/c

To Underwriting commission A/c

11. For closing the Equity Shareholders A/c:

Equity Shareholders A/c Dr.

To Equity Shares in Transferee Co. A/c

To Cash/Bank A/c

Note:

AS-14 has not stated any specific accounting treatment to be followed by the transferor company. The transferor company will pass entries for liquidation (sale) of its business and closure of its books of account. Accounting treatment in the books of Transferor Company is similar in both types of amalgamation whether it is Amalgamation in the nature of Merger or Amalgamation in the nature of Purchase.

Illustration 3: [Amalgamation in the nature of Purchase]

W Ltd. agreed to acquire the business of G Ltd. The Balance Sheet of G Ltd. on that date was as follows:

Liabilities	Amount	Assets	Amount
60,000 equity shares of Rs. 10 Each	6,00,000	Goodwill	1,00,000
General Reserve	1,70,000	Land & Building	2,30,000
Profit and Loss A/c	1,10,000	Plant & Machinery	4,10,000
12% Debentures	1,00,000	Stock	1,68,000
Creditors	20,000	Bank	56,000
		Debtors	36,000
	10,00,000		10,00,000

The consideration payable by W Ltd. was as follows:

(*a*) A cash payment of Rs. 2.50 for each share of Rs. 10 in G Ltd.

(*b*) The issue of 90,000 equity shares of no each fully paid in W Ltd. having an agreed value of Rs. 15 per share.

(*c*) W Ltd. agreed to discharge the 12% Debentures of G Ltd. at a Premium of 20% by allotment of its 14% Debentures at 96%.

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(*d*) While computing the consideration, the directors of W Ltd. valued the following Assets at values noted against them:

Land & Building Rs. 7,50,000, Plant & Machinery Rs. 4,50,000, Stock Rs. 1,42,000; Debtors subject to an allowance of 5% for doubtful debts.

(*e*) The cost of liquidation came to Rs. 5,000 which was borne by W Ltd.

Prepare Realisation A/c and give journal entries in the books of G Ltd. and W Ltd.

Solution:

Calculation of purchase consideration

Cash 60,000 × Rs. 2.50	Rs. 1,50,000
Shares 90,000 × Rs. 15	Rs. 13,50,000
Purchase Consideration	Rs. 15,00,000

Books of G Ltd.

Realisation A/c

Particulars	Amount	Particulars	Amount
Goodwill A/c	1,00,000	By 12% Debentures A/c	1,00,000
To Land & Building A/c	2,30,000	By Creditors A/c	20,000
To Plant & Machinery A/c	4,10,000	By W. Ltd. A/c	15,00,000
To Stock A/c	1,68,000	(Purchase Consideration)	
To Debtors A/c	36,000		
To Bank A/c	56,000		
To Equity Shareholders A/c (profit)	6,20,000		
	16,20,000		16,20,000

Journal Entries

Particulars	Dr. (Rs.)	Cr. (Rs.)
Realisation A/c Dr.	10,00,000	
To Goodwill A/c		1,00,000
To Land & Building A/c		2,30,000
To Plant & Machinery A/c		4,10,000

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Particulars		Dr. (Rs.)	Cr. (Rs.)
To Stock A/c			1,68,000
To Debtors A/c			36,000
To Bank A/c			56,000
(Being all the assets transferred to realisation account)			
12% Debentures A/c	Dr.	1,00,000	
Creditors A/c	Dr.	20,000	
To Realisation A/c			1,20,000
(Being all the liabilities transferred to realisation account)			
W. Ltd. A/c	Dr.	15,00,000	
To Realisation A/c			15,00,000
(Being agreed purchase consideration recorded on amalgamation)			
Bank A/c	Dr.	1,50,000	
Equity Shares in W Ltd. A/c	Dr.	13,50,000	
To W. Ltd. A/c			15,00,000
(Being equity shares and cash received in satisfaction of purchase consideration)			
Realisation A/c	Dr.	6,20,000	
To Equity Shareholders A/c			6,20,000
(Being profit on realisation transferred to shareholders account)			
Equity Share Capital A/c		6,00,000	
General Reserve A/c		1,70,000	
Profit & Loss A/c		1,10,000	
To Equity Shareholders A/c			8,80,000
(Being equity share capital and accumulated profits transferred to shareholders account)			
Equity Shareholders A/c		15,00,000	
To Equity Shares in Transferee Co. A/c			13,50,000
To Cash/Bank A/c			1,50,000
(Being equity shares and cash distributed among shareholders)			

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Notes

Journal Entries in the Books of W Ltd.

Particulars		Dr. (Rs.)	Cr. (Rs.)
Business Purchase A/c	Dr.	15,00,000	
To Liquidator of G Ltd. A/c			15,00,000
(Being purchase consideration payable recorded)			
Land & Building A/c	Dr.	7,50,000	
Plant & Machinery A/c	Dr.	4,50,000	
Stock A/c	Dr.	1,42,000	
Debtors A/c	Dr.	36,000	
Bank A/c	Dr.	56,000	
Goodwill A/c **(Bal. Fig.)**	Dr.	2,07,800	
To 12% Debentures A/c			1,20,000
To Creditors A/c			20,000
To Provision for Doubtful Debts A/c			1,800
(5% of Rs. 36,000)			
To Business Purchase A/c			15,00,000
(Being assets and liabilities taken over)			
Liquidator of G. Ltd. A/c	Dr.	15,00,000	
To Equity Share Capital A/c			9,00,000
To Securities Premium A/c			4,50,000
To Bank A/c			1,50,000
(Being shares allotted and cash paid in consideration)			
12% Debentures in G. Ltd. A/c	Dr.	1,20,000	
Discount on Issue of Debentures A/c	Dr.	5,000	
To 14% Debentures A/c			1,25,000
(Being discharge of liability of 12% debenture of G Ltd.)			
Securities Premium A/c	Dr.	5,000	
To Discount on Issue of Debentures A/c			5,000
(Being discount on issue of debentures set off against securities premium)			
Goodwill A/c	Dr.	5,000	
To Bank A/c			5,000
(Being cost of liquidation of G Ltd. paid)			

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Illustration 4:

A Ltd. takes over B Ltd. on 31.12.2019 on which date B's Balance Sheet stood as follows:

Liabilities	Amount	Assets	Amount
1,62,500 equity shares of Rs. 10 Each	16,25,000	Patents	2,12,500
		Building	18,00,000
5,000, 12% Preference Shares of Rs. 100 each	5,00,000	Debtors	1,42,500
		Preliminary Expenses	45,000
10% Debentures	3,75,000	Stock	1,25,000
Creditors	5,75,000	Profit & Loss A/c	7,50,000
	30,75,000		30,75,000

Preference Dividend is in arrears for 2 years A Ltd. takes over B Ltd. on the following terms:

(*i*) Take over patents after depreciating 10%; Building at Rs. 82,875 less; Debtors subject to a provision of 5% for bad debts; stock to be written off by Rs. 6,250.

(*ii*) Take over 10% Debentures.

(*iii*) Discharge the consideration by allotment of 50,000 equity shares of Rs. 10 each at an agreed value of Rs. 12 each of B Ltd. and balance in cash.

(*iv*) Preference shareholders of S Ltd. agreed to accept Rs. 4,50,000 in full settlement of the claim.

(*v*) The cost of winding up amounted to Rs. 10,000 to be borne by B Ltd.

Close the books B Ltd. and pass Journal entries in the book of A Ltd.

Solution:

Calculation of Purchase Consideration	Amount
Patent Rs. (2,12,500 - 21,500)	1,91,250
Building Rs. (18,00,000 - 82,875)	17,17,125
Debtors Rs. (1,42,500 - 7,125)	1,35,375
Stock Rs. (1,25,000 - 6,250)	1,18,750
Less : 10% Debentures and Creditors Rs. (3,75,000 + 5,75,000)	(9,50,000)
Discharge of Purchase consideration	**12,12,500**

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Calculation of Purchase Consideration	Amount
50,000 equity shares of no each at Rs. 12	6,00,000
Cash as balancing figure	6,12,500
	12,12,500

Realisation Account

Particulars	Amount	Particulars	Amount
To Patents A/c	2,12,500	By 10% Debentures A/c	3,75,000
To Building A/c	18,00,000	By Creditors A/c	5,75,000
To Debtors A/c	1,42,500	By A Ltd. A/c (Purchase Cons.)	12,12,500
To Preliminary Expenses A/c	45,000	By 12% Pref. Shareholders A/c	50,000
To Stock A/c	1,25,000	By Equity Shareholders (Loss)	77,500
To Bank A/c (Liquidation Expenses)	10,000		
	22,90,000		22,90,000

Bank Account

Particulars	Amount	Particulars	Amount
To A Ltd. A/c	6,12,500	By Realisation A/c (Expenses)	10,000
		By 12% Pref. Shareholders A/c	4,50,000
		By Equity Shareholders A/c	1,52,500
	6,12,500		6,12,500

12% Preference Share Account

Particulars	Amount	Particulars	Amount
By 12% Pref. Shareholders A/c	5,00,000	By Balance b/d	5,00,000
	5,00,000		5,00,000

12% Preference Shareholders Account

Particulars	Amount	Particulars	Amount
To Bank A/c	4,50,000	By 12% Pref. Share Capital A/c	5,00,000
To Realisation A/c	50,000		
	5,00,000		5,00,000

A Ltd. Account

Particulars	Amount	Particulars	Amount
To Realisation A/c	12,12,500	By Shares in A Ltd. A/c	6,00,000
		By Bank A/c	6,12,500
	12,12,500		12,12,500

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Equity Shareholders Account

Particulars	Amount	Particulars	Amount
To Preliminary Expenses A/c	45,000	By Equity Share Capital A/c	16,25,000
To Profit & Loss A/c	7,50,000		
To Realisation A/c (Loss)	77,500		
To Shares in A Ltd. A/c	6,00,000		
To Bank A/c	1,52,500		
	16,25,000		16,25,000

Amalgamation by way of Purchase:

In the books of A Ltd.

Particulars		Dr. (Rs.)	Cr. (Rs.)
Business Purchase A/c	Dr.	12,12,500	
To Liquidator of B Ltd. A/c			12,12,500
(Being purchase consideration payable as per scheme of amalgamation)			
Patent A/c	Dr.	1,91,250	
Building A/c	Dr.	17,17,125	
Stock A/c	Dr.	1,18,750	
Debtors A/c	Dr.	1,42,500	
To Business Purchase A/c			12,12,500
To Creditors A/c			7,125
To 10% Debentures A/c			3,75,000
To Provision for Bad Debts A/c			5,75,000
(Being assets and liabilities taken over from B Ltd.)			
Liquidator of B Ltd. A/c	Dr.	12,12,500	
To Equity Share Capital A/c			5,00,000
To Securities Premium A/c			1,00,000
To Bank A/c			6,12,500
(Being payment of purchase consideration by way of issue of equity shares and cash)			

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Notes

1.8 Dissenting Shareholders

Dissenting shareholders are those shareholders to whom scheme of amalgamation/absorption is not acceptable. Shares of dissenting shareholders may be acquired by the transferee company:

(*a*) On the same terms on which willing shareholders transferred their shares; or

(*b*) On the terms agreed upon between the amalgamated company and dissenting shareholders;

(*c*) On the terms ordered by the court.

Following steps may be followed to complete the accounting for dissenting shareholders:

(*i*) Transfer paid up value of share capital of Dissenting Shareholders to a separate account *i.e.* Dissenting Shareholders Accounting.

(*ii*) Accumulated Profits/Losses will not be transferred to Dissenting Shareholders Account.

(*iii*) Pass required entry for payment to Dissenting Shareholder.

(*iv*) If Dissenting Shareholders are paid more or less in comparison to willing shareholders then the difference is transferred to Realisation Account.

Illustration 5: [Dissenting Shareholders]

X Ltd. took over the business of Y Ltd. on the date of Balance Sheet which stood as follows:

Liabilities	Amount	Assets	Amount
24000 equity shares of Rs. 50 each	12,00,000	Sundry Fixed Assets	6,10,000
General Reserve	2,40,000	Bank	50,000
Profit and Loss A/c	1,30,000	Other Current Assets	10,60,000
Creditors	1,50,000		
	17,20,000		17,20,000

X Ltd. took over all the assets and liabilities of Y Ltd. except Rs. 20,000 to provide for winding up expenses and payment to dissenting shareholders The consideration was discharged by the allotment to the shareholders of the transferor company of one share of Rs. 100 (Rs. 90 paid up) of X Ltd. for every two shares in Y Ltd. amounted of Rs. 6,000 which was

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borne by Y Ltd. Dissenting shareholders of 200 shares were paid at Rs. 70 per share. Close the books of Y Ltd. and pass journal entries in the books of X Ltd.

Solution:

Realisation Account

Particulars	Amount	Particulars	Amount
To Sundry Fixed Assets A/c	6,10,000	By Creditors A/c	1,50,000
To Bank A/c	30,000	By X Ltd. A/c (Purchase Cons.)	10,71,000
To Other Current Assets A/c	10,60,000	By Equity Shareholders A/c (willing) (Loss)	4,89,000
To Bank A/c (Liquidation Expenses)	6,000		
To Dissenting Shareholders A/c	4,000		
	17,10,000		17,10,000

Shareholders Account (willing)

Particulars	Amount	Particulars	Amount
To Realisation A/c (Loss)	4,89,000	By Share Capital A/c (23,800 @ Rs. 50)	11,90,000
To Shares in X Ltd. A/c	10,71,000	By General Reserve A/c	2,40,000
		By Profit and Loss A/c	1,30,000
	15,60,000		15,60,000

X Ltd. Account

Particulars	Amount	Particulars	Amount
To Realisation A/c	10,71,000	By Shares in X Ltd. A/c	10,71,000
	10,71,000		10,71,000

Shares in X Ltd. Account

Particulars	Amount	Particulars	Amount
To X Ltd. A/c	10,71,000	By Shareholders A/c (Willing)	10,71,000
	10,71,000		10,71,000

Bank Account

Particulars	Amount	Particulars	Amount
To Balance bid	50,000	By Realisation A/c (Transfer)	30,000
		By Realisation A/c (Expenses)	6,000
		By Dissenting Shareholders A/c	14,000
	50,000		50,000

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Notes

In the books of X Ltd.

Particulars		Dr. (Rs.)	Cr. (Rs.)
Business Purchase A/c	Dr.	10,71,000	
To Liquidator of Y Ltd. A/c			10,71,000
(Being purchase consideration payable as per scheme of amalgamation)			
Sundry Fixed Assets A/c	Dr.	6,10,000	
Bank A/c	Dr.	30,000	
Other Current Assets A/c	Dr.	10,60,000	
To Creditors A/c			1,50,000
To Business Purchase A/c			10,71,000
To Capital Reserve A/c **[Balancing fig.]**			4,79,000
(Being assets and liabilities taken over from Y Ltd. and also for recording excess of net assets over purchase consideration in Capital Reserve A/c)			
Liquidator of Y Ltd. A/c	Dr.	10,71,000	
To Equity Share Capital A/c			10,71,000
(Being payment of purchase consideration by way of issue of equity shares)			

1.9 Summary

To 'Amalgamate' means to join or unite to form a larger organisation or group. It simply means taking over by a new company of two or more existing companies. Companies which are taken over go into liquidation and a new company is formed to take over business of these companies. According to Accounting Standard 14 - Amalgamation means an amalgamation pursuant to the provision of the Companies Act, 1956 or any other statute which may be applicable to the Companies, Amalgamation involves acquisition of one company by another. After Amalgamation, the acquired company is dissolved and ceases to exist.

Amalgamation involves two companies *i.e.* Transferor Company and Transferee Company Transferor company means a company, which is amalgamated into another company. The company selling its business is also called "Vendor Company". Transferee company means the company into which a transferor Company is amalgamated (purchasing company).

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The I.C.A.I. has issued Accounting Standard 14 governing the procedure and accounting of Amalgamation of companies. This standard is effective since the accounting period beginning on or after 01.04.1995 and is mandatory in nature. AS-14 does not make any difference between an amalgamation and absorption. It only recognizes two types of amalgamation that is Amalgamation in the nature of Merger and Amalgamation in the nature of Purchase.

Accounting Standard-14 only recognizes Pooling of Interest Method for 'Merger' and Purchase Method in case of 'Purchase'.

Purchase Consideration is the sale price of the business agreed mutually between the two parties, the transferor (Selling Co.) and the transferee (Purchasing Co.). AS-14 defines the Purchase Consideration as - "the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the "Shareholders of the Transferor Company". Lumpsum Method, Net Payment Method, Net Assets Method, Exchange of Shares Method/ Intrinsic Value Method are prominent methods of calculating purchase consideration.

In case of amalgamation, Transferor company loses its identity and its assets and liabilities becomes assets and liabilities of the Transferee company and these are presented in the financial statements of the transferee company, prepared subsequent to the date of amalgamation. Accounting treatment in the books of Transferee Company will be different in two types of amalgamation *i.e.* Amalgamation in the nature of Merger (Pooling of interest Method) and Amalgamation in the nature of Purchase (The purchase Method).

1.10 Questions For Practice

Exercise 1: Very Short Answer Type Questions

(*a*) Write any two basic differences between amalgamation, absorption and reconstruction.

....

....

....

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(*b*) Explain meaning of purchase consideration as per AS-14.

....

....

....

(*c*) What do you mean by dissenting shareholders.

....

....

....

Exercise 2: Descriptive Questions

1. Define amalgamation and explain types of amalgamation in brief.

   ....

   ....

   ....

2. Differentiate between amalgamation in the nature of purchase and amalgamation in the nature of merger.

   ....

   ....

   ....

3. What do you mean by purchase consideration as per Accounting Standard-14.

   ....

   ....

   ....

Exercise 3: True and False

(*a*) Distinction between amalgamation and absorption for accounting purpose is of no significance as per AS-14.

(*b*) Consideration means shares etc. received for shareholders of the transferor company.

(c) Provident fund represents accumulated past profits.

(*d*) External reconstruction and internal reconstruction is one and the same.

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(*e*) The term all assets includes discount on issue of securities also.

(*f*) Amalgamation Reserves appears in the books of the transferor company.

Ans.: (*a*) True (*b*) True (*c*) False (*d*) False (*e*) False (*f*) False

Exercise 4: Fill in the Blanks

(*a*) To ‘ _____________ ’ means to join or unite to form a larger organisation or group.

(*b*) Reconstruction is resorted to tide over the difficulties arising out of accumulated past losses or financial stringencies. It is of two types - _____________ and _____________.

(*c*) The I.C.A.I. has issued Accounting Standard _______ governing the procedure and accounting of Amalgamation of companies.

(*d*) Accounting Standard-14 only recognizes Pooling of Interest Method for ‘ ______________ ’ and Purchase Method in case of ‘ ______________’.

Ans.: (*a*) amalgamate (*b*) Internal and External (*c*) 14 (*d*) Merger and amalgamation in the nature of Purchase

Exercise 5: Practical Question

Following is the balance sheets of P Ltd. & S Ltd. as on 31-03-2019

Equity & Liabilities:	**P Ltd.**	**S Ltd.**
Equity Share Capital [Rs. 10 each]	8,000	3,000
10% Preference Share Capital [Rs. 100 each]	----	1,000
General Reserve	4,610	980
Statutory Reserve	390	125
Surplus Ale	563	355
12% Debenture	----	250
Trade payables	1,437	990
Total	**15,000**	**6,700**
Assets:		
Fixed Assets	11,000	4,730
Current Assets	4,000	1,970
Total	**6,700**	**6,700**

On 1st April 2019 P Ltd. takes over S Ltd. on the following terms—

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(*i*) P Ltd. will issue 3,50,000 equity shares of Rs. 10 each at par to the equity shareholders of S Ltd.

(*ii*) P Ltd. will issue 11,000 10% Preference shares of Rs. 100 each at par to the Preference shareholders of S Ltd.

(*iii*) The Debenture holders of S Ltd. will be converted into an equal number of 12.5% debentures of the same denomination.

You are informed that statutory reserves of S Ltd. are to be maintained for two more years. You are required to show the Balance Sheet of P Ltd. immediately after the above mentioned scheme of amalgamation has been implemented assuming that:

(*a*) The amalgamation is in the nature of purchase.

(*b*) The amalgamation is in the nature of merger.

Also pass journal entries of P Ltd. in both the cases.

Ans.: Purchase consideration – Rs. 4,60,000; (*a*) Capital Reserve – Rs. 8,60,000 (*b*) General Reserve – Rs. 3,80,000.

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LESSON

2

Internal Reconstruction

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STRUCTURE

2.1 *Learning Objectives*
2.2 *Concept of Internal Reconstruction*
2.3 *Difference between Internal and External Reconstruction*
2.4 *Reasons Responsible for Internal Reconstruction*
2.5 *Accounting Entries for Internal Reconstruction*
2.6 *Summary*
2.7 *Questions for Practice*

2.1 Learning Objectives

This Chapter will assist you to:

- Understand meaning of internal reconstruction.
- Differentiate between internal reconstruction and external reconstruction.
- Know the reasons responsible for internal reconstruction.
- Accounting entries to be passed in case of internal reconstruction.

2.2 Concept of Internal Reconstruction

Reconstruction is resorted to tide over the difficulties arising out of accumulated past losses or financial stringencies. It is of two types, external and internal. External reconstruction takes place when a new company is floated to take over an existing company. The latter company is wound up. A Ltd. is formed to take over the business of B Ltd.; in this case B Ltd. will wound up and shareholders of B Ltd. will become the shareholder of A Ltd.

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Notes

and it is a case of external reconstruction. So, in case of external reconstruction one liquidation and one formation take place.

Internal reconstruction means a scheme undertaken to make necessary changes in the capital structure of a company without liquidating the existing company to infuse new life in that company. It simply means the reduction of capital without going into liquidation. Thus in internal reconstruction, neither any company goes into liquidation nor is a new company formed. Reconstruction is a means available for continuously loss making and sick companies to move on a revival path.

Note: External reconstruction is almost similar to absorption and accounting treatment of external reconstruction will be same as it is done in the case of 'Amalgamation in the nature of Merger' [AS-14]. Section 319 of Companies Act, 2013 deals with the issues related with external reconstruction.

2.3 Difference Between Internal and External Reconstruction

Basis	Internal Reconstruction	External Reconstruction
Liquidation	No Liquidation	Existing company gets liquidated
Formation	No Formation	Here a new company comes into picture which takes over the business of the old company
Relevant Section of Co.'s Act	Section 66 of Companies Act, 2013	Section 319 of Companies Act, 2013

2.4 Reasons Responsible for Internal Reconstruction

The following reasons force the company for the internal reconstruction:

(*i*) When there is an overvaluation of assets and undervaluation of liabilities.

(*ii*) When company is suffering from continuous losses and it becoming difficulty for it to solve the financial crisis.

(*iii*) When there are huge accumulated losses and it is required to write off these losses to depict a fair view of the state of affairs of the company.

(*iv*) When there is a complex capital structure of the company and it is required to make it simple.

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2.5 Accounting Entries for Internal Reconstruction

When scheme of reconstruction is approved for a particular company then an Account titled 'Capital Reduction Account' or 'Internal Reconstruction Account' or 'Capital Reorganization Account' is opened, the entries to be passed can be briefed in following two lines:

An appreciation in the value of an asset or reduction in the amount of a liability should be debited to the Account concerned & credited to 'Capital Reduction Account' also called 'Internal Reconstruction Account'.

After passing all concerned entries under the scheme; the balance so generated is transferred to 'Capital Reduction Account' [Reconstruction A/c] which is used to of write off all fictitious assets (including Goodwill, Patents) and eliminate all over valued assets by crediting the accounts concerned & Debiting 'Capital Reduction A/c'.

Alteration of Share Capital:

A company can alter its share capital; alteration never leads to reduction of share capital. The alteration of share capital may be done in following different ways:

A company can alter share capital in any of the following ways:

(*a*) The company may increase its capital by issuing new shares.

(*b*) It may consolidate the whole or any part of its share capital.

(*c*) It may sub-divide the whole or any part of its share capital.

(*d*) It may convert shares into stock or *vice versa.*

(*e*) Through surrender of shares.

(*f*) It may cancel some of its unissued shares.

Explanation of the above points:

(*a*) Increase in share capital by the issue of new shares.

(*b*) Consolidation of Shares:

Consolidation refers to conversion of shares of the smaller denomination into shares of larger denomination e.g. 5,000 equity shares of Rs. 10 each can be consolidated into 500 shares of Rs. 100 each. Following journal entry is passed for consolidation purpose:

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Share Capital A/c (Old Denomination) Dr.

To Share Capital A/c (New Denomination)

(*c*) Sub-division of shares:

When the shares of a company are sub-divided in shares of small value, it is known as sub-division of shares. For example X Ltd. decided to sub-divide its 4,000 Equity Shares of Rs. 100 each fully paid up into Equity Shares of Rs. 10 each fully paid up. Journal entry for sub-division is passed in the same way as it was passed in the last case.

