Centre for Distance & Online Education

UNIVERSITY OF JAMMU

JAMMU

SELF LEARNING MATERIAL

FOR

ADVANCE CORPORATE ACCOUNTING

For the examination to be held in 2025 onwards

B.COM SEMESTER – IV **Unit I – IV**

COURSE NO. : BCG – 401 **LESSON NO. 1-20**

COURSE CO-ORDINATOR:

Prof.Sandeep Kour Tandon

TEACHER INCHARGE:

Dr. Sumeet Kour

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UNIVERSITY OF JAMMU

B.COM. FOURTH SEMESTER

ADVANCECORPORATEACCOUNING

Course 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 OFTHE 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 CLASSROOM TEACHING AND INTERNALASSESSMENT)

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

❖ Helpthestudentsinsolvingnumericalproblemsrelatingthetopicsspecifiedabove.

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

BOOKS RECOMMENDED

1. Jain, S.P. & Narang, K.L. – *Corporate Accounting*, Kalyani Publishers, New Delhi.
2. Gupta, R.L. & Swamy, Radhaswamy – *Advanced Company Accounts,* Sultan Chand & Sons, New Delhi.
3. Maheshwari, S.N. – *Corporate Accountancy,* Vikas Publishing House, New Delhi.
4. Monga, J.R. & Ahuja – *Financial Accounting*, Mayur Paper Books, Noida.
5. Grewal, T.S., Shukla, M.C., & Sehgal, Ashok – *Advanced Accounts*, S. Chand & Company, New Delhi.
6. Moore, C.L., Jaedicke, R.K., & Gupta, S.C. – *Managerial Accounting*, South-Western Publishing Co., Cincinnati, Ohio.
7. Tulsian, P.C. – *Corporate Accounting*, S. Chand Publishing, 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 20marks.

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 must attempt any four questions selecting one from each unit. Total weightage to this section shall be 60 marks. Note for paper setter: At least one numerical question from each unit.

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MODEL QUESTION

ADVANCE CORPORATE ACCOUNTING

Max Marks:80 Time allowed: 3 Hrs

Section- A (Marks 20)

Attempt all questions. Each question carries five marks.

1. Explain different methods for calculation of goodwill?

2 .Explain various steps involved in the process of internal reconstruction?

3. List various statutory provisions regarding CSR?

4. Define the concept of liquidation and modes of liquidation?

Section- B (Marks 60)

Attempt any four questions selecting one question from each unit. Each question carries 15 marks.

1. (Purchase of average Profits): Following particulars are available in respect of the business carried on by X Ltd

Profits earned by X Ltd.: 2009 Rs. 50,000; 2010 Rs. 48,000 and 2011 Rs. 52,000.

Profits of 2010 is reduced by Rs. 5,000 due to stock destroyed by fire and profit of 2009 included a non – recurring income of Rs. 3,000.

Profits of 2011 include Rs. 2,000 income on investment.

The stock is not insured, and it is thought prudent to insure the stock in future. The insurance premium is estimated at Rs. 500 p.a.

Fair remuneration to the proprietor (not taken in the calculation of profits) is Rs. 10,000 p.a.

You are required to compute the value of goodwill on the basis of 2 years purchase of average profits of the last three years.

Or

What is goodwill? How is it generally valued. Explain and illustrate at least three important methods of its valuation.

2. From the following information, calculate the value per equity share by yield basis method:

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

Normal rate of earning	15%

Or

Describe two methods of valuation of shares and discuss which method, in your view, is most appropriate.

3. The directors of a company prepared a scheme of reconstruction as follows:

(a) To forfeit 3,000 equity shares of Rs. 10 each on which Rs. 3 per share call money is not paid.

(b) To reduce the remaining 9,000 equity shares of Rs. 10 each by Rs. 3 per share.

(c) To reissue the forfeited shares at Rs. 5 per share.

(d) To make use of provision for taxation available Rs. 4,000.

(e) To reduce the assets as follows: Goodwill Rs. 10,000 to nil. Machinery from Rs. 15,000 to Rs. 10,000. Stock Rs. 30,000 to Rs. 15,000. Debtors from Rs. 20,000 to Rs. 10,000. Pass the Journal entries to record the above transaction.

Or

Explain various factors that you keep in mind while framing a reconstruction scheme?

4. Give a proforma of the statement of Affairs with imaginary figures.

Or

Differentiate between winding up of a company and dissolution of a company. State the various modes by which the winding up of a company can be brought about?

Dear Learner,

Welcome to **Advanced Corporate Accounting**—a subject that stands at the heart of modern financial reporting and corporate strategy.

As you step into this advanced course, you're not just learning numbers; you're mastering the language of business at a sophisticated level. This journey will deepen your understanding of complex accounting topics such as corporate restructuring, consolidation, international financial reporting standards (IFRS), share-based payments, and more.

This course is designed to:

- Sharpen your analytical skills,
- Strengthen your grasp of corporate financial practices,
- Prepare you for high-stakes decision-making in the world of finance and accounting.

You are encouraged to approach each topic with curiosity and diligence. While the concepts may be challenging, they are essential for anyone aiming to work in corporate finance, audit, consultancy, or advanced accounting roles.

Remember: true competence in accounting is not just about compliance—it's about clarity, insight, and responsibility. Your effort today lays the foundation for your credibility tomorrow.

Wishing you success and confidence as you advance on this academic and professional path.

Warm regards,
[CDOE]

UNIT I **B.Com 4th Semester Course**
No. BCG-401 **Lesson No. 1**

INTRODUCTION TO GOODWILL

STRUCTURE

1.1 INTRODUCTION

In this lesson, you will be introduced to the fundamental concept of goodwill in business. You will understand what goodwill means, why it is considered an important intangible asset, and the various business situations in which its valuation becomes necessary.

Goodwill reflects the reputation and earning potential of a business that cannot be seen on the balance sheet but plays a crucial role in business decisions like mergers, acquisitions, and partnership changes.

You will also explore the key factors that influence the value of goodwill—such as location, customer loyalty, brand image, and management efficiency. These factors help determine why one business might be valued higher than another, even if both have similar physical assets.

By the end of this lesson, you will:

- Clearly understand the definition and nature of goodwill
- Know why and when businesses need to value goodwill
- Identify and explain the factors that affect the value of goodwill

This foundational knowledge will prepare you for the upcoming lessons on the methods and calculations used in goodwill valuation.

1.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

By the end of this lesson, learners will be able to:

- Understand the concept and nature of goodwill as an intangible asset.
- Explain the importance of goodwill in business transactions.
- Identify the situations or events that require valuation of goodwill.
- Describe the key factors that influence the value of goodwill.
- Develop a conceptual base to understand why goodwill is valued differently across businesses.

Learning Outcomes

After completing the lesson, learners will be able to:

- Define goodwill in simple terms and explain its characteristics.
- List and explain various circumstances where goodwill valuation is necessary (e.g., sale of business, admission of partner).
- Analyse how factors like reputation, location, and customer loyalty affect goodwill.
- Differentiate between goodwill and other tangible/intangible assets.
- Apply your understanding to real-life examples where goodwill plays a critical role in business valuation.

1.3 CONCEPT AND NATURE OF GOODWILL

Goodwill refers to the reputation, brand value, customer loyalty, and overall image of a business in the market. It represents the intangible asset arising from a firm's ability to earn profits consistently above the average or normal profits expected from similar firms in the same industry. This excess of actual profits over normal profits is termed super profits, and it is these super profits that give rise to goodwill. Therefore, goodwill exists only when a business enjoys a competitive advantage that enables it to generate super profits. Conversely, a firm earning merely normal profits or incurring losses is unlikely to possess any significant goodwill.

From a financial perspective, especially when considering the time value of money, goodwill can also be defined as the present value of anticipated super profits. Additionally, goodwill may stem from factors such as quality management, skilled workforce, strong customer relationships, strategic location, or a recognizable brand—all of which contribute to a firm's ability to outperform its competitors.

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 are the characteristics of goodwill that emerge from the above definitions:

It is an intangible asset having a definite value.

It is enjoyed only by profitable firms.

It increases a firm's ability to earn profits.

It is an attractive force which brings in the customers.

It distinguishes an old and well-established business from the new business.

Depending on how goodwill is acquired and recognized, it can be broadly classified into two types: purchased goodwill and internally generated goodwill.

1. Purchased goodwill – It arises when a business acquires another business and pays an amount greater than the fair value of the net identifiable assets of that business. The excess amount paid represents the value of goodwill and is recognized as an intangible asset in the acquiring firm’s books. This type of goodwill is the result of a specific financial transaction and is recorded in the balance sheet. For instance, if a company acquires another firm for ₹80 lakhs, and the fair value of that firm’s net assets is ₹65 lakhs, the additional ₹15 lakhs paid is considered as purchased goodwill. This form of goodwill can be amortized or tested for impairment as per accounting standards.

2. Internally generated goodwill - It is the value that a business develops over time through its operations, good customer relations, brand recognition, employee efficiency, and managerial excellence. It also includes what is sometimes called "inherent goodwill," referring to the natural worth of a business due to its future earning potential, market leadership, or strategic position. Unlike purchased goodwill, internally generated goodwill is not recorded in the financial statements because it is not the result of a specific purchase transaction, and its valuation lacks objectivity and reliability. For example, a long-standing local business with a strong customer base and reputation will have significant internally generated goodwill even though it has never been sold or formally valued.

1.4 IMPORTANCE OF GOODWILL

Goodwill plays a crucial role in the financial and operational strength of a business. Though it is an intangible asset, goodwill significantly contributes to a firm’s long-term profitability and market standing. The following points highlight the importance of goodwill in detail:

1. Enhances the Value of a Business - Goodwill increases the overall value of a business beyond the worth of its tangible assets. A company with high goodwill is often valued more during mergers, acquisitions, or partnerships, as it reflects strong brand equity, customer loyalty, and future profit potential.

2. Attracts and Retains Customers - A good reputation in the market helps a business attract new customers and retain existing ones. This customer trust, built over time through consistent

service and quality, becomes a valuable intangible asset goodwill.

3. Helps in Earning Higher Profits - Firms with strong goodwill often experience repeat business, higher customer retention, and better pricing power. This leads to increased revenues and improved profit margins, even in competitive markets.

A. CHECK YOUR PROGRESS

Fill in the Blanks

1. A business with high goodwill can earn ___________ profits than its competitors.

Answer: more

2. Goodwill increases the ___________ value of a business at the time of sale.

Answer: market

3. In the case of merger or acquisition, goodwill helps in determining the ___________ value of the company.

Answer: purchase

4. Goodwill is considered an ___________ asset in the books of accounts.

Answer: intangible

5. A good reputation enhances the ___________ image of the business in the eyes of the public.

Answer: brand

6. Goodwill helps a business to stand out from its ___________.

Answer: competitors

7. A company with good management and customer feedback builds ___________ goodwill over time.

Answer: internal

4. Strengthens the Brand Image - Goodwill enhances the overall brand image of the company. A strong reputation leads to better brand recall, positive public perception, and trustworthiness, which are vital in establishing a strong market presence.

5. Provides Competitive Advantage - A business with goodwill enjoys a strategic edge over competitors. Positive goodwill may reduce the need for aggressive marketing or discounting, as customers are more inclined to choose a trusted brand.

6. Useful During Mergers and Acquisitions - In mergers or acquisitions, goodwill plays a key role in negotiation. A company with high goodwill can command a premium price as it reflects the firm’s long-term earning potential and reputation.

7. Increases Investor Confidence - Investors and stakeholders view goodwill as a sign of business stability and future growth. A company with a good name in the market is more likely to gain investor trust and attract funding or partnerships.

8. Influences Business Valuation - Goodwill is a component in determining the total worth of a business. It is often considered during accounting for acquisitions and during financial reporting to reflect the fair market value of a company.

9. Facilitates Easy Entry into New Markets - A business with established goodwill finds it easier to enter new markets. Its reputation precedes it, helping in building new customer relationships and forming strategic alliances more easily.

10. Supports Long-Term Business Sustainability - Goodwill reflects the strength of intangible elements like customer satisfaction, employee loyalty, and ethical practices. These contribute to the long-term survival and success of the business, even during challenging times.

1.5 NEED FOR VALUATION OF GOODWILL

While goodwill is not always recorded in the books, there are specific circumstances in business when its valuation becomes necessary. This chapter explores those situations in which the assessment of goodwill is essential for accurate financial reporting, fair transactions, and strategic decision-making.

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.

B. CHECK YOUR PROGRESS

Fill in the Blanks

1. Why is goodwill valued at the time of admission of a partner in a partnership firm?

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2. State two reasons why goodwill is valued when a business is sold.

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3. In what situations is goodwill valuation necessary in a joint stock company?

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4. Why is goodwill valued at the time of retirement or death of a partner?

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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.

Goodwill valuation is not a routine accounting task, but a vital requirement during major structural changes in a business. Accurately valuing goodwill ensures transparency, fairness, and informed decision-making in a variety of business contexts. Understanding these situations prepares business professionals to deal effectively with transitions involving this important intangible asset.

1.6 FACTORS AFFECTING GOODWILL

Since goodwill is an intangible asset, its value depends on various qualitative and quantitative factors. These factors help determine how much goodwill a business holds in the eyes of its stakeholders, customers, and potential investors.

Below are the major factors that influence the value of goodwill:

1. Nature of Business - The kind of products or services a business offers has a significant impact on its goodwill. Businesses that deal in essential goods or services that are in constant demand (like FMCGs, healthcare, or utilities) tend to have a steady customer base and predictable income, which leads to higher goodwill. On the other hand, businesses operating in seasonal, luxury, or highly volatile industries may have lower goodwill due to unpredictable earnings.

2. Location of Business - The physical location of a business plays a crucial role in attracting customers. A business situated in a prime commercial area, with easy accessibility and high footfall (such as malls, marketplaces, or near transportation hubs), is likely to have higher goodwill compared to one located in remote or low-traffic areas. Location advantages lead to higher sales and better brand visibility

3. Reputation and Brand Image - A business that has built a strong reputation over the years through ethical practices, consistent quality, and excellent customer service enjoys greater goodwill. A well-established brand inspires trust among customers and investors, leading to increased loyalty, repeat purchases, and the ability to charge premium prices.

4. Efficiency of Management - The capability and efficiency of a business's management team directly impact its performance and profitability. A well-managed company ensures smooth operations, strategic decision-making, innovation, cost control, and employee satisfaction—all of which contribute to higher goodwill. In contrast, poor management can damage reputation and reduce the business's market value.

5.Customer Base and Loyalty - A broad, stable, and loyal customer base adds immense value to a business. When customers consistently choose a particular business over competitors, it indicates strong goodwill. Loyal customers not only ensure recurring revenue but also act as brand ambassadors, further strengthening the firm's market position.

6. Profitability and Future Earnings Potential - One of the most direct indicators of goodwill is the ability of a business to earn profits consistently over time. High profitability signals efficient operations and customer satisfaction. Furthermore, a strong potential for future earnings—through expansion, innovation, or market growth—adds to the value of goodwill.

7. Monopoly Position or Competitive Advantage - If a business operates in a monopolistic environment or holds certain competitive advantages (such as patents, licenses, exclusive supply chains, or strong brand recall), it enjoys higher goodwill. These advantages act as entry barriers for competitors, helping the business maintain market share and profitability.

8. Quality of Products or Services - Delivering high-quality products or services creates long-term customer satisfaction and positive word-of-mouth marketing. Businesses known for their quality tend to have fewer customer complaints and better retention rates, which naturally enhances their goodwill.

C. CHECK YOUR PROGRESS

True or False

1. Accurate valuation of goodwill helps ensure fairness in partnership changes.

Answer: True

2. The value of goodwill remains constant over time and does not require revaluation.

Answer: False

3. Goodwill has no role in determining compensation in case of business takeover.

Answer: False

4. Goodwill is a tangible asset, so its valuation is straightforward.

Answer: False

5. Accurate valuation of goodwill helps ensure fairness in partnership changes.

Answer: True

9. Employee Relations and Workforce Stability - A motivated, skilled, and stable workforce is a key asset for any business. Positive employee relations led to higher productivity, better service quality, and a collaborative work environment. Companies known for treating employees well are also perceived positively in the market, contributing to enhanced goodwill.

10. Market Conditions and Industry Trends - External factors such as general economic conditions, government policies, technological changes, and industry-specific trends can affect goodwill. For instance, a business in a booming sector like renewable energy or digital technology will have higher goodwill than one in a declining or overregulated industry.

11. Longevity and Stability of the Business - Businesses that have been operating successfully for a long period often enjoy greater goodwill. Longevity implies trustworthiness, reliability, and a history of stable operations. Established firms tend to have stronger customer relationships, better market knowledge, and a more resilient reputation.

1.7 LET US SUM UP

The concept of goodwill as an intangible but valuable asset that reflects the reputation, brand loyalty, and earning potential of a business beyond its tangible assets. Goodwill arises when a business earns stable profits, builds a positive image, and establishes customer trust over time. The need to value goodwill typically arises in situations such as mergers, acquisitions, changes in business structure, or when a partner retires or dies. It plays a crucial role in determining the fair worth of a business during such changes and is often essential for maintaining fairness among stakeholders.

The various factors that influence the value of goodwill include the nature and location of the business, quality of products or services, efficiency of management, profitability, market competition, brand recognition, and customer satisfaction. Businesses that enjoy a monopoly position, have experienced management, or offer consistent quality often have higher goodwill. Overall, this chapter lays the foundation for understanding what goodwill is, why it matters in the business world, and what internal and external elements shape its value.

1.8 KEYWORDS

- **Goodwill** - Goodwill is an intangible asset that represents the reputation, brand value, customer loyalty, and earning potential of a business over and above its tangible assets.
- **Intangible Asset** - An intangible asset is a non-physical asset that has value, such as goodwill, patents, trademarks, and brand recognition. It cannot be touched but contributes to the business's earnings.
- **Valuation** - Valuation is the process of determining the current worth or value of an asset, business, or liability. In this context, it refers to estimating the monetary value of goodwill.
- **Monopoly Position** - A monopoly position occurs when a business is the sole provider of a particular product or service in a market. Such exclusivity often increases the goodwill of the business.
- **Management Efficiency** - Management efficiency refers to how well the leadership 17 of a business utilizes its resources to generate profits and maintain growth. Efficient management improves business performance and thus positively affects goodwill.

1.9 SELF ASSESSMENT QUESTIONS

1. Define goodwill. Why is it considered an intangible asset?

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2. State the situations where the valuation of goodwill becomes necessary.

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3. Explain any three major factors that affect the value of goodwill in a business.

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1.10 LESSON END EXERCISE

1. What is goodwill? Discuss the need for valuing goodwill in different forms of business organizations.

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2. Explain the various factors that influence the valuation of goodwill. How do these factors impact the goodwill of a business?

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3. Explain the importance of goodwill in business. How does it contribute to the long-term success and valuation of an enterprise?

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1.11 SUGGESTED READINGS

1. T.S. Grewal, Financial Accounting, Sultan Chand & Sons, 2023.
2. S.N. Maheshwari & S.K. Maheshwari, Advanced Accountancy – Volume I, Vikas Publishing House Pvt. Ltd., 2022.
3. P.C. Tulsian & Bharat Tulsian, Financial Accounting, S. Chand Publishing, 2023.
4. K.L. Narang & S.P. Jain, Corporate Accounting, Kalyani Publishers, 2023.

UNIT I **B.Com 4th Semester Course**

No. BCG-401 **Lesson No. 2**

GOODWILL VALUATION METHODS

STRUCTURE

2.1 INTRODUCTION

In this lesson, you will gain a comprehensive understanding of the various methods used to value goodwill in a business. You will begin by exploring why the valuation of goodwill is essential and under what circumstances each method is most appropriately applied. The chapter introduces you to the core principles behind each valuation approach, helping you recognize the relevance of different techniques depending on the consistency of profits, the nature of the business, and expectations about future earnings.

You will learn five important valuation methods in detail—Simple Average Profit Method, Super Profits Method, Capitalization Method, and Annuity Method. Each method will be explained with its concept, formulas, step-by-step procedures, suitable situations for application, and illustrative examples. By the end of this chapter, you will be equipped with the analytical tools to choose and apply the most suitable goodwill valuation technique based on real-life business scenarios.

2.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

After completing the lesson, learners will be able to:

- Understand the concept of valuing goodwill in business.
- Identify different situations where each method of goodwill valuation is applicable.
- Learn the conceptual basis and formulas of various goodwill valuation methods.
- Analyze and compare the use of different valuation techniques in practical scenarios.
- Accurately compute goodwill using Simple Average, Super Profits, Capitalization, and Annuity methods.

Learning Outcomes

After completing the lesson, learners will be able to:

- Define and explain the purpose of goodwill valuation.
- Select the appropriate goodwill valuation method based on business conditions.
- Calculate average profits and determine goodwill using the Simple Average Profit Methods.
- Compute super profits and apply the Super Profits and Capitalization Methods for valuation.
- Use the Annuity Method to account for the time value of super profits in specific situations.
- Apply theoretical knowledge to solve practical accounting problems related to goodwill.

2.3 INTRODUCTION TO METHODS OF VALUATION

Valuation of goodwill refers to the process of assigning a monetary value to the intangible asset "goodwill" when certain business circumstances demand it. The value of goodwill is not fixed and depends on the firm’s reputation, profitability, and position in the industry. The selection of the method for valuation depends on the nature and purpose of the valuation, availability of data, and the structure of the business. Some methods focus on average profitability, while others consider the excess earnings or the present value of future benefits. The selection of the appropriate method ensures fairness and accuracy in financial decision-making. Below is a brief overview of some commonly used methods for calculating goodwill.

Simple Average Profit Method

The Simple Average Profit Method is one of the most basic and widely used techniques for valuing goodwill. It assumes that the business will continue to earn the average profits it has earned in the past. This method calculates goodwill by taking the simple average of past adjusted profits and multiplying it by an agreed number of years' purchase. It is suitable for businesses with stable and consistent earnings over time.

Weighted Average Profit Method

The Weighted Average Profit Method improves upon the simple average method by assigning more importance to recent profits. This approach acknowledges that the most recent financial performance of a firm is often more indicative of future profitability. In this method, each year’s profit is multiplied by a specific weight (usually increasing year by year), and the weighted average is then multiplied by the number of years’ purchase to calculate goodwill. This method is ideal when profits show a rising or falling trend.

Super Profits Method

The Super Profits Method focuses on the excess earnings of a business over the normal expected return. Super profits are calculated by subtracting the normal profit (based on capital employed and industry rate of return) from the business's average actual profit. The value of goodwill is then derived by multiplying these super profits by a certain number of years' purchase. This method is particularly useful when a firm is earning above-average returns compared to other businesses in the same industry.

A. CHECK YOUR PROGRESS
Match the Following

Column A (Methods)	Column B (Key Features)
A. Simple Average Profit Method	1. Values goodwill based on the excess of actual profit over normal profit
B. Weighted Average Profit Method	2. Considers time value of money using discounted super profits
C. Super Profits Method	3. Uses more recent profits with higher weights to calculate average profit
D. Capitalization Method	4. Capitalizes profit or super profit and deducts capital employed
E. Annuity Method	5. Takes average of past profits and multiplies by number of years' purchase

Answers: A → 5, B → 3, C → 1, D → 4, E → 2

Capitalization Method

The Capitalization Method values goodwill by assessing the total value of the business based on its earning capacity and then deducting the actual capital employed. There are two variants: capitalization of average profit and capitalization of super profits. In both cases, the business's profits are capitalized using the normal rate of return to estimate the business's value, from which the existing capital is subtracted to determine goodwill. This method is ideal when valuing the business, not just its intangible assets.

Annuity Method

The Annuity Method is a refined version of the super profits method, which incorporates 22 the concept of the time value of money. It assumes that super profits will be earned for a limited number of years in the future. These expected super profits are discounted to their present value using an annuity factor based on a chosen discount rate. This method is suitable when profits are expected for a fixed period and future earnings need to be brought to present value.

2.4 WHEN TO USE EACH METHOD

Valuation of goodwill is not a one-size-fits-all process. Each method has its own logic, assumptions, and applicability based on the business's financial characteristics and the purpose of valuation. Choosing the right method ensures a realistic and justifiable valuation of goodwill.

1. Simple & Weighted Average Profit Methods: This method is ideal when the business has shown consistent and stable profits over the past few years. They are commonly used when the business is being sold as a going concern, undergoing internal restructuring, or when there is a change in ownership or partnership. The Simple Average Method is preferred when profits do not vary significantly from year to year.

2. Weighted Average Profit Method - The Weighted Average Profit Method is suitable when the business shows a definite trend in profits either increasing or decreasing over the years. Since this method gives more weight to recent profits, it is particularly helpful in scenarios where the recent performance is more relevant to future expectations. It is often used during partnership changes, business conversions, or restructuring, especially when profits have not been uniform and stakeholders want a more realistic value of goodwill.

3. Super Profits Method: This method is best used when a business earns higher-than normal profits compared to other similar firms in the industry. It is especially useful in cases where a company has a competitive edge, strong market position, or brand loyalty, allowing it to earn above-average returns. This method isolates the "super" profits (i.e., excess earnings) and uses them as the basis for goodwill valuation. It is ideal during partnership changes, mergers, or when justifying premium pricing for acquisitions.

4. Capitalization Method: The capitalization method is appropriate when the goal is to value the entire business, not just goodwill. It considers the earning potential of the business and compares it to the capital invested to derive the value of intangible assets. This method is useful when assessing a company for complete acquisition, listing on stock exchange, or when determining share value in absence of market quotation. It assumes that the firm will continue to earn at its current level indefinitely.

B. CHECK YOUR PROGRESS

Fill in the Blanks

1. The __________ Method gives more importance to recent years' profits in goodwill valuation.

Answer: Weighted Average Profit

2. In the __________ Method, future super profits are discounted to present value using annuity factors.

Answer: Annuity

3. The Capitalization Method assumes that a firm will continue to earn profits at its current level __________.

Answer: indefinitely

4. The Super Profits Method uses __________ earnings as the basis for valuing goodwill.

Answer: excess / super

5. Goodwill is usually valued using the Simple Average Method when the business has shown __________ and __________ profits.

Answer: stable and consistent

5. Annuity Method: This method is employed when super profits are expected to continue for a limited period, and the time value of money must be considered. It discounts future expected super profits to their present value using annuity factors. This method is appropriate when profits are not permanent but are likely to be earned for a few specific years, such as during a short-term monopoly, favorable government contract, or temporary market dominance.

2.5 SIMPLE AVERAGE PROFIT METHOD

The Simple Average Profit Method is a basic but widely used technique to estimate the value of goodwill. It assumes that future profits will be like the average of past profits, making it suitable for businesses with relatively stable performance over time.

The objective of calculating average profit is to project future maintainable profits, which form the basis for valuing goodwill. Therefore, only normal, recurring, and operational profits should be considered abnormal, extraordinary, or non-recurring items must be adjusted to reflect a realistic earning potential.

The formula used to calculate goodwill using simple average profit method is as follows:

GOODWILL = AVERAGE PROFIT × NUMBER OF YEARS' PURCHASE

- **Steps for calculation of goodwill using simple average profit method:**

1. Selection of relevant years:
   Choose 4–5 normal past years (free from major fluctuations like fire, strike, or extraordinary gains/losses) for estimating the profit that the business can earn in the future years. If the business is affected by cyclical trends, choose a longer time frame to cover peak, trough, and recovery.
2. Adjust the Profits:
   To reflect true business potential, the following adjustments should be made:

a) Add back abnormal losses: Loss due to strikes, floods, fire, abnormal repairs, lump sum compensation, etc., should be added back if not expected to recur.

b) Ensure all operating expenses are included: Interest on debentures and depreciation should be properly charged based on revalued asset figures.

c) Exclude non-operating incomes/expenses: Profits from non-trading investments or capital receipts should be removed if they don't reflect core operations.

d) Adjust director/manager remuneration: If not already accounted for, deduct fair market remuneration. If overcharged or undercharged, make necessary adjustments.

e) Account for auditor's comments: Adjust for inadequate provisions for taxes, bad debts, gratuity, depreciation, or improper stock valuation as per audit remarks.

f) Taxation Adjustment: Deduct applicable income tax as per the latest Finance Act. Average profit should be post-tax.

g) Account for strategic changes: Discontinuation or expansion of business, major policy shifts, and expected gains/losses from development work should be adjusted in profits.

h) Provision for liabilities: Ensure sufficient and appropriate provision is made.

i) Legal Precedent Consideration: As per Clifford and Martin case, anticipated director loss or future tax increases should not be factored into average profits.

After adjusting all the non-recurring items, we get Future Maintainable Profits (FMP). These profits expected to continue in the foreseeable future, based on past performance, after making appropriate adjustments.

3. Calculate the Simple Average Profit:

AVERAGE PROFIT = TOTAL ADJUSTED PROFITS / NUMBER OF YEARS

4. Multiply by Years of Purchase:

Multiply the calculated FMP by the agreed-upon Years of Purchase to determine goodwill.

Years of Purchase is a multiplier that represents the number of years the buyer expects to earn similar profits from the business. For instance, if the buyer expects to benefit from goodwill for 3 years, then 3 becomes the Years of Purchase. This figure is usually agreed upon during negotiations and depends on factors like industry norms, stability, competition, and risk.

- **Advantages of Simple Average Profit Method**

1) This method is simple and easy to understand and apply.
2) This method is based on actual performance.
3) 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.
4) Suitable for many small to medium-sized businesses.

- **Limitations of Simple Average Profit Method**

1) Assumes equal weight for all years, ignoring recent trends.
2) Doesn't consider the time value of money.
3) Not appropriate when profits show consistent growth or decline.
4) Only profits are considered to ascertain the value of goodwill. No account is taken for capital employed while that is an important factor affecting goodwill.
5) 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 the business of Mr. Ramesh:

a) Profit-2022 Rs.6, 00,000; 2023 Rs.4, 80,000; 2024 Rs. 3, 80,000; 2025 Rs. 5, 30,000.

b) Profit for 2022 has been reduced by Rs. 70,000 due to loss of stock by fire.

c) Profit for 2023 includes Rs. 40,000 which was a non-recurring income.

d) The goods were previously not insured; however, it has now been decided to obtain insurance, with an expected annual premium of ₹3,000.

e) The profit for the year 2024 includes ₹10,000 earned from non-trading investments.

f) Profit for 2025 includes Rs. 70,000 for a claim lodged in 2018 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 2022 *Add*: lost due to fired	6,00,000 70,000	6,70,000
Profits of 2023 *Less*: non-recurring income	4,80,000 (40,000)	4,40,000
Profits of 2024 *Less*: income from non-trading investment	3,80,000 (10,000)	3,70,000
Profits of 2025 *Less*: income relating to 2018 (claim lodged)	5,30,000 (70,000)	4,60,000
Total profit of four years		19,40,000

Average Profits = 19,40,000 / 4 = Rs. 4, 85,000

Less: Expected Expenses:

Insurance Premium 3000

Proprietor’s remuneration 50000 (53,000)

4,32,000

Therefore, the future maintainable profit for the business of Mr. Ramesh is Rs. 4,32,000.

Illustration 2 (Calculation of Goodwill using Simple Average profit Method)

A, B and C share profits and losses in the ratio 3:2:1. Their deed says that on retirement, goodwill is valued at two years’ purchase of the average net profits of the preceding four years. B retires on 31 March 2025. Profits after tax were:

Year ended 31 March	Net profit (₹)
2022	1,50,000
2023	1,80,000
2024	1,20,000
2025	2,00,000

Compute (a) the firm's goodwill and (b) B's share of goodwill.

Solution:

Calculation of Average Profits

	Rs.
Profits of 2022	1,50,000
Profits of 2023	1,80,000
Profits of 2024	1,20,000
Profits of 2025	2,00,000
Total Profits of 4 years	6,50,000

Average Profit = 1,50,000 + 1,80,000 + 1,20,000 + 2,00,000 / 4 = 1,62,500

A) Goodwill of firm 1,62,500 × 2 = **3,25,000**
B) B's share (ratio 3:2:1 ⇒ B's share = 2/6)
   3,25,000 × 2/6 = **1,08,333**

2.6 WEIGHTED AVERAGE PROFIT METHOD

The Weighted Average Method of goodwill valuation is used when a business's profits are inconsistent over the years, and more importance (or weight) is given to the recent profits compared to older ones. This assumes that recent profits better reflect the firm's current earning capacity.

The formula used to calculate goodwill using weighted average profit method is as follows:

GOODWILL=WEIGHTED AVERAGE PROFIT × NUMBER OF YEARS' PURCHASE

- **Steps for calculation of goodwill using weighted average profit method:**

1. Selection of relevant years:

   Choose 4–5 normal past years (free from major fluctuations like fire, strike, or extraordinary gains/losses) for estimating the profit that the business can earn in the future years. If the business is affected by cyclical trends, choose a longer time frame to cover peak, trough, and recovery.
2. The next step is to adjust each year's profit to reflect the true earning capacity of the business. This involves removing the effects of abnormal income or losses such as those arising from strikes, natural calamities, or one-time gains. Any errors in stock valuation that may have inflated or deflated profits must be corrected. If capital expenditures were wrongly treated as revenue expenses, those amounts should be capitalized, and appropriate depreciation should be charged. Non-operating items such as interest income, rental income, or gains from asset sales, which are not part of core operations, should be excluded. Additionally, depreciation adjustments must be made to align with realistic asset values. Lastly, if managerial salary or commission was not charged earlier, it should now be deducted to reflect the true cost of running the business. These adjustments ensure that the profits used in goodwill valuation are normal, consistent, and reflective of future maintainable profits.
3. Assign weights to each year (generally increasing toward the most recent year).
4. Multiply each year’s adjusted profit by its weight.
5. Calculate the weighted average profit.

WEIGHTED AVERAGE PROFIT = ∑ (ADJUSTED PROFIT × WEIGHT) / ∑ WEIGHTS

6. Multiply the weighted average profit by the number of years’ purchase (agreed between buyer and seller).

C. CHECK YOUR PROGRESS

True or False

1. Weighted Average Profit Method is used when profits are highly stable and do not change much over the years.

Answer: False

2. The Simple Average Profit Method is usually used when the business is recently established.

Answer: False

3. The Simple Average Profit Method gives equal importance to all years' profits.

Answer: True

4. In the Simple Average Profit Method, abnormal and non-recurring items should be adjusted before calculating average profit.

Answer: True

5. In Weighted Average Method, weights must always be the same for all years.

Answer: False

- **Advantages of Weighted Average Profit Method**

1. It assigns more weight to the latest years' profits, which are generally more reflective of current business trends and future potential.
2. By averaging over several years with different weights, the method reduces the impact of any abnormal year (very high or very low profits).
3. Compared to simple average, this method gives a better estimate of Future Maintainable Profits (FMP) when the business is growing or declining.
4. It is useful in situations where the company's performance has shown a steady increase or decrease.

- **Limitations of Weighted Average Profit Method**

1. The selection of weights is subjective and may vary from one evaluator to another, affecting the consistency of results.
2. Profits must be adjusted for numerous factors (like stock errors, capital expenses, non-operating income), which can be time-consuming and may lead to errors if done incorrectly.
3. In industries with highly unpredictable profit patterns, even weighted averages may not represent future earnings accurately.
4. Unlike the Super Profits or Capitalization methods, this approach does not link goodwill to the capital used in the business.

