



**UNIVERSITY EXAMINATIONS**

**2020/2021 ACADEMIC YEAR**

**FOURTH YEAR FIRST SEMESTER  
SUPPLEMENTARY EXAMINATION**

**FOR THE DEGREE OF BACHELOR OF COMMERCE**

**COURSE CODE: BCA 448E**

**COURSE TITLE: BANKRUPTCY AND REORGANIZATION**

**DATE: 10<sup>TH</sup> FEBRUARY, 2021**

**TIME: 2.00PM - 4.00PM**

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**INSTRUCTIONS TO CANDIDATES**

Answer Question One in Section A and Any other TWO (2) Questions in Section B

TIME: 2 Hours

KIBU observes ZERO tolerance to examination cheating

This Paper Consists of 4 Printed Pages. Please Turn Over.



Kimberly MacKenzie, president of Kim's Clothes Inc., a medium-sized manufacturer of women's casual clothing, is worried. Her firm has been selling clothes to Russ Brothers department store for more than ten years, and she has never experienced any problems in collecting payment for the merchandise sold. Currently, Russ Brothers owes Kim's Clothes \$65,000 for spring sportswear that was delivered to the store just two weeks ago. Kim's concern was brought about by an article that appeared in yesterday's *Wall Street Journal* that indicated that Russ Brothers was having serious financial problems. Further, the article stated that Russ Brothers' management was considering filing for reorganization, or even liquidation, with a bankruptcy court.

Kim's immediate concern was whether or not her firm would collect its receivables if Russ Brothers went bankrupt. In pondering the situation, Kim also realized that she knew nothing about the process that firms go through when they encounter severe financial distress. To learn more about bankruptcy, reorganization, and liquidation, Kim asked Ron Mitchell, the firm's chief financial officer, to prepare a briefing on the subject for the entire board of directors. In turn, Ron asked you, a newly hired financial analyst, to do the groundwork for the briefing by answering the following questions:

- a.
  1. What are the major causes of business failure?
  2. Do business failures occur evenly over time?
  3. Which size of firm, large or small, is more prone to business failure? Why?
- b. What key issues must managers face in the financial distress process?

- c. What informal remedies are available to firms in financial distress? In answering this question, define the following terms: (1) workout, (2) restructuring, (3) extension, (4) composition, (5) assignment, and (6) assignee (trustee).
- d. *Briefly describe Kenyan Bankruptcy Law, including the following terms: I) trustee, (II) voluntary bankruptcy, and (III) involuntary bankruptcy.*

- g. Briefly describe the priority of claims in a Chapter 7 liquidation. Assume that RISALA Brothers did indeed fail, and that it had the following balance sheet when it was liquidated (in millions of shillings):

|                  |             |                          |                |
|------------------|-------------|--------------------------|----------------|
| Current assets   | sh.40.0     | Accounts payable         | Sh.10.0        |
| Net fixed assets | 5.0         | Notes payable (to banks) | 5.0            |
|                  |             | Accrued wages            | 0.3            |
|                  |             | Municipal council taxes  | 0.5            |
|                  |             | State and local taxes    | 0.2            |
|                  |             | Current liabilities      | <u>sh.16.0</u> |
|                  |             | First mortgage           | sh 3.0         |
|                  |             | Second mortgage          | 0.5            |
|                  |             | Subordinated debentures  | 4.0            |
|                  |             | Total long-term debt     | <u>7.5</u>     |
|                  |             | Preferred stock          | 1.0            |
|                  |             | Common stock             | 13.0           |
|                  |             | Paid-in capital          | 2.0            |
|                  |             | Retained earnings        | <u>5.5</u>     |
| Total assets     | <u>45.0</u> | Total equity             | <u>21.5</u>    |
|                  |             | Total claims             | <u>45.0</u>    |

<sup>A</sup>the debentures are subordinated to the notes payable.

