CMA Students Newsletter(For Intermediate Students)

Vol.4C: February 28,2014

Corporate Laws & Compliance

Buyback of Shares – An Insight

The provisions regulating buy back of shares are contained in Section 77A, 77AA and 77B of the Companies Act, 1956. These were inserted by the Companies (Amendment) Act,1999. The Securities and Exchange Board of India (SEBI) framed the SEBI(Buy Back of Securities) Regulations,1999 and the Department of Company Affairs framed the Private Limited Company and Unlisted Public Company (Buy Back of Securities) Rules,1999 pursuant to Section 77A(2)(f) and (g) respectively.

What is Buy-back?

Buyback of Securities (Buyback) is the reverse of issue of shares by a company wherein the company offers to take back its securities owned by the investors at a specified price; this offer can be binding or optional to the investors.

Why Buy Back?

- to improve the earnings per share;
- to improve return on capital, return on net worth and to enhance the long-term shareholders value;
- to provide an additional exit route to shareholders when shares are undervalued or thinly traded;
- to enhance consolidation of stake in the company;
- to prevent unwelcome takeover bids;
- to return surplus cash to shareholders;
- to achieve optimum capital structure;
- to support share price during periods of sluggish market condition;
- to serve the equity more efficiently.

What is the manner in which the company can buy back its own shares?

The company can buy back its shares in any of the following manners :

i. From the existing shareholders on a proportionate basis through the tender offer;
ii. From open market through:
    a. Book building process
    b. Stock exchange,
iii. From odd lot holders.

Can a company buyback its shares without passing shareholders' resolution?

Yes. a company can buy back its own shares up to a maximum of 10% of its paid up capital and free reserves by passing a resolution only in the Board Meeting. However, if the Buy Bank is more than 10% and up to a maxim of 25% of it's paid up capital and free reserves, it required the consent of Shareholders by way of Special Resolution to authorizing the directors for buy back.

In terms of clause (c) of sub section (2) of section 77A the Company can buy back its own shares and specified securities, up to 25% of its paid up capital and free reserves in a financial year provided that 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.

The aforesaid limit is to be applied not to the number of securities to be bought back but to the amount required for buy-back of such securities. Paid up capital includes both preference and equity.

Other conditions and restrictions :

1. The Company is eligible to buy back its own securities out of
    i. its free reserves [or]
    ii. securities premium account [or]
    iii. proceeds of any shares or other specified securities

However, no buy-back of any kind of shares or other specified securities can be made out of the proceeds of an earlier issue of the same kind of shares or the same kind of other specified securities.
Here "Securities" means equity shares, preference shares and any other securities as may be notified by the Central Government from time to time.

2. Articles of Association of the Company should authorize for buyback.
3. Only fully paid up shares can be bought back.
4. Post buy back, the company's debt equity ratio should not exceed 2:1.

Buyback shall be completed within a period of 12 months from the date of passing the special resolution.

Where a company completes a buyback 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 81) or other specified securities with in a period of six months from the completion of buyback. However, the Company may issue shares by way of Bonus issue or in discharging of subsisting obligations such as conversion of warrants, stock option schemes, sweat equity or conversion of preference shares or debentures into equity shares.

The Company shall maintain a Register of shares bought back mentioning the particulars as specified after completion of buy back.

A Company should not buyback its securities or other specified securities in case there is a default:

- in repayment of deposits or interest payable thereon, or in redemption of debentures or preference shares or repayment of any term loan or interest payable thereon to any financial institution or bank.
- in relation to preparation and filing of its annual return U/S 77B(2).
- in relation to payment of dividend to any equity or preference shareholder.
- in preparation of annual accounts U/S 77B(2)

Prohibition of Buy Back:

A Company cannot buy-back its shares or other specified securities out of the proceeds of an earlier issue of the same kind of shares or specified securities

A company shall not 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;

Buyback of shares – Tax Implications – Recent change by Finance Act 2013:

The buy-back of shares in India historically has been considered to be a transaction subject to capital gains treatment, and thus is taxed at the applicable capital gains tax rate by virtue of section 46A.

