

❖ **REDEMPTION OF PREFERENCE SHARES (Sec.80)** ❖

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.

INTRODUCTION

Preference shares that can be redeemed by the company in accordance with the terms of issue are called Redeemable Preference shares. However the Articles of the company must have the provision in this regard.

The terms of issue, generally stipulate the time of redemption and whether the redemption will be at par or premium.

Prior to the amendment of the Companies Act, 1988, companies were permitted to issue both redeemable and irredeemable preference shares. For all practical purposes there is not much difference between the equity shares and irredeemable preference shares. But in terms of return (dividend), the equity shareholders enjoy a better return than the holders of irredeemable preference shares do. This was considered as an anomaly and the Companies (Amendment) Act, 1988, prohibited the issue of irredeemable preference shares in future and also provided for the redemption of such shares, which were issued prior to the Act of 1988.

REDEMPTION OF PREFERENCE SHARES:

Redemption of preference shares means to discharge or return the amount of preference share capital to the preference share holders

Under section 100 of the companies Act 1956, a company cannot refund of its paid up share capital except with the permission of the court. But no court's permission is required in case of preference shares, being the companies are prohibited to issue the irredeemable preference share.

PREFERENCE SHARES:

Section 85(1) of the Companies Act defines preference shares as those shares which carry preferential rights as the payment of dividend at a fixed rate and as to repayment of capital in case of winding up of the company. Thus, both the preferential rights viz.

- ❖ A preference share always enjoys fixed rate of dividend.
- ❖ Though preference share **does not** enjoy any voting rights, but it enjoys two privileges:-
 1. Preference in payments of dividends before any dividends can be paid to common shareholders.
 2. Preference in repayments of capital in the event of liquidation / winding up of company.
- ❖ Unless otherwise mentioned, every preference share is cumulative and redeemable.

The rate of dividend on these shares is fixed and the dividend on these shares must be paid before any dividend is paid to ordinary shares. Directors, however, may decide not to pay any dividend to any class of shareholders even if there are sufficient profits. But, if any how, they decide to pay the dividend, preference shareholders will get the priority over the ordinary shareholders.

Following are the basic features of preference share:

- a) Fixed rate of dividend only whereas **equity** shareholders get the dividend at the rate which is fixed in AGM depending on the profit available for a particular year hence dividend of ESH varies from year to year
- b) Preferential payment of dividend
- c) Preferential right in redemption of capital in case of winding up of a company.
- d) But absence of voting rights

Preference shares may be classified according to the rights attached to them as follows:

a) Cumulative and Non-cumulative Preference shares

Cumulative preference shares enjoy the right to receive the dividends which were in arrears for the years in which company earned no profits or insufficient profits, in the year in which company earns profits.

In case of **non-cumulative** preference shares dividend does not get accumulated and therefore, no arrears of dividend will be paid in the year of profits. If company does not have any profits in a year, no dividend will be paid to non-cumulative preference shareholders.

According to section 80 of the companies Act 1956, the company must satisfy the following legal conditions:

Provisions of the Companies Act 1956 (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)** A company limited by shares can issue redeemable preference shares subject to the provisions of Sec. 80 of the Act such an issue must also be authorized by the Articles of the company.
- (b)** With effect from 1st March 1997 a company cannot issue irredeemable preference shares or shares which can be redeemed beyond a period of 20 years (Amendment Act, 1996). [See 80-5 (A)]
- (c)** A company is permitted to carry out redemption from only two sources. They are:
 - (a) Profits of the company which would **otherwise** be available for dividend.
 - (b) Proceeds of fresh issue of shares made for the purpose of redemption.The section rules out any other source such as issue of **debentures, borrowing from banks and other financial institutions** for carrying out redemption.
- (c)** Where shares are redeemed from out of profits otherwise available for dividend, a sum equal to the nominal value of the shares redeemed must be transferred to 'Capital Redemption Reserve Account'.
- (d)** Only fully paid preference shares are to be redeemed. If partly paid shares are to be redeemed, call must be made first and then redemption must be carried out.
- (e)** Redemption may be at par or at premium according to the terms of issue. If redemption is at premium, such premium must be met out of profits of company or the balance in 'security premium account'.
- (f)** Capital Redemption Reserve Account is available only for the purpose of issue of bonus shares. This reserve must be kept intact unless otherwise sanctioned by the court.
- (g)** Redemption of redeemable preference shares does not result in the reduction of authorized capital of the company. To the extent reduction has taken place, company can issue further shares, as if those shares had never been issued.
- (h)** If new shares are issued for the purpose of redemption, it will not amount to increase in capital.
- (i)** Subject to the provisions of this section, redemption must be carried out in accordance with the terms provided in the Articles of the company.

