CHAPTER 3
COMPANIES

What is a company?

A company is a legal person. This means that a company can enter into contracts with other persons. A company can also be sued by other persons and can employ other persons. The powers of a company and what acts a company can perform are set out in the **Companies Act.**

The company is a separate person to the shareholders. All the plant and equipment and other assets purchased by the company, belong to the company. Any liabilities the company incurs will be obligations of the company.

Formation of a company

The procedure for the formation and registration of a company is laid down in the Companies Act. Two documents, namely a memorandum of association and the articles of association, are prepared by the founders of the company and submitted to the Registrar of Companies for registration.

The memorandum of association deals with the external affairs of the company. It contains information about the purpose of the company and its main business activity, the name of the company and details of the share capital. The articles of association regulate the internal affairs of the company, for example meetings, voting rights, duties and powers of correctors.

Once the Registrar of Companies accepts these documents, he issues a certificate stating that the company has been incorporated (registered) and has come into existence. The company can now start business.

Finally a public company issues a prospectus inviting the general public to invest in company shares and so become owners or shareholders of the company.

Profits (losses) belong to the company unless dividends have been declared. As a legal entity a company can continue to exist indefinitely.

The capital of a company is divided into transferable units called shares. In the case of a public company these shares may be sold or bought freely on the open market (i.e. on the stock exchange). In the case of a private company the shares may be sold with the approval of the directors.

A public company normally obtains most of its capital by inviting the public to become members/shareholders by buying one or more shares. The company advertises its offer in a document called a prospectus. The Companies Act prescribes what information is given in the prospectus.

A share register is kept and the total number of shares in this register must agree with the number of issued shares in the share capital account in the general ledger. By buying shares in a company a person becomes a shareholder or member of the company. A person becomes a shareholder in a company through his or her shareholding in the company, and the share certificate, which he or she receives, is proof of his or her membership or shareholding.

Equity

The equity of a company consists of four main components:

- **Issued share capital –** this is the value of the shares issued.
- **Non distributable reserves -** are reserves that are not available for the payment of dividends to the shareholders e.g. the capital redemption reserve.
- **Distributable reserves –** are reserves, which are available for the payment of dividends to shareholders, e.g. the general reserve.
- **Accumulated profits –** Are profits from the previous year/s which were not transferred to a reserve or declared as a dividend.

Authorised share capital

This is the number and classes of shares which the company has noted in the memorandum of association. This information represents the maximum number of shares which the company is registered to sell – **not the number which have been sold.**

Is the various classes of shares the company is authorised to issue.

Issued share capital

This reflects the nominal value of each class of shares issued to shareholders at the date of the balance sheet. The difference between the issued and authorised share capital represent the unissued share capital.

The different classes of shares are:

- Ordinary shares
- Preference shares
- Redeemable preference shares
- Deferred shares

Ordinary shares

This is the basic form of "company equity". Ordinary shares are considered for dividends only after provision has been made for a dividend on preference shares. There is no limit on the amount of the dividend ordinary shareholders may receive on condition that there is income available for distribution and the rights attached to other classes of shares have been considered. As regards the right to participate in distribution in the case of the company's liquidation, ordinary shareholders are entitled to what remains after the other shareholders have been paid out. By exercising the voting power that goes with their shares, ordinary shareholders control the company.

Preference shares

These can only be issued if another class of share exists as well. Preference shares have certain preference rights compared with other classes of shares. These shares generally do not carry voting power.

Cumulative preference shares

The difference between preference shares and cumulative preference shares is that the fixed preferential dividend accumulates if not paid our. The company is obliged to pay all arrears as soon as sufficient funds become available.

Participating preference shares

These preference shares only share in the profits after payment of the preference dividend.

Convertible preference shares

These shares are convertible to ordinary shares at a specific date in the future.

Redeemable preference shares

The company may buy back i.e. redeem, these shares after a specific period at a predetermined price.

Share premium

This the total amount paid by shareholders in excess of the nominal value of shares issued and is included in the statement of changes in equity as well on the face of the balance sheet. Where capital consists of no par value shares the premium does not exist.

The share premium can be used for:

- issue of capitalisation shares
- writing off preliminary expenses
- writing off the premium payable on the redemption of redeemable preference shares

Reserves

A company's articles of association generally give directors the power to transfer part of the net profits to reserves and apply them for other purposes at their discretion.

Dividends

The board of directors usually recommends a dividend which is confirmed at an annual general meeting (i.e. the meeting agrees to a distribution of a certain amount of the distributable profit). A dividend which is confirmed at an annual general meeting, is usually known as a "final dividend".

Unless the articles of association stipulate otherwise, a company is not obliged to declare a dividend. It is therefore also not required to pay out all or part of the profit available for distribution to the shareholders.

Dividends on ordinary shares are not fixed at a predetermined amount. When declared, dividends on ordinary shares are usually quoted on a "per share" basis, i.e. "25 cents per share".

Annual financial statements

The Companies Act requires that the following statements are presented to the annual general meeting:

- Balance sheet
- Income statement
- Statement of changes in equity
- Cash flow statement
- Notes to the annual financial statements
- Directors' report
- Auditor's report

Share transactions

Capital invested in a company by shareholders is known as share capital. The maximum amount of share capital a company may issue, as described in its Memorandum and Articles of Association upon incorporation, is known as the authorized share capital. The share capital that the company issues is known as the issued share capital and can never be more than the authorized share capital.

Par value shares

These shares may be defined as shares to which a value has been assigned i.e. ordinary shares of R1.00 each. Should a par value share be issued for an amount higher than its par value e.g. R1.10 then the R0.10 is defined as the premium. The share premium is considered part of share capital, but is shown separately in the books and statements of the company.

No par value shares

These may be defined as shares to which no specific value is attached i.e. ordinary no par value shares. Should no par value shares be issued at R1.50 each the R1.50 will form part of the stated capital. The total proceeds from the issue of no par value shares are credited to the stated capital account – consequently there will be no share premium account.

Conversion of par value shares into no par value shares

When par value shares are converted into no par value shares, the amount that stands to the credit of the share capital account **and** the share premium account concerned must be transferred to the stated capital account.

The stated capital account may be utilised for writing off preliminary expenses and the expenses of or the commission paid on the creation or issue of no par value shares.

Conversion of no par value into par value shares

When no par value shares are converted into par value shares, the amount to the credit of the stated capital account for ordinary shares is simply transferred to the credit of the ordinary share capital account.

Application for, allocation and issue of shares

A public company usually obtains the greater part of its capital by inviting the public to buy shares. Payment is received together with the applications and when the application lists are closed and provided the minimum subscription is fully subscribed, the directors consider all the applications received and allocate shares in accordance with the powers vested in them by the Articles of Association of the company.

