

Module - III

Internal Reconstruction

Introduction: Internal Reconstruction is neither liquidation nor formation of a new company to take over any new business. The existing company continues in its legal entity form and is only reorganized internally. Thus, internal reconstruction is concerned with the complete overhauling of the financial position of the company.

Meaning of Internal Reconstruction: Internal reconstruction refers to the internal re-organization of the financial structure of a company.

What is Reconstruction: Reconstruction is a process of the company's reorganization, concerning legal, operational, ownership and other structures, by revaluing assets and reassessing the liabilities.

Objectives of Reconstruction

1. To resolve the problem of over-capitalization/huge accumulated losses/over valuation of assets.
2. When the capital structure of a company is complex and is required to make it simple
3. When change is required in the face value of shares of the company
4. To generate surplus for writing off accumulated losses & writing down overstated assets.
5. Raising the fresh capital by issuing new shares.
6. Changing altogether the memorandum of association of the company.
7. To generate cash for working capital needs, replacement of assets, to add balancing equipment's, modernise plant & machinery etc.

Types of Reconstruction

1. External Reconstruction and
2. Internal Reconstruction.

1. External Reconstruction: External reconstruction refers to the sale of the business of existing company to another company formed for the purpose. In external reconstruction, one company is liquidated and another new company is formed. The liquidated company is called "Vendor Company" and the new company is called "Purchasing Company".

2. Internal Reconstruction: Internal reconstruction refers to the internal re-organization of the financial structure of a company. It is also termed as re-organization which permits the existing company to be continued. Generally, share capital is reduced to write off the past accumulated losses of the company.

Conditions/Provisions regarding Internal Reconstruction

1. Authorization by Articles of Association: The company must be authorized by its articles of association to resort for capital reduction. Articles of association contains all the details regarding the internal affairs of the company and mention the clause containing manner of reduction of capital.

2. Passing of Special Resolution: The company must pass the special resolution before resorting to capital reduction. The special resolution can be passed only if the majority of the stakeholders are assenting to the internal reconstruction. This special resolution must be get signed by the tribunal and deposited to the registrar appointed under the Companies Act, 2013.

3. Permission of Tribunal: The company must get the due permission of the court or tribunal before starting the process of the capital reduction. The tribunal grants permission only it feels satisfied with the point that the company is going fair and there is positive consent of every stakeholder.

4. Payment of borrowings: As per Section 66 of the Companies Act, 2013, the company has to repay all the amounts it gets deposited and also the interest due thereon before going for capital reduction.

5. Consent of Creditors: The written consent of the creditors is required for the company which is going for capital reduction. The court requires the company to secure the interest of the dissenting creditors. The company gets the permission of the court after the court thinks fit that reduction of capital will not harm the interest of the creditors.

6. Public Notice: The company has to make a public notice as per the directions of the tribunal stating that the company is resorting to capital reduction. Also, the company has to state the valid reasons for the same.

Reconstruction Jorنال Entries:

Sr.No.	Particulars	LF	Debit	Credit
01	For Reduction of Shares face value Share capital A/c (Old) Dr To share capital A/c (New) To Capital reduction A/c		XXX	XXX XXX
02	For Debentures reduction Debentures A/c (Old) Dr To Debentures A/c (New) To Capital Reduction A/c		XXX	XXX XXX
03	For Debentures taken stock and debtors Debentures A/c (Old) Dr To Stock A/c To Debtors A/c To Capital Reduction A/c		XXX	XXX XXX XXX

04	For any external liability paid for cash External liabilities A/c Dr To Cash or Bank A/c		XXX	XXX
05	For Increase or Appreciation in the value of fixed assets Fixed assets A/c (Increased value) Dr To Capital Reduction A/c		XXX	XXX
06	For Debentures reduction Debentures A/c (Old) Dr To Debentures A/c (New) To Capital Reduction A/c		XXX	XXX XXX

Sr.No.	Particulars	LF	Debit	Credit
07	For Issue of new Shares for cash Cash A/c Dr To share capital A/c (New)		XXX	XXX
08	For capital reduction amount written off Capital Reduction A/c (Total of all above capital reduction) Dr To Goodwill A/c To Bad debts A/c To preliminary expenses A/c To Discount on issue of shares A/c To Debit balance of P&L A/c To Depreciation on fixed assets To Patents A/c To Discount on issue of debentures A/c To Capital Reserve A/c (Bal.Fig)		XXX	XXX XXX XXX XXX XXX XXX XXX XXX XXX

