CHAPTER 2

ISSUANCE OF BONUS SHARES AND RIGHT SHARES

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ISSUANCE OF BONUS SHARES & RIGHT SHARES

In the previous chapter Balance Sheet of Yousaf Industries Ltd. a newly formed company was given in Illustration No.1 as.

Yousaf Industries Ltd.

Balance Sheet

Liabilities	Rs.	Assets	Rs.
Authorised Capital:		**Current Assets:**	
3,00,000 ordinary shares of Rs. 10 each	30,00,000	Bank Balance	800,000
Issued, subscribed & paid up capital:			
80,000 shares of Rs-10 each	800,000		
	800,000		800,000

After some time in illustration No.7 Yousaf Industries Ltd. have acquired assets from Mr. Hayat and paid them by issuing shares at premium.

Then the position of assets and liabilities of Yousaf Industries in the Balance Sheet was as follow:

Yousaf Industries

Balance Sheet

Liabilities	Rs.	Assets	Rs.
Authorised Capital:		**Fixed Assets:**	
3,00,000 ordinary shares of		Land	400,000
Rs. 10 each	30,00,000	Building	500,000
		Machinery	100,000
Issued, subscribed & paid up capital:		**Current Assets:**	
		Bank Balance	550,000
1,40,000 shares of Rs. 10 each	14,00,000		
Reserves:			
Shares Premium	1,50,000		
	15,50,000		15,50,000

It is assumed that after six years of the profitable operation of the company, it has earned profit every year. In early years normally profit is not distributed to the shareholders and if distributed then at very low rate. According to the legal provision of the companies ordinance 1984, companies have to transfer a part of profit to general reserves for the strong footing and considering public interest. In other business there are no legal compulsions for distribution of their profit.

At the end of six years the balance sheet of Yousaf Industries Ltd. Shows the following position.

Balance Sheet

Liabilities	Rs.	Assets	Rs.
Authorised Capital:		**Fixed Assets:**	
3,00,000 ordinary shares of		Land & Building	9,75,000
Rs. 10 each	30,00,000	Plant & Machinery	8,75,000
Issued, subscribed & paid up:		Furniture	190,000
1,40,000 shares of Rs. 10 each	14,00,000	Vehicles	380,000
Reserves:		**Current Assets:**	
Share premium	1,50,000	Stock	290,000
General Reserves	12,70,000	Debtors	280,000
Profit & loss Appropriation	90,000	Prepaid Expenses	5,500
Current Liabilities:		Bank Balance	49,500
Sundry creditors	1,20,000		
Outstanding expenses	15,000		
	30,45,000		30,45,000

The above balance sheet of the company shows under capitalisation position, because Reserve and Surplus cannot be treated as permanent part of capital structure of the company. As from reserves & surplus company can issue dividend and may transfer from it to dividend equalisation fund and these are not permanently utilised in business. But when company issue bonus shares then these reserves are converted into share capital of company which becomes permanent part of capital structure of company and from which dividend or any fund cannot be paid or maintained. "So the process by which temporary investment (Reserves & surplus) of the company is converted into permanent investment (Share Capital) of the company by the issue of Bonus shares is called capitalization".

Capitalisation of reserves is necessary for the company:

(1) To use the amount of reserves in the business on permanent basis.

(2) To bring the rate of dividend in controlled line i.e. to maintain a normal dividend rate as before capitalisation the dividend rate is very much high.

(3) To handle labour force efficiently as high rate of dividend may create problems among the labourors.

(4) To maintain the portion of company's shareholding among the shareholders.

If the board of directors of company want to capitalise the reserves of Rs. 600,000 by issuing the shareholders free shares at par. Then effect of capitalisation on equity per share of the company will be as follows:

	Before Bonus Shares	After Bonus Shares
Ordinary Share Capital	14,00,000	20,00,000
Share Premium	150,000	1,50,000
Profit & Loss	90,000	90,000
General Reserves	12,70,000	6,70,000
Total Shareholders equity	29,10,000	29,10,000
Number of shares issued	140,000	200,000
Equity per share	20.79	14.55
Mr. A (Shareholder of company)		
No of shares owned	140	200
Total Equity	2910	2910
Portion of company's shareholding	0.1%	0.1%

BONUS SHARES

The term bonus means something more than what was expected or agreed. Bonus reference to company means an extra dividend paid to its shareholders out of reserves besides their usual dividend. If a company has large accumulated profits and reserves, the directors of company may decide to distribute a part of these reserves to its shareholders in the form of bonus. Company may distribute to its shareholders the amount of bonus in the form of cash or in the form of shares. Thus the shares issued to its shareholders by the company from its accumulated profits and reserves free of cost are known as 'bonus shares'.

Cash bonus is paid by company when it has surplus profits and reserves and also sufficient cash or bank balance for payment of amount of bonus to its shareholders. Sometimes the company has sufficient cash and bank balance for payment of amount of bonus but not paid cash bonus because of adverse effects on the working capital. So company prefers to issue free shares to its shareholders for bonus instead of cash payment.

Why Companies Issue Bonus Shares:

(1) Companies issue bonus shares out of their surplus profits and reserves, the shares issued cause an increase in the amount of paid up capital and decrease in surplus profits and reserves. By issuing bonus shares companies use their surplus profits on permanent basis in the business.

Balance Sheet of X Ltd.

(Before issuing bonus shares)

Liabilities	Rs.	Assets	Rs.
Share Capital	7,50,000	Fixed Assets	15,00,000
Reserves	12,50,000	Current Assets	700,000
Current liabilities	2,00,000		
	22,00,000		22,00,000

If the X Ltd. issued 5000 shares of Rs. 100 each to its shareholders free of cost as bonus. Then after the issuance of bonus shares the Balance Sheet of X Ltd. will be as :

Liabilities	Rs.	Assets	Rs.
Shares Capital (750,0000 + 500,000)	12,50,000	Fixed Assets	15,00,000
		Current Assets	700,000
Reserves (12,50,000-500,000)	7,50,000		
Current liabilities	2,00,000		
	22,00,000		22,00,0000

We can see that after issuing bonus shares the amount of bonus of Rs. 5,00,000 become permanent part of share capital.

