PART 3

Statement of financial position – equity, liability and asset measurement and disclosure

CHAPTER 10

Share capital, distributable profits and reduction of capital

10.1 Introduction

The main purpose of this chapter is to explain the issue and reduction of capital and distributions to shareholders in the context of creditor protection.

Objectives

After completing this chapter, you should be able to:

- describe the reasons for the issue of shares;
- describe the rights of different classes of shares;
- prepare accounting entries for issue of shares;
- explain the rules relating to distributable profits;
- explain when capital may be reduced;
- prepare accounting entries for reduction of capital;
- discuss the rights of different parties on a capital reduction.

10.2 Common themes

Companies may be financed by equity investors, loan creditors and trade creditors. Governments have recognised that for an efficient capital market to exist the rights of each of these stakeholders need to be protected. This means that equity investors require a clear statement of their powers to appoint and remunerate directors and of their entitlement to share in residual income and net assets; loan creditors and trade creditors require assurance that the directors will not distribute funds to the equity investors before settling outstanding debts in full.

Statutory rules have, therefore, evolved which attempt a balancing act by protecting the creditors on the one hand, e.g. by restricting dividend distributions to realised profits, whilst, on the other hand, not unduly restricting the ability of companies to organise their financial affairs, e.g. by reviewing a company's right to purchase and hold Treasury shares. Such rules may not be totally consistent between countries but there appear to be some common themes in much of the legislation. These are:

- Share capital can be broadly of two types, equity or preference.
- Equity shares are entitled to the residual income in the statement of comprehensive income after paying expenses, loan interest and tax.

- Equity itself is a residual figure in that the standard setters have taken the approach of defining assets and liabilities and leaving equity capital as the residual difference in the statement of financial position.
- Equity may consist of ordinary shares or equity elements of **participating** preference shares and compound instruments which include debt and equity, i.e. where there are conversion rights when there must be a split into their debt and equity elements, with each element being accounted for separately.
- Preference shares are not entitled (unless participating) to share in the residual income but may be entitled to a fixed or floating rate of interest on their investment.
- Distributable reserves equate to retained earnings when these have arisen from realised gains.
- Trade payables require protection to prevent an entity distributing assets to shareholders if creditors are not paid in full.
- Capital restructuring may be necessary when there are sound commercial reasons.

However, the rules are not static and there are periodic reviews in most jurisdictions, e.g. the proposal that an entity should make dividend decisions based on its ability to pay rather than on the fact that profits have been realised.

- The distributable reserves of entities are those that have arisen due to realised gains and losses (retained profits), as opposed to unrealised gains (such as revaluation reserves).
- There must be protection for trade payables to prevent an entity distributing assets to shareholders to the extent that the trade payables are not paid in full. An entity must retain net assets at least equal to its share capital and non-distributable reserves (a capital maintenance concept).
- The capital maintenance concept also applies with regard to reducing share capital, with most countries generally requiring a replacement of share capital with a non-distributable reserve if it is redeemed.

Because all countries have company legislation and these themes are common, the authors felt that, as the UK has relatively well developed company legislation, it would be helpful to consider such legislation as illustrating a typical range of statutory provisions. We therefore now consider the constituents of total shareholders' funds (also known as total owners' equity) and the nature of distributable and non-distributable reserves. We then analyse the role of the capital maintenance concept in the protection of creditors, before discussing the effectiveness of the protection offered by the Companies Act 2006 in respect of both private and public companies.

10.3 Total owners' equity: an overview

Total owners' equity consists of the issued share capital stated at nominal (or par) value, non-distributable and distributable reserves. Here we comment briefly on the main constituents of total shareholders' funds. We go on to deal with them in greater detail in subsequent sections.

10.3.1 Right to issue shares

Companies incorporated[1] under the Companies Act 2006 are able to raise capital by the issue of shares and debentures. There are two main categories of company: private limited companies and public limited companies. Public limited companies are designated by the letters plc and have the right to issue shares and debentures to the public. Private limited companies are often family companies; they are not allowed to seek share capital by invitations to the public. The shareholders of both categories have the benefit of limited personal indemnity, i.e. their liability to creditors is limited to the amount they agreed to pay the company for the shares they bought.

10.3.2 Types of share

Broadly, there are two types of share: ordinary and preference.

Ordinary shares

Ordinary shares, often referred to as equity shares, carry the main risk and their bearers are entitled to the residual profit after the payment of any fixed interest or fixed dividend to investors who have invested on the basis of a fixed return. Distributions from the residual profit are made in the form of dividends, which are normally expressed as pence per share.

Preference shares

Preference shares usually have a fixed rate of dividend, which is expressed as a percentage of the nominal value of the share. The dividend is paid before any distribution to the ordinary shareholders. The specific rights attaching to a preference share can vary widely.

10.3.3 Non-distributable reserves

There are a number of types of **statutory** non-distributable reserve, e.g. when the paid-in capital exceeds the par value as a share premium. In addition to the statutory non-distributable reserves, a company might have restrictions on distribution within its memorandum and articles, stipulating that capital profits are non-distributable as dividends.

10.3.4 Distributable reserves

Distributable reserves are normally represented by the retained earnings that appear in the statement of financial position and belong to the ordinary shareholders. However, as we shall see, there may be circumstances where credits that have been made to the statement of comprehensive income are not actually distributable, usually because they do not satisfy the **realisation** concept.

Although the retained earnings in the statement of financial position contain the cumulative residual distributable profits, it is the earnings per share (EPS), based on the post-tax earnings for the year as disclosed in the profit and loss account, that influences the market valuation of the shares, applying the price/earnings ratio.

When deciding whether to issue or buy back shares, the directors will therefore probably consider the impact on the EPS figure. If the EPS increases, the share price can normally be expected also to increase.

10.4 Total shareholders' funds: more detailed explanation

10.4.1 Ordinary shares – risks and rewards

Ordinary shares (often referred to as equity shares) confer the right to:

- share proportionately in the rewards, i.e.:
  - the residual profit remaining after paying any loan interest or fixed dividends to investors who have invested on the basis of a fixed return;
  - any dividends distributed from these residual profits;
  - any net assets remaining after settling all creditors' claims in the event of the company ceasing to trade;
- share proportionately in the risks, i.e.:
  - lose a proportionate share of invested share capital if the company ceases to trade and there are insufficient funds to pay all the creditors and the shareholders in full.

10.4.2 Ordinary shares – powers

The owners of ordinary shares generally have one vote per share which can be exercised on a routine basis, e.g. at the Annual General Meeting to vote on the appointment of directors, and on an *ad hoc* basis, e.g. at an Extraordinary General Meeting to vote on a proposed capital reduction scheme.