Illustration 3 (Calculation of Goodwill using Weighted Average profit Method)

X & Y proposes to buy the business of Mr. A. Goodwill is to be valued at three years' purchase of the weighted average profits of the last four years. Weights and profits are:

Year	Weight	Reported profit (₹)
2019	1	90,000
2020	2	1,10,000
2021	3	95,000
2022	4	1,30,000

Additional information

1. Closing stock for 2020 was over-valued by ₹8,000.
2. On 1 July 2021 a capital repair costing ₹20,000 was wrongly debited to revenue. Depreciate it at 10 % p.a. on reducing balance.
3. A fixed management charge of ₹30,000 per year must be provided.

Compute the value of goodwill of the firm.

Solution:

Computation of Adjusted Profits	**(₹)**	**(₹)**
Profit - 2019		90,000
Less: Management charge		(30,000)
Adjusted Profit for the year 2019		60,000
Profit - 2020		1,10,000
Less: Management charge	(30,000)	
Stock overvaluation	(8,000)	(38,000)
Adjusted Profit for the year 2020		72,000
Profit - 2021		95,000
Add: Stock overvaluation of 2020	8,000	
Capital repair	20,000	
Less: Management charge	(30,000)	
Depreciation (capital repair)	(1,000)	(3,000)
Adjusted Profit for the year 2021		92,000
Profit - 2022		
Less: Management charge	(30,000)	
Depreciation (capital repair)	(1,900)	(31,900)
Adjusted Profit for the year 2022		98,100

Computation of WeightedAverage Profits

Year	Adjusted profit	Weight	Product
2019	60,000	1	60,000
2020	72,000	2	1,44,000
2021	92,000	3	2,76,000
2022	98,100	4	3,92,400
Totals		**10**	**8,72,400**

Average Profits = Total of Profit / Total of Weights

= 8,72,400 / 10 = 8,72,40

Goodwill = Average Profit × No. of years' purchase

= 87,240×3 = **₹2,61,720**

2.7 LET US SUM UP

Understanding and applying appropriate methods for valuing goodwill is crucial for organizations during structural changes such as mergers, acquisitions, or reconstitution of partnerships. These methods provide a systematic approach to determine the monetary worth of a business's reputation and earning potential. The selection of the method—whether simple or weighted average—depends on the nature and trend of the firm's past profits and the reliability of those profits in projecting future earnings.

While the Simple Average Profit Method offers a basic yet useful estimate for stable businesses, the Weighted Average Method adds depth by emphasizing recent years' performance, making it more suitable for firms experiencing consistent growth or decline. Just as sound management controls protect a company from operational risks, choosing the right goodwill valuation method ensures fair and informed financial decisions. Businesses that apply these valuation techniques correctly—especially during critical events like retirement of partners or corporate buyouts—are better positioned to maintain transparency, equity, and financial health.

2.8 KEYWORDS

- **Average Profit -** Average profit is calculated by summing up the net profits of a business over a specific number of past years and then dividing the total by the number of years. It is used as a base to predict the future profits of the business, assuming that past performance is a good indicator of future profitability, especially if the profits were stable.
- **Years' Purchase** - Years' purchase is the number of years for which a buyer of a business is willing to pay for the expected future profits. It represents the period over which the goodwill will continue to generate benefits for the buyer.
- **Future Maintainable Profit (FMP)** - FMP refers to the level of profit that a business is expected to maintain consistently in the future. It is calculated after adjusting past profits to remove any abnormal items or one-time effects. The FMP provides a realistic estimate of earnings that can be expected in the coming years and serves as the foundation for valuing goodwill.
- **Adjusted Profit** - Adjusted profits are the profits that have been modified or corrected to reflect the true earnings of a business. Adjustments include removing one-time gains or losses, correcting errors like over- or under-valuation of stock, charging appropriate depreciation, and accounting for missing or excessive managerial salaries. These adjustments help in calculating an accurate average or weighted profit for goodwill valuation.
- **Weighted Average** - The weighted average method of goodwill valuation gives greater importance (weight) to recent years' profits compared to older years. This is done by multiplying each year's profit by a predetermined weight (like 1, 2, 3, etc.) based on relevance. It is more appropriate than a simple average when a business has shown a rising or falling trend in profitability.

2.9 SELF ASSESSMENT QUESTIONS

1. What is meant by the term 'adjusted profit' and why is it important in the valuation of goodwill?

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2. Explain the steps involved in calculating average profit from the profits of previous years?

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3. Why is Weighted Average Method preferred when profits are increasing or decreasing?

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2.9 SELF ASSESSMENT QUESTIONS

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1. Discuss the key differences between the Simple Average and Weighted Average Profit Methods.

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2. Explain the various methods of goodwill valuation in detail. Under what business circumstances is each method most appropriately used?

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3. Describe the Simple Average Profit Method. What are its merits and demerits? When is this method preferred over others?

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2.11 SUGGESTED READINGS

1. T.S. Grewal, Financial Accounting, Sultan Chand & Sons, 2023.
2. S.N. Maheshwari & S.K. Maheshwari, Advanced Accountancy – Volume I, Vikas Publishing House Pvt. Ltd., 2022.
3. P.C. Tulsian & Bharat Tulsian, Financial Accounting, S. Chand Publishing, 2023.
4. K.L. Narang & S.P. Jain, Corporate Accounting, Kalyani Publishers, 2023.

UNIT I **B.Com 4th Semester Course**

No. BCG-401 **Lesson No. 3**

SUPER PROFIT METHOD

STRUCTURE

3.1 INTRODUCTION

In this lesson, you will develop a clear and practical grasp of the Super Profits Method, one of the most widely adopted techniques for valuing goodwill. You will first examine the rationale behind this approach. How it isolates a firm's "super profits," or earnings that exceed a normal industry return and why this surplus is considered the best indicator of a business's intangible value. Step by step, the lesson guides you through determining capital employed, selecting an appropriate normal rate of return, computing normal profit, and finally deriving super profit.

Once these fundamentals are in place, you will learn to translate super profit into goodwill by applying the agreed years' purchase multiplier, thereby linking exceptional earning power to a concrete monetary figure. Throughout the lesson, worked examples with varied data sets illustrate how changes in capital structure, industry benchmarks, and years' purchase affect the final valuation. By the end, you will not only understand how to calculate goodwill using this method but also know when and why to choose this method over others, equipping you to handle goodwill assessments confidently in real-world business situations.

3.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

By the end of this lesson, learners will be able to:

- Understand the concept of super profits and its significance in valuing goodwill.
- Identify and calculate capital employed using appropriate methods.
- Determine the normal rate of return based on industry standards.
- Compute normal profit and differentiate it from actual profits.

- Derive super profit and apply the appropriate years' purchase.
- Apply the Super Profits Method formula to calculate goodwill in practical business scenarios.
- Analyse different business situations where the Super Profits Method is most suitable.

Learning Outcomes

After completing this unit, learners will be able to:

- Clearly explain the logic and assumptions behind the Super Profits Method.
- Accurately calculate super profits using real or hypothetical data.
- Justify the selection of the Super Profits Method in different organizational contexts.
- Solve practical problems involving goodwill valuation using this method.
- Make informed decisions when valuing goodwill during mergers, acquisitions, or changes in business structure.

3.3 CONCEPT OF SUPER PROFITS

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:

GOODWILL = SUPER PROFIT × NUMBER OF YEARS' PURCHASE

Merits of Super Profit Method

- This method values goodwill based on the actual profits over and above the normal expected profits, which reflects the true earning advantage of the business.
- The method is relatively simple to understand and easy to apply using standard financial data.
- Especially suitable for firms that earn more than the industry average or expected return on capital employed.
- Since it excludes profits that are just sufficient to earn a normal return on capital, it offers a balanced and fair estimate of goodwill.

- It allows for the use of future maintainable profits, making it more adaptable to business forecasts and realistic assumptions.

A. CHECK YOUR PROGRESS

Fill in the Blanks

1. Super Profits Method calculates goodwill based on the excess of __________ profit over normal profit.

Answer: Actual (or average)

2. Normal Profit is calculated by multiplying __________ with the normal rate of return.

Answer: Capital employed

3. If the business earns the same as the normal return, then goodwill under the super profit method is _________.

Answer: Zero

4. Abnormal and non-recurring income should be __________ from actual profits before calculating super profits.

Answer: Excluded

5. Super profits reflect the business's __________ advantage or earning potential beyond normal expectations.

Answer: Competitive

Demerits of Super Profit Method

- Adjusting past profits to estimate future maintainable profits involves judgment and assumptions, which may lead to errors or bias.
- The method treats all super profits equally, regardless of whether they are earned today or in the future, which can distort the value.
- What constitutes a "normal" rate of return may vary by industry and circumstance, leading to inconsistent valuations.
- The method assumes the same capital employed and profit structure will continue, which may not hold true in a dynamic business environment.
- If a business has erratic or negative past profits, this method may not give a realistic or usable valuation.

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 mean 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.

B. CHECK YOUR PROGRESS

Statement Classification

Classify the following adjustments as: (A) Add, (B) Deduct, or (C) Ignore

a) One-time compensation received from legal settlement
b) Increase in future salary of employees
c) Regular rent paid for office
d) Profit on sale of obsolete stock
e) Bad debts written off (non-recoverable)

Answer:
a) A — Add
b) B — Deduct
c) C — Ignore
d) A — Add
e) B — Deduct

(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) Rate of Financial Risk: This refers to the rate that compensates for the financial risks associated with the way a business is financed, such as the use of debt or variability in financial obligations.

(iv) Rate of Return: The sum of the above three components will give the 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: Capital Employed refers to the total amount of capital invested in a business for the purpose of generating profits. It is a crucial component in calculating normal profits, which are then used to determine super profits for goodwill valuation.

For valuing goodwill, Capital Employed can be calculated using either of the following two methods:

(i) Assets Side Approach: In this method, capital employed may be calculated as either gross or net. Gross capital employed includes the total of all business assets, while net capital employed commonly used for goodwill valuation is derived by subtracting external liabilities from total assets. Only tangible assets used in the business are considered, and these are valued at their replacement cost to reflect current values. Intangible assets such as goodwill, non-operational patents or trademarks, non-trading investments, and fictitious assets like preliminary expenses or discounts on shares and debentures are excluded. After determining the total of eligible tangible assets, all current and external liabilities also valued at current cost are deducted to arrive at the capital employed.

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: The Liability Side Approach is another widely accepted method for calculating capital employed in the valuation of goodwill. This approach focuses on the equity and internal funds reflected on the liability side of the balance sheet. Under this method, capital employed is determined by adding the paid-up share capital to accumulated profits, general and specific reserves, and any surplus arising from the revaluation of fixed assets and liabilities. From this total, certain deductions are made, including losses on the revaluation of assets, any debit balance in the Profit and Loss Account, fictitious assets such as preliminary expenses or underwriting commission, and non-trading assets that do not contribute to the core operations of the business.

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 number of debentures or loans should be subtracted from the total assets of the business, because profits are considered after interest on debentures or loans. 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, based on 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.

3.4 STEPS TO CALCULATE GOODWILL THROUGH SUPER PROFITS METHOD

The Super Profits Method is a widely used approach for valuing goodwill. It is based on the principle that a well-established business often earns profits more than what similar firms in the industry would normally earn on the same amount of capital. This extra earning is called super profit, and goodwill is calculated by capitalizing this super profit over a specified number of years. Following are the steps to calculate goodwill using this method:

1. Calculate Adjusted Average Profit / Future Maintainable Profit (FMP): Start by averaging the past profits after making necessary adjustments. Add back abnormal losses and capital expenses wrongly charged to revenue (after depreciation), and subtract abnormal gains, errors in stock valuation, unaccounted management salaries, and non-operating incomes. Also adjust for provisions and discontinued operations. The result is the Future Maintainable Profit (FMP), reflecting realistic earnings.

FMP (Average Profit) = Total of Adjusted Profits / Number of Years Considered

2. Calculate Average Capital Employed: Capital employed is the average amount of funds used in the business to generate profits. It can be calculated using either:

(a) Assets Side Approach:

Capital Employed = Total Tangible Assets (at replacement cost) − External Liabilities

(b) Liability Side Approach:

Capital Employed=Share Capital+ Reserves & Surplus − Losses and Fictitious Assets

Average Capital Employed can be calculated using two formulas:

$$\text{Average Capital Employed} = \frac{\text{Capital at Beginning} + \text{Capital at End}}{2}$$

or

$$\text{Average Capital Employed} = \text{Capital Employed} + \frac{1}{2} \times \text{Current Year's Profit After Tax}$$

3. Determine Normal Rate of Return (NRR): This is the return expected from a similar business in the industry. It may be given in the question (e.g., 10%, 12%) or derived from market/industry standards.

4. Calculate Normal Profit: Normal Profits are calculated using the Normal Rate of Return (NRR) applied to the Average Capital Employed. This represents the expected earnings that a business should generate under normal conditions, based on industry standards or comparable businesses. It serves as a benchmark for evaluating whether a business is earning more than the standard return on its capital.

Normal Profit = (Average Capital Employed × Normal Rate of Return) / 100

5. Compute Super Profit: This is the difference between the actual average (maintainable) profit and the normal profit.

Super Profit = FMP − Normal Profit

If the result is negative or zero, goodwill is assumed to be nil.

6. Calculate Goodwill: 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 the super profits of a business are estimated at ₹90,000, they may be divided into three slabs as follows:

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 based on sliding scale of S.P. method	1, 60,000

C. CHECK YOUR PROGRESS
Match the Following

Column A (Step)	Column B (Description)
1. Step 1	A. Multiply super profit with years' purchase
2. Step 2	B. Compute average of adjusted past profits
3. Step 3	C. Calculate expected return on capital employed
4. Step 4	D. Find difference between actual and normal profit
5. Step 5	E. Final goodwill calculation

Answers: 1 → B, 2 → C, 3 → D, 4 → A, 5 → E

3.5 PRACTICAL QUESTIONS

Illustration 3 (Calculation of Goodwill through Super Profits Method)

The net results of a firm for the last four years are:

- 2020: ₹1,10,000
- 2021: ₹1,20,000
- 2022: ₹50,000 (Loss)
- 2023: ₹1,50,000

The average capital employed in the business is ₹5,00,000. The normal rate of return expected is 10%. The annual remuneration of the proprietor is ₹20,000. Calculate the value of goodwill on the basis of 3 years' purchase of super profit.

Solution:

Calculation of Average Profit

	Amount (₹)	**Amount (₹)**
Profit for 2020	1,10,000	
Profit for 2021	1,20,000	
Profit for 2023	1,50,000	
Less: Loss for 2022	(50,000)	
Total profits of four years		3,30,000
Average profit (Total Profits / No. of years)		82,500
Less: Remuneration		(20,000)
Adjusted profit		62,500

Calculation of Normal Profit

Normal Profit = (Average Capital Employed × Normal Rate of Return) / 100

= (5,00,000 × 10) / 100 = 50,000

Calculation of Super Profit

Super Profit = Average Profit (adjusted) - Normal Profit

= ₹62,500 − ₹50,000 = ₹12,500

Calculation of Goodwill

Goodwill = Super Profit × No. of Years' Purchase

= ₹12,500 × 3 = **₹37,500**

Illustration 4 (Calculation of Goodwill through Super Profits Method)

The profits/losses of a firm for the last four years are:

- 2020: ₹1,00,000
- 2021: ₹1,10,000

- 2022: ₹30,000 (Loss due to fire: ₹70,000)
- 2023: ₹1,50,000

During 2022, an abnormal loss of ₹70,000 occurred due to fire, which is not expected to recur in future. Average capital employed in the business is ₹6,00,000. The normal rate of return is 10%. Goodwill is to be valued at 2 years' purchase of super profit.

Solution:

Calculation of Average Profit

		Amount (₹)	Amount (₹)
Profit for 2020		1,00,000	
Profit for 2021		1,10,000	
Loss for 2022	(30,000)		
Add: Loss by fire	70,000		
Adjusted profit of 2022		40,000	
Profit for 2023		1,50,000	
Total profits of four years			4,00,000
Average profit (Total Profits / No. of years)			1,00,000

Calculation of Normal Profit

Normal Profit = (Average Capital Employed × Normal Rate of Return) / 100

= (6,00,000 × 10) / 100 = 60,000

Calculation of Super Profit

Super Profit = Average Profit (adjusted) - Normal Profit

₹1,00,000 − ₹60,000 = ₹40,000

Calculation of Goodwill

Goodwill = Super Profit × No. of Years' Purchase

₹40,000 × 2 = **₹80,000**

3.6 LET US SUM UP

The Super Profit Method is a widely accepted and logical approach for valuing goodwill, especially when a business earns profits above the normal industry expectations. Unlike basic average profit methods, this technique considers what the business would ordinarily earn (normal profit) and identifies the surplus or "super" profit as the real basis for goodwill. It effectively rewards the business for its exceptional earning capacity.

By calculating goodwill as the present value of future super profits, this method provides a more realistic and justified estimate of a firm's intangible value. It is particularly suitable for firms that enjoy competitive advantages such as brand reputation, superior management, or strategic location—factors that result in earnings exceeding the normal return on capital. However, care must be taken to ensure that average profits are fairly adjusted for abnormal items and one-time events to ensure accuracy.

3.7 KEYWORDS

- **Super Profit** - Super profit is the excess of actual average profit (after necessary adjustments) over the normal profit expected from the capital employed. It reflects the extra earning capacity of a business due to its unique advantages.
- **Average Profit -** Average profit is the arithmetic mean of the adjusted profits over a given number of years. It represents the future maintainable earnings of a business under normal circumstances.
- **Normal Profit -** Normal profit is the return a business is expected to earn on its capital employed, based on the average rate of return in the industry. It serves as a benchmark to judge whether the firm is earning more or less than what is reasonably expected.
- **Capital Employed -** Capital employed refers to the total amount of funds invested in the business operations, usually including equity, reserves, and long-term debt. It may be calculated from the asset side (net assets) or liability side (shareholders' equity + long-term liabilities).
- **Normal Rate of Return (NRR) -** Normal Rate of Return is the standard percentage return that investors expect on capital employed, based on industry trends and market conditions. It is used as a benchmark to calculate normal profit for goodwill valuation.

3.8 SELF ASSESSMENT QUESTIONS

1. When does super profit arise in the business?

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2. What is the difference between average profit and normal profit?

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3. What do you mean by the term "capital employed"?

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3.9 LESSON END EXERCISE

1. What is the concept, benefits, and limitations of the Super Profit Method?

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2. Explain how capital employed is calculated for the purpose of goodwill valuation.

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3. Discuss the steps involved in calculating goodwill using super profit method in detail.

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3.10 SUGGESTED READINGS

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1. T.S. Grewal, Financial Accounting, Sultan Chand & Sons, 2023.
2. S.N. Maheshwari & S.K. Maheshwari, Advanced Accountancy – Volume I, Vikas Publishing House Pvt. Ltd., 2022.
3. P.C. Tulsian & Bharat Tulsian, Financial Accounting, S. Chand Publishing, 2023.
4. K.L. Narang & S.P. Jain, Corporate Accounting, Kalyani Publishers, 2023.

UNIT I **B.Com 4th Semester Course**

No. BCG-401 **Lesson No. 4**

ANNUITY METHOD

STRUCTURE

4.1 INTRODUCTION

The Annuity Method of goodwill valuation is a refined approach that considers the time value of money. Unlike simpler methods that multiply super profits by a fixed number of years, this method treats super profits as an annuity a stream of income expected over several years and discounts them to their present value using an appropriate rate of return.

This approach is particularly useful when future super profits are expected to continue for a definite period and there is a need to reflect their actual worth in today's terms. By using present value factors, the method provides a more realistic valuation, accounting for inflation, risk, and the decreasing value of future earnings.

4.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

By the end of this lesson, learners will be able to:

- Understand the concept and significance of the Annuity Method in goodwill valuation.
- Explain the time value of money and its application in financial decision-making.
- Define super profits and how they are treated as an annuity under this method.
- Learn how to use present value factors to discount future profits.
- Apply the Annuity Method to real-life valuation scenarios using step-by-step numerical illustrations.

Learning Outcomes

After completing this lesson, students will be able to:

- Accurately calculate goodwill using the Annuity Method.

- Distinguish this method from other traditional methods of goodwill valuation.
- Interpret annuity tables and apply present value formulas in accounting problems.
- Justify the use of this method in situations where future earnings are uncertain or time sensitive.
- Solve practical problems involving discounted super profits in goodwill valuation.

4.3 CONCEPT OF TIME VALUE OF MONEY IN ANNUITY METHOD OF GOODWILL

In accounting and finance, the Time Value of Money (TVM) is a crucial principle that acknowledges the changing value of money over time. According to this concept, a rupee received today is more valuable than a rupee received in the future. This is because the money available today can be invested to earn interest or returns, making it worth more over time. The time value of money is influenced by factors such as inflation, risk, and the potential earning capacity of funds.

In the context of goodwill valuation using the Annuity Method, this principle becomes particularly important. Businesses often earn super profits that is, profits exceeding the normal expected return for a specific number of years. While these profits are valuable, they occur in the future and must therefore be discounted to their present value before they can be used to calculate goodwill accurately.

Similar to the previously discussed methods, Annuity Method assumes that super profits will be earned over a fixed period, such as 3 or 5 years but rather than simply multiplying the annual super profit by the number of years (as in the Super Profit Method), the Annuity Method treats the future super profits as an annuity (a fixed stream of income over time). These profits are then discounted using the present value of annuity factors, which are based on a chosen discount rate (usually the normal rate of return expected in the industry).

This process gives us the present value of those future profits, representing what they are worth today. The final amount, after discounting, is considered the value of goodwill.

This approach is especially suitable in cases where future profits are expected to decline gradually, or where the business environment involves uncertainty. By applying the time value of money, the Annuity Method provides a more accurate and fair valuation of goodwill, ensuring that future earnings are not overestimated.

Concept of Present Value

In the Annuity Method of goodwill valuation, the concept of Present Value plays a vital role. As discussed earlier, future super profits are considered valuable, but their actual worth depends on when they are received. The present value represents the current equivalent of a future amount, considering the rate of return or discount rate over time.

For example, ₹1 received today is more valuable than ₹1 received after a year because today's money can be invested and earn interest. If ₹1 is expected after one year, and the interest rate is 10%, its present value today is only ₹0.91. This principle is applied over multiple years when calculating the present value of a series of expected future profits.

Concept of Annuity Value

An annuity is a series of equal payments or receipts made at regular intervals over a period. In goodwill valuation, super profits expected to be earned every year for a certain number of years are treated as an annuity. These profits are not one-time earnings but are expected to continue annually, for example, ₹30,000 every year for 4 years.

The Annuity Method assumes that these future annual super profits form a fixed stream of income, similar to an annuity. Since these profits will be earned in the future, their total value must be converted to present value by using present value annuity factors, which are based on a chosen rate of return (usually the normal industry rate).

Present Value Factor (PVF)

Present Value Factor (PVF) helps in calculating the present worth of a single future sum. It is based on the idea that money has time value. It is a value which when multiplied with a future amount, will give the present value of that amount.

For instance, If you expect to receive ₹1 after 1 year and the interest rate is 10%, it means that you would only need to invest ₹0.91 today to get ₹1 after a year. That ₹0.91 is the present value of ₹1 received after one year.

A. CHECK YOUR PROGRESS
Match the Following

Column A (Term)	**Column B (Description)**
1. Present Value	A. Value of money at a future date
2. Future Value	B. Process of finding present worth of money
3. Discounting	C. Value of money today
4. Compounding	D. Process of calculating future value

Answers: 1 → C, 2 → A, 3 → B, 4 → D

Formula:

PVF = 1 / $(1 + r)^n$

Where:

- r is the rate of interest or return (also called the discount rate)
- n is the number of years into the future

Present Value of Annuity Factor (PVAF)

Present Value of Annuity Factor (PVAF) is used when you are dealing with a series of equal future payments, like ₹20,000 of super profit every year for 5 years. Instead of discounting each year's profit one by one, PVAF lets you multiply the annual profit by a single factor.

For example, the PVAF for ₹1 annuity for 5 years at 10% is approximately 3.7908. This means that ₹1 received every year for 5 years is equivalent to ₹3.7908 today.

Formula:

$$PVAF = \frac{1 - (1 + r)^{-n}}{r}$$

Where:

- r is the discount rate

- n is the number of years

4.4 STEPS TO CALCULATE GOODWILL THROUGH ANNUITY METHOD

The Annuity Method is a refined version of the Super Profits Method. While the Super Profits Method multiplies the super profit by the number of years' purchase, the Annuity Method further considers the time value of money by discounting future super profits. This is done using the Present Value of Annuity Factor (PVAF).

Let us now understand the step-by-step process of valuing goodwill under this method.

1. **Calculate Average Future Maintainable Profits (FMP) -** Begin by determining the average profit that is expected to be maintained in the future which is done by taking the average of adjusted profits over a suitable number of past years.
2. **Calculate Normal Profits** - This is the return a business is expected to earn on its capital employed, assuming a normal level of efficiency.
3. **Calculate Super Profits** - This represents the excess earnings of the firm over and above what is expected from a similar investment.
4. **Determine the Present Value of Annuity Factor (PVAF)** - Super profits are assumed to continue for a fixed number of years (say 3 to 5 years), but their present value is what contributes to goodwill.
   To calculate this, use the formula:

$$PVAF = \frac{1-(1+r)^{-n}}{r}$$

Where:

- r = discount rate or interest rate (usually equal to the normal rate of return)
- n = number of years of purchase (i.e., duration for which super profits are expected)

Alternatively, you can use **PVAF Values** given in the question**.**

5. **Calculate Goodwill Using Annuity Formula -** This gives the present value of future super profits, which is taken as the value of goodwill under this method. The formula for this is:

GOODWILL = SUPER PROFIT × PVAF

6. **Use of Sliding Scale (Advanced)** - If the super profits are abnormally high, then a sliding scale approach (advocated by A.E. Cutforth) may be used. Under this method:
   - Super profits are broken into slabs.
   - Each slab is multiplied by a different (lowering) number of years' purchase.
   - This reflects the idea that very high profits may not be sustainable over the long run.

However, this variation is used rarely and only in exceptional circumstances.

Merits of the Annuity Method

- Unlike the Super Profit Method, the Annuity Method discounts future super profits to their present value, making the valuation more realistic and financially accurate.
- This method works well when a business is expected to earn consistent super profits over a fixed period, making it suitable for stable and mature businesses.
- The use of present value annuity factors (PVAF) introduces a more scientific approach to valuation by taking future cash flows and discount rates into account.
- Since future benefits are valued in today's terms, it gives a more accurate picture of goodwill's worth to a potential buyer or investor.
- This method prompts businesses to analyse future profit sustainability and financial assumptions more carefully.

Demerits of the Annuity Method

- It requires knowledge of present value calculations and the use of PVAF tables, which can be difficult for individuals without a financial background.
- The accuracy of goodwill depends on the reliability of future super profit estimates and the correct selection of discount rates.
- Businesses with fluctuating or uncertain profits may not be able to use this method effectively, as it assumes a steady stream of super profits.
- The process involves multiple steps and may require detailed financial projections, making it more time-consuming than simpler methods like average profit or super profit methods.
- If the discount rate is set too high, the present value of super profits and hence goodwill may be understated.

B. CHECK YOUR PROGRESS

Fill in the Blanks

1. The annuity method of goodwill valuation considers the _________ of money over time.
   Answer: time value
2. Super profits are discounted using a _________ rate to find their present value.
   Answer: discount
3. The annuity method assumes that super profits will continue for a _________ number of years.
   Answer: fixed
4. In the annuity method, goodwill is the _________ of the present values of expected super profits.
   Answer: sum
5. The factor used to discount super profits in the annuity method is called the _________ factor.
   Answer: annuity

4.5 PRACTICAL QUESTIONS

Illustration 4 (Calculation of Goodwill through Annuity Method)

Calculate the value of goodwill of Alpha Traders by the Annuity Method.

Year	Net Profit / Loss
2020	1,20,000
2021	(10,000)
2022	1,45,000

Additional information:

1. The average capital employed is ₹6,50,000.
2. A normal return of 9 % is considered reasonable.
3. Profit of 2022 includes an abnormal insurance claim of ₹15,000.

4. A reasonable manager’s salary is ₹18,000 per annum (not yet charged).
5. Super profits are expected to continue for the next four years only.
6. Present value of an annuity of ₹1 for 4 years at 9 % = 3.531.

Solution:

Calculation of Average Profit

		Amount (₹)	Amount (₹)
Profit for 2020		1,20,000	
Profit for 2022	1,45,000		
Less: abnormal insurance claim	(15,000)		
Adjusted Profit for 2022		1,30,000	
Less: Loss for 2021		(10,000)	
Total profits			2,40,000
Average profit (Total Profits / No. of years)			80,000
Less: Remuneration			(18,000)
Adjusted profit			62,000

Calculation of Normal Profit

Normal Profit = (Average Capital Employed × Normal Rate of Return) / 100

= (₹6,50,000 × 9) / 100 = 58,500

Calculation of Super Profit

Super Profit = Average Profit (adjusted) - Normal Profit

= ₹62,000 – ₹58,500 = ₹3,500

Calculation of Goodwill

Goodwill = Super Profit × PVAF

= ₹3,500 × 3.531 = **₹12,358.50**

C. CHECK YOUR PROGRESS

True or False

1. The annuity method values goodwill based on the assumption that super profits will continue indefinitely.

Answer: False

2. The annuity method and the super profits method always give the same goodwill value.

Answer: False

3. The annuity method incorporates the time value of money while valuing goodwill.

Answer: True

4. Discounting future super profits to their present value is a key step in the annuity method.

Answer: True

5. Under the annuity method, goodwill is calculated by multiplying average profit with years of purchase.

Answer: False

Illustration 5 (Calculation of Goodwill through Annuity Method)

From the following particulars, determine goodwill of Beta Manufacturing Co. by the Annuity Method.

Year	Net Profit
2021	2,05,000
2022	1,95,000
2023	2,10,000

Extra details:

1. Average capital employed in the business is ₹8,00,000.
2. Industry-normal rate of return is 12 %.
3. Profit of 2022 is after charging a one-time litigation expense of ₹25,000.
4. Profit of 2021 is before providing the proprietor’s fair remuneration of ₹30,000.
5. Super profits are likely to remain stable for five years.
6. PVAF of ₹1 for 5 years at 12 % = 3.6048.

Solution:

Calculation of Average Profit

		Amount (₹)	Amount (₹)
Profit for 2020	2,05,000		
Less: remuneration	(30,000)		
Adjusted Profit for 2020		1,75,000	
Profit for 2021	1,95,000		
Add: litigation expense	(25,000)		
Adjusted Profit for 2022		2,20,000	
Profit for 2023		2,10,000	
Total profits			6,05,000
Average profit (Total Profits / No. of years)			2,01,667

Calculation of Normal Profit

Normal Profit = (Average Capital Employed × Normal Rate of Return) / 100

= (₹8,00,000 × 12) / 100 = ₹96,000

Calculation of Super Profit

Super Profit = Average Profit (adjusted) - Normal Profit

= ₹2,01,667 – ₹96,000 = ₹1,05,667

Calculation of Goodwill

Goodwill = Super Profit × PVAF

= ₹1,05,667 × 3.6048 = ₹**3,80,907.20**

4.6 LET US SUM UP

The Annuity Method is a refined and advanced extension of the Super Profits Method, offering a more realistic valuation of goodwill by considering the time value of money. While the Super Profits Method assumes that the value of future super profits remains constant across years, the Annuity Method recognizes that a rupee earned today is more valuable than a rupee earned in the future. Hence, it discounts each year's expected super profit to its present value using Present Value Annuity Factors (PVAFs).

This method is particularly useful when the business is expected to earn super profits for a definite number of years, and the investor wants to understand their worth in today's terms. By multiplying the annual super profits with the PVAF corresponding to the rate of return and time period, the method helps in arriving at a more accurate and financially sound valuation.

In essence, the Annuity Method builds upon the Super Profit Method by incorporating a discounting mechanism, aligning the goodwill valuation process with modern financial principles and providing a more reliable benchmark for decision-making in acquisitions, mergers, or partnership changes.

4.7 KEYWORDS

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1. **Annuity -** A fixed amount of income or profit received or expected to be received every year for a specified number of years. In goodwill valuation, it refers to the super profits expected annually.
2. **Time Value of Money** - A financial concept that recognizes that money received today is more valuable than the same amount received in the future due to its potential earning capacity.
3. **Discount Rate** - The rate of return used to discount future super profits to their present value. It usually reflects the normal rate of return or market interest rate.
4. **Present Value (PV)** - The current worth of future cash flows (super profits) discounted at a specified rate of return. It reflects the idea that money has a time value.
5. **Present Value Annuity Factor (PVAF)** - A multiplier used to calculate the present value of an annuity (a series of equal annual super profits). It is based on the number of years and the rate of return.

4.8 SELF ASSESSMENT QUESTIONS

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1. What do you understand by the term "annuity"?

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2. Why is the time value of money considered in the annuity method of goodwill valuation?

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3. What kind of business situations justify the use of the annuity method?

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4.9 LESSON END EXERCISE

1. Explain the annuity method of goodwill valuation. How does it improve upon the super profit method?

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2. Discuss the role of the time value of money in the annuity method. Why is it important to discount future super profits while calculating goodwill?

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3. Differentiate between the Super Profits Method and the Annuity Method of goodwill valuation. Under what circumstances would you recommend using the annuity method?

4.10 SUGGESTED READINGS

1. T.S. Grewal, Financial Accounting, Sultan Chand & Sons, 2023.
2. S.N. Maheshwari & S.K. Maheshwari, Advanced Accountancy – Volume I, Vikas Publishing House Pvt. Ltd., 2022.
3. P.C. Tulsian & Bharat Tulsian, Financial Accounting, S. Chand Publishing, 2023.
4. K.L. Narang & S.P. Jain, Corporate Accounting, Kalyani Publishers, 2023.

UNIT I **B.Com 4th Semester Course**

No. BCG-401 **Lesson No. 5**

CAPITALIZATION METHOD

STRUCTURE

5.10 Suggested Readings

5.1 INTRODUCTION

The Capitalization Method of goodwill valuation is grounded in the principle that the value of a business is intrinsically linked to its ability to generate sustainable profits. This approach aims to determine the amount of capital that would be required to earn those profits at a normal rate of return. The excess of this hypothetical capital over the actual capital employed in the business represents the value of goodwill.

Two main approaches are used under this method: the Capitalization of Super Profits Method, which values goodwill based on excess profits earned beyond the expected norm, and the Capitalization of Future Maintainable Profits Method, which treats average adjusted profits as a basis to estimate the firm's total value. These methods are particularly useful in scenarios where consistent profits are expected and a long-term view of business performance is desired.

Understanding these methods equips learners with the ability to assess the intangible worth of a firm beyond its tangible assets, offering deeper insights into business valuation practices.

5.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

By the end of this chapter, the learner will be able to:

1. Understand the concept and rationale behind the capitalization method of goodwill valuation.
2. Differentiate between capitalization of super profits and capitalization of future maintainable profits.
3. Identify the components required to compute capital employed and average profits.
4. Apply the correct formulae to calculate goodwill using both capitalization approaches.
5. Analyze which capitalization method is most appropriate based on the nature of business earnings and available data.

Learning Outcomes

After completing this chapter, learners will be able to:

1. Define and explain the capitalization method and its importance in valuing goodwill.
2. Accurately compute capitalized value, normal profits, and super profits.
3. Determine goodwill using both the Capitalization of Super Profit and Capitalization of Average Profit methods.
4. Interpret real-life financial data and apply capitalization techniques to assess intangible business value.
5. Demonstrate clarity in selecting the most appropriate method of valuation in various business restructuring scenarios such as mergers, acquisitions, and partnerships.

