UNIT – 5: REDEMPTION OF PREFERENCE SHARES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- understand the meaning of redemption and the purpose of issuing redeemable preference shares;
- learn various provisions of the Companies Act, 2013 regarding preference shares and their redemption;
- familiarise yourself with various methods of redemption of fully paid-up preference shares by:
  - (i) Fresh issue of shares; Or
  - (ii) Capitalisation of divisible or undistributed profits; Or
  - (iii) Combination of (i) and (ii) above;
- understand the logic behind the creation of Capital Redemption Reserve;
- learn the accounting treatment for redemption of:
  - (i) fully paid-up preference shares;
  - (ii) partly called-up preference shares; and
  - (iii) fully called-up but partly paid-up preference shares.

UNIT OVERVIEW

Methods of redemption of Preference shares

- (a) By fresh issue of shares
- (b) By capitalisation of undistributed profits
- (c) By combination of (a) and (b)

Section 52 of the Companies Act, 2013 provides that the securities premium account may be applied by the company:

[NOTE: Certain class of Companies whose financial statements comply with the Accounting Standards as prescribed under Section 133 of the Companies Act, 2013, can't apply the securities premium account for the purposes (b) and (d)]

- (a) Towards issue of un-issued shares of the company to be issued to members of the company as fully paid bonus securities
- (b) To write off preliminary expenses of the company
- (c) To write off the expenses of, or commission paid, or discount allowed on any of the securities or debentures of the company
- (d) To provide for premium on the redemption of redeemable preference shares or debentures of the company.
- (e) For the purchase of its own shares or other securities.

5.1 INTRODUCTION

Redemption is the process of repaying an obligation, at prearranged amounts and timings. It is a contract specifying the obligation to redeem preference shares within or at the end of a given time period at an agreed price. These shares are issued on the terms that shareholders will at a future date be repaid the amount which they invested in the company (apart from the frequent payments of a specified amount of dividend as return on investment during the tenure of the preference shares). The redemption date is the maturity date, which specifies when repayment is scheduled to take place and is usually printed on the preference share certificate. Through the process of redemption, a company can also adjust its financial structure, for example, by eliminating preference shares and replacing those with other securities if future growth of the company makes such change advantageous.

5.2 PURPOSE OF ISSUING REDEEMABLE PREFERENCE SHARES

A company may issue redeemable preference shares because of the following:

1. It is a proper way of raising finance in a dull primary market.
2. A company may face difficulty in raising share capital, as its shares are not traded on the stock exchange. Potential investors who may, hesitate in putting money into shares that cannot easily be sold may be encouraged to invest if the shares are redeemable by the company.
3. The preference shares may be redeemed when there is a surplus of capital and the surplus funds cannot be utilised in the business for profitable use.
4. No dividend is required to be paid, if there is loss or no profit, whereas interest is payable on debentures or loans even in case of loss. In other words, preference dividend declared / paid continues to be regarded as an appropriation of profits (similar treatment is given for equity shares), as against interest on debentures, which is a charge against profits.

In India, the issue and redemption of preference shares is governed by Section 55 of the Companies Act, 2013.

5.3 PROVISIONS OF THE COMPANIES ACT (SECTION 55)

A company limited by shares if so authorised by its Articles, may issue preference shares which at the option of the company, are liable to be redeemed within a period, normally not exceeding 20 years from the date of their issue. It should be noted that:

(a) no shares can be redeemed except out of divisible or distributable profit, (i.e. out of the profit of the company which would otherwise be available for dividend) or out of proceeds of fresh issue of shares made for the purpose of redemption;

(b) no such shares can be redeemed unless they are fully paid;

(c) (i) in case of such class of companies, as may be prescribed and whose financial statement comply with the accounting standards prescribed for such class of companies under Section 133, the premium, if any, payable on redemption shall be provided for out of the profits of the company, before the shares are redeemed:

Provided also that premium, if any, payable on redemption of any preference shares issued on or before the commencement of this Act by any such company shall be provided for out of the profits of the company or out of the company's securities premium account, before such shares are redeemed.

(ii) in case of other companies (not falling under (i) above), the premium, if any payable on redemption shall be provided for out of the profits of the company or out of the company's securities premium account, before such shares are redeemed.

(Refer to the Note given in para 5.4.1 for the basis applied in the Illustrations in this Chapter.)

(d) where any such shares are proposed to be redeemed out of the profits of the company, there shall, out of the divisible profits, i.e. the profits which would otherwise have been available for dividends, be transferred to a reserve account to be called Capital Redemption Reserve Account, a sum equal to the nominal amount of the shares redeemed; and the provisions of the Act relating to the reduction of the share capital of a company shall, except as provided in the Section, apply as if the Capital Redemption Reserve (CRR) Account were the paid-up share capital of the company. The utilisation of CRR Account is further restricted to issuance of fully paid-up bonus shares only.

From the legal provision outlined above, it is apparent that on the redemption of redeemable preference shares out of accumulated divisible profits, it will be necessary to transfer to the Capital Redemption Reserve Account an amount equal to the amount repaid on the redemption of preference shares on account of face value less proceeds of a fresh issue of shares made for the purpose of redemption. The object is that with the repayment of redeemable preference shares, the security for creditors/ bankers, etc. should not be reduced. At times, a part of the preference share capital may be redeemed out of accumulated divisible profits and the balance out of a fresh issue.

5.4 METHODS OF REDEMPTION OF FULLY PAID-UP SHARES

Redemption of preference shares means repayment by the company of the obligation on account of shares issued. According to the Companies Act, 2013, preference shares issued by a company must be redeemed within the maximum period (normally 20 years) allowed under the Act. Thus, a company cannot issue irredeemable preference shares.

Section 55 of the Companies Act, 2013, deals with provisions relating to redemption of preference shares. It ensures that there is no reduction in shareholders' funds due to redemption and, thus, the interest of outsiders is not affected. For this, it requires that either fresh issue of shares is made, or distributable profits are retained and transferred to 'Capital Redemption Reserve Account'.

