4

Company Accounts

Unit – 1: ESOP and Buy-back of Shares

Learning Objectives

After studying this unit, you will be able to

- Learn the provisions of the Companies Act 2013 regarding employees' stock option.
- Understand the accounting policies of employees' stock option plan.
- Learn the accounting treatment of employees' stock options.
- Learn the provisions of Guidance Note on Employee Share-Based Payments.
- Learn the provisions of the Companies Act regarding buyback of securities
- Understand equity shares with differential rights.

1.1 Employees Stock Option Plan

Under Section 62 (1) (b) of the Companies Act 2013, where at any time a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares may be offered to employees under a scheme of employees' stock option, subject to a special resolution passed by the company and subject to such conditions as may be prescribed.

Earlier Securities and Exchange Board of India (SEBI) issued Employees Stock Option Scheme and Employee Stock Purchase Scheme Guidelines (applicable for listed companies) in 1999 under section 11 of the Securities and Exchange Board of India Act, 1992. This guideline has now been replaced by the SEBI (Share Based Employee Benefits) Regulations, 2014* (applicable for listed companies). It cover the provisions regarding accounting policies, pricing, disclosures, administration and implementation process of various schemes and other issues relating to Employee Stock Option

---

* ***SEBI (Share Based Employee Benefits) Regulations, 2014 has been issued on October 28, 2014 and are applicable from the same date.***

Scheme (ESOS), Employee Stock Purchase Scheme (ESPS), Stock Appreciation Rights Scheme (SRS), General Employee Benefits Scheme (GEBS) and Retirement Benefit Scheme (RBS). The Regulation stipulate to follow the requirements of the 'Guidance Note on Accounting for Employee Share Based Payments' or Accounting Standards as may be prescribed by the ICAI from time to time including the disclosure requirements prescribed therein.

1.1.1 Important terms to be remembered

1. ***Grant***: Grant means issue of option to the employees under ESOS.
2. ***Vesting:*** It is the process by which the employee is given the right to apply for shares of the company against the option granted to him in purchase of employee in pursuance of employee stock option scheme (ESOS).
3. ***Vesting Period****:* It is the time period during which the vesting of the option granted to the employee on pursuance of ESOS takes place.
4. ***Option****:* Option means a right but not an obligation granted to an employee in pursuance of ESOS to apply for shares of the company at a pre-determined price.
5. ***Exercise Period:*** It is the time period after vesting within which the employee should exercise his right to apply for shares against the option vested in him in pursuance of the ESOS.
6. ***Exercise Price:*** It is the price payable by the employee for exercising the option granted to him in pursuance of ESOS.
7. ***Intrinsic Value:*** It is the excess of the market price of the share under ESOS over the exercise price of the option (including up-front payment, if any).
8. ***Fair Value:*** It is the amount for which stock option granted or a share offered for purchase could be exchanged between knowledgeable, willing parties in an arm's length transaction.

1.1.2 Provisions of Guidance Note on Employee Share-Based Payments

Recognizing the need for establishing uniform sound accounting principles and practices for all types of share-based payments, the Accounting Standards Board of the Institute is developing an Accounting Standard covering various types of share-based payments including employee share-based payments. However, as the formulation of the Standard is likely to take some time, the Institute has decided to bring out this Guidance Note. Once the Accounting Standard dealing with Share-based Payments comes into force, this Guidance Note will automatically stand withdrawn.

This Guidance Note establishes financial accounting and reporting principles for employee share-based payment plans, viz., employee stock option plans, employee stock purchase plans and stock appreciation rights. For the purposes of this Guidance Note, the term 'employee' includes a director of the enterprise, whether whole time or not.

For accounting purposes, employee share-based payment plans are classified into the following categories:

- Equity-settled: Under these plans, the employees receive shares.
- Cash-settled: Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares.
- Employee share-based payment plans with cash alternatives: Under these plans, either the enterprise or the employee has a choice of whether the enterprise settles the payment in cash or by issue of shares.

An enterprise should recognize as an expense (except where service received qualifies to be included as a part of the cost of an asset) the services received in an equity-settled employee share-based payment plan when it receives the services, with a corresponding credit to an appropriate equity account, say, 'Stock Options Outstanding Account'. This account is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve as recommended in this Guidance Note. If the shares or stock options granted vest immediately, the employee is not required to complete a specified period of service before becoming unconditionally entitled to those instruments. In the absence of evidence to the contrary, the enterprise should presume that services rendered by the employee as consideration for the instruments have been received. In this case, on the grant date, the enterprise should recognize services received in full with a corresponding credit to the equity account. If the shares or stock options granted do not vest until the employee completes a specified period of service, the enterprise should presume that the services to be rendered by the employee as consideration for those instruments will be received in the future, during the vesting period. The enterprise should account for those services as they are rendered by the employee during the vesting period, on a time proportion basis, with a corresponding credit to the equity account.

