



chapter



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THE NATURE AND ENVIRONMENT
OF COMPANIES

introduction

People sometimes claim that they prefer the company of their friends to that of their families. They probably make this claim because they feel that their friends have more in common with them in terms of interests, aspirations and objectives. The word 'company', therefore, carries implications of commonly held beliefs, aims and interests. In a business context, this is equally true, and the company form of business organisation arose from such circumstances. The first companies were created when business ventures were undertaken that needed the resources of more than one person. People who had a common aim, such as to increase their wealth from the ventures, would get together and form a company, pooling their resources and know-how with the aim of sharing the resulting gains or, in many unfortunate cases, the losses. Thus, a company is an organisation in which many people pool their resources in order to undertake economic activity, usually with the aim of increasing their wealth. In simple terms, those involved have ownership rights in the company in proportion to their resource contributions. The resources contributed by the members form the equity capital of the company, which is divided into units called shares. Members hold varying numbers of these shares and they are referred to as shareholders. When the company distributes profits earned, it does so in proportion to the shareholders' share holdings. Such distributions are called dividends.

shares

shareholders

dividends

The company has proved to be the most efficient form of business organisation, and over the years governments in many countries have encouraged its development, because it has motivated and facilitated economic development. This has been achieved through the enactment of company laws. As companies have developed, economic activity has become increasingly complex and sophisticated. The company form of organisation has also changed to meet these challenges, and the laws necessary to regulate company activities have also become complex. Nevertheless, the simple description above remains the essence of companies: they are entities created by law with many of the same privileges and responsibilities enjoyed by individuals, such as the ability to own property and to borrow money.

The development of companies

The company form of business organisation has been around for 400 years, but the modern form of company emerged in Britain in the middle of the 19th century. It is no coincidence that it grew with the increasing industrialisation of the period, as the company was seen as a convenient form of organisation for the accumulation of capital. Thus, in the 17th century, when European traders were making ventures to newly 'discovered' parts of the world, the need for capital exceeded the amounts that could be raised by one or two partners. There was also a considerable risk in investing in these ventures. They involved small ships travelling vast distances over uncharted (or scantily charted) oceans — and often the ships never returned! Many companies were formed to gather different levels (amounts) of funds from many investors. The venture was funded with the prospect of large rewards for contributors when the ships returned with their precious and exotic cargoes. Some famous companies, such as the Dutch East Indies Company in the Netherlands and the East India Company of Great Britain, were formed in this period.

In the 19th century, business activity in the industrial revolution and the expansion of railway networks usually required very large amounts of capital, amounts beyond the means of a few investors. It is generally believed that this provided the impetus for the growth in the company form of organisation, which was accompanied by growth in company legislation. One of the most important elements in this new law was the notion of limited liability, which limited the liability of investors to the extent of their investment. This meant that individuals could invest their savings in a company in the knowledge that they would lose only their investment if the company failed. In other forms of business organisation, such as partnerships, the investors (the partners) are personally liable for the debts of the business. So, while the company is responsible for all its debts, if it has insufficient resources to meet them, the private resources of the shareholders are *not* available.

limited liability

Other legal provisions facilitated the growth of the company, such as the requirement of audit and the possibility of transfer of ownership interests. With the growth of the company, there was an increasing separation of ownership and control. Specialist managers came to control the company's day-to-day activities with little or no involvement from the owners — the shareholders. The audit — the independent investigation of and report on the company's financial affairs — provided some protection for the shareholders against the actions of the managers. A partnership, unlike a company, ceases to exist on the death (or withdrawal) of one of the partners. In a company, the shares owned by a shareholder may be sold or transferred (for example, as a gift or bequest) to others, giving the company, unless otherwise designed, a potentially unlimited life.

audit
transfer of
ownership interests

The capacity of transfer of ownership has transformed the modern company. As legal entities, companies can hold shares in other companies, and today the major shareholders in companies are in fact other companies. Share ownership gives voting rights at company meetings, so shareholders can direct the operation of a company through their votes, and so any entity holding a majority of the shares and voting rights can control the company. Achieving such control is a strategy of many

controlling interest companies: they can obtain a controlling interest in other companies through, for example, buying a majority of their shares. This relationship affects the accounting of such economic entities, and that is the subject of many of the later chapters of this book. There are other means of controlling an entity, but the most common is through ownership rights. This process of control and cross-ownership has transformed companies from their 19th century form and made them extremely important economic and social institutions in modern developed economies.

Different perspectives on companies

Today the significance of companies extends well beyond merely facilitating economic activity. Globalisation has meant that many companies now extend their activities across national boundaries and may have incomes larger than those of many nation states. Some of these companies have the power to greatly affect the societies in which they operate. There are many angles from which the company can be viewed, and there are many theories of what companies are.¹ In more general terms, there are a number of different perspectives on companies, and here we discuss five — legal, economic, financial, political and sociological — all of which overlap to some extent.

A LEGAL PERSPECTIVE

Legally a company in Australia is a body incorporated, or taken to be incorporated, under the Australian Corporations Act. The Corporations Act is one of the biggest and most complex statutes in the country, so it is not easy to summarise it in a few sentences. For the purposes of this book, it is important to be aware of only certain provisions of the Corporations Act. These relate to the formation, the winding up and reorganisation of companies, the need to maintain accounting records, and the extent to which the company must present financial information to various interested parties. Even this is complicated. For example, there are different types and classes of companies, with a variety of ways in which they can be formed. Nevertheless, certain common principles can be borne in mind, and it is to these that we direct attention in this book. A company is created by the law to have rights and responsibilities similar to those enjoyed by individuals, and the law is designed to protect all those who deal with the company — the owners or investors, the suppliers of credit, its customers, its employees, and the state generally.

From a legal perspective, a company can be regarded as an artificially created entity that needs a body of law to control its creation and operation. This is sometimes referred to as the concession theory of a company: that is, the company owes its existence to the state. The company then needs to meet the requirements, in the form of company law, imposed upon it by the state. Those involved in the formation and management of a company must conform to this body of law to ensure that all other entities dealing with the company are offered some protection. Part of this law is concerned with the establishment and maintenance of financial records, and with the financial reporting that the company is obliged to undertake. This is the subject of company accounting.

AN ECONOMIC PERSPECTIVE

Societies have designed laws to enable the creation of companies because they have considered it desirable to do so. There are various reasons for this. Adherents to the aggregate theory of companies believe that individuals have the right to join together for whatever reason they choose, such as to act in business together. Thus, a company is not some privilege granted by the state but the right of individuals to associate. The law, then, should be concerned to facilitate such association and ensure the internal operations of the company are in order. As corporations have increased in size and economic significance, the view has developed that it is natural for such organisations to exist — in other words, companies are ‘natural entities’, which is slightly different from regarding them as artificial entities, as in concession theory.

Irrespective of whether they are regarded as artificial or natural entities, companies have the capacity to engage in economic activity that individuals acting as sole traders or small groups of individuals working in partnerships cannot. Essentially this is the capacity to serve as the collecting point of large quantities of resources — capital. These large amounts of capital can then be employed in activities that require large-scale investment: for example, the construction of large (or even small) factories, the purchase of expensive equipment or the operation of a large number of geographically dispersed activities. However, many small companies also exist, so there are other advantages in the company form of business organisation. One of the more important of these is the limiting of the potential liability of the owners or investors: where a group of investors each invests \$100 000, their liability is limited to their original investment (or commitment to invest) in the event, for instance, that the company fails. This limited liability provision in companies has long been viewed as the major reason for the growth in the company form of business organisation over the last 160 or so years.

From an economic perspective, a company is a facilitator of economic activity. As a legal entity, a company can engage in most of the economic activities that any individual can: it can borrow, own resources and generally trade in its own right. A major objective of company accounting is to record and report on the economic actions taken by the company; that is, to indicate the resources owned by the economic entity and its commitments to providers of equity; and to report on the success of its operations over a given period.

One feature of the company that has become increasingly important as companies have grown in size and complexity is the separation of ownership from control. Although not immediately obvious, this may affect how the company accounts for certain items. With the separation of ownership from control arises the potential of a conflict of interest between owners and managers. If managers are rewarded for the company’s performance, they are likely to prefer the accounting treatment that shows the company in the ‘best light’, that is with the maximum profits. Such treatment may be to the short-term advantage of the company only, but managers are likely to be more concerned with the short term — current profits rather than the long-term survival of the company. Various theories exist as to how this relationship can be viewed and analysed — many are quite contentious.

**stock exchange
securities****A FINANCIAL PERSPECTIVE**

The ownership of most companies is reflected in their share capital: most companies are formed with a number of ownership units called shares, which are owned by shareholders. The share capital contributed on the formation of a company enables it to undertake economic activity. Once issued by the company, these ownership rights, the shares, can usually be transferred, and formal markets exist for selling and buying shares — stock exchanges. In addition, a company can issue other types of securities to raise funds in the economy by borrowing and issuing documentary evidence of the debt. Like shares, these securities are issued in units that are normally transferable. In recent years, other types of financial securities have been developed, and formal securities markets, such as stock exchanges, have evolved for trading and investing in most company securities. These security markets have become an important part of the economic activity of most developed countries as is evidenced, for example, in daily television news reports of the level or trend of prices for that day: reports concern, for example, the All Ordinaries Index (popularly referred to as the All Ords) in Australia, the Hang Seng in Hong Kong, the Dow Jones Industrial Average in New York, the FTSE in London and the Nikkei in Japan. The markets are important because companies can only operate if there are sufficient numbers of entities willing to invest in the securities markets and provide them with the necessary capital. Investors are interested in companies as opportunities for investment. They are less interested in the everyday economic activities of the company than in the extent to which these activities affect the prices that other investors are willing to pay for the securities.

From a financial perspective, company accounting provides investors and potential investors with information on the financial stability, liquidity and operating potential of companies. This information is useful to those making investment decisions. Investment and efficient securities or financial markets are crucial to the well-being of companies, as it is only through investment in them that companies can undertake economic activity. However, as with the economic perspective of companies, the problem of the separation of ownership from control is an important consideration. Very generally speaking, the current value of shares is the market's assessment of the future cash flows from the shares. If different accounting treatments lead to different cash flows, then the share price is affected. Considerable research effort has been devoted to examining this problem.

A POLITICAL PERSPECTIVE

The well-being of individuals in the various communities of a society is largely dependent on the level of economic activity. For example, some towns are referred to as 'company towns'. This means that the town survives because of the presence of a company. The company provides employment for the community, which in turn necessitates services such as retail shops, educational and medical facilities, and so on. Therefore, companies are important politically; often policies need to be implemented to encourage them to locate in certain areas, and their closure causes severe social problems not only for small communities but also in large metropolitan

cities. Governments, then, will implement policies that induce companies to operate in certain locations. One of the major goals of developing economies is to encourage investment, and this is often done by international or multinational companies. In Australia there is considerable competition between the States to encourage companies to set up business in their States. Investment brings employment, which is a fundamental part of economic activity and the economic wealth of a community. This view of companies is consistent with what is known as the communitarian theory of companies.

Company accounting is important to political decision makers as it provides a guide to the contribution companies are making to the well-being of the community and even the whole economy. Sometimes companies making losses are subsidised in order to enable them to continue operations, as their closure would result in a significant social cost to the community through the loss of employment and other derived economic activities. Sometimes there needs to be state investment or economic cooperation in order that the company remains economically viable. Therefore, decisions to provide state support for companies are based on political considerations, such decisions being affected by the success or otherwise of the operation of these companies.

All of the different perspectives of companies discussed here overlap to a certain extent. The political perspective overlaps the financial as more and more people become shareholders. The proportion of the population in Australia that have become shareholders has increased. In the USA, a large proportion of the public invests in shares either directly or through institutions designed to provide pension funds. Consequently there are political implications of movements in share prices — the stock market — and governments are increasingly making policy decisions sensitive to the public's concern.

A SOCIOLOGICAL PERSPECTIVE

Societies create laws to regulate their operation: some activities are encouraged through regulation, while others are discouraged. For instance, it is considered desirable to have some types of economic activity, such as the creation of employment, but not others, such as the selling of narcotic drugs. The fact that companies have been created by law indicates that they are considered to be desirable. Yet their activities must be controlled to ensure that they do not hurt those who deal with them. Historically, company law has increased significantly, reflecting the expansion and increasing sophistication of business and economic activity over the years. In fact, as a result of the increasing complexity of economic activity and business ownership, the original concept of a company (of 160 years ago) no longer exists. The sheer size of some companies, the international activities of many, and their increasingly complex ownership structures have been major forces in the changing nature of companies. Some sections of society are demanding more from companies than before. For example, they argue that if a company is going to exploit the country's economic resources, it must be able to demonstrate benefits and not costs that flow to society from its operation. A good example is the effect company operations may have on the environment, such as the mining of natural resources and pollution.

Our economic system is open to the abuse of privilege, and the law has attempted to restrict such abuses. No society is perfect and there will always be those who try to take unfair advantage. Some well-publicised recent law cases in Australia, and elsewhere, have demonstrated the existence of people in charge of companies who attempt to manipulate situations to their own advantage. The costs of bringing (and attempting to bring) these people to justice are often enormous and are borne by society as a whole. And the costs of a large-scale company failure inevitably trickle through to the rest of the economy.

This perspective is consistent with the social responsibility theory of companies. This theory holds that if the companies are regarded as being the equivalent of 'natural' entities (the natural entity theory referred to above), then the company has the same 'moral responsibility' to other members of society as natural entities — that is, people.

The law requires most large companies to publish financial statements in their annual reports, and then the accounting information becomes public information. Announcements of profits (and losses) often attract the attention of the media, and where these results are seen to be 'unfair', considerable pressure is placed on the regulators to remedy the perceived ills. For example, where banks report unusually large profits, there will be public pressure for a reduction in the bank charges or interest rates charged to customers.

