III SEMESTER B.COM

CORPORATE ACCOUNTING

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Valuation of Goodwill

Definition

> "Goodwill may be said to be that element arising from the 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 the net tangible assets employed in the business".

Types of goodwill

Purchased goodwill
Non-purchased goodwill

Features of goodwill

- It is an intangible asset
- It is an real asset but not a fictitious asset
- It always exist with business but it cannot exist by itself
- It is subject to fluctuations

Factors that affect the valuation of goodwill

- Location factor
- Time factor
- Nature of business
- Efficiency of business

Methods of valuation of goodwill

- Average Profits Method
- Capitalization Method
- Super Profits Method
- Annuity Method
- Average Profits Method?

Under this method, the value of goodwill is calculated by multiplying the adjusted average annual profits by the number of years of purchase.

Value of Goodwill = Adjusted average annual profits x Number of years of purchase

Average capital employed is calculated by =

½(capital employed at the beginning + capital employed at the end of the year)

This is the rate of profit or return which an investor expects on his investment in a particular type of industry

It is the excess of the average profits over the normal profits based on normal rate of return for representative firm in the industry

1. What are circumstances of valuation of goodwill?

   a) In the case of a partnership,

      - when there is an admission of a partner,
      - when retirement of a partner,
      - when death of a partner
      - when change in the profit sharing ratio take place,
      - Sale of partnership firm valuation of goodwill becomes necessary.

   b) In the case of a company,

      - when two or more companies amalgamate,
      - one company absorbs another company,
      - one company wants to acquire controlling interest in another company ,
      - on the external reconstruction of a company
      - When the Government takes over the business, valuation of goodwill becomes necessary.

   c) In the case of a sole trader concern,

      - goodwill is valued at the time of selling the business
      - when a sole trading is converted into partnership or joint stock company
      - when a sole trading is amalgamated with another sole trading concern

   d) In the case of individuals, goodwill is valued for purpose of Estate Duty, Death Duty, etc. On the death of a person.

Problem: I year Rs. 30,000; II year Rs. 40,000 III year Rs. 50,000; IV year Rs. 60,000. The profit includes non-recurring profits on an average basis of Rs. 3,000.

	Rs.
Average capital employed	3,00,000
Normal rate of profit	10%

Present value of annuity of Re. 1 for 4 years at 10% is 2.5.

SOLUTION :

Total profits Rs. 30,000 + 40,000 + 50,000 + 60,000 = Rs. 1,80,000

	Rs.
Average Profit = $\frac{1,80,000}{4}$	= 45,000
Less: Non-recurring profit	= 3,000
	42,000

Normal Profit = $\frac{3,00,000 \times 10}{100}$ = Rs. 30,000

Super profit = Rs. 42,000 – 30,000 = Rs. 12,000

(*a*) Goodwill as per annuity method: 12,000 × 2.5 = Rs. 30,000

(*b*) Goodwill as per purchase of super profit method: 12,000 × 4 = Rs. 48,000

(*c*) Goodwill as per capitalisation method: $\frac{12,000 \times 100}{10}$ =Rs. 1,20,000

Problem **:** The net profits of a Company, after providing for taxation, for the past five years are Rs. 42,000; Rs. 47,000; Rs. 45,000; Rs. 39,000 and Rs. 47,000. The capital employed in the business is Rs. 4, 00,000 on which a reasonable rate of return of 10% is expected.

Calculate the goodwill under**:**

(a) Capitalisation of Average Profit Method and

(*a*) Average Profit $= \frac{\text{Total profits of 5 years}}{5}$

$= \frac{\text{Rs. } 42{,}000 + 47{,}000 + 45{,}000 + 39{,}000 + 47{,}000}{5}$

$= \frac{\text{Rs. } 2{,}20{,}000}{5} = \text{Rs. } 44{,}000$

Capitalised value of the business at 10% $= \frac{\text{Rs. } 44{,}000 \times 100}{10}$	= Rs. 4,40,000
Less: Capital employed (given)	Rs. 4,00,000
Value of goodwill :	40,000
(*b*) Average Profit (as above)	Rs. 44,000
Less: Normal return on capital employed (at 10% on Rs. 4,00,000)	Rs. 40,000
Super Profit	4,000

Capital value of super profit $= \frac{4{,}000 \times 100}{10}$ =Rs. 40,000

Problem: Balance Sheet of Mr. X as on 31st Dec. 2004 was as under

Capital	2,50,000	Land	1,80,000
Creditors	80,000	Machinery	1,10,000
Bills Payable	20,000	Furniture	2,000
		Stock	8,000
		Cash at Bank	50,000
	3,50,000		3,50,000

The profit of the business for the five years ending 31st Dec. 2004 are:

	Rs.
2000	40,000
2001	42,000
2002	45,000
2003	50,000
2004	53,000

The assets are revalued as under:

Land	1,94,000
Machinery	1,18,000
Furniture	1,000

The reasonable return on capital invested is 10% p.a.

Assume that normal management remuneration is Rs. 6,000.

Find out Goodwill by Capitalisation Method.

Solution:

(a) Average profit $= \frac{\text{Total profits of 5 years}}{5}$

$= 2,30,000 \div 5 = 46,000$

Less: Remuneration	=	6,000
Average Profit		40,000

Calculation of normal capital by capitalisation of average profit

$= \frac{40,000 \times 100}{10} = \text{Rs. } 4,00,000$

		Rs.
Land		1,94,000
Machinery		1,18,000
Furniture		1,000
Stock		8,000
Cash		50,000
Total Assets		3,71,000
Less: Liabilities		
Creditors	80,000	
B/P	20,000	1,00,000
Net assets (capital employed)		2,71,000

Goodwill = Normal Capital – Actual Capital Employed

= Rs. 4,00,000 – 2,71,000 = **Rs. 1,29,000**

(*b*) Capitalisation of super profit:

Average Profit	Rs. 40,000
Less: Normal profit : 10% on Rs. 2,71,000	Rs. 27,100
Super Profit :	12,900

Goodwill = Rs. $12,900 \times \frac{100}{10}$ = **Rs. 1,29,000**

Problem: Ram runs a chemist shop. His net assets on 31st December 2004 amount to Rs. 20, 00,000. After paying a rent of Rs. 20,000 a year and salary of Rs. 20,000 to the chemist, he earns a profit of Rs. 1,50,000. His landlord, who happens to be an expert chemist, is interested in purchasing the shop 12% is considered to be a reasonable return on capital employed. What can Ram expect as payment for goodwill?

