MAR GREGORIOS COLLEGE
OF ARTS & SCIENCE

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PG DEPARTMENT OF COMMERCE

SUBJECT NAME: ADVANCED CORPORATE ACCOUNTING AND ACCOUNTING STANDARDS

SUBJECT CODE: KDA1E

SEMESTER: I

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SYLLABUS

Advanced Corporate Accounting and Accounting Standards

Objective: To impart knowledge on corporate accounting methods and procedures and to develop skills in the preparation of accounting statements and in their analysis

Unit I Advanced problems in share capital and debenture transactions including underwriting - Valuation of goodwill and shares

Unit II Acquisition, Amalgamation, absorption and reconstruction (internal and external) schemes - Statements for liquidation of companies

Unit III Consolidated final statement of Holding companies and subsidiary companies –inter-company holdings and owings -treatment of dividends

Unit IV : Statement of Liquidation of Companies

Unit V Basic postulates of accounting theory and generally accepted accounting principles and practices recommended by the ICAI -Mandatory Accounting Standards (AS) issued by Ministry of Corporate affairs.

Note: The proportion between theory oriented and problem oriented questions in the University examination shall be 20:80

<u>Book References</u>

1. Shukla M C and T. S. Grewal, Advanced Accounts, New Delhi, S. Chand and Co.

2. Gupta R L and M. Radhaswamy, Advanced Accounts, New Delhi, Sultan Chand

3 Jain S P and K.L. Narang, Advanced Accounts, Ludhiana, Kalyani Publishers

4 Reddy T S and Murthy, Corporate Accounting, Chennai, Margam Publications

<u>Web references</u>

www.indiacorporateadvisor.com
www.iimcal.sc.in
www.futureaccountant.com

UNIT I

ADVANCED PROBLEMS IN SHARE CAPITAL AND DEBENTURE TRANSACTIONS INCLUDING UNDERWRITING - VALUATION OF GOODWILL AND SHARES

Issue, Forfeiture and Reissue of Shares

Meaning and Definition of Company

Company is a voluntary association of persons created by law usually for the purpose or carrying on some business for profit. with perpetual succession and common seal.

In the words of Haney. "A company is an artificial person, created by law, having a separate entity with a perpetual succession and a common seal."

Section 3 (1) () of the Indian Companies Act, 1956 defined a company as "a company formed and registered under this Act, or an existing company." An existing company means a company formed and registered under any of the former Companies Act. Thus, a company is an artificial person, invisible and existing only in contemplation of the law. Its main features are as follows:

(1) Voluntary Association – It is a voluntary association of persons usually for profit.

(2) Created by Law – A company gets its existence according to some law.

(3) Artificial Person – It is an artificial person and acts through human beings who are called directors.

(4) Separate Entity – A company is a separate legal entity, it is independent of its members and its existence is not affected by the change of its members. It can claim and be sued on its own name.

(5) Perpetual Succession – Its life is not affected by the life of its members.

(6) Common Seal – The company has its common seal. Only those documents can be said to belong to the company which contain its common seal.

(7) Limited Liability – Most of the companies are limited companies. The liability of the members of such companies is limited by the unpaid amount on their shareholdings.

Share Capital of a Company

The capital of a company is divided into units of small denomination. Each unit is called a share. A company collects capital by selling its shares in the public. The person who takes share/shares of the company is called the member or shareholder of the company. Shareholders are the real owners of the company. The Institute of Chartered Accountants of India defines the term share capital as "the aggregate amount of money paid or credited as paid on the shares and/or stocks of a corporate enterprise". For accounting purposes, the share capital of a company can be divided into the following categories:

1 Authorised Capital – It is the maximum amount of the share capital, set out in the memorandum of association of the company, which the company is entitled to issue. It is that amount by which the company is registered and on the basis of which its registered fees is paid. This sets out a limit beyond which a company can not issue its shares to the public. Authorised capital is also termed as 'registered capital' or 'nominal capital'. The amount of authorised capital is not included in the sum of balance sheet and hence a line is sketched below its amount

2. Issued Capital-It refers to the nominal value of that part of the authorised capital which has actually been offered for subscription. It also includes-bonus-shares and shares issued for consideration other than cash. It sets out the limit or the amount receivable from share issue. Like authorised capital this capital is also demarcated from other amounts of balance sheet by sketching a line below its amount.

3. Subseribed Capital – It refers to the nominal value of that part of issued capital which has actually been subscribed and allotted. If the public has fully subscribed the offer of the company, then issued and subscribed capitals can be shown in the balance sheet under one head as ” Issued and Subscribed Capital”.

Note : (i) Shares issued as bonus shares and shares issued for consideration other than cash should be separately stated under this heading.

(ii) Where the public has fully subscribed the offer of the company, the amounts of issued and subscribed capitals will be the same and so they can be shown in the balance sheet under one head as “Issued and Subscribed Capital”.

(iii) Where shares have been forfeited for non-payment of calls then the issued and subscribed pals will differ. In such a case, the subscribed capital shall be reduced by the number and the value of shares forfeited

4. Called-up Capital – (It is that portion of subscribed capital which the shareholders are called upon to pay on the shares allotted to them

Note: The amount of the share premiun is not a part of the called up share capital but discount on shares is a part of called up capital.

5. Paid-up Capital – It refers to that part of the called up capital which has actually been paid by the shareholders. In case of calls – in – arrear the amount of calls – in – arrear is deducted from the called up capital to arrive at the figure of paid up capital. This is the actual capital of the company and is included in the total of balance sheet.

It is important to note that Part I of Schedule VI of Companies Act, 1956 requires to classify the share capital of a company into three categories only: Authorised, Issued and Subscribed

Reserve Capital – It is that part of the uncalled share capital which a limited liability company has resolved by special resolution, not to call up in its life span. This capital can be called up only in the event of winding up of the company. Thus, it is in the nature of guarantee fund for the creditors on the winding up of the company. Under Section 99 of the Companies Act the word ‘reserve capital has been substituted by the more accurate expression: “reserve liability of limited company”.

Illustration 1. A company was registered with a capital of Rs. 20,00,000, divided into shares of Rs. 100 each. The company issued 12,000 shares, on which Rs. 80 per share had been called up. All shareholders paid the amount with the exception of a call of Rs. 20 on 1,000 shares. Besides, the company issued 3,000 shares as fully paid to the vendor in exchange of machineries. How will you show this information in the Balance Sheet of the company

Issue Forfeiture Reissue Shares

Classes of Shares

Section 2(46) of the Companies Act, 1956 defines a share as “a share in the share capital of a company and includes stock except where a distinction between stock and shares is expressed or implied”. The Companies Act provides for three classes of shares viz., preference shares, equity shares and deferred shares. However. the companies formed after the commencement of this Act are allowed to issue only preference and equity shares.

(1) Preference Shares – The Act defines preference share capital as that part of the share capital which carries preferential rights as to-i) the payment of dividend at a fixed rate, and (ii) the return of capital on winding up of the company. It may be remembered that the preference shareholders can enforce their right of getting dividend prior to equity shareholders only when the directors declare the dividend.

Classes of Preference Shares – The preference shares are sub-divided as follows:

Cumulative and Non-Cumulative Preference Shares – The term 'cumulative' implies that the amount Fixed dividend which the preference shares carry, accumulates if it is not paid in any year or years and such dividend must be paid out of the profits of the subsequent years before dividend is paid to the equity shareholders. Such arrears of preference dividend are shown in the Balance Sheet by way of note under the heading 'Contingent Liabilities'. Unless Articles provide otherwise, a preference share is deemed to be cumulative.

A non-cumulative preference share is that share on which arrears of dividend do not accumulate. If dividend is not paid for any year, the right to receive dividend for that year lapses.

(ii) Redeemable and Irredeemable Preference Shares – Redeemable preference shares are those the amount of which will be repaid on or after a certain date as per the terms of their issue. On the other hand, irredeemable preference shares are those which can not be redeemed except in the case of winding of the company. After commencement of the Companies (Amendment) Act, 1988 no company limited by shares can issue irredeemable preference shares. Companies (Amendment) Act, 1996 which is effective since 1-3-1997 provides that no company can issue redeemable preference shares which are redeemable after 20 years of their issue.

(iii) Convertible and Non-Convertible Preference Shares – A convertible preference share is that which can be converted into equity shares while a non-convertible preference share is that which does not possess such right. Unless stated otherwise, a preference share is deemed to be non-convertible.

(iv) Participating and Non-Participating Preference Shares – Participating preference shares are those which in addition to receiving dividend at a fixed rate, also carry a right of sharing with equity shares in any (1) surplus profits left after paying a specified equity dividend and/or (ii) surplus assets remained after the entire capital has been repaid on winding up of the company. Non-participating preference shares on the other hand, are those which do not carry such right. Unless stated otherwise, a preference share is deemed to be non -participating

(2) Equity or Ordinary Shares – According to Section 85 of Companies Act, an equtiy share is a share. which is not a preference share. That is to say, if a share does not possess the preferential right as to payment of dividend or repayment of capital, such share is called an equity share. Thus, equity shareholders get dividend and repayment of capital after meeting the claims of preferential shareholders. An equity share carries voting right.

(3) Deferred Shares – A deferred share is that which ranks for dividend only after the equity shares have received dividend at some specified maximum rate. These shares are generally of small nominal value but carry the right to receive a considerable proportion of the surplus profits and also extensive voting powers. Seldom created now-a-days, these shares were often issued to promoters of the company and sometimes to the vendors. After the commencement of Companies Act, 1956, these shares now can be issued by independent private companies only.

Issue of Shares

A company can issue its shares (i) for cash and (ii) for consideration other than cash.

Shares Issued For Cash

Shares can be issued for cash to friends, relatives, important financial organizations and to public. A private company usually issues shares informally, by personal contact between the directors and the prospective -often existing-shareholders. No notice or circular etc. is issued by such companies. A contract is executed, consideration passes, share certificates are made out and records made in the company's books. The Registrar of Companies is informed by filing him the return of allotment within 30 days after allotment.

In the case of a public company, a large amount of capital is required. It is therefore, necessary for such companies to make public issue of their share capital. The following procedure is followed by these companies :

(1) Issue of Prospectus – First of all, the company issues a prospectus which is an invitation to the general public to apply for its shares. The main contents of prospectus are usually advertised in leading newspapers , radio and T.V. for the information of general public. The prospectus gives information about the company and the terms of issue. The Companies Act has laid down the details of contents which must be included in the prospectus. Besides other information, it states the number and types of shares offered for issue, the minimum subscription, the date of opening and closure of the lists and the mode of payment

(2) Receipt of Applications – After the issue of prospectus the intending shareholder is required to deposit his application form duly filled alongwith the application money with the prescribed scheduled bank.

(3) Of the Companies Act, application money can not be less than 5% of the face value of the share. However, according to SEBI guidelines dated 6-3-1995 the minimum application money to be paid shall not be less than 25% of the issue price. These guidelines also provide that where on application and on allotment an amount exceeding Rs. 250 crores is raised the amount to be called up on application allotment and on various calls shall not exceed 25% of the total quantam of issue. It, therefore, follows that for issues on less than Rs. 250 crores, the issuer company is permitted to call up entire issue price on application set. For the issues of less than Rs. 500 crores the issue amount should be fully called up within a period of 12 months from the date of allotment. For the issues of Rs. 500 crores and above the issue price can be fully called up within the said period only after the financial institutions are satisfied about the utilisation of the issue proceeds.

Section 69 (5) of the Companies Act requires that the amount received on applications for shares has to be kept in a Scheduled Bank till the minimum subscription as laid down in the prospectus is raised and till cerificate of commencement of business obtained, in case of a new company. If the company fails to raise the minimum subscription within 120 days of issue of prospectus, the whole of the application money received has to be refunded to the applicants within the next ten days. Failing this, the directors of the company shall be jointly and severally liable to repay the money with interest at the rate of 6 percent per annum from the expiry of 130th day. As per SEBI guidelines, if the company does not receive 90% of the issued amount from public subscription including accepted devolvement from underwriters, if any, within 60 days from the date of closure of the issue, the amount of subscription received is required to be refunded.

In terms of Section 73(2) and (2A), the company should refund the excess application money after adjusting the allotment call within 10 weeks of closing of the subscription list and pay interest @ 15% p.a. if refunds are delayed by more than 8 days after this period.

(3) Allotment of Shares – After satisfying the conditions laid down in Section 69 and 70 of the Companies Act, the Board of Directors meets and allots the shares. If the number of shares applied for falls short of the number of shares offered, the allotment can be made only for the shares applied for , provided minimum subscription has been received. But if the number of shares applied for exceeds the number of shares offered, the Board of Directors must set a criterion for allotment. Directors have discretionary power either to reject or to accept partially the applications.

On the shares being allotted, a letter known as "the letter of allotment" is sent by the company to each allottee informing him of the number of shares allotted and asking him to pay the allotment money due from him, by a specified date. The allotment money becomes due immediately after allotment is made. On dispatch of the letter of allotment, an applicant becomes the bonafide shareholder of the company. On receipt of this letter, the allottees will forward to the company the amount due on allotment which will be recorded in the Application and Allotment Book. Where no allotment is made to an applicant, a letter of regret" is sent to him alongwith refund of his application money.

(4) Calls on Shares – The entire share money may be payable either in a lump sum alongwith the application money or in instalments. If the amount is payable in instalments, the amount payable alongwith application is known as application money, the amount payable on allotment as allotment money and the remainder is known as call money. If the balance due is collected in more than one instalment, the instalments are known as the first call, the second call and so on, the last call being termed as the final call. Calls are made by the directors on specified dates fixed by its Articles. If the Articles are silent in this respect, the provisions laid down in Table A shall apply. Table A imposes the following restrictions:

(i) a period of one month must elapse before another call is made;

(ii) The amount of the call should not exceed 25% of the face value of the share: and

(iii) fourteen days notice is given to the shareholders to pay the amount.

According to Section 91 of Comapnies Act, calls must be made on a uniform basis on all shares within the same class. Particulars of each call are entered in "Share Call Book"

Application and Allotment Account-As application and allotment both calls are due on the date of allotment of shares, some accountants do not open separate application and allotment accounts, but make entries regarding both in one account called " Application and Allotment Account". If this procedure is adopted, journal entries regarding application and allotment moneys in illustration 2 will be as follows:

Preparation of Cash Book – When shares (or debentures) are issued, it would be proper to prepare the Cash Book and enter the cash transactions in this book. If Cash Book is prepared, it would not be necessary record entries for cash transactions in the Journal. In that case only non-cash transactions will be journalized If Cash Book is prepared, the solution to illustration 2 will be as follows:

Two classes of shares – Where both preference and equity shares are issued, there will be separate preference and equity shares accounts to record applications, allotments and calls. Similarly, 'share capital account will be separated into "Preference share capital account and Equity share capital account

Illustration 3. Calcutta Textiles Ltd. was incorporated on January 1, 1998. The authorised capital of the company was Rs. 5,00,00,000 divided into 30,00,000 equity shares of Rs. 10 each and 2,00.000 12% preference shares of Rs. 100 each. The company issued 12,00,000 equity shares and half of the preference shares payable as follows Equity Shares – Rs. 3 on application, Rs. 3 on allotment, Rs. 2 on first call and Rs. 2 on final call Preference Shares – Rs. 30 on application, Rs. 30 on allotment, Rs. 20 on first call and Rs. 20 on final call All these shares were subscribed. Prepare Cash Book and Journal assuming that all money was duly received Solution:

Terms of Issue of Shares : Shares of a company may be issued in any of the following three ways: (1) At par, (2) At premium or (3) At discount.

(1) Issue of Shares at Par : Shares are said to have been issued at par where an applicant has to pay a total sum equal to the face value of the share. This has already been discussed earlier.