Such capital gain was taxable in the hands of the shareholders. For non-residents (including foreign companies), the provisions of Indian domestic tax law or an applicable income tax treaty, if more beneficial, apply.

Finance Act 2013 has introduced a new section 115QA w.e.f. 1st June 2013, which states that a company proposing to buy back its unlisted shares will be liable to tax at the rate of 20% (plus surcharge and cess thereby making the effective rate 22.66%) on the distributed income. The salient features of the new regime are summarised below:

- The shares being bought back are not listed on any recognised stock exchange in India;
- The tax shall be payable by the company executing buy back of its shares;
- The additional tax is payable even if the company is not otherwise liable for any income tax;
- The tax needs should be deposited within 14 days of payment to shareholders;
- The shareholder is not required to pay any tax on the amount received on account of buy back [section 10(34A);
- The tax so paid is not liable for deduction in computing taxable income of the shareholder; and
- The amount on which tax is to be paid by the company is arrived at by reducing from the amount payable to shareholders on buy back, the amount received on issue of such shares.

Impact of the proposed changes

As noted above, the new regime is only applicable to unlisted shares. Hence, the erstwhile provisions will continue to apply for listed shares.

Further, the new regime does not elaborate on the computation mechanism of the taxable amount. Although the proposed changes state that the taxable amount is arrived at by reducing from the amount payable to shareholders on buy back, the amount received on the issue of such shares, it provides little guidance on the practical issues that may arise. For instance, if the shares were issued by a company in different tranches to the same or different investors at different premiums, then whether the average price of shares will be adopted for computing the taxable amount or whether the computation will be made according to the scrip number of the scrip being bought back. The problem will be acute if the shares are dematerialised and there is no identifiable correlation between shares issued and shares bought back.

The new regime also seeks to undo the benefit conferred on foreign investors by the respective DTAAs without renegotiating the treaty. The changes are going to add fuel to the fire of unrest among the foreign investors after last year's retrospective amendments.

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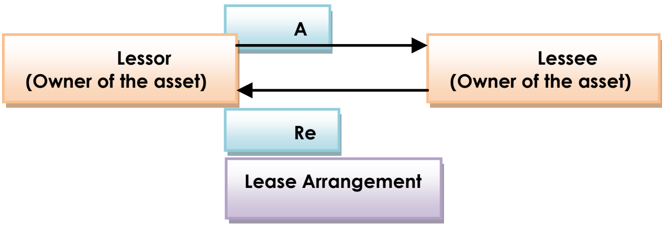
Lease Financing

What Is a Lease?

- An agreement that conveys the right to use Property, generally for a specified period of time
- Parties to a lease are...
  - ✓ Lessor—owner of the asset who receives payments
  - ✓ Lessee—user of the asset who makes payments

for a specified period of time, referred as the lease period, in exchange for periodic payments, called lease rentals. Most of us have entered into lease agreements of some sort of some time or the other. The hiring of a taxi for a day is the simplest example of leasing in our day-to-day life. Similarly an apartment on rent is an example of a lease where the tenant pays rent to live in the apartment owned by the landlord, for a fixed period of time as agreed upon. A typical lease is depicted in the below Figure:



The lessor owns the asset but does not use it, while the lessee uses the asset but does not own it. Normally assets are owned by the firms because they have to be put them to use for making economic gains. Under a lease, assets are not owned by the firms. Leasing provides the unique advantage of separating ownership and usage. Leasing enables (i) possession of the asset to the party interested in deriving benefits by exploiting the asset, and (ii) ownership to another party interested in deriving the benefits that are attached with ownership. Depreciation is one expense that can be claimed by the owner only and becomes important because it is a non-cash expense that is tax deductible. This reduces the burden for the owner.

