3. PREFERENCE SHARES – ISSUE AND REDEMPTION

3.1 Different types of Preference Share Capital

Based on Rights to Dividends	Based on Maturity Period	Based on Participation in Surplus Profits /Assets	Based on Convertibility
1. Cumulative and 2. Non–Cumulative	Redeemable (**Note:** Irredeemable Preference Shares cannot be issued)	1. Participating and 2. Non–Participating	1. Convertible and 2. Non–Convertible

1. **Cumulative and Non– Cumulative Preference Shares**

	Cumulative Preference Shares	Non–Cumulative Preference Shares
(a)	Dividend is at a fixed rate, but keeps on accumulating until it is fully paid.	Dividend is at a fixed rate, but does not accumulate for future years.
(b)	Dividend is payable even out of future profits, if current year's profits are insufficient for that purpose.	If no dividend is declared in a year due to any reason, the right to receive such dividend for that year expires.
(c)	Holder is entitled to fixed dividend of the past and current year, out of future profits.	Holder of this Share is not entitled to Arrears of Dividend in future.
(d)	Arrears of Fixed Cumulative Dividend are shown in the Balance Sheet as a Contingent Liability.	There is no Contingent Liability.
(e)	These Shareholders will get voting rights if dividend remains in arrears for not less than 2 years.	Such Shareholders will get voting rights if dividend remains in arrears for – (a) not less than 2 years, or (b) total of not less than 3 years comprised in the 6 years ending with the expiry of the financial year.

2. **Redeemable Preference Shares**

Point	Description
Max. 20 Years Period for Redemption	Companies **cannot** issue the following types of Preference Shares – (a) **Irredeemable** Preference Shares, or (b) Preference Shares **redeemable after 20 years** from the date of its issue. So, the **maximum** time limit for Redeemable Preference Share is **20 years**.
Extended Time Limit of 30 years for Infrastructure Facilities	The maximum limit is extended to **30 years** in the following situation – (a) Such issue can be made only by a Company engaged in the setting up and dealing with of **Infrastructural Projects** [See **Note** below.] (b) Such Preference Shares may for a period exceeding 20 years but **not exceeding 30 years.** (c) **Minimum 10%** of such Preference Shares should be **redeemed every year** from the 21st year onwards or earlier, on **proportionate basis**, at the **option** of the Preference Shareholders.

3. **Participating and Non– Participating Preference Shares**

	Participating Preference Shares	Non– Participating Preference Shares
(a)	In addition to a fixed dividend, the holders of these Shares have the right to participate in the surplus profits, if any, after the Equity Shareholders have been paid dividend at a stipulated rate.	Here, only a fixed rate of dividend is paid every year, without any additional rights in surplus profits.
(b)	In the event of winding–up of the Company, the holders have the right to receive a pre–determined proportion of surplus, after the Equity Shareholders have been paid off towards their Capital.	In case of winding–up of the Company, the holders of these Shares are not entitled to any additional rights in the surplus on winding–up.

4. **Convertible and Non–Convertible Preference Shares**

	Convertible Preference Shares	Non–Convertible Preference Shares
(a)	These Shares give the right to the holder to get them converted into Equity Shares **at their option,** and according to the terms and conditions of their issue.	There is no right to the holder, to get his holding converted into Equity Shares.
(b)	They are in the form of **Permanent Capital,** since the Preference Capital is not redeemed or repaid, it is only converted into Equity Shares.	They are to be redeemed in accordance with the terms of issue.

Note: Unless otherwise stated, a Preference Share is always –
(a) **non–cumulative**, (b) **redeemable**, (c) **non–participating**, and (d) **non–convertible.**

3.2 Entries in respect of Issue of Preference Shares

The Journal Entries for Issue of Preference Shares are the same as for Equity Shares. **Refer Page 9.13**

3.3 Redemption of Preference Shares

1. **Redemption** of Preference Shares means repaying the Capital back to the Preference Shareholders, at an agreed amount at an agreed date.
2. The process of discharging the liability / obligation towards Preference Share Capital is called **redemption**. So, Redemption = Repayment of Capital during the lifetime of the Company.
3. The terms of issue of Preference Shares usually contain a "**Call Option**" or "Call Provision", i.e. a right to redeem preference shares within or at the end of a given time period, at an agreed price.
4. The date of redemption is called "**Maturity Date**", and is usually printed on the Preference Share Certificate itself.

