

5

ACCOUNTING FOR RECONSTRUCTION OF COMPANIES

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SECTION A - CONCEPT

1. MEANING OF RECONSTRUCTION

- When a company has been **making losses for several years**, the financial position **does not present a true and fair view** of the state of the affairs of the company.
- In such a company the assets are overvalued, the assets side of the balance sheet consists of fictitious assets, useless intangible assets and **debit balance in the profit and loss account**.
- Such a situation does not depict a true picture of financial statements and **shows a higher net worth than what the real net worth ought to be**.
- In short, the **company is over capitalized**. Such a situation brings the need for reconstruction.
- Reconstruction is a process by which affairs of a company are reorganized by -
 - (a) **Revaluation of assets,**
 - (b) **Reassessment of liabilities and**
 - (c) **By Writing off the losses already suffered by reducing the paid-up value of shares and/or varying the rights attached to different classes of shares**
- The object of reconstruction is usually to reorganize capital or to compound with creditors or to affect economies.
- Such a process is called **Internal Reconstruction**, which is carried out **without liquidating** the company and forming a new one.

2. DIFFERENCE BETWEEN INTERNAL & EXTERNAL RECONSTRUCTION

Basis	Internal Reconstruction	External Reconstruction
Liquidation	The existing company is not liquidated .	The existing company is liquidated .
Formation	No new company is formed but only the rights of shareholders and creditors are changed.	A new company is formed to take over the liquidated company.
Reduction of capital	There is certain reduction of capital and sometimes the outside liabilities may have to reduce their claims like debenture holders.	There is no reduction of capital . In fact, there is a fresh share capital of the company.
Legal position	Internal reconstruction is done as per provisions of section 66 of the Companies Act, 2013.	External reconstruction is regulated by section 232 of the Companies Act, 2013.

3. METHODS OF INTERNAL RECONSTRUCTION:

A. ALTERATION OF SHARE CAPITAL			
Sub-division & Consolidation of Shares	Variation of Shareholders Rights	Reduction of Share Capital	Surrender of Shares
<p>This process does not result in reduction of Share Capital, it only affects the Face Value of the Share & No. of Shares.</p>	<p>When a company has issued different classes of shares with different rights or privileges attached to such shares e.g. rights as to dividend, voting rights etc., any such right may be changed in any manner. It happens with the consent in writing of the holders of not less than three-fourths of the issued shares of that class.</p> <p>For example, the company may change rate of (a) dividend on preference shares or (b) convert cumulative preference shares into non-cumulative preference shares without changing the amount of share capital by passing the following journal entries:</p> <p style="margin-left: 20px;">Debit (Old)% Cum. Pref. Share Capital Account</p> <p style="margin-left: 20px;">Credit (New)% Cum. Pref. Share Capital Account</p>	<ul style="list-style-type: none"> • Extinguishing or reducing the liability of the shareholders in respect of unpaid amount on the shares • Paying off any paid-up share capital. • Cancelling any paid-up share capital without reducing Face Value of Shares. • Reduction in both nominal and paid up values. <p>Note: Refer Examples after this table</p>	<p>In this method, shares are divided into shares of smaller denominations and then the shareholders are made to surrender their shares to the company. These shares are then allotted to debenture holders and creditors so that their liabilities are reduced. The unutilized surrendered shares are then cancelled by transferred to Reconstruction Account (Refer Q.211 & Q.217)</p>

B. COMPROMISE/ARRANGEMENTS

A scheme of compromise and arrangement is an agreement between a company and its members and outside liabilities when the company faces financial problems.

Such an arrangement therefore also involves **sacrifices by shareholders, or creditors and debenture holders** or by all.

Accounting treatment for some of the cases is as follows:

(i) When equity shareholders give up their claim to reserves and accumulated profits:

Reserves Account	Dr. (With the amount of reserves)
To Reconstruction Account	

(ii) Settlement of outside liabilities at lesser amount:

Liabilities such as sundry creditors may agree to accept less amount in lieu of final settlement.

