Accounting Principles

STUDENT STUDY PACK

PRBA001

Accounting Principles

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Revision 1

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Week 8

Companies: Share Capital and the Balance Sheet

LEARNING OUTCOMES FOR THIS WEEK

On completion of this week's work you will be able to:

Identify the characteristics of a company
Record the issue of shares
Prepare the shareholders' equity section of a company balance sheet
Account for cash dividends
Use different share values in decision-making
Evaluate return on assets and return on shareholders' equity
Account for the income tax of a company

LEARNING RESOURCES

Presentations, powerpoints, tutorial exercises, tutorial solutions, tutorial workshops, online tests, and the readings from the Textbook, Horngren, Harrison, Bamber, Best, Fraser and Willett, 2010, *Financial Accounting*, **6th** ed, Prentice Hall, Frenchs Forest. ISBN 9781442505087. Chapter 14.

Chapter 14

LEARNING OUTCOME 1: IDENTIFY THE CHARACTERISTICS OF A COMPANY

A company, or a corporation, is a separate legal entity that has been established under the Corporations Act 2001. This is done by completing the registration requirements of the Australian Securities and Investment Commission (ASIC) which administers companies. ASIC then issues a certificate of incorporation. This certificate is like a birth certificate which acknowledges that the company has been formed and is now a legal person with all the rights, duties and responsibilities of any other person. It can enter into contracts, buy and sell property, sue and be sued, hire and fire staff. Companies are responsible for their own liabilities and pay income tax on their profits.

Most companies raise their equity by issuing shares. If the company is a public company it can raise funds by issuing shares to the public. The laws are a lot stricter as the public are providing the funds but are delegating the management to directors who must account to them by providing regular financial statements. For companies that are quoted on the Australian Stock Exchange (ASX) there are further disclosure regulations that must be complied with.

Proprietary or private companies also raise funds by issuing shares but are not allowed to offer the shares to the public and are restricted to a maximum number of members of 50. The disclosure requirements are not as strict as for public companies as the size of the funds being raises and the risk are not perceived to be as great as that for public companies.

Unlike sole traders and partnerships, where the business ends when the ownership changes, companies have a continuous life no matter who owns the shares. The transfer of shares will not end a company's business.

In a partnership the act of a partner in business will bind the other partners as they each act as agents of the partnership under the principle of mutual agency. This does not apply to companies and the acts of a shareholder does not bind the company nor any other shareholder.

A major difference between companies and partnerships and sole traders is the liability of the equity providers. In partnerships and sole traders in law the proprietors are responsible for the debts of their businesses. In companies the debts of the companies are the companies' responsibility and not those of equity providers. The maximum that a shareholder can lose if the company goes into liquidation is the full amount of their investment. The shareholders' liability is limited to any unpaid amounts on their shares. This then reduces the risk a little and makes potential equity providers more likely to invest.

In order to raise large amounts of capital to finance the company shares are issued which can be owned by very many shareholders, too many to ensure a smooth running of the company if all of the shareholders were involved in the day to day management. As a result the management is delegated by the shareholders to directors who are elected by the shareholders for that purpose. Companies therefore have a separation of ownership and management. It is because of this separation that the directors are required to account to the shareholders by producing financial statements.

Besides being separate legal entities companies are separate taxable entities. Taxes are paid on a company's taxable income. To minimise the effect of the profits being taxed twice, once on the company's profits and then again on the dividends paid to shareholders out of those profits, there is the imputation system which provides the shareholders with a credit against their own personal income tax.

LEARNING ACTIVITY 1

Reading Textbook Horngren, Harrison, etc pages 532 to 535 and study Exhibit 14 –1 on the advantages and disadvantages of a company

Forming a Company

In order to form a company certain information must be lodged in an application form with the ASIC. This is covered by Section 117 (2) of the Corporations Act. This will tell ASIC the type of company that the applicants wish to register, its name, the name and address of the first members, details of the first directors, and the company secretary, together with their written consent to act as such, and the address of the company's registered office. Because the company is an artificial person it is important that anybody who has to deal with the company knows where they can get in touch with it to serve official documents etc and the registered office is that address. Other

details about the registered office opening times, the principal place of business also must be given. For companies with a share capital, the class and amount of shares that the members have agreed o take up, the amount that they have agreed to pay for those shares and whether the shares are fully paid. Other information is also required.

