Accounting and Reporting for Buyback in India

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Many accounting and reporting issues for buyback of shares have not been resolved as yet by the regulators in India. The international scenario does not also help her to emulate. In this background, this paper examines the provisions on accounting treatment and reporting aspects of buyback transactions and suggests accounting treatments and disclosures to be made.

1. Introduction

Buying back its own shares by a company has been permitted in India since 31st October, 1998 through the introduction of three new Sections- 77A, 77AA and 77B in the Companies (Amendment) Act, 1999. Soon after, the Securities and Exchange Board of India (SEBI) guidelines have been issued to further regulate buyback activities of listed Indian companies. Since such legislations have come into force, 'buyback' has become the new buzzword in Indian corporate environment.

Accounting and reporting for a particular transaction assumes importance in view of the fact that it may affect the state of affairs of the business. But accounting and reporting for buyback is still very much a grey area in India. In this perspective, this paper aims at examining the provisions, if any, on accounting treatment and reporting aspects of the buyback transactions prevailing in India and making suggestions for suitable accounting treatment of the transactions and reporting thereof in the light of the provisions existing internationally.

The remainder of the paper is organized as follows. Section 2 sketches the international scenario relating to buyback. Section 3 discusses the accounting issues of buyback and the legal provisions in respect thereof. Section 4 outlines the accounting entries to be passed in books on share buyback. Section 5 deals with the disclosure requirements of buyback operations while Section 6 makes suggestions for disclosure of relevant information on buyback.

2 International scenario

While talking about international scenario, we propose to deal with the environment prevailing in the U.S. and U.K., Canada, Australia and New Zealand. The financial reporting scenario in the U.S.A. is one of the best and hence we cover this briefly. India inherits a lot in terms of corporate governance, accounting and education from the U.K. environment. Accordingly, a

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description of the U.K. scenario may help one to compare Indian position. Canada, Australia and New Zealand, being commonwealth countries, culturally follow U.K. developments predominantly. The U.S. environment might also have some impact on these countries. Thus, the scenario prevailing in these countries in relation to buyback has been discussed in two parts: (a) regulatory buyback provisions and (b) accounting and reporting for buyback.

(a) Buyback provisions

A U.S. company can buyback its shares in any one of the following ways – (i) fixed price tender offer (ii) Dutch auction repurchase (iii) open market repurchase and (iv) private negotiation and may finance the offer either by cash or by debt. For the said purpose, the company requires authority under its Articles of Association and needs to pass a Board Resolution at the directors' meeting. There is however no statutory limit on the buyback program size or duration in the U.S. No matter by whichever method a company buys back its own shares in the U.S., it must not violate the anti-manipulative and anti-fraud provisions of Rule 10b-18 of the Securities and Exchange Act, 1934. The Rule requires that buyback be made only through one broker or dealer, not to be executed at the opening or during last ½ hour of trading, not to be done at a price that exceeds the highest current independent bid price or last independent sale price whichever is higher and the buyback volume not to exceed one round lot (i.e., 100 shares) or the number of round lots that is closest to 25% of the company's stocks' average daily trading volume over the preceding four calendar weeks whichever is greater. Shares bought back by the U.S. companies must be held in 'treasury' for the purpose of reissuing them in future. Surprisingly, there is a lack of statute in the U.S. imposing penalty on the companies for failing to implement a buyback program or for non-compliance with buyback provisions.

Section 162 of the U.K. Companies Act, 1985 allows a limited company to purchase its own shares subject to an authority in its articles. This provision is also retained in the Amended Act of 1989. In the U.K., a company can purchase its own shares either through off-market or on-market or through contingent purchase contracts. An ordinary resolution is required for on-market purchases whereas off-market purchases must be authorised by a special resolution. In either case, the said resolution must specify the limits as to the maximum number of shares proposed to be bought back, maximum and minimum buyback prices etc. and shall remain valid for a maximum period of 18 months from the date of the resolution. Such resolutions can be varied, revoked or renewed by a similar kind of resolution and shall be subject to the same provisions as are applicable to previous resolution. A contingent purchase contract does not amount to contracts to purchase own shares but specified conditions under which the company may become entitled or obliged to purchase those shares. Such contracts are regulated in the same way as off-market purchase contracts. A buyback transaction in the U.K. may be financed either out of distributable profits or out of proceeds of a fresh issue made specifically for buyback purposes or out of capital in case of private companies only provided that the profits together with the proceeds of fresh issue fall short of the amount required for buyback.

