

Buy Back of securities by private limited and unlisted public limited companies

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APPLICABILITY

These rules shall be applicable to buy-back of equity shares or other specified securities of a Private Limited Company and Unlisted Public Limited Company i.e. not listed on any recognized stock exchange.

MEANING OF BUY BACK

Buy back of securities simply implies purchase of its own shares by the Company. Till the issue of these Rules, buy back of shares was prohibited under the law and by introducing section 77A by Companies (Amendment) Act, 1999, effective from 31.10. 1998. The Company generally resorts to it for the following reasons :

- 1) to enhance the true or intrinsic value of its shares.
- 2) to return surplus cash to its shareholders.
- 3) to achieve desired capital structure.

The buy-back of the shares or other specified securities, if listed on a stock exchange, shall be carried out in accordance with the Regulations framed by the SEBI.

However, in the case of securities of unlisted companies, the buy-back shall be done as per the guidelines framed by the Central Government.

Securities includes:

- i) shares, scrips, stocks, bonds, debentures, debentures stock or other marketable **hybrid** securities of a like nature in or of any incorporated company or other body corporate;
- ii) derivative;
- iii) units or any other instruments issued by any collective investment scheme to the investors in such schemes;
- iv) Government securities;
- v) Such other instruments as may be declared by the Central Government to be securities: (not so far) and
- vi) Rights or interest in such securities.

“**Hybrid** means any security which has the character of more than one type of securities, including their derivatives”.

FUNDS FOR FINANCING BUY BACK

A Company may buy back its own shares by utilising the money only out of the following heads:

- Free reserves;
- The proceeds of any issue of shares or specified securities other than proceeds of an earlier issue of the same kind of shares or same kind of specified securities which are proposed to be bought back;
- Cash reserves of the Company. However, the money borrowed from Banks/Financial Institutions can not be utilised for the same.

MEANING OF FREE RESERVES

Free reserves mean those reserves which as per the latest audited Balance Sheet are free for distribution of dividend and shall include the amount to the credit of securities premium account and balance kept in the Profit and Loss Account. The share application amount and revaluation reserve will not form part of free reserve.

CONDITIONS TO BE FULFILLED BEFORE BUY BACK

Section 77A(2) provides that no Company shall purchase its own shares unless the following conditions are met:

- (a) There must be a specific provision in the Articles of Association authorising the Company to buy back its own shares, otherwise the Articles must be amended by a special resolution to incorporate a suitable provision. Special resolution must also be passed in the General Meeting authorising Board of Directors to buy-back the shares of the Company or other specified securities. However no special resolution in General Meeting is required in case the buy-back is of or less than 10% of the total paid up equity capital and free reserves of the Company and the same is authorised by way of a resolution passed at a duly convened Board Meeting.

- (b) The quantum of buy back could be upto **25% of paid up capital and free reserves** provided the buy back of the equity shares in any financial year shall not exceed **25% of its total paid up equity capital in that financial year.**
- (c) The company shall after the buy-back ensure that the debt of the Company viz., the amount of secured and unsecured debts shall not be more than twice the paid up capital and free reserves. It is open, however, for the Central Government to prescribe a higher ratio of debt for any class or classes of Companies.
- (d) All the shares or other specified securities involved in buy-back must be fully paid-up.
- (e) The explanatory statement sent to members along with the notice for passing the special resolution referred to in clause (a) above shall, inter-alia, set out the following particulars:
- A full and complete disclosure of all material facts ;
 - The necessity for the buy-back ;
 - The class of security proposed to be bought back ;
 - The amount involved in the buy-back ;
 - An indication of time limit for completion of buy-back. In any case, the buy-back should be completed within 12 months from the date of passing the special resolution.
- (f) The Company shall make no offer of buy-back within a period of 365 days reckoned from the date of the preceding offer of buy-back, if any. Further the Company can not come out with a fresh issue of shares of the same class within a period of 6 months except by way of bonus issue or in the discharge of subsisting obligations such as conversion of warrants, Stock options schemes, sweat equity or conversion of preference shares or debentures into equity shares.

MANNER OF MAKING BUY-BACK

The buy-back may be made as follows:

- (a) From the existing shareholder holders on a proportionate basis through private offers.
- (b) By purchasing the securities issued to employees of the Company pursuant to a scheme of stock option or sweat equity.