5.3 CONCEPT OF CAPITALIZATION

The Capitalization Method of goodwill valuation is based on a simple yet powerful idea: if a business consistently earns profits, how much total capital would be required to generate those same profits at a normal rate of return (i.e., the average return expected in the industry)? This method helps us understand how much an investor would need to invest elsewhere to earn similar profits. If the business is earning more than what is typically expected from the same amount of capital, the difference represents its goodwill.

The Capitalization Method is used to calculate goodwill by comparing the capital required to earn the business's profits with the actual capital already invested. This method helps us find out how much extra value the business has because of its ability to earn more profits than usual.

Merits of the Capitalization Method

- It is based on a logical financial principle: capitalizing future earnings at a normal rate of return to assess business value.
- It focuses on the maintainable profit-earning ability of the business, which is a key determinant of goodwill.
- Uses a formula-driven, structured approach, which minimizes subjectivity and personal bias.

- Especially helpful in valuing firms during mergers, acquisitions, and buyouts, where complete business value needs to be estimated.
- By comparing expected returns to actual capital employed, it gives a realistic picture of how valuable the firm is beyond its tangible assets.

Demerits of the Capitalization Method

- Estimating accurate future profits is challenging and may lead to errors if based on unreliable past data or assumptions.
- Choosing an appropriate normal rate of return is subjective and may differ across industries or evaluators, affecting consistency.
- If a firm's profits are erratic or irregular, this method may give misleading results since it assumes stable future earnings.
- Calculating actual capital employed requires correct valuation of assets and liabilities, which can be complex and open to interpretation.
- Non-quantifiable elements like brand reputation, customer loyalty, or management quality are not factored directly into the calculation.

5.4 STEPS TO CALCULATE GOODWILL THROUGH CAPITALIZATION METHOD

The Capitalization Method converts future maintainable profits into a capital value and then compares that figure with the actual capital already employed. Any excess is treated as goodwill. There are two variants:

A. Capitalization of Super Profit Method

1. Compute Future Maintainable Profits (FMP)

The first step is to determine the Future Maintainable Profits (FMP), which represents the expected average annual profit that the business can consistently earn in the future. This figure is derived by adjusting the historical profits for any abnormal, non-recurring, or extraordinary items such as one-time losses or gains, misclassified capital expenditures, or errors in accounting. Proper adjustment ensures that only the recurring and operational earnings are considered for goodwill valuation.

2. Calculate Normal Profit

Once FMP is determined, the next step is to calculate the Normal Profit. This is the profit that a similar business in the same industry would earn on the same amount of capital, considering the prevailing normal rate of return.

Normal Profit = (Capital Employed × Normal Rate of Return) / 100

A. CHECK YOUR PROGRESS

True or False

1. Normal Rate of Return is a benchmark used to evaluate a firm's performance.

Answer: True

2. NRR remains constant for all companies regardless of their industry.

Answer: False

3. A company earning exactly at the normal rate of return is considered to have no goodwill.

Answer: True

4. A business earning above the NRR is generating abnormal profits.

Answer: True

5. If actual return is less than NRR, the company is said to have super profits.

Answer: False

3. Find Super Profit

Super Profit is the excess of the Future Maintainable Profit over the Normal Profit. It is calculated as:

Super Profit = FMP − Normal Profit

This figure indicates how much more the firm earns compared to an average business. A higher super profit reflects the business's efficiency, brand value, market position, or other advantages, justifying the recognition of goodwill.

4. Capitalize Super Profit

The final step is to capitalize the super profit to estimate goodwill. This is done by converting the annual super profit into a lump-sum value using the normal rate of return. The formula used is:

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

The result represents the present capital equivalent of the business's excess earnings, which buyers would be willing to pay as goodwill.

B. Capitalization of Future Maintainable Profits (FMP) Method

1. Compute Future Maintainable Profits (FMP)

The first step is to determine the Future Maintainable Profits (FMP), which represents the expected average annual profit that the business can consistently earn in the future. This figure is derived by adjusting the historical profits for any abnormal, non-recurring, or extraordinary items such as one-time losses or gains, misclassified capital expenditures, or errors in accounting. Proper adjustment ensures that only the recurring and operational earnings are considered for goodwill valuation.

B. CHECK YOUR PROGRESS

Rearrange the Steps

Rearrange the following steps which are given in random order:

A. Compare the capitalized value with the actual capital employed to find goodwill.

B. Identify the average maintainable profit of the business.

C. Determine the normal rate of return (NRR) applicable to the business.

D. Calculate the capitalized value using the formula:

Capitalized Value = Average Profit × (100 / NRR)

E. Compute the actual capital employed in the business.

Answer: B → C → D → E → A

2. Capitalize the Future Maintainable Profits

The FMP is then capitalized at the normal rate of return to estimate the total value of the business as if its profits were the return on capital. The formula used is:

$$\text{Capitalized Value of Business} = \frac{\text{FMP} \times 100}{\text{Normal Rate of Return}}$$

This value tells us how much capital would be needed to earn the FMP at the industry norm, essentially estimating the business's total worth based on its earning capacity.

3. Compute Actual Capital Employed (Net Assets)

Next, we determine the actual capital employed in the business. This includes total tangible assets (excluding fictitious assets, goodwill, and non-operational assets) minus current and long-term liabilities. The value can be taken at book value or replacement cost, but the method should be consistent. This figure represents the actual funds currently invested in the business.

4. Calculate Goodwill

Finally, goodwill is computed by subtracting the actual capital employed from the capitalized value of the business. The formula used is:

Goodwill = Capitalized Value of FMP − Net Capital Employed

If the capitalized value is higher than the net assets, the difference is attributed to goodwill i.e., the value of the business's reputation, brand, customer loyalty, or unique advantages that contribute to excess earnings.

C. CHECK YOUR PROGRESS

Fill in the Blanks

1. Goodwill is the excess of Capitalized Value over actual ______________.

   Answer: Capital Employed

2. The Normal Rate of Return (NRR) represents the expected return in the ___________.

   Answer: industry

3. Goodwill = Capitalized Value – _____________.

   Answer: Capital Employed

4. Capital Employed refers to the total of all assets minus ___________ liabilities.

   Answer: external

5. A higher-than-normal profit indicates the presence of ____________.

   Answer: goodwill

5.5 PRACTICAL QUESTIONS

Illustration 6 (Capitalization of Super Profit)

Balance Sheet of Cosmos Garments Ltd. as at 30 June 2025

Liabilities	**₹**	**Assets**	**₹**
30,000 Equity Shares of ₹50 each	15,00,000	Goodwill (book)	2,10,000
General Reserve	3,20,000	Freehold Factory	5,75,000
Profit & Loss A/c	3,60,000	Plant & Machinery (book)	9,40,000
12% Bank Loan (long-term)	3,50,000	Inventory	12,80,000
Trade Creditors	4,10,000	Trade Debtors (net)	8,45,000
Provision for Tax	3,00,000	Bank Balance	1,30,000
	32,40,000		**32,40,000**

Additional information

- Profits before tax: 2022 – ₹9,00,000; 2023 – ₹8,60,000; 2024 – ₹9,70,000; 2025 – ₹10,20,000.
- Dividends declared: 2022 & 2023 at 12 %, 2024 & 2025 at 16 %.
- Tax rate: 50 %.
- Plant & Machinery is now valued at ₹10,80,000.
- Average Capital Employed may be taken as the closing capital employed (after revaluation).
- Normal industry return is the average dividend rate declared by the company.
- Determine goodwill using the Capitalization of Super Profit Method.

Solution:

(A) Capital Employed:

Total Tangible Assets (after plant revaluation):

Land & Building	₹4,50,000
Revalued Plant	₹8,00,000
Stock	₹10,20,000
Book Debts	₹7,30,000
Cash	₹60,000
Total Assets	**₹30,60,000**

Less: Total Liabilities

Loans	₹4,00,000
Bank Loan	₹2,00,000
Creditors	₹3,40,000
Provision for Tax	₹2,60,000
Total Liabilities	**₹18,60,000**

(B) Average Profit (After Tax):

Given profits: ₹4,80,000, ₹5,10,000, ₹5,70,000, ₹6,30,000

Average Profit = ₹5,47,500

(C) Normal Profit:

= 12% of Capital Employed = ₹18,60,000 × 12%

= ₹2,23,200

(D) Super Profit:

= Average Profit − Normal Profit

= ₹5,47,500 − ₹2,23,200 = ₹3,24,300

(E) Goodwill (Capitalized Value of Super Profit):

Goodwill = Super Profit ÷ Normal Rate of Return

= ₹3,24,300 ÷ 0.12 = **₹27,02,500**

Illustration 7 (Capitalization of Future Maintainable Profits)

Balance Sheet of Mr. Kumar as at 31 December 2025.

Liabilities	**₹**	**Assets**	**₹**
Capital	3,00,000	Land and Buildings	2,40,000
Trade Creditors	90,000	Plant and Machinery	1,50,000
Bills Payable	30,000	Furniture & Fixtures	3,000
		Closing Stock	18,000
		Cash at Bank	9,000
Total	**4,20,000**	**Total**	**4,20,000**

Additional Information

1. The business earned profits of ₹60,000 in 2021, ₹62,000 in 2022, ₹65,000 in 2023, ₹74,000 in 2024, and ₹78,000 in 2025.
2. Tax rate: 40 % is already accounted for in the above profits.
3. Asset revaluation (current values):
4. Land and Buildings: ₹2,60,000
5. Plant and Machinery: ₹1,68,000
6. Furniture & Fixtures: ₹2,000
7. Manager's salary of ₹12,000 p.a. has not been charged, even though Mr Kumar devotes full time to the business.
8. Normal rate of return expected in this line of business is 10 %.

Solution:

(A) Capital Employed (at current values)

	₹	**₹**

Asset (revalued)		
Land & Buildings	2,60,000	
Plant & Machinery	1,68,000	
Furniture & Fixtures	2,000	
Stock	18,000	
Cash	9,000	
A. Total Tangible Assets		**4,57,000**
Less: External Liabilities		
Creditors	(90,000)	
Bills Payable	(30,000)	
B. Total External Liabilities		**(1,20,000)**
Capital Employed (A-B)		**3,37,000**

(B) Future Maintainable Profits (FMP)

i. Average Profit = (60,000 + 62,000 + 65,000 + 74,000 + 78,000) / 5 = ₹67,800

ii. Less: Manager's salary not yet charged = (₹12,000)

FMP = 67,800 – 12,000 = ₹55,800

(C) Capitalized Value of FMP

Capitalized Value (FMP) = (FMP×100) / Normal Rate = (55,800 × 100) / 10 = ₹5,58,000

(D) Goodwill (Capitalization Method)

Goodwill = Capitalized Value − Actual Capital Employed

= 5,58,000 − 3,37,000 = **₹2,21,000**

5.6 LET US SUM UP

The Capitalization Method of goodwill valuation provides a systematic and rational approach to estimating the value of a business's goodwill by linking it directly to the earning potential and the capital required to generate those earnings. This method assumes that goodwill represents the excess earning capacity of the business compared to what is normally expected from the capital employed at a given rate of return.

It offers two variants: the Capitalization of Future Maintainable Profits and the Capitalization of Super Profits. While the former focuses on valuing the entire business and then deducting the actual capital employed to find goodwill, the latter capitalizes only the excess (super) profits to determine goodwill directly. Both approaches rest on a firm understanding of normal returns and adjusted profits, making them more suitable for stable and established businesses. This method complements other techniques like the Super Profit Method and Annuity Method by offering a broader, more long-term view of goodwill valuation.

5.7 KEYWORDS

1. **Capitalization Method** - This method values goodwill by estimating how much capital would be needed to earn the business's future profits at a normal rate of return. The goodwill is found by comparing this capitalized value with the actual capital the business has employed.
2. **Capitalized Value of Profits -** This is the total amount of capital that would be needed to earn the expected profits at the normal rate. It gives an idea of the worth of the business based on its earning capacity.
3. Capital Employed - In the Capitalization Method, capital employed refers to the net investment in the business, usually calculated as the value of all tangible assets (after revaluation) minus any external liabilities. It represents how much the owner has effectively invested in the business.
4. **External Liabilities -** These include items like creditors, bank loans, and outstanding bills that the business must repay. They are subtracted from the total asset value to find the net capital employed.
5. **Revalued Assets** - In this method, assets are often updated to reflect their current market value before calculating capital employed. This ensures that goodwill is based on an accurate estimate of what the business is worth.

5.8 SELF ASSESSMENT QUESTIONS

1. What is meant by 'Capital Employed' in the Capitalization Method?

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2. Explain the role of the normal rate of return in the Capitalization Method.

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3. What does the term 'capitalized value of maintainable profits' mean?

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5.9 LESSON END EXERCISE

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1. Differentiate between Capitalization of Super Profit Method and Capitalization of Average Profit Method.

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2. What are the steps involved in calculating goodwill using the Capitalization of Average Profits Method?

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3. “Capitalization Method is a refinement of the Super Profit Method.” Do you agree? Justify your answer with reasoning

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5.10 SUGGESTED READINGS

1. T.S. Grewal, Financial Accounting, Sultan Chand & Sons, 2023.
2. S.N. Maheshwari & S.K. Maheshwari, Advanced Accountancy – Volume I, Vikas Publishing House Pvt. Ltd., 2022.
3. P.C. Tulsian & Bharat Tulsian, Financial Accounting, S. Chand Publishing, 2023.
4. K.L. Narang & S.P. Jain, Corporate Accounting, Kalyani Publishers, 2023.

UNIT II **B.Com 4th Semester Course**
No. BCG-401 **Lesson No. 6**

INTRODUCTION TO SHARES

STRUCTURE

6.9 Lesson End Exercise

6.10 Suggested Readings

6.1 INTRODUCTION

In this section, you will explore the foundational concepts that form the backbone of corporate financing, shares and share capital. Every business, especially one structured as a company, requires funds to grow and operate, and shares are one of the most common ways to raise this capital.

You will begin by understanding the concept of shares, which represent a unit of ownership in a company and give shareholders certain rights and responsibilities. Following this, you will delve into the structure of share capital, which explains how companies divide and categorize the funds they raise through shares.

Finally, you will study the types of shares typically issued by companies, such as equity shares and preference shares, each having unique characteristics in terms of voting rights, dividend entitlement, and risk. These concepts are critical to understanding how businesses are financed and how investors engage with the corporate world.

By the end of this lesson, you will be able to distinguish between different forms of share capital, recognize the roles and rights of various types of shareholders, and understand how shares contribute to the structure and functioning of a company.

6.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

By the end of this lesson, you will be able to:

- Understand the fundamental concept and meaning of a share in a company.
- Explain the significance of share capital and its role in financing a business.
- Identify and describe the key components of share capital structure, including authorized, issued, subscribed, and paid-up capital.

- Distinguish between the different types of shares, particularly equity shares and preference shares.
- Recognize the features, rights, and responsibilities associated with each type of share.

6.3 CONCEPT OF SHARES

The capital of a company is divided into indivisible units of a fixed denomination, known as shares. A share represents a unit of ownership in the capital of a company. Legally, the term "share" also includes stock, except where a clear distinction is made or implied between the two. In essence, a share signifies a shareholder's interest in a specified portion of the company's capital. It reflects a proprietary relationship between the shareholder and the company. While a shareholder is considered a proportionate owner of the company, they do not have ownership rights over the company's individual assets, as those are held by the company in its own name, being 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.

A person who holds ownership of shares in a company is known as a “shareholder”. The income or return that the shareholder receives on their investment in the form of profits distributed by the company is referred to as a “dividend”.

Example: Suppose a company's total capital is ₹5,00,000, which is divided into 50,000 shares of ₹10 each. In this case, each unit of ₹10 represents one share. Therefore, the company has 50,000 shares, each valued at ₹10, making up the total share capital of ₹5,00,000.

Features of Equity Shares

1. Equity shareholders are the real owners of the company. They hold a share in the company’s capital and have voting rights in important decisions.
2. Equity shareholders have the right to vote on matters like electing directors and approving major policies of the company.
3. They bear the highest risk in the company. If the business suffers losses, equity shareholders may not get any return.
4. They are paid only after all other obligations, such as payments to creditors and preference shareholders, are settled. But they enjoy all remaining profits in the form of dividends and capital appreciation.

A. CHECK YOUR PROGRESS

True or False

1. Equity shareholders receive a fixed rate of dividend annually.

Answer: False

2.Equity shareholders have voting rights in company decisions.

Answer: True

3. Equity shares are repaid after 10 years.

Answer: False

4. Equity shareholders can freely sell their shares in the stock market.

Answer: True

5. In case of winding up, equity shareholders are paid before preference shareholders.

Answer: False

5. Dividend on equity shares is not fixed. It depends on the company's profits and the decision of the Board of Directors.
6. Equity shares are permanent in nature. They are not repaid during the lifetime of the company, except in case of winding up.
7. Equity shares are generally freely transferable, which means shareholders can sell them in the stock market.
8. The liability of equity shareholders is limited to the unpaid amount on their shares. If shares are fully paid, they are not personally liable for company debts.
9. Equity shares of public companies are traded in stock exchanges, allowing easy buying and selling.
10. In case of winding up, equity shareholders have the right to a share in the remaining assets after all liabilities have been cleared.

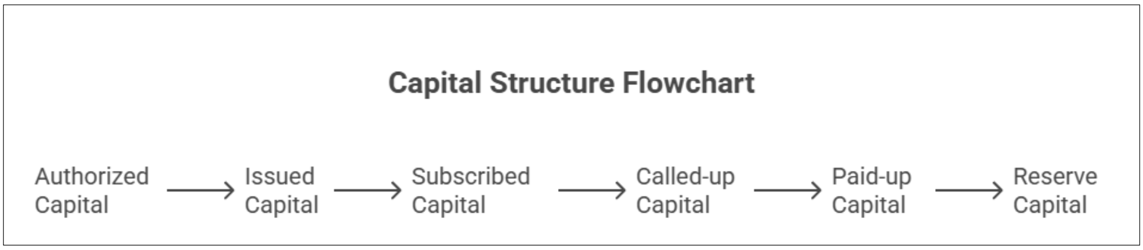
6.4 SHARE CAPITAL STRUCTURE

The share capital structure of a company refers to the way in which a company's total capital is divided into different types of shares issued to investors. This structure plays a crucial role in determining the ownership pattern, voting rights, and distribution of profits.

A company can issue different classes of shares to meet its financial needs and appeal to different types of investors. The two most common types are equity shares and preference shares. Each type comes with its own rights and privileges concerning voting, dividends, and repayment.

Components of Share Capital Structure:

1. Authorized Capital - Also known as nominal or registered capital, this is the maximum amount of capital that a company is allowed to raise through the issue of shares as stated in its Memorandum of Association.
2. Issued Capital - This refers to the portion of authorized capital that the company offers to investors for subscription.
3. Subscribed Capital - This is the part of issued capital that investors have agreed to buy and have subscribed to.



4. Called-up Capital - The amount of money that the company has requested shareholders to pay on the shares they hold. It may be less than the face value if the company decides to collect it in installments.
5. Paid-up Capital - The portion of called-up capital that shareholders have actually paid to the company. This is the real capital available to the company for use in business.
6. Reserve Capital - This is a part of the uncalled capital that a company decides will be called only at the time of winding up, providing a cushion to meet liabilities.

6.5 TYPES OF SHARES

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

(a) Preference

(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.

Types of Preference Shares

Preference shares are a special class of shares that entitle the holder to receive dividends at a fixed rate before any dividend is paid to equity shareholders. Various types of preference shares exist to cater to different investment preferences and business structures. The most important types are explained below:

1. **Cumulative Preference Shares -** Cumulative preference shares carry the right to receive dividends for all years, even if they are unpaid in any particular year due to insufficient profits. The unpaid dividends accumulate and must be paid before any dividends can be

distributed to equity shareholders. For example, if a company has issued 10,000 8% cumulative preference shares of ₹100 each and has not paid dividends for the years 1987 and 1988, it must first pay ₹2,40,000 in accumulated dividends (₹80,000 per year for three years) before making any payment to equity shareholders in 1989.

2. **Non-Cumulative Preference Shares** - Non-cumulative preference shares entitle shareholders to a dividend only out of the profits of the current year. If the company does not earn sufficient profits or decides not to declare a dividend in a given year, the dividend lapses and cannot be claimed in subsequent years. Unless specifically stated otherwise, preference shares are assumed to be cumulative.

B. CHECK YOUR PROGRESS
Match the Following

Column A (Types of Shares)	Column B (Description)
1. Equity Shares	A. Fixed dividend, priority in payment
2. Preference Shares	B. Carry voting rights in company matters
3. Cumulative Preference Shares	C. Unpaid dividends are carried forward
4. Non-Cumulative Preference Shares	D. No claim on past unpaid dividends
5. Redeemable Preference Shares	E. Can be bought back by the company after a time

Answers: 1 → **B**, 2 → **A**, 3 → **C**, 4 → **D**, 5 → **E**

3. **Participating Preference Shares** - These shares entitle holders to a fixed dividend and, in addition, a share in the surplus profits of the company alongside equity shareholders. They may also have the right to participate in surplus assets upon winding up of the company. This right must be clearly stated in the company's Memorandum or Articles of Association.
4. **Non-Participating Preference Shares** - Non-participating preference shares are entitled only to a fixed dividend and do not participate in any surplus profits or residual assets of the company. Unless otherwise stated, preference shares are presumed to be non-participating.

5. **Convertible Preference Shares** - Convertible preference shares come with a feature that allows them to be converted into equity shares within a specified time frame and under agreed conditions. This option adds flexibility and appeal to investors seeking potential growth.
6. **Non-Convertible Preference Shares** - These are preference shares that cannot be converted into equity shares. They remain as preference shares for their entire term and typically appeal to investors looking for fixed income rather than ownership benefits.
7. **Redeemable Preference Shares** - As per Section 80 of the Companies Act, a company may issue redeemable preference shares if authorized by its Articles of Association. These shares are repayable after a specified period or earlier at the option of the company. The terms of redemption must comply with legal provisions regarding repayment from profits or a fresh issue of shares.
8. **Guaranteed Preference Shares** - Guaranteed preference shares carry a fixed dividend, even if the company earns insufficient or no profits. The dividend is backed by a guarantee, usually from a third party or promoter. These shares offer an added level of security to the investor.

Advantages and Disadvantages of Preference Shares

Preference shares are hybrid financial instruments that combine features of both equity and debt. They offer various benefits and limitations for both companies issuing them and investors holding them.

(A) Advantages from the Company's Point of View

1. **No Dilution of Control**: Unlike equity shares, preference shares generally do not carry voting rights. Hence, the company can raise funds without affecting the control of existing equity shareholders.
2. **Fixed Dividend Liability**: The dividend on preference shares is fixed and known in advance, which helps in financial planning and budgeting.
3. **No Obligation to Repay**: Unless they are redeemable, preference shares do not create a repayment liability like loans or debentures.
4. **Improved Capital Structure**: Issuing preference shares helps maintain a balanced capital structure and can make the company appear less risky to lenders.
5. **Flexibility in Dividend Payment**: In the case of non-cumulative preference shares, the company is not under pressure to pay dividends in years of low profit.

(B) Advantages from the Investor’s Point of View

1. **Fixed and Regular Income**: Preference shareholders receive a fixed dividend, making it attractive for conservative investors seeking regular income.
2. **Priority over Equity Shareholders**: In terms of dividend and repayment in case of liquidation, preference shareholders rank ahead of equity shareholders.
3. **Lower Risk**: Preference shares are generally less risky than equity shares due to fixed returns and priority status.
4. **Conversion Option (if convertible)**: Investors may benefit from potential capital appreciation if preference shares are convertible into equity.
5. **Redemption Option**: In the case of redeemable preference shares, investors get back their capital at maturity.

(C) Demerits for Companies

1. **Costly Source of Finance**: The dividend on preference shares is not tax-deductible (unlike interest on debt), making it a relatively expensive financing option.
2. **Permanent Dividend Obligation**: In the case of cumulative preference shares, unpaid dividends accumulate, creating a financial burden in future years.
3. **Investor Resistance**: Preference shares may be less attractive to investors compared to debt instruments due to limited capital gains and fixed returns.
4. **Redemption Pressure**: For redeemable shares, the company must arrange funds to repay the capital at the time of redemption, which may strain cash flows.

(D) Demerits for Investors

1. **No Voting Rights**: Preference shareholders generally have no say in the company’s management or decisions.
2. **Limited Return Potential**: Unlike equity shareholders, preference shareholders do not benefit from increasing profits or company growth.
3. **Risk of Dividend Omission**: In the case of non-cumulative preference shares, if a dividend is skipped in a loss-making year, it is permanently lost.
4. **Marketability**: Preference shares are not as actively traded as equity shares, making them less liquid.

Types of Equity Shares

Equity shares form the primary source of long-term financing for a joint stock company. These shares represent ownership in the company and are issued to the public. Equity shares can be issued in multiple ways, and in some cases, such as a bonus issue, they do not result in actual cash inflow for the company.

Below are the different types of equity share issues commonly used by companies:

1. **New Issue** - A new issue occurs when a company issue shares to the public for the first time or as part of a subsequent offering. This is typically done by issuing a prospectus, which invites investors to subscribe to the company's shares.

- Payment for these shares is often collected in instalments, such as application, allotment, and call money.
- A company can issue shares up to its authorized capital, and such offerings must comply with regulatory requirements of the Registrar of Companies and the Securities and Exchange Board of India (SEBI) through registered merchant bankers.

2. **Bonus Issue** - A bonus issue refers to the distribution of free shares to existing shareholders out of the company's accumulated profits or reserves. It is a way to capitalize profits without distributing cash.

- SEBI guidelines permit a bonus issue only if authorized by the Articles of Association.
- These shares are issued in proportion to the number of equity shares already held.

Advantages of Bonus Issue

- No outflow of cash, so the liquidity position remains unaffected.
- Receive additional shares free of cost, increasing their stake in the company.

Disadvantages of Bonus Issue

- Bonus issue reduces the earnings per share (EPS) and may lower the market price per share due to dilution.

3. **Rights Issue** - A rights issue is a subsequent issue of shares offered to existing shareholders in proportion to their current shareholding, usually at a concessional rate.

- Governed by Section 81 of the Companies Act, 1956 and regulated by SEBI, rights issues require the Articles of Association to authorize such an offer.
- Shareholders have the option to subscribe to the offer or renounce (sell) the rights.

Value of Right = (Market Price of Share – Issue Price) / (Number of Old Shares + 1)

Advantages of Rights Issue:

- Retains control with existing shareholders.

- Lower floatation costs compared to public issues.
- Provides monetary benefits due to discounted pricing.

  Disadvantages of Rights Issue:
- Shareholder wealth may decline if rights are not exercised within the stipulated time.
- Company raises less capital due to concessional pricing.

4. **Sweat Equity Shares** - Sweat equity shares are issued by a company to its employees or directors at a discount or for non-cash consideration, such as services rendered, or intellectual property contributed.

- Governed by Section 79A of the Companies Act, 1956, and SEBI's Issue of Sweat Equity Regulations, 2002.
- Requires approval by special resolution in a general meeting.

  Advantages of Sweat Equity Shares:
- Encourages retention of skilled employees and contributes to intellectual capital.
- No floatation or brokerage costs are incurred.

  Disadvantages of Sweat Equity Shares:
- As these shares are issued at a discount or for no cash, the company may incur a financial cost in terms of dilution of ownership or reduced capital raised.

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 shareholders are the real owners of the company and have voting rights in important company matters, giving them a say in decision-making.

(b) There is no fixed dividend rate. Shareholders can benefit from high profits through increased dividends and appreciation in share value.

(c) Equity shares are usually listed on stock exchanges, making them easily tradable.

(d) Shareholders can receive bonus shares and subscribe to additional shares at discounted rates through rights issues.

(e) In the event of liquidation, equity shareholders have a residual claim on the assets after all liabilities are cleared.

ii. Advantages from the Company's Point of View

(a) Equity capital is permanent in nature and does not require repayment, thus offering financial stability.

(b) Unlike debt, equity dividends are not obligatory and depend on profit availability, helping the company manage cash flow.

(c) A strong equity base improves the company's borrowing capacity and creditworthiness.

(d) Equity capital is raised without pledging any of the company's assets.

(e) It enables companies to raise large sums of money from the public for business expansion and modernization.

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 do not earn a guaranteed return. Dividends are paid only when the company earns sufficient profits.

(b) Being residual claimants, equity shareholders bear the maximum risk in case of business losses or liquidation.

(c) Frequent issues of additional equity shares (e.g., rights or bonus issues) can dilute existing shareholders' ownership and control.

(d) In large companies, small shareholders have negligible influence on company policies.

ii. Disadvantages from the Company's Point of View

(a) Equity capital is often more expensive than debt because dividends (though not mandatory) are expected and not tax-deductible.

(b) Issuing more equity can reduce the control of existing promoters or major shareholders.

(c) Equity investors expect higher returns compared to fixed-income investors, pressurizing management during low-profit periods.

(d) Equity financing requires compliance with strict legal, regulatory, and disclosure norms (SEBI, stock exchange, Companies Act), increasing administrative burden.

Comparison Between Equity Shares and Preference Shares

Basis of Comparison	Equity Shares	Preference Shares
Ownership	Represent ownership in the company and carry voting rights.	Have preferential rights but usually do not carry voting rights.
Dividend	Dividend is variable and depends on company's profits.	Dividend is fixed and paid before equity dividends.

Voting Rights	Equity shareholders have voting rights in general meetings.	Usually no voting rights, except in special situations (e.g., non-payment).
Repayment on Liquidation	Paid after preference shareholders and creditors.	Paid before equity shareholders but after creditors.
Dividend Priority	Get dividend after preference shareholders.	Get dividend before equity shareholders.
Risk Level	High risk, as returns are not guaranteed.	Lower risk, due to fixed dividend preference.
Return Potential	High return potential through capital appreciation and bonus shares.	Limited return due to fixed dividend.
Convertibility	Generally non-convertible into any other type of share.	May be convertible or non-convertible into equity shares.
Issue Objective	Issued to raise long-term permanent capital.	Issued to raise funds without diluting control (as no voting rights).
Capital Structure Role	Forms the base of ownership capital in the company.	Acts as a hybrid between debt and equity in the capital structure.

Key Differences Between Equity Shares and Preference Shares

1. **Ownership and Control:** Equity shareholders are the real owners and have voting rights, while preference shareholders have no control or voting power in most matters.
2. **Dividend Entitlement:** Equity shareholders receive dividends only after preference dividends are paid and the rate is not fixed, whereas preference shareholders receive a fixed dividend first.
3. **Priority in Liquidation:** Preference shareholders are repaid before equity shareholders if the company winds up.
4. **Risk and Return:** Equity shares carry higher risk but offer potential for higher returns, while preference shares provide lower but stable returns.
5. **Convertibility:** Preference shares can be issued as convertible, but equity shares are not convertible.
6. **Participation in Management:** Equity shareholders can vote and influence decisions, while preference shareholders generally cannot.
7. **Type of Investment:** Equity shares are long-term permanent capital, whereas preference shares have fixed financial obligations like debt.
8. **Bonus and Rights Issue:** Equity shareholders are eligible for bonus and rights issues, while preference shareholders are not usually entitled.

C. CHECK YOUR PROGRESS

One Word Answer

1. Who enjoys voting rights in company matters?

   Answer: Equity Shareholders

2. Which type of shareholder has priority in dividend payments?

   Answer: Preference Shareholder

3. Who receives dividends at a fixed rate?

   Answer: Preference Shareholder

4. Which shareholders bear more risk in case of losses?

   Answer: Equity Shareholders

5. Whose return is linked directly to company performance?

   Answer: Equity Shareholders

6.6 LET US SUM UP

The concept of shares forms the foundation of a company's ownership and financial framework. Shares represent a unit of ownership, allowing individuals to invest in and become part-owners of a corporate entity. A company's share capital structure outlines how capital is raised through various classes of shares, each with specific rights and obligations. By exploring different types of shares which are equity and preference. We understand the varying degrees of risk, return, and control they offer to investors. Grasping these concepts not only helps in interpreting a company's financial setup but also supports sound investment and corporate financing decisions.

6.7 KEYWORDS

1. **Share Capital** - Share capital refers to the total amount of capital raised by a company through the issuance of shares to shareholders. It represents the owners' equity in the company and serves as the financial foundation upon which the company operates.
2. **Equity Shares** - Equity shares, also known as ordinary shares, are the primary source of long-term finance for a company. They confer ownership rights and voting power to shareholders. Equity shareholders receive dividends based on the company's profitability and have a residual claim on assets in the event of liquidation.
3. **Preference Shares** - Preference shares are a class of shares that provide shareholders with a fixed rate of dividend and priority over equity shareholders in the distribution of profits and capital repayment during liquidation. They typically do not carry voting rights.
4. **Sweat Equity Shares** - Sweat equity shares are equity shares issued by a company to its directors or employees at a discount or for consideration other than cash. These shares are typically granted in recognition of their contributions in terms of technical expertise, know-how, or value addition to the company.
5. **Bonus Shares** - Bonus shares are additional shares issued by a company to its existing shareholders free of cost. These are issued from the company's accumulated profits or reserves in proportion to their existing shareholding, to capitalize the retained earnings.

6.8 SELF ASSESSMENT QUESTIONS

1. Define the term 'share capital'.

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2. Who is a shareholder, and what return does a shareholder receive?

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3. Mention some key features of equity shares.

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6.9 LESSON END EXERCISE

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1. Define a share. Explain its essential features and the nature of ownership it represents in a company.

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2. Discuss the advantages and disadvantages of preference shares from both the company's and investor's perspectives.

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3. Compare equity shares and preference shares under various points such as return, risk, voting rights, and repayment.

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6.10 LESSON END EXERCISE

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UNIT II **B.Com 4th Semester Course**

No. BCG-401 **Lesson No. 7**

INTRODUCTION TO VALUATION OF SHARES

STRUCTURE

7.1 INTRODUCTION

In the dynamic world of corporate finance, the valuation of shares plays a pivotal role in determining the fair worth of a company's equity. This lesson introduces you to the critical need for share valuation and the foundational principles that guide it. Valuation becomes essential in a variety of scenarios such as mergers and acquisitions, tax assessments, inheritance settlements, buy-back of shares, litigation, and employee stock compensation plans. These circumstances demand a reliable and rational method to assess what a share is truly worth.

Several factors influence the value of a share—such as the company's earnings potential, the value of its underlying assets, prevailing market sentiment, liquidity, and the rights attached to the shares. An accurate understanding of these factors ensures fair decision-making for investors, management, and other stakeholders.

In this lesson, you will also explore a basic comparison of the three primary approaches to share valuation: asset-based, earnings-based, and market-based methods. Understanding when and why each approach is used will equip you with a comprehensive perspective to evaluate equity in various financial and legal contexts.

7.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

By the end of this lesson, learners will be able to:

- Understand the concept and significance of share valuation in corporate finance.
- Identify the key situations where share valuation becomes essential, such as mergers, buy-backs, inheritance, and employee compensation plans.
- Recognize the factors that influence the value of a share, including earnings potential, asset value, market sentiment, and liquidity.
- Differentiate between the three major approaches to share valuation: asset-based, earnings-based, and market-based methods.
- Develop a practical foundation for selecting the appropriate valuation method depending on the financial context.

Learning Outcomes

After completing this lesson, learners will be able to:

- Explain the need for share valuation in various financial and business scenarios.
- Evaluate how different factors affect the valuation of equity shares.
- Apply basic knowledge of asset-based, earnings-based, and market-based valuation approaches.
- Make informed decisions about the appropriate valuation method to use in a given situation.
- Demonstrate a clear understanding of share valuation as a tool for financial analysis and strategic decision-making.