Once the company has satisfied all the requirements the ASIC will issued a certificate of registration which details the name, the Australian company number that has been allocated to the company, the type of company that it is, the date of registration, and the fact that the company has been registered as a company under the Act. This certificate is like a birth certificate and is proof that the company now exists.

Because the company is an artificial creation it needs a set of rules for the management and shareholders to follow when running the company. It can either have its own constitution or use the Replaceable Rules which are set out in the Corporations Act. These deal with the appointment, powers, remuneration and termination of the directors, their meetings, the members' meetings, share transfers and the members right of inspection of the company's books. If the company wants different rules then it must register its own constitution. These rules/constitution act as a contract between the company and each member, the company and each director and company secretary, and between each member. The Act also states which books, records, registers and minutes that the company must maintain.

Funding a company

After registration a company can raise funds by issuing shares which forms the equity of the company and by borrowing funds through the issuing of debentures or loan stock. Share can be of different classes, eg ordinary, preference etc, as the rules set out. They can be issued fully or partly paid. If the company is a public company the issue price that the company will ask prospective shareholders to pay may well be affected by the market. Debentures are a form of loan and can be secured by a mortgage against the company's assets. If instead of a single loan the debentures are offered in units there may be a large number of them and it will be necessary to have a representative to look after their interests. This is usually done through a debenture trust deed which sets out the terms of the loan and the rights of the debenture holders which are maintained by a Trustee for the debenture holders.

It is important that when a company wishes to raise funds, whether by shares or debentures, that the persons to whom any advertisement is being addressed are provided with enough information to enable them to make an informed decision about the nature of the project, the risks and the rewards, the financial status of the company, the amounts to be paid, the dates, rights of share/debenture holders and in such a manner that it is easily understandable, timely and accurate. This is usually done in the form of a prospectus. The prospectus is usually audited and will contain financial statements and experts reports and must be lodged with the ASIC.

LEARNING ACTIVITY 2

Reading Textbook Horngren, Harrison, etc pages 535 to 538 and study Exhibits 14 – 2, 14 - 3, & 14 – 4.

Share capital

The prospectus provides the prospective shareholder with enough information so that they can decide how many shares to apply for and how much they will have to pay for the shares.

The minimum subscription level is the minimum number of shares that the directors require applications for to ensure that there will be sufficient funding to make a success of the project. If this level isn't reached the funds must be returned to the prospective shareholders. Once the minimum subscription level has been reached the company goes ahead with the share issue. This is when the company accepts the offer of the prospective shareholders and the shares are allotted and the names of the shareholders are entered on the register of shareholders.

Before this time any application monies that have been received are kept in a cash/bank trust account because they might have to be returned if the minimum subscription isn't reached. Once the shares are allotted the cash is transferred from the cash/bank trust account to the company cash/bank account. What started out as a liability is now converted into equity.

On the balance sheet the company reports the assets and liabilities in a manner similar to that of sole traders and partnerships. It is the owners' equity section that is different. This is called Shareholders' equity or just equity. It is made up of share capital, which may also be known as issued capital, paid up capital or contributed capital. This represents the amount that has been contributed to the company by the shareholders and normally is made up of ordinary shares. When a company makes a profit it is not added to owner's equity like a sole trader but is transferred to a retained earnings or retained profits account.

When shares are issued the assets of a company increase and shareholders' equity increases. When a company closes its accounts at the end of a financial period the revenue and expense accounts are closed off to the income summary account which in turn is closed to the retained earnings account. Where the retained earnings account has a debit balance because of many losses the accumulated losses balance on the retained earnings are shown as a negative amount in the shareholders' equity.

Where a company has made profits it may distribute cash in the form of dividends to the shareholders. These are similar to drawings and decrease assets, cash, and retained earnings. Dividends are not allowed to be funded out of capital.

Unless the company's constitution states otherwise shareholders have four basic rights which include the right to **vote** at company meetings on the basis of one share one vote and where more that 50% of the votes cast are in favour can elect the directors. Shareholders also have a right to **dividends**, to a return of their monies, providing that all the liabilities of the company have been paid for upon a **liquidation** of the company, and a right to **pre-emption**. This means that if there is a new issue of shares the existing shareholders have the right to apply for shares in the same proportion as their existing shareholding.

