Company

By Sarah Azhar

The need for limited companies

- Limited liability companies, more commonly referred to as limited companies, came into existence originally because of the growth in the size of businesses, and the need to have a lot of people investing in the business who would not be able to take part in its management.

Limited liability

- The capital of a limited company is divided into shares. Shares can be of any nominal value – 10p, 25p, £1, £5, £10, or any other amount per share. To become a member of a limited company, or a shareholder, a person must buy one or more of the shares.
- If shareholders have paid in full for their shares, their liability is limited to what they have already paid for those shares. If a company loses all its assets, all those shareholders can lose is their shares. They cannot be forced to pay anything more in respect of the company’s losses.
- Shareholders who have only partly paid for their shares can be forced to pay the balance owing on the shares, but nothing else.

Public and private limited companies

- There are two classes of company, the public company and the private company. In the UK, private companies far outnumber public companies. In the Companies Acts, a public company is defined as one which fulfils the following conditions:
- Its memorandum (a document that describes the company) states that it is a public company, and that it has registered as such.

-It has an authorised share capital of at least £50,000

- Minimum membership is two
- There is no maximum.
- Its name must end with the words ‘public limited company’ or the abbreviation ‘PLC’

- It can offer its shares on Stock exchange but a private limited company cannot.

Public and private limited companies

- A private company is usually, but not always, a smaller business, and may be formed by one or more persons. It is defined by the Act as a company which is not a public company. The main differences between a private company and a public company are that a private company

-It can have an authorised capital of less than £50,000

-It cannot offer its shares for subscription to the public at large, whereas public companies can.

Public and private limited companies

The shares that are dealt in on the Stock Exchange are all of public limited companies. This does not mean that all public companies' shares are traded on the Stock Exchange, as, for various reasons, some public companies have either chosen not to, or not been allowed to have their shares traded there. The ones whose shares are traded are known as 'quoted companies' meaning that their shares have prices quoted on the Stock Exchange. They have to comply with Stock Exchange requirements in addition to those laid down by the Companies Acts and accounting standards.

Directors of a company

The day-to-day business of a company is not carried out by the shareholders. The possession of a share normally confers voting rights on the holder, who is then able to attend general meetings of the company. At one of these general meetings, normally the Annual General Meeting or AGM, the shareholders vote for directors, these being the people who will be entrusted with the running of the business. At each AGM, the directors report on their stewardship, and this report is accompanied by a set of financial statements for the year – the 'annual report'.

Legal status of a company

A limited company is said to possess a ‘separate legal identity’ from that of its shareholders. Put simply, this means that a company is not seen as being exactly the same as its shareholders. For instance, a company can sue one or more of its shareholders, and similarly, a shareholder can sue the company. This would not be the case if the company and its shareholders were exactly the same thing, as one cannot sue oneself.

Share capital

- Shareholders of a limited company obtain their reward in the form of a share of the profits, known as a dividend.
- The directors consider the amount of profits and decide on the amount of profits which are placed to reserves.
- The dividend is usually expressed as a percentage. A dividend of 10 per cent in Business A on 500,000 ordinary shares of £1 each will amount to £50,000, while a dividend of 6 per cent in Business B on 200,000 ordinary shares of £2 each will amount to £24,000.

Share capital

There are two main types of shares

1- Preference shares: Holders of these shares get an agreed percentage rate of dividend before the ordinary shareholders receive anything.

2-Ordinary shares: Holders of these shares receive the remainder of the total profits available for dividends. There is no upper limit to the amounts of dividends they can receive.

Share capital

Exhibit 45.2

A company has 500,000 £1 ordinary shares and 100,000 5 per cent non-cumulative preference shares of £1 each. The profits available for dividends are: year 1 £145,000, year 2 £2,000, year 3 £44,000, year 4 £118,000, year 5 £264,000. Assuming all profits are paid out in dividends, the amounts paid to each class of shareholder are:

Year	*1*	*2*	*3*	*4*	*5*
	£	£	£	£	£
Profits appropriated for dividends	145,000	2,000	44,000	118,000	264,000
Preference dividend (non-cumulative) (limited in year 2)	5,000	2,000	5,000	5,000	5,000
Dividends on ordinary shares	140,000	-	39,000	113,000	259,000
	145,000	2,000	44,000	118,000	264,000

