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Financial Accounting Fundamentals

Revised edition relevant for 2005/2006 Computer Based Assessment



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CIMA'S Official *Study System*
Revised edition relevant for 2005/2006
Computer Based Assessment

Certificate Level

Financial Accounting Fundamentals

**Henry Lunt
Margaret Weaver**



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Important Note

A new edition of the *CIMA Official Terminology* is due to be published in September 2005. As this is past the publication date of this Study System the page reference numbers for 'Management Accounting Official Terminology' contained in this Study System are for the 2000 edition. You should ensure that you are familiar with the 2005 *CIMA Official Terminology* (ISBN: 0 7506 6827 X) once published, available from www.cimapublishing.com

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Contents

| | |
|---|------|
| The CIMA Study system | xi |
| Acknowledgements | xi |
| How to use your CIMA <i>Study System</i> | xi |
| Guide to the Icons used within this Text | xii |
| Study technique | xiii |
| Computer-based assessment | xv |
| The Financial Accounting Fundamentals Syllabus | xv |
| Learning outcomes and syllabus content | xvi |
| | |
| 1 The Accounting Scene | 1 |
| Learning Outcomes | 1 |
| 1.1 Introduction | 1 |
| 1.2 What is accounting? | 1 |
| 1.2.1 The objectives of accounting | 2 |
| 1.3 Who uses accounts? | 3 |
| 1.4 The characteristics of useful information | 4 |
| 1.5 Terminology | 5 |
| 1.5.1 Bookkeeping | 5 |
| 1.5.2 Financial accounting | 5 |
| 1.5.3 Management accounting | 6 |
| 1.6 The differences between external and internal information | 6 |
| 1.7 What is a business organisation? | 7 |
| 1.7.1 Profit-making organisations | 7 |
| 1.7.2 Non-profit-making organisations | 7 |
| 1.8 Summary | 8 |
| Revision Questions | 9 |
| Solutions to Revision Questions | 11 |
| | |
| 2 The Framework of Financial Accounts | 13 |
| Learning Outcomes | 13 |
| 2.1 Introduction | 13 |
| 2.2 The separate entity concept | 13 |
| 2.3 The accounting equation | 14 |
| 2.3.1 The accounting equation in action | 15 |
| 2.4 The accounting equation and the balance sheet | 17 |
| 2.4.1 The contents of a balance sheet | 18 |
| 2.4.2 Vertical presentation of a balance sheet | 20 |

| | | |
|----------|---|----|
| 2.5 | The profit and loss account | 21 |
| 2.5.1 | The cost of goods sold | 23 |
| 2.6 | Profit and cash | 25 |
| 2.7 | Capital and revenue | 25 |
| 2.7.1 | Capital transactions | 25 |
| 2.7.2 | Revenue transactions | 26 |
| 2.8 | Summary | 26 |
| | Revision Questions | 27 |
| | Solutions to Revision Questions | 31 |
| 3 | The Accounting System in Action | 35 |
| | Learning Outcomes | 35 |
| 3.1 | Introduction | 35 |
| 3.2 | What is a ledger account? | 35 |
| 3.3 | What is double-entry bookkeeping? | 36 |
| 3.4 | Bookkeeping entries for expenses and revenue | 39 |
| 3.4.1 | Bookkeeping entries for purchases and sales | 40 |
| 3.4.2 | Nominal ledger accounts | 44 |
| 3.5 | Balancing the accounts | 44 |
| 3.5.1 | Calculating the balance on the account | 44 |
| 3.6 | Summary | 45 |
| | Revision Questions | 47 |
| | Solutions to Revision Questions | 53 |
| 4 | Summarising the Ledger Accounts | 59 |
| | Learning Outcomes | 59 |
| 4.1 | Introduction | 59 |
| 4.2 | Preparing the trial balance | 59 |
| 4.2.1 | Does the trial balance prove the accuracy of the ledger accounts? | 60 |
| 4.3 | Preparing a statement of profit | 61 |
| 4.3.1 | The trading account | 62 |
| 4.3.2 | The profit and loss account | 65 |
| 4.3.3 | The balance on the profit and loss account | 67 |
| 4.3.4 | Dealing with drawings | 67 |
| 4.4 | Preparing the balance sheet | 68 |
| 4.5 | Balancing off the accounts | 69 |
| 4.6 | Columnar ledger accounts | 73 |
| 4.7 | Summary | 73 |
| | Revision Questions | 75 |
| | Solutions to Revision Questions | 79 |
| 5 | Further Aspects of Ledger Accounting | 83 |
| | Learning Outcomes | 83 |
| 5.1 | Introduction | 83 |

| | | |
|----------|---|-----|
| 5.2 | Accounting for specialised transactions | 83 |
| 5.2.1 | Carriage costs | 83 |
| 5.2.2 | Discounts | 84 |
| 5.3 | Accounting for VAT | 86 |
| 5.3.1 | VAT on fixed assets and expenses | 89 |
| 5.3.2 | VAT in separate accounts | 89 |
| 5.3.3 | Non-registered businesses | 89 |
| 5.3.4 | Zero-rated and exempt supplies | 90 |
| 5.3.5 | Mixed supplies | 90 |
| 5.3.6 | Exports and imports | 91 |
| 5.4 | Accounting for wages and salaries | 91 |
| 5.4.1 | Gross pay and net pay | 91 |
| 5.4.2 | Other deductions | 92 |
| 5.4.3 | Pension contributions | 93 |
| 5.5 | Accruals and prepayments | 93 |
| 5.5.1 | Recording accruals and prepayments in the ledger accounts | 94 |
| 5.6 | Bad debts and provisions for doubtful debts | 96 |
| 5.6.1 | Accounting for bad debts | 96 |
| 5.6.2 | Bad debts recovered | 97 |
| 5.6.3 | Providing for doubtful debts | 99 |
| 5.7 | The exchange of goods | 102 |
| 5.8 | Summary | 103 |
| | Revision Questions | 105 |
| | Solutions to Revision Questions | 113 |
| 6 | Accounting for Fixed Assets | 119 |
| | Learning Outcomes | 119 |
| 6.1 | Introduction | 119 |
| 6.2 | Capital and revenue expenditure | 119 |
| 6.3 | Depreciation | 121 |
| 6.4 | Calculating depreciation | 122 |
| 6.4.1 | The straight-line method | 122 |
| 6.4.2 | The reducing-balance method | 123 |
| 6.4.3 | The machine-hour method (rate of usage method) | 124 |
| 6.4.4 | The revaluation method | 125 |
| 6.4.5 | Depreciation in the year of acquisition and disposal | 125 |
| 6.5 | Accounting for the disposal of a fixed asset | 125 |
| 6.6 | A comprehensive example | 127 |
| 6.7 | Controlling tangible fixed assets | 128 |
| 6.8 | Accounting for intangible fixed assets | 130 |
| 6.8.1 | What is goodwill? | 130 |
| 6.9 | Summary | 131 |
| | Revision Questions | 133 |
| | Solutions to Revision Questions | 147 |

| | | |
|----------|--|-----|
| 7 | Final Accounts with Adjustments | 157 |
| | Learning Outcome | 157 |
| 7.1 | Introduction | 157 |
| 7.2 | The trial balance | 157 |
| 7.3 | The adjustments | 158 |
| 7.4 | Step 1: Labelling the trial balance | 159 |
| 7.5 | Step 2: Preparing workings | 160 |
| 7.6 | Step 3: Preparing the accounts | 161 |
| 7.7 | Summary | 169 |
| | Revision Questions | 171 |
| | Solutions to Revision Questions | 183 |
| | | |
| 8 | Organising the Bookkeeping System | 191 |
| | Learning Outcomes | 191 |
| 8.1 | Introduction | 191 |
| 8.2 | Organising the ledger accounts | 191 |
| | 8.2.1 Advantages of dividing the ledger | 192 |
| 8.3 | Supporting books and records | 192 |
| | 8.3.1 Source documents | 193 |
| 8.4 | Sales, purchases and returns daybooks | 193 |
| | 8.4.1 Recording transactions in the daybooks | 194 |
| | 8.4.2 Making the ledger entries | 195 |
| | 8.4.3 Extending the use of daybooks | 199 |
| 8.5 | The cash books | 199 |
| | 8.5.1 The banking system | 200 |
| | 8.5.2 The cash book | 200 |
| | 8.5.3 The petty-cash book | 203 |
| 8.6 | The journal | 204 |
| | 8.6.1 The layout of the journal | 205 |
| | 8.6.2 Using the journal for miscellaneous transactions | 205 |
| | 8.6.3 Using the journal for end-of-year transactions | 205 |
| 8.7 | Stock records and valuation methods | 206 |
| | 8.7.1 The process of stock valuation | 207 |
| | 8.7.2 Application of cost-valuation techniques | 208 |
| | 8.7.3 Issues and receipts | 211 |
| 8.8 | Summary | 212 |
| | Revision Questions | 215 |
| | Solutions to Revision Questions | 223 |
| | | |
| 9 | Controlling the Bookkeeping System | 229 |
| | Learning Outcomes | 229 |
| 9.1 | Introduction | 229 |
| 9.2 | Preventing errors | 229 |
| | 9.2.1 Authorisation procedures | 230 |

