Topic: Internal Reconstruction

Notes

* Utilisation of Capital Reduction A/c :-

Capital Reduction A/c must have credit Balance before writing off :-

a) Losses (कचरा) P&L a/c Dr. Bal.

b) Overvalued Assets

c) Fictitous Assets (Preliminary Exp. not yet writeoff, share issue expense not yet write off)

d) Some Intangible Assets (such as goodwill)

All above items, must be write off with capital Reduction A/c

After writing off above items, Capital Reduction A/c Balance may be :-

- Sufficient
  ↓
  Remainning Balance transfer to CR
  ↓
  capital Reserve
- Insufficient
  ↓
  First check GR or any other Reserves Cr. Balance

(Continue) → next page

If it is available	If it is not available
↓ then GR Balance shall also be utilised to w/off Remaining losses.	↓ Remainning Loss (P&L A/C Dr. Bal.) shall be continued

* Reconstruction means making changes in Business. Such changes are required to continue the Business activity & to avoid the liquidation of company.

These changes consist of :-

a) Changing the share capital structure of company.

b) Compromise arrangement with outside liabilities.

c) Writing off the Accumulated losses.

d) Remeasuring the overvalued Assets (or) write off irrelevant Assets.

* Internal Reconstruction means to change the financial position of the company.

* Sub division & consolidation does not reduce or increase the total paid up capital of entity, means no capital profit can be generated.

*. Reduction in Share Capital:

1) Extinguishment of uncalled capital

↓

1,00,000 no. of 10/-
fv shares :- 7.5/- paid up

↓

2.5 uncalled is now cancelled

↓

It is called conversion from partly paid to fully paid without calling money.

↓

ESC (10/-) A/c Dr.	7,50,000	
To ESC (7.5/-) A/c		7,50,000

2) Paying off paid up share capital:

↓

1,00,000 shares of 10/- each fully paid,
Now it will be 6/- fully paid.

↓

with no change in numbers

↓

means 4/- to be refunded & reducing share capital

↓

ESC A/c (10) Dr.	10,00,000	
To ESC A/c (6)		6,00,000
To Bank A/c		4,00,000

3) **Cancellation of Paid up Capital without reducing face Value:**

↓

50,000 shares of 10/- each fully paid
Now, it is 7/- partly Paid with 10/- FV.

↓

It is called conversion from fully paid to partly paid.

↓

ESC A/c	Dr.	1,50,000	
To Capital Reduction A/c			1,50,000

↓

It is capital profit which will be used to write off losses.

4) **Reducing face Value & paid up value of shares.**

↓

70,000 shares of 10/- each fully paid is now reduced to 4/- fully Paid.
(No Repayment of 6/-)

↓

ESC A/c (10/-)	Dr.	7,00,000	
To ESC A/c (4/-)			2,80,000
To Capital Reduction A/c			4,20,000

→ No. (shares) will always be same

* The Expenses of Reconstruction shall be incurred through Capital Reduction A/c only.

Capital Reduction A/c Dr. ---
  To Cash A/c ----

* If Preference Dividend is in arrears :→ It is a liability.

First check if it is shown in B/S or not.

If not shown in B/S & Question says :-

arrears to be waived off
↓
No entry.

arrears to be settled in cash or issue of share
↓
Capital Reduction A/c Dr.
  To Cash/Bank A/c
  To Eq. Sh. Capital A/c

* Debentureholders took over freehold property

at its Book value of 5,00,000
↓
Debentures A/c Dr. 5,00,000
  To Property A/c 5,00,000

(OR)

whose Book value is 5,00,000 & agreed to take over at 5,25,000
↓
Debentures A/c Dr. 5,25,000
  To Property A/c 5,00,000
  To Capital Reduction A/c 25,000

* Cancelling any contractual commitment & paying of penalty is Expense of Reconstruction.

↓

Capital Reduction A/c Dr. ---

To Bank A/c ---

* Adjustments & Treatment:-

1) Preference shares dividend in arrears for 3 years to be waived by 2/3rd and balance 1/3rd, Equity shares to be alloted.

↓

Capital Reduction A/c Dr. ---

To Equity Share Capital A/c ---

(Being 1/3rd arrears of PS dividend of 3 years to be satisfied by issue of Equity shares)

2) The preference shareholders have agreed to forego the arrears of dividend and to accept for preference shares, 4 new 12 % Preference shares, plus 3 new equity shares, all credited as fully paid.

