TOPIC - 5

(CHAPTER 7 OF ICAI)

REDEMPTION OF PREFERENCE SHARES

INTRODUCTION

- Redemption is the process of repaying an obligation, at prearranged amounts and timings. It is a contract giving the right to redeem preference shares within or at the end of a given time period at an agreed price.
- These shares are issued on the terms that shareholders will at a future date be repaid the amount which they invested in the company (along with frequent payment of a specified amount as return on investment during the tenure of the preference shares).
- The redemption date is the maturity date, which specifies when repayment takes place and is usually printed on the preference share certificate.

PURPOSE OF ISSUING REDEEMABLE PREFERENCE SHARES

A company may face difficulty in raising share capital, as its shares are not traded on the stock exchange. Potential investors, hesitant in putting money into shares that cannot easily be sold, may be encouraged to invest if the shares are redeemable by the company.

PROVISIONS OF THE COMPANIES ACT (SECTION 55)

A company limited by shares if so authorised by its Articles, may issue preference shares which at the option of the company, are liable to be redeemed within a period, normally not exceeding 20 years from the date of their issue. Thus, a company cannot issue irredeemable preference shares. It should be noted that:

(a) no shares can be redeemed except out of profit of the company which would otherwise be available for dividend or out of proceeds of fresh issue of shares made for the purpose of redemption;

(b) no such shares can be redeemed unless they are fully paid;

(c) the premium, if any, payable on redemption shall be provided for out of the profits of the company or out of the company's securities premium account, before the shares are redeemed:

(d) where any such shares are proposed to be redeemed out of the profits of the company, there shall, out of profits which would otherwise have been available for dividends, be transferred to a reserve account to be called Capital Redemption Reserve Account, a sum equal to the nominal amount of the shares redeemed.

(e) The utilisation of CRR Account is further restricted to issuance of fully paid-up bonus shares only.

Important Note:

From the legal provision outlined above, it is apparent that on the redemption of redeemable preference shares out of accumulated profits it will be necessary to transfer to the Capital Redemption Reserve Account an amount equal to the amount repaid on the redemption of preference shares on account of face value less proceeds of a fresh issue of capital made for the purpose of redemption. The object is that with the repayment of redeemable preference shares, the security for creditors/ bankers, etc. should not be reduced. At times, a part of the preference share capital may be redeemed out of accumulated profits and the balance out of a fresh issue.

Section 55 of the Companies Act, 2013, deals with provisions relating to redemption of preference shares. It ensures that there is no reduction in shareholders' funds due to redemption and, thus, the interest of outsiders is not affected. For this, it requires that either fresh issue of shares is made or distributable profits are retained and transferred to 'Capital Redemption Reserve Account'.

The rationale behind these provisions is to protect the interest of outsiders to whom the amount is payable before redemption of preference share capital.

In case of redemption of preference shares out of proceeds of a fresh issue of shares, replacement of capital and tangible assets is obvious. But, if redemption is done out of distributable profits, replacement of capital is ensured in an indirect manner by retention of profit by transfer to Capital Redemption Reserve. In this case, the amount which would have gone to shareholders in the form of dividend is retained in the business and is used for settling the claim of preference shareholders.

Thus, there is no additional claim on net assets of the Company. The transfer of divisible profits to Capital Redemption Reserve makes them non-distributable profits. As Capital Redemption Reserve can be used only for issue of fully paid bonus shares, profits retained in the business ultimately get converted into share capital.

From the above paras, it can be concluded that the 'gap' created in the company's capital by the redemption of redeemable preference shares much be filled in by:

(a) the proceeds of a fresh issue of shares;

(b) the capitalisation of undistributed profits; or

(c) a combination of (a) and (b).

METHOD - 1

REDEMPTION OF PREFERENCE SHARES BY FRESH ISSUE OF SHARES

One of the methods for redemption of preference shares is to use the proceeds of a fresh issue of shares. A company can issue new shares (equity share or preference share) and the proceeds from such new shares can be used for redemption of preference shares.

The proceeds from issue of debentures cannot be utilised for the purpose.

