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SCHOOL OF LAW

UNIT I – CORPORATE ACCOUNTING I- SBA1303

Final Account of companies

The term final account is popularly used to refer to (i) Profit & Loss Account and (ii) Balance sheet. In case of sole proprietorship and partnership firm maintenance of proper books of accounts and preparation of final accounts at the end of an accounting period is desirable but not compulsory. But the companies Act has made it is statutory requirement for a company to keep proper books of accounts for recording financial transactions and preparing its keep proper books of accounts for recording financial transactions and preparing its profit & loss Account and Balance sheet in the prescribed form at the proper time. The principles and methods of preparing final accounts by joint stock companies are the same as in case of other organizations. However, the form and contents of these two statements are governed by the relevant provision of the companies Act.

Profit &Loss Account

In the case of a Joint stock company, it is not necessary to split the final accounts into two sections i.e., Trading Account and Profit &Loss Account. There is only one account which is known as profit &Loss account. It consists of trading account, profit &loss account and profit &loss appropriation account. Its first part represents trading account. The items which are shown in trading and profit &Loss are known as items 'above the line' and items which are shown in profit & loss appropriation accounts are known as items' below the line'. An imaginary line' is presumed between P&L A/c and Appropriation A/c.

Every profit &loss account of a company shall give a true and fair view of the profit and loss of the company for the financial year and shall comply with the requirements of part II of schedule VI so far as they are applicable thereto.

Nothing contained in the above para shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity or any other class of company for which a form a profit &loss account has been specified in or under the act governing such class of company.

Dividend

The expression dividend has two meanings. Applied to a company, which is a going concern, it ordinarily means that portion of the profits of the company which is allocated to the holders of the shares in the company. In case of a winding up, it means a division of the realized assets among the creditors and contributories according to their respective rights.

The legal provisions relating to dividend are as follows.

(a) Dividend is paid in proportion to the amounts paid up on each share
(b) Calls-in –advance should not be considered for dividend purpose
(c) Dividend should be paid even on calls- in – arrears unless prohibited by the articles;

and

(d) Dividend must be paid in cash unless it is capitalized by issuing bonus shares
(e) Dividend must be paid within 42 days of declaration
(f) Dividend is paid only to registered shareholder or on his order to his banker. In case where shares are converted into warrants, the bearer of the warrant is entitled to dividend.

(2)Sources of Divided:

(A) According to section 205, the dividend can be declared or paid by a company for any financial year only;

(a) Out of current year's profits after providing for depreciation, or
(b) Out of previous year's profits after providing for depreciation, or
(c) Out of both or
(d) Out of moneys provided by the central or state govt. for the payment of dividend in pursuance of a guarantee given by that govt.

The central govt. may permit any company to declare or pay dividend for any financial year out of the profit of the company for that year or any previous year or year without providing for depreciation.

Interim Dividend

It is a dividend paid between two annual general meetings,i.e., in the middle of the year, before ascertainment of the profit for the year. Directors have full authority to pay interim dividend in anticipation of profit for the year. However, directors will be personally liable to reimburse the interim dividend paid, if there are no profits at the end of the financial period. This dividend is usually paid for six months and can be declared and paid only if the depreciation for the full year has already been provided. If the interim dividend is paid without sufficient profits then it amounts to payments of dividend out of capital and directors are liable to make good the amounts.

Calculation of interim dividend

Interim dividend is generally paid for six months. The calculation of actual amount depends upon the term used. If the interim dividend on Rs.6,00,000 for six month is 6% p.a. the actual amount is6% of Rs.6,00,000 for six months or 3% of Rs.6,00,000 for the full year i.e., Rs.18,000 . If , however , the rate is mentioned as 6% interim dividend on Rs.6,00,000 the actual amount is simply 6% of Rs.6,00,000=Rs.36,000 .To avoid this confusion , most companies mention the amount, as so many rupees or paisa per share as the interim dividend .

Interim dividend paid should be recorded in the debit side of Profit &Loss

Appropriation Account.

Managerial Remuneration

(a)Introduction:-

The companies Act lays down a number of restrictions on managerial remuneration payable by a public company or a private company which is a subsidiary of public company. The term 'managerial remuneration' includes remuneration payable to the (i) Managing Director, (ii)Manager (iii) Part time director, and (iv) whole time directors. It does not include the remuneration payable to technical advisors or secretaries.

According to Section 198 of the companies Act, 1956 the total managerial remuneration payable by a public company or a private company which is subsidiary of a public company to its directors and its manager in respect of any financial year shall not exceed 11% of the net profits of that company for that financial year computed in the manner laid out in section 349,350and 351 except that the remuneration of the directors shall not be deducted from the gross profit. Percentage aforesaid shall be exclusive of any fees payable to directors under sec.309 (2)

Within the limits of maximum remuneration specified above , a company may pay a monthly remuneration to its managing or whole time director in accordance with the provisions of section 309 or to its manager in accordance with the provisions of section 387.

The above limit of 11% does not include any fees payable to directors for attending the meeting of the Board or Committee.

If, in any financial year a company has no profit or its profits are inadequate, it may , subject to the approval of the central government, pay to its directors of manager, by way of minimum remuneration , such sum not exceeding Rs.50,000 per annum.

(b) Perquisites to be included in managerial remuneration

In order to make the limit of managerial remuneration effective, explanation to Section 198 provides that the term "remuneration" includes the following.

(i) Any expenditure incurred by the company in providing any rent-free accommodation or any other benefit or amenity in respect of accommodation free of charge.
(ii) Any expenditure incurred by the company in providing any other benefit or amenity free of charge or at a concessional rate.
(iii) Any expenditure incurred by the company in respect of any obligation or service , which but for such expenditure by the company, would have been incurred by any of the persons aforesaid ;and
(iv) Any expenditure incurred by the company to effect any insurance on the life of or to

provide any pension, annuity or gratuity for any of the persons aforesaid or his spouse or child.

Under section 200, no company can now pay to any of its officers or employees remuneration free of any tax or varying with any tax payable by him.

c) Remuneration payable to different categories of managerial personnel.

The following are the amount of remuneration payable to different categories of managerial personnel.

1. Manager: - He is an employee of the company , He is the person who has got the control of the whole or substantially the whole of the affairs of the company. A company cannot have more than one manager at a time. The remuneration payable to the manager cannot be more than5% of the net profits of the company.
2. Managing director:- He is a director who has substantial powers of management. It is not possible to have both a managing director as well as a manager at a time. But there can be one or more than one managing directors at a time in a company. The remuneration payable to the managing director shall not exceed 5% of the net profit of the company. If a company has more than one managing

   director, the total remuneration payable to the managing directors shall not exceed 10% of the net profit of the company.
3. Whole time directors:- He is a director who spends his whole attention for the company . It is permissible to have one or more whole time directors with or without a managing director. The remuneration payable to the whole time director shall not exceed 5% of the net profits of the company. If a company has more than one whole time director, the total remuneration payable to the whole time directors (including managing director, if any) should not exceed 10% of the new profits of the company.
4. Director:- He is the person who guides , directs or manages the affairs of the company . As per the companies act, the term director includes any person occupying the position of director by whatever name called.

A public company must have at least three directors. Whereas in case of private company, it must have atleat two directors.

As per section 309, the remuneration payable to all directors, when not assisted by whole time directors or manager or managing directors, shall not exceed 3% of the net profits of the company. In case, the directors are assisted by whole time directors or manager or managing directors, the remuneration payable to them shall not exceed 1% of the net profits of the company. Of course, this does not include the sitting fees payable to these directors.

The maximum remuneration payable to different categories of managerial personnel, as stated above can be summarized as follows.

Managerial Personnel	Maximum % of new profits
(i) Maximum remuneration to all the managerial personnel	11%
(ii) Manager	5%
(iii) Managing director or whole time director	5%
(iv) Managing director whole time directors when there is more than one	10%
(v) Pat time directors when the company is not having managing directors, whole time director or manager	3%
(vi) Part time directors when assisted by a managing directors, whole time director or manager	1%

PROBLEMS:

1. Determine the maximum remuneration available to the part time directors and manager of Blueprint Co., Ltd, (a manufacturing company) under section 309 and 387 of the companies act, 1956, from the following particulars:
   Before charging and such remuneration the profit & loss A/c showed a credit balance of Rs.660000 for the year ended march 31, 1983 after taking into account the following matters:
   Capital expenditure – 150000
   Subsidy received from Govt – 120000
   Special depreciation – 20000
   Multiple shift allowance – 30000
   Bonus to foreign technicians – 90000
   Provision for taxation – 800000
   Compensation paid to injured workman – 20000
   Ex – gratia to an employee – 10000
   Loss on sale of fixed asset – 20000
   Profit on sale of investment – 60000

2. A company carried forward a balance of Rs.120000 in the profit & loss account from the year ended 31st march 1996. During the year 1997 it made a further profit before tax of Rs. 800000. It was decided that following provisions and transfer be carried out :
   (i) Dividend equalization account Rs. 30000
   (ii) Provision for taxation Rs. 220000
   (iii) General reserve Rs. 105000
   (iv) Development rebate reserve Rs. 110000
   (v) Dividend at 9% on preference shares of Rs. 500000

(vi) Dividend at 15% on 100000 equity shares of Rs.10 each fully paid.

