Directorate of Distance Education

UNIVERSITY OF JAMMU

JAMMU

SELF LEARNING MATERIAL

B.COM SEM. IV

ADVANCE CORPORATE ACCOUNTING **UNIT : I-IV**
COURSE CODE-BCG-401 **LESSON NO. : 1-12**

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ADVANCE CORPORATE ACCOUNTING

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UNIVERSITY OF JAMMU

B.COM. FOURTH SEMESTER

ADVANCE CORPORATE ACCOUNING

C.No. BCG 401	**Max Marks**	**=**	**100**
Time : 3 Hrs.	**Internal assessment**	**=**	**20**
	External exam.	**=**	**80**

OBJECTIVE: To acquaint the students with the concept and methods of corporate accounting.

UNIT -I: VALUATION OF GOODWILL

Valuation of goodwill-Meaning, need, factors affecting goodwill; Methods of valuation of goodwill;Computation of goodwill by simple and weighted average method, super profits method, capitalization method and annuity method.

UNIT -II: VALUATION OF SHARES

Meaning of shares, different types of shares, needs for valuation of shares, methods of valuation of shares. Computation of value of equity shares by net worth method/ net assets backing method, yield method & fair value method.

UNIT -III: LIQUIDATION OF THE COMPANIES

Meaning of liquidation, modes of liquidation; Concept of contributory; Various types of creditors, calculation of liquidator's remuneration; Preparation of statement of affairs as regards creditors and contributors; Liquidator's final statement of account.

UNIT-IV: ALTERATION OF SHARE CAPITAL & INTERNAL RECONSTRUCTION

Meaning of internal reconstruction; Procedure for reducing the share capital, scheme of internal reconstruction & various steps involved in the process of internal reconstruction; Journal entries to effect the scheme of reconstruction & balance sheet after reconstruction.

SKILL DEVELOPMENT (GUIDELINES FOR CLASS ROOM TEACHING AND INTERNAL ASSESSMENT)

❖ Clarify the reasons compelling a company to resort to internal reconstruction.

❖ Help the students in solving numerical problems relating the topics specified above.

❖ Create deep understanding of all concepts specified in the syllabus.

BOOKS RECOMMENDED

1. Jain & Narang	Corporate Accounting, Kalyani Publishers, New Delhi.
2 Gupta, R.L. and Swamy, Radha:	Advanced Company Accounts, Sultan Chand & Son, New Delhi
3 Maheshwari, S.N. :	Corporate Accountancy, Vikas Publishing House, New Delhi
4 Monga, J.R. Ahuja, :	Financial Accounting, Mayur Paper Books, Noida Girish and Sehgel Ashok
5 Shukia, M.C. Grewal:	Advanced Accounts, S. Chand and Co. New Delhi T.S. and Gupta SC
6 Moore, C.L. and Jaedicke, R.K.	Managerial Accounting, South Western Publishing Co., Cinnannati, Ohia
7 Tulsain, P.C	Corporate Accounting, S. Chand Publication, New Delhi.

NOTE FOR PAPER SETTER

Equal weightage shall be given to all the units of the syllabus. The external paper shall be of the two sections viz; A & B .

Section-A: This section will contain four short answer questions selecting one from each unit. Each question carries 5 marks. A candidate is required to attempt all the four questions. Total weightage to this section shall be 20 marks.

Section-B: This section will contain eight long answer questions of 15 marks each. Two questions with internal choice will be set from each unit . A candidate has to attempt any four questions selecting one from each unit. Total weightage to this section shall be 60 marks.

Note for paper setter: Atleast one numerical question from each unit.

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Valuation of Goodwill

STRUCTURE

1.1 INTRODUCTION AND MEANING OF GOODWILL

Goodwill of a business means reputation, popularity or image of the business in the market. Goodwill is the value of reputation of a firm in respect of the profits expected in future over and above the normal profits earned by other similar firms belonging to the same industry, Such excess of future profits over the normal profits is known as super profits. Thus goodwill exists only when the firm earns super profits. Any firm that earns only normal profits or is increasing losses has no goodwill. If time value of money is considered, goodwill can be defined as the present value of anticipated super profits.

Other Definitions:

1) According to SSAP-22, UK Accounting Standard on accounting for goodwill. "Goodwill is the difference between the value of a business as a whole and the aggregate of the fair values of its separable net assets". ***Separable net assets*** are those assets which can be identified and sold (or discharged) separate without necessarily disposing off the business as a whole.

2) "Goodwill is a thing very easy to describe , very difficult to define. It is the benefit and advantage of the good name, reputation and connection of a business. It is the attractive force which brings in customers. It is one thing which distinguishes an old established business from a new business at its first start….. Goodwill is composed of a variety of elements. It differs in its composition in different trades and in different businesses in the same trade. One element may preponderate here and another there."

———— ***Lard McNaughton in IRC vs. Muller (1901)***.

3) From the accountant's point of view, goodwill is said to be that element arising from reputation, connection or other advantages possessed by a business which enables it to earn greater profits than the return normally to be expected on the capital represented by net tangible assets employed in the business.

Following Characteristics of goodwill emerge from the above definition:-

a) It is an intangible asset having a definite value

b) It is enjoyed only by profitable firms

c) It helps in earning more profits

d) It is an attractive force which brings in the customers

e) It distinguishes an old and well established business from the new business

1.2 OBJECTIVES

After completion of this lesson you shall be able to know:

- Meaning, Types and Nature of Goodwill
- Need for Valuation of Goodwill
- Methods of Valuation of Goodwill
- Computation of Goodwill

1.3 TYPES OF GOODWILL

Goodwill is generally of two types:

(a) Purchased Goodwill: Purchased goodwill arises when a business concern is purchased and the purchase consideration paid exceeds the fair value of the separable net assets acquired. The purchased goodwill is shown on the assets side of the Balance sheet. Para 36 of AS-10 'Accounting for fixed assets' states that only purchased goodwill should be recognized in the books of accounts.

(b) Non-purchased or Inherent Goodwill: Inherent goodwill is the value of business in excess of the fair value of its separable net assets. It is referred to as internally generated goodwill and it arises over a period of time due to good reputation of a business. The value of goodwill may be positive or negative. Positive goodwill arises when the value of business as a whole is more than the fair value of its net assets. It is negative when the value of the business is less than the value of its net assets.

1.4 NATURE OF GOODWILL

Goodwill is regarded as an intangible asset and not a fictitious asset, but like other tangible assets it contributes to the profit earning capacity of the business. Goodwill is a valuable asset if the firm is earning profits and is a valueless asset if the firm is incurring losses.

However, in the periods of temporary recessions, the goodwill of the firm which is incurring least losses as compared to other similar firms, may be a valuable asset.

1.5 FEATURES OF GOODWILL

It is relevant to state the special features of goodwill, which are as under:

1) Goodwill is an unidentifiable intangible asset.

2) Goodwill of a business cannot be sold in a part or isolation. It is always sold with the business except admission and retirement of a partner.

3) Individual intangible factors which may contribute to goodwill cannot be valued.

4) The value of goodwill may fluctuate widely according to internal and external factors over relatively short periods of time.

5) The valuation of goodwill is subjective and not objective, because its valuation will differ from estimator to estimator.

6) The value of goodwill has no reliable or predictable relationship to any costs which may have been increased.

7) Goodwill of a business can be positive or negative in value. When the purchase consideration of a business is more than its net assets, there will be a positive goodwill. If purchase consideration is less than net assets, there will be negative goodwill which is also known as capital reserve.

8) Value of goodwill changes time to time with changes in the factors of production.

1. 6 FACTORS IN THE VALUATION OF GOODWILL

The customer's confidence in the partnership firm helps in originating the goodwill which in turn results in an extra ordinary increase in the profits of the firm. Thus, all the factors, which help a firm in earning profits, affect the goodwill of the firm. The following factors affect the goodwill of a firm:-

1. Favorable Location

If the firm is situated at a centrally feasible place that is a place which is easily accessible by the customers then it helps in increase of sale and economics in production. In that case the value of goodwill will be correspondingly higher

2. Efficiency of Management

If the firm is managed and controlled by the experienced, capable and efficient staff, its profits will go on increasing, which results in increasing the value of goodwill.

3. Time Period

If the business has been profitably carried out for several years, the value of its goodwill will be higher than the newly established business.

4. Possession of license

Running certain business requires license. If the partnership firm does not possess the necessary license it cannot run the business due to the licensing restrictions imposed by the governing authorities. In such a case if the business possesses the required license, goodwill will be correspondingly higher.

5. Personal Popularity

If the owners of the firm are honest, sincere, customer friendly, hardworking and socially conscious, the business will earn higher profits due to popularity.

6. Impressive publicity and advertisement

Effective and impressive publicity and advertisement by the firms helps in creating the demand for its products resulting to an increase in goodwill.

7. Good Quality of Products

If the firm enjoys the good reputation for the quality of its products, there will be ready sale leading to an increase in the goodwill. Similarly If a business produces goods of daily use, it will have steady profits as the demand for these goods will be regular and the business will have more goodwill.

8. Contacts

If the contact of the firm is with other reputed firms and business house or if the firm has received bulk orders from highly reputed firms, its goodwill will increase tremendously.

9. Relations:

If the firm has good and harmonious relations with its customers then it can increase the turnover resulting in increased profits which ultimately increases the goodwill.

10. Types of Businesses

If the firm has a monopoly in the trade or product the business will have excellent goodwill.

11. Types of Customers

Goodwill is also affected by the nature of customers. Types of customers can be classified in the nature of cat, dog and rat.

Cat is not intimated to the owner but to the place where she resides. She does not leave the premises when the owner changes the premises rather she is attracted to the place. Similarly, in some kind of businesses customers do not desire to move with the owner. In these types of businesses goodwill is related to the place where business activities are undertaken. So goodwill of the place where business activities are undertaken is high.

Dog is faithful and loyal to his owner that he always likes to go along with. Similarly, in some types of businesses or professions customers re always like to attract themselves with the owner as they have utmost faith on them like advocates or doctors etc in these types of professions goodwill can be affected with the change in ownership. So, goodwill of business in such cases is less than the earlier one.

However rat is not loyal to the owner and is not attached to any place. Similarly, in some types of businesses, customers are neither aware of the owner of the product nor they move to the same and particular place all the time. This highlights that such customers have the habit of buying anything from anywhere as they like. Hence the goodwill of such businesses is too low.

1.7 NEED FOR VALUATION OF GOODWILL

The need for valuating goodwill arises when there is a change in the form, structure, constitution or control of the business. If a business is sold and purchased or amalgamated or merged with other business or converted from one form to another etc need for valuation of goodwill arises.

However the goodwill is to be valued under the following cases:

1) ***In case of a joint stock company*****:** The valuation of goodwill may be required in the following cases:

a) When the business of a company is purchased by another company or when two companies of the same nature amalgamate.

b) When a company wants to acquire the controlling interest in another company.

c) When government takes over the business of another company.

d) When valuation of shares is done for taxation purposes- estate duty, gift tax etc., in case stock exchange quotation are not available.

e) When one class of shares is converted into another.

2) ***In case of partnership firm:*** Valuation of goodwill is required in the following cases:

a) When the existing partners have agreed to change the profit-sharing ratio.

b) When a partner retires or expires.

c) When the business is sold to a company.

d) When firm is dissolved or amalgamated with another firm.

3) ***In case of Sole proprietorship*****:** Valuation of goodwill is required in the following cases:

a) When business is sold.

b) When estate duty is levied at the time of death of the proprietor.

1.8 FACTORS AFFECTING GOODWILL/ FACTORS DETERMINING THE VALUE OF GOODWILL

Capacity to earn more profit over normal profits in future is the main factor in determining the value of goodwill of a business. But there are some other factors which affect the value of goodwill. Some important factors are given below:

(a) ***Nature of business***. This includes many things such as:

1 **Nature of goods:** If the business deals in articles of daily use (e.g., necessities of life) the demand for it is likely to be constant or stationary and thus fluctuations in profits are minimum. But if the business is dependent on popular taste (e.g., video games, music cassettes) or fashion or public fancy (e.g., jeans), the profits are subject to erratic fluctuations; it is also likely that profits will decline once the public fancy dies out. The more steady or stable profits, the more is goodwill, and vice versa.

2 **Risk involved:** The general rule is that the risk follows the profits, for greater the risks involved the higher the percentage of return: on capital But if "" the business is purely of speculative nature and consequently very risky, the goodwill will have very little value.

3 **Monopolized business:** If the past profits of a business are due to complete or near monopolistic nature of the business, the' value of goodwill would depend upon the fact whether the benefit of such trade monopoly is likely to continue. If the answer is 'yes' the goodwill is more because of assured future profits. Furthermore, it should also be enquired into whether the success of the business is likely to be affected by the new inventions (e.g., electronic goods) or by new rivals setting up in same line of trade.

4 **Trade name:** If the business entity possesses a trade name or trade mark for its products which is known not only in national markets hut also in international markets, it is an important factor in estimating the value of goodwill.

5 **Import license, etc.:** If the existing business is dependent upon the license and other clearances, it would be difficult for the new persons to enter the field. Thus the existing business enjoys the monopoly and earns the profits. But the duration of the license is an important factor in assessing the value of goodwill.

(b) ***Use of Capital*****:** The amount of capital used in the business will affect the value of its goodwill. If there are two business units which are earning the same profits but their capital employed is different, that business unit will enjoy more goodwill which utilizes the lesser amount of goodwill.

(c) ***Favorable location or site of the business*****:** A favourable location or site of business is sometime more important than all other factors put together. If the business is established in the main market of a city, the site of business will play an important role in assessing the value of goodwill.

(d) ***Access to supplies***: At present, as the things stand, there is all round shortage of almost every type of raw materials. Under these conditions, if a business enterprise has 'assured supplies' because it possesses the import licenses, it would be in a position to realize large amounts for their goodwill as long as import restrictions are 'likely to continue.

(e) ***Use of Patents and Trademarks*****:**. A firm possessing valuable patent rights for long term use will have valuable goodwill. And also when a business enterprise has built up good reputation for its products by means of a trade mark, e.g. Gagan for vegetable ghee and Liril for toilet soap. Furthermore, the value of the goodwill also goes up when the business enterprise has copyrights, say for publishing the works of renowned authors or old scripts.

(f) ***Exceptional contracts***: There is no doubt that exceptionally favourable contracts for the supply of goods or services to the customers are helpful in raising the value of goodwill. But if the contracts were obtained due to personal skill or other special circumstances and are not likely to recur, the value of goodwill will not be influenced by such existing contracts. Thus if special circumstances have helped in producing results which are not likely to recur, such profits will have to be eliminated in arriving at the average normal returns of the business.

(g) ***Future competition***: The likelihood or possibility of future competition either by the vendor of the goodwill himself or some other party would definitely reduce the value of goodwill. It is always necessary in the interest of the purchaser to see that the agreement for the sale of goodwill to him contains a clear declaration that the vendor is restrained from setting himself up in the same class of business. The more restrictive such an agreement is, the more valuable the goodwill of the business will be to the purchaser.

(h) ***Skill in Management*****:** In some business or professions, the personal skill of the owner in the management plays an important role, e.g., success of the firm of a chartered accountant depends upon the personal skill and ability of its owner. In these cases, goodwill of the firm will not be higher. If the success of the employees and its officials, there will be more value of goodwill.

(i) ***Government's industrial policy*****:** If the attitude of the government's industrial policy is to promote a specific line of trade or industry, such a favourable future prospect for industry increases the value of goodwill, i.e., Computer industry, Cement industry etc.

(j) ***Profit trends***: If the trend of profits of a business is steadily increasing, this will increase the value of goodwill. If the trend of profit is decreasing or has been stable in the previous years, the value of goodwill will decrease.

(k) ***Political protection*****:** If political protection is being provided to a business or is expected to be given in future , the value of goodwill of that business will be higher.

(l) ***Risk involved in business*****:** If there is greater risk in a business, the amount of goodwill will be less than those businesses in which risk is less.

(m) ***Know-how of the business*****:** Here, know how means the knowledge to solve a particular problem relating to production or marketing of the business. Generally, this knowledge is acquired through foreign collaboration, experience in the business, sound thinking or a systematic research etc. If the business unit obtains such a knowledge to face all its problems, its goodwill will be greater.

(n) *Long-term contracts*: If a business unit has favourable long-term contracts for the supply of raw materials or components or as regards sales, these will help in raising the value of goodwill. If these contracts are obtained due to the personal skill of the proprietor, the value to goodwill will not be affected by such existing contracts.

1.9. METHODS OF VALUATION OF GOODWILL

The following four methods are used for valuing the goodwill:

(i) Average Profit Method / Simple profit method

(ii) Super Profit Method.

(iii) Capitalisation Method

(iv) Annuity Method

1.9.1 Average Profit Method: Under this method, goodwill is calculated by multiplying the average future maintainable profit of last few years with a certain number of years (commonly known as number of years' purchase). In this method, there is an assumption that a new business will not be able to earn any amount of profit during the first few years of its operations. Therefore, a person who wants to acquire a running business has to pay in the form of goodwill, a sum equal to the average profits multiplied by a certain number of years during which he is likely to receive the profits multiplied by a certain number of years during which he is likely to receive the profits for the first few years. In this method the following two steps are involved:

(1) Calculation of Average Profits;

(2) Multiplication of Average Profits with the number of years' purchase.

Calculation of average profit or average future maintainable profit:

The purpose of calculating the average profits is to project the future profits which are likely to be earned in the coming years. And goodwill will be based on these profits.

Therefore, the years chosen for average profits should be normal years. For this purpose, necessary adjustments are made in the light of future possibilities. These are as under:

a) If there is any abnormal loss due to strikes, floods, fires, theft, damage, abnormal repair charges, lump sum compensation etc., in a particular year and that is not likely to occur in future, the same should be added back to past profits.

b) All operational expenses, including the interest on debentures, should be provided for and depreciation on fixed assets should be charged on the value arrived at as a result of the revaluation.

c) If non-trading investments are excluded from the capital employed, profit or loss derived from these investments should be excluded from the total earnings of the business enterprise.

d) If any capital receipt has already been adjusted in profits that must be subtracted from the earnings of the business enterprise.

e) If directors' or managers' remuneration or commission is not adjusted in the profits, the same must be subtracted from profits, In case of under or over-charge of this commission or remuneration, necessary adjustment should be made.

f) If the auditor has passed a comment regarding the inadequacy of provision for taxation, bad debts, gratuity or depreciation and improper valuation of stock, necessary adjustment should be made in the profits of these.

g) All necessary adjustments should be made for provision for liabilities.

h) From the past profits, the necessary income tax according to the relevant Financial Act must be deducted (profit after tax must be taken to calculate the average profit).

i) Results due to discontinuation of part of the business, expansion of business and any major change in policies of the business must also be adjusted in the profits.

j) If some developmental work has taken place whose results are expected to materialize in future, those should be adjusted in the profits.

k) Profits of past four or five normal years should be taken to calculate the average profits, because average profits are more reliable than a single year's profit. If there are cyclical fluctuations in a business, the number of years selected for average must be long enough so that recovery, peak and recession phases of the business cycle may be covered. In such a case the longer period will get closer to the average future maintainable earnings. If there is steady and gradual growth in a business, the average of a short period will be more useful.

l) According to the court's decision in the case of Clifford and Martin, any allowances for loss pf a director with exceptional quality and for future increase in taxation should not be considered at the time of calculating the average profits.

m) If the profits of a business unit are markedly falling or rising over the past four or five years, a simple average fails to project the future maintainable profits and then weighted average should be used to calculate the average profits. In such a case more importance (weight) is given to the recent year (latest years) and least importance (weight) is given to the first year. A simple method to calculate the weighted average is to multiply the profits by their respective number of years after arranging them chronologically in such manner, that most importance (weight) to the first year (the remotest year). For instance, if we consider the period 1995-2000, a period of 6 years, profit of the year 1995 will have the least weight i.e. 1 and the profit of the year 2000 will get the highest weight i.e. 6.

GOODWILL=AVERAGE PROFITS × NO. OF YEARS' PURCHASE

Merits of Average Profit Method

1) This method is simple and easy to understand and apply.

2) As the average profits are considered to find out the value of goodwill, there is the possibility that result will be satisfactory. Average profits are more reliable than one year's profit to know the future earning capacity.

3) Generally, this method is adopted when a partner retires or expires.

Demerits of Average Profit Method

1) Only profits are considered to ascertain the value of goodwill. No account is taken for capital employed while that is an important factor affecting the goodwill.

2) There is uncertainty regarding the number of years for finding out the average profits and number of years' purchase. Therefore, results arrived are far from satisfactory.

Illustration 1 (Calculation of Average profits)

The following information is available in respect of a business of Mr. Ramesh:

a) Profit-2002 Rs. 6, 00,000, 2003 Rs. 4, 80,000, 2004 Rs. 3, 80,000, 2005 Rs. 5, 30,000.

b) Profit for 2002 has been reduced by Rs. 70,000 being the loss of stock by fire.

c) Profit for 2003 includes Rs. 40,000 non-recurring income.

d) The goods were not insured but it is decided to go for insurance in future and insurance premium is expected to be Rs. 3000 p.a.

e) Profit for 2004 includes Rs. 10,000 being the income from non-trading investments.

f) Profit for 2005 includes Rs. 70,000 for a claim lodged in 1998 for which no entry was made then.

g) The reasonable amount of remuneration of the proprietor of the business id Rs. 50,000 p.a. This has not been considered in ascertaining the profits for the past years.

Calculate the future maintainable average profits:

Solution

	Rs.	Rs.
Profits of 2002.	6,00,000	
Add: Loss due to fire	70,000	6,70,000
Profit of 2003.	4,80,000	
Less: Non-recurring income	40,000	4,40,000
Profits of 2004.	3,80,000	
Less: Income from Non-trading Investments	10,000	3,70,000
Profit of 2005.	5,30,000	
Less: Income relating to 1998(claim lodged)	70,000	4,60,000
Total Profit of four years		19,40,000

Average Profits = $\frac{19,40,000}{4}$ = Rs. 4, 85,000

Less: Expected Expenses:

Insurance Premium 3000

Proprietor's remuneration 50000 53,000

4,32,000

Number of Years' Purchase: Average maintainable profits are multiplied by a certain number of years to determine the value of goodwill. The logic behind multiplication is that the purchaser has to pay the seller the profits of the business which the purchaser would derive from the business due to vendor's efforts. In other words, the purchaser compensates the vendor of goodwill for the few years' profit which the purchaser receives due to vendor's efforts. Generally, Average Profits are multiplied by two or three years. Whatever number of years is taken for finding out total profits for average profits, normally, their half is the number which should be used after approximating and would be used for multiplying the average profits. For example, if 5 years' profits are to be totaled up, half of 2 $\frac{1}{2}$ years, it is approximated to 3 years. Thus, average maintainable profits will be multiplied by 3 years to determine the value of goodwill.

Illustration 2 (Average Profit Method)

X, Y and Z are partners, sharing profits and losses in the ratio of 1:2:2. It is provided in partnership deed that, on the death or retirement of a partner goodwill should be calculated on the basis of three years' purchase of the average net profits for the preceding five years. Y retires on 31st December, 2005. Calculate the value of firm's goodwill. The net profits for the five years ended 31st December, 2005 were Rs. 2,70,000, Rs. 2,40,000, Rs. 1,20,000, Rs. 2,50,000, and Rs. 1,70,000 (Loss).

Solution	**Rs**
Calculation of Average Profits	
1st Year's Profit	2, 70,000
2nd Year's Profit	2, 40,000
3rd Year's Profit	1, 20,000
4th Year's Profit	2, 50,000
	8, 80,000
Less: 5th Year loss	1, 70,000
Total Profits of 5 years	7, 10,000

Average Profit = $\frac{7,10,000}{5}$ = Rs. 1, 42,000

Value of goodwill = Average Profits $\times$ No. of Years' Purchase

= Rs. 1, 42,0003

Firm's goodwill = Rs. 4, 26,000

Y's share of goodwill = 4, 26,000 = Rs. 1, 70,400

Illustration 3 (Weighted Average Profit Method)

P Ltd. Proposed to purchase the business carried on by Mr. C. Goodwill for this purpose is agreed to be valued at three years' purchase of the weighted average profits of the past four years. Weights and profits are as below:

Years	Weights	Profits (Rs.)
2001	1	1, 01,000
2002	2	1, 24,000
2003	3	1, 00,000
2004	4	1, 50,000

On scrutiny of the accounts, the following matters were revealed:

a) On 1st September, 2003 a major repair was made in respect of the plant Rs. 30,000 which amount was charged to revenue. The said sum is agreed to be capitalized for goodwill calculation, subject to adjustment of depreciation of 10% p.a. on reducing balance method.
b) The closing stock for the year 2002 was overhauled by Rs. 12,000

These profits are based on the last completed year's profit i.e.; Rs. 26,400, therefore, half year profit will be $\frac{\mathbf{26.400}}{\mathbf{2}}$ **= 13,200**

Rs. 24,000 – Rs. 13200 = Rs. 10,800

c) To cover management cost an annual charge of Rs. 24,000 should be made for the purpose of goodwill valuation. C prepares his accounts on 31st December each year.

Compute the value of goodwill of the firm.

Solution

Computation of Adjusted Profits	**Rs.**	**Rs.**
Profits – 2001		1, 01,000
Less: Annual charge for management cost		24,000
Adjusted Profit for the year 2001		77,000
Profits – 2002		1, 24,000
Less: Overvaluation of closing stock	12,000	
Annual charge for management cost	24,000	36,000
Adjusted profits for the year 2002		88,000
Profits – 2003		1, 00,000
Add: Overvaluation of opening stock (as closing Stock of previous year becomes opening stock of Current year)	12,000	
Major repair of plant (nature of capital expenditure)	30,000	42,000
Less: Depreciation Capital expenditure (major Repair @ 10% for 4 months September To December)	1,000	1, 42,000
Annual charge for management cost	24,000	25,000
Adjusted Profits for 2003.		1, 17,000
Profits – 2004		1, 50,000

Less: 10% depreciation on capital expenditure		
$\frac{30,000 - 1000}{100} \times 10 =$	2,900	
Annual charge for management cost	24,000	26,000
Adjusted profits for the year 2004		1, 23,100

Computation of Weighted Average Profits

Years	Adjusted Profits (Rs.)	Weights	Produces
2001	77,000	1	77,000
2002	88,000	2	1, 76,000
2003	1, 17,000	3	3, 51,000
2004	1, 23,100	4	4, 92,400
		10	10, 96,400

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

$$= \frac{10,96,400}{10} = \text{Rs. } 1,\ 09,640$$

Goodwill = Average Profit No. of years' purchase

= Rs. 1, 09,640 3 = Rs. 3, 28,920.

1.9.2. Super Profit Method

Under this method, goodwill is determined by multiplying the super profits by a certain number of years' purchase. Super profit means excess of the average profits which is earned by a business over normal profit, based on the normal rate of return for representative firm in the industry. Thus:

Super profit = Average Profit – Normal Profit

To calculate the value of goodwill under this method, the following three items are required:

1. Average Profits or future maintainable profits.

2. Normal rate of return.

3. Capital employed in the business.

1. *Average Profits or Future Maintainable Profits:* Average profits will show the future earnings of the business. These are based on the past profits. Generally 3 to 5 years' profits are considered to calculate the average profits. Before taking the past profits, all necessary adjustments should be done, taking into consideration future possibilities. Necessary adjustments means abnormal or extraordinary profits of past years of non-recurring nature should be deducted and abnormal or extraordinary losses should be added back to the past to the relevant past years' profit.

In the following two cases, weighted average is suggested in the place of simple average.

(i) For those businesses which are in existence only for a short period and its definite trend of profits is not visible.

(ii) Where there is a marked increase or decrease in the past profits of business.

2. *Normal Rate of Return or Profit:* Normal rate of return or profit is that rate which investors in general expect on their investments in a particular type of industry. In other words, that rate of earning which satisfies the investors is the normal rate of return. This normal rate of return differs from industry to industry. In examination problems, generally normal rate of return is given. In an extreme case, the normal rate of return or earning is not mentioned the student should assume the normal rate of return basing his judgment on merits of the case. At the time of assuming the normal rate of return the students should keep in mind the following points:

(i) Pure rate of return: That rate of return which one can earn by investing his funds without incurring any risk e.g., purchasing government securities.

(ii) *Rate of business risk:* If more risk is attached to an investment, there will be high rate of return. Risk depends on the nature of the business.

(iii) *Rte of financial risk:* That rate covers risks connected with the finance of a business connected.

(iv) *Rate of return:* The addition of the above three will be normal rate of return.

The normal rate of return of an industry is also affected by the bank rate, the period for which investment is made, risk attached to the investment and the general economic and political situation.

3. *Capital Employed:* For the purpose of valuation of goodwill, capital employed can be calculated by any one of the following two methods:

(i) Assets Side Approach: If we take the total of all assets, that is called gross capital employed. And net capital employed or capital employed means total of all assets minus current liabilities. In this approach to calculate the net capital employed or capital employed, all assets of the business are totaled excluding intangible assets as goodwill, useless patents, trademarks, non-trading investments, fictitious assets as preliminary expenses and discount on issue of shares or debentures etc. All the fixed assets of the business should be taken at their replacement cost. Similarly, all current liabilities should be taken at their current price. The entire procedure under assets side approach can be understood in the following steps:

Calculation of capital employed

All Tangible Assets (excluding Goodwill, useless Patents and Trademarks, Non-trading Investments Preliminary Expenses and Discount on Issue of Share and Debentures) at replacement cost.		××××
Less: All external liabilities at current cost		
Preference shares capital (if these are non-participating)	××××	××××
		××××

(ii) ***Liability Side Approach:*** Capital employed can also be calculated from the items of the liability side of the balance sheet by adding to share capital (paid up), all Profits, various Reserves, Profit on Revaluation of Fixed Assets and Liabilities and deducting there from Loss on Revaluation of Fixed Assets, Debit Balance of Profit and Loss Account shown in the Balance sheet, Fictitious Assets and Non-Trading Assets. Thus, the procedure can be summarized:

Calculation of Capital employed

Paid up share capital		××××
Add: Credit Balance of P&L Account		××××
Reserves		××××
Profit on Revaluation of Fixed Assets		××××
		××××
Less: Debit Balance of P&L A/c	××××	
Loss on Revaluation of Assets	××××	
Fictitious Assets	××××	
Non-Trading Assets	××××	××××
Capital Employed		××××

According to the views of some accountants, for the purpose of valuation of goodwill, the amount of debentures or loans should be subtracted from the total assets of the business, because profits are considered after interest on debentures or loans. In order to make the agreement between capital employed and profits, debentures and loans should be excluded.

Some accountants express the view that average capital employed should be used in the place of capital employed for the purpose of valuation of goodwill. If there are given the balance sheets of the previous years, on the basis of these balance sheets, capital employed will be calculated for every year and then average capital employed will be calculated. If the previous years' balance sheets are not available, average capital employed can be calculated by adding the capital in the beginning and capital at the end divided by 2. In another method, if half of the current year's loss after tax is subtracted from the capital at the end, or by adding the half of the current year's profit after tax to the capital at the beginning, average capital employed can be found.

Note: If the current year's profits are not clearly mentioned in the liability side of the balance sheet, in examination problems, students should presume capital employed as average capital employed and a note should be given that question is solved through capital employed.

Normal Profits: With the help of Normal Rate of Return and Average Capital employed, the normal profit can be ascertained.