An enterprise should measure the fair value of shares or stock options granted at the grant date, based on market prices if available, taking into account the terms and conditions upon which those shares or stock options were granted. If market prices are not available, the enterprise should estimate the fair value of the instruments granted using a valuation technique to estimate what the price of those instruments would have been on the grant date in an arm's length transaction between knowledgeable, willing parties. The valuation technique should be consistent with generally accepted valuation methodologies for pricing financial instruments (e.g., use of an option pricing model for valuing stock options) and should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price. Vesting conditions, other than market conditions, should not be taken into account when estimating the fair value of the shares or stock options at the grant date. Instead, vesting conditions should be taken into account by adjusting the number of shares or stock options included in the measurement of the transaction amount so that, ultimately, the amount recognized for employee services received as consideration for the shares or stock options granted is based on the number of shares or stock options that

eventually vest. Hence, on a cumulative basis, no amount is recognized for employee services received if the shares or stock options granted do not vest because of failure to satisfy a vesting condition (i.e., these are forfeited), e.g., the employee fails to complete a specified service period, or a performance condition is not satisfied.

To apply the requirements of the Guidance Note, the enterprise should recognize an amount for the employee services received during the vesting period based on the best available estimate of the number of shares or stock options expected to vest and should revise that estimate, if necessary, if subsequent information indicates that the number of shares or stock options expected to vest differs from previous estimates. On vesting date, the enterprise should revise the estimate to equal the number of shares or stock options that ultimately vest. Market conditions, such as a target share price upon which vesting (or right to exercise) is conditioned, should be taken into account when estimating the fair value of the shares or stock options granted. On exercise of the right to obtain shares or stock options, the enterprise issues shares on receipt of the exercise price. The shares so issued should be considered to have been issued at the consideration comprising the exercise price and the corresponding amount standing to the credit of the relevant equity account (e.g., Stock Options Outstanding Account). In a situation where the right to obtain shares or stock option expires unexercised, the balance standing to the credit of the relevant equity account should be transferred to general reserve.

For cash-settled employee share-based payment plans, the enterprise should measure the services received and the liability incurred at the fair value of the liability. Until the liability is settled, the enterprise is required to re-measure the fair value of the liability at each reporting date and at the date of settlement, with any changes in value recognized in profit or loss for the period.

For employee share-based payment plans in which the terms of the arrangement provide either the enterprise or the employee with a choice of whether the enterprise settles the transaction in cash or by issuing shares, the enterprise is required to account for that transaction, or the components of that transaction, as a cash-settled share-based payment plan if, and to the extent that, the enterprise has incurred a liability to settle in cash (or other assets), or as an equity-settled share-based payment plan if, and to the extent that, no such liability has been incurred.

Accounting for employee share-based payment plans is based on the fair value method. There is another method known as the 'Intrinsic Value Method' for valuation of employee share-based payment plans. Intrinsic value, in the case of a listed company, is the amount by which the quoted market price of the underlying share exceeds the exercise price of an option. In the case of a non-listed company, since the shares are not quoted on a stock exchange, value of its shares is determined on the basis of a valuation report from an independent valuer. For accounting for employee share-based payment plans, the intrinsic value may be used, mutatis mutandis, in place of the fair value as described in paragraphs 5 to 14.

Apart from the above, the Guidance Note also deals with various other significant aspects of

the employee share-based payment plans including those related to performance conditions, modifications to the terms and conditions of the grant of shares or stock options, reload feature, graded vesting, earnings-per-share implications, accounting for employee share-based payments administered through a trust, etc. The Guidance Note also recommends detailed disclosure requirements.

Illustration 1

A Company has its share capital divided into shares of ₹ 10 each. On 1st April, 2012 it granted 10,000 employees' stock options at ₹ 40, when the market price was ₹ 130. The options were to be exercised between 15th March, 2013 and 31st March, 2013. The employees exercised their options for 9,500 shares only; the remaining options lapsed. The company closes its books on 31st March every year.

Show Journal Entries.

Solution

Journal Entries

	Particulars	*Dr.* ₹	*Cr.* ₹
15th Mar. 2013 to 31st Mar.2013	Bank A/c Dr.	3,80,000	
	Employee compensation expense A/c Dr.	8,55,000	
	To Equity share capital A/c		95,000
	To Securities premium A/c		11,40,000
	(Being allotment to employees of 9,500 equity shares of ₹ 10 each at a premium of ₹ 120 per share in exercise of stock options by employees)		
31st March 2013	Profit and Loss A/c Dr.	8,55,000	
	To Employee compensation expense A/c		8,55,000
	(Being transfer of employee compensation expense to profit and loss account)		

Illustration 2

ABC Ltd. grants 1,000 employees stock options on 1.4.2010 at ₹ 40, when the market price is ₹ 160. The vesting period is 2½ years and the maximum exercise period is one year. 300 unvested options lapse on 1.5.2012. 600 options are exercised on 30.6.2013. 100 vested options lapse at the end of the exercise period.

Pass Journal Entries giving suitable narrations.

Solution

In the books of ABC Ltd.

