

## CORPORATE ACCOUNTING

### What are Shares?

When the total capital of the company is divided into units of small denominations, it is known as **shares**. *For example*, if the total capital of the company is ₹ 5, 00,000, divided into 10,000 units of ₹50 each, each unit of ₹50 will be called a share (of ₹ 10 each). Thus, in the above case, the company has 1, 00,000 shares of ₹10 each. In order to identify the shares, they must be numbered.

*According to the Companies Act, 2013, "Share" means a share in the share capital of a company including stocks. Shares are considered as a type of security."*

### Key Features of Shares

1. **Fractional Ownership:** Each share represents a portion of the total ownership of a company, meaning investors own a piece of the business.
2. **Liquidity and Transferability:** Shares of publicly traded companies can be easily bought and sold on stock exchanges, providing liquidity. They can also be transferred from one owner to another.
3. **Dividends:** Shareholders may receive a portion of the company's profits as dividends, but these payments are not guaranteed and depend on the company's performance.
4. **Voting Rights:** Equity shareholders typically have the right to vote on important company matters, such as electing the board of directors.
5. **Limited Liability:** Shareholders' financial responsibility is limited to the amount of money they have invested in the shares; they are not personally liable for the company's debts.
6. **Potential for Capital Appreciation:** The value of shares can increase over time if the company performs well, offering investors potential long-term capital gains.
7. **No Maturity Date:** Unlike other financial instruments, shares do not have a fixed maturity date; they can be held indefinitely.
8. **Risk:** Investing in shares carries the risk of losing money if the company performs poorly or if the market experiences a downturn.
9. **Face Value:** Each share has a specified face value, which is its nominal value, though its market value can fluctuate significantly.

### Types of Shares

A company may issue two types of Shares under Section 43 of the Companies Act, 2013. They are:

1. **Preference Shares**
2. **Equity Shares**

## 1. Preference Shares

Preference shares have the following two rights:

1. They are liable to receive the dividend at a fixed rate before any dividend is paid on the equity shares.
2. At the time of winding up the company, they have the right to the return of capital before that of equity shares.

They also have the **right to participate in excess profits** when a specified dividend has been paid on the equity shares or the **right to receive premium** at the time of redemption.

### Features of Preference Shares:

1. **Steady income:** Preference shares provide steady income and shareholders get a fixed rate of return and safety of investment.
2. **No Voting Right:** Preference Shareholders do not have any voting rights and say in the management.
3. **Preferential Right of Repayment:** Preference shareholders have a preferential right of repayment over equity shareholders in the event of the liquidation of a company.
4. **No Assured Return:** Shareholders do not have assured return as the dividend on these shares is to be paid only when the company earns profit.
5. **Less Risk:** Less risk is involved in case of preference shares and that is why it is not suitable for investors who are willing to take risks for higher return.

### Types of Preference Shares

#### *On the basis of Arrears of Dividend:*

1. **Cumulative Preference Shares:** Shares in which the shareholders are entitled to recover the arrears of preference dividend before any dividend is paid on equity are known as **Cumulative Preference Shares**. In such shares, if the profits of the company in any year are insufficient to pay dividend on these shares, the dividend keeps on accumulating until it is fully paid. The arrears of dividend on these shares are shown in the balance sheet under 'Contingent Liability and Commitments'.
2. **Non-Cumulative Preference Shares:** When the holders of shares get a fixed amount of dividend out of the profits of each year, such shares are known as **Non-Cumulative Preference Shares**. Such shareholders get nothing, nor can they claim unpaid dividend of any year in any subsequent year if no dividend is declared due to any reason.

#### *On the basis of Share in Profits:*

1. **Participating Preference Shares:** The shares which allow the shareholders to participate in the surplus profits, if any, after dividend at a stipulated rate has been paid to equity shareholders, in addition to the fixed preference dividend. Such shares are known as **Participating Preference Shares**.

2. **Non-Participating Preference Shares:** Shares that get only a fixed rate of dividend every year and do not carry a right to participate in the surplus profits or in any surplus on winding up of the company is known as **Non-Participating Preference Shares**.

***On the basis of Convertibility:***

1. **Convertible Preference Shares:** The shares which can be converted into equity shares as per the terms of issue, are known as **Convertible Preference Shares**.
2. **Non-Convertible Preference Shares:** The shares which cannot be converted into equity shares are known as **Non-Convertible Preference Shares**.

***On the basis of Redemption:***

1. **Redeemable Preference Shares:** The shares which will be repaid by the company within a stipulated period in accordance with the terms of issue and the fulfilment of certain conditions laid down in Section 55 of the Companies Act 2013, are known as **Redeemable Preference Shares**.
2. **Irredeemable Preference Shares:** The shares in which the capital cannot be refunded before winding up is known as **Irredeemable Preference Shares**.

## **2. Equity Shares**

Shares which are paid dividends only when profits are left after the preference shareholders have been paid fixed rate of dividends is known as **Equity Shares**. There is no fixed rate of dividend in case of equity shares. The equity shareholders receive nothing if in any year there are no profits or insufficient profits. They get a higher rate of dividend when the company earns more profits. Equity share capital is returned only when preference share capital is returned in full. Equity shareholders have voting rights and control the affairs of the company.

### **Features of Equity Shares:**

- **Right to vote:** Equity shareholders have right to vote and can participate in the management of the business.
- **Permanent Capital:** Equity shares are permanent capital of the business, as it is to be repaid only at the time of liquidation of a company.
- **No charge on Assets:** When funds are raised using equity shares, then there is no charge on the assets of the company.
- **Higher Risks:** Equity shares involve higher risks and are suitable for investors who are willing to take risk for higher returns.
- **Costly:** It is more costly than other sources of funds.
- **Creditworthiness:** It provided creditworthiness to the company and confidence to prospective loan providers.

## DIFFERENCE BETWEEN PREFERENCE SHARE AND EQUITY SHARE

Basis	Preference Shares	Equity Shares
Right to Dividend	First Right	Subsequent right
Rate of Dividend	Fix	Variable
Arrears of Dividend	If Cumulative – Payable	Not Payable
Convertibility	If convertible then yes	Not convertible
Redemption	If redeemable then yes	Company can buy back
Voting Rights	Only in specified circumstances	Yes
Refund of capital	Preferential rights in case of wound up	Subsequent right
Right to participate in management	No rights	Have rights

### What is Share Capital?

The Capital raised by a company through the issue of shares is known as **Share Capital**. There is no separate Capital Account for each individual or institution even after they contribute varying sums to the company's capital. There is one Consolidated Capital Account called the Share Capital Account.

### Kinds of Share Capital

The kinds of Share Capital are as follows:

**1. Authorised, Registered, or Nominal Capital:** The amount, which is stated in the Memorandum of Association is termed **Authorised Capital**. Authorised, Registered or Nominal Capital is the maximum capital for which a company is authorised to issue shares during its lifetime.

**2. Issued Capital:** That part of Authorised Capital, which is actually offered to the public for subscription is known as **Issued Capital**. The remaining part of the Authorised Capital, which can be issued later, is known as '**Unissued Capital**'.

**3. Subscribed Capital:** That part of the capital that has been subscribed for by the public is known as **Subscribed Capital**. *For example*, 12,000 shares of Rs. 100 each are offered to the public, and the public applies for 10,000 shares, then the Subscribed Capital will be  $10,000 \times 100 = \text{Rs. } 10,00,000$ .

**Subscribed Capital is shown in the Balance Sheet under two heads:**

1. **Subscribed and fully paid up**
2. **Subscribed but not fully paid up**

**(i) Subscribed and fully paid up:**

When the entire or nominal (face) value of a share is called by the company, and also paid up by the shareholders, it is known as **Subscribed and Fully paid-up Capital**.

**(ii) Subscribed but not fully paid up:**

When the company has called up the full nominal value of the share, but the shareholder has not paid some part of the nominal value of the share, and when the company has not

called up the full nominal value of the share, the shares are said to be **Subscribed and not fully paid-up**.

Terms like **Called-up** and **Paid-up** are also used in the case of 'Share Capital'.

**Called-up Share Capital:** The part of the face value of a share which is called by the directors from the shareholders is known as **Called-up Share Capital**. *For example*, if the directors call at the rate of ₹ 50 per share on 1,000 shares of ₹100 each, ₹50,000 will be the called up Capital. The remaining ₹ 50 per share will be uncalled share capital.

**Paid-up Share Capital:** That portion of called-up capital that has been actually received from the shareholders is known as **Paid-up Share Capital**. The only point of difference between called-up capital and paid-up capital is that some shareholders may not have paid the amount of calls. The unpaid amount is called **Calls in Arrear**. *For example*, ₹ 4 has been paid against the called-up amount of ₹10, then ₹4 is the paid-up amount.

$$\text{Paid-up Amount} = \text{Capital} - \text{Amount of Calls in Arrear}$$

**4. Reserve Capital:** That portion of the increased nominal capital or uncalled share capital of an organisation which shall not be called up, except in the event of winding up is known as Reserve Capital. It is not necessary to create Reserve Capital. Reserve Capital is not shown in the Balance Sheet of a Company. A firm can use Reserve Capital only at the time of winding up of the Company.

**5. Capital Reserve:** The reserves which are created out of the Capital Profits of a firm are known as **Capital Reserves**. Here, capital profits are the profits that are not earned during the normal course of the business. However, an organisation cannot utilise the capital reserve for the distribution of dividends. The items that give rise to the Capital Profits and ultimately Capital Reserves of an organisation are as follows:

- Profit on Sale of Fixed Assets.
- Profit on Revaluation of Fixed Assets.
- Profit on Redemption of Debentures.
- Profit earned by a company prior to its corporation.
- Profit on forfeiture and re-issue of shares.
- Premium on Issue of Shares and Debentures.

## ISSUE OF SHARE

### What is Issue of Shares?

Share capital is capital obtained through the issuance of shares. A company's capital is divided into small units called **shares**. Each share has a nominal value. *For example*, a company can issue 2,00,000 shares of Rs. 10 each for a total of Rs. 20,00,000. The person who holds the shares is referred to as the **shareholder**. A company raises its capital through the **issue of shares**.

