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Name:

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ALLAMA IQBAL OPEN UNIVERSITY, ISLAMABAD

Course: Advanced Accounting (444) • Level: B. Com/AD

Semester: Autumn 2026

Assignment No. 2 (Units 6–9)

SOLVED ASSIGNMENT GUIDE

(For Study & Reference)

Note: This guide is prepared for study and reference purposes. Students are advised to read the relevant units of the course book, understand the concepts, and then write the assignment in their own words. Total marks of the assignment are 100; each question carries the marks shown with it.

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Question 1: Contract Account — National Construction Company (20 Marks)

Q. 1: A contract of Rs. 50,000,000 was awarded on 5 January, 2025 to the National Construction Company by Askari Flour Mills for the construction of a building. The job was carried out progressively and by the end of December 2025, the following information relating to the contract was extracted from the accounting record of the contractor: Material purchases Rs.10,000,000; Material issued from stores 6,000,000; Wages paid 10,120,000; Wages outstanding 3,752,000; New machine purchased 14,800,000; Other direct Costs 810,000; Administrative Salaries 640,000. By the end of December 2025 the unused material at the site was valued at Rs.2,162,000. The Machine was subject to depreciation by 20% per annum. The resident engineer certified the works amounting to Rs. 35,000,000 and uncertified works at Rs. 1,800,000. The contractor received payment to the extent of 80% of the works certified. Required: A) Prepare the contract account in the books of National Construction Company end of December 2025. B) Prepare contractee account in the books of National Construction Company at the end of December 2025.

Introduction

Contract costing is a form of job costing applied to long-term construction work such as buildings, roads, bridges and dams, where each contract is treated as a separate cost unit and a separate Contract Account is opened for it. Because such contracts often run beyond one accounting year, special rules are needed to decide how much profit may safely be taken to the profit and loss account on an incomplete contract. Profit is recognised only on the work certified by the contractee's engineer or architect, and even then only a prudent fraction of it, so that possible future losses are not ignored. In this question the National Construction Company is executing a building contract of Rs. 50,000,000 for Askari Flour Mills, started on 5 January 2025, and the Contract Account and the Contractee Account are to be prepared for the year ended December 2025.

Working Notes

Working Note 1 — Wages. Wages paid of Rs. 10,120,000 plus wages outstanding of Rs. 3,752,000 give the total wages chargeable to the contract, Rs. 13,872,000, because outstanding wages relate to work already done on this contract. Working Note 2 — Plant and depreciation. The new machine cost Rs. 14,800,000 and is depreciated at 20 per cent per annum. The contract ran from 5 January 2025 to the end of December 2025, effectively the whole year, so a full year's depreciation of Rs. 2,960,000 is charged and the machine is credited to the Contract Account at its written-down value of Rs. 11,840,000 as plant still at site. Working Note 3 — Stage of completion. Work certified of Rs. 35,000,000 is 70 per cent of the contract price of Rs. 50,000,000, that is, the contract is more than half but less than three-quarters complete. Working Note 4 — Profit to be taken to profit and loss. The notional profit thrown up by the

Contract Account (computed below) is Rs. 5,320,000. For a contract at this stage the standard formula is: Notional Profit multiplied by 2/3 multiplied by (Cash Received divided by Work Certified). Cash received is 80 per cent of Rs. 35,000,000, that is Rs. 28,000,000, so the profit to be credited to the Profit and Loss Account is Rs. 5,320,000 × 2/3 × 80/100 = Rs. 2,837,333, and the remaining Rs. 2,482,667 is kept as a reserve in the work-in-progress against contingencies. Working Note 5 — Administrative salaries of Rs. 640,000 are general office overheads and not a direct cost of this contract; they are therefore charged to the general Profit and Loss Account of the company and are excluded from the Contract Account.

Table 1: Contract Account (in the books of National Construction Company) for the year ended 31 December 2025

Particulars	Rs.	Particulars	Rs.
To Materials purchased	10,000,000	By Materials at site (unused, 31 Dec 2025)	2,162,000
To Materials issued from stores	6,000,000	By Plant at site (cost 14,800,000 less depreciation @ 20%: 2,960,000)	11,840,000
To Wages: paid 10,120,000 + outstanding 3,752,000	13,872,000	By Work-in-Progress A/c:	
To Plant / new machine purchased	14,800,000	Work certified	35,000,000
To Other direct costs	810,000	Work uncertified (at cost)	1,800,000
To Notional Profit c/d	5,320,000		
Total	**50,802,000**	**Total**	**50,802,000**
To Work-in-Progress A/c (profit kept in reserve)	2,482,667	By Notional Profit b/d	5,320,000
To Profit & Loss A/c (profit taken: 5,320,000 × 2/3 × 80%)	2,837,333		
Total	**5,320,000**	**Total**	**5,320,000**

Part (B): Contractee Account

The Contractee Account is the personal account of Askari Flour Mills in the contractor's books. It is credited with the value of work certified, because certification is the point at which the contractee becomes liable for the work done, and it is debited with the cash actually received, 80 per cent of the certified value. The remaining 20 per cent, Rs. 7,000,000, is the retention money, which the contractee withholds as security for satisfactory completion and rectification of defects; it remains as the debit balance of the Contractee Account and appears as an asset in the contractor's balance sheet until it is released after the defect-liability period. It should be noted that work uncertified does not enter the Contractee Account at all, because the contractee has not yet accepted liability for it; it is carried only within work-in-progress.