| | | |
|-----------|---|-----|
| 9.2.2 | Documentation | 230 |
| 9.2.3 | Organisation of staff | 230 |
| 9.2.4 | Safeguarding assets | 230 |
| 9.3 | Detecting errors | 231 |
| 9.3.1 | Spot checks | 231 |
| 9.3.2 | Comparison with external evidence | 231 |
| 9.3.3 | Reconciliations | 231 |
| 9.3.4 | Carrying out an audit | 231 |
| 9.4 | Bank reconciliation statements | 232 |
| 9.5 | Reconciliation of suppliers' statements | 235 |
| 9.6 | Control accounts | 236 |
| 9.6.1 | The status of the control account | 239 |
| 9.6.2 | Contra entries | 242 |
| 9.6.3 | Credit balances in the sales ledger; debit balances in the purchase ledger | 243 |
| 9.6.4 | The control account and provision for doubtful debts | 244 |
| 9.6.5 | Advantages of control accounts | 244 |
| 9.6.6 | Reconciling control accounts and ledger accounts | 244 |
| 9.7 | Suspense accounts and the correction of errors | 245 |
| 9.8 | Computers in accounting | 248 |
| 9.8.1 | Aspects of computerised accounting systems | 249 |
| 9.9 | Accounting coding systems | 249 |
| 9.10 | Summary | 251 |
| | Revision Questions | 253 |
| | Solutions to Revision Questions | 265 |
| 10 | The Regulatory Framework of Accounting | 273 |
| | Learning Outcomes | 273 |
| 10.1 | Introduction | 273 |
| 10.2 | Accounting concepts | 274 |
| 10.2.1 | The business entity concept | 274 |
| 10.2.2 | The money measurement concept | 274 |
| 10.2.3 | The cost concept | 274 |
| 10.2.4 | The objectivity concept | 275 |
| 10.2.5 | The dual aspect concept | 275 |
| 10.2.6 | The realisation concept | 275 |
| 10.2.7 | The periodicity concept | 275 |
| 10.2.8 | The accruals and matching concepts | 275 |
| 10.2.9 | The materiality concept | 276 |
| 10.2.10 | The fairness concept | 277 |
| 10.2.11 | The going concern concept | 277 |
| 10.2.12 | The consistency concept | 277 |
| 10.2.13 | The prudence concept | 277 |
| 10.3 | Accounting policies and estimation techniques | 278 |
| 10.4 | The historical cost convention and its alternatives | 279 |
| 10.4.1 | The theory of capital maintenance | 279 |

| | | |
|-----------|--|-----|
| 10.4.2 | Current purchasing power (CPP) accounting | 280 |
| 10.4.3 | Current cost accounting (CCA) | 281 |
| 10.4.4 | Market value (fair value) | 281 |
| 10.4.5 | Economic value (value in use) | 281 |
| 10.4.6 | The valuation of intangible assets | 282 |
| 10.5 | Regulations in accounting | 284 |
| 10.5.1 | The Companies Act | 284 |
| 10.5.2 | The accountancy profession | 285 |
| 10.5.3 | Accounting standards | 285 |
| 10.6 | The role of the auditor | 287 |
| 10.6.1 | The true and fair concept | 288 |
| 10.6.2 | The role of the external auditor | 289 |
| 10.6.3 | The role of the internal auditor | 290 |
| 10.6.4 | The value-for-money audit | 290 |
| 10.7 | The role of management | 290 |
| 10.8 | Summary | 291 |
| | Revision Questions | 293 |
| | Solutions to Revision Questions | 299 |
| 11 | Incomplete Records; Income and Expenditure Accounts | 303 |
| | Learning Outcomes | 303 |
| 11.1 | Introduction | 303 |
| 11.2 | Calculating 'missing figures' | 303 |
| 11.2.1 | Sales figures | 304 |
| 11.2.2 | Purchases figures | 305 |
| 11.2.3 | Expenses figures | 305 |
| 11.2.4 | Opening capital | 305 |
| 11.2.5 | Cash and bank summaries | 306 |
| 11.3 | Accounts of non-profit-making bodies | 310 |
| 11.3.1 | Accounting terminology for non-profit-making bodies | 310 |
| 11.3.2 | Accounting for membership fees and subscriptions | 311 |
| 11.3.3 | The accounts of non-trading organisations | 313 |
| 11.4 | Summary | 317 |
| | Revision Questions | 319 |
| | Solutions to Revision Questions | 331 |
| 12 | The Manufacturing Account | 341 |
| | Learning Outcome | 341 |
| 12.1 | Introduction | 341 |
| 12.2 | Why is a manufacturing account needed? | 341 |
| 12.2.1 | Stocks in manufacturing organisations | 342 |
| 12.3 | Costs to include in the manufacturing account | 342 |
| 12.3.1 | Other direct costs | 343 |
| 12.3.2 | Prime cost | 343 |

| | | |
|-----------|--|-----|
| 12.3.3 | Indirect costs | 343 |
| 12.3.4 | Factory cost of production | 343 |
| 12.3.5 | Work in progress | 343 |
| 12.3.6 | Factory cost of goods completed | 344 |
| 12.4 | Layout of a manufacturing account | 344 |
| 12.5 | Trading accounts for manufacturing organisations | 344 |
| 12.6 | Profit and loss accounts for manufacturing organisations | 345 |
| 12.7 | Balance sheets for manufacturing organisations | 345 |
| 12.8 | The accounting system for manufacturing organisations | 345 |
| 12.9 | Summary | 348 |
| | Revision Questions | 351 |
| | Solutions to Revision Questions | 355 |
| 13 | The Accounts of Limited Companies and Cash-Flow Statements | 357 |
| | Learning Outcomes | 357 |
| 13.1 | Introduction | 357 |
| 13.2 | Limited companies | 357 |
| 13.2.1 | The accounting statements of companies | 358 |
| 13.2.2 | Published accounts and terminology in company accounts | 358 |
| 13.2.3 | Taxation in company accounts | 359 |
| 13.2.4 | Directors of limited companies | 359 |
| 13.2.5 | Sources of finance for a limited company | 359 |
| 13.2.6 | Dividends | 361 |
| 13.2.7 | Reserves | 362 |
| 13.3 | Cash-flow statements | 367 |
| 13.3.1 | What is a cash-flow statement? | 367 |
| 13.3.2 | Why does the profit earned not equal the change in bank and cash balances? | 368 |
| 13.3.3 | Net cash flow from operating activities | 368 |
| 13.3.4 | The cash-flow statement | 370 |
| 13.3.5 | Cash-flow statements for sole traders | 372 |
| 13.4 | Summary | 372 |
| | Revision Questions | 375 |
| | Solutions to Revision Questions | 397 |
| 14 | The Interpretation of Accounts | 411 |
| | Learning Outcome | 411 |
| 14.1 | Introduction | 411 |
| 14.2 | What is meant by 'interpretation of accounts'? | 411 |
| 14.3 | Calculating ratios | 412 |
| 14.3.1 | Using the ratios | 413 |
| 14.4 | Types of ratios | 413 |
| 14.5 | Profitability ratios | 414 |
| 14.5.1 | Gross profit margin | 414 |

| | | |
|--------|---|-----|
| 14.5.2 | Gross profit mark-up | 415 |
| 14.5.3 | Net profit margin | 415 |
| 14.5.4 | Return on capital employed (ROCE) | 415 |
| 14.6 | Liquidity ratios | 417 |
| 14.6.1 | The current ratio | 417 |
| 14.6.2 | The quick ratio | 417 |
| 14.7 | Efficiency ratios | 418 |
| 14.7.1 | Asset turnover ratios | 418 |
| 14.7.2 | Stock turnover | 419 |
| 14.7.3 | Debtors collection period | 419 |
| 14.7.4 | Creditors payment period | 420 |
| 14.7.5 | Total working capital ratio | 420 |
| 14.8 | Capital structure ratios | 421 |
| 14.8.1 | The gearing ratio | 421 |
| 14.8.2 | Interest cover | 421 |
| 14.9 | Ratio analysis for sole traders | 422 |
| 14.10 | Summary | 422 |
| | Revision Questions | 425 |
| | Solutions to Revision Questions | 445 |
| | Preparing for the Assessment | 457 |
| | Revision technique | 457 |
| | Planning | 457 |
| | Getting down to work | 458 |
| | Tips for the final revision phase | 458 |
| | Format of the assessment | 458 |
| | Structure of the assessment | 458 |
| | Weighting of subjects | 458 |
| | Revision Questions | 459 |
| | Solutions to Revision Questions | 533 |
| | Mock Assessment 1 | 569 |
| | Mock Assessment 2 | 587 |
| | Index | 603 |

The CIMA Study System

Acknowledgements

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How to use your CIMA Study System

This *Financial Accounting Fundamentals Study System* has been devised as a resource for students attempting to pass their CIMA computer-based assessment, and provides:

- a detailed explanation of all syllabus areas;
- extensive 'practical' materials;
- generous question practice, together with full solutions;
- an exam preparation section, complete with exam standard questions and solutions.

This Study System has been designed with the needs of home-study and distance-learning candidates in mind. Such students require very full coverage of the syllabus topics, and also the facility to undertake extensive question practice. However, the Study System is also ideal for fully taught courses.

The main body of the text is divided into a number of chapters, each of which is organised on the following pattern:

- *Detailed learning outcomes* expected after your studies of the chapter are complete. You should assimilate these before beginning detailed work on the chapter, so that you can appreciate where your studies are leading.
- *Step-by-step topic coverage*. This is the heart of each chapter, containing detailed explanatory text supported where appropriate by worked examples and exercises. You should work carefully through this section, ensuring that you understand the material being explained and can tackle the examples and exercises successfully. Remember that in many cases knowledge is cumulative: if you fail to digest earlier material thoroughly, you may struggle to understand later chapters.

- *Activities.* Some chapters are illustrated by more practical elements, such as comments and questions designed to stimulate discussion.
- *Question practice.* The test of how well you have learned the material is your ability to tackle exam-standard questions. Make a serious attempt at producing your own answers, but at this stage do not be too concerned about attempting the questions in exam conditions. In particular, it is more important to absorb the material thoroughly by completing a full solution than to observe the time limits that would apply in the actual exam.
- *Solutions.* Avoid the temptation merely to ‘audit’ the solutions provided. It is an illusion to think that this provides the same benefits as you would gain from a serious attempt of your own. However, if you are struggling to get started on a question you should read the introductory guidance provided at the beginning of the solution, where provided, and then make your own attempt before referring back to the full solution.

