Introduction to company accounting

- Limited liability companies
- Shares
- Reserves
- Bonus and rights issues

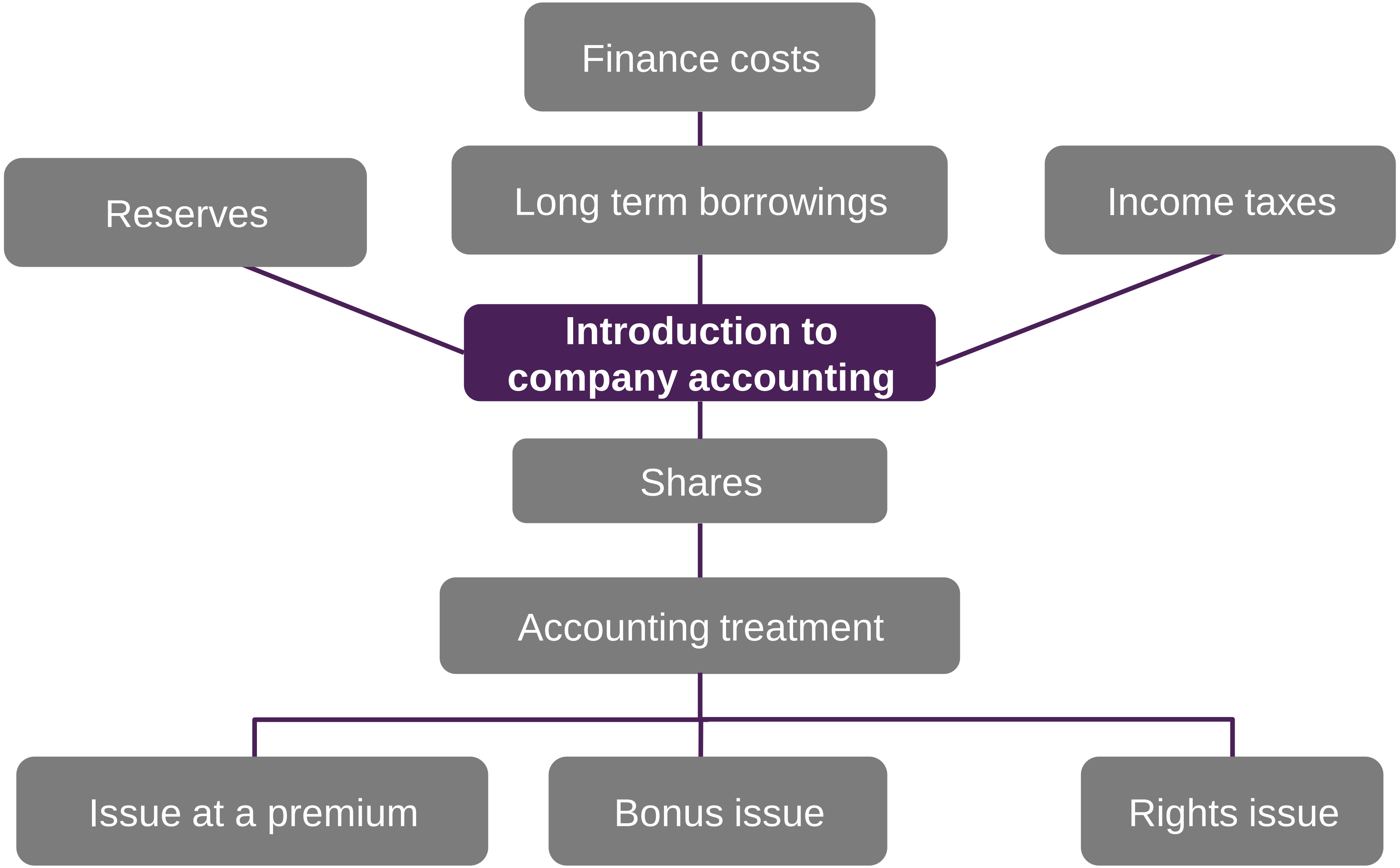
Syllabus learning outcomes 1

- Understand the capital structure of a limited liability company including ordinary shares, preference shares and loan notes.
- Record movements in the share capital and share premium accounts.
- Define a bonus issue and a rights issue, their advantages and disadvantages and show how they are recorded in the statement of financial position.