A problem arises when a fresh issue is made for the purpose of redemption of preference shares, at a premium. The point to ponder is that whether the proceeds of a fresh issue of shares will include the amount of securities premium for the purpose of redemption of preference shares.

For securities premium account, Section 52 of the Companies Act, 2013 provides that the securities premium account may be applied by the company;

(a) Towards issue of un-issued shares of the company to be issued to members of the company as fully paid bonus securities

(b) To write off preliminary expenses of the company

(c) To write off the expenses of, or commission paid, or discount allowed on any of the securities or debentures of the company

(d) To provide for premium on the redemption of redeemable preference shares or debentures of the company.

(e) For the purchase of its own shares or other securities.

Note: If may be noted that certain class of Companies whose financial statements comply with the Accounting Standards as prescribed under Section 133 of the Companies Act, 2013, can't apply the securities premium account for the purposes (b) and (d) mentioned above.

Note: All the questions in this chapter have been solved on the basis that the companies referred in the questions are governed by Section 133 of the Companies Act, 2013 and comply with the Accounting Standards prescribed for them. Accordingly the balance in securities premium account has not been utilized for the purpose of premium payable on redemption of preference shares.

Thus, the proceeds of a fresh issue of shares will not include the amount of securities premium for the purpose of redemption of preference shares.

Reasons for issue of New Equity Shares

A company may prefer issue of new equity shares for the following reasons:

(a) When the company has come to realise that the capital is needed permanently and it makes more sense to issue Equity Shares in place of Redeemable Preference Shares which carry a fixed rate of dividend.

(b) When the balance of profit, which would otherwise be available for dividend, is insufficient.

(c) When the liquidity position of the company is not good enough.

Disadvantages of redemption of preference shares by issue of fresh equity shares

The disadvantages are:

(1) There will be dilution of future earnings;

(2) Share-holding in the company is changed.

Accounting Entries

1. When new shares are issued at par	Bank Account Dr. To Share Capital Account (Being the issue of ....shares of Rs......each for the purpose of redemption of preference shares, as per Board's Resolution No...... dated.......)
2. When new shares are issued at a premium	Bank Account Dr. To Share Capital Account To Securities Premium Account (Being the issue of ....shares of Rs......each at a premium of Rs......each for the purpose of redemption of preference shares as per Board's Resolution No..... Dated......)
3. When preference shares are redeemed at par	Preference Share Capital Account Dr. To Preference Shareholders Account
4. When preference shares are redeemed at a premium	Preference Share Capital Account Dr. Premium on Redemp of Pref. Shares A/c Dr. To Preference Shareholders Account
5. When payment is made to preference shareholders	Preference Shareholders Account Dr. To Bank Account
6. For adjustment of premium on redemption	Profit and Loss Account Dr. To Premium on Redemp. of Pref. Shares A/c

Calculation of Minimum Fresh Issue of Shares

Sometimes, examination problem does not specify the number of shares to be issued for the purpose of redemption of preference shares and requires that the minimum number of shares should be issued to ensure that provisions of Section 55 of the Companies Act, 2013, are not violated. This is done in four steps as given below:

(1) In such cases, the maximum amount of reserves and surplus available for redemption is ascertained taking into account the balances appearing in the balance sheet before redemption and the additional information provided in the problem. For example, if balance of general reserve in the balance sheet is Rs 1,00,000 and additional information provides that the Board of Directors have decided that the balance of general reserve should not be less than Rs 40,000 under any circumstances, then, the maximum amount of general reserve available for redemption is Rs 60,000.

(2) After ascertaining the maximum amount of reserves and surplus available for redemption, adjustment for premium on redemption payable out of profits is made and then it is compared with the nominal value of shares to be redeemed. By comparison, one gets the minimum proceeds of fresh issue as Section 55 permits redemption either out of proceeds of fresh issue or out of divisible profits.

Thus, Minimum Proceeds of Fresh Issue of shares =

Nominal value of preference shares to be redeemed – Maximum amount of reserve and surplus available for redemption.