Solution:

		Rs.
Profit earned by Ram		1,50,000
Add: Rent, no more to be paid		20,000
Add: Chemist salary, no more to be paid		20,000
		1,90,000
Less: Reasonable remuneration for the new proprietor assumed		25,000
Adjusted profit:		1,65,000
Capital employed amounted to:		20,00,000
Add: Value of buildings, now form part of the capital (assume)		2,00,000
		22,00,000
Normal Profit @ 12% on Rs. 22,00,000		2,64,000
Adjusted profit	Rs. 1,65,000	
Less: Normal profit	Rs. 2,64,000	
	Nil	

Since, there is no super profit, there will be no goodwill.

Problem (Capitalisation of weighted average profit):P. Ltd. proposed to purchase the business carried on by Mr. A. Goodwill for this purpose is agreed to be valued at three years purchase of the weighted average profits of the past four years.

The appropriate weights to be used are:

2001 – 1
2002 – 2
2003 – 3
2004 – 4

The profit for these years are:

2001 – Rs. 1,01,000
2002 – Rs. 1,24,000
2003 – Rs. 1,00,000
2004 – Rs. 1,50,000

On a scrutiny of the accounts, the following matters are revealed:

(a) On 1st September 2003, a major repair was made in respect of the plant incurring Rs. 30,000 which amount was charged to revenue. The said sum is agreed to be capitalised for goodwill calculation subject to adjustment of depreciation of 10% p.a. on reducing balance method.
(b) The closing stock for the year 2002 was overvalued by Rs. 12,000.
(c) To cover management cost of annual charge of Rs. 24,000 should be made for the purpose of goodwill valuation.
Compute the value of goodwill of the firm.
Solution:

	2001	2002	2003	2004
Profit	Rs. 1,01,000	1,24,000	1,00,000	1,50,000
Less: Management expenses	24,000	24,000	24,000	24,000
	77,000	1,00,000	76,000	1,26,000
Less: Overvaluation of stock	–	(–) 12,000		–
Add: Overvaluation of stock			(+) 12,000	
Add: Major repair cost			(+) 30,000	
Less: Depreciation (10% for 4 months on 30,000)			(–) 1,000	
Less: Depreciation $\left(30,000-1,000=29,000\times\frac{10}{100}\right)$				(–) 2,900
Adjusted Profits	77,000	88,000	1,17,000	1,23,100

Average profits calculated

2001 Rs. 77,000 × 1	77,000
2002 Rs. 88,000 × 2	1,76,000
2003 Rs. 1,17,000 × 3	3,51,000
2004 Rs. 1,23,100 × 4	4,92,400
Total	10,96,400

Average Profit: $\frac{10,96,400}{10}$ = Rs. 1,09,640

Goodwill at 3 years purchase = Rs. 1,09,640 × 3 = Rs. 3,28,920

Problem :On 31st December 2004, the Balance Sheet of a Limited Company disclosed the following position:

Liabilities	Rs.	Assets	Rs.
Issued Capital in shares of Rs. 10 each	4,00,000	Fixed Assets	5,00,000
Reserves	90,000	Current Assets	2,00,000
Profit and Loss	20,000	Goodwill	40,000
5% Debentures	1,00,000		
Current Liabilities	1,30,000		
	7,40,000		7,40,000

On 31st December 2004, the fixed assets were independently valued at Rs. 3, 50,000 and the goodwill at Rs. 50,000.
The net profits for the three years were:
2002 Rs. 51,600; 2003 Rs. 52,000 and 2004 Rs. 51.650 of which 20% was placed to Reserve Account and this proportion being considered reasonable in the industry in which the Company is engaged and where a fair investment return may be taken at 10%. Compute the value of the Company’s share by (a) the Assets Method and (b) the Yield Method.

(*a*) Value of shares according to the Assets method:

		Rs.
Current Assets as per Balance Sheet		2,00,000
Revalued fixed Assets		3,50,000
Revalued goodwill		50,000
		6,00,000
Less: Liabilities: 5% Debentures	1,00,000	
Current Liabilities	1,30,000	2,30,000
Net Assets		3,70,000

$$\text{Intrinsic value per share} = \frac{\text{Net Assets}}{\text{No. of Equity shares}}$$

$$= \frac{3{,}70{,}000}{40{,}000} = \textbf{Rs. 9.25}$$

(*b*) Value of shares according to Yield Method:
Calculation of average expected future profits:

Profit for 2002	Rs. 51,600
Profit for 2003	Rs. 52,000
Profit for 2004	Rs. 51,650
	1,55,250

$$\text{Average profit} = \frac{1{,}55{,}250}{3} = \text{Rs. } 51{,}750$$

Less : 20% transferred to Reserve =	10,350
Average profit after reserve	41,400

$$\text{Calculation of Expected Return} = \frac{\text{Expected Profits} \times 100}{\text{Equity Capital}}$$

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

$$\text{Calculation of Yield value of share} = \frac{\text{Expected Rate} \times \text{Paid up value of share}}{\text{Normal Rate}}$$

$$= \frac{10.35}{10} \times 10 = \textbf{Rs.10.35}$$

Problem: The Balance Sheet of Sumana Ltd. as at 31.12. 2004 were as follows:

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital:		Fixed Assets:	
50,000 Equity Shares of Rs. 10 each, fully paid	5,00,000	Goodwill	10,000
2,000, 8% Preference shares of Rs. 100 each fully paid.	2,00,000	Land & Building	1,50,000
Reserves and Surplus:		Plant & Machinery	3,50,000
Capital Reserve	1,00,000	*Investments:*	
General Reserve	50,000	5% Govt. Securities at cost (face value Rs. 40,000)	50,000
Secured Loan.		*Current Assets:*	
6% Mortgage Debentures	1,00,000	Stock	3,00,000
Current Liabilities & Provisions:		Debtors	2,00,000
Trade Creditors	1,50,000	Cash at Bank	50,000
Provision for Taxation	10,000		
	11,10,000		11,10,000

The assets were revalued as follows:

Land and Building Rs. 1, 00,000: Plant and Machinery Rs. 4, 50,000. The normal rate of return on capital employed for valuation of Goodwill is 10%. Goodwill should be valued on the basis of 3 years' purchase of the super profits of the company. The average annual profits of the company is Rs. 1, 06,000. 40% of the money invested in Building is treated as non-trading assets; because Rent of Rs. 10,000 is collected from the building annually. You are asked to compute the value of each Equity share. Ignore taxation.

SOLUTION :

Capital employed will be Rs. 9,00,000 (Building Rs. 60,000 + Plant and Machinery Rs. 4,50,000 + Current Assets Rs. 5,50,000 – Current Liabilities Rs. 1,60,000).

∴	Normal Profit @ 10% on capital employed is Rs. 90,000		Rs.
	Average Annual Profit		1,06,000
Less:	Non-trading income:		
	Rent	Rs. 10,000	
	Interest on Investment (@ 5% on Rs. 40,000)	Rs. 2,000	12,000
			94,000
Add:	Debentures Interest		6,000
			1,00,000

Super Profit = Average Profit – Normal Profit
= Rs. 1,00,000 – Rs. 90,000
= Rs. 10,000

∴ Value of Goodwill = Rs. 10,000 × 3 years' purchase = Rs. 30,000

	Rs.	Rs.
Net Assets:		
Goodwill (calculated as above)	30,000	
Land and Building	1,00,000	
Plant and Machinery	4,50,000	
Investments	50,000	
Stock	3,00,000	

Debtors	2,00,000	
Cash and Bank	50,000	
		11,80,000
Less: Current Liabilities		
Trade Creditors	1,50,000	
Prov. for Taxation	10,000	
	1,60,000	
6% Mortgage Debentures (assume short-term)	1,00,000	
8% Preference Share Capital	2,00,000	
		4,60,000
Funds available for Equity shareholders		7,20,000

$\therefore$ Intrinsic value of each Equity share : $= \text{Rs.} \dfrac{7,20,000}{50,000} = $ **Rs. 14.40**

UNIT- 2

VALUATION OF SHARES

Meaning

The share capital is the most important requirement of a business. It is divided into a 'number of indivisible units of a fixed amount. These units are known as 'shares'. According to Section 2 (46) of the Companies Act, 1956, a share is a share in the share capital of a company, and includes stock except where a distinction stock and shares is expressed or implied. The person who is the owner of the shares is called 'Shareholder' and the return he gets on his investment is called 'Dividend'.

Factors Affecting the Value of Shares

The value of a share is greatly affected by the economic, political and social factors such as:

- The nature of the company's business
- The economic conditions of the country
- Other political and economic factors (e.g., possibility of nationalization, excise duty on goods produced etc.)
- The demand and supply of shares
- Proportion of liabilities and capital
- Rate of proposed dividend and past profit of the company
- Yield of other related shares of the Stock Exchange etc

Need for Share Valuation: The necessity for valuation of a share arises in the following circumstances:

a) For Estate Duty and Wealth Tax purposes

b) For Amalgamation and Absorption schemes
c) For Gift Tax purposes
d) For discharge of debts and liabilities, in exceptional nature
e) Purchasing shares for control
f) For selling shares of a shareholder to a purchaser (which are not quoted in the Stock Exchange)
g) For the conversion of one class of share to another class
h) For the compensation made to a company when the said company is being nationalized

Methods of Share Valuation
The valuation of Shares may broadly be classified as:
Asset-Backing Method: Since the valuation is made on the basis of the assets of the company, it is known as Asset-Basis or Asset- Backing Method} At the same time, the shares are valued on the basis of real internal value of the assets of the company and that is why the method is also termed as Intrinsic Value Method or Real Value Basis Method. This method may be made either:
(i) On a going/continuing concern basis; and
(ii) break-up value basis. In the case of the former, the utility of the assets is to be considering for the purpose of arriving at the value of the assets, but, in the case of the latter, the relisable value of the assets is to be taken. Under this method, value of the net assets of the company is to be determined first. Thereafter, the net assets are to be divided by the number of shares in order to find out the value of each share. At the same time, value of goodwill (at its market value), investment (non-trading assets) are to be added with net assets. Similarly, if there are any preference shares, those. are also to be deducted with their arrear dividends from the net assets. Alternatively — Net Assets = Share Capital + Reserves and Surplus – Miscellaneous Expenditure + Profit on Revaluation – Loss on Revaluation.

Applicability of the Method:
(i) The permanent investors determine the value of shares under this method at the time of purchasing the shares;
(ii) The method is particularly applicable when the shares are valued at the time of Amalgamation, Absorption and Liquidation of companies; and
(iii) This method is also applicable when shares are acquired for control motives.

