**Unit – II: Redemption of Preference Shares and Debentures**

Redemption of Preference shares: Introduction – Provisions of Companies Act – Methods. Redemption of Debentures – Introduction – Condition of Redemption of Debentures – Methods

**Meaning:**

 Shares for which the amount should be repayable after the expiry of a specified period are called redeemable preference shares. The Articles of the company should permit such redemption. The redemption is carried out either at premium or at face value. A company cannot return its share capital to the shareholders without the permission of the court of law.

**Provision of the companies Act:**

 The following are the important provisions of Sec 80 Companies Act 1956, relating to issue and redemption of redeemable preference shares.

* A company limited by shares, may if authorized by its Articles of Association, issue of preference shares which are liable to be redeemed as per terms of the issue.
* Shares cannot be redeemed unless they are fully paid up.
* Shares can be redeemed either out of the profits of the company which would otherwise be available for dividend or out of the proceeds of a fresh issue of shares made for the purpose of redemption.
* If any premium is payable on redemption of preference shares, such premium has to be provided out of the profits of the company or out of the Securities Premium Account.
* When such shares are redeemed out of profits a sum equal to the nominal amount of the shares so redeemed must be transferred out of the profits of the company which would otherwise be available for dividend to a reserve account called Capital Redemption Reserve Account.
* Capital Redemption reserve can be utilised to issue fully paid bonus shares to the equity shareholders.
* Redemption of preference shares by a company shall not be take as reduction of its Authorized capital.

**Procedures for redemption of preference shares:**

* Only fully paid shares can be redeemable. If the shares are partly paid up, then it should be converted into fully paid and then redemption is made.
* The premium required for redemption is to be paid from share premium account only. The share premium account may be in liability side of the balance sheet or raised at the time of fresh issue of equity shares at a premium.
* If the premium account is not sufficient for redemption then the balance amount may be paid out of profit and loss account.
* The refund of capital amount should be made from fresh issue of equity share capital, profit and loss account and or general reserve account in balance sheet.
* The fresh issue of equity shares may be at face value or at premium value or at discount value.
* Before taking an amount from profit and loss account and general reserve, an amount equal to the same should be transferred to capital redemption reserve.
* Redemption should not be made from issue of debentures or sale of any investments.

**Capital Redemption Reserve:**

A limited [company](https://www.toppr.com/guides/business-laws/companies-act-2013/meaning-and-features-of-a-company/) may issue redeemable preference shares if it’s [Articles](https://www.toppr.com/guides/english/articles/introduction-to-articles/) of Association provide. Thus, these preference shares are liable for [redemption](https://www.toppr.com/guides/accountancy/issue-and-redemption-of-debentures/redemption-of-debentures/) within a period not exceeding twenty years from the date of issue. A company cannot issue irredeemable preference shares. Also, a company can redeem only fully paid-up preference shares out of the profits available for dividend or out of the proceeds of a fresh issue of shares for redemption. Hence, the preference shares are redeemed from the capital reserve account created for the purpose of the redemption.

**Capital Redemption Reserve Account:**

When the company proposes to redeem the preference shares out of the [profits](https://www.toppr.com/guides/maths/compairing-quantities/profit-and-loss/), it transfers an amount equal to the nominal value of the redeemable preference shares to the Capital Redemption [Reserve](https://www.toppr.com/guides/accountancy/depreciation-provision-and-reserves/reserves/) A/c out of the profits of the company.

Also, in this case, the provisions relating to the reduction of share capital shall apply. The company can also use the Capital Redemption Reserve to issue the fully paid-up bonus shares.

**Difference between share and Debenture:**

|  |  |  |
| --- | --- | --- |
| **Basis** | **Shares** | **Debentures** |
| Nature | It is the part of the owned capital | It is a part of the borrowed funds. |
| Status | Shareholders are the owners of the company. | Debenture holders are the creditors of the company. |
| Returns | A shareholder gets dividend out of profits and cannot be claimed by him till declared by the company. | A debenture holder gets interest even if there are losses. |
| Repayment | Amount of equity share capital is not returned during the lifetime of the company. | They are redeemed on the due date. |
| Charge | No charge is created on assets of the company when it issues shares. | A charge fixed of floating is created on company’s assets when debentures are issued. |
| Voting Rights | Shareholders enjoy voting rights. | Debenture holders do not enjoy any voting rights. |
| Convertibility | Shares cannot be convertible. | Debenture can be converted into equity shares. |
| Restriction | There are legal restrictions on the purchase of its own shares. | There is no legal restriction on purchase of its own debentures. |
| Winding up | Share capital is returned after all claims are met. | At the time of winding up debenture holders are repaid after the payment to the shareholders is made. |

**Types of preference shares:**

**1. Convertible Preference Shares:** Convertible preference shares are those shares that can be easily converted into equity shares.

