Chapter 5 Company accounts

Riding a tiger

Indian outsourcing group chief admits to $1bn accounting fraud

FT

By Joe Leahy

The head of one of India's biggest outsourcing groups has confessed to fixing the company's books in a $1bn ($662m) fraud.

B. Ramalinga Raju, chairman and chief executive of Satyam Computer Services, resigned yesterday after admitting that he had manipulated the accounts for 'several' years to show hugely inflated profits and fictitious assets.

The scandal will raise questions about how outsourcing groups are regulated and audited. Satyam was audited by PwC and was the first Indian company to list on three international stock exchanges – Mumbai, New York and Amsterdam – yet the fraud went unnoticed for years.

In a letter to the Satyam board, Mr Raju confessed and said he would resign and 'subject myself to the laws of the land'. He said that the cover up started as an attempt to disguise a poor quarterly performance by inflating group profit and got out of hand.

'It was like riding a tiger, not knowing when to get off without being eaten,' Mr Raju wrote.

The Securities and Exchange Board of India, the regulator, said it was launching an inquiry and would 'check whether the audit was done properly'.

Mr Raju said the accounts in the quarter ended last September included a cash pile of Rs53.61bn (£728m), of which 94 per cent was 'fictitious'. Among other irregularities, the operating margin was inflated to 24 per cent of revenue against an actual figure of 3 per cent, Mr Raju said.

www.ft.com, 8 January 2009.

Source: Reproduced with permission from *The Financial Times*.

Questions relating to this news story can be found on page 119

About this chapter

In the previous chapter we have shown you how to prepare a set of basic financial statements for a sole trader entity. The management and organization of such entities are not normally very complex, so we have been able to cover the overall procedures without becoming *too* bogged down in the detail (although this may rather surprise you).

Many non-accountants using this book are, however, likely to work for a *company*. There are many different types of companies but the most common ones are private limited liability companies and public limited liability companies (as we explained in Chapter 2). By law, all companies have to prepare a set of annual accounts and supply a copy to their shareholders. They also have to file a copy with the Registrar of Companies, i.e. send it to the Registrar. This means that the accounts are then open to inspection by the public. The amount of detail disclosed or published in company accounts (i.e. included) depends upon their type and size.

We shall be dealing with the disclosure requirements of companies in Chapters 8 and 9. In this chapter we explain how to prepare a company's financial accounts for the *internal* management. There are no legal requirements covering the presentation and contents of financial accounts for such a purpose, so a company can do more or less as it wants. Nevertheless, in order to cut down on the amount of work involved, most companies probably produce internal accounts that are similar to the ones required for external purposes, except that they are likely to be much more detailed.

Learning objectives

By the end of this chapter you should be able to:

- explain what is meant by limited liability;
- distinguish between private and public companies;
- describe how companies are organized;
- prepare a basic set of financial statements for a company.

Why this chapter is important

This chapter is important for a non-accountant because it shows how the material covered in earlier chapters can be adapted for use in preparing company accounts. As many non-accountants work for a company (while others will have contact with one) this chapter will help them to do a better job if they know something about the origin, structure and operation of companies. They will be even better placed if they can then use the available accounting information to assess the past and future performance of their own company and compare it with its competitors. In order to be able to do so, it is necessary to know where the accounting information comes from, what it includes, how it has been summarized and any deficiencies that it may have. This can be best achieved by being able to prepare a simple set of financial statements for a company. This chapter provides non-accountants with that opportunity.

We start our study of company accounts with an explanation of what is meant by 'limited liability'.

Limited liability

There is a great personal risk in operating a business as a sole trader or as a partnership. If the business runs short of funds, the owners may be called upon to settle the business's debts out of their own private resources. This type of risk can have a damaging effect on the development of new businesses. So there is a need for a different type of entity that will neither make the owners bankrupt nor inhibit new developments. This need became apparent in the nineteenth century following the Industrial Revolution when enormous amounts of capital were required to finance new and rapidly expanding industries such as the railways and shipbuilding.

These sorts of ventures were undertaken at great personal risk. By agreeing to become involved in them many investors faced bankruptcy if the ventures were unsuccessful (as they often were). It became apparent that the development of industry would be hindered unless some means could be devised of restricting the personal liability of prospective investors.

So the concept of *limited liability* was born although it was not entirely an innovation of the nineteenth century. It eventually received legal recognition in 1855 when the Limited Liability Act was passed. The Act only remained in force for a few months before it was repealed and incorporated into the Joint Stock Companies Act 1856. By distinguishing between the private and public affairs of business proprietors, the 1855 Act effectively created a new form of legal entity. Since the 1850s Parliament has passed a number of other Companies Acts, all of which have continued to give legal recognition to the concept of limited liability.

The important point about a limited liability company is that no matter what financial difficulties it may get into, its members cannot be required to contribute more than an agreed amount of capital, so there is no risk of its members being forced into bankruptcy.

The concept of limited liability is often very difficult for business owners to understand, especially if they have formed one out of what was originally a sole trader or a partnership entity (this point is illustrated in Figure 5.1). Unlike such entities, companies are bound by some fairly severe legal operating restrictions. The legal restrictions can be somewhat burdensome but they are necessary for the protection of all those parties who might have dealings with the company (such as creditors and employees). This is because if a limited liability company runs short of funds the creditors and employees might not get paid. It is only fair, therefore, to warn all those people who might have dealings with it that they run a risk in doing business with it. So companies have to be more open about their affairs than do sole traders and partnerships.