(2) Companies issue bonus shares to show the true and fair position of capital structure as before bonus issue capital do not show true picture, after issuing bonus shares it shows more realistic view.

(3) If companies issue bonus shares then there are no any adverse effects on the liquidity position of the companies.

(4) Companies also issue bonus shares to bring down their high rate of return on their share capital. For example if X Ltd. earns a profit of Rs 4,12,500 in the year.

The return on capital will be:

$$\frac{4,12,500}{7,50,000} \times 100 = 55\%$$

The high rate of return on capital may cause many problems. e.g., company do not want to maintain this high rate of return as shareholders many expect in future more higher rate as compared to previous and labour force may demand higher rate of remuneration. The company wants to bring down this high rate of return, may issue bonus shares from where the return on capital will fall down.

$$\frac{4,12,500}{12,50,000} \times 100 = 33\%$$

ADVANTAGES AND DISADVANTAGES OF BONUS SHARES:

From the following we can see the advantages and disadvantages of issuing bonus shares.

Advantages:

Advantages of issuing of bonus shares can be discussed from company's view point and shareholders view point.

(1) *From Company's View Point:*

(i) The main advantage with company's viewpoint is that it has not to pay cash so it has no effects of working capital position of company.

(ii) Company can expand its volume by using the surplus profits and reserves permanently in business.

(iii) By using surplus profits and reserves permanently in business the creditability of company also improves.

(iv) Share capital of the company will show more realistic view if the bonus shares are issue.

(v) By issuing bonus shares the capital of company increases due to which the rate of return on capital will decrease which will show real earning capacity of company.

(2) *From Shareholders View Point:*

(i) The main advantage from shareholders view point is that they receive extra dividend by their same amount of investment in the company.

(ii) If the shareholders want to receive amount of bonus shares in the form of cash they may sell these shares in stock exchange and receive cash.

(iii) Shareholders can receive dividend in future on their increased investment in the company due to bonus shares.

(iv) Shareholders have another advantage that they are receiving the new shares from company free of cost. As it is much difficult to purchase the new shares of such an excellent company.

Disadvantages:

(i) The main disadvantage of issuing bonus shares is that the rate of return on capital is being decreased e.g. before bonus issue rate was 55% and after bonus issue rate of return on capital is decreased to 33%. From which discontent feelings may arise amongst the shareholders.

(ii) By issuing bonus shares there may raise the chances of speculation in the company's shares, which may cause fluctuation in their market value.

(iii) The surplus profits and reserves being capitalised if in the periods of depression then these cannot be used for equalisation of dividends or writing off capital losses.

LEGAL PROVISION FOR BONUS ISSUE:

Section 3(6) of the Capital Issues Exemption Order 1967 states that bonus shares can be issued by the companies whose securities are listed on any of the stock Exchanges subject to the fulfillment of the following conditions namely:

(i) The free reserves of the company are sufficient to permit issue of the bonus shares after retaining in the reserves 25 percent of the capital as it will be increased by the proposed bonus shares.

(ii) A certificate from the auditors is obtained before the issue of the bonus shares to the effect that the free reserves and surpluses remained after the issue of bonus shares will not be less than 25 percent of the increased capital.

(iii) All contingent liabilities disclosed in the audited accounts shall be taken into account in the calculation of minimum residual reserves of 25 percent.

(iv) All the existing shares are fully paid up.

(v) Observance of such other guidelines as may, from time to time, be issued by controller of capital issues:

(vi) Simultaneously, with the issue of the bonus shares, a return shall be filed with the controller of capital issues together with a copy of the auditors certificate and relevant Balance Sheet.

Upto What Extent Bonus Share can be Issued:

According to the legal provisions mentioned above the maximum amount of bonus can be calculated as:

That residual reserves should be at least 25% of the increased capital:

Residual Reserves = Free Reserves – Quantum of bonus (maximum amount of bonus)

Increased Capital = Existing Capital + Quantum of bonus.

Assume:

Free Reserves = FR

Existing Capital = C

Quantum of Bonus = Q

Residual Reserves = FR – Q

Increased Capital = C+Q

The Quantum of bonus may be calculated by using the following formula.

Residual Reserves = 25% of increased Capital

$$FR - Q = 25\% (C + Q)$$

$$FR - Q = \frac{C+Q}{4}$$

$$C + Q = 4FR - 4Q$$

$$Q + 4Q = 4FR - C$$

$$5Q = 4\,FR - C$$

$$Q = \frac{4FR - C}{5}$$

Sources of Bonus Issue:

The bonus shares can be issued from one or more of the following reserves and surplus.

(a) Balance of profit & Loss Appropriation.

(b) Premium on issue of shares and debentures.

(c) Capital Reserves.

(d) General Reserves.

(e) Debenture Redemption Fund (after redemption of debentures) bonus shares cannot be issued out of specific reserves i.e. reserves created for specific purposes.

Accounting Treatment of Bonus Issue:

Bonus shares issued out of reserves and surplus may be distributed to shareholder at per or at premium.

(1) Issue of Bonus Shares at Par:

We know that there are two changes on account of bonus shares:

(i) Decrease in reserves and surplus.

(ii) Increase in capital

When fully paid bonus shares are issued the following two entries should be passed in company's books.

(a) Entry for declaration of bonus:

Reserves Account ... Dr.

  Bonus to shareholders Account

(b) Entry for allotment of bonus shares:

Bonus to shareholders Account ... Dr.

  Share Capital Account

Issuance of Bonus share at Premium:

If bonus shares are issued at premium the following two entries are made:

(a) Entry for declaration of bonus:

Reserves Account ... Dr.

  Bonus to shareholders Account

(b) Entry for allotment of bonus shares:

Bonus to shareholders Account ... Dr.

