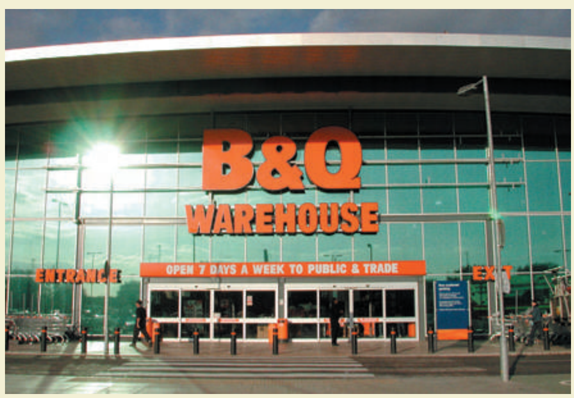
Chapter 12

Ownership interest

REAL WORLD CASE

Balance sheets as at 29 January 2005

		Group		Company	
£ millions	Notes	**2005**	2004	**2005**	2004
Capital and reserves					
Called up share capital	29	**369.0**	366.3	**369.0**	366.3
Share premium account	30	**2,166.2**	2,150.9	**2,166.2**	2,150.9
Revaluation reserve	30	**611.7**	441.3	**–**	–
Non-distributable reserves	30	**159.0**	159.0	**2,934.2**	2,934.2
Profit and loss account	30	**1,615.6**	1,286.2	**808.3**	836.7
Equity shareholders' funds	31	**4,921.5**	4,403.7	**6,277.7**	6,288.1
Equity minority interests		**2.7**	2.9	**–**	–
		4,924.2	4,406.6	**6,277.7**	6,288.1



Property

Property income (primarily rent charged to B&Q on UK properties owned by the Group) grew at 28.2% to £41.4m (2004: £32.2m) reflecting rental inflation and some additional properties.

Kingfisher owns a significant property portfolio, substantially all of which is now used for trading purposes and which, at the year end, had a value of £2.4bn. Kingfisher has continued its normal practice of externally valuing, on an existing use basis, one-third of the property portfolio on a rolling basis, with internal valuations being performed for the other two-thirds. In both cases, these revalued amounts have been incorporated into the accounts, giving rise to a revaluation surplus in the year of £175.8m.

Source: Kingfisher Annual Report and Accounts 2004/5, pp. 29, 25.

Discussion points

1 How did the group measure the revaluation of its property assets?

2 How did the group record the revaluation?

Contents

Learning outcomes

After reading this chapter you should be able to:

- Define ownership interest.
- Explain and demonstrate how the ownership interest is presented in company accounts.
- Understand the nature and purpose of the statement of changes in equity in the IASB system and also the UK ASB equivalents.
- Explain the needs of users for information about the ownership interest in a company.
- Read and interpret the information reported by companies in their annual reports, in respect of the ownership interest.
- Explain the accounting treatment of dividends.
- Understand the methods by which a company's shares may be issued when the company has a Stock Exchange listing.
- Show that you understand the impact of transactions and events on ownership interest in company accounts.

Additionally, for those who choose to study the Supplement:

- Record end-of-period adjustments as debit and credit adjustments to a trial balance taken from the ledger accounts and produce figures for financial statements.

12.1 Introduction

The final element of the accounting equation has been reached. It was explained in Chapter 2 that the ownership interest is the residual amount found by deducting all liabilities of the entity from all of the entity's assets:

Assets	minus	**Liabilities**	equals	**Ownership interest**

The terminology was also explained in Chapter 2. The words equity and net assets both appear in the press and in commentaries in connection with the ownership interest. **Equity** is a word used to describe the ownership interest in the assets of the business after all liabilities are deducted. This is also referred to as the **net assets**, calculated as the assets minus the liabilities.

The structure which has been adopted for Chapters 8 to 12 is based on a series of questions:

- What are the principles for defining and recognising these items?
- What are the information needs of users in respect of the particular items?
- What information is currently provided by companies to meet these needs?
- Does the information show the desirable qualitative characteristics of financial statements?
- What are the principles for measuring, and processes for recording, these items?

Each of these questions will be addressed in turn.

12.2 Definition and recognition

The definition of **ownership interest** was presented in Chapter 2 as: 'the residual amount found by deducting all of the entity's liabilities from all of the entity's assets'.

Because the ownership interest is the residual item of the equation, it can only increase or decrease if something happens to an asset or to a liability. Recognition conditions are applied to assets and liabilities but there cannot be any additional recognition criteria applied to the ownership interest.

Events which change assets or liabilities include:

- making a profit (or loss) through the operations of the business – earning revenue and incurring expenses;
- a contribution of cash by incoming shareholders purchasing new shares;
- holding an asset which increases or decreases in value;
- holding a liability which increases or decreases in value.

Each one of these events is important to the users of the financial statements and affects the claims of owners on the assets of the business. Since owners are the user group most interested in the ownership interest, this chapter will focus primarily on the information which is helpful to them. Reporting a profit or a loss has been dealt with in some length in previous chapters. In this chapter we concentrate on the issue of new shares and on the events which cause increases or decreases in assets and liabilities which are *not* reported in the profit and loss account.

12.3 Presentation of ownership interest

Chapters 7 to 11 have concentrated primarily on the limited liability company. For any limited liability company the **income statement (profit and loss account)** is the primary financial statement which reports the revenues and expenses of the business that arise through operations.

The change in value of an asset or liability while it is *held* by the company gives more cause for debate. If the asset has increased in value while still being held by the company, then there may be an increase in the valuation for financial reporting purposes. That is not a **realised** gain and so cannot be reported in the profit and loss account. There is another primary financial statement which companies must use to report **unrealised** gains. For companies using the IASB system in their financial statements, the unrealised gains are reported in a **statement of recognised income and expense** or a **statement of changes in equity**. For companies continuing to follow UK company law and standards the unrealised gains are reported in a **statement of total recognised gains and losses**.

Example of an unrealised gain

A business buys a building at a cost of £10m. One year later similar buildings are selling for £13m. The business does not intend to sell but would like to report the potential increase in the market value of the asset. Because there is no sale, the £3m estimate of the increase in value is unrealised. It is not reported in the income statement (profit and loss account) but is reported in the statement of recognised income and expense (statement of total recognised gains and losses).

The presentation of the ownership interest is therefore a potentially complex affair, using more than one financial statement. There is information about the current position of the ownership interest contained in the balance sheet and the related notes to the accounts. There is information about changes in the ownership interest in the income statement (profit and loss account) and the statement of recognised income and expense (statement of total recognised gains and losses). The approach taken in this chapter is first of all to 'walk through' the early years of operating a limited liability company and the various types of ownership interest which arise.

12.3.1 Issue of shares at the date of incorporation

When the company first comes into existence it issues shares to the owners, who become **equity holders (shareholders)**. The date on which the company comes into existence is called the **date of incorporation**.

Each share has a *named value* which is called its **nominal value**. Sometimes it is referred to as the **par value**. This amount is written on the **share certificate** which is the document given to each owner as evidence of being a shareholder. Exhibit 12.1 shows the share certificate issued by a company which confirms that J. A. Smith is the owner of 100,000 ordinary shares of 25p nominal value each. This means that J. A. Smith has paid £25,000 to the company and that is the limit of this person's liability if the company fails.