3.4 Purposes of issuing Redeemable Preference Shares

Redeemable Preference Shares may be issued because of the following reasons –

1. It is easy **to attract investors** for Preference Shares, since the redemption period and maturity date is specified by the Company. The Shareholders get back their Capital, on the maturity date.
2. It is a better way of raising finance, when the primary market is **dull**. (**Primary Market** refers to Public Issue of Shares by Companies.)
3. If a Company requires **funds for a medium–term project**, Redeemable Preference Shares are an ideal source of funding, since they can be repaid, after the project is completed.
4. When there is **surplus funds** available with the Company, and if the Company cannot use it for a profitable purpose, then it may redeem its Preference Shares.

3.5 Conditions for Redemption of Preference Shares

1. **Authorized by Articles:** The Articles of Association should contain a provision authorizing the Company to issue Redeemable Preference Shares.
2. **Fully Paid:** Preference Share Capital cannot be redeemed unless they are fully paid. If the Company has partly paid–up Preference Shares which are to be redeemed, they should be made fully paid before redeeming them.
3. **Time Limit for Redemption:** The Maximum time limit for redemption of Preference shares shall be **20 years**. Extended time limit of **30 years** shall be allowed for those Company engaged in Setting up and dealing with of Infrastructural Projects.
4. **Sourcing Redemption:** The Preference Shares can be redeemed only out of –
   (a) **Fresh Issue:** Proceeds of Fresh Issue of Shares made for the purpose of redemption, and / or
   (b) **Divisible Profits:** Profits otherwise available for distribution as Dividend.

   Note: In case of specified classes of companies and whose Financial Statements comply with the Accounting Standards specified u/s 133, the premium on Redemption of PSC issued after 01.04.2014 shall be provided **only out of profits of the company**, [i.e Securities premium A/c is not usable.]
5. **Sourcing Premium on Redemption:** Premium, if any, payable on redemption can be provided out of –
   (a) **Securities Premium:** Premium collected on issue of Shares, and / or
   (b) **Divisible Profits:** Profits otherwise available for distribution as Dividend.
6. **Capital Redemption Reserve:** If the Redemption is not sourced by Fresh Issue of Share Capital, then an amount equal to the Nominal Value of shares redeemed, to the extent not financed by Fresh Issue, should be transferred to a Reserve Fund called the **Capital Redemption Reserve (CRR)**. Hence, amount to be transferred to CRR = Face Value of Preference Shares to be redeemed **Less** Proceeds of Fresh Issue of Share Capital.
7. **Utilisation of CRR:** The balance in CRR can be utilized only for the purpose of issuing Bonus Shares. It shall not be used for any other purpose, e.g. distribution of dividend, etc. The provisions of the Act relating to reduction of Capital, shall apply to CRR also, as if the CRR were Paid–Up Capital of the Company.

