Redemption of Preference Shares

Prepared By: CA Kapileshwar Bhalla

Fundamentals Of Accounting

Learning Objectives

After studying this unit, you will be able to:

- Understand the meaning of redemption and the purpose of issuing redeemable preference shares,
- Learn various provisions of the Companies Act regarding preference shares and their redemption,
- Familiarise yourself with various methods of redemption of fully paid-up preference

shares: (i) Fresh issue of shares; (ii) Capitalisation of undistributed profits; (iii) Raising funds through sale of investments. Combination of (i) and (ii); and (iii).

- understand the logic behind the creation of capital redemption reserve account,
- learn the accounting treatment for redemption of partly called-up and fully called-up but partly paid-up preference shares.

Provisions of the Companies Act (Section 80)

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. 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 must be provided for out of the profits of the company or out of the company's share premium account before the shares are redeemed.

(d) where 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 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; and the provisions of the Act relating to the reduction of the share capital of a company shall, except as provided in the section, apply as if the Capital Redemption Reserve Account were the paid-up share capital of the company.

Note

After the commencement of the Companies (Amendment) Act, 1996, a company cannot issue any preference share, which is irredeemable or is redeemable after the expiry of a period of twenty year from the date of its issue.

Remember

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).

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 new shares are issued at a discount

Bank Account Dr.

Discount on Issue of Shares Account Dr.

To Share Capital Account

(Being the issue of …….shares of Rs……each at a discount of Rs….. each for the purpose of redemption of preference shares, as per Board’s Resolution No…dated…..)

4. When preference shares are redeemed at par

Redeemable Preference Share Capital Account Dr.

To Preference Shareholders Account

5. When preference shares are redeemed at a premium

Redeemable Preference Share Capital Account Dr.

Premium on Redemption of
Preference Shares Account Dr.

To Preference Shareholder Account

6. When payment is made to preference shareholders

Preference Shareholders Account Dr.

To Bank Account

7. For adjustment of premium on redemption

Profit and Loss Account Dr.

Securities Premium Account Dr.

To Premium on Redemption of Preference Shares Account

Illustration 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 Rs. 10 each fully up at par. You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Solution

In the books of Hinduja Company Ltd.

Journal

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
	Bank A/c Dr.	5,00,000	
	To Equity Share Capital A/c		5,00,000
	(Being the issue of 50,000 Equity Shares of Rs. 10 each at par for the purpose of redemption of preference shares, as per Board Resolution No….dated….)		

	8% Redeemable Preference Share Capital A/c Dr. To Preference Shareholders A/c (Being the amount payable on redemption of preference shares transferred to Preference Shareholders Account)	5,00,000	5,00,000
	Preference Shareholders A/c Dr. To Bank A/c (Being the amount paid on redemption of preference shares)	5,00,000	5,00,000

Illustration 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.

Solution

In the books of C Limited

Journal

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
	Bank A/c Dr.	12,00,000	
	To Equity Share Capital A/c		10,00,000
	To Securities Premium A/c		2,00,000
	(Being the issue of 1,00,000 Equity Shares of Rs. 10 each at a premium of Rs.2 per share as per Board's Resolution No……dated……)		

	10% Redeemable Preference Share Capital A/c Dr.	10,00,000	
	To Preference Shareholders A/c		10,00,000
	(Being the amount payable on redemption of preference shares transferred to preference Shareholders A/c)		
	Preference Shareholders A/c Dr.	10,00,000	
	To Bank A/c		10,00,000
	(Being the amount paid on redemption of preference shares)		

Note

Amount required for redemption is Rs. 10,00,000. Therefore, face value of equity shares to be issued for this purpose must be equal to Rs. 10,00,000. Premium received on new issue cannot be used to finance the redemption.

Illustration 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. 10 each fully paid up at a discount of 10%.

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

Solution

In the books of G India Limited

Journal

Date	Particulars		Dr. (Rs.)	Cr. (Rs.)
	Bank A/c	Dr.	90,000	
	Discount on Issue of Shares A/c	Dr.	10,000	
	To Equity Share Capital A/c			1,00,000
	(Being the issue of 10,000 Equity Shares of Rs.10 each at a discount of 10%, as per Board's Resolution No…… Dated…..)			