All share certificates are recorded in the share register by the company secretary. The share certificate is a piece of paper which may be sold by the existing owner to another person who wishes to become a shareholder. The person who wishes to become a shareholder is often referred to as a **prospective investor**. That is not a legal term but is a useful way of indicating a person who has an interest in finding out more about the company, without having the legal rights of ownership. When the

Exhibit 12.1
Share certificate issued by a company

Certificate number 24516

Public Company plc

SHARE CERTIFICATE

This is to certify that

J. A. Smith

is the registered owner of 100,000 ordinary shares of 25 pence each.
Given under Seal of the Company the 15th day of August 20XX

Signed *P McDowall* *J Jones*
Company Secretary *W Brown*
Directors

new owner has acquired the shares, the term 'investor' may continue to be used as a description which emphasises that this person now has a financial interest in knowing that the company is performing well.

The issue of 100,000 shares at a price of 25 pence each will collect £25,000 cash for the company. The effect on the accounting equation is that the asset of cash increases by £25,000 and the ownership interest is increased by £25,000.

Assets ↑	−	Liabilities	=	**Ownership interest** ↑
Increase in cash £25,000				Increase in nominal value of shares £25,000

For a company, the ownership interest created by the issue of new shares at their nominal value is recorded as **share capital**.

Activity 12.1

Look at the financial pages of a newspaper. Find the daily list of share prices. What information does the newspaper provide about shares in each company? Which of these items of information would you expect to find in the annual report of the company? Give reasons for your answer.

12.3.2 Retained earnings

Once the business is in operation it starts to make profits. The income statement (profit and loss account) shows the profit earned in a time period. This profit increases the ownership interest. The accumulation of past profits in the balance sheet is called **retained earnings**. The retained earnings represent the ownership interest in the net assets of the business. It is one type of **reserve**. At any point in time someone could ask the owner 'How much would you expect to receive if this business were to close down today?' The owner would look at the balance sheet and reply with the total of the **ownership interest**, shown by **equity share capital** plus all **reserves**.

You should be aware that the reserves are given different names in different countries. In some there is a legally defined reserve with a tax-deductible transfer to the reserve from the profit and loss account. It requires careful reading of the ownership interest section of the balance sheet.

12.3.3 Buying and selling shares

The company itself has no concern about the purchase and sale of shares from one owner to another, other than having to record the new owner's name in the share register. The purchase and sale may take place by private arrangement or may take place in an established **stock market** (also called a **stock exchange**) if the company is a public limited company. If the shares are traded in an established stock market they are called listed shares because the daily prices are listed on screens for buyers and sellers to see. If there is high demand for the shares, their price will rise. If there is little demand, the price will fall. The market price on any day will depend on investors' expectations about the future of the company. Those expectations will be influenced by announcements from the company, including financial information but also covering a much wider range of company news. The expectations may also be influenced by information about the industry in which the company operates. One of the main purposes of a well-regulated stock exchange is to ensure that all investors have access to the same information at the same time so that no one has an advantage.

12.3.4 Issue of further shares after incorporation

As time goes by, the company may wish to raise new finance and to issue new shares. This could be intended to buy new non-current (fixed) assets, or even to provide cash so that the company may purchase the shares of another company and create a larger group.

Although the **nominal value** remains the same, the **market value** may be quite different.

Example

Suppose a company has shares of nominal value 25 pence but finds that its shares are selling in the market at 80 pence each. If the company issues 200,000 new shares it will collect £160,000 in cash. That is the important piece of information for the company because it can use the cash to buy new assets and expand the activities of the business. The asset of cash has increased by £160,000 and the ownership interest has increased by £160,000.

The accounting records are required by company law to show separately the nominal value of the shares and any extra amount over the nominal value. The nominal value is 25 pence and the total amount collected per share is 80 pence. So the extra amount collected is 55 pence. This extra amount is called a **premium** (the word means 'something extra'). So the £160,000 increase in the ownership interest is recorded as two separate items, namely the **nominal value** of £50,000 and the **share premium** of £110,000.

Assets ↑	−	Liabilities	=	**Ownership interest** ↑→
Increase in cash £160,000				Increase in nominal value of shares £50,000 *and* increase in share premium £110,000

12.3.5 Revaluation of non-current (fixed) assets

Suppose a company buys a hotel costing £560,000. The hotel is run successfully for a period of three years and at the end of that period a professional valuer confirms that the hotel, if sold, would probably result in sale proceeds of £620,000 because of the change in property values and the reputation which the hotel has established. The directors of the company may wish to tell shareholders about this increased market value of the company's non-current (fixed) asset.

There are two ways of informing shareholders in the financial statements. One is to continue to record the balance sheet value at £560,000 (the historical cost) but to include a note to the balance sheet explaining that the market value has been confirmed as £620,000 by an expert. That information would allow the investor to think, 'That makes me feel better off by £60,000.'

This feeling of investor happiness is surrounded by a note of caution, because the gain in value is not **realised**. The asset has not in fact been sold in the market. It only needs a rumour of pollution on the local beach to depress the market value of all the hotels in the town. Some companies feel that this note of caution is conveyed by providing the information on the increase in value in the notes to the accounts rather than the balance sheet itself.

Other companies take a bolder view and decide that, in the interests of providing information which is relevant to the needs of users, the company should apply the accounting equation on behalf of the readers of the financial statement. These companies then have a problem of deciding on the name to be given to describe this £60,000 increase in the ownership interest. It cannot be called revenue and included in the profit and loss account because it has not been realised by the operations of the business. It represents a new ownership interest as a newly identified 'reserve' of wealth. The wealth lies in the asset, but the interest in that wealth is a claim which belongs to the owners. The increased wealth is caused by revaluation of the asset, and so the name chosen for this claim is **revaluation reserve**. In terms of the accounting equation there is an increase in the value of an asset and an increase in the ownership interest.

Assets ↑	−	Liabilities	=	**Ownership interest** ↑
Increase in value of non-current (fixed) asset £60,000				Increase in revaluation reserve as part of the ownership interest £60,000

This section has explained the accounting processes for revaluing non-current (fixed) assets. You may see revaluation of non-current assets in some annual reports of UK companies. It is not compulsory but if companies choose to revalue then they must do so regularly. In contrast such revaluation is not allowed in the USA or Germany. In other countries, such as France, it is allowed but rarely used. Revaluation is permitted by the IASB but is not a requirement. So while the IASB system has brought standardisation of accounting practices across Europe it does not entirely take away the choices that may make comparisons less easy.

Example

A company, Office Owner Ltd, is formed on 1 January Year 1 by the issue of 4m ordinary shares of 25 pence nominal value each. The cash raised from the issue is used on 2 January to buy an office block which is rented to a customer for an annual rent of £50,000. The tenant carries all costs of repairs. The company's administration costs for the year are £10,000. At the end of the year the office block is valued by an expert at £1,015,000. On the last day of the year the company issues a further 2 million ordinary shares at a price of 40 pence each, to raise cash in Year 2 for expansion plans.