The rationale behind these provisions is to protect the interest of outsiders to whom the amount is payable before redemption of preference share capital. The interest of outsiders is protected if the nominal value of capital redeemed is substituted, thus, ensuring the same amount of shareholders' fund.

- In case of redemption of preference shares out of proceeds of a fresh issue of shares, replacement of capital and tangible assets is obvious.
- If redemption is done out of distributable profits, replacement of capital is ensured in an indirect manner by retention of profit by transfer to Capital Redemption Reserve. In this case, the amount which would have otherwise gone to shareholders in the form of dividend is retained in the business and is used for settling the claim of preference shareholders. Thus, there is no additional drain from the net assets of the Company. The transfer of divisible profits to Capital Redemption Reserve makes them non-divisible profits. As Capital Redemption Reserve can be used only for issue of fully paid bonus shares, profits retained in the business ultimately get converted into share capital.

Security cover available to outside stakeholders depends upon called-up capital as well as uncalled capital to be demanded by the company as per its requirements. To ensure that the interests of outsiders are not reduced, Section 55 provides for redemption of only fully paid-up shares.

From the above paras, it can be concluded that the 'gap' created in the company's capital by the redemption of redeemable preference shares must be filled in by:

(a) the proceeds of a fresh issue of shares; or

(b) the capitalisation of undistributed profits (by creating Capital Redemption Reserve); or

(c) a combination of (a) and (b) above.

5.4.1 Redemption of Preference Shares by Fresh Issue of Shares

One of the methods for redemption of preference shares is to use the proceeds of a fresh issue of shares. A company can issue new shares (equity shares or preference shares) and the proceeds from such new shares can be used for redemption of preference shares.

The proceeds from issue of debentures cannot be utilised for the purpose.

A problem arises when a fresh issue is made for the purpose of redemption of preference shares, at a premium. The point to ponder is that whether the proceeds of a fresh issue of shares will include the amount of securities premium for the purpose of redemption of preference shares.

For securities premium account, Section 52 of the Companies Act, 2013 provides that the securities premium account may be applied by the company;

(a) Towards issue of un-issued shares of the company to be issued to members of the company as fully paid bonus securities

(b) To write off preliminary expenses of the company

(c) To write off the expenses of, or commission paid, or discount allowed on any of the securities or debentures of the company

(d) To provide for premium on the redemption of redeemable preference shares or debentures of the company.

(e) For the purchase of its own shares or other securities.

Note: It may be noted that certain class of Companies whose financial statements comply with the Accounting Standards as prescribed under Section 133 of the Companies Act, 2013, can't apply the securities premium account for the purposes (b) and (d) mentioned above.

Note: All the questions in this chapter have been solved on the basis that the companies referred in the questions are governed by Section 133 of the Companies Act, 2013 and comply with the Accounting Standards prescribed for them. Accordingly the balance in securities premium account has not been utilized for the purpose of premium payable on redemption of preference shares.

Any other way, except the above prescribed ways, in which securities premium account is utilised will be in contravention of law.

Thus, the proceeds of a fresh issue of shares will not include the amount of securities premium for the purpose of redemption of preference shares.

Reasons for issue of New Equity Shares

A company may prefer issue of new equity shares for the following reasons:

(a) When the company has come to realise that the capital is needed permanently and it makes more sense to issue Equity Shares in place of Redeemable Preference Shares as Preference Shares carry a fixed rate of dividend.

(b) When the balance of profit, which would otherwise be available for dividend, is insufficient.

(c) When the liquidity position of the company is not good enough.

Advantages of redemption of preference shares by issue of fresh equity shares

Following are the advantages of redemption of preference shares by the issue of fresh equity shares:

(1) No cash outflow of money – now or later.

(2) New equity shares may be valued at a premium.

(3) Shareholders retain their equity interest.

Disadvantages of redemption of preference shares by issue of fresh equity shares

The disadvantages are:

(1) There will be dilution of future earnings;

(2) Share-holding in the company is changed if the fresh issue is made to outsiders. In case the fresh issue is made to existing shareholders in proportion to their shareholding (i.e., rights issue), the disadvantage of change in shareholding pattern can be mitigated.

5.4.2 Accounting Entries

1. When new shares are issued at par

Bank Account Dr.

To Share Capital Account

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

2. When new shares are issued at a premium

Bank Account Dr.

To Share Capital Account

To Securities Premium Account

(Being the issue of ....shares of ₹......each at a premium of ₹......each for the purpose of redemption of preference shares as per Board's

Resolution No..... dated......)

3. When preference shares are redeemed at par

Redeemable Preference Share Capital Account Dr.

To Preference Shareholders Account

4. When preference shares are redeemed at a premium

Redeemable Preference Share Capital Account Dr.

Premium on Redemption of Preference Shares Account Dr.

To Preference Shareholders Account

5. When payment is made to preference shareholders

Preference Shareholders Account Dr.

To Bank Account

6. For adjustment of premium on redemption

Profit and Loss Account Dr.

To Premium on Redemption of Preference Shares Account

ILLUSTRATION 1

Hinduja Company Ltd. had 5,000, 8% Redeemable Preference Shares of ₹ 100 each, fully paid up. The company decided to redeem these preference shares at par by the issue of sufficient number of equity shares of ₹ 10 each fully paid up at par. You are required to pass necessary Journal Entries including cash transactions in the books of the company.

SOLUTION

In the books of Hinduja Company Ltd.

Journal Entries

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.	5,00,000	
	To Equity Share Capital A/c			5,00,000
	(Being the issue of 50,000 Equity Shares of ₹10 each at par for the purpose of redemption of preference shares, as per Board Resolution No. ....dated........)			