Having worked through the chapters you are ready to begin your final preparations for the exam. The final section of this CIMA *Study System* provides you with the guidance you need. It includes the following features:

- A brief guide to revision technique.
- A note on the format of the exam. You should know what to expect when you tackle the real exam, and in particular the number of questions to attempt, which questions are compulsory and which optional, and so on.
- Guidance on how to tackle the exam itself.
- A table mapping revision questions to the syllabus learning outcomes allowing you to quickly identify questions by subject area.
- Revision questions. These are of exam standard and should be tackled in exam conditions, especially as regards the time allocation.
- Solutions to the revision questions. As before, these indicate the length and the quality of solution that would be expected of a well-prepared candidate.

Two mock assessments. You should plan to attempt these just before the date of the real assessment. By this stage your revision should be complete and you should be able to attempt the mock papers in exam conditions.

If you work conscientiously through this CIMA *Study System* according to the guidelines above you will be giving yourself an excellent chance of exam success. Good luck with your studies!

Guide to the Icons used within this Text



Key term or definition



Equation to learn



Exam tip or topic likely to appear in the exam



Exercise



Question



Solution



Comment or Note

Study technique

Passing exams is partly a matter of intellectual ability, but however accomplished you are in that respect you can improve your chances significantly by the use of appropriate study and revision techniques. In this section we briefly outline some tips for effective study during the earlier stages of your approach to the exam. Later in the text we mention some techniques that you will find useful at the revision stage.

Planning

To begin with, formal planning is essential to get the best return from the time you spend studying. Estimate how much time in total you are going to need for each subject that you face. Remember that you need to allow time for revision as well as for initial study of the material. The amount of notional study time for any subject is the minimum estimated time that students will need to achieve the specified learning outcomes set out earlier in this chapter. This time includes all appropriate learning activities, for example, face-to-face tuition, private study, directed home study, learning in the workplace, revision time, etc. You may find it helpful to read *Better Exam Results* by Sam Malone, CIMA Publishing, ISBN: 075066357X. This book will provide you with proven study techniques. Chapter by chapter it covers the building blocks of successful learning and examination techniques.

The notional study time for Certificate level *Financial Accounting Fundamentals* is 130 hours. Note that the standard amount of notional learning hours attributed to one full-time academic year of approximately 30 weeks is 1,200 hours.

By way of example, the notional study time might be made up as follows:

| | Hours |
|---|--------------|
| Face-to-face study: up to | 40 |
| Personal study: up to | 65 |
| 'Other' study – e.g. learning in the workplace, revision, etc.: up to | <u>25</u> |
| | <u>130</u> |

Note that all study and learning-time recommendations should be used only as a guideline and are intended as minimum amounts. The amount of time recommended for face-to-face tuition, personal study and/or additional learning will vary according to the type of course undertaken, prior learning of the student, and the pace at which different students learn.

Now split your total time requirement over the weeks between now and the exam. This will give you an idea of how much time you need to devote to study each week. Remember to allow for holidays or other periods during which you will not be able to study (e.g. because of seasonal workloads).

With your study material before you, decide which chapters you are going to study in each week, and which weeks you will devote to revision and final question practice.

Prepare a written schedule summarising the above – and stick to it!

The amount of space allocated to a topic in the study material is not a very good guide as to how long it will take you. For example, ‘Summarising and Analysing Data’ has a weight of 25 per cent in the syllabus and this is the best guide as to how long you should spend on it. It occupies 45 per cent of the main body of the text because it includes many tables and charts.

It is essential to know your syllabus. As your course progresses you will become more familiar with how long it takes to cover topics in sufficient depth. Your timetable may need to be adapted to allocate enough time for the whole syllabus.

Tips for effective studying

- (1) Aim to find a quiet and undisturbed location for your study, and plan as far as possible to use the same period of time each day. Getting into a routine helps to avoid wasting time. Make sure that you have all the materials you need before you begin so as to minimise interruptions.
- (2) Store all your materials in one place, so that you do not waste time searching for items around the house. If you have to pack everything away after each study period, keep them in a box, or even a suitcase, which will not be disturbed until the next time.
- (3) Limit distractions. To make the most effective use of your study periods you should be able to apply total concentration, so turn off the TV, set your phones to message mode, and put up your ‘do not disturb’ sign.
- (4) Your timetable will tell you which topic to study. However, before diving in and becoming engrossed in the finer points, make sure you have an overall picture of all the areas that need to be covered by the end of that session. After an hour, allow yourself a short break and move away from your books. With experience, you will learn to assess the pace you need to work at. You should also allow enough time to read relevant articles from newspapers and journals, which will supplement your knowledge and demonstrate a wider perspective.
- (5) Work carefully through a chapter, making notes as you go. When you have covered a suitable amount of material, vary the pattern by attempting a practice question. Preparing an answer plan is a good habit to get into, while you are both studying and revising, and also in the examination room. It helps to impose a structure on your solutions, and avoids rambling. When you have finished your attempt, make notes of any mistakes you made, or any areas that you failed to cover or covered only skimpily.
- (6) Make notes as you study, and discover the techniques that work best for you. Your notes may be in the form of lists, bullet points, diagrams, summaries, ‘mind maps’, or the written word, but remember that you will need to refer back to them at a later date, so they must be intelligible. If you are on a taught course, make sure you highlight any issues you would like to follow up with your lecturer.
- (7) Organise your paperwork. There are now numerous paper storage systems available to ensure that all your notes, calculations and articles can be effectively filed and easily retrieved later.

Computer-based assessment

CIMA has introduced computer-based assessment (CBA) for all subjects at Certificate level. The website says

Objective questions are used. The most common type is “multiple choice”, where you have to choose the correct answer from a list of possible answers, but there are a variety of other objective question types that can be used within the system. These include true/false questions, matching pairs of text and graphic, sequencing and ranking, labelling diagrams and single and multiple numeric entry.

Candidates answer the questions by either pointing and clicking the mouse, moving objects around the screen, typing numbers, or a combination of these responses. Try the online demo at <http://www.cimaglobal.com> to see how the technology works..

The CBA system can ensure that a wide range of the syllabus is assessed, as a pre-determined number of questions from each syllabus area (dependent upon the syllabus weighting for that particular area) are selected in each assessment.

In every chapter of this study system we have introduced these types of questions but obviously we have to label answers A, B, C, etc. rather than using click boxes. For convenience we have retained quite a lot of questions where an initial scenario leads to a number of sub-questions. There will be questions of this type in the CBA but they will rarely have more than three sub-questions. In all such cases examiners will ensure that the answer to one part does not hinge upon a prior answer.

There are two types of questions which were previously involved in objective testing in paper-based exams and which are not at present possible in a CBA. The actual drawing of graphs and charts is not yet possible. Equally there will be no questions calling for comments to be written by students. Charts and interpretations remain on many syllabi and will be examined at Certificate level but using other methods.

For further CBA practice, CIMA Publishing has produced CIMA Inter@ctive CD-ROMs for all certificate level subjects. These products use the same software as found in the real Computer-based assessment and are available at www.cimapublishing.com.

Financial Accounting Fundamentals and Computer-based Assessment

The assessment for Financial Accounting Fundamentals is a 90-min computer-based assessment comprising 40 compulsory questions, with one or more parts. Single part questions are generally worth 1–2 marks each, but two and three part questions may be worth 4 or 6 marks. There will be no choice and all questions should be attempted if time permits. CIMA are continuously developing the question styles within the CBA system and you are advised to try the on-line website demo at www.cimaglobal.com, to both gain familiarity with assessment software and examine the latest style of questions being used.

The Financial Accounting Fundamentals Syllabus

Syllabus overview

This is an introduction to financial accounting and assumes no prior knowledge of the subject. It deals with the recording of accounting transactions and the preparation of accounting statements for single entities. The basic concepts of accounting are dealt with, and the student will be expected to understand the limitations of financial accounts

in attempting to meet the needs of all users. An understanding of the different approaches to asset valuation and the resulting influence on profit measurement is required.

There is an introduction to the regulatory framework that determines published accounts requirements and a basic introduction to the role of accounting standards. An awareness of published accounts is required, but students will not be asked to prepare accounts in a published accounting format. No knowledge of any specific accounting standard is required. There will be an introduction to accounting systems and their control.

Although the emphasis is on the basic methods and techniques of the subject, students will be expected to develop a critical approach by asking why the methods and techniques are used and in what circumstances they are appropriate.

This syllabus addresses the fundamentals of the subject and recognises that some terms and definitions vary from one area of the world to another. As a result, students can use accepted alternative names to those that appear in this syllabus and be aware of alternative accounting formats. For example, International Accounting Standard 1 (IAS 1) uses *income statement* instead of profit and loss account and *non-current assets* instead of fixed assets. Others include *inventories*, *receivables* and *payables* instead of *stock*, *debtors* and *creditors*. All of these are acceptable for use in answers in this paper, but it will be expected that they are applied consistently. Similarly, IAS 1 provides illustrations of accounting formats that are used widely in published accounts and are acceptable in this paper.

Aims

This syllabus aims to test the student's ability to:

- explain the conceptual and regulatory framework of accounting;
- explain the nature of accounting systems and understand the control of such systems;
- prepare accounts for a single entity.

Assessment

This subject is assessed by computer based assessment.

The assessment is 90 min and comprises 40 compulsory questions with one or more parts. A varied range of objective test questions are used.

