III B. COM (V SEMESTER) – UNDER CBCS

PART III – MAJOR CORE -13

CORPORATE ACCOUNTING I

CLASS: III B.Com **SUBJECT CODE: SMCO51**

Unit III: Amalgamation, Absorption and External Reconstruction, Methods of purchase consideration.

AMALGAMATION

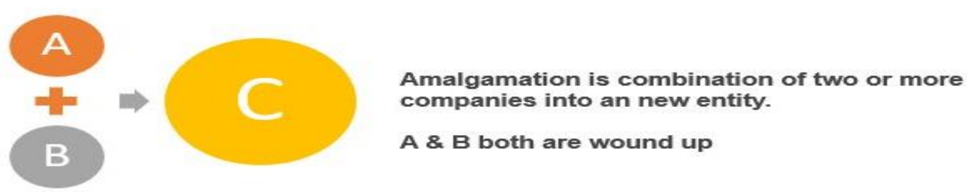
Amalgamation is defined as the combination of one or more companies into a new entity. It includes:

- Two or more companies join to form a new company.
- Absorption or blending of one by the other.

Thereby, amalgamation includes absorption.

However, one should remember that Amalgamation as its name suggests, is nothing but two companies becoming one. On the other hand, Absorption is the process in which the one powerful company takes control over the weaker company.

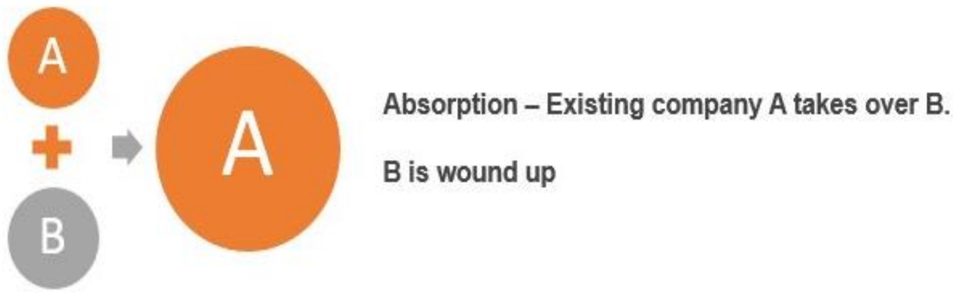
EXAMPLE



ABSORPTION

Absorption is the process under which an existing large company purchases the business of another small company or companies doing similar business. In other words, when an existing company takes over the business of one or more existing companies carrying similar business, it is called absorption.

EXAMPLE



3. RECONSTRUCTION

Reconstruction means reconstruction of a company's financial structure. It may takes place with or without liquidation of the company. The objectives of the reconstruction of your company or not the same of amalgamation and absorption. In the case of server financial problems as over capitalization, heavy losses and over valuation of fixed assets, reconstruction of financial structure is necessary. Reconstruction may be of two types namely.

a) Internal Reconstruction

It is also known as capital reduction. It means the reorganization of the capital structure of a company without forming new company and without liquidating the existing company. Under this method share capital (RS.100) face value is reduced to the lowest amount (Rs.60). This gain amount (RS.40) is utilised to write of losses, overvaluation of assets, goodwill, preliminary expenses.

Example

Company A suffered heavy losses and got Court order to implement scheme of capital reduction on the share capital from Rs.100 to RS.60 on 1,000 shares. It is internal reconstruction.

Company A(Rs.1,00,000 share capital)

Company A(RS.60,000 share capital)

b) External Reconstruction:

External reconstruction takes place when on existing weak company goes into liquidation and a new company is formed to take over its business and runs it under some are new name. It means One liquidation and one formation. The share holder of old company becomes the share holders of the new company .

In other words, when an existing company formed especially for the purpose of taking over the business of wound-up company by the very same members or by most of the members of the wound up company. Simply it is just like replacement of old house by new house by the same owner.

Example: Company a was taken over by the new company A. Then the former company will be a transferor company being wound up and the latter company will be the transferee company.

Amalgamation	**= Two or more liquidation and one formation**
Absorption	**= One liquidation and no formation**
Internal reconstruction	**= No liquidation and no formation**
External reconstruction	**= One liquidation and one formation**

2. Differentiate internal reconstruction from external reconstruction

The following are the important differences between internal reconstruction and external reconstruction

1) **Liquidation**

Under internal reconstruction the existing company is not liquidation. But under external reconstruction the existing company is liquidated.