7.3 CONCEPT AND NEED FOR VALUATION OF SHARES

Concept of Share Valuation

In a company, the capital is divided into units known as shares. While each share carries a face value or par value (as determined by the company's memorandum of association), its actual worth can vary greatly in the real world. This market value is influenced by various economic and company-specific factors such as performance, profitability, investor sentiment, and prevailing market conditions.

Share valuation is the process of determining the fair price or intrinsic value of these shares. It reflects what a share is genuinely worth, beyond its printed or nominal value. In the case of listed companies, the market value is publicly visible. However, for unlisted or private companies, where shares are not traded freely on the stock market, share valuation becomes essential for a variety of purposes.

Need for Valuation of Shares

Shares generally carry a face value (also known as par value), which is printed on the share certificate and is assigned by the promoters of the company. This face value is mentioned in the Memorandum of Association. However, apart from face value, a share also acquires a market value, especially if it is traded on a stock exchange. This market value is influenced by investor sentiment, supply and demand, market speculation, economic trends, and other psychological factors.

Since the market price does not always reflect the true intrinsic value of a share, proper valuation becomes essential, particularly in situations where shares are not freely traded, such as in private limited companies. In such cases, determining the fair value of shares is crucial for maintaining transparency and fairness in financial and legal transactions.

The value of shares can be assessed based on a company's earning capacity or net assets. The selection of a valuation method typically depends on the purpose of the valuation.

The valuation of shares becomes imperative in a wide range of situations where an accurate estimation of the worth of a company's equity is essential for decision-making, legal compliance, or financial reporting. The need for valuation arises from both practical business scenarios and regulatory requirements.

1. **Mergers, Amalgamations, and Acquisitions**

When two or more companies combine, or one company takes over another, the shareholders of the merging companies are issued shares in the new or acquiring company. In such cases, valuation of shares is critical to determine the fair exchange ratio, ensuring that shareholders receive equitable value for their holdings. It also safeguards the interests of minority or dissenting shareholders who may not agree with the merger.

2. **Reconstruction and Reorganization**

During internal restructuring, such as capital reduction, buy-back of shares, or corporate reorganization, share valuation helps assess the value of ownership before and after restructuring. This ensures that shareholders and creditors are treated fairly and that no party is unjustly enriched or disadvantaged.

3. **Private Sale or Transfer of Shares**

In private limited companies, where shares are not traded on stock exchanges, there is no visible market price. Hence, when an existing shareholder transfers shares to another, or when new investors come in, valuation is necessary to determine the fair price per share, especially in closely held businesses where each share represents a substantial stake.

4. **Taxation and Legal Assessments**

Various tax laws require share valuation for calculating wealth tax, gift tax, capital gains tax, or during inheritance or estate settlements. The value of shares impacts how much tax is payable. Additionally, in litigation cases involving shareholder disputes, divorce settlements, or bankruptcy proceedings, fair valuation is vital.

5. **Conversion of Securities**

When preference shares, debentures, or other convertible instruments are exchanged for equity shares, a fair share valuation ensures that the conversion ratio reflects the economic value of each instrument and avoids dilution or overvaluation of shareholder equity.

A. CHECK YOUR PROGRESS
One Word Answer

1. What do we call shares that are not traded on a stock exchange?

   Answer: Unlisted

2. What process is used to assign monetary worth to a share?

   Answer: Valuation

3. What document legally states the face value of a share?

   Answer: Memorandum

4. What plan involves issuing shares to employees as compensation?

   Answer: ESOP

5. What value reflects the real worth of a share beyond market speculation?

   Answer: Intrinsic

6. **Loan and Security Purposes**

When companies or individuals seek loans against shares as collateral, financial institutions require a reliable estimate of the share value to determine how much loan can be safely extended and whether the security is adequate.

7. **Government Acquisition and Nationalization**

In scenarios where the government acquires shares under public interest or nationalization schemes, a fair valuation ensures that existing shareholders receive adequate compensation for the shares acquired, based on the company's earnings and asset position.

8. **Employee Stock Option Plans (ESOPs)**

Many companies offer shares to employees under stock option or compensation plans. Valuation is necessary to determine the issue price of shares under these schemes and to comply with accounting and taxation regulations.

9. **Dissolution of Partnership Firms Holding Shares**

When a partnership that owns shares in a company dissolves, the shareholding must be valued to facilitate the equitable distribution of assets among partners.

7.4 PRINCIPLES AND FACTORS INFLUENCING VALUATION OF SHARES

Principles of Share Valuation

Valuing shares accurately requires adherence to certain core principles that ensure the valuation is fair, consistent, and reliable. These principles guide the selection of appropriate valuation methods and help maintain uniformity across different contexts.

1. **Principle of Going Concern -** This principle assumes that the business will continue to operate in the foreseeable future. Therefore, share valuation must consider the potential future earnings and long-term profitability, not just current financial data or liquidation values.

2. **Principle of Fairness and Objectivity -** The valuation process should be neutral and free from bias. It must reflect a fair price that a willing buyer would pay to a willing seller in an open and unrestricted market.

3. **Principle of Relevance -** Only relevant and material financial data should be used in the valuation process. Factors affecting the company's ability to generate profits and grow sustainably must be emphasized.

4. **Principle of Consistency** - Once a particular valuation approach or method is chosen, it should be consistently applied across comparable transactions or over time, unless a change in method is justified and disclosed.

5. **Principle of Transparency** - All assumptions, calculations, and adjustments made during the valuation should be clearly disclosed to ensure that the result is verifiable and understandable to stakeholders.

Key Factors Influencing Valuation of Shares

Valuation is not a one-size-fits-all approach. It is influenced by a combination of company-specific, market-driven, and economic factors. Below are the most significant ones:

1. **Earnings and Profitability** - One of the most crucial factors is the company's current and projected earnings. A consistently profitable business is more valuable, as it indicates the ability to generate returns for shareholders.

2. **Net Asset Value** - The value of the company's assets (after deducting liabilities) forms the basis for asset-based valuation. Companies with a strong asset base tend to have higher intrinsic value.

3. **Dividend Record and Policy** - The company's history of paying dividends and its dividend payout policy affect share value, particularly for investors who seek regular income.

4. **Nature of the Business and Industry Outlook** - Companies in fast-growing, high-demand industries (like tech or green energy) tend to attract higher valuations than those in declining or highly regulated sectors.

B. CHECK YOUR PROGRESS

True or False

1. Share valuation must always assume the company is going to liquidate soon.

Answer: False

2. A transparent valuation process helps stakeholders verify and understand the final value.

Answer: True

3. Market sentiment never affects the value of shares.

Answer: False

4. Valuation should be based on consistent methods unless there is a valid reason to change.

Answer: True

5. Company profitability is irrelevant to its share valuation.

Answer: False

5. **Management Quality and Corporate Governance** - Efficient, ethical, and visionary leadership adds credibility and confidence in future performance, thereby enhancing share value.

6. **Market Sentiment and Liquidity** - The overall investor perception, demand for the company's shares, and ease of buying/selling in the market impact valuation. Illiquid shares (e.g., in private companies) often carry a discount.

7. **Rights Attached to Shares** - Shares may carry different rights such as voting power, dividend priority, or preferential treatment in liquidation. The presence or absence of these rights significantly affects valuation.

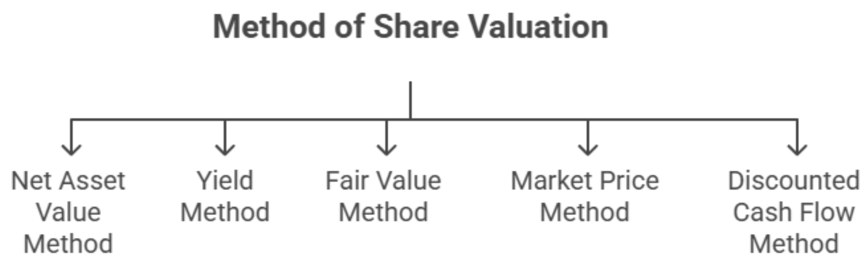
8. **Economic Environment** - Macroeconomic factors such as inflation rates, interest rates, exchange rates, and government policies influence investor behavior and the risk-adjusted value of shares.

9. **Legal and Regulatory Framework** - Provisions under the Companies Act, SEBI guidelines, and other relevant laws may impact the eligibility, valuation methodology, and reporting of share transactions.

7.5 METHODS OF VALUATION OF SHARES

Valuation of shares is essential to determine the fair price of a company's stock, especially in cases like mergers, acquisitions, taxation, litigation, buy-back, or transfer of shares. There are several methods used to value shares, and the choice of method depends on the purpose of valuation, availability of data, and the nature of the company.

1. **Net Asset Value Method / Net Worth Method** - This method calculates the value of shares based on the net assets of a company. It involves determining the total assets of the company and subtracting all external liabilities and preference share capital to arrive at the net assets available for equity shareholders. The net assets are then divided by the number of equity shares to get the value per share. This method is most suitable for asset-rich companies, especially when the company is not actively generating profits or is being liquidated.
2. **Yield Method / Earning Capacity Method** - Under the yield method, the value of shares is derived from the company's ability to earn profits. This method considers the average maintainable profits and compares them with the normal rate of return expected by investors. The share value is calculated by capitalizing the expected earnings. It is a suitable method for profit-making companies with stable and predictable earnings, as it emphasizes the earning potential rather than the asset base.



3. **Fair Value Method** - The fair value method is a hybrid approach that combines the net asset value and yield value to arrive at a balanced valuation. This method assumes that both the assets and the earnings capacity of a company are important in determining its worth. The value per share is taken as the average of values obtained under the Net Asset and Yield methods. It is commonly used in practical scenarios where both tangible assets and profitability play a role in decision-making.
4. **Market Price Method** - This method applies only to listed companies whose shares are traded on stock exchanges. The valuation is based on the average market price over a specified period, which reflects investor sentiment and market trends. It provides a real-time valuation of a share based on demand and supply in the market. However, it may be influenced by external factors and speculation and is not suitable for unlisted companies.

C. CHECK YOUR PROGRESS
Match the Following

Column A	Column B
1. Yield Method	A. Asset-rich or liquidating companies
2. DCF Method	B. Combines asset and earning approaches
3. Fair Value Method	C. Startups or future-focused businesses
4. Net Asset Method	D. Stable profit-making companies
5. Market Price Method	E. Listed companies with stock market data

Answers: 1 → **D**, 2 → **C**, 3 → **B**, 4 → **A**, 5 → **E**

5. **Discounted Cash Flow (DCF) Method** - The DCF method estimates the present value of all expected future cash flows of a company, discounted at an appropriate rate. This forward-looking method is particularly useful for valuing startups or companies with irregular or uncertain earnings. It is based on projected performance and assumes that future cash flows can be reasonably estimated. Though powerful, it requires accurate forecasting and can be highly sensitive to assumptions.

7.6 LET US SUM UP

Valuation of shares is a crucial aspect of corporate finance, especially in scenarios such as mergers, acquisitions, taxation, inheritance, and legal disputes. Understanding the concept and need for share valuation helps stakeholders recognize the importance of determining the true worth of a company's equity, beyond its face or market value. The principles and influencing factors, such as earnings potential, asset base, liquidity, and shareholder rights, ensure that valuation is conducted with fairness, accuracy, and consistency.

Various methods of valuation including Net Asset Value, Yield, Fair Value, Market Price, and Discounted Cash Flow offer different perspectives depending on the purpose and nature of the company. By carefully selecting the appropriate method and applying it in line with the underlying principles, investors, analysts, and decision-makers can make more informed, rational, and transparent financial decisions. A sound grasp of these fundamentals enables equitable outcomes for all parties involved in corporate transactions and strategic planning.

7.7 KEYWORDS

- **Face Value (Par Value)**: Face value, also called par value, refers to the nominal or original value of a share as mentioned in the company's memorandum of association. It is the fixed amount assigned when the share is issued, usually ₹1, ₹10, or ₹100. This value is mostly used for accounting purposes such as calculating the company's share capital or determining dividends (when declared as a percentage of face value). Unlike the market value, the face value does not change over time and has no direct relation to the price of the share in the stock market.
- **Market Value:** Market value represents the current trading price of a share in the open market. It fluctuates based on various factors such as the company's financial performance, industry trends, investor perception, market demand and supply, and broader economic conditions. The market value can be higher or lower than the face value and is a key indicator of how investors perceive the worth of a company at a given time.
- **Book Value:** Book value of a share is calculated by dividing the net assets (total assets minus liabilities) of a company by the number of its equity shares. It represents the value of each share based on the company's financial books, hence the term "book value." It gives shareholders an idea of what their shares would be worth if the company were to liquidate its assets and pay off all liabilities. This method is especially important for evaluating the asset backing of a company's equity.
- **Yield:** Yield refers to the return earned by a shareholder on a share, usually in the form of dividends. It is generally expressed as a percentage of the market price or the face value. Yield helps investors evaluate the efficiency and profitability of their investment. A higher yield indicates better returns relative to the price paid for the share. In valuation, the yield

method uses expected returns to estimate the value of the share, making it especially relevant for income-generating shares.

- **Fair Value:** Fair value is the estimated true value of a share, calculated by averaging the results from the Net Asset Method and the Yield Method. It provides a more balanced and realistic picture of what a share is worth, combining both asset strength and earning potential. This method is commonly used in situations where neither asset value nor yield alone provides a fair estimate, such as in cases of mergers, buybacks, or private share transfers.

7.8 SELF ASSESSMENT QUESTIONS

1. What is the face value of a share? How is it different from the market value?

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2. Define market value of a share. What factors influence it?

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3. Explain the term book value of a share.

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7.9 LESSON END EXERCISE

1. Explain the concept and importance of share valuation. In what situations does the need for share valuation arise?

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2. Discuss the various principles and key factors that influence the valuation of shares. How do earnings, assets, and market conditions affect the value of a share?

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3. Explain the different methods used for the valuation of shares.

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7.10 LESSON END EXERCISE

- T.S. Grewal, Financial Accounting, Sultan Chand & Sons, 2023.
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UNIT II **B.Com 4th Semester Course**

No. BCG-401 **Lesson No. 8**

NET ASSET METHOD

STRUCTURE

8.1 Introduction

8.1 INTRODUCTION

In the realm of share valuation, the Net Asset Method stands as one of the most widely accepted approaches, especially when valuing shares of companies with significant tangible assets and relatively less fluctuating profits. This method focuses on determining the worth of a company based on the value of its net assets essentially what would remain for shareholders if all liabilities were paid off and the assets were realized at their fair value.

This lesson begins with an exploration of the concept and significance of the Net Asset Value Method, laying the foundation for understanding how a company's financial position contributes to the valuation of its equity shares. It then guides you through the step-by-step procedure of calculating NAV per share, including adjustments for revalued assets, contingent liabilities, fictitious assets, and external dues.

Finally, practical problems based on real-world-style balance sheet data will help reinforce the conceptual understanding and provide hands-on experience in applying the method to compute share value accurately.

8.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives:

By the end of this lesson, learners will be able to:

1. Understand the concept and rationale behind the Net Asset Value (NAV) Method of share valuation.
2. Identify the types of companies and situations where the NAV method is most appropriate.
3. Learn and apply the step-by-step procedure to calculate net assets and determine NAV per share.
4. Understand the role of asset revaluation, liabilities, and fictitious assets in share valuation.
5. Develop the ability to analyse and solve practical problems using the NAV method.

Learning Outcomes:

After completing this lesson, learners will be able to:

1. Clearly explain what the Net Asset Value Method is and when it is used.
2. Accurately compute the value of equity shares using the NAV method from a given balance sheet.
3. Make appropriate adjustments to asset values and liabilities during the calculation process.
4. Differentiate NAV from other valuation methods like the Yield Method or Fair Value Method.
5. Confidently handle practical share valuation scenarios in academic or real-world settings.

8.3 CONCEPT OF NET ASSET METHOD

The Net Asset Method, also commonly referred to as the Net Worth Method, Intrinsic Value Method, or Balance Sheet Method, is one of the most straightforward and widely used methods of share valuation. This method determines the value of equity shares based on the company's net assets, that is, the total assets minus the total liabilities. It is particularly useful in valuing shares of private companies, investment firms, or companies undergoing liquidation, amalgamation, or reconstruction where the market value of shares may not be readily available or may not reflect the true financial strength of the company.

The NA method is based on the premise that the real value of a company lies in the net value of its assets. If a company were to sell off all its assets and pay off all its liabilities, the remaining amount would belong to the equity shareholders. Therefore, by calculating the net asset value and dividing it by the number of equity shares, we arrive at a fair estimate of what each share is worth. This method gives more weight to the company's financial position as recorded in its books rather than its income-generating potential.

While applying the NA method, it is important to revalue certain assets to reflect their current market worth, especially if the books carry outdated or historical values. Fixed assets, investments, and inventories may need to be adjusted. Fictitious assets such as preliminary expenses, accumulated losses, or goodwill (if not valued independently) are excluded from the calculation. On the liability side, all outside liabilities such as creditors, loans, and provisions are deducted, while equity capital, reserves, and surpluses are considered part of shareholders' funds.

This method is ideal for firms with substantial tangible assets or those that do not have a stable earnings track record. It is commonly used during mergers, acquisitions, internal share transfers, liquidation proceedings, or disputes among stakeholders. For companies with large real estate holdings or investments (such as real estate or investment firms), the NAV method provides a more accurate reflection of value than earnings-based methods.

Two Assumptions in Net Assets Method

The valuation under this method can be approached under two assumptions:

(i) If the Company Is Assumed to Be Liquidated:

In this case, the shares are valued assuming that the company is winding up. All recorded and unrecorded assets, including goodwill, are considered at their realisable (market) value. From this, all liabilities (both recorded and unrecorded) are deducted. The net amount thus obtained is the total amount available for distribution to shareholders.

The value per share is calculated as:
Intrinsic value per share = Net Assets Available for Shareholders / Number of Shares

Treatment of Preference Shares:

If preference shares have priority over equity shares regarding return of capital, then their capital amount is deducted from net assets before calculating the value of equity shares.

If preference shares are on par with equity shares in terms of capital repayment (e.g., participating preference shares), then the net assets are divided among all shares proportionately.

(ii) If the Company Is Assumed to Be a Going Concern:

Here, the business is expected to continue its operations. All assets are revalued at their current market or replacement cost (not realisable value). This includes non-trading assets like outside investments. Fictitious assets such as preliminary expenses are excluded.

Treatment of Depreciation and Provisions:

- Full provision for depreciation, bad debts, and losses is made before valuation.
- Fictitious assets (like deferred revenue expenditure) are excluded from total assets.

Treatment of Goodwill:

There are two approaches:

- Ignore goodwill if the question is silent about it.
- Include goodwill if specifically mentioned, and value it is using a standard method (Average Profit, Super Profit, Annuity, etc.).

Formula for Equity Share Valuation:

Value per equity share = (Net Assets available to equity shareholders) / (Number of equity shares)

Where:

Net Assets = Total adjusted assets – Total external liabilities – Preference share capital (if it has capital repayment priority).

A. CHECK YOUR PROGRESS

True or False

1. Fictitious assets like preliminary expenses are excluded in this method.

Answer: True

2. In a going concern, assets are revalued at replacement cost.

Answer: True

3. Market sentiment never affects the value of shares.This method requires revaluation of liabilities only.

Answer: False

4. Net Asset Method is also known as the Balance Sheet Method.

Answer: True

5. The value of equity shares depends on total net assets and number of equity shares.

Answer: True

Merits of Net Asset Method

- It is simple and objective, based on actual figures from the balance sheet.
- Useful in cases of liquidation, mergers, or takeovers where asset backing is crucial.
- Provides a realistic estimate of the minimum value of a share, especially for asset-rich companies.
- Does not depend on future earnings or market speculation, making it more stable and reliable.
- Ideal for private limited companies and companies with irregular profits.

Demerits of Net Asset Method

- Ignores the company's earning capacity, making it less suitable for profitable businesses.
- Not suitable for service-oriented or tech companies with minimal tangible assets.
- Requires subjective revaluation of assets and liabilities, which may lead to inconsistency.
- The treatment of goodwill and intangible assets can vary, affecting comparability.
- May result in undervaluation if the company has strong prospects but fewer physical assets.

8.4 STEPS OF NET ASSET METHOD

Following are the steps involved in computing the value of shares using net asset value method:

Step 1: Revaluation of Assets and Liabilities
The first step in the Net Asset Value (NAV) Method is to revalue all assets and liabilities. The values shown in the balance sheet may not reflect current market realities, so assets should be reassessed either at their fair market value (if the company is a going concern) or their realisable value (in case of liquidation). Similarly, liabilities must also be adjusted for accuracy. Any fictitious or intangible assets like preliminary expenses or deferred revenue expenditures must be excluded from the valuation.

Step 2: Adjust for Provisions and Non-Productive Items
After revaluation, full provision must be made for depreciation on assets and for bad or doubtful debts. This ensures that the net asset figure is realistic and conservative. Intangible or non-productive items such as goodwill (unless specified), preliminary expenses, or any losses carried forward should be removed. If goodwill is to be included, it should be valued using a recognized method like Super Profit or Annuity method.

B. CHECK YOUR PROGRESS

Rearrange the Steps

Rearrange the following steps which are given in random order:

A. Deduct external liabilities from total assets.

B. Adjust for provisions and non-productive items.

C. Compute the value per equity share.

D. Revaluation of assets and liabilities.

E. Determine net assets available to equity shareholders.

Answer: D → B → A → E → C

Step 3: Deduct External Liabilities from Total Assets

From the total of all revalued assets, all external liabilities are deducted. These include loans, creditors, bills payable, outstanding expenses, and provisions like tax or dividends. If the preference shareholders have a prior right to repayment (especially in liquidation), their capital must also be deducted before calculating the amount attributable to equity shareholders.

Step 4: Determine Net Assets Available to Equity Shareholders

The resulting amount after subtracting liabilities and any priority capital (like preference shares) is the total net asset value available to equity shareholders. This figure represents the real worth of what the equity shareholders would receive if the company's assets were sold and liabilities paid off.

Step 5: Compute the Value Per Equity Share

Finally, the net assets available to equity shareholders are divided by the total number of equity shares issued. This gives the intrinsic or net asset value per equity share. It is considered a reliable measure of the share's worth, especially when market values are not readily available or in the case of private companies.

Particulars	Amount (₹)	Amount (₹)
I. Non-Current Assets		
Land and Building	xx	
Plant and Machinery	xx	
Furniture and Fixtures	xx	
Motor Vehicles	xx	
Goodwill (if considered)	xx	
Patents, Copyrights, Trademarks	xx	
Trade Investments	xx	
Work-in-Progress / Development Expenses	xx	

Long-term Loans and Advances	xx	
Total Non-Current Assets (A)		xxxxx
II. Current Assets		
Stock-in-Trade	xx	
Debtors / Account Receivables	xx	
Less: Provision for Bad and Doubtful Debts	(xx)	
Bills Receivable	xx	
Cash in Hand and Bank	xx	
Short-term Investments / Loans & Advances	xx	
Other Current Assets (if any)	xx	
Total Current Assets (B)		xxxxx
Total Realisable Assets (A + B) = (C)		xxxxx
III. Less: External Liabilities		
Long-term Loans / Debentures	xx	
Interest Due on Loans	xx	
Sundry Creditors	xx	
Bills Payable	xx	
Provision for Tax / Outstanding Expenses	xx	
Other Liabilities (if any)	xx	
Total External Liabilities (D)		xxxxx
Net Realisable Assets (C – D) = (E)		xxxxx
Less: Preference Share Capital (if applicable)	(xx)	
Net Assets for Equity Shareholders (F)		xxxxx
No. of Equity Shares	xx	
Value per Equity Share = F ÷ No. of Shares		₹xx

Alternatively

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

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C. CHECK YOUR PROGRESS

One Word Answer

1. What is another name for the Net Asset Method?

   Answer: Intrinsic

2. What is deducted from total assets to compute net assets?

   Answer: External Liabilities

3. What kind of value is used for assets in liquidation?

   Answer: Realisable

4. What kind of value is used for assets in going concern?

   Answer: Market

5. Which shareholder category is last in claim during liquidation?

   Answer: Equity

8.5 PRACTICAL PROBLEMS

ILLUSTRATION 1

The summarized Balance Sheet of M/s ABC Ltd. as on 31st March 2025 is given below. You are required to calculate the intrinsic value per equity share using the Net Assets Method.

Balance Sheet of M/s ABC Ltd. as on 31st March 2025

Liabilities	₹	Assets	₹
Equity Share Capital (₹10 each)	5,00,000	Fixed Assets	6,00,000
Preference Share Capital	2,00,000	Investments	50,000
Reserves & Surplus	1,50,000	Current Assets	3,00,000
Long-Term Loans	1,00,000		
Sundry Creditors	50,000		
Total	**10,00,000**	**Total**	**9,50,000**

Solution:

Particulars	Amount (₹)	Amount (₹)
A. Total Assets (Realisable):		
Fixed Assets	6,00,000	
Investments	50,000	
Current Assets	3,00,000	**9,50,000**
B. Less: Outside Liabilities		
Long-Term Loans	1,00,000	
Sundry Creditors	50,000	**1,50,000**
C. Net Assets (A – B)		**8,00,000**
D. Less: Preference Share Capital		**2,00,000**
E. Net Assets Available to Equity Shareholders		**6,00,000**
Number of Equity Shares		**50,000**
F. Intrinsic Value per Equity Share		**₹12**

ILLUSTRATION 2

Given below is the Balance Sheet of Navya Ltd. as on 31st March 2025. You are required to calculate the intrinsic value per equity share using the Net Assets Method, based on the realizable values of assets.

Balance Sheet of Navya Ltd. as on 31st March 2025

Liabilities	₹	Assets	₹
Equity Share Capital (₹10 each)	4,00,000	Land and Building	3,50,000
40,000 Shares fully paid		Machinery	2,50,000
10% Preference Share Capital	1,00,000	Investments	80,000
Creditors	90,000	Debtors	1,20,000
Outstanding Expenses	10,000	Stock	1,00,000
		Cash at Bank	50,000
Total	**6,00,000**	**Total**	**9,50,000**

Realizable Values of Assets:

- Land and Building: ₹4,00,000
- Machinery: ₹2,20,000
- Investments: ₹85,000
- Debtors: ₹1,10,000
- Stock: ₹90,000
- Cash at Bank: ₹50,000

Solution:

Particulars	₹ (Amount)	₹ (Amount)
A. Total Realisable Assets:		
Land and Building (realisable)	4,00,000	
Machinery (realisable)	2,20,000	
Investments (realisable)	85,000	
Debtors (realisable)	1,10,000	
Stock (realisable)	90,000	
Cash at Bank	50,000	**8,55,000**
B. Less: Outside Liabilities:		
Creditors	90,000	
Outstanding Expenses	10,000	**1,00,000**
C. Net Realisable Value of Assets (A – B)		**7,55,000**
D. Less: Preference Share Capital		**1,00,000**
E. Net Assets Available for Equity Shareholders		**6,55,000**
No. of Equity Shares		40,000
F. Intrinsic Value per Equity Share		₹6,55,000 ÷ 40,000 = ₹16.375 ≈ ₹16.38

ILLUSTRATION 3

From the following Balance Sheet of Sparsh Ltd. as on 31st March 2025, calculate the intrinsic value per equity share using the Net Assets Method, assuming the company is a going concern, and some assets have different realizable values.

Balance Sheet of Sparsh Ltd. as on 31st March 2025

Liabilities	₹	Assets	₹
Equity Share Capital (₹10 each)	6,00,000	Land and Building	5,00,000

60,000 Shares fully paid		Machinery	3,00,000
12% Preference Share Capital	2,00,000	Debtors	2,50,000
General Reserve	50,000	Stock	1,20,000
Creditors	1,40,000	Cash at Bank	40,000
Outstanding Expenses	10,000		
	10,00,000	**Total**	**11,10,000**

Realisable Values of Assets:

- Land and Building: ₹6,00,000
- Machinery: ₹2,70,000
- Debtors: ₹2,40,000
- Stock: ₹1,10,000
- Cash at Bank: ₹40,000

Solution:

Particulars	**₹ (Amount)**	**₹ (Amount)**
A. Total Realisable Assets:		
Land and Building (realisable)	6,00,000	
Machinery (realisable)	2,70,000	
Debtors (realisable)	2,40,000	
Stock (realisable)	1,10,000	
Cash at Bank	40,000	**12,60,000**
B. Less: Outside Liabilities:		
Creditors	1,40,000	
Outstanding Expenses	10,000	**1,50,000**
C. Net Realisable Value of Assets (A – B)		**11,10,000**
D. Less: Preference Share Capital		**2,00,000**
E. Net Assets Available for Equity Shareholders		**9,10,000**
No. of Equity Shares		60,000
F. Intrinsic Value per Equity Share		₹9,10,000 ÷ 60,000 = ₹15.17

8.6 LETS SUM IT UP

The Net Asset Method, also known as the Intrinsic Value Method, provides a logical and asset-based approach to valuing equity shares. It is particularly effective when a company's true worth lies in the value of its tangible and intangible assets rather than its earnings. By calculating the net realisable value of total assets after deducting all external liabilities and preference share capital, this method helps determine the actual wealth available to equity shareholders.

This approach is most suitable for investment holding companies, asset-rich businesses, or firms undergoing liquidation or reconstruction. It provides a clear and realistic picture of the underlying asset backing of each share, making it a useful tool for investors, financial analysts, and auditors. However, one must exercise care in determining the fair market values of assets and in handling items like goodwill or non-trading assets, especially in going concern scenarios.

8.7 KEYWORDS

1. **Net Assets** – It refer to the total value of a company's assets after deducting all external liabilities. This amount represents the wealth attributable to shareholders and forms the foundation for calculating the value of each equity share. It essentially reflects the net worth of the business from a shareholder's point of view.
2. **Realisable Value** – It is the amount an asset is expected to fetch if it were sold in the open market. Since the values recorded in the books may not reflect current market conditions, realisable values are considered more reliable in this method. For instance, assets like machinery, land, or investments may have appreciated or depreciated over time and should be revalued accordingly.
3. **Book Value** – It is the value of an asset or a company as shown in the financial statements. It is typically the original cost of an asset minus accumulated depreciation. While book values are useful for accounting purposes, they might not reflect actual market worth, which is why adjustments to realisable value are necessary in the Net Assets Method.
4. **Outside Liabilities** – It are the obligations that a company owes to parties other than its owners, such as debentures, creditors, bills payable, outstanding expenses, and tax provisions. These liabilities must be subtracted from total assets to arrive at the net assets available for shareholders.
5. Intrinsic Value of a Share - It is the fair value of one equity share based on the net assets of the company. It is calculated by dividing the amount available to equity shareholders by the number of equity shares. This value helps investors judge whether the market price of a share is justified based on the company's actual financial position.

8.8 SELF ASSESSMENT QUESTIONS

1. What is the formula used to calculate the intrinsic value of a share?

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2. What does 'realisable value of assets' mean?

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3. What is the difference between book value and realisable value?

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8.9 LESSON END EXERCISE

1. Discuss the steps involved in calculating the value of a share using the Net Assets Method.

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2. What are the merits and demerits of the Net Assets Method of valuation? Under what circumstances is this method most appropriate?

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3. How does the treatment of preference share capital affect the value of equity shares under the Net Assets Method?

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8.10 LESSON END EXERCISE

- T.S. Grewal, Financial Accounting, Sultan Chand & Sons, 2023.
- S.N. Maheshwari & S.K. Maheshwari, Advanced Accountancy – Volume I, Vikas Publishing House Pvt. Ltd., 2022.
- P.C. Tulsian & Bharat Tulsian, Financial Accounting, S. Chand Publishing, 2023.
- M.C. Shukla, T.S. Grewal & S.C. Gupta, Advanced Accounts, S. Chand Publishing, 2023.

UNIT II **B.Com 4th Semester Course**

No. BCG-401 **Lesson No. 9**

YIELD METHOD

STRUCTURE

9.1 INTRODUCTION

The Yield Method of share valuation focuses on the return that an investor can expect to earn from a share, based on the company's ability to generate consistent profits. It links the value of a share to the income it provides, either through dividends or earnings, and expresses that return in relation to the normal rate of return expected in the market.

This method emphasizes a company's profit-earning capacity rather than its asset base. It is particularly suitable for businesses that are operating as going concerns, where earnings are relatively stable and predictable. The investor's expected yield is capitalized using a standard rate of return to arrive at the share's value.

The Yield Method is especially relevant in situations involving investment decisions, transfer of shares, or business restructuring, where the focus is on future income potential rather than historical costs or asset values.

9.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

By the end of this lesson, learners will be able to:

1. Understand the meaning and significance of the Yield Method in valuing equity shares.
2. Differentiate between earning yield and dividend yield and understand when each is applicable.
3. Identify the information required to apply the yield method effectively (e.g., average profits, dividend per share, market expectations).
4. Apply the formula for calculating share value based on expected yield and normal rate of return.
5. Interpret the results of share valuation and relate them to investment decisions.

Learning Outcomes

After completing this lesson, learners will be able to:

- Accurately calculate the value of equity shares using the yield method.

- Analyze financial data to determine maintainable profits and dividend yields.
- Make informed judgments on the attractiveness of a company's shares from an investor's point of view.
- Evaluate the appropriateness of using the yield method in different business contexts.
- Demonstrate a clear understanding of how return expectations influence the value of shares.

9.3 CONCEPT OF YIELD METHOD

The Yield Method of share valuation is based on the concept that the value of a share is directly linked to the returns it generates for its holder. Yield refers to the effective rate of return that an investor earns on their investment, usually expressed as a percentage. Since share valuation here depends on the expected return, the approach is rightly called the Yield-Based Method.

This method is especially useful in cases where the focus is on the income-producing ability of the company, rather than just its asset base.

Suppose an investor purchases a share having a face value of ₹100 at a market price of ₹150, and the dividend received on this share is ₹30. The yield for the investor will be:

Yield = (Normal Profit / Capital employed) x 100

Yield = (30 ÷ 150) × 100 = 20%

This means the investor earns a 20% return on the amount invested.

Merits of Yield Method

1. Reflects True Earning Potential - This method considers the company's profitability, which is crucial for long-term investors focused on returns.
2. Useful for Investors - Since it calculates value based on expected returns, it helps investors make rational decisions based on potential yield.
3. Accounts for Market Conditions - It adapts to changes in earnings and dividend trends, which are influenced by both internal performance and external market factors.
4. Helps in Fair Valuation During Transactions - Ideal for mergers, acquisitions, or private sales where the buyer is interested in the income-generating ability of shares.
5. Supports Decision-Making - Particularly helpful when companies have consistent dividend records, as it allows for yield-based comparison with other investments.

Demerits of Yield Method

1. Not Suitable for Non-Dividend Paying Firms - If a company doesn't declare dividends regularly, this method becomes irrelevant or misleading.

2. Ignores Asset Base - It focuses only on earnings and ignores the actual asset backing or financial strength of the company.
3. Difficult to Apply in Fluctuating Profits - If profits or dividends vary widely year to year, yield calculations may not give a stable or reliable valuation.
4. Assumptions May Be Unrealistic - It assumes a constant rate of return or dividend, which may not always align with real-world business fluctuations.
5. Vulnerable to Accounting Manipulations - If profits are artificially inflated or understated, the calculated value using yield will be misleading.

