

Accounting for Legal Finance Professionals

Tutorial 9 – Limited Companies

Financial statements for small companies

9.1 Introduction

In previous tutorials we've looked at producing financial statements for traditional partnerships and also considered an overview of the underlying accounting concepts and standards that form the framework within which financial statements should be produced. This framework is necessary so that users of financial statements can have confidence not only in the financial statements themselves but also in the comparability of financial statements for different entities.

As we have seen, users of financial statements are not only the business owners but also the stakeholders in a business such as banks, other investors and HMRC. In the case of limited liability entities, where annual financial statements must be filed with Companies House and so are available (for a small fee) to anyone to review, the importance of comparability is more pronounced.

In this and the next tutorial we will consider the financial reporting requirements of the two main types of limited liability entities that legal service providers use to offer their services: limited companies and limited liability partnerships.

Limited liability entities' financial accounts are often referred to as 'annual accounts' or 'statutory accounts'. As we have already seen, they should be prepared every year to report the financial activity and performance of a company during its most recent financial year – this is usually a 12-month period that ends on the 'accounting reference date'. Annual accounts are also used to work out how much corporation tax a company has to pay on the profit it makes during each accounting period.

You should note that these tutorials provide an overview only of the requirements and should not be taken as a comprehensive guide to producing company accounts. The layout and inclusion of certain details such as how the share capital is made up and other reporting requirements does change from time to time and the ILFM would always recommend that professional accounting advice on how to set out and file a correct set of company accounts should be sought. Additionally, the impact of taxation on limited companies is complicated and quickly changes and so corporation tax is limited within this course to an assumed rate of 20%.

9.2 What is limited liability?

Limited liability means that the owners (typically the shareholders) are not liable for the debts of the limited liability entity beyond the money invested by way of shares. A sole trader or partners in a traditional partnership in contrast are personally liable for the debts of the business, to the extent of their personal assets.

Limited liability entities were created with the passing of two separate Acts. The first was the Limited Liability Act 1855 and the second was the Companies Act 1861. These two Acts introduced and enabled the formation of companies of limited liability and as time has passed further Acts have been passed which have continued to shape and legislate these entities.

The basis of limited liability is that all debts incurred by a company are the company's liabilities and so are not directly the legal liabilities of the shareholders or the directors of the company. In essence, the company is a separate legal entity (or person) from its shareholders and the directors. The directors incur no personal liability as all their acts are undertaken as agents for the company. This means that as the company incurs debts in the course of its business, only it is liable for those.

However, there are certain circumstances where liability may be imposed by the court, particularly in respect of wrongful or fraudulent trading. Also some potential creditors of a small private limited liability entity may ask the owners to provide personal guarantees for money owed to them. This is often the case where a small company requests a bank loan or overdraft or when taking a lease of premises.

Over the 150 years that limited liability entities have existed, various different forms of limited liability entities have arisen. These include:

- private company limited by shares – where the shareholders' obligation is to pay the company for the shares they have taken ownership of. Once the nominal value of those shares has been fully paid for (and this would usually be the case with a private limited company) no further money is payable by the shareholders in respect of the company's debts. We will consider this form of limited liability in this tutorial;
- company limited by guarantee – where the members are bound by a guarantee in the company's memorandum of association requiring them to pay the company's debts up to a fixed sum, which is usually £1;
- limited liability partnership – where the members liability is limited to the amount of money they invest in the business. Members' responsibilities and share of profits or losses should be set out in an LLP agreement. We will consider this form of limited liability in the following tutorial;
- public limited company – similar to private limited company save that the company's shares are traded on a stock exchange and can be bought and sold by anyone.

There may be millions of ordinary shareholders, holding various numbers and classifications of shares. Shares are sold to the public through the Stock Exchange and their values are reported in the press in the daily stock exchange listings.

9.3 Sizes of limited companies

All companies, whether trading or dormant, must provide copies of their accounts to their members (shareholders or guarantors) as well as Companies House. There are three classifications of company accounts: small, medium and large. Within the small company classification there is a subset called micro-entity, which applies to very small companies. The size of a company is determined by various thresholds for annual turnover, balance sheet total, and average number of employees.

Companies that qualify for micro-entity, small or medium accounts may prepare abbreviated accounts for Companies House, but large companies that exceed all of these thresholds must prepare full statutory accounts comprising a balance sheet, a profit and loss account, a director's report, notes about the accounts and, in many cases, an auditor's report. All sizes of companies, however, must prepare full statutory accounts for HMRC with their Company Tax Returns.

