8

Accounts of limited companies

Objectives

By the end of this chapter you should be able to:

- Explain what is meant by corporate entity.
- Identify the nature of capital invested in companies and the returns available on this capital.
- Identify the main changes to company law from the company law review.
- Describe the term 'reserves'.
- Identify and account for the taxation charge within company accounts.
- Prepare the income statement and balance sheet for companies.

The need for companies

In previous chapters we have assumed that the business is that of a sole trader. This is where an individual invests his capital in a business and trades with the intention of earning profit that will belong to him to do with as he chooses. However, this type of business has several drawbacks.

Activity 8.1

Identify two drawbacks of sole trader businesses.

Answer

You should have chosen two from the following list. However, this list is not exhaustive and you may have come up with drawbacks that we have not mentioned. You should be able to explain whether your drawbacks are reasonable.

- A sole trader has limited resources available – the capital he is able to invest in the business – limited specialist and management skills.
- For a business to grow, more resources are required in terms of capital and expertise.
- The sole trader is personally liable for all debts of the business – creditors can claim on the personal assets of the sole trader.
- The sole trader business is dependent upon the owner.

Establishing the business as a **limited company** can overcome all the above drawbacks. Capital resources are available from more than one person, and the company also has easier access to loan funds. Specialist and management skills can be brought into the business by widening the number of owners. A company provides what is known as **limited liability** to the owners. Ownership can change without there being any effect on the business.

The company

A company has two notions as its basis:

- Corporate entity
- Limited liability.

The notion of **corporate entity** means that several people can band together as owners of a business by investing capital. The business will be a legal entity separate from the owners. It also means that the owners, the investors of capital, can change without the need to change the legal entity of the company.

The notion of limited liability limits the claim on the owners of the business from any of its creditors to the capital these owners invested. It also means that a creditor has to sue the company, not the owners, for payment of any debts due to him, and these creditors could indeed force the winding up, or liquidation, of the company. There are several hundred thousand companies in the United Kingdom and mainland Europe, many of them large conglomerates such as British Telecom, Guinness, Shell and ICI.

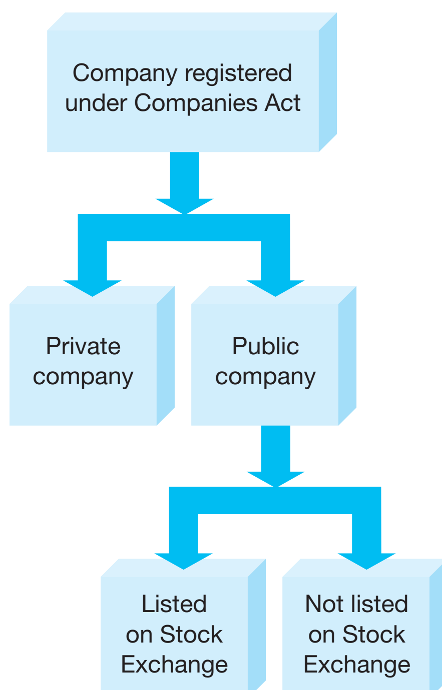
The law in relation to companies in the UK was established by the first Companies Act of 1844, which fused these two notions of corporate entity and limited liability. Any confusion in respect of the two notions was put to rest by the judgment in the case of *Salomon* v *Salomon & Co Ltd* (1897). The judgment handed down by the House of Lords stated that the company was a separate legal entity distinct from the owners and that creditors could not claim on the personal assets of the owners, only on the assets of the company. Creditors trade with a limited company at their own risk. It is advisable for creditors to investigate the financial stability of a company before they trade with it.

Formation of a company

Further detail in respect of the formation of a company will be found in a company law course, but it is worthwhile identifying the main points here.

- All companies must be registered with the Registrar of Companies by the submission of a number of legal documents. This marks the legal birth of a company.
- The two most important documents to be filed are the **Memorandum of Association** and the **Articles of Association**.

- The Memorandum of Association defines the relationship between the company and any external parties and states the objectives of the company, that is what sort of trade it will undertake. It also identifies the maximum capital to be invested in the company by the owners, known as the Share Capital. All companies must have at least two shareholders whose names and addresses appear in the memorandum.
- The Articles of Association define the rights of shareholders, the rules of operation of the company and the rights and duties of owners and employees of the company.
- Companies are registered as either public limited companies (plcs) or private companies. Essentially the distinction is that plcs can, if they wish, raise capital by selling shares to the general public. They must have a minimum allotted (i.e. issued to shareholders) share capital of £50,000. Many plcs are quoted on the London Stock Exchange, thus anyone who wants to can become an owner of the company as long as they have the necessary capital to invest. Private companies have restricted ownership. The following diagram illustrates the type of companies in general that exist.



- There must be at least two shareholders in any company but there is no maximum number.
- The day-to-day business of the company is generally not carried out by the owners but by directors who are appointed by the owners. The directors report to the owners through the facility of an Annual General Meeting and an Annual Report that incorporates the financial statements.

Company law review in the UK

A review of company law is currently underway. This is the most extensive reform of Company Law for nearly 150 years in the UK. As a result of Enron and other corporate scandals across the world there has been a significant push to require companies to report clearly about their business actions through new legislation. Much of the detail of the review was produced in a steering group report in July 2001 and then in a Government White Paper, *Modernising Company Law*, in July 2002. The objective of the review is to streamline procedures for all companies, especially smaller companies, to make the law clearer, more accessible and responsive to developments. According to the Department of Trade and Industry website on modernising company law, the Company Law Review will:

- enable better shareholder engagement,
- modernise and de-regulate the law,
- give greater clarity to directors on their duties and responsibilities, so that they do not inadvertently fall foul of the law,
- facilitate better communications with shareholders,
- help speed up decision making, and
- deregulate aspects of current law.