A. CHECK YOUR PROGRESS
True or False

1. The Yield Method is primarily based on the company's asset valuation.
Answer: False
2. Yield method assumes that the company will pay regular and predictable dividends.
Answer: True
3. Yield is calculated using the book value of the share.
Answer: False
4. Yield method gives preference to the earning ability of a company over its tangible assets.
Answer: True
5. Yield method provides a stable valuation when a company's dividend payout is irregular.
Answer: False

9.4 PROFIT BASIS METHOD

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

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

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

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

Under the Profit Basis of the Yield Method, the value of an equity share is derived based on the profits the business is expected to maintain in the future. The concept relies on computing the sustainable level of earnings (known as *Future Maintainable Profit*) and then capitalizing those profits using a standard return rate expected by investors, known as the normal rate of return.

Steps Involved in the Profit Basis Approach

Step 1: Compute Average Maintainable Profit

Calculate the average of past profits, typically over the last 3 to 5 years. However, this average should be adjusted to reflect only those profits that are expected to continue in the future. The following adjustments are essential:

- Deduct adequate depreciation on fixed assets if not already adjusted.
- Exclude appreciation in fixed assets. However, appreciation in current assets (like inventory) may be included if realisable.
- Exclude income from non-trading or non-operating assets (e.g., rent from investment property or gain on sale of machinery).
- Exclude non-recurring expenses (e.g., one-time legal expenses or restructuring costs).
- Exclude casual income (e.g., one-time lottery win or insurance claim).
- Provide for taxation to reflect profits after tax.
- Deduct reserve provisions, if any are created from profits.
- Deduct preference dividend to determine earnings available for equity shareholders.

Step 2: Identify the Normal Rate of Return (NRR)

This is the return typically expected by investors in similar businesses or industries. It is usually expressed as a percentage (e.g., 10% or 12%). This rate helps in determining how much capital investors would invest for the expected level of profit.

Step 3: Calculate the Capitalized Value of the Business

Use the following formula:

Capitalized Value of Business = (Future Maintainable Profit ÷ Normal Rate of Return) x 100

This gives the total value of the business based on its earning capacity.

Step 4: Determine the Value per Equity Share

Once the total value of the business (based on earnings) is found, divide this value by the number of equity shares issued to determine the value of one equity share:

Value per Equity Share = Capitalized Value of Business / Number of Equity Shares

This method assumes that investors are primarily concerned with the profits the company can maintain over time and are willing to invest capital accordingly. It gives a fair and rational value of shares in companies with stable and predictable earnings.

B. CHECK YOUR PROGRESS

Rearrange the Steps

Rearrange the following steps which are given in random order:

A. Capitalize the maintainable profit using the normal rate of return

B. Determine the maintainable profit available for equity shareholders

C. Compute the value per share by dividing capitalized value by the number of equity shares

D. Calculate the normal rate of return expected by investors

E. Identify and adjust past profits to calculate average maintainable profits

Answer: E → B → D → A → C

ILLUSTRATION 4

A Ltd. wants to determine the value of its equity shares based on the profits it has earned in the past three years. Since the profits are stable and reflective of the business's performance, the Profit Basis of the Yield Method is applied. The value per share is calculated using the average maintainable profit and the normal rate of return expected by investors.

Balance Sheet of A Ltd. as on 31 March 2025

Liabilities	₹	Assets	₹
Equity Share Capital (₹10 each)	4,00,000	Fixed Assets	3,00,000
General Reserve	1,00,000	Investments	1,00,000
Creditors	80,000	Debtors	1,20,000
Outstanding Expenses	20,000	Cash & Bank	60,000
		Stock	40,000
Total	6,00,000	**Total**	6,00,000

Additional Information:

- Profits for past 3 years: ₹1,80,000; ₹2,20,000; ₹2,00,000
- Normal Rate of Return: 10%
- Number of Equity Shares: 40,000

Solution:

1. **Average Maintainable Profit** =
   (1,80,000 + 2,20,000 + 2,00,000) ÷ 3 = ₹2,00,000
2. **Capitalized Value of Business** =
   ₹2,00,000 × 100 ÷ 10 = ₹20,00,000
3. **Value per Equity Share** =
   ₹20,00,000 ÷ 40,000 shares = ₹50 per share

ILLUSTRATION 5

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:

Company A

Particulars	**Amount (₹)**
Average Profit	1,30,000
Less: Preference Dividend (6% of ₹10,00,000)	60,000
Profit Available for Equity Shareholders	70,000
Number of Equity Shares	10,000
Normal Rate of Return (NRR)	8%
Capitalization of Profit (70,000 ÷ 8) × 100	8,75,000
Value per Equity Share	**87.50**

Company B

Particulars	**Amount (₹)**
Average Profit	1,30,000
Less: Preference Dividend (6% of ₹1,00,000)	6,000
Profit Available for Equity Shareholders	1,24,000
Number of Equity Shares	1,00,000
Normal Rate of Return (NRR)	8%
Capitalization of Profit (1,24,000 ÷ 8) × 100	15,50,000
Value per Equity Share	**15.50**

9.4 DIVIDEND BASIS METHOD

Under the Dividend Basis, the value of equity shares is calculated using the actual dividend distributed to shareholders. This method assumes that shareholders are mainly interested in the dividends received, and hence, the valuation is based on dividend yield.

There are two approaches to this:

(a) Based on Total Amount of Dividend

When the total amount of dividend paid to equity shareholders is known, the following formulas are used:

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

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

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

(b) Based on Percentage or Rate of Dividend

If the rate of dividend (i.e., the percentage declared on paid-up value) is known:

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

When the Rate of Dividend is not given:

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

ILLUSTRATION 6

An investor is analyzing the intrinsic value of shares in X Ltd., which has recently declared a dividend for equity shareholders. The valuation is to be performed using the dividend yield method, based on the total dividend amount distributed.

Balance Sheet of X Ltd. as on 31st March, 2025

Liabilities	₹	Assets	₹
Equity Share Capital (₹10)	5,00,000	Fixed Assets	3,50,000
10% Preference Capital	1,00,000	Cash and Bank	1,00,000
General Reserve	50,000	Debtors	1,00,000

Creditors	1,00,000	Stock	1,00,000
Total	**7,50,000**	**Total**	**7,50,000**

Additional Information:

Total dividend declared and paid to equity shareholders: ₹60,000

Normal rate of return (expected yield): 10%

Number of equity shares: 50,000 shares (₹10 each, fully paid-up)

Solution:

Step 1: Capitalised Value of Equity = 60000 × (100 / 10) = **₹6,00,000**

Step 2: Value per Equity Share = 6,00,000 / 50,000 = **₹12**

C. CHECK YOUR PROGRESS

One Word Answer

1. The average rate expected by investors is known as __________ rate.

   Answer: Normal

2. In yield method of share valuation, if the dividend rises, the yield will __________.

   Answer: Increase

3. The Yield Method is also called the __________ capacity method.

   Answer: Earning

4. In yield method of share valuation, when market price of shares is high, yield becomes __________.

   Answer: Low

5. If yield is less than the market expectation, share is considered __________.

   Answer: Overvalued

ILLUSTRATION 7

From the following information, calculate the value per equity share of AMCO Ltd. using the dividend basis method:

The company has 2,50,000 equity shares of ₹1 each, fully paid-up.

The annual net earnings of the company normally amount to ₹35,000.

The normal rate of return (expected yield) on the paid-up value of equity share capital is 7%.

Solution:

Step 1: Calculate the Rate of Dividend

Rate of Dividend = (Net Earnings / Paid up Equity Share Capital) × 100

= (35,000 / 2,50,000) × 100 = 14%

Step 2: Calculate the Value per Equity Share

Value per Equity Share = (Rate of Dividend × Paid-up value of each share) / Normal Rate of Return = (14 × 1) / 7 = **₹2**

9.6 LETS SUM IT UP

The Yield Method of share valuation provides a logical and income-based approach to estimating the worth of equity shares. It emphasizes the actual return (yield) an investor expects from their investment in relation to the profits or dividends distributed by the company. By comparing the maintainable earnings or dividends of a company against a normal rate of return, this method captures both the profitability and market expectations of the business.

The Yield Method is especially relevant for companies with stable profit histories or predictable dividend patterns and is frequently used by investors and analysts for decision-making. While it offers a clear picture of the return-generating potential of a share, the method is highly sensitive to the accuracy of profit projections and the appropriateness of the chosen yield rate.

9.7 KEYWORDS

1. **Yield** - Yield refers to the return an investor earns from a share, usually expressed as a percentage of the investment. It is calculated based on the income (like dividends or profits) received from the share compared to its purchase or market value. For example, if a share priced at ₹100 gives a ₹10 dividend annually, the yield is 10%. Yield reflects the earning potential of a share and plays a central role in this method.
2. **Maintainable Profit** - Maintainable profit is the expected average annual profit that a company is likely to earn in the future, based on past performance and after making

necessary adjustments. These adjustments may include removing abnormal gains or losses, deducting non-recurring expenses, or accounting for future expenses like depreciation and taxes. It represents a realistic estimate of future earnings used in the profit-based valuation.

3. **Capitalized Value** - Capitalized value is the total value of a business calculated by capitalizing the maintainable profit or dividend at the normal rate of return. It shows what the business would be worth if it consistently earns the expected level of profits or dividends, making it a key step in determining the value per share.
4. **Dividend** - A dividend is the portion of profits distributed to shareholders. In the yield method (particularly the dividend basis), the amount or percentage of dividend declared becomes the core input for calculating the return and, subsequently, the value of the share.
5. **Capitalization Rate** - The capitalization rate is another name for the normal rate of return used in the yield method. It represents the return investors expect from similar risk investments. This rate is used to convert maintainable profits into the capitalized value of the business.

9.8 SELF ASSESSMENT QUESTIONS

1. What is meant by the yield method of share valuation?

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2. What does "capitalized value" mean in the context of the yield method?

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3. Why is the normal rate of return important in the yield method?

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9.8 LESSON END EXERCISE

1. Explain the concept of the Yield Method of share valuation.

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2. What are the merits and demerits of the Yield Method in comparison to the Net Asset Method?

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3. What is meant by capitalization of profits in the Yield Method? Explain how this approach helps in determining the fair value of equity shares.

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9.10 LESSON END EXERCISE

- T.S. Grewal, Financial Accounting, Sultan Chand & Sons, 2023.
- S.N. Maheshwari & S.K. Maheshwari, Advanced Accountancy – Volume I, Vikas Publishing House Pvt. Ltd., 2022.
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FAIR VALUE METHOD

STRUCTURE

10.1 INTRODUCTION

The Fair Value Method of share valuation is a balanced approach that combines the strengths of both the Net Asset Method and the Yield Method to arrive at a realistic and equitable valuation of equity shares. It is often used when neither asset-based nor earnings-based methods alone provide a complete picture of a company's true value. This method helps reconcile differences in valuations that may arise due to variations in asset worth and profit-generating capacity.

Under this method, the Fair Value of a share is calculated as the average of the value derived from the Net Asset Method (which considers the company's tangible worth) and the Yield Method (which focuses on income or return). As a result, the Fair Value Method offers a more comprehensive assessment of share value, making it particularly useful for negotiations during mergers, acquisitions, internal restructuring, and settlements involving minority shareholders.

In this lesson, learners will understand the rationale behind using the fair value approach, its practical computation steps, and its importance in situations where both profitability and asset base need to be considered to estimate the true worth of equity shares.

10.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives:

By the end of this lesson, learners will be able to:

- Understand the concept and rationale behind the Fair Value Method of share valuation.
- Differentiate between the Net Asset Method, Yield Method, and how their combination leads to fair value.
- Learn the step-by-step procedure to compute the fair value of an equity share.
- Identify situations where the fair value method is most appropriate (e.g., mergers, acquisitions, minority buyouts).
- Analyze the advantages and limitations of using this method in practical valuation scenarios.

Learning Outcomes:

After completing this lesson, learners will be able to:

- Clearly explain what constitutes the fair value of a share.
- Apply both Net Asset and Yield Method to determine the combined fair value of equity shares.
- Solve numerical problems involving fair value calculations.
- Critically assess when and why this method should be preferred over other valuation techniques.
- Make informed decisions in cases requiring a balanced view of a company's assets and earnings.

10.3 CONCEPT OF FAIR VALUE METHOD

Many accountants and financial analysts believe that neither the Net Asset Value (NAV) Method nor the Earnings or Yield Method alone can fully and accurately reflect the true value of a company’s shares. The Fair Value Method, also known as the Dual Method, emerges as a rational and balanced approach by averaging the results of these two traditional methods. It acknowledges that both a company’s asset base and its earning capacity are important indicators of its overall worth.

The formula for calculating the fair value per share is:

$$\text{Fair Value per Share} = \frac{\text{Value of Share as per Net Assets Method} + \text{Value of Share as per Earning Method}}{2}$$

This method minimizes the individual shortcomings of both the asset-based and earnings-based approaches by considering them together. As such, it provides a more realistic and equitable valuation, especially useful in cases like internal share transfers, mergers, family settlements, or share valuation of unlisted companies.

Merits of Fair Value Method

1. Balanced Perspective: It combines both tangible asset backing and future income potential, offering a fuller picture of a share's value.
2. Minimizes Bias: Averages the overvaluation tendency of earnings-based methods and the undervaluation possibility of asset-based methods.
3. Practical Application: Widely used for private companies, legal settlements, and when market price is unavailable.
4. Rational and Acceptable: Often accepted by courts, regulators, and stakeholders due to its well-rounded approach.

Demerits of Fair Value Method

1. Time-Consuming Calculations: Requires detailed computations from two separate methods, increasing complexity.
2. Dependence on Assumptions: The accuracy of fair value relies heavily on the correctness of estimates like maintainable profits, revalued assets, and normal rate of return.
3. Limited Use in Volatile or Unique Situations: Not always suitable for startups, companies with intangible-heavy balance sheets, or those with unpredictable earnings.

A. CHECK YOUR PROGRESS
True or False

1. The Fair Value Method considers only the book value of assets.
Answer: False
2. Fair Value method provides a balanced view by considering both assets and earnings.
Answer: True
3. The Fair Value Method always gives the highest value compared to other methods.
Answer: False
4. Fair value is calculated by taking the average of Net Asset Value and Yield Value.
Answer: True
5. Fair Value method reduces the risk of overvaluation and undervaluation.
Answer: True

10.4 STEPS OF FAIR VALUE METHOD

B. CHECK YOUR PROGRESS
Rearrange the Steps

Rearrange the following steps which are given in random order:

A. Compute the average of values obtained from Net Asset and Earnings-based methods to determine Fair Value per Share.

B. Calculate the value per share using the Net Asset Method by subtracting liabilities from assets and dividing by number of equity shares.

C. Use the Fair Value result for decision-making in mergers, acquisitions, or share buybacks.

D. Calculate the value per share using the Yield Method by capitalizing future maintainable profits and dividing by equity shares.

Answer: B → D → A → C

Step 1: Calculate the Value per Share Using the Net Assets Method
Begin by determining the Net Asset Value (NAV) of the business. This involves calculating the total realisable value of all assets and deducting all external liabilities (including preference share capital, if applicable). The resulting figure is the net worth attributable to equity shareholders. Divide this net worth by the total number of equity shares to arrive at the Net Asset Value per Share.

Step 2: Calculate the Value per Share Using the Yield (Earnings) Method
Next, determine the Future Maintainable Profit (FMP) of the business, usually by averaging past profits after making necessary adjustments (for abnormal items, depreciation, taxes, etc.). Capitalize this maintainable profit using the Normal Rate of Return (NRR) to find the total capitalized value of the business. Then divide this by the number of equity shares to obtain the Earnings or Yield-Based Value per Share.

Step 3: Calculate the Average of the Two Values
Once you have both the Net Asset Value per Share and the Earnings-Based Value per Share, compute the average of these two values. This average is known as the Fair Value per Share.

It represents a balanced estimate that considers both the asset backing and earning potential of the business.

Step 4: Interpret the Result
The final fair value per share offers a more holistic assessment of share value. This figure is useful in situations such as mergers, acquisitions, share buybacks, or taxation purposes where a fair and justifiable share price is necessary.

10.5 PRACTICAL PROBLEMS

ILLUSTRATION 8

From the following information, calculate the fair value of an equity share of X Ltd.:

- Total Assets (at revalued figures): ₹12,00,000
- External Liabilities: ₹3,00,000
- Number of Equity Shares: 30,000
- Future Maintainable Profit: ₹1,80,000
- Normal Rate of Return: 10%

Solution:

Step 1: Net Asset Value per Share
Net Assets = Total Assets – External Liabilities
= ₹12,00,000 – ₹3,00,000 = ₹9,00,000

Net Asset Value per Share = ₹9,00,000 ÷ 30,000 = ₹30

Step 2: Yield Value per Share as per Capitalized Value Approach
Capitalized Value = ₹1,80,000 × 100 ÷ 10 = ₹18,00,000

Yield Value per Share = ₹18,00,000 ÷ 30,000 = ₹60

Step 3: Fair Value per Share
= (Net Asset Value + Yield Value) ÷ 2
= (₹30 + ₹60) ÷ 2 = **₹45**

C. CHECK YOUR PROGRESS

One Word Answer

1. Which method is suitable for asset-rich companies?

   Answer: Net Asset

2. Which method focuses on earning capacity?

   Answer: Yield

3. Which method combines asset and income approaches?

   Answer: Fair

4. What kind of assets are excluded in net asset method?

   Answer: Fictitious

5. Which rate is used to capitalize maintainable profits?

   Answer: Normal

ILLUSTRATION 9

When both the assets and earning capacity of a company are important for valuation, relying on only one method may not give a complete picture. In such situations, the Fair Value Method provides a balanced view by taking the average of the Net Asset Value and the Yield Value of a share. Use this approach to calculate the fair value of each equity share of Y Ltd., based on the following data.

Balance Sheet of Y Ltd. as on 31st March 2025

Liabilities	₹	Assets	₹
Equity Share Capital (₹10 each)	5,00,000	Land and Building	4,00,000
8% Preference Share Capital	2,00,000	Machinery	2,20,000
General Reserve	1,50,000	Investments	1,00,000
Creditors	1,00,000	Debtors	1,40,000
Outstanding Expenses	50,000	Stock	1,00,000
		Cash & Bank	40,000
Total	10,00,000	Total	10,00,000

Additional Information:

- Number of equity shares = 50,000
- Future maintainable profit = ₹3,60,000
- Normal rate of return = 12%

Solution:

Step 1: Calculate Net Assets (Net Asset Method)

Particulars	Amount (₹)
Total Assets	
Land and Building	4,00,000
Machinery	2,20,000
Investments	1,00,000
Debtors	1,40,000
Stock	1,00,000
Cash & Bank	40,000
Total Assets (A)	10,00,000
Less: Outside Liabilities	
Creditors	1,00,000
Outstanding Expenses	50,000
Total Liabilities (B)	1,50,000
Net Assets (A – B)	8,50,000
Less: Preference Share Capital	2,00,000
Net Assets Available to Equity Shareholders	6,50,000
Number of Equity Shares	50,000
Net Asset Value per Share	₹13.00

Step 2: Calculate Yield Value (Capitalization Method)

Capitalized Value = ₹3,60,000 × 100 ÷ 12 = ₹30,00,000

Yield Value per Share = ₹30,00,000 ÷ 50,000 = ₹60

Step 3: Calculate Fair Value per Share

Fair Value = (Net Asset Value + Yield Value) ÷ 2
Fair Value = (₹13 + ₹60) ÷ 2 = **₹36.50**

ILLUSTRATION 10

The following is the Balance Sheet of X Co. Ltd. as on 31.12.2012. You are required to ascertain the value per equity share using the Fair Value Method.

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**

Additional Information:

- Assets revalued:
  - Building: ₹3,20,000
  - Plant: ₹1,80,000
  - Stock: ₹45,000
  - Debtors: ₹36,000
- Average profit: ₹1,20,000
- 12.5% of profit transferred to General Reserve
- Tax rate: 50%
- Normal equity dividend expected: 8%
- Normal rate of return: 10%
- Goodwill to be valued at 3 years' purchase of super profit

Solution:

Step 1: Computation of Goodwill

Revised Net Assets:

Particulars	Amount (₹)
Building	3,20,000
Plant	1,80,000
Stock	45,000

Debtors	36,000
Cash	10,000
Total Assets	5,91,000
Less: Creditors	80,000
Capital Employed	5,11,000

Normal Profit = 10% of ₹5,11,000 = ₹51,100

Actual Profit:

- Average profit: ₹1,20,000
- Less: Non-trading income (10% of ₹50,000) = ₹5,000 → ₹1,15,000
- Add: Debenture interest = ₹15,000 → ₹1,30,000
- Less: Preference dividend (12% of ₹1,00,000) = ₹12,000 → ₹1,18,000
- Less: Tax @ 50% = ₹59,000 → ₹59,000
- Less: Transfer to Reserve (12.5%) = ₹7,375
- Profit available to equity shareholders = ₹51,625

Super Profit = ₹51,625 – ₹51,100 = ₹525
Goodwill = ₹525 × 3 = ₹1,575

Step 2: Net Asset Method

Particulars	Amount (₹)
Capital Employed	5,11,000
Add: Investments	48,000
Add: Goodwill	1,600
Total	5,60,600
No. of Equity Shares	10,000
Intrinsic Value/Share	₹56.06

Step 3: Yield Method

Particulars	Amount (₹)
Dividend Rate	8%
Face Value	₹10
Normal Return	10%
Value per Share	₹8.00

Step 4: Fair Value Method

Fair Value = (Intrinsic Value + Yield Value) ÷ 2
= (₹56.06 + ₹8.00) ÷ 2
= ₹32.03

ILLUSTRATION 11

Question:

From the following data, calculate the value of a fully paid equity share of ₹10 under:

(i) Dividend Basis

(ii) Return on Capital Employed Basis

Assume market expectations (normal rate of return) to be 12%.

Year	Capital Employed (₹ Cr.)	Profit Earned (₹ Cr.)	Dividend (%)
1999	50	8	12%
2000	80	16	15%
2001	100	22	18%
2002	120	30	20%

Solution:

(i) Valuation on Dividend Basis

Step 1: Weighted Average Rate of Dividend

Year	Dividend (%)	Weight	Product
1999	12	1	12
2000	15	2	30
2001	18	3	54
2002	20	4	80
		10	176

Weighted Average Dividend = 176 ÷ 10 = 17.6%

Step 2: Value of Share

Value per Share = (Average Dividend Rate × Face Value) / Market Expectations = (17.6×10) / 12 = ₹14.67

(ii) Valuation on Return on Capital Employed Basis

Step 1: Weighted Average Return on Capital Employed

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

Weighted Average Return = 222 ÷ 10 = 22.2%

Step 2: Value of Share

Value per Share = (22.2 × 10) / 12 = ₹18.50

ILLUSTRATION 12

The following is the Balance Sheet of A Ltd. as on 31st March 2002:

Liabilities	Amount	Assets	Amount
Equity Share Capital – ₹10 fully paid	3,00,000	Building	2,00,000
Equity Share Capital – ₹10, ₹5 paid	2,00,000	Plant & Machinery	4,00,000
9% Preference Share Capital (₹100)	2,00,000	Sundry Debtors	2,10,000
Reserve	3,00,000	Stock	2,50,000
Sundry Creditors	2,00,000	Cash at Bank	40,000
Total	11,00,000	Total	11,00,000

Additional Information:

Past profits and dividend declared were as follows:

Year	Profit Before Tax (₹)	Equity Dividend
1999–2000	2,20,000	12%
2000–2001	2,50,000	15%
2001–2002	3,20,000	18%

- Land and Building is worth ₹4,00,000 (revalued).
- Managerial remuneration is expected to increase by ₹20,000 per annum.
- Income tax should be provided at 50%.
- Equity shares of companies in the same industry with a dividend rate of 10% are quoted at par.
- Ignore goodwill, depreciation adjustment for revaluation, and transfer to general reserve.

Required:

(a) Calculate the value of equity shares (both fully and partly paid) using the following methods:

(i) Earnings (Yield) Method

(ii) Net Asset Method

(iii) Fair Value Method

(b) If only a few shares are being transferred, calculate their value based on the Dividend Yield Approach using:

(i) Average dividend rate

(ii) Weighted average dividend rate

Solution:

(a) Valuation of Equity Shares

Step 1: Weighted Average Maintainable Profit (Earnings Method)

Year	Profit (₹)	Weight	Product (₹)
1999–2000	2,20,000	1	2,20,000
2000–2001	2,50,000	2	5,00,000
2001–2002	3,20,000	3	9,60,000
Total		6	16,80,000

Weighted Average Profit = 16,80,000 ÷ 6 = ₹2,80,000
Less: Managerial Remuneration = ₹20,000 → ₹2,60,000
Less: Tax @ 50% = ₹1,30,000 → Profit After Tax = ₹1,30,000
Less: Preference Dividend = 9% of ₹1,00,000 = ₹9,000
Maintainable Profit for Equity = ₹1,21,000

Capitalized Value @ 10% = ₹1,21,000 × 100 / 10 = ₹12,10,000
Add: Notional call on 40,000 partly paid shares @ ₹5 = ₹2,00,000
Total Equity Value (Earnings Basis) = ₹14,10,000

Shares:

Fully Paid = ₹3,00,000 ÷ ₹10 = 30,000
Partly Paid = ₹2,00,000 ÷ ₹5 = 40,000
Total Shares (Post Call) = 70,000

Value per share (Earnings Basis):

Fully Paid = ₹14,10,000 ÷ 70,000 = ₹20.14
Partly Paid = ₹20.14 – ₹5 = ₹15.14

Step 2: Net Asset Basis

Assets	₹
Building (Revalued)	4,00,000
Plant & Machinery	4,00,000
Sundry Debtors	2,10,000
Stock	2,50,000
Cash at Bank	40,000
Notional Call on Shares	2,00,000
Total Assets	15,00,000

Less:
Sundry Creditors = ₹2,00,000

Preference Share Capital = ₹1,00,000
Total Deductions = ₹3,00,000

Net Assets for Equity = ₹12,00,000
Value per Fully Paid Share = ₹12,00,000 ÷ 70,000 = ₹17.14
Partly Paid = ₹17.14 – ₹5 = ₹12.14

Step 3: Fair Value Method
Fair Value per Fully Paid Share = (₹20.14 + ₹17.14) ÷ 2 = ₹18.64
Fair Value per Partly Paid Share = (₹15.14 + ₹12.14) ÷ 2 = ₹13.64

b) Valuation of a Few Shares (Dividend Approach)
(i) Average Dividend Method
Average Dividend = (12% + 15% + 18%) ÷ 3 = 15%
Value of Fully Paid Share = 15% × ₹10 ÷ 10% = ₹15
Value of Partly Paid Share = 15% × ₹5 ÷ 10% = ₹7.50
(ii) Weighted Average Dividend Method

Year	Dividend %	Weight	Product
1999–2000	12	1	12
2000–2001	15	2	30
2001–2002	18	3	54
Total		6	96

Weighted Average = 96 ÷ 6 = 16%
Value of Fully Paid Share = 16% × ₹10 ÷ 10% = ₹16
Value of Partly Paid Share = 16% × ₹5 ÷ 10% = ₹8

Notes:

1. The profits given in the problem show an increasing trend. Therefore, weighted average profit should be used to arrive at the maintainable profit instead of simple average profit.
2. It is assumed that A Ltd. is a going concern and the unpaid amount of partly paid shares will be called in due course. If not, the partly paid shares would be valued on a pro-rata basis.

10.6 LET US SUM UP

The Fair Value Method offers a balanced and comprehensive approach to valuing equity shares by combining both the Net Asset Value method and the Yield (or Earnings) method. Since each of these methods focuses on different aspects—assets and profitability respectively—their average provides a more realistic and fairer estimate of a share's value.
This method addresses the limitations of using either approach in isolation. While Net Asset Value may not account for a company's earning potential, and the Yield Method may overlook

the strength of its assets, the Fair Value Method integrates both dimensions. This dual perspective is especially useful in cases of share transfer, buyback, or valuation for investment decisions, where both profitability and financial stability are relevant.

10.7 KEYWORDS

- **Fair Value** - Fair value is the average of two values: the value of a share calculated under the Net Asset Method and the value calculated using the Yield Method. It gives a more balanced estimate of a share's worth by considering both the company's financial position and its profit-earning capacity. It is especially useful in estimating a realistic price for a share during sale, acquisition, or settlement.
- **Intrinsic Value (Net Asset Value)** - This refers to the value of a share based on the net assets of the company. Net assets are calculated by subtracting all liabilities (including preference share capital, if applicable) from the total realisable value of the company's assets. The remaining value is then divided by the number of equity shares to get the value per share.
- **Yield Value** - Yield value, also called value based on earnings, reflects the profitability of a company. It is calculated using the maintainable profit available for equity shareholders and dividing it by the normal rate of return expected by investors. It shows how much an investor earns compared to the amount invested and is useful for evaluating shares from an income perspective.
- **Maintainable Profit** - Maintainable profit is the adjusted profit that a company is expected to earn consistently in the future. It is calculated by analyzing the average of past profits and removing unusual, non-recurring incomes or expenses. It ensures that only sustainable profits are considered while valuing the share using the earnings basis.
- **Normal Rate of Return** - This is the benchmark rate of return expected by investors in the market for similar kinds of investments or businesses. It is used in both yield and fair value methods to compare actual profits with what is generally expected in the industry.

10.8 SELF ASSESSMENT QUESTIONS

1. What is the Fair Value Method of share valuation?

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2. Write the formula for calculating fair value per equity share.

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3. Why is the Fair Value Method considered better than the Net Asset or Yield Method alone?

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10.9 LESSON END EXERCISE

1. Explain the Fair Value Method of share valuation. How is it computed?

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2. Discuss the merits and demerits of the Fair Value Method. In what situations is this method considered most appropriate?

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3. Compare and contrast the Net Asset Method, Yield Method, and Fair Value Method. Highlight how the Fair Value Method incorporates the strengths of the other two.

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10.10 SUGGESTED READINGS

- T.S. Grewal, Financial Accounting, Sultan Chand & Sons, 2023.
- S.N. Maheshwari & S.K. Maheshwari, Advanced Accountancy – Volume I, Vikas Publishing House Pvt. Ltd., 2022.
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UNIT III **B.Com 4th Semester**

Course No. BCG-401 **Lesson No. 11**

INTRODUCTION TO LIQUIDATION

11.1 INTRODUCTION

This chapter provides a foundational understanding of the concept of liquidation of companies, a legal process through which a company's operations come to an end and its existence is formally dissolved. In this chapter, we will explore the objectives of liquidation, the meaning and definition of liquidation and the circumstances under which a company may be liquidated.

We will also examine the various reasons that may lead to liquidation, which are broadly classified into financial reasons (such as insolvency or inability to pay debts) and legal reasons (such as violation of statutory provisions or court orders). Furthermore, the chapter elaborates on the different modes of liquidation, including compulsory winding up by the Tribunal, voluntary winding up by members or creditors and winding up under the supervision of the court.

By the end of this chapter, students will have a clear understanding of the basic legal and procedural framework of liquidation, helping them build a strong base for more detailed topics in subsequent chapters.

11.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

The primary aim of this chapter is to familiarize students with the concept, causes and types of liquidation under the Companies Act. The specific objectives are:

- To understand the meaning and significance of liquidation.
- To identify the financial and legal reasons that may lead a company to undergo liquidation.
- To distinguish between different modes of liquidation or winding up.
- To comprehend the legal implications and procedural differences between compulsory, voluntary, and court-supervised winding up.

Learning Outcomes

After studying this chapter, learners will be able to:

- Define liquidation and explain its purpose and importance in the corporate lifecycle.
- List and explain the key reasons that lead to the liquidation of a company.
- Differentiate between compulsory winding up, voluntary winding up and winding up under court supervision.
- Understand the basic legal framework governing liquidation under the Companies Act.
- Apply this foundational knowledge to interpret and analyze real-life corporate insolvency cases and their resolution mechanisms.

11.3 MEANING OF LIQUIDATION (OR WINDING UP)

Liquidation, also known as winding up, is the formal legal process by which a company comes to an end. It involves stopping the company's business activities, selling its assets, paying off its debts, and distributing any remaining funds to its shareholders.

The process begins with the appointment of a liquidator, who may be selected by the shareholders or appointed by the court. The liquidator takes control of the company's affairs, replacing the role of the directors. Their main responsibility is to act in the best interest of all the creditors and ensure that the company's assets are fairly and lawfully managed.

During liquidation, the liquidator:

- Takes charge of the company's operations and assets.
- Sells (realises) the company's assets.
- Pays off all outstanding debts and liabilities.

- Distributes any remaining funds to shareholders, according to the provisions of the Companies Act, 1956.

At the end of the liquidation process, the company should have no assets or liabilities. What remains is a formal step called dissolution, where the company's legal existence is permanently terminated. Once dissolved, the company ceases to exist as a legal entity, it can no longer own property, file lawsuits, or be sued.

However, it's important to note that:

- A company does not stop existing immediately after liquidation begins. It still exists legally until it is officially dissolved.
- During this period, although the control of the company shifts to the liquidator, the company still owns its property and assets.
- The company can also still be involved in legal proceedings during the winding-up phase.

The main objective of liquidation is to ensure that the company's assets are distributed fairly, and its debts are paid efficiently and lawfully. The process must not be misused for the personal benefit of any party, such as shareholders or petitioners.

In summary, winding up is a transition phase where a company moves from being operational to complete closure, under the supervision of a liquidator, leading to final dissolution and end of legal existence.

11.4 CONCEPT OF LIQUIDATION (OR WINDING UP)

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.

A. CHECK YOUR PROGRESS

Multiple Choice Questions

1. What is liquidation in the context of a company?
a) Starting a new business
b) Merging with another company
c) Winding up of a company's operations
d) Changing the business structure

Answer: c) Winding up of a company's operations

2. One of the main objectives of liquidation is:
a) To maximize employee bonuses
b) To settle the company's obligations to creditors
c) To expand business operations
d) To raise capital from shareholders

Answer: b) To settle the company's obligations to creditors

3. Liquidation generally results in:
a) Reinvestment in new assets
b) Distribution of surplus assets among shareholders
c) Increase in share capital
d) Expansion of company activities

Answer: b) Distribution of surplus assets among shareholders

4. Which of the following is not a consequence of liquidation?
a) Business ceases to exist
b) Assets are sold to pay off liabilities
c) New shares are issued
d) Employees may lose jobs

Answer: c) New shares are issued

5. Liquidation is legally defined as:
a) The process of increasing share capital
b) The sale of assets for investment purposes
c) The legal ending of a company's existence
d) The declaration of bankruptcy by the directors

Answer: c) The legal ending of a company's existence

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 realization 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.

11.5 CONCEPT OF LIQUIDATION (OR WINDING UP)

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."

11.6 CONSEQUENCES OF LIQUIDATION (OR 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.

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

11.7 REASONS FOR LIQUIDATION (OR WINDING UP)

There are basically two reasons for the liquidation of a Joint Stock Company. They are as under:

1. Financial Reasons
2. Legal Reasons

11.7.1 Financial Reasons

I. When the company's financial position has eroded beyond repair and the company can neither payoff its debts nor is able 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.

11.7.2 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.

11.8 MODE FOR LIQUIDATION (OR WINDING UP)

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

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

11.8.1 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

B. CHECK YOUR PROGRESS

Fill in the Blanks

1. Liquidation refers to the process of __________ a company and distributing its assets.
Answer: winding up

2. The main objective of liquidation is to __________ the debts and liabilities of the company.
Answer: settle

3. Liquidation is the legal ending of a company's __________.
Answer: existence

4. In liquidation, the company's assets are __________ to pay off debts.
Answer: sold

5. According to company law, liquidation is a __________ process to dissolve a company.
Answer: legal

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

11.8.2 Voluntary winding up

Voluntary winding up made either Members' voluntary winding up or Creditors—voluntary winding When a company's solvency is declared by 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

11.8.3 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.

