UNITS 3 BUY BACK OF SHARES

Structure

3.0 OBJECTIVES

After studying this unit, you will be able to:

- Understand the concept of buy back of shares,
- Explain the motives of buy back of shares,
- Identify the conditions for buy back of shares,
- Describe the methods of buy back of shares,
- State the advantages of buy back of shares, and
- Discuss the accounting procedures of buy back of shares.

3.1 INTRODUCTION

The act of purchasing its own shares by the company either from free reserves, securities premium or proceeds of any shares or securities, is called the buy back of shares. The Companies Amendment) Act, 1999 via sections 77A, 77AA, and 77B allows companies to purchase their own shares subject to the certain conditions. These conditions are discussed in the next section.

3.2 CONDITIONS FOR BUY BACK OF SHARES

1. The Articles of Association of the company authorize buy back of shares.
2. The special resolution is to be passed in the General Meeting of the company.

3. The buy back of shares should not exceed 25% of the paid-up capital and free reserves of the company.
4. After such buy back, the debt equity ratio should not exceed 2:1.
5. From the 12 months of the date of passing the resolution, the buy back should be completed.
6. All the buy back shares should be fully paid-up.
7. A declaration of the company should be filed with the Registrar of the Companies and Securities Exchange Board of India in the form of an affidavit.
8. The securities should be listed at the Stock Exchange of India.
9. Within seven days of the last date of completion of buy back, the company shall extinguish or physically destroy such shares.
10. Company shall not make further issue of shares within a period of 24 months, except the issue of bonus shares after completing the buy back of shares.
11. The buy back cannot be done through a subsidiary or investment company.

3.3 MOTIVES OF BUY BACK OF SHARES

There may be various objectives of buy back of shares. Some of them are as follow:

- Return the surplus cash to shareholders.
- Enhance the Earning Per Share (EPS).
- Convey the view of the management to investors
- Stabilize the market price of the share of the company.
- Raise the promoters' voting power without spending any amount.
- Word off a hostile takeover threat.
- Move towards a desirable Capital Structure.

3.4 SEBI GUIDELINES

SEBI has made certain regulations in 1998, in relation to the buy back of shares, which are as follows:

1. Buy back of shares cannot be done through negotiated deals. Therefore, the company is required to make public announcements through one national English daily newspaper, one national Hindi daily, and one national language daily where the registered office of the company is situated.
2. Buy back should be permissible:
    - From the existing shareholders on a proportionate basis.
    - From the open market.
    - From the old lot of holders.
    - By purchasing the shares issued to employees of the company pursuant to the scheme of stock option or sweat equity.

- Buy back offer should remain open for a minimum of 15 days and a maximum of 30 days.
- The maximum price of buy back should be determined by the shareholders through the special resolution of the shareholders or through a special resolution of the board of directors.
- If the tendered shares are more than the number of shares to be bought back, the buy back should be done on a proportionate basis.

3.5 METHODS OF BUY BACK OF SHARES

There are two methods of buy back. Let us discuss both the methods in detail.

3.5.1 Tender Method

In this method, company preparing the buy back fixes the price at which it is prepared to buy back. If number of shares offered for buy back by the shareholders at this price exceeds the total number of shares determined by the company to be bought back, then shares shall be bought from each shareholder proportionately. In this method, promoters may also offer their shares for buy back provided proper disclosures are made. Under this method, price offered by company will be at a premium over the prevalent market price in order to act as an incentive to the shareholders to offer their shares for buy back.

Example: Current market price of shares of X Ltd.	Rs. 40
Numbers of shares announced to be bought back by company of X Ltd.	2, 00,000
Buy Back price announced by company	Rs. 50
Number of shares offered for buy back at Buy Back Price	8, 00,000

Solution:

As only 2,00,000 shares have been announced to be bought back proportionately i.e. only 25% of each shareholder's offering will be accepted by the company for buy back.

3.5.2 Open Market Purchases

(A) **Through Stock Exchange:** In this method, company buys back through the stock exchanges for cancellation till it reaches the maximum number of shares it had originally started out to buy back and cancel. While adopting this method of buy back, company has to comply with the given regulations.

(1) Company has to specify maximum price of buy back in the special resolution through which the buy back decision has been made.

(2) Promoters and persons in control of the company are not permitted to offer their shares for buy back under this method.

(3) The buy back of shares shall be made only on the stock exchanges with electronic trading facility.

(4) The buy back of shares shall be through the ‘all or none' order matching mechanism on these stock exchanges.