However, there are some companies that have issued non-voting ordinary shares which may confer the right to a proportional share of the residual profits but not to vote.

Non-voting shareholders can attend and speak at the Annual General Meeting but, as they have no vote, are unable to have an influence on management if there are problems or poor performance – apart from selling their shares.

The practice varies around the world and is more common in continental Europe. In the UK, institutional investors have made it clear since the early 1990s that they regard it as poor corporate governance and companies have taken steps to enfranchise the non-voting shareholders. The following is an extract from a letter from John Laing plc to shareholders setting out its enfranchisement proposals:

> ***LAING SETS OUT ENFRANCHISEMENT PROPOSALS*** *23 March 2000*
> John Laing plc today issues enfranchisement proposals to change the Group voting structure.
>
> The key points are as follows:
>
> - Convert the Ordinary A (non-voting) Shares into Ordinary Shares
> - All redesignated shares to have full voting rights ranking pari passu in all respects with the existing Ordinary Shares
> - Compensatory Scrip Issue for holders of existing Ordinary Shares of one New Ordinary Share for every 20 Ordinary Shares held [authors' note: this is in recognition of the fact that the proportion of votes of the existing ordinary shareholders has been reduced – an alternative approach would be to ask the non-voting shareholders to pay a premium in exchange for being given voting rights]
> - EGM to be held on 18th May 2000

Reasons for enfranchisement

- To increase the range of potential investors in the Company which the Directors believe should enhance the marketability and liquidity of the Company's Shares.
- To enable all classes of equity shareholders, who share the same risks and rewards, to share the same voting rights.
- To ensure the Company has maximum flexibility to manage its capital structure in order to reduce its cost of capital and to enhance shareholder value.

In other countries, however, there may be sound commercial reasons why non-voting shares are issued. In Japan, for example, the Japanese Commercial Code was amended in 2002 to allow companies to issue shares with special rights, e.g. power to veto certain company decisions, and to increase the proportion of non-voting shares in issue. The intention was to promote successful restructuring of ailing companies and stimulate demand for Japanese equity investments.

10.4.3 Methods and reasons for issuing shares

Methods of issuing shares

Some of the common methods of issuing shares are: *offer for subscription*, where the shares are offered directly to the public; *placings*, where the shares are arranged (placed) to be bought by financial institutions; and *rights issues*, whereby the new shares are offered to the existing shareholders at a price below the market price of those shares. The rights issue might be priced significantly below the current market price but this may not mean that the shareholder is benefiting from cheap shares as the price of existing shares will be reduced, e.g. the British Telecommunications plc £5.9 billion rights issue announced in 2001 made UK corporate history in that no British company had attempted to raise so much cash from its shareholders. The offer was three BT shares for every ten held and, to encourage take-up, the new shares were offered at a deeply discounted rate of £3 which was at a 47% discount to the share price on the day prior to the launch.

Reasons for issuing shares

- **For future investment**, e.g. Watford Leisure plc (Watford Football Club) offered and placed 540,000,000 ordinary shares and expected to raise cash proceeds of about £4.7 million. The company has since been floated on the AIM.
- **As consideration on an acquisition**, e.g. Microsoft Corp. acquired Great Plains Software Incorporated, a leading supplier of mid-market business applications. The acquisition was structured as a stock purchase and was valued at approximately $1.1 billion. Each share of Great Plains common stock was exchanged for 1.1 shares of Microsoft common stock.
- **To shareholders to avoid paying out cash from the company's funds**, e.g. the Prudential plc Annual Report 2009 has a scrip dividend scheme which enables shareholders to receive new ordinary shares instead of the cash dividends they would normally receive. This means they can build up their shareholding in Prudential without going to the market to buy new shares and so will not incur any dealing costs or stamp duty.
- **To directors and employees to avoid paying out cash in the form of salary from company's funds**, e.g. in the Psion 2000 Annual Report the note on directors' remuneration stated:

Name	As at 1/1/00	Exercised	As at 31.12.00	Option price	Market price
M.M. Wyatt	150,000	150,000	—	£0.73	£12.09

- **To shareholders to encourage re-investment**, e.g. some companies operate a Dividend Reinvestment Plan whereby the dividends of shareholders wishing to reinvest are pooled and reinvested on the Stock Exchange. A typical Plan is operated by GKN where the Plan is operated through a special dealing arrangement.
- **To shareholders by way of a rights issue** to shore up statement of financial positions weakened in the credit crisis by reducing debt and to avoid breaching debt covenants, e.g. in February 2009 the Cookson Group plc announced a 12 for 1 Rights Issue to raise net proceeds of approximately £240 million in order to provide a more suitable capital

structure for the current environment and enhance covenant and longer-term liquidity headroom under current debt facilities.

- **To loan creditors in exchange for debt**, e.g. Sirius XM, a satellite radio station, with about $1 billion debt due to mature in February 2009, in January 2009 exchanged shares for $2^1/_2$% convertible debt.
- **To obtain funds for future acquisitions**, e.g. SSL International, a successful company that had outperformed the FTSE All-Share index 2008, raised £87 million to fund its medium-term growth plans. Other companies were raising funds to acquire assets that were being sold by companies needing to obtain cash to reduce their debt burden.
- **To reduce levels of debt** to avoid credit rating agencies downgrading the company which would make it difficult or more expensive to borrow.
- **To overcome liquidity problems**, e.g. Brio experienced liquidity problems and refinanced with the isue of SK300 million shares to raise over £25 million.

10.4.4 Types of preference shares

The following illustrate some of the ways in which specific rights can vary.

Cumulative preference shares
Dividends not paid in respect of any one year because of a lack of profits are accumulated for payment in some future year when distributable profits are sufficient.

Non-cumulative preference shares
Dividends not paid in any one year because of a lack of distributable profits are permanently forgone.

Participating preference shares
These shares carry the right to participate in a distribution of additional profits over and above the fixed rate of dividend after the ordinary shareholders have received an agreed percentage. The participation rights are based on a precise formula.

Redeemable preference shares
These shares may be redeemed by the company at an agreed future date and at an agreed price.

Convertible preference shares
These shares may be converted into ordinary shares at a future date on agreed terms. The conversion is usually at the preference shareholder's discretion.

There can be a mix of rights, e.g. Getronics entered into an agreement in 2005 with its cumulative preference shareholders whereby Getronics had the right in 2009 to repurchase (redeem) the shares and, if it did not redeem the shares, the cumulative preference shareholders had the right to convert into ordinary shares.

10.5 Accounting entries on issue of shares

10.5.1 Shares issued at nominal (par) value

If shares are issued at nominal value, the company simply debits the cash account with the amount received and credits the ordinary share capital or preference share capital, as appropriate, with the **nominal value** of the shares.