Share capital

Exhibit 45.3

Assume that the preference shares in Exhibit 45.2 had been cumulative. The dividends would have been:

Year	*1*	*2*	*3*	*4*	*5*
	£	£	£	£	£
Profits appropriated for dividends	145,000	2,000	44,000	118,000	264,000
Preference dividend	5,000	2,000	8,000*	5,000	5,000
Dividends on ordinary shares	140,000	–	36,000	113,000	259,000
	145,000	2,000	44,000	118,000	264,000

*including arrears.

Share capital

The term ‘share capital’ can have any of the following meanings:

1 -**Authorised share capital**.: Sometimes known as registered capital or nominal capital. This is the total of the share capital which the company is allowed to issue to shareholders.

2-Issued share capital: This is the total of the share capital actually issued to shareholders.

If all of the authorised share capital has been issued, then 1 and 2 above would be the same amount.

3-Called-up capital: Where only part of the amount payable on each issued share has been asked for, the total amount asked for on all the issued shares is known as the called-up capital.

4- **Uncalled capital**: This is the total amount which is to be received in future relating to issued share capital, but which has not yet been asked for.

5- **Calls in arrears**: The total amount for which payment has been asked for (i.e. ‘called for’), but has not yet been paid by shareholders.

6 -**Paid-up capital**: This is the total of the amount of share capital which has been paid for by shareholders.

Redeemable and non-redeemable preference shares

- Redeemable preference shares allow for the repayment of the preference shares to shareholders. The company may redeem these shares at an agreed value on a specified date.
- Non-redeemable preference shares cannot be redeemed during the lifetime of a company.

Share capital

Exhibit 45.4

1 Better Enterprises Ltd was formed with the legal right to issue 1 million shares of £1 each.
2 The company has actually issued 750,000 shares.
3 None of the shares has yet been fully paid up. So far, the company has made calls of 80p (£0.80) per share.
4 All the calls have been paid by shareholders except for £200 owing from one shareholder.

(a)	Authorised or nominal share capital is:	1	£1 million.
(*b*)	Issued share capital is:	2	£750,000.
(*c*)	Called-up share capital is:	3	750,000 × £0.80 = £600,000.
(*d*)	Calls in arrears amounted to:	4	£200.
(e)	Paid-up share capital is:	(*c*)	£600,000 less (*d*) £200 = £599,800.

Bonus shares

Bonus shares are ‘free’ shares issued to shareholders without their having to pay anything for them. The reserves (e.g. accumulated profits held in the profit and loss account and shown in the balance sheet) are utilised for the purpose. Thus, if before the bonus issue there were £20,000 of issued share capital and £12,000 reserves, and a bonus issue of 1 for 4 was then made (i.e. 1 bonus share for every 4 shares already held) the bonus issue would amount to £5,000. The share capital then becomes £25,000 and the reserves become £7,000.

Debentures

- The term debenture is used when a limited company receives money on loan, and certificates called debenture certificates are issued to the lender.
- Interest will be paid to the holder, the rate of interest being shown on the certificate.
- They are not always called debentures; they are often known as loan stock or as loan capital.
- Debenture interest has to be paid whether profits are made or not. They are, therefore, different from shares, where dividends depend on profits being made.
- A debenture may be either Redeemable, i.e. repayable at or by a particular date, or Irredeemable, normally repayable only when the company is officially terminated by its going into liquidation. (Also sometimes referred to as 'perpetual' debentures.)

Debentures

- If a date is shown behind a debenture, e.g. 2005/2012, it means that the company can redeem it in any of the years 2005 to 2012 inclusive.
- People lending money to companies in the form of debentures will be interested in how safe their investment will be.
- Some debentures are given the legal right that on certain happenings the debenture holders will be able to take control of specific assets, or of the whole of the assets. They can then sell the assets and recoup the amount due under their debentures, or deal with the assets in ways specified in the deed under which the debentures were issued. Such debentures are known as being ‘secured’ against the assets – (The term ‘mortgage’ debenture is sometimes used instead of ‘secured’.)
- Other debentures have no prior right to control the assets under any circumstances. These are known as ‘simple’ or ‘naked’ debentures.

