

# BUY-BACK OF SECURITIES AND EQUITY SHARES WITH DIFFERENTIAL RIGHTS



## LEARNING OUTCOMES

**After studying this chapter, you will be able to:**

- ❑ Understand the meaning of buy-back of securities and Accounting Treatment thereof.
- ❑ Comprehend the concept of equity shares with differential rights and Describe the procedure for issuing equity shares with differential rights.
- ❑ Learn the provisions of the Companies Act regarding buy-back of securities and equity shares with differential rights.
- ❑ Differentiate between the two types of share capital and their differing voting rights.

**CHAPTER OVERVIEW****Buy-Back of Shares**

- As per Section 68 (1) of the Companies Act 2013, buy-back of shares can be made out of: its free reserves; or the securities premium account; or the proceeds of any shares or other specified securities.
- The buy-back of equity shares in any financial year shall not exceed twenty-five per cent of its total paid-up equity capital in that financial year.
- There shall be a minimum gap of one year in a buy-back offer from the date of closure of the previous buy-back.
- The ratio of the debt owed by the company is not more than twice the capital and its free reserves after such buy-back.

**Equity Shares with Differential Rights**

- As per the Companies Act 2013, companies can issue equity shares with differential rights subject to the fulfilment of certain conditions. Rule 4 under Companies (Share Capital and Debentures) Rules, 2014 deals with equity shares with differential rights.
- Differentiation can be done by giving a superior dividend / Superior voting right / diluted voting right to a class of equity shareholders.
- Preference shares are not issued with differential rights. It is only the equity shares, which are issued.

**1. BUY-BACK OF SECURITIES****1.1 Introduction**

Buy-back of shares means purchase of its own shares by a company. When shares are bought back by a company, they have to be cancelled by the company. Thus, shares buy-back results in decrease in share capital of the company. A company cannot buy its own shares for the purpose of investment. A company having sufficient cash may decide to buy-back its own shares. The following may be the objectives/advantages of Buy-back of shares:

- (a) to increase earnings per share if there is no dilution in company's earnings as the buy-back of shares reduces the outstanding number of shares.
- (b) to increase promoters holding as the shares which are bought back are cancelled.
- (c) to discourage others to make hostile bid to take over the company as the buy-back will increase the promoters holding.
- (d) to support the share price on the stock exchanges when the share price, in the opinion of company management, is less than its worth, especially in the depressed market.
- (e) to pay surplus cash to shareholders when the company does not need it for business.

The Companies Act, 2013 under Section 68 (1) permits companies to buy-back their own shares and other specified securities out of:

- (i) its free reserves; or
- (ii) the securities premium account; or
- (iii) the proceeds of the issue of any shares or other specified securities.

Note: No buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities. For example, if equity shares are to be bought-back, then, preference shares may be used for the purpose.

The other important provisions relating to the buy-back are:

- (1) Section 68 (2) further states that no company shall purchase its own shares or other specified securities unless—
  - (a) the buy-back is authorised by its articles;
  - (b) a special resolution has been passed in general meeting of the company authorising the buy-back;

However, the above provisions do not apply where the buy-back is ten percent or less of the paid-up equity capital + free reserves and is authorized by a board resolution passed at a duly convened meeting of the directors. Hence, in case the buy-back is up to 10% of paid up equity + free reserves, the same may be done with the authorization of the Board Resolution without the necessity of its being authorized by the

articles of association of the company and by a special resolution of its members passed at a general meeting of the company.

- (c) the buy-back must be equal or less than twenty-five per cent of the total paid-up capital and free reserves of the company: (Resource Test)
- (d) Further, the buy-back of shares in any financial year must not exceed 25% of its total paid-up capital and free reserves: (Share Outstanding Test)
- (e) the ratio of the debt owed by the company (both secured and unsecured) after such buy-back is not more than twice the total of its paid-up capital and its free reserves: (Debt-Equity Ratio Test)

Note: Central Government may prescribe a higher ratio of the debt than that specified under this clause for a class or classes of companies. Debt here should include both long-term debt as well as short term debt.

- (f) all the shares or other specified securities for buy-back are fully paid-up;
- (g) the buy-back of the shares or other specified securities listed on any recognised stock exchange is in accordance with the regulations made by the Securities and Exchange Board of India in this behalf;
- (h) the buy-back in respect of shares or other specified securities other than those specified in clause (f) is in accordance with the guidelines as may be prescribed.

Provided that no offer of the buy-back under this sub section shall be made within a period of one year reckoned from the date of closure of a previous offer of buy-back if any. This means that there cannot be more than one buy-back in one year.

- (2) The notice of meeting at which special resolution is supposed to be passed must be accompanied by an explanatory statement stating-
  - (a) a full and complete disclosure of all material facts;
  - (b) the necessity of the buy-back;
  - (c) the class of security intended to be purchased under the buy-back;
  - (d) the amount to be invested under the buy-back;
  - (e) the time limit for completion of the buy-back.

- (3) Every buy-back shall be completed within twelve months from the date of passing the special resolution, or the resolution passed by the board of directors.
- (4) The buy-back may be—
  - (a) from the existing security holders on a proportionate basis; or
  - (b) from the open market; or
  - (c) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.
- (5) Where a company has passed a special resolution under clause (b) of Sub-section (2) to buy-back its own shares or other securities under this section, it shall, before making such buy-back, file with the Registrar and the Securities and Exchange Board of India a declaration of solvency in the form as may be prescribed and verified by an affidavit to the effect that the Board of Directors has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year of the date of declaration adopted by the Board of Directors. It must be signed by at least two directors of the company, one of whom shall be the managing director, if any:  

Note: No declaration of solvency shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.
- (6) Where a company buys-back its own securities, it shall extinguish and physically destroy the securities so bought-back within seven days of the last date of completion of buy-back.
- (7) Where a company completes a buy-back of its shares or other specified securities under this section, it shall not make further issue of same kind of shares (including allotment of further shares under clause (a) of Sub-section (1) of Section (62) or other specified securities within a period of six months except by way of bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock option scheme, sweat equity or conversion of preference shares or debentures into equity shares.
- (8) Where a company buy-back its securities under this section, it shall maintain a register of the securities so bought, the consideration paid for the securities bought-back, the date of cancellation of securities, the date of extinguishing

and physically destroying of securities and such other particulars as may be prescribed.

- (9) A company shall, after the completion of the buy-back under this section, file with the Registrar and the Securities and Exchange Board of India, a return containing such particulars relating to the buy-back within thirty days of such completion, as may be prescribed, provided that no return shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.
- (10) If a company makes default in complying with the provisions of this section or any regulations made by SEBI in this regard, the company may be punishable with a fine which shall not be less than Rs One Lakh but which may extend to three lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for upto 3 years or with a fine of not less than one lakh rupees but which may extend to three lakh rupees or with both.
- (11) Section 69 (1) states that where a company purchases its own shares out of the free reserves or securities premium account, a sum equal to the nominal value of shares so purchased shall be transferred to the Capital Redemption Reserve Account and details of such account shall be disclosed in the Balance Sheet.
- (12) The shares or other specified securities which are proposed to be bought-back must be fully paid-up.
- (13) The Capital Redemption Reserve Account may be applied by the company in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.
- (14) Premium (excess of buy-back price over the par value) paid on buy-back should be adjusted against free reserves and/or securities premium account. Revaluation reserve represents unrealized profit and hence it cannot be used for buy-back of securities.

#### Some Important Terms

- (a) "specified securities" includes employees' stock option or other securities as may be notified by the Central Government from time to time;

- (b) "free reserves" means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend:

Provided that-

- (i) any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or
- (ii) any change in carrying amount of an asset or a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value, shall not be treated as free reserves.

### **1.2 Provisions of Section 70 of the Companies Act 2013**

- (1) No company shall directly or indirectly purchase its own shares or other specified securities—
- (a) through any subsidiary company including its own subsidiary companies; or
  - (b) through any investment company or group of investment companies; or
  - (c) if a default is subsisting, in repayment of deposit or interest payable thereon, redemption of debentures or preference shares or payment of dividend to any shareholder or repayment of any term loan or interest payable thereon to any financial institutions or bank. Provided that the buy-back is not prohibited if the default is remedied and a period of three years has elapsed since the cessation of the default.
- (2) In accordance with schedule III, no company shall directly or indirectly purchase its own shares or other specified securities in case such company has not complied with provisions of Sections 92 (filling of annual return), 123 (payment of dividend within 30 days of declaration), 127 (failure to distribute dividend) and 129 (preparation of financial statement of the company).

*Explanation I.*— For the purposes of Section 68 and Section 70 of the companies Act, 2013 "specified securities" includes employees' stock option or other securities as may be notified by the Central Government from time to time.

*Explanation II.* — For the purposes of Section 68, "free reserves" includes securities premium account.

**NOTE:** In exercise of the powers conferred under section 30 of the Securities and Exchange Board of India Act, 1992, SEBI made Securities and Exchange Board of India (Buy-back of Securities) (Amendment) Regulations, 2013 to amend the Securities and Exchange Board of India (Buy-back of Securities) Regulations, 1998. The important provisions of the new regulations are: (i) No offer of buy-back for fifteen per cent or more of the paid up capital and free reserves of the company shall be made from the open market. (ii) A company shall not make any offer of buy-back within a period of one year reckoned from the date of closure of the preceding offer of buy-back, if any. (iii) The company shall ensure that at least fifty per cent of the amount earmarked for buy-back is utilized for buying-back shares or other specified securities.

