Chapter 6

Accounting for companies

Introduction

By this stage you should have a good grasp of the method of preparing financial reports and have a good idea of the most significant issues with which accountants have to grapple. In Chapter 1 we introduced the idea of limited companies and traced their development from the early merchant trading businesses of the Elizabethan era, through the industrial revolution to the modern day. Accounting for companies opens up new areas of interest for us: how to account for equity financing through shares, the creation of reserves for different purposes, accounting for group companies and the requirements of the professional regulators and the Stock Exchange in setting standards for disclosure. In addition to this, limited liability companies have to operate in accordance with the Companies Acts in terms of their disclosure of information to the public. This introduces the requirement that accounts are audited so that the public and other stakeholders can have some assurance of the quality of the information they contain.

You may remember from Chapter 1 that there are two types of limited company: those that are limited by shares and those limited by guarantee. The former is overwhelmingly the most common type and is always used if the promoters of the company wish to run the company for personal profit. Companies limited by guarantee are technically not allowed to make profits for distribution to their owners but the surpluses must be used for the charitable or other purpose for which the business has been established. We will not explicitly consider the specific issues relating to such companies apart from saying that their disclosure requirements and liability to tax are in most respects identical to those for companies limited by shares.

In this chapter we will deal with all of these topics and also build upon the accounting skills you have already acquired both in producing but also in reading and interpreting accounting information. In the next chapter we will pursue the topic of interpretation in much more detail.

Learning objectives

The outcomes we seek to achieve in this chapter are as follows.

The characteristics of limited companies

- That you understand the nature of limited companies, and the reasons why they are created.
- That you are aware of the legal and other regulatory requirements placed upon companies and their management.

How limited companies are created

- That you know how companies are created and the role and importance of the shareholder.
- That you can perform the accounting transactions and create an opening balance sheet for a new limited company.
- That you understand the distinguishing features of the financial reports of a company compared with a sole trader or unincorporated partnership.

Group companies – acquisition and mergers

- That you can understand the meanings of the terms 'associated company' and 'subsidiary' and can undertake the accounting entries for the formation of a group.
- That you can consolidate the balance sheet and income statements for two companies to form a group and are aware of the distinctive features of a group financial report.

Becoming a public limited company

- That you have an understanding of how a public limited company is formed and the process it must go through to obtain a listing.

The characteristics of limited companies

Limited companies are created in order to protect their members from the risk to which a sole trader or unincorporated partnership is exposed. If a sole trader's business fails then the owner is liable for the financial commitments he or she has made. They will face bankruptcy and the consequential loss of their property. Their house and all other personal assets apart from a limited set of 'tools of their trade' can be sold to pay their creditors. Individuals in partnerships can be bankrupted if something goes wrong. In addition, they also face the jeopardy of 'joint and several liability' whereby all partners are liable for the debts of the whole company. So even if all the other partners were to disappear, the remaining partner would face the full claim in law.

Limited liability provides protection for businesses in that the company's creditors do not have an unlimited claim against the owners or the management, providing that the individuals concerned have not acted criminally by knowingly continuing to operate the business whilst it is insolvent. In the event of a company's failure the shareholders only risk the loss of the capital they have personally invested in the business.

The principal characteristics of limited companies are discussed in Chapter 1 but here are a few more points that are pertinent to accountants and financial managers more generally:

1. Under the Companies Act 1985, a business can be incorporated as either a private or a public limited company (the latter being designated as 'plc'). Private limited companies (designated as 'Ltd') cannot issue shares to the general public and their share capital is normally restricted to a small group of people such as a family or partners in a business who decide to incorporate.
2. The directors of a limited company are required to produce accounts and the type of information they are required to produce in the UK is dependent upon the company's size. Other countries have slightly different rules but most do not require small companies