Syllabus learning outcomes 1

- Identify and record the other reserves which may appear in the company statement of financial position.
- Record dividends in ledger accounts and the financial statements.
- Calculate and record finance costs in ledger accounts and the financial statements.

Overview


Finance costs
Reserves
Long term borrowings
Income taxes
Introduction to company accounting
Shares
Accounting treatment
Issue at a premium
Bonus issue
Rights issue

Limited liability companies 1

Features

Limited liability companies offer limited liability to their owners (shareholders).

If the company becomes insolvent, the maximum amount that an owner stands to lose is his share of the capital of the business.

This is an attractive prospect to investors. Limited liability companies may be private or public. IAS 1 sets out a suggested format for financial statements.

Limited liability companies 2

- Owners = shareholders or members
- Large number of owners
- Owner/manager split
- Owners appoint directors to run business on their behalf
- Owners receive share of profits in form of dividends

Limited liability companies 3

Disadvantages

- Compliance with national legislation
- Compliance with national accounting standards and/or IFRS
- Any formation or annual registration costs

Limited liability companies 4

Funding

Companies are funded in the following ways:

- Retained profits
- Share capital
- Short term liabilities (trade accounts payable etc)
- Loan notes

Limited liability companies 4

Capital = Equity + Debt

- Equity is the money that belongs to the owners
- Debt is the money that belongs to outsiders

Debt has two features;

1. A predetermined / agreed rate of return
2. A fixed duration after which it must be returned

Limited liability companies 4

Capital = Equity + Debt

Equity Components are;

1. Share Capital
2. Share Premium
3. Retained Earnings (Profits – dividend)
4. Reserves

Debt

1. Bank Loans
2. Bonds
3. Notes Payable, etc

Specimen paper question

ACCA

Section A

Question 3 | 0 of 2 marks

Time Remaining 1:57:03

Exam 0% Complete

Exam Progress Details

FFA-Financial Accounting (Full Exam)

Exit

Which of the following statements are TRUE about limited liability companies?

(1) The company exposure to debt and liability is limited

(2) Financial statements must be produced

(3) A company continues to exist regardless of the identity of its owners

- 1 and 3 only
- 1, 2 and 3
- 2 and 3 only
- 1 and 2 only

Source: ACCA Paper FFA/F3 Financial Accounting Specimen Exam

Specimen paper answer

ACCA

Section A

Question 3 — 2 of 2 marks

Time Remaining 1:58:11

Exam 4% Complete

Exam Progress Details

FFA-Financial Accounting (Full Exam)

Exit

Which of the following statements are TRUE about limited liability companies?

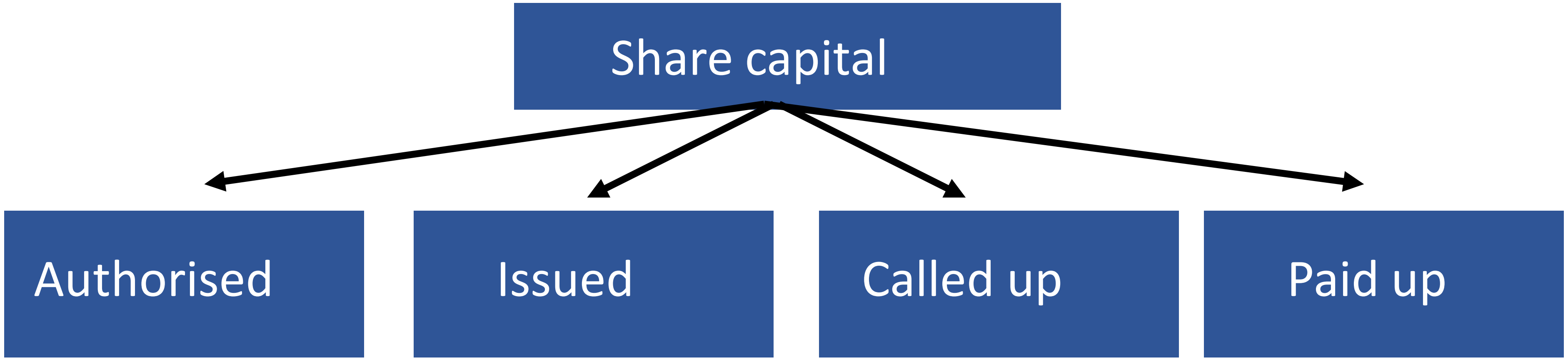
(1) The company exposure to debt and liability is limited