(2) Issue of Shares at Premium : Shares are said to have been issued at premium where an applicant has to pay a total sum in excess of the face value of the shares, the premium being the difference of issue price and face value of the share. For example, if a share of Rs. 10 is issued at Rs. 15, then Rs. 15 – Rs. 10 = Rs. 5 is premium. The word ‘share’ used in Section 78 has been substituted by ‘Securities’ by Companies (Amendment) Act, 1999. Section 2 (45 AA) inserted by the Companies (Amendment) Act, 2000, defines the expression securities to include shares, scrip, stock, bonds, debentures, debenture stock etc. Hence, now the amount of share premium will be credited to Securities Premium Account which will be shown on the liabilities side of Balance Sheet under the head “Reserves and Surplus”.

There are no restrictions in the Companies Act on the issue of shares at premium but there are restrictions on its disposal. Section 78 provides that a company may apply Securities Premium Account wholly or in part only for :

(i) issuing fully paid bonus shares to the members:

(ii) writing off preliminary expenses of the company;

(iii) writing off the expenses of, or the commission paid or discount allowed on any issue of shares or debentures of the company; or

(iv) providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.

In addition, according to Section 77A, a company may purchase its own shares or other specified securities out of the Securities Premium Account.

Accounting Entries : A company can realize premium with any installment but in the absence of any information to the contrary, it is presumed to be payable on allotment. Therefore, the amount of premium be debited (along with the amount due in respect of share capital) to share allotment account and Securities Premium Account. For example, if a share of Rs. 100 is issued at a premium of Rs. 20 and Rs 45 including premium is due on allotment, the journal entry will be as follows:

Shares Share Allotment Account	Dr. 45	
To Share Capital Account		25
To Securities Premium Account		

When the amount is received, following entry will be made :

Bank Account	Dr. 45	
To Share Allotment Account		45

Securities Premium Account is shown on the liabilities side of a company’s balance sheet under the head “Reserves and Surplus”.

Illustration 4. Dinarpur Paper Mills Ltd. issued 25.000 Equity shares of Rs. 100 each, payable as to S. 20 on application, Rs. 30 on allotment (including Rs. 10 premium) and Rs. 60 on call. All shares were applied for and allotted. All money was received. Make journal entries in the books of the company.

(3) Issue of Shares at Discount : Shares are said to have been issued at discount where an applicant has to pay a total sum less than the face value of the share, the discount being the difference of face value and issue price of the share. For example, if a share of Rs. 10 is issued at Rs. 9 then Rs. 10 – Rs. 9 – Re. I is the discount. It must be remembered that according to Section 79 of Companies Act, a company can issue shares at a discount only when the following conditions are fulfilled :

(i) The shares must belong to a class already issued.

(ii) The issue is authorised by a resolution passed by the general meeting and sanctioned by Company Law Board;

(iii) The issue is made at a discount specified in the above resolution but in no case the rate of discount should exceed 10 percent or such higher rate as permitted by the Company Law Board.

(iv) At least one year has elapsed since the date on which the company was entitled to commence business.

(v) The issue is made within two months from the date of receiving the sanction of the Company Law Board or within such extended time as the Board may allow.

Discount on issue of shares is a loss of capital nature and as such debited to a separate account called Discount on Issue of Shares Account". Until it is written off, it must be distinctly shown on the assets side of the company's Balance Sheet under the head "Miscellaneous Expenditure".

Accounting Entries : The journal entry for discount on shares is generally made at the time of allotment of shares. Share

Allotment Account is debited only with the net amount due and the discount allowed is count due and the discount allowed is debited to Discount on mares Account, the total amount is credited to Share Capital Account For example, if a share on 100 is issued at Rs. 90, of which Rs. 25 is payable on allotment, the journal entry at the day as follows:

Calls-In-Arrear

If a shareholder makes a default in sending the call money within the specified period, the money not so sent is called calls-in-arrear. There are two alternative methods of dealing with this problem:

(A) Opening a Separate Account – If some shareholders fail to pay the amount of a call, Calls-inArrear Account is debited and the relevant call account is credited. In this method, allotment and other call accounts will not show any balance but the Calls-in-Arrear Account will show a debit balance equal to the total unpaid amount on various instalments. The balance of calls-in-arrear account is shown as a deduction from the called up capital on the liabilities side of the company's Balance Sheet. On receipt of amount of calls-in-arrear on a subsequent date, Bank Account will be debited and Calls-in-Arrear Account credited.

(b) Not Opening a Separate Account – It is not necessary to open a separate account for calls-inarrear. In that case, amount actually received is credited to the call account and hence the various call accounts will show debit balance equal to the total unpaid amount of each call. On receipt of amount of calls-in-arrear on a subsequent date, Bank Account will be debited and the relevant Call Account will be credited. At the year end, the balance of various call accounts may be transferred either to Calls-in-Arrear Account or to the Balance Sheet. In both circumstances, total amount of unpaid calls will be shown as a deduction from the called up capital.

It must be remembered that if there are more than one class of shares, Calls-in-Arrear in respect of each class of shares should be shown separately.

Interest on Calls-in-Arrear – Directors are actually authorised by the Articles to charge interest at a rate on calls-in-arrear from the due date to the date of payment. However, if the Articles are silent,

Calls-in-Advance

The money received by a company from its shareholders in excess of what has been called upon the shares is called Calls-in-Advance. Section 92 of Companies Act states that calls-in-advance can be accepted only when company is so authorised by its Articles. On receipt of such sums by a company, the amount should be credited to a separate account, called Calls-in-Advance Account by passing the following entry :

Bank Account Dr

To Calls-in-Advance Account

The amount received as calls-in-advance is a debt of the company until the calls are made and the amount is actually payable by the shareholders. As and when calls are made, the appropriate amount is transferred from the Calls-in-Advance Account to the relevant Call Account by passing the following entry :

Calls-in-Advance Account Dr

To Relevant Call Account

It is to be noted that the money so received does not form part of the company's share capital. So, the shareholders making advance are not entitled to any voting rights in respect of such amount. They are also not entitled to receive dividend on such advance amount. The balance of Calls-in-Advance Account is shown as a separate item on the Balance Sheet after paid up capital. Some companies show this balance as a current liability

Interest on Calls-in-Advance – Generally, Articles of the company specify the rate at which interest is payable on calls-in-advance. If the company has adopted Table A, the Board of Directors can pay interest on such advances subject to the maximum of 6% per annum from the date of receipt to the date when the call is due for payment. It is to be noted that this interest is a charge on profits of the company. As such, this interest will be paid even if no profit is earned by the company.

Issue Forfeiture Reissue Shares

Accounting Entries :

1 If interest is paid in cash –

Interest on Calls-in-Advance Account **Dr.**

To Bank Account

Issue, Forfeiture and Reissue of Shares

2. If interest is not paid in cash

Interest on Calls-in-Advance Account **Dr**.

To Sundry Shareholders Account

3. For writing off the amount of interest –

Profit & Loss Account

To Interest on Calls-in-Advance Account

Illustration 7 On 1st January, 1998, X Ltd. makes an issue of 10.000 equity shares of Rs. 10 each payable as below:

On application Rs. 2

On allotment Rs. 3

On first and final call Rs. 6

(Three month after allotment) The issue was subscribed for in full and the shares were allotted. A shareholder holding 20 shares paid first and final call with allotment money and another shareholder did not pay allotment money on his 30 shares but which he paid with first and final calls Directors have decided to charge and allow interest, as the case may be, on calls-in-arrears and calls-in-advance respectively according to the provisions of Table A. Journalise the transactions including cash transactions.

Under-Subscription of Shares

The shares are said to be under-subscribed if the number of shares applied for is less than the number of shares offered for issue. A company may go ahead with its allotment plan provided the subscription is more than the minimum amount of subscription. In such a case entries are made on the basis of the number of shares applied for.

Redemption of Preference Shares

Redemption of preference shares implies paying back by a company the amount of its preference shareholders. Section 80 of Indian Companies Act, 1956 provides that a company limited by shares may, so authorized by its Articles, issue redeemable preference shares. By virtue of sub-section (SA) of section 80 inserted by the companies (Amendment) Act, 1996, which came into force on 1-3-97, no company can issue any preference share, which is irredeemable or is redeemable after the expiry of 20 years from the date of its issue.

Conditions for Redemption of Preference Shares

Preference shares can be redeemed either at the option of the company or after the expiry of an stipulated period of time without the permission of the Court as required under Section 100. But such redemption is subject to the following legal restrictions :

(1) No such shares can be redeemed unless they are fully paid. As such, redemption of redeemable partly paid preference shares is not allowed.

Explanatory Notes : (i) If only partly paid preference shares are given in the examination problem and it is required to redeem these shares, then it will be presumed that the company has made and received the final call on these shares before their redemption.

(ii) If both partly paid and fully paid preference shares are given in the examination problem then in the absence of any specific instruction, it will be presumed that only fully paid preference shares are required to be redeemed.

(2) Such shares can be redeemed either (a) out of the profits of the company, which would otherwise be available for dividend, or (b) out of the proceeds of a fresh issue of shares made for the purpose of redemption.

Explanatory Notes.

(i) Such shares can be redeemed out of the proceeds of a fresh issue of shares, whether preference or equity, but certainly not out of the proceeds of borrowings, loans or debentures or of any property of the company.

(ii) No where in the Act, the phrase "proceeds of fresh issue" has precisely been defined. As such, there is much scope for confusion as to what constitute the proceeds of fresh issue in various circumstances like issue of shares – (a) at par, (b) at premium or (C) at discount. If the fresh issue is at par then the nominal value of shares issued will constitute the proceeds of fresh issue. If the fresh issue is at premium then also the nominal value of shares issued (i.e., excluding the amount of securities premium) should be treated as the proceeds of fresh issue. The securities premium is excluded because firstly, Section 78 (2) of the Act has clearly specified the four purposes for which this amount can be utilised and the use of this amount for redemption purposes is outside the scope of the four purposes. So, if securities premium account is used for redemption purposes, it will amount to reduction of capital. Secondly, since securities premium can be utilised for the various purposes as stated under Section 78 (2), it can not be treated as substitute for paid-up capital and so the security available to creditors may be reduced later on by the amount of premium utilised for these purposes. If the fresh issue is at discount then net amount received on issue of shares (not the nominal value of shares) should constitute the proceeds since the amount of discount does not represent tangible assets capable of providing protection to the creditors.

(iii) Such shares may also be redeemed partly out of profits and partly out of the proceeds of a fresh issue of shares.

(iv) In the examination problem, existence of profits may be assumed if preference shares are conceded without issue of fresh shares.

(v) The use of general reserve for redemption of preference shares would not be desirable as long as were is a balance in profit and loss account.

(3) Where any such shares are redeemed out of profits, a sum equal to the nominal amount of the lates so redeemed must be transferred out of the profits of the company, which would otherwise be available for dividend to a reserve account called "Capital Redemption Reserve Account", otherwise such redemption would involve a reduction of share capital. Examples of profits available for dividend are general reserve, reserve fund, contingency reserve, dividend equalisation fund, insurance fund, workmen's compensation fund, workmen's accident fund, voluntary debenture sinking fund, profit and loss account etc. But capital profits such as share forfeiture account, securities premium account, development rebate reserve, capital reserve, investment allowance reserve, profit prior to incorporation etc. are not available for dividend.

(4) If such shares are redeemable at premium then such premium must be provided for out of the profits of the company or out of the company's securities premium account, before the shares are redeemed.

Explanatory Note : Any balance on securities premium account, whether arising in connection with the fresh issue of shares made for the purpose of redemption of preference shares or any other previous issue, may be applied in providing the premium on the redemption of redeemable preference shares. Although there is no compulsion to utilise this account for this purpose but it would be wise to take advantage of the opportunity to do so, as the utilisation of this account is very much limited. As such, in the examination problem, balance of securities premium account should be applied for this purpose in priority to profits or any other reserve of the company.

(5) The Capital Redemption Reserve Account can be used for issuing fully paid bonus shares to the shareholders of the company. Otherwise, it must be maintained intact unless otherwise sanctioned by the Court. It is quite obvious that partly paid up shares can not be made fully paid up by the issue of bonus shares out of Capital Redemption Reserve Account.

(6) Redemption of preference shares shall not be taken as reduction of the amount of its authorised share capital. So, such reduced shares shall remain part of the authorised capital in the balance sheet. The company shall have the power to issue upto the nominal amount of the shares redeemed or to be redeemed as if those shares had never been issued.

(7) If new shares are issued for the purpose of redemption of preference shares, it will not be treated as increase of capital for the purpose of capital duty under Section 611. But where the new shares are issued before redemption, they are not exempted from capital duty unless the redeemable preference shares are redeemed within one month.

(8) If a company fails to comply with provisions of this section, the company and every officer of the company who is in default shall be punishable with fine, which may extend to one thousand rupees.

The Intention of Section 80: The intension of the provisions of Section 80 is to protect the interest of creditors of the company by keeping the share capital intact even after the redemption of redeemable preference shares. When the redemption is made by the fresh issue of shares, the same amount of share capital (though not necessarily the same class of share capital) is maintained intact. Similarly, when the redemption is made out of divisible profits, Capital Redemption Reserve Account takes the place of Redeemable Preference Share Capital Account after the redemption. There is no depletion of the company's assets after the redemption since Capital Redemption Reserve Account is created by retaining! permanently the profits, which may be paid to shareholders by way of dividend at any time. The purpose of disallowing the redemption of partly paid redeemable preference shares is also to protect the interest of the creditors who calculate the security of their loans on the basis of the face value of the issued capital. If redemption of partly paid shares is allowed, it would mean replacement of only the paid-up value of such shares and uncalled amount of such shares, which the creditors may expect to receive upon the liquidation of the company, will never be available to them after the redemption.

Redemption Preference Shares

5. If the company utilises the amount of Capital Redemption Reserve Account in issuing fully paid ares to its shareholders, the following journal entries are made :

(i) Capital Redemption Reserve Account Dr.

To Bonus to Shareholders Account

(ii) Bonus to Shareholders Account Dr.

To Share Capital Account

Some Important Notes:

(1) Untraceable Shareholders : It may be that after giving notice, some preference shareholders could not be traced and so their amount can not be paid to them. This amount will remain in the Balance Sheet under current liabilities in, say, Preference Shareholders Account.

(2) Calls-in-Arrears : It may be that some of the preference shareholders might not have paid some of the calls made on their shares, in such a case :

(i) Only that portion of the capital is to be replaced out of proceeds of fresh issue and free reserves, which are fully paid.

(ii) The partly paid preference shares would be redeemed only when their amount of unpaid calls is collected by the company. The unredeemed preference shares would continue to be shown under share capital of the company until the calls-in-arrears are received.

(iii) To protect the interest of creditors, the company should accumulate sufficient balance in divisible profits accounts for the unredeemed preference share capital so that when calls-in-arrears are collected on these preference shares, the company could capitalise the divisible profits by creating a Capital Redemption Reserve Account equal to the nominal value of unredeemed preference shares. However, it is advisable that full capital redemption reserve should be created in the beginning for all the preference shares, if forfeiture of defaulting shares is not intended and the redemption is out of profits.

(3) Forfeiture of Shares: If the company has forfeited the defaulting shares then the question of their redemption does not arise. It is unlikely that such forfeited shares will be reissued because of immediate redemption of rest of the preference shares. Hence, it is necessary to make arrangement for all the preference shares including the forfeited shares to protect the interest of the creditors. If, however, such forfeited shares have been reissued as fully paid up then these shares will be redeemed like other preference shares.

Redemption of Preference Shares at Par

Illustration 1, Pass necessary journal entries in each of the following cases : (A) Komalika Ltd. had issued 10,000, 8% Redeemable Preference Shares of Rs. 100 each which are redeemable at par on January 1, 2006. In order to meet this obligation, the company decides to issue 50,000 fresh equity shares of Rs. 10 each at Rs. 12 and 5,000 9% preference shares of Rs. 100 each at Rs. 110. The whole amount is received in cash and 8% preference shares are redeemed. Show the necessary Journal entries in the books of the company.

