Chapter 6:
Accounting for Joint Stock Companies

Prof. Ram Kumar Kakani

Prof. N. Ramachandran

Tanmoy Chatterjee

Introduction

- Basic tenet of accounting *"Business Entity Concept"*
- A Company is an incorporated association
- Formed by a group of people but acquires its status as a juridical personality with perpetual succession by registration under the law
- Lead to Joint Stock Companies
  - The Indian Companies Act, 1956 regulates the formation and working of Joint Stock Companies
  - Recognized in law as a separate and distinct entity from the members constituting it

Forms of Companies

- Public Limited Companies
- Private Limited Companies

Most Common

- Statutory Corporations
  - Created for a specific and narrow purpose by an ‘Act of Parliament’ and are closely controlled by state
  - Example: LIC and FCI
- Guarantee Companies
  - Are limited by guarantees
  - Licensed by the state laws and appropriately empowered to grant guarantees in respect of any legal proceedings
  - Example: Exim Bank is a guarantee company in Zimbabwe

Two Fundamental Documents

- ‘*Memorandum of Association*’ contains:
  - (1) Name (2) Domicile (3) The Objects (4) Statement of Liability (5) Authorized Capital and its divisions and (6) The Declaration of Association.
- ‘*Articles of Association*’ is the constitution for the internal management of the companies
  - Defines the relationship between various members within the company as well as between company and its members
- Both filed at the time of incorporation

Characteristics of Companies

- **Voluntary Association -** Pre-determined objectives in the MoA.
- **Separate Legal Entity -** Can sue and be sued in a court of law, enter into contracts, acquire and dispose of assets, etc.
- **Perpetual Succession -** Death, insolvency or lunacy of the members does not interfere with the continuance of the entity
- A shareholder cannot be held liable for the actions of the company; nor can the company be held liable for the actions of the shareholder.
- Since the company is only a 'legal personality' and not a 'physical personality', it has to operate through its **Agents.** The Board of Directors are the Agents for the company.