Redemption of Irredeemable Preference Shares (just for information purpose)

While sub-section 5A of Sec. 80 bars the issue of irredeemable preference shares after the commencement of the Amendment Act 1996, Sec. 80 (A) provides *for* the redemption of irredeemable preference shares and redeemable preference shares which are redeemable beyond ten years. The important points governing such redemption are:

1. Irredeemable preference shares issued, prior to the Amendment Act of 1988 are to be redeemed, within a period of 5 years *from* the date of the commencement of amendment. This in effect means that all irredeemable preference shares, issued prior to the amendment, must have been redeemed by 14th June 1993.
2. Redeemable preference shares providing redemption beyond ten years and issued before the Amendment Act are required to be redeemed on the date on which they are due or within a period not exceeding ten years whichever is earlier.

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 must be filled in by:

- (a) the proceeds of a fresh issue of shares; **or**
(b) the capitalisation of undistributed profits; **or**
(c) a combination of (a) and (b).

[illegible]

Redeemable Preference shares are preference shares which have to be repaid by the company after the term of which for which the preference shares have been issued.

The redeemable preference shareholders should be paid out of undistributed profit or out of fresh issue of shares for the purpose of **redemption of preference share.**

The proceeds of fresh issue mean issue of preference / equity share capital but not debentures. It means debenture cannot be issued for **redemption of preference share**.

The amount of capital reserve cannot be used for **redemption of preference shares.**

If the shares are redeemed out of undistributed profit, the nominal value of share capital, so redeemed should be transferred to **Capital Redemption Reserve Account**. This is also known as **capitalization of profit otherwise available for dividend**.

- A company can issue the preference shares which from the very beginning are redeemable on a fixed date or after certain period of time not exceeding 20 years provided it comprises of following conditions:-
 - It must be authorised by the articles of association to make such an issue.
 - A company cannot redeem preference share unless and until it is fully called and paid up. In other words, partly paid up shares **cannot be redeemed**.
 - The redeemable preference shares must be fully paid up. If there is any partly paid share, it should be converted in to fully paid shares before redemption. These shares will be redeemable only if they are fully paid up.
- ❖ **A redeemable preference share can be redeemed either -----**
- Entirely out of fresh issue of new preference / equity shares (but not debentures) **or**
 - Entirely out of divisible profits **or**
 - Partly out of fresh issue and partly out of divisible profits.

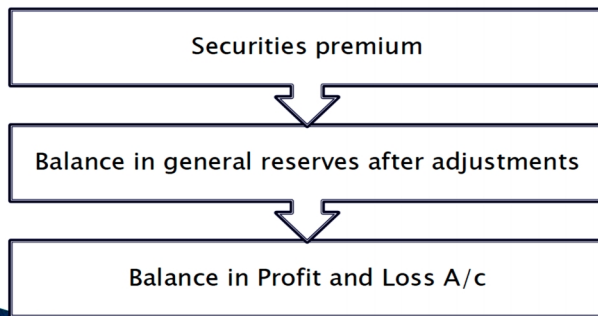
Sources used for redemption can be

- Fresh proceeds of new shares
- Divisible profits

Amount of divisible profits transferred to capital redemption reserve + fresh proceeds of new shares cumulatively should be equal to *face value* of preference shares so redeemed.