↓

--% Preference Share Capital A/c Dr ---

Capital Reduction A/c (b/f) ---

To --% Preference Share Capital A/c ---

To Equity Share Capital A/c ---

3) The rate of Int. on Debentures increased to ---%. The Debenture holders surrender their existing debentures and exchange for the same for fresh debentures for every debenture held by them.

50000 100/-

1:1 10/-

↓

---% Debentures A/c Dr. 5000000

To ---% Debentures A/c 500000

To Capital Reduction A/c (b/f) 45 lacs.

4) One of creditors of co. to whom the company owes Rs 40,00,000 decides to forgo 40% of his claim. The creditor is allotted with 60,000 equity shares of ₹ 40 each in full and final settlement of his claim.

↓

Sundry Creditors A/c Dr. 40,00,000

To Equity Share Capital (₹40) A/c 60% 24,00,000

To Capital Reduction A/c 40% 16,00,000

5) The company would issue 11% Debentures for Rs 3,00,000 and augment its working capital requirement after settlement of Bank OD

↳1,50,000

↓

Bank A/c Dr. 3,00,000
To 11% Debentures A/c 3,00,000
(Debenture issue)

Bank Overdraft A/c Dr. 1,50,000
To Bank A/c 1,50,000
(Being settlement of bank overdraft)

6) The balance on Securities Premium A/c (10,000) was utilized and was transferred to Capital Reduction A/c.

↓

Securities Premium A/c Dr. 10,000
To Capital Reduction A/c 10,000

7) A contingent liability of which no provision had been made was settled at Rs 7,000 and of this amount, Rs 6,300 was recovered from the insurance.

↓

Capital Reduction A/c Dr. 7,000
To Bank A/c 7,000
(Contingent liability paid)

Bank A/c Dr. 6,300
To Capital Reduction A/c 6,300
(Insurance co. remit part of contingency payment amount)

8) The debenture holders took over the freehold property at an agreed figure of Rs 75,000 and paid the balance to the co. after deduction the amount due to them.

[Freehold property :- Rs 1,20,000] BV

[9% Debenture :- 50,000
Accrued Int. on Debt : 5000]

↓

Two hints:

1. Since remaining property are not being revalued, so it seems that whole property is given.
2. Since the Book value of property taken over is not given separately, assume that entire property is given.

↓

9% Debentures A/c	Dr.	50,000	
Accrued Int. on Deb. A/c	Dr.	5,000	
Bank A/c	Dr.	20,000	
Capital Reduction A/c	Dr.	45,000	
To Freehold Property A/c			1,20,000

* Priority of writing off following items:

(after writing off overvalued Assets as required by question)

P&L A/c → Dr. → Balance

Goodwill (if any)

Note: Other Intangible assets (other than goodwill) shall be write off only if it is required by question.

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* Treatment of Equity Share Surrender:

Step 1: Shareholder's surrender their 50% shares.

Share Capital A/c Dr ---
  To Share Surrender A/c ---

Step 2: Now surrendered shares shall be reissued first, in the form of preference shares.

Share Surrender A/c Dr. ---
  To PSC A/c ---

Step 3: The re-issued shares shall be used to settle any liability. [Debentureholder, Creditor]

Liability A/c Dr. ---
  To Capital Reduction A/c ---

Note: In this, liability holder shall be alloted the above re-issued shares for which additional entry, not required.

Step 4: The surrendered shares not yet re-issued shall be permanently transfer to Capital Reduction A/c.

Share Surrender A/c Dr ----
To Capital Reduction A/c ----

(for more, refer summary book page no.:- 5.8)

Adjustments:-

* Mr. Y & Mr. Z agreed to cancel 50% each of their respective total debt including int. on debt. Mr Y & Mr Z also agreed to pay 1,00,000 & Rs 60,000 respectively in cash & to receive new 12% Debt for Bal. Mr. Y holds 60% of Debt & Mr. Z holds 40% of debt. And, 1,00,000 & Rs 60,000 were also payable to Mr Y and Mr Z as trade Payable.