Yield-Basis Method:

Yield is the effective rate of return on investments which is invested by the investors. It is always expressed in terms of percentage. Since the valuation of shares is made on the basis of Yield, it is called Yield-Basis Method. For example, an investor purchases one share of Rs. 100 each (face value and paid-up value) at Rs. 150 from a Stock Exchange on which he receives a return (dividend) @ 20%. In that case, yield of the said investor will be: Note: Practically, yield may also be termed as: Expected Yield, Normal Rate of Return/Earning, Rate of Fair Return, Rate of General Expectations, Estimated Rate for Capitalisation etc.

Under Yield-Basis method, valuation of shares is made on
(i) Profit Basis;
(ii) Dividend Basis

(i) Profit Basis: Under this method, at first, profit should be ascertained on the basis of past average profit. Thereafter, capitalized value of profit is to be determined on the basis of normal rate of return, and, the same (capitalized value of profit) is divided by the number of shares in order to find out the value of each share. The following procedure may be adopted: Here, profit means and includes Future Maintainable Profit, i.e., the rate of profit which is expected to be earned in future. "It is to be remembered that the analysis of profit that is made in order to determine future annual maintainable profit must seek a profit that is capable of distribution as dividend

PROBLEM: From the following information, calculate the value of an equity share:
(i) The subscribed share capital of a company consists of 10 lakh 13% preference shares of Rs 10 each and 20 lakh equity shares of Rs 10 each. All the shares are fully paid up.
(ii) The average annual profits of the company after providing depreciation but before taxation are Rs 1,80,00,000. It is considered necessary to transfer Rs 34,50,000 to general reserve before declaring any dividend. Rate of taxation is 30%.
(iii) The normal return expected by investors on equity shares from the type of business carried on by the company is 20%.

	₹
Average annual profits before tax	1,80,00,000
Less : Income tax @ 30%	54,00,000
	1,26,00,000
Less : Transfer to general reserve	34,50,000
Amount available for dividend	91,50,000*
Less : Preference dividend @ 13% on ₹ 1 crore	13,00,000
Amount available for equity dividend	78,50,000

$$\text{Rate of dividend} = \frac{₹\ 78,50,000}{₹\ 2,00,00,000} \times 100 = 39.25\ \%$$

Normal rate of dividend = 20 %

$$\text{Value of an equity share} = ₹\ \frac{39.25}{20} \times 10 = ₹\ 19.63$$

*If there is dividend distribution tax, say @ 17%, the amount available for dividend will be :

$$₹\ 91,50,000 \times \frac{110}{117} = ₹\ 78,20,513$$

As a result, subsequent calculations will also change.

Problem: From the following particulars, calculate the fair value of an equity share assuming that out of the total assets, those amounting to Rs. 41,00,000 are fictitious (*i*) Share capit l :

5,50,000 10% preference shares of ₹ 100 each, fully paid

55,00,000 Equity shares of ₹ 10 each, fully paid.

(*ii*) Liability to outsiders = ₹ 75,00,000

(*iii*) Reserves and surplus = ₹ 45,00,000

(*iv*) The average normal profit after taxation earned every year by the Company during the last five years = ₹ 85,05,000

(*v*) The normal profit earned on the market value of fully paid equity shares of similar companies is 12%. [*C.S. (Inter), June, 2001*]

Solution :

Intrinsic value of shares :	₹	₹
Preference share capital		5,50,00,000
Equity share capital		5,50,00,000
Reserves & surplus		45,00,000
Liabilities to outsiders		75,00,000
Gross assets		12,20,00,000
Less : Fictitious assets	41,00,000	
Liabilities to outsiders	75,00,000	1,16,00,000
Assets available to shareholders		11,04,00,000
Less : Amount due to preference shareholders		5,50,00,000
Net assets available to equity shareholders		5,54,00,000

Intrinsic value of an equity shares = $\frac{5,54,00,000}{55,00,000}$ = ₹ 10.07

Market value by capitalisation of profits :

	₹
Average profits	85,05,000
Less : Preference dividend	55,00,000
Profit available to equity share holders	30,05,000
Profits capitalised at 12% = ₹ 30,05,000 × 100 / 12	2,50,41,667

Problem: On march 31, 2012, the balance sheet of Harsh Ltd. disclosed the following position.

Harsh Ltd.
Balance Sheet as on 31st March, 2012

(₹)

Particulars	*Note No.*	*Amounts as on 31st March, 2012*
I. Equity and Liabilities		
(1) *Shareholders' fund*		
(a) Share capital	1	4,000
(b) Reserves and surplus	2	3,100
(2) *Non-current liabilities*		
(a) Long-term borrowings	3	1,000
(b) Current liabilities		1,300
		9,400
II. Assets		
(1) *Non-current assets*		
(a) Fixed assets		
(i) Tangible assets	4	5,000
(ii) Intangible assets	5	4,000
(2) *Current assets*		9,400

Notes:

	₹
1. Share Capital	
Authorised	?
Issued, Subscribed and Paid Up:	
4 lakh Equity Shares of ₹ 10 each, fully paid	4,000
2. Reserve and Surplus	1,500
General Reserve	1,200
Surplus	2,700
3. Long-trem Brrowings	
13% Secured Debentures	1,000
4. Tangible Assets	
Sundry Tanagible (Fixed) Assets	5,000
5. Intangible Assets	
Goodwill	400

On the abovementioned date, the tangible fixed assets were independently valued at ₹ 3,500 thousand and goodwill at ₹ 500 thousand. The net profits for the three years were : 2009-10, ₹ 1,032 thousand; 2010-2011, ₹ 1,040 thousand; and 2011-2012, ₹ 1,033 thousand of which 20 per cent was placed to General Reserve, this proportion being considered reasonable in the industry in which the company is engaged and where a fair return on investment may be taken at 18 per cent. Compute the value of the company's share by (*a*) the net assets method and (*b*) the yield method. Ignore taxation. *(Adapted C.A. Inter)*

UNIT-3
UNDER WRITING OF SHARES

Underwriters and Brokers

The persons or institutions underwriting a public issue of shares or debentures are called 'Underwriters'. The underwriters may be individuals, partnership firms or joint stock companies. But, an issue of shares or debentures is hardly underwritten by a single individual as it involves more risk and attaches greater responsibility. Generally, an issue of shares or debentures of a company is underwritten by two or more firms jointly. Some specialized financial institutions set up by the Government in the public sector are also playing an active role these days in underwriting shares or debentures of a company.