A company typically issues [two types of shares](#) Equity and Preference shares. The money raised by issuing equity shares is referred to as **Equity Share Capital**; whereas, money raised by issuing preference shares is referred to as **Preference Share Capital**.

### Types of Share Issues

1. **Public Issue (IPO/FPO)**
  - **Initial Public Offering (IPO):** First time a company offers shares to the public.
  - **Follow-on Public Offering (FPO):** Additional shares offered after IPO.
2. **Private Placement**
  - Shares are issued to a selected group of investors (e.g., institutions, banks).
3. **Rights Issue**

- Offered to existing shareholders in proportion to their holdings, usually at a discount.
- 4. **Bonus Issue**
  - Free shares issued to existing shareholders from company reserves.
- 5. **Preferential Allotment**
  - Shares allotted to a specific group (e.g., promoters) at a pre-determined price.

## PROCESS OF ISSUE OF SHARE

- **Issue of Prospectus:** The enterprise initially issues the prospectus to the public generally. The prospectus is an appeal to the public that a new enterprise has come into the presence and it would require funds for operating the trading concern. It comprises of complete data regarding the enterprise and the way in which the money is to be collected from the prospective investors.
- **Receipt of Applications:** When the prospectus is circulated to the public, prospective investors contemplating to sign up and subscribe the share capital of the enterprise would make an application along with the application money and deposit it with a scheduled bank as mentioned in the prospectus.
- **Allocation of shares:** Once the minimum subscription has been done, the shares can be allocated. Normally, there is always oversubscription of shares, so the allocation is done on pro-rata ground. Letters of Allotment are sent out to those people who have been allocated their part of shares. This results in an authentic contract between the enterprise and the claimant, who will now be a part-owner of the enterprise.

### Accounting Entries on Issue of Shares at Par:

#### 1. Entries on Receiving Application Money:

The applicants who want to invest in a company deposit the application money directly in the bank. The bank then sends the application forms to the company's office.

#### A. For entry is made by the company on receiving the application money:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Bank A/c <span style="float: right;">Dr.</span>		XXXX	
	To Share Application A/c			XXXX
	(Being application money received on xxxx shares at the rate of ₹XX per share)			

#### B. For Application money is transferred to Share Capital A/c (When a share application is accepted, it is an allotment of shares):

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Share Application A/c <span style="float: right;">Dr.</span>		XXXX	
	To Share Capital A/c			XXXX
	(Being share application money transferred to the share capital account)			

## 2. Entries on Allotment:

The applicants who are allotted shares are sent a letter of allotment. The letter consists of information regarding the number of shares allotted and the amount due to allotment. Once the allotment letter is sent to the applicants, the allotment money becomes due on the allotment and becomes a part of the share capital.

### A. For making allotment for money due:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Share Allotment A/c <span style="float: right;">Dr.</span>		XXXX	
	To Share Capital A/c			XXXX
	(Being share allotment money due on xxxx shares @ ₹XX per share)			

### B. For receipt of allotment money:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Bank A/c <span style="float: right;">Dr.</span>		XXXX	
	To Share Allotment A/c			XXXX
	(Being amount received on allotment on XXXX shares @ ₹XX per share)			

## 4. Entries of Second and Final Call:

### A. For the second call money due as follows:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Share Second & Final Call A/c <span style="float: right;">Dr.</span>		XXXX	
	To Share Capital A/c			XXXX
	(Being second and final call due on xxxx shares @ ₹XX per share)			

### B. For receipt of Second Call Money:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Bank A/c <span style="float: right;">Dr.</span>		XXXX	
	To Share Second & Final Call A/c			XXXX
	(Being second and final call money received on xxxx shares @ ₹XX per share)			

## Forfeiture of Shares:

Cancellation of shares of a shareholder who fails to pay the amount due on allotment or on any call within the specific time period is known as **Forfeiture of Shares**. A company or its directors can forfeit the shares only if its Articles of Association allow for the same. If a

company wants to make the forfeiture valid, it has to follow the rules laid down in the Articles of Association. If the Articles of Association is silent about the rules of forfeiture, then the company must give the defaulting shareholder a **minimum of 14 days' notice** requiring him to pay the amount unpaid on his shares with the accrued interest thereon. Besides, the notice must state if the shareholder does not pay the unpaid amount within a certain period, his/her shares will be forfeited. Hence, despite of sending the notice, if the shareholder does not pay the unpaid amount on his/her shares, they may be forfeited by a resolution of the Board of Directors. Once the shares are forfeited, the name of the shareholders is removed from the Registrar of Members. Also, the amount already paid by the defaulter shareholder remains with the company.

## Forfeiture of Shares

Assume a shareholder subscribed to 100 shares but failed to pay the final call of ₹4 per share. The amount paid per share was ₹6.

### Initial Entries for Subscription and Partial Payment

On Application (₹3 per share)

Bank A/c Dr. Rs. 300
To Share Application A/C Rs. 300

### Transfer from Application to Share Capital

Share Application A/C Dr. Rs. 300
To Share Capital A/C Rs. 300

**On Allotment (Rs. 3 per share)**

Bank A/c Dr. Rs. 300  
To Share Allotment A/C Rs. 300

**Transfer form Allotment to Share Capital**

Share Allotment A/C Dr. Rs. 300  
To Share Capital A/c Rs. 300

**Final Call Not Paid (Rs. 4 per share):**

On Final Call:  
Final Call A/C Dr. Rs. 400  
To Share Final Call A/C Rs. 400

**Forfeiture of Shares**

Share Capital A/C Dr. Rs. 1000  
To Share Final Call A/C Rs. 400  
To Forfeiture Share A/C Rs. 600

**Reissue of Shares**

A company can reissue shares when those shares were forfeited by virtue of the original shareholders failing to pay their dues. The reissue, therefore, allows a company to collect dues that were not collected earlier and optimize its capitalization. A vital aspect of reissue of shares is that it is one of the financial mechanisms used by the company to recover unpaid capital related to forfeiture. Therefore, working through the orderly issuance of shares in fully compliant manner will not only ensure recovery of dues, but would also lead to optimum utilization of capital, thereby enhancing the financial standing and operational efficiency of the entity.

## Reissue of Forfeited Shares

Assume the company reissues the 100 forfeited shares at ₹8 per share.

### Entry for Reissue

Bank A/C Dr. Rs. 800  
To Share Capital A/C Rs. 800

Transfer of Forfeited Amount to Capital Reserve: Assuming Rs. 600 was originally forfeited

Forfeited Shares A/C Dr. Rs. 600  
To Capital Reserve A/C Rs. 600

# 7. REDEMPTION OF PREFERENCE SHARES

## CONCEPT 1 : INTRODUCTION

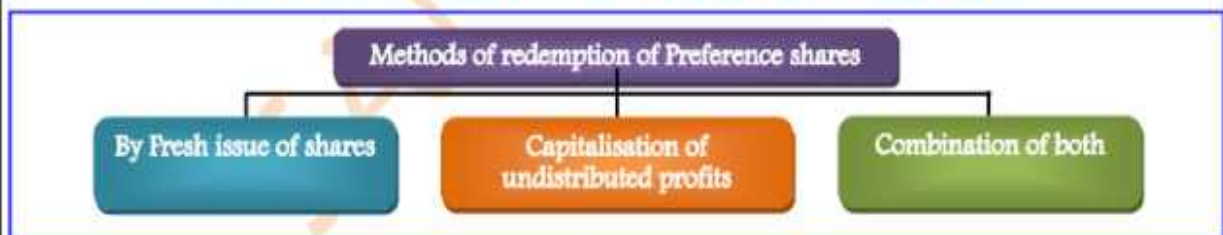
- ↳ Redemption is the process of repaying an obligation, at prearranged amounts and timings.
- ↳ It is a contract giving the right to redeem preference shares within or at the end of a given time period at an agreed price.
- ↳ Shareholders will be repaid at a future date, the amount which they invested in the company (along with frequent payment as return on investment)
- ↳ The redemption date is the maturity date on which repayment takes place.
- ↳ The redemption date is printed on the preference share certificate.
- ↳ A company can adjust its financial structure by eliminating PS & replacing it with other securities if it is advantageous.
- ↳ A company cannot issue irredeemable preference shares.

## CONCEPT 2 : PURPOSE OF ISSUING REDEEMABLE PREFERENCE SHARES



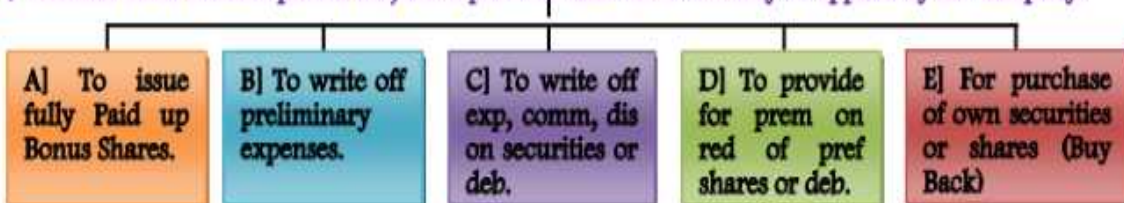
↳ In India, issue & redemption of preference shares is governed by Section 55 of the Companies Act, 2013.