### Illustration 1

M Ltd. furnishes the following Balance Sheet as at 31<sup>st</sup> March, 20X1:

Particulars		Notes	₹ (in 000)
	<b>Equity and Liabilities</b>		
<b>1</b>	<b>Shareholders' funds</b>		
A	Share capital	1	5,000
B	Reserves and Surplus	2	6,310
<b>2</b>	<b>Non-current liabilities</b>		
	Long term borrowings	3	400
<b>3</b>	<b>Current liabilities</b>		
A	Trade Payables		40
	<i>Total</i>		11,750
	<b>Assets</b>		
<b>1</b>	<b>Non-current assets</b>		
A	Property, plant and Equipment	4	2,750
B	Non-Current Investments (at cost)		5,000
<b>2</b>	<b>Current assets</b>		
A	Inventories		1,000
B	Trade receivables		2,000
C	Cash and Cash equivalents		1,000
	<i>Total</i>		11,750



**Notes to accounts**

<b>No.</b>	<b>Particulars</b>	<b>₹ in ('000)</b>
<b>1</b>	<b>Share Capital</b>	
	<i>Authorized, Issued and Subscribed Capital:</i>	
	<i>3,00,000 Equity shares of ₹ 10 each fully paid up</i>	<i>3,000</i>
	<i>20,000 9% Preference Shares of 100 each</i>	<i><u>2,000</u></i>
	<i>Total</i>	<i><u>5,000</u></i>
<b>2</b>	<b>Reserves and Surplus</b>	
	<i>Capital reserve</i>	<i>10</i>
	<i>Revenue reserve</i>	<i>4,000</i>
	<i>Securities premium</i>	<i>500</i>
	<i>Profit and Loss account</i>	<i><u>1,800</u></i>
	<i>Total</i>	<i><u>6,310</u></i>
<b>3</b>	<b>Long term borrowings</b>	
	<i>10% Debentures</i>	<i><u>400</u></i>
<b>4</b>	<b>Property, Plant and Equipment (PPE)</b>	
	<i>PPE: Cost</i>	<i>3,000</i>
	<i>Less: Provision for depreciation</i>	<i><u>(250)</u></i>
	<i>Net carrying value</i>	<i><u>2,750</u></i>

The company passed a resolution to buy-back 20% of its equity capital @ ₹ 15 per share. For this purpose, it sold its investments of ₹30 lakhs for ₹ 25 lakhs.

You are required to pass necessary Journal entries.

**Solution**

**Journal Entries in the books of M Ltd.**

**₹ in '000**

	<b>Particulars</b>	<b>Dr.</b>	<b>Cr.</b>
1.	Bank A/c	Dr. 2,500	
	Profit and Loss A/c	Dr. 500	

	To Investment A/c (Being investment sold for the purpose of buy-back of Equity Shares)			3,000
2.	Equity share capital A/c	Dr.	600	
	Premium payable on buy-back	Dr.	300	
	To Equity shares buy-back A/c (Being the amount due on buy-back of equity shares)			900
3.	Equity shares buy-back A/c	Dr.	900	
	To Bank A/c (Being payment made for buy-back of equity shares)			900
4.	Securities Premium A/c	Dr.	300	
	To Premium payable on buy-back (Being premium payable on buy-back charged from Securities premium)			300
5.	Revenue reserve A/c	Dr.	600	
	To Capital Redemption Reserve A/c (Being creation of capital redemption reserve to the extent of the equity shares bought back)			600

**Illustration 2**

Anu Ltd. (a non-listed company) furnishes you with the following balance sheet as at 31<sup>st</sup> March, 20X1:

(in crores ₹)

		Particulars	Notes	₹
		<b>Equity and Liabilities</b>		
<b>1</b>		<b>Shareholders' funds</b>		
	A	Share capital	1	100
	B	Reserves and Surplus	2	300
<b>2</b>		<b>Current liabilities</b>		
	A	Trade Payables		40
		<i>Total</i>		440

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		<b>Assets</b>	
<b>1</b>		<b>Non-current assets</b>	
	A	Property, plant and equipment	3                      -
	B	Non-Current Investments	4                      100
<b>2</b>		<b>Current assets</b>	
	A	Trade receivables	140
	B	Cash and Cash equivalents	200
		<i>Total</i>	440

**Notes to accounts**

<b>No.</b>	<b>Particulars</b>	<b>₹</b>
<b>1</b>	<b>Share Capital</b>	
	<b>Authorized, issued and subscribed share capital:</b>	
	12% Redeemable preference shares of ₹ 100 each, fully paid up	75
	Equity shares of ₹ 10 each, fully paid up	<u>25</u>
	<i>Total</i>	<u>100</u>
<b>2</b>	<b>Reserves and Surplus</b>	
	Capital reserve	15
	Securities premium	25
	Revenue reserves	<u>260</u>
	<i>Total</i>	<u>300</u>
<b>3</b>	<b>Property, Plant and Equipment</b>	
	PPE Cost	100
	Less: Provision for depreciation	<u>(100)</u>
	Net carrying value	<u>NIL</u>
<b>4</b>	<b>Non-Current Investments</b>	
	Non-current investments at cost (Market value ₹ 400 Cr.)	<u>100</u>

The company redeemed preference shares on 1<sup>st</sup> April, 20X1. It also bought back 50 lakhs equity shares of ₹ 10 each at ₹ 50 per share. The payments for the above were made out of the huge bank balances, which appeared as a part of current assets.

You are asked to:

- (i) Pass journal entries to record the above.  
(ii) Prepare balance sheet as at 1.4.20X1.

### Solution

#### Journal entries in the books of Anu Ltd.

₹ in crores

	<b>Particulars</b>	<b>Dr.</b>	<b>Cr.</b>
1 <sup>st</sup> April, 20X1	12% Preference share capital A/c To Preference shareholders A/c (Being preference share capital account transferred to shareholders account)	Dr. 75	75
	Preference shareholders A/c To Bank A/c (Being payment made to shareholders)	Dr. 75	75
	Shares buy-back A/c To Bank A/c (Being 50 lakhs equity shares bought back @ ₹ 50 per share)	Dr. 25	25
	Equity share capital A/c (50 lakhs x ₹ 10) Securities premium A/c (50 lakhs x ₹ 40) To Shares buy-back A/c (Being cancellation of shares bought back)	Dr. Dr. 5 20	25
	Revenue Reserve A/c To Capital Redemption Reserve A/c (75+5) (Being creation of capital redemption reserve to the extent of the face value of preference shares redeemed and equity shares bought back)	Dr. 80	80

**(ii) Balance Sheet of Anu Ltd as at 1.4.20X1**

(in crores ₹)

<i>Particulars</i>		<i>Notes</i>	<i>₹</i>
<b>Equity and Liabilities</b>			
<b>1</b>	<b>Shareholders' funds</b>		
A	Share capital	1	20
B	Reserves and Surplus	2	280
<b>2</b>	<b>Current liabilities</b>		
A	Trade Payables		40
	Total		340
<b>Assets</b>			
<b>1</b>	<b>Non-current assets</b>		
A	Property, plant and equipment	3	-
B	Non-Current Investments	4	100
<b>2</b>	<b>Current assets</b>		
A	Trade receivables		140
B	Cash and Cash equivalents	5	100
	Total		340

**Notes to accounts**

<i>No.</i>	<i>Particulars</i>		<i>₹</i>
<b>1</b>	<b>Share Capital</b>		
	Authorized, issued and subscribed share capital 200 lakhs Equity shares of ₹ 10 each fully paid		<u>20</u>
	Total		<u>20</u>
<b>2</b>	<b>Reserves and Surplus</b>		
	Capital reserve		15
	Capital redemption reserve		80
	Securities premium	25	
	Less: Utilization for buy-back of shares	<u>(20)</u>	5

	Revenue Reserve	260	
	Less: transfer to Capital redemption reserve	<u>(80)</u>	<u>180</u>
	Total		<u>280</u>
<b>3</b>	<b>Property, plant and Equipment</b>		
	PPE: cost		100
	Less: Provision for depreciation		<u>(100)</u>
	<b>Net carrying value</b>		-
<b>4</b>	<b>Non-Current Investments</b>		
	Non-current investments at cost		<u>100</u>
	(Market value ₹ 400 Crores)		
<b>5</b>	<b>Cash and Cash Equivalents</b>		
	Cash and Cash Equivalents as on 31.3.20X1		200
	Less: Bank payment for redemption and buy-back		<u>(100)</u>
	Total		<u>100</u>

**Illustration 3**

Dee Limited (a non-listed company) furnishes the following Balance Sheet as at 31<sup>st</sup> March, 20X1:

(in thousand ₹)

Particulars		Notes	₹
	<b>Equity and Liabilities</b>		
<b>1</b>	<b>Shareholders' funds</b>		
	A Share capital	1	2,700
	B Reserves and Surplus	2	9,700
<b>2</b>	<b>Current liabilities</b>		
	A Trade Payables		1,400
	<i>Total</i>		<u>13,800</u>
	<b>Assets</b>		
<b>1</b>	<b>Non-current assets</b>		
	A Property, plant and Equipment		9,300
	B Non-Current Investments		3,000

<b>2</b>	<b>Current assets</b>		
	A Inventories		500
	B Trade receivables		200
	C Cash and Cash equivalents		800
		<i>Total</i>	<u>13,800</u>

**Notes to accounts**

No.	Particulars		₹
<b>1</b>	<b>Share Capital</b>		
	<i>Authorized, issued and subscribed capital:</i>		
	<i>2,50,000 Equity shares of ₹ 10 each fully paid up</i>		2,500
	<i>2,000, 10% Preference shares of ₹ 100 each</i>		200
	<i>(Issued two months back for the purpose of buy-back)</i>		
	Total		<u>2,700</u>
<b>2</b>	<b>Reserves and Surplus</b>		
	<i>Capital reserve</i>		1,000
	<i>Revenue reserve</i>		3,000
	<i>Securities premium</i>		2,200
	<i>Profit and loss account</i>		<u>3,500</u>
	Total		<u>9,700</u>

The company passed a resolution to buy-back 20% of its equity capital @ ₹ 50 per share. For this purpose, it sold all of its investment for ₹ 22,00,000.

