Bachelor of Commerce
(B.Com.)

Corporate Accounting

(OBCMCO301T24)

Self-Learning Material
(SEM- III)

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Centre for Distance and Online Education

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Jaipur National University

Course Code: OBCMCO301T24
Corporate Accounting

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Expert Committee

Prof. R.L. Raina
Former Vice Chancellor, JKLU
Professor of Communication, IIM Lucknow

Prof. J.K. Tandon
Former Dean, Faculty of Commerce
Former Head of EAFM Department
University of Rajasthan

Course Coordinator

Mr. Girdhar Agarwal
Assistant Professor
Department of Business & Management, JNU, Jaipur

Unit Preparation

Unit Writers

Dr. Vicky Likhar
Department of Business & Management, JNU, Jaipur
(Unit 1-5)

Ms. Neha Goyal
Department of Business & Management, JNU, Jaipur
(Unit 6-10)

Ms. Indra Sharma
Department of Business & Management, JNU, Jaipur
(Unit 11-15)

Assisting & Proof Reading

Dr. Harish Kumar
Department of Business & Management, JNU, Jaipur

Editor

Prof. Prashant Madan
Jaipur National University, Jaipur

Secretarial Assistance

Mr. Nitin Parashar

Course Introduction

Corporate Accounting is assigned 5 credits and contains 15 units. Application of Corporate Accounting develops proficiency in utilizing accounting software and tools, preparing students for practical, real-world financial management and decision-making.

The decisions taken on the basis of Corporate Accounting are subject to evaluation and objective assessment.

Each unit is divided into sections and sub-sections. Each unit begins with statement of objectives to indicate what we expect you to achieve through the unit.

Course Outcomes

After studying this course, a student will able to:

1. Describe foundation in accounting and reporting requirements of the Companies Act and relevant Indian Accounting Standards.
2. Discuss and understanding of the advanced issues in accounting for assets, liabilities and owner's equity.
3. Evaluate and solve Account for mergers and amalgamations, Value goodwill and shares under various methods.
4. Develop treatment regarding issue of bonus shares and treatment of prior period profits
5. Apprise the accounting of various companies
6. Prepare accounting reports relevant to Indian corporate accounting standards

We hope you will enjoy the course.

Acknowledgement

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Unit- 1

International Financial Reporting Standards (IFRS)

Learning Outcomes:

- Students will be able to learn the scope and objectives of IFRS.
- Students will get knowledge of the International Accounting Standards Board (IASB).
- Students will be able to differentiate between IFRS and US GAAP.

Structure:

1.1. Meaning of IFRS

Meaning of IFRS

Scope and Objectives of IFRS

Overview of IFRS

IFRS issues to date

1.2. International Accounting Standard Board (IASB)

What is IASB?

Role of IASB

Knowledge Check 1

Outcome-Based Activity 1

1.3. Disclosures as per IFRS

Disclosure requirements as per IFRS

Advantages of IFRS to Indian Companies

Difference between IFRS and Indian Accounting Standards

US GAAP

Knowledge Check 2

Outcome-Based Activity 2

1.4. Summary

1.5. Self-Assessment Questions

1.6. References

1.1. Meaning of IFRS

IFRS stands for International Financial Reporting Standards. The IFRS provides a set of accounting rules that enables companies to prepare their annual accounts and financial statements. IFRS assists organizations in identifying how a particular transaction or event will be recorded in the financial statements. They help maintain transparency and credibility of the financial statements and provide a clear picture of the state of affairs prevailing in an organization. In this manner, it assists investors in making informed decisions on financial matters. IFRS are issued and maintained by the International accounting standards board (IASB). They establish commonality in accounts of different countries. Thus, it helps in comparing the financial statements of various companies at various geographical locations.

IFRS brings uniformity in accounting that makes the financial statements of the company compatible across different countries worldwide. Nowadays, IFRS has emerged as the new accounting standard in the world. The four basic principles of IFRS are relevancy, clarity, reliability, and comparability. IFRS was first published in the year of 2003. Since then, it has been adopted by around 144 jurisdictions worldwide. However, the government of the United States still follows US GAAP for accounting purposes. Before IFRS, international accounting standards (IAS) were applicable.

Scope and Objectives of IFRS

IFRS creates an accounting culture of transparency and trust in the financial market around the globe and the companies listed on the global markets. It makes the investors believe in the financial statements of an entity. IFRS helps in developing the faith of the investors in any information presented by an organization. There will be an unstable economy and few international transactions. It helps in conducting financial and fundamental analyses of a company's performance. IFRS serves a multitude of purposes. Some of the major objectives of IFRS are as follows:

a) **Creation of common law**: to bring every organization in various jurisdictions on the same page, IFRS aims to introduce a common law that is implemented and adopted by companies globally. It shows that the organization follows common guidelines and rules for preparing the financial statements and implements them to ensure commonality.

b) **Conducting meaningful analysis:** IFRS ensures the credibility and accuracy of data. It helps in categorizing the financial data and reporting them with accuracy and consistency. Such transparency and answer records help in better understanding and decision-making. Thus, it helps the stakeholders in evaluating the performance of an organization and interpreting its financial health.

c) **Preparation of reliable financial records:** The international financial reporting standards provide a uniform set of rules that enables organizations to prepare books of accounts that are accurate, uniform, reliable and transparent. This high quality of financial records is useful for various stakeholders of an organization.

d) **Ensures flexibility, transparency, and compatibility in the reporting**: since it encourages consistency in the preparation of financial statements, it helps in easy comparison of those financial statements of companies following IFRS across the nations. This comparison provides investors with the ability to compare risks and opportunities before making any investment decisions. It also boosts foreign trade and investments. It requires three disclosure of the information that is relevant to the stakeholders. However, the guiding rules and principles are not rigid and can be flexibly adopted by the companies.

Overview of IFRS

The European Union introduced IFRS intending to make business affairs and accounts accessible across the globe. It was quickly adopted by various jurisdictions and became the common accounting language of nations. IFRS is a mandatory requirement for public companies and is followed in the European Union, Section 62(1)(a) of the Companies Act, 2013 permits a public or private company to increase its subscribed share capital by offering new shares to the market. However, the governance and voting rights of the existing owners are diminished by the issuance of more shares. Consequently, the rights of the existing stockholders are preserved. As per the 2013 Companies Act, present shareholders are entitled to a one-two the option to apply right away in the case of recently issued shares. Current shareholders may subscribe for shares if they so want. But, if people decide not to subscribe for the shares, they can also forego these advantages. IFRS issues to date

Following are the International Financial Reporting Standards (IFRS) that are issued to date:

IFRS issued to date	Particulars	Year of issue
IFRS 1	First-time Adoption of International Financial Reporting Standards	2008
IFRS 2	Share-Based Payment	2004
IFRS 3	Business Combinations	2008
IFRS 4	Insurance Contracts (Will be superseded by IFRS 17 as of 1 January 2023)	2004
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations	2004
IFRS 6	Exploration for and evaluation of mineral resources	2004
IFRS 7	Financial Instruments: Disclosures	2005
IFRS 8	Operating Segments	2006
IFRS 9	Financial Instruments	2014
IFRS 10	Consolidated Financial Statements	2011
IFRS 11	Joint Arrangements	2011
IFRS 12	Disclosure of interests in other entities	2011
IFRS 13	Fair Value Measurement	2011
IFRS 14	Regulatory Deferral Accounts	2014
IFRS 15	Revenues from contracts with customers	2014
IFRS 16	Leases	2016
IFRS 17	Insurance Contracts	2017

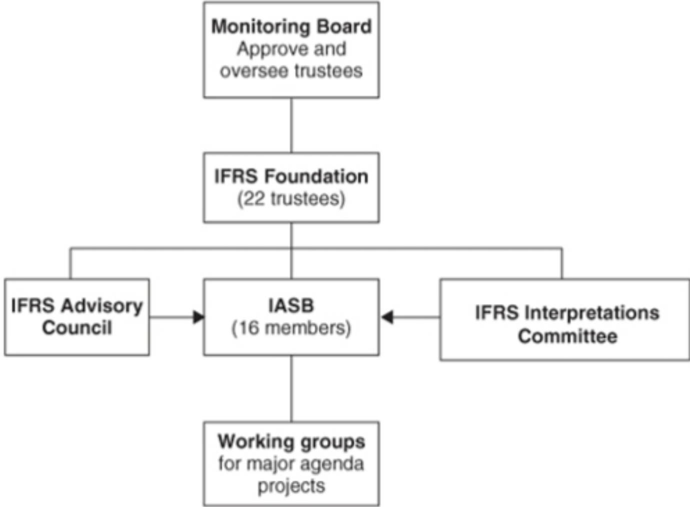
1.2. International Accounting Standard Board (IASB)

What is IASB?

In 1973, International Accounting Standards Committee (IASC) was established that issued several standards on accounting known as International Accounting Standards (IAS). The

organization was re-formed in 2001, and it changed from International Accounting Standards Committee (IASC) to International Accounting Standards Board (IASB). A foundation known as International Accounting Standards Committee Foundation (renamed as IFRS Foundation in 2010) was formed to oversee the IASB. It was then in 2001, it was decided that the newly issued accounting standards will be referred to as IFRS instead of IAS. In 2021, the IFRS foundation established the International Sustainability Standards Board (ISSB), a sister concern to IASB. ISSB was established to assist IASB in setting the standards. The newly issued IFRS is a combination of accounting principles and sustainability-related issues. The naming convention for the new accounting standards shall be IFRS-S.

Therefore, it can be concluded that IASB is a non-profit independent and private body drafting and developing the International Financial Reporting Standards. IASB consisted of 14 members originally, and each member had voting power. The members are a group of experts, having expertise and experience in the field of market finance, accounting, and academic work from various geographical locations. The IFRS Interpretation Committee, on the other hand, has 15 members. It is an interpretative body. The major role of the IFRS Interpretation Committee is to give guidance on the application of IFRS.



Role of IASB

The IASB is under the umbrella of the IFRS foundation. The major role of IASB are enumerated as follows:

a) To draft and develop the international financial reporting standards in consultation with the general public and the trustees of the board.
b) To issue the exposure draft of the IFRS. The exposure draft of the IFRS is generally issued after following the transparent, exhaustive, and inclusive guidelines of the relevant statutes
c) To issue the analysis and interpretations that are formulated by the IFRS interpretations committee.
d) To periodically review and update the IFRS issued considering the needs of the changing times.

Knowledge Check 1

Fill in the Blanks:

1. IFRS helps in maintaining ____________ and _____________ of the financial statements and provides a clear picture of the state of affairs prevailing in an organization.
2. To bring every organization in various jurisdictions on the same page, IFRS aims to introduce a ____________ that is implemented and adopted by companies globally.
3. The ____________ introduced IFRS to make business affairs and accounts accessible across the globe.
4. In 2021, the IFRS foundation established ___________ a sister concern to IASB.
5. The IFRS Interpretation Committee is an _____________body and has around ____________ members.
6. The International Accounting Standards Board is under the umbrella of the _________ foundation.
7. The role of IASB includes issuing the ____________ and ________ that are formulated by the IFRS interpretations committee.

Outcome-Based Activity 1

Identify and analyze the major requirements of the following IFRS:

a) IFRS 3 b) IFRS 6 c) IFRS 9 d) IFRS 12

Provide a summarized explanation and application of the IFRS.

1.3. Disclosures as per IFRS

Disclosure requirements as per IFRS

The disclosure requirements of the IFRS issued to date are enumerated as follows:

a) **IFRS 1** demands the reporting entity to provide an explanation of how the organization's cash flows, accounts, financial reporting, and performance were impacted by the switch from the previous generally accepted accounting rules to IFRS. This entails balancing the equity recorded under the old GAAP with IFRS on the transition date as well as when yearly reports are being prepared. Moreover, the reporting entity is also required to disclose the total comprehensive income, an explanation of the material adjustments, errors that were discovered in the previous GAAP, recognition, reversal of impairment, losses, etc.
b) **IFRS 2** requires the reporting entity to make adequate and extensive disclosures to enable the users of the financial statements to understand and comprehend the nature of share-based transactions that were entered into during the year.
c) **IFRS 3** requires the reporting entity to disclose the initial date of the business combination and the initial accounting treatment of the components of financial statements, such as the assets, liabilities, equity, etc. Moreover, the reporting entity is required to disclose the status of the contingent consideration and recognition of the contingent liabilities.
d) **IFRS 4** requires the reporting entity to disclose to the users of the financial statements the portion of the amount that appears in the insurer's financial statements that are funded by the insurance contracts. It also requires the reporting entity to disclose information on accounting policies and the recognition of assets, liabilities, and equity.
e) **IFRS 5** requires the reporting entity to disclose information on the assets or the disposal group of assets that are identified as held for sale in the financial statements. Further disclosure includes the description of the non-current assets. The estimated time required to sell the asset, facts, and information on the sale, impairment losses, reversal of impairment, losses, and reportable segment of the reporting entity, to which the asset belongs.
f) **IFRS 6** requires the reporting entity to disclose information on the amounts that are recognized in the financial statements as arising from the exploration of mineral

resources. It further requires disclosure of the number of assets, liabilities, income, expenses, operating cash flow, cash flow arising from investing activities, etc.

g) **IFRS 7** requires the reporting entity to disclose information on the importance of financial instruments and the nature and extent of risk that arises from the financial instruments.

h) **IFRS 8**: requires the reporting entity whose securities such as debt and equity Are listed on the recognized stock exchange and traded publicly to disclose such information to enable the users of the financial statement to analyze the nature and effects of the business activities in which the organization yeah, engages. It also requires disclosure of the different economic and social environments in which the entity operates.

i) **IFRS 9**: this standard has amended some of the disclosure requirements of IFRS 7. The additional disclosures R information on the equity in instruments that are identified as fair value through other comprehensive income that is FVTOCI. Rather requires the reporting entity to disclose the risk of managing activities, hedge accounting, management of credit, risk, and management of impairment.

j) **IFRS 10, IFRS 11 & IFRS 12,** there are no disclosures as per IFRS 10 and IFRS 11. However, IFRS 12 outlines the disclosures that are required. IFRS 12 requires the reporting entity to disclose such information that will enable the users of the financial statement to analyze and evaluate the risk that is related to investments in a subsidiary or joint venture or joint arrangement, or an associate or inner and consolidated and unstructured entity.

k) **IFRS 13** requires the reporting entity to disclose the fair value of the assets and liabilities that are appearing in their financial statements

l) **IFRS 14** requires the reporting entity to disclose to the users of the financial statement to enable them to assess the type of risk that is associated with the regulation of rate and price that an entity can charge from the customers for goods or services provided by them. It further requires the reporting entity to disclose the effect of the regulation of rate on the financial statements of the entity. The disclosure also includes the basis on which the balances of the regulatory deferral accounts are recognized and assessed.

m) **IFRS 15** requires the reporting entity to disclose the qualitative as well as quantitative information of the annual and interim periods. This includes the disclosure of revenue

disaggregation, contact, balances, performance obligations, and the significant judgments that are required in the application and implementation of the standards

n) **IFRS 16** This requires reporting entity to provide both qualitative and quantitative disclosures to the users of the financial statements to enable them to analyze the effect of the lease that would have an impact on the financial statements.

o) **IFRS 17** requires the reporting entity to provide specific disclosures on the group of insurance contracts that are in force during the transition period.

Advantages of IFRS to Indian Companies

As the IFRS is gaining huge popularity all around the world, the adoption of IFRS would be beneficial for the Indian economy. In 2007, India announced the complete adoption of IFRS 2011. The adoption of IFRS was supposed to be completed in phases.

Phase 1 required the companies that are listed on the NSE (Nifty 50) Index, the BSE (Sensex 30) Index, companies that have shared securities listed on a recognized stock exchange outside India, and listed companies with a net worth of more than 1000 crores to prepare their financial statements as per IFRS by 1st April 2011.

Phase 2 required listed and unlisted companies having a net worth of more than 500 crores but less than 1000 crores to prepare their financial statements as per IFRS by 1st April 2013.

Phase 3 required the companies having a net worth of fewer than 500 crores to prepare their balance sheet as per IFRS by 1st April 2014.

However, the plan could not be implemented by March 14. The Institute of Chartered Accountants of India (ICAI) recommended to the Ministry of Corporate Affairs (MCA) implementation of Indian Accounting Standards, and hence the new roadmap for implementation of IFRS/Ind-AS was issued as follows:

Phase 1 Ind AS was mandatory for the companies that were unlisted or listed in India and had a net worth of more than or equal to 500 crores from 1st April 2017.

Phase 2 Ind AS was mandatory for the companies that were listed or were about to be listed by 31 March 2016 and had a net worth of more than or equal to 250 crores but less than 500 crores from 1st April 2017.

Phase 3 Ind AS for the banks, insurance companies, and NBFC companies having a net worth of more than or equal to 500 crores from 1st April 2018.

The adoption of IFRS has a multitude of benefits that are enumerated as follows:

a) **The Growth of the economy**: The Ministry of Corporate Affairs and the Institute of Chartered Accountants of India have issued general guidelines regarding the convergence of Indian accounting standards with the IFRS. This is expected to benefit the Indian economy through humongous growth in international trade and commerce. The capital market will be efficient, it will increase capital formation and attract foreign investments and hence result in economic growth.

b) **Benefit the corporate world**: The financial statements prepared following the new standards will be transparent, clear, and comparable, which will help in building the trust of the investors and shareholders. It will also enable foreign multinationals to understand and evaluate the financial position of the organizations. This will also help Indian companies to raise additional capital from the international market.

c) **Benefit the investors**: The financial statements prepared after the adoption of IFRS/Ind-AS will be understandable and comprehensible by investors all around the world. The investors will not be required to convert the financial statements. This will not only save time but also provide investors with an opportunity to invest in the Indian market.

d) **New job opportunities**: The accounting professionals who know IFRS will be able to sell their knowledge and experience in India and different parts of the world. They will also prove to be meaningful resources for multinational organizations and large Indian companies to transition their accounts from previous GAAP to Ind AS.

Difference between IFRS and Indian Accounting Standards

IASB has released a set of accounting guidelines known as International Financial Reporting Standards (IFRS) for use in the financial statements of publicly traded companies. The goal of IFRS is to make financial statements easily comparable across borders, transparent, and understandable. Each nation used its own unique set of generally accepted accounting rules for the preparation and presentation of financial statements prior to the adoption of IFRS. The Indian Accounting Standards are referred to as Ind AS. The International Financial Reporting Standards and Indian Accounting Standards have converged to form Ind AS. The national advisory council on accounting standards (NACAS) and the Institute of Chartered Accountants of India (ICAI) were consulted before the federal government of India released Indian Accounting Standards, or Ind AS. Several of the main distinctions between the

a) The IFRS is a globally recognized accounting standard. However, the Ind As is a modified version of IFRS. It is specific to Indian companies and is not followed anywhere else. IFRS is followed in 144 countries around the world.
b) IFRS is developed by the International Accounting Standards Board (IASB), whereas Ind AS is developed by the Ministry of Corporate Affairs along with the ICAI in consultation with NACAS.
c) Companies following the IFRS have to disclose this by way of a note that the accounts are prepared by the IFRS whereas no such disclosure is required in the case of Ind AS.

- **US GAAP**

For the purpose of financial reporting, a set of widely accepted accounting standards and principles is known as US GAAP, or GAAP (widely Accepted Accounting Principles). The U.S. Securities and Exchange Commission (SEC) adopts US GAAP. Standardization, definitions, concepts, principles, and industry-specific regulations are all included in the overview of US GAAP. Ensuring that financial statements are clear, consistent, and understandable from one business to another is the primary goal of US GAAP. Despite the fact that US GAAP guarantees uniformity and openness in the financial statement creation process. They do not guarantee that a business's financial statements and books of accounts are devoid of inaccuracies or false assertions that could deceive investors.

The SEC has expressed its willingness to shift from the US GAAP to IFRS, but there is a significant difference, and the convergence might be too slow and time-consuming. The US GAAP or not regulated. However, it exists because of the combined efforts of the government and business houses. It is not mandatory for all the corporate's, but the SEC has made it mandatory for companies that are publicly traded and regulated to follow GAAP for their financial reporting purposes.

The companies that issue stock are required to get their accounts audited by an independent external auditor and are mandatorily required to follow the standards, but the companies with no external investors are not under the obligation to prepare accounts as per US GAAP. In 2008, SEC came up with a draft roadmap to ensure that around 100 companies in the United States of America join the universally accepted standards i.e. IFRS for the preparation and presentation of financial statements.

Knowledge Check 2

State whether the given statements are true or false

1. As per IFRS 1, the reporting entity is required to disclose the total comprehensive income
2. As per IFRS 6, the reporting entity is required to disclose information on the amounts that are recognized in the financial statements as arising from the sale of assets classified as held for sale.
3. Ind AS was mandatory for the companies that were unlisted or listed in India and had a net worth of more than or equal to 500 crores from 1st April 2017 and belonged to Phase 3 of the new roadmap issued by the ICAI
4. The Ministry of Corporate Affairs and the Institute of Chartered Accountants of India have issued general guidelines regarding the convergence of Indian accounting standards with the IFRS

Outcome-Based Activity 2

Briefly describe the disclosure requirements as per IFRS 2, IFRS 4, IFRS 6, IFRS 10 and IFRS 12, IFRS 14, and IFRS 16.

1.4. Summary

- IFRS stands for International Financial Reporting Standards.
- IFRS serves a multitude of purposes, such as the creation of common law, conducting meaningful analysis, preparation of reliable financial records, and ensuring flexibility, transparency, and compatibility in reporting.
- The European Union introduced IFRS to make business affairs and accounts accessible across the globe.
- IASB is a non-profit independent and private body drafting and developing the International Financial Reporting Standards. IASB consisted of 14 members originally, and each member had voting power.
- US GAAP or GAAP (Generally Accepted Accounting Principles) are a set of generally - followed accounting principles and standards for financial reporting purposes.

1.5. Self-Assessment Questions

1. What are the scope and objectives of IFRS?
2. What is the role of IASB?
3. What are the advantages of IFRS to Indian Companies?
4. Give differences between IFRS and Ind AS.
5. Write a short note on US GAAP.

1.6. References

- Illustrated Guide to Indian Accounting Standards by B.D. Chatterjee and Jinender Jain
- ACCA Diploma in International Financial Reporting DIPIFR Book By BPP Professional Education
- Wiley 2022 Interpretation and Application of IFRS Standards
- Bharat Practical Guide to Ind AS & IFRS With Exhaustive Case Studies & Comprehensive IIlustrations by KAMAL GARG Edition 2020
- International Financial Reporting Standards (IFRS) & Indian Accounting Practices by Raiyani Jagadish R

Unit- 2

Valuation of Goodwill

Learning Outcomes:

- Students will be able to understand the meaning and features of Goodwill.
- Students will get knowledge of factors that affect Goodwill.
- Students will be able to understand different methods of valuation of Goodwill.

Structure:

2.1. .... Meaning of Goodwill

Meaning of Goodwill

- Features of Goodwill
- Factors affecting the value of Goodwill
- Types of Goodwill

2.2. ....Goodwill as an Asset

What is Goodwill as an Asset

Knowledge Check 1

Outcome-Based Activity 1

2.3. Methods of valuation of Goodwill

Average Profit Method

Weighted Average Profit Method

Knowledge Check 2

Outcome-Based Activity 2

2.4. .... Summary

2.5. .... Self-Assessment Questions

2.6. ....References

2.1 Meaning of Goodwill

The value of reputation and brand that an organization generates over time is termed goodwill. It is calculated with respect to the future maintainable profits that are over and above the normal profits of an organization. An organization that is well-established in the market earns the respect of its investors and stakeholders. Such entities usually have a strong business network and build good connections. This is an added advantage to the existing organization. The monetary value of this advantage that another organization or investor is ready to pay for is termed goodwill. The buyer pays extra for the Goodwill and expects to enjoy the supernormal profits generated by the firm as compared to others. Thus, it can be concluded that goodwill is expected only in the case of firms and organizations earning super-normal profits and not organizations with normal profits or losses. It is an intangible asset that cannot be touched or felt but exists and can be traded upon. It has value and plays a significant role in an organization.

Features of Goodwill

Goodwill is an intangible asset that is generally calculated at the time of acquisition of one company by another. It is the price paid over and above the net fair value of the assets of an organization. The unique characteristics and features of goodwill are defined as follows:

a) **Intangible Asset:** Goodwill is an intangible asset, i.e., it cannot be touched or seen but can be felt. It plays an essential role in the valuation of the business. It belongs to the group of trademarks, patents, copyrights, etc. Its value does not depreciate over a period of time, and hence no depreciation is charged on the same.

b) **Value of Goodwill constantly fluctuates**: Although goodwill is a non-depreciable asset, its value is liable to constant fluctuations and variations. It is present as an invisible asset only in situations where there are excess profits. Its value decreases with the decrease in the earnings of an entity.

c) **Valued only in case of a disposition of the entire business**: The value of goodwill is calculated only when the business is sold entirely to another organization. It cannot be sold in parts or in shares.

d) **Amount of Goodwill**: It is advisable to calculate the value of goodwill only at the time of the transaction as the value of goodwill varies from time to time and depends highly on the internal and external business environment.

e) **Source of generating revenue**: Goodwill is the reputation and the brand name that an entity earns over a period of time. It helps the company to generate extra revenue by gaining a share of the market. This generates extra profit for the organization.

f) **Value-generating asset**: Goodwill is considered a valuable asset, and there are numerous methods for estimating its value. This includes the average profit method, weighted average profit method, super profit method, capitalization of super profit method, etc.

Factors affecting the value of Goodwill

The value of goodwill keeps on fluctuating and depends on a variety of factors that are enumerated as follows:

a) **Location of the business**: When a business is at a favourable or accessible location, it is more appealing to the customers and therefore, it increases the value of the goodwill.

b) **Efficient management**: The efficiency of the management is a driving force of any business. If the business is managed and operated by skilled and effective management, the profits of the business will increase and thereby increase the value of the goodwill.

c) **Longevity of a business**: One of the factors that increase the value of goodwill is the longevity of the business. If the business is old, it is better recognized and perceived by the customers and hence is more appealing. The longer the business, the more the number of customers. The wide customer base is an indication of the profit-generating capability of a business entity.

d) **Nature of goods and services:** Goods and services that belong to the daily utility category will have stable profits as the demands of these goods and services will be constant and regular. Such business will generate more goodwill. However, if the transaction is in fancy items, the profit will be indeterminate, and therefore, it will be hard to ascertain the value of the goodwill.

e) **Possession of a valid license:** If a firm possesses a valid import-export license and the goodwill of the firm will be high as it will be difficult for other firms to enter the industry, and hence the threat of new entrants will be less.

f) **Money market situation and support of the government**: Where the business is supported by the government. Customers are willing to spend their money on the products and services of such organizations, which increases goodwill. Similarly, when the conditions of the money market are favourable, that is it is easy to borrow money for the expansion of business or the cash flows are easily realizable, the goodwill of the industry, and thereby the firm may increase.

g) **Profit trend and capital required**: If the profits are constantly increasing, the value of goodwill will tend to increase. However, if the profit is undefined, the value of the goodwill will be much lesser. On a similar note, if two businesses are in the same industry, making a profit at a similar rate, the business that requires lesser capital shall have more goodwill.

h) **Monopolistic rights and the risk involved:** If a business has a monopoly in the market, it is guaranteed that it will be profit-generating. The monopolistic business has certain privileges, such as copyrights and patents, and these intangible assets, along with tangible assets, increase the value of any business. Similarly, if the business is risky, the value of the goodwill will be low.

- **Types of Goodwill**

Goodwill can be classified into two categories that are enumerated and defined as follows:

a) **Purchased Goodwill:** When an organization plans to acquire another organization, the consideration paid for the acquisition of the business that exceeds the value of net identifiable assets is termed purchased goodwill. It is the premium over and above the net fair value of assets. Sometimes the premium is also connected with the option of cutting down the cost when the negotiation between the new and existing entity is violated. The value of the well-known reputation or the solid customer base is paid as a premium by the acquirer, and the premium is referred to as purchase goodwill. The accounting entries for the purchased goodwill are disclosed in the balance sheet of the company.

b) **Self-generated or inherent goodwill**: Inherent goodwill or self-generated goodwill is the fair value of the net assets of an organization. It is internally generated goodwill, and it is due to the status and reputation of the business. The value of goodwill may be negative or positive. Positive goodwill happens when the value of a business is higher than the net

fair value of the assets. It is adverse when the value of a business is lower than the net fair value of the assets.

2.2. Goodwill as an Asset

- **What is Goodwill as an Asset**

Goodwill is an intangible asset of an organization that is generally associated with the purchase of an entity. It is a competitive advantage that an entity enjoys. The value that is paid over and above the net assets of the acquiree is the goodwill of the acquiree. If the acquiring company pays less than the net asset, it is negative goodwill. This means the sale is a distressed sale or there is a bargain purchase gain. Goodwill is recognized as an intangible asset under the head of long-term assets in the balance sheet of an entity. Under the Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS), the goodwill of a business entity must be tested for impairment at least annually. Goodwill is different from other intangible assets as it is the premium paid over and above the fair value of the assets of the company. It is an asset that cannot be sold independently. Other intangible assets, such as patents, trademarks, and copyrights, can be purchased or sold independently. The life of goodwill is indefinite.

For instance, the assets minus liabilities of Reyu Ltd is INR 12 lakhs. However, Sal Ltd purchased Reyu Ltd at INR 15 lakhs. The premium i.e. (15-12) lakhs i.e. INR 3 lakhs is termed as goodwill and will appear in the balance sheet of Sal Ltd as goodwill. Similarly, if Reyu Ltd was acquired by Sal Ltd at INR 11 lakhs, then 1 lakh shall be termed a Bargain Purchase Gain or adverse goodwill.

Knowledge Check 1

Fill up the Blanks.

1. The buyer pays extra for the Goodwill, which is generally the ________________ profits generated by the firm as compared to others.
2. Goodwill is ________________ asset that cannot be touched or felt but exists and can be traded upon.
3. Although goodwill is a ________________ asset, its value is liable to constant fluctuations and variations.

4. The value of goodwill varies from time to time and depends highly on the ______________ and ________________ business environment.
5. Where two businesses are in the same industry, making a profit at a similar rate, the business that requires _________________ capital shall have more goodwill.
6. When an organization plans to acquire another organization, the consideration paid for the acquisition of the business that exceeds the value of _______________ is termed as ________________.

- **Outcome-Based Activities 1**

Calculate the value of goodwill/ bargain purchase gain in each of the following cases:

1) The following data relates to ABC Ltd:

a) Value of assets = $ 150,000

b) Value of liabilities = $ 90,000

c) Consideration Paid = $ 100,000

2) The following data relates to XYZ Ltd:

a) Value of assets = $ 100,000

b) Value of liabilities = $ 60,000

c) Consideration Paid = $ 20,000

2.3. Methods of valuation of Goodwill

The goodwill is valued on the basis of assumptions made by the valuer. A well-developed and successful business earns a reputation in the respective market, develops trust with its clients, and has an extensive network. All these factors lead to the evaluation of the goodwill of the business and estimating its financial worth. The entity that is looking forward to buying such a company hopes to gain supernormal profits in the near future. Therefore, it is essential to calculate the value of goodwill in order to assess the supernormal profits that will be earned on the acquisition of such a company. There are several methods of valuation of goodwill, and that are enumerated as follows:

1. **Average Profits Method:** Average Profit Method is one of the easiest methods for the calculation of goodwill. This method is commonly used and is one of the least complexes. In this method. The value of goodwill is calculated by multiplying the

average estimated profits or the average of future maintainable profits by the number of years purchased. The method is subdivided into the average profit method and the weighted average profit method.

2. **Super Profits Method:** Super Profit is the profit above the normal profit. It is the excess or additional profits earned by businesses on account of reputation and goodwill. The total is calculated by multiplying the super-profits by the number of years purchased.
3. **Capitalization Method**: Capitalization Method is one of the methods for the calculation of goodwill. In this method, the value of goodwill is calculated by reducing the actual capital employed from the value derived after the capitalization of average profits based on the normal rate of return. The method is subdivided into two categories: The capitalization of the average profit method and the Capitalization of the super profit method.

Average Profits Method

The simple average profit method involves the calculation of the goodwill of a business using the average profits and the number of years purchased. Profits earned over the years are totalled, and then their average is calculated. The number of years purchased means the number of years that the firm will continue to earn profits as a result of its past operations and effort, even after the change in ownership of the business. When a continued business is purchased, the query has to pay a certain amount of goodwill to enjoy the profits. The calculation of goodwill involves the following steps:

Step 1: Calculation of normal profits of business: Firstly, calculate the normal profits of the business for each year after reducing the abnormal gains and non-recurring business expenses.

Step 2: Take the total of the profits of the previous year, as calculated in Step 1. Adjust any future recurring expenses and additional income. Now take the average of the adjusted profits earned in past years. This profit is called average maintainable profit or future maintainable profit.

$$Average\ Profits = \frac{Total\ Profits}{Number\ of\ Years}$$

Step 3: Now apply the following formula and calculate the value of goodwill:

Goodwill = Average Profits x Number of years' purchased

Illustration 1: ABC Pvt. Ltd is engaged in the business of ores and minerals. ABC Pvt. Ltd sells its business to XYZ Pvt. Ltd. XYZ Pvt. Ltd seeks professional advice for the valuation of the goodwill of the company. From the information available below help XYZ Pvt. Ltd to ascertain the value of goodwill using the average profit method for 3 years' purchase:

Years	**Profits Earned in rupees**
2015-2016	2,45,550
2016-2017	2,92,570
2017-2018	3,62,500
2018-2019	3,75,400
2019-2020	4,25,400

Additional Information: With effect from 1st April, 2020, the Managing Directors' remuneration was increased by 90,000 instead of 85,000. The company has secured a contract from which it can earn an additional 1,00,000 per annum for the next five years.

Solution: Step 1: Calculation of future maintainable profits

Years	**Profits**	
2015-2016	2,45,550	
2016-2017	2,92,570	
2017-2018	3,62,500	
2018-2019	3,75,400	
2019-2020	4,25,400	
Total Profits	17,01,420	17,01,420
Number of Years		5
Average Profits	17,01,420/5	3,40,284
Future Maintainable Profits		3,40,284

Step 2: Calculation of Goodwill:

$$Goodwill = Average\ Profits\ x\ Number\ of\ years' purchased$$

Therefore, Goodwill = 3,40,284 * 3

= 10, 20, 852

Weighted Average Profit Method

The weighted average profit method involves multiplying the profit of each year by the weights, such as 1,2,3,4 …and so on. to calculate the value of goodwill. The calculation of goodwill is done in the following manner:

Step 1: Weights are assigned to the profits. The weights are assigned in chronological order. The highest weight is assigned to the profit of the most recent year.

Step 2: The product of the profits is calculated after multiplying the weight with the respective profit of a particular year.