Types of Underwriting

An underwriting agreement may be of any one of the following types:

(a) Complete Underwriting

If the whole of the issue of shares or debentures of a company is underwritten, it is said to be complete underwriting. In such a case, the whole of the issue of shares or debentures may be underwritten by –

(a) One firm or institution, agreeing to take the entire risk;

(b) A number of firms or institutions, each agreeing to take risk only to a limited extent.

(b) Partial Underwriting

If only a part of the issue of shares or debentures of a company is underwritten, it is said to be partial underwriting. The part of the issue of shares or debentures may be underwritten by -

(a) One person or institution;

(b) A number of firms or institutions each agreeing to take risk only to a limited extent.

In case of partial underwriting, the company is treated as "Underwriter" for the remaining part of the issue.

(c) Firm Underwriting

It refers to a definite commitment by the underwriter or underwriters to take up a specified number of shares or debentures of a company irrespective of the number of shares or debentures subscribed for by the public. In such a case, the underwriters are committed to take up the agreed number of shares or debentures in addition to unsubscribed shares or debentures, if any. Even if the issue is over-subscribed, the underwriters are liable to take up the agreed number of shares of debentures.

Underwriting Commission

The consideration payable to the underwriters for underwriting the issue of shares or debentures of a company is called underwriting commission. Such a commission is paid at a specified rate on the issue price of the whole of the shares or debentures underwritten whether or not the underwriters are called upon to take up any shares or debentures. Thus, the underwriters are paid for the risk they bear in the placing of shares before the public. Underwriting commission may be in addition to brokerage. (a) the payment of such commission shall be authorized in the company's articles ofassociation;

(b) The commission may be paid out of proceeds of the issue or the profit of the company or both;

(c) the rate of commission paid or agreed to be paid shall not exceed, in case of shares, five percent (5%) of the price at which the shares are issued or a rate authorised by the articles, whichever is less, and in case of debentures, shall not exceed two and a half per cent (2.5 %) of the price at which the debentures are issued, or as specified in the company's articles, whichever is less;

PROBLEM: The following underwriting took place for a company:

X 6,000 shares; Y 2,500 shares; Z 1,500 shares.In addition, there were firm underwriting as: X 800 shares; Y 300 shares; Z 1,000 shares. The share issue was 10,000 shares. Total subscriptions including firm underwriting was 7,100 shares and the forms included the following marked forms:X 1000 shares; Y 2000 shares; and Z 500 shares.

Show the allocation of the liability of the underwriters.

Solution

Calculation of Unmarked Applications

Underwriters	Marked Applications	Firm Applications	Total
X	1,000	800	1,800
Y	2,000	300	2,300
Z	500	1,000	1,500
	3,500	2,100	5,600

∴ **Unmarked application = 7,100 – 5,600 = 1,500 shares**

Statement showing the Liabilities of Underwriters

	Name of the Underwriters:	X	Y	Z	Total
		Shares	Shares	Shares	Shares
	Gross Liability	6,000	2,500	1,500	10,000
Less:	Marked Application (including firm underwriting)	1,000	2,000	500	3,500
		5,000	500	1,000	6,500

		Shares	Shares	Shares	Shares
Less:	Unmarked Application 1,500 shares divided as per ratio of gross liabilities 12 : 5 : 3	(–) 900	(–) 375	(–) 225	(–) 1,500
		4,100	125	775	5,000
Less:	Firm Underwriting	(–) 800	(–) 300	(–) 1,000	(–) 2,100
	Balance	3,300	–175	– 225	2,900
	Adjustment of Negative balance	– 175	+ 175		—
		– 225		+ 225	
		2,900	—	—	2,900
	Firm Liability	800	300	1,000	2,100
		3,700	300	1,000	5,000

PROBLEM: Sardar Limited issued to public 1,50,000 equity shares of Rs. 100 each at par. Rs. 60 per share was payable along with application and the balance on allotment. This issue was underwritten equally by Ali, Bali and Charlie for a commission of 2.5 per cent.

Applications for 1,40,000 shares were received as per details:

Underwriter	Firm Application	Marked Application	Total
Ali	5,000	40,000	45,000
Bali	5,000	46,000	51,000
Charlie	3,000	34,000	37,000
Unmarked Applications			7,000
Total			1,40,000

It was agreed to credit the unmarked applications equally to Ali and Charlie. Sardar Limited accordingly made the allotment and received the amounts due from the public. The underwriters settled their accounts. Prepare a statement showing the liability of the underwriters.