You are required to pass necessary journal entries and prepare the Balance Sheet.

**Solution**

**Journal Entries in the books of Dee Limited**

(in thousand ₹)

	Particulars		Dr.	Cr.
(i)	Bank Account	Dr.	2,200	
	Profit and Loss Account	Dr.	800	
	To Investment Account			3,000
	(Being the investments sold at loss for the purpose of buy-back)			

(ii)	Equity Share buy-back Account To Bank Account (Being the payment made on buy-back)	Dr.	2,500	2,500
(iii)	Equity Share Capital Account Premium Payable on Buy-Back Account To Equity Shares Buy-Back Account (Being the buy-back amount allocated to equity share capital)	Dr. Dr.	500 2,000	2,500
(iv)	Securities premium Account To Premium payable on buy-back Account (Being the premium payable on buy-back adjusted against securities premium account)	Dr.	2,000	2,000
(v)	Revenue reserve Account To Capital Redemption Reserve Account (Being the amount equal to nominal value of equity shares bought back out of free reserves transferred to capital redemption reserve account)	Dr.	300	300

**Balance Sheet of Dee Limited as at 1<sup>st</sup> April, 20X1  
(After buy-back of shares)**

(in thousand ₹)

<i>Particulars</i>		<i>Notes</i>	<i>₹</i>
	<b>Equity and Liabilities</b>		
<b>1</b>	<b>Shareholders' funds</b>		
A	Share capital	1	2,200
B	Reserves and Surplus	2	6,900
<b>2</b>	<b>Current liabilities</b>		
A	Trade Payables		1,400
	Total		10,500
	<b>Assets</b>		
<b>1</b>	<b>Non-current assets</b>		
A	Property, plant and Equipment		9,300
<b>2</b>	<b>Current assets</b>		
A	Inventories		500



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	B	Trade receivables		200
	C	Cash and Cash equivalents		500
		Total		10,500

### Notes to accounts

No.	Particulars		₹
<b>1</b>	<b>Share Capital</b>		
	Authorized, issued and subscribed capital:		
	2,50,000 Equity shares of ₹ 10 each fully paid up		2,000
	2,000, 10% Preference shares of ₹ 100 each (Issued two months back for the purpose of buy-back)		200
	Total		<u>2,200</u>
<b>2</b>	<b>Reserves and Surplus</b>		
	Capital reserve		1,000
	Capital redemption reserve		300
	Securities Premium	2,200	
	Less: Premium payable on buy-back of shares	<u>(2,000)</u>	200
	Revenue reserve	3,000	
	Less: Transfer to Capital redemption reserve	<u>(300)</u>	2,700
	Profit and loss A/c	3,500	
	Less: Loss on investment	<u>(800)</u>	<u>2,700</u>
	Total		<u>6,900</u>

### Illustration 4

Extra Ltd. (a non-listed company) furnishes you with the following Balance Sheet as at 31<sup>st</sup> March, 20X1:

(in lakhs ₹)

		Particulars	Notes	₹
<b>1</b>		<b>Equity and Liabilities</b>		
		<b>Shareholders' funds</b>		
	A	Share capital	1	120
	B	Reserves and Surplus	2	118

2		<b>Non-current liabilities</b>		
		Long term borrowings	3	4
3		<b>Current liabilities</b>		
	A	Trade Payables		70
		Total		312
		<b>Assets</b>		
1		<b>Non-current assets</b>		
	A	Property, plant and Equipment		50
	B	Non-current Investments		120
2		<b>Current assets</b>		
	A	Cash and Cash equivalents		142
		Total		312

**Notes to accounts**

No.	Particulars		₹
1	<b>Share Capital</b>		
	Authorized, issued and subscribed capital:		
	Equity shares of ₹ 10 each fully paid		100
	9% Redeemable preference shares of ₹ 100 each fully paid		<u>20</u>
	Total		<u>120</u>
2	<b>Reserves and Surplus</b>		
	Capital reserves		8
	Revenue reserves		50
	Securities premium		<u>60</u>
	Total		<u>118</u>
3	<b>Long term borrowings</b>		
	10% Debentures		<u>4</u>

- (i) The company redeemed the preference shares at a premium of 10% on 1<sup>st</sup> April, 20X1.

- (ii) It also bought back 3 lakhs equity shares of ₹ 10 each at ₹ 30 per share. The payment for the above was made out of huge bank balances.
- (iii) Included in its investment were "investments in own debentures" costing ₹ 2 lakhs (face value ₹ 2.20 lakhs). These debentures were cancelled on 1<sup>st</sup> April, 20X1.
- (iv) The company had 1,00,000 equity stock options outstanding on the above-mentioned date, to the employees at ₹ 20 when the market price was ₹30 (This was included under current liabilities). On 1.04.20X1 employees exercised their options for 50,000 shares.
- (v) Pass the journal entries to record the above.
- (vi) Prepare Balance Sheet as at 01.04.20X1.

**Solution**

**(₹ in lakhs)**

<b>Date</b>	<b>Particulars</b>	<b>Debit</b>	<b>Credit</b>
20X1			
1 <sup>st</sup> April	9% Redeemable preference share capital A/c Dr.	20.00	
	Premium on redemption of preference shares A/c Dr.	2.00	
	To Preference shareholders A/c		22.00
	(Being preference share capital transferred to shareholders account)		
	Preference shareholders A/c Dr.	22.00	
	To Bank A/c		22.00
	(Being payment made to shareholders)		
	Equity shares buy-back A/c Dr.	90.00	
	To Bank A/c		90.00
	(Being 3 lakhs equity shares of ₹ 10 each bought back @ ₹ 30 per share)		
	Equity share capital A/c Dr.	30.00	
	Securities premium A/c Dr.	60.00	
	To Equity Shares buy-back A/c		90.00
	(Being cancellation of shares bought back)		
	Revenue reserve A/c Dr.	50.00	

	To Capital redemption reserve A/c (Being creation of capital redemption reserve account to the extent of the face value of preference shares redeemed and equity shares bought back as per the law)		50.00
	10% Debentures A/c Dr.	2.20	
	To Investment (own debentures) A/c		2.00
	To Profit on cancellation of own debentures A/c (Being cancellation of own debentures costing ₹ 2 lakhs, face value being ₹ 2.20 lakhs and the balance being profit on cancellation of debentures)		0.20
	Bank A/c Dr.	10.00	
	Employees stock option outstanding (Current liabilities) A/c Dr.	5.00	
	To Equity share capital A/c		5.00
	To Securities premium A/c (Being the allotment to employees, of 50,000 shares of ₹ 10 each at a premium of 20 per share in exercise of stock options by employees)		10.00
	Securities premium A/c Dr.	2.00	
	To Premium on redemption of preference shares A/c (Being premium on redemption of preference shares adjusted through securities premium)		2.00

**Balance Sheet of Extra Ltd. as at 01.04.20X1**

(in lakhs ₹)

		<i>Particulars</i>	<i>Notes</i>	₹
1		<b>Equity and Liabilities</b>		
		<b>Shareholders' funds</b>		
	A	Share capital	1	75.00
	B	Reserves and Surplus	2	66.20

**BUY-BACK OF SECURITIES AND EQUITY  
SHARES WITH DIFFERENTIAL RIGHTS**

4.21

<b>2</b>	<b>Non-current liabilities</b>		
	Long term borrowings	3	1.80
<b>3</b>	<b>Current liabilities</b>		
	A Other Current Liabilities	4	65.00
	Total		208
	<b>Assets</b>		
<b>1</b>	<b>Non-current assets</b>		
	A Property, plant and Equipment		50.00
	B Non-current Investments	5	118.00
<b>2</b>	<b>Current assets</b>		
	A Cash and Cash equivalents	6	40.00
	Total		208

**Notes to accounts**

No.	Particulars		₹
<b>1</b>	<b>Share Capital</b>		
	Equity shares of ₹ 10 each fully paid		100
	Less: Cancellation of bought back shares		(30)
	Add: Shares issued against ESOP		<u>5</u>
	Total		<u>75</u>
<b>2</b>	<b>Reserves and Surplus</b>		
	Capital Reserve		
	Opening balance	8.00	
	Add: Profit on cancellation of debentures	<u>0.20</u>	8.20
	Revenue reserves		
	Opening balance	50.00	
	Less: Creation of Capital Redemption Reserve	<u>(50.00)</u>	-
	Securities Premium		
	Opening balance	60.00	
	Less: Adjustment for cancellation of equity shares	<u>(60.00)</u>	