	8% Redeemable Preference Share Capital A/c	Dr.	5,00,000	
	To Preference Shareholders A/c			5,00,000
	(Being the amount payable on redemption of preference shares transferred to Preference Shareholders Account)			
	Preference Shareholders A/c	Dr.	5,00,000	
	To Bank A/c			5,00,000
	(Being the amount paid on redemption of preference shares)			

ILLUSTRATION 2

C Ltd. had 10,000, 10% Redeemable Preference Shares of ₹ 100 each, fully paid up. The company decided to redeem these preference shares at par, by issue of sufficient number of equity shares of ₹ 10 each at a premium of ₹ 2 per share as fully paid up. You are required to pass necessary Journal Entries including cash transactions in the books of the company.

SOLUTION

In the books of C Ltd.

Journal Entries

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.	12,00,000	
	To Equity Share Capital A/c			10,00,000
	To Securities Premium A/c			2,00,000
	(Being the issue of 1,00,000 Equity Shares of ₹10 each at a premium of ₹2 per share as per Board's Resolution No..... dated.........)			
	10% Redeemable Preference Share Capital A/c	Dr.	10,00,000	
	To Preference Shareholders A/c			10,00,000
	(Being the amount payable on redemption of preference shares transferred to Preference Shareholders A/c)			
	Preference Shareholders A/c	Dr.	10,00,000	
	To Bank A/c			10,00,000
	(Being the amount paid on redemption of preference shares)			

Note: Amount required for redemption is ₹ 10,00,000. Therefore, face value of equity shares to be issued for this purpose must be equal to ₹ 10,00,000. Premium received on new issue cannot be used to finance the redemption.

ILLUSTRATION 3

G India Ltd. had 9,000 10% redeemable Preference Shares of ₹ 10 each, fully paid up. The company decided to redeem these preference shares at par by the issue of sufficient number of equity shares of ₹ 9 each fully paid up.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

SOLUTION

In the books of G India Limited

Journal

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.	90,000	
	To Equity Share Capital A/c			90,000
	(Being the issue of 10,000 Equity Shares of ₹9 each at par, as per Board's Resolution No.......Dated.....)			
	10% Redeemable Preference Shares Capital A/c	Dr.	90,000	
	To Preference Shareholders A/c			90,000
	(Being the amount payable on redemption of preference shares transferred to Preference Shareholders A/c)			
	Preference Shareholders A/c	Dr.	90,000	
	To Bank A/c			90,000
	(Being the amount paid on redemption of preference shares)			

5.4.3 Calculation of Minimum Fresh Issue of Shares

Sometimes, examination problem does not specify the number of shares to be issued for the purpose of redemption of preference shares and requires that the minimum number of shares should be issued to ensure that provisions of Section 55 of the Companies Act, 2013, are not violated. This is done in four steps as given below:

(1) In such cases, the maximum amount of reserves and surplus available for redemption is ascertained taking into account the balances appearing in the balance sheet before

redemption and the additional information provided in the problem. For example, if balance of general reserve in the balance sheet is ₹1,00,000 and additional information provides that the Board of Directors have decided that the balance of general reserve should not be less than ₹40,000 under any circumstances, then, the maximum amount of general reserve available for redemption is ₹ 60,000.

(2) After ascertaining the maximum amount of reserves and surplus available for redemption, adjustment for premium on redemption payable out of profits is made and then it is compared with the nominal value of shares to be redeemed. By comparison, one gets the minimum proceeds of fresh issue as Section 55 permits redemption either out of proceeds of fresh issue or out of divisible profits. Thus,

Minimum Proceeds of Fresh Issue of shares :

Nominal value of preference shares to be redeemed – Maximum amount of reserve and surplus available for redemption.

(3) After computation of minimum proceeds, the minimum number of shares to be issued are determined by dividing minimum proceeds by the proceeds of one share. This is done as follows:

Minimum Number of Shares = Minimum proceeds to comply with Section 55/ face value of one share

Proceeds of one share mean the par value of a share issued, if it is issued at par or premium. However, in case of issue of share at a discount, it refers to the discounted value.

(4) Minimum number of shares calculated as per (3) above, needs to be adjusted due to various reasons. Firstly, shares fractions cannot be issued. Thus, if minimum number of shares as per (3) above includes a fraction, it must be approximated to the next higher figure to ensure that provisions of Section 55 are not violated. Secondly, if the examination problem states that the proceeds/number of shares should be a multiple of say, 10 or 50 or 100, then again the next higher multiple should be considered.

ILLUSTRATION 4

The Board of Directors of a Company decided to issue minimum number of equity shares of ₹ 9 to redeem ₹ 5,00,000 preference shares. The maximum amount of divisible profits available for redemption is ₹ 3,00,000. Calculate the number of shares to be issued by the company to ensure that the provisions of Section 55 are not violated. Also determine the number of shares if the company decides to issue shares in multiples of ₹ 50 only.

SOLUTION

Nominal value of preference shares	₹ 5,00,000
Maximum possible redemption out of profits	₹ 3,00,000
Minimum proceeds of fresh issue	₹ 5,00,000 – 3,00,000 = ₹ 2,00,000
Proceed of one share	= ₹ 9
Minimum number of shares	$= \frac{2,00,000}{9} = 22,222.22$ shares

As fractional shares are not permitted, the minimum number of shares to be issued is 22,223 shares.

If shares are to be issued in multiples of 50, then the next higher figure which is a multiple of 50 is 22,250. Hence, minimum number of shares to be issued in such a case is 22,250 shares.

5.4.4 Fresh Issue at a Premium and Minimum Fresh Issue

The calculation of minimum number of shares, when fresh issue is at a premium should be handled very carefully Minimum fresh issue cannot be calculated unless one knows the profits available for replacement of preference shares and profit available for replacement cannot be determined unless one knows the portion of profit available for redemption which is required for paying premium on redemption. To tackle this, assume that profits available for redemption is not required for paying premium on redemption of preference shares. In other words, it means that securities premium including premium on fresh issue is comparatively more than premium on redemption.

If the above assumption holds good, minimum number of shares can be calculated in a simple manner without use of equation. But, if above condition does not hold good, then an equation is used to determine the minimum number of shares.