Trading and profit and loss accounts of companies

- The trading and profit and loss accounts for both private and public companies are drawn up in exactly the same way.
- The trading account of a limited company is no different from that of a sole trader or a partnership. However, some differences may be found in the profit and loss account.
- The two main expenses that would be found only in company accounts are directors’ remuneration and debenture interest.

Trading and profit and loss accounts of companies

Directors' remuneration

As directors exist only in companies, this type of expense is found only in company accounts.

Directors are legally employees of the company, appointed by the shareholders. Their remuneration is charged to the profit and loss account.

Debenture interest

The interest payable for the use of the money is an expense of the company, and is payable whether profits are made or not. This means that debenture interest is charged as an expense in the profit and loss account itself. Contrast this with dividends which are dependent on profits having been made.

Appropriation account

Next under the profit and loss account is a section called the 'profit and loss appropriation account'. The appropriation account shows how the net profits are to be appropriated, i.e. how the profits are to be used. This is similar in nature to the appropriation account you learnt about when you looked at partnership

Appropriation account-credit side

- **Net profit for the year:** This is the net profit brought down from the main profit and loss account.
- **Balance brought forward from last year:** As you will see, all the profits may not be appropriated during a period. This then will be the balance on the appropriation account, as brought forward from the previous year. It is usually called retained profits.

Appropriation account-debit side

Transfers to reserves: The directors may decide that some of the profits should not be included in the calculation of how much should be paid out as dividends. These profits are transferred to reserve accounts. There may be a specific reason for the transfer such as a need to replace fixed assets. In this case an amount would be transferred to a fixed assets replacement reserve. Or the reason may not be specific. In this case an amount would be transferred to a general reserve account.

Appropriation account-debit side

- **Amounts written off as goodwill:** Goodwill, in a company, may have amounts written off it from time to time. When this is done the amount written off should be shown in the appropriation account and not in the main profit and loss account.
- **Preliminary expenses:** When a company is formed, there are many kinds of expenses concerned with its formation. These include, for example, legal expenses and various government taxes. Since 1981 these cannot be shown as an asset in the balance sheet, and can be charged to the appropriation account.
- **Taxation payable on profits:** the taxation levied upon them is called corporation tax. It is shown as a deduction from profit for the year before taxation (i.e. this is the net profit figure) to show the net result, i.e. profit for the year after taxation.
- **Dividends:** Out of the remainder of the profits the directors propose what dividends should be paid.
- **Balance carried forward to next year:** After the dividends have been proposed there will probably be some profits that have not been appropriated. These retained profits will be carried forward to the following year.

Exhibit 45.5

IDC Ltd has share capital of 400,000 ordinary shares of £1 each and 200,000 5 per cent preference shares of £1 each.

- The net profits for the first three years of business ended 31 December are: 20X4, £109,670; 20X5 £148,640; and 20X6 £158,220.
- Transfers to reserves are made as follows: 20X4 nil; 20X5, general reserve, £10,000; and 20X6, fixed assets replacement reserve, £22,500.
- Dividends were proposed for each year on the preference shares at 5 per cent and on the ordinary shares at: 20X4, 10 per cent; 20X5, 12.5 per cent; 20X6, 15 per cent.
- Corporation tax, based on the net profits of each year, is 20X4 £41,000; 20X5 £52,500; 20X6 £63,000.

IDC Ltd
Profit and Loss Appropriation Accounts (1)
For the year ended 31 December 20X4

	£	£
Profit for the year before taxation		109,670
Less Corporation tax		(41,000)
Profit for the year after taxation		68,670
Less Proposed dividends:		
Preference dividend of 5%	10,000	
Ordinary dividend of 10%	40,000	
		(50,000)
Retained profits carried forward to next year		18,670

(2) For the year ended 31 December 20X5

	£	£	£
Profit for the year before taxation			148,640
Less Corporation tax			(52,500)
Profit for the year after taxation			96,140
Add Retained profits from last year			18,670
			114,810
Less Transfer to general reserve		10,000	
Proposed dividends:			
Preference dividend of 5%	10,000		
Ordinary dividend of $12\frac{1}{2}$%	50,000		
		60,000	
			(70,000)
Retained profits carried forward to next year			44,810