	10% Redeemable Preference Shares Capital A/c Dr. To Preference Shareholders A/c (Being the amount payable on redemption of preference shares transferred to Preference shareholders A/c)	90,000	90,000
	Preference Shareholders A/c Dr. To Bank A/c (Being the amount paid on redemption of preference shares)	90,000	90,000

Note

When shares are redeemed by issuing shares at a discount, the proceeds from new issue must be sufficient to cover the face value of shares redeemed. Here, face value of shares to be redeemed is Rs. 90,000. Proceeds from each new share is Rs. 9 (Rs.10 – 10 x 10% discount). Therefore, the number of new shares to be issued = Rs. 90,000/ Rs. 9 = 10,000 shares.

Illustration 4

The Board of Directors of a Company decide to issue minimum number of equity shares of Rs. 10 each at 10% discount 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 80 are not violated. Also determine the number of shares if the company decides to issue shares in multiples of Rs. 50 only.

Solution

Nominal value of preference shares	Rs. 5,00,000
Maximum possible redemption out of profits	Rs. 3,00,000
Minimum proceeds of fresh issue	Rs. 5,00,000-3,00,000
	Rs. 2,00,000

Proceed of one share = Nominal value – Discount

= 10-1= Rs. 9

Minimum Number of shares $= \dfrac{2,00,000}{9}$ = 22,222.22 shares

As fractional shares are not permitted, the minimum number of shares to be issued is 22,223 shares.

If shares are to be issued in multiples of 5-, then the next higher figure which is a multiple of 50 is 22,250. Hence, minimum number of shares to be issued in such a case is 22,250 shares.

Illustration 5

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.

Date	Particulars		Dr. (Rs.)	Cr. (Rs.)
	Bank A/c	Dr.	2,50,000	
	To Equity Share Capital A/c			2,50,000
	(Being the issue of 25,000 equity shares of Rs. 10 each at par as per Board's resolution No……. dated…….)			

	Bank A/c	Dr.	1,00,000	
	To 14% Debenture A/c			1,00,000
	(Being the issue of 1,000 Debentures of Rs. 100 each as per Board's Resolution No….. dated……)			
	12% Redeemable Preference Share Capital A/c	Dr.	3,00,000	
	Premium on Redemption of Preference Shares A/c	Dr.	30,000	
	To Preference Shareholders A/c			3,30,000

	(Being the amount payable on redemption transferred to Preference Shareholders Account)			
	Preference Shareholders A/c	Dr.	3,30,000	
	To Bank A/c			3,30,000
	(Being the amount paid on redemption of preference shares)			
	Profit & Loss A/c	Dr.	30,000	
	To Premium on Redemption of Preference Shares A/c			30,000
	(Being the adjustment of premium on redemption against Profits & Loss Account)			

	Profit & Loss A/c	Dr.	50,000	
	To Capital Redemption Reserve A/c (Note 1)			50,000
	(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)			

Working Note

(1) Amount to be transferred to Capital Redemption Reserve Account

Face value of shares to be redeemed	Rs. 3,00,000
Less: Proceeds from new issue	Rs. 2,50,000
Total Balance	Rs. 50,000

Illustration 6

The Balance Sheet of XYZ as at 31st December, 2005 *inter alia* includes the following:

	Rs.
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	1,00,000
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, 2006 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, 2007. The issue was fully subscribed and

Allotment made on 1st March, 2006. The money due on allotment were received by 31st March, 2006. The preference shares were redeemed after fulfilling the necessary conditions of Section 80 of the Companies Act, 1956. The company decided to make minimum utilisation of general reserve.

You are asked to pass the necessary Journal Entries and show the relevant extracts from the balance sheet as on 31st March, 2006 with the corresponding figures as on 31st December, 2005.

Solution

Journal

			Rs.	Rs.
	8% Preference Share Final Call A/c To 8% Preference Share Capital A/c (For final call made on preference shares @ Rs. 30 each to make them fully paid up)	Dr.	15,00,000	15,00,000

	Bank A/c To 8% Preference Share Final Call A/c (For receipt of final call money on preference shares)	Dr.	15,00,000	 15,00,000
	Bank A/c To Equity Share Application A/c (For receipt of application money on 50,000 equity shares @ Rs. 20 per share)	Dr.	10,00,000	 10,00,000

	Equity Share Application A/c	Dr.	10,00,000	
	To Equity Share Capital A/c			10,00,000
	(For capitalisation of application money received)			
	Equity Share Allotment A/c	Dr.	17,50,000	
	To Equity Share Capital A/c			12,50,000
	To Securities Premium A/c			5,00,000
	(For allotment money due on 50,000 equity shares @ Rs. 35 per share including premium of Rs. 10 per share			