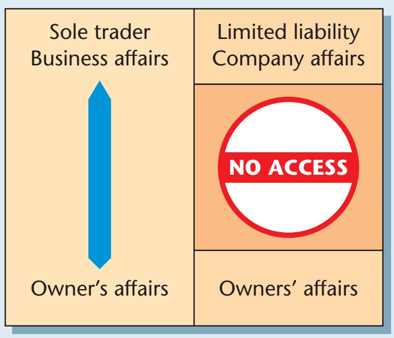

Figure 5.1 **Access: sole trader vs limited liability company**

Structure and operation

In this section we examine the structure and operation of limited liability companies. In order to make it easier to follow we have broken down our examination into a number of subsections. A summary of the section is also presented in diagrammatic format in Figure 5.2.

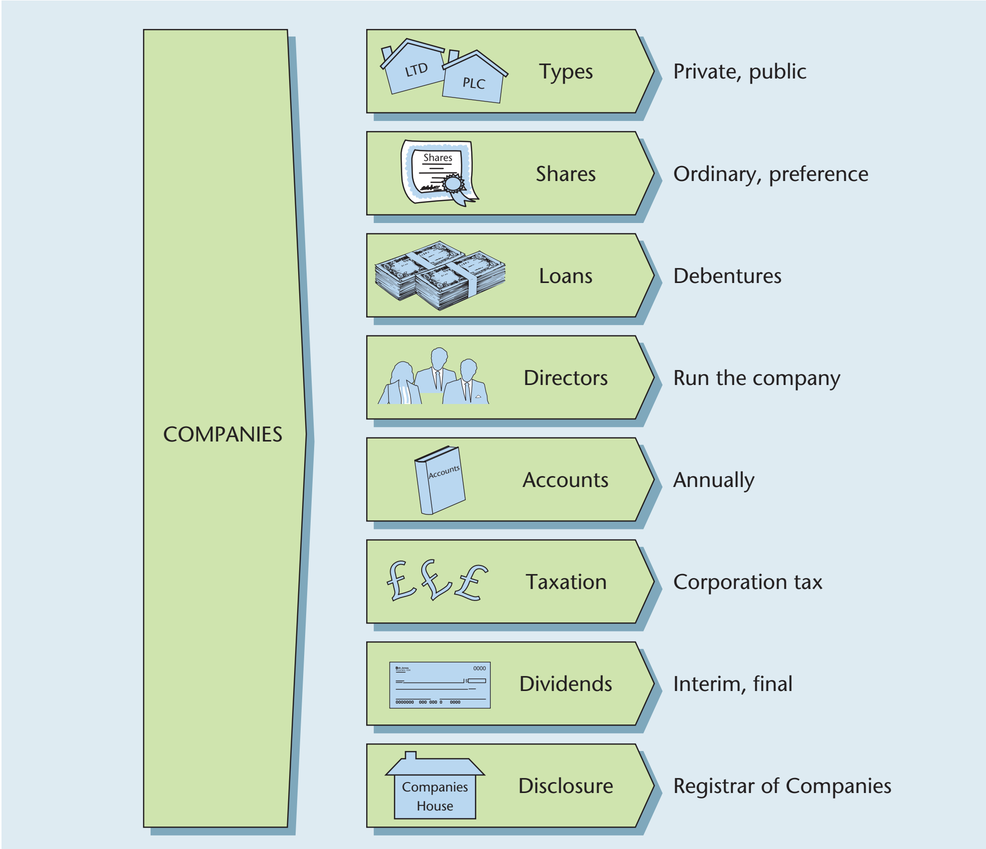

Figure 5.2 Structure and operation of companies

Share capital

Although the law recognizes that limited liability companies are separate beings with a life of their own, i.e. separate from those individuals who collectively own and manage them, it also accepts that someone has to take responsibility for promoting the company and giving it life. Only one person is required to form a private company and that person (or persons if there is more than one) agrees to make a capital contribution by buying a number of shares. The capital of a company is known as its *share capital*. The share capital will be made up of a number of shares of a certain denomination, such as 10p, 50p or £1. Members may hold only one share, or many hundreds or thousands depending upon the total share capital of the company, the denomination of the shares and the amount that they wish to contribute.

The maximum amount of capital that the company envisages ever raising has to be stated. This is known as its *authorized share capital*, although this does not necessarily mean that it will issue shares up to that amount. In practice, it will probably only issue sufficient capital to meet its immediate and foreseeable requirements. The amount of share capital that it has actually issued is known as the *issued share capital*. Sometimes, when shares are issued, prospective shareholders are only required to pay for them in instalments. Once all the issued share capital has been paid for, it is described as being *fully paid*.

There are two main types of shares: *ordinary shares* and *preference shares*. Ordinary shares do not usually entitle the shareholder to any specific level of dividend. Preference shareholders are normally entitled to a fixed level of dividend and they have priority over the ordinary shareholders if the company is liquidated. Sometimes the preference shares are classed as *cumulative*; this means that if the company cannot pay its preference dividend in one year, the amount due accrues until such time as the company has the profits to pay all of the accumulated dividends.

We show the share capital structure of companies in Figure 5.3.

Types of companies

A prospective shareholder may invest in either a public company or a private company. A *public company* must have an authorized share capital of at least £50 000, and it becomes a public company merely by stating that it is a public company. In fact, most public limited companies in the United Kingdom have their shares listed on the London Stock Exchange and so they are often referred to as *listed* (or quoted) companies. As a warning to those parties who might have dealings with them, public companies have to include the term 'public limited liability company' after their name (or its abbreviation 'plc').