## CONCEPT 3 : METHODS OF REDEMPTION OF FULLY PAID-UP SHARES

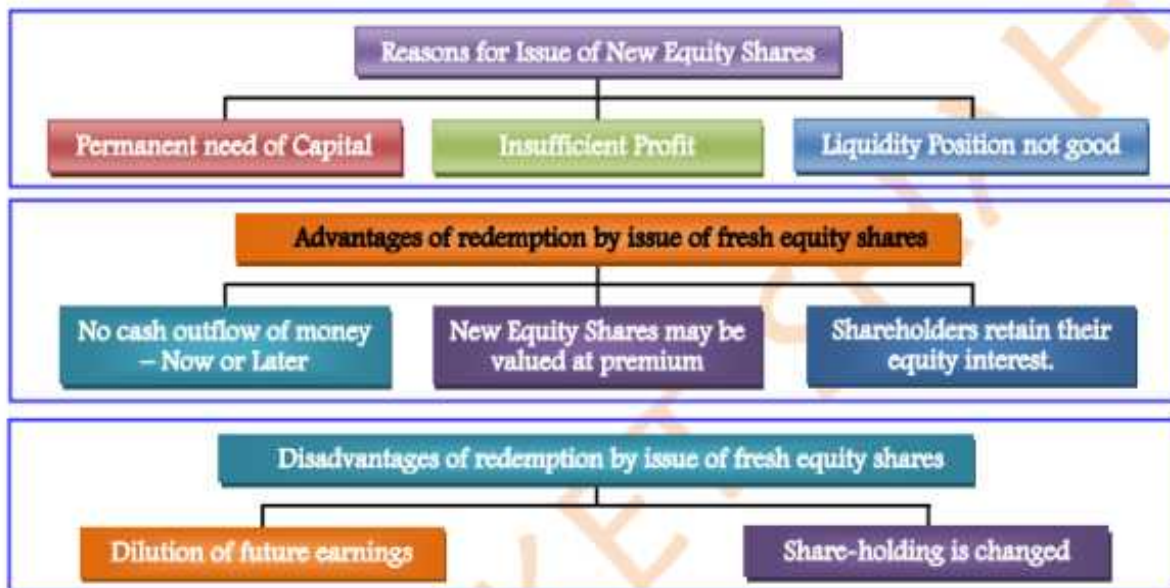


### [a] Redemption of Preference Shares by Fresh Issue of Shares :

- ↳ The proceeds from issue of debentures cannot be utilised for the purpose.
- ↳ When a fresh issue is made for the purpose of redemption of preference shares at a premium, the question arises whether the proceeds of a fresh issue of shares will include the amount of securities premium (SP) for the purpose of redemption of preference shares or not.
- ↳ Section 52 of the Companies Act, 2013 provides that the SPA/c may be applied by the company:



↳ Thus, the proceeds of a fresh issue of shares will not include the amount of SP for the purpose of redemption of preference shares.

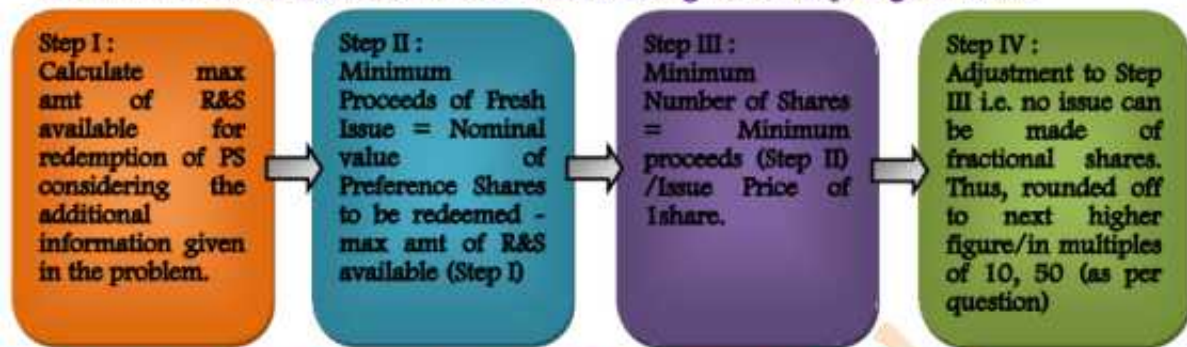


\* Accounting Entries:

Sr. no.	Particulars	Dr. (₹)	Cr. (₹)
1]	When new shares are issued at par Bank Account Dr. To Share Capital Account		
2]	When new shares are issued at a premium Bank Account Dr. To Share Capital Account To Securities Premium Account		
3]	When preference shares are redeemed at par Redeemable Preference Share Capital Account Dr. To Preference Shareholders Account		
4]	When preference shares are redeemed at a premium Redeemable Preference Share Capital Account Dr. Premium on Redemption of Preference Shares Account Dr. To Preference Shareholders Account		
5]	When payment is made to preference shareholders Preference Shareholders Account Dr. To Bank Account		
6]	For adjustment of premium on redemption Profit and Loss Account Dr. To Premium on Redemption of Preference Shares Account		

**\* Calculation of Minimum Fresh Issue of Shares :**

- If examination problem does not specify the no. of shares to be issued for the purpose of redemption, the minimum number of shares should be issued following the four steps as given below :

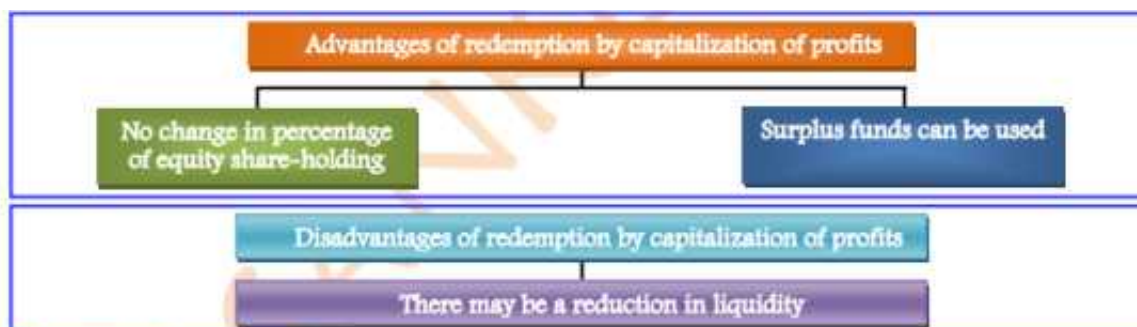


**ib) Redemption of Preference Shares by Capitalisation of Undistributed Profits :**

- ↳ Another method is to use the distributable profits in place of issuing new shares.
- ↳ When shares are redeemed by utilising distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Redemption Reserve Account (CRR) by debiting the distributable profit.

**⚡ The provisions of the Companies Act state that :**

- ▶ 'When any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall out of profits which would otherwise have been available for dividend, be transferred to a reserve fund to be called the CRR A/c sum equal to the nominal amount of the shares redeemed'.



**\* Accounting Entries :**

Sr. No	Particulars	Dr. (₹)	Cr. (₹)
1]	When shares are redeemed at par Redeemable Preference Share Capital Account To Preference Shareholders Account	Dr.	
2]	When shares are redeemed at a premium Redeemable Preference Share Capital Account Premium on Redemptions of Preference Shares Account To Preference Shareholders Account	Dr. Dr.	
3]	When payment is made to preference shareholders Preference Shareholders Account To Bank Account	Dr.	
4]	For adjustment of premium of redemption Profit and Loss Account To Premium on Redemption of Preference Shares Account	Dr.	

5]	For transferring nominal amount of shares redeemed to CRR Account		
	General Reserve Account	Dr.	
	Profit and Loss Account	Dr.	
	To Capital Redemption Reserve Account		

**[c] Redemption of Preference Shares by Combination of (a) & (b) :**

**Formula :**

Sr. No	Particulars	₹
i]	Amount to be Transferred to Capital Redemption Reserve	
	Face value of shares redeemed	xxx
	Less: Proceeds from new issue	xxx
		xxx
ii]	Proceeds to be collected from New Issue	
	Face value of shares redeemed	xxx
	Less: Profits available for distribution as dividend	xxx
		xxx

**[d] Sale of Investments to Provide Sufficient Funds for Redemption**

- Companies may have sufficient investments, which can be sold, in the market to arrange funds for redemption of preference shares.

**CONCEPT 4 : REDEMPTION OF PARTLY CALLED-UP PREFERENCE SHARES**

- One of the conditions of redemption is that only fully paid up preference shares can be redeemed.

**Notes :**

- If examination problem states that it is decided to redeem partly called up pref shares, then it is assumed that final call on these shares is demanded & recd before proceeding with redemption of these shares.
- If information of both fully & partly paid pref shares is provided, then, only fully paid shares are redeemed.

**CONCEPT 5 : REDEMPTION OF FULLY CALLED BUT PARTLY PAID-UP PREFERENCE SHARES**

**\* When calls-in-arrears is received by the company :**

- If the amount of unpaid calls is received before redemption, the entry passed is as under:

Bank A/c	Dr.
	To Calls-in-Arrears A/c

- After receipt of calls in arrears, the shares become fully paid up.
- Now, the company can proceed with redemption in the normal course.

**\* In case of Forfeited Shares :**

- If the shareholders fail to pay the unpaid calls after getting proper notice, the BOD may decide to forfeit and cancel these share instead of reissuing the forfeited shares.
- This is because redemption of these shares is due immediately or in near future.
- In this case, entry for forfeiture is passed as usual.

# DEBENTURE

## Meaning of Debentures

A debenture is a long-term debt instrument of any corporation issued to borrow money from the public or other financial institutions. The company undertakes an obligation at the time of issuance to pay interest at a fixed rate for some period and the repayment of the principal amount at the time of maturity. Debentures are unlike loans tied to assets because they are not secured by any physical assets or collateral. This has made debentures one of the favourite ways of raising capital, which does not dilute ownership. They are substantially used by the corporate world, and companies need an efficient way to raise capital without diluting ownership.



## Key Features of Debentures

Debentures have some important features that distinguish them from other financial instruments. These are as follows:

1. **Fixed interest payments:** The interest rate on the debenture takes the form of a known rate of interest, called the “coupon rate.” It is paid periodically, usually annually or semi-annually. The interest payment is an absolute obligation of the issuing company to pay, irrespective of the financial performance of the issuing firm.
2. **No problem of dilution:** The debenture holder is a creditor rather than the owner. Hence, the debenture issues do not bring about dilution or dilute the control or ownership stakes of existing shareholders, as in the case of issuing equity shares.
3. **Maturity period:** Debentures carry a specific term or period of maturity. At the maturity period, the holder is repaid the principal amount. The maturity period varies from short-term, under 5 years, to long-term, for more than 10 years.
4. **Secured vs. Unsecured:** Most of the debentures are issued on an unsecured basis, but some are made to be secured ones, supported by the company’s assets, which provide additional security in case of default to the investors.
5. **Convertibility:** Some are convertible, whereby they are convertible into equity shares either at a stipulated time or under certain circumstances.
6. **Priority in Liquidation:** Debenture holders are paid before shareholders but after secured creditors in case of liquidation.