'Unlike U.S.A., treasury operations are not allowed in U.K. Under Section 178 of the U.K. Companies Act, shareholders have the right to seek specific performance of the contract to repurchase shares if the company fails to implement the buyback program.'

Moreover, company's directors may be personally liable and may commit offence in the event of non-compliance with buyback provisions.

In Canada, public companies are allowed to buyback shares only if it is authorized by a resolution of the board of directors. The company must also seek approval of the concerned stock exchange where its shares are traded before effecting buyback. Canadian law limits all buyback programs to 12 months or less. Therefore, companies wishing to buyback shares in subsequent

years must renew the board resolution and reapply for obtaining approval of the stock exchange. The trading limits for buyback in Canada are similar to those enacted in Rule 10b-18 applicable in the U.S.

Buyback by an Australian company must be authorized by its articles which shall remain valid for 3 years and can be renewed again by amending the articles. Public companies in Australia are allowed to buyback upto 10% of their shares every 12 months by means of an ordinary resolution either through an offer to all shareholders or from employees of the company. Selective buyback is also permitted in Australia provided that it is sanctioned by a special resolution of atleast 75% members who together hold atleast 75% in nominal value of the shares of the company. Shares bought back in Australia must be cancelled and all rights attached therein must be extinguished.

The charter constituting a company should expressly permit buyback of own shares by the company in New Zealand. A New Zealand company can buyback its own shares either by making a pro rata offer to all shareholders, or a targeted offer to one or more shareholders, or an offer to all shareholders in the stock market or by taking a limited stand in the stock market for shares quoted on the New Zealand Stock Exchanges.

(b) Accounting and reporting for buyback

Not much legal guidance is available in this respect either in the U.S. or in the U.K. the two countries which have pioneered the legislation of buyback Due to the lack of a specific accounting standard in the U.S. or in the U.K., ambiguity persists in these two countries regarding the accounting treatment of the expenses incidental to buyback and the premium paid or discount earned by the company in the event of buyback. In contrast, a specific accounting standard exists in Australia in this respect which states that the company must apply the amount standing to the credit of share premium account and distributable profits in writing off buyback premium.

As regards disclosure of actual buyback transactions, there are no such requirements in the U.S. other than the mandated initial disclosures to the market. Such mandatory disclosures are limited to a few pieces of information scattered throughout the firm's financial statements. They are (i) line items in the cash flow statements published in the 10-Q; (ii) disclosure of actual buyback trades under 10-K reports; and (iii) information on the number of shares bought back, price etc. in the management discussion and analysis section. Besides the minimal summary information provided in the quarterly and annual financial statements, U.S. companies have no obligation to disclose any aspect of their buyback transactions on a periodic basis either to the Securities and Exchange Commission (SEC) or to the public. Markedly, disclosure of actual buyback activity is far more extensive and meaningful in Canada.

The Canadian stock exchanges gather and publish each month a comprehensive table showing previous month's buyback activity (as well as the absence of such activity) for all authorized programs.

Although specific trade details such as buyback price are not reported, overall volume is clearly reported and available on a timely basis. As a result, it is easy to find the exact level of buyback activity at any point in time, the number of shares still authorized for buyback and the program's termination date.

In the U.K., Section 234 of its Companies Act, 1985 requires the companies to give details of the shares bought back in any financial year in the directors' report. If the companies are listed, additional information upto the date of the report must also be included and details of any shareholders' authority for buyback which is still valid at the end of the period under review must also be given as per The Listing Rules. The Rules further require that the stock exchange must be given details of actual purchases as soon as possible and in any event not later than 8-30a.m. on the business day following the calendar day on which the dealings took place.

In the above backdrop, accounting and reporting issues of buyback in India are now examined.