5.4.5 Minimum Fresh Issue to Provide Funds for Redemption

Besides, ensuring compliance with Section 55, the fresh issue of shares is made to provide funds for making payment to preference shareholders. To calculate minimum number of fresh shares to be issued to provide funds, amount payable to preference shareholders is compared with funds available for redemption and the balance of funds to be raised by fresh issue of shares are calculated. The amount to be raised is divided by the issue price of a share (amount payable by shareholder including premium, if any, on fresh issue) to compute the minimum number of shares to be issued.

ILLUSTRATION 5

X Ltd. gives you the following information as at 31st March, 2023:

	Particulars	₹
	EQUITY AND LIABILITIES	
1.	***Shareholders' funds***	
	a Share capital	*2,90,000*
	b Reserves and Surplus	*48,000*
2.	***Current liabilities***	
	Trade Payables	*56,500*
	ASSETS	
1.	***Property, Plant and Equipment***	*3,45,000*
2.	***Non-current investments***	*18,500*
3.	***Current Assets***	
	Cash and cash equivalents (bank)	*31,000*

The share capital of the company consists of ₹ 50 each equity shares of ₹ 2,25,000 and ₹ 100 each Preference shares of ₹ 65,000(issued on 1.4.2021). Reserves and Surplus comprises Profit and Loss Account only.

In order to facilitate the redemption of preference shares at a premium of 10%, the Company decided:

(a) to sell all the investments for ₹ 15,000.

(b) to finance part of redemption from company funds, subject to, leaving a bank balance of ₹ 12,000.

(c) to issue minimum equity share of ₹ 50 each share to raise the balance of funds required.

You are required to pass the necessary Journal Entries to record the above transactions.

SOLUTION

Journal

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.	37,500	
	To Share Application A/c			37,500
	(For application money received on 750 shares @ ₹ 50 per share)			

	Share Application A/c	Dr.	37,500	
	To Equity Share Capital A/c			37,500
	(For disposition of application money received)			
	Preference Share Capital A/c	Dr.	65,000	
	Premium on Redemption of Preference Shares A/c	Dr.	6,500	
	To Preference Shareholders A/c			71,500
	(For amount payable on redemption of preference shares)			
	Bank A/c	Dr.	15,000	
	Profit and Loss A/c (loss on sale) A/c	Dr.	3,500	
	To Investment A/c			18,500
	(For sale of investments at a loss of ₹ 3,500)			
	Profit and Loss A/c	Dr.	27,500	
	To Capital Redemption Reserve A/c			27,500
	(For transfer to CRR out of divisible profits an amount equivalent to excess of nominal value of preference shares over proceeds (face value of equity shares) i.e., ₹ 65,000 - ₹ 37,500)			
	Preference Shareholders A/c	Dr.	71,500	
	To Bank A/c			71,500
	(For payment of preference shareholders)			
	Profit and Loss A/c	Dr.	6,500	
	To Premium on Redemption of Preference Shares A/c			6,500
	(For writing off premium on redemption out of profits)			

Working Note:

Calculation of Number of Shares:	₹
Amount payable on redemption (₹ 65,000 + 10% of ₹ 65,000)	71,500
Less: Sale price of investment	(15,000)
	56,500
Less: Available bank balance (31,000 - 12,000)	(19,000)
Funds from fresh issue	37,500

∴ No. of shares = 37,500/50=750 shares

5.5 REDEMPTION OF PREFERENCE SHARES BY CAPITALISATION OF UNDISTRIBUTED DIVISIBLE PROFITS

Another method for redemption of preference shares, as per the Companies Act, is to use the distributable profits in place of issuing new shares. When shares are redeemed by utilising distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Redemption Reserve Account by debiting the distributable profit. In other words, some of the distributable profits are kept aside to ensure that it can never be distributed to shareholders as dividend.

Profit or a portion of profit that can be otherwise legally distributed as dividend to the shareholders is known as Divisible or Distributable Profit.

In this connection, the provisions of the Companies Act state that 'When any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall out of profits which would otherwise have been available for dividend (i.e. out of divisible profits), be transferred to a reserve to be called the Capital Redemption Reserve Account sum equal to the nominal amount of the shares redeemed'.

Note: Only Divisible Profits can be used to create Capital Redemption Reserve, Non-Divisible Profits cannot be used for this purpose.

5.5.1 Advantages of redemption of preference shares by capitalisation of undistributed divisible profits

The advantages of redemption of preference shares by capitalisation of undistributed divisible profits are:

(1) No change in the percentage of equity share-holding of the company;

(2) Surplus funds can be used.

5.5.2 Disadvantages of redemption of preference shares by capitalisation of undistributed divisible profits

The disadvantage of redemption of preference shares by capitalisation of undistributed profits is that there will be a reduction in liquidity or assets may need to be sold such as investments.

Accounting Entries

1. **For transferring nominal amount of shares redeemed to Capital Redemption Reserve Account**

General Reserve Account	Dr.
Profit and Loss Account	Dr.
any other Divisible Profits	Dr.
To Capital Redemption Reserve Account	

(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act).

2. **When shares are redeemed at par**

Redeemable Preference Share Capital Account	Dr.
To Preference Shareholders Account	

(Being the amount payable on redemption of preference shares transferred to Preference Shareholders Account)

3. **When shares are redeemed at a premium**

Redeemable Preference Share Capital Account	Dr.
Premium on Redemption of Preference Shares Account	Dr.
To Preference Shareholders Account	

(Being the amount payable on redemption transferred to Preference Shareholders Account)

4. **When payment is made to preference shareholders**

Preference Shareholders Account	Dr.
To Bank Account	

(Being the payment to preference shareholders as per terms)

5. **For adjustment of premium of redemption**

Divisible Profit Account	Dr.
To Premium on Redemption of Preference Shares Account	

(Being the premium on redemption adjusted against Profit and Loss Account)

ILLUSTRATION 6

The following are the extracts from the Balance Sheet of ABC Ltd. as on 31st December, 2022.