Activity 12.2

For the analysis of each transaction you should look back to the previous sections where each type of transaction is dealt with in detail. Write down the effect of each transaction on the accounting equation. Check your answer against Exhibit 12.2. When you are satisfied that you understand Exhibit 12.2 look to Exhibit 12.3 where you will find the amounts entered in the spreadsheet.

Exhibit 12.2

Office Owner Ltd – analysis of transactions for Year 1

Date	*Transaction or event*	*Effect on assets*	*Effect on ownership interest*
Year 1			
Jan. 1	Issue of shares at nominal value	Increase asset of cash	Increase share capital at nominal value
Jan. 2	Purchase of office block	Increase asset of property	Decrease asset of cash
Jan.–Dec.	Rent received	Increase asset of cash	Revenue of the period
Jan.–Dec.	Administration costs	Decrease asset of cash	Expense of the period
Dec. 31	Revaluation of asset	Increase asset of property	Increase ownership interest by revaluation
Dec. 31	Issue of further shares	Increase asset of cash	Increase share capital at nominal value and increase share premium

Exhibit 12.3

Office Owner Ltd – spreadsheet of transactions for Year 1

Date	*Transaction or event*	*Cash*	*Office block*	*Share capital*	*Share premium*	*Income statement (profit and loss account)*	*Revaluation reserve*
Year 1		£000s	£000s	£000s	£000s	£000s	£000s
Jan. 1	Issue of shares	1,000		1,000			
Jan. 2	Purchase of office block	(1,000)	1,000				
Jan.–Dec.	Rent received	50				50	
Jan.–Dec.	Administration costs	(10)				(10)	
Dec. 31	Revaluation of asset		15				15
Dec. 31	Issue of further shares	800		500	300		
		840	1,015	1,500	300	40	15
		1,855		1,855			

Entering the amounts in the spreadsheet of Exhibit 12.3 shows, in the final line, that the accounting equation is satisfied and allows a balance sheet to be prepared as in Exhibit 12.4.

Exhibit 12.4
Office Owner Ltd – balance sheet at end of Year 1

Office Owner Ltd
Balance sheet at end of Year 1

	£000s
Non-current (fixed) asset: Office block (at valuation)	1,015
Current asset: Cash	840
Net assets	1,855
Share capital	1,500
Share premium	300
Revaluation reserve	15
Retained earnings	40
	1,855

Activity 12.3

Suppose you note that a company has revalued its land and buildings as reported in the balance sheet. What evidence would you expect to see as justification for the amount of the revaluation? What questions might you ask about the basis of revaluation?

12.3.6 Changes in exchange rates of foreign currency

All information in the financial statements of a UK company is shown in pound (£) sterling. Where exchange rates alter, a company may lose or gain purely because of the exchange rate movement. That loss or gain must be reported.

The accounting process is called translation. Translation from one currency to another is particularly important when the financial statements of companies in a group are added together and so must all be restated in a common currency. The word 'translation' is used because the process is comparable to translating words from one language to another.

There are different methods of reporting depending on the type of transaction or event. Two different stories are considered here. The first is the purchase of an asset located in a foreign country. The second is the purchase, by a group of companies, of the share capital of a company in a foreign country.

Purchase of an asset

Take first of all the example of a UK company which buys a factory in Sweden. The factory is priced at Kr10,000,000. At the date of purchase of the factory the exchange rate is Kr10 = £0.70. The UK company has agreed to pay for the factory on the day of the transfer of legal title.

For accounting purposes the cost of the factory is recorded at the amount paid at the date of purchase. This is calculated as:

$$\frac{0.70}{10} \times \text{Kr}10{,}000{,}000 = £700{,}000$$

The effect of the transaction on the balance sheet of the UK company is:

Assets ↑↓	−	Liabilities	=	Ownership interest
Increase in asset of factory £700,000 Decrease in asset of cash £700,000				

That is the end of the story so far as the UK company is concerned. The exchange rate between the krona and the £ may fluctuate, and this may affect the company's view of the price for which the factory might eventually be sold, but that information will not appear in the financial statements of the UK company until such time as the factory is sold.

Purchase of shares in another company

Suppose now that a UK group of companies has decided to purchase the entire share capital of a Swedish company whose only asset is the same factory. The purchase price is Kr10,000,000. The Swedish company distributes its entire profit as dividend each year so that the only item remaining in its balance sheet is the factory at a cost of Kr10,000,000. (This is a very simplistic example but is sufficient to illustrate the exchange rate problem.)

At the date of purchase of the investment, the factory will be recorded in the group balance sheet at £700,000.

Assets ↑↓	−	Liabilities	=	Ownership interest
Increase in sterling equivalent of group's asset of factory £700,000 Decrease in group's asset of cash £700,000				

One year later the exchange rate has altered to Kr10 = £0.68. The factory is the only asset of the subsidiary. In the Swedish accounts it remains at Kr10,000,000 but, translated into £ sterling, this now represents only £680,000:

$$\frac{0.68}{10} \times \text{Kr}10{,}000{,}000 = £680{,}000$$

This represents a potential loss of £20,000 on the translated value of the asset at the start of the year. The loss is unrealised but as a matter of prudence the fall in the translated asset value should be reported. However, there have been strong feelings expressed by companies over many years that the unrealised loss should not affect the reported profit of the period. Consequently the relevant accounting standard[1] allows the effect on the ownership interest to be shown in reserves.

Assets ↓	−	Liabilities	=	**Ownership interest ↓**
Reduction in sterling equivalent of assets of subsidiary £20,000				Decrease in reserve £20,000

The reporting of the reduction in the asset value as a decrease in reserves is controversial because less attention is sometimes paid to reserves than is paid to the profit and loss account. This means that the impact on the ownership interest may pass unnoticed.

This practice of translation is required by the accounting standard on the subject. In group accounting there is considerable complexity to the technical aspects of which exchange rate effects must pass through the profit and loss account and which may pass through the reserves. The important message for the reader of the annual reports is to be alert to the possibility of exchange rate effects on the ownership interest being reported in reserves.

12.4 Additional primary financial statements

In Chapter 7 it was noted that the IASB specifies four primary financial statements:[2]

- a balance sheet
- an income statement (showing the profit or loss for the period)
- a statement of changes in equity, and
- a cash flow statement.

The balance sheet, income statement and cash flow statement were dealt with in Chapter 7. The statement of changes in equity is now explained.

12.4.1 Statement of changes in equity (IASB standards)

The **statement of changes in equity** must show on the face of the statement:

(a) The profit or loss for the period.
(b) Each item of income and expense for the period that is required by accounting standards to be recognised directly in equity.
(c) The effects of changes in accounting policies and corrections of errors.

If these are the only items reported then the statement of changes in equity is called a statement of **recognised** income and expenses.

An entity must also report, either in the statement of changes in equity or in the notes to the accounts:

(d) Transactions with equity holders (e.g. share capital issued, dividends paid).
(e) The balance of retained earnings at the start and end of the accounting period, and changes during the period.
(f) An explanation of the amounts of changes in each class of equity and each type of reserve.