  Share Capital Account (with par value)

  Share Premium Account (with amount of premium)

ILLUSTRATION NO. 1:

The following figures have been extracted from the books of ABC & Co. Ltd. on 31-12-2010.

Existing Share Capital	Rs. 55,00,000
Free Reserves	Rs. 70,00,000

The company proposes to capitalise its reserves in order to declare fully paid bonus shares. Determine the maximum amount available for capitalisation. After calculating the amount of bonus, the residual reserve should be equal to 25% of the increased capital.

SOLUTION:

Free Reserves = FR = Rs. 70,00,000

Existing Share Capital = C = Rs. 55,00,000

Quantum of bonus = Q

Increased capital = C + Q

Residual Reserves = FR − Q

$$Q = \frac{4FR - C}{5}$$

$$Q = \frac{4(70{,}00{,}000) - (55{,}00{,}000)}{5}$$

$$Q = \frac{280{,}00{,}000 - 55{,}00{,}000}{5}$$

$$Q = \frac{225{,}00{,}000}{5}$$

$$Q = \text{Rs. } 45{,}00{,}000$$

Check:

Residual reserves should be atleast 25% of increased capital.

Residual Reserves = FR − Q

= 70,00,000 − 45,00,000 = Rs. 25,00,000

Increased Capital = C + Q

= 55,00,000 + 45,00,000 = Rs. 100,00,000

Residual Reserves = 100,00,000 × 25%

= Rs. 25,00,000

ILLUSTRATION NO. 2: (Issuance of Shares at Par)

A company had an issued capital of Rs. 15,00,000 and reserve fund of Rs. 14,00,000. Company distributed a bonus out of reserve fund @ 50% of the original capital by issuing fully paid bonus shares. Bonus shares are issued at Rs. 100 each and their market price was Rs. 180 each. **Pass the journal entries.**

SOLUTION:

Journal

Date	Details		L/F	Debit Rs.	Credit Rs.
	Reserve fund Account	Dr.		750,000	
	Bonus to shareholder Account				750,000
	(Being the bonus declared)				
	Bonus to shareholders Account	Dr.		750,000	
	Share Capital Account				750,000
	(Being the allotment of bonus shares)				

Working Notes:

(w - 1) Amount of bonus = 50% of 15,00,000 = Rs. 750,000

ILLUSTRATION NO. 3: (Issuance of Shares at Premium)

ABC Co. Ltd. had a paid up capital of Rs. 800,000 divided in 8000 shares of Rs. 100 each. The company resolves to capitalise a part of reserve fund of Rs. 600,000 by issuing bonus shares. One bonus share is issued for every two shares held in the company. Bonus shares are to be issued at 25% premium. **Give the necessary journal entries.**

SOLUTION:

Journal

Date	Details		L/F	Debit Rs.	Credit Rs.
	Reserve fund Account	Dr.		500,000	
	Bonus to shareholder Account				500,000
	(Being the bonus declared)				
	Bonus to shareholders Account	Dr.		500,000	
	Share Capital Account (4000 × 100)				400,000
	Share premium Account (4000 × 25)				100,000
	(Being the allotment of bonus shares at premium)				

Workings Notes:

(w–1) No. of Bonus Shares:

$$= \text{Existing shares} \times \frac{\text{New shares}}{\text{Old shares}}$$

$$= 8000 \times \frac{1}{2}$$

$$= 4000 \text{ bonus shares}$$

(w–2) Amount of Bonus:

No. of shares × per share value

$= 4000 \times (100 + 25\%)$

$= 4000 \times 125 = \text{Rs. } 500{,}000$

ILLUSTRATION NO. 4:

The extracts are given from the draft balance sheet of Z Ltd. as on 31st December 2010:

Authorised Capital:	
50,000 Shares of Rs. 100 each	Rs. 50,00,000
Issued, Subscribed and paid up:	
10,000 shares of Rs. 100 each	Rs. 10,00,000
Reserve fund	Rs. 5,00,000
Profit & loss Appropriation A/c	Rs. 4,00,000

The Board of Directors pass a resolution to capitalise a part of existing reserves and profits by issuing bonus shares.

Two bonus shares are being issued for every five shares of Rs. 100 each held in the company. For this purpose the amount is to be provided equally from reserve fund and profit and loss Appropriation Account.

Make the necessary Journal Entries to give the effect to the above resolution and also prepare the amended balance sheet.

SOLUTION:

Journal

Date	Details	L/F	Debit (Rs.)	Credit (Rs.)
	Reserve fund Account Dr.		**200,000**	
	Profit & Loss Appropriation Account Dr.		**200,000**	
	Bonus to shareholder Account			**400,000**
	(Being the bonus declared equally from reserves and profit)			
	Bonus to shareholders Account Dr.		**400,000**	
	Share Capital Account			**400,000**
	(Being the allotment of bonus shares)			

Z Ltd
Amended Balance Sheet
As on 31st December 2010

Liabilities	Rs.
Authorised Capital:	
50,000 ordinary shares of Rs. 100 each	50,00,000
Issued, Subscribed and Paid up:	
14000 shares of Rs. 100 each	14,00,000
Reserves:	
Reserve fund (500,000 – 200,000)	300,000
P & L Appropriation A/c	200,000
(400,000 – 200,000)	
	19,00,000

Workings Notes:

(w–1) No. of Bonus Shares:

Existing Shares	:	Bonus Shares
5	:	2
10,000	:	x

$$x = \frac{2 \times 10000}{5} = 4000 \text{ shares}$$

(w–2) Amount of Bonus:

4000 Shares × Rs. 100 = Rs. 400,000

Bonus out of reserves = $400{,}000 \times \frac{1}{2}$ = Rs. 200,000

Bonus out of profit = $400{,}00 \times \frac{1}{2}$ = Rs. 200,000

(w-3) Total No. of Shares:

Existing Shares = 10,000

Add: Bonus Shares = 4,000

14,000

ILLUSTRATION NO. 5:

XYZ Co. Ltd. presents the following balance sheet as on 31st December 2010.