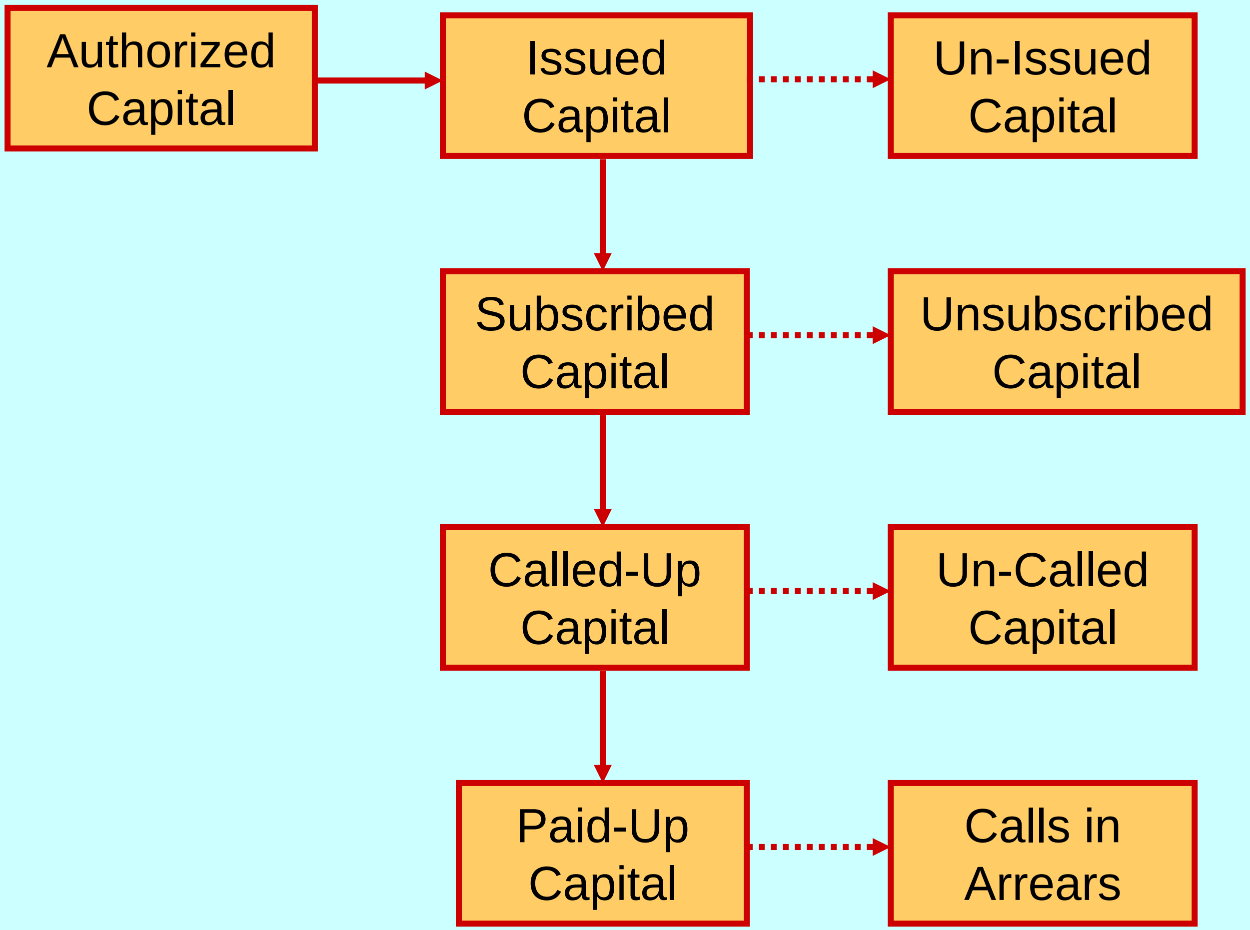
Shares and Share Capital

- Sec 2(46) of the Indian Companies Act, 1956 defines "share" as a **unit** in the share capital of the company
- Section 86 of the Companies Act allows a company to issue only two types of shares viz., Ordinary and Preference Shares
- Ordinary **equity shares** represent the risk capital of an entity
  - No right to fixed dividends; Control through voting rights
- **Preference equity shares** enjoy preferential rights with respect to payment of fixed dividend and repayment of capital at the time of liquidation
- Additional rights can be granted to preference shares by virtue of provisions contained in the MoA and AoA

Types of Preference Shares

- Classified is dependent on the rights attached to them
- Cumulative Preference Shares
  - Entitled to unpaid dividends in the past
- Non-Cumulative preference shares
  - Shareholders **do not carry any right to unpaid dividends**
- Participating Preference Shares
  - Carry a **right to share in the profit** after a fixed rate is paid to equity shareholders (over and above the fixed dividend)
- Redeemable Preference shares
- Cumulative Redeemable Non-Participating Preference shares are most common

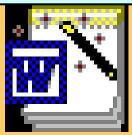
Share Capital Types



Share Capital Types - explained

- Authorized or Registered Share Capital
  - Maximum amount of capital, which a company is allowed to raise during its lifetime
  - Based on the amount mentioned in the MoA
- Issued Capital
  - The portion of authorized capital, which has been issued to all the investors including public
  - The amount of issued capital is taken in the balance sheet only if the total amount of issued capital is subscribed, called up by the company and paid by the share holders
  - Otherwise, its presentation is similar to authorized capital

Share Capital Types - explained



Real Life Examples

- Subscribed Capital
  - The portion of the issued capital, which has been subscribed by all the investors including the public
- Called up Capital
  - The portion of the subscribed capital that has been called up by the company for payments is the called up capital
- Paid-up Capital
  - That part of called up capital, which has been paid up by the subscribers of share capital
  - The amount, which is due but yet to be received, is known as calls in arrears