Share capital: 40,000 Equity shares of ₹ 10 each fully paid – ₹ 4,00,000; 1,000 10% Redeemable preference shares of ₹ 100 each fully paid – ₹ 1,00,000.

Reserve & Surplus: Capital reserve – ₹ 50,000; Securities premium – ₹ 50,000; General reserve – ₹ 75,000; Profit and Loss Account – ₹ 35,000

On 1st January 2023, the Board of Directors decided to redeem the preference shares at par by utilisation of reserve.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

SOLUTION

In the books of ABC Limited
Journal Entries

Date	Particulars		Dr. (₹)	Cr. (₹)
2023				
Jan 1	10% Redeemable Preference Share Capital A/c	Dr.	1,00,000	
	To Preference Shareholders A/c			1,00,000
	(Being the amount payable on redemption transferred to Preference Shareholders Account)			
	Preference Shareholders A/c	Dr.	1,00,000	
	To Bank A/c			1,00,000
	(Being the amount paid on redemption of preference shares)			
	General Reserve A/c	Dr.	75,000	
	Profit & Loss A/c	Dr.	25,000	
	To Capital Redemption Reserve A/c			1,00,000
	(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)			

Note: Securities premium and capital reserve (not being distributable profits) cannot be utilised for transfer to Capital Redemption Reserve.

5.5.3 Redemption of Preference Shares by combination of Fresh Issue and Capitalisation of Undistributed divisible Profits

A company can redeem the preference shares partly from the proceeds from new issue and partly out of profits. In order to fill in the 'gap' between the face value of shares redeemed and the proceeds of new issue, a transfer should be made from distributable profits (Profit & Loss Account, General Reserve and other Free Reserves) to Capital Redemption Reserve Account.

Formula:

		₹
(i)	Amount to be Transferred to Capital Redemption Reserve	₹
	Face value of shares redeemed	***
	Less: Proceeds from new issue	***
		***
(ii)	Proceeds to be collected from New Issue	₹
	Face value of shares redeemed	***
	Less: Profits available for distribution as dividend	***
		***

The term 'proceeds from fresh/new issue' shall be interpreted as:

(a) Amount credited to Share Capital, in case of issue at par

(b) Amount credited to Share Capital, in case of issue at premium. Though premium is received which is credited to the Securities Premium A/c, the same shall not be regarded as 'proceeds', because if it were to be treated as such, the transfer of distributable profits to the Capital Redemption Reserve would be lower by the amount of the premium received.

(c) Amount received (i.e., debited to Cash/Bank), in case of issue at a discount.

Note: Section 53 of the Companies Act, 2013 prohibits issue of shares at a discount, except in case of issue of Sweat Equity Shares as outlined in Section 54.

ILLUSTRATION 7

C Limited had 3,000, 12% Redeemable Preference Shares of ₹ 100 each, fully paid up. The company had to redeem these shares at a premium of 10%.

It was decided by the company to issue the following:

(i) 25,000 Equity Shares of ₹ 10 each at par,

(ii) 1,000 14% Debentures of ₹ 100 each.

The issue was fully subscribed and all amounts were received in full. The payment was duly made. The company had sufficient profits. Show Journal Entries in the books of the company.

SOLUTION

In the books of C Limited
Journal Entries

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.	2,50,000	
	To Equity Share Capital A/c			2,50,000
	(Being the issue of 25,000 equity shares of ₹ 10 each at par as per Board's resolution No……dated…..)			
	Bank A/c	Dr.	1,00,000	
	To 14% Debenture A/c			1,00,000
	(Being the issue of 1,000 Debentures of ₹ 100 each as per Board's Resolution No…..dated……)			
	Profit & Loss A/c	Dr.	50,000	
	To Capital Redemption Reserve A/c			50,000
	(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)			
	12% Redeemable Preference Share Capital A/c	Dr.	3,00,000	
	Premium on Redemption of Preference Shares A/c	Dr.	30,000	
	To Preference Shareholders A/c			3,30,000
	(Being the amount payable on redemption transferred to Preference Shareholders Account)			
	Preference Shareholders A/c	Dr.	3,30,000	
	To Bank A/c			3,30,000
	(Being the amount paid on redemption of preference shares)			
	Profit & Loss A/c	Dr.	30,000	
	To Premium on Redemption of Preference Shares A/c			30,000
	(Being the adjustment of premium on redemption against Profits & Loss Account)			

Working Note:

Amount to be transferred to Capital Redemption Reserve Account

Face value of shares to be redeemed	3,00,000
Less: Proceeds from new issue	(2,50,000)
Total Balance	50,000

ILLUSTRATION 8

The capital structure of a company consists of 20,000 Equity Shares of ₹ 10 each fully paid up and 1,000 8% Redeemable Preference Shares of ₹ 100 each fully paid up (issued on 1.4.2021).

Undistributed reserve and surplus stood as: General Reserve ₹ 80,000; Profit and Loss Account ₹ 20,000; Investment Allowance Reserve out of which ₹ 5,000, (not free for distribution as dividend) ₹ 10,000; Securities Premium ₹ 2,000, Cash at bank amounted to ₹ 98,000. Preference shares are to be redeemed at a Premium of 10% and for the purpose of redemption, the directors are empowered to make fresh issue of Equity Shares at par after utilising the undistributed reserve and surplus, subject to the conditions that a sum of ₹ 20,000 shall be retained in general reserve and which should not be utilised.

Pass Journal Entries to give effect to the above arrangements.

