

Accounting theory and practice

[Science](#), [Mathematics](#)



Accounting theory and practice Task Introduction This is a project about Yeats PLC, the company issued £ 25 million, 2 preference shares at par as of 1st January 2010. An accounting treatment has been provided to show the preference shares as an equity without considering the time value of money, to show the preference shares as a financial liability without adjustments of the time value of money, to show the preference share as a financial liability using amortized cost, and to show the preference shares as a financial liability at fair value through profit and loss. Lastly, a description of an alternative accounting treatment, under IAS, for financial liabilities and the circumstances under which those treatments are required.

Q1 (I): since the preference share is short-lived (it is to be redeemed in 2013, thus not a permanent source of capital), it can be classified under temporary equity. The following journal entries should be made in 2010, 2011, 2012 and 2013 (Swart 2002, pp. 140-176).

31st Dec. 2010

Details

£

£

Cash

2, 558. 25 M

Preferred stock

25M

Amount in excess of par value

2533. 25M

31 st Dec. 2011

Details

£

£

Cash

2, 619. 5M

Preferred stock

25 M

Amount in excess of par value

2, 594. 5M

31st Dec. 2012

Details

£

£

Cash

2, 683. 3M

Preferred stock

25 M

Amount in excess of par value

2, 658. 3 M

31st Dec 2013

Details

£

£

2% redeemable preference share a/c

25, 000, 000

Premium on redemption (10%)

2, 500, 000

Redeemable preference shareholders a/c

27, 500, 000

Q1 (II): the preference shares are redeemable and the shareholders have exclusive rights to dividends (2%) of the par value. Therefore, it is treated as a debt and would be recorded as below in the financial statements (Swart 2002, pp. 140-176)

31st Dec. 2010, 2011 and 2012

Balance sheet extract

Shareholders equity

25 M, 2% preference share @ £ 1 par value

-25, 000, 000

31st Dec. 2013

Profit and loss a/c extract

Expenses:

10% premium of 2%, 25 M preference shares (0. 1*25M)

2, 500, 000

Q1 (III): the amortized cost

Interest rate = 10%

Preference share rate = 2%

Opening

Interest

Cash

Closing

Year

Amount

Payable

Flow

Amount

2010

18, 659, 900

1, 865, 990

500, 000

20, 025, 890

2011

20, 025, 890

2, 002, 589

500, 000

21, 528, 479

2012

21, 528, 479

2, 152, 848

500, 000

23, 181, 327

2013

23, 181, 327

2, 318, 133

25, 500, 000

0

Year

Discount F.

Cash F.

NPV

2010

0.9091

500,000

454,550

2011

0.8264

500,000

413,200

2012

0.7513

500,000

375,650

2013

0.683

25,500,000

17,416,500

18,659,900

Journal entry as of 31 st Dec. 2013

Items

£

£

Loans payable

18, 659, 900

Finance income

6, 340, 100

Cash

25, 000, 000

Explanation to the process of amortization

In the above process of determining the amortized costs, the cash flow = $(2\% \times 25M)$ except for the year 2013, which contains the principal amount (25M) plus the cash flow (500, 000). Second, the cash flows are discounted using the presumed interest rate of 10% to get the opening amount (18, 659, 900). In the row marked 2010, the opening amount is multiplied by 10% to get the interest payable (1, 865, 990). The difference between interest payable and cash flow for that year is added to the opening for that year, to get the closing amount (20, 025, 890). The closing amount for 2010 becomes the opening amount for 2011. Follow the same process up to year 2012. Since the shares are redeemed in the year 2013, there will not be a closing amount for the year.

Q1 (IV): profit and loss account

The difference between the carrying amount and the consideration (fair value) for the liability should be reflected in the profit and loss account as done below.

Item

Amount £

Fair value

25, 000, 000

Beginning carrying amount

18, 659, 900

Gain (P&L)

6, 340, 100

Part B: the general accounting rules require that financial items be treated as liabilities if it obligates a company to part with cash or other financial assets. Secondly, if the issuer (a company), has no control over factors that leads to its maturity date. Lastly, if the requirement to pay principal amount may induce a contractual obligation to pay interest on dividends. However, the internal accounting standard has done major reviews on the mentioned regulations to include other emerging issues. The review of the rules regulating the accounting treatment of liabilities paved way for alternative treatment to liabilities under specific circumstances as follows: first, a fixed charge preference share (a liability) that is solely under the control of the issuer should be classified as equity. The circumstance justifying the treatment is “ full control by the issuer”. For instance, the issuance of a preferred stock might be done under terms providing authority to the issuer to solely decide the portion or if a company’s assets should be sold to provide enough cash to facilitate the redemption preference shares. In this case, the liability would be treated as a portion of permanent equity because the preferred stockholders have no voice in the sale of a company’s assets, but the issuer (Price Water House Coopers 2013, pp. 20-78).

Second, an issuance of a preferred stock might be accompanied by the terms that allow the redemption of the preference shares in case of mergers

and acquisitions. It should be noted that the board's approval prior to any merger is imperative. Therefore, assuming that the preferred stockholders have no control or input in the board's decision, through direct or indirect representation, the preferred shares are classified under permanent equity shares. The circumstance allowing for this alternative treatment is the fact that the preferred shareholders have no voice in making the decision on whether a company should pursue a merger (Price Water House Coopers 2013, pp. 54-131).

Third, in the event a fixed-charge non-redeemable preference shares are issued, if the terms of issuance provide for no obligation to pay cash or any other financial assets, the security should be classified as equity (Price Water House Coopers 2013, pp. 54-131).

Fourth, in the event that a combination of convertible and non-convertible shares are issued, if it is stated in the terms of the contract that the convertible preference shares will be replaced with common stock, the portion of the convertible preference share should be classified as equity whereas, the non-convertible portion should be classified as a liability (assuming the rights are with the preference shareholders) (Price Water House Coopers 2013, pp. 54-131).

List of References

Price Water House Coopers (FIRM), 2013, Similarities and differences: a comparison of current UK GAAP new UK GAAP (FRS 102) and IFRS.

Swart, N 2002, Personal financial management, Lansdowne, Juta.