(3) After computation of minimum proceeds, the minimum number of shares to be issued are determined by dividing minimum proceeds by the proceeds of one share. This is done as follows:

Minimum Number of Shares = Minimum proceeds to comply with Section 55/ face value of one share

Proceeds of one share mean the par value of a share issued, if it is issued at par or premium. However, in case of issue of share at a discount, it refers to the discounted value.

(4) Minimum number of shares calculated as per (3) above, needs to be adjusted due to various reasons. Firstly, shares fractions cannot be issued. Thus, if minimum number of shares as per (3) above includes a fraction, it must be approximated to the next higher figure to ensure that provisions of Section 55 are not violated. Secondly, if the examination problem states that the proceeds/number of shares should be a multiple of say, 10 or 50 or 100, then again the next higher multiple should be considered.

Fresh Issue at a Premium and Minimum Fresh Issue

The calculation of minimum number of shares, when fresh issue is at a premium should be handled very carefully Minimum fresh issue cannot be calculated unless one knows the profits available for replacement of preference shares and profit available for replacement cannot be determined unless one knows the portion of profit available for redemption which is required for paying premium on redemption. To tackle this, assume that profits available for redemption is not required for paying premium on redemption of preference shares. In other words, it means that securities premium including premium on fresh issue is comparatively more than premium on redemption.

If the above assumption holds good, minimum number of shares can be calculated in a simple manner without use of equation. But, if above condition does not hold good, then an equation is used to determine the minimum number of shares.

Minimum Fresh Issue to Provide Funds for Redemption

Besides, ensuring compliance with Section 55, the fresh issue of shares is made to provide funds for making payment to preference shareholders. To calculate minimum number of fresh shares to be issued to provide funds, amount payable to preference shareholders is compared with funds available for redemption and the balance of funds to be raised by fresh issue of shares are calculated. The amount to be raised is divided by the issue price of a share (amount payable by shareholder including premium, if any, on fresh issue) to compute the minimum number of shares to be issued.

METHOD - 2

REDEMPTION OF PREFERENCE SHARES BY CAPITALISATION OF UNDISTRIBUTED PROFITS

Another method for redemption of preference shares, as per the Companies Act, is to use the distributable profits in place of issuing new shares. When shares are redeemed by utilising distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Redemption Reserve Account by debiting the distributable profit. In other words, some of the distributable profits are kept aside to ensure that it can never be distributed to shareholders as dividend.

In this connection, the provisions of the Companies Act state that 'When any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall out of profits which would otherwise have been available for dividend, be transferred to a reserve fund to be called the Capital Redemption Reserve Account sum equal to the nominal amount of the shares redeemed'.

Advantages of redemption of preference shares by capitalisation of undistributed profits

The advantages of redemption of preference shares by capitalisation of undistributed profits are:

(1) No change in the percentage of equity share-holding of the company;

(2) Surplus funds can be used.

Disadvantages of redemption of preference shares by capitalisation of undistributed profits

The disadvantage of redemption of preference shares by capitalisation of undistributed profits is that there may be a reduction in liquidity.

Accounting Entries

1. When shares are redeemed at par	Redeemable Preference Share Capital Account Dr. To Preference Shareholders Account (Being the amount payable on redemption of preference shares transferred to Preference Shareholders Account)
2. When shares are redeemed at a premium	Redeemable Preference Share Capital Account Dr. Premium on edemptions of Preference Shares Account Dr. To Preference Shareholders Account (Being the amount payable on redemption transferred to Preference Shareholders Account)
3. When payment is made to preference shareholders	Preference Shareholders Account Dr. To Bank Account (Being the payment to preference shareholders as per terms)
4. For adjustment of premium of redemption	Profit and Loss Account Dr. To Premium on Redemption of Preference Shares Account (Being the premium on redemption adjusted against Profit and Loss Account)
5. For transferring nominal amount of shares redeemed to Capital Redemption Reserve Account	General Reserve Account Dr. Profit and Loss Account Dr. To Capital Redemption Reserve Account (Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act).