Step 3: Weighted average profit is calculated by dividing the value derived in Step 3 by total weights using the following formula:

$$\boldsymbol{Weighited\ Average\ Profits = \frac{Total\ of\ the\ products\ of\ profits}{Total\ Weights}}$$

Step 4: The value of goodwill is then calculated using the following formula:

$$\boldsymbol{Goodwill = Weighted\ Average\ Profit\ x\ Number\ of\ years' purchase}$$

Illustration 1: Agni Pvt. Ltd is engaged in the business of manufacturing garments. Agni Pvt. Ltd decided to dispose of its business to Dignity Pvt. Ltd. From the information provided below, calculate the value of goodwill for two years' purchase weighted average profits:

Year 2020: Rs 94,000 (the profit does not include the insurance premium of Rs 8,000 on the firm's property and plants, which will now be included)

Year 2021: Rs 1,25,000 (the profits include an abnormal gain of Rs 20,000)

Year 2022: Rs. 78,600 (after excluding an abnormal loss of Rs 4,000)

Solution: **Calculation of Goodwill**:

Years	Calculation	Adjusted Profits	Weights	Weighted Profits
2020	(94000-8000)	86,000	1	86,000
2021	(125000 - 20000)	1,05,000	2	2,10,000
2022	(78600+4000)	82,600	3	2,47,800
	Total		6	5,43,800
	Weighted Average	5,43,800/6		90,633
	Number of Years			2
	Goodwill			1,81,267

Knowledge Check 2

Calculate the value of Goodwill based on four years' purchase of the weighted average profit after assigning weights 1,2,3,4,5, and 6, respectively to the profits for 2016, 2017, 2018, 2019, 2020, and 2021. The profits of the firm for the year ended 31st March for the last six years were:

Years	Profits (Rupees)
2016	15,500
2017	18,400
2018	9,800
2019	13,600
2020	12,000
2021	20,200

Outcome-Based Activities 2

Tisha Ltd is engaged in the business of manufacturing tools and equipment. Tisha Ltd decided to dispose of its business to Misha Ltd. From the information provided below, calculate the value of goodwill for two years' purchase weighted average profits:

Year 2020: Rs 1,06,000 (the profit does not include the insurance premium of Rs 12,000 on the firm's property and plants, which will now be included)

Year 2021: Rs 1,75,000 (the profits include an abnormal gain of Rs 37,500)

Year 2022: Rs. 1,92,500 (after excluding an abnormal loss of Rs 32,500)

2.4 Summary

- The value of reputation and brand that an organization generates over time is termed goodwill.
- The value of goodwill keeps on fluctuating and depends on a variety of factors that are: The location of the business, efficient management, the longevity of a business, the nature of goods and services, possession of a valid license, monopolistic rights, and the risk involved, etc.
- When an organization plans to acquire another organization, the consideration paid for the acquisition of the business that exceeds the value of net identifiable assets is termed as purchased goodwill
- Inherent goodwill or self-generated goodwill is the fair value of the net assets of an organization. It is internally generated goodwill, and it is due to the status and reputation of the business
- There are several methods of valuation of goodwill, and those are Average Profits Method, Super Profits Method, and Capitalization Method.

2.5 Self-Assessment Questions

1. Write a short note on Goodwill.
2. What are the features of goodwill?
3. What are the various factors affecting the value of goodwill?
4. Why goodwill is considered an asset of an organization?
5. List and define various methods for the valuation of goodwill.

2.6 References

- Financial Valuation and Modelling Paperback – 1 by Sheeba Kapil (Author)
- Advanced Corporate Accounting Paperback by Anita Raman P Radhika (Author)
- Advanced Corporate Accounting by Ruqsana Anjum, McGraw Hill
- Taxmann Cracker - Advanced Accounting Book for CA Inter by CA Parveen Sharma, CA Kapileshwar Bhalla.

Unit- 3

Accounting for Holding Companies

Learning Outcomes:

- Students will be able to understand the meaning of holding and subsidiary companies.
- Students will get knowledge of consolidated financial statements.
- Students will be able to understand the meaning of minority interest and its calculation.

Structure:

3.1. Meaning of Holding and Subsidiary Company

What is a Holding Company?

- What is a Subsidiary Company?
- Types of Holding and Subsidiary Companies

3.2. Meaning of Consolidated Financial Statement

What is a Consolidated Financial Statement?

Advantages of Consolidated Financial Statements

Knowledge Check 1

Outcome-Based Activity 1

3.3. Legal Requirements of Consolidation

What are the legal requirements for Consolidation?

3.4. Minority Interest

Meaning of Minority Interest

Calculation of Minority Interest

Knowledge Check 2

Outcome-Based Activity 2

3.5. Summary

3.6. Self-Assessment Questions

3.7. References

3.1. Meaning of Holding and Subsidiary Company

- What is a Holding Company?

A parent company is another name for a holding corporation. Either a limited liability company or a limited partnership with the majority of voting shares in another firm is the parent company. The structure of the shareholding arrangement allows the holding company to dictate the rules and choices made by another business. The management is likewise under the holding company's control. The holding company is able to exercise control over another company's properties and assets. On the other hand, the holding firm does not oversee the daily operations of a different company with three times the managerial capacity. A firm that is owned and managed by another company is referred to as a subsidiary company under Indian company law, and the

1. Greater control with small investment: The holding company can acquire control of another company by purchasing 51% or more of the voting shares of another company. Therefore, the holding company need not acquire 100% of the business of another company in order to gain control. This enables a business to gain control of several businesses using a considerable and reasonable amount of investment.
2. Creation of independent entity: The holding company and the subsidiary company are independent of each other. Each of the companies in which the holding company invests is considered an independent legal entity. This goes to show that if the subsidiary company faces any lawsuit, the plaintiff cannot claim the assets of another subsidiary company or parent company for that matter. It is highly unlikely that the parent company will be held liable for the actions of the subsidiary company.
3. Continuity of the management: When the holding company acquires another company, it generally retains the strategic decision-making and monitoring of the performance of the subsidiary company. Therefore, the managers and supervisors of the subsidiary company retain their previous designation and continue conducting the operations of the business in the usual manner.

- Tax benefits: By submitting a consolidated tax return, holding businesses that own 80% or more of another business can benefit from tax savings. A consolidated tax return is one that shows a true and fair picture of the overall group's financial situation by combining the financial records of all the companies the parent business has purchased. As a result, the gains of one subsidiary firm balance the losses of the other subsidiaries, lowering the parent company's overall tax obligation.
- What is a Subsidiary Company?

A subsidiary is a business that another business, referred to as the parent company or holding company, owns all or part of. The percentage of shares held by the parent firm typically determines ownership.

The parent company needs to hold at least a 51% stake in the subsidiary company. A subsidiary company is an independent entity. It operates as a distinct entity from its parent company. The subsidiary company can see you and can be sued in its own name. The companies benefited from taxation, regulation, and liability perspectives. The liabilities and obligations of the subsidiary company are its own and the parent company usually does not have any liability. The parent company, however, exercises control in the decision-making of the subsidiary company. There is no necessity that the holding company and a subsidiary company need to be in the same location and the same line of business. A subsidiary company can also have its own subsidiary company and together the companies are considered as a group of companies. The features and advantages of the subsidiary companies are as follows:

1. Tax benefits: The losses of subsidiary companies help to reduce the tax liability of the parent company. Income from multiple subsidiaries sometimes increases the tax of the parent. However, the losses help in reducing that liability.
2. Reduction of risks: The framework and relationship of parent and subsidiary help in mitigating risks as the entities are independent, separate, and distinct. The losses incurred by subsidiary companies are not transferred to the parent company and hence the risk is reduced to a significant level.
3. Increase in efficiency and diversification: Sometimes the subsidiary helps the parent company to achieve greater operational efficiencies by splitting a larger company into smaller ones i.e. silos for managing the day-to-day operations.

- Types of Holding and Subsidiary Companies

Company owners can increase operations and scalability, diversify their business into new markets, and safeguard their assets by forming parent and subsidiary relationships. In order to successfully handle several business streams and companies, a holding company is created. A single organization with ownership and control over several businesses has greater influence on the businesses and is better able to make decisions. The following lists the various kinds of holding subsidiary relationships:

1. Pure Holding Company: A pure holding company is a company that does not produce any goods or provides services on its own; it rather invests in the valuable assets of another company or in the controlling interest of its subsidiaries.
2. Parent Company: A parent company is a company that comes into existence when an organization acquires a controlling stake or more than 51% of the shares of another company or starts a new company under its control.
3. Offspring Company: An offspring company is one that comes into existence to exercise control over another company.
4. Proprietary Company: A proprietary company is a company that comes into existence to hold the total shares of the subsidiary company.
5. Finance Company: A finance company is a company that finances the subsidiaries and earns profits through the business activities of the subsidiary company. It is not involved in the business operations of the subsidiary company.
6. Investment Company: An investment company is one that acts as an intermediary and deals with the companies by providing investments. It invests in the securities and shares of various companies and benefits from the returns and interest. It is not engaged in the business operations of the subsidiary company.
7. Mixed Holding Company: A mixed holding company is a company that has a business of its own i.e., it is involved in the production of goods or provision of services. It also acquires shares in other companies. This can also be considered as an example of the parent company. So it can be concluded that a parent company is a holding company. However, a holding company might not be a parent company.
8. Intermediate Holding Company: An intermediate holding company is a company that exists within a chain of companies. An intermediate holding company is part of a large group of companies. For example, holding company A has a controlling stake in holding company B. Holding company B also has a stake in company C and company D. In the given scenario, holding companies B and C are considered intermediate companies.

3.2. Meaning of Consolidated Financial Statement

What is a Consolidated Financial Statement?

A collection of financial statements from a company with several subsidiaries or divisions is known as consolidated financial statements. Financial statements of a collection of businesses presented as a single economic unit are known as consolidated financial statements. The statements support the examination and evaluation of the group's overall financial situation. The goal of the consolidated financial statements is to present an accurate and impartial picture of the entity's current situation as well as a personal perspective. The genuine picture of the entity's overall financial health is not given by the financial statements of the separate entities. Consolidated financial statements must be prepared by significant entities, including the group's parent company and all of its subsidiaries, as well as a subsidiary that is

Advantages of Consolidated Financial Statement

Parent firms must prepare consolidated financial statements in accordance with generally accepted accounting principles in order to disclose the financial health of the parent company and each of its subsidiaries. The following are the goals and advantages of the consolidated financial statements:

1. Complete overview: Consolidated financial statements give a complete overview of the state of affairs of the entity. It provides a comprehensive view of the parent firm to investors, analysts, enterprises, owners, stakeholders, and other interested parties. It offers a quick overview of the company's general health as well as the impact of its subsidiaries on its parent companies.
2. Reduction of paperwork: Consolidated financial statements reduce the paperwork. For instance, if the parent company owns nine subsidiaries then the investor has to view 40 Consolidated financial statements reduce the number of reports to just four, replacing the four fundamental financial statements for each subsidiary that make up separate financial statements. This lowers the amount of paperwork and the cost of determining the parent company's financial stability.
3. Simplification: Consolidation eliminates the inter-company transaction between the parent and subsidiary. The elimination of transactions gives a simplified view of the business performance of the organization.
4. Information about overall profitability: The subsidiary business and the holding company may be indebted to one another. Financial statement consolidation can be used to assess

the profitability of holding subsidiaries. The financial accounts are analyzed by both internal and external users, who determine if the company is worth investing in or not.

Knowledge Check 1

Fill in the Blanks.

1. As per the Company Law of India, a company that is _____________ and ___________ by another company is termed a _____________company, and the former is termed the holding company.
2. When the holding company acquires another company, it generally retains the _________________and ___________ of the performance of the subsidiary company.
3. A _____________ is a company that comes into existence to hold the total shares of the subsidiary company.
4. According to ______________, parent companies are required to prepare consolidated financial statements to report the financial health of the parent company and all its subsidiaries
5. Consolidation eliminates the _______________ between the parent and subsidiary giving a simplified view of the business performance of the organization.

Outcome-Based Activity 1

List down and define different types of holding and subsidiary relationships.

3.3. Legal Requirements on Consolidation

What are the legal requirements for Consolidation?

Consolidated financial statements must be prepared by all companies, including unlisted companies, with one or more subsidiaries, joint ventures, or associates, in accordance with the Companies Act of 2013. Prior until this, only the listed company was required to prepare the consolidated financial statements by the Securities and Exchange Board of India (SEBI). One step toward harmonizing reporting standards across borders is the requirement for the creation of consolidated financial statements. From the group's standpoint, the solo financial statements do not give a true and fair picture of the situation.

In accordance with section 129(3) of the Companies Act, 2013, a company that has one or more subsidiaries is required to prepare and present a consolidated financial statement of the company

and all of its subsidiaries in the same format and style, in addition to a standalone financial statement, and to present it to the members during the annual general meeting. Thus, it is mandatory to prepare the consolidated financial statement early before the members at the annual General meeting along with the standalone financial statement. The audited financial statements of the listed entities should also be made available on the website of the entity. If it is requested by the shareholders, it is the duty of the entity to provide audited financial statements of all its subsidiaries to such members.

3.4. Minority Interest

- **Meaning of Minority Interest**

Minority interest generally refers to the stage in an organization that is owned and controlled by a parent company. It is less than 50% stake in the total voting power of an organization. Minority interest usually represents the stake not held by the parent company that holds the majority of the voting power. The stake of minorities ranges from 20% to 30%. Typically, minority interests do not exercise control over the company and they do not have any voting rights. They have little influence on the decision-making process. The financial reporting of minority interest occurs only occurs when an organization prepares two sets of financial statements which are a separate set of financial statements and consolidated financial statements. The adjustments relating to minority interest generally happen when the parent company owns less than 100% stake in the subsidiary company. As far as the profit and loss are concerned, the minority interest is given its share of profit and loss arising from ordinary activities after taxation.

In accordance with US GAAP, the minority interest represents the non-controlling shareholders' portion of an organization's assets and can be shown as either a non-current liability or a portion of equity on the parent company's consolidated balance sheet. But according to IFRS, it can only be noted in the balance sheet's equity section. It needs to be documented independently of the parent's equity. According to the Financial Accounting Standards Board's guidelines, the minority interest is shown in the consolidated income statement as the minority shareholders' profit share. As an example, XYZ Ltd owns 80% of ABC Ltd. The corporation is worth a hundred crores rupees. It will appear in the consolidated balance sheet

Calculation of Minority Interest

The minority interests represent important information for the users of the financial statement. It helps them to evaluate and make informed investment decisions. The stake of a parent determines the decision-making process and the influence of the parent on the subsidiary company. The basic steps for the calculation of minority interest are as follows:

Step 1: Calculation of the book value or the net asset value of the subsidiary company. The book value or the net asset value of the company is its total asset minus the intangible assets (patents, goodwill, etc.) and liabilities.

Step 2: The book value or the net asset value so derived in Step 1 is multiplied by the percentage of subsidiary old by the minority shareholders.

Step 3: The third step is to calculate the net income that belongs to the minority shareholders. It is simply the total income of the subsidiary multiplied by the percentage of the stake held by the minority shareholders. The amount calculated in this step is shown as a separate line item on the consolidated income statement of the parent company as the "net income attributable to minority shareholders".

For example, Agni Pharma Ltd owns a 75% stake in Vayu Pharma Ltd. The total assets of the company including patents and goodwill worth Rs 2 crores is Rs 10 crores. The total liabilities of the company are Rs 6 crores. Calculate the share of minority shareholders in the net assets of the organization.

Step 1: Net Asset Value of Vayu Pharma Ltd = Total Assets – Intangible Assets – Liabilities

= Rs (10-2-6) crores

= Rs 2 crores

Step 2: Shares held by minority shareholders = 25%

Therefore, Minority Interest = 2 crores * 25%

= Rs 0.5 crores

- Knowledge Check 2

1. BB Ltd owns an 80% stake in Malay Ltd. The total assets of the company including patents and goodwill worth Rs 20 crores is Rs 100 crores. The total liabilities of the company are Rs 60 crores. Also, the total income of Malay Ltd for the year ended 31.03.2022 is Rs

22.5 lakhs. Calculate the share of minority shareholders in the net assets of the organization and profits of Malay Ltd.

Outcome-Based Activity 2

Newar Ltd owns a 90% stake in Ghewar Ltd. From the balance sheet and income statement of Ghewar Ltd for the year ended 31.03.2022, calculate the share of minority shareholders in the net assets of Ghewar Ltd.

Particulars	Amount (in lakhs)
Assets	
Current Assets	6,300
Property, Plant, and Equipment	2,567
Goodwill	6,456
Acquired Intangible Assets	3,834
Other	588
Total Assets	19,745
Liabilities	8,573
Equity	11,172
Total Liabilities and Equity	19,745

3.5. Summary

- A holding company is also known as a parent company. The parent company is either a limited liability company or a limited partnership holding the majority of the voting power or voting shares in another company.
- A subsidiary company is a company that is fully or partially owned by another company known as the parent company or holding company.
- Consolidated financial statements are a group of financial statements of an entity having multiple subsidiaries or divisions. Consolidated financial statements are financial statements of a group of companies as a single economic entity.
- As per section 129(3) of the Companies Act, 2013, where a company has one or more subsidiaries, it shall, in addition to a standalone financial statement, prepare and present a

consolidated financial statement of the company and all its subsidiaries in the same form and manner and lay it before the members at the Annual General Meeting

- Minority interest generally refers to the stage in an organization that is owned and controlled by a parent company. It is less than 50% stake in the total voting power of an organization.

3.6. Self-Assessment Questions

1. Define holding and subsidiary companies.
2. State the advantages of a holding company.
3. What are the different types of holding and subsidiary companies?
4. What are the legal requirements for consolidation?
5. Write a short note on minority interest.

3.7. References

- Financial Valuation and Modelling Paperback – 1 by Sheeba Kapil (Author)
- Advanced Corporate Accounting Paperback by Anita Raman P Radhika (Author)
- Advanced Corporate Accounting by Ruqsana Anjum, McGraw Hill
- Taxmann Cracker - Advanced Accounting Book for CA Inter by CA Parveen Sharma, CA Kapileshwar Bhalla.

Unit- 4

Acquisition of Business

Learning Outcomes:

- Student will be able to define the meaning of 'Acquisition of Business'.
- Student will be capable of demonstrating the objectives of 'Business Taken Over'.
- Students will be able to define Purchase Consideration and Methods for determining Purchase Consideration.

Structure:

4.1 Meaning of 'Acquisition of Business'

4.2 Objectives of 'Business Taken Over'

4.3 Assets Taken Over

4.4 'Assets and Liabilities Taken Over

Knowledge Check 1

Outcome-Based Activity 1

4.5 Purchase Consideration

4.6 Methods for determining Purchase Consideration

4.7 Mode of Discharge of Purchase Consideration

4.8 Accounting Entries

Knowledge Check 2

Outcome-Based Activity 2

4.9 Summary

4.10 Self-Assessment Questions

4.11 References

4.1 Meaning of 'Acquisition of Business'

- Definition of Business Acquisition

Business acquisition is the process of purchasing another company or business entity to expand the acquirer's operations, market share, or capabilities. In a business acquisition, one company takes over another by purchasing either its assets or its shares, resulting in the target company becoming a subsidiary of the acquiring company.

A stock acquisition involves the acquiring company buying the target company's shares, so acquiring full ownership of the business, whereas an asset acquisition involves the acquiring company purchasing the target company's assets as well as its liabilities. The particular acquisition strategy chosen will rely on the objectives and demands of the acquirer as well as the financial and legal conditions of the target company.

The primary reasons for business acquisitions include strategic growth, increased profitability, cost savings, access to new markets or technologies, and competitive advantage. The acquisition process usually involves an extensive due diligence process in which the acquirer assesses the target company's financial performance, market position, intellectual property, customer base, and other factors to determine its value and potential risks.

Business acquisitions can be complex and time-consuming, involving legal and regulatory considerations, tax implications, financing arrangements, negotiation, and post-acquisition integration. As a result, companies typically rely on professional advisors such as lawyers, accountants, and investment bankers to assist them in navigating the acquisition process.

In summary, a business acquisition involves the purchase of another company or business entity by an acquiring company, typically for strategic, financial, or operational reasons. The process can take many forms and involve a range of considerations, including due diligence, legal and regulatory compliance, financing, and integration planning.

Types of Business Acquisitions

A corporation may choose to pursue one of numerous business acquisition strategies, based on its strategic objectives, the resources at its disposal, and the characteristics of the target company. The following are a few of the most typical forms of company acquisitions:

1. Horizontal Acquisition: To increase market share, drive out rivals, or broaden its product line, a business may purchase a rival or another business in the same sector. This kind of

purchase is typical in sectors like telecommunications and aviation that have few players and significant entry barriers.

1. Vertical Acquisition: A vertical acquisition occurs when a company acquires a business that is either a supplier or a customer. The goal is to control the supply chain or distribution channel and to improve efficiency and profitability. For example, a clothing manufacturer might acquire a textile mill to reduce its raw material costs or ensure quality control.
2. Conglomerate Acquisition: A conglomerate acquisition occurs when a company acquires a business in a completely different industry or unrelated business. The goal is to diversify the company's operations and revenue streams and reduce risk. For example, a technology company might acquire a food and beverage company to enter a new market.
3. Concentric Acquisition: A concentric acquisition occurs when a company acquires a business that is related to its existing operations but not in the same industry. The goal is to leverage existing resources and capabilities and enter a new market. For example, a software company might acquire a company that provides IT services.
4. Reverse Acquisition: A reverse acquisition occurs when a smaller company acquires a larger company. This is also known as a reverse merger. The goal is to gain access to the larger company's resources, such as its customer base, brand recognition, or intellectual property.
5. Friendly Acquisition: A friendly acquisition occurs when the target company agrees to be acquired, and both parties work together to facilitate the acquisition. This is often a smoother process with fewer complications.

Asset Acquisition vs. Stock Acquisition

Asset acquisition and stock acquisition are two common ways for a company to acquire another company. They differ in the way that the acquiring company purchases the target company's assets and liabilities.

In an asset acquisition, the acquiring company purchases the specific assets and liabilities of the target company. This type of acquisition allows the acquiring company to select which assets and liabilities it wants to acquire and which ones it wants to leave behind. Typically, this includes things like physical assets, intellectual property, customer lists, contracts, and other specific assets. The liabilities that the acquiring company assumes can also be chosen, such as debt or ongoing contractual obligations. In an asset acquisition, the target company is

usually liquidated, and its operations are absorbed into the acquiring company. The acquiring company assumes all assets, liabilities, and obligations of the target company, including any unknown or hidden liabilities. The target company becomes a subsidiary of the acquiring company, and its operations are typically continued without significant change.

Both asset and stock acquisitions have their own advantages and disadvantages. Asset acquisitions allow the acquiring company to pick and choose which assets and liabilities to acquire, avoiding any unwanted or unknown liabilities. However, asset acquisitions can be complex, as the acquiring company needs to negotiate with the target company to purchase specific assets and liabilities.

Stock acquisitions, on the other hand, are typically less complex and can provide a faster path to integration, as the target company's operations can be continued with minimal disruption. However, stock acquisitions may also come with hidden liabilities and can be more costly, as the acquiring company must purchase the entire company, including any unwanted assets or liabilities.

In summary, asset and stock acquisitions are two different ways for a company to acquire another company. Asset acquisitions involve the purchase of specific assets and liabilities of the target company, while stock acquisitions involve the purchase of the entire company.

Business Acquisition Process

The business acquisition process is the series of steps that a company goes through to acquire another company. The process can be complex and time-consuming, and it typically involves several stages, including the following:

1. Develop a Strategic Plan: The first step in the acquisition process is to develop a strategic plan that outlines the company's goals, objectives, and criteria for potential acquisition targets. This includes identifying the type of company to be acquired, the geographic location, and the size of the target company.

2. Identify Potential Targets: Once the strategic plan is in place, the next step is to identify potential acquisition targets. This can be done through research and analysis of the industry and market, networking, and the use of investment bankers or other advisors.

3. Evaluate Potential Targets: The company then evaluates potential targets to determine if they meet the criteria outlined in the strategic plan. This includes financial analysis, due diligence, and a review of the target company's operations, management, and culture.

4. Negotiate the Deal: Once a suitable target has been identified and evaluated, the company begins negotiations with the target company's management or owners. This involves developing a term sheet, negotiating the price and other deal terms, and drafting a letter of intent or purchase agreement.

5. Secure Financing: The acquiring company secures financing for the acquisition, which can come from a variety of sources, including equity or debt financing, bank loans, or private equity.

6. Close the Deal: The final step is to close the deal and transfer ownership of the target company to the acquiring company. This involves finalizing the purchase agreement, obtaining regulatory approval, and transferring assets and liabilities.

Throughout the acquisition process, it's important to keep communication lines open and to ensure that all parties involved are on the same page. It's also important to have a solid plan in place for integrating the target company into the acquiring company's operations, which can include changes to management, processes, and systems.

4.2 Objectives of ‘Business Taken Over’

1. **Synergy:** Reaching synergy—the state in which the combined business is worth more than the sum of its parts—is one of the primary goals of corporate acquisitions. Cost reductions, gaining market share, or other operational improvements can all lead to synergy.

2. .Diversification: Acquiring a business can help the acquiring company diversify its operations and reduce its overall risk. By entering into new markets or adding new products or services, the acquiring company can reduce its dependence on any one product or market.

3. Geographic Expansion: Acquiring a business in a new geographic location can help the acquiring company expand its operations and increase its market share. This can be especially valuable for companies looking to enter new international markets.

4. Talent Acquisition: Acquiring a business can also provide access to new talent and expertise. The acquiring company can benefit from the skills and knowledge of the target company's employees, which can help to drive innovation and growth.

5**. Increased Market Share:** Acquiring a business can help the acquiring company increase its market share in a particular industry or market segment.

6. Elimination of Competition: Acquiring a business can also help the acquiring company eliminate competition by taking over a competitor's market share. This can help the acquiring company to gain a competitive advantage and increase its market power.

7. Cost Savings: Acquiring a business can help the acquiring company achieve cost savings through economies of scale, increased purchasing power, or other operational efficiencies. This can lead to increased profitability and competitiveness.

8. Innovation: Acquiring a business can also provide access to new technology or intellectual property, which can help the acquiring company drive innovation and growth.

4.3 Assets Taken Over

In a business acquisition, the acquiring company takes over the assets of the target company. The assets that are taken over can include both tangible and intangible assets. Here are some examples and details about these types of assets:

a. Tangible Assets: Physical assets that can be seen, felt, or held that have a quantifiable worth are known as tangible assets. In an acquisition, tangible assets like the following could be acquired: a

b. Land: This includes any real estate or property owned by the target company, including any buildings or structures on the land.

c. Buildings: Any buildings owned by the target company, whether they are used for manufacturing, storage, or office space, would be included in the acquisition.

d. Equipment: Any machinery, tools, or other equipment used by the target company in its operations would be considered tangible assets.

e. Inventory: This includes any raw materials, work-in-progress, or finished goods that the target company has on hand.

f. Vehicles: Any vehicles owned by the target company, such as trucks or delivery vans, would be considered tangible assets.

2. Intangible Assets: Intangible assets are non-physical assets that have value but cannot be seen or touched. Examples of intangible assets that may be taken over in an acquisition include:

a. Intellectual property: This includes patents, trademarks, copyrights, and trade secrets that the target company owns.

b. Goodwill: Goodwill is the value of the target company's reputation and customer relationships. This is often included in the purchase price of the target company.

c. Branding: The target company's brand name and any associated logos or slogans would be considered intangible assets.

d. Contracts: Any contracts that the target company has with customers, suppliers, or other third parties would be included in the acquisition.

e. Software: Any software applications or systems used by the target company would be considered intangible assets.

The acquiring company must carefully evaluate and assess the value of each asset that is being taken over in the acquisition. This includes determining the fair market value of tangible assets and assessing the potential value and risks associated with intangible assets. The acquiring company must also ensure that all necessary transfer of ownership documents and agreements are in place to ensure a smooth transition of the assets from the target company to the acquiring company.

4.4 Assets and Liabilities Taken Over

In a business acquisition, the acquiring company takes over not only the assets of the target company but also its liabilities. Here are some important things to consider when taking over assets and liabilities:

1. Assets: The acquiring company must carefully evaluate and assess the value of each asset that is being taken over in the acquisition. This includes determining the fair market value of tangible assets and assessing the potential value and risks associated with intangible assets. The acquiring company must also ensure that all necessary transfer of ownership documents and agreements are in place to ensure a smooth transition of the assets from the target company to the acquiring company.

2. Liabilities: The acquiring company must also assess the liabilities of the target company that it will be taking on. These can include both known and potential liabilities, such as outstanding debts, legal claims, and obligations to employees and suppliers. The acquiring company must carefully evaluate these liabilities to determine their potential impact on the financial health of the company.

3. Purchase Price: The purchase price for the acquisition is often based on the value of the assets and liabilities being taken over. The acquiring company must negotiate the purchase price with the target company based on a careful assessment of the value of the assets and liabilities. The purchase price may also include a premium for the value of the target company's brand name, customer relationships, and other intangible assets.

4. Integration: After completing the acquisition, the acquiring company must integrate the assets and liabilities of the target company into its own operations. This may involve consolidating operations, restructuring the company, or reorganizing staff. The acquiring company must also ensure that it has the necessary resources and expertise to manage the new assets and liabilities effectively.

- **Knowledge Check 1**

Fill in the Blanks.

1. A business ¬¬¬¬¬¬¬¬¬¬¬¬¬¬¬¬¬¬¬¬¬¬¬¬¬¬¬¬______________ is the process of purchasing another company or business entity to expand the acquirer's operations, market share, or capabilities.
2. There are several types of business acquisitions that a company can undertake, depending on its ¬¬¬¬____________goals, available resources, and the nature of the target company.
3. Throughout the acquisition process, it's important to keep _________________lines open and to ensure that all parties involved are on the same page.
4. In a business acquisition, the acquiring company takes over the assets of the target company. The assets that are taken over can include both _____________ and intangible assets.
5. The acquiring company must carefully ______________and assess the value of each asset that is being taken over in the acquisition.

- **Outcome-Based Activity 1**

Analyze the financial statements of a target company to assess its value and potential for growth.

4.5 Purchase Consideration

The sum that the acquiring company consents to pay for the target company in a commercial acquisition is known as the buy consideration. The target company's and the acquiring company's financial health may be significantly impacted by this, which can take many various forms. When calculating the purchase consideration for a business acquisition, keep the following points in mind:

1. **Cash:** One of the most common forms of purchase consideration is cash. This involves the acquiring company paying a lump sum of cash to the target company in exchange for its ownership. The amount of cash paid will depend on the value of the target company's assets and liabilities, as well as other factors such as the target company's potential for future growth.

2. **Stock:** Another common form of purchase consideration is stock. This involves the acquiring company issuing shares of its own stock to the target company in exchange for its ownership. The value of the stock will depend on the current market price of the acquiring company's shares, as well as other factors such as the potential for future growth.

3. **Debt:** In some cases, the acquiring company may agree to assume some or all of the target company's outstanding debt as part of the purchase consideration. This can be beneficial for the acquiring company if the target company has a strong financial position and a good credit rating.

4. **Earn-Outs:** An earn-out is a form of purchase consideration that is based on the future performance of the target company. This can be beneficial for both the acquiring company and the target company, as it provides an incentive for the target company to continue performing well after the acquisition.

5. **Combination:** In many cases, the purchase consideration for a business acquisition may involve a combination of these different forms of payment. For example, the acquiring company may agree to pay a portion of the purchase price in cash, issue shares of its own stock, and assume some of the target company's outstanding debt.

Determining the appropriate purchase consideration for a business acquisition requires careful consideration of many different factors, including the value of the target company's assets and liabilities, the potential for future growth, and the financial position of the acquiring company. The acquiring company must also carefully assess the potential risks and

benefits associated with each form of payment to ensure that it can successfully integrate the target company into its own operations and achieve long-term profitability.

4.6 Methods for determining Purchase Consideration

There are several methods for determining the purchase consideration for a business acquisition. Here are some common methods for determining purchase consideration:

1. **Asset valuation:** In an asset acquisition, the purchase consideration is typically based on the fair market value of the target company's assets. This involves a thorough analysis of the target company's tangible and intangible assets, including property, plant and equipment, inventory, accounts receivable, and intellectual property. This method can be time-consuming and complex, but it provides a good indication of the target company's overall value.

2. **Value based on earnings:** This approach is frequently applied when the target company is an established enterprise with a track record of consistent earnings. The purchase consideration is determined by multiplying the predicted or historical earnings of the target company. Although this approach is quite easy to use, it might not fully capture the underlying value of the target company if its earnings are highly variable.

3. **Comparable company analysis:** This technique establishes the target company's relative value by contrasting it with other comparable businesses in the same sector. This approach may prove beneficial for businesses that are challenging to assess using conventional financial indicators. Nevertheless, it necessitates a thorough comprehension of the sector and might not precisely capture the distinctive qualities of the target organization. Discounted cash flow analysis:

4. This method involves estimating the future cash flows of the target company and discounting them back to their present value. This can be a useful method for companies with significant growth potential or companies that have unpredictable earnings. However, it requires accurate forecasting and may be subject to significant uncertainty.

5. **Negotiation:** Ultimately, the purchase consideration for a business acquisition may be determined through negotiation between the acquiring company and the target company's owners or representatives. This method can be flexible and can take into account a wide range of factors, including the strategic value of the target company, the specific goals of the

acquiring company, and the competitive landscape. However, it can also be time-consuming and may result in a less transparent process.

4.7 Mode of Discharge of Purchase Consideration

The mode of discharge of purchase consideration refers to the methods used to pay for the acquisition of a business. The mode of discharge can have a significant impact on the overall cost and financial structure of the acquisition. Here are some common modes of discharge of purchase consideration:

1. **Cash:** Cash is the simplest and most straightforward method of discharging purchase consideration. The acquiring company simply pays the purchase price in cash to the target company's owners or representatives. This method provides immediate liquidity to the target company's owners, but it may not be feasible if the acquiring company does not have sufficient cash reserves.
2. **Stock:** The acquiring company may choose to issue its own stock as payment for the acquisition. This can be a useful method if the target company's owners are willing to accept stock in the acquiring company as payment. However, it can also be risky if the acquiring company's stock price is volatile or if the target company's owners are not confident in the acquiring company's long-term prospects.
3. **Debt:** The acquiring company may choose to finance the acquisition with debt, such as a bank loan or bond issuance. This can be a useful method if the acquiring company has a strong credit rating and can secure favourable terms from lenders. However, it can also increase the acquiring company's overall leverage and interest expenses, which can impact its financial flexibility and profitability.
4. **Earnouts:** An earnout is a contingency payment that is based on the performance of the target company after the acquisition. This can be a useful method if the target company's future earnings are difficult to predict or if the acquiring company is hesitant to pay the full purchase price upfront. However, it can also be complex and may result in disputes between the acquiring company and the target company's owners over the calculation of the earnout.
5. **Combination of methods:** The acquiring company may choose to use a combination of the above methods to discharge the purchase consideration. For example, it may pay a portion of the purchase price in cash, issue stock for another portion, and finance the

remaining portion with debt. This can provide a more flexible and balanced approach, but it can also increase the complexity of the acquisition.

The appropriate mode of discharge of purchase consideration will depend on the specific circumstances of the acquisition, including the financial strength and strategy of the acquiring company, the target company's financial situation and prospects, and the preferences of the target company's owners or representatives. The acquiring company should carefully evaluate each option and seek professional advice as needed to ensure that it chooses the most appropriate mode of discharge.

4.8 Accounting Entries

In an acquisition, the mode of accounting entries refers to how the acquiring company records the purchase of the target company in its financial statements. The accounting entries can have a significant impact on the acquiring company's financial statements and performance measures. Here are some common modes of accounting entries:

1. Purchase Method: Purchase Method: In this approach, the target business's assets and liabilities are recorded by the acquiring company at their fair market value on the acquisition date. Goodwill is the amount that is recorded as the difference between the purchase price and the fair market value of the assets and liabilities. This difference is then amortized over time. When the acquiring corporation buys a majority stake in the target company, it employs this strategy.

