

Accounting For Companies-II

DCOM205

Edited by:
Ashwani Panesar



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ACCOUNTING FOR COMPANIES - II

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SYLLABUS

Accounting for Companies - II

Objectives:

- To develop an understanding about accounting treatment in case of amalgamation and reconstruction.
- To acquaint students with the accounting procedure and in-depth knowledge of preparation of various accounts
- To develop an understanding of the company regulations among the students

Sr. No.	Description
1	Acquisition of Business
2	Amalgamation: Basics and their concepts
3	Amalgamation: Accounting treatment as per AS: 14 (excluding intercompany holdings).
4	Internal Reconstruction of Companies (Including reconstruction schemes)
5	External Reconstruction of Companies
6	Accounting for Banking Companies
7	Accounting for Insurance Companies
8	Liquidation of Companies: Preparation of Statement of Affairs and Deficiency account, Liquidator's Final statement of Accounts, List B Contributories.
9	Valuation of Goodwill
10	Valuation of Shares and Valuation of Preference Shares

CONTENT

Unit 1:	Acquisition of Business <i>Ashwani Panesar, Lovely Professional University</i>	1
Unit 2:	Amalgamation: Basics and their Concepts <i>Pavitar Parkash Singh, Lovely Professional University</i>	25
Unit 3:	Accounting Standards (AS) – 14 <i>Anand Thakur, Lovely Professional University</i>	36
Unit 4:	Amalgamation: Accounting Treatment <i>Ashwani Panesar, Lovely Professional University</i>	49
Unit 5:	Internal Reconstruction of Companies <i>Pavitar Parkash Singh, Lovely Professional University</i>	79
Unit 6:	External Reconstruction of Companies <i>Anand Thakur, Lovely Professional University</i>	108
Unit 7:	Accounting for Banking Companies <i>Ashwani Panesar, Lovely Professional University</i>	129
Unit 8:	Accounting for Insurance Companies <i>Pavitar Parkash Singh, Lovely Professional University</i>	153
Unit 9:	Fundamentals of Liquidation of Companies <i>Anand Thakur, Lovely Professional University</i>	174
Unit 10:	Liquidation of Companies: Preparation of Accounts <i>Ashwani Panesar, Lovely Professional University</i>	198
Unit 11:	Valuation of Goodwill <i>Pavitar Parkash Singh, Lovely Professional University</i>	231
Unit 12:	Valuation of Shares <i>Anand Thakur, Lovely Professional University</i>	259
Unit 13:	Valuation of Preference Shares <i>Anand Thakur, Lovely Professional University</i>	290

Unit 1: Acquisition of Business

Notes

CONTENTS

Objectives

Introduction

- 1.1 Some Important Terms Relating to Acquisition of Business
- 1.2 Accounting Treatment
 - 1.2.1 Accounting Treatment: In the Books of Vendor
 - 1.2.2 Accounting Treatment: In the Books of Purchasing Company
- 1.3 Summary
- 1.4 Keywords
- 1.5 Review Questions
- 1.6 Further Readings

Objectives

After studying this unit, you will be able to:

- Define the term acquisition of business
- Discuss some important terms related to acquisition of business
- Explain the accounting treatment for acquisition of business
- Solve some numerical problems related to purchase of business

Introduction

Acquisition or purchase of business by an incorporated company means the purchase of or taking over the existing business of a non-corporate body as sole proprietorship or partnership firm. An existing business of a sole trader or partnership firm can be acquired by an existing corporate company or by a newly formed company. When a corporate business is purchased by another corporate body it is related to the subject matter of amalgamation, absorption and reconstruction of companies. The company that acquires the business is called the purchaser company and the seller of the business is called the vendor.

In this unit, we will discuss few important terms related to acquisition of business. Then, we will focus on accounting treatment of the business which will be further elaborated by few illustrations.

1.1 Some Important Terms Relating to Acquisition of Business

Acquisition of business by a limited company generally refers to the purchase of a non-corporate business like sole-proprietorship or partnership form of business by a company. This does not necessarily mean that a limited company cannot acquire the business of a corporate body i.e., another limited company. But strictly speaking, the acquisition of business of a limited company by another limited company comes under the purview of amalgamation absorption and reconstruction of companies.

Notes

Following are some important terms used in acquisition of business:

1. **Purchase Consideration:** The amount payable by the purchaser company to the vendors for acquisition of business is called Purchase Consideration or Purchase Price. This is determined by agreement between the purchase and the seller. Generally, purchase consideration is asked in the examination problem. If it is not given in the question, it can be determined by any one of the following methods:

- (a) **Net Assets Method:** If in the examination problem there is neither information regarding the purchase price non-payment, purchase consideration can be computed by N.A. method as below:

Purchase Price = Total agreed value of assets less value of liabilities assumed by the purchaser.

- (b) **Net Payment Method:** In this method, purchase price is computed by adding up the various payments made by the purchaser to vendor. This payment can be in the following manner:
 - (i) Payment in cash,
 - (ii) Payment by issue of equity shares or preference shares or both,
 - (iii) Payment by issue of debentures.
2. **Goodwill or Capital Reserve:** If in the examination problem the amount of goodwill is not given, value of goodwill is calculated by the comparison of purchase price paid and net assets or net worth. Net assets are calculated by taking the difference of assets taken over and liabilities taken over. Here, only revised value of assets and liabilities taken are considered. If, in the problem, revised value of assets and liabilities are not given, book value of the assets and liabilities should be treated as revised value.

$$\text{Goodwill} = \text{Purchase Price} - \text{Net Assets}$$

$$\text{Capital Reserve} = \text{Net Assets} - \text{Purchase Price.}$$

If the purchase consideration is more than the net assets, excess should be treated as goodwill. On the other hand, if net assets are more than the purchase price, excess of net assets should be treated as capital reserve (capital profit).

3. **Assets taken over by the purchasing company:** If the question is silent regarding the assets taken by the purchasing company, all assets including the cash balance of the vendor are assumed to be taken by purchaser, but fictitious assets and miscellaneous expenses are not taken.
4. **Liabilities taken over by the purchasing company:** If the question is silent regarding the liabilities taken by the purchasing company, all liabilities excluding the internal liabilities (as share capital, reserve funds and undistributed profits) of vendor are assumed to be taken by purchaser.
5. **Interest payable to vendors on purchase consideration:** If the payment of purchase price is delayed by the purchaser, the vendor can demand for interest on purchase, price for delayed period from the date of purchase of business to the date of payment.
6. **Expenses of realisation of vendor:** The payment of realisation expenses is made either by vendor or by purchasing company. When these expenses are paid by purchasing company, sufficient amount is given to vendor by purchasing company to meet the cost of realisation in addition to purchase price. The amount paid for realisation expenses is in the nature of capital expenditure; therefore it is debited to either goodwill account or preliminary expenses account.



Did u know? Net assets are calculated by taking the difference of assets taken over and liabilities taken over.

Notes

Self Assessment

Fill in the blanks:

1. Purchase price of a business is called
2. Purchasing company is with purchase consideration in the books of vendor.
3. Purchase consideration is determined on the basis of
4. Total of Real Assets - External liability =
5. All the assets are transferred to..... by the vendor company.



Caselet

Hindalco's Acquisition of Novelis

The case discusses the acquisition of US-Canadian aluminium company Novelis by India-based Hindalco Industries Limited (Hindalco), a part of Aditya Vikram Birla Group of Companies, in May 2007. The case explains the acquisition deal in detail and highlights the benefits of the deal for both the companies. It also examines the valuation of the acquisition deal and how the deal was financed. The case concludes by describing the challenges that Hindalco would face in integrating the operations of Novelis and analysing if the deal was overvalued as opined by some industry experts.

The Deal

Hindalco acquired Novelis through its wholly owned subsidiary AV Metals on February 10, 2007. AV Metals purchased 100 percent of the issued and outstanding common shares of Novelis at US\$ 44.93 per share, amounting to US\$ 3.6 billion. Hindalco paid a premium of 16.6 percent on the closing price of Novelis' stock. Apart from equity purchase, Hindalco also acquired Novelis' debts to the tune of US\$ 2.4 billion.

After the deal was signed for the acquisition of Novelis, Hindalco's management issued press releases claiming that the acquisition would further internationalise its operations and increase the company's global presence. By acquiring Novelis, Hindalco aimed to achieve its long-held ambition of becoming the world's leading producer of aluminium flat rolled products. Hindalco had developed long-term strategies for expanding its operations globally and this acquisition was a part of it. Novelis was the leader in producing rolled products in the Asia-Pacific, Europe, and South America and was the second largest company in North America in aluminium recycling, metal solidification and in rolling technologies worldwide.

The Pitfalls

Though the Hindalco-Novelis merger had many synergies, some analysts raised the issue of valuation of the deal as Novelis was not a profit-making company and had a debt of US\$ 2.4 billion. They opined that the acquisition deal was over-valued as the valuation was done on Novelis' financials for the year 2005 and not on the financials of 2006 in which the company had reported losses (Refer to Exhibit IX for Novelis P&L statements and balance sheets). They said that Hindalco might have to collect a huge amount of resources to revive and restructure Novelis.

Source: <http://www.icmrindia.org/casestudies/catalogue/Business%20Strategy/BSTR265.htm>

1.2 Accounting Treatment

There are two bases for accounting treatment: in the books of the vendor and in the books of the purchasing company.

1.2.1 Accounting Treatment: In the Books of Vendor

When the business is sold to a public limited company by a sole trader or a partnership firm, same accounting treatment will be adopted in the books of the vendor as one in the problems relating to dissolution of partnership or sale of business.

The following entries are recorded in the books of vendor at the time of sale of business:

1. When assets are transferred to realisation account:
Realisation Account Dr.
 To Relative Assets Account (with the amount of assets taken over)
(Being assets transferred to realisation account)
2. When liabilities are transferred to realisation A/c:
Various Liabilities Account Dr.
 To Realisation Account
(Being transfer of liabilities taken by purchasing company)
3. When winding up expenses are paid:
Realisation Account Dr.
 To Bank Account
(Being payment of expenses)
4. When purchase consideration is recorded:
Purchasing Company Dr.
 To Realisation Account
(Being purchase price recorded)
5. When the profit on realisation (credit balance of realisation a/c) is transferred to capital a/c:
Realisation Account Dr.
 To Vendor's Capital Account
(Being transfer of profit on realisation)
6. When general reserve is transferred to capital a/c:
General Reserve Account Dr.
 To Vendor's Capital Account
(Being transfer of general reserve)
7. When purchase consideration is received:
Shares in Purchasing Company Dr.

Debentures in Purchasing company	Dr.	Notes
Cash Account	Dr.	
To Purchasing Company		
(Being receipt of purchase consideration in shares, debentures and cash)		

1.2.2 Accounting Treatment: In the Books of Purchasing Company

The following journal entries are passed in the books of purchasing company:

When New Books are Maintained

1. When purchase consideration is recorded

Business Purchase Account	Dr.	(purchase consideration)
To Vendor's Account		

2. When assets and liabilities taken over are recorded:

Sundry Assets Account	Dr.	(revalued value)
To Sundry Liabilities Account		(revalued value)
To Business Purchase Account		(purchase consideration)

Alternatively: For the above two entries the following one entry can be passed-

Sundry Assets Account	Dr.	(revalued value)
To Sundry Liabilities Account		(revalued value)
To Vendor's Account		(purchase consideration)

If the total of credit side is more than the total of debit side, excess will be debited to goodwill account: On the other hand if total of debit side exceeds the total of credit side, excess will be credited to capital reserve account.

3. When payment is made to vendors:

Vendors' Account	Dr.
To Bank Account	
To Share Capital Account	
To Debentures Account	

If shares or debentures are issued to vendor at a premium, share premium or debenture premium will be credited. If shares or debentures are issued at discount, discount on shares or discount on issue of debentures account will be debited.

4. When amount is paid to vendor for realisation expenses:

Goodwill Account	Dr. or
Preliminary Expenses Account	Dr.
To Bank Account	

5. When interest is payable to vendor on purchase price for delayed period:

Interest to Vendors' Account	Dr.
To Vendors' Account.	

Notes

6. When amount of goodwill is adjusted with capital reserve because both are not shown in the balance sheet:

Capital Reserve Account Dr.
 To Goodwill Account (amount adjusted)



Notes If the purchase consideration is more than the net assets, excess should be treated as goodwill.

Self Assessment

State whether the following statements are true or false:

6. On the purchase of business, the excess of purchase consideration over the net assets acquired is called goodwill.
7. On the acquisition of a business of a firm by a corporate body, the purchasing company must open the new books of accounts.
8. After the sale of business, if the partners of the firm want to receive the dividend from the new company in their old profit-sharing ratio, they must share the equity shares in their capital ratio.
9. If the same set of books of the vendor is continued, assets and liabilities not taken over by the purchasing company must be shared by the partners in their final claim ratio.
10. The payment of realisation expenses is made either by vendor or by purchasing company.

Illustration 1 (When Purchase Price is given)

The Balance Sheet of Alfa Mills is given below as on 31st Dec., 2011.

Liabilities	₹	Assets	₹
Capital	1, 66,000	Machinery	70,000
Sundry Creditors	64,700	Investments	40,000
Bills Payable	20,000	Stock	28,700
		Bank Balance	62,000
		Debtors	50,000
	2, 50,700		2, 50,700

Bitra Ltd. was formed to purchase the business of Alfa Mills. Its purchase consideration was decided ₹ 2,00,000 which was payable in equity shares of ₹ 50,000, 12% debentures of ₹ 1,00,000 and balance in cash. Pass the necessary journal entries in the books of Bitra Ltd.

Solution

**Bitra Limited
Journal Entries**

Date	Particulars	L.F.	₹	₹
	Machinery Account	Dr.	70,000	
	Investments Account	Dr.	40,000	
	Stock Account	Dr.	28,700	

Bank Account	Dr.	62,000		Notes
Debtors Account	Dr.	50,000		
Goodwill Account	Dr.	34,000		
To Bills Payable Account			20,000	
To Sundry Creditors Account			64,700	
To Alfa Mills			2,00,000	
(Being sundry assets and liabilities purchased from Alfa Mills and Goodwill recorded)				
Alfa Mills	Dr.	2,00,000		
To Bank Account			50,000	
To Equity share Capital Account			50,000	
To 12% Debentures Account			1,00,000	
(Being payment made to Alfa Mills in cash, shares and partly in Debentures)				

Working Note:

Goodwill = ₹ 2,00,000 – (70,000 + 40,000 + 28,700 + 62,000 + 50,000 – 20,000 – 64,700) = 34,000

Illustration 2 (Purchase of Business and Thereafter Issue of Shares)

A Ltd. is registered with an authorised capital of ₹ 20,00,000 in order to purchase the business of X Limited. The share capital of new company was divided into 1,00,000 equity shares of ₹ 10 each and 1,00,000; 5% Preference shares of ₹ 10 each. The purchase price is ₹ 12,00,000. It is paid as under: ₹ 3,00,000 in cash, ₹ 4,00,000 in equity shares and ₹ 5,00,000 in 5% preference shares. A new company has also taken over the liabilities of X limited.

The following is the Balance Sheet of X limited on the date of purchase:

Liabilities	₹	Assets	₹
Capital	10,00,000	Freehold Property	3,60,000
Creditors	1,40,400	Plant and Machinery	3,78,600
Bank Loan	20,000	Debtors	1,87,640
		Stock	2,24,400
		Cash in hand	9,760
	11,60,400		11,60,400

The remaining shares of the company were issued to the public payable ₹ 2.50 on application, ₹ 2.50 on allotment and ₹ 5 on first call. All the amounts were duly received except that one shareholder who has 250 equity shares failed to pay the first call of ₹ 5 per share. Pass the necessary journal entries in the books of the new company.

Solution

Date	Particulars	L.F.	₹	₹
	Freehold Property Account	Dr.	3,60,000	
	Plant and Machinery Account	Dr.	3,78,600	
	Debtors Account	Dr.	1,87,640	
	Stock Account	Dr.	2,24,400	
	Cash Account	Dr.	9,760	

Notes	Goodwill Account	Dr.	2,00,000
	To Creditors Account		1,40,400
	To Bank Loan Account		20,000
	To X		12,00,000
	(Being sundry assets and liabilities of X limited purchased and goodwill recorded)		
	X	Dr.	12,00,000
	To Bank Account		3,00,000
	To Equity Share Capital Account		4,00,000
	To 5% Preference Share Capital Account		5,00,000
	(Being payment made to X)		
	Bank Account	Dr.	2,75,000
	To Equity Share Application Account		1,50,000
	To 5% Preference Share Application Account		1,25,000
	(Being receipt of application money on equity shares and preference Shares)		
	5% Preferences Share Application Account	Dr.	1,25,000
	To 5% Preference Share Capital Account		1,25,000
	(Being transfer of application money to share capital account)		
	Equity Share Application Account	Dr.	1,50,000
	To Equity Share Capital Account		1,50,000
	(Being transfer of application money to share capital account)		
	5% Preference Share Allotment Account	Dr.	1,25,000
	To 5% Preference Share Capital Account		1,25,000
	(Being allotment money due on preference shares)		
	Equity Share Allotment Account	Dr.	1,50,000
	To Equity Share Capital Account		1,50,000
	(Being allotment money due on equity shares)		
	Bank Account	Dr.	2,75,000
	To 5% Preference Share Allotment Account		1,25,000
	To Equity Share Allotment Account		1,50,000
	(Being receipt of allotment money on preference shares and equity shares)		
	5% Preference Share First Call Account	Dr.	2,50,000
	To 5% Preference Share Capital Account		2,50,000
	(Being first call money due on preference shares)		
	Equity Share First Call Account	Dr.	3,00,000
	To Equity Share Capital Account		3,00,000
	(Being first call money due on equity shares)		

Bank Account	Dr.	5,48,750	Notes
To 5% Preference Share First Call Account			2,50,000
To Equity Share First Call Account			2,98,750
(Being receipt of first call money on preference and equity shares except 250 equity shares)			

Working Note:

$$\begin{aligned}
 \text{Goodwill} &= \text{Purchase Price} - \text{Net Assets} \\
 &= 12,00,000 - (3,60,000 + 3,78,600 + 1,87,640 + 2,24,400 + 9,760 - 20,000 - 1,40,400) \\
 &= ₹ 2,00,000.
 \end{aligned}$$

Illustration 3 (Calculation of Purchase Consideration and Business Purchase Account)

Karan & Company Limited acquired the business of M/s. Raheza Brothers. The balance sheet of M/s. Raheza Brothers as on 31st December 2011 was as below:

Liabilities	₹	Assets	₹
Creditors	1,00,000	Goodwill	10,000
Loans	80,000	Machinery	70,000
B/P	40,000	Patents	70,000
Capital	30,000	Debtors	40,000
		Stock	50,000
		Bank	10,000
	2,50,000		2,50,000

The values put on the assets taken over excluding bank were:

Goodwill	₹ 25,000
Machinery	₹ 80,000
Patents	₹ 60,000
Debtors	₹ 40,000
Stock	₹ 60,000

The company did not agree to take loans but agreed to pay the creditors and bills payable. In payment of consideration the company issued 10,000 equity shares of ₹ 10 each and 250 debentures of ₹ 100 each.

Pass journal entries of acquisition of business in the books of the company and its balance sheet.

Solution

Calculation of purchase consideration:

Assets taken over:	₹
Goodwill	25,000
Machinery	80,000
Patents	60,000
Debtors	40,000
Stock	60,000
	2,65,000

Notes

Less liabilities taken:

Creditors	1, 00,000	
Bills payable	40,000	1, 40,000
Purchase consideration		1, 25,000

Journal Entries

Date	Particulars	L.F.	₹	₹
	Business Purchase Account	Dr.	1, 25,000	
	To Raheza Brothers			1, 25,000
	(Being record of purchase consideration)			
	Goodwill account	Dr.	25,000	
	Machinery account	Dr.	80,000	
	Patents account	Dr.	60,000	
	Debtors' Account	Dr.	40,000	
	Stock Account	Dr.	60,000	
	To Creditors Account			1, 00,000
	To Bills Payable Account			40,000
	To Business Purchase Account			1, 25,000
	(Being above assets and liabilities taken over)			
	Raheza Brothers	Dr.	1, 25,000	
	To Equity Share Capital Account			1, 00,000
	To Debentures Account			25,000
	(Being payment made to Reheza Brothers in shares and debentures)			

**Balance Sheet of Karan & Company Limited
as on 1st January, 2012**

Liabilities	₹	Assets	₹
Equity Share Capital		Goodwill	25,000
(10,000 share of ₹ 10 each)	1, 00,000	Machinery	80,000
Debentures (250 debentures of ₹ 100 each)	25,000	Patents	60,000
Creditors	1, 00,000	Debtors	40,000
Bills payable	40,000	Stock	60,000
	2, 65,000		2, 65,000

Illustration 4 (Calculation of Purchase Price and Balance Sheet)

The following is the Balance Sheet of Rohan & Sons as on 31st December 2011:

Liabilities	₹	Assets	₹
Capital	5, 00,000	Goodwill	87,500
Revenue Reserve	50,000	Building	2, 12,500
Bank Loan	2, 50,000	Plant & Machinery	4, 00,000
Bills Payable	1, 00,000	Stock	1, 37,500
Creditors	2, 00,000	Sundry Debtors	1, 62,500

	Cash	85,000	
	Patents	15,000	Notes
11, 00,000		11, 00,000	

The business of Rohan & Sons is taken over by a Khajura Limited as on that date on the following terms:

- (a) Khajura Limited to take over all assets except cash to value the assets at book value less 10% except goodwill, which is to be valued at 4 years' purchase of the excess of average (3 years) profits over 8% of the combined capital and revenue reserve.
- (b) The company to take over trade liabilities subject to a discount of 5%.
- (c) The purchase consideration was to be discharged as follows:
 - (i) Issue of 30,000 equity shares of ₹ 10 each valued at ₹ 12.50 per share.
 - (ii) Issue of 2,500 10% Debentures of ₹ 100 each at a discount of 10%.
 - (iii) The balance in cash.
- (d) The average of three years profits was ₹ 75,250.
- (e) The cost of realisation amounting to ₹ 5,000 was paid by the purchasing company.

Show the necessary journal entries in the books of Khajura Limited and prepare the opening balance sheet of the company.

Solution

**Khajura Limited
Journal**

Date	Particulars	L.F.	₹	₹
	Business Purchase Account	Dr.	6,74,750	
	To Rohan & Sons			6,74,750
	[Being record of purchase (Consideration payable to Rohan & Sons)]			
	Goodwill Account	Dr.	1,25,000	
	Building Account	Dr.	1,91,250	
	Plant & Machinery Account	Dr.	3,60,000	
	Stock Account	Dr.	1,23,750	
	Sundry Debtors Account	Dr.	1,46,250	
	Patents Account	Dr.	13,500	
	To Bills Payable Account			95,000
	To Creditors' Account			1,90,000
	To Business Purchase Account			6,74,750
	(Being above assets and liabilities taken over)			
	Rohan & Sons	Dr.	6,74,750	
	Discount on Issue of Debentures A/c	Dr.	25,000	
	To Equity Share Capital Account			3,00,000
	To Share Premium Account			75,000

Notes	To 10% Debentures Account		2,50,000
	To Bank Account		74,750
	(Being payment of purchase consideration to Rohan & Sons)		
	Bank account	Dr.	79,750
	To Bank Loan Account		79,750
	(Being bank loan raised for the part payment of purchase consideration and realisation exps.)		
	Goodwill Account	Dr.	5,000
	To Bank Account		5,000
	(Being payment of realisation expenses of Rohan & Sons)		
	Share Premium Account	Dr.	25,000
	To Discount on Issue of Debentures Account		25,000
	(Being discount on debentures written off against share premium)		

**Balance Sheet of Khajura Limited
as on 1st January 2012**

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
Issued, Subscribed, Called up & Paid up Capital (30,000 Equity shares of ₹ 10 each)	3,00,000	Good will (1, 25,000 + 5,000)	1,30,000
		Building	1,91,250
		Patent & Machinery	3,60,000
		Patents	13,500
Reserve & Surplus:		Investments	Nil
Share Premium Secured loans:	50,000	Current Assets: Stock	1,23,750
2,500; 10% Debentures of ₹ 100 each:	2,50,000	Sunday Debtors	1,46,250
Unsecured Loans:			
Bank Loan	79,750		
Current Liabilities:			
Sundry Creditors	1,90,000		
Bills Payable	95,000		
	9,64,750		9,64,750

Working Notes:

- Calculation for valuation of goodwill-

Capital Employed	=	Capital + Revenue Reserve
	=	5,00,000 + 50,000 = ₹ 5,50,000
Normal Profit	=	8% of Capital Employed
	=	5,50,000 × 8/100 = ₹ 44,000
Three years' average profit (given)	=	₹ 75,250

Excess of average profits (super profit) Notes

$$= ₹ 75,250 - ₹ 44,000 = ₹ 31,250$$

$$\text{Goodwill} = 4 \times 31,250 = ₹ 1,25,000$$

2. Calculation of Purchase Consideration-

	₹
Goodwill calculated in (1) above	1,25,000
Buildings (₹ 2,12,500 - ₹ 21,250)	1,91,250
Plant and Machinery (₹ 4,00,000 - ₹ 40,000)	3,60,000
Stock (₹ 1,37,500 - ₹ 13,750)	1,23,750
Sundry Debtors (₹ 1,62,500 - ₹ 16,250)	1,46,250
Patents (₹ 15,000 - ₹ 1,500)	13,500
	9,59,750

Less: Trade liabilities taken over

Bills Payable (₹ 1,00,000 - ₹ 5,000)	95,000	
Creditors (₹ 2,00,000 - ₹ 10,000)	1,90,000	2,85,000

Purchase Consideration 6,74,750

3. In the absence of information for part payment of purchase consideration and realisation expenses the company has taken a bank loan i.e.; ₹ 74,750 + ₹ 4000 = ₹ 78,750.
4. When the business of a partnership firm is sold and a part of purchase consideration is received in shares at the time of distribution of shares, the following points should be kept in mind:
- (a) If any ratio has been agreed among partners for the distribution of share, these must be distributed in that ratio.
 - (b) If the partners want that dividend from the new company should be distributed in the old profit-sharing ratio, equity shares as well as preference shares must be distributed in the old profit-sharing ratio.
 - (c) Distribution of shares in the old profit-sharing ratio means that partners are entitled to get profit in the old profit-sharing ratio. It does not protect the right of repayment of capital in priority over other partners. If repayment of capital is to be guaranteed than the capital, it can be protected by allotting the preference shares because preference shares have a priority to refund of capital over ordinary shares. Here, dividend on these shares may correspond to the interest on capital.
 - (d) If any partner has given a loan to the firm, he must be satisfied by first preference shares. This guarantees the repayment of loan (preference shares) priority over other partners' capital (ordinary shares). This entire process can be understood by the following illustration:

Illustration 5 (Distribution of Shares among Partners)

Ram, Rahim and Rogers carry business in partnership under the style of M/s. R. & Co. sharing profits and losses in the ratio of 5:3:2. They have floated R. Pvt. Ltd. for the purchase of takeover of their business. The following is the balance sheet of the firm as on 30th September, 2011:

Notes

M/s. R & Co.
Balance Sheet as on 30.9.2011

Liabilities		₹	Assets		₹
Creditors		50,000	Cash		6,000
Capitals:			Bank		14,000
Ram	1,01,000		Debtors	60,000	
Rahim	1,51,000		Less Provision for D/D	<u>2,000</u>	58,000
Rogers	<u>1,33,000</u>	3,85,000			
			Stock		42,000
			Fixed Assets:		
			Written down value		3,00,000
			Expenditure in Relation to R. Pvt .Ltd.		
			Formation expenses	12,000	
			Bank A/c in the name of R. Pvt. Ltd.: Deposit of par value of 300 equity shares of ₹ 10 each subscribed equally by Ram, Rahim & Rogers as subscribers to the Memorandum and Articles of Association.		
				<u>3000</u>	15,000
		<u>4,35,000</u>			<u>4,35,000</u>

On that day R. Ltd. took over the business for a total consideration of ₹ 5,00,000. The purchase consideration was to be discharged by the allotment of equity shares of ₹ 10 each at par in the profit-sharing ratio and 15% Debentures of ₹ 100 each at par for surplus capital.

The directors of R. Pvt. Ltd. revalued the fixed assets of R & Co. at ₹ 4,00,000. You are asked to:

- State the number of equity shares and debentures allotted by R. Pvt. Ltd. to Ram, Rahim and Rogers.
- Show journal entries in connection with above transaction in the books of R. Pvt. Ltd. Show your workings.

Solution

	₹
Total of assets taken over	4,32,000
- Creditors	50,000
Net Assets	3,82,000
Purchase consideration	5,00,000
Profit on sale of business/Capital Revenue	1,18,000

(a) Statement of distribution of shares amongst partners

	Ram ₹	Rahim ₹	Rogers ₹
Balance of Capitals	1,01,000	1,51,000	1,33,000
Add: Profit on sale of business (in old ratio)	59,000	35,400	23,600
Balance of Capital (a)	1,60,000	1,86,400	1,56,600

	5	3	2	Notes
Profit-sharing ratio (b)				
Capital Profit Ratio (a ÷ b)	32,000	62,133	78,300	
Capital in profit sharing ratio taking Ram's Capital as basis because it is least.	1,60,000	96,000	64,000	
Total of equity share capital to be issued to partners including the initial allotment of ₹ 3,000.	1,60,000	96,000	64,000	
Less: Initial allotment	1,000	1,000	1,000	
Further allotment	1,59,000	95,000	63,000	
For balance issue of debentures	—	90,400	92,600	
Because the price of each debenture is ₹ 100 No. of debentures issued	—	904	926	
Total no. of equity shares issued	16,000	9,600	6,400	

(b) Journal of R. Pvt. Limited

Date	Particulars	L.F.	₹	₹
	Business Purchase Account	Dr.	5,00,000	
	To R & Company			5,00,000
	(Being purchase price recorded)			
	Bank Account	Dr.	3,000	
	To Equity Share Capital Account			3,000
	(Being allotment of 300 shares to Ram Rahim and Rogers as subscribed to Memorandum of Association)			
	Goodwill Account	Dr.	1,18,000	
	Fixed Assets Account	Dr.		3,00,000
	Stock Account	Dr.	42,000	
	Debtors Account	Dr.	60,000	
	Bank Account	Dr.	14,000	
	Cash Account	Dr.	6,000	
	Preliminary Expenses Account	Dr.	12,000	
	To Creditors' Account			50,000
	To Provision for D/D Account			2,000
	To R & Company			5,00,000
	(Being above assets and liabilities of R & Co. taken over)			
	R & Company	Dr.	5,00,000	
	To Equity Share Capital Account			3,17,000
	To Debentures Account			1,83,000
	(Being payment of purchase consideration in shares and debentures)			

Note: If we assume that ₹ 3,000 equity shares are already allotted to vendors, the purchase consideration will be reduced by the amount ₹ 3000 and purchase consideration will be ₹ 5,00,000 – ₹ 3000 = ₹ 497,000, and capital reserve/profit on sale of business will be ₹ 1,15,000.

Illustration 6 (Distribution of Equity and Preference Shares amongst Partners)

A, B & C were partners sharing profits and losses in the ratio of 5:3:2 respectively. The trial balance of the firm on 31st March 2012 was as follows:

Notes	Debit	₹	Credit	₹
	Machinery	1,00,000	Sundry Creditors	64,700
	Stock	68,700	Bills Payable	20,000
	Sundry Debtors	62,000	Capital Accounts:	
	Drawing Accounts:		A	68,000
	A	25,000	B	45,000
	B	23,000	C	23,000
	C	17,000	Depreciation on Machinery	40,000
	Cash at bank	89,300	Profit for the year ending 31.3.2012	
				1,24,300
		3,85,000		3,85,000

Interest on capital accounts at 10% p.a. on the amount standing to the credit of partners Capital accounts at the beginning of the year was not provided before preparing the above trial balance. On 1st April, 2012, they formed a private limited company with an authorised share capital of ₹ 2,00,000 in shares of ₹ 10 each to be divided in different classes to take over the business of partnership.

You are informed as under:

- Machinery is to be transferred at ₹ 70,000.
- Shares in the company are to be issued to partners, at par, in such number and in such classes as will give the partners, by reason of their share-holding alone the same right as regards interest on capital and sharing of profit and losses as they had in partnership.
- Before transferring the business the partners wish to draw from partnership profits to such an extent that the balance is reduced to ₹ 50,000. For this purpose, sufficient profits of the year are to be retained in profit-sharing ratio.
- All assets and liabilities except machinery and the bank are to be transferred at their book value as on 31 March, 2012.

Required:

- Capital accounts showing all adjustments required to dissolve the partnership.
- Statement showing the workings of the number of shares of each class to be issued by the company to each of the partners and statement of additional drawings in cash.
- The balance sheet of the company immediately after acquiring the business of partnership and issuing of shares.

Solution

(i) Capital Accounts

March 31, 2012	A	B	C	March 31, 2012	A	B	C
	₹	₹	₹		₹	₹	₹
To Drawing	25,000	23,000	17,000	By Balance b/d	68,000	45,000	23,000
To Bank (additional drawing)	27,150	8,710	3,440	By Interest on capital	6,800	4,500	2,300
To 10% Preference Share A/c.	68,000	45,000	23,000	By P/L Account (balance of profit)	55,350	33,210	22,140

To Equity Shares	15,000	9,000	6,000	Machinery A/c (profit on transfer)	5,000	3,000	2,000	Notes
	1,35,150	85,710	49,440		1,35,150	85,710	49,440	

(ii) Calculation of additional drawing made by partners in cash

Total drawings made by partners	₹
(25,000 + 23,000 + 17,000)	65,000
+ Further funds available in bank for additional drawings (89,300 – 50,000)	39,300
	1,04,300
– Interest on capitals paid (6,800 + 4,500 + 2,300)	13,600
Total drawings including additional drawings	90,700

Statement of Additional Drawings

	A	B	C
	₹	₹	₹
Drawings (divided into profit-sharing Ratio)	45,350	27,210	18,140
Add: Interest on capital	6,800	4,500	2,300
	52,150	31,710	20,440
Less: Already drawn by partners	25,000	23,000	17,000
Amount of additional drawings	27,150	8,710	3,440

(iii) Calculation for number of shares allotted to partners

	₹	₹
Machinery	70,000	
Stock	68,700	
Debtors	62,000	
Bank balance (89,300 – 39,300)	50,000	2,50,700
Less: Creditors	64,700	
B/P.	20,000	84,700
Purchase Consideration		1,66,000
10% Preference shares given to partners (as they want at least 10% earnings fixed)		
	₹	₹
A	68,000	
B	45,000	
C	23,000	1,36,000
Balance for equity shares		30,000
Equity shares of ₹ 30,000 will be allotted to partners in profit-sharing ratio		
A	15,000	
B	9,000	
C	6,000	

Notes

Balance Sheet as on 31st March, 2006

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
Authorised		Machinery	70,000
20,000 shares of ₹ 10 each	2,00,000	Current Assets:	
Issued and paid up		Stock	68,700
Capital (13,600; 10%		Bank Balance	50,000
Preference shares of ₹ 10 each)	1,36,000	Debtors	62,000
3,000 Equity shares of ₹ 10 each	30,000		
Current Liabilities:			
Sundry Creditors	64,700		
Bills Payable	20,000		
	2,50,700		2,50,700



Task

Discuss the entries that are recorded in the books of vendor at the time of sale of business.

Self Assessment

Choose the correct answer from the following options:

11. Excess of net assets over purchase consideration is:
 - (a) Goodwill
 - (b) Capital reserve
 - (c) Premium
 - (d) Dividend
12. If, after the sale of a partnership firm, the partners want to receive the dividends in future in a profit sharing ratio, equity shares received from the company must be distributed in the ratio of:
 - (a) Capital
 - (b) Final claim
 - (c) Profit-sharing
 - (d) No. of shares given in memorandum.
13. Purchase consideration is determined by:
 - (a) Shareholders
 - (b) Promoters
 - (c) Debenture-holder and creditors
 - (d) Mutual Agreement.

14. Excess of purchase consideration over net assets is called:
- Goodwill
 - Capital Reserve
 - Capital Profit
 - None of the above.
15. If purchase price = ₹ 40,00,000, Total assets = ₹ 35,00,000 and Liabilities = ₹ 10,00,000, value of goodwill will be:
- ₹ 15,00,000
 - ₹ 30,00,000
 - ₹ 15,00,000
 - None of these.

Notes



Case Study **The Saxton Management Group Story**

When your business represents speakers as diverse as Paul Keating, Molly Meldrum and Cathy Freeman, a background as a teacher might seem unusual. In fact, it has been ideal for Winston Broadbent, who was head of mathematics and computer science at Melbourne's Carey Grammar in 1988 when he and his partner, Nanette Moulton, purchased Saxton Speakers Bureau. Winston (named after Churchill) says: "In some ways, it was a parallel switchover from teaching to managing this company; both roles involved staff management, public speaking and good systems."

Joan Saxton - a well-known, world-championship-winning speaker - established Australia's first professional speakers' bureau in 1965. She managed the business for more than twenty years. In 1988, Joan Saxton met Winston and Nanette through her children. The Broadbents wanted a business opportunity and Joan wanted to retire. Winston says: "Joan has remained a close personal friend. Saxton celebrated 40 years last year and Joan spoke at the celebration."

The Challenge

Managing expansion and acquisitions.

The Solution

One of Winston's first priorities after buying Saxton was to update the office systems. He says: "We were using carbon copy books: top copy for the client, a copy for the speaker and an office copy." He commissioned a consultant to create tailor-made software to meet the company's needs. "We have probably spent more than \$200,000 over the years on upgrading and improving our systems... we are leading edge." Getting the right systems laid the basis for expansion.

Saxton has managed a steady 30% minimum annual growth since 1988. Winston says: "Part of our growth has been organic and part of it has been through acquisition and merging with other companies." In 1996, Saxton made its first acquisition, Harry M. Miller's Speakers Bureau. Winston says: "He was our major competitor, with a good reputation, but we were already bigger than he was. We picked up some big names like Rod McGeoch and Bryce Courtenay, who are still with us."

Contd...

Notes

Since 2002, Saxton has expanded rapidly, opening speakers' bureaus in Sydney and Brisbane; a total management business for celebrities; and acquiring a training business. The expansion has been funded by cashflow. Winston says: "We only invest in good businesses then we add the Saxton infrastructure and expertise to help the businesses grow."

With six businesses with overlapping interests, Winston stresses the importance of streamlining office systems and creating a non-threatening environment. "When we acquire a business, we need to put that office on our system and merge our two databases. To avoid conflict as to who owns the client, we deal with that at set-up - so ownership is clear and the service delivery is consistent."

A team culture is maintained through weekly telephone conferences and a clear rewards system. Winston says: "Each week, two members of the team are responsible for listing the week's highlights and acknowledging an individual's outstanding contribution."

Although the businesses are spread over three states, the administrative and support staff mostly work from the Melbourne head office. The businesses are encouraged to share information and the rewards of success are also shared. Winston says: "We have an intercompany referral rewards system. A consultant in Melbourne might assist our training company with leads; we reward this through commission sharing between the offices."

Winston says it is a big challenge to find great speakers. "Clients want to hear from people who are new and fresh but [who] have been in business a long time." To find speakers, Winston stresses the importance of networking and listening to what is happening in the industry. "Speakers are usually referred by somebody we respect."

The Result

Each year since 1988, Saxton Management Group has experienced steady growth of at least 30%. The stable of speakers has increased ten-fold in that time. Winston says: "In Australia, you need a large shop front. In the United States, an agency can be successful with the likes of Bill Clinton and a few other high-profile personalities."

Streamlining the office systems and ensuring that the same database is used in all six businesses have saved time and effort. Winston says: "Now when a consultant has information to update or a phone number is changed, it can all be done from one location. Everything now takes one hour instead of two."

Questions

1. Discuss the issue behind the story.
2. Identify the solution and consequences of the problem.

Source: http://www.ceonline.com.au/case_studies/succession_ipos_acquire/pages/1_16_2199.aspx

1.3 Summary

- There are numerous issues that a purchase should consider when buying a business. These issues may vary depending on the type of business and complexity of the purchase transaction.
- Purchasers must bear in mind that different types of businesses have different statutory requirements relating licensing and that these statutory requirement must be complied with before business operations commencing.
- As the purchase of a business requires considerable financial obligation purchasers should be satisfied that the business is not only viable but also operational.
- Initially, the purchaser should ascertain whether they are purchasing the shares in a company that owns the business or they are purchasing the business and the assets.

- In most circumstances, there is no choice as to how the vendor sells the business, however if there is a choice then the purchaser should consider what is the best type of purchase transaction for their specific circumstance.
- One should consider what legal vehicle to use to purchase the business (i.e. sole trader, partnership, company etc).
- Once decided as to how to buy the business the purchaser should then conduct a thorough investigation regarding the various issues.
- Purchasers should allow themselves adequate time to conduct all necessary enquiries of the vendor, business, and the property on which the business operates.
- If the vendor is a company, one should search the company's records about directors and secretary, registered office and mode of execution of instruments (contained in its regulations).
- The search will also indicate whether assets of the company are the company and possibly the business may be secured by way of a company charge.
- Searched should also be conducted of the business name, trade name, and trade mark or product name included in the sale to determine whether the vendor is the registered owner.
- The purchaser should consider if whether it wants to trade under the same business name or a different business name.

1.4 Keywords

Acquisition Financing: The type of funding obtained by a business for the purpose of purchasing another business.

Acquisition Planning: Coordination of the activities of the personnel involved in the purchase of an asset or supply to ensure it's timely and cost effective acquisition.

Customer Acquisition: The process of persuading a consumer to purchase a company's goods or services.

Debts: An amount of money borrowed by one party from another.

Employee: A person who is hired to work for another or for a business, firm, etc., in return for payment.

Goodwill: An account that can be found in the assets portion of a company's balance sheet.

Single Acquisition: It refers to one company buying the assets and operations of another company and absorbing what is needed while simply discarding duplicated or unnecessary pieces of the acquired business.

1.5 Review Questions

1. What do you mean by purchase of business?
2. What is purchase consideration? How is it determined?
3. What do you mean by vendor's guarantee?
4. Explain the concept of vendor's suspense account.
5. What do you mean by acquisition of business? What factors should be kept in mind while calculating purchase consideration?

Notes

6. When a company purchases a business what accounting records are made in the books of purchasing company?
7. What journal entries are passed when debtors and creditors are not taken over by the purchasing company?
8. At the time of acquisition of business, what entries are recorded in the books of the purchasing company?
9. How are 'Profit prior to incorporation' dealt with? How will you ascertain such profits?
10. Why is it necessary to find out profit prior and after incorporation? Explain it in detail.
11. Why and how are pre- and post-incorporation profits and losses calculated?
12. Lalit Construction Limited was registered with an authorised capital of ₹ 10,00,000 divided into 50,000. Equity shares of ₹ 10 each and 2,500; 12% preference shares of ₹ 100 each. The company purchased the business of Satish Brothers whose balance sheet was as follows:

Liabilities	₹	Assets	₹
Bills Payable	8,750	Cash at Bank	11,250
Sundry Creditors	16,000	Book Debits	18,750
Capital	3,30,250	Stock	87,500
		Plant and Machinery	1,25,000
		Buildings	1,12,500
	3,55,000		3,55,000

The purchase consideration was fixed at ₹ 4,37,500 which was to be paid in fully paid 12,500 equity shares of ₹ 10 each and in fully paid 1,250; 12% preference shares of ₹ 100 each and the balance in cash.

The remaining shares were issued to the public. All were paid up. Give the journal entries to record the above mentioned transactions and the initial balance sheet of the company after the acquisition of business.

13. On 31st December, 2011 the following is the balance sheet of a firm.

Liabilities	₹	Assets	₹
Capital Accounts:		Fixed Assets:	
A - 1,10,000		Factory Buildings	66,000
B - 1,10,000	2,20,000	Plant & Machinery	84,000
Creditors	80,000	Furniture	10,000
		Current Assets:	
		Stock	30,000
		Sundry Debtors	70,000
		Cash	40,000
	3,00,000		3,00,000

On 1st January, 2012 the firm is converted into a limited company on the following terms:

- (a) Debtors and Creditors of the firm were not to be taken over as well as the cash balances.
- (b) Assets were revalued as to furniture at ₹ 6,000, plant and machinery at ₹ 80,000 and the buildings at ₹ 70,000.

- (c) Preliminary expenses amounting to ₹ 4,000 were disbursed by the firm to be recovered from the company.
- (d) As per purchase consideration, the partners were to be allotted at par 26,000 equity shares of ₹ 10 each. They were also entitled to receive ₹ 40,000 in cash.

Notes

Submit the Balance Sheet as on 1st January, 2012 of the limited company assuming the authorised capital to be ₹ 4,00,000 made up wholly of equity share of ₹ 10 each.

14. On 1st January, 2006 Naveen Limited purchased the business of Pankaj taking over his all assets, except debtors of ₹ 2,80,000, which it undertook to collect on behalf of Mr. Pankaj and out of this proceeds pay the creditors of Pankaj for ₹ 1,75,000, and an amount of ₹ 2,45,000 was realised from the debtors. Out of this amount ₹ 1,68,000 were paid to the creditors in full settlement of their account. The company had to pay a contingent liability of ₹ 12,250 on account of a claim against Pankaj for damages. The company also collected a debt of ₹ 7,000 which was previously treated as bad by Pankaj. The company was to get a commission of 5% on the amount collected and 2% on the amount paid. Pass the necessary journal entries in the books of Naveen Limited.
15. On 1st January, 2005, K. Ltd. purchased the business of Puneet, taking over his all assets except debtors of ₹ 80,000, which it undertook to collect on the behalf of Mr. Puneet and out of this proceeds pay the creditors of Puneet for ₹ 50,000. An amount of ₹ 70,000 was realised from the debtors. ₹ 48,000 was paid to creditors in full settlement of their account. It had to pay a contingent liability of ₹ 3,500 on account of a claim against Puneet for damages. The company collected a debt of ₹ 2,000 which was previously treated as bad by Puneet. The company was to get a commission of 5% on the amounts collected and 2% on amount paid. Pass the necessary journal entries in the books of K. Ltd.

Answers: Self Assessment

- | | |
|---------------------------|---|
| 1. Purchase Consideration | 2. Credited |
| 3. Net Assets | 4. Net Assets |
| 5. Realisation A/c | 6. True |
| 7. False | 8. False |
| 9. True | 10. True |
| 11. (b) Capital Reserve | 12. (d) No. of shares given in Memorandum |
| 13. (d) Mutual Agreement | 14. (a) Goodwill |
| 15. (c) ₹ 15,00,000 | |

1.6 Further Readings



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Online links

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Unit 2: Amalgamation: Basics and their Concepts

Notes

CONTENTS

Objectives

Introduction

2.1 Amalgamation of Companies

2.1.1 Absorption of Companies

2.1.2 Types of Amalgamation

2.2 Difference between Amalgamation in Case of Merger and Purchase of Companies

2.2.1 Merits of Amalgamation

2.2.2 Demerits of Amalgamation

2.3 Important Technical Terminology Used in Acquisition of Business

2.4 Summary

2.5 Keywords

2.6 Review Questions

2.7 Further Readings

Objectives

After studying this unit, you will be able to:

- Define the term amalgamation of companies
- Recognise the difference between amalgamation in case of merger and purchase of companies
- Describe the important technical terminology used in acquisition of business

Introduction

The modern age is the age of competition and large-scale business. In order to derive the economies of large scale production and to eliminate or reduce the competition, two or more than two companies engaged in the similar nature of business, may combine their undertakings. Combination of the undertakings reduces the duplication of expenditures, decreases the amount of risk of competition and also reduces cost per unit of the production. Combination of the companies may be in the form of Amalgamation, Absorption and Reconstruction of Companies.

Corporate restructuring in the form of amalgamations have become very popular in the economic environment of the world. Amalgamations gained momentum in the Indian economy following economic liberation in 1991. Earlier amalgamations were considered to be a hostile business strategy, but today the Indian business house accepts its willingly as a measure to grow at an accelerated pace. Amalgamations help in diversification of business. If a company wants to enter into a new line of business, it will easier and economical to amalgamate with another company that is already matured in the business rather than setting up the whole new venture from the scratch.

2.1 Amalgamation of Companies

When two or more companies having similar nature of business merge their businesses in order to form a new company, such a merging is known as amalgamation of companies. In other words, two or more existing companies will liquidate themselves and a new company will be formed to take over the business of these companies.



Example: Suppose there are two companies X Limited and Y Limited engaged in the similar nature of business. In the case of amalgamation, these two companies will liquidate themselves and a new company (assume X Y Ltd.) will be formed to take over the business of these two existing companies.

According to *Halsbury's Laws of England* "Amalgamation is a blending of two or more existing undertakings into one undertaking, the shareholder of each blending company becoming substantially the shareholders in the company which is to carry on the blended undertakings. There may be amalgamation either by transfer of two or more undertakings to a new company or by the transfer of one or more undertakings to an existing company."



Caselet

Multi-Use Facility

The Cove Sports and Community Club was incorporated in 1994, but never really functioned effectively as an overall management support body for the eight clubs located there. Other issues such as financial sustainability and operational efficiency also drove the formation of a new amalgamated structure. The process was a 12-month project that also saw the Cove Sports and Community Club change its image from traditional, smoky, sports clubrooms to a smoke-free centre connecting to all sectors of the community.

The City of Marion played a facilitator role with the clubs embracing the concept for a new 'management group/committee' taking ultimate control. In February 2003 the incorporated body made some constitutional changes and formed a management committee made up of local business people, community members and some representation from the clubs. Some of the barriers included some negative response due to the project needing to overcome some difficult hurdles (financial, mistrust and lack of confidence that the complex would achieve goals). A major issue has been the re-imaging of the complex as a leisure club that responds to the leisure consumer, yet still balancing the needs of traditional, structured sports such as football, cricket and netball. Positive outcomes have included increased community ownership of the whole facility with a focus towards self-sufficiency.

Source: http://fulltext.ausport.gov.au/fulltext/2003/sa/amalgamation_guide_final.pdf

2.1.1 Absorption of Companies

In absorption, an existing company takes over the business of one or more existing companies, which dissolve their businesses. In other words, no new company will be formed to take over the business of the liquidating companies. Only an existing company will acquire the business of these companies.



Example: If A Limited (an existing company) acquires the business of B Limited (an existing company), it will be a case of absorption. In this case, B Limited has to dissolve itself.

Objectives of Amalgamation & Absorption

Notes

These are as follows:

- (1) To eliminate or reduce cut-throat competition.
- (2) To reap the economies of the production of goods and services on a large scale.
- (3) To gain control over the market.
- (4) To gain the benefits of the service of the experts.
- (5) To promote research and development schemes.
- (6) To derive the other advantage of the amalgamation.



Notes In absorption, an existing company takes over the business of one or more existing companies, which dissolve their businesses.

2.1.2 Types of Amalgamation

According to AS-14 for the purpose of accounting, the amalgamation of companies is divided into two categories:

Amalgamation in the Nature of Merger

Upon the satisfaction of the following conditions of AS-14, the amalgamation of the companies is considered as merger:

- (i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.
- (ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than equality shares already held therein, immediately before the amalgamation of the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of amalgamation.
- (iii) The consideration for the amalgamation receivable by those equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.
- (iv) The business of the transferee company is intended to be carried on, after the amalgamation by the transferee company.
- (v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company, except to ensure uniformity of accounting policies.

Amalgamation in the Nature of Purchase

If an amalgamation does not satisfy any one or more of the conditions mentioned above for amalgamation in the nature of merger, such an amalgamation is called the amalgamation in the nature of purchases.



Example: If X Ltd. purchases the business of Y Ltd. with an intention not to continue the business of Y Ltd., it will be an amalgamation in the nature of purchase and not merger.

Notes

Self Assessment

State whether the following statements are true or false:

1. In the case of amalgamation, two or more companies go into liquidation to form a new company.
2. Absorption of companies is also included into amalgamation.
3. Taking over the business of one company by another company, is called amalgamation.
4. External reconstruction of company means the reduction of its share capital.
5. Upon the formation of a new company and liquidation of another existing company, external reconstruction takes place.

2.2 Difference between Amalgamation in Case of Merger and Purchase of Companies

In the case of an amalgamation of companies in the nature of merger, the identity and business of the Transferor Company and Transferee Company remain in existence. Assets, liabilities and reserves of both the companies are pooled and then shown in the annual financial statements. Along with these, the shareholder interest of both the companies continues.

While in an amalgamation of companies in the natures of purchase, one company acquires another company with an intention of not running the business of Transferor Company. The shareholders of the transferor company normally do not continue to have a proportionate share in the equity of the transferee company.



Caution If an amalgamation does not satisfy any one or more of the conditions mentioned above for amalgamation in the nature of merger, such an amalgamation is called the amalgamation in the nature of purchases.

2.2.1 Merits of Amalgamation

The merits are as follows:

1. After the amalgamation of two or more companies, the prevailing competition among themselves is eliminated.
2. On the amalgamation of two or more companies, certain expenses are reduced.
3. When two or more companies amalgamate themselves, it is easy for them to control the market through the supply of goods.
4. If there is an amalgamation of two or more companies, there will be more capital and the problem of finance will be removed.
5. After amalgamation of companies, there will be greater control on the business.
6. Production on a larger scale is possible through the amalgamation of two or more companies.
7. In the case of amalgamation, it is possible to avail of the services of experts otherwise, heavy remuneration has to be paid to experts.
8. After the amalgamation of companies, distribution channel of the products becomes easy.

2.2.2 Demerits of Amalgamation

Notes

The demerits are as follows:

1. Amalgamation of companies may give rise to problems of over-capitalisation.
2. Amalgamation of companies reduces the expenditure, cost and price of the products of the bigger companies, smaller businessmen therefore, cannot last for long when confronted by the bigger players.
3. Upon increasing the size of the business after amalgamation, managerial problems multiply.
4. The possibilities of exploitation of customers by amalgamated companies are manifold.
5. There is also one more danger of monopoly by the amalgamation of company.
6. Increased production by the amalgamated companies may give rise to problems of proper distribution and over-production.
7. The event of non-cooperation between the managerial staff of the amalgamated companies, may retard the growth of the business.

Self Assessment

Fill in the blanks:

6. An amalgamation in the nature of merger, of interest method is used.
7. Accumulated losses in the transferor company are transferred to

2.3 Important Technical Terminology Used in Acquisition of Business

Before proceeding to discuss the accounting methods and calculation of purchase consideration, the students should know the meaning of the various technical terms which are often used in the problems of amalgamation. We will discuss the accounting methods and calculation in next unit. After understanding the meaning of these terms, it would be easy for the students to solve the examination problem. Some of the most common terms are given below:

- **Business and All Assets:** Here, the business means the vendor company's business, which includes all assets and all liabilities. In other words, the term 'business,' stands for assets minus all liabilities. While all assets includes cash and bank balance, but shall not include fictitious assets as preliminary expenses, discount on issue of shares and debentures, underwriting commission, debit balance of profit and loss accounts etc. All assets will also include the value of goodwill and prepaid expenses until otherwise stated in the problem.
- **Trade Liabilities:** Trade liabilities are those liabilities, which are incurred due to the purchase of goods of the business. These include the trade creditors and bills payable.



Did u know? Only those assets are transferred to realisation account, which are taken over by the purchasing company.

- **Liabilities:** Liabilities mean all those liabilities which are payable to third parties (except company and shareholders). These include the trade liabilities and non-trade liabilities. This means that it is a broader term. Thus, it will not include the accumulated profits or reserves or funds which are payable to the shareholders and not to the third parties. The term 'liabilities,' include both the trade liabilities and non-trade liabilities. The liabilities include both the financial liabilities and liabilities for expenses i.e. Trade Creditor, Bill Payable,

Notes

Bank Overdraft, Debentures, Outstanding Expenses, Provision for Taxation, Creditors for Expenses, Unclaimed Dividend, Provident Fund, Pension Fund, Superannuating Fund, Saving Bank A/c of Workmen, Long-term & Short-term Loans, Employees Security Deposit, Workmen’s Profit-sharing Fund, etc.

- **Accumulated Profits:** That portion of profits which is not distributed to the shareholders for more than one year is known as accumulated profits. It is distributed among the shareholders of the company at the time of liquidation of the company. In other words, these are not transferred to the realisation account (it will be discussed later). These are directly transferred to the shareholders’ account. Therefore, the student should have a precise knowledge regarding these in order to solve the problems of amalgamation, absorption and reconstruction correctly. The following accounts are treated as accumulated profits – (a) Profits & Loss A/c (credit balance), (b) Revenue Reserve, (c) General Reserve, (d) Capital Reserve, (e) Debenture Redemption Reserve/Sinking Fund A/c (f) Development Rebate Reserve, (g) Capital Redemption Reserve, (h) Forfeited Shares Account (i) Share Premium Accounts, (j) Workmen’s Compensation Fund (k) Dividend Equalisation Fund, (l) Insurance Fund (m) Workmen’s Accident Fund.
- **General Reserve & Dividend Equalisation Fund:** These two items are the examples of accumulated profits. These are made from profits of the company. General reserve is created to strengthen the financial position of the company, while Dividend Equalisation fund is created to maintain the rate of dividend of the company during a period of crises.
- **Accident Fund and Workmen’s Compensation Fund:** These funds are created out of profits to meet any liability on these accounts in future. These are the examples of internal insurance. If there is no liability on these accounts at the time of liquidation of the company, these are treated as accumulated profits and are transferred to the shareholders’ accounts. And if there is some liability on these accounts, they are first to be met out of these funds and the balance is transferred to the shareholder’s account.
- **Insurance Fund:** This fund is also created out of profits to meet any contingency in the form of a loss by fire, theft etc., in future. It is an internal arrangement of insurance. It is created to avoid payment of premium to an outside insurance company. At the time of liquidation, the balance of this fund is transferred to the shareholders’ account as the balance of this account represents the accumulated profits.
- **Accumulated Losses:** Accumulated losses are shown in the assets side of the balance sheet of a company. Accumulated losses include debit balance of profits and loss accounts, preliminary expenses, discount on issue of shares and debentures, commission on issue of shares and debentures, premium on redemption of preference shares, etc. Like accumulated profits these are also transferred to the shareholders’ accounts at the time of liquidation of a company.



Did u know? Dividend Equalisation fund is created to maintain the rate of dividend of the company during a period of crises.

- **Provisions:** There are some provisions, which may be shown in the liability side of the balance sheet or may be shown in assets side as deduction from the particular assets. Such type of provisions may be provisions for bad and doubtful debts, provision for depreciation, provision for investment, provision for repairs and renewals, etc. These provisions are transferred to the realisation accounts at the time of liquidation only when that particular asset is transferred to this account.



Notes the assets along with its provisions are transferred to the realisation account.

A summary of various examples of Trade liabilities, Liabilities, Provisions, Accumulated Profits and Loss is given in Table 2.1 below:

Notes

Table 2.1: Examples of Trade Liabilities, Liabilities, Accumulated Profits and Losses

Trade Liabilities	Liabilities	Provisions & Accumulated Losses	Accumulated Profits
(i) Trade Creditors or Creditors	(i) Trade Creditors (ii) Bills Payable (iii) Bank Overdraft (iv) Debentures (v) Loans (vi) Workmen's Sharing Bank Account (vii) Workmen's Profit-sharing Fund. (viii) Pension Fund (ix) Superannuation Fund. (x) Provident Fund (xi) Taxation Provision (xii) Unclaimed Dividend (xiii) Outstanding Expenses	(i) Provisions for Doubtful Debts. (ii) Provisions for Depreciation. (iii) Investment Fluctuation Fund or Provision for Investment (iv) Preliminary Expenses. (v) Debit Balance of Profit and Loss Account. (vi) Discount on Issue of Shares and Debentures. (vii) Provision for Repairs and Renewals.	(i) Credit Balance of Profit and Loss Account. (ii) General Reserve Fund. (iii) General Reserve Account. (iv) Capital Reserve. (v) Revenue Reserve (vi) Capital Redemption Reserve A/c. (vii) Shares forfeited A/c (viii) Share Premium A/c (ix) Workmen's Compensation Fund. (x) Workmen's Accident Fund. (xi) Insurance Fund. (xii) Dividend Equalisation Fund (xiii) Development Rebate Reserve.

Self Assessment

Choose the correct answer from the following options:

8. Absorption arises when:
 - (a) An existing company takes over the business of one or more companies.
 - (b) Two or more companies liquidate themselves to take over another company.
 - (c) A new company is registered to take over another company.
 - (d) An existing company holds more than 50% shares in another company.
9. When two or more companies, doing similar nature of business, liquidate themselves to form a new company, such a combination of companies is known as:
 - (a) Absorption
 - (b) Amalgamation
 - (c) Internal Reconstruction
 - (d) External Reconstruction.
10. Amalgamation takes place with the objective of:
 - (a) To eliminate the competition between themselves.
 - (b) To reduce the expenses.

Notes

- (c) To capture the market.
- (d) None of these.



Task

Discuss the difference between merger and purchase of companies.



Case Study

Adidas-Reebok Merger

The sporting goods industry has seen many Mergers and Acquisitions (M&A) driven by rising competition and industrial growth. In 1997, Adidas acquired the Salomon Group for \$1.4 billion. In 2003, Nike acquired Converse for \$305 million and in 2004 Reebok acquired The Hockey Company for \$330 million.

Adidas and Reebok - Two Mega Brands with Great Strengths

In August 2005, German Adidas-Salomon AG announced plans to acquire Reebok at an estimated value of \$3.1 billion (\$3.78 billion). At the time, Adidas had a market capitalisation of about \$8.4 billion, and reported net income of \$423 million a year earlier on sales of \$8.1 billion. Reebok reported net income of \$209 million on sales of about \$4 billion. While analysts opined that the merger made sense, the purpose of the merger was very clear. Both companies competed for No. 2 and No. 3 positions following Nike (NKE).

Competition with Nike and Puma

Nike was the leader in U.S. and had made giant strides in Europe even surpassing Adidas in the soccer shoe segment for the first time. According to 2004 figures by the Sporting Goods Manufacturers Association International, Nike had about 36%, Adidas 8.9% and Reebok 12.2% market share in the athletic-footwear market in the U.S. Adidas was the No. 2 sporting goods manufacturer globally, but it struggled in the U.S. - the world's biggest athletic-shoe market with half the \$33 billion spent globally each year on athletic shoes. Adidas was perceived to have good quality products that offered comfort whereas Reebok was seen as a stylish or hip brand. Nike had both and was a favourite brand because of its fashion status, colours, and combinations. Adidas focused on sport and Reebok on lifestyle. Clearly the chances of competing against Nike were far better together than separately. Besides Adidas was facing stiff competition from Puma, the No. 4 sporting-goods brand. Puma had then recently disclosed expansion plans through acquisitions and entry into new sportswear categories. For a successful merger, the challenge was to integrate Adidas's German culture of control, engineering, and production and Reebok's U.S. marketing- driven culture.

The ADDYY and RBK Merger - Impossible is Nothing

On January 31, 2006, Adidas closed its acquisition of Reebok International Ltd. The combination provided the new Adidas Group with a footprint of around €9.5 billion (\$11.8 billion) in the global athletic footwear, apparel and hardware markets.

Adidas-Salomon AG Chairman and CEO Herbert Hainer said, "We are delighted with the closing of the Reebok transaction, which marks a new chapter in the history of our Group. By combining two of the most respected and well-known brands in the worldwide sporting goods industry, the new Group will benefit from a more competitive worldwide platform, well-defined and complementary brand identities, a wider range of products, and a stronger presence across teams, athletes, events and leagues."

Contd...

Hainer also said, "The brands will be kept separate because each brand has a lot of value and it would be stupid to bring them together. The companies would continue selling products under respective brand names and labels."

Question

Discuss the recent large mergers and acquisitions and their strategies in the Indian context.

Notes

Source: <http://www.casestudyinc.com/adidas-reebok-merger-case-study>

2.4 Summary

- In accounting parlance, amalgamation means merger of two or more companies into one new or existing company. Absorption, on the other hand, refers to acquisition of business of one company by another company.
- According to the Accounting Standard 14, "Accounting for Amalgamations" amalgamations fall into two broad categories.
- In the first category are those amalgamations where there is a genuine pooling not merely of the assets and liabilities of the two companies but also of the shareholders' interests and of the businesses of these companies. Such amalgamations are known as "amalgamation in the nature of merger".
- The second type of amalgamations are those which are in effect a mode by which one company acquires another company and as a consequence the shareholders of the company which is acquired normally do not continue to have a proportionate share in the equity of the combined company or the business of the company which is acquired is not intended to be continued. Such amalgamations are known as "amalgamation in the nature of purchase."
- All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.
- Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than equality shares already held therein, immediately before the amalgamation of the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of amalgamation.
- The consideration for the amalgamation receivable may those equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.
- Amalgamation of companies may give rise to problems of over-capitalisation.
- Amalgamation of companies reduces the expenditure, cost and price of the products of the bigger companies, smaller businessmen therefore, cannot last for long when confronted by the bigger players.

2.5 Keywords

Accident Fund and Workmen's Compensation Fund: These funds are created out of profits to meet any liability on these accounts in future.

Accumulated Losses: Accumulated losses are shown in the assets side of the balance sheet of a company. Accumulated losses include debit.

Notes

Accumulated Profits: That portion of profits which is not distributed to the shareholders for more than one year is known as accumulated profits.

Amalgamation: It means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute which may be applicable to companies.

Business and All Assets: Here, the business means the vendor company's business, which includes all assets and all liabilities.

Dividend Equalisation Fund: It is created to maintain the rate of dividend of the company during a period of crises.

General Reserve: General Reserve is created to strengthen the financial position of the company,

Insurance Fund: It is created to avoid payment of premium to an outside insurance company.

Liabilities: Liabilities mean all those liabilities which are payable to third parties (except company and shareholders).

Trade Liabilities: Trade liabilities are those liabilities, which are incurred due to the purchase of goods of the business. These include the trade creditors and bills payable.

2.6 Review Questions

1. What do you mean by amalgamation? Explain its objectives.
2. What are the differences between amalgamation and absorption?
3. Explain different types of amalgamation.
4. How is purchase consideration determined? Explain.
5. What are the merits and demerits of amalgamation?
6. Write short notes on the following:
 - (a) Accumulated Losses.
 - (b) Insurance Fund.
 - (c) Pooling of Internal method.
 - (d) Provisions.
 - (e) Accident Funds.
7. How will you deal with accumulated losses?
8. What are the objectives of amalgamation and absorption?
9. Define the term amalgamation of companies in terms of Halsburry's Laws of England.

Answers: Self Assessment

1. True
2. True
3. False
4. False
5. False
6. Pooling

7. Shareholder's Account
8. (a) An existing company takes over the business of one or more companies.
9. (b) Amalgamation
10. (c) To capture the market

Notes

2.7 Further Readings



Books

Collins. Harper, Gaughan. Patrick A. (1991), *Mergers and Acquisitions*, New York.
Dr. Verma J C, Dr. Kumar Sanjeev *Corporate Merger, Amalgamation & Takeovers*.



Online links

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http://highered.mcgraw-hill.com/sites/0072922559/student_view0/chapter6/chapter_highlights.html
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Unit 3: Accounting Standards (AS) - 14

CONTENTS

Objectives

Introduction

3.1 Accounting Standards

3.2 Summary

3.3 Keywords

3.4 Review Questions

3.5 Further Readings

Objectives

After studying this unit, you will be able to:

- Define the term accounting standards
- Understand the various terms or definitions used in accounting standards
- Explain the types and methods of amalgamation
- Recognise the accounting standard

Introduction

Any activity that you perform is facilitated if you have a set of rules to guide your efforts. Further, you find that these rules are of more value to you if they are standardised. When you are driving your vehicle, you keep to the left. You are in fact following a standard traffic rule. Without the drivers of vehicles adhering to this rule, there would be much chaos on the road. A similar principle applies to accounting which has evolved over a period of several hundred years, and during this time certain rules and standards have come to be accepted as useful.

This Accounting Standard includes paragraphs 1 to 46 which should be read in the context of the Preface to the Statements of Accounting Standards. The following is the text of Accounting Standard (AS)-14, Accounting for Amalgamations, issued by the Institute of Chartered Accountants of India. This standard has come into effect in respect of accounting periods commencing on or after 1.4.1995 and will be mandatory in nature. The Guidance Note on Accounting Treatments of Reserves in Amalgamations issued by the Institute in 1983 will stand withdrawn from the aforesaid date.

1. This statement deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves. This statement is directed principally to companies, although some of its requirements also apply to financial statements of other enterprises.
2. This statement does not deal with cases of acquisitions which arise when there is a purchase by one company (referred to as the acquiring company) of the whole or part of the shares, or the whole or part of the assets of another company (referred to as the acquired company) in consideration for payment in cash or by issue of shares or other securities in the acquiring company or partly in one form and partly in the other. The distinguishing feature of acquisition is that the acquired company is not dissolved and its separate entity continues to exist.



Notes

The text of Accounting Standard (AS)-14, Accounting for Amalgamations, issued by the Institute of Chartered Accountants of India will come into effect in respect of accounting periods commencing on or after 1.4.1995 and will be mandatory in nature.

3.1 Accounting Standards

3. The following terms are used in this statement with the meaning specified:
- (a) *Amalgamation* means an amalgamation pursuant to the provisions of the Companies Act, 1956, or any other statute which may be applicable to companies.
 - (b) *Transferor Company* means the company, which is amalgamated into another company.
 - (c) *Transferee Company* means the company into which a transferor company is amalgamated.
 - (d) *Reserve* means the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability.
 - (e) *Amalgamation in the nature of merger* is an amalgamation, which satisfies all the following conditions:
 - (i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.
 - (ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held, therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.
 - (iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.
 - (iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.
 - (v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company, except to ensure uniformity of accounting policies.
 - (f) *Amalgamation in the nature of purchase* is an amalgamation that does not satisfy any one or more of the conditions specified in sub-paragraph (e) above.
 - (g) *Consideration for the amalgamation* means for 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.

Notes

- (h) *Fair value* is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.
- (i) *Pooling of interest* is a method of accounting for amalgamation, the object of which is to account for the amalgamation as if the separate businesses of the amalgamating companies were intended to be continued by the transferee company. Accordingly, only minimal changes are made in aggregating the individual financial statements of the amalgamating companies.



Did u know? An amalgamation is classified as an amalgamation in the nature of merger when all the conditions listed in paragraph 3(e) are satisfied.



Caselet

Hockey Clubs

The Brighton and Seacliff Hockey Clubs were located close together, with each having advantages the other didn't (one had strong membership and Premier League status, the other facilities with a new artificial playing surface). Financial viability would have been an issue for both clubs if they continued to operate separately.

Meetings between clubs, in addition to separate meetings of each club's members, occurred during 1994 resulting in various constitution drafts and planning proposals. The final constitution included provision for an inaugural committee with equal membership from each parent club and the future management structure. This was followed by a final combined "vote" meeting, allowing amalgamation to occur in 1995.

Both club management committees, along with strong support from Council and the state peak body drove the process to create one strong club with long-term viability. Club uniforms were an issue, along with change of traditional colours, new fee structures, differences over the new club's name, cultural differences – one club being elite player oriented, the other more socially oriented, and there was some loss of members from both sides.

However, since amalgamation there has been growth in membership (exceeding that of the two parent bodies) and a stronger volunteer base to ensure long-term viability of the club.

Methods of Accounting for Amalgamations

- 7. There are two main methods of accounting for amalgamations:
 - (a) the pooling of interests method; and
 - (b) The purchase method.
- 8. The use of the pooling of interests method is confined to circumstances, which meet the criteria, referred to in paragraph 3 (e) for an amalgamation in the nature of merger.
- 9. The object of the purchase method is to account for the amalgamation by applying the same principles as are applied in the normal purchase of assets. This method is used in accounting for amalgamations in the nature of purchase.

The Pooling of Interest Method

- 10. Under the pooling of interests method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts (after making the adjustments required in paragraph 11).

11. If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies is adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies are reported in accordance with Accounting Standard (AS)-5, 'Prior Period and Extraordinary Items and Changes in Accounting Policies'.

The Purchase Method

12. Under the purchase method, the transferee company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts, or by allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.
13. Where assets and liabilities are restated on the basis of their fair values, the determination of fair values may be influenced by the intentions of the transferee company.



Example: The transferee company may have a specialised use for an asset, which is not available to other potential buyers. The transferee company may intend to effect changes in the activities of the transferor company which necessitate the creation of specific provisions for the expected costs, e.g., planned employee termination and plant relocation costs.

Consideration

14. The consideration for the amalgamation may consist of securities, cash or other assets. In determining the value of the consideration, an assessment is made of the fair value of its elements. A variety of techniques is applied in arriving at fair values.



Example: When the consideration includes securities, the value fixed by the statutory authorities may be taken to be the fair value. This may be determined by reference to the market value of the assets given up. Where the market value of the assets given up cannot be reliably assessed, such assets may be valued at their respective net book values.

15. Many amalgamations recognise that adjustments may have to be made to the consideration in the light of one or more future events. When the additional payment is probable and can reasonably be estimated at the date of amalgamation, it is included in the calculation of the consideration. In all other cases, the adjustment is recognised as soon as the amount is determinable.



Caution The object of the purchase method is to account for the amalgamation by applying the same principles as are applied in the normal purchase of assets. This method is used in accounting for amalgamations in the nature of purchase.

Treatment of Reserves on Amalgamation

16. 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. Thus, for example, the 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. As a result of preserving the identity, reserves which are available for

Notes

distribution as dividend before the amalgamation would also be available for distribution as dividend after the amalgamation. The difference between the amounts recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company is adjusted in reserves in the financial statements of the transferee company.

17. If the amalgamation is an 'amalgamation in the nature of purchase', the identity of the reserves, other than the statutory reserves dealt with in paragraph 1, is not preserved. The amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and dealt with in the manner stated in next section (Treatment of Goodwill arising on Amalgamation). If the result of the computation is positive, the difference is credited to Capital Reserve.
18. Certain reserves may have been created by the transferor company pursuant to the requirements of, or to avail of the benefits under the Income-tax Act, 1961; for example, Development Allowance Reserve, or Investment Allowance Reserve. The Act requires that the identity of the reserves should be preserved for a specified period. Likewise, certain other reserves may have been created in the financial statements of the transferor company in terms of the requirements of other statutes. Though, normally, in an amalgamation in the nature of purchase, the identity of reserves is not preserved, an exception is made in respect of reserves of the aforesaid nature (referred to hereinafter as 'statutory reserves') and 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 statutes.