Journal Entries

Date	*Particulars*		*Dr. (₹)*	*Cr. (₹)*
31.3.2011	Employees compensation expenses account	Dr.	48,000	
	To Employee stock option outstanding account			48,000
	(Being compensation expenses recognized in respect of the employee stock option i.e. 1,000 options granted to employees at a discount of ₹ 120 each, amortised on straight line basis over 2 $\frac{1}{2}$ years - 1,000 stock options x ₹ 120/2.5 years)			
	Profit and loss account	Dr.	48,000	
	To Employees compensation expenses account			48,000
	(Being expenses transferred to profit and loss account at year end)			
31.3.2012	Employees compensation expenses account	Dr.	48,000	
	To Employee stock option outstanding account			48,000
	(Being compensation expense recognized in respect of the employee stock option i.e. 1,000 options granted to employees at a discount of ₹ 120 each, amortised on straight line basis over 2 $\frac{1}{2}$ years - 1,000 stock options x ₹ 120/2.5 years)			
	Profit and loss account	Dr.	48,000	
	To Employees compensation expenses account			48,000
	(Being expenses transferred to profit and loss account at year end)			
31.3.2013	Employee stock option outstanding account (W.N.1)	Dr.	12,000	
	To General Reserve account (W.N.1)			12,000
	(Being excess of employees compensation expenses transferred to general reserve account)			
30.6.2013	Bank A/c (600 × ₹ 40)	Dr.	24,000	
	Employee stock option outstanding account (600 × ₹ 120)	Dr.	72,000	

	To Equity share capital account (600 × ₹ 10)			6,000
	To Securities premium account (600 x ₹ 150)			90,000
	(Being 600 employee stock option exercised at an exercise price of ₹ 40 each)			
01.10.2013	Employee stock option outstanding account (W.N.2)	Dr.	12,000	
	To General reserve account (W.N.2)			12,000
	(Being ESOS outstanding A/c on lapse of 100 options at the end of exercise of option period transferred to General Reserve A/c)			

Working Notes:

1. At 31.3.2013, ABC Ltd. will examine its actual forfeitures and make necessary adjustments, if any to reflect expenses for the number of options that actually vested. Considering that 700 stock options have completed 2.5 years vesting period, the expense to be recognized during the year is in negative i.e.

No. of options actually vested (700 x 120)	₹ 84,000
Less: Expenses recognized ₹ (48,000 + 48,000)	(₹ 96,000)
Excess expenses transferred to general reserve	₹ 12,000

2. Similarly, on 1.10.2013, Employee Stock Option Outstanding Account will be

No. of options actually vested (600 x 120)	₹ 72,000
Less: Expenses recognized	(₹ 84,000)
Excess expenses transferred to general reserve	₹ 12,000

Employee Stock Options Outstanding will appear in the Balance Sheet as part of Net Worth or Shareholders' Fund.

Illustration 3

Choice Ltd. grants 100 stock options to each of its 1,000 employees on 1.4.2009 for ₹ 20, depending upon the employees at the time of vesting of options. Options would be exercisable within a year it is vested. The market price of the share is ₹ 50 each. These options will vest at the end of year 1 if the earning of Choice Ltd. is 16%, or it will vest at the end of the year 2 if the average earning of two years is 13%, or lastly it will vest at the end of the third year if the average earning of 3 years will be 10%. 5,000 unvested options lapsed on 31.3.2010. 4,000 unvested options lapsed on 31.3.2011 and finally 3,500 unvested options lapsed on 31.3.2012.

Following is the earning of Choice Ltd. :

Year ended on	*Earning (in %)*
31.3.2010	*14%*

31.3.2011	*10%*
31.3.2012	*7%*

850 employees exercised their vested options within a year and remaining options were unexercised at the end of the contractual life. Pass Journal entries for the above.

Solution

Date	*Particulars*		*₹*	*₹*
31.3.2010	Employees compensation expenses A/c	Dr.	14,25,000	
	To ESOS outstanding A/c			14,25,000
	(Being compensation expense recognized in respect of the ESOP i.e. 100 options each granted to 1,000 employees at a discount of ₹ 30 each, amortised on straight line basis over vesting years- Refer W.N.)			
	Profit and Loss A/c	Dr.	14,25,000	
	To Employees compensation expenses A/c			14,25,000
	(Being expenses transferred to profit and Loss A/c)			
31.3.2011	Employees compensation expenses A/c	Dr.	3,95,000	
	To ESOS outstanding A/c			3,95,000
	(Being compensation expense recognized in respect of the ESOP- Refer W.N.)			
	Profit and Loss A/c	Dr.	3,95,000	
	To Employees compensation expenses A/c			3,95,000
	(Being expenses transferred to profit and Loss A/c)			
31.3.2012	Employees compensation Expenses A/c	Dr.	8,05,000	
	To ESOS outstanding A/c			8,05,000
	(Being compensation expense recognized in respect of the ESOP- Refer W.N.)			
	Profit and Loss A/c		8,05,000	
	To Employees compensation expenses A/c			8,05,000
	(Being expenses transferred to profit and Loss A/c)			
2012-13	Bank A/c (85,000 × ₹ 20)	Dr.	17,00,000	
	ESOS outstanding A/c	Dr.	25,50,000	

	[(26,25,000/87,500) x 85,000]			
	To Equity share capital (85,000 x ₹ 10)			8,50,000
	To Securities premium A/c (85,000 x ₹ 40)			34,00,000
	(Being 85,000 options exercised at an exercise price of ₹ 50 each)			
31.3.2013	ESOS outstanding A/c	Dr.	75,000	
	To General Reserve A/c			75,000
	(Being ESOS outstanding A/c on lapse of 2,500 options at the end of exercise of option period transferred to General Reserve A/c)			

Working Note:

Statement showing compensation expenses to be recognized at the end of

Particulars	Year 1 (31.3.2010)	Year 2 (31.3.2011)	Year 3 (31.3.2012)
Number of options expected to vest	95,000 options	91,000 options	87,500 options
Total compensation expense accrued (50-20)	₹ 28,50,000	₹ 27,30,000	₹ 26,25,000
Compensation expense of the year	28,50,000 x 1/2 = ₹ 14,25,000	27,30,000 x 2/3 = ₹ 18,20,000	₹ 26,25,000
Compensation expense recognized previously	Nil	₹ 14,25,000	₹ 18,20,000
Compensation expenses to be recognized for the year	₹ 14,25,000	₹ 3,95,000	₹ 8,05,000

1.2 Buy Back of Securities

The Companies Act, 2013 under Section 68 (1) permits companies to buyback their own shares and other specified securities out of:

(i) its free reserves; or

(ii) the securities premium account; or

(iii) the proceeds of the issue of any shares or other specified securities.