10.5.2 Shares issued at a premium

The market price of the shares of a company, which is based on the prospects of that company, is usually different from the par (nominal) value of those shares.

On receipt of consideration for the shares, the company again debits the cash account with the amount received and credits the ordinary share capital or preference share capital, as appropriate, with the **nominal value** of the shares.

Assuming that the market price exceeds the nominal value, a premium element will be credited to a share premium account. The share premium is classified as a **non-distributable reserve** to indicate that it is not repayable to the shareholders who have subscribed for their shares: it remains a part of the company's permanent capital.

The accounting treatment for recording the issue of shares is straightforward. For example, the journal entries to record the issue of 1,000 £1 ordinary shares at a market price of £2.50 per share payable in instalments of:

on application	on 1 January 20X1	25p
on issue	on 31 January 20X1	£1.75 including the premium
on first call	on 31 January 20X2	25p
on final call	on 31 January 20X4	25p

would be as follows:

	Dr	Cr
1 Jan 20X1	Dr	Cr
	£	£
Cash account	250	
Application account		250
31 Jan 20X1	Dr	Cr
	£	£
Cash account	1,750	
Issue account		1,750
31 Jan 20X1	Dr	Cr
	£	£
Application account	250	
Issue account	1,750	
Share capital account		500
Share premium in excess of par value		1,500

The first and final call would be debited to the cash account and credited to the share capital account on receipt of the date of the calls.

10.6 Creditor protection: capital maintenance concept

To protect creditors, there are often rules relating to the use of the total shareholders' funds which determine how much is distributable.

As a general rule, the paid-in share capital is not repayable to the shareholders and the reserves are classified into two categories: distributable and non-distributable. The directors have discretion as to the amount of the distributable profits that they recommend for distribution as a dividend to shareholders. However, they have no discretion as to the treatment of the non-distributable funds. There may be a statutory requirement for the company to retain within the company net assets equal to the non-distributable reserves. This requirement is to safeguard the interests of creditors and is known as **capital maintenance**.

10.7 Creditor protection: why capital maintenance rules are necessary

It is helpful at this point to review the position of unincorporated businesses in relation to capital maintenance.

10.7.1 Unincorporated businesses

An unincorporated business such as a sole trader or partnership is not required to maintain any specified amount of capital within the business to safeguard the interests of its creditors. The owners are free to decide whether to introduce or withdraw capital. However, they remain personally liable for the liabilities incurred by the business, and the creditors can have recourse to the personal assets of the owners if the business assets are inadequate to meet their claims in full.

When granting credit to an unincorporated business, the creditors may well be influenced by the personal wealth and apparent standing of the owners and not merely by the assets of the business as disclosed in its financial statements. This is why in an unincorporated business there is no external reason for the capital and the profits to be kept separate.

In partnerships, there are frequently internal agreements that require each partner to maintain his or her capital at an agreed level. Such agreements are strictly a matter of contract between the owners and do not prejudice the rights of the business creditors.

Sometimes owners attempt to influence creditors unfairly, by maintaining a lifestyle in excess of what they can afford, or try to frustrate the legal rights of creditors by putting their private assets beyond their reach, e.g. by transferring their property to relatives or trusts. These subterfuges become apparent only when the creditors seek to enforce their claim against the private assets. Banks are able to protect themselves by seeking adequate security, e.g. a charge on the owners' property.

10.7.2 Incorporated limited liability company

Because of limited liability, the rights of creditors against the private assets of the owners, i.e. the shareholders of the company, are restricted to any amount unpaid on their shares. Once the shareholders have paid the company for their shares, they are not personally liable for the company's debts. Creditors are restricted to making claims against the assets of the company.

Hence, the legislature considered it necessary to ensure that the shareholders did not make distributions to themselves such that the assets needed to meet creditors' claims were put beyond creditors' reach. This may be achieved by setting out statutory rules.

10.8 Creditor protection: how to quantify the amounts available to meet creditors' claims

Creditors are exposed to two types of risk: the business risk that a company will operate unsuccessfully and will be unable to pay them; and the risk that a company will operate successfully, but will pay its shareholders rather than its creditors.

The legislature has never intended trade creditors to be protected against ordinary business risks, e.g. the risk of the debtor company incurring either trading losses or losses that might arise from a fall in the value of the assets following changes in market conditions.

In the UK, the Companies Act 2006 requires the amount available to meet creditors' claims to be calculated by reference to the company's annual financial statements. There are two possible approaches:

- The **direct** approach which requires the **asset** side of the statement of financial position to contain assets with a realisable value sufficient to cover all outstanding liabilities.
- The **indirect** approach which requires the **liability** side of the statement of financial position to classify reserves into distributable and non-distributable reserves (i.e. respectively, available and not available to the shareholders by way of dividend distributions).

The Act follows the indirect approach by specifying capital maintenance in terms of the total shareholders' funds. However, this has not stopped certain creditors taking steps to protect themselves by following the direct approach, e.g. it is bank practice to obtain a mortgage debenture over the assets of the company. The effect of this is to disadvantage the trade creditors. The statutory restrictions preventing shareholders from reducing capital accounts on the liability side are weakened when management grants certain parties priority rights against some or all of the company's assets.

We will now consider total shareholders' funds and capital maintenance in more detail, starting with share capital. Two aspects of share capital are relevant to creditor protection: minimum capital requirements and reduction of capital.

10.9 Issued share capital: minimum share capital

The creditors of public companies may be protected by the requirements that there should be a minimum share capital and that capital should be reduced only under controlled conditions.

In the UK, the minimum share capital requirement for a public company is currently set at £50,000 or its euro equivalent although this can be increased by the Secretary of State for the Department for Business, Innovation and Skills.[2] A company is not permitted to commence trading unless it has issued this amount. However, given the size of many public companies, it is questionable whether this figure is adequate.

The minimum share capital requirement refers to the nominal value of the share capital. In the UK, the law requires each class of share to have a stated nominal value. This value is used for identification and also for capital maintenance. The law ensures that a company receives an amount that is at least equal to the nominal value of the shares issued, less a controlled level of commission, by prohibiting the issue of shares at a discount and by limiting any underwriting commissions on an issue. This is intended to avoid a material discount being granted in the guise of commission. However, the requirement is concerned more with safeguarding the relative rights of existing shareholders than with protecting creditors.

There is effectively no minimum capital requirement for private companies. We can see many instances of such companies having an issued and paid-up capital of only a few £1 shares, which cannot conceivably be regarded as adequate creditor protection. The lack of adequate protection for the creditors of private companies is considered again later in the chapter.