All of this should help maintain the UK's position as the best place to set up and run a business. The detailed work of updating company law in respect of detailed requirements for accounting and other company disclosures is to be handled by a non-governmental business-led body based on the Accounting Standards Board (ASB). We deal with the ASB in Chapter 10. The review of company law is a major task that the current government has set itself. It is not envisaged that this will change the form of a company, but it might well bring about changes to the reporting of a company's financial position and performance.

At the current rate of progress, the Company Law Review Act is not expected to receive full parliamentary approval in the UK until Autumn 2005.

Company capital

The capital of a company is divided into **shares**. Investors purchase as many of these as they are able, and want, to buy. For example, a company could be registered with a maximum share capital of 100,000 £1 shares. The maximum capital of the company would therefore be £100,000 and this would be termed its Authorised Share Capital. A company, not the same one, could also be registered with a share capital of say 50,000 £3 shares – a maximum capital of £150,000. The pound value attached to a share is known as its nominal (or par) value and a company can decide on the nominal value and total number of shares it wishes to issue. The decision will depend on how much capital the company needs to commence its operations. Note that the company does not have to issue all its authorised share capital.

Once a company has made the initial issue of the shares, further trading in these shares can take place in what is known as the share market – for many plcs this is the Stock Exchange. Company shares may well be bought and sold every day on the Stock Exchange, but the company will make no reference to this in the ledger accounts as it is not a transaction between the corporate entity and the buyer, but between the separate shareholder and the buyer. Thus we are differentiating again between the entity of a company and the individual. The company will need to keep a list of who owns shares in it so that it can pay over any return from the trading of the company due to the shareholders. This return paid over to shareholders is known as the **dividend**.

Companies are also able to vary the rights of shareholders within a company by issuing different types of shares. The following activity is concerned with share issues and share transactions.

Activity 8.2

Obtain a set of company financial statements. This can be done by accessing library facilities, using company websites or by using the Annual Reports Service offered in the *Financial Times* – read the small print at the end of the daily stock exchange listings to see how this is done. Identify the types of shares in issue for your chosen company from the financial statements and notes.

Answer

Your company almost certainly has in issue ordinary shares. These are the most important type of share and are those most commonly traded on the stock exchange. They generally carry voting rights in proportion to the number of shares held. These voting rights give control over the operations of the company to the shareholders through the right to appoint the directors. You should also have been able to identify the dividends paid to ordinary shareholders.

Preference shares may also have been issued by the company. The main feature of preference shares is that they usually carry a specific rate of return to the holder from the company's profits. For example, 5% £1 preference shares would require a payment to the shareholders every year of 5p for every share held. A holder of £10,000 of these preference shares would receive £500.

Preference shares can also be termed cumulative. This means that if the company does not make enough profit in any one year to pay out the amount due to the preference shareholders, it carries over to the next year and accumulates until the company does have enough profit to pay out the amount due – the dividend.

The preference shares may also be *redeemable*, giving the company the right to repay the capital to the preference shareholders at a determined future date.

Shares can also be issued by a company at a value above the nominal value declared in the Memorandum of Association. This is known as issuing shares at a **premium**.

Activity 8.3

Explain why a company may wish to issue shares at a premium.

Answer

A company may wish to raise additional capital. To issue £1 ordinary shares at a price of £1 to new investors would be unfair to the initial investors in the company. The following example illustrates this point.

A company was initially formed by the issue of 100 £1 ordinary shares. The balance sheet of the company at its formation can be summarised as follows:

	£
Bank	100
Capital 100 £1 ordinary shares	100

The company trades for a number of years, earning profits of £250 in total. Its balance sheet will then appear as follows:

Assets	£350
Capital 100 £1 ordinary shares	100
Profit	250
	£350

From this balance sheet we can conclude that each share now has a book value of £3.50. It is also feasible that if these ordinary shares were traded on the stock exchange they would probably sell at a price in excess of £1. The company at this stage now wishes to raise more capital, £140, so that it can expand by the purchase of further assets. If it issues more £1 ordinary shares at their nominal value then this will be unfair to the original shareholders as the balance sheet would now be:

Assets	£490
Capital 240 £1 ordinary shares	240
Profit	250
	£490

Now each share has a book value of £2.04. The original shareholders have lost £1.46 on each share!

To ensure equity (fairness) between old and new shareholders the new shares will be issued at a premium. In this case the shares of £1 nominal value will be issued at £3.50 and the number issued will be 40.

The balance sheet will now be:

Assets	£490
Capital 140 £1 ordinary shares	140
Share premium	100
Profit	250
	£490

Now each share has a book value of £3.50.

Note that the premium paid on the shares is entered in a separate ledger account known as share premium.

Activity 8.4

A company is formed with a total authorised (authorised by its inclusion in the Memorandum of Association) share capital of £500,000, consisting of 300,000 £1 ordinary shares and 100,000 5% £2 preference shares. The company wishes to raise £400,000 in capital to start the business. Identify the number of shares of each type it should issue to minimise the preference dividend payment in each of the following circumstances:

1 All shares are to be issued at par.
2 Ordinary shares are to be issued at a premium of 25p and preference shares at a premium of 50p.