SOLUTION

In the books of ....
Journal Entries

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.	25,000	
	To Equity Share Capital A/c			25,000
	(Being the issue of 2,500 Equity Shares of ₹ 10 each at a premium of Re. 1 per share as per Board's Resolution No.....dated.......)			
	General Reserve A/c	Dr.	60,000	
	Profit & Loss A/c	Dr.	10,000	
	Investment Allowance Reserve A/c	Dr.	5,000	
	To Capital Redemption Reserve A/c			75,000
	(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)			
	8% Redeemable Preference Share Capital A/c	Dr.	1,00,000	

	Premium on Redemption of Preference Shares A/c	Dr.	10,000	
	To Preference Shareholders A/c			1,10,000
	(Being the amount paid on redemption transferred to Preference Shareholders Account)			
	Preference Shareholders A/c	Dr.	1,10,000	
	To Bank A/c			1,10,000
	(Being the amount paid on redemption of preference shares)			
	Profit & Loss A/c	Dr.	10,000	
	To Premium on Redemption of Preference Shares A/c			10,000
	(Being the premium payable on redemption is adjusted against Profit & Loss Account)			

Working Note:

No of Shares to be issued for redemption of Preference Shares:

Face value of shares redeemed			₹ 1,00,000
Less:	Profit available for distribution as dividend:		
	General Reserve : ₹(80,000-20,000)	₹ 60,000	
	Profit and Loss (20,000 – 10,000 set aside for adjusting premium payable on redemption of preference shares)	₹10,000	
	Investment Allowance Reserve: (₹ 10,000-5,000)	₹ 5,000	(₹ 75,000)
			₹ 25,000

Therefore, No. of shares to be issued = ₹ 25,000/₹10 = 2,500 shares.

5.5.4Sale of Investments to Provide Sufficient Funds for Redemption

Companies may have sufficient investments, which can be sold, in the market to arrange funds for redemption of preference shares.

5.6 REDEMPTION OF PARTLY CALLED-UP PREFERENCE SHARES

One of the conditions of redemption is that only fully paid up preference shares can be redeemed by a company. Hence:

1) If the problem states that it is decided to redeem preference shares which are partly called up, then it is assumed that the final call on these shares is demanded and received before proceeding with redemption of these shares.

2) If information about both fully paid and partly paid preference shares is provided, then, it is presumed that only fully paid shares are to be redeemed and partly paid shares are left intact.

3) The company can forfeit the shares, if the call money is not received by the company in spite of giving opportunity to pay the same via reminders.

ILLUSTRATION 9

The Balance Sheet of XYZ Ltd. as at 31st December, 2021 inter alia includes the following information:

	₹
50,000, 8% Preference Shares of ₹100 each, ₹70 paid up	*35,00,000*
1,00,000 Equity Shares of ₹100 each fully paid up	*1,00,00,000*
Securities Premium	*5,00,000*
Capital Redemption Reserve	*20,00,000*
General Reserve	*50,00,000*
Bank	*15,00,000*

Under the terms of their issue, the preference shares are redeemable on 31st March, 2022 at 5% premium. In order to finance the redemption, the company makes a rights issue of 50,000 equity shares of ₹ 100 each at ₹ 110 per share, ₹ 20 being payable on application, ₹ 35 (including premium) on allotment and the balance on 1st January, 2023. The issue was fully subscribed and allotment made on 1st March, 2022. The money due on allotment were duly received by 31st March, 2022. The preference shares were redeemed after fulfilling the necessary conditions of Section 55 of the Companies Act, 2013.

You are asked to pass the necessary Journal Entries. (Ignore date column)

SOLUTION

Journal Entries

		₹	₹
8% Preference Share Final Call A/c	Dr.	15,00,000	
To 8% Preference Share Capital A/c			15,00,000
(For final call made on preference shares @ ₹ 30 each to make them fully paid up)			
Bank A/c	Dr.	15,00,000	
To 8% Preference Share Final Call A/c			15,00,000
(For receipt of final call money on preference shares)			
Bank A/c	Dr.	10,00,000	
To Equity Share Application A/c			10,00,000
(For receipt of application money on 50,000 equity shares @ ₹ 20 per share)			
Equity Share Application A/c	Dr.	10,00,000	
To Equity Share Capital A/c			10,00,000
(For capitalisation of application money received)			
Equity Share Allotment A/c	Dr.	17,50,000	
To Equity Share Capital A/c			12,50,000
To Securities Premium A/c			5,00,000
(For allotment money due on 50,000 equity shares @ ₹ 35 per share including a premium of ₹ 10 per share)			
Bank A/c	Dr.	17,50,000	
To Equity Share Allotment A/c			17,50,000
(For receipt of allotment money on equity shares)			
General Reserve A/c	Dr.	27,50,000	
To Capital Redemption Reserve A/c			27,50,000
(For transfer of CRR the amount not covered by the proceeds of fresh issue of equity shares i.e., 50,00,000 - 10,00,000 - 12,50,000)			
8% Preference Share Capital A/c	Dr.	50,00,000	

Premium on Redemption of Preference Shares A/c	Dr.	2,50,000	
To Preference Shareholders A/c			52,50,000
(For amount payable to preference shareholders on redemption at 5% premium)			
Preference Shareholders A/c	Dr.	52,50,000	
To Bank A/c			52,50,000
(For amount paid to preference shareholders)			
General Reserve A/c	Dr.	2,50,000	
To Premium on Redemption A/c			2,50,000
(For writing off premium on redemption of preference shares)			

Note: Amount received (excluding premium) on fresh issue of shares till the date of redemption should be considered for calculation of proceeds of fresh issue of shares. Thus, proceeds of fresh issue of shares ₹ 22,50,000 (₹ 10,00,000 application money plus ₹ 12,50,000 received on allotment towards share capital) will be considered.

5.6 REDEMPTION OF FULLY CALLED BUT PARTLY PAID-UP PREFERENCE SHARES

The problem of unpaid calls on fully called up shares may be studied under following categories:

5.6.1 When the amount of calls-in-arrears is received by the company

If the amount of unpaid calls is received by the Company before redemption, the entry passed is as under:

Bank A/c	Dr.
To Calls-in-Arrears A/c	

After receipt of calls in arrears, the shares become fully paid up and then, company can proceed with redemption in the normal course.