Liabilities	Rs.	Assets	Rs.
Authorised Capital	20,00,000	**Fixed Assets:**	
Issued & paid up:		Plant and machinery	880,000
9000 shares of Rs. 100 each	900,000	Furniture	100,000
Reserves:		**Current Assets:**	
Reserve fund	350,000	Stock	400,000
Share premium	50,000	Debtors	110,000
Profit & loss A/c	120,000	Bills Receivable	20,000
Current Liabilities:		Bank	85,000
Sundry Creditors	95,000		
Provision for taxation	80,000		
	15,95,000		15,95,000

The company purchases fresh machinery for Rs. 125000 for which it pays Rs. 25000 by cheque and allots shares of Rs. 100 each at a premium of Rs. 25 per share for balance amount to vendors. The company then issues one bonus shares for every four shares held at present. For the purpose of bonus the balance in profit & loss Account and reserve funds are used to the necessary extent.

You are required to pass journal entries for the above arrangements and redraft the company's balance sheet.

SOLUTION:

Journal

Date	Details		L/F	Debit (Rs.)	Credit (Rs.)
	Machinery Account	Dr.		125,000	
	Vendor's Account				125,000
	(Being the purchase of fresh machinery)				
	Vendor's Account	Dr.		125,000	
	Bank Account				25,000
	Share Capital Account (800×100)				80,000
	Share Premium Account (800×25)				20,000
	(Being the payment to vender in the cash and shares)				
	Profit & loss appropriation Account	Dr.		120,000	
	Reserve fund Account	Dr.		105,000	
	Bonus to share holders Account				225,000
	(Being the declaration of bonus)				
	Bonus to shareholder Account	Dr.		225,000	
	Share Capital Account				225,000
	(Being the issuance of bonus shares)				

XYZ Co. Ltd.
Balance Sheet
As on 31^{st} December, 2010

Liabilities	Rs.	Assets		Rs.
Authorised Capital:	20,00,000	**Fixed Assets:**		
Issued, subscribed & & paid up:		Plant and machinery	880,000	
12,050 shares of Rs. 100 each (w-4)	12,05,000	Add: New	125,000	10,05,000
Reserves:		Furniture		1,00,000
Reserve fund (350,000 – 105000)	2,45,000	**Current Assets:**		
Share premium (50,000 + 20,000)	70,000	Stock		4,00,000
Current Liabilities:		Debtors		1,10,000
Sundry Creditors	95,000	Bills Receivable		20,000
Provision for taxation	80,000	Bank (85000 – 25000)		60,000
	16,95,000			16,95,000

Workings Notes:

(w-1) No. of Shares issued to vendor:

$$= \frac{\text{Amount payable}}{\text{Net value per share}}$$

$$= \frac{100000}{100 + 25} = 800 \text{ shares}$$

(w-2) No. of Bonus Shares:

$$= \text{Existing Shares} \times \frac{\text{New Shares}}{\text{Old Shares}}$$

$$= 9000 \times \frac{1}{4} = 2250 \text{ Shares}$$

(w-3) Amount of bonus Shares:

2250 × Rs. 100	=	Rs. 2,25,000
Bonus out of profit & Loss A/c	=	120,000
Bonus out of Reserve fund	=	105,000
	=	225,000

(w-4) No. of Total Shares:

Existing Shares	=	9000
+ Shares issued to vendor	=	800
+ Bonus Shares	=	2250
	=	12,050

RIGHT ISSUE

Introduction:

Financial needs of company for expansion purposes may be of:

(a) Short term

(b) Long term

Short term financial needs are for working capital of the company which may be obtained from credit suppliers or short term loans. Long term financial needs are for expansion of plant and machinery and these needs are fulfilled by:

(a) Long term Borrowings

(b) By issuing further/fresh shares

(c) By issuing Bonds, Debentures or TFC.

One of the way by which company may satisfy its financial needs is that it may issue fresh shares.

When a company wants to increase its share capital by issuing new shares, first option to purchase new shares is given to existing shareholders. The first option or a pre-emptive or simply termed as "right" may therefore be defined as.

"An option to buy a share at a specified price during specified period."

"Right Shares" are the shares so issued to the existing shareholders under such pre-emptive right.

According to Section 86 of the Companies Ordinance, 1984:

(1) Where the directors decide to increase the capital of the company by the issue of further shares, such shares shall be offered to the members in proportion to the existing shares held by each member, irrespective of class, and such offer shall be made by notice specifying the number of shares to which the member is entitled, and limiting within which the offer, if not accepted, will be deemed to be declined. Such a notice is known as letter of right.

(2) The offer of new shares shall be strictly in proportion to the number of existing shares held.

Provided that fractional shares shall not be offered and all fractions less than a shares shall be consolidated and disposed of by the company and the proceeds from such disposition shall be paid to such of the entitled shareholders as may have accepted such offer.

(3) The offer of new shares shall be accompanied by a circular duly signed by the directors or an officer of the company authorised by them in this behalf in the form prescribed by the Authority containing material information about the affairs of the company, latest statement of the accounts and setting forth the necessity for issue of further capital.

(4) A copy of the circular referred to in sub-section (3) duly signed by the directors or an officer authorised as aforesaid shall be filed with the registrar before the circular is sent to the shareholders.

(5) The circular referred to in sub section (3) shall specify a date by which the offer, if not accepted, will be deemed to be declined.

(6) If, in the case of a public company, the whole or any part of the issue of shares so offered is declined or is not subscribed, the directors shall offer the unsubscribed part to any one or more institutions as may be specified by the Authority, and, if the said institution do not subscribed to the whole or any part of the offer, such whole or part may be allotted to and issued in such manner as the directors may deem fit.

Purposes of Right Shares:

The issue of right shares serves the following purposes:

(1) It preserves the power of control of the existing shareholders. In the absence of such a right, the existing shareholders may be deprived of their controlling power if a large number of shares are offered for subscription to outsiders.

(2) The existing shareholders may get benefit by receiving right shares as these shares are offered to them on a price which is lower than market price.