2) **Formation**

Under internal reconstruction no new company is formed but only the rights of share holders and creditors are changed. But under external reconstruction a new company is formed to take over the liquidated company.

3) **Reduction of capital**

There is some reduction of capital, some times the outside liabilities like debenture holders may have to reduce there claims. There is no reduction of capital under external reconstruction ie.,fresh share Capital of the company

4) **Legal Position**

Internal reconstruction is done as per the provision of section 100 of the Companies Act, 1956. Where external reconstruction is regulated under the section394 of the Companies Act, 1956.

5) **Concept**

Internal reconstruction involves reoraganisation of the company. But external reconstruction involves liquidation of an old company and formation of a new company.

6) **Business**

Internal reconstruction does not involve takeover of the Business of an enterprise. But external reconstruction involves takeover of the business of an enterprise.

7) Court Confirmation

Internal reconstruction requires Court's Confirmation. But external reconstruction can be effected without court confirmation.

8) Reduction of future income tax liability

In the case of internal reconstruction, the company can set off past losses against future profits, and thereby reduces it’s future income tax liability. But in case of external reconstruction the past losses of the company (transferor company) cannot be set off against the future profits of the new company (transferee) for the purpose of income tax, as the old company is liquidated.

3. Difference between amalgamation, absorption and reconstruction?

The following are the important differences between amalgamation and absorption and reconstruction. They are explained as below.

1. Liquidation

Under amalgamation, two or more companies go into liquidation. In case of absorption, one or more companies go into liquidation. But under external reconstruction only one company goes into liquidation.

2. Level of companies

The level of amalgamating companies is generally same under amalgamation. under adsorption the economic status of purchasing company is higher then liquidating company. under external reconstruction the economic condition of the old company is found to recify the situation

3. Shareholders

Under amalgamation the shareholders of the new company are those who were in the old company under absorption, there will be shareholders of the purchasing company only. Under external reconstruction the shareholders if the new company are those who were in old company.

4. Formation of new company

A new company is formed to take over the business of the wound up company under amalgamation in case of absorption, only the existing company acquires the business of wound up company. Whereas a new company is formed to acquire the business liquidated company under external reconstruction.

5. Minimum number of companies involved;

Under amalgamation minimum number of companies involved is three. But in casw of absorption and external reconstruction it is two

4. Methods of calculating Purchase Consideration

Purchase consideration refers to the consideration payable by the purchasing company to the vendor company for taking over the assets and liabilities of Vendor Company. Accounting standard -14 defines the term purchase consideration as the "aggregate of the shares and the securities issued and the payment made in the form of cash other assets by the transferee company to the shareholders of the transferor company Although, purchase consideration refers to total payment make by purchasing company to the shareholders of vendor company. Payment made to debenture holders or creditors should not be considered as part of purchase consideration. The following are the important methods of calculation of purchase consideration.

1. Lump sum payment

When the purchase company is agrees to pay a fixed sum to the vendor company, It is known as lump sum payment of purchase consideration. Under this method there is no need for calculation of purchase consideration. Generally under this method it is specifically stated as lump sum in the problem.

2. Net worth or net asset method

Under this method the value of purchase consideration is calculated by adding the agreed value/market value or the fair value of the assets taken over by the purchasing (transferee) company and deducting the agreed values of the liabilities take over by the (purchasing) transferee company. It is calculated as follows:

Agreed value of assets taken over	xxx
Less: Agreed value of liabilities taken over	xxx
Purchase Consideration	xxx

Important points to be noted

1. The term assets taken over will always include cash in hand and cash at bank, goodwill and prepaid expenses unless otherwise stated, but shall not include fictitious assets as preliminary expenses discount on issue of shares or debentures, underwriting commission debit balance of profit and loss account.

2. The term 'liabilities' will mean all liabilities to third parties (ie excluding company and Shareholders Company - first party shareholders - second party)

3. The term trade liabilities will include trade creditors and bills payable. it will exclude other liabilities to third parties bank overdraft, debentures, outstanding, tax liabilities.