(B) Goodluck Ltd. issued on 1-1-1993 10,000, 8% Redeemable Preference Shares of Rs. 100 each, redeemable at par on January 1, 2006. The company has a credit balance of Rs. 8,00,000 in Profit and Loss Account and Rs. 5,00,000 General Reserve. Show necessary entries in the books of the company for the redemption of 8% preference shares.

Redemption of Preference Shares at Premium

Illustration 3. Pass the necessary journal entries in the books of the company in connection with redeemable preference shares in the following cases, assuming sufficient balance of profits:

(1) For payment of 200, 12% redeemable preference shares of Rs. 100 each at a premium of 10%, the company used its profits.

(2) For payment of 200, 12% redeemable preference shares of Rs. 100 each at a premium of 5%, the company issued 2,000 equity shares of Rs. 10 each at a premium of 10%.

(3) For payment of 2,000, 12% redeemable preference shares of Rs. 500 each at a premium of 15%, the company issued 1,15,000 equity shares of Rs. 10 each at par.

(4) The company issued 2,000 equity shares of Rs. 10 each at a premium of Rs. 2 per share for cash to redeem at par 3,000, 14% redeemable preference shares of Rs. 10 each.

(5) For payment of 1,000, 12% redeemable preference shares of Rs. 100 each at a premium of 15%, the company issued 5,000 equity shares of Rs. 10 each at a discount of 10%.

Issue of Debentures

Meaning of Debenture – A company can raise funds by issuing debentures. A debenture is an instrument of acknowledgement of a debt under the common seal of the company. In actual practice, debentures refer to long-term or perpetual indebtedness. According to Section 2 (12) of Indian Companies Act, debenture includes debenture stock, bonds and any other securities of a company, whether constituting a charge om the assets of the company or not." Terms of repayment of the principal sum and payment of interest are given in each debenture certificate. It is usual to prefix "Debentures" with the rate of interest. Thus, if the rate of interest is 12%, the name given will be "12% Debentures."

Kinds of Debentures

Debentures are classified from various point of views as follows:

(1) From security point of view – From this point of view, debentures may be put into two categories – naked debentures and mortgage debentures. Naked debentures are those which provide no security to the lenders for the payment of interest and repayment of principal. Such debentures are not very common. Mortgage debentures, on the other hand, are those which are secured. The security may be a particular asset called fixed charge or it may be the assets in general called floating charge.

(2) From permanence point of view – From this point of view, debentures may be either redeemable or irredeemable. Redeemable debentures are those which are repayable after a specified time or by instalments during the existence of the company while irredeemable debentures are those which are not repayable during the lifetime of the company issuing it and hence they are repaid only when the company goes into liquidation. Usually, debentures are redeemable and their terms of redemption are given in the debenture certificate.

(3) From record point of view — From this point of view, debentures can be bearer or registered. Bearer debentures are those which are transferable by mere delivery. Such debentures are repayable to their bearers. Company does not keep any record of debentureholders. Interest on such debentures is paid to those persons who produce to the company coupons attached with the debentures. On the other hand, registered debentures are those, the names of whose holders are registered in the books of the company, These debentures can be transferred only by the execution of a regular transfer deed. Interest on such a debenture is paid to the person whose name appears in the company's register.

(4) From the priority point of view — From this point of view, debentures may be first debentures. second debentures and so on. First debentures are those which are repayable before other debentures while second debentures are those which are repaid only when first debentures have been redeemed.

(5) From the convertibility point of view — From this point of view, debentures can be either convertible or inconvertible. Convertible debentures are those the holders of which are given an option of exchanging the whole or a part of the amount of their debentures for shares on certain dates or during certain periods as laid down in the terms of issue. Thus, debentures can be fully convertible (FCD) or partly convertible (PCD). Fully convertible debentures are whose full amount is converted into equity shares of the company on the expiry of a specified period. Partly convertible debentures consist of two parts — convertible and non-convertible. Convertible portion of such debentures is converted into equity shares at the expiry of specified period whereas non-convertible portion is redeemed at the expiry of a certain period. Non-convertible debentures are those which are not convertible into shares and the whole amount of which is redeemed in accordance with the terms of issue.

Issue of Debentures

A company can borrow by issuing debentures subject to the restrictions imposed by section 293 (1) (d) of the Companies Act. The procedure for issuing debentures is very much similar to that of an issue of shares. A prospectus is issued in which terms and conditions of the issue are given. The intending lenders apply for debentures in the company on a prescribed form, which is deposited with the company's bankers alongwith the application money. The company may ask for payment of the whole of the amount along with the application or by instalments. If debentures are issued payable by application, allotment and call instalments, the same procedure will be followed as for shares. That is to say, Debenture Application and Allotment Book, Debenture Call Book, and a Register of debenture-holders will be employed for recording the details of the debentures issued.

Like shares, debentures may also be issued either (i) at par, or (ii) at a premium, or (iii) at a discount but restrictions of Sections 78 and 79 do not apply in the case of debentures.

Accounting Entries – Debentures may be issued by a company (1) for cash. (2) for consideration other than cash and (3) as collateral security. Accounting entries under each circumstance are given hereunder.

(1) Debentures Issued for Cash

(A) Issue of debentures at par

A debenture is said to have been issued at par when the amount collected for it is equal to the face value of the debenture. Accounting entries, in this case, are as follows:

(B) Issue of Debentures at Premium

Debenture is said to have been issued at premium where an applicant is required to pay a total sum in excess of the face value of the debenture, the premium being the difference of issue price and face value of the debenture. Prior to Companies (Amendment) Act, 1999, there was no mention of debenture premium any where in the Act. Hence, the amount of debenture premium could be used for any purpose for which the profits of the company can be used including even for distribution of dividend. However, companies following the principle of conservatism were usually transferring such premium to Capital Reserve Account at the end of the year and the same could be utilised in writing off capital losses like discount on issue of shares and debentures, premium on redemption of shares and debentures, underwriting commission, preliminary expenses etc. and also goodwill.

The Companies (Amendment) Act, 1999 substituted the words Share Premium Account by the words Securities Premium Account'. Section 2 (45AA) inserted by the Companies (Amendment) Act, 2000 defines securities to include inter alia debentures and debenture stock also. Thus, now the words Securities Premium Account would also cover the premium on issue of debentures also. Hence, now the amount of premium on issue of debentures would be credited to Securities Premium Account.

Illustration 2. TELCO Ltd. issued 20,000 12% Debentures of Rs. 500 each at Rs. 550 payable Rs. 125 on application, Rs. 175 (including premium) on allotment and the balance on final call. The issue was fully subscribed and the moneys were duly received.

Show the necessary Cash Book and the Journal entries and prepare the Balance Sheet of the company.

(C) Issue of Debentures at Discount

Debenture is said to have been issued at discount where an applicant is required to pay a total sum less than the face value of the debenture. The excess of the face value over the issue price is regarded as the discount. When debentures are issued at a discount, cash account is debited with net sum received, the Discount on Debentures account is debited with the amount of discount allowed and the Debentures Account is credited with the full nominal value of the debentures. But if, the amount of debenture is payable in installments, the entry for discount is made with the allotment as follows:

Debenture Allotment account Dr. (with the money due on allotment)

Discount on Issue of Debentures account Dr. (with the amount of discount)

To Debentures account (with the total)

There is no legal restriction on the companies for issuing debentures at discount. Maximum limit for discount on debentures is also not prescribed by the Companies Act. However, this Act requires that the amount of discount must be shown on the assets side of the Balance Sheet till written off under the head "Miscellaneous Expenditure."

Write off of Discount on Issue of Debentures

Discount on issue of Debentures is a capital loss of the company. Although there is no legal obligation E me company to write off such a loss, sound accounting policy requires that it should be written not at the earliest. There are two ways of writing off this loss :

(1) Being a loss of capital nature, it can be written off against capital profits and/or share premium account of the company.

(2) It can be treated as deferred revenue expenditure and can be written off against revenue profits over the period having the benefit of the use of the money raised by debentures. There can be the following two methods to achieve this end :

(1) Equal Installment Method – Under this method, the total discount is spread over the life of the debentures equally. So, the amount of discount to be written off annually is calculated by dividing the total amount of discount by the number of years after which the debentures will be redeemed. This method is suitable only if the debentures are repayable at the expiry of a given period.

(2) Fluctuating Installment Method or Proportion Method – Where the debentures are repayable by annual drawings, the first method becomes unsuitable because in such a case, the burden of discount will not be in proportion of the benefit received by the company out of the money raised by issuing debentures..

Calls-in-Advance and Calls-in-Arrear on Debentures

If the amount of debentures is payable in installments, alike shares there can be calls-in-arrear and callsin-advance on debentures too. If a debenture holder pays the amount before calls are made, the amount of advance will be credited to "Calls-in-Advance on Debentures Account" just as in case of shares. If the company accepts such advance, subject to the provisions of Articles, it can pay interest on such money from the date of the receipt till the due date of the call. Such interest is debited to P. & L. account.

If a debenture holder has failed to pay any call/calls made on him, the company can forfeit his debentures for non-payment of any call but it can not sue against the defaulter under section 122 for the recovery of the arrears. Accounting entries for calls-in-arrear on debentures are just similar to those passed in case of shares.

Debentures Issued as Collateral Security

The term 'collateral security' implies subsidiary or secondary security given for a loan. When debentures are issued as a subsidiary or additional security for a loan from a bank or insurance company, such an issue of debentures is known as 'issue of debentures as collateral security.' No interest is payable on such debentures, the interest on the loan being paid in the usual way. Such debentures remain in the possession of the lender until and unless the loan is repaid. On repayment of the loan, the lender is bound to return the debentures. But in case loan is not repaid by the company on the due date, the lender will become a debentureholder entitled to exercise all the rights conferred by the debentures including the right to sell the debentures in the market.

Issue of debentures in such a case can be dealt with in either of the following two ways:

(a) First Method – At the time of issue of such debentures, no entry is passed in the books of the company but a note is appended below the item of loan in the liabilities side of the Balance Sheet mentioning the fact that it has been secured by the issue of debentures as collateral security.

Second Method – If it is desired to record this event in the books of account, following entries will be passed :

(1) On issue of debentures as collateral security –

Debenture Suspense Account Dr. with the face value of debentures

To Debentures Account issued

Debenture Suspense Account is shown in the assets side of Balance Sheet under the head Miscellaneous Expenditure' while Debentures Account is shown in the liabilities side under the head "Secured Loans'.

(ii) On repayment of the loan and release of debentures, the above entry is cancelled by passing a reverse entry. As the net effect of (i) and (ii) is nil, this method is rarely followed in practice.

Issue of Debentures redeemable at premium

If a company issues debentures redeemable at a premium, such premium on redemption is a capital loss to the company and hence should be dealt with in the same way as discount on issue of debentures. As premium on redemption is a known loss, it would be prudent on the part of the company to spread this loss equitably over the life of the debentures. For this purpose, the liability for premium payable on redemption is recorded in the books at the time of issue of the debentures by passing the following accounting entry :

Bank Account Dr.(With the amount received on issue of debentures)

Loss on Issue of Debentures Account Dr. (With the amount of loss to be incurred)

To Debentures Account (With the nominal value of debentures issued)

To Premium on Redemption of Debentures A/c (With the amount of premium payable on redemption)

When the debentures are issued at a discount and are redeemable at a premium, the loss on issue of debentures will be equal to the total of the amount of discount on issue and the amount of premium on redemption. In such a case, there is no need to debit Discount on Debentures Account for the amount of discount allowed. Instead, it is included in "Loss on Issue of Debentures Account".

The "Loss on Issue of Debentures Account" is written off gradually every year during the lifetime of the debentures so that it is completely written off before the debentures are due for payment. The unwritten off portion of this account appears in the Balance Sheet on the assets side under the head "Miscellaneous Expenditure". "Premium on Redemption of Debentures Account" appears in the Balance Sheet on the liabilities side until it is paid on redemption of debentures.

Interest on Debentures

Wherever a company issues debenture it undertakes to pay periodically interest thereon at a fixed percentage. Interest payable on debentures is a charge against the profits of the company, i.e., it is to be paid by the issuing company to the debenture holders irrespective of the fact whether the company earns profit or not. If interest is payable only if the company earns profit then such debentures are termed as 'income bonds'. Interest on debentures is normally payable half-yearly and is calculated at the fixed percentage on the nominal value of the debentures issued and not on the issue price.

The accounting entries in such a case are as follows:

(1) On interest becoming due : Debenture Interest Account Dr. (with the gross amount of interest due)

To Income Tax Payable Account (with the amount of income tax deducted)

To Debenture holders Account (with the net amount payable)

(2) On payment of interest : Debenture holders Account Dr. with the amount To Bank Account of interest paid

(3) On depositing the tax to the Government : Income Tax Payable Account Dr. with the amount To Bank Account of tax deposited

(4) The gross amount debited to Debenture Interest Account is transferred to the Profit and LOSS Account at the end of the year. The entry is : Profit and Loss Account Dr. To Debenture Interest Account Notes:

(i) If the examination problem is silent as to the tax deducted at source, students need not make entries for income-tax payable on debenture interest. A footnote may be given in this regard.

(ii) If the company fails to deposit with the Government the tax deducted at source, it will be treated as the liability and shown as a current liability in the Balance Sheet.

(iii) If the debentures are tax free, the interest payable on debentures has to be grossed up. In such a case, tax is paid on interest by the company on behalf of the debenture holders.

Valuation of Goodwill

Meaning of Goodwill

Goodwill is an intangible but real asset. It is not a fictitious asset. Sometimes, it is more valuable than a tangible asset. It is the value of good name and reputation of a business house which brings in the customers, as a result of which the business is expected to earn in future higher return on its capital employed as compared to normal level of return in the same class of business. In technical language it may be defined as the present value of firm's anticipated excess earnings. The words "excess earnings" imply the rate of return on tangible assets and intangible assets other than goodwill over and above the normal rate of return earned by respective firms in the same industry. In his "A Dictionary for Accountants". Kohler defines goodwill as "the current value of expected future income in excess of a normal return on the investment in net tangible assets."

Features of Goodwill

Following are the special features of goodwill:

(i) It is an intangible asset.

(ii) It is a real and not a fictitious asset.

(iii) It can not be sold in isolation. Except on admission and retirement of a partner, goodwill is valuable only when the entire business is sold.

(iv) It is valuable only if it is capable of being transferred from one person to another.

(v) It is difficult to place an exact cost on goodwill.

(vi) Valuation of goodwill is based on the subjective judgment of the valuer.

Reasons for arising Goodwill

As stated earlier, the main reason for arising goodwill is firm's expectation of higher earnings in future and this expectation is influenced by a number of causes which are as follows:

1 Personality of owner, his integrity, ability and behaviour.

2. Managerial superiority, i.e., active, intelligent, dynamic and forward looking management.

3. Managerial attitude towards fulfilment of commitments (e.g., timely delivery of goods, timely payment to creditors, delivery of goods at committed prices etc.).

4. Efficiency, integrity and faithfulness of employees.

5. Long-term arrangement of availability of technical knowhow of high degree.

6. Reputation of goods sold or services rendered and their reasonable price.

7. Good labor relations.

8. Favorable location of business premises and effective advertisement.

9. Possession of special advantages, such as patents, trade marks, copyrights, agencies and monopoly.

10. Special business gains, e.g. regular supply of raw materials and components, low rate and assured supply of electricity, favourable long-term sale contracts, import licence etc.

11. Adequate financial resources and good credit worthiness

12. After sales services.

Need for Valuation of Goodwill

Need for valuation of goodwill may be in the following circumstances :

(A) In the case of a company :

(i) When two or more companies are amalgamated.

(ii) When a company absorbs the other.

(iii) When a company is desirous of acquiring controlling interest in another company.

(IV) When the business of the company is sold or taken over by the Government.

(v) When stock exchange quotations are not available and shares have to be valued for estate duty or tax purposes

(vi) When shares of one class are being converted into shares of other class.

(Vii) when the company has previously written off goodwill and now it wants to write it back in order to wipe off or reduce the debit balance in the profit and loss account.

(B) In the case of a partnership firm:

(i) On admission of a partner.