2. **Pooling of Interest Method:** The pooling of interest method was an accounting method that was commonly used in the past, but is no longer allowed under U.S. Generally Accepted Accounting Principles (GAAP) as of 2001. Under this method, the acquiring company combines the assets and liabilities of the target company with its own assets and liabilities as if they had been combined all along, and no goodwill is recorded. This method was used when the acquiring company and the target company were roughly the same size and had similar operations.

3. Equity Method: The equity method is used when the acquiring company acquires a significant but not a controlling interest in the target company. Under this method, the acquiring company records its investment in the target company on its balance sheet as an asset and recognizes its share of the target company's earnings on its income statement.

4. Consolidation Method: The consolidation method is used when the acquiring company acquires a controlling interest in the target company. Under this method, the acquiring company combines the assets and liabilities of the target company with its own assets and liabilities and records the difference as goodwill. The financial statements of the target company are then eliminated and replaced with a single set of consolidated financial statements for the combined entity.

- **Knowledge Check 2**

State whether given statements are true or false.

1. There are several methods for determining the purchase consideration for a business acquisition. (T/F)
2. The mode of discharge of purchase consideration refers to the methods used to pay for the acquisition of a business. (T/F)

- **Outcome-Based Activity 2**

Analyze a case study of a company that has been acquired, identify the types of purchase consideration used, and discuss their impact on the financial statements of the acquiring company.

4.9 Summary

- Business acquisition is the process of purchasing another company or business entity to expand the acquirer's operations, market share, or capabilities.
- The primary reasons for business acquisitions include strategic growth, increased profitability, cost savings, access to new markets or technologies, and competitive advantage.
- Business acquisitions can be complex and time-consuming, involving legal and regulatory considerations, tax implications, financing arrangements, negotiation, and post-acquisition integration.
- Asset acquisition and stock acquisition are two common ways for a company to acquire another company.
- The business acquisition process is the series of steps that a company goes through to acquire another company.

- The first step in the acquisition process is to develop a strategic plan that outlines the company's goals, objectives, and criteria for potential acquisition targets.
- **Synergy:** One of the main objectives of acquiring a business is to achieve synergy, which means that the combined company is more valuable than the sum of its parts.
- **Increased Market Share:** Acquiring a business can help the acquiring company increase its market share in a particular industry or market segment.
- **Land:** This includes any real estate or property owned by the target company, including any buildings or structures on the land.
- **Inventory:** This includes any raw materials, work-in-progress, or finished goods that the target company has on hand.
- **Intellectual property:** This includes patents, trademarks, copyrights, and trade secrets that the target company owns.
- In a business acquisition, the acquiring company takes over not only the assets of the target company but also its liabilities.
- **Assets:** The acquiring company must carefully evaluate and assess the value of each asset that is being taken over in the acquisition.
- **Integration:** After completing the acquisition, the acquiring company must integrate the assets and liabilities of the target company into its own operations.
- The purchase consideration is the amount that the acquiring company agrees to pay for the target company in business acquisition.
- **Stock:** Another common form of purchase consideration is stock. This involves the acquiring company issuing shares of its own stock to the target company in exchange for its ownership.
- Determining the appropriate purchase consideration for a business acquisition requires careful consideration of many different factors, including the value of the target company's assets and liabilities, the potential for future growth, and the financial position of the acquiring company.
- **Earnings-based valuation:** This method is often used when the target company is a mature business with a stable earnings history.
- **Earnouts:** An earnout is a contingency payment that is based on the performance of the target company after the acquisition.

- The acquiring company should carefully evaluate each option and seek professional advice as needed to ensure that it chooses the most appropriate mode of discharge.
- In an acquisition, the mode of accounting entries refers to how the acquiring company records the purchase of the target company in its financial statements.

4.10 Self-Assessment Questions

1. Explain the Meaning of 'Acquisition of Business'.
2. Explain 'Assets and Liabilities Taken Over'.
3. Explain Purchase Consideration in your own words.
4. Explain Mode of Discharge of Purchase Consideration.
5. Explain different Accounting Entries

4.11References

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Unit- 5

Amalgamation of Companies

Learning Outcomes:

- Students will be able to understand the meaning of the amalgamation of companies.
- Students will get knowledge of provisions of Accounting Standard 14.
- Students will be able to understand the accounting entries in the books of the Transferor and the Transferee.

Structure:

5.1. Meaning of Amalgamation of Companies

Meaning of Amalgamation of Companies

Objectives of Amalgamation of Companies

Meaning of different terms used in Amalgamation

5.2. Provisions as per Accounting Standard 14

Provisions for Amalgamation of Companies as per Accounting Standard 14

Knowledge Check 1

Outcome-Based Activity 1

5.3. Basis of arriving at Purchase Consideration

What is Purchase Consideration?

How is Purchase Consideration calculated?

5.4. Accounting Entries

Accounting Entries in the books of the Transferor Company

Knowledge Check 2

Outcome-Based Activity 2

5.5. Summary

5.6. Self-Assessment Questions

5.7. References

5.1. Meaning of Amalgamation of Companies

- Meaning of Amalgamation of Companies

The amalgamation of companies refers to the process of combining two or more business organizations to form one large entity. Two separate units combine together to form an entirely new unit. The combination of two entities helps the business to act in a collective manner with respect to its resources and expertise. Amalgamation is different from mergers because the companies coming together do not have any legal existence. A new entity is formed with the assets and liabilities of both companies. Generally, the Transferor company is absorbed by a stronger Transferee company leading to a strong customer base with large assets and infrastructure. The amalgamation also leads to the creation of resources, an increase in cash reserves, elimination of competition, and saving of taxes. However, it can lead to a monopoly if the competition is eliminated to a great extent and increases the debt load of the entity.

- Objectives of Amalgamation of Companies

Entities around the world amalgamate to enjoy various tax benefits that act as a significant measure of tax planning. Through amalgamation, companies enjoy the advantage of economies of scale. The newly formed entity results in financial and capital growth. It provides opportunities for growth and development. The amalgamation also results in synergy benefits. The following are the main objectives of the amalgamation of companies:

1. Elimination of Competition: The main aim of the amalgamation of companies is to eliminate competition among the companies in the same industry. This will give the organization a competitive edge and create sustainability.

2. Reduction in cost: The amalgamated company will derive advantages in operating costs by lowering the cost of production. Coming together of two entities will result in economies of scale and benefits of large-scale production.

3. Financial gain: The amalgamated company will drive financial advantage in the form of advantages and taxes, an increase in creditworthiness, a reduction in interest rates, and lower borrowing of funds.

4. Growth and diversification: The amalgamated company will result in the creation of pool of resources to facilitate the internal growth of the organization and prevent the threat

from competitors. Amalgamation will also result in diversification as it will lower the risk and act as a hedge for the weakly operating organization.

Meaning of different terms used in Amalgamation

1. Amalgamation of companies: Amalgamation refers to a situation where two or more companies are wound up and a When two or more businesses are wound up and a new firm is formed to take over their operations, this is referred to as an amalgamation. At least three companies are participating in an amalgamation. There is just one resulting company. There are two other firms that are wound up and do not exist legally. For instance, Company C is formed when Company A and Company B combine. Company C is referred to as a transferee company, and Company A and B as transferor companies. We refer to this tactic as amalgamation.

2. Absorption of companies Absorption of firms: In this scenario, two or more existing companies' operations are taken over by one existing company. Such an arrangement involves two or more entities. The resulting business has existed before and is not a brand-new enterprise. Achieving economies of scale and reducing competition are made possible via absorption. As an illustration, Company B (the buyer) acquires control of Company A. In this instance, Company B is referred to as the transferee company and Company A as the transferor company. We refer to this tactic as absorption of companies.

3. External Reconstruction: This is a situation where a new entity is incorporated to take over the business of an existing entity. Only two entities are involved in such an arrangement. One resultant company is formed that takes over the business of an existing company. In order to reorganize the financial structure of an organization external reconstruction is carried out. For example, Company A has been incurring heavy losses for the past five years. A new Company B has been incorporated to take over the business of the existing Company A. In this situation Company A is the transferor company and Company B is the transferee company. This arrangement is known as external reconstruction.

4. Reserves: The part of an entity's revenues or suppliers that management appropriates for a particular or general use is referred to as reserves. It does not include the amount set aside for a known liability or any allowance for depreciation or reduction in asset value.

5.2. Provisions of Accounting Standard 14

Provisions for Amalgamation of Companies as per Accounting Standard 14

Accounting Standard 14 addresses the accounting for mergers and how goodwill or reserves are handled in them. Though most of the rules are connected to the financial statements of other businesses, the standard is best suited for firms. The criterion does not apply when one firm (referred to as the acquiring company) buys all or a portion of the shares of another company (referred to as the acquired company) without receiving payment or issuing shares in exchange. One unique feature of business acquisitions is that the acquired company does not dissolve as a result of the transaction. Two distinct amalgamation kinds are recognized by Accounting Standard 14 and are described as follows:

Amalgamation in the nature of merger: In this method, there is a genuine pooling of not only the assets and liability of the transferor and the transferee companies but also the interest of the shareholders and the business of the companies. As per paragraph 3(e) of AS-14, amalgamation in the nature of a merger is an amalgamation that satisfies all of the following conditions:

1. After amalgamation, all the assets and liabilities of the transferor company become the assets and liabilities of the transferee company.
2. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company becomes the shareholder of the transferee company by virtue of the amalgamation. The shareholding of 90% excludes the shares held by the transferee company or its subsidiaries or their nominees immediately before the amalgamation.
3. After the amalgamation, the business of the transferor company is intended to be carried out by the transferee company.
4. The assets and liabilities of the transferor company are transferred at their book values. They are recorded at the book value in the financial statements of the transferee company. In some cases to ensure the uniformity of accounting policies, some modifications to the values are made. For example, if the transferor company is following the written-down value method for depreciating the property, plant, and equipment. This will be revised by following the straight-line method of depreciation, in case the transferee company follows the straight-line method of depreciation.

If one or more conditions of the above conditions are not satisfied in the case of amalgamation, such an amalgamation will be an amalgamation in the nature of the purchase. The method of If one or more of the aforementioned requirements are not met in the event of a merger, the merger will take the form of a purchase merger. The accounting technique used in merger-like amalgamations is known as the pooling of interests method. According to the pooling of interest technique, unless there is a need for an adjustment because of the firms' different accounting standards, the transferor company's assets, liabilities, and reserves will be assumed by the transferee company at their carrying amounts. Reserves should be modified to reflect the discrepancy between the amount reported as share capital and the share capital of the transferor firm, including any cash or other asset to settle the fractional shares.

Step 1: Equity Share Capital + Preference Share capital + Any consideration in the form of asset or cash by the Transferee Company.

Step 2: Equity Share Capital + Preference Share Capital existing in the books of the Transferor Company.

Step 3: Amount to be adjusted from the reserves of the Transferee Company = Step 1 – Step 2.

Amalgamation in the nature of purchase: In this method, it is not necessary that all the assets and liabilities are transferred. It is mandatory to transfer the purchase consideration by way of equity shares. The business of the transferee company can be different from that of the transferor company. The assets and liabilities are generally recorded at their fair values. The method of accounting in case of amalgamation in the nature of purchase is the purchase method. The purchase consideration is allocated to each identifiable asset at its fair value on the date of amalgamation. When the transferee company pays more for the acquisition consideration than the transferor firm's net assets, the difference is shown in the transferee company's financial statements as goodwill. Any deficit must be noted as a capital reserve. Unless a shorter term is warranted, the goodwill so recorded should be amortized over a five-year period. Stated differently, the following stages are used to compute the amount that should be reported as goodwill or capital reserve:

Step 1: Calculate the value of net assets using the formula: Total Assets – (Non-current liabilities + Current liabilities)

Step 2: Calculate the purchase consideration as per any of the methods specified in the calculation of the purchase consideration point (refer to point 5.3.)

Step 3: If Step 1- Step 2 turns out to be positive, the amount should be recorded as a capital reserve since the assets received are more than the amount paid to acquire them. If Step 1- Step 2 turns out to be negative, the amount should be recorded as goodwill since more amount is paid to acquire the assets.

Treatment of Reserves in case of amalgamation in the nature of purchase: The transferee company's financial statements should only include the transferor company's statutory reserve. The transferor company's other free reserves, profit and loss statement, and general reserve balance are all missing from the record. The exception to this rule is in the event of statutory reserves. Generally, reserves in amalgamations involving purchases are not identified. These reserves must be shown in the transferee company's financial statements exactly as they were in the transferor company's statements. This will be kept on file for as long as it takes to preserve them in accordance with the applicable statute's requirements. There is an exception.

Amalgamation Adjustment Reserve A/c……………….Dr

To Statutory Reserves A/c

The Amalgamation Adjustment Reserve A/c shows the balance of Statutory Reserves taken over from the transferor company. The reserve is shown as a deduction from the total reserves of the Transferee company. Once the time period to represent such reserve us over, the above entry is reversed. Hence, the Amalgamation Adjustment Reserve A/c is shown as a separate line item and not set off against the Statutory Reserve taken over from the Transferor company.

Knowledge Check 1

Fill up the Blanks:

1. Amalgamation is the combination of two entities that helps the business to act in a ___________manner with respect to its _____________ and ____________.

2. The amalgamated company will result in the creation of a pool of resources to facilitate the ___________of the organization and prevent the threat from ______________.

3. _____________ is a situation where a new entity is incorporated to take over the business of an existing entity in order to reorganize the _____________ of an organization.

4. In amalgamation in the nature of merger, shareholders holding not less than _______________ of the __________________ of the equity shares of the transferor company should become the shareholder of the transferee company.

5. In amalgamation in the nature of the purchase, only the ______________ of the transferor company should be incorporated in the financial statements of the transferee company.

Outcome-Based Activity 1

Identify three real-life scenarios of amalgamation of companies, absorption of companies, and external construction. Also, list down the conditions to be satisfied in order to classify the amalgamation in the nature of the merger.

5.3. Basis of arriving at Purchase Consideration

What is Purchase Consideration?

Purchase consideration refers to the amount of the consideration payable by the transferee company to the shareholders or owners of the transferor company in lieu of the assets and liabilities taken over. If a company is purchasing another company as a going concern that is with the intention to continue the operations till eternity, the purchase consideration can be discharged in one or more of the following methods:

1. Shares: The Transferee Company discharges the consideration by issuing shares of the transferee company to the owners of the Transferor Company.
2. Debentures: The Transferee Company discharges the consideration by offering debentures to the shareholders of the Transferor Company.
3. Cash: The consideration is discharged by cash. This is a rare scenario and is generally combined with shares or debentures of the transferee company.

It must be kept in mind that the value of assets and liabilities are different from the values appearing in the financial statements of the transferor company. They are valued to reflect their current worth in the market and this value is known as the fair value of the assets and liabilities. Hence, the price paid by the company for the purchase of the business of another company is called purchase consideration. In many cases, the purchase consideration is not equal to the net assets bought and the difference is recorded as goodwill or capital reserves

as described in point 5.2. As per Accounting Standard 14, purchase consideration is defined as the “aggregate of shares and other securities issued and payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company”. The important thing to be noted is that purchase consideration is the amount paid to the equity shareholders and preference shareholders of the Transferor company. This does not include any sum that is paid to the debenture holders or creditors of the transferor company. In case any liability is not assumed by the transferee company it shows that such liability will be paid off by the transferor company.

How is Purchase Consideration calculated?

The purchase consideration to be paid in the form of cash, shares or debentures can be determined in the following manner:

1. Lump Sum Method:

In this method, the Transferee Company and the Transferor Company arrive at a mutual decision to fix the consideration at a lump sum amount. This lumpsum amount is then paid to the shareholders of the Transferor Company.

Here's an example of the Lump Sum Method :

Suppose you are considering investing in a project that will generate a lump sum of INR 50,000 five years from now. Assuming a discount rate of 8%, the present value of this future cash flow would be calculated as follows using the Lump Sum Method:

Present Value = Future Value / (1 + Discount Rate)^Number of Years

Present Value = INR 50,000 / (1 + 0.08)^5

Present Value = INR 31,408.53

Therefore, the present value of the future lump sum of INR 50,000 is INR 31,408.53, given a discount rate of 8% and a time horizon of 5 years. This means that if you were to invest INR 31,408.53 today at a discount rate of 8%, it would grow to INR 50,000 in five years.

2. Net Payment Method:

In this method, the transferee company makes payment to the equity shareholders and preference shareholders of the transferor company by way of cash, issue of shares or issue of the debentures.

Here's an example of the Net Payment Method :

Suppose you are considering purchasing a car from a dealership that offers you two different payment options:

Option A: Pay INR 500,000 today and receive a rebate of INR 50,000 in 1 year.

Option B: Pay INR 450,000 today and receive a rebate of INR 55,000 in 1 year.

Assuming a discount rate of 10%, we can use the Net Payment Method to determine which option is more financially beneficial. Here's how we can calculate the present value of each option's net payments:

Option A:

Net payment in year 0 = -INR 500,000 (payment today) Net payment in year 1 = INR 50,000 (rebate received in 1 year) Present value of net payments = -INR 500,000 + INR 50,000 / (1 + 0.10)^1 = -INR 454,545.45

Option B:

Net payment in year 0 = -INR 450,000 (payment today) Net payment in year 1 = INR 55,000 (rebate received in 1 year) Present value of net payments = -INR 450,000 + INR 55,000 / (1 + 0.10)^1 = -INR 400,000.00

Based on the Net Payment Method, Option B is the better choice, as it has a lower present value of net payments (-INR 400,000.00) compared to Option A (-INR 454,545.45). Therefore, choosing Option B would result in a lower total cost of the car over the two-year period.

3. Net Asset Method:

In this method, the purchase consideration is calculated based on the total value of total assets minus liabilities. It does not take into account the share capital and reserves of the transferor company. As per Accounting Standard 14, the value of assets and liabilities shall be the such value that is agreed upon between the two parties. In case, the value is not agreed upon between the two parties, purchase consideration is calculated based on the assets and liabilities taken at their book value. Usually, the purchase consideration depends upon the fair value. The fair value shall be determined by the statutory authority may be taken or it may be determined with reference to the market value of the asset given up.

Here's an example of the Net Asset Method :

Suppose you are considering purchasing a business that has total assets worth INR 1,000,000 and total liabilities of INR 300,000. Using the Net Asset Method, we can calculate the

business's net asset value, which is the difference between its total assets and total liabilities. Here's how we can calculate the net asset value:

Net asset value = Total assets - Total liabilities Net asset value = INR 1,000,000 - INR 300,000 Net asset value = INR 700,000

Therefore, the net asset value of the business is INR 700,000. This means that if you were to purchase the business, you would be paying INR 700,000 for its net assets, which includes its property, equipment, inventory, and other assets, less its liabilities. However, it's important to note that the Net Asset Method doesn't take into account the business's future earnings potential, so it's important to also consider other valuation methods when making a decision to purchase the business.

4. Intrinsic value or share exchange method:

In this method, the intrinsic value of the shares of the transfer and transferee company is calculated. A ratio is then computed and multiplied by the intrinsic value of the shares. The total share capital of the transferor company is then divided by the total number of shares. There are some adjustments that may have to be made in the purchase consideration in case of one or more future events. When it is probable that any additional payment can be made, it is to be included in the calculation of purchase consideration.

Here's an example of the Intrinsic Value or Share Exchange Method :

Suppose Company A is considering acquiring Company B. Company A's stock is currently trading at INR 150 per share, and Company B has 100,000 shares outstanding. Company B's net income for the most recent fiscal year was INR 1,000,000, and Company A believes that it can generate an additional INR 500,000 in annual net income by acquiring Company B.

To use the Intrinsic Value or Share Exchange Method, we need to calculate the intrinsic value of Company B, which is the value of its net assets plus the present value of its future earnings. Here's how we can calculate the intrinsic value of Company B:

Step 1: Calculate the value of Company B's net assets

Net asset value = Total assets - Total liabilities Assuming Company B has net assets of INR 500,000.

Step 2: Calculate the present value of Company B's future earnings

Using a discount rate of 10%, we can calculate the present value of Company B's additional annual net income of INR 500,000:

Present value of future earnings = Future earnings / (1 + Discount rate)^Number of years
Present value of future earnings = INR 500,000 / (1 + 0.10)^1 = INR 454,545.45

Step 3: Calculate the intrinsic value of Company B

Intrinsic value = Net asset value + Present value of future earnings Intrinsic value = INR 500,000 + INR 454,545.45 = INR 954,545.45

Therefore, the intrinsic value of Company B is INR 954,545.45. Based on this valuation, Company A could offer to acquire Company B for INR 954,545.45 / 100,000 shares = INR 9.55 per share, which is less than Company A's current stock price of INR 150 per share. However, it's important to note that this is just one method of valuation and that there may be other factors to consider when making an acquisition decision.

Illustration 1: XYZ is absorbed by PQR Ltd. Compute the purchase consideration using the information provided on the date of the absorption:

Particulars	Amount (Rs)
Sundry Assets	26,00,000
Share capital:	
4,000 7% Preference shares of Rs 100 each (fully paid up)	4,00,000
10,000 Equity shares of Rs 100 each (fully paid up)	10,00,000
Reserves	6,00,000
6% Debentures	4,00,000
Trade payables	2,00,000

Additional Information:

PQR Ltd. has agreed to issue 12% Preference shares of Rs. 100 each, in the ratio of 3 shares of PQR Ltd. for 4 preference shares in XYZ Ltd. PQR Ltd also agreed to pay Rs. 40 per share in cash and to issue six equity shares of Rs 100 each issued at the market value Rs 125 in lieu of every five shares held in XYZ Ltd.

Solution:

Particulars	Amount (Rs)
12% Preference Shares (4000 x 3/4 x 100)	3,00,000
Equity Shares (10000 x 6/5 x 125)	15,00,000

Cash (10000 x 40) 4,00,000

Total 22,00,000

5.4. Accounting Entries

Accounting Entries in the books of the Transferor Company

In case of amalgamation under any of the methods i.e. amalgamation in the nature of merger or amalgamation in the nature of the purchase, there shall be an accounting treatment in the books of the Transferor Company. On the closure of the books of the Transferor Company, the assets and liabilities of the transferor Company shall be transferred to a separate account known as the 'Realization Account'. Purchase consideration represents the amount realized on the transfer of the business and is credited to the Realization Account. Any balance of the realization A/c is transferred to the Equity Shareholders Account. Following are the journal entries in the books of the Transferor Company:

Serial No Particulars Amount (Dr) Amount (Cr)

1. Transfer of Assets to Realization A/c

Realization A/c……………………………….Dr

To Assets A/c

(Being Assets transferred to Realization Account)

Note: The debit balance of the Profit & Loss Account and expenses not written off are not assets, hence, not transferred.

2. Transfer of Liabilities to Realization A/c

Liabilities A/c……………………………….Dr

To Realization A/c

(Being Liabilities transferred to Realization Account)

Note:In case of liabilities not taken over by the Transferee Company, the profit or loss on such transfer shall be transferred to Realization Account.

3. Recording the purchase consideration

Transferee Company A/c…………………….Dr

To Realization A/c

(Being business sold and purchase consideration booked)

4. On receipt of the purchase consideration

Equity Shares in Transferee Company A/c……..Dr

Preference Shares in Transferee Company A/c…Dr

Cash A/c……………………………………...Dr

To Realization A/c

(Being purchase consideration received)

5 On payment of the expenses on liquidation

Realization A/c…………………….Dr

To Cash A/c

(Being liquidation expenses paid by the Transferor Company)

6. In case the liquidation is later reimbursed by the Transferee Company

Transferee Company A/c…………………….Dr

To Cash A/c

(Being liquidation expenses paid to be reimbursed later by the Transferee Company)

In case of reimbursement of the liquidation expenses by the Transferee Company

Cash A/c………………………………………Dr

To Transferee Company A/c

(Being liquidation expenses reimbursed later by the Transferee Company)

7. On discharge of liabilities not taken over by the Transferee Company

Liabilities A/c…………………………………Dr

To Cash A/c

(Being liabilities discharged by the Transferee Company)

8. On payment of consideration to the preference shareholder

Old Preference Share Capital A/c……………Dr

Realization A/c (b.f.)……………………….....Dr

To Preference Shareholders A/c

To Realization A/c (b.f.)

(Being the discharge of consideration to preference shareholders)

9. Transfer Equity Share Capital & Reserves & the balance of the Realization Account of the Transferor Company to the Equity Shareholders Account

Equity Share Capital A/c………………………Dr

Reserves A/c……………………………………Dr

Realization A/c…………………………………Dr

To Equity Shareholder A/c

To Realization A/c

(Being the transfer of Equity Share Capital & Reserves & the balance of the Realization Account of the Transferor Company to the Equity Shareholders Account)

10. On satisfaction of claims of the equity shareholder

Equity Shareholder A/c………………………Dr

To Equity Share Capital of Transferor Co. A/c

To Cash A/c

(Being the claims of equity shareholders settled and the cash balance transferred to equity shareholders account)

Here's an example of the accounting entries in the books of the transferor company :

Suppose Company A sells a piece of equipment to Company B for INR 1,000,000. Here's how the accounting entries would be recorded in the books of Company A, the transferor company:

1. Recording the sale of equipment:

Equipment Account Debit INR 1,000,000 Sales Account Credit INR 1,000,000

2. Recording the removal of the equipment from the books:

Accumulated Depreciation Account Debit INR XXX Equipment Account Credit INR XXX

Note: This entry records the accumulated depreciation on the equipment up to the date of sale. The exact amount will depend on the depreciation method used by the company.

3. Recording the gain or loss on the sale:

Cash/Bank Account Debit INR XXX Profit and Loss Account Credit INR XXX

Note: This entry records any gain or loss on the sale of the equipment. The exact amount will depend on the difference between the selling price and the carrying amount of the equipment (original cost less accumulated depreciation).

After recording these entries, the books of Company A will reflect the sale of the equipment and any resulting gain or loss. The corresponding entries would be recorded in the books of Company B, the transferee company, to reflect the acquisition of the equipment.

- Accounting Entries in the books of the Transferee Company

In the books of the Transferee Company, the following journal entries are made:

Serial No Particulars Amount (Dr) Amount (Cr)

1. Recording the purchase consideration

Business Purchase A/c………………………..Dr

To Liquidator of the Transferor Co. A/c

(Being amount payable to the Transferor Company)

2. Recording Assets and Liabilities

Assets A/c……………………………….Dr

Goodwill A/c (b.f.)……………………………Dr

To Liabilities A/c

To Business Purchase A/c

To Capital Reserve A/c (b.f.)

(Being Assets and Liabilities transferred to recorded in the books of Transferor Company)

3. On discharge of purchase consideration

Liquidator of Transferor Company A/c…………Dr

To Equity Share Capital of Transferor Co. A/c

To Preference Share Capital A/c

To Cash A/c

To Securities Premium A/c

(Being purchase consideration discharged)

4. On the issue of debentures by the Transferee Company

Debentures in Transferee Company A/c……..Dr

Discount on issue of debentures A/c…Dr

To New Debentures A/c

To Premium on issue of debentures A/c

(Being the debentures issued by the Transferee Company)

5 On payment of the expenses on liquidation

Goodwill or Capital Reserve A/c…………..Dr

To Cash A/c

(Being liquidation expenses paid by the Transferee Company)

Here's an example of the accounting entries in the books of the transferee company :

Suppose Company A sells a piece of equipment to Company B for INR 1,000,000. Here's how the accounting entries would be recorded in the books of Company B, the transferee company:

1. Recording the acquisition of the equipment:

Equipment Account Debit INR 1,000,000 Cash/Bank Account Credit INR 1,000,000

2. Recording the depreciation on the equipment:

Depreciation Expense Account Debit INR XXX Accumulated Depreciation Account Credit INR XXX

Note: This entry records the depreciation expense on the equipment, which reduces the carrying amount of the asset over time. The exact amount will depend on the depreciation method used by the company.

After recording these entries, the books of Company B will reflect the acquisition of the equipment and the corresponding depreciation expense. The corresponding entries would be recorded in the books of Company A, the transferor company, to reflect the sale of the equipment and any resulting gain or loss.

- **Knowledge Check 2**

State whether the following statements are True or False.

1. Purchase consideration refers to the amount of the consideration payable by the transferor company to the shareholders or owners of the transferee company
2. The purchase consideration is usually discharged in cash.
3. The assets and liabilities are valued to reflect their current worth in the market and this value is known as the fair value of the assets and liabilities.
4. In the Net Payment Method, the transferee company makes payment to the equity shareholders and preference shareholders of the transferor company by way of cash, issue of shares, or issue of the debentures.
5. The debit balance of the Profit & Loss Account and expenses not written off are also transferred to the Realization Account of the Transferor Company.

- Outcome-Based Activity 2

Vayu Ltd acquires the business of Pharma Ltd. The balance sheet of the entities as of 31.12.2022 are as follows:

Particulars	Amount	Amount
Equity and Liabilities		
Shareholders' funds		
Equity Share capital (Rs. 100 each)	8,00,000	
6% Preference Share capital (Rs. 100 each)	4,00,000	12,00,000
Reserves & Surplus		
Capital reserve	1,00,000	
Profit and loss A/c	58,000	1,58,000
Non-current liabilities		
6% Debentures	2,00,000	2,00,000
Current liabilities		
Trade Payables	1,20,000	
Other current liabilities	12,000	1,32,000
		16,90,000
Assets		
Non-current assets		
Land and Building	4,00,000	
Plant and machinery	6,00,000	
Goodwill	2,40,000	
Patents	50,000	12,90,000
Current assets		
Inventories	1,50,000	
Trade receivables	1,80,000	
Cash and Cash equivalents	70,000	4,00,000
		16,90,000

Additional Information:

Vayu Ltd. Takes over all the assets of Pharma Ltd. (except cash) and liabilities for the following amounts:

1. Rs. 2,00,000 7% Debentures (Rs. 100 each) in Vayu Ltd. for the existing debentures in Pharma Ltd. For this purpose, each debenture of Vayu Ltd. is to be treated as worth Rs. 105.
2. For each preference share in Pharma Ltd. Rs. 10 in cash and one 9% preference share of Rs. 100 each in Vayu Ltd.
3. For each equity share in Pharma Ltd. Rs. 20 in cash and one equity share in Vayu Ltd. of Rs.100 each having a market value of Rs.140.
4. The expense of liquidation of Pharma Ltd. is to be reimbursed by Vayu Ltd. to the extent of ` 10,000. Actual expenses amounted to Rs. 12,500.
5. Vayu Ltd. valued Land and building at Rs. 5,50,000 Plant and Machinery at Rs. 6,50,000 and patents at Rs. 20,000 of Pharma Ltd for the purpose of amalgamation.

Calculate purchase consideration. Pass journal entries in the books of Vayu Ltd. and Pharma Ltd.

5.5. Summary

- The amalgamation of companies refers to the process of combining two or more business organizations to form one large entity.
- Entities around the world amalgamate to enjoy various tax benefits that act as a significant measure of tax planning. Through amalgamation, companies enjoy the advantage of economies of scale.
- External Reconstruction is a situation where a new entity is incorporated to take over the business of an existing entity. Only two entities are involved in such an arrangement. One resultant company is formed that takes over the business of an existing company.
- Accounting Standard 14 deals with the accounting for amalgamation and the treatment of goodwill or reserve on such amalgamation. The standard is ideally designed for companies, however, some of the provisions are related to the financial statements of other enterprises.

- Purchase consideration refers to the amount of the consideration payable by the transferee company to the shareholders or owners of the transferor company in lieu of the assets and liabilities taken over.

5.6. Self-Assessment Questions

1. What are the objectives of the amalgamation of companies?
2. Write short notes on the Absorption of companies and External Reconstruction.
3. What are the conditions to be satisfied for amalgamation in the nature of a merger?
4. Write a short note on the pooling of interest method.
5. What is purchase consideration and how it is calculated?

5.7. References

- Financial Accounting by Monga, J.R. Ahuja, Girish Ahuja and Ashok Shehgal, Mayur Paper Back, Noida.
- Financial Accounting by Williams, Tata Mc. Grow Hill and Co. Ltd., Mumbai.
- Financial Accounting by V. Rajasekaran, Pearson Publications, New Delhi.
- Introduction to Financial Accounting by Horngren, Pearson Publications, New Delhi.
- Financial Accounting by M. Mukherjee and M. Hanif, Tata McGraw Hill Education Pvt. Ltd., New Delhi.

Unit- 6

Internal Reconstruction of Companies

Learning Outcomes:

- Students will be able to define the meaning of External Reconstruction and Internal Reconstruction of Companies.
- Students will be capable of demonstrating the situations which call for the Internal Reconstruction of a Company.
- Students will be able to define the Advanced Corporate Accounting of Share Capital and Reduction of Share Capital.

Structure:

6.1 Meaning of External Reconstruction and Internal Reconstruction of Companies

6.2 Difference between External Reconstruction and Internal Reconstruction

6.3 Situations which call for Internal Reconstruction of a Company

- Knowledge Check 1
- Outcome-Based Activity 1

6.4 Forms of Internal Reconstruction of Companies

6.5 Alteration Advanced Corporate Accounting of Share Capital and Reduction of Share Capital

6.6 Accounting Treatment on Internal Reconstruction of Companies

- Knowledge Check 2
- Outcome-Based Activity 2

6.7 Summary

6.8 Self-Assessment Questions

6.9 References

6.1 Meaning of External Reconstruction and Internal Reconstruction of Companies

- Definition and Meaning of External Reconstruction

External reconstruction is a process in which a company restructures its business by merging or acquiring another company, or by demerging its own operations into a new separate entity. This process is also known as external reorganization.

External reconstruction is typically undertaken by companies that want to expand their operations, enter new markets, or restructure their existing business operations. In this process, a company may merge with another company to create a larger entity, acquire another company to gain its assets or market share, or demerge its operations into a new separate entity to focus on a specific business line.

External reconstruction can be an effective way for companies to achieve their strategic objectives, such as reducing costs, improving operational efficiency, increasing market share, or diversifying their business operations. However, it can also be a complex process that requires careful planning, due diligence, and legal and regulatory compliance.

External reconstruction may involve several steps, such as identifying potential merger or acquisition targets, conducting a thorough evaluation of the target company's financial and operational performance, negotiating the terms of the transaction, obtaining regulatory approvals, and integrating the operations of the merged entity. The process may also require the services of external advisors, such as investment bankers, lawyers, and accountants.

External reconstruction can have a significant impact on the financial statements of the companies involved, as it may result in changes to the value and composition of their assets and liabilities, as well as the recognition and treatment of goodwill and other intangible assets. It is important for companies to carefully consider the accounting treatment of the transaction and to ensure compliance with legal and regulatory requirements.

Types of External Reconstruction

There are several types of external reconstruction that companies may consider, depending on their strategic objectives, financial resources, and market conditions. Some of the common types of external reconstruction are:

1. Merger: A merger is a type of external reconstruction in which two or more companies combine their operations and assets to form a new entity. In a merger, the companies involved usually have a similar size and market position. The new entity formed as a result

of the merger may have a new name, management team, and ownership structure. A merger can be either a friendly or hostile takeover.

2. Acquisition: An acquisition is a type of external reconstruction in which one company purchases the assets or shares of another company. In an acquisition, the acquiring company gains control over the target company's operations, assets, and liabilities. The acquired company may continue to operate as a separate entity or be merged with the acquiring company.