Accountability

The separation of ownership from control is an important consideration in companies. When someone deposits money in the bank, they are entrusting the bank (management) to look after that money and keep it safe until it is withdrawn. Similarly, investors in companies expect company management to look after their investment and ensure its safety. The person who deposited the money in the bank will receive regular statements, containing information relating to their account, from the bank. Or the person will be able to access information on their account(s) through Internet banking. This is accountability — information provided so that the person can make informed decisions. For example, the person may be saving to buy a car and needs to know when she or he has sufficient funds to buy that car. The information provided by the bank helps the person make the decision. A shareholder invests in a company and also needs to have information about her or his investment. For example, one company may not be making as much profit as another, and so the investor needs to be able to decide whether they should sell their shares in this company and buy shares in another, in order to maximise returns. But business and companies have become complex. Companies can borrow, so lenders as well as shareholders invest in the company. So do suppliers of goods and services on credit. That means many parties are now interested in the results and the financial position of a company. All of these parties expect some accountability, and published company financial reports provide a significant part of this accountability.

accountability

There are a large number of companies in Australia, and most of them are small companies. Fundamental company accounting is the same for both small and large

companies, but the form differs in the degree of detail and complexity, and small companies are usually not required to publish their financial reports. In any case, it is the larger companies that have the most significant impact on the economy — investment in them far exceeds the investment in smaller companies.

One advantage of the company form of organisation is that it allows specialist managers to administer the day-to-day operations of the company. This is especially true of larger companies, because smaller companies are invariably managed by their owners. For example, a small retail store may be a family company: family members are the only shareholders, and many of them may work in the business. This is not possible for a large industrial company with a great number of shareholders living in different parts of the country or the world. These companies are administered by directors, who are accountable to the shareholders, and this is one of the reasons why company law requires companies to provide annual reports containing financial statements.

The law imposes strict obligations on directors so that the interests of investors (and others) are protected. However, as mentioned in the section on the economic perspective of companies, there are differing views of the relationship between the owners and the directors as managers of the companies. One view of directors is that they act as stewards for the shareholders, protecting their investment: the stewardship relationship means that they must act in the best interests of the shareholders. Others argue that the directors have their own interests and personal aspirations, and that they are simply agents for the shareholders (and other investors), so there must be a system of rewards for them to ensure that their interests coincide with the investors, so that all parties benefit from the decisions they make in operating the company. Whatever the view, a vast body of regulation relating to companies has developed, of which the (statute) law is only a part.

agent

regulation

Regulation

The history of companies is littered with spectacular collapses in which it has been claimed accounting has played a significant part and, unfortunately, this continues today. Consequently, a body of regulation has emerged to try to reduce the potential for such economic disasters in which many people suffer — shareholders, creditors and employees to name a few. Despite this, some believe that there should be minimal regulation. Such views are driven by economic ideology. That is, adherents of this view believe that information is subject to supply and demand, just like goods and services, and that the market will determine the extent of information that a company must disclose about its activities. The spectacular corporate collapses recently witnessed in Australia and other countries suggest that the situation is much more complex than that. The differing perspectives of companies outlined above need to be considered, and the anti-regulation view concentrates too heavily on too limited a view of economic activity. It rests on the presumptions of efficiently operating markets and economic rationality — that people always act in their own self-interest.

Many people believe that regulation is necessary. As with the no-regulation view, many so-called theories have been advanced to justify particular positions. Some

stress private interests, some stress the public interest, while others take a more general approach. The private interest view is similar to the views of those opposing regulation, except that it is believed that individuals will get together to jointly protect their (individual) interests — for example, by lobbying the regulators. There are many examples of such lobbying in Australia and in other countries. Those lobbying have the objective of making the regulators change existing or proposed regulation, or remove regulation, so that their interests are better served. This is why it is referred to as the private interest viewpoint.

Those holding a public interest view believe that regulation is necessary because of inefficient and inequitable market practices, and claim that regulation is necessary to boost confidence in the business environment for potential participants. Market inefficiencies emerge for many reasons. Those arguing for the public interest include people and bodies with vastly differing rationales for the regulation; for example, conservationists argue for pollution controls in industry, and others argue for regulations to compensate for lack of competition in particular industries, such as the airline industry.

Despite all the theoretical arguments, a few characteristics seem apparent. Regulation exists, and it has always been the result of political processes. That means elements of power are involved: the best lobbyists have their interests served by regulation. One example is of business leaders opposing a regulation that prescribed how assets and liabilities are to be defined and measured — attempts to pass the regulation failed. Another concerns employees losing their entitlements when companies failed: employee groups lobbied for regulations that require employees to be paid entitlement in preference to other creditors. As a result the government changed the bankruptcy insolvency legislation.

The various views of regulation obviously depend on the perspective of companies that is taken.

Regulation of companies

Companies are legally created entities, so there has always been a body of law that has governed their formation and operation. The accounting profession, through its professional bodies, has also sought to regulate the accounting information provided by companies. Initially these endeavours to regulate company accounting were separate, but they have increasingly converged, with the law recognising the professional accounting bodies' attempts to ensure reliable company financial reporting. The overarching principle with which regulation has been concerned has been accountability — the provision of information to interested parties.

LEGISLATION

The Companies Act of 1844 in the United Kingdom is usually cited as the start of *modern* company legislation. Several acts were passed subsequent to this Act. Australian company legislation initially closely followed the British law, but the 20th century saw increasing divergence, especially when the UK entered the European Union, and British law had to become more aligned with European expectations.

Company Law
Economic Reform
Program (CLERP)

As companies and their activities in the modern business world became increasingly complicated, the law did too. In Australia companies were initially governed by State laws, and there were significant differences between the laws. In the late 20th century significant rationalisation took place. First, the States agreed to a unified approach to company law and then the Commonwealth Government assumed responsibility for company legislation. A simplification of the complicated process of forming and operating companies was also sought, and several new laws were passed, which radically changed some aspects of how companies could be formed and operated. At present the main legislation in Australia is the Corporations Act of July 2001. However, in understanding company accounting the *Company Law Economic Reform Program Act 1999*, looms large: it is referred to by its acronym, CLERP.

ACCOUNTING STANDARDS

accounting standards

Recognising that the law could not cover every aspect to ensure effective financial reporting by companies, the accounting profession has sought to develop and issue statements of 'best practice'. These statements, issued by professional bodies, were intended to be mandatory (complied with) for their members. However, it was not always agreed as to what constituted 'best practice' and how compliance with the statements could be enforced. The history of accounting since the 1930s in many countries, but especially in the USA, Britain and Australia, is characterised by attempts by the accounting profession to develop generally agreed upon statements of best accounting practice. There was a belief that theoretical justifications for the statements and the terms used had to be established first. Various names have been applied to these statements and their foundations, but we now refer to the statements as accounting standards.

The two major professional accounting bodies in Australia are CPA Australia (formerly the Australian Society of Accountants) and the Institute of Chartered Accountants in Australia. In the 1940s, 1950s and 1960s, both bodies attempted to issue accounting standards, but compliance with them was low, as companies did not accept them as necessary. In 1965 the two bodies created and jointly sponsored the Australian Accounting Research Foundation (AARF) to carry out research and develop accounting standards that the two bodies could issue jointly. This initiative was largely taken to avoid government intervention in the accounting standard process. At that time there had been several corporate collapses, and there was public pressure to develop effective standards for reliable financial reporting. The professional bodies claimed they could achieve this rather than have accounting legislated; that is, they claimed the capacity for professional self regulation. The Accounting Standards Board (AcSB), a division of the AARF, had responsibility for the final form of the accounting standards and issued several in the 1970s and early 1980s. By 1984, however, the professional bodies had lost the argument for self-regulation, and the Commonwealth and States set up the Accounting Standards Review Board (ASRB), giving it legislative power to sponsor the development of and approve accounting standards. In 1988 the ASRB merged with the AcSB, which suggested that the professional bodies had in fact successfully 'captured' the standard

setting process. Yet another twist was to come in 1991, when the Commonwealth Government established the Australian Accounting Standards Board (AASB) to replace the ASRB, as a result of the Federal Government assuming the legislative responsibility for companies in Australia from the States.

While all this sounds complicated (and it gets even more so!), it must be understood in order to understand company accounting, because governments, investors and the business community need to have confidence in the financial reporting of companies for the efficient operation of the economy.

A CONCEPTUAL FRAMEWORK

The AARF, early in its life, had set about determining a sound theoretical foundation for accounting standards. This was called the Conceptual Framework project. The conceptual framework consisted of four Statements of Accounting Concepts (SAC):

conceptual
framework
Statements of
Accounting
Concepts (SAC)

- SAC 1 Definition of the Reporting Entity
- SAC 2 Objective of General Purpose Financial Reporting
- SAC 3 Qualitative Characteristics of Financial Information
- SAC 4 Definition and Recognition of the Elements of Financial Statements

A fifth SAC on accounting measurement never eventuated due to a lack of agreement on how to measure some items. Other than the reissue of SAC 4 in 1995 following the removal of the appendix in which the implications of SAC 4 were explained, no further substantive work was completed on the project. The CLERP Act established a new AASB, and one of its tasks was development of a conceptual framework. Nevertheless, much of the material covered in the SACs greatly influenced accounting — especially definitions. The definitions contained in the SACs seem to be those preferred by the accounting profession and the business community (and in textbooks such as this). However, the situation is not clear. The process is not simple, because of the differing perspectives taken by different groups, and the political power relationships of these groups. The CLERP Act tried to resolve the conflict by creating an overall policy oversight body, the Financial Reporting Council (FRC), and gave it responsibility for the AASB. In 2001, the AASB articulated the role of the SACs in guiding the development and review of accounting standards in Australia with the SACs described as evolving documents subject to on-going review. But by July 2002 the FRC had directed the AASB to pursue the adoption of the standards developed by the IASB, effectively ceasing further work on an Australian CF project. As at 1 January 2005 the SACs operative in Australia have comprised SACs 1 and 2 together with the Australian equivalent of the IASB's Framework for the Preparation and Presentation of Financial Statements..

Financial
Reporting Council

The accounting standards issued by the AASB have legislative backing, and they must pass through both houses of Parliament. The Board can seek technical support from any source. It has recognised the expertise in the AARF so, although it is not required by law to do so, early indications are that it will continue to view the AARF as a valuable source of technical support. In 1994 the AARF formed the Urgent Issues Group (UIG) to deal quickly with any accounting problems that arise. Similar bodies

Urgent Issues Group

exist in other countries. The UIG would meet to discuss an issue and publish Abstracts. More recently as a subcommittee of the AASB its abstracts have been mandatory. As of July 2006 the UIG has been replaced with a new interpretations model and the AASB has assumed direct responsibility for developing interpretations. An Interpretations Agenda Committee will make recommendations to the AASB on interpretations of the International Financial Reporting Interpretations Committee (IFRIC) Draft Interpretations or issues requiring interpretation. In some instances the matter will be referred to IFRIC for potential inclusion on its work program. Where circumstances warrant a unique domestic interpretation (such as in the case of public sector entities), the AASB will add the issue to its own work program, forming an ad hoc Advisory Panel comprising persons with a mix of skills and experience relevant to the particular issue.

When it was established, CLERP changed the process of formulating accounting standards from professional self-regulation to one established in law. One of the main reasons for CLERP was to make Australian business more internationally competitive. Although the issuing of accounting standards had become a legal process, the accounting profession still had a significant influence because many of the individuals and the institutions that had previously worked towards creating accounting standards were involved in the new legal process, formally as members of the new entities, or informally as having recognised expertise in the area.

Towards Globalisation

As previously noted the FRC has made the AASB responsible for issuing accounting standards. It formulates the standards, which are then approved by Parliament and become law. The FRC has directed the AASB to adopt international accounting standards: the international standards are incorporated into Australian legislation and are now mandatory for financial reporting by companies in financial years commencing on or after 1 January 2005.

THE INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB)

In 1973 a group of people representing professional accounting bodies formed the International Accounting Standards Committee (IASC). The aim of the IASC was to issue a set of accounting standards that would apply globally— not necessarily as the final set of standards, but rather as one that is totally compatible with the national accounting standards. This is referred to as the process of harmonisation of accounting standards. So where a national accounting standard in Australia differed from an international accounting standard, the difference and the effect of it were to be clearly stated in the Australian accounting standard. Now, however, the international standard has become the Australian standard.

Recently, the IASC changed its name to the International Accounting Standards Board (IASB), extended membership to all interested stakeholders and employed a full-time staff. IASC accounting standards — now called International Financial Reporting Standards (IFRSs) — were designed to reduce the differences in national accounting standards and to assist uniformity across national boundaries to facilitate global economic activity (such as movements of capital).

— harmonisation

International
Financial Reporting
Standards

Many countries have simply adopted the international accounting standards, because developing their own standards is a costly process — too costly for some economies. The European Union (EU) has adopted international standards to be consistent with its common or single market objective (as with its currency). In the United States, the standard-setting body, the Financial Accounting Standards Board (FASB) issued a ‘memorandum of understanding’ in October 2002 formalising their commitment to the convergence of US and international standards. In other countries, such as Australia, political pressure and lobbying from stock exchanges and other groups have been directed at the acceptance of the international accounting standards, and this has occurred in Australia.

This movement can be seen as another example of increasing globalisation — the growth of the global economy. As international accounting standards become more accepted internationally, there is going to be a *convergence*. This is designed to overcome the considerable divergence that has existed between various national accounting standards and the international accounting standards. As the movement progresses, this will imply that international financial reporting standards will reflect those of the biggest players — and Australia’s economy is smaller than that of California, just one of the States of the USA. As with other global movements, these global accounting standards will most probably increasingly reflect the wishes of the most powerful economies —and the world’s biggest economy is the USA.

