INTERNAL RECONSTRUCTION OF COMPANIES

Internal reconstruction is concerned with the complete overhauling of the financial position of a company. The purpose is to improve the profitability of an existing company in relation to the true or real value of the assets as compared to the existing book values which are either overvalued or fictitious.

Internal reconstruction involves removal of useless intangible assets, accumulated losses and the correct valuation of tangible fixed assets. Obviously, such a correction has a direct effect on share capital which in most of the cases stands reduced. Outside liabilities are also required to allow reduction in their claims in some cases.

The following methods are often used simultaneously to give proper shape to the scheme of internal reconstruction:

(1) Alteration of share capital
(2) Change in shareholders' rights
(3) Reduction of share capital
(4) Compromise and Arrangement
(5) Surrender of shares

(1) Alteration of Share Capital

(i) Through the issue of new share capital

(a) Bank A/c --Dr.
To Share Application and Allotment A/c --Cr.

(b) Share App. & All. A/c --Dr.
To Share Capital A/c --Cr.

(ii) Through the consolidation of shares of smaller nominal value into shares of higher nominal values

S. Capital (say Rs 10 per share) A/c --Dr. (Old no. of shares × old nominal value per share)
To Share Capital (say, Rs 100 per share) A/c ----Cr. (New no. of shares × new nominal value per share)

(iii) Through the subdivision of shares of higher nominal value into shares of lower nominal values.

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S. Capital (say, Rs 100 per share) A/c --Dr. (Old no. of shares X old nominal value per share)

To S. Capital (say, Rs 10 per share) A/c ----Cr. (New no. of shares X new nominal value per share)

(iv) Through the conversion of fully paid shares into stock

E. S. Capital (say, Rs. 10 per share) A/c --Dr. say, Rs 50,000

To Equity Stock A/c --50,000

(v) Through the reconversion of stock into fully paid shares

Equity Stock A/c - Dr. say, Rs 50,000

To E. S. Capital (Rs 100 per share) A/c ---Rs 50,000

(vi) Through the cancellation of unissued shares

No accounting entry is needed for such cancellation. Only the reduced authorised capital is to be shown in the next balance sheet.

(2) Change in Shareholders' Rights

When a company

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has issued different classes of shares with different rights attached to such shares, e.g. rights as to dividend, voting rights, repayment of capital, etc., any of such rights may be changed in any manner. For example, the company may change the rate of dividend on preference shares or convert cumulative preference shares into non-cumulative preference shares without changing the amount of share capital.

(a) For reducing the rate of dividend

9% Cumulative P.S. Capital A/c --Dr, say, Rs 50,000 (Old shares)

To 7% C.P.S. Capital A/c ---Cr, Rs 50,000 (New shares)

(b) For change from Cumulative to Non-cumulative preference shares

9% C.P.S. Capital A/c ---Dr, say, Rs 50,000

To 9% N.P.S. Capital A/c ---Cr., Rs 50,000

(3) Reduction of Share Capital

(i) Reducing share capital by refunding excess capital

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S. Capital A/c ...Dr.
To Sundry Shareholders' A/c ...Cr.
(with the amount to be refunded)

(b) Sundry Shareholders' A/c ...Dr.
To Bank A/c ....Cr.
(with the amount actually refunded)

(ii) Reducing uncalled share capital

Share Capital (partly paid-up) A/c ..Dr.
To S. Capital (fully paid-up) A/c ..Cr.
(with the paid-up amount of the shares)

In such a case, there is a reduction in nominal value only and there is no reduction in the paid-up value of shares.

(iii) Reducing paid-up share capital through sacrifice by the shareholders

(a) Reduction in paid-up value only :- It means the nominal value of the shares remains the same and only the paid-up value is reduced. For example, the shareholders may agree to reduce the paid-up capital (3) of Rs 100 per share to paid-up value of Rs 10 per share, the sacrifice being Rs 90 per share.

Share Capital A/c ..Dr. (Rs 90 × no. of shares)
To Reconstruction A/c ... Cr. (Rs 90 × no. of shares)

(b) Reduction in both nominal and paid-up values :- Continuing the same example as given above, the journal entry is —

S. Capital (Rs 100 per share) A/c ...Dr. (Rs 100 × no. of shares)
To S. Capital (Rs 10 per share) A/c ..Cr. (Rs 10 × no. of shares)
To Reconstruction A/c ...... Cr. (Rs 90 × no. of shares)

(4) Compromise and Arrangement

A scheme of compromise and arrangement is an agreement between a company and its members and outside liabilities when the company faces financial problems or difficulties. Such an arrangement therefore involves sacrifices by shareholders or creditors or by all. These sacrifices are credited to Reconstruction A/c.

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(i) For equity shareholders giving up their claims to reserves and accumulated profits

Reserves A/c / P & L A/c ---Dr.
To Reconstruction A/c--Cr.

(ii) For appreciation in the value of assets on revaluation

Fixed Assets A/c-Dr.
To Reconstruction A/c ---Cr.

(iii) For sale of fixed assets at a profit

Bank A/c--Dr.
To F. Assets A/c --Cr.
To Reconstruction A/c--Cr.
(with profit on sale)

(iv) For the settlement of outside liabilities at lesser amount

Bank Loan A/c -- Dr.
S. Creditors A/c-Dr
Debentureholders A/c-Dr.
Provision A/c (if any) --Dr.
To Reconstruction A/c ---Cr.
(with the amount of sacrifice made by creditors, debentureholders etc.)

(v) For the payment of outside liabilities

Bank Loan A/c --Dr.
S. Creditors A/c--Dr.
Debentureholders A/c -- Dr
To Bank A/c -... Cr.
To S. Capital A/c -- Cr.
To New debentures A/c ---. Cr.
To Assets A/c ---Cr.
(with the amounts of liabilities paid in cash, shares, new debentures, assets, etc.)

