

CHAPTER 17 Financial statements of limited companies

- 17.1 (a) • Ordinary shares are the most commonly issued class of share. They take a share of the profits which remain after all other expenses of the business. The main risk of ordinary shares is that part or all of the value of the shares will be lost if the company loses money or becomes insolvent.
- Preference shares usually carry a fixed rate of dividend which is paid in preference to that of ordinary shareholders. In the event of the company ceasing to trade, the preference shareholders will also receive repayment of capital before the ordinary shareholders.
- (b) • Nominal value is the face value of a share which is entered in the accounts, eg 5p, 10p, 25p, 50p or £1.
- Market value is the price at which issued shares are traded, ie bought and sold.
- (c) • Capital reserves are created as a result of a non-trading profit; examples include revaluation reserve, share premium account.
- Revenue reserves are retained profits from the income statement; examples include retained earnings, general reserve.
- (d) • A bonus issue is the capitalisation of reserves – either capital or revenue – in the form of free shares issued to existing shareholders in proportion to their holdings; no cash flows into the company.
- A rights issue is the raising of cash by offering shares to existing shareholders, in proportion to their holdings, at a favourable price.
- 17.2 (a) debenture interest is shown as an expense in the income statement
- (b) directors' remuneration is shown as an expense in the income statement
- (c) corporation tax is shown in the income statement, and any amount not yet paid is shown as a current liability on the balance sheet
- (d) dividends paid are shown in the statement of changes in equity
- (e) revaluation reserve is shown as a capital reserve as a part of the equity section of the balance sheet
- (f) goodwill is shown as an intangible asset in the non-current assets section of the balance sheet; it is amortised in the same way as tangible non-current assets are depreciated

17.3 **CHAPELPORT LIMITED**
INCOME STATEMENT (EXTRACT) FOR THE YEAR ENDED 30 JUNE 20-8

	£
Profit from operations	135,000
Finance costs	<u>(12,500)</u>
Profit before tax	122,500
Tax	<u>(48,000)</u>
Profit for the year	<u>74,500</u>

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 30 JUNE 20-8

<i>Retained earnings</i>	
Balance at 1 July 20-7	185,000
Profit for the year	<u>74,500</u>
	259,500
Dividends paid £30,500 + £18,000	<u>(48,500)</u>
Balance at 30 June 20-8	<u>211,000</u>

17.4 (a)

MASON MOTORS LTD
INCOME STATEMENT (EXTRACT) FOR THE YEAR ENDED 31 DECEMBER 20-1

	£
Profit from operations	75,000
Finance costs	<u>(5,500)</u>
Profit before tax	69,500
Tax	<u>(20,050)</u>
Profit for the year	<u>49,450</u>

(b)

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20-1

<i>Retained earnings</i>	
Balance at 1 January 20-1	100,000
Profit for the year	<u>49,450</u>
	149,450
Dividends paid	<u>(10,000)</u>
Transfer to general reserve	<u>(20,000)</u>
Balance at 31 December 20-1	<u>119,450</u>

- (c) General reserve is created from profit which has been kept in the company. It belongs to the shareholders, but is represented by assets in the balance sheet and is not a bank balance available to rebuild the garage forecourt.

17.5

JOBSEEKERS LIMITED
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20-6

	£
<i>Retained earnings</i>	
Balance at 1 January 20-6	8,400
Profit for the year	<u>68,200</u>
	76,600
Dividends paid	<u>(10,000)</u>
Balance at 31 December 20-6	<u>66,600</u>