Dormant companies can simply submit dormant accounts to Companies House. Accounts for HMRC will only be required if a dormant company was previously trading and has to file a final tax return for that period.

9.3.1 Micro-entity company accounts

A micro-entity company can prepare and submit accounts according to special provisions in the Companies Act 2006 and Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 as amended by the Small Companies (Micro-Entities' Accounts) Regulations 2013. This enables very small companies to disclose less information than small, medium and large companies and need not require an audit.

To qualify as a micro-entity company, at the time of writing at least two of the following conditions must be met:

- Annual turnover below £632,000
- Balance sheet total of less than £316,000
- Average number of employees of 10 or less

There are a number of exceptions to this qualification and amongst them are that it is not possible to prepare and file micro-entity accounts if a business is, or was at any time during its financial year, a limited liability partnership (LLP) or limited partnership or a public limited company (PLC).

Micro-entity accounts must include a balance sheet drawn up as at the last day of the financial year, but this document can contain a reduced set of information compared with the accounts required by small, medium and large companies. Explanatory notes and disclosures to the accounts should also be included, where relevant.

9.3.2 Small company accounts

A small company can prepare and submit accounts according to special provisions in the Companies Act 2006 and the relevant regulations. This means they may choose to disclose less information than medium-sized and large companies, and they need not submit to an audit.

A company is classed as small at the time of writing if it satisfies at least 2 of the following conditions:

- Its annual turnover is less than £6.5 million
- It has a balance sheet of no more than £3.26 million
- It employs less than 50 people

There are exceptions and the main ones are that a company may not prepare and submit small accounts if it is, or was at any time during its financial year, a public company, an authorised insurance company or a banking company.

Small companies need only submit abbreviated accounts (balance sheet and notes) to Companies House, but full accounts should be prepared for members and HMRC.

9.3.3 Medium-sized company accounts

To qualify as a medium-sized company, at least two of the following conditions must be met:

- Annual turnover is less than £25.9 million
- Balance sheet total of less than £12.9 million
- Average number of employees does not exceed 250

There are exceptions and the main ones are that a company will not be considered medium sized if it is, or was at any time during its financial year, a public company, a company that has permission under Part 4 of the Financial Services and Markets Act 2000 to carry on a regulated activity or that carries on an insurance market activity.

Medium-sized accounts must include the following particulars for their members (although they may submit abbreviated accounts to Companies House):

- Profit and loss account
- Balance sheet with a director's printed name and signature
- Notes to the accounts

- Group accounts (if appropriate)
- Directors' report, including a business review (or strategic report) showing the printed name of the approving secretary or director.
- Auditor's report that includes the name of the registered auditor, unless the company is exempt from audit and includes an audit exemption statement.

9.4 Sources of finance for limited companies

The basic principle of funding is the "share", which is a proportion of the capital invested in the company. It is given a "face value" or "nominal value" as it is correctly called but is often bought for a different amount to the face value. Examples of nominal share values are 10p or £1. The basic shares are known as "ordinary" shares, and they form part of the "equity" of the firm or business.

Ordinary shareholders have a vote per share so the larger the shareholding the more votes a shareholder can have at the Annual General Meeting (AGM) or other meetings of shareholders. The votes can be used to influence the way the firm is run such as director's remuneration, appointing the reporting accountant and other issues.

Being "equity" shares, ordinary shares are risk bearing i.e. they take the ordinary trading risks of any business. If the business does well and is profitable the value of the shares will increase and in the case of a public limited company this increase would be quoted on the open market at a higher value than their nominal values. Thus an ordinary share with a nominal value of £1, in a successful company, may be quoted at say £9 per share.

In addition to the variation of their share or capital prices, the reward for the purchase of shares to finance the company is by way of payment of "dividends". These are calculated on the nominal value of the ordinary shares. So that a dividend of 20% on £1 ordinary shares would mean the investor would receive 20p for each £1 ordinary share held. Dividends will vary year to year as they are dependent on the profitability of the company. If trading losses are made, no dividends can be paid as dividends must be paid out of revenues and not from capital reserves (it is illegal to use capital reserves for the payment of dividends). Where no profits are made, there can be no dividend payment and so no return on the shareholder's investment; this is why ordinary shares are regarded as "risk bearing".

