

Redemption of Preference Shares

Dr. Vaseemuddin

Assistant Professor

Durga Mahavidyalaya, Raipur

Introduction

Redemption of preference shares refers to the process whereby a company repurchases its issued preference shares from shareholders at a predetermined date and price. This financial mechanism enables companies to buy back their preference shares, effectively returning the invested capital to shareholders while simultaneously adjusting their capital structure. The redemption process is governed by specific legal provisions and conditions that ensure the protection of both shareholders' and creditors' interests.

The term "redeem" in financial context means to buy back or settle an obligation. When applied to preference shares, redemption represents a contractual arrangement that gives the company the right to repurchase these shares within a specified timeframe at an agreed price. This process not only provides investors with a return of their principal investment but also offers companies flexibility in managing their capital structure and financial obligations.

Legal Framework under Companies Act, 2013

Section 55 - Issue and Redemption of Preference Shares

The redemption of preference shares in India is primarily governed by Section 55 of the Companies Act, 2013, which establishes comprehensive guidelines for both the issuance and redemption of preference shares.

Key Legal Provisions:

Prohibition on Irredeemable Preference Shares: Section 55(1) explicitly prohibits companies limited by shares from issuing irredeemable preference shares after the commencement of the Act. This provision ensures that all preference shares issued must have a redemption mechanism, preventing companies from creating perpetual obligations toward preference shareholders.

Authorization Requirements: Companies may issue redeemable preference shares only if their Articles of Association authorize such issuance. This requirement ensures that the company's constitutional documents explicitly permit such transactions.

Redemption Period: Preference shares must be redeemed within a period not exceeding twenty years from their date of issue. However, companies engaged in infrastructure projects may issue preference shares for periods exceeding twenty years but not exceeding thirty years, subject to minimum annual redemption requirements.

Shareholder Approval: The issuance of preference shares requires approval through a special resolution at a shareholders' meeting, ensuring democratic decision-making in capital structure modifications.

Conditions for Redemption

The Companies Act, 2013 establishes several mandatory conditions that must be fulfilled for the redemption of preference shares:

Fully Paid Shares Requirement

Preference shares can only be redeemed if they are fully paid-up. This condition ensures that the company has received the complete subscription amount for the shares before proceeding with redemption. Partly paid shares cannot be redeemed unless they are first made fully paid through appropriate calls.

Source of Redemption Funds

Preference shares may be redeemed from two specific sources:

Out of Profits Available for Dividend: Companies may use their distributable profits that would otherwise be available for dividend distribution to redeem preference shares. This method requires the creation of a Capital Redemption Reserve.

Proceeds of Fresh Issue: Companies may issue new shares (equity or preference) specifically for the purpose of generating funds to redeem existing preference shares. This method maintains the company's capital base while facilitating redemption.

Capital Redemption Reserve Creation

When preference shares are redeemed out of company profits, a sum equal to the nominal amount of shares being redeemed must be transferred to a Capital Redemption Reserve Account. This reserve serves multiple purposes:

- Maintains the company's capital integrity
- Protects creditor interests
- Ensures compliance with capital maintenance provisions
- Can be utilized for issuing fully paid bonus shares to existing shareholders

Premium Payment Provisions

If preference shares are redeemed at a premium, the premium amount must be provided from specific sources before redemption:

- For companies complying with prescribed accounting standards: premium must be paid from company profits
- For other companies: premium may be paid from company profits or securities premium account
- For preference shares issued before the Act's commencement: premium may be paid from profits or securities premium account

Methods of Redemption

There are three primary methods through which preference shares can be redeemed:

1. Redemption from Profits

This method involves using the company's distributable profits to redeem preference shares. The process requires:

- Identification of sufficient distributable profits
- Transfer of an amount equal to the nominal value of redeemed shares to Capital Redemption Reserve
- Payment of redemption amount to shareholders
- Appropriate accounting entries to reflect the transaction

2. Redemption through Fresh Issue of Shares

Companies may issue new equity or preference shares to raise funds specifically for redemption purposes. This method:

- Maintains the company's overall capital base
- Does not require Capital Redemption Reserve creation if fully funded through fresh issue
- Allows companies to restructure their capital composition
- May involve issuing shares at par, premium, or discount as permitted by law

3. Combination Method

Companies may utilize both profits and proceeds from fresh issue to fund redemption. In such cases:

- Capital Redemption Reserve must be created for the portion funded from profits
- The reserve amount equals: Nominal value of redeemed shares minus nominal value of new shares issued
- Provides flexibility in funding redemption while maintaining capital adequacy

Capital Redemption Reserve (CRR)

The Capital Redemption Reserve represents a crucial component of the preference share redemption process, serving as a statutory reserve that protects stakeholder interests.