		Y	Z
10% Secured Debt.	:- 16,00,000	960000	640000
Int. due on Debt.	:- 1,60,000	96000	64000
		100000	60000
		1156000	

Solution :-

Dues of Mr. Y :

10% Debt	:-	9,60,000
Int.	:-	96,000
Trade Payable	:-	1,00,000
Total Debt	:-	11,56,000

(–) 50% forego (578,000)

5,78,000

(+) Bank received 1,00,000

New 12% Debn :- 6,78,000

Dues of Mr. Z :

10% Debenture :- 6,40,000

Int. :- 64,000

Trade Payable :- 60,000

Total Debt :- 7,64,000

(–) 50% forego (3,82,000)

3,82,000

(+) Bank Received 60,000

New 12% Debn :- 4,42,000

Entry :-

1/2) 10% Debn A/c Dr. 16,00,000
Int. A/c Dr. 1,60,000
Trade Payable A/c Dr. 1,60,000
To Mr Y A/c 11,56,000
To Mr. Z A/c 7,64,000

2/2) Mr. Y A/c Dr. 11,56,000
Bank A/c Dr. 1,00,000
To Reconstruction A/c 5,78,000
To 12% Debn A/c 6,78,000

3) Mr. Z A/c Dr. 7,64,000
Bank A/c Dr. 60,000
To 12% Debn A/c 4,42,000
To Reconstruction A/c 3,82,000

* Capital commitments of Rs 3 lacs were cancelled on payment of Rs 15,000 as penalty.

Reconstruction A/c Dr. 15,000
To Bank A/c 15,000

* If claim of debenture holders is write anywhere in adjustment, then claim includes interest also.

* Uncalled Capital is to be called up in full & such shares & other fully paid up equity shares to be reduced to ₹ 5/- share.

25,000 Equity shares : ₹ 10 each, ₹ 8 paid up : 2,00,000
50,000 Equity shares : ₹ 10 fully paid up :- 5,00,000

1) Bank A/c Dr. 50,000
To ESC A/c 50,000

2) ESC A/c (Rs 10) Dr. 7,50,000
To ESC (Rs 5/-) A/c 3,75,000
To Capital Reduction A/c 3,75,000
(75,000 × 5)

*. Preference shareholders will forego their claim of dividend for one year & one equity share of ₹5 each is to be issued for remaining arrears of dividend.

↓

Preference Share Capital :-

30,000 8% Cumulative shares of ₹10 each 3,00,000

(Preference dividend has been in arrears for 3 years)

↓

$3,00,000 \times 8\% \Rightarrow 24,000 \times 2 \text{ years} = \frac{48,000}{5}$

$\Rightarrow$ 9,600 no. new shares

Capital Reduction A/c	Dr.	48,000	
To ESC A/c			48,000

*. The Co. will further issue 12% debentures for such amount which is sufficient to pay off Bank OD and other o/s liabilities & maintain its cash/bank balance at ₹85,000

↓

Firstly make/prepare Bank A/c by taking closing balance of ₹85,000, then,

↓

Bank A/c	Dr.	- - - -	
To 12% Debn A/c			- —

Bank OD A/c Dr. ----
Int. Payable A/c Dr. ----
(O/s Liabilities)
To Bank A/c ----

*. Directors to accept settlement of their loans as to 90% thereof by allotment of Equity shares of ₹ 2 & as to 5% in cash, & balance 5% being waved.

Loan from Directors :- 1,00,000

↓

Director's Loan A/c Dr.	1,00,000	
To ESC A/c		90,000
To Bank A/c		5,000
To Capital Reduction A/c		5,000

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*. Bank Overdraft (Bank OD) :-

If bank overdraft balance is given in the question on liability side and nothing is mentioned about its set off with Bank A/c, It is better to set off the Bank OD with the debit balance of Bank, if available. Hence, we shall always set off the same with Bank A/c.

(Note) :- At the last of the (question) solution, We shall make an "additional note as under",

"Alternatively the Bank OD balance, could have been shown separately in the Balance Sheet without set off"

* In case of any conflict or contradiction between the genuine accounting treatment and ICAI's suggested treatment, we can follow any one of the treatment as per situation & make a note of alternative treatment along with its impact on Capital Reduction A/c with that treatment.

Remaining Adjustments & Treatment:-

* A holds the first debentures for Rs 3,00,000 and second debentures for Rs 3,00,000. He is also an unsecured creditor for Rs 90,000. B holds second debentures for Rs 3,00,000 and is an unsecured trade payables for Rs 60,000.

