17 FINANCIAL STATEMENTS OF LIMITED COMPANIES

In the last few chapters we have looked at a number of adjustments made to the final accounts of sole traders in order to improve their relevance and reliability. In this chapter we turn our attention to limited companies and their financial statements (final accounts), including:

- the differences between ordinary shares and preference shares
- the use of loans and debentures to raise finance
- the concept of reserves, and the differences between capital reserves and revenue reserves
- the layout of a company's income statement (trading and profit and loss account), statement of changes in equity, and balance sheet for internal use
- recording the revaluation of freehold land and buildings
- recording bonus issues and rights issues on company balance sheets

COMPANIES ACT 2006

The Companies Act 2006 requires that companies produce financial statements (final accounts) and states the detailed information that must be disclosed. For larger companies the financial statements are audited by external auditors – this is a costly and time-consuming exercise (smaller companies are often exempt from audit). Nevertheless, the audit process enhances the reliability of the financial statements for stakeholders – such as shareholders, creditors and lenders. The financial statements must be sent to Companies House, where they are available for public inspection. The financial statements are available to all shareholders, together with a report on the company's activities during the year.

In this chapter we study the 'internal use' financial statements, rather than being concerned with the accounting requirements of the Companies Act 2006.

The financial statements comprise:

- an income statement
- a statement of changes in equity
- a balance sheet

INTRODUCTION TO LIMITED COMPANY ACCOUNTS

The preparation of the financial statements of limited companies is a natural progression from the final accounts of sole traders and partnerships. Similar layouts are used for limited companies; however some of the terminology is different. In particular, we use the terminology of international accounting standards (IAS) which, together with the Companies Act, form the 'rules' under which company financial statements must be prepared.

The diagram which follows shows the main changes to terminology and will help in the transition from sole trader and partnership final accounts to the financial statements of limited companies.

International accounting standards (IAS) terminology

Pre IAS terms	IAS terms
Final accounts	Financial statements
Trading and profit and loss account	*Income statement, or* *Statement of comprehensive income*
Turnover/Sales	Revenue
Interest payable	Finance costs
Net profit	Profit for the year
Balance sheet	*Balance sheet, or* *Statement of financial position*
Fixed assets	Non-current assets
Stocks	Inventories
Trade debtors	Trade receivables
Cash at bank and in hand	Cash and cash equivalents
Trade creditors	Trade payables
Long-term liabilities	Non-current liabilities
Capital and reserves	Equity

Important note: for the next few years both the 'old' and the 'new' terms will be used in the AS examination and will be accepted when answering examination questions.

Shares Issued by Limited Companies

Before we study the financial statements in detail we will examine first the principal ways in which a company raises finance by the issue of shares. There are different types of shares which appear in a company's balance sheet.

limited liability

One of the benefits of owning shares in a limited company is that the shareholders (members) of a company can only lose the amount of their investment. In the event of the company becoming insolvent (going 'bust'), the shareholders' personal assets are not available to the company's creditors because the shareholders have limited liability.

The amount of a shareholder's investment comprises the money paid for the shares, together with any money unpaid on their shares (unpaid instalments on new share issues, for example). This means that, if the company became insolvent, shareholders would have to pay any unpaid instalments to help pay the creditors. As this happens very rarely, shareholders are usually in a safe position.

authorised capital

Many companies have a stated amount of **authorised share capital** which is the maximum share capital that the company is allowed to issue. For companies formed prior to the Companies Act 2006, the statement of authorised share capital is given in a governing document of the company called the Memorandum of Association. Under the terms of the Companies Act 2006 there is no requirement for a company to have authorised capital – however, many existing companies will have been formed under earlier company legislation.

Where a company has an amount stated for authorised capital, it can increase the amount by passing a resolution at a general meeting of the shareholders. This will enable a company that has already issued the amount of the authorised capital to expand the business by issuing more shares.

Authorised capital can be shown as a note to the balance sheet for information.

issued capital

The **issued share capital** is the amount of share capital that the company has issued. Note that, where a company has authorised capital, the issued capital cannot exceed the amount authorised. Another name for issued capital is **called up share capital**.

Share capital – authorised and issued – may be divided into a number of classes or types of share; the main types are **ordinary shares** and, less commonly, **preference shares**.

ordinary (equity) shares

Ordinary shares – often called 'equities' – are the most commonly issued class of share which carry the main 'risks and rewards' of the business. The risks are of losing part or all of the value of the shares if the business loses money or becomes insolvent; the rewards are that they take a share of the profits – in the form of **dividends** – after allowance has been made for all expenses of the business, including

loan and debenture interest (see page 313), taxation, and after preference dividends (if any). Amounts paid as dividends to ordinary shareholders will vary: when a company makes large profits, it will have the ability to pay higher dividends to the ordinary shareholders; when losses are made, the ordinary shareholders may receive no dividend.

Often dividends are paid twice a year to shareholders. An **interim dividend** is paid just over half-way through the company's financial year and is based on the profits made during the first half of the year. A **final dividend** is paid early in the next financial year and is based on the profits made for the full year. Note that dividends are expressed as either pence per share or a percentage (based on the nominal value of the shares). For example, 5 pence per share is the same as a 5 per cent dividend for shares that have a nominal value of £1; 3 pence per share is the same as a 6 per cent dividend for shares that have a nominal value of 50 pence.

Companies rarely pay out all of their profits in the form of dividends; most retain some profits as reserves. These can always be used to enable a dividend to be paid in a year when the company makes little or no profit, always assuming that the company has sufficient cash in the bank to make the payment. Ordinary shareholders, in the event of the company becoming insolvent, will be the last to receive any repayment of their investment: other creditors will be paid off first.