Dividend payments are not tax allowable. As such they should be shown in the financial statements in the Profit and Loss Appropriation Account.

Another category of share is the "preference" share. In return for receiving the first available part of the profits in the form of a dividend, preference shareholders receive a fixed rate of return on their capital. A common rate is 10% although the rate offered will vary in line with the economic trading climate at the time the shares are first offered. Thus if an investor holds 1,000 10% £1 preference shares, the annual dividend would be £100.

As with ordinary shares, if trading losses are made by the company, no dividend can be paid in that year. There is however a type of preference share which also includes the word "Cumulative" in their title, i.e. "10% Cumulative Preference share of £1 each". This changes the nature of the share to enable the right to receive dividends each year to be carried forward. In other words if in one year there were no trading profits and therefore no preference dividend, the right to that dividend would not lapse but would be carried forward as a priority to be paid from the next available profits.

Some preference shares are issued for a fixed period, after which they will be repaid or redeemed.

The control of the day to day operation of the company is vested in the "Directors", who are responsible to the shareholders, through the annual general meeting for the running of the company. Every company has an accounting period, normally of one year, when the accounts are prepared, generally audited and then submitted to the shareholders. At the annual general meeting ordinary shareholders can ask questions and vote on items in the agenda. These will include the approval of the published accounts, appointment of the auditors, appointment of directors and authorisation of the payment of the recommended dividends. Preference shareholders rarely have any voting rights.

Another form of finance for limited companies is the issuing of "debentures". These are really straight loans to a limited company by debenture holders, who unlike ordinary shareholders, generally have no rights or say in the running of the company. Debentures do not form part of the equity of the firm and so do not appear in the capital section of the balance sheet. Debenture interest must be paid to debenture holders whether or not the company makes a profit and is a tax allowable expense. As such debenture interest is shown as an expense in the Profit and Loss Account. Debentures are usually issued with a nominal value in round pounds e.g. with a face value of £1 or £10 each, or even higher values.

Debentures are referred to as being "naked" or "secured". Naked debentures are unsecured loans to the company, and these rank equally with other trade debts of the company in the event of liquidation. On the other hand secured debentures are secured on the assets of the company. Under the terms of issue of the debentures, a charge is created over certain assets, which will be held by people called "debenture trustees", these are often commercial bankers. The type of property against which the charge is secured is normally the freehold property but it can also be the debtors or other assets. Thus if the debenture interest or capital instalments are not repaid on the due dates, then the debenture holder will have a powerful form of security in priority to any other normal creditors of the company. Where the charge is over the freehold property it is often referred to as a "fixed charge". In contrast, a "floating charge" may be used over other types of assets, such as the book debts of customers of the company.

9.5 Illustration of a Company Financial Statements

The General Trading Co Ltd.

Profit and Loss Appropriation Account for the year ended 31 December Year 4

	£	£
Profit for the year before taxation		57,570
Less Corporation Tax		<u>11,514</u>
Profit for the year after taxation		46,056
Add retained profits from last year		<u>17,071</u>
		63,127
Less Appropriations		
Transfer to General Reserve	35,000	
Paid Dividends:-		
Preference Dividend of 7.5%	1,500	
Ordinary Dividend of 5%	<u>5,000</u>	
		<u>41,500</u>
Retained profits carried forward to next year		<u><u>21,627</u></u>

The General Trading Co Ltd

Balance Sheet as at 31 December Year 4

	£ Cost to date	£ Depn	£ Net
<u>Fixed Assets</u>			
Intangible Assets			
Goodwill	25,000	10,000	15,000
Tangible Assets			
Buildings	175,000	70,000	105,000
General Equipment	68,000	16,320	51,680
Motor Vehicles	38,000	28,500	9,500
	<u>306,000</u>	<u>124,820</u>	<u>181,180</u>
<u>Current Assets</u>			
Stock		30,470	
Trade Debtors		16,675	
Bank - Current Account		10,583	
Cash in Hand		<u>302</u>	
		58,030	
<u>Creditors: Amounts falling due within one year</u>			
Trade Creditors	18,869		
Other Creditors (corporation tax)	11,514		
Accruals (debenture interest)	<u>1,200</u>		
		<u>31,583</u>	
Net Current Assets			<u>26,447</u>
Total Assets less Current Liabilities			<u>207,627</u>
<u>Creditors - Amounts falling due after more than one year</u>			
6% Debentures – Repayable Year 6			<u>20,000</u>
			<u>187,627</u>
<u>Capital and Reserves</u>			
Authorised share capital 150,000 Ordinary shares of £1 each			
<u>Called-up share capital:</u>			
100,000 Ordinary Shares of £1 each fully paid			100,000
20,000 7 1/2% Preference Shares of £1 each			20,000
Share Premium Account			11,000
<u>Other reserves</u>			
General Reserve			35,000
Profit and Loss Account			<u>21,627</u>
			<u>187,627</u>