↓

A is to cancel Rs 2,10,000 of total debt owing to him, to bring Rs 30,000 in cash and to take first debentures (in cancellation of those already issued to him) for Rs 5,10,000 in satisfaction of all his claims.

B is to accept Rs 90,000 in cash in satisfaction of all claims by him.

Solution :

Mr A's Debts (₹)		Mr. B's Debts	
1st Debt :-	3,00,000	IInd Debt :-	3,00,000
IInd Debt :-	3,00,000	Creditors :-	60,000
Creditors :-	90,000	Total Debt :-	3,60,000
Total Debt :-	6,90,000		
(–) Cancelled :-	(2,10,000)		
	4,80,000		
(+) Cash Receipt :	30,000		
New Debt. :-	5,10,000		

Entry :-

1) 1st Debt. A/c	Dr.	3,00,000	
IInd Debt. A/c	Dr.	6,00,000	
Trade Payables A/c (90,000 + 60,000)	Dr.	1,50,000	
To Mr. A A/c			6,90,000
To Mr. B A/c			3,60,000
2) Mr. A A/c	Dr	6,90,000	
Bank A/c	Dr.	30,000	
To 1st Debt (New) A/c			5,10,000
To Capital Reduction A/c			2,10,000
3) Mr. B A/c	Dr.	3,60,000	
To Bank A/c			90,000
To Capital Reduction A/c			2,70,000

*. In full settlement of 75% of claim, unsecured Creditors (other than A & B) agreed to accept four shares of ₹ 7.50 each, fully paid against their claim for each shares of Rs 60. The balance of 25% is to be postponed and to be payable at the end of three years from the date of court's approval of the scheme. The nominal share capital is to be increased accordingly.

↓

Total Unsecured Trade Payables : 4,50,000 (₹)

A - Unsecured creditor ⇒ 90,000 (₹)

B - Unsecured creditor ⇒ 60,000 (₹)

Solution:- Remaining creditors (other than A & B)

⇒ ₹ 3,00,000 [4,50,000 - 90,000 - 60,000]

75%
↓
2,25,000
↓
For every 60/-
they will get 4
shares of 7.5/- each.
↓
$\frac{2,25,000}{60} \times 4$ shares (no.)

⇒ 15,000 shares × 7.5/-

⇒ 1,12,500 ₹

25%
↓
75,000
↓
No settlement
↓
They will be continued

Entry:

Creditors A/c	Dr.	2,25,000	
To ESC A/c			1,12,500
To Capital Reduction A/c			1,12,500

* "B" 6% Debenture holders agreed to take over the Chennai works of Rs 4,25,000 and to accept an allotment of 1,500 equity shares of Rs 10 each at par, and upon their forming a co. called Zia Ltd. (to take over the Chennai works) they allotted 9,000 equity shares of Rs 10 each fully paid at par to Star Ltd.

↓

Total Chennai Works (PPE) :- 7,75,000 ₹

Solution: Exchange Transaction:

"B" debenture of 3,50,000 Dr. settled with :-

Chennai PPE :- 4,25,000 (Cr.)

Equity shares :- 15,000 (Cr.)
(1,500 no.)
(10/-)

4,40,000

Debentureholder got excess 90,000 in settlement. Hence, they are issuing, 9000 equity of 10/- of their Co. Zia ltd. to us (Star Ltd.)

↓

"B" 5% Debenture A/c	Dr.	3,50,000	
Investment in Zia ltd. A/c	Dr.	90,000	
To Chennai PPE A/c			4,25,000
To ESC A/c			15,000

*. The Chennai Workmen's Compensation fund disclosed that there were actual liabilities of Rs 1,000 only. As a consequence, the investments of the fund were realized to the extent of the balance. Entire investments were sold at a profit of 10% on book value & the proceeds were utilized for part payment of the creditors.

