Topic- Internal Reconstruction of Companies

(1) What do you mean by the term ‘Reconstruction’?

Answer: The term ‘reconstruction ‘ implies the process followed for reorganization of a company with respect to its capital structure including the reduction of claims of both the shareholders and the creditors of the company. Reconstruction of a company is required when it faces acute financial problems due to over – capitalization or accumulation of operating losses.

(2) What are the 2 ways of effecting reconstruction of a company?

Answer: There are 2 ways of effecting reconstruction of a company. They are-

a. **External Reconstruction= The term external reconstruction is applied to a limited company means the winding up of an existing company and registered itself into a new one after a rearrangement of its financial position, as approved by its shareholders and creditors and sanctioned by the NCLT.**
b. **Internal Reconstruction= Internal Reconstruction means a recourse undertaken to make necessary changes in the capital structure of a company without affecting the existence of the company. It is a plan in which efforts are made to bring out the company from losses and put it in profitable position. In internal reconstruction, neither the existing company is liquidated nor a new company is incorporated.**

(3) What are the situations which call for Internal Reconstruction of a Company?

Answer: In the following situations, the internal reconstruction of a company becomes desirable:

- **(a) When the capital structure of a company is complex and it is required to be made simple.**
- **(b) When accumulated losses of a company are also so huge that they are required to be written off so that the company can depict a better position.**
- **(c) When a part of the capital is not represented by available tangible assets.**
- **(d) When change is required in the face value of shares of the company so that they can become attractive for future investors.**

(4) What are the different forms of Internal Reconstruction?

Answer: Following are the different ways through which the internal reconstruction of a company can be carried out:

- **(a) Alternation of Share Capital.**
- **(b) Reduction in share capital.**

(c) Reduction in capital involving sacrifice from shareholders and other stakeholders.

(5) Write notes on the following:

(i) Alteration in share capital

Answer: A company limited by shares, can alter the capital clause of its memorandum of association under section 61 (1) of the companies act , 2013 if:

a. The articles of association of the company permits.
b. A resolution to this effect has been passed by the company in the general meeting. Alteration of share capital may be done in any of the following ways:
    a. Increase of capital.
    b. Consolidation of capital.
    c. Conversion of capital.
    d. Sub- division of capital.
    e. Cancellation of capital.

(ii) Reduction of capital.

Answer: A reduction of capital is unlawful except when sanctioned by NCLT. 'Conversion of capital is one of the main principles of company law'. The share capital of a company is the only security on which the creditors rely. Any reduction of capital, therefore , diminishes the fund out of which they are to be paid.

A company can reduce its capital as per the provisions contained in Sections 64 to 66 of the Companies Act, 2013 . Following conditions are required to be fulfilled by a company to reduce its share capital-

a. The Articles of association of the company must permit to reduce its capital.
b. The company in general meeting has passed a special resolution.
c. The NCLT has approved the scheme of reduction in share capital.

(iii) Reduction in capital with sacrifice from shareholders and other stakeholders.

Answer: This is the third way through which internal reconstruction of a company can be carried out. Normally, without the approval of the creditors , the scheme of internal reconstruction cannot be carried out. So, as a part of strategy , sometimes the creditors are also required to sacrifice their claims along with the shareholders.

When the directors of the company decide to reconstruct the company through capital reduction, they prepare a scheme of capital reduction in accordance with the provisions of section 66 of the companies act, 2013. The capital reduction scheme is given effect through a new account called ' Capital Reduction Account' opened in the books of the company. The amount sacrificed by shareholders, debenture holders and

creditors are credited to this account and it is used to write off accumulated losses and deferred revenue expenditure.

(iv) Reorganization through surrender of shares.

Answer: Re-organization of capital may also be done through surrender of shares by the shareholders . Under this method, generally shares are subdivided into shares of smaller denominations. In order to facilitate capital reorganization, shareholders are made to surrender a part of their holdings. In that case, the portion of shares surrendered by the shareholders is transferred to a new account called ' shares surrendered account' . Such surrendered shares are usually utilized to reduce or extinguish the liability in respect of debentures and trade creditors.