Any company that does not make its shares available to the public is regarded as being a *private company*. Like public companies, private companies must also have a stated amount of authorized share capital although no minimum amount is prescribed. Otherwise, their share capital requirements are very similar to public companies.

Private companies also have to warn the public that their liability is limited. They must do so by describing themselves as 'limited liability companies' and attaching the term 'limited' after their name (or the abbreviation 'ltd').

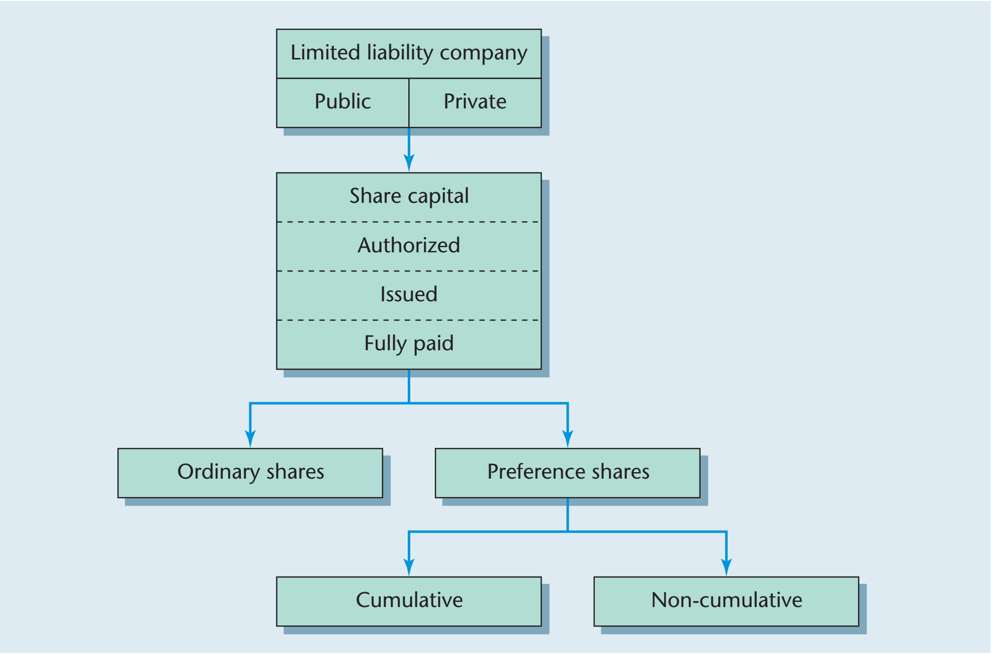

Figure 5.3 Types of shares

Activity 5.1

Limited liability companies have to disclose some information about their operations as well as putting 'limited' ('ltd') or public limited company ('plc') after their name in order to warn the public that their liability is limited.

Do you think that such safeguards are adequate? What more can be done? How far do you think that it is fair for individuals to set up businesses under the protection of limited liability? The business may then go into liquidation and the creditors will be left without any means of getting their money back from the owners of the company. Is this acceptable if the concept of limited liability encourages new businesses to be formed?

Loans

Besides obtaining the necessary capital from their shareholders, companies often borrow money in the form of *debentures*. A company may invite the public to loan it some money for a certain period of time (the period can be unspecified) at a certain rate of interest. A debenture loan may be secured on specific assets of the company, on its assets generally or it might not be secured at all. If the loan is secured and the company cannot repay it on its due repayment date, the debenture holders may sell the secured assets and use the amount to settle what is owing to them.

Debentures, like shares, may be bought and sold freely on the Stock Exchange. The nearer the redemption date for the repayment for the debentures, the closer the market price will be to their nominal value, i.e. their face, or stated paper value. If they are to be redeemed at a premium, i.e. in excess of their nominal value, the market price may exceed the nominal value.

Debenture holders are not shareholders of the company and they do not have voting rights. From the company's point of view, one further advantage of raising capital in the form of debenture loans is that for taxation purposes the interest can be charged as a business expense against the profit for the year (unlike dividends).

Disclosure of information

It is necessary for both public and private companies to supply a minimum amount of information to their members. The detailed requirements will be examined in Chapters 8 and 9. You might find it surprising to learn that shareholders have neither a right of access to the company's premises nor a right to receive any information that they demand. This might not seem fair but it would clearly be difficult for a company's managers to cope with thousands of shareholders, all of whom suddenly turned up one day demanding to be let into the building in order to inspect the company's books of account.

Instead, shareholders in both private and public companies have to be supplied with an annual report containing at least the minimum amount of information required by the Companies Act 2006. The company also has to file (as it is called) a copy of the report with the Registrar of Companies. This means that on payment of a small fee the report is open to inspection by any member of the public who wants to consult it. Some companies (defined as small or medium-sized) are permitted to file an abbreviated version of their annual report with the registrar, although the full report must still be sent to their shareholders.

The disclosure requirements are shown in summary form in Figure 5.4.