Companies can issue different classes of shares with different rights attached to them. The basic ownership of a company will be represented by ordinary shares which will have the four basic rights. Other classes of shares may have their rights varied for example B Ordinary shares might not be given a vote at the annual general meeting. Preference shares normally have preference over the ordinary shares when it comes to the paying of dividend, and the return of capital upon a

company liquidation. The rate of dividend is usually fixed, whereas ordinary shareholders can receive dividends that fluctuate with the size of the company profits. When the company does well the dividend can be high. When the profits are low or non-existent there may be no ordinary shareholder dividend at all. As the retained earnings grow so does the value of the ordinary shares. The preference shares do not participate in this growth and should there be funds available will only receive what they have invested in the company upon a liquidation unless the terms of issue permit a premium being paid. Preference shares do not normally have a vote at the annual general meeting.

LEARNING ACTIVITY 3

Reading Textbook Horngren, Harrison, etc pages 538 to 540 and study Exhibit 14 – 5.

LEARNING OUTCOME 2: RECORD THE ISSUE OF SHARES

When shares are issued the cash account will be debited with the amount received and the share capital account will be credited. The equity section of the balance sheet will show for the class of shares issued the numbers of shares in issue, the amount that the company has received for them and the balance on the retained earnings account.

It is possible to issue shares and to receive assets other than cash in return for them. For example a developer may sell land to a company in return for shares in that company. AASB2 states that the value attached to the transaction must be the fair value of the land at the time that control of the land is exchanged and this value must be entered in the share capital account. The entries in this case would be to debit land and credit share capital account.

Most companies issue shares in a single transaction but where the shares already have a high market price the company may wish to issue shares by instalments. In this case the main accounts that are required for the issue of shares are the cash/bank trust account, application account, allotment account, call account and paid-up capital account.

When application monies are received the Cash Trust Account is debited and the Application Account (liability) is credited. When the minimum subscription level has been reached to shares are allotted, that is issued. The Application Account is debited with the amount due on application, the Allotment Account is debited with the amount due on allotment, thereby creating a receivable amount, and the Share Capital account is credited with the full amount due on application and allotment. The shareholders names and the numbers of shares that have been issued to them will be entered in the register of members. When the cash on allotment is received by the company there is no need to debit the cash trust account as the shares have been issued. The cash account is debited instead and the allotment account is credited.

Should further instalments be required a call or calls, as determined in the terms of issue, will be made. The call account will be debited, creating the receivable amount, and the share capital account will be credited. When the monies due on call are received the cash account is debited and the call account is credited.

It is unlikely in a public offering that the applications that are received will exactly match the numbers that are required. Where an oversubscription is received, depending upon the powers given to the directors, either in the constitution or the terms of issue, they may return the excess monies to the applicants or apply that excess to the monies that are due on allotment. In such a case the numbers of shares issued to the shareholders would be reduced proportionately.

Where a shareholder does not submit the allotment or call monies that are due then those shares may be forfeited. When this happens the shares are cancelled, the shareholder ceases to be a member and they lose the money that they have already paid t the company. The share capital account is debited with the full amount that had been previously credited to that account in respect of those shares. The allotment/call account is credited with the amount that is outstanding which the shareholder had failed to pay. The balance, the monies that the company had actually received in respect of these shares, is credited to a forfeited shares account.

As the original purpose of management was to raise fund for a project they now have a situation where they have a shortfall. In order to reissue the shares that have been forfeited they may issue the shares at a discount to encourage a swift take up of the shares. The issue price will be debited to cash. The full original issue price will be credited to the share capital account and the discount will be funded out of the forfeited shares account with a debit entry.

Depending upon the constitution the company may retain the balance on the forfeited shares account and this will then appear under shareholders' equity as a forfeited shares surplus account. The rules of the stock exchange, however, require that the balance on the forfeited shares account, after and discount and other reissue costs, be returned to the former shareholder. In which case the forfeited shares account would be designated a forfeited shares liability account. Once the reissue has taken place the forfeited shares liability account would be debited with any balance on the account and the cash account would be credited with the payment.

Where different classes of shares are issued, including preference share, it will be necessary to maintain a separate application, allotment, call and share capital account for each class of share. The balance sheet usually lists ordinary shares first and then preference shares followed by the retained earnings.

There can be ethical issues with respect to issuing shares for a non cash consideration. The promoters may wish to show that the share issue and the company is more successful than it really is by inflating the value of the asset that is given in consideration for the shares. This way the assets are overstated as is the shareholders' equity. It is important that the company does the right this and behaves ethically by having the assets independently valued so that the fair value is used as required by AASB 2.