INTERNATIONALISATION OF AUSTRALIAN ACCOUNTING STANDARDS

As indicated above, the FRC directed the AASB to ‘adopt’ the IFRSs as Australian accounting standards effective for financial years beginning on or after 1 January 2005, and the AASB expressed its intention to do so in its Policy Statement 4 ‘International Convergence and Harmonisation Policy’ (issued April 2002). In addition, the Commonwealth Government had foreshadowed the general objective of adopting international financial reporting standards as part of its 1997 *Corporate Law Economic Reform Program* (CLERP) initiative. This means that Australian accounting standards have the same requirements as the IFRSs: there is now a convergence of Australian standards with the international accounting reporting standards. This has been a significant change in the development of Australian accounting regulation and has involved a great deal of effort by those involved. Many of the requirements of the Australian accounting standards were compatible with international accounting standards, so it was a matter of having consistent definitions and references, but some more substantial changes have also been necessary. The matter has been complicated by the fact that the IASB has itself undertaken a major review and a significant ‘improvements’ program, with many new and revised standards emerging. As a result, the AASB has also issued many exposure drafts, followed by revised standards. This project commenced in July 2003 and is continuing with the issue of revised requirements in what are perceived to be in order of importance.

The main benefits arising from the convergence (summarising those listed in Policy Statement 4) include:

- (a) increasing comparability of financial reports to assist participants in international capital markets;
- (b) removing barriers to international capital flows;
- (c) reducing financial costs for Australian multinational companies and foreign companies operating in Australia;
- (d) facilitating more meaningful comparisons between Australian and foreign public sectors; and
- (e) improving the quality of financial reporting in Australia to best international practice.

As noted earlier, there has been a need to reconcile elements of the Conceptual Framework. SAC 1 contains the definition of a reporting entity, which has been a crucial element underlying Australian accounting standards, so it has been retained by the AASB.

The process of this convergence has been extensive and complex, and is ongoing. When referring to accounting standards in this book, we will refer to the latest versions, as this is now the requirement for accounting for companies in Australia.

OTHER REGULATORY INFLUENCES

As indicated above, the main legislation in Australia governing the formation, operation and winding up of companies is the Corporations Act. The Australian Securities and Investments Commission (ASIC) is charged to enforce and administer the Corporations Act. The financial reporting of corporations is only one part of its responsibilities, and while it does not determine the accounting standards, it does enforce compliance.

The word 'corporation' refers to bodies corporate — entities incorporated under the law. The word 'company' usually refers to the joint stock company, an entity in which ownership units (that is, shares) are jointly held by several individuals (other entities). Although the terms are strictly speaking different, in practice they are generally used interchangeably, as companies form the most significant form of corporations. This book is concerned with company accounting, but often the term corporation will be used. All bodies incorporated under the Corporations Act are required to maintain records and file financial reports, but there are differences in obligations, depending on the size of the entity. In this book we are concerned mainly with large companies that are obliged to publish financial reports. These reports are referred to as general-purpose financial reports. The expression is defined in SAC 1, which also defines who should publish such reports: reporting entities. Such entities are defined in terms of the existence of users, but this is yet another term that is not clearly defined. These matters are discussed in greater depth later in the book. Simply speaking, reporting entities include companies that have issued shares to or borrowed money from the public, but the term also covers many other entities, with which we are not primarily concerned in this book.

Australian Securities
and Investments
Commission (ASIC)

corporation
joint stock company

general-purpose
financial reports

reporting entities

Australian Stock Exchange**The Australian Stock Exchange**

Stock exchanges were developed to facilitate the trade in financial securities. The Australian Stock Exchange (ASX) is a public company designed to do just that. It is concerned with protecting all those parties that make use of it, so it has requirements with which all companies that have their securities listed on the Exchange must comply. These are Listing Rules, and they include reporting requirements. The ASX has influenced the development of accounting standards in Australia both as a lobbyist and as a sponsor providing financial support. In determining its interests, the ASX takes the financial perspective of companies.

Listing Rules

Stock exchanges always have a significant influence on accounting standards. It is an advantage for a company to have its shares listed on an exchange. Internationally, one of the most important is the New York Stock Exchange (NYSE), as it gives companies access to the US finance market, the largest in the world. Before a company can have its securities listed on the NYSE, the Exchange requires it to comply with US accounting regulations, and similar compliance requirements apply in Australia. The ASX was an important lobbyist with the Government and for the development of CLERP. The Exchange wanted Australian accounting standards to conform more to international accounting standards, and the Government responded.

Financial Reporting Panel**Financial Reporting Panel**

The Financial Reporting Panel (FRP), established under the CLERP (Audit Reform and Corporate Disclosure) Act 2004, provides a dispute resolution procedure in circumstances where the ASIC and a company disagree on the application of accounting standards. A financial report may be referred to the FRP by ASIC or a company, but the latter is dependent on consent from ASIC to do so. Prior to its formation differences of opinion on compliance were settled by negotiation between the company, its auditors, ASIC and/or the courts. Given the very technical nature of accounting matters, the FRP represents a timely and efficient means of resolving disputes by a panel of members with relevant expertise. However, the findings of the FRP are not binding, nor are the matters referred to it precluded from pursuit in the courts. The Panel commenced operation in July 2006 and, at the time of writing, no matters had been determined by it.

Companies, accounting and regulation

The above discussion has briefly outlined the legal and regulatory environment in which companies in Australia operate, and in which the accounting for them is undertaken. Some of the issues raised will be taken up in greater depth in subsequent chapters. Because of the economic importance of companies to the country, governments and other bodies have attempted to ensure their smooth operation for the economic and social benefit of the country. The two key issues in respect of companies are first, that there is a separation of control from ownership and, second, that they operate as full legal entities with all the rights and responsibilities of an entity. Regulation and the law have sought to protect all those who have dealings

with the company. However, what should be apparent from the discussion above is that there are differing perspectives of what represents necessary protection and for whom that protection is designed. These perspectives are largely ideological, but they are determined through power and political influence. While there may be considerable agreement on what is desirable, it is not possible to fully reconcile these different interests. Traditionally, accountants have believed they have been objective and removed from these political influences, but this has been somewhat short-sighted, and the profession has been subject to considerable public pressure for its perceived failures. While there are significant *economic consequences* of the activities of companies, there are also *social consequences*.

The separation of control and ownership made possible by the existence of the company form of organisation has led to the development of specialist managers. Ensuring these specialist managers operate in the interests of the shareholders has, from time to time, been questioned. For example, there is considerable disquiet over the remuneration of management when a company's operating performance is not seen to be acceptable. A fixed salary is only one way in which managers are remunerated: often they also receive one or more incentives, most commonly a bonus dependent on actual performance. Advocates of such schemes argue that managers will then work to maximise performance, which serves both the owners and the managers. But where alternative accounting treatments are available, it is likely that managers will use the alternative that shows maximum performance (profit), even though it may not be appropriate or in the company's medium- or long-term interests. The situation is not as simple as it would at first seem. It is also the case that, in times of crisis, shareholders have little power: in the last few years the directors of some companies have paid themselves large bonuses just before the financial collapse of their companies — examples are One Tel Ltd, HIIH Insurance Ltd and Ansett Ltd. Is this appropriate?

As individuals in society, we are all expected to behave responsibly: to obey the laws and not harm the interests of others and so on. Companies act through their management and, as legal entities, companies should also act responsibly within society. They are allowed to exploit societies' scarce resources on the understanding that they contribute to the benefit of society. However, over the last fifty years in Australia, there have been some spectacular corporate collapses, which have had disastrous effects on the economy and society. When a company collapses, many sectors of society are affected, not just the shareholders: these include creditors, suppliers, customers, employees and governments (lost taxes), as well as shareholders. When one of Australia's largest insurance companies, HIIH Insurance Ltd, collapsed in 2001, its losses were equivalent to almost 1% of the country's gross domestic product. Its collapse impacted on its customers — those who suddenly found that they were no longer insured, despite having paid their premiums. This included many small businesses and professional service providers (especially lawyers and builders). Many thousands of employees lost not only their jobs but also their entitlements, such as retirement benefits. A general consequence is that insurance premiums *for everyone* have risen. These are just a few of the consequences of corporate failure, and HIIH is only one of many such stories. The legal and regulatory

framework is designed to avoid such events, but the question needs to be asked: just how effective is it in preventing disasters? Maybe there would have been more collapses if the framework had not already been improved.

Accounting is not solely responsible for corporate collapses, but if the purpose of accounting is to provide information to users — accountability — then it must accept part of the responsibility. This is a dual responsibility — the reliability of the financial information in the financial reports, as well as the effectiveness of the audit. Accountants employ accounting (and auditing) standards as a defence: compliance with the standards is used as an indicator of having acted with professional responsibility. For that reason, the profession needs to ensure that the standards and other statements it issues are soundly based and do in fact represent the very best practice. Auditors are among the first targets for blame after a collapse, and some of the big accounting firms have millions of dollars in outstanding lawsuits lodged against them. Auditors have to report that they have verified the financial position and performance of the company. Sometimes it has been shown that a company received a ‘clean bill of health’ from its auditors just before its collapse: the collapse in the USA — one of the largest in its history — of the Enron Corporation is a good example. In discussing the responsibilities of auditors, many issues that need to be considered go well beyond the scope of this book. Suffice to say, the role of accountants is inextricably linked with the operations of companies. The ‘law’ will seek to make redress where it can be shown that accountants have been at fault. The largest corporate collapse in US history was the World Com failure, which involved US\$11 billion. The company — or what remained of it — was required to pay back US\$500 million to stockholders because of its defective ‘accounting’.

Many so-called theories in the literature purport to explain the role of accounting in the operation of companies. We stress again: these theories depend on the ideology of the proposer. So, if there is a belief in non-regulation, it is likely that there will be market-based reasons to support the arguments. At the other extreme will be those who believe totally in regulation as necessary for the fair and equitable operation of the economy (extreme examples are the centrally planned economies in Europe from 1917 to the late 1980s). None of these theories seems to have worked, as we have witnessed corporate collapses as well as total systemic economic collapses.

Review

This book is primarily concerned with accounting for companies, and there is a large technical component in this. This chapter has sought to place accounting in the broader economic and social environment, and it is important to be aware of this when learning and practising company accounting. Companies are created by the law, and an extensive body of corporate law determines the activities of companies. ASIC is charged with the oversight of this law and its enforcement. In addition, a range of professional regulations deal with more specific aspects of company accounting. Originally promulgated by the professional bodies, in Australia these standards of best practice have legal backing. The FRC is charged with determining the policy and direction of these standards but the direct responsibility for their

issuance and interpretation is the AASB. All this exists within a broader economic, social and political context.

Endnote

- 1 The various theories are usually described in legal textbooks, for example, see R Tomasic, S Bottomley and R McQueen, *Corporations Law in Australia*, 2nd edn (Sydney, Federation Press, 2002).

KEY TERMS

accountability	different perspectives on companies	limited liability
accounting standards	dividends	Listing Rules
agent	Financial Reporting Council	regulation
audit	Financial Reporting Panel	reporting entities
Australian Stock Exchange	general-purpose financial reports	securities
Australian Securities and Investments Commission (ASIC)	harmonisation	shares
Company Law Economic Reform Package (CLERP)	International Accounting Standards Board (IASB)	shareholders
conceptual framework	International Financial Reporting Standards	Statements of Accounting Concepts (SAC)
controlling interest	joint stock company	stock exchange
corporation		transfer of ownership interests
		Urgent Issues Group

Further Reading and Research

This chapter has provided a brief introduction to the legal and regulatory environment in which company accounting exists. Several places provide more detailed information. The regulatory bodies have websites that can be browsed:

ASIC: www.asic.gov.au
 AASB: www.aasb.com.au
 ASX: www.asx.com.au
 IASB: www.iasb.org

Hard copies of the Corporations Act and several books on company law have also been published.

Many books examine company failures and collapses. An excellent, fairly recent, title is *Collapse Incorporated: Tales, Safeguards and Responsibilities of Corporate Australia* (CCH Australia Ltd, 2001). In similar vein is F Clarke, G Dean and K Oliver, *Corporate Collapse: Regulatory, Accounting and Ethical Failure*, 2nd edn, Cambridge University Press, 2003.

Further back, in the period from the 1960s, two commentators stand out for having drawn attention to the failures in regulating company accounting. Both make use of many examples to illustrate their arguments and are interesting reading. They are, in Australia, R J Chambers (for example, his book *Securities and Obscurities*, Sydney, Gower Press, 1973) and, in the USA, Abraham J Briloff (for example, his book, *More Debits Than Credits*, New York, Harper & Row, 1972). Among commentary in the UK, Terry Smith's *Accounting for Growth: Stripping the Camouflage from Company Accounts* (Century Business, 1992), drew attention to many irregularities in company accounting in that country.

Current cases are always discussed in the media generally and especially the financial media. For example, in 2001 the collapse of energy giant, the Enron Corporation in the USA, distressed many and called into question the role of accounting and accountants and why early warning signs were ignored and instances of fraud went undetected. Two early articles appeared in the *Washington Post*: 'After Enron, New Doubts about Auditors' (5 December 2001) and 'Auditors Face Scant Discipline' (6 December 2001) by David Hilzenrath; their titles are indicative of the arguments proposed, but a considerable amount has also been published subsequently on this case. Many other articles have been published since then that address the failure and the role of accountants — the demise of a once major international accounting firm, Arthur Andersen and Company, has been one of the consequences.

In Australia, an inquiry into the circumstances surrounding the restructuring of James Hardie and the sufficiency of funds set aside to meet current and future asbestos-related liabilities was the subject of a Special Commission of Inquiry into the Medical Research and Compensation Foundation commissioned by the NSW Government. In this inquiry, which was eagerly reported in the print media, Commissioner Jackson raised several issues concerning corporate governance and disclosure and indicated potential breaches of the Corporations Act.

By December 2004 James Hardie had given an undertaking to pay appropriate compensation to victims but, due to the sheer enormity of the potential claims — estimated by KPMG Actuaries to have a present value of \$1.555 billion — this necessitated the development of a funding agreement to be put to lenders and shareholders for approval. An extraordinary meeting was held on 7 February 2007, where security holders voted to approve the long-term compensation funding arrangements. It is expected that the fund will last for forty or more years.