Differences between Internal Reconstruction and External Reconstruction:

Basis for Comparison	Internal reconstruction	External reconstruction
1. Inherent meaning	IR is a restructuring method that doesn't create a new company via liquidation.	ER is a restructuring method that creates a new company via liquidation.
2. Application	It is done to ensure an inner re-arrangement of financial structure.	It is done to form a new company.
3. Approval of court	Required.	Not required.
4. Existence	No new existence is formed.	A new company is formed.
5. Liquidation	Liquidation isn't done.	Liquidation is done.
6. Process	Very slow, tedious, and takes a long time.	Quick and swift, doesn't take much time.
7. Losses against profits	It can set off past losses against future profits.	Since a new company is established, losses of the old company can't be set off against the profits of the new company.

RCUB 5 marks 2023**Recommendation for internal reconstruction or Reasons for internal reconstruction**

- Overvaluation of assets and undervaluation of liabilities
- Continuous losses and difficulty meeting financial crisis
- Low sales and high competition
- Overcapitalization
- Complex company structure
- Need to change the face value of shares

2023 IV sem RCUB (10Marks)

The assets of “A” Ltd. were overstated and hence it is decided to reconstruct the company on the following terms:

The shareholders to receive in lieu of their present holding of 25,000 shares of Rs. 10 each (fully paid) the following:

1. Equity shares of Rs. 10 each fully paid to the extent of $\frac{2}{5}$ th of their holding.
2. Preference shares of Rs. 10 each fully paid to the extent of $\frac{2}{5}$ th of above new equity shares.
3. Debentures of Rs. 10,000

The assets to be written down are as follows:

- A. Goodwill which stood at Rs. 1,20,000 was written down to Rs. 70,000
- B. Machinery which stood at Rs. 1,30,000 was written down to Rs. 90,000
- C. Buildings were written down by Rs. 10,000

Pass the journal entries in the books of the company and calculate capital reduction amount.

Solution:

Journal entries in the books of “A” Co. Ltd.

Sr. No.	Particulars	L.F.	Debit	Credit
01	Equity shares capital A/c (Old share) Dr 25,000 shares X Rs. 10 each		2,50,000	--
	To Equity share capital A/c (New) [2,50,000 X $\frac{2}{5}$]		--	1,00,000
	To Preference shares capital A/c (New) [1,00,000 X $\frac{2}{5}$]		--	40,000
	TO Debentures A/c		--	10,000
	To capital reduction A/c (Bal. Fig)		--	1,00,000
	[Being old equity shares cancelled and issued new equity, preference and debentures]			
02	Capital Reduction A/c Dr		1,00,000	--
	To Goodwill A/c [1,20,000 – 70,000]		--	50,000
	To Machinery A/c [1,30,000 – 90,000]		--	40,000
	To Budlings A/c		--	10,000
	[Being capital reduction amount written off]			

10 or 15 marks:

The statement of assets and liabilities of A Co. Ltd. as on 31-03-2024 was as follows:

Particulars	Note	Amount	Total
I. Equities and liabilities			
1. Shareholder's fund			
a. share capital	01	9,00,000	
b. Reserves and surplus (Debit balance)		-	
		3,67,500	5,32,500
2. Non- current liabilities			
a. Long term borrowings (9% debentures)			1,50,000
3. Current Liabilities			
a. Short term borrowings (Bank overdraft)			75,000
b. Trade payables (Creditors)			1,50,000
Total Equities and liabilities			9,07,500
II. Assets			
1. Non – Current assets			
a. Tangible fixed assets	02	7,50,000	
b. Intangible fixed assets (Goodwill)		15,000	7,65,000
2. Current assets			
a. Inventories (Stock)		75,000	
b. Trade receivables (Debtors)		60,000	
c. Cash and cash equivalents (cash in hand)		7,500	1,42,500
Total Assets			9,07,500

The company got the following scheme of capital reduction approved by the court:

- The preference shares to be reduced to Rs. 75 per share fully paid up and equity shares to Rs. 40 per share fully paid.
- The debentures took over the stock and debtors in full satisfaction of the amount due to them.
- The goodwill; account is to be eliminated.
- The value of buildings is to be increased by 30%
- The value of machinery is to be depreciate by 33 1/3%
- The expenses of reconstruction amounted to Rs. 4,000.

Give the journal entries for the above and prepare the revised balance sheet.