(3) If the shares are offered to general public then its issuing cost may also be saved by right shares.

(4) Right shares also restricts the directors to issue these shares to their friends and relatives at lower price and their controlling rights in the company may also be checked.

FACTORS TO BE CONSIDERED TO MAKE THE RIGHT ISSUE SUCCESSFUL:

Following are the important factors which determine the success of right issue:

(1) Trend of Investment Market
(2) Size of the Right Issue
(3) Price of Right Issue
(4) Right Issue and Earning Per Share.

(1) Trend of Investment Market:

One of the important factors which determine the success of right issue is the attraction of the shares of the company but the trend of the investment market has also strong effects on the success of right issue. If there is a favourable trend in the investment market it will show success on the part of right issue otherwise unfavourable trend affects the success adversely.

(2) Size of the Right Issue:

Success of right issue, also depends upon its size. If the size of right issue is small in relation to existing share capital then there are bright chances of its success as compared to large size. This is because of fresh issue bring profit after some time where as number of shares are increased then earning per share will decrease and it may show bad effects on the market value of shares. As the market value of shares decreases then the offer of right issue has less attraction among the shareholders which cause a failure on the part of right issue. So success of right issue also depends upon its small size in relation to share capital.

(3) Price of Right Issue:

Another important factor which influences the success of right issue is the price at which the right shares are offered. The directors while deciding the price to be offered to the shareholders for purchasing new shares have to be very careful. While determining the issue price the following factors should be kept in mind:

(i) trend of investment market,

(ii) the size of right issue,

(iii) earning capacity of the company,

(iv) past dividend records etc.

Issue price should be lower than the market price i.e., if market price of shares come down due to some factors then it should not be below than the issue price. This will provide charm for the shareholders to exercise the right offer and then may sold these shares in the market and may gain benefit.

(4) Right Issue and Earning Per Share:

New shares issued has reverse effect on earning per share. As number of shares has increased, so investment will also be increased but increased investment will give earning after sometime. In the meanwhile earning per share will decrease which may affect the current market price of share; and if market price comes down than the issue price then there are chances for failure of right issue. So while issuing right shares directors should clearly analyse earning per share.

VALUATION OF RIGHTS:

When a company offers new shares to the existing shareholders, they are generally offered at a much lower price than their market price. This is because of two reasons.

First, the company wants to give the existing shareholders some advantage because of their continued association with the company.

Secondly, the company wants to make the right issue a success and therefore it takes into account the possible fall in the market value of company's shares on account of a right issue.

On a right issue being made, the existing shareholders have the privilege of either applying for the shares offered with in a fixed period (usually 30 days) or to renounce their right to apply for these shares in favour of some other person since the right issue is being offered at a confessional price an existing shareholder can make a profit by selling his right to apply for new shares. He may sell this right with or without selling his existing shareholding.

Suppose a company offers to its existing shareholders the right to buy one ordinary share of Rs. 100 each at 120 for every two shares of Rs. 100 each held. Suppose the market value of one ordinary share is Rs. 180. Then the value of the right will be calculated as follows:

Market value of 2 ordinary shares @ Rs. 180 each =	Rs. 360
Add: offered price of 1 right share @ Rs. 120 each=	120
	480

Average price $= \frac{\text{Rs. } 480}{3} = \text{Rs. } 160$

The value of right = Market price – Average price

= 180 – 160 = Rs. 20

Check:

$$\text{Value of right} = \frac{\text{New Shares}}{\text{Total Shares}} \times (\text{Market Price} - \text{Offered Price})$$

$$= \frac{1}{3} \times (180 - 120)$$

$$= \frac{1}{3} \times 60 \quad = \text{Rs. } 20$$

Alternatively:

The whole process can be expressed in the form of the following formula also:

$$V = \frac{M - S}{N + 1}$$

M = Market value

S = Offered price

N = No. of shares for getting one right share

$$V = \frac{180 - 120}{2 + 1} = \frac{60}{3} = \text{Rs. } 20$$

ILLUSTRATION NO. 6:

X Ltd. Offers to its existing shareholders the right to buy one right share at Rs. 120 for every four shares of Rs. 100 each held. The market value of the share on the date of such offer is Rs. 180 per share.

REQUIRED:

Calculate the value of the right.

SOLUTION:

	Market value of 4 Shares @ Rs. 180 each	=	Rs. 720
Add:	Issue price of 1 right share @ Rs. 120 each	=	Rs. 120
	Total price of 5 shares	=	Rs. 840

$$\text{Average Price} = \frac{\text{Total value}}{\text{Total shares}} = \frac{\text{Rs. } 840}{5} = \text{Rs. } 168$$

Value of Right = Market Price – Average price

= Rs. 180 – Rs 168

= Rs. 12

Check:

$$\text{Value of right} = \frac{\text{New Shares}}{\text{Total Shares}} \times (\text{Market Price} - \text{Offered Price})$$

$$= \frac{1}{5} \times (180 - 120)$$

$$= \frac{1}{5} \times 60 \quad = \text{Rs. } 12$$

ILLUSTRATION NO. 7:

Z Ltd. Offers to its exiting shareholders the right to purchase 3 shares of Rs. 100 each at premium of 50% for every 7 shares of Rs. 100 each held in the company. The market value of the share is Rs. 250 each.

REQUIRED:

Calculate the value of right.

SOLUTION:

	Market value of 7shares @ Rs. 250 each	=	Rs. 1750
Add:	Issue price of 3 right shares @ Rs. 150 each	=	450
	Total price of 10 shares	=	2200

$$\text{Average Price} = \frac{\text{Total Price}}{\text{Total Shares}} = \frac{\text{Rs. } 2200}{10} = \text{Rs. } 220$$

$$\text{Value of Right} = \text{Market Price} - \text{Average price}$$

$$= \text{Rs. } 250 - 220$$

$$= \text{Rs. } 30$$

Check:

$$\text{Value of right} = \frac{\text{New Shares}}{\text{Total Shares}} \times (\text{Market Price} - \text{Offered Price})$$

$$= \frac{3}{10} \times (250 - 150)$$

$$= \frac{3}{10} \times 100$$

$$= \text{Rs. } 30$$

ACCOUNTING TREATMENT FOR RIGHT ISSUE:

When a company offers new shares to the existing shareholders, they are generally offered at a low price than their market price in order to make the right issue attractive. From shareholders view point difference between market price and issue price due to receipt of right is considered as bonus whereas from company's view point the difference between issue price and face price is treated as premium if right shares are issued at above the par value.