- These shares can be redeemed only out of 2 source viz. out of the profits of the company which is divisible otherwise would be available for dividends or out of proceeds of new issue of shares made for the purpose of redeem shares i.e. by fresh issue of either equity share capital or preference share capital.
- The premium if any payable on redemption then it must have been provided out of the company's securities premium account or out of the profits of the company before the shares are redeemed. In other word whenever preference shares are redeemed at premium, then premium payable on redemption must be provided out of securities premium A/c, **if available**, or/and any other revenue reserve (divisible profits). (The word **and** is used because if securities premium available and fall short then we will have to use revenue reserve (i.e. divisible profits).

Following order should be used



Premium on redemption can be paid firstly out of securities premium, and then from divisible profits

- According to the companies Amendment Act (1996) company must redeem the redeemable preference share within a period of 20 years from the date of issue such shares.
- When the preference shares are redeemed out of profits, an amount equivalent to nominal value of shares so redeemed must be transferred out of company's divisible profits to a special reserve called "Capital Redemption Reserve Account".
- **In other words** whenever redemption is **fully** out of revenue profits (divisible profits) or **partly** out of revenue profits (divisible profits) **and** partly out of fresh issue, then a sum equivalent to nominal value of preference shares so redeemed out of divisible profits must be transferred to a special reserve called "Capital Redemption Reserve Account".

Capital redemption reserve must be created which would be equal to face value of preference shares so redeemed but reduced by any fresh proceeds of new issue of shares

Fresh Proceeds of new issue of shares means:

- 1. Net amount received from issue of shares after discount.**
- 2. Amount received from issue of shares but excluding securities premium if being received with new issue.**

- This reserve (i.e. CRR) can be used to issue of fully paid bonus shares to the members of the company.
- The redemption of preference share **will not be taken as** reduction of/in the companies authorised share capital.

Irredeemable preference shares means, preference shares need not to be repaid by the company except on winding up of the company. In other word, Irredeemable preference shares, on the other hand, are those preference shares which cannot be redeemed except the event of the company being wound up.

However, presently under the Indian Companies Act, a company **cannot issue irredeemable** preference shares. In fact, a company limited by shares cannot issue preference shares which are redeemable after more than 20 years from the date of issue. In other words the maximum tenure of preference shares is only 20 years. If a company is unable to redeem any preference shares within the specified period, it may, with consent of the Company Law Board, issue further redeemable preference shares equal to redeem the old preference shares including dividend thereon.

b) Convertible and Non-convertible preference shares

Where the preference shareholders are given a right to convert their holding into ordinary equity shares, **however** this option can be availed only after a prescribed period, such shares as known as convertible preference shares. The holders of non-convertible preference shares have no such right of conversion. The holders of these shares do not enjoy the right to get the shares converted into equity shares. Unless otherwise stated, all preference shares are non-convertible.

c) Participating and Non-participating Preference Shares

The holders of participating preference shares have a right to participate in the surplus profits of the company if any remained after paying dividend to the ordinary shareholders (as per the rate fixed in AGM) and preference shareholders at a fixed rate.

The preference shares which do not have such right to participate in surplus profits, are known as non-participating preference shares.

Advantages of Preference shares

1. Helpful in raising long term capital for a company.
2. There is no need to mortgage property on these shares.
3. Redeemable preference shares have the added advantages of repayment of capital whenever there is surplus in the company.
4. Rate of return is guaranteed.

Disadvantages of Preference shares

1. Permanent burden on the company to pay a fixed rate of dividend before paying anything on the other shares.
2. Not advantageous to investors from the point of view of control and management as preference shares do not carry voting rights.
3. Compared to other fixed interest bearing securities such as debentures, usually the cost of raising the preference share capital is higher.