3. Joint Venture: A joint venture is a type of external reconstruction in which two or more companies form a separate legal entity to undertake a specific business project or activity. The companies involved in the joint venture may have complementary skills or resources that they can leverage to achieve their strategic objectives. Joint ventures can be structured as equity joint ventures or contractual joint ventures.

4. Spin-Off: A spin-off is a type of external reconstruction in which a company separates a part of its operations and assets into a new separate entity. The new entity can be either a subsidiary or an independent company. The spin-off allows the parent company to focus on its core business activities and provide a more focused investment opportunity to its shareholders.

5. Divestiture: A divestiture is a type of external reconstruction in which a company sells all or a part of its operations or assets to another company. Divestitures are usually undertaken to reduce debt, raise capital, or exit non-core business activities. Divestitures can be structured as asset sales or stock sales.

Examples of External Reconstruction

There are many examples of external reconstruction, which involve a range of different types of transactions. Some of the common examples of external reconstruction are:

1. Merger: In 2019, Bristol-Myers Squibb completed a merger with Celgene, creating a leading biopharmaceutical company with a strong pipeline of products and a global footprint. The merger was valued at $74 billion and involved the exchange of shares and cash.

2. Acquisition: In 2019, the Walt Disney Company completed the acquisition of 21st Century Fox for $71.3 billion, which included the film and television studios, cable and international TV businesses, and other assets. The acquisition allowed Disney to expand its

media and entertainment empire and compete more effectively with streaming services such as Netflix and Amazon.

3. Joint Venture: In 2018, Volkswagen Group and Ford Motor Company announced a joint venture to develop commercial vans and medium-sized pickups for global markets. The joint venture allows the companies to share resources and reduce costs while leveraging their respective strengths in engineering, production, and distribution.

4. Spin-Off: In 2020, Intel Corporation announced the spin-off of its memory and storage business into a new company called Intel Memory and Storage Solutions (IMSS). The spin-off allows Intel to focus on its core business of manufacturing microprocessors while providing IMSS with the resources and expertise to grow its own business.

5. Divestiture: In 2019, General Electric completed the divestiture of its biopharma business to Danaher Corporation for $21.4 billion. The divestiture allowed General Electric to reduce its debt and focus on its core businesses while providing Danaher with a leading position in the biopharma market.

These examples illustrate the range of transactions that can be classified as external reconstruction and the different strategic objectives that companies can achieve through these transactions. External reconstruction can be a powerful tool for companies to drive growth, reduce costs, and increase shareholder value, but it is also a complex process that requires careful planning, due diligence, and legal and regulatory compliance.

Definition and Meaning of Internal Reconstruction

Internal reconstruction is a process in which a company reorganizes its operations, assets, and liabilities without going through a formal liquidation or winding-up process. The purpose of an internal reconstruction is to restructure the company's financial affairs, streamline its operations, and make it more efficient and profitable. Internal reconstruction can also be used to simplify the company's structure, reduce its debt, and improve its financial position.

Internal reconstruction is a complex process that requires careful planning, financial analysis, and legal and regulatory compliance. It can be a useful tool for companies to restructure their operations and improve their financial position, but it can also be risky if not done properly. Companies that are considering internal reconstruction should seek the advice of legal and

financial professionals to ensure that the process is carried out effectively and in compliance with all applicable laws and regulations.

Types of Internal Reconstruction

There are several types of internal reconstruction that a company can undertake to improve its financial position and streamline its operations. The most common types of internal reconstruction are:

1. Reduction of Capital: In this method, a company reduces its capital by writing off or cancelling its losses or by cancelling its uncalled capital. The reduction in capital is then used to offset any losses or liabilities that the company may have.
2. Consolidation: In this method, a company combines its operations with another company to create a new entity. The consolidation can be done through a merger, acquisition, or joint venture.
3. Amalgamation: In this method, two or more companies combine their operations and assets to form a new company. The new company takes over the operations and assets of the old companies, and the old companies are dissolved.
4. Restructuring of Debt: In this method, a company restructures its debt by negotiating with its creditors to reduce the amount of debt owed, extend the payment terms, or reduce the interest rate.
5. Sale of Assets: In this method, a company sells some of its non-core or underperforming assets to generate cash and reduce debt. The sale of assets can also help to streamline the company's operations and focus on its core business.
6. Spin-off: In this method, a company creates a new, independent company by separating a portion of its business into a new entity. The new entity is then sold to new investors or listed on a stock exchange.
7. Divestiture: In this method, a company sells a portion of its business to another company to raise capital and focus on its core business. Divestitures can include the sale of a subsidiary, business unit, or product line.
8. Recapitalization: In this method, a company restructures its balance sheet by changing the mix of debt and equity. The company may issue new shares or bonds or convert debt into equity, to improve its financial position.

Internal reconstruction can be a complex and time-consuming process that requires careful planning, analysis, and execution. Companies that are considering internal reconstruction should seek the advice of legal, financial, and accounting professionals to ensure that the process is carried out effectively and in compliance with all applicable laws and regulations.

Examples of Internal Reconstruction

Here are some examples of internal reconstruction:

1. Reduction of capital: A company may decide to reduce its capital by cancelling or writing off losses, or by cancelling its uncalled capital. The reduction in the capital can then be used to offset any losses or liabilities that the company may have.
2. Consolidation: In this method, a company combines its operations with another company to create a new entity. The consolidation can be done through a merger, acquisition, or joint venture. For example, in 2019, Bristol-Myers Squibb completed its acquisition of Celgene to create a leading biopharmaceutical company.
3. Amalgamation: In this method, two or more companies combine their operations and assets to form a new company. The new company takes over the operations and assets of the old companies, and the old companies are dissolved. For example, in 2015, Royal Dutch Shell acquired BG Group to create one of the world's largest integrated energy companies.
4. Restructuring of debt: A company may decide to restructure its debt by negotiating with its creditors to reduce the amount of debt owed, extend the payment terms, or reduce the interest rate. For example, in 2019, Argentine retailer Garbarino negotiated a debt restructuring deal with its creditors to avoid bankruptcy.
5. Sale of assets: A company may decide to sell some of its non-core or underperforming assets to generate cash and reduce debt. The sale of assets can also help to streamline the company's operations and focus on its core business. For example, in 2019, General Electric sold its biopharmaceutical business to Danaher for $21.4 billion to focus on its core industrial businesses.
6. Spin-off: In this method, a company creates a new, independent company by separating a portion of its business into a new entity. The new entity is then sold to new investors or listed on a stock exchange. For example, in 2019, Hewlett Packard Enterprise completed the spin-off of its software business, which was then merged with Micro Focus International.

7. Divestiture: In this method, a company sells a portion of its business to another company to raise capital and focus on its core business. Divestitures can include the sale of a subsidiary, business unit, or product line. For example, in 2019, Nestle sold its U.S. ice cream business to Froneri for $4 billion to focus on its core food and beverage businesses.
8. Recapitalization: In this method, a company restructures its balance sheet by changing the mix of debt and equity. The company may issue new shares or bonds or convert debt into equity to improve its financial position. For example, in 2020, Carnival Corporation announced a $6 billion recapitalization plan to raise capital and improve its liquidity during the COVID-19 pandemic.

6.2 Difference between External Reconstruction and Internal Reconstruction

External reconstruction and internal reconstruction are two different methods of reorganizing a company's financial and business structure. Here are some differences between external and internal reconstruction:

1. Meaning: External reconstruction refers to the process of changing the legal and financial structure of a company through amalgamation, merger, acquisition, or consolidation with another company, while internal reconstruction refers to the process of reorganizing a company's financial structure through changes in share capital, debentures, and reserves.
2. Purpose: The purpose of external reconstruction is to create a new legal entity by merging two or more companies or acquiring one company from another. This is done to achieve economies of scale, gain market share, diversify products or services, or improve the financial position of the company. The purpose of internal reconstruction is to reorganize the capital structure of a company by reducing or eliminating accumulated losses, writing off fictitious assets, or consolidating the company's share capital.
3. Legal framework: External reconstruction involves changes in the legal framework of the company, such as altering the Memorandum of Association, Articles of Association, and other legal documents. Internal reconstruction does not involve changes in the legal framework of the company, but rather focuses on the financial restructuring of the company.
4. Accounting treatment: External reconstruction requires the transfer of assets and liabilities of the acquired company to the acquiring company, which is recorded in the balance sheet of

the acquiring company. Internal reconstruction involves changes in the capital structure of the company, which are recorded in the company's books of accounts.

5. Process: External reconstruction involves a complex and lengthy process of negotiations, due diligence, legal documentation, and regulatory approvals, while internal reconstruction involves a simpler process of passing resolutions, making accounting entries, and complying with regulatory requirements.

6. Risks: External reconstruction involves higher risks of integration issues, cultural clashes, regulatory hurdles, and financial risks, while internal reconstruction involves lower risks as it does not involve external stakeholders and legal and regulatory issues.

6.3 Situations which call for Internal Reconstruction of a Company

Internal reconstruction is a process of reorganizing the capital structure of a company. It is usually carried out to address financial difficulties, such as accumulated losses, write-offs of fictitious assets, and consolidation of share capital. Here are some situations that call for the internal reconstruction of a company:

1. Accumulated losses: When a company incurs losses over a period of time, it may lead to a negative net worth. In such cases, the company may consider internal reconstruction to write off the accumulated losses and restore its financial health. This is usually done by reducing the face value of shares, cancelling the existing shares, and issuing new shares to raise fresh capital.

2. Fictitious assets: Fictitious assets are those assets that have no real value, such as preliminary expenses, discounts on the issue of shares, and loss on the issue of debentures. These assets are usually written off from the company's books through internal reconstruction. This helps to improve the accuracy of the company's financial statements and enhances the credibility of the company among investors and other stakeholders.

3. Over-capitalization: Over-capitalization occurs when a company's share capital is more than its actual requirement. This leads to a low return on investment and reduces the company's profitability. Internal reconstruction can help to address over-capitalization by reducing the share capital and returning the excess capital to shareholders.

4. Consolidation of share capital: A company may consider consolidating its share capital by reducing the number of shares and increasing the face value of the remaining shares. This

helps to simplify the company's capital structure and make it more transparent and easier to understand for investors and other stakeholders.

5. Business restructuring: A company may undergo internal reconstruction to restructure its business operations, such as merging business divisions, spinning off non-core businesses, or reorganizing the management structure. This helps to improve the efficiency of the company's operations and make it more competitive in the market.

In summary, internal reconstruction is usually carried out to address financial difficulties or to restructure a company's capital or management structure. It helps to improve the financial health of the company, enhance the credibility of its financial statements, and make it more efficient and competitive in the market.

- **Knowledge Check 1**

Fill in the Blanks.

1. External reconstruction is typically undertaken by companies that want to expand their operations, enter new markets, or __________their existing business operations.
2. There are several types of external reconstruction that companies may consider, depending on their strategic objectives, _____________ resources, and market conditions
3. External reconstruction requires the transfer of assets and _____________ of the acquired company to the acquiring company, which is recorded in the balance sheet of the acquiring company.

- **Outcome-Based Activity 1**

Analyze a case study of a company that has undergone external reconstruction, identify the reasons for such a reconstruction, and discuss its impact on the company's financial position. The activity promotes critical thinking, analysis, and communication skills.

6.4 Forms of Internal Reconstruction of Companies

Internal reconstruction is a process of reorganizing the capital structure of a company. It involves making changes to the company's share capital, reserves, and other financial assets to address financial difficulties, such as accumulated losses, over-capitalization, or

consolidation of share capital. Here are some forms of internal reconstruction that a company can undertake:

1. Reduction of share capital: This involves reducing the face value of the shares held by shareholders or cancelling the existing shares and issuing new shares. This is usually done to write off accumulated losses or to address over-capitalization.
2. Consolidation of share capital: This involves reducing the number of shares in circulation and increasing the face value of the remaining shares. This helps to simplify the company's capital structure and make it more transparent and easier to understand for investors and other stakeholders.
3. Conversion of shares: This involves converting one type of share into another type, such as converting preference shares into equity shares or vice versa. This helps to address financial difficulties, such as accumulated losses or over-capitalization, and to align the company's capital structure with its business needs.
4. Writing off fictitious assets: This involves writing off assets that have no real value, such as preliminary expenses, discounts on the issue of shares, or loss on the issue of debentures. This helps to improve the accuracy of the company's financial statements and enhance its credibility among investors and other stakeholders.
5. Transfer of reserves: This involves transferring the accumulated profits or reserves of the company to other reserves, such as a capital redemption reserve or a general reserve. This helps to strengthen the company's financial position and provides a buffer against future losses.
6. Reorganization of management: This involves reorganizing the management structure of the company, such as merging business divisions or spinning off non-core businesses. This helps to improve the efficiency of the company's operations and make it more competitive in the market.

6.5 Alteration Advanced Corporate Accounting of Share Capital and Reduction of Share Capital

Share capital refers to the funds raised by a company by issuing shares to its shareholders in exchange for ownership in the company. The share capital of a company can be altered by increasing or decreasing the number of shares, changing the face value of the shares, or

converting one type of share into another type. Here we will discuss the alteration of share capital and the reduction of share capital.

Alteration of Share Capital: The alteration of share capital involves making changes to the structure of the company's share capital. The following are some of the situations where a company may consider altering its share capital:

1. To raise additional funds: A company may need to raise additional funds to finance its operations or to undertake new projects. In such a case, the company may increase its share capital by issuing new shares to its existing shareholders or to the public.
2. To simplify the share capital structure: A company may have a complex share capital structure that is difficult to understand for investors and other stakeholders. In such a case, the company may consider altering its share capital to simplify the structure and make it more transparent.
3. To comply with regulatory requirements: A company may need to alter its share capital to comply with regulatory requirements, such as the Companies Act or the Securities and Exchange Board of India (SEBI) guidelines.

The process of alteration of share capital involves obtaining approval from the shareholders of the company, the Board of Directors, and the regulatory authorities if required. The company also needs to file the necessary documents with the Registrar of Companies (ROC).

Reduction of Share Capital: A company may need to reduce its share capital for various reasons, such as to write off accumulated losses or to address over-capitalization. The following are some of the situations where a company may consider reducing its share capital:

1. To write off accumulated losses: A company may have accumulated losses that it wants to write off by reducing its share capital. This helps to improve the financial health of the company.
2. To address over-capitalization: A company may have a large share capital that is not commensurate with its business needs. In such a case, the company may consider reducing its share capital to address over-capitalization.

3. To return surplus funds to shareholders: A company may have surplus funds that it wants to return to its shareholders. In such a case, the company may consider reducing its share capital and returning the surplus funds to its shareholders.

The reduction of share capital can be done by either cancelling the existing shares or by reducing the face value of the shares. The process of reducing the share capital involves obtaining approval from the shareholders of the company, the Board of Directors, and the regulatory authorities if required. The company also needs to file the necessary documents with the ROC.

6.6 Accounting Treatment on Internal Reconstruction of Companies

Internal reconstruction of a company is an accounting process that involves the reorganization of a company's financial structure, with the objective of improving the financial position and performance of the company. This is done by changing the structure of the company's assets, liabilities, and equity.

The accounting treatment of internal reconstruction depends on the nature and extent of the reconstruction. In general, the accounting treatment is based on the principle of maintaining the continuity of the company's financial records.

One of the key principles of internal reconstruction is that it should not affect the company's capital. This means that the company's capital should not be reduced, and the reconstruction should not be treated as a capital reduction. Instead, the accounting treatment should reflect the fact that the company's assets and liabilities have been reorganized.

The following are some of the accounting entries that may be required in an internal reconstruction:

1. Transfer of assets and liabilities: In an internal reconstruction, assets and liabilities are usually transferred from one category to another. For example, an asset may be transferred from the fixed assets category to the current assets category. The accounting entry for such transfers should reflect the value of the asset or liability being transferred.

2. Adjustment of capital: The capital of the company may need to be adjusted in some cases. For example, if the company has accumulated losses, these may need to be written off against the company's capital. The accounting entry for such adjustments should reflect the value of the adjustment being made.

3. Write-off of liabilities: In some cases, liabilities may need to be written off as part of the internal reconstruction. For example, if liability is deemed to be uncollectible, it may need to be written off. The accounting entry for such write-offs should reflect the value of the liability being written off.

4. Revaluation of assets and liabilities: The values of assets and liabilities may need to be revalued as part of the internal reconstruction. For example, if the value of a fixed asset has changed, it may need to be revalued. The accounting entry for such revaluations should reflect the change in the value of the asset or liability.

It is important to note that the accounting treatment of internal reconstruction should be done in accordance with the accounting principles and standards applicable to the company. It is advisable to seek the advice of a qualified accountant or auditor to ensure that the accounting treatment is done correctly.

- **Knowledge Check 2**

State whether given statements are true or false.

1 Share capital refers to the funds raised by a company by issuing shares to its shareholders in exchange for ownership in the company. (T/F)

2. The process of alteration of share capital does not involve obtaining approval from the shareholders of the company, the Board of Directors, and the regulatory authorities if required. (T/F)

3. The reduction of share capital can be done by either cancelling the existing shares or by reducing the face value of the shares. (T/F)

- **Outcome-Based Activity 2**

Analyze the effects of different methods of altering share capital, such as stock splits or reverse stock splits, on the financial statements of a company.

6.4 Summary

- External reconstruction is a process in which a company restructures its business by merging or acquiring another company or by demerging its own operations into a new separate entity.

- External reconstruction can be an effective way for companies to achieve their strategic objectives, such as reducing costs, improving operational efficiency, increasing market share, or diversifying their business operations.
- Acquisition: An acquisition is a type of external reconstruction in which one company purchases the assets or shares of another company.
- Spin-Off: A spin-off is a type of external reconstruction in which a company separates a part of its operations and assets into a new separate entity.
- External reconstruction can be a powerful tool for companies to drive growth, reduce costs, and increase shareholder value, but it is also a complex process that requires careful planning, due diligence, and legal and regulatory compliance.
- Internal reconstruction is a process in which a company reorganizes its operations, assets, and liabilities without going through a formal liquidation or winding-up process.
- Internal reconstruction is a complex process that requires careful planning, financial analysis, and legal and regulatory compliance.
- Internal reconstruction can be a complex and time-consuming process that requires careful planning, analysis, and execution.
- External reconstruction and internal reconstruction are two different methods of reorganizing a company's financial and business structure.
- Internal reconstruction is a process of reorganizing the capital structure of a company. It is usually carried out to address financial difficulties, such as accumulated losses, write-offs of fictitious assets, and consolidation of share capital.
- Internal reconstruction is a process of reorganizing the capital structure of a company.
- Consolidation of share capital: This involves reducing the number of shares in circulation and increasing the face value of the remaining shares.
- Reorganization of management: This involves reorganizing the management structure of the company, such as merging business divisions or spinning off non-core businesses.
- Alteration of Share Capital: The alteration of share capital involves making changes to the structure of the company's share capital.
- The accounting treatment of internal reconstruction depends on the nature and extent of the reconstruction.

- One of the key principles of internal reconstruction is that it should not affect the company's capital.

6.5 Self-Assessment Questions

1. Explain the meaning of External and Internal Reconstruction of Companies.
2. What are the situations which call for Internal Reconstruction of a Company?
3. Explain the difference between External Reconstruction and Internal Reconstruction.
4. Explain the forms of Internal Reconstruction of Companies.
5. Explainthe Accounting Treatment on Internal Reconstruction of Companies.

6.6 References

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Unit- 7

Issue of Bonus Shares and Right Shares

Learning Outcomes:

- Students will be able to understand the meaning of bonus shares and right shares.
- Students will get knowledge of the accounting treatment of bonus shares and right shares.
- Students will be able to understand the advantages and disadvantages of bonus shares and right shares.

Structure:

7.1. Meaning of Bonus Shares

- What are Bonus Shares?
- Objectives of Issue of Bonus Shares
- Advantages and Disadvantages of Bonus Shares

7.2. Accounting Treatment of Bonus Shares

- Accounting Treatment of Bonus Shares
- Knowledge Check 1
- Outcome-Based Activity 1

7.3. Meaning of Right Shares Objectives

- What are the Right Shares?
- Objectives of Issue of Right Shares
- Advantages and Disadvantages of Right Shares

7.4. Accounting Treatment of Right Shares

- Calculation of the Ex-Right Value of the Shares
- Calculation of the Right of Renunciation
- Accounting Entries for the issue of right shares
- Knowledge Check 2
- Outcome-Based Activity 2

7.5. Summary

7.6. Self-Assessment Questions

7.7. References

7.1. Meaning of Bonus Shares

- **What are Bonus Shares?**

Bonus shares are shares that the company issues to its current owners. The shares are distributed without charge. The amount of shares that current shareholders currently own serves as the basis for issuing new shares. Bonus shares enhance the total number of issued shares and ownership of shares but do not result in the raising of fresh cash. It doesn't raise the company's net worth. The proportion of shares held by each current shareholder does not change while the number of shares does. Another name for a bonus issuance is a capitalization of earnings. Bonus issues are, to put it simply, the issuance of additional shares to the company's current shareholders .Capitalisation of profits is considered as converting the profits or reserves of the company into paid-up capital. A company may either capitalise its profits or reserves by way of issue of fully paid-up bonus shares or distribute them as dividends to the shareholders of the company. In case the subscribed and paid-up capital exceeds the authorised capital of the company. if the capital that has been subscribed for and paid for beyond the company's authorized capital. A resolution to raise the company's authorized capital is passed at the general meeting of shareholders following the issuance of bonus shares. Together with a copy of the resolution authorizing the issuance of bonus shares, the firm must also file a return of the bonus issue with the Registrar of Companies.

Objectives of Issue of Bonus Shares

Bonus shares are generally issued to expand the capital base of an organisation. The issue of bonus shares also attracts investors' attention which results in increasing the trading in the shares of the company. The issue of bonus shares also results in retaining the cash of the organisation. The issue of bonus shares also indicates the financial soundness of the organisation as it brings parity between the fixed assets and the share capital. Bonus shares provide information on the actual capital employed by an entity.

- Advantages and Disadvantages of Bonus Shares

A: Advantages of Issue of Bonus Shares

Bonus shares are issued in a way that benefits the organization and its owners. The benefits of awarding bonus shares to the entity's shareholders or investors are as follows:

1. Taxation Benefits: One of the main advantages of receipt of bonus shares is that it results in tax benefits to the shareholders. The cash dividend that the shareholder receives is taxed at the standard rate of taxation and is included in their income. However, bonus shares are not subject to income tax for shareholders who receive them. Capital gains tax is due upon the selling of bonus shares. The sale of bonus shares results in capital gains tax. The capital gains tax is usually taxed at a rate lower than the ordinary rate of tax.

2. Indicator of higher profits in the future: The issue of bonus shares is an indicator of higher profits in the future. When the profits of the company are constant and do not rise, the declaration of bonus shares by the company will result in the dilution of the earnings of the entity. The additional shares will result in lowering the earnings per share of the organisations. Therefore, usually, the directors distribute bonus shares only when they are expecting a rise in earnings. The rise in earnings will offset the additional issue of shares. Bonus shares convey positive information on the value and growth expectation of the shares.

3. Increase in future dividends: In situations where the company follows a fixed dividend policy. The amount of dividend paid per share will increase, and hence the total cash dividends to the shareholders will increase. For example, a company is paying a dividend of Rs.2 per share and declares a bonus of 1:1. A shareholder holding 100 shares will receive another 100 shares as a bonus and will have a total of 200 shares. The dividend will increase from Rs.200 to Rs.400, and hence in this manner, the declaration of bonus shares results in an increase in the dividends in the hands of the investors.

4. Psychological Value: The investors usually associate the declaration of bonus with the prosperity of the company. The declaration of bonus shares has a positive impact on the psychology of the shareholders as it enables them to sell the bonuses and make profits instead of impairing the initial investment. Due to the positive impact of the bonus issue, the market perceives it positively. The sale of bonus shares by the investors widens the market for the shares of the company. This tends to increase the interest of the market in the shares of the company, thereby supporting and increasing the share price.

The following are the advantages of issue of bonus shares to the company:

1. Retention of Cash: The Company can declare dividends by way of the issue of bonus shares and retain the cash profits to provide funds for investment opportunities that are

profitable and investible. In this way, the company is able to satisfy both the shareholders of the company as well as new investment opportunities for the organisation. While declaring the dividends, the directors must keep in mind the interest of the shareholders as well as the financial structure of the company. By the issue of bonus shares, their directors are able to satisfy these objectives in a sufficient manner. Thus it helps to satisfy the shareholder psychologically because it increases the cash dividends and capital gains of the investors.

2. Distribution of dividends during cash crunch: In situations where the company is not able to earn enough profit for the payment of dividends, it can satisfy the desires of the investors by issuing bonus shares. When the company faces financial difficulty, the only alternative is to replace the cash dividends with the issue of bonus shares.

3. Increase in share price: In certain cases, the goal of the directors' bonus payments is to lower the share's market value and increase investor appeal. A share that has a very high market price may not be as desirable as other mid-range stocks. Therefore, bonus shares are given in an effort to lower the share price and boost trading activity. It is a strategy to increase share trading. The shares can also be split in order to accomplish this goal.

4. B: Disadvantages of Issue of Bonus Shares

1. No increase in the value: Although bonus shares are considered valuable by the shareholders, it is difficult to realise the bonus shares do not have any impact on the wealth of the investor and hence does not affect its value. The declaration of bonus shares is the means of capitalising profits. It merely divides the ownership of the company among a large number of investors. In short, bonus shares do not benefit the shareholders.

2. Issue of bonus shares is costly: The issue of bonus shares is a costly means of distribution of dividends. The company needs to print thousands of share certificates and post them to various shareholders.

3. Adjustment of earnings per share and price-earnings ratio: Sometimes, the issue of bonus shares brings a disparity in the earnings per share and price-earnings ratio. The investment analyst usually does not adjust the earnings per share for small issues of bonus shares. Where the earning per share is not adjusted for the issue of additional bonus shares, it fails to disclose the true view of the entity. As a result of which, the price-earnings ratio would be distorted downwards.

7.2. Accounting Treatment of Bonus Shares

- **Accounting Treatment of Bonus Shares**

Partially paid-up bonus shares and fully paid-up bonus shares are the two categories of bonus issuance. Bonus shares that are fully paid up are those that are distributed to shareholders at no additional expense, directly from the company's reserves. Capital Reserves, Profit & Loss Accounts, Capital Reserves, and Security Premium Accounts are the sources from which they are issued. A share that has paid part of the share price is known as a partly paid-up share. When requested by the company, the remaining sum must be paid. As a result, the partially paid-up shares are converted to fully paid-up without requiring the uncalled amounts when the bonus is applied to them. It is not possible to withdraw partially paid-up bonus shares from the Security Premium Account or the Capital Redemption Reserve Account. Regarding the

Serial No Particulars Amount (Dr) Amount (Cr)

1. On sanction of issuing bonus shares

Capital Redemption Reserve A/c………………Dr

Securities Premium A/c…………………………Dr

General Reserve A/c…………………………….Dr

Profit & Loss A/c……………………………….Dr

To Bonus to Shareholders A/c

(Being bonus issues sanctioned)

Note: According to SEBI Regulations, the securities premium account must be realised in cash. However, as per the Companies Act, 2013, there is no such requirement. As per Section 52 of the Companies Act, 2013, a securities premium account may arise as a result of shares otherwise than by way of cash. Thus, in case of unlisted companies such securities premium (not realised in cash) can be used for the issue of bonus shares in the case of unlisted companies, but not in the case of listed companies.

2. On the issue of bonus shares

Bonus to Shareholders A/c………………………Dr

To Share Capital A/c

(Being bonus shares issues)

3. On payment of bonus by issuing converting partly paid-up shares to fully paid-up

General Reserve A/c…………………………..Dr

Profit & Loss Account…………………………Dr

To Bonus to Shareholders A/c

(Being payment of bonus by conversion of partly paid-up shares to fully paid-up shares sanctioned)

4. On making the final call due on shares

Share Final Call A/c…………………………….Dr

To Share Capital A/c

(Being the final call on the shares made)

5 On adjustment of the final call

Bonus to Shareholders A/c…………………….Dr

To Share Final Call A/c

(Being final call amount adjusted)

Illustration 1: The extracts from the Trial Balance of Janta Ltd (a listed entity) as of 31.03.2022 is presented as follows:

Particulars	Amount
80,000 Equity shares of Rs 10 each	8,00,000
Capital Redemption Reserve	1,10,000
Securities Premium (realised in cash)	60,000
General Reserve	2,10,000
Credit Balance of Profit & Loss Account	1,00,000

Janta Ltd has decided to issue bonus shares to its equity shareholders at the rate of 1 share for every 4 shares held in the entity. Pass necessary journal entries in the books of accounts of Janta Ltd.

Solution: Journal Entries in the books of Janta Ltd

	Dr	Cr
Capital Redemption Reserve A/c………………Dr	1,10,000	
Securities Premium A/c…………………………Dr	60,000	
General Reserve A/c…………………………….Dr	30,000	
To Bonus to Shareholders A/c		2,00,000

(Being 1 bonus share issued for every four shares held in the company)

Bonus to Shareholders A/c…………………Dr 2,00,000

To Equity Share Capital A/c 2,00,000

(Being bonus shares issued to the shareholders)

Working Note:

Number of shares to be issued = 80,000 x ¼ = 20,000

Value of bonus shares to be issued = 20,000 x 10 = 2,00,000

Illustration 2: Journalise the following transactions:

- The Rs 10,00,000 subscribed capital of Bharat Ltd is made up of 1,00,000 equity shares at a price of Rs 10 apiece, with Rs 7.50 called up. A bonus of Rs 2,50,000 was issued out of the company's general reserve in order to fully pay for the shares. 2. The fully paid-up capital of Rs. 50,00,000, which is composed of equity shares of Rs. 10 apiece, is possessed .
- Ratna Ltd. There was Rs 9,00,000 in the company's General Reserve. The firm agreed to issue 50,000 fully paid bonus shares with a face value of Rs. 10 each, with the intention of allocating Rs. 5,00,000 from General Reserve to bonus shares. Each shareholder will receive one of these shares for every ten shares they own in the company.

Solution:

1 General Reserve A/c…………………………….Dr 2,50,000

To Bonus to Shareholders A/c 2,50,000

(Being provision for bonus made by the company)

Share Final Call A/c…………………………….Dr 2,50,000

To Equity Share Capital A/c 2,50,000

(Being final call of Rs 2.50 on 1,00,000 equity shares due)

Bonus to Shareholders A/c……………………………Dr 2,50,000

To Share Final Call A/c 2,50,000

(Being bonus money applied for call)

2 General Reserve A/c……………………………Dr 5,00,000

To Bonus to Shareholders A/c 5,00,000

(Being provision for bonus made by the company)

Bonus to Shareholders A/c……………………………Dr 5,00,000

To Equity Share Capital A/c 5,00,000

(Being 50,000 bonus shares issued at Rs 10 each)

- **Knowledge Check 1**

Fill up the Blanks.

1. Bonus shares are shares that are issued to the ________________shareholders of the company at no cost on the basis of the _____________ already held by the shareholders.
2. Where due to a bonus issue, the _______________ exceeds the authorised capital, it is necessary to pass a resolution at the _____________ of the company to increase the authorised share capital.
3. The different types of bonus issues are ____________ shares and _____________ shares.
4. Partly paid-up bonus shares cannot be made out of the ______________________ and __________________.
5. Bonus shares cannot be issued out of the _________________________, i.e. the revaluation reserve that is created for the revaluation of assets of the company.

- **Outcome-Based Activity 1**

The extracts from the Trial Balance of Hindustan (a listed entity) as of 31.03.2022 is presented as follows:

Particulars	Amount
1,00,000 Equity shares of Rs 10 each	10,00,000
Capital Redemption Reserve	1,50,000

Securities Premium (realised in cash) 50,000

General Reserve 2,10,000

Credit Balance of Profit & Loss Account 1,00,000

Hindustan Ltd has decided to issue bonus shares to its equity shareholders at the rate of 1 share for every 4 shares held in the entity. Pass necessary journal entries in the books of accounts of Hindustan Ltd.

7.3. Meaning of Right Shares

- **What are the Right Shares?**

A public or private business that wants to raise its subscribed share capital may do so by issuing new shares to the market in accordance with section 62(1)(a) of the Companies Act, 2013. On the other hand, the issuance of more shares dilutes the current shareholders' governance and voting rights. As a result, the current stockholders are permitted to keep their rights. According to the Companies Act of 2013, current shareholders are granted a one-two right to apply immediately in the case of the freshly issued shares. If they so want, current shareholders have the option to subscribe for shares. However, individuals can also forgo such benefits if they choose not to subscribe for the shares..

For example, Maya Ltd makes a right issue of 10,000 shares. The existing issued and subscribed share capital of Maya Ltd is 1,00,000 shares. The right enables the shareholders to have 10 shares to subscribe to 1 new share of Maya Ltd. Mr. Parbat, an existing shareholder holding 1000 shares, may subscribe for 100 right shares. The existing shareholding of Mr. Parbat is 1% (1,000/1,00,000). If he subscribes to the right, his percentage holding in Maya Limited will remain the same i.e. 1% (1,100/1,10,000). However, if he does not subscribe to the right issue, he will dilute the shareholding to 0.91% (1,000/1,10,000). However, he has the option to renounce his right in favour of Mr. Ocean. Mr. Parbat may recover some money from Mr. Ocean as a privilege for the value of this right.

As per Section 62(1) (a) of the Companies Act, 2013, a company that desires to issue new shares has to offer shares to its existing shareholders through a letter of offer. The letter of offer is subject to the following conditions:

1. A notice shall be sent to the shareholders, specifying the number of shares offered and the time limit for accepting the offer. The time limit shall not be less than 15 days and should not exceed 30 days from the date on which the offer is made. If the offer is not accepted within the specified time limit, it shall be deemed to have been declined by the shareholder.
2. The notice shall also contain a statement allowing the person to renounce the right offered to him in favour of any other person. However, such a renunciation right can be allowed only if it is authorised by the articles of the company.
3. The board of directors of the company may dispose of the rights in such a manner as they deem fit that would be advantageous for the organisation, usually when the time specified in the notice expires or an intimation is received from the shareholders declining the right.

- Objectives of Issue of Right Shares

The main objectives of the issue of right shares are as follows:
1. The right shares are issued to increase the subscribed share capital of the company. When a company is expanding its operations, it may require a huge amount of capital. Therefore, instead of raising funds by means of debt, it may raise funds by issue of equity shares in order to avoid fixed payment of interest. In order to raise equity capital, the right shares are the faster option to achieve this objective.
2. Another main objective of the issue of rights shares is to comply with the provisions of the Companies Act 2013 on the issue of equity shares to the existing shareholders. The main objective of the issue of equity shares is to offer the shares to the existing shareholders at a price lower than the market price.

- Advantages and Disadvantages of Issue of Right Shares

One of the main advantages of the issue of right shares is that it helps in increasing the subscribed share capital of the company. It also retains the right of the existing shareholders. In this manner, it helps in resolving the discontentment of the existing shareholders in regard to the benefits of the issue of new shares. However, the issue of the right shares may lead to speculation in the share market. Due to the issue of equity shares, the rate of return per share declines as the dividend is distributed to an increased number of shareholders. It will have a negative impact on the minds of the prospective investors, and ultimately, the organisation receives less amount of money as the right shares are offered at a price that is lower than the market price of the existing shares.