10.10 Distributable profits: general considerations

We have considered capital maintenance and non-distributable reserves. However, it is not sufficient to attempt to maintain the permanent capital accounts of companies unless there are clear rules on the amount that they can distribute to their shareholders as profit. Without such rules, they may make distributions to their shareholders out of capital. The question of what can legitimately be distributed as profit is an integral part of the concept of capital maintenance in company accounts. In the UK, there are currently statutory definitions of the amount that can be distributed by private, public and investment companies.

10.10.1 Distributable profits: general rule for private companies

The definition of distributable profits under the Companies Act 2006 is:

> Accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, as far as not previously written off in a reduction or reorganisation of capital.

This means the following:

- Unrealised profits cannot be distributed.
- There is no difference between realised revenue and realised capital profits.
- All accumulated net realised profits (i.e. realised profits less realised losses) on the statement of financial position date must be considered.

On the key question of whether a profit is realised or not, the Companies Act (para. 853) simply says that realised profits or realised losses are

> such profits or losses of the company as fall to be treated as realised in accordance with principles generally accepted, at the time when the accounts are prepared, with respect to the determination for accounting purposes of realised profits or losses.

Hence, the Act does not lay down detailed rules on what is and what is not a realised profit; indeed, it does not even refer specifically to 'accounting principles'. Nevertheless, it would seem reasonable for decisions on realisation to be based on generally **accepted accounting principles** at the time, subject to the court's decision in cases of dispute.

10.10.2 Distributable profits: general rule for public companies

According to the Companies Act, the undistributable reserves of a public company are its share capital, share premium, capital redemption reserve and also 'the excess of accumulated unrealised profits over accumulated unrealised losses at the time of the intended distribution and . . . any reserves not allowed to be distributed under the Act or by the company's own Memorandum or Articles of Association'.

This means that, when dealing with a public company, the distributable profits have to be reduced by any net unrealised loss.

10.10.3 Investment companies

The Companies Act 2006 allows for the special nature of some businesses in the calculation of distributable profits. There are additional rules for investment companies in calculating their distributable profits. For a company to be classified as an investment company, it must invest its funds mainly in securities with the aim of spreading investment risk and giving its members the benefit of the results of managing its funds.

Such a company has the option of applying one of two rules in calculating its distributable profits. These are either:

- the rules that apply to public companies in general, but excluding any realised capital profits, e.g. from the disposal of investments; or
- the company's accumulated realised revenue less its accumulated realised and unrealised revenue losses, provided that its assets are at least one and a half times its liabilities both before and after such a distribution.

The reasoning behind these special rules seems to be to allow investment companies to pass the dividends they receive to their shareholders, irrespective of any changes in the values of their investments, which are subject to market fluctuations. However, the asset cover ratio of liabilities can easily be manipulated by the company simply paying creditors, whereby the ratio is improved, or borrowing, whereby it is reduced.

10.11 Distributable profits: how to arrive at the amount using relevant accounts

In the UK, the Companies Act 2006 stipulates that the distributable profits of a company must be based on **relevant accounts**. Relevant accounts may be prepared under either UK GAAP or EU adopted IFRS. On occasions a new IFRS might have the effect of making a previously realised item reclassified as unrealised, which would then become undistributable. For a more detailed description on the determination of realised profits for distribution refer to the ICAEW Technical Release 7/08 (www.icaew.co.uk). These would normally be the audited annual accounts, which have been prepared according to the requirements of the Act to give a true and fair view of the company's financial affairs. In the case of a qualified audit report, the auditor is required to prepare a written statement stating whether such a qualification is material in determining a company's distributable profit. Interim dividends are allowed to be paid provided they can be justified on the basis of the latest annual accounts, otherwise interim accounts will have to be prepared that would justify such a distribution.

10.11.1 Effect of fair value accounting on decision to distribute

In the context of fair value accounting, volatility is an aspect where directors will need to consider their fiduciary duties. The fair value of financial instruments may be volatile even though such fair value is properly determined in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. Directors should consider, as a result of their fiduciary duties, whether it is prudent to distribute profits arising from changes in the fair values of financial instruments considered to be volatile, even though they may otherwise be realised profits in accordance with the technical guidance.

10.12 When may capital be reduced?

Once the shares have been issued and paid up, the contributed capital together with any payments in excess of par value are normally regarded as permanent. However, there might be commercially sound reasons for a company to reduce its capital and we will consider three such reasons. These are:

- writing off part of capital which has already been lost and is not represented by assets;
- repayment of part of paid-up capital to shareholders or cancellation of unpaid share capital;
- purchase of own shares.

In the UK it has been necessary for both private and public companies to obtain a court order approving a reduction of capital. In line with the wish to reduce the regulatory burden on private companies the government legislated[3] in 2008 for private companies to be able to reduce their capital by special resolution subject to the directors signing a solvency statement to the effect that the company would remain able to meet all of its liabilities for at least a year. At the same time a reserve arising from the reduction is treated as realised and may be distributed, although it need not be and could be used for other purposes, e.g. writing off accumulated trading losses.

10.13 Writing off part of capital which has already been lost and is not represented by assets

This situation normally occurs when a company has accumulated trading losses which prevent it from making dividend payments under the rules relating to distributable profits. The general approach is to eliminate the debit balance on retained earnings by setting it off against the share capital and non-distributable reserves.

10.13.1 Accounting treatment for a capital reduction to eliminate accumulated trading losses

The accounting treatment is straightforward. A capital reduction account is opened. It is debited with the accumulated losses and credited with the amount written off the share capital and reserves.

For example, assume that the capital and reserves of Hopeful Ltd were as follows at 31 December 20X1:

	£
200,000 ordinary shares of £1 each	200,000
Statement of comprehensive income	(180,000)

The directors estimate that the company will return to profitability in 20X2, achieving profits of £4,000 per annum thereafter. Without a capital reduction, the profits from 20X2 must be used to reduce the accumulated losses. This means that the company would be unable to pay a dividend for forty-five years if it continued at that level of profitability and ignoring tax. Perhaps even more importantly, it would not be attractive for shareholders to put additional capital into the company because they would not be able to obtain any dividend for some years.

There might be statutory procedures such as the requirement for the directors to obtain a special resolution and court approval to reduce the £1 ordinary shares to ordinary shares of 10p each. Subject to satisfying such requirements, the accounting entries would be:

	Dr	Cr
	£	£
Capital reduction account	180,000	
Statement of income:		180,000
Transfer of debit balance		
Share capital	180,000	
Capital reduction account:		180,000
Reduction of share capital		

Accounting treatment for a capital reduction to eliminate accumulated trading losses and loss of value on non-current assets – losses borne by equity shareholders

Companies often take the opportunity to revalue all of their assets at the same time as they eliminate the accumulated trading losses. Any loss on revaluation is then treated in the same way as the accumulated losses and transferred to the capital reduction account.