3. The accounts of M.N Prabhu Ltd showed an amount of Rs. 175000 to the credit of Profit & Loss Account on 31st march 1998 out of which the directors decided to place Rs. 25000 to General reserve and Rs. 7000 to debentures redemption fund. At the annual general meeting held on 15th june, 1998, it was decided to place Rs. 12000 to a development reserve and to pay a bonus of 3% of the profit to the directors as additional remuneration. The payment of the Half yearly dividends on Rs.300000 ^% cumulative preference shares on Sep 30 1997 and march 31 1998 was confirmed and a dividend at the rate of 10% was declared on the equity share capital of the face value of Rs. 500000. The balance of Profit & Loss account to be carried forward to next year. Draw up the profit & loss appropriation Account.

Notes to Accounts on Balance Sheet (Format)

		Rs.	Rs.
I.	**Share Capital:**		
	Share capital		XXX
II.	**Reserve & Surplus:**		
	Reserve	XXX	
	Share Premium	XXX	
		XXX	
	Profit for the year	XXX	
		XXX	
	Preliminary Exp	XXX	XXX
III.	**Long term borrowings:**		
	Unsecured Loan	XXX	
	Debenture	XXX	XXX
IV.	**Trade Payable:**		
	Creditors	XXX	
	Bills payable	XXX	XXX
V.	**Other Current Liabilities:**		
	Tax Payable	XXX	
	Outstanding Exp	XXX	XXX
VI.	**Tangible Assets:**		
	Investment	XXX	
	Other fixed Assets-Dep	XXX	
	Stock	XXX	XXX
VII.	**Intangible Assets:**		
	Goodwill		XXX
VIII.	**Trade Receivable:**		
	Debtors	XXX	
	Bills Receivable	XXX	XXX

Balance Sheet as on …..

Particulars	Note No	Rs.
I. Equity and Liabilities:		
Share Capital	1	XXX
Reserve & Surplus	2	XXX
Long term borrowings	3	XXX
Trade Payable	4	XXX
Total		XXX
II. Assets:		
Tangible Assets	5	XXX
Intangible Assets	6	XXX
Trade Receivable	7	XXX
Bank Balance		XXX
Total		XXX

Preparation of Balance sheet

4. From the following balances, prepare the balance sheet of a company in the prescribed format.

   Goodwill Rs.150000; Investments Rs.200000; Share capital Rs.500000; Reserves Rs.110000; Share premium Rs.15000; Preliminary expenses Rs.10000; Profit and loss A/c (cr) Rs.25000; Debenture Rs.2,50,000;Other fixed assets Rs.470000; Stock Rs.80000; Debtors Rs. 60000; Bank balances Rs.30000; Unsecured Loan Rs.65000; Sundry creditors Rs. 35000.

5. From the following balances, prepare the balance sheet of a company in the prescribed format.

   Goodwill Rs.75,000; Investments Rs.1,00,000; Share capital Rs.2,50,000; Reserves Rs.55,000; Share premium Rs.7,500; Preliminary expenses Rs.5,000; Profit and loss A/c (cr) Rs.12,500; Debenture Rs.1,25,000;Other fixed assets Rs.2,35,000; Stock Rs.40,000; Debtors Rs. 30,000; Bank balances Rs.15,000; Unsecured Loan Rs.32,500; Sundry creditors Rs. 17,500

6. Nathiya Ltd., has a credit balance on P&L a/c of Rs.300000 on 1.4.2000 and the net profit for the year 2000-01 is Rs.3000000. It was decided that the following decisions be carried out regarding provisions, reserves and dividends:

   (i) General Reserve Rs.350000

(ii) Investment Allowance Reserve Rs.350000
(iii) Provision for taxation @50%
(iv) Dividend equalization fund a/c Rs.200000
(v) Dividend on 10% preference shares of Rs.2000000
(vi) Dividend at 15% on 300000 equity shares of Rs.10 each fully paid. You are required to give P&L Appropriation A/c and give journal entries for payment of dividend.

Part-A

1. How is provision for taxation treated in the final accounts of a Company?
2. What is managerial remuneration?
3. What is interim dividend?
4. What is contingent liability?
5. The provision for tax at the end of 31-3-2011 stood at Rs. 300000. During 2011-2012, the tax liabilities up to 31-3-2011 were settled for Rs. 2,74,000. Provision required in respect of 2011-2012 is Rs. 82000. How will you show provision for tax in profit and loss a/c.?
6. A company pays interest on 30th June and 31st December on its 100000 15% debentures of Rs.100 each, the books are closed on 31st March. How will the relevant items appear in the company's balance sheet?
7. From the particulars of XLtd, calculate the managerial remuneration assuming there are two whole time directors; a part time director and manager: (i) Net profit before provision for income tax and managerial remuneration but after depreciation- Rs. 870410 (ii) Depreciation provided in the books- Rs 310000 and (iii) Depreciation allowable under schedule XIV- Rs. 260000.

Part-B

1. Explain the law relating to calculation of managerial remuneration.
2. What is the legal requirement as to calculation of 'Divisible profits"?
3. Gokul Ltd., is a company with an authorized capital of Rs. 5,00,000 divided into 5,000 equity shares of Rs.100each. On 31.12.2012 shares were fully called up. The following balances where extracted from the ledger of the company as on 31.12.2012.

Rs.

Stock	50,000
Sale	4,25,000
Purchases	3,00,000
Wages	70,000
Discount allowed	4,200
Discount received	3,150
Insurance up to 31.3.13	6,720
Salaries	18,500
Rent	6,000
General Expenses	8,950
Profit and loss account(Cr)	6,220
Printing and Stationary	2,400
Advertisement	3,800
Bonus	10,500
Debtors	38,700
Creditors	35,200
Plant and Machinery	80,500
Furniture	17,100
Cash and Bank balance	1,34,700
Reserve	25,000
Loan from Managing Director	15,000
Bad Debts	3,200
Calls-in-arrears	5,000

Prepare Trading and Profit and loss account for the year ended 31.12.2012 and the Balance Sheet as on that date. Additional information:

(a) Closing stock Rs. 91,500
(b) Provide depreciation at 15% on plant and machinery and 10% on furniture
(c) Outstanding liabilities: Wages Rs.5,200; Salary Rs.1,200; Rent Rs.600.
(d) Provide 5% dividend on the paid-up share capital

4. A Ltd. Company with an authorized capital of Rs.500000 dividend into 5000 Equity shares of Rs.100each on 31.12.2012, 2500 shares were fully called up. The following balances were extracted from the ledger of the company as on 31.12.2012. Stock Rs.50,000; sales Rs.4,25,000; purchases Rs.3,00,000; Wages(Productive)Rs.70,000; discount allowed Rs.4200; discount received Rs.3150; Insurance upto 31.3.13 Rs.6720; Salaries Rs. 18,500; rent Rs.6,000; general expenses Rs.8950; P&L a/c (credit)Rs.6,220; printing and stationery Rs.2400; advertisement Rs.3,800; bonus Rs.10,500; debtors Rs.38,700; creditorsRs.35,200; plant and machinery Rs.80,500; furnitureRs.17,100; cash and bank balance Rs.1,34,700; reserve Rs.25,000 loan from managing Director Rs.15,700; Bad debtsRs.3,220; calls is arrears Rs.5,000.

   You are required to prepare Trading and Profit and Loss a/c for the year ended 31.12.2012 and balance sheet as on that date.

   Additional information;

   (i) Closing stock Rs.91,500
   (ii) Provide depreciation at 15% on plant and machinery and 10% on furniture.
   (iii) Outstanding liabilities: wages Rs.5,200; Salary Rs.1,200; Rent Rs.600.
   (iv) Provide 5% dividend on the paid up share capital

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UNIT II – CORPORATE ACCOUNTING I- SBA1303

INTRODUCTION

Underwriting is an agreement, with or without conditions, to subscribe to the securities of a company when existing shareholders of the company or the public do not subscribe to the securities offered to them.

When a company goes in for an initial public offer (IPO), it may face certain uncertainty about whether its offer of shares or other securities will be subscribed in full or not. As per SEBI Guidelines 14(4)(b) , it is required that if the company is not able to collect 90% of the offer amount, then it needs to compulsorily return the money to those who have subscribed to the shares and causing lot of issue expenses to go waste. This uncertainty could be avoided by the help of a specialised group of risk-redeemers — called Underwriters.

UNDERWRITING COMMISSION

It may be paid in cash or in fully paid-up shares or debentures or a combination of all these. Companies Act, 2013 provides that payment of commission should be authorized by Articles of Association and the maximum commission payable will be as under:

In case of shares	5% of the issue price of the shares
In case of debentures	2.5 % of the issue price of the debentures

Underwriting commission is not payable on the amounts taken up by the promoters, employees, directors, their friends and business associates.

Commission is payable on the whole issue underwritten irrespective of the fact that whole of the issue may be taken over by the public. Commission is calculated on issue price unless otherwise mentioned.