Ordinary shares carry voting rights – thus shareholders have a say at the annual general meeting and at any other shareholders' meetings.

Ordinary shares are not normally repayable, so the company will have the finance for the foreseeable future.

preference shares

Whereas ordinary share dividends will vary from year-to-year, preference shares usually carry a fixed percentage rate of dividend – for example, "5 per cent preference shares" will receive a dividend of five per cent of nominal value (see next page). Their dividends are paid in preference to those of ordinary shareholders; but they are only paid if the company makes profits. In the event of the company ceasing to trade, the preference shareholders will also receive repayment of capital before the ordinary shareholders. Sometimes preference shares are issued as **redeemable** – this means that they are repayable at some date in the future.

Preference shares do not carry voting rights.

advantages and disadvantages of shares

To the company raising finance, the advantages and disadvantages of issuing ordinary and preference shares need to be considered.

ordinary shares

advantages to the company:

- ordinary shares are not normally repayable
- 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

disadvantage to the company:

- ordinary shareholders can speak and vote at a general meeting of the company, and each share carries one vote; this could be a problem to the company if the shareholders are dissatisfied

preference shares

advantages to the company:

- the dividend is fixed so, if profits of the company increase, more profit is retained in the company
- preference shareholders cannot vote at general meetings of the company, so they have little control over the company

disadvantages to the company:

- preference dividends are usually cumulative, that is they must be paid each year; if not, they have to be carried forward to the next year
- shareholders can attend meetings of the company (but cannot vote)
- preference shares may be redeemable (repayable) in the future
- in the event of insolvency of the company, preference shareholders must be repaid in full before any money can be paid to ordinary shareholders

nominal value of shares

Each share has a nominal value – or face value – which is entered in the accounts. Shares may be issued with nominal values of 5p, 10p, 25p, 50p or £1, or indeed for any amount. Thus a company with an issued share capital of £100,000 might divide this up into:

100,000 ordinary shares of 50p each	£50,000
50,000 five per cent preference shares of £1 each	£50,000
	£100,000

market value of shares

The market value is the price at which issued – or 'secondhand' – shares are traded. For ordinary shares this value can go up or down depending on, amongst other things, the success of the company – the 'risks and rewards' of equity shares. The market value usually bears little relationship to the nominal value. Note that only a small number of limited companies have their shares bought and sold on the Stock Exchange (eg Tesco, BT); the very large majority of companies are much smaller and are not quoted on the stock market and will only need to be valued if the company is up for sale.

issue price

This is the price at which shares are issued to shareholders by the company – either when the company is being set up, or at a later date when it needs to raise more funds. The issue price is either

'at par' (ie the nominal value), or above nominal value. In the latter case, the amount of the difference between issue price and nominal value is known as a **share premium** (see page 323): for example – nominal value £1.00; issue price £1.50; therefore share premium is 50p per share. Share premium often comes about when established companies issue additional shares – the new shareholders are paying extra to buy a stake in a profitable business.

LOANS AND DEBENTURES

In addition to money provided by shareholders, who are the owners of the company, further funds can be obtained by borrowing **loan capital**, usually in the form of loans or debentures.

loans

Loans are money borrowed by companies from lenders (such as banks) and investors on a medium or long-term basis. Generally repayments are made throughout the period of the loan, but can often be tailored to suit the needs of the borrower. Lenders often require security for loans so that, if the loan is not repaid, the lender has an asset – such as the company's premises – that can be sold.

Smaller companies are sometimes also financed by directors' loans.

debentures

Debentures are formal certificates issued by companies raising long-term finance from lenders and investors. Debenture certificates issued by large public limited companies are often traded on the Stock Exchange. Most debentures state the date they will be repaid, for example, "debentures 2020-2025" means that repayment will be made by the issuer between the years 2020 and 2025, at a date to be decided by the issuer. Debentures are commonly secured against assets such as property so that, in the event of the company ceasing to trade, the assets could be sold and used to repay the debenture holders.

Loans and debentures usually carry fixed rates of interest – for example, "5 per cent debentures" – that must be paid, just like other business expenses, whether a company makes profits or not. As loan and debenture interest is a business expense, this is shown in the income statement under the heading of 'finance costs'. In the event of the company ceasing to trade, loan and debenture-holders would be repaid before any shareholders.

A major advantage to a company of raising finance by means of loans and debentures is that the lender receives interest payments at an agreed rate and, if profits increase, more profit is retained in the company. However the disadvantage is that, if profits fall, interest payments must still be made and the company may cut dividends to ordinary shareholders; at worst the company could become insolvent.

Shares or Loan Capital? – an Investment Choice

A person who has money to invest in a company is faced with the dilemma of whether to buy ordinary shares, preference shares, or loans/debentures. To make the decision, much depends on the 'risk profile' of the investor – is he/she prepared to take risks (a risk taker), or is he/she a more cautious person (risk averse)? Then there is the question of how much income the investor wants from the shares or loans, and whether he/she wants to receive a regular income.

