Buyback of Shares

IPCC Paper 5: Advanced Accounting Chapter 4

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Learning Objectives

1. After studying this unit, you will be able to learn the provisions of the Companies Act, 1956 for buy-back of shares
2. Learn the process of buy-back of shares
3. Learn the conditions prescribed for buy-back of shares
4. Learn to solve the questions under different scenarios

Buyback – An Introduction

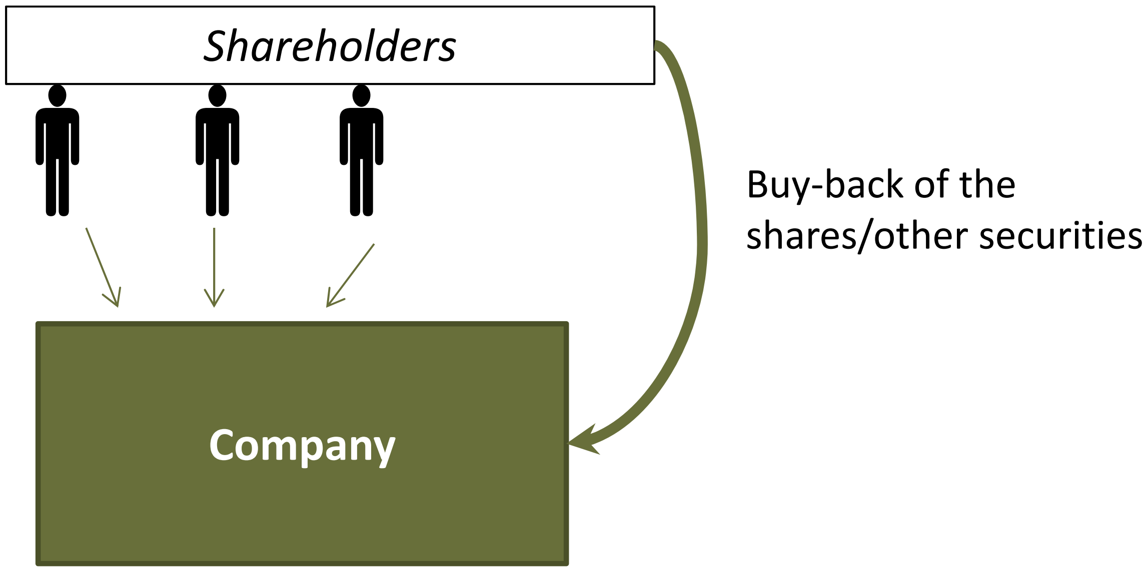
Buy back is an offer by a company to its shareholders to acquire pre-agreed number of its own securities at a pre-agreed price.

In layman words, Buyback of shares is one of the forms of cancellation of shares/ repayment of capital (both Equity and Preference Share Capital)

Buy-back of shares can be undertaken by both public and private limited companies

Provisions of section 77, 77A, 77AA of the Companies Act would apply for buy-back of shares

Understanding Buyback of Securities



Buyback of Shares

Provisions of Companies Act, 1956

Section 77A(2) of the Companies Act 1956

- As per the Section 77A(2) of the Companies Act 1956, no Company shall purchase its own shares/other securities unless the following two conditions are satisfied:
  - The Articles of Association should authorize the Company to buyback its own shares.
  - A special resolution should be passed in the general meeting of the Company authorizing the buyback the shares.

However, buy-back of shares can be made without a special resolution if the following conditions are fulfilled –

  - The buy-back is 10% or less, of the paid up equity capital and free reserves of the Company; and
  - Such buy-back has been authorized by a Board resolution [at a Board meeting]; and
  - There is a gap of at least 365 days between two buy-back offers sanctioned by the Board.