Learning outcomes and syllabus content

1(i) Conceptual and regulatory framework – 20%

Learning outcomes

On completion of their studies students should be able to:

- identify the various user groups which need accounting information and the characteristics of such information necessary to meet their objectives;
- explain the function of and differences between financial and management accounting systems;
- identify and explain the fundamental accounting concepts, bases and policies;
- explain the concepts of capital and revenue, cash and profit, income and expenditure and assets and liabilities;

- explain the historical cost convention;
- identify the basic methods of valuing assets on current cost, market value and economic value bases, and demonstrate their impact on profit measures and balance sheet values;
- explain the influence of legislation (e.g. Companies Acts) and accounting standards on the production of published accounting information for organisations.

Syllabus content

- Users of accounts and the objectives of financial statements; functions of financial and management accounts; purpose of accounting statements; stewardship; the accounting equation.
- Fundamental accounting concepts, bases and policies; capital and revenue; cash and profit; income, expenditure, assets and liabilities.
- Historical cost convention.
- Methods of asset valuation and their implications for profit measurement and the balance sheet.
- The regulatory influence of company law and accounting standards; items in formats for published accounts.

1(ii) Accounting systems – 20%

Learning outcomes

On completion of their studies students should be able to:

- explain the purpose of accounting records and their role in the accounting system;
- prepare cash and bank accounts; prepare bank reconciliation statements;
- prepare petty cash statements under an imprest system;
- prepare accounts for sales and purchases, including personal accounts and control accounts;
- identify the necessity for financial accounting codes and construct a simple coding system;
- prepare nominal ledger accounts; prepare journal entries; prepare a trial balance;
- prepare accounts for indirect taxes (e.g. VAT);
- prepare accounts for payroll.

Syllabus content

- The accounting system and accounting records.
- Ledger accounts; double-entry bookkeeping.
- Preparation of accounts for cash and bank; bank reconciliations; imprest system for petty cash.
- Accounting for sales and purchases, including personal accounts and control accounts.
- Financial accounting codes and their uses.
- Nominal ledger accounting; journal entries.
- Trial balance.
- Accounting for indirect taxes (e.g. VAT).
- Accounting for payroll.

1(iii) Control of accounting systems – 15%

Learning outcomes

On completion of their studies students should be able to:

- identify the requirements for external audit and the basic processes undertaken;
- explain the purpose and basic procedures of internal audit;
- explain the meaning of true and fair view;
- explain the need for financial controls;
- explain the purpose of audit checks and audit trails;
- explain the nature of errors, and be able to make accounting entries for them;
- explain the nature of fraud and basic ideas of prevention.

Syllabus content

- The purpose of external audit and the meaning of true and fair view.
- Internal audit.
- Financial controls; audit checks on financial controls; audit trails.
- Errors or fraud.

1(iv) Preparation of accounts – 45%

Learning outcomes

On completion of their studies students should be able to:

- prepare accounts using accruals and prepayments;
- explain the difference between and prepare accounts for bad debts and provisions for doubtful debts;
- explain and calculate the methods of depreciation, including straight line, reducing balance and revaluation, and prepare accounts using each method;
- prepare a fixed asset register;
- explain, calculate and prepare accounts for stock;
- prepare trading accounts, profit and loss accounts, appropriations of profit and balance sheets from trial balance;
- prepare manufacturing accounts;
- prepare income and expenditure accounts;
- prepare accounts from incomplete records;
- calculate and explain basic ratios;
- prepare cash-flow statements.

Syllabus content

- Adjustments to the trial balance; accruals and prepayments.
- Bad debts and provision for doubtful debts.
- Accounting treatment for depreciation (straight line, reducing balance and revaluation methods).
- Fixed asset register.
- Accounting for stocks (excluding long-term contract work in progress); methods of stock valuation (FIFO, LIFO and average cost).
- Trading, profit and loss accounts and balance sheets from trial balance; accounting for the appropriations of profit.

- Manufacturing accounts.
- Income and expenditure accounts.
- Production of accounting statements from incomplete data.
- Ratios: return on capital employed; gross and net profit margins; asset turnover; debtors collection and creditors time to pay; current and quick ratios; stock turnover; gearing.
- Cash-flow statements.

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The Accounting Scene



LEARNING OUTCOMES

When you have completed this chapter, you should be able to:

- ▶ identify the various user groups who need accounting information and the characteristics of such information necessary to meet their objectives;
- ▶ explain the function of and differences between financial and management accounting systems.

1.1 Introduction

This chapter provides an introduction to the accounting framework and introduces the function of accounting systems. Much of the chapter relates to the first syllabus area ‘conceptual and regulatory framework’, which is also continued in Chapter 10. This chapter covers the objectives of accounting, an essential feature of which is a discussion of who uses accounts. This raises the question of how we can measure the usefulness of accounting information to those who use accounts.

1.2 What is accounting?

Accounting can be described as being concerned with *measurement* and *management*. Measurement is largely concerned with the recording of past data, and management with the use of that data in order to make decisions that will benefit the organisation.

The measurement process is not always easy. One of the most common problems is that of when to recognise a transaction. For example, if we are to obtain goods from a supplier with payment to be due 60 days after the goods are received, when should the transaction be recorded?

The following possibilities may be considered:

- when we place the order;
- when we take delivery of the goods;
- when we receive the invoice from the supplier; or
- when we pay the supplier for the goods.

Accounting therefore involves the exercising of judgement by the person responsible for converting data into meaningful information. It is this that distinguishes accounting from bookkeeping.

Accounting is defined in the CIMA *Official Terminology* as:

- ‘the classification and recording of monetary transactions;
- the presentation and interpretation of the results of those transactions in order to assess performance over a period and the financial position at a given date;
- the monetary projection of future activities arising from the alternative planned courses of action.’

Note the three aspects considered in this definition: recording, reporting and forecasting:

- Accounting is partly a matter of record-keeping. The monetary transactions entered into by a business need to be controlled and monitored, and for this a permanent record is essential. For an efficient system of record-keeping, the transactions must first be classified into categories appropriate to the enterprise concerned.
- At appropriate intervals, the individual transactions must be summarised in order to give an overall picture.
- Finally, accounting information can be the basis for planning and decision-making.

An alternative explanation is that accounting is part of the management information system (MIS) of an organisation. In this context, the accounting element is referred to as an accounting information system (AIS).



Accounting can thus be said to be a method of providing information to management (and other users) relating to the activities of an organisation. In order to do this it relies on the accurate collection of data from sources both internal and external to the organisation. The recording of this data is often referred to as bookkeeping.

1.2.1 The objectives of accounting

The objectives of accounting are to provide financial information to the managers, owners, and other parties interested in an organisation. This is done by the production of financial statements. You will see in Chapter 10 that the Accounting Standards Board (ASB) in their *Statement of Principles for Financial Reporting (Statement of Principles)* says that



the objective of financial statements is to provide information about the financial position, performance and financial adaptability of an enterprise that is useful to a wide range of users for assessing the stewardship of management and for making economic decisions.

The International Accounting Standards Board (IASB) which is a similar organisation operating internationally, also has a definition of the objective of financial statements, which encompasses much the same ideas.

If these objectives are to be achieved, then the information provided by the accounting system must be reliable and easily understood, and prepared consistently not only from one accounting period to the next but also between similar organisations so that

meaningful comparisons may be made. This need for consistency has led to a number of accounting rules being devised. Some of these rules are contained in legislation – these rules apply particularly to companies; some are included in accounting standards, including documents such as the *Statement of Principles*; and others simply represent recognised practice. These rules are used by accountants to determine the treatment to be adopted in respect of certain financial transactions and the preparation of accounting statements.

1.3 Who uses accounts?

Accounting information is used by many people, both as individuals and in organisations. To get a feel for the purpose of accounts it is useful to classify these users into groups, and to look at the reasons why they use accounts and what they hope to get from them.

Any classification of this sort is somewhat arbitrary, and many users fall into more than one classification. However, the following groups are commonly recognised as having particular needs for accounting information:



- (a) *The equity investor group.* This group includes both existing and potential owners of shares in companies. They require information concerning the performance of the company measured in terms of its profitability and the extent to which those profits are to be distributed to shareholders. They are also interested in the social/economic policies of the company so that they may decide if they wish to be associated with such an organisation.
- (b) *The loan creditor group.* This group includes both existing and potential providers of secured or unsecured, long- or short-term loan finance. They require information concerning the ability of the organisation to repay the interest on such loans as they fall due; and the longer-term growth and stability of the organisation to ensure that it is capable of repaying the loan at the agreed time. In addition, if the loan is secured, the value of the appropriate secured assets is important as a means of recovering the amount due.
- (c) *The employee group.* This group includes existing, potential and past employees. They require information concerning the ability of the organisation to pay wages and pensions today. In addition, they are interested in the future of the organisation because this will affect their job security and future prospects within the organisation.
- (d) *The analyst/adviser group.* This group includes a range of advisers to investors, employees and the general public. The needs of these users will be similar to those of their clients. The difference is, perhaps, that in some instances, the members of this group will be more technically qualified to understand accounting reports.
- (e) *The business contact group.* This group includes customers and suppliers of the organisation. Customers will be concerned to ensure that the organisation has the ability to provide the goods/services requested and to continue to provide similar services in the future. Suppliers will wish to ensure that the organisation will be capable of paying for the goods/services supplied when payment becomes due.
- (f) *The government.* This group includes taxation authorities, and other government agencies and departments. The taxation authorities will calculate the organisation's taxation liability based upon the accounting reports it submits to them. Other departments require statistical information to measure the state of the economy.

- (g) *The public.* This group includes taxpayers, consumers and other community and special interest groups. They require information concerning the policies of the organisation and how those policies affect the community. The public is increasingly interested in environmental issues.
- (h) *Internal users.* The management of the company require information to assist them in the performance of their duties. Three different levels of management can be identified:
- *Strategic.* This is the level of management found at the top of organisations. In a commercial organisation it is referred to as the board of directors. These people require information to assist them in decisions affecting the long-term future of the organisation.
 - *Tactical.* This is often referred to as middle management. These people require information to assist them in monitoring performance and making decisions to enable the organisation to achieve its short- to medium-term targets.
 - *Operational.* This is the level of management responsible for decisions concerning the day-to-day activities of the organisation. It is common for the information provided to them to be quantified in non-monetary units, such as hours worked, number of components produced, etc.