LEARNING ACTIVITY 4

Reading Textbook Horngren, Harrison, etc pages 540 to 545

LEARNING OUTCOME 3: PREPARE THE SHAREHOLDERS' EQUITY SECTION OF THE BALANCE SHEET.

The equity section of the balance sheet will show share capital and retained earnings and any other reserves. Under share capital the number of ordinary shares will appear first together with the amount received on their issue. If the shares are only partly paid, then this must be stated, otherwise the shares will be shown as fully paid. Next will appear the preferences shares with the same disclosures for those shares. Only the numbers of shares and the amounts received as at the balance sheet date will appear on the balance sheet. Movements that have happened during the year will appear as a note to the accounts but not on the face of it. The different classes of shares will be subtotalled to give total share capital with the retained earnings and reserves being added to give total equity.

LEARNING ACTIVITY 5

Reading Textbook Horngren, Harrison, etc pages 545 to 546. Please study Exhibit 14 – 6 and attempt the summary problem for your review.

LEARNING OUTCOME 4: ACCOUNT FOR CASH DIVIDENDS

Dividends are the return that a shareholder receives for their investment. If the company prospers then the shareholder may also receive a growth in the market value of the shares. Dividends can only be paid when there are retained earnings to cover them and sufficient cash to pay for them. The directors will review the financial statements of the company, determine the working capital and cash needs for the company over the coming six months, the profit forecasts and also assess the market's expectations before declaring a dividend. Once this dividend is declared a liability is created and there is then a legal responsibility to pay that dividend to the shareholders. So the declaration date creates the liability.

It is important for the company to know that when the dividend is paid that the dividend goes to the correct recipient. With companies having their shares traded upon stock exchanges the ownership of shares can change hands many times in a short space of time. Who should the company pay? This is determined by the date of record. Shareholders whose names appear on the register of shareholders at that time will be entitled to receive the dividend.

The third important date is the payment date. This is when the dividend is paid. The date of record usually follows the declaration date by one or two weeks and the payment date follows the date of record by about two to four weeks.

When recording the declaration of the dividend the retained earnings are debited and dividends payable are credited. When the dividends are paid the dividends payable are debited and cash at bank is credited. Where there are preference shares as well as ordinary shares the preference shareholders receive their dividends first. Ordinary shareholders will only receive a dividend if there are sufficient retained earnings and cash to cover the preference dividend, so it is necessary to declare a large enough dividend to cover both preference and ordinary dividends.

Preference dividends are usually a fixed amount whereas the ordinary dividend will fluctuate according to the size of the company profits. The larger the profits the higher the dividend, when there are losses the ordinary shareholders may not receive any dividend at all.

Preference shares can be cumulative or non-cumulative. Unless otherwise stated it is generally assumed that the preference shares will be cumulative. This means that should a company not pay a preference dividend one year, then the arrears of dividend are said to cumulate or roll over to the next year. In this subsequent year the preference shareholders should receive the arrears of dividend and the current year's dividend before the ordinary shareholders can receive theirs.

The arrears of preference dividends are not liabilities until they are declared. Never the less any arrears of preference dividend must appear as a note to the financial statements in order to inform the ordinary shareholders how much dividend must be paid before the ordinary dividend can be paid.

LEARNING ACTIVITY 6

Reading Textbook Horngren, Harrison, etc pages 546 to 548. Please study Exhibit 14 – 7.

LEARNING OUTCOME 5: USE DIFFERENT SHARE VALUES IN DECISION MAKING

There are a number of ways to value shares. Market value and book value can be used for decision making. The value that gets the most attention and which is popular with shareholders is market value. This is the price that the market is prepared to pay or receive when buying or selling shares. The market sets the price after taking the company's past profit history, its future prospects, the current financial position, the industry cycle and the general economic circumstances into consideration.

Market price is only available to a company that is listed upon the stock exchange where market demand for the shares sets the price. Most companies are not listed on an exchange and so there needs to be another way of placing a value upon the shares. As a company becomes profitable the retained profits increase retained earnings which are part of shareholders' equity. It is the ordinary shareholders that participate in this growth. The book value of an ordinary share is calculated by dividing the number of ordinary shares in issue into the total shareholders' equity.

If the company has preference shares in addition to ordinary shares then the preference shares have a prior claim to the shareholders' equity. To calculate the ordinary shareholders' book value per share the shareholders' equity must first have the monies that would be due to the preference shares deducted leaving the residue as that due to the ordinary shareholders. It is then this reduced figure which is divided by the number of ordinary shares in issue to calculate the book value of each ordinary share. The amount due to the preference shares would be the amount to be paid to the preference shareholders at liquidation plus any arrears of preference dividends.