Free Reserves for Buyback of Securities

- Free reserves for the limited purpose of buy-back of securities would mean:

  - Securities Premium
  - General Reserve
  - Profit and loss account

Maximum amount available for buy-back of Securities

- Maximum amount available for buy-back of shares/other securities:

  Condition 1. The buyback should not exceed 25 percent of the Company's paid- up equity capital in a single financial year

  - This limit is applicable in the context of maximum number of equity shares that can be bought back by a Company in a financial year

Example 1

Extract of Balance Sheet of Y Ltd consists of :

Equity Share Capital – Rs 500,000 of Rs 10 each

12% Preference Share Capital – Rs 100,000 of Rs 100 each

14% Debenture Capital – Rs 200,000 of Rs 100 each

Maximum equity share capital that can be bought back
= Rs 500,000*25% = Rs 125,000

Maximum number of equity shares that can be bought back
= Rs 125,000/Rs 10 = 12500 equity shares

Buy-Back of Securities

Condition No 2. The buyback cannot exceed 25 percent of the paid-up capital and free reserves of the Company

This limit applies in the context of the "maximum amount" that a Company can payout to the shareholders in a buyback offer

Example 2 : *Extract of Balance Sheet of A Ltd consists of :*

- *Equity Share Capital – Rs 1000*
- *Preference Share Capital – Rs 500*
- *Capital reserve – Rs 300*
- *General Reserve – Rs 200*
- *Profit and loss account – Rs 100*

Maximum buy back price = (1000+500+200+100)*25% = 450

Example 3

Extract of Balance Sheet of ABC Ltd consists of :

Equity Share Capital – Rs 500,000 of Rs 10 each

12% Preference Share Capital – Rs 100,000 of Rs 100 each

14% Debenture Capital – Rs 200,000 of Rs 100 each

Revaluation reserve – Rs 50,000

General reserve – Rs 200,000

Profit and loss account – Rs 200,000

Answer

1.Maximum buy back price
= (500,000+100,000+200,000+200,000)*25% = 250,000

2. Maximum number of preference shares that can be bought back
= No limit. Therefore, entire preference share capital can be bought back

2a. Maximum buy-back price for buying back preference shares
= Rs. 250,000/1000 shares = Rs 250 per share

3. Maximum number of equity shares that can be bought back
= 500,000/10 * 25% =12,500 shares

3a. Maximum price that can be paid per equity share bought back
= Rs 250,000/12,500 shares = Rs. 20 per equity share

Resources for buy-back

A buy-back of shares may be made out of the following:

- Free reserves.
- Securities premium account.
- Proceeds of any shares or specified securities [however, no buy-back of shares can be made out of the proceeds of an earlier issue of the same kind of shares].

◦ ***Note :*** Where the buy-back is funded through free reserves –

- A sum equal to the nominal value of the shares bought back should be transferred to the "Capital Redemption Reserve" (CRR).

Example 4

Liabilities		Assets	
Equity Share capital	1000		
Preference share capital	~~200~~		
Revaluation reserve	100	Cash/Bank	150
Capital reserve	100		
General reserve	150		
Profit and loss account	150		

Other Conditions

Post –buyback condition

- The ratio of debt [all secured and unsecured debts] should not be more than "**twice**" the capital and free reserves after buy-back.

The shares to be bought back should be fully paid up

After buy-back of shares, the Company cannot issue further shares of the same kind as bought back for a period of six months

- Except in case of bonus shares, discharge of subsisting obligations such as conversion of warrants, stock options, conversion of preference shares/ debentures

Buy-back of shares is not permitted, inter alia, where the Company has under the Companies Act not filed its annual return or defaulted in distribution of dividends or repayment of term loan/ interest to any financial institution/ bank.

Other Conditions

Buy-back should be completed within 12 months from the date of passing of the special resolution in the General Meeting of the shareholders or the resolution by the Board of Directors, as the case may be.

After buy-back, the Company is required to extinguish and physically destroy the shares bought back within 7 days of last date completion of buy-back

How does actual Buy-Back happen?