(6) What are the different methods of reduction in share capital?

Answer: As per the provision of Section 66 of the companies act, 2013, a company can reduce its share capital by any of the following 3 methods:

a. **Extinguishing or reducing the liability of any of its shares.**
b. **Paying off any paid up share capital which is in excess of what is required by the company.**
c. **Cancelling any paid up capital which is lost or is unrepresented by any available assets.**

(7) Elaborate the accounting entries to be made in the books of a limited company that has adopted a scheme of internal reconstruction.

Answer: The following accounting entries are passed for giving effect to the scheme of Capital Reduction:

1) **When denomination of shares is not reduced; only paid up value is reduced-**
   Share Capital A/C Dr
   To Capital Reduction A/C

2) **When denomination of shares is reduced-**

   Share Capital A/C (old denomination) Dr

   To Share Capital A/C (new denomination)

   To Capital Reduction A/C

3) **If balance of any reserve transferred to Capital Reduction A/C-**

   Capital Reserve A/C Dr

General Reserve A/C Dr

Any other Reserve A/c Dr

To Capital Reduction A/C

4) For sacrifice made by debenture holders, if any-

Debentures A/C Dr

To Capital Reduction A/C

5) For sacrifice made by creditors, if any-

Creditors A/C Dr

To Capital Reduction A/C

6) For recording any increase in the value of assets (on revaluation)-

Assets A/C (particular) Dr

To Capital Reduction A/C

7) For recording decrease in the value of any liability-

Liability A/C (particular) Dr

To Capital Reduction A/C

8) For making any provision for Contingent Liability-

Capital Reduction A/C Dr

To Provision for Contingencies A/C

9) When amount of capital reduction is utilized for writing off fictitious assets, past losses and excess value of other assets:

Capital Reduction A/C Dr

To Surplus A/C

To Goodwill A/C

To Discount on Debentures A/C

To Patents or Trademarks A/C

To Provision for doubtful debt A/C (if created)

To Other Assets A/C

To capital reserve A/C

(8) What are the different types of reconstruction?

Answer: Internal and external reconstruction are two different approaches to restructuring a company's capital and operations, each with its own characteristics and implications:

1. **Internal Reconstruction**:
    - **Definition**: Internal reconstruction involves making changes to the capital structure and operations of the company without affecting its legal existence. It typically involves reorganizing existing assets, liabilities, and share capital within the company.
    - **Characteristics**:
        - Existing company remains intact legally.
        - No change in the legal identity or corporate entity.
        - Usually done to address financial distress, improve efficiency, or streamline operations.
        - Often involves debt restructuring, equity infusion, asset reallocation, and operational changes.
    - **Example**: Consolidating different classes of shares, converting debt into equity, transferring assets or liabilities between subsidiaries, or reorganizing business units within the company.
2. **External Reconstruction**:
    - **Definition**: External reconstruction involves creating a new legal entity or entities to absorb the assets, liabilities, and operations of the existing company. It essentially involves transferring the business of the old company to a new entity.
    - **Characteristics**:
        - Creation of a new legal entity or entities.
        - Transfer of assets, liabilities, and operations from the existing company to the new entity.
        - Often used in cases of significant restructuring, mergers, acquisitions, or spin-offs.
        - Requires compliance with legal and regulatory requirements for formation of new entities.
    - **Example**: Creating a new holding company and transferring the shares of subsidiaries to it, merging two companies to form a new entity, or spinning off a division of the company into a separate entity.

Both internal and external reconstruction can be used to achieve various objectives, such as improving financial performance, restructuring debt, enhancing operational efficiency, or pursuing strategic growth opportunities. The choice between internal and external reconstruction depends on factors such as the company's specific circumstances, regulatory considerations, tax implications, and strategic objectives.