The liquidation sales resulted in the following proceeds:

|                             |                      |
|-----------------------------|----------------------|
| From sale of current assets | sh.14,000,000        |
| From sale of fixed assets   | <u>sh.2,500,000</u>  |
| Total receipts              | <u>sh.16,500,000</u> |

For simplicity, assume that there were no trustee's fees or any other claims against the liquidation proceeds. Also, assume that the mortgage bonds are secured by the entire amount of fixed assets. What would each claimant receive from the liquidation distribution?

## QUESTION TWO

Below is the balance sheet of Yeye LTD as at 31 December 2009

|                 | Sh.     | Sh. |
|-----------------|---------|-----|
| <b>Assets</b>   |         |     |
| Land & Building | 280,000 |     |

|                       |                |               |
|-----------------------|----------------|---------------|
| (-) Acc. Depreciation | <u>80,000</u>  | 200,000       |
| Plant & Machinery     | 80,000         |               |
| (-) Acc. Depreciation | <u>10,000</u>  | 70,000        |
| Goodwill              |                | 30,000        |
| Preliminary expenses  |                | 3,000         |
| Inventories           |                | 70,000        |
| Debtors               |                | <u>45,000</u> |
|                       | <u>418,000</u> |               |

#### **Equity and Liabilities**

|                                     |                |
|-------------------------------------|----------------|
| 500,000 ordinary shares @ sh.1.00   | 500,000        |
| 200,000 preference shares @ sh.1.00 | 200,000        |
| Premium shares                      | 100,000        |
| Accumulated losses                  | (450,000)      |
| Creditors                           | 50,000         |
| Bank overdraft                      | <u>18,000</u>  |
|                                     | <u>418,000</u> |

Company approved a special resolution to do the restructuring of the company and a court permission was obtained. Restructuring scheme consists of the following:

1. The ordinary shares to be reduced to 30 cent per share and preference shares will be reduced to 75 cent per share.
2. Share premium account to be utilized for the scheme
3. Assets were revalued as follows :

|                   |            |
|-------------------|------------|
| Land & Building   | sh.220,000 |
| Plant & Machinery | sh.60,000  |

|             |           |
|-------------|-----------|
| Inventories | sh.50,000 |
| Debtors     | sh.38,000 |

4. All intangible assets and accumulated losses are to be written off.
5. The Board of Director has agreed to subscribe for 200,000 ordinary shares of 30 cent per share paid in cash and partly used to pay the bank overdraft.

**You are required to prepare:**

- a) Journal entries to record the capital reduction 5 marks
- b) The capital reduction account 5 marks
- c) The Statement of Financial Position of Yeye LTD immediately after the capital reduction. 5 marks
- d) KuindwaPlc filed own petition before the court at the end of June last year .Explain five acts of bankruptcy the court may consider before adjudging Kuindwa bankrupt.

**QUESTION THREE**

- a) Differentiate between receivership and liquidation. 2 marks
- b) Syarikat Sejagat Ltd has been operating for 10 years of financial difficulties and had suffered business losses a few years in a row. This caused the company cannot declare or pay any dividends for four consecutive years. In the 2005 general meeting of shareholder have agreed to implement the capital restructuring plan. The following is the balance sheet of Syarikat Sejagat ltd as at 31.12.2005

Syarikat Sejagat Ltd  
Financial Position As At 31 December 2005

Sh.

**NON- CURRENT ASSET**

|                   |         |
|-------------------|---------|
| Land & Building   | 175,000 |
| Plant & Machinery | 114,000 |
| Vehicle           | 95,400  |
| Furniture         | 46,000  |
| R &D Expenses     | 24,000  |
| Patent            | 38,000  |

**CURRENT ASSETS:**

|             |             |
|-------------|-------------|
| Bank        | (32,000)    |
| Debtors     | 75,000      |
| Inventories | 136,600     |
|             | <hr/>       |
|             | 672,000     |
|             | <hr/> <hr/> |

**AUTHORIZED CAPITAL:**

|                                       |         |
|---------------------------------------|---------|
| 600000 Ordinary Shares @ sh.1.20      | 720,000 |
| 200000 4% Preference Shares @ sh.1.00 | 200,000 |