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Table 2: Askari Flour Mills (Contractee) Account

Particulars	Rs.	Particulars	Rs.
To Bank A/c (80% of work certified, received)	28,000,000	By Contract A/c (work certified during the year)	35,000,000
To Balance c/d (retention money, 20% of Rs. 35,000,000)	7,000,000		
Total	**35,000,000**	**Total**	**35,000,000**

For completeness, the contract would appear in the balance sheet of the National Construction Company as at 31 December 2025 through the work-in-progress figure: work certified Rs. 35,000,000 plus work uncertified Rs. 1,800,000 gives Rs. 36,800,000; from this are deducted the profit reserve of Rs. 2,482,667 and the cash received from the contractee of Rs. 28,000,000, leaving a net work-in-progress of Rs. 6,317,333 on the assets side. Materials at site of Rs. 2,162,000 and plant at site of Rs. 11,840,000 are also assets of the business at the year end. This presentation ensures that neither the incomplete contract's profit nor its value is

overstated: only Rs. 2,837,333 of profit has been recognised although the notional profit is Rs. 5,320,000, and the work-in-progress is shown net of the cash already received from the contractee.

Further Notes on the Contract

Two further points deserve emphasis because students frequently mishandle them. The first is the treatment of the plant. Because the machine was bought specially for this contract and remains at the site, its full cost is debited to the Contract Account and its depreciated value is credited back, which has exactly the same effect as charging only the depreciation of Rs. 2,960,000 as a cost of the contract; what must never be done is to debit the full cost and omit the credit for the closing value, for that would overstate the cost of work done by Rs. 11,840,000. The second point is the meaning of certification. The resident engineer or architect certifies only work that conforms to the specification, and the contractee pays a percentage of the certified value, retaining the balance as security. Work actually done but not yet certified, Rs. 1,800,000 here, is valued at cost, never at selling price, because no profit may be anticipated on work the contractee has not yet accepted. Together these conventions explain why the contract figures, although large, are stated conservatively throughout.

Conclusion

To conclude, the Contract Account for the year ended December 2025 shows a notional profit of Rs. 5,320,000, of which Rs. 2,837,333 is transferred to the Profit and Loss Account, being two-thirds of the notional profit scaled down by the 80 per cent cash-received ratio, and Rs. 2,482,667 is retained as reserve in work-in-progress. The Contractee Account shows Rs. 28,000,000 received and a retention balance of Rs. 7,000,000 still due from Askari Flour Mills.

The solution illustrates the central principles of contract costing: charging all direct costs and depreciation to the contract, crediting materials and plant remaining at site, valuing work through certification, and recognising profit on incomplete contracts prudently.

Question 2: Acquisition of Business — Issue of Shares at Par, Discount and Premium (20 Marks)

Q. 2: Subhan Textile Mills Ltd acquired the business of Modern Weaving Factory, where assets and liabilities as on 30 June, 2024 were as under. Assets — Land and Building Rs. 40,000,000; Machinery 10,000,000; Furniture 5,000,000; Liabilities — Creditors 10,000,000. The purchase consideration is agreed to be paid through the issuance of fully paid-up shares of the company of Rs. 100 each face value. Required: Record the acquisition of business assets and liabilities of Modern Weaving Factory in the books of accounts if shares are issued: a) At par value b) At 10% discount c) At 5% premium

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Introduction

When a company acquires the running business of an existing firm, it takes over the firm's assets and liabilities at agreed values, and the price it pays for them is called the purchase consideration. Where the purchase consideration is exactly equal to the value of the net assets taken over, no goodwill or capital reserve arises; where it exceeds the net assets, the excess is goodwill, and where it is less, the difference is a capital reserve. The consideration may be discharged in cash, in debentures, or, as in the present question, by issuing fully paid shares of the purchasing company. In this case Subhan Textile Mills Ltd acquires the business of Modern Weaving Factory on the basis of its position as on 30 June 2024, and the discharge of the

consideration through shares of Rs. 100 each is to be recorded under three alternatives: issue at par, issue at a discount of 10 per cent, and issue at a premium of 5 per cent.

