4 BUYBACK OF SECURITIES

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SECTION A – CONCEPTS

1. IMPORTANT CONDITIONS FOR BUYBACK OF EQUITY SHARES:

- Buy back must be authorized by Articles of Association of the company.
- Special Resolution has been passed in the GM of the company authorizing the buy back. However, Board of Directors can also authorized the buyback by passing Board resolution if buyback is equal to or less than 10% of the paid up capital of the company.
- Buy back of equity share in any financial year shall not exceed 25% of the total paid up capital of that equity share.
- Aggregate buyback of equity shares shall not exceed 25% of total paid up capital and free reserves of the company,
- Debt Equity ratio should not exceed 2:1 after such buy back.
- Equity shares must be fully paid.
- Buy back process must be completed within 12 months from the date of passing special resolution.

2. SOME IMPORTANT PROVISIONS:

(1) There are three sources of Funds for Buy Back of Equity shares:
- Out of Free Reserves; (GR + P&L)
- Out of Securities Premium; or
- Out of the proceeds of any Fresh issue of shares or other specified securities. (Debenture issue is not allowed for Buyback)

(2) Free Reserves includes:
- General Reserve
- P&L account (Cr. Balance)
- Security Premium a/c
- It does not include Capital Reserve, Share application a/c and revaluation reserves.

(3) Where a company purchases its own shares out of free reserves and Securities premium account, then a sum equal to the nominal value of the shares so bought back shall be transferred to the 'Capital Redemption Reserve Account' out of Free Reserves.

(4) Premium payable on buy-back can be set off against Security Premium a/c if any; otherwise it would be set off against Revenue Reserve.

(5) Capital Redemption Reserve can be utilized only for issuing Bonus shares to members.

3. JOURNAL ENTRIES FOR BUYBACK OF SECURITIES:

On Announcement of Buyback	Equity Share Capital A/c Dr. (Face Value) Premium Payable on Buy-Back A/c Dr. To Equity Shares Buy-back A/c (Buyback Value)
On Payment to Shareholders	Equity Shares Buy-back A/c Dr. To Bank A/c
Writing off Premium on Buy-back	Security Premium A/c Dr. (1st Priority) Revenue Reserves Dr. (Gen. Reserve and P&L) To Premium Payable on Buyback a/c
Transfer to CRR (Equal to Nominal Value)	Revenue Reserve Dr. (Gen. Reserve and P&L A/c) Security Premium A/c Dr. To Capital Redemption Reserve
On Fresh issue of other securities such as Pref. Shares	Bank A/c Dr. To Pref. Share Capital A/c To Security Premium A/c
On sale of Investment for the purpose of Buy-back	Bank A/c Dr. To Investment A/c (Gain or Loss on sale transfer to P&L A/c)
On Issue of Bonus Shares out of CRR and Other Free Res.	Capital Redemption Reserve Dr. (1st Priority if available) Revenue Reserves Dr. (Gen. Res and P&L) To Bonus Shares A/c Bonus Shares A/c Dr. To Equity Share Capital A/c

Note 1: There is no priority defined for above Entries. Entries can be passed in any order.

Note 2: For the purpose of Creating CRR, there is no priority set for utilising which part of free reserve. We can use different combinations. But the best combination is as follow:

1st Priority - General Reserve
2nd Priority - Profit and Loss A/c Cr. Balance
3rd Priority - Security Premium A/c

Note 3: Premium collected on issue of debentures/bonds can not be utilized for creating CRR if other Free Reserves balances are sufficient. In case, other Free Reserve balances are insufficient, then above premium could be used as Least Priority.

Note 4: Buyback expenses shall be written off either from Profit and Loss A/c (1st Priority) or from General Reserves (IInd Priority) or from Securities Premium A/c (Last Priority).