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920,000

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**ISSUED CAPITAL:**

|  |  |
|--|--|
| 450 000 Ordinary Shared @ sh. 1.20     | 540,000                                |
| 100 000 4% Preference Shared @ sh.1.00 | 100,000                                |
| Retained Profit                        | (185,000)                              |
| Shared Premium                         | 42,000                                 |
| Director Loan                          | 60,000                                 |
| Creditor                               | 115,000                                |
|  | <hr/> <hr/> <p>672,000</p> <hr/> <hr/> |

The company passed a special resolution to reduce its capital and approval of the court was duly obtained. The following is the scheme of reduction of capital:

- i Preference shared to be reduced at sh.0. 25 per unit and ordinary shared are to be reduced by sh. 0.70 per unit. Both classes of shared are then combined and converted into ordinary shared of sh.1.00 each.
- ii Share premium account and profit and loss account shall be fully eliminated.
- iii Bank overdrafts will be paid by issued of 5% debentures.
- iv Creditor amounting to sh.80 000 agreed to settle the debts by issuing ordinary share @sh.1.00 for every 4 unit ordinary shared held for every sh.5.00 due. The balance is paid in cash
- v Directors agreed to eliminate the debt on the company by received 4 unit of ordinary shared @sh. 1.00 for every sh. 5.00 owed
- vi Intangible assets are eliminated in full



vii Assets were revalue are eliminated in full:  
sh.

|                   |         |
|-------------------|---------|
| Land& building    | 205,000 |
| Plant & machinery | 75,000  |
| Vehicle           | 50,000  |
| Furniture         | 26,000  |

viii Stock revalue to the value of sh.112,000 and bad debts increased to 10%ix  
Preference shareholder, agree to receive two units of ordinary share of sh1.00 each for  
every sh.5.00 of the scheme above and fully paid.

x The cost to fiancé this scheme amounting to sh. 12,000

xi The company has received approval to increase authorized capital of 800 000 ordinary  
shares unit @sh. 1.00

**Required:**

a) Journal entry for the transaction above.

(10 marks)

**QUESTION FOUR**

a) Explain the evidence that must prevail for a registrar to declare a company defunct.

(10 marks)

A compulsory winding up order was made on 30 November 2003 against Hasara Ltd. A  
summary of the company's balance sheet as at that date was as follows:

|  | Sh. "000"  | Sh. "000" | Sh. "000"     |
|--|------------|-----------|---------------|
| <b>Non-current assets:</b>   |            |           |               |
| Goodwill   |            |           |               |
| Freehold property  |            |           | 2,689         |
| Plant and machinery  |            |           | 4,940         |
| Shares in subsidiaries   |            |           | <u>14,620</u> |
|  |            |           | 22,249        |
| <b>Current assets:</b>   |            |           |               |
| Stocks   |            | 19,180    |               |
| Debtors  |            | 9,040     |               |
| Cash in hand   |            | <u>20</u> |               |
|  |            | 28,240    |               |
| <b>Current liabilities:</b>  |            |           |               |
| Bank overdraft   | 22,790     |           |               |
| Creditors  | 20,900     |           |               |
| Customs and excise tax   | 200        |           |               |
| Accruals   | 399        |           |               |
| Debenture interest due   | <u>100</u> |           |               |
|  |            | (44,389)  | (16,149)      |
|  |            |           | <u>6,100</u>  |
| <b>Financed by:</b>  |            |           |               |
| Share capital 5,000,000<br>ordinary shares of Sh.20<br>each – fully paid |            |           | 10,000        |
| 400,000 ordinary shares<br>of Sh.20 each- Sh.12.50<br>paid               |            |           | <u>5,000</u>  |
|  |            |           | 15,000        |
| <b>Revenue reserves:</b>   |            |           |               |
| Retained profits (losses)  |            |           | (12,900 )     |
| Shareholders' funds  |            |           | <u>2,100</u>  |
| <b>Non-current liability:</b>  |            |           |               |
| 10% debentures   |            |           | <u>4,000</u>  |
|  |            |           | <u>6,100</u>  |