Accounting procedure:

Step 1.
On receipt of applications and monies:

Debit - Bank account with the application monies received
Credit - Application and allotment account

Step 2.
On allocation of shares sold at a premium:

Debit - Application and allotment
Credit - Ordinary share capital with the par value or
the amount received for no par value shares.
Credit - Share premium with the value of the premium received.

Step 3.
On allocation of shares offered at a discount:

Debit - Application and allotment with the monies received
Debit - Share discount with the amount of the discount allowed
Credit - Ordinary share capital with the total par value of the shares

Issue of capitalisation shares

Occasionally companies build up large reserves from net profits. For one reason or another it may no be desirable to distribute these reserves in the form of dividends ad this could adversely affect the cash position of the company. To enable the shareholders to derive some tangible benefits from these reserves, the company may decide to capitalize these reserves and distribute them among the shareholders in the form of capitalization shares. No cash is paid out, but each shareholder receives their rightful share of the reserves in the form of capitalisation shares.

A capitalisation issue is frequently also referred to as a bonus issue since no payment is received from shareholders for an issue of this kind.

Capitalisation shares may be issued by utilising the following reserves:
- Capital redemption reserve fund
- Share premium
- Accumulated profits
- General reserve

Accounting procedure:

1. **Shares issued at par**: depending on whether they are capitalised from either non-distributable or distributable reserves:

Debit - Capital redemption reserve fund – non-distributable reserve **or**
General reserve – distributable reserve
Credit - Ordinary share capital

2. **Shares issued above par**:

Debit - Relevant reserve account/s
Credit - Relevant share capital account
Credit - Relevant share premium account

EXAMPLE

Lexus Ltd with an issued share capital of 10 000 6% preference s shares of R1.00 each and 30 000 ordinary shares of R1.00 each had credit balances at 30 June 2003 of R8 000 and R4 000 respectively in the general reserve and the accumulated profits account. The company decided at a general meeting that, in order to protect its liquidity, it would not pay out cash dividends but would instead issue fully paid-up capitalization shares of R1.00 each at R1.10 to shareholders in the ratio of one capitalization share to every five preference shares held and one additional capitalization share to every six ordinary shares held. R500 of the balance on the accumulated profits account was, however to be carried over to the following year.

SOLUTION

Calculation of number of shares to be issued.

Preference shares
10 000 ÷ 5 = 2 000 shares to be issued

Ordinary shares
30 000 ÷ 6 = 5 000 shares to be issued

Reserves required
2 000 x R1.10 = R2 200
5 000 x R1.10 = <u>R5 500</u>
<u>R7 700</u>

Available accumulated profits = R4 000 – R500
= R3 500

The deficit of R4 200 (7 700 – 3 500) should therefore be made good from the general reserve.

Journal entries

2003		R	R
Jun-30	General reserve	4200	
	Accumulated profits		4200
	Transfer of part of the general reserve to be used for the issue of capitalisation shares		
	Accumulated profits	7700	
	Preference share capital		2000
	Preference share premium		200
	Ordinary share capital		5000
	Ordinary share premium		500
	Issue of fully paid-up captialisation shares in the ratio of one capitalisation share for every five preference shares and one capitalisation share for every six ordinary shares previously held.		

Underwriting share issues

When a company requires funds from the public, such funds are obtained by means of a shares issue. The company would normally employ a financial institution to handle such issues. This means that the underwriter guarantees that if the whole issue of shares is not taken up by the public the financial institution will itself take up the remainder of the unsold shares.

In return for furnishing a guarantee that the whole issue will be taken up the underwriter receives a commission. The commission is stipulated in the underwriting agreement and is payable in the form of either cash or paid-up shares in the company concerned. The commission is calculated on the portion being underwritten irrespective of whether the entire issue is taken up or not.

Section 80 of the Companies Act 61 of 1973 states that a company may remunerate the underwriter a maximum of 10% of the price at which the shares are issued or a lower rate provided in the articles of association.

Calculation of the underwriter's commission

Pearson Ltd underwrites an issue of 50 000 ordinary shares of R2.00 each in Shore Ltd. The underwriting commission is 7%. The public takes up 45 000 shares.

Commission = 50 000 x R2.00 x 7% = R7 000.

NB: The commission is not affected by the number of shares the public took up.

If the full issue is underwritten the underwriter is liable for the **difference** between the value of the full issue and the amount for which the public subscribed.

In the example above the public subscribed for 45 000 shares and Pearson Ltd is therefore liable for 5 000 x R2.00 = R10 000.

If the issue is partly underwritten, the underwriter has a pro rata liability. Suppose that in the example above Pearson Ltd underwrites only 50% of the issue, their liability is:
50% of the shortfall = 50% x 7% = R5 000.
The commission will be adjusted accordingly:
(50% x 50 000) x R2.00 x 7% = R3 500.

An issue may also be underwritten by joint underwriters, that is a single issue is underwritten by more than one body. If there is an undersubscription each of the underwriters is responsible for taking up that portion of the shares that corresponds to their portion of the underwriter's obligation.

Redemption of preference shares

One of the ways in which the Companies Act protects the rights of creditors of the company is that it deals specifically with the reduction of the capital of a company. A company can only reduce its share capital by means of a special resolution provided that:

- It is so authorised by its memorandum
- It has no creditors or all the creditors have agreed to such a reduction in the capital
- he court, under certain circumstances, permitted such a reduction.

An exception to the general rule regarding the reduction of capital concerns redeemable preference shares. Certain requirements in the Companies Act must however be adhered to. In short these are:

- No preference shares may be redeemed except
    - From profits of the company which would otherwise be available for dividends and /or
    - From the proceeds of a new issue of shares made for the purpose of the redemption
- When the redemption from profits method is used:
    - An amount equal to the nominal value of the par value shares which are redeemed or
    - An amount equal to the book value of the no par value shares which are redeemed must be transferred to a reserve fund known as the capital redemption reserve fund.

The capital redemption reserve fund (CRRF) is a statutory non-distributable reserve, created when redeemable preference shares are redeemed without replacing the capital with other shares.

The purpose of the transfer is to transfer distributable reserves into permanent capital of the company. The transfer is shown in the statement of changes in equity . This entry protects the creditors of the company as the CRRF may not be distributed to shareholders.

The credit balance on the CRRF may only be used to issue capitalization shares. It should be clear that the redemption of redeemable preference shares is not considered to constitute a reduction of the company's authorised share capital.

Premium on redemption of preference shares

Should a premium be payable on the redemption, provision must be made for its repayment on redemption either, from the profits of the company or /and from an existing share premium account. If the redemption takes place by issuing new shares at a premium, the new share premium can also be used to write off the premium on the redemption of preference share.