In late 2004, following the Jackson report, ASIC commenced its investigations into the possible breaches of the Corporations Act. Special funding to conduct this investigation was provided by the Federal Government. On 15 February 2007 ASIC commenced legal proceedings against a number of former and current directors and executives of James Hardie concerning the adequacy of disclosures relating to the Medical Research and Compensation Foundation and other related matters.

Although the investigation into James Hardie focussed on the inadequacy of funds set aside to compensate asbestos victims, the inquiry raised several broader issues, in particular the duties of directors with respect to stakeholders other than shareholders. The Federal Government conducted its own inquiry into corporate responsibility, seeking comment from all stakeholders on the extent to which

organisational decision makers do, or should, take the interests of stakeholders into account. The Corporations and Markets Advisory Committee (CAMAC) has also sought input from stakeholders on the appropriateness of revising the Corporations Act to clarify the responsibilities of directors to stakeholders generally.

In addition to the financial media, professional and academic journals have a very large number of articles on company accounting and accounting standards. A useful recent example is that by Philip Brown and Ann Tarca, 'It's here, ready or not: A review of the Australian financial reporting framework', *Australian Accounting Review*, vol. 15, 2005, pp 68-78).

REVIEW QUESTIONS

- 1.1 What are some of the reasons generally believed to have contributed to the growth of the joint stock company form of business organisation?
- 1.2 What is meant by the expression 'investment is made on the basis that there be some accountability'?
- 1.3 What are the different views of a company, and in what ways do these views differ?
- 1.4 Why do some people believe it is unnecessary to have regulation of companies?
- 1.5 Regulation of corporations is regarded by many as absolutely necessary. Outline some of the arguments supporting this view.
- 1.6 What are accounting standards, and why are they considered important?
- 1.7 What is the conceptual framework project, and what influence does it have on accounting?
- 1.8 What role does the Australian Securities and Investments Commission (ASIC) play in regulating accounting?
- 1.9 Why is the Australian Stock Exchange interested in accounting regulation?
- 1.10 What is the function of the International Accounting Standards Board?

DISCUSSION QUESTIONS

- 1.11 Why are there different theories and perspectives of what companies are? What are the implications for company accounting of the differing views?
- 1.12 In what way does the regulation of companies reflect the state's attitude to business activity?
- 1.13 In what ways do the success and failure of companies affect the societies in which they operate?
- 1.14 Is accounting a profession?

- 1.15** Why has Australia adopted international financial reporting standards as its domestic accounting standards?
- 1.16** Discuss the mechanisms that have been introduced in Australia to facilitate international comparability in accounting standards, their application and enforcement.



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COMPANY FORMATION, SHARE
CAPITAL AND DEBT SECURITIES

introduction

As indicated in Chapter 1, companies are the most common form of business organisation. They exist as separate legal entities, but are created through the efforts and capital of people or entities who have common goals. In Australia they operate under the legal auspices of the Corporations Act of July 2001. Company ownership exists in the form of units called shares. This chapter is concerned with accounting for these shares and some other similar financial instruments. First, however, we discuss some general considerations concerning the formation of companies and then the issue of shares.

Types of company

LIMITED LIABILITY COMPANIES

proprietary company
public company

Limited liability refers to the liability of each member of a company with share capital to contribute up to the amount, if any, unpaid on the shares if called upon to do so. Although it has been seen as one of the most attractive features of the company form of organisation, not all companies have the liability of members limited. There are a number of different types of company permitted under the Corporations Act, but the main one discussed in this book will be those which have a share capital with the liability of the members limited. There are two broad types of such companies — proprietary companies and public companies. A company which has its liability limited must contain the word 'Limited', often abbreviated to 'Ltd', as part of its name, indicating to all who deal with it that the liability of the members is limited. A proprietary company must also have the word 'Proprietary' (or the abbreviation 'Pty') included in its title. A proprietary company is usually smaller than a public company and can be formed by one or more (but not more than 50) persons and must have a share capital. There are restrictions on some activities of a proprietary company, for example it is not able to raise money from the public and there are restrictions on the transfer of shares. Proprietary companies are further classified as being either a *large proprietary company* or a *small proprietary company*. A large proprietary company is one that satisfies at least two of the following three tests. It has:

- 1 a consolidated annual gross operating revenue of at least \$10 million;
- 2 end of financial year consolidated gross assets of at least \$5 million;
- 3 50 or more full-time employees (or their part-time equivalent) at the end of the financial year.

Australian Securities
and Investments
Commission

A large proprietary company is required to lodge audited accounts each year with the Australian Securities and Investments Commission (ASIC), while the small proprietary company has no obligation even to prepare annual accounts, although they must maintain sufficient records to allow them to be prepared and audited if necessary (such as, for example, where it is controlled by a foreign company). (Good business practice suggests the desirability of preparing financial reports to monitor performance, assist in attracting financing, complete taxation returns etc. even in the absence of a formal requirement under the Corporations Act.)

Traditionally, small proprietary companies have been more suited to small operations, often family-controlled businesses, but which wish to have the advantages of being a company.

Public companies used to have to have a minimum of five members, but with recent changes in the law in respect of proprietary companies, a public company is any other company that is not a proprietary company (and, therefore, may have only one member). Public companies have the advantage of being able to invite the public to invest in them through the subscription to share or debt capital (these terms will be more fully explained later). The large companies that are discussed in the news and which have become familiar names are public companies. However, some of Australia's well-known public companies started as proprietary companies and grew

**company limited
by guarantee**

and were converted to public companies — for example, some of the large retail store companies such as David Jones Ltd.

There is a less common form of company with limited liability: a company limited by guarantee. The liability of the members is limited to a prearranged amount similar to any type of guarantee. The Australian Society of Anaesthetists (www.asa.org.au) is a public company limited by guarantee. The members are responsible for contributing to the debts and liabilities of the company to the limit of ten dollars each. Trading companies usually do not adopt this form and such companies are often encountered as clubs, non-profit charitable organisations or schools. It used to be possible for a company to be limited by shares and guarantee, but these too are rare and no new such companies can be formed.

UNLIMITED LIABILITY COMPANIES

Companies may also be formed without the protection of limited liability for their shareholders. Because it does not have what has been viewed as one of the most beneficial advantages, namely limited liability for members, this type of company is rare. The advantage of unlimited liability is that there are fewer legal restrictions on the issue and redemption (in effect, buying back or cancelling) of shares.

SPECIAL COMPANIES

There are a variety of other types of companies involved in special industries — usually the service industries — which have special conditions applying to them. Usually these companies are subject to special companies' legislation relating to their industry. For example, banking companies are subject to the Commonwealth's banking legislation. In addition, companies incorporated outside Australia but which trade in the country are recognised as foreign companies and have certain legal obligations in Australia, such as registering with ASIC.

This book is concerned with the general principles involved in accounting for companies, so we will direct attention to companies with a share capital and limited liability. Only slight modifications to the procedures described would be necessary to account for the extra conditions imposed by special industry legislation.

Forming a company**certificate
of registration
Australian
Company Number**

The administration of the Corporations Act is the responsibility of ASIC. In order to form a company, those who are promoting (organising) it must submit an application to ASIC. The application must include certain information (as set out in s 117 of the Corporations Act) such as the name of the company, the names and addresses of the original subscriber(s), the address of the business, etc. If satisfied that the application contains the necessary information ASIC will issue a certificate of registration and a registration number — an Australian Company Number (abbreviated to ACN), which must appear on certain company documents. The company formally comes into existence on the day on which it is registered.

constitution
directors

replaceable rules

Another legal document which can be prepared and attached to the application is the company's constitution. This contains the rules for managing the internal affairs of the company, the responsibilities of the directors and their relationship to the shareholders. A company need not include a constitution, in which case the replaceable rules in the Corporations Act will apply. Section 141 provides a table of replaceable rules, which summarises sections of the Act relating to officers and employees, inspection of books, directors' meetings, meetings of members, shares and transfers of shares. However, a company can replace or discard any of the replaceable rules by passing a special resolution at a general meeting of the company. The replaceable rules will not apply to a small proprietary company with one member who is the sole director.

Until recently a company needed to have a *memorandum* to lodge with the application for registration and could also have *articles of association* which contained the day-to-day management rules of the company. The requirement for these has been removed (simplification) and much of the information they included is now found in the application and the constitution.

prospectus

Once registered, the company, if it is a public company, can issue an invitation to the public to subscribe to its shares. This invitation is called a prospectus and, because it is inviting investment from the public, there are strict legal requirements that must be adhered to. Such regulation tries to ensure that prospective shareholders are not misled.

Financing a company

securities
shares
shareholders
members
equity capital

Australian
Stock Exchange

share listing

listing rules
or requirements

Before a company can commence operations it must have the funds to do so. Similarly, if an existing company wishes to expand its operations it needs to finance this expansion. An existing company can borrow from a lending institution in the same way as any individual can. A new company will have to raise funds through issuing securities to investors, more particularly issuing shares. As indicated in Chapter 1, those investors who purchase the shares become the members or shareholders (the terms are mostly used interchangeably) of the company: they provide the equity capital of the company and, as part owners of it, are entitled to a share in the future profits and a voice in the management of the company. For public companies these shares are transferable — that is, the owner may sell them to a third party. This is usually (although not always) done through the medium of the Australian Stock Exchange (ASX) and this concerns the financial perspective of companies discussed earlier. When the company issues the shares, it receives the funds. When the shares are traded on the ASX it is the owner of the shares who receives the proceeds. However, companies tend to want to have their shares listed on a stock exchange — that is, have them officially recognised as tradable on the stock exchange. In order for companies to have this privilege they must comply with various regulations and rules imposed by the stock exchange; these are referred to as the listing rules or requirements. The benefits to the company arise from the fact that listing provides a 'market incentive' in the finance market — investors are aware of the company and will be prepared to invest in any future issues of securities by the company, reducing the cost of any additional finance.

debt capital
debentures

There are other forms of securities which a company can issue and these are usually referred to as debt capital. These other securities include debentures, convertible notes or other units of prescribed interest (for example, the right to purchase shares at some future date). Providers of debt capital do not form part of the owners of the company but they are important to the financing of company operations. In order to facilitate this investment the Corporations Act has the underlying principle of enhanced disclosure (or continuous disclosure). This is the principle that as the company wishes to raise money from the public it should keep the public informed of events that could affect the price of the company's securities — an example of accountability. It indicates how the financial perspective of companies is seen as important and is especially relevant to companies with securities listed on the ASX. Basically it involves the lodgment of half-yearly reports and any price-sensitive information with the ASX (for listed companies) and ASIC.

Issuing of shares

Before any securities such as shares, debentures or prescribed interest can be issued for public subscription the company must issue a prospectus. The strict legal requirements of prospectuses are designed to protect prospective investors. Throughout history there have been many instances of dishonest offers of investment and the subsequent financial distress — or even ruin — of investors as their companies failed and they lost their investment. Unfortunately, no law will stop the unscrupulous, but prospectuses are in line with the enhanced disclosure idea that providing as much reliable information as possible will avoid investors being financially hurt. Recent legislation has adopted the principles of solvency, fairness and disclosure: keeping the company in a sound financial position so that it can continue operating, being fair to all who deal with it, and providing all the relevant information on the company that the investors need to make their decisions. Prospectuses must not only be *lodged* with ASIC; they usually must be *registered* with ASIC, an extra step involving ASIC scrutinising the prospectus before it is issued.

A share is defined in the Corporations Act (s 9) as a share in the share capital of a body, but it can more appropriately be viewed as a right to a specified amount of the share capital of a company with rights and liabilities in respect to that company. The share represents a share in the net worth of the company in proportion to the amount of share capital the company issues. A company may, in its constitution, limit the number of shares the directors can issue.

ordinary shares

The capital may be divided into different types of shares, each with different rights.

The most common types of shares are called ordinary shares (they are called common stock in the United States). Many companies, especially proprietary companies, will only have this class of share. The ordinary shareholders have an entitlement to assets remaining after all obligations have been satisfied. This is referred to as a residual interest and it relates to the net (ie assets less liabilities) assets of the company. Ordinary shares form the basic 'ownership' units for which members subscribe. For example, if a company is formed with a capital of 1 000 000 shares, each share will represent one millionth ownership of the company. Alternatively, the company may have a capital of 750 000 ordinary shares and 250 000 preference shares. In both cases

preference shares

the number of shares is the same — 1 000 000. In the second situation the shares have been divided into two types of shares. The 750 000 will be ordinary shares with the usual rights attaching to ordinary shares, such as entitlement to shares in any profit, but only in so far as a profit has been made. The preference shares will have some preferential right. For example, they could be entitled to a fixed amount of return (dividend) each year irrespective of whether or not a profit has been earned. If the company does not have the cash to pay these amounts, then it assumes a liability for the amounts due. Or they could be preferential as to return of capital in preference to (that is, before) the ordinary shareholders in the event that the company ceases to operate (is wound up). Or they could be both preferential as to income and capital return. They may be participating, which means that they are entitled to a fixed income return and they share with the ordinary shares in any remaining distributable profit. Sometimes preference shares are issued for a set period and on the expiration of this period the shareholders are paid back their capital or are able to convert their shares into ordinary shares. These shares are called redeemable preference shares. Because of their preferential rights, preference shares may have restricted voting rights.

Dependent on the features attaching to preference shares, their attributes may be wholly debt, wholly equity or both equity and debt (i.e. hybrid securities or compound instruments), while their legal status is that of share capital. The accounting treatment follows the ‘substance’ of the transaction: preference shares may be classified as liabilities, equity or classified separately into both equity and liability components respectively.

AASB 132, ‘Financial Instruments Presentation’ provides definition and classification criteria for shares and other types of financial instruments. (Note that from 1 January 2007 AASB 7 “Financial Instruments: Disclosure”, supersedes the disclosure requirements in AASB 132.) Paragraph 18(a) provides examples of features of preference shares that require their classification as a liability. Redeemable preference shares subject to mandatory redemption by the company, or those where the shareholder may demand that the company redeem the shares, are classified as a financial liability.