Buyback Exp. A/c Dr. To Bank A/c	P&L/GR/SP A/c Dr. To Buyback Exp. A/c

4. HOW TO CALCULATE MAXIMUM PERMISSIBLE BUYBACK

Here we need to conduct three important Tests for calculating Maximum permissible Buyback in accordance with Companies Act, 2013. These Tests are:

1. **Share Outstanding Test:** Maximum no. of buyback should not excess 25% of total Outstanding Equity Shares immediately before buyback.
2. **Resource Test:** Maximum Amount of Buyback should not excess 25% of Total Equity Paid up capital plus Free Reserves including Securities premium.
3. **Debt Equity Test:** After the Buyback of Equity, Debt-Equity Ratio should not exceed 2:1. (Here equity means ESC + PSC + Free Reserves)

Note: Debt means All Borrowings (Long term + Short Term) including Debentrues and Bank Loans but does not include any other current liabilities such as Creditors/BP.

EXAMPLE 1 (on Maximum Permissible Buyback):

The Buyback Price is Rs. 25/-

Outstanding Equity Share Capital (10/- each)	35,00,000
General Reserve	25,00,000
Profit & Loss Balance	11,50,000
Securities Premium	17,50,000
Debentures	60,00,000
Bank Loan (Non-Current Liability)	70,00,000
Current Maturity of Bank Loan	15,00,000
Sundry Creditors	25,00,000
Investment allowance Reserve	10,00,000

SOLUTION:

(1) Shares outstanding Test: -

Total Outstanding No. of Equity Shares x 25%

3,50,000 x 25% = **87,500 No.**

(2) Resources Test: -

(Total Paid-up Capital + Free Reserve) x 25% = Maximum Amount of Buyback

89,00,000 x 25% = 22,25,000/-

Therefore, Maximum No. of Buyback = 22,25,000/25 = **89,000 no.**

(3) Debt Equity Test: -

Debt Equity Ratio should not exceed 2:1 after Buyback

Debt (after buyback) = 1,45,00,000

Equity after Buyback Should be = 1,45,00,000 / 2 = 72,50,000

Current Equity – Buyback effect = Equity after Buyback

Assume No. of shares to be bought back is X

Therefore, Buyback Effect = Face Value (10X) + Premium on BB (15x) + CRR to be Created equal to FV out of FR (10X) = 35X

89,00,000 – 35x = 72,50,000

X = 47,142 No.

Note: for the purpose of this chapter, equity means Share Capital + Free reserves + Securities Premium

(Capital Redemption Reserve will not be a part of Equity)

Conclusion: Hence Final No. of Shares to be bought back should not be more than 47142 No. (whichever is lower in above three tests)

EXAMPLE 2 (Maximum Permissible Buyback with Preference Share Capital):

Continuing the Example 1 with additional information:

There are preference share Capital also of Rs. 30,00,000 (100/- each)

SOLUTION:

(1) Shares outstanding Test: -

Total Outstanding No. of Equity Shares x 25%

3,50,000 x 25% = 87,500 No.

(2) Resources Test: -

(Total Paid-up Capital + Free Reserve + Preference Share Capital) x 25% = Maximum Amount of Buyback

1,19,00,000 x 25% = 29,75,000/-

Therefore, Maximum No. of Buyback = 29,75,000/25 = 1,19,000 no.

(3) Debt Equity Ratio:-

Debt (after buyback) = 1,45,00,000

Equity after Buyback Should be = 1,45,00,000 / 2 = 72,50,000

Current Equity – Buyback effect = Equity after Buyback

1,19,00,000 – 35x = 72,50,000

X = 1,32,857 no.

Note: Current Equity here should include the Preference Share Capital also.

SECTION B – MCQ's

(MCQ's From ICAI Module)

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.
   (d) 10% 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)
   (d) Neither (a) nor (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
   (d) Special reserve

4. 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.
   (d) Partly paid shares can be bought back by a company.

5. 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).
   (d) Neither (a) nor (b).

6. 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.

(d) All of the above.

ANSWERS	1.	2.	3.	4.	5.	6.
	a	c	b	b	c	c

Student Notes:-