Formula:

$$\textit{Normal Profits} = \frac{\textbf{Average Capital Employed} \times \textbf{Normal Rate of Return}}{\textbf{100}}$$

Valuation of Goodwill Based on Super Profit

There are two methods to calculate the value of goodwill based on super profit. These methods are as below:

(i) ***Purchase of super profit method:*** Under this method goodwill of a business will be:

   Goodwill = Super Profit   No. of years' Purchase

(ii) ***Valuation of goodwill according to the sliding-scale of super profit:*** Sliding-scale of super profit method was advocated by A.E Cutforth and it is based upon the theory that the greater the amount of super profit, the more difficult it is to maintain its uniformity over a long period. The logic behind this is that high super profit would attract more traders and thus it will shorten the period during which this high super profit would be earned. Therefore, Cutforth split the super profit into two or three slabs according to the nature of the business. Each of these slabs is multiplied by a different number of years' purchase in descending order from the first slab. Thus, total of the purchase of such slabs gives the value of the goodwill. This method should be applied only in those cases on a continuous where super profits are enormously high. Such super profits cannot be obtained on a continuous basis in the future.

For example: if super profits of a business are estimated at Rs. 90,000 they may be spited into three slabs as under:

First Rs. 20,000 of S.P. at 3 years' purchase	60,000
Second Rs. 30,000 of S.P. at 2 years' purchase	60,000
Third Rs. 40,000 of S.P. at 1 year's purchase	40,000
Total amount of goodwill on the basis of sliding scale of S.P. method	1, 60,000

Therefore, the procedure of calculating the value of goodwill under the super profit method is summarized as under:

(i) Goodwill = Super profit No. of years' Purchase

(ii) Super profit = Average Future Maintainable Profit Normal Profits

(iii) Normal profit = $\frac{\textit{Average Capital Employed}}{100} \times \textit{Normal Rate of return}$

(iv) Average Future Maintainable Profits = $\frac{\textit{Total of Adjusted Profits}}{\textit{No. of years}}$

(v) Average Capital Employed =

$$\frac{\textit{Capital employed in the beginning + Capital employed at end of the year}}{2}$$

Or

Capital employed in the beginning of the year + half of the current years' profit after tax

Or

Capital employed at the end of the year – Half of the current years' profit after tax

Illustration No. 4 (Super Profit Method)

The profit and loss for the year last years are 2002 profit-Rs. 20,000, 2003 Loss- Rs. 34000, 2004 Profit- Rs 1,00,000, 2005 profit- Rs 1, 50,000. The average capital employed in the business is Rs. 4, 00,000; the rate of interest expected from capital invested is 10%. The remuneration of partners is estimated to be Rs. 12000 p.a. Calculate the value of goodwill on the basis of 2 years' purchase of super profit based on the average of 3 years.

Solution

Calculation of Average Profits

	Rs.
2004 Profit	1, 00,000
2005 Profit	1, 50,000
	2, 50,000
Less: Loss 2003	34,000
Total Profits of 3 years	2, 16,000

Average Profits = $\frac{2,16,000}{3}$ = 72,000

Less: Partners remuneration = 12,000

1. Actual average profit 60,000

2. Normal profits = $\frac{(\textit{Average Capital Employed} \times \textit{Normal Rate of Return})}{100}$

= (4,00,000 ×10)/100 = Rs. 40,000

3. Super Profit = Actual Average Profit - Normal Profit

= Rs. 60,000 - Rs. 40,000

= Rs. 20,000

4. Goodwill = Super Profit × No. of years' Purchase

= Rs. 20,000 × 2

= Rs. 40,000

1.9.3. Annuity Method

When a purchaser acquires a business, he pays some amount for goodwill along with the amount for net assets of the business. At the time of purchase of business, the purchaser thinks that amount paid for goodwill would be recouped by him during the coming three or four years in the form of super profit, But super profits are made in future and he pays for the goodwill immediately upon purchase of business. For instance, the super profits of a business are Rs. 50,000 and the number of years of purchase is decided at 3. Then, value of goodwill will be Rs. 1, 50,000 as per super profit method. This value will be paid by the purchaser to the vendor immediately at the time of purchase of business and this amount will be reimbursed fully by the business to him in the form of super profit in the coming three years (or Rs. 50,000 per annum). But in this case he is not being fully reimbursed, because he paid Rs. 1, 50,000 immediately on the purchase of business and he is receiving Rs. 50,000 annually (in installments). Thus, the purchaser is suffering a loss of interest on Rs. 1, 50,000. Therefore, the amount of goodwill should be equal to the present value of future returns. For this purpose the super profits are discounted at the normal rate of return. This procedure is called the annuity method of super profit. The present value of Re. 1 paid annually can be determined with the help of Annuity Table or a formula.

Here, it should be noted that super profits of the business are not multiplied by the number of years' purchase.. But it is multiplied by the present value of Re. 1 paid annually at the normal rat e of return to calculate the value of goodwill.

Goodwill = Super Profit With Reference to Annuity Table

Generally, in examination problems, the present value is given to calculate the value of goodwill if, not given, can be calculated with the help of following formula:

$$A = 1 - \frac{\left(1 + \frac{r}{100}\right)^n}{\frac{r}{100}} \text{ or } \left(\frac{1 - \frac{1}{(1+i)^n}}{i}\right)$$

Where A = present value of Re. 1 paid annually

I or r = value of interest in percent

n = number of years.

To ascertain the value of goodwill, under this method, the present value of Re. 1 paid annually can be multiplied by the super profit or average profit. If average profit is multiplied by present value of Re. 1 paid annually, product will be the present value of the business. And to calculate the value of goodwill, capital employed is subtracted from this product.

Illustration No. 7 (Annuity Method of Super Profit)

From the following particulars, calculate the value of goodwill of XYZ as per annuity method:

a) Net Profit: 2003 Rs. 1, 05,000, 2004 Rs. 97,000 & 2005 Rs. 1, 08,000.

b) The average capital employed in the business is Rs. 5, 00,000.

c) Return expected from invested capital having regard to risk involved is 10%.

d) An amount of Rs. 900 is included in the profits of 2004, which has been recovered from a debtor whose account had been written as bad several years before.

e) Remuneration of Rs. 10,000 p.a. to the proprietors is considered reasonable.

f) It is expected that super profit can be maintained for the next five years.

g) Present value of an annuity of one rupee for 5 years at 10% is Rs. 3.78.

Solution

Valuation of Goodwill by Annuity Method

	Rs.	Rs.
(A) Adjusted Average Profits:		
Net Profits 2003		1, 05,000
Net Profits 2004	97,000	
Less: Bad debts recovered	900	96,100
Net Profit 2005		1, 08,000
Total Profits of 3 years		3, 09,100
Average Profits = $\frac{(Rs.3,09,100)}{3}$		1, 03,033
Less: Proprietors' remuneration		10,000
Adjusted Average Profits		93,033

(B) Normal Profits

$$= \frac{\text{Average Capital Employed} \times \text{Normal Rate of Return}}{100}$$

$$= \frac{\text{Rs. } 5,00,000 \times 10}{100} = \text{Rs. } 50,000$$

(C) Super Profits:

	Rs.
Adjusted Average Profits	93,033
Less: Normal Profits	50,000
Super Profits	43,033

(D) Goodwill:

Present Value of an annuity of Re. 1 for 5 years at 10% is 3.78

Goodwill = Rs. 43,033 $\times$ 3.78

= Rs. 1, 62,665

1.9.4. Capitalization Method

Under this method goodwill is valued by capitalizing the future maintainable profits (average profits) applying the normal rate of return. In capitalization method it is estimated that much amount of capital will be needed for earning a definite amount of profit at the normal rate of return. There are two methods to find out the value of goodwill:

a) Capitalization of Super Profit Method

b) Capitalization of Future Maintainable Profits (Average Profit) Method

a) Capitalization of Super Profit: In this method, it is attempted to assess the capital required to earn the amount of super profit. The capitalized value of super profit (excess of future maintainable profits over normal profit on capital employed) is called goodwill. To ascertain the value of goodwill under this method, Super Profit of the business and Normal Rate of Return are required and then the following formula is used.

Goodwill as per Capitalization Method = $\frac{Super\ Profit \times 100}{Normal\ Rate\ of\ Return}$

b) Capitalization of Future Maintainable Profits (Average Profit) Method or Capitalization Method: Under this method, goodwill is determined by deducting the actual capital employed in the business from the capitalized value of future maintainable profits (adjusted average profits) applying the normal rate of return. To ascertain the value of goodwill under this method, the following steps are adopted:

(i) Compute the Future Maintainable Profits (average profits) as per the method explained in Average Profit Method earlier.

(ii) Compute the capitalized value of these Future Maintainable Profits (average profits) apply in the following formula

$$= \frac{Future\ Maintainable\ Profits\ (Average\ Profits)}{Normal\ Rate\ of\ Return} \times 100$$

(iii) Compute the Actual Capital Employed in the Business (Net Assets of the business) according to the method explained in the super profit method earlier:

(iv) Compute the value of goodwill as under:

Goodwill = Capitalized Value of Future Maintainable Profits – Actual Capital Employed

Value of goodwill be equal to the goodwill computed in capitalization of super profit.

Illustration No. 5 (Capitalization of Super Profit)

The balance sheet of Arvind Mills Ltd. As on 31st December, 2005 is as under:

Liabilities	Rs.	Assets	Rs.
Share Capital:		Goodwill at cost	2,25,000
22,500 Equity Shares of Rs. 100 each	22,50,000	Land and Building	4,95,000
Profit and Loss Account	3,09,000	Plant	9,01,500
Loans	6,00,000	Stock-in-trade	12,50,000
Creditors	3,75,000	Book Debts & Less Reserve	8,62,500
Provision for Tax	3,00,000	Cash at Bank	1,00,000
	38,34,000		38,34,000

The profits of the company since the commencement of the business were:

2001 Rs. 5, 40,000, 2002 Rs. 5, 70,000, 2003 Rs. 6, 40,000 and 2005 Rs. 7, 00,000. Dividends were paid at 10% in 2002, 2002, and 2003, while for 2004 and 2005 the rate was 15%. Calculate the goodwill assuming the rate of tax 50% and the value of the plant 10, 57,000. Use capitalization method based on super profit.

Solution

Valuation of Goodwill of Arvind Mills Ltd.

(A) Capital Employed

	Rs.	**Rs.**
Land and Buildings		4, 95,000
Plant		10, 57,000
Stock-in-trade		12, 50,000
Book Debts & Less Reserve		8, 62,000
Cash		1, 00,000
		37, 64000
Less: Sundry Liabilities		
Loans	6, 00,000	
Creditors	3, 75,000	
Provision for Tax	3, 00,000	12, 75,000
Capital Employed at the end of the year		24, 89,500

(B) Normal Rate of Return (assumed average rate of dividend)

$= \frac{10+10+10+15+15}{5} = \frac{60}{5} = 12\%$

(C) Normal Profits on Capital Employed

$= \frac{Capital\ Employed \times Normal\ Rate\ of\ Return}{100}$

$=$ Rs. $\frac{24,89,500 \times 12}{100}$ = Rs. 2, 98,740

(D) Future Maintainable Profits

$= \frac{Rs.5,40,000 + Rs.5,70,000 + Rs.6,00,000 + Rs.6,40,000 + Rs.7,00,000}{5}$

$= \frac{Rs.30,50,000}{5}$ = Rs. 6, 10,000 – 50% tax

= Rs. 3, 05,000

(E) Super Profits

Future Maintainable Profits	Rs. 3, 05,000
Less: Normal Profits	Rs. 2, 98,740
Super profit	Rs. 6,260

Goodwill = Rs. $\frac{6,260 \times 100}{12}$ = Rs. 52,167.

Illustration No. 6 (Capitalization of Future Maintainable Profits)

The balance sheet of Mr. A on 31st December, 2005 was as under:

Liabilities	Rs.	Assets	Rs.
Capital	2,50,000	Land and Buildings	1,80,000
Creditors	80,000	Machinery	1,10,000
Bills Payable	20,000	Furniture	2,000
		Stock	8,000
		Cash at Bank	50,000
	3,50,000		3,50,000

The profits of the business for the five years ending 31st December 2005 are:

1st year – Rs. 40,000

2nd year – Rs. 42,000

3rd year – Rs. 45,000

4th year – Rs. 50,000

5th year – Rs.53, 000

The assets were revalued as under:

Land and Building Rs. 1, 94,000, Machinery Rs. 1, 18,000 and Furniture Rs. 1,000.

No remuneration was charged by A though he was actively engaged in the business.

Find out goodwill by Capitalization Method after assuming the rate of normal return.

Solution:

Valuation of Goodwill of the Business of Mr. A

(A) Capital Employed:

	Rs.	Rs.
Land and Buildings at current price		1, 94,000
Machinery at current price		1, 18,000
Furniture at current price		1,000
Stock		8,000
Cash at Bank		50,000
		3, 71,000
Less: Sundry Liabilities		
Creditors	80,000	
Bills Payable	20,000	1, 00,000
Capital Employed at the end of the year		2, 71,000

(B) Future Maintainable Profits:

Average Profits $= \frac{Rs.40{,}000 + Rs.42000 + Rs.45000 + Rs.50{,}000 + Rs.53000}{5}$

$= \frac{2{,}30{,}000}{5} =$ Rs. 46,000

Less: Remuneration of A (assumed) 10,000

Future Maintainable Profits 36,000

(C) Capitalized Value of Future Maintainable Profits at the normal rate of 10%(assumed)

$= \frac{Rs.36000 \times 100}{10} =$ Rs. 3, 60, 000

(D) Goodwill under Capitalization Method:

Capitalized value of Future Maintainable Profits	Rs. 3, 60,000
Less: Capital Employed	Rs. 2, 71,000
Goodwill	Rs. 89,000

1.10. SUMMARY

Goodwill consists of the advantages a business has in connection with its customers, employees and outside parties with whom it has to contact. Goodwill is sometimes described as a 'momentum or a push'. Goodwill is valuable only if it is capable of being transferred from one person to another. The value of goodwill is based on subjective judgment of the valuer.

1.11. IN-TEXT ACTIVITY

A. Short Questions

a) What is Goodwill?

b) When does super profit arise in the business?

c) Explain the super profit method to compute the value of goodwill.

d) Explain the nature of goodwill.

e) "Goodwill is an intangible asset." Explain this statement.

f) How id goodwill computed on average profit method? Explain.

g) When does the valuation of goodwill need arise? Explain.

B. Long Questions

1. Define goodwill. Explain the various methods of valuation of goodwill.

2. Write short notes on the valuation of goodwill.

3. Define goodwill. Is it real or fictitious? Describe the factors on which it is based and discuss the various methods of its valuation.

4. What is the importance of goodwill? What factors should be kept in mind at the time of valuation of goodwill?

5. Describe the concept of goodwill and explain the various methods of its valuation.

6. What are accounting characteristics of goodwill? Explain capitalization of profit method with the help of an imaginary illustration.

7. Explain the following terms:

   a) Super Profit.

   b) Future Maintainable Profit.

   c) Annuity Method of Super Profit.

   d) Capitalization of maintainable Profits.

C. Practical Questions

(A) Average Profit Method

1. XYZ Co. Ltd. Decided to purchase the business of ABC Co. for Rs. 2, 00,000 on 1st January 2006. Its profits for the last four years are as under:

   2002- Rs. 50,000, 2003- Rs. 62,500, 2004- Rs. 60,000 and 2005- Rs. 57,500.

   The business was looked after by the owner, the remuneration from alternative employment if not engaged in the business, for the owner, comes to Rs. 7,500 p.a. Find out the amount of goodwill if it is valued on the basis of three years' purchase of the average net profit of the last four years.

Ans: Average Profit Rs. 50,000, Goodwill Rs. 1, 50,000.

(B) Super Profit Method

2. From the following information, calculate the value of goodwill taking three years' purchase of super profit:

   a) Average capital employed Rs. 9,00,000

   b) Net trading profits for the preceding three years were: Rs 1,61,400, Rs. 1,36,050, Rs. 1,68,750.

   c) Expected return on capital invested in the same type of business is 12%.

   d) Fair remuneration to the proprietor for his service is Rs. 18,000.

   e) Total assets Rs. 9, 84,000 and current liabilities Rs. 45,000.

   Ans: Rs. 29,400 Super Profit, Rs. 88,200 Goodwill.

(C) Capitalization Method

3. The Balance Sheet of Mr. Ankur as on 31st December, 2005 was as under:

Liabilities	Rs	Assets	Rs.
Capital	5,00,000	Land and Buildings	3,60,000
Creditors	1,60,000	Machinery	20,000
B/P	40,000	Furniture	4,000
		Investments	2,00,000
		Stock	16,000
		Cash and Bank Balance	1,00,000
	7,00,000		7,00,000

The annual profits for the last five years ending 31st December, 2005 were as follows:

Year	**Rs.**
2001	80,000
2002	84,000
2003	90,000
2004	1, 00,000
2005	1, 06,000

The revaluation of the assets revealed the following values:

		Rs.
Land and Building	:	3, 80,000
Machinery	:	16,000
Furniture	:	3,000

The remuneration was not paid to Mr. Ankur, although he worked actively in the business. Assuming that the normal rate of return is 10% and Mr. Ankur's remuneration is Rs. 12,000 p.a. Find out the value of the goodwill by the capitalization method.

Ans: Capital Employed Rs. 5, 15,000,

Average Profits Rs. 80,000,

Goodwill Rs. 2, 85,000.

(D) Annuity Method

4. From the following particulars, compute the value of goodwill by annuity method-

(i) Average capital employed Rs. 6, 25,000.

(ii) Normal rate of return 10%.

(iii) Profit of the previous three years is Rs. 88,500, Rs. 72,000 and Rs. 85,000.

(iv) Profits of Rs. 72,000 have been arrived at after writing off abnormal loss of Rs. 3,000 and profit of Rs. 85,000 includes a non recurring income Rs. 3,750.

(v) Goodwill is to be estimated on the basis of three years' purchase of super profit.

Ans: Average Profits Rs. 81,583.3, Super Profit Rs. 19,083.3, Goodwill Rs. 47,456.43.

1.12. REFERENCES

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C. No. :- BCG-401 UNIT II

SEMESTER: IV LESSON: 4-6

VALUATION OF SHARES

STRUCTURE

2.1 INTRODUCTION

Generally shares quotes on a recognised stock exchange prices are taken as the basis for the valuation of those shares. However, the stock exchange quotation are not acceptable when a large block of company's shares is involved. Actually the exchange price it determines on the interactions of demand and supply of business cycles. In this regard, the council of the London stock exchange has also passed the following remark.

"The stock exchange may be linked to a scientific recording instrument which registers, not its own actions and opinions but the actions and opinions of private institutional investors all over the country and indeed the world. These actions and opinions are result of fear, guess work, intelligent or otherwise, good or bad investment policy and many other considerations. The quotations that result definitely do not represent valuation of a company by reference to its assets and its earning potential".

In practice stock exchange quotations are not form a fair and equitable or rational basis for compensation. Therefore accountants of business houses are frequently required to place a proper value on the shares in a company.

The shares of joint stock company quoted on the stock exchange have a value different from the face value. The shares of private companies are not freely purchased and sold to the public. Only the share of public limited companies are freely transferable and hence their valuation is absolutely necessary.

The valuation of shares may be done by an accountant for two reasons:

(i) Where there is no market price as in the case of a proprietary company.

(ii) Where for special reasons, the market price does not reflect the true of intrinsic value of the shares.

The problem does not arise if the shares are quoted on the stock exchange as it provides a ready means of ascertaining the value placed on such shares by the buyers and sellers.

2.2 OBJECTIVES

After completion of this lesson you shall be able to:

- Understand meaning and different types of shares
- Explain the needs and methods of valuation of shares
- Know computation of values of equity shares
- Explain Net Worth Method/ Net Assets Backing Method
- Understand Yield Basis Method of valuation of shares
- Focus on Profit Basis and Dividend Basis for calculation of yield.
- Discuss the Fair value method of valuation of shares

2.3 MEANING OF SHARES

The capital of a company is usually divided into certain indivisible units of a fixed amount. These units are called shares. Share means share in the capital of a company. It includes stock except where a distinction between stock and share is expressed or implied. In other words, a share is the interest of a shareholder in a definite portion of the capital. It expresses a proprietary relationship between the company and the shareholder. A shareholder is the proportionate owner of the company but he does not own the company's assets which belong to the company as a separate legal entity.

According to Section 2 (46) of the Companies Act, 1956 defines "Share" means a share in the share capital of a company, and includes stock except where a distinction stock and shares is expressed or implied.

According to Section 44 of the Company Act, 2013, the shares of any member in a company shall be movable property. It is transferable in the manner provided by the articles of the company.

Definition:

According to Farwell J., "A share is the interest of a shareholder in the company, measured by a sum of money, for the purpose of liability in the first place, and of interest the second, but also consisting of a series of mutual covenants entered into by all the shareholder inter se in accordance with the companies act". Thus a share

i) Measures the right of a shareholder to receive a certain proportion of the profits of the company while it is a going concern and to contribute to the assets of the company when it is being wound up; and

ii) Forms the basis of the mutual covenants contained in the articles binding the shareholders inter se.

A share is a personal estate capable of being transferred in the manner laid down in the articles of association. It is a movable property which can either be mortgaged or pledged. Share is included in the definition of 'good' under the provisions of the sale of goods act, 1930. A share is evidenced by a share certificate which is issued by a company under the common seal. It specifies the number of shares held by each member. The share certificate is not a negotiable instrument.

The person who is the owner of the shares is called 'Shareholder' and the return he gets on his investment is called 'Dividend'.

Example: Total capital of a company is? 5, 00,000 divided in to 50,000 shares of Rs. 10 each, each unit of Rs. 10 is called share. In this case there are 50,000 unit i.e. shares of Rs. 10 each and the capital is Rs. 5, 00,000.

Share capital of a company is classified into following categories:

Authorised share capital	The maximum amount of capital which a Company is authorized to raise by the issue of shares is known as authorized capital. It is the capital with which a Company is registered. Therefore, it is also known as 'registered capital' or 'nominal capital'. It is shown in the Balance Sheet at face value.
Issued share capital	Issued capital is that part of the authorized capital which is offered for subscription. Issued capital also includes: ▪ Shares issued to subscribers of the Memorandun ▪ Shares issued for consideration other than cash and ▪ Shares allotted as bonus shares Issued share capital is shown in the Balance Sheet at face value.
Subscribed share capital	Subscribed capital is that part of the issued share capital which is subscribed by the public. It also includes the face value of shares that are issued for consideration other than cash.
Called-up share capital	It is that part of the subscribed capital, which is called by the Company to pay on the shares allotted. It is not necessary for the Company to call for the entire amount of the shares subscribed for by shareholders. The amount which is not called on the subscribed shares is called uncalled capital.
Paid-up share capital	It is that part of the called-up capital, which is actually paid by the shareholders. Therefore, it is known as the real capital of the Company. Whenever a particular amount is called and a shareholder fails to pay the amount fully or partially, such an amount is known as unpaid calls or calls-in-arrears.
Reserve share capital	It is that part of the uncalled capital which has been reserved by the Company, by passing a special resolution, to be called only in the event of its liquidation. Reserve capital cannot be called up during the existence of the Company. It would be available only in the event of liquidation as an additional security to the creditors of the Company.

2.4 DIFFERENT TYPES OF SHARES

According to Section 86 of the Companies Act, a company can issue only two types of shares viz:

(a) Preference and

(b) Equity

(a) Preference Shares: The law defines preference share capital as that part of the share capital of a company which fulfils both the following conditions namely:

(i) It carries a preferential right in respect of the dividends;

(ii) It carries preferential right in regard to the repayment of capital.

The preference shareholders are entitled to receive the fixed rate of dividend out of the net profits of the company. After the payment of dividends at fixed rate is made to them, the balance can be used for declaring a dividend on ordinary shares. Similarly, the assets remaining after payments of debts of the company are first used for returning the capital contributed by the preference shareholders. The rate of dividend on preference shares is specified in the articles of association.

The limitation of the preference shares is that it does not carry voting rights. Preference shareholders have no voting rights except on those issues which affect their interests such as non-payment of dividends for more than two years.

(b) Equity Shares: Equity shares are those shares which are not preference shares. These shares do not enjoy any preferential rights. They rank after the preference shares for the purpose of dividend payment and repayment of capital. The rate of dividend is also generally not fixed and may vary from year depending upon the profit of the company. This rate of dividend is recommended by the directors of the company. They are the real owners of the company. They have voting rights in the management of the company.

Classes of Preference Shares

Some of the most important types of preference shares of a company are as follows:

(i) Cumulative preference shares: A preference share is said to be cumulative when the arrears of dividend are cumulative and such arrears are paid before paying any dividend to equity shareholders. Suppose a company has 10,000 8% preference shares of Rs. 100 each. The dividends for 1987 and 1988 have not been paid so far. The directors before they can pay the dividend to equity shareholders for the year 1989, must pay the pref.

dividends of Rs. 2, 40,000 i.e. for the year 1987, 1988 and 1989 before making any payment of dividend to equity shareholders for the year 1989.

(ii) Non-cumulative preference shares: In the case of non-cumulative preference shares, the dividend is only payable out of the net profits of each year. If there are no profits in any year, the arrears of dividend cannot be claimed in the subsequent years. If the dividend on the preference shares is not paid by the company during a particular year, it lapses. Preference shares are presumed to be cumulative unless expressly described as non-cumulative.

(iii) Participating preference shares: Participating preference shares are those shares which are entitled in addition to preference dividend at a fixed rate, to participate in the balance of profits with equity shareholders after they get a fixed rate of dividend on their shares. The participating preference shares may also have the right to share in the surplus assets of the company on its winding up. Such a right may be expressly provided in the memorandum or articles of association of the company.

(iv) Non-participating preference shares: Non- participating preference shares are entitled only to a fixed rate of dividend and do not share in the surplus profits. The preference shares are presumed to be non-participating, unless expressly provided in the memorandum or the articles or the terms of issue.

(v) Convertible preference shares: Convertible preference shares are those shares which can be converted into equity shares within a certain period.

(vi) Non-Convertible preference shares: These are those shares which do not carry the right of conversion into equity shares.

(vii) Redeemable preference shares: A company limited by shares, may if so authorized by its articles issue preference shares which are redeemable as per the provisions laid down in Section 80. Shares may be redeemed either after a fixed period or earlier at the option of the company.

(viii) Guaranteed preference shares: These shares carry the right of a fixed dividend even if the company makes no or insufficient profits.

Advantages of Preference Shares

The advantages of preference shares are as follows:

(A) Advantages from Company point of view:

The company has the following advantages by issue of preference shares.

I. Fixed Return: The dividend payable on preference shares is fixed that is usually lower than that payable on equity shares. Thus they help the company in maximizing the profits available for dividend to equity shareholders.

II. No Voting Right: Preference shareholders have no voting right on matters not directly affecting their right hence promoters or management can retain control over the affairs of the company.

III. Flexibility in Capital Structure: The company can maintain flexibility in its capital structure by issuing redeemable preference shares as they can be redeemed under terms of issue.

IV. No Burden on Finance: Issue of preference shares does not prove a burden on the finance of the company because dividends are paid only if profits are available otherwise no dividend.

V. No Charge on Assets: No-payment of dividend on preference shares does not create a charge on the assets of the company as is in the case of debentures.

VI. Widens Capital Market: The issue of preference shares widens the scope of capital market as they provide the safety to the investors as well as a fixed rate of return. If company does not issue preference shares, it will not be able to attract the capital from such moderate type of investors.

(B) Advantages from Investors Point of View:

Investors in preference shares have the following advantages:

I. Regular Fixed Income: Investors in cumulative preference shares get a fixed rate of dividend on preference share regularly even if there is no profit. Arrears of dividend, if any, is paid in the year's of profits.

II. Preferential Rights: Preference shares carry preferential right as regard to payment of dividend and preferential as regards repayment of capital in case of winding up of company. Thus they enjoy the minimum risk.

III. Voting Right for Safety of Interest: Preference shareholders are given voting rights in matters directly affecting their interest. It means, their interest is safeguarded.

IV. Lesser Capital Losses: As the preference shareholders enjoy the preferential right of repayment of their capital in case of winding up of company, it saves them from capital losses.

V. Fair Security: Preference share are fair securities for the shareholders during depression periods when the profits of the company are down.

Disadvantages of Preference Shares

The important disadvantages of the issue of preference shares are as below:

(A) Demerits for Companies:

The following disadvantages to the issuing company are associated with the issue of preference shares.

I. Higher Rate of Dividend: Company is to pay higher dividend on these shares than the prevailing rate of interest on debentures of bonds. Thus, it usually increases the cost of capital for the company.

II. Financial Burden: Most of the preference shares are issued cumulative which means that all the arrears of preference dividend must be paid before anything can be paid to equity shareholders. The company is under an obligation to pay dividend on such shares. It thus, reduces the profits for equity shareholders.

III. Dilution of Claim over Assets: The issue of preference shares involves dilution of equity shareholders claim over the assets of the company because preference shareholders have the preferential right on the assets of the company in case of winding up.

IV. Adverse Effect on Credit-Worthiness: The credit worthiness of the company is seriously affected by the issue of preference shares. The creditors may anticipate that the continuance of dividend on preference shares and suspension of dividend on equity capital may deprive them of the chance of getting back their principal in full in the event of dissolution of the company, because preference capital has the preference right over the assets of the company.

V. Tax Disadvantage: The taxable income is not reduced by the amount of preference dividend while in case of debentures or bonds, the interest paid to them is deductible in full.

(B) Demerits for Investors:

Main disadvantages of preference shares to investors are:

I. No Voting Right: The preference shareholders do not enjoy any voting right except in matters directed affecting their interest.

II. Fixed Income: The dividend on preference shares other than participating preference shares is fixed even if the company earns higher profits.

III. No Claim Over Surplus: The preferential shareholders have no claim over the surplus. They can only ask for the return of their capital investment in the company.

IV. No Guarantee of Assets: Company provides no security to the preference capital as is made in the case of debentures. Thus their interests are not protected by the assets of the company.

Types of Equity Shares

Equity shares are the main source of long-term finance of a joint stock company. It is issued by the company to the general public. Equity shares may be issued by a company in different ways but in all cases the actual cash inflow may not arise (like bonus issue).

The different types of equity issues have been discussed below:

1. New Issue: A company issues a prospectus inviting the general public to subscribe its shares. Generally, in case of new issues, money is collected by the company in more than one instalment-known as allotment and calls. The prospectus contains details regarding the date of payment and amount of money payable on such allotment and calls. A company can offer to the public up to its authorized capital. Right issue requires the filing of prospectus with the Registrar of Companies and with the Securities and Exchange Board of India (SEBI) through eligible registered merchant bankers.

2. Bonus Issue: Bonus in the general sense means getting something extra in addition to normal. In business, bonus shares are the shares issued free of cost, by a company to its existing shareholders. As per SEBI guidelines, if a company has sufficient profits/reserves it can issue bonus shares to its existing shareholders in proportion to the number of equity shares held out of accumulated profits/ reserves in order to capitalize the profit/reserves. Bonus shares can be issued only if the Articles of Association of the company permits it to do so.

Advantage of Bonus Issues:

From the company's point of view, as bonus issues do not involve any outflow of cash, it will not affect the liquidity position of the company. Shareholders, on the other hand, get bonus shares free of cost; their stake in the company increases.

Disadvantages of Bonus Issues:

Issue of bonus shares decreases the existing rate of return and thereby reduces the market price of shares of the company. The issue of bonus shares decreases the earnings per share.

3. Rights Issue: According to Section 81 of The Company's Act, 1956, rights issue is the subsequent issue of shares by an existing company to its existing shareholders in proportion to their holding. Right shares can be issued by a company only if the Articles of Association of the company permits. Rights shares are generally offered to the existing shareholders at a price below the current market price, i.e. at a concessional rate, and they have the options either to exercise the right or to sell the right to another person. Issue of rights shares is governed by the guidelines of SEBI and the central government.