Computation of the Purchase Consideration

The assets taken over are Land and Building Rs. 40,000,000, Machinery Rs. 10,000,000 and Furniture Rs. 5,000,000, totalling Rs. 55,000,000. The only liability taken over is Creditors of Rs. 10,000,000. The purchase consideration is therefore Rs. 55,000,000 minus Rs. 10,000,000, that is Rs. 45,000,000, exactly equal to the net assets, so no goodwill or capital reserve arises in any of the three cases. The common first journal entry in the books of Subhan Textile Mills Ltd, recording the takeover itself, is the same in all three cases: Land and Building Account debited Rs. 40,000,000, Machinery Account debited Rs. 10,000,000, Furniture Account debited Rs. 5,000,000, Creditors Account credited Rs. 10,000,000 and Modern Weaving Factory (the vendor) credited Rs. 45,000,000 with the purchase consideration payable. The difference between the three cases lies only in the second entry, which discharges the vendor's account by issuing shares, because the number of shares to be issued depends on the issue price per share: at par the issue price is Rs. 100, at 10 per cent discount it is Rs. 90, and at 5 per cent premium it is Rs. 105.

Table 1: Number of Shares to be Issued in Each Case

Case	Issue price per share (Rs.)	Shares to be issued (Rs. 45,000,000 ÷ issue price)	Share Capital credited (Rs.)	Discount / Premium (Rs.)
(a) At par	100	450,000 shares	45,000,000	—
(b) At 10% discount	90	500,000 shares	50,000,000	Discount 5,000,000 (debit)
(c) At 5% premium	105	428,571 shares (see note)	42,857,100	Premium 2,142,855 (credit)

Journal Entries

Case (a) — Issue at par. The vendor is issued 450,000 fully paid shares of Rs. 100 each. The entry is: Modern Weaving Factory Account debited Rs. 45,000,000 to Share Capital Account Rs. 45,000,000. The vendor's account is fully closed and the share capital of the company increases by exactly the amount of the consideration. Case (b) — Issue at 10 per cent discount. Each share of face value Rs. 100 is issued for Rs. 90, so 500,000 shares must be issued to make up Rs. 45,000,000. The entry is: Modern Weaving Factory Account debited Rs. 45,000,000, Discount on Issue of Shares Account debited Rs. 5,000,000, to Share Capital Account Rs. 50,000,000. The discount of Rs. 5,000,000 is a capital loss of the company; it appears on the assets side of the balance sheet as an unamortised discount (or is written off over a period or against the securities premium account, where available and permitted). Students should note that under modern company law the issue of shares at a discount is heavily restricted and generally allowed only in specific situations such as sweat equity or restructuring, but the accounting mechanics remain as shown and are a standard examination requirement. Case (c) — Issue at 5 per cent premium. Each share is issued for Rs. 105, being Rs. 100 capital plus Rs. 5 premium.

In case (c) a practical difficulty arises which should be faced honestly: Rs. 45,000,000 divided by Rs. 105 gives 428,571.43 shares, and a fraction of a share cannot be issued. The company therefore issues 428,571 shares, which realise 428,571 multiplied by Rs. 105, that is Rs. 44,999,955, and pays the small balance of Rs. 45 to the vendor in cash so that the consideration of Rs. 45,000,000 is discharged in full. The entry is: Modern Weaving Factory Account debited Rs. 45,000,000, to Share Capital Account Rs. 42,857,100 (428,571 shares at the face value of Rs. 100), to Securities Premium Account Rs. 2,142,855 (428,571 shares at Rs. 5 premium per share),

and to Bank Account Rs. 45 (cash paid for the fraction). The securities premium is a capital receipt; it is shown separately under shareholders' equity and may be used only for the purposes permitted by company law, such as issuing bonus shares, writing off preliminary expenses or the discount on issue of shares, or providing for premium payable on redemption.

Table 2: Journal Entries in the Books of Subhan Textile Mills Ltd

No.	Particulars	Dr. (Rs.	Cr. (Rs.)
1	Land and Building A/c Dr. 40,000,000; Machinery A/c Dr. 10,000,000; Furniture A/c Dr. 5,000,000 — To Creditors A/c 10,000,000; To Modern Weaving Factory A/c 45,000,000 (assets and liabilities of Modern Weaving Factory taken over; purchase consideration payable)	55,000,000	55,000,000
2(a)	Modern Weaving Factory A/c Dr. — To Share Capital A/c (450,000 shares of Rs. 100 each issued at par as purchase consideration)	45,000,000	45,000,000
2(b)	Modern Weaving Factory A/c Dr. 45,000,000; Discount on Issue of Shares A/c Dr. 5,000,000 — To Share Capital A/c (500,000 shares of Rs. 100 each issued at 10% discount)	50,000,000	50,000,000
2(c)	Modern Weaving Factory A/c Dr. — To Share Capital A/c 42,857,100; To Securities Premium A/c 2,142,855; To Bank A/c 45 (428,571 shares issued at 5% premium; fraction settled in cash)	45,000,000	45,000,000

Goodwill, Capital Reserve and the Vendor Account

It is worth restating why no goodwill or capital reserve appears in this acquisition. Goodwill arises only when the purchase consideration exceeds the value of the net assets taken over, because the buyer is then paying for something extra, such as the firm's reputation, customer connections or earning capacity. A capital reserve arises in the opposite case, when net assets exceed the consideration, representing a bargain purchase. Here the consideration of Rs. 45,000,000 is exactly equal to the net assets of Rs. 45,000,000, so the vendor's account is settled precisely by the value of what was received, and the acquisition is neutral. The vendor account itself is a temporary personal account: it is credited when the takeover is recorded and debited when the shares (and, in the premium case, the small cash balance) are issued, after which it closes with no balance. The shares issued to the vendor are fully paid, so no calls will ever be made on them, and the vendor becomes a shareholder of Subhan Textile Mills Ltd instead of the owner of Modern Weaving Factory.