	Bank A/c	Dr.	17,50,000	
	To Equity Share Allotment A/c			17,50,000
	(For receipt of allotment money on equity shares)			
	8% Preferences Share Capital A/c	Dr.	50,00,000	
	Premium on Redemption of Preference Share A/c	Dr.	2,50,000	
	To Preference Shareholders A/c			52,50,000
	(For amount payable to preference shareholders on redemption at 5% premium			

	Securities Premium A/c To Premium on Redemption A/c (For writing off premium on redemption of preference shares)	Dr.	2,50,000	 2,50,000
	General Reserve A/c To Capital Redemption Reserve A/c (For transfer of CRR the amount not covered by the proceeds of fresh issue of equity shares i.e., 50,00,000 – 10,00,000 – 12,50,000)	Dr.	27,50,000	 27,50,000

	Preference Shareholders A/c To Bank A/c (For amount paid to preference shareholders)	Dr.	52,50,000	52,50,000

Balance Sheet (extracts)

	As at 31.3.2006	**As at 31.3.2005**
Share Capital:		
Issued, Subscribed and Paid up:		
1,00,000 Equity Shares of Rs. 100 each fully paid up	1,00,000	1,00,000

50,000 Equity Shares of Rs. 100 each Rs. 45 paid up	22,50,000	-
50,000 8% Preference Shares of Rs. 100 each, Rs. 70 called up	-	35,00,000
Reserves and Surplus:		
Capital Redemption Reserve	47,50,000	20,00,000
Securities Premium	7,50,000	5,00,000
General Reserve	22,50,000	50,00,000

Note

Amount received (excluding premium) on fresh issue of shares till the date of redemption should be considered for calculation of proceeds of fresh issue of shares. Thus, proceeds of fresh issue of shares are Rs. 22,50,000 (Rs. 10,00,000) application money plus Rs. 12,50,000 received on allotment towards share capital).

MCQ 1

1. Which of the following statements is **false?**
   (a) A company can redeem its preference shares
   (b) Preference shareholders are creditors of a company
   (c) The part of the authorized capital which can be called up only in the event of liquidation of a company is called reserve capital
   (d) Capital redemption reserve can be utilized for issuing fully paid bonus shares.

MCQ 2-3

Use the following information for questions 2 and 3.

The Balance sheet of A Ltd. as on March 31, 2006 is as under:

Liabilities	**Rs.**	**Assets**	**Rs.**
Share Capital:		Land and building	4,00,000
Equity shares of Rs. 100 each	5,00,000	Plant and machinery	3,00,000
12% Preferences shares of Rs.10 each	3,00,000	Furniture and fixtures	2,50,000
Reserves and surplus		Investments	2,25,000

General reserve	1,50,000	Sundry debtors	1,00,000
Profit and loss account	2,50,000	Inventories	1,50,000
18% Debentures	2,00,000	Cash	50,000
Sundry creditors	50,000		
Bank overdraft	25,000		
	14,75,000		14,75,000

The 12% preference shares are redeemable at a premium of 10%. The company wishes to maintain the cash balance at Rs. 25,000. For the purpose of redemption of preference shares, it proposed to sell the investments for Rs. 2,00,000. The company proposes to issue sufficient number of equity shares of Rs. 100 each at a premium of 5% to raise required cash resources.

MCQ 2

2. Cash required to effect the above decisions is _______.

(a) Rs. 3,30,000

(b) Rs. 3,55,000

(c) Rs. 25,000

(d) Rs. 1,05,000

MCQ 3

3. Number of equity shares to be issued is______.

(a) 1,500

(b) 1,000

(c) 950

(d) 1,500

MCQ 4-5

Use the following information for questions 4 and 5.

The following is the balance sheet of G Ltd. as on March 31, 2006:

Liabilities	**Rs.**	**Assets**	**Rs.**
Equity shares of Rs. 10 each fully paid-up	10,00,000	Sundry assets	19,50,000
12% Redeemable preference shares of Rs. 100 each fully paid-up	8,00,000	Investments	4,50,000

General Reserve	4,00,000	Cash at bank	2,00,000
Profit & Loss account	2,50,000		
Share premium	25,000		
Sundry creditors	1,25,000		
	26,00,000		26,00,000

The Board of Directors of the company decided to redeem the preference shares at a premium of 10%. In order to facilitate the redemption, the Board has taken the following decisions:

- To sell the investments for Rs. 4,00,000.
- To issue sufficient equity shares at a premium of Rs. 2 per share to raise the balance of funds needed.
- To maintain minimum bank balance of Rs. 50,000.