Type of lease:

Example

Net Advantage of Leasing

XYZ Corporation is planning to procure a server for IT applications costing ₹ 45 lakh. Due to fast changing developments in the field of information technology and to avoid the risk of obsolescence, the firm is considering leasing the server for a period of 3 years at a rental of ₹ 18 lakh per annum payable in arrears. There is no salvage value for the server after 3 years. Alternatively, the firm can buy the server by borrowing at 12%. The firm pays tax at 40%. The depreciation rate that can be claimed by the firm is 33.33%.

(a) Find whether it is beneficial for XYZ Corporation to lease the server or buy it.

(b) If the salvage value is reckoned to be ₹3 lakh at the end of 3 years, does your decision change?

Solution

***(a) Following data** about the equipment is available.*

	(₹lakh)		(%)
Cost of Equipment	45.00	Cost of Debt (Pre-tax)	12.00%
Lease Rentals	18.00	Cost of Debt (Post-tax)	7.20%
Salvage Value	0.00	Rate of Depreciation	33.3%
Life (Years)	3.00	Tax Rate	40.00%

Cash flows of lease are as follows:

Year	Present Value	0	1	2	3
A. Lease Option					
Lease Rentals			-18.00	-18.00	-18.00
Tax Saved on Lease Rents			7.20	7.20	7.20
Cash Flow - Lease		0.00	-10.80	-10.80	-10.80
A. Present Value (Lease)	-28.24	0.00	-10.07	-9.40	-8.77
B. Buy Option					
Initial Cost		-45.00			
Depreciation			15.00	15.00	15.00
Tax Saved on Depreciation		6.00	6.00	6.00	
Cash flow		-45.00	6.00	6.00	6.00
B. Present Value (Buy)	-29.31	-45.00	5.60	5.22	4.87
Net Advantage of Leasing NAL	(A-B)	45.00	-16.80	-16.80	-16.80
Present Value of NAL	1.07	45.00	-15.67	-14.62	-13.64

NAL is > 0 and hence we must go for lease. Since net present value of the costs of lease option is less by ₹1.07 lakh, it costs less to lease the server, and hence, XYZ Corporation must go for lease.

(b) ***If there is salvage value at the end of three years the buy option may become more valuable to the extent of increased cash flow due to salvage value realized. However, the firm will have to pay taxes if there is profit on sale of asset. In case there is a capital loss it would result in saving of tax on the operational income. The cash flows for buy option are shown below with depreciation charged to the lessor to the extent of salvage value at Rs 14 lakh each year and salvage realized.***

CAUTION: ***Realization of salvage value is an operational cash flow and must be discounted at WACC of the firm and not at cost of debt. In the absence of WACC the cash flow pertaining to the salvage value is discounted at post-tax cost of debt.***

The present value of buy decision is lesser than that of lease option. In case the salvage value is realizable, the decision to buy rather than lease is more economical (by an amount of ₹0.32 lakh).

Initial Cost		-45.00			
Depreciation			14.00	14.00	14.00
Tax Saved on Depreciation			5.60	5.60	5.60
Salvage Value Realized					3.00
Tax Saved on Salvage					0.00
Cash flow		-45.00	5.60	5.60	8.60
Present Value (Buy)	-27.92	-45.00	5.22	4.87	6.98
Net Advantage of Leasing					
NAL (A - B)		45.00	-16.40	-16.40	-19.40
Present Value of NAL	-0.32	45.00	-15.30	-14.27	-15.75

Indirect Taxation

Doctrine of Unjust Enrichment

The doctrine of unjust enrichment means no one can be allowed to enjoy at the expense of another. Since the law authorizes recovery of indirect taxes (excise duty, customs, sales/purchases tax) from buyer, therefore, it is always presumed that incidence of duty has been passed. Therefore, if any refunds becomes due to the manufacturer, then, since manufacturer has recovered the duty from the buyer, thus, to be fair, refund should be made to the customer.