Bearing these points in mind, the main advantages and disadvantages to the investor of ordinary shares, preference shares, and loans/debentures are:

ordinary shares

advantages to the investor:

– ordinary shareholders can speak and vote at a general meeting of the company, and each share carries one vote
– if the company prospers, there is the potential for shares to increase in value giving the shareholder capital growth
– if the company makes high profits, there is the possibility of the shareholder receiving high dividends

disadvantages to the investor:

– there is the risk of losing some or all of the money invested if the share price falls
– the dividend will vary, being dependent on profits
– if a dividend is not paid in one year, it is not carried forward
– in the event of insolvency of the company, ordinary shareholders will be paid off last

preference shares

advantages to the investor:

– the dividend is paid at a fixed rate which will not go down if the general level of interest rates falls
– preference dividends are usually cumulative, that is they must be paid each year or, if not, they have to be carried forward to the next year
– less risky than ordinary shares
– in the event of insolvency of the company, preference shareholders must be repaid in full before any money can be paid to ordinary shareholders
– preference shareholders can attend general meetings of the company (but, usually, cannot vote)

disadvantages to the investor:

– generally, preference shareholders do not have voting rights
– the dividend rate is fixed, so there can be no growth in dividends if the company prospers
– there are fewer capital growth prospects than with ordinary shares

loans/debentures

advantages to the investor:

- where a fixed rate of interest is paid, this will not go down if the general level of interest rates falls
- the interest must be paid by the company each year
- loans and debentures are are a much safer investment than shares because they are often backed by the security of the company's assets
- in the event of insolvency of the company, loan and debenture holders will look firstly to their security backing; in any case, they must be repaid in full before anything is paid to shareholders
- altogether, loans and debentures are a much safer investment than shares

disadvantages to the investor:

- where a fixed rate of interest is paid, loan and debenture holders will not receive any benefit from any increase in the general level of interest rates
- there are no prospects for capital growth

the gearing ratio

In order to check the long-term financial stability of a company we use an accounting ratio called **gearing** (see Chapter 18 for more on ratios). Gearing measures the balance of the company's financing between debt and equity as follows:

$$\frac{\text{Debt (loan capital + preference shares, if any)}}{\text{Equity (ordinary shares + reserves)}}$$

Gearing can be expressed as either a ratio or a percentage (to get a percentage multiply the ratio by 100). The higher the gearing, the less secure will be the company. This is because debt can be costly in terms of interest payments (if a company's profit falls, or a loss is made, interest on debt must still be paid).

It is difficult to set an acceptable standard for gearing – much depends on the individual company. However, in general, investors would not wish to see gearing exceeding a ratio of 1:1 (a percentage of 100%). At this level, the debt (loan capital + preference shares, if any) is the same as the equity (ordinary shares + reserves) stake in the company. Experience shows that this is the point beyond which a company will have difficulty in making interest payments on its debt – a failure to keep up with interest payments often leads to insolvency of the company.

We will look more at the gearing ratio in the next chapter.

Income Statement

A limited company uses a similar form of financial statements (final accounts) as a sole trader, although the term income statement is used instead of trading and profit and loss account.

There are two expense items commonly found in the income statement of a limited company that are not found in those of other business types:

- **directors' remuneration** – ie amounts paid to directors; as directors are employed by the company, their pay appears amongst the income statement expenses of the company – this contrasts with the drawings taken by a sole trader which appear in the balance sheet
- **loan/debenture interest** – as already noted, the interest on loans and debentures is shown as a finance cost in the income statement

Note that a figure is shown in the income statement for **profit from operations** after the deduction of expenses, but before the deduction of finance costs (such as debenture interest, bank and loan interest). The profit from operations of a company is important to investors, lenders and other stakeholders because it shows them the profit made after deduction of the running expenses (distribution expenses, sales and marketing expenses, and administration expenses) but before finance costs are deducted, ie it shows them the ability of the company to generate profits from its day-to-day activities.

The income statement concludes with the profit for the year. Limited company accounts require a further statement – a **statement of changes in equity** – to show how the profit for the year has been distributed and to provide a link to the balance sheet. The following shows how to set out the part of a statement of changes in equity that deals with retained earnings:

Statement of changes in equity (extract)

*Retained earnings**	£
Balance at start of year	x
Profit for the year	x
Transfers from other reserves	x
	x
Dividends paid in the year	(x)
Transfers to other reserves	(x)
Balance at end of the year	x

* retained earnings is a revenue reserve – see page 323

Notes:

- dividends paid include *interim dividends* (usually paid just over half-way through the financial year) and the previous year's *final dividends* (proposed at the end of the previous year, but paid early in the current financial year)
- transfers to and from other reserves – see below

- the balance at the end of the year is shown on the balance sheet as 'retained earnings' in the equity section
- statements of changes in equity where there has been an issue of shares are shown on page 326

The diagram on pages 318 and 319 shows the income statement of Orion Limited as an example. Explanations are set out on the left-hand page.

BALANCE SHEET

The balance sheet of limited companies follows a similar layout for those of sole traders and partnerships, but the equity section is more complex with the issued shares and various reserves. The diagram on pages 320 and 321 shows the balance sheet of Orion Limited as an example. Explanations are set out on the left-hand page.

TOTAL EQUITY

On a company balance sheet, the total equity section represents the stake of the ordinary shareholders in the company and comprises:

- issued ordinary shares
- capital reserves (see page 322)
- revenue reserves (see page 323)

Total equity in a company balance sheet is the same concept as the owner's capital in a sole trader balance sheet.

DEALING WITH DIVIDENDS IN THE FINANCIAL STATEMENTS

Dividends are distributions to the shareholders, who own the company, as a return on their investment. Many companies pay dividends twice a year – an *interim dividend*, which is usually paid just over halfway through the financial year, and a *final dividend* which is paid early in the next financial year. The interim dividend is based on the profits reported by the company during the first half of the year, while the final dividend is based on the profits reported for the full year. The final dividend is proposed by the directors and has to be approved by shareholders at a meeting of the company. Thus the financial calendar for a company with a financial year end of 31 December 20-8 might take the following form:

continued on page 322

Revenue is sales less sales returns, ie the turnover of the company.