SOLE UNDERWRITERS AND JOINT UNDERWRITERS

Sole Underwriters:

When the issue is underwritten by only one underwriter, such underwriting is termed as ‘Sole Underwriting’.

For example, if an issue of 1,00,000 shares of Rs.10 each of X Ltd is underwritten by A, it is the case of Sole Undewriting. In such a case, the distinction between marked and unmarked applications is not of such significance.

Joint Underwriters:

The company may enter into underwriting arrangement with number of underwriters. This arrangement is called Joint Underwriting (Co-underwriting). An individual underwriter will be responsible only to the extent of shares underwritten by him.

For example, if an issue of 1,00,000 shares of Rs.10 each of X Ltd. is underwritten by A, B, C, D in the ratio of 2:2:1:1, it is the case of Joint Underwriting.

In such case, the benefit of unmarked applications is given to the underwriters in the ratio of their gross liability. The benefit of marked applications is given to the concerned underwriters in whose favour applications have been marked.

UNDERWRITING AGREEMENT

Conditional underwriting:

Under this type of agreement, the underwriter agrees to take up agreed proportion of shares, not taken up by the public. If the shares are fully subscribed by the public, the underwriter does not take up any share.

Firm underwriting:

Under this type of agreement, the underwriter agrees to take up a specified number of shares irrespective of the number of shares subscribed for by the public. Unless it has otherwise agreed, the underwriters' liability is determined without considering the number of shares taken up 'firm' by him.

For Example, the entire issue X Ltd. Is underwritten as follows:

1,60,000 Shares (Firm Underwriting 3,600 Shares)

1,60,000 Shares (Firm Underwriting 2,000 Shares)

80,000 Shares (Firm Underwriting 1,200 Shares)

80,000 Shares (Firm Underwriting 10,000 Shares)

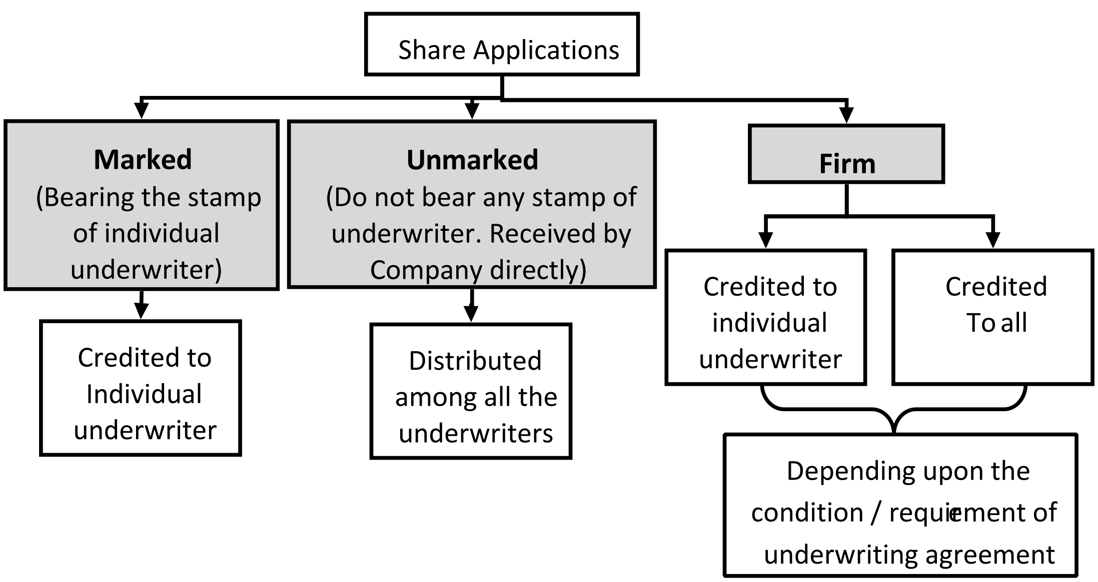
In this case only 4,63,200 shares (i.e. 4,80,000 shares – firm underwriting of 16,800 shares) will be offered to public and 16,800 shares will be taken by the underwriters even if the issue is oversubscribed.

The benefit of firm underwriting may be given either

- To an individual underwriter on the basis of his individual firm underwriting, or
- To all the underwriters in the ratio of their gross liability

That is Firm Underwriting may be treated at par with either 'Marked Applications' or 'Unmarked Application'.

TYPES OF SHARE APPLICATIONS



Types of Applications	Treatment for different types of application
Marked (Bearing the stamp of individual underwriter)	Treatment No.1 Marked applications are always credited to the individual underwriter
Unmarked (Do not bear any stamp of underwriter. Received by Company directly)	Treatment No.2 Unmarked applications are always distributed among all the underwriters
Firm Underwriting (Applications made by the underwriters themselves)	Treatment No.3 The applications for the firm shares are either credited to individual underwriter (i.e. Treatment No.1) or credited to all (i.e. Treatment No.2) depending upon the conditions/ requirement of underwriting agreement.

FULL AND PARTIAL UNDERWRITING

Full underwriting:

When the whole issue is underwritten by the underwriter(s) it is called as full underwriting.

For Example, X Ltd. Decided to make a public issue of 1,00,000 equity shares of Rs.10 each which is entirely underwriter by A, B, C, D in the ratio of 2:2:1:1. In such case, the benefit of unmarked applications is given to the underwriter in the ratio of their gross liability.

Partial underwriting:

When a part (say 75%) of the whole issue is underwritten by the underwriters it is called as partial underwriting. For Example, X Ltd. Decided to make a public issue of 1,00,000 equity shares of Rs.10 each out of which 90,000 shares are underwritten by A, B, C, D in the ratio of 2:2:1:1. It means 10,000 shares are underwritten by Company itself.

In this case if figure of marked application is not given separately, (Marked applications = Total number of applications received x percentage of underwriting.) For the uncovered portion we can say company is liable, but company will not take its own share rather it will remain unsubscribed.

CALCULATION OF LIABILITY OF UNDERWRITERS

Statement showing Net and Total liability of underwriters

[Figures - No. of shares]

No	Particulars	Basis	A	B
A	Gross liability	Ratio of Shares Underwritten	×××	×××
B	Less: Marked applications (excluding firm underwriting)	Actual	×××	×××
C	Balance [A - B]		×××	×××
D	Less: Unmarked applications allotted in the ratio of gross liability	Ratio of Gross Liability	×××	×××
E	Balance [C- D]		×××	×××
F	Less: Firm underwriting	Actual or Ratio of Gross Liability	×××	×××
G	Net Liability as per agreement (if no balance is negative) [E- F]		×××	×××
H	Add: Firm underwriting		×××	×××
I	Total liability		×××	×××

STATEMENT SHOWING THE NET AMOUNT DUE FROM/TO OF UNDERWRITERS

Statement Showing the Net Amount Due From/To Of Underwriters

[Figures - No. of shares]

No	Particulars	A	B
A	Total liability (Including firm underwriting) (No of Shares)	×××	×××
B	Amount due on total liability	×××	×××
C	Less Amount already paid on Firm Applications	×××	×××
D	Amount due on net liability	×××	×××
E	Less Underwriting Commission	×××	×××
F	Net Amount due to Underwriters (if D<E) Or Net Amount from Underwriters (if D>E)	×××	×××

ACCOUNTING ENTRIES IN THE BOOKS OF THE COMPANY

No	Particulars	L.F.	Debit	Credit
1.	**Application Money received towards firm Underwriting** Bank A/c Dr. To Underwriter's Personal A/c			
2.	**Underwriter's Liability [Application + Allotment money]** Underwriter's Personal A/c Dr. To Equity Share Capital A/c To Share premium A/c			
3.	**Commission due** Underwriting Commission A/c Dr. To Underwriter's Personal A/c			
4.	**Settlement of Account**			
(a)	**Receipt of money due from underwriters** Bank A/c Dr. To Underwriter's Personal A/c			
(b)	**Payment to underwriters** Underwriter's Personal A/c Dr. To Bank A/c			

Illustration:

A company issues 50,000 shares of Rs.10 each at par. The whole issue has been underwritten by X & Co. for a commission of 4%. The company received applications only for 47,000 shares. All the applications were accepted. Give the journal entries to record the above transactions.

Solution

DATE	PARTICULARS	LF	AMOUNT (DR)	AMOUNT (CR)
	Bank A/c Dr. To Equity Share Capital A/c (being application money of 47000 shares@ 10each received)		4,70,000	4,70,000
	X & Co.A/c Dr. To Equity Share Capital (being the allotment of 3000 shares of 10each not taken up by public)		30,000	30,000
	Comm. on issue of shares A/c Dr. To X & Co.A/c (being commission due to X &Co. @4% on 50000 shares of 10 each)		20,000	20,000
	Bank A/c Dr. To X & Co. (being balance due from X & Co. received)		10,000	10,000

Illustration:

A entered into an underwriting agreement with B Ltd. for 60% of the issue of rs.50,00,000 15% debentures with a firm underwriting of rs. 5,00,000. Marked applications were for rs. 35,00,000 debentures. Calculate the liability of the underwriter and the commission payable to him.

