

# **CHAPTER 5**

## **CAPITAL STRUCTURE AND FINANCE COSTS**

### **PART 1**

#### **LEARNING OBJECTIVES**

- I. THE CAPITAL STRUCTURE OF A LIMITED LIABILITY COMPANY**
- II. ORDINARY SHARE CAPITAL**
- III. RIGHTS ISSUES**
- IV. BONUS ISSUES**

# **I. THE CAPITAL STRUCTURE OF A LIMITED LIABILITY COMPANY**

Finance is provided by the capital invested in the business. There are a number of ways that a business can attract financial capital but each has its own characteristics and consequences. In general all forms of finance can be loosely categorised into two distinct groups.

- Debt, which requires some form of mandatory transfer of economic benefit to the provider of the finance, or
- Equity, which gives the provider of the finance the rights to share in the residual assets of the business when it ceases to trade.

# I. THE CAPITAL STRUCTURE OF A LIMITED LIABILITY COMPANY

For this chapter, you need to be aware of three forms of financial capital and how to record them in the financial statements:

- i. Ordinary (equity) share capital: this is equity as the directors are under no obligation to repay the investors (shareholders) or to pay them a dividend. An ordinary shareholding is evidence of ownership of company and the shareholders receive the residual interest in the business once it ceases to trade in proportion to the size of their shareholdings. Ordinary shares are shown under equity on the statement of financial position.

Directors may choose to pay the shareholders an annual dividend. These are recognised in the statement of changes in equity, not the statement of profit or loss. This is not a deduction from profit; it is a distribution of profit to the rightful owners of it.

# **I. THE CAPITAL STRUCTURE OF A LIMITED LIABILITY COMPANY**

ii. Loan notes: under the terms of loan note agreements directors are usually required to pay the loan holder an annual interest amount and are obliged to repay the full debt at a fixed point in time. This is therefore a form of debt and appears as a liability on the statement of financial position.

The interest payment is treated as a finance charge, which is shown as an expense in the statement of profit or loss. This is a deduction from profit.

## **I. THE CAPITAL STRUCTURE OF A LIMITED LIABILITY COMPANY**

iii. Preference shares: these can be either debt or equity, depending on their terms. If there is any obligation to repay the preference shareholder (redeemable) then this is evidence of a debt. These are shown as liabilities on the statement of financial position and any dividends paid to these shareholders would be treated as finance charges.

Irredeemable preference shares are shares that do not have to be repaid. They are therefore treated as equity in the statement of financial position. It must be made clear that they are not the same as ordinary shares as they do not entitle the owner to a residual interest in the business. The accompanying dividends are, however, treated the same as ordinary dividends in the financial statements.

## II. ORDINARY SHARE CAPITAL

As stated above, ordinary share capital is treated as equity and the associated dividend payments are recorded in the statement of changes in equity.

Each share has a nominal or par value, often \$1, 50c or 25c. It is often perceived as the share's minimum value. This value remain fixed, whereas the market value of the share fluctuates over time. This value is often used as a means of calculating dividends to shareholders ( paid as a percentage of the nominal value).

## II. ORDINARY SHARE CAPITAL

### Accounting for the issue of shares:

If a company were to issue shares at their nominal value the double entry to record this raising of finance would be:

Dr. Cash .....issue price x no.of shares

Cr. Share capital...nominal value x no. of shares

In reality companies generally issue shares at a price above their nominal value. This referred to as issuing shares at a premium.

Dr. Cash.....issue price x no. of shares

Cr. Share capital.....nominal value x no. of shares

Cr. Share premium ....difference between cash and share capital.

### Test 1

Bourbon issued 200,000 25c shares at a price of \$1.75 each.

Show journal entry and ledger accounts.

### III. RIGHTS ISSUES

**A rights issue** is the offer new shares to existing shareholders in proportion to their existing shareholding at a stated price (normally below market values).

**The advantages are:**

- A rights issue is the cheapest way for a company to raise finance through the issuing for further shares.
- A rights issue to existing shareholders has a greater chance of success compared with a share issue to the public.

**The disadvantages are:**

- A rights issue is more expensive than issuing debt.
- It may not be successful in raising the finance required.



# III. RIGHTS ISSUES

A rights issue is accounted for in the same way as a normal share issue and therefore has exactly the same impact on the statement of financial position as an issue at full price.

## Test 2

Upon incorporation in 20x4, The Jammy Dodger, a limited liability company, issues 1,000 50c shares at nominal value. Needing further funds, in 20X5 it makes a rights issue of 1 for 5 at \$0.75. this offer is fully taken up.

**What accounting entries are required in 20x4 and 20x5 ? Illustrate the relevant section of the statement of financial position at year end 20x5.**

# IV. BONUS ISSUES

A bonus issue is the issue of new shares to existing shareholders in proportion to their existing shareholding. No cash is received from a bonus issue.

The advantages are:

- Issued share capital is divided into a larger number of shares, thus making the market value of each one less, and so more marketable.
- Issued share capital is brought more into line with assets employed in the company by reducing stated reserves and increasing share capital.

The disadvantages are:

The admin costs of making the bonus issue.

## IV. BONUS ISSUES

As no cash is received from a bonus issue, the issue must be funded from reserves. Any reserve can be used, though a non-distributable reserve such as the share premium account would be used in preference to reserves which can be distributed:

Dr. share premium.....nominal value  
( or other reserve)  
Cr. Share capital .....nominal value.

### **Test 3:**

Ginger Knut, a limited liability company, has 20,000 50c shares in issue ( each issued for \$1.25) and makes a 1 for 4 bonus issue, capitalising the share premium account.

**What are the balances on the share capital and share premium accounts after this transaction.**

# IV. BONUS ISSUES

## Test 4:

Rich T is a limited liability company with 200,000 25c shares in issue. At 1 January the balance on the share premium account is \$75,000. The following transactions occur in the year ended 31 December 20X6:

31 January there is fully taken-up 2 for 5 rights issue. The issue price is \$1.80.

12 August there is a 1 for 10 bonus issue made using the share premium account.

**What are the balance on the share capital and share premium accounts on 31 December 20X6?**