Example 1: X Ltd. manufactured and sold goods to its buyer by collecting excise duty. Subsequently X Ltd. claimed refund of excise duty for the same transaction. Hence, such refund of duty to the manufacturer will amount to excess and un-deserved profit. This is called as 'Unjust Enrichment'

Example 2: Y Ltd. collected the excise duty and not remitted to the department of Excise. This is known as 'Unjust Enrichment'

Example 3: Z Ltd. claimed the Cenvat credit of excise duty and duty drawback. This is called as 'Unjust Enrichment'.

However, it is not practicable to locate individual buyers and pay refund to them. Moreover, the Government cannot retain the excess duty collected without the authority of Law. To deal with such cases, section 11B (custom section 27) provides that any refund due to an assessee shall be transferred to a Consumer Welfare Fund and would be used for the purpose of protection and benefits of the consumers. The refunds shall be granted to the assessee only when he proves that incidence of duty has not been passed to any other person or in certain other specified case.

Refund is subject to doctrine of unjust enrichment, i.e. refund will be available only if the amount was not recovered from buyer. These are overriding provisions.

Doctrine of unjust enrichment applies to captive consumption, provisional assessment and also when duty was paid under protest.

Case law on Unjust enrichment –

1. **CCE vs. Gem Properties (P) Ltd. 2010 (257) E.L.T. 222 (Kar.)**

Merely because assessee has sustained loss more than the refund claim, is it justifiable to hold that it is not a case of unjust enrichment even though the assessee failed to establish non-inclusion of duty in the cost of production?

Decision of the Case:

The High Court answered the question of law in favour of the Revenue. The Court observed that indisputably, the assessee was not liable to pay the duty and was entitled to the refund of the excise duty wrongly paid by it. The claim of the assessee had been rejected on the ground that if the application was allowed, it would amount to unjust enrichment because all the materials sold by the assessee had been inclusive of the duty. Therefore, the burden had been heavy on the assessee to prove that while computing the cost of the material it had not included the duty paid by it.

The Court elucidated that merely because the assessee had sustained the loss in the relevant year, could not be a ground to hold it had not been a case of unjust enrichment. It was evident from the Chartered Accountant's certificate that the cost of the duty was included while computing the cost of production of the material. Therefore, on facts of the case, the High Court held that assessee could not be granted relief since it had failed to establish that the cost of the duty was not included while computing the cost of the products.

2. **CCEx. V. Manjunath Food & Packaging P. Ltd. [2009] 239 ELT A22 (Kar.)**

When the price before and after demand of duty remains the same on account of buyer denying to bear the burden of any additional duty, the principle of unjust enrichment cannot apply to deny the refund.

Facts of the case:

The assessee, a manufacturer of packaged drinking water, was availing of SSI-exemption and was clearing its goods to its buyer at a price of ₹43 per case of 12 bottles of 500 ml. Proceeding were initiated against the assessee for denying SSI-exemption; hence, the assessee started paying duty under protest. When the assessee sought to claim increase in price from its buyer to bear the burden of duty, the buyer, by way of a letter, made it clear that:

"we wise to inform you that we cannot absorb any additional duties and levies etc. on the agreed prices. In view of this, you have to bill to us at the same prices which were charged/billed earlier."

Therefore, the assessee continued to clear its product at earlier rate of ₹43 per case of 12 bottles. The assessee informed the Department that they are not passing the burden of duty paid under protest to their buyer and they will be claiming the refund in due course, if the proceeding against them were dropped subsequently. Later on, the adjudicating authority dropped the proceedings initiated against the assessee. Accordingly, the assessee filed a claim for refund of duty paid under protest, which was rejected on the ground of unjust enrichment.