	Less: Adjustment for premium on redemption of preference shares	(2.00)	
	Add: Shares issued against ESOP at premium	<u>10.00</u>	8.00
	Capital Redemption Reserve		<u>50.00</u>
	Total		<u>66.20</u>
<b>3</b>	<b>Long term borrowings</b>		
	10% Debentures		4.00
	Less: Cancellation of own debentures		<u>(2.20)</u>
	Total		<u>1.80</u>
<b>4.</b>	<b>Other Current liabilities</b>		
	Opening balance		70.00
	Less: Adjustment for ESOP outstanding		<u>(5.00)</u>
	Total		<u>65.00</u>
<b>5.</b>	<b>Non-current investments</b>		
	Opening balance		120.00
	Less: Investment in own debentures		<u>(2.00)</u>
	Total		<u>118.00</u>
<b>6.</b>	<b>Cash and Cash Equivalents</b>		
	Opening balance		142.00
	Less: Payment to preference shareholders		(22.00)
	Less: Payment to equity shareholders		(90.00)
	Add: Share price received against ESOP		<u>10.00</u>
	Total		<u>40.00</u>

**Illustration 5**

Pratham Ltd. (a non-listed company) has the following Capital structure as on 31<sup>st</sup> March, 20X1:

<b>Particulars</b>	<b>₹</b>	<b>₹</b>
Equity Share Capital (shares of ₹ 10 each fully paid)		30,00,000
Reserves & Surplus		
General Reserve	32,50,000	

Security Premium Account	6,00,000	
Profit & Loss Account	4,30,000	
Revaluation Reserve	<u>6,20,000</u>	49,00,000
Loan Funds		42,00,000

You are required to compute by Debt Equity Ratio Test, the maximum number of shares that can be bought back in the light of above information, when the offer price for buy-back is ₹ 30 per share.

**Solution**

**Debt Equity Ratio Test**

	<b>Particulars</b>	<b>₹</b>
a)	Loan funds	42,00,000
(b)	Minimum equity to be maintained after buy-back in the ratio of 2:1 (₹ in crores)	21,00,000
(c)	Present equity shareholders fund (₹ in crores)	72,80,000
(d)	Future equity shareholder fund (₹ in crores) (See Note 2)	59,85,000 (72,80,000-12,95,000)
(e)	Maximum permitted buy-back of Equity (₹ in crores) [(d) – (b)] (See Note 2)	38,85,000 (by simultaneous equation)
(f)	Maximum number of shares that can be bought back @ ₹ 30 per share (shares in crores) (See Note 2)	1,29,500 (by simultaneous equation)

**Working Note:**

- Shareholders' funds

<b>Particulars</b>	<b>₹</b>
Paid up capital	30,00,000
Free reserves (32,50,000 + 6,00,000 + 4,30,000)	<u>42,80,000</u>
	<u>72,80,000</u>

- As per section 68 of the Companies Act, 2013, amount transferred to CRR and maximum equity to be bought back will be calculated by simultaneous equation method.

Suppose amount equivalent to nominal value of bought back shares transferred to CRR account is 'x' and maximum permitted buy-back of equity is 'y'.

Equation 1 : (Present equity – Nominal value of buy-back transfer to CRR) – Minimum equity to be maintained = Maximum permissible buy-back of equity

$$(72,80,000 - x) - 21,00,000 = y \quad (1)$$

$$\text{Since } 51,80,000 - x = y$$

$$\text{Equation 2: } \left( \frac{\text{Maximum buy-back}}{\text{Offer price for buy-back}} \times \text{Nominal Value} \right)$$

= Nominal value of the shares bought –back to be transferred to CRR

$$= \left( \frac{y}{30} \times 10 \right) = x$$

$$3x = y \quad (2)$$

$$x = ₹ 12,95,000 \text{ crores and } y = ₹ 38,85,000 \text{ crores}$$

### Illustration 6

*Perrotte Ltd. (a non-listed company) has the following Capital Structure as on 31.03.20X1:*

	<b>Particulars</b>	<b>(₹ in crores)</b>	
(1)	Equity Share Capital (Shares of ₹ 10 each fully paid)	-	330
(2)	Reserves and Surplus		
	General Reserve	240	-
	Securities Premium Account	90	-
	Profit & Loss Account	90	-
	Infrastructure Development Reserve	<u>180</u>	600
(3)	Loan Funds		1,800

*The Shareholders of Perrotte Ltd., on the recommendation of their Board of Directors, have approved on 12.09.20X1 a proposal to buy-back the maximum permissible number of Equity shares considering the large surplus funds available at the disposal of the company.*

*The prevailing market value of the company's shares is ₹ 25 per share and in order*



to induce the existing shareholders to offer their shares for buy-back, it was decided to offer a price of 20% over market.

You are also informed that the Infrastructure Development Reserve is created to satisfy Income-tax Act requirements.

You are required to compute the maximum number of shares that can be bought back in the light of the above information and also under a situation where the loan funds of the company were either ₹ 1,200 crores or ₹ 1,500 crores.

Assuming that the entire buy-back is completed by 09.12.20X1, show the accounting entries in the company's books in each situation.

**Solution**

**Statement determining the maximum number of shares to be bought back**

Number of shares

Particulars	When loan fund is		
	₹ 1,800 crores	₹ 1,200 crores	₹ 1,500 crores
Shares Outstanding Test (W.N.1)	8.25	8.25	8.25
Resources Test (W.N.2)	6.25	6.25	6.25
Debt Equity Ratio Test (W.N.3)	Nil	3.75	Nil
Maximum number of shares that can be bought back [least of the above]	Nil	3.75	Nil

**Journal Entries for the Buy-Back  
(applicable only when loan fund is ₹ 1,200 crores)**

₹ in crores

	Particulars		Debit	Credit
(a)	Equity share buy-back account	Dr.	112.5	
	To Bank account			112.5
	(Being buy-back of 3.75 crores equity shares of ₹ 10 each @ ₹ 30 per share)			
(b)	Equity share capital account	Dr.	37.5	
	Securities premium account	Dr.	75	

(c)	To Equity share buy-back account (Being cancellation of shares bought back)		112.5
	General reserve account To Capital redemption reserve account (Being transfer of free reserves to capital redemption reserve to the extent of nominal value of share capital bought back out of redeemed through free reserves)	Dr.	37.5 37.5

**Working Notes:****1. Shares Outstanding Test**

<b>Particulars</b>	<b>(Shares in crores)</b>
Number of shares outstanding	33
25% of the shares outstanding	8.25

**2. Resources Test**

<b>Particulars</b>	
Paid up capital (₹ in crores)	330
Free reserves (₹ in crores)	<u>420</u>
Shareholders' funds (₹ in crores)	<u>750</u>
25% of Shareholders fund (₹ in crores)	₹ 187.5 crores
Buy-back price per share	₹ 30
Number of shares that can be bought back (shares in crores)	6.25 crores shares

**3. Debt Equity Ratio Test**

	<b>Particulars</b>	<b>When loan fund is</b>		
		<b>₹ 1,800 crores</b>	<b>₹ 1,200 crores</b>	<b>₹ 1,500 crores</b>
(a)	Loan funds (₹ in crores)	1,800	1,200	1,500
(b)	Minimum equity to be maintained <b>after</b> buy-back in the ratio of 2:1 (₹ in crores)	900	600	750
(c)	Present equity shareholders fund (₹ in crores)	750	750	750

(d)	Future equity shareholder fund (₹ in crores) <b>(See Note 2)</b>	N.A.	712.5 (750-37.5)	N.A.
(e)	Maximum permitted buy-back of Equity (₹ in crores) [(d) – (b)] <b>(See Note 2)</b>	Nil	112.5 (by simultaneous equation)	Nil
(f)	Maximum number of shares that can be bought back @ ₹ 30 per share (shares in crores) <b>(See Note 2)</b>	Nil	3.75 (by simultaneous equation)	Nil

**Note:**

- Under Situations 1 & 3 the company does not qualify for buy-back of shares as per the provisions of the Companies Act, 2013.
- As per section 68 of the Companies Act, 2013, the ratio of debt owed by the company should not be more than twice the capital and its free reserve after such buy-back. In the question, it is stated that the company has surplus funds to dispose of therefore, it is presumed that buy-back is out of free reserves or securities premium and hence a sum equal to the nominal value of the share bought back shall be transferred to Capital Redemption Reserve (CRR). Utilization of CRR is restricted to issuance of fully paid-up bonus shares only. It means CRR is not available for distribution as dividend. Hence, CRR is not a free reserve. Therefore, for calculation of future equity i.e. share capital and free reserves, amount transferred to CRR on buy-back has to be excluded from present equity.

Amount transferred to CRR and maximum equity to be bought back will be calculated by simultaneous equation method.

Suppose amount equivalent to nominal value of bought back shares transferred to CRR account is 'x' and maximum permitted buy-back of equity is 'y'.