3. Accounting issues of buyback and legal provisions in respect thereof

The buyback transaction entails investing in its own shares by a company by repurchasing them from its shareholders either out of free reserves or securities premium account or out of proceeds of an earlier issue. It becomes imperative to know how such a transaction could be captured in the books of accounts. The following are the most imminent questions that arise relating to accounting of buyback:

- What journal entries are required to be passed in the books of accounts while accounting for buyback?
- How will surplus of price paid over face value of shares bought back be accounted for? Will the excess of such price paid over book value be written off in profit and loss account?
- What would happen if the price bid for buyback is lower than the book value?
- Will the appropriate portion of the free reserves be frozen by way of transfer to capital reserves restricting any use except issue of bonus shares?
- How would the expenses incidental to buyback, e.g. fees of advocate and merchant bankers, legal expenses, costs of paper announcements and printing of offer letters etc., be treated in books of accounts?

Before examining the above issues in Indian context, there is a need to see what the law provides. The legal provisions on buyback, as inserted by the Companies (Amendment) Act, 1999, do not expressly deal with the accounting aspects of buyback thereby giving total freedom to the Indian companies to treat the buyback transactions as they think fit. As the law is silent, the acceptable accounting treatment of the buyback transactions may be determined by applying authoritative accounting principles to the form and substance of the transactions.

Sub-section (7) of Section 77A of the Companies (Amendment) Act, 1999 requires the securities bought back to be extinguished and physically destroyed within seven days of the last date of completion of buyback. This makes it clear that there is a time gap between the buyback of shares and their reduction from the share capital consequent upon the cancellation and physical destruction of such shares. Accordingly, the entries in the accounting books for the cancellation of the shares bought back by way of reduction from the share capital would be passed on a date subsequent to the purchase of such shares.

According to Section 77A(1), buyback can be financed out of free reserves or securities premium account or the proceeds of any shares or other specified securities not of the same kind as those bought back. Further, Section 77AA of the Act states that where buyback is done out of free reserves or securities premium account, a sum equivalent to the nominal value of the shares repurchased shall be transferred to the Capital Redemption Reserve Account on the same line as is done in case of redemption of preference shares out of distributive profits under Section 80(1)(d) of the Companies Act, 1956. Such a transfer of profit becomes necessary to prevent capital erosion and hence to ensure that the interests of the creditors, debenture-holders and financial institutions are not adversely affected on account of buyback. That is, in so far as the use of funds accumulated through plough back of profit, there is reduction in net worth of the company as no further issue of capital is made. Hence, to maintain sanctity of the capital structure of the business and to prevent capital reduction, it is provided that there should be a transfer to capital redemption reserve that can be utilized only for issue of fully paid bonus shares. It may also be noted that the requirement to make a transfer to the capital redemption reserve do not apply when buyback is funded from the proceeds of any share issue because the company's distributable reserves and the aggregate value of the paid-up capital remain intact in this case as the new kind of securities simply replace those which are bought back.

The third key accounting issue relates to the excess amount paid on buyback over and above the nominal value of the shares bought back. For instance, if a Rs.10 share is bought back for Rs.15, how should the excess amount of Rs.5 per share paid on buyback be accounted for by the company? Should such premium of Rs.5 per share be debited to the profit and loss account of the current year as revenue expenditure or should it be debited to free reserves/ securities premium account as capital expenditure? There being no clear-cut guidelines nor any accounting standard issued by the Institute of Chartered Accountants of India (ICAI) in the context of payment of premium on buyback, varying treatment may be found in practice. But, logically, there is no doubt that the entire Rs.15 payment per share on buyback (in the above example) is capital expenditure and no part of it is in the nature of capital payment. Thus, any premium paid on buyback should be adjusted against free reserves i.e., against balance of general reserves or accumu-

lated profit and loss balance or any other free reserve or against securities premium account.

Another issue relates to accounting treatment of the discount earned on buyback. Should the discount amount be credited to the profit and loss account of the current year as a revenue gain or should it be credited to reserves treating it as a capital gain? If it is credited to reserves, should such reserves be capital reserve or reserves available for distribution as dividend? Once again, there being no legal requirement, nor any accounting standard issued by ICAI on the treatment of such discount, varying treatments are likely to be found in practice.

But, as a matter of prudence, such discount benefit earned by a company in the event of buyback should be treated as a capital gain and credited to capital reserve not available for distribution as dividend.