(3) For the year ended 31 December 20X6

	£	£	£
Profit for the year before taxation			158,220
Less Corporation tax			(63,000)
Profit for the year after taxation			95,220
Add Retained profits from last year			44,810
			140,030
Less Transfer to fixed assets replacement reserve		22,500	
Proposed dividends:			
Preference dividend of 5%	10,000		
Ordinary dividend of 15%	60,000		
		70,000	
			(92,500)
Retained profits carried forward to next year			47,530

Balance sheet

- Prior to the UK Companies Act 1981, provided it disclosed the necessary information, a company could draw up its balance sheet and profit and loss account for publication in any way that it wished.
- Exhibit 45.6 is for students sitting examinations based on UK laws.
- Exhibit 45.7 is for students sitting local overseas examinations not based on UK legislation.

Exhibit 45.6 (for students sitting examinations based on UK company legislation)

Letters in brackets (A) to (G) refer to notes following the balance sheet.

Balance Sheet as at 31 December 20X7

		£000	£000	£000
Fixed assets				
Intangible assets	(A)			
Goodwill				10,000
Tangible assets	(B)			
Buildings			9,000	
Machinery			5,600	
Motor vehicles			2,400	
				17,000
				27,000
Current assets				
Stock			6,000	
Debtors			3,000	
Bank			4,000	
			13,000	
Creditors: Amounts falling due within one year	(C)			
Proposed dividend		1,000		
Creditors		3,000		
Corporation tax owing		2,000		
			(6,000)	
Net current assets	(D)			7,000
Total assets less current liabilities				34,000
Creditors: amounts falling due after more than one year	(E)			
Debenture loans				(8,000)
				26,000
Capital and reserves				
Called-up share capital	(F)			20,000
Share premium account	(G)			1,200
Other reserves				
General reserve				3,800
Profit and loss account				1,000
				26,000

Notes:

(A) Intangible assets are those not having a 'physical' existence; for instance, you can see and touch tangible assets under (B), i.e. buildings, machinery etc., but you cannot see and touch goodwill.

(B) Tangible fixed assets under a separate heading. Note that figures are shown net after depreciation. In a note accompanying the accounts the cost and depreciation on these assets would be given.

(C) Only items payable within one year go under this heading.

(D) The term 'net current assets' replaces the more familiar term of 'working capital'.

(E) These particular debentures are repayable several years hence. If they had been payable within one year they would have been shown under (C).

(F) An analysis of share capital will be given in supplementary notes to the balance sheet.

(G) One reserve that is in fact not labelled with the word 'reserve' in its title is the share premium account. For various reasons (discussed fully in *Business Accounting 2*) shares can be issued for more than their face (or 'nominal') value. The excess of the price at which they are issued over the nominal value of the shares is credited to a share premium account. This is then shown with the other reserves in the balance sheet.

Exhibit 45.7 (for local overseas examinations)

Balance Sheet as at 31 December 20X7

		Cost	Depreciation to date **(b)**	Net book value
Fixed assets	**(a)**	£000	£000	£000
Goodwill		15,000	5,000	10,000
Buildings		15,000	6,000	9,000
Machinery		8,000	2,400	5,600
Motor vehicles		4,000	1,600	2,400
		42,000	15,000	27,000
Current assets				
Stock			6,000	
Debtors			3,000	
Bank			4,000	
			13,000	
Less Current liabilities				
Proposed dividend		1,000		
Creditors		3,000		
Corporation tax owing		2,000		
			(6,000)	
Net current assets				7,000
				34,000
Debentures				
Six per cent debentures: repayable 20X9				(8,000)
				26,000
Financed by:				
Share capital				
Authorised 30,000 shares of £1 each	**(c)**			30,000
Issued 20,000 ordinary shares of £1 each, fully paid	**(d)**			20,000
Reserves	**(e)**			
Share premium			1,200	
General reserve			3,800	
Profit and loss account			1,000	
				6,000
	(f)			26,000

Notes:

(*a*) Fixed assets should normally be shown either at cost or alternatively at some other valuation. In either case, the method chosen should be clearly stated.