## Different Types of Debentures

As you would imagine, debentures come in a variety of different forms to meet the needs of investors and company strategy. The most basic types are as follows:

1. **Secured Debentures:** These are secured by the assets of the company so that, in case of default by the company, the debenture holder is paid using such assets. In case of default, secured debenture holders have a claim on the assets associated with the debenture.
2. **Unsecured Debentures:** Also known as “naked debentures,” they are not supported by any collateral. The payment of such debentures depends upon the creditworthiness of the issuing firm. They are riskier than secured debentures, but their paybacks are usually higher.
3. **Convertible Debentures:** Convertible debentures can be converted into equity shares of the issuer company after a specified period. Such debentures are quite tempting to investors who look at the future as owning some amount of the company.
4. **NCDs:** The word NCD defines itself. That is, NCDs are non-convertible. In other words, these debentures cannot be converted into shares. These debentures are purely debt instruments, and the company has to pay back the principal and interest on maturity.
5. **Redeemable Debentures:** The Corporation has to repay, on a known date, the principal amount of redeemable debentures. Its redemption is always at par, at a premium or at a discount, which would have been agreed upon before issuance.
6. **Irredeemable Debentures (Perpetual Debentures):** These debentures do not carry any maturity date, so the principal need not be returned by the company. The interest keeps flowing to the debenture holders perpetually so long as the company is solvent.
7. **Registered Debentures:** They are registered in the company’s register, and further transfer can only take place upon registration with the company. These offer additional safety to the investors.
8. **Bearer Debentures:** These are non-registered and can be transferred simply by delivery. Payments of interest are payable to the bearer, making these types of debentures more flexible but more dangerous.

## DIFFERENCE BETWEEN DEBENTURE AND SHARE

Aspect	Debentures	Shares
Nature	Debt instrument	<a href="#">Equity</a> instrument
Ownership	No ownership stake	Ownership stake in the company
Returns	Fixed interest payments	Variable dividends based on profits
Risk	Lower risk, fixed returns	Higher risk, returns depend on company performance
Repayment	Principal repaid at maturity	No repayment, represents ownership
Voting Rights	No voting rights	Voting rights in company decisions

# ISSUE OF DEBENTURE

## Issue of Debentures

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Company debenture is one of the important sources of finance for large companies, in addition to equity stocks, bank loans, and bonds. Companies need to follow certain procedures for issue of debentures to raise money. There are several ways of issuing a debenture viz. at a par, premium or discount and even for consideration other than cash.

### Issue of Debentures

The procedure of issuing debentures by a company is similar to the one followed while issuing equity stocks. The company starts by releasing a prospectus declaring the debenture issuance. The interested investors, then, apply for the same. The company may need the entire amount while applying for the debentures or may ask for installments to be paid while submitting the application, on allotment of debentures or on various calls by the company. The company can issue debentures at a par, at a premium or at a discount as explained below.

### Different ways for issuing of Debenture

Once the company invites the applications and the investors apply for the debentures, the company can issue debentures in one of the following ways:

#### Issue of Debenture at par

When the issue price of the debenture is equal to its face value, the debenture is said to be issued at par. When a debenture is issued at par, the long-term borrowings in the liabilities section of the balance sheet equals the cash in the assets side of the balance sheet. Thus, no further adjustment is required to balance the assets and the liabilities of the company. The company can collect the whole amount in one installment i.e. on an application or in two installments i.e. on an application and subsequent allotment. However, there might be a scenario in which money is collected in more than two installments i.e. on an application, on an allotment and at various calls by the company.

#### Issue of debenture at discount

The debenture is said to be issued at a discount when the issue price is below its nominal value. Let us take an example – a Rs. 100 debenture is issued at Rs. 90, then Rs.10 is the discount amount. In such a scenario, the liabilities and the assets sides of the balance sheet do not match. Thus, the discount on debentures' issuance is noted as a capital loss and is charged to 'Securities Premium Account' and is reflected as an asset. The discount can be written off later.

## Issue of Debenture At Premium

When the price of the debenture is more than its nominal value, it is said to be issued at a premium. For example, a Rs. 100 debenture is issued for Rs.105 and Rs.5 is the premium amount. Again, assets and liabilities do not match in such situation. Therefore, the premium amount is credited to Securities Premium Account and is reflected under 'Reserves and Surpluses' on the liabilities side of the balance sheet.

## The Issue of Debenture as Collateral

The debentures can be issued as a collateral security to the lenders. This happens when the lenders insist on additional assets as security in addition to the primary security. The additional assets may be used if the complete amount of loan cannot be realized from the sale of the primary security. Therefore, the companies tend to issue debentures to the lenders in addition to some other physical assets already pledged. The lenders may redeem or sell the debentures on the open market if the primary assets do not pay for the complete loan.

## Issue of Debenture for Consideration Other Than Cash

Debentures can also be issued for consideration other than cash. Generally, companies follow this route with their vendors. So, instead of paying the cash for the assets purchased from the vendor, the companies issue debentures for consideration other than cash. In this case, also, the debentures can be issued at a par, premium or discount and are accounted for in the similar fashion.

## Over Subscription

The company invites the investors to subscribe to its debenture issue. However, it may happen that the applications received for the debentures may be more than the original number of debentures offered. This scenario is referred to as oversubscription. In the case of over-subscription, a company cannot allocate more debentures than it had originally planned to issue. So, the company refunds the money to the applicants to whom debentures are not allotted. However, the excess money received from applicants who are allocated debentures is not refunded. The same money is used towards allotment adjustment and the subsequent calls to be made.

## REDEMPTION OF DEBENTURE

Typically, it can be described as the process of repaying [debentures](#) issued by a company to its debenture holders. In other words, it is the process of repaying the principal amount to debenture holders.

It is a noteworthy transaction for most companies as the amount required for redemption is quite substantial.

Once debentures are redeemed, the issuing company discharges its share of liability and takes it out from the balance sheet. Resultantly, businesses build a robust provision out of their gains and accumulate capital for reclaiming debentures.

Typically, the terms of redemption are stated in the debenture certificate. Notably, the approach behind redemption of debentures can be understood by glancing at these following pointers –

- Debentures can either be redeemed at premium or par.
- Redemption signifies – repaying the number of debentures to debenture holders.
- All terms and conditions accompanying redemption are mentioned in a company's prospectus that initiates an invite for issuance of debentures.

### Methods of Redemption of Debentures

#### 1. Lump-sum payment on a prefixed date

This one-time method is considered to be among the simplest redeeming options. As per this method, debenture holders receive the promised sum on the prefixed date.

If the debentures are not redeemed at discount or premium, the lump sum amount, calculated by the summation of the principal value of all debentures, is paid out on the prefixed or maturity date that is mentioned on debenture agreement. The issuing company may decide to pay off the debenture amount before its maturity. Since companies know in advance, when they have to pay off for debenture, they are better positioned to streamline it.

The accounting treatment of redemption of debentures in this method is given below –

S.N.	Particulars	Amount (Rs.)	Amount (Rs.)
1.	Bank A/C (Dr) To Debenture Redemption Investment A/C (investment sold)	xxxx	xxxx
2.	Profit and Loss Appropriation A/C (Dr) To Debenture Redemption A/C (Being amount of profit transferred)	xxxx	xxxx
1.	Debenture Redemption Fund A/C (Dr) To General Reserve A/C To Capital Reserve A/C (Profit on sale of investment)	xxxxx	xxxx

## 2. Payment in annual instalment

This method is considered similar to the redeeming process of a term loan. As per this method, companies pay a portion of a debenture's principal each year to holders until its maturity date. The total liability is divided by the number of investment years, and the outcome is paid off each year.

## 3. Debenture redemption reserve

This is also known as the sinking fund. Essentially, it is a reserve that is built by accumulating at least 25% of the face value of debenture every year until its maturity. The main objective of this reserve is to protect the interest of debenture holders. According to the Indian Companies Act, 1956, companies that issue debentures need to create this reserve before the maturity date of a specific debenture.

## 4. Call and put option

Some companies issue debentures with both calls and put options for redemption. Typically, the call option enables companies to purchase their debenture either before or on the maturity date at a predetermined price. On the other hand, in the put option, debenture

holders avail the right to sell the debenture back to the company at an agreed price, either before or on the maturity date.

#### 5. Conversion into shares

This particular method is directed towards convertible debentures. Such debentures come with a clause that enables holders to convert their units into company's ordinary [equity shares](#). It is at that point of conversion that the total liability of debentures is discharged.

#### 6. Buy from the open market

Companies can also purchase debentures from an open market if their units are being traded on a regulated exchange. It will save them from the hassle of being subject to administrative documentation. Furthermore, often debentures are traded at a discount in the market. In turn, it allows individuals to lower redemption payout and helps retain more revenue.

Its accounting treatment is shown in a tabular format below –

##### a) When purchased for a premium

S.N.	Particulars	Amount (Rs.)	Amount (Rs.)
1.	Debenture A/c (Dr) Loss on Redemption A/C (Dr) To Bank A/c	xxxx xxxx	
2.	Profit & Loss A/c (Dr) To Loss on Redemption A/c	xxxx	xxxx

b) When purchased at a discount

S.N.	Particulars	Amount (Rs.)	Amount (Rs.)
1.	Debenture A/C (Dr) To Profit on Redemption A/C (Dr) To Bank A/C	XXXX XXXX	XXXX
2.	Profit on Redemption A/C (Dr) To Capital Reserve A/c	XXXX	XXXX

## PROFIT PRIOR TO INCORPORATION

It is the **profit earned during the period between the date of starting the business and the date of incorporation** of the company.

- For example:
  - A business starts operations on **1st January**.
  - It becomes legally incorporated on **1st April**.
  - The **profits from January to March** are considered *Profit Prior to Incorporation*.