Conclusion

To conclude, the net assets of Modern Weaving Factory taken over amount to Rs. 45,000,000, which is also the purchase consideration, so there is no goodwill and no capital reserve. The consideration is discharged by issuing 450,000 shares at par, or 500,000 shares at a 10 per cent discount (creating a discount of Rs. 5,000,000), or 428,571 shares at a 5 per cent premium (creating a securities premium of Rs. 2,142,855, with Rs. 45 settled in cash for the fractional entitlement). The comparison teaches an important lesson: issuing shares at a discount forces the company to issue more shares and dilutes the existing shareholders more heavily, while

issuing at a premium issues fewer shares and builds a capital reserve, which is why healthy companies prefer to issue at a premium.

Question 3: Company Final Accounts — Ideal Sports Company Ltd (20 Marks)

Q. 3: Ideal Sports Company Ltd was incorporated with a nominal capital of Rs. 20,000,000 comprising 2,000,000 ordinary shares of Rs 10 each. The following trial balance was prepared from the accounting record of the company as on 30 June, 2025 by the concerned accountant. (20) Trial Balance as at 30 June, 2025 — Share Capital Cr. 10,000,000; Premium on Share Capital Cr. 600,000; Discount on Share Capital Dr. 480,000; Gross Profit Cr. 3,100,000; Accounts Receivable Dr. 120,000; Accounts Payable Cr. 75,000; Closing Inventories Dr. 1,340,000; Land and Building Dr. 8,000,000; Plant and Machinery Dr. 3,500,000; Furniture Dr. 1,400,000; Accumulated Depreciation: Land and Building Cr. 1,200,000, Plant and Machinery Cr. 1,570,000, Furniture Cr. 420,000; Salaries expenses Dr. 350,000; Printing and stationery exp Dr. 12,000; Utility expenses Dr. 120,000; Investment in shares at cost Dr. 1,350,000; Audit fee Dr. 75,000; Directors fee Dr. 45,000; Reversal of unclaimed Dividends Cr. 85,000; Profit and Loss Appropriation Account Cr. 70,000; Cash in hand Dr. 88,000; Cash at the bank Dr. 240,000; Total 17,120,000 / 17,120,000. Additional information: 1) The market value of an investment in shares at the end of the year was to the tune of Rs. 1,500,000. 2) Depreciation for the current year is to be provided on the declining balance method at the following rates: a) Land and Building 5% b) Plant and Machinery 15% c) Furniture 10%. 3) Provision for tax at 30% is to be created. 4) Proposed dividend at 10% on share capital. 5) A revenue reserve is to be created at Rs. 200,000. Required: A) Prepare Profit and Loss Account for the year ended 30 June, 2025. B)

Prepare Profit and Loss Appropriation Account as at 30 June, 2025. C) Draw a Balance Sheet as at 30 June, 2025.

Introduction

A limited company prepares its final accounts in a prescribed vertical or account form: a Profit and Loss Account to measure the profit earned from operations during the year, a Profit and Loss Appropriation Account to show how that profit (together with the balance brought forward) is disposed of among taxation already provided, reserves, dividends and the balance carried forward, and a Balance Sheet to present the financial position on the last day of the year. In this question, Ideal Sports Company Ltd has an authorised (nominal) capital of Rs. 20,000,000 divided into 2,000,000 ordinary shares of Rs. 10 each, of which shares of Rs. 10,000,000 have been issued. The trial balance as at 30 June 2025 already contains the gross profit of Rs. 3,100,000 and closing inventories of Rs. 1,340,000, so the Profit and Loss Account begins from gross profit; the accounting task is to charge the remaining expenses and current-year depreciation, provide for tax, and then deal with the appropriations listed in the additional information.

Working Notes

Working Note 1 — Depreciation on the declining balance method. Depreciation is charged on the written-down value, that is cost minus accumulated depreciation to date. For Land and Building: Rs. 8,000,000 minus Rs. 1,200,000 equals Rs. 6,800,000, and 5 per cent of this is Rs. 340,000. For Plant and Machinery: Rs. 3,500,000 minus Rs. 1,570,000 equals Rs. 1,930,000, and 15 per cent of this is Rs. 289,500. For Furniture: Rs. 1,400,000 minus Rs. 420,000 equals Rs. 980,000, and 10 per cent of this is Rs. 98,000. Total depreciation for the year is therefore Rs.