The classification of financial instruments has a consequential impact on the treatment of any distributions to shareholders (see AASB 132 paragraph 35). For example, where a security is classified as a liability, payments made to shareholders have the character of an interest expense and are deducted from revenue in calculating profit, whereas payments to shareholders on shares classified as equity will be treated as a distribution of profit.

Ordinary shares are nowadays the most common type of shares, but over the years many companies have issued some form of preference shares. There may be many other types of shares, but we will be mostly concerned with those two types. For example, the promoters of a company may be entitled to promoters’ or founders’ deferred shares, employees entitled to employee shares, and so on.

Investors apply for shares, and this application in contractual terms is treated as an offer. When the application is successful, the shares are allotted, the allotment or the notice of acceptance of the application being the acceptance. As with most contracts, there must be both offer and acceptance for the contract to be binding. Once the shares are allotted, this becomes the company’s issued capital. The shareholders receive from the company a share certificate indicating the number of shares held and the company keeps a register of all shareholders — a share register.

application

allotment

issued capital

Accounting for the share issue

It is usual for an application for shares to require some payment, either full payment for the shares applied for or a proportion as a 'deposit'. For example, a company may decide to issue 500 000 ordinary shares at \$1 and require applicants to pay 25 cents for each share applied for on application. The money so received does not belong to the company as there is no contract until the offer has been accepted. Therefore, the company must keep the money received for applications in a special trust bank account. If the company received applications for all these shares, it would record in its books the receipt of this money with the following general journal entry:

	<i>Debit</i>	<i>Credit</i>
	\$	\$
Bank trust	125 000	
Application		125 000
(cash received on application, 25 cents on 500 000 shares)		

At this stage the company has no assets and no capital which can be accounted for because the money received for applications does not legally belong to the company but is held in trust for the applicants. Once the closing date for applications is reached, the directors will meet and allot the shares and send allotment letters to the successful applicants. Now the money belongs to the company (the contract is completed) and the company has a share capital of \$125 000. It will need to record this in the general journal.

	<i>Debit</i>	<i>Credit</i>
	\$	\$
Application	125 000	
Share capital		125 000
(application money of 25 cents due on 500 000 allotted shares)		
Bank	125 000	
Bank trust		125 000
(transfer of money received on application)		

At this stage the company has an

Issued capital	500 000
of which	
Share capital is	125 000
and an asset:	
Bank	125 000

Note that the issued capital is *not* recorded in the general journal, so a balance sheet as at this date would only comprise the last two items.

	\$
<i>Shareholders' equity</i>	
Share capital	<u>125 000</u>
<i>Asset</i>	
Bank	<u>125 000</u>

COMPANY FORMATION, SHARE CAPITAL AND DEBT SECURITIES

In a *published* balance sheet the issued capital would be disclosed, but it would not be added in with other shareholders' equity items.

The company must also account for the cost of issuing those shares. According to AASB 132 paragraph 35, the (transaction) costs of issuing shares classified as equity are deducted from equity. Costs include registration, legal, accounting and underwriting fees, stamp duties etc, which would have been avoided had the issue not been made. On the other hand, if the costs are not directly attributable to the issue they are expensed as incurred.

Because the share capital recorded by a company immediately after issue of new shares is net of the incremental costs of issue, AASB 101 paragraph 97 requires a reconciliation of opening and closing balances for each class of contributed equity. The reconciliation identifies the gross proceeds received, share issue costs and the net amount available for use by the company. To illustrate, assume a company issues 100 000 fully paid shares at \$1 immediately after formation and incurs costs associated with the share issue of \$10 000. The entry to record the share issue is identical to that recorded above; for share issue costs Debit Share Capital for \$10 000. The amount of cash available is now \$90 000 and the movement in Share Capital disclosed in the Notes to the Accounts would be shown as follows:

SHARE CAPITAL	\$
Ordinary shares	
Balance at start of period	0
Issue of share capital	100 000
Share issue costs	<u>10 000</u>
Balance at end of period	<u>90 000</u>

In the remaining illustrations we do not explicitly consider share issue costs again. Let us now return to our previous example of partly paid shares, and assume that the company now requires the shareholders (successful applicants) to pay a further 50 cents per share on receipt of the allotment letter. This would be recorded in the general journal as:

	<i>Debit</i>	<i>Credit</i>
	\$	\$
Allotment	250 000	
Share capital (being 50 cents per share due on allotment)		250 000

When the cash is received from all shareholders, a summary general journal entry would record this.

Bank	250 000	
Allotment (being amount received on allotment)		250 000

The balance sheet as at this date (assuming no other transactions) would now appear as follows:

	\$
<i>Shareholders' equity</i>	
Share capital	<u>375 000</u>
<i>Asset</i>	
Bank	<u>375 000</u>

Note that the company has an

Issued capital	\$500 000
<i>of which</i>	
Share capital is	\$375 000

The remaining 25 cents per share that is as yet not paid may be left by the company to a later date when the directors feel the money would be needed for a second or later stage in the set-up or the expansion of the business. Thus, it could be due a year later, so when the directors resolve that this is due they make a call. The entry in the general journal would be:

call

	<i>Debit</i>	<i>Credit</i>
	\$	\$
Call	125 000	
Share capital		125 000
(amount of 25 cents per share due on call)		

and when the money is all received a general journal entry would record:

	<i>Debit</i>	<i>Credit</i>
	\$	\$
Bank	125 000	
Call		125 000
(cash received for payment of call)		

The balance sheet at this date would include the shareholders' equity item of share capital of \$500 000.

Note that the receipt of money would be over a period of time. The company would maintain a cashbook or cash journal that would record the receipt of the cash separately, and the above journal entry would be for the total amounts received.

OVER- AND UNDERSUBSCRIPTION

oversubscription

The success of a share issue will depend on the economic conditions of the time. In a buoyant, confident economic climate it is likely that there would be applications for more shares than were available (being issued). In such a case, there is an oversubscription, in which case the shares would be allotted on some basis the directors had decided on. In accounting terms, the cash received would be in excess of that due so some would have to be returned or, if the terms of the issue permit (indicated in the prospectus), be used to pay the amounts that became due on allotment and/or calls.

Thus, if in our example there were applications for 600 000 shares, the general journal entry would be:

COMPANY FORMATION, SHARE CAPITAL AND DEBT SECURITIES

	<i>Debit</i>	<i>Credit</i>
	\$	\$
Bank trust	150 000	
Application		150 000
(cash received on application, 25 cents on 600 000 shares)		

If the amount received for the oversubscribed shares was to be returned to the unsuccessful applicants, a general journal entry to record this would be:

Application	25 000	
Bank trust		25 000
(amounts refunded to unsuccessful applicants)		

This could be combined with the entry to transfer the money for the successful applications.

	\$	\$
Application	25 000	
Bank	125 000	
Bank trust		150 000
(transfer and refund of amounts received for application)		

If everyone who applied for shares were allotted some and the terms of issue permitted it, the extra money received on oversubscription could be used to pay amounts due on allotment. Using the same illustrative information as above, the general journal entries would be:

	<i>Debit</i>	<i>Credit</i>
	\$	\$
Bank trust	150 000	
Application		150 000
(cash received on application, 25 cents on 600 000 shares)		
Bank	150 000	
Bank trust		150 000
(transfer of amount received on application)		
Application	150 000	
Share capital		125 000
Allotment		25 000
(amounts received on application transferred to allotment amounts due)		

and when allotment is made:

Allotment	250 000	
Share capital		250 000
(amount due on allotment)		

and when amounts due on allotment are received:

Bank	225 000	
Allotment		225 000
(amounts received in settlement of that owing on allotment)		

At this stage the assets and equities are the same as where there was no oversubscription and would include:

Share capital	375 000
Bank	375 000

undersubscription
underwriter

Where the directors have misread the economic climate and there are too few applicants, there has been an undersubscription. Often this situation is avoided by the use of an underwriter (a broking firm, a financial institution, etc). The underwriter undertakes to take up any undersubscribed shares in return for an underwriting commission. In such situations there are no complications in respect of the accounting for the share issue. Where the underwriter takes up part of the issue the share issue will be accounted for as a full issue (as above). Where there is an undersubscription the amount received (bank trust) will simply be a lower figure.

ISSUE FOR PAYMENT IN FULL

In the above examples it has been assumed that shares are issued requiring payment in instalments — that is, part on application, part on allotment and part as a call. However, the shares may have been issued requiring payment in full on application. In this situation the full amount will be recorded in the first general journal entry. Using the same information as in the above examples the entries would be:

	<i>Debit</i>	<i>Credit</i>
	\$	\$
Bank trust	500 000	
Application		500 000
(amounts received on application for 500 000 ordinary \$1 shares)		

and then:

	<i>Debit</i>	<i>Credit</i>
Bank	500 000	
Bank trust		500 000
(transfer of money received on application)		
Application	500 000	
Share capital		500 000
(amount due on application for shares issued)		

ILLUSTRATIVE EXAMPLE 2.1

BASIC SHARE ISSUE

Ariel Ltd was formed on 1 July 20X4 with a clause in its constitution limiting the number of shares to 1 000 000. The directors decide to issue 600 000 shares at \$1 each with the terms being that 50 cents is payable on application by 31 July, allotments to be made on 1 August with 25 cents on allotment and due by 30 September, and a first and final call of 25 cents to be made on 30 November and due by 31 December 20X4. The issue is fully subscribed and all amounts due are received by the specified dates.

COMPANY FORMATION, SHARE CAPITAL AND DEBT SECURITIES

General journal

		<i>Debit</i>	<i>Credit</i>	
20X4		\$	\$	
July 31	Bank trust	300 000		
	Application		300 000	
				(amounts received on application of 50 cents on 600 000 ordinary shares)
Aug 1	Bank	300 000		
	Bank trust		300 000	
				(transfer of amounts received on application)
	Application	300 000		
	Share capital		300 000	
				(amounts due on application for shares allotted)
	Allotment	150 000		
	Share capital		150 000	
				(amounts due on allotment)
Sept 30	Bank	150 000		
	Allotment		150 000	
				(amounts received for allotment)
Nov 30	Call	150 000		
	Share capital		150 000	
				(first and final call of 25 cents per share)
Dec 31	Bank	150 000		
	Call		150 000	
				(amounts received for call)

General ledger

		<i>Debit</i>	<i>Credit</i>	<i>Balance</i>	
20X4		\$	\$	\$	
	Application				
July 31	Bank trust		300 000	300 000	Cr
Aug 1	Share capital	300 000		–	
	Bank trust				
July 31	Application	300 000		300 000	Dr
Aug 1	Bank		300 000	–	
	Bank				
Aug 1	Bank trust	300 000		300 000	Dr
Sept 30	Allotment	150 000		450 000	Dr
Dec 31	Call	150 000		600 000	Dr
	Allotment				
Aug 1	Share capital	150 000		150 000	Dr
Sept 30	Bank		150 000	–	
	Call				
Nov 30	Share capital	150 000		150 000	Dr
Dec 31	Bank		150 000	–	
	Share capital				
Aug 1	Application		300 000	300 000	Cr
	Allotment		150 000	450 000	Cr
Nov 30	Call		150 000	600 000	Cr

In illustrative example 2.1 there were no complications with the share issue. Often, however, this is not the case. A company may have different types of shares and if they were to be issued at the same time there needs to be an entry for each type. For example, if a company were to issue 500 000 ordinary shares at \$1 and 300 000 preference shares at \$2, payable in full on application, the company would have recorded the cash received for applications as:

	<i>Debit</i>	<i>Credit</i>
	\$	\$
Bank Trust	1 100 000	
Application – ordinary		500 000
Application – preference		600 000
(amounts received on application for shares)		
Application – ordinary	500 000	
Application – preference	600 000	
Share capital – ordinary		500 000
Share capital – preference		600 000
(amounts due on application for ordinary \$1 shares and preference \$2 shares)		
Bank	1 100 000	
Bank trust		1 100 000
(amounts received on share issues transferred)		

If the issue was to be by instalments the entries would be similar to those in the illustrative example, except there would be an entry for each type of share affected — for example, Allotment — Ordinary, Allotment — Preference, and so on.

There may be other complications. As indicated above, there may be an oversubscription, with the need for some money to be returned to unsuccessful applicants, some money transferred to offset amounts due on allotment, and/or the call. Some successful applicants may pay the call amounts when they pay the amounts due on allotment. Alternatively, as shown earlier, there may be an oversubscription and the proceeds may be held by the company and applied to allotment. In these circumstances, when amounts are received before they are due and the company keeps them, they are described as calls in advance and are in effect a liability of the company similar to revenue received in advance. This is an instance when the law becomes complicated and care should be exercised when dealing with calls in advance. Sometimes calls are not received by the due dates, in which case they become calls in arrears. These will be reflected in any debit balance in a call account. For example, if Ariel Ltd received only \$145 000 for the call by 31 December there would be a debit balance in the call account, implying that there were calls in arrears of \$5000 (meaning that holders of 20 000 shares had not yet paid the 25 cents due on the call).

calls in advance

calls in arrears

Forfeiture of shares

An advantage of issuing shares by instalment is that investors can purchase a large number without having to pay the full amount up front — as with the purchase of many other assets by instalments. However, there is a legally binding commitment to pay the calls the company makes. When an investor does not pay the calls by the due dates the company, if its constitution so authorises, may forfeit the shares. When it does this the issue of the shares that have been forfeited is in effect cancelled. (In fact, the company can formally cancel the forfeited shares.) That is, those shares no longer form part of the company's issued capital. In accounting terms, all the entries in respect of the shares forfeited have to be reversed and any amounts received for those shares are transferred to a Forfeited Shares Account.

ILLUSTRATIVE EXAMPLE 2.2

FORFEITURE OF SHARES

Using the same information as in illustrative example 2.1 except that by 31 December \$5000 remains outstanding on the call. The directors, in accordance with the company's constitution, resolve on 15 January 20X5 to forfeit the shares on which calls remain unpaid.