4. The term liabilities will not include past accumulated profits or reserve such as general reserve, dividend equalization fund, reserve, fund, sinking fund, capital reserve securities premium, capital redemption fund, credit balance of profit loss account as these are liabilities

5. The term 'acquired business, always mean all assets and liabilities

6. Liabilities not taken over should be excluded from computation of purchase consideration

3. Net Payment Method

In the net payment method the value of the purchase consideration is calculated by summing up the total amount paid by the transferee company to the equity shareholders, preference shareholders of the transferor company including the amount paid in cash if any but it will not include any payment which is being made to the debenture holders of the transferor company

Amount of preference shares	xx
Amount of equity shares	xx
Cash for preference shareholders and equity shareholders	xx
Purchase consideration	xx

Important points to be noted

1. The assets and liabilities taken over by the transferee company are not to be considered in purchase consideration

2. All payments agreed upon should be added if it is meant for equity sherholders or preferance share holders.

3. Do not consider any payments made to creditor or debentures holders.

4. Liquidation expenses of transferor company are agreed to paid by transferee company. it should with purchase consideration.

4. Intrinsic value methods/share Exchange method:

In the intrinsic value method, the purchase consideration is computed on the basis of 'intrinsic value' (i.e real value) of the shares. The intrinsic value is calculated by dividing the value of net assets of equity shareholders by the number of equity shareholders. if the exchange ratio are swap ratio of the two companies are given then intrinsic value need not be calculated

$$\text{Intrinsic value} = \frac{\text{Assets available for equity shareholders}}{\text{No. of equity shares}}$$

Assets available = Agreed value of assets - liabilities- pref. shares

5**. Methods of accounting for amalgamation**

Accounting standard - 14 (AS - 14) Accounting for amalgamation issued by the institute of chartered Accounting of India and to come into effect in respect of accounting periods commencing on or after 1.4.1995, distinguishes two types of amalgamation. They are

1. Amalgamation in the nature of Merger or pooling interest method and

2. Amalgamation in the nature of purchase

1. Amalgamation in the nature of a merger

Following are the condition for amalgamation in the nature of manager

1. The purchasing company or the transferee takes over all the assets of the vendor or the transferor company.

2. The shareholders holding 90% or more face value of the equity shares of vendor (transferor) becomes the equity shareholders of the purchasing (transferee) company.

3. The consideration due to the equity shareholders of the transferor for amalgamation is to be paid wholly by the issue of equity share in the transferee except cash which is to be paid to dissenting shareholders.

4. After the amalgamation, transferor, business is to be run by the transferee

5. The purchasing company takes over all assets and liabilities of transferor at their book values except for ensuring uniformity in the accounting policies.

Accounting treatment

1. In preparing financial statements of the transferee company assets, liabilities and reserve of the transferor company should be recorded as existing carrying amounts and in the same from at the date of amalgamation, balance of the profit and loss account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to general reserve it any.

2. If the time of amalgamation the accounting policies followed by the transferor company and transferee company are in conflict, it should be resolved, and brought in line with the policies of the transferee company

3. The difference between the amount recorded in share capital issued and the amount of share capital issued by the transferor company should be adjusted in reserve, however in some cases courts may stipulate the manner in which the reserve should be adjusted.

2**. Amalgamation in the Nature of Purchase**

If any of the condition provided for the merger is not satisfied then it is said to be an amalgamation in the nature of a purchase

Accounting treatment

In purchase method accounting for amalgamation is done by applying same principles used in accounting fpr normal purchase of assets. some rules adopted are the following.

1. The Assets and liabilities (not reserve) of the transferor company are incorporated in the books of Transferee Company at the existing amount. Alternatively, the purchase consideration should be allocated individual identified assets and liabilities the basis of their fair values at the date of amalgamation.

2. Non statutory reserves of the transferor company are not included in the financial statements of the transferee company.

3. If purchase consideration greater than net assets, the difference is debited to the goodwill account. If purchase consideration less then net assets, the difference is credited to the capital reserve.

6.Distinguish between Amalgamation in the nature of Merger and in the nature of Purchase

Assets and liabilities

Purchasing company takes all over assets and liabilities of the vendor company under merger method. But under purchase method the purchasing company may not take all assets and liabilities of the vendor company.

Status of equity shareholders

Equity shareholders (holding 90% of shares) of the vendor company become shareholders of the purchasing company under merger method. But under purchase method this does not take place.

Business

The business of the vendor company is carried out by the purchasing company under merger method. But in purchase method transferee company may not carry over the business of the transferor company.

Payment

The entire purchase consideration is made with issue of equity shares under merger method. Under purchase method purchase consideration is not done by issue of equity shares.

Book value

The purchasing company takes all assets and liabilities of the vendor company at their book value under merger method. But under purchase method the transferred company may not buy assets and liabilities at their book value.