727,500. Working Note 2 — Investment in shares. The investment cost Rs. 1,350,000 and its market value has risen to Rs. 1,500,000. Following the prudence convention and the rule that current investments are carried at the lower of cost and market value while long-term investments are carried at cost, no entry is made for the rise in value; the investment stays at cost in the Balance Sheet and the market value is disclosed by way of a note. Working Note 3 — Tax and dividend. Profit before tax (computed in the Profit and Loss Account below) is Rs. 1,855,500, so the provision for tax at 30 per cent is Rs. 556,650 and the profit after tax is Rs. 1,298,850. The proposed dividend is 10 per cent of the paid-up share capital of Rs. 10,000,000, that is Rs. 1,000,000. Working Note 4 — Discount on share capital of Rs. 480,000 has no adjustment attached to it, so it is not written off in this year; it is carried in the Balance Sheet as an unamortised discount on the assets side, as is the customary treatment in such problems.

Table 1: Profit and Loss Account for the year ended 30 June 2025

Particulars	Rs.	Particulars	Rs.
To Salaries expenses	350,000	By Gross Profit	3,100,000
To Printing and stationery expenses	12,000	By Reversal of unclaimed dividends (written back)	85,000
To Utility expenses	120,000		
To Audit fee	75,000		
To Directors fee	45,000		
To Depreciation: Land & Building 340,000; Plant & Machinery 289,500; Furniture 98,000	727,500		
To Provision for taxation (30% of Rs. 1,855,500)	556,650		
To Net Profit transferred to P&L Appropriation A/c	1,298,850		
Total	**3,185,000**	**Total**	**3,185,000**

Table 2: Profit and Loss Appropriation Account for the year ended 30 June 2025

Particulars	Rs.	Particulars	Rs.
To Revenue (General) Reserve A/c	200,000	By Balance b/d (profit brought forward)	70,000
To Proposed Dividend A/c (10% on share capital of Rs. 10,000,000)	1,000,000	By Profit and Loss A/c (net profit after tax for the year)	1,298,850
To Balance c/d (carried to Balance Sheet)	168,850		
Total	**1,368,850**	**Total**	**1,368,850**

The appropriation account shows the discipline of company profit distribution. Out of the total available profit of Rs. 1,368,850 (brought forward Rs. 70,000 plus the year's profit after tax of Rs. 1,298,850), the directors first strengthen the company's finances by transferring Rs. 200,000 to a revenue (general) reserve, then propose a dividend of Rs. 1,000,000, which is 10 per cent on the paid-up capital and will become payable only after approval by the shareholders at the annual general meeting, and finally carry forward a balance of Rs. 168,850. Note that the provision for taxation is a charge in the Profit and Loss Account itself, because tax is an expense of earning the profit, whereas the reserve and the proposed dividend are appropriations shown below it, because they are applications of profit already earned.

Table 3: Balance Sheet as at 30 June 2025

Liabilities	Rs.	Assets	Rs.
Authorised Capital: 2,000,000 ordinary shares of Rs. 10 each	20,000,000	Land and Building 8,000,000 less accumulated depreciation (1,200,000 + 340,000) 1,540,000	6,460,000
Issued & Paid-up Capital: 1,000,000 ordinary shares of Rs. 10 each	10,000,000	Plant and Machinery 3,500,000 less accumulated depreciation (1,570,000 + 289,500) 1,859,500	1,640,500
Premium on Share Capital	600,000	Furniture 1,400,000 less accumulated depreciation (420,000 + 98,000) 518,000	882,000

Revenue (General) Reserve	200,000	Investment in shares at cost (market value Rs. 1,500,000)	1,350,000
Profit and Loss Appropriation A/c (balance)	168,850	Closing Inventories	1,340,000
Accounts Payable	75,000	Accounts Receivable	120,000
Provision for Taxation	556,650	Cash in hand	88,000
Proposed Dividend	1,000,000	Cash at bank	240,000
		Discount on Share Capital (unamortised)	480,000
Total	**12,600,500**	**Total**	**12,600,500**

The Balance Sheet balances at Rs. 12,600,500 on both sides, which proves the arithmetical accuracy of the final accounts. On the equity and liabilities side, shareholders' funds consist of the paid-up capital of Rs. 10,000,000, the share premium of Rs. 600,000 (a capital reserve which cannot be distributed as dividend), the revenue reserve of Rs. 200,000 and the retained profit of Rs. 168,850. The current liabilities are modest: trade payables of Rs. 75,000, the tax provision of Rs. 556,650 and the proposed dividend of Rs. 1,000,000. On the assets side, the fixed assets stand at written-down values after charging the year's depreciation, the investment is prudently held at its cost of Rs. 1,350,000 despite a market value of Rs. 1,500,000, and the current assets of inventories, receivables and cash totalling Rs. 1,788,000 comfortably exceed the current liabilities other than the proposed dividend, indicating a satisfactory liquidity position. The discount on share capital of Rs. 480,000 is shown as a deferred (fictitious) asset because no instruction was given to write it off.