Solution

In the books of Sardar Ltd.
Statement showing Number of Shares to be taken up and Commission Receivable by each Underwriter

Name of the Underwriters :		Ali	Bali	Charlie	Total
		No. of Shares	No. of Shares	No. of Shares	No. of Shares
	Gross Liability (1,50,000 shares equally)	50,000	50,000	50,000	1,50,000
Less:	Marked Application (excluding firm underwriting]	40,000	46,000	34,000	1,20,000
		10,000	4,000	16,000	30,000
Less:	Unmarked Application (1,27,000 – 1,20,000)	3,500	—	3,500	7,000
		6,500	4,000	12,500	23,000
Less:	Firm Underwriting	5,000	5,000	3,000	13,000
		1,500	(–) 1,000	9,500	10,000
Excess of Bali's Surplus to Ali and Charlie in 1 : 1		– 500	+ 1,000	– 500	—
		1,000	—	9,000	10,000
Add:	Firm Underwriting	5,000	5,000	3,000	13,100
	Gross Liability	6,000	5,000	12,000	23,000

Net Amount Due from/Due to Underwriters

Name of the underwriters :		Ali	Bali	Charlie
	No. of shares subscribed	6,000	5,000	12,000
	Amount due @ Rs. 60 per share	3,60,000	3,00,000	7,20,000
Less :	Amount already paid on firm applications	3,00,000	3,00,000	1,80,000
		60,000	—	5,40,000
Less:	Underwriting Commission @ 2.5% on issue price	1,25,000	1,25,000	1,25,000
		(–) 65,000	(–) 1,25,000	4,15,000

PROBLEM: Libra Ltd. came up with an issue of 20,00,000 equity shares of Rs. 10 each at par. 5,00,000 shares were issued to the promoters and the balance to the public was underwritten by three underwriters—Anand, Vijay and Ashoke equally, with firm underwriting of 50,000 shares each. Subscriptions totaled 12,97,000 shares including the marked forms which were: Anand 4,25,000 shares;Vijay 4,50,000 shares;Ashoke 3,50,000 shares. The underwriters had applied for shares covered by firm underwriting. The amount payable on application and allotment were Rs. 2.50 and Rs. 2, respectively. The agreed commission was 2.5%.

Solution

In the books of Libra Ltd.
Statement showing Liability of the Underwriters

Name of the Underwriters:		Anand	Vijay	Ashoke	Total
		Shares	Shares	Shares	Shares
	No. of shares underwritten	5,00,000	5,00,000	5,00,000	15,00,000
Less:	Marked Application	4,25,000	4,50,000	3,50,000	12,25,000
		75,000	50,000	1,50,000	2,75,000

	Shares	Shares	Shares	Shares
Less: Firm Application	50,000	50,000	50,000	1,50,000
	25,000	—	1,00,000	1,25,000
Less: Unmarked Applications (equally) (12,97,000 – 12,25,000)	36,000	—	36,000	72,000
	(–) 11,000	—	64,000	53,000
Less: Anand's Surplus to Ashoke	11,000	—	(–) 11,000	—
Net Liability	—	—	53,000	53,000
Add: Firm Underwriting	50,000	50,000	50,000	
∴ Gross Liability	50,000	50,000	1,03,000	

Statement showing the Amount to be Received/Paid by the Underwriters

Name of the Underwriters:	Anand	Vijay	Ashoke
Underwriters' liability (calculated as above)	50,000	50,000	1,03,000
	Rs.	Rs.	Rs.
Amount to be paid by them @ Rs.4.50 per share =	2,25,000	2,25,000	4,63,500
Less: Amount paid on firm applications @ Rs. 2.50 on 50,000 shares	1,25,000	1,25,000	1,25,000
	1,00,000	1,00,000	3,38,500
Less: Commission to be received on underwriting shares @ 2.5% on 50,000 shares each	1,25,000	1,25,000	1,25,000
Amount Paid	25,000	25,000	—
Amount Received	—	—	1,13,500

Unit 4

Profit/Loss Prior to Incorporation

When a running business is taken over from a date prior to its incorporation/commencement, the profit earned up to the date of incorporation/commencement (incorporation, in case of private company; and commencement, in case of public company) is known as 'Pre-incorporation profit'.

The same is to be treated as capital profit since these are profits which have been earned before the company came into existence. In short, the profit earned after the date of purchase of business is called 'Post-incorporation or Post-acquisition profit' and the profit earned before the date of purchase of business is termed as 'Pre-incorporation profit'.

For example, X Ltd. was incorporated on 1st April 2017, took over a running business, Y Ltd., from 1st January 2017 and it closed its accounts on 31st December 2017. Now, the company X Ltd. is entitled not only to the profit/loss made by Y Ltd. from 1st April to 31st December 2017 but also to the profit/loss made by Y Ltd. from 1st January 2017 to 31st March 2017.

Thus, any profit/loss made before the incorporation is known as “Profit (Loss) Prior to Incorporation” which is treated as a capital profit and the same cannot be distributed as business profit. Hence, it cannot be distributed by way of dividend.

The same is to be transferred to Capital Reserve or may be adjusted against Goodwill. “Loss prior to incorporation” is treated as a capital loss and, hence, the same is shown under the head “Miscellaneous Expenditure” in the assets side of the Balance Sheet

i) Sales Ratio:Amount of sales should be calculated for the pre-incorporation and post-incorporation periods

(ii) Time Ratio:It is calculated after considering the time period, i.e., one is required to calculate the period falling between the date of purchase and the date of incorporation and the period between the date of incorporation and the date of presenting final accounts.

Ruling/Format

In the Books of ....
Statement of Profit Pre- and Post-incorporation

Particulars	*Total*	*Basis of Allocations/ Apportionment*	*Pre-incorporation Profit*		*Post-incorporation Profit*	
			Dr.	*Cr.*	*Dr.*	*Cr.*
			Rs.	Rs.	Rs.	Rs.
Gross Profit	• • •	Sales Ratio	—	• • •	—	• • •
Less: Expenses and Losses						
Fixed Expense	• • •	Time Ratio	• • •	—	• • •	—
(Variable Expenses		Sales Ratio	• • •	—	• • •	—
before						
Incorporation)	• • •	—	• • •	—	—	—
Expenses after		—	—	—	• • •	—
Incorporation	• • •					
Net Profit c/d	• • •		• • •	—	• • •	—
			• • •	• • •	• • •	• • •
Net Profit b/d	.					
Dividend		Actual	—	• • •		• • •
Any Income		Actual	—	• • •		• • •
Net Profit						
—Transferred to Capital Reserve			• • •	—	—	—
—Net Profit transferred to P & L App. A/c			—	—	• • •	—
			• • •	• • •	• • •	• • •

S. Ltd was registered on 1st January 2000 to buy over the business of M/s P. Ltd. as on 1st October 2008 and obtained its certificate for commencement of business on 1st February 2009. The accounts of the company for the period ended 30th September 2009 disclosed the following facts:(i) The turnover for the whole period amounted to

Rs. 3,00,000 of which Rs. 50,000 related to the period from 1st October 2008 to 1st February 2009.(ii) The Trading Account showed a Gross Profit of Rs. 1,20,000.