If items (d), (e) and (f) are included on the face of the statement it is called a **statement of changes in equity**.

The reason for this flexibility of presentation is that different countries have applied different practices in the past. UK companies have been producing a **statement of total recognised gains and losses** for more than ten years while US companies have been presenting a **statement of changes in equity** for some years past. The annual report of Safe and Sure plc shown in Appendix I, presents a statement of total recognised gains and losses with the remaining movements on equity shown in a note to the financial statements.

12.4.2 Statement of total recognised gains and losses (UK ASB standards)

The statement of total recognised gains and losses (STRGL) was introduced by the UK ASB Standards Board[3] as a result of well-publicised company failures where it was apparent that important information about changes in the ownership interest had not been understood fully by the users of the financial statements. In particular, losses caused by exchange rate fluctuations had been reported in the notes on reserves, apparently without the expert observers pointing to the fact that these losses cancelled out the profits gained from operating activities.

As well as exchange rate gains and losses, the STRGL reports unrealised gains and losses arising on revaluation of non-current (fixed) assets of a period. Its purpose is to show the extent to which shareholders' funds have increased or decreased from all the various gains and losses recognised in the period.

12.4.3 Reconciliation of movements in shareholders' funds (UK ASB standards)

In addition to the statement of total recognised gains and losses the UK Accounting Standards Board also requires a reconciliation of movements in shareholders' funds. It may also be presented as a primary financial statement,[4] so that it has comparable prominence with other important information, or may be presented as a note to the financial statements. Most companies give this reconciliation the prominence of a primary financial statement.

12.5 Users' needs for information

The owners of a company, and potential investors in a company, are primarily interested in whether the business will make them better off or worse off. They also want to be reassured that the business has taken care of the resources entrusted to it (carrying out the function of **stewardship**). The first source of an increase in the ownership interest is the **profit** generated by the company. Professional investors will use the phrase **quality of earnings** to refer to the different components of profit. They tend to regard profits generated by the main operating activity as being of higher quality than windfall gains such as profits on the sale of non-current (fixed) assets which are not a regular feature of the company's activity.

Owners of a company expect to receive a reward for ownership. One form of reward is to watch the business grow and to know that in the future a sale of shares will give them a satisfactory gain over the period of ownership. That requires a long-term horizon. Some investors prefer to see the reward more frequently in the form of a dividend. They want to know that the ownership interest is adequate to support the dividend and yet leave sufficient assets in the business to generate further profits and dividends.

Creditors of a company know that they rank ahead of the shareholders in the event of the company being wound up, but they want to know that the company is generating sufficient wealth for the owners to provide a cushion against any adverse events. Therefore creditors will also be concerned with the ownership interest and how it is being maintained or is growing.

Employees, suppliers and customers similarly look for reassurance as to the strength of the business to continue into the future. The ownership interest is a convenient focus which summarises the overall impact of the state of assets and liabilities, although what employees are really interested in is the preservation of the earnings capacity of the business.

12.6 Information provided in the financial statements

In Chapter 7 the balance sheet of Safe and Sure plc was presented. The final section of that balance sheet presented information on the capital and reserves representing the claim of the shareholders on the assets.

		Year 7	*Year 6*
		£m	*£m*
Capital and reserves			
Called-up share capital	*12*	19.6	*19.5*
Share premium account	*13*	8.5	*5.5*
Revaluation reserve	*14*	4.6	*4.6*
Retained earnings	*15*	431.6	*340.8*
Equity holders' funds		464.3	*370.4*

In the discussion contained in Chapter 7 it was emphasised that the most important feature of this information is that, in total, it represents the shareholders' legal claim. There is nothing to see, touch, count or hold. If the company were to cease trading at the balance sheet date, sell all its assets for the balance sheet amount and pay off all liabilities, the shareholders would be left with £464.3m to take away. The shareholders have the residual claim, which means that if the assets were to be sold for more than the balance sheet amount, the shareholders would share the windfall gain. If the assets were sold for less than the balance sheet amount, the shareholders would share the loss.

The total ownership interest is a claim which is described by this company as 'equity holders' funds'. It is equal to the **net assets** of the company. The total claim is subdivided so as to explain how the various parts of the claim have arisen. This section now considers each part of the claim in turn.

12.6.1 Share capital

The information shown by the company at note 12 is as follows:

Note 12 Share capital

	Year 7	*Year 6*
	£m	*£m*
Ordinary shares of 2 pence each		
Authorised: 1,050,000,000 shares		
(Year 6: 1,000,000,000)	21.0	*20.0*
Issued and fully paid: 978,147,487 shares	19.6	*19.5*

Certain senior executives hold options to subscribe for shares in the company at prices ranging from 33.40p to 244.33p under schemes approved by equity holders at various dates. Options on 3,479,507 shares were exercised during Year 7 and 66,970 options lapsed. The number of shares subject to options, the years in which they were purchased and the years in which they will expire are:

Purchase	*Expiry*	*Numbers*
	Year 8	13,750
All	Year 9	110,000
purchased	Year 10	542,500
10 years	Year 11	1,429,000
before	Year 12	2,826,600
expiry	Year 13/14	3,539,942
	Year 15	3,690,950
	Year 16	2,279,270
	Year 17	3,279,363
		17,711,375

Called-up means that the company has called upon the shareholders who first bought the shares to make payment in full. When a new company is brought to the stock market for the first time, investors may be invited to buy the shares by paying an instalment now and the rest later. That was quite common in the 1980s when former nationalised industries, such as electricity and water companies, were being sold to the private sector. The **prospectus**, which is issued to invite the purchase of shares, specifies the dates on which the company would make a call for the rest of the share price due. After all the cash has been received by the company, the shares are described as **fully paid**.

Ordinary shareholders are entitled to vote at meetings, usually in proportion to the number of shares held. That means that the power of the individual shareholder depends on the number of shares held. For most large companies there are relatively small numbers of shareholders who control relatively large proportions of the share capital. A company which is part of a larger group of companies is required to report in the notes to the accounts the name and country of the ultimate parent company. Companies which are listed on the Stock Exchange are required to disclose in the directors' report the name of any shareholder interested in 3% or more of the company's issued share capital.

Before the directors of a company may issue new shares, they must be authorised to do so by the existing shareholders. The existing shareholders need to be aware that their claim will be diluted by the incoming shareholders. (If there are 50 shares owned equally by two persons, each controls 50% of the company. If 25 new shares are issued to a third person, then all three have 33.3% each, which dilutes the voting power of the first two persons.)

One of the controversial aspects of share capital in recent years has been the privilege of share options taken by directors and other employees (usually senior employees of the business but sometimes spreading to the wider employee range). A share option allows the person holding the option to buy shares in the company, at any future date up to a specified limit in time, at an agreed fixed price. The argument in favour of such an arrangement is that it gives senior management an incentive to make the company prosperous because they want the share price to increase above the price they have agreed to pay. The argument against it is that they have no very strong incentive because the worst that can happen to directors and other employees is that they decide not to take up the option when the share price has not performed well. Until 1995 there were also some personal tax advantages in taking options rather than a normal portion of salary, but since then, the tax rules have limited such benefits.