(9) What are the need for reconstruction of companies?

Answer: The need for the reconstruction of companies can arise due to various factors and circumstances, including:

1. **Financial Distress**: Companies facing financial difficulties, such as declining revenues, mounting debt, or cash flow problems, may need reconstruction to improve their financial health and avoid insolvency or bankruptcy.
2. **Overleveraged Capital Structure**: Companies burdened with excessive debt may need reconstruction to restructure their debt obligations, reduce interest costs, and improve liquidity.
3. **Operational Inefficiencies**: Companies experiencing operational inefficiencies, such as high costs, low productivity, or outdated business processes, may require reconstruction to streamline operations, improve efficiency, and enhance competitiveness.
4. **Changing Market Conditions**: Companies operating in industries experiencing significant changes, such as technological advancements, shifts in consumer preferences, or increased competition, may need reconstruction to adapt to evolving market conditions and remain relevant.
5. **Mergers and Acquisitions**: Companies pursuing mergers, acquisitions, or strategic alliances may require reconstruction to integrate operations, consolidate resources, achieve synergies, and maximize value for shareholders.
6. **Diversification or Focus**: Companies seeking to diversify their business activities, enter new markets, or focus on core competencies may need reconstruction to reallocate resources, divest non-core assets, or spin off business units.
7. **Legal or Regulatory Compliance**: Companies facing legal or regulatory challenges, such as compliance issues, litigation, or regulatory changes, may need reconstruction to address legal liabilities, mitigate risks, and ensure compliance with laws and regulations.
8. **Shareholder Value Enhancement**: Companies aiming to enhance shareholder value, attract investors, or improve their stock price may need reconstruction to optimize their capital structure, enhance financial performance, and implement value-creating strategies.
9. **Succession Planning**: Companies undergoing changes in ownership, management, or leadership may need reconstruction to facilitate succession planning, ensure smooth transitions, and sustain long-term growth and profitability.
10. **Crisis Management**: Companies experiencing crises, such as management scandals, corporate governance failures, or reputational damage, may require reconstruction to restore trust, rebuild stakeholder confidence, and regain stability.

Overall, the need for reconstruction of companies often arises from a combination of internal and external factors that necessitate strategic restructuring to address challenges, seize opportunities, and position the company for sustainable growth and success.

(10) Distinguish between Internal And External Reconstruction of companies.

Answer: Following are the 10 points of distinction between internal and external reconstruction of companies:

1. **Legal Entity**: Internal reconstruction involves restructuring within the existing legal entity of the company, while external reconstruction creates new legal entities to absorb the assets and liabilities of the existing company.
2. **Continuity**: Internal reconstruction maintains the continuity of the existing company's legal identity, whereas external reconstruction may result in the dissolution or liquidation of the original company and the creation of one or more new entities.

3. **Shareholder Involvement**: In internal reconstruction, existing shareholders typically remain involved in the restructured company, while in external reconstruction, shareholders may receive shares in the new entity or compensation for their shares in the old company.
4. **Regulatory Requirements**: Internal reconstruction may involve fewer regulatory hurdles compared to external reconstruction, which often requires compliance with legal and regulatory requirements for the formation of new entities, such as approval from regulatory authorities and shareholders.
5. **Tax Implications**: Internal reconstruction may have different tax implications compared to external reconstruction, depending on factors such as the treatment of accumulated losses, capital gains, and the transfer of assets and liabilities.
6. **Cost and Complexity**: Internal reconstruction is generally less costly and complex compared to external reconstruction, which may involve legal, accounting, and administrative expenses associated with creating new entities, transferring assets, and satisfying regulatory requirements.
7. **Operational Disruption**: Internal reconstruction may result in minimal disruption to operations since it involves restructuring within the existing company, whereas external reconstruction may cause more significant disruptions due to the transfer of assets, liabilities, and operations to new entities.
8. **Strategic Objectives**: Internal reconstruction is often used to address internal financial or operational challenges, while external reconstruction may be driven by strategic objectives such as mergers, acquisitions, divestitures, or spin-offs to achieve growth, diversification, or focus.
9. **Creditors' Rights**: Internal reconstruction may have implications for creditors' rights and claims against the company, depending on the treatment of debt obligations and the extent of creditor involvement in the restructuring process. External reconstruction may involve negotiations with creditors and may require their consent for the transfer of liabilities to new entities.
10. **Ownership Structure**: Internal reconstruction may result in changes to the ownership structure of the existing company through alterations to share capital, while external reconstruction may involve changes in ownership due to the creation of new entities and the issuance of shares to existing and new shareholders.