9.6 The Profit & Loss Appropriation Account

You may have noted that this illustration does not include the detailed Profit and Loss Account showing the detailed calculation to arrive at the net profit before tax; as this is something that you should be quite familiar with the illustration starts at the Profit and Loss Appropriation Account. However a company Profit and Loss Account does vary from those of a normal partnership in respect of salaries paid to the company directors. Unlike partners, directors are employees of the company and so salaries paid to them are tax allowable.

There are a few differences between the Profit and Loss Appropriation of a partnership and the Profit and Loss Appropriation of a limited company. The first of these differences is that the limited company profit and loss appropriation account should show the amount of Corporation Tax payable on the net profit of the year. Corporation Tax is paid by limited companies and for the purpose of these illustrations, the tax rate is always assumed to be 20%. The next difference is that the unallocated net profit brought forward from previous accounting periods (i.e. the retained profits brought forward) should be added to the current year's net profit after taxation so that the full available net profit for allocation and distribution by way of dividend is clearly shown.

As we have seen previously with the presentation of Balance Sheet, it is important that allocations and distributions are shown in the correct order. First is the transfer to General Reserve which should be made to retain sufficient working capital within the company to enable it to function efficiently over the next accounting period.

Additionally there are also some specific expenses which should be written off through the Appropriation Account. The first of these is goodwill. As we saw in tutorial 7, goodwill arises when a business pays more for the purchase of another business than the value of the net assets taken over. However, the reality of paying for goodwill is that as soon as you have purchased the business, your own work within that business starts to replace the goodwill of the previous owner. After a while the purchased goodwill becomes entirely replaced which is why it should be amortised (written off) over a period of time e.g. 5 years.

Other types of expenses written off via the Appropriation Account are preliminary set up costs. These are the costs of creating a limited company such as legal costs, stamp duty and company formation expenses. Again they have no real value once the money has been spent but as they are not trading expenses these are written off in the appropriation account.

Legally all unallocated net profits can be used for the payment of dividends, subject to the availability of cash, but you'll appreciate that this could be a little short sighted and could even be considered a little reckless as however rosy the future looks to be, there is always potential for trading conditions to change. (There may also be restrictions in the Articles and Memorandum of Association of the company on how much net profit can be distributed by

way of dividend. The Articles and Memorandum of Association are the legal rules and context within which the company works, together with the relevant Companies Acts.) The amount to be transferred to the General Reserve will usually be a recommendation by the directors to be approved by the ordinary shareholders at the annual general meeting.

Next should be the paid preference and ordinary share dividends. If there are insufficient profits to pay both dividends, then the preference dividend will take precedence. The rate of preference dividend is normally fixed by the terms of the issue of preference shares. However, the rate of dividend on the ordinary shares will tend to vary with the annual profits of the company. The rate agreed for the year 4 in the illustration above is 5%.

Dividends paid on ordinary shares vary from year to year and as previously explained if there are insufficient profits available for distribution then no dividend will be paid out. The directors make recommendations to the shareholders regarding dividends and these are then approved at the AGM. It is important to note that from 1st January 2005 dividends declared (i.e. agreed) after the Balance Sheet date should not be included in liabilities at the balance sheet date. In other words, dividends that are proposed but not paid at the Balance Sheet date should not appear in the accounts. This means only paid dividends are shown in the Profit and Loss Appropriation Account and no corresponding creditor for proposed dividends will appear in the balance sheet.

Any balance of unallocated net profit is then carried forward to the following year. In many ways general profits carried forward can be seen to fulfil the same purpose as the transfer to the General Reserve; however the latter is a more conscious act to set aside funds to secure the short-term trading cash flows of the business.