The buy-back may be from :

- The existing security holders on a proportionate basis
- The open market
- Odd lots
- Purchasing the securities issued to the employees of the Company pursuant to a scheme of stock option or sweat equity

Accounting entries

1. Sale of assets

- Bank account ….Dr
- Loss on sale of investments/assets account .. Dr
- To Investments/ assets account (at book value)

2. Transferring loss on sale of investments/assets to profit and loss account

- Profit and loss account… Dr
- To loss on sale of investments/assets account

Accounting entries

3. Due entry for buy-back of shares

- Concerned share capital account .. Dr
- Premium on buy-back of shares account.. Dr
- To concerned shareholders account

  To discount on buy-back of shares account

4. Payment towards shares bought back

- Concerned shareholders account … Dr
- To Bank account

Accounting entries

5. Issue of fresh shares for the purpose of buy-back

- Bank account .. Dr
  - To Concerned share capital account

6. Writing off premium on buy-back against securities premium balance

- Securities premium account .. Dr
- To Premium on buy-back of shares account

7. Transferring required amount to CRR

- Securities premium account .. Dr
- General reserve account.. Dr
- Profit and loss account … Dr
- To Capital redemption reserve account

Points to be noted

It must be noted by the students that while solving the questions in the examination, following three cumulative conditions should be met

- Condition of maximum buy-back price
- Condition of maximum number of equity shares
- Condition of maintaining post buy-back debt-equity and free reserves ratio

Illustration 1

Problem Statement…

- PQR Limited has the following capital structure as on 31 .03. 2011

Particulars	(Rs in crores)
Equity Share capital (Shares of Rs 10 each fully paid)	330
General reserve	240
Securities premium account	90
Profit and loss account	90
Infrastructure development reserve	180
Loan funds	1800

- The shareholders of PQR limited on the recommendation of their BOD have approved on 12 September 2011 a proposal to buyback the maximum permissible number of equity shares considering the large surplus funds available at the disposal of the Company

…Problem Statement

- 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 20% over the market price.
- You are 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 Rs 1200 crores or Rs 1500 crores
- Assuming that the entire buy-back is completed by 9 December 2011, show the accounting entries in the company’s books in each situation

Answer (1/5)

Statement determining maximum number of shares to be bought back

Particulars	Situation 1	Situation 2	Situation 3
Shares outstanding test	8.25	8.25	8.25
Resources test	6.25	6.25	6.25
Debt equity ratio test	Nil	5.00	Nil
Maximum number of shares that can be bought back (least of the above)	Nil	5.00	Nil

Answer (2/5)

Journal entries for the buy-back (applicable only for Situation 2)

Particulars	Debit (Rs in crores)	Credit (Rs in crores)
1. Equity shares buy back account … Dr To Bank account (Being equity shares bought back vide Board resolution dated …)	150	150
2. Equity share capital account… Dr Securities premium account .. Dr General reserve account … Dr To Equity share capital buy back account (Being equity shares buy back due vide Board resolution dated …)	50 90 10	150
3. General reserve account… Dr To Capital redemption reserve account (Being general reserve used for creation of capital redemption reserve on account of equity shares buy-back)	50	50

Answer (3/5)

Working note No 1 : Shares outstanding test

Particulars	Shares in crores
1. Number of shares outstanding	33
2. 25% of the shares outstanding	8.25

Answer (4/5)

Working note no 2 : Resources test

Particulars	
1. Paid up capital (Rs in crores)	330
2. Free reserves (Rs in crores)	420
2. Shareholders funds	750
2. 25% of the sharehodlers funds	187.5
2. Buy-back price per share	Rs 30
2. Number of shares that can be bought back (shares in crores)	6.25

Answer (5/5)

Working note no 3 : Debt equity ratio test

Particulars	Situation 1 (in crores)	Situation 2 (in crores)	Situation 3 (in crores)
Loan funds	1800	1200	1500
Minimum equity to be maintained after buy-back in the ratio of 2:1	900	600	750
Present equity shareholders funds	750	750	750
Maximum permitted buy-back of equity	Nil	150	Nil
Maximum Number of shares that can be bought back at Rs 30 per share (Shares in crores)	Nil	5	Nil