Debentures/Bonds

- A debenture is an acknowledgement under seal of a debt or loan
- It is a large amount of loan raised by a company wherein the loan is divided into regular parts and is usually offered to retail and institutional investors
- A debenture could also be privately placed
- Interest on Debenture is a charge against profits
- Debentures are usually tradeable (unlike fixed deposits)
- Hence one can say that ‘Shares’ stand for ‘ownership’ and ‘Debentures’ stand for Long-term creditors

Classes of Debentures

- Secured or Mortgage debentures
  - Secured by a fix charge or by a floating charge (in general it would be accounts receivable or inventory)
  - First and Second debentures (a.k.a senior and junior debentures)
- Simple or Naked debentures
  - Unsecured debentures i.e., in case of default any asset as security does not back them
- Redeemable and Irredeemable debentures
  - Repaid in a specified period Vs a permanent loan
- Registered and Bearer debentures

Issue of Securities

Issue of Prospectus

Receiving Applications with Application Money

Allotment of shares

Making Calls for payment of balance money

Steps to Raise Capital

Prospectus

- Is a regulator-approved document inviting offers from the public for the subscription or purchase of any shares or debentures
- Can be issued only by public limited companies
- Prospectus needs to be signed by every director before its publication and a copy of the same filed with the Registrar of Companies (RoC) and the regulator, Securities Exchange Board of India (SEBI)
- It should supply all the important information for the company on the basis of which the general public can take a decision whether to subscribe for the share capital or not

Receiving Applications

- Needs to be in the prescribed form along with the prescribed application money and delays
- The initial application money shall not be less than 5 percent
- If within the prescribed time a company does not receive applications equal to the minimum subscription, the whole of the application money received has to be refunded to the applicants
- For delays, the directors of the company are liable to repay the amount with a penal interest
- Share application money has to be kept deposited in a scheduled bank until the company has received the minimum subscription

Allotment of Shares

- Implies acceptance of the offer of the applicant for the purchase of share of the company by the directors
- Done when the company has received applications amounting to the minimum subscription
- In case of over subscription, the allotment is based on a pro-rata basis in consultation with a stock exchange
- Once the allotment is made the applicant becomes liable to pay the full amount of the shares allotted

Making Calls

- The company can either collect the whole amount due on such shares on allotment or a part on allotment and the balance in one or more installments
- After allotment, installments demanded by the directors against the sum payable by shareholders on their shares are known as calls. Calls must be made on a uniform basis on all shares within the same class
- Example: Using the installment route, Nagarjuna Fertilizers and Chemicals Limited issued Rs 10 par value share in 1990 (par value was divided as Rs 2.50 on application; Rs 2.50 on allotment; Rs 2.50 on first call; and Rs 2.50 on final call)

Par Value and No Par Value Shares

- Indian company laws requires shares to have a par value; it is a certain amount of joint stock is divided into a number of shares
- However, the companies may issue a share at a price above, equal to or below the par value
- Share Premium
  - When the issue price is higher than the face value, the amount received in excess is considered as share premium
- No Par Value Shares
  - The company will only have a certain number of shares with no par value ascertained
  - Value will be what a shareholder is prepared to pay for it

Forfeiture, Shares at a Discount

- Forfeiture of Shares
  - When some shareholders fail to pay on demand any money due, the issued shares may be forfeited
  - Results in the removal of name. The company forfeits amount already paid in by such shareholders
  - The directors can reissue the forfeited shares (the price charged should not be less than the amount in arrears)
- Shares at a Discount
  - Ordinarily, shares cannot be issued at a discount (unless such shares were previously forfeited)
  - Issue is subject to the stringent conditions

Share Issue – Accounting Records

- Based on the GAAP and the Company Law
- The accounting entries can be split into three parts – (a) issue of shares; (b) allotment of shares; and (c) making calls for balance payment of allotted equity shares
- Accounting Record for issue of shares
- On receipt of share applications along with application money

Bank (Dr)
Share Application (Cr.)
(Narration: Being the amount of application money received on ________ shares at Rs. ___ per share)

- Money is collected by banks and kept in special accounts

Issue of shares – Entries

- When the directors allot the shares, the application money received is transferred to the share capital account

Share Application (Dr)

Share Capital (Cr.)