This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with. In such cases, the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable accounts head 'Amalgamation Adjustment Accounts' which is disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

Treatment of Goodwill Arising on Amalgamation

19. Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life. Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty. Such estimation is, however, made on a prudent basis. Accordingly, it is considered appropriate to amortized goodwill over a period not exceeding five years unless a somewhat longer period can be justified.
20. Factors which may be considered in estimation the useful life of goodwill arising on amalgamation include:
 - (a) The foreseeable life of the business or industry.
 - (b) The effects of product obsolescence, changes in demand and other economic factors.
 - (c) The service life expectancies of key individuals or groups of employees.
 - (d) Expected actions by competitors or potential competitors; and
 - (e) Legal, regulatory or contractual provisions affecting the useful life.

Balance of Profit and Loss Account

Notes

21. In the case of an 'amalgamation in the nature of merger' the balance of the Profit and Loss Account appearing in the financial statements of the transferor company is aggregated with the corresponding balance appearing in the financial statements of the transferee company. Alternatively, it is transferred to the General Reserve if any.
22. In the case of an 'amalgamation in the nature of purchase', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company whether debit or credit, loses its identity.

Treatment of Reserve Specified in a Scheme of Amalgamation

23. The scheme of amalgamation sanctioned under the provisions of the Companies Act, 1956 or any other statute may prescribe the treatment to be given to the reserve of the transferor company after its amalgamation. Where the treatment is so prescribed, the same is followed.

Disclosure

24. For all amalgamations, the following disclosures are considered appropriate in the first financial statements following the amalgamation:
 - (a) Names and general nature of business of the amalgamating companies;
 - (b) Effective date of amalgamation for accounting purpose;
 - (c) The method of accounting used to reflect the amalgamation; and
 - (d) Particulars of the scheme sanctioned under a statute.
25. For amalgamation accounted for under the pooling of interests method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:
 - (a) Description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;
 - (b) The amount of any difference between the consideration and the value of net identifiable assets acquired and the treatment thereof.
26. For amalgamations accounted for under the purchase method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:
 - (a) Consideration for the amalgamation and a description of the consideration paid or contingently payable; and
 - (b) The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof, including the period of amortisation of any goodwill arising on amalgamation.

Amalgamation after the Balance Sheet Date

27. When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure is made in accordance with 'AS-4, 'Contingencies and Events Occurring after the Balance Sheet Date, but the amalgamation is not incorporated in the financial statements. In certain circumstances, the amalgamation may also provide additional information affecting the financial statements themselves; for instance, by allowing the going concerned assumption to be maintained.

Notes

Accounting Standard Procedures

The Accounting Standard comprises paragraphs 28 to 46 of this statement. The Standard should be read in the context of paragraphs 1 to 27 of this Standard and of the Preface to the Statements of Accounting Standards.

28. An amalgamation may be either:
 - (a) An amalgamation in the nature of merger, or
 - (b) An amalgamation in the nature of purchase.
29. An amalgamation should be considered to be an amalgamation in the nature of merger when all the following conditions are satisfied:
 - (a) All the 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 the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.
 - (c) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferor company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.
 - (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 values of the assets and liability of the transferor company when they are incorporated in the financial statements of the transferee company, except to ensure uniformity of accounting policies.
30. An amalgamation should be considered to be an amalgamation in the nature of purchase, when any one or more of the conditions specified in paragraph 29 is not satisfied.
31. When an amalgamation is considered to be an amalgamation in the nature of merger, it should be accounted for the pooling of interest method described in paragraphs 33-35.
32. When an amalgamation is considered to be an amalgamation in the nature of purchase, it should be accounted for under the purchase method described in paragraphs 36-39.

The Pooling of Interests Method

33. In preparing the transferee company's financial statements, the assets, liabilities and reserves (whether capital or revenue or arising on revolution) of the transferor company should be recorded at their existing carrying amounts and in the same form as on the date of amalgamation. The balance of the Profit and Loss Account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to the General Reserve, if any.
34. If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies should be adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies should be reported in accordance with Accounting Standard (AS)-5. Prior Period and Extraordinary Items and Changes in Accounting Policies.

35. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company should be adjusted in reserves.



Did u know? No adjustment is intended to be made to the book values of the assets and liability of the transferor company when they are incorporated in the financial statements of the transferee company, except to ensure uniformity of accounting policies.

The Purchase Method

36. In preparing the transferee company's financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to the date of amalgamation. The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company, except as stated in paragraph 39.
37. Any excess of the amount of the consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve.
38. The goodwill arising on amalgamation should be amortised to income on a systemic basis over its useful life. The amortisation period should not exceed five years, unless a somewhat longer period can be justified.
39. Where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with, statutory reserves of the transferor company should be recorded in the financial statements of the transferee company. The corresponding debit should be given to a suitable account head (e.g., 'Amalgamation Adjustment Account'), which should be disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet.
- (a) When the identity of the relevant statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account should be reversed.

Common Procedures

40. The consideration for the amalgamation should include any non-cash element at fair value. In case of issue securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the fair-value may be determined by reference to the market value of the assets given up. Where the market value of the assets given up cannot be reliably assessed, such assets may be valued at their respective net book values.
41. Where the scheme of amalgamation provides for an adjustment to the consideration contingent on one or more future events, the amount of the additional payment should be included in the consideration, if payments are probable and a reasonable estimate of the amount can be made. In all other cases, the adjustment should be recognised as soon as the amount is determinable [See Accounting Standard (AS)-4, Contingencies and Events Occurring after the Balance Sheet Date].

Notes

Treatment of Reserve Specified in a Scheme of Amalgamation

42. Where the scheme of amalgamation sanctioned under a statute prescribes the treatment to be given to the reserve of the transferor company after amalgamation, the same should be followed.



Caution If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve.

Disclosure

43. For all amalgamations, the following disclosures should be made in the first financial statements following the amalgamation:
- (a) Names and general nature of business of the amalgamating companies;
 - (b) Effective date of amalgamation for accounting purposes;
 - (c) The method of accounting used to reflect the amalgamation; and
 - (d) Particulars of the scheme sanctioned under a statute.
44. For amalgamations accounted for under the pooling of interest method, the following additional disclosures should be made in the first financial statements following the amalgamation:
- (a) Description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;
 - (b) The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.
45. For amalgamations accounted for under the purchase method, the following additional disclosures should be made in the first financial statements following the amalgamation:
- (a) Consideration for the amalgamation and a description of the consideration paid or contingently payable; and
 - (b) The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof, including the period of amortisation of any goodwill arising on amalgamation.

Amalgamation after the Balance Sheet Date

46. When an amalgamation is effected after the balance sheet date, but before the issuance of the financial statements of either party to the amalgamation, disclosure should be made in accordance with AS-4, 'Contingencies and Events Occurring after the Balance Sheet Date' but the amalgamation should not be incorporated in the financial statements. In certain circumstances, the amalgamation may also provide additional information, affecting the financial statements themselves, for instance, by allowing the going concern assumption to be maintained.



Notes The consideration for the amalgamation should include any non-cash element at fair value.

Self Assessment

Notes

Fill in the blanks:

1. Any activity that you perform is facilitated if you have a set of rules to your efforts.
2. This Accounting should be read in the context of the Preface to the Statements of Accounting Standards.
3. is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.
4. When the of the relevant statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account should be reversed.
5. The business of the company is intended to be carried on, after the amalgamation by the transferee company.
6. All the assets and liabilities of the transferor company become, after, the assets and liabilities of the transferee company.

State whether the following statements are true or false:

7. Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life.
8. The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof, including the period of amortisation of any goodwill arising on amalgamation.
9. There are five main methods of accounting for amalgamations.



Task Discuss the two types of amalgamation with examples.



Case Study Alternative to Amalgamation

Historically soccer has developed a number of controlling bodies each looking after a different part of the sport. Over time this has led to duplication of activity and resources and difficulties in gaining funding or sponsorship.

Whilst there has been support from government and other agencies for a peak body, the process has been driven by the soccer community to address these issues and attempt to repair the public perception and media profile of soccer in South Australia.

Discussions about a peak body started over four years ago with initial meetings of representatives from various soccer bodies, chaired by an independent, high profile soccer identity. The outcome was that four key soccer organisations (South Australian Soccer Federation, South Australian Amateur Soccer League, South Australian Junior Soccer Association and South Australian Women's Soccer Association) formed a new body - 'Soccer SA'.

Contd...

Notes

Initially, all four partners retain incorporation and control of their own affairs, but have agreed to work together on particular elements of business (namely sponsorship and marketing, common registration database and better coordination of events and fixtures). The SA Soccer Federation retains its status as the member to the national body, but must consult with the other partners on any decisions to be taken. The arrangement is detailed in a Memorandum of Understanding signed by all partners in December 2002 for a one-year period. Following the signing of the MOU, an independent chair was nominated and endorsed by the partners.

It has taken time to build trust amongst the group, share commercial in confidence information and put aside the history between many of the partners. Whilst work has begun on a number of projects (common database, sponsorship) progress has been hampered by the upheaval in soccer at a national level. At the end of the MOU term, a more lasting arrangement is envisaged which includes the development of a business plan and incorporation of Soccer SA. Whilst there are still issues to be resolved, the parties are now sitting around the table, with a formal agreement outlining how they can work together, discussing their collective future.

Question

List the various alternatives to amalgamation.

Source: http://fulltext.ausport.gov.au/fulltext/2003/sa/amalgamation_guide_final.pdf

3.2 Summary

- The Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards.
- *“Treatment of Reserves Specified in A Scheme of Amalgamation Where the scheme of amalgamation sanctioned under a statute prescribes the treatment to be given to the reserves of the transferor company after amalgamation, the same should be followed.”*
- There are two main methods of accounting for amalgamations: the pooling of interests method; and the purchase method.
- In some cases, the scheme of amalgamation sanctioned under a statute prescribes a different treatment to be given to the reserves of the transferor company after amalgamation as compared to the requirements of AS 14 that would have been followed had no treatment been prescribed by the scheme.
- A description of the accounting treatment given to the reserves and the reasons for following a treatment different from that prescribed in AS 14.
- Deviations in the accounting treatment given to the reserves as prescribed by the scheme of amalgamation sanctioned under the statute as compared to the requirements of AS 14 that would have been followed had no treatment been prescribed by the scheme.

3.3 Keywords

Accounting Standards: An accounting standard is a guideline for financial accounting, such as how a firm prepares and presents its business income and expense, assets and liabilities.

Amalgamation: It means an amalgamation pursuant to the provisions of the Companies Act, 1956, or any other statute which may be applicable to companies.

Consideration: Consideration for the amalgamation means for 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.

Fair value: It is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.

Pooling of Interest: Pooling of interest is a method of accounting for amalgamation, the object of which is to, account for the amalgamation as if the separate businesses of the amalgamating companies were intended to be continued by the transferee company.

Reserve: It means the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability.

Transferee Company: It means the company into which a transferor company is amalgamated.

Transferor Company: It means the company, which is amalgamated into another company.

3.4 Review Questions

1. Define the term accounting standards.
2. What do you mean by amalgamation?
3. Explain the pooling of interest method.
4. Discuss the types of amalgamation.
5. How reserves on amalgamation are treated in accounting standards?
6. Discuss the factors which may be considered in estimating the useful life of goodwill arising on amalgamation.
7. For amalgamations accounted for under the purchase method, some disclosures are considered appropriate in the first financial statements. What are they?
8. Explain the following terms:
 - (a) Fair value
 - (b) Consideration

Answers: Self Assessment

- | | |
|---------------|-----------------|
| 1. Guide | 2. Standard |
| 3. Fair value | 4. Identity |
| 5. Transferor | 6. Amalgamation |
| 7. True | 8. True |
| 9. False | |

3.5 Further Readings



Books

John Blake and Henry J. Lunt, *Accounting Standards*.

Opperman, 14th Edition, *Accounting Standards*.

Opperman H. R. B., Booyesen S. F., Binnekade C. S. and Oberholster J. G. I. Twelfth Edition, *Accounting Standards*.

Notes



Online links

http://www.mca.gov.in/Ministry/notification/pdf/AS_14.pdf

http://www.caalley.com/list_as.html

[http://www.wirc-icai.org/material/AS%2014%20Amalgamations%20\[Compatibility%20Mode\].pdf](http://www.wirc-icai.org/material/AS%2014%20Amalgamations%20[Compatibility%20Mode].pdf)

<http://icwai.wordpress.com/tag/accounting-standard-14/>

"Indian Accounting Standards Converged with IFRS Notified". Press Information Bureau. Retrieved 25 February 2011.

Unit 4: Amalgamation: Accounting Treatment

Notes

CONTENTS

Objectives

Introduction

4.1 Calculation of Purchase Consideration

4.2 Accounting Treatment

4.2.1 Journal Entries in the Books of Transferor Company

4.2.2 Journal Entries in the Books of Transferee Company

4.3 Summary

4.4 Keywords

4.5 Review Questions

4.6 Further Readings

Objectives

After studying this unit, you will be able to:

- Discuss the calculation of purchase consideration
- Describe the accounting treatment of amalgamation
- Explain the difference between pooling of interest and purchase method
- Categorise the journal entries in the books of transferor company and transferee company

Introduction

In the previous two units, we have discussed the basic concepts of amalgamation and accounting standards procedures.

Accounting Standard came into effect in respect of accounting periods starting on or after April 1, 1995. This statement deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves. As per the Accounting Standard (AS)-14, there are two methods of accounting for the amalgamation of companies in the books of Transferee Company. They are: the pooling of interest method and the purchase method.

In this unit, we will elaborate and focus on accounting treatment of amalgamation on various bases. Firstly we will focus on calculation of purchase consideration. Four methods will be discussed in detail with illustrations to determine the amount of purchase consideration. Then focus is given on the journal entries which are passed in the books of Transferor Company and in the books of Transferee Company.

4.1 Calculation of Purchase Consideration

The purchase consideration is that amount which is determined at the time of amalgamation. In other words, it is that amount which is payable by the transferee company (purchasing company) to the transferor company (vendor company) for the purchase of business. Purchase consideration may be paid in cash, shares, debentures or other securities. As per Accounting Standard (AS)-14 "consideration is the aggregate of the shares and the other securities issued

Notes

and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company." Mode of Payment is generally decided by the mutual agreement between Transferor Company and Transferee Company. Fair value of the different elements of the consideration is also considered as the market value of assets. It is to be noted that purchase consideration must be paid directly to the shareholders of the transferor company. If any amount is directly paid to the creditors or debenture-holders of the transferee company, it will not be included in the amount of purchase consideration.

The following methods are used to determine the amount of purchase consideration:

- (a) **Lump Sum Method:** It is the simplest method among the above four methods. Under this method, no calculation is required. The amount of purchase consideration is clearly given as a lump sum in the examination problems.



Example: If A Ltd. acquires the business of B Ltd., for ₹ 35,00,000 will be the purchase consideration in lump sum.

- (b) **Net Assets Method:** Under this method, the purchase consideration is calculated by adding the agreed value of all the assets which have been taken over by the transferee (purchasing) company and deducting there from the total of agreed value of those liabilities, which have been taken by the transferee company.

In the form of formula:

Purchase consideration = Total of agreed value of assets taken over - Total of agreed value of liabilities taken over.

At the time of calculating the purchase consideration by this method, the students should consider the following points:

- (i) Only those assets are aggregated which have been taken over by the transferee company.
 - (ii) The fictitious assets and miscellaneous expenditure such as preliminary expenses, debit balance of profits and loss account etc., are never included in the total of assets.
 - (iii) In the absence of any contrary information, the book value of the assets and liabilities taken by Transferee Company is treated as agreed value.
 - (iv) Only those liabilities are considered, which have been taken over by the transferee company. In the absence of contrary information, all the liabilities belonging to third party are assumed to be taken by the transferee company.
 - (v) Accumulated profits appearing in the liability sides are not considered in calculating the consideration.
 - (vi) Payments directly made to the debenture holders and outside liabilities of the transferor company by the transferee company are not considered.
- (c) **Net Payment Method:** Under this method, the purchase consideration is calculated by aggregating the payments made by the transferee company to the shareholders of transferor company in the form of cash, shares, debentures and agreed value of assets given. There is a point for the students to be noted that all the payments made by the transferee company only to the shareholders of the transferor company are the parts of purchase consideration. And the payments made by the transferee company to the outside liabilities, creditors and debenture holders of the transferor company are not considered into the above aggregation of payments because it is presumed that outside liabilities are taken over and paid by the transferor company. If the liquidation expenses of the transferor company are paid

by the transferee company that must also be added in the purchase consideration. The transferee company may issue the shares and debentures to the transferee company at par at premium or a discount. In the absence of instruction, the transferee company must issue the shares, to the transferor company at par in the case of amalgamation of the companies in the nature of merger, and at market price in case of amalgamation of companies in the nature of purchase.

Notes

- (d) **Intrinsic Worth Method:** Under this method, first of all the intrinsic value of the shares of the transferor is calculated on the basis of net assets. The net assets are calculated according to net assets method. Therefore, purchase consideration calculated under this method becomes equal to the purchase consideration calculated under net assets method. To find out the intrinsic value of the shares, the net assets of the company are divided by the number of shares. After finding this value, the rate of exchange of shares between Transferor Company and Transferee Company is determined. If, in the examination problem, the agreed values of the shares of both the companies are given, there is no requirement to calculate the intrinsic values of the shares. Suppose there are two companies Ankit Limited and Shobhit Limited carrying on business in the same line of activities. Their capitals are ₹ 24,00,000 and ₹ 8,00,000 (value of each share, ₹ 100). The two companies decided to amalgamate in Akshaye Limited. If each share of Ankit Limited and Shobhit Limited is valued at ₹ 150 and ₹ 250 respectively for the purpose of amalgamation, then purchase consideration will be as follows':

	Ankit Ltd.	Shobhit Ltd.
24,000 shares @ ₹ 150 each	36,00,000	-
8,000 shares @ ₹ 250 each	-	20,00,000

At the time of issuing the shares to the individual shareholders, there may be fraction of shares. However, the fractional shares cannot be issued by the company. In such a situation, the company can issue the fractional certificate or pay cash for the fractions.



Did u know? All the payments made by the transferee company only to the shareholders of the transferor company are the parts of purchase consideration.

Illustration 1 (Calculation of Purchase Consideration by Net Payment Method)

Tom Company Limited agrees to take over the business of Jerry Company Limited, the consideration being the assumption of trade liabilities ₹ 62,500, the payment of the cost of liquidation ₹ 2,500, the redemption of the 'Y' Debentures of ₹ 2,50,000 at a premium of 10%, the discharge of 'X' Debentures of ₹ 5,00,000 at a premium of 8% by the issue of 10% Debentures in the Tom Company Limited and the payment of ₹ 10 per share in cash and exchange of 2 fully paid ₹ 10 in Tom Co. Ltd., at the market price of ₹ 15 per share for every share in the Jerry Co Ltd. The share capital of the Jerry Company Ltd. consists of 25,000 shares of ₹ 25 each fully paid.

Calculate the purchase consideration by net payment method.

Solution

Calculation of Purchase Consideration

	₹
1. Payments in cash for cost of Liquidation	2,500
2. Payment in cash for redemption of 'Y' type Debentures (2,50,000 + 25,000)	2,75,000
3. Payment to 'X' type Debentures (New Debentures)	5,40,000
4. Payment to Shareholders:	

Notes	in cash (25,000×10)	2,50,000
	in shares (25,000×2×15)	7,50,000
	Total Purchase Price	18,17,500

Illustration 2 (Calculation of Purchase Consideration by Net Assets Method)

X Company Limited takes over the business of Y Company Limited on 31st December 2010. The Balance Sheet of Y Limited on this date was as follows:

Balance Sheet of Y Limited as on 31st December 2010

Liabilities		₹	Assets		₹
Shares Capital			Goodwill		1, 40,000
30,000 Equity shares of ₹ 10 each.	3,00,000		Land & Buildings		80,000
			Plant & Machinery		1, 40,000
10% Debentures	50,000		Stock		80,000
Sundry Creditors	30,000		Debtors		40,000
General Reserve	20,000		Cash Balance		10,000
Profits & Loss A/c	1,00,000		Preliminary Expenses.		10,000
		5,00,000			5,00,000

On the basis of above Balance Sheet of Y Company Limited, calculate the purchase consideration assuming:

- The values agreed for various assets are: Goodwill ₹ 1,10,000, Land & Buildings ₹ 1,25,000, Plant and Machinery ₹ 1,20,000, Stock ₹ 65,000 and Debtors ₹ 40,000.
- X Company Limited does not take over cash but agrees to assume the liability of sundry creditors at ₹ 25,000.

Solution

Calculation of Purchase Consideration

Agreed value of various assets	₹
Goodwill	1, 10,000
Land & Buildings	1, 25,000
Plant & Machinery	1, 20,000
Stock	65,000
Debtors	<u>40,000</u>
Total of Assets	4, 60,000
Less: External liabilities Sundry Creditors taken by X Ltd.	25,000
Purchase Consideration	4, 35,000

Illustration 3 (Purchase Consideration by Intrinsic Worth Method)

Notes

Following are the Balance Sheets of Aakash Ltd. and Gagan Ltd. as on 31st March, 2011:

Liabilities	Aakash Ltd. ₹	Gagan Ltd. ₹	Assets	Aakash Ltd. ₹	Gagan Ltd. ₹
Share Capital:			Fixed Assets:		
Shares of ₹ 10 each	4, 50,000	3, 60,000	At Cost less dep.	4, 20,000	2, 25,000
Reserves	2, 85,000	30,000	Current Assets:		
Secured Loans:			Stock	1, 26,000	1, 41,000
10% Debentures	—	60,000	Trade Debtors	90,000	1, 50,000
Current Liabilities:			Bank Balance	2, 40,000	30,000
Sundry Creditors	1, 41,000	96,000			
	8, 76,000	5, 46,000		8, 76,000	5, 46,000

Aakash Ltd. agreed to absorb to Gagan Ltd., as on 31st March, 2011 on the following terms:

- Aakash Ltd. agreed to repay 10% debentures of Gagan Ltd.
- Aakash Ltd. agreed to revalue its fixed assets at ₹ 5, 85,000 to be incorporated in the books.
- Shares of both the companies, to be valued on net assets basis after considering ₹ 1, 50,000 towards value of goodwill of Gagan Ltd.
- The cost of absorption of ₹ 9,000 is met by Aakash Ltd.

You are required to calculate the net assets and ratios of exchange of shares.

Solution**Calculation of Net Assets**

Particulars	Aakash Ltd. ₹	Gagan Ltd. ₹
Goodwill	—	1, 50,000
Fixed Assets	5, 85,000	2, 25,000
Stock	1, 26,000	1, 41,000
Trade Debtors	90,000	1, 50,000
Bank Balance	2, 40,000	30,000
Total of assets	10, 41,000	6, 96,000
Less: External Liabilities:		
10% Debentures	60,000	—
Sundry Creditors	<u>96,000</u>	1, 56,000
Net Assets	9,00,000	5, 40,000
Intrinsic worth of a share	9,00,000	5, 40,000
	45,000	36,000
	= ₹ 20	= ₹ 15

On the basis of above calculation, it can be analysed that 4 share of Aakash Ltd., be equal to 3 shares of Gagan Ltd. Thus, the exchange ratio will be 3 : 4.

Notes



Notes

- (a) All liabilities will be shown individually.
- (b) Accumulated profits are not transferred to Realisation A/c.
- (c) If the transferee company agrees to pay some liabilities directly, such liabilities will not be transferred to the realisations A/c.
- (d) Those liabilities, which have not been taken by the transferee company, will also not be transferred to the Realisation A/c.

- (3) For recording the purchase consideration due-

Transferee Company A/c Dr.
 To Realisation A/c

(Being purchase consideration receivable)

- (4) For selling the assets which are not taken over by the transferee company:

Bank or Cash A/c Dr.
 To Realisation A/c

(Being the realisation of assets)

- (5) For liquidness expenses of the transferee company.

- (a) When the payment of liquidation expenses or realisation expenses is made by the transferor company itself.

Realisation A/c Dr.
 To Bank A/c

(Being payment of liquidation expenses)

- (b) If liquidation expenses are borne and paid by the transferee company, it would be better not to pass any entry. Alternatively, the following two entries may be passed-

- (i) When expenses are paid-

Transferee Company A/c Dr.
 To Bank A/c

(Being payment of liquidation expenses on the behalf of Transferee Company)

- (ii) When the expenses are reimbursed-

Bank A/c Dr.
 To Transferee Company's A/c

- (c) If the transferee company pays the liquidation expenses with purchase consideration and not pay separately-

Realisation A/c Dr.
 To Bank A/c

(Being payment of Realisation Expenses)

- Notes**
- (6) For the discount or premium to the debenture-holders or preference shareholders: At the time of amalgamation, absorption and external reconstruction shares may be repaid at premium or discount. Such a premium or discount is first transferred to the realisation account. Entries would be-
- (a) For discount-
- | | |
|---------------------------------|-----|
| Debenture-holders Account | Dr. |
| Preference Shareholders Account | Dr. |
| To Realisation A/c | |
- (Being transfer of discount to realisation A/c)
- (b) For Premium
- | | |
|--------------------------------|-----|
| Realisation Account | Dr. |
| To Debenture-holders A/c | |
| To Preference Shareholders A/c | |
- (Being transfer of premium to realisation A/c)
- (7) For gain or loss on the payment of liabilities not taken over - If there are some liabilities which are not taken over by the transferee company, those will not be transferred to the realisation account. But if any profit or loss may occur on the redemption of such liabilities, such a profit or loss will be transferred to the realisation account. Then, journal entries would be-
- (a) If there is loss:
- | | |
|---------------------------|-----|
| Realisation A/c | Dr. |
| To Relative liability A/c | |
- (Being transfer of loss on repayment of the liability)
- (b) If there is a profit:
- | | |
|------------------------|-----|
| Relative Liability A/c | Dr. |
| To Realisation A/c | |
- (Being transfer of profit on repayment of liability)
- (8) For receiving the purchase consideration from transferee company-
- | | |
|--------------------------------------|-----|
| Bank A/c | Dr. |
| Shares in Transferee Company A/c | Dr. |
| Debentures in Transferee Company A/c | Dr. |
| To Transferee Company's A/c | |
- (Being receipt of purchase consideration in cash, shares and debentures)
- (9) For closing the realisation A/c
- (a) On closing the Realisation A/c if there is profit-
- | | |
|-----------------------------|-----|
| Realisation A/c | Dr. |
| To Equity shareholders' A/c | |
- (Being transfer of profit on realisation A/c to the equity shareholder's A/c)

Notes

- (b) On closing the realisation accounts, if there is a loss-
 Equity shareholders' A/c Dr.
 To Realisation A/c
 (Being transfer of loss on Realisation A/c to the equity shareholder's A/c)
- (10) For transferring the fictitious assets and accumulated losses:
 Equity Shareholders' A/c Dr.
 To Profit and Loss A/c
 To Preliminary Expenses A/c
 To Underwriting Commission A/c
 To Discount on issue of Shares A/c
 To Discount on issue of Debentures A/c
 (Being transfer of fictitious assets and accumulated losses to shares to shareholders A/c)
- (11) For transferring equity share capital and accumulated profits:
 Equity Share Capital A/c Dr.
 General Reserve A/c Dr.
 Profit and Loss A/c Dr.
 Capital Reserve A/c Dr.
 To Equity shareholders capital A/c
 (Being transfer of share capital and accumulated profits to equity shareholders A/c)
- (12) For the payment of debenture-holders:
 (a) Debentures A/c Dr.
 To Debenture-holders A/c
 (Being transfer of debentures to debenture-holders A/c)
- (b) On payment-
 Debenture-holders A/c Dr.
 To Bank A/c
 To Debentures in Transferee company
 (Being payment of debenture-holders)
- (13) For the payment of preference share capital:
 (a) Preference shares Capital A/c Dr.
 To Preference Share Capital A/c
 (Being transfer of preference share capital to preference shareholders A/c)
- (b) On payment-
 Preference Shareholders A/c Dr.
 To Bank A/c
 To Debentures in Transferee company

Notes

To Equity Shares in Transferee company
 To Preference Shares in Transferee company
 (Being payment of preferences shareholders in cash, shares and debentures)

(14) For the final payment of equity shareholders:

Equity shareholders A/c	Dr.
To Bank A/c	
To Equity Shares in Transferee Company	
To Debentures in Transferee Company	

(Being payment of equity shareholders)

 *Notes* After passing this entry, not a single account would have any balance. All the accounts will be closed.

 *Caselet*

Calcutta High Court has held that the difference between amount recorded as additional share capital issued by transferee company upon amalgamation and amount of share capital of transferor company in lieu of which such additional share capital was to be issued, can be adjusted and reflected in general reserves and / or other reserves of the transferee company at the discretion of its board of directors. The High Court of Calcutta held that Accounting Standard 14 issued by ICAI that deals with treatment of accounts upon amalgamation for amalgamation in the nature of merger does not require the surplus or deficit to be made part of the capital.

ArevaT and D India Ltd., In re (2008)81 SCL 140 (Cal.)

AS - 14 not applicable to demerger of business Company had filed a petition to sanction a scheme of demerger. Setting aside the objections raised that the scheme did not provide for the compliance with respect of AS-14\ issued by ICAI, Allahabad High Court sanctioned the scheme holding that, AS-14 applies to amalgamation and not to demerger.

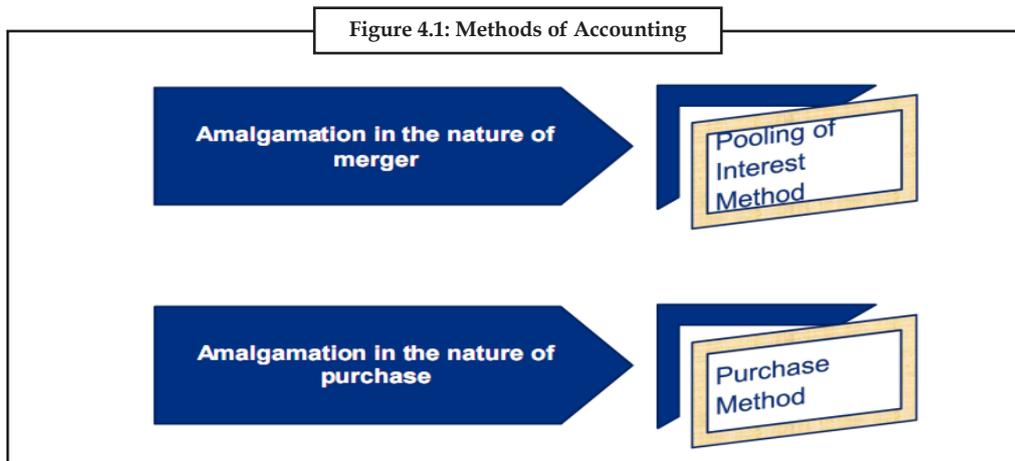
Jagran TV P. Ltd. and Others In re. [2009] 150 Comp Case 532 (All)

Source: <http://www.wirc-icai.org/material/Merger%20-%20Co.%20law%20and%20accounting%20aspects.pdf>

4.2.2 Journal Entries in the Books of Transferee Company

As per the Accounting Standard (AS)-14, there are two methods of accounting for the amalgamation of companies in the books of Transferee Company. These are given below:

- (a) Pooling of Interests Methods
- (b) Purchase Method



Source: <http://www.wirc-icai.org/material/Merger%20-%20Co.%20law%20and%20accounting%20aspects.pdf>

Pooling of Interests Methods

When amalgamation is in the nature of merger, this method of accounting is adapted. The main features of the pooling of interests method are given below:

- (1) In preparing the transferee company's financial statements, the assets, liabilities and reserves (whether capital or revenue or arising on revolution) of the transferor company should be recorded at their existing carrying accounts and in the same form as at the date of amalgamation.
- (2) The balance of the Profit and Loss Account of the transferor company should be aggregated with the corresponding balance of the transferee company, or transferred to the general reserve, if any.
- (3) The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of transferor company should be adjusted in reserves.
- (4) If, at the time of amalgamation, the transferor and transferee companies have conflicting accounting policies, a uniform set of accounting policies should be adopted following the amalgamation. The effects on the financial statements of any changes in the accounting policies should be reported in accordance with Accounting Standard (AS)-5, Prior Period of Extraordinary Item and Changes in Accounting Policies.

Accordingly, the following entries are passed in the books of Transferee Company to incorporate the financial statements of transferor company:

- (1) For recording the purchase consideration:

Business Purchase A/c	Dr.
To Liquidators of Transferor Company	
(Being purchase consideration due to the liquidators of Transferor Company)	

- (2) For recording the assets, liabilities and reserves taken over-

Sundry Assets (Individually) A/c	Dr.
To Sundry Liabilities (individually) A/c	

Notes

To Various Reserves A/c
 To Business Purchase A/c
 (Being sundry assets, liabilities and reserves of Transferor Company taken over)



Notes

- (a) All the assets and liabilities will be shown individually at the book value.
- (b) The difference between debit and credit an account of purchase consideration will be adjusted in the General Reserve of the transferee company. If the credit side is greater than the debit side, the following entry will be passed.

Various Assets A/c	Dr.
General Reserve (Balancing figure) A/c	Dr.
To Various Liabilities A/c	
To Reserve & Funds A/c	
To Business Purchase A/c	

- (3) For making the payment of purchase consideration to the liquidation of transferor company-

Liquidator of Transferor Company A/c	Dr.
To Bank A/c	
To Debentures A/c	
To Equity Share Capital A/c	
To Preference Share Capital A/c	

(Being discharge of purchase consideration in cash, debentures and shares)

If shares or debentures are issued on discount, discount account will also be debited and if shares or debentures are issued at premium, premium account will be credited in the above entry.

- (4) For the payment of liquidation expenses of transferor company-

Goodwill/Liquidation Expenses A/c	Dr.
To Bank A/c	

(Being payment of liquidation expenses)

- (5) For the payment of preliminary/formation expenses of the transferee company-

Preliminary Expenses A/c	Dr.
To Bank A/c	

(Being payment of preliminary expenses)

- (6) For discharging the debentures of the transferor company-

Debentures of the Transferor Company A/c	Dr.
To Bank A/c	

To Debentures of the Transferor Company
 To Shares of the Transferor Company.

(Being discharges of debentures of the transferor company)



Did u know? The balance of the Profit and Loss Account of the transferor company should be aggregated with the corresponding balance of the transferee company, or transferred to the general reserve, if any.

Purchase Method

Purchase method of amalgamation is adapted by the transferee Company, when amalgamation is in the nature of purchase. The following points are kept in mind at the time of passing of accounting entries under this method:

- (i) In preparing the transferee company's financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying accounts or, alternatively, the consideration should be allocated to the individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation.
- (ii) The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company.
- (iii) Any excess of the amount of the consideration over the value of net assets of the transferor company acquired by the transferee company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as capital reserve.
- (iv) The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortisation period should not exceed five years unless a somewhat longer period can be justified.
- (v) Where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with, statutory reserves of the transferor company should be recorded in the financial statements of the transferee company. The corresponding debit should be given to a suitable account head (e.g. Amalgamation Adjustment Account), which should be disclosed as a part of 'Miscellaneous Expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account should be reversed.



Caution Purchase method of amalgamation is adapted by the transferee Company, when amalgamation is in the nature of purchase.

Accordingly, the following journal entries are made in the books of Transferee Company to incorporate the financial statements of the transferor company:

- (1) For recording the purchase consideration-

Business Purchase Account	Dr.
To Liquidator of Transferor Company	
(Being purchase price due to the liquidator of the transferor company)	
- (2) For recording the assets, liabilities and reserves taken over-

Sundry Assets (individually) A/c	Dr.
To Sundry Liabilities (individually) A/c	

Notes

To Various Reserve A/c

To Business Purchase A/c

(Being sundry assets, liabilities and reserves of Transferor Company taken over)



Notes (a) All the assets and liabilities will be shown individually at the book values.

(b) If debit side is greater than credit side, difference will be credited to the Capital Reserve A/c and if credit side is greater than the debit side, difference will be debited to the Goodwill A/c.

- (3) For making the payment of purchase consideration to the liquidator of the transferor company:

Liquidator of Transferor Company A/c Dr.

To Bank A/c

To Debentures A/c

To Equity Share Capital A/c

To Preference Capital A/c

(Being discharge of purchase consideration in cash, debentures and shares)

If shares or debentures are issued on discount, discount account will also be debited and if shares or debentures are issued at premium, premium account will be credited in the above entry.

- (4) For the payment of liquidation expenses of the transferor company

Goodwill A/c Dr.

To Bank A/c

(Being payment of liquidation expenses)

- (5) For maintaining the statutory reserve-

Amalgamation Adjustment A/c Dr.

To statutory Reserve A/c

(Being incorporation of statutory reserves of the transferor company)

- (6) For the payment of preliminary expenses-

Preliminary Expenses Account Dr.

To Bank A/c

(Being payment of preliminary expenses)

- (7) For the payment of various liabilities of the transferor company-

Various Liabilities A/c Dr.

To Bank A/c

To Debentures A/c

To Share capital A/c

(Being payment of liabilities of the transferor company)

(8) For writing off the goodwill against Capital reserves-

Capital Reserve A/c

Dr.

To Goodwill A/c

(Being goodwill written off against capital reserves)

Notes

Self Assessment

State whether the following statements are true or false:

6. Under the Net Payment Method, the purchase consideration is computed by adding all the payments made by the transferee company to several interests in the transferor company.
7. Under the Net Assets Method, the purchase consideration by taking all assets including fictitious assets.
8. Under the Net Assets Method, the net assets are calculated by adding the agreed value of assets taken over minus agreed value of liabilities.
9. Workmen's Accident Compensation Fund is an outside liability and must be closed by transferring to realisation account.
10. Only in the case of amalgamation in the nature of merger, Goodwill or Capital Reserve arises.

Differences between Pooling of Interests Method and Purchase Method

The differences between Pooling of Interest Method and Purchase Method may be based on the points given in Table 4.1.

Table 4.1: Differences between Pooling of Interests and Purchase Methods

Basis of Difference	Pooling of Interest Method	Purchase Method
(1) Nature of Amalgamation	It is adapted in the case of amalgamation in the nature of merger.	It is adapted in the case of amalgamation in the nature of purchase.
(2) Incorporation of Profit and Reserves	Under this method, profits and reserves are incorporated with the financial statements of Transferee Company.	Under this method, profits and reserves are not incorporated with the financial statements of transferee company.
(3) Requirement of Amalgamation Adjustment A/c	Under this method, there is no requirement of this account.	Here, this account is required at the time of opening of statutory reserves.

Illustration 4 (Lump Sum Method for Consideration in Absorption)

The following was the Balance Sheet of Radhe Company Limited on 31st December, 2010:

Balance Sheet			
Liabilities	₹	Assets	₹
20,000 Equity		Goodwill	1,00,000
Shares of ₹ 100 each		Land & Buildings	6,00,000
Fully paid	20,00,000	Plant & Machinery	13,40,000
Reserves	7,40,000	Stock	9,00,000

Notes				
	Profit and Loss A/c	60,000	Debtors	5,00,000
	Debentures	3,00,000	Cash at Bank	60,000
	Creditors	4,20,000	Preliminary Expenses	20,000
		35,20,000		35,20,000

Shyam Company Limited took over the business of the above-mentioned company as on this date except (Cash at Bank and Debentures for ₹ 32,40,000 payable as to ₹ 30,00,000 in the form of fully paid 2,00,000 equity shares of ₹ 10 each at a premium of ₹ 5 per share and the balance in cash. Radhe Company Limited redeemed its debentures at par. Expenses of winding up of Radhe Limited came to ₹ 20,000 and were borne by Shyam Company Limited.

You are required to-

- Prepare Realisation Account, Equity Shareholders' Account and Cash Account in the books of Radhe Company Limited.
- Pass journal entries in the books of Shyam Company Limited.

Solution

- In the books of Radhe Company Ltd.

Realisation Account			
Particulars	₹	Particulars	₹
To Goodwill A/c	1,00,000	By Debentures A/c	3,00,000
To Land & Building A/c	6,00,000	By Creditors A/c	4,20,000
To Plant & Machinery	13,40,000	By Shyam Ltd.	32,40,000
To Stock A/c	9,00,000		
To Debtors A/c	5,00,000		
To Bank A/c	3,00,000		
To Equity Shareholders A/c (Profit)	2,20,000		
	39,60,000		39,60,000

Equity Shareholders' Account			
Particulars	₹	Particulars	₹
To Preliminary Expenses A/c	20,000	By Equity Share Capital A/c	20,00,000
To Shares in Shyam Limited A/c	30,00,000	By Reserves	7,40,000
		By Profit & Loss A/c	60,000
		By Realisation A/c	2,20,000
	30,20,000		30,20,000

Cash A/c			
Particulars	₹	Particulars	₹
To Balance b/d	60,000	By Realisation A/c	
To Shyam Ltd.	2,40,000	(Payment to Debenture-holders)	3,00,000
	3,00,000		3,00,000

Notes

Shyam Co. Ltd.'s A/c			
Particulars	₹	Particulars	₹
To Realisation A/c	32,40,000	By Shares in Shyam Co. Ltd.	30,00,000
		By Bank A/c	2,40,000
	32,40,000		32,40,000

(ii) In the Books of Shyam Co. Ltd.

Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
(i)	Business Purchase A/c	Dr.		32,40,000
	To Liquidators of Radhe Ltd.			32,40,000
	(Being purchase consideration due to the Liquidators of Radhe Ltd.)			
(ii)	Land & Building A/c	Dr.		6,00,000
	Plant & Machinery A/c	Dr.		13,40,000
	Stocks A/c	Dr.		9,00,000
	Debtors A/c	Dr.		5,00,000
	Goodwill A/c	Dr.		3,20,000
	To Creditors A/c			4,20,000
	To Business Purchase A/c			32,40,000
	(Being above assets and liabilities taken over and balance transferred to Goodwill account)			
(iii)	Liquidators of Radhe Co. Ltd.,	Dr.		32,40,000
	To Bank A/c			2,40,000
	To Share Capital A/c			20,00,000
	To Premium on Share Capital A/c			10,00,000
	(Being payment of purchase consideration in cash, and issuing of shares on premium)			
(iv)	Goodwill A/c	Dr.		20,000
	To Bank A/c			20,000
	(Being payment of winding up of Radhe Ltd.)			

**Balance Sheet of Shyam Co. Ltd.
(After absorption of Radhe Ltd.)**

Liabilities	₹	Assets	₹
Share Capital (2,00,000)		Land & Buildings	6,00,000
Shares of ₹ 10 each	20,00,000	Plant & Machinery	13,40,000
Share Premium	10,00,000	Stock	9,00,000
Creditors	4,20,000	Debtors	5,00,000
Bank overdraft	2,60,000	Goodwill (320,000+20,000)	3,40,000
	36,80,000		36,80,000

Notes

Working Note:

1. Debentures are redeemed through Realisation A/c.
2. It is assumed that liquidation expenses are paid of directly by the Shyam Ltd.
3. It is further assumed that cash payment of ₹ 2,40,000 to the liquidation of Radhe Ltd. and ₹ 20,000 to the liquidation expenses of Radhe Ltd. are paid by Shyam Ltd. by taking a bank loan of ₹ 2,60,000.

Illustration 5 (Amalgamation in the Nature of Merger and in the Nature of Purchase)

Following are the abridged Balance Sheets of Ding Company Limited and Dong Company Limited as on 31st March, 2011:

Liabilities	Ding Co. ₹	Dong Co. ₹	Assets	Ding Co. ₹	Dong Co. ₹
Share Capital:			Fixed Assets	6,60,000	2,83,800
Equity Share Capital (₹ 10 each)	4,80,000	1,80,000	Current Assets	2,40,000	1,18,200
12% Preference Share Capital (₹ 100 each)	-	60,000			
General Reserve	2,76,600	58,800			
Statutory Reserve	23,400	7,500			
Profit and Loss A/c	33,780	21,300			
13 % Debentures	-	15,000			
Current Liabilities	86,220	59,400			
	9,00,000	4,02,000		9,00,000	4,02,000

On 1st April, 2011 Ding Limited takes over Dong Limited on the following terms:

- (a) Ding Limited will issue 21,000 shares of ₹ 10 each at per to the equity shareholders of Dong Ltd.
- (b) Ding Ltd. will issue 660 12% Preference shares of ₹ 100 each at par to the Preference Shareholders of Dong Ltd.
- (c) The debentures of Dong Ltd. will be converted into equal no. of 14% debentures of the same denomination.

You are informed that the statutory reserves of the Dong Ltd. are to be maintained for two more years. You are required to show the Balance Sheet of Ding Ltd. immediately after the scheme of the amalgamation has been implemented assuming that:

- (a) The amalgamation is in the nature of merger and
- (b) The amalgamation is in the nature of purchase.

Solution

- (a) When amalgamation is in the nature of merger:

Calculation of General Reserve:

Purchase Consideration	₹
(21,000 equity shares of ₹ 10 each)	2,10,000
+ 660 preference shares of ₹ 100 each	<u>66,000</u>
	2,76,000

<i>Less:</i> Share Capital of Dong Ltd.		Notes
Equity Capital	1,80,000	
Pref. Capital	<u>60,000</u>	<u>2,40,000</u>
Excess of Consideration		36,000
Excess of Consideration will be subtracted from the general reserve of Dong Ltd.		
General Reserve		58,800
- Excess of Consideration		<u>36,000</u>
		22,800
+ General Reserve of Ding Ltd.		<u>2,76,600</u>
		2,99,400

Balance Sheet of Ding Limited as on 31st March, 2011

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets	9,43,800
Equity capital (shares of ₹ 10 each)	6,90,000	Investments	-
12% Preferences capital (Shares of ₹ 100 each)	66,000	Current Assets, Loans and Advances	
Reserve & Surplus:		Current Assets	3,58,200
General Reserve (calculated above)	2,99,400	Loans & Advances	-
Statutory Reserve	30,900	Miscellaneous Expenditures	-
Profit and Loss A/c	55,080		
Secured Loans			
13% Debentures	15,000		
Unsecured Loans:	-		
Current Liabilities and Provisions			
(a) Current Liabilities	1,45,620		
(b) Provisions	-		
	<u>13,02,000</u>		<u>13,02,000</u>

(b) When amalgamation is in the nature of purchase:

Calculation of Goodwill or Capital Reserve on Amalgamation-

		₹
Fixed Assets of Dong Ltd.		2,83,800
+Current Assets of Dong Ltd.		1,18,200
Total of Assets		4,02,000
<i>Less:</i> External Liabilities		
13% Debentures	15,000	
Current Liabilities	<u>59,400</u>	<u>74,400</u>

Notes	Net Assets of Dong Ltd.	3,27,600
	-Purchase Consideration (₹ 2,10,000 + ₹ 66,000)	2,76,000
	Capital Reserve	<u>51,600</u>

**Balance Sheet of Ding Ltd.
as on 31st March, 2011**

Liabilities	₹	Assets	₹
Share capital:		Fixed Assets:	9,43,800
Equity Capital (shares of ₹ 10 each)	6,90,000	Investments	-
12% Preference Capital (Shares of ₹ 100 each)	66,000	Current Assets	3,58,200
Reserve & Surplus:			
Capital Reserve	51,600	Amalgamation Adjustment	
General Reserve	2,76,600	Account	7,500
Statutory Reserve	30,900		
Profit & Loss A/c	33,780		
Secured Loans:			
13% Debentures	15,000		
Current Liabilities & Provision:			
Current Liabilities	1,45,620		
	13,09,500		13,09,500

Illustration 6 (Purchase and Net Payment Method)

The summarised Balance Sheet of Ashutosh Ltd. as on 31st March, 2011 was as follows:

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
Shares of ₹ 10 each fully Paid	21,00,000	Goodwill	3,50,000
General Reserve	5,95,000	Land & Buildings	22,40,000
Profit and Loss A/c	3,85,000	Current Assets	
10% Debentures	3,50,000	Stock	5,88,000
Creditors	70,000	Debtors	1,26,000
		Cash	1,96,000
	35,00,000		35,00,000

Kamal Jeet Ltd. agreed to absorb the business of Ashutosh Ltd. with effect from 1st April, 2011.

The purchase consideration payable by Kamal Jeet Ltd. was agreed as follows:

- (i) A cash payment equivalent to ₹ 2.50 for every ₹ 10 per share in Ashutosh Ltd.
- (ii) The issue of 3,15,000 Equity shares of ₹ 10 each fully paid in Kamal Jeet Ltd. having an agreed value of ₹ 15 per share.
- (iii) The issue of such an amount of fully paid 8% Debentures in Kamal Jeet Ltd. at 96% as is sufficient to discharge 10% Debentures in Ashutosh Ltd. at a premium of 20%.

When computing purchase consideration, Kamal Jeet Ltd. valued Land & Buildings at ₹ 42,00,000 stock at ₹ 4,97,000 and Debtors at their face value subject to a reserve of 5% for doubtful debts. The cost of liquidation of Ashutosh Ltd. was ₹ 17,500 and to be met by Ashutosh Limited and the balance of cash to be taken over by Kamal Jeet Ltd.

Notes

You are required to:

- (i) Close the books of Ashutosh Ltd., by preparing Realisation A/c Kamal Jeet Ltd. A/c Shareholders A/c and Debentures A/c.
- (ii) Pass journal entries in the books of Kamal Jeet Ltd. regarding the acquisition of business.

Solution

Calculation of Purchase Consideration by Net Payment Method

	₹
Cash Payment (₹ 2.50 for every share of ₹ 10)	
₹ 2.50 × 2, 10,000 shares	5,25,000
Issue of Equity shares of ₹ 10 at an agreed value of ₹ 15	
₹ 15 × 3, 15,000 shares	47,25,000
Purchase Consideration	52,50,000

In the Books of Transferor Company

**Ledger of Ashutosh Ltd.
Realisation A/c**

Particulars	₹	Particulars	₹
To Goodwill A/c	3,50,000	By 10% Debentures A/c	3,50,000
To Land & Buildings A/c	22,40,000	By Creditors A/c	70,000
To Stock A/c	5,88,000	By Kamal Jeet Ltd.	52,50,000
To Debtors A/c	1,26,000		
To Cash A/c (1, 96,000 - 17,500)	1,78,500		
To Cash (Liquidation Exps)	17,500		
To Equity Shareholders' A/c	21,70,000		
	56,70,000		56,70,000

Equity Shareholders' A/c

Particulars	₹	Particulars	₹
To cash A/c	5,25,000	By Share Capital A/c	21,00,000
To Equity shares in Kamal Jeet Ltd.	47,25,000	By General Reserve	5,95,000
		By Profit and Loss A/c	3,85,000
		By Realisation A/c	21,70,000
	52,50,000		52,50,000

Notes

10% Debentures A/c			
Particulars	₹	Particulars	₹
To Realisation A/c	3,50,000	By Balance b/d	3,50,000
	3,50,000		3,50,000

Kamal Jeet Ltd. (Transferee Company) A/c			
Particulars	₹	Particulars	₹
To Realisation A/c (Purchase Consideration)	52,50,000	By Cash A/c	5,25,000
		By Equity shares A/c in Kamal Jeet Ltd.	47,25,000
	52,50,000		52,50,000

In the Books of Transferee Company Journal of Kamal Jeet Ltd.				
Date	Particulars	L.F.	₹	₹
2011 March 31	Business Purchase A/c	Dr.	52, 50,000	
	To Liquidator of Ashutosh Ltd.			52, 50,000
	(Being purchase price due to the liquidator of Ashutosh Ltd.)			
	Land & Building A/c	Dr.	42,00,000	
	Stock A/c	Dr.	4, 97,000	
	Debtors A/c	Dr.	1, 26,000	
	Cash A/c	Dr.	1, 78, 500	
	Goodwill A/c	Dr.	7, 44,800	
	To Creditors A/c			70,000
	To 10% Debentures A/c (+Premium)			4, 20,000
	To Provision for B/D A/c			6,300
	To Business Purchase A/c			52, 50,000
	(Being various assets and liabilities of the Ashutosh Ltd., taken over and the balance transferred into Goodwill A/c)			
	Liquidators of Ashutosh Ltd.	Dr.	52, 50,000	
	To Cash A/c			5, 25,000
	To Equity Shares Capital A/c			31, 50,000
	To Securities Premium A/c			15, 75,000
	(Being purchase consideration paid off partly in cash and partly by issue of equity shares at premium)			
	10% Debentures A/c	Dr.	4, 20,000	
	Discount on issue of Debentures	Dr.	17,500	
	To 8% Debentures A/c			4, 37,500
	(Being discharge of 12% debentures of Ashutosh Ltd. at discount)			

Working Note:

Notes

	₹
10% Debentures of Ashutosh Ltd.	3,50,000
+ 20% Premium on Redemption	70,000
Total amount payable on redemption	4,20,000
Redemption will be by the issue of 8% Debentures in Kamal Jeet Ltd. at ₹ 96.	
Thus, No. of 8% Debentures = ₹ 4,20,000/96=4,375	
Face values of 4,375 debentures =	₹ 4,37,500
Amount of Discount @ 4% =	₹ 17,500
Net amount payable	4, 20,000

Illustration 7 (Intrinsic Value Method)

The Balance Sheets of Moon Limited and Sun Limited as on 31st March, 2011 are as follows:

Liabilities	Moon Ltd. ₹	Sun Ltd. ₹	Assets	Moon Ltd. ₹	Sun Ltd. ₹
Share Capital			Goodwill	60,000	-
Authorised Capital			Fixed Assets	6,00,000	12,00,000
(Shares of ₹ 100 each and shares of ₹ 10 each)	7,50,000	15,00,000	Current Assets	6,75,000	4,95,000
Issued Capital			Bank	-	1,50,000
Fully Paid	7,50,000	6,00,000			
Capital Reserve	1,50,000	-			
General Reserve	52,500	6,00,000			
Secured Loans	-	3,75,000			
Unsecured Loans	1,50,000	-			
Sundry Creditors	2,32,500	2,70,000			
	13,35,000	18,45,000		13, 35,000	18, 45,000

It was proposed that Moon Ltd. should be taken over by Sun Ltd. The following arrangement was proposed by both the companies:

- (a) Goodwill of Moon Ltd. is considered valueless.
- (b) Arrears of depreciation in Moon Ltd. amounted to ₹ 30,000.
- (c) The holder of every 2 shares in Moon Ltd., was to receive:
 - (i) As fully paid at par, 10 shares in Sun Ltd., and
 - (ii) As much cash as is necessary to adjust the right of shareholders of both the companies in accordance with the intrinsic value of the shares as per their Balance Sheets subject to necessary adjustments with regard to goodwill and depreciation in Moon Ltd.'s Balance Sheet.

You are required to:

- (a) Determine the composite of purchase consideration and
- (b) Show the Balance Sheet after absorption.

Notes

Solution

Calculation of Intrinsic Value of Moon Ltd., and Sun Ltd.

Particulars	Moon Ltd.		Sun Ltd.	
	₹	₹		₹
Fixed Assets	6,00,000	—	—	12,00,000
Less: Depreciation	30,000	5,70,000		
Current Assets	—	6,75,000	—	4,95,000
Bank Balance	—			1,50,000
Total Assets		12,45,000		18,45,000
Less Liabilities:				
Secured Loans	—		3,75,000	
Unsecured Loans	1,50,000		—	
Sundry Creditors	2,32,500	3,82,500	2,70,000	6,45,000
Net Assets		8,62,500		12,00,000
No. of Shares		= 7,500		= 60,000
Intrinsic value of each share		= ₹ 115		= ₹ 20

As per amalgamation scheme a shareholder of every 2 shares in the Moon Ltd. will get 10 shares in the Sun Ltd., and the difference will be paid in cash.

	₹
Intrinsic value of 2 shares in Moon Ltd., (2×115) (calculation above)	230
Intrinsic value of 10 shares in Sun Ltd. (10×20)	200
Difference (which will be paid in cash)	30

Thus, a shareholder of every 2 shares in the Moon Ltd. will get 10 shares in Sun Ltd. and cash of ₹ 30.

Now, 7,500 Shares in Moon Ltd. will get as follows:

Share in Sun Ltd.	
Intrinsic value of 37,500 shares in Moon Ltd. @ ₹ 20	7,50,000
Cash payment for 7,500 shares @ ₹ 30 for every 2 shares $7,500 \times 30 / 2$	1,12,500
	8,62,500

The intrinsic value of a share in Sun Ltd. is ₹ 20 while it is being issued at ₹ 10. It means the Sun Ltd. is issuing the shares at a premium of ₹ 10.

**Balance Sheet of Sun Ltd.
as on 31st March, 2011**

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets	17,70,000
Authorised: 1,50,000 shares of ₹ 10 each fully Paid	15,00,000	Investments	—

			Notes
Issued & Subscribed Capital		Current Assets:	
(97,500 shares of ₹ 10 each out of which 37,500 issued for other than cash)	9, 75,000	Others	11, 70,000
Reserve & Surplus:		Cash Balance	
		(1, 50,000-1, 12,500)	37,500
General Reserve	6,00,000		
Share Premium	3, 75,000		
Secured Loans	3, 75,000		
Unsecured Loans	1, 50,000		
Current Liabilities & Provisions			
Sundry Creditors	5,02,500		
	29, 77,500		29, 77,500

Self Assessment

Choose the correct answer from the following options:

11. Excess of purchase consideration over net assets is called-
 - (a) Revenue loss
 - (b) Capital reserve
 - (c) Capital profit
 - (d) Goodwill

12. As per AS-14, purchase consideration is payable to-
 - (a) Debenture-holders
 - (b) Shareholders
 - (c) Creditors
 - (d) Shareholders, Debenture-holders and Creditors.

13. X Limited takes over the business of Y Limited and agrees to issue two shares of ₹ 10 each, ₹ 8 paid up and market value of ₹ 15 per share for every three shares in Y limited. If Y limited has 90,000 shares of ₹ 10 each, ₹ 7 paid up and market value ₹ 9 per share, the amount of purchase consideration is -
 - (a) ₹ 4,80,000
 - (b) ₹ 9,00,000
 - (c) ₹ 4,20,000
 - (d) None of these.



Task

When credit side is greater than debit side then on an account of purchase of consideration what journal entries should be made?

Notes



Case Study **Assistance in a Client Merger Process**

The Challenge

Our client is a logistic services provider with one operational business based in Luxembourg. One of its competitors was acquired during a group external growth operation and the management decided to merge the two separate businesses into one single entity. PwC Luxembourg was asked to provide Global Compliance Services (GCS) to help the client manage all the administrative, tax, accounting and operational issues generated by the merger, within a short time frame.

Our Approach

In close cooperation with our client, we prepared and validated an action plan including key areas of focus and specific milestones. Our initial involvement was oriented on the choice of the best structure to optimise the efficiency of the merger.

Strong efforts were also put in on tax and statutory compliance in order to ensure that all regulatory and legal requirements (filing of statutory accounts, direct and indirect tax returns) were completed before the merger was initiated. During this step, our experts mainly provided advice on treatments and on the preparation of the statutory accounts and tax returns (VAT and direct taxes).

Our GCS experts then greatly assisted our client in the preparation of the merger project, the agendas of the different board meetings and extraordinary general meeting of shareholders and coordinated the involvement of other external parties (notaries, auditors, lawyers, banks.). We also assisted our client by providing specific help on the proper transfer of the employees, suppliers and customer contracts. We helped our client manage all the administrative tasks with the local authorities (social security, VAT, business licence.). Moreover, our team was involved in the development and implementation of a common accounting manual in order to optimise the existing financial processes.

The outcome

The dedicated GCS team helped the client reach its objective to go through a smooth transition process with a high involvement of its team. Our GCS experts provided strong coaching to the client's team. At present, we keep providing specific services and coaching on various accounting, tax and corporate secretarial matters.

Question

Discuss if the process of assistance was in sync with the outcome.

Source: <http://www.pwc.lu/en/accounting/international-merger.jhtml>

4.3 Summary

- The purchase consideration is that amount which is payable by the transferee company (purchasing company) to the transferor company (vendor company) for the purchase of business.
- Purchase consideration may be paid in cash, shares, debentures or other securities.
- As per Accounting Standard (AS)-14 "consideration is the aggregate of the shares and the 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."

- Mode of Payment is generally decided by the mutual agreement between Transferor Company and Transferee Company.
- Fair value of the different elements of the consideration is also considered as the market value of assets.
- When an amalgamation is considered to be an amalgamation in the nature of merger, it should be accounted for under the pooling of interests method.
- When an amalgamation is considered to be an amalgamation in the nature of purchase, it should be accounted for under the purchase method.
- The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life.
- The consideration for the amalgamation should include any non-cash element at fair value.

4.4 Keywords

Amalgamation: It means an amalgamation pursuant to the provisions of the Companies Act, 1956, or any other statute which may be applicable to companies.

Consideration: Consideration for the amalgamation means for 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.

Fair value: It is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.

Liability: A company's legal debts or obligations that arise during the course of business operations.

Liquidation: When a business or firm is terminated or bankrupt, its assets are sold and the proceeds pay creditors. Any leftovers are distributed to shareholders.

Purchase consideration: The purchase consideration is that amount which is determined at the time of amalgamation.

Transferee Company: It means the company into which a transferor company is amalgamated.

Transferor Company: It means the company, which is amalgamated into another company.

4.5 Review Questions

1. What journal entries are passed in the books of Transferor Company and Transferee Company regarding amalgamation/absorption?
2. What do you understand by purchase consideration? How is it determined? Explain.
3. Distinguish between amalgamation in the nature of merger and amalgamation in the nature of purchase. Explain.
4. How is the difference between purchase consideration and net assets treated?
5. How will you deal with accumulated losses?
6. Pass journal entries in the books of Transferee Company relating to the liquidation cost of Transferor Company.
7. How is purchase consideration determined? Explain.

Notes

8. Write short notes on the following:
 - (a) Dissenting shareholders.
 - (b) Pooling of Internal method.
 - (c) Purchase consideration.
 - (d) Amalgamation in the nature of purchase.
 - (e) Amalgamation in the nature of merger.
9. The Sun Company Limited and the Stars Company Limited have agreed to amalgamate. A new company Universal Company Limited has been formed to take over the combined concerns as on 31st March, 2011. After negotiations, the assets of the two companies have been agreed at as shown in the following Balance Sheets:

The Sun Company Limited			
Liabilities	₹	Assets	₹
Issued Capital:		Land & Buildings	2,50,000
5,000 Equity shares of ₹		Machinery & Plant	1,00,000
100 each fully paid	5,00,000	Patents	55,000
Sundry Creditors	40,000	Stock	75,000
Profit & Loss A/c	25,000	Sundry Debtors	60,000
		Cash at Bank	25,000
	5,65,000		5,65,000

The Stars Company Limited			
Liabilities	₹	Assets	₹
Issued Capital:		Land & Buildings	1,50,000
2,500 Equity shares		Machinery & Plant	1,25,000
of ₹ 100 each.	2,50,000	Goodwill	25,000
Sundry Creditors	25,000	Stock	10,000
Reserve Fund	25,000	Sundry Debtors	10,000
Profit & Loss A/c	25,000	Cash at Bank	5,000
	3,25,000		3,25,000

Show the amount payable to each company by the Universal Company Limited at the time of amalgamation of these companies.

10. National Company Limited is absorbed by Universal Company Limited, the consideration being the taking over of liabilities. The payment of cost of absorption as a part of purchase consideration not exceeding ₹ 25,000 (actual cost ₹ 22,500), the payment of debentures of ₹ 2,50,000 at a premium of 10% in 13% Debentures issued at 96%, and the payment of ₹ 15 per share in cash and allotment of one 8% preference share of ₹ 10 each and 5 equity shares of ₹ 10 each fully paid for every 4 shares in National Company Limited. The number of shares of the National Company Limited is 2 lakhs of ₹ 10 each fully paid.

You are required to calculate the purchase consideration.

11. The Balance Sheets of AXE Co. Limited and WYE Co. Limited as on 31st March, 2011 were as follows:

Notes

Liabilities	AXE Ltd. ₹	WYE Ltd. ₹	Assets	AXE Ltd. ₹	WHY Ltd. ₹
Share Capital:			Goodwill	-	35,000
2,500 Preference Shares of ₹ 100 each fully paid	2,50,000	-	Patents	1,25,000	-
7,500 Equity Shares of ₹ 100 each.	7,50,000		Land & Buildings	7,00,000	-
25,000 Equity shares of ₹ 10 each.	-	2,50,000	Plant & Machinery	7,50,000	-
General Reserve	4,00,000	-	Motor Vehicles	75,000	1,40,000
P&L A/c	4,50,000	1,60,000	Furniture	35,000	12,500
Creditors	60,000	25,000	Investments	55,000	-
			Stock	1,00,000	1,35,000
			Debtors	50,000	82,500
			Bank	20,000	30,000
	19,10,000	4,35,000		19,10,000	4,35,000

A new company XYZ Limited was formed to acquire the assets and liabilities of AXE Limited and WYE Limited. The terms of acquisition of business were as under:

- (a) XYZ Limited to have an authorised capital of ₹ 30,00,000 divided into 2,50,000 equity shares of ₹ 10 each and 5,000, 11% Preference Shares of ₹ 100 each.
- (b) Business of AXE Limited was valued at ₹ 20,00,000 and settlement was made by the issue of equity shares of ₹ 20 each.
- (c) Business of WYE Limited was valued at ₹ 5,00,000 to be satisfied by issue of 25,000 equity shares of ₹ 20 each.
- (d) XYZ Limited made a public issue of 4,000, 11% Preference Shares of ₹ 100 each at par and 50,000 equity shares of ₹ 20 each.
- (e) Cost of formation of XYZ Limited amounted to ₹ 36,000.
- (f) Cost of liquidation of AXE Limited amounted to ₹ 8,200 and WYE Limited ₹ 3,550 and the same was paid by XYZ Limited.

Give journal entries to close the books of AXE Limited and WYE Limited and show the opening Balance Sheet of XYZ Limited.

12. The following is the balance sheet of Alpha Limited on 31st March, 2011:

Liabilities	₹	Assets	₹
Capital:		Buildings	3,00,000
60,000 Equity shares of ₹ 10 each	6,00,000	Machinery	4,50,000
Debentures	3,00,000	Work-in-Progress	90,000
Creditors	90,000	Stock	1,80,000
Reserve Fund	75,000	Furniture	7,500
Dividend Equalisation Fund	60,000	Debtors	75,000
P&L A/c	15,300	Cash	37,800
	11,40,300		11,40,300

Notes

The company is absorbed by Beta Limited on the above date. The consideration for the absorption is discharge of the debentures at a premium of 5%, taking over of the liability in respect of the creditors and payment of ₹ 7 in cash per share and one share of ₹ 5 in Beta Limited at the market value of ₹ 8 per share in exchange for one share in Alpha Limited. The cost of liquidation of ₹ 1,500 is to be met by the purchasing company. Pass necessary journal entries in the books of both the companies and open necessary accounts in the books of Alpha Limited. Show how the purchase price is arrived at.

Answers: Self Assessment

- | | |
|---------------------------|--------------------|
| 1. Realisation Account | |
| 2. Purchase Consideration | 3. Agreed |
| 4. Amalgamation | 5. Par |
| 6. True | 7. False |
| 8. True | 9. False |
| 10. False | 11. (d) Goodwill |
| 12. (b) Shareholders | 13. (b) ₹ 9,00,000 |

4.6 Further Readings



Books

Dr. Verma, J. C., Dr. Kumar, Sanjeev, Corporate Merger, Amalgamation & Takeovers.
Gaughan, Patrick A. Mergers and Acquisitions, New York: Harper Collins, 1991.



Online links

http://www.caalley.com/list_as.html
[http://www.wirc-icai.org/material/AS%2014%20Amalgamations%20\[Compatibility%20Mode\].pdf](http://www.wirc-icai.org/material/AS%2014%20Amalgamations%20[Compatibility%20Mode].pdf)
http://highered.mcgraw-hill.com/sites/0072922559/student_view0/chapter6/chapter_highlights.html
<http://www.scribd.com/doc/5990975/Amalgamation>
“Consolidated Statements (Interco eliminations)”. FindMyBestCPA.com

Unit 5: Internal Reconstruction of Companies

Notes

CONTENTS

Objectives

Introduction

5.1 Reconstruction of Companies

5.2 Summary

5.3 Keywords

5.4 Review Questions

5.5 Further Readings

Objectives

After studying this unit, you will be able to:

- Describe the meaning and types of reconstruction
- Explain the two types of internal reconstruction viz. alternation and reduction of share capital
- Recognise the internal reconstruction procedure with practical illustrations

Introduction

In previous unit, we have discussed the meaning of amalgamation, types of amalgamation, difference between merger and purchase. Also, we have focused on Accounting Standards (AS)-14 in detail. Then with the help of illustrations accounting treatment of amalgamation has also been discussed.

Reconstruction means reorganization of a company's financial structure. In reconstruction of a company, usually the assets and liabilities of the company are revalued, the losses suffered by the company are written off by a deduction of the paid-up value of shares and/or varying of the rights attached to different classes of shares and compounding with the creditors. It may be done without liquidating the company and forming a new company in which case the process is called internal reconstruction. However, there may be external reconstruction in which case the undertaking being carried on by the company is transferred to a newly started company consisting substantially of the same shareholders with a view to the business of the transferee company being continued by the transferee company. An attempt is made that the newly started company has a sound financial structure and a good set of assets and liabilities recorded in the books of the transferee company at their fair values.

Further, we will focus on the reconstruction of companies in two ways. We will discuss internal reconstruction in this unit and external reconstruction will be specifically elaborated in the next unit.

5.1 Reconstruction of Companies

The word reconstruction of a company implies the reorganization of the financial structure of the company. It is different from amalgamation and absorption. In the case of heavy losses, over capitalization or several financial problems, the reconstruction of a company is adopted to remove these defects and to reorganize the financial structure. Thus term 'reconstruction of a

Notes

company' is used to reorganize the financial structure. During the reconstruction of a company, several changes take place such as change in shareholders' rights and interests, debenture-holders' rights, creditors' rights etc.

Reconstruction of companies may be of two types: External Reconstruction and Internal Reconstruction.

1. **External Reconstruction:** When the capital structure of a company is reorganized through the liquidation of the existing company and formation of the new company, it is called external reconstruction. Thus, in the case of external reconstruction, one existing company will go into liquidation and a new company will be formed in order to purchase the business of the existing company.



Example: When Ankit Limited goes into liquidation and a new company Ankit Mohan Limited is formed to purchase the business of Ankit Limited, it is a case of external liquidation. In this way, the shareholders and persons interested and business will be same in the newly formed company as were in the old company.

2. **Internal Reconstruction:** Internal reconstruction means the reorganization of the capital structure of a company without forming a new company and without liquidating the existing company. Internal reconstruction of a company is done to alter the share capital or to reduce the share capital without going into liquidation. It means the reorganized form of the company will run the business of the existing company. The claims of the shareholders, creditors and outsiders are adjusted towards the amount of writing off the losses and fictitious assets. This is further discussed in the following pages. Thus, in the internal reconstruction, the following two are included:

- (a) Alteration of share capital
- (b) Reduction of share capital

Self Assessment

State whether the following statements are true or false:

1. All types of companies undertake capital reduction.
2. Internal reconstruction means the reduction of capital.
3. There is no need for a company to take the permission of court to cancel any paid up capital which is lost or not represented by the available assets.
4. Share premium account cannot be transferred to capital reduction account.
5. To return the excess paid up capital, the permission of the court is required.
6. Cancellation of nominal capital is also called capital reduction.
7. If reduction of capital is not sanctioned by the court, it is unlawful.

Alteration of Share Capital

According to Section 94 of the Companies Act, a limited company having a share capital may, if so authorized by its Articles of Association, alter the capital clause of its Memorandum of Association by the ordinary resolution in the general meeting. These alterations do not require the approval of the Company Law Board. Alteration in the capital clause may be in any of the following ways:

- (a) Increase in its share capital by the issue of fresh shares of such amount as it thinks expedient.

- (b) Consolidation of all or part of its existing shares of smaller denomination into shares of larger denomination.
- (c) Conversion of all or part of its fully paid shares into stock and vice-versa.
- (d) Sub-division of its shares or part of them of larger denominations into smaller denominations.
- (e) Cancellation of those shares which have not been issued.



Caution Internal reconstruction of a company is done to alter the share capital or to reduce the share capital without going into liquidation.



Caselet

Reconstruction of Full-thickness Nasal Defect

Reconstruction of complex full-thickness nasal defects requires the reconstitution of the mucous internal nasal lining, the cartilaginous framework, and the aesthetic contour of the cutaneous nasal covering. Goals of reconstruction include restoration of a functional nasal airway and redefinition of the contours of the nose as well as its relationship to the cheek and lip with the least amount of morbidity to the patient. This article details a multistaged approach to repairing such a defect using an ipsilateral septal mucoperichondrial flap, multiple cartilage grafts, a paramedian forehead flap, and a cheek flap in a woman who had undergone Mohs surgery.

Source: <http://www.ncbi.nlm.nih.gov/pubmed/21112520>

Increase in Share Capital by Issue of Fresh Shares

A limited company may increase its nominal or subscribed capital by making fresh issue of shares. To increase its nominal capital, the company has to alter its capital clause in its Memorandum of Association. On the passing of the resolution for increasing of the nominal capital, the Registrar of the Companies must be informed within thirty days of passing such resolution. The offer for the issue of fresh shares must first be made to existing shareholders in the proportion of their holdings, unless the company has decided otherwise by a special resolution or by an ordinary resolution approved by the Central Government. If the existing shareholders fail to exercise their option within fifteen days, the Board of Directors will be free to issue such shares. Accounting treatment for the issue of such shares will be same as is adopted for the issue of new shares explained earlier.

Consolidation of Shares: As per Section 94 of the Companies Act, 1956, a limited company may consolidate its shares of smaller denomination (value) into larger denomination (value). Generally, consolidation is done when the value of shares is in very small amount.

On consolidation of shares, the amount of paid up share capital remains at old figure, but the number of shares decreases.



Example: XYZ Limited having a share capital of ₹ 10,00,000 divided into 1,00,000 shares of ₹ 10 each on which ₹ 8 per share are paid up, resolve to consolidate 10 shares of ₹ 10 each into one share of ₹ 100. On consolidation the paid up value of the shares will be same but the number of shares will reduce.

Notes

On consolidation, the company will pass the following journal entry-

Share Capital (₹ 10) Account	Dr.	8,00,000	
To Share Capital (₹ 100) Account			8,00,000

(Being consolidation of 10 shares of ₹ 10 each, ₹ 8 paid up into one share of ₹ 100).

Sub-division of Shares: Section 94 of the Companies Act, 1956, also provides that a company may sub-divide its shares of larger amount into shares of smaller amount if so authorised by the Articles of Association. If the shares are not fully paid up, the proportion between the amount paid and the amount unpaid on each reduced share must be the same as it was before sub-division.

On the sub-division of shares, the amount of paid up capital remains the same, but the number of shares increases.



Example: XYZ Limited having a share capital of ₹ 10,00,000 divided into 10,000 equity shares of ₹ 100 each, resolves to split up one equity share of ₹ 100 each into 2 equity shares of ₹ 50 each. After sub-division, the company will have the same amount of capital and it will pass the following journal entry-

Equity Share Capital (₹ 100) Account	Dr.	10,00,000	
To Equity Share Capital (₹ 50) Account			10,00,000

(Being sub-division of 10,000 shares of ₹ 100 each into 20,000 shares of ₹ 50 each).