Solution:

Net liability of A being 60% of rs.50,00,000 i.e., Rs.30,00,000.

Since the issue is oversubscribed and there is a firm underwriting the liability of underwriter will be limited to the extent of firm underwriting i.e. Rs.5,00,000.

Commission 2.5% of 30,00,000rs = Rs.75,000

Illustration :

Gemini ltd. go for public issue of 50,00,000 equity shares of Rs. 10 each. A, B & C took underwriting of the issue in 15,00,000; 25,00,000 and 10,00,000 shares. Applications were received for 48,50,000 shares. The marked applications were 45,50,000 shares as follows:

A 12,00,000 shares

B 25,00,000 shares

C 8,50,000 shares

Unmarked application: 3,00,000 Calculate the net liability of underwriters

Solution:

Particulars	**A**	**B**	**C**
Gross liability	15,00,000	25,00,000	10,00,000
Less: marked application	12,00,000	25,00,000	8,50,000
Less: unmarked application (3:5:2)	90,000	1,50,000	60,000
Balance	**2,10,000**	**(1,50,000)**	**90,000**
Less: negative balance (3:2)	90,000	(1,50,000)	60,000
Underwriters Net liability	**1,20,000**	**Nil**	**30,000**

Illustration :

Gemini ltd. go for public issue of 20,000 equity shares of Rs. 10 each. A, B & C took underwriting of the issue in 10,000; 6,000 and 4,000 shares. Applications were received for 16,000 shares. The marked applications were 15,000 shares as follows:

A 8,000 shares

B 2,850 shares

C 4,150 shares

Unmarked application (16000- 15000)= 1000 Calculate the net liability of underwriters

Solution:

Particulars	**A**	**B**	**C**
Gross Liability (10:6:4)=(5:3:2)	10,000	6,000	4,000
Less: Marked application	8,000	2,850	4,150
Less: unmarked application(1000)	500	300	200
Balance	**1,500**	**2,850**	**(350)**
Less: Negative balance management(5:3)	219	131	(350)
Underwriters Net Liability	**1,281**	**2,719**	**Nil**

Illustration

Gemini ltd. go for public issue of 20,000 equity shares of Rs. 10 each. A, B & C took underwriting of the issue in 10,000, 6,000 and 4,000 shares. Applications were received for 20350 shares. The marked applications were as follows:

Assume that the marked application were 19350 as follows:

- A: 8000
- B: 6850
- C: 4500

Unmarked application 1000

Solution:

Particulars	**A**	**B**	**C**
Gross Liability	10,000	6,000	4,000
Less: marked application	8,000	6,850	4,500
Less: unmarked application (10:6:4)	500	300	200
Balance	1,500	(1,150)	(700)
Less: negative balance	1,850	(1,150)	(700)
Net Liability of Underwriters	(350)	Nil	Nil

Illustration

XYZ ltd issue 25,00,000 shares @Rs. 10 each , 7,00,000 shares issued to promoter, balance given to public. P,Q, & R underwriter in the ratio of 2:3:4. Firm Underwriting 50,000, 60,000 & 70,000 respectively.

Total Subscription is 13,88,000 excluded firm underwriting and including marked applications. Marked Application of P,Q,R is 3,00,000; 3,50,000 & 4,50,000 respectively. Unmarked and surplus application is to be distributed in Gross liability ratio. Ascertain the liability of each underwriter

Solution

25,00,000 – 7,00,000= 18,00,000

Gross Liability Ratio is 2:3:4

18,00,000*2/9= 4,00,000= P

18,00,000*3/9= 6,00,000= Q

18,00,000*4/9= 8,00,000 =R

Un marked applications: 13,88,000 – 11,00,000 = 2,88,0000

2,88,000 * 2/9= 64,000

288000*3/9= 96,000

288000*4/9=1,28,000

Particulars	**P**	**Q**	**R**
Gross Liability	4,00,000	6,00,000	8,00,000
Less: Marked Application	3,00,000	3,50,000	4,50,000
Balance Before Firm Underwriting	1,00,000	2,50,000	3,50,000
Less: Firm Underwriting	50,000	60,000	70,000
Balance Before Unmarked Application	50,000	1,90,000	2,80,000
Less: Unmarked application	64,000	96,000	1,28,000
Balance after unmarked applications	**-14,000**	**94,000**	**1,52,000**
Less: negative balance (0:3:4)	-14,000	6,000	8,000
Net Liability	0	88,000	1,44,000
Firm underwriting	50,000	60,000	70,000
Total Liability	**50,000**	**1,48,000**	**2,14,000**

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UNIT – II – CORPORATE ACCOUNTING-1- SBAA1303

REDEMPTION OF PREFERENCE SHARES

When the preference shares are issued it is to be paid back by the company to such shareholders after the expiry of a stipulated period whether the company is to be wound up or not.

Types OR Classes of Preference Shares

(a) With Reference to Dividend:

(i) Cumulative Preference shares: Cumulative preference shares are these preference shares, the holders of which are entitled to receive arrears of dividend before any dividend is paid on equity shares.

(ii) Non-cumulative Preference shares: Non-cumulative preference shares are those preference share, the holders of which do not have the right to receive arrear of divided. If no dividend is declared in any year due to any reason. Such shareholders get nothing, nor can they claim unpaid dividend in any subsequent years.

(b) With Reference to Participation

(i) Participating preference shares: such shares, in addition to the fixed preference dividend, carry a right to participate in the surplus profit, ifany, after providing dividend at a stipulated rate to equity shareholders.

(ii) Non-Participating preference shares: Such shares get only a fixed rate of dividend every year and do not have a right to participate in the surplus profit.

(c) With Reference to Convertibility

(i) Convertible preference shares: are those preference shares which have the right/option to be converted into equity shares.

(ii) Non-convertible preference shares: are those preference shares which do not have the right/option to be converted into Equity shares.

(**d) With Reference to Redemption**

(i) Redeemable preference shares: are those preference shares the amount of which can be redeemed by the company at the time specified for their repayment or earlier. **(ii) Irredeemable preference shares**: are those preference shares the amount of which cannot be refunded by the company unless the company is wound up. Now a company cannot issue irredeemable preference shares.

As per Sec 80 of the Companies Act, a company limited by shares can redeem the preference shares, subject to the following conditions:

1. The shares to be redeemed must be fully paid up.
2. Such shares can be redeemed either out of profit or out of the proceeds of fresh issue of shares. But these cannot be redeemed out of fresh issue of debentures or out of sale proceeds of any property of the company.
3. Premium payable on redemption must be provided out of profits of company or out of company's security premium account.
4. When shares are redeemed out of profit, a sum equal to the nominal amount of shares so redeemed must be transferred out of profit to a reserve account namely Capital Redemption Reserve A/c.
5. The Capital Redemption reserve A/c can be utilized only for the issue of fully paid up bonus Shares.

The preference shares can be redeemed either at par or at premium (but not at discount).Premium on redemption is provided out of existing security premium account or security premium on fresh issue. If they are not sufficient, the redemption premium should be provided out of P&L A/c or General Reserve.

Methods of Redemption

There are three methods for redemption of preference shares. They are:

(a) Redemption out of fresh issue of shares

(b) Redemption out of profits

(c) Redemption partly out of fresh issue and partly out of profit

Accounting Procedure for Redemption

1. Ensure that the redeemable preference shares are fully paid. If they are partly paid, the Following entries are passed to make them fully paid.

    (a) Preference Share Final Call A/c Dr

    To Preference Share Capital A/c

    (b) Bank A/c Dr

    To Preference Share Final Call A/c

2. Entry for total amount due to preference shareholders

Preference Shares Capital A/c Dr (face value)

Premium on Redemption A/c Dr (premium on redemption)

To Preference Shareholders A/c (total amount payable on redemption)

3. Entry for issue of equity shares either with or without premium

Bank A/c Dr (amount received)

Discount on issue of shares A/c Dr (if shares issued at discount)

To Equity share capital A/c (face value of shares issued)

To Security Premium A/c (if shares issued at premium) 4.

Entry for providing premium on redemption

Security premium A/c or P& L A/c or General Reserve A/c Dr

To Premium on Redemption A/c

5. Entry for appropriation from divisible profits to meet deficiency of amount on Redemption (Or if redemption is out of profit)

P & L A/c or General Reserve A/c Dr

To Capital Redemption Reserve A/c

6. Entry for payment to preference shares

Preference Shareholders A/c Dr

To Bank A/c

Working Note:

Calculation of amount to be transferred to Capital redemption Reserve A/c

Face value of Pref. share redeem	xxx
Less: Issue of fresh Equity share	xxx
Less: amount utilized for CRR:	
Profit & Loss A/c	xxx
General reserve	xxx
Security premium	xxx
Capital Redemption Reserve	**xxx**

DEBENTURES

Meaning of Debenture

It is a document issued by a company under its common seal acknowledging the debt and it also contains the terms of repayment of debt and payment of interest at a specified rate.

Section 2 (30) of Companies Act, 2013 defines debenture as "Debenture includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the company's assets or not."