(Narration: Being the amount of application money transferred to Share capital account)

- In some cases, the directors do not allot any shares. In this case, the application money is required to be returned

Share Application (Dr)

Bank Account (Cr)

(Narration: Being the excess of application money returned back to the applicants who have not been allotted any shares)

Illustration

- Gurmeet Company Ltd. issued a prospectus inviting application for 1,00,000 shares of Rs. 10 each for which Rs. 2 per share is required to be paid with application
- The company received applications for 1,10,000 shares along with the application money
- The directors of the company decided to allot shares to applicants applying for 1,00,000 shares and returning back the money to the applicants who have not been allotted any shares

Solution

Bank	(Dr)		2,20,000	
Share Application		(Cr.)		2,20,000

(Narration: Being the amount of application money received on 1,10,000 shares at Rs. 2 per share)

Share application	(Dr)		2,00,000	
Share capital		(Cr.)		2,00,000

(Narration: Being the amount of application money transferred to Share capital account)

Share Application	(Dr)		20,000	
Bank Account		(Cr.)		20,000

(Being the excess of application money returned back to applicants of 10,000 shares who were not allotted any shares)

Allotment of shares – Entries

The company sends allotment letters to the applicants who have been allotted the shares. With the allotment letter, the allotment money becomes due and the entry required to be passed is

Share Allotment (Dr)
Share Capital (Cr)
(Being amount due on ____ Shares at Rs. __ per share)

On receipt of the allotment money from equity shareholders we pass the same entry that is passed for receipt of money i.e,

Bank Account (Dr)
Share Allotment (Cr)
(Being amount received on allotment of ____ shares)

Illustration Continues …

Continuing with the same example of Gurmeet Company. If the amount payable on allotment is Rs. 5 per share then the journal entries will be

Share Allotment	(Dr)		5,00,000
Share Capital		(Cr)	5,00,000

(Being amount due on 1,00,000 Shares at Rs. 5 per share)

Bank Account	(Dr)		5,00,000
Share Allotment		(Cr)	5,00,000

(Being amount received on allotment of 1,00,000 Shares)

Journal entries on Call

Whenever the shareholders are informed to pay the call money, the call money becomes due for payment by the shareholders

Share Call (Dr)
Share Capital (Cr)
(Being the amount due on call on _____ shares at __ per share)

On receipt of the call money we pass the following entry
Bank Account (Dr)
Share Call (Cr)
(Being the amount received on ____ shares at __ per share)

Similar entries are passed on subsequent calls

Illustration Continues ...

Assuming that Rs. 3 is to be paid on account of first and final call. We pass the entry for due and receipt in the following way

Share Call	(Dr)		3,00,000	
Share Capital		(Cr)		3,00,000

(Being the amount due on call on 1,00,000 shares at 3 per share)

On receipt of the call money:

Bank Account	(Dr)		3,00,000	
Share Call		(Cr)		3,00,000

(Being the amount received on 1,00,000 shares at 3 per share)

Calls in Arrears & Calls in Advance

- Calls in Arrears
  - Amount of called up money, which has not been received
  - Transferred to the calls in arrears account at the end of the accounting year
  - Shown as a deduction from the paid up capital
- Calls in Advance
  - Amount which is received before the calls are made
  - Balance of calls in advance for the period is shown separately in the balance sheet under the called up and paid up capital of the company
- Interest rate on the calls is prescribed by the AoA