BALANCE SHEET AS AT 31 DECEMBER 20-6

	<i>Cost</i>	<i>Depreciation</i>	<i>Net book value</i>
	£	£	£
Non-current Assets			
<i>Intangible</i>			
Goodwill	20,000	6,000	14,000
<i>Property, plant and equipment</i>			
Premises	175,000	10,500	164,500
Office equipment	<u>25,000</u>	<u>5,000</u>	<u>20,000</u>
	<u>220,000</u>	<u>21,500</u>	<u>198,500</u>
Current Assets			
Inventories			10,750
Trade and other receivables			42,500
Cash and cash equivalents			<u>1,950</u>
			<u>55,200</u>
Current Liabilities			
Trade and other payables			(17,250)
Tax liabilities			<u>(14,850)</u>
			<u>(32,100)</u>
Net Current Assets			<u>23,100</u>
Non-current Liabilities			
Bank loan			<u>(55,000)</u>
Net Assets			<u>166,600</u>
EQUITY			
Issued Share Capital			
100,000 ordinary shares of £1 each, fully paid			100,000
Revenue Reserve			
Retained earnings			<u>66,600</u>
TOTAL EQUITY			<u>166,600</u>

- 17.6 (a) **Ordinary shares**
- Advantage Voting rights
 Potential capital growth
 High dividends in good years
- Disadvantage Risk of losing money invested
 Low (or no) dividend in poor years
- 7% preference shares**
- Advantage Fixed rate of dividend which will not go down if
 interest rates fall
 Less risky than ordinary shares

Disadvantage Generally, no voting rights
 Fixed dividends, so no growth in dividends
 Fewer capital growth prospects than ordinary shares

6% debentures

Advantage Fixed rate of interest which will not go down if interest
 rates fall
 Loans rather than shares
 Less risky than shares

Disadvantage No capital growth prospects
 Fixed rate of interest, whatever may happen to
 interest rates

- (b)
- Jill is probably better off investing in ordinary shares
 - The risk is that she could lose the amount invested but, if the company does well, she could make large capital gains
 - Her income – in the form of dividends – will vary from year-to-year, depending on how successful the company has been
- (c)
- Jack is probably better off investing in debentures
 - These are the safest form of investment for him and will give him an income of £600 per year
 - If he wishes to take a slightly higher risk he could invest some or all of the money in preference shares; if all, then his income will be £700 per year
 - With preference shares there could also be some capital growth
 - Debentures offer the safest investment: in the event of the company going into liquidation, debentures will be repaid before the preference and ordinary shareholders

17.7 (a) **SRIAN PLC**
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 MAY 20-3

	£
<i>Retained earnings</i>	
Balance at 1 June 20-2	3,400,000
Profit for the year	<u>6,000,000</u>
	9,400,000
Dividends paid	(2,800,000)
Transfer to general reserve	<u>(2,000,000)</u>
Balance at 31 May 20-3	<u>4,600,000</u>

- (b) **Issue of ordinary shares**
- ordinary shares are not normally repayable, so the company will have the finance for the foreseeable future
 - the new shareholders will have voting rights
 - not essential to pay dividends every year, although a failure to do so might cause difficulties with future share issues
 - the power of the existing shareholders will be diluted because there will be more shares in issue
 - the company's gearing ratio will be improved

Issue of debentures

- a different type of financing based on loans and interest, rather than shares and dividends
- the interest charge will rise by £1,800,000 from £1,200,000 to £3,000,000
- interest must be paid whether or not profits are made
- a failure to pay interest could lead the company into insolvency
- no voting rights, so no dilution of shareholders' power
- debentures must be repaid at an agreed date in future
- interest rate is fixed, whatever may happen to the level of interest rates
- debenture holders likely to require security for their loan in the form of a mortgage over company assets; this may restrict the use the company can make of the assets
- if repayment not made at due date, debenture holders can realise assets to obtain repayment
- the company's gearing ratio will be worsened

Gearing ratio

Without having information on the company's revenue reserves (retained earnings and general reserve), the gearing ratio is currently:

$$\frac{\text{Debt}}{\text{Equity}} = \frac{£20,000,000}{£25,000,000} = 0.8:1 \text{ or } 80\%$$

This is already a high gearing ratio which investors will not wish to see going above 1:1 or 100%.