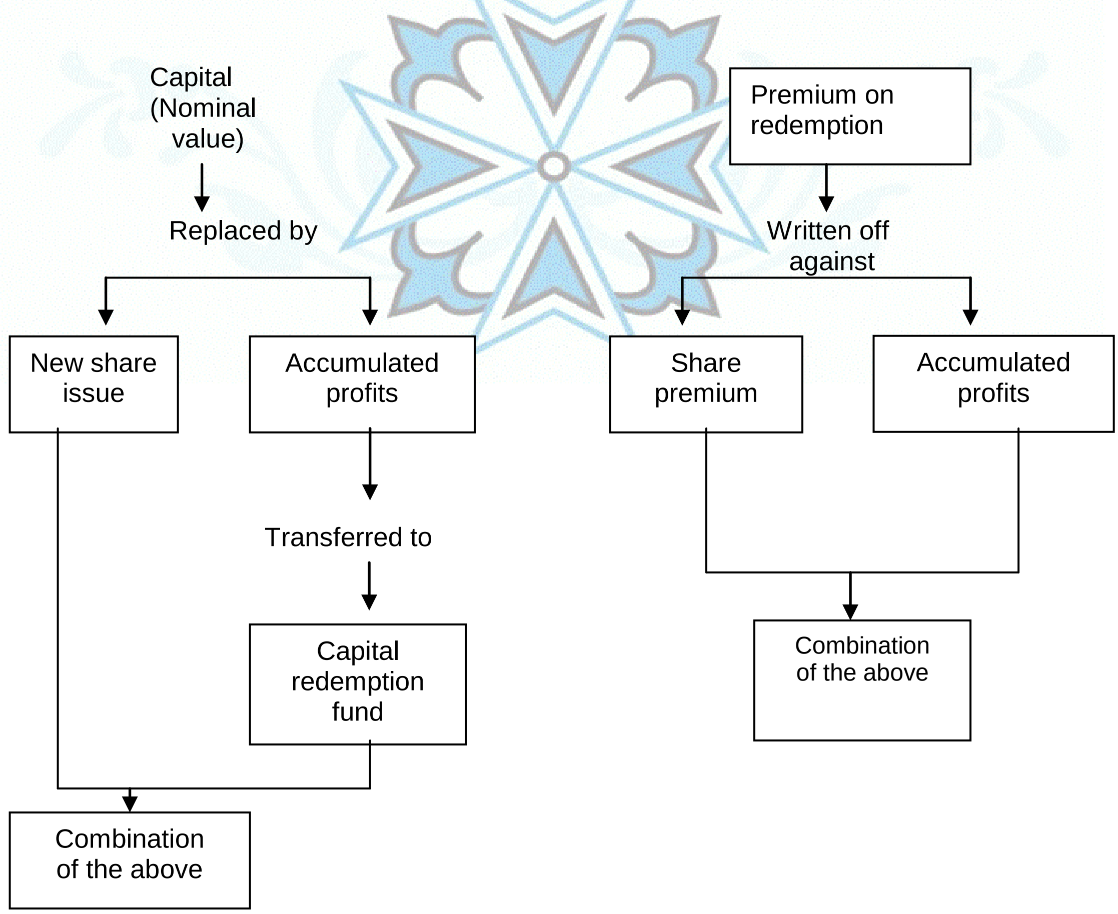
With regard of the premium on redemption of preference shares the Companies Act requires:

- The premium on redemption should be determined at a date proceeding the allotment of the redeemable preference shares, and
- The conditions of redemption should be noted in the Articles of Association of the company before the share premium account may be used for writing off a premium on redemption.

Provision for dividends on shares which are to be redeemed must be made from current or accumulated profits available for distribution. Where the redeemable preference shares are cumulative, accumulated dividends should also be provided for.

Accounting procedures

The following diagram summarises the accounting procedures with regard to the redemption of redeemable preference shares.



EXAMPLE

The following is an extract from the accounting records of Pacer Ltd at 28 February 2003. (The income statement and balance sheet had been prepared).

Authorised share capital	R
400 000 ordinary shares of R1.00 each	400 000
50 000 12% redeemable preference shares of R1.00 each	50 000
Issued share capital	
300 000 ordinary shares of R1.00 each	300 000
50 000 12% redeemable preference shares of R1.00 each	50 000
Share premium	30 000
Accumulated profits	180 000
Cash and cash equivalents	80 000
Non-current assets (property, plant and equipment)	540 000
Trade and other payables	60 000

The 12% redeemable preference shares are redeemable on 1 March 2003 at a premium of R0.20 per share.

Required

1. Show the necessary journal entries to record the redemption.
2. Prepare the balance sheet of Pacer Ltd at 1 March 2003 after the redemption was recorded. Use only the information provided.

SOLUTION 1 – Redemption of redeemable preference shares by means of a new share issue.

The board of directors decided to issue 50 000 ordinary shares at a premium of R0.15 per share in order to redeem the preference shares on 1 March 2003. The new issue was fully taken up on issue. All the transactions took place on 1 March 2003.

Calculation:

	Capital redeemed R	Premium on redemption R
Shares to be redeemed		
50 000 preference shares of R1.00	50,000.00	
Premium payable on redemption (50 000 x R0.20)		10,000.00
Redemption by means of the issue of new shares		
Ordinary shares		
Capital (50 000 x R1.00)	-50,000.00	
Premium (50 000 x R0.15)		-7,500.00
Balance on premium to be provided from existing premium account		2,500.00
Balance on existing premium account		30,000.00

Pacer Ltd

Journal entries at 1 March 2003

	R	R
Preference share capital	50,000.00	
Premium payable on redemption	10,000.00	
Preference shareholders		60,000.00
Redemption of 12% redeemable preference shares at a premium of R0.20 per share		
Preference shareholders	60,000.00	
Bank		60,000.00
Payment of preference shareholders		
Share premium	10,000.00	
Premium payable on redemption		10,000.00
Premium payable on redemption, written off against the premium account		
Bank	57,500.00	
Application and allotment: Ordinary shares		57,500.00
Cash received on issue of new shares (50 000 x R1.15)		
Application and allotment: Ordinary shares	57,500.00	
Ordinary share capital		50,000.00
Share premium		7,500.00
Allocation of new shares		

Balance sheet at 1 March 2003

		R
Assets		
Non-current assets		540,000.00
Property, plant and equipment		540,000.00
Current assets		77,500.00
Cash and cash equivalents (80 000 - 60 000 + 57 500)		77,500.00
TOTAL ASSETS		617,500.00
Equity and liabilities		
Capital and reserves		557,500.00
Share capital		377,500.00
Authorised:	R	
400 000 ordinary shares of R1.00 each	400,000.00	
50 000 12% redeemable preference shares of R1.00 each	50,000.00	
Issued:		
350 000 ordinary shares of R1.00 each		350,000.00
Share premium (30 000 + 7 500 - 10 000)		27,500.00
Distributable reserves:		180,000.00
Accumulated profits		180,000.00
Current liabilities		60,000.00
Trade and other payables		60,000.00
TOTAL EQUITY AND LIABILITIES		617,500.00

SOLUTION 2 – Redemption of redeemable preference shares from accumulated profits

Use the same example information **except** that the directors decided to redeem the preference shares from accumulated profits without making a new issue of shares.