The buy-back under sub-section(1) may be-

- (a) from the existing security-holders on a proportionate basis;
- (b) from the open market
- (c) from odd lots, that is to say, where the lot of securities of a public company, whose shares are listed on a recognised stock exchange, is smaller than such marketable lot, as may be specified by the stock exchange
- (d) by purchasing the securities issued to employees of the company pursuant to scheme of stock option or sweat equity.

CIRCUMSTANCES WHERE BUY-BACK IS NOT ALLOWED

No Company shall directly or indirectly purchase its own shares: -

(Section 77 B)

- Through any subsidiary Company or its own subsidiaries if any;
- Through any investment Company or companies;

- If the Company commits a default in the repayment of deposit or payment of interest, redemption of debentures or preference shares or payment of dividend to any shareholder or repayment of term loans or payment of interest to any financial institution which is subsisting;

The idea seems to be to stop accumulation of its shares by indirect means.

- Where a Company has not complied with the provisions of sections:
 159 regarding Annual Return
 207 regarding failure to pay dividend within 30 days of declaration; and
 211 regarding disclosure of true and fair view in the Balance Sheet. Sub-section 211(3A) requires that every company's profit & Loss account and balance sheet shall comply with the accounting standards.

There should be no subsisting default by the Company in payment of-

- i) any deposit or interest due thereon
- ii) redemption of debentures or preference shares
- iii) payment of dividend
- iv) any term loan or interest thereon to any financial institution or bank.

SECURITIES NOT PURCHASABLE

- a) partly- paid securities
- b) securities which are subject to lock-in period or otherwise non- transferable.
- c) Securities held by promoters or persons in control of the company, if the buy-back is through stock exchange.

PROCEDURAL FORMALITIES

The process of Buy-back, inter-alia, includes the following steps to be taken up by the Company:

1. A Board resolution should be passed at a duly convened Board meeting authorising buy-back and approving the draft notice for convening Extra-ordinary General Meeting to pass the necessary resolution(s) and amending Articles of Association, if required.
 2. Notice convening EGM should be sent to each and every shareholder entitled to receive and attend the general meeting along with an explanatory statement containing prescribed particulars.
 3. Necessary resolution(s) should be passed at the Extra-ordinary General Meeting of the members of the Company authorising the Company to buy-back its own shares / securities and amending Articles of Association, if required.
 4. As soon as the Company has passed the special resolution for buy-back and before making the buy-back, the Company shall file with the Registrar of Companies the following forms/ documents:
- Form No 23 pursuant to Section 192 of the Act.
 - Declaration of Solvency in Form No 4A signed by two directors including the Managing Director, if any of the Company and duly verified by way of an affidavit.
 - A draft letter of Offer containing prescribed particulars. On filing of the same the offer becomes irrevocable on the part of the Company.

5. Letter of offer, shall be sent to the shareholders of the Company, within 21 days of filing of draft letter of offer with the ROC.
6. The letter of offer should contain inter alia the following :-
 - true factual and material information;
 - no misleading information;
 - a statement that the directors of the company accept the responsibility for the information contained in it.
7. No shares including bonus shares shall be issued till the date of the closure of the offer of buy-back of shares.
8. Confirm in the letter of offer the opening of a separate bank account testifying the availability of funds earmarked for it and also about payment of consideration only by way of cash or Bank Draft/pay order.
9. Once the draft letter of offer has been filed with the Registrar of Companies, it shall not be withdrawn.
10. Any money borrowed from Banks/Financial Institutions shall not be used for the purpose of buying back the company's shares.
11. The offer should remain open for a period not less than 15 days and not exceeding 30 days from the date of despatch of letter of offer.
12. The Company shall complete the verification of the offers received from the shareholders within 15 days from the date of closure of offer and the shares lodged shall be deemed to be accepted unless shareholders are communicated otherwise within 21 days from the closure of the offer.
13. In case of the number of shares offered by the shareholders is more than the total number of shares to be brought back by the company, see that the acceptance per shareholder is made on proportionate basis.
14. The Company should make arrangement to ensure that payment is made to the shareholders within 7 days of the time specified in clause 12, supra, by opening a special bank account, immediately after the closure of offer.
15. The share certificates should be extinguished and physically destroyed by the Company within 7 days of acceptance of shares. And a certificate to this effect shall be filed with ROC duly verified by two whole time directors including Managing Director, if any and a Company Secretary in whole time Practice within 7 days of the extinguishment and destruction of share certificates.
16. As soon as the buy-back is complete the Company shall file with The Registrar of Companies within 30 days of such completion a return containing prescribed particulars called return of buy-back.
17. The Company should maintain a Register of Shares Bought Back by the Company in the prescribed form.