Reserves

. All reserves are maintained at their book value under merger method. But statutory reserves are only recorded if they are to be maintained statutorily under purchase method.

Profit and losses

It is recorded in the book of purchasing company under merger method. But it is not recorded in books of purchasing company under purchase method.

Transfer of difference amount

Difference between net assets and purchase consideration is transferred to general reserve account under merger method. But under purchase method it is transferred to either goodwill account or capital reserve.

Journal entries in the books of vendor company or transferor company

1 To transfer assets taken over

Realisation a/c Dr

To Sundry assets a/c

2 To transfer liabilities taken over

Sundry liabilities a/c Dr

To Realisation a/c

3 For Purchase consideration

Purchasing company a/c Dr

To Realisation a/c

4 To receive purchase consideration

Shares in Purchasing company a/c Dr

Debentures in Purchasing company a/c Dr
Cash / Bank a/c Dr
To Purchasing company a/c

5 Assets not taken over sold out

i Cash / Bank a/c Dr
To Assets a/c

ii) Loss
Cash a/c Dr.
Realisation a/c Dr
To Assets a/c

iii) Profit
Cash a/c Dr.
To Realisation a/c
To Assets a/c

6 Liabilities not taken over paid out

i Liabilities a/c Dr
To Bank a/c
ii Liabilities a/c Dr

ii) Paid more amount – loss
Liabilities a/c Dr.
Realisation a/c Dr
To Bank a/c

iii) **Paid less amount - Profit**
Liabilities a/c Dr.
To Realisation a/c
To Bank a/c

7 Realisation expenses

A Paid by vendor company
Realisation a/c Dr
To Bank a/c

B Paid by purchasing company
No Entry

8 a To transfer realisation profit
Realisation a/c Dr
To share holders a/c

b To transfer realisation loss
Shareholders a/c Dr
To Realisation a/c

9 Debentures not taken over paid out

A Debentures a/c Dr
To Shares in purchasing co a/c
To Debentures in purchasing co a/c
To Bank a/c

B Paid more amount – Premium
Debentures a/c Dr
Realisation a/c Dr
To Shares in purchasing co a/c
To Debentures in purchasing co a/c
To Bank a/c

C Paid less amount – Discount
Debentures a/c Dr
To Realisation a/c
To Shares in purchasing co a/c
To Debentures in purchasing co a/c
To Bank a/c

10 To transfer preference share capital
Pref share capital a/c Dr
To Pref share holders a/c

11 Payment to pref share holders
Pref share holders a/c Dr
To Shares in Purchasing company a/c
To Debentures in purchasing company a/c
To Bank a/c

12 To transfer Share capital, Reserves and surplus
Eq Share capital a/c Dr
Reserves and surplus a/c Dr
P&L a/c Dr

Any other reserves / fund belong to share holders a/c Dr
To Eq share holders a/c

13 To transfer loss

Eq share holders a/c Dr
To P&L a/c
To Preliminary expenses a/c
To Any other loss a/c

14 Payment to Eq share holders

Eq share holders a/c Dr
To Shares in Purchasing company a/c
To Debentures in purchasing company a/c
To Bank a/c

Journal entries in the books of purchasing company or transferee company

1 For purchase consideration

Business purchase a/c Dr
To liquidator of vendor company a/c

2 For assets and liabilities taken over

Sundry assets a/c Dr
Goodwill a/c Dr (a) (b.f)
To Capital reserve a/c (b) (b.f)
To Sundry liabilities a/c
To Business purchase a/c

3 For payment to vendor company

Liquidator of vendor company a/c Dr
Discount on issue of shares a/c Dr (a)
To share capital a/c
To share premium a/c (b)
To Debentures a/c
To Bank a/c

4 For payment of liquidation expenses

Goodwill a/c Dr
To Bank a/c

Methods of calculating purchase consideration:

1 Net assets method (Assets taken over – Liabilities taken over)
2 Net payment method (Shares in pur co + Deb in pur co+ Bank)
3 Lumpsum method (Amount directly given)
4 Intrinsic value method (Assets available to eq sh holders / No. of eq shares)

Hints:

i) Purchasing co takes over the business – Take assets and liabilities
ii) Purchasing co takes over the assets – Take only assets
iii) Purchasing co issues shares at market value – Take market value
iv) Simply market value of purchasing co is given – Ignore

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