As there are currently no accounting standard dealing with the accounting treatment of incidental expenses incurred for buyback of shares, there arises a number of critical questions relating to accounting treatment of such expenses:

- Should these expenses be set off against the current Profit and Loss Account of the company as revenue items? Or
- Should these expenses be treated as capital expenses and hence debited to Free Reserves as they represent the related costs of buyback? Or
- Should the expenditure be capitalized and amortised over a definite period of time and hence carried forward in the Balance Sheet as a deferred revenue expenditure till it is fully written off?

Although the treatment of the buyback expenses as revenue expenses may reduce the current earnings of the company, yet it may be justified on the ground that these expenses are incurred during the current period and should be matched against the revenues of that period. Moreover, such a treatment would also help the company in claiming these expenses as deductions while computing taxable income.

Since the buyback expenses are not exactly of capital nature, treating the expenses as deferred revenue expenditure and capitalizing and amortising them over a definite period may be more justified because the purpose for which such expenses are incurred is likely to benefit the company for a sizeable length of time. Further, such a treatment would still make it possible for the company to claim the entire expenditure as deduction against taxable profits. Thus, in the absence of any stipulation regarding the accounting treatment of such incidental buyback expenses, treating the related expenditure as deferred revenue expenditure would perhaps be the best accounting method because the benefit of buyback is expected to accrue over a long span time in future.

In the light of the above discussions and in view of the fact that there is no accounting standard in the U.S. or in the U.K. to guide such transactions, the accounting entries for buyback transaction have been developed in the following section.

4. Accounting entries

Since reissue for treasury operations of the shares bought back is not permitted under the existing Indian statutory framework, the following journal entries may be passed in the account books chronologically to record buyback of shares and its cancellation:-

(i) In case investments are sold for buying back own shares:

Bank Account Dr. *(with the amount realized)*

To Investment Account *(with the book-value)*

[The difference, if any, between the sale-proceeds and book-value of such investments, will be either credited to 'Profit On Sale of Investment Account' or debited to 'Loss on Sale of Investment Account', which in turn will be transferred to 'Profit and Loss Account'.]

Note: Generally free reserves are invested in the assets/ investments of the company. So to utilize free reserves for buyback purposes, assets/ investments must be realized first.

(ii) In case the proceeds of fresh issue are used for buyback purpose, then on fresh issue:

Bank Account Dr. *(with the issue proceeds)*

To Debentures/ Other Securities Account *(with the nominal value)*

To Securities Premium Account *(with the premium received on such shares, if any)*

(iii) For buying back of shares/ specified securities:

Shareholders' / Security holders' Account Dr.

To Bank Account *(with the amount paid on buyback)*

(iv) For cancellation of

shares/securities bought back:

Share Capital/ Specified Security Account Dr.

(with the nominal value of security bought back)

Free Reserves/Securities Premium Account Dr.

(with the excess amount i.e., premium paid over nominal value)

To Shareholders'/ Security holders' Account

(with the amount paid)

(v) In case the shares/specified securities are bought back at a discount:-

Share Capital/ Specified Security Account Dr.

(with the nominal value)

To Shareholders'/Security holders' Account

(with the amount paid)

To Capital Reserve Account

(with the amount of discount on buy-back)

(vi) For transfer of nominal value of shares purchased out of free reserves/securities premium account to capital redemption reserve account:

Free Reserve Account Dr.

Securities Premium Account Dr.

To Capital Redemption Reserve Account

(with the nominal value of securities bought back)

(vii) For expenses incurred on buy-back of shares:

Buyback Expenses Account Dr.

To Bank Account

(with the amount of such incidental expenses incurred on buyback)

(viii) For writing-off buyback expenses against profit and loss account:

Profit and Loss Account Dr.