(*d*) Conversion of shares into stock:

A company may convert all or any of its fully paid up shares into Stock or Stock into fully paid up shares. **Entry for conversion of shares into stock:**

Equity Share Capital A/c Dr.

To Equity Stock A/c

Entry for conversion of stock into shares:

Equity Stock A/c Dr.

To Equity Share Capital A/c

(*e*) Surrender of Shares:

Surrender of shares means - to give up the possession of some shares by its holders. Such surrendered shares may be either used for immediate cancellation or for issue to some of the creditors/ debenture holders of the company in satisfaction of their claim in full or in part.

Journal entries to be passed for surrender of shares is:

Share Capital A/c Dr.

To Share Surrendered A/c

Here it must be noted that equity as well as preference shares may be surrendered. Such surrendered shares may be either used for immediate cancellation or for issue to some of the creditors/ debenture holders of the company in satisfaction of their claim in full or in part.

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Unutilised Balance of Surrendered shares should be transferred to capital Reduction A/c

Share Surrendered A/c Dr.

To Capital Reduction/Reconstruction A/c

Note: Company can surrender only fully paid shares.

(*f*) **Cancellation of Unissued Shares:**

Under this company simply cancels its unissued shares. At the time of drafting companies balance sheet after reconstruction authorised capital of the company shall be reduced with the amount of cancelled shares; at the same time capital clause of Memorandum should also be amended accordingly.

Variation of Shareholders Right

A company may change dividend rate on its Preference Shares e.g. 10% Preference Shares to 12% Preference Shares or just opposite of it; company may also convert its cumulative shares into non-cumulative preference. Following entry will be passed for the above example:

10% Preference Share Capital A/c Dr.

To 12% Preference Share Capital A/c

Compromise/Arrangement

Chapter XV of Companies Act, 2013 [Section 230 to Section 240] deals with the matter related to Compromise, Arrangement and Amalgamation in detail. Compromise or arrangement may be proposed between

(*i*) a company and its creditors or any class of them; [Section 230(1)(*a*)]

Or

(*ii*) a company and its members or any class of them, [Section 230(1)(*b*)]

Compromise and arrangement is an agreement between company and its different stakeholders for the purpose of saving the company from financial problems and crisis. Company may enter into an agreement with its Shareholders/Creditors/Debenture holders through which they may agree to Compromise on their claims by sacrificing a portion of what they are entitled to.

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Notes

Reduction of Share Capital

Legal requirements for capital reduction-As per Section 66(1) of Companies Act, 2013 a company limited by shares or a company limited by guarantee and having a share capital may reduce its share capital by passing a special resolution and after getting confirmation by the Tribunal on an application by the company.

A company can reduce its share capital in the followings ways:

1. By extinguishing or reducing the liability on any of its shares in respect of the share capital not paid-up; [Section 66(1)(*a*)] Or
2. By cancelling any paid-up share capital which is lost or is unrepresented by available assets; [Section (66)(*b*)(*i*)] Or
3. By paying off any paid-up share capital which is in excess of the wants of the company, [Section (66)(*b*)(*i*)]

Note: Company must add the expression " ......And Reduced" with its name for the period prescribed.

On the basis of the discussion above we may compile the entries as under:

1. When the face value of share is changed: [reduction in nominal value]

Share Capital A/c (old) Dr. (With paid up value of old shares)
  To Share Capital A/c (new) (paid up value of new shares)
  To Capital Reduction A/c (With difference)

2. When there is reduction in paid up value of share capital (face value is not changed) —

Share Capital A/c Dr.

  To Capital Reduction A/c (With the amount of reduction).

3. When shares are consolidated —

Share Capital A/c (say Rs. 10) Dr.

  To Share Capital A/c (say Rs. 100)

4. When Shares are sub-divided —

Share Capital A/c (say Rs. 100) Dr.

  To Share Capital A/c (say Rs. 10)

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5. When any sacrifice is made by the creditors —

Creditors A/c (with sacrifice) Dr.

To Capital Reduction A/c

6. When the value of any asset is appreciated —

Asset A/c (increase in value) Dr.

To Capital Reduction A/c

7. Entry for decreasing (writing off) the value of asset —

Capital Reduction A/c Dr.

To Asset A/c (decrease in value)

8. For Reduction in the value of liability —

Liability A/c Dr.

To Capital Reduction A/c [with amount of sacrifice made by creditors]

9. Entry for increasing the liability —

Capital Reduction A/c [with amount of increase in liability] Dr.

To Liability A/c

10. For recording new liability or provision —

Capital Reduction A/c Dr.

To Concerned Liability A/c

To Concerned Provision A/c

11. When contingent liability/unrecorded liability is paid for —

Capital Reduction A/c Dr.

To Bank A/c

12. When recorded assets are disposed off —

Bank A/c Dr.

To Assets A/c

To Capital Reduction A/c [Profit]

13. When an unrecorded assets is sold off —

Bank A/c Dr.

To Capital Reduction A/c

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Notes

14. For recording bad Debts & doubtful Debts —

Capital Reduction A/c Dr.

To Debtors A/c [with bad debts]

To provision for doubtful Debts A/c [with doubtful debts]

15. When shares are converted into stock —

Share Capital A/c Dr.

To Share Stock A/c

16. When Reconstruction expenses are paid —

Capital Reduction A/c Dr.

To Bank A/c

17. When finance is raised by issue of shares —

Bank A/c Dr.

To Share Capital A/c

18. When arrears of preference dividend are cancelled- No Entry

19. When the rate of preference dividend is changed —

x% Preference Share Capital A/c (Old) Dr.

To y% Preference Share Capital A/c (New)

20. When new debentures are exchanged —

x% Debentures A/c [Old]

To y% Debentures A/c [New]

21. When new debentures are issued for old & sacrifice is also made by the debenture holders —

x% Debentures A/c [Old] Dr.

To y% Debentures A/c [New]

To Capital Reduction A/c [with sacrifice/reduced liability]

22. For sacrifice made by debenture holders of Accrued Interest on debentures [given inside Balance Sheet] —

Outstanding/Accrued Interest on Debentures A/c Dr.

To Capital Reduction A/c

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23. When provision for taxation, Capital Reserve, Securities Premium is utilised for this purpose:

Provision for Taxation A/c Dr.

Capital Reserve A/c Dr.

Securities Premium A/c Dr.

To Capital Reduction A/c

24. When capital reduction is utilised for writing off fictitious assets, losses and excess value of other assets:

Capital Reduction A/c Dr.

To Profit and Loss A/c

To Goodwill A/c

To Preliminary Expenses A/c

To Discount on Shares/Debentures A/c

To Other Assets A/c

To Capital Reserve A/c (if any balance is left)

Note :

1. After implementation of the whole of reconstruction process the New Balance Sheet of the Company must use…..And Reduced term with its name.
2. The expressions Capital Reduction A/c or Reconstruction A/c or Reorganisation A/c are one and the same.

Format of [Reconstruction A/c] Capital Reduction A/c

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To P & L A/c (Loss written off)		By Share Capital A/c (Amount of reduction)	
To Goodwill/Patent/Copyright/trade Mark A/c (Written off)		By Debentures A/c (Amount of Reduction)	
To Preliminary expenses A/c (Written off)		By Creditors A/c (Amount of Sacrifice)	
To Discount/Expenses on Shares/ Debentures (Written off)		By Assets A/c (Increase in value)	
To Assets A/c (Decrease in value)		By Bank A/c (sale of unrecorded assets)	

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Notes

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Bank A/c (for paying Reconstruction Expenses) To Bank A/c (for paying unrecorded liability) To Capital Reserve (Balancing figure)*		By any Accumulated Profit A/c (If required-* Bal. Fig.)	

Illustration 1:

The following is the Balance Sheet of Megha Ltd. as on 30th June 2019

Liabilities	Rs.	Assets	Rs.
Share Capital:		Goodwill	1,20,000
8,000 equity shares of Rs. 100 each	8,00,000	Land & Building	3,00,000
fully paid		Plant & Machinery	6,00,000
10% 10,000 pref. shares of Rs. 100	6,00,000	Stock	4,40,000
each fully paid		Patent	60,000
Capital Reserve	20,000	Bank	10,000
11% Debentures	6,00,000	Debtors	3,00,000
Creditors	4,00,000	Preliminary Expenses	50,000
		Profit and Loss A/c	5,40,000
	24,20,000		24,20,000

The scheme of reconstruction was approved as follows —

(*a*) Equity Shares to be reduced to fully paid as Rs. 50 each.

(*b*) 10% 10,000 Preference Shares of Rs. 100, to be converted into 11% Preference Shares, the amount being reduced by 30%.

(*c*) Debentures to be reduced by 20%.

(*d*) Land and Building to be increased by 20%.

(*e*) All intangible and fictitious assets including patents to be written off.

Pass journal entries and prepare Reconstruction Account and Balance Sheet after the above scheme has been put through.

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Notes

Solution:

Journal Entries in the Books of Megha Ltd.

Particulars	Dr. (Rs.)	Cr. (Rs.)
10% Preference Share Capital A/c Dr.	6,00,000	
To 11% Preference Share Capital A/c		4,20,000
To Reconstruction A/c		1,80,000
(For conversion of 10% preference shares into 11% preference shares and reduction of 30% amount balance transferred to reconstruction account)		
Equity Share Capital A/c [Rs. 100] Dr.	8,00,000	
To Equity Share Capital A/c [Rs. 50]		8,00,000
To Reconstruction A/c		-----
(For reduction of 8,000 equity shares of Rs. 100 each fully paid into 8,000 equity shares of Rs. 50 each fully paid)		
11% Debentures A/c Dr.	1,20,000	
To Reconstruction A/c		1,20,000
(For reduction in liability for 11% debentures by 20%)		
Land and Building A/c Dr.	60,000	
To Reconstruction A/c		60,000
(For increasing the value of land and building and transferring the resultant balance to reconstruction account)		
Capital Reserve A/c Dr.	10,000	
To Reconstruction A/c		10,000
(For transfer of required amount from capital reserve account to reconstruction account to make the scheme successful)		
Reconstruction A/c Dr.	7,70,000	
To Profit and Loss A/c		5,40,000
To Preliminary Expenses A/c		50,000
To Goodwill A/c		1,20,000
To Patent A/c		60,000
(For utilising the amount available in reconstruction account to write off intangible assets and accumulated losses)		

Reconstruction A/c

Particulars	Amount	Particulars	Amount
To Profit and Loss A/c	5,40,000	By 10% Preference Share Capital A/c	1,80,000
To Preliminary Expenses A/c	50,000	By Equity Share Capital A/c	4,00,000
To Goodwill A/c	1,20,000	By 11% Debentures A/c	1,20,000
To Patent A/c	60,000	By Land and Building A/c	60,000
		By Capital Reserve	10,000
	7,70,000		7,70,000

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Notes

Megha Ltd.

Balance Sheet (and reduced) as at 30th June 2019

Particulars	Note No.	Amount
Equity and Liabilities		
1. Shareholder's Fund		
Share Capital	1	8,20,000
Reserves & Surplus	2	10,000
2. Share Application Money Pending Allotment		
3. Non-current Liabilities		
Long-term Borrowings		4,80,000
4. Current Liabilities		
Trade Payables (Sundry Creditors)	3	4,00,000
Total		**17,10,000**
Assets		
Non-current Assets		
1. Fixed Assets		
Tangible Assets	4	9,60,000
2. Current Assets		
Inventories (Stock)		4,40,000
Trade Receivables (Debtors)		3,00,000
Cash & Cash Equivalents (Bank)		10,000
Total		**17,10,000**

Notes to Account: [Balance Sheet]

	Particulars		Amount
1.	**Share Capital**		
	Authorised		
	Issued subscribed and paid up capital		4,00,000
	8,000 Equity Shares of Rs. 50 each		4,20,000
	6,000, 11% Preference Share Capital of Rs. 70 each		8,20,000
2.	**Reserves & Surplus**		
	Capital Reserve	Rs. 20,000	
	Less: utilised and transferred to reconstruction A/c	Rs. 10,000	10,000
3.	**Long-term Borrowings**		4,80,000
	11% Debentures		
4.	**Tangible Assets**		
	Land and Building	Rs. 3,00,000	
	Add: Increased under scheme of reconstruction	Rs. 60,000	3,60,000

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Notes

Illustration 2:

Following is the Balance Sheet of Bharat Co. Ltd. as on 31st March 2019

Liabilities	Amount	Assets	Amount
Authorised:	10,00,000	Patent at Cost	8,50,000
10,000 Equity Shares of Rs. 100		Leasehold Premises	1,30,800
each fully paid		Plant and Machinery	42,200
		Sundry Debtors	76,500
		Stock in Trade	55,000
10,000 9% Pref. Shares of Rs. 100	10,00,000	Discount on Issue of	18,000
each fully paid		Securities	12,000
		Preliminary Expenses	1,15,000
Subscribed Capital:	5,00,000	Profit and Loss A/c	500
5,000 Equity Shares of Rs. 100		Cash in Hand	
each fully paid			
7,500 9% Pref. Shares of Rs. 100	7,50,000		
each fully paid	30,000		
Sundry Creditors Rs.	20,000		
Bank Overdraft			
	13,00,000		13,00,000

Note: Preference Dividend in arrear for the last four years.

The company suffered huge losses and was not getting well. The following scheme of reduction of capital was adopted:

(*a*) The Preference Shares be reduced to an equal number of fully paid shares of Rs. 50 each.

(*b*) The Equity Shares reduced to an equal number of fully paid shares of Rs. 25 each.

(*c*) No payment to be made for arrears of preference dividend.

The amount available to be used to write off Discount on Issue of Securities, Preliminary Expenses, Profit and Loss A/c completely and to write off Rs. 30,800 on the leasehold premises, Rs. 15,000 of stock, 20% of Plant and Machinery and Sundry Debtors and the balance available of patents.

Journalise the above transactions; prepare Reconstruction A/c and Balance Sheet after the completion of reconstruction process.

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Notes

Solution:

Journal Entries in the Books of Bharat Co. Ltd.

Particulars		Dr. (Rs.)	Cr. (Rs.)
Equity Shares Capital A/c (Rs. 100)	Dr.	5,00,000	
9% Preference Share Capital A/c (Rs. 100)	Dr.	7,50,000	
To Equity Shares Capital A/c (Rs. 25)			1,25,000
To 9% Preference Share Capital A/c (Rs. 50)			3,75,000
To Capital Reduction A/c			7,50,000
(Being face value of Equity Shares and 9% Preference Share reduced balance so generated transferred to capital reduction account)			
Capital Reduction A/c	Dr.	7,50,000	
To Discount on Issue of Securities A/c			18,000
To Preliminary Expenses A/c			12,000
To Profit and Loss A/c			1,15,000
To Leasehold Premises A/c			30,800
To Plant and Machinery A/c			8,440
To Stock A/c			15,000
To Provision for Bad Debts A/c			15,300
To Patents A/c (Bal. Fig.)			5,35,460
(Being balance of capital reduction account utilised to write off various fictitious assets and to write down the other assets.)			

Reconstruction A/c

Particulars	Amount	Particulars	Amount
To Discount on Issue of Securities A/c	18,000	By Equity Shares Capital A/c	3,75,000
To Preliminary Expenses A/c	12,000	By 9% Preference Share Capital A/c	3,75,000
To Profit and Loss A/c	1,15,000		
To Leasehold Premises A/c	30,800		
To Plant and Machinery A/c	8,440		
To Stock A/c	15,000		
To Provision for Bad Debts A/c	15,300		
To Patents A/c (Bal. Fig.)	5,35,460		
	7,50,000		7,50,000

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Bharat Co. Ltd.

Balance Sheet as at 31-03-2019

Particulars	Note No.	Amount
Equity and Liabilities		
1. Shareholder's Fund		
Share Capital	1	5,00,000
Reserves & Surplus		
2. Share Application Money Pending Allotment		
3. Non-Current Liabilities		
Long-term Borrowings		
4. Current Liabilities		
Trade Payables (Sundry Creditors)		30,000
Other Current Liabilities (Bank Overdraft)		20,000
Total		**5,50,000**
Assets		
Non-Current Assets		
1. Fixed Assets	2	1,33,760
Tangible Assets	3	3,14,540
Intangible Assets		
2. Current Assets		
Inventories (Stock)		40,000
Trade Receivables (Debtors)	4	61,200
Cash & Cash Equivalents (Bank)		500
Total		**5,50,000**

Notes to Account: [Balance Sheet]

Particulars	Amount
1. Share Capital	
Authorised :	2,50,000
10,000 Equity Shares of Rs. 25 each	5,00,000
10,000 9% Pref. Shares of Rs. 50 each	7,50,000
Subscribed Capital :	1,25,000
5,000 Equity Shares of Rs. 25 each fully paid	3,75,000
7,500 9% Pref. Shares of Rs. 50 each fully paid	5,00,000

Particulars		Amount
2. Tangible Assets		
Leasehold Premises	Rs. 1,30,800	
Less : Written off	Rs. 30,800	1,00,000

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Plant and Machinery	Rs. 42,200	
Less: Written off	Rs. 8,440	33,760
		1,33,760
3. Intangible Assets		
Patent	Rs. 8,50,000	
Less: Written off	Rs. 5,35,460	3,14,540
4. Trade Receivables		
Sundry Debtors	Rs. 76,500	
Less: Provision for Doubtful Debts	Rs. 15,300	61,200

Illustration 3: [Surrender of Shares]

A company has equity share capital of Rs. 10,00,000 consisting 10,000 shares of Rs. 100 each. It is resolved to:

(*a*) Sub-divide the shares into shares of Rs. 10 each.

(*b*) Ask their shareholders to surrender 50% of their shares.

(*c*) Issue 60% of the surrendered shares to 15% debenture holders of Rs. 4,00,000 in full settlement of their claims.

(*d*) Cancel the unissued surrendered shares. Give entries in the books of the company.

Solution:

Particulars		Dr. (Rs.)	Cr. (Rs.)
Equity Share Capital A/c (Rs. 100)	Dr.	10,00,000	
To Equity Share Capital A/c (Rs. 10)			10,00,000
(For sub-division of equity shares into Rs. 10 each)			
Equity Share Capital A/c	Dr.	5,00,000	
To Surrendered Shares A/c			5,00,000
(For surrender of 50% shares)			
Surrendered Shares A/c	Dr.	3,00,000	
15% Debentures A/c	Dr.	4,00,000	
To Equity Share capital A/c			3,00,000
To Capital Reduction A/c			4,00,000
(For issue of 60% surrendered shares to debenture holders in full settlement of their claims)			
Surrendered Shares A/c	Dr.	2,00,000	
To Capital Reduction A/c			2,00,000
(For cancellation of unissued surrendered shares)			

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Illustration 4: [Surrender of Shares]

The balance sheet of revised Ltd. as at 31st March, 2019:

Liabilities	Amount	Assets	Amount
10,000 Equity shares of Rs. 100 each	10,00,000	Machinery	1,00,000
P & L A/C	(6,00,000)	Stock	3,20,000
12% Debentures	2,00,000	Debtors	2,70,000
Accrued Interest	24,000	Bank	30,000
Creditors	72,000		
Provision for income tax	24,000		
	7,20,000		**7,20,000**

It was decided to reconstruct the company for which necessary resolution was passed and sanctions were obtained from appropriate authorities. Accordingly, it was decided that:

(*a*) Each share be sub-divided into 10 fully paid equity shares of Rs. 10 each.

(*b*) After sub-division, each shareholder shall surrender to the company 50% of their holdings for the purpose of re-issue to debenture holders and creditors as necessary.

(*c*) Out of shares surrendered, 10,000 shares of Rs. 10 each shall be converted into 12% preference shares of Rs. 10 each fully paid up.

(*d*) The claims of the debenture-holders shall be reduced by 75%. In consideration of the reduction, the debenture holders shall receive preference shares of Rs. 1,00,000 which are converted out of shares surrendered.

(*e*) Creditors claim shall be reduced to 50%, the reduced claims to be settled by equity shares of Rs. 10 each out of the shares surrendered.

(*f*) The shares surrendered and not re-issued shall be cancelled.

(*g*) Balance of profit and loss account to be written off.

Pass necessary journal entries.

Solution:

Particulars	Dr. (Rs.)	Cr. (Rs.)
Equity Share Capital A/c (Rs. 100) Dr.	10,00,000	
To Equity Share Capital A/c (Rs. 10)		10,00,000
(For sub-division of equity shares into Rs. 10 each)		

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Particulars		Dr. (Rs.)	Cr. (Rs.)
Equity Share Capital A/c	Dr.	5,00,000	
To Surrendered Shares A/c			5,00,000
(For surrender of 50% shares)			
Surrendered Shares A/c	Dr.	1,00,000	
To 12% Preference Share Capital A/c			1,00,000
(For issue of 10,000 shares of Rs. 10 each from surrendered shares to debenture holders in settlement of their claims)			
12% Debentures A/c	Dr.	1,50,000	
Accrued Interest A/c	Dr.	18,000	
To Capital Reduction A/c			1,68,000
(For transfer of 75% of claims of debenture-holders to capital reduction A/c)			
Surrendered Shares A/c	Dr.	36,000	
To Equity Share Capital A/c (Rs. 10)			36,000
(For issue of 3,600 shares of Rs. 10 each from surrendered shares to creditors in settlement of their claims)			
Sundry Creditors A/c	Dr.	72,000	
To Capital Reduction A/c			72,000
(For transfer of Sundry Creditors amount to capital reduction A/c)			
Surrendered Shares A/c	Dr.	3,64,000	
To Capital Reduction A/c			3,64,000
(For cancellation of shares surrendered)			
Capital Reduction A/c	Dr.	6,04,000	
To Profit & Loss A/c			6,00,000
To Capital Reserve A/c			4,000
(For writing off Profit & Loss A/c debit balance of Rs. 6,00,000 and balance of Rs. 4,000 transferred to capital reserve A/c)			

When Profit and Loss Account Balance is Not Given

In some of the examination problems we get Profit and Loss A/c (Dr.) balance missing; in that case we must prepare Memorandum Balance Sheet of the company first by incorporating available information's of assets and liabilities. Balancing figure is considered as - Profit and Loss A/c (Dr.); now we must proceed in the usual manner.

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Illustration 5: [Preparation of Opening Balance Sheet]

The ledger balance of XYZ Ltd. as on 31st March 2019, are as follows –

Particulars	Amount (Rs.)
Land and Building	5,00,000
Plant and Machinery	2,00,000
Investment	1,00,000
Stock	6,00,000
Sundry Debtors	2,50,000
Cash at Bank	35,000
Preliminary Expenses	15,000
Equity Share Capital (shares of Rs. 10 each)	10,00,000
10% Debentures (debentures of Rs. 100 each)	8,00,000
Interest on Debentures	80,000
Sundry Creditors	9,20,000

Due to heavy losses, the following scheme of reconstruction is agreed:

1. To reduce the equity shares to Re. 1 each;
2. To reduce the value of Plant and Machinery, Investment and Stock by 10%;
3. To appreciate Land and Building to 50%;
4. To cancel the claim of debenture holders for interest on debentures;
5. To reduce the claim of creditors to Rs. 8,50,000;
6. To pay expenses of reconstruction amounting to Rs. 10,000;
7. To make a provision of Rs. 50,000 for doubtful debts; and
8. To write off fictitious assets and profit and loss account.

Assuming that all formalities are duly complied with, pass journal entries to give effect to the above scheme and prepare Reconstruction A/c.

Solution:

Memorandum Balance Sheet of XYZ Ltd. as on 31st March 2019

Liabilities	Rs.	Assets	Rs.
1,00,000 equity shares of Rs. 10 each fully paid	10,00,000	Land and Building	5,00,000
		Plant & Machinery	2,00,000
10% Debentures	8,00,000	Investment	1,00,000

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Liabilities	Rs.	Assets	Rs.
Interest on Debentures	80,000	Stock	6,00,000
Sundry Creditors	9,20,000	Debtors	2,50,000
		Cash at Bank	35,000
		Preliminary Expenses	15,000
		Profit and Loss A/c (bal. fig)	11,00,000
	28,00,000		28,00,000

Journal Entries in the Books of XYZ Ltd.