Answer

1 300,000 £1 ordinary shares and 50,000 £2 5% preference shares. Preference dividend payment £5,000.
2 300,000 £1 ordinary shares at £1.25 raises £375,000, the further £25,000 required is raised by issuing 10,000 £2 5% preference shares at £2.50. Preference dividend payment £1,000. Issuing the minimum number of preference shares in each case ensures that the preference dividend payment will be minimised. Note that the preference dividend is only calculated on the nominal value of shares issued not the premium.

Rights issues and bonus issues

Companies often make what is termed a rights issue of shares. This is an offer of shares to the existing shareholders that they have a right to purchase at a price below the current market value of the shares. The amount the existing shareholders are allowed to purchase is pro-rata to their existing share holding.

Example 8.1

Alpha plc has in issue one million £1 (nominal value) shares. The current market value of the shares is £3.50. The company proposes a rights issue of one share for every four held at a price of £2.

If all of this rights issue is taken up by the shareholders then the company will issue a further 250,000 shares and will receive £500,000 from the shareholders. The company has benefited in this transaction, as it is a very inexpensive way to raise further capital. It does not have to go through all the formalities associated with a full share issue to the public, such as producing what is known as a prospectus. The shareholders benefit, as they are able to buy more shares in the company at a beneficial price and, of course, control of the company remains in their hands. Under a normal issue of shares the existing shareholders could have their control diluted if they did not buy all of the shares issued.

A company can also make a ‘bonus issue’ of shares to its existing shareholders. As is the case with a sole trader, a company will build up its retained profits over the years and these will appear as a reserve on the balance sheet. We will talk further about reserves after Activity 8.8.

Example 8.2

Alpha plc's balance sheet as at 31 March 20X5 shows the following:

	£
Share capital – £1 ordinary shares	500
Retained profits	1,000
	1,500

The company makes a bonus issue of two shares for every one held by the existing shareholders. This means every shareholder receives two free shares for every one held. Note no money changes hands and the cash of the company will not be increased. The balance sheet after the bonus issue will appear as follows:

	£
Share capital – £1 ordinary shares	1,500
Retained profits	0
	1,500

Once a bonus issue of shares is made, the market value of the shares will fall to reflect the extra number of shares in issue.

Other forms of capital

When considering the business of a sole trader you saw that the owner could increase the funds available in the business not only by investing more money himself, but also perhaps by acquiring a loan from a bank. Companies can also raise extra finance in a similar way. However, they are also able to raise loan capital by the issue of **debentures** that can be traded in the market in the same way as a share.

The debenture document sets out the capital value, the interest rate payable, the date the loan is redeemable and any security for the loan. The capital value of the debenture is expressed in nominal value terms, usually in multiples of £100. The interest rate payable on the debenture is set at a fixed percentage of this nominal value. It is important to remember that debentures are loans to the company, not part of its share capital. Because of this, debenture interest is shown as a charge against profits within the income statement, rather than an appropriation of profits. The only difficulty with debentures is that they are often issued at a value above or below nominal value. Thus a £100 debenture could be issued at £99. This means that on issue the cash received by the company will only be £99; that is, the debenture has been issued at a discount of £1. Note, though, that the amount payable by the company on redemption, repayment, of the loan will be £100. In the same way that shares are entered into the company's ledger accounts at nominal value so are the debentures. The question to answer is 'How do we account for the £1 discount on issue?'

Activity 8.5

A company makes an issue of £10,000 6% debentures at £99. Show the entries in the ledger accounts, including cash, to account for this issue.

Answer

The debenture account is used to record the nominal value of the debentures issued as for share capital.

6% DEBENTURES ACCOUNT

		Issue	10,000

CASH ACCOUNT

Debentures	9,900		

The above entries do not maintain duality. A debit of £100 is required to be made somewhere in the ledgers.

This £100 discount on issue can be considered as an expense of making the debenture issue. Therefore we have:

DEBENTURE DISCOUNT ACCOUNT

Issue	100		

Like all other expenses this debenture discount should be written off to the income statement by debiting the income statement.

DEBENTURE DISCOUNT ACCOUNT

Issue	100	Income statement	100

There is also another possibility for the write-off of this discount on issue which is permitted by the Companies Act in the UK and that is to charge it against the share premium account if there is one.

Return on shares and debentures

Any investment is made with the expectation of some form of return. For the sole trader this return was in the form of profits that he was free to withdraw from the business. In the same way the profits of a company belong to the shareholders and they will expect some return on their capital invested. This return is made in the form of a dividend payment. These dividend payments are usually made in two instalments, the interim dividend and the final dividend.

Activity 8.6

From your set of company accounts identify the interim and final dividend payments made.

Answer

The dividends identified were probably expressed as so many pence per share. For example, if the dividend was declared as 6p per share and there were 100,000 £1 shares in issue, then the total dividend payment made would be £6,000. Note the dividend is calculated by reference to the nominal value of shares issued.

The interim dividend is generally paid halfway through the financial period and the final dividend, an additional payment, is proposed at the year end. This means that the shareholders will vote at the annual general meeting on the payment of this final dividend as proposed by the directors and after a vote in favour, the dividend will be paid. Note that this means that all final, proposed, dividends are unpaid at the year end. It has long been UK accounting practice to include this proposed dividend as a current liability in the balance sheet. However International Accounting Standards now explicitly state that dividends declared after the balance sheet date, i.e. proposed dividends should not be recognised as a liability at the balance sheet date. This will be a change of accounting practice for all UK companies who report under IASs.