REDEMPTION OF PREFERENCE SHARES BY COMBINATION OF FRESH ISSUE AND CAPITALISATION OF UNDISTRIBUTED PROFITS

A company can redeem the preference shares partly from the proceeds from new issue and partly out of profits. In order to fill in the 'gap' between the face value of shares redeemed and the proceeds of new issue, a transfer should be made from distributable profits (Profit & Loss Account, General Reserve and other Free Reserves) to Capital Redemption Reserve Account.

(i) Amount to be Transferred to Capital Redemption Reserve	
Face value of shares redeemed	***
Less: Proceeds from new issue	***
	***

(ii) Proceeds to be collected from New Issue	
Face value of shares redeemed	***
Less: Profits available for distribution as dividend	***
	***

SALE OF INVESTMENTS TO PROVIDE SUFFICIENT FUNDS FOR REDEMPTION

Companies may have sufficient investments, which can be sold, in the market to arrange funds for redemption of preference shares.

REDEMPTION OF PARTLY CALLED-UP PREFERENCE SHARES

One of the conditions of redemption is that only fully paid up preference shares can be redeemed by a company. If the examination problem states that it is decided to redeem preference shares which are partly called up, then it is assumed that final call on these shares is demanded and received before proceeding with redemption of these shares. If information about both fully paid and partly paid preference shares is provided, then, only fully paid shares are redeemed.

REDEMPTION OF FULLY CALLED BUT PARTLY PAID-UP PREFERENCE SHARES

The problem of unpaid calls on fully called up shares may be studied under following categories:

WHEN CALLS-IN-ARREARS IS RECEIVED BY THE COMPANY

If the amount of unpaid calls is received by the Company before redemption, the entry passed is as under: Bank A/c Dr. to Calls-in-Arrears A/c After receipt of calls in arrears, the shares become fully paid up and, then, company can proceed with redemption in the normal course.

IN CASE OF FORFEITED SHARES

If, on getting a proper notice from the company, the shareholders fail to pay the unpaid calls, the Board of Directors may decide to forfeit the shares and cancel these shares instead of reissuing the forfeited shares because redemption of these shares is due immediately or in near future. In this case, entry for forfeiture is passed as usual.

Question 1.

Hinduja Company Ltd. had 5,000, 8% Redeemable Preference Shares of Rs 100 each, fully paid up. The company decided to redeem these preference shares at par by the issue of sufficient number of equity shares of `10 each fully paid up at par. You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Question 2.

C Ltd. had 10,000, 10% Redeemable Preference Shares of Rs 100 each, fully paid up. The company decided to redeem these preference shares at par, by issue of sufficient number of equity shares of Rs 10 each at a premium of Rs 2 per share as fully paid up. You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Question 3.

G India Ltd. had 9,000 10% redeemable Preference Shares of Rs 10 each, fully paid up. The company decided to redeem these preference shares at par by the issue of sufficient number of equity shares of Rs 9 each fully paid up.
You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Question 4.

The Board of Directors of a Company decide to issue minimum number of equity shares of Rs 9 to redeem Rs 5,00,000 preference shares. The maximum amount of divisible profits available for redemption is Rs 3,00,000. Calculate the number of shares to be issued by the company to ensure that provisions of Section 55 are not violated. Also determine the number of shares if the company decides to issue shares in multiples of Rs 50 only.

Question 5.

The Balance Sheet of X Ltd. as on 31st March, 20X3 is as follows:

	Particulars	Rs
	EQUITY AND LIABILITIES	
1.	Shareholders' funds	
	Share capital	2,90,000
	Reserves and Surplus	48,000
2.	Current liabilities	
	Trade Payables	
	Total	3,94,500
	ASSETS	
1.	PPE	
	Tangible asset	3,45,000
	Non-current investments	18,500
2.	Current Assets	
	Cash and cash equivalents (bank)	31,000
	Total	3,94,500

The share capital of the company consists of Rs 50 each equity shares of Rs 2,25,000 and Rs 100 each Preference shares of Rs 65,000(issued on 1.4.20X1). Reserves and Surplus comprises Profit and Loss Account only.

In order to facilitate the redemption of preference shares at a premium of 10%, the Company decided:

(a) to sell all the investments for Rs 15,000.