Particulars		Dr. (Rs.)	Cr. (Rs.)
Equity Share Capital A/c (Rs. 10)	Dr.	10,00,000	
To Equity Share Capital A/c (Re. 1)			1,00,000
To Reconstruction A/c			9,00,000
(Being conversion of Equity Shares of Rs. 10 each into Equity Shares of Re. 1 each)			
Land and Building A/c	Dr.	2,50,000	
To Reconstruction A/c			2,50,000
(Being value of land and building appreciated)			
Interest on Debentures A/c	Dr.	80,000	
To Reconstruction A/c			80,000
(Being Interest on Debenture cancelled and amount transferred to reconstruction account)			
Sundry Creditor A/c	Dr.	70,000	
To Reconstruction A/c			70,000
(Being claim of creditors reduced by Rs. 70,000)			
Reconstruction A/c	Dr.	10,000	
To Bank A/c			10,000
(Being reconstruction expenses paid)			
Reconstruction A/c	Dr.	90,000	
To Plant & Machinery A/c			20,000
To Investment A/c			10,000
To Stock A/c			60,000
(Being value of Plant & Machinery, Investment and Stock A/c reduced)			

Reconstruction Account

Particulars	Rs.	Particulars	Rs.
To Plant & Machinery A/c	20,000	By Equity Shares Capital A/c	9,00,000
To Investment A/c	10,000	By Land and Building A/c	2,50,000
To Stock A/c	60,000	By Interest on Debentures A/c	80,000

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Particulars	Rs.	Particulars	Rs.
To Bank A/c (Expenses paid)	10,000	By Sundry Creditor A/c	70,000
To Provision for Doubtful Debts A/c	50,000		
To Preliminary Expenses A/c	15,000		
To Profit and Loss A/c	11,00,000		
To Capital Reserve A/c [Balancing Figure]	35,000		
	13,00,000		13,00,000

2.6 Summary

Internal reconstruction means a scheme undertaken to make necessary changes in the capital structure of a company without liquidating the existing company to infuse new life in that company. It simply means the reduction of capital without going into liquidation. Thus in internal reconstruction, neither any company goes into liquidation nor is a new company formed. Reconstruction is a means available for continuously loss making and sick companies to move on a revival path.

When scheme of reconstruction is approved for a particular company then an Account titled 'Capital Reduction Account' or 'Internal Reconstruction Account' or 'Capital Reorganization Account' is opened, the entries to be passed can be briefed as -An appreciation in the value of an asset OR reduction in the amount of a liability should be debited to the Account concerned & credited to 'Capital Reduction Account' also called 'Internal Reconstruction Account'. After passing all concerned entries under the scheme; the balance so generated is transferred to 'Capital Reduction Account' [Reconstruction Ale] which is used to of write off all fictitious assets (including Goodwill, Patents) and eliminate all over valued assets by crediting the accounts concerned & Debiting 'Capital Reduction Ale'.

A company can alter its share capital; alteration never leads to reduction of share capital. The alteration of share capital may be done in different ways such as - company may increase its capital by issuing new shares or it may consolidate the whole or any part of its share capital or it may sub-divide the whole or any part of its share capital or it may convert shares into stock or *vice versa.*

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Notes

Chapter XV of Companies Act, 2013 [Section 230 to Section 240] deals with the matter related to Compromise, Arrangement and Amalgamation in detail. Compromise or arrangement may be proposed between - a company and its creditors or any class of them; [Section 230(1)(*a*)] or a company and its members or any class of them, [Section 230(1)(*b*)]. Compromise and arrangement is an agreement between company and its different stakeholders for the purpose of saving the company from financial problems and crisis. Company may enter into an agreement with its Shareholders/Creditors/Debenture holders through which they may agree to Compromise on their claims by sacrificing a portion of what they are entitled to.

2.7 Questions For Practice

Exercise 1: Very Short Answer Type Questions

(*a*) What are the reasons responsible for Internal Reconstruction?

....

....

....

(*b*) What do you mean by consolidation of shares?

....

....

....

(*c*) How will you close capital reconstruction account?

....

....

....

Exercise 2: Descriptive Questions

1. What is meant by internal reconstruction?

....

....

....

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2. Distinguish between internal and external reconstruction.

 ....

 ....

 ....

3. What do you mean by disposal of balance in reconstruction account ?

 ....

 ....

 ....

4. Write a note on surrender of shares?

 ....

 ....

 ....

5. What do you mean by capital reduction?

 ....

 ....

 ....

Exercise 3: Fill in the Blanks

(*a*) Reconstruction is resorted to tide over the difficulties arising out of accumulated past losses or financial stringencies. It is of two types - ___________ and ___________

(*b*) **Entry for conversion of shares into stock**

Equity Share Capital A/c Dr.

To ___________ A/c

(*c*) ___________________ reconstruction is almost similar to absorption and accounting treatment of external reconstruction will be same as it is done in the case of 'Amalgamation in the nature of Merger'.

Ans.: (*a*) Internal and Reconstruction (*b*) Share Stock Account (*c*) External

Exercise 4: True and False

(*a*) Internal reconstruction means a scheme undertaken to make necessary changes in the capital structure of a company without liquidating the existing company to infuse new life in that company.

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Notes

(*b*) A company can alter its share capital; alteration never leads to reduction of share capital.

(*c*) Company must add the expression " ______ And Reduced" with its name for the period prescribed.

Ans.: (*a*) True (*b*) True (*c*) True

Exercise 5: Practical Question

HCB Ltd. adopts the following scheme of Capital Reconstruction:

(*a*) Each shareholder shall surrender to the company 80% of his holding for the purpose of reissue to Debenture holders and creditors so far as required and otherwise for cancellation. The share capital of the company consists of 1,00,000 shares of Rs. 10 each fully paid.

(*b*) The claim of the, Debenture holders shall be reduced and they shall receive 45,000 shares of Rs. 10 each in full satisfaction of their claim of Rs. 10,00,000 including interest accrued Rs. 60,000.

(*c*) The Creditors' claim of Rs. 4,20,000 shall be reduced by 3/5th of the amount and the balance shall be satisfied by allotting them equity shares from the shares surrendered.

(*d*) Shares surrendered and not re-issued shall be cancelled.

(*e*) The debit balance of Profit & Loss Account amounting to Rs. 15,25,000 shall be written off.

Journalise the transactions.

Ans.: Capital Reserve - Rs. 77,000

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LESSON

3

Accounting for Liquidation of Companies

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STRUCTURE

3.1 *Learning Objectives*
3.2 *Definition of Winding Up*
3.3 *Modes of Winding Up*
3.4 *Winding Up by the Tribunal*
3.5 *Petition For Winding Up*
3.6 *Voluntary Winding Up*
3.7 *Commencement of Winding Up by the Tribunal*
3.8 *Statement of Affairs*
3.9 *Preferential Creditors*
3.10 *Deficiency Account*
3.11 *Summary*
3.12 *Questions for Practice*
3.13 *References*

3.1 Learning Objectives

You would be able to understand after learning this Chapter.

- Meaning of liquidation of company.
- Insolvency of a company and Bankruptcy Code, 2016.
- Preparation of statement of affairs in the form laid down in the Act.

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- Preferential payments.
- Preparation of Deficiency Account.

Liquidation of company is a legal process through which a company ceases to exist and finally dissolved. A company first liquidates and then wind up.

3.2 Definition of Winding Up

Conferring to section 2(*94A*) of Companies Act, 2013, winding up of a company means, winding up under this Act, or liquidation under the Insolvency and Bankruptcy Code, 2016. (Companies Act, 2013, Ministry of Corporate Affairs)

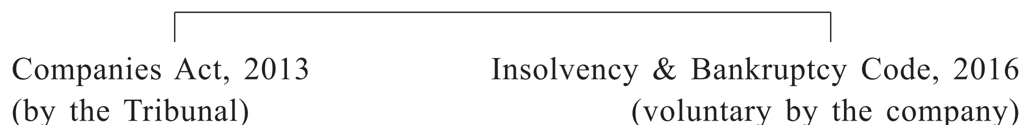
3.3 Modes of Winding Up

Under section 270(1) of Companies Act, 2013, the winding up of a company may be either:

(*a*) by the Tribunal; or

(*b*) voluntary (Companies Act, 2013, Ministry of Corporate Affairs)

Winding Up of the Company



Companies Act, 2013 (by the Tribunal) | Insolvency & Bankruptcy Code, 2016 (voluntary by the company)

3.4 Winding Up by the Tribunal

Section 271(1) of Companies Act, 2013 has specified the circumstances whereby a company may be wound up by the tribunal on petition under section 272:

(*a*) If the company has, by special resolution, agreed that the company should be wound up by the Tribunal;

(*b*) Where the company has proceeded against the interests of the sovereignty and independence of India, the State security, friendly relations with foreign States, public order, dignity or morality;

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(*c*) Where the Tribunal has ordered the liquidation of the company in compliance with Chapter XIX;

(*d*) Where on request made by the Registrar or any other person approved by the Central Government by notification under this Act, the Tribunal considers that the affairs of the company have been conducted in a fraudulent manner or the company has created for fraudulent and unlawful purposes or the persons concerned in the formation or management of its affairs have been guilty of fraud in the creation or management of its affairs;

(*e*) Where the company has failed to file its financial statements or annual returns with the Registrar for the period immediately preceding five consecutive financial years; or

(*f*) Where the Tribunal is of the opinion that the company should be wound up justly and equitably. (Companies Act, 2013, Ministry of Corporate Affairs)

With effect from 1st April, 2107, if the company fails to pay off its debts, then the winding up of the company is governed by Insolvency and Bankruptcy Code, 2016.

3.5 Petition for Winding Up

Under section 272 of Companies Act, 2013 the following can file a petition to the Tribunal for winding up of the company:

(*a*) the company,

(*b*) any creditor or creditors of including any prospective creditor or creditors,

(*c*) any contributory or contributories,

(*d*) the Registrar,

(*e*) any individual authorised by the Central Government in that behalf,

(*f*) in the event of fraudulent conduct of company's affairs, by the Central Government or State Government.

A contributory shall be entitled to file a petition for the liquidation of a corporation, given that he may be the holder of fully paid-up shares, or that the company may have no assets at all or may have no surplus

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assets left for distribution between the shareholders after its liabilities have been met, and shares in respect of which he is a investor or some of them were either originally allocated to him or owned by him, and registered in his name, for at least six months during the eighteen months immediately prior to the beginning of the winding up or have entrusted on him through the death of a former investor. The Registrar shall be entitled to file a petition for winding up under sub-section (1) on any of the reasons set out in sub-section (1) of section 271, except for the reasons set out in clause (*b*), clause (*d*) or clause (*g*) of that sub-section. The Registrar shall obtain the Central Government prior sanction for the submission of a petition. A petition submitted before the Tribunal by the company for winding up shall be admitted only if accompanied by a statement of affairs in the form and in such manner as may be prescribed. (Companies Act, 2013, Ministry of Corporate Affairs).

3.6 Voluntary Winding Up

Section 304 of Companies Act, 2013 stipulates that a company may be wounded on voluntary basis:

(*a*) If the company in general meeting passes a resolution requesting the company be wounded on voluntary basis as a result of the expiry of the term for its duration, if any, set by its articles or any event in respect of which the articles provide that the company should be dissolved; or

(*b*) If a company passes a special resolution to voluntarily wound the company up. (Companies Act, 2013, Ministry of Corporate Affairs).

The voluntary winding up of the company is regulated by the Insolvency and Bankruptcy Code, 2016 with effect from 1st April, 2017.

Section 59 of the Insolvency and Bankruptcy Code, 2016, states:

(1) A corporate person who intends to voluntarily liquidate and has not committed any default may initiate voluntary liquidation proceedings pursuant to this section.

(2) A corporate's person voluntary liquidation pursuant to sub-section (1) shall meet the conditions and procedural criteria as defined by the Board.

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(3) Without exception to sub-section (2), voluntary liquidation proceedings of a company registered as a company shall meet the following conditions, namely:—

(*a*) a declaration by the majority of company's directors as confirmed by an affidavit stating that:

(*i*) they have carried out a full investigation into company's finances and have expressed the opinion that either the company has no debt or that it will be able to pay its debts in full from the proceeds of properties to be sold in the voluntary liquidation; and

(*ii*) the company is not being liquidated to defraud any person;

(*b*) the declaration referred to sub-clause (*a*) shall be followed by the following documents, namely:—

(*i*) audited financial statements and reports of company's operation for the preceding two years or for the duration from the incorporation thereof, whichever is later;

(*ii*) a summary of the valuation of company's assets, if any prepared by a licensed valuer;

(*c*) within four weeks of a declaration under sub-clause (*a*), there shall be—

(*i*) a special resolution by the members of the company in a general meeting requesting that the company be voluntarily liquidated and that an insolvency lawyer named to serve as the liquidator; or

(*ii*) a resolution of the members of the company at a general meeting allowing the company be liquidated voluntarily as a result of expiry of the time of its existence, if any, specified by its statutes or on the occurrence of any event in respect of which the articles provide that the company to be dissolved, as the case may be and appointment of an insolvency lawyer to serve as the liquidator:

Provided that the company owes some debts to any individual, creditors representing two-thirds Company's debt value shall accept

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the resolution passed under sub-clause (*c*) within seven days of such settlement.

(4) The company shall, as the case may be, notify the Registrar of Companies and the Board of the resolution referred to in sub-section (3) to liquidate the company within seven days of such resolution or the subsequent approval by the creditors.

(5) Subject to consent of the creditors pursuant to sub-section (3), the voluntary liquidation proceedings in respect of a corporation shall be deemed to have begun from the date on which the resolution pursuant to sub-clause (*c*) of sub-section (3) is passed.

(6) The rules of Chapter III and Chapter VII, sections 35 to 53 of shall apply to voluntary liquidation proceedings for corporate entities with such amendments as may be appropriate.

(7) Where company's affairs have been fully wound up, and its properties completely liquidated, the liquidator shall apply to the Adjudicating Authority for the dissolution of such corporate entity.

(8) On a request filed by the liquidator under sub-section (7), the Adjudicating Authority shall pass an order that the corporate debtor be dissolved accordingly.

(9) A copy of an order pursuant to sub-section (8) shall be forwarded to the authority with which the corporate person is registered within fourteen days from date of such order. (Insolvency and Bankruptcy Code, 2016)

3.7 Commencement of Winding Up by the Tribunal

Section 357 of Companies Act, 2013 states that where, the Tribunal submits a petition for the liquidation of the company, a resolution has been passed by the company for voluntary liquidation, the liquidation of the company shall be deemed to have started at the time decision was passed, and unless, the Tribunal, considers it appropriate to direct otherwise on the evidence of fraud or error, all proceedings in the voluntary liquidation shall be deemed to have been commenced. In any other case, the liquidation of a business by the Tribunal shall be deemed to start at the time of filing of winding up petition. (Companies Act, 2013, Ministry of Corporate Affairs).

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3.8 Statement of Affairs

Sub-section (5) of Section 272 of Companies Act, 2013 mandates that a winding up filed by the company before Tribunal shall be admitted only if followed by a statement of affairs in form and manner specified. However, section 274(1) states that where request for winding up is lodged before the Tribunal by any person other than the company, the Tribunal, if it is satisfied that a *prima facie* case for liquidation of the company is filed, directs the company to lodge its objections together with the statement of it affairs within 30 days of the order in the form and manner that may be followed by it. In situation of crises or special circumstances the Tribunal may allow additional duration of 30. (Companies Act, 2013, Ministry of Corporate Affairs).

A statement of affairs is a statement giving full details of company assets and liabilities. This statement is blueprint of the company prepared by the directors giving idea about the current status and value of the company. It provides useful information to shareholders, creditors and other interested parties as in addition to details of assets and liabilities and fixed or floating charge on them, it also shows value that could be realised by selling assets so that it could be know what would be left after paying creditors and other liabilities. The directors prepare the statement of affairs and later, it is approved by the creditors and shareholders of the company.

Preparation of statement of affairs

The statement of affairs is prepared as follows:

1. First, all the assets on which there is no fixed charge are included at the value which is expected to be realised. The point to be considered here is that call-in-arrears will be included but uncalled capital should be excluded.
2. Secondly, the amount expected to be realised from the assets having fixed charge is to be compared with the amount due to concerned creditors having such charge. If the amount expected to be realised is greater than the claim, then it is surplus, otherwise deficit. In case there is deficit the amount is to be added to the amount of unsecured creditors.

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3. Total amount in item 1 and surplus, if any in item 2, is available to creditors other than secured creditors covered by specific charge in item number 2.
4. From the amount calculated in point 3 the following should be deducted in the order:
   (*i*) preferential creditors for rates, taxes, salaries, wages and or else.
   (*ii*) debentures having floating charge.
   (*iii*) unsecured creditors.

   if the balance come out to be negative, it means there is deficiency as regards creditors.
5. The total amount of paid up capital of each class of shares should be added and the resulting amount will be members' deficiency.

The following list should be enclosed with the statement of affairs:

List A: Assets not specifically pledged.

List B: Assets specifically pledged and creditors fully or partly secured.

List C: Preferential creditors for rates taxes salaries and otherwise.

List D: List of debenture holders secured by floating charge.

List E: Unsecured creditors.

List F: List of preference shareholders.

List G: List of equity shareholders.

List H: Deficiency or Surplus Account (Form 57 of Companies (Court) Rules, 1959).

Format of Statement of Affairs
(as per Form 57 of Companies (Court) Rules, 1959)

	Estimated Realisable Value Rs.
Assets not specifically pledged (As per List A)	
Cash	xxx
Debtors	xxx
Stock	xxx
Call-in-arrears	xxx

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Assets specifically pledged (As per List B)					
	Estimated Realisable	Amount of Secured			
Asset	Value	Creditors	Defi-ciency	Surplus	Surplus
Xxx	Xxx	xxx	xxx		
Xxx	Xxx	xxx		xxx	
	Xxx				
Summary					
Assets not specifically pledged			xxx		
Assets specifically pledged			xxx		
Gross Assets			xxx		
				Total	xxx
Book Value	Liabilities				
Xxx	Creditors having specific fixed charge				
				Balance	
Xxx	Preferential creditors (as per List C)				xxx
				Balance	
Xxx	Creditors having floating charge (as per List D)				xxx
				Balance	xxx
Xxx	Unsecured creditors (as per List E)				
	Deficiency/ Surplus as regards Creditors				xxx
	Issued and Called-up Capital				
	Preference Share Capital (as per List F)				
	Equity Share capital (as per List G)				
	(paid-up share capital +call-in-arrears realised)				
	Estimated Deficit/ Surplus as regards members (List H)				xxx

3.9 Preferential Creditors

Section 326 of Companies Act, 2013 provides that while liquidation of a company, the following preferential creditors should be paid prior to the secured creditors and the creditors having floating charge:

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1. All revenues, taxes, duty and tariffs due by the company to the Central Government or a State Government or to a local authority on the relevant date, and having become due and payable within the twelve months immediately prior to that date.
2. All salaries or wages (including wages payable on either time or piece work and remuneration earned fully or in part as commission) of any employee in respect of services rendered to the company and due for a period not exceeding four months within twelve months immediately before the applicable date, subject to the condition that the amount payable under this provision to any worker shall not exceed the amount notified (currently notified amount is Rs. 20,000).
3. All accrued holiday remuneration shall be paid to any employee on the termination of his employment before, or by liquidation, or the dissolution of the company.
4. Unless the company is voluntary wounded for the sole purposes of reconstruction or amalgamation with another company, all amounts due in respect of contributions payable by the company as employer of person under the Employee State Insurance Act, 1948 or any other law, for time being in force during the period of twelve months immediately before the relevant date.
5. Any amount due in respect of any compensation or liability for compensation under the Workmen's Compensation Act for death or disability of any employee of the company.
6. All sums owed to any employee for the provident fund, the pension fund, the gratuity fund or any other employee benefit fund administered by the company.
7. The cost of any investigation carried out in accordance with sections 213 and 216 to the extent that they are payable by the company. (Companies Act, 2013, Ministry of Corporate Affairs).

3.10 Deficiency Account

The deficiency account manifests reconciliation between the last set of public accounts and the statement of affairs. According to the last set of

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published accounts either assets exceed liabilities plus capital, then there would be reserve or accumulated losses. Deficiency account explains every item that either increases or decreases reserve/accumulated losses and resulting into deficiency or surplus as stated by statement of affairs. Hence, deficiency account is divided in two parts. First part includes all items underwriting to the deficit or decreasing surplus, while the other part displays matters decreasing deficit or funding to surplus.

Format of Deficiency/Surplus Account- list-H

		Rs.
	Items increasing Deficiency	
1.	Capital & liabilities in excess over assets as per Balance Sheet	
2.	Declared net dividend & bonuses for the period	
3.	Net trading losses for the period after charging depreciation, taxation, interest on debentures	
4.	Losses other than trading losses written off or provided in the books over the period	
5.	Estimated losses written off or for which provision was made to prepare the statement	
6.	Other items increasing deficiency	
	Items decreasing Deficiency	
7.	Assets in excess over capital and liabilities as per Balance Sheet	
8.	Net trading profit during the period	
9.	Profit & Incomes during the period other than trading profit	
10.	Other items reducing deficit	
	Deficiency/Surplus as per the Statement of Affairs	

(Companies (Court) Rules, 1959)

Example 1: The following is the summarized Balance Sheet of Axe Ltd. on 1st April, 2019, which is to be liquidated:

Liabilities	Rs.
Capital	
4,800 Equity Shares of Rs. 100 each	4,80,000
Debentures (secured with floating charge)	3,00,000
Bank Overdraft	1,08,000
Creditors	1,20,000
Total	**10,08,000**

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Assets	**Rs.**
Machinery	1,80,000
Land and Building	2,40,000
Inventory	6,000
Trade Receivables	3,00,000
Investments	36,000
Cash-in-hand	6,000
Profit & Loss account	2,40,000
Total	**10,08,000**

Expected Realisable Value of Assets are: Rs.

Machinery	3,60,000
Land & Building	4,36,000
Investment	24,000
Inventory	12,000
Trade Receivables	2,80,000

The bank overdraft is secured by Land & Building. The creditors for Rs. 3,000 were preferential creditors, which were not included in the above figure.

Prepare a Statement of Affairs of the Axe Ltd as per form 57.

Solution:

Statement of affairs of Axe Ltd.
as on 1st April, 2019

					Estimated Realisable Value Rs.
Assets not specifically pledged (As per List A)					
Cash in hand					6,000
Investments					24,000
Trade Receivables					2,80,000
Inventory					12,000
Machinery					3,60,000
Assets specifically pledged (As per List B)					
Asset	Estimated Realisable Value Rs.	Amount of secured creditors Rs.	Deficiency Rs.	Surplus Rs.	3,28,000
Land & Building	4,36,000	1,08,000		3,28,000	

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Summary				
Assets not specifically pledged		6,82,000		
Assets specifically pledged		4,36,000		
Gross Assets		11,18,000		
			Total	10,10,000
Book Value Rs.	Liabilities			
1,08,000	Creditors having specific fixed charge			
			Balance	10,10,000
3,000	Preferential creditors (as per List C)			3,000
			Balance	10,07,000
	Creditors having floating charge (as per List D)			3,00,000
3,00,000	Debentures			
			Balance	7,07,000
1,20,000	Unsecured creditors (as per List E)			1,20,000
	Estimated Surplus as regards Creditors			5,87,000
	Issued and Called-up Capital			
	Equity Share Capital (as per List G)			
	4,800 Equity Shares of Rs. 100 each			4,80,000
	Estimated Surplus as regards members (List H)			1,07,000

Example 2: The summarized Balance Sheet of Citizen Ltd. as on 31st March, 2019 is as under:

Liabilities	Rs.
Capital	
25,000 Equity Shares of Rs. 50 each	12,50,000
Secured Debentures (Freehold Premises)	5,00,000
Unsecured Loan	10,00,000
Creditors	15,50,000
Total	**43,00,000**
Assets	**Rs.**
Freehold Premises	5,00,000
Other Fixed Assets	10,00,000
Current Assets	20,00,000
Profit & Loss Account	8,00,000
Total	**43,00,000**
Contingent Liabilities	
Bills Discounted	50,000
Goods & Service Tax	1,00,000

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Company is to be liquidated. The expected realizable value of Freehold Premises Rs. 6,00,000, other fixed assets Rs. 8,00,000 and current assets Rs. 15,00,000. Prepare the Statement of Affairs in accordance with form 57.

Solution:

The Statement of affairs of Citizen Ltd.