The return made to the debenture holder is in the form of interest at the rate specified on the debenture. In the example at Activity 8.5, the interest payable was 6% on a nominal debenture value of £10,000. Thus the company will be required to pay £600 in interest.

Activity 8.7

Is the interest payable on the debenture an expense of trading for the company?
Is the dividend payable to the shareholders an expense of trading for the company?

Answer

For the debenture interest the answer is yes. This interest is treated in exactly the same way as the interest on a loan for a sole trader, as an expense of trading.

The dividend payable, though, is not an expense. Remember the drawings of a sole trader were not an expense but an extraction of capital invested.

For a company, the dividend payment is shown as a change in equity, as the following example demonstrates.

Example 8.3

Alpha Ltd made a net profit before the payment of interest and dividends of £35,000 in year X. There were £10,000 6% debentures in issue and 100,000 £1 ordinary shares in issue at the beginning of year X and retained profits were £20,000. No further issues of shares or debentures were made during the year. The interim dividend declared was 3p per share and the final proposed dividend 4p per share. The interest and dividend payments are shown in the income statement, as follows.

INCOME STATEMENT FOR ALPHA LTD

Profit		35,000
Interest on debentures	6%	600
Net profit		34,400

Statement of changes in equity

		Share capital	Retained profits	Total
Balance at beginning of year		100,000	20,000	120,000
Net profit for the year			34,400	34,400
Interim dividend	3p = 3,000			
Final dividend	4p = 4,000		(7,000)	(7,000)
Balance at end of year		100,000	47,400	147,400

Financing a company

This chapter has shown us so far that a company can raise capital by issuing ordinary shares, preference shares and debentures. There are many different forms of these instruments, e.g. options, warrants, deep discounted bonds, interest rate swaps, but we leave these to later, more detailed, studies of finance and financial management. However, in addition to companies using these various instruments to raise finance they also use bank overdraft facilities and their own earnings, in the form of non-distributed profit, to provide finance. We look at the non-distributed profit under the next section on reserves.

Activity 8.8

Pump Ltd, a newly forming company, estimates it will need capital of £1m so that it can remain in business. It estimates its profits per annum before interest payments and dividends as £100,000 in the first year with an estimated 2% increase year on year. It proposes to issue 500,000 50p ordinary shares at a premium of 40p, 220,000 4% £2 preference shares and to raise the remaining capital it needs from an issue of 3% debentures. Show the capital section of the balance sheet and the non-current liabilities assuming estimated profit is realised, the statement of changes in equity and the income statement as far as the information provided permits for the first two years of trading. The interim and final dividends for Year 1 are expected to be 2p and 3p and for Year 2 4p and 5p. Assume the final dividend is paid before the year end.

Answer

INCOME STATEMENT FOR PUMP LTD

	Year 1	Year 2
	£	£
Profit	100,000	102,000
Interest on debentures 3%	3,300	3,300
Net profit	96,700	98,700

Statement of changes in equity

		Share capital	Share premium	Accounting profits	Total
Balance as at 1.1.Year 1		690,000	200,000		890,000
Profit for Year 1				96,700	96,700
Preference dividend				(17,600)	
Interim dividend	2p			(10,000)	
Final dividend	3p			(15,000)	(42,600)
Balance as at 31.12. Year 1		690,000	200,000	54,100	944,100
Profit for Year 2				98,700	98,700
Preference dividend				(17,600)	
Interim dividend	4p			(20,000)	
Final dividend	5p			(25,000)	(62,600)
Balance as at 31.12. Year 2		690,000	200,000	90,200	980,200

CAPITAL BALANCE SHEET SECTION PUMP LTD

	Year 1	Year 2
Capital 500,000 50p ordinary shares	250,000	250,000
220,000 £2 4% preference shares	440,000	440,000
Share premium account	200,000	200,000
Profit	54,100	90,200
	944,100	980,200
Non-current liabilities		
3% debentures	110,000	110,000

There are several issues to note in the above activity. First, you needed to calculate the amount of debentures issued. Ordinary share raised £450,000 (including the share premium remember thus 500,000 × 90p), preference shares raised £440,000 (220,000 × £2) and therefore the remaining amount (£1m – 890,000 = £110,000) was required from the debenture issue.

In Year 2, the profit after dividends of £36,100 is in addition to that already accumulated at Year 1, £54,100.

The percentage payable on the preference shares and debentures is applied to the monetary amount whereas the dividend payable is calculated by reference to the number of shares.

Taxation in company accounts

If you look at the income statement in your set of company accounts you will notice that there is another item that did not appear in the income statement of a sole trader, and that is **taxation**.

Companies are separate legal entities, unlike a sole trader's business, and are subject to taxation, corporation tax, which will be shown in the income statement. A sole trader does not show taxation in his accounts as the taxation authorities view the earnings of the business of the sole trader as his personal income and tax accordingly. The calculation of corporation tax is complicated and based on taxable profits, which are not the same as accounting profits. At this level of study you will be given a figure to use as the taxation charge for the year. This tax will not be payable until nine months after the end of the accounting year, so it will be shown as a liability in the year-end accounts, and an expense in the income statement.