|  | Sh. "000"  | Sh. "000" | Sh. "000"     |
|--|------------|-----------|---------------|
| <b>Non-current assets:</b>   |            |           |               |
| <b>Goodwill</b>  |            |           |               |
| Freehold property  |            |           | 2,689         |
| Plant and machinery  |            |           | 4,940         |
| Shares in subsidiaries   |            |           | <u>14,620</u> |
|  |            |           | 22,249        |
| <b>Current assets:</b>   |            |           |               |
| Stocks   |            | 19,180    |               |
| Debtors  |            | 9,040     |               |
| Cash in hand   |            | <u>20</u> |               |
|  |            | 28,240    |               |
| <b>Current liabilities:</b>  |            |           |               |
| Bank overdraft   | 22,790     |           |               |
| Creditors  | 20,900     |           |               |
| Customs and excise tax   | 200        |           |               |
| Accruals   | 399        |           |               |
| Debenture interest due   | <u>100</u> |           |               |
|  |            | (44,389)  | (16,149)      |
|  |            |           | <u>6,100</u>  |
| <b>Financed by:</b>  |            |           |               |
| Share capital 5,000,000 ordinary shares of Sh.20 each – fully paid |            |           | 10,000        |
| 400,000 ordinary shares of Sh.20 each- Sh.12.50 paid               |            |           | <u>5,000</u>  |
|  |            |           | 15,000        |
| <b>Revenue reserves:</b>   |            |           |               |
| Retained profits (losses)  |            |           | (12,900)      |
| Shareholders' funds  |            |           | <u>2,100</u>  |
| <b>Non-current liability:</b>                                      |            |           |               |
| 10% debentures   |            |           | <u>4,000</u>  |
|  |            |           | <u>6,100</u>  |

**Additional information:**

1. The 10% debentures are secured by a first charge on freehold property and the bank overdraft is secured by a floating charge on the assets.
2. The accruals consisted of:

|   | Sh. "000" |
|---|-----------|
| Directors fee, 6 months to 30 November 2003.    | 75        |
| Managers salary, 2 months to 30 November 2003   | 80        |
| Wages of 3 workmen, 4 weeks to 30 November 2003 | 18        |

|  |            |
|--|------------|
| Rates – half year to 30 November 2003  | 20         |
| Taxes for the year to 30 November 2001 | 120        |
| Miscellaneous expenses                 | <u>86</u>  |
|  | <u>399</u> |

3. A holder of 20,000 of the partly paid shares was bankrupt and it was anticipated that his trustees would be in a position to pay a dividend of 25% to his unsecured creditors.
4. The company's assets were estimated to be realized as follows:

|                     | Sh. "000" |
|---------------------|-----------|
| Freehold property   | 4,480     |
| Plant and machinery | 14,000    |
| Stocks              | 18,760    |

5. The debtors were considered to be good except as to Sh. 520,000 of which Sh. 400,000 were doubtful and were expected to realize Sh.110, 000. The remaining Sh.120, 000 were considered bad. Goodwill was regarded as valueless.
6. Legal proceedings for breach of contract were pending against the company as at 30 November 2003. The company was considered to have a poor defense and attempts were being made to settle the claim out of court for Sh.100, 000 plus costs estimated at sh.80, 000. No provision for this claim is included in the balance sheet.
7. The company had incurred losses of Sh.3, 040,000, Sh.3, 840,000 and 6,020,000 respectively in each of the three years ended 30 November 2003. The aggregate of the sums charged to the profit and loss accounts during the three years in respect of depreciation, debenture interest and directors' remuneration were Sh.2, 380,000, Sh.600, 000 and Sh.1, 800,000 respectively.

**Required:**

- (a) Statement of affairs as at 30 November 2003.

(10 marks)