As on 31st March, 2019

					Estimated Realisable Value Rs.
Assets not specifically pledged (As per List A)					
Other fixed Assets					8,00,000
Current Assets					15,00,000
Assets specifically pledged (As per List B)					
Asset	Estimated Realisable Value Rs.	Due to secured creditors Rs.	Deficiency Rs.	Surplus Rs.	1,00,000
Freehold Premises	6,00,000	5,00,000		1,00,000	
Summary					
Assets not specifically pledged			23,00,000		
Assets specifically pledged			6,00,000		
Gross Assets			29,00,000		
				Total	24,00,000
Book Value Rs.	Liabilities				
5,00,000	Creditors having specific fixed charge				
				Balance	24,00,000
	Preferential creditors (as per List C)				1,00,000
1,00,000	Goods & service Tax				
				Balance	23,00,000
	Unsecured creditors (as per List E)				10,00,000
10,00,000	Unsecured Loan				
15,50,000	Trade creditors				15,50,000
50,000	Contingent Liability for Bill Discounted				50,000
	Estimated Deficiency as regards Creditors				3,00,000
	Issued and Called up Capital				
	Equity share capital (as per List G)				12,50,000
	25,000 Equity Shares of Rs. 50 each				
	Estimated Deficiency as regards members (List H)				15,50,000

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Example 3: Alpha Industries Ltd. was wound up on 31st March, 2019. The summarized Balance Sheet of Alpha on the same date is:

Liabilities	Rs.	Assets	Rs.
Equity Share Capital 10,000 shares of Rs. 100 each		Goodwill	1,00,000
5% Debentures 160,000		Land & Building	3,50,000
Accrued Interest on Debentures 4,000		Plant & Machinery	5,50,000
(with floating charge on assets)	10,00,000	Furniture & Fixtures	23,000
Bank Overdraft	1,64,000	Inventory	38,000
(secured by inventory)	25,000	Trade Receivables	25,000
Creditors	36,000	Cash	500
		Profit & loss Account	1,38,500
Total	**12,25,000**	**Total**	**12,25,000**

The estimated amounts to be realized for Goodwill Rs. 1,000; Land & Building Rs. 3,00,000; Plant & Machinery Rs. 5,25,000; Furniture & Fixtures Rs. 10,000; Inventory Rs. 31,000; Trade Receivables Rs. 20,000.

Creditors include Rs. 6,000 for wages of 15 men at Rs. 100 per month per employee for 4 months prior to winding up; Rs. 9,000 for the salaries of 5 employees at Rs. 300 per month per employee for the 6 months preceding liquidation. Godown rent of Rs. 3,000 was due for the last 6 months. Tax deducted from source from salaries of employees Rs. 1,000. Directors fees due is Rs. 500.

The debit balance of the Profit and Loss Account, three years earlier was Rs. 77,925 and from that date the following figures have shown by the company's books of accounts:

	31st March, 2017 Rs.	31st March, 2018 Rs.	31st March, 2019 Rs.
Gross Profit	65,000	45,000	40,000
Salaries and Wages	40,500	36,000	34,400
Electricity	5,750	6,380	5,260
Interest on Debentures	8,000	8,000	8,000
Bad Debt	8,540	7,600	6,700
Depreciation on Assets	6,700		
Directors' Fees	1,000	1,000	1,000
Miscellaneous Expenses	10,500	7,265	7,980
Total Expenses	**80,990**	**66,245**	**63,340**

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There was a contingent liability of Rs. 5,000 for the compensation to an employee for injuries suffered by him.

Prepare the Statement of Affairs and the Deficiency Account. (ICAI study material)

Solution:

Statement of Affairs of Alpha Ltd.
as on 31st March, 2019

					Estimated Realisable Value Rs.
Assets not specifically pledged (As per List A)					
Cash-in-hand					500
Trade Receivables					20,000
Land & Building					3,00,000
Plant & Machinery					5,25,000
Furniture & Fixtures					10,000
Goodwill					1,000
Assets specifically pledged (As per List B)					
Asset	Estimated Realisable Value Rs.	Amount of secured creditors Rs.	Deficiency Rs.	Surplus Rs.	6,000
Inventory	31,000	25,000		6,000	
Summary					
Assets not specifically pledged			8,56,500		
Assets specifically pledged			31,000		
Gross Assets			8,87,500		
				Total	8,62,500
Book Value Rs.	Liabilities				
25,000	Creditors having specific fixed charge				
				Balance	8,62,500
	Preferential creditors (as per List C)				
	Wages (15 men for 4 month @ Rs. 100 p.m)			6,000	
	Salaries (5 men for 4 months @ Rs. 300 p.m)			6,000	
	TDS for salaries			1,000	
18,000	Workmen Compensation			5,000	
18,000					18,000
				Balance	8,44,500

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	Creditors having floating charge (as per List D)	
	Debentures 1,60,000	
1,64,000	Interest accrued 4,000	1,64,000
	Balance	6,80,500
	Unsecured creditors (as per List E)	
	Trade Creditors 16,500	
	Salaries 3,000	
	Godown rent 3,000	
23,000	Directors Fees 500	23,000
	Estimated Surplus as regards Creditors	6,57,500
	Issued and Called-up Capital	
	Equity Share Capital (as per List G)	
	1,000 Equity Shares of Rs. 100 each	10,00,000
	Deficiency as regards members (List H)	3,42,500

Deficiency Account-List H

		Rs.
	Items increasing Deficiency	
1.	Capital & liabilities in excess over assets as per Balance Sheet (3 years ago)	77,925
2.	Declared net dividend & bonuses for the period	Nil
3.	Net trading losses for the period after charging depreciation, taxation, interest on debentures (2017-2019)	60,575
4.	Losses other than trading losses written off or provided in the books over the period	Nil
5.	Estimated losses written off or for which provision was made to prepare the statement Bad Debts 5,000 Loss on Goodwill 99,000 Land & Building 50,000 Plant & Machinery 25,000 Furniture & Fixtures 13,000 Inventory 7,000 Workmen's 5,000 Compensation	2,04,000

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		Rs.
6.	Other items increasing deficiency	Nil
	Items decreasing Deficiency	Nil
7.	Assets in excess over capital and liabilities as per Balance Sheet	Nil
8.	Net trading profit during the period	Nil
9.	Profit & Incomes during the period other than trading profit	Nil
10.	Other items reducing deficit	Nil
	Deficiency/ Surplus as per the Statement of Affairs	**3,42,500**

3.11 Summary

The company ceases to exist after winding up. Winding up of a company can be defined as a process where its assets are being realized and amount so realized is used for the payment to creditors and shareholders. The result may be surplus or deficit as regard to creditor or shareholders. The winding up may be voluntary or by the Tribunal. Where the company is unable to pay off its debt or voluntary winding up, it is governed by the Insolvency & Bankruptcy Code, 2016. The provisions of sections 271, 272, 274, 304 and 357 of Companies Act, 2013 apply to winding up by Tribunal. The Statement of Affairs has been prepared as per format specified in section 274 of Companies Act, 2013 by the company on the direction of Tribunal stating the estimating value to be realized from its assets and estimated payment to be made to different creditors and shareholders. Section 326 of Companies Act, 2013 also specified the creditors having the preferential right of payment over the others. The liquidator prepares the Deficiency Account explaining the surplus or deficit as stated by the Statement of Affairs.

3.12 Questions for Practice

(1) Define winding up of company.

(2) What are the different modes of winding-up of the company?

(3) Explain the circumstances whereby a company may on petition be wound up by Tribunal.

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(4) Who can file petition for winding up to the Tribunal under section 272 of Companies Act, 2013?

(5) Write short note on the following:

  (*i*) Statement of Affairs

  (*ii*) Deficiency Account

  (*iii*) Preferential Creditors

(6) Name the lists to be enclosed with the Statement of affairs.

(7) Write the order of payment in case of liquidation of the company.

3.13 References

- www.mca.gov.in
- www.icai.org.in

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LESSON

1

Introduction to Corporate Financial Reporting

Dr. Rakesh Kumar Gupta

STRUCTURE

1.1 *Learning Objectives*
1.2 *Introduction*
1.3 *What is Corporate Financial Reporting*
1.4 *Need and Objectives of Corporate Financial Reporting*
1.5 *Constituents of Annual Report and How it is Different from Financial Statements*
1.6 *Contents of Report of the Board of Directors*
1.7 *Summary*
1.8 *Questions for Practice*
1.9 *References*

1.1 Learning Objectives

After studying this Chapter, students will be able:

- To understand the meaning and definition of Corporate Financial Reporting (CFR).
- To gain knowledge about Need, Objectives and significance of Corporate Financial Reporting (CFR).
- To understand the components of an annual report and how financial statements differ from them.
- To learn about the director's report.

1.2 Introduction

Financial reporting is a method of presenting financial information about a company's performance, financial position, and cash flow to stakeholders such as shareholders, investors, lenders, government, and others who need to make financial and commercial decisions. The primary objective of financial reporting standards is to provide relevant

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financial information that can help stakeholders understand the financial performance of an entity over a period and make informed decisions based on that information. The American Financial Accounting Standards Board also emphasizes that financial reporting is intended to serve the informational needs of external users who lack the authority to prescribe the financial information they want from an enterprise, and therefore must rely on the information that management communicates to them. Overall, financial reporting is an important way for organizations to communicate their financial information and performance to stakeholders, helping them to make informed decisions.

1.3 What is Corporate Financial Reporting

Corporate financial reporting plays a crucial role in the functioning of any business. It provides vital information to various stakeholders, including investors, creditors, and decision-makers, about the financial health and performance of the organization. This information helps them make informed decisions about investing or lending money to the company.

Accuracy and timeliness are essential components of financial reporting, as incorrect or outdated information can lead to reputational and legal issues. Proper financial reporting should also highlight significant financial information and demonstrate the implementation of financial policies.

Financial reporting is not only important for external stakeholders but also for internal decision-making. It helps management in identifying areas where the organization needs to improve, and it provides insights into the organization's financial strengths and weaknesses.

Overall, corporate financial reporting is an essential function that requires accuracy, timeliness, and transparency. It provides valuable information to various stakeholders that helps them make informed decisions about the organization's financial health and performance.

1.3.1 *The types of Corporate Financial Reporting*

There are typically four different sorts of financial statements that can be employed when creating business financial reports. For tax planning and audit defense, corporate financial statements are very crucial. You

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can utilize the data from your company's monthly or quarterly reports, which demonstrate the health of the firm, to prepare additional, more complicated reports come tax time or have them on hand in case your organization is ever the target of an audit.

These are income statements, balance sheets, cash flow statements, and statements of changes in equity. Each one is based on somewhat different data and offers readers a unique perspective on the company's financial situation.

Financial statements are essential tools for analyzing a company's financial performance and overall health. Each of the four types of financial statements discussed as under serves a different purpose and provides different information:

1. **Income statement:** Also known as a profit and loss statement, shows a company's revenue and expenses over a specific period. It provides insight into a company's profitability, highlighting its ability to generate income and manage costs.
2. **Balance sheet:** Presents a snapshot of a company's financial position at a given point in time, showing its assets, liabilities, and equity. It provides insight into a company's financial stability and solvency, highlighting its ability to meet its financial obligations.
3. **Cash flow statement:** Shows how a company generates and uses cash over a specific period. It provides insight into a company's liquidity, highlighting its ability to pay its debts and expenses.
4. **Statement of changes in equity:** Shows the changes in a company's equity accounts over a specific period. It provides insight into a company's financial structure and performance, highlighting its ability to generate profits and distribute them to shareholders.

   By analyzing these financial statements, business owners, investors, and other stakeholders can gain a better understanding of a company's financial performance, health, and prospects for future growth. They can also use this information for tax planning and audit defense purposes.

Let's understand these financial statements in details:

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1. *Income Statement*

An income statement, also known as a profit and loss statement, shows a company's financial performance over a specific period, typically a month, quarter, or year. The income statement lists all revenue generated from sales, as well as any expenses incurred during the period. By deducting the total expenses from the total revenue, one can calculate the net income or loss of the company.

The income statement is a critical financial statement as it provides an overview of a company's financial performance, including its revenue, expenses, and profitability, during a specific period. This information can help investors, creditors, and other stakeholders evaluate the company's financial health and prospects for future growth.

The Earnings-Per-Share (EPS) number is a calculation that can be included in the income statement to show the amount of profit attributable to each outstanding share of common stock. It is calculated by dividing the net income by the number of outstanding shares of common stock. The EPS number is an essential metric for companies that have shareholders, as it helps investors evaluate the company's profitability and potential return on investment.

Overall, the income statement is a crucial component of a company's financial reporting, as it provides a comprehensive picture of the company's financial performance over a specific period and can be used for financial analysis and decision-making.

2. *Balance Sheet*

A balance sheet is a financial statement that presents a company's financial position by showing its assets, liabilities, and equity at a particular point in time. Assets are resources that a company owns or controls and are expected to provide future economic benefits. Liabilities are obligations that a company owes to others and require future payments or sacrifices of resources. Equity represents the residual interest in the assets of a company after deducting its liabilities.

Generally Accepted Accounting Principles (GAAP) require that assets and liabilities be presented on the balance sheet in order of their liquidity, or

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how quickly they can be converted into cash or used to settle liabilities. This means that the most liquid assets, such as cash and cash equivalents, are presented first, followed by short-term investments, accounts receivable, inventory, and other assets in descending order of liquidity. Liabilities are presented in a similar manner, with the most immediate obligations, such as accounts payable and short-term loans, presented first, followed by longer-term liabilities.

Balance sheets are important to creditors and investors as they provide a snapshot of a company's financial position and its ability to meet its obligations. Investors can use this information to assess the company's financial health and make informed decisions about investing in the company's stock or debt. Creditors can use the balance sheet to assess the company's creditworthiness and ability to repay its debts.

Regenerate response

3. *Statements of Cash Flow*

Statements of Cash Flow are used to depict the money that has entered and left a business over a specific time period. Operating operations, investment activities, and financing activities are the three main components that make up this kind of financial statement. Because it provides a less precise picture of a company's overall financial situation, this form of report is typically less extensively disseminated. Also, it may be challenging for the average individual to understand.

4. *Statement of Changes in Equity*

This report details all changes to stock shares, dividends, and profits or losses over a specified time period. The ending equity for this kind of report is equal to the starting equity plus net income, minus dividends, and plus or minus any additional adjustments. Only outside parties normally receive statements of changes in equity. The usefulness of this kind of report for management and internal financial decision-making is constrained.

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Income Statement

- Profit and loss account is another name for it. We learn whether a corporation is making a profit or a loss from the income statement.

Balance Sheet

- It shows the financial position at given point of time.

Statements of Cash Flow

- It provides an explanation of the company's liquidity sources and uses.

Statement of Changes in Equity

- It reports all stock share transactions, dividend payments, and gains or losses for a given time frame.

It is desirable to analyse all four corporate financial reports in order to gain the clearest picture possible of a company's overall financial health and well-being. By doing this, you can get a comprehensive picture of the business's good and bad points and, because it is shown on such a big picture, you might get suggestions for development that you might not see if you view the reports separately. The release of corporate financial statements to outside parties must be done with prudence, though. Only information that is important for decision-making by creditors and investors or that is required by Generally Accepted Accounting Principles (GAAP) should be disclosed to them.

1.4 Need and Objectives of Corporate Financial Reporting

General purpose financial reporting aims to provide financial information about a reporting entity to a wide range of users, including investors, lenders, and other creditors, who use this information to make decisions about providing resources to the entity.

Users of financial information may use this information to make decisions such as granting or settling loans and other types of credit, purchasing, selling, or holding equity and debt instruments, or exercising their right to vote or exert other control over management decisions that have an impact on how the company uses its financial resources.

Therefore, the information provided in general purpose financial reports should be relevant, reliable, comparable, and understandable to enable users to make informed decisions. Additionally, financial reports should

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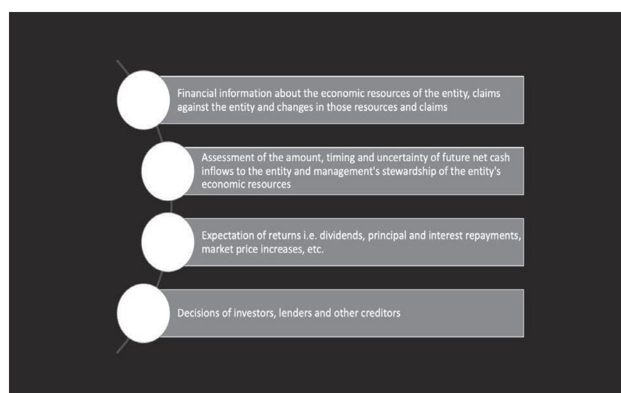
comply with relevant accounting standards and regulations to ensure consistency and comparability across different entities and time periods.

The following figure demonstrate the strong correlation between general purpose financial reports and decision making process of relevant stakeholders:



Financial reporting's objective is to "present information on the financial status, performance, and changes in financial position of an enterprise that is relevant to a wide variety of users in making economic decisions," according to the International Accounting Standard Board (IASB).

The objectives and functions of financial reporting can be summarized as follows:

1. **Supporting management decision making:** Financial reporting provides information to an organization's management to assist with planning, analysis, benchmarking, and decision making.
2. **Facilitating external decision making:** Financial reporting provides data to investors, promoters, debt providers, and creditors to help them make informed investment and credit decisions.
3. **Promoting transparency and accountability:** Financial reporting provides information to shareholders and the general public, promoting transparency and accountability in publicly traded corporations.
4. **Communicating an organization's financial position:** Financial reporting provides details on an organization's financial resources, claims (liabilities and owner equity) against those resources, as well as how these resources and claims have changed over time.

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5. **Communicating an organization's resource usage:** Financial reporting provides information on the resources that an organization is buying and using.
6. **Assessing ethical and fiduciary obligations:** Financial reporting provides stakeholders with information on how rigorously and ethically an organization is carrying out its fiduciary duties and obligations.
7. **Facilitating auditing:** Financial reporting provides the statutory auditors with access to information to help the audit process.
8. **Promoting societal welfare:** Financial reporting can improve societal welfare by considering government, union, and employee interests.

1.4.1 *The Significance of Corporate Financial Reporting*

The Financial Accounting Standards Board, which replaced the Accounting Principles Board and has been in operation in the United States since 1973, has established guidelines for corporate financial reporting. To ensure that data presented across industries can be understood by everyone, all corporate financial reporting must adhere to Generally Accepted Accounting Standards. Corporate financial reporting is crucial for several reasons:

1. It provides management and other stakeholders with important information to make informed decisions regarding potential investments, purchases, or loans.
2. Financial reports allow corporate leaders to compare current data with past performance, enabling them to evaluate the effectiveness of their decisions and make adjustments going forward.
3. Financial reporting helps companies to determine their overall financial health, which is essential for making strategic decisions such as increasing or decreasing the workforce, making financial or economic expenditures, exploring mergers and acquisitions, or adjusting prices.
4. Financial reporting also helps companies to assess their liquidity and ability to operate as a "going concern" in the foreseeable future.
5. Finally, financial reporting is critical for creditors and investors, as it provides clear information about a company's debts and liabilities,

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allowing them to make informed decisions about lending or investing in the business.

1.4.2 *Application of Corporate Financial Reporting*

Corporate financial reporting has several applications, including:

1. **Investment Decisions:** Corporate financial reports provide investors with essential information that can assist them in deciding whether or not to invest in a company. This includes financial statements such as balance sheets, income statements, and cash flow statements, which can be used to assess a company's financial health and profitability.
2. **Credit Decisions:** Financial reporting is also critical for creditors, as it allows them to evaluate a company's ability to repay debts and meet financial obligations. This information is used to determine creditworthiness and the terms of lending, such as interest rates and repayment periods.
3. **Strategic Decision-making:** Financial reports provide corporate leaders with data that can be used to evaluate the effectiveness of previous decisions and make strategic decisions going forward. This includes decisions related to investment, capital expenditures, workforce, pricing, and mergers and acquisitions.
4. **Compliance and Regulation:** Companies are required to comply with various financial reporting regulations, including Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). Financial reporting is essential for ensuring compliance with these regulations and avoiding penalties and legal action.
5. **Stakeholder Communication:** Financial reports are also an essential communication tool between companies and their stakeholders, including shareholders, employees, customers, and suppliers. By providing transparent and accurate financial information, companies can build trust and credibility with their stakeholders, leading to better relationships and increased investment and business opportunities.

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Overall, corporate financial reporting plays a crucial role in decision-making for various internal and external parties. It provides valuable insights into the financial health and performance of a company, which is crucial for making informed decisions regarding investments, loans, hiring, and expansion. Corporate financial reporting enables stakeholders to evaluate the company's financial position and prospects, assess risks and opportunities, and make strategic decisions based on that information. Therefore, understanding and analyzing financial reports can be beneficial for individuals, businesses, and institutions alike.

1.4.3 *Ways to improve Corporate Financial Reporting*

Corporate financial reporting is crucial for making informed decisions about businesses. However, it is essential to ensure that the financial reports are transparent, accurate, and understandable. Here are some ways to improve corporate financial reporting:

1. **Standardization:** The use of standardized financial reporting formats would make it easier for investors, creditors, and other stakeholders to understand and compare financial information across companies.
2. **Clarity and transparency:** Financial reports should be presented in a clear and transparent manner to ensure that stakeholders can easily understand the financial performance and position of a company.
3. **Timeliness:** Financial reports should be released in a timely manner to ensure that stakeholders have access to up-to-date financial information.
4. **Materiality:** Companies should ensure that their financial reports provide material information that could impact the decisions of stakeholders.
5. **Disclosure of non-financial information**: Companies should also consider disclosing non-financial information such as social and environmental impacts, governance structures, and risk management strategies.
6. **Independent auditing:** External auditors should review financial statements to ensure that they are accurate and reliable.

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7. **Technology:** The use of technology, such as artificial intelligence and blockchain, can improve the accuracy and efficiency of financial reporting.
8. **Simplification:** Companies should consider simplifying financial reports by using plain language, tables, and graphs to make them more accessible and understandable for stakeholders.

In conclusion, improving corporate financial reporting can increase transparency, reduce information asymmetry, and promote informed decision-making.

1.5 Constituents of Annual Report and How it is Different From Financial Statements

1.5.1 *Meaning of Annual Report*

An annual report is a comprehensive document that publicly traded companies are required to produce and distribute to shareholders and other interested parties at the end of each fiscal year. The annual report provides a summary of the company's financial performance and position, as well as other relevant information about the company's operations, governance, and social responsibility. It typically includes a range of sections, such as a letter from the CEO or chairman, a management discussion and analysis (MD&A) section, financial statements, notes to the financial statements, an auditor's report, and other disclosures required by securities regulators. The purpose of the annual report is to provide shareholders and other stakeholders with a comprehensive view of the company's performance and to provide insight into its future prospects.

1.5.2 *What is Included in an Annual Report?*

An annual report is a comprehensive document that publicly traded companies publish annually to provide shareholders and other interested parties with information about the company's performance and financial position. The report typically includes several sections, such as the following:

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1. **Chairman's statement:** A letter from the chairman or CEO of the company outlining the company's strategy, vision, and future plans.
2. **Management discussion and analysis (MD&A):** A section that provides an in-depth analysis of the company's financial performance, including its revenue, expenses, profits, and cash flow.
3. **Financial statements:** A set of financial statements, including the balance sheet, income statement, and cash flow statement.
4. **Notes to the financial statements:** A section that provides additional information and context to the financial statements, including explanations of accounting policies and estimates, contingencies, and other relevant details.
5. **Auditor's report:** An independent auditor's report on the financial statements, which provides an opinion on whether the financial statements are accurate and comply with accounting standards.
6. **Corporate governance:** A section that describes the company's governance structure, including the board of directors, executive compensation, and any related party transactions.
7. **Social responsibility:** A section that outlines the company's social and environmental initiatives, such as sustainability efforts, community engagement, and corporate social responsibility programs.

The financial statements are a key component of the annual report, but they are only one part of the overall document. While the financial statements provide a summary of the company's financial performance, the annual report provides a more comprehensive overview of the company's operations, strategy, and outlook. The annual report is intended to provide shareholders and other stakeholders with a broader perspective on the company's performance and prospects, beyond just the financial statements.

1.5.3 *Annual Reports used by whom?*

Frequently made available to the public, annual reports serve a sizable external audience that includes shareholders, potential investors, employees, and clients. The general public can also serve as an audience, since some businesses or non-profits will probably read the annual report of

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another business to better understand its values and determine whether a collaboration or other cooperative endeavours is possible.

The annual report is used as a marketing tool to showcase some of the company's major objectives or recent successes, however its primary purpose is to convey financial and performance-related information.

Annual reports are typically used by a variety of stakeholders, including:

1. **Shareholders:** Annual reports provide an overview of a company's financial performance, including revenue, expenses, profits, and losses. Shareholders use this information to make informed decisions about their investment in the company.
2. **Potential investors:** Prospective investors often review a company's annual report to evaluate its financial health, potential risks, and growth prospects before making an investment decision.
3. **Financial analysts:** Analysts use annual reports to assess a company's financial health, analyze its performance compared to industry peers, and make recommendations to investors.
4. **Employees:** Annual reports often include information about a company's vision, mission, and goals. Employees can use this information to understand the company's direction and how they can contribute to its success.
5. **Regulators and government agencies:** Annual reports contain information about a company's compliance with regulatory requirements, including financial reporting standards and tax laws.
6. **Customers and suppliers:** Annual reports can provide insights into a company's stability and future plans, which may be important to customers and suppliers when making decisions about doing business with the company.

They also effectively utilize the financial data provided in the annual report, which offers them a clear understanding of the company's financial situation.