Reserves

If you look at the balance sheet in your set of company accounts you will notice that the share capital is entered under the heading, Capital and Reserves. **Reserves** that you have met so far consist of accumulated profits of the business, that is, profits that have not been extracted from the business by the shareholders but have been left as further investment, and share premium that was an initial investment by shareholders. These reserves are further classified into capital or revenue reserves. Share premium is an example of a capital reserve, initial capital invested by shareholders. Accumulated profit is an example of a revenue reserve, capital earned from the trading of the business. Another distinction between capital and revenue reserves is that revenue reserves can be distributed in the form of dividends; capital reserves must be retained within the business and cannot be distributed in the form of dividends. This is to protect creditors. Share capital and capital reserves are sometimes known as the creditors' buffer, i.e. the base capital of the company that must not be repaid to shareholders except in very exceptional circumstances.

Another reserve that you might see in your set of accounts is a revaluation reserve. When we considered the non-current assets of a business in our double entry system we tended to record them at historical cost or what the purchaser had paid for them. Look back to Chapter 5 and the details in the Mr Bean examples to revise this. However, there might be circumstances when recording the historical cost or purchase price of the non-current asset does not provide very relevant information to the user of the accounts.

Activity 8.9

Identify a circumstance when recording a non-current asset at historical cost might not be the most relevant to the user.

Answer

When the asset has increased in value as the owner has held it due to circumstances outside his control. For example, business assets such as land and buildings tend to increase in value in the same way as your house price does. Providing the information on this increase in value is highly relevant, as the owner could if he wished sell the asset and increase the business worth. Knowledge of this unrealised, until actual sale, worth is useful both to owners and those who wish to invest in the business as well as other users of accounts.

Common practice has arisen and company law permits us to carry assets at their revalued amount, but we need to know how to account for this increase in value.

Activity 8.10

Company A purchased land in 20X1 for £10,000 for cash. As at 31.12.X5 the company estimates that the land could be sold for £50,000. Identify how this increase in value could be recorded in the company's books (ledgers).

Answer

The land would have been originally recorded in the books at its original purchase price of £10,000. The increase in value the company wishes to reflect is £40,000. This is the amount of the revaluation. Quite simply the fixed asset account of land is shown at £50,000 and the uplift in value, the revaluation, is credited to a revaluation reserve as follows:

LAND ACCOUNT

1.1.X5	Balance b/d	10,000			
31.12.X5	Revaluation reserve	40,000	31.12.X5	Balance c/d	50,000
		50,000			50,000
1.1.X6	Balance b/d	50,000			

REVALUATION ACCOUNT

31.12.X5	Balance c/d	40,000	31.12.X5	Land	40,000
		40,000			40,000
			1.1.X6	Balance b/d	40,000

The revaluation reserve, the £40,000 in the activity above, is shown in the balance sheet under the capital and reserves section and is a capital unrealised reserve. We will consider revaluation reserves again in Chapter 12.

The following activity brings together various issues that you have come across in your studies so far.

Activity 8.11

The trial balance of Beta Ltd as at 31.12.X5, before adjustment for any of the items listed in the notes, is as follows:

	Dr	*Cr*
Issued £1 ordinary shares		50,000
Share premium		5,000
Buildings (cost)	55,000	
Fixtures and fittings (cost)	27,000	
Vehicles (cost)	15,000	
Depreciation as at 1.1 X5		
Buildings		3,300
Fixtures and fittings		6,750
Vehicles		5,400
Sales		111,000
Purchases	75,000	
Wages and salaries	12,000	
Other expenses	8,000	
Stock 1.1.X5	2,500	
6% debentures		30,000
Debenture interest paid	900	
Interim dividend paid	2,000	
Debtors and creditors	28,000	15,000
Accumulated profits 1.1.X5		9,500
Cash	10,550	
	£235,950	£235,950

The following notes are to be taken into account:

1. Stock as at 31.12.X5 is £3,400 valued at cost.
2. Depreciation is to be provided for as follows:
   - Buildings 2% per annum straight line
   - Fixtures and fittings 25% straight line
   - Vehicles 20% reducing balance.
3. Corporation tax for the year is estimated at £3,500.

4 Fittings originally costing £2,400 on which depreciation of £1,200 had been provided were sold on 31.12.X5 for £950. No entries have been made in the accounts for the sale nor has any cash been received.

Prepare the income statement, statement of changes in equity and balance sheet for Beta Ltd for the year ended 31.12.X5.

Answer

BETA LTD
INCOME STATEMENT FOR THE YEAR ENDED 31.12.X5

Sales			111,000
Opening inventory		2,500	
Purchases		75,000	
		77,500	
Closing stock		3,400	74,100
Gross profit			36,900
Wages and salaries		12,000	
Office expenses		8,000	
Debenture interest		1,800	
Depreciation:			
Buildings	1,100		
Fixtures and fittings	6,150		
Vehicles	1,920	9,170	
Loss on sale		250	31,220
Profit before tax			5,680
Taxation			3,500
Profit after tax			2,180

BETA LTD
STATEMENT OF CHANGES IN EQUITY

	Share capital	Share premium	Accumulated profits	Total
Balance as at 1.1.X5	50,000	5,000	9,500	64,500
Profit for the year			2,180	2,180
Dividends			(2,000)	(2,000)
Balance as at 31.12.X5	50,000	5,000	9,680	64,680