7.4. Accounting Treatment of Right Shares

- **Calculation of the Ex-Right Value of the Shares**

The book value of the share is calculated using the formula: Net Worth / Number of Shares. However, the market value of the shares is slightly different from the book value. The market price of the shares that exists just before the issue of right shares is called Cum-right Market Price of the share. However, the market price might be affected by the issue of the right shares. Theoretically, after the issue of right shares, the value of the company's shares must be equal to the sum of market capitalisation prior to the right issue and cash flows that are generated from the rights issue. After the issue of right shares, the market price is termed as the Ex-right Market price of the shares. The formula is as follows:

- Calculation of the Right of Renunciation

The right of renunciation provides a right to the existing shareholder to surrender their shares in favour of someone else. Where right shares are offered to existing shareholders, they have three options: either to accept the offer, renounce the right in favor of someone else, or reject the offer. The right of renunciation can be monetised and is known as the 'value of right'. The value of the right is calculated as follows:

Illustration 3: An entity offers new shares of Rs. 10 each at a premium of 15% to the existing shareholders. The shares are offered in the ratio of 1:4. The cum-right market price of the share is Rs. 15. Calculate the value of the right and the ex-right price of the share.

Solution: Ex-right price of the share

= (Cum-right value of shares + (Right share x Issue Price))/ (Existing Number of Shares + Number of Right Shares)

= (15 x 4 +12.5 x 1) / (4+1) share

= 72.5 / 5 shares

= Rs. 14.5

Value of the right = Cum-right value of the share-Ex-right value of the share

= Rs (15 - 14.5)

= Rs. 0.05

Therefore, the value of the right = Rs (0.05 x 4)

= Rs 2

- Accounting Entries for the issue of right Shares

Serial No Particulars Amount (Dr) Amount (Cr)

1. On the issue of right shares

Bank A/c……………………………………Dr

To Equity Share Capital A/c

(Being right shares issued)

2. On the issue of right shares at a premium

Bank A/c……………………………………Dr

To Equity Share Capital A/c

To Securities Premium A/c

(Being right shares issued at a premium)

Illustration 4: Bharti Ltd has 1,00,000 shares at Rs 10 each. The market value of the shares is Rs. 46. Bharti Ltd. issues right shares in the ratio of 1:10 at a price of Rs 31. Journalise the transaction.

Solution:

Bank A/c……………………………………Dr 3,10,000

To Equity Share Capital A/c 1,00,000

To Securities Premium A/c 2,10,000

(Being 10,000 right shares issued at Rs. 31 each)

- Knowledge Check 2

State whether the following statements are True or False:

1. A notice shall be sent to the shareholders, specifying the number of shares offered and the time limit for accepting the offer. The time limit shall not be less than 15 days and should not exceed 30 days from the date on which the offer is made.

2. As per section 62(1) (a) of the Companies Act 2013, only a public which intends to increase its subscribed share capital may do so by the issue of new shares in the market.

3. The Companies Act 2013 allows existing shareholders to retain their position by giving them a right to apply to the newly issued shares at first instance.

4. The main objective of the issue of equity shares is to offer the shares to the existing shareholders at a price higher than the market price.

5. The issue of the right shares may lead to speculation in the share market.

- Outcome-Based Activity 2

Harsh Ltd has 70,000 shares at Rs 10 each. The market value of the shares is Rs. 21. Harsh Ltd. issues right shares in the ratio of 1:10 at a price of Rs 10. Journalise the transaction.

7.5. Summary

- Bonus shares are shares that are issued to the existing shareholders of the company at no cost on the basis of the number of shares already held by the shareholders.
- Capitalisation of profits is considered as converting the profits or reserves of the company into paid-up capital. A company may either capitalise its profits or reserves by way of issue of fully paid-up bonus shares or distribute them as dividends to the shareholders of the company.
- Fully paid-up bonus shares are those that are issued from the reserves of the company at no extra cost to the shareholders. They are issued from Capital Redemption Reserves, Profit & Loss Accounts, Capital Reserves, and Security Premium Accounts.
- As per section 62(1) (a) of the Companies Act, 2013, a company, whether public or private, which intends to increase its subscribed share capital may do so by the issue of new shares in the market.
- Right Shares also retains the right of the existing shareholders. In this manner, it helps in resolving the discontentment of the existing shareholders in regard to the benefits of the issue of new shares.

7.6. Self-Assessment Questions

1. Write a short note on Bonus Shares
2. What are the objectives of issuing bonus shares?

3. List down the advantages and disadvantages of issuing the right shares.
4. Write a short note on the Capitalisation of Profits.
5. What are ex-right values and renunciation of rights?

7.7. References

- Financial Accounting by Monga, J.R. Ahuja, Girish Ahuja and Ashok Shehgal, Mayur Paper Back, Noida
- Financial Accounting by Williams, Tata Mc. Grow Hill and Co. Ltd., Mumbai
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Unit- 8

Issue of Debentures

Learning Outcomes:

- Students will be able to define the Meaning and Features of Debentures
- Students will be capable of demonstrating Differences between Shares and Debentures.
- Students will be able to define the Accounting Treatment on the Issue of Debentures when consideration is Received in Cash.

Structure:

8.1 Meaning and Features of Debentures

8.2 Types of Debenture

8.3 Differences between Shares and Debentures

Knowledge Check 1

Outcome-Based Activity 1

8.4 Techniques for Issuing Debentures for Advanced Corporate Accounting

8.5 Accounting Procedure for Debenture Issues when Cash Is Received as Consideration

8.6 Issuance of Debentures for Values Apart than Cash

Knowledge Check 2

Activity Based on Outcomes 2

8.7 Summary

8.8 Self-Assessment Questions

8.9 References

8.1 Meaning and Features of Debentures

Investors in debentures receive a fixed rate of interest, which is typically higher than the interest paid on bank deposits. Debentures can be traded in the market and are a popular investment option for those looking for regular income through fixed-interest payments.

Companies typically issue debentures when they need to raise long-term funds for expansion or other capital expenditures. Debentures offer companies an alternative to raising equity capital, which can dilute the ownership of existing shareholders. However, the interest paid on debentures is a fixed obligation and must be paid regardless of the company's profitability. This can be a disadvantage in times of financial stress when the company may not have sufficient profits to pay the interest on the debentures.

Features are follow :

Here some of the features of debentures:

1. Fixed-rate of interest: Debentures carry a fixed rate of interest that is agreed upon by the issuing company and the debenture holder. The interest rate is usually higher than the interest paid on bank deposits and is paid to debenture holders at regular intervals.

2. Maturity period: Debentures have a fixed maturity period, which can range from a few years to several decades.

3. Secured or unsecured: Secured debentures are generally considered to be less risky than unsecured debentures.

4. Convertible or non-convertible: Convertible debentures can be converted into equity shares of the issuing company, while non-convertible debentures cannot.

5. Tradability: Debentures can be traded in the market just like shares. This means that investors can buy and sell debentures in the secondary market, and the price of the debenture can fluctuate based on market conditions.

6. Priority of repayment: In the event of a default by the issuing company, debenture holders are given priority over equity shareholders in terms of repayment of their investments. This is because debentures are considered to be a form of secured debt.

7. Fixed obligation: The interest paid on debentures is a fixed obligation and must be paid by the issuing company regardless of its profitability. This means that even if the company is not making profits, it still has to pay the interest on its debentures.

Advantages and disadvantages of issuing debentures

Issuing debentures has both advantages and disadvantages for companies. Here are some of the advantages:

1. Lower cost of capital: This makes them an attractive source of long-term finance for companies.

2. Fixed interest payments: Debentures offer a fixed rate of interest, which means that companies can plan their cash flows and budget for interest payments accordingly. This makes it easier for companies to manage their finances.

3. No dilution of ownership: This means that the existing shareholders retain their ownership rights and control over the company.

4. Access to a wider pool of investors: By issuing debentures, companies can access a wider pool of investors, including institutional investors such as insurance companies and pension funds.

However, there are also some disadvantages to issuing debentures:

1. Interest payments are a fixed obligation: Companies must make interest payments on their debentures regardless of their profitability. This can put pressure on cash flows, particularly if the company is not performing well.

2. Increased debt levels: Issuing debentures increases the debt levels of the company, which can make it more difficult to obtain further finance in the future.

3. Security may be required: If the debentures are secured, the company must provide specific assets as collateral. This can restrict the company's ability to use those assets for other purposes.

4. Limited flexibility: Debenture agreements often have strict covenants that limit the company's ability to undertake certain activities, such as paying dividends or taking on additional debt.

8.2 Types of Debenture

Here are some of the common types of debentures:

1. Convertible Debentures: Typically, the terms of conversion are specified in the debenture agreement, including the conversion ratio and the time period within which the conversion must take place.

2. Non-Convertible Debentures: They are a simple form of debt that pays a fixed rate of interest to the debenture holder over the life of the debenture.

3. Secured Debentures: This provides additional security to the debenture holder, as the assets can be used to repay the debenture in the event of default by the issuing company.

4. Unsecured Debentures : They are a form of debt that is based on the creditworthiness of the issuing company and their ability to repay the debenture.

5. Redeemable Debentures: Typically, the terms of the redemption are specified in the debenture agreement, including the redemption date, the interest rate, and any penalties for early redemption.

6. Irredeemable Debentures: They are a form of long-term debt that pays a fixed rate of interest to the debenture holder over the life of the debenture.

7. Perpetual Debentures: Perpetual debentures are a type of irredeemable debenture that pays a fixed rate of interest to the debenture holder in perpetuity. They are a form of long-term debt that does not need to be repaid by the issuing company.

8. 3 Differences between Shares & Debentures :

Some of the main differences are:

1. Ownership: Debentures represent a loan to the company.

2. Voting rights: Debenture holders, on the other hand, do not have voting rights.

3. Returns: Shareholders receive dividends on their investments.

4. Risk: If the company does poorly, shareholders may not receive dividends and may even lose some or all of their investments. Debenture holders, however, are typically paid interest regardless of how the company is performing.

5. Priority of payment: This means that debenture holders will be paid first from the company's assets before any money is paid to shareholders.

6. Transferability: Shares are generally more easily traded than debentures, as they can be bought and sold on stock exchanges. Debentures, on the other hand, are typically held until maturity, as they are not traded on stock exchanges.

Both shares and debentures have their own advantages and disadvantages, and the choice between them will depend on the company's specific needs and circumstances.

- **Knowledge Check 1**

Fill in the Blanks.

1. Investors in debentures receive a fixed rate of interest, which is typically higher than the interest paid on bank ____________.
2. Companies typically issue debentures when they need to raise ___________ funds for expansion or other capital expenditure.
3. Shares are generally more easily traded than ____________, as they can be bought and sold on stock exchanges.

- **Outcome-Based Activity 1**

Identify and classify examples of debentures into secured, unsecured, convertible, and non-convertible types, and discuss their characteristics and uses. The activity promotes critical thinking, analysis, and knowledge sharing skills.

8.4 Methods of Issue of Advanced Corporate Accounting Debenture

Companies can issue debentures to raise funds for various purposes, such as financing new projects or expanding existing ones. There are several methods that a company can use to issue debentures. Some of the most common methods are:

1. Public issue: In a public issue, the company offers its debentures to the general public. This can be done through a prospectus, which provides details about the debentures and the company's financial performance. The public can then subscribe to the debentures by submitting an application form and payment.

2. Private placement: The investors can then subscribe to the debentures by submitting an application form and payment.

3. Rights issue: In a rights issue, the company offers its debentures to its existing shareholders in proportion to their existing shareholdings. This means that shareholders have the right to subscribe to the debentures before they are offered to the general public.

4. Convertible debentures: This means that the debenture holder has the option to convert their investment into shares if they choose to do so.

Accounting Treatment on Issue of Debentures when consideration is Received in Cash

Journal entries for the issue of debentures for cash

When a company issues debentures for cash, the following journal entries are recorded:

1. To record the receipt of cash:

Bank Account Dr Debenture Subscription A/c Cr

2. To record the issue of debentures:

Debenture Subscription A/c Dr Debenture A/c Cr

The first entry is passed on recording the receipt of cash from the subscribers against the issue of debentures. The second entry is passed on recording the issue of debentures against the cash received. The Debenture Subscription account is a current liability account that is used to record the amount of money received from subscribers. The Debenture account is a long-term liability account that is used to record the face value of the debentures issued.

It is important to note that the amount received for the issue of debentures may be equal to the face value of the debentures or may be different depending on the terms of the issue. If the amount received is higher than the face value of the debentures, it is called an issue of debentures at a premium, and if the amount received is lower than the face value of the debentures, it is called an issue of debentures at a discount.

The journal entries for an issue of debentures at a premium or discount would differ from the above entries.

Accounting treatment for a discount on issue of debentures

The accounting treatment for the discount on the issue of debentures is as follows :

1. Calculate the discount on the issue of debentures

The discount on the issue of debentures is calculated by subtracting the issue price of the debentures from their face value. For example, if a company issues 100 debentures of face value Rs. 1,000 each at a discount of 5%, the total amount received would be Rs. 95,000 (i.e., 100 x 1,000 x 0.95), and the discount on the issue of debentures would be Rs. 5,000 (i.e., 100 x 1,000 x 0.05).

2. Record the receipt of cash

The receipt of cash is recorded in the same way as for an issue of debentures at face value. The entry would be:

Bank Account Dr

Debenture Subscription A/c Cr

Treatment of debenture issue expenses in accounting

When a company issues debentures, it incurs certain expenses related to the issue, such as underwriting fees, legal fees, printing charges, and registration fees. These expenses are treated as deferred revenue expenditures and are recorded on the assets side of the balance sheet. The deferred revenue expenditure is then written off over the life of the debentures, usually using the straight-line method.

The accounting treatment for debenture issue expenses is as follows:

1. Initially, the expenses incurred are recorded in a separate account called "Debenture Issue Expenses Account" on the assets side of the balance sheet.
2. The balance in the Debenture Issue Expenses Account is then written off over the life of the debentures, usually using the straight-line method. The amount written off each year is recorded in the profit and loss account.
3. If the company issues the debentures at a premium, the premium amount can be used to offset the debenture issue expenses. For example, if the company issues debentures of Rs. 1,000 each at a premium of 10%, the total proceeds from the issue will be Rs. 1,100. The premium of Rs. 100 can be used to offset the debenture issue expenses.

The journal entry for the debenture issue expenses is as follows:

Debenture Issue Expenses Account Dr. To Bank/Cash Account

The amount recorded in the Debenture Issue Expenses Account is then written off over the life of the debentures, and the journal entry for the write-off is as follows:

Profit and Loss Account Dr. To Debenture Issue Expenses Account

If the company issues the debentures at a premium, the journal entry for the offset of the debenture issue expenses is as follows:

Bank/Cash Account Dr. To Debenture Application and Allotment Account To Debenture Premium Account To Debenture Issue Expenses Account

The Debenture Premium Account is then used to write off the premium over the life of the debentures.

8.6 Issue of Debentures for consideration for Cash

A company may issue debentures in exchange for the purchase of a fixed asset or in settlement of liability. In such cases, the accounting treatment of the transaction is different from that of a cash transaction.

If the debentures are issued in exchange for the purchase of a fixed asset, the amount of the debentures is credited to the fixed asset account, and the asset acquired is debited by the same amount. The debenture account is credited for the nominal value of the debentures issued. The difference between the nominal value of the debentures issued and the amount credited to the fixed asset account is considered a premium on the issue of debentures and is shown as a liability in the balance sheet.

If the debentures are issued in settlement of liability, the liability account is debited for the amount of the liability settled, and the debenture account is credited for the nominal value of the debentures issued. The difference between the nominal value of the debentures issued and the amount of the liability settled is considered as a premium on the issue of debentures and is shown as a liability in the balance sheet.

The premium on the issue of debentures should be amortized over the period of the debentures using the effective interest method, and the amount of the debenture issue expenses should be written off to the profit and loss account over the period of the debentures.

- **Knowledge Check 2**

State whether given statements are true or false.

1. Companies can issue debentures to raise funds for various purposes, such as financing new projects or expanding existing ones.(T/F).
2. The first entry is passed on recording the receipt of cash from the subscribers against the issue of debentures. (T/F).
3. The discount on the issue of debentures is an expense and needs to be amortized over the life of the debentures. (T/F)

- **Outcome-Based Activity 2**

Analyze a case study of a company that has issued convertible debentures, identify the benefits of such issuance and discuss how it affects the company's financial position. The activity promotes critical thinking, analysis, and communication skills.

7.4 Summary

- Debentures are considered to be a safer investment option as compared to equities since they are a form of secured debt.
- Fixed-rate of interest: Debentures carry a fixed rate of interest that is agreed upon by the issuing company and the debenture holder.
- Lower cost of capital: Debentures typically offer a lower cost of capital than equity, as the interest paid on debentures is tax-deductible.
- Interest payments are a fixed obligation: Companies must make interest payments on their debentures regardless of their profitability.
- Shares and debentures are both financial instruments used by companies to raise funds, but there are several differences between them.
- Debentures, on the other hand, are typically held until maturity, as they are not traded on stock exchanges.
- Rights issue: In a rights issue, the company offers its debentures to its existing shareholders in proportion to their existing shareholdings.
- The Debenture Subscription account is a current liability account that is used to record the amount of money received from subscribers.
- It is important to note that the amount received for the issue of debentures may be equal to the face value of the debentures or may be different depending on the terms of the issue.
- The amount of discount to be amortized is calculated by dividing the total discount by the number of years for which the debentures are issued.
- When a company issues debentures, it incurs certain expenses related to the issue, such as underwriting fees, legal fees, printing charges, and registration fees.
- The Debenture Premium Account is then used to write off the premium over the life of the debentures.

- Debentures can also be issued for consideration other than cash. For example, a company may issue debentures in exchange for the purchase of a fixed asset or in settlement of liability.
- If the debentures are issued in exchange for the purchase of a fixed asset, the amount of the debentures is credited to the fixed asset account, and the asset acquired is debited by the same amount.
- If the debentures are issued in settlement of liability, the liability account is debited for the amount of the liability settled, and the debenture account is credited for the nominal value of the debentures issued.

7.5 Self-Assessment Questions

1. Explain the meaning & features of debentures.
2. Explain the types of debentures.
3. Explain the differences between shares & debentures.
4. Explain the Issue of debentures for consideration other than cash.

7.6 References

- Financial Accounting by Monga, J.R. Ahuja, Girish Ahuja and Ashok Shehgal, Mayur Paper Back, Noida
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Unit- 9

Redemption of Debentures

Learning Outcomes:

- Students will be able to learn and understand the meaning of the Redemption of Debentures.
- Students will be able to understand the methods of Redemption of Debentures.
- Students will be able to understand and learn the modes of Finance for the Redemption of Debentures and Legal Provisions for the Redemption of Debentures.
- Students will be able to understand and learn accounting Treatment for the Redemption of Debentures.

Structure:

9.1 Meaning of Redemption of Debentures

9.2 Methods of Redemption of Debentures

9.3 Price at which Debentures can be Redeemed

Knowledge Check 1

Outcome-Based Activity 1

9.4 Modes of Finance for Redemption of Debentures

9.5 Legal Provisions for Redemption of Debentures

9.6 Accounting Treatment on Redemption of Debentures

Knowledge Check 2

Outcome-Based Activity 2

9.7 Summary

9.8 Self-Assessment Questions

9.9 References

9.1 Meaning of Redemption of Debentures

- **Definition and explanation of debentures**

Debentures are a type of long-term financial instrument that companies use to raise funds from the market. A debenture is essentially a debt security issued by a company that promises to pay a fixed rate of interest to the debenture holder at a specified interval of time and to repay the principal amount at a predetermined maturity date.

Debentures are unsecured in nature, meaning they are not backed by any collateral or asset, and therefore, the debenture holders do not have any claim on the company's assets in case of default. This is in contrast to secured debt, such as mortgage-backed securities, where the lender has a claim to specific assets in the event of default.

Debentures can be issued in various forms, including convertible debentures, non-convertible debentures, redeemable debentures, and irredeemable debentures.

Convertible debentures are those that can be converted into equity shares of the issuing company at a predetermined conversion ratio. Non-convertible debentures, on the other hand, cannot be converted into equity shares.

Redeemable debentures are those that can be redeemed by the issuing company at a predetermined date or over a period of time, whereas irredeemable debentures are those that do not have a fixed maturity date and are repaid only at the discretion of the issuing company.

Debentures are typically issued to institutional investors, such as mutual funds, insurance companies, and pension funds, as they are considered low-risk investments that provide a steady stream of income.

Meaning of redemption of debentures

Redemption of debentures refers to the process of paying back the principal amount of a debenture to the debenture holders by the issuing company. When a company issues debentures, it typically sets a maturity date or a period of time during which the debentures will be outstanding. At the end of this period, the company is obligated to pay back the principal amount to the debenture holders.

Redemption of debentures can be done in a few different ways, depending on the terms of the debenture agreement. One way is through lump-sum payment, where the company pays

back the entire principal amount of the debentures in one go. Another way is through redemption by instalments, where the company pays back the principal amount in a series of instalments over a period of time.

Redemption of debentures can also be done through the purchase of the debentures in the open market. This is known as redemption by purchase, and it can be advantageous for companies if the market value of the debentures is lower than their face value. By purchasing the debentures at a lower price, the company can reduce the amount of money it needs to pay back to the debenture holders.

In some cases, companies may choose to redeem debentures before their maturity date. This is known as early redemption or premature redemption. The terms of the debenture agreement typically specify the conditions under which early redemption can occur, such as a change in the company's financial situation or the availability of funds to pay back the debentures.

Redemption of debentures can be a significant event for both the company and the debenture holders. For the company, it can free up capital that was previously tied up in the form of debt. For the debenture holders, it provides a return on their investment and allows them to reinvest the money elsewhere.

Types of debenture redemption - redeemable and irredeemable debentures

Debentures can be classified into two main categories based on their redemption features: redeemable and irredeemable debentures.

1. **Redeemable Debentures:** Redeemable debentures are those debentures that are issued with a predetermined date of redemption. The issuing company has an obligation to repay the principal amount of these debentures to the debenture holders on the specified redemption date. The company can choose to redeem these debentures in a lump sum or in instalments over a period of time. Redeemable debentures can be further classified into fully redeemable and partly redeemable debentures.

Fully redeemable debentures are those debentures that have to be redeemed in full on the redemption date. The issuing company is required to pay the principal amount and any interest accrued until the redemption date to the debenture holders.

Partially redeemable debentures are those debentures that are redeemed only in part on the redemption date. The issuing company repays a specified percentage of the principal amount to the debenture holders, and the remaining amount continues to be outstanding.

2. Irredeemable Debentures: Irredeemable debentures, also known as perpetual debentures, are those debentures that do not have a fixed maturity date or redemption date. The issuing company does not have an obligation to repay the principal amount of these debentures to the debenture holders. Instead, the company pays interest on these debentures to the debenture holders indefinitely until the debentures are called for redemption.

Irredeemable debentures can be converted into equity shares of the issuing company at a predetermined conversion ratio. These debentures are called convertible debentures and provide the option to the debenture holders to convert their debentures into equity shares after a certain period of time.

9.2 Methods of Redemption of Debentures

- **Methods of debenture redemption**

Debentures can be redeemed by the issuing company in a few different ways, depending on the terms of the debenture agreement. The three most common methods of debenture redemption are redemption in a lump sum, redemption by instalments, and redemption by purchase in the open market.

1. Redemption in Lump Sum: Redemption in lump sum is a method of debenture redemption in which the issuing company pays back the entire principal amount of the debentures to the debenture holders in one go. This method of redemption is commonly used when the issuing company has sufficient funds to pay back the entire amount of the debentures. Lump-sum redemption provides the debenture holders with a single payment and allows the issuing company to clear its debt obligations in one transaction.

2. Redemption by Installments: Redemption by instalments is a method of debenture redemption in which the issuing company pays back the principal amount of the debentures in a series of instalments over a period of time. This method of redemption is commonly used when the issuing company does not have sufficient funds to pay back the entire amount of the debentures in one go. The instalments are usually paid at regular intervals, such as monthly or quarterly until the entire principal amount of the debentures is repaid. This

method of redemption provides the debenture holders with a regular source of income and allows the issuing company to manage its cash flow more effectively.

3. Redemption by Purchase in the Open Market: Redemption by purchase in the open market is a method of debenture redemption in which the issuing company buys back the debentures from the market at a price that is lower than their face value. This method of redemption is commonly used when the market value of the debentures is lower than their face value. By purchasing the debentures at a lower price, the issuing company can reduce the amount of money it needs to pay back to the debenture holders. This method of redemption can be advantageous for the issuing company, but it may not be beneficial for the debenture holders, who may have to sell their debentures at a lower price than the face value.

Advantages and disadvantages of redeemable debentures

Redeemable debentures have both advantages and disadvantages for the issuing company and the debenture holders. Let's take a look at some of the most significant advantages and disadvantages of redeemable debentures:

Advantages of Redeemable Debentures:

1. Lower Interest Costs: Redeemable debentures usually have lower interest rates compared to other debt instruments such as bank loans. This lower cost of borrowing can reduce the financial burden on the issuing company.

2. Greater Flexibility: Redeemable debentures offer greater flexibility to the issuing company in terms of managing its debt obligations. The company can choose to redeem the debentures at a time and in a manner that is most convenient and cost-effective.

3. Improved Creditworthiness: Redeemable debentures can help improve the creditworthiness of the issuing company. By issuing redeemable debentures, the company can demonstrate to creditors that it has a reliable source of long-term funding.

Disadvantages of Redeemable Debentures:

1. Restrictive Covenants: Issuing redeemable debentures may require the company to agree to certain restrictive covenants that limit its operational and financial flexibility. These covenants may include limitations on the company's ability to take on additional debt or pay dividends to shareholders.

2. Redemption Risk: There is always a risk that the issuing company may not be able to redeem the debentures at the agreed-upon redemption date due to financial constraints or unforeseen circumstances. This risk can result in a loss of confidence in the company's creditworthiness and may negatively impact the value of the debentures.

3. Limited Access to Equity: Redeemable debentures are a form of debt financing and do not provide the debenture holders with an ownership stake in the company. This means that the company's access to equity financing may be limited, as investors may prefer to invest in companies that offer equity ownership.

Reasons for debenture redemption - voluntary and compulsory redemption

Debenture redemption is the process of repaying the principal amount of the debentures to the debenture holders on the maturity date or at an earlier date, as specified in the debenture agreement. The reasons for debenture redemption can be broadly classified into two categories: voluntary and compulsory redemption.

1. **Voluntary Redemption:** Voluntary redemption occurs when the issuing company chooses to redeem the debentures before their maturity date. The reasons for voluntary redemption may include the following:

a. **Refinancing:** The company may choose to redeem the debentures early to refinance its debt at a lower cost of borrowing.

b. **Improved Financial Position:** The company may redeem the debentures early if it has a surplus of cash or if its financial position has improved, allowing it to pay back the debentures earlier than expected.

c. **Financial Restructuring:** The company may choose to redeem the debentures early as part of a financial restructuring plan, which may involve reducing its debt load or simplifying its capital structure.

2. Compulsory Redemption: Compulsory redemption occurs when the issuing company is legally required to redeem the debentures. The reasons for compulsory redemption may include the following:

a. Maturity Date: Debentures are typically issued with a fixed maturity date, and the company is legally required to redeem the debentures on or before this date.

b. Default: If the issuing company defaults on its debt obligations, the debenture holders may have the right to demand early redemption of the debentures.

c. Regulatory Requirements: Certain regulatory authorities may require companies to redeem their debentures as a condition of obtaining a license or complying with other regulations.

9.3 Price at which Debentures can be Redeemed

Redemption by Purchase in the Open Market is a method of debenture redemption where the issuing company buys back its own debentures from the open market before the maturity date. The price at which the debentures can be redeemed in this method is typically the market price of the debentures at the time of the purchase.

The market price of a debenture is influenced by several factors, including interest rates, credit ratings of the issuing company, and market demand for the debentures. If the market price of the debentures is higher than their face value, the company may have to pay a premium to buy them back. If the market price is lower than the face value, the company may be able to redeem the debentures at a discount.

Redemption by purchase in the open market is generally more flexible than the other two methods of debenture redemption. It allows the company to redeem the debentures in a manner that best suits its financial position and market conditions at the time of redemption. However, the cost of redemption can be higher if the market price of the debentures is higher than their face value. On the other hand, if the market price of the debentures is lower than their face value, the company may be able to save money by redeeming them at a discount.

- **Knowledge Check 1**

Fill in the Blanks.

1. Debentures are a type of long-term ___________instrument that companies use to raise funds from the market.
2. Convertible debentures are those that can be converted into ______ shares of the issuing company at a predetermined conversion ratio.

3. Redemption of debentures can also be done through the________ of the debentures in the open market.
4. ______redeemable debentures are those debentures that have to be redeemed in full on the redemption date.
5. The reasons for debenture redemption can be broadly classified into two categories: voluntary and ________ redemption.

- **Outcome-Based Activity 1**

Evaluate the advantages and disadvantages of bond redemption as a method of debt management for a company, taking into account the cost of financing and its impact on the company's credit rating.

9.4 Modes of Finance for Redemption of Debentures

The redemption of debentures can be financed through various modes of Finance. These modes of Finance include:

1. Internal Accruals: The issuing company can use its internal resources or earnings to finance the redemption of debentures. This mode of Finance is generally preferred as it does not require the company to take on additional debt or dilute its equity. However, the company must have sufficient profits or cash reserves to fund the redemption.

2. Issue of New Debentures: The company may choose to issue new debentures to finance the redemption of existing debentures. This mode of Finance is particularly useful when the company is short on cash but has a good credit rating and can issue new debentures at a lower interest rate. However, the issuing of new debentures can increase the company's debt load and interest payments.

3. Issue of Equity Shares: The issuing company can raise funds for debenture redemption by issuing equity shares. This mode of Finance allows the company to avoid taking on additional debt and reduces its interest payments. However, the issuing of equity shares can dilute the ownership and control of the company and reduce the earnings per share.

4. Sale of Assets: The company may sell its assets to raise funds for debenture redemption. This mode of Finance is useful when the company has assets that are not needed for its core

business and can be sold at a profit. However, the sale of assets may affect the company's long-term growth prospects and profitability.

5. Borrowing from Banks or Financial Institutions: The issuing company can borrow funds from banks or financial institutions to finance the redemption of debentures. This mode of Finance is useful when the company does not have sufficient internal accruals or cannot issue new debentures or equity shares. However, the borrowing of funds increases the company's debt load and interest payments.

9.5 Legal Provisions for Redemption of Debentures

- **Legal requirements and procedures for debenture redemption**

Redemption of debentures is a complex process that involves several legal requirements and procedures to ensure that the interests of both the debenture holders and the issuing company are protected. The legal requirements and procedures for debenture redemption are governed by the Companies Act 2013, and the rules and regulations issued by the Securities and Exchange Board of India (SEBI). Some of the important legal requirements and procedures for debenture redemption are as follows:

1. Approval of the Board of Directors: The redemption of debentures must be approved by the board of directors of the issuing company. The board must pass a resolution authorizing the redemption and specifying the terms and conditions of the redemption.

2. Creation of a Debenture Redemption Reserve: The issuing company must create a debenture redemption reserve and transfer at least 25% of the nominal value of the debentures to this reserve before the redemption of the debentures. This reserve is used to redeem the debentures when they become due.

3. Issuing a Notice of Redemption: The issuing company must issue a notice of redemption to the debenture holders at least 30 days before the date of redemption. The notice must specify the amount of the redemption, the date of redemption, and the place where the debentures can be surrendered for payment.

4. Payment of Redemption Amount: The issuing company must pay the redemption amount to the debenture holders on the date of redemption. The payment must be made in cash or by issuing a bank draft or a cheque.

5. Filing of Form with Registrar of Companies: The issuing company must file a form with the Registrar of Companies within 30 days of the redemption of the debentures. The form must contain details of the redemption, including the amount of debentures redeemed, the amount of debenture redemption reserve, and the date of redemption.

6. Compliance with SEBI Regulations: The issuing company must comply with the regulations issued by SEBI regarding the redemption of debentures. These regulations specify the terms and conditions of the redemption, the disclosures to be made to the debenture holders, and the procedures to be followed for the redemption.

Redemption of debentures with premium or at par or at a discount

Debentures can be redeemed at par, at a premium, or at a discount. The redemption price of debentures is determined by the terms and conditions of the debenture issue. The company issuing the debentures may choose to redeem the debentures at par, at a premium, or at a discount, depending on its financial position and the prevailing market conditions.

Redemption at par: When a company chooses to redeem its debentures at par, it means that it will pay the face value of the debentures to the debenture holders on the date of redemption. For example, if a debenture has a face value of Rs. 1,000 and the company chooses to redeem it at par, it will pay Rs. 1,000 to the debenture holder on the date of redemption.

Redemption at a premium: When a company chooses to redeem its debentures at a premium, it means that it will pay a price higher than the face value of the debentures to the debenture holders on the date of redemption. The premium amount is typically determined by the terms and conditions of the debenture issue. For example, if a debenture has a face value of Rs. 1,000 and the company chooses to redeem it at a premium of 10%, it will pay Rs. 1,100 to the debenture holder on the date of redemption.

Redemption at a discount: When a company chooses to redeem its debentures at a discount, it means that it will pay a price lower than the face value of the debentures to the debenture holders on the date of redemption. The discount amount is typically determined by the terms and conditions of the debenture issue. For example, if a debenture has a face value of Rs. 1,000 and the company chooses to redeem it at a discount of 10%, it will pay Rs. 900 to the debenture holder on the date of redemption.

Redemption at a premium or at a discount is not allowed unless the terms and conditions of the debenture issue specifically allow it. The Companies Act 2013 mandates that a company cannot redeem its debentures at a premium unless the premium has been provided for out of profits of the company or out of the securities premium account. Similarly, a company cannot redeem its debentures at a discount unless it has obtained the approval of the National Company Law Tribunal (NCLT) and complies with the conditions specified by the NCLT.

9.6 Accounting Treatment on Redemption of Debentures

The redemption of debentures has significant accounting implications for a company. The accounting treatment of debenture redemption depends on several factors, including the terms and conditions of the debenture issue, the mode of redemption, and the price at which the debentures are redeemed.

When a company redeems its debentures, it needs to make the necessary entries in its books of accounts to reflect the transaction. The following are the accounting entries that need to be made for the redemption of debentures:

1. **For debentures redeemed at par:** When a company redeems its debentures at par, it needs to make the following entries:

a) Debit the "Debenture Redemption Reserve" account for the amount transferred from it to the "Debenture Account".

b) Credit the "Debenture Account" for the amount paid to the debenture holders.

c) Debit the "Interest on Debentures" account for the interest accrued on the debentures up to the date of redemption.

2. For debentures redeemed at a premium: When a company redeems its debentures at a premium, it needs to make the following entries:

a) Debit the "Debenture Redemption Reserve" account for the amount transferred from it to the "Debenture Account".

b) Debit the "Securities Premium Account" for the premium paid on the debentures.

c) Credit the "Debenture Account" for the amount paid to the debenture holders.

d) Debit the "Interest on Debentures" account for the interest accrued on the debentures up to the date of redemption.

3. For debentures redeemed at a discount: When a company redeems its debentures at a discount, it needs to make the following entries:

a) Debit the "Debenture Redemption Reserve" account for the amount transferred from it to the "Debenture Account".

b) Credit the "Debenture Account" for the amount paid to the debenture holders.

c) Debit the "Discount on Issue of Debentures" account for the discount allowed on the debentures.

d) Debit the "Interest on Debentures" account for the interest accrued on the debentures up to the date of redemption.