The Board of Directors initiated the above course of action during the month of April, 2006 and redeemed all the preference shares.

MCQ 4

4. Premium on issue of fresh equity shares = ?

   (a) Rs. 55,000

   (b) Rs. 60,000

   (c) Rs. 65,000

   (d) Rs. 66,000

MCQ 5

5. The amount to be transferred to Capital Redemption Reserve = ?

(a) Rs. 70,000

(b) Rs. 60,000

(c) Rs. 65,000

(d) Rs. 66,000

MCQ 6

6. S Ltd. issued 2,000, 10% Preference shares of Rs. 100 each at par, which are redeemable at a premium of 10%. For the purpose of redemption, the company issued 1,500 Equity Shares of Rs. 100 each at a premium of 20% per share. At the time of redemption of Preference Shares, the amount to be transferred by the company to the Capital Redemption Reserve Account = ?

(a) Rs. 50,000
(b) Rs. 40,000
(c) Rs. 2,00,000
(d) Rs. 2,20,000

MCQ 7

7. During the year 2000-2001, T Ltd. issued 20,000, 12% Preference shares of Rs. 10 each at a premium of 5%, which are redeemable after 4 years at par. During the year 2005-2006, as the company did not have sufficient cash resources to redeem the preference shares, it issued 10,000, 14% debentures of Rs. 10 each at a premium of 10%. At the time of redemption of 12% preference shares, the amount to be transferred to capital redemption reserve =?

   (a) Rs. 90,000 (b) Rs. 1,00,000

   (c) Rs. 2,00,000 (d) Rs. 1,10,000

MCQ 8

8. According to section 78 of the Companies Act, the amount in the Securities Premium A/c cannot be used for the purpose of

(a) Issue of fully paid bonus shares

(b) Writing off losses of the company

(c) Writing off preliminary expenses

(d) Writing off commission or discount on issue of shares

MCQ 9

9. Which of the following can be utilized for redemption of preference shares ?

(a) The proceeds of fresh issue of equity shares.

(b) The proceeds of issue of debentures

(c) The proceeds of issue of fixed deposit

(d) The sale proceeds of investments

MCQ 10

10. Which of the following can be utilized for redemption of preference shares?

(a) The proceeds of fresh issue of equity shares.

(b) The proceeds of issue of debentures

(c) The proceeds of issue of fixed deposit

(d) The sale proceeds of investments

(e) Both (a) and (b) above.

MCQ 11

11. Which of the following statement is **false?**

(a) Capital redemption reserve cannot be used for writing off miscellaneous expenses and losses.

(b) Capital profit realized in cash can be used for payment of dividend.

(c) Reserves created by revaluation of fixed assets are not permitted to be capitalized

(d) Dividend is payable on the calls paid in advance by shareholders.

MCQ 12

12. Consider the following information pertaining to E Ltd.

On September 4, 2005, the company issued 12,000 7% Debentures having a face value of Rs. 100 each at a discount of 2.5%. On September 12, the company issued 25,000 8% Preference share of Rs. 100 each. On September 29, the company redeemed 30,000, 6% Preferences shares of Rs. 100 each at a premium of 5% together with one month dividend thereon. Bank balance as on August 31, 2005 was Rs. 29,25,000.

After effecting the above transactions, the Bank balance as on September 30, 2005 = ?

(a) Rs. 33,15,000 (b) Rs. 33,30,000

(c) Rs. 33,45,000 (d) Rs. 34,30,000

MCQ 13

13. O Ltd. has redeemed its 12% preference shares of Rs. 2,00,000 at a premium of 4%. To meet the redemption it has issued Rs. 1,98,084 worth of shares of Rs. 20 each at a premium of 5%. The balance outstanding to the credit of share premium account after adjusting premium on redemption of preference shares = ?

(a) Rs. Nil (b) Rs. 1,904

(c) Rs. 1,432 (d) Rs. 8,000

MCQ 14

14. Which of the following accounts can be transferred to capital redemption reserve account ?

(a) General reserve account

(b) Forfeited shares account

(c) Profit prior to incorporation

(d) Share premium account

MCQ 15

15. Preference shares amounting to Rs. 2,00,000 are redeemed at a premium of 5%, by issue of shares amounting to Rs. 1,00,000 at a premium of 10%. The amount to be transferred to capital redemption reserve = ?

(a) Rs. 1,05,000 (b) Rs. 1,00,000

(c) Rs. 2,00,000 (d) Rs. 1,11,000

THE END

Redemption of Preference Shares