BETA LTD
BALANCE SHEET AS AT 31.12.X5

	Cost	*Depreciation*	*Net book value*
Non-current assets			
Buildings	55,000	4,400	50,600
Fixtures and fittings	24,600	11,700	12,900
Vehicles	15,000	7,320	7,680
	94,600	23,420	71,180
Current assets			
Inventory		3,400	
Debtors		28,000	
Debtors (fixtures)		950	
Cash		10,550	
		42,900	
Current liabilities			
Creditors	15,000		
Taxation	3,500		
Debenture interest	900	19,400	23,500
			94,680
Non-current liabilities			
6% Debentures			30,000
			£64,680
Capital and reserves			
Ordinary shares of £1			50,000
Share premium			5,000
Accumulated profits			9,680
			£64,680

Format presentation

As you have been looking at your set of company accounts you may have noticed that the presentation of the income statement and balance sheet is slightly different from the one we have used so far. The Companies Act UK and the EU Fourth Directive actually specifies four **formats** that can be used for the presentation of the income statement of a company and two for the balance sheet. However the IASs are not as specific as UK law or the EU directives on the format for the income statement and balance sheet. We will use for our purposes at this level of study simplified versions of the Fourth Directive formats, which also take account of the IAS regulations.

INCOME STATEMENT FOR THE YEAR ENDED 20YZ

Turnover/Revenue		X
Cost of sales		(X)
Gross profit		X
Distribution costs	X	
Administration costs	X	(X)
Operating profit		X
Income from investments		X
Interest paid and similar charges		(X)
Profit on ordinary activities before tax		X
Tax on ordinary activities		(X)
Profit on ordinary activities after tax		X
Extraordinary charges	X	
Tax	(X)	(X)
Profit for year		X

This presentation of the income statement requires the analysis of expenses under three headings: cost of sales, distribution and administration. Wages and salaries will have to be analysed across these three headings as will depreciation.

BALANCE SHEET AS AT 20YZ

Non-current assets			
Intangible assets			X
Property, plant and equipment			X
Investments			X
			X
Current assets			
Inventory		X	
Debtors		X	
Cash at bank and in hand		X	
		X	
Current liabilities due within one year			
Creditors	(X)		
Other	(X)	(X)	
Net current assets			X
Total assets less current liabilities			X
Non-current liabilities due after one year			(X)
			£X
Capital and reserves			
Called up share capital			X
Share premium account			X
Revaluation reserve			X
Other reserves			X
Accumulated profit			X
			£X

You might also have noticed in your set of accounts two more statements in addition to the income statement and balance sheet, the cash flow statement and the statement of changes in equity. The cash flow statement we will deal with in Chapter 9 and we will look further at the statement of changes in equity in Chapter 12.

Other organisations

We have looked in some detail in this chapter at accounts for companies. There are many other types of organisations that have a need to keep records and prepare information similar to that of companies. We have referred to clubs and societies in Chapter 7, but charities and public sector organisations also need similar information. Income statements and balance sheets for these types of organisations are prepared using the same principles and concepts as for companies but of course the Companies Act does not apply to them. Charity accounts have to be prepared in accordance with the Charities Acts and the government provides detailed requirements for the public sector. Below, we provide a fully worked example for the preparation of a set of accounts for a club. We advise you to work through this example diligently, then you will be able to answer the question on clubs at the end of chapter. You will remember we initially looked at these in Chapter 3.

The following information is extracted from the records of Mudby Rugby Club for the year ended 31.12.X5.

	1.1.X5	31.12.X5
	£	£
Bar inventory	16,200	17,860
Creditors for bar purchases	8,600	8,100
Creditors for other expenses	230	1,240

Summary of bank account for the year ended 31.12.X5

	£		£
Balance 1.1.X5	16,290	Bar purchases	120,650
Subscriptions received	24,530	Bar wages	15,230
Bar sales	146,320	Other salaries and wages	5,340
Interest on investments	1,230	Rent and rates of club premises	5,670
		General expenses	8,760
		Cost of fittings and furniture	7,680
		Balance 31.12.X5	25,040
	188,370		188,370

Other information available at the year end is as follows:

- Rent and rates have only been paid for three quarters of the year
- Investments held by the club at 1.1.X5 had several years ago cost £30,750
- Fixtures and fittings held at 1.1.X5 had cost £42,500 on 1.1.X2 and all fixtures and fittings are to be depreciated at 10% on original cost

Prepare a bar trading account and an income and expenditure account for year ended 31.12.X5 and a balance sheet as at that date in good form.

A bar trading account simply groups together all the income and expenditure relating to the bar to see if it has been operating at a profit.

Bar trading account for Mudby Rugby Club for the year ended 31.12.X5

	£	£
Bar sales		146,320
Opening inventory	16,200	
Bar purchases (120,650 – 8,600 + 8,100)	120,150	
	136,350	
Closing inventory	17,860	118,490
Gross profit on bar		27,830
Bar wages		15,230
Net profit on bar		12,600

Income and expenditure account for the year ended 3.12.X5

Subscriptions		24,530
Bar net profit		12,600
Interest on investments		1,230
		38,360
Other salaries and wages	5,340	
Rent and rates (5,670 + 1,890 for last quarter)	7,560	
General expenses (8,760 – 230 + 1,240)	9,770	
Depreciation of fixtures and fittings		
(10% × 42,500 + 7,680)	5,018	27,688
		10,672

Balance sheet as at 31.12.X5

	£ *Cost*	£ *Depreciation*	£ *Net book value*
Non-current assets			
Fixtures and fittings	50,180	17,768 (W1)	32,412
Investments			30,750
			63,162
Current assets – inventory bar	17,860		
Cash at bank	25,040	42,900	
Current liabilities – rent and rates	1,890		
Creditors other expenses	1,240		
Bar purchases	8,100	11,230	31,670
			94,832
Accumulated fund 1.1.X5			84,160 (W2)
Surplus			10,672
			94,832