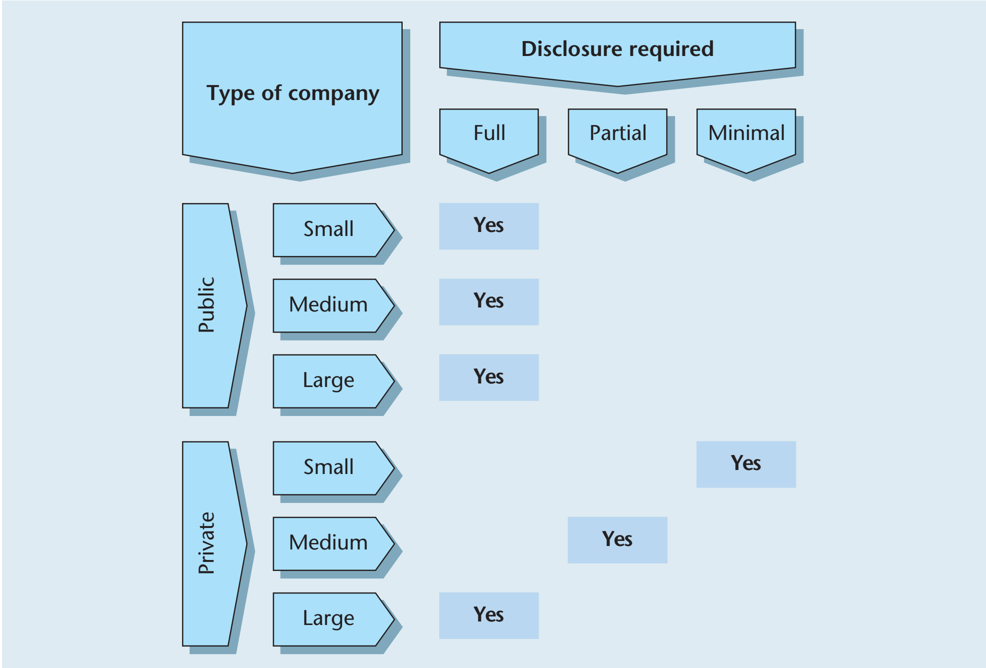

Figure 5.4 Disclosure of information

Accounts

Company accounts are very similar to those of sole traders. They do, however, tend to be more detailed and some modifications have to be made in order to comply with various legal requirements.

Directors

A limited liability company must always be regarded as a separate entity, i.e. separate from those shareholders who own it collectively and separate from anyone who works for it. This means that all those who are employed by it are its employees, no matter how senior they are. Nevertheless, someone has to take responsibility for the management of the company and so the shareholders usually delegate that responsibility to *directors*.

Directors are the most senior level of management. They are responsible for the day-to-day running of the company and they answer to the shareholders. Any remuneration paid to them as directors is charged as an expense of the business. They may also be shareholders but any dividends that they receive are regarded as being a private matter. They should not be confused with any payments that they receive as directors.

The distinction between employees and shareholder–employees is important even if the sole member of a private company works full time in the business. The same requirement applies to public companies except that they must have at least two members. As we have emphasized throughout the chapter, in law the company is regarded as being a separate entity. Even if there are just two shareholders who both work full-time for the company, the company is still treated as distinct from that of the two individuals who happen to own it. They may take decisions that appear to affect no one else except themselves but because they operate the company under the protection of limited liability they have certain obligations as well as rights. As a result they are not as free to run the company as they would be if it were (say) a partnership.

Dividends

News clip

Dividend pay-out

Between 2000 and 2006 Sanyo, the Japanese electronics group, admitted that it had added up its figures incorrectly. This meant that its losses over this period were greater than had been reported and that it had paid out 28 billion yen too much in dividends.

Source: Adapted from *The Guardian*, 27 December 2007, p. 38.

Profits are usually distributed to shareholders in the form of a dividend. A dividend is calculated on the basis of so many pence per share. The actual dividend will be recommended by the directors to the shareholders. It will be based on the amount of net profit earned during the year and how much profit the directors want to retain in the business.

A dividend may have been paid during the year as an *interim dividend*, i.e. a payment on account. At the year end the directors may recommend a *final* dividend. The final dividend has to be approved by the shareholders at a general meeting.

Taxation

Taxation is another feature which clearly distinguishes a limited liability company from that of a sole trader entity. Sole traders do not have tax levied on them as entities. Instead, tax is levied on the amount of profit the owner has made during the year. The tax payable is a private matter and in accordance with the entity rule, it lies outside the boundary of the entity. Any tax that appears to have been paid by the entity on the owner's behalf is treated as part of the owner's drawings, i.e. an amount paid as part of the share of the profits.

Activity 5.2

Assume that you would like to start a small business of your own. You have heard that a limited liability company will not make you bankrupt if it is unsuccessful. So you decide to form a company.

List three advantages and three disadvantages in the table below of running your business as a limited liability company.

Advantages	Disadvantages
(1)	(1)
(2)	(2)
(3)	(3)

Companies are treated quite differently. They are taxed in their own right like individuals. They have their own form of taxation known as *corporation tax*. Corporation tax was introduced in 1965 and all companies are eligible to pay it. It is based on the company's accounting profit for a particular financial year. The accounting profit has to be adjusted, however, because some items are treated differently for tax purposes, e.g. the depreciation of fixed assets. Any corporation tax due at the year end is treated as a current liability.

Now that we have outlined the basic structure and operation of limited liability companies we can begin to examine company accounts in some detail. We start with the profit and loss account.

The profit and loss account

News clip

Concealed costs

A £16.5m fraud was uncovered at the Scottish mineral water division of Greencore, the Irish good group. It appears that the internal auditors found that 'significant costs' had been concealed.

Source: Adapted from www.accountancyage.com/2223234.

As we suggested earlier, the preparation of a company's trading and profit and loss account is basically no different from that of sole trader entities. Almost an identical format or structure may be adopted and it is only after the net profit stage that some differences become apparent. Company accounts usually include a *profit and loss appropriation account*. Such an account is usually placed below the profit and loss account although no clear dividing line may be drawn between them. An example of a company's profit and loss appropriation account is shown in Example 5.1.