Rights shares provide some monetary benefits to the existing shareholders as they get shares at a concessional rate-this is known as value of right which can be computed as:

Value of right = Cum right market price of a share – Issue price of a new share / Number of old shares + 1

Advantages of Rights Issue:

Rights issues do not affect the controlling power of existing share-holders. Floatation costs, brokerage and commission expenses are not incurred by the company unlike in the public issue. Shareholders get some monetary benefits as shares are issued to them at concessional rates.

Disadvantages of Rights Issue:

If a shareholder fails to exercise his rights within the stipulated time, his wealth will decline. The company loses cash as shares are issued at concessional rate.

4. Sweat Issue: According to Section 79A of The Company's Act, 1956, shares issued by a company to its employees or directors at a discount or for consideration other than cash are known as sweat issue. The purpose of sweat issue is to retain the intellectual property and knowhow of the company. Sweat issue can be made if it is authorized in a general meeting by special resolution. It is also governed by Issue of Sweet Equity Regulations, 2002, of the SEBI.

Advantages of Sweat Issue:

Sweat equity shares cannot be transferred within 3 years from the date of their allotment. It does not involve floatation costs and brokerage.

Disadvantage of Sweat Issue:

As sweat equity shares are issued at concessional rates, the company loses financially.

Advantages of Equity Shares

Equity shares are amongst the most important sources of capital and have certain advantages which are mentioned below:

i. Advantages from the Shareholders' Point of View

(a) Equity shares are very liquid and can be easily sold in the capital market.

(b) In case of high profit, they get dividend at higher rate.

(c) Equity shareholders have the right to control the management of the company.

(d) The equity shareholders get benefit in two ways, yearly dividend and appreciation in the value of their investment.

ii. Advantages from the Company's Point of View:

(a) They are a permanent source of capital and as such; do not involve any repayment liability.

(b) They do not have any obligation regarding payment of dividend.

(c) Larger equity capital base increases the creditworthiness of the company among the creditors and investors.

Disadvantages of Equity Shares

Despite their many advantages, equity shares suffer from certain limitations. These are:

i. Disadvantages from the Shareholders' Point of View:

(a) Equity shareholders get dividend only if there remains any profit after paying debenture interest, tax and preference dividend. Thus, getting dividend on equity shares is uncertain every year.

(b) Equity shareholders are scattered and unorganized, and hence they are unable to exercise any effective control over the affairs of the company.

(c) Equity shareholders bear the highest degree of risk of the company.

(d) Market price of equity shares fluctuate very widely which, in most occasions, erode the value of investment.

(e) Issue of fresh shares reduces the earnings of existing shareholders.

ii. Disadvantage from the Company's Point of View:

(a) Cost of equity is the highest among all the sources of finance.

(b) Payment of dividend on equity shares is not tax deductible expenditure.

(c) As compared to other sources of finance, issue of equity shares involves higher floatation expenses of brokerage, underwriting commission, etc.

Features of Equity Shares

The main features of equity shares are:

1. They are permanent in nature.

2. Equity shareholders are the actual owners of the company and they bear the highest risk.

3. Equity shares are transferable, i.e. ownership of equity shares can be transferred with or without consideration to other person.

4. Dividend payable to equity shareholders is an appropriation of profit.

5. Equity shareholders do not get fixed rate of dividend.

6. Equity shareholders have the right to control the affairs of the company.

7. The liability of equity shareholders is limited to the extent of their investment.

Comparison Between Equity Shares And Preference Shares

Basis for Comparison	Equity Shares	Preference Shares
Meaning	Equity shares are the ordinary shares of the company re-presenting the part ownership of the shareholder in the company.	Preference shares are the shares that carry preferential rights on the matters of payment of dividend and repayment of capital.
Payment of Dividend	In the event of winding up of the company, equity shares are repaid at the end.	In the event of winding up of the company, preference shares are repaid before equity shares.
Rate of dividend	Fluctuating	Fixed
Redemption	No	Yes
Voting rights	Equity shares carry voting rights.	Normally, preference shares do not carry voting rights. However, in special circumstances, they get voting rights.
Convertibility	Equity shares can never be converted.	Preference shares can be converted into equity shares.
Arrears of Dividend	Equity shareholders have no rights to get arrears of the dividend for the previous years.	Preference shareholders generally get the arrears of dividend along with the present year's dividend, if not paid in the last previous year, except in the case of non-cumulative preference shares.

Key Differences Between Equity Shares and Preference Shares

1. Equity shares cannot be converted into preference shares. However, Preference shares could be converted into equity shares.

2. Equity shares are irredeemable, but preference shares are redeemable.

3. The next major difference is the 'right to vote'. In general, equity share carry the right to vote, although preference shares do not carry voting rights.

4. If in a financial year, dividend on equity shares is not declared and paid, then the dividend for that year lapses. On the other hand, in the same situation , the preference shares dividend gets accumulated which is paid in the next financial year except in the case of non-cumulative preference shares.

5. The rate of dividend is consistent for preference shares, while the rate of equity dividend depends on the amount of profit earned by the company in the financial year. Thus it goes on changing.

Conclusion

Now, if anyone wants to invest his money in equity shares and preference shares you can do it very easily. For this you, first you should gain complete knowledge about the stock market. Otherwise, there are a lot of chances that you may suffer loss. One thing you must remember while making an investment in any of these is, purchasing the shares or stock when the market is down because at that time the prices are generally low and sell them when the market is up as the prices of shares are relatively higher. Similarly, another point of relevance is you must try to go for a long-term investment; it will give you good returns for longer periods.

The best form of investment is a mutual fund as the risk is comparatively less than the individual stocks. Do not recklessly believe on any good advice, because there are some investments which will give you high returns, but they are the riskiest ones so think twice before you invest anywhere in the stock market. If you don't want to invest in the mutual funds, then there are still better options for you like, you can directly purchase the stock of any company, when they bring new issue of shares in the form of an Initial Public Offer (IPO), this purchasing is known as buying from the primary market. Before investing money in any company just remember one formula Investigate before you Invest your money in any stocks as there are chances of money loss.

If you couldn't find any such direct purchasing, then you can contact a broker to help you in purchasing the securities of the companies which are already listed on the Stock Exchanges like National Stock Exchange or Bombay Stock Exchange. This type of purchasing is known as buying from Secondary Market. It could be a little bit expensive as you have to pay the brokerage charges. But, the broker will help you in opening an account and complete the legal formalities on your behalf. Now, you have to decide that how much you can invest at the inception. After deciding it, you need to deposit some amount as a part of initial investments with your broker who will purchase the securities on your instructions. And so in this way you can easily invest in the securities.

2.5 NEED FOR VALUATION OF SHARES

The value of every share is printed in front of the shares. Such a value is called as par value or face value of shares. The face value is assigned by the promoters of joint stock company and is given in the memorandum of association. Except the face value, it has also get market value on stock exchange market which may be differ from face value. The market value of a share is determined by the demand and supply. Such a value is affected by the action and opinions of investors and their fear, guess, investment policy etc. Hence, the market price does not reflect the true value of shares and requires a proper valuation of shares. Specially, in the case of private limited company the shares of such a company are not freely purchased and sold to the public. In that case, the valuation becomes absolutely necessary.

The value of shares can be determined in different ways. It can be valued either by taking the earning of a company or net assets that comprise the company. The choice is governed by the reasons for investment.

The following are the circumstances where need for the valuation of shares arises:

1. Where companies amalgamate or are similarly reconstructed, it may be necessary to arrive at the value of shares hold by the members of the company being absorbed or taken over. This may also be necessary to protect the rights of dissenting shareholders under the provisions of the Companies Act, 1956.

2. Where shares are held by the partners jointly in a company and dissolution of the firm takes place, it becomes necessary to value the shares for proper distribution of the partnership property among the partners.

3. Where a portion of the shares is to be given by a member of proprietary company to another member as the member cannot sell it in the open market, it becomes necessary to certify the fair price of these shares by an auditor or accountant.

4. When a loan advanced on the security of shares, it becomes necessary to know the value of shares on the basis of which loan has been advanced.

5. When shares are given in a company as gift it may be necessary for the purpose of assessing gift tax, to place a value on the shares.

6. When preference shares or debentures are converted into equity share it becomes necessary to value the equity shares for ascertaining the number of equity shares required to be issued for debentures or preference shares which are to be converted.

7. When equity shareholders are to be compensated on the acquisition of their shares by the government under a scheme of nationalisation, then it becomes necessary to value the equity shares for reasonable compensation to be given to their holders.

2.6 METHODS OF VALUATION OF SHARES

The methods of valuation of shares are shown in figure as follows:

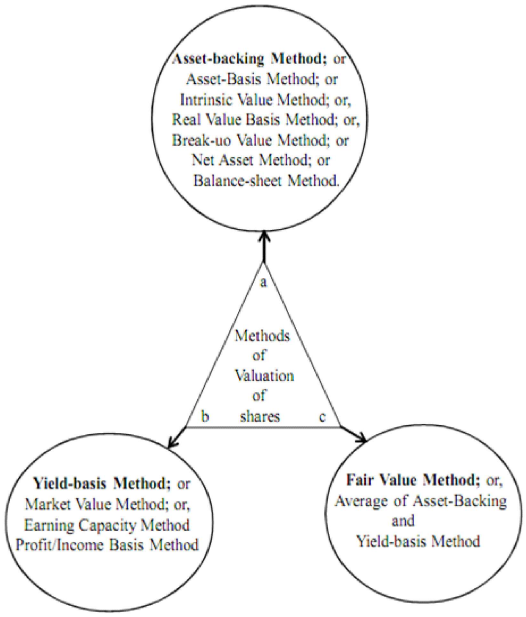


Figure: Methods of Valuation of Shares.

(a) Net Asset Method/ Asset Backing Method;

(b) Yield Basis Method, and

(c) Fair Value Method

(a) Net Assets Method : Under this method the value of a share is based on what the assets less liabilities are worth after allowing for a probable loss or expected gain on balance sheet values. For calculating the values of shares under this method two alternative assumptions are made.

(i) The company is going into liquidation

(ii) The company is a going concern.

(i) When the company is assumed to go into liquidation: Under such situation, all recorded and unrecorded assets including goodwill are to be valued at their realisable value. From the total assumed realisable value of assets the total amount of all liabilities recorded as well as unrecorded is deducted. The amount thus arrived at is the asset backing for the shareholders. If the amount is divided by the number of shares, we get the intrinsic value of each share.

Treatment of preference share: If the share capital of a company consists of both equity and preference share will depend on the nature of preference given to preference shares. If preference shares have priority over equity shares regarding refund of capital then preference share capital should also be deducted from assets like other liabilities. But if preference shares are at par with equity capital (having participating rights) regarding refund then the net tangible assets will be considered to be the combined value of all the shares and by division the value of each preference share and equity share will be calculated.

(ii) When the company is assumed to be a going concern: If the shares of a company are to be valued on a going concern basis, all the assets (except intangible assets and preliminary expenses) are taken at their market value of replacement value. Assets were also include non trading assets like outside investments. For valuing assets, first of all, the assets and liabilities are revalued as their values shown in the balance sheet are taken to be out moded. At the time of revaluation of assets and liabilities full provision for depreciation and bad and doubtful debts should be made and fictitious assets should be removed.

Treatment of Goodwill: So far as goodwill is concerned, there are two alternative approaches. According to first approach goodwill should not be considered at all at the time of valuation of shares. Second approach does take into account goodwill. In case goodwill is to be considered, it should be valued according to the method specified in the problem. In the absence of any method specified in the problem, it should be valued by any one the method of valuation of goodwill. There if question is silent about goodwill, it is better to ignore it while valuing shares.

Value of an equity share as per Net Assets Method

$$\text{Value per equity share} = \frac{\text{Amount available for equity shareholders}}{\text{Number of equity shares}}$$

Amount available for equity shareholders=Assets at realisable or market value (as the case may be) less all liabilities and preference share capital.

b) Yield Method: Under this method the shares of a company are valued on the basis of its prospective earning. The market value of assets and liabilities are not at all considered. Prospective earnings are estimated on the basis of company's past performance and should be adjusted in the light of any known factor likely to affect future profitability. The value of share is calculated by comparing the expected earnings of the company with normal rate of return on investment. If the expected rate of return is more than the normal rate of return the paid up value of the share increases proportionately and the resulting value is known as the market value of shares. This method is based on the philosophy that shareholders values the return which he received and not the earnings of the company. The calculations under this method are split up in three parts:

(i) Expect rate of return $= \dfrac{\text{Profit available for dividend to equity shareholders}}{\text{Paid up equity share}} \times 100$

(ii) Value of equity share $= \dfrac{\text{Expected rate of return}}{\text{Normal rate of return}} \times \text{Paid up value of share}$

(iii) Calculation of average expected profits

In the calculation of average expected profits following items have to be deducted from the profits of the company.

(a) Estimated tax charges.

(b) Amount to be transferred to reserves.

(c) Performance dividend if any.

The profits have to be adjusted mainly to determine the maintainable profits in future which must be available for distribution as dividend to equity shareholders.

c) Fair Value Method: Both the methods of valuation of shares discussed above, possesses certain drawbacks. Net assets methods may not given true picture of value per share when the company is earning super-profits and similarly earning capacity method also give misleading position when the company undertakes expansion plans. So experts feel that both the methods do not give clear picture of value of shares, so dual method or fair value method is preferred.

Fair value of a share is the simple average of intrinsic value and yield value of a share. Mathematically fair value can be expresses as:

$$\text{Fair value} = \frac{\text{Intrinsic value per share} + \text{Yield value per share}}{2}$$

2.7 COMPUTATION OF VALUES OF EQUITY SHARES

The computation of values of equity shares depend on the purpose for which valuation is required. Generally, there are three methods of computation of values of equity shares:

1. Net Worth Method/ Net Assets Backing Method

2 Yield Method

3 Fair Value Method

2.7.1 Net Worth Method/ Net Assets Backing Method

Since the valuation is made on the basis of the assets of the company, it is known as Asset-Basis or Asset-Backing Method. At the same time, the shares are valued on the basis of real internal value of the assets of the company and that is why the method is also termed Intrinsic Value Method or Real Value Basis Method. This method may be made either (i) on a going \ continuing concern basis; and (ii) break-up value basis.

Here the emphasis is on the safety of investment as the investors always need safety for their investments. Under this method, net assets of the company are divided by the number of share to arrive at the net asset value of each share. The following points may be borne in mind:

(1) The value of goodwill will be ascertained.

(2) Fixed assets of the company, disclosed or undisclosed in Balance Sheet, are taken at their realisable value.

(3) Floating assets are to be taken at market value.

(4) Remember to exclude fictitious assets, such as Preliminary Expenses, Accumulated Losses etc.

(5) Provision for depreciation, bad debts provision etc. must be considered.

(6) Find out the external liabilities of the company payable to outsiders including contingent liabilities.

Thus the value of net asset is;

Total of realisable value of assets - Total of external liabilities = Net Assets

(Intrinsic value of asset)

Total value of Equity shares = Net Assets - Preference share capital

$$\text{Value of one Equity share} = \frac{\text{Net Assets - Preference share capital}}{\text{Number of Equity shares}}$$

The following chart will make the above points clear :

Computation of Net Assets		
Net Assets		`
Fixed Assets (Market Value)		xx
Investments (Market Value)		xx
Current Assets (Market Value)		xx
Goodwill, any (Market Value)		xx
		xx
Less :		
Current Liabilities	xx	
Debentures	xx	
Pref. Share Capital (with arrear Dividend)	xx	---
Net Assets /Funds available for Equity Shareholders		xx

$$\text{Intrinsic Value of each share} = \frac{\text{Funds available for equity shareholders}}{\text{Number if Equity shares}}$$

Alternatively -

Net Assets = Share Capital + Reserves and surplus - Miscellaneous Expenditure + Profit on Revaluation - Loss on Revaluation

EXAMPLE

From the following information compute the 'Intrinsic Value' of an Equity share of Sumana Ltd.

Balance sheet as at 31.03.2013

Liabilities	`	Assets	`
1,000 Equity Share		Land and Buildings	40,000
of ` 100 each fully		Plant and Machinery	40,000
paid-up	1,00,000	Sundry Debtors	5,000
100, 6% Perference Share		Stock	20,000
of ` 100 each,		Cash at Bank	25,000
fully paid	10,000	Investment in	
Reserves and Surplus	25,000	5% Govt. Securities	10,000
100, 5%Debentures		Cash in hand	10,000
of ` 100each	10,000	Preliminary Expenses	5,000
Sundry Creditors	10,000		
	1,55,000		**1,55,000**

(i) Fair return on capital employed in this type of business is around 10% p.a..

(ii) Goodwill is to be taken at 5 years' purchase value of super profits.

(iii) Average of the profits (after deduction of preliminary expenses) for the last seven years is 19,000. Preliminary expenses to the extent of 1,000 has been written-off every year for the last seven years. Profit is more or less stable over years and the same trend is expected to be maintained in the near future. Ignore tax.

SOLUTION

1) Computation of Goodwill :

Capital Employed:		40,000
Land and Building		40,000
Plant and Machinery		5,000
Sundry Debtors		20,000
Stock		25,000
Cash at Bank		10,000
Cash in Bank		10,000
		1,40,000
Less : Liabilities		
5% Debentures	10.000	
Creditors	10.000	20,000
Capital Employed:		1,20,000

$$\text{Normal Profit} \quad 1,20,000 \times \frac{10}{100} = 12,000$$

Super Profit

Average Profit	19,000
Less : Non-trading income	500
Interest on Investment	
@ 5% on 10,000	18,500

Super Profit = Average Profit - Normal Profit

= 18,500 - 12,000 = 6,500

Value of Goodwill = 6,500 x 5 = 32,500

Computation of Intrinsic Value of Equity Share :

Total Assets (as above)	1,40,000
Add : Investment	10,000
Add : Goodwill	32,500
	1,82,500
Less : Liabilities (as above)	20,000
	1,62,500
Less : Preference Share Capital	10,000
Funds available to equity Shareholders:	1,52,500

$$\therefore \text{ Intrinsic Value of Equity Share} = \frac{1,52,500}{1,000 \text{ sh.}} = \mathbf{152.50}$$

2.7.2 Yield-Basis Method

Yield is the effective rate of return on investments which is invested by the investors. It is always expressed in terms of percentage. Since the valuation of shares is made on the basis of Yield, it is called Yield-Basis Method. For example, an investor purchases one share of Rs. 100 each (face value and paid-up value) at 150 from a Stock Exchange on which he receives a return (dividend) @ 30%. In that case, yield of the said investor will be:

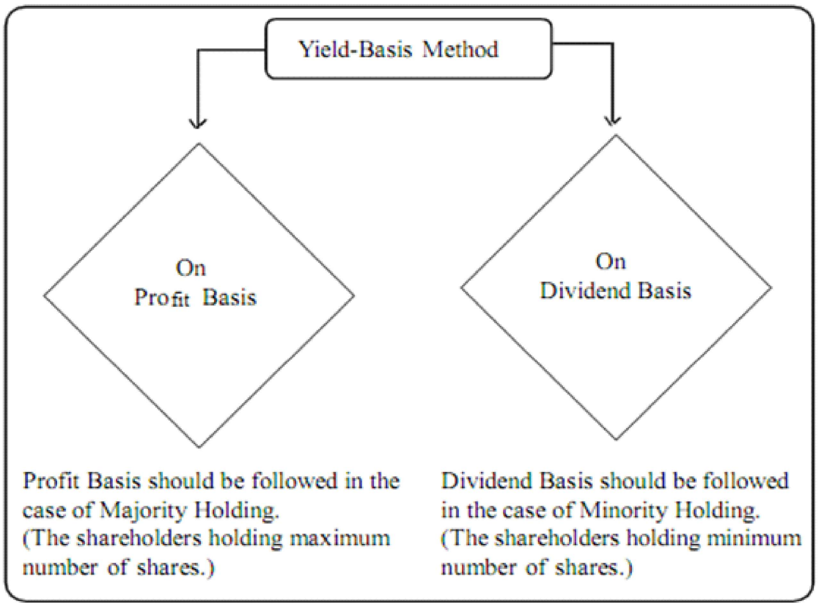
$$\text{Yield} = \frac{30 \times 100}{150} = 20\%$$

Practically, yield may also termed as: Expected Yield Normal Rate of Return/ Earning, Rate of Fair Return, Rate of General Expectations, Estimated Rate for Capitalisation etc.

Yield may be calculated as under :

$$\text{Yield} = \frac{\text{Normal Profit}}{\text{Capital employed}} \times 100$$

Under Yield-Basis Method, valuation of shares is made on (i) **Profit Basis**; or (ii) **Dividend Basis.**



(i) Profit Basis :

Under this method, at first, profit should be ascertained on the basis of past average profit. Thereafter, capitalised value of profit is to be determined on the basis of normal rate of return, and the same (capitalised value of profit) is divided by the number of share in order to find out the value of each share. The following procedure may be adopted.

$$\text{Capitalised Value of Profit} = \frac{\text{Profit}}{\text{Normal rate of return}}$$

$$\text{Value of each Equity Share} = \frac{\text{Capitalised Value of Profit}}{\text{Number of shares}}$$

$$\text{or, Value of each equity share} = \frac{\text{Profit}}{\text{Normal rate of return x Number of Equity shares}} \text{ x } 100$$

Here, profit means and includes Future Maintainable Profit, i.e. the rate of profit which is expected to be earned in future. " It is to be remembered that the analysis of profit that is made in order to determine future annual maintainable profit must seek a profit that is capable of distribution as dividend." - Yorston, Smyth and Brown.

The following principle should be kept in mind while ascertaining maintainable profit.

(i) Average profit for the last few years should be taken as base.

(ii) Average profit should be properly adjusted such as:

(a) Proper depreciation on assets should be deducted;

(b) Appreciation in Fixed Assets should not be included whereas appreciation in current assets should, however, be included;

(c) Income from non-trading assets should be excluded.

(d) Non-recurring expenses, which may not be incurred in future, are not to be included;

(e) Any casual income (Which is not expected in future) should not to be included;\

(f) provision should be made for taxation;

(g) If any reserve is created, the same should be deducted; and

(h) Preference dividend should always be deducted from profit.

EXAMPLE

Two companies, A Ltd. and B. Ltd., are found to be exactly similar as to their assets, reserve and liabilities except that their share capital structures are different.

The Share Capital of A. Ltd is Rs. 11,00,000, divided into 10,000, 6% Preference Shares of Rs. 100 each and 10,000 Equity Share of Rs. 10 each.

The Share Capital of B. Ltd. is also Rs.11,00,000, divided into 1,000, 6% Preference Shares of Rs. 100 each and 1,00,000 Equity Share of Rs. 10 each.

The fair yield in respect of the Equity Share of this type of companies is ascertained at 8%.

The profits of the two companies for 2013, and 2012 are found to be Rs. 1,10,000 and Rs. 1,50,000, respectively.

SOLUTION

Calculate the value of the Equity Share of each of these two companies on 31.12.2012 on the basis of this information only. Ignore taxation.

A. Valuation of Shares of A Ltd.	Rs.	Valuation of Shares of B Ltd.	Rs.
Average profit of two years $\frac{(1,10,000 + 1,50,000)}{2}$	1,30,000	Average profit	1,30,000
Less: Preference Dividend		Less: Pref.Dividend	
6% on 10,00,000	60,000	6% on 1,00,000	6,000
Maintainable Profit	**70,000**	**Maintainable profit:**	**1,24,000**
Capitalised Value of Profit		Capitalised Value of profit:	
$= \frac{70,000}{8} \times 100$	8,75,000	$\frac{1,24,000}{8} \times 100 =$	15,50,000
∴ Value of each Equity Share		∴ Value of each Equity Share	
$= \frac{8,75,000}{10,000 \text{ Equity Share}} \times 87.50$		$= \frac{15,50,000}{1,00,000 \text{ Equity Share}} \times 15.50$	

(ii) Dividend Basis

Valuation of shares may be made either (a) on the basis total amount of dividend, or (b) on basis of percentage or rate of dividend.

(a) On the basis of total amount of Dividend:

$$\text{Capitalised Value of Profit} = \frac{\text{Divisible Profit i.e. Total amount of Dividend}}{\text{Normal Rate of Return i.e. Yield}} \times 100$$

$$\text{Value of each Equity Share} = \frac{\text{Capitalised Value of Profit}}{\text{Number of Equity Shares}}$$

$$\text{Or, Value of each Equity Share} = \frac{\text{Divisible Profit x 100}}{\text{Normal Rate of Return x No. of Equity Share.}}$$

(b) On the basis of percentage or Rate of Dividend:

Value of each Equity Share

$$= \frac{\text{Rate of Dividend}}{\text{Normal Rate of Return x No. of Equity Share}} \text{ x Paid-up value of each Equity Share}$$

When the Rate of Dividend is not given:

$$\text{Rate of Dividend} = \frac{\text{Profit}}{\text{Equity Share Capital (paid-up)}} \text{ x } 100$$

EXAMPLE

On December 31, 2012, the Balance Sheet of xyz Ltd,. Disclosed the following position:

Liabilities	Rs.	Assets	Rs.
Share Capital 40,000 Equity	4,00,000	Fixed Assets	5,00,000
Shares of Rs.10 each		Current Assets	1,50,000
Reserves and Surplus	90,000	Goodwill	40,000
Profit and Loss Account	20,000		
5% Debentures	1,00,000		
Current Liabilities	80,000		
	6,90,000		**6,90,000**

The Net Profit for the three years were.

Year	Rs.
2010	51,150
2011	50,300
2012	53,800

On which 20% was placed to Reserve, this proportion being considered reasonable in the industry in which the company is engaged and where a fair investment return may be taken at 10%. Compute the value of the company's share under yield-basis method.

SOLUTION

$$\text{Average Profit} = \frac{\text{Rs. } 51{,}150 + \text{Rs. } 50{,}300 + \text{Rs. } 53{,}800}{3} = \frac{\text{Rs. } 1{,}55{,}250}{3} = \text{Rs. } 51{,}750$$

Less : Transfer to Reserve @ 20%	= Rs. 10,350
Maintainable Profit	= Rs. 41,400

Here, the rate of dividend is not given, the same can be found out with the help of the following:

$$\text{Rate of Dividend} = \frac{\text{Profit}}{\text{Paid up Equity Capital}} \times 100$$

$$= \frac{\text{Rs. } 41{,}400}{\text{Rs. } 4{,}00{,}000} \times 100 = 10.35\%$$

$\therefore$ Value of each Equity Shares

$$= \frac{\text{Rate of Dividend}}{\text{Normal Rate of Return}} \times \text{Paid -up Value of each Equity Share}$$

$$= \frac{\text{Rs. } 10.3}{\text{Rs. } 10} \times \text{Rs. } 10$$

$$= \text{Rs. } 10.35$$

EXAMPLE

Form the following information supplied to you ascertain the value per share of AMCO Ltd. on Dividend Basis.

1) 2,50,000 Equity Shares of Rs. 1 each fully paid-up .

2) The annual net earnings of the company normally amounts to Rs. 35,000.

3) The normal rate of return on paid-up value of Equity share capital is 7%.

SOLUTION

1) Calculation of Rate of Dividend :

$$\text{Rate of Dividend} = \frac{\text{Profit}}{\text{Paid-up Equity share Capital}} \times 100$$

$$= \frac{\text{Rs. } 35{,}000}{\text{Rs. } 2{,}50{,}000} \times 100$$

$$= 14\%$$

2) Calculation of value per Equity Share :

Value Per Equity Share

$$= \frac{\text{Rate of Dividend}}{\text{Normal Rate of Return}} \times \text{Paid up value of each Equity Share}$$

$$= \frac{14}{7} \times \text{v1}$$

$$= \text{Rs. } 2$$

2.7.3 Dual (or Fair Value Method)

Many accountants are of the view that neither the net assets basis nor the earning basis of valuation of shares is correct, but the fair valuation method may be an average of the two methods of valuation of shares. The formula for the valuation of shares according to the dual method or fair value method is as follows:

Value of Share

$$= \frac{\text{Value of share on net assets basis} + \text{Value of share on net earning basis}}{2}$$

OR

$$\text{Fair value per Share} = \frac{\text{Intrinsic Value per Share} + \text{Yield Value per Share}}{2}$$

Since this method takes the average of values obtained in net assets basis and earning basis, it makes an attempt to minimise the demerits of both net assets basis and earnings basis methods.

EXAMPLE

The Balance Sheet of Ganesh Ltd., as on 31-03-2002 was as Under:

Liabilities	*Rs. in Lakhs*	*Asstes*	*Rs. in Lakhs*
2,000 Equity Shares of Rs.		Land and Building	1,25,000
100 each	2,00,000	Plant and Machinery	75,000
General Reserve	50,000	Investment at cost	
Profit and Loss Account	25,000	(Market Value Rs. 37,500)	45,000
Creditors	45,000	Debtors	50,000
Provision for Taxation	20,000	Stock	37,500
Provident Fund	17,500	Cash at bank	25,000
	3,57,500		3,57,500

Additional Informations:

(1) Land and Building and Machinery are valued at Rs. 1,37,500 and Rs. 55,000 respectively.

(2) Of the total debtors, Rs. 25,00 are bad.

(3) Goodwill is to be taken at Rs. 25,000.

(4) The normal rate of dividend, declared by such type of companies is 15% on the up capital.

(5) The average rate of dividend, declared and paid by this company is Rs. 18% on its paid up capital.

Calculate the fair value of Equity Share of the company.

SOLUTION

Value of Equity Share according to Yield Method

$$\text{Value of Share} = \frac{\text{Rate of Dividend}}{\text{Normal Rate of Dividend}} \times \text{Paid up value of share}$$

$$= \frac{18\%}{15\%} \times \text{Rs. } 100$$

$$= \text{Rs. } 120$$

Value of Equity Share on the Basis of Intrinsic Value		Rs.
Goodwill		25,000
Land and Building		1,37,500
Machinery		55,000
Investment at Market Value		37,500
Debtors less Bad Debts Rs. 2,500		47,500
Stock		37,500
Cash at Bank		25,000
		3,65,000
Less: Creditors	45,000	
Provision for Taxation	20,000	
Provident Fund	17,500	
		82,500

Net Assets available for Equity Shareholders	2,82,500
Number of Equity Shares	2,000

Value of Equity Shares $= \dfrac{\text{Rs. } 2,82,500}{2,000} = \text{Rs. } 141.25$

Fair Value of Equity Share

$$= \frac{\text{Value on the Basis of Yield} + \text{Value on the Basis of Net Assets}}{2}$$

$$= \frac{\text{Rs. } 120 + \text{Rs. } 141.25}{2}$$

$= \text{Rs. } 130.63.$

The Asset Backing Method, Yield Basis Method and Fair Value Method of Valuation of shares can be understood with the help of following illustrations:

ILLUSTRATION 1

From the following information relating to Adwani Ltd., Ahmednagar. Compute the 'Intrinsic Value' of each Equity Share.