Note: No buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

The other important provisions relating to the buyback are:

(1) Section 68 (2) further states that no company shall purchase its own shares or other specified securities unless—

(a) the buy-back is authorised by its articles;

(b) a special resolution has been passed in general meeting of the company authorising the buy-back;

However, the above provisions do not apply where the buy back is ten percent or less of the paid up equity capital + free reserves and is authorized by a board resolution passed at a duly convened meeting of the directors. Hence, in case the buy back is upto 10% of paid up equity + free reserves, the same may be done with the authorization of the Board Resolution without the necessity of its being authorized by the articles of association of the company and by a special resolution of its members passed at a general meeting of the company.

(c) the buy-back is equal or less than twenty-five per cent of the total paid-up capital and free reserves of the company:

(d) the ratio of the debt owed by the company (both secured and unsecured) after such buy - back is not more than twice the total of its paid up capital and its free reserves:

Note: Central Government may prescribe a higher ratio of the debt than that specified under this clause for a class or classes of companies.

(e) all the shares or other specified securities for buy-back are fully paid-up;

(f) the buy-back of the shares or other specified securities listed on any recognised stock exchange is in accordance with the regulations made by the Securities and Exchange Board of India in this behalf;

(g) the buy-back in respect of shares or other specified securities other than those specified in clause (f) is in accordance with the guidelines as may be prescribed.

Provided that no offer of buy back under this sub section shall be made within a period of one year reckoned from the date of closure of a previous offer of buy back if any. This means that there cannot be more than one buy back in one year.

(2) Every buy-back shall be completed within twelve months from the date of passing the special resolution, or the resolution passed by the board of directors where the buy back is upto 10% of the paid up equity capital + free reserves.

(3) The buy-back may be—

(a) from the existing security holders on a proportionate basis; or

(b) from the open market; or

(c) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

(4) Where a company has passed a special resolution under clause (b) of Sub-section (2) to buy-back its own shares or other securities under this section, it shall, before making such buy-back, file with the Registrar and the Securities and Exchange Board of India a declaration of solvency in the form as may be prescribed and verified by an affidavit to the effect that the Board has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year of the date of declaration adopted by the Board, and signed by at least two directors of the company, one of whom shall be the managing director, if any :

Note: No declaration of solvency shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.

(5) Where a company buys-back its own securities, it shall extinguish and physically destroy the securities so bought-back within seven days of the last date of completion of buy-back.

(6) Where a company completes a buy-back of its shares or other specified securities under this section, it shall not make further issue of same kind of shares (including allotment of further shares under clause (a) of Sub-section (1) of Section (62) or other specified securities within a period of six months except by way of bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock option scheme, sweat equity or conversion of preference shares or debentures into equity shares.

(7) If a company makes default in complying with the provisions of this section or any regulations made by SEBI in this regard, the company may be punishable with a fine which shall not be less than Rs One Lakh but which may extend to three lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for upto 3 years or with a fine of not less than one lakh rupees but which may extend to three lakh rupees or with both.

(8) Section 69 (1) states that where a company purchases its own shares out of the free reserves or securities premium account, a sum equal to the nominal value of shares so purchased shall be transferred to the Capital Redemption Reserve Account and details of such account shall be disclosed in the Balance Sheet.

(9) The Capital Redemption Reserve Account may be applied by the company in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

(10) Where a company buy-back its securities under this section, it shall maintain a register of the securities so bought, the consideration paid for the securities bought-back, the date of cancellation of securities, the date of extinguishing and physically destroying of securities and such other particulars as may be prescribed.

(11) A company shall, after the completion of the buy-back under this section, file with the Registrar and the Securities and Exchange Board of India, a return containing such particulars relating to the buy-back within thirty days of such completion, as may be prescribed, provided that no return shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.

Some Important Terms

(a) "specified securities" includes employees' stock option or other securities as may be notified by the Central Government from time to time;

(b) "free reserves" means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend:

Provided that-

(i) any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or

(ii) any change in carrying amount of an asset or of a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value, shall not be treated as free reserves;

1.2.1 Provisions of Section 70 of the Companies Act 2013

(1) No company shall directly or indirectly purchase its own shares or other specified securities—

(a) through any subsidiary company including its own subsidiary companies; or

(b) through any investment company or group of investment companies; or

(c) if a default, by the company, in repayment of deposit or interest payable thereon, redemption of debentures or preference shares or payment of dividend to any shareholder or repayment of any term loan or interest payable thereon to any financial institutions or bank, is subsisting. Provided that the buy – back is not prohibited if the default is remedied and a period of three years has elapsed since the cessation of the default.

