



PRIVATE COMPANY REDUCTION OF SHARE CAPITAL

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INTRODUCTION

This helpsheet has been issued by ICAEW's Technical Advisory Service to help ICAEW members understand key legal and accounting aspects of a reduction of share capital in a private limited company.

Members may also wish to refer to the following related helpsheet and guidance:

- [Purchase of own shares in a private limited company](#)
- [TECH 02/17 BL Guidance on realised and distributable profits under the Companies Act 2006](#)

1 SUMMARY OF THE PROVISIONS

- 1.1. The purpose of this helpsheet is to consider the accounting consequences arising from a reduction of capital by a private company.
- 1.2. There are various reasons why a company might want to reduce its capital. Section 641 of the Companies Act 2006 allows, for all companies, a reduction of share capital by way of a special resolution of the members, which sets out and approves the transaction, which is then subject to court approval. However, in the case of a private company the need for court approval can be avoided provided the directors are prepared to sign a declaration of solvency.
- 1.3. Often a company may wish to repay excess capital or cancel capital that is lost or unrepresented by assets. In the former case it is worth noting that when the capital is reduced with an immediate payment to shareholders there is no need to take account of accumulated losses, whereas if a reserve is created instead of an immediate payment, such reserve is treated by the legislation as a realised profit subject to any directions to contrary effect in the company's articles and/or the special resolution to reduce the capital. This will be distributable subject to section 654 of the Companies Act 2006 and article 3 of The Companies (Reduction of Share Capital) Order 2008 (SI 2008/1915) (other references in this helpsheet to the reserve being a realised profit are subject to this proviso, but for convenience it is not repeated). However, this realised profit is only distributable subject to Part 23 of the Companies Act 2006 i.e. brought forward losses must be taken into account (see example 5.4). See paragraphs 2.7-2.8E of [ICAEW TECH 02/17 BL Guidance on realised and distributable profits under the Companies Act 2006](#).

- 1.4. The directors will need to be mindful of any restriction/prohibition present in the company's articles at the time of the reduction and give due consideration to the impact on any contractual undertakings, particularly banking covenants. Therefore careful planning may be needed so as to amend the articles as necessary to permit the special resolution to reduce capital and to ensure all interested parties consent to what is being proposed before the special resolution is executed. The articles may need to be amended, for instance, if they prohibit capital reductions or require a unanimous resolution. The directors would be well advised to take professional advice at this stage as the declaration of solvency comes with a sanction: if the directors make a solvency statement without having reasonable grounds for the opinions expressed in it, an offence is committed by every director who is in default, the penalty for which is up to two years in prison, a fine or both.
- 1.5. For the purposes of a reduction of capital, the share premium account, redenomination reserve and the capital redemption reserve are treated as part of the share capital (but not the merger relief reserve or revaluation reserve).

2. PROCEDURE TO FOLLOW

Directors must go through the following steps in order to perform a reduction of capital supported by solvency statement.

- 2.1. Review the company's articles and any other relevant documents (e.g. banking facilities and shareholders agreement), and undertake a review of the company's solvency.
- 2.2. A solvency statement must be prepared by the directors not more than 15 days before the date on which the special resolution is passed (Companies Act 2006 section 642). This is a statement that each of the directors has formed the opinion after taking account of all liabilities including contingent and prospective liabilities that:
 - a) there are no grounds on which the company could be found to be unable to pay its debts when the statement is made; **and**
 - b) the company will be able to pay its debts as they fall due during the following 12 months (or, if the company is to be wound up in that period, within 12 months of commencing the winding up).

This requires diligent examination and enquiry, i.e. thorough investigation to ensure the directors have considered the requirements and satisfied themselves that the statement can be made, especially given the sanctions for giving the statement without reasonable grounds (see 1.4 above).

- 2.3. The special resolution, which should clearly set out the transaction including the details of the reduction that is to be effected (see 3.3 below), must be approved by the members as follows:

- if it is a written resolution, the solvency statement must be sent to every eligible member (Companies Act 2006 section 289) at or before the time at which the proposed resolution is sent to him (section 642(2)), and the resolution must be approved (within 15 days of the date of the solvency statement) by not less than 75% of total voting rights of eligible members (section 283(2)), **or**
 - if the resolution is proposed at a general meeting, a copy of the solvency statement must be made available for inspection by members of the company throughout that meeting (section 642(3)) and the resolution must be approved by a majority of not less than 75% of votes cast (section 283(4)).
- 2.4. A statement of capital must be prepared using Form SH19 which shows the alteration in the company's share capital by setting out the following information for the remaining capital of the company after the reduction:
- the total number of shares of the company;
 - aggregate nominal value of those shares;
 - certain information about each class of shares, the total number of shares of each class and the aggregate nominal value of shares of that class. (See article 2(3) of The Companies (Shares and Share Capital) Order 2009 (SI 2009/388) and section 685(3)(b) of the Companies Act 2006); **and**
 - amount paid up and (if any) the amount unpaid on each share.
- 2.5. Directors must deliver the following to the registrar within 15 days of the date of the resolution (Companies Act 2006 section 644(1)):
- Copy of solvency statement (see 2.2 above);
 - Statement of capital (using Form SH19, see 2.4 above);
 - Copy of resolution (see 2.3 above); **and**
 - Statement of compliance signed by all the directors confirming that the solvency statement was made not more than 15 days before the date the resolution was passed and that it was provided to members in accordance with section 642.
- 2.6. The reduction does not take effect until these documents are registered by Companies House (not simply delivered to them).

3. POTENTIAL PITFALLS AND PROBLEMS

- 3.1. Directors should have regard to their general duties under both common law and under Part 10 of the Companies Act 2006 as well as possible criminal offences (section 644(7), section 642(2) or (3) and section 643(4)). Before signing the solvency statement, if the directors have insurance they should check whether their insurance would cover the cost of defending proceedings.
- 3.2. It is also important to note that Companies Act 2006 section 641(2) requires that the reduction does not result in only redeemable shares left in issue; some non-redeemable shares must remain in issue.

- 3.3. The special resolution must spell out precisely what is to occur (because the accounting follows the wording of the resolution). A common error is for the resolution to set out the result of the reduction but not the process by which it is to be effected.
- 3.4. Reductions are normally done pro rata across all shares and in these circumstances there is no need to specify the issue numbers of the shares, and such pro rata treatment for all members should avoid any risk of a claim for unfair prejudice. However, if the procedure is used to pay out only one or some shareholders, then the procedure would need to identify the shares affected and consideration should be given to the procedures that should be undertaken in order to minimise the risk of a claim for unfair prejudice.
- 3.5. The resolution should clearly set out what share capital remains. For example (assuming there is no share premium), shares with a nominal value of £1 suffer a capital reduction of 50p. The statement of capital should set out what is left, which could be:
- Shares of 50p nominal value fully paid
 - Half the pre-reduction number of shares of £1 nominal value fully paid.
- 3.6. If using the solvency statement route for a reduction of capital that will result in a reserve, the reserve will be treated as a realised profit (under The Companies (Reduction of Share Capital) Order 2008 (SI 2008/1915)) and thus will only be distributable to the extent it exceeds accumulated realised losses (i.e. in accordance with Part 23 of the Companies Act 2006). Any subsequent distribution must be made by reference to 'relevant accounts' (Companies Act 2006 section 836). Therefore, unless the most recent annual accounts contain sufficient distributable profits, interim accounts would need to be produced showing the realised profits created by the reduction in order to justify the distribution. However, if the reduction of capital takes the form of a payment to shareholders, no reserve arises and so the company can make the payment without needing to take account of brought forward losses (and without the need to draw up interim accounts).
- 3.7. This helpsheet does not explore the tax issues faced when contemplating a reduction of share capital.

We would always recommend that when there has been a bonus issue, or a share reduction credited to profit and loss account, you seek tax advice so that you fully understand the tax implications of subsequent distributions.

4. ACCOUNTING TREATMENT

- 4.1. Where the resolution reduces the liability for uncalled share capital (e.g. £1 shares 75p called, reduced to 75p nominal value, thereby eliminating the uncalled 25p), no accounting entries would be required. However, the accounts disclosure for share capital would reflect the new status of the shares in issue (e.g. now 75p shares not £1 shares 75p called).

- 4.2. If the amount of paid up capital including share premium is reduced then the share capital will be debited with the amount of the reduction. If the reduction was effected by a repayment then the credit will go to cash, otherwise a reserve account will be created which is treated as a realised profit.
- 4.3. A reduction in the capital redemption or share premium reserve will create a realised profit.
- 4.4. No capital redemption reserve is created on a reduction of share capital under these sections.

5. EXAMPLES

Please note: These answers provide the accounting solutions only and do not consider the tax consequences of the decisions implicit therein. Tax advice should be taken before undertaking any action regarding the reduction of capital.

5.1. Inadequate reserves to pay a dividend

The directors of company A have turned the company around and made a profit of £20,000 this year and want to pay a dividend to the shareholders; can they?