The "Debenture Redemption Reserve" account is a special reserve created by a company for the purpose of redeeming its debentures. As per the Companies Act, 2013, a company is required to create a debenture redemption reserve of at least 25% of the amount of debentures issued before it can redeem any of its debentures.

- **Knowledge Check 2**

State whether given statements are true or false.

1. The issuing company can borrow funds from banks or financial institutions to finance the redemption of debentures.(T/F)
2. The issuing company must create a debenture redemption reserve and transfer at least 25% of the nominal value of the debentures to this reserve before the redemption of the debentures.(T/F)
3. Debentures can be redeemed at par, at a premium, or at a discount. (T/F)

- **Outcome-Based Activity 2**

Prepare the necessary journal entries for the redemption of debentures, including the debenture redemption account and interest on the debentures account.

9.7 Summary

- Debentures are a type of long-term financial instrument that companies use to raise funds from the market

- Debentures are unsecured in nature, meaning they are not backed by any collateral or asset, and therefore, the debenture holders do not have any claim on the company's assets in case of default.
- Debentures can be issued in various forms, including convertible debentures, non-convertible debentures, redeemable debentures, and irredeemable debentures.
- Convertible debentures are those that can be converted into equity shares of the issuing company at a predetermined conversion ratio.
- Redemption of debentures refers to the process of paying back the principal amount of a debenture to the debenture holders by the issuing company.
- Redemption of debentures can be done in a few different ways, depending on the terms of the debenture agreement.
- Redemption of debentures can also be done through the purchase of the debentures in the open market.
- Redemption of debentures can be a significant event for both the company and the debenture holders.
- Redeemable Debentures: Redeemable debentures are those debentures that are issued with a predetermined date of redemption.
- Irredeemable Debentures: Irredeemable debentures, also known as perpetual debentures, are those debentures that do not have a fixed maturity date or redemption date.
- Debentures can be redeemed by the issuing company in a few different ways, depending on the terms of the debenture agreement.
- Redeemable debentures have both advantages and disadvantages for the issuing company and the debenture holders.
- The reasons for debenture redemption can be broadly classified into two categories: voluntary and compulsory redemption.
- Redemption by Purchase in the Open Market is a method of debenture redemption where the issuing company buys back its own debentures from the open market before the maturity date.
- The market price of a debenture is influenced by several factors, including interest rates, credit ratings of the issuing company, and market demand for the debentures.

- Issue of New Debentures: The company may choose to issue new debentures to finance the redemption of existing debentures.
- Borrowing from Banks or Financial Institutions: The issuing company can borrow funds from banks or financial institutions to finance the redemption of debentures.
- Redemption of debentures is a complex process that involves several legal requirements and procedures to ensure that the interests of both the debenture holders and the issuing company are protected.
- The issuing company must create a debenture redemption reserve and transfer at least 25% of the nominal value of the debentures to this reserve before the redemption of the debentures.
- The issuing company must comply with the regulations issued by SEBI regarding the redemption of debentures.
- Debentures can be redeemed at par, at a premium, or at a discount. The redemption price of debentures is determined by the terms and conditions of the debenture issue.
- When a company chooses to redeem its debentures at a premium, it means that it will pay the price higher than the face value of the debentures to the debenture holders on the date of redemption.
- When a company chooses to redeem its debentures at a discount, it means that it will pay the price lower than the face value of the debentures to the debenture holders on the date of redemption.
- The redemption of debentures has significant accounting implications for a company.

9.8 Self-Assessment Questions

1. Explain the Meaning of 'Redemption of Debentures'
2. Explain 'Methods of Redemption of Debentures'
3. Explain Modes of Finance for Redemption of Debentures.
4. Explain Legal Provisions for Redemption of Debentures in your own words.
5. Explain Accounting Treatment on Redemption of Debentures.

9.9 References

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Unit- 10

Buy Back of Shares

Learning Outcomes:

- Students will be able to learn and understand the meaning of Buy Back of Shares
- Students will be able to understand the Advantages and Disadvantages of Buyback of Shares
- Students will be able to understand and learn the Legal Provisions and Sources of Funds for Buyback of Shares
- Students will be able to understand and learn Accounting Treatment on Buyback of Shares.

Structure:

10.1 Meaning of Buy Back of Shares

10.2 Advantages and Disadvantages of Buyback of Shares

Knowledge Check 1

Outcome-Based Activity 1

10.3 Legal Provisions and Sources of Funds for Buyback of Shares

10.4 Accounting Treatment on Buyback of Shares.

Knowledge Check 2

Outcome-Based Activity 2

10.5 Summary

10.6 Self-Assessment Questions

10.7 References

10.1 Meaning of Buy Back of Shares

Meaning of Buy Back of Shares

This is a common practice in the corporate world and is usually done to return surplus cash to shareholders or to increase the value of the remaining shares.

For example, it can increase the value of the remaining shares, increase earnings per share, and reduce the company's overall cost of capital. It's important to note that buybacks are not the same as dividends. While both are ways to return value to shareholders, dividends are a regular payout made to shareholders, while buybacks are a one-time or periodic event.

Reasons why a company may choose to buy back shares

1. Ownership: Debentures signify a debt to the company, whereas shares reflect ownership in the business.
2. Voting rights: As part of the corporation, shareholders are able to cast ballots. take part in significant choices, such choosing the board of directors. Conversely, holders of debentures are not entitled to vote.
3. Returns: Debenture holders earn interest on their investments, whereas shareholders receive dividends, which are a portion of the company's profits.
4. Risk: Compared to holders of debentures, shareholders are more at risk. In the event that the business performs poorly, investors would not get paid dividends and might possibly lose all of their money. On the other hand, debenture holders normally receive interest payments regardless of the company's performance.
5. Payment priority: If there is a liquidation.

Types of share buyback programs

1. **Open market buyback:** The advantage of an open market buyback is that it provides the company with the flexibility to buy back shares as and when it has surplus cash available.
2. **Fixed price tender offer:** The advantage of a fixed-price tender offer is that it provides certainty to shareholders about the price at which they can sell their shares.

3. Dutch auction tender offer: The advantage of a Dutch auction tender offer is that it allows the company to buy back shares at the lowest possible price while still achieving its desired number of shares.

4. Targeted buyback: In a targeted buyback, the company may choose to buy back shares from a specific shareholder or group of shareholders. This could be done as a way to prevent a hostile takeover or to remove a large shareholder who is perceived to be a threat to the company. The advantage of a targeted buyback is that it can be a more effective way to achieve the company's strategic objectives.

5. Employee share buyback: In an employee share buyback, the company may offer to buy back shares from its employees. This is typically done as part of an employee share ownership plan or to reward employees who have been with the company for a long time. The advantage of an employee share buyback is that it can help to align the interests of the company and its employees.

10.2 Advantages and Disadvantages of Buyback of Shares

Benefits for the company:

1. **Boosts share price:** which can increase the demand for the remaining shares and thus boost the share price.
2. **Increases earnings per share (EPS):** which can increase the EPS and make the company more attractive to investors.
3. **Enhances financial ratios:** The company more attractive to investors.
4. **Signals confidence:** The company's future growth prospects, which can be reassuring to investors.
5. **Prevents dilution:** Share buybacks can prevent the dilution of existing shareholders.

Drawbacks for the company:

1. **Uses up the cash:** Such as investing in the business or paying down debt.
2. **May not be a good investment:** If the company overpays for its own shares, the buyback may not be a good investment and could result in a loss for the company.
3. **Can be seen as a lack of investment opportunities:** If a company consistently uses share buybacks as a way to return value to shareholders, it may signal to investors that the company lacks investment opportunities or growth prospects.

Benefits for shareholders:

1. Potential for higher dividends: Share buybacks can increase the earnings per share, which can lead to higher dividends per share for existing shareholders.

2. May prevent dilution: Share buybacks can prevent the dilution of existing shareholders' ownership in the company when the company issues new shares.

Drawbacks for shareholders:

1. Limits growth potential: Share buybacks reduce the amount of capital available for investment in the company's growth and expansion.

2. May not provide a good return: If the company overpays for its own shares, the buyback may not provide a good return for shareholders.

3. May be seen as the short-term focus: If the company consistently uses share buybacks as a way to return value to shareholders, it may signal to investors that the company has a short-term focus rather than a long-term growth strategy.

Comparison between share buybacks and dividend payouts

1. Purpose: Share buybacks and dividend payouts are both ways for companies to return value to shareholders, but they have different purposes. while dividend payouts provide shareholders with a regular income stream.

2. Flexibility: Share buybacks provide companies with more flexibility than dividend payouts. Companies can choose to buy back shares when they have excess cash, and they can adjust the timing and amount of the buybacks based on their financial needs. In contrast, dividend payouts are more fixed and require companies to commit to a regular **payment schedule.**

3. Tax treatment: Share buybacks and dividend payouts have different tax treatments. Share buybacks are typically taxed as capital gains, while dividend payouts are taxed as ordinary income. This means that shareholders may pay a lower tax rate on share buybacks than they would on dividend payouts.

4. Signal to investors: Share while dividend payouts can be seen as a signal that the company may not have investment opportunities or growth prospects.

5. Impact on share price: Share buybacks and dividend payouts can have different impacts on share price. Share buybacks can boost share prices by reducing the number of

outstanding shares, while dividend payouts may not have a significant impact on share prices.

6. Risks: Share buybacks and dividend payouts have different risks. Share buybacks can be risky if the company overpays for its own shares, while dividend payouts can be risky if the company is unable to sustain its dividend payments over the long term.

- **Knowledge Check 1**

Fill in the Blanks.

1. A company may choose to buy back shares as a way to signal its ________ in its future growth prospects.
2. Share buybacks can be seen as a signal of confidence in the company's future growth prospects, which can be ____________to investors.
3. Share buybacks ___________ the amount of capital available for investment in the company's growth and expansion.

- **Outcome-Based Activity 1**

Analyze the impact of share buyback on a company's financial statements rationale behind the decision to buy back shares.

10.3 Legal Provisions and Sources of Funds for Buyback of Shares

- **Legal provisions for buyback of shares**

Legal provisions for the buyback of shares refer to the laws, rules, and regulations that companies must comply with when conducting a share buyback. The provisions are typically set by the government or the stock exchange, and they vary by jurisdiction.

Here are some common legal provisions for the buyback of shares:

1. Approval requirements: Companies are required to obtain approval for share buybacks from their board of directors, shareholders, or both, depending on the jurisdiction. In some cases, the approval of regulatory bodies may also be required.

2. Timing: The timing of share buybacks is usually subject to legal restrictions. In some jurisdictions, companies are not allowed to buy back shares during certain periods, such as blackout periods or before releasing financial results.

3. Limits on the amount of shares: There are usually limits on the amount of shares that can be bought back.

4. Price: The price of the shares must be determined in accordance with the applicable laws and regulations. In some jurisdictions, the price must be at or above the prevailing market price, while in others, it must be at a premium or a discount to the market price.

5. Funding: Companies are required to disclose the source of funds for share buybacks. The funds must be obtained through legal means and in compliance with applicable laws and regulations.

6. Disclosure requirements: Companies are required to disclose details of the share buyback, including the number of shares bought back, the price paid, the funding source, and the impact on the company's financial position.

7. Reporting requirements: Companies must report on the share buyback in their financial statements and annual reports. The reports must comply with applicable accounting standards and provide details of the buyback's impact on the company's financial position.

8. Record keeping: Companies must keep records of the share buyback, including the number of shares bought back, the price paid, and the funding source. The records must be maintained for a specified period of time, which varies by jurisdiction.

It is important for companies to comply with the legal provisions for share buybacks to avoid legal and regulatory consequences. Non-compliance can result in fines, penalties, and legal action and can damage the company's reputation.

The approval process for buyback of shares

The approval process for the buyback of shares involves several steps that a company must follow to ensure compliance with the applicable legal provisions and obtain approval from the relevant authorities. The specific steps and requirements vary by jurisdiction, but some common elements of the approval process include:

1. Board approval: The first step in the approval process is obtaining approval from the company's board of directors. The board must evaluate the proposed buyback, including the purpose, funding source, timing, and number of shares to be repurchased, and determine whether it is in the best interests of the company and its shareholders.

2. Shareholder approval: In many jurisdictions, companies must obtain shareholder approval for the buyback. The level of approval required may vary, depending on the

amount of shares to be repurchased or the proportion of the company's capital that is being used for the buyback. Shareholders must be provided with adequate information about the buyback, including the purpose, funding source, timing, and number of shares to be repurchased, so that they can make an informed decision.

3. Regulatory approval: In some jurisdictions, companies must obtain approval from regulatory bodies, such as stock exchanges or securities regulators, before proceeding with the buyback. The regulatory approval process may involve additional disclosures, filing of documents, or obtaining clearance from the relevant authorities.

4. Timelines: Companies must ensure that they comply with any legal timelines for the approval process. The timelines may vary by jurisdiction, but companies may need to provide notice of the buyback to shareholders, regulatory bodies, or other parties a certain number of days in advance of the buyback.

5. Documentation: Companies must prepare and file the necessary documentation to support the buyback. This may include board resolutions, shareholder resolutions, filings with regulatory bodies, and other legal documents.

The approval process for buyback of shares is an important part of the legal and regulatory framework that governs corporate actions

Limitations on buyback of shares

Limitations on buyback of shares refer to the legal and regulatory restrictions that apply to the amount of shares that a company can repurchase. The limitations are designed to ensure that companies do not engage in buybacks that could harm their financial position or affect the rights of shareholders. The specific limitations on buybacks vary by jurisdiction, but some common examples include:

1. Percentage of share capital: Many jurisdictions place limits on the percentage of a company's share capital that can be repurchased. For example, a company may be prohibited from repurchasing more than 10% of its share capital in any given year.

2. Funding source: Companies may be required to use only certain sources of funds for buybacks. For example, a company may be prohibited from using borrowed funds or proceeds from the sale of new securities to finance a buyback.

3. **Trading Restrictions:** Companies may be prohibited from conducting buybacks during certain periods, such as blackout periods when trading is restricted. This is designed to prevent insider trading and ensure that all shareholders have equal access to information.
4. **Price:** The price of shares being repurchased may be subject to limitations. For example, a company may be required to pay a price that is at or above the market price or that is determined by a formula based on the company's financial performance.
5. **Reporting requirements:** Companies may be required to disclose details of the buyback, such as the number of shares repurchased, the price paid, and the funding source. This information is used to monitor compliance with legal and regulatory limitations.

Limitations on buybacks are intended to protect the interests of shareholders and prevent companies from engaging in activities that could harm their financial position. However, they can also limit a company's ability to repurchase shares.

10 .4 Accounting Treatment on Buyback of Shares

- **Definition and explanation of buyback of shares**

Buyback of shares is a financial transaction where a company purchases its own shares from its shareholders in exchange for cash or other consideration. This process is also known as share repurchase or stock buyback.

The accounting treatment of buyback of shares depends on the method used and the type of shares being repurchased. The company can either retire the shares or hold them as treasury shares, which can be reissued in the future or cancelled.

However, share buybacks can also have negative consequences. If the company is unable to generate sufficient returns from the repurchased shares, the value of the remaining shares may decline. Additionally, if the company buys back shares at a premium price, it may reduce the company's cash reserves and limit its ability to invest in growth opportunities.

Accounting treatment for buyback of shares

The accounting treatment for buyback of shares depends on the method used and the type of shares being repurchased. The accounting treatment for buyback of shares is governed by

the International Financial Reporting Standards & Generally Accepted Accounting Principles .

If the company is retiring the shares, the following accounting entries are required:

1. Debit the amount paid to repurchase the shares to the "treasury shares" account, which is a contra-equity account that reduces the company's equity.
2. Debit any transaction costs incurred in the share buyback to an expense account.
3. Credit the nominal value of the shares repurchased to the "share capital" account.
4. Credit any excess amount paid to the "share premium" account, if applicable.

If the company is holding the shares as treasury shares, the following accounting entries are required:

1. Debit the amount paid to repurchase the shares to the "treasury shares" account.
2. Debit any transaction costs incurred in the share buyback to an expense account.
3. Credit the cash account for the total cost of the shares repurchased.
4. No entries are made to the "share capital" or "share premium" accounts.

Treasury shares are recorded on the balance sheet as a reduction to shareholders' equity, and they are not included in the calculation of earnings per share (EPS). In addition to the accounting entries, companies are required to disclose the buyback of shares in their financial statements. The disclosure should include the number of shares repurchased, the total cost of the shares, and any transaction costs incurred.

Impact of buyback of shares on the financial statements

The impact of buyback of shares on the financial statements depends on various factors, such as the method used, the type of shares being repurchased, and the amount paid to repurchase the shares

Balance Sheet:

The impact of buyback of shares on the balance sheet depends on whether the shares are retired or held as treasury shares.

a. If the shares are retired, the number of outstanding shares decreases, which reduces the "share capital" account and increases the "treasury shares" account. This reduces the

company's equity, and the company's financial ratios, such as earnings per share (EPS), return on equity (ROE), and price-to-earnings ratio (P/E ratio) may improve.

b. If the shares are held as treasury shares, they are recorded as a reduction to shareholders' equity. The treasury shares account is shown as a negative amount under the "shareholders' equity" section of the balance sheet. The amount paid to repurchase the shares is recorded as a reduction in the company's cash and cash equivalents.

2. Income Statement: The income statement shows the revenues, expenses, and net income of a company for a specific period. The impact of buyback of shares on the income statement depends on whether the shares are retired or held as treasury shares.

a. If the shares are retired, there is no impact on the income statement.

b. If the shares are held as treasury shares, any gains or losses on the subsequent sale of treasury shares are recognized in the income statement.

Cash Flow Statement:

a. If the company uses cash to repurchase shares, the cash outflow is recorded in the cash flow statement under the "financing activities" section.

b. If the company uses debt to finance the share repurchase, the cash inflow from the debt issuance is recorded in the cash flow statement under the "financing activities" section.

c. Any transaction costs incurred in the share buyback are also recorded in the cash flow statement under the "operating activities" section.

Overall, the impact of buyback of shares on the financial statements can have both positive and negative effects on the company's financial position and performance. Companies must carefully consider the impact of buyback of shares on their financial statements and ratios before deciding to proceed with the transaction.

- **Knowledge Check 2**

State whether given statements are true or false.

1. In many jurisdictions, companies must obtain shareholder approval for the buyback.(T/F)
2. Limitations on buybacks are intended to protect the interests of shareholders and prevent companies from engaging in activities that could harm their financial position.(T/F)

3. The accounting treatment of buyback of shares depends not on the method used and the type of shares being repurchased.(T/F)

- **Outcome-Based Activity 2**

Interpret the financial implications of share buyback for various stakeholders, including shareholders, creditors, and potential investors, and make recommendations on the optimal timing and size of the buyback program based on the company's financial goals and market conditions.

10.5 Summary

- It's important to note that buybacks are not the same as dividends.
- Share buybacks and dividend payouts are both ways for companies to return value to shareholders, but they have different purposes.
- Share buybacks and dividend payouts can have different impacts on share price.
- Companies are required to obtain approval for share buybacks from their board of directors, shareholders, or both, depending on the jurisdiction.
- The timing of share buybacks is usually subject to legal restrictions.
- There are usually limits on the amount of shares that can be bought back.
- Companies are required to disclose the source of funds for share buybacks. The funds must be obtained through legal means and in compliance with applicable laws and regulations.
- Companies must keep records of the share buyback, including the number of shares bought back, the price paid, and the funding source.
- In some jurisdictions, companies must obtain approval from regulatory bodies, such as stock exchanges or securities regulators, before proceeding with the buyback.
- The approval process for buyback of shares is an important part of the legal and regulatory framework that governs corporate actions.
- Limitations on buyback of shares refer to the legal and regulatory restrictions that apply to the amount of shares that a company can repurchase.
- Buyback of shares is a financial transaction where a company purchases its own shares from its shareholders in exchange for cash or other consideration.

- The accounting treatment for buyback of shares depends on the method used and the type of shares being repurchased.
- Treasury shares are recorded on the balance sheet as a reduction to shareholders' equity, and they are not included in the calculation of earnings per share (EPS).
- The impact of buyback of shares on the financial statements depends on various factors, such as the method used, the type of shares being repurchased, and the amount paid to repurchase the shares.

10.6 Self-Assessment Questions

1. Explain the Meaning of 'Buy Back of Shares'.
2. Explain 'Advantages and Disadvantages of Buyback of Shares'
3. Explain Legal Provisions for Buyback of Shares in your own words.
4. Explain Accounting Treatment on Buyback of Shares.

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Unit- 11

Forfeiture and Reissue of Shares

Learning Outcomes:

- Students will be able to learn and understand the meaning of Forfeiture of Shares
- Students will be able to understand the Effect of Forfeiture of shares
- Students will be able to understand and learnaboutRe-issue of Forfeited Shares
- Students will be able to understand and learn accounting Treatment on Reissue of Forfeited Shares.

Structure:

11.1 Meaning of Forfeiture of Shares

11.2 Effect of Forfeiture of shares

11.3 Accounting Treatment on Forfeiture of Share

Knowledge Check 1

Outcome-Based Activity 1

11.4 Reissue of Forfeited Shares

11.5 Accounting Treatment on Reissue of Forfeited Shares.

Knowledge Check 2

Outcome-Based Activity 2

11.6 Summary

11.7 Self-Assessment Questions

11.8 References

11.1 Meaning of Forfeiture of Shares

Definition and explanation of forfeiture of shares

When a shareholder fails to pay the required call or other payments, the company has the right to forfeit the shares. This means that the shares are taken back by the company, and the shareholder loses ownership of the shares.

The process of forfeiture of shares involves the following steps:

1. Notice: The company must give notice to the shareholder of its intention to forfeit the shares. The notice must specify the amount due, the date by which the payment must be made, and the consequences of failure to pay.

2. Time for payment: The shareholder is given a reasonable time to pay the amount due. If the payment is made within the specified time, the shares are not forfeited.

3. Forfeiture: In case the shareholder is unable to pay the required amount within the designated timeframe, the company holds the right to forfeit the shares. Consequently, the shares are deemed invalid, and the shareholder forfeits all entitlements associated with them.

4. Reissue: The forfeited shares can be reissued by the company to another shareholder or sold to the public.

Forfeiture of shares is a drastic action and is usually a last resort when other remedies have failed. As a result of the forfeiture, the shareholder's privileges to engage in the company's affairs, including voting rights, may be revoked. Additionally, the shareholder may no longer be entitled to receive dividends or any other benefits that come with owning the shares.

Forfeiture of shares is not the same as a sale of shares or transfer of ownership, as the shareholder is not voluntarily giving up ownership of the shares. It is a legal process that allows the company to cancel the shares and recover any amounts owing to it.

Forfeiture of shares is regulated by the company's articles of association, and the process must comply with legal requirements. It is important to note that the company is required to notify the shareholder of the situation and grant a reasonable period for payment. Moreover, the company must follow the appropriate procedures for cancelling the shares to ensure the process is conducted lawfully.

Reasons for forfeiture of shares

Forfeiture of shares may occur for a variety of reasons. The most common reasons for the forfeiture of shares include:

1. **Failure to pay calls:** One of the most common reasons for the forfeiture of shares is the failure of a shareholder to pay calls on their shares. A call is a request for payment of the amount due on shares. If a shareholder fails to pay the required amount within the specified time, the company may forfeit their shares.
2. **Non-compliance with company regulations:**When a shareholder fails to adhere to the company's articles of association or other regulations, the company may choose to forfeit their shares.For example, if a shareholder engages in activities that are detrimental to the company's interests or violate its regulations, the company may choose to forfeit their shares.
3. **Bankruptcy or insolvency:** If a shareholder becomes bankrupt or insolvent, the company may choose to forfeit their shares. This is because the shares may become part of the bankrupt or insolvent estate, and the company may need to protect its interests.
4. **Death of a shareholder:** In certain situations, if a shareholder passes away, the company may decide to forfeit their shares. This is because the shares may become a part of the shareholder's estate, and the company may need to safeguard its interests.
5. **Transferring Shares in Breach of Company Regulations:** If a shareholder transfers their shares in violation of the company's regulations, the company may choose to forfeit their shares. For example, if a shareholder transfers their shares to a person who is not eligible to hold the shares, the company may forfeit the shares.

Difference between forfeiture and surrender of shares

Forfeiture of shares and surrender of shares are two distinct concepts related to the cancellation of shares, but they have different implications for the shareholder and the company.

Forfeiture of shares occurs when a shareholder fails to pay the required call or other payments or fails to meet the obligations associated with the ownership of the shares. In this case, the company has the right to forfeit the shares, and the shareholder loses ownership of the shares, along with any rights associated with the shares.

Surrender of shares, on the other hand, occurs when a shareholder voluntarily gives up their shares to the company. The shareholder may do this for a variety of reasons, such as

retirement or as part of a buyback program. In this case, the shareholder receives consideration for the shares, such as cash or other assets, and the shares are cancelled.

The main differences between forfeiture and surrender of shares are:

1. **Voluntariness:** Forfeiture of shares is an involuntary action taken by the company, while surrender of shares is a voluntary action taken by the shareholder.
2. **Implications for shareholder rights:** Forfeiture of shares results in the shareholder losing all rights associated with the shares, such as voting rights, whereas surrender of shares is often accompanied by the consideration that compensates the shareholder for their loss of ownership.
3. **Legal procedures:** Forfeiture of shares is a legal process that follows specific procedures set out in the company's articles of association, while surrender of shares may be governed by a separate agreement between the company and the shareholder.
4. **Reasons for cancellation:** Forfeiture of shares is usually a result of the shareholder failing to meet their obligations, while surrender of shares may be due to various reasons, such as the shareholder wanting to exit the company or the company buying back its own shares.

Legal requirements for the forfeiture of shares

The forfeiture of shares is a legal process that involves the cancellation of shares issued by a company. There are certain legal requirements that must be followed when a company chooses to forfeit shares. These requirements include:

1. **Compliance with the company's articles of association:** The articles of association are the rules that govern the internal affairs of the company, including the issuance and forfeiture of shares. These rules must be followed when a company chooses to forfeit shares. It is important for companies to review their articles of association to ensure that they are following the correct procedures.
2. **Notice to the shareholder**: Before shares can be forfeited, the company must give notice to the shareholder of their intention to forfeit the shares. The notice should specify the amount of money that is due and the date by which the payment must be made to avoid forfeiture. The notice must be given in writing and must be sent to the shareholder's last known address.

3. Timeframe for payment: The notice given to the shareholder must specify a reasonable timeframe within which the payment must be made to avoid forfeiture. The timeframe must be at least 14 days from the date of the notice. The shareholder must be given a reasonable amount of time to make the payment before the shares are forfeited.

4. Right to be heard: The shareholder has the right to be heard before the shares are forfeited. The shareholder can make representations to the company as to why the shares should not be forfeited. This ensures that the shareholder has a fair opportunity to explain their situation and to make any necessary arrangements to avoid forfeiture.

5. Proper resolution: The forfeiture of shares must be approved by a resolution of the board of directors of the company. The resolution must be properly recorded in the minutes of the board meeting. This ensures that the forfeiture is authorized by the appropriate corporate authority and that the decision is properly documented.

6. Disclosure of forfeiture: After the shares have been forfeited, the company must disclose the forfeiture in the register of members and in the annual return filed with the Registrar of Companies. This ensures that the forfeiture is properly recorded and that the company's records are up-to-date.

7. Return of money paid: If the shareholder pays the amount due after the shares have been forfeited, the company must return the money paid, less any expenses incurred by the company in relation to the forfeiture. This ensures that the shareholder is not unfairly penalized and that any expenses incurred by the company are properly accounted for.

It is important for companies to follow these legal requirements when forfeiting shares to ensure that the process is carried out properly and fairly. Failure to comply with these requirements can lead to legal disputes and potential liabilities for the company. Shareholders should also be aware of their rights and obligations when it comes to the forfeiture of shares and seek legal advice if necessary.

11.2 Effect of Forfeiture of shares

- **Impact of forfeiture of shares on the company's financial statements**

Forfeiture of shares refers to the cancellation of shares that were issued by a company due to the failure of the shareholder to comply with the terms of their share agreement. This can

occur when a shareholder fails to pay the required amount of money for the shares they have subscribed to or when they fail to comply with other conditions of the share agreement.

The effect of forfeiture of shares can vary depending on the circumstances. Some of the key effects are:

1. **Loss of investment:** When shares are forfeited, the shareholder loses their investment in the company. They will not receive any dividends or other benefits that may have been associated with owning the shares. This can be a significant loss for the shareholder, especially if they have invested a substantial amount of money in the company.
2. **Reduced share capital:** Forfeiture of shares leads to a reduction in the share capital of the company. Share capital is the amount of money that a company has raised from the sale of its shares. If some of these shares are forfeited, then the total share capital of the company is reduced. This can have implications for the financial health of the company, as it may affect the ability of the company to raise capital in the future.
3. **Reissue of shares:** When shares are forfeited, the company can choose to reissue those shares to other investors. This can help the company to raise additional capital, but it can also dilute the ownership and control of existing shareholders. For example, if a shareholder owns 10% of the shares of the company and the company reissues forfeited shares, the shareholder's ownership percentage will be reduced if they do not purchase the newly issued shares.
4. **Liability for unpaid amounts:** When shares are forfeited due to non-payment, the shareholder may still be liable for any unpaid amounts. For example, if a shareholder subscribed to 100 shares but only paid for 50 of them, and the remaining 50 shares are forfeited, the shareholder may still be liable for the payment of the remaining 50 shares. The company may take legal action to recover the unpaid amounts from the shareholder.
5. **Effect on shareholder voting rights:** Forfeiture of shares can also affect the voting rights of shareholders. The number of shares held by the shareholder is reduced, which means their voting power is also reduced. This can have implications for the control and management of the company.

It is important to note that the effects of forfeiture of shares may vary depending on the circumstances, such as the reason for the forfeiture and the terms of the share agreement. It

is important for both companies and shareholders to understand the potential implications of forfeiture of shares and to take appropriate measures to mitigate any negative effects.

11.3 Accounting Treatment on Forfeiture of Share

Accounting treatment of forfeited shares involves the recording of the forfeiture and the subsequent actions taken by the company. The accounting treatment of forfeited shares is as follows:

1. Debiting share capital account: Upon the forfeiture of shares, the company records a debit to the share capital account for the nominal value of the shares that were forfeited. This results in a reduction in the total share capital of the company.

2. Crediting share forfeiture account: The amount paid by the shareholder on the forfeited shares is credited to a special account called the share forfeiture account. The purpose of this account is to record the amount received by the company from the shareholder and to monitor the shareholder's liability for the forfeited shares.

3. Recognizing share premium account: If the shares were issued at a premium, the share premium account is debited with the amount of the premium forfeited. This reduces the total share premium account.

4. Refund of excess amount: If the company sells the forfeited shares for more than the amount due on the shares, the excess amount is credited to the share forfeiture account. This amount is then refunded to the shareholder, reducing the liability of the shareholder for the forfeited shares.

5. Recognition of reserve account: If the company sells the forfeited shares for less than the amount due on the shares, the shortfall is credited to a reserve account called the capital reserve account. This reserve account increases the company's reserves and is available for distribution as dividends.

6. Cancellation of shares: Once the shares have been forfeited, the company cancels the shares and enters the cancellation in the register of members.

7. Adjustment of earnings per share: The forfeiture of shares affects the earnings per share (EPS) calculation. The EPS is adjusted to reflect the reduction in the number of shares outstanding.

- **Knowledge Check 1**

Fill in the Blanks.

1. Forfeiture of shares refers to the process of ________ the shares of a shareholder who has failed to meet the obligations associated with the ownership of the shares.
2. Forfeiture of shares is not the same as a sale of shares or transfer of ownership, as the shareholder is not____________ giving up ownership of the shares.
3. One of the most common reasons for the forfeiture of shares is the ____________ of a shareholder to pay calls on their shares.
4. Forfeiture of shares is an involuntary action taken by the company, while surrender of shares is a __________ action taken by the shareholder.
5. The amount paid by the shareholder on the forfeited shares is credited to a special account called the share ______________ account.

- **Outcome-Based Activity 1**

Analyze the financial impact of forfeiting shares on a company's share capital and shareholders' equity.

11.4 Reissue of Forfeited Shares

- **Definition and explanation of reissue of forfeited shares**

Reissue of forfeited shares refers to the process of selling shares that were previously forfeited by a shareholder. Forfeiture of shares occurs when a shareholder fails to pay for the shares they have subscribed to in accordance with the terms of the company's articles of association. Once the shares have been forfeited, the shareholder loses all their rights in respect of the shares, and the shares become the property of the company.

The reissue of forfeited shares is a way for the company to recover the amount due on the forfeited shares and to increase its share capital. The company can reissue the forfeited shares at a price that is not less than the amount due on the shares. The amount received from the reissue of the forfeited shares is credited to the company's share capital account.

The reissue of forfeited shares is governed by the company's articles of association and by the relevant laws and regulations. The articles of association must provide for the reissue of

forfeited shares and specify the procedure to be followed in the process. The reissue of forfeited shares must also comply with the requirements of the Companies Act or other applicable laws.

The process of reissue of forfeited shares involves several steps. First, the company must determine the amount due on the forfeited shares, including any unpaid calls, interest, and expenses. The company must then offer the forfeited shares for reissue to existing shareholders, in proportion to their existing holdings, before offering the shares to the public. If the existing shareholders do not take up the offer, the shares can be offered to the public.

The reissue of forfeited shares can provide numerous benefits to the company. Firstly, it enables the company to recover the amount due on the forfeited shares, improving its cash flow. Secondly, it increases the company's share capital, which can be utilized to fund new projects or expand the business. Additionally, the reissue of forfeited shares can aid in sustaining the company's share price, as the rise in the number of shares outstanding is counterbalanced by the growth in the company's assets.

Legal requirements for the reissue of forfeited shares

The reissue of forfeited shares is governed by the company's articles of association and by the relevant laws and regulations. The articles of association must provide for the reissue of forfeited shares and specify the procedure to be followed in the process. The reissue of forfeited shares must also comply with the requirements of the Companies Act or other applicable laws.

The Companies Act or other applicable laws set out the requirements and procedures that must be followed when a company reissues forfeited shares. Some of the legal requirements for the reissue of forfeited shares include:

1. **Timeframe:** The reissue of forfeited shares must take place within a certain timeframe, as specified by the Companies Act or other applicable laws. This timeframe is usually six years from the date of forfeiture, after which the shares become the property of the company.

2. **Notice:** The company must give notice to the forfeiting shareholder before reissuing the forfeited shares. This notice must be in writing and must specify the amount due on the forfeited shares, the date of reissue, and the price at which the shares will be reissued.

3. Offer to existing shareholders: The company must offer the forfeited shares to existing shareholders first, in proportion to their existing holdings, before offering the shares to the public. If the existing shareholders do not take up the offer, the shares can be offered to the public.

4. Price: The forfeited shares must be reissued at a price that is not less than the amount due on the shares, including any unpaid calls, interest, and expenses. The price can be set by the company's directors, but it must be approved by the shareholders.

5. Registration: The reissue of forfeited shares must be registered with the Companies House, and the company's register of members must be updated accordingly.