C. CHECK YOUR PROGRESS

Fill in the Blanks

1. During liquidation, the company ceases to __________ as a business entity.
Answer: operate

2. __________ are the last to be paid in case of liquidation.
Answer: Shareholders

3. A major financial reason for liquidation is the company's inability to __________ its obligations.
Answer: pay

4. Continuous __________ losses can lead to the liquidation of a company.
Answer: operating

5. A company may be liquidated by court order if it fails to comply with __________ requirements.
Answer: statutory

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.

11.9 LETS US SUM UP

Liquidation refers to the legal process of winding up a company’s affairs by selling its assets to repay creditors and distributing any remaining funds to shareholders. The objective of liquidation is to ensure an orderly closure of business, protect creditor rights, and resolve financial or legal non-compliance.

It can occur due to various **financial** (like insolvency, continuous losses) or **legal** (non-compliance, court orders) reasons. Liquidation leads to the cessation of business operations, loss of jobs, and termination of contracts.

There are three main **modes of liquidation**:

1. **Compulsory Winding Up** – ordered by a tribunal or court.
2. **Voluntary Winding Up** – initiated by company members or creditors.
3. **Winding Up Under Court Supervision** – a court oversees a voluntary winding up due to irregularities.

Understanding these aspects helps in analyzing corporate failures and the importance of legal and financial compliance in business sustainability.

11.10 KEYWORDS

- **Liquidation** – The legal process of closing down a company by settling its debts and distributing any remaining assets.
- **Winding Up** – Another term for liquidation; the process by which a company’s existence is brought to an end.
- **Dissolution** – The final step in liquidation where the company legally ceases to exist.
- **Liquidator** – A person appointed to manage the process of liquidation, realize assets, pay liabilities, and distribute surplus.

- **Contributories** – Members or shareholders who may be called upon to contribute to the company's assets in case of a shortfall.
- **Insolvency** – A financial state where a company is unable to pay its debts.

11.11 SELF ASSESSMENT QUESTIONS

1. What is liquidation? Explain modes of liquidation.

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2. Explain the reasons for liquidation of companies.

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3. Explain consequences of Liquidation.

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11.12 SELF ASSESSMENT QUESTIONS

1. What is the process of voluntary winding up?

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2. What are the major consequences of liquidation for a company?

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3. What are the legal grounds under which a court may order liquidation?

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11.13 SUGGESTED READINGS

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UNIT III **B.Com 4th Semester**
Course No. BCG-401 **Lesson No. 12**

LIQUIDATOR

12.1 Introduction

12.2 Learning Objectives and Outcomes

12.3 Meaning of Liquidator

12.4 Power of Liquidator

12.5 Duties of Liquidator

12.1 INTRODUCTION

In the life cycle of a company, liquidation marks the final stage—an organized process to settle the company's affairs when it is no longer able or willing to continue operations. The person appointed to oversee this crucial phase is known as a liquidator. Whether appointed by a court, tribunal, creditors, or members, the liquidator plays a pivotal role in ensuring that the winding-up process is carried out fairly, legally and efficiently.

The powers and duties of a liquidator are central to the liquidation process. These powers allow the liquidator to take full control of the company's assets, continue the business temporarily if required, settle claims, initiate legal actions, and distribute the final proceeds among stakeholders. However, these powers are not absolute and must be exercised within the framework provided by the Companies Act, which may differ based on whether the liquidation is voluntary, compulsory or subject to tribunal supervision.

Simultaneously, the duties of the liquidator ensure accountability, transparency and ethical conduct. The liquidator is legally obliged to protect the rights of creditors, employees and shareholders, and to report all activities truthfully to the appropriate authorities. These duties include maintaining records, safeguarding assets, realizing outstanding dues, distributing funds in the correct order of priority, and ensuring compliance with all statutory obligations.

This chapter aims to provide a comprehensive understanding of the powers and duties of a liquidator under the Companies Act, highlighting their role in managing the legal and financial obligations of a company during its final stage. Understanding these responsibilities is essential for anyone involved in corporate governance, insolvency or financial restructuring.

12.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

By the end of this chapter, students will be able to:

1. Understand the concept and role of a liquidator in the winding-up process of a company.
2. Identify the circumstances under which a liquidator is appointed and by whom (e.g., court, creditors, shareholders).
3. Analyze the legal powers conferred on a liquidator under the Companies Act.
4. Understand the responsibilities and duties of a liquidator, including statutory reporting, asset management, and claim settlement.
5. Differentiate between the powers and duties of a liquidator in different types of liquidation (compulsory, voluntary, supervised).
6. Evaluate the importance of transparency and ethical conduct in the liquidation process.
7. Examine real-life cases involving liquidators to understand the practical application of their roles and powers.

Learning Outcomes

After studying this chapter, learners will be able to:

1. Define the role of a liquidator and explain their significance in the corporate liquidation process.
2. List and explain the powers a liquidator possesses during different forms of winding up.
3. Describe the key duties and responsibilities of a liquidator under the law.
4. Interpret and apply relevant provisions of the Companies Act relating to the liquidation process.
5. Analyze case-based scenarios involving misconduct, negligence, or overreach by a liquidator.
6. Develop a legally and ethically sound approach to handling liquidation duties in a simulated business scenario.

12.3 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 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.

A. CHECK YOUR PROGRESS

Multiple Choice Questions

1. Who appoints the liquidator in a compulsory winding-up?

a) Registrar of Companies

b) Board of Directors

c) National Company Law Tribunal (NCLT)

d) Ministry of Corporate Affairs

Answer: c) National Company Law Tribunal (NCLT)

2. The primary responsibility of a liquidator is to:

a) Promote company shares

b) Manage daily business operations

c) Collect and distribute company assets during winding up

d) Prepare the company's annual budget

Answer: c) Collect and distribute company assets during winding up

3. Which of the following is NOT a power of a liquidator?

a) To sell the company's assets

b) To file tax returns

c) To compromise with creditors

d) To initiate or defend legal proceedings

Answer: b) To file tax returns

4. What is a major fiduciary duty of a liquidator?
a) Maximizing company profit
b) Maintaining secrecy of company records
c) Ensuring fair treatment of all stakeholders
d) Promoting company business
Answer: c) Ensuring fair treatment of all stakeholders
5. The legal existence of the company comes to an end after:
a) Declaration of solvency
b) Appointment of a liquidator
c) Completion of asset distribution
d) Dissolution
Answer: d) Dissolution

12.4 POWER OF LIQUIDATOR

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

B. CHECK YOUR PROGRESS
Short Answer Questions

1. In which type of liquidation is a declaration of solvency required?
Answer: Members' voluntary winding-up

2. What is one of the key duties performed by a liquidator?
Answer: Submitting a statement of affairs to the Registrar

3. Under which law are a liquidator's powers defined?
Answer: Companies Act, 2013

4. What is a valid reason for the removal of a liquidator?
Answer: Negligence in performing duties

5. In whose interest is a liquidator legally bound to act?
Answer: In the interest of creditors and shareholders

i. To institute civil 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 carry on 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 may be necessary for the liquidation of the affairs of the company and distributing its assets.

12.5 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 must convene a meeting of the creditors to find out whether they would like to appoint a committee of inspection. A Liquidator must also supposed to convene meetings of creditors or contributories when requisitioned by at least 1/10 in value of the creditors or contributories; He is supposed 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 about setting contributories, lists, admitting claims, making calls, convening meetings of members etc.

C. CHECK YOUR PROGRESS

Fill in the Blanks

1. The person appointed to carry out the process of winding up of a company is known as the_________.

Answer: Liquidator

2. A liquidator is primarily responsible for collecting and distributing the company's _________.

Answer: Assets

3. The powers and duties of the liquidator are governed under the _________ Act, 2013.

Answer: Companies

4. In a compulsory winding up, the liquidator is appointed by the _________.

Answer: National Company Law Tribunal (NCLT)

5. A liquidator can institute or defend _________ on behalf of the company.

Answer: Legal proceedings / lawsuits

12.6 LET US SUM UP

In this chapter, we studied the essential role of the liquidator in the winding-up process of a company. The liquidator is an officer appointed by the court, creditors, or company members depending on the type of liquidation. Their primary role is to manage and oversee the orderly closure of a company's affairs.

The powers of a liquidator include selling the company's assets, taking legal action on behalf of the company, and making payments to creditors. The responsibilities of a liquidator extend beyond asset management to include accurate financial reporting, fair distribution of proceeds, and ensuring compliance with the provisions of the Companies Act.

The duties of a liquidator are both legal and fiduciary in nature, emphasizing integrity, fairness, and adherence to statutory obligations. Liquidators play a pivotal role in safeguarding the interests of creditors and shareholders during the liquidation process. They must act diligently and ethically to maintain trust in the corporate dissolution framework.

12.7 KEYWORDS

- **Liquidator**: A person appointed to wind up the affairs of a company during liquidation.

- **Winding Up**: The process of dissolving a company by selling its assets and paying off its liabilities.
- **Compulsory Liquidation**: Court-ordered dissolution of a company.
- **Voluntary Liquidation**: Winding up initiated by members or creditors.
- **Powers of Liquidator**: Legal rights granted to act on behalf of the company during liquidation.
- **Duties of Liquidator**: Statutory and ethical responsibilities in managing the liquidation process.
- **Realisation of Assets**: Converting company assets into cash for distribution.
- **Statement of Affairs**: A document showing the financial position of the company during liquidation.

12.8 SELF ASSESSMENT QUESTIONS

1. Mention any three powers of a liquidator as per the Companies Act.

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2. Explain the difference between the powers and duties of a liquidator.

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3. What is the significance of the liquidator's role in company liquidation?

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12.9 LESSON END EXERCISE

1. Explain the powers of a liquidator in both compulsory and voluntary winding up of a company.

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2. Discuss the duties and responsibilities of a liquidator under the Companies Act.

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3. What is the process followed by the liquidator in the realization and distribution of company assets?

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UNIT III **B.Com 4th Semester**
Course No. BCG-401 **Lesson No. 13**

STAKEHOLDERS IN LIQUIDATION

13.1 INTRODUCTION

The process of liquidation involves not just the dissolution of a company but also the distribution of its assets among various stakeholders. These stakeholders include contributories (members/shareholders), different categories of creditors, and sometimes the government. Each stakeholder has a specific role and claims in the liquidation process, governed by the provisions of the Companies Act. Understanding the rights, duties and hierarchy of these stakeholders is crucial for the fair and legal distribution of assets during winding up. This chapter explores who the stakeholders are, what claims they hold, and how they are treated under the law during the liquidation of a company.

13.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

This chapter aims to provide students with an in-depth understanding of the role and significance of stakeholders in the liquidation process. The specific objectives are:

- To introduce the concept and legal status of contributories in liquidation.
- To distinguish among various types of creditors and understand their priority in claim settlement.

- To understand how secured, unsecured, preferential, and contingent creditors are treated during winding up.
- To explain the order of repayment and rights of each class of stakeholder under the Companies Act.
- To build a conceptual foundation for understanding complex liquidation cases involving multiple stakeholders.

Learning Outcomes

After studying this chapter, learners will be able to:

- Define and explain the term contributory and identify who qualifies as a contributory during liquidation.
- Classify creditors into secured, unsecured, preferential and contingent categories.
- Understand the rights and priorities of each stakeholder group in the distribution of the company's assets.
- Analyze and interpret real-world examples of stakeholder claims during company liquidation.
- Apply theoretical knowledge to practical problems related to stakeholder settlements in liquidation proceedings.

13.3 MEANING OF CONTRIBUTORY

Members: If liabilities of the members of the companies are 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 nevertheless liable to pay the same.

A. CHECK YOUR PROGRESS

Short Answer Questions

1. Who is considered a contributory in the context of liquidation?

Answer: A person liable to contribute to the assets in case of winding up

2. Which of the following is not considered a type of creditor?

Answer: Participating creditor

3. Who are secured creditors?

Answer: Creditors who hold collateral against the debt

4. When are preferential creditors paid during liquidation?

Answer: After secured creditors but before unsecured creditors

5. In the liquidation of a solvent company, interest to creditors is paid up to which date?

Answer: Up to the date of actual payment

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, fulfil 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.

B. CHECK YOUR PROGRESS

Match the Following

Column A (Statement)	Column B (Correct Description)
1. Payment to debenture holders with floating charge	A. Asset-rich or liquidating companies
2. Equity shareholders receive payment	B. Combines asset and earning approaches
3. Arrears of dividend on cumulative preference shares	C. Startups or future-focused businesses
4. Contingent creditors	D. Stable profit-making companies
5. Preferential payment under the Companies Act	E. Listed companies with stock market data

Answers: 1 → d, 2 → c, 3 → a, 4 → b, 5 → e

13.4 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 pan pass

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 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:-
   a. Preference shares
   b. Equity shares

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

C. CHECK YOUR PROGRESS

Fill in the Blanks

1. A ___________ is a person who is liable to contribute to the assets of a company in the event of its winding up.
   Answer: contributory

2. ___________ creditors have a legal right or interest in specific company assets as security for their debt.
   Answer: Secured

3. Unsecured creditors are paid only after ___________ creditors have been paid in full.
   Answer: preferential

4. A ___________ charge covers all current and future assets of the company in a general way.
   Answer: floating

5. In the case of an ___________ company, interest is payable up to the date of commencement of liquidation.
   Answer: insolvent

b. **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 up to the date of actual payment. If the company is insolvent, the interest will be payable only up to 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, then calls in advance will have priority in repayment over the paid-up share capital of that class. Finally, the equity shareholder has 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.

13.5 LET US SUM UP

In this chapter, we explored the various stakeholders involved in the liquidation process of a company. These stakeholders include contributories, different categories of creditors, debenture holders, and shareholders. Each stakeholder has a specific position and entitlement in the order of repayment based on the company's solvency status.

A contributory is any person liable to contribute to the assets of a company in the event of its winding up. Creditors are classified into secured, unsecured, preferential, and contingent creditors. Secured creditors have legal rights over specific assets of the company, whereas unsecured creditors have no such security and are repaid after secured and preferential creditors. Preferential creditors, such as employees and tax authorities, enjoy statutory priority in repayment over others.

Debenture holders may hold either fixed or floating charges. Their rights in liquidation depend on the nature of the charge they hold. Preference is given to those with fixed charges, while those with floating charges are paid after preferential creditors.

Shareholders, both preference and equity are considered only after settling all outside claims. Preference shareholders have a right to capital repayment and in case of cumulative shares, arrears of dividends up to the date of liquidation. Equity shareholders are the last to be paid and are entitled to any remaining surplus after all other obligations are met. Calls-in-arrears and calls-in-advance are also accounted for before distributing the remaining capital.

Understanding this hierarchy of claims is essential for proper management of the liquidation process, ensuring fairness and legal compliance while settling a company's financial obligations.

13.6 KEYWORDS

- **Liquidation** – The process of winding up a company's financial affairs and distributing its assets.
- **Stakeholders** – Individuals or groups with an interest in the company's liquidation outcome, such as creditors, shareholders, and employees.
- **Contributory** – A person liable to contribute to the company's assets in case of winding up.
- **Secured Creditors** – Creditors who have specific legal claims (charges) over the company's assets.
- **Unsecured Creditors** – Creditors who do not hold any charge over company assets and are repaid after secured and preferential creditors.
- **Preferential Creditors** – Creditors granted priority by law, e.g., employees, government dues.
- **Contingent Creditors** – Creditors whose claim depends on the occurrence of a future event.
- **Fixed Charge** – A charge attached to a specific asset of the company.
- **Floating Charge** – A general charge over the company's assets that becomes fixed upon liquidation.
- **Calls-in-Arrears** – Unpaid amounts on partly paid shares that may be called up during liquidation.

- **Calls-in-Advance** – Amounts paid by shareholders before being called; these get repayment priority.

13.7 SELF ASSESSMENT QUESTIONS

1. Differentiate between fully secured and partly secured creditors in liquidation.

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2. Explain the rights of preference shareholders at the time of liquidation.

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3. Describe the position of debenture holders with fixed and floating charges during liquidation.

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13.8 LESSON END EXERCISE

1. Discuss the various types of creditors in the liquidation process.

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2. Explain the hierarchy of payments during the liquidation of a company.

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3. What is the treatment of arrears of dividends on cumulative preference shares during liquidation?

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13.9 SUGGESTED READINGS

- T.S. Grewal, Financial Accounting, Sultan Chand & Sons, 2023.
- S.N. Maheshwari & S.K. Maheshwari, Advanced Accountancy – Volume I, Vikas Publishing House Pvt. Ltd., 2022.
- P.C. Tulsian & Bharat Tulsian, Financial Accounting, S. Chand Publishing, 2023.
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UNIT III **B.Com 4th Semester**
Course No. BCG-401 **Lesson No. 14**

FINANCIAL ASPECTS OF LIQUIDATION

14.1 Introduction

14.2 Learning Objectives and Outcomes

14.3 Liquidator's Remuneration / Commission

14.4 Preparation of Statement of Affairs

14.1 INTRODUCTION

Liquidation is the final stage in the life of a company, involving the orderly winding up of its operations, settlement of liabilities, and distribution of surplus assets. The financial aspects of this process play a crucial role in ensuring legal compliance, fairness to stakeholders, and proper accountability. Two major components in this regard are the liquidator's remuneration or commission and the preparation of the Statement of Affairs.

The liquidator, being an officer appointed to administer the process of liquidation, is entitled to receive remuneration for the services rendered. The method of computing this commission and the legal provisions guiding it are essential for maintaining transparency and fairness.

The Statement of Affairs is a critical financial document prepared during liquidation. It provides a snapshot of the company's financial position, detailing its assets, liabilities, list of creditors (secured, unsecured, preferential), and the expected deficiency to be borne by contributors. This document helps in assessing the solvency status of the company and assists the stakeholders, particularly creditors, in understanding the prospects of recovery.

Understanding these financial dimensions is vital for commerce and management students to interpret the mechanics of winding-up procedures and the fiduciary responsibilities involved in closing down a business.

14.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

By the end of this chapter, students will be able to:

- Understand the concept and purpose of liquidator's remuneration and how it is calculated.
- Identify the legal provisions related to payment of commission to liquidators under the Companies Act.
- Explain the process and importance of preparing a Statement of Affairs during liquidation.

- Differentiate between various types of creditors shown in the Statement of Affairs.
- Learn how to determine deficiency in the context of contributors and its implications.
- Recognize the significance of accuracy and transparency in financial reporting during liquidation.

Learning Outcomes

After studying this chapter, the students will be able to:

- Calculate liquidator's remuneration based on fixed percentage or slab-wise commission.
- Prepare a Statement of Affairs showing assets (with expected realization), liabilities, and deficiency.
- Distinguish between different types of creditors: secured, unsecured, preferential, and contingent.
- Analyze and interpret the financial condition of a company undergoing liquidation.
- Appreciate the role of financial documentation in the equitable settlement of claims and responsibilities during company winding up.

14.3 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 supposed to get commission on the surplus from such assets left after making the payment of secured creditors as he tries 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 supposed to get a commission on realization of assets, he also gets a commission on (ash and bank balance unless otherwise stated.

A. CHECK YOUR PROGRESS
Match the Following

Column A	**Column B**
1. Paid first in case of liquidation	A. Equity shareholders
2. Entitled to receive residual surplus	B. Debenture holders
3. Have no security for their loan	C. Preferential creditors
4. Rank after preferential creditors under a floating charge	D. Unsecured creditors
5. Cumulative dividend paid after equity repayment	E. Cumulative preference shareholders

Answers: 1 → c), 2 → a) , 3 → d), 4 → b), 5 → e)

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:

a. If the funds available are adequate to pay off unsecured creditors, the liquidator's commission is calculated as:

Liquidator's Commission =

$$\frac{\text{Amount Payable to Unsecured Creditors} \times \text{Rate of Commission (\%)}}{100}$$

b. If the available amount is not enough to pay unsecured creditors in full, the liquidator's commission is calculated using the following formula:

Liquidator's Commission =

$$\frac{\text{Amount Payable to Unsecured Creditors} \times \text{Rate of Commission (\%)}}{100 + \text{Rate of Commission (\%)}}$$

14.4 PREPARATION OF 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;

B. CHECK YOUR PROGRESS
Fill in the Blanks

1. _________ shareholders have the last claim on the company's assets during liquidation.
Answer: Equity

2. Preferential creditors are paid _________ secured and unsecured creditors in an insolvent liquidation.
Answer: Before

3. A _________ creditor has a charge or claim on specific assets of the company.
Answer: Secured

4. Contingent creditors have a claim that arises based on the occurrence of a _________.
Answer: Future event

5. Interest is paid to debenture holders up to the date of _________ in case of an insolvent company.
Answer: Liquidation

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.
e. 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 / District Court at: (Original Jurisdiction)

In the matter of the Companies Act, 1956

In the matter of: [Company Name] Ltd.

Company Petition No: [Number] of [Year]

Statement of Affairs under Section 454

Statement of affairs of the above-named company as on the [Date] being the date of the winding-up order (or the order appointing the Provisional Liquidator or the date directed by the Official Liquidator).

I/We, [Name(s) and Address(es)], do solemnly affirm and say that the statement made herein and the several lists annexed hereto 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.

The said company carried on the following business: [State Nature of Business]

Signature(s):

Solemnly affirmed on [Date] before me Commissioner for Oaths

(Note: The Commissioner should ensure the full name, address, and description of deponent(s) are stated and initial any alterations. Lists annexed are not exhibits to the affidavit.)

STATEMENT OF AFFAIRS OF [Company Name] Ltd. (As on the date of winding-up order or as directed)

A. ASSETS NOT SPECIFICALLY PLEDGED (List A)

(Estimated Realisable Values)

- Balance at Bank
- Cash in Hand
- Marketable Securities
- Bills Receivable
- Trade Debtors
- Loans & Advances
- Unpaid Calls
- Stock-in-Trade
- Work-in-Progress
- Freehold Property
- Leasehold Property
- Plant & Machinery
- Furniture, Fittings, Utensils, etc.

- Investments (non-marketable)
- Livestock
- Other property, etc.

B. ASSETS SPECIFICALLY PLEDGED (List B)

- Freehold Property
- Estimated Surplus (if any)

Estimated Total Assets Available for:

- Preferential Creditors
- Debenture Holders (Floating Charge)
- Unsecured Creditors

SUMMARY OF GROSS ASSETS

- (a) Realisable Value of Specifically Pledged Assets
- (b) Other Assets (from above)

C. LIABILITIES

(As per Lists B–H)

- Secured Creditors (covered by List B)
- Preferential Creditors (List C)
- Debenture Holders (Floating Charge) (List D)
- Unsecured Creditors (List E)
    - Balance from specific asset claims
    - Trade Creditors
    - Bills Payable
    - Outstanding Expenses
    - Contingent Liabilities

D. SHARE CAPITAL

- Preference Shares (List F)
- Equity Shares (List G)

E. ESTIMATED SURPLUS/DEFICIENCY (List H)

LISTS (Annexures)

- **List A**: Assets not specifically pledged
- **List B**: Assets specifically pledged with secured creditors
- **List C**: Preferential creditors
- **List D**: Debenture holders with floating charge
- **List E**: Unsecured creditors
- **List F**: Preference shareholders
- **List G**: Equity shareholders
- **List H**: Deficiency or Surplus Account

DEFICIENCY OR SURPLUS ACCOUNT (List H)

Covering period: From [Start Date] to [Winding-up Date]

Items contributing to Deficiency:

1. Excess of liabilities over assets as per balance sheet
2. Net dividends/bonuses declared during the period
3. Net trading losses
4. Losses written off/provided for
5. Estimated losses for preparation of SoA
6. Other items increasing deficiency

Items contributing to Surplus: 7. Excess of assets over liabilities 8. Non-trading profits or income 9. Other surplus items

NOTES FOR PREPARATION

1. Ignore personal sureties.
2. Calls in arrear = Asset (List A).
3. Debentures assumed to have floating charge.
4. Even solvent companies may be liquidated.
5. Bills discounted = Contingent liability (List E).
6. Unclaimed dividends = Unsecured creditors (List E).
7. Fictitious assets (e.g., P&L debit, preliminary expenses) are excluded.
8. Interest:
    a. **Solvent company**: up to date of payment
    b. **Insolvent company**: up to commencement of winding-up only

Checklist for Completion:

- Free assets entered at realisable value
- Add surplus from pledged securities
- Deduct unsecured creditors and unsatisfied balances
- Deduct share capital
- Surplus or deficiency derived from above

C. CHECK YOUR PROGRESS

True or False

1. In case of an insolvent company, interest on debentures is payable till the date of actual payment.

Answer: False

2. Floating charge becomes fixed upon liquidation.

Answer: True

3. Calls in arrears reduce the capital liability of shareholders during liquidation.

Answer: False

4. Interest on debentures is never payable if the company is insolvent.

Answer: False

5. Calls in advance are considered as a liability in the statement of affairs.

Answer: True

14.5 LET US SUM UP

The liquidation process involves detailed financial disclosures and legal compliance, primarily managed by the liquidator appointed under the provisions of the Companies Act.

A liquidator's remuneration or commission is a fee allowed for the services rendered during the liquidation process. It is usually calculated as a percentage of the amount realized from assets and the amount distributed among unsecured creditors or shareholders.

The Statement of Affairs is prepared early in the liquidation process and provides a snapshot of the company's assets and liabilities. It includes various categories of creditors—secured, unsecured, preferential and contingent—and is crucial for understanding the financial position of the company at the time of winding up.

The Liquidator's Final Statement of Account is prepared at the end of the liquidation and details how all realized assets were applied toward payments—such as legal charges, liquidator's commission, and dues to creditors and shareholders.

Accuracy in these statements is essential for transparency, accountability and legal compliance and helps in ensuring fair treatment of all stakeholders involved in the liquidation.

14.6 KEYWORDS

- **Remuneration/Commission** – The payment made to the liquidator, usually calculated as a percentage of the assets realized and liabilities discharged.
- **Statement of Affairs** – A financial document prepared to show the company's assets, liabilities, and the expected value realizable from assets.
- **Secured Creditors** – Creditors who hold security against the loan provided to the company.
- **Unsecured Creditors** – Creditors without any collateral security; they are paid after secured and preferential creditors.
- **Preferential Creditors** – Creditors who have legal priority to be paid before others under the Companies Act (e.g., employees, taxes).
- **Deficiency** – The shortfall that arises when liabilities exceed assets.
- **Contributories** – Shareholders or members who are liable to contribute to the assets of the company in the event of winding up.
- **Final Statement of Account** – A detailed statement prepared by the liquidator showing how assets have been realized and distributed among claimants.

14.7 SELF ASSESSMENT QUESTIONS

1. Distinguish between cumulative and non-cumulative preference shares in liquidation context.

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2. How are debenture holders with both fixed and floating charges paid during liquidation?

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3. Write a note on the treatment of calls in arrears and calls in advance.

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14.8 LESSON END EXERCISE

1. Discuss the treatment of contingent and partly secured creditors during winding up.

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2. How is interest on debentures treated in a solvent vs. insolvent company?

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3. Describe the rights and priorities of Preference Shareholders in liquidation.

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14.9 SUGGESTED READINGS

- T.S. Grewal, Financial Accounting, Sultan Chand & Sons, 2023.
- S.N. Maheshwari & S.K. Maheshwari, Advanced Accountancy – Volume I, Vikas Publishing House Pvt. Ltd., 2022.
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UNIT III **B.Com 4th Semester**
Course No. BCG-401 **Lesson No. 15**

15.1 INTRODUCTION

This chapter focuses on the practical and accounting aspects involved in the final stage of company liquidation, the preparation of the Liquidator's Final Statement of Account. When a company goes into liquidation, the appointed liquidator is entrusted with the responsibility of realizing the company's assets, settling its liabilities and preparing an accurate final account that shows how the funds have been managed and distributed.

This final statement acts as a comprehensive summary of all the financial transactions carried out during the liquidation process. It highlights how much was collected from the sale of assets, what payments were made (including liquidation expenses, creditor claims, debentures, etc.), and what, if anything remains for the shareholders. The chapter will also include illustrative examples to help students understand the step-by-step preparation and format of the final statement.

By the end of this chapter, learners will not only understand the purpose and importance of this statement but will also be able to prepare it accurately, ensuring legal and financial transparency in the liquidation process.

15.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

The specific objectives of this chapter are:

- To understand the concept and importance of the Liquidator's Final Statement of Account.
- To learn the correct format and structure used in the final accounts during company liquidation.
- To develop the ability to apply accounting rules and legal provisions related to liquidation in a practical scenario.
- To analyse how payments are prioritized and how available funds are distributed among stakeholders.
- To gain familiarity with common items and entries appearing in a liquidator's final statement.

Learning Outcomes

After completing this chapter, students will be able to:

- Clearly explain the role of the final statement in the liquidation process.
- Accurately prepare the Liquidator's Final Statement of Account as per prescribed format.
- Apply relevant legal provisions and accounting treatments while calculating payments to creditors, debenture holders, and shareholders.
- Determine and classify different liabilities and understand their order of priority during liquidation.
- Analyse illustrative problems and construct a statement that reflects true and fair disclosure of financial information in the liquidation context.

15.2 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.

Liquidator's Final Statement of Account

(As per Schedule in line with the Companies Act, applicable rules)

Receipts	₹	Payments	₹
1. Balance at Bank (opening)		1. Legal charges	
2. Cash in hand		2. Liquidator's remuneration	
3. Sale of Assets:		3. Payment to secured creditors	
• Freehold Property		4. Preferential creditors	
• Leasehold Property		5. Unsecured creditors	
• Plant & Machinery		6. Debenture holders (with floating charge)	
• Furniture & Fixtures		7. Interest on debentures	
• Investments		8. Calls in advance repaid	
• Stock in trade		9. Other payments (e.g. unpaid wages, outstanding expenses)	
• Sundry Debtors		10. Return of capital to preference shareholders	
• Bills Receivable		11. Return of capital to equity shareholders	
4. Calls in arrears received			
5. Interest received			
6. Other income (if any)			
Total		**Total**	

ILLUSTRATION 1

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% Preference Shares 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, 000 and 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.

(1) 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, shares. 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.

A. CHECK YOUR PROGRESS

Short Answer Questions

1. When is the Liquidator's Final Statement of Account prepared?

Answer: At the end of liquidation.

2. Which document is NOT included in the Liquidator's Final Statement of Account?

Answer: Balance sheet of next year.

3. When are preferential creditors paid during liquidation?

Answer: Before all other creditors.

4. Who receives the remaining amount after all liabilities are paid off during liquidation?

Answer: Equity shareholders.

5. From where is the remuneration of the liquidator paid?

Answer: Realisation from assets.

ILLUSTRATION 2

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	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 produce Rs. 1,00,000)	1,50,000
Stock (Estimated to produce Rs. 40,000)	50,000
Machinery (Estimated to produce Rs. 2,000)	
Cash in Hand	100

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

B. CHECK YOUR PROGRESS
Fill in the Blanks

1. The liquidator is responsible for preparing the ___________ at the end of the liquidation.
   Answer: Final Statement of Account

2. ___________ creditors are given preference in payment over others.
   Answer: Preferential

3. The remaining amount after paying off all liabilities is distributed among ___________ shareholders.
   Answer: Equity

4. The process of selling assets during liquidation is known as ___________.
   Answer: Realisation

5. ___________ is the shortfall that arises when liabilities exceed assets.
   Answer: Deficiency

ILLUSTRATION 3

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 pro rata basis. Equity shareholders of 50 each have to pay 20 and receive 20 each. As a result, they would be getting nothing in return.

C. CHECK YOUR PROGRESS

Match the Following

Column A	Column B (Correct Description)
1. Cash received from asset sales	a) Receipt side
2. Liquidator's remuneration	b) Payment side
3. Unsecured creditor payment	c) After preferential creditors
4. Preferential creditors	d) Paid before unsecured creditors

Answers: 1 → a, 2 → b, 3 → c, 4 → d

ILLUSTRATION 4

A company in liquidation has the following details:

- Plant & Machinery sold for ₹2,50,000
- Stock sold for ₹1,00,000
- Sundry Debtors realized ₹50,000
- Cash in hand: ₹10,000
- Payments made:
    - Liquidator's remuneration: ₹25,000
    - Legal charges: ₹15,000
    - Payment to secured creditors: ₹1,50,000
    - Payment to unsecured creditors: ₹1,00,000

Prepare the Liquidator's Final Statement of Account.

Solution:

Liquidator's Final Statement of Account

Receipts	₹	Payments	₹
Balance (Cash in hand)	10,000	Legal charges	15,000
Sale of Plant & Machinery	2,50,000	Liquidator's remuneration	25,000
Sale of Stock	1,00,000	Payment to secured creditors	1,50,000
Realization of Sundry Debtors	50,000	Payment to unsecured creditors	1,00,000
Total Receipts	₹4,10,000	**Total Payments**	₹3,90,000

Closing Balance = ₹4,10,000 – ₹3,90,000 = ₹20,000

ILLUSTRATION 5

The following details are available from a company under liquidation:

- Sale of Land: ₹3,00,000
- Debtors collected: ₹75,000
- Cash at bank: ₹25,000
- Liquidator's remuneration: ₹20,000
- Legal expenses: ₹10,000
- Secured creditors paid: ₹2,50,000
- Preference shareholders returned: ₹50,000
- Equity shareholders returned: ₹25,000

Prepare the final statement of account.

Solution:

Liquidator's Final Statement of Account

Receipts	₹	Payments	₹
Bank balance	25,000	Legal charges	10,000
Sale of Land	3,00,000	Liquidator's remuneration	20,000
Collection from Debtors	75,000	Secured creditors	2,50,000
		Return to Preference shareholders	50,000
		Return to Equity shareholders	25,000
Total Receipts	₹4,00,000	**Total Payments**	₹3,55,000

Closing Balance = ₹45,000

ILLUSTRATION 7

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.

ILLUSTRATION 7

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).
iii. Prepare a statement of affairs and Deficiency account as regards creditors A/c.

Ans. Deficiency on regards to S/A Rs. 3, 76,000.

15.4 LET US SUM UP

In this chapter, we studied the final phase of a company's liquidation process—preparing the Liquidator's Final Statement of Account. The statement summarizes all receipts and payments made during the liquidation. It shows how the liquidator realized assets, paid off liabilities and distributed any remaining funds to shareholders.

We also understood the legal framework and accounting format used in liquidation, along with illustrative examples to reinforce practical understanding. This statement is crucial for ensuring transparency, accountability and legal compliance in closing a company.

15.5 KEYWORDS

- **Liquidator** – A person appointed to wind up the affairs of a company.
- **Final Statement of Account –** A summary of all receipts and payments made by the liquidator.
- **Preferential Creditors –** Creditors who are paid before others under law.
- **Realisation –** The process of selling the assets of the company.
- **Contributories** – Shareholders liable to contribute to the company's debts.
- **Deficiency –** The shortfall between liabilities and available assets.
- **Remuneration –** Compensation paid to the liquidator for services rendered.

15.6 SELF ASSESSMENT QUESTIONS

1. Explain the purpose and importance of preparing a Liquidator's Final Statement of Account.

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....

2. What are the rules for calculating liquidator's remuneration under the Companies Act and how does it affect the final distribution of assets?

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3. Differentiate between Preferential Creditors and Unsecured Creditors in the context of a liquidation. How are they treated while preparing the Final Statement of Account?

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....

....