Notes on Individual Items

Three items in the trial balance call for a final comment. The reversal of unclaimed dividends of Rs. 85,000 represents dividend warrants issued in earlier years which shareholders never encashed and which, after the prescribed period, are written back; it is a non-operating income

of the current year and is therefore credited to the Profit and Loss Account, increasing the profit available for tax computation, as has been done above. The premium on share capital of Rs. 600,000, received when shares were originally issued above their face value of Rs. 10, is a capital profit: it is not earned by trading, it cannot be distributed as dividend, and it accordingly stands untouched among the shareholders' funds in the Balance Sheet, where it may in future be used for purposes allowed by company law, such as issuing bonus shares. Finally, the audit fee of Rs. 75,000 and the directors' fee of Rs. 45,000 are administrative expenses of the year and are charged in full to the Profit and Loss Account; no part of either is outstanding, since no such information is given, and unpaid amounts, had there been any, would additionally have appeared as current liabilities in the Balance Sheet.

Conclusion

To conclude, Ideal Sports Company Ltd earned a profit before tax of Rs. 1,855,500 for the year ended 30 June 2025; after providing tax of Rs. 556,650 the profit after tax is Rs. 1,298,850. From the available appropriation balance, Rs. 200,000 is transferred to revenue reserve and a dividend of Rs. 1,000,000 (10 per cent) is proposed, leaving Rs. 168,850 to be carried forward. The Balance Sheet as at 30 June 2025 totals Rs. 12,600,500 on both sides. The exercise brings together the characteristic features of company accounts: depreciation on written-down values, provision for taxation as a charge, reserves and proposed dividend as appropriations, share premium as a capital reserve, and disclosure of the market value of investments.

Question 4: Reorganization of a Company — Necessity and Options (20 Marks)

Q. 4: Describe the necessity of reorganization of a company and what options are available for it? Explain in detail.

Introduction

Reorganization, also called reconstruction, means a major rearrangement of a company's capital structure, ownership, liabilities or business operations in order to restore it to financial health or to fit it for changed circumstances. In the life of a company there may come a stage when its existing structure no longer works: losses have eaten away its capital, its debts have become unpayable on the agreed dates, its shares have fallen far below their face value, or its internal arrangements have become an obstacle to raising fresh funds. Simply carrying on is impossible, and complete liquidation would destroy a business that may still have valuable assets, goodwill, employees and earning potential. Reorganization is the middle path between passive decline and liquidation: the company is reshaped, with the consent of its shareholders, creditors and, where required, the court or the Securities and Exchange Commission, so that it can start again on a sound footing. This answer first explains why reorganization becomes necessary and then describes in detail the options available for carrying it out.

Necessity of Reorganization

- Accumulated losses and erosion of capital: when years of losses have wiped out reserves and part of the share capital, the balance sheet no longer shows the true position; the capital is 'lost' and must be written down to the level justified by the remaining assets before the company can pay dividends or attract investors again.

- Over-capitalisation: if the company issued more capital than its earning capacity can service, the rate of return on capital falls, shares trade below par, and the company cannot pay a reasonable dividend; the capital must be reduced to a realistic level.
- Inability to pay debts: heavy debentures and loans with approaching repayment dates, or a shortage of working capital, may push an otherwise sound company towards default; rescheduling debts, converting debt into shares or obtaining sacrifices from creditors becomes necessary.
- Need for fresh capital: a company whose shares stand at a heavy discount cannot issue new shares successfully, because new investors will not pay par for shares available cheaply in the market; reconstruction that writes down the old capital removes this obstacle and makes fresh fund-raising possible.
- Obsolete or unbalanced capital structure: too much debt and too little equity (high gearing), or too many classes of shares with conflicting rights, increases financial risk and the cost of capital; reorganization rebalances equity, preference capital and debt.
- Merger, expansion and diversification opportunities: a company may need to reorganise to merge with another business, to absorb a competitor, to separate a division into a new company, or to enter new lines of business for which the existing structure is unsuitable.
- Changes in law, taxation or market conditions: new regulations, tax changes or a permanent fall in demand for the company's products may make the old organisation unviable, requiring a redesigned structure.

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- Deadlock or disputes among shareholders and management: where groups of shareholders cannot agree and decision-making is paralysed, a scheme of arrangement can restructure shareholdings and restore workable governance.
- To avoid liquidation and protect stakeholders: reorganization preserves jobs, keeps a going concern alive, protects creditors from the heavy losses of a forced sale of assets, and gives shareholders a chance to recover something instead of losing everything in winding up.

Options Available for Reorganization

The options for reorganization fall broadly into two groups: internal reconstruction, in which the same company continues with a rearranged capital structure, and external reconstruction, in which the old company is wound up and a new company takes over its business. Within and around these groups several specific devices are used, often in combination in a single scheme.