Calculation:

	Capital redeemed R	Premium on redemption R
Shares to be redeemed		
50 000 preference shares of R1.00	50,000.00	
Premium payable on redemption (50 000 x R0.20)		10,000.00
Redemption from accumulated profits	-50,000.00	-10,000.00

Pacer Ltd

Journal entries at 1 March 2003

	R	R
Preference share capital	50,000.00	
Premium payable on redemption	10,000.00	
Preference shareholders		60,000.00
Redemption of 12% redeemable preference shares at a premium of R0.20 per share		
Preference shareholders	60,000.00	
Bank		60,000.00
Payment of preference shareholders		
Accumulated profits	10,000.00	
Premium payable on redemption		10,000.00
Premium payable on redemption, written off against profits (50 000 x R0.20)		
Accumulated profits	50,000.00	
Capital redemption reserve fund		50,000.00
Transfer to CRRF of nominal value of the preference shares which were redeemed (50 000 x R1.00)		

Balance sheet at 1 March 2003

		R
Assets		
Non-current assets		540,000.00
Property, plant and equipment		540,000.00
Current assets		20,000.00
Cash and cash equivalents (80 000 - 60 000)		20,000.00
TOTAL ASSETS		560,000.00
Equity and liabilities		- -
Capital and reserves		500,000.00
Share capital		330,000.00
Authorised:	R	
400 000 ordinary shares of R1.00 each	400,000.00	
50 000 12% redeemable preference shares of R1.00 each	52,000.00	
Issued:		
300 000 ordinary shares of R1.00 each		300,000.00
Share premium		30,000.00
Reserves:		170,000.00
Distributable reserves:		
Accumulated profits (180 000 - 60 000)		120,000.00
Non-distributable reserves		
Capital redemption reserve fund		50,000.00
Current liabilities		60,000.00
Trade and other payables		60,000.00
TOTAL EQUITY AND LIABILITIES		560,000.00

Note: The premium payable on redemption could also have been written off against the share premium account.

SOLUTION 3 - Redemption of redeemable preference shares partially from profits and partially by the issue of new shares

Use the same EXAMPLE information **except** the board of directors decided that the redemption should be financed as follows:

1. An issue of 30 000 ordinary shares at a premium of R0.20 per share
2. The balance from the accumulated profits
3. The above decisions should be implemented so as to have a minimum effect on distributable reserves.

Calculation:

	Capital redeemed R	Premium on redemption R
Shares to be redeemed		
50 000 preference shares of R1.00	50,000.00	
Premium payable on redemption (50 000 x R0.20)		10,000.00
Redemption		
From new share issue		
30 000 ordinary shares at a premium of R0.20 per share	-30,000.00	-6,000.00
From accumulated profits	-20,000.00	
From existing share premium		-4,000.00

Pacer Ltd

Journal entries at 1 March 2003

	R	R
Preference share capital	50,000.00	
Premium payable on redemption	10,000.00	
Preference shareholders		60,000.00
Redemption of 12% redeemable preference shares at a premium of R0.20 per share		
Preference shareholders	60,000.00	
Bank		60,000.00
Payment of preference shareholders		
Share premium	10,000.00	
Premium payable on redemption		10,000.00
Premium on redemption written off against the share premium account		
Bank	36,000.00	
Application and allotment: Ordinary shares		36,000.00
Cash received on the issue of 30 000 ordinary shares of R1.00 each at a premium of R0.20		
Application and allotment: Ordinary shares	36,000.00	
Ordinary share capital		30,000.00
Share premium		6,000.00
Allotment of shares		
Accumulated profits	20,000.00	
Capital redemption reserve fund		20,000.00
Transfer to CRRF of the nominal value of preference shares redeemed from accumulated profits		

Balance sheet at 1 March 2003

	R	R
Assets		
Non-current assets		540,000.00
Property, plant and equipment		540,000.00
Current assets		56,000.00
Cash and cash equivalent (80 000 – 60 000 + 36 000)		56,000.00
TOTAL ASSETS		596,000.00
Equity and liabilities		
Capital and reserves		536,000.00
Share capital		356,000.00
Authorised:		
400 000 ordinary shares of R1.00 each	400,00.00	
50 000 12% redeemable preference shares of R1.00 each	52,000.00	
Issued:		
300 000 ordinary shares of R1.00 each		330,000.00
Share premium (30000 – 100000 + 6000)		26,000.00
Reserves:		180,000.00
Distributable reserves:		
Accumulated profits (180 000 – 20 000)		160,000.00
Non-distributable reserves		
Capital redemption reserve fund		20,000.00
Current liabilities		60,000.00
Trade and other payables		60,000.00
TOTAL EQUITY AND LIABILITIES		596,000.00

SOLUTION 4 - Redemption of redeemable preference shares from profits and by means of a new share issue and dividends payable to preference shareholders.

Use the same EXAMPLE and SOLUTION 3 information **except** the board of directors also decided that preference dividends for the year of R6 000 (R50 000 x 12%) should be declared and paid.

Pacer Ltd

Journal entries at 1 March 2003

	R	R
Preference share capital	50,000.00	
Premium payable on redemption	10,000.00	
Preference shareholders		60,000.00
Redemption of 12% redeemable preference shares at a premium of R0.20 per share		
Preference shareholders	60,000.00	
Bank		60,000.00
Payment of preference shareholders		
Accumulated profits	10,000.00	
Premium payable on redemption		10,000.00
Premium payable on redemption, written off against profits (50 000 x R0.20)		
Accumulated profits	50,000.00	
Capital redemption reserve fund		50,000.00
Transfer to CRRF of nominal value of the preference shares which were redeemed (50 000 x R1.00)		
Accumulated profits	6,000.00	
Dividends on preference shares		6,000.00
Dividend expense account written off against profits		

Balance sheet at 1 March 2003

		R
Assets		
Non-current assets		540,000.00
Property, plant and equipment		540,000.00
Current assets		50,000.00
Cash and cash equivalents		50,000.00
(80 000 - 66 000 + 36 000)		
TOTAL ASSETS		590,000.00
Equity and liabilities		
Capital and reserves		530,000.00
Share capital		356,000.00
Authorised:	R	
400 000 ordinary shares of R1.00 each	400,000.00	
50 000 12% redeemable preference shares of R1.00 each	52,000.00	
Issued:		
300 000 ordinary shares of R1.00 each		330,000.00
Share premium (30000-100000+6000)		26,000.00
Reserves:		174,000.00
Distributable reserves:		
Accumulated profits (180 000 - 20 000)		154,000.00
Non-distributable reserves		
Capital redemption reserve fund		20,000.00
Current liabilities		60,000.00
Trade and other payables		60,000.00
TOTAL EQUITY AND LIABILITIES		590,000.00

Debenture transactions

By law a debenture is a debt owed by a company to a debenture holder on the conditions specified in the debenture deed.