15.7 LESSON END EXERCISE

Question 1: The following information relates to XYZ Ltd., which is under liquidation. You are required to prepare the Liquidator's Final Statement of Account:

- Assets realised:
  - Land and Building: ₹2,00,000
  - Plant and Machinery: ₹1,20,000
  - Stock: ₹80,000
  - Debtors: ₹1,00,000
- Payments made:
  - Liquidator's remuneration: 3% on assets realised and 2% on payments to unsecured creditors
  - Preferential creditors: ₹30,000
  - Unsecured creditors: ₹1,50,000
  - Debenture holders (with floating charge): ₹1,00,000
  - Expenses of liquidation: ₹10,000

Prepare Liquidator's Final Statement of Account showing receipts and payments.

Question 2: A company is in the process of liquidation. The liquidator has realised the following assets:

- Land and Building: ₹3,50,000
- Furniture: ₹50,000
- Stock: ₹70,000
- Debtors: ₹30,000

Other details are:

- Liquidator's remuneration: 5% on amount realised
- Preferential creditors: ₹20,000
- Unsecured creditors: ₹80,000
- Debenture holders with floating charge: ₹1,00,000
- Equity share capital: 5,000 shares of ₹100 each, ₹75 paid
- Call of ₹25 made on 2,000 shares

You are required to prepare the Liquidator's Final Statement of Account.

Question 3: From the following details, prepare the Final Statement of Account:

- Assets Realised:
  - Building: ₹5,00,000

- Machinery: ₹3,00,000
- Vehicles: ₹50,000
- Debtors: ₹1,20,000

- Liabilities:
  - Secured Creditors (on Building): ₹2,00,000
  - Debenture Holders with floating charge: ₹2,50,000
  - Preferential Creditors: ₹30,000
  - Unsecured Creditors: ₹3,00,000
  - Expenses of liquidation: ₹20,000
  - Liquidator’s remuneration: 2% on amount realised and 3% on payments made to unsecured creditors

Also mention if there is any deficiency or surplus and how it will be treated.

Question 4: Assets Realised:

- Freehold Property: ₹4,00,000
- Plant & Machinery: ₹1,50,000
- Debtors: ₹80,000
- Cash at Bank: ₹20,000

Payments to be made:

- Liquidation expenses: ₹25,000
- Preferential creditors: ₹35,000
- Secured creditors: ₹1,00,000
- Unsecured creditors: ₹2,50,000
- Liquidator’s remuneration: 2% on total assets realised and 3% on payments made to unsecured creditors

Equity Capital:

- 6,000 equity shares of ₹100 each ₹75 paid
- Call of ₹25 made on all shares. Only 5,800 shares paid the call; 200 did not.
- 100 shares had already paid ₹25 in advance.

Prepare the Liquidator’s Final Statement of Account and explain the treatment of calls in arrears and calls in advance.

Solution 1) ₹1,92,000 2) ₹1,14,000 3) ₹16,000 Surplus 4) ₹77,000 Surplus

15.8 SUGGESTED READINGS

- T.S. Grewal, Financial Accounting, Sultan Chand & Sons, 2023.
- S.N. Maheshwari & S.K. Maheshwari, Advanced Accountancy – Volume I, Vikas Publishing House Pvt. Ltd., 2022.
- P.C. Tulsian & Bharat Tulsian, Financial Accounting, S. Chand Publishing, 2023.

M.C. Shukla, T.S. Grewal & S.C. Gupta, Advanced Accounts, S. Chand Publishing, 2023.

UNIT IV **B.Com 4th Semester**
Course No. BCG-401 **Lesson No. 16**

ALTERATION OF SHARE CAPITAL & INTERNAL RECONSTRUCTION

16.1 INTRODUCTION

This chapter introduces the foundational concept of internal reconstruction, its need in corporate financial management and the essential differences between internal and external reconstruction. It also explores the purpose, scope and various scenarios that necessitate this process, such as recurring losses, overvalued assets or excessive liabilities.

Understanding internal reconstruction is vital for students of commerce and accountancy as it demonstrates how companies attempt to restore financial health, maintain investor confidence, and ensure long-term sustainability without ceasing business operations.

16.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

The primary objectives of this chapter are to help students:

- Understand the concept and meaning of internal reconstruction.
- Recognize the importance of internal reconstruction in the financial management of distressed companies.
- Differentiate between internal and external reconstruction.
- Identify various circumstances that necessitate internal reconstruction, such as recurring losses, overvalued assets, or compliance issues.
- Gain a preliminary understanding of the purpose and scope of internal reconstruction within the framework of the Companies Act.

Learning Outcomes

After studying this chapter, students will be able to:

- Clearly define internal reconstruction and explain its significance.
- Compare and contrast internal and external reconstruction with relevant examples.
- Identify key financial or structural issues in a company that may require internal reconstruction.
- Explain how internal reconstruction can help a company regain financial stability without dissolving or merging.
- Apply the conceptual knowledge to understand the next steps, such as capital reduction and accounting treatment, in the internal reconstruction process.

16.3 CONCEPT OF INTERNAL RECONSTRUCTION

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.

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.

16.4 PURPOSE OF INTERNAL RECONSTRUCTION

The main purpose of internal reconstruction is to restructure the financial position of a company without altering its legal existence. It is typically undertaken when a company is facing heavy losses, has overvalued assets, or is burdened by liabilities that prevent it from operating profitably.

Key purposes include:

1. Eliminating Accumulated Losses: Companies can write off past losses by reducing capital or revaluing assets.
2. Restoring Financial Health: It helps revive the company by presenting a healthier balance sheet to investors, creditors, and the market.
3. Avoiding Liquidation: Rather than winding up, internal reconstruction allows the company to continue its operations.
4. Maintaining Shareholder and Creditor Confidence: A reconstructed balance sheet shows better prospects and builds trust.
5. Legal Compliance and Regulatory Clean-up: It may be done to rectify issues that make the company non-compliant with laws and listing norms.

A. CHECK YOUR PROGRESS

True or False

1. Internal reconstruction is mainly undertaken to merge with another company.

Answer: False

2. Section 66 of the Companies Act permits share capital reduction in India.

Answer: True

3. Issue of debentures is considered a method of internal reconstruction.

Answer: False

4. Surrender of shares involves shareholders voluntarily returning their shares.

Answer: True

5. Revaluation of assets under internal reconstruction is done to match their market value.

Answer: True

16.5 SCOPE OF INTERNAL RECONSTRUCTION

The scope of internal reconstruction is broad and strategic, covering various financial, legal, and accounting aspects of a business.

It includes:

1. Reduction of Share Capital: Cancelling or reducing paid-up capital that is lost or unrepresented by assets.
2. Revaluation of Assets and Liabilities: Bringing them to their fair value to reflect a more accurate financial position.
3. Settlement or Reorganization of Creditors' Claims: Negotiating revised terms with creditors, sometimes accepting part-payment or conversion to equity.
4. Writing off Intangible or Fictitious Assets: Such as accumulated losses, goodwill, or deferred revenue expenses.
5. Altering the Structure of Shares or Debentures: This may include converting preference shares to equity or modifying terms.

B. CHECK YOUR PROGRESS
Fill in the Blanks

1. Internal reconstruction is carried out without __________ the company.
   Answer: liquidating

2. Reduction of capital is governed by Section ______ of the Companies Act, 2013.
   Answer: 66

3. __________ of assets means changing the value of assets to reflect current market value.
   Answer: Revaluation

4. When a shareholder voluntarily gives up his shares, it is called __________ of shares.
   Answer: surrender

5. Internal reconstruction helps in writing off __________ losses.
   Answer: accumulated

16.6 MEANING OF ALTERNATION 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	(1,00,000 shares of Rs. 10 each) 8,00,000 (80,000 shares of Rs. 10 each

		stock	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. 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.

16.7 CONSEQUENCES OF LIQUIDATION

Liquidation refers to the process of winding up a company's affairs, during which its assets are sold off, liabilities paid, and any remaining surplus distributed among the shareholders. The consequences of liquidation are both legal and financial, and they impact various stakeholders of the company, including shareholders, creditors, employees, and directors.

1. Cessation of Business Operations

- The company ceases to carry out its normal business activities. It continues to exist only for the purpose of winding up.
- No new business transactions (other than those necessary for liquidation) can be initiated.

2. Appointment of a Liquidator

- A liquidator is appointed by the tribunal or the shareholders (depending on the type of liquidation).
- The powers of the board of directors are suspended, and the liquidator takes over management and control of the company’s affairs.

3. Realisation of Assets

- All assets of the company are sold (realised), either piece by piece or as a whole.
- The proceeds are used to discharge liabilities.

4. Payment of Liabilities

- Payments are made in the following order:
    - Costs of liquidation (including liquidator's remuneration)
    - Secured creditors
    - Preferential creditors (e.g., unpaid wages, taxes)
    - Unsecured creditors
    - Shareholders (preference shareholders before equity)

5. Termination of Contracts

- Most of the company's contracts, including employment contracts, are automatically terminated unless otherwise agreed upon.
- Employees may become preferential creditors for unpaid wages or other dues.

6. Legal Proceedings Are Stayed

- No new legal proceedings can be initiated or continued against the company without the permission of the tribunal or the liquidator.

7. Loss of Stake for Shareholders

- Equity shareholders are the last to be paid and often receive nothing if the company's liabilities exceed its assets.
- Preference shareholders may receive payment only after creditors are fully satisfied.

8. Dissolution of Company

- After the liquidation process is complete and the final accounts are submitted, the company is officially dissolved by the order of the tribunal or registrar.
- The company ceases to exist as a legal entity.

9. Implications for Directors and Officers

- Directors may face investigations regarding the conduct of business.
- If found guilty of fraud or misconduct, they may face penalties or be disqualified from holding directorships in the future.

10. Impact on Stakeholders

- Creditors may not recover the full amount due.
- Employees may lose jobs and pending dues.
- Investors may lose their entire investment.
- The economy may feel a ripple effect, especially if the company was large or in a key sector.

C. CHECK YOUR PROGRESS
One Word Answer

1. Liquidation leads to the ___________ of business operations.

   Answer: Cessation

2. During liquidation, a ___________ is appointed to manage the winding-up process.
   Answer: Liquidator

3. All assets of the company are ___________ to pay liabilities.
   Answer: Realised

4. Employees with unpaid wages are treated as ___________ creditors.
   Answer: Preferential

5. After liquidation, the company is officially ___________ by the tribunal.
   Answer: Dissolved

16.8 LET US SUM UP

Internal Reconstruction is a strategic financial reorganization carried out by a company facing financial distress, with the goal of reviving its operations without opting for liquidation. It involves adjustments within the company's existing legal framework, allowing it to continue as the same legal entity. The primary objective of internal reconstruction is to improve the company's financial position by writing off accumulated losses, revaluing over- or under-valued assets, and restructuring liabilities. This process aims to restore investor confidence, enhance operational efficiency, and ensure the company's long-term sustainability.

The scope of internal reconstruction is wide-ranging. It may include altering the capital structure by consolidating or subdividing shares, reducing share capital, settling outstanding obligations with creditors, or modifying shareholder rights. Unlike external reconstruction, internal reconstruction is an in-house corrective action and does not involve forming a new company or transferring assets and liabilities to a different entity.

An essential aspect of internal reconstruction is the alteration of share capital, which refers to changes such as consolidation (merging multiple smaller shares into one of higher value), subdivision (splitting shares into smaller denominations), reduction of capital (to eliminate losses or liabilities), or cancellation of unissued shares. These adjustments must comply with the provisions of the Companies Act.

Finally, understanding the consequences of liquidation such as business closure, loss of employment, stakeholder losses, and dissolution of the company underscores the importance of internal reconstruction. It acts as a preventive and corrective strategy, allowing companies to recover and avoid the severe implications of being wound up.

16.9 KEYWORDS

- **Internal Reconstruction -** A process by which a company reorganizes its capital structure without undergoing liquidation, to eliminate accumulated losses and restore financial health.
- **Capital Restructuring -** Changing the composition of equity and debt in a company's capital to improve financial stability and operational efficiency.
- **Reduction of Capital -** Decreasing the issued share capital, often by reducing the face value of shares or cancelling unpaid share capital to write off losses.
- **Alteration of Share Capital -** Modification in the structure of share capital through consolidation, subdivision, increase, or reduction of shares, as allowed by law.
- **Reorganization of Shareholders' Rights -** Adjusting the rights attached to different classes of shares (e.g., preference vs. equity shares) during reconstruction to balance interests.
- **Accumulated Losses -** Past losses recorded on the balance sheet that have not been written off; these reduce the net worth of a company.
- **Solvency -** The company's ability to meet its long-term obligations; internal reconstruction helps in regaining solvency.
- **Write-off -** The accounting process of removing a loss, liability, or asset from the books, often done during internal reconstruction to clear bad debts or fictitious assets.
- **Revaluation of Assets -** The process of reassessing the value of assets to reflect their fair market value, done to present a true financial position.
- **Scheme of Reconstruction -** A formal plan approved by shareholders and creditors outlining the steps for internal restructuring.
- **Surrender of Shares -** When shareholders voluntarily give up their shares, which may then be reissued or cancelled as part of the reconstruction.
- **Creditors' Settlement -** Negotiating with creditors to accept reduced payments or new terms to reduce the company's liability burden.
- **Share Capital Adjustment -** Modifying the amount or structure of share capital to align with the company's reconstructed financial framework.

- **Revival of Company -** The process of restoring a company's profitability and market reputation through strategic financial adjustments.
- **Companies Act Provisions -** Legal guidelines under the Companies Act that regulate the procedures for internal reconstruction and share capital alteration.
- **Consolidation of Shares -** Combining two or more existing shares into a single share of higher value (e.g., 10 shares of ₹1 into 1 share of ₹10).
- **Subdivision of Shares -** Splitting a share into multiple shares of smaller denominations (e.g., 1 share of ₹10 into 10 shares of ₹1).
- **Liquidation -** The process of winding up a company's affairs by selling its assets to pay off liabilities, avoided through successful reconstruction.

16.10 SELF ASSESSMENT QUESTIONS

1. State two methods of internal reconstruction.

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2. Define 'alteration of share capital' under the Companies Act.

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3. What is meant by capital reduction?

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16.11 LESSON END EXERCISE

1. Describe the consequences of liquidation and suggest how reconstruction can prevent it.

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2. Differentiate between internal and external reconstruction with examples.

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3. Discuss the objective and scope of internal reconstruction.

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16.12 SUGGESTED READINGS

- T.S. Grewal, Financial Accounting, Sultan Chand & Sons, 2023.
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UNIT IV **B.Com 4th Semester**

Course No. BCG-401 **Lesson No. 17**

CAPITAL REDUCTION AND LEGAL FRAMEWORK

17.1 Introduction

17.2 Learning Objectives and Outcomes

17.1 INTRODUCTION

This chapter provides a comprehensive understanding of internal reconstruction through capital reduction, a method adopted by financially distressed companies to reorganize their capital structure without dissolving the entity. Internal reconstruction enables companies to wipe off accumulated losses, revalue assets and liabilities, and present a healthier financial position.

One of the most significant methods of internal reconstruction is capital reduction, which involves decreasing the share capital of a company either by reducing the face value of shares, canceling unpaid capital, or writing off fictitious or non-represented assets.

The Companies Act provides a legal framework under which such reduction can be carried out, subject to necessary approvals from the shareholders, the National Company Law Tribunal (NCLT), and creditors (if applicable). The chapter also explores different forms of capital reduction and the procedural steps involved in executing them.

17.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

The primary objectives of this chapter are to help students:

- To explain the concept and importance of internal reconstruction through capital reduction.
- To help students understand the legal provisions of the Companies Act related to capital reduction.
- To familiarize learners with the forms of capital reduction, such as writing off losses and refunding surplus capital.

- To explain the procedure and steps involved in reducing share capital, including required approvals.
- To clarify the role of shareholders, creditors and the tribunal (NCLT) in the process.
- To develop the ability to apply accounting treatment and journal entries related to capital reduction.

Learning Outcomes

After studying this chapter, learners will be able to:

- Define and explain the term capital reduction in the context of internal reconstruction.
- Demonstrate knowledge of the legal procedures and approvals required for reducing share capital.
- Describe the various forms and purposes of capital reduction with practical examples.
- Analyze how internal reconstruction through capital reduction improves a company's financial stability and helps in reviving operations.
- Apply the understanding to solve practical problems involving capital reduction entries and balance sheet adjustment.

17.3 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) Rs. 16,00,000

(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)

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:

Share Capital A/c .... Dr. Rs. 1,60,000

To Shareholders A/c Rs. 1,60,000

(Being the amount to be repaid to shareholders On reduction of paid-up capital)

Shareholders A/c.............................. Dr Rs. 1,60,000

To Bank A/c Rs. 1,60,000

1,60,000

(Being the amount paid off)

Profit & Loss A/c.............................. Dr 1,60,000

To General Reserve A/c Rs. 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 .... Dr 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:

Share Capital A/c (Rs. 10) .... Dr   Rs. 8

To Share Capital A/c (Rs. 6)   Rs. 6

To Capital Reduction A/c   Rs. 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 them. consent to such types of capital reduction, the company will have to settle their claims before getting sanction from the court.

17.4 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.

A. CHECK YOUR PROGRESS

Short Answer Questions

1. What does internal reconstruction primarily involve?

Answer: Reorganizing the internal financial structure of a company.

2. Under which section of the Companies Act, 2013 is capital reduction governed?

Answer: Section 66.

3. What approvals are required for a valid capital reduction under the Companies Act, 2013?

Answer: Approval by a special resolution and confirmation by the National Company Law Tribunal (NCLT).

4. Name one process that is *not* considered a method of capital reduction.

Answer: Issuing bonus shares.

5.Who must approve the reduction of share capital through a special resolution?

Answer: The shareholders of the company.

B. CHECK YOUR PROGRESS
Fill in the Blanks

1. Internal reconstruction refers to changes made in the ____________ structure of the company without winding up.
Answer: capital

2. A __________ resolution is required for reducing share capital under the Companies Act, 2013.
Answer: special

3. Capital reduction must be confirmed by the ____________.
Answer: National Company Law Tribunal (NCLT)

4. Cancelling uncalled capital is a form of ____________.
Answer: capital reduction

5. The main purpose of internal reconstruction is to eliminate __________ losses.
Answer: accumulated

C. CHECK YOUR PROGRESS
Short Answer Questions

1. Define internal reconstruction.

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2. Mention any two forms of capital reduction.

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3. What legal procedure must be followed for reducing share capital?

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17.5 LET US SUM UP

Internal reconstruction is a strategic process through which a company reorganizes its financial structure internally without being dissolved or forming a new entity. It is typically undertaken to improve financial stability and efficiency, especially when the company has accumulated losses or needs to adjust its capital structure. One of the key aspects of internal reconstruction is capital reduction, which is used to write off accumulated losses, cancel uncalled capital, or refund surplus capital to shareholders. As per Section 66 of the Companies Act, 2013, this process requires approval by a special resolution of the shareholders and confirmation by the National Company Law Tribunal (NCLT). The purpose of capital reduction is to ensure fair treatment of creditors, improve transparency in financial reporting, and restore the company's credibility. Common forms of capital reduction include writing off past losses, cancelling uncalled capital, and refunding surplus paid-up capital.

17.6 KEYWORDS

- **Internal Reconstruction:** A process of reorganizing a company's capital structure without dissolving it. It helps eliminate accumulated losses and improve financial health.
- **Capital Reduction:** A strategy under internal reconstruction that involves reducing a company's share capital to write off losses, return excess capital, or restructure debt.
- **Accumulated Losses**: Losses incurred over time that are carried forward in the company's financial statements. These can be adjusted through capital reduction.
- **Special Resolution:** A resolution passed by at least 75% of shareholders' votes, required for approving capital reduction under the Companies Act.
- **NCLT (National Company Law Tribunal):** A quasi-judicial body in India that approves corporate restructuring activities such as capital reduction, mergers, and liquidations.
- **Court Approval:** Mandatory confirmation by the NCLT to ensure fairness and legality of the capital reduction process.
- **Loss Absorption:** The process of adjusting or eliminating past losses using capital reduction or other accounting techniques.
- **Balance Sheet Restructuring:** Adjusting the components of a company's balance sheet (such as share capital and reserves) to reflect its true financial condition.
- **Reorganization Scheme:** A formal plan outlining the steps and methods a company will adopt during internal reconstruction or capital reduction.

17.7 SELF ASSESSMENT QUESTIONS

1. What do you mean by capital reduction? Explain its purpose.

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2. State the legal provisions under the Companies Act related to reduction of share capital.

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3. Mention any three forms of capital reduction with examples.

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17.7 LESSON END EXERCISE

1. Why is the approval of the National Company Law Tribunal (NCLT) necessary in case of capital reduction?

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2. What precautions must be taken to protect the interests of creditors during capital reduction?

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3. What role does the shareholders' resolution play in the process of capital reduction?

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17.8 SUGGESTED READINGS

- T.S. Grewal, Financial Accounting, Sultan Chand & Sons, 2023.
- S.N. Maheshwari & S.K. Maheshwari, Advanced Accountancy – Volume I, Vikas Publishing House Pvt. Ltd., 2022.
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UNIT IV **B.Com 4th Semester**
Course No. BCG-401 **Lesson No. 18**

ACCOUNTING TREATMENT IN INTERNAL

18.1 INTRODUCTION

This chapter focuses on Internal Reconstruction, specifically the reduction of share capital as a key method of reorganizing a financially distressed company. Internal reconstruction is an important mechanism through which a company reorganizes its capital structure without going through liquidation or external mergers. It is generally adopted when a company has accumulated heavy losses, overvalued assets, or an imbalanced capital structure.

One of the major forms of internal reconstruction is capital reduction, which involves reducing a company's issued, subscribed, or paid-up capital. This is done with the intention to write off past losses, eliminate fictitious assets, or return surplus capital to shareholders. The process of capital reduction is governed by specific legal provisions under the Companies Act, 2013 (Section 66), and requires approval from both the shareholders and the National Company Law Tribunal (NCLT).

This chapter explores the legal framework, procedural requirements, and forms of capital reduction in detail and helps students understand the practical implications of internal reconstruction through illustrative examples and case-based learning.

18.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

After studying this chapter, students will be able to:

- Understand the meaning and significance of internal reconstruction.
- Identify the difference between internal and external reconstruction.
- Explain the concept and purpose of capital reduction as a form of internal restructuring.
- Comprehend the legal provisions under Section 66 of the Companies Act, 2013 regarding reduction of share capital.
- Understand the role of NCLT and shareholders' approval in the capital reduction process.
- Describe the various forms of capital reduction, such as writing off losses, refund of surplus capital, and cancellation of uncalled capital.
- Learn the procedural steps involved in implementing a scheme of capital reduction.

Learning Outcomes

By the end of this chapter, learners will be able to:

- Define and explain internal reconstruction and its relevance in corporate restructuring.
- Differentiate between internal and external methods of reconstruction.
- Describe capital reduction and its application in reviving financially weak companies.
- Apply knowledge of the Companies Act to assess the legal and procedural aspects of reducing share capital.

- Analyze the role of key stakeholders such as shareholders, creditors, and regulatory authorities in the reconstruction process.
- Illustrate different forms of capital reduction through practical examples and journal entries.
- Evaluate the financial implications of capital reduction for stakeholders and the company's future prospects.

18.3 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 loss Account	
Interest Accrued Theare on	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 account 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:

1. Journal Entries

	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 (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)		80,000
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 (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)		80,000
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)		

2. 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 Current Assets	20,000	To Securities Premium A/c	25,000
To Loss on Sale of Investments	15,000	By Freehold Property A/c (Profit)	55,000
To Goodwill written off	50,000		
To Share Issue Expenses	20,000		
To Profit & Less A/c (Bal.)	1,10,000		

	2,50,000		2,50,0 00

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.

3. Cash Account

	Rs	Rs.		Rs.
. To Freehold Property	1,30,000		Balanced c/d	56,000
Less : Debenture holders	84,000			
		46,000		
To investments A/c		10,000		
		56,000		56,000

4. 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 Rs. 10 each	1,00,000	Lensehold Property	1,00,000	
25,000 Equity Shares of Rs. 10 each	2,50,000	Less : Written of under reconstruction scheme dated......	20,000	
Issued Subscribed and Paid up				80,000
8,00 10% Cum. Pref. Shares of Rs. 10 each	80,000	Plant and Machinery	60,000	
10,500 Equity Shares of Rs. 10 each (of the above 10,500 equity shares 500 equity shares were issued for consideration other than cash)	1,05,000	Less : Written off under reconstruction scheme dated.......	10,000	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	Amount (Rs.)	Assets	Amount (Rs.)
Share Capital		**Freehold Property,**	3,50,000
2,000 6% Cum. Preference Shares of ₹100	2,00,000	**Plant**	50,000
75,000 Equity Shares of ₹10 each fully paid	7,50,000	**Trade Investments (at Cost)**	60,000
6% Debentures (Secured by Property)	3,75,000	**Stock**	2,00,000
Accrued Interest on Debentures	22,500	**Deferred Advertising Expenditure**	1,50,000
Creditors	12,500	**Profit & Loss A/c (Debit)**	3,50,000
Directors' Loan	2,00,000	**Debtors**	4,00,000
Total	**15,60,000**	**Total**	**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.

Particulars		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 equity shares 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 issue of Rs. 12,000 equity shares to the extent of 25% of Rs. 48,000)			
Accrued Debentures Interest A/c	Dr.	22,500	
To Bank			22,500
(Being Accrued debentures interest paid)			
6%DebenturesA/c Dr.		1,50,000	
To Freehold Property A/c			1,50,000
(Being Claim of debenture holders 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%Debentures issued for Cash)			

Capital Reduction A/c Dr. To Profit & Loss A/c To Deferred Advertising Expenses A/c To Stock A/c To Bad Debts A/c (Being various assets written off as per reconstruction scheme)	9,33,000	3,50,000 1,50,000 2,00,000 2,33,000
Freehold Property A/c Dr. To Capital Reduction A/c (Being appreciation in value of property Rs. 4,00,000 – [3,50,000 – 1,50,000])	2,00,000	2,00,000
Bank A/c Dr. To Trade Investments A/c To Capital Reduction A/c (Being trade investments sold and profit transferred to Capital Reduction A/c)	1,50,000	60,000 90,000
Directors' Loan A/c Dr. To Equity Share Capital A/c To Capital Reduction A/c (Being directors' loan discharged by issue of share capital and balance transferred to capital reduction)	2,00,000	1,80,000 20,000
Capital Reduction A/c Dr. To Bank A/c (Being payment of 5% penalty for cancellation of capital commitments of ₹3,00,000)	15,000	15,000

BALANCE SHEET OFA & CO. (After Reconstruction)

as on 1st April, 2008

Liabilities	Amount (₹)	Assets	Amount (₹)
Share Capital:		Fixed Assets:	
Equity Shares: 1,71,000 shares of ₹2 each	3,42,000	Freehold Property *(including ₹2,00,000 appreciation)*	4,00,000
(of which 90,000 shares for consideration other than cash)		Plant	50,000
6% Cumulative Preference Shares of ₹75 each (2,000 shares, fully paid)	1,50,000		
		Current Assets, Loans & Advances:	

Secured Loans:		Debtors (₹4,00,000 – ₹2,33,000)	1,67,000
6% Debentures	1,30,000	Cash at Bank *(₹1,30,000 + ₹1,50,000 – ₹22,500 – ₹15,000)*	2,42,500
10% Debentures	1,30,000		
Current Liabilities: Creditors	12,500		
Total	8,59,000	Total	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 each, Rs. 5 paid	10,00,000	Fixed Assets	11,40,000
		Patents and Copyrights	80,000
6,000 8% Preference Shares of Rs. 100 each	6,00,000	Investments at cost (Market value Rs. 55,000)	65,000
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 Accrued 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

i. 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.

viii. 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

Date	Particulars	Dr. Amount (₹)	Cr. Amount (₹)
31st March 2008	8% Preference Share Capital A/c Dr. To Preference Shareholders A/c To Capital Reduction A/c *(Being 30% of claim given up by preference shareholders as per reconstruction scheme)*	6,00,000	 4,20,000 1,80,000
	Capital Reduction A/c Dr. To Preference Shareholders A/c *(Being 70% of arrears of preference dividend payable as per reconstruction scheme)*	33,600	 33,600
	Preference Shareholders A/c Dr. To Bank A/c *(Being amount due to preference shareholders discharged)*	4,53,000	 4,53,000
	9% Debentures A/c Dr. Interest Accrued on Debentures A/c Dr. To 12% Debentures A/c To Capital Reduction A/c *(9% debentures converted into 12%; interest sacrificed as per scheme)*	6,00,000 1,08,000	 6,00,000 1,08,000
	Bank of India A/c Dr. Interest Accrued on Bank Overdraft A/c Dr. To Bank A/c To Capital Reduction A/c *(Bank overdraft settled; interest partly waived)*	1,50,000 15,000	 1,57,500 7,500
	Creditors A/c Dr. To Bank A/c To Capital Reduction A/c *(Creditors settled at 95%; 5% waived and credited to capital reduction)*	69,000	 65,550 3,450

	Capital Reduction A/c Dr. To Profit & Loss A/c To Patents & Copyrights A/c To Debtors A/c To Investments A/c To Fixed Assets A/c *(Assets written down and losses written off per reconstruction scheme)*	5,62,000	 4,08,000 80,000 30,000 10,000 34,000
	Equity Share Capital A/c Dr. To Capital Reduction A/c *(Reduction in face value of equity shares per Board Resolution)*	3,00,000	 3,00,000
	Bank A/c Dr. To Equity Share Capital A/c *(Amount received on fresh issue of equity shares)*	7,00,000	 7,00,000
	Capital Reduction A/c Dr. To Bank A/c *(Reconstruction expenses paid from capital reduction account)*	3,350	 3,350

BALANCE SHEET OF XY LTD. (And Reduced)

as on 31st March, 2008

Liabilities	Amount (₹)	Assets	Amount (₹)
Share Capital		Fixed Assets (₹11,40,000 – ₹34,000 written off)	11,06,000
Issued & Paid-up: 2,00,000 Equity Shares		Investments	4,00,000
of ₹10 each, ₹7 paid-up	14,00,000	Current Assets:	
		Stock	4,09,000
Secured Loans:		Debtors	30,000
12% Debentures	6,00,000	Bank	30,000
Total	**20,00,000**	**Total**	**20,00,000**

Working Notes:

1. **Statement Showing Liabilities and Equity Sacrificed and Their Uses as per Scheme**

Liabilities and Equity Sacrificed	Amount (₹)	Uses	Amount (₹)
Preference Shareholders (30% of ₹6,00,000)	1,80,000	Reconstruction Expenses	3,350
Debenture Holders (Interest on Debentures)	1,08,000	Profit and Loss Account Balance	4,08,000

Bank of India (Interest on Bank Overdraft – 50%)	7,500	Patents & Copyrights	80,000
Creditors (5% of ₹69,000)	3,450	Arrear Preference Dividend (70% of ₹48,000)	33,600
Equity Shareholders (Sacrifice @ ₹1.50 per share)	3,00,000	Writing down Debtors	30,000
		Writing down Investments	10,000
		Writing down Fixed Assets	34,000
Total	5,98,950	Total	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 (including	

3,000 Cumulative Preference Shares of Rs. 100 each fully paid up	3,00,000	goodwillofRs.1,00,000)	10,80,000
		Investments	20,000
7,500 Equity Shares of Rs. 100 each fully paid up	7,50,000	Stock in Trade	2,00,000
		Trade Debtors	1,54,500
Securities Premium – Preference Shares	12,000	Bank Balances	62,500
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

Particulars	**Dr. Amount (₹)**	**Cr. Amount (₹)**
Cumulative Preference Share Capital A/c Dr. Capital Reduction A/c Dr. To Cumulative Preference Shareholders A/c *(Being cumulative preference shares & arrear dividend transferred as per Board resolution)*	3,00,000 66,000	 3,66,000
Cumulative Preference Shareholders A/c Dr. To 13% Unsecured Debentures A/c To Equity Share Capital A/c *(Being issue of debentures and equity shares as per Board resolution)*	3,66,000	 2,92,800 73,200
Equity Share Capital A/c Dr. To Capital Reduction A/c *(Being reduction of equity shares to ₹50 each for 7,500 shares)*	3,75,000	 3,75,000
Cash A/c Dr. To Equity Share Capital A/c *(Being receipt of cash @ ₹50 per share for 8,964 shares as per call)*	4,48,200	 4,48,200
Investments A/c Dr. Capital Reduction A/c Dr. To Goodwill A/c To Stock A/c To Fixed Assets A/c To Provision for Doubtful Debts A/c *(Being revaluation of assets as per Board's resolution)*	10,000 2,97,725	 1,00,000 50,000 1,50,000 7,725
Capital Reduction A/c Dr. To Capital Reserve A/c *(Being transfer of Capital Reduction balance to Capital Reserve)*	11,275	 11,275

Blackened Prospects Ltd.

BALANCE SHEET

as on 30th September, 2008

Liabilities	Amount (₹)	Assets	Amount (₹)
Subscribed Capital 8,964 Equity Shares of ₹100 each	 8,96,400	Fixed Assets After reduction 8,30,000 Less: Depreciation 83,000	

		Net Fixed Assets		7,47,000
Securities Premium	12,000	Investments		30,000
Capital Reserve	11,275	Stock in Trade		2,30,000
General Reserve	80,000	Trade Debtors	2,14,500	
Profit and Loss A/c	80,000	Less: Provision for Debts	7,725	
13% Unsecured Debentures	2,92,800	Net Debtors		2,06,775
Trade Creditors	3,92,000	Bank Balance		5,50,700
Total	17,64,475	Total		17,64,475

Working Notes:

(1) No. of equity shares issued to cumulative pref. shareholders	**1,464**
No of 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 Shares 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 ofRs.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 15% 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 be 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:

a.

Journal Entries

	Particulars	Dr. Amount (₹)	Cr. Amount (₹)
	Equity Share Capital A/c Dr. To Capital Reduction A/c *(Reduction of nominal value of 1,00,000 shares @ ₹7.50 each)*	7,50,000	 7,50,000
	Bank A/c Dr. To Equity Share Capital A/c To Securities Premium A/c *(Subscription of 50,000 equity shares @ ₹2.50 with ₹1.50 premium)*	2,00,000	 1,25,000 75,000
	10% Preference Share Capital A/c Dr. To 15% Preference Share Capital A/c *(Conversion to 30,000 15% Pref. Shares of ₹10 each)*	3,00,000	 3,00,000
	Interest Payable on Debentures A/c Dr. To Equity Share Capital A/c To Capital Reduction A/c *(Share capital issued against interest payable on debentures)*	90,000	 40,000 50,000
	12% Debentures A/c Dr. To 14% Debentures A/c *(Conversion of 12% to 14% Debentures)*	1,00,000	 1,00,000
	Bank A/c Dr. Discount on Issue of Debentures A/c Dr. To 14% Debentures A/c *(Issue of 14% Debentures at ₹10 discount)*	25,000 5,000	 30,000
	Loan from Directors A/c Dr. To Equity Share Capital A/c To Securities Premium A/c To Capital Reduction A/c *(Cancellation of loan from directors against equity)*	1,00,000	 75,000 15,000 10,000
	Bank A/c Dr. To Investment A/c To Capital Reduction A/c *(Realization from investment sale)*	3,00,000	 2,25,000 75,000

	Bank Overdraft A/c Dr. To Bank A/c *(Payment of bank overdraft)*	1,50,000	 1,50,000
	Creditors A/c Dr. To Bank A/c *(Payment to creditors)*	1,59,000	 1,59,000
	Capital Reduction A/c Dr. To Goodwill A/c To Advertisement Suspense A/c To Profit & Loss A/c To Discount on Issue of Debentures A/c To Land A/c To Building A/c To Machinery A/c To Stock A/c To Debtors A/c To Capital Reserve A/c *(Writing off fictitious assets and depreciation on others)*	8,76,000	 3,00,000 25,000 2,90,000 10,000 80,000 50,000 40,000 40,000 20,000 21,000

b.