Example 5.1

A company's profit and loss appropriation account

	£000
Net profit for the year before taxation	1 000
Taxation	(300)
Net profit for the year after taxation	700
Dividends	(500)
Retained profit for the year	200

You can see from Example 5.1, that the company's net profit for the year is appropriated (or used) in three ways:

- to pay tax;
- to pay dividends;
- for retention within the business.

Activity 5.3

Complete the following equations.

(a) ______________________________ – taxation = net profit for the year after taxation.

(b) Net profit for the year after taxation – __________ = retained profit for the year.

The balance sheet

News clip

Going, going ...

ITN's accounts show a £39.9 million pension deficit, an increase of £17.7 million over the previous year. The deficit was likely to be 'significantly higher' in the following year. It is possible that the broadcasting giant would be unable to continue trading as there is 'uncertainty over future funding requirements'.

Source: Adapted from www.accountancyage.com/articles, 29 May 2009.

The structure of a limited liability company's balance sheet is also very similar to that of a sole trader. The main difference arises because of the company's capital structure although there are some other features that are not usually found in non-company balance sheets.

The main features of a company's balance sheet are shown in Example 5.2. It includes a number of tutorial notes which will help you as you work through the example.

Example 5.2

A company's balance sheet

Exhibitor Ltd
Balance sheet at 31 March 2011

	£000	£000	£000
Fixed assets			600
Investments (1)			100
Current assets		6 000	
Less: Current liabilities			
Trade creditors	2 950		
Accruals	50		
Corporation tax (2)	300		
Proposed dividend (3)	500	3 800	2 200
			2 900

Financed by:

Capital and reserves (4):	*Authorized*	*Issued and fully paid*
	£000	*£000*
Ordinary shares of £1 each (5)	2 000	1 500
Preference shares of £0.50 each (5)	500	500
	2 500	2 000
Capital reserves (6)		200
Revenue reserves (7)		600
Shareholders' funds (8)		2 800
Loans (9)		100
		2 900

Note: The number shown after each narration refers to the tutorial notes below.

Tutorial notes to Example 5.2

1 *Investments*. This item usually represents long-term investments in the shares of other companies. Short-term investments (such as money invested in bank deposit accounts) would be included in current assets. The shares may be either in public or private limited liability companies. The market price of the investments should be stated. A directors' valuation should be obtained if this is not available.

2 *Corporation tax*. This represents the outstanding tax due on the company's profits for the year.

3 *Proposed dividend*. This will probably be due for payment very shortly after the year end, and so it will usually be shown as a current liability.

4 *Capital and reserves*. Details of the authorized, issued and fully paid-up share capital should be shown.

5 *Ordinary shares and preference shares*. Details about the different types of shares that the company has issued should be disclosed.

6 *Capital reserves*. This section may include several different reserve accounts of a capital nature, i.e. amounts that are not available for distribution to the shareholders as dividend. It might include, for example, a share premium account (an extra amount paid by shareholders in excess of the nominal value of the shares). The premium does not rank for dividend but prospective shareholders are sometimes willing to pay it if they think that the shares are particularly attractive. Another example of a capital reserve is that of an asset that has been revalued. The difference between the original cost and the revalued amount will be credited to a *revaluation* reserve account.

7 *Revenue reserves*. Revenue reserve accounts are amounts that are available for distribution to the shareholders. Any profits retained in the business and not paid out to shareholders may be included under this heading. Retained profits are normally shown separately under the heading 'profit and loss account'.

8 *Shareholders' funds*. The total amount available to shareholders at the balance sheet date is equal to the share capital originally subscribed plus all the capital and revenue reserve account balances.

9 *Loans*. The loans section of the balance sheet will include all the long-term loans obtained by the company, i.e. those loans that do not have to be repaid for at least twelve months, such as debentures and long-term bank loans.

Activity 5.4

State in which section of the balance sheet you are likely to find the following items.

(a) Amount owing for corporation tax.
(b) Debenture stock.
(c) Plant and machinery.
(d) Preference shares.
(e) Trade debtors.

A comprehensive example

Example 5.3 brings together the material covered in this chapter.

Example 5.3

Preparation of a company's accounts

The following information has been extracted from the books of Handy Ltd as at 31 March 2011:

	Dr £	*Cr* £
Bank	2 000	
Capital: 100 000 issued and fully paid ordinary shares of £1 each		100 000
50 000 issued and fully paid 8% preference shares of £1 each		50 000
Debenture loan stock (10%: repayable 2025)		30 000
Debenture loan stock interest	3 000	
Dividends received		700
Dividends paid: Ordinary interim	5 000	
Preference	4 000	
Freehold land at cost	200 000	
Investments (listed: market value at 31 March 2011 was £11 000)	10 000	
Office expenses	47 000	
Motor van at cost	15 000	
Motor van: accumulated depreciation (at 1 April 2010)		6 000
Motor van expenses	2 700	
Purchases	220 000	
Retained profits (at 1 April 2010)		9 000
Sales		300 000
Share premium account		10 000
Stocks at cost (at 1 April 2010)	20 000	
Trade creditors		50 000
Trade debtors	27 000	
	555 700	555 700

Additional information:

1 The stocks at 31 March 2011 were valued at their historical cost of £40,000.
2 Depreciation is to be charged on the motor van at a rate of 20 per cent per annum on cost. No depreciation is to be charged on the freehold land.

3 The corporation tax for the year has been estimated to be £10,000.
4 The directors propose a final ordinary dividend of 10p per share.
5 The authorized share capital of the company is as follows:
   (a) 150,000 ordinary shares of £1 each; and
   (b) 75,000 preference shares of £1 each.

Required:
(a) Prepare Handy Ltd's trading and profit and loss account for the year to 31 March 2011.
(b) Prepare a balance sheet as at that date.