Forfeiture of Shares

- When the amount is not paid by any shareholder as and when the amount is due, the directors of the company are empowered, by the AoA, to forfeit the shares
  - Done only after issuing 14 days notice to the shareholder
  - The board of directors of the company must pass a resolution for forfeiture of the shares
  - Name of the defaulter shareholder is struck off from the register of members and the amount received till date on such shares will be forfeited by the company
  - The gain on re-issue of these shares is a capital gain in nature – transferred to the Capital Reserve Account

Illustration

Lilly was holding 100 shares of Rs. 10 each of Bhuva Tea Limited. She had paid Rs. 3 on application, Rs. 5 on allotment but failed to pay the first and final call of Rs. 2 per share. The company forfeited these shares after passing a valid resolution by the board.

Share Capital Account	(Dr)	1,000		
Share First & Final Call Account		(Cr)		200
Shares Forfeiture Account		(Cr)		800

(Being 100 shares forfeited on account of non-payment of first and final call of Rs. 2 per share. The amount already paid on these 100 shares at Rs. 8 per equity share has been forfeited pursuant to the forfeiture)

Illustration …

If the reissue is at a discount, such discount should not exceed the balance in the forfeited shares account. The entries would be

Bank (face value less discount allowed)	(Dr)	
Discount on Reissue of Forfeited shares	(Dr)	
Share capital (Face value of shares)		(Cr.)

Transfer to the forfeited shares account will write off the discount on 'reissue of forfeited shares account'

Forfeited Shares Account	(Dr)	
Discount on Reissue of Forfeited Shares		(Cr.)

After the reissue and adjusting for any discounts allowed, the balance, if any remaining in the forfeited shares account will be transferred to the capital reserves

Forfeited shares account	(Dr)	
Capital Reserves		(Cr.)

Legal Requirements

- As per the provisions of the law, every company shall keep proper books of account at its registered office with respect to:
  - All sums of the money received and expended;
  - All sales and purchases of goods by the company;
  - The assets and liabilities of the company; and
  - Particulars relating to utilization of material or to other items of cost as may be prescribed for companies in production
- The books of account relating to a period of last eight years together with the vouchers relevant to any entry in such books shall be preserved. The books shall be open to inspection during business hours by authorized Government Officers

Annual Accounts

- At every AGM held, the Board of Directors shall lay before members -
- A balance sheet at the end of the relevant period and a profit & loss account for that period;
- The profit & loss account shall relate -
  - In the case of the first AGM to the period ending with a day not preceding by more than nine months
  - Other AGM's: To the period beginning with the day immediately after the period for which the account was last submitted and ending with a day not preceding by more than six months.
  - The accounting period may be less or more than a calendar year, but it shall not exceed fifteen months (or eighteen months in rare cases)
- Approval of the Accounts

Form and Contents of Statements

- Balance Sheet: should be as per Part I of Schedule VI of Companies Act with due regard to the general instructions under the heading 'notes' at the end of the schedule
- Profit & Loss Account should give a true and fair view of the company and comply with the requirements of Part II of Schedule VI of the Act
- Every financial statement of a company shall be signed on behalf of the Board of Directors (BoD) by secretary and by not less than two directors (compulsorily including the managing director)
- The BoD shall approve these financial statements before they are signed on behalf of the Board and submitted to the auditors for their report thereon
- The profit & loss account is usually annexed to the balance sheet and the auditor's report shall be attached thereto

Distribution of Profits

- No dividend shall be declared or paid by a company for any financial year except out of the profits of the company for that year; or revenue reserves; or out of money, provided by the government for the payment of dividend in pursuance of a guarantee given by that government.
- No dividend shall be payable except in cash

Dividend – Types

Dividend

Interim Dividend

- Dividend announced during the accounting period due to exceptional performance
- Provisions in Companies Act, 1956 (Section 205)

Final Dividend

- At the end of an accounting period
- Based on company’s performance during the whole of the accounting period
- See Sections 205, 205A, 205C, 206 and 206A of the Companies Act

