

Share buyback transactions (Lecture A806 – 8.48 minutes)

It is not uncommon to hear of companies purchasing their own shares from shareholders. A typical scenario which would involve a share buyback transaction would be where a shareholder wishes to retire and asks the company to buyback his/her shares.

The accounting for share buybacks can be tricky and there is a whole host of legalities to consider – some of which are obvious; whereas other are not. In this section of the course, we take a look at some of the more common scenarios where share buybacks are concerned and the legal issues that must also be considered.

1.1 Company law considerations

Companies Act 2006 (CA 2006) deals with the acquisition by a company of its own shares in Part 18, Sections 658 to 737. S658, CA 2006 places a restriction on companies acquiring their own shares (whether by purchase, subscription or otherwise) unless the exceptions in s659, CA 2006 apply. The exceptions are summarised as follows:

- (a) A limited company may acquire any of its own fully paid shares otherwise than for valuable consideration.
- (b) Section 658 [the section which places a general prohibition on a company acquiring its own shares] does not prohibit:
 - (a) the acquisition of shares in a reduction of capital duly made;
 - (b) the purchase of shares in pursuance of an order of the court under:
 - (i) section 98 (application to court to cancel resolution for re-registration as a private company);
 - (ii) section 721(6) (powers of court on objection to redemption or purchase of shares out of capital);
 - (iii) section 759 (remedial order in case of breach of prohibition of public offers by private company); or
 - (iv) part 30 (protection of members against unfair prejudice);
- (c) The forfeiture of shares, or the acceptance of shares surrendered in lieu, in pursuance of the company's articles, for failure to pay any sum payable in respect of the shares.

1.2 Accounting issues

S686(1), CA 2006 only allows redeemable shares to be redeemed if they are fully paid. A similar rule is contained in s691(1), CA 2006 which prohibits companies from purchasing

their own shares if the shares are not fully paid. S691(2), CA 2006 also requires companies that purchase their own shares to pay for those shares on acquisition.

S733, CA 2006 *Supplementary Provisions* refers to the 'capital redemption reserve'. S733(2), CA 2006 requires a company whose shares are redeemed or purchased wholly out of a company's retained earnings to transfer a sum equivalent to the amount by which the company's share capital is diminished on cancellation of those shares.

This rule is there to maintain the company's capital and also to protect creditors. It should be borne in mind that the capital redemption reserve can only be used to make a bonus issue of shares.

Example – Share buyback at par value

The balance sheet of Parr Ltd is as follows:

| | |
|------------------------------------|----------------|
| Cash at bank | £40,000 |
| Ordinary share capital (£1 shares) | 18,000 |
| Retained earnings | 22,000 |
| | <u>£40,000</u> |

A resolution was passed for the company to repurchase 4,000 shares at par value. The share buyback is recorded as follows:

| | |
|---------------------------|--------|
| Dr Ordinary share capital | £4,000 |
| Cr Cash at bank | £4,000 |

Redemption of capital

| | |
|--|--------|
| Dr Retained earnings | £4,000 |
| Cr Capital redemption reserve (equity) | £4,000 |

To maintain capital following buyback

Alternatively, the journals could be:

| | |
|-------------------------------|--------|
| Dr Retained earnings | £4,000 |
| Cr Cash at bank | £4,000 |
| Dr Share capital | £4,000 |
| Cr Capital redemption reserve | £4,000 |

The balance sheet will now look like this:

| | |
|------------------------------------|--------|
| Cash at bank | 36,000 |
| Ordinary share capital (£1 shares) | 14,000 |
| Capital redemption reserve | 4,000 |
| Retained earnings | 18,000 |
| | 36,000 |

1.3 Share buyback at a premium

There may be occasions when a company decides to repurchase some shares at a premium. Using the same example as Parr Ltd above, if it is assumed that the company has repurchased the shares at a 50p premium, the entries to record the transaction are:

Dr Ordinary share capital £4,000

Dr Retained earnings (4,000 shares x 0.50p) £2,000

Cr Cash at bank £6,000

Redemption of shares at a premium

Dr Retained earnings £4,000

Cr Capital redemption reserve £4,000

To maintain capital following buyback

The balance sheet will then look like this:

| | |
|------------------------------------|---------|
| Cash at bank | £34,000 |
| Ordinary share capital (£1 shares) | 14,000 |
| Capital redemption reserve | 4,000 |
| Retained earnings | 16,000 |

34,000

Hence, the company has still maintained capital at £18,000 and the company has made the purchase out of distributable profits (because the total debited to retained earnings is the £6,000 which is equivalent to the consideration for the share buyback).