For example, assume that the capital and reserves and assets of Hopeful Ltd were as follows at 31 December 20X1:

	£	£
200,000 ordinary shares of £1 each		200,000
Statement of income		(180,000)
		20,000
Non-current assets		
Plant and equipment		15,000
Current assets		
Cash	17,000	
Current liabilities		
Trade payables	12,000	
Net current assets		5,000
		20,000

The plant and equipment is revalued at £5,000 and it is resolved to reduce the share capital to ordinary shares of 5p each. The accounting entries would be:

	Dr £	Cr £
Capital reduction account	190,000	
Statement of income		180,000
Plant and machinery:		10,000
Transfer of accumulated losses and loss on revaluation		
Share capital	190,000	
Capital reduction account:		190,000
Reduction of share capital to 200,000 shares of 5p each		

The statement of financial position after the capital reduction shows that the share capital fairly reflects the underlying asset values:

	£	£
200,000 ordinary shares of 5p each		10,000
		10,000
Non-current assets		
Plant and equipment		5,000
Current assets		
Cash	17,000	
Current liabilities		
Trade payables	12,000	5,000
		10,000

The pro forma statement of financial position shown in Figure 10.1 is from the Pilkington's Tiles Group plc's 2002 Annual Report. It shows the position when the company proposed the creation of distributable reserves after a substantial deficit in the reserves had been caused by the writing down of an investment – this was to be achieved by transferring to the profit and loss account the sums currently standing to the credit of the capital redemption reserve and share premium account.

The proposal was the subject of a special resolution to be confirmed by the High Court – the court would consider the proposal taking creditor protection into account. The company recognised this with the following statement:

the Company will need to demonstrate to the satisfaction of the High Court that no creditor of the Company who has consented to the cancellations will be prejudiced by them. At present, it is anticipated that the creditor protection will take the form of an undertaking . . . not to treat as distributable any sum realised . . . which represents the realisation of hidden value in the statement of financial position.

Figure 10.1 Pilkington's Tiles Group pro forma balance sheet assuming the competition of the restructuring plan

	31 March 2002	*Adjustment*	*Adjusted balance*
	£000	£000	£000
Capital and reserves			
Share capital	9,247		9,247
Share premium	25,429	(25,429)	—
Capital redemption reserve	645	(645)	—
Merger reserve	(1,001)	1,001	—
Revaluation reserve	1,581	—	1,581
Profit and loss account	(21,738)	25,073	3,335
Equity shareholders' funds	14,163	—	14,163

10.13.2 Accounting treatment for a capital reduction to eliminate accumulated trading losses and loss of value on non-current assets – losses borne by equity and other stakeholders

In the Hopeful Ltd example above, the ordinary shareholders alone bore the losses. It might well be, however, that a reconstruction involves a compromise between shareholders and creditors, with an amendment of the rights of the latter. Such a reconstruction would be subject to any statutory requirements within the jurisdiction, e.g. the support, say, of 75% of each class of creditor whose rights are being compromised, 75% of each class of shareholder and the permission of the court. For such a reconstruction to succeed there needs to be reasonable evidence of commercial viability and that anticipated profits are sufficient to service the proposed new capital structure.

Assuming in the Hopeful Ltd example that the creditors agree to bear £5,000 of the losses, the accounting entries would be as follows:

	£	£
Share capital	185,000	
Creditors	5,000	
Capital reduction account:		190,000
Reduction of share capital to 200,000 shares of 7.5p each		

Reconstruction schemes can be complex, but the underlying evaluation by each party will be the same. Each will assess the scheme to see how it affects their individual position.

Trade payables

In their decision to accept £5,000 less than the book value of their debt, the trade payables of Hopeful Ltd would be influenced by their prospects of receiving payment if Hopeful were to cease trading immediately, the effect on their results without Hopeful as a continuing customer and the likelihood that they would continue to receive orders from Hopeful following reconstruction.

Loan creditors

Loan creditors would take into account the expected value of any security they possess and a comparison of the opportunities for investing any loan capital returned in the event of liquidation with the value of their capital and interest entitlement in the reconstructed company.

Preference shareholders

Preference shareholders would likewise compare prospects for capital and income following a liquidation of the company with prospects for income and capital from the company as a going concern following a reconstruction.

Relative effects of the scheme

In practice, the formulation of a scheme will involve more than just the accountant, except in the case of very small companies. A merchant bank, major shareholders and major debenture holders will undoubtedly be concerned. Each vested interest will be asked for its opinion on specific proposals: unfavourable reactions will necessitate a rethink by the accountant. The process will continue until a consensus begins to emerge.

Each stakeholder's position needs to be considered separately. For example, any attempt to reduce the nominal value of all classes of shares and debentures on a proportionate basis would be unfair and unacceptable. This is because a reduction in the nominal values of preference shares or debentures has a different effect from a reduction in the nominal value of ordinary shares. In the former cases, the dividends and interest receivable will be reduced; in the latter case, the reduction in nominal value of the ordinary shares will have no effect on dividends as holders of ordinary shares are entitled to the residue of profit, whatever the nominal value of their shares.

Total support may well be unachievable. The objective is to maintain the company as a going concern. In attempting to achieve this, each party will continually be comparing its advantages under the scheme with its prospects in a liquidation.

Illustration of a capital reconstruction

XYZ plc has been making trading losses, which have resulted in a substantial debit balance on the profit and loss account. The statement of financial position of XYZ plc as at 31 December 20X3 was as follows:

		£000
Ordinary share capital (£1 shares)		1,000
Less: Accumulated losses	Note 1	(800)
		200
10% debentures (£1)		600
Net assets at book value	Note 2	800

Notes:

1 The company is changing its product and markets and expects to make £150,000 profit before interest and tax every year from 1 January 20X4.

2 (a) The estimated break-up or liquidation value of the assets at 31 December 20X3 was £650,000.

(b) The going concern value of assets at 31 December 20X3 was £700,000.

The directors are faced with a decision to liquidate or reconstruct. Having satisfied themselves that the company is returning to profitability, they propose the following reconstruction scheme:

- Write off losses and reduce asset values to £700,000.
- Cancel all existing ordinary shares and debentures.
- Issue 1,200,000 new ordinary shares of 25p each and 400,000 12.5% debentures of £1 each as follows:
  - the existing shareholders are to be issued with 800,000 ordinary 25p shares;
  - the existing debenture holders are to be issued with 400,000 ordinary 25p shares and the new debentures.

The stakeholders, i.e. the ordinary shareholders and debenture holders, have first to decide whether the company has a reasonable chance of achieving the estimated profit for 20X4. The company might carry out a sensitivity analysis to show the effect on dividends and interest over a range of profit levels.