Major companies now disclose, in the directors' report, the options held by each of the directors.

The analyst's view

David and Leona are on the plane flying from London to Aberdeen for a week's holiday in the Cairngorms. David has brought the annual report of Safe and Sure plc as a precaution against inclement weather disturbing their plans for outdoor activities. While they wait for lunch to be served, David turns to the annual report and finds it is quite helpful to have Leona alongside him.

DAVID: *At the present time nothing seems to excite more comment from the financial journalists than the salaries paid to the directors and the options they hold. I have to confess that it's something I look for in the annual report. Maybe I'm looking for my future earning potential! One of my more cynical colleagues says that directors can't lose on options. If the share price rises they make money, which we don't mind because our investment is rising in value. What happens if the share price falls? The directors take new options at the lower price and then wait for the market to rise again so that they make a profit! We can't do that for our investment.*

I always look at the note on share capital to see whether new shares have been issued during the year. It reminds me to find out the reason. In this case the increase is £0.1m and the reason is explained in the accounts as being due entirely to the issue of options.

12.6.2 Share premium

It was explained earlier in this chapter that when shares are issued by a company it may well be that the market price of the shares is greater than the nominal value. What really matters to the company is the amount of cash contributed by the new shareholders but company law insists that the claim of these new shareholders is split into a nominal amount and a share premium (the amount received in excess of the nominal amount).

Note 13 Share premium account

	Year 7	*Year 6*
	£m	*£m*
At 1 January	5.5	*3.6*
Premium on shares issued during the year under the share option schemes	3.0	*1.9*
At 31 December	8.5	*5.5*

DAVID: *I look at the share premium account only as a check on the amount of cash raised by issuing shares during the year. If I add the £3.0m shown in this note to the £0.1m shown as an increase in nominal value, then I know that £3.1m was raised in total by the issue of shares. I can check that in the cash flow statement.*

12.6.3 Revaluation reserve

Earlier in the chapter the effect of revaluing assets was explained in terms of the accounting equation. It was also explained that the effects of foreign currency exchange rates may appear in reserves. The note to the accounts of Safe and Sure plc appears as follows:

Note 14 Revaluation reserve

	Year 7	*Year 6*
	£m	*£m*
At 1 January	4.6	*4.6*
At 31 December	4.6	*4.6*

DAVID: *I always look at the reserves note to see what is happening to the overall shareholders' claim. There is no change in the reserve during Year 6 or Year 7 so does that mean the company has not revalued the non-current assets in that period?*

LEONA: *The directors are required to review the valuations at each balance sheet date. So if there is no change in the revaluation reserve there must have been no change in the value of the assets involved.*

12.6.4 Statement of total recognised gains and losses

Safe and Sure plc
Statement of total recognised income and expense

	Year 7	*Year 6*
	£m	*£m*
Profit attributable to equity holders	114.8	*94.6*
Exchange rate adjustments	5.5	*(6.0)*
Total recognised gains for the year	120.3	*88.6*

LEONA: *Let me take you through the Statement of total recognised income and expense. It brings together the items which cause an overall decrease or increase in the ownership interest. On the first line you can see the profit attributable to equity holders which comes from the income statement. On the next line there are the exchange rate adjustments that relate to translation of investments held in other currencies. In Year 6 the exchange rates worked against the interests of equity holders but in Year 7 there was a favourable effect.*

12.6.5 Reconciliation of movements in equity

Safe and Sure plc
Reconciliation of movements in equity

	Year 7	*Year 6*
	£m	*£m*
Profit attributable to equity holders	114.8	*94.6*
Dividends	(29.5)	*(24.4)*
New share capital issued	3.1	*2.0*
Exchange adjustments	5.5	*(6.0)*
Net change in equity holders' funds	93.9	*66.2*
Opening equity holders' funds	370.4	*304.2*
Closing equity holders' funds	464.3	*370.4*

LEONA: *Now you really can start to tie things together. Look at the balance sheet. (See Chapter 7.) The final line there shows the closing equity holders' funds which appear as the final line in this reconciliation. Starting at the top line the profit attributable to equity holders comes from the income statement (profit and loss account). (See Chapter 7.) The next line shows the dividend of £29.5m paid during year 7. That dividend relates to the profits earned in Year 6. For the dividend recommended in respect of Year 7 we have to look at the Finance Director's review. On the next line we see that the new share capital issued is £3.1m which is a combination of the increase of £3.0m in share premium (Note 13) and the increase of £0.1m in nominal share capital (Note 12). That is really tricky to sort out from the Notes – it's very helpful to have the reconciliation give the information in one place. The exchange adjustments repeat the information shown in the statement of total recognised gains and losses.*

DAVID: *You have given me plenty to think about. I can see the drinks trolley on its way – what would you like?*

12.7 Dividends

Shareholders who invest in a company do so because they want the value of their shares to increase over time and return greater wealth when eventually sold. In the meantime the shareholders look for an income to spend each year. That comes to some of them by means of dividends.

Companies are not obliged to pay dividends and may decide not to do so if there is a shortage of cash or it is needed for other purposes. The directors make a recommendation to the shareholders in the annual general meeting. The shareholders may vote against taking the dividend but that happens only very rarely. Final dividend payments usually take place soon after the annual general meeting. Some companies also pay an interim dividend during the accounting year. Major UK companies have in past years ensured that a dividend was paid every year, however small, because it allowed the shares to be regarded as sufficiently 'safe' for investors such as trustees of charitable institutions.

When a company decides it wants to pay a dividend, there are two essential tests. The first is, 'Does the company have the cash resources to pay a dividend?' The second is, 'Has the company made sufficient profits, adding this year to previous years, to justify the dividend as being paid out of wealth created by the business?'

Even where the company has cash in the bank from which to pay the dividend, it must look forward and ensure that there are no other commitments in the near future which will also need cash. The company may decide to borrow short term to finance the dividend. In such a situation the company has to weigh the interest cost of borrowing against the risk of its shares being undervalued because of lack of interest from shareholders. These are all problems of cash management (more often called 'treasury management').

Company law imposes a different viewpoint. It takes the view that a company should not return to shareholders, during the life of the company, a part of the capital contributed by the shareholder body. Accordingly there is a requirement that dividends must be covered by accumulated reserves of past profit in excess of accumulated reserves of past losses. It is not required that the dividend is covered by the profit of the year. A company might choose to smooth things over by maintaining the dividend reasonably constant even where profits are fluctuating.

The dividend declared by the company is usually expressed in pence per share. Shareholders receive dividend calculated by multiplying the dividend in pence per share by the number of shares held. For the company there is a reduction in the asset of cash and a reduction in the ownership claim. The management of the company may regard the dividend as an expense of the business but it is more properly regarded as a reduction in the claim which the owners have on the net assets as a whole. The reduction in the ownership interest is reported in the statement of changes in equity because it is a transaction with the owners.