Conversion of Shares into Stock and Vice-Versa: As per Section 94 of the Companies Act 1956, a company is also allowed to convert its fully paid up shares into stock or to reconvert that stock into fully paid up shares. Stock is the set of fully paid shares of a number merged into one fund having equal value.



Notes

Stock is always made from fully paid up share, it is never made from partly paid up shares and shares cannot be transferred into fractions, while stock can be transferred into any fraction.



Did u know? As per Section 94 of the Companies Act 1956, a company is also allowed to convert its fully paid up shares into stock or to reconvert that stock into fully paid up shares.

On the conversion of shares into stock, the shareholder becomes stockholders. The stockholders have the same rights, privileges and advantages as to dividends and voting as were carried by the shares before conversion into stock took place. On conversion of shares into stock, the work of maintaining register and issuing certificate is very simplified.

Accounting treatment: On conversion of fully paid up shares into stock, the company has to pass the following journal entry-

Equity Share Capital Account	Dr.	
To Equity Stock Account		

(Being conversion of fully paid up equity shares into equity stock).

On the conversion of equity stock into fully paid up equity shares, the above journal entry will be just reverse.



Did u know? Generally, consolidation is done when the value of shares is in very small amount.

Notes

Illustration 1 (Alteration in Capital by Sub-division)

XY Limited with a share capital of 50,000 equity shares of ₹ 100 each fully paid, resolves to sub-divide these shares into shares of ₹ 50 each fully paid. Show journal entries.

Solution

Journal of XY Limited				
Date	Particulars	L.F.	₹	₹
	Equity Share Capital (₹ 100) A/c	Dr.	50,00,000	
	To Equity Share Capital (₹ 50) A/c			50,00,000
	(Being sub-division of 50,000 equity shares of ₹ 100 each fully paid into 1,00,000 equity shares of ₹ 50 each)			

Illustration 2 (Conversion of Shares into Stock at Discount)

XYZ Limited passed a resolution for the conversion of its 50,000 equity shares of ₹ 10 each fully paid into ₹ 5,25,000 stock on the basis of ₹ 105 of stock for every 10 fully paid shares of ₹ 10 each. Show the journal entries in the books of XYZ limited.

Journal of XYZ Limited				
Date	Particulars	L.F.	₹	₹
	Equity Share Capital Account	Dr.	5,00,000	
	Discount on Stock Account	Dr.	25,000	
	To Equity Stock Account			5,25,000
	(Being conversion of 50,000 equity shares of ₹ 10 each fully paid into 5,000 equity stock of ₹ 105 each)			

Illustration 3 (Reconversion of Equity Stock into Fully Paid up Shares)

A limited company passed a necessary resolution to convert its ₹ 10,00,000 equity stock of ₹ 100 each into 1,00,000 equity shares of ₹ 10 each fully paid up. Show necessary journal entries in the books of the company.

Solution

Journal Entries				
Date	Particulars	L.F.	₹	₹
	Equity Stock Account	Dr.	10,00,000	
	To Equity Share Capital Account			10,00,000
	(Being reconversion of 10,000 equity stock in 1,00,000 equity shares of ₹ 10 each fully paid)			

Cancellation of Unissued Share Capital: As per Section 94(1)(e) of the Companies Act, 1956, a company is permitted to decrease the amount of its nominal capital by cancellation of shares. Cancellation will be of those shares which at the date of passing of the resolution for cancellation of shares in general meeting in that behalf have not taken or agreed to be taken by any person and

Notes

thus diminish the amount of its nominal share capital. Diminution of share capital is different from the reduction of share capital. Diminution of capital is unissued share capital, while reduction of share capital is for subscribed/paid up capital. For the reduction of capital, sanction of the court is mandatory while cancellation of unissued capital does not require the sanction of court.

Accounting Treatment: Cancellation of the unissued shares capital does not require any journal entry in the books of the company because it does not have any effect on the issued shares capital.

Self Assessment

Fill in the blanks:

8. Reduction of capital is lawful only when it is sanctioned by.....
9.is required for the cancellation of unissued share capital.
10. Internal reconstruction is adopted to write off
11. On the reduction of capital, the security of creditors
12. Only adopts internal reconstruction.
13. Alteration of the capital must be noticed to the Registrar within days of doing so as per Section 95.
14. Consent of creditors is required when share capital is reduced.

Reduction of Share Capital

Capital reduction of a company takes place strictly in accordance with the legal provisions of Section 100 to 105 of the Companies Act, 1956. If the company is authorized by its Articles of Association, it may, by a special resolution and on its confirmation by the court on petition, reduce its shares capital by the following ways:

- (a) Reducing or extinguishing the liability of shareholders in respect of share capital not paid up.
- (b) Writing off or cancelling any paid up capital which is lost by available assets.
- (c) Paying off paid up capital in excess of the requirements of the company.
- (d) Any other method approved by the court.

As per Section 100, reduction (b) and (c) may be made either in addition to or without extinguishing or reducing the liability of shareholders for uncalled capital.

Any reduction of capital is dangerous for creditors, as issued capital of a company represents the security on which the creditors rely. Generally, companies do not call the full value of shares at one time. The uncalled capital acts as a future security for the creditors of the company. Therefore, any reduction in capital reduces the security of the creditors. In such a situation the creditors are entitled to object to the reduction. For this purpose the court shall settle a list of creditors and hear their objections, if any, and on being satisfied that either the creditors consent to the reduction or that their debts have been discharged or secured by the company, may confirm the reduction on any terms it thinks fit. As per Sections 101 & 102 the court may direct the company to add the words "and reduced" to its name for a fixed period and to publish the reasons for reduction for the information of the public.

As per Section 103, the order of the court and minutes as approved by the court have to be filed with the Registrar who will register them and issue a certificate of registration which will be a conclusive evidence that everything is in order.

Reduction of capital is purely democratic and is decided by securing the consent of the holders of at least three-fourth of the shares concerned in separate class meetings by means of special resolution. If at least one-tenth of the issued shareholders are not satisfied with the resolution of reduction of capital, they may apply to the court within 21 days after the resolution is passed. In this case the decision of the court will be final.

Following are some exceptional cases in which reduction may take place without the sanction of the court:

- (a) When shares are forfeited by the company for non-payment of calls on instalments.
- (b) When redeemable preference shares are redeemed in accordance with the provisions of Section 80.
- (c) When shares are surrendered to the company.
- (d) When the company cancels any share of its nominal capital which has not been taken or agreed to be taken by any person.

Accounting Treatment for Reduction of Capital: The accounting treatment of all the above cases is mentioned below separately –

Case I: Reducing the Liability of Shareholders in Respect of Uncalled/Unpaid Amount

When unpaid amount of the share capital is reduced/extinguished by the company, shareholders are benefited as they do not have to pay the amount to that extent in future. On the other side the security of the creditors is reduced. As a result, the partly paid up shares become the fully paid up shares and the face value of the shares reduced. The required journal entry to cancel the uncalled amount will be as follows:

Share Capital (Partly paid up) Account (with paid up amount of shares)	Dr.
To Share Capital (fully paid up) Account	

Case II: Reduction in Capital by Refunding the Excess Capital

If the company is facing a problem of overcapitalization owing to more than one reason, such as closure of a particular line of production, it may reduce the capital by refunding the excess capital to its shareholders. As the reduction of paid up capital reduces the creditors' security, the creditors may object to such a scheme. Therefore, the scheme of reducing of capital by refunding of excess capital should be sanctioned by the court after meeting out the creditors' objections for the purpose the following journal entries are recorded-

- (a) When refunded amount of capital is due to shareholders-

Share Capital Account (amount to be refunded)	Dr.
To Shareholders' Account.	

- (b) When excess amount of capital is to be refunded

Shareholders' Account (amount of refund)	Dr.
To Bank Account	

Case III: Reduction in Capital by Reducing the Paid up Capital

If a limited company suffers losses continuously over a number of years, the assets side of its balance sheet will show accumulated losses in the form of deferred expenses, intangible assets, discount on issue of shares and debentures, underwriting commission, cost of issue of shares and

Notes

debentures, debit balance of P & L A/c etc. In the case of such companies, goodwill appearing in the assets side of the balance sheet will also a form of accumulated loss. Further, such companies may show the fixed assets, both tangible and intangible, at more than reasonable value due to writing off minimum amount of depreciation. It means that the capital of such companies (suffering losses continuously over a number of years) is not represented by its assets in the balance sheet. For the true representation of the assets by capital. A capital reduction programme is adopted. Under this programme that portion of capital which is already lost by assets is washed out. It is carried out by eliminating the lost capital and using the same for writing off the accumulated losses, overvaluation amount of assets and miscellaneous expenses appearing in assets side. This procedure is adopted by opening a new account 'Capital Reduction Account' or 'Reorganization Account' or 'Reconstruction Account' with the amount of Capital Reduction in the books of the company.

Accounting Treatment: For this purpose, the following journal entries are recorded:

1. When capital is reduced by writing off the paid up value (face value) of shares, it means the change the category of shares. For this purpose, old share capital is closed by debiting and new share capital account is opened by crediting and the difference between these two is transferred to Capital Reduction Account. The journal entry will be:

Share Capital (Old) Account (paid up value of old shares)	Dr.
To Share Capital (New) Account (paid up value of new shares)	
To Capital Reduction Account (amount of reduction)	



Notes If capital is reduced by writing off the paid up amount of shares capital which is lost, it means face value of the shares remains uncharged and the category of the share capital does not change.

The journal entry will be:

Share Capital Account (amount of reduction of Capital)	Dr.
To Capital Reduction Account	
or	
To Reconstruction Account	

2. If some debenture-holders or creditors have been agreed to sacrifice their claims against company towards reconstruction-

Debentures Account	Dr.	(amount of sacrifice)
Creditors Account	Dr.	
To Reconstruction Account		

Sometimes new debentures are issued in the exchange of old debentures-

Old Debentures Account (amount of old debentures)	Dr.
To New Debentures Account (amount of new debentures)	

Notes

machinery by ₹ 45,000 and of goodwill by ₹ 20,000. (c) To reduce the value of investment to market value by writing off ₹ 40,000.

The reduction was made by converting 25,000 preference shares of ₹ 20 each fully paid to the same number of preference shares of ₹ 15 each fully paid and by converting 25,000 equity shares of ₹ 20 each, ₹ 15 paid up into 25,000 equity shares of ₹ 10 each fully paid. Give journal entries necessary in relation to the reduction of share capital and show how you would deal with the balance of the reduction of share capital account.

Solution

Journal of Ravi Raghav Co. Ltd.				
Date	Particulars	L.F.	₹	₹
	Preference Shares (₹ 20) Capital Account	Dr.		5,00,000
	To Preference Shares (₹ 15) Capital Account			3,75,000
	To Capital Reduction Account			1,25,000
	(Being reduction in capital by converting 25,000 Pref. Shares of ₹ 20 each fully paid in 25,000 Preference Shares of ₹ 15 each fully paid)			
	Equity Share Capital (₹ 20) Account	Dr.		3,75,000
	To Equity Share Capital (₹ 10) Account			2,50,000
	To Capital Reduction Account			1,25,000
	(Being reduction in capital by converting 25,000 shares of ₹ 20, ₹ 15 Paid up into 25,000 shares of ₹ 10 each)			
	Capital Reduction Account	Dr.		2,10,000
	To Profit and Loss Account			1,05,000
	To Goodwill Account			20,000
	To Plant & Machinery Account			45,000
	To Investment Account			40,000
	(Being utilization of capital reduction into writing off debit balance of P & L A/c, Goodwill, overvaluation of Plant & Machinery and Investment)			
	Capital Reduction Account	Dr.		40,000
	To Capital Reserve Account			40,000
	(Being transfer of balance of capital reduction to capital reserve account)			

Illustration 5

On the reconstruction of ABC Ltd. the following terms were agreed upon:

The shareholders to receive in lieu of their present holding (viz 1,00,000 shares of ₹ 10 each) the following:

- (a) Fully paid equity shares equal to $2/5^{\text{th}}$ of their holding.
- (b) 10% preference shares fully paid to the extent of $1/5^{\text{th}}$ of the above new equity shares.
- (c) ₹ 1,20,000, 7% debentures.

An issue of ₹ 1,00,000, 6% debentures was made and allotted, payment for the same having been received in cash. The goodwill, which stood at ₹ 6,00,000, was written down to ₹ 3,00,000. The plant and machinery, which stood at ₹ 2,00,000, was written down to ₹ 1,50,000. The freehold and leasehold premises, which stood at ₹ 3,00,000, were written down to ₹ 2,50,000. Make necessary journal entries in the books of the company on the basis of above transactions.

Solution

Notes

Journal of ABC Ltd.

Date	Particulars	L.F.	₹	₹
	Equity Share (₹ 10) Capital Account	Dr.	10,00,000	
	To Equity Share Capital (New) Account			4,00,000
	To 10% Preference Share Capital Account			80,000
	To 7% Debentures Account			1,20,000
	To Reconstruction Account			4,00,000
	(Being issue of equity shares, preference shares and debentures in lieu of present holdings)			
	Reconstruction Account	Dr.	4,00,000	
	To Goodwill Account			3,00,000
	To Plant & Machinery Account			50,000
	To Freehold & Leasehold Premises A/c			50,000
	(Being utilization of capital reduction in writing off goodwill, over-valuation of plant & machinery and premises)			
	Bank Account	Dr.	1,00,000	
	To 6% Debentures Account			1,00,000
	(Being issue of 6% debentures to the public)			

Illustration 6

The balance sheet of the Bhagwan Company Limited as on 31st March, 2006 was given below:

Liabilities	₹	Assets	₹
Authorised Capital:		Patents at cost	4,25,000
5,000 Preference shares of ₹ 100 each.	5,00,000	Leasehold Premises	65,400
5,000 Equity shares of ₹ 100 each.	5,00,000	Plant & Machinery	21,100
	10,00,000	Sundry Debtors	38,250
		Stock	27,500
Issued Capital:		Discount on issue of shares	9,000
3,750 Preference shares of ₹ 100 each fully paid up	3,75,000	Preliminary Expenses	6,000
		P & L A/c	57,500
2,500 Equity shares of ₹ 100 each fully paid up.	2,50,000	Cash	250
Sundry Creditors	15,000		
Bank Overdraft	10,000		
	6,50,000		6,50,000

The company proved unsuccessful and the following scheme of reconstruction is passed:

- (i) ₹ 100 Preference Shares to be reduced to an equal number of fully paid shares of ₹ 50 each.
- (ii) ₹ 100 Equity Shares be reduced to an equal number of fully paid shares of ₹ 25 each.

Notes (iii) That the amount thus rendered available for the reduction of the assets is apportioned as follows:

Preliminary Expenses, Profit and Loss Account and Discount on issue of shares to be written off entirely, ₹ 15,400 off the leasehold premises, ₹ 7,500 off the stock, 20% off the plant and machinery and sundry debtors and the balance available to be written off patents. Pass necessary journal entries and prepare the Balance Sheet after reconstruction in the books of the Bhagwan Co. Ltd.

Solution

Journal of Bhagwan Co. Ltd.

Date	Particulars	L.F.	₹	₹
2006				
March, 31	Preference Share (₹ 100) Capital A/c	Dr.		3,75,000
	To Preference Share (₹ 50) A/c			1,87,500
	To Capital Reduction A/c			1,87,500
	(Being reduction in capital by converting 3,750 Preference Shares of ₹ 100 each fully paid up into 3,750 preference shares of ₹ 50 each fully paid up)			
	Equity Shares (₹ 100) Capital A/c	Dr.	2,50,000	
	To Equity Shares (₹ 25) Capital A/c			62,500
	To Capital Reduction A/c			1,87,500
	(Being reduction in capital by converting 2,500 equity shares of ₹ 100 each into 2,500 equity shares of ₹ 25 each fully paid)			
	Capital Reduction A/c	Dr.	3,75,000	
	To Profit and Loss A/c			57,500
	To Preliminary Expenses A/c			6,000
	To Discount on Issue of Shares A/c			9,000
	To Leasehold Premises A/c			15,400
	To Stock A/c			7,500
	To Plant & Machinery A/c			4,220
	To Provision for Bad Debts A/c			7,650
	To Patents A/c			2,67,730
	(Being utilization of the amount of capital reduction in writing off the fictitious assets and accumulated losses)			

**The Bhagwan Company Ltd. (and Reduced)
Balance Sheet as on 31st March, 2006**

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
Authorised Capital		Leasehold Premises	
5,000 preferences shares of ₹ 50 each	2,50,000	(₹ 65,400 - 15,400)	50,000
5,000 equity shares of ₹ 25 each	1,25,000	Plant & Machinery	
	3,75,000	(₹ 21,100 - ₹ 4,220)	16,880

Issued and Subscribed Capital:		Patents (₹ 4,25,000 – ₹ 2,67,730)	1,57,270	Notes
3,750 preference shares of ₹ 50 each fully paid	1,87,500	Current Assets, Loans and Advances:		
		Stock (₹ 27,500 – ₹ 7,500)	20,000	
2,500 equity shares of ₹ 25 each fully paid	62,500	Sundry Debtors (₹ 38,250 – ₹ 7,650)	30,600	
Unsecured Loans:		Cash	250	
Bank Overdraft	10,000			
Current Liabilities & Provisions:				
Sundry Creditors	15,000			
	2,75,000		2,75,000	

Illustration 7

The Balance Sheet of Nirmala Co. Ltd. on 31st March, 2006 was as follows:

Liabilities	₹	Assets	₹
Share Capital:		Goodwill	45,000
6,000, 10% Preference shares of ₹ 100 each	6,00,000	Freehold Properties	6,00,000
12,000, Equity shares of ₹ 100 each	12,00,000	Plant & Machinery	9,00,000
8% Mortgage Debentures	3,00,000	Stock-in-trade	1,50,000
Bank Overdraft	1,50,000	Debtors	1,20,000
Creditors	3,00,000	Profit & Loss A/c	7,35,000
	25,50,000		25,50,000

The company got the following scheme of capital reduction approved by the court:

- (1) The 10% preference shares to be reduced to ₹ 75 per share, fully paid and the equity shares to ₹ 37.50 each.
- (2) The 8% Mortgage Debentures took over the stock-in-trade and the book debts in full satisfaction of the amount due to them.
- (3) The goodwill account to be eliminated.
- (4) The freehold properties to be depreciated by 50%.
- (5) The value of the plant and machinery to be increased by ₹ 1,50,000.

Give journal entries for the above and prepare the revised Balance Sheet.

Solution

**Nirmala Co. Ltd.
Journal**

Date	Particulars	L.F.	₹	₹
	10% Preference Share Capital A/c	Dr.	1,50,000	
	Equity Share Capital A/c	Dr.	7,50,000	
	To Reconstruction A/c			9,00,000
	(Being reduction in capital by reducing 10% preference shares @ ₹ 25 per share and equity shares @ ₹ 62.50 per share)			
	8% Mortgage Debentures A/c	Dr.	3,00,000	
	To Stock-in-trade A/c			1,50,000

Notes	To Debtors A/c		1,20,000
	To Reconstruction A/c		30,000
	(Being reduction in mortgage debentures by transferring the stock and debtors in full settlement of the claim of debenture-holders and balance transferred to reconstruction account)		
	Plant and Machinery A/c	Dr.	1,50,000
	To Reconstruction A/c		1,50,000
	(Being utilization of the amount of capital reduction in the appreciation of plant and machinery)		
	Reconstruction A/c	Dr.	10,80,000
	To Goodwill A/c		45,000
	To Freehold Properties A/c		3,00,000
	To Profit and Loss A/c		7,35,000
	(Being utilization of the balance of capital reduction account in writing off the fictitious assets and accumulated losses)		

**Balance Sheet of Nirmala Co. Ltd.
as on 31st March, 2006**

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
Authorised, Issued, Subscribed and paid up capital:		Goodwill	-
6,000 preference shares of ₹ 75 each fully paid up	4,50,000	Freehold Properties	3,00,000
12,000 equity shares of ₹ 37.5 each fully paid up	4,50,000	Plant & Machinery (9,00,000 + 1,50,000)	10,50,000
Secured Loans:			
Bank overdraft	1,50,000		
Current Liabilities:			
Creditors	3,00,000		
	13,50,000		13,50,000

Illustration 8

The following was the Balance Sheet of Galgotia Industries Limited as on 31.03.2006:

Liabilities	₹	Assets	₹
Share Capital :		Goodwill	50,000
60,000 Equity Shares of ₹ 10 each	6,00,000	Machinery	2,54,250
Less: Calls-in-Arrear		Furniture	51,375
(₹ 3 per share on 15,000 shares)	<u>45,000</u>		
Sundry Creditors	77,125	Stock	1,02,500
Provision for Taxation	20,000	Debtors	75,000
		Cash	7,500

	Preliminary Exps.	7,500	
	Profit and Loss A/c	1,10,000	
	Less: Profit for the year	<u>6,000</u>	1,04,000
		6,52,125	6,52,125

The directors have had a valuation made of the machinery and find it overvalued by ₹ 50,000. It is proposed to write down this asset to its true value and to extinguish the deficiency in the profit and loss account and to write off the goodwill and preliminary expenses, by the adoption of the following course:

- (i) Forfeit the shares on which the call is outstanding.
- (ii) Reduce the paid up capital by ₹ 3 per share.
- (iii) Reissue the forfeited shares as fully paid shares of ₹ 7 each at ₹ 5 per share.
- (iv) Utilize the provision for taxation, if necessary.

The shares on which the calls were in arrear were duly forfeited and reissued on payment of ₹ 5 per share.

You are required to-

- (a) Draft the necessary journal entries
- (b) Draw the company's balance sheet immediately after the implementation of the scheme of reconstruction.

Solution

**Galgotia Industries Ltd.
Journal**

Date	Particulars	L.F.	₹	₹
	Share Capital Account	Dr.		1,50,000
	To Forfeited Shares Account			1,05,000
	To Calls-in-Arrear Account			45,000
	(Being forfeiture of 15,000 shares for non-payment of final call of ₹ 3 per share)			
	Bank Account	Dr.	75,000	
	Forfeited Shares Account	Dr.	30,000	
	To Share Capital Account			1,05,000
	(Being reissue of 15,000 shares of ₹ 7 each at ₹ 5 each)			
	Forfeited Shares Account	Dr.	75,000	
	To Capital Reserve Account			75,000
	(Being transfer of the balance of forfeited shares account to capital reserve account)			
	Share Capital (₹ 3) Account	Dr.	1,35,000	
	To Capital Reduction Account			1,35,000
	(Being reduction in capital by reducing ₹ 3 per share on 45,000 equity shares)			
	Capital Reduction Account	Dr.		2,11,500
	To Machinery Account			50,000

Notes	To Profit and Loss Account		1,04,000
	To Goodwill Account		50,000
	To Preliminary Expenses Account		7,500
	(Being writing off the fictitious assets, accumulated losses and miscellaneous expenses under reconstruction scheme)		
	Provision for Taxation Account	Dr.	1,500
	Capital Reserve Account	Dr.	75,000
	To Capital Reduction Account		76,500
(Being utilization of reserve and provision for taxation for reduction of capital)			

Working Note:

Capital Reduction Account

Particulars	₹	Particulars	₹
To Machinery A/c	50,000	By Share Capital A/c	1,35,000
To P & L A/c	1,04,000	By Capital Reserve A/c	75,000
To Goodwill A/c	50,000	By Provision for Taxation (Balancing figures)	1,500
To Preliminary Expenses.	7,500		
	2,11,500		2,11,500

Balance Sheet of Galgotia Industries Ltd. as on 31st March, 2006

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
Issued and Paid up:		Machinery	
60,000 shares of ₹ 7 each fully paid.	4,20,000	(₹ 2,54,250 - ₹ 50,000)	2,04,250
Secured Loans:	-	Furniture	51,375
Unsecured Loans:	-	Current Assets:	
Current Liabilities and Provisions:		Stock	1,02,500
Creditors	77,125	Debtors	75,000
Provision for taxation	18,500	Cash & Bank balance	
		(₹ 7,500 + ₹ 75,000)	82,500
	5,15,625		5,15,625

Illustration 9

The ledger-balances of S. K. include - Fixed Assets ₹ 14,00,000, Investments ₹ 20,000, Inventories ₹ 7,80,000, Trade Debtors ₹ 9,20,000, Preliminary Expenses ₹ 40,000, Equity Shares Capital (60% paid up) ₹ 12,00,000, 10% First Debentures ₹ 4,00,000, 12% Second Debentures ₹ 10,00,000, Bank Overdraft ₹ 1,00,000, Trade Creditors (including Mr. Ramesh for ₹ 17,00,000) ₹ 23,00,000.

Outstanding interest for one year on debentures ₹ 1,60,000.

The company has incurred heavy losses. The following scheme of reconstruction is agreed upon:

Notes

- (a) to make the existing ₹ 100 equity shares fully paid up, and then to reduce them to ₹ 20 each.
- (b) to settle the claims of the holders of the first debentures by issuing 4,000 12.5% Debentures of ₹ 100 each.
- (c) to discharge the claims of the holders of the second debentures by issuing 8,000, 14% debentures of ₹ 100 each.
- (d) to pay ₹ 6,00,000 to Mr. Ramesh in the full settlement of his account.
- (e) to allot 30,000 fresh equity shares of ₹ 20 each to discharge the remaining trade creditors.
- (f) to write off the fictitious assets and to reduce the fixed assets.

Pass the necessary journal entries to give effect to the aforesaid scheme and show the post reconstruction Balance Sheet. Assume that (i) all the formalities are duly complied with and (ii) the company has only one bank account to transact all the receipts and payments.

Solution

Journal of S. K. Industries Limited

Date	Particulars	L.F.	₹	₹
2006				
June 30	Equity Shares Final Call Account	Dr.	8,00,000	
	To Equity Share Capital Account			8,00,000
	(Final Call money due on 20,000 equity shares @ ₹ 40 per share)			
	Bank Account	Dr.	8,00,000	
	To equity share final call account			8,00,000
	(Being receipt of final call money on 20,000 share @ ₹ 40 per share)			
	Equity Share Capital Account	Dr.	16,00,000	
	To Reconstruction Account			16,00,000
	(Being reduction of equity capital @ ₹ 80 per share on 20,000 shares)			
	10% first debentures account	Dr.		4,00,000
	Outstanding Interest on Debentures A/c	Dr.	40,000	
	To 12½% Debentures Account.			4,00,000
	To Reconstruction Account			40,000
	(Being issue of 4000, 12½% Debentures in lieu of 10% First Debentures and outstanding interest on debentures)			
	12% Second Debentures Account	Dr.	10,00,000	
	Outstanding Interest on Debentures A/c	Dr.	1,20,000	
	To 14% Debentures Account			8,00,000
	To Reconstruction Account			3,20,000

Notes

(Being issue of 8,000, 14% Debentures in lieu of 12% debentures and outstanding Interest on debentures and balance transferred to Reconstruction Account)

Trade Creditors Account (Mr. Ramesh)	Dr.	17,00,000
To Bank Account		6,00,000
To Reconstruction Account		11,00,000

(Being the final settlement of Mr. Ramesh and balance transferred to Reconstruction Account)

Trade Creditors Account	Dr.	6,00,000
To Equity Share Capital A/c		6,00,000

(Being the issue of equity shares of ₹ 20 each to the creditors)

Reconstruction Account	Dr.	30,60,000
To Fictitious Assets A/c		20,00,000
To Preliminary Expenses A/c		40,000
To Fixed Assets A/c		10,20,000

(Being the utilization of Reconstruction A/c in writing off the fictitious assets, preliminary expenses and overvaluation of assets)

Working Note:

Fictitious assets are calculated by preparing the following Balance Sheet:

Liabilities	₹	Assets	₹
Equity Share Capital	12,00,000	Fixed Assets	14,00,000
First Debenture	4,00,000	Investment	20,000
Second Debentures	10,00,000	Inventories	7,80,000
Bank Overdraft	1,00,000	Debtors	9,20,000
Creditors	23,00,000	Preliminary Expenses	40,000
O/s Interest on Debentures	1,60,000	Fictitious Assets (Balance)	20,00,000
	51,60,000		51,60,000

**Balance Sheet of
S. K. Industries Ltd. as on 30th June, 2006**

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
50,000 Equity Shares of ₹ 20 each (out of which 30,000 shares have been issued to creditors)	10,00,000	(₹ 14,00,000 - ₹ 10,20,000)	3,80,000
Secured Loans:		Investments	20,000
Debentures	4,00,000	Current Assets:	
14% Debentures	8,00,000	Inventories	7,80,000
		Debtors	9,20,000
		Cash (₹ 8,00,000 - ₹ 6,00,000 - ₹ 1,00,000)	1,00,000
	22,00,000		22,00,000

Illustration 10

Notes

The following scheme of capital reduction was duly sanctioned by the court:

- (i) Equity shares to be reduced by ₹ 90 each
- (ii) Preference shares to be reduced by ₹ 90 each.
- (iii) The debenture-holders to waive their outstanding interest.
- (iv) One equity share ₹ 5 paid will be issued for every ₹ 100 of preference dividend which was in arrear for one year.
- (v) Share premium and all intangible assets to be written off.
- (vi) Both types of fixed assets to be reduced proportionately by the balance available.

The Balance Sheet of D. K. Manufacturing Company Limited as on 30th June, 2006 is as under:

Liabilities	₹	Assets	₹
Share Capital:			
12,000 8% Cumulative Preference Shares of ₹ 100 each.	12,00,000	Fixed Assets:	
		Goodwill	1,36,000
		Freehold Assets	8,80,000
		-Depreciation	<u>1,60,000</u>
			7,20,000
16,000 Equity Shares of ₹ 100 each		Machinery	17,60,000
	16,00,000	-Depreciation	3,20,000
			14,40,000
Share Premium	4,00,000	Patents	1,76,000
7% Debentures	4,00,000	Stock	1,20,000
Interest on Debentures:		Debtors	2,49,600
Accrued	24,000	Preliminary Expenses	2,58,400
Creditors	1,60,000	P&L A/c	6,84,000
	37,84,000		37,84,000

You are required to give journal entries and prepare Balance Sheet after capital reduction.

Solution

D. K. Manufacturing Co. Ltd.
Journal

Date	Particulars	L.F.	₹	₹
	Equity Share (₹ 100) Capital A/c	Dr.	16,00,000	
	To Equity Share (₹ 10) Capital A/c			1,60,000
	To Reconstruction A/c			14,40,000
	(Being reduction in capital by converting 16,000 equity shares of ₹ 100 each in 16,000 equity shares of ₹ 10 each)			
	10% Preference Shares (₹ 100) A/c	Dr.	12,00,000	
	To 10% Preference Shares (₹ 90) A/c			10,80,000
	To Reconstruction A/c			1,20,000
	(Being reduction in capital by converting 12,000 Preference Shares of ₹ 100 each in 12,000 Preference Shares of ₹ 90 each.)			

Notes	Interest on Debentures Accrued A/c	Dr.	24,000	
	To Reconstruction A/c			24,000
	(Being accrued interest on debentures utilized in capital reduction)			
	Reconstruction A/c	Dr.	9,600	
	To Preference Shares Dividend A/c			9,600
	(Being declaration of Preference Shares dividend out of Reconstruction Account)			
	Preference Shares Dividend A/c	Dr.	9,600	
	To Equity Share Capital A/c			9,600
	(Being payment of preference shares dividend by issue of equity shares of ₹ 5 each)			
	Share Premium A/c	Dr.	4,00,000	
	To Reconstruction A/c			4,00,000
	(Being written off of Share Premium Account)			
	Reconstruction A/c	Dr.	19,74,400	
	To Goodwill A/c			1,36,000
	To Patents A/c			1,76,000
	To Preliminary Expenses A/c			2,58,400
	To P & L A/c			6,84,000
	To Freehold Assets A/c			2,40,000
	To Machinery A/c			4,80,000
	(Being utilization of the amount of capital reduction in writing off the fictitious assets and accumulated losses)			

Working Note:

Reconstruction A/c			
Particulars	₹	Particulars	₹
To Preference Shares Dividend	9,600	By Equity Share Capital	14,40,000
To Goodwill	1,36,000	By Preference Share Capital	1,20,000
To Patent	1,76,000	By Int. on Debentures	24,000
To Preliminary Expenses	2,58,400	By Share Premium	4,00,000
To P & L A/c	6,84,000		
To Balance (transferred to Freehold Assets and Machinery in the ratio of 1:2)	7,20,000		
	19,84,000		19,84,000

**Balance Sheet of D K Manufacturing Co. Ltd
as on 30th June, 2006**

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
12,000 8% Preference		Freehold Assets	

Shares of ₹ 90 each fully paid up	10,80,000	(₹ 7,20,000 – ₹ 2,40,000)	4,80,000	Notes
16,000 Equity Shares of ₹ 10 each	1,60,000	Machinery		
1,920 Equity Shares of ₹ 5 each	9,600	(₹ 14,40,000 – ₹ 4,80,000)	9,60,000	
Secured Loans:		Current Assets:		
6% Debentures	4,00,000	Stock	1,20,000	
Current Liabilities:		Debtors	2,49,600	
Creditors	1,60,000			
	18,09,600		18,09,600	

Illustration 11

XYZ Industries Ltd. whose Balance Sheet as on 31st March, 2006 appears below, formulated a scheme of reconstruction, details of which follows and sacred approval of all concerned:

Balance Sheet of XYZ Industries Ltd.

Liabilities	₹	Assets	₹
Equity Shares Capital:		Fixed Assets	11,20,000
1,00,000 Shares of ₹		Patents & Copyrights	80,000
20 each, ₹ 10 paid up	10,00,000	Investment at cost	65,000
8% preference shares 8,000 shares of ₹ 100 each, ₹ 75 paid up	6,00,000	(Market value ₹ 55,000)	
Secured Loans:		Current Assets	8,49,000
9% Debentures	6,00,000	Profit and Loss A/c	4,28,000
+ Interest	<u>1,08,000</u>		
Bank Overdraft	1,50,000		
Sundry Creditors			
(including interest of ₹ 15,000 due to Bank)	84,000		
	25,42,000		25,42,000

Preference dividend is in arrear for one year.

- (a) Preference shareholders to give up their claims, inclusive of dividends, to the extent of 30% and desire to be paid off.
- (b) Debenture-holders agreed to give up their claims to interest in consideration of their rate of interest being enhanced to 10%.
- (c) Bank agrees to give up 50% of their interest outstanding in consideration of their being paid off at once.
- (d) Sundry creditors would like to grant a discount of 5% if they were to be paid off immediately.
- (e) Balances on Profit and Loss A/c, Patents and Copyrights and 25% of the total Sundry Debtors of ₹ 1,20,000 to be written off. Fixed assets to be written down by ₹ 14,000. Investments to reflect their market value.
- (f) To the extent not specifically stated, equity shareholders suffer on reduction of their rights.
- (g) Cost of reconstruction ₹ 3,350.

Notes

Pass journal entries in the books of the company, assuming that the scheme has been put through fully with the equity shareholders bringing in necessary cash to pay off the parties and to leave a working capital of ₹ 20,000.

Also draw the Balance Sheet after reconstruction.

Solution

Journal of XYZ Industries Ltd.

Date	Particulars	L.F.	₹	₹
2006 June, 30	8% Preference Share Capital A/c	Dr.	6,00,000	
	To Preference Shareholders' A/c			4,20,000
	To Reconstruction A/c			1,80,000
	(As per the scheme of reconstruction Preference shareholders agreed to take 70% of their claim)			
	Reconstruction A/c	Dr.	33,600	
	To Preference Shareholders' A/c			33,600
	(As per the scheme of reconstruction, 70% of preference dividend of ₹ 48,000 due to shareholders)			
	Preference Shareholders' A/c	Dr.	4,53,600	
	To Bank A/c			4,53,600
	(Being payment of preference shareholders as per scheme of reconstruction) 9% Debentures A/c	Dr.	6,00,000	
	Interest on Debentures A/c	Dr.	1,08,000	
	To 10% Debentures A/c			6,00,000
	To Reconstruction A/c			1,08,000
	(Being conversion of 9% debentures into 10% debentures and debenture-holders waive off their claim on interest)			
	Bank Overdraft A/c	Dr.	1,50,000	
	Sundry Creditors A/c	Dr.	15,000	
	To Bank A/c			1,57,500
	To Reconstruction A/c			7,500
	(Being payment of bank overdraft and 50% of interest accrued thereon)			
	Sundry Creditors A/c	Dr.	69,000	
	To Bank A/c			65,550
	To Reconstruction A/c			3,450
	(Being payment of sundry creditors at 5% discount as per scheme of reconstruction)			
	Reconstruction A/c	Dr.	5,65,350	
	To Profit and Loss A/c			4,28,000
	To Patents and Copyrights A/c			80,000
	To Investments A/c			10,000

To Sundry Debtors A/c		30,000		Notes
To Fixed Assets A/c		14,000		
To Bank Account (Cost of Reconstruction)		3,350		
(Being utilization of the amount of capital reconstruction in writing off the accumulated losses, fictitious assets and overvaluation of fixed assets)				
Equity Share Capital A/c	Dr.	3,00,000		
To Reconstruction A/c			3,00,000*	
(Being reduction in capital by reducing the value of equity shares by ₹ 3 each)				
Bank A/c	Dr.	7,00,000		
To Equity Share Capital A/c			7,00,000*	
(Being amount received on calls @ ₹ 7 per share on 1,00,000 shares)				

Note: The amount of reduction in equity capital of ₹ 3,00,000 is computed by the balance of reconstruction account and the amount received on equity shares of ₹ 7,00,000 is computed by the bank account.

Reconstruction A/c

Particulars	₹	Particulars	₹
To Pref. Dividend	33,600	By 8% Preference Capital	1,80,000
To P & L A/c	4,28,000	By Debenture-holders (Int.)	1,08,000
To Patents & Copyright	80,000	By Bank (Int.)	7,500
To Investments	10,000	By Sundry Creditors	3,450
To Sundry Debtors	30,000	By Balance (Equity shareholders)	3,00,000
To Fixed Assets	14,000		
To Bank (Exps.)	3,350		
	5,98,950		5,98,950

Bank A/c

Particulars	₹	Particulars	₹
		By Bank Overdraft including interest	1,57,500
To Equity Share Capital	7,00,000	By Preference Shareholders	4,53,600
		By Sundry Creditors	65,550
		By Reconstruction (Expenses)	3,350
		By Cash Retained for Working Capital.	20,000
	7,00,000		7,00,000

**Balance Sheet of XYZ Industries Ltd. (after Reconstruction)
(as on 30th June, 2006)**

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets	11,06,000
Issued & Subscribed		Investments	55,000

Notes		Current Assets:	
	Capital: 1,00,000 equity	Sundry Debtors	
	Shares of ₹ 20 each ₹ 14 paid up	(₹ 1,20,000 - ₹ 30,000)	90,000
		Other Current Assets	
	Secured Loans:	(₹ 8,49,000 - ₹ 1,20,000)	7,29,000
	10% Debentures	Bank balance	20,000
	20,00,000		20,00,000



Task

Discuss the two types of reconstruction of companies.

Self Assessment

Choose the correct answer from the following options:

15. In the case of internal reconstruction
 - (a) Only one company is liquidated.
 - (b) Two or more companies are liquidated.
 - (c) One or more companies are liquidated.
 - (d) No company is liquidated.
16. The amounts sacrificed by shareholders, debenture-holders and creditors are credited to:
 - (a) General reserve account
 - (b) Capital reserve account
 - (c) Statutory reserve account
 - (d) Capital reduction account
17. If there is any balance in the reconstruction account after writing off the accumulated losses, that is transferred to:
 - (a) Contingency account
 - (b) General reserve account
 - (c) Capital reserve account
 - (d) Statutory reserve account
18. For the reduction of capital, the permission is required from:
 - (a) Court
 - (b) Controller
 - (c) Central Government
 - (d) Company Law Board



Case Study **Decentralizing Mexico's Health Care Facilities**

Edward Echeverria

The earthquake of 1985 caused disproportionately heavy damage to Mexico's health care facilities because they were concentrated in the capital city center. The Ministry of Health's Centro Medico (3,000 beds) and the Central Hospitals of the Social Security Institute (IMSS, 2,600 beds) – which included important Mexico City hospitals – were virtually destroyed. Immediately after the quake, plans to rebuild these health care facilities followed the national strategy of decentralizing federal government functions to other states.

Health Care Reconstruction

The Government of Mexico (GOM) took an integrated approach to decentralization. Financing and investments were coordinated at the federal level, planning and programs at state and municipal levels. The World Bank had supported a policy of decentralization since 1985, helping the GOM in projects aimed at achieving spatial decentralization by developing alternative growth poles outside of Mexico City. The earthquake and reconstruction provided an opportunity to execute this policy.

IMSS, the second most important health care provider in Mexico, serves 40 percent of the population: workers covered by health insurance. In the last 20 years, IMSS has gained extensive experience in the design, construction, and operation of health care facilities throughout the country. IMSS's technical design office, which had a deconcentration plan, organized and managed the replacement of 2,000 beds destroyed by the earthquake. It proposed to provide about 1,200 beds in six second-level" zonal hospitals to serve an estimated 1.2 million people on the periphery of Metropolitan Mexico City. Each hospital would provide ambulatory and hospital services, including gynecology, obstetrics, pediatrics, general surgery, internal medicine, orthopedics, trauma, ENT (ear, nose and throat), and ophthalmology. These zonal hospitals would take care of 95 percent of the cases locally, eliminating the need to travel to the Centro Medico – which henceforth would provide specialized "third-level" services, with only 300 beds. Before the earthquake, about 40 percent of IMSS hospital beds were in the city center, more than two hours from most of the 7 to 10 million IMSS beneficiaries living in the metropolitan area.

The remaining 800 beds were to be built in five regional hospitals distributed countrywide according to need. Some were new nursing units and health care facilities added to existing hospitals so that the five regions – Ciudad Obregon, Vera Cruz, Leon, Puebla, and Merida – could become fully autonomous in providing all types of health care. This would reduce further the need to transfer second- and third-level-care patients for treatment in Mexico City. These actions would improve the level of health services and make them more accessible, at lower unit costs. Costs would continue to be recovered through user and employer fees in accordance with established practices.

Cost and Schedules

Four of the hospitals on the periphery of Metropolitan Mexico were built on schedule and operating in 1989. Problems in site acquisition delayed the other two. They had to be relocated, which meant revising site and building plans. Their completion was scheduled for September 1990. The five regional hospitals were completed, equipped, and operating in 1989.

Procuring medical equipment (especially the CAT scan) required a long lead time. Bids for more than US\$44 million worth of equipment were finally opened in December

Contd...

Notes

1987. Despite large price increases the project had to absorb, costs remained within the projected range of US\$50,000 to \$55,000 per bed for equipment and \$50,000 per bed for construction.

Questions

1. Discuss the case situation.
2. Elaborate the solution in detail.

Source: <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTURBANDEVELOPMENT/EXTDISMGMT/0,,contentMDK:20296276~menuPK:1242068~pagePK:148956~piPK:216618~theSitePK:341015~isCURL:Y,00.html>

5.2 Summary

- A company may be reconstructed in the event of acute financial problems.
- A company may be reconstructed in two ways- (a) External reconstruction, where a company is wound up and a new company is formed; (b) Internal reconstruction, where some changes are made in the capital structure of the company without liquidating the company.
- There are two aspects of 'External Reconstruction', one, winding up of an existing company and the other, rearrangement of the company's financial position. Such arrangement shall be approved by its shareholders and creditors and shall be sanctioned by the National Company Law Tribunal (NCLT).
- Internal reconstruction of a company becomes necessary in various situations like, to change the face value of the shares of the company, to write off accumulated losses etc.
- Internal reconstruction of a company can be carried out in two ways- (a) Alteration of share capital; and (b) Reduction in share capital.
- In internal reconstruction neither the existing company is liquidated, nor is a new company incorporated.
- It is a scheme in which efforts are made to bail out the company from losses and put it in profitable position. Internal reconstruction of a company is done through the reorganization of its share capital.
- It is a scheme of reorganization in which all interested parties in the capital structure volunteer to sacrifice. They are the company's shareholders, debenture holders, creditors etc.
- Under internal reconstruction, the accumulated trading losses and fictitious assets are written off against the sacrifice made by these interest holders in the form of reduction of paid up value of their interest.
- Accounting entries on alteration of share capital and reduction in share capital.

5.3 Keywords

Consolidation: Consolidation is generally regarded as a period of indecision, which ends when the price of the asset breaks beyond the restrictive barriers.

External Reconstruction: When the capital structure of a company is reorganized through the liquidation of the existing company and formation of the new company, it is called external reconstruction.

Internal Reconstruction: Internal reconstruction means the reorganization of the capital structure of a company without forming a new company and without liquidating the existing company.

Liquidation: To settle the affairs of (a business firm, for example) by determining the liabilities and applying the assets to their discharge.

Memorandum of Association: A document that regulates a company's external activities and must be drawn up on the formation of a registered or incorporated company. As the company's charter it (together with the company's articles of association) forms the company's constitution.

Reconstruction: Reconstruction of a company implies the reorganization of the financial structure of the company.

Reorganisation: The act of organising a business or an activity related to a business; the imposition of a new organisation; organising differently (often involving extensive and drastic changes).

5.4 Review Questions

1. What do you understand by reconstruction of a company?
2. What are the objectives of internal reconstruction of a company?
3. What are the differences between internal and external reconstruction?
4. What journal entry will be passed, if a company reduces its 25,000 equity shares of ₹ 100 each fully paid up to ₹ 10 each fully paid up?
5. Make the journal entry for the sub-division of 20,000 equity shares of ₹ 100 each fully paid into 10 fully paid equity shares of ₹ 10 each.
6. What do you mean by internal reconstruction? Briefly, explain the essential conditions for internal reconstruction.
7. What do you mean by Capital Reduction Account? Explain how and why, it is prepared.
8. Explain various legal provisions of the Companies Act, 1956 for the reduction of capital.
9. What is capital reduction scheme? Explain its objectives and legal formalities, if there is any.
10. Explain the term internal reconstruction. What entries are made in the books of the company in this connection?
11. What journal entries are made for following cases:
 - (a) Sub-division of shares
 - (b) Conversion of shares into stock.
 - (c) Consolidation of shares.
12. Make the journal entries for the following:
 - (a) A company, having 50,000 equity shares of ₹ 10, ₹ 7 per share called up decided to reduce ₹ 10 shares to ₹ 7 shares as fully paid by cancelling unpaid amount to ₹ 3 per share.
 - (b) A company resolved to convert 50,000 equity shares of ₹ 10 each fully paid into ₹ 5,00,000 stock on the basis of ₹ 100 of stock for every 10 fully paid shares of ₹ 10 each.
 - (c) A company, having 50,000 equity shares of ₹ 10 each fully paid, resolved to sub-divide its existing shares into shares of ₹ 5 each fully paid.

Notes

13. Ram Dev Co. Ltd. passed necessary resolution and obtained the sanction of the court for the reduction of its share capital by ₹ 5,00,000 for the purposes enumerated hereunder:

- (a) To write off the debit balance of Profit and Loss Account of ₹ 2,10,000.
- (b) To reduce the value of Plant and Machinery by ₹ 90,000 and Goodwill by ₹ 40,000.
- (c) To reduce the value of Investments to market value by writing off ₹ 80,00,000

The reduction was made by converting 50,000 preference shares of ₹ 20 each, fully paid to the same number of preference shares of ₹ 15 each fully paid, and by converting 50,000 equity shares of ₹ 20 each, ₹ 15 paid up into 50,000 equity shares of ₹ 10 each fully paid.

Show journal entries necessary in relation to the reduction of share capital.

14. On the reconstruction of a company, the following terms were agreed upon:

The shareholders to receive in lieu of their present holding (viz. 1,00,000 shares of ₹ 10 each) the following:

- (a) Fully paid equity shares to 2/5th of their holding.
- (b) 12% preference shares fully paid to the extent of 1/5th of the above new equity shares.
- (c) ₹ 1,20,000, 16% second debentures.

An issue of 1,00,000 15% first debentures were made and payment for the same fully received in cash.

The goodwill, which stood at ₹ 6,00,000, was written down to ₹ 3,00,000. The plant and machinery which stood at ₹ 2,00,000 was written down to ₹ 1,50,000. The freehold premises which stood at ₹ 3,00,000 were written down to ₹ 2,50,000.

Make the journal entries in the books of the company based on the above reconstruction.

15. The Balance Sheet of Danish Co. Ltd. as on 30th June, 2006 is as follows:

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
Issued Share Capital 50,000 equity shares of ₹ 10 each fully paid up.	5,00,000	Goodwill	50,000
50,000 7% preference shares of ₹ 10 each fully paid up.	5,00,000	Other fixed assets	4,50,000
		Current Assets:	
		Stock	1,25,000
		Debtors	1,50,000
		Miscellaneous Expenditure:	
		P&L A/c	2,25,000
	10,00,000		10,00,000

It was resolved that equity shares of ₹ 10 each to be reduced to fully paid shares of ₹ 6 each and 7% preference shares of ₹ 10 each be reduced to 7½% fully paid preference shares of ₹ 7 each. Number of shares in each case remained the same. It is further resolved that the amount so available be used for writing off the debit balances of the profit and loss account and goodwill account completely and other fixed assets as far as possible. There were arrears of preference dividend for the last three years and it was decided that they be cancelled.

You are required to make journal entries and prepare the revised Balance Sheet.

Answers: Self Assessment

Notes

1. False
2. True
3. True
4. False
5. True
6. True
7. True
8. The Court
9. No Journal Entry
10. Accumulated Losses
11. Reduces
12. Unsuccessful Companies
13. Thirty
14. Paid Up
15. (d) No company is liquidated
16. (d) Capital reduction account
17. (c) Capital reserve account
18. (a) Court

5.5 Further Readings



Books

Dam, B. B. & Gautam, H. C. *Corporate Accounting*, Capital Publishing.

Das, K. R. *Corporate Accounting*, LBS Publication.

Dr. Sehgal, A. & Dr. Sehgal, D. *Advanced Accounting & Corporate Accounting*. Taxman.



Online links

http://www.kkhsou.in/main/EVidya2/commerce/internal_reconstruction.html

<http://www.topcafirms.com/index.php/white-paper/72-asset-reconstruction-companies-an-overview>

<http://www.livemint.com/Opinion/dNMY05fLnJwWQuacrsAQEN/Reconstructing-asset-reconstruction-firms.html>

<http://www.svtuition.org/2010/06/absorption-and-reconstruction.html>

Unit 6: External Reconstruction of Companies

CONTENTS

Objectives

Introduction

6.1 Concept of External Reconstruction

6.1.1 Legal Position as Regards External Reconstruction

6.1.2 Differences between Amalgamation and External Reconstruction

6.1.3 Differences between Absorption and External Reconstruction

6.1.4 Features of the Amalgamation, Absorption and External Reconstruction

6.2 Accounting for External Reconstruction

6.2.1 Purchase Consideration

6.2.2 Discharge of Purchase Consideration

6.3 Summary

6.4 Keywords

6.5 Review Questions

6.6 Further Readings

Objectives

After studying this unit, you will be able to:

- Define external reconstruction of companies
- Explain the accounting for external reconstruction of companies
- Describe the concept of purchase consideration and discharge of consideration

Introduction

In the previous unit, we have discussed about the internal reconstruction of companies in detail. Further in this unit we will study the external reconstruction of companies with the help of illustrated examples.

Reorganisation or rearrangement of the capital structure of a business unit is called reconstruction of the company. The objectives of the reconstruction of a company are not the same as those of business combination. In the case of severe financial problems as overcapitalisation, heavy losses and over valuation of fixed assets, reconstruction of the financial structure becomes necessary. Reconstruction of the financial structures of the company is expressed to alter the rights and interest of the shareholders, debenture-holders and creditors or outsider's liability. On the reconstruction of the company it may or may not go into liquidation.

6.1 Concept of External Reconstruction

Reconstruction refers to certain arrangements made by financially unsound companies. The reconstruction arrangement made by a company, to come out of its financial difficulties, may be external or internal. External reconstruction refers to closing/liquidating the company and

starting again a new or a fresh. That is technically, a new company will be floated or formed to take over the existing company. Internal reconstruction refers to making internal arrangements for overcoming financial difficulties.



Notes Reconstruction of the financial structures of the company is expressed to alter the rights and interest of the shareholders, debenture-holders and creditors or outsider's liability.

We have already discussed the Internal Reconstruction of Companies in previous unit. Now, we will elaborate the External reconstruction accounting treatment in more detail. In the case of external reconstruction, an existing company goes into liquidation and a new company is formed in order to buy its business. Thus, shareholders of the old existing company become the shareholders of the newly formed company.

From the point of view of an accountant, external reconstruction is similar to amalgamation in the nature of purchase; the books of the transferee company are closed and in the books of the transferee company, the purchase of the business is recorded. But otherwise external reconstruction and amalgamation differs as follows:

- (i) In external reconstruction, only one company is involved whereas in amalgamation, there are at least two existing companies which amalgamate.
- (ii) In external reconstruction, a new company is certainly formed whereas in amalgamation a new company may be formed or in the alternative one of the existing companies may take over the other amalgamating company or companies and no new company may be formed.
- (iii) The objective of the external reconstruction is to reorganise the financial structure of the company, on the other hand, the objective of the amalgamation is to cut competition and reap the economies of larger scale.

6.1.1 Legal Position as Regards External Reconstruction

Sec. 494 of the Companies Act permits the liquidator of a company to transfer the whole or any part of the company's business or property to another company and receive from the transferee company for distribution among the share holders of the company under liquidation. The liquidator must obtain the sanction of the company by a special resolution. Any sale of arrangement in pursuance of this section is binding on the members of the transferor company.

But a shareholder who has not voted for the special resolution may, within seven days of the resolution, serve a notice on the liquidator expressing his dissent and requiring the liquidator either,

- (a) To abstain from carrying the resolution into effect, or
- (b) To purchase his interest at a price to be determined by agreement or by arbitration.



Did u know? In external reconstruction, only one company is involved whereas in amalgamation.

Notes

6.1.2 Differences between Amalgamation and External Reconstruction

The points of differences are:

1. Amalgamation of companies involves liquidation of two or more companies, while external reconstruction involves liquidation of only one company,
2. Amalgamation of companies results in combination of companies, but external reconstruction does not result in any such combination.

6.1.3 Differences between Absorption and External Reconstruction

The points of differences are:

1. Absorption of companies does not involve formation of a new company; however, external reconstruction involves formation of a new company,
2. Absorption of companies results in liquidation of one or more companies while external reconstruction results in liquidation of only one company.
3. Absorption of companies involves combination of companies, whereas external reconstruction does not involve any combination.

6.1.4 Features of the Amalgamation, Absorption and External Reconstruction

The features of amalgamation, absorption and external reconstruction are shown in the following table:

Basis of Difference	Amalgamation	Absorption	External Reconstruction
Liquidation	Two or more companies go into liquidation.	One or more companies go into liquidation.	One and only one company goes into liquidation.
Formation of New Company	A new company is formed to take over the business of the wound up company.	Only the existing company acquires the business of the wound up company.	A new company is formed to acquire the business of the liquidated company.
Shareholders	The shareholders of the new company are those who were in the old company.	There will be the shareholders of the purchasing company only.	The shareholders of the new company are those who were in the old company.
Level of Companies	The level of the amalgamating companies is generally same.	The economic status of the purchasing company is, enhanced in comparison to that of the liquidating company.	The economic condition of the old company is found to be unsound, and a new company is formed to rectify the situation.

Self Assessment

State whether the following statements are true or false:

1. External reconstruction of a company means the reduction of its share capital.
2. Absorption of companies results in liquidation of one or more companies.

3. External reconstruction involves any combination.
4. The objective of the external reconstruction is to reorganise the financial structure of the company.
5. Shareholders of the old existing company become the shareholders of the newly formed company.
6. The objectives of the reconstruction of a company are not the same as those of business combination.
7. On the reconstruction of the company it may or may not go into liquidation.



Caselet

Hitachi's Difficulty in Finding Buyers

In November 1998, Hitachi unveiled a three year-plan (fiscal 1999 to 2002), "i.e. HITACHI Plan." The plan set the growth vision of becoming the "best solution partner". Under the plan, Hitachi split its Consumer Products Group and Industrial Components & Equipment Group into two new subsidiaries in April 2002.

They were Hitachi Home & Life Solutions and Hitachi Industrial Equipment Systems. Hitachi also completed splits of businesses, including the display, printer, telecommunications equipment, and substation and system LSI businesses. However, none of the split businesses have been divested.

In January 2003, Hitachi launched a new plan (fiscal 2003 to 2005), "i.e. HITACHI Plan II", calling for a thorough restructuring of its business portfolio. In the early phase of the new plan, Hitachi will exit underperforming businesses altogether amounting to 20% of its 8 trillion yen consolidated sales, while focusing on two business domains: "new era lifeline support solutions" and "global products incorporating advanced technologies". It has been publicly reported that approximately 30 money-losing businesses have been listed for divestiture. However, since the plan was announced, no divestitures have been made. The greatest challenge confronting Hitachi seems to be finding suitable buyers for underperforming businesses.

Source: http://www.abeam.com/research_reports/eng/RR057_E (Corporate%20Restructuring).pdf

6.2 Accounting for External Reconstruction

The accounting procedure in case of external reconstruction is the same as in case of amalgamation or absorption in the nature of purchase. However, there are no different kinds in this case, unlike in case of amalgamation or absorption, which were of two kinds viz, in nature of merger and in the nature of purchase. The steps in accounting for external reconstruction are outlined below:

1. Ascertainment of discharge of purchase consideration
2. Closing the books of vendor company (Vendor company is the company which is being liquidated and taken over) or transferor company
3. Passing opening entries in the books of purchasing company (i.e., Transferee Company) or the new company floated



Notes

In case of amalgamation in the nature of merger, only share capital must be transferred to equity shareholders account and all other items belonging to shareholders must be transferred to realisation account.

Notes

6.2.1 Purchase Consideration

Purchase Consideration refers to the consideration payable by the purchasing company to the vendor company for taking over the assets and liabilities of Vendor Company.

Para 3(g) of Accounting Standard - 14 defines the term purchase consideration as the "aggregate of the shares and other securities issued and the payment made in the form of such or other assets by the transferee company to the shareholders of the transferor company". Although, purchase consideration refers to total payment made by purchasing company to the shareholders of Vendor Company, its calculation could be in different methods, as explained below:

- (a) Lump sum method
- (b) Net payments method
- (c) Net Assets Method
- (d) Other basis for purchase consideration

We have discussed the above said methods in unit 4.

6.2.2 Discharge of Purchase Consideration

Discharge of purchase consideration refers to the form in which, the purchase consideration is discharged by the purchasing company. Under net payments method calculation and discharge of purchase consideration would be one and the same. Under net Assets Method and Lump Sum Method based on the information in the problem the mode of discharge must be ascertained. When the problem is silent about the mode of discharge of purchase consideration, it must be assumed that purchase consideration is discharged by issue of equity shares of purchasing company.



Notes In case of amalgamation in the nature of purchase, all items relating to equity shareholders must be transferred to the equity shareholders account other than statutory reserves, which must be transferred to realisation account.

Self Assessment

Fill in the blanks:

- 8. Under and Lump Sum Method based on the information in the problem the mode of discharge must be ascertained.
- 9. Purchase consideration refers to made by purchasing company to the shareholders of Vendor Company.
- 10. The accounting procedure in case of is the same as in case of amalgamation or absorption in the nature of purchase.
- 11. Discharge of purchase consideration refers to the form in which, the purchase consideration is discharged by the company.
- 12. Under method calculation and discharge of purchase consideration would be one and the same.



Caution Under net Assets Method and Lump Sum Method based on the information in the problem the mode of discharge must be ascertained.

Illustration 1

On 1st April, 2010 the Balance Sheet of Raman & Company Limited was as under:

Liabilities	₹	Assets	₹
Authorised & Issued Capital 12,000, 7% Cumulative Preference shares of ₹ 25 each fully paid	3, 00,000	Goodwill	4, 00,000
32,000 Equity shares of ₹ 50 each fully paid	16, 00,000	Fixed Assets	10, 00,000
6% Debentures	2, 00,000	Cash	40,000
Creditors	1, 00,000	Profit and Loss A/c	7, 60,000
	22, 00,000		22, 00,000

The preference dividends were in arrears for two years. A scheme of reconstruction agreed upon was as under: (1) A new company was to be formed, called Raman Co. (2011) Limited with an authorised capital of ₹ 20,00,000 all in equity shares of ₹ 100 cash, (2) One equity share of ₹ 100 each fully paid in the new company to be issued in exchange of 3 preference shares in the old company, (3) One equity share of ₹ 100 each fully paid in the new company to be exchanged for 4 equity shares in the old company, (4) Arrears of preference dividend to be cancelled, (5) Debenture-holders to receive 2,000 equity shares in the new company as fully paid, (6) Creditors to be taken over by the new company and immediately paid off, (7) The new company to issue remaining equity shares for public subscribed, (8) The new company to take over old company's assets subject to revolution of fixed assets at ₹ 10,60,000.

Prepare the necessary ledger accounts in the books of Raman & Company Limited and open the books of the new company by means of journal entries, assuming that the public subscription was fully responded.

Solution

Calculation of Purchase Consideration by Payment Method

One Equity Share of ₹ 100 each for 3 Preference shares in the old company $(12,000 \times 1/3) = 4,000 \times 100$	₹ 4,00,000
One Equity Shares of ₹ 100 each for 4 Equity shares in the old company $(32,000 \times 1/4) = 8,000 \times 100$	₹ 8,00,000
Purchase Consideration	₹ 12, 00,000

Ledger of Raman & Co. Ltd. Realisation Account

Particulars	₹	Particulars	₹
To Goodwill A/c	4, 00,000	By Creditors A/c	1, 00,000
To Fixed Assets A/c	10, 00,000	By 6% Debentures A/c	2, 00,000
To Cash A/c	40,000	By Raman & Co. (2011) Ltd. A/c	12, 00,000

Notes

To 7% Preference Shareholders A/c (Excess paid)	1, 00,000	By Equity Shareholders A/c	40,000
	15, 40,000		15, 40,000

7% Preference Shareholders' A/c

Particulars	₹	Particulars	₹
To Equity Shares in Raman & Co. (2011) Ltd.	4, 00,000	By 7% Preference Shares Capital A/c	3, 00,000
		By Realisation A/c	1, 00,000
	4, 00,000		4, 00,000

Equity Shareholders' A/c

Particulars	₹	Particulars	₹
To Realisation A/c	40,000	By Equity Share Capital A/c	16, 00,000
To P&L A/c	7, 60,000		
To Equity Shares in Raman & Co. (2011) Ltd.	8, 00,000		
	16, 00,000		16, 00,000

Journal of Raman & Co. (2011) Ltd.

Date	Particulars	L.F.	₹	₹
	Business Purchase A/c	Dr.	12,00,000	
	To Liquidator of Raman & Co. Ltd.			12,00,000
	(Being purchase price due to the liquidator of Raman & Co. Ltd.)			
	Fixed Assets A/c	Dr.	10,60,000	
	Cash A/c	Dr.	40,000	
	Goodwill A/c	Dr.	4,00,000	
	To Creditors A/c			1,00,000
	To 7% Debentures A/c			2,00,000
	To Business Purchase A/c			12,00,000
	(Being above-mentioned assets and liabilities taken over and balance transferred to the goodwill account)			
	Liquidators of Raman & Co Ltd.	Dr.	12,00,000	
	To Equity Share Capital A/c			12,00,000
	(Being purchase consideration paid off into shares)			
	7% Debentures A/c	Dr.	2,00,000	
	To Equity Share Capital A/c			2,00,000
	(Being debentures paid off by the issue of shares)			
	Bank A/c	Dr.	6,00,000	
	To Equity Shares App. & Allot. A/c			6,00,000
	(Being fresh issue of equity shares)			

Equity Shares App. & Allotment A/c	Dr.	6,00,000		Notes
To Equity Shares Capital A/c			6,00,000	
(Being transfer of application and allotment money into Capital A/c)				
Creditors A/c	Dr.	1,00,000		
To Bank A/c			1,00,000	
(Being payment of creditors)				

Illustration 2

The Balance Sheet of Kapoor & Co. Ltd. was as follows:

As on 31 st December, 2010			
Liabilities	₹	Assets	₹
12,500, 7% Preference shares of ₹ 20 each fully paid.	2, 50,000	Patents	1, 22,500
15,000 equity shares of ₹ 20 each fully paid	3, 00,000	Buildings	3, 00,000
8% Debentures	50,000	Cash	2,500
+ Interest	<u>10,000</u>	Debtors	60,000
Creditors	40,000	Stock	90,000
		Profit & Loss A/c	75,000
	6, 50,000		6, 50,000

The following scheme was passed and sanctioned: (i) Shastri Company Limited to be formed to take over the business, (ii) One share of ₹ 10 fully paid in the new company to be issued for every three equity shares in the old company, (iii) Three shares of ₹ 10 fully paid in the new company to be issued for every five preference shares in the old company, (iv) Debenture-holders to be paid in full by Shastri Ltd., (v) The creditors to receive 8% of the sums due to them in fully paid shares of ₹ 10 in the new company in full settlement, (vi) Patents and Profits and Loss Account to be written off, (vii) Arrears of preference dividend to be cleared by issuing one ₹ 10 fully paid equity share in Shastri Ltd. for every twenty held, and (viii) Any balance available by the scheme to be used in writing down buildings.

Give opening journal entries and prepare the initial Balance Sheet of Shastri Ltd.

Solution

Calculation of Purchase Consideration by Payment Method

	₹
(i) One share of ₹ 10 for every 3 equity shares in the old company (15,000×1/3×10)	50,000
(ii) Three shares of ₹ 10 each for every five preference shares in the old company (12,500×3/5×10)	75,000
(iii) Shares for creditors (40,000×80/100)	32,000
(iv) One equity share for every twenty shares to clear the preference shares (12,500×1/20)×10	6,250

Notes	Purchase Consideration	1,63,250
	Total number of shares = 1,63,250/10=16,325	

Journal of Shastri Limited

Date	Particulars	L.F.	₹	₹
2010				
Dec 31	Business Purchase A/c	Dr.	1,63,250	
	To Liquidators of Kapoor Ltd.			1,63,250
	(Being purchase consideration payable to the liquidators of Kapoor Ltd.)			
	Cash A/c	Dr.	2,500	
	Debtors A/c	Dr.	60,000	
	Stock A/c	Dr.	90,000	
	Buildings A/c	Dr.	70,750	
	To 8% Debentures A/c			50,000
	To Debenture Interest Payable			10,000
	To Business Purchase A/c			1,63,250
	(Being above-mentioned assets and liabilities taken over and the balance adjusted into Buildings A/c)			
	Liquidators of Kapoor Ltd.	Dr.	1,63,250	
	To Equity Shares Capital A/c			1,63,250
	(Being purchase price paid off by the issue of equity shares)			

**Balance Sheet of Shastri Ltd.
as on 31st December, 2010**

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
Authorised, Issued Subscribed & Paid up		Buildings	70,750
Capital (16,325 equity Shares of ₹ 10 each Fully paid)	1,63,250	Current Assets:	
Reserve & Surplus:	-	Stock	90,000
Secured Loans	-	Debtors	60,000
8% Debentures	50,000	Cash	2,500
Debenture Interest Payable	10,000		
	2,23,250		2,23,250

Illustration 3

Abhijeet Ltd. has just recovered from a great financial difficulty. Its Balance Sheet as on December 31, 2010 was as follows:

Liabilities	₹	Assets	₹
Equity Shares Capital	12,00,000	Buildings	8,00,000
10% Preference Shares Capital	8,00,000	Plant & Machinery	4,00,000

Creditors	3,00,000	Current Assets	4,00,000	
		Profit and Loss A/c	7,00,000	
	23,00,000		23,00,000	

Abhijeet (2011) Ltd. is formed to take over buildings at ₹ 6,00,000. Plant & Machinery ₹ 2,80,000 and Stock ₹ 1,20,000. Preference shareholders are to be settled in full by allotment of the new preference shares.

Purchase consideration is to be satisfied by 11% preference shares (₹ 100) and equity shares (₹ 10) of Abhijeet (2011) Ltd. in the ratio of 3:2 sundry debtors realised. ₹ 3,00,000 and ₹ 2,20,000 was paid to creditors in full settlement. There is no other current asset except stock and debtors. The cost of winding up amounted to ₹ 20,000.

Show ledger accounts in the books of Abhijeet Ltd. and journal entries in the books of Abhijeet (2011) Ltd. Also, draft Balance Sheet of Abhijeet (2011) Ltd.

Solution

Calculation of Purchase Consideration

	₹
(A) Payment for Assets-	
Buildings	6,00,000
Plant & Machinery	2,80,000
Stock	1,20,000
Total Assets taken	10,00,000
Purchase consideration will be discharged by the issue of Preference shares and equity shares in the ratio of 3:2	
11% Preference shares	6,00,000
Equity shares	4,00,000
(B) Payment of Preference shares in Abhijeet Ltd. by the issue of new Preference shares	8,00,000
Total Purchase Consideration	18,00,000

**Ledger of Abhijeet Ltd.
Realisation A/c**

Particulars	₹	Particulars	₹
To Buildings	8,00,000	By Creditors	3,00,000
To Plant & Machinery	4,00,000	By Bank (Debtors Realised)	3,00,000
To Current Assets	4,00,000		
To Bank (Payment to creditors)	2,20,000	By Abhijeet (2011) Ltd. (purchase consideration)	18,00,000
To Bank A/c (payment of liquidation expenses)	20,000		
To Equity Shareholders' A/c	5,60,000		
	24,00,000		24,00,000

Notes

Equity Shareholders' A/c				
Particulars	₹	Particulars	₹	
To Profit and Loss A/c	7,00,000	By Equity Share Capital	12,00,000	
To Equity shares in Abhijeet (2011) Ltd.	4,00,000	By Realisation A/c (profit on realisation)	5,60,000	
To 11% Preference shares In Abhijeet (2011) Ltd.	6,00,000			
To Bank A/c	60,000			
	17,60,000		17,60,000	
10% Preference Shareholders' A/c				
Particulars	₹	Particulars	₹	
To Preference Shares in Abhijeet (2011) Ltd.	8,00,000	By 10% Preference share Capital A/c	8,00,000	
	8,00,000		8,00,000	
Abhijeet (2011) Ltd.'s A/c				
Particulars	₹	Particulars	₹	
To Realisation A/c (Purchase Consideration)	18,00,000	By Equity shares in Abhijeet (2011) Ltd.	4,00,000	
		By 11% Pref. Share in Abhijeet (2011) Ltd. (8,00,000+6,00,000)	14,00,000	
	18,00,000		18,00,000	
Bank A/c				
Particulars	₹	Particulars	₹	
To Realisation A/c (debtors realisation)	3,00,000	By Realisation A/c (payment of creditors)	2,20,000	
		By Realisation A/c (Liquidation Expenses)	20,000	
		By Equity Shareholders A/c	60,000	
	3,00,000		3,00,000	
Journal of Abhijeet (2011) Ltd.				
Date	Particulars	L.F.	₹	₹
	Business Purchase A/c	Dr.	18,00,000	
	To Liquidators of Abhijeet Ltd.			18,00,000
	(Being purchase price due to the liquidators of Abhijeet Ltd.)			
	Buildings A/c	Dr.	6,00,000	
	Plant & Machinery A/c	Dr.	2,80,000	
	Stock A/c	Dr.	1,20,000	

Goodwill A/c	Dr.	8,00,000	Notes
To Business Purchase A/c		18,00,000	
(Being various assets taken over and balance transferred to Goodwill Account)			
Liquidators of Abhijeet Ltd.	Dr.	18,00,000	
To Equity Share Capital A/c		4,00,000	
To 11% Preference Share Capital A/c.		14,00,000	
(Being purchase consideration paid off)			

**Balance Sheet of Abhijeet (2011) Ltd.
as on 31st December, 2010**

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
40,000 Equity shares of ₹ 10 each	4,00,000	Goodwill	8,00,000
14,000, 11% Preference Shares of ₹ 100 Each	14,00,000	Building	6,00,000
		Plant & Machinery	2,80,000
		Current Assets:	
		Stock	1,20,000
	18,00,000		18,00,000

Illustration 4 (Fraction of Shares & Treatment of Liquidation Expenses)

The following was the Balance Sheet of Kavita Ltd. as on 31st March 2011:

Liabilities	₹	Assets	₹
Share Capital:		Intangible Assets	6,50,000
Equity shares of ₹ 10 each.	10,00,000	Fixed Assets	15,00,000
General Reserve	5,00,000	Current Assets	10,00,000
Capital Redemption:		Unwritten off Expenses	2,00,000
Reserve Account	5,00,000		
Development Rebate Reserve	2,00,000		
Debenture Redemption A/c	3,00,000		
Creditors	5,00,000		
Outstanding bills	3,50,000		
	33,50,000		33,50,000

The purchasing company, Sunita Ltd. took away assets except debtors of ₹ 1,50,000. These were later on collected by the Kavita Ltd. and could realise only ₹ 1,40,000. Sunita Ltd. also agreed to pay trade liabilities. The purchase consideration is the exchange of three shares of ₹ 20 each in Sunita Ltd. for two shares in Kavita Ltd. fractions total 75 shares which Sunita Ltd. agreed to pay in cash. The cost of liquidation amounted to ₹ 2,500 which the purchasing company agreed to bear. You are required to give journal entries in the books of Kavita Ltd. and assume shares of Sunita Ltd. are quoted in the market at ₹ 52.

What entries will be made if: (i) Liquidation expenses are borne by Kavita Ltd., (ii) Liquidation expenses are borne by Sunita Ltd. but the payment is made through Sunita Ltd.