1.4 The characteristics of useful information

All of the above user groups, both internal and external to the organisation, require the information provided to be useful. In this context information should:



- (a) enable its recipient to make effective decisions;
- (b) be adequate for taking effective action to control the organisation or provide valuable details relating to its environment;
- (c) be compatible with the responsibilities and needs of its recipient;
- (d) be produced at optimum cost;
- (e) be easily understood by its recipient;
- (f) be timely;
- (g) be sufficiently accurate and precise for the purpose of its provision.

The ASB's *Statement of Principles* also suggests that financial statements should have certain qualitative characteristics, including relevance, reliability, completeness, comparability, understandability and timeliness.

For decisions to be made, the information must be relevant to the decision and be clearly presented, stating any assumptions upon which the information is based, so that the user may exercise judgement as appropriate.

Often, better information may be provided at additional cost or after an additional time delay. The adequacy of information is important, and factors such as the cost of the information and the speed with which it is available may be more important than it being 100 per cent accurate.

The information provided must be communicated to the person responsible for taking any action in respect of the information provided. In this regard it is better to distinguish information between that which relates to controllable aspects of the business and that which relates to non-controllable aspects. The controllable aspects may then be further divided into those that are significant and an exception reporting approach applied.

Exception reporting is the technique of reducing the size of management reports by including only those items that should be drawn to the manager's attention, rather than including all items.

Most organisations will set targets against which actual performance can be compared. You will learn more about the setting of such targets in your studies of management accounting. Their use enables exception reports to be produced to highlight the differences between the actual and target results. The use of exception reporting avoids wasting unnecessary management time reading reports that merely advise the management that no action is required and concentrates on those issues that do require management action.

In conclusion, therefore, internal information will be much more detailed than external information and will be prepared on a more regular basis.

1.5 Terminology

1.5.1 Bookkeeping

Bookkeeping can be described as: The recording of monetary transactions, appropriately classified, in the financial records of an entity, either by manual means or otherwise.

Bookkeeping involves maintaining a detailed 'history' of transactions as they occur. Every sale, purchase or other transaction will be classified according to its type and, depending on the information needs of the organisation, will be recorded in a logical manner in the 'books'. The 'books' will contain a record, or *account*, of each item showing the transactions that have occurred, thus enabling management to track the individual movements on each record, that is, the increases and decreases.

Periodically a list of the results of the transactions is produced. This is done by listing each account and its final position or *balance*. The list is known as a *trial balance* and is an important step prior to the next stage of providing financial accounts.

1.5.2 Financial accounting

Financial accounting can be described as: the classification and recording of monetary transactions of an entity in accordance with established concepts, principles, accounting standards and legal requirements, and their presentation, by means of various financial statements, during and at the end of an accounting period.

Two points in particular are worth noting about this description:

- Financial statements must comply with accounting rules published by the various advisory and regulatory bodies. In other words, an organisation does not have a completely free hand. The reason for this is that the end product of the financial accounting process – a set of financial accounts – is primarily intended for the use of people outside the organisation. Without access to the more detailed information available to insiders, these people may be misled unless financial accounts are prepared on uniform principles.
- Financial accounting is partly concerned with summarising the transactions of a period and presenting the summary in a coherent form. This again is because financial accounts are intended for outside consumption. The outsiders who have a need for and a right to information are entitled to receive it at defined intervals, and not at the whim of management.

1.5.3 Management accounting



Management accounting can be described as: The process of identification, measurement, accumulation, analysis, preparation, interpretation and communication of information used by management to plan, evaluate and control within an entity and to assure appropriate use of and accountability for its resources. Management accounting also comprises the preparation of financial reports for non-management groups such as shareholders, creditors, regulatory agencies and tax authorities.

Although the needs of external users of accounts are addressed in this definition, it can be seen that the emphasis of management accounting is on providing information to help managers in running the business. The kind of information produced, and the way in which it is presented, are at the discretion of the managers concerned; they will request whatever information, in whatever format, they believe to be appropriate to their needs.

1.6 The differences between external and internal information

External information is usually produced annually, though in larger organisations it may be produced on an interim basis more frequently – as a result of Stock Exchange rules, for example. External information is provided mainly by limited companies, in accordance with the relevant company legislation. These may prescribe the layouts to be used and the information that is to be disclosed either on the face of the financial statements or in the notes that accompany them. For other organisations that are not regulated by such legislation, accounts may have to be provided for other interested parties such as those dealing with taxation and lenders. For these organisations, the requirements of legislation are not mandatory and may not be appropriate. However, these requirements are often considered to be good accounting practice.

External information is often available publicly and is therefore available to the competitors of the organisation as well as its owners and employees. Of necessity, therefore, it is important that the information provided does not allow the organisation's competitors to obtain detailed information concerning the working of the organisation. Thus external information is summarised in order to protect the organisation from losing any competitive edge that it may possess.

Internal information is produced on a regular basis in order for management to compare the organisation's performance with its targets and to make decisions concerning the future. Accounting information is usually produced on a monthly basis, although other non-financial performance measures may be produced more regularly. Whereas external information is almost exclusively measured in monetary terms, internal information will most likely involve reporting financial and non-financial measures together. There is a very good reason for this: many managers, particularly those in control of operational matters, will not feel competent to understand accounting reports. They will understand differences in output levels and in usage of materials and labour much more readily than they will understand the implications of these same differences upon profit.

1.7 What is a business organisation?

A business is an organisation that regularly enters into transactions that are expected to provide a reward measurable in monetary terms. It is thus obvious from everyday life that many business organisations exist; what is less obvious is that their organisational (legal) structure and therefore their accounting requirements may differ.

There are two main reasons for the different organisational structures that exist – the *nature of their activities* and their *size*.

1.7.1 Profit-making organisations

Some organisations are formed with the intent of making profits from their activities in order to provide income to their owners:

- (a) *Sole traders (sole proprietors)*. These are organisations that are owned by one person. They tend to be small because they are constrained by the limited financial resources of their owner.
- (b) *Partnerships*. These are organisations owned by two or more persons working in common with a view to making a profit. The greater number of owners compared with a sole trader increases the availability of finance and this is often the reason for forming such a structure.
- (c) *Limited companies*. These are organisations recognised in law as ‘persons’ in their own right. Thus a company may own assets and incur liabilities in its own name.

The accounting of these organisations must meet certain minimum obligations imposed by legislation, for example, via the Companies Acts and other regulations. Some of these requirements constitute recommended accounting practice and are also used by other types of organisation.

Two types of limited companies can be identified: *private* limited companies; and *public* limited companies.

Public limited companies can be further divided according to their size, and whether they are ‘listed’ on the Stock Exchange. These distinctions can be important when considering the accounting requirements. A common feature of private limited companies is that their owners are actively involved in running the business. In this way they are similar to sole traders and partnerships. This is rarely true of public companies, where the owners may not become involved in the day-to-day activities of the business. Listed companies may have many thousands of owners (shareholders) who are even further removed from the running of the business.

1.7.2 Non-profit-making organisations

Other organisations are formed with the intent of providing services, without intending to be profitable in the long term:

- (a) *Clubs and societies*. These organisations exist to provide facilities and entertainments for their members. They are often sports and/or social clubs and most of their income is derived from the members who benefit from the club’s facilities. They may carry out some activities that are regarded as ‘trading’ activities, in which profits are made, but these are not seen as the main purpose of the organisation.

- (b) *Charities*. These exist to provide services to particular groups, including disadvantaged people and animals, or to support and protect the environment and other causes. Although they are regarded as non-profit-making, they too often carry out trading activities, such as running shops.
- (c) *Local and central government*. Government departments are financed by members of society (including limited companies). Their finances are used to provide the infrastructure in which we live, and to redistribute wealth to other members of society. You will not look at the accounts of government bodies in this study system.

1.8 Summary

In this chapter you have learnt:

- that ‘accounting’ involves recording, summarising and forecasting, to meet the information needs of different user groups;
- the characteristics of useful information;
- the distinction between ‘bookkeeping’, ‘financial accounting’ and ‘management accounting’;
- the differences between internal and external information; the different types of business organisation.

Revision Questions



Question 1 Multiple choice

- 1.1 The main aim of accounting is to:
- (A) maintain ledger accounts for every transaction.
 - (B) provide financial information to users of such information.
 - (C) produce a trial balance.
 - (D) record every financial transaction individually.
- 1.2 The main aim of financial accounting is to:
- (A) record all transactions in the books of account.
 - (B) provide management with detailed analyses of costs.
 - (C) present the financial results of the organisation by means of recognised statements.
 - (D) calculate profit.
- 1.3 Financial accounts differ from management accounts in that they:
- (A) are prepared monthly for internal control purposes.
 - (B) contain details of costs incurred in manufacturing.
 - (C) are summarised and prepared mainly for external users of accounting information.
 - (D) provide information to enable the trial balance to be prepared.
- 1.4 Which *one* of the following does *not* apply to the preparation of financial accounts?
- (A) They are prepared annually.
 - (B) They provide a summary of the outcome of financial transactions.
 - (C) They are prepared mainly for external users of accounting information.
 - (D) They are prepared to show the detailed costs of manufacturing and trading.
- 1.5 Which of the following statements gives the best definition of the objective of accounting?
- (A) To provide useful information to users.
 - (B) To record, categorise and summarise financial transactions.
 - (C) To calculate the taxation due to the government.
 - (D) To calculate the amount of dividend to pay to shareholders.

1.6 Which one of the following sentences does *not* explain the distinction between financial accounts and management accounts?