(iv) The following items appear in the Profit and Loss Account:

	Rs.
Directors' fees	2,000
Auditor's fees	1,000
Rent, Rates and Taxes etc.	5,400
Bad Debts (of which Rs. 1,000 related to Book Debts created before 1st February 2009)	3,000
Salaries	18,000
Advertising	6,000
Travelling Expenses and Salaries	9,000
Commission on sales	1,200
General Expenses	2,100
Debenture Interest	4,000
Preliminary Expenses	2,000
Depreciation on Plant	1,200
Printing and Stationery	1,500
Interest to vendors @ 12% on Rs. 50,000 from 1.10.2008 to 31.5.2009	4,000

Prepare a statement showing the amount of profit made before incorporation and after incorporation.

Solution

In the Books of S. Ltd.
Statement of Profit Pre- and Post-incorporation

Particulars	*Amount*	*Basis of Apportion*	*Profit for the pre-incorporation period*		*Profit for the post-incorporation period*	
			Dr.	*Cr.*	*Dr.*	*Cr.*
	Rs.		Rs.	Rs.	Rs.	Rs.
Gross profit	1,20,000	Turnover (1: 5)		20,000		1,00,000
Less: Expenses and Losses						
Directors' fees	2,000	Actual	—		2,000	
Auditor's fees	1,000	"	—		1,000	
Rent, Rates & Taxes	5,400	Time (1 : 2)	1,800		3,600	
Bad debts	3,000	Actual	1,000		2,000	
Salaries	18,000	Time (1 : 2)	6,000		12,000	
Advertising	6,000	Turnover (1 : 5)	1,000		5,000	
Travelling Expenses	9,000	" " "	1,500		7,500	
Commission on Sales	1,200	" " "	200		1,000	
General Expenses	2,100	Time (1 : 2)	700		1,400	
Debenture Interest	4,000	Actual	—		4,000	
Preliminary Expenses	2,000	"	—		2,000	
Dep. on Plant	1,200	Time (1 : 2)	400		800	
Printing & Stationery	1,500	Time (1 : 2)	500		1,000	
Interest to vendors	4,000	Time (1 : 1)	2,000		2,000	
Net Profit Transferred to:						
— Capital Reserve			4,900		—	
— P & L Appropriate			—		54,700	
			20,000	20,000	1,00,000	1,00,000

Moon Ltd., which was incorporated on 1st June 2009, took over the business of N, a proprietary concern, from 1st January 2009, for Rs. 1,00,000 on condition that all profits earned from 1.1.2009 shall belong to the company. Following are the data for Profit and Loss Account for the year ended 31st December 2009:

Gross Profit Rs. 2,00,000; Salaries and Bonus Rs. 15,000; Rent Rs. 1,000; Bad Debts Rs. 5,000; Preliminary Expenses Rs. 9,000; Commission on Sales Rs. 12,000; Interest payable to or against purchase consideration Rs. 1,000; Directors' fees Rs. 3,000; Managing Directors' Remuneration Rs. 14,600; Establishment Charges Rs. 21,000; Depreciation Rs. 10,000; and Advertisement Rs. 27,000.

(a) Sales for first six months amounted to Rs. 10,00,000; rate of gross profit being 12% on sales. In the second six months, rate of gross profit was 8% on sales. Commission on sales was at 6% throughout the year. Question of stock and work-in-progress does not arise in the business.

(b) N used to carry out the business up to 31.5.2009 in own premises without any depreciable assets on cash sales basis only.

(c) Advertisement for the first six months was at the rate of Rs. 4,000 per month.Prepare a Statement of Profit Account for pre-incorporation and post-incorporation periods in columnar form stating against each items the basis of segregation. How much was the pre-incorporation profit? Take calendar months as of equal length. Confine to the data given only.

Heads of Accounts	*Debit*	*Credit*
	Rs.	Rs.
Opening Stock	43,000	
Purchases	1,89,000	
Carriage Outwards	3,300	
Sales		2,78,000
Travellers' Commission	7,500	
Office Salaries	21,000	
Administration Expenses	19,900	
Rent and Rates	12,000	
Directors' Fees	18,000	
X's Capital on 1.4.2006		2,30,000
Fixed Assets	1,00,000	
Current Assets (other than stock)	34,000	
Preliminary Expenses	5,200	
Current Liabilities		37,000

(a) Stock on 31st March 2007 amounted to Rs. 44,000.

(b) The Gross Profit Ratio is constant and monthly sales in April '06, Feb. '07 and March '07 are double the average monthly sales of the year.

(c) The purchase consideration was agreed to be satisfied by the issue of 3,000 Equity Shares of Rs. 100 each.

(d) The Preliminary Expenses are to be written-off.

(e) You are to assume that carriage outwards and travellers' commission vary in direct proportion to sales.