(2) No company shall directly or indirectly purchase its own shares or other specified securities in case such company has not complied with provisions of Sections 92,123, 127 and 129. Section 92 relates to the filing of Annual Return, Section 123 and 127 to declaration and payment of dividend and Section 129 to the financial statement of the company.

NOTE: In exercise of the powers conferred under section 30 of the Securities and Exchange Board of India Act, 1992, SEBI made Securities and Exchange Board of India (Buy-back of

Securities) (Amendment) Regulations, 2013 to amend the Securities and Exchange Board of India (Buy back of Securities) Regulations, 1998. The important provisions of the new regulations are: (i) No offer of buy-back for fifteen per cent or more of the paid up capital and free reserves of the company shall be made from the open market. (ii)A company shall not make any offer of buy-back within a period of one year reckoned from the date of closure of the preceding offer of buy-back, if any. (iii)The company shall ensure that at least fifty per cent of the amount earmarked for buy-back is utilized for buying-back shares or other specified securities.

Illustration 4

Perrotte Ltd. (a non-listed company) has the following Capital Structure as on 31.03.2011:

	Particulars	*(₹ in crores)*	
(1)	*Equity Share Capital (Shares of ₹ 10 each fully paid)*	*-*	*330*
(2)	*Reserves and Surplus*		
	General Reserve	*240*	*-*
	Securities Premium Account	*90*	*-*
	Profit & Loss Account	*90*	*-*
	Infrastructure Development Reserve	*180*	*600*
(3)	*Loan Funds*		*1,800*

The Shareholders of Perrotte Ltd., on the recommendation of their Board of Directors, have approved on 12.09.2011 a proposal to buy back the maximum permissible number of Equity shares considering the large surplus funds available at the disposal of the company.

The prevailing market value of the company's shares is ₹ 25 per share and in order to induce the existing shareholders to offer their shares for buy back, it was decided to offer a price of 20% over market.

You are also informed that the Infrastructure Development Reserve is created to satisfy Income-tax Act requirements.

You are required to compute the maximum number of shares that can be bought back in the light of the above information and also under a situation where the loan funds of the company were either ₹ 1,200 crores or ₹ 1,500 crores.

Assuming that the entire buy back is completed by 09.12.2011, show the accounting entries in the company's books in each situation.

Solution

Statement determining the maximum number of shares to be bought back

Number of shares

Particulars	*When loan fund is*		
	₹ 1,800 crores	*₹ 1,200 crores*	*₹ 1,500 crores*
Shares Outstanding Test (W.N.1)	8.25	8.25	8.25
Resources Test (W.N.2)	6.25	6.25	6.25
Debt Equity Ratio Test (W.N.3)	Nil	3.75	Nil
Maximum number of shares that can be bought back [least of the above]	Nil	3.75	Nil

Journal Entries for the Buy Back (applicable only when loan fund is ₹ 1,200 crores)

			₹ in crores	
			Debit	*Credit*
(a)	Equity share buy back account	Dr.	112.5	
	To Bank account			112.5
	(Being buy back of 3.75 crores equity shares of ₹ 10 each @ ₹ 30 per share)			
(b)	Equity share capital account	Dr.	37.5	
	Securities premium account	Dr.	75	
	To Equity share buy back account			112.5
	(Being cancellation of shares bought back)			
(c)	General reserve account	Dr.	37.5	
	To Capital redemption reserve account			37.5
	(Being transfer of free reserves to capital redemption reserve to the extent of nominal value of share capital bought back out of redeemed through free reserves)			

Working Notes:

1. **Shares Outstanding Test**

Particulars	*(Shares in crores)*
Number of shares outstanding	33
25% of the shares outstanding	8.25

2. **Resources Test**

Particulars	
Paid up capital (₹ in crores)	330

Free reserves (₹ in crores)	420
Shareholders' funds (₹ in crores)	750
25% of Shareholders fund (₹ in crores)	₹ 187.5 crores
Buy back price per share	₹ 30
Number of shares that can be bought back (shares in crores)	6.25 crores shares

3. Debt Equity Ratio Test

	Particulars	*When loan fund is*		
		₹ 1,800 crores	*₹ 1,200 crores*	*₹ 1,500 crores*
(a)	Loan funds (₹ in crores)	1,800	1,200	1,500
(b)	Minimum equity to be maintained **after** buy back in the ratio of 2:1 (₹ in crores)	900	600	750
(c)	Present equity shareholders fund (₹ in crores)	750	750	750
(d)	Future equity shareholder fund (₹ in crores) **(See Note 2)**	N.A.	712.5 (750-37.5)	N.A.
(e)	Maximum permitted buy back of Equity (₹ in crores) [(d) – (b)] **(See Note 2)**	Nil	112.5 (by simultaneous equation)	Nil
(f)	Maximum number of shares that can be bought back @ ₹ 30 per share (shares in crores) **(See Note 2)**	Nil	3.75 (by simultaneous equation)	Nil

Note:

1. Under Situations 1 & 3 the company does not qualify for buy back of shares as per the provisions of the Companies Act, 2013.
2. As per section 68 of the Companies Act, 2013, the ratio of debt owed by the company should not be more than twice the capital and its free reserve after such buy-back. In the question, it is stated that the company has surplus funds to dispose off therefore, it is presumed that buy- back is out of free reserves or securities premium and hence a sum equal to the nominal value of the share bought back shall be transferred to Capital Redemption Reserve (CRR). Utilization of CRR is restricted to issuance of fully paid-up bonus shares only. It means CRR is not available for distribution as dividend. Hence, CRR is not a free reserve. Therefore, for calculation of future equity i.e. share capital and free reserves, amount transferred to CRR on buyback has to be excluded from present equity.