Notes

Solution

Calculation of Purchase Consideration by Net Payment Method

Total No. of shares to be issued by Sunita Ltd. = $(1,00,000 \times 3/2)$ - Fractions of shares

= $1,50,000 - 75 = 1,49,925$ shares

Face value of 1,49,925 shares @ ₹ 20 = ₹ 29,98,500

+Payment in cash for 75 shares @ ₹ 52 = ₹ 3,900

Total Purchase Consideration = 30,02,400

Journal of Kavita Ltd. (Transferor Company)

Date	Particulars	L.F.	₹	₹
2011				
March 31	Realisation A/c	Dr.	30,00,000	
	To Intangible Assets A/c			6,50,000
	To Fixed Assets A/c			15,00,000
	To Current Assets A/c			8,50,000
	(Being assets taken over by Sunita Ltd. transferred to Realisation A/c)			
	Creditors A/c	Dr.	5,00,000	
	To Realisation A/c			5,00,000
	(Being trade liabilities taken over by Sunita Ltd. transferred to Realisation A/c)			
	Sunita Limited	Dr.	30,02,400	
	To Realisation A/c			30,02,400
	(Being purchase consideration receivable from Sunita Ltd.)			
	Equity Share Capital A/c	Dr.	10,00,000	
	General Reserve A/c	Dr.	5,00,000	
	Capital Red. Reserve A/c	Dr.	5,00,000	
	Development Rebate Reserve A/c	Dr.	2,00,000	
	Debentures Redemption A/c	Dr.	3,00,000	
	To Equity Shareholders' A/c			25,00,000
	(Being capital and various reserves transferred to Equity Shareholders' A/c)			
	Equity Shareholders' A/c	Dr.	2,00,000	
	To Unwritten off Expenses A/c			2,00,000
	(Being unwritten off expenses transferred to Equity Shareholders' A/c)			
	Cash A/c	Dr.	1,40,000	
	Realisation A/c	Dr.	10,000	
	To Current Assets (Debtors) A/c			1,50,000

			Notes
(Being amount realised from debtors and loss on realisation transferred to Realisation A/c)			
Cash A/c	Dr.	2,06,128	
To Shares of Sunita Ltd.			79,280
To Profit on sale of shares of Sunita Ltd.			1,26,848
(Being 3,964 shares sold at profit)			
Outstanding Bills A/c	Dr.	3,50,000	
To Cash A/c			3,50,000
(Being payment of non-trade liabilities)			
Realisation A/c	Dr.	4,92,400	
Profit on sale of shares of Sunita Ltd.	Dr.	1,26,848	
To Equity Shareholders' A/c			6, 19,248
(Being profit on sale of shares and Realisation transferred to Equity Shareholders' A/c)			
Cash A/c	Dr.	3,900	
Shares in Sunita Ltd.	Dr.	29, 98,500	
To Sunita Ltd.			30, 02,400
(Being purchase consideration received partly in cash and partly in shares)			
Equity Shareholders' A/c	Dr.	29, 19,248	
To Cash A/c			28
To Shares in Sunita Ltd.			29, 19,220
(Being final payment made to the equity shareholders in 1, 45,961 shares of ₹ 20 and in cash of ₹ 28)			

Working Note:

- (1) It is assumed that debtors are included in the current assets and loss on realisation of debtors is transferred to realisation, which will be distributed among shareholders.
- (2) Debtors can be realised through Realisation Account.
- (3) Outstanding bills are not trade liabilities. Therefore, not taken over by the Sunita Ltd.
- (4) Outstanding bills, first, will be paid from the amount realised from debtors and cash received from Sunita Ltd. then, the rest will be paid from the sales proceeds of shares in Sunita Ltd. by Kavita Ltd. Required sales proceeds of shares in Sunita Ltd. will be as follows:

	₹	₹
Outstanding Bills		3,50,000
Less: Debtors Realisation	1,40,000	
Cash received from Sunita Ltd.	<u>3,900</u>	<u>1,43,900</u>
Amount to be collected from the sale of shares as the market price of one share is ₹ 52		2,06,100

To get ₹ 2,06,100, the number of shares to be sold = $1/52 \times 2,06,100 = 3,96,34 = 3,964$ shares

Notes	(5)	Profit on sale of 3,964 shares	₹
		Sales of 3,964 @ ₹ 52	2,06,128
		-Value of shares @ ₹ 20	79,280
		Profit on sale of shares	1,26,848
	(6)	Profit on Realisation	

Realisation A/c

Particulars	₹	Particulars	₹
To Intangible Assets	6,50,000	By Creditors	5,00,000
To Fixed Assets	15,00,000	By Sunita Ltd.	30,02,400
To Current Assets	8,50,000		
To Current Assets (Debtors Realisation loss)	10,000		
To Equity shareholders	4,92,400		
	35,02,400		35,02,400

(7) Cash A/c

Particulars	₹	Particulars	₹
To Current Assets (Debtors)	1,40,000	By Outstanding Bills	3,50,000
To Shares in Sunita Ltd.	2,06,128	By Equity Shareholders	28
To Sunita Ltd.	3,900		
	3,50,028		3,50,028

(8) Equity shareholders' A/c

Particulars	₹	Particulars	₹
To Unwritten off Expenses.	2,00,000	By Equity Share Capital	10,00,000
To Cash	28	By General Reserve	5,00,000
To Shares in Sunita Ltd.	29,19,220	By Capital Reserve	5,00,000
		By Development Rebate Reserve	2,00,000
		By Debenture Redemption A/c	3,00,000
		By Realisation A/c	4,92,400
		By Profit on shares	1,26,848
	31,19,248		31,19,248

In the Books of Kavita Ltd.

Treatment of liquidation expenses of Kavita Ltd.

- (i) When liquidation expenses are borne by Kavita Ltd.

Realisation A/c	Dr.	2,500	
To Cash A/c			2,500

- (ii) When liquidation expenses are borne by Sunita Ltd.-

- (a) If these are included in purchase consideration

Realisation A/c	Dr.	2,500	
To Cash A/c			2,500

(b) If these are paid by Sunita Ltd. through Kavita Ltd.

Notes

Sunita Ltd.	Dr.	2,500	
To Cash A/c			2,500
Cash A/c	Dr.	2,500	
To Sunita A/c			2,500



Task

Discuss the concept of purchase consideration.



Case Study

Sell-offs

A sell-off is the sale of a business or subsidiary of the parent company to another firm outside the group, generally resulting in a payment of cash to the parent. In theory, sell-offs are the least complex of restructuring structures.

Acquirers can usually be divided into two groups: strategic buyers and financial buyers. Strategic buyers are those who are interested in acquiring a business for strategic purposes (e.g., increasing market share, creating economies of scale or exploiting synergies).

Strategic buyers are typically companies engaged in the same business as, and therefore competing with, the business or company under consideration. In contrast, financial buyers are those who are interested in acquiring a business to secure a financial return in the short-to medium-term before selling the business or otherwise exiting the investment. Financial buyers are likely to be buyout firms.

Buyout firms raise funds in order to be able to take equity stakes in companies through funding and assisting with management buyouts (MBOs) and leveraged buyouts (LBOs). Buyout firms generally focus on established companies with potential to grow after transformation. Non-core divisions and subsidiaries of large public companies are their typical targets. For example, as part of its restructuring efforts, Nissan Motor sold its shares in at least 24 subsidiaries from 2000 to 2002. 17 were sold to strategic buyers and the remaining 7 were sold to buyout firms (Figure 1 below). It was expected that, like Nissan, large companies would sell off non-core divisions and subsidiaries as they pursued restructuring initiatives. Fuelled by expectations, the number of new buyout firms rose significantly. However, some buyout firms have been unable to find places to invest, as evidenced by the withdrawal of some such firms (e.g., 3i) from Japan.

Target Company	Buyout Firms	Nissan's Stake	Form	Date
Vantec	3i Group	66.7%	MBO	Jan.'01
Niles Parts	Ripplewood Holdings	40.0%	Buyout	Apr.'01
Nissan Transport	AIG Japan Partners; Tokyo Marine Capital	100.0%	MBO	May'01
Nissan Altia	Fuji Management	86.9%	MBO	Oct.'01
IID Inc.	NIF Ventures; Fuji Capital Markets (now Mizuho Capital); New Business Investment	100.0%	MBO	Nov.'01
KIRIU	Unison Capital	36.7%	MBO	Dec.'01
Rhythm	J.P. Morgan Partners	51.0%	MBO	Aug.'02

Source: Abeam Research

Figure 1: Nissan's Sell-offs to Subsidiaries to Buyout Firms

Contd...

Notes

Due to the pressure for banks to dispose of non-performing loans, it is expected that turnaround deals will increase dramatically over years to come. Consequently, the number of corporate turnaround funds has increased sharply and is expected to increase even further. For buyout firms, corporate turnarounds provide an important source of investment opportunities. Accordingly, most buyout firms have been expanding their activities into corporate turnarounds.

There are several types of buyout firms in Japan (Figure 2 below):

- Venture capital-affiliated buyout firms (e.g., JAFCO's Structured Investment Group);
- Domestic independent buyout firms (e.g., Advantage Partners, Unison Capital, MKS Partners);
- Foreign independent buyout firms (e.g., Ripplewood Holdings, Carlyle Japan Partners);
- domestic principal investment firms (e.g., Nomura Principal Finance, Daiwa Securities SMBC Principal Investments, Mizuho Capital, Tokyo Marine Capital); and
- Foreign principal investment firms (e.g., Goldman Sachs, BNP Paribas, J.P. Morgan Partners).

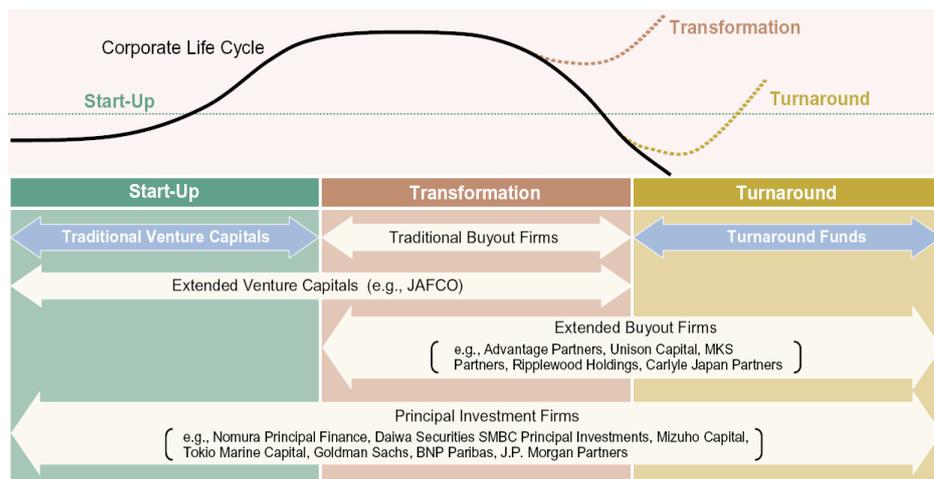


Figure 2: Buyout Firms in Japan

Questions

1. Discuss the case in brief.
2. Explain the types of buyouts firms in Japan.

Source: [http://www.abeam.com/research_reports/eng/RR057_E\(Corporate%20Restructuring\).pdf](http://www.abeam.com/research_reports/eng/RR057_E(Corporate%20Restructuring).pdf)

6.3 Summary

- In external reconstruction a new company is formed for the purpose of taking over the business of an existing sick company which has incurred huge losses and is facing financial difficulties.
- Existing company is wound up by selling its business to the newly formed company which is generally similarly named and owned by the same shareholders to a great extent.

- When a company is suffering losses for the past several years and facing financial crisis, the company can sell its business to another newly formed company. Actually, the new company is formed to take over the assets and liabilities of the old company. This process is called external reconstruction.
- In other words, external reconstruction refers to the sale of the business of existing company to another company formed for the purpose.
- In external reconstruction, one company is liquidated and another new company is formed. The liquidated company is called "Vendor Company" and the new company is called "Purchasing Company". Shareholders of Vendor Company become the shareholders of purchasing company.
- Amalgamation of companies involves liquidation of two or more companies, while external reconstruction involves liquidation of only one company.
- Absorption of companies does not involve formation of a new company, however, external reconstruction involves formation of a new company.

6.4 Keywords

Discharge of Purchase Consideration: It refers to the form in which, the purchase consideration is discharged by the purchasing company.

External Reconstruction: External Reconstruction refers to the situation when an existing company goes into liquidation for the express purpose of selling its assets and liabilities to a newly formed company which is generally owned and named alike.

Internal Reconstruction: It refers to making internal arrangements for overcoming financial difficulties.

Liquidation: To settle the affairs of (a business firm, for example) by determining the liabilities and applying the assets to their discharge.

Purchase Consideration: Amount payable by the purchasing company to the vendor company as the purchase price of the business.

Reconstruction: An arrangement by which a financially unsound and weak company is strengthened by certain measures to avoid closure.

6.5 Review Questions

1. Differentiate amalgamation, absorption and external reconstruction.
2. The Balance Sheet of XYZ Company Limited as on 31st March, 2011 was as follows:

**Balance Sheet of XYZ CO. Ltd.
As on 31st March, 2011**

Liabilities	₹	Assets	₹
Share Capital:		Goodwill	77,500
75,000 Equity Shares of ₹ 10 each	7,50,000	Buildings	4,25,000
Creditors	2,70,000	Machinery	2,00,000
		Stock	1,35,000
		Debtors	1,12,500
		P&L A/c	70,000
	10,20,000		10,20,000

Notes

The committee of shareholders and creditors resolved as follows: (i) that the company will be taken into voluntary liquidation and a new company will be formed with a nominal capital of ₹ 10,00,000 in shares of ₹ 10 each to take over the assets and liabilities of existing company, (ii) that the item of goodwill be eliminated and machinery be valued at 20% less in the books of the new company, (iii) that 75,000 shares of ₹ 10 each will be issued to the shareholders in the old company @ ₹ 7.50 per share paid-up, (iv) the shareholders to pay up the balance of ₹ 2.50 per share in cash, (v) the creditors of the company will be satisfied by the payment to them as half of the amount in cash and by the issue of 5% Debentures as the other half.

Show the journal entries in the old company's books to give the effect to the above. Also, show the entries to open the books of the new company and opening balance sheet.

3. On 1st April, 2011 the Balance Sheet of Shital Co. Ltd. was as follows:

Liabilities	₹	Assets	₹
Share Capital:		Goodwill	1,60,000
20,000 6% Preference		Patents	60,000
Shares of ₹ 10 each fully paid	2,00,000	Fixed Assets	6,58,000
60,000 Equity Shares of ₹ 10		Cash	2,000
each fully paid	6,00,000	P&L A/c	1,12,000
6% Debentures	1,20,000	Preliminary Exps.	8,000
Creditors	80,000		
(Preferences dividends in Arrears for four years)			
	10,00,000		10,00,000

A scheme of reconstruction was agreed upon as follows: (i) A new company to be formed called New Shital Co. Ltd. with an authorised capital of ₹ 13,00,000 all in equity shares of ₹ 10 each, (ii) One equity shares ₹ 5 paid, in new company to be issued for each equity shares in the old company, (iii) Two equity shares, ₹ 5 paid in the new company to be issued for each preference share in the old company, (iv) Arrears to be cancelled, (v) Debenture-holders to receive 12,000 equity shares in the new company credited as fully paid, (vi) Creditors to be taken up by the new company, (vii) The remaining unissued shares to be taken up and paid for in full by the directors, (viii) The company to take over the old company's assets except patents, subject to writing down sundry assets by ₹ 1,40,000 and (ix) Patents were realised by Shital Co. Ltd. for ₹ 4,000, (x) Expenses of Shital Co. Ltd. Came to ₹ 4,000.

Close the books of Shital Co. Ltd. and open the books of New Shital Co. Ltd. by means of journal entries and give the Balance Sheet of the New Shital Co. Ltd.

4. The books of Rajubai Limited showed the following balances on 31st March, 2011:

Liabilities	₹	Assets	₹
Share Capital:		Patents	6,00,000
Equity shares of ₹ 10 each	6,00,000	Plant	2,00,000
Creditors	7,00,000	Stock	1,50,000
		Debtors	2,50,000
		Cash	6,250
		Preliminary expenses	36,250
		P&L A/c	57,500
	13,00,000		13,00,000

The company cannot raise further capital and patents are shown at the higher value. The following scheme is adopted:

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- The company to go into voluntary liquidation and a new company called New Rajubai Limited to be formed with an authorised capital of ₹ 10,00,000 to take over the assets and liabilities.
- Liability to the creditors to be discharged by the new company by cash payment of 25 paise in the rupee and 50 paise in the rupee by the issue of 6% debentures in the new company.
- The shareholders of the old company to be issued 60,000 shares of ₹ 10 each, ₹ 5 per share as paid and the balance of ₹ 5 per share being payable on allotment.
- The liquidation expenses ₹ 8,750 to be paid by the new company as part of purchase consideration.

Prepare: (a) Realisation account (b) Shareholders account (c) Statement of Purchase Consideration in the books of old company.

5. On 31st March, 2011 the Balance Sheet of Hari Om Limited was as follows:

Liabilities	₹	Assets	₹
Share Capital:		Goodwill	2,00,000
25,000 12% cumulative		Plant & Machinery	3,50,000
Preference shares of ₹ 10 each fully paid	2,50,000	Furniture & Fixture	1,00,000
75,000 equity shares of ₹ 10 each fully paid	7,50,000	Patents	75,000
10% Debentures	1,50,000	Stock	2,45,000
Creditors	1,00,000	Debtors	1,27,500
(Preference Dividend in arrear for 3 years)		Bank Balance	2,500
		Preliminary Exps.	4,000
		Discount on issue of debentures	6,000
		Profit and Loss a/c	1,40,000
	12,50,000		12,50,000

The following scheme of external reconstruction was agreed upon:

- A new company to be formed called Hari Mohan Limited with an authorised capital of ₹ 16,25,000 in equity shares of ₹ 10 each.
- One equity share, ₹ 5 paid up, in the new company to be allotted for each equity share in the old company.
- The two equity shares, ₹ 5 paid up, in the new company to be allotted for each preference share in the old company.
- Arrears of preference dividend to be cancelled.
- Debenture-holders to receive 15,000 equity shares in the new company credited as fully paid.
- Creditors to be taken over by the new company.
- The remaining unissued shares to be taken up and paid for in full by the directors.
- The new company to take over the old company's assets except patents, subject to writing down plant and machinery by ₹ 1,45,000 and stock by ₹ 30,000.
- Patents were realised by Hari Om Limited for ₹ 5,000.

Notes

Show important ledger accounts in the books of Hari Om Limited and open the books of Hari Mohan Limited by means of journal entries and give the initial Balance Sheet of Hari Mohan Limited. Expenses of Hari Om Limited came to ₹ 5,000.

Answers: Self Assessment

- | | |
|------------------|-----------------------------|
| 1. False | 2. True |
| 3. False | 4. True |
| 5. True | 6. True |
| 7. True | 8. Net Asset Method |
| 9. Total payment | 10. External reconstruction |
| 11. Purchasing | 12. Net payment |

6.6 Further Readings



Books

B. B. Dam and H. C. Gautam, *Corporate Accounting*, Capital Publishing.

Das, K. R. and others, *Corporate Accounting*, LBS Publication.

Sehgal, A. and Sehgal, D., *Advanced Accounting & Corporate Accounting*, Taxman Publishers.



Online links

<http://accountlearning.blogspot.in/2011/04/concept-and-types-of-reconstruction.html>

<http://dynamictutorial.blogspot.in/2012/02/company-accounts-amalgamation-and.html>

http://sjecnotes.weebly.com/uploads/5/2/5/1/5251788/corporate_accounting-24th_sem.pdf

Unit 7: Accounting for Banking Companies

Notes

CONTENTS

Objectives

Introduction

- 7.1 Accounting for Banks
 - 7.1.1 Non-banking Assets
- 7.2 Basics of Banking Accounts
 - 7.2.1 The Difference between Accounting and Bookkeeping
 - 7.2.2 Double-entry Bookkeeping
 - 7.2.3 Keeping Good Accounting Records
 - 7.2.4 Debits and Credits
 - 7.2.5 Accounting Equations
 - 7.2.6 Capital Receipt and Revenue Receipt
 - 7.2.7 Depreciation
 - 7.2.8 Bank Reconciliation
- 7.3 Companies' Accounts
- 7.4 Important Facts
 - 7.4.1 Balance Sheet
- 7.5 Summary
- 7.6 Keywords
- 7.7 Review Questions
- 7.8 Further Readings

Objectives

After studying this unit, you will be able to:

- Define the concept of accounting for banks
- Discuss the basics of banking accounts
- Explain the term Companies Accounts
- Describe the important facts related to accounting for Banking Companies

Introduction

A banking company means any company which carries on business or which transacts banking business in India. A banking business is generally governed by the provisions of the Companies Act 1956 and specifically by the Banking Regulation Act. The Banking regulation Act of 1949 came into force on 16th March 1949 as a result of long-felt need to regulate the banking business in India and protect the interest of number of depositors. The existence of well-organised, regulated and efficient banking system is pre-requisite for economic growth. Banks are agencies responsible

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for mobilising and channelling of funds in a country. The major institutions carrying business, in India, include: (a) Nationalised banks (b) State Bank of India and Associates banks (c) Foreign banks having branches in India (d) Cooperative banks (e) Rural banks and (f) Private sector banks.

In addition to banking business, a bank is permitted under Section 6 of the Banking Regulation Act to engage in certain class of business which is incidental to the business of banking. Section 8 of the Banking Regulation Act prohibits a bank from buying and selling or dealing in goods except in connection with realisation of a security held by it or in connection with the business of collections or negotiating bills of exchange.

7.1 Accounting for Banks

Section 5(h) of the Banking Companies Act defines banking as “The accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, and order or otherwise”. (Till 1949 there was no special legislation to regulate banking companies but since that year the provisions of Banking Regulation Act and Companies Act, 1956 applies to corporation entities carrying on banking business including the nationalised banks). Section 6 of the Act lay down that in addition to the usual business, the following business may also be carried on by a banking company –

- (a) Acting as agents for any Government or local authority or any other person or persons,
- (b) Carrying on and transacting every kind of guarantee and indemnity business, and
- (c) Undertaking and executing trusts.

Other types of business are prohibited for a banking company. No banking company can directly or indirectly deal in the buying or selling or bartering of goods, except in connection with the realisation of security given to or held by it or engage in any trade or buy or sell or barter goods for others otherwise than in connection with bills of exchange. Immovable property, except that required for its own use, however acquired, must be disposed of within seven years from the date of acquisition.

7.1.1 Non-banking Assets

A bank cannot acquire certain assets but it can always lend against the security of such assets. This means that sometimes, in case of failure on the part of the loan to repay the loans, the bank may have to take possession of such assets. In that case, the assets will be shown in the balance sheet as “non-banking assets”. These must be disposed of within seven years. Income from or profit on sale and loss on sale of such assets has to be separately shown in financial statements like Profit and Loss Account of the bank.



Caselet

Exchange Rate Interventions by Bank of Japan

Japan has been criticised for its continuous & regular interventions in the foreign exchange market. The motive behind these interventions was to control the extreme movement of the yen with respect to other currencies like the US dollar. But the intervention by the Bank of Japan on September 15, 2010, was different from the earlier ones as it was the first time it was being done after March 31, 2004, when the government of Japan had to interfere in the foreign exchange market.

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The September 2010 intervention caused a variety of reactions across the world. This case analyses the complete story of Japanese intervention including the political and economic situation during the intervention period. A parallel approach is used to critically analyse the relevance of such interference in the present globally integrated market structure.

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Source: http://www.ibscdc.org/Case_Studies/Finance,%20Accounting%20and%20Control/Investment%20and%20Banking/INB0016.htm

7.2 Basics of Banking Accounts

The accountants design the accounting systems the bookkeepers use. They establish the internal controls to protect resources apply the principles of standards-setting organisations to the accounting records and prepare the financial statements, management reports and tax returns based on that data. The auditors that verify the accounting records and express an opinion on financial statements are also accountants, as are management, tax and forensic accounting specialists.



Notes

A bank cannot acquire certain assets but it can always lend against the security of such assets.

7.2.1 The Difference between Accounting and Bookkeeping

Bookkeeping is an unglamorous but essential part of accounting. It is the recording of all the economic activity of an organisation – sales made, bills paid, capital received – as individual transactions and summarising them periodically (annually, quarterly, even daily). Except in the smallest organisations, these transactions are now recorded electronically; but before computers they were recorded in actual books, thus *bookkeeping*.

7.2.2 Double-entry Bookkeeping

The economic events of a business are recorded as transactions and applied to the accounts (hence *accounting*).



Example: The cash account tracks the amount of cash on hand; the sales account records sales made. The chart of accounts of even small companies has hundreds of accounts; large companies have thousands.

The transactions are posted in journals, which were (and for some small organisations, still are) actual books; nowadays, of course, the journals are typically part of the accounting software. Each transaction includes the date, the amount and a description.



Example: Suppose you have a stationery store. On April 19, a saleswoman for an antiques company visits you, and you buy a lamp for your office for \$250. A journal entry to record the transaction as a debit to the Office Furniture account and a \$250 credit to Accounts Payable could be written as follows (*Dr.* is the abbreviation for debit, while *Cr.* is for credit):

Date	Account	Dr.	Cr.
April 19	Office Furniture	250	
	Accounts Payable		250
<i>(Bought antique lamp; voucher #0016)</i>			

Each accounting transaction affects a minimum of two accounts, and there must be at least one debit and one credit.

7.2.3 Keeping Good Accounting Records

Even a seemingly simple transaction like this one raises a host of accounting issues.



Example: Date: Suppose you had already agreed by phone to buy the lamp on April 15, but the paperwork wasn't done until April 19. And the lamp wasn't delivered on the 19th, but the 23rd. Or even as you bought it, you were thinking that you didn't like it that much, and there's a strong chance you'll return it by the 30th, when the sale becomes final. On which date - 15th, 19th, 23rd, or 30th - did an economic event occur for which a transaction should be recorded?

Amount: The sales price is \$250, but you get a 10% discount (to \$225) if you pay in 30 days; business is bad, though, so you may need the full 90 days to pay. Similarly, however, you know the antique business is also lousy; even though you agreed to pay \$250, you can probably chisel another \$50 off the price if you threaten to return it. On the other hand, being in the stationery business, you know one of your customers has been looking for a lamp like that for a long time; he told you in February he'd pay \$300 for one.

So what amounts should you record on April 19 (if indeed you record a transaction on that date)? \$250 or \$225 or \$200 or \$300?

Accounts: You've debited the Office Furniture account. But actually you buy and sell antiques frequently to your customers, and you're always ready to sell the lamp if you get a good offer. Instead of an Office Furniture account used for fixed assets, should the lamp be recorded in a Purchases account you use for inventory? And if this was a big company, there might be dozens of office furniture sub-accounts to choose from.

Accountants rely on various resources to answer such questions. There are basic, time-honoured accounting conventions: standards set forth by various rules-making bodies, long-standing industry practices and, most important, their own judgment honed through years of experience.

But the important point is that even the most basic accounting questions - when did an economic event take place? What is the value of the transaction? Which accounts are affected by the transaction? - can get very complex and the right answers prove very elusive. There's no excuse for out-and-out misrepresentation of company results and sloppy auditing that certainly occurs. But the seeming precision of financial statements, no matter how conscientiously prepared, is belied by the uncertainty and ambiguity of the business activities they seek to represent.

7.2.4 Debits and Credits

We're accustomed to thinking of a "credit" as something "good" - our account is credited when we get a refund; you get "extra credit" for being polite. Meanwhile, a "debit" is something negative - a debit reduces our bank balance; it's used to mean shortcoming or disadvantage.

In accounting, debit means one thing: left-hand side. Credit means one thing: right-hand side. When you receive cash – a “good” thing – you increase the Cash account by debiting it. When you use cash – a “bad” thing – you decrease Cash by crediting it. On the other hand, when you make a sale, which is nice, you credit the Sales account; when someone returns what you sold, which is not nice, you debit sales.

“Good” and “bad” have nothing to do with debit and credit.

Debit = Left; Credit = Right. That’s it. Period.

Accrual vs. Cash Basis Accounting: As we’ve seen, deciding when an economic event occurs and an accounting transaction should be recorded is a matter of judgment. Accrual accounting looks to the economic reality of the business, rather than the actual inflows and outflows of cash.

Although cash basis statements are simpler and make good sense for many individual taxpayers and small businesses, it results in misleading financial statements. Consider a Halloween costume maker: it conceives, produces and sells costumes throughout the year, but gets paid for its costumes mostly in October. If sales were recognised only when cash was received, October would show an enormous profit while all other months would show losses. Accrual accounting seeks to match the revenues earned during a period with the expenses incurred to generate them, regardless of when cash comes in or goes out.

Rules for ‘Debit’ and ‘Credit’

- **Personal Account:** Debit the receiver (on sale of goods on credit to a person, his account would be debited). Credit the giver (on purchase of furniture on credit, the seller’s account is credited).
- **Real Account:** Debit what comes in (when cash is received, cash account is debited). Credit what goes out (when furniture is purchased for cash, the cash account is credited).
- **Nominal Account:** Debit all losses and expenses (when salary is paid to an employee instead of his personal account, the salary expenses account is debited). Credit all gains and income (when commission is received, the commission account is credited rather than the person, from whom the commission is received) below is given Table 7.1 and 7.2 showing the summary of debit and credit to various accounts and journal entries, respectively.

Table 7.1: Summary of Effect of Debit & Credit to Various Accounts

Name of the account	Effect on balance when account is debited	Effect on balance when account is credited
Asset accounts	Balance Increases	Balance Decreases
Liability Accounts	Balance Decreases	Balance Increases
Capital Account	Balance Decreases	Balance Increases
Expenses Account	Balance Increases	Balance Decreases
Income or revenue a/c	Balance Decreases	Balance Increases

Notes

Table 7.2: Journal Entries

Nature of Transaction	Account to be debited	Account to be credited
Commencement of business with cash	Cash account	Capital account or any other liability account
Purchase of assets or goods out of for cash	Asset account or purchase account	Cash account
Purchase of assets or goods on credit	Asset account or purchase account	Seller's account or Creditor's account
Sale of assets or goods for cash	Cash account	Asset or sale account
Sale of assets or goods on credit	Buyer's or Debtor's account	Asset or sale account
For any type of expenses which are due within the accounting period	Expenses account (respective head)	Cash account for cash payment. In case of on credit account of the supplier of the service
For any type of income due within the accounting period	Cash account for cash entry or account of the buyer of services for on-credit entry	Income Account (respective head)
For outstanding expenses	Expenses account (respective head)	Outstanding expenses a/c
For pre-paid expenses	Pre-paid expenses account	Expenses account (respective head)
For outstanding or accrued income	Account of the person from whom such income is to be received	Income account (respective head)
For income received in advance	Income account (respective head of account)	Income received in advance account
Depreciation on fixed assets	Depreciation account	Asset account on which depreciation charged
For goods taken for personal use	Drawing account	Respective asset account
Payment made by cheque to creditors	Creditor's account	Bank account
Payment received by way of cheque from debtors	Bank account	Debtor's account
For transfer of Opening stock	Trading account	Opening stock account
For transfer of Closing stock	Closing stock account	Trading account

7.2.5 Accounting Equations

Capital or owner's equity	=	Assets – outside liabilities
Asset	=	Capital + outside liabilities
Outside liabilities	=	Assets – capital
Income i.e. profit	=	Revenue – Expenses
Revenue	=	Expenses + profits

7.2.6 Capital Receipt and Revenue Receipt

Capital receipts are the amounts that are received in the form of capital introduced by the promoters, term loan received for banks and the sale proceeds from fixed assets. Such receipts do not affect the profit or loss. These either increase the liability or reduce the assets.

Revenue receipt on the other hand, is the amount received in normal and regular course of business such as by sale of goods and service. These affect the profit and loss position. These are shown on the credit side of the profit loss account. Table 7.3 showing the examples of types of errors.

Table 7.3: Different Types of Errors

Error	Explanation and example
Error of principle	When a real or personal account transaction is treated as a nominal account item. Machinery installation charges debited to wages, as installation was done by the factory labourers.
Error of omission	When there is complete omission to record a transaction e.g. cash sales of ₹ 5,000 not recorded. Neither cash account debited nor sales account credited. Or Though cash has been debited, but sales not posted to the sales book.
Error of commission	Where posting has taken place but there is some mistake. The examples for each case above, are given as under: Sales of ₹ 5,670 recorded as ₹ 6,570 Sales of ₹ 5,670 recorded in the purchase book Balance of ₹ 34,000 in the sales book taken as ₹ 43,000 in the trial balance In the debtors' ledger, debited an amount of ₹ 5,400 as ₹ 4,500 to the debit of buyer of goods on credit The amount of ₹ 2,000 or, account of goods sold to one Mr. Ramesh on credited, credited to his account instead of debiting his account While balancing the account of Mr. Ramesh the balancing was done for an amount of ₹ 8,500 instead of ₹ 9,500.
Compensating error	Cash received from Ramesh ₹ 2,500 debited to cash account for ₹ 2,000 and cash paid to Mr. Dinesh ₹ 2,500 recorded in the cash book as ₹ 3,000.

7.2.7 Depreciation

Depreciation means reduction in the value of a fixed asset over the years. This is a continuing process due to which the book value of the assets declines. The rate at which, this value declines varies from asset to asset depending upon a number of factors, such as wear and tear, passage of time, obsolescence, fall in market price, etc. Charging depreciation is a process of distribution of cost of the fixed assets over the useful life of the asset.

Straight Line Method or Fixed Instalment Method: Under SLM method, the depreciation is charged on the original value of the asset inclusive of its installation and transportation cost but excluding scrap value, if any.



Example: An asset has been purchased for ₹ 2 lac including tax and ₹ 10,000 has been incurred on its installation and another ₹ 5000 on its transportation etc. If it is also estimated that its scrap value is ₹ 35,000, at the end of 4 years commercial use, the amount of annual depreciation would be ₹ 45,000 $[(2,00,000 + 10,000 + 5,000 - 35,000)/4]$.

Written Down Value Method or Diminishing Balance Method: Under WDV method, depreciation is charged at fixed rate on the reducing balance (called written down balance i.e. original cost less depreciation). This also means that the cost of the asset reduced by the scrap value is to be written off over its expected commercial life. In the above example, the rate of depreciation of 25% will be applied on ₹ 1,80,000 during the first year, while during the 2nd year it will be on ₹ 1,35,000 (1,80,000 - 45,000), when the amount of depreciation would be ₹ 33,750 (25% of ₹ 1,35,000).



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The rate at which this value declines varies from asset to asset depending upon a number of factors such as wear and tear, passage of time, obsolescence, fall in market price etc.

Notes

7.2.8 Bank Reconciliation

Reconciliation is a statement with the help of which a party reconciles its cashbook with the bank pass book based on certain causes of difference between these two books.

Procedure for Reconciliation

Whenever the task of reconciliation is taken in hand, the following procedure can be adopted:

1. Make comparison of two books i.e. cash book and passbook to locate the transactions which appear in one of books and not the other.
2. Take balance of one book as starting point, say balance as per cash book or pass book. This balance can be credit balance or debit balance. This gives rise to four situations (debit or credit balance as per cash book or as per passbook).
3. Adjust the balance with starting point by adding the amount of transaction or deducting the amount of transaction depending upon the nature of the transaction.
4. The opposite balance at the end of these adjustments will be answer (if balance is credit in cash book, it will be debit in pass book and vice versa).

Adjustment entries: After completion of the process of trial balancing or drawing final accounts, at times, subsequently, it may come to the notice of the management that certain expenses which were to be incurred have not been paid and certain expenses have been paid in advance. Similarly, there may be some income which was due to be received, but has been received so far and some income which was still not due has been received. As a result, the actual position of profit or loss may not be reflected unless these are adjusted in the final accounts. The summary of some of the adjustments is given as under Table 7.4 and 7.5.

Table 7.4: Adjustment Entries for Various Kinds of Transactions

Nature of transactions	Account to be debited (along with name of financial statement)	Account to be credited (along with name of financial statement)
Outstanding/unpaid expenses (like rent, wages, depreciation etc.)	Respective expenses a/c (profit and loss account)	Expenses outstanding (balance sheet)
Prepaid expense (such as insurance, commission etc.)	Prepaid expenses (balance sheet)	Respective expenses a/c (profit and loss account)
Income accrued/ due not received (Any kind of Income)	Accrued income (balance sheet)	Respective Income account (profit and loss account)
Income received In advance (any kind of income)	Respective income a/c (profit and loss account)	Income received in advance (balance sheet)
Provision against doubtful debts	Expenses provisions - doubtful debts (profit and loss accounts)	Provision for doubtful debts (balance sheet)
More provisions for doubtful debts (for the additional amount only)	Expense provisions-doubtful debts (profit and loss accounts)	Provision for doubtful debts (balance sheet)
Writing-off of bad debts (when no provision is already available)	Expenses: write-off bad debts (profit and loss account)	Respective party's accounts (balance sheet)
Write-off of bad debts (when provision is already held)	Provision for doubtful debts (balance sheet)	Respective party's accounts (balance sheet)
Write-off of bad debts (when adequate provision is not held)	Provision for doubtful debts (balance sheet) Expenses write-off of bad debts for shortfall amount (P & L Account)	Respective party's accounts (balance sheet)
Excess provision on doubtful debts	Provision for doubtful debts (balance sheet)	Expenses provision doubtful debts (profit and loss account)
Interest on capital not paid	Expenses: Interest on capital (Profit and loss account)	Capital account (balance sheet)
Interest on drawings	Capital or drawings account (balance sheet)	Income-interest on drawings (profit and loss account)

Table 7.5: Effects of Different Accounts on Various Adjustments

Transaction	Trading account	Profit/loss account	Balance Sheet
Closing stocks	Credit Side		Asset Side
Depreciation		Debit side	Reduction from Fixed Asset
Expenses outstanding	Addition to related exp. a/c debit side	Addition to related exp. a/c debit side	To be shown as liability
Prepaid expenses	Reduction from related exp. a/c	Reduction from related exp. a/c	To be shown as an asset
Accrued income		Addition to related income account	To be shown as an asset
Income received in advance		Reduction from related income a/c	To be shown as liability
Interest on capital		Intt. account to be debited	Add to amount of capital
Interest on drawing		Intt. account to be credited	Reduction from capital
Provision for bad debts		Debts to P& L account	Reduction from amount of debtors
Discount on debtors		Debit to discount account to P&L a/c	Reduction from amount of debtors
Commission payable to Manager*			

* If commission is to be calculated before charging such commission = Net profit before such commission \times rate/100.

If commission is to be calculated after charging such commission = Net profit before such commission \times rate/100 + rate.

Table 7.6 is showing the summary of adjustment with journal entries.

Table 7.6: Summary of Adjustment with Journal Entries

Nature of transaction	Account to be debited	Account to be credited
Closing stocks	Closing stocks	Trading account
Outstanding expenses	Concerned Expenses account	Outstanding expenses a/c
Prepaid expenses	Prepaid/ unexpired expenses account	Concerned expenses account
Accrued or outstanding income	Accrued income	Concerned income account
Income received in advance	Concerned income account	Income received in advance
Depreciation	Depreciation account	Asset account
Interest on capital	Interest on capital a/c	Capital account
Interest on drawings	Capital account	Interest on drawings a/c
Interest on loan	Interest account	Interest outstanding a/c
Bad debts	Bad debt account	To debtor's account
Making provision for bad debt	Profit and loss account	To provision for bad and doubtful debt account
Provision for discount on debtors	Discount allowed a/c	To provision on debtor's account
Provision for discount on creditors	Provision for discount on creditors	To profit and loss account
Accidental loss, say fire	Loss by Fire	To trading account for stock of goods or other asset's account which has been damaged
Commission payable on profits	Commission on profits	Profit and loss account
Drawings of goods by the promoter	Drawings account	Purchase account
Goods received but bill not received	Purchase account	Supplier's account
Claim admitted by insurance company but money not received	Insurance company	Trading account
Returns inwards	Returns inward	Debtor's account
Returns outward	Creditor concerned	Returns outward account

Notes

Self Assessment

Fill in the blanks:

1. If an amount has been wrongly written on the debit side of a nominal a/c, it will the profit or the loss.
2. If any mistake is committed in the real a/c, it will affect.....
3. A bill of exchange must be signed by the
4. The due date is calculated after adding days of grace to the actual period of the bill.
5. If the due date falls on a public holiday, then it becomes due on the working day.
6. If the agent is to be made responsible for debts, he is to be paid a commission called
7. Amount paid to the person who is not an employee of the organisation is called

7.3 Companies' Accounts

A joint stock company is formed by way of incorporation under the provisions of Companies Act, 1956. Such companies are artificial legal persons, having their own legal entity separate from members. It could be private company or a public company or a govt. company. While a private company has minimum 2 members and maximum 50, a public or govt. company should have minimum 7 members without any upper ceiling. In case of public company the minimum capital should be ₹5 lac with 25%, from members of the public. The important documents which a company must have are Memorandum of Association, Certificate of Incorporation and Certificate of Commencement of business.



Did u know? Whenever a company wishes to raise capital it has to issue shares by way of a prospectus. Prospectus is an invitation to the public to subscribe to the shares or debentures which is signed by directors.

So far as share capital is concerned, it may be categorised as Authorised, issued, subscribed or paid up capital as shown in Table 7.7 below:

Table 7.7: Description of Types of Capital

Nature of Capital	Description
Authorised Capital	Maximum amount of capital, that a company could raise and is capital clause in MOA of the company.
Issued capital	The amount which has been offered to public for subscription. It can be maximum up to the authorized capital.
Subscribe capital	The number of shares and the face value of the shares which the prospective shareholders want to take up.
Paid up capital	The amount actually received from the shareholder against the allotted shares.

Self Assessment

Notes

State whether the following statements are true or false:

8. Cash discount and trade discount are same.
9. Del Credera commission is calculated on credit sales only.
10. Amount of depreciation arrived at on the basis of straight line method and reducing balance method are same.
11. The practice of providing for unpaid expenses and prepaid expenses is based on accrual basis of accounting.
12. Dual aspect is not an accounting convention.
13. The ICAI is a member of the International Accounting standards committee.
14. There are 29 accounting standards in India.
15. The three columns of each side of the three columned cash book represent Real, Personal and Nominal A/c.

7.4 Important Facts

The following facts must be kept in mind, while dealing with a company's accounts relating to issue of shares by a company:

1. An equity share carries the voting rights.
2. Preference share-holders have voting right when the dividend is outstanding for more than 2 years for cumulative preference shares and for 3 years in case of non-cumulative preference shares.
3. Forfeited shares when reissued can be issued at a discount provided the reissue price plus the amount already received from defaulting shareholder is not less than the amount credited as paid up on reissue of the share.
4. It is mandatory to cancel the discount on issue of shares account at the time of forfeiture of shares which were issued at a discount.
5. Preference share enjoys the preferential right only in respect of return of capital on winding up of the company. It does not have a right to get the dividend.
6. Entries for surrendering the shares are the same as are applicable in case of forfeiture of shares.
7. Capital redemption reserve is available for declaring fully paid bonus shares.
8. A company can purchase its own shares as well as debentures.
9. A convertible preference share can be converted into equity shares.
10. Face value is the value of a share stated on the share certificate. Paid-up value represents the amount called by the company and paid by the shareholder, which may or may not be equal to the face value.
11. Shareholders are not entitled to get dividend on the amount paid as calls-in-advance.
12. Unless permitted by the Central Government, a share cannot be issued at a discount exceeding 10% of the nominal value. A company can issue shares at discount when minimum one year has lapsed since commencement of business.

- Notes**
13. A partly paid preference share cannot be redeemed.
 14. Balance of share forfeited account after reissue of the forfeited shares i.e. transferred to capital reserve.
 15. Transfer to capital redemption reserve account is permitted from profit and loss account and dividend equalisation account.



Caution At the time of issue of shares, an applicant is required to pay minimum 5% of the nominal value of the share as application money.

7.4.1 Balance Sheet

The prescribed form of the Balance Sheet is given in Part I of Schedule VI of The Companies Act, 1956.

The Companies Act has laid down two forms of the Balance Sheet known as:

- (i) Horizontal form
- (ii) Vertical form

Format of Summarised Balance Sheet (Horizontal Form)

Schedule VI Part I

Balance Sheet ofCo. Ltd.

As at ...

Figures for the Previous year ₹	Liabilities	Figures for the current year ₹	Figures for the Previous year ₹	Assets	Figures for the current year ₹
	1. Share Capital			1. Fixed Assets	
	2. Reserves and surplus			2. Investments	
	3. Secured Loans			3. Current Assets, Loans and Advances	
	4. Unsecured Loans			(a) Current Assets	
	5. Current Liabilities and Provisions			(b) Loans and Advances	
	(a) Current Liabilities			4. Miscellaneous Expenditure	
	(b) Provisions			5. Profit and Loss A/c	



Notes A footnote to the Balance Sheet may be added to show the contingent liabilities.

The format of the detailed Balance Sheet of a company in a horizontal form is given below:

Format of the Detailed Balance Sheet in a Horizontal Form

Notes

Horizontal Form of Balance Sheet

Balance Sheet of..... (Name of the company) as on.....

Figures for the Previous year ₹	Liabilities	Figures for the current year ₹	Figures for the previous year ₹	Assets	Figures for the current year ₹
	Share Capital: Authorised ...shares of ₹...each Preference Equity Issued : ...shares of ₹...each Preference Equity Less: Calls Unpaid: Add: Forfeited Shares Reserves and Surplus: Capital Reserve Capital Redemption Reserve Securities Premium Other Reserves Profit and Loss Account Secured Loans: Debentures Loans and Advance from Banks Loans and Advances from subsidiary Companies Other Loans and Advances Unsecured Loans: Fixed Deposits Loans and Advances from subsidiary companies Short Term Loans and Advances Other Loans and Advances Current Liabilities and Provisions: A. Current Liabilities Acceptances Sundry Creditors Outstanding Expenses B. Provisions: For Taxation For Dividends For Contingencies For Provident Fund Schemes For Insurance, Pension and Other similar benefits			Fixed Assets: Goodwill Land Building Leasehold Premises Railway Sidings Plant and Machinery Furniture Patents and Trademarks Live stock Vehicles Investments: Government or Trust Securities, Shares, Debentures, Bonds Current Assets, Loans and Advances: (A) Current Assets: Interest Accrued on investments Stores and Spare parts Loose Tools Stock in Trade Work in Progress Sundry Debtors Cash and Bank balances (B) Loans and Advances: Advances and Loans to Subsidiaries Bills Receivable Advance Payments and unexpired discounts Miscellaneous - Expenditure: Preliminary Expenses Discount on Issue of Shares and Other Deferred Expenses Profit and Loss Account (debit Balance: if any)	

Notes

Format of the Balance Sheet in Vertical Form

Balance Sheet of as on

Particulars	Schedule Number	Figures as at the end of current financial year	Figures as at the end of previous financial year
I. Source of Funds: 1. Shareholder's Funds: (a) Share capital (b) Reserves and Surplus 2. Loan Funds: (a) Secured loans (b) Unsecured loans Total (Capital Employed) II. Application of Funds 1. Fixed Assets: (a) Gross block (b) Less: depreciation (c) Net block (d) Capital work-in-Progress 2. Investments: 3. Current Assets, Loans and Advances: (a) Inventories (b) Sundry Debtors (c) Cash and Bank Balances (d) Other Current Assets (e) Loans and Advances Less: Current Liabilities and Provisions: 4. (a) Current liabilities (b) Provisions Net Current Assets (a) Miscellaneous expenditure to the extent not written-off or adjusted. (b) Profit and Loss account (debit balance, if any) TOTAL			



Notes A footnote to the Balance Sheet may be added to show the contingent liabilities.

Illustration 1

A commercial bank has the following capital funds and assets. Segregate the capital funds into Tier I and Tier II capital, Find out the risk-adjusted asset and risk weighted asset and risk weighted assets ratio:

Capital Funds:	Figures in ₹ Lakhs	Notes
Equity Share Capital	4,80,00	
Statutory Reserve	2,80,00	
Capital Reserve (of which ₹ 280 lakhs were due to revaluation of assets and the balance due to sale)	12,10	
Assets:		
Cash Balance with RBI	4,80	
Balance with other Bank	12,50	
Certificate of Deposits with other commercial Bank	28,50	
Other investments	78,250	
Loans and Advances:		
(i) Guaranteed by government	128,20	
(ii) Guaranteed by public sector undertakings of Government of India	702,10	
(iii) Other	52,02,50	
Premises, furniture and fixtures	182,00	
Other Assets	201,20	
Off-Balance Sheet Items:		
Acceptances, endorsements and letters of credit	3,70,250	

Solution**Capital Funds - Tier I :**

	₹ in Lakhs	₹ in Lakhs
Equity Share Capital		48,000
Statutory Reserve		28,000
Capital Reserve (arising out of sale of assets)		930
		<u>76,930</u>

Capital Funds - Tier II :

Capital Reserve (arising out of revaluation of assets)	280	
Less: Discount to the extent of 55%	<u>154</u>	126
Total		<u>77,056</u>

Risk Adjusted Assets

Funded Risk Assets	₹ in Lakhs	Percentage Weight	Amount ₹ in lakhs
Cash Balance with RBI	480	0	-
Balance with other Banks	1,250	20%	250

Notes	Certificate of deposits	2,850	22.5%	641
	Other Investments	78,250	102.5%	80,206
	Loans and Advances:			
	(i) Guaranteed by government	12,820	0	-
	(ii) Guaranteed by public sector undertaking of Central Govt.	70,210	10%	70,210
	(iii) Other	5,20,250	100%	5,20,250
	Premises, furniture and fixtures Other Assets	18,200	100%	18,200
		20,120	100%	20,120
	Total			7,09,887
	Off-Balance Sheet Item	₹ in Lakhs	Credit Conversion Factor	
	Acceptances, Endorsements and Letters of credit	3,70,250	100%	3,70,250
	Total			10,80,127
	Risk Weighted Assets Ratio:	i / ii × 100		

$$= 77,056 / 10,80,127 \times 100 = 7.13\%$$

Expected ratio is 9%. So the bank has to improve the ratio.

Illustration 2

On the 31st March 1996 Karur Vaishya Bank has following Capital funds and asset:

Capital Funds	₹ (in Crores)	Assets	₹ (in Crores)
Equity shares capital	52.50	Cash balance	5.80
Statutory Reserve	26.00	Balance with RBI	4.00
Capital Reserve (₹ 2.8 Crore for revaluation of assets and Balance due to Sales)	5.00	Deposit certificates in other banks	20.00
Share premium	3.00	Equity investments in Subsidiaries	5.00
General Reserve	5.00	Other investments	78.00
Off-balance Sheet Items		Loans and Advances	
Acceptances	365.00	(i) Granted to Government	15.00
Endorsements and letters of credit		(ii) Guaranteed by government of Govt. of India.	80.00
		(iii) Other	625.00
		Premises	100.00
		Furniture & Fixtures	75.00
		Other Assets	200.00
		Intangible assets	10.00

Calculate capital adequacy ratio of the bank.

Solution**Notes**

Capital Adequacy Ratio = (Capital ÷ Risk with assets) × 100 = (89.96 ÷ 1467.075) × 100 = 6.132%

Working Note

1. Calculation of capital employed:

	<u>Tier I</u>	<u>Tier II</u>
Equity share capital	52.50	
Statutory reserve	26.00	
Capital reserve	2.20	1.26
Security premium	3.00	
General reserve	5.00	
	88.70	1.26

2. Calculation of Risk weighted Assets

Particulars	B.V	Risk (%)	Amount
Cash	5.8	0	0
Balance with RBI	4.0	0	0
Balance with other Banks	15.00	20	3.00
Deposits in other banks	20.00	22.5	4.00
Eq. Investment in subsidiaries	5.00	102.50	5.125
Other investment	78.00	102.50	79.95
Loan & Advance:			
- by Government	15.00	0	0
- by Government of India	80.00	100%	0
- other	625	100	625.00
Premises	100	100	100.00
Furniture & Fixtures	75	100	100.00
Other Assets	200	100	200.00
Intangible Assets	10	100	10.00
AEOO	365	100	10.00
Total			1467.075

Illustration 3

Check and maintain C.R.R. for schedule bank

Trial Balance	Dr.	Cr.
Saving deposits		15,000
Term deposits		40,000
Demand deposits	- 4,000	
R.B.I. current account	- 6,000	
Cash in hand	8,000	

Notes

Solution.

1. Demand & time liability		
Saving deposits		15,000
Term deposits	40,000	
Demand deposits	80,000	1,20,000
		<u>1,35,000</u>
2. Cash reserve to be maintained = $135000 \times 10\% = 13500 - 8000 = 5500$		
3. RBI - Current A/C		₹ 5,500
To RBI - Non/ Current		5,500
Or Cash in hand		

Statutory Liquidity Ratio:

- Every Commercial Bank
- Should maintain 25% of demand & time liabilities
- In approved securities
- On every alternate Friday starting from 21-4-97

Approved securities means:

1. Cash in hand
2. Cash for Reserve Bank of India - Non Current A/c
3. Cash for other banks
4. Money at call and short notice
5. Unencumbered securities: unencumbered means free for disposal w/o instruction
6. Gold, etc.

Illustration 4

Calculate C.R.R. and S.L.R. for a scheduled bank :

Particulars	₹
Deposits (Nets)	1,50,000
Debit Deposits	10,000
Gold	5,000
Cash with R.B.I. (Current Account)	6,000
Cash in Hand	20,000
Encumbered securities	20,000
Money at call & short notice	5,000
Balance with other banks	15,000

Solution

Notes

Demand & time liabilities - calculation

Deposits (Net)	1,50,000
+ Debit Deposits	10,000
Demand & time liabilities	1,60,000

1. Cash Reserve Ratio = $16,000 - 6,000 = 10,000$ be maintained additionally

2. Statutory Liquidity Ratio

Liquidity required = 25% of 1,60,000 40,000

(-) Liquidity available:

Cash in hand	10,000	
Gold	5,000	
Money at call & short notice	5,000	
Balance with other banks	15,000	35,000
Deficiency (in liquidity)		5,000

Shortage of SLR

Illustration 5

Calculate capital for capital adequacy ratio.

Particulars	₹
Share Capital	10,00,000
Statutory Reserve	2,00,000
Capital reserve (40% realise in cash)	5,00,000
Revaluation resave	40,00,000

Solution

Particulars	Tier I	Tier II
Share Capital	10,00,000	-
Statutory reserve	2,00,000	-
Capital Resave (40% cash)	2,00,000	-
(60% $5,00,000 \times 45\%$)	-	1,35,000
Revaluating Reserve ($40,00,000 \times 45\%$)	-	18,00,000
Total	14,00,000	19,35,000

Capital employed = Capital Tier I + Tier II
 = 14,00,000 + 14,00,000
 = 28,00,000



Task Discuss the rules for accounting equations.

Notes

Self Assessment

Choose the correct answer from the following options:

16. Acquisition of fixed asset is an example of:
 - (a) Capital expenditure
 - (b) Revenue expenditure
 - (c) Deferred revenue expenditure
 - (d) None of the above
17. Maintenance of fixed assets is an example of:
 - (a) Capital expenditure
 - (b) Revenue expenditure
 - (c) Deferred revenue expenditure
 - (d) None of the above
18. Construction of building is an example of:
 - (a) Capital expenditure
 - (b) Revenue expenditure
 - (c) Deferred revenue expenditure
 - (d) None of the above
19. Expenditure on advertisement for furtherance of market for products is an example of:
 - (a) Capital expenditure
 - (b) Revenue expenditure
 - (c) Deferred revenue expenditure
 - (d) None of the above
20. An expenditure that is charged to profit and loss account over a period of 3 to 5 years is an example of:
 - (a) Capital expenditure
 - (b) Revenue expenditure
 - (c) Deferred revenue expenditure
 - (d) None of the above



Case Study

Morgan Stanley: Growth Strategies in the Chinese Banking Sector

Morgan Stanley, a global financial services firm's major business segment included Institutional Securities, Retail Brokerage, Asset Management and Discover Financial Services. Morgan Stanley entered China by forming joint venture with China International Capital Corporation Ltd. in 1995. In October 2006 Morgan Stanley

Contd...

acquired 100% stake in China's Nan Tung Bank to expand its footprint in the Chinese Commercial Banking Sector. The Nan Tung Bank which was founded in 1985, offered comprehensive set of commercial banking products like deposits, home mortgage loans, and foreign currency exchange and remittance services. But it mainly focused on foreign funded companies and residents of Hong Kong, Macau and Taiwan. Morgan Stanley did not have significant retail banking capabilities and the penetration of Nan Tung Bank in terms of domestic corporate and retail accounts was nearly zero. Still, the acquisition made Morgan Stanley a promising participant in rising Chinese banking sector.

In China, Morgan Stanley faced stiff competition from Citigroup which had acquired 85.6% stake in Guangdong Development Bank for 24.267 billion Yuan (US\$3.06 billion) in November 2006. Moreover China's accession to WTO in 2001, promised opening of banking sector to overseas participation over a five year period and full liberalisation by December 11, 2006. This was expected to lead significant competition for Morgan Stanley from international banks. In such an increasing competitive scenario, would Morgan Stanley with acquisition of Nan Tung Bank be able to significantly mark its presence in commercial banking sector of China?

Pedagogical Objectives:

- To discuss the expansion strategies and the inorganic growth strategy
- To understand the influence of government policies in the Chinese banking sector
- To discuss the competitive strategies
- To analyse the growth prospects for Morgan Stanley in China.

Questions

1. Analyse the case facts and figures.
2. Discuss the solution to the case issue.

Source: http://www.ibscdc.org/Case_Studies/Finance,%20Accounting%20and%20Control/Investment%20and%20Banking/INB0002A.htm

7.5 Summary

- Accounting is a glorious but misunderstood field. The popular view is that it's mostly mind-numbing number-crunching; it certainly has some of that, but it's also a rich intellectual pursuit with an abundance of compelling and controversial issues.
- Accountants are often stereotyped as soulless drones labouring listlessly in the bowels of corporate bureaucracies. But many accountants will tell you that it's people skills, not technical knowledge, that are crucial to their success.
- A Company registered under the Companies Act, 1956 is required to present its financial statements, i.e. balance sheet and profit and loss account in the format laid down in Schedule VI annexed to the Companies Act.
- Three copies of the balances sheet and profit and loss account prepared under Section 29 together with auditors' report under Section 30 must be submitted to the Reserve Bank of India within three months from the period to which they refer. However, it can be extended up to the period of further three months by RBI.
- Section 8 of the Banking Regulation Act prohibits a bank from buying and selling or dealing in goods except in connection with realisation of a security held by it or in connection with the business of collections or negotiating bills of exchange.
- No banking company can directly or indirectly deal in the buying or selling or bartering of goods, except in connection with the realisation of security given to or held by it or engage

Notes

in any trade or buy or sell or barter goods for others otherwise than in connection with bills of exchange.

- Immovable property, except that required for its own use, however acquired, must be disposed of within seven years from the date of acquisition.
- However, any company which is engaged in the manufacture of goods or carries on any trade and which accepts deposits of money from the public merely for the purpose of financing its business as manufacturer or trader shall not be deemed to transact the business of banking.
- It may be mentioned that the Banking Regulation Act, 1949 is not applicable to a primary agricultural society, a cooperative land mortgage bank and any other co-operative society except in the manner and to the extent specified in Part V of the Act.

7.6 Keywords

Annuity: A series of receipts or payments of a fixed amount for a specified number of years. Alternatively, a pattern of cash flows that is equal in each year, i.e. equal annual cash flows.

Asset: Anything which enables the firm to get cash or some benefit in future, is an asset which include fixed asset, current assets.

Balance Sheet: Statement of assets and liabilities at a specific date. This is part of final accounts of a Firm.

Bonus Shares: Dividend paid in form of equity shares and not in cash.

Book Value: The value of an asset, a liability or equity, as recorded in the accounts of a firm. The book value of an ordinary share is equal to the paid up capital plus retained earnings i.e. net worth.

Capital: The amount that the promoter invests in the business, which he can claim from the business, as it is liability of the business and asset for the promoter. It can be called net worth or owner's equity.

Credit Period: The time given to a buyer to make full payment for credit purchases beyond the expiry of which the payment becomes outstanding.

Creditors: The persons to whom the money is owing by the firm, when goods are purchased by the firm on credit.

Debtors: The persons who owe money to the firm to whom the goods have been sold by the firm on credit.

Income Statement: It presents the net income of a firm for a period of time (say a quarter of year).

Revenue: It is the result of operations and increases the inflow of assets and also the increase in owner's equity, if the net result is profit.

7.7 Review Questions

1. Explain the accounting equation concept.
2. Discuss the rules for Debit and Credit of all three accounts.
3. Salaries paid during the year 2006-07 amounted to ₹ 15000 which included ₹ 1500 in respect of 2005-06 and ₹ 500 in respect of 2007-08. In 2005-06, ₹ 700 was paid as advance salary for 2006-07. Salaries for 2006-07, amounting to ₹ 1,200 remained outstanding on 31st March, 2007. Calculate the salaries expenses for the year 2006-07.

Notes

4. The manager is entitled to a commission @ 10% of profits after charging his commission. The net profit is ₹ 110,000. The commission payable to the manager.
5. ABCD Associates, a partnership firm, had taken a joint life policy for ₹ 3,00,000. D, a partner dies and the policy amount is received from the LIC Premium paid so far is ₹ 60,000. Partners share profits and losses in the ratio of 4:3:2:1. Show the distribution of the policy money among the partners.
6. A partnership firm purchases machinery from a limited company for ₹ 99,000. The payment is to be settled by issue of equity shares of face value of ₹10 each at par, 10% discount and 10% premium. Determine the number of shares to be issued by the company in each case.
7. ABC Ltd. has the practice of creating provision for doubtful debts @ 5% on debtors. The balance of provision for doubtful debts on April 01, 2006 and March 31,2007 is ₹ 30,000 and ₹ 40,000 respectively. If the amount collected from debtors is ₹ 56,00,000 during the year 2006-07, credit sales during the year under review.
8. Ray Ltd. purchased furniture of ₹ 60,000 two years ago. The current book value of the furniture ₹ 43,350. If the company charges depreciation on furniture under written down value method, calculate the rate of depreciation.
9. Sukanya Ltd. purchased a machinery on April 01, 2002 for ₹ 1,50,000. It was estimated that the machinery will have a useful life of 5 years after which it will have no salvage value. If the company follows sum of the years' digits method of depreciation, calculate the amount of depreciation charged during the year 2006-07.
10. While preparing reconciliation statement, an accountant observed that following entries are at disagreement between passbook and firm's cash book.
 - (a) A personal cheque of ₹ 3,000 issued by the partner had been paid from firm's account.
 - (b) A bank draft of ₹ 3,950 was got issued from bank account and bank had debited commission of ₹ 60 on that account.
 - (c) Bank had recovered ₹ 200 on one occasion and ₹ 300 on another occasion on account of inspection charges.

Passbook presently shows a debit balance of ₹ 3,19,200. Calculate the balance as per cash book.

Answers: Self Assessment

- | | |
|--------------------------------------|--------------------------------------|
| 1. Reduce/Increase | 2. Balance sheet |
| 3. Drawer/Maker | 4. Three |
| 5. Previous | 6. Delcredre Commission |
| 7. Honorarium | 8. False |
| 9. False | 10. False |
| 11. True | 12. True |
| 13. True | 14. True |
| 15. True | 16. (a) Capital expenditure |
| 17. (b) Revenue expenditure | 18. (a) Capital expenditure |
| 19. (c) Deferred revenue expenditure | 20. (c) Deferred revenue expenditure |

Notes

7.8 Further Readings



Books

B B Dam and H C Gautam, *Corporate Accounting*, Capital Publishing.

Das. K R and others, *Corporate Accounting*, LBS Publication.

Sehgal, Dr. A and Sehgal, Dr. D, *Taxman Advanced Accounting & Corporate Accounting*.



Online links

http://220.227.161.86/19019comp_sugans_pe2_accounting_cp10.pdf

http://classof1.com/homework_answers/financial_accounting/accounting_of_banking_companies/

<http://www.scribd.com/doc/21987582/Final-Accounts-of-Banking-Companies>

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<http://www.investopedia.com/university/accounting/accounting3.asp#axzz2HTcYPGQX>

Unit 8: Accounting for Insurance Companies

Notes

CONTENTS

Objectives

Introduction

8.1 Types of Life Insurance Products

8.1.1 Term Insurance

8.1.2 Whole-life Assurance

8.1.3 Endowment Assurance

8.1.4 Maximum Investment Contracts

8.1.5 Annuities

8.1.6 Pensions

8.1.7 Permanent Health Insurance (PHI)

8.1.8 Premiums

8.2 Accounting for Insurance

8.2.1 Premiums

8.2.2 Claims

8.2.3 Commissions

8.2.4 Reinsurance

8.3 Insurance Accounting

8.3.1 Loss and Loss Adjustment Expense Accounting

8.3.2 Reinsurance Accounting Basics

8.3.3 Deposit Accounting

8.4 Summary

8.5 Keywords

8.6 Review Questions

8.7 Further Readings

Objectives

After studying this unit, you will be able to:

- Discuss the types of Life insurance products
- Describe the basics of accounting for insurance
- Explain the concept of Insurance accounting
- Discuss the accounting for insurance companies with the help of few illustrations

Introduction

The major differences in accounting for life insurance as compared with other industries derive from the long time period between receipt of premiums and the payment of claims. This gives rise to the need for actuarial estimates of the liability in order to determine both the solvency and the profitability of life business.

Life insurance products include term; whole-life; endowment; maximum investment contracts including unit-linked policies; annuities; pensions; and permanent health insurance. In with-profits insurance policyholders as well as shareholders participate in the surpluses arising on the business. Premiums may be paid as single, regular or recurring single premiums. In setting premium rates the actuary must allow for mortality, interest, expenses and contingencies, as well target profit and market competition. Accounting practices are needed for premiums, for claims on death, maturity and surrenders (including bonuses), and for commissions (including deferred acquisition costs).

8.1 Types of Life Insurance Products

There are different types of life Insurance products which are explained in the following sub-sections.

8.1.1 Term Insurance

Term insurance is designed to provide pure life cover and so will provide benefit on death during the term of a policy. The policy can be purchased for any selected time period. The insurer pays the policyholder's estate if she/he dies during the term of the policy, but if she/he survives she/he will receive nothing. Term insurance is a protection product, for example it is commonly written in conjunction with repayment mortgages to provide a form of repayment protection.

8.1.2 Whole-life Assurance

A whole life policy has no fixed term and there will always be a benefit (contractual amount, adjusted for items such as policy loans and dividends, if any) at the death of the insured.



Example: Whole-life policies are sometimes used to provide a benefit on death to enable beneficiaries to pay the Inheritance Tax Liability on the estate.

8.1.3 Endowment Assurance

An endowment assurance policy will pay the policyholder a sum after a fixed period or on death before the period is completed. Unlike term assurance and whole life assurance the policyholder can receive the benefit. Endowment policies are generally used as investment/saving products.



Example: Repayment of the capital amount owing on a mortgage. Many whole life and endowment policies are written as 'with-profit' policies whereby the policyholders are entitled to share in surpluses arising on the business. In a proprietary company such surpluses are often divided on the basis of 90% to policyholders and 10% to shareholders.

8.1.4 Maximum Investment Contracts

Certain contracts are designed to provide minimal life cover and are principally investment products, for example, unit linked policies. Benefits may take the form of a capital sum on maturity

which is often partly guaranteed (they are typically subject to market value adjusters, so that the return is reduced if the investment return obtained by the life company is not sufficient to support the guarantee) or may be paid as income through the period of the policy. As investments, these products will be in direct competition with other forms of medium term deposits, such as building society deposits or unit trusts.

Unit Linked Policies: With a unit-linked policy the policyholder buys units in a pooled investment fund and therefore participates directly in the investment performance of the underlying funds. The return arising from a unit linked policy is determined by reference to the value of a particular fund of investments. The performance of the contract is objectively linked to the investment performance of the fund investments rather than being at the discretion of the insurer and thus the investment risk is passed on to the policyholder.

A unit linked policy differs from a conventional policy in that:

- A guaranteed percentage of each premium is allocated to units in the life fund.
- The capital growth, and frequently the income of the fund, is re-invested in the fund, and is reflected in the increased value of the units. The policyholder benefits directly from the total investment growth and income.
- The basis of the charges by the life company is normally fixed at the outset of any policy. Companies that write only unit linked policies tend to be subsidiaries of banks ('bancassurers').

8.1.5 Annuities

An annuity policy provides for payments to be made at regular intervals, starting at a specified date, and usually continuing until the death of the policyholder. The amount of the payment is specified by the policy, and may be constant throughout the annuity period, or may increase at a prescribed rate.

8.1.6 Pensions

Pension policies involve paying regular or single premiums to create a stream of income (starting at retirement), usually also with the option of paying a capital sum. In essence, these policies are savings contracts, leading to a deferred annuity and a capital payment.



Example: The premiums paid and the investment incomes generated are tax deductible and exempt from tax respectively.

8.1.7 Permanent Health Insurance (PHI)

A permanent health policy provides for income to be paid in the event of the insured falling ill. The sum paid depends on the particular contract, and may be either fixed or escalating, and for a limited period or paid indefinitely.

8.1.8 Premiums

A premium is a sum paid to the life office to assure the benefit specified by the policy.

Payment of premiums: Single premium contracts: These contracts require the payment of a single amount by the policyholder at the start of the contract term.

Regular premium contracts: The policyholder is contractually obliged to make payments at regular periods to the insurer over the term of the policy, e.g. monthly, annually.

Notes

Recurring single premium: Neither the timing nor the amount is determined in advance. Pension policies are often structured in this manner so as to allow the policyholder maximum flexibility in making contributions, for example by reference to the level of his/her income in any year.

The calculation of the premium: Insurance companies need to set a price for the cover given which is sufficient to pay:

- (a) The cost of any benefits which may be paid to the policyholder,
- (b) The commission paid to salespersons or intermediaries,
- (c) The costs of administering the policy, and
- (d) The target profit.

Calculating the level of premium for a particular type of policy involves the expertise of a company's actuary. There are four main factors the actuary must consider when setting the level of premium:

Mortality: The actuary will refer to 'mortality tables', and from these, on the basis that the policy will be sold to a sufficiently large number of policyholders, the actuary can determine the appropriate premium to be charged to someone of a given age, sex and state of health.



Example: Statistically women have a higher life expectancy and generally pay lower premiums for life cover.

Thus for a person aged 55 who requires ₹ 2,000 cover for a period of one year, the premium required for purely mortality risk might be ₹ 23. However for a person aged 25, the premium required might be only ₹ 4. Thus the 55 year old policyholder pays a higher premium because of the increasing probability of death with advancing age.

So if life assurance was taken out on an annual basis, premiums would have to increase year by year as the risk of the policyholder dying increases. In practice such a system would be unworkable since (a) as the policyholder gets older the annual increases in premiums would get greater and greater until they eventually became prohibitive; and (b) in order to assess accurately the life assured's risk of dying in the next year other factors would be relevant, for example: the general health of the policyholder. Thus the insurance company would have to require the policyholder to submit to a medical examination prior to yearly premiums being set. This would substantially increase the costs of administering the policy and premiums would have to be boosted still further.

Investment Income: Premiums received by the company earn investment income in the form of dividends and interest from the shares and other investments owned by the company and additional profit may result from eventually selling the shares at a higher price than they originally cost. Thus the actuary will need to consider likely future rates of interest and allow for this within the calculation of the premium.

Expenses: Some margin must be added to cover the life assurance company's future expense levels to be experienced in administering the policy. These include: agents' and brokers' initial and renewal commissions, overhead expenses, staff salaries, advertising, etc. The expense loading to a premium is not simply a matter of sharing out the total expenses to each policyholder since each policy does not give rise to the same types or amounts of expenses. Therefore the expense loading must reflect in some equitable manner the expenses the particular type of policy gives rise to.



Did u know? Life assurance companies have generally adopted the practice of writing long-term contracts whereby a level premium is paid throughout the duration of the policy.

Contingency Factor: Actuaries are very conservative in their assumptions on mortality, interest and expenses and include a contingency factor to give a safety margin to meet any unforeseen results. They also allow for the probable rate of lapses or early surrenders of policies before their term.

Concluding, in determining premium rates the actuary will consider, inter alia:

1. The sum assured;
2. The age of the policyholder, his/her general health and life style e.g. Smoker/non-smoker;
3. Future investment returns;
4. Future expense levels in administering the policy;
5. Allowance for contingencies given the uncertainties involved;
6. The target profit;
7. The price at which similar products are being sold by other companies.



Caselet

Optimising a Global Insurance Company's Procure-to-Pay Function

The Client's Challenge

A global insurance group had already established a shared services/global in-house centre (GIC), but was concerned that the promises around savings and customer satisfaction made by its previous advisory firm were failing to be realised. As a result, it engaged Everest Group to assist with analysing and optimising its Procure-to-Pay (P2P) function.

Insight to Action

Putting its Service Improvement methodology to work, Everest Group initiated a rigorous data collection activity to capture baseline costs and construct a comprehensive view of the current P2P environment (FTEs, costs, application environment, and organisational structure). Everest Group also extensively analysed the client's spending distribution across all its purchases. Leveraging its extensive knowledge of P2P best practices gained by its frequent interaction with outsourcing providers and the marketplace in general, Everest Group quickly formulated a list of "gaps to best practice," and built a detailed implementation plan to jump those gaps to the desired future state. Further, Everest Group suggested a large-scale procurement enhancement project to cleanse the vendor master file, analyse and optimise spend, dramatically reduce the number of vendors it currently used, and employ strategic sourcing initiatives.

Impact

Via its Service Improvement methodology, Everest Group was able to rationalise the client's P2P accounting resource base by more than 30 percent, and the client is currently realising savings of more than 18 percent on total spend. End users of the P2P process are reporting enhanced satisfaction with the management reporting being provided and on time vendor payment percentage has risen from 68 percent to 98 percent. As a result, millions of dollars in available discounts are now being realised as well. Consequently, the client engaged Everest Group to optimise its "Order to Cash" and "Record to Report" accounting processes.

Source: <http://www.everestgrp.com/functions/finance-accounting/case-study-optimizing-procure-to-pay-function-for-insurance-company.html>

Notes

Self Assessment

Fill in the blanks:

1. Some margin must be added to cover the life company's future expense levels to be experienced in administering the policy.
2. A health policy provides for income to be paid in the event of the insured falling ill.
3. A is a sum paid to the life office to assure the benefit specified by the policy.
4. Pension policies involve paying or single premiums to create a stream of income (starting at retirement), usually also with the option of paying a capital sum.
5. The return arising from a policy is determined by reference to the value of a particular fund of investments.

8.2 Accounting for Insurance

There are following concepts which are used to describe the accounting for insurance:

8.2.1 Premiums

There are two types of premium:

Regular Premiums: The accounting entries to recognise a ₹ 50 renewal premium on a regular premium policy in the month in which the premium **falls due** would be:

Policyholder/Intermediary Debtor (Balance sheet)	Dr	50	
Premiums Written (Technical Account)			50

When the premium is actually received the following entries will be made:

Cash	Dr	50	
Policyholder/Intermediary Debtor			50

If a debit balance remains on the policyholder/intermediary debtor account this will indicate that a premium has not be received and either the policy may have lapsed or the intermediary has not yet settled the account.

Single Premiums and Initial Premiums: Under these cases the cash is usually required when the policy proposal is made and the accounting entry would be:

Cash	Dr	50	
Premiums Written			50

8.2.2 Claims

The amount of claim that is paid to the policyholder depends on the type of policy written, and in particular whether it is without or with profit. It is paid either on death or on the maturity of an endowment type policy.

Without-profit Policies: The only benefit derived by the policyholder (or his/her estate) is payment of the sum assured. This amount is determined by the original terms of the policy.