Other income could include rental income, cash discount, profit on sale of assets, etc.

The **overheads** of a limited company are usually split between the expenses of distribution, sales and marketing, and administration, although different headings can be used, eg wages, depreciation of assets, etc.

The company has recorded a **profit from operations** (operating prfit) of £49,000, before deduction of finance costs (such as debenture interest, bank and loan interest).

Tax, the corporation tax that a company has to pay, based on its profits, is shown. We shall not be studying the calculations for corporation tax in this book. It is, however, important to see how the tax is recorded in the financial statements.

The company has recorded a **profit for the year**, ie after deducting finance costs and tax, of £28,000. This amount is taken to the statement of changes in equity.

The **statement of changes in equity**, of which an extract is shown here, demonstrates how profit for the year is added to the brought forward balance of retained earnings (a revenue reserve), while dividends paid during the year are deducted. The resultant balance of retained earnings at the end of the year is shown in the balance sheet in the equity section.
Also included in the statement of changes in equity would be other items such as a new issue of shares (see page 324) and the increase in value from, for example, an upwards revaluation of property.

ORION PLC

INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 20-6

	£	£
Revenue		725,000
Opening inventories	45,000	
Purchases	381,000	
	426,000	
Less Closing inventories	50,000	
Cost of sales		(376,000)
Gross profit		349,000
Other income		10,000
		359,000
Overheads:		
Distribution expenses	(85,000)	
Sales and marketing expenses	(100,000)	
Administration expenses	(125,000)	
		(310,000)
Profit/(loss) from operations		49,000
Finance costs		(6,000)
Profit/(loss) before tax		43,000
Tax		(15,000)
Profit/(loss) for the year		28,000

STATEMENT OF CHANGES IN EQUITY (EXTRACT)

Retained earnings	
Balance at 1 January 20-6	41,000
Profit for the year	28,000
	69,000
Dividends paid in the year	(20,000)
Balance at 31 December 20-6	49,000

The **non-current assets** section of a limited company balance sheet usually distinguishes between:

intangible non-current assets, which do not have material substance but belong to the company and have value, eg goodwill (the amount paid for the reputation and connections of a business that has been taken over), patents and trademarks; the intangible non-current assets are amortised (depreciated).

property, plant and equipment, which are tangible (ie have material substance) non-current assets and are depreciated over their useful lives.

As well as the usual **current liabilities**, for limited companies, this section also contains the amount of tax to be paid within the next twelve months.

Non-current liabilities are those liabilities that are due to be repaid more than twelve months from the date of the balance sheet, eg loans and debentures.

Authorised share capital can be included on the balance sheet 'for information', but is not added into the balance sheet total, as it may not be the same amount as the issued share capital. Alternatively it may be disclosed as a note to the balance sheet for information.

Issued share capital shows the shares that have been issued. In this balance sheet, the ordinary shares are described as being fully paid, meaning that the company has received the full amount of the value of each share from the shareholders. Sometimes shares will be partly paid, eg ordinary shares of £1, but 75p paid. This means that the company can make a call on the shareholders to pay the extra 25p to make the shares fully paid.

Capital reserves (see page 322) are created as a result of non-trading profit and cannot be distributed as dividends.

Revenue reserves (see page 323) are retained earnings from the statement of changes in equity and can be distributed as dividends.

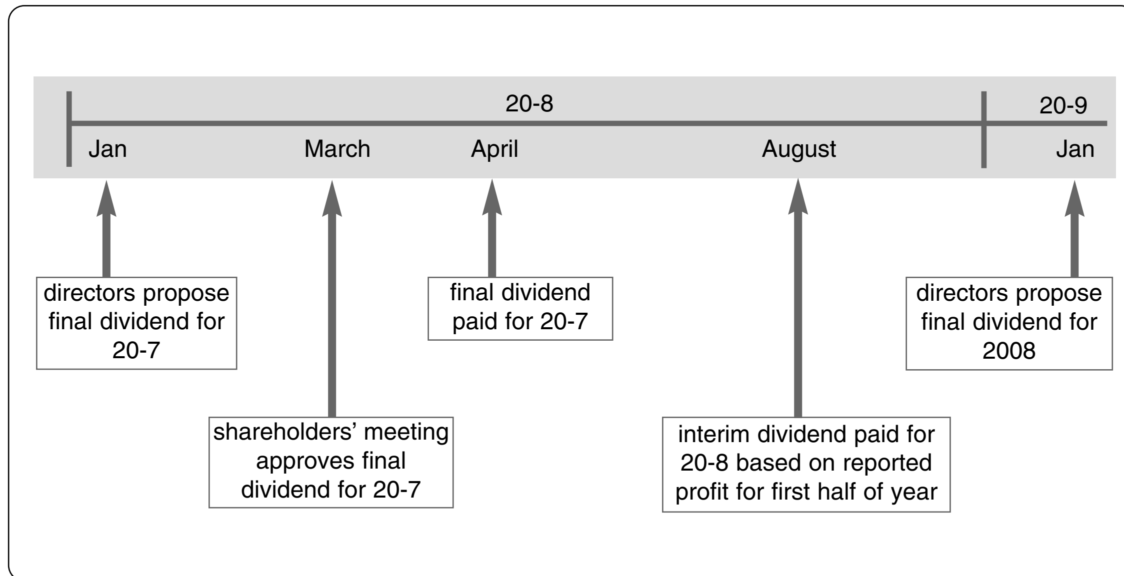
Total equity is the stake of the ordinary shareholders in the company. It comprises issued ordinary share capital, plus capital and revenue reserves.