(b) to finance part of redemption from company funds, subject to, leaving a bank balance of Rs 12,000.

(c) to issue minimum equity share of Rs 60 each share to raise the balance of funds required.

You are required to pass:

The necessary Journal Entries to record the above transactions and prepare the balance sheet as on completion of the above transactions.

Question 6.

The following are the extracts from the Balance Sheet of ABC Ltd. as on 31st December, 20X1.

Share capital: 40,000 Equity shares of Rs 10 each fully paid – Rs 4,00,000; 1,000 10% Redeemable preference shares of Rs 100 each fully paid – Rs 1,00,000.

Reserve & Surplus: Capital reserve – Rs 50,000; Securities premium – Rs 50,000; General reserve – Rs 75,000; Profit and Loss Account – Rs 35,000

On 1st January 20X2, the Board of Directors decided to redeem the preference shares at par by utilisation of reserve.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Question 7.

C Limited had 3,000, 12% Redeemable Preference Shares of Rs 100 each, fully paid up. The company had to redeem these shares at a premium of 10%.

It was decided by the company to issue the following:

(i) 25,000 Equity Shares of Rs 10 each at par,

(ii) 1,000 14% Debentures of Rs 100 each.

The issue was fully subscribed and all amounts were received in full. The payment was duly made. The company had sufficient profits. Show Journal Entries in the books of the company.

Question 8.

The capital structure of a company consists of 20,000 Equity Shares of Rs 10 each fully paid up and 1,000 8% Redeemable Preference Shares of Rs 100 each fully paid up (issued on 1.4.20X1). Undistributed reserve and surplus stood as: General Reserve Rs 80,000; Profit and Loss Account Rs 20,000; Investment Allowance Reserve out of which Rs 5,000, (not free for distribution as dividend) Rs 10,000; Securities Premium Rs 2,000, Cash at bank amounted to Rs 98,000. Preference shares are to be redeemed at a Premium of 10% and for the purpose of redemption, the directors are empowered to make fresh issue of Equity Shares at par after utilising the undistributed reserve and surplus, subject to the conditions that a sum of Rs 20,000 shall be retained in general reserve and which should not be utilised.

Pass Journal Entries to give effect to the above arrangements and also show how the relevant items will appear in the Balance Sheet of the company after the redemption carried out.

Question 9.

The Balance Sheet of XYZ as at 31st December, 20X1 inter alia includes the following:

Particulars	Amount
50,000, 8% Preference Shares of Rs 100 each, Rs 70 paid up	35,00,000
1,00,000 Equity Shares of Rs 100 each fully paid up	1,00,00,000
Securities Premium	5,00,000
Capital Redemption Reserve	20,00,000
General Reserve	50,00,000

Under the terms of their issue, the preference shares are redeemable on 31st March, 20X2 at 5% premium. In order to finance the redemption, the company makes a rights issue of 50,000 equity shares of Rs 100 each at Rs 110 per share, Rs 20 being payable on application, Rs 35 (including premium) on allotment and the balance on 1st January, 20X3. The issue was fully subscribed and allotment made on 1st March, 20X2. The money due on allotment were received by 31st March, 20X2. The preference shares were redeemed after fulfilling the necessary conditions of Section 55 of the Companies Act, 2013.

You are asked to pass the necessary Journal Entries and show the relevant extracts from the balance sheet as on 31st March, 20X2 with the corresponding figures as on 31st December, 20X1.

Question 10.

The books of B Ltd. showed the following balance on 31st December, 20X3:

30,000 Equity Shares of Rs 10 each fully paid; 18,000 12% Redeemable Preference Shares of Rs 10 each fully paid; 4,000 10% Redeemable Preference Shares of Rs 10 each, Rs 8 paid up (all shares issued on 1st April, 20X2).

Undistributed Reserve and Surplus stood as: Profit and Loss Account Rs 80,000; General Reserve Rs 1,20,000; Securities Premium Account Rs 15,000 and Capital Reserve Rs 21,000.