If ordinary shares are issued to raise the money for expansion, the gearing ratio (including share premium account) becomes:

$$\frac{£20,000,000}{£55,000,000^*} = 0.36:1 \text{ or } 36\%$$

* ordinary shares £25,000,000 + £20,000,000 and share premium account £10,000,000

This is a much improved gearing ratio.

If debentures are issued, the gearing ratio becomes:

$$\frac{£50,000,000^*}{£25,000,000} = 2:1 \text{ or } 200\%$$

* 6% debentures £20,000,000 + £30,000,000

This is an extremely high gearing ratio, well above the 'normal' maximum of 1:1 or 100% acceptable to investors. It may be that Srian plc will have difficulty in meeting the annual interest costs of this option.

Conclusion

It seems to be preferable for Srian to finance its expansion scheme with an issue of ordinary shares. This has a much lower gearing ratio than the issue of debentures – the company may have difficulty in the future meeting the extra annual interest cost of £1,800,000.

17.8

	Profit for the year	Retained earnings	Total equity	Current assets	Current liabilities
(a)	decrease £12,000	decrease £12,000	decrease £12,000	no change	increase £12,000
(b)	increase £50,000	increase £50,000	increase £50,000	no change	no change
(c)	no change	decrease £25,000	no change	no change	no change
(d)	decrease £43,000	decrease £43,000	decrease £43,000	no change	increase £43,000

17.9 (a) STOULBY LIMITED STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2006

	£
<i>Retained earnings</i>	
Balance at 1 January 2006	410,000
Profit for the year	<u>650,000</u>
	1,060,000
Dividend paid	(63,000)
Transfer to general reserve	<u>(120,000)</u>
Balance at 31 December 2006	<u>877,000</u>

	£	£
(b) TOTAL EQUITY AT 31 DECEMBER 2006		
Issued share capital		
4,000,000 ordinary shares of 50p each		2,000,000
Capital Reserve		
Share premium account		500,000
Revenue Reserves		
General reserve	*420,000	
Retained earnings	<u>877,000</u>	
		<u>1,297,000</u>
TOTAL EQUITY		<u>3,797,000</u>

* general reserve: £300,000 + £120,000 transfer

- (c) Revenue reserves are profits from trading activities which have been retained in the company to help build the company for the future
- (d) Retained earnings or general reserve
- (e) Revenue reserves can be used to fund dividend payments or to provide bonus shares to shareholders

17.10 (a)

DAVID MARK LIMITED					
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20-2					
	<i>Issued share capital</i>	<i>Share premium</i>	<i>General reserve</i>	<i>Retained earnings</i>	<i>Total</i>
	£	£	£	£	£
Balances at 1 January 20-2	250,000	–	75,000	*250,000	575,000
Profit for the year	–	–	–	150,000	150,000
Dividend paid	–	–	–	** (35,000)	(35,000)
Transfer to general reserve	–	–	45,000	(45,000)	–
Issue of shares	100,000	50,000	–	–	150,000
Balances at 31 December 20-2	350,000	50,000	120,000	320,000	840,000

* £400,000 – £150,000 profit for the year ** 500,000 shares x 7p

(b)

DAVID MARK LIMITED
SUMMARISED BALANCE SHEET AS AT 31 DECEMBER 20-2

	£	£
Non-current assets		<u>600,000</u>
Current assets		
Inventories		85,000
Trade and other receivables		60,000
Cash and cash equivalents		*132,000
		<u>277,000</u>
Current liabilities		
Trade and other payables		(37,000)
Net Current Assets		<u>240,000</u>
Net Assets		<u>840,000</u>
EQUITY		
Issued Share Capital		
700,000 ordinary shares of 50p each, fully paid		350,000
Capital Reserve		
Share premium account		50,000
Revenue Reserves		
Retained earnings	320,000	
General reserve	<u>120,000</u>	
		<u>440,000</u>
TOTAL EQUITY		<u>840,000</u>
* Cash and cash equivalents:	£	
balance at start	17,000	
share issue	150,000	
dividend paid	(35,000)	
closing balance	<u>132,000</u>	

- (c) • Limited company, or
- Private Limited Company
- (d) • The term 'Ltd' means that the shareholders of David Mark Limited have limited liability.
- This means that they could lose their investment but cannot be asked to contribute further in the case of liquidation (unless the shares are not fully paid).
- Thus the risk taken by shareholders is limited.