1.5.4 *Difference Between Annual Report and Financial Statements*

An annual report is a comprehensive document that provides an overview

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of a company's performance over the course of a year. It typically includes a variety of information beyond just financial statements, such as a letter from the CEO or Chairman, an analysis of the company's operations, information about major projects or initiatives, and a summary of the company's financial performance.

On the other hand, financial statements are a specific component of the annual report that provide detailed information about a company's financial performance. They typically include the following three statements:

1. **Income statement:** This statement shows a company's revenue and expenses over a period of time and calculates its net income or loss.
2. **Balance sheet:** This statement shows a company's assets, liabilities, and equity at a specific point in time.
3. **Cash flow statement:** This statement shows the inflow and outflow of cash over a period of time.

While financial statements are an important component of the annual report, they do not provide the full picture of a company's operations and overall performance. The other sections of the annual report provide additional context and information that is important to stakeholders, such as a company's vision, mission, and strategic direction.

The difference between Annual Report and Financial Statements can be clearly understand on the following basis:

1. **Scope:** The financial statements are a part of the annual report, but they only provide information about the company's financial performance, while the annual report covers a broader range of topics such as the company's vision, mission, values, strategic plans, major projects, and initiatives.
2. **Format:** Financial statements follow a standard format and provide specific information such as income, expenses, assets, liabilities, and equity, while annual reports are more flexible in format and can include various types of information such as graphs, charts, images, and narratives to convey a company's performance and future prospects.
3. **Audience:** Financial statements are primarily designed for investors, analysts, and regulatory bodies to evaluate a company's financial health

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and compliance, while annual reports are intended to communicate with a wider audience, including shareholders, employees, customers, suppliers, and the general public, about the company's overall performance, strategy, and corporate social responsibility.

4. **Legal requirements:** Publicly traded companies are legally required to submit their financial statements to the Securities and Exchange Commission (SEC) and other regulatory bodies, while annual reports are not mandatory but are often produced voluntarily as a way to communicate with stakeholders and promote the company's brand and reputation.

In short, while financial statements provide specific financial information in a standard format, the annual report is a broader document that covers a wider range of topics and is designed to communicate with a wider audience.

Constituents of Annual Report and how it is different from Financial Statements

1.6 Contents of Report of the Board of Directors

1.6.1 *Responsibilities of the Director of a Company*

Directors of a company have a range of responsibilities that are designed to ensure the effective management and governance of the organization. Some of the key responsibilities of directors include:

1. **Fiduciary duty:** Directors have a fiduciary duty to act in the best interests of the company and its shareholders. This means that they must exercise their powers and make decisions in good faith, with care, skill, and diligence, and with the objective of promoting the long-term success of the company.
2. **Strategic planning:** Directors are responsible for setting the strategic direction of the company and ensuring that the organization has a clear vision, mission, and strategy. This includes overseeing the development of annual plans and budgets, and making decisions about major investments, acquisitions, or divestitures.

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3. **Oversight of management:** Directors are responsible for hiring and overseeing the performance of the senior management team, including the CEO and other top executives. They must ensure that the organization has the right leadership, resources, and systems in place to execute its strategy and achieve its goals.
4. **Risk management:** Directors must identify and manage the risks facing the organization, including financial, operational, and reputational risks. They must ensure that the company has appropriate risk management policies and procedures in place, and that the board is informed of any significant risks or exposures facing the organization.
5. **Compliance:** Directors are responsible for ensuring that the company complies with all applicable laws, regulations, and standards of business conduct. They must establish and maintain effective systems of internal controls, and ensure that the company's financial reporting is accurate and reliable.
6. **Shareholder engagement:** Directors must engage with shareholders and other stakeholders, and ensure that the company's communications are transparent and timely. They must be responsive to shareholder concerns and questions, and ensure that the board is accountable to the company's owners.

Overall, the responsibilities of directors are complex and multifaceted, and require a high degree of skill, knowledge, and judgment. Effective directors must be able to balance the interests of the company, its shareholders, and other stakeholders, and make decisions that are in the best long-term interests of the organization.

1.6.2 *What is the Director's report?*

The report of the board of directors is a section of a company's annual report that provides an overview of the company's performance, operations, and strategic direction. This report is typically written by the board of directors and includes information on the company's financial results, major accomplishments, and challenges over the past year. The report of the board of directors may also provide information about the company's governance structure, leadership team, and corporate social responsibility initiatives.

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In addition to providing a summary of the company's performance over the past year, the report of the board of directors may also offer insights into the company's strategy and future plans. This section of the annual report may discuss the company's priorities for the coming year, major investments or initiatives that are planned, and any risks or challenges that the company anticipates.

The report of the board of directors is an important component of a company's annual report, as it provides stakeholders with a high-level overview of the company's operations and performance, and helps to build trust and transparency with investors, customers, employees, and other stakeholders.

1.6.3 *Why is there a need for a Director's Report?*

The director's report is an important component of a company's annual report. It provides an opportunity for the directors to communicate with stakeholders and provide an overview of the company's performance, operations, and future prospects. Some of the key reasons why a director's report is important include:

1. **Accountability:** The director's report is a key tool for holding directors accountable for their decisions and actions. It provides stakeholders with information on how the company has been managed over the past year, and allows them to assess the performance of the board and the senior management team.
2. **Transparency:** The director's report promotes transparency and openness in the company's operations. It provides stakeholders with a clear understanding of the company's strategy, performance, and risk management practices, and allows them to make informed decisions about their investments or other interactions with the company.
3. **Communication:** The director's report is a key tool for communication between the board and stakeholders. It provides an opportunity for directors to share their insights and perspectives on the company's performance and future prospects, and to respond to questions or concerns raised by shareholders or other stakeholders.

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4. **Compliance:** The director's report is a legal requirement for many companies, particularly those that are publicly traded or subject to regulatory oversight. Failure to provide a director's report can result in penalties or other legal consequences.
5. **Marketing:** The director's report can also be used as a marketing tool to promote the company's brand and reputation. A well-crafted director's report can help to build trust and confidence in the company, and to attract new investors or customers.

Overall, the director's report is an important means of promoting transparency, accountability, and effective communication in the company's operations. It provides stakeholders with a clear understanding of the company's performance, operations, and future prospects, and helps to build trust and confidence in the organization.

1.6.4 *Contents of the Director's Report*

The contents of a director's report can vary depending on the company and the industry in which it operates. However, some common elements that are typically included in a director's report are:

1. **Introduction:** The report should begin with an introduction that provides an overview of the company's performance over the past year, its operations, and its strategic direction.
2. **Business review:** This section should include a review of the company's business operations, including any significant events, changes, or challenges that have occurred during the year. It should also cover the company's market position, competitive landscape, and future prospects.
3. **Financial performance:** The director's report should provide a summary of the company's financial performance over the past year, including revenue, profits, and cash flow. It should also include any significant financial risks or uncertainties that the company faces.
4. **Corporate governance:** This section should cover the company's corporate governance practices, including the composition and activities of the board of directors, the company's policies on ethical and responsible behaviour, and any changes or improvements that have been made to governance practices over the past year.

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5. **Risk management:** The director's report should include a discussion of the risks that the company faces, how these risks are being managed, and any significant changes or developments in the company's risk management practices over the past year.
6. **Sustainability:** Increasingly, director's reports include a section on the company's sustainability performance and initiatives. This section should cover the company's Environmental, Social and Governance (ESG) performance, as well as any initiatives or programs that the company has implemented to improve sustainability.
7. **Future outlook:** The director's report should conclude with an outlook on the company's future prospects, including any significant opportunities or challenges that the company is likely to face in the coming year.

Overall, the director's report should provide stakeholders with a comprehensive and balanced view of the company's performance, operations, and future prospects, as well as its corporate governance and risk management practices.

Before it can be included in the company's annual report, the directors' report needs to be authorised by the board of directors. The shareholders of the corporation are the intended audience for the directors' report. The directors' report is a public document that can be obtained from the company by anyone who asks for it, it should be mentioned.

1.6.5 *Preparation of the Director's Report*

The preparation of a director's report is typically the responsibility of the board of directors or a committee appointed by the board. The report should be prepared in accordance with relevant laws, regulations, and accounting standards, as well as any guidelines issued by the company's regulatory body.

The following are some general steps that may be involved in preparing a director's report:

1. **Gather relevant information:** The board should gather relevant information from various sources, such as management, auditors, and other advisers, to ensure that the report is accurate and complete.

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2. **Review the previous year's report:** The board should review the previous year's report to ensure that any required disclosures or updates are included in the current report.
3. **Discuss the contents of the report:** The board should discuss the contents of the report and ensure that it addresses all relevant areas, including the company's business operations, financial performance, corporate governance, risk management, and sustainability performance.
4. **Obtain necessary approvals:** The report should be reviewed and approved by the board and any relevant committees before it is finalized.
5. **Review for accuracy and completeness:** The report should be reviewed for accuracy and completeness to ensure that all required disclosures and information are included.
6. **Publish the report:** Once the report has been finalized, it should be published and made available to stakeholders, such as shareholders, regulators, and other interested parties.

   It is important for the board to take the preparation of the director's report seriously, as it is an important communication tool for the company and can impact stakeholders' perceptions of the company's performance, governance, and future prospects.

1.6.6 *Purpose of the Directors' Report*

A report created by a company's directors and delivered to the shareholders at the annual general meeting is known as the directors' report. It is a prerequisite under the 2013 Companies Act. An summary of the company's financial situation and performance for the year is provided by this statement of affairs. The corporate governance report offers information on the company's compliance with the corporate governance code of conduct, while the director's report includes information on the business operations and results of the organisation.

It is one of the most crucial sections of a company's annual report since it informs shareholders about the performance and prospects of the company and enables directors to discuss the company's strategy and future.

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Also, the report provides directors with an opportunity to interact personally with shareholders and resolve any issues they may be experiencing. The director's report must include a fair assessment of the operations and affairs of the company as well as disclosure of any significant facts that might affect shareholders' choices. In addition, it ought to describe the corporation's dividend policy and give any.

1.6.7 *Why a Director's Report is Beneficial?*

The advantages of a director's report are numerous and diverse, however they can be summed up as follows:

- The operations and performance of the company over a specific time period are clearly and simply outlined.
- It aids in enhancing dialogue between the board of directors and shareholders.
- Any possible issues or trouble spots inside the business may be found with its assistance.
- It may contribute to increased shareholder trust in the business and its leadership.
- It can be used to draw attention to any threats to the company's long-term success.
- Between the board and shareholders, it may aid in improving communication.
- The board may be able to use the occasion to discuss its plans and strategy.
- It can provide information on the company's performance and development to shareholders and other interested parties.
- It may contribute to fostering trust in the organisation and its leadership.
- Any hazards or issues the business could be facing can be identified with its assistance.
- It might offer a record of the choices and actions made by the board.

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1.6.8 *Conclusion*

The Director's Report should provide shareholders with a comprehensive overview of the company's operations, financial position, and performance over the past year, as well as any significant changes to corporate governance. This includes a summary of the company's strategic objectives, its financial performance, and any risks or challenges it may be facing. The report should also provide information on the company's management structure and practices, including any significant changes in leadership or management policies. Overall, the Director's Report should provide shareholders with a clear and transparent picture of the company's overall health and prospects for future growth and success.

1.7 Summary

Corporate Financial Reporting (CFR) refers to the process of preparing and presenting financial information about a company to stakeholders. The purpose of CFR is to provide information about a company's financial performance and position to various stakeholders, including investors, creditors, employees, regulators, and the general public.

The main objectives of CFR are to provide timely, accurate, and relevant financial information to stakeholders, to promote transparency and accountability, and to facilitate informed decision-making. CFR is significant because it enables stakeholders to assess a company's financial health and make informed decisions about investments or other actions.

An annual report is a comprehensive report that provides an overview of a company's financial performance, corporate governance, and other relevant information for a specific fiscal year. The financial statements are a key component of the annual report, which include the income statement, balance sheet, and cash flow statement. These statements provide information about a company's revenues, expenses, assets, liabilities, and cash flow.

In addition to financial statements, an annual report may include other components, such as the director's report, which provides an overview of the company's operations and highlights key achievements and challenges. The director's report may also include information about the company's future plans and strategies.

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1.8 Questions for Practice

1. Corporate Financial Reporting contains:
   (1) Qualitative information
   (2) Quantitative information
   Select the correct answer from the options given below:
   (*a*) (1) only
   (*b*) Neither (1) nor (2)
   (*c*) (2) only
   (*d*) Both (1) and (2)
   Ans.: (*d*) Both (1) and (2)
2. Define corporate financial reporting?
3. Explain the need and Objectives of corporate financial reporting.
4. What is the Director's report? Explain its content.
5. What is an annual report? How is it different from Financial Statements?

1.9 References

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LESSON

2

XBRL Reporting

Dr. Rakesh Kumar Gupta

STRUCTURE

2.1 *Learning Objectives*
2.2 *Introduction*
2.3 *Meaning of XBRL*
2.4 *Definition of XBRL*
2.5 *Users of XBRL*
2.6 *Benefits of XBRL*
2.7 *Who developed XBRL?*
2.8 *Future prospects of XBRL?*
2.9 *XBRL International*
2.10 *XBRL in India*
2.11 *Taxonomy*
2.12 *Summary*
2.13 *Self-Assessment Questions*
2.14 *References*

2.1 Learning Objectives

After reading this chapter, students will be able to:

- Understand the purpose and challenges of electronic business reporting.
- Understand the principles and concepts of XBRL as the reporting standard.
- Recognize the framework and key components of the XBRL standard.
- Recognize the requirements to successfully implement XBRL reporting.

2.2 Introduction

XBRL (eXtensible Business Reporting Language) is a standardized computer language used for electronic communication and exchange of financial information. It is a global

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standard for exchanging financial information and is based on XML (eXtensible Markup Language).

The unique tags in XBRL, known as "elements," allow for the identification and capture of specific data points within financial information. These elements are standardized and can be read by computer systems, making it easier to process and analyze financial information across different platforms and systems.

By using tags, XBRL provides context for financial information, including information such as units of measure, currencies, dates, and other relevant data points. This allows for more efficient and accurate analysis of financial information and enables stakeholders to better understand the financial performance and position of a company.

XBRL allows for the tagging of financial data with contextual information, such as units of measurement, currency, and time period, making it easy to understand and analyze financial data across different platforms and systems. This standard is used to report financial data to various regulators and is also used by companies to exchange financial information with investors, analysts, and other stakeholders.

XBRL is based on XML, which is a markup language used to encode documents in a format that can be read by both humans and computers. XML allows for the creation of custom tags that can be used to define and structure data, making it an ideal tool for sharing information between businesses and on the internet.

XBRL aims to improve the quality, accuracy, and transparency of financial reporting, reduce the time and cost of preparing and disseminating financial information, and enable more efficient and effective analysis of financial data. It is used by a wide range of organizations, including regulatory bodies, accounting firms, financial institutions, and corporations.

XBRL is an important tool for improving financial reporting and increasing transparency in the financial markets. It provides a standardized way of presenting financial information that can be easily understood and analyzed, leading to better decision-making and more informed stakeholders.

Additionally, XBRL can also help to streamline the process of data validation and reduce the risk of errors in financial reporting. By adopting best practices for electronic transmission and utilizing standardized data

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elements, XBRL can facilitate greater consistency and accuracy in the reporting process, which can ultimately benefit both the banks and the RBI.

One of the key features of XBRL is the use of taxonomies, which are collections of standardized data elements and relationships between them that are used to define the structure of financial reports. Taxonomies are developed and maintained by organizations such as XBRL International Inc. (XII) and are designed to be compatible with worldwide standards and best practices.

By using taxonomies, XBRL is able to ensure standardization and consistency in the data pieces that make up financial reports. This makes it easier for stakeholders to compare and analyze financial information across different companies and industries, and for regulators to enforce reporting requirements and monitor compliance.

XBRL is indeed an open standard, which means that it is freely available for use and development by anyone. This has contributed to its widespread adoption and use in various industries and sectors around the world

2.3 Meaning of XBRL

XBRL stands for eXtensible Business Reporting Language. It is a standardized language for communication in electronic form that can be used by companies to express, report, or file financial information in accordance with regulatory requirements. The main idea behind XBRL is to give each financial term its own unique tag that can be read by a computer, making it easier to standardize and rationalize financial reporting, reduce the reporting burden, and enable more efficient analysis of financial data.

Business reporting is undergoing a revolutionary transformation all over the world as a result of the introduction of XBRL, a language that allows for the electronic interchange of commercial and financial data. The term XBRL is made up of four terms *i.e.*

X- Extensible

B- Business

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R- Reporting

L- Language

These terms are briefly explained as under:

- **X (Extensible):** This refers to the fact that XBRL is a flexible and adaptable language that can be customized and extended to suit the needs of different organizations and industries. The "extensible" aspect of XBRL is what allows it to be used for a wide range of financial reporting and business communication purposes.
- **B (Business):** This refers to the fact that XBRL is specifically designed for business and financial reporting. It is a specialized language that is tailored to the unique needs and requirements of the business world.
- **R (Reporting):** This refers to the fact that XBRL is primarily used for reporting financial and business information. It is a standardized way of presenting financial data that makes it easier to compare and analyze information from different sources.
- **L (Language):** This simply refers to the fact that XBRL is a computer language, which means that it is a structured way of encoding information so that it can be read and processed by machines. The language consists of a set of rules and syntax that govern how information is represented and communicated.

XBRL is an open, non-proprietary technology standard that is designed for sharing business and financial data electronically. It is a type of XML language that uses tags to identify each data element within a financial statement or report, which makes it easier to search, analyze, and compare data across different companies and industries. With XBRL, financial reporting becomes more transparent, efficient, and accessible to stakeholders such as investors, regulators, and analysts. It also helps to reduce errors, streamline processes, and improve data quality.

The shift to XBRL-based reports is indeed similar to the transition from film photography to digital photography or from paper maps to digital maps. XBRL allows for more precise and accurate information that can be easily shared, analysed, and manipulated. Just as digital photography and maps provide additional possibilities and capabilities that were not available with film or paper maps, XBRL offers new opportunities for

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data analysis and processing that were not available before. Additionally, just as digital photography and maps are more efficient and cost-effective, XBRL-based reporting is also more efficient, streamlined, and cost-effective compared to traditional paper-based or PDF-based reporting.

2.4 Definition of XBRL

The Companies (Filing of Documents and Forms in Extensible Business Reporting Language) Rules, 2015 defines XBRL as a standardized language for electronic communication that can be used by companies to express, report, or file financial information in accordance with the Companies Act, 2013. This means that companies are required to use XBRL for filing financial statements and other documents with the Ministry of Corporate Affairs in India.

In simple parlance, XBRL can be defined as under:

1. XBRL (eXtensible Business Reporting Language) is a standardized computer language used for the electronic communication and exchange of financial and business information. It allows for the tagging of financial data with contextual information, making it easy to understand and analyze financial data across different platforms and systems.
2. XBRL is a global standard for electronic reporting of business and financial data. It enables the exchange of data in a machine-readable format that can be easily understood and processed by computers, facilitating the efficient and effective analysis of financial data.
3. XBRL is a computer language that is used for the electronic exchange of financial and business information. It is designed to improve the accuracy, quality, and transparency of financial reporting, and reduce the time and cost associated with preparing and disseminating financial information.

2.4.1 *Important concepts related to XBRL*

Some important concepts related to XBRL include:

1. XML stands for eXtensible Markup Language and it is a markup language that is used to describe and store data in a format that

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is both human-readable and machine-readable. XBRL is built on top of XML and uses XML tags to identify and describe financial information within a report. Each tag corresponds to a specific financial concept, such as revenue, expenses, assets, and liabilities.

One of the key advantages of using XML in XBRL is that it allows for the creation of custom taxonomies that can be used to describe financial information in a standardized way. Taxonomies are essentially lists of financial concepts that are used to identify and describe data in XBRL reports. By using standardized taxonomies, financial data can be compared and analyzed more easily across different companies, industries, and countries.

Another advantage of using XML in XBRL is that it makes it easy to transform financial data into different formats, such as HTML or PDF. This can be useful for companies that need to share financial information with investors, regulators, or other stakeholders who may not have the software tools to read XBRL reports directly.

Overall, the use of XML in XBRL allows for the creation of standardized, machine-readable financial reports that can be easily shared, analyzed, and compared across different platforms and systems.

2. **Taxonomy:** A taxonomy is a hierarchical structure that defines the terms and relationships used in XBRL reporting. It provides a standardized set of definitions for the various financial concepts used in reporting, making it easier to compare and analyze data.
3. **Instance Document:** An instance document is an XBRL file that contains the actual financial data for a specific reporting period. It is created by mapping the financial data from the accounting system to the appropriate elements in the XBRL taxonomy.
4. **Element:** An element is a specific piece of financial information, such as a balance sheet line item or income statement category. Each element is assigned a unique identifier in the XBRL taxonomy.
5. **Namespace:** A namespace is a unique identifier that identifies a set of elements within an XBRL taxonomy. It is used to distinguish elements from different taxonomies that might have the same name.

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6. **Linkbase:** A linkbase is a file that contains information about the relationships between elements in an XBRL taxonomy. It defines how the elements are related to each other, such as which elements are part of which calculation or which elements are related to specific footnotes.
7. **Validation:** Validation is the process of checking XBRL files for errors or inconsistencies. XBRL validation ensures that the instance document is consistent with the taxonomy, and that the data is accurate and complete.
8. **Rendering:** Rendering is the process of presenting XBRL data in a human-readable format, such as a table or chart. Rendering tools allow users to view and analyze XBRL data without having to understand the underlying XBRL syntax.

2.4.2 *Features of XBRL*

1. **Business Rules Validation**

   Business Rules Validation is a significant feature of XBRL. It allows users to verify that the information contained in the XBRL instance document is consistent with the taxonomy and the predefined business rules. Business Rules Validation ensures that the data is valid, reliable, and consistent with the specified format. This feature can significantly reduce the amount of time and effort required to verify the accuracy and consistency of financial data, particularly for regulators and auditors.

   In XBRL, Business Rules are essentially data validation rules, which may be defined in the taxonomy itself or as separate business rule files. Business Rules Validation ensures that the XBRL instance document meets these validation rules, providing a consistent and reliable way to verify the accuracy of financial data. If the document does not pass the validation process, the user is alerted to the specific errors or inconsistencies that need to be addressed.
2. **Clear Definitions**

   Clear definitions are an important feature of XBRL that helps to ensure consistency and accuracy in financial reporting. XBRL taxonomies

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provide clear and precise definitions for financial reporting terms, such as revenue, expenses, assets, and liabilities, which can be easily understood by users of the financial data. This feature helps to eliminate ambiguity and reduces the risk of misinterpretation or errors in reporting. Clear definitions in XBRL also facilitate the automatic validation and verification of financial data, which helps to ensure its accuracy and reliability. Overall, the clear definitions provided by XBRL taxonomies enhance the quality of financial reporting and make it easier for users to understand and analyze financial data.

3. **Strong Software Support**

   One of the key features of XBRL is strong software support. XBRL provides a standardized way of representing financial data, which enables software developers to create applications that can read, process, and analyze XBRL data. This has led to the development of a wide range of software tools and applications that support XBRL, including accounting software, data analysis tools, financial reporting tools, and more.

   XBRL-enabled software tools can help businesses and other organizations streamline their financial reporting processes and reduce errors by automating many of the tasks involved in preparing financial reports. These tools can also help stakeholders better understand financial data by providing more detailed and accurate information in a standardized format. Additionally, software support for XBRL enables businesses to more easily share financial data with other stakeholders, such as investors, regulators, and analysts

4. **Support Multi language**

   This means that XBRL allows for the creation of taxonomy labels in multiple languages, making it easier for companies to report financial information across different regions and to comply with local language requirements. XBRL also supports multilingual presentations, which enables users to view financial information in their preferred language. This feature is particularly important for multinational corporations operating in multiple countries with different language requirements.

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2.4.3 *Uses of XBRL*

XBRL has several uses in business and financial reporting. Some of them are:

1. **Financial Reporting:** XBRL enables financial data to be exchanged between businesses, financial institutions, and government agencies in a standard, digital format. This reduces the time and cost involved in manual data entry and analysis.
2. **Regulatory Compliance:** Many regulatory bodies such as the SEC, RBI, and MCA have mandated the use of XBRL for reporting financial data. This ensures standardisation and accuracy in reporting, making it easier for regulators to analyse the data.
3. **Investor Analysis:** XBRL data can be used by investors to perform analysis and comparison of financial data across companies, industries and regions. It provides them with access to standardised, comparable data which can aid in making informed investment decisions.
4. **Risk Management:** The use of XBRL in financial reporting helps companies to identify and manage risks more effectively. It enables risk data to be captured in a standardised format, allowing for better analysis and decision-making.
5. **Efficiency and Transparency:** The use of XBRL promotes transparency and efficiency in financial reporting. It allows for faster, more accurate data analysis and sharing, reducing errors and the need for manual data entry.