For example Rs. 100 shares of a company may be valued on stock exchange at Rs. 275. New Shares may be issued at Rs. 150 to members which means that they are given a bonus of Rs. 125 i.e. (Difference between market price and issued price). From company's view point it receives a premium of Rs. 50 i.e. (Difference between issue price and face value). Following are the accounting entries for right issue.

Entries:

(1) ***When right offer is made:***

Sundry Shareholders Account ... Dr. (with market value)

Ordinary Share Capital Account (with face value)

Share premium Account (with difference between market value and face value)

(2) ***When amount is received from Shareholders:***

Bank Account ... Dr. (with issued price)

Sundry shareholders Account

(3) ***Close of Shareholders Account:***

Bonus Share Dividend Account ... Dr.

Sundry Shareholders Account (with balance in shareholders A/c)

ILLUSTRATION NO. 8:

A company with issued capital of Rs. 9,00,000 dividend into 9000 ordinary shares of Rs. 100 each decided to make a right issue to its shareholders @ Rs. 100 share for every share held at Rs. 120 each. Market value on the date of issue is Rs. 150 each. All the rights were taken up.

Pass the Journal Entries necessary to record the above transactions and also show the relevant accounts.

SOLUTION: **Journal**

Date	Details		L/F	Debit (Rs.)	Credit (Rs.)
	Sundry shareholders Account (9000×150)	Dr.		13,50,000	
	Share Capital Account (9000×100)				900,000
	Share Premium Account (9000×50)				450,000
	(Being the right offer of 9000 shares)				
	Bank Account (9000 × 120)	Dr.		10,80,000	
	Sundry shareholders Account				10,80,000
	(Being the amount received from members on account of right shares)				
	Bonus share dividend Account	Dr.		270,000	
	Sundry shareholders Account				270,000
	(Being the close of sundry shareholder A/c)				

Ledger Accounts

Ordinary Share Capital Account

Dr. Cr.

Date	References	Amount Rs.	Date	References	Amount Rs.
	Balance c/d	1,800,000		Balance b/d	900,000
				Shareholders A/c	900,000
		1,800,000			18,00,000

Sundry Shareholders Account

Dr. Cr.

Date	References	Amount Rs.	Date	References	Amount Rs.
	Ordinary Share Capital A/c	900,000		Bank A/c	10,80,000
	Share Premium A/c	450,000		Bonus Share Dividend A/c	270,000
		13,50,000			13,50,000

Bonus Share Dividend Account

Dr. Cr.

Date	References	Amount Rs.	Date	References	Amount Rs.
	Sundry Shareholder A/c	270,000		Balance c/d	270,000
		270,000			270,000

Share Premium Account

Dr. Cr.

Date	References	Amount Rs.	Date	References	Amount Rs.
	Balance c/d	450,000		Sundry shareholder A/c	450,000
		450,000			450,000

Bank Account

Dr. Cr.

Date	References	Amount Rs.	Date	References	Amount Rs.
	Balance c/d	10,80,000		Sundry shareholder A/c	10,80,000
		10,80,000			10,80,000

ILLUSTRATION NO. 9:

A company with issued capital of 100,000 shares of Rs. 10 each decided to make a right issue to the shareholders at the rate Rs. 10 share for every 2 shares held. The shares are to be issued at Rs. 15. All the rights were to be taken up.

Pass the necessary Journal Entries:

Journal

Date	Details	L/F	Debit (Rs.)	Credit (Rs.)
	Sundry shareholders Account Dr.		750,000	
	Share Capital Account (50,000 × 10)			500,000
	Share Premium Account (50,000 × 5)			250,000
	(Being the right offer is made for 50,000 shares)			

	Bank Account Dr. Sundry shareholders Account (Being the amount received on account of right shares)		750,000	750,000

Working Notes:

(1) Calculation of No of Right Shares:

Existing Shares	:	New/Right Shares
2	:	1
100,000	:	x

$$x = \frac{1 \times 100,000}{2} = 50,000 \text{ Shares}$$

ILLUSTRATION NO. 10:

The extracts are given from the draft balance sheet of XYZ company as on 31st December 2010:

Authorised Capital: 50,000 Shares of Rs. 100 each	Rs. 50,00,000
Issued, Subscribed and Paid up Capital:	
20,000 Ordinary shares of Rs. 100 each	20,00,000
Share Premium	1,00,000
General Reserve	16,00,000
Profit & Loss Account	4,00,000

The board of directors pass a resolution to capitalize a part of existing reserves and profit by issuing bonus shares. Four bonus shares are being issued for every ten shares of Rs. 100 each already held in the company. For the purpose of bonus issue, to utilize the share premium account, Rs. 300,000 out of profit & loss account and balance out of general reserve.

Company also offers to its shareholders the right to buy 3 shares of Rs. 100 each at Rs. 125 each for every 5 shares held. All the rights were taken up:

You are required to pass necessary Journal Entries and also redraft the balance sheet after the above arrangements.