- (A) Financial accounts are primarily for external users and management accounts are primarily for internal users.
- (B) Financial accounts are normally produced annually and management accounts are normally produced monthly.
- (C) Financial accounts are more accurate than management accounts.
- (D) Financial accounts are audited by an external auditor and management accounts do not normally have an external audit.



Question 2

Match the following users with their information requirements.

- | | |
|---------------------------|---|
| 1. Equity investors | A Firm's ability to provide goods now and in future and pay debts |
| 2. Loan creditors | B Performance, profitability, dividends |
| 3. Employees | C Profit levels and tax liability and statistics |
| 4. Business contacts | D Firm's ability to pay interest and repay loans, the value of secured assets |
| 5. Government departments | E Firm's ability to pay wages, cash resources, future prospects, pay pensions |



Question 3

State six characteristics of useful accounting information?

- (A) R.....
- (B) R.....
- (C) C.....
- (D) C.....
- (E) U.....
- (F) T.....

Solutions to Revision Questions



Solution 1

1.1 Answer: (B)

Maintaining ledger accounts, producing a trial balance and recording transactions are all part of the bookkeeping system.

1.2 Answer: (C)

Recording transactions is part of the bookkeeping function. This should be capable of providing management with internal information, but this is part of the management accounting function. The calculation of profit (or surpluses and gains) also results from the bookkeeping system and contributes towards the presentation of the financial results.

1.3 Answer: (C)

Management accounts are prepared monthly (or more frequently) for internal control purposes; they also contain detailed information such as costing figures. The trial balance is prepared from the bookkeeping system and is used as a basis for the preparation of financial accounts.

1.4 Answer: (D)

Management accounts would provide detailed costs and other information regarding manufacturing and trading.

1.5 Answer: (A)

1.6 Answer: (C)



Solution 2

1 Answer: (B)

2 Answer: (D)

3 Answer: (E)

4 Answer: (A)

5 Answer: (C)



Solution 3

- (A) Relevant
- (B) Reliable
- (C) Comparable
- (D) Complete
- (E) Understandable
- (F) Timely.

The Framework of Financial Accounts

2

LEARNING OUTCOMES

When you have completed this chapter, you should be able to:

- ▶ explain the concepts of capital and revenue, cash and profit, income and expenditure and assets and liabilities.

2.1 Introduction

In this chapter, we begin to look at what is contained in financial accounts and how the information is compiled and presented. The chapter also introduces some of the basic concepts of accounting, although these are covered in more depth in Chapter 10. In particular, the chapter looks at the *accounting equation* as the basis on which accounting systems are built, and how the equation changes as financial transactions are undertaken. The chapter also considers the concept that an organisation must be regarded as an entity completely separate from the people who own it.

2.2 The separate entity concept

In discussing limited companies in Chapter 1, it was mentioned that the law recognises a company as a ‘person’ in its own right, distinct from the personalities of its owners (known as shareholders). In other words, if a company runs up debts in its own name and then has difficulty in paying them, its creditors may be entitled to seize the assets owned by the company. But they have no claim against the personal assets owned by the shareholders: it is the company that owes money, *not* its owners. In law, this distinction does not exist with other forms of business entity, such as the sole proprietor. If Bill Smith is in business as a plumber, trading under the name of ‘Smith & Co. Plumbing Services’, the law recognises no distinction between the business and the individual. If there are large debts outstanding for plumbing supplies, and the business assets of Smith & Co. are insufficient to pay them, the creditors can demand payment from Bill Smith the individual, who may be forced to sell his personal assets – home, car, etc. But in this respect accounting conventions do not correspond with the strict legal form of the business. It is an absolutely crucial concept in

accounting that, regardless of the legal form of a business – limited company, sole trader, partnership or whatever – the business is treated as a separate entity from its owner(s). For accounting purposes, Bill Smith the individual is not the same as Smith & Co. Plumbing Services. This reflects the fact that accounting information relates only to business transactions. What Bill Smith does as an individual is of no concern to the accountant, and his private activities must be kept quite separate from the business transactions of Smith & Co. Students often find this concept hard to grasp, particularly when they notice that, as a consequence of it, Bill Smith the individual can actually have business dealings with Smith & Co. For example, Bill may take some copper piping from the stock held by Smith & Co. in order to repair the heating system in his own home. From the accounting point of view, a business transaction has occurred: Smith & Co. has supplied an individual called Bill Smith with some piping, and its value must be accounted for.

Despite its apparent artificiality, the importance of this concept will become apparent in the next section, where we look at an arithmetic relationship called the *accounting equation*.

2.3 The accounting equation

The accounting equation shows that:

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

What do these terms mean?

Asset: A resource that may be used by a business or other organisation to derive income in the future.

Examples of assets are land, buildings, plant and machinery, motor vehicles, stocks of goods (inventories), debtors, bank balances and cash. Assets may be described as *tangible* or *intangible*. Tangible assets are those that can be physically seen or touched (e.g. land, buildings, equipment, stock, etc.). Intangible assets cannot be physically seen or touched (e.g. goodwill, which represents the value of a business as a whole compared with the sum of the values of its individual assets. As such, goodwill represents the value of the organisation's customer base, employee relationships, etc.). Other intangible assets might include patents and trademarks. You will learn more about intangible assets in Chapter 10.

Debtor: A person or entity owing money.

These are assets to the business because they are eventually converted into cash, which is a resource that can be used by the business. Debtors are also sometimes referred to as 'accounts receivable' or 'receivables'.

Liability: An entity's obligations to transfer economic benefits as a result of past transactions or events.

Thus a liability can be described as an amount owed by a business or organisation to an individual or other business organisation. Examples of liabilities are creditors, loans received and bank overdrafts.

Creditor: A person or an entity to whom money is owed as a consequence of the receipt of goods or services in advance of payment.

These are financial obligations or liabilities of a business until they are paid. Creditors are also sometimes referred to as ‘accounts payable’ or ‘payables’. These lists of assets and liabilities are not exhaustive, and you will encounter other examples as your studies progress.



Capital, in this context, is difficult to define, but it can be regarded as a special kind of liability that exists between a business and its owner(s).

To return to the accounting equation, you can perhaps see that the assets of an organisation have been provided, or ‘financed’, by liabilities either to outsiders or to the owner. This emphasises the importance of the separate entity concept described above. Because we regard the owner as being separate from the business, we can regard the amount owed by the business to its owner as a kind of liability. Effectively, we can restate the accounting equation in an even simpler form:

$$\text{Assets of the business} = \text{Liabilities of the business}$$

This statement is always true no matter what transactions the business undertakes. Any transaction that increases or decreases the assets of the business must increase or decrease its liabilities by an identical amount.

You may be wondering exactly what is meant by saying that capital is an amount ‘owed’ by the business to its owner. How can the business ‘owe’ anything in this way? How has it incurred a debt? The answer is that when a business commences, it is common for the owners to ‘invest’ some of their private resources in the business. As the business operates it generates its own resources in the form of profits, which technically belong to the owner. Some of the profits may remain in the business, while some may be withdrawn by the owner in the form of goods or cash. This withdrawal of profits in simple organisation structures such as sole traders and partnerships is known as ‘drawings’.

The equation that states that:

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

can thus be seen to demonstrate the relationships that exist within any business. The equation is the basis of one of the most common accounting statements to be prepared – the *balance sheet*. It is worth noting here that the presentation of a balance sheet relies on the rearrangement of the accounting equation. Like any mathematical equation its subject can be changed, provided that the same treatment is given to both sides of the original equation. By subtracting the liabilities from both sides of the equation, the original version can be rewritten as:

$$\text{Assets} - \text{Liabilities} = \text{Capital}$$

This is the version of the equation that is consistent with the presentation of a balance sheet, which you will look at later in this chapter.

2.3.1 The accounting equation in action

To see how this works, study the following example.

Example 2.A

On 31 March, Henry's employment with Gigantic Stores Ltd came to an end. On 1 April, Henry sets up in business by himself, trading as 'Henry's Matches', and selling boxes of matches from a tray on a street corner. Henry puts £100 into a bank account opened in the name of Henry's Matches. He persuades a supplier of matches to let him have an initial stock of 400 boxes, costing 5p each, promising to pay for them next week. During his first day of trading he sells 150 boxes at 12p each – £18 in all. Feeling well pleased, he takes £5 from the cash tin and treats himself to supper at the local café. He also writes a cheque for £5 to his supplier in part payment for the initial stock of boxes. Show what happens to the accounting equation as each of these transactions takes place.