3.6 Redemption of Preference Shares - Sources

Redemption of Preference Shares

	Out of Capital (i.e. Out of Fresh Issue of Shares)	**Out of Profits** (i.e. Capitalisation of Undistributed Profits)
Meaning	(a) To raise finance for repaying the Preference Shareholders, the Company can issue either Equity Shares or Preference Shares. (b) Such fresh issue can be made either at Par, or at Premium or at Discount.	A Company having surplus cash position (due to its earning profits and undistributed dividends), can use these surplus funds for redemption of Preference Shares. In such a case, transfer to CRR as required by Sec.80, is necessary.
Reasons	(a) Insufficient Profits, for redemption to Preference Shareholders. (b) Inadequate Bank Balance (i.e. poor liquidity position) to pay the Preference Shareholders. (c) Need to maintain Capital Base permanently, and not to return Capital to the Shareholders after some point of time.	(a) Sufficient Profits available for redemption to Preference Shareholders. (b) Good liquidity position (Bank Balances, Short Term Invts) to pay Preference Shareholders. (c) Need to transfer profits to CRR, and for further issue of Bonus Shares to Equity Shareholders.
Merits	(a) No cash outflow of money – now or later. (b) New Equity Shares may be issued at a premium. (c) Shareholders retain their Equity Interest. (d) No Capital Gain tax for shareholders	(a) No change in Shareholding Pattern or %age. (b) No scope for dilution of further earnings. (c) Surplus funds in the business can be used for redemption.
Demerits	(a) Shareholding Pattern in the Company will undergo a change. (b) There is a possibility of dilution of further earnings. (c) Mere inflow and outflow of Capital.	(a) Reduction in liquidity position. (b) Need to sell some Investments, at a loss, to finance redemption. (c) Profits transferred to CRR cannot be later claimed for distribution as Dividend. (d) Capital gain taxability for preference share holders

Note:

1. A Company may redeem its Preference Share Capital out of Capital and Profits, i.e. combination of above.
2. Securities Premium collected on fresh issue can be used for payment of Premium on Redemption of Preference Shares. However, it cannot be used for redemption of Preference Capital itself.
3. Redemption out of Capital means that the Company can issue either Equity Shares or Preference Shares. So, Preference Shares **cannot** be redeemed by fresh issue of **Debentures**.

3.7 Purpose of transfer to CRR

1. **Transfer:** Amount to be transferred to CRR = Face Value of Preference Shares to be redeemed **Less** Proceeds of Fresh Issue of Share Capital.
2. **Utilisation of CRR:** CRR can be utilized only for the purpose of issuing Bonus Shares. It shall not be used for any other purpose, e.g. distribution of dividend, etc.
3. **Retention of Capital:** So, when Preference Shares are redeemed out of Profits, **replacement /** retention of Capital is ensured in an indirect manner, by transfer of profit to CRR. The amount, which would otherwise have been distributed as dividend, is now **retained** in the business, in the form of CRR, and this is subsequently converted into Equity Share Capital, by issuing Bonus Shares.
4. **Non–Distributable Profits:** Transfer to CRR ensures replacement of Capital and Tangible Assets. There is no additional claim on the Net Assets of the Company. Transfer to CRR creates non–distributable profits, and maintains the Capital Base of the Company.
5. **Protection of Outsiders Interests:** The purpose of transfer to CRR is ensure Capital Maintenance, and to protect the interests of Outsiders / Creditors of the Company. Transfer to CRR ensures that there is **no reduction in "Shareholders' Funds"** or Capital Base due to the redemption, and hence the interests of outsiders are not affected.

3.8 Accounting Entries for Redemption of Preference Shares

	Transaction	Journal Entry
1.	Calling unpaid portion of Preference Share Capital, if any	Redeemable Preference Share Final Call A/c Dr. To Redeemable Preference Share Capital A/c
2.	Receipt of Final Call Amount **[Also see Note below]**	Bank A/c Dr. To Redeemable Preference Share Final Call A/c
3.	Fresh issue of Share Capital for the purpose of redemption	Bank A/c Dr. To Share Capital A/c (at Face Value) To Securities Premium A/c (if issued at a Premium)
4.	Sale of Investments or Current Assets for raising funds for redemption	Bank A/c Dr. Profit and Loss A/c (if sold at a Loss) Dr. To Investments / Current Asset A/c To Profit and Loss A/c (if sold at a Profit)
5.	Transfer of Preference Share Capital and Premium on Redemption of Preference Share Capital (if any), to Preference Shareholders A/c	Redeemable Preference Share Capital A/c Dr. Premium on Redemption of Pref. Shares A/c (if any) Dr. To Preference Shareholders A/c
6.	Transferring Divisible Profit to Capital Redemption Reserve Account	Profit and Loss A/c Dr. General Reserve A/c Dr. Other Divisible Profits A/c Dr. To Capital Redemption Reserve A/c (Amt trfd to CRR = Nominal Value of PSC to be redeemed **Less:** Nominal Value of any Fresh Issue of Share Capital
7.	Sourcing Premium payable on Redemption of Preference Shares	General Reserve A/c Dr. Profit and Loss A/c Dr. Other Reserves A/c Dr. To Premium on Redemption of Preference Shares A/c
8.	Making payment to Preference Shareholders	Preference Shareholders A/c Dr. To Bank A/c