Then

Equation 1 : (Present equity – Nominal value of buy-back transfer to CRR) – Minimum equity to be maintained = Maximum permissible buy-back of equity

$$(750 - x) - 600 = y \quad (1)$$

Since  $150 - x = y$

$$\text{Equation 2: } \left( \frac{\text{Maximum buy-back}}{\text{Offer price for buy-back}} \times \text{Nominal Value} \right)$$

= Nominal value of the shares bought –back to be transferred to CRR

$$= \left( \frac{y}{30} \times 10 \right) = x$$

[here (30 = 25% x 120)]

$$\text{Or} \quad 3x = y \quad (2)$$

by solving the above two equations we get

$$x = ₹ 37.5 \text{ crores}$$

$$y = ₹ 112.5 \text{ crores}$$



## 2. EQUITY SHARES WITH DIFFERENTIAL RIGHTS

### 2.1 Introduction

Section 43 Companies Amendment Act, 2013 allows companies to issue equity shares with differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed. As we know that share capital is of two types – equity and preference. Preference share capital with reference to any company limited by shares, means that part of the issued share capital of the company which carries or would carry a preferential right with respect to:

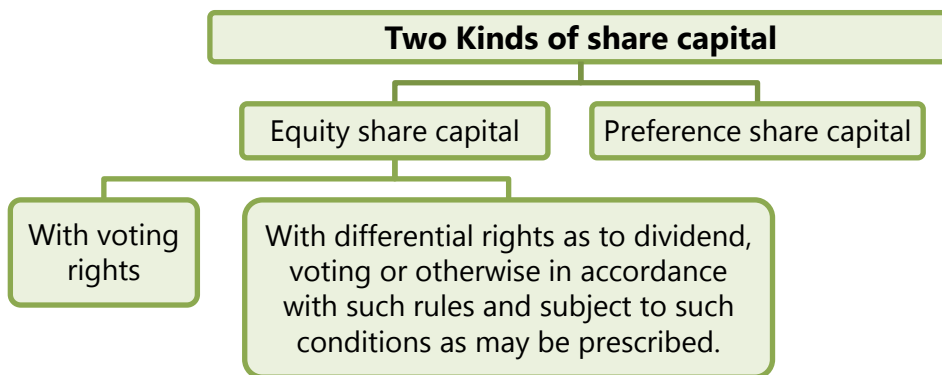
- (i) Payment of dividend, either as a fixed amount or an amount calculated at a fixed rate, which may either be free of or subject to income-tax; and
- (ii) Repayment, in the case of a winding up or repayment of capital, of the amount of the share capital paid-up or deemed to have been paid-up, whether or not, there is a preferential right to the payment of any fixed premium or premium on any fixed scale, specified in the memorandum or articles of the company.

Section 43(a) of The Companies Act, 2013 defines equity share capital to include of two types viz.,

- (i) With voting rights; or
- (ii) With differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed

Hence, differentiation can be done by giving superior dividend / Superior voting right/ diluted voting right to a class of equity shareholder. A residual category 'otherwise' has also been created to give enough leeway to the management in structuring shareholder agreements with desired divisions of managerial control interest and financial interest. *It must be appreciated that preference shares are not issued with differential rights. It is only the equity shares, which are issued.*

Thus, new issues of share capital shall be only two kinds only, as depicted in the chart given below: –



## 2.2 Voting Rights

Section 2 (93) defines "voting right," as the right of a member of a company to vote in any meeting of the company or by means of postal ballot.

### Equity shareholder voting rights

Of the two types of shares, equity shares have a general voting right, whereas preference shares have restrictive voting rights.

According to section 47 (1), Subject to the provisions of section 43 and sub-section (2) of section 50:

- (i) Every member of a company limited by shares and holding equity share capital therein, shall have a right to vote on every resolution placed before the company; and
- (ii) His voting right on a poll shall be in proportion to his share in the paid-up equity share capital of the company.

Normally, the blanket rule in Companies Act is **one share-one vote**. This gives equal voting right to every shareholder. This is a fairly democratic process and is quite robust from the corporate governance perspective.

However, sometime a segment of shareholders, normally promoters and executive management may like to have more control over decision-making process. But that may not be possible if shareholding is quite diffused. This intention of shareholders / management can be activated if they have more voting rights, even if they hold fewer shares. This can be structured by giving them shares with superior voting rights. *This is enabled by section 43(a)(ii) in the form of equity shares with differential rights.*

### **Preference shareholder restrictive voting rights**

Normally preference shareholders have superior financial rights but less management control rights. Every member of a company limited by shares and holding any preference share capital therein shall, in respect of such capital, have a restrictive right to vote only on resolutions placed before the company

- a. Which directly affect the rights attached to his preference shares and,
- b. Any resolution for the winding up of the company or
- c. For the repayment or
- d. Reduction of its equity or preference share capital.

In these situations, preference shareholders voting right on a poll shall be in proportion to his share in the paid-up preference share capital of the company. This once again points to one share – one vote doctrine of company law.

### **Release of Preference shareholder restrictive voting rights**

It is provided further that where the dividend in respect of a class of preference shares has not been paid for a period of two years or more, such class of preference shareholders shall have a right to vote on **all the resolutions** placed before the company.

### **Relative weight of equity and preference share capital, when entitled to vote**

It is further provided that the proportion of the voting rights of equity shareholders to the voting rights of the preference shareholders shall be in the same proportion as the paid-up capital in respect of the equity shares bears to the paid-up capital in respect of the preference shares,

### **Example**

*Equity capital is held by X, Y and Z in the proportion of 40:40:20. A, B and C hold preference share capital in the proportion of 50:30:20. If the paid up equity share capital of the company is ₹ 1 Crore and Preference share capital is ₹ 50 Lakh, then*

*relative weight in the voting right of equity shareholders and preference shareholders will be 2/3 and 1/3. The respective voting right of various shareholders will be*

$$X = \frac{2}{3} \times \frac{40}{100} = \frac{4}{15}$$

$$Y = \frac{2}{3} \times \frac{40}{100} = \frac{4}{15}$$

$$Z = \frac{2}{3} \times \frac{20}{100} = \frac{2}{15}$$

$$A = \frac{1}{3} \times \frac{50}{100} = \frac{1}{6}$$

$$B = \frac{1}{3} \times \frac{30}{100} = \frac{1}{10}$$

$$C = \frac{1}{3} \times \frac{20}{100} = \frac{2}{30}$$

*Hence their relative weights are 4/15 : 4/15 : 2/15 : 1/6 : 1/10 : 2/30 or 8:8:4:5:3:2.*

*Their voting power is X (26.67%), Y (26.67%), Z (13.33%), A (16.67%), B (10%) and C (6.67%)*

**Note:** The members are not entitled to voting rights in respect of money not called up by the company, but voluntarily paid by the member.

### **2.3 Share Capital and Debentures Rules**

In exercise of the power conferred under the Companies Act, the Central Government announced Companies (**Share Capital and Debentures**) Rules, 2014, to deal with equity shares with differential rights.

The rules lay down the following conditions to be compulsorily complied with:

- The articles of association of the company authorizes the issue of shares with differential rights;
- The issue of shares is authorized by an ordinary resolution passed at a general meeting of the shareholders: Provided that where the equity shares of a company are listed on a recognized stock exchange, the issue of such shares shall be approved by the shareholders through postal ballot;
- The voting power in respect of shares with differential rights shall not exceed **seventy four percent** of the total voting power including voting power in respect of equity shares with differential rights issued at any point of time;
- The company has **not defaulted in filing** financial statements and annual returns for three financial years immediately preceding the financial year in which it is decided to issue such shares;
- The company has no **subsisting default in the payment** of a declared dividend to its shareholders or repayment of its matured deposits or

redemption of its preference shares or debentures that have become due for redemption or payment of interest on such deposits or debentures or payment of dividend;

- The company has not ***defaulted in payment*** of the dividend on preference shares or repayment of any term loan from a public financial institution or State level financial institution or scheduled Bank that has become repayable or interest payable thereon or dues with respect to statutory payments relating to its employees to any authority or default in crediting the amount in Investor Education and Protection Fund to the Central Government;

Provided that a company may issue equity shares with differential rights upon expiry of five years from the end of financial year in which such default was made good.

- The ***company has not been penalized*** by Court or Tribunal during the last three years of any offence under the Reserve Bank of India Act, 1934, the Securities and Exchange Board of India Act, 1992, the Securities Contracts Regulation Act, 1956, the Foreign Exchange Management Act, 1999 or any other special Act, under which such companies being regulated by sectoral regulators.

It is further clarified that the company shall not convert its existing equity share capital with voting rights into equity share capital carrying differential voting rights and *vice-versa*. It is further clarified that the holders of the equity shares with differential rights shall enjoy all other rights such as bonus shares, rights shares etc., which the holders of equity shares are entitled to, subject to the differential rights with which such shares have been issued.

It is also specified that where a company issues equity shares with differential rights, the Register of Members maintained under section 88 shall contain all the relevant particulars of the shares so issued along with details of the shareholders.

It is further provided that for the purposes of this rule, it is hereby clarified that differential rights attached to such shares issued by any company under the provisions of Companies Act, 1956, shall continue till such rights are converted with the differential rights in accordance with the provisions of the Companies Act, 2013. To that extent rights of existing shareholders have been grandfathered.

It must be appreciated that issue of equity shares with differential rights comes with a cost. This kind of arrangement certainly dilutes the corporate governance perspective. The system clearly violates the principles of democracy. It creates classes within classes. TATA were the first in 2008 to issue equity shares with



differential rights. They came out with a differential right issue under the nomenclature of class A shares, the voting rights were diluted to 1/10th and the rate of the dividend was 5% more as compared to the other category of Tata motors shares being traded on the stock exchange. Similarly, Pantaloons issued *bonus shares* with differential voting rights with an additional 5% dividend but one-tenth voting rights to ordinary equity shares. Gujarat NRE Coke and Jain Irrigation Systems issued similar bonus shares with differential voting rights.