Depreciation

- For computing Net Income, depreciation has to be provided as per the following broad guidelines:

a) Depreciation shall be calculated as per written down value of the assets at rates specified for the assets by the Indian Income Tax Act, 1922

b) If any asset is sold or destroyed before the depreciation of such asset has been provided for in full, the excess, shall be written off in the same financial year

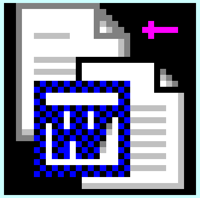
c) In respect of each item of depreciable asset, depreciable amount is arrived at by dividing 95% of the original cost by the specified period in respect of such asset

d) Any other basis approved by the Central Government

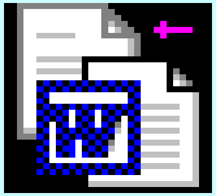
Company Law Requirements

- Company Law lays down elaborate requirements as to disclosure & presentation of company accounts in Schedule VI of the Indian Companies Act 1956

Forms of Balance Sheet



Horizontal Form



Vertical Form

SEBI Guidelines for Issue of Shares

- Regulates the way money is raised by firms from interested investors, both retail and institutional in India
- The issuing companies offer through an offer document, shall, satisfy the following broad norms specified by SEBI:
  - No company shall make any public issue of securities, unless a prospectus has been filed (and approved) with the SEBI, through an eligible Merchant Banker
  - No listed company shall make any issue of security though a rights issue where the aggregate value exceeds Rs. 50 lakhs, unless the letter of offer is filed (and approved) with the SEBI, through an eligible Merchant Banker

Other Regulatory Restrictions

- Companies barred not to issue security
  - If the company has been prohibited from accessing the capital market under any order passed by the SEBI
- Application for Listing
  - No company shall make any public issue of securities unless it has made an application for listing
- Issue of securities in dematerialized form
  - No company shall make public or rights issue or an offer for sale of securities, unless the company enters into an agreement with a depository for dematerialization of securities proposed to be issued

Public Issue by Unlisted Cos.

- An unlisted company is eligible to make a public issue of any equity shares at a later date subject to the following:
  - It has a pre-issue net worth of not less than Rs. 1 crore in three out of preceding five years (especially, last two years)
  - It has a track record of distributable profits in terms of the Companies Act, 1956, for at least three out of immediately preceding five years
  - Provided that the issue size (i.e., offer through offer document *plus* firm allotment *plus* promoters' contribution through the offer document) does not exceed five times its pre-issue net worth

Public Issue by Unlisted Cos.

- An unlisted company can make a public issue of equity shares (or any security convertible into equity shares at a later date), only through the book-building process if,
  - It does not comply with the ‘minimum net worth’ condition specified in previous slide; or
  - Its proposed issue size exceeds five times its pre-issue net worth as per the last available audited accounts either at the time of filing draft offer document with the SEBI or at the time of opening of the issue; or
  - A company, whose equity shares are offered through an offer for sale, shall also comply with the provisions mentioned above