Answer to Example 5.3(a)

Handy Ltd
Trading and profit and loss account for the year to 31 March 2011

	£	£	£
Sales			300 000
Less: Cost of goods sold:			
Opening stocks		20 000	
Purchases		220 000	
		240 000	
Less: Closing stocks		40 000	200 000
Gross profit			100 000
Add: Incomes:			
Dividends received			700
Less: Expenditure:			100 700
Debenture loan stock interest		3 000	
Motor van depreciation (1)	3 000		
Motor van expenses	2 700	5 700	
Office expenses		47 000	
			55 700
Net profit for the year before taxation			45 000
Less: Corporation tax (2)			10 000
Net profit for the year after taxation			35 000
Less: Dividends (3):			
Preference dividend paid (8%)		4 000	
Interim ordinary paid (5p per share)		5 000	
Proposed final ordinary dividend (10p per share)		10 000	19 000
Retained profit for the year			16 000
Retained profits brought forward			9 000
Retained profits carried forward (4)			25 000

Answer to Example 5.3(b)

Handy Ltd Balance sheet at 31 March 2011

	£	£	£
Fixed assets	*Cost*	*Accumulated depreciation*	
Freehold land (5)	200 000	–	200 000
Motor van (6)	15 000	9 000	6 000
	215 000	9 000	206 000
c/f			206 000

Answer to Example 5.3(a) *continued*

	£	£	£
	b/f		206 000
Investments			
At cost (market value at 31 March 2011: £11 000) (7)			10 000
Current assets			
Stocks at cost		40 000	
Trade debtors		27 000	
Bank		2 000	
		69 000	
Less: Current liabilities			
Trade creditors	50 000		
Corporation tax (8)	10 000		
Proposed ordinary dividend (9)	10 000	70 000	
Net current assets			(1 000)
			215 000

Financed by:		
Capital and reserves	*Authorized*	*Issued and fully paid*
Ordinary shares of £1 each (10)	150 000	100 000
Preference shares of £1 each (10)	75 000	50 000
	225 000	150 000
Share premium account (11)		10 000
Retained profits (12)		25 000
Shareholders' funds (13)		185 000
Loans (14)		
10% debenture stock (repayable 2025)		30 000
		215 000

Note: The number shown after each narration refers to the following tutorial notes.

Tutorial notes

1 Depreciation has been charged on the motor van at a rate of 20 per cent per annum on cost (as instructed in question note 2).

2 Question note 3 requires £10,000 to be charged as corporation tax. Corporation tax is applied to the taxable profit and not to the accounting profit. The taxable profit has not been given in the question.

3 A proposed ordinary dividend of 10p has been included as instructed in question note 4.

4 The total retained profit of £25,000 is carried forward to the balance sheet (see tutorial note 12 below).

5 Question note 2 states that no depreciation is to be charged on the freehold land.

6 The accumulated depreciation for the motor van of £9000 is the total of the accumulated depreciation brought forward at 1 April 2010 of £6000, plus the £3000 written off to the profit and loss account for the current year (see tutorial note 1 above).

7 Note that the market value of the investments has been disclosed on the face of the balance sheet.

Answer to Example 5.3(b) ***continued***

8 The corporation tax charged against profit (question note 3) will be due for payment in 2012. The amount due is treated as a current liability (this requirement is different for public companies).

9 The proposed ordinary dividend will be due for payment shortly after the year end and so it is also a current liability. The interim dividend and the preference dividend have already been paid so they are not current liabilities.

10 Details of the authorized, issued and fully paid share capital should be disclosed.

11 The share premium is a capital account: it cannot be used for the payment of dividends. It will normally remain unchanged in successive balance sheets although there are a few highly restricted purposes for which it may be used.

12 The retained profits become part of a revenue account balance that could be used for the payment of dividends. The total retained profits of £25,000 is the amount brought in to the balance sheet from the profit and loss account.

13 The total amount of shareholders' funds should always be shown.

14 The loans are long-term loans. Loans are not part of shareholders' funds and so they need to be shown separately in the balance sheet.

Questions you should ask

Many of the questions that we have suggested in previous chapters that non-accountants should ask are of relevance in this chapter. For example, the various accounting rules adopted by the accountants in preparing the company's profit and loss and balance sheet, especially those with a significant impact on revenue, stock valuation, depreciation and provisions for bad and doubtful debts.

The following questions relate particularly to this chapter.

- Can our accounting records disclose with reasonable accuracy (as the 2006 Companies Act requires) our financial position at any time?
- Do the accounting records contain entries for all money received and spent?
- Do they also contain a record of all assets and all liabilities?
- Do the accounting records include a statement of the stock held at the financial year end?
- Are there details of stocktaking from which the statement of stock has been compiled?
- Is a record kept of all goods sold and purchased as well as all the buyers and sellers so that they can all be identified?
- Have both the profit and loss account and the balance sheet been prepared in accordance both with the requirements of the Companies Act 2006 and with recommended practice?
- Do the accounts genuinely represent a 'time and fair' view of the company's affairs?

Conclusion

This chapter has briefly examined the structure and content of limited liability company accounts using a number of simple examples. Although a great deal of information can be obtained from studying the annual accounts of a company, it is difficult to extract the most relevant and significant features. Some further guidance is needed, therefore, in how to make the best use of the financial accounting information presented to you. This will be provided in Chapters 7 to 10, but first we need to examine some other types of account. We do so in the next chapter.