Solution

To begin with, the only asset of the business is £100 in the business bank account. Capital invested by Henry also amounts to £100 and the accounting equation looks like this:

| | | | | | | |
|--------|------|---|-------------|---|---------|------|
| Assets | | = | Liabilities | + | Capital | |
| Bank | £100 | = | 0 | + | Capital | £100 |

The business then acquires a stock of matches, worth £20, with a corresponding liability to the supplier. The accounting equation now looks like this:

| | | | | | | |
|--------|-------------|---|-------------|-----|-------------|------|
| Assets | | = | Liabilities | + | Capital | |
| Bank | £100 | = | Creditor | £20 | Capital | £100 |
| Stock | £20 | | | | | |
| | <u>£120</u> | = | <u>£20</u> | + | <u>£100</u> | |

When Henry sells 150 boxes, he makes a profit of $(150 \times 7p) = £10.50$. His stock falls to 250 boxes at 5p each (£12.50). He also acquires a further asset in the process: cash in hand of £18. The accounting equation now looks like this:

| | | | | | | |
|--------------|----------------|---|-------------|-----|------------------|--------|
| Assets | | = | Liabilities | + | Capital | |
| Bank | £100 | = | Creditor | £20 | Original capital | £100 |
| Cash in hand | £18 | | | | Profit | £10.50 |
| Stock | £12.50 | | | | | |
| | <u>£130.50</u> | = | <u>£20</u> | + | <u>£110.50</u> | |

Then Henry withdraws £5 from the business for his private use. This amount (referred to as *drawings*) reduces the sum owed to him by the business. The accounting equation now looks like this:

| | | | | | | |
|--------------|----------------|---|-------------|-----|------------------|--------|
| Assets | | = | Liabilities | + | Capital | |
| Bank | £100 | = | Creditor | £20 | Original capital | £100 |
| Cash in hand | £13 | | | | Profit earned | £10.50 |
| Stock | £12.50 | | | | Less drawings | (£5) |
| | <u>£125.50</u> | = | <u>£20</u> | + | <u>£105.50</u> | |

Finally, Henry makes a payment to his supplier, reducing the funds in the business bank account, and also reducing the amount of his liability. The accounting equation now looks like this:

| | | | | | | |
|--------------|----------------|---|-------------|-----|------------------|--------|
| Assets | | = | Liabilities | + | Capital | |
| Bank | £95 | = | Creditor | £15 | Original capital | £100 |
| Cash in hand | £13 | | | | Profit earned | £10.50 |
| Stock | £12.50 | | | | Less drawings | (£5) |
| | <u>£120.50</u> | = | <u>£15</u> | + | <u>£105.50</u> | |



Exercise 2.1

J Jones commenced business on 31 January 20X1, transferring £5,000 from her personal bank account into a business bank account.

During the first week of February 20X1 the following transactions occurred:

| | |
|------------|--|
| 1 February | Bought motor van costing £800 paying by cheque |
| 2 February | Bought goods on credit: P Smith £400 E Holmes £250 |
| 3 February | Sold goods for cash £600 (cost £400) |
| 4 February | Banked cash £600 Paid P Smith £400 by cheque |
| 5 February | Bought goods on credit: P Smith £200 A Turner £300 |

You are required to show the accounting equation at the end of each day's transactions.



Solution

| <i>Assets</i> | | = | <i>Liabilities</i> | | + | <i>Capital</i> | |
|-------------------|--------------|---|--------------------|------------|---|----------------|--------------|
| <i>31 January</i> | | | | | | | |
| Bank | 5,000 | | | Nil | | | 5,000 |
| <i>1 February</i> | | | | | | | |
| Bank | 4,200 | | | | | | |
| Van | 800 | | | | | | |
| | <u>5,000</u> | | | <u>Nil</u> | | | <u>5,000</u> |
| <i>2 February</i> | | | | | | | |
| Bank | 4,200 | | P Smith | 400 | | | |
| Van | 800 | | E Holmes | 250 | | | |
| Stock | 650 | | | | | | |
| | <u>5,650</u> | | | <u>650</u> | | | <u>5,000</u> |
| <i>3 February</i> | | | | | | | |
| Bank | 4,200 | | P Smith | 400 | | Original | 5,000 |
| Van | 800 | | E Holmes | 250 | | Profit | 200 |
| Stock | 250 | | | | | | |
| Cash | 600 | | | | | | |
| | <u>5,850</u> | | | <u>650</u> | | | <u>5,200</u> |
| <i>4 February</i> | | | | | | | |
| Bank | 4,400 | | | | | Original | 5,000 |
| Van | 800 | | | | | Profit | 200 |
| Stock | 250 | | E Holmes | 250 | | | |
| | <u>5,450</u> | | | <u>250</u> | | | <u>5,200</u> |
| <i>5 February</i> | | | | | | | |
| Bank | 4,400 | | E Holmes | 250 | | Original | 5,000 |
| Van | 800 | | P Smith | 200 | | Profit | 200 |
| Stock | 750 | | A Turner | 300 | | | |
| | <u>5,950</u> | | | <u>750</u> | | | <u>5,200</u> |

2.4 The accounting equation and the balance sheet

The balance sheet is simply a statement of the assets, liabilities and capital of a business at a particular time. It is thus nothing more than a detailed representation of the accounting equation.

2.4.1 The contents of a balance sheet

In its simplest form the balance sheet is presented horizontally with assets being shown on the left and liabilities and capital being shown on the right. As a result the total of each side of the balance sheet will be the same – hence *the balance sheet balances*. When we prepare balance sheets, assets are divided into two categories: fixed assets and current assets.

Fixed assets: Any asset acquired for retention by an entity for the purpose of providing a service to the business, and not held for resale in the normal course of trading.

In other words, a fixed asset is a resource acquired by an organisation with the intention of using it to earn income for a long period of time. Examples of fixed assets include land, buildings, motor vehicles, machinery and equipment. Fixed assets are also sometimes referred to as ‘non-current assets’, or ‘long-term assets’.

Current assets: Cash or other asset, for example, stock, debtors, and short-term investments, held for conversion into cash in the normal course of trading.

In other words, a current asset is one that either already is cash, or will be converted into cash within a short period of time. Liabilities are similarly divided into two categories, reflecting the time between the balance sheet date and the date by which the liability should be settled. These categories are referred to as current liabilities and long-term liabilities.

Current liabilities: Liabilities that fall due for payment within 1 year. They include that part of long-term loans due for repayment within 1 year.

Long-term liabilities are those that are due for repayment more than one year after the balance sheet date.

Example 2.B

John had the following assets and liabilities on 1 January:

| | |
|--------------|----------------|
| | £ |
| Land | 200,000 |
| Buildings | 60,000 |
| Stock | 10,000 |
| Debtors | 15,000 |
| Cash in hand | 5,000 |
| Bank balance | 32,000 |
| | <u>322,000</u> |
| Creditors | 17,000 |
| Bank loan | 240,000 |
| | <u>257,000</u> |

We can calculate the value of John’s capital using the accounting equation.

The total value of John’s assets on 1 January is £322,000; his liabilities totalled £257,000. Therefore his capital must be £65,000:

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \text{Capital} \\ 322,000 &= 257,000 + 65,000 \end{aligned}$$

We can now prepare John’s balance sheet.

Balance sheet of John at 1 January

| | | | | |
|----------------|-----------|------------|-----------------------|------------|
| | £000 | £000 | | £000 |
| Fixed asset | | | Capital | 65 |
| Land | 200 | | Long-term liabilities | |
| Buildings | <u>60</u> | 260 | Bank loan | 240 |
| Current assets | | | Current liabilities | |
| Stock | 10 | | Creditors | 17 |
| Debtors | 15 | | | |
| Bank balance | 32 | | | |
| Cash in hand | <u>5</u> | | | |
| | | <u>62</u> | | |
| | | <u>322</u> | | <u>322</u> |

We can see from the above that the balance sheet could be used to calculate the value of capital. If this method were used the capital value is the figure to make the balance sheet balance. You should also note the order in which the current assets are listed. This is referred to as the order of liquidity. Liquidity is the measure of closeness of assets to being cash, and it is usual for current assets to be listed from the least liquid to the most liquid (as above). Returning to our example, let us assume that John had the following transactions during the first week of January:

1. Bought office equipment costing £7,000, paying £2,000 deposit by cheque, the balance to be paid at the end of March.
2. Returned some office equipment to his supplier because it was faulty. John had originally been charged £3,000 for it.
3. Received £8,000 from his debtors. They all paid him by cheque.

We can now see how these transactions affected his accounting equation.

1. Assets (office equipment) increase by £7,000
Assets (bank balance) decrease by £2,000
Liabilities (creditors) increase by £5,000

John's accounting equation is amended to:

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \text{Capital} \\ 327,000 &= 262,000 + 65,000 \end{aligned}$$

2. Assets (office equipment) decrease by £3,000
Liabilities (creditors) decrease by £3,000

John's accounting equation becomes:

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \text{Capital} \\ 324,000 &= 259,000 + 65,000 \end{aligned}$$

3. Assets (debtors) decrease by £8,000
Assets (bank balance) increase by £8,000

This has no effect on John's accounting equation.

John's balance sheet after these three transactions looks as follows:

| Balance sheet | | | |
|----------------------|----------|------------|-----------------------|
| | £000 | £000 | £000 |
| Fixed assets | | | Capital |
| Land | 200 | | 65 |
| Buildings | 60 | | Long-term liabilities |
| Office equipment | <u>4</u> | | Bank loan |
| | | 264 | 240 |
| Current assets | | | Current liabilities |
| Stock | 10 | | Creditors |
| Debtors | 7 | | 19 |
| Bank balance | 38 | | |
| Cash in hand | <u>5</u> | | |
| | | <u>60</u> | |
| | | <u>324</u> | <u>324</u> |

2.4.2 Vertical presentation of a balance sheet

The balance sheet presentation used so far is known as the horizontal format. It may be thought of as representing a set of scales, whereby the amount on each side of the centre is equal. In this way it can be said to balance.

The disadvantage with this presentation is that it does not show the value of the organisation. The net worth of the organisation to the owner is the value of the owner's capital. As we have learned, this is found by rearranging the accounting equation. In the same way, the presentation of the balance sheet can be rearranged:

Balance sheet: vertical format

| | £000 | £000 |
|-----------------------|-------------|--------------|
| Fixed assets | | |
| Land | 200 | |
| Buildings | 60 | |
| Office equipment | <u>4</u> | |
| | | 264 |
| Current assets | | |
| Stock | 10 | |
| Debtors | 7 | |
| Bank balance | 38 | |
| Cash in hand | <u>5</u> | |
| | 60 | |
| Current liabilities | | |
| Creditors | <u>(19)</u> | |
| Net current assets | | 41 |
| Long-term liabilities | | |
| Bank loan | | <u>(240)</u> |
| Net assets employed | | <u>65</u> |
| Financed by | | |
| Capital | | <u>65</u> |

Note how the above presentation still balances while showing the net worth of the business to the owner – that is, the capital – quite clearly. It has also introduced the idea of deducting the current liabilities from the current assets. This difference is known as the net current assets or working capital of the business. In later studies you will learn that this is an important measure of the short-term liquidity of the organisation. If the current liabilities are greater than the current assets, the description is 'net current liabilities', sometimes referred to as 'negative working capital'.

