CHAPTER 2.

BUYBACK OF SECURITIES AND EQUITY SHARES WITH DIFFERENTIAL RIGHTS

IMPORTANT CONDITIONS FOR BUY BACK OF EQUITY SHARES:

- Buy back must be authorized by **Articles of Association** of the company.
- **Special Resolution** has been passed in the GM of the company authorizing the buy back. However, Board of Directors can also authorized the buyback by passing Board resolution if buyback is **equal to or less than 10%** of the paid up capital of the company.
- Buy back of equity share in any financial **year shall not exceed 25% of the total paid up capital** of that equity share.
- **Aggregate buyback of equity shares shall not exceed 25% of total paid up capital and free reserves** of the company,
- Debt Equity ratio **should not exceed 2:1** after such buy back.
- Equity shares must be fully paid.
- Buy back process must be completed within 12 months from the date of passing special resolution.

SOME IMPORTANT PROVISIONS:

(1) There are three sources of Funds for Buy Back of Equity shares:

- Out of **Free Reserves;**
- Out of **Securities Premium**; or
- Out of the **proceeds of any Fresh issue** of shares or other specified securities.

(2) **Free Reserves includes**:

- General Reserve / Revenue Reserve
- P&L account (Cr. Balance)
- Security Premium a/c
- It does not include Capital Reserve, Share application a/c, Revaluation reserves, CRR/DRR.

(3) Where a company purchases its own shares out of free reserves and Securities premium account, then **a sum equal to the nominal value** of the shares so bought back shall be transferred to the 'Capital Redemption Reserve Account' out of Free Reserves.

(4) Premium payable on buy-back can be set off against Security Premium a/c if any; otherwise it would be set off against Revenue Reserve.

(5) Capital Redemption Reserve can be utilized only for issuing Bonus shares to members.

JOURNAL ENTRIES FOR BUYBACK OF SECURITIES:

On Announcement of Buyback	Equity Share Capital A/c Dr. (Face Value) Premium Payable on Buy-Back A/c Dr. To Equity Shares Buy-back A/c (Buyback Value)
On Payment to Shareholders	Equity Shares Buy-back A/c Dr. To Bank A/c
Writing off Premium on Buy-back	Security Premium A/c Dr. (1st Priority) Revenue Reserves Dr. (Gen. Reserve and P&L) To Premium Payable on Buyback a/c\
Transfer to CRR (Equal to Nominal Value if BB is out of Free Reserve)	Revenue Reserve Dr. (Gen. Reserve and P&L A/c) Security Premium A/c Dr. To Capital Redemption Reserve
On Fresh issue of other securities such as Pref. Shares	Bank A/c Dr. To Pref. Share Capital A/c To Security Premium A/c
On sale of Investment for the purpose of Buy-back	Bank A/c Dr. To Investment A/c (Gain or Loss on sale transfer to P&L A/c)
On Issue of Bonus Shares out of CRR and Other Free Res.	Capital Redemption Reserve Dr. (1st Priority if available) Revenue Reserves Dr. (Gen. Res and P&L) To Bonus Shares A/c Bonus Shares A/c To Equity Share Capital A/c

EQUITY SHARES WITH DIFFERENTIAL RIGHTS

1. The Companies Act, 2013 (Sec 43 a) defines equity share capital to include of two types viz.,
   a) With voting rights; or
   b) With differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed
2. Hence, differentiation can be done by giving superior dividend / Superior voting right/ diluted voting right to a class of equity shareholder.
3. It must be appreciated that preference shares are not issued with differential rights. It is only the equity shares, which are issued.
4. Normally, the blanket rule in Companies Act is **one share-one vote**. This gives equal voting right to every shareholder.
5. However, sometime a segment of shareholders, normally promoters and executive management may like to have more control over decision-making process.
6. This intention of shareholders / management can be activated if they have more voting rights, even if they hold fewer shares. This can be structured by giving them shares with superior voting rights. This is enabled by section 43(a)(ii) in the form of equity shares with differential rights.
7. It is provided further that where the dividend in respect of a class of preference shares has not been paid for a period of two years or more, such class of preference shareholders shall have a right to vote on ***all the resolutions*** placed before the company.
8. It is further provided that the proportion of the voting rights of equity shareholders to the voting rights of the preference shareholders shall be in the same proportion as the paid-up capital in respect of the equity shares bears to the paid-up capital in respect of the preference shares.
9. The members are not entitled to voting rights in respect of money not called up by the company, but voluntarily paid by the member.
10. The shares with differential rights shall not exceed ***twenty-six percent*** of the total post-issue paid up equity share capital including equity shares with differential rights issued at any point of time;
11. It is further clarified that the company shall not convert its existing equity share capital with voting rights into equity share capital carrying differential voting rights and *vice–versa*.