Balance Sheet as on 31st March 2014

Liabilities	Rs.	Assets	Rs.
Share Capital :		Goodwill	35,000
Issued and Paid-up Capital		Land and Buildings	95,000
• 20,000 Equity Shares of		Plant and Machinery	1,35,000
Rs. 10 each	2,00,000	Investments	55,000
• 13,000 Preference Share		Stock in Trade	65,000
Rs. 10 each	1,30,000	Trade Debtors	36,000
Reserve Fund	60,000	Cash in Hand	24,000
Trade Creditors	45,000	Underwriting Commission	15,000
Bills Payable	20,000		
Taxation Provision	5,000		
	4,60,000		**4,60,000**

For the purpose of valuing the equity shares of the company, various assets were revalued as under :

- Book Debts realised 100% of book value
- Stock-in-Trade realised at a profit of Rs. 15,000
- Investments - Rs. 60,000
- Goodwill - Rs. 50,000
- Land and Building - Rs. 1,10,000
- Plant and Machinery - Rs. 1,40,000

SOLUTION

1) Computation of Total Net Assets :

Total Assets	**Rs.**
• Goodwill	50,000
• Land and Buildings	1,10,000
• Plant and Machinery	1,40,000
• Investments	60,000
• Stock-in-Trade	80,000
• Trade Debtors	36,000
• Cash in hand	(+) 24,000
	5,00,000
Less : Current Liabilities	70,000

• Trade Creditors 45,000

• Bills Payable 20,000

• Taxation Provision (+) 5,000 (-)

Total Net Assets **4,30,000**

2) Computation of Funds available for equity shareholders :

	Rs.
Total Net Assets	4,30,000
Less : Preference Share Capital	(-) 1,30,000
∴ Fund available for Equity Shareholders	**3,00,000**

3) Computation of Intrinsic Value of each Equity Share :

$$= \frac{\text{Funds available for Equity Shareholders}}{\text{Number of Equity Shares}}$$

$$= \frac{\text{Rs. } 3{,}00{,}000}{20{,}000 \text{ Equity Shares}}$$

$$= \text{Rs. } 15$$

ILLUSTRATION 2

(Net Assets Basis Method excluding goodwill). The following is the summarised Balance Sheet of X company as at March 31, 2002:

Liabilities	Rs.	Assets	Rs.
Share Capital:		Fixed Assets	38,00,000
10,000 5% preference share of Rs.		Investments	10,25,000
100 each fully paid	10,00,000	*Current Assets:*	5,72,000
2,00,000 equity shares Rs. 10 each		Stock-in-trade	12,78,000
fully paid	20,00,000	*Sundry Debtors:*	2,25,000
Reserve and Surplus:		*Less:* Provision	
General Reserve	15,00,000	Cash and Bank Balances	
Profit and Loss Account (Cr.)	12,00,000		
Secured Loans: 6% debentures	8,00,000		
Current Liabilities:			
Sundry Creditors	27,5000		
Liabilities for Expenses	1,25,000		
	69,00,000		69,00,000

For purposes of valuation of shares, Fixed Assets are to be depreciated by 10 percent and investments are to be revalued at Rs. 10,80,000. Debtors will realise Rs. 12,14,100.

Interest on Debentures is accrued due for 9 months and preference dividend for the year ending 31st March, 2002 is also due; neither of these has been provided for in the Balance Sheet. Calculate the value of each Equity Share.

SOLUTION

Valuation of Shares of X Company Ltd. by the Net Assets Method.

Particulars		Rs.
Fixed assets		34,20,000
Investments as per revaluation		10,80,000
Sock-in-trade		5,72,000
Sundry Debtors		12,14,100
Cash and Bank Balances		2,25,000
		65,11,100
Less: Liabilities:		
6% Debentures	8,00,000	
Sundry Creditors	2,75,000	
Liabilities for expenses	1,25,000	
Interest of Debentures (accrued for 9 months)	36,000	12,36,000
		52,75,100
Less: Preference Share Capital	10,00,000	
Preference Share Dividend @ 5% on Rs. 10,00,000	50,000	
		10,50,000
Value of 2,00,000 Equity Shares		42,25,100
Hence Value of 1 Equity Share= $\frac{\text{Rs. 42,25,100}}{\text{2,00,000}}$= Rs. 21.13 (approx.)		

ILLUSTRATION 3

(Net Assets Basis Method including goodwill). The summarised balance sheet of BK Ltd. as at 31st March, 2002 is as follows:

BALANCE SHEET

Liabilities	Rs.	Assets	Rs.
30,000 Equity Shares of Rs. 10 each		Goodwill	70,000
fully paid up	3,00,000	Other Fixed Assets	4,50,000
10,000 Equity Shares of Rs. 10 each		Current Assets	2,20,000
Rs. 8 paid up	80,000	Preliminary Expenses	10,000
Reserves	1,80,000		
11% Debentures	1,00,000		
Current Liabilities	90,000		
	7,50,000		7,50,000

The goodwill is independently Valued at Rs. 50, 000 and other fixed assets at Rs. 4,20,000. There was a contingent liability of Rs. 20,000 which has become payable. Determine the value of both the shares under net asset method.

SOLUTION

Valuation of Shares by Net Assets Method

		Rs.
Assets		
Goodwill		50,000
Other fixed assets		4,20,000
Current assets		2,20,000
Notional Calls		20,000
		7,10,000
Less: Outside Liabilities		
Debentures	1,00,000	
Current Liabilities	90,000	
Contingent Liability becoming payable	20,000	
		2,10,000
Net Assets available for Equity Shares		5,00,000

Value per (fully paid) Equity Share = $\frac{\text{Rs. } 5,00,000}{40,000}$

= Rs. 12.50

Value per (partly paid) Equity Share = Rs. 12.50 - Rs. 2

= Rs. 10.50

ILLUSTRATION 4

(Yield Method). The following in the Balance Sheet of a company as on 31st December, 2002.

Liabilities	Rs.	Assets	Rs.
Equity Share Capital		Fixed Assets	14,60,000
(Rs. 100 per share)	12,00,000	Investment (5% Securities)	1,20,000
Reserve and Surplus	2,50,000	Current Assets	5,40,000
Sundry Creditors	5,60,000	Preliminary Expenses	33,000
Provision for Taxation	1,43,000		
	21,53,000		21,53,000

The provision for taxation for the current year is @ 55% of net profits. Returns on Capital employed in this industry is 10%. Ascertain the yield value of share.

SOLUTION

Provision for Taxation	55% of profits
Amount for provision for Taxation	Rs. 1,43,000
\ Profit for the current year (1,43,000 x100/55)	Rs. 2,60,000

Profit	Rs.
Less: Provision for Taxation @ 55%	2,60,000
Profit available for Equity Shareholders	1,43,000
	1,17,000

Equity Share Capital	12,00,000
Expected Rate of Return $\left[\frac{\text{Rs. } 1{,}17{,}000}{\text{Rs. } 12{,}00{,}000} \times 100\right]$	9.75%
Normal rate of Return	10%

$$\text{Value of Share} = \frac{\text{Expected Rate}}{\text{Normal Rate}} \times \text{paid up value of share}$$

$$= \frac{9.75\%}{10\%} \times \text{Rs. } 100$$

$$= \text{Rs. } 97.50$$

ILLUSTRATION 5

Bremain Ltd., Bareli issued 50,000 Equity Shares of Rs. 10 each fully called-up and paid-up respectively. The company has earned sizable amount of net profit during the last five years which as follows:

Year	**Net Profit Rs.**
2009	55,390
2010	57,820
2011	60,140
2012	61,280
2013	65,370

Of the profits so earned 20% was transferred to General Reserve, this proportion being considered reasonable in the manufacturing industry in which the company is engaged and where a fair investment return may be taken at 10%.

You are required to compute the value of company's Equity Share in the **Yield Basis Method** under Dividend Basis and Profit Basis separately.

SOLUTION

1) Calculation of average expected future Profits:

Average Profit = Rs. 55,390 + Rs. 57,820 + Rs. 60,140 + Rs. 61,280 + Rs. 65,370

$$= \frac{\text{Rs. } 3{,}00{,}000}{5}$$

= Rs. 60,000

2) Calculation of Maintainable Profit:

= Average Profit Less 20% of Transfer to General Reserves

= Rs. 60,000 - 20% of Rs. 60,000

= Rs. 60,000 - Rs. 12,000

= Rs. 48,000

3) Calculation of Rate of Dividend:

$$\text{Rate of Dividend} = \frac{\text{Maintainable Profit}}{\text{Equity Share Capital (paid-up)}} \times 100$$

$$= \frac{\text{Rs. } 48{,}000}{\text{Rs. } 5{,}00{,}000} \times 100$$

= 9.60 %

4) Calculation of value of each Equity Share under Yield Basis Method :

A) On Dividend Basis:

$$\text{Value of each Equity Share} = \frac{\text{Rate of Dividend}}{\text{Normal Rate of Return}} \times \text{Paid up value of each Equity Share}$$

$$= \frac{9.60}{10} \times Rs.\ 10$$

$$= Rs.\ 9.60$$

B) On Profit Basis :

i) Calculation of Capitalised Value of Maintainable Profit :

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

$$= \frac{Rs.\ 48{,}000}{10} \times 100$$

$$= Rs.\ 4{,}80{,}000$$

ii) Calculation of value of each Equity Share :

$$\text{Value of Equity Share} = \frac{\text{Capitalised Value of Profit}}{\text{Number of Equity Share}}$$

$$= \frac{Rs.\ 4{,}80{,}000}{50{,}000 \text{ Equity Shares}}$$

$$= Rs.\ 9.60$$

ILLUSTRATION 6

(Valuation of rate of earnings basis). From the following particulars, calculate the value of an equity shares:

2,000, 9% Preference shares of Rs. 100 each	Rs. 2,00,000
50,000 Equity shares of Rs. 10 each, Rs. 8 per share paid up	Rs. 4,00,000
Expected profit per year before tax	Rs. 2,18,000
Rate of tax	40%
Transfer to general reserve every year	20% of profit
Normal rate of earning	15%

SOLUTION

(i) Calculation of profit available to equity shareholders:

	Rs.
Expected profit before tax	2,18,000
Less: Tax @ 40%	87,200
Profit after tax	1,30,800
Less: Transfer to general reserve @ 20%	26,160
Profit after tax and transfer to general reserve	1,04,640
Less: Preference dividend @ 9% on Rs. 2,00,000	18,000
	86,640

(ii) Calculation of Expected Rate of Earnings

$$\text{Expected Rate} = \frac{\text{Profit available}}{\text{Total paid up equity share capital}} \times 100$$

$$= \frac{\text{Rs. } 86,640}{\text{Rs. } 4,00,000} \times 100 = 21.66\%$$

(iii) Calculation of Value of an Equity Share

$$\text{value per share} = \frac{\text{Expected rate}}{\text{Normal rate}} \times \text{paid up value of shares}$$

$$= \frac{21.66}{15.0} \times \text{Rs. } 8 = \text{Rs. } 11.55.$$

ILLUSTRATION 7

The following is the Balance Sheet of X Co. Ltd as on 31.12.2012.

Liabilities	Rs.	Assets	Rs.
Share Capital :		Goodwill	50,000
Equity Shares of Rs. 10 each	1,00,000	Buildings	1,50,000
12% Pref. Shares of		Plant	1,00,000
Rs. 100 each	1,00,000	Investment in 10% stock	
General Reserve	60,000	(Market value of 52,000)	
Profit and Loss	40,000	Normal Value Rs. 50,000	48,000
15% Debentures	1,00,000	Stock	60,000
creditors	80,000	Debtors	40,000
		Cash	10,000
		Preliminary Expenses	22,000
	4,80,000		**4,80,000**

Ascertain the value of each equity share under Fair Value Method on the basis of the information given below.

Assets are revalued as follows :

Building Rs. 3,20,000; Plant Rs. 1,80,000; Stock Rs. 45,000 and Debtors Rs. 36,000.

Average profit of the company is Rs. 1,20,000 and 12 1/2% of profit is transferred to General Reserve. Rate of taxation being 50%. Normal dividend expected on Equity Shares is 8% whereas fair return on capital employed is 10%. Goodwill may be valued at 3 year's purchase of super profit.

SOLUTION

Computation Goodwill :

Total Net Assets :	Rs.
Buildings	3,20,000
Plant	1,80,000

Stock	45,000
Debtors	36,000
Cash	10,000
	5,91,000
Less : Current Liabilities :	
Creditors	80,000
Capital Employed	**5,11,000**

Normal Profit Rs. 51,100

$\left\{ \text{i.e. Rs. } 5,11,000 \times \frac{10}{100} \right\}$

Actual Profit	
Average Profit	1,20,000
Less : Non-trading Income (i.e. income from investment) @ 10% on Rs. 50,000	(-) 5,000
	1,15,000
Add : Debenture Interest	15,000
	1,30,000
Less : Preference Dividend @ 12 % of Rs. 1,00,000	(-) 12,000
1,18,000	
Less : Taxation @ 50% of Rs. 1,18,000	(-) 59,000
	59,000
Less : Transfer to Reserve @ 12 1/2 %	(-) 7,375
	51,625

Super Profit = Actual Profit - Normal Profit

= Rs. 51,625 - Rs. 51, 100

= Rs. 525

Goodwill is to be valued at three years purchase of Super Profit.

∴ Value of Goodwill = Rs. 525 x 3

= Rs. 1,575

Valuation of Shares :

Assets-Backing Method	Rs.
Sundry Assets (as above)	5,11,000
Add : Investments	48,000
Add : Goodwill	1,600
Funds available for Equity Shareholders	5,60,000

$$\text{Intrinsic Value of Share} = \text{Rs. } \frac{5,60,600}{10,000}$$

= Rs. 56.06

Yield - Basis :

$$\text{Value of share} = \frac{\text{Rate of Dividend}}{\text{Normal Rate of return}} \times \text{Paid up value of each share}$$

$$= \frac{8}{10} \times \text{Rs. } 10$$

= Rs. 8

Fair Value :

$$\text{Fair value} = \frac{\text{Intrinsic Value + Yield Basis}}{2}$$

$$= \frac{\text{Rs. } 56.06 + \text{Rs. } 8.00}{2}$$

$$= \text{Rs. } 32.03$$

ILLUSTRATION 8

(*Valuation of shares based on (i) dividend (ii) return on capital employed*). From the following figure, Calculate the value of fully paid equity share of Rs. 10 on (i) dividend basis; and (ii) return on capital employed basis, assuming in each case the market expectation to be 12%

Year Ended	Capital Employed Rs.	Profit Earned Rs.	Dividend
1999	50 crore	8 crore	12%
2000	80 crore	16 crore	15%
2001	100 crore	22 crore	18%
2002	120 crore	30 crore	20%

SOLUTION

(i) Valuation of Shares on dividend basis

The dividend rate on simple average is 65/4 or 16 $^{1/4}$%. But since the dividend has been rising, it would be better to take the weighted average which comes to 17.6% as calculated below:

Year ended	Rate	Weight	Product
1999	12	1	12
2000	15	2	30
2001	18	3	54
2002	20	4	80
		10	176

$$\text{Weighted Average} = \frac{176}{10} = 17.6\%$$

$$\therefore \text{ Value of Share} = \frac{17.6}{12} \times 10 = \text{Rs. } 14.67$$

(ii) Valuation of Share on return on capital employed basis

Year ended	Return on Capital Employed (%)	Weight	Product
1999	16	1	16
2000	20	2	40
2001	22	3	66
2002	25	4	100
		10	222

$$\text{Weighted Average} = \frac{222}{10} = 22.2\%$$

$$\therefore \text{ Value of Share} = \frac{22.2}{12} \times 10 = \text{Rs. } 18.50$$

ILLUSTRATION 9

(Fair Value Method). Balance sheet of A ltd. as on 31-3-2002 was as under:

Liabilities	Rs.	Assets	Rs.
Equity share capital (Rs. 10)		Building	2,00,000
Rs. 10 paid up per share	3,00,000	Plant and Machinery	4,00,000
Rs. 5 paid up per share	2,00,000	Sundry Debtors	2,10,000
9% Preference share capital		Stock	2,50,000
(Rs. 100)	2,00,000	Cash at bank	40,000
Reserve	3,00,000		
Sundry Creditors	2,00,000		
	11,00,000		11,00,000

Profit and dividend in last several years were as under:

Year	Profit before tax	Equity Dividend
2001-02	3,20,000	18%
2000-01	2,50,000	15%
1999-2000	2,20,000	12%

Land and Buildings are worth Rs., 4,00,000. Managerial remuneration is likely to go up by Rs. 20,000 p.a. income-tax may be provided at 50%. equity shares of companies in the same industry with dividend rate of 10% are quoted at par.

Find the most appropriate value of an equity share assuming that:

(a) Controlling interest is to be transferred.

(b) Only a few shares are to be transferred.

Ignore the goodwill value, depreciation adjusted for revaluation and the need of transfer to general reserve.

SOLUTION

Calculation of Maintainable Profit for equity shareholders

Year	Profit Rs.	Weight	Product Rs.
1999-2000	2,20,000	1	2,20,000
2000-01	2,50,000	2	5,00,000
2001-02	3,20,000	3	9,60,000
		6	16,80,000

Average Profit $= \frac{\text{Rs. } 16,80,000}{6}$ 2,80,000

Less: Increase in managerial remuneration	20,000
	2,60,000
Less: Provision for taxation @ 50%	1,30,000
	1,30,000
Less: Preference dividend @ 9% on Rs. 1,00,000	9,000
Maintaining profit for equity shareholders	1,21,000

(a) Valuation of controlling Interest

Method-I-Earning Basis	Rs.
Capitalised value of maintainable profit	
@ 10% for equity shareholders $\left(1{,}21{,}000 \times \frac{100}{10}\right)$	12,10,000
Add: Notional call on 40,000 partly paid shares	
@ Rs. 5 per share	2,00,000
	14,10,000
No. of fully paid equity shares $\left(\frac{\text{Rs. } 3{,}00{,}000}{10}\right)$	30,000
No. of partly paid equity shares $\left(\frac{\text{Rs. } 2{,}00{,}000}{5}\right)$	40,000
Total number of fully paid shares after notional call	70,000

Value of each fully paid equity share $= \frac{\text{Rs. } 14,10,000}{70,000} = $ Rs. 20.14

Value of each partly paid equity share = Rs. 20.14-Rs. 5 = Rs. 15.14

Method II-Net Assets Basis

		Rs.
Assets after revaluation:		
Buildings		4,00,000
Plant and Machinery		4,00,000
Sundry Debtors		2,10,000
Stock		2,50,000
Cash at bank		40,000
		13,00,000
Add: Notional call on 40,000 partly paid shares @ Rs. 5 each		2,00,000
		15,00,000
	Rs.	
Less: Sundry creditors	2,00,000	
9% Pref. Share Capital	1,00,000	3,00,000
Net Assets		12,00,000

Value of Fully paid equity share $= \frac{\text{Rs. } 12,00,000}{70,000} = $ Rs. 17.14

Value of partly paid equity share = Rs. 17.14-Rs. 5 = Rs. 12.14.

Method III-Fair Value Method:

Fair value of shares

$$= \frac{\text{Value of share on earning basis} + \text{Value of share on assets basis}}{2}$$

Fair Value of fully paid share $= \frac{\text{Rs. } 20.14 + \text{Rs. } 17.14}{2} = \text{Rs. } 18.64$

Fair value of partly paid share $= \frac{\text{Rs. } 15.14 + \text{Rs. } 12.14}{2} = \text{Rs. } 13.64$

(b) Valuation of Few Shares

A few shares can be better valued on the basis of dividend paid.

Year	Rate of Dividend
1999-2000	12%
2000-01	15%
2001-02	18%
	45%

Average rate of dividend = 45% + 3 = 15%

Value of share $= \frac{\text{Average Rate of Dividend}}{\text{Normal Rate of Dividend}} \times \text{Paid up Value of Share}$

Value of fully paid share $= \frac{15\%}{10\%} \times \text{Rs. } 10 = \text{Rs. } 15$

Value of Partly paid share $= \frac{15\%}{10\%} \times \text{Rs. } 5 = \text{Rs. } 7.50$

Alternatively, weighted average rate of dividend can also be taken for calculating the value of a few shares as shown below:

Year	Rate of Dividend	Weight	Product
1999-2000	12 %	1	12%
2000-01	15%	2	30%
2001-02	18%	3	54%
		6	96%

Average rate of dividend = $\frac{96\%}{6}$ = 16%

Value of fully paid share = $\frac{16\%}{10\%}$ x Rs. 10 = Rs. 16

Value of Partly paid share = $\frac{16\%}{10\%}$ x Rs. 5 = Rs. 8

Notes.

(1) The profits given in the problem indicate increasing trend, therefore, weighted average profit would give a better figure of maintainable average profit than simple average profit.

(2) It has been assumed that A Ltd. is a going concern and it will call the unpaid amount of partly paid shares in due course. If the amount is not to be called in due course then partly paid shares can be valued on pro-rata basis.

2.8 SUMMARY

The capital of a company is divided into shares. Each share forms a unit of ownership of a company and is offered for sale so as to raise capital for the company. Shares can be broadly divided into two categories - equity and preference shares. Equity Shares are the shares that carry voting rights and the rate of dividend also fluctuate every year as it depends on the amount of profit available to the company. On the other hand, Preference Shares are the shares that do not carry voting rights in the company as well as the amount of dividend is also fixed. One of the major difference between equity shares and preference shares is that the dividend on preference shares is cumulative in nature, whereas the equity share dividend does not cumulates, even if not paid for several years. The term 'value of share' means face value of the market share. The face value of a share is the value assigned to it in the capital clause of the Memorandum of Association. The market value of a share is the value determined by the market force i.e. demand and supply. The necessity for valuation of a share arises in the following circumstances: (i) for estate duty and wealth tax purposes; (ii) for amalgamation and absorption schemes; (iii) for gift tax purposes; (iv) for discharge of debts and liabilities, in exceptional nature; (v) purchasing shares for control; (vi) for selling shares of a shareholder to a purchaser (which are not quoted in the Stock Exchange); (vii) for the conversion of one class of share to another class; (viii) for the compensation made to a company when the said company is being nationalised. (ix) for granting loans on the basis of security of shares (i.e. when the shares are held as security, etc.). There are three methods of valuation of shares: 1. Net assets method of valuation of shares; 2. Yield or market value method of valuation of shares; 3. Dual (or fair) value method of valuation of shares. Net Asset Method-Under this method, value of share is equal to net assets. Yield/Earning Capacity Method-Under this method, value of share is equal to the proportion of expected earning and normal earning of paid up value of shares. Fair Value Method- Fair value method is a combination of Intrinsic value method and Yield Method which calculate the 'Mean' of these two methods. Computation of values of equity shares by Net worth method/ net assets backing method; Yield method; Fair value method.

2.9 GLOSSARY

Shares: A share is defined as a "share in the share capital of the company and includes stock". Share is one of the units into which total capital of a company is divided. The person who is the owner of the shares is called 'Shareholder' and the return he gets on his investment is called 'Dividend'.

Preference shares: Shares which enjoy the preferential rights as to dividend and repayment of capital in the event of winding up of the company over the equity shares are called preference shares. The holder of preference shares will get a fixed rate of dividend.

Equity shares: Equity shares are the main source of finance of a firm. It is issued to the general public. Equity shareholders do not enjoy any preferential rights with regard to repayment of capital and dividend. They are entitled to residual income of the company, but they enjoy the right to control the affairs of the business and all the shareholders collectively are the owners of the company.

Valuation of Share- The term 'value of share' means face value of the market share. The face value of a share is the value assigned to it in the capital clause of the Memorandum of Association. The market value of a share is the value determined by the market force i.e. demand and supply.

Net Assets Valuation Method : Under this method of valuation, it is ascertained that what amount of assets is available with the company for every share, so this method is known as "Assets backing Method." Also known as "Net Assets Method" and "Balance sheet Method" and "intrinsic value method" or break-up value method."

Yield or Market Value Method of Valuation of Shares: The expected rate of return in investment is denoted by yield. The term "rate of return" refers to the return which a shareholder earns on his investment. Further it can be classified as (a) Rate of earning and (b) Rate of dividend. In other words, yield may be earning yield and dividend yield.

Fair Value of Shares : Fair value of share means the average of intrinsic value of share and yield value of share.

2.10 SELF ASSESSMENT QUESTIONS

1. What do you understand by Valuation of Shares? Discuss the different methods of Valuation of Shares.

2. Under which circumstances valuation of Shares is needed?

3. Define the term 'Share'. Explain in brief the different types of shares.

4. What is 'Asset Backing Method' of valuation of shares. State the entire procedure for computation of a value of share under this method.

5. What is 'Yield Basis Method'? State the procedure for computation of a value of share under profit Basis Method.

6. *(Net Assets Basis Method).* Below is given the Balance Sheet of Prosperous Ltd. as at 31st March, 2002:

	Rs.			Rs.
Share Capital:		*Fixed Assets:*		
6% preference Shares of Rs. 100 each fully paid	1,00,000	Goodwill	50,000	
		Land and Building	1,10,000	
Equity Shares of Rs. 100 each fully paid	2,00,000	Machinery	1,50,000	
		Furniture	20,000	3,30,000
Reserve and Surplus:	30,000	Investments:		
Development Rebate reserve	50,000	5% Govt. Securities at cost		
General Reserve	10,000	(nominal Rs. 40,000)		50,000
Capital Reserve	60,000	*Current Assets, Loans and Advances:*		
Profit and Loss Account				
Secured Loan:	60,000	Stock	1,50,000	
5% Debentures		Debtors	60,000	
Current Liabilities and Provision:	90,000	Cash and Bank		
Sundry Creditors	20,000	Balances	30,000	2,40,000
Provision for Taxation				
	6,20,000			6,20,000

Assets are revalued as under:

	Rs.
Land and Building	1,50,000
Machinery	1,25,000
Furniture	25,000

The normal return on capital employed for valuation of goodwill is 10%, the basis of valuation being 3 years' purchase of super profits. 50% of the investment in Building is treated as non-trading asset because a sum of Rs. 7,000 is collected annually as rent from the building. Ascertain the value of each Equity Share assuming that the average annual profit (less tax) is Rs. 60,000.

Ans. (Rs. 199)

Hint: Trading Capital Rs. 2,95,000; Super Profit Rs. 26,000; Goodwill Rs. 78,000.

2.11 LESSON END EXERCISE

1. Explain in brief the various methods of valuation of share.
2. Write Short note on Fair Value of Shares.
3. How do you ascertain the value of a share under Dividend Basis Method.
4. Calculate the value of each equity share by Intrinsic value Method from the following accenting information made available by AMCO. Ltd; as on 31st March, 2014.

Balance - Sheet as on 31st March, 2014.

Liabilities	Rs.	Assets	Rs.
3,000 Equity Shares of of Rs.100 each fully paid	3,00,000	Goodwill	32,000
3,000 8% preference shares of Rs.100 each fully paid	3,00,000	Buildings	1,67,000
		machinery	3,05,000
Reserve fund	1,20,000	Investments	76,000
creditors	40,000	Stock in Trade	1,10,000
Bills payable	25,000	Debtors	90,000
Bank Overdraft	15,000	cash at Bank	10,000
		under writers commission	10,000
	8,00,000		**8,00,000**

The assets were revalued for the purpose of valuation of shares of the company as follows:

Goodwill - Rs. 72,000, Buildings - Rs. 2,27,000, machinery - Rs. 2,65,000, Investment of Book value, stock - Rs. 1,70,000, Debtors less Rs. 8,000.

(2) The issued capital of Bokaro Ltd., is Rs. 10,00,000 divided into 1,00,000 Equity shares of Rs. 10 each. The net profits of the company for the last five years were as follows:

Year	**Net Profit** Rs.
2010	72,000
2011	97,000
2012	1,16,000
2013	1,41,000
2014	1,74,000

Every year 20% of the profits were transferred to General Reserve. The normal rate of return in respect of equity shares of this type of companies is 10%.

Calculate the value of the equity shares of Bokaro Ltd. by Yield Basis Method.

5. *(Fair Value Method)*. Given below is the Balance Sheet of Wye Co. Ltd. as on 31st March, 2002:

Liabilities	Rs.	*Assets*		Rs.
1,000 8% Preference Shares of Rs. 100 each fully paid	1,00,000	Building	1,55,000	
		Less: Depreciation	25,000	
2,000 Equity Shares of Rs. 100 each fully paid	2,00,000			1,30,000
General Reserve	1,10,000	Machinery	1,60,000	
Profit and Loss Account	40,000	*Less:* Depreciation	40,000	
Creditors	1,00,000			1,20,000
		Furniture	25,000	
		Less: Depreciation	5,000	
				20,000
		Investments in 6% Govt. Securities (Face Value Rs. 1,00,000)		90,000
		Stock		1,00,000
		Debtors	65,000	
		Less: Bad Debt Reserve	5,000	
				60,000
		Cash and Bank Balances		20,000
		Preliminary Expenses		10,000
	5,50,000			5,50,000

You are given the following information:

(1) The present value of Building is Rs. 1,80,000 and that of Machinery is Rs. 80,000.

(2) Companies doing similar business show profit earning capacity of 10% on market value of their shares.

(3) The average annual profit after 50% tax of last three years is Rs. 48,000.

(4) The company has held 6% Govt. Securities for last 3 years and the interest on the Govt. Securities is liable to tax.

(5) Goodwill of the company is to be taken at 5 years' purchase of super profits.

(6) It is considered necessary to transfer Rs. 10,000 to General Reserve before declaring any dividend.

Calculate the fair value of the share of the company.

Ans. (Rs. 173.75 per share)

Hint: Value of Goodwill Rs. 45,000; Intrinsic Value of Share Rs. 197.50; Value of Share on Yield Basis Rs. 150.

2.12 SUGGESTED READING

Advanced Accounts : Shukla M.C., Grewal T.S. and Gupta S.C.

Taxmann's Fundamentals of Corporate Accounting : Sehgal Ashok

Corporate Accounting : Jain S.P. and Narang, K.L.

Advanced Accounting : Hoyle, J.B., Schaefer, T. and Doupnik, T.

Corporate Accounting : Tulsian, P.C.

Liquidation of Companies

STRUCTURE

3.1 INTRODUCTION

Liquidation (or "winding up") is a process by which a company's existence is brought to an end. First, a liquidator is appointed, either by the shareholders or the court. The liquidator represents the interests of all creditors. The liquidator supervises the liquidation, which involves collecting and realising the company's assets , discharging the company's liabilities, and distributing any funds left over among the shareholders in accordance with the provisions of Companies Act, 1956 . Winding-up is the process by which management of a company's affairs is taken out of its directors' hands, its assets are realized by a liquidator and its debts are realized and liabilities are discharged out of proceeds of realization and any surplus of assets remaining is returned to its members or shareholders. At the end of the winding up the company will have no assets or liabilities and it will, therefore, be simply a formal step for it to be dissolved, that is, for its legal personality as a corporation to be brought to an end. The main purpose of winding up of a company is to realize the assets and pay the debts of the company expeditiously and fairly in accordance with the law. However, the purpose must not be exploited for the benefit or advantage of any class or person entitled to submit petition for winding up of a company. It may be noted that on winding up, the company does not cease to exist as such except when it is dissolved. The administrative machinery of the company gets changed as the administration is transferred in the hands of the liquidator. Even after commencement of the winding-up, the property and assets of the company belong to the company until dissolution takes place. On dissolution the company ceases to exist as a separate entity and becomes incapable of keeping property, suing or being sued. Thus in between the winding up and dissolution, the legal status of the company continues and it can be sued in the court of law.

3.2 OBJECTIVE

After reading this lesson, you should be able:

- To know the concept of Liquidation
- To know the Legal and Financial Reasons for Liquidation
- To know the Modes of Liquidation
- To know the concept of contributory
- To know the types of creditors
- To understand the Liquidator's Final Statement of Account.
- To know the Deficiency Account as regards contributory Account

3.3 CONCEPT OF LIQUIDATION

Liquidation or winding up is a Legal term and refers to the procedure through which the affairs of the company are wound up by law. It is a legal process through which the business of a company is terminated or wound up is known as liquidation. Thus, the' winding up or to terminate the business of a joint stock company in the legally prescribed manners is known as liquidation. An Administrator called the Liquidator is appointed and he takes control of the company, collects its assets, pays its debts & finally distributes any surplus among the members in accordance with their rights.