Next, stakeholders must consider whether allowing the company to continue provides a better return than that available from the liquidation of the company. Assuming that it does, they assess the effect of allowing the company to continue without any reconstruction of capital and with a reconstruction of capital.

The accountant writes up the reconstruction accounts and produces a statement of financial position after the reconstruction has been effected.

The accountant will produce the following information:

Effect of liquidating

		Debenture holders	*Ordinary shareholders*
	£	£	£
Assets realised	650,000		
Less: Prior claim	(600,000)	600,000	
Less: Ordinary shareholders	(50,000)		50,000
	—	600,000	50,000

This shows that the ordinary shareholders would lose almost all of their capital, whereas the debenture holders would be in a much stronger position. This is important because it might influence the amount of inducement that the debenture holders require to accept any variation of their rights.

Company continues without reconstruction

		Debenture holders	*Ordinary shareholders*
	£	£	£
Expected annual income:			
Expected operating profit	150,000		
Debenture interest	(60,000)	60,000	
Less: Ordinary dividend	(90,000)		90,000
Annual income	—	60,000	90,000

However, as far as the ordinary shareholders are concerned, no dividend will be allowed to be paid until the debit balance of £800,000 has been eliminated, i.e. there will be no dividend for more than nine years (for simplicity the illustration ignores tax effects).

Company continues with a reconstruction

	£	*Debenture holders* £	*Ordinary shareholders* £
Expected annual income:			
Expected operating profit	150,000		
Less: Debenture interest (12.5% on £400,000)	(50,000)	50,000	
Less: Dividend on shares	(33,000)	33,000	
Less: Ordinary dividend	(67,000)		67,000
Annual income	—	83,000	67,000

How will debenture holders react to the scheme?

At first glance, debenture holders appear to be doing reasonably well: the £83,000 provides a return of almost 14% on the amount that they would have received in a liquidation (83,000/600,000 × 100), which exceeds the 10% currently available, and it is £23,000 more than the £60,000 currently received. However, their exposure to risk has increased because £33,000 is dependent upon the level of profits. They will consider their position in relation to the ordinary shareholders.

For the ordinary shareholders the return should be calculated on the amount that they would have received on liquidation, i.e. 134% (67,000/50,000 × 100). In addition to receiving a return of 134%, they would hold two-thirds of the share capital, which would give them control of the company.

A final consideration for the debenture holders would be their position if the company were to fail after a reconstruction. In such a case, the old debenture holders would be materially disadvantaged as their prior claim will have been reduced from £600,000 to £400,000.

Accounting for the reconstruction

The reconstruction account will record the changes in the book values as follows:

Reconstruction account

	£000		£000
Statement of comprehensive income	800	Share capital	1,000
Assets (losses written off)	100	Debentures (old debentures cancelled)	600
Ordinary share capital (25p)	300		
12.5% debentures (new issue)	400		
	1,600		1,600

The post-reconstruction statement of financial position will be as follows:

Ordinary share capital (25p)	300,000
12.5% debentures of £1	400,000
	700,000

10.14 Repayment of part of paid-in capital to shareholders or cancellation of unpaid share capital

This can occur when a company wishes to reduce its unwanted liquid resources. It takes the form of a pro rata payment to each shareholder and may require the consent of the creditors.

At the same time, the Directors need to retain sufficient to satisfy the company's capital investment requirements. The following is an extract from the AstraZeneca 2005 Annual Report:

> **Dividend and share re-purchases**
> In line with the policy stated last year, the Board intends to continue its practice of growing dividends in line with earnings (maintaining dividend cover in the two to three times range) whilst substantially distributing the balance of cash flow via share re-purchases. During 2005, we returned $4,718 million out of free cash of $6,052 million to shareholders through a mix of share buy-backs and dividends. The Board firmly believes that the first call on free cash flow is business need and, having fulfilled that, will return surplus cash flow to shareholders.
>
> The primary business need is to build the product pipeline by supporting internal and external opportunities. Accordingly, in 2006, the Board intends to re-purchase shares at around the same level as 2005, with any balance of free cash flow available firstly for investment in the product pipeline or subsequent return to shareholders.

10.15 Purchase of own shares

This might take the form of the redemption of redeemable preference shares, the purchase of ordinary shares which are then cancelled and the purchase of ordinary shares which are not cancelled but held in treasury.

10.15.1 Redemption of preference shares

In the UK, when redeemable preference shares are redeemed, the company is required either to replace them with other shares or to make a transfer from distributable reserves to non-distributable reserves in order to maintain permanent capital. The accounting entries on redemption are to credit cash and debit the redeemable preference share account.

10.15.2 Buyback of own shares – intention to cancel

There are a number of reasons for companies buying back shares. These provide a benefit when taken as:

- a strategic measure, e.g. recognising that there is a lack of viable investment projects, i.e. expected returns being less than the company's weighted average cost of capital and so returning excess cash to shareholders to allow them to search out better growth investments;
- a defensive measure, e.g. an attempt to frustrate a hostile takeover or to reduce the power of dissident shareholders;
- a reactive measure, e.g. taking advantage of the fact that the share price is at a discount to its underlying intrinsic value or stabilising a falling share price;
- a proactive measure, e.g. creating shareholder value by reducing the number of shares in issue which increases the earnings per share, or making a distribution more tax efficient than the payment of a cash dividend;
- a tax efficient measure, e.g. Rolls Royce made a final payment to shareholders in 2004 of 5.00p, making a total of 8.18p per ordinary share (2003 8.18p), stating that: 'The Company will continue to issue B Shares in place of dividends in order to accelerate the recovery of its advance corporation tax.'

There is also a potential risk if the company has to borrow funds in order to make the buyback, leaving itself liable to service the debt. Where it uses free cash rather than loans it is attractive to analysts and shareholders. For example, in the BP share buyback scheme (one of the UK's largest), the chief executive, Lord Browne, said that any free cash generated from BP's assets when the oil price was above $20 a barrel would be returned to investors over the following three years.

10.15.3 Buyback of own shares – treasury shares

The benefits to a company holding treasury shares are that it has greater flexibility to respond to investors' attitude to gearing, e.g. reissuing the shares if the gearing is perceived to be too high. It also has the capacity to satisfy loan conversions and employee share options without the need to issue new shares which would dilute the existing shareholdings.

National regimes where buyback is already permitted

In Europe and the USA it has been permissible to buy back shares, known as treasury shares, and hold them for reissue. In the UK this has been permissible since 2003. There are two common accounting treatments – the cost method and the par value method. The most common method is the cost method, which provides the following:

On purchase

- The treasury shares are debited at gross cost to a Treasury Stock account – this is deducted as a one-line entry from equity, e.g. a statement of financial position might appear as follows:

Owners' equity section of statement of financial position

	£
Common stock, £1 par, 100,000 shares authorised, 30,000 shares issued	30,000
Paid-in capital in excess of par	60,000
Retained earnings	165,000
Treasury Stock (15,000 shares at cost)	(15,000)
Total owners' equity	240,000

In some countries, e.g. Switzerland, the treasury shares have been reported in the statement of financial position as a financial asset. When a company moves to IAS this is not permitted and it is required that the shares are disclosed as negative equity.