**2. Non-Convertible Preference Shares:** Non-Convertible preference shares are those shares that cannot be converted into equity shares.

**3. Redeemable Preference Shares:** Redeemable preference shares are those shares that can be repurchased or redeemed by the issuing company at a fixed rate and date. These types of shares help the company by providing a cushion during times of inflation.

**4. Non-Redeemable Preference Shares:** Non-redeemable preference shares are those shares that cannot be redeemed or repurchased by the issuing company at a fixed date. Non-redeemable preference shares help companies by acting as a lifesaver during times of inflation.

**5. Participating Preference Shares:** Participating preference shares help shareholders demand a part in the company’s surplus profit at the time of the company’s liquidation after the dividends have been paid to other shareholders.
However, these shareholders receive fixed dividends and get part of the surplus profit of the company along with equity shareholders.

**6. Non-Participating Preference Shares:** These shares do not benefit the shareholders the additional option of earning dividends from the surplus profits earned by the company, but they receive fixed dividends offered by the company.

**7. Cumulative Preference Shares:** Cumulative preference shares are those type of shares that gives shareholders the right to enjoy cumulative dividend payout by the company even if they are not making any profit.
These dividends will be counted as arrears in years when the company is not earning profit and will be paid on a cumulative basis the next year when the business generates pro

**8. Non - Cumulative Preference Shares:** Non - Cumulative Preference Shares do not collect dividends in the form of arrears. In the case of these types of shares, the dividend payout takes place from the profits made by the company in the current year. So if a company does not make any profit in a single year, then the shareholders will not receive any dividends for that year. Also, they cannot claim dividends in any future profit or year.

**9. Adjustable Preference Shares:** In the case of adjustable preference shares, the dividend rate is not fixed and is influenced by current market rates.

**Debentures:**

Debenture is an important source of raising funds by a company as a company requires large number of funds to finance its new projects or for its expansion. Debenture is a written instrument acknowledging a debt taken under the common seal of the company. It contains terms and collections of contract as regard the payment of interest and redemption of the principal.

**Types of debentures:**

**1. Security point of view:**

 **(a) Simple or naked or unsecured debentures:** These are those debentures that have no security. The holders of such debentures are treated as unsecured creditors at the time of winding up of the company.

 **(b) Secured debenture:** These are the debentures that are secured against the particular assets of the company. If the company is unable to repay the amount of debentures, than the debenture holders can realize their dues from the assets mortgaged with them.

**2. Tenure point of view:**

 **(a) Redeemable debentures:** These are those debentures that will be repaid by the company at the end of the specified period during the existence of the company.

 **(b) Irredeemable debenture:** These are those debentures which ar not to be repaid during the lifetime of the company.

**3. Mode point of view:**

 **(a) Convertible debentures:** These are those debentures which can be converted into the equity shares on the option of the debenture holders.

 **(b) Non Convertible debentures:** These are those debentures which cannot be converted into the equity shares on the option of the debenture holders.

**4. Registration point of view:**

 **(a) Registered debenture:** These are the debentures in which the details of the debenture holders are registered in the register of the company. These debentures cannot be transferred from one debenture holders to another.

 **(b) Bearer debenture:** These are those debentures which can be transferred by way of delivery and the company does not keep any record of the debenture holder.

**Methods of redemption of debentures:**

Repayment or discharge of liability on account of debentures is called redemption of debentures. The method of debenture redemption adopted determines to a very large extent the actual accounting for redemption as well as the marshalling of resources for the same.

**(a) Lump sum payment method:**

 In Lump sum payment method, redemption of debentures is done by repayment in one lump sum after the expiry of a stipulated period. The total amount payable to debenture holders is decided at the time of issue of debentures. Usually a company creates sinking fund or an insurance policy fund for the redemption of debentures.