SOLUTION:

Journal

Date	Details	L/F	Debit (Rs.)	Credit (Rs.)
	Share Premium Account Dr. Profit & Loss Appropriation Account Dr. General Reserve Account Dr. Bonus to shareholders Account (Being the declaration of bonus)		100,000 300,000 400,000	 800,000
	Bonus to shareholders Account Dr. Share Capital Account (Being the issuance of bonus shares)		800,000	 800,000
	Sundry Shareholders Account Dr. Share Capital Account (12000×100) Share Premium Account (12000×25) (Being the issuance of right shares)		15,00,000	 12,00,000 3,00,000
	Bank Account Dr. Sundry Shareholders Account (Being the amount received from shareholders)		15,00,000	 15,00,000

XYZ Co. Ltd.
Balance Sheet (As on 31st Dec. 2010)

Liabilities	Rs.	Assets	Rs.
Authorised Capital:		**Fixed Assets:**	
50,000 ordinary shares of Rs. 100 each	50,00,000	Sundary Assets	41,00,000
Issued, subscribed & & paid up:		**Current Assets:**	
40,000 shares of Rs. 100 each	40,00,000	Cash at Bank	15,00,000
Reservers:			
Share premium	3,00,000		
General Reserve (16,00,000 – 400,000)	12,00,000		
Profit & Loss A/c	100,000		
	56,00,000		56,00,000

Workings Notes:

(w-1) No. of Bonus Shares:

$$= \text{Existing Shares} \times \frac{\text{New Shares}}{\text{Total Shares}}$$

$$= 20{,}000 \times \frac{4}{10} = 8{,}000 \text{ Shares}$$

(w-2) Amount of Bonus:

		Rs.
8000 Shares × Rs. 100	=	800,000
Bonus out of P & L A/c	=	300,000
Bonus out of Share premium	=	100,000
Bonus out of General reserve	=	400,000
	=	800,000

(w-3) No. of Right Shares:

$$= \text{Existing Shares} \times \frac{\text{New Shares}}{\text{Total Shares}}$$

$$= 20{,}000 \times \frac{3}{5} = 12{,}000 \text{ Shares}$$

(w-4) Total No. of Shares:

Existing Shares	=	20,000
Bonus Share	=	8,000
Right Shares	=	12,000
	=	40,000

OBJECTIVE QUESTIONS

Give the short answers of the following questions: **Page**

- Define bonus shares. 33
- Define quantum of bonus. 36
- What is the formula of quantum of bonus? 36
- Derive the formula of quantum of bonus. 36
- What are the advantages of the issuance of bonus shares? (any two). 35
- What are the disadvantages of the issuance of bonus shares? (any two) 35
- Why companies issue bonus shares? 33
- What is the rule of issuance of bonus shares? 36
- Write down the names of sources used to issue bonus shares. 37
- What is difference between free reserves and residual reserves? 36
- Calculate the value of quantum of bonus from the following particulars: 38

Free reserve	Rs. 70,000
Existing share capital	Rs. 55,000

- Pass the journal entry for the allotment of bonus shares. 37
- Define right share. 44
- What is meant by letter of right? 44
- Write down the formula of value of right. 47
- What are the advantages of right issue? (any three) 45
- What is the difference between right share and bonus share? .... 33 & 44
- Calculate the value of right if a company offers the right to buy 2 shares for every 5 shares held at Rs. 15. Market value of share quoted at Rs. 30 47
- Pass the journal entry, when right offer is made 49

THEORETICAL QUESTIONS

Q.1 Define bonus shares. Why companies issue bonus shares?

Q.2 What are the advantages and disadvantages of issuing bonus shares?

Q.3 What are the legal provisions regarding bonus?

Q.4 What is 'Quantum of Bonus'? How is it calculated?

Q.5 What do you mean by 'Capitalisation of Reserves'? Explain its methods and give also its accounting treatment?

Q.6 What are the advantages of (a) Bonus issue (b) Right Issue?

Q.7 What is meant by pre-emptive right of Shareholders?

Q.8 Explain the main purposes of right issue.

Q.9 What is the mode of calculation of value of right?

Q.10 Explain the accounting treatment regarding right issue.

PRACTICAL QUESTIONS

BONUS ISSUE:

Q.1 The following figures have been extracted from the books of Umar Trading company Ltd. as on 31.12.2010:

Existing capital:	Rs. 40,00,000
Free Reserves:	Rs. 50,00,000

The company wants to capitalise its reserves in order to declare fully paid bonus shares. What will be the maximum amount available.

Ans: *[Quantum of Bonus Rs. 32,00,000]*

Q.2 Free reserves of ACG company Ltd. as on 31st December, 2010, are Rs. 32,00,000 (160% of existing capital).

ACG Co. Ltd. wants to know the maximum amount of bonus available for Capitalisation from free reserves. Residual reserves should be equal to 25% of the increased capital after calculating the amount of bonus.

Calculate the quantum of bonus:

Ans: *[Quantum of Bonus Rs. 21,60,000]*

Q.3 A company had an issued capital of Rs. 30,00,000 and reserve fund of Rs. 28,00,000. Company distributes a bonus out of reserve fund @ 60% of the issued capital by issuing fully paid bonus shares. Bonus shares are issued at par i.e., at Rs. 100 each and their market price was Rs. 250 each.

Pass the necessary journal entries.

Q.4 Mehmood Company Ltd. had paid up capital of Rs. 600,000 divided into 6,000 ordinary shares of Rs. 100 each. The company resolves to capitalise a part of reserve fund of Rs. 525,000 by issuing bonus shares. One bonus shares is issued for every two shares already held in the company.

REQUIRED:

Give the necessary journal entries.

Q.5 Ahmad company Ltd. had an authorised capital of 20,000 shares of Rs. 100 each of which 50% was issued and paid up. Company had a balance of Rs. 800,000 in General Reserves and Rs. 500,000 in profit & Loss Account.

The directors of the company resolves to issue bonus to its shareholders @ 40% of paid up capital in the fully paid bonus shares. For this purpose Rs. 250,000 are taken out of profit & Loss account and balance out of general reserves.

Give necessary Journal Entries to record the above arrangement.