In other words, the term liquidation refers to winding up of a company or to close up a company or to dissolve the business of a company or to stop the business of a company. It is the last stage in the life of the company. It is the proceeding by which a company is liquidated or dissolved or wound up.

Liquidation of a company can take place under both the cases e.g. (i) in case the company is insolvent or (ii) in case the company is not insolvent. On dissolution of the company, the assets of the company are ‘disposed of through sale or realisation and the liabilities of the company are discharged out of the amount of realized assets. In case there is some surplus, it would be distributed among members. An administrator called ‘liquidator’ is appointed who takes over the control of the company, collects its assets, pays its liabilities and finally distributes the surplus among its member in accordance with their rights as per the Companies Act of 1956. In between winding up and dissolution, the legal entity of the company remains and it can be sued in a Courts of Law.

DEFINITIONS

Important definitions of the term ‘Liquidation’ are as under.

1. According to the Companies Act, 1956, “Winding up of a company is defined as, “the process whereby its life is ended and its property is administered for the benefit to its creditors and members.”

2. According to Prof. Gower, “Winding up of a company is the process in which the life of a company comes to an end and its assets administered for the financial benefit of its creditors and the members of the companies.”

CONSEQUENCES OF WINDING UP

The following are the consequences of winding up:

1. An officer called a liquidator is appointed & he takes over the administration of the company. He may be appointed by High Court, members or by the creditors as the case may be.

2. The powers of the board of directors will cease & will now vest the liquidator.

3. Winding up order or resolution of voluntary winding up shall operate as a notice of discharge to all the members of the company. Members of company are called ‘Contributories’.

4. Liquidator of the company will prepare a list of contributories who be made liable to contribute to the assets of the company in case assets are not sufficient to meet the claims

of various claimants. In case there is a surplus in the assets, the liquidator of the company will prepare a list of those members, who are entitled to share this surplus.

5. Liquidator of the company will collect & realise its assets & distribute the proceeds among right claimants as per the procedure of the law.

6. Winding up ultimately leads to dissolution of the company. The company's life will come to an end & it will be no more an artificial person in the eyes of law. CONT

3.4 REASONS FOR THE LIQUIDATION

There are basically two reasons for the liquidation of a Joint-Stock-Company.

They are as under:

(1) Financial Reasons

(2) Legal Reasons

3.4.1 FINANCIAL REASONS

I. When the company's financial position has eroded beyond repair and the company can neither payoff its debts nor is in a position to get financially rehabited despite liberal financial accommodation made available by the financial institutions.

II. Where the before has adjudicated the financial position of a company as bad and it is not in the interest of public to carry out the objectives of the company.

3.4.2. LEGAL REASONS

Liquidation is a legal procedure by which the corporate life of a company is brought to an end. A company which is wound up need not necessarily be a bankrupt company, sometimes even solvent companies are liquidated.

3.5 MODE OF LIQUIDATION

Some salient features of liquidation include the realization of various assets the collection of uncalled capital, if required, and the settlement of the debts and obligations of the company out of the proceeds If any surplus-is-left, it sleuthed to the shareholders of the company according to their rights. The job of rising various assets and settling the debts and obligations of the company is performed by a person called the liquidation. The, liquidation can take place in any of the following three ways:

(1) Compulsory winding up by the Court.

(2) Voluntary winding tip:

a) Members' voluntary winding up.

b) Creditors' voluntary winding up

c) Winding-up subject to supervision of the Court

3.5.1 Compulsory winding up by the Court

A court may order the winding up of a company on any one or more of the following grounds

(a) If the company has passed a special resolution to the effect that the company be wound up by the court,

(b) If default is made in filing statutory reports or in holding statutory meetings

(c) If the company does not commence business within a year from its incorporation or suspends its business for a whole year

(d) If the number of members is reduced to below two in the case of a private company and below seven in the case of any other company,

(e) If the company is unable to pay its debts and

3.5.2 Voluntary-winding up

Voluntary-winding up made either Members' voluntary winding up or Creditors—voluntary winding When a company's solvency is declared b the directors in voluntary winding up it is called Members' voluntary winding up When a company s solvency is not declared by the directors in voluntary winding up, it is called Creditors voluntary winding up. Winding up subject to supervision of the Court

3.5.3 Winding up Under the Supervision of Court:

This is voluntary winding up with the supervision of court. The-object of a supervision order is to ensure the protection of interests of all persons concerned — the company, the contributories and the creditors.

1. Members' Voluntary Winding Up

When the company is solvent and is able to pay its liabilities in full, it need not consult the creditors or call their meeting. Its directors, or where they are more than two, the majority of its directors may, at a meeting of the Board, make a declaration of solvency verified by an affidavit stating that they have made full enquiry into the affairs of the company and that having done so they have formed an opinion that the company has no debts or that it will be able to pay its debts in full within such period not exceeding three years from the commencement of the winding up as may be specified in the declaration.

In Shri Raja Mohan Manucha v. Lakshminath Saigal (1963) 33 Comp. Cas. 719, it was held that where the declaration of solvency is not made in accordance with the law, the resolution for winding up and all subsequent proceedings will be null and void. Such a declaration must be made within five weeks immediately preceding the date of the passing of the resolution for winding up the company and be delivered to the Registrar for registration before that date. The declaration must be accompanied by a copy of auditor's report on the balance sheet and profit & loss account as at the latest practicable date before the making of the declaration and also embody a statement of the company's assets and liabilities as at that date. . Any director making a declaration without having reasonable grounds for the aforesaid opinion, shall be punishable with imprisonment extending up to six months or with fine extending up to ' 50,000 or with both [Section 488].

A winding up in the case of which such a declaration has been made and delivered in accordance with Section 488 is referred to as "a member's voluntary winding up".

2. Creditors' Voluntary Winding Up

As discussed earlier, where a declaration of solvency of the company is not made and delivered to the Registrar in a voluntary winding up it is a case of creditor's voluntary winding up.

3.6 MEANING OF LIQUIDATOR

The Liquidator is a person appointed by the shareholders (in case of voluntary liquidation) for the purpose of conducting the legal proceedings in liquidation of a company and performs such duties relating thereto, as may be imposed upon him. He is also called as an Official (Liquidator) Receiver when appointed by the Court in case of compulsory liquidation.

The liquidator is either a whole-time officer attached to each High Court and appointed by the Central Government. For compulsory liquidation, the official liquidator will be appointed by the Court and he functions, as a provisional liquidator until an order of liquidation is passed. Subsequently, he becomes the liquidator of the company. For voluntary Liquidation, the Liquidator is appointed by the company in a general meeting, and his remuneration is fixed by the company. The remuneration fixed cannot be increased even with the sanction of the court. In case of voluntary liquidation by creditors, the Liquidator is appointed by the both members and creditors at their respective meeting. In case the creditors and members appoint different persons, the persons nominated by the creditors will be Liquidator of the company.

3.7 POWERS OF LIQUIDATOR

According to Section 457 of the Act, with the sanction of the Court, the Liquidator can exercise the powers as:

i. To institute cavil and criminal proceedings in the name of the company and on behalf of the company
ii. To sell the assets/properties of the company.
iii. To raise money on the security of the assets.
iv. To carryon the business of the company so far as may be necessary for the liquidation of the company.
v. To execute all deeds, receipts and documents in the name and on behalf of the company.
vi. To draw, accept, make and endorse any negotiable instrument in the name and on behalf of the company.
vii. To prove, rank and claim in the insolvency of any contributory.

viii. To do such other things as maybe necessary for the liquidation of the affairs of the company and distributing its assets,

3.8 DUTIES OF LIQUIDATOR.

It includes-

a) **In case of compulsory liquidation:** The Liquidator has to, on receipt of the statement of affairs of the company prepared as per Section 454 of the Act and not later than six months from the date of liquidation order, prepare and submit a preliminary report to the Court. Within two months of the liquidation, Liquidator has to convene a meeting of the creditors to find out whether they would like to appoint a committee of inspection. A Liquidator must also suppose to convene meetings of creditors or contributories when requisitioned by at least 1/10 in value of the creditors or contributories; He is suppose to maintain the proper books of the account and should deposit all the funds of the company into the RBI.

b) **In case of voluntary liquidation:** Since a Liquidator is appointed by the members or by the creditors or both as an agent and not an officer of the court. As per Section 512 of the Act, a Liquidator has to discharge the duties imposed upon him. He is not allowed to keep the money with him or in his account, nor make secret profits He is also liable for misfeasance if-he pays money to a person who has no claim. He is directed to deposit the funds of the company in a scheduled bank in the name of the 'Liquidation account of... Co. Ltd. As per Section 512 of the Act he is authorized to do everything without the sanction of the members or creditors. He is authorized to exercise some of the powers with regard to setting contributories, lists, admitting claims, making calls, convening meetings of members etc.

3.9 CONCEPT OF CONTRIBUTORY

Members: If liabilities of the members of the companies is limited by shares, every member is liable to pay the full face value of shares held by him. This liability which is declared in the case of going concern also continues after the company is liquidated. In the latter case, however, the members are called as contributories.

Definition of Contributory:

According to Section 428 of the Companies Act 1956 a contributory is defined as, “every person liable to contribute to the assets of a company in the event of its being wound up and includes a holder of fully paid up shares and also any person alleged to be contributories.”

As per this definition, a contributory is a present member or past member, and the term also includes the holders of fully paid shares. Present members are those who continue to be members at the commencement of liquidation, and past members are those whose membership ceased by transfer, surrender or forfeiture within one year before the commencement of liquidation. The contributories are sub-divided as

L**ist A**. It includes present members and they are liable to pay tile unpaid amounts and uncalled amounts on their holdings.

List B. it includes past members, the liability of a past member included in list B arises only in the event of the transferee who is a present member fails to pay and debts incurred by the company during his membership remain unpaid after applying all the assets and contributions of the present members. The maximum amount which a past member may be called upon to pay is limited to the sum remaining unpaid on the shares held his transferee as a present member.

In case the company is a going concern, the liability to pay call money is contractual in nature. However, at the time of liquidation, the liability becomes legal. As such, although unpaid call money before winding up might have become time-barred the contributories are never the less liable to pay the same.

A contributory cannot claim any set-off in respect of his liability to pay call money against, amounts due to him by the company for dividend or any other sum. He should, first of all, fulfill his obligation of contribution and then claim the amount due to him. Even in this respect, the claim will be considered at par with other members and not with creditors.

In case of surplus of assets, the rights and interests of contributories should also be adjusted for the purpose of distributing the surplus of assets. In other words, if any surplus left after discharging all outside liabilities, the same should be distributed amongst the contributories according to their interests. It is necessary to distribute the surplus to those who have paid in full on their holding in preference to any other class of shareholders belonging to the same group holding partly paid-up shares.

In case any surplus still remaining after repayment of share capital in fuji, will go to the equity shareholders unless the Articles mention that preference shares are participating.

3.10 VARIOUS TYPES OF CREDITORS

For a solvent company being liquidated or wound up, creditors would be paid in-full, subject to their claims being proved. However, on liquidation of an insolvent company, the insolvency principles which are applied in the matter of payments to the creditors include:

1. Secured Creditors: Secured creditors are those creditors which are either fully secured or partly secured. In case they are fully secured, the value of security would be more than the amount due, and if the partly secured creditors, the value of the security would be less than the amount due.

In case a solvent company is liquidated, no distinction is made between fully secured and partly secured creditors, and all claims against the company are admissible and paid when approved. In case of liquidation of an insolvent company, however, a secured creditor may:

- Rely on the security and ignore the liquidation, or
- Realize his security and prove for the balance, or
- Give up his security and prove for the whole amount.

2. **Partly Secured Creditors**. These creditors stand midway between and fully secured creditors and unsecured creditors. To the level of security held by them, they are secured and for the unsecured creditors portion of the amount due they are unsecured creditors. As such, after realizing their security they rank as unsecured creditors proving for the Balance amount.

3. **Unsecured Creditors**. Unsecured creditors are those creditors who do not have any security for the amount due to them. They comprise preferential creditors and others. In the case of liquidation of an insolvent company, the order of payment is:

a) Preferential creditors, and

b) Other debts panpassu

If the company is solvent, a creditor can prove for interest till the date of payment of his debt. However, in the case of an insolvent company, interest can be proved only up to the commencement of liquidation or winding up.

4. Preferential Creditors Payment. As per Companies Act, 1956, in every mode of liquidation, the following debts are to be paid in priority over all other debts, after retaining necessary amount for costs and expenses of liquidation. Further, these debts rank equally among themselves and be paid in full-. However, in the event of the assets, being inadequate, they shall allocate in equal proportions. The preferential payments are may be of:

(a) All revenues, taxes, cesses and rates due to government or a local authority,, and payable within the twelve months before the commencement of liquidation or winding up.

(b) All wages or salaries of an employee due for the period not exceeding 4 months within the 12 months next before the commencement of liquidation, and any compensation payable to any workman under any of the provisions of the Industrial Disputes Act, provided the amount payable to anyone claimant will not exceed Rs. 1000.

(c) All accrued holiday remuneration becoming payable to any employee on the termination of his employment before or by the liquidation order or resolution.

(d) Unless the company is being liquidated voluntarily for reconstruction Or amalgamation, all amounts due in respect of contributions payable during the 12 months next before liquidation, by company under the Employees State Insurance (E.S.I.) Act or any other law for the time being in force.

(e) Unless the company is being liquidated voluntarily for reconstruction or amalgamation, or where it has taken out a workmen's compensation insurance policy, all compensations due under the Workmen's Compensation Act.

(f) All payments due to an employee from a provident funds, pension fund, gratuity fund or any other fund for the welfare of the employees maintained by the company.

(g) The expenses of any investigation held under Section 235 or 137, in so far as they are payable by the company.

Persons who advance money for the purpose of making preferential payments under (ii) and (iii) above will be treated as preferential creditors. Persons who claim to be creditors must prove their debts within the time fixed by the court or by the liquidation in the case of voluntary liquidation. Preferential creditors mentioned above have priority over debenture holders carrying a floating charge created by the company.

5. Debentures: Debentures are loans for a fixed period carrying a fixed rate of interest. It is a document which either creates a debt or acknowledges it. It includes debenture stock, bonds and any other securities of a Company, whether constituting a charge on the assets of the company or not Section 2(12) of the Companies Act 1956.

Debenture holders carrying a fixed charge stand in the same position as that of secured creditors. They enjoy priority over all the other claimants to the extent of the value of security held by them or the amount due to them, whichever is less. In case of floating charge, however, their claim arises only after the claims of preferential creditors but before payment to unsecured creditors.

Interest of debentures is payable up to the date of repayment of debts in case of a solvent company and up to the commencement of liquidation in case of an insolvent company.

At the time of making payment to debenture holders, it is necessary to consider their position, if they carry both fixed and floating charge. For this, in case the value of fixed charge they are paid in full, and for the balance which is covered by floating charge, they rank only next to preferential creditor. However, if they carry only a fixed charge and the value of the same is less their claim, they rank for the balance due only as unsecured creditors.

6. Unsecured Creditors. It includes creditors or trade creditors, trade expenses, open creditors, bills payable, bank loan or overdraft which is of unsecured nature, balance of partly secured creditors, balance of fixed charge in the case of debentures and any other debt.

7. Shareholders. According to Section 86 of the Companies Act 1956, company is limited by shares and empowered to issue only two types of shares which are as under: -

I. Preference shares

II. Equity shares

(i) Preference Shareholders According to Section 85(1) of the Companies Act 1956, preference shares enjoy two very important rights such as:

(a) Preference as regards dividends

(b) Preference as regards to repayments of capital at the time of liquidating the business of the company.

These rights being statutory, cannot be taken away by a suitable clause in the Memorandum or Articles of Association of the companies. It is also necessary to remember that the right to receive dividends in preference to equity shareholders is not an absolute right but only a limiting right. The holders of preference shares are entitled to claim a preferential treatment only when dividends are declared. The right of preference shareholders is not a right to dividends but to preferential treatment, if any, when a dividend is to be distributed as per Palmer's Company Law, Page 293. It may be noted that right to claim arrears is available only to the holders of cumulative preference shares. Preference shares are always taken as cumulative unless otherwise stated. In any case any dividend declared but unpaid has to be paid in priority to even return of capital to the preference shareholders.

(ii) Equity Shareholders: Equity shareholders are the shareholders having priority to get money at the time of liquidation after the payment of preference shareholders. In case any surplus is left, such surplus will go to the equity shareholders. However, in case the preference shares are participating, they will be entitled to share such surplus with the equity shareholders in the ratio as given in the company's articles.

8. Interest on Debt: Interest on loan payable by the company on loans, debenture etc. depends on the position of a company whether the company is solvent or insolvent. If the company is solvent, interest will be paid upto the date of actual payment. If the company is insolvent, the interest will be payable only upto the date of commencement of company's liquidation of winding up.

9. Debentures and Debentures Interest: Debentures are presumed to be having a floating charge (unless specifically contradicted) and interest on debentures should be paid upto the date of actual payment to the debenture holders and not only upto the date 'of liquidation provided the company is solvent. Students are therefore advised to be careful about the date of the payment given in an examination problem.

10. Arrears of Dividends on Preference Shares: It should be paid only upto the date of liquidation and not for any period falling after the commencement of winding tip provided such preference shares are cumulative ones. In the absence of specific wordings, the preference shares are treated as cumulative preference shares. The question of arrears does arise in case of non-cumulative preference shares. As regards, dividend up to the date of winding up, the provisions of Articles of Association will apply. According to the rules, the dividend becomes payable only when declared by the shareholders in general meeting. If dividend on preference shares was declared, it is to be paid as a debt and not as an arrear of dividend.

The problem arises when it is desired to give to the preference shareholders priority in a winding up not only as to capital but also as to arrears of dividend. It is pointed out that arrears of preference dividend will be paid when preference share capital and equity share capital have been paid in full and surplus is left. The reason given is that the preference shareholders have priority as regards repayments of capital and they also enjoy priority in respect of payments of preference dividend over the payments of equity dividend. But the preferences shareholders have no priority of payment of preference dividend over the payment of equity capital. Thus the arrears of preference dividend should be paid on only after paying the equity capital. Section 205 which provides that dividend can be paid only out of profits, applies only up to the stage prior to winding up; it applies only to a company as a going concern and not to one in liquidation.

i) Payment to Equity Shareholders: Calls in Arrears and Calls-in-Advance. Equity shareholders are paid only ill the funds are available after the settlement of all claims of the outsiders and, the preference shareholders. In case, the equity shares are partly paid up and the funds available are not sufficient to meet the claims of the preference shareholders in full, the liquidator will have to make a call: in order to repay the preference shareholders not in full, in some cases, such shareholders may not pay such calls then if the surplus after meeting claims of preference shareholders to sufficient for the refund of equity capital in full, such surplus will be first utilized to return the Share capital of those equity shareholders who have paid the call, till the paid up capital equals the amount paid up by the defaulting shareholders. If there is still surplus, it will be distributed equally among all, including the defaulting shareholders.

ii) Calls-in-advance: It may be noted, than calls in advance will have priority in repayment over the paid up share capital of that class. Finally, lithe equity shareholder have paid different amounts on their shares, the loss suffered by each shareholder should be equal. It should be ensured that all equity shareholders suffer equally while calling upon them to pay.

3.11 LIQUIDATOR'S REMUNERATION COMMISSION.

General liquidator-gets the remuneration in the form of commissions which is to be calculated on the value of assets realized and the amount payable to unsecured creditors.

Following points to be taken into consideration while calculating the Liquidator's commission:

(i) Commission on Assets given as Securities Creditors. The Liquidator is suppose to get commission on the surplus from such assets left after making the payment of secured creditors as he makes an effort of realizing the surplus of such assets from secured creditors. In case he sells the assets himself, he gets a commission on the total proceeds of such assets.

(ii) Cash and Bank Balance. In case the liquidator is suppose to get a commission on realization of assets, he also gets a commission on (ash and bank balance unless otherwise stated.

(iii) Commission on Unsecured Creditors. In case the liquidator is to get a commission on the amount payable or due to unsecured creditors, unsecured creditors will also include preferential creditors for the purpose of calculation of remuneration unless otherwise stated. There are two formulas suggested for the calculation of liquidator's commission which are as under:

(iv) In case amount payable to unsecured creditor's is sufficient, the formula for the calculation of liquidator's commission is as under

Liquidator's commission

$$\frac{\text{Amount payable to unsecured creditor X \% of Commission}}{100}$$

(v) In case amount payable to-unsecured creditor's is not sufficient, formula for the calculation of liquidator's commission is asunder:

$$\frac{\text{Amount payable to unsecured creditors X \% of commission}}{(100 \quad \text{\% of commission})}$$

3.12 PREPARATION OF STATEMENT OF AFFAIR'S AS REGARD'S CREDITORS

Preparation of the Statement of Affairs:

The officers and directors of a company under liquidation must, according to Section 454 read with Section 51 1A, make out and submit, within 21 days of the Court's order (or within such extended 3 months, as the liquidator or the Court may allow), a statement showing the following:

(a) the assets of the company, stating separately the cash balance in hand and at bank, if any, and the negotiable securities, if any, held by the company;

(b) its debts and liabilities;

(c) the names, residences and occupations of its creditors, stating separately the amount of secured debts particulars of the securities given, whether by the company, or its officers, their value and the dates on which they were given;

(d) the debts due to the company and the names, residences and occupations of the persons from whom they are due and the amount likely to be realized;

such further or other information as may be prescribed by the Central Government or as the Official Liquidator may require.

The statement has to be properly verified on an affidavit. It has to be open for inspection by any person stating himself creditor or contributory of the company, on payment of prescribed fee. The person concerned can also acquire a copy or extract from -it. The form in which it has to be made out has been prescribed by the Supreme Court; it is given below:

Form 57

(See Rule 127)

In the High Court	(Or) in the District Court at
Original jurisdiction	In the matter of companies act 1956

In the matter of ………..Ltd.

Company Petition No of

Statement of Affairs under section 454

Statement of affairs of the above-named company as on the day of the date of.. the winding-up order (or the order appointing provisional Liquidator or the date directed by the Official (Liquidator).

I/We of do solemnly affirm say that the statement made overleaf and the several lists hereunto annexed marked 'A' to 'H' are to the best of' my /our knowledge and belief, a full', true and complete statement as to the affairs of the above named company, on the day of 20 the date of the winding-up order (or the order appointing Provisional Liquidator or the date directed by the Official Liquidator) and the said company carries/carried on the following business:

(Here set out nature of company's business)

Signature (s)

Solemnly affirmed this day of before me.

- Commissioner for Oaths

The Commissioner is particularly requested, before swearing the affidavit, to ascertain that the full name, address and description of the deponents are stated, and to initial any crossing-out or other alternations in the printed form. A deficiency in the affidavit in any of the above respects will entail its refusal by the Court, and will necessitate its being re-sworn.

Note The several list annexed are not exhibits to the affidavit

STATEMENT OF AFFAIRS

Statement as to the affairs of Ltd. on the day of being the date of winding-up order (or order appointing Provisional Liquidator or the date directed by the Official Liquidator, as the case may be) showing assets at estimated realizable values and liabilities expected to rank:

Assets not specifically pledged (as per List 'A')

	Estimated Realizable values Rs.
Balance at Bank	
Cash in Hand	
Marketable securities	
Bills receivable	
Trade Debtors	

Loan & Advances

Unpaid Calls

Stock in Trade

Work in Progress

Freehold Property, Land & Buildings

Leasehold Property

Plant & Machinery

Furniture, Fittings, Utensils, etc.

Investments other than marketable securities Livestock

Other property, etc.

	A	b	c	d
Assets specially	estimated	due to	deficiency	surplus
pledged	reliable	secured	ranking as	carried
(as per list B)	values	creditors	unsecured	to last

Column

Freehold property Rs Rs Rs Rs Rs.

Estimated surplus from assets

Specifically estimated total assets available for preferential creditors liabilities-holders secured by a floating charge, and unsecured creditors (carried forward) Rs.

Summary of Gross Assets

(a) Gross realizable value of assets specialty pledged

Other Assets

Estimated total assets available for preferential creditors, debenture-holders

secured by a floating charge, and unsecured creditors

(brought forward)

(e) Liabilities

Gross Liabilities (to be deducted from surplus or added to deficiency as the case

may be) Rs.

Secured creditors (as per List 'B' to the extent to which estimated to be covered by assets specifically pledged [Item as above, whichever is lessi (insert Preferential creditors (as per list 'C'

Estimated balance of assets available for secured by a floating charge and unsecured Debenture holders secured by a floating charge (as per list 'D')

Estimated Surplus/Deficiency as regards Debenture

Unsecured Creditors (as per list 'E'):

Estimated unsecured balance of claims of creditors on specific assets, brought from proceeding page (c)

Trade Creditors

Bills payable

Outstanding Expenses

Contingent Liabilities (state nature)

Rs. Estimated surplus/deficiency as regards Creditors (being difference between Gross Assets brought preceding page (d) and Gross Liabilities, as per colunm (e']

Issued and Called-up Capital:

Preference shares of each,

Rs called-up (as per List 'F)

equity share of each,

Rs called-up (as per List 'G')

Estimated surplus/Deficiency as regards Members

(as per List 'H') Rs.

List of G containing details of assets and liabilities supplementary schedules are not given.

List A gives a complete list of assets which are not in the hands or pledged in favour of secured creditors.

List B gives the list of assets which are specifically pledged with creditors both fully secured and partly secured.

List C is a list of preferential creditors and the amounts due.

List D is a list of debenture holders having floating charge.

List E contains names of unsecured creditors and the amount due.

List F gives the names and holdings of preference shareholders. List G is a list of equity shareholders together with the amount the share held.

List H is a statement showing how the surplus or deficiency on the statement of affairs arose as a result of the profits and losses of the company (from given below).

List 'H' Deficiency or Surplus Account.

The period covered by this Account must commence on a dare not less than three years before the date of winding-up order (or the order appointing Provisional Liquidator, or the date directed by the Official Liquidator) or, if the company has not been incorporated for that the period, the date of formation of the company, unless the Official Liquidator otherwise agrees. Items contributing to Deficiency (or reducing Surplus):

1. Excess (if any) of Capital and Liabilities over Assets on the as shown by Balance Sheet (copy annexed).

2. Net dividends and bonuses declared during the period from . to the date of the statement.

3. Net trading losses (after charging items shown in note to follow for the same period).

4. Losses other than trading losses written oil or for which provision has been made in the books during the same period (Give particulars annex schedule.

5. Estimated losses now written off or for which provision has been made for the purpose of preparing the statement (give particulars schedule).

6. Other items contributing to deficiency (or reducing Surplus Items reducing deficiency (or contributing to Surplus) —-

7. Excess (if any) of Assets over Capital and Liabilities on the 20 to the date of statement.

8. Profits and income other than trading profits during the same period (give particulars or annex schedule).

9. Other items reducing deficiency or contributing to Surplus:

Deficiency/Surplus (as shown by the Statement of Affairs).

Rs.

Note as to Net Trading Profits and Losses

Particulars are to be inserted here (so far as applicable) of the items mentioned below, which are to be taken into account in arriving at the amount of net trading profits or losses shown in this account:

Provisions for depreciation, renewals or diminution in value of fixed assets. Charges for Indian income-tax and other Indian taxation on profit. Interest on debentures and other fixed loans, payments to directors made by the Company and required by law to be disclosed in the accounts. Exceptional or Non-recurring expenditure:

Less: Exceptional or non-recurring receipts:

Balance, being other trading profits or losses.

Net trading profits or losses as shown in Deficiency or-Surplus Account above

Signature: Dated as on

Briefly, the scheme of the statement of affairs is as follows:

Put down the "free" assets (assets not specially pledged) at their realizable

Add any surplus expected from securities in the hands of the creditors.

Deduct unsecured creditors together with unsatisfied balance of partly secured

(a)

(b)

(c)

Deduct Share Capital.

If at any stage the deduction to be made IS more than the amount available, Deficiency appears: otherwise there is a Surplus.

In preparing the statement, the following further points should be noted:

Liability in respect of bills discounted by the company is contingent; any amount expected to be paid in respect of bills discounted should be included in List E. This applies to all contingent liabilities,

Bills payable are creditors and should be included in the appropriate lists according to the securities held by the holders of the bills. Generally, Bills payable are included in unsecured creditors. (List E.)

Debentures should be assumed to have a floating charge if nothing is mentioned regarding the security debenture holders (List D)

Unclaimed dividends should be included in unsecured creditors. Uncalled capital should not be treated as an asset but W' in arrear should be treated as an asset. (List A),

(f) Personal securities should be ignored.

Salient Points regarding Preparation of Statement ofAffairs6

(1) Personal sureties should be ignored.

(ii) Calls in arrear should be treated as an asset.

(iii) Debenture holders should be assumed to have a floating charge on the whole of assets of the company.

(iv) Even solvent company can be liquidated.

(v) Bill discounted expected to be dishonored or expected to be paid should be considered as contingent liabilities and should be include4 in 'List E'.

(vi) Unclaimed dividends should be included in unsecured creditors. (List E). (vii) The fictious assets such as P/LA/c, Debit balance, Discount on issue of shares or debentures, underwriting commission, Preliminary expenses etc. should not be taken as asset in statement of affairs.

(viii) The interest on loan or debenture is payable upto the date of payment if the company is solvent. Otherwise, the interest is payable only up to the date of commencement of winding up. Solvent means if the company can pay to the unsecured creditors.

3.13 PREPARATION OF LIQUIDATOR'S STATEMENT OF ACCOUNT.

A liquidator final statement of account is prepared by the Liquidator at the time of liquidation in the prescribed form No. 156 of Companies Act, 1956. This account, also known as Liquidator's Statement of Account, is a true copy of the income and expenditure or receipt and payment account. All items concerning to income are adjusted on the receipt side and all items concerning to expenditure are adjusted on the payment side of the Liquidator's final statement account.

Transactions are adjusted strictly as per proforma of the statement suggested by the Act.

FINAL

PROFORMA

Liquidator's Final Statement of Account

Receipt	Amount	Payment	Amount
To Realisation of Assets Cash in Hand Cash at Bank Marketable Securities Bills Receivable. Trade Debtors Loans & Advances To Call in Arrears:		By Legal charges remuneration By Liquidator's % on Rs.. realized By Auctioneer's charges By Cost of Notice By Cost of Outlay (Establishment and other charges) By Debenture Holders	

(Unpaid calls at the commencement of winding up) To Calls Received: (Amounts received from calls on made in winding up) Stock in Trade Leasehold property Plant & Machinery Furniture, Fittings Patents, Trade Mark To Surplus from Securities		(including interest on debentures upto the date of payment) Payment of Rs. per Investments By Creditors: (a)Preferential (b) Equity shareholders	

Illustration 1

The Unlucky Co. Ltd. went into liquidation. Its assets realized Rs. 3, 50,000 excluding amount realized by sale of securities it held by the secured creditors

Share Capital 1,000 Shares of Rs. 100 each	1,00,000
Secured Creditors (Securities realized)	35,000
Preferential Creditors	6,000
Unsecured Creditors	1,40,000
Debentures having Floating charge on	
the assets of the Company	2,50,000
Liquidation Expenses	5,000
Liquidator's Remuneration	7,500
Prepare the Liquidator's final statement of account.	

The Unlucky Co. Ltd.

Liquidator's Final Statement of Account

Solution:

Receipt	Rs	Payment	Rs
To assets	3,50,000	By liquidators remuneration	7500
To surplus from seared		By liquidation expenses	5000
Creditors (40000-35000)	5000	By debentures	
	355000	(having floating charge)	250000
		By Preferential Creditors	6000
		By Unsecured Creditors	
		(Remaining amount)	86500
	355000		355000

Note. Nothing can be paid to the Shareholders as the amount available is not even sufficient to pay the creditors in full.