Decision of the case:

Even though the assessee had to pay the duty under protest, the buyer had made it clear that they would not absorb any additional duties and levies. The price was kept at the same level as earlier. Hence, the burden of duty was not, and could not have been, passed onto the buyer. The burden of duties paid under protest was borne by the assessee itself. Therefore, there is no bar of unjust enrichment at all. Hence, the Department couldn't deny refund.

Cost and Management Audit

CAS -13 Cost Accounting Standards on cost of Service Cost Centre

This standard deals with the principles and methods of determining the cost of Service Cost Centre. It excludes Utilities and Repairs & Maintenance Services dealt with in CAS-8 and CAS-12 respectively.

This standard deals with the principles and methods of classification, measurement and assignment of Cost of Service Cost Centre, for determination of the Cost of product or service, and the presentation and disclosure in cost statements.

Service Cost Centre: the cost centre which primarily provides auxiliary services across the enterprise.

Example:

Engineering workshop ,Research & development ,Quality control, Quality assurance, Designing, laboratory, Welfare services, safety, Transport ,Component, tool stores ,Pollution control, Computer cell, Dispensary, School, crèche, Township, security etc.

Example 1:

Find out the cost of each unit of production of the service departments from the following data for 2012:

Service Departments	Stream	Water	Power
Production	18,000 MT	7,00,000 CM	30,00,000 kWh
Direct materials	₹2,50,000	₹2,00,000	₹50,000
Direct labour	1,00,000	1,90,000	1,50,000
Direct expenses	1,60,000	1,24,000	1,20,000
Overheads	1,74,240	1,58,000	2,72,000
Steam	-	-	10,000 MT
Water	56,000 CM	--	1,05,000 CM
Power	1,46,400 kWH	4,20,000 kWH	80,000 kWh

Solution:

Service Departments	Stream	Water	Power
Production	18,000 MT	7,00,000 CM	30,00,000 kWh
Assumed cost per unit	x	y	z
Total cost	18,000 x	7,00,000 y	30,00,000 z
As per given data	₹	₹	₹
Direct materials	2,50,000	2,00,000	50,000
Direct labour	1,00,000	1,90,000	1,50,000
Direct expenses	1,60,000	1,24,000	1,20,000
Overheads	1,74,240	1,58.000	2.72.000
	6,84,240	6,72,000	5,92,000

Inter-Services Consumes

Steam	-	-	10,000x
Water	56,000y	-	1,05,000y
Power	1,46,400z	4,20,000z	80,000z

From the above information, we have the following equations:

18,000x = 6,84,240 + 56,000y +1,46,400z ....(i)

7,00,000y = 6,72,000 + 4,20,000z ....(ii)

30,00,000z = 5,92,000 + 10,000x + 1,05,000y + 80,000z ....(iii)

First of all, equation (ii) is solved

7,00,000y = 6,72,000 + 4,20,000z
or y = 6,72,000+ 4,20,000z/7,00,000

or y = 0.96 + 0.6z ....(v)

Then equation (i) is solved,

18,000x = 6,84,240 + 56,000y + 1,46,400z

or 18,000x = 6,84,240 + 56,000 (0.96 + 0.6z) + 1,46,400z

or 18,000x = 6,84,240 + 53,760 +,33,600z + 1,46,400z

or 18,000x = 7,38,000 + 1,80,000z

or x = (7,38,000 + 1,80,000z) ÷ 18,000

or x = 41 + 10z ....(v)

Now equation (iii) is solved.

30,000 = 5,92,000 + 10,000x + 80,000z

By substituting values of x and y in the above equation

30,00,000z = 5,92,000 + 10,000 (41 + 10z) + (1,05,000 (0.96 + 0.6z) = 80,000z

30,00,000z = 5,92,000 + 1,00,000z + 1,00,800 + 63,000z + 80,000z

27,57,000z = 11,02,800
or z = 0.4

Now substitute the value of z in equation (v) and (iv),

X = 41 +10z

X = 41 + 10x0.4

Or X = 45

y = 0.96 + 0.6z

y = 0.96 + 0.6 x 0.4

or y = 1.20

Thus the unit rate of steam, water and power are:

Steam = ₹45.00 per MT

Water = ₹1.20 per CM

Power = ₹0.40 per kWh.