## **2.4 Dilution in case of private companies**

Section 43 (a) (ii) and its corresponding stringent Rules were mandatorily applicable to both private and public companies as far as issue of equity share capital with differential voting rights is concerned. However the Ministry of Corporate Affairs has *vide* its notification G.S.R 464 (E), Exemptions to private companies notification, Ministry of Corporate Affairs, June 5, 2015, has exempted private companies from the applicability of Section 43 and related Rules, and private companies are now free to structure their share capital in a manner they deem best in the interests of the company. The rule has been essentially diluted to enable start-ups to structure their financial deals without compromising much on management control.

## **2.5 Variation of shareholder's rights**

The rights of a shares of a particular class, once issued, can be varied or altered under section 48 if

- (a) If provision with respect to such variation is contained in the memorandum or articles of the company; or
- (b) In the absence of any such provision in the memorandum or articles, if such variation is not prohibited by the terms of issue of the shares of that class.

However, it would require consent in writing of the holders of not less than three-fourths of the issued shares of that class or by means of a special resolution passed at a separate meeting of the holders of the issued shares of that class.

Hence, if equity shareholders Series A require a change in their right, of a particular nature, either a special resolution of a specially convened meeting of this particular class of shareholders will suffice, or otherwise more than 75% shareholders can give their consent in writing.

However, it must be understood that a company having equity shares with voting rights cannot convert them into equity shares with differential voting rights, or vice-

versa. However, the variation in their rights should not affect the rights of any other class, say Equity shares 'B' class or Preference shares.

In such situation, if variation by one class of shareholders affects the rights of any other class of shareholders, the consent of three-fourths of such other class of shareholders shall also be obtained and the provisions of this section shall apply to such variation.

## 2.6 Protection of minority shareholder clause

If a particular class of shareholders wants their variation of rights, 75% shareholders can achieve the purpose. What shall be the fate of remaining 25%? If they are fragmented, not much can be done. But if the holders of **not less than ten per cent** of the issued shares of a class did not consent to such variation or vote in favor of the special resolution for the variation, they may apply to the Tribunal to have the variation cancelled, and where any such application is made, the variation shall not have effect unless and until it is confirmed by the Tribunal.

However, the application under this section shall be made within twenty-one days after the date on which the consent was given or the resolution was passed, as the case may be, and may be made on behalf of the shareholders entitled to make the application by such one or more of their number as they may appoint in writing for the purpose. The decision of the Tribunal on any application under sub-section (2) shall be binding on the shareholders. The company must comply with the order and, within thirty days of the date of the order of the Tribunal, file a copy thereof with the Registrar.

### SUMMARY

- Buy-back of shares can be made out of:
  - (i) its free reserves; or
  - (ii) the securities premium account; or
  - (iii) the proceeds of any shares or other specified securities.
- No company shall purchase its own shares or other specified securities unless—
  - The buy-back is authorized by the Articles of Association and by a special resolution passed at a general meeting. However, in case the buy-back is for a sum less than or equal to ten percent of the paid-up equity shares + free reserves the same may be authorized by the resolution of the directors passed at a duly convened Board Meeting.
  - the buy-back is or less than or equal to twenty-five per cent of the total paid-up capital and free reserves of the company:

- Partly paid shares cannot be bought back by a company;
  - the buy-back of equity shares in any financial year shall not exceed twenty-five per cent of its total paid-up equity capital in that financial year.
  - No offer of buy-back will be made within a period of one year from the date of closing of the previous buy-back if any. Hence, there can be a maximum of one buy-back in one year.
  - the ratio of the debt owed by the company (both secured and unsecured) is not more than twice the paid-up capital and its free reserves after such buy-back:
- As per the new Companies Act 2013 companies can issue equity shares with differential rights subject to the fulfilment of certain conditions.
  - The rights of a particular class of shareholders can be varied, provided more than 75% of the shareholders of that class agree. If this variation affects any other class of shares, the consent of more than 75% of that other class's shareholders is required. If 10% or more shareholders do not approve of the variation, they can make a plea to the tribunal and contest it.
  - Companies (Share Capital and Debentures) Rules, 2014, deals with equity shares with differential rights.

## **TEST YOUR KNOWLEDGE**

### **MCQs**

1. As per section 68(1) of the Companies Act, buy-back of own shares by the company, shall not exceed
  - (a) 25% of the total paid-up capital and free reserves of the company.
  - (b) 20% of the total paid-up capital and free reserves of the company.
  - (c) 15% of the total paid-up capital and free reserves of the company.
2. The companies are permitted to buy-back their own shares out of
  - (a) Free reserves and Securities premium
  - (b) Proceeds of the issue of any shares.
  - (c) Both (a) and (b)

3. When a company purchases its own shares out of free reserves; a sum equal to nominal value of shares so purchased shall be transferred to
  - (a) Revenue redemption reserve.
  - (b) Capital redemption reserve.
  - (c) Buy-back reserve
4. Of the following, preference shareholders do not have a right to vote on resolutions
  - (a) Which directly affect the rights attached to his preference shares.
  - (b) For entering a private equity agreement to raise further capital diluting their overall stake in the company.
  - (c) For the repayment.
5. Preference shareholders will have a right to vote on all resolutions if the dividend on their share remains unpaid for
  - (a) 1 year
  - (b) 2 year
  - (c) 3 year
6. The differential in the class of equity shares can be created for
  - (a) Dividend.
  - (b) Voting rights.
  - (c) Both (a) and (b).
7. State which of the following statements is true?
  - (a) Buy-back is for more than twenty-five per cent of the total paid-up capital and free reserves of the company.
  - (b) Partly paid shares cannot be bought back by a company.
  - (c) Buy-back of equity shares in any financial year shall exceed twenty-five per cent of its total paid-up equity capital in that financial year.
8. Premium (excess of buy-back price over the par value) paid on buy-back should be adjusted against
  - (a) Free reserves.

- (b) Securities premium.
  - (c) Both (a) and (b).
9. Advantages of Buy-back of shares include to
- (a) Encourage others to make hostile bid to take over the company.
  - (b) Decrease promoters holding as the shares which are bought back are cancelled.
  - (c) Discourage others to make hostile bid to take over the company as the buy-back will increase the promoters holding.

### Theoretical Questions

#### Question 1

What are the conditions to be fulfilled by a Joint Stock Company to buy-back its equity shares as per Companies Act, 2013? Explain in brief.

#### Question 2

Explain the meaning of equity shares with differential rights.

#### Question 3

Can preference shares be also issued with differential rights? Explain.

#### Question 4

Explain the conditions under Rule 4 under Companies (Share Capital and Debentures) Rules, 2014, to deal with equity shares with differential rights.

### Practical Questions

#### Question 1

SMM Ltd. has the following capital structure as on 31<sup>st</sup> March, 20X1: ₹ in crore

	<i>Particulars</i>	<i>Situation I</i>	<i>Situation II</i>
(i)	Equity share capital (shares of ₹ 10 each)	1,200	1,200
(ii)	Reserves:		
	General Reserves	1,080	1,080
	Securities Premium	400	400
	Profit & Loss	200	200

	Infrastructure Development Reserve (Statutory Reserve)	320	320
(iii)	Loan Funds	3,200	6,000

The company has offered buy-back price of ₹ 30 per equity share. You are required to calculate maximum permissible number of equity shares that can be bought back in both situations and also required to pass necessary Journal Entries.

### Question 2

KG Limited furnishes the following Balance Sheet as at 31<sup>st</sup> March, 20X1:

<i>Particulars</i>		<i>Notes</i>	<i>₹</i>
	<b>Equity and Liabilities</b>		
<b>1</b>	<b>Shareholders' funds</b>		
A	Share capital	1	1,200
B	Reserves and Surplus	2	810
<b>2</b>	<b>Non-current liabilities</b>		
	Long term borrowings	3	750
<b>3</b>	<b>Current liabilities</b>		
A	Trade Payables		745
B	Other Current Liabilities		195
	Total		3,700
	<b>Assets</b>		
<b>1</b>	<b>Non-current assets</b>		
A	Property, plant and equipment	4	2,026
B	Non-current Investments		74
<b>2</b>	<b>Current assets</b>		
A	Inventories		600
B	Trade receivables		260
C	Cash and Cash equivalents		740
	Total		3,700

### Notes to accounts

<i>No.</i>	<i>Particulars</i>		<i>₹</i>
<b>1</b>	<b>Share Capital</b>		
	Authorized, issued and subscribed capital		

	Equity share capital (fully paid up shares of ₹ 10 each)		<u>1,200</u>
<b>2</b>	<b>Reserves and Surplus</b>		
	Securities premium		175
	General reserve		265
	Capital redemption reserve		200
	Profit & loss A/c		<u>170</u>
	Total		<u>810</u>
<b>3</b>	<b>Long term borrowings</b>		
	12% Debentures		<u>750</u>
<b>4</b>	<b>Property, plant and equipment</b>		
	Land and Building		1,800
	Plant and machinery		<u>226</u>
	Net carrying value		2,026

On 1<sup>st</sup> April, 20X1, the company announced the buy-back of 25% of its equity shares @ ₹ 15 per share. For this purpose, it sold all of its investments for ₹ 75 lakhs.

On 5<sup>th</sup> April, 20X1, the company achieved the target of buy-back. On 30<sup>th</sup> April, 20X1 the company issued one fully paid up equity share of ₹ 10 by way of bonus for every four equity shares held by the equity shareholders.