A debenture deed contains the conditions upon which the debentures are issued and normally includes the following:

- Whether or not the debentures are secured
- The assets encumbered, if secured
- The interest rate
- The period of the debenture loan
- Repayment conditions
- The possibility of converting debentures into shares where applicable
- Whether redeemed debentures may be re-issued at a later date.

Debentures do not form part of the equity in a company but are classified under non-current liabilities. Debenture holders receive a fixed interest irrespective of whether the company is making a profit.

Interest on debentures is a finance cost and is always shown on the income statement. Debenture holders have an undisputed claim against the company for the regular payment of debenture interest and they can always rely on the security of the debentures for the payment of their interest.

Can be classified as follows:

- According to security
  1. Secured – for example by any asset or by a mortgage over assets
  2. Unsecured – the debenture liability is not secured by any asset.

- According to preferential rights:
  1. For example, first debentures or second debentures.

- According to permanence:
  1. For example, redeemable debentures or convertible debentures. These debentures are convertible into shares, usually ordinary shares. The conditions of conversion frequently provide that the debentures are convertible into ordinary shares at a fixed price after a certain period, if the debenture holder or the company so chooses.

Debenture issues

It is necessary to differentiate between the face value and the actual issue price of debentures when they are issued. The face value if a debenture is its nominal value i.e. R100 debentures. The issue price is the actual amount paid for the debenture and can be indicated as a percentage of the face value i.e. R100 debentures issued at 105% or at R97.

This means that debentures may be issued at par, at a premium or at a discount. The premium or discount arising from the debenture issue, must be allocated to the income statement for the period during which the debentures were in issue. The premium or discount should be deferred in the books of the company that issued the debentures and then systematically written off or added to the interest in the income statement over the period during which the debentures were issued.

EXAMPLE

Debentures issued at par

On 1 January 2003 Cross Limited issued 1 000 10% debentures of R100 each at par. The debentures are repayable at par by 1 January 2013 and interest is payable annually on 30 December of each year. The security for the debentures is a mortgage on land and buildings. Cross Limited's year end is 31 December.

Accounting procedure:

Journal

Date		Debit	Credit
2003		R	R
01-Jan	Bank	100,000.00	
	10% R100 Debentures		100,000.00
	Issue of 1 000 10% debentures at par		
31-Dec	Interest on debentures	10,000.00	
	Bank		10,000.00
	Interest paid to debenture holders		

Note to the financial statements for the year ended 31 December 2003

Non- current liability

	R
Secured	
1 000 10% Debentures of R100 each	100,000.00

The debentures are secured by a mortgage on land and buildings, are fully .
repayable at par on or before 31 December 2013.
The debentures bear interest at 10% per annum.

Debentures issued at a premium

On 1 January 2003 Cross Limited issued 1 000 10% debentures of R100 each at R105. The debentures are repayable at par by 1 January 2013 and interest is payable annually on 30 December of each year. The security for the debentures is a mortgage on land and buildings. Cross Limited's year end is 31 December.

Journal

Date		Debit	Credit
2003		R	R
01-Jan	Bank	105,000.00	
	10% R100 Debentures		100,000.00
	Premium on issue of debentures		5,000.00
	Issue of 1 000 10% debentures at R105		
31-Dec	Interest on debentures	10,000.00	
	Bank		10,000.00
	Interest paid to debenture holders		
	Premium on issue of debentures *	500.00	
	Interest on debentures		500.00
	Matching premium to interest paid over term		
	of issue		

* The premium of R5 000 is spread evenly over the ten year period of issue since the funds are available for the full term.

Note to the financial statements for the year ended 31 December 2003

<u>Non- current liability</u>

	R
Secured	
1 000 10% Debentures of R100 each	100,000.00
Premium on issue of debentures	4,500.00
Amount received	5,000.00
Written off during the year	-500.00
	104,500.00

The debentures are secured by a mortgage on land and buildings, are fully .
repayable at par on or before 31 December 2013.
The debentures bear interest at 10% per annum.

Debentures issued at a discount

On 1 January 2003 Cross Limited issued 1 000 10% debentures of R100 each at 96%. The debentures are repayable at par by 1 January 2013 and interest is payable annually on 30 December of each year. The security for the debentures is a mortgage on land and buildings. Cross Limited's year end is 31 December.

Journal

Date		Debit	Credit
2003		R	R
01-Jan	Bank	96,000.00	
	Discount on issue of debentures	4,000.00	
	10% R100 Debentures		100,000.00
	Issue of 1 000 10% debentures at R105		
31-Dec	Interest on debentures	10,000.00	
	Bank		10,000.00
	Interest paid to debenture holders		
	Interest on debentures	400.00	
	Discount on issue of debentures		400.00
	Matching discount to interest paid over term of issue		

* The discount of R4 000 is spread evenly over the ten year period of issue since the funds are available for the full term.

Note to the financial statements for the year ended 31 December 2003

<u>Non- current liability</u>

		R
Secured		
1 000 10% Debentures of R100 each		100,000.00
Discount on issue of debentures		3,600.00
Amount discount	4,000.00	
Written off during the year	-400.00	
		96,400.00

The debentures are secured by a mortgage on land and buildings, are fully .
repayable at par on or before 31 December 2013.
The debentures bear interest at 10% per annum.

Redemption of debentures

The ways in which debentures may be redeemed are:

- Drawing – where debentures have to be redeemed over a number of years an annual drawing would take place to determine which debentures should be redeemed in the year in question.
- Redemption may take place upon demand i.e. when the holder of the debenture requests redemption.
- Redemption may take place at a predetermined future date. In this case a date is fixed for redeeming the debenture.

Debentures may be redeemed in full or in instalments, and either at par or at a premium. It is doubtful whether they will be redeemed at a discount. It is important not confuse premium on redemption with premium on issue.