Illustration 2.

The New India Co. Ltd. went into voluntary liquidation on 1.1.2002 on which date dividends on the preference shares were in arrears for two years. The subscribed capital of the company consisted of:

40,0006% PrefShares of Rs. 10/- each fully paid.

50,000 Equity Shares of Rs. 10/- each Rs. 6 paid.

The Assets realized Rs. 3,50,000. The expenses of liquidation come to Rs. 9,800.

The Liquidator is entitled to a remuneration of Rs. 11, 000and a commission of 2.5% on

The amount paid to the Preference shareholders as Capital and dividend. The liabilities

Amounted to Rs. 20,000. There is an express provision in the A/c about the payment of

Arrears of dividends in priority to equity share capital

Prepare Liquidator's Final Statement of Account.

Solution: Liquidator's Final Statement of Account

Receipt	Rs	Payment	Rs
To Assets realized	3,50,000	By Liquidation Expenses	9,800
To Calls made		By Liquidator's remuneration	11,000
and Realized		By Liquidator's Commission	50,000
Rs. 3 per share on		2.5% on 4,48,000	11,200
Shares	150,000	By Liabilities (Creditors)	20,000
		By Preference Share Holders	
		Share Capital Rs. 4,00,000	
		Two years' Div. Rs. 48,000	4,48,000
	5,00,000		5,00,000

Working Notes.

i. Total amount required (including commission at 2.5% on payment to Pref. Shareholders) is Rs. 5, 00,000 whereas amount realized from assets is Rs. 3,00,000, thus leaving a deficit of Rs. 1,50,000. This amount is realized from the unpaid Equity Share Capital @ Rs. 3 per share on 50,000, s hares. It is assumed that the call is made and realized.

(2) In fact arrears on account on Pref. dividends should not be paid unless mentioned directly or indirectly.

Illustration 3

The following particulars are extracted from books of the J.P. Products Ltd., on 31St December, 2002 on which day, winding up order was made.

20,000 Equity Shares of Rs. 10 each, Rs. 5 paid up	1,00,000
20,000 Pref. Shares of Rs. 10 each fully paid up	2,00,000
5% First Mortgage Debentures by a floating, chary upon the whole assets of the company. exclusive of uncalled capital	1,50,000
Fully Secured Creditors (Value of Securities Rs. 35.000)	30,000
Partly Secured Creditors (Value of Securities P.s. 10,000)	20,000
Preferential Creditors	6,000
Bills payable	1,00,000
Unsecured Creditors	70,000
Bank Overdraft	10,000
Bills Receivable in band	.15,000
Bills discounted (of which Rs. 10,000 are bad)	40,000
Bad Debts good	10,000
Doubtful debts (50%)	7,000
23,00G	6,000
Land and buildings (Estimated to ;pro4uceRs. 1,00,00.0)	1,50,000
Stock (Estimated to produce Rs. 40,000)	50,000
Machinery (Estimated to produce Rs. 2,000)	
Cash in Hand	

Solution: **J.P. Products Ltd.**

Statement of Affairs as on 31-12-2002

Assets not specifically pledged (List A)		**Rs.**
Bill receivable		15,000
Books Debts: Good	10,000	
Doubtful (Estimated)	3,500	
Bad	6,000	
Land and Building (estimated)		1,00,000
Stock (estimated)		40,000
Machinery (estimated)		2,000
Cash in Hand		100
		1,70,600

Assets not specifically pledged (List A)			**Rs.**	
	Estimated Realisable	Due to Secured Value	Deficiency Ranking Creditors	Surplus carried to last unsecured Column
Securities	35,000	30,000	–	5,000
Estimated	10,000	20,000	10,000	—
	45,000	50,000	10,000	5,000

Illustration 4

The position of Valueless Ltd. on its liquidation is as under: Issued and paid up Capital: 5,000 10% preference shares of ` 100 each fully paid. 7,000 Equity shares of ` 100 each fully paid. 6,000 Equity shares of ` 50 each ` 30 per share paid. Calls in Arrears are ` 20,000 and Calls received in Advance ` 17,000. Preference Dividends are in arrears for one year. Amount left with the liquidator after discharging all liabilities is` 8,27,000. Articles of Association of the company provide for payment of preference dividend arrears in priority to return of equity capital. You are required to prepare the Liquidators final statement of account.

Solution

LIQUIDATOR FINAL STATEMENT OF ACCOUNT

Receipt `	Amount Rs.	Payment	Amount Rs.
Cash	8,27,000	Calls in advance	17,000
Realisation from calls in arrears	20,000	Preference dividend	50,000
		Preference shareholders	5,00,000
		Equity share holders of Rs 100 each (` 40 per share)	2,80,000
	8,47,000		**8,47,000**

Working Note

Cash account balance		8,27,000
Less: Payment for dividend	50,000	
Preference shareholders	5,00,000	
Calls in advance	17,000	**5,67,000**
Add: Calls in arrears		2,60,000
Add: Amount to be received from equity shareholders of ` 50 each (6,000 X 20)		20,000 1,20,000
Amount disposable		**4,00,000**

Number of equivalent equity shares:

7,000 shares of ' 100 each = 14,000 shares of ' 50 each

6,000 shares of ' 50 each = 6,000 shares of ' 50 each

= 20,000 shares of ' 50 each

Final payment to equity shareholders = Total number of equivalent equity shares/ Amount left for distribution

= ' 4,00,000 / 20,000 shares

= ‘ 20 per share to equity shareholders of ‘ 50 each.

Therefore for equity shareholders of ‘ 100 each , the amount payable would be = ‘ 40 per share.

Calls in advance would be paid first for paying the shareholders on prorata basis. Equity shareholders of ‘ 50 each have to pay ‘ 20 and receive ‘ 20 each. As a result, they would be getting nothing in return.

PRACTICAL QUESTIONS

Preparation of Statement of Affairs as regards Creditors and Deficiency A/c as regards Contributories A/c :

1. **Bharat Ltd. was liquidated on 30th April, 2002 on which date the balance sheet was as under:-**

Liabilities	Rs.	Assets	Rs.
Share capital 20,000 to%		Machinery	1,50,000
Pref. shares of Rs. 10 each		Stock in trade	1,10,000
fully paid up	2,00,000	Book debts	90,000
40,000 Equity shares of Rs. 10		Bills receivable	30,000
each Rs. 7.50 paid up	3,00,000	Land & buildings	
15% Debentures	1,50,000	(Mortgaged against	
		bank overdraft	2,50,000
Bank overdraft	80,000	Cash in hand	20,000
Trade creditors	1,05,000	Profit & Loss account	2,00,000
Rent, rates and taxes	150,000		
	8,50,000		8,50,000

The following further information is:

(i) Land and buildings are valued for Rs 1, 80,000, Machinery Rs. 60,000, Stock 1, 25,000, Bad debts are Rs. 10,000 and doubtful debts are Rs. 40,000

Estimated to realize Rs. 30,000, bills receivable estimated to produce Rs.

25,000.

(ii) Bills discounted Rs. 18,000 (one bill for Rs. 6,000 known to be bad).

Prepare a statement of affairs and Deficiency account as regards creditors A/c.

Ans. Deficiency on regards to S/A Rs. 3, 76,000.

Illustration No. 1 The following information is extracted from books of Mehsana Limited on 31st July, 2012 on which date a winding up order was made.

Unsecured creditors	3,50,000
Salaries due for five months	20,000
Managing director's remuneration	30,000
Bills payable	1,06,000
Debtors — good	4,30,000
doubtful (estimated to produce rs. 62,000)	1,30,000
— bad	88,000
Bills receivable (good ' 10,000)	16,000
Bank overdraft	40,000
Land (estimated to produce '5,00,000)	3,60,000
Stock (estimated to produce '5,80,000)	8,20,000
Furniture and fixtures	80,000
Cash in hand	4,000
Estimated liability for bills discounted	60,000
Secured creditors holding first mortgage on land	4,00,000
Partly secured creditors holding second mortgage on land	2,00,000

Weekly wages unpaid	6,000
Liabilities under workmen's compensation Act,1925	2,000
Income tax due	8,000
5000 9% Mortgage debentures of 100 each interest payable to 30th June and 31st December, paid 30th June, 2012	5,00,000
Share capital :	
20,000 10% preference share s of ' 10 each	2,00,000
50,000 Equity shares of ' 10 each	5,00,000
General reserve since 31st December, 2004	1,00,000

In 2009, the company earned profit of ' 4, 50,000 but thereafter it suffered trading losses totaling ' 5,84,000. The company also suffered a speculation loss of ' 50,000 during the year 2010. Excise authorities imposed a penalty of ' 3,50,000 in 2011 for evasion of tax which was paid in 2012. From the foregoing information, prepare the Statement of Affairs and the Deficiency Account.

3.14 SUMMARY

If liability of the members of the companies is limited by shares, every member is liable to pay the full face value of shares held by him. This liability which is declared in the case of going concern also continues after the company is liquidated. In the latter case, however, the members are called as contributories. A contributory is a present member or past member.

3.15 Glossary

Liquidator: The Liquidator is a person appointed by the shareholders (in case of voluntary liquidation) for the purpose of conducting the legal proceedings in liquidation of a company and performs such duties relating thereto, as may be imposed upon him.

Contributory: A contributory is "every person liable to contribute to the assets of a company in the event of it being wound up & includes a holder of fully paid up shares, & also any person alleged to be contributory "

3.16 Self Assessment Questions

1. What is liquidation? Explain modes of liquidation.

2. Discuss the concept of Contributory

3. Define the terms:

   (a) Fully Secured Creditors;

   (b) Unsecured Creditors.

4. Explain the duties of Liquidators

5. Explain the reasons for liquidation of companies.

3.17 Suggested Reading

- Corporate Accounting by S.P. Jain & K.L. Narang.
- Corporate Accounting by S.L.Kohli.
- Corporate Accounting by Shukla and Grewal.

Alteration of Share Capital & Internal Reconstruction

STRUCTURE

4.1 INTRODUCTION

Internal reconstruction is the process in which the financial structure of a company is reorganized without dissolving the existing company and forming a new company. Internal reconstruction includes the following: Alternation of share capital; Reduction of share capital; Variation of shareholders rights; Scheme of compromise.

In order to undertake internal reconstruction a company may attempt to alter the share capital in the following ways: Reduction in the number of shares: Under this method a company may pass a resolution in the annual general body meeting to reduce the number of shares. Example: 10,000 shares of Rs 10, may be reduced to 5,000 shares of Rs 10 each. Reduction in the face value of the shares: Under this method, a company may reduce the face value of the shares. Example, shares of Rs 10 each may be reduced to the shares of Rs 5 each.

4.2 OBJECTIVES

- To understand the concept of Alternation of Share Capital
- To know the concept of Capital Reduction
- To understand the Accounting Entries on Internal Reconstruction.
- To understand the concept of Surrender of Shares.
- To know the scheme of Reconstruction.
- To know the steps of Reconstruction.

4.3 Meaning of Alteration of Share Capital:

According to Section 94 of the Companies Act, a limited company can, if authorised by its articles of association, alter the capital clause of its memorandum of association in any of the following ways

(a) Increase its share capital by such amount as it thinks expedient by issue of new shares. Accounting entries are the same as are done for issue of new shares.

(b) Consolidate all or part of its existing shares of smaller denomination into shares of higher denomination. Journal entry for the consolidation is as follows:

Share Capital (say Rs. 10) Account Dr. 5,00,000

To Share Capital (say Rs. 100) Account 5,00,000

(Being consolidation of 50,000 shares of Rs. 10 each into

5,000 shares of Rs. 100 each fully paid as per resolution

number......dated ......)

(c) Sub-divide its shares of higher denomination into shares of smaller denomination subject to the condition that in case of partly paid-up shares, the proportion between the paid-up and the unpaid amount on the shares continues to be the same after sub-division as before. Journal entry for sub-division is as under:

Equity Share Capital (say Rs.100) Account Dr. 5,00,000

To Equity Share Capital (say Rs.10) Account 5,00,000

(Being sub-division of 5,000 shares of Rs. 100 each into

50,000 shares of Rs. 10 each as per resolution number

……..dated......)

ILLUSTRATION 1. On 31-12-2005, A Ltd. has 10,000 Equity shares of Rs. 10 each as authorised capital and the shares were all issued on which Rs. 8 was paid up. In June, 2006 the company in general meeting decided to subdivide each share into two shares of Rs. 5 each, Rs. 4 paid up. June, 2007 the company in general meeting resolved to consolidate 20 shares of Rs. 5 each, Rs. 4 per share paid up into one share of Rs. 100 each, Rs. 80 paid up.

Pass Journal entries and show how share capital will appear in the Balance Sheet as on 31-12-2005, 31-12-2006 and 31-12-2007.

SOLUTION

JOURNAL ENTRIES

		Rs.	Rs.
2006 JUNE	Equity share Capital (Rs. 10)A/c Dr To Equity Share Capital (Rs 5)A/c (Being subdivision of 10,000 shares of Rs. 10, Rs. 8 paid up with 20,000 shares of Rs. 5 each, Rs. 4 paid up by resolution in general meeting dated……….)	80,000	 80,000
2007 June	Equity share Capital (Rs. 5)A/c Dr To Equity Share Capital (Rs 100)A/c (Being subdivision of 20,000 shares of Rs. 5, Rs. 4 paid up into1000 shares of Rs100 with Rs. 80 paid up by resolution in general meeting dated……….)	80,000	 80,000

BALANCE SHEET (INCLUDES)

Liabilities	31.12.2005	31.12.2006	31.12.2007
Share Capital Authorised	Rs. 1,00,000	Rs. 1,00,000	Rs. 1,00,000
Issued and Subscribed	(10,000 shares of Rs. 10 each) 80,000 (10,000 shares of Rs. 10 each, Rs. 8 paid up)	(20,000 shares of Rs. 5 each) 80,000 (20,000 shares of Rs. 5 each, Rs. 4 paid up)	(1,000 shares of Rs. 100 each) 80,000 (10,000 shares of Rs. 100 each, Rs. 80 paid up)

(d) Convert all or any of its fully paid-up shares into stock or reconvert that stock into fully paid-up shares. Journal entry for conversion of fully paid-up shares into stock is as under:

Equity Share Capital Account Dr. Rs. 5,00,000

To Equity Stock Account Rs.5,00,000

(Being conversion of 50,000 equity shares of Rs. 10

each fully paid into Rs. 5,00,000 equity stock as per

resolution number ......dated .....)

Journal entry for conversion of equity stack into fully paid equity shares will be reverse of the entry just passed.

ILLUSTRATION 2. A Ltd. had Rs 10,00,000 authorised capital on 31-12-2005 divided into shares of Rs. 100 each out of which 8,000 shares were issued and fully paid up. In June, 2006, the company decided to convert the issued shares into stock. But in June 2007 the company converted stock into shares of Rs. 10 each fully paid up.

Pass Journal entries and show how Share Capital will appear in the Balance Sheet as on 31-12-2005, 31-12-2006 and 31-12-2007.

SOLUTION

JOURNAL ENTRIES

		Rs.	Rs.
2006 JUNE	Equity share Capital A/c Dr To Equity Stock A/c (Being subdivision of 8,000fully paid equity shares of Rs. 100 each into Rs. 8,00,000 equity stock as per resolution in general meeting dated.........)	8,00,000	 8,00,000
2007 June	Equity share Capital A/c Dr To Equity Stock A/c (Being subdivision of 8,00,000 equity stock into 8,00,000 shares of Rs. 10 each fully paid equity shares as per resolution in general meeting dated ....)	8,00,000	 8,00,000

BALANCE SHEET (INCLUDES)

Liabilities	31.12.2005	31.12.2006	31.12.2007
Share Capital	Rs.	Rs.	Rs.
Authorised	10,00,000	10,00,000	10,00,000
Issued and Subscribed	(10,000 shares of Rs. 100 each) 8,00,000 (8,000 shares of Rs. 100 each fully called up)	(10,000 shares of Rs. 100 each) 8,00,000 (8,000 shares of Rs. 100 each converted into stock	(1,00,000 shares of Rs. 10 each) 8,00,000 (80,000 shares of Rs. 10 each fully called up)

(e) Cancel those shares which have not been taken up i.e. decrease its unissued capital without resulting in the reduction of paid-up capital. It does not require any journal entry because it does not affect paid-up issued capital in any way.

Alteration of capital can be done in any of the above five ways by passing n ordinary resolution in the general meeting. Confirmation of the court is not required.

Notes. 1. The powers under section 94 can be exercised only if authorised by the articles. In case the articles do not contain any such authorisation, the articles must first be amended before the power to alter the share capital is exercised.

2. It would be perfectly valid if in a single meeting both a special resolution amending the articles and a resolution for exercise of any of the powers under this section are passed.

3. The power should be exercised bonafide in the interest of the company and not to benefit any group.

Under Section 95, the company shall give notice of the alteration of capital to the Registrar within thirty days of doing so. If a default is made in complying with this provision, the company and every officer of the company who is in default is punishable with a fine which may extend to fifty rupees for every day the default continues.

4.4 INTERNAL RECONSTRUCTION OR CAPITAL REDUCTION

Internal reconstruction means the reduction of capital to cancel any paid up share capital which is lost or unrepresented by available assets. This is generally resorted to write off the past accumulated losses of the company. Thus internal reconstruction and reduction of capital mean the same.

Reduction of capital is unlawful except when sanctioned by the court because conservation of capital is one of the main principles of the company law. The issued share capital of a company represents the security on which the creditors rely. Companies usually do not call the full value of shares at one time. The uncalled capital acts as a future security for the company's creditors. Therefore, any reduction of capital reduces the security of the creditors. Keeping this in view, all safeguards have been provided for in the Companies Act, 1956 to conserve the capital of a company. However, in genuine cases, a company is permitted to reduce its share capital by Section 100 in any of the following ways:

(i) By extinguishing or reducing the liability on any of its shares in respect of share capital not paid up, i.e., reducing or extinguishing the uncalled liability of members of the company. For example, the capital of a company consists of 2,00,000 equity shares of Rs. 10 each on which Rs. 8 has been paid now being reduced to a fully paid share of Rs 8 Journal entry/ for this is as follows:

Equity Share Capital Account (Rs. 10)	Dr.	Rs. 16,00,000	
To Equity Share Capital Account (Rs. 8) (Being 2,00,000 equity shares of Rs. 10 each, Rs. 8 per share paid up converted into 2,00,000 equity shares of Rs. 8 each fully paid up as per special resolution number ......dated ...... vide court sanction number......dated.........)			Rs. 16,00,000

(ii) By paying off any paid up capital which is in excess of the needs of the company. For example, a company has a paid up share capital of Rs. 6,40,000 divided into equity shares of Rs. 10 each, Rs. 8 per share paid up. The Profit & Loss Account shows a credit balance of Rs. 2,80,000. The company decides to reduce paid up share capital to Rs. 6 per share paid up paying off the necessary amount out of accumulated profits. The appropriate journal entries are as follows:

		Rs.	Rs.
Share Capital A/c	Dr.	1,60,000	
To Shareholders A/c			1,60,000
(Being the amount to be repaid to shareholders On reduction of paid-up capital)			
Shareholders A/c	Dr.	1,60,000	
To Bank A/c			1,60,000
(Being the amount paid off)			
Profit & Loss A/c	Dr.	1,60,000	
To General Reserve A/c			1,60,000
(Being transfer on repayment of share capital)			

(iii) Where any paid up share capital is being reduced without reducing the liability on the shares. For example, a share of Rs. 10 on which Rs. 8 has been paid up is being reduced to a share of Rs. 10, Rs.6 paid-up. The journal entry is as follows

Share Capital A/c	Rs. 2	
To Capital Reduction A/c		Rs. 2

(iv) Where any paid up share capital is being reduced reducing the liability on the shares. For example a share of Rs. 10 on which Rs. 8 has been paid up is being reduced to fully paid share of Rs. 6. Journal entry is as follows:

	Rs.	Rs.
Share Capital A/c (Rs. 10)	8	
To Share Capital A/c (Rs. 6)		6
To Capital Reduction A/c		2

(v) By any other method approved by the court.

The court ordinarily gives sanction for the third type of capital reduction without consulting the creditors because creditors' interest is in no way affected by such reduction. Such capital reduction neither amounts to reducing or extinguishing the uncalled liability of the members nor returning of any paid-up capital.

The court consults creditors for giving approval of the first and second type of capital reduction because security available to creditors is affected by these types of capital reduction. If some creditors are unwilling to give their. consent to such types of capital reduction, the company will have to settle their claims before getting sanction from the court.

4.5 PROCEDURE FOR REDUCING SHARE CAPITAL

The following procedure is followed for reducing share capital:

(i) A company cannot reduce its share capital unless it is authorised by its articles. However, if the articles do not permit capital reduction, they may be altered by special resolution to enable the company to reduce its share capital.

(ii) The company must pass a special resolution for reduction of capital.

(iii) The company must apply to the court for an order confirming the capital reduction. The court must look after the interests of creditors and shareholders before giving an order confirming the capital reduction.

The court may make an order confirming the capital reduction on such terms and conditions as it thinks proper, if it is satisfied that every creditor of the company entitled to object capital reduction has consented to the reduction or that his debt has been discharged or secured by the company. The court may also order the company to add the words "and reduced" to the name of the company for such period as it deems fit. The court may also order the company to publish reasons for reduction and all other information in regard thereto for public information.

(iv) The order of the court confirming the reduction must be produced before the Registrar and a certified copy of the order and of the minutes of reduction should be filed with the Registrar for registration.

Notes : In the following cases, procedure of reduction of capital is not called for:

(a) Where redeemable preference shares are redeemed in accordance with the provisions of Section 80 of the Companies Act, 1956.

(b) Where any shares are forfeited for non-payment of calls.

(c) Where there is surrender of shares or a gift is made to a company of its own shares.

(d) Where the nominal share capital of a company is reduced by cancelling any shares which have not been taken or agreed to be taken by any person.

4.6 ACCOUNTING ENTRIES ON INTERNAL RECONSTRUCTION

(1) When the face value of the shares is changed or the rate of dividend on preference shares is changed, it is treated as change in the category of the share capital. The journal entry in such a case on reduction of capital is

(Old) Share Capital Account	Dr.	(with the paid-up value of the old shares)
To (New) Share Capital Account		(with the paid-up value of the new shares)
To Capital Reduction		(with the difference i.e. amount of capital
(or Reconstruction) Account		reduced)

On the other hand, when the face value of the shares or rate of dividend on preference shares is not changed on reduction of share capital, it does not result in the change of the category of the share capital. Category of share capital remaining the same, the journal entry then is:

Share Capital Account Dr. (with the amount of reduction of capital)

To Capital Reduction (or Reconstruction) Account.

(2) If any sacrifice has been made by creditors and debenture holders:

Creditors A/c Dr. (with the amount of sacrifice)

Debentures A/c Dr. (with the amount of sacrifice)

To Capital Reduction (or Reconstruction) A/c

(3) If the value of any asset is appreciated

Respective Assets Account Dr. (with the amount of appreciation)

To Capital Reduction (or Reconstruction) Account

(4) Where any Contingent Liability (say sales tax) arises and is to be paid immediately, the following entries will be passed:

(a) Capital Reduction A/c Dr

(or Reconstruction A/c)

To Liabilities (Sales Tax) Payable A/c

(b) Liabilities (Sales Tax) Payable A/c Dr
To Bank A/c.

(5) When amount of capital reduction is utilized for writing off fictitious assets past losses and excess value of other assets:

Capital Reduction (or Reconstruction)A/c Dr.

To Profit and loss A/c

To Goodwill A/c

To Preliminary Expenses A/c

To Discount on shares or Debentures A/c

To Patents or Trademarks A/c

To Plant and Machinery A/c

To other Assets A/c

To Capital Reserve A/c

The amount to be written off cannot exceed the amount credited to Capital Reduction Account. But if any reserve appears on the liabilities side of the Balance sheet, the same may be utilized in writing off the accumulated losses and assets. The amount written off or appreciated in respect of fixed assets under as scheme off reconstruction must be shown for five years in the Balance Sheet along with respective fixed assets as a deduction or addition as required in the schedule VI. The words "And Reduced" should be added to the name of the company for such period as the court deems fit. The words "And Reduced" may not be added to the name of the company if no such direction has been given by the court.

ILLUSTRATION 3: RNR Ltd. Decided to have internal reconstruction. The Balance sheet of the company as on 31st March 2008 was as follows:

Liabilities	Rs.	***Assets***	Rs.
Authorised, Issued and Subscribed:		Goodwill	50,000
10,000 10% Cumulative Preference		Freehold Property	75,000
Shares of Rs. 10 each	1,00,000	Leasehold Property	1,00,000
25,000 Equity Shares of Rs. 10 each	2,50,000	Plant and Machinery	60,000
Securities premium Account	25,000	Investments	25,000
10% 800 Debentures of Rs. 100		Current Assets	60,000
each	80,000	Share Issues Expenses	20,000
(Secured on freehold property		Profit and less Account	
Interest Accrued Theareon	4,000	Balance	1,10,000
Creditors for Goods	30,000		
Creditors for Expenses	11,000		
	5,00,000		5,00,000

Preference dividends are in arrears for 2 years. A scheme for reduction of capital was sanctioned by the court as follows:

10% cumulative preference shares of Rs. 10 each to be reduced to Rs. 8 per share. Equity shares of Rs. 10 each to be reduced to Rs. 4 per share. After reduction, the shares are to be consolidated into shares of Rs. 10. The authorized capital to be restores to Rs. 1,00,000 in 10% cumulative preference shares of Rs. 10 each and Rs, 2,50,000 in equity shares of Rs. 10 each. One (new) equity share of Rs. 10 each is to be issued for every Rs. 40 of gross preference dividends in arrears.

The debenture holders agreed to take over the freehold property at Rs. 1,30,000 and paid the balance to the company after satisfying their claim

Fictitious and intangible assets are to be written off.

The value of assets are to be as follows:

Leasehold property	Rs. 80,000
Plant and Machinery	Rs. 50,000
Current Assets	Rs. 40,000

Investments realized Rs. 10,000.Securities premium accpount balance is allowed to be utilized. The scheme as sanctioned by the court was implemented.

Required:

1. Journal entries for reduction of share capital and consolidated of preference shares and equity shares.
2. Capital Reduction Account
3. Cash Account
4. Balance Sheet after Reduction.

Solution

(i) **JOURNAL ENTERIES**

		Rs.	Rs.
	10% culumative Preference Share Capital (Rs. 10) A/c Dr.	1,00,000	
	To Capital Reduction A/c		20,000
	To 10% Cumulative Preference Share Capital (Rs. 8) A/c		80,000
	(Being reduction of 10,000 10% cumulative proference share of Rs. 10 each to shares of Rs. 8 each as per scheme of capital reduction sanctioned by the court)		
	Equity Share Capital (Rs. 10 A/c Dr.	2,50,000	
	To Capital Reduction A/c		1,50,000
	To Equity Share Capital (Rs. 4) A/c		1,00,000
	(Being reduction of 25,000 equity share of Rs. 4 each as per scheme of capital reduction sanctioned by the court)		
	10% culumative Preference Share Capital (Rs. 8) A/c Dr.	80,000	
	To 10% Cumulative Preference Share Capital (New Rs. 10) A/c		80,000
	(Being consolidation of 10,000, 10% Pref. Share of Rs. 8 each into 8,000 10% Cumulative Pref. Shares of Rs. 10 each) of capital reduction sanctioned by the court)		
	Equity Share Capital (Rs. 4) A/c Dr.	1,00,000	
	To Equity Share Capital (New Rs. 10) A/c		1,00,000
	(Being consolidation of 25,000 equity shares of Rs. 4 each into 10,000 equity shares of Rs. 10 each)		

(ii)	CAPITAL REDUCTION ACCOUNT		
	Rs.		Rs.
To Equity Share Capital (New Rs. 10) each (See note)	5,000	By 10% Cum. Pref. Share Capital (Rs. 10)A/c	20,000
To Leashold Property	20,000	By Equity Share Capital (Rs. 10) A/c	1,50,000
To Plant and Machinery	10,000	To Securities Premium A/c	25,000
To Current Assets	20,000	By Freehold Property A/c (Profit)	55,000
To Loss on Sale of Investments	15,000		
To Goodwill written off	50,000		
To Share Issue Expenses	20,000		
To Profit & Less A/c (Bal.)	1,10,000		
	2,50,000		2,50,000

Note: Arrears of Pref. Dividend = 2x 10% of Rs. 20,000

To be discharged in equity shares of arrears of every Rs. 40 = Rs. 20,000/Rs. 40 = 500 shares of Rs. 10 each=Rs. 5,000.

CASH ACCOUNT

	Rs.	Rs.		Rs.
To Freshold Property	1,30,000		Balanced c/d	56,000
Less : Debentureholders	84,000			
		46,000		
To investments A/c		10,000		
		56,000		56,000

(ii) BALANCE SHEET OF RNR LTD.

as on 31st March, 2008 (and Revised)

Liabilities	Rs.	*Assets*		Rs.
Authorised Capital		**Fixed Assets :**	Rs.	
10,000 10% Cum. Pref. Shares of		Lensehold Property	1,00,000	
Rs. 10 each	1,00,000	Less : Written of under		
25,000 Equity Shares of Rs. 10 each	2,50,000	reconstruction		
Issued Subscribed and Paid up		scheme dated......	20,000	
8,00 10% Cum. Pref. Shares of				80,000
Rs. 10 each	80,000	Plant and Machinery	60,000	
10,500 Equity Shares of Rs. 10 each		Less : Written off under		
(of the above 10,500 equity shares		reconstruction		
500 equity shares were issued for		scheme dated.......	10,000	
consideration other than cash)	1,05,000			50,000
Current Liabilities		**Current Assets**		
Creditors for Expenses	11,000	Cash	56,000	
Creditors for Goods	30,000	Other Current Assets	40,000	
				96,000
	2,26,000			2,26,000

Illustration 4 : The Balance Sheet of A Co. Ltd. as on 31-03-2008 is as below:

Liabilities		Rs.	*Assets*	Rs.
Share Capital :	Rs.		Freshold Property	3,50,000
2,000 6% Cumulative Preference			Plant	50,000
Shares of Rs. 100 each			Trade Investments (At cost)	60,000
fully paid up		2,00,000	Debtors	4,00,000
75,000 Equity Shares of			Stock	2,00,000
Rs. 10 each fully paid up		7,50,000	Defered Advertising Exp.	1,50,000
6% Debenture			Profit & Loss A/c	3,50,000
(Secured by Freehold				
Property)	3,75,000			
Accured Interest	22,500			
		3,97,500		
Creditors		12,500		
Directors' Loan		2,00,000		
		15,60,000		15,60,000

The Court approved a scheme of reorganisation to take effect on 1-4-2008 whereby:

(i) Preference Shares to be written down to Rs. 75 each and Equity Shares to Rs. 2 each.

(ii) Preference Dividends-in-arrears for 4 years, 75% to be waived and Equity Shares of Rs. 2 each to be allotted for the remaining quarter.

(iii) Accrued Debenture Interest to be paid in Cash.

(iv) Debenture holders agreed to take over Freehold Property (Book Value— Rs. 1,50,000) at a valuation of rs. 1,50,000 in part repayment of their holdings and to provide additional Cash of Rs. 1,30,000 secured by a floating charge on the Company's assets at an interest rate of 10% p.a.

(v) Deferred Advertising to be written off.

(vi) Stock to be written off fully.

(vii) Rs. 2,33,000 to be provided as Bad Debts.

(viii) Remaining Freehold Property to be revalued at Rs. 4,00,000.

(ix) Investments sold out for Rs. 1,50,000.