9.7 The Balance Sheet

A feature of accounts for many limited companies, particularly the big public ones, is that only summary figures are shown in the Balance Sheet; the details are given by way of notes to the accounts. This gives clearer Balance Sheet figures, although often the amount of detail in the notes provides only a broad brush view and is not sufficiently detailed to really draw valid conclusions on how the company is faring. For smaller companies there is also the option for an abbreviated form of annual accounts to be filed at Companies House, this again provides only very summarised information.

The Balance Sheet layout is similar to the layouts you have studied previously in relation to the partnership financial statements; with one very important distinction which is that the layout followed is a legal requirement and is contained within the various Companies Acts.

So fixed assets are listed in a particular order. Firstly you have "Intangible Assets" e.g. goodwill, or patents – these are fixed assets that cannot be physically touched. As noted

above, the only time they are accurately valued is at the time of the purchase of the business.

Then the fixed assets are listed in order of permanence. For example, the most permanent fixed asset is likely to be land/buildings as they are least likely to be changed and often the least permanent are motor cars as they are changed every two to three years. Fixtures and fittings and computer equipment such as servers and IT infrastructure generally fall between these two as they are changed but generally not as frequently as cars. Computer equipment such as PC's and laptops are increasingly becoming out of date very quickly and so increasingly these are being treated as less permanent assets – for some firms it may even be the case that replacement PC's are treated more as a revenue expense as opposed to a fixed asset.

Current assets are listed in order of least liquid (i.e. how long it would take to convert the asset into cash) to the most liquid. So generally stock or WIP would take longest to convert to cash and as cash is cash this would be listed last. One important point to note is that the headings for current assets are also legally prescribed. If you refer back to the illustration you'll see work in progress should be headed as Stock and debts due from clients should be headed as Debtors.

Current liabilities are those debts owed by the company that will fall due for payment within one year of the Balance Sheet date. Normally the trade creditors are shown first followed by other creditors such as corporation tax and any VAT due to HMRC at the Balance Sheet date. A bank overdraft being repayable upon demand is usually listed last.

Capital and Reserves refers to the share capital and long term reserves of the company. A company has the power, under the Articles and Memorandum to issue shares up to a certain amount, for example the General Trading Co. Ltd can issue 150,000 £1 ordinary shares. This is called the "nominal" capital, and in this illustration means that the company can issue an additional 50,000 shares in the future if it chooses to. "Called up" capital refers to the shares issued to shareholders and it is important that the amounts of the called up capital of preference and ordinary shares are stated, with details of the nature of each type being shown on the face of the Balance Sheet or by way of a note. These details include the number of shares issued, the nominal or face value and whether they are redeemable at a future date.

When shares are issued, it may be that the company may offer them for sale in stages. For example, for a £1 ordinary share on the market, the first payment to the company may be 50p, with two separate later payments of 25p spread over a period of time, which better suits the cashflow requirement of company raising finance by way of a share issue. The term to describe payments to the company in stages is "called up" capital and this must be shown clearly in the Balance Sheet. "Calls in arrear" are the amount that the company has asked to be subscribed by shareholders, but has not yet received at a given date. This

means that if the Balance Sheet is prepared at a time when there are calls in arrear, full details of this must be disclosed.

The item noted as "share premium" means that some of the shares were sold for more than their nominal or face value. From the Balance Sheet details it is not possible to say whether this came from the sale of preference or ordinary shares but in any event the excess over face value is posted to the share premium account.

The general reserve is shown under "Other reserves" and this tends to be built up over a period of time by annual allocation. As in this illustration the transfer is the same amount as the general reserve in the Balance Sheet, this is the first year of any allocation, which will probably be added to in future years. Next there is the balance remaining from the profit and loss appropriation account which shows the unallocated profits from the last and previous years available for dividend payments in the future.

Finally when accounts are published, there will be comparative figures in full for the previous year, so that the user of the accounts can compare the performance of the company over both periods.

9.8 Common notes to company accounts

As noted previously, some companies may meet criteria (generally these will be small or micro companies) which allows them to take advantage of certain exemptions enabling them to produce and file abbreviated accounts. Where a company is eligible and takes advantage of these exemptions, the notes to the accounts are extremely limited.

However for companies that are not eligible for these exemption, their financial statements will include explanatory notes. These are important disclosures that further explain the numbers within the financial statements.

As we have seen previously, financial statements must provide a true and fair view of the company's activities, performance and financial position; the notes assist the users in both interpreting each individual set of financial statements and also better enable comparison between different companies. Generally, the notes to the accounts include a very general overview of the business and its significant accounting policies.