For redemption, 3,000 equity shares of Rs 10 each are issued at 10% premium. At the same time, Preference shares are redeemed on 1st January, 20X4 at a premium of Rs 2 per share. The whereabouts of the holders of 100 shares of Rs 10 each fully paid are not known.

A bonus issue of equity share was made at par, two shares being issued for every five held on that date out of the Capital Redemption Reserve Account. However, equity shares, issued for redemption are not eligible for bonus.

Show the necessary Journal Entries to record the transactions.

Question 11.

The following is the summarised Balance Sheet of Bumbum Limited as at 31st March, 20X1:

Particulars	Rs
Sources of funds Authorized capital	
50,000 Equity shares of Rs 10 each	5,00,000
10,000 Preference shares of Rs 100 each (8% redeemable)	10,00,000
	15,00,000
Issued, subscribed and paid up	
30,000 Equity shares of Rs 10 each	3,00,000
5,000, 8% Redeemable Preference shares of Rs 100 each	5,00,000
Reserves & Surplus	
Securities Premium	6,00,000
General Reserve	6,50,000
Profit & Loss A/c	40,000
2,500, 9% Debentures of Rs 100 each	2,50,000
Trade payables	1,70,000
Total	25,10,000
Application of funds	
Fixed Assets (net)	7,80,000

Investments (market value Rs 5,80,000)	4,90,000
Deferred Tax Assets	3,40,000
Trade receivables	6,20,000
Cash & Bank balance	2,80,000
Total	25,10,000

In Annual General Meeting held on 20th June, 20X1 the company passed the following resolutions:

- To split equity share of Rs 10 each into 5 equity shares of Rs 2 each from 1st July.
- To redeem 8% preference shares at a premium of 5%.
- To redeem 9% Debentures by making offer to debenture holders to convert their holdings into equity shares at Rs 10 per share or accept cash on redemption.
- To issue fully paid bonus shares in the ratio of one equity share for every 3 shares held on record date.

On 10th July, 20X1 investments were sold for Rs 5,55,000 and preference shares were redeemed.

40% of Debenture holders exercised their option to accept cash and their claims were settled on 1st August, 20X1.

The company fixed 5th September, 20X1 as record date and bonus issue was concluded by 12th September, 20X1

You are requested to journalize the above transactions including cash transactions and prepare Balance Sheet as at 30th September, 20X1. All working notes should form part of your answer.

Question 12.

The following is the summarized Balance Sheet of Trinity Ltd. as at 31.3.20X1:

Liabilities	Amount	Assets	Amount
Share Capital (A)		Fixed Assets	
Authorised		Gross Block	3,00,000
10,000 10% Redeemable Preference		Less : Depreciation	1,00,000
Shares of ` 10 each	1,00,000		2,00,000
90,000 Equity Shares of ` 10 each	9,00,000	Investments	1,00,000
	10,00,000	Current Assets and Loans and Advances	
Issued, Subscribed and Paid-up Capital			
10,000 10% Redeemable Preference		Inventory	45,000
Shares of ` 10 each	1,00,000	Trade receivables	25,000
10,000 Equity Shares of ` 10 each	1,00,000	Cash and Bank Balances	50,000
(A)	2,00,000		
Reserves and Surplus (B)			

General reserve	120000		
Securities Premium	70000		
Profit and Loss A/c	18,500		
(B)	2,08,500		
Current Liabilities and Provision (C)	11,500		
Total (A + B + C)	4,20,000	Total	4,20,000

For the year ended 31.3.20X2, the company made a net profit of Rs 35,000 after providing Rs 20,000 depreciation.

The following additional information is available with regard to company's operation:

1. The preference dividend for the year ended 31.3.20X2 was paid.
2. Except cash and bank balances other current assets and current liabilities as on 31.3.20X2, was the same as on 31.3.20X1.
3. The company redeemed the preference shares at a premium of 10%.
4. The company issued bonus shares in the ratio of one share for every equity share held as on 31.3.20X2.
5. To meet the cash requirements of redemption, the company sold investments.
6. Investments were sold at 90% of cost on 31.3.20X2.

You are required to prepare necessary journal entries to record redemption and issue of bonus shares.