Why is it Important?

1. **Legal Entity:** A company doesn't legally exist before incorporation, so profits during that time are not earned by the company in a legal sense.
2. **Accounting Treatment:** Profit prior to incorporation is **not available for dividend distribution** to shareholders.
3. **Allocation:** Profits are divided into **pre-incorporation** and **post-incorporation** periods for proper accounting

How is it calculated?

Typically, you calculate profit for the entire period and **apportion it** between:

- **Pre-Incorporation Period**
- **Post-Incorporation Period**

☒ *Methods of Apportionment:*

1. **Time Basis** – for general expenses (e.g., rent, salaries)
2. **Sales Basis** – for revenue-related items (e.g., gross profit)
3. **Actual Basis** – when exact data is available for each period

## USE OF PROFIT AND LOSS PRIOR TO INCORPORATION

Profits prior to incorporation are considered capital profits and are used to offset capital expenses like goodwill or to create a capital reserve. They cannot be used for distributing

dividends because a company doesn't legally exist and cannot earn operational revenue during that pre-incorporation period. These profits must be kept separate from operating profits and are typically used to write off initial capital losses, overvalued assets, preliminary expenses, or can be transferred to a capital reserve.

#### Key Uses of Pre-Incorporation Profits

- **Offsetting Capital Losses:** Used to cover capital losses incurred before the company's official start.
- **Writing Off Goodwill:** Applied to reduce the book value of goodwill acquired when taking over a business.
- **Writing Down Overvalued Assets:** Can be used to reduce the value of assets that were overvalued by the vendor.
- **Creating a Capital Reserve:** Transferred to a special capital reserve account within the company.
- **Issuing Bonus Shares:** Some profits may be used to issue bonus shares to existing shareholders, according to some sources.
- **Paying up Partly Paid Shares:** Used to pay for partly paid shares.

#### Why They Cannot Be Used for Dividends

- **Capital Nature:**

The profit earned is considered capital in nature because it was generated before the company was legally established to earn operational revenue.

- **Legal Prohibition:**

A company cannot legally earn revenue or profits prior to its date of incorporation.

#### How Pre-Incorporation Profits Are Accounted For

1. **Separate Preparation:**

A separate Profit and Loss account or statement is prepared for the pre-incorporation period.

2. **Calculation:**

Profits or losses are calculated by apportioning items (like revenue and expenses) based on reasonable criteria such as turnover or time.

3. **Allocation of Expenses:**

- **Time-based expenses:** Such as rent or salaries that run for the entire period are divided using a time ratio.

- **Sales-based expenses:** Variable costs like commission or advertisement costs are divided based on the sales ratio.

4. **Interest on Purchase Consideration:**

Any interest paid to the vendor on the purchase price of a business for the period before incorporation is charged against these pre-incorporation profits.

5. **Journal Entries:**

Pre-incorporation profits are transferred to a Capital Reserve Account or Goodwill Account, not the main Profit and Loss Account, and cannot be distributed as dividends.

## **Methods of Computing Pre-Incorporation Profit and Loss:**

There are three primary methods used to compute profit and loss prior to incorporation:

1. **The Time Ratio Method**
2. **The Sales Ratio Method**
3. **A Combined Approach**

Each method serves a specific purpose and is used based on the nature of business transactions and available data.

### **Time Ratio Method**

**Time Ratio Method** is one of the simplest and most commonly used methods for computing pre-incorporation profit and loss. This method is based on the principle that the profits or losses during the pre-incorporation period are proportionate to the time elapsed during that period compared to the total period.

#### **• How It Works:**

The time ratio is calculated by dividing the number of months in the pre-incorporation period by the total number

For example, if the company was incorporated on July 1st and the financial year ends on December 31st:

- Pre-Incorporation Period: January 1st to June 30th (6 months)
- Post-Incorporation Period: July 1st to December 31st (6 months)
- Total Accounting Period: January 1st to December 31st (12 months)

Time Ratio = 6 months (pre-incorporation) : 6 months (post-incorporation) = 1:1

#### **Application of Time Ratio:**

This ratio is applied to expenses and income that are time-related. Examples include rent, salaries, insurance, and utilities. These expenses are assumed to be evenly spread across both the pre-incorporation and post-incorporation periods, making the time ratio a fair way to allocate them.

#### **Advantages:**

- Simple to apply and understand.
- Suitable when expenses are incurred uniformly over time.

#### **Disadvantages:**

- Not suitable for businesses with fluctuating income or seasonal sales.
- Does not consider varying business activity levels during the pre- and post-incorporation periods.

### **Sales Ratio Method**

**Sales Ratio Method** is used when income and expenses are more directly related to sales than to time. This method assumes that profits or losses are proportional to the level of sales during the pre-incorporation and post-incorporation periods.

#### • **How It Works:**

The sales ratio is calculated by dividing the sales revenue during the pre-incorporation period by the total sales revenue for the entire accounting period.

For example, if a company's total sales for the year were ₹1,200,000, with ₹400,000 earned during the pre-incorporation period and ₹800,000 earned post-incorporation, the sales ratio would be: Sales Ratio = ₹400,000 (pre-incorporation) : ₹800,000 (post-incorporation) = 1:2

#### • **Application of Sales Ratio:**

This ratio is applied to expenses and income directly related to sales, such as commissions, discounts, advertisement costs, and cost of goods sold. The sales ratio is considered more accurate for businesses where revenue generation is not uniform throughout the period.

#### **Advantages:**

- More accurate when revenue fluctuates or when there is significant variation in sales activity across different periods.
- Suitable for industries with seasonal sales or variable market conditions.

#### **Disadvantages:**

- Requires detailed sales data, which might not be available or reliable for the pre-incorporation period.
- Does not consider time-related expenses.

### **Combined Approach**

In practice, a combination of the Time Ratio and Sales Ratio methods is often used to allocate different types of expenses and income. This approach recognizes that some costs are time-based (fixed expenses like rent and salaries), while others are related to sales volume (variable expenses like cost of goods sold or sales commissions).

### **How It Works:**

1. **Fixed Costs Allocation:** Fixed costs, such as rent, insurance, and utilities, are allocated based on the time ratio.
2. **Variable Costs Allocation:** Variable costs, like sales commissions, discounts, and cost of goods sold, are allocated based on the sales ratio.

### **For example:**

- If the rent for the year is ₹600,000, and the time ratio is 1:1 (as in the previous example), the pre-incorporation period would be allocated ₹300,000.
- If sales commissions total ₹150,000 for the year, and the sales ratio is 1:2, the pre-incorporation period would be allocated ₹50,000.

### **Advantages:**

- Provides a more accurate allocation of expenses by considering the nature of costs.
- Flexible and adaptable to different business models and industries.

### **Disadvantages:**

- More complex to calculate, requiring accurate data and careful judgment.
- May require significant bookkeeping effort, especially if sales data is not well-documented for the pre-incorporation period.

### **Steps Involved in Computing Pre-Incorporation Profit and Loss:**

#### **1. Identify the Pre-Incorporation and Post-Incorporation Periods:**

Determine the exact dates of incorporation and establish the time periods for calculation.

#### **2. Classify Expenses and Income:**

Categorize all revenue and expenses into fixed (time-related) and variable (sales-related) components.

#### **3. Determine Time and Sales Ratios:**

Calculate the time and sales ratios based on the periods and revenue figures.

#### 4. Allocate Expenses and Income:

Apply the relevant ratios to allocate income and expenses to the pre-incorporation and post-incorporation periods.

#### 5. Compute Profit or Loss:

Subtract the pre-incorporation expenses from the pre-incorporation income to determine the profit or loss for the period.

#### 6. Accounting Treatment:

Record the pre-incorporation profit as a capital profit, often transferred to a capital reserve. If there is a loss, it is treated as a deferred revenue expenditure or capitalized as part of the company's preliminary expenses.

## FINAL ACCOUNTS

Final accounts refer to a set of financial statements prepared at the end of an accounting period. These statements include the trading account, profit and loss account, and the balance sheet. The final accounts can be divided into three distinct parts.

- The Trading Account shows the gross profit or loss.
- The [Profit and Loss Account](#) reveals the net profit or loss.
- The Balance Sheet reflects the financial position of the business.

### Trading Account

The trading account is the first part of the final accounts and focuses on determining the gross profit or loss during the [accounting period](#). It contains all the direct expenses and revenues relating to the production and sale of goods.

### Components of Trading Account

1. **Opening Stock:** The value of stock at the beginning of the accounting period.
2. **Purchases:** All goods purchased for sale.
3. **Sales:** The total revenue generated from the sale of goods.
4. **Direct Expenses:** Costs directly associated with production, such as wages, freight, and factory expenses.
5. **Closing Stock:** The value of stock remaining at the end of the accounting period.

### Formula for Gross Profit

$$\text{Gross Profit} = \text{Net Sales} - \text{Cost of Goods Sold (COGS)}$$

Where,

$$\text{COGS} = (\text{Opening Stock} + \text{Purchases} + \text{Direct Expenses}) - \text{Closing Stock.}$$

# Profit and Loss Account

Having arrived at the gross profit, the next step is preparing the profit and loss account. It is seeking to determine net profit or net loss considering the costs and revenues of both operating and non operating natures.

## Components of Profit and Loss Account

1. **Indirect Expenses:** These include salaries, rent, electricity, and administrative costs.
2. **Other Incomes:** Revenue from sources other than sales, like interest received or dividends.
3. **Depreciation:** The gradual reduction in the value of assets.
4. **Interest and Taxes:** Expenses for interest payments and taxes.

## Formula for Net Profit

$$\text{Net Profit} = \text{Gross Profit} + \text{Other Incomes} - \text{Indirect Expenses}$$

## Balance Sheet

The [Balance Sheet](#) forms the last constituent of the final accounts and offers a summary of the company's health at a point in time. It consists of assets, liabilities, and equity.