Assets ↓	−	Liabilities	=	**Ownership interest ↓**
Decrease asset of cash				Decrease ownership interest by the amount of the dividend, as a reduction in the owners' claim on the business

At the end of the accounting period the company will calculate profit and then declare a recommended dividend. The dividend is recommended by the directors to the shareholders. The shareholders, in the annual general meeting, may accept or decline but are not allowed to increase the amount. At the balance sheet date there is no legal liability because the shareholders' meeting has not been held. Therefore there is no information reported in the financial statements. The directors' report, which is required by company law, will contain a statement of the recommended dividend for the year. There will probably also be information in the chairman's statement or on a 'highlights' page.

12.8 Issue of further shares on the Stock Exchange

Once a company has a listing on the Stock Exchange it may decide to issue further shares. There are different methods by which this may be done, depending on the company's motive for the action. This section describes an offer for sale, a capitalisation issue and a rights issue.

12.8.1 Offer for sale

When a company seeks a listing of its shares for the first time, it must offer those shares to the public (using the services of a member firm of the Stock Exchange as a sponsor) and issue a **prospectus** setting out information about itself. Some of the information to be included in the prospectus is required by the Companies Act but this is expanded upon by the **Listing Rules**. The prospectus is a highly informative document, revealing far more about a company than would be found in the annual report. There is a requirement for an accountant's report which includes a three-year history of the financial statements. In particular, there must be a specific statement confirming the adequacy of working capital.

There may also be a forecast of the expected profits for the next accounting period. The reporting accountants will be asked to give an opinion on the forecast. Particularly interesting are the assumptions on which the forecast is based. The reporting accountants will confirm that the amounts in the forecast are consistent with the assumptions but the reader will have to decide how appropriate the assumptions themselves are.

Exhibit 12.5 contains an example of a statement of assumptions taken from a company prospectus.

Exhibit 12.5
Assumptions on which profit forecast is based

The forecasts have been prepared on a basis consistent with the accounting policies normally accepted by the Group and on the following principal assumptions:

(i) there will be no changes in taxation or other legislation or government regulations or policies which will have a significant effect on the Group; and
(ii) the operations of the Group and its suppliers will not be significantly affected by weather conditions, industrial action or civil disturbances.

You may be surprised to learn that the wording in Exhibit 12.5 is extracted from the prospectus of a company retailing high quality chocolates. You may be further surprised to learn that very similar wording appeared in the prospectus of a company offering dry cleaning services. There is no regulation which says that the statement of assumptions has to be helpful to the user of the annual report.

12.8.2 Capitalisation issue

After the shares have been listed for some time, the market value may have grown to the point where the shares are less marketable because the price of each is too large for convenient trading in small lots. The company may decide to increase the number of shares held by shareholders without making any change to the assets or liabilities of the company. One way of achieving this is to convert reserves into share capital. Take the simplified balance sheet in Exhibit 12.6. The company decides to convert £1m of reserves into share capital. It writes to each shareholder saying, 'You will receive one new share for each share already held'. The balance sheet now becomes as shown in Exhibit 12.7.

The shareholder now holds twice as many shares by number but is no better or worse off financially because the total value of the company has not changed. The shares will each be worth one-half of the market price of an old share at the moment of issue. This process is sometimes referred to as a bonus issue because the shareholders receive new share certificates, but in reality there is no bonus because no new wealth is created.

Exhibit 12.6
Balance sheet of company prior to capitalisation

	£m
Assets	7
Liabilities	(4)
	3
Share capital, in shares of 25 pence each	1
Reserves	2
	3

Exhibit 12.7
Balance sheet of company after capitalisation

	£m
Assets	7
Liabilities	(4)
	3
Share capital, in shares of 25 pence each	2
Reserves	1
	3

In terms of the accounting equation the effect on the balance sheet is:

Assets	–	Liabilities	=	**Ownership interest** ↑↓
				Increase in share capital £1m Decrease in reserves £1m

12.8.3 Rights issue

Once a company has a market listing it may decide that it needs to raise further finance on the stock market. The first people it would ask are the existing shareholders, who have already shown their commitment to the company by owning shares in it. Furthermore, it is desirable to offer them first chance because if strangers buy the shares the interests of the existing shareholders may be diluted. Suppose the company in Exhibit 12.6 wishes to raise £3m new finance. It will offer existing shareholders the right to pay for, say, 2 million new shares at 150 pence each. There are already 4 million shares of 25p nominal value in issue, so the letter to the shareholders will say: 'The company is offering you the right to buy 1 new share at a price of 150p for every 2 existing shares you hold.' Existing shareholders will be attracted by this offer provided the market price stays above 150 pence for existing shares. They may take up the rights themselves or sell the right to someone else. In either event, the company will receive £3m cash, the company will issue 2 million new shares at 150 pence each and the balance sheet will appear as in Exhibit 12.8.

Exhibit 12.8
Balance sheet after rights issue

	£m
Assets	7.0
New cash	3.0
	10.0
Liabilities	(4.0)
	6.0
Share capital, in shares of 25 pence each	1.5
Share premium	2.5
Reserves	2.0
	6.0

The issue price of 150 pence is split for accounting purposes into the nominal value of 25 pence and the premium of 125 pence. In terms of the accounting equation the effect of the rights issue on the balance sheet is:

Assets ↑	–	Liabilities	=	**Ownership interest** ↑
Increase in cash £3m				Increase in share capital £0.5m Increase in share premium £2.5m

Activity 12.4

Look in the financial section of a newspaper for the list of recent issues of new shares. Obtain the address of one company from a trade directory and write politely to ask for a copy of the prospectus. If you are sufficiently fortunate to obtain a copy of a prospectus, look at the accounting information and compare it with the amount and type of information published in the annual report. Why are they not the same?

12.9 Summary

- **Ownership interest** is the residual amount found by deducting all of the entity's liabilities from all of the entity's assets.
- Unrealised gains are reported in a **statement of recognised income and expense** or a **statement of changes in equity** in the IASB system. They are reported in a **statement of total recognised gains and losses** in the UK ASB system.
- Each share has a named value when the company is formed. This is called its nominal value. It does not change unless the shareholders agree to split shares into smaller units.
- When the shares are sold on a stock market they have a **market value**. The market value of frequently traded shares changes daily with the forces of supply and demand.
- The difference between the nominal value and the market value is called the **share premium**. When the company issues further shares at market price the share premium is recorded separately from the nominal value.
- When non-current assets are revalued, the **unrealised** increase in value is recorded in the **revaluation reserve**.
- **Dividends** paid to shareholders reduce the ownership interest. The effect on the accounting equation is reported when dividends are paid. Dividends proposed to be paid in future are described in the directors' report.
- When a company issues more shares after incorporation it may be through a capitalisation issue, an offer for sale or a rights issue. A **capitalisation issue** gives more shares to equity shareholders. It changes the relationship between share capital and reserves but brings no new resources into the business. An **offer for sale** increases the ownership interest and brings in new cash. A **rights issue** also increases the ownership interest and brings in new cash but it gives the existing shareholders the first choice of maintaining their proportionate interest in the company.

QUESTIONS

The Questions section of each chapter has three types of question. 'Test your understanding' questions to help you review your reading are in the 'A' series of questions. You will find the answers to these by reading and thinking about the material in the book. 'Application' questions to test your ability to apply technical skills are in the 'B' series of questions. Questions requiring you to show skills in problem solving and evaluation are in the 'C' series of questions. A letter [S] indicates that there is a solution at the end of the book.