You are required to:

- (1) Pass necessary journal entries for the above transactions.
- (2) Prepare Balance Sheet of KG Limited after bonus issue of the shares.

**Question 3**

Following is the Balance Sheet of Competent Limited as at 31st March, 20X1:

<b>Particulars</b>		<b>Notes</b>	<b>₹</b>
<b>1</b>	<b>Equity and Liabilities</b>		
	<b>Shareholders' funds</b>		
	A Share capital	1	12,50,000
	B Reserves and Surplus	2	18,75,000
<b>2</b>	<b>Non-current liabilities</b>		
	Long term borrowings	3	28,75,000

<b>3</b>		<b>Current liabilities</b>		
	A	Other Current Liabilities		16,50,000
			Total	76,50,000
		<b>Assets</b>		
<b>1</b>		<b>Non-current assets</b>		
	A	Property, plant and Equipment	4	46,50,000
<b>2</b>		<b>Current assets</b>		
	A	Other Current Assets		30,00,000
			Total	76,50,000

### Notes to accounts

No.	Particulars		₹
<b>1</b>	<b>Share Capital</b>		
	Authorized, issued and subscribed capital:		
	Equity share capital (fully paid up shares of ₹ 10 each)		<u>12,50,000</u>
<b>2</b>	<b>Reserves and Surplus</b>		
	Securities premium		2,50,000
	Profit and loss account		1,25,000
	Revenue reserve		<u>15,00,000</u>
	Total		<u>18,75,000</u>
<b>3</b>	<b>Long term borrowings</b>		
	14% Debentures		18,75,000
	Unsecured Loans		<u>10,00,000</u>
	Total		<u>28,75,000</u>
<b>4</b>	<b>Property, plant and equipment</b>		
	Land and Building		19,30,000
	Plant and machinery		18,00,000
	Furniture and fitting		<u>9,20,000</u>
	Net carrying value		<u>46,50,000</u>

The company wants to buy-back 25,000 equity shares of ₹ 10 each, on 1st April, 20X1 at ₹ 20 per share. Buy-back of shares is duly authorized by its articles and



necessary resolution has been passed by the company towards this. The payment for buy-back of shares will be made by the company out of sufficient bank balance available shown as part of Current Assets.

Comment with your calculations, whether buy-back of shares by company is within the provisions of the Companies Act, 2013. If yes, pass necessary journal entries towards buy-back of shares and prepare the Balance Sheet after buy-back of shares.

**Question 4**

W, X, Y and Z hold Equity capital is held by in the proportion of 40:30:10:20. A, B, C and D hold preference share capital in the proportion of 30:40:20:10. If the paid up capital of the company is ₹ 40 Lakh and Preference share capital is ₹ 20 Lakh, find their voting rights in case of resolution of winding up of the company.

**ANSWERS/HINTS**

**MCQs**

1. (a); 2. (c); 3. (b); 4. (b); 5. (b); 6. (c);  
7. (b); 8. (c); 9. (c)

**Theoretical Questions**

**Answer 1**

Section 68 to 70 of the Companies Act, 2013 lays down the provisions for a company to buy-back its own equity shares. For details, refer Para 1.1 and 1.2 of the chapter.

**Answer 2**

Equity shares with Differential Rights means the share with dissimilar rights as to dividend, voting or otherwise.

**Answer 3**

No; the preference shares cannot be issued with differential rights. It is only the equity shares, which are issued. Refer para 2.1 of the chapter.

**Answer 4**

Refer para 2.3 of the chapter.

### Practical Questions

#### Answer 1

Statement determining the maximum number of shares to be bought back

*Number of shares (in crores)*

<b>Particulars</b>	<b>When loan fund is</b>	
	<b>₹ 3,200 crores</b>	<b>₹ 6,000 crores</b>
Shares Outstanding Test (W.N.1)	30	30
Resources Test (W.N.2)	24	24
Debt Equity Ratio Test (W.N.3)	32	Nil
Maximum number of shares that can be bought back [least of the above]	24	Nil

#### Journal Entries for the Buy-Back

(applicable only when loan fund is ₹3,200 crores)

<b>₹ in crores</b>				
	<b>Particulars</b>		<b>Debit</b>	<b>Credit</b>
(a)	Equity shares buy-back account	Dr.	720	
	To Bank account			720
	(Being payment for buy-back of 24 crores equity shares of ₹ 10 each @ ₹ 30 per share)			
(b)	Equity share capital account	Dr.	240	
	Premium Payable on buy-back account	Dr.	480	
	To Equity share buy-back account			720
	(Being cancellation of shares bought back)			
	Securities Premium account	Dr.	400	
	General Reserve / Profit & Loss A/c	Dr.	80	
	To Premium Payable on buy-back account			480
	(Being Premium Payable on buy-back account charged to securities premium and general reserve/Profit & Loss A/c)			

(c)	General Reserve / Profit & Loss A/c	Dr.	240	
	To Capital redemption reserve account (Being transfer of free reserves to capital redemption reserve to the extent of nominal value of share capital bought back out of redeemed through free reserves)			240

**Working Notes:**

**1. Shares Outstanding Test**

<b>Particulars</b>	<b>(Shares in crores)</b>
Number of shares outstanding	120
25% of the shares outstanding	30

**2. Resources Test**

<b>Particulars</b>	
Paid up capital (₹ in crores)	1,200
Free reserves (₹ in crores) (1,080 + 400 + 200)	<u>1,680</u>
Shareholders' funds (₹ in crores)	<u>2,880</u>
25% of Shareholders fund (₹ in crores)	₹ 720 crores
Buy-back price per share	₹ 30
Number of shares that can be bought back	24 crores shares

**3. Debt Equity Ratio Test: Loans cannot be in excess of twice the Equity Funds post Buy-Back**

<b>Particulars</b>	<b>When loan fund is</b>	
	₹ 3,200 crores	₹ 6,000 crores
(a) Loan funds (₹)	3,200	6,000
(b) Minimum equity to be maintained after buy-back in the ratio of 2:1 (₹) (a/2)	1,600	3,000
(c) Present equity shareholders fund (₹)	2,880	2,880
(d) Future equity shareholders fund (₹) (see W.N.4)	2,560 (2,880-320)	N.A.

(e) Maximum permitted buy-back of Equity (₹) [(d) – (b)]	960	Nil
(f) Maximum number of shares that can be bought back @ ₹ 30 per share	32 crore shares	Nil
As per the provisions of the Companies Act, 2013, company	Qualifies	Does not Qualify

**4. Amount transferred to CRR and maximum equity to be bought back will be calculated by simultaneous equation method**

Suppose amount transferred to CRR account is 'x' and maximum permitted buy-back of equity is 'y' Then

**Equation 1: (Present Equity- Transfer to CRR)- Minimum Equity to be maintained = Maximum Permitted Buy-Back**

$$\begin{aligned}
 &= (2,880 - x) - 1,600 = y \\
 &= 1280 - x = y \qquad \qquad \qquad (1)
 \end{aligned}$$

**Equation 2: Maximum Permitted Buy-Back X Nominal Value Per Share/Offer Price Per Share**

$$y/30 \times 10 = x$$

or

$$3x = y \qquad \qquad \qquad (2)$$

by solving the above two equations we get

$$x = ₹ 320$$

$$y = ₹ 960$$

**Answer 2**

**In the books of KG Limited  
Journal Entries**

<b>Date 20X1</b>	<b>Particulars</b>	<b>Dr.</b>	<b>Cr.</b>
		<b>(₹ in lakhs)</b>	
April 1	Bank A/c	Dr.	75
	To Investment A/c		74

## BUY-BACK OF SECURITIES AND EQUITY SHARES WITH DIFFERENTIAL RIGHTS

4.45

	To Profit on sale of investment (Being investment sold on profit)		1
April 5	Equity share capital A/c <span style="float: right;">Dr.</span>	300	
	Securities premium A/c <span style="float: right;">Dr.</span>	150	
	To Equity shares buy-back A/c (Being the amount due to equity shareholders on buy-back)		450
April 5	Equity shares buy-back A/c <span style="float: right;">Dr.</span>	450	
	To Bank A/c (Being the payment made on account of buy-back of 30 Lakh Equity Shares)		450
April 5	General reserve A/c <span style="float: right;">Dr.</span>	265	
	Profit and Loss A/c <span style="float: right;">Dr.</span>	35	
	To Capital redemption reserve A/c (Being amount equal to nominal value of buy-back shares from free reserves transferred to capital redemption reserve account as per the law)		300
April 30	Capital redemption reserve A/c <span style="float: right;">Dr.</span>	225	
	To Bonus shares A/c (W.N.1) (Being the utilization of capital redemption reserve to issue bonus shares)		225
	Bonus shares A/c <span style="float: right;">Dr.</span>	225	
	To Equity share capital A/c (Being issue of one bonus equity share for every four equity shares held)		225

### Balance Sheet (After buy-back and issue of bonus shares)

<i>Particulars</i>		<i>Notes</i>	<i>₹</i>
<b>1</b>	<b>Equity and Liabilities</b>		
	<b>Shareholders' funds</b>		
A	Share capital	1	1,125
B	Reserves and Surplus	2	436
<b>2</b>	<b>Non-current liabilities</b>		
	Long term borrowings	3	750