## Components of a Balance Sheet

1. **Assets:** These include both current and non-current assets like cash, accounts receivable, and machinery.
2. **Liabilities:** Short-term (current) and long-term (non-current) obligations, such as loans and accounts payable.
3. **Equity:** The owners' claim on the assets after deducting liabilities, including share capital and retained earnings.

A **Balance Sheet** must always balance, following the formula:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

## Objectives of Final Accounts

The primary objectives of preparing final accounts include:

1. **Determining Profitability:** The final accounts enable a business to determine the gross and net profitability of the business.
2. **Evaluation of Financial Standing:** It gives an idea about the financial standing of a business.

3. **Compliance with Legal Requirements:** Final accounts help ensure compliance with financial rules and tax authorities.
4. **Tool for Decision-Making:** The statements are useful tools for [management](#) and stakeholders while making decisions concerning finance.

### Importance of Final Accounts

Final accounts are essential for several reasons:

1. **Stakeholder Information:** These accounts enable investors, creditors, and other stakeholders to have information about the health of the business.
2. **Legal Requirement:** Final accounts are legally required for regulatory purposes, mainly for tax filing purposes.
3. **Management Control:** They give the necessary data for internal control and future financial planning.
4. **Comparison with Previous Years:** Final accounts enable companies to track progress by comparing the current [financial results](#) with previous data.

### Limitations of Final Accounts

Despite their importance, final accounts have certain limitations:

1. **Historical Data:** These are only past and cannot indicate what the future holds concerning change in trends.
2. **Non-Physical Factors Not Included:** [Goodwill](#), employee morale, etc. are not included in the financial statements.
3. **Risk of Manipulation:** The risk is always there, for accounts can be tampered with the intent to present favourable data.
4. **Accounting Basis of Assumptions:** Accounts are based on assumptions. Sometimes these assumptions may be wrong.

## GENERAL INSTRUCTIONS

### General Instructions for the Statement of Profit & Loss

1. **Gather financial data:** Collect all income and expense information from the company's ledgers and records for the reporting period.
2. **Select a reporting period:** Determine the specific period for which you are preparing the P&L, such as a month, quarter, or year.
3. **List revenues and costs:** Detail all forms of revenue, such as from sales of products and services, and subtract the cost of goods sold (COGS).
4. **Record expenses:** List all operating and non-operating expenses, including interest, taxes, depreciation, and amortization.

5. **Calculate net income:** Determine the final profit or loss by subtracting total expenses from total revenues.
6. **Notes to Accounts:** Cross-reference any detailed or additional information for revenue and expense items within the "notes to accounts" section.

### **General Instructions for the Balance Sheet**

1. **Determine the reporting date:** Establish the specific date at which the financial position is being reported.
2. **List assets:** Categorize and list all company assets as either current (expected to be realized within 12 months) or non-current.
3. **List liabilities:** Detail all liabilities, separating current liabilities from non-current liabilities.
4. **Show shareholders' equity:** Include all components of owner's or shareholders' equity.
5. **Verify the accounting equation:** Ensure that total assets equal total liabilities plus shareholders' equity.
6. **Notes to Accounts:** Cross-reference any detailed information for asset, liability, or equity items in the notes to accounts.

### **Key General Instructions (Applicable to both)**

- **Compliance:** Follow the specific guidelines and formats provided by the applicable accounting standards and laws, such as Schedule III of the [Companies Act, 2013](#).
- **Consistency:** Maintain a consistent unit of measurement throughout the financial statements.
- **Comparatives:** Include corresponding amounts from the immediately preceding reporting period to provide a basis for comparison.
- **Balance:** Strike a balance between providing too much information and not providing enough, ensuring that all necessary information is disclosed without being excessive.
- **Cross-referencing:** Link every item on the face of the P&L and Balance Sheet to related information in the notes to accounts.

## VALUATION OF GOODWILL

### GOODWILL

Goodwill is valued when there are significant business events like sales, mergers, acquisitions, changes in partnership, or for financial reporting to reflect the intangible value of a company's reputation and customer relationships. This valuation is crucial for accurate accounting, ensuring fair compensation for partners in a firm, determining appropriate purchase prices for businesses, and performing impairment tests to prevent overstating assets.

#### Nature of Goodwill

- **Intangible:** It cannot be seen or touched but has a real economic value.
- **Indefinite Life:** Unlike other intangible assets, goodwill has an indefinite useful life.
- **Subjective Value:** Its value is often subjective, based on the value's judgment and the prevailing trade customs.
- **Dependent on Factors:** Its existence and value are tied to factors like effective management, good customer service, favourable location, and a positive brand image.

#### Key Reasons for Goodwill Valuation

- **Business Sales and Acquisitions:** When a business is sold or bought, a goodwill valuation helps determine the overall price, which includes the value of the company's reputation and future earning potential beyond its tangible assets.
- **Mergers and Acquisitions:** For a merger, goodwill valuation is necessary to understand the combined entity's value and to correctly record the intangible assets acquired.
- **Partnership Changes:** In a partnership, when a partner is admitted, retires, or changes the profit-sharing ratio, goodwill is valued to compensate the outgoing partner or the firm for the value of its established reputation and earning capacity.
- **Financial Reporting and Accounting:** Goodwill is an intangible asset that needs to be recorded on the balance sheet. Valuation ensures accurate financial statements and is necessary for impairment testing, which prevents the overstatement of asset values.
- **Taxation:** Proper goodwill valuation is required for calculating taxes during business transfers or restructurings.
- **Loan and Credit Facilities:** Financial institutions may consider the value of goodwill when providing loans or credit to a business, as it contributes to the overall value and stability of the firm.

## Methods of Valuation of Goodwill

The Three Methods of Valuing Goodwill have been discussed below:

1. **Average Profit Method of Calculating Goodwill**

The Average Profit Method is the simplest and widely used method for the valuation of Goodwill. The following factors are considered under this method:

- The abnormal profit of the year is subtracted from the net profit of that year.
- The abnormal loss of the year is added to the net profit of that year.
- Income not earned from the business operations, such as income from investments is deducted from the net profit of that year.

This method is further divided into **two** methods:

### **A. Simple Average Profit Method**

In this method, the number of past years' profits serves as the basis for the valuation of goodwill. The average of such profits is calculated by dividing the total of such profits by the number of years. Then, the average of the profits is multiplied by the agreed number of years of purchase to calculate the value of Goodwill.

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

**Value of Goodwill = Average Profit × Number of Years of purchase**

**Example of Simple Average Profit Method**

Calculate the value of the firm's goodwill on the basis of 2 years of the purchase of the average profit for the last three years.

2019- ₹80,000 (Including an Abnormal gain of ₹ 10,000)

2020- ₹1,00,000 (After charging Abnormal loss of ₹20,000)

2021- ₹90,000

**Solution:**

**Calculating Average Profit:**

Particulars	Amount (₹)	Amount (₹)
Profit for 2019	80,000	
Less: Abnormal gain	10,000	70,000
Profit for 2020	1,00,000	
Add: Abnormal loss	20,000	1,20,000
Profit for 2021	90,000	90,000
<b>Total Profit</b>		<b>2,80,000</b>

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

$$\text{Average Profit} = \frac{2,80,000}{3}$$

$$\text{Average Profit} = 93,334$$

**Calculating Value of Goodwill:**

**Value of Goodwill = Average Profit X Number of Years of purchase**

$$\text{Value of Goodwill} = 93,334 \times 2$$

$$\text{Value of Goodwill} = 1,86,668.$$

**B. Weighted Average Profit Method:**

The weighted Average Profit Method is a modified form of the Average Profit Method, under which each profit is assigned a weight. More weightage is assigned to the profits of the latest year to ensure the accuracy in the calculation of anticipated future profits and Goodwill. The weighted Average Profit Method is preferable when the profit over the past consecutive years shows a continuous rise or fall.

In this method following, **steps** are to be followed to calculate the value of the goodwill:

Step 1: Assigning weightage to the profits. The highest weight is assigned to the profit of the most recent year.

Step 2: Product of profits is calculated by multiplying the weight with the respective profit of that particular year.

Step 3: Weighted Average Profit is then calculated by dividing the Total of products of profits by the Total Weights.

**Weighted Average Profit = Total of products of profits ÷ Total Weights**

Step 4: The value of Goodwill is calculated by multiplying the Weighted Average Profit by the Number of years of purchase.

**Goodwill = Weighted Average Profit × Number of years of purchase**

*Example of Weighted Average Profit Method:*

*Calculate the value of Goodwill based on two years' purchase of the weighted average profit after assigning weights 1,2,3,4,5 and to the profits for 2018, 2019, 2020, 2021, and 2022, respectively from the following information:*

<b>Year (ended on 31st March)</b>	<b>Profit (₹)</b>
2018	21,500
2019	25,000
2020	26,000
2021	32,500
2022	42,500

**Solution:**

**Calculating Weighted Average Profit:**

Year	Profit (₹)	Weight	Product
2018	21,500	1	21,500
2019	25,000	2	50,000
2020	26,000	3	78,000
2021	32,500	4	1,30,000
2022	42,500	5	2,12,500
<b>Total</b>		<b>15</b>	<b>4,92,000</b>

$$\text{Weighted Average Profit} = \frac{\text{Total of Product of Profits}}{\text{Total Weights}}$$

$$\text{Weighted Average Profit} = \frac{4,92,000}{15}$$

$$\text{Weighted Average Profit} = ₹32,800$$

**Calculating Value of Goodwill:**

*Goodwill = Weighted Average Profit X Number of years of purchase*

$$\text{Goodwill} = 32,800 \times 2$$

$$\text{Goodwill} = ₹65,600$$

## 2. Super Profit Method of Calculating Goodwill

Under Super Profit Method, the value of a firm's goodwill is calculated on the basis of the Super Profit. **Super Profit** is the excess profit earned by a firm in comparison to the average profits earned by other firms in the same industry or trade. The firm has no goodwill if there is no anticipated Super Profit.

Steps to calculate the value of Goodwill under the Super Profit Method:

Step 1: Calculation of Actual Average Profit.