ORION PLC

BALANCE SHEET AS AT 31 DECEMBER 20-6

Non-current Assets	*Valuation*	*Cost*	*Depreciation*	*Net book value*
	£	£	£	£
Intangible				
Goodwill		50,000	20,000	30,000
Property, plant and equipment				
Freehold land and buildings	280,000		40,000	240,000
Machinery		230,000	100,000	130,000
Fixtures and fittings		100,000	25,000	75,000
	280,000	380,000	185,000	475,000
Current Assets				
Inventories				50,000
Trade and other receivables				38,000
Cash and cash equivalents				21,000
				109,000
Current Liabilities				
Trade and other payables				(30,000)
Tax liabilities				(15,000)
				(45,000)
Net Current Assets				64,000
				539,000
Non-current Liabilities				
7% debentures (repayable in 20-9)				(60,000)
Net Assets				479,000
EQUITY				
Authorised Share Capital				
600,000 ordinary shares of £1 each				600,000
Issued Share Capital				
400,000 ordinary shares of £1 each, fully paid				400,000
Capital Reserves				
Share premium account			10,000	
Revaluation reserve			20,000	
				30,000
Revenue Reserve				
Retained earnings				49,000
TOTAL EQUITY				479,000

Note: the balance sheet can be presented using a number of columns, as required.



Only the dividends paid during the year can be recorded in the financial statements. In the above example, the dividends paid in April 20-8 (final dividend for the previous year) and August 20-8 (interim dividend for the current year) are recorded in the financial statements for the year ended 31 December 20-8. The proposed final dividend for the year ended 31 December 20-8 is disclosed as a note to the accounts, stating that it is subject to approval by the shareholders at a company meeting. All dividends for the year which have been authorised and paid are shown in the statement of changes in equity.

RESERVES

A limited company rarely distributes all its profits to its shareholders. Instead, it will often keep part of the profits earned each year in the form of reserves. There are two types of reserves:

- capital reserves, which are created as a result of a non-trading profit, or may be unrealised profits
- revenue reserves, which are retained profits from the income statement

capital reserves

Capital reserves are created as a result of a non-trading profit. Note that capital reserves cannot be used to fund dividend payments.

Examples of capital reserves include:

- **Revaluation reserve.** This occurs when a non-current asset, most probably freehold land and buildings, is revalued (in an upwards direction) in the balance sheet. The amount of the revaluation is placed in a revaluation reserve where it increases the value of the ordinary shareholders' investment in the company.

  In the example below a company revalues its freehold land upwards by £250,000 from £500,000 to £750,000.

BALANCE SHEET (EXTRACTS)

Before revaluation	£
Non-current asset: freehold land at cost	500,000
Ordinary shares of £1 each	500,000
After revaluation	
Non-current asset: freehold land at revaluation	750,000
Ordinary shares of £1 each	500,000
Capital reserve: revaluation reserve	250,000
	750,000

  The book-keeping entry for this revaluation transaction is:

  – debit freehold land account £250,000

  – credit revaluation reserve account £250,000

  Note that this is purely a 'book' adjustment – no cash has changed hands.

- **Share premium account.** An established company may issue additional shares to the public at a higher amount than the nominal value. For example, a company seeks finance for further expansion by issuing additional ordinary shares. The shares have a nominal value of £1 each, but, because it is a well-established company, the shares are issued at £1.50 each. Of this amount, £1 is recorded in the issued share capital section, and the extra 50p is the share premium.

revenue reserves

Revenue reserves are profits from trading activities which have been retained in the company to help build the company for the future. Revenue reserves include the balance of retained earnings from the statement of changes in equity (see page 316). Also, there may be named revenue reserve accounts, such as general reserve, or a revenue reserve for a specific purpose, eg a reserve for the replacement of machinery. Transfers to or from these named revenue reserve accounts are made in the statement of changes in equity.

As revenue reserves have been created from the trading activities of the company, they are available to fund dividend payments (as we have seen on page 316, dividends paid and authorised are deducted in the statement of changes in equity). A further use of revenue reserves is to provide bonus shares for shareholders (see below).

reserves: profits not cash

It should be noted that reserves – both capital and revenue – are not cash funds to be used whenever the company needs money, but are in fact represented by assets shown on the balance sheet. The reserves record the fact that the assets belong to the ordinary shareholders via their ownership of the company.

Bonus Issues and Rights Issues

Limited companies – and particularly public limited companies – quite often increase their capital by means of either **bonus issues** or **rights issues** of shares. Whilst both of these have the effect of increasing the number of shares in issue, they have quite different effects on the structure of the company balance sheet.

bonus issues

A bonus issue is made when a company issues free shares to existing ordinary shareholders; it does this by using reserves that have built up and capitalising them (ie they are turned into permanent share capital). The bonus issue is distributed on the basis of existing shareholdings – for example, one bonus share for every two shares already held.

With a bonus issue no cash flows in or out of the company. The shareholders are no better off: with more shares in issue the stock market price per share will fall in proportion to the bonus issue, ie the company's net assets are now spread among a greater number of shares.

Bonus issues are made in order to acknowledge the fact that reserves belong to shareholders. Often a build-up of reserves occurs because a company hasn't the cash to pay dividends, so a bonus issue is a way of passing the reserves to ordinary shareholders.