W1 total cost value of fixtures and fittings £42,500 + £7,680 = £50,180

Depreciation 10% on £50,180 = £5,018 for Year 31.12.X5

Depreciation at 10% for 3 years on £42,500 = £12,750

Total depreciation £12,750 + £5,018 = £17,768

W2 Net book value 1.1.X5 fixtures and fittings (£42,500 – £12,750 depreciation)	£29,750
Investments	30,750
Inventory	16,200
Bank	16,290
Creditors (£8,600 + £230)	(8,830)
	84,160

Summary

This chapter has:

- introduced you to the accounts of a limited company
- identified the concept of legal entity of a company and the differences between a company and a sole trader
- noted that the capital of a company was issued in the form of shares
- noted that companies were subject to taxation, which was accounted for as a deduction from the profit of the company
- identified the fact that companies are required to publish their final accounts in a specified format. However, the preparation of the income statement and balance sheet of the company required the same techniques as those used for a sole trader.

At the end of this chapter there are several exercises for you that will test your knowledge and understanding of accounting for companies and also the preparation of final accounts in accordance with the specified formats.

Chapter 9 looks at several other statements that a company is required to publish in its final accounts (or **annual report** as it is known).

Key terms

limited company (p. 128)
limited liability (p. 128)
corporate entity (p. 128)
Memorandum of Association (p. 128)
Articles of Association (p. 128)
shares (share capital) (p. 130)
dividend (p. 131)
premium (p. 131)
debentures (p. 134)
taxation (p. 138)
reserves (p. 138)
format presentation (p. 142)
annual report (p. 147)

Self-assessment questions

1 Answer the following questions for both sole traders and companies:

(a) Is there any statutory regulation governing them?
(b) Who owns the business?
(c) Who manages the business?
(d) Is the business a separate legal entity?
(e) Does the business end when its owners change?
(f) Is taxation an expense of the business?
(g) How do owners extract profits from the business for their own use?
(h) Is the business quoted on the stock exchange?

2 The directors of Britton plc wish to raise additional capital. They currently have in issue one million £1 ordinary shares and no long-term loans. What options do they have available to raise extra capital and which would you advise them to choose?

3 The following is an extract from the balance sheet of Comp plc as at 31.3.X6:

	£m
Ordinary shares £1	20
Share premium account	5
Accumulated profits	12
5% debentures £1	8

(a) What is the par value of each share?
(b) What is the book value of each share?
(c) What is the interest payable per annum on the debentures?
(d) If the interest rate in the market for debentures similar to those of Comp plc was higher than 5% would the market price of Comp's debentures in the market place be higher or lower than £1?

4 The following trial balance was extracted from the books of Cuddly Toy Ltd as at 31.12.X5

	Dr	*Cr*
	£000	£000
Sales		1,562
Inventory 1.1.X5	660	
Purchases	885	
Land	1,010	
Buildings	980	
Equipment	55	
Vehicles	72	
Depreciation: Buildings		390
Equipment		18
Vehicles		25
Debtors and creditors	180	235
Bank	121	
£1 ordinary shares		900
Share premium		350
Distribution expenses	98	
Administration expenses	24	
Accumulated profits 1.1.X5		185
5% debentures		420
	£4,085	£4,085

The following information has not yet been accounted for:

- Closing inventory 31.12.X5 is valued at £560,000.
- Depreciation is to be charged as follows:
  - 2% straight line on buildings
  - 20% straight line on equipment
  - 25% reducing balance on vehicles.
- Assets are used as follows:
  - buildings: 50% cost of sales, 25% distribution and 25% administration
  - equipment: all cost of sales
  - vehicles: all distribution.
- Taxation to be charged for the year is estimated at £200,000.
- An interim dividend has been declared but not yet paid of 6p per share.

Prepare the published income statement, statement of changes in equity and balance sheet for the company as at 31.12.X5.

5 You are required to prepare the income statement for the year ended 31.3.X6 and the balance sheet as at that date for internal purposes for the following company:

TRIAL BALANCE OF GERRY LTD AS AT 31.3.X6

	Dr	*Cr*
Ordinary shares £1		100,000
6% preference shares £1		20,000
8% debentures		30,000
Share premium		9,500
Revaluation reserve		10,000
General reserve		12,000
Accumulated profit b/f 1.4.X5		976
Non-current assets (cost £210,000)	191,000	
Inventory 1.4.X5	14,167	
Debtors and creditors	11,000	7,500
Provision for doubtful debts		324
Bank	9,731	
Purchases and sales	186,000	271,700
Wages and salaries	31,862	
General expenses	15,840	
Debenture interest	1,200	
Preference dividend	1,200	
	£462,000	£462,000

You are also given the following information:

- Inventory 31.3.X6 £23,483.
- Depreciation of non-current assets is to be provided at the rate of 10% per annum on cost.
- The provision for doubtful debts is to be at 5% of debtors.
- £1,200 of debenture interest and £1,437 of general expenses are to be accrued.
- £925 of general expenses have been paid in advance.
- Provision is to be made for taxation on this year's profits of £9,700.
- The directors have decided to increase the general reserve by a further £3,000.