On resale

- If on resale the sale price is higher than the cost price, the Treasury Stock account is credited at cost price and the excess is credited to Paid-in Capital (Treasury Stock).
- If on resale the sale price is lower than the cost price, the Treasury Stock account is credited with the proceeds and the balance is debited to Paid-in Capital (Treasury Stock). If the debit is greater than the credit balance on Paid-in Capital (Treasury Stock), the difference is deducted from retained earnings.

The UK experience

Treasury shares have been permitted in the UK since 2003. The regulations relating to Treasury shares are now contained in the Companies Act 2006.[4] These regulations permit companies with listed shares that purchase their own shares out of distributable profits to hold them 'in treasury' for sale at a later date or for transfer to an employees' share scheme.

There are certain restrictions whilst shares are held in treasury, namely:

- Their aggregate nominal value must not exceed 10% of the nominal value of issued share capital (if it exceeds 10% then the excess must be disposed of or cancelled).
- Rights attaching to the class of share – e.g. receiving dividends, and the right to vote – cannot be exercised by the company.

Treasury shares – cancellation

- Where shares are held as treasury shares, the company may at any time cancel some or all of the shares.
- If shares held as treasury shares cease to be qualifying shares, then the company must cancel the shares.
- On cancellation the amount of the company's share capital is reduced by the nominal amount of the shares cancelled.

The Singapore experience

It is interesting to note that until 1998 companies in Singapore were not permitted to purchase their own shares and had to rely on obtaining a court order to reduce capital. It was realised, however, that regimes such as those in the UK allowed a quicker and less expensive way to return capital to shareholders. UK experience meant that public companies were able to return capital if there were insufficient investment opportunities, and private companies were able to repurchase shares to resolve disputes between family members or minority and majority shareholders.

The following criteria apply:

- the company should have authority under its Articles of Association;
- the repayment should be from distributable profits that are realised;
- the creditors should be protected by requiring the company to be solvent before and after the repayment (assets and liabilities to be restated to current values for this exercise);
- on-market acquisitions require an ordinary resolution;
- selective off market acquisitions require a special resolution because of the risk that directors may manipulate the transaction.

The amount paid by the company will be set against the carrying amount of the contributed capital, i.e. the nominal value plus share premium attaching to the shares acquired and the retained earnings. In order to maintain capital, there will be a transfer from retained earnings to a capital redemption reserve. For example, a payment of $100,000 to acquire shares with a nominal value of $20,000 would be recorded as:

	Dr	Cr
Share capital	$20,000	
Retained earnings	$80,000	
Cash		$100,000

Being purchase of 20,000 $1 shares for $100,000 and their cancellation

	Dr	Cr
Retained earnings	$20,000	
Capital redemption reserve		$20,000

Being the creation of capital redemption reserve to maintain capital.

Summary

Creditors of companies are not expected to be protected against ordinary business risks as these are taken care of by financial markets, e.g. through the rates of interest charged on different capital instruments of different companies. However, the creditors are entitled to depend on the non-erosion of the permanent capital unless their interests are considered and protected.

The chapter also discusses the question of capital reconstructions and the need to consider the effect of any proposed reconstruction on the rights of different parties.

REVIEW QUESTIONS

1 What is the relevance of dividend cover if dividends are paid out of distributable profits?

2 How can distributable profits become non-distributable?

3 Why do companies reorganise their capital structure when they have accumulated losses?

4 What factors would a loan creditor take into account if asked to bear some of the accumulated loss?

5 Explain a debt/equity swap and the reasons for debt/equity swaps, and discuss the effect on existing shareholders and loan creditors.

EXERCISES

An extract from the solution is provided on the Companion Website (www.pearsoned.co.uk/elliott-elliott) for exercises marked with an asterisk (*).

Question 1

The draft statement of financial position of Telin plc at 30 September 20X5 was as follows:

	£000		£000
Ordinary shares of £1 each, fully paid	12,000	Product development costs	1,400
12% preference shares of £1 each, fully paid	8,000	Sundry assets	32,170
Share premium	4,000	Cash and bank	5,450
Retained (distributable) profits	4,600		
Payables	10,420		
	39,020		39,020

Preference shares of the company were originally issued at a premium of 2p per share. The directors of the company decided to redeem these shares at the end of October 20X5 at a premium of 5p per share. They also decided to write off the balances on development costs and discount on debentures (see below).

All write-offs and other transactions are to be entered into the accounts according to the provisions of the Companies Acts and in a manner financially advantageous to the company and to its shareholders.

The following transactions took place during October 20X5:

(a) On 4 October the company issued for cash 2,400,000 10% debentures of £1 each at a discount of 2½%.

(b) On 6 October the balances on development costs and discount of debentures were written off.

(c) On 12 October the company issued for cash 6,000,000 ordinary shares at a premium of 10p per share. This was a specific issue to help redeem preference shares.

(d) On 29 October the company redeemed the 12% preference shares at a premium of 5p per share and included in the payments to shareholders one month's dividend for October.

(e) On 30 October the company made a bonus issue, to all ordinary shareholders, of one fully paid ordinary share for every 20 shares held.

(f) During October the company made a net profit of £275,000 from its normal trading operations. This was reflected in the cash balance at the end of the month.

Required:

(a) Write up the ledger accounts of Telin plc to record the transactions for October 20X5.

(b) Prepare the company's statement of financial position as at 31 October 20X5.

(c) Briefly explain accounting entries which arise as a result of redemption of preference shares.

* Question 2

The following is the statement of financial position of Alpha Ltd as on 30 June 20X8:

	£000 *Cost*	*£000* *Accumulated depreciation*	*£000*
Non-current assets			
Freehold property	46	5	41
Plant	85	6	79
	131	11	120
Investments			
Shares in subsidiary company		90	
Loans		40	130
Current assets			
Inventory		132	
Trade receivables		106	
		238	
Current liabilities			
Trade payables		282	
Bank overdraft		58	
		340	
Net current liabilities			(102)
Total assets less liabilities			148
Capital and reserves			
250,000 8½% cumulative redeemable preference shares of £1 each fully paid			250
100,000 ordinary shares of £1 each 75p paid			75
			325
Retained earnings			(177)
			148

The following information is relevant:

1 There are contingent liabilities in respect of (i) a guarantee given to bankers to cover a loan of £30,000 made to the subsidiary and (ii) uncalled capital of 10p per share on the holding of 100,000 shares of £1 each in the subsidiary.