A Test your understanding

A12.1 Why may it be said that the ownership interest is the residual item in the accounting equation? (Section 12.1)

A12.2 What is the definition of ownership interest? (Section 12.2)

A12.3 What is the effect on the accounting equation where new shares are issued for cash? (Section 12.3.1)

A12.4 Why does the company not record the buying and selling of shares in its balance sheet? (Section 12.3.3)

A12.5 What is a share premium? How is it recorded? (Section 12.3.4)

A12.6 How is the revaluation of a non-current (fixed) asset reported? (Section 12.3.5)

A12.7 Why may the revaluation of a non-current (fixed) asset not be reported in the profit and loss account? (Section 12.3.5)

A12.8 Where may the reader of the annual report find out about the effect of movements in foreign exchange rates? (Section 12.3.6)

A12.9 What is the purpose of the statement of total recognised income and expenses? (Section 12.6.4)

A12.10 What is the purpose of the reconciliation of movements in equity? (Section 12.6.5)

A12.11 How do the directors report their recommended dividend for the financial period, to be agreed at the shareholders' meeting? (Section 12.7)

A12.12 What is meant by:

(a) offer for sale; (section 12.8.1)
(b) capitalisation issue; and (section 12.8.2)
(c) rights issue? (section 12.8.3)

Explain the effect of each of the above on the balance sheet of a company.

B Application

B12.1 [S]

Explain the effect on the accounting equation of each of the following transactions:

(a) At the start of Year 1, Bright Ltd issues 200,000 shares at nominal value 25 pence per share, receiving £50,000 in cash.
(b) At the end of Year 2, Bright Ltd issues a further 100,000 shares to an investor at an agreed price of 75 pence per share, receiving £75,000 in cash.
(c) At the end of Year 3 the directors of Bright Ltd obtain a market value of £90,000 for a company property which originally cost £70,000. They wish to record this in the balance sheet.

B12.2 [S]

Explain the effect on the accounting equation of the following transactions and decisions regarding dividends:

(a) The company pays a dividend of £20,000 during the accounting period.
(b) The directors recommend a dividend of £30,000 at the end of the accounting year. It will be paid following shareholder approval at the Annual General Meeting, held two months after the accounting year-end.

B12.3 [S]

The following is a summarised balance sheet of Nithsdale Ltd.

	£000s
Cash	20
Other assets less liabilities	320
	340
Ordinary shares (400,000 of 25 pence each)	100
Share premium	40
Reserves of retained profit	200
	340

The company is considering three possible changes to its capital structure:

(a) issue for cash 50,000 additional ordinary shares at £1 per share, fully paid; or
(b) make a 1 for 4 capitalisation issue of ordinary shares; or
(c) make a 1 for 5 rights issue at £3 per share.

Show separately the impact of each change on the balance sheet of the company.

B12.4 [S]

Fragrance plc has owned a factory building for many years. The building is recorded in the balance sheet at £250,000, being historical cost of £300,000 less accumulated depreciation of £50,000. The recent report of a professional valuer indicated that the property is valued at £380,000 on an open market basis for its existing use. Explain the effect this information will have on the reported financial statements.

B12.5 [S]

Suppose the factory building in question **B12.4** was valued by the professional expert at £240,000. What effect would this information have on the reported financial statements?

C Problem solving and evaluation

This question reviews your understanding of Chapters 8–12 and the effect of transactions on ownership interest.

C12.1

Set out below is a summary of the accounting records of Titan Ltd at 31 December Year 1:

	£000s	£000s
Assets		
Land and buildings	200	
Plant and machinery	550	
Investment in shares	150	
Stock	250	
Trade receivables (debtors)	180	
Cash	150	
Liabilities		
Trade payables (creditors)		365
Debenture loan 10% nominal rate of interest		250
Ownership interest		
Share capital		600
Retained earnings at 1 Jan. Year 1		125
Revenue		
Sales		1,815
Cost of goods sold	1,505	
Expenses		
Overhead expenses	145	
Debenture interest paid	25	
Totals	3,155	3,155

The summary of the accounting records includes all transactions which have been entered in the ledger accounts up to 31 December, but investigation reveals further adjustments which relate to the accounting period up to, and including, that date.

The adjustments required relate to the following matters:

(i) No depreciation has been charged for the year in respect of buildings, plant and machinery. The depreciation of the building has been calculated as £2,000 per annum and the depreciation of plant and machinery for the year has been calculated as £55,000 for the year.
(ii) The company is aware that electricity consumption during the months of November and December, Year 1, amounted to around £5,000 in total, but no electricity bill has yet been received.
(iii) Overhead expenses include insurance premiums of £36,000 which were paid at the start of December, Year 1, in respect of the 12-month period ahead.
(iv) The stock amount is as shown in the accounting records of items moving into and out of stock during the year. On 31 December a check of the physical stock was made. It was discovered that raw materials recorded as having a value of £3,000 were, in fact, unusable. It was also found that an employee had misappropriated stock worth £5,000.
(v) The company proposes to pay a dividend of £30,000.
(vi) The corporation tax payable in respect of the profits of the year is estimated at £45,000, due for payment on 30 September, Year 2.

Required

(a) Explain how each of the items (i) to (vi) will affect the ownership interest.
(b) Calculate the amount of the ownership interest after taking into account items (i) to (vi).

(*Hint*: First calculate the profit of the year.)

Activities for study groups

Turn to the annual report of a listed company which you have used for activities in earlier chapters. Find every item which relates to the ownership interest (including any discussion in the non-regulated part of the annual report).

As a group, imagine you are shareholders in this company. You are holding a meeting of the shareholders' action group calling for clarity of information about your total interest in the business. Make lists of the good points and weak points in the quality of information available to you and then arrange the weak points in descending order of importance. Then draft an action plan for improved communication with shareholders which you would propose sending to the company.

Notes and references

1. IASB (2004), IAS 21, *The effects of changes in foreign exchange rates*, International Accounting Standards Board.
2. IASB (2004), IAS 1, *Presentation of Financial Statements*, para. 8.
3. ASB (1992), Financial Reporting Standard (FRS 3), *Reporting Financial Performance*, Accounting Standards Board; and ASB (1999), *Statement of Principles for Financial Reporting*, ch. 7.
4. ASB (1992), FRS 3, para. 59.

Supplement to Chapter 12

A spreadsheet for adjustment to a trial balance at the end of the accounting period

End-of-period adjustments and the ownership interest

If you look back to Chapter 6 you will see that it finished with a trial balance and a promise that the trial balance would be used later as the starting point for preparation of financial statements. The moment has now arrived where the trial balance is used as a starting point for making end-of-period adjustments to show the change in the ownership interest during the period.

The accruals concept (or the parallel argument of matching in the profit and loss account) requires all items relevant to the period to be included in the financial statements of the period. Most items will be included because they will have been recorded in the ledger and hence in the financial statements. However, there will be some items of information, emerging from enquiry at the end of the period, which have not yet resulted in a transaction but which are undoubtedly based on events relevant to the period.