The overview might include where the company sits in any group structure, where it is geographically based and might give summarised information around the trading conditions experienced for the accounting year in question.

A note is needed for each significant accounting policy choice made by the company and also whether the company has made any changes to their policies over the year. So in summary the notes should indicate whether the accounts have been prepared using the

historic cost convention or if another basis has been used (such as fair value) and on the basis that the company is a going concern (or not), the depreciation methods and policies in use, accounting for intangible assets, how a company values its stock and recognises revenue to which it has earned a right, the basis of consolidation for group accounts, policies around accounting for income taxes, information about employee numbers and costs and post balance sheet events.

Depreciation

As we have seen previously, depreciation is the method used to recognise the cost of a long-term asset over its useful life (which may be years after the purchase) and there are several different ways of applying this. In tutorial four, we considered the two more commonly used depreciation methods: the straight-line method and the reducing balance method.

The user needs to know both the depreciation policies and the depreciation methods the company uses particularly when comparing financial statement figures with another company's figures. Differences in net profit between the two companies could arise that are really as a result of differing depreciation policies or valuation methodology.

Intangibles

As we have seen, intangible assets aren't physical in nature, like a desk or computer. Common examples of intangibles are patents, which are licensing for inventions or other unique processes and designs, trademarks, which are unique signs, symbols, or names that the company uses and goodwill.

Besides explaining the different intangible assets the company owns via an explanatory note to the financial statements, the business needs to explain how it has determined the intangible asset's value showing on the balance sheet.

Valuing stock and revenue recognition

Legal service providers are unlikely to carry a physical stock of goods; instead they will generally have work in progress at the end of each year. Work in progress is recorded on any practice management system as the amount of time worked on behalf of a client not yet billed which is generally valued at the appropriate charge rate for the fee earner and the type of activity. Depending on the legal service provider's own internal policies and procedures, this work in progress may also be valued at a cost rate.

For the annual financial statements, as we have seen in tutorial eight, the requirements of FRS5 and UITF40 means that where a right to bill exists at the year end, that work in progress must be recognised as a revenue adjustment valued as though it had been billed at the year end. Where no right to bill exists at the year end, the work in progress should be valued accordingly i.e. at the lower of cost or net realisable value. Cost comprises direct

staff overhead (including directors remuneration) along with a proportion of overheads. Net realisable value is the expected amount that will be billed for the work carried out.

Explanatory notes are required to the financial statements, which explain to the user the basis on which revenue is recognised and also the basis on which work in progress is valued.

Group consolidation

Consolidation refers to the aggregation of financial statements of a group company (i.e. a parent company and its subsidiaries) so that they can be reported as a whole. Some legal service providers may have quite a complicated corporate structure; others will simply be structured as one company.

Employee numbers and costs

Companies are required to disclose the average number of employees employed over the year as well as the associated costs of those employees.

Post balance sheet events and contingencies

The company should also include information on material subsequent events that happen after the close of the accounting period. This includes a need to disclose material contingent liabilities.

A contingent liability is when an existing circumstance may cause a loss in the future, depending on other events that have not yet happened or indeed that may never happen. For example, the company may be involved in an income tax dispute which if found in HMRC's favour could mean significant penalties and interest may have to be paid.

Tutorial 9 - Self Test Questions

Part A

Discuss the various forms of investments and funding available to a limited company and list the main advantages and disadvantages from both the company and the investor's points of view.

Part B

Baxter Ltd.

From the following information, prepare a Profit and Loss Appropriation Account for the Year to 5 April Year 8 and a Balance Sheet as at that date laid out in accordance with company law requirements.

The company has an authorised share capital of 300,000 Ordinary shares of £1 each, together with 75,000 7.5% Preference shares of £1 each. Of the Ordinary shares, 200,000 have been issued as fully paid, together with all the Preference shares.

Other balances remaining in the books of account after the Profit and Loss Account for the year to 5 April Year 8 has been prepared, which showed a Net Profit for that year of £49,600, are: -

	£
Stock	37,195
Trade Creditors	18,746
Debtors	22,401
Premises at Cost	320,000
Bank - Current Account	10,176
Wages - Owing	4,185
Motor Vehicles	66,000
Depreciation to date:-	
Motor Vehicles at Cost	49,500
Premises	80,000
Net Loss B/Fwd	(4,963)
Prepaid expense	263
Cash in Hand	408

The Board of Directors recommended and paid in the accounts for the year to 5 April Year 8 the Preference dividend and a 5% dividend on the Ordinary Shares. They also decided on a transfer to the General Reserve of £15,000 from the Appropriation Account.