(ii) On retirement of a partner.

(iii) On death of a partner.

(iv) On change in the profit-sharing ratio among the partners.

(v) On sale of business by a firm.

(vi) On amalgamation of two or more firms.

(vii) On conversion of partnership into a company.

(C) In the case of a sole trader :

(i) On death of the owner for wealth tax purpose.

(ii) On sale of business.

(iii) On admitting somebody as a partner in the business.

(iv) On amalgamation of two sole trade businesses for making a partnership firm.

Main factors Affecting the value of Goodwill

The main determinants of the value of goodwill of a business are as follows:

(1) Profitability of business.

(2) Income expectations of investors.

(3) Capital employed in the business.

(4) Other factors.

(4) Profitability of Business : Future profitability of the business is the chief factor in the valuation of goodwill. Future profitability implies assessment of the quantity of future maintainable profits of the concern. Greater the amount of such profits, higher will be the goodwill of the business. Future maintainable profits of a business concern are assessed on the basis of its past profits, their markedly rising or falling tendency and expected developments.

(A) Profits of past years : Profits of past years of the business concern is the most important basis for estimating the profits expected to be earned by the concern. While calculating the past profits, the following points should be duly considered :

(i) All usual working expenses including interest to debenture holders and depreciation of assets should be provided for

(ii) All necessary provisions including provision for taxation should be made. But no appropriation of profit should be made, such as transfer to general reserve, dividend equalization fund or sinking fund for redemption of liabilities etc.

(iii) If non-trading assets have been excluded from capital employed then the income derived from such assets should also be excluded.

(iv) Average of the profits of four or five years is more reliable than a single year’s profit. If results of any year in the past have been affected by certain exceptional events such as earthquake, flood etc. then results of such exceptional year should be excluded in the calculation of average profit.

(v) In determining the profit of each year, extra-ordinary and non-recurring incomes or expenses should be excluded.

(vi) In case assets have been revalued or shown at their replacement cost then depreciation should be calculated on their revised values.

(B) Markedly rising or falling profits : If the profits over the past years have been continuously falling or rising in a marked manner then average profit should be calculated by weighted average basis instead of simple average, attaching more importance to the profits of the last year and least importance to the profits of the first year. For example, if profits of 1998, 1999, 2000 and 2001 are given and they are showing continuous rise then they can respectively be attached weights of 1, 2, 3 and 4 for calculating average profits. If, however, there is continuous and marked decline in profits then profits for the future should be estimated on the basis of the trend – they will be lower than the profits for the latest year.

(C) Expected developments : If development expenditures in the undertaking are significant then the average profit of past years should be adjusted for the likely fruits in future of such expenditure in order to arrive at the future maintainable profit.

(2) Yield Expected by Investors : In the valuation of goodwill, the second main factor is the income expectation of investors on their investments. In fact, expectations of investors determine the normal level of profits or normal rate of return. This rate is determined on the basis of prevalent price-earnings ratio of shares of other companies of similar nature in the same industry. On increase in income-expectation rate of investors, goodwill decreases and goodwill increases on decrease in this rate. This expectation is affected by the following factors

(i) The degree of business and financial risk in the investment – Higher the risk, higher will be the income expectation rate of investors.

(ii) The period of investment – Longer the period, higher the income expectation rate.

(iii) The bank rate – An increase in the bank rate will lead to an increase in income-expectation rate and on decrease, the rate decreases.

(iv) Business cycle – During boom period, investors' income expectation rate increases and during depression, this rate decreases.

(v) The general economic and political situation – Stable economic and political situation in the country leads to decrease in investors' income-expectation rate. In case investors' confidence is shaken in the economic and political stability, there will be a sharp rise in this rate.

(3) Capital Employed : This is the third important factor in the valuation of goodwill, since the size of profits is significant only in relation to the capital used to earn it. Capital employed generally implies net fixed assets plus net current assets and non-trading assets (e.g. investment of spare funds in government securities) are excluded. This may also be expressed as aggregate of share capital, reserves and surplus and long-term loans

The aforesaid idea of capital employed is not suitable for the valuation of goodwill of a company since the advantage of goodwill accrues to shareholders only. Hence, the amount of debentures and other loans should not be included in capital employed. Here, it is important to note that profit considered for valuation of goodwill should also be after interest on debentures and loans. Again, as profits are expressed at current values, it is proper that fixed assets are shown at their current prices.

In brief, capital employed may be calculated by either of the following two approaches :

1 Assets side approach :

Rs. Assets (other than goodwill, fictitious

assets, such as preliminary

expenses, discount etc. and trading losses) at market value

Less Liabilities to outside parties (such as creditors, bills payable,

debentures, taxation, outstanding bills, loans etc.) at revised values, if any

Capital Employed

Liabilities side approach :

Share Capital

Add Reserves, profits and gains on revaluation of assets and liabilities

Less Fictitious assets, goodwill, trading losses and losses on revaluation of assets and liabilities Capital Employed

Note : Some authors are of the view that capital employed should be calculated on the basis COSE or assets. If this view is followed then it will be essential to adjust depreciation on the basis replacement cost of the assets.

Average Capital Employed

A refinement to the above approach of capital employed is that the figure of capital employed should be the average for the year concerned since this figure changes during the year at least because of the profit. The average capital employed is calculated as follows**:**

(1) Average capital employed may be calculated by taking the mean of the capital employed at the end of the year and that employed in the beginning of the year, i.e. opening capital employed plus closing capital employed divided by two.

(2) As, except for fresh capital, capital employed increases over a year mainly due to profits earned, hence average capital employed can be found out by deducting half the profit of the year from the capital employed at the end of the year or by adding half of the profits of the year to the capital employed in the beginning of the year. This approach is based on the assumption that profits have been earned evenly over the year (hence by the middle of the year half the profits were earned and so used in the business) and that the profits have not yet been distributed.

If proposed dividend appears in the balance sheet of the company, this amount should be treated as part of profits for this purpose. If the business concern pays advance income-tax then the amount of income-tax will also be deducted from the profit of the year and adjustment will be made for half of the profit after tax.

(4) Other Factors : Besides the above mentioned three main factors, the following factors also affect the value of goodwill :

(A) Personal Skill in Management : If higher profits in the business are due to personal skill and reputation of its management and owners, goodwill can not be valued at a high figure if the services of old management and owners are not to be available.

(B) Nature of Business : If there are effective barriers for the new firms to enter into that business, the goodwill of existing firms will be high by the mere fact of their existence. Similarly, if the firm deals in articles or services of continuous demand, its goodwill will be higher as compared to a firm which deals in articles of fashion or public fancy (e.g. jeans).

(C) Favourable Location : A favourable location plays a significant role in assessing the value of goodwill.

(D) Easy availability of raw materials and trained labour : If the firm enjoys favourable position regarding regular supply of materials and trained labour, its goodwill will be high.

(E) Useful life of patents and trade mark : A firm possessing valuable patent rights for long-term use will have valuable goodwill. Similarly, if the firm has built up good reputation for its products by means of a trademark or if the firm has copyrights of publishing the works of renounced authors, its goodwill is likely to go up.

(F) Political and Government Protection : The value of goodwill of those firms will be high which enjoy political and/or government protection.

(G) Capital Requirements : If the capital required is large considering the profits likely to be available, the value of goodwill will be small. Conversely, if the capital required is relatively small and the business is highly profitable, the value of goodwill will be higher.

(H) Specific Contracts : Exceptionally favourable contracts for supply of goods or services to the customers will raise the value of goodwill. But if it is unlikely that such contracts will be obtained in future, the value of goodwill will not be influenced by such existing contracts.

Methods of Valuation of Goodwill

Following are the methods of valuation of goodwill!

1 Average Profit Method.

2. Super Profit Method.

3. Capitalization of Profit Method.

Average Profit Method Under this method, goodwill is valued at an agreed number of years' purchase (normally two or three years and this is purely arbitrary) of the average annual profits of three to five past years. Average annual profit is calculated by aggregating the amounts of profit or loss of specified years and then dividing this aggregate by the number of years.

In arriving at the annual profits, all income and expenditure of extra-ordinary and non-recurring nature should be excluded. Similarly, expenses and losses expected to be borne in future are deducted and all profits likely to come in future are added to such profits. Where the profits of the concern are progressively rising or falling, it is better to calculate the average annual profits by means of a weighted average instead of a simple average. Alternatively, simple average of past profits may be adjusted considering the trend of the business.

Merits of Average Profit Method

1 This is a simple method and is free from mathematical complexities.

2. Since under this method average profit is calculated on the basis of results of past several years, it is possible to know the true earning capacity of the business.

Demerits of Average Profit Method

1 This method ignores the amount of capital employed for earning the profit. In fact the amount of profit of a business concern is relevant only in reference to capital used to earn it.

2. There can be no any concrete basis of ascertaining the number of past years on the basis of which average profit is to be calculated.

3. There is no scientific basis of ascertaining the number of years' purchase of profits.

4. It is wrong to make total profits of business as the base for valuation of goodwill. If fact goodwill is attached to profits over and above the normal profits. Hence, every rupee of profit earned does not accrue goodwill. Due to this very defect this method is not popular in business world. However, this method is usually adopted for valuing the goodwill of the professional persons or firms such as chartered accountants or doctors.

Super Profit Method

Under this method, super profits (or excess earnings) of the business concern are taken as a basis of computing the value of goodwill. The super profits of a business are the excess of actual average profit of the business over its normal profit, i.e..

Super Profit – Actual Average Profit – Normal Profit

Actual average profit implies estimated future annual profit or future maintainable profit of the business concern. For this purpose, the amount of average normal profits of past few years is adjusted with reference to future expectations. Normal profit is calculated by multiplying the firm's average capital employed (or net capital employed) with normal rate of return for representative firms in the industry. The normal rate of return is that rate of earning which investors in general expect on their investments having regard to the prevailing rates of interest and the business and financial risks associated with the investment.

For example, estimated future annual profit of a firm are Rs. 1.50,000 and capital employed in it is Rs. 8.00.000. If normal rate of return in that business is 10% then the super profit will be 1.50.000 – 10% of 800.000 = Rs. 70.000 and this figure will be taken as the basis of computation of goodwill.

Here, it is important to remember that if the amount of super profit is zero or a negative figure, the value of goodwill will be considered zero.

Valuation of Shares

Valuation of shares implies finding out that value of shares on which they are purchased, sold transferred and assessed. This is an important but a complex problem. The basic principles are by no means difficult but their application calls for a considerable knowledge of technical points Necessity of Valuation of Shares

From valuation point of view, shares may be classified into two categories — listed shares and unlisted shares. Listed shares are those which are registered for purchase and sale in any recognized stock exchange whereas shares which are not registered for purchase and sale in any stock exchange, are called as unlisted shares. Listed shares are purchased and sold in the stock exchange and their prices are published by the stock exchange. Normally, these published prices are taken as the fair values of shares specifically for transactions involving small block of shares. But stock exchange prices form an unreliable basis because prices on a particular day are affected by so many external factors which are outside the control of the company. Hence, not only shares of private companies and the unquoted shares of public companies need valuation but even the quoted shares of public companies are also required to be valued.

Generally the necessity for valuation of shares arises in the following circumstances :

(1) When unquoted shares are being purchased and sold.

(2) When shares of a private company are being sold or fair value of its shares is to be found out.

(3) When two or more companies are to be amalgamated.

(4) When a company absorbs the other company.

(5) When a company is reconstructed under section 494 of the Act and there are dissentient shareholders whose shares have to be acquired.

(6) When a shareholder dies and his shares have to be valued for estate duty purposes.

(7) When shares are pledged as a security against a loan.

(8) When shares of one class are to be converted into shares of another class.

(9) When block of shares are purchased for acquiring controlling interest in another company.

(10) When assets of a finance company or an investment trust company are to be valued.

(11) Where a company is not nationalized and the amount of compensation to the shareholders is to be ascertained.

(12) For wealth tax purposes where the assets of an assessed included shares of a company.

(13) Purchase of shares by the employees of the company where retention of such shares is limited to the period of their employment.

(14) Sometimes shares are valued on the order of the Court.

Factors Affecting Valuation of Shares

The main factors affecting the value of shares of a company are:

(1) Nature of business of the company.

(2) Profitability of the company.

(3) Net tangible assets of the company.

Besides these three factors, the following factors also affect the value of shares of a company

(1) The demand for and supply of shares in market.

(2) The extent of competition among different companies.

(3) Dividend declared by the company in the past.

(4) Capitalization of the company.

(5) Reserves of the company.

(6) Number of shareholders of the company.

(7) Restrictions on transfer of shares of the company.

(8) Possibility of bonus and rights issues.

(9) Goodwill of company products.

(10) Possibility of future progress of the company.

(11) Ability, capacity and experience of directors of the company.

(12) Death of owner of major holdings or sale of shares by such a shareholder.

(13) Change in company management.

(14) Political conditions in the country.

(15) Peace and safety conditions in the country.

(16) The extent of government control on the company.

(17) The extent of investment restrictions in the country.

(18) General economic conditions, e.g. difficulty in the supply of labour and materials, transport bottlenecks, trade boom and depression etc.

Methods of Valuation of Shares

The method of valuation depends on the purpose for which the valuation is required. Following are three methods of valuation of shares:

1 Assets Valuation Method t o

2. Yield Valuation Method Sue s

3. Fair Value Method

Assets Valuation Method

The other names of this method are as follows:

(i) Net Assets Method

(ii) Internal Value Method or Intrinsic Value Method

(iii) Assets Cover Method or Assets Backing Method

(iv) Equity Valuation Method

(v) Break-up Value Method

(vi) Capital Valuation Method

This method aims at finding out the possible value of share in the event the company goes into liquidation. Under this method, net assets of the company are determined and then this figure is divided by the number of shares. The procedure is as follows:

(1) Calculation of Net Assets : This can be done by any of the following two ways:

(a) By deducting all external or outside liabilities of the company from the realisable value (or market value) of its real assets including non-trading and intangible assets* but excluding fictitious assets, i.e.

Net Assets = Realisable Value of Real Assets – External Liabilities

For wealth tax purpose, assets are taken at their book values for valuation of unquoted equity shares.

External or outside liabilities imply claims against the company of parties other than shareholders of the company whether recorded in the books of account or not but are likely to rank for payment. This includes debentures, trade creditors, bills payable, outstanding expenses, provision for taxation, liabilities on account of gratuities, arrears of preference dividends, employees provident fund, employees account etc ;

Proposed Dividend : The treatment of this item would depend upon the fact whether the value of the is to be calculated ex-dividend or cum-dividend. If the valuation is done after the declaration of dividend resulting in ex-dividend price, it is deducted from the realisable value of the assets treating it as a liability However, if the valuation is done before the declaration of dividend, it is not deducted from the realisable value of the assets resulting in cum-dividend price. Unless stated otherwise, it is presumed that the company has not declared the current year's dividend and hence the share price is cum-dividend.

(b) By aggregating the share capital, reserves and surplus and profit on revaluation and deducting there from all fictitious assets (such as preliminary expenses, underwriting commission, discount on issue of shares or debentures, deferred revenue expenditures etc.) and loss on revaluation of assets. The formula is : Net Assets = (Share Capital + Reserves and Surplus + Profit on Revaluation) – (Fictitious Assets + Trading Losses +Loss on Realization**)**

(2) Finding out the value per share : This is found out as follows:

(A) If the company has issued only equity shares and all equity shares are on the same type and equally paid-up : In such a case, the value per share is calculated by dividing the net assets by the number of equity shares, i.e., Value Per Share =

Net Assets

Number of Equity Shares (See illustrations from 1 to 6.)

(B) If the company has issued only equity shares but the paid up value of the same type er different types of equity shares is different : In such a case there are the following three alternative methods of determining the value of each type of share : (i) On the basis of unit value of capital : In this case, at first the unit value of capital is calculated by dividing the amount of net assets of the company by the total of paid up values of all types of equity shares and then the value per share of each type of share is found out separately by multiplying the unit value of capital with the paid up value of each type of equity share. In brief, the calculation procedure is as follows:

Net Assets

Step 1. Unit Value of Capital =

Paid – up Value of Total Equity Capital

Step 2. Value Per Share = Paid-up Value Per Share Unit Value of Capital

(See illustrations 7 and 8.)