Working:

Number of shares forfeited is $5000/.25 = 20\ 000$		
Amounts paid are	Application – 20 000 @ 50 cents =	\$10 000
	Allotment – 20 000 @ 25 cents =	5 000
		<u>\$15 000</u>
Amount not paid	Call – 20 000 at 25 cents	\$5 000

General journal

		<i>Debit</i>	<i>Credit</i>
20X5		\$	\$
Jan 15	Share capital	20 000	
	Call		5 000
	Forfeited Shares account		15 000
	(forfeiture of 20 000 shares for non-payment of call)		

General ledger (extract)

		<i>Debit</i>	<i>Credit</i>	<i>Balance</i>	
		\$	\$	\$	
Call					
20X4					
Nov 30	Share capital	150 000		150 000	Dr
Dec 31	Bank		145 000	5 000	Dr
20X5					
Jan 15	Share capital		5 000	–	

	<i>Debit</i>	<i>Credit</i>	<i>Balance</i>	
	\$	\$	\$	
Share Capital				
<hr/>				
20X4				
Aug 1	Application	300 000	300 000	Cr
	Allotment	150 000	450 000	Cr
Nov 30	Call	150 000	600 000	Cr
20X5				
Jan 15	Call & Forfeited Shares Account	20 000	580 000	Cr
Forfeited Shares Account				
<hr/>				
Jan 15	Share Capital		15 000	Cr

REISSUE OF FORFEITED SHARES

Although the company can formally cancel the forfeited shares, it may want to reissue shares that have been forfeited. Accounting for the reissue will be the same as for the issue. However, the conditions of the reissue will most likely be different. For example, the shares forfeited by Ariel Ltd in illustrative example 2.2 may be issued for a single payment of \$1 per share rather than by instalments, in which case the general journal entry would be:

	<i>Debit</i>	<i>Credit</i>
	\$	\$
Bank	20 000	
Share capital (reissue of forfeited shares)		20 000

When dealing with forfeited shares and their reissue, it is advisable to bear in mind the number of shares involved and the desired effect on the share capital. Thus, in the simple situation above, it is clear that the reissue brings the issued shares back to 600 000 and the share capital to \$600 000, which is what the balance would have been had all shares been paid for without any forfeiture. Note that the company still retains the amounts received from the previous shareholders from whom the shares were forfeited. The constitution will indicate what should be done with that amount. At present it is indicated by the balance in the Forfeited Shares Account. It is usual for the constitution to state that the amount be returned to those from whom the shares were forfeited, after deducting any expenses or loss incurred in reissuing the shares. Where the company is permitted to retain the amounts received from forfeited shares (net of any reissue and associated costs), the amount is properly denoted as equity and the account may carry the title Forfeited Share Reserve.

Share issue amounts

Until the recent changes to the Corporations Act, when formed, a company was required to have a stated amount of capital and how it was comprised in respect of types of shares. This was referred to as the company's authorised capital, and the

par value

company could not issue capital in excess of that. In addition, each share had to be of a stated amount. This was the par value or nominal value of a share and was the value stated on the shares at the date of incorporation (most commonly \$1 or 50 cents). The only funds a company receives from a share issue are those from the initial issue. It is the owners of the shares who receive any benefit from a subsequent increase in the value of those shares. Where the market value of shares is above the par value the company will want to take advantage of this and issue the shares for a price in excess of the par. This was referred to as issuing shares at a premium. However, the law no longer requires companies to have an authorised capital or shares to have a par value. The company, if permitted by its constitution, can issue additional shares and at a price it considers the market can bear. The changes to the law were not retrospective, so there are many companies that will still have in their accounts amounts referred to as the Share Premium account (or Share Premium Reserve). These represent the amounts in excess of the par values that the company received from share issues and will be kept separate from the issued and share capital. As shares now have no par values, the amount received from future share issues will simply increase the share capital. Thus, if a company, which had previously issued shares at \$1 each, were to make a new issue of 1 000 000 ordinary shares at \$1.50 cents per share, amounts to be fully paid on application, anyone wishing to invest in the issue would have to pay \$1.50 for each share. If all shares are subscribed, the general journal entries to record the applications received would be:

premium

	<i>Debit</i>	<i>Credit</i>
	\$	\$
Bank Trust	1 500 000	
Application		1 500 000
(amounts received on application for shares)		

and then when the allotment is made —

Application	1 500 000	
Share capital		1 500 000
(issue of shares at \$1.50 per share)		
Bank	1 500 000	
Bank trust		1 500 000
(transfer of amounts received on share issue)		

Previously, if the shares had a par value of \$1 the company would have been required to show the extra 50 cents per share in a Share Premium account; many companies had such accounts prior to the law change but no longer have such an account.

When deciding at what price to issue shares, the directors would have to be careful as any new shares will affect the market price of the existing shares. However, there are many compounding influences on the share price.

In the past, if a company issued shares for less than the par value, then it was said to have issued shares at a discount.

discount

Other aspects of share issues

RIGHTS ISSUES

rights issues

In illustrative example 2.1 the directors of Ariel Ltd did not issue all the shares its constitution permitted it to — the limit on the capital was 1 000 000 shares, yet they only issued 600 000 shares. This is common, as the directors could have anticipated some expansion at a later date for which the company would need funds. These funds could come from a further issue. It is usual for the constitution to contain a provision that any additional shares be first offered to the existing shareholders before being offered to the public — the existing shareholders have first right of refusal, so such issues are called rights issues. The shareholders would be entitled to a number of shares in proportion to their existing shareholdings — for example, a one-for-six rights issue means that the existing shareholders have rights to purchase an additional share for each six held. The new issue may be at the original price but would more likely be at a greater price in order to take advantage of any increased market price. The price would likely be a little less than the market price of the shares so as to encourage subscription. The new shares are in effect ‘allotted’ to the existing shareholders, so the accounting entries are slightly simpler than the initial issue. The rights issue may be by payment in full or by instalments.

For example, a company with an issued and share capital of 600 000 ordinary \$1 shares decides to make a one-for-six rights issue at \$1.30 per share.

	<i>Debit</i>	<i>Credit</i>
	\$	\$
Bank	130 000	
Share capital		130 000
(a 1-for-6 rights issue fully subscribed)		

In this example it is assumed that the entry is made after the cash has been received. It would have been possible to make an entry at the date of the resolution to issue the shares using an allotment account, but this seems to be unnecessary work. Note also that in the case of a rights issue the invitation constitutes an offer by the company to the shareholder and the shareholder completes the contract by accepting it. In contrast, in a new share issue the prospective shareholder is making the offer to the company, and the company has the option to accept or reject it. Hence there is no need for a Trust account in a rights issue.

renounceable rights

Sometimes the rights are renounceable — that is, the shareholders are permitted to sell their rights to purchase the shares in the new issue. Thus, a market has arisen whereby rights can be sold and bought.

PRIVATE ISSUES

private issue

Proprietary companies cannot offer shares to the public — they are sold privately. A public company, where authorised by its constitution, can also offer shares for sale privately. The shares may be sold to a large institutional investor to avoid the cost and time involved in a full public issue. The ASX usually prohibits listed public companies from issuing more than 10% of its shares in this manner: a private issue.

SHARE OPTIONS

call option

A company may sell the right to buy a certain number of shares in the company at some fixed time in the future. This right is called a company-issued call option. Where the company issues options for some valuable consideration, the amount received will increase the shareholders' equity. For example, a company may issue options over 100 000 shares to purchase shares in the company at the price of \$2.10 after one year's time for a cash payment now of 30 cents. When the cash is received the general entry would be:

	<i>Debit</i>	<i>Credit</i>
	\$	\$
Bank	30 000	
Options		30 000
(issue of options at 30 cents over a potential future issue of 100 000 shares)		

An option provides the recipient with the right, but not the obligation, to acquire a specified number of shares in the company. An option will usually be granted close to the prevailing market price and the recipient will exercise the option *only* if the market price exceeds the exercise price. If the option is exercised, Share Capital will increase. If the option is allowed to lapse however there will be no change in Share Capital. In the example above, the account 'Options' is an equity account. If the option holder exercises the option to acquire all the shares it will record an increase in equity arising from that transaction:

	<i>Debit</i>	<i>Credit</i>
Bank	210 000	
Share capital		210 000

The 'Options' account of \$30 000 may be transferred within equity to, say, Share Capital, on exercise of the options. In any case the cost of issuing the options effectively increases the cost of those shares from \$2.10 per share to \$2.40.

Does the issuing of share options free of charge give rise to a 'cost'? For example, options may be provided without cost to employees to compensate employees for services provided in the past. This matter has been debated by standard setters, and AASB 2 'Share Based Payment' now requires that options be measured and recorded in the financial statements to the extent that the share-based payment represents goods or services acquired or received. It is necessary to measure the fair value of the equity instruments granted as at grant date and record the resultant increase in expense and equity. Paragraph 12 explains the rationale for the measurement approach as follows:

Typically, shares, share options or other equity instruments are granted to employees as part of their remuneration package, in addition to a cash salary and other employment benefits. Usually, it is not possible to measure directly the services received for particular components of the employee's remuneration package. It might also not be possible to measure the fair value of the total remuneration package independently, without measuring directly the fair value of the equity instruments granted. Furthermore, shares or share options are sometimes granted as part of a

bonus arrangement, rather than as a part of basic remuneration, for example, as an incentive to the employees to remain in the entity's employ or to reward them for their efforts in improving the entity's performance. By granting shares or share options, in addition to other remuneration, the entity is paying additional remuneration to obtain additional benefits. Estimating the fair value of those additional benefits is likely to be difficult. Because of the difficulty of measuring directly the fair value of the services received, the entity shall measure the fair value of the employee services received by reference to the fair value of the equity instruments granted.

By way of illustration, assume that on April 1 20X4 an employee is given 1000 options to acquire shares in the company and that the options may be exercised immediately (this is its vesting rights). The value of the option is determined as \$2 on grant date. The exercise price of the option is \$2.50 and the market price reaches \$2.80 on 1 May when the option is exercised. The company would record the transactions as follows:

		<i>Debit</i>	<i>Credit</i>
20X4		\$	\$
Apr 1	Wages expense	2 000	
	Options		2 000
	(Options granted to employee)		
May 1	Cash	2 500	
	Share capital		2 500
	(Exercise of options)		

If the company wishes to transfer the balance of the Options account to Share Capital, the following entry would also be made:

		<i>Debit</i>	<i>Credit</i>
	Options	2 000	
	Share capital		2 000
	(transfer to Share Capital on exercise of options)		

BONUS ISSUES

A company can also issue shares to existing shareholders for no cost. The company uses past profits (or gains) to make the issue as a bonus issue to existing shareholders in proportion to their current shareholding. The next chapter will indicate how this is entered in the books.

Shareholders' equity

shareholders' equity

As the name implies, the shareholders' equity in the balance sheet represents the owners' equity in a company. As such it will include all equity attributable to the shareholders. This will not only be the share capital but also many of the items discussed above, as well as undistributed past profits. Therefore, a company could have a shareholders' equity that includes several items (assumed figures for illustrative purposes only):

COMPANY FORMATION, SHARE CAPITAL AND DEBT SECURITIES

	\$	\$
<i>Shareholders' equity</i>		
Share capital		
1 000 000 ordinary shares at \$1 paid to 80 cents	800 000	
500 000 preference shares at \$1 fully paid	<u>500 000</u>	1 300 000
Forfeited Shares account	30 000	
Options	20 000	
Retained profits	<u>123 897</u>	<u>173 897</u>
		1 473 897

AASB 101, paragraph 8 states that the components of a financial report include a statement of changes in equity showing either: (i) all changes in equity, or (ii) changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders. There are therefore *four* main financial statements, as the Statement of Changes in Equity is added to the existing Statement of Cash Flows, Income Statement and Balance Sheet. The following extract from AASB 101, paragraphs 96-97, describes the disclosures required with respect to the Statement of Changes in Equity:

96. An entity shall present a statement of changes in equity showing on the face of the statement:
- (a) profit or loss for the period;
 - (b) each item of income and expense for the period that, as required by other Australian Accounting Standards, is recognised directly in equity, and the total of these items;
 - (c) total income and expense for the period (calculated as the sum of (a) and (b)), showing separately the total amounts attributable to equity holders of the parent and to minority interest; and
 - (d) for each component of equity, the effects of changes in accounting policies and corrections of errors recognised in accordance with AASB 108.

A statement of changes in equity that comprises only these items shall be titled a statement of recognised income and expense.

97. An entity shall also present, either on the face of the statement of changes in equity or in the notes:
- (a) the amounts of transactions with equity holders acting in their capacity as equity holders, showing separately distributions to equity holders;
 - (b) the balance of retained earnings (i.e. accumulated profit or loss) at the beginning of the period and at the reporting date, and the changes during the period; and
 - (c) a reconciliation between the carrying amount of each class of contributed equity and each reserve at the beginning and the end of the period, separately disclosing each change.

In Part C of AASB 101, full reconciliations are shown for Share Capital (by classes if there is more than one class), Reserves (Asset Revaluation, Translation and Other Reserves) and Retained Earnings complementing the line disclosures for Shareholders' Equity displayed on the Balance Sheet.

ILLUSTRATIVE EXAMPLE 2.3**SHARE ISSUES (COMPREHENSIVE)**

On 2 January 20X5, Ptolemy Ltd was registered as a public company with an established share capital of 5 000 000 ordinary shares and 1 000 000 preference shares. At the same date the company published a prospectus for an issue of shares on the following terms:

- 3 000 000 ordinary shares at \$1 with 50 cents payable on application by 31 January, 30 cents payable on allotment due by 28 February; and
- 1 000 000 preference shares at \$1 payable in full on application by 31 January.

By 31 January all the preference shares had been subscribed and applications for 3 600 000 ordinary shares received. On 1 February the directors made a pro rata allotment to all applicants and, in terms of the prospectus, excess application monies were used as part payment of allotment money due.

On 28 February the directors made a first and final call of 20 cents on the ordinary shares, payable by 31 March.

By 31 March all call money had been received except for that on 50 000 shares which the directors resolved to forfeit for non-payment of call in accordance with the articles. At the same date they reissued these shares as fully paid for a payment of 60 cents per share due by 21 April.