X Ltd.

BALANCE SHEET (And Reduced) *(Rs.in '000)*

Liabilities & Equity	Amount	Assets	Amount
Share Capital		Fixed Assets (Net of Write-offs):	
Authorized:		Land (₹400 – ₹80)	320
10,00,000 Equity Shares of ₹2.50 each	2,500	Building (₹300 – ₹50)	250
15% 50,000 Preference Shares of ₹10 each	500	Machinery (₹140 – ₹40)	100
Issued, Subscribed & Paid-up:		Current Assets, Loans & Advances:	
2,10,000 Equity Shares of ₹2.50 each fully paid-up 525		Stock 320	
15% 30,000 Preference Shares of ₹10 each 300	825	Debtors 180	
Reserves & Surplus		Cash in Hand 5	
Capital Reserve 21		Cash at Bank 281	
Securities Premium 110		Total Current Assets	786
	131		
Secured Loans			
14% Debentures	400		
Current Liabilities & Provisions			
Sundry Creditors	100		

Total Liabilities & Equity	1,456	Total Assets	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

$$\text{Equity Shareholders Return on Net Worth} = \frac{\text{Rs. } 1,49,000}{\text{Rs. } 5,25,000} \times 100 = 28.38\%$$

A. CHECK YOUR PROGRESS

Short Answer Questions

1. What is the main objective of internal reconstruction?
Answer: To reorganize the capital structure of a company.

2. Which account is specifically used to record internal reconstruction adjustments?
Answer: Reconstruction Account.

3. Give one example of a fictitious asset that is written off during internal reconstruction.
Answer: Preliminary Expenses.

4. Why is reduction of capital generally carried out during internal reconstruction?
Answer: To write off accumulated losses.

5. Under which section of the Companies Act, 2013 is capital reduction legally permitted?
Answer: Section 66.

B. CHECK YOUR PROGRESS

Fill in the Blanks

1. Internal reconstruction helps a financially weak company to _________ its capital structure.

Answer: reorganize

2. _________ Account is opened to pass adjustment entries during internal reconstruction.

Answer: Reconstruction

3. A company may reduce its share capital with the approval of _________ and the Tribunal.

Answer: shareholders

4. Fictitious assets like _________, preliminary expenses, and debit balance of P&L are written off.

Answer: goodwill

5. After completing reconstruction, a _________ balance sheet is prepared to reflect the new financial position.

Answer: revised

C. CHECK YOUR PROGRESS

True or False

1. The Reconstruction Account is used to record the adjustments made during internal reconstruction.

Answer: True

2. Fictitious assets such as goodwill, preliminary expenses, and discount on issue of shares are retained after reconstruction.

Answer: False

3. A revised balance sheet is not required after internal reconstruction.

Answer: False

4. The Reconstruction Account shows both the sacrifices made and the benefits gained during internal reconstruction.

Answer: True

5. Only physical assets are adjusted in the Reconstruction Account.

Answer: False

18.4 LET US SUM UP

Internal reconstruction helps a financially distressed company reorganize its capital without dissolving and forming a new company. It typically involves accounting treatments such as writing off accumulated losses, eliminating fictitious assets, and adjusting the capital structure. The most common method used is the reduction of share capital, which may be accompanied by revaluation of assets, elimination of liabilities, or fresh capital infusion. To systematically record these changes, a Reconstruction Account is opened. This ensures transparency and proper tracking of all adjustments. After reconstruction, a revised balance sheet is prepared, reflecting the company's improved financial position. Importantly, every reconstruction must adhere to the legal provisions under the Companies Act, 2013, particularly Section 66, which governs the reduction of share capital.

18.5 KEYWORDS

1. **Internal Reconstruction** – It refers to the internal reorganization of a company's financial structure without liquidating or forming a new legal entity. This method is adopted by financially distressed companies to clean up their balance sheet, improve their financial health, and continue operations. It involves steps like capital reduction, asset revaluation, and restructuring liabilities.
2. **Capital Reduction –** This is a key tool used in internal reconstruction where the paid-up share capital is reduced, either by cancelling unpaid capital, writing off past losses, or returning excess capital to shareholders. It allows a company to present a more accurate and healthier financial picture by eliminating fictitious or overvalued elements in the balance sheet.
3. **Reconstruction Account** – A temporary account opened specifically for internal reconstruction purposes. All adjustments related to the reduction of capital, writing off losses, elimination of fictitious assets, and other restructuring transactions are routed through this account. It helps track how the capital structure is altered during reconstruction.
4. **Fictitious Assets** – These are intangible assets with no realizable value, often resulting from past expenditures or accounting practices. Examples include preliminary expenses, debit balance of Profit and Loss account, discount on issue of shares/debentures, and advertising suspense. These are written off during internal reconstruction to reflect a true financial position.
5. **Revised Balance Sheet** – After the completion of reconstruction, a fresh balance sheet is prepared, incorporating all the changes made. This Revised Balance Sheet presents a cleaned-up and restructured financial position of the company, free from accumulated losses or overvalued assets, giving stakeholders a clearer picture of the company's health.

18.6 SELF ASSESSMENT QUESTIONS

1. Define internal reconstruction and differentiate it from external reconstruction.

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2. Describe the legal provisions related to reduction of share capital under the Companies Act, 2013.

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3. Explain the procedure and journal entries involved in eliminating accumulated losses and fictitious assets through internal reconstruction.

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18.7 LESSON END EXERCISE

1. Write the accounting entries to reduce share capital and eliminate fictitious assets like goodwill, profit & loss debit balance and preliminary expenses.

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2. Discuss the purpose and benefits of internal reconstruction for a company in financial difficulty.

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3. Prepare a revised balance sheet after accounting for reconstruction and capital reduction adjustments.

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18.8 SUGGESTED READINGS

- T.S. Grewal, Financial Accounting, Sultan Chand & Sons, 2023.
- S.N. Maheshwari & S.K. Maheshwari, Advanced Accountancy – Volume I, Vikas Publishing House Pvt. Ltd., 2022.
- P.C. Tulsian & Bharat Tulsian, Financial Accounting, S. Chand Publishing, 2023.

M.C. Shukla, T.S. Grewal & S.C. Gupta, Advanced Accounts, S. Chand Publishing, 2023.

UNIT IV **B.Com 4th Semester**

Course No. BCG-401 **Lesson No. 19**

REORGANIZATION THROUGH SURRENDER OF SHARES

19.1 INTRODUCTION

Reorganization through surrender of shares is a significant part of internal reconstruction where shareholders voluntarily give up their shares, either partially or fully, to help the company restructure its financial position. This concept is primarily adopted when a company faces continuous losses, overcapitalization, or needs to realign its share capital in a legally compliant and economically viable manner.

Surrender of shares may be used to cancel unissued or underperforming capital or as a mechanism to reduce the paid-up share capital of the company. The shares surrendered are typically reissued or cancelled, which affects the share capital structure and financial statements of the company.

This chapter covers the meaning and purpose of share surrender, the procedure and accounting treatment involved, and the effects on the company's capital structure. It also discusses how this process helps revive a financially weak company without resorting to external reconstruction or liquidation.

19.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

After completing this chapter, students will be able to:

- Understand the concept and rationale behind surrendering shares in the context of internal reconstruction.
- Learn the legal and procedural framework for share surrender as per company law.
- Identify the accounting treatment for surrendered shares in the company's books.
- Recognize how surrender of shares impacts the capital structure and balance sheet of a company.
- Distinguish between surrender, forfeiture and cancellation of shares.

Learning Outcomes

On successful completion of this chapter, learners will be able to:

- Clearly define and explain the term *surrender of shares* and its application in internal reconstruction.
- Apply the appropriate accounting entries for surrender and reissue or cancellation of shares.
- Analyze how surrender of shares helps in reorganizing overcapitalized companies.
- Explain the impact of share surrender on authorized, issued and paid-up capital.

- Evaluate real-life scenarios where share surrender is used as a strategic financial tool to stabilize a company's capital structure.

19.3 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 1

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
Accrued Interest on Debentures	70,000	Investments	15,000
Sundry Creditors	4,50,000	Cash at Bank	1,03,000
Income Tax Liability	10,000	Cashin 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 Debenture holders 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 debenture holders.
4. The debenture holders' 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.

Particulars	Dr. Amount (₹)	Cr. Amount (₹)
Equity Share Capital (₹100) A/c Dr. To Equity Share Capital (₹10) A/c *(Being subdivision of 8,000 shares of ₹100 each into 80,000 shares of ₹10 each as per special resolution No..... dated......)*	8,00,000	 8,00,000
Equity Share Capital A/c Dr. To Shares Surrendered A/c *(Being surrender of 90% of shares i.e., 72,000 shares of ₹10 each as per reconstruction scheme dated...)*	7,20,000	 7,20,000
Shares Surrendered A/c Dr. To 8% Preference Share Capital A/c *(Being conversion of 50,000 surrendered shares into 8% Preference Shares of ₹10 each and issue of these shares to the debenture holders)*	5,00,000	 5,00,000
Shares Surrendered A/c Dr. To Equity Share Capital A/c *(Being reissue of shares worth ₹90,000 to sundry creditors in full satisfaction of their claims as per reconstruction scheme dated...)*	90,000	 90,000
Shares Surrendered A/c Dr. Debentures A/c Dr. Interest Accrued A/c Dr. Sundry Creditors A/c Dr. To Capital Reduction A/c *(Being cancellation of unissued surrendered shares and transfer of liabilities to Capital Reduction A/c)*	1,30,000 14,00,000 70,000 4,50,000	 20,50,000
Capital Reduction A/c Dr. To Profit & Loss A/c To Fixed Assets A/c *(Being debit balance of P&L written off and remaining balance used to write down fixed assets)*	20,50,000	 10,70,000 9,80,000

BALANCE SHEET OF RAMAN LTD. (And reduced)

as on 31st March, 2008

Liabilities & Equity	**Amount (₹)**	**Assets**	**Amount (₹)**
Share Capital		Fixed Assets	
Equity Share Capital (17,000 shares of ₹10 each)	1,70,000	Land, Building & Machinery 14,00,000	
8% Preference Share Capital (50,000 shares of ₹10)	5,00,000	Less: Written off under reorganisation scheme (9,80,000)	
		Net Fixed Assets	4,20,000
Reserves & Surplus	—	Investments	15,000
Secured Loans	—	Current Assets	
Unsecured Loans	—	Stock-in-Trade	1,00,000
Current Liabilities & Provisions		Sundry Debtors	40,000
Income Tax Liability	10,000	Cash in Hand	2,000
		Cash at Bank	1,03,000
Total	**6,80,800**	**Total**	**6,80,000**

ILLUSTRATION 2

The Balance sheet of Revise Limited as at 31st March, 2008 was as follows:

BALANCE SHEET

Liabilities	**Amount (₹)**	**Assets**	**Amount (₹)**
Share Capital		Fixed Assets	
10,000 Equity Shares of ₹100 each, fully paid	10,00,000	Machineries	1,00,000
Unsecured Loan		Current Assets	
12% Debentures	2,00,000	Stock	3,20,000
Accrued Interest on Debentures	24,000	Debtors	2,70,000
Current Liabilities		Bank	30,000
Creditors	72,000		
Provision for Income Tax	24,000	Profit & Loss Account	6,00,000
Total	**13,20,000**	**Total**	**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 subdivided 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

	Particulars	**Dr. Amount (₹)**	**Cr. Amount (₹)**
	Equity Share Capital (Rs. 100) A/c Dr. To Equity Surrendered A/c To Equity Share Capital (Rs. 10) A/c (Sub-division of 10,000 shares of Rs. 100 each into 1,00,000 shares of Rs. 10 each and surrender of 50,000 shares)	10,00,000	 5,00,000 5,00,000
	12% Debentures A/c Dr. Accrued Interest A/c Dr. To Reconstruction A/c (Transferred 75% of claims of debenture holders to reconstruction account)	1,50,000 18,000	 1,68,000
	Creditors A/c Dr. To Reconstruction A/c (Transferred creditors' claims to reconstruction account)	72,000	 72,000
	Shares Surrendered A/c Dr. To 12% Preference Share Capital A/c To Equity Share Capital A/c To Reconstruction A/c (Issued shares to settle claims; remaining balance transferred to reconstruction account)	5,00,000	 1,00,000 36,000 3,64,000
	Reconstruction A/c Dr. To Profit and Loss A/c To Capital Reserve A/c (Adjusted P&L balance; remaining transferred to capital reserve)	6,04,000	 6,00,000 4,000

BALANCE SHEET REVISE LIMITED (and Reduced)

as on 1st April, 2008

Liabilities	Rs.	Assets	Rs.
Share Capital		Fixed Assets	
Equity Share Capital (53,600 × ₹10)	5,36,000	Machineries	1,00,000
12% Preference Share Capital (10,000 × ₹10)	1,00,000		
(All shares allotted fully paid under capital reduction scheme without cash)		Current Assets, Loans & Advances	
		(A) Current Assets	
Reserves and Surplus		Stock	3,20,000
Capital Reserve	4,000	Debtors	2,70,000
		Bank	30,000
Unsecured Loans		(B) Loans and Advances	Nil
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 3

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 years 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. Creditors 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 to be 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	**Rs. 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 sharesofRs.80each, 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 Shares 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 Loan		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

A. CHECK YOUR PROGRESS

Short Answer Questions

1. What is surrender of shares a part of?

Answer: Internal Reconstruction

2. What are surrendered shares?

Answer: Voluntarily returned by shareholders

3. What is the role of share surrender in internal reconstruction?

Answer: It helps in reorganization of capital

4. Which law governs reorganization through share surrender?

Answer: Companies Act

B. CHECK YOUR PROGRESS

Fill in the Blanks

1. Surrender of shares is a _______ action by shareholders.
Answer: voluntary

2. Cancelled surrendered shares lead to _______ of capital.
Answer: reduction

3. Reissue of surrendered shares increases _______ capital.
Answer: paid-up

4. The process of surrender helps to clean the _______ of a company.
Answer: balance sheet

5. Internal reconstruction is governed under the _______ Act.
Answer: Companies

C. CHECK YOUR PROGRESS

True or False

1. Reorganization through surrender of shares refers to shareholders voluntarily returning their shares to the company as part of internal reconstruction.

Answer: True

2. Surrender of shares is not governed by any legal provision in the Companies Act.

Answer: False

3. Surrender of shares increases the company's capital base.

Answer: False

4. Surrender of shares is typically used to facilitate capital reduction and issue of new securities.

Answer: True

5. Surrender of shares always requires court approval under the Companies Act.

Answer: False

19.4 LET US SUM UP

Reorganization through Surrender of Shares is a strategic method adopted during internal reconstruction, wherein existing shareholders voluntarily return their shares to the company. This approach is typically employed in scenarios involving accumulated losses, overcapitalization, or financial distress. The surrendered shares may be either cancelled or reissued, based on the company's restructuring objectives.

This method allows the company to clean up its balance sheet, reduce inflated capital, and present a healthier financial position—without opting for liquidation. It plays a crucial role in maintaining business continuity while restoring investor confidence.

Proper accounting treatment is essential to accurately reflect changes in capital structure and ensure compliance with legal provisions under the Companies Act. Notably, surrender of shares differs from forfeiture, as it is a voluntary action taken by shareholders, not a penalty imposed by the company.

19.5 KEYWORDS

1. Surrender of Shares - Surrender of shares refers to the voluntary return of shares by the shareholders to the company. This typically happens during internal reconstruction, where the company may be undergoing financial difficulties or restructuring. Unlike forfeiture, which is compulsory, surrender is initiated willingly by the shareholder, often in exchange for revised capital terms or new types of securities.

2. Internal Reconstruction - Internal reconstruction is the process of restructuring the financial framework of a company without dissolving it or forming a new entity. It is used to address accumulated losses, overcapitalization, or misaligned capital structure. Methods include capital reduction, revaluation of assets, cancellation of fictitious assets, and settlement with creditors.

3. Capital Reduction - Capital reduction means a deliberate decrease in the company's issued, subscribed, or paid-up share capital. It is usually done to write off accumulated losses, cancel unpaid capital, or return excess capital to shareholders. It requires approval through a special resolution and confirmation by the National Company Law Tribunal (NCLT) under Section 66 of the Companies Act, 2013.

4. Reissue of Shares - Reissue of shares refers to the second-time allotment of shares that were earlier surrendered or forfeited. These shares are reissued to new or existing shareholders, sometimes at a discount, depending on their original issue and the company's policy. It is often a part of the internal reconstruction scheme.

5. Overcapitalization - Overcapitalization is a financial condition where the capital raised by the company exceeds its actual requirements or earning capacity. This leads to lower returns on investment, reduced dividends, and an inflated balance sheet. Internal reconstruction, especially capital reduction, is often used to correct this situation.

6. Share Cancellation - Share cancellation involves the removal of surrendered or forfeited shares from the company's records, leading to a reduction in share capital. This is done when shares are surrendered and are not reissued. Cancellation helps the company maintain a more accurate representation of its equity structure.

7. Forfeiture of Shares - Forfeiture of shares is a compulsory action taken by the company when a shareholder fails to pay calls or dues on time. The company cancels the defaulted shares, removes them from its books, and may reissue them. Unlike surrender, forfeiture is not voluntary and is considered a penalty.

19.6 SELF ASSESSMENT QUESTIONS

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1. XYZ Ltd. has 10,000 shares of ₹100 each fully paid. 2,000 shares are surrendered and cancelled. Pass journal entries.

....

....

....

2. DEF Ltd. reissues 1,500 surrendered shares of ₹10 each at ₹12. Pass journal entries for surrender and reissue.

....

....

....

3. A company has 20,000 equity shares of ₹10 each fully paid. Due to reconstruction, 5,000 shareholders surrender their shares. Show journal entries assuming shares are cancelled.

....

....

....

19.7 LESSON END EXERCISE

1. A company with 50,000 shares of ₹10 each has requested surrender of 5,000 shares due to overcapitalization. These shares are later reissued at ₹8 per share. Pass journal entries.

....

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....

2. Explain the term "reorganization through surrender of shares" with suitable examples

....

....

....

3. List and explain the accounting treatment for surrendered and reissued shares.

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....

……………………………………………………………………………………………

19.8 SUGGESTED READINGS

- T.S. Grewal, Financial Accounting, Sultan Chand & Sons, 2023.
- S.N. Maheshwari & S.K. Maheshwari, Advanced Accountancy – Volume I, Vikas Publishing House Pvt. Ltd., 2022.
- P.C. Tulsian & Bharat Tulsian, Financial Accounting, S. Chand Publishing, 2023.

M.C. Shukla, T.S. Grewal & S.C. Gupta, Advanced Accounts, S. Chand Publishing, 2023.

UNIT IV **B.Com 4th Semester**

Course No. BCG-401 **Lesson No. 20**

SCHEME OF RECONSTRUCTION

20.1 Introduction

20.2 Learning Objectives and Outcomes

20.3 Concept of Scheme of Reconstruction

20.4 Steps of Reconstruction

20.5 Journal Entries & Revised Balance Sheet

20.6 Let Us Sum Up

20.7 Keywords

20.8 Self Assessment Questions

20.9 Lesson End Exercise

20.10 Suggested Readings

20.1 INTRODUCTION

This chapter delves into the formal scheme of internal reconstruction, which is a comprehensive plan designed to reorganize a company's capital structure without going through the process of liquidation. Internal reconstruction is primarily aimed at reviving financially distressed companies by reducing liabilities, writing off accumulated losses, and adjusting overvalued or undervalued assets.

The chapter also explains the steps involved in implementing a reconstruction scheme, such as reducing share capital, rearranging liabilities, and realigning the asset base. One of the most critical parts of reconstruction is the correct recording of these adjustments, which is done through proper journal entries. Finally, the chapter discusses the preparation of the revised Balance Sheet, which reflects the updated financial position of the company after implementing the reconstruction scheme.

Understanding this process is crucial for students and professionals in accounting and corporate finance, as it combines legal, financial, and strategic elements of corporate restructuring.

20.2 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

By the end of this chapter, learners will be able to:

- Understand the meaning and importance of a scheme of internal reconstruction.
- Identify the key components and steps in the process of implementing a reconstruction plan.
- Learn how to prepare journal entries to account for adjustments under internal reconstruction.
- Comprehend how to prepare a Revised Balance Sheet after adjustments.
- Analyze how internal reconstruction improves a company's financial health without liquidation.

Learning Outcomes

By the end of this chapter, learners will be able to:

- Understand the meaning and importance of a scheme of internal reconstruction.
- Identify the key components and steps in the process of implementing a reconstruction plan.
- Learn how to prepare journal entries to account for adjustments under internal reconstruction.
- Comprehend how to prepare a Revised Balance Sheet after adjustments.
- Analyze how internal reconstruction improves a company's financial health without liquidation.

20.3 CONCEPT OF 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. **Future Viability is Crucial -** A company should only be reconstructed if its future prospects appear positive. Even though its current financial state may be poor, reconstruction is justified only when the company is expected to generate enough profit to cover all expenses, interest, taxes, depreciation, and still pay reasonable dividends to shareholders.
2. **Stakeholder Approval is Essential -** Any scheme of reconstruction must gain approval from the key stakeholders — particularly shareholders and creditors. Their support is necessary because they are directly impacted by the changes in capital structure, and their consent ensures the legal and operational feasibility of the plan.
3. **Equity Shareholders Bear the Major Loss -** Equity shareholders, being the true owners of the company, are expected to bear the maximum loss under any reconstruction scheme. Other parties like preference shareholders, debenture holders, or creditors may agree to a smaller loss only if it's less than what they would suffer in case of liquidation.
4. **Provision for Working Capital is a Must -** A reconstructed company needs sufficient working capital to operate efficiently and pay off any immediate claims, including those from dissenting shareholders or creditors. Just writing off losses isn't enough — without fresh capital, the company cannot sustain its revived operations.
5. **Continuation of Control Encourages Support -** For the scheme to succeed, it's often necessary to allow the existing controlling group of shareholders to retain their control. If they feel they'll lose their power or decision-making role, they may vote against the reconstruction plan.
6. **Internal vs. External Reconstruction -** The choice between internal and external reconstruction depends on the severity of the situation. Internal reconstruction (capital reduction) is suitable when only balance sheet adjustments are needed. External reconstruction (forming a new company) is preferred if the company's financial and operational condition is severely poor and stakeholders are unwilling or unable to infuse new funds.

C. CHECK YOUR PROGRESS
Fill in the Blanks

1. Equity shareholders are expected to bear the ___________ loss under any reconstruction scheme.
Answer: maximum

2. Even with a poor current financial state, reconstruction is justified only when the company is expected to generate enough profit to cover all expenses, interest, taxes, depreciation, and still pay reasonable ___________ to shareholders.
Answer: dividends

3. For the scheme to succeed, it's often necessary to allow the existing ___________ group of shareholders to retain their control.
Answer: controlling

4. ___________ reconstruction (capital reduction) is suitable when only balance sheet adjustments are needed.
Answer: Internal

5. ___________ reconstruction (forming a new company) is preferred if the company's financial and operational condition is severely poor and stakeholders are unwilling or unable to infuse new funds.
Answer: External

20.4 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 the 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 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 have 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 scheme. They agree to the maximum amount of loss because they know that if they do not agree, the 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, if preference share capital, preference shareholders will have to bear some portion of loss although their 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 they 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 shareholders for the payment of arrears of dividends because it upsets the voting power of existing shareholders. As far as possible, preference shareholders should be made to agree to forego their arrears of dividends.
4. Debenture holders 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 debenture holders 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. Debenture holders 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 along with 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 debenture holders 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.

A. CHECK YOUR PROGRESS

Rearrange the Steps

Rearrange the following steps which are given in random order:

A. Allocate the total determined loss among different stakeholder groups such as equity shareholders, preference shareholders, and creditors.

B. Decide whether internal or external reconstruction is more suitable based on the financial and operational condition of the company.

C. Arrange adequate working capital through methods like fresh share issue, bank overdraft, or making fully paid shares partly paid.

D. Calculate the total loss to be written off, including accumulated losses, fictitious assets, overvalued assets, and under-provided liabilities.

E. Plan fair compensation to preference shareholders, debenture holders, and creditors if they bear any loss under the scheme.

F. Finalize the treatment of capital, such as surrender or reissue of shares, and settle claims using reduced or newly issued shares.

Answer: D → A → E → F → C → B

ILLUSTRATION 1

The following is the Balance Sheet of N.D. Ltd as at 31st March 2008:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Share Capital:		Goodwill	25,000
10,000 10% Cumulative Preference Shares of Rs. 10 each fully paid-up	1,00,000	Freehold Property at cost	90,000
20,000 Equity Shares of Rs. 10 each fully paid-up	2,00,000	Plant & Machinery at cost	85,000
		Less: Depreciation	
Creditors	75,000	Investments (M.V. Rs. 86,000)	80,000
Bank Overdraft	15,000	Stock	35,000
General Reserve	70,000	Debtors	40,000
		Cash at Bank	500
		Profit & Loss A/c (Debit Balance)	1,04,000
Total	**4,60,000**	**Total**	**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: CAPITALREDUCTION SCHEME

Calculation of loss to be written off **Rs.**

Profit and Loss Account	1,04,000
Goodwill	25,000
	1,29,000
Less: General Reserve	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 than 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	Amount (Rs.)	Assets	Amount (Rs.)
Share Capital:		Freehold Property (at cost)	90,000
10,000 12% Cumulative Preference Shares of Rs. 10 each, fully paid-up	1,00,000	Plant & Machinery (at cost) Less: Depreciation	85,000
20,000 Equity Shares of Rs. 10 each, fully paid-up	2,00,000	Investments (at cost)	80,500
		Stock	35,000
Creditors	75,000	Debtors	40,000
Bank Overdraft	15,000	Cash at Bank (Rs. 500 + Rs. 59,000)	59,500
Total	**3,90,000**	**Total**	**3,90,000**

ILLUSTRATION 2

The Balance Sheet of the Bharat Darshan Co. Ltd. is as follows:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Share Capital		Goodwill	1,50,000
5,000 10% Cumulative Preference Shares of Rs. 100 each, fully paid	5,00,000	Sundry Fixed Assets	25,00,000
1,50,000 Equity Shares of Rs. 10 each, fully paid up	15,00,000	Sundry Current Assets	12,50,000
12% Debentures of Rs. 100 each	10,00,000	Cash and Bank Balance	2,50,000
Sundry Creditors	26,20,000	Profit and Loss Account	15,50,000
Income Tax Payable	1,00,000	Preliminary Expenses	20,000
Total	**57,20,000**	**Total**	**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 debenture holders 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 sacrifices 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

$$\frac{\text{Rs. } 36{,}000 \times 100}{\text{Rs. } 1{,}50{,}000} = 24\%$$

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.

B. CHECK YOUR PROGRESS

True or False

1. Capital Reduction Account is used to write off accumulated losses and fictitious assets.

Answer: True

2. Appreciation in the value of an asset is debited to the Capital Reduction Account.

Answer: False

3. Under external reconstruction, the company continues with the same legal entity.

Answer: False

4. Capital Reserve Account is created from the leftover balance in the Capital Reduction Account.

Answer: True

5. Capital Reduction Account can be used to pay dividends to shareholders.

Answer: False

In the above calculation, income-tax has been ignored due to past losses.

1. 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

	Particulars		**Debit (Rs.)**	**Credit (Rs.)**
	10% Cumulative Preference Share Capital A/c Dr. To 12% Cumulative Preference Share Capital A/c To Reorganisation A/c *(Being reduction of preference shares by ₹60 each and dividend increased from 10% to 12%)*		5,00,000	 2,00,000 3,00,000

	Equity Share Capital A/c Dr. **Sundry Creditors A/c** Dr. To Reorganisation A/c *(Being reduction of equity share capital and sundry creditors as agreed upon)*		13,50,000 6,50,000	 20,00,000
	Reorganisation A/c Dr. To Profit and Loss A/c To Preliminary Expenses A/c To Goodwill A/c To Fixed Assets A/c To Current Assets A/c *(Being balance in Reorganisation A/c utilised to write off losses, goodwill, preliminary expenses, and adjust asset values)*		23,00,000	 15,50,000 20,000 1,50,000 5,00,000 80,000
	Equity Share Final Call Account Dr To Equity Share Capital Account *(Being Final call made on 1,50,000 equity shares @ Rs. 1 each)*		1,50,000	 1,50,000
	Bank Account Dr To Equity Share Final Call Account *(Being amount of final call received)*		1,50,000	 1,50,000

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	20,00,000
12% Debentures of Rs. 100 each	10,00,000	Current Assets	
Sundry Creditors	19,70,000	Cash and Bank Balance	11,70,000
Income Tax Payable	1,00,000	(Rs. 2,50,000+Rs. 1,50,000)	4,00,000
	35,70,000		**35,70,000**

20.5 JOURNAL ENTRIES AND 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
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 A/c
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 affected 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 A/c

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 remains unchanged

Equity Share Capital A/c

To Capital Reduction A/c

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)

Nature of Transaction	Journal Entry
Reduction of share capital **without change in face value**	Share Capital A/c Dr. To Capital Reduction/Reconstruction A/c
Reduction of capital **with change in face value** (new category of share)	Share Capital A/c (Old) Dr. To Share Capital A/c (New) To Capital Reduction A/c
Change in **rate of dividend on preference shares**	Preference Share Capital A/c (Old) Dr. To Preference Share Capital A/c (New)
Debenture holders or creditors reducing their claims	Debenture A/c Dr. Creditors A/c Dr. To Capital Reduction A/c
Appreciation in value of assets	Asset A/c Dr. To Capital Reduction A/c
Contingent liability matures and is paid	Capital Reduction A/c Dr. To Liability Payable A/c To Bank A/c
Writing off accumulated losses and fictitious assets	Capital Reduction A/c Dr. To Profit & Loss A/c To Preliminary Expenses A/c To Goodwill A/c To Discount on Issue A/c To Trade/Other Assets A/c
Transfer of surplus in Capital Reduction A/c to Capital Reserve	Capital Reduction A/c Dr. To Capital Reserve A/c
Extinguishing uncalled liability of members	Equity Share Capital A/c Dr. To Equity Share Capital A/c
Writing off part of paid-up capital not represented by assets	Equity Share Capital A/c Dr. To Equity Share Capital A/c To Capital Reduction A/c
If face value remains unchanged, but capital is reduced	Equity Share Capital A/c Dr. To Capital Reduction A/c
Return of excess capital to shareholders	Equity Share Capital A/c Dr. To Equity Share Capital A/c To Equity Shareholders A/c
Payment to shareholders after capital return	Equity Shareholders A/c Dr. To Bank A/c

ILLUSTRATION 3

Repair Ltd. is the hands of a receiver for debenture holders who holds a charge on all assets except uncalled capital. The following statement shows the position as regards creditors as on 30th June, 2012.

Balance Sheet Before Reconstruction

(as on 30th June, 2012)

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
6,000 shares of Rs. 60 each (Rs. 30 paid-up)	1,80,000	Property, Machinery, Plant etc.	2,70,000
First Debentures	3,00,000	Cash in hand (with receiver)	1,50,000
Second Debentures	6,00,000		
Unsecured Creditors	4,50,000		
Uncalled Capital	6,00,000		
Deficiency	7,50,000		
Total	**13,50,000**	**Total**	**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 necessarily journal entries.

Solution:

Journal Entries

	Particulars		Debit (Rs.)	Credit (Rs.)
	First Debentures A/c Dr. Second Debentures A/c Dr. Unsecured Creditors A/c Dr. To A's A/c *(Being A's total liability transferred)*		3,00,000 90,000 2,10,000	 6,00,000
	A's A/c Dr. To Reconstruction A/c *(Being cancellation of part of A's claim)*		2,10,000	 2,10,000
	Bank A/c Dr. To A's A/c *(Being cash received from A)*		30,000	 30,000
	A's A/c Dr. To First Debentures A/c *(Being issue of new first debentures to A in settlement)*		5,10,000	 5,10,000
	Second Debentures A/c Dr. Unsecured Creditors A/c Dr. To B's A/c *(Being B's total liability transferred)*		60,000 3,00,000	 3,60,000
	B's A/c Dr. To Bank A/c To Reconstruction A/c *(Being full settlement of B's claim – part paid in cash, part waived)*		3,60,000	 90,000 2,70,000

Working Notes:

Particulars	Amount (Rs.)
Total Unsecured Creditors (Other than A & B)	3,00,000
75% of the claim to be settled	2,25,000
No. of claims of Rs. 60 each	3,750
No. of new shares issued (4 per Rs. 60)	15,000
Face value of each new share	Rs. 7.50
Value of shares issued	1,12,500
Balance of 75% settled transferred to Reconstruction A/c	1,12,500

Balance Sheet

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
15,000 Equity Shares of Rs. 7.50 each (fully paid)	1,12,500	Property, Machinery & Plant	2,70,000
1st Debentures (Issued to A)	5,10,000	Cash in Hand	1,50,000
Creditors – Postponed Amount (25%)	75,000	P&L debit balance	2,77,500
Total	**6,97,500**	**Total**	**4,20,000**

20.6 LET US SUM UP

A Scheme of Reconstruction is adopted to internally restructure a company's financial position without dissolving its legal entity. This scheme typically involves measures such as capital reduction, revaluation of assets, and adjustments for accumulated losses to reflect a healthier financial outlook. To implement such a scheme, it is essential to obtain approval from shareholders and ensure full compliance with the provisions of the Companies Act. All financial transactions under the scheme are recorded through appropriate journal entries, ensuring accuracy and transparency. Finally, a Revised Balance Sheet is prepared, showcasing the reorganized capital structure and improved asset-liability position of the company post-reconstruction.

20.7 KEYWORDS

- **Reconstruction** – This refers to the process of reorganizing a company's financial structure, often undertaken to overcome accumulated losses, overvaluation of assets, or other financial difficulties. It aims to give the business a fresh start without dissolving the existing entity.
- **Capital Reduction** – This involves decreasing the paid-up or nominal value of the company's share capital. It may be done to write off losses, eliminate fictitious assets, or adjust the capital base to reflect the actual financial position of the company.
- **Revised Balance Sheet** – A new or updated balance sheet prepared after the implementation of a reconstruction scheme. It reflects the adjusted asset values, revised share capital, and any eliminations or provisions made during restructuring.
- **Fictitious Assets** – These are not real or tangible assets and do not have any resale value. Examples include goodwill, preliminary expenses, and discount on issue of shares or debentures. They are generally written off during internal reconstruction to present a more accurate financial picture.

- **Accumulated Losses** – These are losses that have been incurred over time and carried forward in the Profit and Loss Account. Reconstruction schemes aim to wipe out or significantly reduce such losses to clean up the company's financial statements.

20.8 SELF ASSESSMENT QUESTIONS

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1. What is a Scheme of Reconstruction?

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2. Explain with examples the accounting treatment of internal reconstruction.

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3. List the major steps involved in internal reconstruction.

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20.9 LESSON END EXERCISE

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1. What is a Scheme of Reconstruction?

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2. Define Scheme of Reconstruction. Explain its features and purpose.

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3. What approvals are needed to implement a scheme of reconstruction?

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20.10 SUGGESTED READINGS

- T.S. Grewal, Financial Accounting, Sultan Chand & Sons, 2023.
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