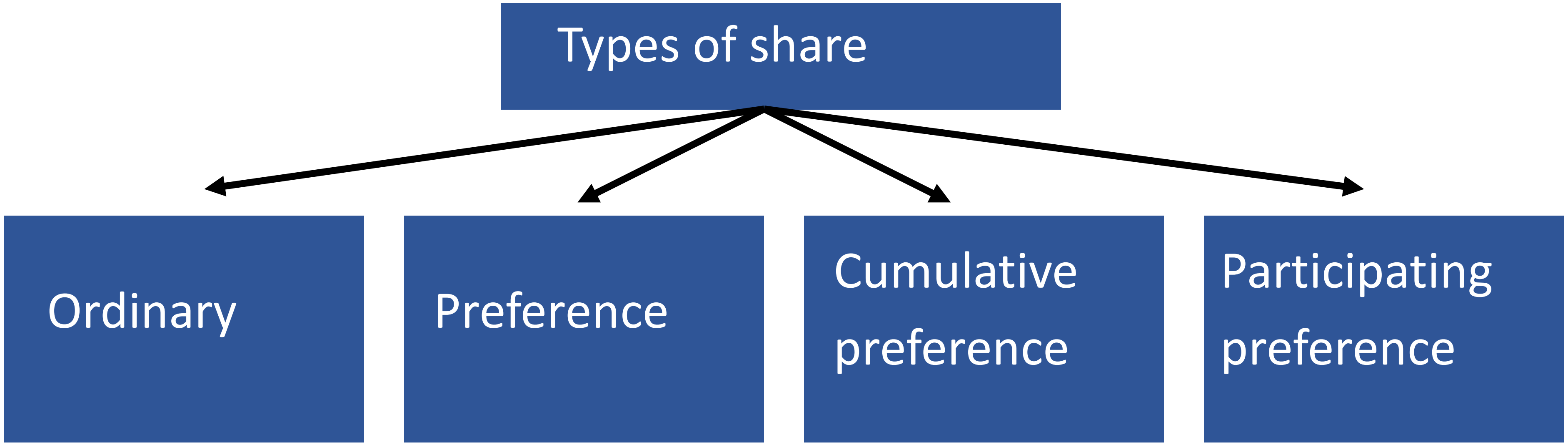
(2) Financial statements must be produced

(3) A company continues to exist regardless of the identity of its owners

- ○ 1, 2 and 3
- ○ 1 and 3 only
- ◉ 2 and 3 only
- ○ 1 and 2 only

Source: ACCA Paper FFA/F3 Financial Accounting Specimen Exam


Share capital
Authorised
Issued
Called up
Paid up


Types of share
Ordinary
Preference
Cumulative preference
Participating preference

Shares 1

Shares

- The proprietors' capital in a limited liability company consists of share capital.

  When a company is set up for the first time it issues shares, which are paid for by investors, who then become shareholders of the company.

- Shares are denominated in units of 25 cents, 50 cents, $1 or whatever seems appropriate.

  This is referred to as their nominal value.

Shares 2

Ordinary shares have the following characteristics:

- No right to fixed dividend
- Entitled to remaining profits after preferred dividend
- Entitled to surplus on repayment of capital

Shares 3

Preferred shares are characterised as follows:

- Rights depend on articles
- Right to fixed dividend with priority over ordinary shares
- Do not usually carry voting rights
- Generally priority for capital in winding up
- May be redeemable (loan) or irredeemable (equity)

Shares 4

Share capital

- **Authorised**. The maximum amount of share capital that a company is empowered to issue.
- **Issued**. The amount of share capital that has been issued to shareholders. The amount of issued capital cannot exceed the amount of authorised capital.

Shares 5

- **Called up**. When shares are issued or allotted, a company does not always expect to be paid the full amount of the issue price at once. It might instead call up only a part of the issue price, and call up the remainder later.

- **Paid-up**. Called up capital that has been paid.

Shares 6

- **Market value**. This is the price at which someone is prepared to purchase the share value from an existing shareholder. It is different from nominal value.

Shares 7

The following are the main types of share issue:

- New issue at par or at a premium
- Bonus/scrip/capitalisation issue
- Rights issue

Shares 8

Loan notes

Companies may issue loan notes. These are long term liabilities not capital. They differ from shares as follows:

- Shareholder = owner; note holder = payable
- Loan note interest must be paid; not so dividends
- Loan notes often secured on company assets

Reserves 1

Reserves

Revenue reserves consist of distributable profits and can be paid out as dividends.

