
Week 2 Workshop – M1 Company regulations and operations

Reporting entities and financial reports

1. Presentation: CH 1 – LO1

This recording is available from the Getting Started section of the Study Desk

2. Discuss Seaside Resorts example

Discussion of review activities – CH 1

3. Issues or questions from review activities

Conceptual framework

4. EX 1.7: Long-term earning power

Presentation

This recording is available from the M1 section of the Study Desk

5. Demonstration Problem 13.1 (pp. 433 – 435)

Discussion of review activities – CH 13

6. Issues or questions from review activities

Comprehension Questions & Exercises

7. CH 13 CQ 2
8. EX 13.1
9. EX 13.4
10. EX 13.11
11. EX 13.14

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Application and analysis exercises – Chapter 1

Exercise 1.7 – Performance of a business entity

A financial analyst said:

I advise my clients to invest for the long term. Buy good shares and hang onto them. Therefore, I am interested in a company's long-term earning power. Accounting standards that result in earnings volatility obscure long-term earning power. Accounting should report earning power by deferring and amortising costs and revenues.

Is this analyst's view consistent with the fundamental characteristics of financial information established in the conceptual framework?

- Accounting standards should help provide relevant and faithfully represented financial information.
- Companies that operate in risky business environments or that enter into risky kinds of transactions are likely to experience real ups and downs in their performance. In such cases, volatility of reported earnings results from the real transactions and activities of the company.
- In other words, the statement of profit or loss and other comprehensive income reflects the underlying risks. It is not the role of financial accounting and reporting to try to smooth the company's earnings by, say, deferring profits in good years and deferring expenses in bad years. The amounts reported in the financial statements would not be faithfully represented because they do not reflect real phenomena.

Comprehension questions – Chapter 13

2. The telecommunications industry in a particular country has been a part of the public sector. As a part of its privatisation agenda, the government decided to establish a limited liability company called Telecom Plus, with the issue of 10 million \$3 shares. These shares were to be offered to the citizens of the country. The terms of issue were such that investors had to pay \$2 on application and the other \$1 per share would be called at a later time. Discuss:

- The nature of the limited liability company, and in particular the financial obligations of acquirers of shares in the company.**
- The journal entries that would be required if applications were received for 11 million shares.**

The *nature* of a limited liability company is such that shareholders' liability is limited to the issue price of a share. If the shares are issued at par value, the liability is limited to payment of that par value per share. If shares are issued at a given price, the limitation is to that price.

The journal entries are – assuming that applications were received for 10 million shares:

Cash Trust	Dr	20 000 000	
Application	Cr		20 000 000
<i>(Receipt of application money)</i>			
Application	Dr	20 000 000	
Share capital	Cr		20 000 000
<i>(Issue of shares)</i>			
Cash	Dr	20 000 000	
Cash trust	Cr		20 000 000
<i>(Transfer from cash trust on issue of shares)</i>			

Application and analysis exercises – Chapter 13

Exercise 13.1 – Repurchase of shares

The directors of Sand Ltd are considering spending \$5 million in a repurchase of the company's shares. Some directors argue that this outlay requires the company to use a large amount of its capital that could be better put to alternative uses. They also argue that current shareholders may prefer to reward a company that grows its own business rather than artificially inflate the share price by a repurchase of shares. There is a fear among some directors that the repurchase could be a sign that the company cannot find anything better to do with its cash.

Required:

Analyse these arguments and set out the main arguments in favour of a share buyback for the company in the form of a report to management of Sand Ltd.

Some of the reasons a company may consider buying back its own shares are:

- to increase the worth per share of the remaining shares: this will depend on whether the funds used to buy back the shares were not being used effectively in the company;
- to manage the capital structure by reducing equity;
- to provide price support for issued shares: by acquiring its own shares a company demonstrates confidence in the future of the company;
- to most efficiently manage surplus funds held by the company: rather than pay a dividend or reinvest in other ventures the company reduces the number of shares on issue and hopefully increases earnings per share.

Should the money spent on buying back shares could be better spent on other uses? Perhaps if there are no suitable investments around then it is in the best interests of shareholders for the company to use excess cash to buy back shares. This allows the shareholders to choose where to invest their money.

Are prices "artificially" raised by buybacks? If the market sees the buyback as a good deal for remaining shareholders then the prices will rise and shareholders will be better off. The price rise is not artificial.

Exercise 13.4 – Cash trust accounts

In accounting for the funds received by the company in the process of raising capital, it is sometimes necessary to raise a cash trust account. However, the cash trust account is not always an appropriate account to use.

Required:

Compare the various ways in which a company may increase its share capital and analyse when a cash trust should be used in the accounting process.

A cash trust is raised whenever investors make an offer to a company to acquire equity instruments. This may occur when a company issues a prospectus outlining the details of a proposed share issue. It may also occur in relation to a proposed issue of options, if investors have to make an offer to the company to acquire the options.

In such cases it is the investor who makes the offer to acquire the equity instrument and it is up to the company to accept/reject that offer. Until the company makes the decision to accept/reject the offer, any monies received by the company are held in trust as no contract has as yet been formed between the offeror and the company.

Where the company makes an offer inviting investors to invest, there is no need to raise a cash trust as on receipt of the cash the contract between the company and the investor is complete.

Exercise 13.11**Issues of shares and options**

White Foam Ltd has been investigating the expansion of the company into new areas of development. In order to fund these new investments the company needs an increase in equity. On 1 April 2016 the company decided to make a public issue to raise \$1 200 000 for new capital development. The company issued a prospectus inviting applications for 400 000 \$3 shares, payable in full on application. There was an additional incentive offered by White Foam Ltd to investors, as those shareholders who acquired more than 20 000 shares were allowed to acquire options at 50 cents each. These options allowed the investors to acquire shares in White Foam Ltd at \$3.20 each, the acquisition having to occur before 30 November 2016.

