CHAPTER 5
CAPITAL STRUCTURE AND FINANCE COSTS
PART 2

LEARNING OBJECTIVES

V. DIVIDENDS

VI. LOAN NOTES (LOAN STOCK)

VII. PREFERENCE SHARES

VIII. OTHER RESERVES

IX. INCOME TAX

V. DIVIDENDS

Dividends represent the distribution of profits to shareholders. They are usually expressed as an amount per share e.g. 10c per share or 10% of nominal value.

Dividends on preference shares are usually based on a pre-determined amount, such as 5% of the nominal value of the shareholding.

The double entry:

A company may pay a mid-year or interim dividend.

Dr. Retained Earnings *………………xxx

Cr. Bank…………………………………….xxx

- RE (dividend) : disclose in statement of changes in equity

At the end of the year companies may propose or declare a dividend (final dividend) to the ordinary shareholders. Proposed dividends at the end of the year that have not been approved by shareholders cannot be recorded as liabilities at the year-end.

VI. LOAN NOTES (LOAN STOCK)

The term ‘loan note’ imply refers to the document that is evidence of the debt, often a certificate that is issued to the lender.

Similar to shares, the loan note will have a set nominal value, e.g. $100. Individual or organizations can buy the loan notes at an agreed price (this can be any value, it does not have to be the same as the nominal value). The life of the loan note will be fixed and the company issuing them will have to pay the loan note holder back at an agreed point in time.

The issuer will also have to pay interest to the loan note holder. The interest will be calculated based on the nominal value of the loan note (for example, 5% of the nominal value per annum). The interest incurred is included in ‘finance costs’ in the statement of profit or loss.

VI. LOAN NOTES (LOAN STOCK)

Accounting Entries:

Finance is received

Dr. Cash

Cr. Non-current liability

Finance charge is recognised

Dr. Finance charges (P/L)

Cr. Cash/current liabilities (depending on whether the interest has been paid or not)

Test 5:

Custard Creameries is an incorporated business which needs to raise funds to purchase plant and machinery. On 1 March 20X5 it issues $150,000 10% loan notes, redeemable in 10 years' time. Interest is payable half yearly at the end of August and February.

What accounting entries are required in the year ended 31 December 20X5 ? Show relevant extracts from the statement of financial position.

VII. PREFERENCE SHARES

If preference shares are redeemable they are treated the same as loan notes; i.e. they are recorded as a liability in the statement of financial position and dividend payments are treated the same as finance charges.

If the preference shares are irredeemable the shareholding and associated dividends are treated exactly the same as ordinary shareholdings, as explained above.

Test 6:

VII. PREFERENCE SHARES

Cracker, a company, has share capital as follows:

Ordinary share capital (50c shares) $200,000

8% irredeemable preference share capital $50,000

The company pays an interim dividend (i.e. a dividend declared part way through the financial year) of 12.5c per share to its ordinary shareholders and pays the preference shareholders their dividend, although this is not mandatory. Before the year end the company proposes a final dividend of 36.5c per share to its ordinary shareholders.

Calculate the amounts shown in the statement of change in equity (SOCIE) and statement of financial position (SFP) in relation to dividends for the year.

VIII. OTHER RESERVES

These capital sources represent the profits made by the business and the inflation in value of tangible non-current assets recognised in a revaluation. They are referred to as reserves or other components of equity.

Other reserves as follows:

Revaluation reserve :

- Records the unrealised gains on revaluation of property, plant and equipment.
- Cannot be paid out as a dividend

Retained earnings:

- Records the total of the net profits and losses earned/incurred to date that have been retained within the business (i.e. they have not been paid out as dividends yet).
- Can be distributed as dividends

IX. INCOME TAX

Steps for recording income tax:

Step 1

Company estimates tax liability

Dr. income tax charges (P&L)

Cr. Income tax liability (SoFP-current liability)

Step 2

Actual tax liability paid

Dr. Income tax liability

Cr. Cash

Step 3

It is unlikely the actual charge will match the estimated liability so the tax liability account will be left with a closing balance carried forward. This needs be removed as the debt has been settled.

IX. INCOME TAX

If there is an overprovision/overestimation in the prior year, it is adjusted as follows:

Dr. Income tax liability

Cr. Income tax charge

If there is an underestimate in the prior year, it is adjusted as follows:

Dr. Income tax charge

Cr. Income tax liability

The charge to the statement of profit or loss for current year as follows:

	$000
Current tax estimate	Xxx
Under/(over) provision in prior year	Xxx/(xxx)
Total income tax charge for the year	xxx

IX. INCOME TAX

Simple has estimated its income tax liability for the year ended 31 December 20X8 at $180,000. In the previous year the income tax liability had been estimated as $150,000.

Required:

Calculate the tax charge that will be shown in the statement of profit and loss for the year ended 31 December 20X8 if the amount that was actually agreed and settled with the tax authorities in respect of 20X7 was:

(a) $165,000

(b) $140,000.

(a) **Under provision**

Statement of profit or loss charge:

	$
Year end estimate	180,000
Under provision re: 20X7 ($165,000 – 150,000)	15,000
	195,000

(b) **Over provision**

Statement of profit or loss charge

	$
Year end estimate	180,000
Over provision re: 20X7 ($150,000 – 140,000)	(10,000)
	170,000