17.11 (a)

LEROY MCDADE PLC
INCOME STATEMENT (EXTRACT) FOR THE YEAR ENDED 31 DECEMBER 20-1

	£
Profit from operations	546,000
Finance costs	*(14,000)
Profit before tax	532,000
Tax	(180,000)
Profit for the year	<u>352,000</u>
	* £200,000 x 7%

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20-1

	£
<i>Retained earnings</i>	
Balance at 1 January 20-1	612,000
Profit for the year	<u>352,000</u>
	964,000
Dividend paid	(160,000)
Transfer to general reserve	<u>(50,000)</u>
Balance at 31 December 20-1	<u>754,000</u>

(b) **BALANCE SHEET EXTRACTS AS AT 31 DECEMBER 20-1**

EQUITY	£	£
Issued share capital		
3,200,000 ordinary shares of 50p each, fully paid		1,600,000
Capital Reserve		
Share premium account		800,000
Revenue Reserves		
General reserve	*200,000	
Retained earnings	<u>754,000</u>	
		<u>954,000</u>
TOTAL EQUITY		<u>3,354,000</u>

Current Liabilities

Trade and other payables	**85,200
Tax liabilities	<u>180,000</u>
	<u>265,200</u>

*general reserve: £150,000 + £50,000 transfer

** including debenture interest accrual £7,000

(c) Debentures*advantages to an investor:*

- a loan rather than shares
- will be repaid in ten years' time
- interest must be paid by the company
- interest rate is fixed and does not vary with profits/changes in general level of interest rates
- most debentures have security for their loan in the form of a mortgage over company assets
- in the event of liquidation of company, debenture holders are paid before shareholders
- lower risk than ordinary shares

disadvantages to an investor:

- no capital growth
- interest rate fixed, regardless of profits/changes in general level of interest rates

Ordinary shares*advantages to an investor*

- variable rate of dividend; if company prospers then higher dividends will be paid
- potential for capital gain if company does well
- voting rights, so a say in the development of the company
- not normally repayable

disadvantages to an investor:

- variable (or no) dividends
- risk of capital loss
- higher risk than debenture

17.12 (a)

PAFFTOL LIMITED
INCOME STATEMENT (EXTRACT) FOR THE YEAR ENDED 31 MARCH 2004

	£	£
Profit from operations		*476,000
Finance costs		**(28,000)
Profit before tax		448,000
Tax		(102,000)
Profit for the year		<u>346,000</u>

* Profit for year	676,000
Less: directors' fees	<u>200,000</u>
Profit from operations	<u>476,000</u>

** Debenture interest: £14,000 paid + £14,000 accrued = £28,000

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 MARCH 2004

<i>Retained earnings</i>	£
Balance at 1 April 2003	369,000
Profit for the year	<u>346,000</u>
	815,000
Dividend paid	(60,000)
Transfer to general reserve	<u>(50,000)</u>
Balance at 31 March 2004	<u>705,000</u>

(b)

BALANCE SHEET AS AT 31 MARCH 2004

Non-current Assets	Cost	Depreciation	Net book value
	£	£	£
Plant and machinery	1,420,000	192,000	1,228,000
Vehicles	710,000	150,000	560,000
	<u>2,130,000</u>	<u>342,000</u>	<u>1,788,000</u>
Current Assets			
Inventories			211,000
Trade and other receivables			24,900
Cash and cash equivalents			<u>113,600</u>
			<u>349,500</u>
Less Current Liabilities			
Trade and other payables			(*30,500)
Tax liabilities			<u>(102,000)</u>
			<u>(132,500)</u>
Net Current Assets			<u>217,000</u>
			2,005,000
Non-current Liabilities			
7% debentures (2015-2018)			(400,000)
Net Assets			<u>1,605,000</u>