(B) **Through Book Building:** This method fixes the buy back price based on the shareholders assessment of the fair price for the shares to be offered by them for buy back. This method is also known as 'Dutch Auction'. Under this method, shareholders are invited to quote a range of prices and the number of shares at each price level that they would be interested in offering for buy back. Based on this information provided by all the quoting shareholders, a common price and the respective number of shares against quoted by all the shareholders, aggregate of which will be equal the total number of shares that the company would like to buy back, will decide the price and number of shares to be bought back from the participating shareholders. In this respect, SEBI requires following compliances:

(1) The special resolution through which buy back decision has been taken should specify the maximum price at which buy back will be made.

(2) The number of bidding centres shall not be less than thirty and there shall be at least one electronically linked computer terminal at all the bidding centres.

(3) The final buy back price, which shall be the highest price accepted shall be paid to all the holders whose shares have been accepted for buy back.

Check Your Progress A

State whether the following statements are **True** or **False**

i) Maximum one buy back is allowed in a period of 365 days.

ii) Premium payable on buy back is adjusted out of security premium account.

iii) For cancellation of shares at the time of buy back share holder account is debited and equity share capital account is credited.

iv) Buy back must be authorised by its article.

3.6 ADVANTAGES OF BUY BACK OF SHARES

There are various advantages of buy back of shares. Some of them are as follow:

1. Under the buy back process, the companies having large amount of free reserves are free to use funds to acquire the shares and other specified securities.
2. Buy back of shares helps the promoters to formulate an effective defense strategy against hostile takeovers.
3. Through buy back of shares, the company avails the advantage of servicing reduced capital base with high dividend yield.

3.7 ESCROW ACCOUNT

Escrow is a contract or bond deposited with the third person by whom it is delivered to the guarantee on the fulfillment of some conditions. For the purpose of buy back, the company has to open the Escrow Account consisting of:

1. Cash deposited with the commercial bank.
2. Bank guarantee in favour of the merchant banker.
3. Deposit of acceptable securities with the appropriate margin.
4. Combination of 1, 2, 3 with the merchant banker with an amount equal to 25% of the consideration payable, if consideration is not more than 100 crores plus 10% of the consideration exceeding 100 crores.

3.8 ACCOUNTING FOR THE BUY-BACK OF SHARES

There are following journal entries which need to be passed at the time of buy back of shares.

For the purpose of buy back, if fresh issue of shares is made

Bank A/c Dr.

To Share Application and Allotment A/c

For transfer of Capital A/c

Share Application and Allotment A/c Dr.

To Share Capital A/c

If the buy back is done at par or at face value

Share Capital A/c Dr. (with the nominal value of Shares re-purchased)

To Bank A/c

If the buy back is done at premium

Share Capital A/c Dr. (with the nominal value of

Shares repurchased)

General Reserve/Securities Premium A/c Dr. (with the additional amount)

To Bank A/C (with the total) (with the total)

If the buy back is done at discount

Share Capital A/c Dr. (with the nominal value of Shares repurchased)

To Bank A/c (with the amount paid)

To Capital Reserve A/c (with the amount of discount)

If the buy back is made out of free reserves, the nominal value of shares to be transferred to Capital Redemption Reserve, Free reserves will also include securities premium

Free Reserves A/c Dr.

To Capital Redemption Reserve A/c

Example 3.1

A Ltd purchases 40,000 Equity shares of Rs. 10 each at Rs. 12 per share and no fresh issue was made for this purpose. Pass journal entries.

Solution:

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
	General Reserve A/c Dr.		4,00,000	
	To Capital Redemption Reserve A/c			4,00,000
	(For transfer of Rs. 4,00,000 from general reserve to capital redemption reserve A/c)			
	Equity Share Capital A/c Dr.		4,00,000	
	General Reserve A/c Dr.		80,000	
	To Equity Shareholders A/c			4,80,000
	(For buy back of 30,000 shares of Rs.10 @ Rs.12)			
	Equity Shareholders A/c Dr.		4,80,000	
	To Bank A/c			4,80,000
	(For payment made for buy back)			

Example 3.2

Liabilities	Amount	Assets	Amount

1,50,000 Equity Shares of 10 each	15,00,000	Land and Building	3,15,000
Profit and Loss A/c	3,50,000	Plant and Machinery	11,75,000
Securities Premium A/c	2,52,500	Furniture	1,75,000
14% Debentures	7,00,000	Investment	2,85,000
Creditors	2,30,000	Stock	6,00,000
		Debtors	2,95,000
		Cash	2,87,500
	30,32,500		30,32,500

On 1st April, 2020, the scheme of buy back was approved by the shareholders:

1 25% of the equity shares would be bought back at Rs. 16.
2 Profit and loss balance will be utilized for the purpose.
3 Premium paid on buy back should be met out of securities premium.
4 Investment would be sold for Rs. 3,00,000

Pass the Journal Entries.