- Alteration of share capital: the company may consolidate shares into larger denominations, subdivide them into smaller ones, convert shares into stock or cancel unissued capital. This changes the form, though not the amount, of capital and is often the first step of a scheme.
- Reduction of share capital: the company cancels the lost part of its capital against accumulated losses and overvalued assets, for example by reducing shares of Rs. 10 to Rs. 4. This writes the balance sheet back to reality without any cash leaving the company and normally requires a special resolution and confirmation under the Companies Act.
- Capitalisation changes and surrender of shares: shareholders may surrender part of their shares, which are then used to compensate debenture holders and creditors who accept shares in place of cash, reducing liabilities without new money.

- Variation of class rights: the rights of preference shareholders (for example, a high dividend rate or arrears of dividend) may be modified with the consent of that class, such as accepting a lower rate or converting arrears into equity shares.
- Compromise or arrangement with creditors: creditors and debenture holders agree to accept less than the full amount, to postpone repayment, to reduce interest, or to convert part of their debt into shares. Such a scheme, approved by the required majorities and sanctioned by the court or Commission, binds all members of the class.
- Debt restructuring and rescheduling: bank loans and debentures are renegotiated for longer maturities, lower interest or a moratorium, often combined with new working-capital finance from lenders who see a viable, reorganised business.
- Issue of fresh capital: after the old capital has been written down and liabilities rearranged, the company issues new shares (often a rights issue) to existing members or new investors, bringing in the cash needed for working capital and revival.
- External reconstruction: a new company is formed which purchases the business of the old company; the old company goes into liquidation and its shareholders receive shares in the new company. This gives a clean break from a damaged name, accumulated losses and awkward contracts.
- Amalgamation and absorption: two or more companies merge into one (amalgamation) or one company takes over another (absorption), achieving reorganization through combination, economies of scale and pooled resources.

- Sale of a part of the business or demerger: unprofitable divisions are sold or separated into another company so that the remaining core business becomes financially and managerially focused.

In practice a court-sanctioned scheme of arrangement is the umbrella under which most of these devices are combined: a single scheme may reduce capital, write off losses, convert debentures into shares, settle creditors' claims partly in shares and partly in postponed cash, and authorise a fresh issue. The accounting entries for internal reconstruction are passed through a Reconstruction (or Capital Reduction) Account: the amounts sacrificed by shareholders, debenture holders and creditors are credited to it, and the accumulated losses, fictitious assets such as preliminary expenses and discount on shares, and the write-downs of overvalued assets are debited to it; any balance remaining is transferred to capital reserve. Legal safeguards exist at every step — special resolutions, class consents, creditor approval and regulatory or court sanction — because reorganization asks some stakeholders to accept sacrifices, and the law ensures that the sacrifice is fair and shared equitably.

Conclusion

To conclude, reorganization becomes necessary when accumulated losses, over-capitalisation, unpayable debts, an unbalanced capital structure or changed circumstances make the existing company unworkable, yet the underlying business is still worth saving. The options range from simple alteration of share capital and capital reduction, through compromises with creditors, debt restructuring, surrender of shares and fresh issues, to external reconstruction, amalgamation and demerger. A properly designed reorganization spreads the unavoidable sacrifices fairly among shareholders and creditors, restores the balance sheet to a true and

workable state, and gives the company a realistic chance of profitable survival, which serves employees, creditors, shareholders and the wider economy better than liquidation.

Question 5: Debentures of a Company — Meaning, Purpose and Classifications (20 Marks)

Q. 5: What do you understand by debentures of a company and the purpose of their issuance? Explain and describe the major classifications of debentures of a company.

Introduction and Meaning

A debenture is a written document or certificate issued by a company under its common seal, acknowledging that the company has borrowed a stated sum of money from the holder and undertaking to repay it on a specified date, or after notice, together with interest at a fixed rate until repayment. The definition given in company law textbooks is essentially this: a debenture is an acknowledgement of debt. The debenture holder is therefore a creditor of the company, not an owner; he lends money to the company for a definite period and receives interest whether the company earns profits or not. Debentures are usually issued in a series of equal denominations, are evidenced by a debenture trust deed which appoints trustees to protect the holders' interests, and are frequently secured by a charge on the company's assets. Along with shares, debentures are one of the two great sources of long-term finance for a company, and a clear understanding of their nature, purpose and varieties is essential for every student of company accounts.

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Purpose of Issuing Debentures

- To raise long-term finance without diluting ownership: debenture holders get no voting rights, so the existing shareholders can raise large funds for expansion while keeping control of the company entirely in their own hands.
- To obtain funds at a fixed and usually lower cost: interest on debentures is a fixed charge, commonly lower than the dividend expected by shareholders, and it must be paid regardless of profits, which makes debentures attractive to cautious investors such as pension funds and insurance companies.
- Tax advantage: interest on debentures is an allowable expense in computing taxable profits, whereas dividends on shares are an appropriation of after-tax profit; debt finance is therefore cheaper in effective, after-tax terms.
- To take advantage of trading on equity (financial leverage): if the company earns a return on its total capital higher than the fixed debenture interest rate, the surplus increases the earnings of the equity shareholders; borrowed funds at a fixed cost magnify shareholders' returns in good years.
- To finance specific long-life projects: debentures with maturities of five, ten or more years match the life of assets such as plant, buildings and infrastructure, so the asset can generate the income from which the loan is repaid.
- To preserve flexibility and credit standing: a company that has not exhausted its borrowing capacity can face emergencies and opportunities better; debentures also spare the company from issuing shares at a time when the market price is unfavourable.