**(b) Drawings of lots method:**

 In order to reduce the liability of debentures, company may repay the debentures in some installments. A certain amount of debentures is redeemed at regular interval of time during the lifetime of the debentures by drawings of lots.

**(c) Purchase in the open market:**

 The company from the open market can purchase its own debentures. Debentures so purchased may be cancelled immediately or may be kept as an investment, which will be cancelled later. It may beneficial for the company if it purchases its own debentures at a discount from the open market.

**(d) Conversion Method:**

 Usually debentures are redeemed in cash but sometimes debenture holders are given an option to get their debentures converted either in shares or for new debenture of the company. The redemption of debentures by means of shares or new debentures is known as redemption by conversion. Debentures which carry such right are called convertible debentures.

**Minimum fresh issue of shares:**

 At the time of redemption of preference shares, some companies may decide to utilize all the permissible reserves for the redemption and make new issue of shares for any balance amount required. The intention is to minimize the new issue of shares. Such minimum new issue may be made at par, at premium and at discount

 **Formula:**

Minimum new issue to be made = [Face value redeemable preference share + Premium payable on redemption – Securities premium in balance sheet – revenue reserve in balance sheet] x 100 / 100 + Premium % on new issue (or) 100 – Discount % on new issue

**Journal entries at time of redemption of preference shares:**

**1. Entries for receiving cash:**

**(a) For making final call on partly paid preference shares:**

Redeemable Preference share final call A/c Dr

 To Redeemable Preference Share capital A/c

**(b) For receiving final call amount:**

 Bank A/c Dr

 To Redeemable preference share final call A/c

**(c) For sale of investment at loss:**

 Bank A/c (cash received) Dr

 Profit and loss A/c (Loss on sale) Dr

 To Investment A/c (or)

 To Asset A/c (Book value)

**2. Entries for transfers:**

**(a) For transfer to capital redemption reserve:**

 General reserve A/c Dr

 Profit & Loss A/c Dr

 To Capital redemption reserve A/c

**(b) For redeemable preference share capital and premium:**

Redeemable preference share capital A/c Dr

Premium on redemption A/c Dr

 To Redeemable preference shareholders A/c

**(c) Adjustment of premium payable on redemption**:

 Securities premium A/c Dr

 Profit & Loss A/C Dr

 To Premium on redemption A/c

**3. Entry for cash payment:**

 Redeemable preference shareholders A/c Dr

 To Bank A/c

**4. Entries for cash payment:**

**(a) For declaration of bonus:**

 Capital redemption reserve A/c Dr

 General reserve A/c Dr

 Profit & Loss A/c Dr

 To Bonus to shareholders A/c

**(b) For issue of bonus shares:**

 Bonus to shareholders A/c Dr

 To Equity Share capital A/c

**Problems:**

1. The following extract from the extract from the balance sheet of Priya Co Ltd as on 31.12.2008 is given to you

|  |  |
| --- | --- |
| **Particulars** | **Rs** |
| 2,00,00 equity shares of Rs.10 each | 20,00,000 |
| 3,00,000 6% redeemable preference shares of Rs.10 each  | 30,00,000 |
| Capital reserve | 15,00,000 |
| General reserve | 9,00,000 |
| Profit & Loss A/c | 25,50,000 |

Show the journal entry for redemption of preference shares.

**Solution:**

 1. General Reserve A/c Dr 9,00,000

 Profit & Loss A/c Dr 21,00,000

 To Capital Redemption reserve A/c 30,00,000

(Being transfer of an amount equal to the nominal value of shares redeemed)

2. 6% Redeemable preference shares capital A/c 30,00,000

 To Redeemable preference shareholders A/c 30,00,000

(Being the amount payable on redemption of preference shares)

3. Redeemable preference share holders A/c Dr 30,00,000

 To Bank A/c 30,00,000

(Being the amount due on preference shares repaid)

2. Kumar Ltd issued 75,000 equity shares of Rs.10 each and 5,000 redeemable preference shares of Rs.100 each all shares being fully called and paid up on 31.3.1992. Profit and loss account showed undistributed profits of Rs.2,50,000 and general reserve stood at Rs.2,50,000. On 1.4.1992 the directors decided to redeem the existing preference shares at Rs.105 utilising as much profits as would be required for the purpose. You are required to pass journal entries in the books of the company.