Note that capital or revenue reserves can be used for bonus issues. If there is a choice, then capital reserves are used first – this is because it is one of the few uses of a capital reserve, which cannot be used to fund the payment of dividends.

rights issues

A rights issue is used by a company seeking to raise further finance through the issue of shares. Instead of going to the considerable expense of offering additional shares to the public, it is cheaper to offer shares to existing shareholders at a favourable price (a little below the current market value). As with a bonus issue the extra shares are offered in proportion to the shareholders' existing holding. The shareholder may take up the rights by subscribing for the shares offered; alternatively the rights can often be sold on the stock market.

WORKED EXAMPLE: BONUS ISSUES AND RIGHTS ISSUES

situation

The following are the summary balance sheets of Severn plc and Wye plc:

	Severn	*Wye*
	£	£
Non-current assets	300,000	300,000
Current assets (including bank)	100,000	100,000
	400,000	400,000
Ordinary shares of £1 each	200,000	200,000
Revenue reserve: retained earnings	200,000	200,000
	400,000	400,000

Severn is planning a one-for-two bonus issue.

Wye is seeking finance for a major expansion programme through a one-for-two rights issue at a price of £1.80 per share.

solution

After the issues, the balance sheets are:

	Severn	*Wye*
	£	£
Non-current assets	300,000	300,000
Current assets (including bank)	100,000	280,000
	400,000	580,000
Ordinary shares of £1 each	300,000	300,000
Capital reserve: share premium account	–	80,000
Revenue reserve: retained earnings	100,000	200,000
	400,000	580,000

The changes are:

Severn Reserves are reduced by £100,000, whilst share capital is increased by the same amount; the ordinary share capital is now more in balance with non-current assets; no cash has been received.

Wye The bank balance has increased by £180,000, being 100,000 shares (assuming that all shareholders took up their rights) at £1.80; share capital has increased by £100,000, whilst 80p per share is the share premium, ie £80,000 in total. The company now has the money to finance its expansion programme. There are also significant reserves which could be used for a bonus issue in the future.

The statement of changes in equity (see page 316) for each company are:

Severn: Statement of changes in equity

	Issued share capital	*Share premium*	*Retained earnings*	*Total*
	£	£	£	£
At start	200,000	–	200,000	400,000
Issue of bonus shares	100,000	–	(100,000)	–
After share issue	300,000	–	100,000	400,000

Wye: Statement of changes in equity

	Issued share capital	*Share premium*	*Retained earnings*	*Total*
	£	£	£	£
At start	200,000	–	200,000	400,000
Issue of shares at a premium	100,000	80,000	–	180,000
After share issue	300,000	80,000	200,000	580,000

differences between a bonus issue and a rights issue

bonus issue	rights issue
• additional shares given free to existing ordinary shareholders	• additional shares offered for sale to existing shareholders in proportion to their holdings
• the capitalisation of reserves into share capital	• offer price is below the current market value
• distributed in proportion to existing shareholdings	• shareholders can either buy the additional shares or can sell the rights on the stock market
• no payment made for shares	• company receives payment from shares sold
• stock market price of shares falls in proportion to bonus issue	• stock market price of shares may fall slightly (because offer price is below current market price)

CHAPTER SUMMARY

- Shareholders have limited liability, but will be liable for any money unpaid on their shares.
- The main types of shares that may be issued by companies are ordinary shares and preference shares.
- Loan capital in the form of loans and debentures is a further source of finance.
- The gearing ratio is used to check the long-term financial stability of a company.
- The financial statements of a company include a statement of changes in equity, which follows the income statement.
- The balance sheet of a limited company includes a total equity section which states the ownership of the company by its shareholders:
  - ordinary shares issued
  - capital reserves and revenue reserves
- Capital reserves are created as a result of a non-trading profit and cannot be used to fund dividend payments.
- Revenue reserves are profits from trading activities.

- A bonus issue is the capitalisation of reserves – either capital or revenue – in the form of free shares issued to existing ordinary 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.

In the next chapter we look at how we can assess business performance by interpreting and analysing the financial statements. To help us in this we shall be calculating ratios, percentages and other performance indicators.

QUESTIONS

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17.1 Distinguish between:

(a) ordinary shares and preference shares

(b) nominal value and market value of shares

(c) capital reserves and revenue reserves

(d) a bonus issue and a rights issue

17.2 Explain where the following items appear in a limited company's financial statements:

(a) debenture interest

(b) directors' remuneration

(c) corporation tax

(d) dividends paid

(e) revaluation reserve

(f) goodwill

17.3

Chapelporth Limited has a balance of retained earnings of £185,000 at 1 July 20-7, the beginning of its financial year.

The company has made an operating profit of £135,000 for the year ended 30 June 20-8.

The following payments have been made during the year ended 30 June 20-8:

	£
• debenture interest	12,500
• final ordinary dividend for the yer ended 30 June 20-7	30,500
• interim ordinary dividend for the half-year ended 31 December 20-7	18,000

Corporation tax to be paid for the year ended 30 June 20-8 is £48,000.