Failure to comply with the legal requirements for the reissue of forfeited shares can result in legal and financial consequences for the company. The company can be fined or face legal action, and the reissue of forfeited shares may be declared invalid. Therefore, it is essential for companies to follow the legal requirements for the reissue of forfeited shares to ensure compliance with the law and protect the interests of the company and its shareholders.

Reasons for the reissue of forfeited shares

Reissuing forfeited shares can be beneficial for a company in several ways. Some of the reasons for the reissue of forfeited shares are:

1. Raising additional capital: By reissuing forfeited shares, a company can raise additional capital without issuing new shares. This can be particularly useful when the company needs to raise capital quickly, and the process of issuing new shares may take too long.

2. Reducing the company's liabilities: When a shareholder forfeits their shares, the company may still be liable for any unpaid calls, interest, and expenses on the forfeited shares. By reissuing these shares, the company can recover the amount due and reduce its liabilities.

3. Maintaining control: When a shareholder forfeits their shares, the company's control may be diluted. By reissuing these shares, the company can maintain its control over its operations and decision-making.

4. Improving liquidity: By reissuing forfeited shares, the company can improve its liquidity by increasing the number of shares available for trading. This can make it easier for shareholders to buy and sell shares in the company, improving the liquidity of the market.

5. Avoiding a negative impact on the company's financial statements: If forfeited shares are not reissued, they must be written off from the company's financial statements. This can have a negative impact on the company's financial position and performance, as it can reduce the company's net assets and increase the loss for the year.

Types of reissue of forfeited shares

There are two types of reissuing forfeited shares - reissue for cash and reissue for non-cash consideration.

1. Reissue for cash: In this type of share reissue, the forfeited shares are made available to the public or existing shareholders for cash consideration. The board of directors determines the share price, which must not fall below the amount due on the shares, encompassing any unpaid calls, interest, and expenses. Existing shareholders have the right of first refusal to acquire the forfeited shares in proportion to their current shareholding. If the existing shareholders decline the offer, the shares can then be offered to the public.

2. Reissue for non-cash consideration: In this type of reissue, the forfeited shares are reissued to a new shareholder in exchange for non-cash consideration, such as a property or an asset. The non-cash consideration offered in exchange for the forfeited shares must be of an equivalent value to the amount owed on the shares, which comprises any outstanding calls, interest, and expenses. The consideration is valued by an independent expert, and the transaction must be approved by the shareholders.

The reissue of forfeited shares must also comply with the company's articles of association and with the relevant laws and regulations. The reissue of forfeited shares must be registered with the Companies House, and the company's register of members must be updated accordingly.

Impact of the reissue of forfeited shares on the company's financial statements

The reissue of forfeited shares can have a significant impact on a company's financial statements. Here are some ways that the reissue of forfeited shares can affect a company's financial statements:

1. Increase in equity: The reissue of forfeited shares increases the number of shares issued and outstanding, which in turn increases the company's equity. The amount received from the reissue of the shares is added to the company's share capital account.

2. Reduction in liabilities: If the reissue of forfeited shares is for cash consideration, the amount received from the sale of the shares is used to settle any unpaid calls, interest, and expenses on the forfeited shares. This reduces the company's liabilities and improves its financial position.

3. Increase in earnings per share: The reissue of forfeited shares increases the number of shares outstanding, which can lead to an increase in earnings per share. This is because the company's net income is now spread over a larger number of shares.

4. Impact on the balance sheet: The reissue of forfeited shares affects the balance sheet by increasing the share capital account and reducing the company's liabilities. This has an impact on the company's financial position and can affect its ability to obtain additional financing.

5. Impact on the income statement: The reissue of forfeited shares does not directly affect the income statement. However, it can indirectly impact the income statement by increasing the number of shares outstanding and potentially leading to an increase in earnings per share.

11.5 Accounting Treatment on Reissue of Forfeited Shares.

The accounting treatment for the reissue of forfeited shares depends on the type of consideration received for the shares. There are two types of reissue - reissue for cash and reissue for non-cash consideration.

1. Reissue for cash: When forfeited shares are reissued for cash consideration, the accounting treatment is straightforward. The amount received from the sale of the shares is credited to the share capital account. Any unpaid calls, interest, and expenses on the forfeited shares are deducted from the amount received, and the balance is credited to the share premium account. The share premium account represents the premium paid by shareholders over and above the par value of the shares.

2. Reissue for non-cash consideration: Reissuing forfeited shares for non-cash consideration can lead to a more intricate accounting treatment. The amount due on the forfeited shares, including any unpaid calls, interest, and expenses, is recorded as a liability on the balance sheet. The non-cash consideration received is recorded at its fair value as determined by an independent expert. In case the fair value of the non-cash consideration is

less than the amount due on the forfeited shares, the discrepancy is recognized as an expense in the profit and loss account.

In both cases, the reissued shares are recorded as an increase in the share capital account. The number of shares outstanding is also increased. The accounting treatment for the reissue of forfeited shares must comply with the relevant accounting standards and regulations.

When a company forfeits shares, it cancels the shares and reduces its share capital by the amount of the forfeited shares. However, if the forfeited shares are reissued, the accounting treatment for the reissue depends on whether the reissued shares are sold at a profit or a loss.

Let's consider an example. ABC Ltd. forfeited 1,000 shares of face value INR 10 each held by Mr. X, who had paid INR 8 per share. The company then reissued these forfeited shares to Mr. Y at INR 12 per share. In this case, the company has made a profit on the reissue of forfeited shares.

The accounting treatment for the reissue of forfeited shares, in this case, is as follows:

1. First, the company reduces its share capital account by the amount of the forfeited shares, which is INR 10,000 (1,000 shares x INR 10 face value per share).

Share Capital A/c Dr. INR 10,000 To Forfeited Shares A/c INR 10,000

2. The company then reissues the forfeited shares to Mr. Y at INR 12 per share, which amounts to INR 12,000 (1,000 shares x INR 12 per share).

Bank A/c Dr. INR 12,000 To Share Capital A/c INR 10,000 To Securities Premium A/c INR 2,000

3. The company then calculates the profit on the reissue of forfeited shares, which is INR 4,000 (INR 12,000 reissue price - INR 8,000 forfeited price).

Securities Premium A/c Dr. INR 4,000 To Capital Reserve A/c INR 4,000

4. Finally, the company records the reissued shares in its share capital account at the nominal value of the shares, which is INR 10,000 (1,000 shares x INR 10 face value per share).

Share Capital A/c Dr. INR 10,000 To Forfeited Shares A/c INR 10,000

In this example, the company has made a profit of INR 4,000 on the reissue of forfeited shares, which is transferred to the capital reserve account. The share capital account is credited for the nominal value of the reissued shares.

It is important to note that the accounting treatment for the reissue of forfeited shares is different from that of new shares issued for cash. When new shares are issued for cash, the excess of the issue price over the nominal value of the shares is treated as a share premium, which is a reserve that can be used for various purposes, including the distribution of dividends.

- **Knowledge Check 2**

State whether given statements are true or false.

1. The reissue of forfeited shares is governed by the company's articles of association and by the relevant laws and regulations. (T/F)
2. The articles of association must provide for the reissue of forfeited shares and specify the procedure to be followed in the process. (T/F)
3. By reissuing forfeited shares, the company can improve its liquidity by increasing the number of shares available for trading (T/F)

- **Outcome-Based Activity 2**

Evaluate the advantages and disadvantages of reissuing forfeited shares as a method of raising capital for a company, taking into account the potential dilution of existing shareholders' holdings.

11.6 Summary

- If the shareholder fails to pay the amount due within the specified time, the company can forfeit the shares.
- Forfeiture of shares is a drastic action and is usually a last resort when other remedies have failed.
- One of the most common reasons for the forfeiture of shares is the failure of a shareholder to pay calls on their shares.
- If a shareholder becomes bankrupt or insolvent, the company may choose to forfeit their shares.
- Forfeiture of shares and surrender of shares are two distinct concepts related to the cancellation of shares, but they have different implications for the shareholder and the company.

- Forfeiture of shares occurs when a shareholder fails to pay the required call or other payments or fails to meet the obligations associated with the ownership of the shares
- Forfeiture of shares is a legal process that requires compliance with the company's articles of association, as well as the Companies Act 2006 in the UK.
- Forfeiture of shares reduces the share capital of the company.
- Forfeiture of shares may also result in an increase in the reserves of the company.
- Accounting treatment of forfeited shares involves the recording of the forfeiture and the subsequent actions taken by the company.
- Once the shares have been forfeited, the company cancels the shares and enters the cancellation in the register of members.
- Reissue of forfeited shares refers to the process of selling shares that were previously forfeited by a shareholder.
- The company must then offer the forfeited shares for reissue to existing shareholders, in proportion to their existing holdings, before offering the shares to the public.
- The reissue of forfeited shares has several benefits for the company. It allows the company to recover the amount due on the forfeited shares, thereby improving its cash flow.
- The company must give notice to the forfeiting shareholder before reissuing the forfeited shares.
- Failure to comply with the legal requirements for the reissue of forfeited shares can result in legal and financial consequences for the company.
- By reissuing forfeited shares, a company can raise additional capital without issuing new shares..
- In this type of reissue, the forfeited shares are offered to the public or existing shareholders for cash consideration.
- The board of directors must ensure that the reissue of forfeited shares is done at a fair price and in the best interests of the company and its shareholders.
- The reissue of forfeited shares increases the number of shares issued and outstanding, which in turn increases the company's equity.

- The accounting treatment for the reissue of forfeited shares depends on the type of consideration received for the shares.

11.7 Self-Assessment Questions

1. Explain the Meaning of 'Forfeiture of Shares'.
2. Explain 'Effect of Forfeiture of shares'
3. Explain Accounting Treatment on Forfeiture of Share.
4. Explain the Reissue of Forfeited Shares .
5. Explain Accounting Treatment on Reissue of Forfeited Shares.

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Unit- 12

Redemption of Preference Shares

Learning Outcomes:

- Students will be able to learn and understand the meaning of Redemption of Preference Shares.
- Students will be able to understand the methods of Redemption of Preference Shares.
- Students will be able to understand and learn the Legal conditions for the Redemption of Preference Shares.
- Students will be able to understand and learn accounting Treatment on Redemption of Preference.

Structure:

12.1 Meaning of Redemption of Preference Shares

12.2 Legal conditions for Redemption of Preference Share

Knowledge Check 1

Outcome-Based Activity 1

12.3 Methods of Redemption of Preference Shares

12.4 Accounting Treatment on Redemption of Preference

Knowledge Check 2

Outcome-Based Activity 2

12.5 Summary

12.6 Self-Assessment Questions

12.7 References

12.1 Meaning of Redemption of Preference Shares

- **Definition and explanation of redemption of preference shares**

Redemption of preference shares refers to the process of repaying or buying back preference shares by the issuing company before the maturity date. Preference shares are a type of equity security that gives holders preferential rights over common shareholders, such as a fixed dividend payment and priority in case of liquidation.

The redemption of preference shares can be voluntary or mandatory. Voluntary redemption occurs when the company chooses to buy back the shares, while mandatory redemption occurs when the shares have a specified maturity date and the company is required to repay the shareholders at that time.

There are several reasons why a company may choose to redeem preference shares. For example, if the company has excess cash, it may want to reduce its outstanding equity or the number of shareholders. The company may also want to reduce its annual dividend payment by retiring high-yielding preference shares and replacing them with lower-yielding debt. Additionally, if interest rates have declined, the company may want to replace high-interest preference shares with lower-cost debt.

The redemption of preference shares can be beneficial to both the company and its shareholders. Shareholders who receive the redemption proceeds can use the funds to invest in other securities, pay off debt, or reinvest in the company's common shares. The company can benefit from the elimination of the dividend payment on redeemed shares, improved financial flexibility, and a stronger balance sheet.

Reasons for the redemption of preference shares

There are several reasons why a company may choose to redeem its preference shares. Some of these reasons include:

1. Capital restructuring: The redemption of preference shares can be part of a capital restructuring plan. This can be done to improve the company's capital structure, increase financial flexibility, and improve its financial health.

2. Changes in the interest rate: The company may choose to redeem preference shares if interest rates have decreased, and it can replace them with lower-cost debt.

3. Elimination of high dividend payments: The company may redeem preference shares that have a high dividend payment and replace them with lower-yielding debt. This can help to reduce the company's annual dividend payment and improve its financial position.

4. Redemption at maturity: Some preference shares may have a specified maturity date, after which the company is required to redeem them. In such cases, the company must redeem the shares to meet its contractual obligations.

5. Return of capital to shareholders: The redemption of preference shares can be a way of returning capital to shareholders. This can be beneficial to shareholders who may use the funds to invest in other securities, pay off debt, or reinvest in the company's common shares.

6. Reduction of outstanding equity: The company may choose to redeem preference shares to reduce its outstanding equity or the number of shareholders. This can be useful if the company is looking to simplify its capital structure, improve its financial position, or meet other strategic objectives.

Types of redemption of preference shares

There are two types of redemption of preference shares, which include:

1. Redemption at the option of the company: This type of redemption occurs when the company has the option to redeem its preference shares before their maturity date. The company can choose to redeem the shares at any time, depending on its financial position and strategic objectives. The terms and conditions of this type of redemption are usually set out in the preference share prospectus or the company's articles of association.

2. Redemption at the option of the shareholder: This type of redemption occurs when the preference shares have a put option, which gives the shareholder the right to demand that the company redeem the shares. This right can be triggered by certain events, such as a change in control of the company or a breach of a key covenant. The terms and conditions of this type of redemption are usually set out in the preference share prospectus or the company's articles of association.

In addition to the above two types of redemption, there is also mandatory redemption. This occurs when the preference shares have a specified maturity date, after which the company is required to redeem the shares. The terms and conditions of this type of redemption are usually set out in the preference share prospectus or the company's articles of association.

The type of redemption chosen by the company will depend on its specific circumstances and strategic objectives. The company must carefully consider the terms and conditions of each type of redemption before making a decision. It is essential to ensure that the chosen type of redemption aligns with the company's strategic objectives, financial position, and shareholder expectations.

Impact of redemption of preference shares on the company's financial statements

The redemption of preference shares has a significant impact on the company's financial statements. It affects both the balance sheet and income statement. Here are some ways in which the redemption of preference shares can impact the financial statements:

1. **Reduction in equity:** The redemption of preference shares reduces the company's equity. This is because preference shares are classified as equity, and the redemption of these shares results in a decrease in the amount of equity on the balance sheet.
2. **Decrease in liabilities:** The redemption of preference shares also results in a decrease in the company's liabilities. This is because preference shares are classified as liabilities until they are redeemed. Once they are redeemed, the liability is removed from the balance sheet.
3. **Impact on earnings per share (EPS):** The redemption of preference shares can impact the company's EPS. This is because preference shares receive a fixed dividend, and the redemption of these shares reduces the amount of fixed dividends paid out. As a result, the earnings available for common shareholders increase, which can result in an increase in EPS.
4. **Impact on cash flow:** The redemption of preference shares can have a significant impact on the company's cash flow. This is because the company needs to have sufficient cash reserves to redeem the preference shares. If the company does not have enough cash, it may need to raise capital through debt or equity financing.
5. Impact on financial ratios: The redemption of preference shares can also impact the company's financial ratios. For example, the debt-to-equity ratio will decrease as the company's equity increases and the amount of debt remains the same.

12.2 Legal conditions for Redemption of Preference Share

- **Types of preference shares**

Preference shares are a type of share issued by a company that provides certain rights and privileges to the holders of those shares. These rights and privileges can include a fixed rate of dividend payment, priority in payment of dividends and/or return of capital, and a preference in the distribution of assets in the event of liquidation.

There are several types of preference shares, each with different characteristics and legal implications:

1. **Cumulative preference shares:** These shares entitle the holder to receive a fixed rate of dividend payment, which accumulates if not paid in a particular year. In other words, if the company is unable to pay the dividend in any given year, the unpaid dividend will be carried forward to subsequent years, and the holder will be entitled to receive it along with the dividend for that year.
2. **Non-cumulative preference shares:** Unlike cumulative preference shares, holders of non-cumulative preference shares are not entitled to the payment of any unpaid dividends in subsequent years if the company is unable to pay the dividend in any given year.
3. **Participating preference shares:** These shares not only provide a fixed rate of dividend payment but also entitle the holders to participate in any surplus profits after the payment of dividends to other classes of shareholders.
4. **Non-participating preference shares:** In contrast to participating preference shares, holders of non-participating preference shares are not entitled to participate in any surplus profits.
5. **Convertible preference shares:** These shares give the holder the right to convert the preference shares into equity shares at a predetermined price or ratio. This means that the holder can exchange their preference shares for equity shares, which would then entitle them to a share in the profits and ownership of the company.
6. **Redeemable preference shares:** These shares are redeemable by the company at a future date, at a predetermined price or rate, or at the option of the holder. This means that the company can buy back the shares from the holder, which provides the company with flexibility in its capital structure.

Each type of preference share has its own legal implications and conditions for redemption, as well as advantages and disadvantages for both the company and the shareholders. It is

important for companies to carefully consider the different types of preference shares available and the legal and financial implications of each before issuing them.

Redemption of preference shares: meaning and legal framework

Redemption of preference shares refers to the process by which a company buys back its preference shares from the shareholders. The redemption can be made either at a fixed date or at the option of the company or the shareholder, subject to the terms of the preference share agreement.

The legal framework for the redemption of preference shares is governed by company law, which outlines the rules and procedures that companies must follow when redeeming their shares. These laws vary by jurisdiction but generally require companies to comply with certain provisions, including:

1. The company must have sufficient profits or capital to pay for the redemption of preference shares.
2. The company must have the authorization to redeem preference shares in its articles of association or memorandum of association.
3. The company must give notice to the shareholders of the intention to redeem the preference shares, including the redemption price and the date of redemption.
4. The company must follow the procedure for the redemption of preference shares as set out in the articles of association or the terms of the preference share agreement.
5. The company must comply with any requirements for the redemption of preference shares under the relevant stock exchange regulations.
6. The company must keep accurate records of the redemption of preference shares.

Redemption of preference shares is often used by companies to improve their capital structure or to reduce the number of outstanding shares. It can also provide flexibility for the company in managing its debt and equity financing. However, the redemption of preference shares can have financial and tax implications for both the company and the shareholders. It is important for companies to carefully consider the legal and financial implications of redeeming preference shares before doing so.

Conditions for redemption of preference shares

The conditions for redemption of preference shares are typically set out in the articles of association of a company or in terms of the preference share agreement. The conditions may

vary depending on the type of preference share and the specific requirements of the company. Here are some common conditions for the redemption of preference shares:

1. Time period: The conditions will typically specify the date or time period when the company can redeem the preference shares. This may be a fixed date or at the discretion of the company or shareholder, subject to the terms of the preference share agreement.

2. Redemption price: The conditions will specify the price at which the preference shares can be redeemed. This may be a fixed price or calculated based on a formula, such as a percentage of the face value or market value of the preference shares.

3. Notice period: The conditions will specify the notice period that the company must give to the shareholders before redeeming the preference shares. This is typically to give the shareholders an opportunity to sell their shares on the market if they wish.

4. Payment terms: The conditions will specify the payment terms for the redemption of the preference shares. This may include whether the payment is made in cash or by issuing new shares and the timing of the payment.

5. Priority of payment: The conditions will specify the priority of payment for the redemption of the preference shares. This may include whether the preference shareholders have priority over other classes of shareholders or creditors.

6. Tax implications: The conditions will typically address any tax implications of the redemption of the preference shares. This may include the treatment of any capital gains or losses or the effect on the company's tax position.

It is important for companies to carefully consider the conditions for the redemption of preference shares before issuing them. The conditions should be fair and reasonable and take into account the interests of both the company and the shareholders. Companies should also ensure that they comply with all legal requirements when redeeming preference shares, as failure to do so may result in legal or financial consequences.

Statutory provisions for redemption of preference shares

Statutory provisions for the redemption of preference shares are typically provided under the Companies Act or relevant securities laws in a particular jurisdiction. These provisions lay down the legal framework that governs the redemption of preference shares by companies.

Here are some common statutory provisions for the redemption of preference shares:

1. **Company's power to redeem:** The Companies Act provides companies with the power to redeem preference shares, subject to the provisions of the Act, the company's articles of association, and the terms of the preference share agreement.
2. **Authorization for redemption:** The Companies Act requires companies to obtain the authorization for the redemption of preference shares from the shareholders, either through a special resolution or by including the authorization in the company's articles of association.
3. **Adequate profits or capital:** The Companies Act requires companies to have adequate profits or capital to pay for the redemption of preference shares. The profits or capital must be sufficient to cover the redemption price and any related expenses.
4. **Notice period:** The Companies Act requires companies to give notice to the shareholders of the intention to redeem preference shares. The notice period must be at least 21 days before the redemption date unless the company's articles of association provide for a longer period.
5. **Payment of redemption price:** The Companies Act requires companies to pay the redemption price to the preference shareholders on or before the redemption date. The payment can be made in cash, by issuing new shares, or by any other means as provided in the preference share agreement.
6. **Recording of redemption:** The Companies Act requires companies to record the redemption of preference shares in their register of members, and to file the relevant documents with the relevant regulatory authority.

In addition to the Companies Act, other statutory provisions may also apply to the redemption of preference shares, such as the listing rules of the relevant stock exchange, securities laws, or tax laws. Companies should carefully review the applicable statutory provisions and seek legal advice to ensure compliance with all legal requirements.

- **Knowledge Check 1**

Fill in the Blanks.

1. Redemption of preference shares refers to the process of ____________or buying back preference shares by the issuing company before the maturity date.
2. Some preference shares may have a specified __________ date, after which the company is required to redeem them

3. Preference shares are a type of share issued by a company that provides certain_______ and privileges to the holders of those shares.
4. The conditions will specify the payment terms for the ____________of the preference shares.
5. Statutory provisions for redemption of preference shares are typically provided under the ______________ Act or relevant securities laws in a particular jurisdiction.

- **Outcome-Based Activity 1**

Evaluate the advantages and disadvantages of redeeming preference shares as a method of capital management for a company.

12.3 Methods of Redemption of Preference Shares

- **Redemption of cumulative preference shares**

Redemption of cumulative preference shares is a process by which a company repurchases its cumulative preference shares from its shareholders. Cumulative preference shares are a type of preference share that entitles the shareholder to receive a fixed dividend, which accumulates if it is not paid in any particular year.

The redemption of cumulative preference shares is typically governed by the terms of the preference share agreement, the company's articles of association, and relevant statutory provisions. Here are some key considerations for the redemption of cumulative preference shares:

1. Dividend arrears: If there are any arrears of cumulative dividends, the company must pay these before redeeming the cumulative preference shares. This means that the company must pay all accumulated but unpaid dividends before it can redeem any of the cumulative preference shares.

2. Redemption price: The redemption price for cumulative preference shares may be specified in the preference share agreement, or it may be calculated based on a formula that takes into account the face value of the shares, any accrued but unpaid dividends, and any other factors that the company and the shareholder may have agreed to.

3. Notice period: The notice period for the redemption of cumulative preference shares is typically governed by the terms of the preference share agreement or the company's articles

of association. The notice period may be shorter or longer than the minimum notice period required by law, depending on what the parties have agreed to.

4. Payment of redemption price: The payment of the redemption price for cumulative preference shares may be made in cash or by issuing new shares, subject to any legal or regulatory requirements. The payment must be made on or before the redemption date.

5. Tax implications: The redemption of cumulative preference shares may have tax implications for the company and the shareholder. It is important for companies and shareholders to seek legal and tax advice to understand the tax implications of the redemption.

6. Compliance with legal requirements: Companies must comply with all legal requirements for the redemption of cumulative preference shares, such as the Companies Act or relevant securities laws. Failure to comply with these requirements may result in legal or financial consequences.

The redemption of cumulative preference shares is an important process for companies that have issued these types of shares. Companies must carefully consider the terms of the preference share agreement and their legal obligations when redeeming cumulative preference shares to ensure compliance with all legal and regulatory requirements.

Redemption of non-cumulative preference shares

Redemption of non-cumulative preference shares refers to the process by which a company repurchases its non-cumulative preference shares from its shareholders. Non-cumulative preference shares are a type of preference share that entitles the shareholder to receive a fixed dividend for a particular period without the accumulation of any unpaid dividends.

The redemption of non-cumulative preference shares is governed by the terms of the preference share agreement, the company's articles of association, and relevant statutory provisions. Here are some key considerations for the redemption of non-cumulative preference shares:

1. Redemption date: The redemption date for non-cumulative preference shares is typically specified in the preference share agreement, and the company must redeem the shares on or before this date. The redemption date may be fixed or at the discretion of the company.

2. Redemption price: The redemption price for non-cumulative preference shares may be specified in the preference share agreement, or it may be calculated based on a formula that

takes into account the face value of the shares and any other factors that the company and the shareholder may have agreed to.

3. Notice period: The notice period for the redemption of non-cumulative preference shares is typically governed by the terms of the preference share agreement or the company's articles of association. The notice period may be shorter or longer than the minimum notice period required by law, depending on what the parties have agreed to.

4. Payment of redemption price: The payment of the redemption price for non-cumulative preference shares may be made in cash or by issuing new shares, subject to any legal or regulatory requirements. The payment must be made on or before the redemption date.

5. Redemption premium: The preference share agreement may provide for a redemption premium, which is an additional payment made to the shareholder on top of the redemption price. The redemption premium may be a fixed amount or calculated based on a formula specified in the agreement.

6. Compliance with legal requirements: Companies must comply with all legal requirements for the redemption of non-cumulative preference shares, such as the Companies Act or relevant securities laws. Failure to comply with these requirements may result in legal or financial consequences.

Redeemable preference shares: legal provisions and features

Redeemable preference shares are a type of preference share that can be redeemed or repurchased by the issuing company at a future date. The redemption of redeemable preference shares is typically governed by the terms of the preference share agreement, the company's articles of association, and relevant statutory provisions. Here are some key legal provisions and features of redeemable preference shares:

1. Redemption date: The redemption date for redeemable preference shares is typically specified in the preference share agreement, and the company must redeem the shares on or before this date. The redemption date may be fixed or at the discretion of the company.

2. Redemption price: The redemption price for redeemable preference shares may be specified in the preference share agreement, or it may be calculated based on a formula that takes into account the face value of the shares and any other factors that the company and the shareholder may have agreed to.

3. Notice period: The notice period for the redemption of redeemable preference shares is typically governed by the terms of the preference share agreement or the company's articles of association. The notice period may be shorter or longer than the minimum notice period required by law, depending on what the parties have agreed to.

4. Payment of redemption price: The payment of the redemption price for redeemable preference shares may be made in cash or by issuing new shares, subject to any legal or regulatory requirements. The payment must be made on or before the redemption date.

5. Redeemable at the option of the company: Redeemable preference shares may be redeemable at the option of the company, meaning that the company can decide when to redeem the shares. The preference share agreement may specify the conditions under which the company can exercise this option.

6. Redeemable at the option of the shareholder: Redeemable preference shares may also be redeemable at the option of the shareholder, meaning that the shareholder can require the company to redeem the shares at a certain time or on a certain date. The preference share agreement may specify the conditions under which the shareholder can exercise this option.

7. Convertible: Redeemable preference shares may be convertible, meaning that the shareholder can convert the shares into another class of shares, such as ordinary shares. The preference share agreement may specify the conditions under which the conversion can take place.

8. No voting rights: Redeemable preference shares may not carry any voting rights, meaning that the shareholder cannot vote on matters affecting the company.

9. Compliance with legal requirements: Companies must comply with all legal requirements for the redemption of redeemable preference shares, such as the Companies Act or relevant securities laws. Failure to comply with these requirements may result in legal or financial consequences.

The redemption of redeemable preference shares is an important process for companies that have issued these types of shares. Companies must carefully consider the terms of the preference share agreement and their legal obligations when redeeming redeemable preference shares to ensure compliance with all legal and regulatory requirements.

Procedure for redemption of preference shares

The redemption of preference shares is a process that involves the repurchase of the shares by the issuing company, usually at a predetermined price and date. The procedure for redemption of preference shares may vary depending on the terms of the preference share agreement, the company's articles of association, and relevant statutory provisions. Here are some of the key steps involved in the redemption of preference shares:

1. **Check the legal requirements:** Before initiating the process of redemption, the company must ensure that it complies with all legal and regulatory requirements related to the redemption of preference shares. This may include requirements related to the notice period, the redemption price, and the manner of payment.
2. **Review the preference share agreement**: The company must review the terms of the preference share agreement to determine the conditions for redemption, including the redemption date, the redemption price, and the notice period. The company must also check if there are any restrictions on the redemption of preference shares, such as restrictions on the number of shares that can be redeemed or the timing of the redemption.
3. **Give notice to shareholders:** The company must give notice to the preference shareholders of its intention to redeem the shares. The notice must comply with the requirements set out in the preference share agreement and relevant statutory provisions. The notice must include details of the redemption date, the redemption price, and the manner of payment.
4. **Obtain shareholder approval:** Depending on the terms of the preference share agreement and the company's articles of association, the redemption of preference shares may require shareholder approval. The company must ensure that it obtains the necessary approvals from the shareholders before proceeding with the redemption.
5. **Make the payment:** On the redemption date, the company must make the payment to the shareholders in accordance with the terms of the preference share agreement. The payment may be made in cash or by issuing new shares, subject to any legal or regulatory requirements. The company must also update its share register to reflect the redemption of the preference shares.
6. **File the necessary documents**: The company must file the necessary documents with the relevant regulatory authorities to ensure compliance with all legal and regulatory

requirements. This may include filings related to the redemption of shares, changes to the company's share register, and updates to the company's articles of association.

The procedure for redemption of preference shares can be complex and may require careful planning and execution. Companies must ensure that they comply with all legal and regulatory requirements related to the redemption of preference shares and carefully review the terms of the preference share agreement to determine the conditions for redemption. Failure to comply with these requirements may result in legal or financial consequences.

12.4 Accounting Treatment on Redemption of Preference

The redemption of preference shares involves the repurchase of shares by the issuing company, which has important implications for the company's financial statements. Here are some of the key accounting treatments that are relevant to the redemption of preference shares:

1. Accounting for the redemption premium: When a company redeems preference shares, it may have to pay a premium above the par value of the shares. The premium represents a cost to the company and must be accounted for accordingly. Generally, the premium is debited to the company's share premium account or to a separate capital redemption reserve account.

2. Reduction in share capital: The redemption of preference shares results in a reduction in the company's share capital. The amount of the reduction is equal to the par value of the shares that are redeemed. The reduction in share capital must be reflected in the company's balance sheet.

3. Impact on retained earnings: The redemption of preference shares may also have an impact on the company's retained earnings. If the company uses its retained earnings to fund the redemption, then the retained earnings will be reduced accordingly. Alternatively, the company may choose to use other funds, such as proceeds from the sale of assets or new equity issuance, to fund the redemption.

4. Disclosure requirements: The redemption of preference shares may trigger disclosure requirements in the company's financial statements. The company may be required to disclose the terms of the redemption, including the redemption price, the premium paid, and any impact on the company's financial position and performance.

5. Tax implications: The redemption of preference shares may also have tax implications for the company and its shareholders. The company must ensure that it complies with all relevant tax laws and regulations and may need to obtain professional advice to do so.

- **Knowledge Check 2**

State whether given statements are true or false.

4. The redemption of cumulative preference shares may have tax implications for the company and the shareholder. (T/F)

5. Redeemable preference shares are a type of preference share that can be redeemed or repurchased by the issuing company at a future date. (T/F)

6. The redemption of preference shares is a process that involves the repurchase of the shares by the issuing company, usually at a predetermined price and date. (T/F)

- **Outcome-Based Activity 2**

Analyze the financial impact of redeeming preference shares on a company's capital structure and earnings per share.

12.5 Summary

- The redemption of preference shares can be voluntary or mandatory.
- There are several reasons why a company may choose to redeem preference shares.
- The redemption of preference shares can be beneficial to both the company and its shareholders.
- The redemption of preference shares can be part of a capital restructuring plan.
- The company may redeem preference shares that have a high dividend payment and replace them with lower-yielding debt.
- The company may choose to redeem preference shares to reduce its outstanding equity or the number of shareholders.
- The redemption of preference shares can have a significant impact on the company's cash flow.
- The redemption of preference shares can also impact the company's financial ratios.
- These shares entitle the holder to receive a fixed rate of dividend payment, which accumulates if not paid in a particular year.

- Redemption of preference shares refers to the process by which a company buys back its preference shares from the shareholders.
- Redemption of preference shares is often used by companies to improve their capital structure or to reduce the number of outstanding shares.
- It is important for companies to carefully consider the conditions for redemption of preference shares before issuing them.
- The Companies Act requires companies to pay the redemption price to the preference shareholders on or before the redemption date.
- Redemption of cumulative preference shares is a process by which a company repurchases its cumulative preference shares from its shareholders
- If there are any arrears of cumulative dividends, the company must pay these before redeeming the cumulative preference shares
- The redemption of cumulative preference shares may have tax implications for the company and the shareholder.
- Redemption of non-cumulative preference shares refers to the process by which a company repurchases its non-cumulative preference shares from its shareholders
- The redemption of non-cumulative preference shares is governed by the terms of the preference share agreement, the company's articles of association, and relevant statutory provisions.
- Redeemable preference shares are a type of preference share that can be redeemed or repurchased by the issuing company at a future date.
- The redemption of redeemable preference shares is an important process for companies that have issued these types of shares.
- The redemption of preference shares involves the repurchase of shares by the issuing company, which has important implications for the company's financial statements.

12.6 Self-Assessment Questions

1. Explain the Meaning of 'Redemption of Preference Shares'.
2. Explain the Legal conditions for Redemption of Preference Share
3. Explain the Methods of Redemption of Preference Shares .
4. Explain the Accounting Treatment on Redemption of Preference.

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Unit- 13

Company Liquidation

Learning Outcomes:

- Student will be able to learn and understand the meaning of Liquidation
- Student will be able to understand the Modes of Winding up of a Company.
- Students will be able to understand and learn the difference between Compulsory Winding Up and Voluntary Winding Up.
- Students will be able to understand the meaning of Liquidator Preferential Payments.

Structure:

13.1 Meaning of Liquidation
13.2 Modes of Winding up of a Company
13.3 Compulsory Winding Up
Knowledge Check 1
Outcome-Based Activity 1
13.4 Voluntary Winding Up
13.5 Meaning of Contributors
13.6 Meaning of Liquidator Preferential Payments
Knowledge Check 2
Outcome-Based Activity 2
13.7 Summary
13.8 Self-Assessment Questions
13.9 References

13.1 Meaning of Liquidation

- **Definition**

The liquidation process involves the winding up of a company's affairs, which includes the sale of its assets and the payment of its debts to creditors, followed by the distribution of any remaining funds to shareholders. The purpose of Liquidation is to settle the obligations of a company by selling its assets, paying off its debts to creditors, and distributing any remaining funds to shareholders, in compliance with the relevant legal requirements.

During the liquidation process, the company's assets are sold to pay off its debts in a specific order of priority. Typically, secured creditors, such as banks or other lenders, are paid first, followed by unsecured creditors, such as suppliers and employees. Shareholders are paid last after all other debts have been satisfied.

In some cases, a company may be able to avoid Liquidation by entering into an arrangement with its creditors, such as a voluntary arrangement or a voluntary company arrangement. Through these arrangements, the company can make agreements with its creditors to pay off its debts over a certain period instead of going through Liquidation.