You are required to prepare the Trading Account and the Profit and Loss Account for the year ended on 31st March 2007 apportioning the profit or loss of the periods before and after incorporation. Depreciation shall be provided at 25% p.a. on Fixed Assets

Solution

In the Books of Moon Ltd.
Statement of Profit
Pre-and Post-incorporation

Particulars	*Amount*	*Basis of Apportion*	*Profit*			
			Pre-incorporation period 1.1.2009 to 31.5.2009		*Post-incorporation period 1.6.2009 to 31.12.2009*	
			Dr. Rs.	*Cr.* Rs.	*Dr.* Rs.	*Cr.* Rs.
Gross Profit[1]	Rs. 2,00,000	Actual		1,00,000		1,00,000
Less : Expenses and Losses						
Salaries and Bonus	15,000	Time (5 : 7)	6,250		8,750	
Rent	1,000	Time (5 : 7)	417		583	
Bad Debts	5,000	Sales (5 : 7)	2,084		2,916	
Preliminary Expenses	9,000	Actual	—		9,000	
Commission on Sales[1]	12,000	Time (5 : 7)	5,000		7,000	
Interest on Purchase Consideration	1,000	Time (5 : 7)	417		583	
Directors' Fees	3,000	Actual	—		3,000	
Managing Directors' Remuneration	14,600	Actual	—		14,600	
Establishment Charges	21,000	Time (5 : 7)	8,750		12,250	
Depreciation	10,000	Actual	—		10,000	
Advertisement	27,000	Actual	20,000		7,000	
Net Profit transferred to			42,918		75,682	
—Capital Reserve			57,082		—	
—P & L App. A/c			—	—	24,318	—
			1,00,000	1,00,000	1,00,000	1,00,000

Unit 5

Company final accounts

Calculating the Remuneration Paid to the Directors:

The Board of Directors of Sen & Co. Ltd. consists of two whole-time Directors and three part-time Directors. The whole-time Directors are entitled to a monthly salary of Rs. 3,000 each. In addition, they are to get 8% commission and the part-time Directors 1% commission on the profits of the company.

The Profit and Loss Account of the company for the year ended 31.12.1999 was as follows: You are asked to compute the remuneration to be paid to the Directors with your comments, if any.

So, the Directors are entitled to have overall maximum remuneration to the extent of Rs. 3,51,450 as per Sec. 198 of the Companies Act. Since they have taken Rs. 3,59,550, therefore excess amount Rs. 8,100 (Rs. 3,59,550 – Rs. 3,51,450) must be refunded to the company u/s 309 (5A). At the same time, they should have taken previous permission from the Central Government for this purpose.

2. Preparation of Profit and Loss Account of a Company:

The following balance appeared in the books of Regent Company Ltd. as on 31st December 1999:From the above balance and the following information, prepare the Company's Profit and Loss Account for the year ended 31st Dec. 1999:

- Stock on 31st Dec. 1999 Rs. 73,200.
- Outstanding Expenses: Manufacturing Expenses Rs. 45,000 and Salaries and Wages Rs. 3,000.
- Interest accrued on Securities Rs. 200.
- General Charges prepaid Rs. 1,660.
- Provide depreciation on:
- Building @ 2% p.a., Plant and Machinery @ 10% p.a., Furniture @ 10% p.a. and Motor Vehicles @ 20% p.a.
- The Directors proposed a dividend @ 20%.
- The taxation provision shown in the Trial Balance is after payment of taxes for assessment up to 31st Dec. 1999.
- The only liability for taxes is in respect of profit for 1999 for which a provision of 60% on net profit is considered

Solution :

In the books of REGENT Co. Ltd.
Profit and Loss Account
for the year ended 31st Dec. 1999

	Rs	Rs.		Rs.	Rs.
To Opening Stock		51,000	By Sales		11,10,000
" Purchases		8,10,000	" Closing Stock		73,200

Problem: Preparation of Balance Sheet of a Company as Required under Part IB of Schedule VI of the Companies Act, 1956:

Prepare a Balance Sheet in vertical form as at 31st December 2000 from the following information of ABC Limited as required under Part IB of Schedule VI of the Companies Act, 1956:

Staff advances	55,000
Provision for taxation	1,70,000
Share premium	4,75,000
Loose tools	50,000
Investments	2,25,200
Loss for the year	3,00,000
Sundry debtors	12,25,000
Miscellaneous expenses	58,000
Loans from Debtors	2,00,000
Provision for doubtful debts	20,200
Stores	4,00,000
Fixed assets (WDV)	51,50,000
Finished goods	7,50,000
General reserve	20,50,000
Capital work-in-progress	2,00,000

Additional Information:

(1) Share Capital consists of:

(a) 3,000 Equity Shares of Rs. 100 each, fully paid-up.

(b) 10,000,10% Redeemable Preference Shares of Rs. 100 each, fully paid-up.

(2) Term loans secured.

(3) Depreciation on assets Rs. 5,00,000.

(4) Schedules need not be given. However, groupings should form part of the answer

	Rs.	Rs.	Rs.
Add : Depreciation	5,00,000		
	56,50,000		
Less : Depreciation	5,00,000		
		51,50,000	
Capital Work-in-Progress		2,00,000	
			53,50,000
(b) *Investments*			2,25,200
(c) *Current Assets, Loans & Advances :*			
(i) Current Assets :			
Inventories :			
Finished Goods	7,50,000		
Stocks	4,00,000		
Loose Tools	50,000		
		12,00,000	
(ii) Sundry Debtors :	12,25,000		
Less : Provision for Bad Debts	20,200		
		12,04,800	
(iii) Cash and Bank Balances		2,75,000	
(iv) Loans & Advances :			
Advances	3,72,000		
Staff Advances	55,000		
		4,27,000	
		31,06,800	
Less : *Current Liabilities and Provisions :*			
(i) Sundry Creditors	11,45,000		
Loans from Debtors	2,00,000		
	13,45,000		
(ii) Provision for Taxation	1,70,000		
		15,15,000	
			15,91,800
(d) *Miscellaneous Expenditures :*			
P & L A/c (Dr.)		3,00,000	
Misc. Expenses		58,000	
			3,58,000
			75,25,000

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