(ii) On the basis of proportion of paid-up capital : Under it, at first the net assets of the company are divided in different types of equity shares in proportion of their paid-up values and then value per share of each type of equity share is calculated separately by dividing the share in net assets of each type of equity share with its respective number of equity shares.

Here it is important to state that if there is any calls in arrear on any type of share then the paid-up value of that type of share will be found out by assuming the amount of calls in arrear having been received on such shares but the value of such share will be determined by deducting the amount of calls in arrear from the value per share of that type of share calculated on the basis of (i) or (ii) above.

(See illustrations 7 and 8.)

(iii) On the basis of notional call of uncalled part of share capital : If there is possibility of call of uncalled part of partly paid share capital in near future, net assets may be calculated on the assumption of notional realization of such call. In such a case, the uncalled amount of different types of equity shares should be added to the aggregate of revalued value of all other assets of the company and outside liabilities be deducted there from. The amount of net assets so calculated will be divided by the total number of all

Types of shares, the resultant figure will be the value per fully paid share. For finding the value of each type of partly paid share, the uncalled amount of that share will be deducted from the value per fully paid share calculated as above. (See illustrations 12 and 27.)

Note : In the case of liquidation of the company, a different approach is followed. In this case, pald-up value of all types of equity shares is deducted from the net assets of the company and the amount of supus is found out and then this surplus amount is divided among the different types of equity shares in proportion of their numbers. Thereafter the proportionate surplus of each type of share so calculated is added to the paid up value of the concerned share and to find out the value per share the total of paid up value of Share and its proportionate surplus is divided by the number of shares of that type. (See illustration 12)

(C) If the company has issued equity and preference shares both : If both types of shares are issued by a company then for the valuation of shares it is essential to take into consideration the provisions of Articles of the company in respect of the rights of preference shareholders. In the absence of any specific information in the question, the preference shares will be presumed as non-participating having priority in respect of refund of capital only. In this respect there may be the following situations in the Articles :

(1) Preference shares have priority as to capital and dividend both : In this situation, the amount of preference share capital and the amount of arrear of dividend will be deducted from the value of net assets and the balance represents net assets available for equity shareholders. This balance is divided by the number of equity shares to find out the value per equity share. The preference shares are usually valued at their paid-up value and this value is increased by the amount of arrears of dividend, if any. But if the dividend rate on preference shares is different from the normal rate of dividend, the dividend payable on them should be capitalized at a normal rate and the capitalized value be divided by the number of preference shares to calculate their value per share. The procedure is as follows:

Step 1. Capitalized Value of Preference Dividend = Amount of Preference Dividend x 100

Normal Rate of Preference Dividend ”

Step 2. Value Per Preference Share = Capitalized Value of Preference Dividend Number of Preference Shares

(2) Preference shares have priority as to capital only : In this situation, only the amount of preference share capital is deducted from the value of net assets and the balance is divided by the number of equity shares to find out the value per equity share. The preference shares are valued at their paid-up value, if dividend rate attached to them is equal to the normal rate.

(3) Preference shares have priority as to dividend only : In this situation, the arrear of preference dividend is deducted from the value of net assets and the share of preference and equity shareholders in net assets is calculated separately by dividing the balance in proportion of their paid-up capitals. The share of equity shareholders in net assets is divided by the number of equity shares to get the value per equity share. Similarly, the share of preference shareholders in net assets is divided by the number of preference shares to get value per preference share which is further increased by the arrear of dividend per share.

(4) Preference shares have no any priority : If the face value and paid up value of preference and equity shares are equal then value per preference and equity shares is calculated by dividing the net assets of the company by the total of the number of equity and preference shares. If, however, the face value and/or paid-up value of the two classes of shares are not equal then in that case at first the net assets of the company will be divided among the two classes of shares in proportion of paid-up values of their shares and thereafter value per share of each class of shares will be calculated separately by dividing their respective share in net assets of the company by their number of shares.

(5) If preference shares are participating : In this situation, the net assets of the company are divided among the two classes of shares as per the provisions of Articles of the company. Thereafter the share of each in net assets is divided by the number of corresponding share to find out the value per shier class of shares separately.

Suitability of Assets Valuation Method : This method is most appropriate in the following situations

1 Where shares are being valued for wealth tax purposes.

2. Where the shares of a new company are to be valued and it is not possible to forecast its future maintainable profits.

3. Where the company has been consistently trading at a loss and there is no apparent prospect of recovery.

4. Where there is no reliable evidence of future profits due to violent fluctuations in the business or disruption of business.

5. Where the assets of the company are mostly of liquid nature and can be easily realized, e.g. shares of investment companies.

6. Where it is intended to liquidate the company and realise the assets for distribution among the various claimants including shareholders.

7. Where a large block of shares is to be transferred.

8. Where the shares are valued for amalgamation, absorption or external reconstruction purposes.

9. Where shares of private companies are valued.

10. Where shares of a controlled company are valued.

A controlled company is a company which, at any time before the death of a shareholder, was under the control of not more than five persons and which is not a subsidiary company or a company in which the public are substantially interested.

Merits of Net Assets Method

1 Assets basis of valuation of shares is very useful when the company is being liquidated since the very foundation of this method is net realizable value of assets.

2. This method takes into consideration both types of assets, i.e., tangible and intangible.

3. This method creates no problem where the company has issued different types of equity shares.

Demerits of Net Assets Method

1 It is difficult to estimate the realizable value of all the assets. There is considerable scope for personal bias,

2. Where there is no possibility of liquidation of the company in the near future, this method of share valuation is most hypothetical

3. It is difficult to estimate the true value of goodwill of a company.

4. This method of share valuation is not desirable for a growing company since it does not take into consideration the future profit-earning capacity of the company under consideration.

Underwriting

When shares or debentures are issued by a public limited company, it wants that its issue is fully subscribed by the public. In case the company fails to get even the minimum subscription on its issue then it would not have the right of allotment of these shares or debentures and in such a case, it has to refund to the applicants their application money. If the company issues the shares for the first time and fails to receive minimum subscription, it would not be granted the certificate to commence business. So, in order to ensure minimum subscription, the companies usually resort to underwriting.

Underwriting may be defined as an agreement entered into by the company with certain person, persons or institutions, called underwriters, who undertake the responsibility and give guarantee that the shares or debentures underwritten by them will be subscribed for in full by the public and in case of under subscription they will take the shortfall. In consideration of undertaking such responsibility, the remuneration which the underwriters get from the company is called the underwriting commission,

Underwriting Study Material Notes

Payment of Underwriting Commission

Underwriting commission is determined on the basis of a contract entered into by the company with the underwriters. As per the terms of the contract, such a commission is paid at a specified rate on the issue price (or on face value, if the agreement so provides) of the whole of the shares or debentures underwritten whether or not the underwriters are called upon to take any shares or debentures. It may be paid in cash, shares or debentures or partly in one form and partly in another form. In the books of the company, such expense may be written off against its undistributed profits, future profits or share premium and until it is written off, it is shown in the assets side of the Balance Sheet under the heading ‘Miscellaneous Expenditure

Section 76 of the Companies Act, 1956 lays down the following conditions for the payment of underwriting commission:

1 the payment of commission is authorized by the Articles;

2. the commission paid or agreed to be paid does not exceed – (a) in the case of shares, 5% of the issue price of shares or the amount or rate authorised by the Articles, whichever is less, and (b) in the case of debentures, 2 1/2% of the issue price of debentures or the amount or rate authorised by the Articles, whichever is less;

3. no underwriting commission can be paid if the issue is privately placed, i.e. it is not offered to the general public;

4. the amount or rate of commission should be disclosed in the Prospectus or Statement in lieu of Prospectus, as the case may be.

5. a copy of the contract relating to the payment of the commission should be delivered to the Registrar.

Underwriting Study Material Notes

Brokerage

Brokerage is paid to the brokers in consideration of their procuring subscription for shares or debentures issued to the public. Brokers are entitled for brokerage at a specified rate on shares or debentures subscribed by the public through them but they are under no obligation for any shortfall in subscription. Brokerage is paid in addition to the underwriting commission under Section 76.

The main difference between the brokerage and commission is that brokerage is paid for the service of placing the shares or debentures before the public whereas underwriting commission is paid for the guarantee of subscription in full. Hence, a broker is free from the risk of under-subscription whereas an underwriter has to take up himself the shortfall in public subscription.

Current Rates of Underwriting Commission, Brokerage and Remuneration of Managers to the Issue

Pursuant to Guidelines issued by the Stock Exchange division of the Department of Economic Affairs, Ministry of Finance, the following rates for payment of underwriting commission, brokerage and remuneration of Managers to the Issue, are in force :

Note : Underwriting commission will not be payable on amounts taken up by the promoters group, employees, directors, their friends and business associates.

2. Maximum Limit of Brokerage :

(i) Brokerage applicable to all types of public issues of industrial securities is fixed at 1.5% whether the issue is underwritten or not;

(ii) The mailing cost and canvassing expenses of brokers will be borne by the brokers themselves;

(iii) The listed companies are allowed to pay brokerage on private placements of capital at the maximum rate of 0.5 percent;

(iv) Brokerage will not be allowed in respect of promoters' quota, including the amounts taken by the directors, their friends and the employees and the right issues.

(v) Brokerage will not be paid when the applications are made by the institutions/banks against their underwriting commitments or on the amounts devolving on them as underwriters consequent to under subscription of the issues.

3. Maximum Fees of the Managers to the Issue : The companies are free to appoint one or more agencies as managers to the issue but the aggregate amount payable as fees to such persons shall not exceed the following limits :

(i) For issues upto Rs. 5 crores :	0.5 per cent
(ii) For excess over Rs. 5 crores :	0.2 per cent

Further, they shall not be paid for the following:

(a) Amounts agreed to be taken up by the financial institutions and the amounts devolving on the financial institutions as investors/underwriters.

(b) Promoter's quota of capital, including the amount taken up by the employees, directors, their friends and the business associates.

(C) On amounts subscribed on rights basis.

Full (or Complete) Underwriting and Partial Underwriting

Underwriting may be full or partial. If the company enters into a contract for underwriting the whole issue of shares or debentures, it is called as full or complete underwriting ard if the company enters into a contract for underwriting a part of the total issue then it is called as partial underwriting. In case of partial underwriting, the rest part of the issue is sold by the company itself. Whether it is full underwriting or partial, in both cases underwriters may be one or more than one.

Marked and Unmarked Applications

Applications bearing the official stamp of an underwriter or broker are called ‘marked applications while the applications received by the company which do not bear any stamp of underwriters or brokers are called ‘unmarked applications’.

If the entire issue is underwritten by only one underwriter, the marking of applications is immaterial because he will get credit of all the applications whether sent through him or received by the company directly. But if the underwriters are more than one or underwriting is partial, marking of applications becomes material for determining the underwriting liability of the underwriters. Marked applications reflect personal efforts of the underwriters, each underwriter gets credit for his own marked applications and unmarked applications reflect common efforts of all the underwriters, all the underwriters get credit for these applications on some appropriate basis.

Determining the Liability of Underwriters

The liability of the underwriters is determined in various cases as follows:

Determining Underwriters’ Liability in case of Complete Underwriting

If the whole issue is underwritten only by one underwriter, his net liability will be determined by deducting both marked and unmarked applications from his gross liability (i.e. shares underwritten). As such, he will be liable only such shares or debentures which are not subscribed for by the public.

If the whole issue is underwritten by two or more underwriters, the procedure for determining the underwriters liability will be as follows:

(i) Determine the gross liability of each underwriter. It is either given in the question clearly or it m**ay** be calculated according to agreed ratio.

(ii) Deduct the marked applications of each underwriter from his gross liability and find the balance left.

(iii) Deduct each underwriter’s share in unmarked applications from the balance left as calculated in (ii)

above, the balance will be the net liability of each underwriter.

The share of each underwriter in unmarked applications may be determined as per the terms of agreement either (a) in the ratio of their gross liability or (b) in the ratio of balance left as calculated in (ii) above. If the question is silent over this term then the students may follow any of the two bases but they should append a note specifying their basis. In our opinion ratio of gross liability is more logical. (iv) If as a result of above (ii) and (iii), there is any excess of any underwriter (i.e. his balance is in minus) then in the absence of any direction otherwise, this excess should be transferred to other underwriters’ accounts in the ratio of gross liability interse. After this adjustment, net liability of each underwriter on account of shortfall in the public subscription is known.

Firm Underwriting

It is a commitment made by the underwriters to make an outright purchase of certain number of shares or debentures underwritten firm out of their own underwritten shares or debentures. In such a case, if the issue is over-subscribed, shares underwritten as reduced by shares underwritten firm will only be allotted to the public and the underwriters will take the shares underwritten firm by them. If the issue is undersubscribed, the underwriters' total liability will be the sum of net liability under underwriting contract and the shares underwritten firm. It is to be noted that unless stated otherwise firm applications will be deemed to have been included in the marked applications, as each such applications will have the stamp of the concerned underwriter.

UNIT II

Takeovers and acquisitions are common occurrences in the business world. In some cases, the terms takeover and acquisition are used interchangeably, but each has a slightly different connotation. A takeover is a special form of acquisition that occurs when a company takes control of another company without the acquired firm's agreement. Takeovers that occur without permission are commonly called hostile takeovers. Acquisitions, also referred to as friendly takeovers, occur when the acquiring company has the permission of the target company's Board of directors to purchase and takeover the company. Acquisition refers to the process of acquiring a company at a price called the acquisition price or acquisition premium. The price is paid in terms of cash or acquiring company's shares or both.

As the motive is to takeover of other business, the acquiring company offers to buy the shares at a very high premium, that is, the gaining difference between the offer price and the market price of the share. This entices the shareholders and they sell their stake to earn quick money. This way the acquiring company gets the majority stake and takes over the ownership control of the target company.

An acquisition involves purchase of one entity by another (usually, a smaller firm by a larger one). A new company does not emerge from an acquisition; rather, the acquired company, or target firm, is often consumed and ceases to exist, and its assets become part of the acquiring company.

Acquiring an existing business enables a company to speed up its expansion process because they do not have to start from the very scratch. The target company is already established and has all the processes in place. The acquiring company simply has to focus on merging the business with its own and move ahead with its growth strategies.

Section 236 of the Companies Act contains a compulsory acquisition mode for the transferee company to acquire the shares of minority shareholders of Transferor Company.

Where the scheme has been approved by the holders of not less than nine tenth (90%) in value of the shares of the transferor company whose transfer is involved, the transferee company, may, give notice to any dissenting shareholders that transferee company desires to acquire their shares. The scheme shall be binding on all the shareholders of the transferor company (including dissenting shareholders), unless the Tribunal orders otherwise (i.e. that the scheme shall not be binding on all shareholders).

Accordingly, the transferee company shall be entitled and bound to acquire these shares on the terms on which it acquires under the scheme (the binding provision).

The advantage of going through the route contained in Section 235 of the Companies Act is the facility for acquisition of minority stake. The transferee company shall give notice to the minority dissenting shareholders and express its desire to acquire their shares within a period of 4 months after making an offer as envisaged under Section 235 of the Act.

When a Company intends to takeover another Company through acquisition of 90% or more in value of the shares of that Company, the procedure laid down under Section 235 of the Act could be beneficially utilized. When one Company has been able to acquire more than 90% control in another Company, the shareholders holding the remaining control in the other Company are reduced to a minority. They do not even command a 10% stake so as to make any meaningful utilization of the power. Such minority cannot even call an extra-ordinary general meeting under Section 100 of the Act nor can they constitute a valid strength on the grounds of their proportion of issued capital for making an application to the Tribunal under Section 241 of the Act alleging acts of oppression and/or mismanagement. Hence the statute itself provides them a meaningful exit route.