(*b*) The total depreciation from date of purchase to the date of the balance sheet should be shown.

(*c*) The authorised share capital, where it is different from the issued share capital, is shown as a note.

(*d*) Where shares are only partly called up, then it is the amount actually called up that appears in the balance sheet and not the full amount.

(*e*) Reserves consist either of those unused profits remaining in the appropriation account, or those transferred to a reserve account appropriately titled, e.g. general reserve, fixed assets replacement reserve. At this juncture all that needs to be said is that any account labelled as a reserve has originated by being charged as a debit in the appropriation account and credited to a reserve account with an appropriate title. These reserves are shown in the balance sheet after share capital under the heading of 'Reserves'.

(*f*) The share capital and reserves should be totalled so as to show the book value of all the shares in the company. Either the term 'shareholders' funds' or 'members' equity' is often given to the total of share capital plus reserves.

The following trial balance is extracted from the books of F W Ltd as on 31 December 20X5:

Trial balance as on 31 December 20X5

	Dr £	Cr £
10% preference share capital		200,000
Ordinary share capital		700,000
10% debentures (repayable 20X9)		300,000
Goodwill at cost	255,000	
Buildings at cost	1,050,000	
Equipment at cost	120,000	
Motor vehicles at cost	172,000	
Provision for depreciation: buildings 1.1.20X5		100,000
Provision for depreciation: equipment 1.1.20X5		24,000
Provision for depreciation: motor vehicles 1.1.20X5		51,600
Stock 1.1.20X5	84,912	
Sales		1,022,000
Purchases	439,100	
Carriage inwards	6,200	
Salaries and wages	192,400	
Directors' remuneration	123,000	
Motor expenses	3,120	
Business rates and insurances	8,690	
General expenses	5,600	
Debenture interest	15,000	
Debtors	186,100	
Creditors		113,700
Bank	8,390	
General reserve		50,000
Share premium account		100,000
Interim ordinary dividend paid	35,000	
Profit and loss account 31.12.20X4		43,212
	2,704,512	2,704,512

The following adjustments are needed:

(i) Stock at 31.12.20X5 was £91,413.

(ii) Depreciate buildings £10,000; motor vehicles £18,000; equipment £12,000.

(iii) Accrue debenture interest £15,000.

(*iv*) Provide for preference dividend £20,000 and final ordinary dividend of 10 per cent.
(*v*) Transfer £10,000 to general reserve.
(*vi*) Write off goodwill £30,000.
(*vii*) Authorised share capital is £200,000 in preference shares and £1 million in ordinary shares.
(*viii*) Provide for corporation tax £50,000.

The financial statements are shown below. The profit and loss account is suitable for anyone sitting UK examinations and for anyone sitting local overseas examinations. The balance sheets do differ and are therefore shown separately for both groups of students.

(a) Trading and profit and loss accounts suitable both for UK and overseas examinations. For internal use only, not for publication.

F W Ltd
Trading and Profit and Loss Account for the year ended 31 December 20X5

		£	£	£
Sales				1,022,000
Less Cost of goods sold:				
Opening stock			84,912	
Add Purchases			439,100	
Add Carriage inwards			6,200	
			530,212	
Less Closing stock			(91,413)	
				(438,799)
Gross profit				583,201
Less Expenses:				
Salaries and wages			192,400	
Motor expenses			3,120	
Business rates and insurances			8,690	
General expenses			5,600	
Directors' remuneration	(A)		123,000	
Debenture interest	(B)		30,000	
Depreciation: Buildings			10,000	
Equipment			12,000	
Motor vehicles			18,000	
				(402,810)
Profit for the year before taxation				180,391
Less Corporation tax				(50,000)
Profit for the year after taxation				130,391
Add Retained profits from last year				43,212
				173,603
Less Appropriations:				
Transfer to general reserve			10,000	
Goodwill part written off			30,000	
Preference share dividend			20,000	
Ordinary share dividends:				
Interim		35,000		
Final	(C)	70,000		
			105,000	
				(165,000)
Retained profits carried forward to next year				8,603