2.5 Users of XBRL

The XBRL file format has been adopted as the global standard for digital reporting. All individuals who are required to generate, send, consume, or analyse such information can gain from utilising it. There are a wide variety of applications for XBRL, each serving a unique purpose.

The users of XBRL can be divided into two categories:

1. **Business Users:** This includes companies, financial institutions, investors, analysts, auditors, and other stakeholders who use XBRL

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to prepare and analyze financial reports, perform risk assessments, and make investment decisions.

2. **Regulatory Users:** This includes government agencies, regulatory bodies, and standard-setting organizations that use XBRL to collect, analyze, and disseminate financial information. Examples of regulatory users include the U.S. Securities and Exchange Commission (SEC), the European Banking Authority (EBA), and the International Accounting Standards Board (IASB).

Important XBRL users include (but are not limited to) the following:

(*a*) *Regulators*

Regulators are one of the major users of XBRL. They need access to huge amounts of complex data about the firms they regulate in terms of both performance and risk. Some examples of regulatory bodies that use XBRL include:

1. **Financial Regulators:** These regulators need to analyze the performance and risk of financial institutions, such as banks and insurance companies, to ensure they are complying with regulations and maintaining financial stability.
2. **Securities Regulators and Stock Exchanges:** These regulators use XBRL to analyze the performance and compliance of listed firms and securities, and ensure that this information is available for markets to consume and analyze so that they can fulfil their regulatory responsibilities.
3. **Business Registrars:** These organizations are responsible for receiving a variety of corporate data regarding private and public firms, including annual financial statements, and making that data publicly available to the general public.
4. **Tax Authorities:** These authorities need financial statements and other compliance information from businesses in order to process and analyze the corporate tax affairs of those businesses.
5. **Authorities in Charge of Statistics and Monetary Policy:** These authorities require information on the financial performance of a variety of different organizations for statistical analysis and to support monetary policy decisions.

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Overall, XBRL allows regulators to collect and analyze data more efficiently and effectively, improving their ability to regulate the markets and ensure compliance with regulations.

(*b*) *Companies*

Companies can also be users of XBRL in several ways:

1. **Financial Reporting:** Companies can use XBRL to prepare and file their financial statements with regulatory authorities, such as the Securities and Exchange Commission (SEC) in the United States or the Companies House in the United Kingdom. This makes the process faster, more efficient, and more accurate.
2. **Internal Reporting:** Companies can use XBRL to streamline their internal reporting processes. By tagging financial data with XBRL, they can automate the process of consolidating data from various sources, which saves time and reduces errors.
3. **Benchmarking:** Companies can use XBRL to benchmark their financial performance against that of their peers. By using XBRL to tag their financial data, they can compare their performance to other companies in their industry, which helps them identify areas where they can improve.
4. **Investor Relations:** Companies can use XBRL to provide investors with more accurate and timely financial information. By making their financial data available in XBRL format, investors can easily access and analyze the information they need to make informed investment decisions.

(*c*) *Governments*

As a user of XBRL, governments can benefit in several ways. For example, using XBRL can help governments:

1. **Standardize Financial Reporting:** XBRL allows for standardized tagging of financial information, which can make it easier for governments to compare data across different organizations.
2. **Improve Data Accuracy:** XBRL requires specific data elements to be tagged, which can help reduce errors in financial reporting.

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3. **Increase Efficiency:** Using XBRL can streamline the financial reporting process, making it faster and more efficient for governments to collect and analyze financial data.
4. **Enhance Transparency:** XBRL can provide greater transparency into financial reporting by making it easier for governments to access and analyze financial data.

Overall, using XBRL can help governments to more effectively monitor and regulate financial activity, which can ultimately lead to improved economic stability and growth.

(*d*) *Data Providers*

Data providers can also benefit greatly from using XBRL as a standard for reporting financial and business data. As a user of XBRL, data providers can benefit in several ways, such as:

1. **Standardization of Data:** XBRL provides a standardized language and tagging structure for financial and business data, which can make it easier for data providers to exchange data with other entities and platforms.
2. **Streamlining Data Collection and Analysis:** XBRL allows for more efficient collection and analysis of financial data, reducing the time and resources required for data management.
3. **Improved Accuracy:** XBRL requires specific data elements to be tagged, which can help reduce errors in financial reporting and ensure greater accuracy in data collection.
4. **Enhanced Accessibility and Transparency:** XBRL data can be easily accessed and shared across platforms, improving transparency and collaboration among data providers.
5. **Increased Value to Clients:** By using XBRL, data providers can offer clients a standardized, high-quality data format that can be more easily integrated into their own reporting systems.

Overall, using XBRL can help data providers to improve data quality, streamline data management, and provide greater value to clients by offering a standardized and efficient reporting format.

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(*e*) *Analysts and Investors*

Analysts and investors can also benefit from using XBRL as a standard for financial reporting and analysis. As a user of XBRL, analysts and investors can benefit in several ways, such as:

1. **Improved Accuracy and Consistency:** XBRL provides a standardized language and tagging structure for financial and business data, which can help ensure greater accuracy and consistency in financial reporting.
2. **Faster Analysis:** XBRL can facilitate faster and more efficient analysis of financial data by allowing analysts and investors to easily search and compare data across different organizations.
3. **Enhanced Transparency:** XBRL can provide greater transparency into financial reporting by making it easier for analysts and investors to access and analyze financial data.
4. **Better Decision-Making:** By providing a standardized format for financial reporting and analysis, XBRL can help analysts and investors to make better-informed investment decisions.
5. **Increased Efficiency:** XBRL can help investors and analysts to save time and resources by automating the collection and analysis of financial data.

Overall, using XBRL can help analysts and investors to improve their analysis of financial data, make better-informed investment decisions, and enhance transparency in financial reporting.

(*f*) *Accountants*

Accountants can also benefit greatly from using XBRL as a standard for financial reporting and analysis. As a user of XBRL, accountants can benefit in several ways, such as:

1. **Improved Accuracy and Consistency:** XBRL provides a standardized language and tagging structure for financial and business data, which can help ensure greater accuracy and consistency in financial reporting.
2. **Streamlining Financial Reporting:** XBRL can help accountants to streamline the financial reporting process by automating the tagging and exchange of financial data.

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3. **Enhanced Collaboration:** XBRL can facilitate greater collaboration between accountants and other stakeholders by providing a standardized format for financial reporting and analysis.
4. **Increased Efficiency:** XBRL can help accountants to save time and resources by automating the collection and analysis of financial data.
5. **Better Compliance:** By providing a standardized format for financial reporting, XBRL can help accountants to ensure compliance with regulatory requirements and standards.

Overall, using XBRL can help accountants to improve the accuracy and efficiency of financial reporting, enhance collaboration with stakeholders, and ensure compliance with regulatory requirements.

2.6 Benefits of XBRL

Reporting with XBRL has a number of advantages over older forms, including the following:

1. **Standardization:** XBRL provides a standardized language and tagging structure for financial and business data, which helps ensure greater accuracy and consistency in financial reporting.
2. **Automated Data Processing:** XBRL can be easily processed by computers, reducing the need for manual data entry and analysis.
3. **Simplified Data Exchange:** XBRL allows for more efficient exchange of financial and business data between organizations and stakeholders.
4. **Increased Efficiency:** XBRL can help streamline the financial reporting process, reducing the time and resources required for data management and analysis.
5. **Improved Accuracy:** XBRL requires specific data elements to be tagged, which helps reduce errors in financial reporting and ensures greater accuracy in data collection.
6. **Enhanced Transparency:** XBRL provides greater transparency into financial reporting by making it easier for stakeholders to access and analyze financial data.

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7. **Better Decision-Making:** By providing a standardized format for financial reporting and analysis, XBRL can help stakeholders to make better-informed decisions.
8. **Tagging of Transactions:** One of the key benefits of XBRL is the ability to tag transactions with specific data elements, which helps to improve the accuracy and consistency of financial reporting. When transactions are tagged with XBRL, they are identified with specific data elements that can be easily processed and analyzed by computer systems. This enables stakeholders to more easily compare and analyze financial data across different organizations.

For example, when a financial statement is tagged with XBRL, each line item can be identified with a specific data element, such as revenue or net income. This allows for more accurate and consistent reporting across different organizations, and helps to reduce errors in financial reporting.

Tagging transactions with XBRL can also help to streamline the financial reporting process by reducing the need for manual data entry and analysis. With XBRL, financial data can be easily processed by computer systems, which saves time and resources and improves the overall efficiency of financial reporting. Tagging transactions with XBRL provides many benefits for organizations and stakeholders, including improved accuracy and consistency of financial reporting, streamlined data processing, and more efficient analysis of financial data.

Overall, XBRL offers many advantages over older forms of reporting, helping organizations to improve the accuracy and efficiency of financial reporting, enhance transparency and collaboration among stakeholders, and ensure compliance with regulatory requirements.

2.7 Who Developed XBRL?

XBRL was developed by an international non-profit organization called XBRL International Inc. (formerly known as the XBRL Consortium), which was founded in 1998. XBRL International is a global network of companies, organizations, and government agencies that are dedicated to developing and promoting the use of XBRL as a standard for financial reporting and analysis.

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The initial development of XBRL was led by Charles Hoffman, who was working as a consultant at the time. Hoffman recognized the need for a standardized language for financial reporting that would enable more efficient processing and analysis of financial data. With the help of a team of experts, Hoffman developed the first version of XBRL in the late 1990s.

Since then, XBRL International has continued to develop and refine the XBRL standard, with the most recent version of XBRL (XBRL 2.1) released in 2010. Today, XBRL is widely used by organizations, regulators, and other stakeholders around the world, and is considered a key standard for financial reporting and analysis.

2.8 Future Prospects of XBRL?

The future of XBRL is radiant, as the use of this standardized language for financial reporting and analysis continues to grow worldwide. Here are some potential developments that may impact the future of XBRL:

1. **Increased Adoption:** As more organizations and governments adopt XBRL as a standard for financial reporting, its use is likely to continue to expand.
2. **Integration with Emerging Technologies:** XBRL may be integrated with emerging technologies such as blockchain, artificial intelligence, and machine learning to enable more efficient and accurate processing of financial data.
3. **Expansion into New Areas:** XBRL may be adopted in new areas beyond financial reporting, such as supply chain management and sustainability reporting.
4. **Continued Development and Refinement:** XBRL International will likely continue to develop and refine the XBRL standard to meet the evolving needs of stakeholders and to keep pace with changes in technology and reporting requirements.
5. **Improved Interoperability:** The development of improved data exchange protocols and greater interoperability between different XBRL-based systems could help to further expand the use of XBRL.

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Overall, the future of XBRL looks promising, with its use likely to continue to expand and evolve as new technologies and reporting requirements emerge.

2.9 XBRL International

XBRL International (XII) is a non-profit consortium and the primary international standards organization for XBRL. It was formed in 1998 to develop and promote the adoption of XBRL as a global standard for electronic business reporting.

XII is governed by a Board of Directors elected by its members, who come from a variety of organizations, including government agencies, accounting firms, software companies, and financial institutions. The organization's activities are funded by membership fees, grants, and donations from individuals and organizations.

XII works to develop and maintain the XBRL standard, providing technical support and training to its members and promoting the adoption of XBRL around the world. The organization also works closely with regulators and other stakeholders to promote the use of XBRL in financial reporting and analysis.

In addition to its work on XBRL, XII is also involved in a number of related initiatives, including the development of taxonomies for specific industries, the promotion of data quality in financial reporting, and the development of tools and best practices for using XBRL effectively.

XII plays a key role in the development and promotion of XBRL as a global standard for electronic business reporting, and its efforts are helping to drive greater efficiency, accuracy, and transparency in financial reporting and analysis.

2.10 XBRL in India

XBRL is a global initiative directed by the non-profit organization XBRL International Inc. (XII). The organization has members from various agencies located in more than 164 countries. In India, the Ministry of Corporate Affairs (MCA) has shifted its reporting format for Annual Report and Cost Audit report submissions to XBRL from January of this year. Additionally,

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the Reserve Bank of India (RBI) has transitioned to XBRL reporting for the Banking Sector, while the Securities and Exchange Board of India (SEBI) has mandated XBRL reporting for mutual funds. The Institute of Chartered Accountants of India has been given the responsibility of forming an XBRL national jurisdiction and executing the standards for financial reporting in India by the Indian government.

2.10.1 *Implementation of XBRL in India*

The Institute of Chartered Accountants of India (ICAI) has been designated as the official agency for implementing the XBRL reporting standard in India by the government of India. The ICAI is responsible for developing and maintaining the XBRL taxonomy for financial reporting in India, and for promoting the adoption and use of XBRL by companies and other stakeholders.

In the banking sector, the Reserve Bank of India (RBI) has been tasked with implementing XBRL reporting for banks. The RBI has established a High-Level Steering Committee to oversee the implementation of XBRL reporting and to ensure that it aligns with the objectives of the RBI.

The implementation of XBRL reporting in India is aimed at improving the efficiency and standardization of financial reporting, reducing the reporting burden on companies and banks, and promoting greater transparency and accountability in the financial sector.

2.10.2 *Implementation of XBRL in Banking sector*

The Reserve Bank of India (RBI) has recognized the potential benefits of XBRL for improving the efficiency and standardization of financial reporting by banks. The current Online Returns Filing System (ORFS) used by the RBI for data capture and transmission of returns from banks to the RBI does not include any in-built standardization.

By implementing XBRL, the RBI can introduce standardized reporting formats and data elements that can be easily understood and analyzed across different banks and systems. This can help to reduce the reporting burden on banks and improve the accuracy and timeliness of financial reporting to the RBI.

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The implementation of XBRL reporting in India for banks is being done in phases. In phase I, seven returns were implemented using the XBRL system. These returns include:

1. **Section 42(2) Form A of the RBI Act, 1934:** This is a statutory return that banks are required to submit to the RBI on a monthly basis, providing details of their balance sheet and profit and loss account.
2. **Daily return on Gap, Positions and Balances (GPB):** this return provides information on the gap between a bank's assets and liabilities, as well as details on its positions and balances.
3. **Returns on Capital Adequacy (RCA):** This is a set of regulatory returns designed as per Basel II guidelines, which provide information on a bank's capital adequacy, risk-weighted assets, and other related metrics.
4. **Monthly returns such as Form VIII and Form X:** These returns provide information on various aspects of a bank's operations, such as its lending activities, deposits, and investments.
5. **Annual returns such as the Financial Statement:** These returns provide a comprehensive overview of a bank's financial performance over the course of a year.
6. **Form IX:** This is a return that provides details on a bank's statutory reserves and provisions.

By implementing these returns using the XBRL system, the RBI aims to improve the efficiency and accuracy of data reporting by banks, reduce the reporting burden on banks, and facilitate better analysis and monitoring of the financial sector by the RBI.

2.10.3 *Adoption of XBRL in India*

The XBRL International organisation has a jurisdiction in India called XBRL India. Its primary purpose is to promote and support the adoption of XBRL in India as the standard for electronic business reporting in India. This will be accomplished through a combination of promotion and encouragement. Standard Business Reporting Language (XBRL) is

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currently being pushed forward by XBRL India, which is collaborating closely with various regulatory bodies, stock exchanges, and software businesses. XBRL India is now working on building taxonomies for specific industries like as insurance, power, and NBFCs in cooperation with the regulatory bodies for those sectors.

XBRL was officially introduced in India by the Ministry of Corporate Affairs (MCA) in 2011, making it mandatory for certain types of companies to file their financial statements and other regulatory filings in XBRL format. Since then, the adoption of XBRL in India has continued to grow, with more and more companies and regulators using XBRL to improve the accuracy and efficiency of financial reporting and analysis.

In India, XBRL is primarily used for filing financial statements and other regulatory reports with the MCA, including balance sheets, profit and loss statements, and cash flow statements. Companies in India are required to file these reports in XBRL format based on a taxonomy developed specifically for Indian reporting requirements.

In addition to its use in regulatory reporting, XBRL is also being used by companies in India for internal financial reporting and analysis. By using XBRL to tag and standardize financial data, companies can more easily analyze and compare financial data across different business units, departments, and locations.

The adoption of XBRL in India is helping to improve the accuracy, efficiency, and transparency of financial reporting and analysis, and is helping to position Indian companies and regulators for success in an increasingly data-driven business environment.

(A) Adoption of XBRL by Ministry of Corporate Affairs (MCA)

In 2011, the Ministry of Corporate Affairs (MCA) required businesses to submit their financial data in XBRL format. It is a well-established truth that introducing new systems requires some time for the market to adjust and become accustomed to the changes. Furthermore, it is more difficult to achieve success when the systems themselves experience major change before they have been fully accepted. The first startup phase, major transformation, and finally stable operation are the stages that are traversed along the process of XBRL adoption by MCA.

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Before the issuance of Companies Act, 2013

Before the issuance of the Companies Act, 2013, the Ministry of Corporate Affairs (MCA) in India had already introduced XBRL as a voluntary filing option for certain types of companies. In 2010, the MCA launched a pilot project to test the use of XBRL for filing financial statements with the Registrar of Companies (RoC). The pilot project was initially launched in six cities, including Mumbai, Delhi, Chennai, Kolkata, Bangalore, and Hyderabad.

Following the success of the pilot project, the MCA made XBRL filing mandatory for certain types of companies in India in 2011. Under the new rules, companies that met certain criteria were required to file their financial statements and other regulatory filings in XBRL format. The XBRL filing requirement was initially introduced for companies with a paid-up capital of Rs. 5 crore or more, or with a turnover of Rs. 100 crore or more.

To facilitate the adoption of XBRL among Indian companies, the MCA developed an Indian GAAP taxonomy that was specifically tailored to Indian reporting requirements. The MCA also provided training and technical support for XBRL implementation and developed a user manual and an online filing system to help companies comply with the XBRL filing requirements.

The early adoption of XBRL by the MCA helped to establish XBRL as a standard format for financial reporting and analysis in India, and paved the way for the continued growth and expansion of XBRL in the country.

After the issuance of Companies Act, 2013

After the issuance of the Companies Act, 2013, the Ministry of Corporate Affairs (MCA) in India continued to promote and strengthen the adoption of XBRL for financial reporting and analysis. The new Companies Act, which came into effect in April 2014, reinforced the importance of XBRL by requiring companies to file their financial statements and other regulatory filings in XBRL format.

Under the new rules, all companies in India are required to file their financial statements and other regulatory filings in XBRL format using the Indian GAAP taxonomy. The XBRL filing requirement applies to all types of companies, regardless of their size or turnover, and failure to

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comply with the XBRL filing requirements can result in penalties and other legal consequences.

To facilitate compliance with the XBRL filing requirements, the MCA has continued to provide training and technical support for XBRL implementation, and has developed a number of resources and tools to help companies comply with the filing requirements. These resources include an online filing system, a detailed user manual, and a helpdesk to assist companies with any questions or issues related to XBRL.

The adoption of XBRL by the MCA under the new Companies Act has helped to further strengthen the use of XBRL as a standard format for financial reporting and analysis in India, and has helped to position Indian companies and regulators for success in an increasingly data-driven business environment.

Companies required to follow XBRL Reporting

In India, companies are required to follow XBRL reporting for filing their financial statements and other regulatory filings with the Ministry of Corporate Affairs (MCA) under the Companies Act, 2013. The XBRL reporting requirement applies to all companies registered under the Companies Act, regardless of their size, type or turnover.

The specific types of financial statements that must be filed in XBRL format include the balance sheet, profit and loss account, cash flow statement, and statement of changes in equity, along with any other statements or documents required by the MCA.

The XBRL reporting requirement also applies to other regulatory filings, such as the Director's Report, Corporate Governance Report, and Annual Return, among others.

To ensure compliance with the XBRL reporting requirement, the MCA has developed a comprehensive taxonomy based on the Indian Accounting Standards (Ind AS) that companies must use to tag their financial information. The MCA has also developed an online filing system and other resources to assist companies with their XBRL reporting.

Failure to comply with the XBRL reporting requirement can result in penalties and other legal consequences for companies, so it is important for companies to ensure that they are following the proper procedures for XBRL reporting under the Companies Act, 2013.

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Companies exempt from XBRL Reporting

In India, there are certain types of companies that are exempt from XBRL reporting under the Companies Act, 2013. These include:

1. **One Person Companies (OPCs) and Small Companies:** OPCs and small companies are exempt from XBRL reporting if their paid-up capital is less than or equal to Rs. 50 lakh and their turnover is less than or equal to Rs. 2 crore.
2. **Banking and Insurance Companies:** Companies engaged in the business of banking and insurance are exempt from XBRL reporting.
3. **Section 8 Companies:** Section 8 companies, which are non-profit organizations formed for promoting commerce, art, science, sports, education, research, social welfare, religion, charity, or any other useful purpose, are exempt from XBRL reporting.
4. **Foreign Companies:** Foreign companies that are not required to prepare financial statements in accordance with the Indian Accounting Standards (Ind AS) are exempt from XBRL reporting.

It is important to note that these exemptions apply only to the requirement of filing financial statements in XBRL format. These companies are still required to file their financial statements and other regulatory filings with the Ministry of Corporate Affairs (MCA) in the prescribed format, and failure to comply with the filing requirements can result in penalties and other legal consequences.

XBRL & Filing of Cost Audit Report

In India, companies that are subject to cost audit under the Cost and Works Accountants Act, 1959 are required to file their cost audit reports with the Ministry of Corporate Affairs (MCA) in XBRL format. The requirement to file the cost audit report in XBRL format was introduced by the MCA in 2011, in order to streamline the filing process and improve the accuracy and efficiency of data collection.

Under the XBRL reporting framework, companies must use the Cost Audit Taxonomy developed by the Institute of Cost Accountants of India (ICAI) to tag their cost audit information. The cost audit report must be filed within 180 days of the end of the financial year to which the report relates.

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The XBRL reporting requirement for cost audit reports applies to all companies that are subject to cost audit under the Cost and Works Accountants Act, regardless of their size, type or turnover. Failure to comply with the XBRL reporting requirement can result in penalties and other legal consequences for companies.

The use of XBRL for filing cost audit reports has helped to streamline the reporting process and improve the accuracy and consistency of data collection, while also providing greater transparency and accountability for companies subject to cost audit in India.

(B) Adoption of XBRL by Reserve Bank of India (RBI)

The Reserve Bank of India (RBI) has also adopted XBRL for reporting purposes, particularly for regulatory reporting by banks and other financial institutions. In 2013, the RBI introduced the XBRL-based Centralized Data Repository System (CDR) for banks, which allows them to submit their regulatory reports in a standardized, machine-readable format.

Under the CDR system, banks are required to submit their regulatory reports, including the balance sheet, profit and loss account, and other financial statements, in XBRL format. The XBRL reporting requirement applies to all banks and financial institutions regulated by the RBI, regardless of their size or type.

The adoption of XBRL by the RBI has helped to streamline the reporting process for banks and other financial institutions, while also improving the accuracy and consistency of data collection. It has also made it easier for the RBI to analyze and interpret financial data, and to monitor compliance with regulatory requirements.

In addition to the CDR system, the RBI has also introduced other XBRL-based reporting requirements for banks and financial institutions, such as the reporting of credit information by credit information companies in XBRL format. The RBI continues to explore ways to expand the use of XBRL for reporting purposes, with the goal of promoting greater efficiency, transparency, and accountability in the financial sector.

(C) Adoption of XBRL by Securities and Exchange Board of India (SEBI)

The Securities and Exchange Board of India (SEBI), which regulates the securities market in India, has also adopted XBRL for reporting purposes.

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SEBI has introduced a number of XBRL-based reporting requirements for companies listed on stock exchanges in India.

For instance, SEBI has mandated the filing of financial statements in XBRL format by listed companies, starting from the financial year 2010-11. Companies are required to file their financial statements, including the balance sheet, profit and loss account, and cash flow statement, in XBRL format using the Indian GAAP taxonomy.

SEBI has also introduced other XBRL-based reporting requirements for listed companies, such as the requirement to file their shareholding pattern, corporate governance report, and other regulatory filings in XBRL format. The XBRL reporting requirement applies to all listed companies, regardless of their size or type.

The adoption of XBRL by SEBI has helped to improve the efficiency and accuracy of reporting by listed companies, while also making it easier for investors to access and analyze financial data. The use of XBRL has also helped to standardize reporting across different companies and sectors, making it easier for regulators to monitor compliance with regulatory requirements.

The adoption of XBRL by SEBI has been a positive development for the Indian securities market, promoting greater transparency, accountability, and efficiency in financial reporting

(D) Adoption of XBRL by Bombay Stock Exchange (BSE)

The Bombay Stock Exchange (BSE), which is the oldest stock exchange in Asia, has also adopted XBRL for reporting purposes. BSE has introduced a number of XBRL-based reporting requirements for companies listed on its exchange.