Example: Equity capital is held by X, Y and Z in the proportion of 40:40:20. A, B and C hold preference share capital in the proportion of 50:30:20. If the paid up equity share capital of the company is 1 Crore and Preference share capital is ` 50 Lakh, then relative weight in the voting right of equity shareholders and preference shareholders will be 2/3 and 1/3. The respective voting right of various shareholders will be

$X = 2/3 X 40/100 = 4/15$

$Y = 2/3 X 40/100 = 4/15$

Z = 2/3X20/100 = 2/15

A = 1/3X50/100 = 1/6

B = 1/3X30/100 = 1/10

C = 1/3X20/100 = 2/30

Hence their relative weights are 4/15:4/15:1/15:1/6:1/10:2/30 or 8:8:4:5:3:2.

Their voting power is X (26.67%), Y (26.67%), Z (13.33%), A (16.67%), B (10%) and C (6.67%).

CLASS PRACTICE QUESTIONS

Question 1

Umesh Ltd. resolves to buy back 4 lakhs of its fully paid equity shares of ` 10 each at ` 22 per share. This buyback is in compliance with the provisions of the Companies Act and does not exceed 25% of Company's paid up capital in the financial year. For the purpose, it issues 1 lakh 11 % preference shares of ` 10 each at par, the entire amount being payable with applications. The company uses ` 16 lakhs of its balance in Securities Premium a/c and has sufficient Balance in its General Reserve.

Question 2

Jayesh Ltd. provides you the following information:

1. Issued capital: 2,50,000 equity shares of 10/- each
   2,000, 10% Preference shares of 100/- each (Issued two months back for the purpose of buy-back)
2. Reserves and Surplus: Capital Reserve – 10,00,000/-
   Securities Premium- 22,00,000/-
   Revenue Reserve – 30,00,000/-
   Profit & Loss A/c – 40,00,000/-
3. Resolution passed to buy back 20% of its equity capital @ 50/- per share.

Required: Pass journal entries to record the above transactions.

Question 3

P.C. Ltd. furnishes you with following Balance Sheet as at 31st March, 2011:

(Rs. In Crores)

Sources of funds:		
Share Capital:		
Authorised		100
Issued:		
12% redeemable preference shares of 100/- each fully paid	75	
Equity shares of 10/- each fully paid	25	100
Reserves and Surplus:	15	
Capital reserve	25	
Securities Premium	260	300
General reserves		**400**
TOTAL		

Funds employed in:		
Fixed assets : Cost	100	
Less: Provision for depreciation	100	Nil
Investments at cost (market value 400/- crores)		100
Current assets	340	
Less: Current Liabilities	40	300
TOTAL		**400**

The company redeemed preference shares on 1st April, 2011. It also bought back 50 lakh Equity shares of 10/- each at 50/- per share. The payments for the above were made out of huge bank balance, which appeared as part of Current Assets. You are asked to:

- Pass journal entries to record the above;
- Prepare Balance sheet (after buy back) &
- Calculate value of equity share on Net asset basis.

Question 4

On 31st March 2011, the following was the balance sheet of TOKYO Ltd.:

LIABILITES	AMOUNT (in lacs)	ASSETS	AMOUNT (in lacs)
Equity share capital (fully paid of 10/- each)	2,400	Machinery	3,600
		Furniture	452
Security premium	350	Investments	148
General Reserve	930	Stocks	1,200
Profit and Loss a/c	340	Debtors	520
12% Debentures	1,500	Cash at Bank	740
Sundry Creditors	750		
Provisions	390		
	6,660		**6,660**

On 1st April 2011, the company announced the buy-back of 25% of its equity shares @ 15 per share. For this purpose, it sold all of its investments for 150/- lacs and issued 2,00,000, 14% preference shares of 100/- each at par, the entire amount being payable with application.

The issue was fully subscribed. The company achieved the target of buy-back. Later the company issued one fully paid up equity share of 10/- each by way of bonus shares for every four equity shares held by the equity shareholders.

Show the necessary journal entries for all the transactions including cash transactions.