Divisible profits of company would include (i.e. profit which is available for payment of dividend or which is free for any use):-

- _ General Reserves
- _ Revenue Reserves
- _ Dividend Equalisation Reserve/fund
- _ Profit/Loss Account (cr. Bal.)
- _ Reserve Fund
- _ Voluntary debenture Sinking Fund
- _ Voluntary debenture redemption reserve/fund
- _ Insurance Fund
- _ Workmen's Compensation Fund
- _ Workmen's Accident Fund
- _ Investment Fluctuation Fund

Free reserves

. Does not include securities premium, revaluation reserve, capital reserve not received in cash.

Divisible profits (simplified)

(That profit with the help of which dividends can be paid by the company or which is free to use for any purpose. For e.g.)

- General reserve
- Profit & Loss A/c (cr. Balance)
- Dividend equalisation reserve
- *Capital reserves if received in cash*
- Any other reserve with the help of which dividend can be paid as mentioned above.

Capital profits of company which cannot be used for the purpose of redemption would include *(non-divisible profits / non-free reserves means not free for any use i.e reserved for specific purpose only)*: -

- _ Capital Redemption Reserve (CRR) (old as well as new)
- _ Securities Premium A/c
- _ Shares forfeited A/c
- _ Profit prior to incorporation
- _ *Capital Reserve not received in cash*
- _ Debenture redemption reserve/fund
- _ Development rebate reserve
- _ Revaluation Reserve
- _ Statutory Reserve

After redemption the capital base of company must remain same as it was prior to redemption.

- _ When company redeems preference shares out of divisible profits, the amount of revenue profit so used should be immediately transferred to CRR A/c.
- _ a preference share may be redeemed either at par or at premium.
- _ Premium on redemption of preference share represents, "Capital Loss". It is to be immediately set off first out of securities premium and then out of any other, "Divisible Profits".

More descriptions for simplifications

Preference shares represent partial ownership in a company.

Preference Shares will carry preferential (cumulative) right to dividend, at coupon rate, when declared.

The dividend will be calculated on pro rata basis i.e. from the date of allotment of such Preference Shares.

Preference shareholders always receive their dividends first.

Preference shareholders do not enjoy any of the voting rights.
 Preference shareholders have a greater claim on the company's assets than common stockholders.
 The Preference Shares will have the maximum redemption period of 20 years only.
 Only fully paid up Preference Shares will be redeemed.
 The redemption of Preference Shares will not be taken as reduction in the Authorised Share Capital of the Company.
 The Preference Shares will be redeemed at par/ at a premium.
 If the Preference Shares are redeemed at a premium, premium will be provided either out of Securities Premium A/c or Profit and Loss A/c
 Where any Preference Shares are redeemed out of profits otherwise available for dividend, then a sum equivalent to the nominal value of the Preference Shares redeemed, will be transferred to the "Capital Redemption Reserve A/C".
 Where any Preference Shares are redeemed by issuing of new shares, it must be redeemed within 1 month from the date of issue of new shares & it will not be considered as increase of Authorised Share Capital.

Capital Redemption Reserve (CRR) A/C

It is created when a company redeems preference shares or buy-back its own shares which reduces share capital.
 It is created with the sum equivalent to the nominal value of the Preference Shares to be redeemed out of profits otherwise available for dividend.
 Due to its creation the share capital is not reduced after redemption:- CRR A/C is converted into Share Capital.
 $\text{Capital before Redemption} = \text{Capital after Redemption} + \text{CRR A/C}.$
 Is not distributed among the shareholders.
 Used only for issue of fully paid up bonus shares.

REDEMPTION OF PREFERENCE SHARE

Methods Are:

Alternative-1 Redemption out of profit otherwise available for dividends
 Alternative-2 Redemption by issuing new equity or preference shares
 Alternative-3 Redemption partly out of available profit otherwise available for dividends & partly by issuing new shares
Important Note: A company has no right to sales its assets or issues debentures to redeem its preference shares.