Debentures are generally freely transferable by the debenture holder. Debenture holders have no rights to vote in the company's general meetings of shareholders. The interest paid to them is a charge against profit in the company's financial statements.

Types of Debentures

(a)Convertibility point of view: There are two types of debentures:

1. **Convertible debentures**, which can be converted into equity shares of the issuing company after a predetermined period of time. These may be:

Partly Convertible Debentures (PCD): A part of these instruments are converted into Equity shares in the future at notice of the issuer. The issuer decides the ratio for conversion. This is normally decided at the time of subscription.

Fully convertible Debentures (FCD): These are fully convertible into Equity shares at the issuer's notice. The ratio of conversion is decided by the issuer. Upon conversion the investors enjoy the same status as ordinary shareholders of the company.

2. **Non-convertible Debentures**, which are simply regular debentures, cannot be converted into equity shares. These are debentures without the convertibility feature; these usually carry higher interest rates than their convertible counter parts.

(b)On basis of Security, debentures are classified into:

1. **Secured Debentures**: These instruments are secured by a charge on the fixed assets of the issuer company. So if issuer fails to pay of the principal or interest amount, its assets can be sold to repay the liability towards debenture holders.

2. **Unsecured Debentures**: These instruments are unsecured in the sense that if the issuer defaults on payment of the interest or principal amount, the investor is treated like other unsecured creditors of the company.

(c)From Redemption point of view

1. **Redeemable Debentures**: Redeemable debentures are those which are redeemed or paid off after the termination of fixed term. The amount paid off includes the principal amount and the current year's interest. The company always has the option of either to redeem a specific number of debentures each year or redeem all the debentures at specified date.

2. **Irredeemable or Perpetual Debentures**: Irredeemable debentures are those debentures which do not have any fixed date of redemption. They are redeemed either in the event of winding up or at a very remote period of time. Irredeemable or perpetual debenture holders can never force the company to redeem their debentures.

Distinguish between a Share and Debenture

Basis	**Share**	**Debenture**
Ownership	Shareholders are the owners of company.	Debenture holders are the lenders of company.
Form of return	Dividend	Interest
Security	Not Secured	Secured by charge on assets
Voting right	Equity shareholders have the voting right	No voting right in normal course of business
Risk	More risk as compared to Debenture	Risk Free due to secured Debentures
Convertibility	It can't be converted into debenture	It can be converted into share
Rate	Rate of dividend varies year to year	Rate of interest is fixed
Form of capital	It is part of owned capital	It is a part of borrowed capital

Features of Debenture

1. It is an instrument of debt issued by company under its common seal.

2. It carries fixed rate of interest.

3. Debenture is a part of borrowed capital.

4. It is repaid after a long period.

5. It is generally secured.

Issue of Debentures

Debentures can be issued in following ways:

1. From consideration point of view
A. For consideration in cash: Debentures can be issued either at par, at premium or at discount. The entry will be:

Bank A/c Dr

Discount on issue of debentures A/c Dr (if issue at discount)

To Debentures A/c

To Security premium A/c (if issue at premium

B. For consideration other than cash: The entries are **i. For purchase of assets**

Sundry Assets A/c Dr To Vendor A/c

ii. For issuing debentures for payment of purchase consideration

Vendor A/c Dr

To Debentures A/c

iii. When business is purchases: purchase consideration is equal to net value of assets

Sundry Assets A/c	Dr.	Value of asset
To Sundry Liabilities A/c		Value of liabilities
To Vendor A/c		Purchases consideration

Iv. When Purchases consideration more than net value of assets Sundry

Asset Account Dr. Value of asset

Goodwill Account Dr. Excess of purchase value

To Sundry Liabilities A/c Value of liabilities

To Vendor A/c Purchases consideration

v. When Purchase consideration is less than net value of asset

Sundry Assets Account Dr. Value of asset

To Sundry Liabilities A/c Value of liabilities

To Capital Reserve Difference

To Vendor Purchases consideration

C. As collateral security: Collateral security means security provided to lender in addition to the principal security. It is a subsidiary or secondary security. Whenever a company takes loan from bank or from any financial institution it may issue its debentures as secondary security which is in addition to the principal security. Such an issue of debentures is known as 'issue of debentures as collateral security'. The lender will have a right over such debentures only when company fails to pay the loan amount and the principal security is exhausted. In case the need to exercise the right does not arise debentures will be returned back to the company. No interest is paid on the debentures issued as collateral security because company pays interest on loan. In the accounting books of the company issue of debentures as collateral security can be credited in two ways:

(i) **First method:** No Journal entry to be made in the books of accounts of the company for debentures issued as collateral security. A note of this fact is given in this case.

(ii) **Second method**: Entry to be made in the books of accounts of the company. A journal entry is made on the issue of debentures as a collateral security; Debentures Suspense Account is debited because no cash is received for such issue.

Debenture Suspense A/c Dr.

To % Debentures A/c

2. From price point of view: From this point of view debentures can be issued either at par, at premium or at discount:

a. When debentures are issued at par

Bank A/c Dr (with face value)

To debentures A/c

b. When debentures are issued at discount

Bank A/c Dr (net amount received)

To Discount on issue of Debentures A/c (amount of discount)

To Debentures A/c (with face value)

c. When debentures are issued at premium

Bank A/c Dr (total amount)

To Debentures A/c (with face value)

To Security premium Reserve A/c (amount of premium)

Debenture Payable in Installments

1. First installment paid along with application is called as application money.
2. Second installment paid on allotment is called as allotment money.
3. Subsequent installments paid are called as call money calls can be more than one and called First call, second call or as the case may be.

3. From condition of redemption point of view: There are six cases on the basis of terms of issue and conditions of redemption of debentures. They are as follows:

a. Issued at par and redeemable at par.

b. Issued at premium and redeemable at par.

c. Issued at discount and redeemable at par.

d. Issued at par and redeemable at premium.

e. Issued at discount and redeemable at premium.

f. Issued at premium and redeemable at premium

A. When issued at par and redeemable at par.

Bank A/c Dr

To Debentures A/c

B. When issued at premium and redeemable at par.

Bank A/c Dr (face value+ premium)

To Debentures A/c (face value) To

security premium A/c (premium)

C. When issued at discount and redeemable at par.

Bank A/c Dr (amount received)

Discount on issue of debentures A/c Dr (discount)

To Debentures A/c (face value)

D. When issued at par and redeemable at premium.

Bank A/c Dr (amount received)

Loss on issue of debentures A/c Dr (premium on redemption)

To debentures A/c (face value)

To premium on redemption A/c (premium on redemption) **E.**

When issued at discount and redeemable at premium.

Bank A/c Dr (amount received)

Loss on issue of debentures A/c Dr (issue discount+ redemption Premium)

To debentures A/c (face value)

To premium on redemption A/c (redemption premium) **F.**

When issued at premium and redeemable at premium.

Bank A/c Dr (amount received)

Loss on issue of debentures A/c Dr (redemption premium)

To debentures A/c (face value)

To security premium A/c (issue premium)

To premium on redemption A/c (redemption premium)

Discount or Loss on issue of debentures

Discount or loss on issue of debentures and premium on redemption are capital losses. They are shown in the balance sheet under the head "Miscellaneous Expenditure". Being the losses, they are to be written off against capital reserve or security premium A/c. In its absence it is written off to P& L A/c during the life of debentures. The entry is:

Capital reserve/ Security premium A/c/ P & L A/c Dr

To Discount / Loss on issue of debentures A/c.

INTEREST ON DEBENTURES

Interest on Debentures is calculated at a fixed rate on its face value and is usually payable half yearly & is paid even company is suffering from loss because it is charge on profit. Income Tax is deducted from interest before payment to debenture holders. It is called T.D.S. (Tax deducted at source).

REDEMPTION OF DEBENTURE

Meaning: Redemption of debentures means repayment of the due amount of debentures to the debenture holders. It may be at par or at premium.

Time of Redemption

(a) **At maturity**: When repayment is made at the date of maturity of debentures which is determined at the time of issue of debentures.

(b) **Before maturity**: If articles of association and terms of issue mentioned in prospectus allows, then a company can redeem its debentures before maturity date.

Redemption Methods

(1) **Redemption in Lump-sum:** When redemption is made at the expiry of a specific period, as per the terms of issue.

(2) **Redemption by draw of lots :** In this method a certain proportion of debentures are redeem each, year, the debenture for which repayment is to be made is selected by draw of lots.

(3) **Redemption by purchases in open market**: If articles of association of a company authorize, it may purchases its own debentures from open market i.e. stock exchange.

Advantages of this Method

(1) When market price of own debentures is low than the redeemable value is less than the amount payable on maturity.

(2) Decrease the amount of interest payable to outsiders.

(3) If term of issue is provided that debentures are to be redeemed at premium then such premium can be reduced.