6 The trial balance of Hobo Ltd as at 30.9.X6 was as follows:

	Dr	*Cr*
Audit fee	1,200	
Bad debts	5,320	
Debtors and creditors	92,360	111,450
Delivery expenses	22,060	
Productive wages	32,300	
Warehouse wages	30,200	
Administrative salaries	15,200	
Purchases and sales	426,500	623,300
Administration expenses	5,600	
Rents administration	12,600	
Inventory 1.10.X5	18,950	
Ordinary 50p shares		100,000
Share premium account		50,000
Accumulated profits 1.10.X5		26,000
Premises	275,000	
Vehicles	18,500	
Equipment	12,000	
Depreciation as at 1.10.X5		
Premises		3,750
Equipment		3,600
Vehicles		6,500
7% debentures		95,000
Bank	51,810	
	£1,019,600	£1,019,600

The following additional information is available:

- Inventory as at 30.9.X6 was valued at £20,650.
- Premises and equipment are used at 50% production and 50% distribution, and are to be depreciated at the rate of 1% and 10% straight line respectively.
- Vehicles are only used for distribution, and are depreciated at 20% reducing balance.
- A provision for bad debts of 5% is to be allowed for.
- £500 was prepaid for rent and £600 is owing for production wages as at 30.9.X6.
- Taxation for the year is estimated at £22,680.

Prepare the income statement and balance sheet for Hobo Ltd as at 30.9.X6 in a form suitable for publication.

7 The trial balance of Burn Ltd. as at 31.12.X9 was as follows:

		Dr	*Cr*
		£	£
Purchases and sales		15,260	83,460
Inventory 1.1.X9		6,230	
Debtors and creditors		8,240	7,210
Production salaries and wages		12,320	
Production expenses		7,210	
Warehouse expenses		950	
Warehouse wages		10,100	
Administration salaries		14,200	
Administration expenses		950	
Ordinary £1 shares			100,000
Share premium account			20,000
Accumulated profits 1.1.X9			62,000
Premises		200,000	
Equipment		50,000	
Vehicles		15,000	
Provision for depreciation:	Premises		20,000
	Equipment		15,000
	Vehicles		6,560
6% Debentures			50,000
Bank		103,520	
Cash		250	
New capital			80,000
		444,230	444,230

The following additional information is available none of which has been accounted for in the trial balance:

- ▶ Inventory 31.12.X9 £4,560.
- ▶ Premises and equipment are used 50% production, 25% distribution and 25% administration and are depreciated at the rate of 2% and 10% respectively.
- ▶ Vehicles are only used by distribution and are depreciated at 25% reducing balance.
- ▶ A provision for bad debts of 5% is to be made.
- ▶ The new capital consists of the issue on 1.12.X9 of 40,000 £1 shares; the ledger clerk did not know how to treat this item in the ledgers.
- ▶ Tax for the year is estimated at £1,200.
- ▶ A vehicle, purchased 1.1.X7 for £7,000 was sold on 1.8.X9 for £3,750. The proceeds had been credited to sales.
- ▶ 5% Debentures were issued on 1.1.X9, par value £10,000, for £9,500. The £9,500 has been credited to accumulated profits 1.1.X9 account.

Prepare the income statement and the balance sheet for Burn Ltd. as at 31.12.X9 in a form suitable for publication.

▶

8 The trial balance of Black Ltd as at 31 December 20X5 was as follows:

	Dr	*Cr*
Debtors and creditors	46,800	34,200
Returns inwards	2,450	
Productive wages	74,000	
Distribution expenses	32,870	
Administrative salaries	61,230	
Purchases and sales	321,700	552,600
Office expenses	5,630	
Returns outwards		4,670
Inventory 1.1.X5	22,300	
Ordinary £1 shares		150,000
Debentures 6%		50,000
Accumulated profits 1.1.X5		9,870
Premises	150,000	
Vehicles	85,000	
Equipment	70,000	
Depreciation as at 1.1.X5		
Premises		11,600
Equipment		27,500
Vehicles		29,250
Bank		2,290
	£871,980	£871,980

The following information is available none of which has been taken account of in the preparation of the trial balance above:

(a) Inventory as at 31 December 20X5 is valued at £22,000.

(b) Vehicles are primarily used for distribution, buildings equally between production, distribution and administration and equipment equally between production and administration.

(c) Buildings are to be depreciated 1% straight line, equipment 20% straight line and vehicles 25% reducing balance.

(d) Equipment was sold on the 31 December 20X5 for £15,000. This had been credited to sales. The original cost was £20,000 and it had been purchased on 31 December 20X2. No further entries than cash and sales had been made in the books.

(e) Bad debts of £2,600 need writing off and a provision for bad debts at the rate of 5% is to be introduced.

(f) Taxation for the year is estimated at £9,860.

(g) Accruals of £3,500 for administration expense are required and prepayments of £5,600 have been identified within distribution expenses.

(h) The interest on the debentures has not yet been paid.

Prepare the income statement for the year ended 31 December 20X5 and the balance sheet as at that date in a form suitable for publication.

9 Explain the terms rights issue and bonus issue of shares

10 Gamma plc has issued share capital of £1,000,000, nominal value of ordinary shares is £2 and accumulated profits of £456,000 as at 31.12.X6. The company proposes to make a rights issue of 2 for 5 existing shares held at a price of £4.25 and a bonus issue of 200,000 ordinary shares. The market value of the shares as at 31.12.X5 is £6.70. Show the capital section of the balance sheet after the two share issues and also identify how many shares a holder of 1,000 shares before the issues will have afterwards.

Answers to these questions can be found at the back of this book.