EQUITY**Issued Share Capital**

500,000 ordinary shares of £1 each, fully paid 500,000

Capital Reserve

Share premium account 100,000

Revenue Reserves

General reserve **300,000

Retained earnings 705,000

1,005,000

TOTAL EQUITY

1,605,000

* including debenture interest accrual £14,000

** general reserve: £250,000 + £50,000 transfer

(c) **Issue of ordinary shares**

Advantages

- Ordinary shares are not normally repayable, so the company will have the finance for the foreseeable future.
- A variable dividend is paid, which is dependent on profits.
- If profits are low and a dividend is not paid in one year, the dividend is not carried forward.
- In the event of insolvency of the company, ordinary shareholders will be paid off last.
- The company's gearing ratio will be improved by the issue of ordinary shares.

Disadvantages

- The new shareholders will have voting rights.
- The power of existing shareholders will be diluted because there will be more shares in issue.

Gearing ratio

$$\frac{\pounds 400,000}{\pounds 1,605,000 + \pounds 600,000} = \frac{\pounds 400,000}{\pounds 2,205,000} = 0.18:1 \text{ or } 18\%, \text{ ie low-g geared}$$

* total equity

** 200,000 ordinary shares of £1 each + share premium of £2 each

Issue of debentures

Advantages

- Debentures do not carry voting rights so there will be no dilution of the power of existing shareholders.
- The interest rate is fixed, whatever may happen to the level of interest rates.
- The new debentures are at a rate of 6% which is lower than those currently in issue.
- The debt is not permanent and will be repaid at a date in the future.

Disadvantages

- The interest must be paid whether or not profits are made.
- A failure to pay interest could lead the company into insolvency.
- The company's gearing ratio will be worsened by the issue of debentures.
- Debenture holders may require security for their loan.
- Debentures will have a date in the future for repayment – cash will be needed for this.

Gearing ratio

$$\frac{\pounds 400,000 + \pounds 600,000}{\pounds 1,605,000} = \frac{\pounds 1,000,000}{\pounds 1,605,000} = 0.62:1 \text{ or } 62\%, \text{ ie high-g geared, but probably acceptable to lenders}$$

* new debentures

** total equity

17.13

	Avon £	Teme £
Non-current assets	300,000	400,000
Current assets (including bank)	200,000	700,000
	<u>500,000</u>	<u>1,100,000</u>
Ordinary shares of £1 each	400,000	600,000
Capital reserve: share premium account	–	300,000
Revenue Reserve: retained earnings	100,000	200,000
	<u>500,000</u>	<u>1,100,000</u>

AVON: STATEMENT OF CHANGES IN EQUITY				
	<i>Issued share capital</i>	<i>Share premium</i>	<i>Retained earnings</i>	<i>Total</i>
	£	£	£	£
At start	300,000	–	200,000	500,000
Issue of bonus shares	100,000	–	(100,000)	–
After share issue	<u>400,000</u>	<u>–</u>	<u>100,000</u>	<u>500,000</u>

TEME: STATEMENT OF CHANGES IN EQUITY				
	<i>Issued share capital</i>	<i>Share premium</i>	<i>Retained earnings</i>	<i>Total</i>
	£	£	£	£
At start	400,000	–	200,000	600,000
Issue of bonus shares	200,000	300,000	–	500,000
After share issue	<u>600,000</u>	<u>300,000</u>	<u>200,000</u>	<u>1,100,000</u>

- For Avon, £100,000 of reserves is capitalised
- For Teme, 200,000 additional shares are issued at a price of £2.50 per share: £500,000 cash is received (added to current assets); share premium account is 200,000 shares x £1.50 = £300,000