   Amount transferred to CRR and maximum equity to be bought back will be calculated by simultaneous equation method.

Suppose amount equivalent to nominal value of bought back shares transferred to CRR account is 'x' and maximum permitted buy-back of equity is 'y'.

Then

Equation 1 :(Present equity – Nominal value of buy-back transfer to CRR) – Minimum equity to be maintained= Maximum permissible buy-back of equity

(750 –x)-600 = y (1)

Since 150 – x = y

Equation 2: $\left(\frac{\text{Maximum buy - back}}{\text{Offer price for buy - back}} \text{ x Nominal Value}\right)$

= Nominal value of the shares bought –back to be transferred to CRR

$= \left(\frac{y}{30} \times 10\right) = x$

[here (30 = 25% x 120]

Or 3x = y (2)

by solving the above two equations we get

x = ₹ 37.5 crores

y = ₹ 112.5 crores

Illustration 5

Anu Ltd. (a non-listed company) furnishes you with the following summarized balance sheet as at 31st March, 2012:

		(₹ in crores)
Sources of Funds		
Share Capital:		
Authorised		*100*
Issued:		
12% Redeemable preference shares of ₹ 100 each fully paid	*75*	
Equity shares of ₹ 10 each fully paid	*25*	*100*
Reserves and surplus:		
Capital reserve	*15*	
Securities premium	*25*	
Revenue reserves	*260*	*300*
		400

Application of Funds		
Fixed assets: cost	*100*	
Less: Provision for depreciation	*(100)*	*Nil*
Non-current investments at cost (Market value ₹ 400 Cr.)		*100*
Current assets	*340*	
Less: Current liabilities (Trade payables)	*(40)*	*300*
		400

The company redeemed preference shares on 1st April, 2012. It also bought back 50 lakhs equity shares of ₹ 10 each at ₹ 50 per share. The payments for the above were made out of the huge bank balances, which appeared as a part of current assets.

You are asked to:

(i) Pass journal entries to record the above.

(ii) Prepare balance sheet as at 1.4.2012.

Solution

Journal entries in the books of Anu Ltd.

₹ in crores

	Particulars		*Debit*	*Credit*
1st April, 2012	12% Preference share capital A/c	Dr.	75	
	To Preference shareholders A/c			75
	(Being preference share capital account transferred to shareholders account)			
	Preference shareholders A/c	Dr.	75	
	To Bank A/c			75
	(Being payment made to shareholders)			
	Shares buy back A/c	Dr.	25	
	To Bank A/c			25
	(Being 50 lakhs equity shares bought back @ ₹ 50 per share)			
	Equity share capital A/c (50 lakhs x ₹ 10)	Dr.	5	
	Securities premium A/c (50 lakhs x ₹ 40)	Dr.	20	
	To Shares buy back A/c			25
	(Being cancellation of shares bought back)			
	Revenue reserve A/c	Dr.	80	
	To Capital Redemption Reserve A/c (75+5)			80
	(Being creation of capital redemption reserve to the extent of the face value of preference shares redeemed and equity shares bought back)			

(ii) Balance Sheet of Anu Ltd as at 1.4.2012

Particulars	*Note No*	*₹ in crores*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	20
(b) Reserves and Surplus	2	280
(2) Current Liabilities		
(a) Trade payables		40
Total		340
II. Assets		
(1) Non-current assets		
(a) Property, Plant and Equipment	3	-
(b) Non-current investments -Investment at cost (Market value ₹ 400 crores)		100
(2) Current assets	4	240
Total		340

Notes to Accounts

1.	**Share Capital**			*₹ in crores*
	Authorised, Issued and Subscribed			
	200 lakhs Equity shares of ₹ 10 each			20
2.	**Reserves and Surplus**			
	Capital reserve		15	
	Capital redemption reserve		80	
	Securities premium	25		
	Less: Utilisation for buy back of shares	(20)	5	
	Revenue Reserve	260		
	Less: transfer to Capital redemption reserve	(80)	180	280
3.	**Property, Plant and Equipment**			
	Cost		100	
	Less : Provision for depreciation		(100)	-
4.	**Current assets**			
	Current assets as on 31.3.2012		340	
	Less: Bank payment for redemption and buy back		(100)	240

Illustration 6

Extra Ltd. (a non-listed company) furnishes you with the following summarized Balance Sheet as on 31st March, 2012:

(₹ in lakhs)

Liabilities	*Amount*	*Assets*	*Amount*
Equity shares of ₹ 10 each fully paid	*100*	*Fixed assets less depreciation*	*50*
9% Redeemable preference		*Investments at cost*	*120*
shares of ₹ 100 each fully paid	*20*	*Current assets*	*142*
Capital reserves	*8*		
Revenue reserves	*50*		
Securities premium	*60*		
10% Debentures	*4*		
Current liabilities	*70*		
	312		*312*

(i) The company redeemed the preference shares at a premium of 10% on 1st April, 2012.

(ii) It also bought back 3 lakhs equity shares of ₹ 10 each at ₹ 30 per share.

The payment for the above was made out of huge bank balances, which appeared as a part of the current assets.