The advantage of going through the route is the facility for acquisition of minority stake. But even without going through this process, if an acquirer is confident of acquiring the entire control, there is no need to go through Section 235 of the Act. It is purely an option recognized by the statute.

The merit of this scheme is that without resort to tedious court procedures the takeover is affected. Only in cases where any dissentient shareholder or shareholders exist, the procedures prescribed by this section will have to be followed. It provides machinery for adequately safeguarding the rights of the dissentient shareholders also.

Section 235 lays down two safeguard in respect of expropriation of private property (by compulsory acquisition of majority shares). First the scheme requires approval of a large majority of shareholders.

In order to understand the concept of the Regulations, it would be pertinent to go through some of the important definitions:

The term ‘Takeover’ has not been defined under the said Regulations; the term basically envisages the concept of an acquirer acquiring shares with an intention of taking over the control or management of the target company. When an acquirer, acquires substantial quantity of shares or voting rights of the target company, it results in the substantial acquisition of shares. Substantial is again not defined in the Regulations and what is substantial for one company may not be substantial for another company. It can therefore not be quantified in terms of number of shares.

1. Acquirer [Regulation 2(1)(a)]

“Acquirer” means any person who, directly or indirectly, acquires or agrees to acquire whether by himself, or through, or with persons acting in concert with him, shares or voting rights in, or control over a target company;

2. Acquisition [Regulation 2(1)(b)]

"Acquisition" means, directly or indirectly, acquiring or agreeing to acquire shares or voting rights in, or control over, a target company;

It means that agreement to acquire the share or voting or control in a listed company without actual acquisition of share will also be treated as acquisition for the purpose of SEBI Takeover Regulations, 2011.

3. Control [Regulation 2(1)(e)]

"Control" includes the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, includingby virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner:

Provided that a director or officer of a target company shall not be considered to be in control over such target company, merely by virtue of holding such position;

4. Frequently Traded Shares [Regulation 2(1)(j)]

Frequently traded shares means shares of a target company, in which the traded turnover of any stock exchange during the twelve calendar months preceding the calendar month in which the public announcement is made is at least ten per cent of the total number of shares of such class of the target company.

Provided that where the share capital of a particular class of shares of the target company is not identical throughout such period, the weighted average number of total shares of such class of the target company shall represent the total number of shares.

5. Identified Date [Regulation 2(1)(k)]

Identified Date means the date falling on the tenth working day prior to the commencement of the tendering period, for the purposes of determining the shareholders to whom the letter of offer shall be sent.

6. Immediate Relative [Regulation 2(1)(l)]

Immediate relative means any spouse of a person, and includes parent, brother, sister or child of such person or of the spouse.

7. Maximum non Public Shareholding [Regulation 2(1)(o)]

Maximum permissible non-public shareholding means such percentage of shareholding in the target company excluding the minimum public shareholding required under the Securities Contracts (Regulation) Rules, 1957.

It means as per Rule 19(2)(b) of the Securities Contracts (Regulation) Rules, 1957 read with Regulation 38 of the SEBI (LODR) Regulations, 2015 every company shall ensure that at least 25% of each class or kind of equity shares issued by a listed company is held by public shareholders in order to remain continuously listed.

Currently only Listed Public Sector Undertakings are exempted from this requirement and it is sufficient if the public shareholding is maintained at 10% of the paid up capital of such public sector enterprises, which are listed. Therefore the maximum permissible non-public shareholding in the general sense of the term is 75% of the total paid up equity capital of the company for any listed company, which is not a listed public sector undertaking.

8. Offer Period (Regulation 2(1)(p))

Offer Period means the period between the date of entering into an agreement, formal or informal, to acquire shares, voting rights in, or control over a target company requiring a public announcement, or the date of the public announcement, as the case may be, and the date on which the payment of consideration to shareholders who have accepted the open offer is made, or the date on which open offer is withdrawn, as the case may be.

9. Persons Acting in Concert (Regulation 2(1)(q))

Persons Acting in Concert means persons who, with a common objective or purpose of acquisition of shares or voting rights in, or exercising control over a target company, pursuant to an agreement or understanding,

Check-list

1. *Transferor Company (Documents etc. involved in this process):*
2. Offer of a scheme or contract from the transferee company
3. Minutes of Board meeting containing consideration of the offer and its acceptance or rejection
4. Notice calling general meeting
5. Form CAA 14 circulated to the members
6. Minutes of general meeting of the company containing approval of the offer by statutory majority in value and in numbers also, if required
7. Court order, if any
8. Register of Members
9. Notice sent by the transferee company to dissenting shareholders for acquiring their shares
10. Duly filled in and executed instrument(s) of transfer of shares held by the dissenting shareholders
11. Bank Pass Book or Statement of Account in respect of the amount deposited in the special bank account to be kept in trust for the dissenting shareholders
12. Annual Report

Transferee Company (Documents etc. involved in this process):

- Minutes of Board meeting containing consideration and approval of the offer sent to the transferor company
- Offer of a scheme or contract sent to the transferor company

- Notice to dissenting shareholders if any, of the transferor company
- Notice to the remaining shareholders of the transferor company, who have not assented to the proposed acquisition, if any
- Form No: CAA14 received from the transferor company, which has been circulated to its members by that company
- Minutes of general meeting of the company containing approval of the shareholders to the offer of scheme or contract sent to the transferor company
- Court order, if any
- Register of Investments

AMALGAMATION AND RECONSTRUCTION

The modern age is the age of large-sized business units and industrial competition. Companies engaged in the same trade agree to combine with the object of eliminating or at least decreasing competition, pooling financial, technical and commercial resources, securing the economies of large scale production and controlling price and markets by securing the monopolistic situation. Apart from pooling arrangements, combination proceeds either by means of holding companies or through mergers. Accounts of holding companies have been dealt with in a separate chapter elsewhere. This chapter deals with merger and reconstruction only.

Merger may take the form of amalgamation or absorption.

Amalgamation : When two or more existing companies go into liquidation and a new company is formed to take over their business, this type of combination is termed as 'amalgamation'. Thus, in amalgamation (1) existing companies are liquidated and (2) a new company is formed to takeover the business of the existing companies. In this form of merger, the liquidators of old companies become the vendors and the new company becomes the purchaser**.**

Absorption : When an existing company acquires one or more existing companies, it is known as absorption. Under it, (1) no new company is required to be formed, (2) the absorbed company or companies go into liquidation and (3) the absorbing company continues its legal entity. In this form of merger, the liquidators of absorbed companies become the vendors and the absorbing company becomes the purchaser.

Accounting for Amalgamations

The Institute of Chartered Accountants of India has issued in October 1994 Accounting Standard 14 (AS – 14) on "Accounting for Amalgamations". It is in force since accounting periods commencing on or after 1-4-1995 and is mandatory in nature. This standard specified the procedure of accounting for amalgamations and the treatment of any resultant goodwill or reserves.

A S 214 has modified the prevailing concepts of amalgamation and absorption as described above. This standard recognizes that amalgamation may take the shape of merging of one company with another or merging of two or more companies to form a new company. Traditionally, the former situation was called as

absorption and the latter as 'amalgamation'. However, after the issue of AS – 14, this distinction is of no significance and the concept of absorption has been incorporated in the term amalgamation. In this standard, the term 'transferor company' is used for 'absorbed' or 'amalgamating', i.e. vendor company and the word) 'transferee' company has been used for absorbing or amalgamated, i.e. purchasing company. Thus, the h transferor company means the company which is amalgamated into another company and the transferee company means the company into which a transferor company is amalgamated

At is to be noted that AS – 14 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) Here, it is to be noted that in case of acquisitions, the acquired company is not dissolved and its separate entity continues to exist whereas in case of amalgamation the amalgamating company is dissolved without liquidation and is merged into the amalgamated company.

Types of Amalgamation

AS-14 divides amalgamation for accounting purposes into two categories: (1) Amalgamation in the nature of merger and (ii) Amalgamation in the nature of purchase.

(1) Amalgamation in the nature of merger

It is an amalgamation which satisfies all the following five conditions as laid down under paragraph 3(e) of AS-14: 0 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 these 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.

In this type of amalgamation, there is genuine pooling not merely of the assets and liabilities of the combining companies but also of shareholders' interest and of the businesses of these companies. The equity shareholders of the combining entities continue to have a proportionate share in the combined entity. Moreover, the resultant figures of assets, liabilities, capital and reserves more or less represent the sum of the relevant figures of the amalgamating companies.

(2) Amalgamation in the nature of the purchase

Amalgamation may be considered in the nature of purchase when any one or more of the five conditions specified for amalgamations in the nature of merger is not satisfied.

Purchase Consideration

The price payable by the transferee company to the transferor company for the amalgamation of business is called the purchase consideration. In fact, it is the amount payable by the transferee company for the net assets of the transferor company taken over. Para 3 (g) of AS-14 defines the term consideration for amalgamation as the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders (equity and preference both) of the transferor company.' It is very important to note that purchase consideration does not include the amounts of outside liabilities (e.g. creditors, debentures etc.) which will always be presumed to have been taken over and discharged by the transferee company. However, if it is expressly given in the question that any such liability is not being taken over by the transferee company, it will be paid by the transferor company. Moreover, the consideration for amalgamation should include any non-cash element at fair value. For example, in case of securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, market value of the asset given up may be treated as the fair value and in case market value of the asset given up can not be reliably assessed, such asset may be valued at its net book value.

Difference between Amalgamation in the Nature of Merger and Amalgamation in the Nature of Purchase

1 Shareholders' Interest : In the case of merger, there is genuine pooling not merely of assets and liabilities of amalgamating companies but also of the shareholders' interest. At least 90% of the equity shareholders of transferor company become shareholders of the transfer shareholders of transferor company (or companies) continue to company become shareholders of the transferee company. As such, the Steror company (or companies) continue to have a substantial or proportionate share in the equity and management of the transferee company. In the case of amalgamation in the nature of purchase, all the assets and hand necessarily be transferred to the transferee company. Moreover, 90% of the equity shareholder transferor company need not necessarily continue to remain the shareholders of the transferee company As such, the shareholders of transferor company normally do not have controlling interest transferee company.

2. Accounting Method : In the case of merger, pooling of interest method of accounting is applicable in the books of transferee company whereas in the case of amalgamation in the nature of purchase, purchase method of accounting is applicable.

3. Value of Assets and Liabilities : In the case of merger, assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying values but in the case of purchase, assets and liabilities of the transferor company are recorded by the transferee company at their revised fair values.

4. Identity of Reserves : In the case of merger, identity of reserves is maintained and they are merged into the reserves of transferee company in the same form as they appear in the balance sheet of transferor company. On the contrary, reserves of transferor company, other than statutory reserves, are not included in the financial statements of the transferee company.

5. Continuation of Business of the Transferor : In the case of merger, it is intended to continue the business of transferor company but in case of purchase, continuation of business of the transferor company is not a must.

6. Purchase Consideration : In the case of merger, purchase consideration is discharged by the transferee company almost wholly by the issue of its equity shares but in case of purchase, the purchase consideration may be discharged in any way, i.e., in cash, shares or debentures or a combination of any of these three.

Methods of Determining Purchase Consideration

Purchase consideration may be determined by any of the following methods:

(1) Lump Sum Payment Method : The amount of purchase consideration may be expressly given in the problem as a lump sum. In such a case, no calculation is required.

(2) Net Assets Method : If neither the lump sum amount nor the details of various forms of payment receivable by the transferor company from the transferee company are given in the problem then the purchase consideration will be calculated by net assets method. In this method, the amount of purchase consideration is ascertained by adding the fair or agreed value of assets taken over by the transferee company and deducting there from the fair or agreed value of outside liabilities to be assumed by it. If any asset or liability of the transferor company is revalued then the revalued value of such item will be taken as its fair value otherwise book value of the item should be considered as its fair value.

While determining the amount of purchase consideration under this method, the following points merit attention :

(a) Purchase consideration is calculated on the basis of those assets and liabilities which are being taken over by the transferee company. Hence, if any asset or liability is not being taken over by the transferee company, the same should not be included while computing purchase consideration.

(b) The term "all assets" will always include cash in hand and cash at bank, unless otherwise stated but it shall never include any fictitious assets or expenses not written off (e.g. preliminary expenses, underwriting commission, discount on issue of shares or debentures, advertisement suspense account, debit balance of profit and loss account etc.). If there is any goodwill, prepaid expenses, patent, trademark etc., the same will be included in the assets unless otherwise stated.

(c) The term "liabilities will mean all liabilities to third parties (eng. Trade Creditors, Bills Payable overdraft, Outstanding Expenses, Debentures, Loans, Provision for Taxation. Employee Deposit, Unclaimed Dividends etc.) but it shall not include any past accumulated profits (such as General Reserve, Reserve Fund, Sinking Fund. Dividend Equalization Fund, Capital Securities Premium Account, Capital Redemption Reserve Account, Credit balance of Prontando Account Forfeited Shares Account Development Rebate Reserve, Contingency Ry compensation, Accident or Insurance Fund etc) where funds in the nature of my Leasehold Redemption Fund, Rehabilitation Fund Staff Provident Fund, Pension Fund, superannuation Fund, Workmen's Savings Bank Account. Workmen's Profit Sharing Fund, Employees Welfare Fund, Sundry Shareholders Dividend Account, Workmen's Compensation,

Accident or insurance Fund upto the amount of actual claim etc.) shall be included in liabilities.

(d) The term "Trade Liabilities" will mean trade creditors and bills payable only and shall not include outstanding expenses, provision for taxation, bank overdraft, debentures etc.

(e) The term "business" will always mean both the assets and liabilities to outside parties.

(3) Net Payment Method : Under this method, the purchase consideration is ascertained by adding up the cash paid and the agreed values of shares and debentures allotted by the transferee company to the shareholders (equity and preference both) of the transferor company in discharge of their claims but the payment made to debentureholders and other outside liabilities should not be considered as part of the purchase consideration as these liabilities will be presumed to be taken over and paid by the transferee Company. Similarly, cost of winding up of transferor company paid by the transferee company shall also be! ignored for the purpose of purchase consideration.

Notes: (i) Shares and debentures of the transferee company can be issued as fully paid-up or partly paid up. Further, these shares and debentures can be issued at par, at premium or at discount as per the terms! of the agreement

(ii) The assets and liabilities taken over by the transferee company are not ties taken over by the transferee company are not considered in calculating the purchase consideration. If the value of net assets transferred to the transferee com to purchase consideration then necessary entry is passed in the books of the transferee company for adjusting the difference.

(iii) Shares issued by the transferee company to the transferor company as par any to the transferor company as part of purchase consideration should be valued at their paid-up value unless agreed otherwise. That is to say market value of shares issued should be ignored unless it is agreed to issue shares at market value

(IV) Owing to exchange ratio, sometimes it is not possible to find the whole number of shares. Any fraction of shares so arrived at is always satisfied in cash. The value of fractional share is calculated on the basis of the market price of the shares unless an express agreement is made for its valuation on the basis of paid-up value of share.

Illustration 2. X Co. Ltd, agrees to take over the business of Y Ltd., the consideration being the assumption of trade liabilities Rs. 50,000; the payment of the costs of the liquidation Rs. 5,000; the redemption of B Debentures of Rs. 2,00,000 at a premium of 10%: the discharge of 'A' Debentures Rs. 4,00,000 at a premium of 8% by the issue of 10% Debentures in the X Co. Ltd, and the payment of Rs. 10 per share in cash and the exchange of 2 fully paid Rs. 10 shares in the X Co. Ltd. at the market price of Rs. 15 per share for every share in the Y Co. Ltd. The share capital of the vendor company consists of 20,000 shares of Rs. 25 each fully paid. Calculate purchase consideration as per AS – 14.