With-profit Policies: This term is used to describe policies where the policyholders are eligible to participate in the surpluses established. Thus the claim amount is dependent on:

1. The investment performance;
2. The expenses;
3. The mortality experience;
4. The rate of lapses or surrenders of policies; and
5. Taxation.

The policyholder therefore bears much of the risk and only a small proportion of the claim is represented by any guaranteed sum assured.

Unit-Linked Policies: The claim amount is determined by reference to the value of the specified fund of investments.

Reversionary and terminal bonuses: Apart from the guaranteed death benefits assurance companies give the 'with-profits' policyholders bonuses during the policy period which are allocations of surplus arising from the life fund. There are usually two types of bonuses: reversionary bonuses and terminal bonuses. Reversionary bonuses are declared, often annually, during the policy term, normally as a proportion of the sum assured (simple reversionary bonuses) or as a proportion of the sum assured and previously declared bonuses (compound reversionary bonuses). They increase the policyholders' claim entitlement but are actually paid only when a claim arises. Terminal bonuses are paid in addition to the ordinary reversionary bonuses and are allocated only to policies becoming claims by death or maturity.

Some assurance policies include what are known as 'guaranteed bonuses', which form part of the contractual obligations that are allowed for in determining the original premium and are not strictly bonuses at all.

Surrenders: Since many of the assurance policies are used, in part or whole, as a savings vehicle, policyholders may wish not to continue with premium payments, so the insurer builds into the contract a provision for its surrender for a cash sum prior to the end of the policy term. The amount payable will generally be less than the total premiums already paid by the policyholder.

Accounting for Death Claims: Notification of the death of a policyholder will be received by the assurance company. For example, if the sum assured is £2,000, the insurer will immediately set up a provision for this amount.

Claims Paid (Technical Account)	Dr	2,000
Claims Outstanding (Balance Sheet)		2,000

The company will then require a death certificate prior to paying the beneficiaries. Once this is received the following entries will be made:

Claims Outstanding (Balance Sheet)	Dr	2,000
Cash		2,000

For surrenders or a maturity no accounting entries will normally be made until the payment is authorised. For example: a £1,000 surrender or maturity would be:

Claims Paid (Technical Account)	Dr	1,000
Cash		1,000

Although the maturity could be previously foreseen, no entry for the liability is made in the accounts as the amount will have previously been allowed for in the actuarial estimate of the 'technical' provision for the long term business.

Notes

8.2.3 Commissions

Commissions are paid to brokers or agents ('intermediaries') as an incentive to sell policies and maintain and expand the life company's business. They are usually at very high levels ranging from 5% to over 100% of the premiums paid. Commission can therefore amount to a very considerable expense in the technical account of the life company.

There are two types of commission: initial commission on new policies and renewal commissions for subsequent periods. The commission paid to the agents arises in the form of a large initial payment but the insurer generally has the right to recover some of this money if the policy lapses within the period over which the commission is earned.

Accounting Treatment for Initial Commissions: Example: A policy is sold by an agent and the monthly premium payments for the policyholder are £25 a month. The agent receives commission at a rate of 115% of the annual premium value. The policyholder pays the first month's premium and thus the accounting treatment for the commission is:

Deferred Acquisition Costs (Balance Sheet)	Dr	345	
Due to intermediaries (Balance Sheet)			345

The asset for the commission would be written off to the technical account over an appropriate period. The monthly entry required would be:

Acquisition Costs (Technical Account)	Dr	28.75	
Deferred Acquisition Costs			28.75

When the agents are paid the entry is as follows:

Due to intermediaries	Dr	345	
Cash			345

Following the implementation of the EU Insurance Accounts Directive companies are now required to defer acquisition costs over the term of the policy, so the charge to the technical account will be more gradual.

8.2.4 Reinsurance

Companies normally 'lay-off' a proportion of the risk by reinsuring with other insurance, or specialist reinsurance, companies. The accounting for the reinsurance premiums paid, claims reimbursements received and commissions paid is effectively the mirror image of the accounting for the direct insurance.

Self Assessment

Fill in the blanks:

6. Companies normally a proportion of the risk by reinsuring with other insurance, or specialist reinsurance companies.
7. The amount of that is paid to the policyholder depends the type of policy written, and in particular whether it is without or with profit.
8. Commissions are paid to brokers or ('intermediaries') as an incentive to sell policies and maintain and expand the life company's business.
9. There are two types of commission: commission on new policies and commissions for subsequent periods
10. The asset for the would be written off to the technical account over an appropriate period.

8.3 Insurance Accounting

Notes

Certain basic insurance accounting concepts include:

- Loss and loss adjustment expense accounting basics
- Reinsurance accounting basics
- Deposit accounting basics

8.3.1 Loss and Loss Adjustment Expense Accounting

The following uses the terms “loss” and “claim” interchangeably, and “liability” and “reserve” interchangeably. The author is aware that terminology varies by jurisdiction, sometimes by company within a jurisdiction, or even within the same company. Hence the student is advised to confirm the usage of these terms within their business environment. This discussion also discusses losses exclusively, rather than loss and loss adjustment expense, although most of this is also applicable to loss adjustment expenses.

Loss accounts: The basic accounting transactions involving losses are:

- Paying claims
- Increasing or decreasing claim reserves

These two items affect the income statement through *incurred losses*, which equals paid claims (or “losses”) plus the change in loss reserves, or

$$\text{Incurred losses} = \text{paid losses} + (\text{ending loss reserves} - \text{beginning loss reserves})$$

There may be several loss reserve accounts in a company’s ledger. All companies’ ledgers will generally have the categories of *case reserve* (the estimate of unpaid claims established by a claim adjuster or the claim system) and *IBNR* (the reserve for “Incurred but Not Reported” claims), as several jurisdictions require that these amounts be disclosed separately in annual financial reports.

Other accounts that may be set up include:

- **Bulk Reserve:** This reserve represents the estimated deficiency in the aggregate of case reserves for known claims. If forced to assign it to either case reserves or IBNR reserves, some will assign it to case reserves, as it represents reserves for claims that have already been reported. Others will assign it to IBNR, as it represents an aggregate calculation above claim adjuster estimates not reliably assignable to an individual claim.
- **Additional Case Reserve:** This represents an additional reserve for an individual claim, above the level set up by the claim adjuster. It is most common for claims under assumed reinsurance contracts, where the case reserve comes directly from the ceding company, as it allows the assuming company to record a different estimate for the value of a claim than the ceding company.

Companies may or may not also set up loss reserve accounts for reopened claims, anticipated subrogation or salvage recoveries, deductible recoveries (where the full loss is paid by the insurer who then bills the insured for the deductible), expected legal defence costs, etc.

Note that the above amounts may be positive or negative. For example, bulk reserves could be negative if it is assumed that case reserves will be redundant in the aggregate. Case reserves for a claim could be negative if it is assumed that amounts paid-to-date on a claim are greater than the ultimate value, and that some future recovery of paid amounts is expected.

Notes

Loss cycle: Incurred losses reported in financial statements are typically broken out into two pieces, the initial estimate of incurred losses for the most recent exposure period, and changes in the estimate of incurred losses for prior periods. This can frequently be translated in summary form into:

- Incurred losses for the current accident year.
- Changes in incurred loss estimates for prior accident years.

There are also two general approaches to the initial recognition of losses for the current accident year – those based on actual claim activity and those based on accrual of estimated incurred losses based on the level of earned exposure. The following tracks the life-cycle of incurred claims for each of these approaches, first when initial reserves are based on actual claim activity, and then when initial reserves are estimated based on the estimated earned exposure.

Actual claim activity: Under this approach, the incurred losses for the most recent exposure period are initially set based on the actual claim activity, with possible additional loss reserves established to allow for IBNR claims or any expected deficiency/redundancy in claim adjuster reserves. For subsequent valuations of the same group of claims, changes in claim adjuster estimates directly impact incurred losses, and aggregate reserves such as bulk and IBNR reserves are run off over time based on studies of historical data or other actuarial studies.

The following tracks the accounting entries resulting from claims for accident month January 2011 for a hypothetical company/line of business, from initial valuation to the final payment for the accident month.

The following (simplifying) assumptions were made in the following example:

- All claims are reported within 4 months of the loss event.
- Earned premium for the month is ₹ 100.
- Each claim is worth ₹ 10, half paid in the month of reporting, half in the subsequent month.
- The initial IBNR is set based on 30% of earned premium, run off evenly over the following three months.
- No bulk reserve is necessary (beyond that which may be implicit in the IBNR calculation).



Notes

Some claim departments define the case reserve as their estimate of the ultimate value for the claim, including amounts paid-to-date. This can occur even when the term is used to represent unpaid amounts only among the actuaries in the same company.



Example 1: Where reserving is based at inception on actual claim activity

Assume

- All claims are reported within 4 months of the loss event.
- Earned premium for the month is ₹ 100.
- Each claim is worth ₹ 10, half paid in the month of reporting, half in the subsequent month.
- Case reserves are established at ₹ 10 once the claim is reported.
- The initial IBNR is set based on 30% of earned premium, run off evenly over the following three months.
- No bulk reserve is necessary (beyond that which may be implicit in the IBNR calculation).

Accident Accounting Reported			Case			Ending Beginning Incurred			Notes
Month	Month	Claims	Paid	Reserves	IBNR	Reserves	Reserves	Losses	
a	b	c	d	e	f	g	h	i	
						(g) = (e) + (f)		(i) = (d) + (g) - (h)	
Jan. 11	Jan. 11	3	15	15	30	45	0	60	
Jan. 11	Feb. 11	2	25	10	20	30	45	10	
Jan. 11	Mar. 11	0	10	0	10	10	30	-10	
Jan. 11	Apr. 11	1	5	5		5	10	0	
Jan. 11	May11		5	0		0	5	0	
			60					60	

The above displays the life-cycle for a particular accident month. The financials for a particular accounting month will reflect various accident months with transactions or outstanding reserves during that month.

The establishment of the initial reserves for an exposure period based on actual activity is most typical where most of the claims are reported relatively quickly and settled quickly, such as for certain property lines in many jurisdictions. Such an approach is not possible if claims are reported slowly and/or where the initial claim adjuster estimates are not sufficiently reliable indicators of ultimate payout.

For product lines with slower reporting and/or payment patterns or where the initial case reserves are less reliable at initial valuation, it is common to set the initial incurred loss estimate based on an “a priori” estimate of loss exposure for the period. The following is an example of such an approach where the initial estimate of incurred losses is based on an expected loss ratio times earned premium.

Accrual of estimated incurred losses based on the level of earned exposure: The following (simplifying) assumptions were made in the following example:

- Claim activity is tracked and reserves set by accident year.
- Earned premium for the 2012 calendar year is running ₹ 1,000 a month.
- Based on an analysis of pricing and loss trends and expected underwriting, management expects a 60% loss ratio for the 2012 accident year.
- Only two loss reserve accounts are maintained, case and IBNR.
- These two reserve accounts are further split in two AY buckets, the current AY (which is 2012 in this example) and all prior.

In this example, management determines the incurred losses for the current AY based on earned premium for the period, and performs regular reserve reviews to determine if prior accident year estimates should be changed. The illustration shown has such a change in estimate for prior years.



Example 2: June 2012 reserve setting

Step 1 - Determine Incurred Losses		
AY 2012		
June 2012 earned premium	1,000	a
Expected loss ratio	60%	b

Notes					Source
	AY 2012	All prior	Total		
Incurring losses	600				<i>c</i>
All prior years					
Change in prior estimate of ultimate incurred losses	500				<i>d</i>
Step 2 - Determine IBNR reserves					
	AY 2012	All prior	Total		Source
May 31, 2012 case reserves	500	4,800	5,300		<i>e</i> ledger
May 31, 2012 IBNR	900	5,300	6,200		<i>f</i> ledger
May 31, 2012 total reserves	1,400	10,100	11,500		<i>g</i> (<i>e</i>) + (<i>f</i>)
- paid losses in June 2012	100	400	500		<i>h</i> ledger
+ incurred losses in June 2012	600	500	1,100		<i>i</i> (<i>c</i>) and (<i>d</i>)
June 30, 2012 total reserves	1,900	10,200	12,100		<i>j</i> (<i>g</i>) - (<i>h</i>) + (<i>i</i>)
June 30, 2012 case reserves	700	4,750	5,450		<i>k</i> ledger
June 30, 2012 IBNR reserves	1,200	5,450	6,650		<i>l</i> (<i>j</i>) - (<i>k</i>)

It is possible for an insurer to use one of the above approaches for some of its lines and the other approach for its other lines. It may use both approaches on the same line, basing the reserves early in an accident year on a loss ratio times earned premium and then moving to reserving based on actual claim experience once the actual claim data becomes more credible. It may also choose to use one method for some loss types and the other method for other loss types for the same product line. The choice is generally up to the insurer, unless the applicable accounting rules and/or insurance laws/regulations dictate a particular reserve estimation method.

Accounting for discounted reserves: The use of discounted reserves creates its own issues in designing an accounting system, in that the ultimate paid losses will be recorded at nominal value, more than the recorded discounted loss reserves. The accounting system must therefore determine how to treat the increase in the reserve due to the amortisation of discount.

The current approach used in many jurisdictions for this situation is to record the increase due to discount amortisation as incurred losses. This may show up as reserve strengthening in certain reports, unless accompanied by adequate disclosure.

An alternative approach (not yet widely used for insurance loss accounting) is to record the income statement impact of increasing loss reserves due to discount amortisation as interest expense. Where interest expense is reported together with interest income, this would result in incurred losses staying at the initial discounted value, unless incurred loss estimates change. It would also result in lower investment income than occurs in many current insurance accounting systems.

8.3.2 Reinsurance Accounting Basics

It includes the following concepts:

Assumed Reinsurance accounting: In general, the accounting rules applicable to insurers writing direct insurance contracts also apply to those writing assumed reinsurance contracts. That said, there may occasionally be differences, such as different risk transfer rules and different definitions of loss versus loss expense.

Loss adjustment expense: It is common for reinsurance contracts covering tort liability insurance risks to include coverage for legal defence costs. These are frequently coded as loss adjustment expenses and are frequently reported separately from losses by the ceding company. But the assuming company may record such costs as assumed losses on their books.

Ceded reinsurance accounting: There are two general approaches to ceded reinsurance accounting currently in existence:

1. Treating the ceded reinsurance entries as negatives of the direct or assumed reinsurance entries, or
2. Treating the purchase of reinsurance as the purchase of an asset.

These approaches may sometimes be combined in a single accounting system.



Example 3: U.S. GAAP treats ceded reinsurance premiums and losses as negative premiums and negative losses for income statement purposes, but ceded loss reserves as an asset rather than as an offset to a liability for balance sheet purposes.

The following example assumes that the relative entries in an account are added together to get a total. For example, if a company writes \$100 in direct premium and then cedes \$10 in premium, it assumes that the premium entries are + ₹ 100 and - ₹ 10. These values are then **ADDED** to get the net of ₹ 90. There are some accounting systems that record ceded entries as positive values, and that always subtract ceded values in calculating totals for an account. In such a system the premium entries would be + ₹ 100 and + ₹ 10, and the user of the information would have to know to **SUBTRACT** ceded amounts from direct and assumed amounts.



Example 4: Ceded reinsurance impact on income statement, assuming treatment as negative insurance.

Assume the company has (and has historically maintained) a 20% quota share ceded reinsurance contract for all direct insurance, with a ceding commission of 30%.

Assume the loss ratio on direct business is 65%, and the only direct expense is a 30% commission. Assume the direct earned premium for the year is \$100 and the direct loss reserve at year-end is \$200.

Income Statement

Direct Earned Premium	\$100
<u>Ceded Earned Premium</u>	<u>-20</u>
Net Earned Premium	80
Direct Incurred Losses	\$ 65
<u>Ceded Incurred Losses</u>	<u>-13</u>
Net Incurred Losses	\$ 52
Direct Commissions	\$ 30
<u>Ceded Commissions</u>	<u>-6</u>
Net Commissions	24
Net underwriting income	\$ 4

Balance Sheet

Direct Loss Reserve	\$200
<u>Ceded Loss Reserve</u>	<u>-40</u>
Net Loss Reserve	160

If the accounting instead required segregated reporting of the impact of ceded reinsurance, it may require that it be treated as a net expense in the calculation of underwriting income. In the above example, the net cost of ceded reinsurance would be ₹ 1 (equal to an earned premium cost of ₹ 20, less recoveries of ₹ 13 for losses and ₹ 6 for expenses).

Notes



Example 5: Treatment of Ceded Reinsurance as purchase of an asset for balance sheet purposes (such as under U.S. GAAP)

Assume the same facts as in example 4, but with different balance sheet treatment

Assets		Liabilities	
Ceded Loss Reserve	\$40	Direct Loss Reserve	\$200

Reinsurance reporting lags: Reinsurance contracts include language regarding reporting requirements of the ceding company to the assuming company. These reports serve multiple purposes. One is to effect the necessary paid transactions under the contract, including ceded premiums and losses according to the policy terms. Another is to enable the assuming company sufficient data to perform its own reserve analysis (either for the particular contract or contract claims, or for the assuming company's portfolio of contracts or claims). A third is to enable the assuming company to meet its own accounting requirements.



Caution The categorisation of defence costs (and other such expenses) may shift between loss expense and loss when going from the ceding company to the assuming company. This will distort analyses of loss versus loss expense on a combined direct writer plus reinsurer basis.

There can be significant lags in the filing and receiving of these reinsurance reports. The lags can be the result of time necessary for the ceding company to accumulate the data required to be reported. They may also be due to the need to coordinate input from multiple parties, such as where the ceding entity is a pool and the pool administrators must first collect the relevant data from all the pool members before submitting reports to the pool reinsurers. Delays can also be caused by multiple handoffs and consolidations, such as occurs for some retrocession contracts where first the ceding companies must report to their reinsurers, who then must process the data before submitting their report to retrocessionaires (with multiple layers of retrocessionaires possible). Delays of several years have been observed for higher level retrocession contracts involving parties from multiple countries and/or continents.

Some accounting paradigms require the assuming company to record estimated transactions where the lags and the dollars involved are material. This may involve recording estimated premiums, losses and expenses (including estimated "paid" losses) based on anticipated or historical experience. These estimates could be trued up once the actual values are known or improved estimates are available.

8.3.3 Deposit Accounting

Deposit accounting for a contract generally observes the following rules:

- The accounting is done on an individual contract-by-contract basis, and not on a portfolio basis, even if the resulting contract-by-contract amounts are reported on a summary basis in financial reports.
- The amount(s) received for a contract is recorded as a deposit liability, with no revenue or expense impact (and therefore no impact on income).
- The deposit liability is increased due to additional receipts, and usually investment income credits of some sort, and decreased due to payments.
- As such, the deposit generally represents a present value of future payment obligations.

Deposit accounting may be required by accounting paradigm for what might otherwise be an insurance (or reinsurance) contract under the following conditions:

- No risk transfer.
- Timing risk transfer only, but no transfer of amount risk – i.e., where the amount to be paid until the contract is considered fixed or subject to minimal uncertainty, but uncertainty exists as to the timing of the payment.
- Retroactive reinsurance, subject to exceptions.



Notes

Whether a particular accounting paradigm requires deposit accounting under these conditions can vary significantly from one accounting paradigm to another.

Three general forms of deposit accounting currently observable are bank deposit approaches, prospective approaches and retrospective approaches.

Bank Deposit Approach: This is the simplest of the three deposit accounting approaches to be discussed. Under this approach, the initial deposit grows with credited interest at a rate whose calculation is determined in advance (and with possible additional deposits depending on the contract terms) and declines with withdrawals. The defining characteristic is that the ending deposit for a reporting period is dependent solely on the beginning balance, the credited rate for the period, and any deposits or withdrawals during the period. The credited rate may be fixed or variable, dependent on market rates or based on non-market events or rates, but the method of its calculation is generally set in advance.

Prospective Approach: The defining characteristic of this approach is that the current value of the deposit is set equal to the present value of future payments, irrespective of the initial deposit or past payments. The interest rate is generally a market rate, which may be based on risk-free rates and may be locked-in at inception such that it does not change over time. (Conceptually, it is also possible for a prospective method to use a market rate that is updated for each reporting period.)

Under this approach, the deposit value will change with the amortisation of interest, and with a change in projected future losses (and with a change in the discount rate, if the rate is not locked-in by the accounting paradigm).

Retrospective Approach: The defining characteristic of this approach is that the deposit is a function of the initial deposit, all past payments, and the current estimate of all future payments. Under this method the interest rate is the rate for which the discounted value of past payments and estimated future payments would equal the initial deposit. The interest rate can change whenever the estimated cash flows under the contract change. This method could also conceivably generate a negative rate if applied to a contract where the projected outflows no longer exceed the initial inflows. Whereas the prospective approach only cares about future (except possibly for an interest rate locked-in in the past), the retrospective approach cares about all the flows since inception, past and future.

Under this approach, the deposit value and discount rate are subject to change whenever the projected cash flows since inception are changed.

Self Assessment

State whether the following statements are true or false:

11. The defining characteristic of prospective approach is that the current value of the deposit is not equal to the present value of future payments, irrespective of the initial deposit or past payments.

- Notes**
12. Deposit accounting may be required by accounting paradigm for what might otherwise be an insurance (or reinsurance) contract under the following conditions.
 13. Some accounting paradigms require the assuming company to record estimated transactions where the lags and the dollars involved are material.
 14. Reinsurance contracts include language regarding reporting requirements of the ceding company to the assuming company.
 15. The current approach used in many jurisdictions for this situation is to record the increase due to discount amortisation as incurred losses.

Illustration 1

XYZ Insurance Company		Impact of Large Line Capacity Treaty	
Balance Sheet		Without	With
<u>Assets</u>			
Bonds		2,575	2,663
Cash		75	113
Agents Balances		100	140
Total		2,750	2,915
<u>Liabilities</u>			
Loss Reserves	Gross	750	1,125
	Cede	0	300
	Net	750	825
Unearned Premium	Gross	500	700
	Cede	0	150
	Net	500	550
Ceded Agts. Balances		0	30
Total		1,250	1,405
<i>Surplus</i>		1,500	1,510
<u>Income Statement (net of reinsurance)</u>			
Earned Premium		1,000	1,100
Incurred Losses		750	825
Expenses		200	220
Underwriting Income		50	55
Investment Income		133	139
Total income		183	194
Other Financial Statistics			
Written Premium	Gross	1,000	1,400
	Cede	0	300
	Net	1,000	1,100

Gross WP/Surplus	67%	93%	Notes
Net WP/Surplus	67%	73%	
Gross Loss Res./Surpl.	50%	75%	
Net Loss Res./Surpl.	50%	55%	
Ceded balances/Surplus	0%	30%	

Illustration 2: ABC I insurance Company Impact of Catastrophe Protection Treaty

Balance Sheet		No Cat. event		Yes Cat. Event	
		Without	With	Without	With
<u>Assets</u>					
Bonds		2,575	2,525	2,480	2,430
Cash		75	75	120	120
Agents Balances		100	100	100	100
Total		2,750	2,700	2,700	2,650
<u>Liabilities</u>					
Loss Reserves	Gross	750	750	1,200	1,200
	Cede	0	0	0	400
	Net	750	750	1,200	800
Unearned Premium	Gross	500	500	500	500
	Cede	0	0	0	0
	Net	500	500	500	500
Ceded Agts. Balances		0	0	0	20
Total		1,250	1,250	1,700	1,320
Surplus		1,500	1,450	1,000	1,330
<u>Income Statement (net of reinsurance)</u>					
Earned Premium		1,000	950	1,000	930
Incurred Losses		750	750	1,250	850
Expenses		200	200	200	200
Underwriting Income		50	0	-450	-120
Investment Income		133	130	130	128
Total income		183	130	-320	8
<u>Other Financial Statistics</u>					
Written Premium	Gross	1,000	1,000	1,000	1,000
	Cede	0	50	0	70
Net		1,000	950	1,000	930
Gross WP/Surplus		67%	69%	100%	75%
Net WP/Surplus		67%	66%	100%	70%

Notes	Gross Loss Res./Surpl.	50%	52%	120%	90%
	Net Loss Res./Surpl.	50%	52%	120%	60%
	Ceded balances/Surplus	0%	0%	0%	30%



Task Discuss the concept of Insurance accounting.



Case Study **Kelly IT Resources Implements Successful Solution to Reduce Customer Fill Times, Streamline Operations**

Kelly IT Resources developed a streamlined quality program to assist a large, global insurance company in more efficiently filling Information Technology positions and to ensure retention of the company’s IT staff, including temporary, temp-to-hire and direct hire employees.

The Challenge

The insurance company was in need of a staffing vendor capable of developing and implementing a plan to reduce the company’s time in staffing its Information Technology positions. The company was experiencing a high time-to-fill rate of 27-plus days and was seeking a solution to help streamline recruiting, retention and overall temporary staffing operations.

The Solution

Kelly IT Resources (KITR), a specialty service of Kelly Services, was selected to develop a solution to the challenges faced by the insurance company. KITR began by conducting a comprehensive analysis to identify the firm’s needs, and then developed a formalised quality program to ensure employee performance and overall operational success. The program featured:

- A dedicated onsite KITR presence
- A tracking program, which provides monthly assessments of all KITR employees in areas of job knowledge, quality commitments, organisational skills and leadership skills
- Monthly meetings with management team
- Monthly meeting with employees
- Weekly updates to the company regarding overall status

To enhance retention at the firm, KITR developed a comprehensive new employee orientation, highlighting company benefits and training overviews. KITR also implemented a referral bonus program as well as a recognition and reward program, featuring:

- Monthly assignment reviews with each employee and the customer
- Employee recognition initiatives based on project expectations
- Employee career opportunity updates
- Online training incentives

Contd...

Finally, Kelly IT Resources developed a partnership with Project Management Institute (PMI), a national organisation specialising in project management education, training and resources. Through PMI, KITR launched a mentor program that included career path development for IT project coordinators.

The Result

Kelly IT Resources was successful in improving the insurance company's fill time from more than 27 days to 14 days, leading to enhanced productivity and revenue. Consistent client feedback and KITR's overall tracking initiatives revealed high levels of employee performance and satisfaction on the job. KITR's onsite presence and comprehensive quality program led to better communications with the company as well as more direct interaction with employees, thus improving employee retention.

Questions

1. Discuss the problem of the case.
2. What are the consequences of the problem?

Source: <http://www.kellyservices.us/US/Business-Services/Kelly-IT-Resources/Case-Studies/Insurance-Company-Case-Study/>

8.4 Summary

- The major differences in accounting for life insurance as compared with other industries derive from the long time period between receipt of premiums and the payment of claims.
- This gives rise to the need for actuarial estimates of the liability in order to determine both the solvency and the profitability of life business.
- Companies normally 'lay-off' a proportion of the risk by reinsuring with other insurance, or specialist reinsurance, companies. The accounting for the reinsurance premiums paid, claims reimbursements received and commissions paid is effectively the mirror image of the accounting for the direct insurance.
- Investment return comprises interest and dividends and gains and losses from changes in the market value of investments.
- A realised gain arises when an investment is sold for more than its cost. Unrealised gains arise when investments are revalued to market value at the year end but not actually sold.
- As solvency needs to be maintained over the very long periods for which policies are written it is necessary to ensure that not only do assets currently exceed liabilities but even more importantly that future cash inflows will match the requirements for future cash outflows.
- A crucial aspect of investment management is therefore to ensure adequate 'matching' of the maturities of investments against the maturities of anticipated claims.
- As there is usually a significant period between the inception of a policy and the receipt of premiums, and the final payment of benefit, it is necessary to make provision, at the end of each accounting period, for the future liability to pay the ultimate benefits to the policyholders, the amount of which will depend on a range of factors. An actuarial estimate of the 'long term business provision' needs to be made.

8.5 Keywords

Annuity: An annuity policy provides for payments to be made at regular intervals, starting at a specified date, and usually continuing until the death of the policyholder.

Bulk reserve: This reserve represents the estimated deficiency in the aggregate of case reserves for known claims.

Commission: Commissions are paid to brokers or agents ('intermediaries') as an incentive to sell policies and maintain and expand the life company's business.

Endowment Assurance Policy: An endowment assurance policy will pay the policyholder a sum after a fixed period or on death before the period is completed.

Premium: A premium is a sum paid to the life office to assure the benefit specified by the policy.

Prospective Approach: Under this approach, the deposit value will change with the amortisation of interest, and with a change in projected future losses (and with a change in the discount rate, if the rate is not locked-in by the accounting paradigm).

Reinsurance: The practice of insurers transferring portions of risk portfolios to other parties by some form of agreement in order to reduce the likelihood of having to pay a large obligation resulting from an insurance claim.

Whole life policy: A whole life policy has no fixed term and there will always be a benefit (contractual amount, adjusted for items such as policy loans and dividends, if any) at the death of the insured.

Without-profit Policies: The only benefit derived by the policyholder (or his/her estate) is payment of the sum assured. This amount is determined by the original terms of the policy.

With-profit Policies: This term is used to describe policies where the policyholders are eligible to participate in the surpluses established.

8.6 Review Questions

1. There are two general approaches to ceded reinsurance accounting currently in existence. What are they?
2. Define the following terms:
 - (a) Term insurance
 - (b) Endowment assurance
3. Discuss the accounting treatment for initial commission.
4. Explain the following concepts:
 - (a) Prospective Approach
 - (b) Pension plan
5. Discuss the types of life insurance products.
6. Define the term premium. What are the types of premium?
7. Describe the concept of reinsurance.
8. What are the basic concepts of Insurance accounting?
9. What do you mean by bulk and additional case reserve?
10. What are the rules and forms of deposit accounting?

Answers: Self Assessment**Notes**

- | | |
|---------------------|----------------|
| 1. Assurance | 2. Permanent |
| 3. Premium | 4. Regular |
| 5. Unit linked | 6. Lay-off |
| 7. Claim | 8. Agents |
| 9. Initial; renewal | 10. Commission |
| 11. False | 12. True |
| 13. True | 14. True |
| 15. True | |

8.7 Further Readings**Books**

B. B. Dam and H. C. Gautam, *Corporate Accounting*, Capital Publishing.

Das. K R and Others, *Corporate Accounting*, LBS Publication.

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Harrison *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*, AICPA Statement of Position 98-7.

Sehgal, Dr. A and Sehgal, Dr. D, *Advanced Accounting & Corporate Accounting*. Taxman Publishers.

**Online links**

<http://www.pwc.com/us/en/insurance/publications/assets/pwc-tax-accounting-for-insurance-companies.pdf>

http://www.pwc.com/en_US/us/insurance/publications/assets/pwc-tax-accounting-for-insurance-companies-october-2012.pdf

http://www.casact.org/library/studynotes/6_blanchard_selectedl_2007.pdf

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Unit 9: Fundamentals of Liquidation of Companies

CONTENTS

Objectives

Introduction

9.1 Concept of Liquidation

9.2 Types of Liquidation

9.2.1 Compulsory Winding up

9.2.2 Voluntary Winding up

9.2.3 Winding up Subject to Supervision of Court

9.3 Important Terms

9.4 Relevant Date

9.5 Statement of Affairs and Deficiency/Surplus Account

9.5.1 Summary of Gross Assets and Gross Liabilities

9.5.2 List 'H' Deficiency/Surplus Account

9.5.3 Procedure to Prepare Statement of Affairs

9.6 Summary

9.7 Keywords

9.8 Review Questions

9.9 Further Readings

Objectives

After studying this unit, you will be able to:

- Define the concept of liquidation
- Describe the types of liquidation
- Explain few important terms related to liquidation
- Interpret Statement of Affairs and Deficiency/Surplus Account

Introduction

Business organisations are formed by people. Sole trading business organisations are formed by a single person, while other forms of business organisations are formed by group of people. Sole trading and partnership business organisations are comparatively easier to start than the company form of organisations. Companies are creation of law, viz., Companies Act, 1956. Statutory provisions are there to form a company. In the same way, for liquidation or winding up of a company, there are certain provisions in the Act. In this unit we will discuss the meaning of liquidation, modes of winding up of a company, appointment of liquidator, meaning of contributories and preferential payments.

A company comes into existence by law and can come to an end only through a legal process. The legal procedure to wind up a company is called liquidation. Therefore, when the process of winding up begins, the company is said to be in liquidation. The procedure of winding up of a company is laid down in the Companies Act, 1956. A company can be liquidated at any time. It is not compulsory that only insolvent companies should be liquidated. Sometimes, even solvent companies may be liquidated. Liquidation of a company is different from insolvency. The word insolvency is used in the case of individual, partnership firms and Hindu Undivided Families, while the word liquidation is applicable to the companies. Secondly, insolvency of firm, individual or H.U.F. is governed by the Insolvency Act, while liquidation of companies is governed by the companies Act.

9.1 Concept of Liquidation

A company is an artificial person which comes into existence through a process of law. Therefore, its life can also be brought to an end, but only through the process of law. Since a company has a separate existence from its members, its life span is not affected by the life span of any of its members. One of the ways to dissolve a company is to resort to the process of winding up or liquidation. Therefore, when the process of winding up commences, the company is said to be in liquidation. When the directors or members want to liquidate the company, they will have to follow the procedure stated in the company law.

Liquidation of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members. An administrator, called a liquidator, is appointed and he takes control of the company, realises its assets, pays its debts and finally distributes any surplus among the members in accordance with their rights as per the company law. The term 'Liquidation' and 'Winding up' has been used synonymously.

In the case of liquidation of a company, all the assets of the company are realised and amount is collected from unpaid calls on the shares. Then out of the proceeds claims of the external liabilities are settled. After the settlement of the claims of the liabilities and creditors, if any amount is left, it is given to the preferential and equity shareholders according to their rights. A person is appointed to realise the various assets and to make the payments of various liabilities, who is called liquidator.

Self Assessment

Fill in the blanks:

1. of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members.
2. In the case of liquidation of a company, all the of the company are realised and amount is collected from unpaid calls on the shares.

9.2 Types of Liquidation

Under Section 425 (1) of the Companies Act, a company can be liquidated in any of the following three ways:

- (i) Compulsory Winding Up (by court)
- (ii) Voluntary Winding Up (by the members or creditors)
- (iii) Winding up Subject to Supervision of Court.

Notes

9.2.1 Compulsory Winding up

In the following circumstances, a company will be compulsorily wound up by the court:

- (a) If the company has passed a special resolution to be wound up by court.
- (b) If the company is in default to deliver the statutory report to the Registrar of Companies for holding the statutory meeting.
- (c) If the company does not commence its business within a year from the date of its incorporation or suspends its business for a whole year.
- (d) If the number of its member comes below seven and in case of a private company, below two.
- (e) If the company is not in a position to pay its debts.
- (f) If the court is of the opinion that it is just and equitable that the company should be wound up.

In compulsory winding up, any one of the following may file a petition: (1) the company, (2) any creditor, (3) any contributory, (4) all or any of the above mentioned parties (5) the Registrar (6) any person authorised by the Central Government. The Central Government authorises a person to file the petition when it asks for the winding up of a company.

9.2.2 Voluntary Winding up

Voluntary winding up may be two types: (a) Voluntary winding up by members (b) Voluntary winding up by the creditors. In members' voluntary winding up, the directors, or if there are more than two directors, of them, at the meeting of Board of Directors, have to give a declaration of the solvency of the company, verified by an affidavit. The declaration indicates that the company has no debts or will be able to pay its debts in full within three years from the commencement of winding up, as may be specified in the declaration. At the time of passing of resolution for winding up in the general meeting, the company appoints one or more liquidators and also fixes their remuneration. If the liquidator is of the opinion that the company is not in a position to pay its debts in full within the period stated in the declaration, or the period will be over without the payment of debts, he must call a meeting of the company at the end of first year of the commencement of winding up and of each coming years, and should clear the position of his acts and conduct regarding the winding up. Upon the completion of the affairs of the company the liquidator must call a final meeting and lay down these accounts before the meeting. Within one week from this meeting, a copy of these accounts must be dispatched to the Registrar of Companies. After registering these accounts in the register by the Registrar, these accounts are returned to the official liquidator. Then the official liquidator scrutinises these accounts and reports to the court. Then the company is deemed to be dissolved from the date of submission of this report.

If the declaration of solvency is not made by the directors at the meeting of Board and delivered to the Registrar, it is presumed that the company is insolvent. In such a case, it is called creditors' voluntary winding up. In this case, the company must call a meeting of its creditors for passing the resolution for winding up. After passing the resolution of winding up in this meeting, a copy of the resolution is dispatched to the Registrar within 10 days of the date on which the resolution is passed. Members and creditors both appoint their liquidators in their meetings.

9.2.3 Winding up Subject to Supervision of Court

It is a voluntary winding up of the company subject to the supervision of the court on any terms or conditions and with all liberty for creditors, members or others to apply to the court.

The liquidator will continue to exercise all powers, but power will be exercisable subject to any restriction or conditions laid down by the court. Such type of winding up is comparatively rare.

Notes



Caselet

The Regional Services Company

The business of the company operated as an earthmoving equipment importer and on seller, as well as completing contracted earthmoving tasks in the Bendigo and Regional areas.

Upon our appointment we immediately located the company's contact details and made brief contact with the director. The director initially refused to speak with us. So we then attended the principle place of business as per the Australian Securities and Investments Commission ("ASIC") database, in Bendigo, Victoria to investigate the affairs of the company and secure any assets. Whilst in Bendigo we also located the company's accountant via the registered office who was able to provide assistance and open a dialog with the director. We note that we were unable to locate the director in the initial stages, however, with ASIC's and the company's accountant assistance we were able to locate and question the director.

We note that our initial investigations identified some of the items of earthmoving plant and equipment were located at a Melbourne based plant and equipment auctioneer and we were able to secure these assets for the benefit of creditors. Further, we note the director advised that the former director, and former partner in the business, had possession of a leased company vehicle (no equity was determined in the vehicle) had claimed to be in satisfaction of a director's loan account, which was recovered for the benefit of ordinary unsecured creditors, as it reduced the claim of the lessor. The return to the creditors in this administration was approximately 52 cents in the dollar.

Source: http://www.brookebird.com.au/index.php?option=com_content&task=view&id=43

Self Assessment

Fill in the blanks:

3. A limited company can be liquidated by any of..... ways.
4. A creditors for ₹ 5,000 holding a charge on the machinery of the book value ₹ 7,000 (market value ₹ 4,500) will be called.....
5. Deficiency/Surplus Account is prepared as per.....

9.3 Important Terms

Some important terms are as follows:

Liquidator: In the case of voluntary liquidation by members, a liquidator is appointed by passing a resolution in the general meeting of the company, and in the case of winding up by creditors he is appointed in the meeting of creditors and his remuneration is also fixed in the meeting. The appointment of a liquidator is to realise the various assets and making the various payment of the liabilities. He also has to conduct the legal proceedings of the winding up of the company. In case of compulsory winding up, the official liquidator attached to each High Court is appointed liquidator by the Central Government after the winding up order is passed. The official liquidator has to perform the winding up proceedings under the supervision and control of the court which has made the order for winding up. The company prepares its Statement of Affairs which is

Notes

submitted to the liquidator. Assets at realisable values and liabilities at values expected to rank and surplus and deficiency as per List H are shown in the Statement of Affairs. The official liquidator must call two separate meetings of creditors and shareholders to know the views on the appointment of a 'Committee of Inspection'. The committee so appointed should not have more than 12 members made up of an equal number representing creditors and shareholders.

Contributories: When the winding up process of a company begins, shareholders of that company are known as contributories. As per Section 428 of the Companies Act 1956, the term contributory means any person liable to contribute to the assets of a company in the event of its being wound up and includes a holder of fully paid up shares, and also any person alleged to be contributory. All the present as well as past shareholders will be contributories. Present shareholders/members are those whose names are included in register of company when the company is wound up. The past shareholders are those who ceased to be the members within a year following the commencement of winding up. Accordingly, the contributories are classified into two lists. List 'A' includes the present members (even though fully paid up shareholder). List 'B' includes all the past members who ceased to be members (except by death) within one year of the winding up of the company. The past members will be called to contribute only when the present contributories are unable to pay the liability and debts incurred by the company while they were members of the company. If the contribution made by the 'B' List contributories are more than sufficient to pay the debts which were contracted while they were members, the balance must be returned to them. The nature of contributory's liability after winding up is legal and not contractual. If a person is both a contributory and a creditor of the company, he cannot set off his debt against his liability for calls, whether the calls were made before or after the winding up. The court may order the contributory to first pay off the debt due by him to the company and then claim the amount due to him. Debts due from company to the contributory will be taken at par with the other contributories and not with creditors. At the time of winding up the liquidator of the company must distribute the surplus, if any, among contributories, in accordance with the rights provided in the Articles of Association.

Order of Priority in Payment of Debts: After realising the amount from the sale of assets not specifically pledged, surplus of securities from the fully secured creditors and the amount from contributories, the liquidator must distribute in the following order:

- (a) Secured creditors e.g., mortgage loans
- (b) Legal charges
- (c) Liquidator's remuneration
- (d) Costs and charges of winding up u/S 576 and 520
- (e) Preferential creditors under Section 530
- (f) Creditors having the floating charges on any assets of the company e.g., debentures
- (g) Unsecured Creditors
- (h) Return to Contributories
- (i) Preferential Shareholders including any dividend due
- (j) Equity Shareholders - balance of amount



Did u know? The nature of contributory's liability after winding up is legal and not contractual.

Preferential Payments: Under Section 530 of Companies Act, 1956, the following are the preferential payment which has the priority in payment to all other debts: It must be noted that preferential payment or preferential creditors are unsecured. These have the priority of claims over other creditors due to law and not due to any security held by them.

- (a) All revenues, taxes, cases and rates, whether payable to the government or local authority at the relevant date and having become due and payable within twelve months next before the commencement of winding up;
- (b) All wages or salaries (including wages payable for time or piece work and salary earned wholly or in part by way of commission) of any employee, in respect of services rendered to the company and due for the period not exceeding four months within the next twelve months before the winding up, any compensation payable to any workman under any of the provision of Chapter VA of the Industrial Disputes Act, 1947 provided that the amount payable to each employee or workman will not exceed ₹ 1000. [As per notification G.S.R. 80(E) dated 17-02-1997, the sum payable to any one claimant in relation to wages and salary shall not exceed ₹ 20,000];
- (c) All accrued holiday remuneration becoming payable to any employee on account of winding up;
- (Where a person advances money for the payment of employee's wages or salary and holiday remuneration stated above, (b) and (c) will be treated as preferential creditors);
- (d) Unless the company is being wound up voluntarily only for the purpose of reconstruction or amalgamation with another company, all contributions payable during the next twelve months before the winding up, by the company as the employer of any person, under the Employees' State Insurance Act, 1948 or any other law for the time being in force;
- (e) Unless the company is being wound up voluntarily merely for the purpose of reconstruction or of amalgamation with another company, or unless it has taken out a workmen's compensation insurance policy, all compensation due under the Workmen's Compensation Act, 1923;
- (f) All sums due to any employee from a provident fund, a pension fund, a gratuity fund or any other fund for the welfare of the employees, maintained by the company;
- (g) The expenses of any investigation held under Section 235 or Section 237 insofar as they are payable by the company.

Self Assessment

Fill in the blanks:

6. List 'B' includes all the past members who ceased to be members (except by death) within of the winding up of the company.
7. The court may order the to first pay off the debt due by him to the company and then claim the amount due to him.

9.4 Relevant Date

The expression relevant date means:

- (i) In case of a compulsory winding up, the date of appointment of a provisional liquidator, or if no such appointment was made, date of winding up order unless in either case, the company had commenced to be wound up voluntarily;
- (ii) In any other case, date of passing of the resolution for the voluntary winding up of the company.

Notes

Following are few terms related to relevant date:

1. **Interest on Liabilities:** Interest on liabilities e.g., loan and debentures etc., would depend on the solvency of the company. If the company is solvent, and there is surplus after paying the principal amount and interest on the all debts up to the commencement of winding up, interest on liabilities will be payable up to the date of actual payment. And if the company is insolvent, interest on liabilities will be payable up to the date of commencement of the proceeding of winding up.
2. **Fraudulent Preference:** When one creditor is preferred to another creditor in the matter of payment of his dues, it is called fraudulent preference. The object of the Act being a pari passu distribution, Section 531 provides that every transfer of property, movable or immovable, delivery of goods, payment, execution or any act relating to property, made, taken or done by or against a company within six months before commencement of its winding up shall be deemed, in the event of its being wound up, a fraudulent preference of its creditors and therefore invalid.
3. **Voluntary Transfer of Property:** Under Section 531A, any voluntary transfer of property of any kind by a company, otherwise than in the ordinary course of business for valuable consideration, made within a period of one year before the presentation of a petition for winding up, or the passing of a resolution for voluntary winding up, is void against the liquidator.
4. **Over Riding Preferential Payments:** A new Section 529A has been included in the Companies Act in 1985. According to this section a new category of preferential payments known as 'overriding preferential payment' is to be settled in priority to other debts under Section 530. Section 529A of the Companies Amendment Act 1985 states that the following amounts to the extent such debts rank u/S 529(1)(c) shall be paid in priority to all other debts:
 - (a) Workmen's dues;
 - (b) Debts due to secured creditors to the extent such debts rank [under clause (c) of the provision to sub-section (i) of Section 529] pari passu with such dues.

Workmen's dues mean the total of the following sums due from the company:

- (a) All wages or salary including wages payable for time or piece-work and salary earned wholly or in part by way of commission of any workman and any compensation payable to any workman under any of the provisions of the Industrial Disputes Act, 1947;
- (b) All accrued holiday remuneration becoming payable to any workman on account of winding up;
- (c) Unless the company is being wound up voluntarily merely for the purposes of reconstruction or of amalgamation with any other company, or unless it has taken out a workmen's compensation insurance policy, all amounts due in respect of any compensation or liability for compensation under Workmen's Compensation Act, 1923 in respect of death or disablement of any workman of the company;
- (d) All sums due to any workman from a provident fund, a pension fund, a gratuity fund or any other fund for the welfare of the workmen, maintained by the company.

Section 529 provides that workmen's dues and dues to secured creditors shall be paid in full, unless the assets are insufficient to meet them, in which case they shall abate in equal proportions.

Self Assessment**Notes**

State whether the following statements are true or false:

8. Insolvency is not a necessary condition for the liquidation of a company.
9. All persons who ceased to be shareholders within twelve months from the date of winding up are placed in List B of contributories.
10. In the case of insolvency of a company, the interest on the liabilities is payable up to the date of actual payment.

9.5 Statement of Affairs and Deficiency/Surplus Account

Where a company is wound up by the order of the court or an official liquidator is appointed as provisional liquidator by the court, the officers, directors, managers, secretary or other chief officials of the company must submit to the official liquidator a Statement of Affairs of the company within twenty-one days of court's order (or within such extended time, not exceeding three months, as the court may permit). This statement should be verified by an affidavit and it must contain the following particulars:

- (i) The assets of the company stating separately the cash balance in hand and at bank; if any, and the negotiable securities, if any, held by the company;
- (ii) The debts and liabilities;
- (iii) The names, residences and occupations of its creditors, stating separately the amount of secured and unsecured debts and in case of secured debts, particulars of securities given, whether by the company or its officers, their value and the debts on which they were given;
- (iv) The debts due to the company and the names, residences and occupations of the persons from whom they are due and the amount likely to be realised; and
- (v) Such further or other information as may be prescribed by the Central Government or as the official liquidator may require.

The above-mentioned statement is prepared in the case of compulsory winding up of the company, but there is no provision of preparing a statement in the case of voluntary winding up of the company. It must be prepared in a form prescribed by law. The reasonable expenses of the preparation of this statement are paid by the liquidator out of the amount realised by him from the sales proceeds of the assets. The Statement of Affairs is always open to inspection by any person claiming in writing to be a creditor or contributory of the company on the payment of the prescribed fees at all reasonable. This person or his agent can demand the copy of the statement or an extract from it.

The contents of the different lists of the statement in the legal form can be summarised as below:

- (1) List A: The assets of the company which are not specifically pledged are showed in this list.
- (2) List B: In this list, estimated realisable value of assets specifically pledged, amount due to secured creditors, deficiency or surplus from such assets are recorded.
- (3) List C: Preferential creditors are recorded in this list.
- (4) List D: Debentures and other loans secured by a floating charge over particular assets are shown in this list.

- Notes**
- (5) List E: This list contains the unsecured creditors i.e. trade creditors and bills payable etc.
 - (6) List F: Paid up preferential share capital is shown in this list.
 - (7) List G: This list is for issued and called up equity share capital.
 - (8) List H: Finally concluded deficiency or surplus by Statement of Affairs is shown in this list.

Box 9.1: Prescribed Form of Statement of Affairs, Form No. 57 (See Rule 127)

In the High Court at ----- (Or) in the District Court at -----
 Original Jurisdiction ----- In the matter of the Companies Act, 1956.
 In the matter of ----- Ltd.
 Company Petition No. ----- of 19--
 Statement of Affairs and Section 454

Statement of Affairs of the above named company as on the -----date of -----19
 ----the date of the winding up order (or the order appointing Provisional Liquidator or the date
 directed by the official liquidator).

I/we -----of -----do solemnly affirm and say that the statement made
 overleaf and the several lists hereunto annexed marked 'A' to 'I' are to the best of my/ our knowledge
 and belief a full, true and complete statement as to the affairs of the above named company, on the
 -----day of-----19----- the date of the winding up order (or the order
 appointing Provisional Liquidator or the date directed by the Official Liquidator), and that the said
 company carries/carried on the following business:

(Here, set out nature of company's business). Signature(s)

Solemnly affirmed at -----before me-----this -----day
 of-----19-----.

Commissioner for Oaths

The commissioner is particularly requested, before swearing the affidavit, to ascertain that the full
 name, address and description of the deponent are stated, and initial and crossing out or other
 alterations in the printed form. A deficiency in the affidavit in any of the above respects will entail its
 refusal by the court, and will necessitate its being re-sworn.



Notes The several lists annexed are not exhibits of the affidavit.

Box 9.2: Statement of Affairs And Lists to be Annexed

Statement as to the affairs of -----Ltd., on the -----day of-----
 ----19-----being the date of winding up order (or order appointing Provisional
 Liquidator or the dated directed by the Official Liquidator as the case may be) showing assets at
 estimated realisable values and liabilities expected to rank:

Assets not specifically - pledged (as per List 'A')	Estimated realisable value			
	₹			
Balance at Bank	---	---	---	---
Cash-in-Hand	---	---	---	---

Contd...

					Notes
Marketable Securities	---	---	---	---	
Bills Receivables	---	---	---	---	
Trade Debtors	---	---	---	---	
Loans and Advance	---	---	---	---	
Unpaid Calls	---	---	---	---	
Stock-in-Trade	---	---	---	---	
Work-in-progress	---	---	---	---	
-----	---	---	---	---	
-----	---	---	---	---	
Free-hold property, Land & Buildings	---	---	---	---	
Leasehold Property	---	---	---	---	
Plant & Machinery	---	---	---	---	
Furniture, fittings, utensils etc.	---	---	---	---	
Investment other than marketable securities	---	---	---	---	
Livestock	---	---	---	---	
Other property, viz.	---	---	---	---	
-----	---	---	---	---	
-----	---	---	---	---	
Assets specifically pledged (as per List 'B')	(a) Estimated realisable values ₹	(b) Due to secured creditors ₹	(c) Deficiency ranking as unsecured ₹	(d) Surplus carried to last column ₹	
Estimated surplus from assets specifically pledged _____					
Estimated total assets available for preferential creditors, debenture-holders.					
Secured by a floating charge, and unsecured creditors (carried forward) _____ ₹					

9.5.1 Summary of Gross Assets and Gross Liabilities

Gross realisable value of assets specifically pledged

Other assets _____
 Gross Assets ₹ _____

Liabilities

Gross Liabilities (to be deducted from surplus or added to deficiency as the case may be)

₹ Secured creditors (as per List 'B') to the extent to which claims are estimated to be covered by assets specifically pledged [item (a) or (b) whichever is less]
 (insert in 'Gross Liabilities' column only)
 Preferential creditors (as per List 'C')
 Estimated balance of assets available for debentures ₹

Notes

Secured by a following charge and unsecured creditors*		
Debenture-holders secured by a floating charge (as per List 'D')		
Estimated surplus/deficiency as regard debenture-holders.		
Unsecured creditors (as per List 'E'):		
Estimated unsecured balance of claims of creditors		
Partly secured creditors on specific assets, brought from preceding page		
Trade Account		—
Bills Payable		—
Outstanding Expenses		—
Contingent Liabilities (statement nature)	₹	
Estimated Surplus/deficiency as regards creditors [being difference between gross assets brought from preceding page (d) and gross liabilities as per column (e)]	₹	—
Issued and Called up Capital:	₹	—
----- Preference shares of ----- each		
----- Called-up (as per List 'F')		
----- Equity shares of ----- each -----		
----- Called up (as per List 'G')		
Estimated surplus/deficiency as regards member (as per List 'H')		



Caution Section 529 provides that workmen's dues and dues to secured creditors shall be paid in full, unless the assets are insufficient to meet them, in which case they shall abate in equal proportions.

9.5.2 List 'H' Deficiency/Surplus Account

Statement of Affairs List 'H': The period covered by this account must commence on a date not less than three years before the date of winding up order (or the order appointing Provisional Liquidator or the date directed by the Official Liquidator), or if the company has not been incorporated for the whole of that period, the date of formation of the company, unless the Official Liquidator otherwise agrees.

Items contributing of deficiency or (Reducing Surplus):	₹
1. Excess (if any) of Capital and Liabilities over assets on the ----- 19----- as shown by Balance Sheet (copy annexed).	
2. Net dividends and bonuses declared during the period -----19----- to the date of the statement.	
3. Net trading losses (after charging items shown on note below) for the same period.	
4. Losses other than trading losses written off, or for which provision has been made in the books during the same period (give particulars or annex schedule).	

5. Estimated losses now written off, or for which provision has been made for the purpose of preparing the statement (give particulars or annex schedule). Notes

6. Other items contributing to deficiency or reducing surplus.

Items reducing deficiency (or contributing to surplus): ₹

7. Excess (if any) of assets over capital and liabilities on the ---19--- as shown in the Balance Sheet (copy annexed)

8. Net trading profits (after charging items shown in note below) for the period from the ---19--- to the date of statement.

9. Profit and income other than trading profits during the same period (give particulars or annex schedule).

10. Other items reducing deficiency or contributing to surplus:

Deficiency/Surplus as shown by Statement of Affairs

Note as to Net Trading Profit and Losses: ₹

Particulars are to be inserted here (so far as applicable) of the items mentioned below, which are to be taken to account in arriving at the amount of net trading profits or losses shown in this account.

Provision for depreciation, renewals, or diminution in value of fixed assets:

Charge for Indian Income tax and other Indian taxation on profits.

Interest on debentures and other fixed loans, payments to directors made by the company and required by law to be disclosed in the accounts.

Exceptional or non-recurring expenditure:

Less: Exceptional or non-recurring receipts ₹

Balance, being other trading profits or losses

Net trading profit or losses as shown in
Deficiency or Surplus Account above ----- ₹

Signature : Dated ----- 20 -----

9.5.3 Procedure to Prepare Statement of Affairs

The following steps should be kept in mind while preparing the Statement of Affairs of a company:

1. First, take all those assets of the company which are not specifically pledged. These assets should be taken at their realisable value. It may be noted that calls-in-arrear on shares should be taken under this list, but uncalled amount on shares is not included in this list.
2. If there is any surplus from the assets which were specifically pledged with the secured creditors, this should be added to the realisable value of the assets not specifically pledged calculated above (1).
3. Then from the total calculated above (2), first deduct the preferential creditors, then amount payable to creditors having the floating charge (i.e., debentures) and then unsecured creditors.
4. To calculate the amount of unsecured creditors, generally trade creditors, bills payable, bill discounted likely to be dishonoured and unsecured portion from partly secured creditors are taken.

- Notes**
5. The amount left after deducting the unsecured creditors will be called surplus or deficiency as regard unsecured creditors.
 6. From the above balance calculated in (5) deduct (or add in the case of deficiency) the amount of paid up share capital. The resultant figure will be called deficiency or surplus as regards contributories.



Notes Deficiency account depicts how the company lost its assets during its existence. This account shows the deficiency or surplus as the case may be. This deficiency or surplus must be tallied with the deficiency or surplus shown by the Statement of Affairs. This account has ten items which are classified into two groups. In the first group those items are taken which increase the deficiency and in the second group those items are taken which reduce the deficiency. If the total of the first group exceeds the total of the second group, the difference is called deficiency, otherwise surplus and vice versa. This account is an integral part of the Statement of Affairs.

Self Assessment

Fill in the blanks:

11. The is always open to inspection by any person claiming in writing to be a creditor or contributory of the company on the payment of the prescribed fees at all reasonable.
12. Deficiency account depicts how the lost its assets during its existence.

Illustration 1

Mr. R. P. Sharma is appointed as the liquidator of Jagmohan Company Limited in voluntary liquidation on 1st July, 2010, and the following balances are extracted from the books on that date:

Liabilities	₹	Assets	₹
Capital:		Machinery	60,000
32,000 shares of ₹ 5 each	1,60,000	Leasehold properties	80,000
Debentures	1,00,000	Stock-in-trade	2,000
Bank Overdraft	36,000	Book Debts	1,20,000
Liabilities for Purchases	40,000	<i>Less:</i> Reserve for DD	20,000
		Investments	12,000
		Calls-in-arrear	10,000
		Cash-in-hand	2,000
		P&L Account	70,000
	3,36,000		3,36,000

Prepare a Statement of Affairs to be submitted to the meeting of creditors. The assets were valued as under:

	₹
Machinery	1,20,000
Leasehold Properties	1,46,000
Investments	8,000

Stock-in-trade	4,000	Notes
Bad debts	4,000	

The doubtful debts are ₹ 8,000 estimated to realise ₹ 4,000. The Bank Overdraft is secured by the deposit of title deeds of leasehold properties. Preferential creditors for taxes and wages are ₹ 2,000. The telephone rent owing is ₹ 160.

Solution

**Statement of Affairs of Jagmohan Co. Ltd.
as on 1st July, 2010**

Assets	Estimated realisable value ₹
Assets not specifically pledged as per List A:	
Cash-in-hand	2,000
Book Debt	1,12,000
Calls-in-arrear	10,000
Investments	8,000
Stock-in-trade	4,000
Machinery	1,20,000
	2,56,000

Assets Specifically Pledged as per List B

	Estimated realisable value ₹	Due to secured creditors ₹	Deficiency ranking as unsecured ₹	Surplus carried to last column ₹
Leasehold Properties	1,46,000	36,000	—	1,10,000
Estimated surplus from assets specifically pledged				1,10,000
Estimated total available for preferential creditors, Debenture-holders secured by floating charge and unsecured creditors				3,66,000

Summary of Gross Assets

	₹	₹
Gross realisable value of assets specifically pledged	1,46,000	
Other assets	2,56,000	
	4,02,000	
Estimated total assets available for preferential creditors, debenture-holders secured by a floating charge and unsecured creditors		3,66,000
Gross		
Liabilities		
Liabilities ₹ 36,000	Secured creditors as per List B to the extent to which claims are estimated to be covered by assets specifically pledged.	
2000	Preferential Creditors as per List C	2000
	Estimated balance of assets available for debenture-holders secured by a floating charge and unsecured creditors	3,64,000

Notes	1,00,000	Debentures secured by a floating charge as per List D	1,00,000
		Estimated surplus as regards debentures-holders	2,64,000
40,160		Unsecured creditors as per List E.	
		Liabilities for purchases	40,000
		Telephone rent owing	160
		Estimated surplus as regards creditors issued and called up	40,160
1,78,160		capital as per List F	2,23,840
		Estimated surplus as regards contributories as per List H	1,60,000
			63,840

Surplus Account - List H

				₹
Items reducing the surplus:				
	Excess capital and liabilities over assets i.e. P & L A/c.			70,000
	Estimated losses and investment, taxes and wages dues and o/s of telephone bill			<u>6,160</u>
				76,160
Items contributing to surplus:				
Machinery	(₹ 120,000 - ₹ 60,000)	60,000		
Leasehold property	(₹ 146,000 - ₹ 80,000)	66,000		
Stock	(₹ 4,000 - ₹ 2,000)	2,000		
Provision for B/D		20,000		
Less: Bad debts	4,000			
Doubtful Debt	<u>4,000</u>	<u>8,000</u>	12,000	1,40,000
Surplus as shown by Statement of Affairs				63,840

Illustration 2

Insold Ltd. is to be liquidated. Their summarised Balance Sheet as on 30th September, 2010, appears as under:

Liabilities:	₹
2,50,000 Equity Shares of ₹ 10 each	25,00,000
Secured Debentures on (land & building)	10,00,000
Unsecured Loans	20,00,000
Trade Creditors	35,00,000
	90,00,000
Assets:	₹
Land & Buildings	5,00,000
Other Fixed Assets	20,00,000
Current assets	45,00,000
Profit and Loss Account	20,00,000
	90,00,000

Contingent Liabilities are:	₹	
For Bills Discounted		1,00,000
For Excise Duty Demands		1,50,000

On investigation, it was found that the contingent liabilities are certain to devolve and that the assets are likely to be realised follows:

	₹
Land & Buildings	11,00,000
Other Fixed Assets	18,00,000
Current Assets	35,00,000

Taking the above into account, prepare the Statement of Affairs.

Solution

**Statement of Affairs of Insold Co. Ltd.
as on 30th September, 2010**

Assets	Estimated Realisable value
	₹
Assets not specifically pledged as per List A	
Other fixed assets	18,00,000
Current assets	35,00,000
	53,00,000

Assets specifically pledged as per **List B**

	Estimated realisable value	Due to secured creditors	Deficiency ranking as unsecured	Surplus carried to last column	
	₹	₹	₹	₹	
Land & Building	11,00,000	10,00,000	—	1,00,000	
	11,00,000	10,00,000	—	1,00,000	1,00,000

Estimated total assets available for preferential creditors and unsecured creditors 54,00,000

Summary of Gross Assets

	₹
Gross realisable value of assets	11,00,000
specifically pledged Other assets	53,00,000
Gross Assets	64,00,000
Gross liabilities	₹
	Liabilities
10,00,000	Secured creditors as per List B to the extent claims are covered by assets specifically pledged
1,50,000	Preferential creditors as per List C
	1,50,000

Notes	Estimated balance of assets available for debenture-holders having a floating charge and unsecured creditors	52,50,000
20,00,000	Unsecured Creditors as per List E	
35,00,000	Unsecured Loans	20,00,000
1,00,000	Trade Creditors	35,00,000
	Contingent Liabilities (for bills discounted)	1,00,000
67,50,000	Estimated deficiency as regards creditors (67,50,000 – 64,00,000)	3,50,000
	2,50,000 equity shares of ₹ 10 each as per List G	25,00,000
	Estimated deficiency as regards members as per List H	28,50,000

Illustration 3

Mudit Co. Ltd. went into voluntary liquidation on 1st January, 2011. From the following particulars, you are required to prepare (a) Statement of Affairs; (b) Deficiency Account:

	₹
80,000 Equity Shares of ₹ 5 each fully paid up	4,00,000
6%; 40,000 Preference Shares of ₹ 10 each fully paid up	4,00,000
5% First Mortgage Debentures Secured by a floating charge upon the whole of the assets	2,00,000
Fully Secured Creditors	60,000
Partly Secured Creditors	40,000
Preferential Creditor for Rates and Taxes	12,000
Bills Payable	20,000
Unsecured Creditor	1,40,000
Bank Overdraft	20,000
Bills Receivable	30,000
Bills discount (one Bill for 20,000 is likely to be bad)	80,000
Book Debts – Good	20,000
Doubtful (estimated to produce 50%)	14,000
Bad	12,000
Shares in Shobit Ltd. (estimated to produce ₹ 70,000)	90,000
Shares in X Ltd. (estimated to produce ₹ 20,000) (given to partly secured creditors as security)	30,000
Land and Buildings (estimated to produce ₹ 80,000)	3,00,000
Stock-in-trade (estimated to produce ₹ 80,000)	1,00,000
Machinery and Tools etc. (estimated to produce ₹ 40,000)	1,00,000
Cash-in-Hand	20,000

Solution

Notes

Statement of Affairs of Mudit Co. Ltd.
As on 1st January, 2011

Assets	Estimated realisable value			
	₹			
Assets not specifically pledged as per List A				
Cash-in-Hand				20,000
Sundry Debtors (₹ 20,000+50% of ₹ 14,000)				27,000
Bills Receivable				30,000
Shares in Shobit Ltd.				70,000
Stock-in-Trade				80,000
Machinery and Tools, etc.				40,000
Land & Building				80,000
				3,47,000
Assets specifically pledged as per List B				
	Estimated realisable value	Due to secured creditors	Deficiency ranking as unsecured	Surplus carried to last column
	₹	₹	₹	₹
Value of security for fully secured Crs.	60,000	60,000	—	—
Shares in X Ltd.	80,000	1,00,000	20,000	—
Summary of Gross Assets:				
Gross realisable value of assets specifically pledged				80,000
Other assets				3,47,000
				4,27,000
Gross Liabilities				
	Liabilities			
				₹
80,000	Secured creditors as per List B to the extent to which claims are estimated to be recovered by assets specifically pledged			
12,000	Preferential Creditors as per List C			12,000
	Estimated balance of assets available for debentures secured by a floating charge and unsecured creditors.			3,35,000
2,00,000	Debenture-holders secured by floating charges as per List D .			2,00,000
	Estimated Surplus as regards debenture-holders			1,35,000
	Unsecured Creditors as per List E			
				₹
	Unsecured balance of Partly Secured Crs.			20,000
	Bills Payable			20,000
	Unsecured Creditors			1,40,000
	Bank Overdraft			20,000
2,20,000	Liabilities as Bills Discounted			20,000
				2,20,000

Notes	5,12,000	Estimated Deficiency as regards creditors (being the different between gross assets and gross liabilities) Issued and Called up Capital	85,000
		6%; 40,000 Preference Shares of ₹ 10 each fully paid up as per List F	4,00,000
		80,000 Equity Shares of ₹ 5 each fully paid up as per List G	4,00,000
		Estimated deficiency as regards contributories as per List H	8,85,000
Deficiency Account - List H			
Items Contributing to Deficiency:			
		Excess of Capital and Liabilities over Assets on 1 st Jan., 2011 as shown by the Balance Sheet.	5,16,000
		Losses other than trading losses now written off:	₹
		Bills Discounted likely to be dishonoured	20,000
		Bad debts (12,000+7,000)	19,000
		Shares in Shobhit Ltd.	20,000
		Shares in X Ltd.	10,000
		Land & Buildings	2,20,000
		Stock-in-trade	20,000
		Machinery & Tools	60,000
		Deficiency as shown by Statement of Affairs	8,85,000

Working Note:

**Balance Sheet of Mudit Co. Ltd.
As on 1st January, 2011**

Liabilities	₹	Assets	₹
80,000 Equity Shares of ₹ 5 each fully paid up	4,00,000	Land & Buildings	3,00,000
40,000; 6% Pref. Shares of ₹ 10 each fully paid up	4,00,000	Machinery & Tools	1,00,000
5% Mortgage Debentures	2,00,000	Shares in Shobhit Ltd.	90,000
Fully Secured Creditors	60,000	Shares in X Ltd.	30,000
Partly Secured Creditors	40,000	Value of Securities held by fully Secured Creditors	60,000
Preferential Creditors	12,000	Bills Receivable	30,000
Bills Payable	20,000	Book Debts - Good	20,000
Unsecured Creditors	1,40,000	Doubtful	14,000
Bank Overdraft	20,000	Bad	12,000
		Stock-in-trade	1,00,000
		Cash-in-hand	20,000
		Excess of Liabilities over Assets	5,16,000
	12,92,000		12,92,000



Task Discuss the term deficiency account.

Self Assessment

Notes

Choose the correct answer from the following options:

13. A company limited by shares can be liquidated under:
 - (a) Section 425 of the Companies Act, 1956.
 - (b) Section 428 of the Companies Act, 1956.
 - (c) Section 10 of the Presidency Towns Insolvency Act, 1909.
 - (d) Section 428 of the Companies Act, 1956.
14. A contributory is a:
 - (a) Creditor
 - (b) Debenture-holder
 - (c) Shareholders
 - (d) Bankers
15. Preferential creditors of a company at the time of liquidation are in the nature of:
 - (a) Fully secured creditors.
 - (b) Unsecured creditors who have priority of claims over other unsecured creditors
 - (c) Fully unsecured creditors
 - (d) Partly secured creditors



Case Study

Multi State Wind Down-Creditors' Voluntary Liquidation

Prior to liquidation the company had operations in Victoria and also regional (Newcastle) New South Wales. Its financial operations were conducted in Victoria and its manufacturing was conducted in New South Wales. Due to this we were dealing with employees and creditors from both states. Apart from book debts the major asset of the company was its plant and equipment at its manufacturing site in Newcastle. Upon appointment we immediately secured the plant and equipment. Due to our knowledge of the industry we were able to work with a National firm of valuers and auctioneers who were able to coordinate the changing of locks and taking an inventory of the assets located in New South Wales and Victoria.

We also met with the management team from Newcastle and ascertained the general manager (who was not a director or shareholder) was responsible and trustworthy and we retained his services to facilitate the sale of the assets. Initially it was thought that the assets would be sold by way of public auction and the premises vacated however after advertising the business for sale as a whole we entered into negotiations and were able to successfully sell the business and its assets for considerably higher than auction realisation value. Whilst some employees were successful in obtaining employment with the purchaser the majority were not. However the sale price achieved will enable the claims of the employees, many of whom were long standing employees with significant entitlements to receive the bulk of the monies outstanding including paying their superannuation entitlements in full. The employee entitlements including superannuation amount to approximately ₹ 350,000.

Contd...

Notes

Prior to settling the sale negotiations we had to deal with various issues including retention of title claims on various assets, resolve a dispute in relation to the ownership of intellectual property and have all the plant and equipment inspected so as to comply with the relevant occupational health and safety requirements. In order to avoid long and costly litigation we settled with the various parties claiming retention of title and ownership of intellectual property on a commercial basis which allowed the sale to proceed, the monies collected and the small amount required to be paid to the various parties to settle the disputes was considerably less than if we had have litigated the matter when taking into consideration the costs of litigation, the delay caused and the fact that we would have lost the opportunity to sell the assets for a higher price than auction.

Questions

1. Discuss the case situation in brief.
2. Analyse the consequences for the same.

Source: http://www.brookebird.com.au/index.php?option=com_content&task=view&id=45

9.6 Summary

- Liquidation means putting an end to the life of the company.
- The assets of the liquidated company are administered for the benefit of the members and creditors.
- A company can be compulsory wound up by the National Company Law Tribunal.
- The various circumstances under which a company can be compulsorily wound up like- Inability of the company to pay its debt; Reduction in number of membership; if the company does not commence its business within a year from its incorporation or suspends its business for a whole year, etc.
- Voluntary winding up are of two types - Members' voluntary winding up and Creditors' voluntary winding up.
- Contributory means a person who is liable to contribute to the assets of the company in the event of its being wound up and includes holders of shares which are fully paid.
- Liquidator is the person who is appointed to administer the process of liquidation of a company.
- Preferential payments mean the payments to be made in preference to all other debts according to the provisions of the Companies Act.

9.7 Keywords

Contributory: A contributory means a person liable to contribute to the assets of the company in the event of its being wound up and includes holders of shares which are fully paid.

Instalment Installation: Assets are sold on a piece meal fashion and available cash are distributed first to creditors then to partners.

Liquidation: It refers to the winding up of the affairs of the partnership. This leads to sale of all non-cash and payment to creditors and to partners.

Liquidator: A liquidator is a person who is entrusted the duty of winding up of a company. He is appointed to administer and to take control of the company.

Lump-sum Liquidation: All assets are converted into cash, and then payments are made first to creditors then to partners.

Preferential Payments: Preferential payments are those payments which by virtue of provisions in the Act are to be paid in priority to all other debts.

9.8 Review Questions

Notes

1. What is Statement of Affairs? State its salient features.
2. What is deficiency account?
3. What do you mean by liquidation of a company? Explain.
4. What are the different methods for the winding up of a company?
5. What is a Statement of Affairs? How are the liabilities of List B Contributories determined?
6. The order of winding up was given on 31st December, 2010 of a company. The following information is available.

	Estimated Realised Value	
	₹	₹
Cash-in-hand	100	100
Debtors	4,000	3,600
Buildings	60,000	48,000
Furniture	20,000	20,000
Unsecured Creditors	—	20,000
Debentures Secured on Buildings	42,000	—
Debentures having floating charge	10,000	—
Preferential Creditors	6,000	—
Share Capital (3,200 shares of ₹ 100 each)	3,20,000	—

Total liabilities on Bills Discounted is ₹ 6,000, estimated liability ₹ 6,000, other contingent liability ₹ 12,000, estimated liability ₹ 12,000. Prepare Statement of Affairs and Deficiency Account.

7. X Co. Ltd. went into voluntary liquidation on 1st April, 2010. The following balances are extracted from its books on that date:

Liabilities	₹	Assets	₹
Capital: (24,000 Equity shares of ₹ 10 each)	2,40,000	Machinery	90,000
		Leasehold Properties	1,20,000
Debentures (secured by floating charge)	1,50,000	Stock	3,000
		Debtors	1,50,000
Bank Overdraft	54,000	Investment	18,000
Creditors	60,000	Cash-in-hand	3,000
		Profit and Loss Account	1,20,000
	5,04,000		5,04,000

The following assets are valued as under:

	₹
Machinery	1,80,000
Leasehold Properties	2,18,000

Notes

Investment	12,000
Stock	6,000
Debtors	1,40,000

The bank overdraft is secured by deposit of title deeds of leasehold properties. There were preferential creditors ₹ 3,000 which were not included in creditors ₹ 60,000.

Prepare a Statement of Affairs to be submitted to the meeting of members/creditors.

8. From the following particulars, prepare a Statement of Affairs and the Deficiency Account for submission to the official liquidator of the Equipments Ltd., which went into liquidation on March 31, 2010:

	₹	₹
3,000 Equity Shares of ₹ 100 each, ₹ 80 paid		2,40,000
11%; 1,000 Preference Shares of ₹ 100 each paid fully paid	1,00,000	
Less: Calls-in-arrear (estimated to produce)	5,000	95,000
10% Debentures having a floating charge on the assets (interest paid up to December 31, 2009)		1,00,000
Mortgage on Land and Buildings		80,000
Trade Creditors		2,65,500
Owing for Wages		20,000
Secretary's salary @ ₹ 1500 p.m. owing		3,000
Managing Director's salary @ ₹ 6000 p.m. owing		6,000
Assets	Estimated to Produce	Book Value
	₹	₹
Land & Buildings	1,30,000	1,20,000
Plant	1,30,000	2,00,000
Tools	4,000	20,000
Patents	30,000	50,000
Stock	74,000	87,000
Book Debts	60,000	90,000
Investment (in the hand of the bank for an overdraft of ₹ 1,90,000)	1,70,000	1,80,000

On 31st March, 2005 the Balance Sheet of the company showed a General Reserve ₹ 40,000 accompanied by a debit balance of ₹ 25,000 in the Profit and Loss Account. In the year 2005-06 the company earned a profit of ₹ 40,000 and declared a dividend of 10% on equity shares. Beside loss of stock due to fire of ₹ 40,000, the company suffered a total loss of ₹ 1,09,000 during 2006-07, 2007-08 and 2008-09. For 2009-10 accounts were not made up.