(iii) Included in its investment were "investments in own debentures" costing ₹ 2 lakhs (face value ₹ 2.20 lakhs). These debentures were cancelled on 1st April, 2012.

(iv) The company had 1,00,000 equity stock options outstanding on the above mentioned date, to the employees at ₹ 20 when the market price was ₹30 (This was included under current liabilities). On 1.04.2012 employees exercised their options for 50,000 shares.

(v) Pass the journal entries to record the above.

(vi) Prepare Balance Sheet as at 01.04.2012.

Solution

(₹ in lakhs)

Date	*Particulars*		*Debit*	*Credit*
01.04.2012	9% Redeemable preference share capital A/c	Dr.	20.00	
	Premium on redemption of preference shares A/c	Dr.	2.00	
	To Preference shareholders A/c			22.00
	(Being preference share capital transferred to shareholders account)			

01.04.2012	Preference shareholders A/c	Dr.	22.00	
	To Bank A/c			22.00
	(Being payment made to shareholders)			
01.04.2012	Equity shares buy back A/c	Dr.	90.00	
	To Bank A/c			90.00
	(Being 3 lakhs equity shares of ₹ 10 each bought back @ ₹30 per share)			
01.04.2012	Equity share capital A/c	Dr.	30.00	
	Securities premium A/c	Dr.	60.00	
	To Equity Shares buy back A/c			90.00
	(Being cancellation of shares bought back)			
01.04.2012	Revenue reserve A/c	Dr.	50.00	
	To Capital redemption reserve A/c			50.00
	(Being creation of capital redemption reserve account to the extent of the face value of preference shares redeemed and equity shares bought back as per the law)			
01.04.2012	10% Debentures A/c	Dr.	2.20	
	To Investment (own debentures) A/c			2.00
	To Profit on cancellation of own debentures A/c			0.20
	(Being cancellation of own debentures costing ₹ 2 lakhs, face value being ₹ 2.20 lakhs and the balance being profit on cancellation of debentures)			
1.04.2012	Profit on cancellation of debentures A/c	Dr.	0.20	
	To Capital reserve A/c			0.20
	(Being profit on cancellation of debentures transferred to capital reserve account)			
01.04.2012	Bank A/c	Dr.	10.00	
	Employees stock option outstanding (Current liabilities) A/c	Dr.	5.00	
	To Equity share capital A/c			5.00
	To Securities premium A/c			10.00
	(Being the allotment to employees, of 50,000 shares of ₹ 10 each at a premium of 20 per share in exercise of stock options by employees)			

01.04.2012	Securities premium A/c Dr. To Premium on redemption of preference (Being premium on redemption of preference shares adjusted through securities premium)	2.00	2.00

Balance Sheet of Extra Ltd. as on 01.04.2012

Particulars	*Note No*	*(₹ in lakhs)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	75.00
(b) Reserves and Surplus	2	66.20
(2) Non-current Liabilities		
(a) Long term borrowings	3	1.80
(3) Current Liabilities		65.00
Total		208.00
II. Assets		
(1) Non-current assets		
(a) Property, Plant and Equipment		50.00
(b) Non-current investments at cost		118.00
(2) Current assets		40.00
Total		208.00

Notes to Accounts

			₹ in lakhs
1	**Share Capital**		
	Equity share capital		
	Opening balance	100.00	
	Less : Cancellation of bought back shares	(30.00)	
	Add : Shares issued against ESOP	5.00	75.00
2	**Reserves and Surplus**		
	Capital Reserve		
	Opening balance	8.00	
	Add: Profit on cancellation of debentures	0.20	8.20

	Revenue reserves		
	Opening balance	50.00	
	Less: Creation of Capital Redemption Reserve	(50.00)	-
	Securities Premium		
	Opening balance	60.00	
	Less : Adjustment for cancellation of equity shares	(60.00)	
	Less: Adjustment for premium on redemption of preference shares	(2.00)	
	Add: Shares issued against ESOP at premium	10.00	8.00
	Capital Redemption Reserve		50.00
			66.20
3	**Long term borrowings**		
	Secured		
	10% Debentures (4-2.20)		1.80

Working Notes:

		(₹ in lakhs)
1.	**10% Debentures**	
	Opening balance	4.00
	Less: Cancellation of own debentures	(2.20)
		1.80
2.	**Current liabilities**	
	Opening balance	70.00
	Less: Adjustment for ESOP outstanding	(5.00)
		65.00
3.	**Investments at cost**	
	Opening balance	120.00
	Less: Investment in own debentures	(2.00)
		118.00
4.	**Current assets**	
	Opening balance	142.00
	Less : Payment to preference shareholders	(22.00)
	Less : Payment to equity shareholders	(90.00)
	Add : Share price received against ESOP	10.00
		40.00

Illustration 7

Dee Limited (a non-listed company) furnishes the following summarized Balance Sheet as at 31st March, 2012:

	₹ '000	₹ '000
Liabilities		
Share capital:		
Authorised capital		30,00
Issued and subscribed capital:		
2,50,000 Equity shares of ₹ 10 each fully paid up	25,00	
2,000, 10% Preference shares of ₹ 100 each	2,00	
(Issued two months back for the purpose of buy back)		27,00
Reserves and surplus:		
Capital reserve	10,00	
Revenue reserve	30,00	
Securities premium	22,00	
Profit and loss account	35,00	97,00
Current liabilities and provisions		14,00
		1,38,00
Assets		
Fixed assets		93,00
Investments		30,00
Current assets, loans and advances (including cash and bank balance)		15,00
		1,38,00

The company passed a resolution to buy back 20% of its equity capital @ ₹ 50 per share. For this purpose, it sold all of its investment for ₹ 22,00,000.