You are to

- complete the income statement from the profit from operations of £135,000 for the year ended 30 June 20-8
- prepare the statement of changes in equity for retained earnings for the year ended 30 June 20-8

17.4

Mason Motors Limited is a second-hand car business. The following information is available for the year ended 31 December 20-1:

- retained earnings at 1 January 20-1 is £100,000
- operating profit for the year was £75,000
- loan interest of £5,500 was paid
- a transfer to general reserve of £20,000 was made
- corporation tax of £20,050 is to be paid on the year's profit
- an interim dividend of 10% was paid on the issued ordinary share capital of £100,000

You are to

(a) complete the income statement from the profit from operations of £75,000 for the year ended 31 December 20-1

(b) prepare the statement of changes in equity for retained earnings for the year ended 31 December 20-1

(c) state how you would reply to one of the directors of the company who asks if the £20,000 transferred to general reserve could be used to rebuild the garage forecourt

17.5

The following figures are taken from the accounting records of Jobseekers Limited, a recruitment agency, at the end of the financial year on 31 December 20-6:

	£
Issued share capital (£1 ordinary shares), fully paid	100,000
Premises at cost	175,000
Depreciation of premises to date	10,500
Office equipment at cost	25,000
Depreciation of office equipment to date	5,000
Goodwill at cost	20,000
Amortisation* of goodwill to date	6,000
Inventories	10,750
Trade and other receivables	42,500
Trade and other payables	17,250
Cash and cash equivalents	1,950
Bank loan (repayable in 20-9)	55,000
Profit for the year	68,200
Corporation tax owing for the year	14,850
Interim ordinary dividend paid	10,000
Retained earnings at 1 January 20-6	8,400

* amortisation is similar to depreciation

You are to prepare the statement of changes in equity for the year ended 31 December 20-6, together with a balance sheet at that date.

17.6

Jill and her brother Jack have recently inherited £10,000 each. They wish to invest all of their inheritance in Multar plc.

They could invest in one of the following:

ordinary shares

7% preference shares

6% debentures

Jill does not mind taking risks with any money she has whereas her brother is a much more cautious person. He is looking for an investment which will give him a steady income.

REQUIRED

(a) State **one** advantage **and one** disadvantage of each type of investment.

Ordinary shares

Advantage ....

....

Disadvantage ....

....

7% preference shares

Advantage ....

....

Disadvantage ....

....

6% debentures

Advantage ....

....

Disadvantage ....

....

(b) Advise Jill which type of investment she should choose.

....

....

....

(c) Advise Jack which type of investment he should choose.

....

....

....

Assessment and Qualifications Alliance (AQA), 2003

17.7

(a) The profit for the year ended 31 May 20-3 of Srian plc is £6,000,000. The following information for the year is available:

	£
Retained earnings at 1 June 20-2	3,400,000
Ordinary dividends – paid	800,000
Transfer to general reserve	2,000,000

REQUIRED

Prepare the statement of changes in equity for retained earnings for the year ended 31 May 20-3.

(b) The following has been extracted from the balance sheet of Srian plc as at 31 May 20-3.

	£
Ordinary shares of £1 each fully paid	25,000,000
6% Debentures	20,000,000

The directors have seen an opportunity to expand the company's operation. They need to raise £30,000,000.

The directors are considering raising the whole amount by

either an issue of 20,000,000 ordinary shares at £1.50 each

or an issue of £30,000,000 6% debentures.

REQUIRED

Evaluate the two methods of raising finance being considered by the directors of the company.

Assessment and Qualifications Alliance (AQA), 2003 (with amendments)

Tutorial note: part (b) of the question requires an evaluation of two ways in which Srian plc could finance an expansion scheme; your evaluation should include a written comment on the advantages and disadvantages of ordinary shares and debentures, together with a calculation and comment on the gearing ratio under each option.

17.8

The following is the summarised draft balance sheet of Vlasmin plc as at 31 March 2002.

	Cost	*Depreciation*	*Net book value*
	£000	*£000*	*£000*
Non-current assets	1,000	620	380
Current assets		420	
Less Current liabilities		360	60
			440
Ordinary share capital			200
Retained earnings			240
			440

Depreciation has been charged on all non-current assets at 20% per annum using the straight-line method.

After preparing the draft balance sheet the directors of Vlasmin plc have decided to incorporate the following changes in the financial statements.

(a) Wages due but unpaid at the year end amounted to £12,000.

(b) Depreciation on all non-current assets (fixed assets) is to be charged at 15% per annum using the straight-line method.

(c) A transfer of £25,000 to a general reserve.

(d) Corporation tax of £43,000 to be paid on the year's profit.

REQUIRED

Using the table below show the effect that any amendments resulting from notes (a) to (d) above will have on the balance sheet of Vlasmin plc.

If you believe that there is no amendment necessary write *no change*.

Note (a) has been completed as an example.

Note	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)					
(c)					
(d)					

Assessment and Qualifications Alliance (AQA), 2002 (with amendments)

17.9

The directors of Stoulby Ltd provided the following information before the preparation of the final accounts for the year ended 31 December 2006.

	£
Issued capital – 4,000,000 ordinary shares of 50 pence each	2,000,000
Retained earnings 1 January 2006	410,000
General reserve	300,000
Share premium account	500,000
Ordinary dividend paid on 3 August 2006	63,000

Additional information

(1) Profit for the year ended 31 December 2006 was £650,000.

(2) A transfer of £120,000 to general reserve is to be made.

REQUIRED

(a) Prepare the statement of changes in equity for retained earnings for the year ended 31 December 2006.

(b) Prepare the total equity section of the balance sheet at 31 December 2006.

(c) Explain the term 'revenue reserve'.

(d) Identify **one** example of a revenue reserve from the information given for Stoulby Ltd.

(e) Explain **one** way in which a revenue reserve may be used.

Assessment and Qualifications Alliance (AQA), 2007 (with amendments)

17.10

The following is the summarised draft balance sheet as at 31 December 20-2 for David Mark Ltd.