5.6.2 In case of Forfeited Shares

If in spite of receiving a proper notice from the company, the shareholders fail to pay the unpaid calls, the Board of Directors may decide to forfeit the shares and cancel these shares instead of reissuing the forfeited shares because redemption of these shares is due immediately or in near future. In this case, the journal entry for forfeiture is passed as usual, which will be as follows:

Preference Share Capital A/c # Dr

(#Called up share capital only relating to the shares to be forfeited)

To Calls In Arrears A/c

To Shares Forfeited A/c *

(*Amount actually collected on shares forfeited. This will be equal to the balancing amount)

NOTE: But it should be noted, in this case, that the number of shares to be redeemed will be reduced by the number of shares so forfeited. Further, since the preference shares are getting redeemed, the forfeited shares will not be reissued and hence the balance in the Shares Forfeited A/c should be transferred to Capital Reserve by passing the following journal entry:

Shares Forfeited A/c Dr.

To Capital Reserve A/c

ILLUSTRATION 10

With the help of the details in Illustration 9 above and further assuming that the Preference Shareholders holding 2,000 shares fail to make the payment for the Final Call made under Section 55, you are asked to pass the necessary Journal Entries and show the relevant extracts from the balance sheet as on 31st March, 2022 with the corresponding figures as on 31st December, 2021 assuming that the shares in default are forfeited after giving proper notices. (Ignore date column)

SOLUTION

Journal Entries

			₹	₹
	8% Preference Share Final Call A/c	Dr.	15,00,000	
	To 8% Preference Share Capital A/c			15,00,000
	(For final call made on preference shares @ ₹ 30 each to make them fully paid up)			
	Bank A/c (48,000 x ₹30)	Dr.	14,40,000	
	Calls in arrears A/c (2,000x ₹30)		60,000	
	To 8% Preference Share Final Call A/c			15,00,000
	(For receipt of final call money on preference shares)			

	Preference Share Capital A/c (2000 X ₹100) Dr.
	  To Calls in Arrears A/c (2000 X ₹30)
	  To Shares Forefeited A/c (2000 X ₹70)
	(For Shares Forefeited after shareholders fail to pay the Final Call)
		2,00,000	60,000
			1,40,000

	Bank A/c Dr. To Equity Share Application A/c (For receipt of application money on 50,000 equity shares @ ₹ 20 per share)	10,00,000	10,00,000
	Equity Share Application A/c Dr. To Equity Share Capital A/c (For capitalisation of application money received)	10,00,000	10,00,000

	Equity Share Allotment A/c Dr.
	  To Equity Share Capital A/c
	  To Securities Premium A/c
	(For allotment money due on 50,000 equity shares @ ₹ 35 per share including a premium of ₹ 10 per share)
		17,50,000	12,50,000
			5,00,000

	Bank A/c Dr. To Equity Share Allotment A/c (For receipt of allotment money on equity shares)	17,50,000	17,50,000
	General Reserve A/c Dr. To Capital Redemption Reserve A/c (For transfer of CRR the amount not covered by the proceeds of fresh issue of equity shares i.e., 48,00,000 – 10,00,000 – 12,50,000)	25,50,000	25,50,000
	8% Preference Share Capital A/c Dr. Premium on Redemption of Preference Shares A/c Dr. To Preference Shareholders A/c (For amount payable to preference shareholders on redemption at 5% premium)	48,00,000 2,40,000	50,40,000
	Preference Shareholders A/c Dr. To Bank A/c (For amount paid to preference shareholders)	50,40,000	50,40,000

	General Reserve A/c Dr.		2,40,000	
	To Premium on Redemption A/c			2,40,000
	(For writing off premium on redemption of preference shares)			
	Shares Forfeited A/c Dr.		1,40,000	
	To Capital Reserve A/c			1,40,000
	(For transferring balance to Capital Reserve A/c after redemption of preference shares)			

Note: Amount received (excluding premium) on fresh issue of shares till the date of redemption should be considered for calculation of proceeds of fresh issue of shares. Thus, proceeds of fresh issue of shares ₹ 22,50,000 (₹10,00,000 application money plus ₹ 12,50,000 received on allotment towards share capital) will be considered.

SUMMARY

- Redemption is the process of repaying an obligation, at prearranged amount and timing.
- In India, the issue and redemption of preference shares is governed by Section 55 of the Companies Act, 2013.
- A company limited by shares if so authorised by its Articles, may issue preference shares which at the option of the company*, are liable to be redeemed. It should be noted that:

  (a) no shares can be redeemed except out of profit of the company which would otherwise be available for dividend or out of proceeds of fresh issue of shares made for the purpose of redemption;

  (b) no such shares can be redeemed unless they are fully paid;

  * A company cannot issue irredeemable preference shares.
- Methods of redemption of fully paid-up preference shares: (i) by Fresh issue of shares; (ii) by Capitalisation of undistributed profits; (iii) Combination of (i) and (ii),

TEST YOUR KNOWLEDGE

True and False

1. *When shares are redeemed by utilising distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Reserve account by debiting the distributable profit.*

2. *A company who prepares financial statements in compliance with Accounting Standards under Section 133 of the Companies Act, 2013, it cannot utilize securities premium for the purpose of providing for premium on the redemption of Redeemable Preference shares of the Company.*

3. *The balance in forfeited shares account can be used for transfer to capital redemption reserve account.*

4. *Capital redemption reserve cannot be used for writing off miscellaneous expenses and losses*

Multiple Choice Questions

1. *Securities premium cannot be used to _______.*

   (a) *Issue bonus shares*

   (b) *Redeem preference shares*

   (c) *Write-off preliminary expenses*

2. *S Ltd. issued 2,000, 10% Preference shares of ₹ 100 each at par on 1.4.2021, which are redeemable at a premium of 10%. For the purpose of redemption, the company issued 1,500 Equity Shares of ₹ 100 each at a premium of 20% per share. At the time of redemption of Preference Shares, the amount to be transferred by the company to the Capital Redemption Reserve Account = ?*

