

65.1 An exercise on the different claims on the assets of a company

Carefully describe the different claims on the assets of the company whose balance sheet is shown below, stating as far as possible the origin of each claim, how or when it may be reduced, and why some claims may not normally be reduced at all.

Company Balance Sheet	
	£
Assets	1 680 000
(1) Liabilities	<u>(650 000)</u>
Net Assets	<u>£1 030 000</u>
Issued Share Capital	
(2) ordinary shares of 25p	250 000
(3) 6% preference shares	100 000
(4) Share Premium	120 000
(5) Revaluation Reserve	60 000
(6) Capital Redemption Reserve	50 000
(7) General Reserve	75 000
(8) Retained Earnings	<u>375 000</u>
	<u>£1 030 000</u>

1. Liabilities

Liabilities are the claims of all persons who are not shareholders in the company. Their claims may arise:

- because they have supplied the company with goods or services and have not yet been paid in money
- because they have lent money to the company
- because they have a claim on the company by operation of the law (for example in respect of taxes or in respect of compensation for damages caused by the company)

These claims can be reduced only when they are actually paid in money (or, on rare occasions, when the creditor agrees to release the claim without payment).

2. Ordinary Share Capital

This line in the balance sheet represents the ordinary shareholders' claim on the company in respect of the minimum value they had to pay in to the company, in exchange for the issue of their shares.

Under normal circumstances, as long as the company stays in existence, the claim to ordinary share capital may be reduced **only** if it is replaced by another claim which in turn cannot be reduced by repayment from the company unless/until the company is wound up and there are sufficient assets left (after payment of all other claims on the company).

3. Preference Share Capital

This represents the claim of a special class of shareholders in respect of the minimum value they had to pay in to the company, in exchange for the issue of their shares. Preference shareholders have a claim which resembles that of ordinary shareholders, except that the claims of preference shareholders always take precedence over the claims of ordinary shareholders.

4. Share Premium

This represents the claim of ordinary shareholders to any value paid in to the company by shareholders, in excess of the minimum they were required to pay in exchange for the issue of their shares. It may not normally be reduced, except by conversion into another non-reducible claim.

5. Revaluation Reserve

This represents the ordinary shareholders' claim to any unrealized increase in value of assets held in the company. Because the extra value is unrealized, it must not be paid out to shareholders, and to ensure that the extra value is locked in the company, this claim to the extra value may not be reduced.

6. Capital Redemption Reserve

The Capital Redemption Reserve is a claim created to replace another claim (share capital) which otherwise could not be reduced.

7. General Reserve

A general reserve is part of the shareholders' claim to any extra value that may have accumulated in the company as a result of profitable operations. The general reserve is separated from retained earnings to indicate that the company intends to keep this part of the extra value in the business, by not allowing the claim to it to be reduced (as it would have to be if the value were paid out to shareholders).

8. Retained Earnings

This represents the shareholders' claim to any extra value that may have accumulated in the company as a result of profitable operations, and which is legally and constitutionally available to be taken out of the company by shareholders. This is the only part of their claim that may be reduced when shareholders take value out of the company. Retained earnings therefore represents the maximum value that may be paid out to shareholders as a dividend.