**Solution:**

1. General Reserve A/c Dr 2,50,000

 Profit & Loss A/c Dr 21,00,000

 To Capital Redemption reserve A/c 30,00,000

(Being transfer of an amount equal to the nominal value of shares redeemed)

 2. Redeemable preference share capital A/c Dr 5,00,000

 Premium on redemption of preference shareholders A/c 25,000

 To Redeemable preference shareholders A/c 5,25,000

(Being the transfer of amount due to preference shareholders)

3. Profit & Loss A/c Dr 25,000

 To Premium on redemption of preference share A/c 25,000

(Being the premium provided out of P & l A/c for redemption preference shares)

4. Redeemable preference shareholders A/c Dr 5,25,000

 To Bank A/c 5,25,000

(Being the payment made to redeemable preference shareholders on redemption)

3. Redeemable preference share to be redeemed are Rs.2,00,000. Premium payable on redemption is 10%. Securities premium in balance sheet is Rs.10,000. Revenue reserves in balance sheet are Rs. 1,05,000. Compute the Minimum fresh issue of shares (a)at par; (b) at premium 5% and (c) at discount 10% discount.

**Solution:**

**(a) When the fresh issue at par:**

 Minimum new issue to be made = [Face value redeemable preference share + Premium payable on redemption – Securities premium in balance sheet – revenue reserve in balance sheet]

 Fresh issue = 2,00,000 + (10/100 x 2,00,000) – 10,000 – 1,05,000

 = 2,00,000 + 20,000 – 1,15,000

 **= Rs. 1,05,000**

 **(b) When the fresh issue is at 5% premium:**

Minimum new issue to be made = [Face value redeemable preference share + Premium payable on redemption – Securities premium in balance sheet – revenue reserve in balance sheet] x 100 / 100 + Premium % on new issue

 Fresh issue = (2,00,000 + 20,000 – 10,000 – 1,05,000) x 100 / 105

 = 1,05,000 x 100/105

 = **Rs.1,00,000**

Face value of the fresh issue is Rs.1,00,000

Premium on the fresh issue is 1,00,000 x 5/100 = **Rs.5,000**

**(c) When the fresh issue is at 10% discount:**

Minimum new issue to be made = [Face value redeemable preference share + Premium payable on redemption – Securities premium in balance sheet – revenue reserve in balance sheet] x 100 / 100 – Discount % on new issue

 Fresh issue = (2,00,000 + 20,000 – 10,000 – 1,05,000) x 100 / 90

 **= Rs. 1,16,667**

Face value of the fresh issue is Rs.1,16,667

Premium on the fresh issue is 1,16,667 x 10/100 = **Rs.11,667**

Net proceeds = 1,16,667 – 11,667 = **Rs.1,05,000**

4. A company decides to redeem its preference shares amounting to Rs. 1 lakh at a premium of 5% and for this purpose issues 5,000 equity shares of Rs.10 each at a premium of 5%. The company has also balance of Rs.1,00,000 on general reserve and Rs.50,000 on Profit & Loss Account. Show the journal entries

**Solution:**

1. Redeemable preference share capital A/c Dr 1,00,000

Premium on redemption A/c Dr 5,000

 To Preference share holders A/c 1,05,000

(Being amount due)

2. Securities Premium A/c (5,000 x5/100) Dr 2,500

 Profit & Loss A/c (5,000 x5/100) Dr 2,500

 To Premium on redemption A/c 5,000

(Being premium on redemption cancelled)

3. Bank A/c Dr 52,500

 To Equity share capital A/c 50,000

 To Securities premium A/c 2,500

(Being fresh issue of shares)

4. Profit & Loss A/c 50,000 – 2,500) Dr 47,500

 General reserve A/c 2,500

 To Capital redemption reserve A/c 50,000

(Being amount taken from balance sheet)

5. Preference share holders A/c Dr 1,05,000

 To Bank A/c 1,05,000

(Being amount paid to share holder)

5. From the following information, find out what amount shall be transferred to capital redemption reserve account.

Redeemable preference shares redeemed Rs.2,00,000 at par (fresh issue of share capital Rs.80,000) Redeemable preference shares redeemed Rs.2,00,000 at 5% premium (fresh issue of share capital Rs.80,000 at par)

**Solution:**

1. Redeemable preference share capital A/c Dr 2,00,000

 To Preference share holder A/c 2,00,000

(Being amount due)

2. Bank A/c Dr 80,000

 To Equity Share capital A/c 80,000

(Being fresh issue of shares)