The cost of winding up is expected to be ₹ 15,000.

Answers: Self Assessment

Notes

- | | |
|--|----------------------|
| 1. Liquidation | 2. Assets |
| 3. Three | 4. Partly Secured |
| 5. List 'H' | 6. One Year |
| 7. Contributory | 8. True |
| 9. True | 10. False |
| 11. Statement of Affairs | 12. Company |
| 13. (b) Section 428 of the Companies Act, 1956 | 14. (c) Shareholders |
| 15. (b) Unsecured creditors who have priority of claims over other unsecured creditors | |

9.9 Further Readings



Books

B. B. Dam and H. C. Gautam, *Corporate Accounting*, Capital Publishing.

Das. K. R. and others, *Corporate Accounting*, LBS Publication.

Sehgal, A and Sehgal, D, *Advanced Accounting & Corporate Accounting*, Taxman Publishers.



Online links

http://220.227.161.86/19018comp_sugans_pe2_accounting_cp9_5.pdf

<http://www.scribd.com/doc/8283996/Lecture-Notes-on-Liquidation>

http://www.kkhsou.in/main/evidya2/commerce/liquidation_companies.html

http://www.companyliquidator.gov.in/12/liquidation_pro_data.htm#p_338

Unit 10: Liquidation of Companies: Preparation of Accounts

CONTENTS

Objectives

Introduction

10.1 Process of Liquidation

10.2 Primary Duties of Liquidators

10.3 Liquidators' Statement of Account

10.3.1 Preparation of Liquidator's Final Statement Account

10.4 Liquidator's Remuneration

10.5 List B Contributories

10.6 Summary

10.7 Keywords

10.8 Review Questions

10.9 Further Readings

Objectives

After studying this unit, you will be able to:

- Discuss the process of Liquidation
- Describe the primary duties of Liquidators
- Explain the Liquidator's statement of Account
- Discuss the liquidator's remuneration concept
- Describe the concept of List B Contributories

Introduction

A company is an artificial legal entity. It cannot live and it cannot die. Its effective birth is registration and its effective death is dissolution. Liquidation is simply the process by which a company's assets are realised and distributed to those parties legally entitled to them, so that it can be dissolved. A Voluntary Liquidation is one which has been instigated by the passing of a resolution by the shareholders, as opposed to a winding up order made by the court, generally at the behest of an unpaid creditor. A Creditors Voluntary Liquidation is a voluntary liquidation where the directors cannot make the Statutory Declaration of Solvency necessary for a Member's Voluntary Liquidation i.e. It is insolvent, in that it will be unable to pay its debts in full.

It is vital that, in the period between the calling of these meetings and actually holding them, the directors (who remain in control of the company) exercise appropriate caution and take the advice of the proposed Liquidator. There is no embargo on continued trading, although the company cannot accept deliveries of goods for which it has not made provision for payment. It is necessary, during this period, not to improve or worsen the position of any individual creditors, or to dissipate any of the assets, otherwise the directors could have either personal liability or be culpable for misfeasance. In particular, it is vital to ensure that assets that ought to be made available to the Liquidator do not fall into the hands of creditors and thus become available for set off.



Example: As an example all cheques received should be handed to the proposed Liquidator and not paid into an overdrawn bank account. Because of all the risks involved, it is usually safest for the company to cease to trade immediately, and for effective control to be handed to the proposed Liquidator.

10.1 Process of Liquidation

The process is started by the directors holding a board meeting and recognising that the company is insolvent and ought to be placed into liquidation. A meeting of shareholders is convened to pass an extraordinary resolution to place the company into liquidation and to appoint a Liquidator. By law, this meeting requires 14 days notice. However, if the holders of 95% of the issued share capital all agree to accept less than the statutory notice the notice period can be waived and the company placed into liquidation immediately. This would normally be necessary if there were a need for a Liquidator to take control of the assets straight away to protect them, for example, from an unpaid creditor.

At the same time, a notice convening a meeting under Section 98 Insolvency Act 1986 is sent to all creditors. The creditors meeting will be held generally immediately after the shareholders meeting (unless this was held at short notice). A director must be present at the creditors meeting, and preside as chairman. The Liquidator appointed by the shareholders must also attend the meeting.

Whilst the director is chairman of the meeting, to all intents and purposes the meeting is run by the proposed Liquidator. He will read through the Statement of Affairs (effectively a document showing the assets and liabilities of the company at realisable values rather than book values) which must be sworn by a director and a number of other ancillary documents to provide information to the creditors. After that, the meeting will be opened to questions from the creditors. Generally, questions about the documentation provided will be handled by the proposed Liquidator whilst questions concerning the company's history will be dealt with by the chairman.

Once questions have finished (there is no statutory time limit on the length of time allowed for this) a vote is then taken on the appointment of the Liquidator. Whilst the shareholders may have appointed the Liquidator, in an insolvent liquidation it is the creditors who stand to lose or gain by the Liquidator's actions, and hence they have the final say. If they wish, they can nominate an alternative Liquidator, and whoever receives the most votes in value (i.e. By simple majority) is duly appointed. In the overwhelming majority of cases, the creditors choose not to propose an alternative Liquidator.

Further, creditors can appoint a Liquidation Committee (minimum 3 members, maximum 5) who assist the Liquidator in determining matters of policy and with whom the Liquidator can consult on matters of importance. Shareholders can also be represented on this committee but against a backdrop of insolvency this is not normally recommended. Committees are nowadays only found, as a rule, on larger and contentious cases.



Example: As an example all cheques received should be handed to the proposed Liquidator and not paid into an overdrawn bank account. Because of all the risks involved, it is usually safest for the company to cease to trade immediately, and for effective control to be handed to the proposed Liquidator.

Self Assessment

State whether the following statements are true or false:

1. A director must not be present at the creditors meeting, and preside as chairman.

Notes

2. Creditors can appoint a Liquidation Committee (minimum 3 members, maximum 5) who assists the Liquidator in determining matters of policy.
3. A meeting of shareholders is convened to pass an extraordinary resolution to place the company into liquidation and to appoint a Liquidator.

10.2 Primary Duties of Liquidators

Following are the primary duties of Liquidator:

- The realisation of the assets to best effect. This is the Liquidator's overriding responsibility, and the majority of decisions he takes are to be taken with this in mind.



Example: He takes a major risk if he disposes of the assets on credit and does not get paid. It is perfectly legal for the assets to be sold to a party connected with the company, although if he does so he should notify the creditors accordingly. In view of this overriding obligation, it is generally necessary to obtain a professional valuation of all the assets, particularly if they are to be sold to a connected party.

The definition of "assets" is wide, and includes rights of action against third parties, and the potential unravelling of transactions which have already taken place and are considered to be not in the interest of the company.

- The agreement of creditors claims.
- Payment of dividends to the creditors in accordance with their legal rights. Preferential claims have to be paid in full before any funds are paid to ordinary (or non preferential) creditors. Where there are insufficient funds to pay any particular class of creditors in full, he has to make a distribution on a *pari passu* basis. This is to say that all creditors of a particular class should receive an equal percentage of their claim.
- To comply with a plethora of statutory requirements. These are too numerous to fully list but include the convening of annual meetings of members and creditors, where it is too soon to close the liquidation. Once the liquidation is ready for closure, and all assets have been distributed, he must convene final meetings of members and creditors. Three months after his report of the meetings has been forwarded to Companies House, the company is deemed to be dissolved by operation of law.
- No later than six months after his appointment the Liquidator must file a report with the Secretary of State on the conduct of the directors. In this report he must identify any areas of their conduct which, in his opinion, render one or more of them unfit to be concerned in the management of a limited liability company. An adverse report can result in a director being disqualified from holding office for a period of anything between 2 and 15 years.
- From the date of his appointment, the powers of the directors cease and pass to the Liquidator. Responsibility for filing accounts also then rests with the Liquidator, these are in a different form to those normally filed by the company. The Liquidator's appointment means the directors no longer have to file accounts or annual returns, but does not negate any penalties which have already been incurred for default in that respect.

Other than the passing of the director's powers to the Liquidator, and the directors having a duty to assist the Liquidator in his functions, there are few direct consequences which arise simply as a result of putting the company into liquidation. Any guarantees given by the directors of any of the company's debts will, most likely, be immediately crystallised upon liquidation.

Whilst there may be a perceived stigma associated with an insolvent liquidation, the practical impact of the liquidation depends largely upon the circumstances of the particular case, and the manner in which the directors have approached their fiduciary duties towards the company, and whether they have continued the company's operations to the detriment of the creditors.

The major areas to be considered by the Liquidator are as follows:

- **Preferences:** This is where a creditor has had his position improved in the time leading up to the liquidation simply because the directors wished to achieve that effect.
- **Fraudulent Trading:** This is where it can be demonstrated that the business of the company has been continued with a view to defrauding the creditors. This is also a criminal offence. As can be anticipated, this carries a very high burden of proof for the Liquidator who effectively has to prove “the criminal mind”. This has invariably been a very difficult area for Liquidators to succeed in.
- **Wrongful Trading:** This is where a point is reached where the directors knew or ought to have known that the company could not realistically avoid insolvent liquidation. If the directors then fail to take steps to place the company into liquidation, instead continuing the business and worsening the position, then they can be held liable to make a contribution to the assets of the company, commensurate with the further losses incurred. There are defences, such as implementing a rescue package in conjunction with professional advice. However, it therefore follows that as soon as the directors ascertain that a company is insolvent (defined as “unable to pay its debts when they fall due” or “its assets are less than its liabilities, including contingent liabilities”) they must be seen to take professional advice and to act in accordance with it. As and when it becomes clear that the company cannot avoid an insolvent liquidation, they must take steps to place the company into liquidation.

Self Assessment

Fill in the blanks:

4. claims have to be paid in full before any funds are paid to ordinary (or non preferential) creditors.
5. Any guarantees given by the of any of the company’s debts will, most likely, be immediately crystallised upon liquidation.
6. The appointment means the directors no longer have to file accounts or annual returns, but does not negate any penalties which have already been incurred for default in that respect.



Caselet

Franchise Company - Car Window Tinting

The Director of the business invested much of his savings to buy an expensive franchise. He was worried that it was not performing well and he was investing in more and more capital. The business had purchased equipment on HP and had numerous additional debts. However, these could not be satisfied by day to day trading. The director decided that the business was fundamentally flawed as it was based in the wrong location.

The decision was taken to voluntarily liquidate the company. The business ceased to trade. There were little or no business assets. However, there were various debtors due to be collected. Given all payments to creditors were stopped, this cash inflow was sufficient to pay for the cost of the voluntary liquidation and return a minor sum to the creditors.

The director decided to find employment and now works in the same sector but as a manufacturing director for a car tinting company in West London. In this way, he has avoided personal bankruptcy, kept his home and his marriage/family.

Source: <http://coopermatthews.com/case-studies-liquidations.html>

10.3 Liquidators' Statement of Account

The statement prepared by the liquidator showing receipts and payments of cash in case of voluntary winding up is called "Liquidators' statement of account" (Form No. 156 Rule 329 of the Companies Act, 1956). There is no double entry involved in the preparation of liquidator's statement of account. It is only a statement though presented in the form of an account.

While preparing the liquidator's statement of account, receipts are shown in the following order:

- (a) Amount realised from assets are included in the prescribed order.
- (b) In case of assets specifically pledged in favour of creditors, only the surplus from it, if any, is entered as 'surplus from securities'.
- (c) In case of partly paid up shares, the equity shareholders should be called up to pay necessary amount (not exceeding the amount of uncalled capital) if creditors' claims/claims of preference shareholders can't be satisfied with the available amount. Preference shareholders would be called upon to contribute (not exceeding the amount as yet uncalled on the shares) for paying of creditors.
- (d) Amounts received from calls to contributories made at the time of winding up are shown on the Receipts side.
- (e) Receipts per Trading Account are also included on the Receipts side.

Payments made to redeem securities and cost of execution and payments per Trading Account are deducted from total receipts.

Payments are made and shown in the following order:

- (a) Legal charges;
- (b) Liquidator's expenses;
- (c) Debenture holders (including interest up to the date of winding up if the company is insolvent and to the date of payment if it is solvent);
- (d) Creditors:
 - (i) Preferential (in actual practice, preferential creditors are paid before debenture holders having a floating charge);
 - (ii) Unsecured creditors;
- (e) Preferential shareholders (Arrears of dividends on cumulative preference shares should be paid up to the date of commencement of winding up); and
- (f) Equity shareholders.

10.3.1 Preparation of Liquidator's Final Statement Account

The liquidator's main job is to collect the assets of the company and realise them, surplus, if any, from the securities held by the fully secured creditors and proceeds from the partly paid up contributories and distribute the amounts among the various right claimants. This amount is distributed by the liquidator strictly in the prescribed order of payment. For this purpose, he prepares a cash book for recording the receipts and payments. In the case of compulsory winding up, he is required to submit an abstract of cash book to the court and in the case of voluntary winding up to the company. On the completion of winding up, he prepares a statement known as Liquidator's Final Statement of Account which he has to submit. This account must be prepared according to the prescribed Form No. 156 of the Companies Act, 1956. This prescribed form is given below:

Form No. 156
(See Rule 329)
Companies Act, 1956

* Here, state whether the winding up is a Members' or Creditors' voluntary winding up or a winding up under the Supervision of Court. If under the Supervision of Court, mention the number of the petition in which the order was made and the date of the order.

*Strike out what does not apply

Liquidator's Statement of Account of the Winding up (Members'/Creditors' Voluntary Winding up)
(Pursuant to Section 497/509)

1. Name of the Company -----Ltd.
2. Nature of proceeding -----.
3. Date and commencement of the winding up-----
4. Name and address of the Liquidator:

Statement showing how the winding up has been conducted and the property of the company has been disposed of from-----19-----
(commencement of winding up) to-----19---- (close of winding up).

Receipts	Estimated value ₹	Value realised ₹	Payment	₹	₹
Assets:			Legal Charges:		
Cash at Bank			Liquidator's Remuneration:		
Cash-in-hand			Where applicable—		
Marketable Securities			% on ₹ ----- realised		
Bills Receivable			% on ₹ ----- distributed		
Trade Debtors			Total -----		
Loans and Advances			(By whom fixed-----)		
Stock-in-trade			Auctioneers' and Valuers'		
Work-in-Progress			Charges		
Freehold Property			Costs of procession and maintenance of estate		
Leasehold Property			Cost of notice of Gazette on		
Plant & Machinery			News Papers		
Furniture & Fittings			Incidental outlay (establishment charges and other expenses of liquidation)		
Utensils etc.			Total Cost and Charges		
Patents Trade Marks etc.			(i) Debenture-holders		
Investments other than			Payment of ₹— per ₹— debenture		
Marketable			Payment of ₹— per ₹—		
			Debentures		

Contd...

Notes

Securities	
Surplus from Securities	Payment of ₹ -- per
Unpaid calls at the commencement of winding up	₹ -- debentures
Amount receivable from calls on contributories made in winding up	(ii) Creditors: ---*Preferential ---*Unsecured
Receipts from trading account	Dividend(s) -- P. in the rupee on ₹ -- (The estimate of the amount expected to rank for dividend was ₹ --)
Other Property, viz.	
Total --	(iii) Return to Contributories:
Less: Payment to redeem Securities	-- P. per ₹ --**Shares --
Cost of Execution.	P. per ₹ -- **Share -- P. per ₹ --**Share --
Payments per Trading account	Add balance
Net Realisations	
(1) The following assets estimated to be of the value of ₹-----have proved to be unrealisable:	
(Give details of the assets which have proved to be unrealisable)	
(2) Amount paid into the Company Liabilities Account in respect of:	
(a) Unclaimed dividends payable to creditors in winding up ₹ _____	
(b) Other unclaimed distributions in winding up ₹ _____	
(c) Moneys held by the company in trust in respect of dividends or other sum due before the commencement of the winding up to any person as a member of the company ₹ -----	
(3) Add here any remarks the Liquidator thinks desirable.	
Dated this ----- day of -----19-----	
	(Sd.) Liquidator
I declare that the above statement is true and contains a full and accurate account of the winding up from the dated this ----- due of -----19-----	
	(Sd.) Liquidator



Caution At the time of winding up, the Liquidator of the company realises the amount due from the debtors, the sale of the assets of the company, surplus from fully secured creditors, and makes calls on the contributories and realise the amount from them.



Notes While preparing Liquidator's Final Statement of Account some special points should be kept in mind which are as follows:

Realisation of amount by a Liquidator: At the time of winding up, the Liquidator of the company realises the amount due from the debtors, the sale of the assets of the company, surplus from fully secured creditors, and makes calls on the contributories and realise the amount from them.

Disbursement of the amount realised among various claimants: The Liquidator has to disburse the amount in a prescribed order of payment. This is as follows:

1. Payment to fully secured creditors.
2. Payment of legal expenses cost of winding up.
3. Remuneration of the Liquidator.
4. Expenses of Liquidator.
5. Payment to debenture-holders or creditors secured by the floating charge as the assets of the company.
6. Payment to unsecured creditors including the preferential creditors.
7. Payment of preferential shareholders including arrears of dividend.
8. Payment of equity shareholders (the remaining amount.)

Self Assessment

State whether the following statements are true or false:

7. Preference shareholders have the priority over equity capital for their capital as well as the arrears of dividend at the time of winding up of the company.
8. All the voluntary transfers made by the company within one year before the date of winding up are void as against the liquidators.
9. In assets realised, cash and bank balance is always included for the purpose of liquidator's commission.

10.4 Liquidator's Remuneration

The Liquidator receives his remuneration in the form of commission which is usually based as a percentage on assets realised and payment made to unsecured creditors. At the time of calculating the remuneration of the liquidator, students should keep in mind the following points:

1. **Remuneration on Assets Realised:** At the time of calculation of Liquidator's remuneration on assets realised, generally cash-in-hand and cash at bank are not considered, unless the examination problem provides for it directly or indirectly. Only surplus from fully secured creditors is mostly included in the amount of assets realised for the calculation of Liquidator's remuneration. Regarding this, it is assumed that secured creditors themselves realise the assets held by them as security. The Liquidator has only made an effort at realising the surplus from secured creditors. Therefore, it is suggested that the only surplus should be included in the amount of assets realised.

Notes

2. **Remuneration on the Amount Distributed to Unsecured Creditors:** Sometimes the liquidator is also entitled to receive the commission on the amount paid or distributed to unsecured creditors. In this condition, the preferential creditors are also considered because they are basically unsecured creditors. Any one of the following situations can arise in this connection –

- (i) If the amount available for the payment of unsecured creditors is sufficient, remuneration will be calculated as follows:

$$\text{Liquidator's Remuneration} = \frac{\text{Amount of Unsecured Creditors} \times \% \text{ of Commission}}{100}$$

- (ii) If the amount available for the payment of unsecured creditors is insufficient, remuneration will be calculated as follows:

$$\text{Liquidator's Remuneration} = \frac{\text{Amount available for Unsecured Creditors} \times \% \text{ of Commission}}{100 + \% \text{ of Commission}}$$

*Notes*

In this situation, the amount available for unsecured creditors means that total of the amount appearing in the left side of the Final Statement of the Liquidator minus legal charges, remuneration of the liquidator on the assets realised, cost of liquidation and amount paid to debenture-holders having charge.

Suppose the amount to be paid to unsecured creditors is ₹ 2,50,000 and the amount available for the payment of unsecured creditors is ₹ 1,06,000 and a commission of 5%, is to be given on the amount paid to unsecured creditors.

The commission will be calculated as below:

$$\frac{1,05,000 \times 5}{100 + 5} = \frac{1,05,000 \times 5}{105} = ₹ 5,000$$

This is done so because the amount of ₹ 1,05,000 includes the amount of commission of the liquidator of ₹ 5,000. If the whole amount of ₹ 1,05,000 is paid to unsecured creditors, nothing will be left for the commission of liquidator. Actually, the amount of ₹ 105,000 is for unsecured creditors and liquidator's remuneration.

- (iii) **Remuneration on the Amount Distributed to the Contributories:** If the liquidator is also entitled to receive commission on the amount distributed to the member of the company, it is calculated under the following manner:

$$\text{Liquidator's Remuneration} = \frac{\text{Balance of Amount} \times \% \text{ of Commission}}{100 + \% \text{ of Commission}}$$

In this case, balance of amount means that total of amount appearing in the left side of the Final Statement of the Liquidator minus legal charges, cost of liquidation, liquidator's remuneration on assets realised and amount paid to unsecured creditors, payment to debenture-holders and payment to unsecured creditors including preferential creditors.

3. **Distribution of Surplus:** After the payment of all liabilities, if any balance of assets remains, this balance is called the surplus which is distributed among the shareholders of the company as per provisions of the Memorandum of Association and Articles of Association. If the preferential shareholders have the priority over equity shareholders, preference shareholders must be paid off first, before equity shareholders. If there are various types of

paid up value of equity shares and there is no provision, excess amount paid on any share must be paid first and the remaining amount must be distributed among the all types of equity shareholders proportionately.

4. **Interest on Debentures and Loans:** If the company is solvent, interest on loans and debentures should be paid up to the date of payment. On the other hand, if the company is insolvent, interest on debentures and loans should be paid up to the date of commencement of winding up. If the instructions in the examination problem are against this rule, the students must do according to the instructions of the question.
5. **Dividend on Preference Shares:** For non-cumulative preference shares there will be no arrears of dividend. In the absence of specific wording as non cumulative, the preference shares must be treated as cumulative. And the dividend on cumulative preference shares should be paid up to the date of winding up. Regarding the payment of dividend the provisions of Articles of Association must be followed. As a rule, when the dividend is declared, that must be treated as debt not as arrear of dividend. But if the dividend is not declared and that is in arrear, such arrears of dividend will be paid only after the payment of preferential capital and equity shares capital in full and any surplus is left. The reason behind this is that the preference shareholders have priority regarding the return of capital over the return of equity capital. They also have priority regarding the payment of preference dividend over the payment of dividend of equity shareholders. Thus, arrears of dividends of preference shares must be paid after the payment of equity capital, in full. After the payment of equity capital, if any surplus remains, that must be treated as profit. From this profit, first arrears of preferential dividend must be paid before the payment of the dividend of equity shareholders.
6. **Calls-in-Arrear and Calls-in-Advance on Equity Shares:** If the funds are available after the settlement of all claims of all outsiders and preference shareholders, equity shareholders are paid off. And in case a company has partly paid up equity shares and preference shares and the available amount is not sufficient to meet the claims of preference in full, the company should make the necessary calls on the equity shares to collect a suitable amount to the claims of preference shareholders. There are chances that some shareholders may fail to pay such calls. In such cases, if the surplus after the settlement of the claims of the preference shareholders in full, is not enough to refund of equity shareholders, such surplus will be first used to refund the share capital of those shareholders who have paid the calls which were recently made, till the paid up capital equals the amount paid up by the defaulting equity shareholders. After such refund, if there is still surplus, it will be distributed equally among the all equity shareholders, including the defaulters. On the other hand, if some equity shareholders have paid some calls in advance, such calls-in-advance will be given priority in the refund over the paid up share capital of those calls. In case the equity shareholders have paid the different amount on their holdings, at the time of distribution of surplus, an effort should be made that each equity shareholder may undergo equal loss.

Self Assessment

Fill in the blanks:

10. A receiver is appointed by.....
11. The Statement of Receipts and Payments which is prepared by the liquidator is called.....
12. A..... is prepared to pay the full amount of the shares held by him at the time of winding up.

Notes

Illustration 1 (Calculation of Liquidator's Remuneration)

Sushil Co. Limited went into liquidation with the following liabilities:

- (a) Secured Creditors ₹ 20,000 (securities realised ₹ 25,000)
- (b) Preferential Creditors ₹ 6,000
- (c) Unsecured Creditors ₹ 30,500

Liquidation Expenses ₹ 252

Liquidator's Remuneration: 3% on the amount realised and 1½% on the amount distributed to unsecured creditors. ₹ 26,000 were realised from various assets and this amount does not include those securities which are with the secured creditors.

Prepare Liquidator's Final Statement of Account. Liquidator is entitled for remuneration of the amount realised on all the assets, including those which are with the secured creditors.

Solution

Sushil Company Limited
Liquidator's Final Statement of Account

Receipts	Amount (₹)	Payments	Amount (₹)
Assets Realised	26,000	Liquidator Remuneration:	
Surplus from Secured Creditor (₹ 25,000 - ₹ 20,000)	5,000	3% on ₹ 51,000	1,530
		3/2% on ₹ 6,000	90
		% on ₹ 22,786.21	341.79
		Liquidator Expenses	252
		Preferential Creditors	6,000
		Unsecured Creditors	22,786.21
	31,000		31,000

Working Note:

Payment made to Unsecured Creditors-	₹
Total amount available	31,000
Less: Liquidator's Remuneration on Assets Realised and Preferential Creditors (₹ 1,530 + ₹ 90)	=1,620
Liquidation expenses	252
Preferential Creditors	6,000
Amount available for Unsecured Creditors and Liquidator's Remuneration thereon.	7,872
	23,128.00
Less: Liquidator's remuneration $\frac{23,128 \times 1.5}{101.5} =$	341.79
Payment to Unsecured Creditors	22,786.21

Illustration 2 (Liquidator's remuneration on amount distributed to unsecured creditors)

Notes

A company went into liquidation on 31st March, when the following Balance Sheet was prepared:

Liabilities	Amount (₹)	Assets	Amount (₹)
Share Capital:		Goodwill	3,000
(2,000 Shares ₹ 10 each)	20,000	Leasehold Property	2,500
Issued Capital			
(1,452 Shares of ₹ 10 each fully paid)	14,520	Plant and Machinery	3,740
Sundry Creditors:		Stock	5,855
Unsecured Creditors	7,716	Sundry Debtors	4,622
Partly Secured Creditors	2,918	Cash	50
Preferential Creditors	405	Profit and Loss A/c.	5,908
Bank Overdraft (Unsecured)	116		
	25,675		25,675

The Liquidator realised the assets as follows:

Leasehold property which was used in the first instance to pay the partly Secured Creditors Pro-rata	₹ 1,800
Plant & Machinery	2,500
Stock	3,100
Sundry debtors	4,350
Cash	50

The expenses of liquidation amount to ₹ 50 and the liquidator's remuneration was agreed at 2½% on the amount realised and 2% on the amount paid to unsecured creditors. Prepare Liquidator's Final Statement Account showing the distribution.

Solution

Liquidator's Final Statement of Account

Receipts	₹	Payments	₹
Assets Realised:		Liquidator's Remuneration:	
Cash	50		₹
Sundry Debtors	4,350	2½% on ₹ 11,800	295
Stock	3,100	2% on ₹ 9,355	187.10
Plant & Machinery	2,500	Cost of Liquidation	50
		Unsecured Creditors	9,355
		Return to Contributories:	
		Shareholders (1,452 Shares @	
		₹ 0.07775 per share)	112.90
	10,000		10,000

Notes

Working Note

(1)	Payment to Unsecured Creditors	₹
	Unsecured Creditors	7,716
	Balance of Partly Secured Creditors (2,918-1,800)	1,118
	Bank Overdraft (unsecured)	116
	Preferential Creditors (which are also unsecured)	405
		9,355
(2)	Liquidator's Remuneration = $\frac{9,355 \times 2}{100}$	₹ 187.10
(3)	Amount realised by the Liquidator ₹ = 10,000 + 1,800	₹ 11,800
(4)	Dividend Rate for shareholders = $\frac{9,355 \times 2}{100}$	₹ 0.07775

Illustration 3 (Interest on Debentures)

Vinijya Ltd. which has a paid up capital of ₹ 1,00,000 and a loss of ₹ 1,11,500 standing on its Balance Sheet went into voluntary liquidation on 31st March, 2010. The following are the particulars with regard to its assets and liabilities as on that date: Machinery, Stock and Debtors (which realise their book value) ₹ 79,000; Cash ₹ 1,000, Creditors ₹ 40,000, 6% Debentures (which were carrying the floating charge) and interest accrued thereon for 6 months ₹ 1,500.

The above debentures were paid off with interest on 30th September, 2010. On this date, a first and final dividend was also paid to the creditors. ₹ 5,000 of the creditors are preferential and rest are unsecured. The cost of liquidator amounted to ₹ 500. The liquidator is entitled to 3% of the total amount realised from the sale of assets including cash and 2% of the amount distributed to the unsecured creditors by way of his own remuneration. Prepare the Liquidator's Final Statement of Account.

Solution

Vinijya Limited
Liquidator's Final Statement of Account

Receipts	Amount ₹	Payments	Amount ₹
Assets Realised:		Cost of Liquidation	5,000
Machinery, Stock and		Liquidator's Remuneration:	
Debtors	79,000	3% on ₹ 80,000	2,400
Cash	1,000	2% on ₹ 5,000	100
		2% on ₹ 20,098.04	401.96
		6% Debentures	50,000
		+ Interest Accrued	1,500
		Preferential Creditors	5,000
		Unsecured Creditors	20,098.04
	80,000		80,000

Working Note:

Notes

(1) Amount available for unsecured creditors and liquidator's remuneration thereon-

	₹	
Total Amount available		80,000
Less: Cost of Liquidation	500	
Liquidator's remuneration on assets realised and Preferential Creditors (2,400 +100)		
	25,00	
6% Debentures + Interest Accrued	51,500	
Preferential Creditors	5,000	
		59,500
Amount available for unsecured creditors and Liquidator's remuneration		20,500
Less: Liquidator's Remuneration $\frac{20,500 \times 2}{102}$		401.96
Amount for Unsecured Creditors		20,098.04

(2) In the case of solvency of the company, interest on debentures is paid upto the date of payment.

Illustration 4 (Interest on Debentures up to the Date of Commencement of Liquidation)

Bombay Company Limited went into liquidation on 31st December, 2010. Its capital is divided into 10,000 equity shares of ₹ 50 each. Its capital and liabilities on this date were as follows:

Cash-in-hand ₹ 750, Realised from Stock ₹ 29,600, from Book Debts ₹ 49,200, from Furniture ₹ 1050, Investments with Bank for Overdraft of ₹ 4,900.

Unsecured Creditors ₹ 53,775, Preferential Creditors ₹ 5,295, Bank Overdraft ₹ 4,000. 6% Debentures having a floating charge and on which interest has been paid up to 30th June, 2010 ₹ 44,000.

The bank, after deducting its amount from investment of ₹ 4,900, gave the surplus to the liquidator. Debentures were paid up to 30th June, 2011.

Remuneration of the Liquidator: 3% on net amount realised (excluding the amount given to secured creditors, but including cash-in-hand); 2% on the amount paid to unsecured creditor (excluding preferential creditors). Cost of liquidation amounted to ₹ 1,015.

Prepare Liquidator's Final Statement of Account and find out the amount paid to unsecured creditors.

Solution

**Bombay Company Limited
Liquidator's Final Statement of Account**

Receipts	Amount (₹)	Payments	Amount (₹)
Assets Realised:		Liquidators Remuneration:	
Cash-in-Hand.	750		₹
Book Debts	49,200	3% on ₹ 81,500	2,445

Notes					
	Furniture	1,050	2% on ₹ 26,887.25	537.75	2,982.75
	Stock	29,600	Cost of Liquidations		1,015
	Surplus from securities (4,900 - 4,000)	900	Debentures	44,000	
			+ 6 Months' Interest	1,320	45,320
			Preferential Creditors		5,295
			Unsecured Creditors		26887.25
		81,500			81,500

Working Note:

(1) Payment for Unsecured Creditors-		₹
Amount available		81,500
Less: Liquidator's Remuneration on Assets Realised	2,445	
Cost of Liquidation	1,015	
Debentures + Accrued Interest	45,320	
Preferential Creditors	5,295	54,075
Amount for Unsecured Creditors and Liquidator's remuneration thereon		27,425
Less Liquidator's remuneration = $\frac{27,425 \times 2}{102}$		537.75
Amount for Unsecured Creditors		26,887.25

(2) Interest on Debentures $\frac{44,000 \times 6}{100} \times \frac{6}{12} = 1,320$

Illustration 5 (Arrear of Dividend of Preference Shares and Interest on Debentures)

On 31st March, 2010, the date of liquidation of Ram Mohan Company Limited, its Balance Sheet was as under. Prepare the Final Account of the Liquidator.

Liabilities	₹	Assets	₹
Capital:		Buildings	4,00,000
7% Preference Shares	3,00,000	Machinery	1,60,000
6,000 Equity Shares of ₹ 10 each ₹ 8 paid up	48,000	Stock	4,00,000
3,000 Equity Shares of ₹ 10 each ₹ 7 paid up	21,000	Debtors	6,40,000
6% Debentures of ₹ 100 each	12,00,000	Cash	51,000
Outstanding Interest on 6% Debentures	72,000		
Creditors	8,000		
B/ P	2,000		
	16,51,000		16,51,000

Realised on Assets: Buildings ₹ 3,50,000, Machinery ₹ 2,00,000, Debtors ₹ 6,00,000, Stock ₹ 4,61,000, Liquidator's Expenses ₹ 2,000. Remuneration of Liquidator: $1\frac{1}{2}\%$ on realisation

of assets including cash and 2% on the amount paid to unsecured creditors. Creditors shown in the Balance Sheet included ₹ 1,000 preferential creditors. Interest on debentures is to be paid up to 31st May, 2010. Dividend on Preference Shares is in arrear for 1½ years. Arrear of dividend should be paid before payment of capital to equity shareholders as per Articles of Association. Legal charges are ₹ 500. According to Articles of Association, at the time of winding disparity among equity shareholders (if any) will be removed first at the time of repayment of capital.

Notes

Solution

Ram Mohan Company Ltd.
Liquidator's Final Statement of Account

Receipts	Estimated Value (₹)	Value Realised (₹)	Payments	Amount (₹)
Assets Realised:			Legal Charges	1,000
Buildings	4,00,000	3,50,000	Liquidator's Remuneration:	
Machinery	1,60,000	2,00,000		₹
Debtors	6,40,000	6,00,000	1½ on ₹ 16,62,000	24,930
Stock	4,00,000	4,61,000	2% on ₹ 10,000	200
Cash	51,000	51,000	Cost of Liquidation	2,000
			Debentures	12,84,000
			Unsecured Creditors	10,000
			Return to Contributories:	
			7% Pref. Shareholders	3,00,000
			Preference Dividend (arrears of 1½ year)	31,500
			Equity Shareholders (6,000 shares @ ₹ 1.263 approx. per share)	7,580
			Equity Shareholders (3,000 shares @ ₹ 0.263 approx. per share)	790
	16,51,000	16,62,000		16,62,000

Working Note:

(1) Unsecured Creditors include B/P, Creditors and Preferential Creditors ₹ (2000 + 7000 + 1000 = 10,000)

(2) Liquidator's commission on Unsecured Creditors = $\frac{10,000 \times 2}{100} = 200$

(3) As debenture-holders are being paid off on 31st May, 2010, they are entitled to get two

months' extra interest i.e., April & May = $\frac{12,00,000}{100} \times \frac{6 \times 2}{12} = 12,000$

Amount due to debenture-holders = ₹ 12,00,000 + 72,000 + 12,000 = 12,84,000.

(4) Amount left after the payment of Preference Shareholders' Capital and their dividend.

₹ 16,62,000 - (1,000 + 25,130 + 2,000 + 12,84,000 + 10,000 + 3,00,000 + 31,500) = ₹ 8,370 From this amount of ₹ 8,370, first of all 6000 equity shareholders will get ₹ 1 because they have paid ₹ 1 more. That will be ₹ 6,000. Thus amount left ₹ 8,370 - ₹ 6,000 = ₹ 2,370. Now, this amount of ₹ 2,370 will be divided in the ratio of 6000:3000 i.e., ₹ 1,580: ₹ 790.

- Notes**
- (5) 6000 equity shareholders will get = 6000 + 1,580 = 7,580 and dividend rate
- $$= \frac{7580}{6,000} = ₹ 0.1263 \text{ per share approx.}$$
- (6) 3,000 equity shareholders will get ₹ 790 only and their dividend rate will be
- $$\frac{790}{3,000} = ₹ 0.263 \text{ approx. per share.}$$

Illustration 6

Prepare Final Statement of Account of the Liquidator from the following particulars of a company which is voluntarily wound up. Share Capital consists of 1,000 Pref. Share of ₹ 10 each fully paid up, 40,000 Equity shares of ₹ 10 each fully paid, 30,000 first Equity shares of ₹ 10 each ₹ 8 paid up, and 20,000 second Equity shares of ₹ 5 each, ₹ 4 paid up. Preference shares have priority for refund of capital. Out of total creditors of ₹ 2,74,900 creditors of ₹ 10,900 were preferential and creditors ₹ 54,000 were fully secured. An amount of ₹ 3,74,000 was realised by sale of assets (including the sale proceeds of assets charged with fully secured creditors).

Liquidation expenses ₹ 12,000, Liquidator's Remuneration 5% on net assets realised (except belonging to fully secured creditors) and 3% on the amount paid to unsecured creditors (except preferential creditors). The Liquidator made a call of ₹ 1 per share on second Equity shares and ₹ 1.50 per share on first equity shares. All these amounts were duly received except ₹ 1.50 per share on 2,000 first Equity shares which were forfeited.

Solution**Liquidator's Final Statement of Account**

Receipts	Estimated Values (₹)	Value Realised (₹)	Payments	Amount (₹)
Assets Realised		3,20,000	Liquidators Remuneration: 5% on ₹ 3,20,000 = 16,000	
Amount Received from calls on second			3% on ₹ 2,10,000 = 6,300	22,300
Equity shares (20,000 × ₹ 1)		20,000	Liquidator Expenses	12,000
			Preferential Creditors	10,900
Amount Received from first Equity			Unsecured Creditors	2,10,000
Shares (28,000 × ₹ 1.5)		42,000	Return to Contributories:	
			Preferential Shareholders	1,00,000
			Equity Shareholders (40,000 Equity shares @ ₹ 0.600)	24,000
			Equity Shareholders (28,000 Equity shares @ ₹ 0.1)	2,800
		3,82,000		3,82,000

Working Note:

Amount available for Equity shareholders

$$= (₹ 3,20,000 + 20,000 + 42,000) - (₹ 22,300 + 12,000 + 10,900 + 2,10,000 + 1,00,000) = ₹ 26,800$$

From this amount first of all 40,000 equity shareholders will get ₹ 0.5 as they have paid more i.e., ₹ 20,000, then rest ₹ 6,800 will be distributed among Equity shareholders in the ratio 40,000:28,000 i.e., ₹ 4,000 and ₹ 2,800.

Thus, 40,000 Equity shareholders will get 20,000 + 4,000 ₹ = 24,000

Notes

$$\text{Rate per Share} = \frac{24,000}{40,000} = ₹ 0.6$$

28,000 Equity shareholders will get ₹ 2,800

$$\text{Rate of Dividend} = \frac{2,800}{28,000} = ₹ 0.1$$

Illustration 7 (Calls-in-Advance and Calls-in-Arrear on Shares)

Purohit Company Limited, having carried out its business objects, went into voluntary liquidation with the following liabilities:

		₹
Trade Creditors		24,000
Bank Overdraft		40,000
Capital:		
20,000 Preference Shares of ₹ 10 each, ₹ 7 called up		140,000
20,000 Equity Shares of ₹ 10 each, ₹ 9 called up	1,80,000	
Less: Calls in arrear	4,000	1,76,000
Cash received in anticipation of calls:		
On Preference Shares	48,000	
On Equity Shares	8,000	56,000

The assets realised ₹ 4,00,000 and the expenses of liquidation amounted to ₹ 4,000. The calls-in-arrear are recovered in full. The Preference Shareholders have no priority in the return of capital. Prepare the Liquidator's Final Statement of Account.

Solution

Purohit Company Limited
Liquidator's Final Statement of Account

Receipts	₹	Payments	₹
Assets Realised	4,00,000	Liquidation Expenses	4,000
Calls-in-arrear		Unsecured Creditors	
Recovered	4,000	(₹ 24,000 + ₹ 40,000)	64,000
		Calls-in-advance paid	
		On Preference Shares	48,000
		On Equity Shares	8000
			56,000
		Return to Contributories:	
		20,000 Preference Shares @ ₹ 6 per share	1,20,000
		20,000 Equity shares @ ₹ 8 per share	1,60,000
	4,04,000		4,04,000

Notes

Working Note:

Amount available for shareholders –

= ₹ (4,04,000-4000-64,000) = ₹ 3,36,000

Less: Calls-in-advance on Equity and Preference shares (48,000 + 8000) 56,000

Amount to Return the Capital 2,80,000

Less: First Equity shareholders will get ₹ 2 each they have paid more and Preference shares have no priority over return of capital

(20,000 × 2) 40,000

2,40,000

Now, ₹ 2,40,000 will be divided among the Preference Shareholders and Equity Shareholders in the ratio 20,000:20,000 or 1:1 or ₹ 1,20,000: ₹ 1,20,000

Thus, Equity Shareholders will get ₹ 1,20,000 + ₹ 40,000 = ₹ 1,60,000

Each Shareholder will get = $\frac{1,60,000}{20,000} = ₹ 8$

Preference Shareholders will get ₹ 120,000

Each Shareholder will get = $\frac{1,20,000}{20,000} = ₹ 6$

Illustration 8 (Division of Surplus among Preference Shareholders)

Satyam Ltd. went to voluntary liquidation on 1st Jan., 2011. The liquidator realised all the assets and his commission was 3% on realisation of assets and 2% on distribution to shareholders. The following was position on that date:

	₹
Cash or realised of assets	5,00,000
Liquidator Expenses	9,000
Unsecured Creditors (including salary and wages for one month before liquidation ₹ 6,000)	68,000
5,000; 6% Preference shares of ₹ 30 each (Divided paid upto 31-12-2009)	1,50,000
10,000 Equity shares ₹ 10 each ₹ 9 per share called up and paid up	90,000
General Reserve	1,20,000
P&L A/c	20,000

Preference Shareholders have the right to receive 1/3 of the surplus remaining after repaying the Equity Share Capital. Prepare Liquidator's Statement of Account.

Solution

Notes

Satyam Limited
Liquidator's Final Statement of Account

Receipts Values (₹)	Estimated Realised (₹)	Value	Payments (₹)	Amount
Assets Realised		5,00,000	Liquidator's Remuneration:	
			₹	
			3% on ₹ 5,00,000	15,000
			2% on ₹ 4,00,000	8,000
			Liquidation Expenses	9,000
			Payment to Preferential Creditors (for salary and wages)	6,000
			Payment to Unsecured Creditors	62,000
			Preference Shareholders	1,50,000
			Arrear of Preference Dividend for one year	9,000
			Equity Shareholders	90,000
			Payment of Surplus to	
			Preference Shareholders $\left(\frac{1}{3}\right)$	50,333
			Equity Shareholder $\left(\frac{2}{3}\right)$	1,00,667
		5,00,000		5,00,000

Working Note:

(1) Liquidator's Commission on amount distributed to shareholders:

	₹
Assets Realised	5,00,000
Less: Liquidator's Commission on	
Assets Realised	15,000
Liquidation Expenses	9,000
Preferential Creditors	6,000
Unsecured Creditors	62,000
Amount for Shareholders and Liquidator's Commission thereon.	92,000
	4,08,000
Less: liquidator's remuneration $\frac{4,08,000 \times 2}{102}$	8,000
Amount for both shareholders	4,00,000

Notes	(2) Division of Surplus:		
	Amount available for payment		4,00,000
	Less: Pref. Capital	1,50,000	
	Dividend	9,000	
	Equity capital	90,000	2,49,000
	Surplus		1,51,000
	Less: $\frac{1}{3}$ for Preference Shareholders		
	$\frac{1}{3}$ of 1,51,000		50,333
	$\frac{2}{3}$ for Equity Shareholders.		1,00,667
	(3) Preference Dividend: $\frac{1,50,000 \times 6}{100} = 9,000$		
	(4) Unsecured Creditors: = 68,000 - 6,000		= ₹ 62,000

Illustration 9 (Division of Loss)

Omega Company Limited went into liquidation on 30th June, 2010. Its Balance Sheet on that date is given below:

Balance Sheet			
Liabilities	₹	Assets	₹
Share Capital:		Land & Buildings	3,00,000
4,000; 6% Preference Shares of ₹ 100 each	4,00,000	Machinery	3,00,000
8,000 Equity shares of ₹ 10 each; ₹ 9 paid up	72,000	Patents	20,000
4,000 Equity Shares of ₹ 10 each; ₹ 7 paid up	28,000	Stocks	1,60,000
4,000; 5% Debentures of ₹ 100 each	4,00,000	Debtors	2,00,000
Outstanding Interest on		Cash	10,000
Debentures	20,000		
Creditors	40,000		
Outstanding Tax, Wages etc.	4,000		
Bills Payable	6,000		
Bank Overdraft	20,000		
	9,90,000		9,90,000

Preference Shares' dividend is in arrear for one year. Arrears are to be paid at the time of liquidation. Preference shareholders have the priority over equity shareholders. Bank overdraft was on the mortgage of machinery. The assets were realised as follows:

Land and Buildings ₹ 3,00,000, Machinery ₹ 3,20,000, Patents ₹ 16,000, Stock ₹ 1,40,000, and Debtors ₹ 1,80,000.

The expenses of liquidation amounted to ₹ 1,000. The liquidator is entitled to get a commission of 2% on all the assets realised except cash. He is also entitled to get 2% commission on the amount paid to shareholders. Payments were made on 31st December, 2010. Prepare the Liquidator's Final Statement of Account.

Notes

Solution

Omega Company Limited
Liquidator's Final Statement of Account

Receipts	Estimated Values (₹)	Value Realised (₹)	Payments	Amount (₹)
Assets Realised:			Liquidator's Remuneration	
Land & Buildings	3,00,000	3,00,000	2% on ₹ 9,56,000	19,120
Patents	20,000	16,000	2% on ₹ 4,24,000	8,480
Stock	1,60,000	1,40,000	2% on ₹ 13,137.25	262.75
Debtors	2,00,000	1,80,000	Liquidator's Expenses	1,000
Cash		10,000	Debenture-holders	4,00,000
Surplus from Securities Amount Received		3,00,000	+ Arrear of Interest for 1.5 year	30,000
		954.25	Preferential Creditors for Tax, Wages etc.	4,000
			Unsecured Creditors	46,000
			Return to Contributories:	
			Pref. Capital	4,00,000
			Arrear of Dividend	24,000
			Equity Shareholders	
			On 8,000 shares of ₹ 9 paid up @ ₹ 1.7614 approx.	14,091.50
		9,46,954.25		9,46,954.25

Working Note:

(i) Assets realised = 3,00,000 + 16,000 + 1,40,000 + 1,80,000 + 3,20,000 = ₹ 9,56,000

(ii) Amount paid to preference shareholders = 4,00,000 + 24,000
= 4,24,000

(iii) Amount left for Equity shareholders:

Total amount received from assets	9,46,000
Less: Liquidator's commission - ₹ (19,120+8,480)	27,600
Liquidation Expenses	1,000
Debentures + Interest	4,30,000
Preferential Creditors	4,000
Unsecured Creditors	46,000

Notes	Pref. Capital	4,00,000		
	+ Dividend	24,000	4,24,000	9,32,600
	Amount for Equity shareholders and liquidator's commission thereon.			13,400.00
	Less: 2% Liquidator's commission = $\frac{13,400 \times 2}{102}$			262.75
	Amount for Equity shareholders			13,137.25
(iv)	Loss to be borne by the Equity shareholders-			
	Total Equity capital (72,000+28,000)			1,00,000
	Less: Amount available for equity Shareholders			13,137.25
	Loss for Equity Shareholders			86,862.75
	Loss per Equity Share = $\frac{86,862.75}{8,000 + 4,000}$			= 7.238 app.
	Amount of call on per Equity Share of ₹ 7 = ₹ 7.238 - ₹ 7 = ₹ 0.238			
	Amount of refund per share of ₹ 9 = ₹ 9 - ₹ 7.238 = ₹ 1.762			

Illustration 10 (Journal Entries in the Books of Purchasing Company)

Following was the Balance Sheet of Swadeshi Company Limited as on 31st March, 2010:

Liabilities	₹	Assets	₹
24,000 Fully paid Shares of ₹ 10 each	2,40,000	Buildings	2,00,000
Sundry Creditors	60,000	Machinery and Plant	80,000
Bank Overdraft	56,000	Stock	30,000
		Debtors	44,000
		P&L A/c	2,000
	3,56,000		3,56,000

There was voluntary liquidation of Swadeshi Company Limited and the assets were sold for ₹ 3,00,000. Its payment is made as under: (i) ₹ 1,20,000 in cash (which is sufficient to pay off Creditors, Bank Overdraft and Liquidation Expenses of ₹ 4,000), (ii) ₹ 1,80,000 by allotment of 24,000 shares of ₹ 10 each of Videshi Company Limited which will be treated as ₹ 7.50 per share paid up. Prepare Liquidator's Final Statement of Account in the books of Swadeshi Co. Ltd. and pass the Journal Entries in the books of Videshi Co. Ltd.

Solution

Swadeshi Company Limited Liquidator's Final Statement of Account				
Receipts	Estimated Values (₹)	Value Realised (₹)	Payments	Amount (₹)
Assets sold	3,54,000	3,00,000	Liquidation Expenses	4,000
			Creditors (60,000+56,000)	1,16,000
			Return to Contributories : 24,000	
			Shareholders @ ₹ 7.5 per shares	1,80,000
		3,00,000		3,00,000

Journal Entries in the Books of Videshi Co. Ltd.

Notes

Date	Particulars	L.F.	₹	₹
	Building A/c	Dr.	2,00,000	
	Machinery and Plant A/c	Dr.	80,000	
	Stock A/c	Dr.	30,000	
	Debtors A/c	Dr.	44,000	
	To Swadeshi Co. Ltd.			3,00,000
	To Capital Reserve A/c			54,000
	(Above assets of Swadeshi Co. Ltd. being purchased)			
	Swadeshi Co. Ltd.	Dr.	3,00,000	
	To Cash A/c			120,000
	To Share Capital A/c			180,000
	(Payment being made to Swadeshi Co. Ltd. by shares and cash.)			

Illustration 11 (Receiver's Receipt and Payment Account)Following was the Balance Sheet of Oxford Ltd. as on 31st December, 2010:

Liabilities	₹	Assets	₹
Issued Capital:		Sundry Assets	2,39,500
500; 7% Preference shares of ₹ 100 each fully paid	50,000	Buildings	50,000
750 Equity shares of ₹ 100 each ₹ 95 paid	71,250	Preliminary Expenses	5,000
5% Debentures	1,00,000	Profit and Loss A/c.	16,750
Loan on Mortgage	40,000		
Bank Account	12,500		
Creditors including ₹ 27,500 for assessed tax	37,500		
	3,11,250		3,11,250

The mortgage was secured on the buildings and the debentures were secured by floating charge on the Sundry Assets. The Debenture-holders appointed a Receiver who took charge of the Sundry Assets amounting to ₹ 1,57,500. A liquidator was also appointed as the company went into voluntary liquidation. The Receiver realised the assets for ₹ 1,47,500 and his costs and remuneration were ₹ 750 and ₹ 1,000 respectively. ₹ 45,000 were realised from buildings and ₹ 72,500 from the sale of the remaining Sundry Assets. The bank had the guarantees of the directors amounting to ₹ 11,000 which was duly honoured by them. The costs of the liquidation were ₹ 1,500 and the liquidator's remuneration amounted to ₹ 625. Prepare the Accounts of the Liquidator and the Receiver.

Solution

Oxford Co. Ltd.
Receiver's Receipts and Payments Account

Particulars	₹	Particulars	₹
Assets Realised	1,47,500	Cost of Receiver	750
Building Realised	45,000	Receiver's Remuneration	1,000
Less: Mortgage	40,000	Preferential Creditors for Income Tax	27,500
		Payment to Debenture-holders	1,00,000
		Balance given to the liquidator	23,250
	1,52,500		1,52,500

Notes



Notes As there is a legal preference of the receiver for costs and remuneration and preferential creditors over the payment of debenture-holders, they are paid off first.

Liquidator's Final Statement of Account

Receipts	₹	Payments	₹
Surplus from Receiver	23,250	Liquidator's Remuneration	625
Sundry Assets Realised	72,500	Liquidator's costs	1,500
		Unsecured Creditors:	
		Trade Creditors	10,000
		Bank Overdraft	12,500
			22,500
		Return to Contributories:	
		Preference Capital	50,000
		750 Equity shareholders @ ₹ 28.17 per share approximately	21,125
	95,750		95,750

10.5 List B Contributories

The shareholders who transferred partly paid shares (otherwise than by operation of law or by death) within one year, prior to the date of winding up may be called upon to pay an amount (not exceeding the amount not called up when the shares were transferred) to pay off such creditors as existed on the date of transfer of shares.

Their liability will crystallise only

- (i) When the existing assets available with the liquidator are not sufficient to cover the liabilities;
- (ii) When the existing shareholders fail to pay the amount due on the shares to the liquidator.

List B Contributories are following:

- On the appointment of Liquidator, director's position will stand automatically vacated and the shareholders will be referred to as contributories.
- Shareholders who have transferred that partly paid shares within one year earlier to date of winding up will be placed in "B" List. Such contributories will be referred to as "B" List of contributories.
- Liquidator is expected to dispose the assets off to pay off liabilities. In case the disposal of assets was not sufficient to discharge the liabilities, then the liquidator can claim from "A" List of contributories towards their unpaid capital towards the company.
- If "A" List of contributories are not meeting the liabilities, then liquidator can fall upon "B" List of contributories to recover money towards unpaid portion of the capital.
- The liquidator can fall upon only against transfer of partly paid shares effected during within one year earlier to the date of winding up and transmission of shares will not come under this purview.
- If there were to be more than one such contributories, then the liability will be fixed against that many contributories in the ratio in which they are expected to contribute towards the capital.

- In no case, such fixation of liabilities can exceed the statutory liability (towards unpaid capital).

Notes

Illustration 12 (Liabilities of 'B' List Contributories)

Bad Luck Limited went into voluntary liquidation and the proceedings commenced on 2nd July, 2010. Certain creditors could also receive payment out of the contribution from contributories of the 'A' List. The following details of share transfers are made available to you:

Name of the transferor shareholders	No. of shares transferred	Date of the transfer ceasing to be a member	Creditors remaining unpaid and outstanding at the time of the transferor or ceasing to be a member
(i) A	1,000	1 st March, 2009	₹ 6,000
(ii) B	1,250	15 th August, 2009	₹ 8,000
(iii) C	500	1 st October, 2009	₹ 10,750
(iv) D	2,000	1 st December, 2009	₹ 13,000
(v) E	250	1 st April, 2010	₹ 15,000

All the shares were of ₹ 10 each, on which ₹ 5 per share had been paid up. Ignoring other details like liquidator's expenses etc., you are required to work out the liabilities of the individual contributories listed above.

Solution

Only those persons who have transferred their shares within one year before the date of commencement of winding up are liable to pay under List B, subject to the maximum limit of the sum still unpaid on the shares previously held by them. Hence, Mr. A will not be liable to contribute as he transferred his shares prior to one year preceding the date of winding up. His name will not be included in List 'B' of contributories. The outstanding liabilities will be borne by the others in the ratio of their holdings.

Statement of Liabilities of B List Contributories

Creditors on the date of transfer of share	(A) 1,250 shares ₹	(B) 500 shares ₹	(C) 2,000 shares ₹	(D) 250 shares ₹	(E) Amount to be paid to creditors
(i) ₹ 8,000 (5:2:8:1.)	2,500	1,000	4,000	500	8,000
(ii) ₹ 2,750 (2:8:1)	—	500	2,000	250	2,750
(iii) ₹ 2,250 (8:1)	—	—	2,000	250	2,250
(iv) ₹ 4,000	—	—	—	4,000	250
Total (A)	2,500	1,500	8,000	5,000	13,250
Maximum Liability as per their holdings (B)	(1250×5) 6,250	(500×5) 2,500	(2,000×5) 10,000	(250×5) 1,250	
Liability to be paid (A) or (B) whichever is less	2,500	1,500	8,000	1,250	



Task

Discuss the primary duties of Liquidators.

Notes

Self Assessment

Choose the correct answer from the following options:

13. A liquidator is entitled to receive remuneration @ 2% of the assets realised and 3% of the amount distributed among the unsecured creditors. The assets realised ₹ 25,00,000 against which liquidations expenses of ₹ 25,000, Preferential Creditors of ₹ 75,000 and Secured Creditors of ₹ 10,00,000 were paid. Remuneration payable to the liquidator will be:
- ₹ 32,500
 - ₹ 30,000
 - ₹ 50,000
 - ₹ 91,475.
14. The salary of 5 clerks for a period of 9 months before the relevant date was in arrear. If the salary of each clerk is ₹ 1,500 per month, the amount to be included in preferential creditors will be:
- ₹ 67,500
 - ₹ 5,000
 - ₹ 30,000
 - None of these.
15. The liquidator of a company is entitled to a remuneration of 3% on the amount distributed to unsecured creditors. The amount available for distribution to unsecured creditors before paying liquidator's remuneration was ₹ 92,700. The liquidator's remuneration will be:
- ₹ 2,781
 - ₹ 2,700
 - ₹ 3,000
 - None of these.



Case Study **How to Avoid Compulsory Liquidation?**

Protecta (Plymouth) Limited (a fictional company) is a security company providing security guards to other businesses. The company has 50 employees. The company has minimal overheads, apart from the "wage cost" of the employees.

The company had four main customers, the largest of which failed leaving Protecta (Plymouth) Limited with a bad debt of ₹ 100,000. Since that bad debt was incurred three months ago the company has recovered its previous level of turnover, but that turnover is now spread over ten customers.

The cash flow reduction of ₹ 100,000 caused by the bad debt resulted in Protecta (Plymouth) Ltd "stretching the due dates" of the payments needed to be made to the company's creditors. One of those creditors issued a winding up petition two weeks ago and the court is to consider whether or not to make a winding up order at a hearing set to take place in three weeks time.

As soon as they receive the winding up petition the directors of Protecta (Plymouth) Ltd arrange to see a turn around specialist.

Contd...

		Notes
The realisable assets of the company are determined to be:		
	₹	
Good trade debtors	170,000	
Five vans	25,000	
Office equipment	2,000	
Goodwill	?	
Total realisable value of assets	197,000	
The amounts owed out by the company are found to be:		
	₹	₹
Bank (secured by a debenture)		160,000
VAT	120,000	
PAYE	60,000	
Other unsecured creditors	20,000	
		200,000
Total creditors		360,000
The adviser explains that since a change in the law on 15th September 2008 VAT and PAYE are no longer classed as preferential creditors. The advisor prepares a statement of affairs which (ignoring the new rules on "top slicing") shows the order of priority of distributing the realisable assets should a compulsory liquidation ensue.		
	₹	
Realisable value of assets	197,000	
Less: Payable to bankers under their floating charge	160,000	
Surplus cash available for other creditors which total ₹ 200,000 (subject to settling liquidators costs)	37,000	
Clearly the ₹ 200,000 of creditors could not expect much of a dividend in the liquidation after costs were deducted from the ₹ 37,000 net sum available to any liquidator.		
Possible Solutions		
If it is assumed that the company has been restored to profitability, but is subject to the creditors overhang, then the company directors would have explained to them the following alternatives:		
1. Freezing the situation by obtaining an administration order - since new laws were introduced on 15th September 2008 the appointment of an administrator is a much simplified process. The administration "freezes" creditors actions and gives a breathing space to decide what to do. The appointment of an administrator automatically adjourns the winding up petition.		
2. Freezing the situation by proposing a company voluntary arrangement (CVA) - the advisor points out that since 1 st January 2008 there are two types of CVA that can be proposed. The advisor explains the pros and cons of each type. Only one of the CVA's creates an "automatic freeze" on the winding up petition.		
Contd...		

Notes

3. Commencement of a phoenix company – the directors of Protecta decide that they do not wish to propose a CVA but instead wish to incorporate a restart phoenix company. They decide that they do not want to acquire the vans and fixtures owned by Protecta – instead the successor company buys new. In these circumstances the directors will face an uncertain financial position as they will need to purchase the “goodwill” of the business from the ultimate liquidator of Protecta Limited.

Question

Discuss the options your company has if a compulsory liquidation threatens.

Source: <http://www.purnells.co.uk/limited-company/compulsory-liquidations/case-study-compulsory-liquidation.html>

10.6 Summary

- Liquidator’s statement of account of the winding up is prepared for the period starting from the commencement of winding up to the close of winding up.
- If winding up of company is not concluded within one year after its commencement, Liquidator’s statement of account pursuant to section 551 of the Companies Act, 1956 (Form No. 153) is to be filed by a Liquidator within a period of two months of the conclusion of one year and thereafter until the winding up is concluded at intervals of not more than one year or at such shorter intervals, if any, as may be prescribed.
- The number of business liquidations is steadily increasing, and the structure of each liquidation may vary depending upon the particular statutes invoked.
- As the precise type of liquidation can affect a party’s rights and ultimate recovery, troubled businesses contemplating liquidation and those doing business with companies that may be forced into liquidation are advised to seek counsel regarding the various methods of liquidation available.
- It is vital that, in the period between the calling of these meetings and actually holding them, the directors (who remain in control of the company) exercise appropriate caution and take the advice of the proposed Liquidator.
- There is no embargo on continued trading, although the company cannot accept deliveries of goods for which it has not made provision for payment.
- It is necessary, during this period, not to improve or worsen the position of any individual creditors, or to dissipate any of the assets, otherwise the directors could have either personal liability or be culpable for misfeasance.
- In particular, it is vital to ensure that assets that ought to be made available to the Liquidator do not fall into the hands of creditors and thus become available for set off.

10.7 Keywords

Bankruptcy: Bankruptcy is a legal proceeding that relieves a debtor of all or some of the debts the owe.

Contributory: A contributory means a person liable to contribute to the assets of the company in the event of its being wound up and includes holders of shares which are fully paid.

Creditors Voluntary Liquidation: It is a voluntary liquidation where the directors cannot make the Statutory Declaration of Solvency necessary for a Member’s Voluntary Liquidation.

Fraudulent Trading: This is where it can be demonstrated that the business of the company has been continued with a view to defrauding the creditors.

Liquidation: It refers to the winding up of the affairs of the partnership. This leads to sale of all non-cash and payment to creditors and to partners.

Liquidator: A liquidator is a person who is entrusted the duty of winding up of a company. He is appointed to administer and to take control of the company.

Preferences: This is where a creditor has had his position improved in the time leading up to the liquidation simply because the directors wished to achieve that effect.

Voluntary Liquidation: A Voluntary Liquidation is one which has been instigated by the passing of a resolution by the shareholders, as opposed to a winding up order made by the court, generally at the behest of an unpaid creditor.

Wrongful Trading: This is where a point is reached where the directors knew or ought to have known that the company could not realistically avoid insolvent liquidation.

10.8 Review Questions

1. Explain the liquidator's final statement of account.
2. What do you mean by 'B' List of Contributories?
3. Describe the order of payment adopted by a liquidator.
4. Explain the various methods of computing the liquidator's remuneration.
5. Explain the preferential creditors under the Indian Companies Act.
6. Shashi Ltd. went into voluntary liquidation on January 1, 2010. The following was the position of the company:

	₹
Shares Capital	1,56,000
Liabilities:	
Preferential Creditors	19,600
Partly Secured Creditors (with a charge on Leasehold Property)	44,000
Unsecured Creditors	72,000
Assets Realised:	
Leasehold Property	40,000
Other Assets	1,12,000

Cost of liquidation amounted to ₹ 3,328. The liquidator is entitled to a remuneration of ₹ 2,000 and a commission of 2% on the amount realised and 2% on the amount paid to unsecured creditors and preferential creditors. Prepare Liquidator's Final Statement of Account.

7. The following particulars relate to Zebra Limited which has gone into voluntary liquidation. You are required to prepare the Liquidator's Final Account, allowing for his remuneration @ 2% on the amount realised and 2% on the amount distributed among unsecured creditors other than Preferential Creditors:

	₹
Preferential Creditors	20,000
Unsecured Creditors	64,000
Debentures	20,000

Notes

The assets realised the following sums:

Land & Buildings	40,000
Plant & Machinery	37,300
Fixture & Fittings	2,000

The liquidation expenses amounted to ₹ 2,000.

8. Temptation Limited went into voluntary liquidation on 31st December, 2010. The following information is available with the liquidator:

Sundry Creditors amount to ₹ 1,51,320 of which ₹ 16,000 are preferential. 6% Debentures carrying floating charge on the assets amounted to ₹ 1,60,000. Debenture-holders were paid interest up to 30-6-2010.

The assets realised as follows:

Stock-in-Trade	₹ 1,68,000
Plant and Machinery	₹ 1,21,200

Cash-in-Hand stood at ₹ 1,000. Debentures were paid off on 30th June of the following year with interest. Liquidator's expenses amounted to ₹ 3,804 and they were entitled to remuneration at 3% on the amount realised and 2% on the amount distributed to unsecured creditors.

Prepare Liquidator's Final Statement of Account.

9. Amod & Pramod Limited get into financial difficulties and on 31-3-2009 a Receiver was appointed by the Debenture-holders under the terms of agreement which provided a floating charge. A resolution of voluntary winding up was passed on April 30, 2009 when a liquidator was appointed. The following is the summary of company's position as on 31-3-2009.

Balance Sheet

Liabilities	₹	Assets	₹
400, 6% Preference Shares of ₹ 100 each fully paid 2,00,000 Equity shares of ₹ 1 each, 80 paise called up	1,60,000	Fixed Assets	1,55,000
		Stock	1,22,460
10,000 shares	2,000	Debtors	42,730
			1,58,000
5% Debentures	40,000	P & L Account	1,02,450
+ Interest Accrued	750		
Bank Loan @ 5½ %p.a.	17,600		
(Collaterally secured by depositing debentures worth ₹ 20,000 ranking equally with the above)			
Creditors	1,66,290		
	4,22,640		4,22,640

Creditors comprises as follows:

Local Taxes ₹ 296, Sales Tax ₹ 260, Managing Director's Remuneration ₹ 2,400, Directors' fees ₹ 6,000. Income tax ₹ 6,200 and Remaining Creditors ₹ 1,51,134. The Receiver collected ₹ 24,980 from debtors and sold some of the stock for ₹ 61,584. His expenses and remuneration

amounted to ₹ 5,600. On June 30, 2009 he made all his obligatory payments and transferred the balance to the liquidator. The Liquidator realised ₹ 85,772 from the fixed assets and ₹ 56,678 from the remaining Stock and collected the rest of the debtors in full.

Notes

He made a final call. The call was paid in full by all the shareholders except one who owed ₹ 2,000 for calls in arrear because he could not be traced. The liquidator made his distribution on August 31, 2008. His expenses amounted to ₹ 610. His remuneration was fixed at a sum equal to 2% on the amount realised by him and 1% on the amount whatsoever distributed by him. Prepare a Receiver's Receipts and Payments Account and Liquidator's Final Statement of Account.

10. In a winding up that commenced on 15th September, 2010, certain creditors could not receive payment out of realisation of assets and out of contribution from 'A' List of contributories. Following are the details of certain share transfers that took place prior to liquidation and amount of creditors remaining unpaid:

Shareholders outstanding	No. of shares transferred	Date when ceased to be a member	Creditors remaining unpaid and on the date of ceasing to be a member
Lalit	200	31.8.2009	800
Mohan	180	20.9.2009	1,200
Navin	120	15.11.2009	1,740
Om	100	22.4.2010	1,860
Prakash	50	10.7.2010	2,200

All the shares were of ₹ 10 each, on which ₹ 5 per share had been called and paid up. Ignoring the expenses of liquidation remuneration to liquidator, etc., work out the amount to be realised from the above contributories.

11. Japan Company Ltd. went into voluntary liquidation on 1st January, 2008. Some creditors could not be paid due to shortage of realised amount. On inquiry it is found that some shareholders transferred their shares within one year before commencement of liquidation of the company. The following description is about the dates of transfer of shares and the amounts due to creditors:

Name of Shareholders	Date of transfer of Shares	No. of transferred Shares	Amount due and payable to the creditors to the date of transfer ₹
Karim	1 st May, 2006	500	15,000
Ajay	1 st June, 2007	1,500	20,000
Babita	5 th July, 2007	1,250	27,000
Chhotey	7 th August, 2007	500	31,500
Devi	15 th Sep., 2007	750	35,000
Edi	20 th Sep., 2007	750	36,000
Firoj	25 th Dec., 2007	250	36,000

All the shares were of ₹ 100 each and ₹ 90 were paid on each share. No amount was received from contributories of List 'A'. Prepare a statement showing the liabilities of contributories of List 'B'.

Notes

Answers: Self Assessment

- | | |
|---|--------------------------------|
| 1. False | 2. True |
| 3. True | 4. Preferential |
| 5. Directors | 6. Liquidators |
| 7. True | 8. True |
| 9. False | 10. Debenture-holders |
| 11. Liquidator's Final Statement of Account | 12. 'B' List of Contributories |
| 13. (d) ₹ 91,475 | 14. (b) ₹ 5,000 |
| 15. (b) ₹ 2,700 | |

10.9 Further Readings



Books

B B Dam and H C Gautam, *Corporate Accounting*, Capital Publishing.

Das. K R and others, *Corporate Accounting*, LBS Publication.

Sehgal, Dr. A and Sehgal, Dr. D, *Advanced Accounting & Corporate Accounting*, Taxman Publishers.



Online links

<http://www.companyliquidator.gov.in/Form-156.pdf>

http://220.227.161.86/19018comp_sugans_pe2_accounting_cp9_5.pdf

<http://sreeramacademy.net/uploads/files/13263623234f0eaed3d58b1.pdf>

Unit 11: Valuation of Goodwill

Notes

CONTENTS

Objectives

Introduction

11.1 Meaning and Definition of Goodwill

11.2 Nature and Components of Goodwill

11.2.1 Nature of Goodwill

11.2.2 Components of Goodwill

11.3 Features and Need for Valuation of Goodwill

11.3.1 Special Features of Goodwill

11.3.2 Need for Valuation of Goodwill

11.4 Factors Affecting Goodwill

11.5 Methods for Valuation of Goodwill

11.5.1 Average Profit Method

11.5.2 Super Profit Method

11.5.3 Capitalisation Method

11.5.4 Annuity Method

11.6 Summary

11.7 Keywords

11.8 Review Questions

11.9 Further Readings

Objectives

After studying this unit, you will be able to:

- State the meaning and definition of goodwill
- Describe the nature, concept, components and features of goodwill
- Explain the need and factors of goodwill
- Discuss the methods for valuation of goodwill

Introduction

Goodwill of a business means reputation, popularity or image of the business in the market. Goodwill of a business is earned by the entrepreneur by delivering good quality production, honesty of the businessman, harmonious relations with labourers, pricing of the product and availability of technical knowledge etc. Goodwill of a business attracts more customers towards itself like a magnet. As a result, the business earns more or excess profit over the normally-earned profit on the same capital employed by the other concerns engaged in the same business.

Notes

This excess or excess profit is the prime factor in determining the value of goodwill. If a buyer purchases a running concern, he will be ready to pay some extra amount over the net assets of the vendor for more earning capacity. If that concern has more earning capacity, its goodwill will be valuable assets. If it is a losing concern, its goodwill is valueless. Thus, goodwill may be defined as "value of the reputation of business". It is a valuable asset if the concern is profitable. It is useless if the concern is a losing concern. Goodwill can be described as the extra sale able value attached to a prosperous business beyond the intrinsic value of net assets. Thus the existence of goodwill can be felt through extra earning power. Because of such a nature, it seems like a real asset. But since it is invisible such as patents, trademark, copyrights etc. goodwill is termed as intangible assets.

11.1 Meaning and Definition of Goodwill

Goodwill is the value of the popularity or reputation of a concern for more profit earning capacity. Regarding goodwill as more profit earning capacity, Prof. L. R. Dicksee says "when a man pays for goodwill, he pays for something which places him in the position of being able to earn more money than he would be able to do by his own unaided efforts". Thus, goodwill is the present value of a concern's anticipated excess earnings. Taking the profit earning capacity of the concern accountants, writers on accounting economists, engineers and the court have defined the goodwill. "Goodwill is the present value of firm's anticipated excess earning".

-Morrise

"If the expected future earnings are less than a satisfactory return, the capitalisation of this deficiency is sometimes thought of as negative goodwill."

-Hendriksen

"From the accountant's point of view goodwill in the sense of attracting customers has little significance unless it has a saleable value. To the accountant, therefore, goodwill maybe said to be that element arising from reputation, connection or other advantages possessed by a business which enables it to earn greater profit than the return normally to be expected on the capital represented by the net tangible assets employed in the business."

-Spicer & Peglar

Eric L. Kohler in his *Dictionary of Accountants* defines goodwill as: the present value of expected future income in excess of a normal return on investment in tangible assets, not a recorded amount unless paid for. The excess of the price paid for a business as a whole over the book value or over computed or agreed value of all tangible assets purchased. Normally, goodwill thus acquired is only type appearing on books of account and in financial statement.

From the above definitions we can say that goodwill is the value of the reputation of a business unit in respect of profits expected in the future, over and above the normal level of profits earned by other business units belonging to the same class of business.

11.2 Nature and Components of Goodwill

Goodwill is treated as intangible assets, such as trade marks, patents, copyrights etc. in accounts. There will be wear and tear or depreciation on goodwill like other real assets, but its value always fluctuates. It is invisible. It does not become obsolete and does not get used up during the lifetime of the business. If a business has super profits (more than normal profits), there will be goodwill as a silent asset. Goodwill of business cannot be sold in part or isolation. It can be sold with only with the entire business except in the case of admission or retirement of a partner in partnership. It is valuable only if it is capable of being transferred from one person to another person. If the customer of a business is attached with the owner like a faithful dog that business will have non-transferable goodwill and the value of goodwill will be nil.