Redemption at par

Agar Ltd issued 1000 7% debentures of R100 each at par on 1 January 2003. The debentures are unsecured and fully redeemable at par on 1 January 2007.

Journal

Date		Debit	Credit
2003		R	R
01-Jan	Bank	100,000.00	
	10% R100 Debentures		100,000.00
	Issue of 1 000 10% debentures at par		
31-Dec	Interest on debentures	7,000.00	
to 31 Dec	Bank		7,000.00
2006	Interest paid to debenture holders		
2007	7% R100 Debentures	100,000.00	
Jan-01	Bank		100,000.00
	Repayment to debenture holders at par		

Redemption at a premium

Agar Ltd issued 1000 7% debentures of R100 each at par on 1 January 2003. The debentures are unsecured and fully redeemable at R102 each on 1 January 2007.

Journal

Date		Debit	Credit
2003		R	R
01-Jan	Bank	100,000.00	
	10% R100 Debentures		100,000.00
	Issue of 1 000 10% debentures at par		
31-Dec	Interest on debentures	7,500.00	
	Bank		7,000.00
	Provision for premium on redemption		500.00
	Interest paid to debenture holders and		
	provision for premium on redemption *		
2004	Interest on debentures	7,500.00	
Dec-31	Bank		7,000.00
	Provision for premium on redemption		500.00
	Interest paid to debenture holders and		
	provision for premium on redemption *		

- Provision for premium = 102 000 – 100 000 = 2000 ÷ 4 = R500 annually.

Similar journals will also be drafted for 31/121005 and 31/12/2006. The provision for premium on redemption therefore increased by R500 a year until it reached R2000 on 31 December 2006 i.e. the amount payable on redemption on the debentures.

Non- current liability

	R
Unsecured	
1 000 7% Debentures of R100 each	100,000.00
Provision for premium on redemption	1,500.00
	101,500.00

The debentures are unsecured and fully .
repayable on or before 31 December 2007.
The debentures bear interest at 7% per annum.

The journal entry on 1 January 2007 when the debentures are redeemed will look as follows:

		Debit	Credit
		R	R
2007	Interest on debentures	100000	
Jan-01	7% R100 Debentures	2,000.00	
	Provision for premium on redemption		102,000.00
	Bank		
	Repayment of debenture holders at a premium		

Redemption at a premium, repayment in instalments

Agar Ltd issued 1000 7% debentures of R100 each at par on 1 January 2003. The debentures are unsecured and redeemable in four equal annual instalments of R102 each. R102 each. Repayment begins on 31 December 2004.

Redemption schedule

Year ended	Debenture funds available during the year	Portion of premium that must be provided for	Annual provision for premium on redemption	Annual interest at 7%
	R	R	R	R
31.12.2003	100,000.00	100,000.00 250,000.00	800.00	7,000.00
31.12.2004	75,000.00	75,000.00 250,000.00	600.00	5,250.00
31.12.2005	50,000.00	50,000.00 250,000.00	400.00	3,500.00
31.12.2006	25,000.00	25,000.00 250,000.00	200.00	1,750.00
	250,000.00	250,000.00 250,000.00	2,000.00	

Calculations

1. 1 000 x R100 debentures = R100 000. These 1 000 debentures were in issue for the period 1.1.2003 to 31.12.2003. The annual interest was calculated as R100 000 x 7% = R7 000.
2. At 31.12.2003 a quarter (four equal instalments of the 1 000 debentures had been redeemed. For the year 1.1.2004 to 31.12.2004 there were therefore 750 debentures in issue. The annual interest on these debentures was R75 000 x 7% = R5 250.
3. The premium payable on the redemption of debentures is R2 per debenture i.e. R102 R100. The premium is not evenly apportioned over the four year period, however, but is apportioned in proportion to the total Rand value of debentures in issue per year.

For example: 31.12.2003 $\frac{100\ 000}{250\ 000} \times 2\ 000.00 = R800$

31.12.2004 $\frac{75\ 000}{250\ 000} \times 2\ 000.00 = R600$

The journal entries for the year ended 31 December 2004 are as follows:

Journal

		Debit	Credit
2002		R	R
Dec-31	Interest on debentures	5,250.00	
	Bank		5,250.00
	Payment of interest to debenture holders		
	Interest on debentures	600.00	
	Provision for premium on redemption		600.00
	Premium provided on redemption		
	Provision for premium on redemption	500.00	
	7% Debentures	25,000.00	
	Bank		25,500.00
	Repayment of debenture holders -		
	250 debentures at R102		

Note: R600 was provided for the premium payable on the redemption of the debentures, however, only R500 per year was paid on the redemption of the 250 debentures.

Ledger of Agar Ltd

7% Debentures

2003			R	2003			R
Dec-31	Bank		25000	Dec-31	Bank		100000
2004							
Dec-31	Bank		25000				
2005							
31-Dec	Bank		25000				
2006							
31-Dec	Bank		25000				
			100000				100000

7% Debentures

2003			R	2003			R
Dec-31	Bank		7000	Dec-31	Profit and loss		7800
	Provision for premium		800				
	on redemption						
2004				2004			
Dec-31	Bank		5250	Dec-31	Profit and loss		5850
	Provision for premium		600				
	on redemption						
2005				2005			
31-Dec	Bank		400	31-Dec	Profit and loss		3900
	Provision for premium		3500				
	on redemption						
2006				2006			
31-Dec	Bank		1750	31-Dec	Profit and loss		1950
	Provision for premium		200				
	on redemption						

Provision for premium on redemption

2003			R	2003			R
Dec-31	Bank		500	Dec-31	Interest on debentures		800
2004				2004			
Dec-31	Bank		500	Dec-31	Interest on debentures		600
2005				2005			
31-Dec	Bank		500	31-Dec	Interest on debentures		400
2006				2006			
31-Dec	Bank		500	31-Dec	Interest on debentures		200
			2000				2000

QUESTION C1

Development Ltd is a company which was registered with an authorised share capital of R200 000 divided into 200 000 ordinary shares of R1,00 each.

On the basis of favourable prospecting reports the directors decided to offer 100 000 of the shares to the public at R1,20 per share. The company applied to the Johannesburg Stock Exchange for a listing, and the whole issue was underwritten by Merchant Bank Ltd at 2% calculated on the total offer price.

On 1/3/2004 applications for 180 000 shares were received. With a view to retaining control, and in order to ensure an active market for the shares, the following allocation scheme was approved and ratified at a meeting of the board of directors.

(1) Applications for 100 and 200 shares each were granted in full.
(2) In the case of applications for 500 to 1 000 shares each, half the number was granted.
(3) In the case of applications for over 1 000 shares each, only a quarter was granted.