Note: Non–Payment of Final Call:

1. If Final Call is made on partly paid–up Preference Shares (as per Entry 1 above), but some Preference Shareholders fail to pay the call amount due, those Preference Shares can be forfeited.
2. Such Forfeited Shares are **not re–issued,** since redemption of these Shares is due immediately or in the near future. These Forfeited Shares are **cancelled**, i.e. amount in Shares Forfeited A/c is fully transferred to **Capital Reserve A/c.**
3. For arranging funds for redemption, amount **actually payable** to balance Shareholders (i.e. **excluding** forfeited and cancelled Shares) is taken into consideration.
4. For ensuring replacement of Capital, (i.e. transfer to CRR + Fresh Issue of Capital), **Total** Preference Share Capital (i.e. **including** forfeited and cancelled Shares) should be taken into account.

3.9 Calculation of Capital Redemption Reserve

Situation 1: Transfer to CRR first, and balance out of fresh issue of Capital

Step	Description
1	Ensure that Preference Shares are fully paid–up. If not, make the Final Call to make them fully paid–up, and receive the Final Call amount.
2	Forfeit the Preference Shares on which Final Call amount has not been received, and cancel such Forfeited Shares, by transferring the amount to Capital Reserve.
3	Determine the **total amount actually payable** to Preference Shareholders, i.e. – (a) Preference Share Capital + (b) Premium on Redemption of Preference Shares, if any.

Step	Description
4	Ascertain the source for **providing Premium on Redemption** of Preference Shares. For this purpose, the following order of preference will be used – (a) Balance in General Reserve A/c, after adjusting for minimum balance to be maintained in General Reserve A/c as per Directors' decision. (b) Balance in Profit and Loss A/c, after adjusting for – (i) Loss on Sale of Investments / Assets, if any, and (ii) minimum balance to be maintained in P&L A/c as per Directors' decision.
5	Compute the balance **profits available for transfer to CRR** = 4(a) + 4(b) + Other Divisible Profits (e.g. Dividend Equalisation Reserve) XXX **Less:** Premium on Redemption of Preference Shares provided **out of 4(a) or 4(b)**, if any. XX Amount transferred to CRR XXX
6	Compute the **Required Fresh Issue of Shares** = **Face Value** of Preference Shares to be redeemed **Less** Amount transferred to CRR, as per Step 5
7	Find the number of fresh shares to be issued = Required Fresh Issue of Shares as per Step 6 / Face Value per new Share **Less** Discount, if any.
8	Determine the actual number of fresh shares to be issued, to the nearest one, or tens or hundreds of shares as specified in the question. [Fractional Shares cannot be issued.]

Situation 2: Redemption out of fresh issue of Capital and balance transfer to CRR

1. Here, the amount to be transferred to CRR = Face Value of Preference Shares to be redeemed **Less** Proceeds of Fresh Issue of Share Capital.
2. For this purpose, Proceeds of Fresh Issue of Share Capital =
   (a) No. of Shares Issued × Issue Price (if issued at par or at premium)
   (b) No. of Shares Issued × (Issue Price **less** Discount) (if issued at discount)

Illustration 1: Redemption out of Fresh Issue of Capital

Rama Ltd wishes to finance the redemption of its 14% Preference Share Capital (50,000 Shares of ₹ 100 each, redeemable at par), by the issue of Equity Shares of Face Value ₹ 100 each. Pass Journal Entries if such new Equity Issue is made – (a) at par, (b) at 15% premium.