ESCROW ACCOUNT:

Deposit in an escrow account, on or before the opening of the offer the following sum by way of security for performances of obligations by the company under the Regulations:

- (a) if the consideration payable does not exceed Rs 100 crores ; 25% of the consideration payable;
- (b) if the consideration payable exceeds Rs.100 Crores ; 25% on 100 crores and 10% thereafter.

MODE OF PAYMENT TO ESCROW ACCOUNT

The escrow account can consist of either cash deposited with a scheduled commercial bank or bank guarantee in favour of a merchant banker or deposit of acceptable securities with appropriate margin with the merchant banker or a combination of the above.

If the company has deposited the specified sum in an escrow account with a scheduled commercial bank then while opening the account, empower the Merchant banker to instruct the Bank to issue a Banker's cheque or Demand Draft for the amount lying to the credit of the escrow account.

If the escrow account consist of a bank guarantee, the said bank guarantee shall be in favour of the merchant banker which will be valid until thirty days after the closure of the offer.

If the escrow account consist of securities, then empower the merchant banker to realize the value of such escrow account by sale or otherwise.

OPENING SPECIAL ACCOUNT

A special account has to be opened with the bankers , immediately after the date of closure of the offer and deposit therein such sum due as would together with the amount lying in the escrow account make up the entire sum due and payable as consideration for buy-back in terms of Regulations and for this purpose the company may transfer the funds from the escrow account.

Make payment of consideration in cash, within 21 days from the closure of the offer, to those shareholders whose offer has been accepted.

EXTINGUISHMENT OF SHARE CERTIFICATES BOUGHT BACK

The certificates of shares bought back by the company must be extinguished and physically destroyed in the presence of a Company secretary or the Statutory Auditor of the company within seven days from the date of acceptance of the shares.

In case the shares offered for buy-back by the company have already been dematerialized then extinguish and destroy them in the manner specified under Securities and Exchange Board of India (Depositories and Participants) Regulations, 1996 and the bye-laws framed therein.

The company has to furnish to the stock exchanges where shares of the company are listed, the particulars of shares certificates extinguished and destroyed within seven days of such extinguishment and destruction of the certificates.

MAINTENANCE OF RECORD

A record of share certificates which have been cancelled and destroyed as prescribed in sub-section (9) of section 77A of the Companies Act 1956 has to be maintained in Form 4C of the Companies (Central Government's) General Rules & Forms, 1956.

- ✓ Filing of Return of Buyback with ROC and SEBI in Form No. 4C, within 30 days of its completion.

CONSEQUENCES FOR NON COMPLIANCE

If a company makes default in complying with the provisions of this section or rules made there under, or any regulation made under clause (f) of Sec.77A(2), the company and any officer, who is default, shall be punishable with imprisonment for a term which may extend to two years or with fine which may extend to Rs.50,000 /- or with both.

ACCOUNTING TREATMENT

TRANSFER TO CAPITAL REDEMPTION RESERVE ACCOUNT

Where a company purchases its own shares out of free reserves, then a sum equal to the nominal value of the shares purchased shall be transferred to the Capital Redemption Reserve (referred to in section 80(1) clause (d) & proviso) Account and details of such transfer will be shown in the balance sheet.(Sec.77 AA)

The accounting entry is

- (i) In case investment are sold for buying back of own shares :
 Bank **Dr**
 To Investment Account
 (The difference if any will be credited to Profit on sale of Investment Account or debited to Loss on sale of Investment Account, which in turn will be transferred to profit & loss account)
- (ii) In case the proceeds of fresh issues are used for buy-back purpose, then on fresh issue.
 Bank **Dr**
 To Debentures/other Investments Account
 To Securities Premium Account(if any)
- (iii) For buying back of shares:
 Equity Shareholder's Account **Dr**
 To Bank
- (iv) For cancellation of shares bought back:
 Equity Share Capital Account **Dr** (with the nominal value of shares bought Back)
 Free Reserves/Securities Premium Account **Dr** (with the excess amount / premium Paid over nominal value)
 To Equity Shareholder's Account (with the amount paid)
- (v) In case the shares are bought back at a discount:
 Equity Share Capital Account **Dr** (with the nominal value)
 To Equity Shareholders' Account (with the amount paid)
 To Capital Reserve Account (with the amount of discount on buy-back)
- (vi) For transfer of nominal value of shares purchased out of free reserves/securities premium to Capital Redemption Reserve Account:

Free Reserves Account **Dr** (with the amount transferred)
Securities premium Account **Dr** (with the amount transferred)

To Capital Redemption Reserve Account (with the nominal value of shares
bought back)

(vii) For expenses incurred in buy-back of shares:

Buy-back Expenses **Dr** (with the amount)
To Bank

(viii) For transfer of buy-back expenses:

Profit & Loss Account **Dr**
To Buy-back Expenses

The expenses incurred on the buy back formalities eg. Fees of advisers, filing fees , merchant bankers, cost of paper announcements etc. If these expenses are set off against the current Profit & Loss Account of the Company, it would help in claiming these expenses as revenue items for tax deduction purpose. Another alternative is to amortise over a period of 5 years this expenses and carry forward the expenditure in the Balance Sheet as a deferred revenue expenditure till it is fully written off.

EFFECT OF BUY-BACK ON EARNING PER SHARE

Whenever a Company resorts to buy-back, the basic idea underlying is that its own shares represent the best investment opportunity available. Thus those who continue to hold the shares of the Company find that their percentage of holding goes up because as a result of buy-back the total number of outstanding shares, reduced. Further the Earning per share also goes up because the cake is now divided among fewer people. Thus the value of shareholders holding goes up without making any additional investment.

Section 2(22) of Income Tax Act, 1961 (as amended) defines as “ Dividend “ includes inter alia :

- a) any distribution by a company of accumulated profits, whether capitalised or not, if such distribution entails to release by the company to its shareholders of all or any part of the assets of the company.
- b) any distribution to its shareholders by a company of debentures etc. , whether with or without interest.
- c) Any distribution made to shareholders of a company on its liquidation , to the extent to which it is attributable to the accumulated profits of the company.
- d) Any distribution to its shareholders on the reduction of its capital . to the extent to which the Company possess accumulated profits whether capitalised or not.

But “ dividend “ does not include:

As per section 22 (iv) of the Act (as amended), any payment made by a company on purchase of its own shares from a shareholder in accordance with the provisions of section 77A of the Companies Act, 1956.

Thus buy back of shares and securities does not tantamount to distribution of dividend to shareholders.

- **TAX ON DISTRIBUTED PROFITS OF DOMESTIC COMPANIES**

Section 115 O of the Act says that, in addition to the income- tax chargeable in respect of the total income of a domestic company for any assessment year, any amount declared, distributed or paid by such company by way of dividends on or after the 1st April, 2003, whether out of current or accumulated profits shall be charged to additional income-tax at the rate of twelve and one- half per cent.

The Principle officer of the company shall be liable to pay the tax on distributed profits to the credit of the Central Government within fourteen days from the date of:

- a) declaration of any dividend
- b) distribution of any dividend
- c) payment of any dividend

whichever is earliest

As regards expenses incurred in the buy back process, judicial pronouncements are not clear with some holding that expenses are of revenue nature whereas others have advocated as capital nature. Infact, it is for the Company to present its stand about the usefulness of the buy back and claim the expenses as they deem best in their interest.

Once the buy back process is complete, the shares are cancelled. Buy back does not result into a transfer and hence, no stamp duty if payable. It is neither a transfer nor a release as per Indian Stamp Act.

CAPITAL GAIN

Section 46A of the Income Tax Act, 1961 (as amended) says that where a shareholder or a holder of other specified securities receives any consideration from any Company for purchase of its own shares or specified securities held by such shareholders or holder of other specified securities, then, subject to the provisions of section 48, the difference between the cost of acquisition and the value of consideration received by the shareholders or the holders of other specified securities, as the case may be, shall be deemed to be the capital gains arising to such shareholders or the holders of other specified securities, as the case may be, in the year in which such shares or other specified securities were purchased by the company.

- **CONCLUSION**

Thus buy-back is a procedure, which enables the Company to go back to its shareholders and offer to purchase from them the shares that they hold. The decision to buy-back reflects management's view that the Company's future prospects are good and hence investing in its own shares is the best option. It also signals undervaluation of the Company's shares in

relation to its intrinsic value. It appears that only financially sound companies should be able to resort to buy-back. Companies should follow the principles of model corporate governance and there should be transparency in buy-back deals.