11.2.1 Nature of Goodwill

Notes

For the determination of the nature of goodwill it would be better to discuss the case **Whiteman Smith Motor Company vs. Chaplin** in which types of goodwill were zoologically classified by Justice Rich into four as:

1. **Cat's Nature Goodwill:** One of the characteristics of a cat is that it likes to live in one place and does not change its living place occasionally. Therefore, it is said that a cat prefers a place to a person. It represents the customer who goes to a particular place to the person who keeps it. Thus, the nature of some business is like the nature of a cat. Good-will of such type of business does not change due to the change of ownership of the business. The value of goodwill of such types of business is always higher due to its stability.
2. **Dog's Nature Goodwill:** A dog is famous for its faithfulness towards its owner. A dog is always attached to its owner rather than a place. The goodwill of some business depends on the owner of the business. If the owner of the business is changed, goodwill of that business will vanish. In other words, customers are attached to the owner. Such type of goodwill of the business is called dog's nature goodwill.
3. **Rat's Nature Goodwill:** One of characteristics of the rat is that it does not have any attachment to a place. It moves from place to place. If the goodwill of a business often changes, such type of goodwill is rat's nature goodwill.
4. **Rabbit's Nature Goodwill:** One of the characteristics of a rabbit is propinquity. Propinquity means nearness in time and place relationship. Due to this nature it is trouble-some for a rabbit to go elsewhere. If goodwill of a business has such type of nature, it is known as rabbit's nature goodwill.



Did u know? Average future maintainable profit or average profit is also known as expected profits.



Caselet

Cogent Valuation - Asset Approach

With respect to the asset approach, the partners of the subject law firm requested that we investigate the intangible value (goodwill value), if any, of perceived off-balance sheet intangible assets, such as the name and reputation of the firm (i.e., "brand equity"), the client relationships, and the trained and assembled workforce. None were deemed to have intangible value for the firm, based on the following observations. From a nation-wide survey of law firms, we determined that the subject law firm's billing rates were just below the average for the surveyed firms. Thus, clients were not willing to pay premium rates for the firm name (nor for the individual practitioners at the firm), and the firm did not generate earnings in excess of those of the average firm surveyed. Regardless, the name and reputation of a law practice is directly related to the expertise and reputation of the leading attorneys at that practice. Therefore, any goodwill attributable to name and reputation is linked to the individual attorneys, as opposed to the firm. Consequently, the firm name often dissolves withers or changes as senior partners leave a firm or as certain attorneys become senior partners.

Typically, clients are loyal to talented attorneys, not to their law firm affiliations. Attorneys cannot sell or transfer clients. Clients have the liberty to make decisions concerning legal advisors. Even without significant departures among senior partners, the subject law firm experiences a client turnover ratio of about 45.0% for the top clients and 30.0% for the entire

Contd...

Notes

client base. Trained attorneys and support staff can be, and are often, recruited from other firms, and are compensated similar to those trained in-house. Further, law firms cannot prevent employees from departing, and employee turnover is often problematic for law firms.

Source: <http://www.cogentvaluation.com/pdf/valuationissueslawpracticesandgoodwill.pdf>

11.2.2 Components of Goodwill

According to the view of judges, goodwill should not necessarily be related to excess profit-earning capacity of the business. But goodwill should be related with the number of its customers. Customers should come to the shop again and again and they should have confidence in the quality and price of the products of the concern. There should have a good reputation. This concept is known as legal concept.

According of economists, there are some unrecorded assets in addition to recorded assets in the business, which help to earn more than normal profit. Due to this excess profit the business enjoys goodwill. This concept is known as economic concept.

According to the accounting concept, if a business is expected to earn more than normal profits in future, that business has the value of goodwill and such goodwill is recorded in the books.

As explained earlier, if a business earns more than normal profits (meaning super profits) that has the value of its goodwill. This goodwill will be the combination of different factors. Thus, goodwill of a business can be analysed as:

1. Know-how or technology of the business.
2. Advantage of patents enjoyed by the business.
3. Any special advantage of a long-term contract relating to the supply of raw material at low price or supply of finished goods at a remunerative price, enjoyed by the business.
4. Advantage of the location of the business.
5. Advantage of a license possessed by the business.
6. Efficiency of the management.

Self Assessment

Fill in the blanks:

1. Goodwill of the company is assets.
2. If actual average profits of a company are less than the normal profits, value of the goodwill will be
3. Excess of average profits over normal profits is called
4. There are methods to compute the value of goodwill.
5. Dog nature goodwill depends upon
6. should be related with the number of its customers.

11.3 Features and Need for Valuation of Goodwill

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.

11.3.1 Special Features of Goodwill

Notes

Goodwill of a business has some special features, and is therefore distinct from other assets. These features are as follows:

1. Goodwill of a business can be positive or negative in value. When the purchase consideration of a business is more than its net assets, there will be a positive goodwill. If purchase consideration is less than net asset, there will be negative goodwill which is also known as capital reserve.
2. There cannot be the valuation of all its components separately, which contribute to goodwill.
3. Value of goodwill changes time to time with changes in the factors of goodwill which will be explained later.
4. The valuation of goodwill is subjective and not objective, because its valuation will differ from estimator to estimator.
5. There is no relation between the value of goodwill and the amount spent to build the same.
6. Goodwill of a business cannot be sold in a part or isolation. It is always sold with the business except admission and retirement of a partner.

11.3.2 Need for Valuation of Goodwill

Goodwill is valued when the business is disposed of, because no one would like to buy the goodwill i.e., firm's name and other advantages on the condition that the old business would continue to run. This is generally so in the case of sole proprietorship business. But in the case of partnership and company, valuation of goodwill may be required during the running business.

In case of a joint stock company: The valuation of goodwill may be required in the following cases:

- (a) When the business of a company is purchased by another company or when two companies of the same nature amalgamate.
- (b) When a company wants to acquire the controlling interest in another company.
- (c) When government takes over the business of another company.
- (d) When valuation of shares is done for taxation purposes – estate duty, gift tax etc., in case stock exchange quotation is not available.
- (e) When one class of shares is converted into another.

In case of partnership firm: Valuation of goodwill is required in the following cases:

- (a) When the existing partners have agreed to change the profit-sharing ratio.
- (b) When a partner retires or expires.
- (c) When the business is sold to a company.
- (d) When firm is dissolved or amalgamated with another firm.

In case of sole proprietorship: Valuation of goodwill is required in the following cases:

- (a) When business is sold.
- (b) When estate duty is levied at the time of death of the proprietor.

Notes

Self Assessment

State whether the following statements are true or false:

7. Goodwill is not an intangible asset.
8. If there are expected future profits less than normal profits, there will be negative goodwill.
9. Excess of average profits over the normal profit is called super profit.
10. Goodwill calculated according to the purchase of super profit method will be more than the goodwill calculated as per annuity method.
11. For ascertaining the value of goodwill, past profits will not need have to be adjusted keeping in mind the future possibilities.
12. Normal rate of return is that which is decided according to the risk free-rate of interest in government securities and the business and financial risks associated with the investment.

11.4 Factors Affecting Goodwill

Capacity to earn more profit over normal profits in future is the main factor in determining the value of goodwill of a business. But there are some other factors which affect the value of goodwill. Some important factors are given below:

1. **Use of Capital:** The amount of capital used in the business will affect the value of its goodwill. If there are two business units which are earning the same profits but their capital employed are different, that business unit will enjoy more goodwill which utilises the lesser amount of capital.
2. **Skill in Management:** In some business or professions, the personal skill of the owner in the management plays an important role e.g., success of the firm of a chartered accountant depends upon the personal skill and ability of its owner. In these cases, goodwill of the firm will not be higher. If the success of the business depends upon the skill of the employees and its officials, there will be more value of goodwill.
3. **Use of Patents and Trade Marks:** If a firm possesses valuable patents and trademarks and has reputation due to these it will enjoy a valuable goodwill. Here, the period for which patents and trademarks will be used in future must be considered at the time of valuation of goodwill. The longer the future period for the use of patents or trademark, the more will be the value of goodwill.
4. **Favourable Location or Site of the Business:** A favourable location or site of a business is sometime more important than all other factors put together. If the business is established in the main market a of city, the site of the business will play an important role in assessing the value of goodwill. Favourable site may be with respect of availability of raw materials or of selling or of both, enabling the business to enjoy substantial economies through saving in freight or through facility in sale.
5. **Risk Involved in Business:** If there is greater risk in a business, the amount of goodwill will be less than those businesses in which risks is less.
6. **Nature of Business:** The nature of business involves the following:
 - (a) **Nature of Goods in Business:** Profit of a business depends upon the nature of goods. If a business deals in the domestic articles of daily use, profit of such business will be near about constant due to constant demand of the articles of daily use. The more constant the profits, the more is the goodwill and vice versa.

- (b) *Monopolised Business*: If the previous profits of a business are good which are due to the monopolistic nature of the business, the value of goodwill would depend upon the fact whether such a monopolistic benefit is likely to continue or not. If such benefit will continue in the future, the value of goodwill will be more.
- (c) *Import Licence*: If a business is based upon the licence, new persons cannot enter into this business easily, and the existing company will enjoy the monopoly and earn the profits. In such a case, period of licence is an important factor for the determination of the value of goodwill.
- (d) Trade Name or Marks of the Business.
7. *Know-how of the Business*: Here, know-how means the knowledge to solve a particular problem relating to production or marketing of the business. Generally, this knowledge is acquired through foreign collaboration, experience in the business, sound thinking or a systematic research etc. If the business unit obtains such knowledge to face all its problems, its goodwill will be greater.
8. *Long-term Contracts*: If a business unit has favourable long-term contracts for the supply of raw materials or components or as regards sales, these will help in raising the value of goodwill. If these contracts are obtained due to the personal skill of the proprietor, the value to goodwill will not be affected by such existing contracts.
9. *Trends of Profit of the Business*: If the trend of profits of a business is steadily increasing, this will increase the value of goodwill. If the trend of profit is decreasing or has been stable in the previous years, the value of goodwill will decrease.
10. *Political Protection*: If political protection is being provided to a business or is expected to be given in future, value of goodwill of that business will be higher.
11. *Government's Industrial Policy*: If the attitude of the government's industrial policy is to promote a specific line of trade or industry, such a favourable future prospect for industry increase the value of goodwill i.e., computer industry, cement industry etc.

Self Assessment

Choose the correct answer from the following options:

13. If a business has the average capital employed of ₹ 5,00,000, the adjusted average profit of ₹ 90,000, normal rate of return 10%, what will be the value of goodwill on the basis of three years' purchase of super profit?
- (a) ₹ 4,10,000
 (b) ₹ 1,20,000
 (c) ₹ 2,70,000
 (d) ₹ 5,90,000
14. If there is the following information with a company, what will be the normal rate of return? Average Profit ₹ 50,000, Average Capital Employed ₹ 4,00,000 and goodwill of ₹ 30,000 is calculated on the basis of 3 years' purchase of super profits.
- (a) 15%
 (b) 5%
 (c) 10%
 (d) 20%

- Notes**
15. From the following facts of a business, indicate the correct no. of years' purchase:
Goodwill ₹ 36,000, Average profit ₹ 42,000 and Normal Profit ₹ 30,000.
- (a) 3 years
 - (b) 4 years
 - (c) 2 years
 - (d) 5 years

11.5 Methods for Valuation of Goodwill

The following four methods are used for valuing the goodwill, namely:

1. Average Profit Method
2. Super Profit Method
3. Capitalisation Method
4. Annuity Method.

11.5.1 Average Profit Method

Under this method, goodwill is calculated by multiplying the average profit or average future maintainable profit of last few years with a certain number of years (commonly known as number of years' purchase). In these methods, there is an assumption that a new business will not be able to earn any amount of profit during the first few years of its operations. Therefore, a person who wants to acquire a running business has to pay in the form of goodwill, a sum equal to the average profits multiplied by a certain number of years during which he is likely to receive the profits for the first few years. In this method the following two steps are involved:

- (i) Calculation of Average Profits;
- (ii) Multiplication of Average Profits with the number of years' purchase.

Calculation of average profit or average future maintainable profit: The purpose of calculating the average profits is to project the future profits which are likely to be earned in the coming years. And goodwill will be based on these profits. Therefore, the years chosen for average profits should be normal years. For this purpose, necessary adjustments are made in the light of future possibilities. These are as under:

- (a) If there is any abnormal loss due to strikes, floods, fires, theft, damage, abnormal repair charges, lump sum compensation etc., in a particular year and that is not likely to occur in future, the same should be added back to past profits.
- (b) All operational expenses, including the interest on debentures, should be provided for and depreciation on fixed assets should be charged on the value arrived at as a result of the revaluation.
- (c) If non-trading investments are excluded from the capital employed, profit or loss derived from these investments should be excluded from the total earnings of the business enterprise.
- (d) If any capital receipt has already been adjusted in profits that must be subtracted from the earnings of the business enterprise.
- (e) If directors' or managers' remuneration or commission is not adjusted in the profits, the same must be subtracted from profits. In case of under or over-charge of this commission or remuneration, necessary adjustment should be made.

- (f) If the auditor has passed a comment regarding the inadequacy of provision for taxation, bad debts, gratuity or depreciation and improper valuation of stock, necessary adjustment should be made in the profits for these.
- (g) All necessary adjustments should be made for the provision for liabilities.
- (h) From the past profits, the necessary income tax according to the relevant Financial Act must be deducted (profit after tax must be taken to calculate the average profit).
- (i) Results due to discontinuation of part of the business, expansion of business and any major change in policies of the business must also be adjusted in the profits.
- (j) If some developmental work has taken place whose results are expected to materialise in future, those should be adjusted in the profits.
- (k) Profits of past four or five normal years should be taken to calculate the average profits, because average profits are more reliable than a single year's profit.

If there are cyclical fluctuations in a business, the number of years selected for average must be long enough so that recovery, peak and recession phases of the business cycle may be covered. In such a case the longer period will get closer to the average future maintainable earnings.

If there is steady and gradual growth in a business, the average of a short period will be more useful.

- (l) According to the court's decision in the case of Califford and Martin, any allowances for loss of a director with exceptional quality and for future increase in taxation should not be considered at the time of calculating the average profits.
- (m) If the profits of a business unit are markedly falling or rising over the past four or five years, a simple average fails to project the future maintainable profits and then weighted average should be used to calculate the average profits. In such a case more importance (weights) is given to the recent year (latest years) and least importance (weight) is given to the first year. A simple method to calculate the weighted average is to multiply the profits by their respective number of years after arranging them chronologically in such a manner, that most importance (weight) is given to the last year (most recent year) and least importance (weight) to the first year (the remotest year). For instance, if we consider the period 1995-2000, a period of 6 years, profit of the year 1995 will have the least weight i.e., and the profit of the year 2000 will get the highest weight i.e. 6.



Example: The profits of a firm for the last three years were as follows: ₹ 60,000, ₹ 70,000, and ₹ 50,000. Calculate the goodwill of the firm taking 5 year's purchase of the average profits.

Solution:

$$\text{Average Profit} = ₹ (60,000 + 70,000 + 50,000) \div 3 = ₹ 60,000$$

Therefore, Value of Goodwill at 5 years' purchase of average profit

$$= \text{Average profit} \times 5$$

$$= ₹ 60,000 \times 5$$

$$= ₹ 3,00,000$$

Thus, the formula for Goodwill is as follows:

$$\text{Goodwill} = \text{Average Profits} \times \text{No. of years' Purchase}$$

Notes

Merits of Average Profit Method

1. This method is simple and easy to understand and apply.
2. As the average profits are considered to find out the value of goodwill, there is the possibility that result will be satisfactory. Average profits are more reliable than one year's profit to know the future earning capacity.
3. Generally, this method is adopted when a partner retires or expires.

Demerits of Average Profit Method

1. Only profits are considered to ascertain the value of goodwill. No account is taken for capital employed while that is an important factor affecting the goodwill.
2. There is uncertainty regarding the number of years for finding out the average profits and number of years' purchase. Therefore, results arrived are far from satisfactory.

Illustration 1 (Calculation of Average Profits)

The following information is available in respect of a business of Mr. Ramesh:

- (a) Profit - 2006 ₹ 6,00,000, 2007 ₹ 4,80,000, 2008 ₹ 3,80,000, 2009 ₹ 5,30,000.
- (b) Profit for 2006 has been reduced by ₹ 70,000 being the loss of stock by fire.
- (c) Profit for 2007 includes ₹ 40,000 non-recurring income.
- (d) The goods were not insured but it is decided to go for insurance in future and insurance premium is expected to be ₹ 3000 p.a.
- (e) Profit for 2008 includes ₹ 10,000 being the income from non-trading investments.
- (f) Profit for 2009 includes ₹ 70,000 for a claim lodged in 2002 for which no entry was made then.
- (g) The reasonable amount of remuneration of the proprietor of the business is ₹ 50,000 p.a. This has not been considered in ascertaining the profits for the past years.

Calculate the future maintainable average profits:

Solution

	₹	₹
Profits of 2006	6,00,000	
Add: Loss due to fire	70,000	6,70,000
Profit of 2007	4,80,000	
Less: Non-recurring income	40,000	4,40,000
Profits of 2008	3,80,000	
Less: Income from Non-trading Investments	10,000	3,70,000
Profit of 2009.	5,30,000	
Less: Income relating to 1998 (claim lodged)	70,000	4,60,000
Total Profit of four years		19,40,000

$$\text{Average Profits} = \frac{19,40,000}{4} = ₹ 4,85,000$$

Less: Expected Expenses:

Insurance premium 3000

Proprietor's remuneration	50,000	53,000	Notes
Future Maintainable Profits		4,32,000	

Working Note:

Number of Years' Purchase: Average maintainable profits are multiplied by a certain number of years to determine the value of goodwill. The logic behind multiplication is that the purchaser has to pay the seller the profits of the business which the purchaser would derive from the business due to vendor's efforts. In other words, the purchaser compensates the vendor of goodwill for the few years' profit which the purchaser receives due to vendor's efforts. Generally, Average Profits are multiplied by two or three years. Whatever number of years are taken for finding out total profits for average profits, normally, their half is the number which should be used after approximating would be for multiplying the average profits.



Example: For example, if 5 years' profits are to totalled up, half of $2\frac{1}{2}$ years, it is

approximated to 3 years. Thus, average maintainable profits will be multiplied by 3 years to determine the value of goodwill.



Notes In general, Average Profit Method can be applied. Actually the number of years purchase is decided on the basis of mutual agreement between purchaser and vendor of the business.

Illustration 2 (Average Profit Method)

X, Y and Z are partners, sharing profits and losses in the ratio of 1:2:2. It is provided in partnership deed that, on the death or retirement of a partner goodwill should be calculated on the basis of three years' purchase of the average net profits for the preceding five years. Y retires on 31st December, 2010. Calculate the value of firm's goodwill and Y's shares in goodwill. The net profits for the five years ended 31st December, 2010 were ₹ 2,70,000, ₹ 2,40,000, ₹ 1,20,000, ₹ 2,50,000, and ₹ 1,70,000 (Loss).

Solution

Calculation of Average Profits	₹
I Year's Profit	2,70,000
II Year's Profit	2,40,000
III Year's Profit	1,20,000
IV Year's Profit	2,50,000
	8,80,000
Less: V Year loss	1,70,000
Total Profits of 5 years	7,10,000

$$\text{Average Profit} = \frac{7,10,000}{5} = ₹ 1,42,000$$

$$\begin{aligned} \text{Value of goodwill} &= \text{Average Profits} \times \text{No. of Years' Purchase} \\ &= ₹ 1,42,000 \times 3 \end{aligned}$$

$$\text{Firm's goodwill} = ₹ 4,26,000$$

Notes

$$Y's \text{ share is goodwill} = 4,26,000 \times \frac{2}{5}$$

Illustration 3 (Weighted Average Profit Method)

P Ltd. proposed to purchase the business carried on by Mr. C. Goodwill for this purpose is agreed to be valued at three years' purchase of the weighted average profits of the past four years. Weights and profits are as below:

Years	Weights	Profits (₹)
2007	1	1,01,000
2008	2	1,24,000
2009	3	1,00,000
2010	4	1,50,000

On a scrutiny of the accounts, the following matters were revealed:

- (i) On 1st September, 2009 a major repair was made in respect of the plant incurring ₹ 30,000 which amount was charged to revenue. The said sum is agreed to be capitalised for goodwill calculation, subject to adjustment of depreciation of 10% p.a. on reducing balance method.
 - (ii) The closing stock for the year 2008 was overvalued by ₹ 12,000.
 - (iii) To cover management cost an annual charge of ₹ 24,000 should be made for the purpose of goodwill valuation. C prepares his accounts on 31st December each year.
- Compute the value of goodwill of the firm.

Solution**Computation of Adjusted Profits**

	₹	₹
Profits - 2007		1,01,000
Less: Annual charge for management cost		24,000
Adjusted Profit for the year 2007		77,000
Profits - 2008		1,24,000
Less: Over valuation of closing stock	12,000	
Annual charge for management cost	24,000	36,000
Adjusted Profits for the year 2008		88,000
Profits - 2009		1,00,000
Add: Overvaluation of opening stock (as closing stock of previous year becomes opening stock of current year)	12,000	
Major repair of plant (nature of capital expenditure)	30,000	42,000
Less: Depreciation Capital expenditure (major repair @ 10% for 4 months September to December)	1,000	1,42,000
Annual charge for management cost	24,000	25,000
Adjusted Profits for 2009.		1,17,000

Profits - 2010		1,50,000	Notes
Less: 10% depreciation on capital expenditure			
$\frac{30,000 - 1,000}{100} \times 10 =$	2,900		
Annual charge for management cost	24,000	26,900	
Adjusted profits for the year 2010		1,23,100	

Computation of Weighted Average Profits

Years	Adjusted Profits (₹)	Weights	Products
2007	77,000	1	77,000
2008	88,000	2	1,76,000
2009	1,17,000	3	3,51,000
2010	1,23,100	4	4,92,400
		10	10,96,400

$$\text{Average Profits} = \frac{\text{Total of Products}}{\text{Total of Weights}}$$

$$= \frac{10,96,400}{10} = ₹ 1,09,640$$

$$\text{Goodwill} = \text{Average Profit} \times \text{No. of Years' Purchase}$$

$$= ₹ 1,09,640 \times 3 = ₹ 3,28,920$$

11.5.2 Super Profit Method

Under this method, goodwill is determined by multiplying the super profits by a certain number of years' purchase. Super profit means excess of the average profits which is earned by a business over normal profit, based on the normal rate of return for representative firm in the industry. Thus:

$$\text{Super profit} = \text{Average Profit} - \text{Normal Profit}$$

To calculate the value of goodwill under this method, the following three items are required:

1. **Average Profits or Future Maintainable Profits:** Average profits will show the future earnings of the business. These are based on the past profits. Generally 3 to 5 years' profits are considered to calculate the average profit. Before taking the past profits, all necessary adjustments should be done, taking into consideration future possibilities. Necessary adjustment means abnormal or extraordinary profits of past years of non-recurring nature should be deducted and abnormal or extraordinary losses should be added back to the past to the relevant past year's profit.

In the following two cases, weighted average is suggested in the place of simple average.

- (i) For the businesses, which are in existence only for a short period and its definite trend of profits is not visible.
- (ii) Where there is a marked increase or decrease in the past profits of business.

The average profits and weighted average profits and their adjustments are discussed in detail in the average profit method earlier.

Notes

2. **Normal Rate of Return or Profit:** Normal rate of return or profit is that rate which investors in general expect on their investments in a particular type of industry. In other words, that rate of earning which satisfies the investors is the normal rate of return. This normal rate of return differs from industry to industry. In examination problems, generally normal rate of return is given. In an extreme case, the normal rate of return or earning is not mentioned the student should assume the normal rate of return basing his judgment on merits of the case. At the time of assuming the normal rate of return the students should keep in mind the following points:

- (a) *Pure rate of return:* That rate of return which one can earn by investing his funds without incurring any risk e.g., purchasing government securities.
- (b) *Rate of business risk:* If more risk is attached to an investment, there will be high rate of return. Risk depends on the nature of the business.
- (c) *Rate of financial risk:* That rate which covers risks connected with the finance of a business concerned.
- (d) *Rate of return:* The addition of the above three will be normal rate of return.

The normal rate of return of an industry is also affected by the bank rate, the period for which investment is made, risk attached to the investment and the general economic and political situations.

3. **Capital Employed:** For the purpose of valuation of goodwill, capital employed can be calculated by any one of the following two methods:

- (a) *Assets Side Approach:* If we take the total of all assets, that is called gross capital employed. And net capital employed or capital employed means total of all assets minus current liabilities. In this approach to calculate the net capital employed or capital employed, all assets of the business are totalled excluding intangible assets as goodwill, useless patents, trademarks, non-trading investments, fictitious assets as preliminary expenses and discount on issue of shares or debentures etc. All the fixed assets of the business should be taken at their replacement cost. Similarly, all current liabilities should be taken at their current price. The entire procedure under assets side approach can be understood in the following steps:

Calculation of Capital Employed

₹

All Tangible Assets (excluding Goodwill, useless Patents and Trademarks, Non-trading Investments Preliminary Expenses and Discount on Issue of Shares and Debentures) at replacement cost.	xxxx
Less: All external liabilities at current cost	
Preference shares capital (if these are non-participating)	xxx xxxx
Preference shares capital (if these are non-participating)	xxx xxxx

- (b) *Liability Side Approach:* Capital employed can also be calculated from the items of the liability side of the balance sheet by adding to Share Capital (paid up), all Profits, various Reserves, Profit on Revaluation of Fixed Assets and Liabilities and deducting there from Loss on Revaluation of Fixed Assets, Debit Balance of Profit and Loss Account shown in the Balance Sheet, Fictitious Assets and Non-Trading Assets. Thus, the procedure can be summarised:

Calculation of Capital Employed		Notes
		₹
Paid up share capital		XXXX
Add: Credit Balance of P&L Account		XXXX
Reserves		XXXX
Profit on Revaluation of Fixed Assets		XXXX
		XXXX
Less: Debit Balance of P & L A/c	XXXX	
Loss on Revaluation of Assets	XXXX	
Fictitious Assets	XXXX	
Non-Trading Assets	XXXX	XXXX
Capital Employed		XXXX

According to the views of some accountants, for the purpose of valuation of goodwill, the amount of debentures or loans should also be subtracted from the total assets of the business, because profits are considered after interest on debentures or loans. In order to make the agreement between capital employed and profits, debentures and loans should be excluded.

Some accountants express the view that average capital employed should be used in the place of capital employed for the purpose of valuation of goodwill. If there are given the balance sheets of the previous years, on the basis of these balance sheets, capital employed will be calculated for every year and then average capital employed will be calculated. If the previous years' balance sheets are not available, average capital employed can be calculated by adding the capital in the beginning and capital at the end divided by 2. In another method, if half of the current year's after tax are subtracted from the capital at the end, or by adding the half of the current year's profit after tax to the capital in the beginning, average capital employed can be found.



Notes If the current year's profits are not clearly mentioned in the liability side of the balance sheet, in examination problems, students should presume capital employed as average capital employed and a note should be given that question is solved through capital employed.

Normal Profits: With the help of Normal Rate of Return and Average Capital employed, the normal profit can be ascertained formula:

$$\text{Normal Profits} = \frac{\text{Average Capital Employed} \times \text{Normal Rate of Return}}{100}$$

Valuation of Goodwill Based on Super Profit

There are two methods to calculate the value of goodwill based on super profit. These methods are as below:

- (i) **Purchase of super profit method:** Under this method goodwill of a business will be:
Goodwill = Super Profit x No. of years' Purchase.
- (ii) **Valuation of goodwill according to the sliding-scale of super profit:** Sliding-scale of super profit method was advocated by A.E. Cutforth and it is based upon the theory that the greater the amount of super profit, the more difficult it is to maintain its uniformity over

Notes

a long period. The logic behind this is that high super profit would attract more traders and thus it will shorten the period during which this high super profit would be earned. Therefore, Cutforth split the super profit into two or three slabs according to the nature of the business. Each of these slabs is multiplied by a different number of years' purchase in descending order from the first slab. Thus, total of the purchase of such slabs gives the value of the goodwill. This method should be applied only in those cases where super profits are enormously high. Such super profits cannot be obtained on a continuous basis in the future.



Example: If super profits of a business are estimated at ₹ 90,000 they may be splitted into three slabs as under:

	₹
First ₹ 20,000 of S.P. at 3 years' purchase	60,000
Second ₹ 30,000 of S.P. at 2 years' purchase	60,000
Third ₹ 40,000 of S.P. at 1 year's purchase	<u>40,000</u>
Total amount of goodwill on the basis of sliding scale of S. P. method	<u>1,60,000</u>

Therefore, the procedure of calculating the value of goodwill under the super profit method is summarised as under:

1. Goodwill = Super profit × No. of years' Purchase
2. Super profit = Average Future Maintainable Profit × Normal Profits
3. Normal profit = $\frac{\text{Average Capital Employed} \times \text{Normal Rate of Return}}{100}$
4. Average Future Maintainable Profits = $\frac{\text{Total of Adjusted Profits}}{\text{No. of years}}$
5. Average Capital Employed = Capital Employed in the Beginning + Capital

$$\frac{\text{Employed at the end of the year}}{2}$$

or

Capital employed in the beginning of the year + Half of the current year's profit after tax.

or

Capital employed at the end of the year - Half of the current year's profit after tax.

Illustration 4 (Super Profit Method)

The profit and loss for the last years are 2009 profit - ₹ 20,000, 2010 Loss - ₹ 34,000, 2011 Profit - ₹ 1,00,000, 2012 Profit - ₹ 1,50,000. The average capital employed in the business is ₹ 4,00,000; the rate of interest expected from capital invested is 10%. The remuneration of partners is estimated to be ₹ 12,000 p.a. Calculate the value of goodwill on the basis of 2 years' purchase of super profit based on the average of 3 years.

Solution

Notes

Calculation of Average Profits

	₹
2011 Profit	1,00,000
2012 Profit	1,50,000
	2,50,000
Less: Loss 2010	34,000
Total Profits of 3 years	2,16,000
Average Profits = $\frac{2,16,000}{3}$	= 72,000
Less: Partners remuneration	= 12,000
1. Actual average profit	60,000
2. Normal profits = $\frac{\text{Average Capital Employed} \times \text{Normal Rate of Return}}{100}$	
	$= \frac{4,00,000 \times 10}{100} = ₹ 40,000$
3. Super Profit = Actual Average Profit - Normal Profit	
	= ₹ 60,000 - ₹ 40,000
	= ₹ 20,000
4. Goodwill = Super Profit × No. of years' Purchase	
	= ₹ 20,000 × 2
	= ₹ 40,000

Illustration 5

The average net profit is (before adjustment) ₹ 3,10,000. It includes ₹ 3,000 as income on non-trading investment, the cost of which is ₹ 75,000. Expenses amounting to ₹ 4,500 p.a. are likely to be discontinued in future. The burden of annual taxation is 50% and fair return is considered to be 8%. The average capital employed (including investments) is ₹ 19,75,000. Calculate the value of goodwill on the basis of 5 years' purchase of super profit.

Solution

	₹
Average Annual Profit	3,10,000
Add: Expenses likely to be discontinued	4,500
	3,14,500
Less: Non-trading income	3,000
	3,11,500
Less: 50% Provision for Tax	1,55,750
1. Average Future Maintainable Profits	1,55,750

Notes

$$2. \quad \text{Average Capital Employed} = ₹ 19,75,000 - 75,000 \\ = ₹ 19,00,000$$

$$3. \quad \text{Normal Profits} = \frac{\text{Average Capital Employed} \times \text{Normal Rate of Return}}{100} \\ = \frac{19,00,000 \times 8}{100} = 1,52,000$$

$$4. \quad \text{Super Profit} = \text{Average Future Maintainable Profits} - \text{Normal Profits} \\ = ₹ 1,55,750 - ₹ 1,52,000 \\ = ₹ 3,750$$

$$\text{Value of Goodwill} = \text{Super Profit} \times \text{No. of Years' Purchase} \\ = ₹ 3,750 \times 5 \\ = ₹ 18,750$$

*Task*

Ascertain the value of goodwill of Y Company from the following information: Calculate the value of goodwill of Y Company taking 3 year's purchase of the average profits of 4 years. Profits for the last 4 years after tax were: ₹ 10,000; ₹ 8,000; ₹ 5,000; ₹ 7,000.

11.5.3 Capitalisation Method

Under this method goodwill is valued by capitalising the future maintainable profits (average profits) applying the normal rate of return. In capitalisation method it is estimated that much amount of capital will be needed for earning a definite amount of profit at the normal rate of return. There are two methods to find out the value of goodwill:

- (a) Capitalisation of Super Profit Method.
- (b) Capitalisation of Future Maintainable Profits (Average Profit) Method

Capitalisation of Super Profit

In this method, it is attempted to assess the capital required to earn the amount of super profit. The capitalised value of super profit (excess of future maintainable profits over normal profit on capital employed) is called goodwill. To ascertain the value of goodwill under this method, Super Profit of the business and Normal Rate of Return are required and then the following formula is used.

$$\text{Goodwill as per Capitalisation Method} = \frac{\text{Super Profit} \times 100}{\text{Normal Rate of Return}}$$

Capitalisation of Future Maintainable Profits (Average Profit) Method or Capitalisation Method

Under this method, goodwill is determined by deducting the actual capital employed in the business from the capitalised value of future maintainable profits (adjusted average profits) applying the normal rate of return. To ascertain the value of goodwill under this method, the following steps are adopted:

- (i) Compute the Future Maintainable Profits (average profits) as per the method explained in Average Profit Method earlier.
- (ii) Compute the Capitalised Value of these Future Maintainable Profits (average profits) apply in the following formula:

Notes

$$= \frac{\text{Future Maintainable Profits (Average Profits)}}{\text{Normal Rate of Return}} \times 100$$

- (iii) Compute the Actual Capital Employed in the Business (Net Assets of the Business) according to the method explained in the Super Profit Method earlier:
- (iv) Compute the value of goodwill as under:

Goodwill = Capitalised Value of Future Maintainable Profits - Actual Capital Employed

Value of goodwill be equal to the goodwill computed in capitalisation of super profit.

Illustration 6 (Capitalisation of Super Profit)

The balance sheet of Arvind Mills Ltd. as on 31st December, 2011 was as under:

Liabilities	₹	Assets	₹
Share Capital:		Goodwill at Cost	2,25,000
22,500 Equity Shares of ₹ 100 each	22,50,000	Land and Building	4,95,000
Profit and Loss Account	3,09,000	Plant	9,01,500
Loans	6,00,000	Stock-in-trade	12,50,000
Creditors	3,75,000	Book Debts & Less Reserve	8,62,500
Provision for Tax	3,00,000	Cash at Bank	1,00,000
	38,34,000		38,34,000

The profits of the company since the commencement of the business were: 2007 ₹ 5,40,000, 2008 ₹ 5,70,000, 2009, ₹ 6,00,000, 2010 ₹ 6,40,000 and 2011 ₹ 7,00,000. Dividends were paid at 10% in 2007, 2008 and 2009, while for 2010 and 2011 the rate was 15%. Calculate the goodwill assuming the rate of tax 50% and the value of the plant 10,57,000. Use capitalisation method based on super profit.

Solution

Valuation of Goodwill of Arvind Mills Ltd.

(A) Capital Employed:

	₹	₹
Land and Buildings		4,95,000
Plant		10,57,000
Stock-in-trade		12,50,000
Book Debts & Less Reserve		8,62,500
Cash		1,00,000
		<u>37,64,500</u>

Notes	Less: Sundry Liabilities:		
	Loans	6,00,000	
	Creditors	3,75,000	
	Provision for Tax		
		3,00,000	<u>12,75,000</u>
	Capital Employed at the end of the year		<u>24,89,500</u>

(B) Normal Rate of Return (assumed average rate of dividend):

$$= \frac{10 + 10 + 10 + 15 + 15}{5} = \frac{60}{5} = 12\%$$

(C) Normal Profit on Capital Employed:

$$= \frac{\text{Capital Employed} \times \text{Normal Rate of Return}}{100}$$

$$= \frac{24,89,500 \times 12}{100} = ₹ 2,98,740$$

(D) Future Maintainable Profits:

$$= \frac{₹ 5,40,000 + ₹ 5,70,000 + ₹ 6,00,000 + ₹ 6,40,000 + ₹ 7,00,000}{5}$$

$$= \frac{₹ 30,50,000}{5} = ₹ 6,10,000 - 50\% \text{ tax}$$

$$= ₹ 3,05,000$$

(E) Super Profits:

Future Maintainable Profits	₹ 3,05,000
Less: Normal Profits	₹ 2,98,740
Super Profit	₹ 06,260

$$\text{Goodwill} = \frac{6,260 \times 100}{12} = ₹ 52,167.$$

Illustration 7 (Capitalisation of Future Maintainable Profits)

The Balance Sheet of Mr. A on 31st December, 2011 was as under:

Liabilities	₹	Assets	₹
Capital	2,50,000	Land and Buildings	1,80,000
Creditors	80,000	Machinery	1,10,000
Bills Payable	20,000	Furnitures	2,000
		Stock	8,000
		Cash at Bank	50,000
	<u>3,50,000</u>		<u>3,50,000</u>

The profits of the business for the five years ending 31st December 2011 are:

(I) year ₹ 40,000, (II) year ₹ 42,000, (III) year ₹ 45,000, (IV) year ₹ 50,000, (V) year ₹ 53,000.

The assets were revalued as under:

Notes

Land and Building ₹ 1,94,000, Machinery ₹ 1,18,000 and Furniture ₹ 1,000. No remuneration was charged by A though he was actively engaged in the business.

Find out goodwill by Capitalisation Method after assuming the rate of normal return.

Solution

Valuation of Goodwill of the Business of Mr. A

(A) Capital Employed:

	₹	₹
Land and Buildings at current price		1,94,000
Machinery at current price		1,18,000
Furniture at current price		1,000
Stock		8,000
Cash at Bank		50,000
		3,71,000
Less: Sundry Liabilities:		
Creditors	80,000	
Bills Payable	20,000	1,00,000
Capital Employed at the end of the year		2,71,000

(B) Future Maintainable Profits:

Average Profits = $\frac{₹ 40,000 + ₹ 42,000 + ₹ 45,000 + ₹ 50,000 + ₹ 53,000}{5}$		
$= \frac{2,30,000}{5} =$		46,000
Less: Remuneration of A (assumed)		10,000
Future Maintainable Profits		36,000

(C) Capitalised Value of Future Maintainable Profits at the normal rate of 10% (assumed)

$$= = \frac{₹ 36,000 \times 100}{10} = 3,60,000$$

(D) Goodwill under Capitalisation Method:

Capitalised value of Future Maintainable Profits		3,60,000
Less: Capital Employed		2,71,000
Goodwill:		89,000

11.5.4 Annuity Method

When a purchaser acquires a business, he pays some amount for goodwill along with the amount for net assets of the business. At the time of purchase of business, the purchaser thinks that amount paid for goodwill would be recouped by him during the coming three or four years in the

Notes

form of super profit. But super profits are made in future and he pays for goodwill immediately upon purchase of business.



Example: The super profits of a business are ₹ 50,000 and the number of years of purchase is decided at 3. Then, value of goodwill will be ₹ 1,50,000 as per super profit method. This value will be paid by the purchaser to the vendor immediately at the time of purchase of business and this amount will be reimbursed fully by the business to him in the form of super profit in the coming three year (or ₹ 50,000 per annum). But in this case he is not being fully reimbursed, because he paid ₹ 1,50,00 immediately on the purchase of business and he is receiving ₹ 50,000 annually (in instalments). Thus, the purchaser is suffering a loss of interest on ₹ 1,50,000. Therefore, the amount of goodwill should be equal to the present value of future returns. For this purpose the super profits are discounted at the normal rate to return. This procedure is called the annuity method of super profit. The present value of ₹ 1 paid annually can be determined with the help of Annuity Table or a formula.

**Notes**

Here, it should be noted that super profits of the business are not multiplied by the number of years' purchase. But it is multiplied by the present value of ₹ 1 paid annually at the normal rate of return to calculate the value of the goodwill.

Goodwill = Super Profit × Reference to Annuity Table

Generally, in examination problems, the present value is given to calculate the value of goodwill if, not given, can be calculated with the help of following formula:

$$A = 1 - \frac{\left(1 + \frac{r}{100}\right)^n}{\frac{r}{100}} \text{ or } \left(\frac{1 - \frac{1}{(1+i)^n}}{i} \right)$$

where A = present value of ₹ 1 paid annually

i or r = value of interest in per cent.

n = number of years.

To ascertain the value of goodwill, under this method, the present value of Re 1 paid annually can be multiplied by the super profit or average profit. If average profit is multiplied by present value of Re. 1 paid annually, product will be the present value of the business. And to calculate the value of goodwill, capital employed is subtracted from this product.



Caution In case of annuity method, if present value of ₹ 1 paid annually is multiplied by the average profit then the product will be considered as the present value of the business.

Illustration 8 (Annuity Method of Super Profit)

From the following particulars, calculate the value of goodwill of XYZ as per annuity method:

- (i) Net Profit: 2009 ₹ 1,05,000, 2010 ₹ 97,000 & 2011 ₹ 1,08,000.
- (ii) The average capital employed in the business is ₹ 5,00,000.
- (iii) Return expected from invested capital having regard to risk involved is 10%.
- (iv) An amount of ₹ 900 is included in the profits of 2010, which has been recovered from a debtor whose account had been written as bad several years before.

- (v) Remuneration of ₹ 10,000 p.a. to the proprietors is considered reasonable.
- (vi) It is expected that super profit can be maintained for the next five years.
- (vii) Present value of an annuity of one rupee for 5 years at 10% is ₹ 3.78.

Notes

Solution**Valuation of Goodwill by Annuity Method**

(A) Adjusted Average Profits:	₹	₹
Net Profits 2009		1,05,000
Net Profits 2010	97,000	
Less: Bad debts recovered	900	96,100
Net Profit 2011		1,08,000
Total Profits of 3 years		3,09,100
Average Profits		1,03,033
Less: Proprietors' remuneration		10,000
Adjusted Average Profits		93,033

(B) Normal Profits:

$$= \frac{\text{Average Capital Employed} \times \text{Normal Rate of Return}}{100}$$

$$= \frac{5,00,000 \times 10}{100}$$

(C) Super Profit:

	₹
Adjusted Average Profits	93,033
Less: Normal Profits	50,000
Super Profits	43,033

(D) Goodwill:

Present Value of an annuity of ₹ 1 for 5 years at 10% is 3.78

$$\text{Goodwill} = ₹ 43,033 \times 3.78$$

$$= ₹ 1,62,665$$

Illustration 9 (Valuation of Goodwill by All Methods)

From the following information find out goodwill:

- (a) As per Annuity Method
- (b) As per 4 years' Purchase of Super Profit
- (c) As per Capitalisation of Super Profit Method

Notes

Net profit for four years is ₹ 30,000, ₹ 40,000, ₹ 50,000 and ₹ 60,000. The profits include non-recurring profit on an average basis of ₹ 3,000.

Average capital employed ₹ 3,00,000, Normal Rate of Return 10%, Present Value of Annuity of ₹ 1 for four years at 10% is ₹ 2.5.

Solution**Future Maintainable Profit:**

$$\begin{aligned} \text{Average Profits} &= \frac{\text{₹ } 30,000 + \text{₹ } 40,000 + \text{₹ } 50,000 + \text{₹ } 60,000}{4} \\ &= \frac{\text{₹ } 1,80,000}{4} \\ &= \text{₹ } 45,000 \end{aligned}$$

Less: Non-recurring Profit 3,000

Future Maintainable Profits

Normal Profits: ₹ 42,000

$$= \frac{\text{Average Capital Employed} \times \text{Normal Rate of Return}}{100}$$

$$= \frac{\text{₹ } 3,00,000 \times 10}{100} = \text{₹ } 30,000$$

Super Profit:

Future Maintainable Profits ₹ 42,000

Less: Normal Profits ₹ 30,000

Super Profits ₹ 12,000

Value of Goodwill:

(a) As per Annuity Method-

Present value of annuity of ₹ 1 for four years at 10% is ₹ 2.5

$$\text{₹ } 12,000 \times 2.5 = \text{₹ } 30,000$$

(b) As per 4 years purchase of Super Profit

$$\text{₹ } 12,000 \times 4 = \text{₹ } 48,000$$

(c) As per Capitalisation of Super Profit Method:

$$= \frac{\text{Super Profit} \times 100}{\text{Normal Rate of Return}}$$

$$= \frac{12,000 \times 100}{10} = \text{₹ } 120,000$$



Task

Discuss the methods of valuation of goodwill.



Case Study **Cogent Valuation - Market Approach**

In a recent valuation assignment involving a large well-known law firm, the law firm's partners raised issues concerning each of the three valuation approaches. The market-based valuation methods provided no indications of value encompassing goodwill; market pricing information was not available, other than the proprietary database of private law firm in total transactions, which indicated that the subject law firm had no practice goodwill. Since pricing information is not readily available for law practices, the partners of the subject law firm queried the implications, if any, of such information concerning non-law firm professional practices upon the valuation of the subject law firm. The utilisation of disparate rules-of-thumb valuation methods for various types of professional practices implies that the pricing of any particular type of professional practice cannot be relied upon to value other types of professional practices. Further, dissimilar from law practices, non-law firm professional practices are commonly sold, and their sales prices and other relevant information are easily obtained. This observation suggests that law practices are significantly different from non-law firm professional practices. An important difference between law firms and non-law firm professional practices is the inability of the buyer to obtain a covenant-not-to-compete from the seller of a law practice, which is prohibited by the American Bar Association. Even if one were to attempt, to use pricing data for non-law firm professional practices, and assuming that that pricing implied goodwill value related to a given law practice, then one would still have no evidence that the implied goodwill is attributable to the firm or to the individual attorney(s) in the firm.

When valuing a particular business, we seek pricing information from highly similar businesses operating in the same industry and having similar risks and value drivers. Non-law firm professional practices have substantive differences from law firms, precluding the use of their pricing to value law firms. For example, dental practices rely heavily upon long-term repeat business, and a new dentist acquiring a practice typically has at least one opportunity to treat and retain each of the selling dentist's patients. In addition to fees for veterinary services, veterinary practices earn substantial revenue from retail sales of various pet supplies. Not unlike retail businesses, good office locations are critical for optometric practices, and sub-optimal locations "Just around the corner" from good locations could devastate an otherwise successful practice. A general medical practitioner does not accumulate work-in-process or receivables for unbilled time, but conducts and completes the requisite office visit (often in an hour or less) and bills the patient (or insurer) promptly. Large, international accounting firms can charge substantially more for their services than otherwise identical services provided by an independent CPA working in a rural area, yet the rural CPA may receive compensation in excess of a person of equivalent experience at the international firm. Typically, law firms do not exhibit the characteristics listed in this paragraph for other types of professional practices. Thus, the use of the pricing of non-law firm professional practices for the valuation of law practices is not appropriate.

Questions

1. Analyse the case facts and discuss the problem.
2. Throw light on the approach used in the case.

Source: <http://www.cogentvaluation.com/pdf/valuationissueslawpracticesandgoodwill.pdf>

11.6 Summary

- The name and fame of an organisation can be termed as goodwill. Goodwill is the benefit and merit of good name and reputation.
- Goodwill refers to a measure of the capacity of a business to earn excess profit. Therefore, goodwill can be defined as an intangible asset of the business.
- In accounting terms the goodwill means the extra profit available to concern due to various factors i.e. location, specialised product, nature of business etc.
- There are four methods of valuation of goodwill of the firm: Average Profit Method, Super Profit method and Capitalisation Method and Annuity method.
- In the case of sole trading concern, goodwill is valued at the time of selling of business, to take any person as a partner, to convert sole trading concern into a company.
- In the case of company, goodwill is valued at the time of amalgamation of two or more companies, absorption of company, reconstruction and holding company.
- The valuation of goodwill also becomes necessary, if the shares have to be valued on the basis of intrinsic value, market value or fair value and if the stock exchange quotation of the value of shares of a company is not available.
- For taxation purpose such as wealth tax also, the valuation of goodwill is necessary.
- From financial accounting point of view, goodwill is considered as an intangible asset of a firm. 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".

11.7 Keywords

Capital: Capital is an extremely vague term and its specific definition depends on the context in which it is used. In general, it refers to financial resources available for use.

Estate Duty: A tax paid on the property left by a dead person.

Goodwill: Goodwill refers to a measure of the capacity of a business to earn excess profit.

Intangible Assets: Assets that does not have a physical form Non-physical assets, such as patents, trademarks, copyrights, goodwill and brand recognition, are all examples of intangible assets.

Partnership: A business organisation in which two or more individuals manage and operate the business. Both owners are equally and personally liable for the debts from the business.

Super Profits: Super Profits are the profits earned above the normal profits.

Tangible Assets: Assets that have a physical form. Tangible assets include both fixed assets, such as machinery, buildings and land, and current assets, such as inventory.

Trademarks: A symbol, word, phrase, logo, or combination of these that legally distinguishes one company's product from any others. Any infringement on a trademark is illegal and therefore grounds for the company owning the trademark to sue the infringing party.

11.8 Review Questions

1. Define goodwill. Explain the various methods of valuation of goodwill.
2. Write a short note on the valuation of goodwill.
3. Define goodwill. Is it real or fictitious? Describe the factors on which it is based and discuss the various methods of its evaluation.

4. What is the importance of goodwill? What factors should be kept in mind at the time of valuation of goodwill?
5. Describe the concept of goodwill and explain the various methods of its evaluation.
6. What are accounting characteristics of goodwill? Explain capitalisation of profit method with the help of an imaginary illustration.
7. Explain the following terms:
 - (a) Super Profit
 - (b) Future Maintainable Profit
 - (c) Annuity Method of Super Profit
 - (d) Capitalisation of Maintainable Profits.
8. XYZ Co. Ltd. decided to purchase the business of ABC Co. for ₹ 2,00,000 on 1st January 2006. Its profits for the last four years are as under:
2002-₹ 50,000, 2003-₹ 62,500, 2004-₹ 60,000 and 2005-₹ 57,500

The business was looked after by the owner, the remuneration from alternative employment if not engaged in the business, for the owner, comes to ₹ 7,500 p.a.

Find out the amount of goodwill if it is valued on the basis of three years' purchase of the average net profit of the last four years.
9. Ramesh sold his business to Raman. For the determination of purchase consideration, calculate the value of goodwill taking into consideration the following factors:
 - (a) Goodwill should be valued at two years' purchase of the average profits, which, for the last three years are as:
2003-₹ 1,40,000, 2004-₹ 2,03,000, 2005-₹ 1,85,500.
 - (b) Abnormal loss of ₹ 7,000 due to theft has reduced the profit of the year 2003.
 - (c) The profit for the year 2004 includes abnormal profit of ₹ 12,000.
 - (d) A speculative and lottery profit of ₹ 17,000 was received and ₹ 35,000 as depreciation on such machine which was destroyed by fire in the pervious year, have been adjusted to the profit of the year 2005.
10. From the following information, calculate the value of goodwill taking three years' purchase of super profit:
 - (a) Average capital employed ₹ 9,00,000.
 - (b) Net trading profits for the preceding three years were: ₹ 1,61,400, ₹ 1,36,050, ₹ 1,68,750.
 - (c) Expected return on capital invested in the same type of business is 12%.
 - (d) Fair remuneration to the proprietor for his service is ₹ 18,000.
 - (e) Total assets ₹ 9,84,000 and Current liabilities ₹ 45,000.
11. A runs a chemist's shop. His net assets as on 31st March, 2005 amounted to ₹ 10,00,000. After paying a rent of ₹ 22,500 a year and a salary of ₹ 15,000 to the chemist, he earns a profit of ₹ 1,05,000. His landlord, who happens to be an expert chemist, is interested in purchasing the shop. 18% is considered to be a reasonable return on capital employed. What can A expect as payment for goodwill?
12. Mr. Ram is desirous of selling his business to Ranu Ltd., and has earned an average profit of ₹ 3,00,000 in the past. It is considered that such average profit fairly represents the profit likely to be earned in the future except that:

Notes

- (a) Directors' fees of ₹ 20,000 charged against such profits will not be payable by Ranu Ltd. whose existing board can easily cope with additional administrative work at present fees payable to them.
- (b) Rent at ₹ 30,000 p.a. which has been paid by Mr. Ram will not be a charge in future, since Ranu Ltd. owns its own premises and can supply the accommodation necessary for the staff and equipment of Mr. Ram.

The value of net tangible assets of Mr. Ram's business at the proposed date of sale was ₹ 30,00,000 and it was considered that a reasonable return on capital invested for the commodity was 10%. The profit of Mr. Ram would, in no way, be affected by the sale of his business to the purchasing company and goodwill existed, and was to be paid on the basis that Mr. Ram's business is a continuing unit. Compute the value of goodwill by the capitalisation of the expected future profit and super profit.

- 13. During the last three years, the profit of a company was ₹ 50,000, ₹ 48,000 and ₹ 52,000 respectively. The Average Capital employed is ₹ 3,00,000 and in a similar business, return on capital employed is 10%. The present value of ₹ 0.367209 annuity for three years @ 5% p.a. return is ₹ 1. Find out the goodwill by annuity method based on super profit.

Answers: Self Assessment

- | | |
|------------------------------|-------------|
| 1. Fictitious and Intangible | 2. Zero |
| 3. Super Profit | 4. Four |
| 5. Ownership | 6. Goodwill |
| 7. False | 8. True |
| 9. True | 10. True |
| 11. False | 12. True |
| 13. (b) ₹ 1,20,000 | 14. (c) 10% |
| 15. (a) 3 years | |

11.9 Further Readings



Books

- B B Dam and H C Gautam, *Corporate Accounting*. Capital Publishing.
- Das. K R and others, *Corporate Accounting*, LBS Publication.
- Sehgal, Dr. A and Sehgal, Dr. D, *Advanced Accounting & Corporate Accounting*, Taxman Publications.



Online links

- <http://www.caclubindia.com/articles/valuation-of-goodwill-11681.asp#.UO6n7uRfFv4>
- <http://accountlearning.blogspot.in/2011/10/concept-and-meaning-of-goodwill-and.html>
- <http://studyttesttime.com/about-goodwill/10-methods-of-valuation-of-goodwill>
- http://www.kkhsou.in/main/EVidya2/commerce/valuation_goodwill.html
- <http://www.xamidea.in/subject.aspx?q=5&c=88&t=10000584&info=title>

Unit 12: Valuation of Shares

Notes

CONTENTS

Objectives

Introduction

12.1 Meaning of Valuation of Shares

12.2 Necessity of Valuation of Shares

12.3 Various Types of Value of Shares

12.4 Factors Affecting the Value of Shares

12.5 Methods of Valuation of Shares

12.5.1 Assets Valuation Method or Intrinsic Value Method

12.5.2 Earning Basis Method

12.5.3 Average Basis or Fair Value Method

12.6 Summary

12.7 Keywords

12.8 Review Questions

12.9 Further Readings

Objectives

After studying this unit, you will be able to:

- Define the term valuation of shares
- Describe the necessity of valuation of shares
- Explain the types and factors affecting the value of shares
- Discuss the methods of valuation of shares

Introduction

Tax legislation may require that share transfers within a multinational group be conducted at arm's length, i.e. an inter-company share transfer should be made at the same price and terms as it would have been had the parties not been related to each other. This reference leaves room for interpretation and requires judgement and explanation when choosing valuation methods or making valuation assumptions. Making sure that the transfer price complies with local regulations can save costs and time. Independent valuation reports help in providing backing and support where a share transfer is planned. Importantly, transfer pricing associates' unique approach to valuation is based on the premise that any intra-group valuation study must be performed in an integrated way with due regard to core valuations principles as well as specific transfer pricing and tax implications in each jurisdiction.

The valuation of the shares of a company involves use of judgment, experience and knowledge. The accountant undertaking this work should possess knowledge of the analysis and interpretation of financial statements backed by a practical appreciation of business affairs and investments. A valuation based on quantitative information alone will not be adequate for a real valuation. It should also be recognised that the method of valuation of shares would vary, depending on the purpose for which it is to be used.

12.1 Meaning of Valuation of Shares

When a company is floated, it mentions its total capital in the Capital Clause of the Memorandum of Association and also mentions the total number of shares in which total capital of the company is divided. The value of each share is also mentioned in it.



Example: Suppose the total share capital of a company is ₹ 10,00,000 which is divided into 1,00,000 shares then value of one share will be ₹ 10. It is called face value or par value of the share and this value is shown in the balance sheet of the company whether the market price of the share is differing. This market price comes through the stock exchange. But sometimes these prices are not realisable because these prices fluctuate due to demand and supply of the shares in the market. As a result the market price does not show the true value of the share.

Quotation price (market price determined by Stock Exchange) will be available of those companies only, which are listed in the stock exchange. Thus, the market price of private companies and unlisted public companies will not be available on a stock exchange. Therefore, the value of shares of these companies is computed by accountants on a reasonable basis. Here, the citation of the opinion of the Council of London Stock Exchange would be better regarding the quotation price and valuation of shares: "We desire to state authoritatively that Stock Exchange quotations are not related directly to the value of a company's assets or to the accounts of its assets or to the amount of its profits and consequently these quotations, no matter what date maybe chosen for reference, cannot form a fair and equitable or rational basis for compensations."

"The Stock Exchange does not determine the prices of which the official list is a record. The Stock Exchange may be likened to a scientific recording instrument which registers, not its own actions and opinions, but the actions and opinions of private and institutional investors all over the country, and indeed the world. These actions and opinions are the results of hope, fear, guesswork, intelligent or otherwise, good or bad investment policy and many other considerations. The quotations that result definitely do not represent a valuation of a company by reference to its assets and its earning potential." Thus a quotation price neither represents Net Assets Value nor the earning potential.

Self Assessment

State whether the following statements are true or false:

1. The purpose of assets valuation method is to determine the assets backing per share.
2. There is no difference between the equity shares and participating preference shares in calculating the intrinsic value of the shares.
3. If a company is going to be liquidated, assets valuation method per valuation of shares is not suitable.
4. If the shares are being purchased for controlling the interest, one should consider the rate of earning and not the rate of dividend to ascertain the market value of the share.

12.2 Necessity of Valuation of Shares

Due to inadequacy of quotation price on the stock exchange serving the purpose of valuation of shares, in the following cases the necessity of valuation of shares by a competent accountant arises:

1. When amalgamation and absorption of companies take place.
2. When one class of shares is converted into another class.
3. When a company wants to acquire a control of interest of another company by purchasing more than 50% of shares of that company.

4. When the shares of a private company are sold or purchased.
5. When the shares of such a company which is not listed on the stock exchange, are sold or purchased.
6. At the time of reconstruction of the company, if there are some dissentient members, to acquire the shares of such members, valuation of shares takes place.
7. For the purpose of capital gain tax, gift tax, wealth tax and court fees.
8. When compensation is paid by the government upon the nationalisation of the company.
9. On acquiring the loan from bank against the security of banks.
10. When many time the shares of trusts, finance and investment companies are valued.
11. When the shares of an Indian company are transferred by a non-resident.
12. Accounting to the standing orders of the court, valuation of shares takes place.



Caselet

Properly Planned Family Limited Partnership

How to Structure and Value Family Limited Partnerships

A significant part of our practice addresses the value of minority limited partnership interests. Properly planned with an appropriate business purpose and by skilled legal counsel, a family limited partnership can provide a vehicle for family asset management and estate tax minimisation. In two recent cases, we valued non-marketable limited partnership or limited liability corporation interests with specific reference to the actual facts and circumstances of the partnership and operating agreements.

Each family transferred between ₹ 8.0 and ₹ 12.0 million of assets to the Partnership / LLC, generally consisting of a portfolio of marketable securities, directly owned real estate and investments in other partnerships (real estate).

ABA Approach and Solution

Using (i) what we call the specific factor rating system benchmarked to established marketability and lack of control studies; (ii) the Mercer Quantitative Marketability Discount Model ("QMDM"); (iii) the Kam/Schroeder studies; (iv) Partnership Profiles; and (v) other published studies, ABA provides a reasoned and reconciled estimate of the combined adjustment for differences in degree of marketability and control relative to the subject minority interest being appraised. Essentially, we approach the problem from four different viewpoints and then synthesise and reconcile our final estimate with well-reasoned and documented opinion.

In each case, the families liked the concept and result so much that additional assets were later contributed and the family limited partnership became the vehicle for estate management, asset transition and wealth transfer.

In our experience, a reasoned and well-documented appraisal report prepared by a qualified professional appraiser carries significant weight and is meaningful to the IRS. Our experience suggests that the range of the combined adjustment (discount) for differences in degree of marketability and control is from 40% - 52%. Of course, each circumstance and partnership is unique and should be evaluated as such.

Source: http://www.businessval.com/resources/case_studies/planned_family_partnership.pdf

12.3 Various Types of Value of Shares

There may be the following types of the value of shares:

1. **Par Value or Face Value or Nominal Value:** In the Capital Clause of the Memorandum of Association of a company, amount of capital, number of shares and value of each share is mentioned. The value of share which is given in this clause is called the par value or face value or nominal value. This par value of share is shown in the accounts of the company. If the issue price is above the par value, excess of issue price over par value is called share premium and if the issue price is lower than the par value, it is called issue at discount.
2. **Book Value:** Total of share capital, reserve and surplus, including the accumulated profits is called the capital of the company. To find out the book value of a share, the total capital of the company is divided by the total number of shares issued.
3. **Break up Value or Intrinsic Value:** Book value of shares does not represent the transfer price or selling price, because total capital is computed on the basis of historical basis. Due to this drawback, break up value of shares is calculated. Here the realisable amount of all real assets is considered on a particular date. And from the total real assets all external assets are subtracted. The balance left is known as intrinsic value or break up value of shares. To find out the break up value of one share, total intrinsic value of shares is divided by the total number of shares.
4. **Market Value:** Market value of the share means that value at which transactions take place in the stock exchange. This price is determined by the stock exchange. This value is affected due to the demand and supply of shares in the market. This is also known as fair market value of the share.
5. **Cost Price:** It is that price which a shareholder has to pay to acquire the share. It includes market price of the share, brokerage or commission and transfer fees, etc.
6. **Capitalised Value:** In order to find out the capitalised value of shares, average profits of a company are capitalised at the normal rate of return. This capitalised value of shares is then divided by the total number of shares to find out the capitalised value of one share.
7. **Fair Value:** It is the average value of market value and intrinsic value of the share. In order to calculate the average value, the total of market value and intrinsic value is divided by two.



Did u know? Book value of shares does not represent the transfer price or selling price, because total capital is computed on the basis of historical basis.

Self Assessment

State whether the following statements are true or false:

5. The weighted average of intrinsic value of a share and market value of a share is fair value.
6. To purchase a few shares, market value should be calculated on the basis of actual rate of return.

12.4 Factors Affecting the Value of Shares

The basic principle (factor) which is kept in mind at the time of valuation of shares is dividend yield, which the investors expect to receive from the company as compared to the normal rate of return. Minority shareholders or small investors would depend upon the rate of dividend

declared by the company, while majority shareholders or investors holding bulk of shares would depend upon the total earning capacity of the company. In addition to this factor, there are some other factors which influence the value of shares. These are given below:

1. Earning capacity of the company affects the value of shares of the company.
2. Dividends declared by the company in the previous years also affect the value of shares, if dividend rate fluctuates in the previous years has a negative impact on the investors.
3. Rate of return from other companies of the same nature also affects the value of shares in which the investors take interest.
4. Net tangible assets of the company also attract the investors.
5. Restrictions on the transferability of shares would adversely affect the value of shares.
6. Capital employed of the company in relation to the profits earned would affect the value of shares.
7. Qualification, experience and capacity of the management of a company would affect the price of the shares of a company.
8. If some incentives are given by the government in its policy to a particular business, there will be good chances that the value of its shares may go up.
9. Demand and supply of the shares of a company also affect the value of shares.
10. There would be an impact of the political, economical and social conditions on the value of a particular company.
11. Nature of competition in the business also affects the value of the shares. If there is monopoly in the business, value of its shares will be high.
12. Goodwill of the company has its own impact on the value of shares.

Self Assessment

Fill in the blanks:

7. To find the intrinsic value of one equity share, the net assets are divided by
8. Gross assets minus external liabilities are called
9. Market value of the share is based on the rate of or
10. The average of intrinsic value of the share and market value of the share is called
11. To calculate the intrinsic value of the share only assets are considered.

12.5 Methods of Valuation of Shares

The shares are valued on three bases: (1) Assets basis (2) Earning basis and (3) Average basis. On these bases, the following methods are undertaken.

12.5.1 Assets Valuation Method or Intrinsic Value Method

The valuation of shares under this method is an attempt to determine the amount of net assets of the business behind each share. In other words, to determine the amount of safety of fixed assets against the investment of a shareholder, this method is used. Under this method, the following procedure is adopted to determine the value of shares:

Notes

The entire procedure of this method is divided into three parts:

Calculation of Net Value of Assets

For the determination of the total value of assets, assets of the business may be taken as per book value, realisable value or net replacement value. If we have to find out the value of a going concern, net replacement value of the tangible assets should be taken and, for the valuation of the shares of such a concern which is going to be liquidated, net realisable value of the tangible assets should be taken. If there is no information regarding the replacement value and realisable value of the tangible assets, book value of the assets should be used after making the necessary adjustments-regarding the depreciation, etc. But for wealth tax purpose, assets are taken at their book values for the valuation of unquoted shares.

Only tangible assets of the business should be taken and fictitious assets must be ignored for the purpose of valuation of shares. But goodwill should be included with the total of tangible assets after doing a proper valuation. Methods of valuation of goodwill have been discussed in the previous chapter 'Valuation of Goodwill' in detail.

Generally, investments in quoted shares or debentures are taken at their market value. And sundry debtors must be valued after making the necessary provision for Bad and Doubtful Debts. Non-trading assets are also included in the assets at their market values.

In the case of inventories, stock of finished goods must be valued at market price and stock of raw materials, work-in-progress and spare parts must be valued at cost price.

Then all tangible assets are totalled up which are called the gross assets. In order to determine the net assets, all external liabilities are subtracted.

Calculation of External Liabilities

External liabilities are those which have to be paid to outsiders (not shareholders of the company). Ascertaining the amount of liabilities, necessary provision for contingent liabilities and for expenses as outstanding salaries, taxation, rent, etc. should be made.

If the proposed dividend on shares is not treated as liability, the intrinsic value of the share which will be the resultant under this method will be cum-dividend value of the share. In order to calculate the ex-dividend value of the shares, proposed dividend should be treated as liability and must be subtracted from the gross assets.

In ascertaining the value of equity shares, amounts due to preference share-holders must be treated as liability. The amount due to preference shareholders includes the dividends on preference shares in arrear and amount of capital refunded at the time of liquidation of the company. Generally, it is ascertained as per the terms of issue of preference shares. If preference shares are participating, their claim in surplus of profit should be included in the liabilities.



Did u know? Where share schemes are established in a unquoted company, the value of those shares may need to be agreed in advance with the Inland Revenue and will need to be communicated to employees if the share scheme is to incentivise staff as intended.

Fixation of the Value of Shares

In order to determine the value per share, any one of the following methods can be adopted as per the question:

When the entire share capital is in one type of equity shares: To compute the intrinsic value per share, the net assets are divided by the total number of equity shares. Formula:

$$\text{Intrinsic Value per Share} = \frac{\text{Net Assets}}{\text{Number of Equity Shares}}$$

When the share capital is divided into various types of equity shares and the paid up value of each type of shares is equal: To compute the value of each equity share the net assets will be divided by the total number of shares.

When the share capital is divided into various types of equity shares and their paid up values are not equal: To calculate the value of one equity share, any one of the following methods can be adopted:

1. **On the basis of unit value of the share:** Here, the entire net assets of the company are divided by the total paid up amount of the capital and the result is called the unit value of the share. To ascertain the value of the share, it is multiplied with the paid up value of the share. Thus, this procedure is divided into two parts: The formulae:

$$\text{Unit value of the share capital} = \frac{\text{Net Assets}}{\text{Paidup Share Capital}}, \text{ and}$$

Value of one equity share = Unit Value of the Share Capital × Paid up Value of One Share.

2. **On the basis of the proportion to the paid up capital:** First of all, the entire net assets are divided in the proportion to paid-up capital. The net assets of each type of the share capital are divided by its number of shares to find out the value of one share.

Illustration 1

X Ltd.'s equity capital consists of:

A - 1,000 equity shares of ₹ 10 each fully paid-up.

B - 6,250 equity shares of ₹ 10 each ₹ 8 was paid-up.

C - 8,000 equity shares of ₹ 10 each ₹ 5 was paid-up.

The net assets available to the equity share-holders are of ₹ 5,00,000. Here, the intrinsic value of the equity share of each category will be computed as below:

	₹
A - Category 1,000 shares of ₹ 10 each	10,000
B - Category 6,250 shares of ₹ 10 each ₹ 8 paid up	50,000
C - Category 8,000 shares of ₹ 10 each ₹ 5 paid up	40,000
	1,00,000

$$\text{Net Assets for A Category} = ₹ 5,00,000 \times \frac{1}{10} = ₹ 50,000$$

$$\text{Value of one equity share of A category} = \frac{50,000}{1,000} = ₹ 50$$

$$\text{Net Assets for B Category} = ₹ 5,00,000 \times \frac{5}{10} = ₹ 2,50,000$$

$$\text{Value of one equity share of B category} = \frac{2,50,000}{6,250} = ₹ 40$$

Notes

$$\text{Net Assets for C Category} = ₹ 5,00,000 \times \frac{4}{10} = ₹ 2,00,000$$

$$\text{Value of one equity share of C Category} = \frac{2,00,000}{8,000} = ₹ 25$$

Here, one point is to be noted that if there is any calls-in-arrear on the shares, the value of such shares will be calculated in the manner explained above, assuming that the calls-in-arrear have been received in full. After calculating the value of the share, the amount of calls-in-arrear will be subtracted from the respective calculated value of the share.

When there is possibility to receive the unpaid part of the share in near future: When the company expects to receive the uncalled up amount in immediate future, value of shares will be calculated by adding the unpaid and uncalled amount of shares (or making the national call and making the shares fully paid up) to the net assets of the company. Then, the total of net assets will be divided by the total number of equity shares (now fully paid up). The result will be the value of each fully paid up equity share and to ascertain the value of partly paid up shares, the unpaid part of the share will be subtracted from the value of each fully paid up share.

When there are both equity and preference shares: If there are equity and preference shares in the total capital of a company, according to the right of preference shares mentioned in the Articles of Association, the value of shares will be calculated. There can be the following conditions:

- (i) **When the preference shares have the priority of the dividend and repayment of capital on the liquidation of the company:** There will be the following two cases:

First Case: When the rate of dividend on preference shares is equal to the normal rate of return, amount of preference share capital and arrears of preference shares will be deducted from the net assets of the company and the balance of net assets will be divided by the number of equity shares to ascertain the value of each equity share. To ascertain the value of preference share, only that portion of net assets which belongs to preference shares (this will be equal to the paid up capital of preference shares and arrears of dividend on preference shares) will be divided by the number of preference shares.

Second Case: If the rate of dividend on preference shares is more or less than the normal rate of preference dividend, amount of dividend payable on preference shares will be capitalised at the normal rate of preference dividend. Then, the capitalised value of the preference dividend will be divided by the total number of preference dividend to compute the value of preference shares. The formula:

$$\text{Capitalised Value of Preference Dividend} = \frac{\text{Amount of Preference Dividend}}{\text{Normal Rate of Preference Dividend}} \times 100$$

- (ii) **When the preference shares have the priority only to the payment of capital at the time of liquidation:** In such a condition, only the amount of preference share capital is subtracted from the total of net assets of the company and the remaining part of the net assets is divided by the total number of equity shares to ascertain the value of one equity share.
- (iii) **When the preference shares have the priority only for the payment of dividend:** In this case, the amount of arrears of dividend on preference shares is deducted from the total net assets and then the balance of net assets is divided in the ratio of paid up capital of equity and preference shares. To calculate the value of each equity share, that portion of net assets which belongs to equity shares will be divided by the number of equity shares. To ascertain the value of preference shares, that portion of net assets which belongs to preference shares will be divided by the number of preference shares and the arrears of dividend payable per preference share will be added to the intrinsic value of each preference share.

If the arrears of preference dividend are shown in the liability side of the balance sheet that is always subtracted from the net assets of the company and then value of each share is calculated.

Notes

- (iv) **When preference shares have no priority for payment of capital and dividend:** It means preference shares and equity shares are of the same rank. If the paid up value of both type of the shares is the same, total net assets will be divided by the total number of equity and preferences shares to compute the value of each share. Here the value of equity and preference share will be same. If the paid up value of equity and preferences shares is not equal, first the total net assets of the company will be divided in the ratio of paid up capital of equity shares and preference shares. To ascertain the value of each share, each portion of the net assets will be divided by their respective number of shares.
- (v) **When preferences shares are participating:** In this case, the entire net assets will be divided into the equity shares and preference shares as per the rights given in the Articles of Association of the company. Then, each portion of the net assets will be divided by its respective number of shares in order to compute the value of share.

Format for Assets Valuation Method for Valuation of Shares

	₹	
Asset at realisable value or market value		
Fixed Assets:		
Goodwill	x x x x	
Land & Buildings	x x x x	
Plant & machinery	x x x x	
Furniture	x x x x	
Investment:		
Quoted and Unquoted		
Current Assets:		
Stock	x x x x	
Debtors	x x x x	
Bills Receivable	x x x x	
Cash in hand	x x x x	
Cash at bank	x x x x	
Gross Realisable Value of the Assets	x x x x	
Less: External Liabilities:		
Creditors	x x x x	
Bill Payables	x x x x	
Amount Payable to Debenture-holders (including outstanding interest)	x x x x	
Outstanding Liabilities for Expenses	x x x x	x x x x

Contd...

Notes

Net Assets:		x x x x
Less: Preference Share Capital (paid up capital)		x x x x
Balance of Net Assets Available for Equity shareholders or Intrinsic value of Equity Shares		x x x x
Value per equity share =	$\frac{\text{Net Assets Available for Equity Shareholders}}{\text{Number of Equity Shares}}$	
<i>Alternatively</i> , the intrinsic value of equity shares can be computed from the liability side of the balance sheet.		
	₹	₹
Equity Share Capital		x x x x
Add: Reserve and Surplus	x x x x	
Profit on Revaluation of Assets and Liabilities	x x x x	x x x x
Gross Equity		x x x x
Less: Loss on Revaluation of Assets and Liabilities	x x x x	
Miscellaneous Expenditure (fictitious assets) and Other Accumulated Losses	x x x x	x x x x
Net Equity		x x x x
Value per equity share =	$\frac{\text{Net Equity}}{\text{Number of Equity Shares}}$	



Notes Assets Valuation Methods is also known as Net Assets Valuation Method, Assets Backing Method, Assets Cover Method, Break up Value Method, Internal Value Method, Equity Valuation Method and Capital Value Method.

Purpose for which the Assets Valuation Method is suitable: In the following cases, this method is considered suitable:

- (i) When shares are being valued for wealth tax purpose.
- (ii) When shares are being valued of such a company of which reliable information about the profit potential cannot be obtained.
- (iii) When the valuation of share is being done of such a company which is trading at a loss and there is no expectation of earning a profit in future.
- (iv) Due to heavy fluctuations in the business or disruption of business, if there is no reliable evidence of future maintainable profits.
- (v) If the company is going to be liquidated and there is no expectation of doing any business in future.
- (vi) When the companies are going to be amalgamated, absorbed or reconstructed.
- (vii) When the shares of a private company are valued.
- (viii) Where the assets of a company are mostly of liquid character.