Workmen Compensation Fund:

Bombay Works	10,000
Chennai Works	5,000

Investment for WCF :- 15,000

Option 1 — As per ICAI

Workmen Compensation Fund (Liabilities)		Investments
Bombay	10,000	15,000
Chennai	~~5,000~~ 1,000	(-) 1,000
		14,000
		(+) 10%
		Sale: 15,400 ₹

Option-2

Investment
- 10,000 → Bombay — As per logic
- 5,000 → Chennai

(-) 1,000

4,000

(+) 10%

Sale 4,400

Entry:

1) Workmen Compensation fund (Chennai) A/c Dr. 4,000
   To Capital Reduction A/c 4,000

2) Bank A/c Dr. 15,400
   To Investment A/c 14,000
   To Capital Reduction A/c 1400

* If it is given that balance of Capital Reduction A/c is to be applied as two-third to write off the value of .... and one third to capital Reserve, then assuming write off P&L A/c (Balance).

* If it is given in adjustments/points/lines that Authorised capital of company to be refixed at Rs 10 lakhs (preference capital of Rs 3 lakhs & Equity Capital of Rs 7 lakhs) Both classes of shares are of Rs 10 each

↓

"No Entry" in this case.
It used only preparing Balance sheet → Notes to Accounts.

* The preference shares are to be reduced to Rs 5 each & equity shares reduced by Rs 3 per share. Post reduction, both classes of shares to be re-consolidated into Rs 10 share.

↓

Share Capital:
30,000 Equity Shares of Rs 10 each :- 3,00,000
40,000, 8% Cum. Pref. Shares of Rs 10 each :- 4,00,000

(1) Equity Share Capital A/c (Rs 10) Dr. 3,00,000
To Capital Reduction A/c 90,000
To ESC (Rs 7) A/c 2,10,000

(2) 8% Cum. PSC (Rs 10) A/c Dr. 4,00,000
To Capital Reduction A/c 2,00,000
To PSC (Rs 5) A/c 2,00,000

(3) ESC A/c (30,000 X Rs 7) Dr. 2,10,000
PSC A/c (40,000 X Rs 5) Dr. 2,00,000
To ESC A/c (21,000 X Rs 10) 2,10,000
To Pref. Share Capital A/c 2,00,000
(20,000 X Rs 10)

* One fresh equity shares of Rs 10 to be issued for every 40 of preference dividends in arrears (ignore taxation).

40,000, 8% Cum. Preference Shares ⇒ 4,00,000
Rs 10 each

Preference dividends are in arrears for 4 years

Solution: 4,00,000 X 8% X 4 years

⇒ 1,28,000 (₹)

No.		Amount
1	→	40/-
?	→	1,28,000

$\left[\frac{1,28,000}{40}\right]$

⇒ 3200 no.

⇒ 3200 X 10 ⇒ Rs 32,000

Capital Reduction A/c Dr. 32,000
To Equity Share Capital A/c 32,000

* Un-provided contingent liabilities were settled at Rs 54,000 and a pending insurance claim receivable settled at Rs 12,500.

Entry:

(1) Capital Reduction A/c Dr. 54,000
To Bank A/c 54,000

(2) Bank A/c (Ins. claim) Dr. 12,500
To Capital Reduction A/c 12,500

* The preference shares are converted from 6% to 8% but revalued in a manner in which the total return on them remains unaffected.

6% Preference Share Capital :- 6,00,000

↓

Solution :- 6,00,000 × 6% ⇒ 36,000

8% = ?

$$\frac{36,000}{8\%} \Rightarrow 4,50,000$$

Entry:

6% Preference Share Capital A/c Dr. 6,00,000
To 8% Pref. Share Cap. A/c 4,50,000
To Capital Reduction A/c 1,50,000

* The company expects to earn a profit at the rate of Rs 90,000 per Annum from the current year which would be utilized entirely for reducing the debit balance of Profit & Loss accounts for 3 years. The Remaining balance of said account would be written off at the time of Capital reduction process.

Reserve & Surplus (3,00,000)

Solution:

Rs 90,000 × 3 => Rs 2,70,000

Remaining Bal. => (30,000)

Entry: Capital Reduction A/c Dr. 30,000
To P&L A/c 30,000

* A secured loan of Rs 4,80,000 bearing int. at 12% p.a. is to be obtained by mortgaging tangible fixed assets for repayment of Bank Overdraft → 2,00,000 and for providing additional funds for working capital.

Solution 1) Bank A/c Dr. 4,80,000
To Bank Loan A/c 4,80,000

2) Bank Overdraft A/c Dr. 2,00,000
To Bank A/c 2,00,000

*