Example 2:

CMC Public Health Centre runs an Intensive Medical Care Unit. For this purpose, it has hired a building at a rent of ₹5,000 per month with the understanding that it would bear the repairs and maintenance charges also.

The unit consists of 25 beds and 5 more beds can be comfortably accommodated when the occasion demands. The permanent staff attached to the unit is as follows:

2 Supervisors, each at a salary of ₹500 per month.

2 Nurses, each at a salary of ₹500 per month.

2 Ward boys, each at a salary of ₹150 per month.

Though the unit was open for the patients all the 365 days in a year, scrutiny of accounts in 1979 revealed that only for 120 days in the year, the unit had the full capacity of 25 patients per day and for another 80 days, it had on an average 20 beds only occupied per days. But, there were occasions when the beds were full, extra beds were hired at a charge of ₹5 per bed per day and this did not come to more than 5 beds extra above the normal capacity on any one day. The total hire charges for the extra beds incurred for the whole year amount to ₹2,000.

The unit engaged expert doctors from outside to attend on the patients and the fees were paid on the basis of the number of patients attended and time spent by them and on an average worked out to ₹10,000 per month in 2012.

The other expenses for the year were as under:	
Repairs and maintenance	*₹3,600*
Food supplied to patients	*44,000*
Janitor and other services for them	*12,500*
Laundry charges for their bed linen	*28,000*
Medicines supplied	*35,000*
Cost of oxygen, X-ray etc., other than directly borne for treatment of patients	*54,000*
General Administration charges allocated to the unit	*49,550*

Required

i) If the unit recovered an overall amount ₹100 per day on an average from each patient, what is the profit per patient day made by the unit in 2012.

ii) The unit wants to work on a budget for 2012-13, but the number of patients requiring intensive medical care is a very uncertain factor. Assuming that same revenue and expenses prevail in 2013, in the first instance, workout the number of patient days required by the unit to break even.

Solution:

(i) Number of Patient-days in 2012 :

25 beds x 120 days	***3,000***
20 beds x 80 days	***1,600***
Extra bed-days (total hire charges of extra beds/ charges per bed per day = ₹2,000 + ₹5)	***400***
	5,000 patient-day

In order to calculate contribution, the profit per patient-day and the break-even point, it is necessary to classify the different costs into fixed and variable categories. It will be seen that while most of the items can be easily classified as fixed or variable, problem arises in respect of two items, viz. janitor and other services presumption that they are related to number of patient-days. On the other hand, cost of oxygen, X-ray etc., has been taken as a fixed cost since it has been stated that this cost is other than costs directly borne for treatment of patients.

Statement of Profit

Income received (₹100 5,000 patient days)		**₹5,00,000**
Variable Costs:		
Food	**₹44,000**	
Janitor services	**12,500**	
Laundry	**28,000**	
Medicines	**35,000**	
Doctor's fees (₹10,000 x 12)	**1,20,000**	
Fixed Costs:		**2,58,500**
Salaries (2 x ₹500 + 2 x ₹300 + 2 x ₹150) x 12	**22,800**	
Rent (₹5,000x12)	**60,000**	
Repairs and Maintenance	**3,600**	
General Administration	**49,550**	
Cost of oxygen, X-ray etc.		

Profit per patient day = ₹68,550 ÷ 5,000 = ₹13.71

(ii) Breakeven point S - V = F + P

Multiply and divide RHS by S,

S(S - V) ÷ S = F

B.E. point = (Fixed cost ÷ Contribution) x Gross Income

= (1,97,150 + 2,58,500) x 5,00,000

or ₹3,81,335or 3,81,335 ÷100 or 3,813 patient-days.