Sometimes company can purchases the debentures at more than the redeemable Value due to the following reasons:

1. To maintain the solvency ratio.

2. To utilize the surplus money or funds which are lying idle with the company.

3. When rate of interest on debentures is more than the current market rate of interest on debentures in the industry.

Sources of Redemption of Debentures

1. Proceeds from fresh issue of Share Capital to Debenture holder.

2. From accumulated profit.

3. Proceeds from sale of fixed assets.

4. A company may purchase its own debentures out of its surplus funds.

Two terms which are used in the redemption of debentures

1. Redemption out of capital: When a company has not used its reserve or accumulated profit for redemption of its debentures, it is called redemption out of capital, so company using this method has not transferred its profit to DRR A/c. But as per SEBI guidelines it is necessary for a company to transfer 50% amount of nominal value of debentures to be redeemed in DRR A/c before redemption of debentures commence.

2. Redemption out of profit: Redemption out of profit means that adequate amount of profits are transferred to DRR A/c from Statement of Profit & Loss before the redemption of debenture commences. This reduces the amount available for dividends to shareholders.

Debenture Redemption Reserve (DRR) : Section 71 (4) of the companies Act, 2013 requires the company to create DRR out of the profits available for dividend and the amount created in DRR shall not be utilized for any purpose except redemption. Rule 18 (7) of Companies (share capital and Debentures) Rules, 2014 requires the following companies to create DRR of an amount equal to 25% of the value of Debentures:–

(i) NBFCs registered with RBI

(ii) Financial institutions other than all India Financial Institutions regulated by RBI

(iii) Housing finance companies registered with National Housing Bank. DRR is required for publicly three classes of companies, not for privately placed.

(iv) Any other company (whether listed or unlisted), DRR to be created for both public and private placed debenture.

As per rule 18 (7) (c), every company required to create / Maintain DRR shall invest or deposit before 30th April specified. Securities a sum which shall not be less than 15% of the amount of debentures, maturing for payment during the year ending 31st March of the next year. **Exemption to create DRR:–**

(i) All India Financial Institutions regulated by RBI.

(ii) Banking Companies.

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UNIT IV – CORPORATE ACCOUNTING I- SBA1303

Definition of goodwill:-

Goodwill in simple words means the ‘good name’ or the ‘reputation’ of the business which attracts more customers and therefore, helps in earning more profits in future. It is an intangible real asset and not a fictitious one.”It is perhaps the most intangible of intangibles”.

“The capacity of a business to each profits in future is basically what is mean by the term goodwill” –J.O.Magee,

Nature of Goodwill

Goodwill is an intangible asset since it cannot be seen or felt. However it is not fictitious in the case of profitable concerns. It can be sold, though a sale will be possible only along with the sale of business itself. Sometimes, good will is more valuable than the tangible assets.

Sources of goodwill

The following are the main sources which generally give rise to goodwill:

(i) The location of the business premises e.g., a retail shop located in a busy market centre
(ii) The reputation of the articles sold arising for the high standard or quality of the goods themselves
(iii) The personality and reputation of the owner or management, arising through his/its skill and influence, as in the case of a professional man. For example , a chartered Accountant
(iv) Possession of trademarks, patents or copy rights
(v) Possession of advantageous contracts or complete or partial monopoly
(vi) Development of the business and shopping facilities with the changing conditions of the market e.g., provision for the visitor’s rest room.
(vii) Any government or any legislative or any other special advantage enjoyed by the firm .e.g., inclusion in the list of approved suppliers to Government, Municipal Corporation or C.P.W.D etc.

Goodwill is not generally recorded in the books of accounts even though it does exist in a business firm .In fact, goodwill should not appear in the books of a business unless

(a) It has been purchased and paid for

(b) It is necessary to bring it into the books of accounts in connection with admission of a new partner or retirement or death of an existing partner. Moreover, to write up a created goodwill is regarded as contrary to good accounting practice. In a way it is sort of secret reserve.

Methods of valuation of goodwill

In the case of sale of business , the value of goodwill will depend on mutual agreement between the purchaser, and seller of the business. Normally, the following methods are followed for valuing goodwill:

(1) Average profits method
(2) Super profits method
(3) Capitalization method

1. **Average profits method or certain number of years' purchase of average profits method.**

Under this method, goodwill is valued on the basis of an agreed number of years purchase of the average annual profits , calculated by reference to recent years and having regards to the probable maintenance of such profits in future years. Here there are two important steps in the computation

(a) Average normal profit of the past three or four years must be computed. Any abnormal or non-recurring losses and gains should be removed from the profit. Then any future expected savings or additional expenses should be adjusted from the average profit.
(b) They years of profit should be determined, which depends on the capacity of the firm to maintain future profits.

Calculating of weighted average

Sometimes, instead of the simple average of the adjusted profit as discussed above, weighted average is taken into consideration. Weights are given to each year's profit on the consideration of how each year's profit is likely to influence the future profit trend. Generally, more weight age is to be given to the profit of the later years as compared to the former years.

The profit is multiplied by the weight, the products are totalled and them divided by the total of the weights.

2. Super profit method

Average profit of the firm is compared with the normal profit on the invested capital in the firm. Excess of average profit over normal profit is known as super Profits. Defined in another way super profit is the excess of profit which can be expected in future years over and above what is necessary for paying a fair return on capital employed, having regard to the risk involved in that class of business and fair managerial remuneration. This method thus presumes normal profits to cover interest on capital and managerial remuneration and the profits of a business in excess of the normal yield are called super profits.

Calculation of super profits

The following steps are to be taken for calculation of super profits.

(i) The average capital employed during the year should be ascertained

(ii) Normal profit should be calculated. The normal profit is ascertained as follows.

Normal profit = Average capital employed × Normal rate of return

Normal rate of return is the rate of profit generally earned by other similar firms in that industry.

(iii) Then, the expected average (simple or weighted) annual Trading profit after tax, preference dividend and interest on long term loans should be computed [However , transfer to general reserve, dividend equalization fund, sinking fund for redemption of debentures etc. should not be deducted since they, in no way, affect the availability of profits for the equity shareholders]

(iv) Form this expected average profit , reasonable managerial remuneration should be deducted

(v) The profit as obtained after the above adjustments is to be compared with the normal profit . If the expected average profit exceeds the normal profits, the balance represents the super profits.

To sum up:-

Super Profits=Expected average profit –Normal profit

Normal Profits = Average capital employed × Normal rate of return

Expected average profit =Average of the previous three or four years' profits, after adjusting past abnormal losses and gains and also future expected changes in expenses and incomes.

This method is very popular for valuation of goodwill in case of joint stock companies.

Goodwill based on super profits

There are three methods of calculating goodwill based on super profits. The methods and their formulae are given below.

(i) Years of purchase of super profit method

According to this method the value of goodwill is ascertained as follows;

Goodwill= super profit × No. Of years 'purchase.

(ii) Sliding –scale valuation of super profit method

This method of valuation of goodwill is a slight variation of the purchase of super profit method. It has been advocated by A.E. Cut forth. It is based on the logic that the greater is the amount of super profits, the more difficult it is to maintain it. Higher profit will naturally attract competition and soon the firm's ability to make super profit is curtailed.

(iii)Capitalization of super profit method

Under this method the average super profit is capitalized at a certain rate return and this capitalized amount becomes the value of the goodwill. In other words, the method tries to find out the amount of capital needed for earnings the super profit,

(iv)Annuity method

Under this method super profit is being considered as the value of annuity over a certain number of years and for this purpose, compound interest is calculated at a certain respective percentage. The present value of the said annuity will be the value of goodwill.

This method is based on the logic that the purchaser should pay now for goodwill only at the present value of super profits calculated at a proper rate of interest.

3. Capitalization method

Under this method, the total value of the business (or) capitalized value of business is found out by capitalizing the expected average profits on the basis of normal rate of return. The value of goodwill is the difference between the capitalized value of the business so found out and the actual capital employed (i.e., net tangible assets) in the business.

The following steps are to be taken in ascertaining the value of goodwill under this method

I. Expected average net profit should be ascertained after providing for reasonable managerial remuneration

II. Capitalized valued of profit is to be calculated on the basis of normal rate of return. The formula is

$$\text{Capitalized value of the business} = \frac{\text{Expected average net profit}}{\text{Normal rate of return}} \times 100$$

III. Net tangible assets(i.e., total tangible assets –liabilities to outsiders)should also be calculated

IV. When the net tangible assets are deducted from the capitalized value of the business , the difference is goodwill .

Goodwill= capitalized value of business-net tangible assets.

Valuation of shares Introduction

Valuation is NOT AN EXACT SCIENCE: It is “Sophisticated Guess work” Bonbright opens his discussion on valuation with the following quotation form decision by Justice Holmes “A word is not a Crystal transparent and unchanged: It is the skin of a living thought and may vary greatly in colour and content according to the circumstances and the time in which it is used.

Need for valuation of shares

Shares of a limited company have to be valued for different purposes:

(a) When share of unquoted private companies should be purchased or sold

(b) When controlling number of shares are purchased by a company in another

(c) When amalgamation or absorption of companies takes places (d) For settlement of dissenting shareholders in a reconstruction scheme (e) For assessment of wealth tax, capital gains tax, etc.