(x) In settlement of their loans, Directors are to accept Equity Shares of Es. 2 each for 907o of their loans, waving 10% of the balance of their loan amount.

(xi) Capital commitments contracts totaling Es. 3,00,000 are to be cancelled by payment of penalty @5% of Contract Value.

(xii) Taxation and Cost of Scheme are to be ignored.

Show Journal entries, reflecting the effect of the above transactions (including cash transactions) and draw up the Balance Sheet after effecting the Scheme.

SOLUTION

JOURNAL OF A CO. LTD.

		Rs.	Rs.
6% Preference Share Capital A/c	Dr.	50,000	
To Capital Reduction A/c			50,000
(Being Preference Shares of Rs. 100 each reduced to Rs. 76 as per reconstruction scheme)			
Equity Share Capital A/c	Dr.	6,00,000	
To Capital Reduction A/c			6,00,000
(Being equityshares of Rs. 10 reduced to Rs. 2 as per reconstruction scheme)			
Capital Reduction A/c	Dr.	12,000	
To Equity Shares Capital A/c			12,000
(Being Arrears of Preference Share Dividend Rs. 48,000 are to be satisfied by issueof Rs. 12,000 equity shares to the extent of 25% of Rs. 48,000)			
Accured Debentures Interest A/c	Dr.	22,500	
To Bank			22,500
(Being Accured debentures interest paid)			
6% Debentures A/c	Dr.	1,50,000	
To Freehold Property A/c			1,50,000
(Being Claim of debentureholders settled in part in respect of principal amount by transfer of freehold property as per reconstruction scheme.)			
Bank A/c	Dr.	1,30,000	
To 10% Debentures A/c			1,30,000
(10% Debenture sissued for Cash)			

Capital Reduction A/c	Dr.	9,33,000	
To Profit & Loss A/c			3,50,000
To Deferred Advertising Expenses A/c			1,50,000
To Stock A/c			2,00,000
To Bad Debts A/c			2,33,000
(Being various assets written off as per reconstruction scheme)			
Freehold Property A/c	Dr.	2,00,000	
To Capital Reduction A/c			2,00,000
(Being appreciation in the value of property i.e, Rs. 4,00,000-(Rs. 3,50,000 – Rs. 1,50,000)			
Bank A/c	Dr.	1,50,000	
To Trade Investments			60,000
To Capital Reduction A/c			90,000
(Trade investment sold and profit credited to Capital Reduction A/c)			
Directors's Loan A/c	Dr.	2,00,000	
To Equity Share Capital A/c			1,80,000
To Capital Reduction A/c			20,000
(Being Directors' Loan discharged by issue of Share Capital and the balance transferred to Capital Reduction A/c)			
Capital Reduction A/c	Dr.	15,000	
To Bank			15,000
(Being Payment of 5% penalty for cancellation of capital commitments of Rs. 3,00,000)			

BALANCE SHEET OF A & CO. (After Reconstruction)
as on 1st April, 2008

Liabilities	**Rs.**	***Assets***	**Rs.**
Share Capital:		*Fixed Assets :*	
1,71,000 Equity Share of Rs. 2 each	3,42,000	Freehold Property	4,00,000
(of the above 90,000 shares have been issued for consideration other than cash)		(including Rs. 2,00,000 appreciation in value due to reconstruction)	
		Plant	50,000
2,000 6% Cum. Pref. Shares of Rs. 75		*Current Assets, Loans & Advance*	
each fully paid	1,50,000	Debtors (Rs. 4,00,000–Rs. 2,33,000)	1,67,000
Reserves & Surplus	–	Cash at Bank	2,42,500
Secured Loans :		(Rs. 1,30,000+Rs. 1,50,000–	
6% Debentures	2,25,000	Rs. 22,500–Rs. 15,000)	
10% Debentures	1,30,000		
Current Liabilities:			
Creditors	12,500		
	8,59,500		8,59,000

Illustration 5 : Balance Sheet of X Y Limited as at 31st March, 2008 is as under:

Liabilities	**Rs.**	***Assets***	**Rs.**
2,00,000 Equity Shares of Rs. 10		Fixed Assets	11,40,000
each, Rs. 5 paid	10,00,000	Patents and Copyrights	80,000
6,000 8% Preference Shares of		Investments at cost	65,000
Rs. 100 each	6,00,000	(Market value Rs. 55,000)	
9% Debentures	6,00,000	Current Assets :	
Interest Accrued on Debentures	1,08,000	Stock	4,00,000
Bank of India	1,50,000	Debtors	4,39,000
Interest Accured on Bank Overdraft	15,000	Bank	10,000
Current Liabilities		Profit & Loss Account	4,08,000
Creditors	69,000		
	25,42,000		25,42,000

(j) Preference shareholders to give up their claims, inclusive of dividends, to the extent of 30% and desire to be paid off.

(ii) Debenture-holders agree to give up their claims to interest in consideration of their interest being enhanced to 12%.

(iii) Bank agrees to give up 50% of its interest outstanding in consideration of its being paid off at once.

(iv) Creditors would like to grant a discount of 5% if they are paid immediately.

(v) Balance of Profit & Loss Account, Patents and Copyrights and Debtors of Rs. 30,000 to be written off.

(vi) Fixed Assets to be written down by Rs. 34,000.

(vii) Investments are to reflect their market value.

(iii) To the extent not specifically stated, equity shareholders suffer on reduction of their rights. Cost of reconstruction is Rs. 3,350.

Draft journal entries in the books of the company assuming that the scheme has been put through1 fully with the equity shareholders bringing in necessary cash to pay off the parties and to lease a working capital of Rs. 30,000 and prepare the Balance Sheet after reconstruction.

SOLUTION

In the Books of XY Ltd.

JOURNAL ENTRIES

2008			Rs.	Rs.
31st March	8% Preference Share Capital A/c	Dr.	6,00,000	
	To Preference Shareholders A/c			4,20,000
	To Capital Reduction A/c			1,80,000
	(30% of claim given up by preference shareholders as per reconstruction scheme dated.....)			
	Capital Reduction A/c	Dr.	33,600	
	To Preference Shareholders A/c			33,600
	(70% of arrear preference dividend payable to preference shareholders as per reconstruction scheme)			
	Preference Shareholders A/c	Dr.	4,53,000	
	To Bank A/c			4,53,000
	(Amount due to preference shareholders discharged)			
	9% Debentures A/c	Dr.	6,00,000	
	Interest Accured on Debentures A/c	Dr.	1,08,000	
	To 12% Debentures A/c			6,00,000
	Capital Reduction A/c			1,08,000
	(9% debentures converted into equivalent number of 12% debentures and the accured debenture interest sacrified as per reconstruction scheme)			
	Bank of India A/c	Dr.	1,50,000	
	Interest Accured on Bank Overdraft A/c	Dr.	15,000	
	To Bank A/c			1,57,500
	To Capital Reduction A/c			7,500

(Bank overdraft paid off including 50% of accured interest as per reconstruction scheme, the interest sacrified credited to Capital Reduction A/c)			
Creditors A/c	Dr.	69,000	
To Bank A/c			65,550
To Capital Reduction A/c			3,450
(Creditors claim discharged to the extent of 95% as per reconstruction scheme, the balance of the claim sacrifed)			
Capital Reduction A/c	Dr.	5,62,000	
To Profit and Loss A/c			4,08,000
To Patents & Copyrights A/c			80,000
To Debtors A/c			30,000
To Investments A/c			10,000
To Fixed Assets A/c			34,000
(Writing off debit balance of profit and loss account, patents & copy rights and writing down the value of debtors, investments and fixed assets as per reconstruction scheme)			
Equity Share Capital A/c	Dr.	3,00,000 (I)	
To Capital Reduction A/c			3,00,000
(Equity shareholders rights reduced to a share of Rs. 3.50 vide Boards's Resolution No. ....dated....., the amount of sacrifice credited to Capital Reduction Account)			
Bank A/c	Dr.	7,00,000 (2)	
To Equity share Capital A/c			7,00,000
(Amount received on 2,00,000 equity shares @Rs. 3.5 per share as per reconstruction scheme)			
Capital Reduction A/c	Dr.	3,350	
To Bank A/c			3,350
(Reconstruction expenses paid)			

BALANCE SHEET OF XY LTD. (And Reduced)
as on 31st March, 2008

Liabilities	Rs.	*Assets*	Rs.
Share Capital:		Fixed Assets (Rs. 11,40,000–Rs. 34,000	
Authorized	–	written off under Reconstruction	
Issued and paid up : 2,00,000 Equity		Scheme)	11,06,000
Shares of Rs. 10 each , Rs. 7 paid	14,00,000	Investments	
Secured Loan :		Current Assets:	
12% Debentures	6,00,000	Stock	4,00,000
		Debtors	4,09,000
		Bank	30,000
	20,00,000		20,00,000

Working Notes :

1. Statement Showing Liabilities and Equity Sacrified and Their Uses as per Scheme

Liabilities and Equity Sacrified	Rs.	Uses	Rs.
Preference Shareholders :		Writing off :	
30% of Rs. 6,00,000	1,80,000	Reconstruction Expenses	3,350
Debenture holder :		Profit and Loss Account Balance	4,08,000
Interest on Debentures	1,08,000	Patients & Copyrights	80,000
Bank of India :		Arrear Pref. Dividend (70% of	
Interest on Bank Overdraft (50%)	7,500	Rs. 48,000)	33,600
Creditors :		Writing down:	
5% of Rs. 69,000	3,450	Debtors	30,000
Equity Shareholders :		Investments	10,000
Sacrifice @ Rs. 1.50 per share		Fixed Assets	34,000
(Balancing figure)	3,00,000		
	5,98,950		5,98,950

2. *Cash to be brought in by Equity Shareholders:*	*Rs.*
Payment to:	
Preference shareholders (including arrear preference dividend)	
70% of Rs. 6,48,000	4,53,600
Bank of India (including interest on bank overdraft)	
Rs. 1,50,000 + Rs. 7,500	1,57,500
Creditors 95% of Rs. 69,000	65,550
Others	
Reconstruction expenses	3,350
Additional cash required for working capital of Rs. 30,000	
to be maintained (Rs. 30,000— Rs. 10,000 cash in hand)	20,000
	7,00,000

No. of equity shares = 2,00,000

Therefore, contribution per equity share = Rs. 7,00,000/2,00,000 = Rs. 3.50

ILLUSTRATION 6. The following is the Balance Sheet as at 31st March, 2008 of Blackened Prospects Ltd.

Liabilities	Rs.	*Assets*	Rs.
Subscribed Capital		Fixed Assets (invluding	
3,000 Cumulative Preference Shares		goodwill of Rs. 1,00,000)	10,80,000
of Rs. 100 each fully paid up	3,00,000	Investments	20,000
7,500 Equity Sh.ares of Rs. 100 each		Stock in Trade	2,00,000
fully paid up	7,50,000	Trade Debtors	1,54,500
Securities Premium	12,000	Bank Balances	62,500
– Preference Shares			
General Reserve	80,000		
Trade Creditors	3,75,000		
	15,17,000		15,17,000

Contingent liability :

Preference Dividends in arrears Rs. 66,000.

The Board of Directors of the Company decided upon the following scheme of reconstruction:

(i) The preference shares are to be converted into 13% unsecured debentures of Rs. 100 each in regard to 80 % of the dues (Including arrears of dividend) and for the balance equity shares of Rs. 50 paid up would be issued. The authorised capital of the company permitted the issue of additional shares.

(ii) Equity shares would be reduced to shares of Rs. 50 each paid up.

(iii) All equity holders agree to pay the balance in cash.

(iv) Goodwill has lost its value and is to be written off fully. Investments are to reflect their market value of Rs. 30,000. Obsolete items in stock of Rs. 50,000 are to be written off. Bad debts to the extent of 5% of the total debtors would be provided for. Fixed assets to be written down by Rs. 1,50,000.

The scheme was duly approved and put into effect.

The Company carried on trading for six months and after writing off depreciation at 20% pa. on the revised value of fixed assets, made a net profit of Rs. 80,000. The half-yearly working resulted in an increase of Sundry Debtors by Rs. 60,000, Stock by Es. 80,000 and cash by Es. 40,000.

Show the journal entries necessary in the Company's books to give effect to the scheme and draw the Balance Sheet as at 30th September, 2008.

SOLUTION

In the Books of Blackened Prospects Ltd.

JOURNAL ENTRIES

			Rs.	Rs.
	Cumulative Preference Share Capital A/c	Dr.	3,00,000	
	Capital Reduction A/c	Dr.	66,000	
	To Cumulative Preference Shareholders A/c			3,66,000
	(Being the cumulative preference shares & arrear dividend transferred to cumulative preference shareholders account in accordance with the resolution of the Board dated......)			
	Cumulative Preference Shareholders A/c	Dr.	3,66,000	
	To 13% Unsecured Debentures A/c			2,92,800
	To Equity Share Capital A/c			73,200
	(Being the issue of 18% unsecured debentures and 1,464 Equity shares of Rs. 100 each issued as Rs. 50 paid up as per the Board's resolution dated........)			
	Equity Share Capital A/c	Dr.	3,75,000	
	To Capital Reduction A/c			3,75,000
	(Being the entry for reducing every share of Rs. 100 each as Rs. 50 paid up 7,500 Equity shares @ 50 per share as per the Board resolution dated........)			

Cash A/c Dr.		4,48,200	
To Equity Share Capital A/c			4,48,200
(Being the receipt of Cash of Rs. 50 each for 8964*1 being the Call made as per Board's resolution dated......)			
Investments A/c Dr.		10,000	
Capital Reduction (Balancing Figure) Dr.		2,97,725	
To Goodwill A/c			1,00,000
To Stock A/c			50,000
To Fixed Assets A/c			1,50,000
To Provision for Doubtful Debts A/c			7,725
(Being the change in value of assets as per the resolution of the Board dated........)			
Capital Reduction A/c		11,275	
To Capital Reserve A/c			11,275
(Being the transfer of Capital Reduction A/c balance to Capital Reserve)			

Blackened Prospects Ltd.

BALANCE SHEET

as on 30th September, 2008

Liabilities	Rs.	*Assets*		Rs.
Subscribed Capital 8,964 Equity Shares of Rs. 100 each	8,96,400	Fixed Assets (after reduction of Rs. 1,50,000 due to reconstruction)	8,30,000	
Securities Premium	12,000	Less : Depreciation for ½ year	83,000	
Capital Reserve	11,275			7,47,000
General Reserve	80,000	Investments		30,000
Profit and Loss A/c	80,000	Stock in Trade		2,30,000
13% Unsecured Debentures	2,92,800	Trade Debtors	2,14,500	
Trade Creditors (3)	3,92,000	Less : Provision for Doubtful Debts	7,725	2,06,775
		Bank Balance (2)		5,50,700
	17,64,475			17,64,475

Working Notes :

(1) No. of equity shares issued to cumulative pref. shareholders **1,464**

(1)	**No. of equity shares issued to cumulative pref. shareholders**	**1,464**
	Nof shares held by Equity shareholders	7,500
	Total	8,964
(2)	**Bank Balance**	Rs.
	Opening Balance on 31-3-2008	62,500
	Add calls on shares @ Rs. 60 per share	
	(8,964 Rs. 50 per share)	4,48,200
	Balance on implementation of the scheme	5,10,700
	Add change in cash balance (as given)	(+) 40,000
		5,50,700
(3)	Creditors Balance a Balancing figure in the Balance Sheet	
	Alternative approach : Profit & Loss upto 30-9-2008	80,000
	Add : Depreciation (non-cash item)	83,000
	Cash from Operations (A)	1,63,000
	Change in Current assets :	
	Debtors	(+) 60,000
	Stock	(+) 80,000
	Cash Balance	(+) 40,000
	Cash Outflow (B)	1,80,000
	Increase in creditors :	
	Excess of (B) over (A)	17,000
	Add : Opening balance of Creditors	3,75,000
		3,92,000

ILLUSTRATION 7. X Ltd. found itself in financial difficulty. The balance sheet of the company as at 31st March, 2008 was as follows :

	Rs.		Rs.
Equity Shares of Rs. 10 each	10,00,000	Goodwill	3,00,000
10% Preference Shaes of		Land	4,00,000
Rs. 10 each	4,00,000	Building at cost	3,75,000
12% Debentures	3,00,000	Machinery at cost	2,20,000
Interest payable on Debentures	36,000	Investments	2,25,000
Loan from Directors	1,00,000	Stock	3,60,000
Provision for Depreciation:		Debtors	2,00,000
Buildings	75,000	Cash	5,000
Machinery	80,000	Advertisement Suspense Account	25,000
Bank overdraft	1,50,000	Profit and Loss Account	2,90,000
Sundry Creditors	2,59,000		
	24,00,000		24,00,000

The authorised share capital of the company is 2,50,000 equity shares of Rs. 10 each and 50,000, 10% preference shares of Rs. 10 each.

It was decided during a meeting of the shareholders and directors of the company to carry out a scheme of internal reconstruction as follows:

1. Each equity share is to be redesignated as a share of Rs. 250. The equity shareholders are to accept a reduction in the nominal value of their share from Rs. 10 to Rs. 250 and subscribe for a new issue on the basis of 1 for 2 at a price of Rs. 4 per share.

2. The existing preference shares are to be exchanged for a new issue of 30,000 lLi% preference shares of Rs. 10 each and 40,000 equity shares of Rs. 250 each.

3. The debenture holders are to accept 10,000 equity shares of Rs. 250 each in lieu of interest payable. The interest rate is to be increased to 14%. A further Rs. 1,00,000 of 14% debentures of Rs. 100 each is to be issued and taken up by the existing holders at Rs. 90.

4. Rs. 40,000 of director's loan is to be cancelled. The balance amount is to be settled by issue of 10,000 equity shares of Rs. 250 each.

5. The investments are to be sold at current market price of Rs. 3,00,000.

6. The bank overdraft is to be rapid.

7. A sum of Rs. 1,59,000 is to he paid to the creditors immediately and the balance is to be paid at quarterly intervals.

8. All intangible and fictitious assets are to be eliminated.

9. The following assets are to be adjusted to fair values : Debtors Rs. 1,80,000; Stock Rs. 3,20,000; Machinery Rs. 1,00,000 ; Buildings Rs. 2,50,000 ; Land Rs. 3,20,000.

10. It is estimated that under new arrangements net profit before interest and tax will be Rs. 2,50,000 per annum. There will be no tax liability of the company for the next five years.

You are required to:

(a) show the journal entries to effect the reconstruction scheme;

(b) prepare the balance sheet of the company immediately after reconstruction; and

(c) show how the anticipated profits will be distributed under new arrangements.

SOLUTION

JOURNAL ENTRIES

				Rs.	Rs.
	Equity Share Capital A/c	Dr.		7,50,000	
	To Capital Reduction A/c				7,50,000
	(Being amount transferred on reduction of nominal value of 1,00,000 equity shares @ Rs. 7.50 per shares to Capital Reduction A/c as per scheme of reconstruction dated.........)				

Bank A/c	Dr.	2,00,00	
To Equity Share Capital A/c			1,25,000
To Securities Premium A/c			75,000
(Being amount received from existing shareholders for subsribing 50,000 new equity shares @ Rs. 2.50 each at a premium of Rs. 1.50 per share as per scheme of reconstruction dated.....)			
10% Preference Share Capital A/c	Dr.	4,00,000	
To 15% Preference Share Capital A/c			3,00,000
To Equity Share Capital A/c			1,00,000
(Being conversion of 10% Pref. Share Capital to 30,000 15% Pref. shares of Rs. 10 each and 40,000 equity shares of Rs. 2.50 each as per reconstruction scheme).			
Interest Payable on Debentures A/c	Dr.	36,000	
To Equity Share Capital A/c			25,000
To Capital Reduction A/c			11,000
(Being Share Capital issued in lieu of interest payable on debentures as per reconstruction scheme).			
12% Debentures A/c	Dr.	3,00,000	
To 14% Debentures A/c			3,00,000
(Being conversion of 12% debentures to 14% debentures as per reconstruction scheme)			
Bank A/c	Dr.	90,000	
Discount on Issue of Debentures A/c	Dr.	10,000	
To 14% Debentures A/c			1,00,000
(Being issue of new debentures of 14% as per scheme at a discount of Rs. 10 per debenture)			
Loan from Directors A/c	Dr.	1,00,000	
To Equity Share Capital A/c			25,000
To Securities Premium A/c			35,000

	To Capital Reduction A/c			40,000
	(Being issue of Share Capital in cancellation of loan from directors as per reconstruction scheme)			
	Bank A/c Dr.		3,00,000	
	To Investment A/c			2,25,000
	To Capital Reduction A/c			75,000
	(Being amount realised from the sale of investment as per reconstruction scheme)			
	Bank Overdraft A/c Dr.		1,50,000	
	To Bank A/c			1,50,000
	(Being bank overdraft paid as per reconstruction scheme)			
	Creditors A/c Dr.		1,59,000	
	To Bank A/c			
	(Being the amount paid to creditors as per reconstruction scheme)			
	Capital Reduction A/c Dr.		8,76,000	
	To Goodwill			3,00,000
	To Advertisement Suspense A/c			25,000
	To Profit & Loss A/c			2,90,000
	To Discount on Issue of Debentures A/c			10,000
	To Land			80,000
	To Building			50,000
	To Machinery			40,000
	To Stock			40,000
	To Debtors			20,000
	To Capital Reserve			21,000
	(Being various fictious, intangible and depreciation of othre assets written off as per reconstruction scheme)			

(b)

X Ltd.

BALANCE SHEET (And Reduced)

(Rs.in '000)

Liabilities		Rs.	*Assets*		Rs.
Share Capital			Fixed Assets		
Authorized			Land	400	
10,00,000 Eq. Shares @ Rs. 2.50 each		2,500	Less : Written off under		
15% 50,000 Pref. Shaes of Rs. 10 each		500	Reconstruction Scheme		
Issued Subscribed and Paid up			dated...........	80	
2,10,000 Equity Shares of rs. 2.50					320
each fully called & paid up	525		Building	300	
15% 30,000 Pref. Shares of			Less : Written off under		
Rs. 10 each	300		Reconstruction Scheme		
		825	dated...........	50	
(Out of 2,10,000 Equity Shares					250
20,000 shares were issued					
for consideration other than cash)			Machinery	140	
Reserves & Surplus			Less: Written off under		
Capital Reserve	21		Reconstruction Scheme		
Securities Premium	110		dated..........	40	
		131			100
Secured Loans			Current Assets, Loans & Advance		
14% Debentures		400	Stock	320	
Current Liabilities & Provisions			Debtors	180	
Sundry Creditors		100	Cash in Hand	5	
			Cash at Bank	281	
					786
			[Issue of Equity Shares	2,00,000	
			Sales of Investments	3,00,000	
			Issue of Debentures	90,000	
				5,90,000	
			Paid to Creditors	1,59,000	
				4,31,000	
			Paid Bank Overdraft	1,50,000	
				2,81,000	
		1,456			1,456

(c) Distribution of Anticipated Profits

	Rs.
Profit	2,50,000
Less : Debentures Interest	56,000
	1,94,000
Less : Pref. Div. @ 15%	45,000

Profit available for distribution to Equity Shareholders	1,49,000

$$\text{Equity Shareholders Return on Net Worth} = \frac{\text{Rs. } 1,49,000}{\text{Rs. } 5,25,000} \times 100 = 28.38\%$$

4.7 CONCEPT OF REORGANIZATION THROUGH SURRENDER OF SHARES

Under this method shares are subdivided into shares of smaller denominations and to facilitate capital reorganisation shareholders are made to surrender a part of their holding. Such surrendered shares are usually utilised to reduce or extinguish debentures and trade liabilities. The portion of shares surrendered but not reissued are to be cancelled. The claims foregone by creditors and debenture holders are transferred to capital reduction (or reorganisation) account which will be utilized to write off losses.

ILLUSTRATION 8. The Balance sheet of M/s Raman Ltd. as at 31st March, 2008 is as follows:

Liabilities	**Rs.**	***Assets***	**Rs.**
Paid-up Capital :		Fixed Assets :	
8,000 Equity Shares of Rs. 100		Land, Building and Machinery	14,00,000
each fully paid	8,00,000	Current Assets :	
Secured Loan :		Stock	1,00,000
8% Debentures	14,00,000	Sundry Debtors	40,000
Accured Interest on Debentures	70,000	Investments	15,000
Sundry Creditors	4,50,000	Cash at Bank	1,03,000
Income Tax Liability	10,000	Cash in Hand	2,000
		Profit and Loss Account	10,70,000
	27,30,000		27,30,000

The fixed assets are heavily overvalued. A scheme of reorganisation was prepared and passed. The salient points of the scheme are the following:

(1) Each share shall be sub-divided into ten fully paid Equity Shares of Rs. 10 each.

(2) After such sub-division, each shareholder shall surrender to the company 90% of

his holding, for the purpose of reissue to Debentureholders and Creditors so far as required and otherwise for cancellation.

(3) Of those surrendered 50,000 Equity Shares of Rs. 10 each, shall be converted into 8% Preference Shares of Rs. 10 each fully paid for debentureholders.

(4) The debentureholders' total claim shall be reduced to Rs. 5,00,000. This will be satisfied by the issue of 50,000 preference shares of Rs. 10 each fully paid.

(5) The claim of sundry creditors shall be reduced by 80% and the balance shall be satisfied by allotting them Equity shares of Rs. 10 each, fully paid from the shares surrendered.

(6) Shares surrendered and not reissued shall be cancelled.

Assuming that the scheme is duly approved by all parties interested and by the court, draft necessary journal entries and Balance Sheet of the company after the scheme has been carried into effects.

Solution

JOURNAL OF M/S RAMAN LTD.

				Rs.	Rs.
	Equity Share Capital (Rs. 100) A/c	Dr.		8,00,000	
	To Equity Share Capital (Rs. 10) A/c				8,00,000
	(Being subdivision of 8,000 shares of Rs. 100 each into 80,000 shares of Rs. 10 each as per special resolution No.....dated......)				
	Equity Share Capital A/c	Dr.		7,20,000	
	To Shares Surrendered A/c				7,20,000
	(Being surrender of 90% of shares i.e., 72,000 shares of Rs. 10 each as per reconstruction scheme dated.......)				
	Shares Surrendered A/c	Dr.		5,00,000	
	To 8% Preference Share Capital A/c				5,00,000
	(Being the conversion of 50,000 surrendered shares into 8% Preference Shares of Rs. 10 each and issue of these shares to				

the debentureholders in full satisfaction of their claims as per reconstruction scheme dated......)			
Shares Surrendered A/c	Dr.	90,000	
To Equity Share Capital A/c			90,000
(Being reissue of shares worth Rs. 90,000 i.e 1/5 of Rs. 4,50,000 to sundry creditors in full satisfaction of their claims as per reconstruction scheme dated.....)			
Share Surrendered A/c	Dr.	1,30,000	
Debentures A/c	Dr.	14,00,000	
Interest Accrued A/c	Dr.	70,000	
Sundry Creditors A/c	Dr.	4,50,000	
To Capital Reduction A/c			20,50,000
(Being the cancellation of unissued surrendered shares and transfer of the liabilities in respect of debentures and creditors to the Capital Reduction Account because these liabilities have been fully discharged by the issue of surendered shares)			
Capital Reduction A/c	Dr.	20,50,000	
to Profit & Loss A/c			10,70,000
To Fixed Assets A/c			9,80,000
(Being written off the debit balance of Profit and Loss Account and remaining balance utifised to reduce the value of fixed assets)			

BALANCE SHEET OF RAMAN LTD. (And Reduced)
as on 31st March, 2008

Liabilities	Rs.	*Assets*		Rs.
Share Capital		Fixed Assets		
17,000 Equity Shares of Rs. 10 each fully paid	1,70,000	Land & Building & Machinery	14,00,000	
50,000 8% Pref. Shares of Rs. 10 each fully paid	5,00,000	Less : Written off under reorganisation scheme	9,80,000	
Reserve & Surplus	—			4,20,000
Secured Loans	—	Investments		15,000
Unsecured Loans	—	Current Assets :		
Current Liabilities & Provision:		Stock-in-trade		1,00,000

Income Tax Liability	10,000	Sundry Debtors	40,000
		Cash in Hand	2,000
		Cash at Bank	1,03,000
	6,80,800		6,80,000

ILLUSTRATION 9. The Balance sheet of Revise Limited as at 31st March, 2008 was as follows:

Liabilities	Rs.	*Assets*	Rs.
Authoried and subscribed capital:		Fixed assets:	
10,000 equity shares of Rs. 100		Machineries	1,00,000
each fully paid	10,00,000	Current assets :	
Unsecured loan :		Stock	3,20,000
12% debentures	2,00,000	Debtors	2,70,000
Accrued interest	24,000	Bank	30,000
Current liabilities:		Profit and loss account	6,00,000
Creditors	72,000		
Provisions for income-tax	24,000		
	13,20,000		13,20,000

It was decided to reconstruct the company for which necessary resolution was passed and sanctions were obtained from appropriate authorities. Accordingly, it was decided that:

(a) Each share be sub-divided into ten fully paid equity shares of Rs. 10 each.

(b) After sub-division, each shareholder shall surrender to the company 50 percent of his holding, for the purpose of re-issue to debenture holders and creditors as necessary.

(c) Out of shares surrendered, 10,000 shares of Rs. 10 each shall be converted into 12% preference shares of Rs. 10 each fully paid up.

(d) The claims of the debenture-holders shall be reduced by 75 per cent. In consideration of the reduction, the debenture holders shall receive preference shares of Rs. 1,00,000 which are converted out of shares surrendered.

(e) Creditors claim shall be reduced to 50 per cent, to be settled by the issue of equity shares of Rs. 10 each out of shares surrendered.

(f) Balance of profit and loss account to be written off.

(g) The shares surrendered and not re-issued shall be cancelled.

You are required to show the journal entries giving effect to the above and the resultant Balance Sheet.

SOLUTION

JOURNAL ENTRIES

			Rs.	Rs.
	Equity Share Capital (Rs. 100) A/c	Dr.	10,00,000	
	To Equity Surrendered A/c			5,00,000
	To Equity Share Capital (Rs. 10 A/c			5,00,000
	(Sub-division of 10,000 equity shares of Rs. 100 each into 1,00,000 equity shares of Rs. 10 each and surrender of 50,000 of such sub-divided shares as per capital reduction scheme)			
	12% Debentures A/c	Dr.	1,50,000	
	Accured Interest A/c	Dr.	18,000	
	To Reconstruction A/c			1,68,000
	(Transferred 75% of the claims of the debentureholders to reconstruction accoun in consideration of which 12% preference shares are being issued out of share surrender account as per capital reduction scheme)			
	Creditors A/c	Dr.	72,000	
	To Reconstruction A/c			72,000
	(Transferred claim of the creditors to reconstruction account, 50% of which is being clear reduction and equity shares are being issued in consideration of the balance)			

Shares Surrendered A/c Dr.	5,00,000	
To 12% Preference Share Capital A/c		1,00,000
To Equity Share Capital A/c		36,000
To Reconstruction A/c		3,64,000
(Issued preference and equity shares to discharge the claims of the debentureholders and the creditors respectively as per scheme and thebalance in shares surrender account is being transferred to reconstruction acount)		
Reconstruction A/c Dr.	6,04,000	
To Profit and Loss A/c		6,00,000
To Capital Reserve A/c		4,000
(Adjusted debit balance of profit and loss account against the reconstruction account and the balance in the latter is being transferred to capital reserve.)		