2 The arrears of preference dividend amount to £106,250.

3 The following capital reconstruction scheme, to take effect as from 1 July 20X8, has been duly approved and authorised:

(i) the unpaid capital on the ordinary shares to be called up;

(ii) the ordinary shares thereupon to be reduced to shares of 25p each fully paid up by cancelling 75p per share and then each fully paid share of 25p to be subdivided into five shares of 5p each fully paid;

(iii) the holders to surrender three of such 5p shares out of every five held for reissue as set out below;

(iv) the $8^1/2$% cumulative preference shares together with all arrears of dividend to be surrendered and cancelled on the basis that the holder of every 50 preference shares will pay to Alpha a sum of £30 in cash, and will be issued with;

(a) one £40 convertible $7^3/4$% note of £40 each, and

(b) 60 fully paid ordinary shares of 5p each (being a redistribution of shares surrendered by the ordinary shareholders and referred to in (iii) above);

(v) the unpaid capital on the shares in the subsidiary to be called up and paid by the parent company whose guarantee to the bank should be cancelled;

(vi) the freehold property to be revalued at £55,000;

(vii) the adverse balance on retained earnings to be written off, £55,000 to be written off the shares in the subsidiary and the sums made available by the scheme to be used to write down the plant

Required:

(a) Prepare a capital reduction and reorganisation account.

(b) Prepare the statement of financial position of the company as it would appear immediately after completion of the scheme.

Question 3

A summary of the statement of financial position of Doxin plc, as at 31 December 20X0, is given below;

	£		£
800,000 ordinary shares of £1 each	800,000	Assets other than bank (at book values)	1,500,000
300,000 6% preference shares of £1 each	300,000	Bank	200,000
General reserves	200,000		
Payables	400,000		
	1,700,000		1,700,000

During 20X1, the company:

(i) Issued 200,000 ordinary shares of £1 each at a premium of 10p per share (a specific issue to redeem preference shares).

(ii) Redeemed all preference shares at a premium of 5%. These were originally issued at 25% premium.

(iii) Issued 4,000 7% debentures of £100 each at £90.

(iv) Used share premium, if any, to issue fully paid bonus shares to members.

(v) Made a net loss of £500,000 by end of year which affected the bank account.

Required:

(a) Show the effect of each of the above items in the form of a moving statement of financial position (i.e. additions/deductions from original figures) and draft the statement of financial position of 31 December 20XI.

(b) Consider to what extent the interests of the creditors of the company are being protected.

Question 4

Discuss the advantages to a company of:

(a) purchasing and cancelling its own shares;

(b) purchasing and holding its own shares in treasury.

* Question 5

Speedster Ltd commenced trading in 1986 as a wholesaler of lightweight travel accessories. The company was efficient and traded successfully until 2000 when new competitors entered the market selling at lower prices which Speedster could not match. The company has gradually slipped into losses and the bank is no longer prepared to offer overdraft facilities. The directors are considering liquidating the company and have prepared the following statement of financial position and supporting information:

Statement of financial position (000s)

Non-current assets		
Freehold land at cost		1,500
Plant and equipment (NBV)		1,800
Current assets		
Inventories	600	
Trade receivables	1,200	
	1,800	
Current liabilities		
Payables	1,140	
Bank overdraft (secured on the plant and equipment)	1,320	
	2,460	
Net current assets		(660)
Non-current liabilities		
Secured loan (secured on the land)		(1,200)
		1,440
Financed by		
Ordinary shares of £1 each		3,000
Statement of comprehensive income		(1,560)
		1,440

Supporting information

(i) The freehold land has a market value of £960,000 if it is continued in use as a warehouse. There is a possibility that planning permission could be obtained for a change of use allowing the warehouse to be converted into apartments. If planning permission were to be obtained, the company has been advised that the land would have a market value of £2,500,000.

(ii) The net realisable values on liquidation of the other assets are:

Plant and equipment	£1,200,000
Inventory	£450,000
Trade receivables	£1,050,000

(iii) An analysis of the payables indicated that there would be £300,000 owing to preferential creditors for wages, salaries and taxes.

(iv) Liquidation costs were estimated at £200,000

Required:

Prepare a statement showing the distribution on the basis that:

(a) planning permission was not obtained; and

(b) planning permission was obtained.

Question 6

Delta Ltd has been developing a lightweight automated wheelchair. The research costs written off have been far greater than originally estimated and the equity and preference capital has been eroded as seen on the statement of financial position.

The following is the statement of financial position of Delta Ltd as at 31.12.20X9:

	£000	£000
Intangible assets		
Development costs		300
Non-current assets		
Freehold property	800	
Plant, vehicles and equipment	650	1,450
		1,750
Current assets		
Inventory	480	
Trade receivables	590	
Investments	200	
	1,270	
Current liabilities		
Trade payables	(1,330)	
Bank overdraft	(490)	(550)
		1,200
10% debentures (secured on freehold premises)		(1,000)
Total assets less liabilities		200
Capital and reserves		
Ordinary shares of 50p each		800
7% cumulative preference shares of £1 each		500
Retained earnings (debit)		(1,100)
		200

The finance director has prepared the following information for consideration by the board:

1 Estimated current and liquidation values were estimated as follows:

	Current values	Liquidation values
	£000	*£000*
Capitalised development costs	300	–
Freehold property	1,200	1,200
Plant and equipment	600	100
Inventory	480	300
Trade receivables	590	590
Investments	200	200
		2,390

2 If the company were to be liquidated there would be disposal costs of £100,000.

3 The preference dividend had not been paid for five years.

4 It is estimated that the company would make profits before interest over the next five years of £150,000 rising to £400,000 by the fifth year.

5 The directors have indicated that they would consider introducing further equity capital.

6 It was the finance director's opinion that for any scheme to succeed , it should satisfy the following conditions:

   (a) The shareholders and creditors should have a better benefit in capital and income terms by reconstructing rather than liquidating the company.

   (b) The scheme should have a reasonable possibility of ensuring the long-term survival of the company.

   (c) There should be a reasonable assurance that there will be adequate working capital.

   (d) Gearing should not be permitted to become excessive.

   (e) If possible, the ordinary shareholders should retain control.

Required:

(a) Advise the unsecured creditors of the minimum that they should accept if they were to agree to a reconstruction rather than proceed to press for the company to be liquidated.

(b) Propose a possible scheme for reconstruction.

(c) Prepare the statement of financial position of the company as it would appear immediately after completion of the scheme.

References

1 Companies Act 2006.
2 *Ibid*., section 764.
3 Companies (Reduction of Share Capital) Order 2008.
4 The Companies Act 2006, paras 724–732.