	£
Non-current assets	600,000
Current assets	
Inventories	85,000
Trade and other receivables	60,000
Cash and cash equivalents	17,000
	162,000
Less Current liabilities	
Trade and other payables	(37,000)
	125,000
	725,000
Equity	
Ordinary shares of 50 pence each	250,000
Retained earnings	400,000
General reserve	75,000
	725,000

The company's profit for the year was £150,000, which has been included in the retained earnings figure shown in the balance sheet above.

Additional information:

The following have **not** yet been taken into consideration

- Transfer to general reserve £45,000
- A final dividend on ordinary shares of 7 pence per share paid on 20 December 20-2
- An issue of 200,000 ordinary shares of 50 pence each at 75 pence per share.

  (*Note*: these shares are not eligible for dividend in the year ended 31 December 20-2)

REQUIRED

(a) Complete the following statement of changes in equity for the year ended 31 December 20-2:

DAVID MARK LIMITED
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20-2

	Issued share capital £	*Share premium* £	*General reserve* £	*Retained earnings* £	*Total* £
Balances at 1 January 20-2	....	....	....	....	....
Profit for the year	....	....	....	....	....
Dividend paid	....	....	....	....	....
Transfer to general reserve	....	....	....	....	....
Issue of shares	....	....	....	....	....
Balances at 31 December 20-2	....	....	....	....	....

(b) Prepare the summarised balance sheet as at 31 December 20-2 as it would appear, after taking into account the additional information listed above.

(c) State the type of business ownership that would have "Ltd" as part of its name.

(d) Assess the importance of the term "Ltd" to an ordinary shareholder in David Mark Ltd.

Assessment and Qualifications Alliance (AQA), 2003 (with amendments)

17.11

The following information has been extracted from the books of account of Leroy McDade plc as at 31 December 20-1.

	£
Issued share capital:	
ordinary shares of 50p each, fully paid	1,600,000
7% debentures (repayable in 10 years' time)	200,000
Share premium account	800,000
Retained earnings 1 January 20-1	612,000
General reserve	150,000
Ordinary dividend paid 4 August 20-1	160,000
Trade payables	78,200
Corporation tax liability	180,000

Additional information:

- Operating profit for the year was £546,000.
- Debenture interest is payable half-yearly to 30 June and 31 December. It is paid to debenture holders on 27 July and 27 January each year.
- A transfer to general reserve of £50,000 is to be made.

REQUIRED

(a) Complete the income statement and prepare the statement of changes in equity for retained earnings for the year ended 31 December 20-1 of Leroy McDade plc.

(b) Prepare balance sheet extracts as at 31 December 20-1 for Leroy McDade plc showing the sections for:

(i) equity, and

(ii) current liabilities.

(c) Discuss the advantages and disadvantages that an investor should consider when deciding whether to invest in debentures or ordinary shares.

Assessment and Qualifications Alliance (AQA), 2002 (with amendments)

17.12 The following balances have been extracted from the books of account of Pafftol Ltd after a draft income statement was prepared for the year ended 31 March 2004.

	£
Issued share capital:	
ordinary shares £1 each fully paid	500,000
7% debentures (2015-2018)	400,000
Plant and machinery at cost	1,420,000
Vehicles at cost	710,000
Provisions for depreciation:	
plant and machinery	192,000
vehicles	150,000
Profit for the year	676,000
Retained earnings 1 April 2003	369,000
Bank balance (debit)	113,600
General reserve	250,000
Share premium account	100,000
Inventories 31 March 2004	211,000
Trade receivables	24,900
Trade payables	16,500
Ordinary dividend paid	60,000

Additional information and instructions

The following have not been included in the balances shown above:

(1) directors' fees £200,000;

(2) debenture interest paid £14,000;

(3) debenture interest accrued £14,000;

(4) corporation tax payable £102,000;

(5) transfer to general reserve £50,000.

REQUIRED

(a) Complete the income statement and prepare the statement of changes in equity for retained earnings for the year ended 31 March 2004.

(b) Prepare a balance sheet as at 31 March 2004.

The directors of Pafftol Ltd wish to raise £600,000 additional capital. They are unsure whether to:

(1) issue a further 200,000 ordinary shares with a nominal value of £1 each at a premium of £2 each;

or

(2) issue 6% debentures.

REQUIRED

(c) Advise the directors which of the two options would be the most beneficial to the company.

Assessment and Qualifications Alliance (AQA), 2004 (with amendments)

17.13 The following are the summary balance sheets of Avon plc and Teme plc:

	Avon	*Teme*
	£	£
Non-current assets	300,000	400,000
Current assets (including bank)	200,000	200,000
	500,000	600,000
Ordinary shares of £1 each	300,000	400,000
Revenue reserve: retained earnings	200,000	200,000
	500,000	600,000

Avon is planning a one-for-three bonus issue.

Teme is seeking finance for a major expansion programme through a one-for-two rights issue at a price of £2.50 per share.

You are to

(a) show the balance sheets of Avon plc and Teme plc after the issues have taken place (assume that the issues have been taken up fully)

(b) complete the following statement of changes in equity for each company:

AVON: STATEMENT OF CHANGES IN EQUITY

	Issued share capital	*Share premium*	*Retained earnings*	*Total*
	£	£	£	£
At start	....	....	....	....
Issue of bonus shares	....	....	....	....
After share issue	....	....	....	....

TEME: STATEMENT OF CHANGES IN EQUITY

	Issued share capital	*Share premium*	*Retained earnings*	*Total*
	£	£	£	£
At start	....	....	....	....
Issue of bonus shares	....	....	....	....
After share issue	....	....	....	....