- Retained earnings
- Others, as the directors decide, eg general reserve

- **Share premium**. Whenever shares are issued for consideration in excess of their nominal value, such a premium shall be credited to a share premium account

Statement of Financial Position

Assets		Equity and Liabilities		
Non Current Assets	1,000	**Equity**		
		Share Capital	500	
		Share Premium	300	Equity 1,200
		Retained Earnings	200	
		Reserves	200	Belongs to Owners
Current Assets	5,00			
		Non Current Liabilities	200	
				Liabilities
				Belongs to Outsiders
		Current Liabilities	100	
Total Assets	1,500	**Total Equity and Liabilities**	1,500	

Tackling the exam

Exam focus point:

The share premium account cannot be distributed as a dividend under any circumstances.

Reserves 3

Share premium account can be used to:

- Issue bonus shares
- Write off formation expenses and premium on the redemption of shares and loan notes
- Write off the expenses on a new issue of shares/loan notes and the discount on the issue of loan notes

Reserves 4

- **Revaluation surplus**. Created when a company revalues one or more of its non-current assets.
- **Statutory reserves**. The law requires the company to set up these.

Bonus and rights issues 1

Bonus issue

- A bonus (or capitalisation) issue uses reserves to pay for the issue of share capital.

Bonus and rights issues 2

Example

- Issue of 5,000 new $1 shares

DEBIT	Reserves (share premium or retained earnings)	$5,000
CREDIT	Share capital	$5,000

Bonus and rights issues 3

Rights issue

- A rights issue enables existing shareholders to acquire further shares.

- Dr. Cash
- Cr. Share Capital

Share capital: accounting treatment

Nominal value of shares issued recorded in the share capital account

Where shares issued at a premium, the **excess** is recorded in the **share premium account**

Bonus issue

Shares issued for **no** cash consideration

Always done at **nominal value**

Rights issue

Shares issued to existing shareholders for cash

Dividends

An **appropriation** of profits

Dividends are charged to retained earnings they are not an expense of the income statement

Accounting treatment

Rab Co issues 100,000 50c shares for 50c.

Dr	Cash	50,000	
Cr	Share capital		50,000

No premium – as 50c shares were sold for 50c.

Lecture example 1

Shares at a Premium

Rab Ltd. Issued 200,000 50c shares for 80c.

Dr Cash(200,000 x 0.80)	160,000	
Cr Share capital		100,000
Cr Share premium		60,000

Lecture example 1 (cont)

Rab Ltd balance sheet extract:

Share capital and reserves	$
Share capital – 50c ordinary shares (50,000 + 100,000)	150,000
Share premium	60,000
	210,000

Rab makes a 1 for 4 bonus issue.

The double entry would be:

		Dr	Cr
		$	$
Share premium	(75,000 x $0.50)	37,500	
Share capital			37,500

(W1) No. of shares currently in issue

$150,000 / $0.50 = 300,000 shares

(W2) 1 for 4 bonus issue

300,000 x ¼ = 75,000 shares issued

Lecture example 1 (cont)

Rab Ltd balance sheet extract:

Share capital and reserves	$	$
Share capital – 50c ordinary shares (150,000 + 37,500)		187,500
Share premium (60,000 - 37,500)	22,500	
Accumulated profit	200,000	
		222,500
		410,000

Lecture example 1 (cont)

Rab makes a 1 for 5 rights issue at $1.50.

The double entry would be:	Dr	Cr
	$	$
Cash (75,000 x $1.50)	112,500	
Share capital (75,000 x $0.50)		37,500
Share premium (75,000 x $1.00)		75,000

(W1) No. of shares currently in issue

$187,500 / $0.50 = 375,000 shares

(W2) 1 for 5 rights issue

375,000 x 1/5 = 75,000 shares issued

Lecture example 1 (cont)

Rab Ltd balance sheet extract:

Share capital and reserves	$	$
Share capital – 50c ordinary shares (187,500 + 37,500)		225,000
Share premium (22,500 + 75,000)	97,500	
Accumulated profit	230,000	
		327,500
		552,500

Income Tax

An **expense** in the income statement
A **liability** on the statement of financial position

Amount based on a year end estimate

Any under/ over provision is adjusted next year