Solution: **Journal Entries**

	Particulars	Dr.	Cr.
1.	**Amount due to Preference Shareholders**		
	14% Preference Share Capital A/c (50,000 × ₹ 100)	50,00,000	
	To Preference Shareholders A/c		50,00,000
	(Being amount due to Preference Shareholders on redemption)		
2.	**Fresh Issue of Equity Shares**		
(a)	**Equity Issue at Par:**		
	Bank A/c Dr.	50,00,000	
	To Equity Share Capital A/c (50,000 × ₹ 100)		50,00,000
	(Being fresh issue of Equity Shares at par, to finance redemption of PSC)		
(b)	**Equity Issue at Premium:**		
	Bank A/c Dr.	57,50,000	
	To Equity Share Capital A/c (50,000 × ₹ 100)		50,00,000
	To Securities Premium A/c (50,000 × ₹ 15)		7,50,000
	(Being fresh issue of Shares at 15% premium, to finance redemption of PSC)		
	Note: Face Value of ESC to be issued = Amount required for redemption of PSC = ₹ 50,00,000. Securities Premium received on New Issue cannot be used to finance redemption of PSC)		
3.	**Amount paid to Preference Shareholders**		
	Preference Shareholders A/c Dr.	50,00,000	
	To Bank		50,00,000
	(Being amount paid to Preference Shareholders on redemption)		

Illustration 2: Redemption out Profits and Capital – Minimum Amount required

The Balance Sheet of Kailash Ltd as on 31st December includes the following items –

- **11.5% Preference Share Capital of ₹ 100 each, fully paid–up = ₹ 50,00,000 (redeemable at 20% premium)**
- **Securities Premium = ₹ 12,50,000**
- **General Reserve = ₹ 25,00,000**
- **Profit and Loss Account = ₹ 8,50,000**
- **Capital Reserve = ₹ 2,00,000**
- **Workmen Compensation Reserve = ₹ 1,00,000 (not available for distribution as profits)**

On the above date, the Preference Shares are due for redemption. The Directors want to maintain a minimum balance of ₹ 5 Lakhs in General Reserve.

The Company wishes to know the number of Equity Shares (Face Value ₹ 100) to be issued, to ensure compliance with the provisions of Sec.80 of the Companies Act.

Advise the Company on the minimum number of Equity Shares to be issued, if the new Equity Shares are to be issued – (a) at par, and (b) at 10% premium.

Solution:

	Particulars		Amount
1.	Face Value of Preference Share Capital		₹ 50,00,000
2.	Premium on Redemption of Preference Shares = 20% of (1)above		₹ 10,00,000
3.	Total Amount actually payable to Preference Shareholders = (1 + 2)		₹ 60,00,000
4.	Premium on Redemption of Preference Shares is fully provided out of General Reserve available in B/ Sheet, i.e. ₹25,00,000. Hence, balance Securities Premium=		₹ 15,00,000
5.	Profits available for transfer to CRR = General Reserve (after keeping aside minimum balance ₹ 5 Lakhs) **Add:** Profit & Loss Account	 10,00,000 8,50,000	₹ 18,50,000
6.	Required Fresh Issue of Equity Shares = (1 – 5)		₹ 31,50,000
7.	Number of Equity Shares to be issued (a) In case of issue at Par: ₹ 31,50,000 ÷ ₹ 100 per Share = 31,500 Shares (b) In case of issue at Premium: ₹ 31,50,000 ÷ ₹ 100 per Share = 31,500 Shares		This is reqd for keeping the Capital **intact**.

Note: Balance in Securities Premium A/c and Capital Reserve A/c **cannot** be transferred to CRR.
Workmen Compensation Reserve is not available for distribution as profits. So, it cannot be tfd to CRR.

Illustration 3: Redemption of Preference Shares – Fresh Issue, Transfer to CRR

Iswara Limited has an Issued Share Capital of 650 7% Redeemable Preference Shares of ₹ 100 each and 4,500 Equity Shares of ₹ 50 each. The Preference Shares are redeemable at par on 1st April.