White Foam Ltd had received applications for 500 000 shares and 40 000 options by 10 May. On 28 May the shares and options were allotted and money returned to unsuccessful applicants. All applicants who acquired options also received shares.

By 30 November 2016 the price of each of White Foam's shares was \$3.35. Holders of 36 000 options exercised their options in November, with the remaining options lapsing.

Required: Prepare the journal entries in the records of White Foam Ltd in relation to the above events.

WHITE FOAM LTD

10/5	Cash trust – shares	Dr	1 500 000	
	Application – shares	Cr		1 500 000
	<i>(Applications for shares)</i>			
	Cash trust – options	Dr	20 000	
	Application – options	Cr		20 000
	<i>(Applications for options)</i>			
28/5	Cash	Dr	1 220 000	
	Cash trust – shares	Cr		1 200 000
	Cash trust – options	Cr		20 000
	<i>(Transfer on issue of shares and options)</i>			
	Application – shares	Dr	1 200 000	
	Share capital	Cr		1 200 000
	<i>(Issue of shares)</i>			
	Application – shares	Dr	300 000	
	Cash trust	Cr		300 000
	<i>(Refund to unsuccessful applicants)</i>			
	Application – options	Dr	20 000	
	Options	Cr		20 000
	<i>(Issue of options)</i>			
30/11	Options	Dr	18 000	
	Cash (36 000 x \$3.20)	Dr	115 200	
	Share capital	Cr		133 200
	<i>(Issue of shares on issue of options)</i>			
	Options	Dr	2 000	
	Options lapsed reserve	Cr		2 000
	<i>(Transfer of lapsed options)</i>			

Note: The \$2 000 amount for lapsed options could have been included in share capital.

Exercise 13.14**Share issue, options**

On 30 June 2015, the equity accounts of Moray Ltd consisted of:

175 000 'A' ordinary shares, issued at \$2.50 each, fully paid	\$437 500
50 000 6% cumulative preference shares, issued at \$3 and paid to \$2	100 000
Options (20 000 at 56c each)	11 200
Accumulated losses	(6 250)

As the company had incurred a loss for the year ended 30 June 2015, no dividends were declared for that year. The options were exercisable between 1 March 2016 and 30 April 2016. Each option allowed the holder to buy one 'A' ordinary share for \$4.50.

The following transactions and events occurred during the year ended 30 June 2016.

2015	
July 25	The directors made the final call of \$1 on the preference shares.
Aug. 31	All call monies were received except those owing on 7500 preference shares.
Sept. 7	The directors resolved to forfeit 7500 preference shares for non-payment of the call.
	The constitution of the company directs that forfeited amounts are not to be refunded to shareholders. The shares will not be reissued.
Nov. 1	The company issued a prospectus offering 30 000 'B' ordinary shares payable in two instalments: \$3 on application and \$2 on 30 November 2016. The offer closed on 30 November.
Nov. 30	Applications for 40 000 'B' ordinary shares were received.
Dec. 1	The directors resolved to allot the 'B' ordinary shares pro rata with all applicants receiving 75% of the shares applied for. Excess application monies were allowed to be held. The shares were duly allotted.
Dec. 5	Share issue costs of \$5200 were paid.
2016	
April 30	The holders of 15 000 options applied to purchase shares. All monies were sent with the applications. All remaining options lapsed. The shares were duly issued.

Required

- 1. Prepare general journal entries to record the above transactions.**
- 2. If Moray Ltd buys back 25 000 preference shares for \$3.50 per share, what factors would its accountant have to consider in determining how best to record the transaction in the accounts?**

MORAY LTD**1. GENERAL JOURNAL ENTRIES**

DATE	DETAILS			
2015				
July 25	Call – preference	Dr	50 000	
	Share capital - preference	Cr		50 000
	(50 000 shares x \$1.00)			
August 31	Cash	Dr	42 500	
	Call – preference	Cr		42 500
	(50 000 – 7 500 = 42 500 shares x \$1.00)			
Sept 7	Share capital – preference (7 500 x \$3.00)	Dr	22 500	
	Call – preference (7 500 x \$1.00)	Cr		7 500
	Forfeited shares reserve (7 500 x \$2.00)	Cr		15 000
Nov 30	Cash trust	Dr	120 000	
	Application	Cr		120 000
	(40 000 x \$3.00)			
Dec 1	Application	Dr	90 000	
	Share capital – B ordinary	Cr		90 000
	(30 000 shares x \$3.00)			
	Application	Dr	30 000	
	Calls in advance	Cr		30 000
	(10 000 applications x \$3.00)			
	Cash	Dr	120 000	
	Cash trust	Cr		120 000
Dec 5	Share capital – B Ordinary	Dr	5 200	
	Cash	Cr		5 200
	(Share issue costs)			
2016				
April 30	Cash	Dr	67 500	
	Share capital – A ordinary	Cr		67 500
	(15 000 shares x \$4.50)			
	Options	Dr	11 200	
	Share capital – A ordinary	Cr		8 400
	(15 000 x \$0.56)	Cr		2 800
	Options reserve (5 000 x \$0.56)			

2.

The accountant should consider whether there are tax or dividend distribution issues associated with particular equity accounts before determining which accounts are to be affected by the buy-back. If there are no such issues the buy-back can be written off against any equity account or across all equity accounts.