F W Ltd
Balance Sheet as at 31 December 20X5

		£	£	£
Fixed assets				
Intangible assets				
Goodwill				225,000
Tangible assets	(A)			
Buildings			940,000	
Equipment			84,000	
Motor vehicles			102,400	
				1,126,400
				1,351,400
Current assets				
Stock			91,413	
Debtors			186,100	
Bank			8,390	
			285,903	
Creditors: amounts falling due within one year				
Creditors		113,700		
Proposed dividend		90,000		
Debenture interest accrued		15,000		
Taxation		50,000		
			(268,700)	
Net current assets				17,203
Total assets less current liabilities				1,368,603
Creditors: amounts falling due after more than one year				
10% Debentures				(300,000)
				1,068,603
Capital and reserves	(B)			
Called-up share capital	(C)			900,000
Share premium account				100,000
Other reserves				
General reserve				60,000
Profit and loss				8,603
				1,068,603

Balance Sheet as at 31 December 20X5

	Cost	Depreciation to date	Net book value
Fixed assets	£	£	£
Goodwill	255,000	30,000	225,000
Buildings	1,050,000	110,000	940,000
Equipment	120,000	36,000	84,000
Motor vehicles	172,000	69,600	102,400
	1,597,000	245,600	1,351,400
Current assets			
Stock		91,413	
Debtors		186,100	
Bank		8,390	
		285,903	
Less Current liabilities			
Creditors	113,700		
Dividends owing	90,000		
Debenture interest owing	15,000		
Taxation	50,000		
		(268,700)	
Net current assets			17,203
			1,368,603
Loan capital			
10% debentures			(300,000)
			1,068,603
Financed by:			
Share Capital		*Authorised*	*Issued*
		£	£
Preference shares		200,000	200,000
Ordinary shares		1,000,000	700,000
		1,200,000	900,000
Reserves			
Share premium		100,000	
General reserve		60,000	
Profit and loss		8,603	
			168,603
			1,068,603

Statement of changes in equity (Example)

	Ordinary share capital	General reserve	Retained profits	Total
Balance on 1 My 2016	150000	75000	410000	635000
Issue of shares (50000 @ $1)	50000			50000
Add profit for year			90000	90000
Transfer to general reserve		50000	(50000)	-
Dividend paid (interim)			(10000)	(10000)
Dividend paid final			(20000)	(20000)
Balance at 30 April 2017	200000	125000	420000	745000

Why amounts are transferred to general reserve

- To set aside profits for re-investment
- To indicate that part of profit is not available for distribution
- To set aside profits for payment of future dividends

Difference between ordinary shares and Preference shares

Ordinary shares	Preference shares
Ordinary dividends vary according to profits made	Preference dividend is usually a fixed rate
Ordinary dividends are paid after preference dividends	Preference dividends are paid before ordinary dividends
Ordinary shareholders have rights to vote	Preference shareholders have no voting rights
If no dividend is declared in a year, ordinary shareholders will not receive it in future	If no preference dividend is declared in a year, it may accumulate and be paid in future.

Difference between preference shares and debentures

- Preference holders are shareholder, debenture holders are long term loan creditors.
- Debenture holders are paid interest, preference holders receive dividends.
- Debenture interest is an expense, preference dividend is an appropriation of profit.
- Debenture holders receive fixed amount of interest, preference may not receive dividend.
- Debenture holders are paid interest before payment of preference holders.

Difference between ordinary shares and debentures

- Ordinary shareholders are owners of the business whereas debenture holders are lenders of a business.
- For ordinary shares, payment of dividends depend on profits or director's policy, but debenture holders receive a guaranteed interest.
- There is no fixed rate of ordinary dividends, but there is a fixed rate for debenture interest.
- Ordinary share is a permanent capital for business, whereas debentures are borrowed for a specific period and have to be paid back at a future date.

Cumulative and non-cumulative preference shares

- If profits are not sufficient to pay full amount of dividends on non-cumulative preference shares in a particular year, then the amount of unpaid dividend is not carried forward for payment in subsequent years.
- Cumulative preference shareholders have the right to receive any arrears of dividends in a subsequent year before any dividend is paid to ordinary shareholders.