<b>3</b>	<b>Current liabilities</b>		
A	Trade Payables		745
B	Other Current Liabilities		195
		Total	3,251
	<b>Assets</b>		
<b>1</b>	<b>Non-current assets</b>		
A	Property, plant and equipment	4	2,026
<b>2</b>	<b>Current assets</b>		
A	Inventories		600
B	Trade receivables		260
C	Cash and Cash equivalents		365
		Total	3,251

### Notes to accounts

No.	Particulars		₹
<b>1</b>	<b>Share Capital</b>		
	Authorized, issued and subscribed capital:		
	Equity share capital (fully paid up shares of ₹ 10 each)		<u>1,125</u>
<b>2</b>	<b>Reserves and Surplus</b>		
	General Reserve	265	
	Less: Transfer to CR	<u>(265)</u>	-
	Capital Redemption Reserve	200	
	Add: Transfer due to buy-back of shares from P/L	35	
	Add; Transfer due to buy-back of shares from General Reserve	265	
	Less: Utilisation for issue of bonus shares	(225)	275
	Securities premium	175	
	Less: Adjustment for premium paid on buy-back	<u>(150)</u>	25
	Profit & Loss A/c	170	
	Add: Profit on sale of investment	1	

	Less: Transfer to CRR	(35)	<u>136</u>
	Total		<u>436</u>
<b>3</b>	<b>Long term borrowings</b>		
	12% Debentures		<u>750</u>
<b>4</b>	<b>Property, Plant and Equipment</b>		
	Land and Building		1,800
	Plant and machinery		<u>226</u>
	Net carrying value		2,026

**Working Notes:**

1. Amount of bonus shares = 25% of (1,200 – 300) lakhs = ₹ 225 lakhs
2. Cash at bank after issue of bonus shares

<i>Particulars</i>	<b>₹ in lakhs</b>
Cash balance as on 1 <sup>st</sup> April, 20X1	740
<i>Add:</i> Sale of investments	<u>75</u>
	815
<i>Less:</i> Payment for buy-back of shares	<u>(450)</u>
	<u>365</u>

**Note:** In the given solution, it is possible to adjust transfer to capital redemption reserve account or capitalization of bonus shares from any other free reserves or securities premium (to the extent available) also.

**Answer 3**

**Determination of Buy-back of maximum no. of shares as per the Companies Act, 2013**

**1. Shares Outstanding Test**

<i>Particulars</i>	<i>(Shares)</i>
Number of shares outstanding	1,25,000
25% of the shares outstanding	31,250

## 2. Resources Test: Maximum permitted limit 25% of Equity paid up capital + Free Reserves

<b>Particulars</b>	
Paid up capital (₹)	12,50,000
Free reserves (₹) (15,00,000 + 2,50,000 + 1,25,000)	<u>18,75,000</u>
Shareholders' funds (₹)	<u>31,25,000</u>
25% of Shareholders fund (₹)	7,81,250
Buy-back price per share	₹ 20
Number of shares that can be bought back (shares)	39,062
Actual Number of shares for buy-back	25,000

## 3. Debt Equity Ratio Test: Loans cannot be in excess of twice the Equity Funds post Buy-Back

	<b>Particulars</b>	₹
(a)	Loan funds (₹) (18,75,000+10,00,000+16,50,000)	45,25,000
(b)	Minimum equity to be maintained after buy-back in the ratio of 2:1 (₹) (a/2)	22,62,500
(c)	Present equity/shareholders fund (₹)	31,25,000
(d)	Future equity/shareholders fund (₹) (see W.N.) (31,25,000 – 2,87,500)	28,37,500*
(e)	Maximum permitted buy-back of Equity (₹) [(d) – (b)]	5,75,000
(f)	Maximum number of shares that can be bought back @ ₹ 20 per share	28,750 shares
(g)	Actual Buy-Back Proposed	25,000 Shares

\*As per Section 68 (2) (d) of the Companies Act 2013, the ratio of debt owed by the company should not be more than twice the capital and its free reserves after such buy-back. Further under Section 69 (1), on buy-back of shares out of free reserves a sum equal to the nominal value of the share bought back shall be transferred to Capital Redemption Reserve (CRR). As per section 69 (2) utilization of CRR is restricted to fully paying up unissued shares of the Company which are to be issued as fully paid-up bonus shares only. It means CRR is not available for distribution as dividend. Hence, CRR is not a free reserve. Therefore, for calculation of future equity i.e. share capital and free reserves, amount transferred to CRR on buy-back has to be excluded from the present equity.



**Summary statement determining the maximum number of shares to be bought back**

<b>Particulars</b>	<b>Number of shares</b>
Shares Outstanding Test	31,250
Resources Test	39,062
Debt Equity Ratio Test	28,750
Maximum number of shares that can be bought back [least of the above]	28,750

Company qualifies all tests for buy-back of shares and came to the conclusion that it can buy maximum 28,750 shares on 1st April, 20X1.

However, company wants to buy-back only 25,000 equity shares @ ₹ 20. Therefore, buy-back of 25,000 shares, as desired by the company is within the provisions of the Companies Act, 2013.

**Journal Entries for buy-back of shares**

	<b>Particulars</b>		<b>Debit (₹)</b>	<b>Credit (₹)</b>
(a)	Equity shares buy-back account	Dr.	5,00,000	
	To Bank account			5,00,000
	(Being buy-back of 25,000 equity shares of ₹ 10 each @ ₹ 20 per share)			
(b)	Equity share capital account	Dr.	2,50,000	
	Securities premium account	Dr.	2,50,000	
	To Equity shares buy-back account			5,00,000
	(Being cancellation of shares bought back)			
(c)	Revenue reserve account	Dr.	2,50,000	
	To Capital redemption reserve account			2,50,000
	(Being transfer of free reserves to capital redemption reserve to the extent of nominal value of capital bought back through free reserves)			

**Balance Sheet of M/s. Competent Ltd.  
as at 31st March, 20X1**

<i>Particulars</i>		<i>Notes</i>	<i>₹</i>
	<b>Equity and Liabilities</b>		
<b>1</b>	<b>Shareholders' funds</b>		
A	Share capital	1	10,00,000
B	Reserves and Surplus	2	16,25,000
<b>2</b>	<b>Non-current liabilities</b>		
	Long term borrowings	3	28,75,000
<b>3</b>	<b>Current liabilities</b>		
A	Other Current Liabilities		16,50,000
	Total		71,50,000
	<b>Assets</b>		
<b>1</b>	<b>Non-current assets</b>		
A	Property, plant and equipment	4	46,50,000
<b>2</b>	<b>Current assets</b>		
A	Other Current Assets (30,00,000 – 5,00,000)		25,00,000
	Total		71,50,000

**Notes to accounts**

<i>No.</i>	<i>Particulars</i>		<i>₹</i>
<b>1</b>	<b>Share Capital</b>		
	Authorized, issued and subscribed capital:		
	Equity share capital (fully paid up shares of ₹ 10 each)		<u>10,00,000</u>
<b>2</b>	<b>Reserves and Surplus</b>		
	Profit and Loss A/c		1,25,000
	Revenue reserves	15,00,000	

	Less: Transfer to CRR	<u>(2,50,000)</u>	12,50,000
	Securities premium	2,50,000	
	Less: Utilization for share buy-back	<u>(2,50,000)</u>	-
	Capital Redemption Reserves		<u>2,50,000</u>
	Total		<u>16,25,000</u>
<b>3</b>	<b>Long term borrowings</b>		
	14% Debentures		18,75,000
	Unsecured Loans		<u>10,00,000</u>
	Total		<u>28,75,000</u>
<b>4</b>	<b>Property, plant and equipment</b>		
	Land and Building		19,30,000
	Plant and machinery		18,00,000
	Furniture and fitting		<u>9,20,000</u>
	Net carrying value		<u>46,50,000</u>

**Working Note**

Amount transferred to CRR and maximum equity to be bought back will be calculated by simultaneous equation method.

Suppose amount transferred to CRR account is 'x' and maximum permitted buy-back of equity is 'y'.

Then

$$(31,25,000 - x) - 22,62,500 = y \quad (1)$$

$$\left(\frac{y}{20} \times 10\right) = x \quad \text{or} \quad 2x = y \quad (2)$$

by solving the above equation, we get

$$x = ₹2,87,500$$

$$y = ₹ 5,75,000$$

**Answer 4**

W, X, Y and Z hold Equity capital is held by in the proportion of 40:30:10:20 and A, B, C and D hold preference share capital in the proportion of 30:40:20:10. As the paid up equity share capital of the company is ₹ 40 Lakhs and Preference share capital is ₹ 20 Lakh (2:1), then relative weights in the voting right of equity shareholders and preference shareholders will be 2/3 and 1/3. The respective voting right of various shareholders will be

$$W = \frac{2}{3} \times \frac{40}{100} = \frac{4}{15}$$

$$X = \frac{2}{3} \times \frac{30}{100} = \frac{3}{15}$$

$$Y = \frac{2}{3} \times \frac{10}{100} = \frac{1}{15}$$

$$Z = \frac{2}{3} \times \frac{20}{100} = \frac{2}{15}$$

$$A = \frac{1}{3} \times \frac{30}{100} = \frac{1}{10}$$

$$B = \frac{1}{3} \times \frac{40}{100} = \frac{2}{15}$$

$$C = \frac{1}{3} \times \frac{20}{100} = \frac{1}{15}$$

$$D = \frac{1}{3} \times \frac{10}{100} = \frac{1}{30}$$