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

Step 2: Calculation of Normal Profit.

$$\text{Normal Profit} = \text{Capital Invested} \times \frac{\text{Normal Rate of Return}}{100}$$

Step 3: Calculation of Super Profit:

—

**Super Profit = Actual or Average Profit – Normal Profit**

Step 4: Calculation of Firm's Goodwill.

**Goodwill = Super Profit × Number of Years of Purchase**

***Example of Super Profit Method***

*Calculate the value of Goodwill on the basis of 2.5 years of purchases of average super-profits earned during the mentioned seven years. The Capital invested in the firm is ₹6,00,000, and the Normal rate of return in the same industry is 10%. The net profit for the last seven years are:*

<b>Year (ended on 31st March)</b>	<b>Profit (₹)</b>
2016	10,000
2017	(35,000)
2018	(20,000)
2019	1,25,000
2020	1,35,000
2021	1,50,000
2022	1,60,000

**Solution:**

**Calculating Actual Average Profit:**

Total of Profits = 10,000 + (35,000) + (20,000) + 1,25,000 + 1,35,000 + 1,50,000 + 1,60,000

Total of Profits = ₹5,25,000

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

Average Profit =  $\frac{5,25,000}{7}$

Average Profit = ₹75,000

**Calculation of Normal Profit:**

Normal Profit = Capital Invested  $\times \frac{\text{Normal Rate of Return}}{100}$

Normal Profit = 6,00,000  $\times \frac{10}{100}$

Normal Profit = ₹60,000

**Calculation of Super Profit:**

Super Profit = Actual or Average Profit – Normal Profit

Super Profit = 75,000 – 60,000

Super Profit = ₹15,000

**Calculation of Firm's Goodwill:**

Goodwill = Super Profit  $\times$  Number of Years of Purchase

Goodwill = 15,000  $\times$  2.5

Goodwill = ₹37,500

### 3. Capitalisation Method of Calculating Goodwill

Under the Capitalisation Method, the capitalised value of the firm's profit is determined to know the amount of capital required to earn the desired profit. The value of Goodwill can be calculated in **two** ways:

#### A. Capitalisation of Average Profit Method:

In this method, the capitalised value of the average profit is calculated on the basis of a normal rate of return. This helps in the assessment of the amount of capital needed for earning such an average profit.

In this method, following steps are to be followed to calculate the value of the goodwill:

**Step 1:** Calculation of Actual Average Profit.

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

**Step 2:** Calculation of Capitalised Value of the Average Profit.

$$\text{Capitalised Value of the Average Profit} = \text{Average Profit} \times \frac{100}{\text{Normal Rate of Return}}$$

**Step 3:** Calculation of Firm's Goodwill.

$$\text{Goodwill} = \text{Capitalised Value of the Average Profit} - \text{Capital Employed (Net Assets)}$$

here, **Capital Employed** (as on the date of Valuation of Goodwill) = **Assets – Liabilities**

#### **Example of Capitalisation of Average Profit Method:**

*From the following data, calculate goodwill according to the Capitalisation of Average Profit Method:*

*Average Profit: ₹36,000*

*Capital Employed (as on the date of Valuation of Goodwill): ₹2,85,000*

*Normal Rate of Return: 10%*

**Solution:**

**Calculation of Capitalised Value of the Average Profit:**

$$\frac{\text{Capitalised Value of the Average Profit}}{\text{Normal Rate of Return}} = \text{Average Profit} \times \frac{100}{10}$$

$$\text{Capitalised Value of the Average Profit} = 36,000 \times \frac{100}{10}$$

$$\text{Capitalised Value of the Average Profit} = ₹3,60,000$$

**Calculation of Firm's Goodwill:**

$$\text{Goodwill} = \text{Capitalised Value of the Average Profit} - \text{Net Assets}$$

$$\text{Goodwill} = 3,60,000 - 2,85,000$$

$$\text{Goodwill} = ₹ 75,000$$

### B. Capitalisation of Super Profit Method:

In this method, the capitalised value of the Super Profit is calculated on the basis of a normal rate of return for the assessment of the amount of capital needed for earning such a Super Profit.

In this method, following steps are to be followed to calculate the value of the goodwill:

**Step 1:** Calculation of the Super Profit.

$$\text{Super Profit} = \text{Actual or Average Profit} - \text{Normal Profit}$$

**Step 2:** Calculation of the Firm's Goodwill:

Under the Capitalisation of Super Profit Method, the Value of Goodwill is equal to the capitalised value of the Super Profit. Therefore,

$$\text{Goodwill} = \text{Super Profit} \times \frac{100}{\text{Normal Rate of Return}}$$

#### **Example of Capitalisation of Super Profit Method:**

Find out the value of Goodwill on the basis of the Capitalisation of Super Profit Method, when:

1. Profits for the last five years are:

Year (ended on 31st March)	Profit (₹)
2018	40,000
2019	50,000
2020	1,00,000
2021	75,000
2022	1,35,000

2. Capital Employed is ₹2,50,000.

3. Normal Rate of Return is 20%.

4. Average Profit is ₹80,000.

**Solution:**

**Calculating Super Profit:**

Normal Profit = 20% of Capital Employed i.e., 20% of 2,50,000 = ₹50,000

Super Profit = Average Profit – Normal Profit

Super Profit = 80,000 – 50,000

Super Profit = ₹30,000

### Calculation of Firm's Goodwill:

$$\text{Goodwill} = \text{Super Profit} \times \frac{100}{\text{Normal Rate of Return}}$$

$$\text{Goodwill} = 30,000 \times \frac{100}{20}$$

$$\text{Goodwill} = ₹1,50,000$$

## Journal Entries Related to Goodwill

When there is a change in Profit-Sharing Ratio, following entries are passed to make adjustments for the Goodwill:

### I. In the case of the Fixed Capital Method:

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
	Gaining Partner's Current A/c	Dr.	XXXX	
	To Sacrificing Partner's Current A/c			XXXX
	(Being the adjustment for the Goodwill made)			

### II. In the case of the Fluctuating Capital Method:

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
	Gaining Partner's Capital A/c	Dr.	XXXX	
	To Sacrificing Partner's Capital A/c			XXXX
	(Being the adjustment for the Goodwill made)			

## VALUATION OF SHARE

Share valuation is the process of determining a company's stock's fair value by analysing its financial health, growth prospects, and assets, often using methods like Discounted Cash Flow (DCF), dividend discount models, or relative valuation. The goal is to assess if a stock is overvalued, undervalued, or fairly priced to inform buy, sell, or hold decisions.

### Key Concepts

- **Fair Value:** The estimated intrinsic worth of a company's shares, representing what a reasonable buyer would pay today.
- **Intrinsic Value vs. Market Price:** Valuation helps determine a stock's intrinsic value, which may differ from its current market price (set by supply and demand), indicating if it's under or overvalued.

## Purpose of Valuation of Shares

The valuation of stocks helps investors make informed decisions by identifying opportunities and managing risk. Thus, the primary purpose of valuation is to provide a reliable and objective assessment of a stock's future price potential.

The several purposes of valuation can be listed as:

1. **Investment Decision-Making:** By decoding the true value of a stock, valuation helps investors determine whether it is a good buy or not.
2. **Mergers and Acquisitions (M&A):** Companies engage in valuation when considering mergers, acquisitions, or strategic partnerships. Accurate valuation helps in determining the fair price of the company and helps in negotiating favourable terms.
3. **Financial Reporting:** Valuation is a crucial part of financial reporting, i.e. assessment of balance sheet and income statement.
4. **Regulatory Compliance:** Valuation is often required to comply with regulatory requirements, such as financial reporting standards and tax regulations.
5. **Investor Relations:** Companies sometimes use valuation metrics to communicate their worth to potential investors or stakeholders, so as to attract investment decisions and capital.
6. **Risk Management:** Valuation helps businesses and investors manage risk by providing a clearer understanding of the value of assets and investments. It enables risk mitigation strategies.
7. **Litigation and Dispute Resolution:** Valuation serves a crucial part in legal proceedings involving determination of assets distribution.

## **Types of valuation of shares**

The key types of stock valuation can be classified as:

1. **Intrinsic Valuation:** Intrinsic Valuation focuses on determining the true, underlying value of a company's shares based on its financial fundamentals. The Discounted Cash Flow (DCF) method is a commonly used intrinsic valuation method. It involves estimating the present value of future cash flows and is particularly useful for long-term investors who want to assess a company's potential for generating future income.
2. **Market Valuation:** Market Valuation is also known as relative valuation. It is based on how the market perceives a company's value as compared to its peers. The Price-Earnings (P/E) ratio is a widely used market valuation metric. Investors often use P/E ratios to find out whether a stock is overvalued or undervalued as compared to its industry or the overall market.
3. **Market Capitalization:** Market Capitalization or market cap, is a straightforward valuation method that calculates the total value of a company's outstanding shares by multiplying the stock's current market price by the number of shares. It represents the company's total equity value as perceived by the market.
4. **Liquidation Valuation:** Liquidation Valuation is useful in situations where a company faces financial distress or is going out of business. It determines the value of the company's assets if they were sold off and its liabilities paid off. Shareholders receive the residual value if any after creditors are settled.
5. **Control Premium Valuation:** Control Premium Valuation is relevant when evaluating the value of a controlling stake in a company. It accounts for the premium that an investor may pay to acquire a significant influence or control over the company's operations and decision-making.

## **Methods of valuation of shares**

There are several methods to assess the worth of shares, each offering a unique perspective on a company's financial health and growth prospects. Let's delve into some commonly used methods of valuation below:

- **Discounted Cash Flow (DCF) analysis:** DCF method is a widely used intrinsic valuation technique. It involves estimating the present value of expected future cash flows generated by the company. DCF is used for its focus on cash flow projections and its ability to factor in the time value of money.
- **Price-Earnings (P/E) ratio:** The Price-Earnings (P/E) ratio is a prominent metric for assessing market valuation/ relative valuation of a stock. Investors often use the P/E ratio to gauge whether a stock is trading at a premium or discount compared to its earnings and industry averages.
- **Book Value Valuation:** As the name suggests, this valuation relies on a company's book value, which is the net value of its assets minus liabilities (net assets). Investors may consider buying stocks trading below their book value if they believe the assets are undervalued.
- **Comparable Company Analysis (CCA):** CCA involves comparing a target company's financial and operational metrics with those of similar publicly-traded companies. By analysing

multiples such as Price-Earnings, Price-to-Sales and [Price-to-Book ratios](#) of comparable firms, analysts can estimate the fair value of the target company's shares.