For instance, BSE has mandated the filing of financial statements in XBRL format by listed companies, starting from the financial year 2012-13. Companies are required to file their financial statements, including the balance sheet, profit and loss account, and cash flow statement, in XBRL format using the Indian GAAP taxonomy.

In addition to financial statements, BSE has also introduced other XBRL-based reporting requirements for listed companies, such as the requirement to file their shareholding pattern and corporate governance report in XBRL

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format. The XBRL reporting requirement applies to all listed companies on BSE, regardless of their size or type.

The adoption of XBRL by BSE has helped to improve the efficiency and accuracy of reporting by listed companies, while also making it easier for investors to access and analyze financial data. The use of XBRL has also helped to standardize reporting across different companies and sectors, making it easier for regulators to monitor compliance with regulatory requirements.

The adoption of XBRL by BSE has been a positive development for the Indian securities market, promoting greater transparency, accountability, and efficiency in financial reporting.

2.11 Taxonomy

In XBRL, a taxonomy is a set of rules and definitions that define the specific elements, concepts, and relationships between data items. It is essentially a classification system that provides a framework for organizing and exchanging financial information in a standardized manner.

The Companies (Filing of Documents and Forms in Extensible Business Reporting Language) Regulations, 2015 define taxonomy as an electronic lexicon approved by the Central Government for reporting business data in relation to any documents or forms specified in the rules.

There are two main types of taxonomies in XBRL:

1. **Standard Taxonomies:** These are pre-defined and maintained by XBRL International Inc. (XII) and cover general accounting concepts that are applicable across different industries and jurisdictions. Standard taxonomies include elements such as assets, liabilities, income, expenses, and equity.
2. **Custom Taxonomies:** These are created by organizations to meet their specific reporting needs, and may include elements that are unique to their industry or business. Custom taxonomies may be based on the standard taxonomies, or they may be entirely unique to the organization.

Both types of taxonomies are used to create XBRL instance documents, which are XML files containing specific financial data. The taxonomy

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provides the structure and definitions necessary for the data to be accurately interpreted and analyzed.

Multiple taxonomies are required to meet the different business reporting needs of various organisations and jurisdictions. National jurisdictions may have their own reporting requirements that are reflected in their own taxonomies. In addition, specific industries, regulators, and businesses may require taxonomies or taxonomy extensions to meet their unique reporting needs. For example, a regulatory agency may require a specific set of data points to be reported by a particular industry, which may not be covered by the standard taxonomy. In such cases, a taxonomy extension may be created to accommodate the additional data points.

'Recognized Taxonomies' lists taxonomies that have been officially recognised by XBRL International. Some of the recognized taxonomies by XBRL International are:

1. US GAAP (Generally Accepted Accounting Principles) Taxonomy
2. IFRS (International Financial Reporting Standards) Taxonomy
3. SBR (Standard Business Reporting) Taxonomy
4. Japanese GAAP Taxonomy
5. German GAAP Taxonomy
6. UK GAAP Taxonomy
7. Australian Taxonomy
8. Dutch GAAP Taxonomy
9. Chinese Accounting Standards Taxonomy
10. Indian GAAP Taxonomy

There are also many industry-specific taxonomies that have been recognized by XBRL International, such as the Solvency II Taxonomy for the insurance industry and the COREP Taxonomy for banking institutions.

Types of Taxonomies

Types of taxonomies officially recognised by XBRL International are given below:

(1) Global Taxonomies: These are taxonomies that are developed and maintained by XBRL International to provide a common language and framework for reporting across countries and jurisdictions.

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(2) **National Taxonomies:** These are taxonomies that are developed and maintained by individual countries or regions to meet their specific reporting requirements.

(3) **Industry-specific Taxonomies:** These are taxonomies that are developed for specific industries or sectors to address their unique reporting needs.

(4) **Interoperability Taxonomies:** These are taxonomies that are designed to enable the exchange of data between different taxonomies or reporting systems.

(5) **Extension Taxonomies:** These are taxonomies that are created by companies or organizations to supplement existing taxonomies with additional reporting concepts or requirements.

(6) Financial Reporting Taxonomies are a type of taxonomy used in XBRL that are specifically designed for financial reporting purposes. These taxonomies provide a standardized framework for companies to report their financial information in a consistent and structured manner. Financial Reporting Taxonomies typically include elements such as balance sheets, income statements, cash flow statements, and other financial metrics that are commonly used to evaluate the financial performance of a company.

One example of a Financial Reporting Taxonomy is the IFRS Taxonomy, which is designed for companies reporting financial information in accordance with International Financial Reporting Standards (IFRS). Another example is the US GAAP Taxonomy, which is used by companies reporting financial information in accordance with Generally Accepted Accounting Principles (GAAP) in the United States.

Financial Reporting Taxonomies are important because they help to standardize financial reporting across different companies, industries, and regions, making it easier for investors, analysts, and other stakeholders to compare and analyze financial information. They also help to reduce errors and inconsistencies in financial reporting by providing a structured framework for companies to follow.

(7) **GL Taxonomy:** GL (Global Ledger) Taxonomy refers to a specific type of financial reporting taxonomy that is designed to capture and report

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financial data in a standardized manner across multiple accounting systems and organizations. It is typically used as a general-purpose taxonomy for financial reporting and can be customized to fit the needs of individual organizations. The GL Taxonomy provides a standardized set of financial reporting concepts, relationships, and definitions that can be used to report financial data across multiple organizations, accounting systems, and jurisdictions. This makes it easier for companies to share financial information with their stakeholders and for regulators to analyze and compare financial data across different companies and industries. It is a supplement to XBRL for financial reporting, and it links financial reports to the detail that lies behind them. Additionally, it provides all of the precise information that is necessary for audit work papers, budget planning, and detailed reporting.

2.12 Summary

XBRL (eXtensible Business Reporting Language) is a language used for financial reporting. It provides a standardized way to define and exchange financial information between different systems and software applications. XBRL uses XML (eXtensible Markup Language) to tag financial data, making it machine-readable and enabling it to be easily analyzed and compared. This technology is widely used by regulators, companies, and investors to simplify financial reporting and improve the accuracy and transparency of financial data.

2.13 Self-Assessment Questions

1. What is XBRL?
2. Who developed XBRL?
3. What are the advantages of XBRL?
4. Who can benefit from using XBRL?
5. What is the future of XBRL?
6. Does XBRL benefit the comparability of financial statements?
7. Does XBRL cause a change in accounting standards?

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8. What are the benefits to a company from putting its financial statements into XBRL?
9. How does XBRL work?
10. How do companies create statements in XBRL?
11. Is India a member of XBRL International?
12. Which class of companies are required to file financial statements with Registrar as per XBRL Taxonomy?
13. Our Company has not satisfied any conditions specified as per section 137 of Companies Act for current financial year. Are we still required to file financial statements as per XBRL Taxonomy for the current financial year?
14. Which category of companies are exempted from filing financial statements in XBRL?
15. Which taxonomies developed for Indian reporting requirements? Where can I find taxonomies?

2.14 References

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L E S S O N

3

Financial Statement Footnotes & Segment Reporting

Dr. Rakesh Kumar Gupta

STRUCTURE

3.1 *Learning Objectives*
3.2 *Introduction*
3.3 *What are Financial Statement Footnotes?*
3.4 *Segment Reporting*
3.5 *Summary*
3.6 *Self-Assessment Questions*
3.7 *References*

3.1 Learning Objectives

After studying this Chapter, students will be able to:

- Define financial statement footnotes and their purpose.
- Identify the potential drawbacks of financial statement footnotes.
- Identify and describe the most common types of footnotes, including accounting policies, contingencies, and related party transactions.
- Understand the process of drafting financial statement footnotes.
- Define segment reporting and its objectives.
- Identify the scope of segment reporting, including the types of entities and industries that are required to report segments.
- Understand the primary and secondary segment reporting formats.
- Understand constitutes of a reportable segment.
- Understand the importance of segment accounting policies.

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3.2 Introduction

Financial statement footnotes are a crucial part of a company's financial reporting. They provide additional information about the financial statements, such as significant accounting policies, contingencies, and other important details that are not included in the main financial statements. Footnotes can help investors, analysts, and other stakeholders better understand a company's financial performance and position. Additionally, footnotes can help companies comply with regulatory requirements and provide transparency to investors and regulators. In this way, financial statement footnotes are an essential component of a company's financial reporting process.

Segment reporting is an important tool for enhancing transparency and accountability in financial reporting, and for providing valuable information to help investors and other stakeholders make informed decisions about the company's future prospects.

Financial statement footnotes and segment reporting are important components of financial reporting that provide additional information about a company's financial performance and operations. Footnotes are disclosures that provide context and clarification to the information presented in the financial statements, while segment reporting provides information about a company's operating segments and how they contribute to its overall financial results. Both financial statement footnotes and segment reporting are essential for investors and other stakeholders to make informed decisions about a company's financial health and future prospects. In this way, financial statement footnotes and segment reporting contribute to transparency and accountability in financial reporting.

3.3 What are Financial Statement Footnotes?

Those who study financial statements consult the footnotes because they include additional information. The footnotes, which also go by the names of explanatory notes and notes to the financial statements, are used to add supplementary information that helps further explain the related information that is found in the financial statements without clouding the primary information that the statements are attempting to convey.

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3.3.1 *Understanding Financial Statement Footnotes*

Financial statement footnotes, also known as notes to the financial statements, provide additional information and explanations about the financial statements presented in a company's annual report. These footnotes are an important source of information for investors, analysts, and other stakeholders, as they provide context and details about the financial information presented in the primary financial statements.

Some key things to keep in mind when reading financial statement footnotes include:

Accounting policies: The footnotes will provide information about the accounting policies that the company has used in preparing its financial statements. This information can help investors understand how the company has calculated its revenue, expenses, and other financial metrics.

Significant risks and uncertainties: The footnotes may disclose significant risks and uncertainties that the company is facing, such as legal disputes or environmental liabilities. These disclosures can help investors understand the potential risks associated with investing in the company.

Related party transactions: The footnotes may disclose transactions that the company has entered into with related parties, such as its subsidiaries, directors, or major shareholders. These disclosures can help investors understand any potential conflicts of interest that may exist.

Contingencies: The footnotes may disclose contingencies, such as pending litigation or regulatory investigations, that could have a significant impact on the company's financial position. These disclosures can help investors assess the potential risks associated with investing in the company.

Restructuring charges: The footnotes may provide details about charges related to restructuring activities, such as severance payments or asset impairments. These disclosures can help investors understand the company's strategic priorities and the potential impact on its financial results.

Segment reporting: The footnotes may provide information about the company's business segments, including the revenue, expenses, assets, and liabilities associated with each segment. These disclosures can help investors understand the company's operations and how it generates revenue.

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Financial statement footnotes provide important context and details about the financial information presented in a company's annual report. Investors and analysts should carefully review these footnotes to gain a more complete understanding of the company's financial position and performance.

Footnotes are frequently rather lengthy and contribute to the clear description of the smaller details that relate with certain areas of the financial statements. Footnotes are included in financial statements. The footnotes in the financial statements add more information to certain parts of the statements, which helps improve the flow of information for the reader and ensures that the necessary explanatory specifics are included.

The primary audience for footnotes is made up of financial analysts who are looking at the company's financial statements. Footnotes provide these individuals with a significantly more in-depth and all-encompassing perspective on the state of the company's finances. This provides the analysts with a better understanding of the accounting standards and how they may have an impact on the underlying financial health of the organisation.

In order to have a better understanding of the company's financial status, auditors will also study the financial statements and the footnotes that accompany them. Their conclusions regarding the audit will be based on the footnotes practically to the same extent as they would be based on the other primary aspects of the financial statements.

Footnotes are likewise largely reliant on the accounting framework that is being utilised for the particular business. A corporation that adheres to IFRS standards, as opposed to US GAAP standards, will have a distinct appearance for the footnotes on their financial statements, for instance. In order to comply with regulations imposed by regulatory bodies such as the Securities and Exchange Commission (SEC) in the United States, publicly traded corporations will be required to provide financial statements and footnotes that are even more comprehensive.

3.3.2 *Drawbacks of Financial Statement Footnotes*

The inclusion of footnotes is critical to the completion of any financial statement. They do, however, come with a few drawbacks to consider.

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Only footnotes that go “above the legal minimum” are necessary to be included in a document in order to shield the corporation from any potential legal action. Management has complete choice over the manner in which footnotes are communicated and the information that is included.

There will be certain footnotes that are full of accounting jargon, and this may cause the information that is being presented to be difficult for the reader to comprehend. It’s possible that they are trying to keep something hidden from the general public, in which case investors should be skeptical of any financial statements that look like that.

While financial statement footnotes are a valuable source of information for investors and other stakeholders, there are some drawbacks to keep in mind:

1. **Complexity:** Financial statement footnotes can be complex and difficult to understand. The information presented in the footnotes may require a high level of financial literacy to fully comprehend.
2. **Length:** Footnotes can be lengthy and detailed, which can make it difficult for investors to quickly identify the most important information. Additionally, the footnotes may contain information that is not relevant to all investors.
3. **Timing:** Footnotes are typically provided in the annual report, which may not be timely enough for investors who are making decisions based on up-to-date information. Additionally, some footnotes may be provided after the end of the reporting period, which can further delay the availability of important information.
4. **Standardization:** Footnotes may be presented in different formats, which can make it difficult to compare information across companies. Additionally, there may be differences in the level of detail provided by different companies, which can make it difficult to perform meaningful comparisons.
5. **Reliability:** Footnotes are typically prepared by the company’s management, which may have an incentive to present information in a way that is favourable to the company. As a result, investors may need to perform additional research to verify the information presented in the footnotes.

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Overall, while financial statement footnotes are an important source of information, investors and other stakeholders should be aware of these drawbacks and carefully consider the information presented in the footnotes in the context of other available information.

3.3.3 *Common Types of Footnotes*

There is a long list of the various kinds of footnotes that can be included in financial statements. You can find in the footnotes of a financial statement any information that is required to clarify or add extra detail to what is shown in the statement.

A few examples of this would include unanticipated changes from the prior year, mandatory disclosures, corrected data, accounting policies, and so on. Footnotes could also include noteworthy future operations that are anticipated to have a substantial influence on the direction the organisation takes in the future.

The following is a list of some of the typical footnotes that can be found in the financial statements of a corporation. The list that follows is in no way exhaustive; rather, it is meant to serve as an illustration of some of the possible footnotes that you might come across. The financial statements may have some fairly specialised explanation footnotes, however this may vary greatly depending on the firm and the industry.

Footnotes, also known as notes to the financial statements, are additional explanations or disclosures that provide more details about the financial information presented in the primary financial statements. Common types of footnotes include:

1. **Accounting policies:** These footnotes explain the accounting policies that a company has used in preparing its financial statements. These policies can include the methods used for recognizing revenue, valuing assets and liabilities, and determining expenses.
2. **Contingencies:** These footnotes provide information about potential liabilities that a company may face in the future, such as legal disputes, warranty claims, or environmental liabilities.
3. **Significant events:** These footnotes provide information about significant events that have occurred during the reporting period, such

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as mergers and acquisitions, changes in management, or significant investments.

4. **Related-party transactions:** These footnotes disclose transactions that a company has entered into with related parties, such as its subsidiaries, directors, or major shareholders.
5. **Restructuring charges:** These footnotes provide details about charges related to restructuring activities, such as severance payments, asset impairments, or lease terminations.
6. **Income taxes:** These footnotes provide information about a company's income tax expense, including the income tax rate, deferred tax assets and liabilities, and tax credits.
7. **Segment reporting:** These footnotes provide information about a company's business segments, including the revenue, expenses, assets, and liabilities associated with each segment.
8. **Subsequent events:** These footnotes provide information about events that occurred after the balance sheet date but before the financial statements were issued. These events can include significant transactions, changes in the company's financial position, or changes in its operations.

Footnotes provide additional context and details about the financial information presented in the primary financial statements, and are an important source of information for investors, analysts, and other stakeholders.

3.3.4 *Drafting of Notes to Account*

Notes to accounts are an important component of financial statements, providing additional information about the financial performance and position of a company. Here are some guidelines for drafting notes to accounts:

1. **Understand the requirements:** Before drafting notes to accounts, it is important to understand the requirements of the relevant accounting standards or regulations. This will ensure that the notes are accurate and comply with the necessary guidelines.

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2. **Use clear and concise language:** Notes to accounts should be written in clear and concise language, avoiding technical jargon or complex terminology. This will help ensure that the information is easily understood by readers.
3. **Organize the notes logically:** Notes to accounts should be organized in a logical and coherent manner. This may involve grouping related information together or presenting information in a chronological or thematic order.
4. **Provide relevant information:** Notes to accounts should provide relevant information that is material to the financial statements. This may include details of significant accounting policies, key assumptions and estimates, and details of significant transactions or events.
5. **Use supporting data and examples:** To provide context and clarity, notes to accounts may include supporting data and examples, such as tables, charts, or graphs.
6. **Ensure accuracy:** It is essential that notes to accounts are accurate and based on reliable data. Any assumptions or estimates used should be disclosed and supported by appropriate evidence.
7. **Review and revise:** Finally, notes to accounts should be reviewed and revised as necessary to ensure that they are complete, accurate, and comply with the relevant standards or regulations. It may be helpful to have a second person review the notes to ensure that they are clear and understandable.

3.4 Segment Reporting

Accounting Standard (AS-17), deals with segment reporting. This standard requires companies to disclose information about the performance and position of its business segments.

Here are the key requirements of AS-17 for segment reporting:

1. **Identification of reportable segments:** Companies are required to identify their reportable segments, which are defined as components of an entity for which separate financial information is available and evaluated regularly by the Chief Operating Decision Maker (CODM) in deciding how to allocate resources and assess performance.

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2. **Quantitative disclosures:** Companies must provide quantitative disclosures for each reportable segment, including segment revenue, segment result, segment assets, and segment liabilities. These disclosures should be reconciled with the corresponding amounts reported in the financial statements.
3. **Qualitative disclosures:** Companies must also provide qualitative disclosures about the factors that affect the performance of each reportable segment, such as the nature of the products or services, the geographical areas in which it operates, and the regulatory environment in which it operates.
4. **Inter-segment transactions:** Companies must disclose information about transactions between reportable segments, including the basis for determining the transfer price and any adjustments made to eliminate the effects of such transactions on the financial statements.
5. **Reconciliation:** Companies must provide a reconciliation of the total of the reportable segments' results to the entity's profit or loss and total assets and liabilities.

AS-17 requires companies to disclose segment information for the current period and the preceding period. The standard also requires companies to disclose the basis on which segment information is prepared, such as the accounting policies used and any changes in those policies.

3.4.1 *Objectives of Segment Reporting*

The objective of segment reporting is to provide information that is useful to users of financial statements in making decisions about the company. Segment reporting allows users to better understand the performance and position of a company by providing information about the different parts of the business and how they contribute to the overall financial results.

Here are some of the key objectives of segment reporting:

1. **Better decision-making:** Segment reporting provides users with more detailed information about the performance of different parts of the business, allowing them to make better-informed decisions. For example, investors can use segment information to assess the risks and opportunities of different segments and make investment decisions accordingly.

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2. **Increased transparency:** Segment reporting increases transparency by providing more detailed information about the company's operations. This can help to build trust with stakeholders and improve the company's reputation.
3. **Improved resource allocation:** Segment reporting provides information about how resources are allocated within the company, allowing management to identify areas that require additional investment or resources.
4. **Enhanced performance measurement:** Segment reporting allows users to better measure the performance of the company's different segments, allowing them to identify areas of strength and weakness and take appropriate action.

Overall, the objective of segment reporting is to provide users of financial statements with more detailed and relevant information about the performance and position of the company, which can help them to make better-informed decisions.

3.4.2 *Scope of Segment Reporting*

The scope of segment reporting refers to the types of entities and activities that are covered by the requirements of segment reporting. The scope of segment reporting is defined by Accounting Standard 17 (AS-17) and other relevant accounting standards or regulations.

The scope of segment reporting includes the following:

1. **Business segments:** AS-17 requires companies to report information about their business segments, which are defined as components of an entity that engage in activities that generate revenues and incur expenses. Business segments may be organized around product lines, geographical regions, customer groups, or other factors.
2. **Geographic segments:** Companies may also be required to report information about their geographic segments, which are defined as components of an entity that operate in different geographical areas. This may include information about revenues, assets, and liabilities by country or region.

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3. **Other segments:** In some cases, companies may be required to report information about other types of segments, such as segments based on customer groups or channels of distribution.

The scope of segment reporting may vary depending on the size and complexity of the company, as well as the requirements of the relevant accounting standards or regulations. For example, larger companies may be required to report information about more detailed segments, while smaller companies may only be required to report information about their business segments.

Overall, the scope of segment reporting is designed to provide users of financial statements with relevant and reliable information about the performance and position of the company's different segments, which can help them to make better-informed decisions.

3.4.3 *Identifying Reportable Segments*

Identifying reportable segments is an important step in complying with Accounting Standard 17 (AS-17) on segment reporting. Here are the key steps involved in identifying reportable segments:

1. **Determine the organization's operating structure:** The first step in identifying reportable segments is to determine the organization's operating structure. This involves identifying the different parts of the organization that are engaged in activities that generate revenues and incur expenses.
2. **Identify the Chief Operating Decision Maker (CODM):** The CODM is the individual or group of individuals who are responsible for making decisions about the allocation of resources and assessing the performance of the organization's operating segments. This may be the CEO, the board of directors, or another group of executives.
3. **Evaluate the CODM's monitoring process:** The next step is to evaluate the CODM's monitoring process to determine how they evaluate the performance of the organization's operating segments. This may involve reviewing internal reports, financial statements, and other relevant information.
4. **Determine reportable segments:** Based on the information gathered in steps 1-3, the organization can then determine which segments

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are reportable. A reportable segment is defined as a component of an organization that generates revenue and incurs expenses and for which separate financial information is available and evaluated regularly by the CODM in deciding how to allocate resources and assess performance.

5. **Apply quantitative thresholds:** AS-17 requires companies to apply quantitative thresholds to determine which segments are reportable. The standard requires that a segment must meet at least one of three quantitative thresholds to be reportable: (a) its revenue is 10% or more of the combined revenue of all operating segments, (b) its result is 10% or more of the combined result of all operating segments, or (c) its assets are 10% or more of the combined assets of all operating segments.
6. **Review and update reportable segments:** The organization should periodically review and update its reportable segments based on changes in its operating structure or the CODM's monitoring process. This ensures that the organization is providing relevant and reliable information to users of financial statements.

Overall, identifying reportable segments is an important process in complying with AS-17 and providing users of financial statements with relevant and reliable information about the organization's operating segments.

3.4.4 *Primary and Secondary Segment Reporting Formats*

Under Accounting Standard 17 (AS-17), there are two primary segment reporting formats: the business segment format and the geographical segment format. In addition, companies may also use secondary segment reporting formats to provide additional information about their segments beyond the primary reporting formats**.** These are discussed in detail as under:

(A) Primary Segment Reporting Formats

Under Accounting Standard 17 (AS-17), there are two primary segment reporting formats: the business segment format and the geographical segment format:

1. ***Business Segment Format:*** This format requires companies to report financial information about their different business segments, which

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are defined as components of the company that engage in activities that generate revenues and incur expenses. The business segment format requires companies to report information about segment revenues, segment results, and segment assets, among other things. Companies must also disclose additional information about the risks and opportunities associated with each business segment. The business segment format is useful for understanding the company's different business lines, the profitability of each line, and the risks associated with each line of business.

2. ***Geographical Segment Format:*** This format requires companies to report financial information about their different geographical segments, which are defined as components of the company that operate in different geographical areas. The geographical segment format requires companies to report information about segment revenues, segment results, and segment assets by country or region. The geographical segment format is useful for understanding the company's operations in different regions, the profitability of each region, and the risks associated with operating in each region.

Overall, the primary segment reporting formats provide users of financial statements with a comprehensive view of the company's operations and performance, allowing them to make better-informed decisions. By using these primary segment reporting formats, companies can identify the different components of their business and provide transparency into how each component contributes to the company's overall financial performance.

(B) Secondary Segment Reporting Formats

1. Under Accounting Standard 17 (AS-17), companies may use a secondary segment reporting format to provide additional information about their segments beyond the primary reporting formats of business segments and geographical segments. Here are some examples of secondary segment reporting formats.
2. ***Customer-based reporting:*** In this format, companies report financial information about their segments based on customer groups. For example, a company may report financial information separately for segments that serve retail customers versus segments that serve commercial customers.