Solution :

Payment to shareholders :

Cash 20,000 x 10

Shares of purchasing company 20,000 x 2 @ Rs. 15

Purchase Consideration

8,00,000

Note : As per AS – 14, consideration for amalgamation means the aggregate of the shares and other securities issued and payment made in the form of cash or other assets by the transferee company to the transferor company. Hence, payment made to debenture holders and payment of the costs of liquidation should not be considered as part of purchase consideration. (4) Share Exchange Method : In this method, the purchase consideration is ascertained on the basis of the ratio in which the shares of the transferee company are to be exchanged for the shares of the transferor company. It is to be remembered that here also purchase consideration will mean payment to shareholders only. The exchange ratio is generally based on intrinsic value or net assets value of each company's shares. For example, suppose that A Ltd. is taking over B Ltd. and the intrinsic value of shares of the two companies is respectively Rs. 20 and Rs. 8. In this case, the number of shares to be allotted to B Ltd. as purchase consideration will be determined as follows:

Total number of shares of B Ltd. *

It is significant to remember that in the calculation of purchase consideration the shares so issued will be shown at their paid-up value unless it is agreed to issue shares at market value.

Opening entries in the books of transferee (purchasing) company

It is relevant to state that AS-14 regulates the accounting treatment of amalgamation only in the books of the transferee company. The accounting procedure in the books of transferee company will differ upon the type of amalgamation (i.e. amalgamation in the nature of merger or purchase). There are two methods of accounting for amalgamation in the books of transferee company, viz. :

1The pooling of interest method,

2. The purchase method.

Amalgamation Reconstruction Study Material

The Pooling of Interest Method

This method of accounting is applicable for amaleamation in the nature of merger w business of the amalgamating companies are intended to be carried on by the amalgamaton Hence, minimum changes are made in aporeontine the individual financial statements of the amalgamaung companies. Following are the main features of this method:

(1) The assets, liabilities and reserves (whether capital or revenue or arising on revaluation of the transferor company are recorded by the transferee company at their existing carrying amounts and the same form as at the date of amalgamation.

If the transferor and transferee companies have conflicting accounting policies, a uniform set of accounting policies should be adopted to ensure uniformity. The effect on the financial statements of any changes in accounting policies if material should be reported in the year of change in accordance with

AS-5. (ii) 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 General Reserve, if any.

(iii) The identity of the reserves is maintained and they are shown in the balance sheet of the transferee company in the same form as they had appeared in the financial statements of the transferor company For example, general reserve of the transferor company will become the general reserve of the transferee company and the capital reserve of the transferor company will become capital reserve of the transferee company. As a result of this treatment, reserves which were available for distribution as dividend before amalgamation would be available for distribution as dividend after the amalgamation also.

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

Clarification : According to an opinion of Expert Committee of I.C.A.I., the difference between the issued share capital of the transferee company and share capital of transferor company (or companies) should be treated as Capital Reserve. But this will not be available for distribution to shareholders as dividend and/or bonus shares. It clearly means that if purchase consideration exceeds the share capital of transferor company, it is a capital loss and so adjustment must be made, first of all in the capital reserves and if capital reserves are insufficient then in the revenue reserves of transferor and transferee companies. However, if these two are insufficient then the unadjusted difference may be adjusted against Profit and Loss account but in no case statutory reserves should be applied for this purpose. If there is still some unadjusted balance, the net difference will be adjusted by debiting general reserve account of the transferee company. However, if the transferee company is a newly incorporated company or in case of an old company, it has no general reserve then the difference will be adjusted by debiting it to the profit and loss account.

The calculation procedure will be as follows: Purchase Consideration

Paid-up Share Capitals of the transferor company (companies)

Difference (being loss)

Adjustment against capital reserves, revenue reserves and accumulated

profits of the transferor and transferee companies

Net Difference

(V) The liquidation or realization expenses of the transferor company borne by transferee company will be debited to general reserve account or profit and loss account of the transferee company.

UNIT III

Accounts of Holding Companies

An important development of modern business organisation has been the combining on groups. Holding companies have been the most popular form of combination, modern business organization has been the combining of units into have been the most popular form of combination, particularly in U.S.A. In this case, one company acquires the whole or a large proportion of the paid-up share capital or among portion of the paid-up share capital of another so as to secure a controlling interest in that other company. The company acquiring the controming another company is called the “holding company’ or the parent company and the company which Extraosidiary company’. In this form of combination, subsidiary companies retain their institutions, and carry on their business as if they were distinct entities but their policies and management are controlled by the holding company due to latter holding a majority of shares and the consequent voting power**.**

Definition of Holding Company

Section 4 (4) of Companies Act, 1956 states that “a company shall be deemed to be the holding company of another if, but only if, that other is its subsidiary.” This definition indicates that there can be no holding company without there being one or more subsidiaries. So, in order to understand the meaning of holding company, it is necessary to know what makes a company the subsidiary of another.

Definition of Subsidiary Company

According to Section 4 (1), “a company is subsidiary of another, if, but only if –

(a) That other company controls the composition of its Board of Directors; or

(b) That other company –

(i) Where the first mentioned company is an existing company in respect of which the holders of preference shares issued before the commencement of this Act have the same voting rights in all respects as the holders of equity shares, exercises or controls more than half of the total voting power of such company; or

(ii) Where the first mentioned company is any other company, holds more than half in nominal value of its equity share capital; or

(c) The company is a subsidiary of any company which is that other company’s subsidiary.” For example,if B Ltd. is a subsidiary of A Ltd. and C Ltd. is a subsidiary of B Ltd., then C Ltd. is a subsidiary of A Ltd. as well.

AS-21 issued by ICAI has given the name ‘parent company to the holding company. According to this AS, the parent company is an enterprise that has one or more subsidiaries and subsidiary company is an enterprise that is controlled by another enterprise known as parent.

Documents to be attached to the Balance Sheet of the Holding Company

Section 212 (1) of Companies Act, 1956 requires that the following documents in respect of each subsidiary company must be attached to the balance sheet of a holding company :

(1) a copy of the balance sheet of the subsidiary :

(2) a copy of the its profit and loss account ;

(3) a copy of the report of its Board of Directors:

(4) a copy of the report of its auditors;

(5) a statement of the holding company's interest in the subsidiary as specified in sub-section 3 :

(6) if the dates of the accounting year of the holding company and the subsidiary company do not coincide then a statement showing the changes in interest, assets and liabilities in between the period from the date of closing the accounts of subsidiary company up to the date of closing the accounts of the holding company, and

(7) If for any reason the Board of directors of the holding company is unable to obtain information due to which the revenue profit of the subsidiary for the holding company can not be screamed, writing to that effect.

The financial year of Subsidiary Company: The financial year of the subsidiary company may or may not end on the same date as that of the holding company but it should not be earlier than o months from the date on which the financial year of the holding company ends.

Statement of Holding Company's Interest

Section 212 (3) provides that this statement must contain the following particulars in respect of each subsidiary company :

(a) the extent of the holding company's interest in the subsidiary at the end of the financial year of the subsidiary ;

(b) the net aggregate amount of subsidiary's profit after deducting its losses or vise versa so far as it concerns the members of holding company and is not dealt with in the accounts of holding company –

(i) for the aforesaid financial year of the subsidiary:

(ii) for the previous financial years of the subsidiary since it became the subsidiary of the holding company

(c) the net aggregate amount of subsidiary's profits after deducting its losses or vice versa so far as those profits are dealt with, or provision is made for those losses in the holding company's accounts –

(i) for the financial year of subsidiary aforesaid; and

(ii) for the previous financial years of the subsidiary since it became the subsidiary of the holding company.

Requirements of Schedule VI

Holding Company

Part 1 of Schedule VI to the Companies Act, 1956 requires that the Balance Sheet of a holding company must disclose the following: –

(i) Secured loans due to subsidiaries.

(ii) Unsecured loans due to subsidiaries.

(iii) Current debts for goods and services due to subsidiaries.

(iv) Loans and advances to subsidiaries showing separately –

(a) good and in respect of which the company is fully secured,

(b) good for which the company holds the borrower's person security only, and

(c) bad or doubtful.

(v) Investments in shares, debentures or bonds of subsidiary companies showing separately shares fully paid-up and partly paid-up and stating the different classes of shares.

Besides, Part II of Schedule VI requires that the Profit & Loss Account of the holding company must disclose the following: (i) Dividend received from subsidiary, and (ii) Provisions made for losses of subsidiary.

Subsidiary Company

In the balance sheet of a subsidiary company, the number of shares held by (i) the holding company, (ii) the subsidiaries of the holding company, (iii) the ultimate holding company, and (iv) the subsidiaries of the ultimate holding company must be separately stated in respect of subscribed share capital.

Profits and Losses of Subsidiary Companies

The profits of a subsidiary company do not become the property of the holding company unless they are properly declared as dividend. The dividend declared by a subsidiary company is accounted for in the books of the holding company in the financial year during which it is declared. But dividend declared by a subsidiary company after the date of the balance sheet of a holding company can not be included in that balance sheet unless it is in respect of a period which closed on or before the date of balance sheet.

Accounting for Dividend from Subsidiaries

For accounting the dividend received (whether final or interim) from a subsidiary in the books of holding company, it is to be seen whether the dividend paid by the subsidiary is out of its pre-acquisition profits (i.e. out of profits existing on the date of acquisition of its shares by the holding company) or out of post-acquisition profits (i.e, out of profits earned subsequent to the acquisition of its shares by the holding company).

If dividend received from a subsidiary company is out of its pre-acquisition profits, it is of capital nature from the point of view of holding company and hence must be credited to "Investment Account" because while paying the price of shares acquired, the holding company must have taken into consideration the undistributed profits and reserves of the subsidiary company existing at the date of acquisition. So cash received by way of dividend out of such profits and reserves is considered as a return of the part of the price of shares paid at the time of their acquisition and is, therefore, of a capital nature. This transaction is accounted for as follows:

Bank Account Dr

To Investment Account cr

(B) Bonus Dividend : There will be no entry for receipt of bonus shares in the books of H Ltd., since no extra payment has been made for these shares. Moreover, receipt of bonus shares does not effect the true value of equity, only the number of shares held are increased by such shares.

Consolidation of Balance Sheet and Profit and Loss

Account Consolidation of Balance Sheet and Profit and Loss Account implies preparation of a single Balance Sheet and Profit and Loss Account covering the holding company and its subsidiary company or companies. Consolidated accounts have been made compulsory under the English Law. But in India, the Companies Act, 1956 does not make it compulsory for a holding company to prepare consolidated accounts. However, as large funds of the holding company are invested in the shares of the subsidiary company, its shareholders are vitally interested in the affairs of the subsidiary company, hence it is desirable for the directors of a holding company to place before the members consolidated accounts of the group so as to enable them to understand their interest better. These statements are intended to present financial information about a parent and its subsidiary (ies) as a single economic entity to show the economic resources controlled by the group, the obligations of the group and results the group achieves with its resources.

Preparing Consolidated Balance Sheet

Consolidated Balance Sheet is prepared by aggregating the corresponding figures in the separate Balance Sheets of the holding company and its subsidiaries but it is subject to the following adjustments : –

1 Elimination of Investment in Shares Account of Subsidiary : The item "Investment in shares of Subsidiary" which appears in the Balance Sheet of the holding company, is cancelled out with the holding company's equity in the subsidiary as on date of its acquisition of subsidiary's shares. The holding company's equity in the subsidiary implies the total of holding company's share in the share capital. reserves and undistributed profits of the subsidiary as on the date of its acquisition of subsidiary's shares.

2. Calculation of Capital Profits and Revenue Profits of Subsidiary : It is essential to divide the profits of subsidiary company into capital profits (post-acquisition profits) because holding company's share in the former is set off against the cost of investment in subsidiary whereas its share in the latter is shown in the consolidated balance sheet as an addition to its profits. For this division, the date of acquisition of the shares in subsidiary is the deciding factor. Accumulated profits and reserves, which appear in the balance sheet of the subsidiary company on the date of acquisition of its shares by the holding company, are called pre-acquisition or capital profits. Profits earned and reserves built up subsequent to the date of acquisition are called post-acquisition or revenue profits and reserves. Revenue profits are shown in consolidated balance sheet as an addition to holding company's own profits and revenue reserves are added to the general reserve of the holding company.

If there are losses in the balance sheet of subsidiary company on the date of acquisition of its shares by the holding, such losses will be capital losses and the share of holding company in these losses should either be added to the cost of acquisition of shares in subsidiary company or be deducted from the holding company's equity in subsidiary. Subsidiary company's losses subsequent to the date of acquisition of shares are revenue losses and holding company's share in these losses is deducted from the holding company's own profits in the consolidated balance sheet.

The above distinction of capital and revenue profits is immaterial from the point of view of minority shareholders since their share in the total profits and reserves of the subsidiary, whether capital or revenue, is added to the amount of minority interest.

Note: If controlling interest is acquired during the course of the year, profits to the date of acquisition in the absence of any indication to the contrary, will be assumed to be accruing from day-to-day, i.e., the apportionment shall be on time basis.

3. Calculation of Goodwill or Capital Reserve : For this purpose, cost of shares acquired is compared with the value of holding company's equity in subsidiary, e.g.

Cost of Shares acquired

Less Value of Equity in Subsidiary :

Face Value of Shares acquired

Holding Co.'s share in Capital Profits

Goodwill/Capital Reserve

If the cost of acquisition of shares exceeds the value of equity, the excess is termed as goodwill or cost of control. Conversely, if the amount of value of equity in subsidiary exceeds the cost of investment, the excess is called as capital reserve. In the consolidated balance sheet goodwill is shown on the assets side and capital reserve on the liabilities side.

6. Revaluation of Assets and Liabilities of Subsidiary : If the assets and liabilities of a subsidiary were revalued at the time of acquisition of its shares by the holding company for determining the value of share. then these assets and liabilities are shown in the consolidated balance sheet at their revised values and profit or loss on revaluation is treated as capital profit or capital loss, as the case may be, and shared by the holding company and minority shareholders in proportion to their respective equity holdings. It is to be further that any increase in the value of fixed assets of the subsidiary after the date of acquisition will treated as capital profit but in case of reduction in the value of fixed assets, the loss should be treated as ordinary revenue loss.

Here is to be remembered that if fixed assets of the holding company are revalued then, pronto revaluation will be transferred to capital reserve, which may be utilised for setting off goodwill, any. the other hand, loss on revaluation will be canital loss to be set off against capital reserve. If no capital reserve exists then, this loss may be set off against general reserve or revenue profit. In the balance sheet the assets are shown at their revalued figure. Depreciation on Valuation Difference of Depreciable Fixed Assets: If on revaluation, the fixed assets of subsidiary are shown in the consolidated balance sheet at their revalued value then the total revenue profits of the subsidiary company should be adjusted for over or under depreciation provision on valuation difference of depreciable fixed assets for the period passed since the date of revaluation to the date of balance sheet. Thus, if on revaluation there is increase in the value of asset, additional depreciation on revaluation profit should be deducted from the revenue profits and excess depreciation on revaluation loss should be added to revenue profits. Here, it is to be remembered that share of holding company and minority shareholders in the revenue profits shall be determined only after adjusting these profits for the difference in the depreciation provision.

Illustration 8. From the following Balance Sheets of H Ltd. and its subsidiary S Ltd. drawn up at 31st December 2003, prepare a Consolidated Balance Sheet as at that date having regard to the following:

1 Reserves and Profit & Loss Account (Cr.) of S Ltd. stood at Rs. 25,000 and Rs.15,000 respectively on the date of acquisition of its 80% shares by H Ltd.

2. Machinery (Book Value Rs 1,00,000) Furniture (Book Value Rs 20,000) and Land (Book value of Fixing the Price of its shares ; book values of other assists remaining unchanged

Dividends of Subsidiary Company :

(A) Dividend Paid : The treatment of dividend by the subsidiary company in the books of holding company depends on the source from which dividend is paid. If it is out of pre-acquisition profits, it should be credited to 'Investment in Subsidiary Account' but if it is out of post-acquisition profits, it should be credited to Profit and Loss Account. If dividend declared by subsidiary company is partly out of pre-acquisition profits and partly out of post-acquisition profits, the dividend received by the holding company is divided into two parts in proportion to its declaration out of pre-acquisition and post-acquisition profits.