Solution:

Journal

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.
	Bank A/c Dr.		3,00,000	
	To Investment A/c			2,85,000
	To P & L A/c			15,000
	(For sale of investments)			
	Profit and Loss A/c Dr.		3,75,000	
	To Capital Redemption Reserve A/c			3,75,000
	(For transfer of 25% of Rs. 15,00,000 to capital redemption reserve A/c)			
	Equity Share Capital A/c Dr.		3,75,000	
	Securities Premium A/c Dr.		2,25,000	
	To Equity Shareholders A/c			6,00,000
	(For buy back of 37,500 shares of @ Rs. 16)			
	Equity Shareholders A/c Dr.		6,00,000	
	To Bank A/c			6,00,000
	(For payment made by buy back)			

Example 3.3

B Ltd passed a resolution to buy back 70,000 of its fully paid equity shares of Rs. 10 each at Rs. 13 per share. For this purpose, it issued 30,000 Equity shares of Rs. 10 each at par. The company uses Rs. 1, 50,000 of its balance from Securities Premium Account apart from the adequate balance in general reserve. Pass journal entries.

Solution:

Journal

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.
	Bank A/c Dr. To Equity Share Application and Allotment A/c (For receipt of application on 30,000 shares @ Rs. 10)		3,00,000	 3,00,000
	Equity Share Application and Allotment A/c Dr. To Equity Share Capital A/c (For money received on application being capitalised)		3,00,000	 3,00,000
	Securities Premium A/c Dr. General Reserve A/c Dr. To Capital Redemption Reserve A/c (For transfer of amount to capital redemption reserve a/c which is not covered by fresh issue)		1,50,000 2,50,000	 4,00,000
	Equity Share Capital A/c Dr. General Reserve A/c Dr. To Equity Shareholders A/c (For buy back of 80,000 shares of Rs. 10 @ Rs. 13)		7,00,000 2,10,000	 9,10,000
	Equity Shareholders A/c Dr. To Bank A/c (For payment made by buy back)		9,10,000	 9,10,000

Example 3.4

R Ltd. decides to buy back 10% of Rs. 100 crores paid-up Equity capital. The face value per Equity share is 10, but the market price share is Rs. 15. X Ltd. took the following steps for the buy back of its shares:

1. To issue 14% debentures of Rs. 100 each at par, face value Rs. 10 crores.
2. To utilize general reserve.
3. To sell investments of Rs 7 crores for Rs 8 crores.
4. To buy back the shares at the market price.
5. To immediately cancel the shares bought back.

Pass the Journal Entries.

Solution:

Journal

Date	Particulars		L.F.	Dr. (Rs.)	Cr. (Rs.
	Bank A/c	Dr.		10	
	To 14% Debentures A/c				10
	(For issue of 14% debentures)				
	Bank A/c	Dr.		8	
	To Investment A/c				7
	To Capital Reserve A/c				1
	(For sale of investments)				
	Equity Share Capital A/c	Dr.		10	
	General Reserve A/c	Dr.		5	
	To Equity Shareholders				15
	Equity Shareholders A/c	Dr.		15	
	To Bank A/c				15
	(For payment made for buy back				

3.9 LET US SUM UP

The act of purchasing its own share by the company either from free reserves or security premium account or proceeds of share or securities is called buy back of shares. It has various conditions which are as follow:

(i) The article of association of company must authorise buy back of shares.

(ii) Special resolution is to be passed in AGM of the company.

(iii) After buy back, debt equity share ratio should not exceed 2:1

(iv) Buy back of shares must be fully paid up.

(v) Buy back must be completed within 12 months from the date of passing the resolution. (vi) The securities should be listed at the Stock Exchange of India.

Buy back of shares can be done through two methods which are as follow: (i) Through tender method and (ii) Through open market method. There are several advantages of buy back of shares such as (i) it helps the promoters to formulate an effective defense strategy against hostile takeover and (ii) The company avail the advantages of servicing reduced capital base with high dividend yield. Escrow account is a contract or bond deposited with third person by whom it is delivered to the guarantee on the fulfillment of some conditions. For the purpose of buy back, company has to open the escrow account.

3.10 KEY WORDS

Escrow Account: An **escrow account** is an account where funds are held in trust whilst two or more parties complete a transaction. **Escrow** generally refers to money held by a third party on behalf of transacting parties.

Articles of Association: It contains the rules and regulations or bye-laws of the company.

Stock exchange is a centralized location where the shares of publicly traded companies are bought and sold.

3.11 ANSWERS TO CHECK YOUR PROGRESS

(i) True (ii) True (iii) True (iv) True

3.12 TERMINAL QUESTIONS

1 What do you mean by buy back of shares? Explain its conditions.

2 Explain the various methods of buy back of shares.

3 Discuss the advantages of buy back of shares.

4 What is buy back of shares? Explain the accounting treatment of buy back of shares.

5 Explain the motives of buy back of shares.