(f) For sanctioning loan by financial institutions on the security of shares

(g) For conversion of preference shares into equity shares

(h) For advancing loans on the security of shares

(i) For compensating shareholders on the acquisition of shares, by the government under a scheme of nationalization.

Factors affecting the value of shares

The value of shares of a company is greatly affected by the economic, political and social factors, some of which are noted below.

I. The economic condition of the country

II. The nature of company's business

III. Other political and economic factors(e.g., possibility of nationalization, excise duty on goods produced ,etc)

IV. The demand and supply of shares

V. Proportion of liabilities and capital

VI. Rate of proposed dividend and past profits of the company VII. Yield of other related shares of the stock exchange, etc.

Methods of valuation of shares

The valuation of shares may broadly be classified as under

Methods of valuation

Net asset method	Yield method	Fair value method
(or)	(or)	(or)
Asset backing method	market value method	Average of assets backing and yield method
(or)	(or)	
Intrinsic value method	Earning capacity method	
(or)	(or)	
Breakup value method	Dividend yield method	
(or)		
Real value method		
(or)		
Assets-basis method		
(or)		
Net worth method		
(or)		
Equity method		

1. Net assets method (or) intrinsic value method

This method measures the value of the net assets of the company against each share. Since the valuation is made on the basis of the assets of the company, it is known as assets basis or asset backing method. At the same time, the shares are value on the basis of real internal value of the assets of the company and that is why the method is termed an intrinsic value method or real value method. For the purpose of valuating shares of a company by this method, it is necessary to make a start with the assumption that the company in question is liquidated, its assets are realized and liabilities paid off. That is why this method is also called break-up value method. This method may be made either (i) on a going/continuing concern basis; and (ii) break –up value basis . In the case of former, utility of assets is to be considered for the purpose of arriving at the value of the assets but in the case of latter the realizable value is o be taken.

Under this method the assets of the company at market values are added up.The liabilities including debentures and preference shares are reduced. The balance is net assets. It is divided by the number of shares to find the value of each share. Net assets value may be expressed by the following formula.

Net asset value of a share = $\dfrac{\text{Net value of assets} - \text{liabilties} - \text{preference shareholder claims}}{\text{Number of equity shares}}$

Factors to be considered in valuing the assets

I. A proper value should be placed on the goodwill of the business, as explained in the preceding pages. In other words, goodwill should be valued at current cost and therefore any book value appearing as a result of purchase of goodwill must be eliminated
II. Fictitious assets such as debit balance of profit &loss account, discount on issue of shares and debentures, preliminary expenses, etc.should be excluded
III. All other assets(including non-trading assets such as investment) should be taken at their market values. In the absence of information in the question regarding the market values of the different assets, book values may rightly be taken as the market values of the different assets.
IV. While calculating the value of inventories , finished goods may be valued at market price and raw-materials, stocks and work-in –progress should be valued at cost price.
V. In case of book debts, it must be valued after making provision for bad and doubtful debts.

Valuation of liabilities

A. Generally, liabilities are to be taken at book values. However, due consideration is to be given for contingent liabilities, similarly, it is necessary to provide adequate provisions for outstanding expenses
B. It is necessary to provide adequate provision for taxation and dividends so that these are included in the liabilities
C. In case the share capital comprises both equity shares and preference shares, it is necessary to deduct preference share capital from the assets.
D. In case , the preference shares are participating preference shares, their claim f or surplus should also be deducted from the value of the assets.

Treatment of partly paid up equity shares

When there are fully paid up and partly paid – up equity shares, it is necessary to convert partly paid up shares into fully paid up shares by making a national call and uncalled amount should be added to net assets before dividing the same by the number of shares. The value of each partly paid up share will then be the value of each fully paid up share minus the amount due on its.

Different classes of equity shares

Where there are equity shares of different denominations(e.g.,2,000 shares of Rs.100 each fully paid and 2,000 shares of Rs.80 each fully paid) the total assets backing for equity shares being divided by the total amount of paid up equity capital(see that it is not the number of shares but the paid up value of shares which divides the assets backing) gives the value of each Re.1 of the paid up capital , this again being multiplied by the actual paid up value of each class of shares with the asset backing value of that class of shares.

Proforma for net assets method of valuation of shares

	Rs.	Rs.
Assets at market value:		
Goodwill(if any)		xxx
Fixed assets		xxx
Investment		xxx
Current asset		xxx
Total assets		xxx
Less:- Current liabilities	xxx	
Debentures	xxx	
Preference share capital (with arrear of dividend)	xxx	xxx
Net assets available for equity shareholders		xxx

$$\text{Intrinsic value per share} = \frac{\text{Net assets available for equity share holders}}{\text{Number of equity shares}}$$

Alternative method of calculation of net assets

	Rs.	Rs.
Equity share capital		xxx
Reserves		xxx
Other surpluses		xxx
Profit on revaluation of assets		xxx
Gross equity		xxx
Less: Loss on revaluation of assets	xxx	
Miscellaneous expenditure and losses	xxx	xxx
Net equity		xxx

$$\text{Intrinsic value per share} = \frac{\text{Net equity}}{\text{Number of equity shares}}$$

Applicability of the method

I. The method is particularly applicable when the shares are valued at the time of amalgamation, absorption and liquidation of companies; and

II. The permanent investors determine the value of shares under this method at the time of purchasing the shares

III. This method is also applicable when shares are acquired with control motives

1. Yield method /Earning capacity method

Yield is the effective rate of return on the investment made in the shares by the investors. It is always expressed in terms of percentage. Since the valuation of shares is made on the basis of yield, it is called yield method. This method of valuation should be used in all but exceptional cases. Since an investor is much concerned with the return that the expects, this method is valuable. While investing funds, the investor's main point of view is the return, although asset backing is also important because it provides the security. A genuine investor who funds that a company has low dividend rate but high asset backing never invests in the company with a view to liquidating the company and getting the benefit of high asset backing

Under this method, the future maintainable profit for equity dividend is estimated by reference to past performance. This is adjusted by eliminating non-recurring incomes, deducting income tax, making allocation to reserves and preference dividend. The adjusted profit is capitalized at the normal rate of return in similar business. Alternatively, the yield value of each share may be calculated by applying the following two formulae.

$$\text{Expected rate of return} = \frac{\text{Profit available for equity dividend}}{\text{paid up equity capital}} \times 100$$

$$\text{Yield value per share} = \frac{\text{expected rate of return}}{\text{Normal rate of return}} \times \text{paid up value per equity share}$$

The yield method is considered better than net assets method

2. Fair value

There are some accountants who do not prefer to use net assets value or yield value for ascertaining the correct values of shares. They however prefer the fair value of shares, which is the average of net assets value and yield value which provides a better indication about the value of shares that the earlier two methods:

$$\text{Fair value} = \frac{\text{Intrinsic value} + \text{yield value}}{2}$$

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UNIT V – CORPORATE ACCOUNTING I - SBA1303

Profit Prior to Incorporation

A running business may be acquired by another firm. If one company acquires the business of another, it is called ‘Absorption’. When a company acquires the running business of a sole trader or partnership firm, it is termed as ‘acquisition’ of business. The acquiring company may be an existing company or a newly stated company. In the latter case, the accounting problem of ascertaining profit or loss prior to incorporation arises.

Treatment of Profit or Loss Prior to incorporation

Unless the agreement with the vendor provides otherwise, profit or loss from the date of purchase of business till the date of incorporation belongs to the company. Such profit should not be regarded as’ normal trading profit’ or’ revenue profit’ since the company cannot earn profit or incur loss’ before it comes into existence’. The profit or loss should be regarded as ‘capital’ in nature, increasing or decreasing the ‘net assets’ acquired by the company.

The following are the methods of dealing with profit or loss prior to incorporation in the books of accounts of a company.

(A) Profit Prior to incorporation

(i) Being capital profit in its nature, it cannot be allowed to be a part of profit and loss account.

(ii) It should not be used for payment of dividend to shareholders

(iii) It is preferable to credit it to ‘Capital Reserve Account’ which may be used to write off capital losses and expenses like’ preliminary expenses’,’ underwriting commission’,’ discount on issue of debentures’,etc . Unutilized portion of such capital reserve appears in the liabilities side of the balance sheet under the heading ‘reserve and surplus’.

(B) Loss prior to incorporation

(i) Being a ‘capital loss’, it should not be allowed to be a part of profit and loss account.

(ii) It can be debited to a separate account called’ Loss prior to incorporation account’. This loss can be written off using other capital profits of the company . It appears on the assts side of the balance sheet under the heading ‘miscellaneous expenditure’.

(iii) It may be treated as goodwill and debited to goodwill account

(iv) It may be treated as ‘deferred revenue expenditure’ and may be written off out of the profits of the company over several years.

Relevance of ‘Date of Certificate to commence business

A public limited company has to obtain a certificate of commencement of business. This raises the issue of relevant date for ascertaining capital profit or loss in the context of business acquisition. Some accounting experts are of the opinion that all profits or losses before obtaining certificate of commencement of business are ‘capital’ in their nature. However, a company’s power to carry on a business relates back to the date of incorporation, once the certificate to commence business is obtained. Thus, obtaining such a certificate becomes purely a legal formality, without affecting computation of ‘profit or loss’ of capital nature at the time of acquisition of business.

