

INTERNAL RECONSTRUCTION (SEC.66)

Internal reconstruction is basically concerned with the complete overhauling of financial position of a firm. The main purpose is to improve the profitability of the existing company. It refers to restructuring capital, assets and liabilities of the company. Internal reconstruction is followed by SEC.66 of the Company's Act, 1956. It is done by sick company to revive itself. Internal reconstruction involves reduction in capital and liabilities of the company. **Company is not liquidated in internal reconstruction.** However, IR changes the rights of shareholders and lenders. Once the scheme of IR is draft, it is send to **high court** for approval.

❖ NEED FOR INTERNAL RECONSTRUCTION:-

- 1. FINANCIAL STATEMENTS:** Financial statement of sick co., i.e. P&L a/c and Balance Sheet does not show true and fair view of its financial position. The figures of assets, liabilities and capital do not reflect the actual picture of the company.
- 2. ASSETS:** The assets of such sick company show many intangible and fictitious assets. There is a heavy debit balance of profit and loss account due to persistent loss and intangible goodwill represents purely fictitious assets. Tangible assets are recorded unreasonably at high balance by charging low amount of depreciation. Even the current assets like debtors, stock are overvalued.
- 3. LIABILITIES:** Liabilities of such company like bank loan, debentures, interest are overdue for a long period of time. Creditors are not paid on time even company does not record actual liabilities which are declared as the contingent liabilities. Even preference dividends remains in arrears in case of cumulative preference share.
- 4. CAPITAL:** (CAPITAL=ASSETS – LIABILITIES) Capital becomes dependent factors on assets and liabilities. In sick company, assets are overvalued and liabilities are overdue which leads to increase in capital. In other words, capital of such company no longer reflects the actual figure of investment.

❖ SCHEME OF INTERNAL RECONSTRUCTION:-

Sick company assets consist of fictitious assets, there liabilities are overdue for the long period and capital of such company is overvalued. The main area of internal reconstruction of the company consists of assets, liabilities and capital. The essence of this scheme consists:

1. Written off fictitious assets and bring down the value of the assets to its true value.
2. Settlement of external liabilities by reducing or compromising from participants.
3. Reduction in share capital by reducing paid up value of the shares even by changing the rights of preference shares.

Once the IR scheme is completed the fixed assets, investments and current assets are brought to real value. Liabilities and capital will be recorded at the right value. All these things will show true and fair value in the balance sheet of the company.

❖ CAPITAL REDUCTION ACCOUNT:-

When the scheme of IR is implemented that is; reduction or bringing down the value of assets, liabilities and capital may bring loss or gain to the company, such losses or gains are transferred temporary account open by the company called CAPITAL REDUCTION ACCOUNT. It is the combination the real and nominal image which means it not only records assets and liabilities but also the income (gain) and expenditure (loss) incurred on reconstruction schemes. The basic purpose of maintaining this account is to record all expenses or losses and gains or incomes due to internal reconstruction.

As capital reduction account is Nominal in nature,

all Expenses & losses will be debited and Income & Gains will be credited, in other words reduction in the value of assets, expenses of reconstruction and liabilities paid will be debited to capital reduction account.

On the other hand, any gain arising out of reconstruction scheme like increase in value of assets, reduction in share capital and liabilities all the will be credited to capital reduction account.

At the end when scheme is completed, balance in capital reduction account will be transfer to **CAPITAL RESERVE ACCOUNT**.

Accounting Entries

I. Alteration (Sec. 64) - Change in Face Value

for eg. Co. has 2,00,000 shares of FV ₹10 each = ₹ 20,00,000

Consolidation (Increase FV)

Sub-division (Decrease FV)

₹ 10 to ₹ 20

₹ 10 to ₹ 5

ESC a/c (2,00,000x10) Dr 20,00,000	ESC a/c (2,00,000x10) Dr 20,00,000
To ESC a/c (1,00,000x20) 20,00,000	To ESC a/c (4,00,000x5) 20,00,000

There will be **Change in No. of SHARES** but **NO change in SHARE CAPITAL**

II. Reduction (Sec. 66) - Change in Paid Up Value

for eg. Co. has 2,00,000 shares of ₹ 12 each = ₹ 24,00,000

From ₹12 to ₹8 per share

Share capital a/c (2,00,000x12) Dr 24,00,000	
To Share capital a/c (2,00,000x8) 16,00,000	
To Capital Reduction a/c (2,00,000x4) 8,00,000	

There will be **NO Change in No. of SHARES** but **Change in SHARE CAPITAL**

V. External Liabilities/Fixed liabilities (Recorded liabilities)**i. Sacrifice/ Compromise**

External Liability a/c Dr
 Provisions a/c Dr
 To Capital Reduction a/c (GAIN)

ii. Payment

External Liabilities a/c Dr
 To Bank a/c
 To Equity share capital a/c
 To Assets a/c

iii. Settlement

External Liabilities a/c Dr
 To Assets a/c
 To Bank a/c
 To Capital Reduction a/c

**VI. Contingent Liability
(May or May not happen) (Unrecorded liability)****i. If Cancelled / Compromise****ii. If Paid**

*Capital Reduction a/c Dr
 To Bank a/c

(*will treat as expenses)

VII. Compulsory Entry**Even if NOT Specify have to pass this entry****i. Write Off Fictitious Assets**

Capital Reduction a/c Dr
 To Goodwill a/c
 To P/L a/c (Dr)
 To patent a/c

ii. Transferring balance

Capital Reduction a/c Dr
 To Capital Reserve a/c

Asst. Prof. Nimesh Jotaniya (TCSC)

INTERNAL RECONSTRUCTION:-LMR

- IR is done by sick company which is making loss persistently.
- IR does not result in liquidation of the company.
- Capital reduction account – nominal in nature.
- All expenses and losses of reconstruction will be debited to capital reduction account. For e.g.: reduction in the value of land and building, plant and machineries...
- Any gain pertaining to reconstruction will be credited to capital reduction a/c
- Contingent liability:- unrecorded liability
- If contingent liabilities are cancelled there will be NO ENTRY
- In case of reconstruction expenses capital reduction account will be debited
- If recorded liabilities are cancelled or settled will be debited that liability a/c
- Face value increases- number of shares decreases = consolidation
- Face value decreases- no. of shares increases = sub division
- In case of subdivision and consolidation amount of share capital will remain same
- Change in paid up value will lead to reduction in share capital
- All fictitious and intangible assets has to be written off compulsorily even it is specified or not
- Balance in capital reduction account has to be transferred to capital reserve.