The following is a breakdown of the applications received:

Number of shares per application	Number of applications received	Number of shares
100	400	40 000
200	100	20 000
500	20	10 000
1 000	30	30 000
2 000	20	40 000
4 000	10	40 000
		180 000

The stock exchange listing was granted and during the first week the price of Development Ltd rose to R2,10 after which it gradually dropped back to R1,80.

On 31/3/2005 a landslide upset production at the company. The exchange price of the shares dropped to R0.85. Additional capital was urgently needed. The board of directors decided to offer the 100 000 unissued shares at R0.75 per share, in order to make them attractive to the shareholders and the capital market. The necessary court order was issued. Approval for the additional issue was obtained from the stock exchange. Underwriting was arranged with Merchant Bank at 4% commission payable in cash, calculated on the total offer price. Applications for only 60 000 shares were received on 30/4/2005. By 31/5/2005 all the transactions had already been completed.

Required:

1. Record the journal entries required bringing the above transactions to book.
2. Show the relevant ledger accounts, duly closed at 31 May 2005.
3. Show the relevant balances on the balance sheet at 31 May 2005.

QUESTION C2

Jacko Limited was incorporated on 1 June 2004 with an authorized share capital of:

10 000 ordinary no par value shares
10 000 6% redeemable preference shares of R1 each

On 1 July 2004 the following shares are offered:

4 000 ordinary no par value shares at R1,50 each
6 000 6% redeemable preference shares at R1,50 each

On 1 August 2004 applications were received for:

2 000 ordinary shares
8 000 no par value ordinary shares

The following shares were allotted by the directors on 15 August 2004:

2 000 ordinary shares
6 000 preference shares

On 17 August 2004 all surplus application money was returned to unsuccessful applicants.

Required:

1. Show the journal entries to record the above transactions.
2. Complete the following ledger accounts:

   Bank
   Application and allotment account: Ordinary shares
   Application and allotment account: Redeemable preference shares
   Ordinary shares stated capital
   6% redeemable preference share capital
   Share premium

QUESTION C3

Mayfair Fashions Limited was incorporated on 1 January 2004 with an authorised share capital of 500 000 ordinary shares of no par value.
The following transactions took place during the issue of the shares:

2004	
Mar 31	Mayfair Fashions Limited offered 100 000 ordinary shares to the public at R2 each.
May 31	Application money for 105 000 shares was received and the directors allotted all the shares offered. Surplus application money was returned.
July 15	A further 150 000 ordinary shares were offered to the public at R2.10 per share.
Aug 20	Application money for 145 000 shares was received and the shares were allotted.

Required:

Show the entries in the ledger of Mayfair Fashions Limited.

QUESTION C4

Campas Limited is registered with an authorized share capital of:

200 000 ordinary shares of R2 each.
100 000 18% redeemable preference shares of R1 each.

The following transactions took place:

2004	
Feb 1	The directors offered 100 000 ordinary shares at R1,50 each and 100 000 18% redeemable preference shares at R1,50 per share for subscription. The whole issue was underwritten by JHB Bank at 2% calculated on the total offer price.
April 15	Application for 90 000 ordinary shares and 180 000 18% redeemable preference shares were received.
April 20	The directors allotted the maximum number of shares possible and returned the surplus application money with letters of regret to the unsuccessful applicants.

Required:

1. Show the ledger entries for the above transactions.
2. show the equity section of the balance sheet of Campas Limited on 30 April 2004.

QUESTION C5

Kamper Limited was incorporated on 1 January 2004 with an authorized capital of R100 000 divided into 100 000 ordinary shares of R1 each of which 80 000 are offered to the public.

Applications for shares close on 15 January 2004.

On 17 January 2004 70 000 applications were received and allotted. Share issue costs paid per cheque: R3 000.

On 30 June 2004 Kamper Limited offered a further 20 000 ordinary shares to the public at a premium of 20 cents per share. When the applications closed on 31 July 2004 30 000 shares had been applied for and the cheques were received in payment of the applications.

On 1 August 2004 20 000 shares were allotted and the surplus application money was returned to the unsuccessful applicants. Share issue costs amounted to R2 000.

Required:

3. Show the journal entries to record the above transactions.
4. Post the general journal to the ledger accounts.

QUESTION C6 : REDEMPTION AT PAR – NEW SHARES ARE ISSUED

Balances in the books of Alpha Ltd at 28 February 2005:

	R
10% Redeemable preference shares of R1 each	50 000
Share premium account	2 000
Accumulated profit 1 March 2000	4 000

The redeemable preference shares are redeemed at par and the redemption is financed by the issue of 25 000 ordinary shares of R2 at par.

QUESTION C7 : REDEMPTION AT PAR – NO NEW SHARES ARE ISSUED

Balances in the books of Beta Ltd at 28 February 2005:

	R
10% Redeemable preference shares of R1 each	50 000
Share premium account	4 000
Accumulated profit 1 March 2000	80 000
Cash in bank	60 000

The redeemable preference shares are redeemed at par. No new shares are issued.

QUESTION C8 : REDEMPTION AT A PREMIUM – NEW SHARES ARE ISSUED, SHARE PREMIUM IS AVAILABLE

Balances in the books of Blue Ltd at 28 February 2005:

	R
10% Redeemable preference shares of R1 each	50 000
Share premium account	6 000
Accumulated profit 1 March 2000	4 000
Cash in bank	8 000

The redeemable preference shares are redeemed at a premium of 10%. The company decides to issue 25 000 ordinary shares of R3 each at par.

QUESTION C9 : REDEMPTION AT A PREMIUM – NEW SHARES ARE ISSUED AT A PREMIUM, NOT SUFFICIENT SHARE PREMIUM AVAILABLE

Balances in the books of Jack Ltd at 28 February 2005:

	R
10% Redeemable preference shares of R1 each	50 000
Share premium account	500
Accumulated profit 1 March 2000	80 000
Cash in bank	30 000

The redeemable preference shares are redeemed at a premium of 10c per share. Jack Ltd decided to issue 20 000 ordinary shares of R2 each at a premium of 5c per share.

QUESTION C10 : REDEMPTION AT A PREMIUM – NO NEW SHARES ARE ISSUED, NOT SUFFICIENT SHARE PREMIUM AVAILABLE

Balances in the books of Zeta Ltd at 28 February 2005:

	R
10% Redeemable preference shares of R1 each	50 000
Share premium account	1 500
Accumulated profit 1 March 2000	20 000
General reserve	40 000
Cash in bank	60 000

The redeemable preference shares are redeemed at a premium of 10c per share. No new shares are issued.