Treatment will be as follows:

Outside Liabilities Account	Dr. (With the amount of sacrifice)
Provision Account,	Dr. if any made by creditors, debenture holders etc.)
To Reconstruction Account	

Examples on Reduction of Share Capital -

Subject to confirmation by the Tribunal on an application by the company, a company may, by a special resolution, **reduce the share capital** in the following manner-

- (i) Extinguishing or reducing the liability of the shareholders in respect of **unpaid amount on the shares** held by them. For example, a company decides to reduce ₹ 10 per share, into ₹7.5 per share fully paid up, by cancelling the unpaid amount of ₹2.5 per share. The entry in this case would be

Share Capital (Partly Paid-Up) Account	Dr. (₹ 7.5 X No. of Shares)
To Share Capital (Fully Paid-up) Account	(₹ 7.5 X No. of Shares)

- (ii) **Paying off** any paid-up share capital which is **in excess of** its requirements. For example, a company having fully paid-up share of ₹ 10 each, decides to pay-off ₹ 2 per share to make it of ₹ 8 fully paid-up, entries in that case would be

Share Capital Account (₹ 10)	Dr. (₹ 10 X No. of Shares)
To Share Capital Account (₹ 8)	(₹ 8 X No. of Shares)
To Sundry Shareholders Account	(₹ 2 X No. of Shares)

Sundry Shareholders Account	Dr. (₹ 2 X No. of Shares)
To Bank Account	(₹ 2 X No. of Shares)

- (iii) **Cancelling any paid-up share capital** which is lost or is unrepresented by available assets. This reduction is a sacrifice by the shareholders and the amount of reduction or sacrifice is credited to a new account **called Capital Reduction Account (or Reconstruction Account)**.

For example, the shareholders may agree to reduce the paid capital of ₹100 per share to paid value of ₹10 per share. The sacrifice is ₹ 90 and the entry will be

Share Capital Account	Dr. (₹90 X No. of Shares)
To Capital Reduction Account	(₹90 X No. of Shares)

- (iv) **Reduction in both nominal and paid up values-** In this case, both the paid up capital and nominal value of the shares are reduced. Continuing the above example, the entry will be:

Share Capital Account (₹ 100 Share)	Dr. (₹ 100 X No. of Shares)
To Share Capital (₹ 10 Share)	(₹ 10 X No. of Shares)
To Capital Reduction Account	(₹ 90 X No. of Shares)

Thus in such treatment we debit the original Share Capital Account so as to close it, credit new Share Capital Account with the amount treated as paid up; and credit Capital Reduction Account with the

difference. A certified copy of Court's order and Minutes approved by the Court must be filed by the Registrar.

4. Final Procedure of Internal Reconstruction

(With Understanding of Journal Entries)

On a scheme of reconstruction being adopted (through special resolution confirmed by the Court), the entries to be passed are:

- A. An appreciation in the value of an asset or reduction in the amount of a liability should be debited to the account concerned and credited to the Capital Reduction Account (or Reconstruction Account).
- B. Eliminate debit balance of profit and loss account and all over-valuation of assets by crediting the accounts concerned and debiting the Capital Reduction (or Reconstruction) Account. For this purpose, any reserve appearing in the books of the company may be used. If any balance is left in the Capital Reduction (or Reconstruction) Account, it should be transferred to the Capital Reserve Account.
- C. While preparing the balance sheet of a reconstructed company, the following points are to be kept in mind:
- After the name of the company, the words "and Reduced" should be added only if the Court so orders.
 - In the case of fixed assets, the amount written off under the scheme of reconstruction must be shown for five years.

5. IMPORTANT EXAMPLES ON INTERNAL RECONSTRUCTION

EXAMPLE 1:

Debentures outstanding = Rs. 4,20,000

(a) 2,50,000/- settled with Building

(b) Out of 1,70,000/-;

1. 20,000/- paid in cash

2. Remaining 1,50,000/- shall be continued.

New 5% Debenture to be issued of 1,00,000/-

SOLUTION:

Debenture a/c	Dr.	2,70,000	
To Building			2,50,000
To Bank			20,000
(Being Debenture settled against building & cash)			

Bank a/c	Dr.	1,00,000	
			1,00,000
	To 5% Debenture a/c		

EXAMPLE 2:

Balance Sheet (extract)

6% Debenture	6,00,000	Building	7,00,000
Accrued Interest	36,000		

Entire claim of Debenture Holders is settled against Building. Debenture Holder have to pay Rs. 1,00,000 extra for Building.