- **Precedent Transaction Analysis:** This method looks at past transactions involving similar companies to derive a valuation for the target company. By studying historical mergers, acquisitions or sales of comparable businesses, analysts can gain insights into market valuations and deal premiums.
- **Asset-Based Valuation:** Asset-based valuation assesses a company's worth by appraising its tangible and intangible assets. For industries with significant asset holdings, such as real estate or manufacturing, this method can be particularly relevant.

## AMALGAMATION OF COMPANIES

**Amalgamation** is the process of combining two or more companies into a single entity, resulting in the formation of a new company or the absorption of one company by another. It typically occurs when companies seek to consolidate their operations, enhance competitiveness, or achieve economies of scale. In amalgamation, all assets, liabilities, and business operations of the merging companies are transferred to the newly formed or existing company. The shareholders of the merging companies are generally compensated with shares in the new or surviving company. Amalgamation is governed by legal frameworks, such as the Companies Act in India, and can be classified as either a merger or a consolidation, depending on whether a new entity is created or an existing one expands.

### Characteristics of Amalgamation:

#### 1. Combination of Companies

Amalgamation involves the merging of two or more companies into a single entity. This combination can occur either by forming a new company or by one existing company taking over another. In either case, the merging entities cease to exist independently after the amalgamation is complete, and their assets, liabilities, and operations are transferred to the combined entity.

#### 2. Transfer of Assets and Liabilities

In an amalgamation, all assets and liabilities of the amalgamating companies are transferred to the new or surviving company. The transfer is comprehensive, including both tangible and intangible assets, as well as all liabilities. This ensures that the newly formed entity or the surviving company gains complete control over the resources and obligations of the amalgamating companies.

#### 3. Shareholder Compensation

Shareholders of the merging companies receive compensation in the form of shares in the new or surviving company. The ratio at which shares are exchanged is usually determined based on the valuation of the merging companies. Shareholders may also receive cash or other benefits as part of the arrangement. This compensation is crucial in ensuring that the interests of the shareholders are protected during the amalgamation.

#### 4. Legal Process

Amalgamation is a legal process that involves approval from regulatory authorities, courts, and shareholders. It is governed by laws such as the Companies Act in India. The legal procedure ensures transparency and protects the rights of all stakeholders involved, including creditors, employees, and shareholders.

#### 5. Economies of Scale

One of the primary objectives of amalgamation is to achieve economies of scale. By combining resources, operations, and expertise, the amalgamated entity can reduce costs, increase efficiency, and improve competitiveness in the market.

#### **6. Loss of Identity for Amalgamating Companies**

In an amalgamation, the identity of the merging companies is lost, as they either form a new company or are absorbed by an existing one. Their separate legal existence comes to an end, and they function as a single, unified entity moving forward.

#### **Objectives of Amalgamation:**

- **Achieving Economies of Scale**

One of the main objectives of amalgamation is to achieve economies of scale by combining the resources, operations, and production capacities of the merging companies. Larger-scale operations lead to cost savings, more efficient utilization of resources, better bargaining power, and improved profitability. The merged entity can produce goods or services at a lower cost per unit due to increased production levels.

- **Enhancing Market Competitiveness**

Amalgamation helps companies strengthen their competitive position in the market. By joining forces, companies can gain a larger market share, reduce competition, and enhance their brand presence. The merged entity may also diversify its product or service offerings, making it more resilient to market fluctuations and better equipped to cater to customer needs.

- **Expansion and Diversification**

Amalgamation facilitates business expansion and diversification, either by entering new geographical markets or expanding product lines. Through amalgamation, companies can diversify their risk by tapping into different markets, reducing dependency on a single product, service, or region. This expansion can lead to increased revenue streams and more stable earnings.

- **Financial Synergy**

Amalgamation creates financial synergy by pooling financial resources, improving access to capital, and enhancing creditworthiness. The combined entity may benefit from a stronger financial position, enabling better borrowing terms and increased investor confidence. It also allows for better utilization of financial resources, leading to higher returns on investment.

- **Tax Benefits**

In some cases, amalgamation is pursued to gain tax advantages. Companies may be able to carry forward and set off losses of one company against the profits of another, leading to lower tax liabilities. Additionally, certain tax exemptions and deductions may be available to the merged entity.

- **Eliminating Competition**

Amalgamation can be a strategic move to eliminate direct competition by merging with or acquiring a competitor. This reduces market rivalry, stabilizes prices, and improves market control for the merged entity.

## **Kinds of Amalgamation:**

### **1. Amalgamation in the Nature of Merger**

This type of amalgamation involves the blending of two or more companies where both companies combine on equal terms, and no significant alterations occur in the identity or ownership of the combined entity. The characteristics of this type of amalgamation:

- **Pooling of Interests:**

The assets and liabilities of the amalgamating companies are pooled together, and they continue at their existing book values.

- **Continuity of Business:**

The business of the amalgamating companies is carried on by the new or existing company without any major changes.

- **Shareholders' Continuity:**

The shareholders of the amalgamating companies become shareholders in the new or combined entity, retaining similar ownership stakes.

- **No Adjustments to Assets and Liabilities:**

There are usually no adjustments made to the assets and liabilities transferred, except for alignment with accounting standards.

This form of amalgamation is also known as a "genuine merger" and is typically pursued for business expansion, achieving economies of scale, or strengthening market position.

## **2. Amalgamation in the Nature of Purchase:**

In this type of amalgamation, one company acquires another, and the identity of the acquired company ceases to exist. The key characteristics are:

- **Acquisition:**

The acquiring company takes over the assets and liabilities of the acquired company.

- **Adjustments in Valuation:**

Assets and liabilities of the acquired company are revalued and recorded at fair market value or adjusted according to the acquirer's accounting policies.

- **Shareholders' Rights:**

The shareholders of the acquired company may receive compensation in the form of shares, cash, or a combination of both, but their stake in the new entity might differ from their previous ownership.

## **ACCOUNTING FOR INTERNAL RECONSTRUCTION AND EXTERNAL RECONSTRUCTION**

### **Internal Reconstruction**

In Internal Reconstruction, the internal financial structure of the company is reorganised without dissolving the company. Under this system, the internal shape of the company is altered by the alteration or reduction of its share capital. The existing company uses this type of reconstruction to change its financial structure without dissolving its operations. Moreover, it is especially preferable for companies with a large number of accumulated losses and overvalued assets. Therefore, in general words, internal reconstruction is a type of [corporate restructuring](#) wherein the company arranges the organisation by making deliberate changes in the assets and liabilities to improve its financial position without winding up the company or transferring it to a new company.

Henceforth, it can be said that the end objective of the internal reconstruction is to provide surplus through reducing the liabilities such as alteration in the share capital, variation of the rights and settlement of creditors. This surplus received through the arrangement can then be used to write off the accumulated losses and overvalued assets. This type of reconstruction will improve the final position of the company and protects the company from going into liquidation.

## Objectives of the Internal Reconstruction

1. Get rid of the fictitious assets of the company, such as discounts, preliminary expenses etc.
2. Increase the value of the assets by reducing the share capital of the company.
3. Present an accurate and fair picture of the financial position of the company.
4. Protects the company from going into liquidation.

## Methods of Internal Reconstruction

1. **Alteration of the share capital:** The Company can alter its shares by issuing new shares, converting the fully paid-up shares with stock, cancellation of unissued capital, converting the shares into smaller units etc.
2. **Variation of the rights of Shareholders:** The Company may vary the shareholders' rights when the share capital is divided into different classes.
3. **Reduction of the share Capital:** The Company may, by special resolution, reduce the share capital of a company and extinguish or reduce the liability on its shares. It may also cancel any paid-up share capital which is not presented by available assets.
4. **Surrender of Shares:** Under this method, the shareholders surrender their shares to the company, which in turn is allotted to the debenture holders and creditors to reduce the company's share capital.

## External Reconstruction

In External Reconstruction, the company goes into liquidation, and its affairs are transferred to a new company. In other words, it is a process wherein the affairs of the existing company are wound up and transferred to a new company through a scheme of arrangement. The existing company having a large number of accumulated losses and is on the verge of going bankrupt adopts this type of reconstruction by transferring its assets and liabilities to a new company. It is also imperative to mention that external reconstruction is not the same as amalgamation, as, under external reconstruction, the existing company goes into liquidation, and in amalgamation, there is a combination of one or more companies into a single entity.

Under this type of reconstruction, the existing company (transferor) continues to be part of the new company (transferee) and holds a substantial interest in it, as the shareholders transferred to the new company are almost the same.

## Features of External Reconstruction

1. Issuance of fresh shares of the new company through transfer.
2. Liquidation of the transferor company.
3. The transferee company undertakes to pay all the financial liabilities of the transferor company.
4. The transferee company agrees to buy the assets of the transferor company at an agreed value.



### DIFFERENCE BETWEEN INTERNAL & EXTERNAL RECONSTRUCTION

Basis	Internal Reconstruction	External Reconstruction
<b>Meaning</b>	Reconstruction that is undertaken by any entity in which significant changes are done in the company's capital structure without exercising the option of liquidation of the company	Reconstruction under which the company's financial statements are wound up & a new company is formed while the existing assets & liabilities are taken over by the new entity after the reorganization of the financial position.
<b>Methods</b>	Revaluation of assets, removing the fictitious assets, revising share capital, negotiate with third parties such as banks and creditors	Amalgamation and absorption
<b>Loss Treatment</b>	The losses incurred are settled against future profits	The previous losses could not be balanced out by the future profits of the new company
<b>Undertaken By</b>	Solvent companies or companies which have the potential to become profitable again	By companies without the potential to bounce back hence external reconstruction seems last option
<b>Capital</b>	Reduction in capital and external liabilities	No reduction in the capital