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- To widen the investor base: many investors prefer the safety of a secured, fixed-income instrument to the risk of shares; debentures let the company tap this large pool of savings, including institutional investors.

Against these advantages, debentures carry the risk of a fixed interest burden in bad years and the obligation to repay on the due date, which is why prudent companies keep a balance between share capital (owned funds) and debentures (borrowed funds) in their capital structure.

Major Classifications of Debentures

Debentures are classified on several bases, and a single debenture issue normally has one characteristic from each group, for example it may at once be secured, redeemable, registered and non-convertible. The major classifications are as follows.

- From the point of view of security: (i) Secured or mortgage debentures are backed by a charge, fixed or floating, on the company's assets, so that on default the debenture holders (through their trustees) can realise those assets and pay themselves. (ii) Unsecured or naked debentures carry no charge on assets; their holders rank as ordinary unsecured creditors and rely only on the company's general creditworthiness.
- From the point of view of redemption: (i) Redeemable debentures are repayable after a fixed period or by instalments or by drawings, and most modern debentures are of this kind. (ii) Irredeemable or perpetual debentures are not repayable during the company's lifetime and are returned only on liquidation or on a serious default in interest, rather like permanent loan capital.

- From the point of view of records and transfer: (i) Registered debentures are recorded in the company's register of debenture holders in the holder's name and can be transferred only by a proper transfer deed, so interest is paid to the registered holder. (ii) Bearer debentures are payable to the bearer, have interest coupons attached, and are transferable by mere delivery, like currency, with no register maintained.
- From the point of view of conversion: (i) Convertible debentures give the holder the option to convert the loan into equity shares of the company after a specified period and on stated terms; they may be fully or partly convertible. (ii) Non-convertible debentures carry no such option and are simply repaid in cash at maturity.
- From the point of view of priority: (i) First mortgage debentures have the first claim on the charged assets. (ii) Second mortgage debentures are paid out of those assets only after the first mortgage debentures have been satisfied, and therefore carry a higher rate of interest to compensate for the greater risk.
- Other varieties include debentures issued at par, at a premium or at a discount, and debentures issued for cash, for consideration other than cash (for example to a vendor of property) or as collateral security to a bank against a loan, in which case no interest is paid on the debentures themselves unless the loan is defaulted upon.

Table 1: Debentures Distinguished from Shares

Point of Difference	Debentures	Shares
Status of holder	Creditor of the company	Owner of the company
Return	Fixed interest, payable whether there is profit or not	Dividend, payable only out of profits and when declared
Voting rights	None	Shareholders vote and control the company
Repayment	Repayable on the due date during the company's life	Share capital is returned only on liquidation (except redeemable

		preference shares and buy-back)
Security	Usually secured by a charge on assets	Unsecured; shares represent ownership, not a loan
Risk	Comparatively safe, especially if secured	Risky; shareholders are paid last in liquidation
Charge on profits	Interest is a charge against profits	Dividend is an appropriation of profits

Debenture Trust Deed and Payment of Interest

Because a debenture issue may be spread among hundreds of holders, the company normally executes a debenture trust deed in favour of trustees, who hold the security on behalf of all the holders, receive the charge over the assets, and can act collectively if the company defaults, sparing individual holders the burden of suing separately. Interest is paid at the stated fixed rate, usually half-yearly, on the face value of the debentures; in the company's books the interest is debited to the Profit and Loss Account as a charge (after deducting any tax required to be withheld, which is accounted for to the revenue authorities), whether or not the company has made a profit. Debentures may be issued at par, at a premium or at a discount, and may also be issued as collateral security; the discount on issue is a capital loss written off over the life of the debentures, while any premium on issue is a capital gain credited to a premium account. These recording rules flow directly from the classifications described above.

Conclusion

To conclude, a debenture is a company's formal acknowledgement of a loan, carrying fixed interest and, usually, security over assets, repayable at a stated time. Companies issue debentures to raise long-term funds without surrendering control, at a comparatively low and tax-deductible cost, and to increase the return to equity shareholders through leverage when times are good. Debentures are classified chiefly as secured or unsecured according to security,

redeemable or perpetual according to repayment, registered or bearer according to record and transfer, convertible or non-convertible according to the right to exchange them for shares, and first or second mortgage according to priority of claim. Understanding these classifications enables an investor to judge the safety and suitability of a debenture issue, and enables a student to record debenture transactions correctly in company accounts.

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