QUESTION C11

The trial balance of Sun Limited on 31 March 2005, the last day of the current financial year, is as follows:

	Dr R	Cr R
Ordinary share capital		300 000
Share premium		30 000
Accumulated profits		180 000
Preference share capital		75 000
Proceeds on issue of shares		40 000
Land and buildings	300 000	
Plant and machinery	140 000	
Inventories	105 000	
Repayment to preference shareholders	84 375	
Trade and other payables		60 000
Bank	51 625	
Underwriting commission	4 000	
	685 000	685 000

The company was incorporated on 1 November 1997 with an authorized share capital of 1 000 000 ordinary shares of 50c each and 450 000 10% redeemable preference shares of 50c each. At incorporation the company issued 300 000 ordinary shares at par and on 1 January 1998 they issued 300 000 ordinary shares at a premium of 5c each. 150 000 preference shares were issued on 1 April 1998 at a premium of 10c per share and the balance on the share premium account has remained intact since it was created. The articles of the company allow the utilisation of the share premium account for providing the premium on redemption of preference shares.

During the current financial year the following transactions took place, but <u>only the cash transactions were recorded:</u>

1. On 30 April 2004 the ordinary shares were converted to shares with no par value.

2. As the preference shares had to be redeemed on 30 June 2004 at a premium of 5c per share, the company decided on 15 April 2004 to finance the redemption partly by the issue of ordinary shares at 80c each and partly out of the available bank balance.

3. Therefore 50 000 ordinary shares were offered to the public on 30 April 2004 and the issue was fully underwritten by Box Ltd for a commission of 6% of the issue price.

4. On 20 June 2004 45 000 applications were received from the public and the shares were allotted. No entries were passed for the issue expenses of R500 and the underwriting commission payable.

5. On 30 June 2004 the preference shares were redeemed and the cheques, which included the preference dividends to date, were posted to preference shareholders.

6. All commission and issue expenses are to be written off immediately, making minimum use of distributable reserves.

7. On 31 July 2004 capitalisation shares were issued in the ratio of one ordinary share at 80c for every five ordinary shares already held. This transaction must be recorded in such a way as to have the minimum effect on distributable reserves.

Required:

Prepare journal entries necessary to complete the above transactions. Show all calculations.

QUESTION C12

The following balances appear on the trial balance of Trader Ltd on 31 December 2005:

	R
Ordinary share capital	250 000
10% redeemable preference share capital	75 000
Share premium	18 000
Capital redemption reserve fund	70 000
Accumulated profit	60 000
Net assets (including a favourable bank balance of R80 000)	250 000

Additional information:

1. The authorised share capital consists of 900 000 ordinary shares of R2 each and 200 000 10% redeemable preference shares of 50c each.

2. The directors decide to immediately redeem the preference shares at a premium of 10c per share. The redemption will take place through the issue of 25 000 ordinary shares at par and the balance out of available distributable reserves. Preference dividends were paid to date.

3. Share issue expenses amount to R1 000 and must be written off.

4. After the conclusion of the above transactions, capitalisation shares will be issued in the ratio of 1 ordinary share at par for each 10 shares held.

5. The use of distributable reserves must be minimised in all cases.

Required:

Journalise the above transactions (including cash transactions) in the books of Tops Ltd.

QUESTION C13

The following balances were extracted from the books of Murray Ltd at 28 February 2005:

	R
Ordinary shares of R1 each	200 000
10% redeemable preference shares of R2 each	100 000
Share premium	15 000
Non-distributable reserve	50 000
Revaluation of fixed property	
Distributable reserves	12 000
General reserve	2 000
Accumulated profit	10 000
Cash in bank	20 000

<u>Additional information:</u>

The 10% redeemable preference shares are redeemable at a premium of 20c per share on 1 March 2005.

The directors wish to issue the minimum number of ordinary shares at a premium of 20% to make the redemption possible.

All distributable reserves may be used for the redemption and according to the articles of association of the company, the full share premium may be utilised on redemption of the preference shares.

The authorised share capital consists of:

500 000 ordinary shares of R1 each
100 000 10% redeemable preference shares of R2 each.

Required:

Journalise all transactions relating to the redemption of the 10% redeemable preference shares in the books of Murray Ltd at 28 February 2006.
Show all your calculations.

QUESTION C14

The following information was extracted from the balance sheet of Tenpin Ltd at 28 February 2005:

	R
Ordinary shares of R1 each	200 000
14% redeemable preference shares of R2 each	90 000
Share premium	22 000
Non-distributable reserve	20 000
Distributable reserves	70 000
Cash in bank	80 000

<u>Additional information:</u>

The 14% redeemable preference shares are redeemable on 31 March 2005 at a premium of 20c per share.

The directors wish to issue the minimum number of 12% redeemable preference shares at R1.25 each in order to redeem all the 14% preference shares. (Assume nominal value = R1 each).

According to the articles of association of the company, the share premium may be utilised for the premium on redemption of preference shares.

Required:

Journalise all transactions (including cash transactions) relating to the redemption of the 14% preference shares in the books of Tenpin Ltd at 31 March 2005. Show all your calculations.

QUESTION C15

The following balances appear on the trial balance of Seaward Ltd on 31 December 2005:

	R
Ordinary share capital	250 000
10% redeemable preference share capital	75 000
Share premium	6 000
Capital redemption reserve fund	70 000
Accumulated profit	60 000
Net assets (including a favourable bank balance of R61 000)	461 000

<u>Additional information:</u>

1. The authorised share capital consists of 900 000 ordinary shares of 50c each and 200 000 10% redeemable preference shares of R2 each.

2. The directors decide to immediately redeem the preference shares at a premium of 15c per share. The redemption will take place through the issue of 60 000 ordinary shares at par and the balance out of available distributable reserves. Preference dividends were paid to date.

3. Share issue expenses amount to R375 and must be written off.

4. After the conclusion of the above transactions, capitalisation shares will be issued in the ratio of 1 ordinary share at par for each 10 shares held.

5. The use of distributable reserves must be minimised in all cases.

Required:

Prepare Journal entries to give effect to the above transactions (including cash transactions) in the books of Seaward Ltd.

QUESTION C16

Cards Ltd issues 1 000 8% debentures of R400 each on 1 August 2004 at a discount of 2%. The debentures are redeemable at par by means of annual drawings of R80 000 from 31 July 2005. Interest is paid annually on 31 July.

Required:

Complete the following table and show the ledger accounts for the period 1 August 2004 to 31 July 2009 for the following:

- debentures
- debenture interest
- discount on issue of debentures

Year ended	Outstanding debentures	Discount written off	Interest @ 8% p.a.
	R	R	R
31/07/2005	400 000	400 x =	
31/07/2006	320 000	320 x =	
31/07/2007	240 000	240 x =	
31/07/2008	160 000	160 x =	
31/07/2009	80 000	80 x =	