The Company's Balance Sheet as on 31st March (i.e. one day before redemption date) was as follows: –

Liabilities	₹	Assets	₹
Share Capital: Issued Share Capital		**Fixed Assets**	**3,45,000**
650 Fully Paid 7% Redeemable Pref. Shares of ₹ 100 each	**65,000**	**Investments**	**18,500**
4,500 Equity Shares of ₹ 50 each fully paid	**2,25,000**	**Balance at Bank**	**31,000**
	2,90,000		
Profit and Loss A/c	**48,000**		
Sundry Creditors	**56,500**		
Total	**3,94,500**	**Total**	**3,94,500**

In order to facilitate the redemption of the Preference Shares, the Company decided —

1. **To sell all the investments for ₹ 16,000,**
2. **To finance part of the redemption from Company funds, subject to leaving a balance of ₹ 12,000 in the P&L A/c, and**
3. **To issue sufficient Equity Shares of ₹ 50 each at ₹ 13 premium per share to raise the balance of funds required.**

The Preference Shares were redeemed on the due date and the issue of Equity Shares was fully subscribed.

Required: Determine the Number of shares to be issued in the above case.

Solution: **1. Computation of Equity Shares to be issued**

	Particulars		₹	₹
	Balance in Profit and Loss Account (given)			48,000
Less:	Loss on investment to be written off	(18,500 – 16,000)	2,500	
	Amount to be retained	(given)	12,000	(14,500)
	Available for transfer to Capital Redemption Reserve			33,500
	Nominal Amount of Equity Shares to be issued (₹ 65,000 – ₹ 33,500)			**31,500**
	Hence, number of Equity Shares to be issued ₹ 31,500 ÷ ₹ 50 face value			630 nos.
	Amount collected by way of issue of Equity Capital = 630 Shares × ₹ 63			**39,690**

Illustration 4: Preference Shares Redemption, Rights and Bonus Issue

Kapali Limited had Equity Capital of ₹ 2,00,000 divided into shares of ₹ 100 each. It also had 11% Cumulative Redeemable Preference Shares of ₹ 100 each for ₹ 1,00,000 and ₹ 50,000 and ₹ 40,000 respectively to the credit of P & L A/c and General Reserve as on 31st March. It had also ₹ 8,000 to the credit of Securities Premium A/c.

As per the agreement with the Preference Shareholders, the Directors decided to redeem the shares on 1.4.2004 at a premium of 10%. It was also decided to sell certain Investments whose Book and Market Values on 31st March were ₹ 40,000 and ₹ 50,000 respectively, to enable the redemption.

For purposes of redemption, the Board decided to utilize Free Reserves to the minimum extent possible. It was decided to issue Right Equity Shares at a premium of 20% to finance the redemption.

After redemption, the Board decided to issue Bonus Shares to Equity Shareholders in the ratio of 2 for 5. Holders of 100 Preference Shares were not traceable.

Compute (a) amount transferred to Capital Redemption Reserve (b) No. of Shares to be issued to redeem Preference Shares.

Solution: **1. Computation of Transfer to Capital Redemption Reserve**

	Particulars	₹
	Amount payable to Preference Shareholders including 10% Premium	1,10,000
Less:	Amount realized by Sale of Investments	50,000
	Balance amount to be financed by way of Fresh Equity Issue (Rights Issue)	**60,000**
	Equity Shares to be issued = ₹ 60,000 ÷ ₹ 120 Issue Price (₹ 100 + 20% Premium)	500
	Nominal Value of Fresh Issue = 500 Shares × ₹ 100	50,000
	Hence, Transfer to be made to Capital Redemption Reserve = 1,00,000 – 50,000 = Face Value of Preference Shares Redeemed Less Face Value of Fresh Equity Issue	**50,000**

2. Computation of Bonus Shares to be issued

	Particulars	Nos.
	Equity Shares before Rights Issue = Total Equity Capital ₹ 2,00,000 ÷ ₹ 100 per share	2,000
Add:	Equity Shares allotted under Rights Issue (as per WN 1)	500
	Total Equity Shares before Bonus Issue	**2,500**
	Hence, Bonus Shares at 2 Shares for every 5 Shares held = 2,500 × 2 ÷ 5	**1,000**