The enquiry will take a routine form of:

- estimating the depreciation of non-current (fixed) assets where this has not already been recorded;
- examining non-current (fixed) assets for signs of obsolescence beyond the amount allowed for in the depreciation charge;
- counting the inventory (stock) of raw materials, work-in-progress and finished goods, for comparison with the accounting record;
- evaluating the doubtful debts;
- checking files for any purchase invoices received but not yet recorded;
- checking files for any sales invoices for goods sent out but not yet recorded;
- considering whether any resource has been consumed, or service received, for which a supplier has not yet sent an invoice.

Returning to the trial balance contained in Exhibit 6.15 of Chapter 6, it may be noted that the depreciation for the month has been charged, there are no trade receivables (debtors) and therefore no concerns about doubtful debts, and it would appear from the list of transactions for the month that all sales and purchases have been recorded carefully. Suppose, however, that when M. Carter checks the inventory (stock) of goods at the end of the month it is found that the roof has been leaking and rainwater has damaged goods worth £500. Furthermore, the business uses gas to heat a water boiler and it is estimated that consumption for the month amounts to £80.

These items of information are called *end-of-period adjustments*. Both events could, and would, be recorded in the ledger accounts by the business. If you were presented with this information as a class exercise, or you were the auditor taking the trial balance and adjusting it for this further information, you would use a spreadsheet which set out the trial balance and then provided further columns for the end-of-period adjustments. The spreadsheet for this example is set out in Exhibit 12.9 but before looking at that you should read through the next section which explains the recording of end-of-period adjustments. In this case a one-month period is covered and so the adjustments are referred to as month-end adjustments.

Analysis of the month-end adjustments

Before any entries may be made in the adjustments columns of the spreadsheet, the effect of each adjustment on the accounting equation must be considered so that the debit and credit entries may be identified.

(a) At the end of the month it is found that the roof has been leaking and rainwater has damaged goods worth £500

Assets ↓	–	Liabilities	=	Ownership interest ↓
Inventory (stock) decreases by £500				Expense of £500 for inventory (stock) damaged

The loss of inventory (stock) causes the ownership interest to decrease and is recorded as a debit entry in the expense of cost of goods sold. The decrease in the inventory (stock) is recorded as a credit entry in the ledger account.

Dr	Cost of goods sold	£500	
Cr	Inventory (stock) of goods		£500

(b) The business uses gas to heat a water boiler and it is estimated that consumption for the month amounts to £80

Assets	–	Liabilities ↑	=	Ownership interest ↓
		Obligation to pay for gas consumed £80		Expense of £80 for gas consumed

The event of consuming the gas causes the ownership interest to decrease and is recorded as a debit entry in an expense account for gas consumed. The obligation to pay for the gas at a future time is recorded as a credit entry in the ledger account for accruals.

Dr Expense of gas	£80	
Cr Accruals		£80

The spreadsheet

Exhibit 12.9 contains, in the left-hand pair of debit and credit columns, the trial balance of Exhibit 6.15 from Chapter 6. The next pair of columns contains the debit and credit entries necessary for the end-of-period adjustments. The third pair of columns shows the resulting amounts on each line of profit and loss account items. The final pair of columns shows the resulting amounts on each line of balance sheet items. The entire spreadsheet could be thought of as a series of ledger accounts stretched across the page, with one line for each ledger account.

The debit and credit entries identified by the foregoing analysis are shown in the adjustments columns of the spreadsheet with identifying letters in brackets alongside. Where no suitably named line exists, a new line may be inserted. The use of a new line is shown here for accruals and the expense of gas. If the exercise is being carried out using a computer spreadsheet package, the insertion of an extra line is not a problem. For a handwritten exercise it may be necessary to leave spaces at possible insertion points.

Once all adjustments have been entered, each of the adjusted amounts can be carried across to one of the final four columns, depending on whether the item belongs

Exhibit 12.9

Trial balance of M. Carter at the end of May, before month-end adjustments

Ledger account title		*Trial balance*		*Adjustments*		*Income (profit) statement*		*Balance sheet*	
		Dr	*Cr*	*Dr*	*Cr*	*Expense*	*Revenue*	*A*	*L + OI*
		£	£	£	£	£	£	£	£
L3	Buildings	30,000						30,000	
L4	Equipment	5,750						5,750	
L5	Inventory (stock) of goods	8,000			500 (a)			7,500	
L11	R. Welsby	nil							
L1	Cash	6,400						6,400	
	Accruals				80 (b)				80
L6	R. Busby		nil						
L2	Ownership interest		49,000						49,000
Subtotal		*50,150*	*49,000*					*49,650*	*49,080*
Difference: profit of the month									*570*
L10	Sales		7,000				7,000		
L9	Cost of goods sold	3,500		500 (a)		4,000			
L7	Electricity	100				100			
	Gas			80 (b)		80			
L8	Wages	2,000				2,000			
L12	Depreciation	250				250			
Subtotal		*5,850*	*7,000*			*6,430*	*7,000*		
Difference: profit of the month						*570*			
Total of each column		*56,000*	*56,000*	*580*	*580*	*7,000*	*7,000*	*49,650*	*49,650*

to the profit and loss account or the balance sheet. Each pair of columns is added and the difference between the totals in the profit and loss account columns should equal the difference between the totals in the balance sheet columns. If that is not the case, it means that an error has taken place at some point in the spreadsheet and must be found.

Revised statement of profit

The statement of profit before adjustments is shown in section 6.6.2 of Chapter 6 and the balance sheet is in section 6.6.3. From the final four columns of the spreadsheet in Exhibit 12.9, these could now be restated as follows:

M Carter, Wholesaler
Income statement (profit and loss account) (adjusted)
for the month of May Year XX

	£	£
Revenue (sales)		7,000
Cost of goods sold		(4,000)
Gross profit		3,000
Other expenses		
Wages	(2,000)	
Electricity	(100)	
Gas	(80)	
Depreciation	(250)	
		(2,430)
Net profit		570

Statement of financial position: the balance sheet

M Carter, Wholesaler
Balance sheet (adjusted) at 31 May Year XX

	£
Non-current (fixed) assets	
Buildings	30,000
Equipment	6,000
	36,000
Depreciation	(250)
Depreciated cost of non-current (fixed) assets	35,750
Current assets	
Inventory (stock)	7,500
Cash at bank	6,400
	13,900
Accruals	(80)
Net current assets	13,820
Net assets	49,570
Ownership interest	
Capital at start	50,000
Add profit	570
Less drawings	(1,000)
Total ownership interest	49,570

This completes the study of double entry bookkeeping in this book. You are now in a position to be able to carry out the following tasks in relation to the business of a sole trader:

- record transactions in ledger accounts
- prepare a trial balance
- make end-of-period adjustments to the trial balance
- prepare a profit and loss account and balance sheet.

S Test your understanding

S12.1 (a) Using the information provided in question **C12.1**, prepare a spreadsheet containing a trial balance, adjustment and resulting figures for profit and loss account and balance sheet items. (Exhibit 12.9 provides a pattern to follow.)

(b) Present the profit and loss account for the year and the balance sheet at the end of the year in an informative and useful manner.