You are required to pass necessary journal entries and prepare the Balance Sheet.

Solution

In the books of Dee Limited

Journal Entries

	Particulars		Dr.	Cr.
			(₹ in '000)	
(i)	Bank Account	Dr.	22,00	
	Profit and Loss Account	Dr.	8,00	
	To Investment Account			30,00
	(Being the investments sold at loss for the purpose of buy back)			

(ii)	Equity Share capital account	Dr.	5,00	
	Premium payable on buy back Account	Dr.	20,00	
	To Equity shares buy back Account			25,00
	(Being the amount due on buy back)			
(iii)	Securities premium Account	Dr.	20,00	
	To Premium payable on buy back Account			20,00
	(Being the premium payable on buy back adjusted against securities premium account)			
(iv)	Revenue reserve Account	Dr.	3,00	
	To Capital Redemption Reserve Account			3,00
	(Being the amount equal to nominal value of equity shares bought back out of free reserves transferred to capital redemption reserve account)			
(v)	Equity shares buy-back Account	Dr.	25,00	
	To Bank Account			25,00
	(Being the payment made on buy back)			

Balance Sheet of Dee Limited as on 1st April, 2012

(After buy back of shares)

Particulars	*Note No*	*(₹ in 000)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	22,00
(b) Reserves and Surplus	2	69,00
(2) Current Liabilities		14,00
Total		10,500
II. Assets		
(1) Non-current assets		
(a) Property, Plant and Equipment		93,00
(2) Current assets		12,00
Total		10,500

Notes to Accounts

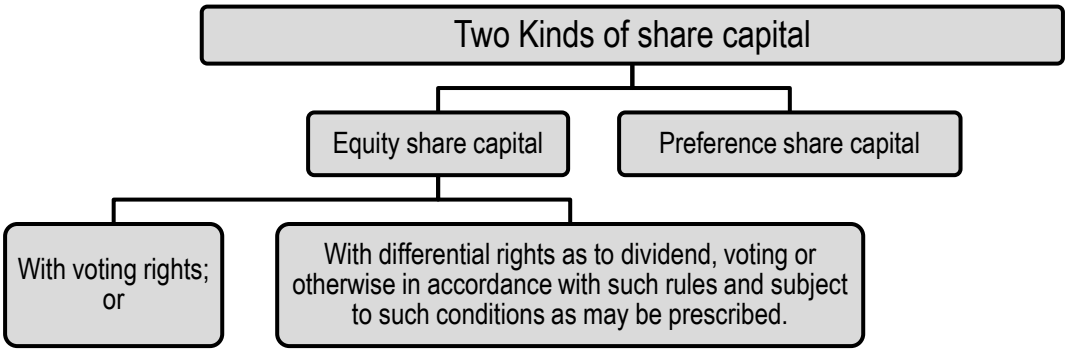
			₹ in 000
1	**Share Capital**		
	Authorised capital:		30,00
	Issued and subscribed capital:		

	2,00,000 Equity shares of ₹ 10 each fully paid up		20,00	
	2,000 10% Preference shares of ₹ 100 each fully paid up		2,00	22,00
2	**Reserves and Surplus**			
	Capital reserve		10,00	
	Capital redemption reserve		3,00	
	Securities Premium	22,00		
	Less: Premium payable on buy back of shares	20,00	2	
	Revenue reserve	30,00		
	Less: Transfer to Capital redemption reserve	3,00	27,00	
	Profit and loss A/c	35,00		
	Less: Loss on investment	8,00	27,00	69,00

1.3 Equity Shares with Differential Rights

The new Companies Amendment Act, 2013 allows companies to issue equity shares with differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed.

Section 43 of Companies Act : New issues of share capital to be only of two kinds – the share capital of a company limited by shares shall be only two kinds only, as depicted in the chart given below:–



Summary

- ESOP is an option given to whole-time or other directors, officers or employees of a company to purchase or subscribe the securities offered by the company at a future date, at a predetermined price.
- Buy back of shares can be made out of:

(i) its free reserves; or

(ii) the securities premium account; or

(iii) the proceeds of any shares or other specified securities.

- No company shall purchase its own shares or other specified securities unless—
- The buy back is authorized by the Articles of Association and by a special resolution passed at a general meeting. However, in case the buy back is for a sum less than or equal to ten percent of the paid up equity shares + free reserves the same may be authorized by the resolution of the directors passed at a duly convened Board Meeting.
- the buy-back is or less than or equal to twenty-five per cent of the total paid-up capital and free reserves of the company:
- Partly paid shares cannot be bought back by a company;
- the buy-back of equity shares in any financial year shall not exceed twenty-five per cent of its total paid-up equity capital in that financial year.
- No offer of buy back will be made within a period of one year from the date of closing of the previous buy back if any. Hence, there can be a maximum of one buy back in one year.
- the ratio of the debt owed by the company (both secured and unsecured) is not more than twice the paid up capital and its free reserves after such buy-back:
- As per the new Companies Act 2013 companies can issue equity shares with differential rights subject to the fulfilment of certain conditions. (Section 43).