(vi) For the treatment of preference dividend

(a) For dividend declared (as given in the B/S) but sacrificed

Proposed preference dividend A/c-Dr.
To Reconstruction A/c--Cr.

(b) For arrears of dividend (not appearing in the B/S) paid now

(x) Reconstruction A/c-Dr.
To P. Shareholders A/c--Cr.

(y) P. Shareholders A/c-Dr.
To Bank A/c --Cr.

(c) For dividend neither declared nor paid

No entry is made because there is no liability on the company and hence there is no sacrifice.

Surrender of shares means handing over possession of ~~the~~ shares to the company by the shareholders. In Companies Act surrender of shares amounts to reduction of share capital although such surrendered shares can be reissued to new shareholders. Such surrendered shares are generally used in reducing trading as well as non-trading liabilities.

Surrender of shares is a part of the scheme of internal reconstruction. When the surrendered shares are not reissued, these are cancelled, and the amount ~~cancelled~~ sacrificed through cancellation is transferred to Reconstruction A/c along with the sacrifice made by creditors and debentureholders, and used in writing off past losses, useless intangible assets, fictitious assets, and bringing down the values of overvalued assets.

Suppose, for example, that Rs 1,0,000 equity shareholders agree to surrender their shares. suppose that Rs 80,000 debentureholders and Rs 50,000 trade creditors agree to give up or sacrifice or forgo their claims by 50% each in exchange for equity shares to be issued from the surrendered shares to settle their remaining claims. The accounting entries would be as follows:

(i) For surrender of shares

E.S. Capital A/c -- 100000
To Shares Surrendered A/c - 1,00000

(ii) For cancellation of claims by debentureholders and creditors

Debenture~~holders~~ A/c - 80000
Creditors A/c --- 50000
To Reconstruction A/c -- 130000

(iii) For issue of equity shares out of shares surrendered

S. Surrendered A/c -- 65000
To E.S. Capital A/c --- 65000

(iv) For cancellation of the balance in Shares Surrendered A/c

S. Surrendered A/c -- 35,000
To Reconstruction A/c --- 35,000

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Utilisation of Reconstruction A/c

At this stage, the Reconstruction A/c would show credit entries on account of sacrifices made by shareholders, outside liabilities etc. and also profit on revaluation or sale of fixed assets. Reconstruction A/c is utilised in the following manner:

(i) **For writing off fictitious and intangible assets**

Reconstruction A/c--Dr.
To Preliminary expenses A/c---Cr.
To P & L A/c ----Cr.
To Discount on issue of shares---Cr.
To Trademarks ---Cr.
To Goodwill A/c, etc.--Cr.

(ii) **For writing down over-valued fixed and current assets**

Reconstruction A/c-Dr.
To Fixed Assets A/c--Cr.
To Current Assets A/c--Cr.

(iii) **For recording new liability or provision**

Reconstruction A/c-Dr.
To Particular Liability A/c---Cr.
To Particular Provision A/c---Cr.

In case unrecorded liability has to be paid in cash, there will be direct entry for payment through Reconstruction.

Reconstruction A/c--Dr.
To Bank A/c---Cr.

(iv) **For expenses of reconstruction**

Reconstruction A/c--Dr.
To Bank A/c ---Cr.

(v) **For credit balance in the Reconstruction A/c**

It may be noted that the amount to be written off can not exceed the amount credited to Reconstruction A/c. However, if there is still some credit balance indicating more sacrifices than the write offs, the same credit balance is transferred to Capital Reserve A/c as follows:

Reconstruction A/c--Dr.
To Capital Reserve A/c--Cr.

Post-Internal Construction Balance Sheet

The following points should be noted while preparing the new B/S after the completion of the scheme for internal reconstruction:

(1) **Name of the Company** :- There is no need to add the words 'And Reduced' after the name of the company.

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Appreciation in the value of assets :- The B/S of the company after the completion of the scheme of internal reconstruction should show the revised appreciated figures of assets in place of their book values. Moreover, the B/S should also show the amount of increase in the value of assets due to revaluation.

(3) Amounts written off :- The rules regarding the amounts written off are as follows:

(a) The balance sheet should show the revised lower figures in place of original book values.

(b) In respect of fixed assets, the amount written off under a reconstruction scheme must be shown separately in the B/S for a period of 5 years.

(c) However, in respect of current assets and investments, the amounts written off are not required to be shown. Thus, debtors, stock, investments etc. shown only at their revised lower figures.

(d) If any provision is created for bad and doubtful debts, the amount of provision must be shown as a deduction from the gross amount in the inner column and the net income in the outer column.

(4) It must be noted that the debit and credit sides of the Reconstruction A/c must tally with each other.

Proforma Reconstruction A/c

To P & L A/c	---	By S. Capital (Reduction in paid-up value)	---
To Goodwill written off	---		
To Prel. expenses	---		
To Discount on issue of shares/debentures	---	By Debentures A/c (reduced)	---
~~To Debentures~~ written off	---	By Creditors A/c (sacrificed)	---
To Fixed Assets	---		
To Current Assets	---	By Fixed/Current Assets A/c (Increase in value)	---
To Prov. for bad & d.d.	---		
To Bank A/c (unrecorded liability paid)	---	By Bank A/c (Sale of unrecorded asset)	---
To Bank A/c (arrears of preference dividend paid)	---	By Reserves/Provisions A/c (not required)	---
To Bank A/c (payment of reconstruction expenses)	---		
To Bank A/c (Director's fees)	---		
To New Liability	---		
To Capital reserve	---		
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