SOURCES OF REDEMPTION:

There are only two sources out of which preferences share capital can be redeemed. One is fresh issue of either preference share or equity share capital and the another is out to shareholders as dividend. Some of the divisible profits are:

General reserve A/c
 Profit & Loss account A/c (credit balance)
 Dividend Equalisation fund/reserve A/c
 etc.

CAPITAL REDEMPTION RESERVE:

There are only two sources out of which, preference share can be redeemed. One is fresh issue of either preference share capital or equity share capital and another is out of divisible profits. When the preference share are to be redeemed out of profits, an amount equivalent to the nominal value of shares so redeemed must be transferred out of company's divisible profit to a special reserve called " Capital Redemption Reserve (C.R.R.) Account". It can't be used for any other purpose except issuing fully paid bonus shares to the equity shareholders. The main objective of this provision is to safeguard the interest of the creditor from the ill effects of reduction of capital due to redemption of preference capital.

USE OF C.R.R. ACCCOUNT:

The amount transferred in the capital Redemption Reserve cannot be used for any other purpose except for the issue of bonus shares to the equity shareholders.

REDEMPTION DOES NOT CONSTITUTE REDUCTION:

Redemption of the preference shares by the company shall not be taken as reducing the amount of its authorised shares capital.

POWER TO ISSUE NEW SHARES:

If the company redeems any of its preference shares, then the company gets power to issue new shares to their existing shareholders. The company can issue fully paid bonus shares to equity shareholders up to the face value or nominal value of shares so redeemed.

If there are two types of redeemable preference share i.e. one is fully paid up and other is partly paid up then: If it is given that both classes of preference shares are to be redeemed then firstly, convert the partly paid up by making final call.

If it is given that only fully paid up preference shares are to be redeemed then only fully paid up preference shares are to be redeemed.

In case minimum bank balance to be maintained then firstly prepared bank account to find out number of fresh shares to be issued.

In case preference shareholders are not traceable then the amount payable to them shown on the liability side of the balance sheet under the head current liabilities.

Balance of CRR will be shown in the balance sheet under the head reserve and surplus until and unless CRR used for the purpose of bonus shares.

Premium on redemptions of preference shares can be written off against/out of:

Securities premium A/C (existing balance of sec. prem. a/c as well as sec. prem. received on fresh issue)

And still if there is short fall then out of credit balance of profit and loss A/C and general reserve A/C.

CRR can be created out of credit balance of general reserve, dividend equalisation fund/reserve, profit & loss A/C, and any other free reserve.

BONUS SHARES

Shares without cost for which nothing is paid by shareholders.

Issued to only existing shareholders [old + new issue for redemption].

Issued in a ratio of the shares an investor holds.

Usually announced by the company with a record date.

Usually gives bonus shares as a substitute of dividend payouts.

The face value of the share doesn't get change after bonus.

Bonus shares increases the number of shares in the market which leads to the reduction in earning per shares (EPS).

WHY BONUS SHARES

Company has more accumulated reserve than normal requirement.

Accumulated Reserve > Normally Necessity.

Company shares this Excess Reserve with their Existing Shareholders in the form of Bonus Shares.

Company is not in position to pay Cash Bonus or Dividend due to Insufficient Cash.

Cash Bonus affects the Working Capital & future plans of Capitalisation.

Issued Capital is Increased.

Assets remains Intact.

Liquidity of the company is not affected.

CAPITALIZATION OF PROFIT

By issuing bonus shares to current shareholders in proportion to their shareholdings.

By making partly paid shares as fully paid without getting cash from the shareholders.

By issuing a stock dividend.

Above activity leads to conversion of Retained Earnings into its Paid-Up Capital.

and Profits or Reserves becomes the part of issued capital.

METHODS OF ISSUING BONUS SHARES

Alternative-1

Capitalisation of Profit by Issuing Bonus Shares.

Issuing of FREE Fully Paid Shares as Bonus Shares.

Alternative-2

Capitalisation of Profit by Without Issuing Bonus Shares

Making Partly Paid Shares as Fully Paid without getting Cash from the shareholders.