For private companies, where the shares are not listed upon a stock exchange, the book value provides a ready valuation of the shares. The book value may be adjusted to reflect the size of the shareholding that is being offered for sale. A very small number of shares with no ability to influence company policy would command a lower price than a large number.

Book value is calculated using figures produced by the accounting system based upon historical costs. Market value is the price set by market demand which is affected by the company's past and future performance. Book value is not directly related to market value and would normally only be used by inside rather than outside investors.

LEARNING ACTIVITY 7

Reading Textbook Horngren, Harrison, etc pages 548 to 549.

LEARNING OUTCOME 6: EVALUATE RETURN ON ASSETS AND RETURN ON SHAREHOLDERS' EQUITY.

Return on assets and return on shareholders' equity are useful ratios when measuring management performance.

Return on assets

Return on assets shows the rate of return from the use of the assets. As assets are financed by either the shareholders equity or by loan providers the profit and interest expense are important returns for each of them. The profit before income tax and interest expense, or EBIT, is an important indicator and is used by investors and loan providers.

As income tax will vary and the size of a company's loan will also vary from one from one company to another, by taking the earnings before tax and interest expense, it is possible to compare one company's performance with another without these two variables.

The rate of return on total assets is calculated by taking profit before tax and interest expense and dividing it by the total assets. Where there have been large changes in asset values during the year an average can be used by taking the opening and closing balances. This ratio can be manipulated by delaying the replacement of depreciable non-current assets. With an old asset the depreciation charge will be low, thereby showing higher profits, and the asset value will also be low, producing a higher rate of return. A business that replaces the asset will face a larger depreciation expense and a higher asset value which will make it more difficult for management to produce a similar return. Return on assets shows how efficient management has been in using those assets to generate returns for all who finance the business.

Return on ordinary shareholders' equity.

The rate of return on ordinary shareholders' equity shows the profits that are available to ordinary shareholders and expressed as a proportion of ordinary shareholders' equity. The profits available to ordinary shareholders will be the profits after the tax and the preference shareholders' dividends have been deducted.

The rate of return on ordinary shareholders' equity is calculated by taking the profit after tax and preference dividends and dividing it by the ordinary shareholders' equity. The average shareholders' equity, taken from the opening and closing balances, can be used in these calculations.

Return on ordinary shareholders' equity shows how efficient management has been in using the resources and finance to generate returns for the shareholders.

Return on equity should be higher than return on assets as the risk to the shareholders investment is greater and the return must reflect that risk. Paying dividends is a more costly exercise than paying interest on loans as interest expense is tax deductible whereas dividends are paid out of post tax profits.

LEARNING ACTIVITY 8

Reading Textbook Horngren, Harrison, etc pages 549 to 550.

LEARNING OUTCOME 7: ACCOUNT FOR THE INCOME TAX OF A COMPANY.

There are two amounts for income tax that appear in a company's financial statements. The income tax expense is based on the accounting profit before income tax multiplied by the income tax rate and appears in the income statement. The income tax payable is based on the taxable income, which is the accounting profit as adjusted for tax purposes, multiplied by the income tax rate and appears in current liabilities on the balance sheet.

The taxable income is calculated on the company's income tax return. The taxable income differs from the accounting profit as expenses and revenue are measured differently. Most of these

differences are timing differences. An example is depreciation. Where the tax rules allow an accelerated rate of depreciation the tax deduction is given earlier in the life of the asset. The taxable income will be lower than the accounting profit in the earlier years and higher in the later years of the assets' life.

The income tax expense, calculated on accounting profit, will be reconciled to the income tax payable, calculate don taxable income, by the use of deferred tax assets and deferred tax liabilities, which adjust for these timing differences.

For example, a tax depreciation rate of 25% will depreciate an asset over 4 years whereas an accounting depreciation rate of 20% will take 5 years. In the fifth year the accounting depreciation will be disallowed as the tax benefit has already been given. To acknowledge that there is this future tax consequence a deferred tax liability is created.

LEARNING ACTIVITY 9

Reading Textbook Horngren, Harrison, etc pages 550 to 555. Please work through the summary problem for your review and then after that please attempt the tutorial exercises as stated in the Unit Outline, Ch14 S 14-5, 14-6, 14-8, 14-9, 14-10, 14-11, E14-2, 14-3, 14-7, 14-11, 14-12.