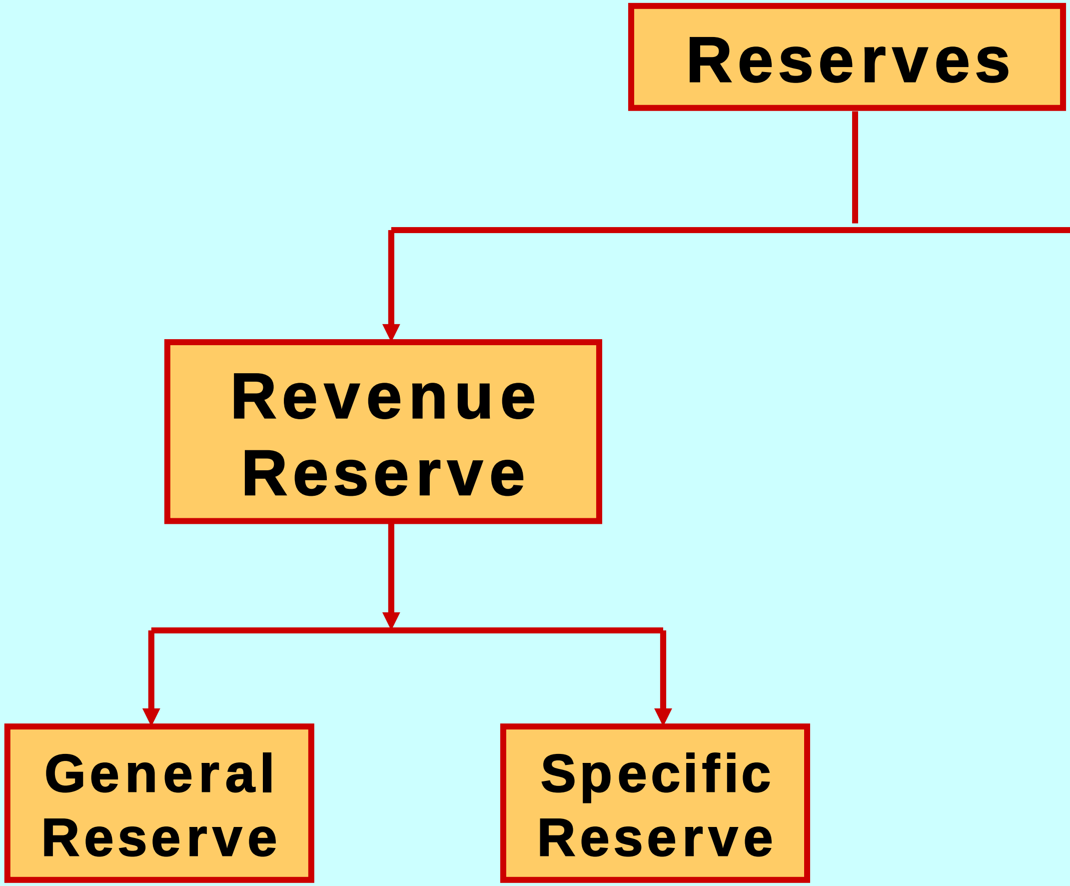
Public Issue by Listed Cos.

- A listed company shall be eligible to make a public issue of equity shares provided:
  - The issue size does not exceed five times its pre-issue net worth as per the last available audited accounts either at the time of filing draft offer document with the SEBI or at the time of opening of the issue.
- Partly Paid Up Equity Shares
  - No company shall make a public or rights issue of equity share, unless all the existing partly paid-up shares have been fully paid or forfeited in a manner specified in the Companies Act

Classification of Equity Reserves

- Reserve is the amount taken out (or separated) from the profit for some purpose
- The term reserve fund means a fund that is earmarked for some purpose other than the normal business activities
- Hence the amount used for the business operations is usually not termed as reserve

Reserves – Classification



Revenue Reserve

- The reserves created out of the revenue profits
- Can be distributed among the shareholders as dividends
- General reserves (a.k.a. free reserves)
  - Created to add financial strength
  - Ensures funds to meet future expenses or contingencies
  - Example: Contingency Reserve
- Specific Reserves
  - Created for some specific purpose, which when attained the balance (if any) can be transferred to General reserve
  - Examples: Statutory reserve, debenture redemption reserve

Capital Reserve

- These reserves are created out of capital profits
- Arise due to non-operational activities of any business
- Examples: Profit on sale of fixed assets, Premium on issues of shares/debentures, and Revaluation of fixed assets/liabilities
- As they are not earned through regular business hence these reserves are often not available for distribution among the shareholders as dividends
- Exception: Profit on sale of fixed assets can be distributed among the shareholders as dividend under specific conditions (such as, in consonance with AoA; Profits realized in cash; Profit remains after revaluation of the balance sheet items)

Thank You

☺