Purpose and Significance

Capital Maintenance: CRR ensures that the company's capital base remains intact despite the redemption of preference shares, maintaining the fundamental principle of capital maintenance under company law.

Creditor Protection: By creating this reserve, companies provide assurance to creditors that sufficient funds remain available to meet obligations, even after share redemption.

Regulatory Compliance: The creation of CRR demonstrates compliance with statutory requirements and sound corporate governance practices.

Calculation and Application

Calculation Formula: $CRR = \text{Nominal value of preference shares redeemed out of profits}$

Permitted Uses: CRR may be applied for:

- Issuing fully paid bonus shares to existing shareholders
- No other purposes including dividend distribution

Treatment: CRR is treated as paid-up share capital for the purposes of capital reduction provisions under the Companies Act.

Accounting Treatment

The accounting treatment for preference share redemption involves several journal entries depending on the method employed:

Basic Redemption Entries

For Redemption from Profits:

1. Transfer to Capital Redemption Reserve:
Dr. Profit and Loss Account
Cr. Capital Redemption Reserve Account
2. Redemption Payment:
Dr. Preference Share Capital Account
Cr. Preference Shareholders Account
Dr. Preference Shareholders Account
Cr. Bank Account

Fresh Issue Method Entries

When New Shares are Issued:

1. Receipt of Application Money:
Dr. Bank Account
Cr. Share Application Account
2. Allotment and Call:
Dr. Share Application Account
Cr. Share Capital Account
3. Redemption Transaction:
Dr. Preference Share Capital Account
Cr. Bank Account

Premium Treatment

Redemption at Premium:

Dr. Preference Share Capital Account (nominal value)
Dr. Profit and Loss Account (premium)
Cr. Bank Account (total payment)

Procedure for Redemption

The redemption process follows a systematic procedure ensuring legal compliance and stakeholder protection:

Step 1: Board Resolution

Directors must pass a board resolution approving the redemption of preference shares, considering:

- Financial feasibility
- Compliance with legal requirements
- Impact on company's capital structure
- Availability of funds

Step 2: Shareholder Notification

All preference shareholders must be individually informed about:

- Proposed redemption details
- Redemption date and amount
- Terms and conditions
- Payment methodology

Step 3: Reserve Creation

If redemption is from profits, transfer the required amount to Capital Redemption Reserve Account before actual redemption.

Step 4: Payment Execution

Make payment of redemption amount and any applicable premium to preference shareholders through appropriate banking channels.

Step 5: Regulatory Filing

File notice of redemption with the Registrar of Companies in Form SH-7 within 30 days of redemption completion, including:

- Details of redeemed shares
- Method of redemption
- Financial particulars

Step 6: Record Updates

Update the company's statutory registers including:

- Register of Members
- Share Capital records
- Financial statements

- Annual return filings

Special Provisions

Infrastructure Projects

Companies engaged in infrastructure projects enjoy special provisions:

- May issue preference shares for periods exceeding 20 years but not exceeding 30 years
- Must redeem minimum 10% of such shares annually from the 21st year onwards
- Redemption may be at the option of preference shareholders

Inability to Redeem

Section 55(3) provides relief for companies unable to redeem preference shares:

- May issue fresh redeemable preference shares equal to unredeemed amount plus dividends
- Requires consent of 75% preference shareholders by value
- Needs Tribunal approval through petition
- Original unredeemed shares deemed redeemed upon fresh issue

Conclusion

Redemption of preference shares represents a sophisticated financial mechanism that balances the interests of companies, shareholders, and creditors. The comprehensive legal framework under the Companies Act, 2013 ensures that redemption transactions are conducted transparently and in accordance with established principles of corporate governance.

The process requires careful attention to legal requirements, particularly the creation of Capital Redemption Reserve, proper accounting treatment, and adherence to prescribed procedures. Companies must evaluate various redemption methods to determine the most appropriate approach based on their financial position and strategic objectives.

The redemption mechanism serves multiple purposes: providing investors with predetermined exit opportunities, enabling companies to optimize their capital structure, and maintaining the integrity of the corporate framework. Through proper implementation of redemption provisions, companies can effectively manage their capital resources while fulfilling their obligations to preference shareholders.

Understanding these provisions is essential for corporate managers, financial professionals, and legal practitioners involved in capital structure decisions and corporate finance transactions. The redemption of preference shares continues to play a vital role in modern corporate finance, offering flexibility and security to both issuers and investors in the dynamic business environment.