On 31 August the directors resolved to make a rights issue of one for three ordinary shares at \$1.30 per share. Application amounts payable were due by 30 September and the issue was fully subscribed.

On 30 November the directors resolved to make a private issue to the underwriting firm of Steeple Insurance Ltd of 500 000 ordinary shares for a single payment of \$1.40 per share.

On 1 December the directors decided to make a call option on the remaining 500 000 unissued ordinary shares of 25 cents per share, the option to be taken up after 30 November 20X1 at \$2 per share. The call closed on 15 December, by which time all options had been sold.

General journal

		<i>Debit</i>	<i>Credit</i>
		\$	\$
20X5			
Jan 31	Bank trust	2 800 000	
	Application – ordinary		1 800 000
	Application – preference		1 000 000
	(cash received on application for shares)		
Feb 1	Application – ordinary	1 500 000	
	Application – preference	1 000 000	
	Share capital – ordinary		1 500 000
	Share capital – preference		1 000 000
	(amounts due on application for shares issue)		
	Allotment – ordinary	900 000	
	Share capital – ordinary		900 000
	(amount due on allotment – 30 cents per share)		
	Application – ordinary	300 000	
	Allotment – ordinary		300 000
	(transfer of oversubscription amounts received)		

COMPANY FORMATION, SHARE CAPITAL AND DEBT SECURITIES

Feb 1	Bank	2 800 000	
	Bank trust		2 800 000
	(transfer of amounts received on issue of shares)		
Feb 28	Bank	600 000	
	Allotment – ordinary		600 000
	(amounts due on allotment received)		
	Call	600 000	
	Share capital – ordinary		600 000
	(first and final call made 20 cents per share)		
Mar 31	Bank	590 000	
	Call		590 000
	(amounts due on call received)		
	Share capital	50 000	
	Call		10 000
	Forfeited Shares account		40 000
	(forfeiture of 50 000 shares for non-payment of call)		
Apr 21	Bank	30 000	
	Forfeited Shares account	20 000	
	Share capital		50 000
	(amounts received on reissue of forfeited shares)		
Sept 30	Bank	1 300 000	
	Share capital		1 300 000
	(amounts received on rights issue)		
Nov 30	Bank	700 000	
	Share capital		700 000
	(private issue of 500 000 shares at \$1.40 cents per share)		
Dec 15	Bank	125 000	
	Options		125 000
	(options issued on 500 000 shares at 25 cents)		

General ledger

20X5		<i>Debit</i>	<i>Credit</i>	<i>Balance</i>	
		\$	\$	\$	
Application – Ordinary					
Jan 31	Bank trust		1 800 000	1 800 000	Cr
Feb 1	Share capital – ordinary	1 500 000		300 000	Cr
	Allotment – ordinary		300 000	–	
Application – Preference					
Jan 31	Bank trust		1 000 000	1 000 000	Cr
Feb 1	Share capital – preference	1 000 000		–	
Bank Trust					
Jan 31	Application – ordinary	1 800 000		1 800 000	Dr
	Application – preference	1 000 000		2 800 000	Dr
Feb 1	Bank		2 800 000	–	

20X5		<i>Debit</i>	<i>Credit</i>	<i>Balance</i>	
		\$	\$	\$	
Bank					
Feb 1	Bank trust	2 800 000		2 800 000	Dr
Feb 28	Allotment – ordinary	600 000		3 400 000	Dr
Mar 31	Call	590 000		3 990 000	Dr
Apr 21	Share capital – ordinary	30 000		4 020 000	Dr
Sept 30	Share capital – ordinary	1 300 000		5 320 000	Dr
Nov 30	Share capital – ordinary	700 000		6 020 000	Dr
Dec 15	Options	125 000		6 145 000	Dr
Allotment – Ordinary					
Feb 1	Share capital – ordinary	900 000		900 000	Dr
	Application – ordinary		300 000	600 000	Dr
Feb 28	Bank		600 000	–	
Call					
Feb 28	Share capital	600 000		600 000	Dr
Mar 31	Bank		590 000	10 000	Dr
	Share capital		10 000	–	
Share Capital – Ordinary					
Feb 1	Application – ordinary		1 500 000	1 500 000	Cr
	Allotment – ordinary		900 000	2 400 000	Cr
Feb 28	Call		600 000	3 000 000	Cr
Mar 31	Forfeited Shares account	50 000		2 950 000	Cr
Apr 21	Bank		50 000	3 000 000	Cr
Sept 30	Bank		1 300 000	4 300 000	Cr
Nov 30	Bank		700 000	5 000 000	Cr
Share Capital – Preference					
Feb 1	Application – Preference		1 000 000	1 000 000	Cr
Options					
Dec 15	Bank		125 000	125 000	Cr
Forfeited Shares Account					
Mar 31	Share capital – ordinary		40 000	40 000	Cr
Apr 21	Share capital – ordinary	20 000		20 000	Cr

Ptolemy Ltd		
Balance Sheet (extract) as at 31 December 20X5		
	\$	\$
<i>Shareholders' equity</i>		
<i>Issued and share capital</i>		
4 500 000 ordinary shares	5 000 000	
1 000 000 preference shares	<u>1 000 000</u>	6 000 000
Forfeited Shares account	20 000	
Options	<u>125 000</u>	145 000
		<u>\$6 145 000</u>
<i>Assets</i>		
Bank		<u>\$6 145 000</u>

Debt securities

convertible note
unsecured note
mortgage
lease

The distinction was made above between equity capital and debt capital as methods by which a company can be financed. So far we have been examining equity capital — that relating to the issue of shares. Debt capital is simply a term for long-term debt (borrowing) incurred by the company and includes debentures, convertible notes, unsecured notes, mortgages and leases. It is usual for the company to issue evidence of the debt and this is referred to as debt securities. Similar legal principles are involved with debt capital as with equity capital — namely, the protection of those dealing with the company — so care should be exercised when dealing with debt capital. The concern here, however, is with the accounting treatment.

DEBENTURES

debenture holder
charge
fixed charge
floating charge
trustee

A debenture is merely an acknowledgment of a debt. However, debentures are usually issued in units similar to shares (but usually larger). By doing this the company is able to borrow funds from a number of investors (in a manner similar to a new share issue). Those who invest in the debentures issued by a company are lending the company money. This 'loan' will be for a period of time and attracts a rate of interest. The debenture holders will have their investment protected in at least two ways. First, the debenture will be secured by a charge over some of the company's assets. This charge will be fixed — relating to specific assets — or floating — relating to the assets generally. Secondly, there will be (unless exempted by law) an entity which serves as the trustee for the debenture holders — a person or an institution appointed to act on behalf of the debenture holders to protect their interests.

The accounting for a debenture issue is similar to that for a share issue — a prospectus is issued inviting offers (applications) which are then accepted (or not) by the company, at which stage a binding contract exists requiring the company to protect the debentures, pay interest, and repay them at the stated date. So, if a company were to issue a prospectus inviting investors to subscribe to an issue of 5 000 debentures of \$100 and the issue is fully taken up, the general journal entry would be:

	<i>Debit</i>	<i>Credit</i>
	\$	\$
Bank trust	500 000	
Debenture application		500 000
(amount received from an issue of 5000 \$100 debentures)		

and when the directors accept the debenture subscriptions:

Bank	500 000	
Bank trust		500 000
(transfer of amount received from debenture issue)		
Debenture application	500 000	
Debentures		500 000
(acceptance of debenture applications)		

The company now has a non-current liability for the debentures, and will each year of the debenture issue incur an expense for the interest.

The debentures can be issued at a *premium* or a *discount*. Opinion is divided as to how to account for the debenture premium and debenture discount. However, as the premium has been received for debentures which have been issued for a period of time, the gain (that is, the premium) should be regarded as being earned over the period of the debentures as it probably reflects the interest rate on the debentures. Alternatively, a simpler approach is to treat the premium as income in the year it is received. An issue at a discount has been made to attract investors to take up the debentures. Therefore, the discount should be amortised over the life of the debentures as it is a cost of raising the funds. Once again, some accountants argue for the simpler treatment of expensing the discount in the year of issue.

redemption

The redemption (repaying) of the debentures when they fall due will require a large amount of funds, so it is wise to set aside an amount each year. When redeemed, the general journal entry will simply reflect the payment of cash (bank) and a reduction in the liability (debentures).

CONVERTIBLE NOTES

Convertible notes are a form of debenture which can be converted to shares after a set period of time. They are now not commonly found in Australia, although they were once a popular method of raising funds.

As discussed earlier in the section on preference shares, some types of securities may have economic characteristics that combine features of debt and/or equity. AASB 132 discusses compound financial instruments and requires their decomposition into liability and equity. Paragraph 29 illustrates how convertible debt may be decomposed into a financial liability and an equity instrument the equity component represents a call option to convert the instrument into a fixed number of ordinary shares of the entity. The economic effect is similar to issuing simultaneously a debt instrument with an early settlement provision and rights to purchase ordinary shares, or issuing a debt instrument with detachable share purchase rights. However, once classified, these components remain unchanged for the remainder of the life of the compound instrument. This approach is justified by arguing that the conversion option is a complex combination of tax and other considerations and the likelihood of conversion will also change over time. Additional explanation and illustrative examples are provided in the appendices to AASB 132. Example 9 is reproduced below.

An entity issues 2 000 convertible bonds at the start of year 1. The bonds have a three-year term, and are issued at par with a face value of \$1 000 per bond, giving total proceeds of \$2 000 000. Interest is payable annually in arrears at a nominal annual interest rate of 6 per cent. Each bond is convertible at any time up to maturity into 250 ordinary shares. When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9 per cent. Using a discount rate of 9 per cent, the market interest rate for similar bonds having no conversion rights, the calculations are as follows:

COMPANY FORMATION, SHARE CAPITAL AND DEBT SECURITIES

Present value of the principal of \$2 000 000 payable at the end of 3 years (present value of \$1 for 3 years at 9% is 0.7722)	1 544 400
Present value of interest of \$120 000 payable annually in arrears (present value of an annuity of \$1 for 3 years at 9% is 2.5313)	303 756
Total liability component	1 848 156
Proceeds of the bond issue	2 000 000
Equity component	151 844

The journal entry to record the issue of the convertible notes would be:

Cash at Bank	2 000 000	
Equity		151 844
Convertible notes		1 848 156

UNSECURED NOTES

As their name implies, these are a form of debt for which there is no charge over the company's assets — they are unsecured.

MORTGAGES

mortgagee
mortgagor

A mortgage is a form of charge over property to secure a loan from a mortgagee (lender) to a mortgagor (borrower — the company).

Accounting for notes and mortgages is similar to that for debentures. Funds are received from the lenders and a liability is incurred. Accounting for leases is more complicated and not appropriately discussed here. Nevertheless, it is viewed as an important method of financing the acquisition of assets.

Review

This chapter has described the different types of companies that can be formed, and how they are formed. The chapter has concentrated on the accounting for share issues and discussed some of the complications that may arise in share issues and how they are accounted for. The share capital is considered to be a company's owners' equity — it is the shareholders' equity in the company. Companies also issue securities other than those relating to the shareholders' equity, and this chapter has introduced some of these debt securities and discussed how they are treated in the accounting system.

KEY TERMS

allotment	debt capital	private issue
application	directors	proprietary company
Australian Company Number	discount	prospectus
Australian Securities and Investments Commission	equity capital	public company
Australian Stock Exchange	fixed charge	redemption
call	floating charge	renounceable rights
call option	issued capital	replaceable rules
calls in advance	lease	rights issues
calls in arrears	listing rules or requirements	securities
certificate of registration	members	shareholders
charge	mortgage	shareholders' equity
company limited by guarantee	mortgagee	share listing
constitution	mortgagor	shares
convertible note	ordinary shares	trustee
debentures	oversubscription	undersubscription
debenture holder	par value	underwriter
	preference shares	unsecured note
	premium	

REVIEW QUESTIONS

- 2.1** What is the purpose of limited liability?
- 2.2** Why is a distinction drawn between a public company and a proprietary company?
- 2.3** What are the important steps in forming a company?
- 2.4** How can a person become a member (shareholder) of a company? How is share capital affected by these different modes of membership?
- 2.5** What is the function of the 'replaceable rules' of the Corporations Act?
- 2.6** In accounting for share issues, one of the first accounts involved is a Bank Trust account. Why is this so?
- 2.7** How are share issue costs treated for accounting purposes?
- 2.8** Distinguish between calls in arrears and calls in advance.
- 2.9** What is a rights issue, and why are such issues made?
- 2.10** Why does the price at which a company issues shares vary over time?

- 2.11** Why would a company buy back shares it has previously issued?
- 2.12** What is meant by debt capital, and what common forms does it take?
- 2.13** Why is it useful to distinguish between (a) liability and equity and (b) different components of debt and different components of equity?

PROBLEMS

Problem 2.14 Accounting for share issue

Sprague Ltd was formed on 1 January 20X1 with a clause in its constitution limiting the number of shares that it could issue to 1 000 000. The directors resolved to issue 500 000 shares at \$1. The terms of the issue are that 50 cents be payable on application and 50 cents on allotment. By 28 February applications had been received for all 500 000 shares with the required application amounts. The directors met on 5 March and allotted the shares to the applicants, and the company issued notices of allotment indicating that all amounts due were to be paid by 31 March. By 31 March, allotment amounts had been received on 450 000 shares.

Required

Prepare general journal entries to record the above.

Problem 2.15 Accounting for share issue

DR Scott Ltd was formed on 1 January 20X3 with a clause in its constitution limiting the number of shares that it could issue to 2 000 000. The directors resolved to issue 1 000 000 shares at \$1. The terms of the issue are that 50 cents be payable on application and 50 cents on allotment. By 1 March 20X3 applications for all 1 000 000 shares had been received with the required application amounts. The directors met on 10 March and allotted the shares to the applicants, and the company issued notices of allotment indicating that all amounts due were to be paid by 30 April. By 30 April allotment amounts had been received on 950 000 shares. The cost of the share issue amounted to \$80,000.