Illustration 2

Problem Statement…

- Following is the Balance sheet of M/s competent limited as on March 31, 2012

Liabilities	Rs	Assets	Rs
Equity shares of Rs 10 each fully paid	1250000	Fixed assets	4650000
Revenue reserve	1500000	Current assets	30,00,000
Securities premium	2,50,000		
Profit and loss account	1,25,000		
12% debentures	18,75,000		
Unsecured loans	10,00,000		
Current liabilities	16,50,000		
Total	76,50,000	Total	76,50,000

…Problem Statement

- The Company wants to buy back 25,000 equity shares of Rs 10 each, on 1st April 2012 at Rs 20 per shares.
- Buyback of shares is duly authorized by its articles of association and necessary resolution has been passed by the Company towards this.
- The payment for 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 the Company is within the provisions of the Companies Act, 1956. If yes, pass necessary journal entries towards buy-back of shares and prepare the Balance Sheet after buy-back of shares.

Solution (1/6)

- Determination of buy-back of maximum number of shares as per Companies Act 1956

Shares outstanding test	Shares
1. Number of shares outstanding	125,000
2. 25% of the shares outstanding	31,250
Resources test	
1. Paid up capital (Rs)	12,50,000
2. Free reserves (Rs 15,00,000+2,50,000+1,25,000)	18,75,000
2. Shareholders funds	31,25,000
2. 25% of the shareholders funds	781,250
2. Buy-back price per share	Rs 20
2. Number of shares that can be bought back	39,063

Solution (2/6)

Debt equity ratio test	Situation 1
Loan funds (Rs 18,75,000+10,00,000+16,50,000)	45,25,000
Minimum equity to be maintained after buy-back in the ratio of 2:1	22,62,500
Present equity shareholders funds	31,25,000
Maximum permitted buy-back of equity	8,62,500
Maximum Number of shares that can be bought back at Rs 20 per share	43,125

Solution (3/6)

Statement determining maximum number of shares to be bought back

Particulars	Shares
Shares outstanding test	31,250
Resources test	39,063
Debt equity ratio test	43,125
Maximum number of shares that can be bought back (least of the above)	31,250

As the Company wants to buy-back only 25,000 equity shares at Rs 20, provisions of the Companies Act, 1956 would be met.

Solution (4/6)

Journal entries for the buy-back

	Debit	Credit
1. Equity shares buy back account … Dr To Bank account	500,000	 500,000
2. Equity share capital account… Dr Securities premium account .. Dr To Equity share capital buy back account	250,000 250,000	 500,000
3. Revenue reserve account… Dr To Capital redemption reserve account	250,000	 250,000

Solution – Balance Sheet (5/6)

	Sch No	Rs
Equity and Liabilities		
1. Shareholder funds		
Share capital (100,000 Equity shares of Rs 10 each)		10,00,000
Reserves and Surplus	1	16,25,000
2. Non-current liabilities	2	28,75,000
3. Current liabilities		16,20,000
Total		71,50,000
Assets		
1. Non-current assets		
Fixed Assets (Tangible assets)		46,50,000
2. Current assets (30,00,000-5,00,00)		25,00,000
Total		

Solution – Schedules to B/S (6/6)

Schedule 1	Rs
CRR	250,000
Revenue reserves	12,50,000
Profit and loss account	125,000
Total	1625,000

Schedule 2	Rs
12% debentures	18,75,000
Unsecured loans	10,00,000
Total	28,75,000

Lesson Summary

Buy-back of shares can be made out of

- Its free reserves; or
- Securities premium; or
- The proceeds of any shares or specifies securities

No company shall purchase its own shares or other specified securities unless:

- The buyback is or less than 25% of the total paid up capital and free reserves of the Company
- The buy-back of equity shares in any financial year shall not exceed 25% of its total paid up equity capital in that financial year
- The ratio of the debt owed by the Company is not more than twice the capital and its free reserves after such buy-back

Thank You

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