SOLUTION:

6% Debenture a/c	Dr.	6,00,000	
Accrued Interest	Dr.	36,000	
Bank a/c	Dr.	1,00,000	
			7,00,000
	To Building a/c		
	To Capital Reconstruction a/c		36,000

Note: Capital reconstruction A/C shall always be credited with gains & debited with losses.

EXAMPLE 3:

Creditors outstanding in B/S 1,20,000/-, 60% of above are to be settled by issue of equity shares of 10/- each at 20% premium.

Rest 40% of above are settled at 40,000/- in full settlement

SOLUTION:

Outstanding Creditors	1,20,000
(-) 60% creditors against equity shares	72,000
40% Balance Outstanding	48,000
Full Settlement	(40,000)
Gain	8,000

Creditor a/c	Dr.	72,000	
			60,000*
			12,000
Being 60% settlement through equity shares			
Creditors a/c	Dr.	48,000	
			40,000
			8,000
(Being remaining Creditor settled in cash)			

EXAMPLE 4:

Loan from Director is Outstanding 50,000/-, it is fully settled by issue of equity shares of 10/- each 4,500 No.

SOLUTION:

Loan from Director A/c Dr.	50,000	
		45,000
		5,000

(Being Loan settled)		
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EXAMPLE 5:

Balance Sheet (extract)

15,000, 10/- each share Outstanding	1,50,000
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10/- share shall be reduced to 6/- per share

SOLUTION

Equity Share capital a/c (10) Dr.	1,50,000	
To ESC A/c (6)		90,000
To capital Reconstruction a/c		60,000
(Being 10/- share reduced to 6/- per share)		

EXAMPLE 6:

Balanced Sheet (Extract)

Equity Share Capital of 100/- each	50,00,000
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It was decided to convert each share as 10/- each.

SOLUTION:

Total Paid up Capital is Rs. 50,00,000/-

New No. should be = $50,00,000 \div 10/- = 5,00,000$ no

This is share split & not a reduction

Equity shares capital a/c (100) Dr.	50,00,000	
To Equity shares capital a/c (10)		50,00,000
(Being 50,000 of 100/- share converted into 5,00,000 no. of 10/- each)		

EXAMPLE 7:

What if in above example 6 each share of 100/- is converted into 500/- each

SOLUTION:

New no. should be = $50,00,000 \div 500 = 10,000$ no

Equity share capital a/c Dr. (100)	50,00,000
To Equity share capital a/c (500)	50,00,000

EXAMPLE 8:

Balance Sheet (Extract)

8% Preference Share capital	9,00,000
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Preference Dividend of last 3 Years is not yet paid (Also not shown in B/S as Liability)

It was decided to cancel the entire arrears of Dividend.

SOLUTION:

No Entry is required to passed, since dividend is not shown as a liability.

EXAMPLE 9:

Balance Sheet (Extract)

8% Preference Share capital	9,00,000
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Preference Dividend of last 3 Years is not yet paid (also not shown in B/S as Liability)

It was decided to pay 1 Year Dividend only in full settlement.

SOLUTION:

P&L a/c To Dividend Payable A/c (Created Liability first)	Dr.	72,000	72,000
Dividend payable A/c To Bank A/c	Dr.	72,000	72,000
Capital Reconstruction A/c To Profit & Loss A/c	Dr.	72,000	72,000

Net entry should be:

Capital Reconstruction A/c To Bank A/c	Dr.	72,000	72,000
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Treatment of Shares Surrender:

Step 1- when shares are surrendered, capital will be reduced

Share Capital	Dr.
To Share Surrender	

(Note: Shares Surrender is Temporary a/c)

Step 2- Re-issue of shares out of share Surrender a/c

Shares Surrender a/c	Dr.
To Share New Capital a/c (It may be new equity or preference)	

Step 3- New shares issued to be physically allotted to creditors or Debenture Holders etc. as per questions requirement.