BALANCE SHEET REVISE LIMITED (and Reduced)

as on 1st April, 2008

Liabilities	Rs.	*Assets*	Rs.
Share Capital :		Fixed Assets :	
Issued Capital		Machineries	1,00,000
53,600 Equity Shares of Rs. 10 each	5,36,000	Current Assets, Loans and Advances:	
12%, 10,000 Preference Shares of		(A) Current Assets :	
Rs. 10 each	1,00,000	Stock	3,20,000
(Off the above shares all are alloted		Debtors	2,70,000
as fully paid up pursuant to capital		Bank	30,000
reduction scheme by conversion of		(B) Loans and Advances	Nil
equity shares without payments			
being received in cash)			
Reserves and Surplus :			
Capital Reserve	4,000		
Unsecured Loans :			
12% Debentures	50,000		

Accrued Interest	6,000		
Current Liabilities and Provisions:			
Provision for Income-tax	24,000		
	7,20,000		7,20,000

Illustration 10 The Balance Sheet of Munna Ltd. on 31st March, 2008 is as under:

Liabilities	**Rs.**	*Assets*	**Rs.**
Authorised and Issued Equity		Goodwill	2,00,000
Share Capital : 20,000 shares of		Plant & Machinery	18,00,000
Rs. 100 each	20,00,000	Stock	3,00,000
10,000 Preference Shares		Debtors	7,50,000
(7%) of Rs. 100 each	10,00,000	Preliminary Expenses	1,00,000
Sundry Creditors	7,00,000	Cash	1,50,000
Bank Overdraft	3,00,000	Profit & Loss Account	7,00,000
	40,00,000		40,00,000

Two year's preference dividends are in arrears. The company had bad time during the last two ors and hopes for better business in future, earning profit and paying dividend provided the vital base is reduced.

An internal reconstruction scheme as follows was agreed to by all concerned:

(i) Creditor's agreed to forego 50% of the claim.

(ii) Preference shareholders withdrew arrear dividend claim. They also agreed to lower their capital claim by 20% by reducing nominal value in consideration of 9% dividend effective after reorganisation in case equity shareholder's loss exceeded 50% on the application of the scheme.

(iii) Bank agreed to convert overdraft into term loan to the extent required for making current ratio equal to 2 : 1.

(iv) Revalued figure for plant and machinery was accepted as Rs. 15,00,000.

(v) Debtors to the extent of Rs. 4,00,000 were considered good.

(vi) Equity shares shall be exchanged for the same number of equity shares at a revised denomination as required after the reorganisation.

Show :

(a) Total loss to be borne by the equity and preference shareholders for the reorganisation;

(b) Share of loss to the individual classes of shareholders;

(c) New structure of share capital after reorganisation;

(d) Working capital of the reorganised Co., and (c) A proforma balance sheet after reorganisation.

Solution

(a) Loss to the borne by Equity and Preference Shareholders

	Rs.
Profit and Loss A/c (debit-balance)	7,00,000
Preliminary Expenses	1,00,000
Goodwill	2,00,000
Plant and Machinery (Rs. 18,00,000 –Rs. 15,00,000)	3,00,000
Debtors (Rs. 7,50,000–Rs. 4,00,000)	3,50,000
Amount to be written off	16,50,000
Less : 50% of Sundry Creditors	3,50,000
Total loss tobe borne by the equity and performance shareholders*	13,00,000

(b) Share of loss to preference shareholders and equity shareholders

Total loss of Rs. 13,00,000 being more than 50% of equity share capital i.e Rs.10,00,000

Preference shareholders share of loss - 20% of Rs. 10,00,000	Rs. 2,00,000
Equity shareholders share of loss (Rs. 13,00,000–Rs. 2,00,000)	Rs. 11,00,000
Total Loss	13,00,000

(c) New Structure of Share Capital after Reorganisation

Equity shares :

20,000 equity shares of Rs. 45 each fully paid up (Rs. 20,00,00–Rs.11,00,000)	9,00,000

Preference shares :

10,000 9% preference shares of Rs. 80 each, fully paid up (Rs. 10,00,000–Rs. 2,00,000)	8,00,000
	17,00,000

(d) Working Capital of the Reorganised Company

Current Assets :		Rs.
Stock		3,00,000
Debtors		4,00,000
Cash		1,50,000
		8,50,000
Less : Current Liabilities	Rs.	
Creditors	3,50,000	
Bank Overdraft**	75,000	
		4,25,000
Working Capital		4,25,000

(e) Munna Ltd.

BALANCE SHEET (And Reduced)

as on 31st March, 2008

Liabilities	**Rs.**	***Assets***	**Rs.**
Share Capital		Fixed Assets:	
20,000 Equity Shaes of Rs. 45 each	9,00,000	Plant and Machinery	15,00,000
10,000 9% Preference Shares of		Current Assets :	
Rs. 80 each	8,00,000	Stock	3,00,000
Unsecured Loand		Debtors	4,00,000
Term Loan with Bank	2,25,000	Cash	1,50,000
Current Liabilities :			
Bank Overdraft**	75,000		
Creditors	3,50,000		
	23,50,000		23,50,000

4.8 SCHEME OF RECONSTRUCTION

In the previous section dealing with internal reconstruction, a cut and dried scheme of capital reconstruction was given to the student. But sometimes a student may be confronted with the problem of suggesting a fair scheme of capital reconstruction. It is a very tedious job. The following points should be taken into consideration before suggesting a scheme of internal reconstruction :

1. The company which is to be reconstructed must have turned the corner i.e. the company's present performance is bad but future performance is expected to be good. The future profits should be sufficient after meeting expenses, financial charges and making provision for depreciation and taxation so that reasonable dividends may be given to shareholders. Reconstruction of a company is like reconstruction of a house. A house is reconstructed only when it has outlived its utility and after reconstruction it will have more utility. Similarly, a company is reconstructed only if its present is bad but the future is expected to be good.

2. The scheme of reconstruction should be acceptable to different interested groups. It should have the approval of shareholders and creditors. The major loss in any scheme of reconstruction should be borne mostly by equity shareholders as they are the real owners of the company. Other arties (i.e. preference shareholders, debentureholders and creditors) may also bear loss to some extent having regard to the amount of loss they are expected to sustain if the company is liquidated is tead of being reconstructed. Other parties will not mind bearing a share of loss which is less ban the amount of loss they are expected to sustain if the company goes into liquidation.

3. Sufficient provision for working capital should be made so that claims of dissenting' hareholders and creditors may be paid without difficulty. Shareholders and creditors should be filling to contribute further money; merely writing off accumulated losses will be of no use. sufficient working capital is needed to run a worn-out company efficiently.

4. The existing control of shareholders should continue, otherwise the present controlling block f shareholders will not vote in favour of the scheme of reconstruction.

5. Sacrifice of each group in any reconstruction scheme is to be passed by 75% majority of the group, so there should be sufficient prospect for each group. Each group should stand benefited in he reconstruction scheme if it considers the loss it is expected to sustain in case the company is liquidated.

6. The scheme of reconstruction should relate to capital reduction (i.e. internal reconstruction) external reconstruction (i.e. floating a new company). External reconstruction should be suggested when the financial and operating position is very bad, huge amount of working capital is required and possibilities of contributing further money by shareholders and creditors are less.

4.9 STEPS OF RECONSTRUCTION

For making out a scheme of reconstruction, the following successive steps are taken:

1. Total amount to be written off should be determined by adding up accumulated losses, fictitious assets, over-valuation (i.e. under-depreciation) of assets, under provision of liabilities and making provision for contingent liabilities that may mature. Total amount of loss to be written off thus determined should be reduced by profit on revaluation of assets or excess provision of liabilities. It may be remembered that assets and liabilities of the company are to be valued as a ping concern. The other method to get at the figure of total amount to be written off is to add up he present value, as a going concern of all the assets and deduct therefrom the amount of liabilities and contingent liabilities that may mature. The resultant figure is value of net assets and amount of paid-up share capital and reserves (if any) deduced from value of net assets will how how much amount is to be written off.

2. Who is to bear the loss as determined above ? A fair and equitable distribution of loss among different groups is the secret of a successful reconstruction scheme. Equity shareholders nave to bear the maximum amount of loss. They are asked to bear the loss to the extent they are not reduced to nil because if their share capital is reduced to nil they will not agree to such a cheme. They agree to the maximum amount of loss because they know that if they do not agree, he company will be liquidated and they will not get any return of capital.

If the value of net assets is more than the amount of preference share capital, the whole of the loss will have to be borne by equity shareholders. If the value of net assets is less than the amount ,f preference share capital, preference shareholders will have to bear some portion of loss although heir rate of sacrifice will be much less than that of equity shareholders. The dividend rate on preference shares should be increased if future profits of the company permit to compensate them or the sacrifice they have made. It should be seen that total dividend at the new higher rate of dividend on the reduced amount of preference share capital should be almost the same as they were getting on original amount at the existing rate of dividend.

There is no necessity of compensating equity shareholders for the loss they will bear because hey will automatically be compensated by better future earnings of the company to which they become entitled.

3. Payment of arrears of dividends on cumulative preference shares in cash immediately presents difficulties so payment in cash immediately should not be resorted to. Redeemable deposit certificates should be issued for arrears of dividends. Shares should also not be issued to preference hareholders for the payment of arrears of dividends because it upsets the voting power of existing hareholders. As far as possible, preference shareholders should be made to agree to forego their arrears of dividends.

4. Debentureholders and other creditors are affected by the reconstruction scheme only if value of assets as a going concern is not sufficient to cover the liabilities. In such an eventuality, first unsecured creditors are to bear the loss and then the turn of debentureholders and other creditors having a floating charge on the assets will come. They will be ready to bear the loss only if they feel that they will suffer more if the company is liquidated. Debentureholders and creditors should be compensated for the loss they agree to bear by increasing their rate of interest as mentioned in case of preference shareholders.

5. Secured creditors will not sacrifice anything to the extent their claims are covered. They are treated as ordinary creditors to the extent their claims are not covered and they may have to bear some loss in connection with that portion alongwith ordinary creditors.

6. No scheme of reconstruction can be considered as good unless proper arrangement for a reasonable amount of working capital is made. The following methods may be resorted to for procuring working capital:

(a) Fresh issue of shares.

(b) Reducing fully paid-up share capital to partly paid-up share capital so that balance of the amount may be called after reconstruction.

(c) Requesting debentureholders to give more loan to the company.

(d) Arrangement of bank overdraft and the like.

7. What should be the mode of reconstruction—internal or external ? As far as possible internal reconstruction should be followed to set matters right for reasons discussed earlier.

Illustration 11. The following is the Balance Sheet of N.D. Ltd as at 31st March 2008:

Liabilities	**Rs.**	***Assets***	**Rs.**
Share Capital :		Goodwill	25,000
Authorised and Issued :		Freehold Property at cost	90,00
10,000 10% Cumulative		Plant & Machinery at cost	
Preference Shares of Rs. 10		Less depreciation	85,000
each fully paid-up	1,00,000	Investments (M.V. Rs. 86,000)	80,000
20,000 Equity Shares of Rs. 10		Stock	35,000
each each fully paid-up	2,00,000	Debtors	40,000
Creditors	75,000	Cash at Bank	500
Bank Overdraft	15,000	Profit & Loss A/c	1,04,000
General Reserve	70,000		
	4,60,000		4,60,000

Prepare a capital reduction scheme and redraft the Balance Sheet after incorporating your proposals for submission to the Board of Directors. The cumulative preference dividends are in arrears for two years.

Solution

CAPITAL REDUCTION SCHEME

Calculation of loss to be written off	Rs.
Profit and Loss Account	1,04,000
Goodwill	25,000

Less : General Reserve	1,29,000
	70,000
	59,000

Calculation of loss to be borne by various parties

Value of assets is :	Rs.
Freehold Property	90,000
Plant and Machinery	85,000
Investments (Market value being more than cost ignored : taken on the principle of cost or market price whichever is lower)	80,500
Stock	35,000
Debtors	40,000
Cash at Bank	500
	3,31,000

As against the value of the above assets, the liabilities amount to Rs. 90,000 (i.e. creditors Rs. 75,000 + Bank Overdraft Rs. 15,000). The value of assets being much more, creditors and bank cannot be asked to make sacrifice. If they are asked to make any sacrifice, they will prefer the liquidation of the company rather n reconstruction because they can get full payment even if the company goes into liquidation.

The value of assets after deducing the liabilities of creditors and bank overdraft is Rs. 2,41,000 (i.e. 3,31,0000 – Rs. 90,000) which is much more than the amount of preference share capital of Rs. 1,00,000; so reference shareholders cannot be asked to bear any loss.

From the above discussion it appears, the only possibility is that the entire loss of Rs. 59,000 should he ne by equity shareholders by reducing equity share capital from Rs. 2,00,000 to Rs. 1,41,000 making each share of Rs. 10 each paid up as Rs. 7.05 . (i.e $\frac{\text{Rs. } 1{,}41{,}000}{20{,}000}$). Keeping in view the additional requirements of working capital, equity shareholders can be asked to pay Rs. 59,000 on 20,000 shares @ Rs. 2.95 per share king each share of Rs. 10 each as fully paid-up (i.e. Rs. 7.05 + Rs. 2.95) .

Preference shareholders can be asked to forego their arrears of dividends for two years. They can be compensated for the loss of their arrears of dividend by increasing the rate of dividend of 10% to 12%. 12%, rate dividend is desirable keeping in view now-a-days 10% bank interest on fixed deposits.

The above reconstruction scheme is recommended on the assumption that the worst is over and the company will make sufficient profit in future enabling payment of reasonable dividend to the equity shareholders.

The balance sheet after carrying out the recommended reconstruction scheme will be as follows

BALANCE SHEET OF N.D. LTD.

as at.............

Liabilities	Rs.	*Assets*	Rs.
Share Capital		Freehold Property at cost	90,000
Authorised and Issued:		Plant and Machinery at cost	
10,000 12% Cumulative Preference		less depreciation	85,000
Shares of Rs. 10 each fully paid up	1,00,000	Investments at cost	80,500
20,000 Equity Shares of Rs. 10		Stock	35,000
each fully paid-up	2,00,000	Debtors	40,000
Creditors	75,000	Cash at Bank (Rs. 500 + Rs. 59,000)	59,500
Bank Overdraft	15,000		
	3,90,000		3,90,000

Illustration 12. The Balance Sheet of the Bharat Darshan Co. Ltd. is as follows:

	Rs.		Rs.
Share Capital		Goodwill	1,50,000
5,000 10% Cummulative		Sundry Fixed Assets	25,00,000
Preference Shares		Sundry Current Assets	12,50,000
of Rs. 100 each fully paid Rs.	5,00,000	Cash and bank Balance	2,50,000
1,50,000 Equity Shares of Rs. 10		Profit and Loss Account	15,50,000
each fully paid up	15,00,000	Preliminary Expenses	20,000

12% Debentures of Rs. 100 each	10,00,000		
Sundry Creditors	26,20,000		
Income Tax Payable	1,00,000		
	57,20,000		57,20,000

The company has passed through a depression but the worst seems to have been over. Preference dividends for past three years have not been paid. Sundry fixed assets are worth Rs. 20,00,000 and sundry current assets are worth Rs. 11,70,000. The company is assured of a good future and is expected to earn Rs. 1,80,000 before providing for interest but after charging adequate depreciation.

From the above information, you are required to (1) draft a scheme of internal reconstruction which would be fair to all the parties; (2) give journal entries after all the formalities relating to reconstruction have been complied with and prepare the new Balance Sheet of the company.

Solution

SCHEME OF INTERNAL RECONSTRUCTION

1. Calculation of Loss to be written off

	Rs.
Profit and Loss Account (Loss)	15,50,000
Preliminary Expenses	20,000
Goodwill	1,50,000
Loss on Fixed Assets (Rs. 25,00,000–Rs. 20,00,000)	5,00,000
Loss on Current Assets (Rs. 12,50,000–Rs. 11,70,000)	80,000
	23,00,000

2. Calculation of Loss to be borne by various parties

Realisable value of the assets is :	Rs.
Sundry Fixed Assets	20,00,000
Sundry Current Assets	11,70,000
Cash and Bank Balances	2,50,000
	34,20,000

Against the value of the above assets, the liabilities amount to Rs. 37,20,000 (i.e. Rs. 10,00,000 Debentures + Rs. 26,20,000 Creditors and Rs. 1,00,000 Income-tax payable). If the company goes into liquidation, tax liability being preferential will be payable in full leaving Rs. 33,20,000 (i.e. Rs. 34,20,000 — Rs. 1,00,000 Tax Payable) for debentureholders who have a prior claim than sundry creditors on account of their having a floating charge on the assets. The amount of debentures is Rs. 10,00,000 and amount available for them is Rs. 33,20,000; so they cannot be asked for any sacrifice. If they are asked to bear loss, they will ask for liquidation because they can get full payment even if the company goes into liquidation.

Amount left for unsecured creditors :

	Rs.	Rs.
Total realisable value of the assets		34,20,000
Less : Income Tax Payable	1,00,000	
Debentures	10,00,000	
		11,00,000
Amount available for creditors		23,20,000

The amount of sundry creditors is Rs. 26,20,000 whereas amount available for them is Rs. 23,20,000; so they will suffer a loss of Rs. 3,00,000. As a matter of fact, sundry creditors should agree to suffer more loss keeping in view the fact that loss will be much more if the company goes into liquidation. The loss of Rs. 3,00,000 is on a going concern basis; so they can be made to agree to bear a loss of (say) Rs. 6,50,000.

The equity shareholders are to bear a major portion of the loss. Amount of equity share capital is Rs. 15,00,000 whereas loss to be written off after meeting a sacrifice of Rs. 6,50,000 by sundry creditors is Rs. 16,50,000 (Rs. 23,00,000 — Rs. 6,50,000). Entire equity capital can be utilised for writing off loss because it is less than the amount of loss to be written off. But this is not a practical proposition because equity shareholders will have no interest in the company on account of their capital being nil. Thus, to sustain their interest and controlling hand in the company, they may be asked to forego 90% of their capital. Balance of the loss can be met by preference shareholders.

Keeping in view the above discussion, it is recommended that the following reductions should be made to write off the losses.

	Rs.
Sundry Creditors	6,50,000
Equity Shareholders (90% of Rs. 15,00,000)	13,50,000
Preference Shareholders (Balancing figure)	3,00,000
	23,00,000

Further, preference shareholders, should be asked to waive payment of arrears of dividend. They will agree to it keeping in view the huge sacrifice made by equity shareholders. Rate of preference dividend should be increased from 10% to 12% partly to compensate the preference shareholders for the sacrifies made by them.

If the scheme is accepted, future distribution of profits will be as follows:

	Rs.
Expected future profits	1,80,000
Less : Interest on Debentures i.e 12% on Rs. 10,00,000	1,20,000
	60,000
Less : 12% Preference dividend on Rs. 2,00,000	24,000
Balance available for equity shareholders	36,000
Balance of equity share capital left after writing off losses (10% of Rs. 15,00,000)	1,50,000

Expected rate of dividend to equity shareholders

$$\left(\frac{\text{Rs. } 36{,}000 \times 100}{\text{Rs. } 1{,}50{,}000}\right) = 24\%$$

Equity shareholders are also compensated because they expect to get good dividend in future. Sundry creditors can also be compensated to some extent by keeping aside at least a sum equal to the equity dividend t of profits for five years to restore the claims of sundry creditors partially.

In the above calculation, income-tax has been ignored due to past losses.

3. For making arrangement of further working capital, equity shares can be made of Rs. 2 each, Re. 1 paid and balance of Re. 1 should be called for procuring more working capital.

JOURNAL ENTRIES

				Rs.	Rs.
	10% Cumulative Preference Share Capital Account	Dr.		5,00,000	
	To 12% Cumulative Preference Share Capital Account				2,00,000
	To Reorganisation Account				3,00,000
	(Being reduction of preference shares by Rs. 60 each and dividend raised from 10% to 12%)				
	Equity Shares Capital Account	Dr.		13,50,000	
	Sundry Creditors Account	Dr.		6,50,000	
	To Reorganisation Account				20,00,000
	(Being reduction of equity share capital and sundry creditors as agreed upon)				
	Reorganisation Account	Dr.		23,00,000	
	To Profit and Loss Account				15,50,000
	To Preliminary Expensess Account				20,000
	To Goodwill Account				1,50,000
	To Fixed Assets				5,00,000
	To Current Assets				80,000
	(Being balance in the Reorganisation Account utilised to wipe off debit balance in the Profit and Loss Account, Preliminary Expenses Account and Goodwill Account and to write down the fixed assets and current assets to their proper value)				

Equity Share Final Call Account	Dr.	1,50,000	
To Equity Share Capital Account			1,50,000
(Being final call made on 1,50,000 equity shares @ Re. 1each)			
Bank Account	Dr.	1,50,000	
To Equity Share Final Call Account			1,50,000
(Being amount of final call received)			

BALANCE SHEET OF THE BHARAT DARSHAN CO. LTD.

as at..............

Liabilities	Rs.	*Assets*	Rs.	
Share Capital:		Sundry Fixed Assets	25,00,000	
5,000 12% Cumulative Preference		Less : Reduced under		
Shares of Rs. 40 each fully paid up	2,00,000	Reconstruction Scheme		
1,50,000 Equity Shares of Rs.2		as per Resolution No.......		
each fully paid up	3,00,000	dated.....	5,00,000	
12% Debentures of Rs. 100 each	10,00,000			20,00,000
Sundry Creditors	19,70,000	Current Assets		11,70,000
Income Tax Payable	1,00,000	Cash and Bank Balance		4,00,000
		(Rs. 2,50,000+Rs. 1,50,000)		
	35,70,000			35,70,000

4.10 JOURNAL ENTRIES & BALANCE SHEET

Accounting Entries on Internal Re-Construction

Entry for share capital reduced without changing the face value of the shares

Share Capital A/c

To Capital Reduction/Reconstruction A/c

Entry if face value of the shares is also changed on reduction of capital a new category of share capital is created:

Share Capital A/c (Old)

To Share capital A/c (New)

To Capital reduction A/c

Entry where rate of dividend on preference shares is changed under the scheme of reconstruction:

Preference Share Capital A/c (OLD)
    To Preference Share Capital A/c (New)

Entry When debenture holder and creditors are also ready to reduce their claim against company:

Debenture A/c
Creditors A/c
    To Capital reduction A/c

Entry in case of appreciation in the value of any asset:

Assets A/c
    To Capital reduction A/c

Entry if any contingent liability matures and is to be paid immediately the following entry is passed:

Capital reduction A/c
To Liability payable A/c

Liability Payable A/c
To Bank A/c

Entry for utilising the amount of capital reduction to w/o accumulated losses.

Capital Reduction A/c
    To Profit & Loss A/c
    To Preliminary Expenses A/c
    To Discount on Shares /Debentures A/c
    To Goodwill A/c
    To Trade Assets A/c
    To Patents/Copy rights
    To Assets A/c

For transferring any balance left in the capital reduction account to capital reserve account

Capital reduction a/c dr. (with the balance left)

To capital reserve a/c

External reconstruction is effected by liquidating the company. It is just like absorption. In it a new company is formed to acquire the business of an existing company are transferred to the newly formed company. But it is not done in the internal reconstruction.

Accounting procedure for Capital Reduction:

For extinguishing or reducing the uncalled liability of the member:

Equity Share Capital A/c

To Equity share Capital Ale

For writing off the part of paid up capital which is lost in operation or which is not representing by available assets:

Equity Share Capital A/c

To Equity Share Capital A/c

To Capital Reduction A/c

If the face value of shares remain unchanged

Equity Share Capital A/c

To Capital Reduction Ale

For reducing the capital by returning the excess capital:

Equity Share Capital A/c

To Equity Share Capital A/c

To Equity Shareholders A/c

For payment to Shareholders

Equity Shareholders A/c
    To Bank A/c

For uses of Capital reduction A/c

Capital Reduction A/c
    To Accumulated Losses A/c
    To Goodwill A/c
    To Fictitious Assets A/c
    To Other Assets A/c
    To Capital Reserve A/c(Balancing Figure)

Accounting entries in alteration of capital

Examples			Dr. (Rs.)	Cr. (Rs.)
(A)	**For increase in share capital** Bank a/c dr. To equity share capital a/c (being the amount received on shares of Rs. each)			
(B)	**for consolidation of shares** Equity share capital A/c dr. To equity share capital A/c (being conversion of Shares of Rs. each into ....shares of Rs. each)			
(c)	**for sub-division of shares** Equity share capital A/c dr. To equity share capital (being conversion of shares of Rs. Each into shares of Rs. each)			

(d)	**For conversion of share into stock or vice versa** Equity share capital A/c dr. To equity stock A/c (being conversion of fully paid Equity shares of Rs. each into equity stock) Equity stock A/c dr. To equity share capital A/c (being conversion of equity stock into Equity shares of Rs. each)			
(e)	**For cancellation of unissued capital** No entry is passed for cancellation of capital			

Illustration 13

Repair Ltd. is the hands of a receiver for debenture holders who holds a charge on all assets axcept uncalled capital. The following statement shows the position as regards creditors as on 30th June, 2012.

Liabilities	Rs.	Assets	Rs.
6,000 shares of Rs. 60 each Rs. 30, paid up		Property, machinery and plant etc. (Cost	
First debentures	3,00,000	Rs. 3,90,000)	
Second debentures	6,00,000	Estimated at	1,50,000
Unsecured creditors	4,50,000	Cash in hand of	
		the receiver	2,70,000
		Charged under debentures	4,20,000
		Uncalled capital	1,80,000
			6,00,000
		Deficiency	7,50,000
	13,50,000		13,50,000

A hold the first debentures for Rs. 3,00,000 and second debentures for Rs. 3,00,000. He is also an unsecured creditor for Rs. 90,000. B holds second debentures for Rs. 3,00,000 and is an unsecured creditor for Rs. 60,000

The following scheme of reconstruction is proposed.

1. A is to cancel Rs. 2,10,000 of the total debt owing to him, to bring Rs. 30,000 in cash and to take first debentures (in cancellation of those already issued to him) for Rs. 5,10,000 in satisfaction of all his claims.

2. B is to accept Rs. 90,000 in cash in satisfaction of all claims by him.

3 In full settlement of 75% of the claim, unsecured creditors (other than A and B) agreed to accept four shares of Rs. 7.50 each, fully paid against their claim for each share of Rs. 60. The balance of 25% is to be postponed and to be payable at the end of three years from the date of court's approval of the scheme. The nominal share capital is to be increased accordingly.

4. Uncalled capital is to be called up in full and Rs. 52.50 per share cancelled, thus making the shares of Rs. 7.50 each.

Assuming that the scheme is duly approved by all parties interested and by the Court, give necessarly journal entries.

Solution

Journal Entries

Particulars		Debit (Rs.)	Credit (Rs.)
First debentures A/c	Dr.	3,00,000	
Second debentures A/c	Dr.	3,00,000	
Unsecured creditors A/c	Dr.	90,000	
To A's A/c			6,90,000
(Being A's total liability ascertained)			
A's A/c	Dr.	2,10,000	
To Reconstruction A/c			2,10,000
(Being cancellation of debt upto Rs. 2,10,000)			
Bank A/c	Dr.	30,000	
To A's A/c			30,000
(Being cash received in course of settlement)			
A's A/c	Dr.	5,10,000	
To First debentures A/c			5,10,000
(Being liability of A, discharged against first debentures)			
Second debentures A/c	Dr.	3,00,000	
Unsecured creditors A/c	Dr.	60,000	
To B's A/c			3,60,000
(Being B's liability ascertained)			
B's A/c	Dr.	3,60,000	
To Bank A/c			90,000
To Reconstruction A/c			2,70,000
(Being B's liability discharged)			

Unsecured creditors A/c	Dr.	3,00,000	
To Equity share capital A/c			1,12,500
To Loan (Unsecured) A/c			75,000
To Reconstruction A/c			1,12,500
(Being settlement of unsecured creditors)			
Share call A/c	Dr.	1,80,000	
To Share capital A/c			1,80,000
(Being final call money due)			
Bank A/c	Dr.	1,80,000	
To Share call A/c			1,80,000
(Being final call money received			
Share capital A/c (Face value Rs. 60)	Dr.	3,60,000	
To share capital (Face value Rs. 7.50)			45,000
To Reconstruction A/c			3,15,000
(Being share capital reduced to Rs. 7.50 each)			
Reconstruction A/c	Dr.	8,70,000	
To Profit and loss A/c			8,70,000
(Being reconstruction surplus used to write off losses)			

Working Notes :

1.	**Settlement of claim of remaining unsecured creditors**			**(Rs.)**
	75% of Rs. 3,00,000			2,25,000
	Considering their claim for share of Rs. 60 each			
	2,25,000/60=3,750 shares			
	Less : Number of shares to be issued			
	3,750×4=15,000 shares of Rs. 7.5 each			
	Total Value = 15,000 × 7.50			(1,12,500)
	Transferred to Reconstruction A/c			1,12,500

2. **Ascertainment of profit and loss account's debit balance at the time of reconstruction.**

	Rs.	Rs.
Asset		
Fixed assets	3,90,000	
Cash	2,70,000	6,60,000
: Capital & Liabilities		
Share Capital	1,80,000	
1st Debenture	3,00,000	
2nd Debenture	6,00,000	
Unsecured creditors	4,50,000	(15,30,000)
Profit and loss A/c (Debit balance)		8,70,000)

4.11 SUMMARY:

Internal reconstruction refers to the reduction of capital to cancel any paid up capital which is lost or unrepresented by available assets. This is generally resorted to, to write off the post accumulated losses and to make the balance sheet show the true and fair value of the assets capital. The capital written off is used to eliminate the losses accumulated and to bring down the assets to their true values.

Reconstruction becomes necessary only when the company is commercially and/or financially unsound. But at the same time, there should be every chance of the company turning the corner and proving successful provided a reconstruction is made. The main purpose of reconstruction is to eliminate the accumulated NPAs and to bring the assets to their true values.

Forfeiture of shares brings about compulsory termination of membership and the company takes away the shares from members by way of penalty for non payment of allotment and/ or call money. The effect of forfeiture of shares is that the defaulting shareholder loses all his rights in shares and ceases to be a member. The power to forfeit shares must be provided in the Article of Association of the company.

1. Reconstruction is a process by which affairs of a company are reorganized by

revaluation of assets, reassessment of liabilities and by writing off the losses already suffered by reducing the paid up value of shares and /or varying the rights attached to different classes of shares.

2. Reconstruction account is a new account opened to transfer the sacrific made by the shareholders for that part of capital which is not represented by lost assets.

3. Reconstruction account is utilized for writing-off fictitious and intangible assets, writing down over-valued fixed assets, recording new liability etc.

4. If some credit balance remains in the reconstruction account, the same should be transferred to the capital reserve account.

5. Methods of Internal reconstruction:

   - Alteration of share capital :

     Sub-divided or consolidate shares into smaller or higher Denomination

     Conversion of share into stock or vice-versa

   - Variation of shareholders' rights :

     Only the specific rights are changed. There is no change in the amount of capital

   - Reduction of share capital

   - Compromise, arrangements etc.

   - Surrender of Shares.

4.12 GLOSSARY

- *Share Capital : It is the part of the company that comes from the issue of shares.*

- *Shares : It is a part or portion of a larger amount which is divided among a number of people or to which a number of people contribute.*

- *Alteration of Share Capital : It is according to Section 94 of the Companies ACt.*

- *Internal Reconstruction : It is reduction of capital to cancel any paid up share capital which is lost or unrepresented by available asset.*

4.13 LESSON END EXERCISES

Q1. Define the meaning of Internal Reconstruction.

Q2. What is the meaning of Alteration of share capital?

Q3. Explain the procedure for reducing Share Capital.

Q4 What is surrender of Shares?

Q5 Discuss the scheme of Reconstruction

Q6 Explain the steps of Reconstruction

4.14 REFERENCES

Corporate Accounting : By Jain and Narang

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