

Financial Reporting Bulletin

Repurchase/redemption of shares that have been classified as liabilities (in all or in part) under FRS 25

Background

FRU has recently received a number of questions about the redemption of preference shares that have been classified as liabilities (in all or part) under FRS 25. This issue is discussed in the ICAEW Technical Release 'TECH 02/07 Distributable Profits: Implications of Recent Accounting Changes' (see FRB Issue 19/2007). As the instruments are legally shares, the capital maintenance requirements of the Companies Act 1985 (the Act) continue to apply. These are, inter alia, that shares should be purchased or redeemed out of distributable profits or out of the proceeds of a fresh issue of shares. A private company may also make a purchase or redemption out of capital. In addition an amount may need to be transferred to the capital redemption reserve.

Key points to bear in mind include:

- The initial presentation of the proceeds of issue (which still legally constitute share capital and share premium) as a liability (or as a compound instrument) does not affect distributable profits.
- Although the **accrued** dividend and the redemption premium on the preference shares may be shown as an accounting loss ('interest charge') under FRS 25, such amounts remain, as a matter of law, distributions or capital repayments for the purposes of the Act. Accordingly, they are not counted as losses and do not reduce realised profits until paid or declared by the company.
- A debit to equity arising from the accrued dividend and the redemption premium on the preference shares will reduce distributable profits for public companies under s264 CA 1985. The accrual will reduce net assets (the liability in respect of the preference shares is increased by the accrual), but the corresponding debit to equity (via the income statement/profit and loss account) does not reduce 'share capital and undistributable reserves'.



Example

A company issues preference shares of total nominal value £80 for £100 on 31/12/X0. The preference shares are issued at fair value.

Immediately before issue of the preference shares the company had ordinary share capital of £50 and a P&L reserve of £140.

The preference shares carry a mandatory, cumulative annual dividend of 5 per cent (£4 per annum) and will be redeemed five years after issue for £130.

Thus over the five years a total 'finance charge' arises of £50, being dividends of £20 and a redemption premium of £30.

- Pre FRS 25 (ie under old FRS 4) the dividends and redemption premium would have been an appropriation of profit (at the foot of the profit and loss account) and would also have been reflected in the allocation of shareholders' funds between equity and non-equity. Old FRS 4 required that the finance costs relating to non-equity shares be accounted for at a constant rate on the carrying amount and that any difference between the finance costs and dividend actually paid treated as an appropriation of profits.
- Under FRS 25, the dividends and redemption premium are accounted for as interest charges which are allocated over the term of the instrument at a constant rate on the carrying amount (per FRS 4) or at amortised cost on an effective interest basis (FRS 26/IAS 39). Broadly, in many cases the two approaches would be expected to give the same result.
- In both cases the £50 is recognised at a constant rate on the carrying amount of the instrument.

Accounting profit before any appropriation/charge for the preference shares is £6 pa in each of the five years (tax is ignored). The dividends on the preference shares are paid each year, ie there is a cash outflow of £4 per annum.

The two tables below show:

- The legal balance sheet that would have been recorded prior to FRS 25. The final two shaded rows illustrate the old equity/ non-equity split as previously required under FRS 4 which are shown here for information only.
- The accounting balance sheet under FRS 25.

Both tables show the issue of the preference shares on inception, the finance charges which arise over the five year term of the preference shares, and the entries associated with the redemption of the shares at the end of year five.

Note that they end up with the same balance sheet post redemption.

Table 1 Legal Position - balance sheet pre FRS 25

	Before issue of prefs	Issue of prefs	After issuing prefs	Profit before effect of prefs	Preference dividend and redemption premium	Prior to redemption	Redemption	After redemption
	£	£	£	£	£	£	£	£
Net assets	190	100	290	30	(20) ²	300 ⁴	(130)	170 ⁵
Share capital	50	80	130	-	-	130 ⁴	(80)	50 ⁵
Share premium	-	20	20	-	-	20 ⁴		20 ⁵
CRR		-	-	-	-		80	80 ⁵
P&L reserve	140	-	140 ¹	30	(20)	150 ³	(130)	20
Total	190	100	290	30	(20)	300	(130)	170
Equity	190	0	190	30	(50) ²	170	-	170
Non equity	0	100	100	-	30 ²	130	(130)	-

(Notes after Table 2)

Table 2 Presentation under FRS 25

	Before issue of prefs	Issue of prefs	After issuing prefs	Profit before effect of prefs	Preference dividend and redemption premium	Prior to redemption	Redemption	After redemption
	£	£	£	£	£	£	£	£
Net assets exc prefs	190	100	290	30	(20)	300	(130)	170
Prefs		(100)	(100)		(30)	(130) ³	130	
Net assets	190	-	190	30	(50) ³	170 ⁴	-	170 ⁵
Share capital	50	-	50	-	-	50 ⁴		50 ⁵
Share premium		-		-	-		20	20 ⁵
CRR							80	80 ⁵
P&L reserve	140		140 ¹	30	(50)	120 ³	(100)	20
Total	190	-	190	30	(50) ³	170		170

Notes

1 P&L Reserve after issuing preference shares

The P&L reserve is £140 under both approaches immediately after the issue of the preference shares. Also net assets exceed the total of share capital and un-distributable reserves by £140 immediately after the issue (£290-£150 in Table 1 and £190-£50 in Table 2). Thus, there is no restriction of distributable profits immediately after the issue if the company is a public company (Plc) as a result of the s264 CA1985 net assets test. This test permits a Plc to make a distribution only if, at the time of the distribution, its net assets after deduction of the distribution are at least equal to the company's called up share capital and un-distributable reserves.

2 Dividend and premium split between equity and non-equity

Under the legal position the net assets and P&L reserve are reduced by the £20 of dividends paid over the five year period. Shareholders' funds attributable to non equity interests increases by the accrued redemption premium of £30. Funds attributable to equity shareholders reduces by £20 being the profit of £30 (before any appropriation/charge for the preference shares) less the preference dividend paid of £20 and less the redemption premium accrued of £30. The P&L reserve is not affected by the redemption premium until redemption.

3 P&L reserve prior to redemption

Under the FRS 25 approach the net assets and P&L reserve are reduced by the £20 of dividends paid **and** by the £30 accrued for the redemption premium over the five year period (ie the combined £50 is charged to the income statement). However the £30 accrual for the redemption premium, although accounted for as an accounting loss, is not a loss, as a matter of law, and does not reduce **distributable profits**. They remain as £150 (the £120 in reserves and the £30 'accrual' for the redemption premium).

4 Net assets prior to redemption

Net assets of £300 exceed share capital and undistributable reserves (£130 + £20) by £150 in table 1 immediately prior to redemption. Net assets of £170 exceed share capital and undistributable reserves (which total £50) by £120 in table 2 immediately prior to redemption. Therefore, distributable profits immediately prior to redemption **are** reduced if the company is a public company (Plc) as a result of the s264 CA 1985 net assets test.

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5 Position after redemption

After the redemption the net assets of £170 exceed share capital and undistributable reserves of 150 (50 + 20 + 80) in both cases so the redemption is not prohibited by s264 CA 1985 even though distributable profits are only £120 in table

Action required

Preparers of accounts should carefully consider the impact of a repurchase or redemption and consider preparing memorandum accounts reflecting the legal position to ensure that the correct reserves are presented after the redemption.

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