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3. ***Product-based reporting:*** In this format, companies report financial information about their segments based on product lines. For example, a company may report financial information separately for segments that produce consumer goods versus segments that produce industrial products.
4. ***Service-based reporting:*** In this format, companies report financial information about their segments based on the types of services they offer. For example, a company may report financial information separately for segments that provide consulting services versus segments that provide logistics services.
5. ***Distribution channel-based reporting:*** In this format, companies report financial information about their segments based on the different distribution channels they use to sell their products or services. For example, a company may report financial information separately for segments that sell through retail stores versus segments that sell through e-commerce channels.
6. ***Cost center-based reporting:*** In this format, companies report financial information about their segments based on the different cost centers within the organization. For example, a company may report financial information separately for segments that are responsible for research and development versus segments that are responsible for manufacturing.
7. ***Strategic Business Unit (SBU) based reporting:*** In this format, companies report financial information about their segments based on the different strategic business units within the organization. For example, a company may report financial information separately for segments that operate in different industries or have different strategic priorities.
8. The use of secondary segment reporting formats can provide additional insights into the performance and position of the company's segments. Companies should choose the secondary reporting format that best aligns with their business model and provides relevant and reliable information about their segments.

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3.4.5 *Reportable Segments*

Reportable segments are components of a company that must be reported separately in accordance with Accounting Standard 17 (AS-17). A segment is considered reportable if it meets at least one of the following quantitative thresholds:

1. **Segment revenue:** If a segment's revenue is 10% or more of the combined revenue of all segments, it is considered a reportable segment.
2. **Segment profit or loss:** If a segment's absolute amount of profit or loss is 10% or more of the combined profit or loss of all segments, it is considered a reportable segment.
3. **Segment assets:** If a segment's assets are 10% or more of the combined assets of all segments, it is considered a reportable segment.

If a segment meets any one of these thresholds, it must be reported separately in the company's financial statements. Additionally, if a company has any other segments that are not separately reportable, those segments may be combined with other segments to create a reportable segment.

The purpose of reporting separate segments is to provide users of financial statements with a better understanding of a company's operations and performance. By reporting separately on each reportable segment, investors and other stakeholders can evaluate the performance of different parts of the company and assess the risks associated with each segment. This information can be useful for making investment decisions, analyzing a company's financial health, and understanding the company's strategy and direction.

3.4.6 *Segment Accounting Policies*

Segment accounting policies refer to the set of principles and procedures that an organization uses to identify, measure, and report on the financial performance of its business segments. A business segment is a part of an organization that engages in distinct business activities, has separate financial results, and is managed separately from other parts of the organization.

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Segment accounting policies are important because they help organizations to:

1. **Measure the profitability of different segments:** By using consistent accounting policies across all business segments, an organization can compare the profitability of different segments and make informed decisions about where to invest its resources.
2. **Identify potential risks and opportunities:** By analyzing the financial results of each business segment, an organization can identify areas that are performing well and areas that need improvement. This information can be used to identify potential risks and opportunities that the organization may face in the future.
3. **Comply with accounting standards:** Accounting standards require organizations to report financial information for each business segment. Segment accounting policies help organizations to comply with these standards by providing a framework for identifying and reporting on each segment's financial performance.

Some of the key elements of segment accounting policies include:

1. **Segment identification:** The first step in segment accounting is to identify the business segments that will be reported on. This can be based on factors such as the products or services offered, the geographical location, or the customer base.
2. **Allocation of expenses:** Once the segments have been identified, expenses need to be allocated to each segment based on how they relate to the segment's operations.
3. **Measurement of revenue and profits:** Each segment's revenue and profits need to be measured using consistent accounting policies to ensure that the results are comparable across segments.
4. **Intersegment transactions:** If business segments engage in transactions with each other, such as the sale of goods or services, these transactions need to be accounted for using specific rules to ensure that the results are reported accurately.

Segment accounting policies are critical for organizations that operate in multiple business segments, as they help to provide clarity and transparency around each segment's financial performance, which can ultimately lead to better decision-making and improved business outcomes.

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3.5 Summary

Financial statement footnotes are additional notes to the financial statements that provide more detailed information about the financial position, performance, and cash flows of a company. Common types of footnotes include accounting policies, contingencies, and related party transactions. However, financial statement footnotes also have some drawbacks, such as being difficult to read and being open to interpretation.

Segment reporting is the process of dividing a company's operations into segments and reporting on the performance of each segment separately. The objective of segment reporting is to provide users of financial statements with more detailed information about a company's operations and the risks and returns associated with them. The scope of segment reporting applies to public companies and other entities that meet certain size and industry criteria.

Primary and secondary segment reporting formats are used to present segment information in financial statements. Reportable segments are identified based on factors such as the nature of the products or services, the geographic location, and the organizational structure of the company. Segment accounting policies are important in ensuring consistency and comparability in segment reporting across different reporting periods.

3.6 Self-Assessment Questions

1. What are financial statement footnotes and why are they important?
2. What are the common types of financial statement footnotes?
3. What are the objectives of segment reporting?
4. How do financial statement footnotes provide additional information beyond the numbers in the financial statements?
5. How do companies determine reportable segments for segment reporting?
6. What is the difference between primary and secondary segment reporting formats?
7. How would you draft footnotes to account for contingencies or uncertainties in the financial statements?

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8. How would you identify reportable segments for a company in a specific industry?
9. How would you develop segment accounting policies for a multinational corporation?
10. How do the drawbacks of financial statement footnotes affect the transparency and accuracy of financial reporting?
11. How can the information provided in segment reporting be useful to investors and stakeholders?
12. How do changes in segment accounting policies impact financial reporting and analysis?
13. To what extent do financial statement footnotes enhance the usefulness and reliability of financial statements?
14. How effective are primary and secondary segment reporting formats in providing relevant information to users?
15. What are the strengths and weaknesses of a company's segment accounting policies in reflecting the performance of its business segments?

3.7 References

- Securities and Exchange Commission (SEC) -https://www.sec.gov/
- Financial Accounting Standards Board (FASB) -https://www.fasb.org/
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L E S S O N

4

Sustainability, Triple Bottom and CSR Reporting

Dr. Rakesh Kumar Gupta

STRUCTURE

4.1 *Learning Objectives*
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4.1 Learning Objectives

After studying this Chapter, students will be able:

- To understand the meaning and definition of Sustainability Reporting.
- To gain knowledge about importance, Principles of Sustainability Reporting.
- To know about the Sustainability reporting in India.
- To learn about the Triple Bottom Line Reporting.
- To understand about CSR Reporting.

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4.2 Introduction

Sustainability reporting, TBL reporting, and CSR reporting are all aimed at promoting corporate transparency and accountability with regard to ESG performance. By providing stakeholders with information on a company's sustainability practices, these reporting practices can help to build trust and encourage more sustainable business practices. Sustainability reporting, also known as corporate sustainability reporting, refers to the practice of companies disclosing their Environmental, Social and Governance (ESG) performance to stakeholders. It aims to provide a transparent account of a company's sustainability performance and its impact on society and the environment. Triple Bottom Line (TBL) reporting is a type of sustainability reporting that takes into account not only the financial performance of a company, but also its social and environmental impact. The TBL framework measures a company's performance in three areas: profit (economic), people (social), and planet (environmental). Corporate Social Responsibility (CSR) reporting is another type of sustainability reporting that focuses specifically on a company's social and environmental impact. It involves disclosing information about a company's policies and practices related to social and environmental issues, such as labour practices, human rights, environmental management and community engagement.

4.3 Definitions of Sustainability Reporting

Sustainability reporting, also known as corporate sustainability reporting, is the process of measuring, disclosing and communicating an organization's Environmental, Social and Governance (ESG) performance to its stakeholders. Sustainability reports aim to provide a transparent account of an organization's sustainability practices and the impact of its operations on the environment, society and the economy.

Sustainability reporting may cover a wide range of issues, including greenhouse gas emissions, energy and water usage, waste management, social and labour practices, human rights, community engagement and corporate governance. The purpose of sustainability reporting is to encourage organizations to integrate sustainable practices into their operations, to identify areas for improvement and to demonstrate their commitment to

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sustainability to stakeholders. Sustainability reporting may be voluntary or mandated by law, stock exchange listing requirements or other regulations.

4.4 Meaning and Importance Sustainability Reporting

Sustainability reporting refers to the practice of measuring, disclosing, and being accountable for an organization's economic, environmental, and social impact. It provides a transparent and holistic view of an organization's sustainability performance to stakeholders such as investors, customers, employees and the wider community.

Sustainability reporting is important because it:

1. **Improves transparency and accountability:** By reporting on sustainability performance, organizations can be more transparent about their impact on the environment and society. This allows stakeholders to make more informed decisions about their engagement with the organization.
2. **Enhances reputation and stakeholder trust:** Sustainability reporting can help build trust with stakeholders and improve the organization's reputation. By demonstrating a commitment to sustainable practices, organizations can attract and retain customers, investors and employees who value sustainability.
3. **Drives sustainability performance:** By tracking and reporting on sustainability performance, organizations can identify areas for improvement and set goals to drive sustainability performance over time.

Some of the key elements of sustainability reporting include:

1. **Materiality assessment:** Organizations should identify and prioritize the sustainability issues that are most relevant to their business and stakeholders.
2. **Reporting framework:** There are several sustainability reporting frameworks available, such as the Global Reporting Initiative (GRI) and the Sustainability Accounting Standards Board (SASB). Organizations should choose a framework that is most appropriate for their business and stakeholders.

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3. **Data collection and measurement:** Organizations should collect and measure data on their sustainability performance using consistent and reliable methods.
4. **Stakeholder engagement:** Organizations should engage with stakeholders to understand their sustainability expectations and to gather feedback on sustainability performance.
5. **Reporting and communication:** Organizations should report on their sustainability performance in a clear, concise and accessible manner.

Sustainability reporting is an important tool for organizations to demonstrate their commitment to sustainability and to improve their sustainability performance over time. By measuring and reporting on sustainability performance, organizations can create value for stakeholders, drive innovation, and contribute to a more sustainable future.

4.5 Seven (7) Principles Sustainability Reporting

The 7 principles of sustainability reporting were developed by the Global Reporting Initiative (GRI), an international organization that sets standards for sustainability reporting. The principles are as follows:

1. **Materiality:** Organizations should report on sustainability issues that are relevant and important to their stakeholders and have a significant impact on the organization's economic, environmental, or social performance.
2. **Stakeholder Inclusiveness:** Organizations should engage with a range of stakeholders and seek to understand their sustainability concerns and expectations.
3. **Sustainability Context:** Organizations should provide a clear understanding of the environmental, social and economic context in which they operate, including the relevant sustainability trends, challenges, and opportunities.
4. **Completeness:** Organizations should report on their sustainability performance comprehensively and include information on both positive and negative impacts.

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5. **Accuracy:** Organizations should ensure the accuracy and reliability of the sustainability information reported.
6. **Timeliness:** Organizations should report sustainability information in a timely manner so that stakeholders can make informed decisions.
7. **Clarity:** Organizations should communicate sustainability information clearly, concisely and in a way that is understandable to a range of stakeholders.

These principles help organizations to report on their sustainability performance in a transparent and meaningful way and provide a framework for continuous improvement.

4.6 Sustainability Reporting in India

Sustainability reporting in India has gained momentum in recent years, driven by regulatory requirements and growing interest from investors and other stakeholders. The Securities and Exchange Board of India (SEBI) issued guidelines in 2015, requiring the top 500 listed companies to disclose their ESG performance in their annual reports, using either the Global Reporting Initiative (GRI) Standards or the Integrated Reporting (IR) Framework.

In addition to SEBI's guidelines, India has several other initiatives aimed at promoting sustainability reporting. The Ministry of Corporate Affairs has developed the National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business, which provide guidance on sustainable business practices and reporting. The Indian government has also launched the Corporate Social Responsibility (CSR) rules, requiring companies to spend a certain percentage of their profits on CSR activities and report on their CSR performance.

There are several Indian organizations that promote sustainability reporting, including the Confederation of Indian Industry (CII), the Federation of Indian Chambers of Commerce and Industry (FICCI), and the Bombay Stock Exchange (BSE). These organizations provide guidance, training, and support to companies on sustainability reporting and ESG performance.

Sustainability reporting in India is still evolving, but there is growing awareness and interest among companies and stakeholders. The adoption

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of sustainability reporting practices is expected to increase in the coming years, as more companies recognize the benefits of transparent reporting on their ESG performance.

4.7 Triple Bottom Line Reporting

4.7.1 *Concept of Triple Bottom Line Reporting*

The concept of Triple Bottom Line (TBL) reporting refers to a framework for measuring and reporting on an organization's social, environmental, and financial performance. TBL reporting is based on the idea that an organization's success should not be measured solely in terms of financial performance, but also in terms of its impact on society and the environment.

The three components of the triple bottom line are often referred to as the "three Ps": people, planet and profit. TBL reporting seeks to integrate these three components into an organization's overall business strategy and decision-making processes.

The benefits of TBL reporting include:

1. **Holistic view of performance:** TBL reporting provides a more comprehensive and holistic view of an organization's performance, taking into account social and environmental impacts in addition to financial performance.
2. **Improved accountability:** By reporting on social and environmental impacts, organizations can be held accountable for their actions and their impact on society and the environment.
3. **Enhanced reputation:** TBL reporting can help build a positive reputation for an organization among stakeholders, including customers, investors and employees.
4. **Better decision-making:** TBL reporting can help organizations make more informed decisions by considering social and environmental impacts in addition to financial considerations.

Some examples of TBL reporting metrics include:

1. **Social:** Employee turnover rate, employee satisfaction, community investment, diversity and inclusion metrics.

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2. **Environmental:** Energy consumption, greenhouse gas emissions, waste reduction, water conservation and other sustainability metrics.
3. **Financial:** Revenue growth, profitability, return on investment and other financial metrics.

TBL reporting provides a framework for organizations to measure and report on their social, environmental, and financial performance, which can help them improve their sustainability performance, enhance their reputation, and make more informed decisions.

4.7.2 *Trend Towards Triple Bottom Line Reporting*

There has been a growing trend towards Triple Bottom Line (TBL) reporting in recent years. This trend is driven by several factors, including increasing stakeholder expectations for transparency and accountability, growing awareness of the social and environmental impacts of business activities and a recognition of the potential benefits of TBL reporting for businesses themselves.

One key driver of the trend towards TBL reporting is the increasing pressure from stakeholders, including customers, investors and employees, for more transparency and accountability from businesses. These stakeholders are increasingly concerned about the social and environmental impacts of business activities and are looking for ways to hold companies accountable for their actions.

Another driver of the trend towards TBL reporting is the growing awareness of the social and environmental impacts of business activities. As society becomes more aware of issues such as climate change, social inequality, and environmental degradation, there is a growing recognition of the need for businesses to address these issues and to report on their efforts to do so.

Finally, there is a recognition of the potential benefits of TBL reporting for businesses themselves. TBL reporting can help businesses to identify areas where they can improve their sustainability performance, enhance their reputation among stakeholders, and make more informed decisions about their business activities.

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Some examples of organizations that have embraced TBL reporting include Unilever, which has set ambitious sustainability targets and reports regularly on its progress and Patagonia, which has a long history of social and environmental activism and reports on its efforts to reduce its environmental impact and support social causes.

The trend towards TBL reporting reflects a growing recognition of the importance of social and environmental sustainability, as well as the potential benefits of reporting on these issues for businesses themselves.

4.7.3 *Benefits of TBL Reporting*

Triple Bottom Line (TBL) reporting is a form of sustainability reporting that focuses on three dimensions of organizational performance: social, environmental and financial. There are several benefits of TBL reporting, including:

1. **Improved sustainability performance:** TBL reporting helps organizations to measure and track their sustainability performance across multiple dimensions, which can lead to improved sustainability practices and outcomes.
2. **Enhanced stakeholder engagement:** TBL reporting provides a platform for organizations to engage with a range of stakeholders, including investors, customers, employees and communities, and to respond to their sustainability concerns and expectations.
3. **Increased transparency and accountability:** TBL reporting provides a transparent and accountable account of an organization's sustainability performance, which can enhance its reputation and build trust with stakeholders.
4. **Improved risk management:** TBL reporting can help organizations to identify and manage sustainability risks, such as environmental risks, social risks and governance risks, which can impact their financial performance.
5. **Cost savings and efficiency gains:** TBL reporting can help organizations to identify opportunities for cost savings and efficiency gains through improved resource management, waste reduction and energy efficiency.

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6. **Improved access to capital:** TBL reporting can help organizations to attract capital from investors who prioritize sustainability performance, such as socially responsible investors and impact investors.

TBL reporting can help organizations to integrate sustainability into their business strategies, improve their sustainability performance and build stronger relationships with stakeholders.

4.7.4 *Forms of Reporting*

There are several forms of Triple Bottom Line (TBL) reporting that organizations can use to communicate their social, environmental and financial performance to stakeholders. Some of the most common forms of TBL reporting include:

1. **Sustainability Report:** A comprehensive report that focuses on the organization's sustainability performance, including social and environmental impacts and governance practices.
2. **Integrated Report:** A report that integrates financial and sustainability information, providing a comprehensive view of the organization's performance.
3. **Environmental, Social and Governance (ESG) Report:** A report that focuses specifically on the organization's ESG performance, covering topics such as climate change, diversity and inclusion, and labour practices.
4. **Carbon Disclosure Report:** A report that focuses specifically on the organization's greenhouse gas emissions and climate change strategy.
5. **Global Reporting Initiative (GRI) Report:** A report that follows the guidelines set by the GRI, an international organization that sets standards for sustainability reporting.
6. **United Nations Sustainable Development Goals (SDG) Report:** A report that focuses on the organization's contributions to the SDGs, a set of global goals aimed at addressing the world's most pressing social and environmental challenges.

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7. **Social Responsibility Report:** A report that focuses specifically on the organization's social impact, covering topics such as community involvement, employee engagement and ethical business practices.
8. **Environmental Report:** A report that focuses specifically on the organization's environmental impact, covering topics such as greenhouse gas emissions, water use and waste management.

The type of TBL reporting that an organization chooses will depend on its specific goals and priorities, as well as the expectations of its stakeholders.

4.7.5 *Triple Bottom Line Accounting*

Triple Bottom Line (TBL) accounting is a type of accounting that incorporates social environmental, and financial performance into an organization's reporting and decision-making processes. It is based on the idea that organizations should not only be financially profitable, but also socially responsible and environmentally sustainable.

TBL accounting involves measuring and reporting on three key areas of performance:

1. **Social:** This includes an organization's impact on society, such as its relationship with employees, customers, suppliers, and communities.
2. **Environmental:** This includes an organization's impact on the environment, such as its energy use, greenhouse gas emissions, water consumption, waste generation and pollution.
3. **Financial:** This includes an organization's financial performance, such as its revenue, expenses, profits and return on investment.

The goal of TBL accounting is to provide a more comprehensive picture of an organization's performance, beyond just financial metrics. By considering social and environmental impacts, TBL accounting can help organizations to make more informed decisions that take into account the long-term consequences of their actions.

Some of the benefits of TBL accounting include:

1. **Improved decision-making:** By considering social and environmental impacts, TBL accounting can help organizations to make more informed decisions that take into account the long-term consequences of their actions.

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2. **Increased transparency:** TBL accounting provides a more complete picture of an organization's performance, which can enhance transparency and accountability.
3. **Enhanced stakeholder engagement:** TBL accounting can help organizations to engage with a range of stakeholders, including investors, customers, employees and communities, and to respond to their social and environmental concerns.
4. **Improved risk management:** TBL accounting can help organizations to identify and manage social and environmental risks, which can impact their financial performance.

TBL accounting is an important tool for organizations that want to integrate sustainability into their business strategies and decision-making processes.

4.8 Corporate Social Responsibility Reporting

CSR (Corporate Social Responsibility) reporting is a type of sustainability reporting that focuses specifically on an organization's social and environmental impacts, as well as its governance practices. It involves measuring and reporting on the organization's initiatives and activities related to ethical and sustainable business practices, community involvement, employee well-being, environmental stewardship and other social responsibility issues.

The goal of CSR reporting is to provide stakeholders with transparent and accountable information about an organization's social and environmental performance. This can help to build trust with stakeholders and enhance the organization's reputation as a socially responsible and sustainable business.

4.8.1 *Key Components of CSR Reporting*

Key Components of CSR reporting Include:

1. ***Ethical business practices:*** This includes the organization's commitment to ethical conduct and compliance with relevant laws and regulations.
2. ***Social and community involvement:*** This includes the organization's engagement with and impact on local communities, as well as its contributions to social and charitable causes.

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3. ***Employee well-being:*** This includes the organization's efforts to ensure the health safety and well-being of its employees, as well as its commitment to diversity, equity, and inclusion.
4. ***Environmental stewardship:*** This includes the organization's efforts to minimize its environmental impact, such as reducing greenhouse gas emissions, conserving natural resources and managing waste and pollution.
5. ***Governance and accountability:*** This includes the organization's governance structure, leadership practices and commitment to transparency and accountability.

CSR reporting can take various forms, including standalone reports, integrated reports, sustainability reports, and annual reports. Some organizations also choose to report their CSR performance through frameworks such as the Global Reporting Initiative (GRI) or the United Nations Global Compact.

CSR reporting is an important tool for organizations that want to communicate their social and environmental performance to stakeholders and demonstrate their commitment to sustainable and socially responsible business practices.

4.8.2 *Types of CSR (Corporate Social Responsibility) Reporting*

There are several different types of CSR (Corporate Social Responsibility) reporting, which vary in their level of detail, scope, and intended audience. Some of the most common types of CSR reporting include:

1. **Standalone CSR reports:** These are separate reports that focus solely on an organization's social and environmental performance. They typically provide detailed information on the organization's CSR initiatives and activities, and are aimed at stakeholders who are specifically interested in the organization's sustainability performance.
2. **Integrated reports:** These reports combine financial and non-financial performance information, including social and environmental data, to provide a more comprehensive picture of an organization's overall performance. They are aimed at a broader range of stakeholders, including investors, customers, employees and regulators.

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3. **Sustainability reports:** These reports provide information on an organization's sustainability performance, including its social, environmental, and economic impacts. They are typically broader in scope than standalone CSR reports and may include information on the organization's governance practices, stakeholder engagement, and strategy for sustainability.
4. **Annual reports:** These reports are required by law in many countries, and provide a summary of an organization's financial performance over the past year. Some organizations also choose to include information on their social and environmental performance in their annual reports.
5. **GRI reports:** These reports follow the Global Reporting Initiative (GRI) framework, which provides a standardized approach to CSR reporting. GRI reports include information on an organization's governance, strategy, performance and impact on sustainability issues, and are aimed at a range of stakeholders.
6. **UN Global Compact Communication on Progress (COP) reports:** These reports are submitted by organizations that have committed to the United Nations Global Compact, a voluntary initiative to promote sustainable business practices. COP reports provide information on an organization's progress towards implementing the Global Compact's principles on human rights, labour, environment, and anti-corruption.

Overall, the type of CSR reporting that an organization chooses will depend on its goals, audience and the level of detail it wishes to provide on its social and environmental performance.

4.9 Summary

Sustainability reporting is the practice of measuring and disclosing an organization's Environmental, Social and Governance (ESG) performance. It helps organizations to identify and manage their sustainability risks and opportunities, and to demonstrate their commitment to sustainable and socially responsible business practices.

The seven principles of sustainability reporting, as defined by the Global Reporting Initiative (GRI), are stakeholder inclusiveness, sustainability

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context, materiality, completeness, accuracy, balance and comparability. These principles provide a framework for organizations to report on their sustainability performance in a transparent and credible manner. In India, the Securities and Exchange Board of India (SEBI) has mandated the top 100 listed companies to submit a Business Responsibility Report (BRR) as part of their annual report. The BRR requires companies to report on their sustainability performance, including their ESG risks and opportunities, governance practices and stakeholder engagement.

Triple Bottom Line (TBL) reporting is a type of sustainability reporting that focuses on an organization's social, environmental and economic performance. TBL reporting provides a framework for organizations to measure and report on their sustainability performance in a holistic and integrated manner.

CSR (Corporate Social Responsibility) reporting is a type of sustainability reporting that focuses specifically on an organization's social and environmental impacts, as well as its governance practices. CSR reporting helps organizations to build trust with stakeholders and enhance their reputation as a socially responsible and sustainable business.

4.10 Self-Assessment Questions

1. What is the meaning and importance of sustainability reporting?
2. Explain the concept of sustainability reporting and why is it important for organizations to engage in it?
3. What are the seven principles of sustainability reporting, and how do they help organizations report on their sustainability performance?
4. What are the seven principles of sustainability reporting, and how do they help organizations to report on their sustainability performance in a transparent and credible manner?
5. How is sustainability reporting mandated in India and what are the requirements for companies to report on their sustainability performance?
6. What is triple bottom line reporting, and how does it differ from other types of sustainability reporting?

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7. What is CSR reporting, and why is it important for organizations to report on their social and environmental impacts?

4.11 References

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978-81-19169-34-4

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