Following are the journal entries in the books of the companies.

First of all see whether the redeemable preference shares are fully or partly paid up. If partly paid up, pass the following journal entries to make them eligible for redemption because only fully paid shares can be redeemed.

Preference Shares Final Call A/c Dr.
 To Preference Share Capital A/C.

Bank A/c Dr.
 To Preference Shares Final Call A/c.

Entry for sale of investments OR to take the Bank Loan for redemption::

Bank account Dr.
Profit & Loss A/c Dr. (if loss on sale of investments)
 To investments A/c
 To Bank Loan A/c
 To Profit & Loss A/c (if profit on sale of investments)

Entry for Amount due for redemption::

When preference shares are redeemed at par-----

Redeemable Preference Share Capital A/c. Dr.
 To Preference Shareholders A/c

When preference shares are redeemed at a premium-----

Redeemable Preference Shares Capital A/c. Dr. (with face value)
Premium on Redemption of Preference Shares A/c. Dr. (with premium to be paid on redemption)
 To Preference Shareholder A/c (total amount to be paid on redemption)

Entry for Issue of Equity Shares to collect the amount for redemption and for premium::

Bank A/c. Dr. (with amount actually received)
Discount on Issue of Shares Dr. (if shares are issued at discount)
 To Equity Shares Capital A/c (with face value of shares issued)
 To Securities Premium A/c (if shares are issued at premium)

(Being the issue of....shares of Rs... each for the purpose of redemption of preference shares, as per Board's Resolution No....dated.....).

(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.....)

(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...)

Entry for payment of redemption Premium by the following entry / For adjustment of premium on redemption:

Securities Premium A/c	Dr.
Profit & Loss A/c	Dr.
General Reserve A/c	Dr.
To Premium on Redemption of Preference Shares A/C.	

Entry for transfer of amount to CRR by passing the following entries:

General Reserve A/c	Dr.
Profit & Loss A/c	Dr.
To Capital Redemption Reserve A/c.	

Entry for payment to preference shareholders:

Preference Shareholders A/c	Dr.
To Bank A/c	

Entry for Issue of New shares for the payment to preference shareholders:

Preference Share Capital A/c	Dr.
To New Share Capital A/c	

Entry for issue of Bonus Shares

In such a case the following entries will be passed

When decision is taken to issue bonus share:

Capital Redemption Reserve A/c	Dr.	
Securities Premium A/c	Dr.	
Any Other Reserve	Dr.	(Specified mentioned in the question)
To Bonus to Equity Shareholders A/c		

When issue of bonus shares is made:

Bonus to Equity Shareholders A/c	Dr.
To Equity Share capital A/c	

When partly paid up shares are made fully paid shares by bonus issue.

In such a case the following journal entries will be passed: (in the beginning only):

1. Shares Final Call A/c	Dr.
To Share capital A/c	

2. Capital Redemption Reserve A/c	Dr.
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Securities Premium A/c	Dr.	
Any Other Reserve	Dr.	(Specified mentioned in the question)
To Bonus to Equity Shareholders A/c		

When issue of bonus shares is made:.....

Bonus to Equity Shareholders A/c	Dr.
To Equity Share Final call A/c	

ACCOUNTING TREATMENT OF BONUS SHARES

☐ Declaration of bonus from Profits and Reserves of LAST YEAR

On Declaration of Bonus Shares:-

Capital Redemption Reserve A/C	Dr.
Capital Reserve A/C	Dr.
Securities Premium A/C	Dr.
General Reserve A/C	Dr.
P&L Appropriation A/C	Dr.
To Bonus to Shareholders A/C	

☐ Declaration of bonus from Profits and Reserves of LAST YEAR

On Issue of Bonus Shares at PAR :-

Bonus to Shareholders A/C	Dr.
To Equity Share Capital A/C	

On Issue of Bonus Shares at PREMIUM :-

Bonus to Shareholders A/C	Dr.
To Equity Share Capital A/C	
To Securities Premium A/C	