1.4 Shares purchased out of a fresh issue of shares

The general rule is that any premium that is paid on the shares that a company acquires must be made out of distributable profits. S687(4), CA 2006 states that if the redeemable shares were issued at a premium, any premium payable on their redemption may be funded from the proceeds of the new share issue.

The amount of the premium that can be funded in this way is equal to the *lower* of:

- (a) the aggregate of the premiums the company received on issuance of the shares that it is now redeeming; and
- (b) the amount of the company's share premium account after crediting the premium (if any) on the new issue of shares it makes to fund the purchase or redemption.

Example – Share purchase out of a fresh issue of shares

On 1 January 2018, Harper Ltd issued 100,000 ordinary £1 shares. Included in this share issue are Stefan's 10,000 ordinary shares which were issued to him at a premium of 0.10p per share. Following this issue, the balance on Harper Ltd's share premium account was £3,500. On 1 January 2020, Harper Ltd made a bonus issue of shares to its shareholders and used the entire balance on the share premium account to carry out this bonus issue.

In 2022, Stefan announced that he would like to retire and has asked the company to purchase his shares. The company has agreed to purchase his shares for £2.50 per share (hence at a premium of £1.50 per share) and to do this has made a further issue of 10,000 ordinary shares with a par value of £1 at a premium of 0.75p (hence the shares have been issued at £1.75). The balance to purchase Stefan's shares of £7,500 has been made from the bank account.

The premium on the purchase is the *lower* of the initial premiums the company received on the original issuance of the shares and the balance on the share premium account after the issue as follows:

| | |
|--|--------|
| Par value of Stefan's shares purchased | 10,000 |
| Lower of: | |
| ▪ initial 10p premium on issue (10,000 shares) | 1,000 |
| ▪ balance on share premium incl. premium on new shares | 7,500 |
| | <hr/> |
| | 1,000 |

| | |
|---|---------------|
| Total (cannot exceed the proceeds of the new issue) | 11,000 |
| Balance funded from distributable profit | <u>14,000</u> |
| Cost of purchase of Stefan's shares | <u>25,000</u> |

The transaction is recorded as follows:

| | |
|---------------------------|---------|
| Dr Cash at bank | £17,500 |
| Cr Ordinary share capital | £10,000 |
| Cr Share premium | £7,500 |

Being new share issue at 0.75p premium

| | | |
|---------------------------|---------|--------|
| Dr Ordinary share capital | £10,000 | |
| Dr Share premium | £1,000 | Note 1 |
| Dr Retained earnings | £14,000 | Note 2 |
| Cr Cash at bank | £25,000 | |

Purchase of 10,000 shares at a premium of £1.50

Note 1

S692(4), CA 2006 allows the share premium account to be reduced by part of the premium payable on the purchase/redemption that is allowed to be funded out of the proceeds of the new share issue, rather than it being made out of retained earnings.

Note 2

In this scenario, no amounts have been credited to the capital redemption reserve. This is because the par value of the shares purchased (£10,000) is less than the total proceeds of the new issue of £17,500 (10,000 shares x £1.75) hence the company's capital has been maintained so there is no requirement for a capital redemption reserve.

This section of the course has considered some of the more complex scenarios where share buyback transactions are concerned.

There are several legal and ethical factors that must be considered. CA 2006 also requires strict procedures to be carried out **before** a payment out of capital can be made as follows:

- The payment out of capital must be approved by way of a special resolution
- A statement must be made by the directors
- The company's auditors must include a report annexed to the directors' statement
- A notice of the proposed capital payment, together with information required by s719, CA 2006 must be published in *The Gazette* within a week of the date of the special resolution

A notice of the proposed capital payment, together with the information required by s719, CA 2006 must be published in a national newspaper, or written notice given to each creditor.