Key points

1 The financial statements of a company are similar in format (i.e. structure) to those of sole traders.

2 The profits of a company are taxed separately (like an individual). The tax is based on the accounting profit for the year. Any tax due at the year end will be shown in the balance sheet as a current liability.

3 The net profit after tax may be paid to shareholders in the form of a dividend although some profit will normally be retained in the business. Proposed dividends should be shown in the balance sheet as a creditor. This requirement is, however, different for public companies. See Chapter 9.

Check your learning

The answers to these questions can be found within the text.

1 What is meant by 'limited liability'?

2 When was it first incorporated into company law?

3 Why was it found necessary to do so?

4 Distinguish between the authorized, issued and fully paid share capital of a company.

5 Name two main types of shares.

6 What is the basic difference between them?

7 What are the two main types of limited liability companies?

8 What is a debenture loan?

9 What is meant by 'disclosure of information'?

10 Why do companies have to let the Registrar of Companies have certain types of information?

11 What is a director?

12 What is a dividend?

13 Name two types of dividend.

14 What name is given to the tax that a company pays on its profits?

15 Name three ways in which a company's profits are appropriated.

16 List three types of assets.

17 Name three items that may be included under the heading of 'current liabilities'.

18 Distinguish between a capital reserve and a revenue reserve.

19 What is a share premium account?

20 What is meant by 'shareholders' funds'?

21 What is the difference between a short-term loan and a long-term loan?

News story quiz

Remember the news story at the beginning of this chapter? Go back to that story and reread it before answering the following questions.

This is yet another report of a fraud – this time in India. You will recall that it is not the duty of the external auditors to discover any fraud that might have taken place. Their responsibility is to report that the accounts represent 'a true and fair view' (at least in the UK). Based on what you have learned so far about accounting and book-keeping, suggest some plausible answers to the following questions.

Questions

1 How could one man on his own fix the company's books on such a grand scale?

2 How do you think it was possible to inflate the group's profit by a margin of 24 per cent?

3 How is it possible for 94 per cent of cash (£685m out of £728m) to be 'fictitious'?

Tutorial questions

The answers to question marked with an asterisk may be found in Appendix 4.

5.1 'The concept of limited liability is an out-of-date nineteenth-century concept.' Discuss.

5.2 Appleton used to operate her business as a sole trader entity. She has recently converted it into a limited liability company. Appleton owns 80 per cent of the ordinary (voting) shares, the remaining 20 per cent being held by various relatives and friends. Explain to Appleton why it is now inaccurate for her to describe the company as 'her' business.

5.3 How far do you think that the information presented in a limited liability company's profit and loss account and balance sheet is useful to the owners of a small business?

5.4* The following balances have been extracted from the books of Margo Ltd for the year to 31 January 2010:

	Dr	*Cr*
	£000	*£000*
Cash at bank and in hand	5	
Plant and equipment:		
At cost	70	
Accumulated depreciation (at 31.1.10)		25
Profit and loss account (at 1.2.09)		15
Profit for the financial year (to 31.1.10)		10
Share capital (issued and fully paid)		50
Stocks (at 31.1.10)	17	
Trade creditors		12
Trade debtors	20	
	112	112

Additional information:

1 Corporation tax owing at 31 January 2010 is estimated to be £3000.
2 Margo Ltd's authorized share capital is £75,000 of £1 ordinary shares.
3 A dividend of 10p per share is proposed.

Required:

Prepare Margo Ltd's profit and loss account for the year to 31 January 2010 and a balance sheet as at that date.

5.5* Harry Ltd was formed in 2003. The following balances as at 28 February 2011 have been extracted from the books of account after the trading account has been compiled:

	Dr	*Cr*
	£000	*£000*
Administration expenses	65	
Cash at bank and in hand	10	
Distribution costs	15	
Dividend paid (on preference shares)	6	
Furniture and equipment:		
At cost	60	
Accumulated depreciation at 1.3.10		36
Gross profit for the year		150
Ordinary share capital (shares of £1 each)		100
Preference shares (cumulative 15% of £1 shares)		40
Profit and loss account (at 1.3.10)		50
Share premium account		20
Stocks (at 28.2.11)	130	
Trade creditors		25
Trade debtors	135	
	421	421

Additional information:

1 Corporation tax owing at 28 February 2011 is estimated to be £24,000.
2 Furniture and equipment is depreciated at an annual rate of 10 per cent of cost and it is all charged against administrative expenses.

3 A dividend of 20p per ordinary share is proposed.
4 All the authorized share capital has been issued and is fully paid.

Required:
Prepare Harry Ltd's profit and loss account for the year to 28 February 2011 and a balance sheet as at that date.

5.6* The following balances have been extracted from the books of Jim Ltd as at 31 March 2011:

	Dr	*Cr*
	£000	*£000*
Advertising	3	
Bank	11	
Creditors		12
Debtors	118	
Furniture and fittings:		
At cost	20	
Accumulated depreciation (at 1.4.10)		9
Directors' fees	6	
Profit and loss account (at 1.4.10)		8
Purchases	124	
Rent and rates	10	
Sales		270
Share capital (issued and fully paid)		70
Stock (at 1.4.10)	16	
Telephone and stationery	5	
Travelling expenses	2	
Vehicles:		
At cost	40	
Accumulated depreciation (at 1.4.10)		10
Wages and salaries	24	
	379	379

Additional information:
1 Stock at 31 March 2011 was valued at £14,000.
2 Furniture and fittings, and the vehicles are depreciated at a rate of 15 per cent and 25 per cent, respectively, on cost.
3 Corporation tax owing at 31 March 2011 is estimated to be £25,000.
4 A dividend of 40p per share is proposed.
5 The company's authorized share capital is £100,000 of £1 ordinary shares.