Required

Prepare general journal entries to record the above. How would the amounts due on the 50 000 for allotment be disclosed in a balance sheet at that date (30 April)?

Problem 2.16 Accounting for share issue by instalments

On 1 July 20X1, Hatfield Ltd was formed. On that date the directors resolved to issue 1 000 000 ordinary shares at \$1 and the prospectus that had been prepared was duly published. It indicated that 50 cents was to accompany applications for each share, with the remainder to be paid, 25 cents on notice of allotment and 25 cents at a call to be made by the directors at a later date. The date set for all applications for shares to be made was 15 August 20X1 and applications for all shares were received by that date. The directors met on 24 August and duly resolved to issue the shares to applicants and indicated that allotment amounts due were to be paid by 30 September 20X1. All amounts due were received by the due date. The directors

concluded that the call should be made to enable the company to purchase extra buildings. This call was made on 1 November with amounts due by 1 December. Amounts due on the call were received on all but 5000 shares.

Required

Prepare general journal entries to record the above in the books of Hatfield Ltd.

Problem 2.17 Accounting for share issue — ordinary and preference

W Paton & Son Ltd was registered on 1 February 20X8. The directors of the company resolved that the promoters were to be issued 500 000 preference shares at \$1 each, amounts to be paid by 15 February, and all amounts were received by that date. They also resolved to make a public issue of 2 000 000 ordinary shares at \$1.75 each to be paid in full on application. The closing date for applications was 31 March 20X8, by which time amounts had been received with applications for 2 300 000 shares. The directors met on 5 April and issued the shares pro rata to applicants, with any amounts in excess of that due being returned to applicants.

Required

Prepare general journal entries to record the above in the books of the company and show the accounts in the general ledger.

Problem 2.18 Accounting for share issue — ordinary and preference

Carl Devine Ltd was registered on 1 February 20X8. The directors of the company resolved that the promoters were to be issued 600 000 preference shares at \$1 each and amounts were to be paid by 15 February. All amounts were received by that date. They also resolved to make a public issue of 2 000 000 ordinary shares at \$2.05 each to be paid in full on application. The closing date for applications was 31 March 20X8, by which time amounts had been received with applications for 2 500 000. The directors met on 5 April and issued the shares pro rata to applicants, with any amounts in excess of that due being returned to applicants.

Required

Prepare general journal entries to record the above in the books of the company, and show the accounts in the general ledger.

Problem 2.19 Accounting for share issue — ordinary and preference

- (a) Assume that the preference shares referred to in Problem 2.18 are cumulative preference shares and redeemable at the option of the *holder*. Record the journal entry to recognise the issue of the preference shares under these conditions. Explain your reasoning.
- (b) Assume now that the preference shares are cumulative but are redeemable at the option of the *company*. Provide the general journal entries to record the issue of the preference shares. Explain your reasoning.
- (c) How would share issue costs be treated under alternatives (a) and (b)?

Problem 2.20 Accounting for share issue including an oversubscription

The constitution of Henrietta Sweeney Ltd indicated that the company could issue up to 5 000 000 ordinary shares and 1 000 000 preference shares. Prospectuses had been published offering 1 000 000 preference shares at \$1.50 payable in full on

application by 31 March 20X9, and 2 000 000 ordinary shares at \$1.20 with 50% due on application by 31 March 20X9, 25% on allotment, and 25% on a call to be made by the directors at a later date. By 31 March amounts due on 800 000 of the preference shares had been received and on applications for 2 400 000 ordinary shares. The directors met on 10 April and resolved to issue the preference and ordinary shares. The ordinary shares were allotted to applicants on a pro rata basis and the amounts received in excess of that due were to be credited against amounts due on allotment. The amount due on the allotment of the ordinary shares was due by 15 May 20X9 and this was received on all shares. The directors made the call on the ordinary shares on 31 August 20X9, with amounts due by 30 September. By this date, amounts due on 1 997 000 ordinary shares had been received.

Required

Show how the above would be recorded in the general journal of the company and the general ledger.

Problem 2.21 **Accounting for share issue including an oversubscription**

In the constitution of AC Littleton Ltd there was a clause that indicated the company could issue up to 10 million ordinary shares and 2 000 000 preference shares. Prospectuses had been published offering 1 000 000 preference shares at \$1.50 payable in full on application by 31 March 20X4, and 4 000 000 ordinary shares at \$1.20, with 50% due on application by 31 March 20X4, 25% on allotment and 25% on a call to be made by the directors at a later date. By 31 March, amounts due on 800 000 of the preference shares had been received, and on applications for 4 800 000 ordinary shares. The directors met on 12 April and resolved to issue the preference and ordinary shares. The ordinary shares were allotted to applicants on a pro rata basis and the amounts received in excess of that due were to be credited against amounts due on allotment. The amounts due on the allotment of the ordinary shares were due by 21 May 20X4 and were received on all shares. The directors made the call on the ordinary shares on 31 August 20X4 with amounts due by 30 September. By this date amounts due on 3 986 000 ordinary shares had been received.

Required

Show how the above would be recorded in the general journal of the company and the general ledger.

Problem 2.22 **Share issue with a forfeiture**

The constitution of Stephens & Gillman Ltd indicated that the directors could forfeit shares for the non-payment of calls. On 31 July 20X8 the directors decided to forfeit 4000 ordinary shares of \$1 held by George O May, upon which the application of 15 cents and the allotment of 40 cents per share had been paid but the first call of 20 cents had not been received. The directors also resolved to reissue the forfeited shares to William Ripley, credited as paid to 75 cents per share for a payment in cash of 80 cents per share.

Required

Show how the above would be recorded in the general journal of the company.

Problem 2.23 Share issue with a forfeiture

Montgomery Ltd had issued 2 000 000 ordinary \$1 shares on which 75 cents per share had been called. The holder of 6000 shares had failed to pay the second call of 25 cents per share, and another shareholder had failed to pay the second call and the first call of 10 cents per share on 4000 shares. In accordance with the provisions of the company's constitution, the directors resolved on 31 May 20X7 to forfeit the shares of both shareholders. On 28 June 20X7 the forfeited shares were reissued for a single payment of 70 cents as being paid to 75 cents.

Required

Prepare general journal entries to record the above transactions.

Problem 2.24 Share issue including an issue not for cash

Canning & Co Ltd was registered on 1 January 20X2 to operate and trade as manufacturers of a newly invented mass data storage medium. The directors issued 40 000 000 ordinary shares at \$2.10, with \$1.50 due with applications due 28 February 20X2 and the remainder on allotment. The directors met on 3 March and allotted shares to applicants for all the shares. In fact, applications had been received for 45 000 000 shares and the amounts received in excess of that due were returned to the unsuccessful applicants. All amounts due on allotment were received by the due date of 31 March 20X2. On 17 March the directors purchased a lease on a factory at a cost of \$35 000 and purchased plant for \$30 000 on 31 March. The company was most successful and it became obvious that it would need to expand within the next two years. The directors, on 31 August 20X2, issued a call option for 30 cents per share to a group of potential investors for one year to purchase 10 000 000 shares at \$4. They also issued an ex gratia option to the employees to participate in that future issue for an additional 5 000 000 shares.

Required

Show how the above would be recorded in the general journal of the company.

Problem 2.25 Debenture issue

The directors of Vatter Brothers Ltd resolved to issue 100 000 debentures of \$100, with \$50 being payable on application and \$50 being paid on allotment, and a prospectus was duly published indicating that the final date for applications was 20 September 20X5. By this date, applications had been received for 130 000 debentures together with the appropriate application amounts. The directors met on 30 September and accepted on a pro rata basis the applications of applicants for 115 000 debentures. The amounts received with these applications in excess of that due were used to apply to sums due on allotment. The unsuccessful debenture applicants had their application amounts returned on 4 October.

Required

Show general journal entries to record the above transaction.

Problem 2.26 Accounting for debenture issue

In 20X0, Sprouse and Moonitz Ltd issued 100 000 ten-year 8% debentures of \$100 at \$95. The issue was fully subscribed and all amounts were received by 1 January 20X1. The directors resolved to amortise any discount over the life of the debentures.

Required

Show general journal entries that relate to the above transactions for the period 1 January 20X1 to 31 December 20X2, assuming that the financial year of the company ends 31 December.

Problem 2.27 Initial and rights share issues

On 2 January 20X4, Mattessisch Ltd decided to issue 3 000 000 ordinary shares at \$1.80 and 1 000 000 8% preference shares at \$2 each. The terms of the issue were that \$1 per share was to accompany applications for the ordinary shares, while applications for the preference shares were to be with the full amount. The date 28 February was set as the last day for applications for both classes of shares. On 31 January the directors resolved to issue 1 000 000 ordinary shares to Paul Grady for the purchase of his business, which had net assets at the agreed value of \$2 000 000. By 28 February, applications had been received for 3 100 000 ordinary shares and 950 000 preference shares. The directors met and allotted the ordinary shares on a pro rata basis, applying the extra amounts received on application to that due on allotment which was to be by 25 March 20X4. They also allotted the preference shares. All allotment amounts due were received by the due date.

On 31 August the directors made a one-for-four rights issue of ordinary shares at \$2.50 per share. The issue date was to be 30 September 20X4 payable in full. All the rights were taken up and amounts received by the due date.

Required

Show general journal entries to record the above share issues transactions. (Show the purchase of Grady's business as net assets.) Also show the balances that would appear in the balance sheet of Mattessisch Ltd at 31 December 20X4, assuming no other transactions had taken place.

Problem 2.28 Share issues and options

RJ Chambers & Co Ltd was formed with the constitution limiting the shares that could be issued to 5 000 000 ordinary A shares and 2 000 000 non-voting ordinary B shares on 5 January 20X3. The company decided to offer to the public 3 000 000 of the ordinary A shares at a price of \$2.50. The shares were to be offered from 20 February, with the closing date for applications being 31 March 20X3 and with \$1 required with the applications, and \$1 due on allotment, with the remaining 50 cents to be called within four months of allotment.

The directors also decided that 1 000 000 of the ordinary B shares were to be issued as fully paid to the promoters for a payment of \$2 per share by 31 January and the remaining B shares were to be part of an employee incentive scheme.

By 31 March, applications for 3 500 000 shares had been received. The directors met and allotted the shares, with \$150 000 being returned to unsuccessful shareholders and any other excess application amounts received being transferred to

amounts due on allotment. Allotment amounts were due by 15 April and by that date all amounts due were received.

The call on the A shares of 50 cents was made on 30 June and due by 31 July 20X3. All call money was received except for that owing on 20 000 shares. On 6 August the directors met and forfeited these shares. They were then reissued to Will Baxter as fully paid for a payment of \$2.75 per share, with the amounts that had been paid by the previous shareholder being returned less \$2000 for reissue costs.

On 8 September the directors announced that they were to make a further issue of 1 000 000 ordinary A shares in 11 months' time for \$4 per share and issued a call option on these shares at 30 cents payable by 30 September. All the options were sold.

Required

Show general journal entries to record the above share issues transactions and indicate what the balance in the Cash at Bank account would be assuming that no other transactions had taken place.

Problem 2.29 Share options

Guggenheim Ltd grants 100 share options to each of its 500 employees. For each of the scenarios below show the general journal entries to record the issue of the options. For simplicity assume that the fair value of each share option is \$15.

- (a) The rights to exercise the options vest immediately.
- (b) The grant is conditional upon the employee working for the entity over the next three years. On the basis of a weighted average probability, the entity estimates that 20 per cent of employees will leave during the three-year period and therefore forfeit their rights to the share options.

Problem 2.30 Issue of shares in consideration for going concern

G & G Ltd was a public company formed to acquire the businesses of L Goldberg Pty Ltd and R Gynther Pty Ltd. It was agreed that the businesses were to be valued at \$1 500 000 for L Goldberg Pty Ltd and \$1 000 000 for R Gynther Pty Ltd and that the shareholders of these two companies were to be allotted 750 000 and 500 000 ordinary shares respectively in G & G Ltd for their companies' net assets. These shares were to be allotted on 1 February 20X8. On 15 January a prospectus was published offering 3 000 000 ordinary shares for \$3 per share. The closing date for applications for the shares was 31 March 20X8, with \$2 per share due with the application and \$1 per share on allotment. The public offering was oversubscribed by 500 000 shares. The allotment was made and allotment amounts were due by 30 April 20X8. Amounts received on oversubscription were returned to the unsuccessful applicants.

On 30 September the company made a further issue of 1 000 000 shares at \$3.50 to the public, payable in full on application by 31 October 20X8. The issue was fully subscribed.

Required

Prepare general journal entries to record the above transactions to 1 November and show the amount that would be included in the shareholders' equity section of a balance sheet if one were to be prepared at that date.

Problem 2.31 Issue of shares in consideration for going concern

In order to meet the increased demands on their companies, the owners of G Sewell Pty Ltd and T Bray Pty Ltd decided to form a new public company, Sewell Bray Ltd, to acquire their businesses. It was agreed that the businesses were to be valued at \$3 000 000 for G Sewell Pty Ltd and \$2 000 000 for T Bray Pty Ltd and that the shareholders of these two companies were to be allotted 1 500 000 and 1 000 000 shares respectively in Sewell Bray Ltd for their companies' net assets. These shares were to be allotted on 1 February 20X5. On 15 January a prospectus was published offering 5 000 000 ordinary shares for \$3 per share. The closing date for applications for the shares was 31 March 20X5, with \$2 per share due with the application and \$1 per share on allotment. The public offering was oversubscribed by 800 000 shares. The allotment was made and allotment amounts were due by 30 April 20X5. Amounts received on oversubscription were returned to unsuccessful applicants.

On 30 September the company made a further issue to the public of 3 000 000 shares at \$3.50 payable in full on application by 31 October 20X5. The issue was fully subscribed.

Required

Prepare general journal entries to record the above transaction to 1 November and show the amount that would appear in the shareholders' equity section of a balance sheet if one were to be prepared at that date.