Types of Liquidation

Voluntary Liquidation and compulsory Liquidation are the two primary types of Liquidation.

a. Members' Voluntary Liquidation (MVL): This refers to the process of members or shareholders deciding to liquidate a solvent company. During this process, the company's assets are sold, and the proceeds are used to settle all outstanding debts, including those owed to shareholders

b. Creditors' Voluntary Liquidation (CVL): In compulsory Liquidation, the company is insolvent and is forced to go through the liquidation process by court order. The court appoints a liquidator to take control of the company's affairs and sell its assets to pay off its debts. The proceeds are distributed to creditors in accordance with the order of priority established by law.

1. Compulsory Liquidation: When a company is unable to pay its debts or in response to a creditor's petition, a court may order the winding up of the company, which is known as

compulsory Liquidation.The court appoints a liquidator to manage the process of Liquidation and sell the company's assets to pay off its creditors. The liquidator is required to follow a specific order of priority when distributing the proceeds of the sale of the assets. The order of priority is as follows:

a. The liquidator's fees and expenses

b. Secured creditors (e.g. banks or lenders)

c. Preferential creditors (e.g. employees)

d. Unsecured creditors (e.g. suppliers)

e. Shareholders

Process of Liquidation

The liquidation process involves systematically concluding the company's operations, selling its assets, and distributing the proceeds among creditors and shareholders.

Appointment of a Liquidator: The initial phase of the liquidation process involves the designation of a liquidator to oversee the liquidation procedure. The appointment of the liquidator may be carried out by either the court in compulsory Liquidation or the shareholders/creditors in voluntary Liquidation.

1. Preparation of Statement of Affairs: The liquidator has to create a statement of affairs, which is a condensed report of the company's assets and liabilities at the time of Liquidation. This statement provides a comprehensive overview of the company's financial position and is utilized to determine the sequence of priority for disbursing the proceeds from the sale of assets.

2. Realization of Assets: The liquidator is tasked with selling the company's assets to generate cash that will be used to pay off its creditors. To ensure the best possible price, the liquidator may use various methods to sell the assets, including but not limited to, an auction, private sale, or tender.

3. Distribution of Proceeds: Once the assets have been sold, the liquidator must distribute the proceeds to the company's creditors and shareholders in accordance with the order of priority established by law. The liquidator will first pay their own fees and expenses,

followed by secured creditors, preferential creditors, unsecured creditors, and finally the shareholders.

4. Finalization of Accounts: After the distribution of the proceeds has been completed, the liquidator must prepare a final account of the Liquidation, which provides a summary of the liquidation process and the amounts paid to creditors and shareholders. The final account is then submitted to the Registrar of Companies, and the Liquidation is complete.

Liquidation and Distribution of Assets

The law determines the order of priority for distributing assets, which varies by jurisdiction. In Liquidation, assets are typically distributed according to this order.

1. Secured Creditors: Creditors who have a security interest in a company's assets, such as through a mortgage or charge, are known as secured creditors. They receive priority in the distribution of proceeds from asset sales, with their claims being paid off before any others.

2. Preferential Creditors: Creditors with a statutory priority for payment, such as employees owed wages or benefits, are considered preferential creditors. Their claims are addressed after those of secured creditors but before any other claims are paid.

3. Unsecured Creditors: Creditors who lack a security interest in a company's assets and have no priority for payment are referred to as unsecured creditors. These creditors receive a pro-rata share of remaining assets only after secured and preferential creditors have been paid.

4. Shareholders: Shareholders hold ownership of a company and have a right to a portion of its remaining assets once all creditors have been paid. However, their entitlement is contingent on the availability of assets after all company debts have been settled.

13.2 Modes of Winding up of a Company

The process of Liquidation or winding up involves selling off a company's assets to pay its creditors and shareholders. Depending on the situation, there are several modes of winding up a company:

1. Voluntary winding up: When shareholders or directors decide the company cannot continue its business .

2. Compulsory winding up: A court can order compulsory winding up if a company has become insolvent or cannot pay its debts. Creditors, shareholders, or the Registrar of Companies can apply to the court for a winding up order. Once granted, a liquidator sells the assets and distributes the proceeds to creditors and shareholders.

3. Creditors' Voluntary Winding up: If creditors believe a company cannot meet its financial obligations, they can initiate voluntary winding up. Shareholders pass a resolution for winding up, and the creditors appoint a liquidator to sell assets and distribute the proceeds to creditors and shareholders.

4. Members' Voluntary Winding up: If shareholders believe the company can pay its debts and distribute remaining assets to shareholders, they can opt for voluntary winding up. Shareholders pass a resolution for winding up, and the liquidator is appointed to sell assets and distribute the proceeds to creditors and shareholders.

5. Winding up by the Tribunal: If a company is being run fraudulently or in a manner prejudicial to the interests of its creditors or shareholders, the court or tribunal can order winding up.

6. Summary Winding up: A court can order summary winding up if a company has no assets or liabilities or if its assets are of nominal value. The court oversees the simplified liquidation process.

13.3 Compulsory Winding Up

- **Introduction to Compulsory Winding Up**

The legal process known as Compulsory Winding Up involves a court ordering a company to be liquidated, also known as compulsory dissolution. This occurs when a creditor or creditors have obtained a court order due to the company being unable to pay its debts. Compulsory winding Up is a serious measure with potential consequences for the company, its shareholders, directors, and employees. When a court orders the winding up of a company, it ceases to exist as a legal entity, and the liquidator takes over the management of the company's affairs.

The factors that may lead to compulsory winding up can vary across different jurisdictions, but commonly include insolvency, failure to pay debts, and an inability to continue trading. Generally, the company's directors or shareholders will have been notified of the creditor's

intention to apply for a winding-up order, giving them an opportunity to take action such as paying off the debts or making alternative arrangements.

Once a court orders compulsory winding up, the liquidator takes over the management of the company's affairs and assets. It is the liquidator's responsibility to ensure that all creditors are paid from the company's remaining assets. If the company is unable to pay all its debts, the liquidator will sell the assets and distribute the proceeds among the creditors based on legal priorities.

Grounds for Compulsory Winding Up

Compulsory winding Up is the legal process where a creditor can seek a court order to liquidate a company. The grounds for this process can differ across jurisdictions but commonly include:

1. **Inability to pay debts**: If a company can't pay debts as they come due, a creditor can seek a court order to wind it up.
2. **Insolvency:** A company is insolvent if it has more liabilities than assets or if it's unlikely to pay debts in the future.
3. **Public interest**: A company can be liquidated if it poses a danger to public safety, health, or welfare or is involved in illegal activities.
4. **Just and equitable grounds:** A court can order a company's Liquidation if there's a deadlock in management or if it's being used for fraudulent or improper purposes.
5. **Failure to comply with statutory requirements**: A company can be wound up if it fails to follow certain legal requirements.

Petition for Compulsory Winding Up

A creditor or group of creditors can file a petition for compulsory winding up with a court to seek an order for the Liquidation of a company. The petition usually outlines the reasons for seeking the winding up, and it may also include evidence to support the creditor(s) claim.

The procedure for filing a petition for compulsory winding up can vary depending on the jurisdiction. However, the general steps involved are:

1. **Preparing the Petition:** The creditor(s) must draft a petition for compulsory winding up containing the company's debt details and evidence to support the creditor's claim.

2. Serving the Petition: The creditor(s) must serve the petition on the company and any other interested parties, such as the directors or shareholders. The court will only consider the petition once it has been correctly served.

3. Advertisement of Petition: The creditor(s) may need to advertise the petition in a newspaper or other publication to inform the public of the proposed winding up in some jurisdictions. This is to provide other creditors with an opportunity to make a claim.

4. Court Hearing: After serving and advertising the petition, the court will schedule a hearing to consider the petition. The company and interested parties will have the chance to attend the hearing and make their case.

5. Winding Up Order: If the court finds that the grounds for winding up have been met, it will issue a winding up order, appoint a liquidator, and provide guidance on the Liquidation of the company's assets.

Procedures for Compulsory Winding Up

While the procedures for mandatory winding up may differ between jurisdictions, they typically share a common process. This involves the court issuing an order to wind up the company and appointing a liquidator to oversee the process. Below are some of the customary procedures associated with compulsory winding up:

1. Court Order: A creditor or group of creditors is responsible for instigating compulsory winding up by submitting a winding-up petition to a court. If the court determines that the criteria for winding up have been met, it will grant a winding up order.

2. Notification of Creditors and Shareholders: Following the liquidator's appointment, they will inform the company's creditors and shareholders about the winding up and ask them to lodge their claims for payment.

3. Reporting to the Court: The liquidator must regularly report to the court on the progress of the winding up and seek approval for any significant actions, such as the sale of assets or the settlement of debts.

4. Distribution of Assets: The liquidator is required to provide periodic updates to the court regarding the winding up process and seek approval for significant actions, such as settling debts or selling off assets.

5. **Dissolution of the Company:** When the liquidation process concludes, the company will be dissolved and cease to exist as a legal entity.

- **Knowledge Check 1**

Fill in the Blanks:

1. The process of __________ involves the realization of the company's assets and the payment of its debts in a specific order of priority.
2. Preferential creditors are those who have a ______________priority for payment, such as employees who are owed wages, salaries, or other benefits.
3. A company can be wound up compulsorily by the court if it has become _________ or has failed to pay its debts.

- **Outcome-Based Activity 1**

Analyze a case study of a company that has been subject to compulsory winding up, identify the reasons for such winding up, and discuss its legal and financial implications, including the appointment of a liquidator, the distribution of assets, and the impact on stakeholders.

13.4 Voluntary Winding Up

- **Introduction to Voluntary Winding Up**

Voluntary winding up refers to the process where a company elects to voluntarily conclude its operations and dissolve the company. This decision can be made by either the members or shareholders or, in the absence of either, the board of directors.

It's crucial to understand that voluntary winding up is distinct from dissolution. Winding up a company is a formal procedure that must adhere to applicable laws and regulations, and it involves distributing the company's assets to its members or shareholders or to its creditors, depending on the case. After the completion of the winding up process, the company is dissolved and no longer exists as a legal entity.

Due to its complexity and time-consuming nature, voluntary winding up requires professional guidance to guarantee that it complies with the relevant laws and regulations.

Modes of Voluntary Winding Up

1. Members' Voluntary Winding Up: This mode can be initiated by passing a resolution to wind up the company. To begin a members' voluntary winding up, the company must be solvent and capable of paying all of its debts in full.

Upon passing a resolution to wind up the company, the members or shareholders will select a liquidator to supervise the winding up process. The liquidator's responsibilities include selling the company's assets, settling any unpaid debts and liabilities, and distributing any remaining assets to the members or shareholders based on their shareholding proportion.

2. Creditors' Voluntary Winding Up: In a creditors' voluntary winding up, the liquidator appointed by the company's creditors will oversee the winding up process. This includes selling the company's assets, paying off outstanding debts and liabilities, and distributing any remaining assets to the creditors based on their legal priorities. The directors of the company may also be required to provide a statement of affairs to the liquidator, detailing the company's assets, liabilities, and creditors.

Members' voluntary winding up and creditors' voluntary winding up differ primarily in terms of who initiates the winding up process: members or shareholders in the former, and directors in the latter.

Procedures for Voluntary Winding Up

Following the correct procedures is crucial in voluntary winding up of a company, as the process can be intricate and lengthy. The general procedures for voluntary winding up of a company are as follows:

1. File relevant documents with the Registrar: To complete the voluntary winding up process, the company must submit several documents to the Registrar of Companies. These include the resolution to wind up the company, the declaration of solvency (in the case of a members' voluntary winding up), and a notice of the liquidator's appointment.

2. Notify creditors and other relevant parties: As part of the voluntary winding up process, the company must inform its creditors, employees, and other concerned parties about the winding up. In addition, the liquidator is required to publish a notice in the Gazette and a local newspaper. This notice will provide information regarding the winding up process and will invite creditors to submit their claims.

3. Settle outstanding debts and liabilities: In a voluntary winding up, the liquidator assumes responsibility for the company's assets and utilizes them to pay off any pending debts and liabilities. The liquidator is also responsible for distributing any remaining assets to the members or shareholders (in the case of a members' voluntary winding up) or the creditors (in the case of a creditors' voluntary winding up).

4. Dissolve the company: Upon the successful completion of the winding up process, the company will be dissolved and will no longer exist as a legal entity.

13.5 Meaning of Contributories

In company law, the term "contributory" refers to an individual or entity that is accountable for contributing to the assets of a company if it is wound up. Essentially, a contributory is someone who possesses a financial stake in the company and is obligated to pay towards the company's debts and obligations.

During the winding-up process, the term "contributory" pertains to anyone who is responsible for contributing to the assets of the company. This includes existing and previous shareholders, as well as individuals who have agreed to join the company but have not yet been included on the company's register of members.

The responsibility of contributories is typically established by the articles of association of the company and any agreements made between the company and its members. In general, members are obligated to contribute to the company's assets up to the amount of any unpaid shares they hold, as well as any other contributions they have consented to make.

To illustrate, suppose a company owes INR 5,00,000 in outstanding debts and a member owns 10% of the company's shares. If the company is wound up, that member would be responsible for contributing INR 50,000 to the company's assets. Even if the member has already paid their entire share capital, they could still be liable for further contributions if they have consented to them in the company's articles of association or in a separate agreement.

Contributories are usually notified of their liability to contribute to the company's assets during the winding-up process. They may be required to provide information and evidence to the liquidator or court regarding the company's affairs. They may also be required to attend meetings and provide evidence regarding the company's affairs, such as the value of the

company's assets and liabilities. The liquidator or court may take legal action against contributories who fail to meet their obligations to contribute to the company's assets.

13.6 Meaning of Liquidator Preferential Payments

When a company goes into Liquidation, "preferential payments" pertain to specific debts or claims that take precedence over others. Although Liquidation seeks to equitably distribute a company's assets among all its creditors, some creditors may receive preferential treatment based on the nature of their claims or their status as a priority creditor.

A liquidator is an individual tasked with concluding a company's affairs and allocating its assets among its creditors. During this undertaking, the liquidator must decide which creditors are eligible for payment and in what sequence. Typically, preferential payments fall into two types: statutory preferential payments and non-statutory preferential payments.

By law, statutory preferential payments are debts or claims that receive priority. In the UK, for instance, the Insolvency Act 1986 outlines a group of preferential creditors who have the right to be paid before other creditors. This category includes the company's employees who are owed wages, vacation pay, and other work-related debts. These creditors are prioritized over other unsecured creditors, such as lenders and suppliers.

Non-statutory preferential payments are payments that the liquidator may elect to make, based on their evaluation of the creditors' claims. These could involve debts owed to crucial suppliers or lenders who play a vital role in the company's ongoing activities. Additionally, the liquidator might extend preferential treatment to certain secured creditors who have a legal right to specific assets of the company.

Ordinarily, the liquidator strives to allocate the company's assets equitably among its creditors. Nevertheless, preferential payments may become necessary in certain instances to guarantee payment to indispensable suppliers or workers, or to preserve the value of the company's assets. In the end, the liquidator must strike a balance between the competing interests of all the company's creditors and make choices that serve the company and its stakeholders' best interests.

- **Knowledge Check 2**

State whether given statements are true or false.

1. If a members' voluntary winding up is chosen, convening a meeting of the company's shareholders or members to pass a resolution to wind up the company is not required.(T/F)

2. Typically, the goal of Liquidation is to ensure the equitable distribution of a company's assets among all its creditors.(T/F)

- **Outcome-Based Activity 2**

Analyze the process of winding up a company, including the appointment of a liquidator and the distribution of assets to creditors and shareholders.

13.7Summary

- Liquidation involves appointing a liquidator, who takes charge of the company's management and asset sales, with the aim of using the proceeds to repay creditors.
- Two types of Liquidation exist voluntary Liquidation, which is the decision of the company's directors and shareholders to wind up affairs; and compulsory Liquidation, which is a court-mandated process.
- The liquidation process aims to settle the company's debts by selling its assets in a specific order of priority.
- To prevent Liquidation, a company may make arrangements with its creditors, such as a voluntary or company voluntary arrangement, provided the company is solvent.
- Insolvency, which refers to a company's inability to meet its debt obligations as they come due, is the trigger for this process.
- The liquidator is responsible for deciding the order of claims and ensuring that assets are distributed appropriately.
- Liquidation, also known as winding up, entails selling a company's assets to repay its creditors and shareholders, ultimately leading to the termination of the company's operations.
- Creditors may petition for a voluntary winding up if they believe the company is incapable of fulfilling its financial commitments.
- Compulsory winding up, which is the court-ordered Liquidation of a company, is introduced through the legal process.

- The grounds for compulsory winding up differ from one jurisdiction to another, but commonly include issues such as insolvency, failure to pay debts, and an inability to maintain operations.
- Procedures for Compulsory Winding Up refer to the steps involved in the legal process by which a court orders the compulsory Liquidation of a company.
- After a petition for compulsory winding up is filed, a hearing is usually scheduled to determine whether the grounds for winding up have been met.
- If the court finds that the grounds for winding up exist, it will issue an order for the company to be wound up and appoint a liquidator to manage the process.
- The liquidator is responsible for selling off the company's assets and distributing the proceeds to its creditors in a specific order of priority.
- During the winding up process, the company ceases to carry on business and its powers are restricted, although it may still be able to enter into transactions to facilitate the winding up process.
- Voluntary winding up is a process in which a company chooses to wind up its affairs voluntarily and dissolve the company.
- There are two types of voluntary winding up for a company, either members' voluntary winding up or creditors' voluntary winding up.

13.8Self-Assessment Questions

1. Explain the meaning of 'Liquidation'.
2. Explain modes of Winding up of a Company
3. Explain Compulsory Winding Up .
4. Explain Voluntary Winding Up .
5. Explain meaning of Contributories

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Unit- 14

Final Accounts of Joint Stock Companies

Learning Outcomes:

- Students will possess the ability to define and describe the meaning and components of final accounts.
- Students will have the capability to demonstrate their knowledge of the relevant provisions of the Companies Act and the structure of final accounts.
- Students will have the ability to provide a clear definition of the Profit and Loss Account.

Structure:

14.1 Meaning and Components of Final Accounts

14.2 Relevant Provisions of Companies Act, Structure of Final Accounts

- Knowledge Check 1
- Outcome-Based Activity 1

14.3 Summary

14.4 Self-Assessment Questions

14.5 References

14.1 Meaning and Components of Final Accounts

- **Definition of final accounts**

Final accounts are a series of financial statements that are created at the end of a financial year to present a comprehensive view of a business's financial standing. Final accounts provide a summary of all the transactions that occurred during the year and offer an accurate representation of a company's performance over the previous year.

In summary, final accounts are an important tool for businesses to assess their financial position and performance. These accounts provide a summary of a company's financial transactions and are used to make informed decisions about the future of the company.

Purpose and importance of final accounts

The significance and necessity of final accounts stem from the fact that they aid in assessing a business's financial status. Final accounts play a critical role in guaranteeing the precision of financial statements and presenting an authentic depiction of the company's financial well-being.

Here are some of the key purposes and importance of final accounts:

1. Performance Evaluation: By comparing the final accounts of different periods, stakeholders can evaluate the trends in the company's financial performance and make informed decisions.

2. Planning and Decision Making: Final accounts provide information for making future plans and strategic decisions. For instance, if a company is making a net profit, the management can plan for expansion, investment, or dividend payouts. Conversely, if a company is making a net loss, the management may need to restructure operations or take corrective measures to address the issues.

3. Compliance with Legal Requirements: Final accounts are required by law for businesses to comply with statutory requirements and taxation laws. A company's failure to prepare and submit final accounts can result in legal penalties or fines.

4. Attracting Investors and Lenders: Final accounts provide information to potential investors and lenders about a company's financial position, which can help in attracting investment and loans. Final accounts are used by investors and lenders to evaluate a company's financial status and potential for growth and profits.

5. Accountability and Transparency: Final accounts provide a transparent and accountable record of a company's financial performance, which enhances the confidence of stakeholders, including investors, creditors, and customers.

Components of final accounts

The final accounts are composed of three main components: the Trading Account, the Profit and Loss Account, and the Balance Sheet. Each component of final accounts offers vital details about a business's financial standing. Now, let's examine each component more closely.

1. **Trading Account:**The Trading Account is the primary component of final accounts and is utilized to calculate a business's gross profit or loss for a specific accounting period. It outlines the revenue generated from the sales of goods and services during that period and the cost of goods sold (COGS) during the same period.COGS includes the direct costs incurred in producing and delivering the goods or services, such as raw materials, labour, and other direct expenses. The difference between revenue and COGS is the gross profit or loss.
2. **Profit and Loss Account:** The objective of the Profit and Loss Account is to determine the net profit or loss of the business. The net profit or loss is computed by deducting all the expenses from the revenue earned during the accounting period. The expenses listed in the Profit and Loss Account include direct expenses, indirect expenses, administrative expenses, and financial expenses. The incomes listed include operating incomes, non-operating incomes, and other incomes.
3. **Balance Sheet:**The Balance Sheet constitutes the ultimate element of final accounts, and it itemizes the assets, liabilities, and equity of the business at a specific date. It offers an overview of the company's financial position at the end of the accounting period. The Balance Sheet is bifurcated into two parts: the Assets section, which enlists all the assets owned by the company, and the Liabilities and Equity section, which lists all the liabilities owed by the company, including the owners' equity.
4. To conclude, the Trading Account, Profit and Loss Account, and the Balance Sheet are the three fundamental constituents of final accounts. Collectively, they offer a comprehensive depiction of a company's financial status, performance, and

profitability.These components are important for decision-making, planning, and evaluation and are also necessary for legal and statutory compliance.

14.2 Relevant Provisions of Companies Act, Structure of Final Accounts

- **Provisions of Companies Act**

The Companies Act 2013 governs the financial reporting requirements of companies incorporated in India. The Act lays down provisions related to final accounts, including the format, contents, and disclosure requirements of financial statements. The following are some of the pertinent provisions of the Companies Act that businesses are obligated to adhere to:

1. Format of Financial Statements: As per the Companies Act, businesses must prepare financial statements in a prescribed format that comprises the Trading Account, Profit and Loss Account, and Balance Sheet.

2. Disclosure Requirements: The Companies Act requires companies to disclose specific information in their financial statements, such as the name of the company, the financial year, the accounting policies followed, and the related party transactions. Additionally, the Companies Act mandates companies to disclose their fixed assets, investments, and other notable accounting items distinctly in the Balance Sheet.

3. Audit and Signing of Financial Statements: The Companies Act requires all companies to get their financial statements audited by a qualified auditor. The auditor is required to provide an opinion on the financial statements, and the audit report must be furnished alongside the financial statements.

4. Filing of Financial Statements: Companies must file their audited financial statements respectively, from the date of the annual general meeting.

5. Penalties for Non-Compliance: The Companies Act imposes penalties for non-compliance with the financial reporting requirements, including fines and imprisonment for the company's officers. Non-compliance can also lead to the disqualification of directors, and the company may be struck off from the Registrar of Companies.

Structure of Final Accounts

The structure of final accounts provides a framework for presenting financial information in a clear and organized manner, enabling the users of the accounts to understand the financial performance and position of the business.

Here is a detailed explanation of the structure of the final accounts:

1. Trading Account: The debit side lists the opening stock, purchases, and other direct expenses, such as wages, carriage, and freight. The credit side lists the sales revenue and closing stock. The gross profit or loss is the discrepancy between the credit and debit sides of a business's accounts.

2. Profit and Loss Account: The Profit and Loss Account is prepared to calculate the net profit or loss of the business. The Profit and Loss Account consists of two parts - the debit side and the credit side. The debit side lists all the expenses, including direct expenses, indirect expenses, administrative expenses, and financial expenses. The credit side lists all the incomes, including operating incomes, non-operating incomes, and other incomes. The net profit or loss of a business is the difference between the credit and debit sides of its accounts.

- **Knowledge Check 1**

Fill in the Blanks.

1. Final accounts are a set of financial statements that are prepared at the end of a financial year to provide an overview of a business's ___________position.
2. The final accounts are composed of three main components: the Trading Account, the Profit and Loss Account, and the _____________.

- **Outcome-Based Activity 1**

Analyze the impact of changes in the cost of goods sold, sales revenue, and operating expenses on a company's gross profit or loss.

14.3 Summary

- The purpose and significance of final accounts lie in the fact that they aid in the assessment of a business's financial position.
- Performance Evaluation: The overview of a company's financial performance provided by final accounts enables stakeholders to assess the company's profitability, efficiency, liquidity, and solvency, making them crucial for evaluating a business's financial position.
- Planning and Decision Making: Final accounts provide information for making future plans and strategic decisions. For instance, if a company is making a net profit, the management can plan for expansion, investment, or dividend payouts.
- The Trading Account, which is the first component of the final accounts, provides information on a business's revenue and cost of goods sold, enabling the calculation of the gross profit or loss for a particular accounting period.
- The Profit and Loss Account is the second component of the final accounts, which lists all the expenses and incomes incurred by a business during an accounting period.
- The Companies Act, 2013, governs the financial reporting requirements of companies incorporated in India.
- The Act lays down provisions related to final accounts, including the format, contents, and disclosure requirements of financial statements.
- Contingent liabilities are potential liabilities that may or may not arise in the future. It is important to identify and disclose all contingent liabilities in the final accounts to provide a full and accurate picture of the company's financial position.
- The notes to the financial statements are an integral part of the final accounts. They provide additional information about the financial performance and position of the business, such as accounting policies, contingent liabilities, and related party transactions.
- It is important for stakeholders as it provides assurance that the financial statements are reliable and can be used for decision-making.

14.4 Self-Assessment Questions

1. Explain the Meaning and Components of Final Accounts.
2. Explain the Relevant Provisions of the Companies Act.

3. Explain the structure of Final Accounts.

4. Explain the Profit and Loss Account.

5. Explain the Items which require special attention at the time of preparation of the final accounts of a company.

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Unit- 15

Profit and Loss Account

Learning Outcomes:

- Students will possess the ability to define and describe the meaning and components of final accounts.
- Students will have the capability to demonstrate their knowledge of the relevant provisions of the Companies Act and the structure of final accounts.
- Students will have the ability to provide a clear definition of the Profit and Loss Account.

Structure:

15.1 Profit and Loss Account

15.2 Some Items which require special attention at the time of preparation of final accounts of a company

- Knowledge Check 2
- Outcome-Based Activity 2

15.1 Profit and Loss Account

Definition and Purpose of Profit and Loss Account

A financial statement called the Profit and Loss Account (P&L) gives a summary of a company's earnings for a given time period, including income, expenses, gains, and losses. The income statement or statement of operations are other names for the P&L. The P&L statement's main objective is to display the company's profitability during the course of the accounting cycle.
The definition and goal of the Loss and Profit Account are explained as follows:
Here is an explanation of the definition and purpose of the Loss and Profit Account:

1. Definition: A financial statement called the Profit and Loss (P&L) statement provides an overview of a company's earnings and outlays for a given time frame, usually a fiscal quarter or year.To determine a net income or loss, the statement starts with revenue and deducts all costs incurred during the time. It is an important financial document that offers insightful information on the company's financial health.

2. Purpose: Reporting a company's profitability is the P&L statement's main objective. It gives a summary of the money received, costs incurred, profits realized, and losses sustained over a given time frame. Businesses can assess their performance and decide on future operations with greater knowledge thanks to the P&L statement. Investors and creditors also use it to assess the company's financial standing.

3. The P&L statement has several other purposes as well, which include:

a. **Assessing the financial performance of the business over time:** The P&L statement is prepared for each accounting period, and the data is used to assess the financial performance of the business over time. By comparing the P&L statements of different periods, business owners can identify trends and patterns that help them make informed decisions.

b. **Facilitating financial planning:** The P&L statement is a valuable tool for financial planning. It helps businesses to determine their revenue and expenses and estimate their future profits or losses. This information is useful in creating a budget and making operational decisions.

c. **Providing information for tax purposes:** The P&L statement is an essential document for tax purposes. The P&L statement provides information on a business's revenue, expenses, gains, and losses, which is necessary for tax reporting purposes.

Components of Profit and Loss Account

A financial statement called the Profit and Loss Account (P&L) gives an overview of a company's earnings for a given time period, including gains, losses, and expenses. The revenue section and the spending section make up the two sections of the P&L statement. These are the elements that comprise the Profit and

a. **Revenue Section:** The total revenue the company made during the accounting period is shown in the revenue section of the P&L statement.The following elements make up the revenue section:

b. **Sales revenue:** This section of the P&L statement includes the revenue generated by the business from the sales of goods or services.

c. **Other revenue:** This component includes any other revenue sources not directly related to the sale of goods or services, such as interest income, dividends, or rent received.

d. **Cost of goods sold**: The direct expenses related to the manufacturing of the products the company sells are included in this component. The cost of labor, supplies, and overhead are all included.

e. **Gross profit:** This component is the difference between the total revenue earned and the cost of goods sold. Gross profit represents the profit earned by the business before deducting the operating expenses.

2. Expense Section: The expense section of the P&L statement displays the total expenses that a business has incurred during the accounting period. This section is comprised of the following components:

a. **Cost of sales:**This component includes the indirect costs that are associated with the production of goods sold by the business, such as depreciation and amortization

b. **Operating expenses:** This component includes all the expenses incurred by the business during the accounting period, such as rent, utilities, salaries, marketing expenses, and depreciation on non-production assets.

c. **Other expenses:** This component includes any other expenses not directly related to the business operations, such as interest expenses and tax payments.

d. Net profit or loss: This component is the difference between the gross profit and total expenses. The net income or net loss earned by the business during the accounting period is represented by this component.

Classification of Expenses in Profit and Loss Account

The costs incurred by a business to generate revenue or maintain its operations are referred to as expenses, which are a crucial component of the Profit and Loss Account (P&L) statement. The P&L statement classifies expenses into various categories to provide a clear understanding of the financial performance of the business. The typical expense classifications in the P&L statement include cost of goods sold, selling and administrative expenses, interest expenses, and income tax expenses. The proper classification of expenses enables businesses to analyze and optimize their spending, improve profitability, and make informed decisions about resource allocation.

Here are the typical expense classifications in the Profit and Loss Account:

1. Cost of Goods Sold (COGS): The cost that is incurred directly in the production of goods or services is called Cost of Goods Sold (COGS) or Cost of Sales. COGS includes all costs spent during the accounting period for materials, direct labor, and other costs related to producing the goods or services sold.

2. Operating Expenses: Expenses incurred to maintain the day-to-day operations of a business are referred to as Operating Expenses or Selling, General, and Administrative Expenses (SG&A). Rent, salaries, utilities, marketing expenses, and other administrative expenses are examples of operating expenses.

3. Depreciation and Amortization: with time. Buildings, machinery, and other tangible assets are all subject to depreciation. Amortization is applied to intangible assets like patents, copyrights, and trademarks, whereas depreciation and amortization are non-cash charges that show how assets deteriorate over time.

4. Interest Expenses: Interest expenses are the costs associated with borrowing money. Interest expenses include the interest paid on loans, credit cards, and other forms of debt.

5. Taxes: Taxes are the mandatory payments made by a business to the government. Taxes include income taxes, sales taxes, property taxes, and other taxes levied by the government.

6. Other Expenses: Other expenses include any expenses that are not included in the above categories. These may include legal fees, insurance premiums, repairs and maintenance, and other miscellaneous expenses.

Classification of Incomes in Profit and Loss Account

Proper classification of expenses in the P&L statement is significant as it enables businesses to analyze their expenses, detect areas where they can reduce costs, and evaluate their financial health. Investors and creditors can also assess the business's financial status based on the classification of expenses in the P&L statement, and it guides them in making informed investment decisions. For business owners, investors, and creditors alike, understanding the classification of expenses in the P&L statement is crucial as it presents a transparent view of the company's financial performance.

A business earns income, also referred to as revenue or sales, from the sale of goods or services. The P&L statement summarizes the income earned by a business during a specific period, and the incomes in the statement are classified into various categories to provide a clear understanding of the sources of revenue. The classification of incomes in the P&L statement is important for analyzing a business's revenue streams and identifying areas for growth. The following are the typical classifications of incomes in the Profit and Loss Account:

1. **Sales Revenue:** Sales revenue is the income earned by a business from the sale of goods or services. This is the primary source of income for most businesses, and it is typically the largest category of income in the P&L statement.
2. **Other Revenue:** Other revenue includes any income received by the business that is not directly related to the sale of products or services. This could be any type of non-operating income, such as dividends, interest income, or rent received.
3. **Gross Revenue:** Gross revenue is the total revenue earned by the business before any deductions. It includes both sales revenue and other revenue.
4. **Net Revenue:** Net revenue is the total revenue earned by the business after deducting any discounts, returns, or allowances. Net revenue is also known as the "net sales."

The classification of incomes in the P&L statement is important because it helps businesses to analyze their sources of revenue and identify areas where they can increase sales. It also helps investors and creditors to evaluate the financial health of the business and make informed decisions about their investments. Understanding the classification of incomes in the P&L statement is essential for business owners, investors, and creditors, as it provides a clear picture of the sources of revenue and the business's ability to generate income.

15.2 Some Items which require special attention at the time of preparation of final accounts of a company

Preparing the final accounts of a company is a crucial task that requires a lot of attention to detail. During the preparation of final accounts, there are specific items that necessitate special attention.These items include:

1. **Depreciation:** Depreciation is the reduction in the value of a company's assets over time due to wear and tear, obsolescence, or other factors. It is important to accurately calculate the amount of depreciation for each asset and include it in the final accounts. Failure to do so can result in an inaccurate representation of the company's financial position.
2. **Accruals and Prepayments:** Accruals and prepayments are expenses or incomes that have not yet been recorded in the accounts. It is important to identify and account for all accruals and prepayments in the final accounts to ensure that the accounts are accurate.
3. **Provisions:** Provisions are amounts set aside to cover future expenses or losses. It is important to identify and account for all provisions in the final accounts to ensure that the accounts accurately reflect the company's financial position.
4. **Contingent Liabilities:**Identifying and disclosing all contingent liabilities in the final accounts is crucial to present a comprehensive and accurate view of a company's financial position, as contingent liabilities are potential liabilities that may or may not arise in the future.
5. **Revenue Recognition:**Accurately recognizing revenue in the final accounts is crucial as it involves the process of recording revenue when it is earned, irrespective of when payment is received. This approach ensures that revenue is recognized in the appropriate period, giving a clear and accurate picture of the financial performance of the company
6. **Stock Valuation:**Valuation of stock is a critical aspect of final accounts preparation, and it is essential to value the stock accurately.
7. **Taxation:** Accurate calculation and accounting of taxation are crucial to the preparation of final accounts. It is important to accurately calculate and account for all taxes, including income tax, sales tax, and other taxes in the final accounts.
8. To sum up, paying close attention to these details is critical to guaranteeing the accuracy of the final accounts and presenting a precise and transparent image of the company's performance and financial situation. If these matters are not addressed, the final accounts

may contain mistakes, omissions, or misstatements. have a big impact on the business and its stakeholders.

- **Knowledge Check 2**

State whether given statements are true or false.

1. The P&L statement is a financial statement that summarizes the revenues, expenses, gains, and losses of a business during a specific period, usually a fiscal quarter or year. (T/F)
2. Assessing the financial performance of the business over time: The P&L statement is prepared for each accounting period, and the data is used to assess the financial performance of the business over time.(T/F)

- **Outcome-Based Activity 2**

Evaluate the effectiveness of a company's depreciation policy and recommend changes based on the nature of the asset, its useful life, and the company's financial goals.