Company A balance sheet extract BEFORE	£'000
Share Capital £1 ordinary, fully paid	10
Share Premium	490
Profit and Loss	(250)
	250

Company A is not in a position to pay a dividend as there are no distributable profits as this year's profit has not been sufficient to make good past accumulated losses. However, section 641 of the Companies Act 2006 can be used to 'remedy' the situation and could be used to reduce the entire share premium account, thereby converting into to a realised profit.

Double entry:

Dr Share premium	£490k
Cr Profit and loss	£490k

Company A balance sheet extract AFTER	£'000
Share Capital £1 ordinary, fully paid	10
Share Premium	0
Profit and Loss	<u>240</u>
	250

5.2. Inadequate reserves to pay a dividend

The directors of company B have just completed a major reorganisation with large write-offs. The budget for next year shows a profit of £120,000 and the directors would like to pay a dividend for that year; can they?

Company B balance sheet extract BEFORE	£'000
Share Capital £1 ordinary, fully paid	1,000
Share Premium	0
Profit and Loss	(250)
	750

Company B will not be in a position to pay a dividend at the end of next year as the expected profits will not cover the accumulated realised losses to leave any distributable profits. However, in company B, section 641 of the Companies Act 2006 could be used to write the profit and loss account deficit against the share capital as permanently lost capital. The resolution could be to the effect that the 250,000 £1 shares are cancelled in order to write off £250,000 of losses, with the post reduction capital made up of 750,000 £1 shares*.

Double entry:

Dr Share capital	£250k
Cr Profit and loss	£250k

Company B balance sheet extract AFTER	£'000
Share Capital £1 ordinary, fully paid*	750
Share Premium	0
Profit and Loss	0
	750

* Alternatively, all 1,000,000 £1 shares could have been reduced by 25p each, leaving the company with share capital of 1,000,000 75p shares.

5.3. Surplus cash

Company C has £1m of cash which is surplus to its requirements and which it wants to return to the shareholders. This could be done by way of a dividend but the company has inadequate reserves What can it do?

Company C balance sheet extract BEFORE	£'000
Share Capital £1 ordinary, fully paid	2,000
Share Premium	490
Profit and Loss	150
	2,640

Section 641 of the Companies Act 2006 can be used to repay excess capital to enable the cash to be paid to the shareholders. E.g. 1,000,000 £1 shares are repaid at £1 each and cancelled.

Double entry:

Dr Share capital	£1,000k
Cr Cash	£1,000k

Company C balance sheet extract AFTER	£'000
Share Capital £1 ordinary, fully paid*	1,000
Share Premium	490
Profit and Loss	<u>150</u>
	1,640

* Alternatively, 50p could be repaid on each of 2,000,000 shares, each thereby reduced to a 50p share, leaving the company with 2,000,000 50p shares.

Or the same resolution could combine a repayment of 1,000,000 £1 shares repaid at £1 each and cancelled and the reduction of the £490,000 share premium account.

Double entry:

Dr Share capital	£1,000k
Dr Share premium	£490k
Cr Profit and loss	£490k
Cr Cash	£1,000k

Company C balance sheet extract AFTER	£'000
Share Capital £1 ordinary, fully paid*	1,000
Share Premium	0
Profit and Loss	<u>640</u>
	1,640

* Alternatively, 50p could be repaid on each of 2,000,000 shares, each thereby reduced to a 50p share, leaving the company with 2,000,000 50p shares.

5.4 Surplus cash (negative reserves)

Company D has £1m of cash which is surplus to its requirements and which it wants to return to the shareholders. This cannot be done by way of a dividend as the company has no profits available for distribution. What can it do?

Company D balance sheet extract BEFORE	£'000
Share Capital £1 ordinary, fully paid	2,000
Share Premium	490
Profit and Loss	(150)
	2,340

Company D can take the same action as Company C. E.g. it could use section 641 of the Companies Act 2006 to repay excess capital to enable the cash to be paid to the shareholders, e.g. 1,000,000 £1 shares are repaid at £1 each and cancelled, and combine this with a cancellation and reduction of the £490,000 share premium account.

Double entry:

Dr Share capital	£1,000k
Dr Share premium	£490k
Cr Profit and loss	£490k
Cr Cash	£1,000k

Company D balance sheet extract AFTER	£'000
Share Capital £1 ordinary, fully paid*	1,000
Share Premium	0
Profit and Loss	340
	1,340

* Alternatively, 50p could be repaid on each of 2,000,000 shares, each thereby reduced to a 50p share, leaving the company with 2,000,000 50p shares.

IF IN DOUBT SEEK ADVICE

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