Methods of ascertaining profit or loss prior to incorporation

There are three possible methods of ascertaining profit or loss prior to incorporation.

(1) Preparation of Trading &Profit &Loss account for the period up to the date of incorporation.

A trial balance has to be prepared as on the date of incorporation of the company by balancing the books of accounts of the business. The closing stock on that date has to be valued. Trading and P&L account has to be prepared in the normal way.

Profit or loss prior to incorporation can be ascertained accurately in this method. At the end of the accounting year, profit or loss of the post incorporation period may be found.

However, balancing of books and stock taking on the date of incorporation may be highly inconvenient and affect the normal functioning of the business. So, this method is not usually adopted in practice.

2.(a) Preparation of Trading and profit and loss account for the whole accounting period and apportionment of the resulting profit or loss between pre and post incorporation periods.

Under this method, Trial Balance is prepared and Trading and Profit and Loss account are prepared at the end of the accounting period. Then, a separate note is prepared, in the form of a statement showing pre and post incorporation profits by apportioning the various expenses between the respective periods. These profit or loss figures are incorporated in the profit and loss account, by transferring the profit prior to incorporation to capital reserve account. Any loss prior to incorporation may be separately shown or it may be debited to goodwill account.

(a) Preparation of Common Trading Account and the Profit and Loss account in 'Columnar form'

Under this method, trading account is prepared at the end of the accounting year form the trial balance in the usual manner. Unless otherwise mentioned, the date of incorporation does not affect the computation of gross profit

The profit and loss account is prepared in columnar form, with separate columns for pre and post incorporation periods. All expenses and the gross profit are divided between the two periods in an appropriate manner.

Under methods (a) and (b) above, profit or loss for the two periods cannot be ascertained as accurately as under the first method. These methods can only give an estimate of the profit or loss of the two periods.

Since the first method involves disruption of work, the other methods seem to be unavoidable.

Basis of Apportionment of Expenses

The various expenses which are shown in profit and loss account should be divided between pre and post incorporation periods on some logical and appropriate basis. The following are the usual bases for such apportionment;

(1) **Time Ratio: -** This is the ratio of months or days before and after incorporation during the accounting period. For example, if business was acquired on 1-1-96, the company was incorporated on 1-5-96 and accounts are closed on 31-12-96, the time ratio is 4:8 or 1:2. Form 1-1-96 till 1-5-96, there are four months before incorporation. Similarly, there are 8 months after incorporation i.e., form 1-5-96 to 31-12-96.

All expenses of a company which can be linked or related to 'time' must be divided between pre and post incorporation periods in Time Ratio. Examples are salaries, rent, stationery, postage, depreciation, bank charges, interest, etc.

(2) **Weighted or 'Adjusted' Time Ratio:-** If any changes were made in the number of employees, or office accommodation, etc., weight age must be given to the changes in arriving at the time ratio. Such a ratio is called weighted time ratio.

Similarly, when some expenditure is incurred only for a part of the accounting period, separate ratio has to be computed, based on the actual months or days in pre and post incorporation periods.

(3) **Sales Ratio:-** This is the ratio of sales or turnover of the company before and after incorporation. For examples, when sales before and after incorporation were Rs.2,00,000 and Rs.6,00,000 respectively, the sales ratio is 1:3

Sales ratio is the logical basis to divide the gross profit earned by the company. Similarly, all expenses related to sales are also to be apportioned in sales ratio. Examples: Advertising, salesman's commission, sales promotion expenses, carriage outwards, bad debts, discount allowed, etc.

(4) **Weighted Sales Ratio:-** If sales were not uniform throughout the accounting period, weight age must be given to the trends observed in the sales. Sales ratio adjusted for the change in trend is called weighted sales ratio

(5) **Allocation of Expenses:-** Specific expenses which can be identified with either period have to be fully allocated to that period. All company related expenses like debenture interest, directors' remuneration or fees, preliminary expenses written off, donations given be the company, etc.,have no connection with the pre incorporation period. So, they must be fully charged to the post incorporation period. Similarly, partners' salaries, interest on purchase price till the date of incorporation may be allocated to the pre incorporation period.

(6) **Actual Expenditure: -** If specific details are available about any particular item of expenditure as to how much was spent in the pre and post incorporation periods, the actual amount should be charged to the respective periods.

Note: - Auditors of a company are appointed only after incorporation. So, audit fee may be shown as post incorporation expenditure. However, the auditors have to audit the accounts of pre incorporation period also. Thus, audit fee can be divided in time ratio also. Whichever way is followed, the alternative may be shown as a note. The later method is used throughout in this chapter.

Steps involved in ascertaining pre and post incorporation profits

Step 1:- Trading account has to be prepared for the accounting periods and gross profit has to be found

Step 2:- After a careful scrutiny of the sales, expenses etc, sales ratio and time ratio have to be computed and a list of expenses which can be allocated to specific periods should be drawn up.

Step3:- If a statement is preferable for ascertaining pre incorporation profit, normal P&L A/c can be prepared. Otherwise, columns for basis of apportionment, total , pre incorporation and post incorporation should be provided on both the sides of the P&L A/c. The gross profit and the expenses can be recorded, dividing them or showing them appropriately. When the P&LA/c is balanced, profit or loss can be found separately for the pre and post incorporation periods

If a statement method is preferable separate statement should be prepared, showing the basis, total pre and post incorporation columns. When the total of the expenses is subtracted from the gross profit, profit or loss for pre and post incorporation periods can be obtained separately.

Step4:- In the profit and loss appropriation A/c (below the line) the amount of pre incorporation profit should be transferred to capital reserve. If there is loss in pre incorporation period, it is carried down form profit and loss account to appropriation account debit side. Then it can be shown on the credit side of the appropriation account as Loss prior to incorporation (or) as goodwill which will appear on Balance sheet asset’s side.

Table showing treatment of different items

Nature of Items	Basis of Apportionment
1. Gross profit /loss	Sales ration or weighted sales ratio
2. All fixed expenses like salaries, rent, rates, taxes, insurance, depreciation, postage etc.	Time ratio or weighted or adjusted
3. All variable expense directly varying with turnover like commission, discount, sales men's remuneration, advertisement, carriage outwards	Sales ratio or weighted sales ratio
4. All expenses related to pre incorporation period alone such as vendor's salary till the incorporation date.	Allocation to the pre incorporation period
5. All expenses wholly applicable to post incorporation period like directors' fees, debentures interest, discount on issue of debentures, preliminary expenses or formation expense written off. Donation given by the company etc.	Allocation to the post incorporation period.

QUESTIONS

1. What is profit prior to incorporation?
2. What is time ratio? How it is calculated?
3. Explain sales ratio.
4. What are the steps ascertaining pre and post incorporation periods?
5. A company was incorporated on 1st May 2018 to take over a business as a going concern from 1st January of the same year. The turnover for the year ended 31st December was Rs. 2,00,000, namely Rs. 60,000 for the first period upto 1st May and Rs. 1,40,000 for the following period. From the profit and loss account given below for the year ended 31st December 2018, you are required to ascertain profits prior to incorporation.
6. S Ltd. was incorporated on 1.7.2018 which took over a running concern with effect from 1.1.2018. The sales for the period up to 1.7.2018 was Rs. 5, 40,000 and the sales from 1.7.2018 to 31.12.2018 amounted to Rs. 6,00,000Examine the expenses and incomes are apportioned between pre and post incorporations period?
7. Analyze the Adjusted time Ratio. How it is computed.
8. Identify the need for calculating Profits prior to Incorporation? Apportion of various expenses and incomes between pre and post incorporation periods- Justify
9. Criticize the ratios used in computing Profit prior to Incorporation Briefly describe each of them.
10. Explain the methods of ascertaining Profit prior to Incorporation.
11. Ganesh Ltd. was incorporated on 1.7.18 to acquire a running business of Suresh & Co. with effect from 1.1.18. calculate profit before and after incorporation from the following was the Profit and Loss account of the company on 31.12.18 :

Particulars	Rs.	Particulars	Rs.
To Office expenses	54,000	By Gross profit b/d	2,25,000
To Formation expenses (written off)	10,000		
To Stationery and postage	5,000		
To Selling expenses	60,000		

To Director's fees	20,000		
To Net profit	76,000		
	2,25,000		2,25,000

12. From the following profit and loss account for the year ended 31.3.2019 of X Co Ltd, was incorporated on 1.7.2018 in order to purchase a running business form 1.4.2018. Calculate pre -incorporation profit

	Rs		Rs
To Opening stock	1,20,000	By Sales Upto 30.6.18 Rs.1,00,000	3,00,000
To Purchase	1,75,000	By Closing stock	70,000
To Balance cd (Gross profit)	75,000		
	3,70,000		**3,70,000**
To Administrative expenses	18,000	By Gross profit b/d	75,000
To Director fees	3,000		
To Selling expenses	36,000		
To Audit fees	1,000		
To Preliminary expenses	3,000		
To Net profit	14,000		
	75,000		**75,000**