Caution Ascertaining the amount of liabilities, necessary provision for contingent liabilities and for expenses as outstanding salaries, taxation, rent, etc. should be made.

Self Assessment

Choose the correct answer from the following options:

12. Intrinsic value of the share is determined by:
 - (a) Net Assets Method
 - (b) Yield Method
 - (c) Fair Value Method
 - (d) None of these.
13. Market value is determined through normal rate and:
 - (a) Rate of Dividend
 - (b) Rate of Earning
 - (c) Yield
 - (d) Net Assets.
14. Value of the share is generally found in comparison to face value:
 - (a) More
 - (b) Less
 - (c) Equal
 - (d) More or less.
15. From the investors' point of view, the best method to find out the value of a share is:
 - (a) Intrinsic Value Method
 - (b) Fair Value Method
 - (c) Income Method
 - (d) None of these.
16. If the rate of earning of a company is 11%, normal rate 10% and paid up value of the share is ₹ 18, the value of the share will be:
 - (a) ₹ 19.80
 - (b) ₹ 16.33
 - (c) ₹ 6.11
 - (d) None of these.

Illustration 2 (Valuation of One Type of Equity Share and Valuation of Goodwill by Average Profit Method)

From the following information, find out the value of each share:

Notes

Balance sheet of X Ltd. as on 31st December, 2010

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
40,000 equity shares of ₹ 10 each	4,00,000	Goodwill	75,000
Reserve and Surplus:		Buildings	3,50,000
General Reserves	3,50,000	Machinery	3,00,000
Profit and Loss Account	50,000	Investment in 6% Loans	1,50,000
Debentures	1,60,000	Current Assets	80,000
Current Liabilities	50,000	Debtors	45,000
		Preliminary Expenses:	10,000
	10,10,000		10,10,000

Buildings and investment in 6% loans were revalued at ₹ 3,00,000 and ₹ 2,25,000 respectively on December 31, 2010. For the purpose of valuation of shares, goodwill shall be taken at two years' purchase of the average profits of the last three years. The profits of the last three years are ₹ 60,000, ₹ 75,000 and ₹ 80,000.

Solution:

- (a) Calculation for the Valuation of Goodwill:

$$\begin{aligned} \text{Average Annual Profit of the last 3 years} &= \frac{60,000 + 75,000 + 80,000}{3} \\ &= \frac{2,15,000}{3} = ₹ 71,667 \\ \text{Goodwill} &= \text{Average Profit} \times \text{No. of Years' Purchase} \\ &= ₹ 71,667 \times 2 = ₹ 1,43,333 \end{aligned}$$

- (b) Calculation for Valuation of Shares

Net Assets:	₹
Goodwill	1,43,333
Buildings	3,00,000
Investments in 6% Loans	2,25,000
Machinery	3,00,000
Current Assets	80,000
Debtors	45,000
Gross total assets	10,93,333
Less: External Liabilities:	₹
Debentures	1,60,000
Current Liabilities	50,000
Net Assets or Intrinsic Value of Shares	8,83,333

- (c) Intrinsic Value per Equity Share =
- $\frac{\text{Net Assets}}{\text{Number of equity shares}}$

$$= \frac{8,83,333}{40,000} = ₹ 22.08 \text{ per share}$$

Notes

Illustration 3 (Valuation of only One Type of Equity Share and Valuation of Goodwill by Super Profit Method)

The net profit of the company whose balance sheet on 31st December, 2010 is given below, after deducting all working expenses and provision for depreciation and taxation are:

2006 – ₹ 70,000, 2007 – ₹ 75,000, 2008 – ₹ 80,000, 2009 – ₹ 90,000, 2010 – ₹ 85,000.

Balance sheet as at 31st December, 2010

Liabilities	₹	Assets	₹
Capital (40,000 shares of ₹ 10 each)	4,00,000	Buildings	3,00,000
Profit and Loss Account	90,000	Machinery	80,000
Creditors	60,000	Debtors	2,00,000
Provision for Tax	30,000	Stock	32,000
Proposed Dividend	70,000	Cash	38,000
	6,50,000		6,50,000

Buildings and Machinery were respectively valued at ₹ 3,10,000 and ₹ 85,000 on 31st December, 2010. The fair return in industry in which the company is engaged may be taken at 8%. Find out the value of equity shares taking into consideration the value of goodwill based on three years' purchase of the annual super profit.

Solution

(A) Valuation of Goodwill

1. Capital Employed:	₹
Buildings	3,10,000
Machinery	85,000
Debtors	2,00,000
Stock	32,000
Cash	38,000
Total Assets	6,65,000
Less: Liabilities	₹
Creditors	60,000
Provision for tax	30,000
	90,000
Capital Employed	5,75,000

2. Average Profits:

$$\text{Average annual profits of the last 3 years} = \frac{85,000 + 90,000 + 80,000}{3}$$

$$= \frac{2,55,000}{3} = ₹ 85,000$$

Notes	3. Super Profits:	₹
	Average Annual Profits	85,000
	Less: Normal profits 8% of capital employed $\frac{5,75,000 \times 8}{100}$	46,000
	Super Profit	39,000
	4. Goodwill = Super Profit × No. of years' purchase.	
	= ₹ 39,000 × 3	
	= ₹ 117,000	

(B) Valuation of Share

(i)	Net Assets:	₹
	Goodwill	1,17,000
	Buildings	3,10,000
	Machinery	85,000
	Debtors	2,00,000
	Stock	32,000
	Cash	38,000
	Gross Total of Assets	7,82,000
	Less: External Liabilities:	
	Creditors	60,000
	Provision for Tax	30,000
	Net Assets or Intrinsic Values of Shares	6,92,000
(ii)	Value of one equity share = $\frac{\text{Net Assets}}{\text{No. of equity shares}}$	
	$= \frac{6,92,000}{40,000} = ₹ 17.3$ per share.	

Illustration 4 (Valuation of Different types of Equity Shares having the Different Paid up Values)

The balance sheet of Rohit and Sons Ltd. (a company engaged in the business of clothing) as at 31st December, 2010 was as under:

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
(i) 35,000 Equity Shares of ₹ 10 each fully paid up	3,50,000	Goodwill	35,000
(ii) 105,000 Equity Shares of ₹ 5 fully paid.	5,25,000	Land & Buildings	2,10,000
		Plant & Machinery	10,50,000
(iii) 70,000 Equity Shares of ₹ 10 each ₹ 8 paid up.	5,60,000	Current Assets:	

			Notes
		Stock	3,50,000
(iv) 1,05,000 equity shares of ₹ 5 each ₹ 3 paid up.	3,15,000	Debtors	4,55,000
		Cash in hand	35,000
Reserves and Surplus:		Miscellaneous Expenditure:	
General Reserve	1,75,000	Preliminary Exps.	35,000
Profit and Loss Account	70,000		
Current Liabilities:			
Creditors	1,40,000		
Other Liabilities	35,000		
	21,70,000		21,70,000

Goodwill is valued at ₹ 1,24,000 and Land & Building at ₹ 1,75,000. Plant & Machinery is to be depreciated by ₹ 87,500. Stock is worth ₹ 3,85,000. Debtors are expected to realise ₹ 4,34,000. There is a contingent liability of ₹ 20,000 which is to be paid. Determine the value of different equity shares.

Solution

Valuation of Shares

Net Assets:	₹	₹
Goodwill		1,24,000
Land and Buildings		1,75,000
Plant and Machinery	10,50,000	
- Depreciation	87,500	9,62,500
Stock		3,85,000
Debtors		4,34,000
Cash in hand		35,000
Total of Assets		21,15,500
Less: External Liabilities		
Creditors	1,40,000	
Other Liabilities	35,000	
Contingent Liabilities	20,000	1,95,000
Net Assets or Intrinsic Value of Shares		19,20,500
Total Paid up Equity Capital is ₹ 17,50,000		

$$\text{Unit value of capital} = \frac{\text{Net Assets}}{\text{Total paid up capital}} = \frac{19,20,500}{17,50,000} = ₹ 1.097$$

- (i) Value of ₹ 10 paid up share = $10 \times 1.097 = ₹ 10.97$
- (ii) Value of ₹ 5 paid up share = $5 \times 1.097 = ₹ 5.485$
- (iii) Value of ₹ 8 paid up share = $8 \times 1.097 = ₹ 8.776$
- (iv) Values of ₹ 3 paid up share = $3 \times 1.097 = ₹ 3.291$

Notes

Alternatively the net assets of the company will be divided in the four.

Types of shares' in the ratio of paid up capital. Paid up capital ratio will be 3,50,000 : 5,25,000: 5,60,000 : 3,15,000 or 70 : 105 : 112 : 63

$$\text{Net Assets for (i) type of shares} = \frac{19,20,0000 \times 70}{350} = ₹ 3,84,000$$

$$\text{Net Assets for (ii) type of shares} = \frac{19,20,0000 \times 105}{350} = ₹ 5,76,000$$

$$\text{Net Assets for (iii) type of shares} = \frac{19,20,0000 \times 112}{350} = ₹ 6,14,400$$

$$\text{Net assets for (iv) type of shares} = \frac{19,20,0000 \times 63}{350} = ₹ 3,45,600$$

Value of Shares

$$(i) \quad \text{Value per share of ₹ 10 fully paid} = \frac{3,84,000}{3,50,000} = ₹ 10.97$$

$$(ii) \quad \text{Value per share of ₹ 5 paid up fully paid up} = \frac{5,76,000}{1,05,000} = ₹ 5.485$$

$$(iii) \quad \text{Value per share of ₹ 8 paid up} = \frac{6,14,400}{70,000} = ₹ 8.77$$

$$(iv) \quad \text{Value per share of ₹ 3 paid up} = \frac{3,45,600}{1,05,000} = ₹ 3.291$$

Illustration 5 (Valuation of the Shares of the Holding Company)

The Balance Sheet of Big Ltd. and Small Ltd. as on 31st December, 2010 is given below:

Liabilities	Big Ltd. ₹	Small Ltd. ₹	Assets	Big Ltd. ₹	Small Ltd. ₹
Equity Share Capital					
(shares of ₹ 10 each)	9,00,000	3,00,000	Fixed Assets	9,00,000	4,00,000
General Reserve	5,00,000	30,000	Investments (75%		
Profit and Loss Account	6,00,000	2,00,000	shares of Small Ltd.)	3,00,000	-
Sundry Creditors	1,00,000	1,70,000	Sundry Debtors	3,60,000	90,000
			Inventory	3,10,000	1,20,000
			Cash and Bank Balance	2,30,000	90,000
	21,00,000	7,00,000		21,00,000	7,00,000

Fixed assets of Big Ltd. and Small Ltd. were valued at ₹ 9,50,000 and ₹ 4,20,000 respectively and the goodwill of Small Ltd. was ascertained at ₹ 30,000.

Calculate the value of shares of each company by Assets Method.

Solution

Notes

Valuation of Shares of Small Ltd.

Net Assets	₹
Fixed Assets revalued	4,20,000
Goodwill	30,000
Sundry Debtors	90,000
Inventory	1,20,000
Cash and Bank Balance	90,000
	7,50,000
Less: Liabilities:	
Sundry Creditors	1,70,000
Net Assets of Small Ltd.	5,80,000

$$\text{Value of one equity share of Small Ltd.} = \frac{5,80,000}{30,000} = ₹ 19.33$$

As Big Ltd. has investment, in the shares of Small Ltd. i.e., 75% of 30,000 shares or 22,500 shares.

The value of investments of Big Ltd. (value of 22,500 shares in Small Ltd.)
 = 22,500 × ₹ 19.33 = ₹ 4,34,925

Valuation of Shares of Big Ltd.

Net Assets:	₹
Fixed Assets	9,50,000
Investment (calculated as above)	4,34,925
Sundry Debtors	3,60,000
Inventory	3,10,000
Cash and Bank Balance	2,30,000
	22,84,925
Less: External Liability:	
Sundry Creditors	1,00,000
Net Assets of Big Ltd.	21,84,925

$$\text{Value of one equity share of Big Ltd.} = \frac{21,84,925}{90,000} = ₹ 24.28$$

12.5.2 Earning Basis Method

Shareholders (investors) invest their money to earn a profit. Therefore, according to the earning, they prepare themselves to pay the amount for investment. If the rate of earning is higher, investors will be ready to pay the higher price for the investment (shares). On the other hand, if investment yields the lower rate of return, accordingly its value will be lower. Thus, in the

Notes

open market the investors (buyers and sellers) are more concerned and influenced by the rate of earning than by complicated calculation of net assets. In such a situation, earning can be taken as the basis for the valuation of shares. In this method, shares can be valued on the following basis:

- (a) **Valuation of Shares Based on Rate of Dividend:** From the point of view of a holder of a small number of shares, this method is suitable because the small investors are only interested in the dividend (or earning) that the directors of a company have declared. The small investor is primarily interested in the profits or return on his invested amount and price of investments (shares) which he would pay for, would depend upon the amount of profit (dividend) that he can expect. Thus, in this method the value of shares is computed by comparing the rate of dividend and normal rate of return. To ascertain the market value of the share, the following formula is used:

$$\text{Value per share} = \frac{\text{Expected Rate of Dividend}}{\text{Normal Rate of Return}} \times \text{Paid-up Value of the Share.}$$

Or

$$\text{Value per share} = \frac{\text{Dividend per Share}}{\text{Normal Rate of Return}} \times 100$$

Expected Rate of Dividend: To compute the value of the shares on the basis of rate of dividend, it is necessary to find out the rate of dividend on shares. From the point of view of small investors, generally the latest rate of dividend is taken. If rates of dividend of the previous years are given, average rate of dividend of these rates is taken. In the case of constant increase or decrease in the rates of the dividends, weighted average of rates should be taken. If in a question, the rate of dividend is not given, it can be calculated on the basis of distributed profits available for equity shareholders' dividend. The distributable profits available for equity shareholders' dividend should be taken after payment of income tax, transfer to reserve and payment of preference dividend. For expected rate of dividend, the formula will be:

$$\text{Expected Rate of Dividend} = \frac{\text{Dividend Profits to Equity Shares}}{\text{Paid-up equity Share Capital}} \times 100$$

Or

$$\text{Expected Rate of Return} = \frac{\text{Dividend per share in ₹}}{\text{Paid-up value per share}} \times 100$$

Normal Rate of Return: This is that rate of earning which is generally expected by the investors on their investments in a particular type of industry. This rate may differ from industry to industry. The normal rate of return has been discussed in the chapter "Valuation of Goodwill". In the light of normal rate of return, some other factors are also being mentioned below:

- (i) If there is uniformity in the rate of dividend of the company, investors may be satisfied with the lower normal rate of return. When the rates of dividend have been fluctuating, investors expect a higher normal rate of return.
- (ii) If there is restriction on the transfer of shares as per the Articles of Association of a Company, for the valuation of shares of such a company, the normal rate of return should be slightly increased. Increase of 0.5% to the normal rate of return is considered reasonable.

- (iii) On the partly paid up shares, the investors will expect a higher yield than that of fully paid up shares. Therefore, on the partly paid up shares the normal rate of return will be higher. Increase of 0.25% to the normal rate of return is considered reasonable.
- (iv) Investors also want adequate safety against their investment. If net tangible assets per share are twice or thrice the paid up value of the share of a company, investors will be satisfied with a lower rate of return or else desire a higher rate of return.
- (v) If a company transfers a major part of profits to its reserves and distributes to its shareholders as dividend, in spite of being a lower rate of dividend, it will attract more investors.

Thus, at the time of valuation of shares, under this method, if any one of the above factors is in operation, normal rate of return should be adjusted accordingly.



Notes Earning method is also known as Yield Basis Method or Market Value Method and Income Valuation Method.

- (b) **Valuation of Share Based on Actual Rate of Earning:** This method is an improvement over the yield value method. Generally, some companies distribute only a part of their profits in the form of dividend to the shareholders and balance of profits is transferred to its reserve funds. And these reserve funds (accumulated profits) are likely to be distributed sooner or later in the form of bonus shares to the shareholders. Therefore, it would be more appropriate to value the shares based on the actual earning rather than the dividend declared by the company. Particularly for those investors who are intended to acquire the controlling interest (majority of shares) in a company, the valuation of their holdings (shares) should be based on the actual earning. The formula, for calculating the value of shares on the basis of actual rate of earning is as under –

$$\text{Value per Share} = \frac{\text{Actual Rate of Earning}}{\text{Normal Rate of Return}} \times \text{Paidup Value of a Share}$$

$$\text{Actual Rate of Earning} = \frac{\text{Actual Profit Earned}}{\text{Effective Capital Employed}} \times 100$$

Actual Profit Earned: To calculate the actual profit earned, average annual profits should be taken after tax, depreciation and transfer to reserves. Profits earned should accord the effective capital employed. If debentures and preference share capital are included in the capital employed, interest on debentures and dividend on preferences shares should not be deducted from the profits earned. And if debentures and preference share capital are not included in the capital employed, profit earned should be taken after deducting the interest on debentures and dividend on preference shares. Income on non-trading assets is also not included in profits, but non-recurring items are allowed.

Effective Capital Employed: To ascertain the effective capital employed, all tangible assets (excluding goodwill and non-trading assets) are taken and then external liabilities are subtracted. Debentures and preference share capital may be deducted from the total tangible assets as per profits (as explained above). All the tangible assets should be taken at their book values. Alternatively, effective capital employed can be calculated by totalling the equity share capital and reserve funds (accumulated profits). Debentures and preference share capital may be included according to the profit calculations.

Notes



Notes Actual Rate of Earning is also known as Earning Method.

- (c) **Valuation of Shares Based on Capitalisation of Divisible Profits:** Under this method, actual rate of earning or rate of dividend is computed as explained earlier. But profits available for distribution to equity shareholders or average future maintainable profits are capitalised on the basis of normal rate of capitalisation or return and profit will be calculated as explained in the last two methods. The following formula is adopted to capitalise the profits-

$$\text{Capitalised Value of Profits} = \frac{\text{Profits Available for Distribution}}{\text{Normal Rate of Capitalisation or Return}} \times 100$$

To determine the value of the share, any one of the following methods can be used-

Capitalised value of profits is divided by the number of equity shares to ascertain the value of share - (if there are only one type of shares having same paid up value of shares)

$$\text{Value of Share} = \frac{\text{Capitalise Value of Profits}}{\text{No. of Equity Shares}}$$

The capitalised value of profits is divided by the paid up equity share capital. The result will be the value of rupee one paid up share and this will be multiplied by the paid up value of the share to ascertain the market value of the share under capitalisation of profit method. (Generally this method is adopted in that condition where the different paid up amounts of the various types of shares are given).

$$\text{Value of Share} = \frac{\text{Capitalise Value of Profits}}{\text{Paid-up Equity Shares Capital}} \times \text{Paid-up Value of a Share}$$

Illustration 6 (Valuation Based on Rate of Dividend)

Calculate the value of equity share 1,000; 14% Preference Shares of ₹ 100 each. 20,000 Equity Shares of ₹ 10 each.

Annual Profits ₹ 1,90,000, ₹ 2,10,000, ₹ 2,05,000 and ₹ 2,15,000, in 2007, 2008, 2009, and 2010 respectively.

Rate of Tax 50%

General Reserve Transfer = 20% of profits

Normal Rate = 20%

Solution

Profits	₹
2007	1,90,000
2008	2,10,000
2009	2,05,000
2010	2,15,000
Total Profits of 4 years	8,20,000

		Notes
Average Annual Profits = $\frac{8,20,000}{4}$	= ₹ 2,05,000	
Less: 50% income tax $\frac{2,05,000 \times 50}{100}$	1,02,500	
Profit after tax (PAT)	1,02,500	
Less: 20% Transfer to General Reserve	20,500	
Amount available for dividend	82,000	
Less: Preference Dividend @ 14% on ₹ 1,00,000	14,000	
Profits Available for Equity Dividend	68,000	

$$\text{Rate of Dividend} = \frac{\text{Profit Available for Equity Dividend}}{\text{Equity Paidup Capital}} \times 100$$

$$= \frac{68,000}{2,00,000} \times 100 = 34\%$$

Normal Rate of Return is given 20%

$$\text{Value of an equity share} = \frac{\text{Dividend Rate}}{\text{Normal Rate of Return}} \times \text{Paidup Value of a Share}$$

$$= \frac{34}{20} \times 10 = ₹ 17$$

Illustration 7 (Necessary Adjustments in Normal rate of Return)

Ranu Ltd. and Sanu Ltd. earn an annual profits of ₹ 2,00,000 each. Each of their share capital consists of 8,000 shares of ₹ 100 each fully paid up. Ranu Ltd. distributes 80% of its profits as dividend, while Sanu Ltd. distributes only 50%. Normal rate of return is 10%. The following further information is available:

- (i) Transfer of Shares of Ranu Ltd. is restricted.
- (ii) Net Tangible Assets of Ranu Ltd. are ₹ 10,00,000 and that of Sanu Ltd. ₹ 24,00,000.

Make the necessary adjustments in the normal rate of return and ascertain the market value of the shares of both the companies.

Solution

Adjusted Normal Rate of Return

	Ranu Ltd.	Sanu Ltd.
Normal Rate of Return (given)	10%	10%
Adjustment for the restriction on the transfer of shares	+ 0.5%	—
Adjustment for Net Tangible Assets backing	+ 1%	- 1%
Adjustment for Financial prudence (transfer to reserve)	+ 0.5%	- 0.5%
Adjusted Normal Rate of Return	12%	8.5%

Notes	Rate of Dividend		
Distributable Profits for Dividend	80% of ₹ 1,00,000		50% of ₹ 1,00,000
	₹ 80,000		₹ 50,000
Paid up Share Capital	₹ 4,00,000		₹ 4,00,000
Rate of Dividend	$\frac{80,000}{4,00,000} \times 100$		$\frac{50,000}{4,00,000} \times 100$
	= 20%		= 12.5%
Market Value per Share = $\frac{\text{Rate of Dividend}}{\text{Normal Rate}} \times \text{Paid up Value of Share} = \frac{20}{12} \times 100$			$= \frac{12.5}{8.5} \times 100$
	= ₹ 166.67		= ₹ 147.06

Illustration 8 (Valuation of Shares on the Basis of Actual Rate of Earning)

From the following information, calculate the value of equity shares:

- (i) 4,000; 4% Preference shares of ₹ 100 each fully paid: ₹ 4,00,000
- (ii) 5,000 Equity Shares of ₹ 100 each, ₹ 80 per share paid up ₹ 4,00,000
- (iii) Expected Profit per year (before tax) – ₹ 2,50,000
- (iv) Income Tax Rate – 50%
- (v) Normal Rate of Earning – 10%
- (vi) Transfer to General Reserve – 20% of profit

Solution**Calculation of Profits Available for Dividends to Equity Shareholders:**

	₹
Expected Profits per year before tax	2,50,000
Less: 50% Income Tax $\frac{2,50,000 \times 50}{100}$	1,25,000
Profit After Tax (PAT)	1,25,000
Less: 20% of Profit transfer to General Reserve	25,000
Profits Available for Dividends	1,00,000
Less: Preference share Dividend @ 4% on ₹ 4,00,000	16,000
Profits Available for Equity Dividend	84,000

Actual Rate of Earning

$$= \frac{\text{Profits Available for Equity Dividend}}{\text{Paid up Equity Share Capital}} \times 100$$

$$= \frac{84,000}{4,00,000} \times 100$$

Market Value of an Equity Share

Notes

$$= \frac{\text{Actual Rate of Earning}}{\text{Normal Rate}} \times \text{Paidup Value of a Share}$$

$$= \frac{21}{10} \times 80 = ₹ 168$$

Illustration 9 (Valuation of Share by Earning Capacity Method)

From the following balance sheet and additional information, ascertain the value of shares according to the Earning Capacity Method:

Liabilities	₹	Assets	₹
Share Capital 10,000 shares of ₹ 100 each	10,00,000	Sundry Assets	25,00,000
Reserve Funds	7,50,000	Investment in Government Securities	5,00,000
10% Debentures	10,00,000		
Other Liabilities	2,50,000		
	30,00,000		30,00,000

The average earnings of the company are ₹ 6,50,000 after interest on debentures but before tax. Income tax rate may be taken as 50%. Normal rate of return in the similar companies is 10%.

Solution**(A) Effective Capital Employed:**

	₹
Total Assets	30,00,000
Less: Non-Trading Assets	5,00,000
Less External Liabilities	25,00,000
Other Liabilities	2,50,000
Effective Capital Employed	22,50,000

(B) Actual Rate of Earning:

Actual Profits after Interest but before tax	6,50,000
Less: 50% Income Tax	3,25,000
Profit After Tax (PAT)	3,25,000
Add: Interest on Debentures @ 10% on ₹ 10,00,000 (to make the agreement between capital employed and profits)	1,00,000
Actual Profit Earned	4,25,000

$$\text{Actual Rate of Earning} = \frac{\text{Actual Profit Earned}}{\text{Effective Capital Employed}} \times 100$$

$$= \frac{4,25,000}{22,50,000} \times 100 = ₹ 18.88\%$$

Notes

$$\text{Market Value per Share} = \frac{\text{Actual Rate of Earning}}{\text{Normal Rate}} \times \text{Paid up Capital of a Share} \times \text{Paid up Capital of a Share}$$

$$= \frac{18.88}{10} \times 100 = ₹ 188.8$$

Alternatively, if debentures are not included in the effective capital employed:

Total Assets		30,00,000
Less: Non-Trading Assets		5,00,000
		25,00,000
Less: External Liabilities		
Debentures	10,00,000	
Other Liabilities	2,50,000	12,50,000
Effective Capital Employed		12,50,000

Actual Rate of Earning:

Actual Average Profits after Interest but Before Tax		6,50,000
Less: 50% Income Tax		3,25,000
Profit After Tax		3,25,000

$$\text{Actual Rate of Earning} = \frac{3,25,000}{12,50,000} \times 100 = 26\%$$

$$\text{Market Value per Share} = \frac{26}{10} \times 100 = ₹ 260$$

Illustration 10 (Valuation by Capitalisation of Profits Method)

Two companies, X Ltd. and Y Ltd. are assumed to be exactly similar, to only as to assets, liabilities and reserves but also as to all other factors, except that the arrangement of the Share Capital differs. The share capital of X Ltd. is ₹ 31,50,000 divided into 30,000; 6% Preference Shares of ₹ 100 each and 1,500 equity shares of ₹ 100 each fully paid up. The share capital of Y Ltd. is ₹ 31,50,000, divided into 3,000; 6% Preference Shares of ₹ 100 each and 28,500 Equity Shares of ₹ 100 each fully paid up. The equity shares of the companies may be taken to represent a somewhat speculative industrial risk and the market yield is 8%. The companies' profits and distributions are:

Year	₹
2009	3,00,000
2010	4,00,000

Estimate the approximate probable price of the equity shares of the companies ignoring all facts other than mentioned above.

Solution

Notes

Valuation of Equity Shares in X Ltd.

	2009 (₹)	2010 (₹)
Profit Earned (given)	3,00,000	4,00,000
Less: 6% Dividend on Preference Shares $\frac{30,00,000 \times 6}{100}$	1,80,000	1,80,000
Profit available for equity shares	1,20,000	2,20,000
Capitalised value of profits available for equity shares		
@ 8% normal rate of return	$\frac{1,20,000 \times 100}{8}$	$\frac{2,20,000 \times 100}{8}$
	= ₹ 15,00,000	= ₹ 27,50,000
Value of an equity share	$\frac{15,00,000}{1,500}$	$\frac{27,50,000}{1,500}$
	= ₹ 1,000	= ₹ 1,833

Valuation of Equity Share of Y Ltd.

	2008 (₹)	2009 (₹)
Profits earned (given)	3,00,000	4,00,000
Less: Dividend on Preference Share @ 6% on ₹ 3,00,000	18,000	18,000
Profits available for equity shares	2,82,000	3,82,000
Capitalised value of profits available for Equity Shareholders @ 8% nominal rate of return	$\frac{2,82,000 \times 100}{8}$	$\frac{3,82,000 \times 100}{8}$
	= ₹ 35,25,000	= ₹ 47,75,000
Value of an equity share	$\frac{35,25,000}{28,500}$	$\frac{47,75,000}{28,500}$
	= ₹ 123.68	= ₹ 167.54

12.5.3 Average Basis or Fair Value Method

Some investors care for the safety of their investment while others are interested in the earnings on their investment. And if some investors are interested in both income as well as safety, such a value of share should be calculated which may serve both the purposes. For this purpose, the fair value of the share is calculated, which is based on the intrinsic value and market or yield

Notes

value of the share. It is considered the most appropriate method. For this method, the following formula is used-

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

To find out the intrinsic value of the share and market or yield value of the share, the Net Assets Valuation Method and Earning Basis Valuation Method are applied respectively. These methods have been elaborated earlier.



Notes Fair Value Method is also known as Dual Method.

Illustration 11 (Fair Value of the Shares)

From the information given below and the Balance Sheet of A Ltd. on 31st December, 2010, find out the value of its equity shares by the Dual Method (appropriate basis):

- Company's prospects for 2011 are good.
- Buildings are now worth ₹ 7,00,000.
- Profits for the last three years have shown an annual increase of ₹ 50,000. The annual transfer to reserve is 25% of the net profit.
- Preferential shares are preferential as to capital and dividend and;
- Normal rate of return expected is 15%.

Balance Sheet

Liabilities		₹	Assets		₹
2,000; 8% Preferential Shares of ₹ 100 each fully paid		2,00,000	Buildings		1,40,000
8,000 Equity Shares of ₹ 100 each fully paid		8,00,000	Furniture		6,000
Reserve and Surplus:			Stock (market value)		9,00,000
Profit and Loss Account		3,00,000	Investments at cost		6,70,000
Balance on 1.1.2010	1,60,000		(Face value ₹ 8,00,000)		
Add: Profits for 2010	8,60,000	10,20,000	Debtors		5,60,000
(before transfer to reserve)			Bank		1,20,000
Creditors		96,000	Preliminary Expenses		20,000
		24,16,000			24,16,000

Solution**Valuation of Shares by Assets Valuation Method-**

	₹
Building	7,00,000
Furniture	6,000
Stock (market value)	9,00,000
Investments	6,70,000

Debtors	5,60,000	Notes
Bank	1,20,000	
Gross Total Assets	29,56,000	
Less: External Liabilities: Creditors	96,000	
Net Assets	28,60,000	
Less: Net Assets for Preference Shares	2,00,000	
Net Assets for Equity Shares	26,60,000	

$$\text{Value per Equity Share (intrinsic value per share)} = \frac{\text{Net Assets for Equity Shareholders}}{\text{No. of Equity Shares}}$$

$$= \frac{26,60,000}{8,000} = ₹ 332.50$$

Valuation of Share by Yield Method

Profit for the year 2005 (given)	8,60,000	₹
Add: Expected increase in next year	1,00,000	
Less: 25% Transfer to Reserve	9,60,000	
	2,40,000	
Profits Available for Dividend	7,20,000	
Less: 8% Preference Dividend on ₹ 2,00,000	16,000	
Profits Available for Equity Shares	7,04,000	

$$\text{Rate of Return on Equity Capital} = \frac{\text{Profits Available for Equity Shares}}{\text{Equity Paidup Capital}} \times 100$$

$$\frac{7,04,000}{8,00,000} \times 100 = 88\%$$

$$\text{Market Value per Equity Share} = \frac{\text{Rate of Earning}}{\text{Normal Rate of Return}} \times \text{Paidup Value of a Share}$$

$$= \frac{88}{15} \times ₹ 100 = ₹ 586.67$$

Fair value (Appropriate Value) of an Equity Share

$$= \frac{\text{Intrinsic Value of the Share} + \text{Market or Yield Value of the Share}}{2}$$

$$= \frac{332.50 + 586.67}{2} = ₹ 459.56$$



Task Discuss the methods of valuation of shares.

Notes



Case Study **The Right Deduction**

Client's Situation

About five days before the deadline to file his annual tax return, a client and his accountant called us to assist in what they thought would be an easy problem to solve. After all, in November, 1997, the client (the sole owner of all 600 outstanding common shares of the subject company) had entered first into a Letter of Intent, then Definitive Agreements to sell his company for ₹ 95.0 million. The transaction was to close March 1, 1998.

A stock transaction, the buyer and seller had (appropriately) agreed to a "collar" on the deal. That is, if the stock to be exchanged by buyer traded at an average price at less than ₹ 21 per share or more than ₹ 29 per share for a twenty-day period prior to closing, either buyer or seller could terminate the transaction. At the date of close, the price of the shares was ₹ 18 per share and "out of the money". Both parties wanted to (and did) terminate the transaction.

The seller, feeling the chances of closing were almost certain, made a 1997 year end gift to a charitable foundation of 2 shares of stock. He and his accountant now needed an appraisal to support and confirm the charitable deduction in Form 1040 to be filed in five days. The accountant and his client thought that the pro-rata share of the failed transaction would be the correct value.

ABA Solution

With client agreement, ABA quickly provided a scope-restricted opinion to file with the tax return. More important, ABA applied appropriate appraisal technique and considered the non-marketable minority interest that was, indeed, the true gift. ABA also applied the fair market value standard (hypothetical buyer; hypothetical seller) rather than the investment value standard (a specific buyer acquiring the company for synergistic and strategic reasons) to the subject equity interest. While the deduction was not as great as the client and his accountant first thought, the deduction was correct and supported by a qualified appraisal opinion completed within a tight timeframe. Both the accountant and his client appreciated the guidance, and the professional and timely service.

Questions

1. Write down the case facts and analyse the situation.
2. Discuss the solution for the case problem.

Source: http://www.businessval.com/resources/case_studies/right_deduction.pdf

12.6 Summary

- The methods of valuation depend on the purpose for which valuation is required. Generally, there are three methods of valuation of shares: Assets basis, Earning basis and Average basis.
- A clear understanding of the purpose of valuation is undoubtedly important, but an equally important imperative is to have a full appreciation of the 'value' emanating from common principles.
- This 'general purpose value' may be suitably modified for the special purpose for which the valuation is done.
- The factors affecting that value with reference to the special purpose must be judged and brought into final assessment in a sound and reasonable manner.

- In India, the Capital Issues (Control) Act, 1947, and the Capital Issues (Exemption) Order, 1969, define the terms and conditions for issuance of securities by the corporate sector.
- The “Fair Value (FV)” of a company’s shares is to be computed by averaging the values obtained by the “Net Asset Value (NAV)” method and the “Profit Earning Capacity Value (PECV)” method. These computations are to be largely based on audited accounts of the recent past.
- The market price of the company’s share based on the previous three years’ high-low would only be kept “in the background” and is to be largely used for fine-tuning the FV.
- The NAV is nothing but the traditional book value per share computed on the basis of the latest published annual accounts.

12.7 Keywords

Capitalised Value: Assessment of the value of an asset, based on the total income expected to be realised over its economic life span.

Cost Price: It is that price which a shareholder has to pay to acquire the share. It includes market price of the share, brokerage or commission and transfer fees, etc.

Dividend: A sum of money paid regularly (typically quarterly) by a company to its shareholders out of its profits (or reserves).

Earning Yield: Under this method, shares are valued on the basis of expected earning and normal rate of return.

External Liabilities: External liabilities are those which have to be paid to outsiders (not shareholders of the company).

Market Value: Market value of the share means that value at which transactions take place in the stock exchange. This price is determined by the stock exchange.

Net Value of Assets: Under this method, the net values of assets of the company are divided by the number of shares to arrive at the value of each share.

Par Value: The nominal value of a bond, share of stock, or a coupon as indicated in writing on the document or specified by charter.

Quotation Price: A Quotation price is a business offer made by a seller to an interested buyer to sell certain goods at specific prices and on certain terms and conditions.

Rate of Return: The term “rate of return” refers to the return which a shareholder earns on his investment.

12.8 Review Questions

1. What factors will you keep in mind while valuing the shares?
2. Explain the circumstances under which valuation of shares is considered necessary.
3. What are the various methods of valuation of shares? Describe and illustrate the yield valuation method of valuing shares.
4. What is meant by intrinsic value and market value of shares and how are they determined?
5. Explain the following terms with reference to the valuation of shares:
 - (a) Fair Value
 - (b) Value of Right Share

Notes

(c) Valuation of Bonus Shares

(d) Normal Rate of Return.

6. The Balance Sheet of X Ltd. is given below. Assuming that the value of goodwill will be ₹ 86,250 and realisable value of fixed assets to be ₹ 6,03,750, compute the value of share by Assets Valuation Method:

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets	8,62,500
Equity Shares of ₹ 10 each	6,90,000	Current Assets	3,45,000
General Reserve	1,55,250	Goodwill	69,000
Profit & Loss Account	34,500		
10% Debentures	1,72,500		
Current : Liabilities	2,24,250		
	12,76,500		12,76,500

7. From the following information, find out the value of each share.

**Balance Sheet of Pratibha Ltd.
as on 31st December, 2010**

Liabilities	₹	Assets	₹
Equity Share Capital (₹ 10 share)	3,45,000	Goodwill	57,500
General Reserve	4,31,250	Land & Buildings	3,85,250
Profit & Loss Account	51,750	Plant & Machinery	2,87,500
Debentures	1,15,000	Investments	1,15,000
Current liabilities	57,500	Current Assets	86,250
		Debtors	51,750
		Preliminary Expenses	17,250
	10,00,500		10,00,500

Land & Buildings and Investments were revalued at ₹ 4,14,000 and ₹ 40,250 respectively on 31st December, 2010. For the purpose of valuation of shares, goodwill will be taken at two years' purchase of the average profits of the last five years. The profits of the last five years are ₹ 63,250, ₹ 92,000, ₹ 86,250, ₹ 69,000 and ₹ 1,15,000.

8. Following information is furnished in respect of Sadhana Fibres Ltd.:

(1) Share Capital – 2,00,000, Equity shares of ₹ 10 each fully paid.

(2) Profits after tax, dividends declared and retained earnings:

Year	Profit after tax ₹	Dividend declared ₹	Retained earnings ₹
2005	7,10,000	3,40,000	3,70,000
2004	6,00,000	3,00,000	3,00,000
2003	4,00,000	2,60,000	1,40,000

(3) Normal Rate of Return expected by shareholders in the market is 12%.

(4) The normal earning of similar companies in the fibre industry is 15%.

You are required to calculate the value of shares, if:

- (a) Only a few shares are to be sold.
- (b) Majority shares are to be sold.
9. In the following cases, work out the Value of Right included in the market quotations:
- (a) A company has a paid up capital of ₹ 10,00,000 in ₹ 100 shares. It increases its share capital by the creation of 5,000 new shares of ₹ 100 each which are offered to the existing shareholders at ₹ 205 each in proportion of one new share for every two old shares held.
- The company has declared a dividend of ₹ 15 per share free of cost for the last year. On the declaration of dividend and announcement of the offer of new shares, the old shares are quoted at ₹ 265 Cum-Dividend Cum-Right.
- (b) A company has a paid up capital of ₹ 5,00,000 in ₹ 100 shares and a General Reserve amounting to ₹ 5,00,000. It increases its share capital by the creation of 5,000 new shares and decides to capitalise ₹ 2,00,000 out of General Reserve by allotting two fully paid shares of ₹ 100 each as bonus shares for every five shares held. On the announcement of bonus issue, the shares of the company are quoted at ₹ 210 Cum-Right.
10. The capital of Nimish Ltd. is ₹ 2,50,000 divided into 2,500 shares of ₹ 100 each. On 31 December, 2005, its reserve is ₹ 50,000. Out of this, the company issued one bonus share of 10 equity shares held. Find out the value of bonus shares: (i) before the issue of bonus shares, and (ii) after the issue of bonus shares.

Answers: Self Assessment

- | | |
|--------------------------|---------------------------|
| 1. True | 2. True |
| 3. False | 4. True |
| 5. False | 6. False |
| 7. No. of equity shares | 8. Net Assets |
| 9. Dividend; Earning | 10. Fair Value |
| 11. Real | 12. (a) Net Assets Method |
| 13. (a) Rate of Dividend | 14. (d) More or less |
| 15. (c) Income Method | 16. (a) ₹ 19.80 |

12.9 Further Readings



Books

B B Dam and H C Gautam, *Corporate Accounting*, Capital Publishing.

Das. K R and others, *Corporate Accounting*, LBS Publication.

Sehgal, Dr. A and Sehgal, Dr. D, *Advanced Accounting & Corporate Accounting*, Taxman Publications.



Online links

<http://accountlearning.blogspot.in/2011/10/methods-of-valuation-of-shares.html>

http://www.tpa-global.com/PDF/brochures/100831_Valuation_Shares.pdf

http://220.227.161.86/22213frpubcd_research3.pdf

Unit 13: Valuation of Preference Shares

CONTENTS

Objectives

Introduction

13.1 Valuation of Preference Shares

13.2 Valuation of Shares for Other Purposes

13.2.1 Valuation for Purposes of Stamp Duty

13.2.2 Valuation for Court Fees

13.2.3 Valuation for Probates

13.2.4 Valuation for Purposes of Bank Advances

13.2.5 Valuation of Shares under Companies Act, 1956

13.2.6 Valuation of Shares for Transfer/Issue of Shares by a Non-resident

13.2.7 Valuation of Shares for Fixation of their Issue Price

13.2.8 SEBI Guidelines for Issue of Securities

13.3 Summary

13.4 Keywords

13.5 Review Questions

13.6 Further Readings

Objectives

After studying this unit, you will be able to:

- Discuss the concept of valuation of preference shares
- Describe the valuation of shares for other purposes
- Explain the valuation of preference shares with the help of illustrations

Introduction

Preference Shares are issued by corporations or companies with the primary aim of generating funds. A preference share usually carries a fixed stated rate of dividend. The dividend is payable only upon availability of profits. In case of cumulative preference shares, arrears of dividends can be accumulated and in the year of profits common stock holders can be paid dividend only upon settlement of all the arrears of cumulative preference dividends.

Preference share holders have preference right over payment of dividend and settlement of principal amount upon liquidation, over common share holders. A preference share can be irredeemable or redeemable. Redeemable preference shares have a fixed maturity date and irredeemable preference shares have perpetual life with only dividend payments periodically upon profit availability. Preference shares can also be cumulative and non-cumulative. Preference shareholders have fixed dividend rights as well as right to priority in repayment of their capital. To equity shareholders on the other hand, belongs the entire business after settling off the claim of preference.

13.1 Valuation of Preference Shares

Notes

The two dominant characteristics of a preference share are that it has a preference regarding both the dividend and capital. Besides these, a preference share may have other benefits also; but they are not obligatory and depend on the terms of issue and provisions in the Memorandum and Articles of Association of the company concerned.

Because of the limit placed on the dividend which may be paid on a preference share and the preferred right for payment of dividend and of capital, the considerations applicable for the valuation of equity shares are not wholly applicable to the valuation of preference shares. Consideration should first be given to the rate of capitalisation.

As can be readily seen, the risk involved in investment in preference shares is considerably less than that in equity shares. It follows, therefore, that the expected rate of return on preference shares is also lower, with the consequent effect upon the rate of capitalisation.



Did u know? Preference shareholders have preference right over payment of dividend and settlement of principal amount upon liquidation, over common share holders.

It frequently happens that owing to the attraction of equity investment as a hedge against inflation as also due to possibility of capital appreciation, a company's equity share is generally capitalised at a lower yield on the stock exchange than the same company's preference share. The theoretical considerations mentioned earlier for the valuation of equity shares do not generally apply.

The rate of capitalisation will depend not only on the percentage of dividend but also on the other benefits attached to the preference shares. Some of these additional benefits which a preference share may carry and their effect on the rate of capitalisation and other aspects of valuation are stated below:

- (a) Preference shares may be cumulative preference shares. In such cases, the risk involved is still lower, with a corresponding effect on the rate of capitalisation. In cases where there is uncertainty of future dividends, this is an important right and a preference share not carrying this right will be valued at a substantially lower figure.
- (b) A preference share may be a participating preference share. In this case, it partly partakes of the characteristics of equity shares and therefore, the rate of capitalisation in respect of the additional dividend which may be paid will not be the same as for the fixed dividend. If this additional payment is unrestricted, then the rate of capitalisation in respect thereof may be taken considerably near to the rate of capitalisation for equity shares, the difference being due to unequal voting rights.

If there are restrictions on the quantum of such additional dividends, then the rate of capitalisation will be somewhere between the rate of capitalisation for the fixed dividend and that for equity shares, depending upon the exact terms of issue. It may also be mentioned here that the possibility of the payment of additional dividend in future will be determined for calculating the maintainable future profits and the payment ratio of the company, and on the terms of payment of such additional dividend. If it is found that the payment of such additional dividend is not expected to be a regular feature, then it would be appropriate to take the present worth of such additional dividend as is expected to be paid in future from time to time.

- (c) Because of changes in the company law, only redeemable preference shares can be issued; if there are non-redeemable ones, they are to be converted into redeemable shares.

Notes

Thus, this aspect becomes important in two circumstances:

- (i) When the date of redemption is not very far; and
- (ii) When the shareholders are also entitled to receive a premium on redemption.



Notes

If there are restrictions on the quantum of such additional dividends, then the rate of capitalisation will be somewhere between the rate of capitalisation for the fixed dividend and that for equity shares, depending upon the exact terms of issue.

In case the date of redemption is not very far, it would be appropriate to estimate all future receipts in respect of dividends as well as capital and to reduce them to their present worth. In case of premium too the best way is to determine its present worth.

- (d) Preference shares may also carry a right to share in the residual value in the event of winding up. In such cases, a definite value may be placed for this right only when it is known that the winding up is imminent.
- (e) Preference shares may have a right of conversion into equity shares. The additional value to be placed on such preference shares will depend upon the exact terms of the right to convert. The price at which conversion can be effected is also relevant. The price of a preference share will in such a case vary, as the price of an equity share rises above the option price.
- (f) In certain circumstances, preference shares also carry voting rights. In case of private companies which are not subsidiaries of public companies there is no legal provision to regulate such rights; they depend on the Memorandum and Articles of Association of the company concerned. In case of public companies and their private subsidiaries, preference shareholders have voting rights in respect of resolutions that directly affect their rights and also in respect of resolution when dividends on such shares remains unpaid for certain periods as specified in law. Preference shares currently carrying unrestricted voting rights become very important in situations where the control of a company is sought to be transferred.

Any additional value in respect of this right should, however, be considered after taking into consideration the circumstances of each individual company.

Problems can arise in the valuation of preference shares with substantial arrears of cumulative dividends. If a company has reached a profit earning stage, the value of the arrears of dividend should be added to the value of the Share.



Notes

In certain circumstances, preference shares also carry voting rights.

Apart from the special considerations mentioned above, the value of a preference share is equal to the value arrived at by dividing the actual rate of dividend by the normal expected rate of capitalisation.



Caselet

The Philanthropist: Gifts of Preference Shares from a Private Company

Robert is in his late 40's and has built a successful business now worth approximately \$20 million. He was recently asked to join the Board of a local charitable foundation and would like to demonstrate his leadership and support by making a large gift. Unfortunately most of his wealth is tied up in the value of his shares and he does not want to significantly reduce his current cash flow, which is being used to support his high standard of living.

His insurance advisor suggested that Robert explore converting some of his common shares in his company (say \$750,000) on a tax deferred basis into redeemable preference shares with a fixed dividend rate. As part of this transaction Robert would use the capital gains exemption to increase the cost base of those shares to equal their fair market value of \$750,000. Robert's company would then acquire a \$750,000 insurance policy on Robert's life, which would be used to redeem the preference shares on Robert's death.

As a next step, Robert would donate the preference shares to the charitable foundation and receive a charitable donation receipt for \$750,000. This donation receipt can be used to offset taxes in the current year and/or carried forward for up to 5 years to offset his taxable income. Assuming Robert is in a 45% tax bracket, this gift would generate tax savings in the range of \$225,000.

While Robert is alive the charitable foundation will receive dividends on the preference shares, which can be used to fund its charitable activities. On Robert's death the shares will be redeemed with the life insurance proceeds, so the foundation will have \$750,000 in cash for charitable endeavours.

There is another benefit of this strategy. The insurance proceeds received by Robert's corporation on his death will create a credit to the its "capital dividend account". Tax-free dividends can be paid from the capital dividend account to the surviving shareholders in the company. This will generate an additional tax savings to Robert's beneficiaries in the range of \$150,000- 225,000 (depending on the dividend tax credit available on the dividend)

To summarise the benefits of this strategy:

1. Robert can make an immediate gift without impacting his cash flow, and benefit from a significant charitable tax credit.
2. The Charity will annually receive income from the shares, and on Robert's death will realise a large cash infusion from the redemption of the shares.
3. The share redemption is funded through corporate owned life insurance, which also creates a credit to the capital dividend account and future tax savings to the beneficiaries of Robert's estate.

The strategy will work provided the super capital gains exemption is available to the operating company worth \$20 million. Below is the criterion for using the super capital gains exemption. According to the CRA Guide Capital Gains, all of the following conditions must be satisfied:

- They are common shares issued by the corporation to you;
- The issuing corporation is an eligible small business corporation;

Contd...

Notes

- That is, 90% or more of the assets are used to generate active business income;
- The total value of the corporation cannot exceed \$50,000,000;
- While you hold the shares, the company must be an eligible active business corporation for at least 730 days;
- And the big hurdle, 90% or more of the company's assets are used to generate active business income and not passive income such as investment income.

Source: <http://benefaction.ca/case-study-gifts-of-preference-shares/>

Self Assessment

State whether the following statements are true or false:

1. In certain circumstances, preference shares also carry voting rights.
2. Preference shares may not be cumulative preference shares.
3. The rate of capitalisation will depend not only on the percentage of dividend but also on the other benefits attached to the preference shares.
4. The two dominant characteristics of a preference share are that it does not have a preference regarding both the dividend and capital.
5. In case of public companies and their private subsidiaries, preference shareholders have voting rights in respect of resolutions that directly affect their rights and also in respect of resolution when dividends on such shares remains unpaid for certain periods as specified in law.

13.2 Valuation of Shares for Other Purposes

There are various other purposes in relation with valuation of shares which are given in the following sub-sections.

13.2.1 Valuation for Purposes of Stamp Duty

When an instrument is chargeable with ad valorem duty in respect of any share, such duty shall be calculated on the value of the share according to the average price or the value thereof on the instrument (Section 21 of Indian Stamp Act, 1899).

For the purposes of the Indian Stamp Act, 1899, the term 'average price' means perhaps the market price. In case of quoted shares, if there are many quotations of the shares in question on the date of the instrument, then the average price is to be taken for stamp duty purposes. In case of unquoted shares also value has to be ascertained for the purpose of this provision. This view is supported by the Bombay High Court in the case of Madhusudan Dwarkadas Vora vs. Superintendent of Stamp Duty (141 ITR 802). In the said case, the honourable judge quoting the judgment of Mysore High Court, given in case of CED vs. J. Krishnamurty (1974) (96 ITR 87), said ".....the Court was concerned with the valuation of unquoted shares for the purpose of estate duty. There was no such rule under the Estate Duty Act for such valuation. The court observed that in the absence of rules, valuation for the purpose of the Act had to be made in accordance with the well recognised valuation method followed in India. The method of valuation prescribed by rule 1D of Wealth Tax Rules being the only statutorily recognised method of valuation of unquoted shares it would not be wrong to adopt the method for Estate Duty Act purposes."

Where the stamp duty has to be paid on the sale of shares, the actual selling price will be taken for its calculation.

13.2.2 Valuation for Court Fees

Notes

For purposes of court fees, if shares have a market value at the date of presentation of the plaint then such market value will be taken into consideration. In case shares have no market value, the value stated by the plaint is accepted for purposes of paying court fees.

13.2.3 Valuation for Probates

While petitioning for the grant of probate or letters of administration, the probate duty has to be paid on the value of shares calculated at the price of day.

Although the price of the day is not explained, it seems that it means market price (Section 19-I and Item 11 of Schedule I of Court Fees Act, 1870).

13.2.4 Valuation for Purposes of Bank Advances

Bankers value shares because against them they advance loans. They ascertain the value of shares to measure the value of the security that will be provided by them. Generally, banks give advances against quoted shares and therefore it is reasonable to base their value on market quotations. In case, bankers are to advance loans against unquoted shares, their value has to be estimated according to what they would fetch in the market.

13.2.5 Valuation of Shares under Companies Act, 1956

Amongst the information required to be furnished to the Central Government in connection with the following matters are Valuation of Shares for Other Purposes Share Valuation the break-up value of shares and the value of shares based on yield:

- Acquisition of shares pursuant to Section 108A (1).
- Proposal to transfer shares pursuant to Section 108B.
- Transfer of shares of foreign companies pursuant to Section 108C.

The break-up value and the value based on yield have to be worked out in accordance with the methods of calculation given in Annexure I and II of Forms 7D and 7E prescribed under Rule 5B of the Companies (Central Government) General Rules and Forms issued under the Companies Act, 1956. These are reproduced in Appendix 'A'.

13.2.6 Valuation of Shares for Transfer/Issue of Shares by a Non-resident

Transfer/issue of shares by a non-resident is governed by regulations in the Foreign Exchange Management Act, 1999, which also lay down restrictions for transfer/issue of shares by a non-resident and provide a framework for valuation of shares. Valuation guidelines for different types of transactions can be referred from Foreign Exchange Management Act, 1999 and the applicable regulations.

13.2.7 Valuation of Shares for Fixation of their Issue Price

It is often necessary to value equity shares of companies for the purpose of fixation of price at which the same should be issued in the primary market. The valuation exercise is also required to be carried out for pricing the shares to be issued to foreign investors.

Notes

13.2.8 SEBI Guidelines for Issue of Securities

SEBI has issued a set of guidelines to be complied with by all companies listed or proposing to be listed on Stock Exchange for making issue of capital any time after promulgation of the Securities and Exchange Board of India Act, 1992. Subsequently, SEBI has also issued a number of clarifications on these guidelines from time to time.

The guidelines issued by SEBI provide that companies are free to price their issues subject to adequate disclosure. The onus, therefore, is on investors to evaluate whether the price at which a company issues its shares, is fair or not. SEBI, while vetting the draft prospectus, merely ensures, on the basis of the information furnished to it, that adequate disclosures have been made in the offer document so that the investors can make informed investment decisions. However, the SEBI guidelines also contain stipulation as to minimum promoters' contribution and lock-in period thereof. It is to ensure that the interests of the promoters of the issuing company are fairly tied up with the interests of outside investors.

The SEBI guidelines require that the issuing company, which decides to price its issue at a premium, gives justification for the issue price in their prospectuses or the letters of offer. However, the guidelines do not provide any guidance for such justification. Appendix 'B' gives some cases of disclosures made by some companies, to give an indication of prevailing practices in this regard.

The SEBI guidelines also require the net asset value of the issuing company, as per its last audited balance sheet, to be disclosed in the offer document.

SEBI Guidelines in Case of Takeover of Listed Companies

SEBI has laid down guidelines for open offer to the public in case of substantial acquisition of shares or takeover of a listed company. The guidelines, inter-alia, lay down the pricing norms to be followed in case of a takeover.



Caution It is often necessary to value equity shares of companies for the purpose of fixation of price at which the same should be issued in the primary market.

Self Assessment

Fill in the blanks:

6. The guidelines issued by provide that companies are free to price their issues subject to adequate disclosure.
7. The SEBI guidelines also contain as to minimum promoters' contribution and lock-in period thereof.
8. Bankers value because against them they advance loans.
9. Generally, banks give against quoted shares and therefore it is reasonable to base their value on market quotations.
10. Where the has to be paid on the sale of shares, the actual selling price will be taken for its calculation.
11. For the purposes of the Indian Stamp Act,, the words 'average price' means perhaps the market price.
12. The SEBI guidelines require that the company, which decides to price its issue at a premium, gives justification for the issue price in their prospectuses or the letters of offer.



Notes It is important to note that the letter of offers and prospectus often refer to terms like Net Asset Value (NAV), Earning Per Share (EPS), Profit Earnings Ratio (PE ratio), etc.

Notes

Illustration 1 (Valuation of Equity and Preference Shares)

The balance sheet of Madhu Pvt. Ltd. is as under:

Balance Sheet (as on 31st December, 2010)

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
1,000; 6% Preference Shares of ₹ 10 each	10,000	Sundry Assets	51,000
3,000 Equity Shares of ₹ 10 each	30,000	Miscellaneous Expenditure:	
Reserve and Surplus:		Discount on Debentures	1,000
General reserve	2,000	Preliminary Expenses	3,000
Debentures Redemption Fund	3,000	Profit and Loss Account	6,000
Depreciation Fund	1,000		
Secured Loans:			
7% Debentures	5,000		
Current Liabilities:			
Sundry Creditors	10,000		
	61,000		61,000

The assets are worth their book value. Interest on debentures for one year is owing and that dividends on the preference shares are in arrears for two years. You are required to find out the value of each share assuming:

1. That the preference shares are preferential to capital and the arrears of dividend are to be paid to the preference shareholders in winding up.
2. That the preference shares are not preferential to capital and the arrears of dividend are payable in priority.
3. That the preference shares are preferential to the payment of capital only.
4. That preference shares are not preferential for the payment of capital and arrears of dividend.

Solution

Computation of Net Assets:

	₹	₹
Sundry Assets		51,000
Less: 7% Debentures	5,000	
Sundry Creditors	10,000	
Depreciation Fund	1,000	16,000
		35,000

Notes

	Less: One years' Debenture Interest due $\frac{5,000 \times 7}{100}$	350
	Net Assets	34,650
(i)	When preference shares have the priority for the payment of capital and arrears of dividend:	
		₹
	Net assets as calculated above	34,650
	Less: Preference Capital	10,000
	Two years' dividend $\frac{10,000 \times 6 \times 2}{100}$	1,200
	Intrinsic value for Equity Shares	23,450
	Value of one Equity Share = $\frac{23,450}{3,000} = ₹ 7.82$	
	Value of one Preference Share = $\frac{11,200}{1,000} = ₹ 11.20$	
(ii)	When the preference shares are not preferential to capital and the arrears of dividends are payable in priority:	
		₹
	Net assets as calculated above	34,650
	Less: Two years' dividend in arrears on preference shares	1,200
	Intrinsic value for both the shares	33,450
	Value of one share = $\frac{33,450}{3,000 + 1,000} = ₹ 8.36$	
	Thus, value of one equity shares = ₹ 8.36	
	Value of one preference share = ₹ 8.36 + $\frac{1200}{1000}$	
	= ₹ 8.36 + ₹ 1.2	
	= ₹ 9.56	
(iii)	When preference shares are preferential for the repayment of capital only at the time of liquidation:	
		₹
	Net assets as calculated above	34,650
	Less: Preferences share capital	10,000
	Intrinsic value for equity shares	24,650
	Thus value of one equity share = $\frac{24,650}{3,000} = ₹ 8.22$	

Notes

$$\text{Value of one preference share} = \frac{10,000}{1,000} = ₹ 10$$

- (iv) When preference shares have no preferential for the payment of capital and arrears of dividend: Here both the shares will be of the same rank for the valuation of shares.

$$\begin{aligned} \text{Value of one share} &= \frac{\text{Net Assets}}{\text{No. of Equity Shares} + \text{No. of Preference Shares}} \\ &= \frac{34,650}{3,000 + 1,000} = \frac{34,650}{4,000} = ₹ 8.66 \end{aligned}$$

Illustration 2 (Valuation of Equity and Preference Shares When Normal Rate of Preference Shares is Given)

The Balance Sheet of Kavita Ltd. as on 31st December, 2010 was given below:

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
Equity Shares of ₹ 10 each	3,00,000	Goodwill	22,500
Equity Shares of ₹ 5 each	1,50,000	Land & Buildings	75,000
8% Preference Shares of ₹ 10 each	1,50,000	Plant & Machinery	2,25,000
Reserve and Surplus:		Furniture	4,500
General Reserve	75,000	Current Assets:	
Profit and Loss Account	30,000	Stock	2,70,000
Provident Fund	45,000	Debtors	2,02,500
Current Liabilities:		Cash	7,500
Creditors	60,000	Prepaid Expenses	3,000
Outstanding Expenses	7,500	Miscellaneous Expenditure:	
		Preliminary Expenses	7,500
	8,17,500		8,17,500

Market value of Land & Buildings is ₹ 1,50,000. Goodwill is worth ₹ 60,000, Plant & Machinery is valued at ₹ 2,50,000. Stock is worth ₹ 3,00,000. Outstanding expenses do not include disputed bonus claim of ₹ 15,000 out of which ₹ 12,000 is likely to be paid. You are required:

- To find out the value of each kind of shares assuming normal rate on preference shares to be 5%.
- To find out the value of each kind of shares if the preference shares have the right of participation in surplus in case of liquidation.

Solution**Valuation of Shares of Kavita Ltd.**

Net Tangible Assets:	₹
Goodwill	60,000
Land & Building (revalued)	1,50,000

Notes	Plant & Machinery (revalued)	2,50,000
	Furniture at book value	4,500
	Stock (revalued)	3,00,000
	Debtors at book value	2,02,500
	Cash	7,500
	Prepaid Expenses	3,000
	Gross Total Assets	9,77,500
	Less: External Liabilities:	₹ ₹
	Provident fund	45,000
	Creditors	60,000
	Outstanding Expenses	7,500
	Bonus Claim to pay	12,000
	Net Assets:	8,53,000

Condition A:

Net Assets calculated as above 8,53,000

Less: Capitalised value for Preference Share Capital = $\frac{1,50,000 \times 8}{5}$ 2,40,000

Net assets available for both type of equity shares 6,13,000

Paid up capital ratio of equity shares = ₹ 3,00,000 : ₹ 150,000 or 2 : 1

Net Assets for equity shares of ₹ 10 each = $\frac{6,13,000 \times 2}{3} = ₹ 4,08,667$

Value per equity share of ₹ 10 paid up = $\frac{4,08,667}{30,000} = ₹ 13.62$

Net Assets for equity shares of ₹ 5 paid up = $\frac{6,13,000 \times 2}{3} = 2,04,333$

Value per equity share of ₹ 5 paid up = $\frac{2,04,333}{30,000} = ₹ 6.8$

Value per preference share = $\frac{2,40,000}{15,000} = ₹ 6$

Condition B:

In this case the entire net assets will be divided in the ratio of paid up capital i.e., 2:1:1

Net assets for the equity shares of ₹ 10 each = ₹ 8,53,000 × $\frac{2}{4} = ₹ 4,26,500$

Notes

$$\text{Value of one equity share of ₹ 10 paid up} = \frac{4,26,500}{30,000} = ₹ 14.22$$

$$\text{Net assets for the equity shares of ₹ 5 each} = ₹ 8,53,000 \times \frac{1}{4} = ₹ 2,13,250$$

$$\text{Value of one equity share of ₹ 5 paid up} = \frac{2,13,250}{30,000} = ₹ 7.12$$

$$\text{Net Assets for preference shares} = \frac{8,53,000 \times 1}{4} = ₹ 2,13,250$$

$$\text{Value of one preference share} = \frac{2,13,250}{15,000} = ₹ 14.22$$

Illustration 3 (Valuation of Equity and Preference Shares on the Basis of Rate of Dividend)

The paid up share capital of a company consists of 1,000; 5% preference shares of ₹ 100 each and 20,000 equity shares of ₹ 10 each. In addition to a fixed dividend of 5% preference shareholders are also entitled to participate in profits up to 4% after payment of a dividend of 10% on the equity shares. Any surplus profits being available to equity shareholders.

The annual average profits of the company are ₹ 50,000 after providing for depreciation and taxation and it is considered necessary to transfer ₹ 3,000 per annum to reserve fund. The normal return expected on preference shares is 8% and that on equity shares is 10%.

You are required to work out the value of each preference share and equity share in the company.

Solution**Calculation of Rate of Dividend**

	₹
Average Annual Profits after Tax	50,000
Less: Transfer to Reserve Fund	3,000
Amount Available for Dividend.	47,000
B.F.	47,000
Less: Preference shares' dividend @ 5% on ₹ 1,00,000	5,000
	42,000
Less: Equity shares' dividend @ 10% on ₹ 2,00,000	20,000
	22,000
Less: 4% Additional Dividend to Preference Shareholders on ₹ 1,00,000	4,000
Balance of Profit for Equity shareholders	18,000
Thus total of Preference Shares Dividend rate 5% + 4% = 9%	

$$\begin{aligned} \text{Rate of Dividend on equity shares} &= 10\% + \frac{18,000}{2,00,000} \times 100 \\ &= 10\% + 9\% = 19\% \end{aligned}$$

Notes

Normal Rate of Return: On Equity shares - 10%

On Preference shares - 8%

$$\text{Value of Share} = \frac{\text{Rate of Dividend}}{\text{Normal Rate}} \times \text{Paidup Value of Shares}$$

$$\text{Value of Equity share} = \frac{19}{10} \times 10 = ₹ 19$$

$$\text{Value of Preference share} = \frac{9}{8} \times 100 = ₹ 112.50$$



Case Study

Network18 Preference Shares - Amazing Return, Amazing Risk!

Network18 Media and Investments Ltd is in the business of forming and selling subsidiaries, getting into joint ventures and raising finance. Its broadly a media company.

In March 2008, the company came out with a rights issue consisting of equity and preference shares. The preference shares of the company are listed on BSE (scrip code 700132) and NSE.

The Opportunity

- The preference shares have a face value of ₹ 150 and are to be redeemed at par in May 2013.
- The preference shares have a 5% dividend payout, which is cumulative.
- Till today, the company has not paid any dividend on the preference shares and it is fair to assume that the entire chunk will be paid along with the principal at the time of redemption.
- So, at the time of redemption, a person holding the preference shares should get ₹ 150 (principal) and ₹ 37.5 (accumulated dividend @ 5% p.a. for 5 years). That's a total of ₹ 187.5/-.
- The preference shares are presently trading at ₹ 105/-.
- So if one buys it at present at ₹ 105, then one would get ₹ 187.5 in May 2013.
- That's a return of 79% in 20 months! Super cool!

The Problems

Nothing is for free and same is the case here. Lets just take a look at the risks and the problems.

- Network18 is not exactly a conservative investor's dream. The business is damn difficult to understand, given the fact that it changes all the time due to frequent M&A activities. The profitability has been erratic, with the company making profits just once in the last 5 years. More importantly, cash-flows have been really pathetic, with the company reporting a negative cash flow from operations of ₹ 306 cr in FY11.
- The company has ₹ 1775 cr of debt but it has about ₹ 350 cr of liquid investments too.

Contd...

Notes

- The company keeps on getting money by selling subsidiaries and businesses here n there!
- The company will require about ₹ 195 cr to redeem the preference shares (along with dividend), which may not seem out of reach, but considering the large debt and negative cash-flows, seems unnerving, to say the least.
- The biggest risk here is the management. They are no saints, lemme tell you! Just look at this postal ballot they got passed.
- Basically what they did was something like this...the Companies Act confers voting rights on preference shareholders, if their dividend is not paid for a period of 2 years. Since Network18 had not paid dividend, the preference shareholders would have gained voting rights.
- So the company declared that it had received letters from preference shareholders that they would like to waive their extra rights (now why would anybody do that) and hence, through postal ballot, they got these preference shareholders' rights waived. (Promoters must be holding at least 50% of the preference shares, as per my reading)
- So would they pay up at the time of redemption? Or would they find some loophole or the other and do some hanky-panky? That's a tough one to answer.

To Conclude

- Although the possible return here is mouth-watering, there are 2 big risks; the financial position and the management.
- Both of them scare me to a great extent, to take a meaningful position.
- If one is ok with these risks and one thinks that they are not very material, Network18 offers a great opportunity to make respectable returns in this uncertain market. The preference shares are fairly liquid too.
- Given my risk appetite, I personally intend to give this one a miss for now, but I would like to keep a watch on future events (like insider buying) to revisit my decision. For the bold and the dangerous people out there, do take a look at this opportunity.

Questions

1. Analyse the problem of the case study.
2. Discuss the case facts and solution to the issue.

Source: <http://neerajmarathe.blogspot.in/2011/10/network18-preference-shares-amazing.html>

13.3 Summary

- Preference Shares are issued by corporations or companies with the primary aim of generating funds.
- A preference share usually carries a fixed stated rate of dividend. The dividend is payable only upon availability of profits.
- Preference share holders have preference right over payment of dividend and settlement of principal amount upon liquidation, over common share holders.
- A preference share can be irredeemable or redeemable.
- Preferred stock is similar to common stock in that it entitles its owners to receive dividends which the firm must pay out of after-tax income. Moreover, the use of preferred stock as a source of financing does not increase the probability of bankruptcy for the firm.

Notes

- One limitation of the intrinsic value formula of valuation of preference shares is that you cannot have a growth rate that exceeds the discount rate or your calculator will return an error or indicate infinity.

13.4 Keywords

Annual Preferred Dividend: The annual preferred dividend is determined by multiplying the preferred dividend rate times the par value of the preferred stock.

Bond: A bond is an instrument of indebtedness of the bond issuer to the holders. It is a debt security, under which the issuer owes the holders a debt and, depending on the terms of the bond, is obliged to pay them interest (the coupon) and/or to repay the principal at a later date, termed the maturity.

Common Stock: Common stock is a form of corporate equity ownership, a type of security.

Dividends: Dividends are payments made by a corporation to its shareholder members. It is the portion of corporate profits paid out to stockholders.

Liquidation: Liquidation is the process by which a company (or part of a company) is brought to an end, and the assets and property of the company redistributed.

Par Value: The par value represents the claim of the preferred stockholder against the value of the firm.

Preferred Dividend/Preferred Dividend Rate: The preferred dividend rate is expressed as a percentage of the par value of the preferred stock.

Preferred Stock: Preferred stock (also called preferred shares, preference shares or simply preferred) is an equity security with properties of both equity and a debt instrument, and is generally considered a hybrid instrument.

13.5 Review Questions

1. Discuss the concept of valuation of shares.
2. What are the SEBI guidelines in relation with valuation of preference shares?
3. The paid up share capital of a company consists of 1,000, 5% preference shares of ₹ 100 each and 20,000 equity shares of ₹ 10 each. In addition to a fixed dividend of 5% the preference shareholders are also entitled to participate in the profits upto 5% after payment of a dividend of 10% on the equity shares, any surplus profits being available to equity shareholders.

The annual average profits of the company are ₹ 50,000 after providing for depreciation and taxation and it is considered necessary to transfer ₹ 3,000 per annum to the Reserve Fund. The annual return expected on Preference Shares is 8% and that on Equity Shares is 10%.

You are required to work out the value of each Preference and Equity share in the company.

Balance Sheet of Good Enterprise Ltd. as on 31st December, 2010 is as under:

Liabilities	₹	Assets	₹
Equity Share Capital of ₹ 10	2,00,000	Goodwill	50,000
Equity Share Capital of ₹ 4	1,00,000	Fixed Assets	1,10,000
General Reserve	30,000	Stock	1,20,000

Profit and Loss A/c	10,000	Debtors	1,35,000	Notes
Gratuity Fund	15,000	Cash	10,000	
Workmen's Compensation Fund	5,000	Prepaid Expenses	2,000	
Depreciation Fund	10,000	Preliminary Expenses	3,000	
Sundry Trade Creditors	25,000			
Expenses - Creditors	5,000			
Bank Overdraft	30,000			
	4,30,000		4,30,000	

A shareholder holding 100 shares of ₹ 10 and 200 shares of ₹ 4 wants to dispose of all the shares. Dividends paid for last three years were 12%, 11% and 13%. Normal expectation is 10%.

Fixed assets are worth ₹ 60,000, goodwill is to be increased by an amount equal to average of book value and a valuation made at 4 years' purchase of average super profit for the last three years. Debtors are estimated to be worth ₹ 1,42,000. ₹ 3,000 of trade creditors are outstanding for many years and it is estimated that this amount will not be payable. On the other hand, ₹ 6,000 being disputed, bonus claim has not been provided in the accounts, but it is likely that the amounts shall have to be paid.

Profits for three years after taxation are ₹ 35,000, ₹ 48,000 and ₹ 43,000.

- Find out break-up value, market value and fair value of the above two types of shares.
- What should be the fair value of the shares if controlling interest of the managing director is being sold?

4. You are given the following Balance Sheet of Dev Private Ltd. as on 31st December, 1991:

Liabilities	₹	Assets	₹
10,000; 6% Preference Shares of ₹ 1 each fully paid	10,000	Sundry Assets	62,000
40,000 Equity Shares of ₹ 1 each fully paid	40,000	Discount on Debentures	2,000
7% Debentures	8,000	Preliminary Expenses	17,000
General Reserve	3,000		
Depreciation Fund	2,000		
Debenture Redemption Fund.	3,000		
Sundry Creditors	15,000		
	81,000		81,000

The assets are worth their book value. Interest on debentures for one year is owing and the dividends on the preference shares are in arrears of two years. You are required to find out the value of each shares assuming:

- That the preference shares are preferential to capital and the arrears of dividends are to be paid to preferential shareholders in winding up.
- The preference shares are not preferential to capital and arrears of dividends are payable in priority.

Notes

5. The following is the Balance Sheet of PQR Ltd. as on 31st December 2010:

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets	3,80,000
10,000; 12% Preference Shares		Investments	1,02,500
of ₹ 10 each	1,00,000	Stock	57,200
20,000 Equity Shares of ₹ 10 each	2,00,000	Debtors	1,27,800
General Reserve	1,50,000	Cash at Bank	22,500
Profit and Loss Account	1,20,000		
14% Debentures	80,000		
Creditors	27,500		
Liabilities for Expenses	12,500		
	6,90,000		6,90,000

For the purpose of valuation of shares, fixed assets are to be depreciated by 10% and investments are to be revalued at ₹ 1,08,000. Debtors will realise only ₹ 1,20,700. Interest on debentures is accrued for 9 months and preference dividend for 2010 is also due. Neither of these has been provided for in the Balance Sheet. Calculate the value of each type of shares.

Answers: Self Assessment

- | | |
|----------------|----------------|
| 1. True | 2. False |
| 3. True | 4. False |
| 5. True | 6. SEBI |
| 7. Stipulation | 8. Shares |
| 9. Advances | 10. Stamp Duty |
| 11. 1899 | 12. Issuing |

13.6 Further Readings



Books

B B Dam and H C Gautam, *Corporate Accounting*, Capital Publishing.

Das. K R and others, *Corporate Accounting*, LBS Publication.

Sehgal, Dr. A and Sehgal, Dr. D, *Advanced Accounting & Corporate Accounting*. Taxman Publications.



Online links

http://220.227.161.86/22213frpubcd_research3.pdf

http://www.icaai.org/resource_file/16341CloselyheldShareValuation.pdf

<http://www.jmoliski.com/FMA%20Sols.pdf>

http://www.oocities.org/mehulmukati/CA_Final/Accounts/Valuation_PrefShares.html

http://www.tutorsonnet.com/homework_help/valuation_of_bonds_and_shares/valuation_of_preference_shares_assignment_help_online_tutoring.htm

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