Corporation Tax is assumed to be 20%.

Tutorial 9 - Self Test Answers

Part A

The most basic form of finance for a limited company is the issuing of ordinary shares. Ordinary shares have a fixed nominal or face value although their market value may vary greatly from this. Dividends are calculated on the nominal value of each share and are not tax allowable. Each ordinary share has an equal vote, so the ordinary shareholder can influence the way in which the firm is run, even if it is only by voting for the approval of the annual accounts, appointment of directors and approval of proposed dividends, at the annual general meeting.

The benefit to a company of raising finance through offering ordinary shares is that no dividend would be payable if there are no net profits available. However as each share carries with it a right to vote, a disadvantage could be a loss of control over the direction of the company. This is a particular risk for small companies, where control over the company could come about relatively easily by holding a majority of shares.

From a shareholder's point of view there is the potential that the rate of return in the form of the dividend paid will be greater than the prevailing bank account savings rate. A further advantage to the shareholder is that the share itself has a value that may also rise in line with the fortunes of the company; so that on sale of the shares a further profit may be made. The disadvantages are that just as there is potential for great rewards there is also the risk that the company will not be profit-making and ultimately the monies invested by the shareholder could be lost.

Another type of share is the preference share. This has a fixed percentage dividend which is expressed in the name of the share e.g. 8% £1 preference shares. This means that for each £1 share the shareholder will receive 8p per year. Preference shareholders are preferred when it comes to the payment of any dividends in that they receive their dividend from the first part of any available profits. Preference shares may also be cumulative which means that if in one year there are insufficient funds to pay the preference dividend, the right to that dividend is carried forward until there are sufficient funds and it can be paid. Sometimes preference shares are offered for a fixed period after which the company will buy back (or redeem) the shares.

From the company perspective, these shares can be useful to issue as they rarely have any voting rights attached to them which means that preference shareholders have little influence over the running of the company. Additionally as the amount of dividend is fixed this helps with company cash flow forecasts.

The benefit to the shareholder of investing in preference shares is that they know what the rate of return will be on the investment in advance and particularly where the shares are

cumulative the risk is limited to whether or not the company has sufficient distributable profits each year and as with ordinary shareholders whether the company is a going concern.

A third type of finance available is the debenture. Essentially this is a loan; a legal right to lend a company a fixed amount of money, for a given rate of interest and for a fixed period of time (unless the debentures are "irredeemable" in which case the company is not obliged to repay the debentures). Debenture holders are essentially creditors of the company and as such do not have any real influence over the running of the company. A "naked" debenture is an unsecured loan; most debenture holders prefer "secured" debentures, where a debenture trustee, often a bank, holds certain security from the company in trust for the debenture holders in case the company does not meet terms of the debenture and defaults on the payment of interest or on the capital repayment. This security is usually in the form of a charge over the fixed assets of the company.

The advantages for the company of raising finance through debentures are that the debentures carry no voting rights, the interest rate is fixed and so can be accurately forecast for cashflow purposes and the debenture interest is a tax allowable expense in the Profit and Loss Account. A disadvantage is that the debenture loan is usually repayable.

From the debenture holder's perspective, there is a guaranteed return as the debenture interest must be paid irrespective of a profit and it is usually at a fixed rate e.g. 7% Debentures.

Other forms of financing might be obtained by way of a bank loan or bank overdraft. These can be more expensive forms of borrowing depending on the economic climate and the appetite within the banks to lend funds.

Another form of finance often overlooked is the credit extended to a company by its creditors. Terms of trade are usually one month's credit, which is the same as the company usually has to offer to its customers and debtors. If the company can delay payment then this may turn into an interest free form of finance. This benefits the company as it is interest free but may prove to damage relationships with the company's creditors and may affect the company's reputation.

In deciding how to use the above types of finance, regard should be given to the types of potential investors available and the needs of the company for finance. Often this will mean that most companies elect to adopt a mixture of financing options.

Part B

Baxter Ltd.