Question 5 (ICAI)

Perrotte Ltd. has the following Capital Structure as on 31.03.2011:

S.No.	Particulars	(in crores)
1	Equity Share Capital (Shares of ` 10 each fully paid)	330
	Reserves and Surplus:	
2	General Reserve	240
3	Securities Premium Account	90
4	Profit & Loss Account	90
5	Infrastructure Development Reserve	180
6	Loan Funds	1800

The Shareholders of Perrotte Ltd., on the recommendation of their Board of Directors, have approved on 12.09.2011 a proposal to buy back the maximum permissible number of Equity shares considering the large surplus funds available at the disposal of the company.

The prevailing market value of the company's shares is Rs. 25 per share and in order to induce the existing shareholders to offer their shares for buy back, it was decided to offer a price of 20% over market.

You are also informed that the Infrastructure Reserve is created to satisfy Income-tax Act requirements.

You are required to compute the maximum number of shares that can be bought back in the light of the above information and also under a situation where the loan funds of the company were either Rs. 1,200 crores or Rs. 1,500 crores.

Assuming that the entire buy back is completed by 09.12.2011, show the accounting entries in the company's books in each situation.

Question 6 (ICAI Module)

W, X, Y and Z hold Equity capital is held by in the proportion of 40:30:10:20. A, B, C and D hold preference share capital in the proportion of 30:40:20:10. If the paid up capital of the company is ` 40 Lakh and Preference share capital is ` 20 Lakh, Find their voting rights in case of resolution of winding up of the company.

HOME WORK QUESTIONS

Question 7 (RTP - Nov10):

Handful Ltd. furnished the following Balance Sheet as at 31st March, 2010:

LIABILITES	AMOUNT (in lacs)	ASSETS	AMOUNT (in lacs)
Authorized Capital	125	Fixed Assets	150
		Investments	120
13% Redeemable Preference shares of 100/- each	75	Current Assets, Loans and Advances	295
Equity share capital (fully paid of 10/- each)	50		
Capital Reserve	50		
Revenue Reserve	250		
Current Liabilities & Provisions	140		
	565		565

The company purchased its own 1 lakh equity shares of 10/- each at 25/- per share on 01/04/2010 out of Free Reserves. The company also redeemed preference shares on the same date. The payment for the above were made from the bank account, which forms part of current assets.

You are required to pass necessary journal entries to record the above and prepare the balance sheet as would appear after the aforesaid transactions.

(Answer: Balance sheet total- 465/-)

Question 8 (ICAI Mod. + Exam Nov. 09)

Dee Ltd. furnishes the following Balance Sheet as at 31st March, 2008:

LIABILITIES:	(in 000')	(in 000')
Share Capital:		
Authorised		3,000
Issued & Subscribed:		
2,000, 10% preference shares of 100/-	200	
(Issued Two Months Back for the purpose of Buy Back)		
2,50,000 Equity shares of 10/- each fully paid	2,500	2,700
Reserves and Surplus:		
Capital reserve	1,000	
Revenue reserve	3,000	
Securities Premium	2,200	
Profit & Loss A/c	3,500	9,700

Current Liabilities and provisions		1,400
TOTAL		**13,800**
ASSETS:		
Fixed assets		9,300
Investments at cost		3,000
Current assets, Loans and Advances (including Cash & Bank Balance)		1,500
TOTAL		**13,800**

The company passed a resolution to buy back 20% of its equity capital @ 50/- per share. For this purpose, it sold all of its investments for 22,00,000/-

You are required to pass necessary journal entries and prepare the Balance Sheet.

Question 9 (May12 - 8 Marks)

Following is the Balance of M/s Component Limited as on 31st March, 2012:

Liabilities	**Amount**	**Assets**	**Amount**
Equity shares of 10/- each	12,50,000	Fixed Assets	46,50,000
Revenue reserve	15,00,000	Current Assets	30,00,000
Securities premium	2,50,000		
Profit & Loss a/c	1,25,000		
Secured Loans:			
12% Debentures	18,75,000		
Unsecured Loans	10,00,000		
Current Maturities of Long-Term Borrowings	16,50,000		
Total	**76,50,000**	**Total**	**76,50,000**

The Company wants to buy back 25,000 equity shares of 10/- each, on 1st April, 2012 at Rs. 20 per share. Buy back of shares is fully authorized by its articles and necessary resolution passed by the company towards this. The payment of buy back of shares will be made by the company out of sufficient bank balance available as part of current assets.

Comment with your calculations, whether buy back of shares by company is within the provisions of the companies act, 2013. If yes, pass necessary journal entries towards buy back of shares and prepare a Balance Sheet after buy back of shares.

Student Notes:-

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