To Buyback Expenses Account

(to the extent the expenses are written-off)

5. Disclosure requirements

Companies buying back own shares should adequately disclose relevant figures relating to buyback operations in their financial statements to provide greater transparency in buyback operations. This would enhance the accuracy and reliability of information disclosed and would increase the confidence of the stakeholders on the company. But, though the Ordinance and the SEBI Regulations have prescribed extensive disclosures in the explanatory statement annexed to the notice convening the general meeting of the company at which the special resolution sanctioning share buyback is proposed to be passed and in the letter of offer document, they are silent as regards the nature and extent of disclosures to be made in the financial statements by the Indian companies about their repurchase activity. As per the newly inserted Sub-section (2B) of Section 217 of the Companies (Amendment) Act, 1999, all that is required to be disclosed in the Board of Directors' Report are the reasons for the failure, if any, on the part of the company to complete the buyback within the time specified [Section 77A(4)]. The case of *Reliance Industries Ltd.* (RIL) may be cited in this regard. The shareholders of RIL had, in the Annual General Meeting held on 13th June, 2000, approved the buyback of the company's shares of Rs.10 each for an amount not exceeding Rs.1100 crore, upto a maximum price of Rs.303 per share, through open market purchases from the stock exchanges. But as the company's share price had closed below the maximum specified buyback price only on a limited number of trading days, it had not bought back any share in the financial year 2000-2001. In terms of Section 217(2B) of the Act, the Reliance' directors have set forth the reasons for not buying back its shares within the prescribed time limit in the Directors' Report segment *(p.40)* of the *Annual Report, 2000-2001* of the company.

As per the provisions of three new Sub-sections (3A), (3B) and (3C) of Section 211 inserted by the Companies (Amendment) Act, 1999, every profit and loss account and balance-sheet of the company should comply with the accounting standards recommended by the ICAI and where such financial statements do not comply with the accounting standards, it must disclose the deviation from the accounting standards, the reasons for such deviation and the financial effect, if any, arising due to such deviation. The responsibility lies with the auditor of a company to check whether the financial statements comply with the accounting standards in the manner as referred to in amended Section 21 of the Act. But, the ICAI is yet to issue a standard regarding disclosure norms of buyback operations and has not even recommended any specific compliances to be ensured by its members in the course of their audit work.

This dearth of mandatory disclosure about actual share repurchases has led regulators and investors to express concern over completion rates of buyback programs and whether firms are making efforts in good-faith to buy the shares they authorize for repurchase. That is, a primary concern of both regulators

and investors in India is that, the lack of compulsory disclosure of buyback activity gives ample scope to the companies to mislead the investors by announcing repurchase programs while having no intention of buying back shares. To put a check on such opportunistic behaviour of the Indian firms, some reasonable disclosures are required to be made. These appear in the next section.

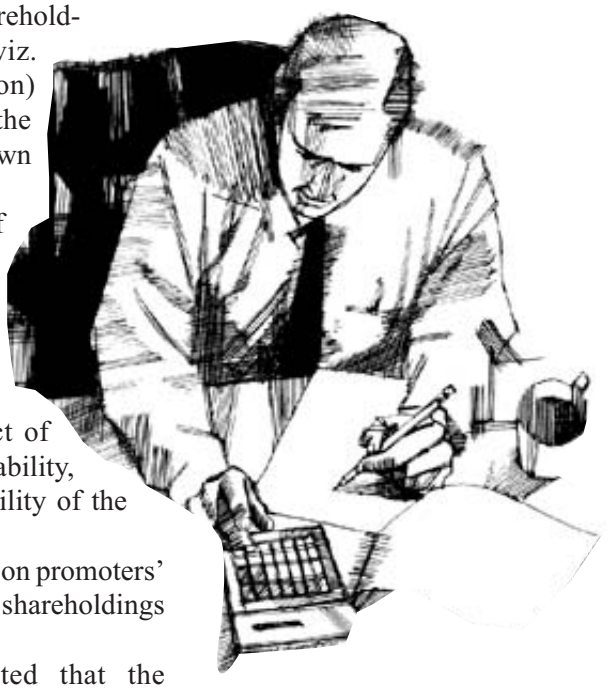
Suggested disclosures to be made on buyback

It would be a useful and fair practice if, at least, the following information are disclosed in the Directors' Report section of the Annual Report of a company which has gone for buyback-

- Structural details of the buyback program;
- Duration of the program;
- Number of shares bought back;
- Details of the shares repurchased in the financial year to which the Annual Report relates; if the company is listed, additional information regarding such repurchase must be provided upto the date of the report;
- Execution method;
- Buyback price and the aggregate amount paid on buyback;
- Sources from which buyback is financed;
- Amount by which the share capital and free reserves including share premium are reduced on account of cancellation of the shares, also specifying the uncancelled shares, if any; and
- Manner of treatment of discount, if any, on buyback of shares.