   (a) *₹ 50,000*

   (b) *₹ 40,000*

   (c) *₹ 2,00,000*

3. *Which of the following cannot be used for the purpose of creation of capital redemption reserve account?*

   (a) *Profit and loss account (credit balance)*

(b) *General reserve account*

(c) *Unclaimed dividend account*

4 *According to Section 52 of the Companies Act, 2013, the amount in the Securities Premium A/c cannot be used for the purpose of*

(a) *Issue of fully paid bonus shares*

(b) *Writing off losses of the company*

(c) *For purchase of own securities*

5. *Which of the following can be utilized for redemption of preference shares?*

(a) *The proceeds of fresh issue of equity shares*

(b) *The proceeds of issue of debentures*

(c) *The proceeds of issue of fixed deposit*

6. *Preference shares amounting to ₹ 2,00,000 (already issued on 1.4.2021) are redeemed at a premium of 5%, by issue of shares amounting to ₹ 1,00,000 at a premium of 10%. The amount to be transferred to capital redemption reserve = ?*

(a) *₹ 1,05,000*

(b) *₹ 1,00,000*

(c) *₹ 2,00,000*

Theoretical Questions

1. *What is the purpose of issuing redeemable preference shares?*

2. *What are the provisions of the Companies Act, 2013 related with redemption of preference shares? Explain in brief.*

Practical Questions

1. *The books of B Ltd. showed the following balance on 31st December, 2023:*

30,000 Equity Shares of ₹10 each fully paid; 18,000 12% Redeemable Preference Shares of ₹10 each fully paid; 4,000 10% Redeemable Preference Shares of ₹ 10 each, ₹ 8 paid up (all shares issued on 1st April, 2022).

Undistributed Reserve and Surplus stood as: Profit and Loss Account ₹ 80,000; General Reserve ₹ 1,20,000; Securities Premium Account ₹ 15,000 and Capital Reserve ₹ 21,000.

For redemption, 3,000 equity shares of ₹10 each are issued at 10% premium. At the same time, Preference shares are redeemed on 1st January, 2024 at a premium of ₹2 per share. The whereabouts of the holders of 100 shares of ₹10 each fully paid are not known.

A bonus issue of equity share was made at par, two shares being issued for every five held on that date out of the Capital Redemption Reserve Account. However, equity shares, issued for redemption are not eligible for bonus.

Show the necessary Journal Entries to record the transactions. (Ignore date column)

ANSWERS/ HINTS

True and false

1. False: When shares are redeemed by utilising distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Redemption Reserve account by debiting the distributable profit.

2. True: A company who prepares financial statements in compliance with Accounting Standards under Section 133 of the Companies Act, 2013, it cannot utilize securities premium for the purpose of providing the premium on the redemption of redeemable preference shares.

3. False: The balance in Forfeited shares account cannot be used for transfer to capital redemption reserve account.

4. True: Capital redemption reserve cannot be used for writing off miscellaneous expenses and losses.

Multiple Choice Questions

1.	(b)	**2.**	(a)[1]	**3.**	(c)	**4.**	(b)	**5.**	(a)	**6.**	(b)[2]

Theoretical Questions

1. A company may issue redeemable preference shares to raise finance in a dull primary market. Preference shares may be redeemed when there is a surplus of capital and the surplus funds cannot be utilised in the business for profitable use. For details, refer para 5.2 of the chapter.

[1] 2,00,000 – 1,50,000
[2] 2,00,000 – 1,00,000

2. Section 55 of the Companies Act, 2013, deals with provisions relating to redemption of preference shares. It ensures that there is no reduction in shareholders' funds due to redemption and, thus, the interest of outsiders is not affected. For details, refer para 5.3 of the chapter.

Practical Questions

1. **In the books of B Limited**

Journal Entries

Particulars		***Dr. (₹)***	***Cr. (₹)***
12% Redeemable Preference Share Capital A/c	Dr.	1,80,000	
Premium on Redemption of Preference Shares A/c	Dr.	36,000	
To Preference Shareholders A/c			2,16,000
(Being the amount payable on redemption of 18,000 12% Redeemable Preference Shares transferred to Shareholders Account)			
Preference Shareholders A/c	Dr.	2,14,800	
To Bank A/c			2,14,800
(Being the amount paid on redemption of 17,900 preference shares)			
Bank A/c	Dr.	33,000	
To Equity Shares Capital A/c			30,000
To Securities Premium A/c			3,000
(Being the issue of 3,000 Equity Shares of ₹ 10 each at a premium of 10% as per Board's Resolution No....... Dated......)			
General Reserve A/c	Dr.	1,20,000	
Profit & Loss A/c	Dr.	30,000	
To Capital Redemption Reserve A/c			1,50,000
(Being the amount transferred to Capital Redemption Reserve A/c as per the requirement of the Act.)			
Capital Redemption Reserve A/c	Dr.	1,20,000	
To Bonus to Shareholders A/c			1,20,000
(Being the amount appropriated for issue of bonus share in the ratio of 5:2 as per shareholders Resolution No...... dated...)			

Bonus to Shareholders A/c Dr. To Equity Share Capital A/c (Being the utilisation of bonus dividend for issue of 12,000 equity shares of ₹ 10 each fully paid)		1,20,000	1,20,000
Profit & Loss A/c Dr. To Premium on Redemption of Preference Shares A/c (Being premium on redemption of preference shares adjusted against to Profit & Loss Account)		36,000	36,000

Working Note:

(1) Partly paid-up preference shares cannot be redeemed.

(2) Amount to be Transferred to Capital Redemption Reserve Account

Face value of share to be redeemed	₹ 1,80,000
Less: Proceeds from fresh issue (excluding premium)	(₹ 30,000)
	₹ 1,50,000

(3) No bonus shares on 3,000 equity shares issued for redemption.

Note: Bonus shares does not result in receipt of cash, and hence the increase in share capital on account of bonus issue cannot be considered in determination of amount to be transferred to Capital Redemption Reserve.