The first part is credited to Investment in Subsidiary Account and the second part, to Profit and Loss Account.

If dividend received (whether final or interim) from subsidiary company out of its pre-acquisition profits has been credited to Profit and Loss Account of the holding company then this mistake should be rectified in the consolidated balance sheet by debiting Profit and Loss Account (i.e. reducing the balance of Profit and Loss Account of holding company) and crediting Investment in Subsidiary Account (i.e. reducing the cost of acquisition of shares in subsidiary) with the amount of such dividend.

(B) Proposed Dividend : Proposed dividend appearing in the balance sheet of holding company will be shown in the liabilities side of the consolidated balance sheet under the heading Provisions.' But the amount of proposed dividend in the balance sheet of subsidiary company must be added with the current year's profits of the subsidiary and then share of holding company and minority shareholders is ascertained in the usual manner. Minority shareholders' share of proposed dividend may, alternatively, be shown as a separate item in the liabilities side of the consolidated balance sheet. If the holding company has already taken credit for its share of proposed dividend, the amount will be eliminated as mutual indebtedness, in between Proposed Dividend and Dividend Accrued.

If the directors of holding and/or subsidiary company have not appropriated the profit for proposed dividend (i.e. the item of proposed dividend does not appear in the balance sheet) but there is a proposal to do so, then the amount of proposed dividend of holding company will be deducted from its profits and shown as a separate item on the liabilities side of consolidated balance sheet. There is no need to take any adjustment for such proposal of subsidiary company. Minority shareholders' share in the proposed dividend may, alternatively, be deducted from minority interest and in that case the same will be shown as a separate item in the consolidated balance sheet.

(C) Unpaid (or Unclaimed) Dividend : Assuming that the whole amount of this item belongs to outside shareholders, it must be added in full to the total of minority interest in the consolidated balance sheet. It may, alternatively, be shown as a liability in the consolidated balance sheet. Illustration 16, Dividend from Post-acquisition Profit

The Indian Tubes Ltd. acquired the whole of the shares in the Bharat Pipes Ltd, as at 1st July 2002 at a tal cost of Rs. 11.20,000. The Balance Sheets at 30th June 2003 when accounts of both companies were prepared were as under:

UNIT IV

Meaning: Liquidation or winding up is a legal term and refers to the procedure through which the affairs of a company are wound up by law. A company is the creation of law, it cannot die itself as an natural death. So it comes to its end by law through the process of liquidation.

The Liquidation or winding up a company is a process through which life of company and it's all affairs are wound up and its property administered for benefits of its creditors and members. An administrator, who is called liquidator, is appoint to take control of company, collect its assents, pay its debts and finally if any surplus assents are left, they are divided among the members of the company in proportion to their rights under the articles. This being done the company is dissolved on compliance within the requisite formalities prescribed by the companies' ordinance.

Process of winding up:

1. Selling of the assets of the company
2. Paying off the liabilities of the company

3. If there is any deficiency to pay to the creditors and the shareholders are called upon to pay unpaid amount on their articles.

4. In case of surplus, after paying off the liabilities, it may be distributed to the contributories according to their rights under the articles.

5. At the end, the Registrar of Companies removes the name of the company from the Register of Companies which is maintained by his office.

Modes of Winding Up:

There are three modes of winding up of the company:

1. Compulsory winding up by the court
2. Voluntary winding up by members or creditors
3. Winding up under the supervision of the court

1. Compulsory winding up by the court

A company formed and registered under the ordinance, may be wound up by the court.

This kind of winding up is also called compulsory winding up.

Explanations:

1) A company needs to pass a special resolution and also court orders for winding up on the basis of some specific grounds

2) When company is unable to pay its debts
3) If company is carrying any illegal business
4) In case of non maintenance of accounts

5) When the statutory meaning is not conducted then the Court may give orders to wind up the company

6) In case of non submission of Statutory Report to the Registrar
7) if company unable to start its business within a year after incorporation

8) If company is not having minimum number of members In case of public: minimum 7 members

In case of private: minimum 2 members

9) If company doesn't follow the directions of the court or registrar or commission etc.

2. Voluntary winding up by members or creditors

The main object of a voluntary winding is that the company and its creditors shall be left to settle their affairs without going to Court, but they may apply to the court for any directions and order if and when necessary.

Explanations:

A) When the period fixed for the duration of the company has expired.
B) If the company passes the special resolution of its winding up by voluntary.
C) When the event occurs and the articles provide information that when this event will occur then company has to be wound up.

3. Winding up under the supervision of the court

When company has passed special or extra-ordinary resolution for its liquidation or winding up, court can pass an order on application of creditors, contributors or other persons for conducting of liquidation or winding up of company under supervision of court.

if company unable to start its business within a year after incorporation

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3. Winding up under the supervision of the court

When company has passed special or extra-ordinary resolution for its liquidation or winding up, court can pass an order on application of creditors, contributors or other persons for conducting of liquidation or winding up of company under supervision of court.

Format of liquidator's final statement.

LIQUIDATOR'S FINAL STATEMENT OF ACCOUNT

Receipts	Amount	Payments	Amount
Cash in hand	xxx	Secured loan/creditors	xxx
Cash at bank	xxx	Legal expenses	xxx
All Assets realized	xxx	Liquidation expenses	xxx
Any calls in arrears	xxx	Liquidator's remuneration	xxx
Any other receipts	xxx	Debenture interest	xxx
		Debenture capital	xxx
		Preferential creditors	xxx
		Unsecured creditors	xxx
		Calls in advance	xxx
		Preference dividend	xxx
		Preference capital	xxx
		Equity capital	xxx
	xxx		xxx

2. Raj ltd went into liquidation. Its assets realized Rs.2,75,000 excluding amount realized by the sale of securities held by Secured creditors

Share capital (per share 10)	1,50,000
Secured creditors (Securities realized Rs. 42,000)	40,000
Preferential Creditors	4,000
Unsecured Creditors	1,25,000
Debentures having floating charge	1,75,000
Liquidation expenses	4,000
Liquidators remuneration	6,500

Prepare liquidator's final statement of account.

Solution

Particulars	Rs	Particulars	Rs
To assets realized	2,75,000	By liquidation expenses	4,000
To surplus (42000-40000)	2,000	By liquidators remuneration	6,500
		By debentures	1,75,000
		By preferential creditors	4,000
		By unsecured creditors	87,500
	2,77,000		2,77,000

3.X Ltd. Went into voluntary liquidation on April 1,2005. The relevant details are given below

liabilities	Rs	Assets	Rs.
Share capital	4,00,000	Land and building&machinery	80,000
5000 shares of Rs. 100		Other fixed assets	2,60,000
Each Rs. 80 per share		Stock	1,05,000
paid		Debtors	1,00,000
Loans (secured by	1,00,000	Loans	40,000
mortgage of		Cash	5,000
landbuilding,machinery)		Profit loss a/c	1,10,000
Unsecured loan and			
liabilities (including	2,00,000		
preferential dues			
10,000)			
	7,00,000		7,00,000

Land and building&machinery were realized by secured creditors for Rs. 1,20,000. Other fixed assets fetched Rs.40,000, debtors Rs. 20,000, stock Rs. 10,000 loans were wholly bad. The liquidator is entitled to a fixed remuneration of Rs.1,000 plus 2% of the amount paid to unsecured creditors. The liquidators pocket expenses amounted to Rs.1,000. Prepare liquidator's final statement of account.

Solution

Particulars	Rs	Particulars	Rs
To cash	5,000	By secured creditors	1,00,000
To assets realized		By liquidation expenses	1,000
Land building	1,20,000	By liquidators	
Fixed assets	40,000	remuneration	1,000
Debtors	20,000	Fixed amount	200
Stock	10,000	On preferential	
To call money	1,00,000	creditors 10000x2%	3584
(5000x20)		On unsecured	
		creditors	10,000
		2/102x182800	1,79,216
		By preferential creditors	
		By unsecured creditors	
	2,95,000		2,95,000

4. From the particulars given below prepare liquidation final accounts allowing for his remuneration at 2 % on the amount realized on assets and 2% on the amount distributed to unsecured creditors other than preferential creditors.

Unsecured creditors	2,24,000
Debentures	75,000
Buildings realized	1,30,000
Other assets realized	7,500
Preferential creditors	70,000
Cash	20,000
Machinery realized	1,10,500

- Liquidation expenses 2,000

A call ofRs.2 per share on the partly paid 10,000 equity shares was made and duly paid except in case of one shareholder owning 500 shares.

Solution

Particulars	Rs	Particulars	Rs
To cash	20,000	By liquidation expenses	2,000
To asset realized		By liquidators remuneration	
Building	1,30,000	On assets realized 248000x2/100	4,960
Other assets	7,500	On unsecured creditors	
Machinery	1,10,500	135040x2/102	2,648
To call money 9500x2	19,000	By debentures	75,000
(10000-500)		By preferential creditors	70,000
		By unsecured creditors	1,32,392,
	2,87,000		2,87,000

UNIT-V

Accountancy is often referred to as an art – the art of recording, classifying and summarizing financial information. As is the case with any form of art, accountancy also involves the use of one's creative skills, to maintain a record of financial transactions. However, if free rein is given on the system of accountancy to be followed, there will be no limit on the scope of manipulation of accounts.

In an environment where financial statements are presented to external stakeholders such as investors, banks, stock exchanges, revenue departments, government, etc., there arises a need for an accounting framework on the basis of which the financial transactions should be recorded so as to make the resulting financial statements comparable. This need led to the framing of the Generally Accepted Accounting Principles (GAAP).

What is GAAP

Generally Accepted Accounting Principles (GAAP) are basic accounting principles and guidelines which provide the framework for more detailed and comprehensive accounting rules, standards and other industry-specific accounting practices. For example, the Financial

Accounting Standards Board (FASB) uses these principles as a base to frame their own accounting standards. Thus GAAP encompasses:
Basic accounting principles/guidelines
Accounting Standards usually issued by the premier accounting body of the country
Industry-specific accounting practices to cover unusual scenarios
In India, financial statements are prepared on the basis of accounting standards issued by the Institute of Chartered Accountants of India (ICAI) and the law laid down in the respective applicable acts (for example, Schedule III to Companies Act, 2013 should be compulsorily followed by all companies). The ICAI also releases guidance notes from time to time on various topics to help in the accounting process and provide clarity. While the basic accounting principles may not directly form part of the accounting standards and the related laws, they are assumed and expected to be universally followed.
Generally Accepted Accounting Principles
The following are the general accounting principles as mentioned earlier:

Business Entity Assumption: It states that every business entity should be treated as an entity that is separate from its owners. Therefore, all financial transactions should also be distinguished in such a manner. This concept is especially important while recording financial transactions of a sole proprietor. When the entire business with its assets and liabilities belong to the proprietor, the financial transactions need to be distinguished between those related to the business and those related to the proprietor personally.

Monetary Unit Assumption: All the financial transactions of a business should be capable of being expressed in a monetary unit (Indian Rupees, for example) and if it is not possible to do so, then it should not be recorded in the books of accounts of the business.

Accounting Period: This principle entails that the accounting process of a business should be completed within a certain time period which is usually a financial year or a calendar year. Thus, every transaction which relates to a particular accounting period will form a part of the financial statements prepared for that period.

Historical Cost Concept: As a general rule, when certain economic resources or assets are acquired by an enterprise, they are recorded as per the cash or cash equivalent actually spent to acquire that resource or asset on the transaction date – even if the transaction happened the previous day or ten years ago. This would result in the value of the remaining asset constant irrespective of the accounting period. The market value of the asset is not taken into account unless specifically required by law or an accounting standard.

Going Concern Assumption: The business entity is assumed to be a going concern, i.e., it will continue to operate for an indefinite amount of time. This assumption is important because if the business entity were to liquidate in the near future, it would have to restate its assets and liabilities in the accordance with the actual amount that could be realised or payable as the case may be so as to reflect the true financial position of the entity.

Full Disclosure Principle: An accounting entry may not independently be able to provide all the relevant information relating to the transaction. Hence the full disclosure principle requires the entity to disclose all the financial information relevant to the investor/user to assist him in decision making. At the transactional level, this is done by recording an adequate narration with every transaction and at the financial statement level, this is implemented by providing notes to the accounts.

Matching Concept: This concept requires the revenue for a particular period to be matched with its corresponding expenditure so as to show the true profit for the period.

Accrual Basis of Accounting: This principle requires all revenue and expenditure to be recorded in the period it is actually incurred and not when cash or cash equivalent has been received/spent. The earning of the income and the incurring of the expenditure is important, irrespective of the corresponding cash flow.

Consistency: An entity may decide to follow a particular accounting procedure in relation to a series of transactions. Such accounting procedures need to be followed consistently over the following accounting periods so as to facilitate comparison of the results between two periods. For example, an entity might choose to adopt the straight-line method of depreciation of its tangible fixed assets. This method needs to be consistently followed even in the coming years.

Materiality: This accounting principle allows an entity to disregard another accounting principle if the result of the same does not affect the decision making of the user of the financial statements. Certain errors or omissions may also be ignored if their effect is immaterial to the financial statements. For example, when a fixed asset is purchased, the matching concept requires the entity to recognise the expenditure over the useful life of the asset. If an entity purchases a keyboard for Rs. 300 and the turnover of such an entity is in crores of rupees, it would be immaterial to the user of financial statements whether such an asset is recognised as an asset or expense. Thus, even if the computer keyboard is considered as an expense in the year of purchase, it would not be violating the basic accounting principles since the amount involved and the impact of the same is immaterial.

Conservatism: In the process of accounting, one might come across various situations where there are two equally acceptable ways of accounting for a particular transaction. One might even have to choose between recording a transaction or not recording the same. In such a situation, a conservative approach should be followed. This means that while accounting for a particular transaction, all anticipated expenses or losses will need to be accounted for but all potential income or gains should not be recorded until actually earned/received. This is why a provision for expenses like bad debts is made but there is no corresponding record provided for an increase in the realisable value of an asset.

Accounting Standards

Definition:

According to ICAI (Institute of Chartered Accountants of India), accounting standards are "written documents, policies, procedures issued by expert accounting body or government or other regulatory body covering the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transactions in the financial statement".

Accounting standards are issued by the "Institute of Chartered Accountants of India" (ICAI).

Objectives or Need for Accounting Standards:

1. Standardize the diverse accounting policies.
2. To eliminate to the extent possible the non comparability of financial statements.
3. It adds the reliability to the financial statements.
4. It increases the arithmetic accuracy of financial statements.
5. Accounting standards helps to understand accounting treatment in financial statement.

Advantages of Accounting Standards:

1. Accounting standards reduces or eliminates confusing variation in the accounting treatments used to prepare the financial statements.
2. Accounting standards may call for disclosure beyond that required by law.
3. It facilitates comparison of financial statements of different companies.

Disadvantages:

1. There may be a trend towards rigidity.
2. It is away from flexibility in applying accounting standards.
3. Accounting standards cannot override the law.
4. Differences in accounting standards are bound to be because of differences in the legal system and traditions from one country to another.

Procedure for issuing accounting standards by ICAI:

The following procedure is adopted for formulating the accounting standards:

1. Accounting Standards Board shall determine the need and priority in regard to the selection thereof.
2. Formation of study groups by ASB.
3. ASB will also hold a dialogue with the representatives of the Government, Public Sector Undertakings and Industry for ascertaining their views.
4. Based on the work of Study Groups and the dialogue with the organizations referred to above, an exposure draft of the proposed standards will be prepared.
5. The draft of the proposed standard will include the following basic points:
   - Concepts and fundamental accounting principles relating to the standard.
   - Definitions of the terms used in the standard.
   - The manner in which the accounting principles have been applied.
   - The presentation and disclosure requirements.
   - Class of enterprises to which the standards will apply.
   - Date from which the standard will be effective.
6. Finalization of proposed standards by ASB and submitted to the Council of the Institute.
7. Modification or issue of accounting standards is the authority of the Council.