In addition, the Management Discussion and Analysis (MD & A) section of the Annual Report should contain the following pieces of information relating to buyback;

- Details of the shareholders' authority (viz. special resolution) for purchase by the company of its own shares;
- Projections of profit, cash flow and net worth for the three years following buyback;
- Immediate impact of buyback on profitability, liquidity and stability of the company; and
- Effect of buyback on promoters' holdings, foreign shareholdings etc.,



It may be noted that the Register of Members of the company shall continue to bear the names of the transferor shareholders who have accepted the offer for buyback till their shares are cancelled and extinguished. The memoranda of the terms for the purchase of own shares and other buyback particulars kept under section 77A(9) must be kept at the company's registered office for a sizeable period of time and must be made available for inspection.

As the shares bought back cannot be reissued and have to be compulsorily cancelled under the legal framework currently existing in India, there is likely to be a time gap between buyback of shares and their actual cancellation. If it so happens that a financial year ends in this intervening period, then the question that arises is how should the shares repurchased (but not cancelled) be disclosed in the balance-sheet? Since no guidance is available as yet in the legal provisions or in Schedule VI relating to the disclosure of such a fact, the following two alternative treatments can be thought of when the shares bought back are not cancelled in the same financial year-

(1) The balance in the shareholders' account denoting the amount paid to the shareholders on buyback shall be transferred to 'Investment in Own Shares Account'. Such investment in own shares account may be shown under the Investment head on the Assets side of the balance-sheet giving full details of the number and face value of shares repurchased, repurchase price, whether the shares have been repurchased out of free reserves or securities premium or proceeds of an earlier issue, repurchase method, etc.

(2) Alternatively, the investment in own shares account [created in the manner as mentioned in point (1) above] may be shown on the Liabilities side of the balance-sheet by way of deduction from the sum total of issued, subscribed and paid-up capital and free reserves, giving similar details as mentioned in (1) above.

Logically, the second alternative would provide a fairer disclosure because, under the present set-up, the shares would eventually be cancelled and the company's net worth would be reduced and hence it would be inappropriate and misleading if such an inevitable consequence is not disclosed in the balance-sheet. It may, however, be noted that whatever may be the nature of disclosure in the balance-sheet, the nominal value of the shares bought back shall continue to be shown on the liabilities side of the balance-sheet as a part of paid-up capital till their cancellation.

After the shares which have been bought back in the immediately preceding financial year are cancelled, the investment in own shares account shall be wiped out from the books of accounts of the company. Instead, the paid-up share capital and free reserves/securities premium account on the Liabilities side of the balance-sheet shall be respectively reduced by the face value of the shares bought back and the premium amount, if any, paid on buyback. In case shares have been bought back at a discount, capital reserve account shall be credited with the discount amount under the Reserves and Surplus head on the Liabilities side of the balance-sheet. Moreover, if the buyback has been effected out of free reserves or securities premium account, then the nominal value of the shares bought back shall be deducted from the said reserve and added to capital redemption reserve under the Reserves and Surplus head on the Liabilities side of the balance-sheet. These adjustments to reserves and surplus are to be shown in detail as per Schedule VI which requires the additions and deductions since last balance-sheet to be shown under each of the specified heads. Schedule VI also requires the companies to provide details of the utilization of securities premium account in the manner as prescribed by Section 78 in the year of utilization and accordingly the companies going for buyback out of securities premium account should comply with such requirement.

In the absence of legal compulsion, the only way to implement the above suggestions in financial statements is through voluntary disclosure. But the important question is: why should companies disclose voluntarily information on buyback? Research evidences suggest that various factors (e.g. lower cost of capital, access to more active and liquid capital markets, enhancing investors' confidence and decision-making ability, better allocation of capital, etc.) motivate management of a company to make voluntary disclosure of information. Indian companies are not also shy in this respect. Let buyback information be added to such a kitty. This will not only harmonise the accounting and reporting practices of Indian companies in relation to buyback but will also bring in uniformity in presentation of accounts which will facilitate a wise judgment of the investors about the impact of buyback on well-being of the company. Besides, India can also give leadership to other developed and developing countries in this context.

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