Q.6 The extracts are taken from the draft balance Sheet of Aslam Limited as on 31st December 2010:

Authorised Capital: 400,000 ordinary shares of Rs. 10 each	Rs. 40,00,000
Issued, Subscribed and paid up Capital:	
100,000 ordinary shares of Rs. 10 each	Rs. 10,00,000
Share Premium	Rs. 2,00,000
General Reserve	Rs. 6,00,000
Profit & Loss Account	Rs. 3,50,000

The Board of Directors pass a resolution to capitalise a part of its existing reserves by issuing bonus shares. Bonus shares be issued at the rate of 50% of the ordinary shares. For this purpose Rs. 1,00,000 is provided out of share premium and balance equally out of general reserve and profit & Loss A/c.

Make the necessary Journal entries to give the effect to the above resolution and prepare also an amended balance sheet.

Ans: *[Balance Sheet Rs. 21,50,000]*

Q.7 Usman Trading Company Ltd. presents the following balance sheet as on 31st December 2010:

Liabilities	Rs.	Assets	Rs.
Authorised Capital:	30,00,000	Fixed Assets:	
Issued, subscribed & paid up capital:		Land & Building	9,00,000
		Plant & Machinery	8,00,000
12,000 shares of Rs. 100 each	12,00,000	Furniture	1,90,000
General Reserve	8,00,000	Current Assets:	
Profit & Loss	2,50,000	Stock	2,50,000
Creditors	1,75,000	Debtors	2,20,000
Provision for Tax	65,000	Bank	1,30,000
	24,90,000		24,90,000

The company purchases fresh machinery for Rs. 200,000 for which it pays Rs. 25000 by cheque and for balance allots ordinary shares of Rs. 100 each at 25% premium. The company then issues two bonus shares for every five ordinary shares held at present. For the purpose of amount of bonus, utilise the profit & Loss A/c and balance out of general reserve.

You are required to pass journal entries for the above arrangements and redraft the company's balance sheet.

Ans: *[Balance Sheet Rs. 26,65,000]*

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Q.8 A balance sheet of Zeeshan Ltd. on December 31, 2010 was as follows:

Liabilities	Rs.	Assets	Rs.
Share Capital:			
25,000 shares of Rs. 10 each	2,50,000	Sundry Assets	6,00,000
Reserve fund	1,10,000		
Profit & Loss A/c	70,000		
Long term Debts	170,000		
	6,00,000		6,00,000

The company decided to pay off long term debts by issuing ordinary shares of Rs. 10 each at Rs. 12.5 each. It further decide to issue bonus shares @ 40% of share capital. For this purpose to utilise profit & Loss A/c and the balance out of reserve fund.

Give journal entries and re-draft the balance sheet.

Ans: *[Balance Sheet Rs. 600,000]*

Q.9 Faisal company Ltd. offers to its existing shareholders the right to buy one right share at Rs. 140 for every two shares of Rs. 100 each held at present. The market value of the share on such date is Rs. 250 per share.

Calculate the value of the right.

Ans: *[Value of Right Rs. 36.67]*

Q.10 Shoaib Company Ltd. offers to its existing shareholders the right to purchase three right shares at Rs. 20 each for every eight shares of Rs. 10 each held at present. The market price of the share on such date is Rs. 50 per share.

Calculate the value of the right.

Ans: *[Value of Right Rs. 8.18]*

Q.11 Ashraf Company Ltd. offers to its shareholders the right to buy four right shares at Rs. 120 each for every ten shares of Rs. 100 each held already in the company. The market value of share on date of such issue is Rs. 225 per share. You are required to calculate the value of right.

Ans: *[Value of Right Rs. 30]*

Q.12 Amir Company Ltd. with an issued capital of 8,000 shares of Rs. 100 each and reserves of Rs. 6,00,000 decided to offer the right to buy one right share at a premium of 20% for every one share of Rs. 100 each held at present in the company. The market price of the share on the date of such offer is Rs. 175. The excess of market price over issue price is treated as bonus. All the rights are taken up.

REQUIRED:

Give the necessary journal entries and also prepare the necessary ledger accounts in the books of Amir Co. Ltd.

Q.13 Aslam company Limited with issued capital of Rs. 30,00,000 divided into 3,00,000 shares of Rs. 10 each and reserve of Rs. 18,00,000 decides to make a right issue to shareholders one share for every one share held. Right shares are issued at 30% premium. All the rights were taken up.

REQUIRED:

Pass the necessary journal entries and prepare the necessary ledger accounts.

Q.14 The extracts are taken from the draft Balance sheet of Modern Appliance Limited as on 31st December 2010:

	Rs.
Authorised capital:	
30,000 ordinary shares of Rs. 100 each	30,00,000
Issued, subscribed and paid up capital:	
12,500 shares of Rs. 100 each	12,50,000
Reserve Fund	8,25,000
Profit & Loss Account	3,30,000

The Board of Directors recommended to issue bonus shares at the rate 15 shares of Rs. 100 each for every 50 shares held at present. For this purpose, Rs. 200,000 are to be provided out of profit & Loss account and the balance out of reserve fund.

The Board also recommended to issue right shares of the company @ 30 shares of Rs. 100 each for every 50 shares at a premium of 20% per share. The approval of controller of Capital issue had already been obtained.

REQUIRED:

Make necessary journal entries to give effect to the recommendation of Board of Directors and show how would they effect the Balance sheet.

Ans: *[Balance Sheet Rs. 33,05,000]*

Q.15 The following are the extracts from the draft Balance sheet of ABC Company Limited as on 30th June 2010:

	Rs.
Authorised capital:	
30,000 ordinary shares of Rs. 100 each	30,00,000
Issued, subscribed & paid up capital:	
20,000 shares of Rs. 100 each	20,00,000
Reserve Fund	12,00,000
Profit & Loss Account	7,00,000

The Board of Directors recommended:

(i) To issue bonus shares in the ratio of one bonus share for every five ordinary shares held.

(ii) To issue right shares in the ratio of one right share for every four ordinary shares held. The bonus shares will not be entitled for above right shares. For the purpose of issue of bonus shares, the funds were to be provided out of Profit & Loss Account and reserve fund in equal proportion.

REQUIRED:

Make necessary journal entries to give the effect to the recommendation of Board and show how would they effect the balance sheet.

Ans: *[Balance Sheet 44,00,000]*