These distinctions highlight the differences in approach, implications, and outcomes between internal and external reconstruction of companies, each suited to address different circumstances and objectives.

(11) Discuss the accounting procedure in Internal and External Reconstruction of companies.

Answer: **Internal Reconstruction:**

1. **Identification of Restructuring Needs**: The company identifies the need for internal reconstruction to address financial distress, operational inefficiencies, or other challenges.
2. **Evaluation of Existing Assets and Liabilities**: The company assesses its existing assets, liabilities, and capital structure to determine the extent of restructuring required.

3. **Share Capital Adjustment**: If necessary, the company adjusts its share capital through methods such as consolidation, subdivision, or conversion to address capital deficiencies or excesses.
4. **Treatment of Reserves and Surplus**: Any existing reserves or surplus may be utilized to offset losses, revalue assets, or strengthen the company's financial position as part of the reconstruction process.
5. **Debt Restructuring**: Debt obligations may be renegotiated or restructured to improve liquidity, reduce interest costs, or extend repayment terms. This may involve debt forgiveness, debt-to-equity conversions, or modifications to debt agreements.
6. **Asset Reallocation**: The company may reallocate assets between business segments or subsidiaries to optimize operational efficiency, enhance profitability, or divest non-core assets.
7. **Financial Reporting**: The company reflects the changes resulting from internal reconstruction in its financial statements, including adjustments to share capital, reserves, asset values, and debt obligations.
8. **Disclosure**: The company discloses relevant information about the internal reconstruction in its financial statements and accompanying notes to provide transparency to stakeholders regarding the nature, rationale, and impact of the restructuring.

External Reconstruction:

1. **Formation of New Entities**: The company initiates the formation of new legal entities, such as a holding company, subsidiaries, or joint ventures, as part of the external reconstruction process.
2. **Transfer of Assets and Liabilities**: The existing company transfers its assets, liabilities, and operations to the newly formed entities through legal mechanisms such as mergers, acquisitions, or spin-offs.
3. **Valuation of Assets and Liabilities**: The assets and liabilities being transferred are valued at fair market value or negotiated prices to determine the consideration received or given in exchange for the transfer.
4. **Issuance of Shares**: The new entities may issue shares to the shareholders of the existing company as consideration for the transfer of assets and liabilities, resulting in changes to the ownership structure.
5. **Accounting for Goodwill or Gain/Loss**: Any difference between the consideration received or given and the fair value of assets and liabilities transferred is accounted for as goodwill or gain/loss on transfer.
6. **Legal and Regulatory Compliance**: The company ensures compliance with legal and regulatory requirements for the formation of new entities and the transfer of assets and liabilities, including obtaining approvals from regulatory authorities and shareholders.
7. **Financial Reporting for Merger or Acquisition**: The company consolidates the financial statements of the new entities with those of the existing company, reflecting

the impact of the merger or acquisition on its financial position, results of operations, and cash flows.

8. **Disclosure**: The company discloses relevant information about the external reconstruction, including details of the merger or acquisition, valuation of assets and liabilities, allocation of consideration, and financial impact, in its financial statements and accompanying notes.

These accounting procedures highlight the complexities involved in internal and external reconstruction of companies and the importance of accurately reflecting the financial effects of restructuring activities in the company's financial reporting.