No Entry to be passed for physical allotment

Step 4 - Outstanding Balance of such creditors/Debentures shall be reversed & transfer to capital Reconstruction A/c

Liability a/c (waived Amount)	Dr.
To Capital reconstruction a/c	

Note: what if Outstanding balance is lower than shares allotted to creditors, in that case Bank/ Cash to be received

Liabilities a/c	Dr.
Bank a/c	Dr.
To Capital reconstruction a/c	

Step 5- Balance remaining in shares surrender a/c to be transfer to capital reconstruction a/c

Share Surrender A/c	Dr.
To Capital reconstruction A/c	

EXAMPLE 10: (On Share Surrender)

B/S (Extract)	
ESC of 10/-	5,00,000
Creditors	70,000
Debentures	1,10,000

Adjustments:-

- 1) All equity shares are sub-divided in the ratio of 2:1 of 5/- each fully.
- 2) Entity requested all SH to surrender their 60% holding.
- 3) Out of Surrendered shares, 30,000 no. were Re-issued as 8% Pref. share capital of 2/- each.
- 4) These Preference shares were allotted to creditors in full and final settlement.
- 5) Out of Surrendered Shares, 20,000 Re-issued as New Equity share of 5/- each & allotted to Debenture Holder in Full Settlement.

SOLUTION:

a) Sub-division

ESC a/c Dr. (10)	5,00,000
To ESC a/c (5)	5,00,000

2) Surrender of 60% Holding

ESC a/c Dr. (5)	3,00,000
To Share surrendered a/c	3,00,000

3) Re-issue out of Shares Surrendered

Share Surrendered Dr.	1,60,000
To 8% PSC a/c	60,000
To ESC a/c	1,00,000

(Being 30,000 New Pref. share & 20,000 New Equity re-issued for liability settlement)

7) Creditors Settlement

Creditors Dr.	70,000
To Reconstruction	70,000

8) Debenture Holder Settlement

Debenture a/c Dr.	1,10,000
To Reconstruction a/c	1,10,000

9) Balance of Surrendered transformer to reconstructor a/c

Share Surrendered A/c Dr.	1,40,000
To Reconstruction a/c	1,40,000

(Balance of Shares Surrendered A/c not re-issued is transferred to Reconstruction A/c)

SECTION B - MCQ's

(MCQ's from ICAI Module)

1. When the object of reconstruction is usually to re-organise capital or to compound with creditors or to effect economies then such type of reconstruction is called
 - a) Internal reconstruction with liquidation
 - b) Internal reconstruction without liquidation of the company
 - c) External reconstruction
 - d) None of the above.

2. The accumulated losses under scheme of internal reconstruction are written off against
 - (a) Capital Reduction account
 - (b) Share Capital account
 - (c) Shareholders' account
 - (d) Reserve and surplus.

3. A process of reconstruction, which is carried out without liquidating the company and forming a new one is called
 - (a) Internal reconstruction.
 - (b) External reconstruction.
 - (c) Amalgamation in the nature of merger.
 - (d) Amalgamation in the nature of purchase.

4. Reconstruction is a process by which affairs of a company are reorganized by
 - (a) Revaluation of assets and Reassessment of liabilities.
 - (b) Writing off the losses already suffered by reducing the paid up value of shares and/or varying the rights attached to different classes of shares.
 - (c) Both (a) and (b).
 - (d) None of the above.

5. For reduction of the share capital, the permission has to be sought from
 - (a) Court.
 - (b) Controller.
 - (c) State government.
 - (d) Shareholders.

6. In case of internal reconstruction
 - (a) Only one company is liquidated.
 - (b) Two or more companies are liquidated.
 - (c) No company is liquidated.

(d) Two companies amalgamated.

ANSWERS	1	2	3	4	5	6
	b	a	a	c	a	c



Student Notes: -