Profit and Loss Appropriation Account for the Year ended 5 April Year 8

	£	£
Net Profit for the year		49,600
Less Corporation Tax		<u>9,920</u>
Net Profit for the year after taxation		39,680
Less Loss from last year brought forward		(4,963)
		34,717
Less Appropriations:-		
Transfer to General Reserve	15,000	
Preference Share dividend	5,625	
5% Ordinary Share dividend	<u>10,000</u>	
		<u>30,625</u>
Retained Profits carried forward to next year		<u><u>4,092</u></u>

Baxter Ltd.

Balance Sheet as at 5 April Year 8

	£ Cost to date	£ Depn	£ Net
<u>Fixed Assets</u>			
<u>Tangible Assets</u>			
Premises	320,000	80,000	240,000
Motor Vehicles	66,000	49,500	16,500
	<u>386,000</u>	<u>129,500</u>	<u>256,500</u>
<u>Current Assets</u>			
Stock		37,195	
Trade Debtors		22,401	
Prepayments		263	
Bank - Current Account		10,176	
Cash in Hand		408	
		<u>70,443</u>	
<u>Current Liabilities - Amounts falling due within one Year</u>			
Creditors and Accruals (18,746 + 4,185)	22,931		
Corporation Tax	<u>9,920</u>		
		<u>32,851</u>	
Net Current Assets			<u>37,592</u>
Total Assets less Current Liabilities			<u>294,092</u>
<u>Capital and Reserves</u>			
Called-up Share Capital			
200,000 Ordinary Shares of £1 each			200,000
75,000 7.5% Preference Shares of £1 each			75,000
General Reserve			15,000
Profit and Loss Account			4,092
			<u>294,092</u>

Tutorial 9 – Assignment

Part A

Fred and Jim are employed as engineers with a large engineering firm. They are friends as well as colleagues and in their spare time they have invented a new engineering tool. They have been advised by business advisors that if this was produced by outside contractors they could achieve sales of £100,000 in their first year and a net profit of £35,000. They decide to set up a private limited company to produce and sell this tool. They would seek directors' salaries of £10,000 each per year.

It is agreed with their bank manager that the new company needs an immediate operating capital of £50,000. The bank has agreed to provide an immediate business loan of £10,000, if required, secured on the houses of the two friends. Friends of the couple have also indicated that they might be interested in investing to help raise some of the required funding.

You are asked by Fred and Jim to advise on the financial structure of the new company and to specifically consider the choice of ordinary shares, preference shares, bank loan and debentures.

Prepare a report outlining the various characteristics of each form of finance and make a recommendation stating your reasoning behind it. Ideally you should ensure there is a good mix of all the finance options available.

You should also prepare a draft Balance Sheet as at the opening of the company, assuming your recommendation is adopted and assuming that all of the required £50,000 is received prior to opening.

Finally prepare an estimated Profit and Loss Appropriation Account as at the end of the first years trading, again assuming that your recommendation is adopted. Assume the rate of Corporation Tax at 20% and please ensure that you state the reasoning behind any other assumptions made (such as rate of ordinary dividend paid).

Part B

From the following details of Construction Litigants Ltd, prepare a Profit and Loss Appropriation Account for the year to 31 December Year 7, together with a Balance Sheet as at that date.

Net Profit for the year to 31 December Year 7 was £68,700, before any adjustments required by information given below.

The directors' salaries payable were £15,000 each for two directors for the year to 31 December Year 7 (these were unpaid at the year end).

The 5% debentures are repayable in 2025 and the debenture interest for this year was also unpaid at the year end.

The balance on the Profit and Loss Account at 31 December Year 6 brought forward was £51,335.

The preference share dividend was paid during the year and an ordinary share dividend of 10% was also paid. A transfer to General Reserve for the year of £55,000 was approved at the AGM.

Corporation Tax should be calculated at the rate of 20%.

Other balances are:

	£
Creditors	9,467
Stock	45,807
Cash in hand	274
Motor Vehicles at cost	35,700
Debtors	17,863
Goodwill at Cost	15,000
Buildings at cost	205,000
General Equipment at cost	64,000
5% Debentures	20,000
Depreciation to date - Goodwill	10,500
Depreciation to date - Buildings	107,625
Depreciation to date - General Equipment	38,400
Depreciation to date - Motor Vehicles	28,125
Bank - Current Account (money in the bank)	25,508
Called-up capital:-	
60,000 Ordinary Shares of £1 each	60,000
10,000 10% Preference Shares of £1 each	10,000
Share Premium Account	12,000