Required:
(a) Prepare Jim Ltd's trading and profit and loss account for the year to 31 March 2011 and a balance sheet as at that date.
(b) Why would the business not necessarily be worth its balance sheet value as at 31 March 2011?

5.7 The following trial balance has been extracted from Carol Ltd as at 30 April 2012:

	Dr	*Cr*
	£000	*£000*
Advertising	2	
Bank overdraft		20
Bank interest paid	4	
Creditors		80
Debtors	143	
Directors' remuneration	30	
Freehold land and buildings:		
At cost	800	
Accumulated depreciation at 1.5.11		102
General expenses	15	
Investments at cost	30	
Investment income		5
Motor vehicles:		
At cost	36	
Accumulated depreciation (at 1.5.11)		18
Preference dividend paid	15	
Preference shares (cumulative 10% shares of £1 each)		150
Profit and loss account (at 1.5.11)		100
Purchases	480	
Repairs and renewals	4	
Sales		900
Share capital (authorized, issued and fully paid ordinary shares of £1 each)		500
Share premium account		25
Stock (at 1.5.11)	120	
Wages and salaries	221	
	1 900	1 900

Additional information:

1 Stock at 30 April 2012 was valued at £140,000.
2 Depreciation for the year of £28,000 is to be provided on buildings and £9000 for motor vehicles.
3 A provision of £6000 is required for the auditors' remuneration.
4 £2000 had been paid in advance for renewals.
5 Corporation tax owing at 30 April 2012 is estimated to be £60,000.
6 The directors propose an ordinary dividend of 10p per share.
7 The market value of the investments at 30 April 2012 was £35,000.

Required:
Prepare Carol Ltd's trading and profit and loss account for the year to 30 April 2012 and a balance sheet as at that date.

5.8 Nelson Ltd was incorporated in 2003 with an authorized share capital of 500,000 £1 ordinary shares, and 200,000 5 per cent cumulative preference shares of £1 each. The following trial balance was extracted as at 31 May 2011:

	Dr	*Cr*
	£000	*£000*
Administrative expenses	257	
Auditor's fees	10	
Cash at bank and in hand	5	
Creditors		85
Debentures (12%)		100
Debenture interest paid	6	
Debtors	225	
Directors' remuneration	60	
Dividends paid:		
Ordinary interim	20	
Preference	5	
Furniture, fittings and equipment:		
At cost	200	
Accumulated depreciation at 1.6.10		48
Investments at cost (market value at 31.5.11: £340 000)	335	
Investment income		22
Ordinary share capital (issued and fully paid)		400
Preference share capital		200
Profit and loss account (at 1.6.10)		17
Purchases	400	
Sales		800
Share premium account		50
Stock at 1.6.10	155	
Wages and salaries	44	
	1 722	1 722

Additional information:

1 Stock at 31 May 2011 was valued at £195,000.
2 Administrative expenses owing at 31 May 2011 amounted to £13,000.
3 Depreciation is to be charged on the furniture and fittings at a rate of $12\frac{1}{2}$ per cent on cost.
4 Salaries paid in advance amounted to £4000.
5 Corporation tax owing at 31 May 2011 is estimated to be £8000.
6 Provision is to be made for a final ordinary dividend of 1.25p per share.

Required:
Prepare Nelson Ltd's trading and profit and loss account for the year to 31 May 2011 and a balance sheet as at that date.

5.9 The following trial balance has been extracted from the books of Keith Ltd as at 30 June 2011:

	Dr	*Cr*
	£000	*£000*
Advertising	30	
Bank	7	
Creditors		69
Debentures (10%)		70
Debtors (all trade)	300	
Directors' remuneration	55	
Electricity	28	
Insurance	17	
Investments (quoted)	28	
Investment income		4
Machinery:		
At cost	420	
Accumulated depreciation at 1.7.10		152
Office expenses	49	
Ordinary share capital (issued and fully paid)		200
Preference shares		50
Preference share dividend	4	
Profit and loss account (at 1.7.10)		132
Provision for bad and doubtful debts		8
Purchases	1 240	
Rent and rates	75	
Sales		2 100
Stock (at 1.7.10)	134	
Vehicles:		
At cost	80	
Accumulated depreciation (at 1.7.10)		40
Wages and salaries	358	
	2 825	2 825

Additional information:

1 Stock at 30 June 2011 valued at cost amounted to £155,000.
2 Depreciation is to be provided on machinery and vehicles at a rate of 20 per cent and 25 per cent respectively on cost.
3 Provision is to be made for auditors' remuneration of £12,000.
4 Insurance paid in advance at 30 June 2011 amounted to £3000.
5 The provision for bad and doubtful debts is to be made equal to 5 per cent of outstanding trade debtors as at 30 June 2011.
6 Corporation tax owing at 30 June 2011 is estimated to be £60,000.
7 An ordinary dividend of 10p per share is proposed.
8 The investments had a market value of £30,000 at 30 June 2011.
9 The company has an authorized share capital of 600,000 ordinary shares of £0.50 each and of 50,000 8 per cent cumulative preference shares of £1 each.

Required:

(a) Prepare Keith Ltd's trading and profit and loss account for the year to 30 June 2011 and a balance sheet as at that date.

(b) Explain why shareholders of Keith Ltd would not necessarily have been able to sell the business for its balance sheet value as at 30 June 2011.

Further practice questions, study material and links to relevant sites on the World Wide Web can be found on the website that accompanies this book. The site can be found at **www.pearsoned.co.uk/dyson**