3. Profit & Loss A/c (2,00,000 – 80,000) Dr 1,20,000

 To Capital redemption reserve A/c 1,20,000

(Being amount taken from P& L A/c)

4. Preference share holders A/c Dr 2,00,000

 To Bank A/c 2,00,000

(Being amount paid to share holders)

5. Redeemable preference share capital A/c Dr 2,00,000

 Premium on redemption A/c 10,000

 To Preference share holders A/c 2,10,000

(Being amount due)

6. Preference shareholders A/c Dr 2,10,000

 To Bank A/c 2,10,000

(Being amount paid to share holders)

**Journal entries in issue and redemption of debentures:**

 **1. Issued at par and redeemable at par:**

 Bank A/c Dr

 To Debenture A/c

**2. Issued at discount and redeemable at par:**

Bank A/c Dr

Discount on debentures A/c Dr

 To Debenture A/c

**3. Issued at premium and redeemable at par:**

 Bank A/c Dr

 To Debenture A/c

 To Premium on debenture A/c

**4. Issued at par and redeemable at premium:**

Bank A/c Dr

Loss on issue of debenture A/c Dr

 To Debenture A/c

 To Premium on redemption of debenture A/c

**5. Issued at discount and redeemable at premium:**

Bank A/c Dr

Discount on debentures A/c Dr

Loss on issue of debenture A/c Dr

 To Debenture A/c

 To Premium on redemption of debenture A/c

**Problems:**

1. A Company issues the following debentures: Show the journal entries

(i) 2,000, 10% debentures of Rs.100 each at par but redeemable at a premium of 10% after ten years.

(ii) 500, 13% debentures of Rs.100 each at a premium of 10% payable at par after five years.

(iii) 1,000 11% debentures of Rs.100 each at a discount of 10% but redeemable at a premium of 5% after 8 years.

(iv) 500 debentures of Rs.100 each as collateral security to a creditor who advanced a loan of Rs.40,000.

**Solution:**

1. Bank A/c Dr 2,00,000

 Loss on issue of debenture A/c Dr 20,000

 To Debenture A/c 2,00,000

 To Premium on redemption of debenture A/c 20,000

(Being debentures issued at par and redeemable at premium)

2. Bank A/c Dr 55,000

 To 13% Debenture A/c 50,000

 To Premium on issue of debenture A/c 5,000

(Being debentures issued at premium and redeemable at par)

3. Bank A/c Dr 90,000

 Discount on debentures A/c Dr 10,000

 Loss on issue of debenture A/c Dr 5,000

 To 11% Debenture A/c 1,00,000

 To premium on redemption 5,000

(Being debentures issued at discount and redeemable at premium)

4. Debenture suspense A/c Dr 50,000

 To Debenture A/c 50,000

(Being debenture issued as collateral security)

2. Timex Ltd issued 1,000 8% debentures of Rs.100 each. Develop appropriate journal entries in the books of the company, if the debenture were issued as follows:

 (a) Issued at par, redeemable at par.

 (b) Issued at a discount of 5%, repayable at par.

 (c) Issued at a premium of 10%, repayable at par.

 (d) Issued at par, redeemable at a premium of 10%

(e) Issued at a discount of 5%, repayable at a premium of 10%

**Solution:**

1. Bank A/c Dr 1,00,000

 To 8% Debenture A/c 1,00,000

(Being issue of debentures at par and repayable at par)

2. Bank A/c Dr 95,000

 Discount on debentures A/c Dr 5,000

 To 8% Debenture A/c 1,00,000

(Being debenture issued at discount and repayable at par)

3. Bank A/c Dr 1,10,000

 To 8% Debenture A/c 1,00,000

 To Securities premium A/c 10,000

(Being Debentures issued at premium and repayable at par)

4. Bank A/c Dr 1,00,000

Loss on issue of debenture A/c Dr 10,000

 To 8% Debenture A/c 1,00,000

 To Premium on redemption of debenture A/c 10,000

(Being debenture issued at par and repayable at premium)

5. Bank A/c Dr 95,000

 Discount on debentures A/c Dr 5,000

 Loss on issue of debenture A/c Dr 10,000

 To 8% Debenture A/c 1,00,000

 To Premium on redemption of debenture A/c 10,000

(Being debentures issued at discount and repayable at premium)