In order to prepare the above statement you should recognise that individual assets and liabilities are grouped as:

- fixed assets;
- current assets;
- current liabilities;
- long-term liabilities.

The items within these groups do not alter whether the horizontal or vertical presentation is used; it is simply a case of moving the groups around and calculating some additional subtotals.

2.5 The profit and loss account

In the course of his business John will attempt to earn money by selling his goods to customers. The money earned in this way is referred to as the *sales revenue* (or simply the *sales*) of the business. To sell goods, he first has to buy them (or manufacture them – but we shall assume that John is a retailer rather than a manufacturer). Obviously there is a cost involved in the buying of the goods. The difference between the cost of the goods he sells and the sales revenue earned from customers is called the *gross profit* of the business. Apart from having to purchase a stock of goods, John incurs other costs in running his business. He must buy fuel for his delivery van. He probably pays rent for the warehouse or shop premises in which he stores his goods. If he employs anyone to help him he will have to pay wages. All of these costs have to be paid for from the gross profit earned by selling goods. The amount remaining after all of these expenses have been paid is called the *net profit* of the business.

What happens to this net profit once it has been earned?

- As a private individual, John has living expenses like everyone else. He will need to withdraw some of the net profit from the business to pay for these; such a withdrawal is referred to as *drawings*.
- Any profit that John does not need to withdraw simply remains in the business, increasing his capital.

In Example 2.A, you saw that Henry, trading as Henry's Matches, made a profit of £10.50, and withdrew £5 for himself, leaving the other £5.50 in the business to increase his capital.

Example 2.C

In the following month, John sells goods on credit to his customers for £6,000. He already had some stock, costing £10,000, so he used £1,000 worth of that existing stock, and bought in another £3,000 worth of stock that was all used to fulfil the order. He has not yet paid for this extra stock. His rent bill for the month is £500 and his van running costs are £300. He withdraws £200 from the business for his private use.

Present a profit and loss account for John for this month, and a balance sheet at the end of the month.

Solution**Profit and loss account for the month**

| | £000 | £000 |
|-------------------------|------------|------------|
| Sales | | 6 |
| Less cost of goods sold | | <u>4</u> |
| Gross profit | | 2 |
| Rent | 0.5 | |
| Van running costs | <u>0.3</u> | |
| | | 0.8 |
| Net profit earned | | <u>1.2</u> |

- *Note 1:* The cost of goods sold figure can be calculated as £1,000 from existing stock, plus £3,000 bought specially. See Section 2.5.1 for another way to calculate the cost of goods sold.
- *Note 2:* John's drawings are not business expenses, but are deducted from his capital on the balance sheet below.

Balance sheet at the end of the month

| | £000 | £000 |
|------------------------------------|-------------|--------------|
| Fixed assets | | |
| As before | | 264 |
| Current assets | | |
| Stock (10 – 1) | 9 | |
| Debtors (7 + 6) | 13 | |
| Bank balance | 38 | |
| Cash in hand (5 – 0.5 – 0.3 – 0.2) | <u>4</u> | |
| | | 64 |
| Current liabilities | | |
| Creditors (19 + 3) | <u>(22)</u> | |
| Net current assets | | 42 |
| Long-term liabilities | | |
| Bank loan | | <u>(240)</u> |
| Net assets employed | | <u>66</u> |
| Financed by | | |
| Capital | | <u>66</u> |

Notice that the capital of the business has increased by £1,000 – the amount of net profit retained in the business. It is possible to prepare a statement of movements on capital, showing exactly how the figure of £65,000 has risen to £66,000.

Statement of movements on capital

| | £000 | £000 |
|-------------------------------------|------------|-------------|
| Capital at start of the month | | 65.0 |
| Net profit earned in period | 1.2 | |
| Net profit withdrawn by John | <u>0.2</u> | |
| Net profit retained in the business | | 1.0 |
| Capital at end of month | | <u>66.0</u> |

You should see clearly from this statement how the profit and loss account links up with the balance sheet: the net profit earned, shown in the profit and loss account, becomes an addition to capital in the balance sheet, and John's drawings are deducted from this.

2.5.1 The cost of goods sold

We shall be looking at the profit and loss account in more detail later on, but at this stage it is worth noting one general point, which will be illustrated by the particular example of the cost of goods sold.

In computing the profit earned in a period the accountant's task is:

- first, to establish the sales revenue earned in the period;
- second, to establish the costs incurred by the business in earning this revenue.

This second point is not as simple as it might sound. For example, it would not be true to say that the costs incurred in an accounting period are equal to the sums of money expended in the period. This could be illustrated by many examples, some of which you will encounter later in the text. For now, we focus on one particular cost: the *cost of goods sold*.

A trader may be continually buying goods and selling them on to customers. At the moment he draws up his financial accounts it is likely that he has a stock of goods that has been purchased in the period but not yet sold. It would be wrong to include the cost of this closing stock as part of the cost of goods sold, for the simple reason that these goods have not yet been sold.

Looking back to the beginning of the accounting period, it is likely that an opening stock of goods was on hand. These have presumably been sold in this period and their cost must form part of the cost of goods sold, even though they were purchased in an earlier period.

What all this illustrates is that the cost of goods *sold* in an accounting period is not the same as the cost of goods *purchased* in the period. In fact, to calculate the cost of goods sold we need to do the following calculation (presented here using the figures from John's business above):

| | |
|---|---------------------|
| | £ |
| Cost of opening stock at start of period | 10,000 |
| Cost of purchases during the period | <u>3,000</u> |
| | 13,000 |
| Less cost of closing stock at end of period | <u>9,000</u> |
| Cost of goods sold | <u><u>4,000</u></u> |

It is this figure of £4,000 – not the purchases of £3,000 – that is matched with the sales revenue for the period in order to derive the figure of gross profit.



Exercise 2.2

Explain briefly what is meant by the following terms:

- assets;
- liabilities;
- capital;
- revenue;
- expense.



Solution

- *Assets.* Items possessed by an organisation, which may be used to provide income in the future. Includes fixed assets (land, buildings, machinery, etc.) and current assets (stocks, debtors, cash, etc.).
- *Liabilities.* Financial obligations or amounts owed by an organisation. Includes loans, overdrafts, creditors.
- *Capital.* The amount of investment made by the owner(s) in the organisation, and not yet withdrawn. The amount includes initial and subsequent amounts introduced by the owner(s), plus any profits earned that have been retained in the organisation.
- *Revenue.* Amounts earned by the activities of the organisation, which eventually result in receiving money. Includes sales revenue, interest received, etc. Income increases profit.
- *Expense.* Costs used up in the activities of the organisation. Includes heat, light, rates, stocks consumed, wages, etc. Expenses reduce profit.



Exercise 2.3

On 1 June 20X1, J Brown started business as a jobbing gardener with a capital of £2,000 in cash. A list of figures extracted from his records on 31 May 20X2 shows the following:

| | |
|--|-------|
| | £ |
| Purchases of seeds, plants, etc. | 700 |
| New motor van | 1,100 |
| Mowing machine | 70 |
| Cultivator | 250 |
| Motor van expenses | 300 |
| Rent of garage | 200 |
| Paid to wife for clerical work | 500 |
| Insurance | 200 |
| Private expenses paid from bank | 1,500 |
| Cash in hand and bank | 180 |
| Cash received from customers | 3,000 |
| Capital at the start of the year | 2,000 |
| Stock of seeds, plants, etc., at the end of the year | 100 |

You are required to prepare:

- an account to show J Brown his profit or loss for the year ended 31 May 20X2,
- a balance sheet as at 31 May 20X2.



Solution

J Brown – Profit and loss account for the year ended 31 May 20X2

| | | |
|-------------------------------------|--------------|--------------|
| Sales | £ | £ |
| Purchases of seeds, plants | 700 | 3,000 |
| Less closing stock of seeds, plants | <u>(100)</u> | |
| Cost of goods sold | | <u>600</u> |
| Gross profit | | 2,400 |
| Motor van expenses | 300 | |
| Rent of garage | 200 | |
| Wife's wages | 500 | |
| Insurance | <u>200</u> | |
| | | <u>1,200</u> |
| Net profit | | <u>1,200</u> |

J Brown – balance sheet at 31 May 20X2

| | £ | £ |
|-----------------------------|------------|--------------|
| Fixed assets | | |
| Motor van | | 1,100 |
| Mowing machine | | 70 |
| Cultivator | | <u>250</u> |
| | | 1,420 |
| Current assets | | |
| Stocks of seeds and plants | 100 | |
| Cash in hand and at bank | <u>180</u> | |
| | | <u>280</u> |
| | | <u>1,700</u> |
| Financed by | | |
| Capital introduced | | 2,000 |
| Add net profit for the year | | <u>1,200</u> |
| | | 3,200 |
| Less drawings | | <u>1,500</u> |
| | | <u>1,700</u> |

2.6 Profit and cash

Note that in Example 2.C John's business made a profit of £1,200. But his bank balance remained unchanged and his cash holdings actually fell. This was because some of his transactions that affected profit did not affect cash at the same time. For example, his customers did not pay John, nor did John pay his suppliers, until after the end of the month. Also, there was a transaction that affected cash, but not profit – John took £200 cash in drawings, which reduced his capital but not his profit. There are lots of other reasons why profit does not always result in an equal change in bank and cash balances. You will look at these in Chapter 13.

2.7 Capital and revenue

Note also that we do not include the cost of fixed assets in the profit calculation. We only include expenses that have been consumed, and have no future benefit for the organisation. Fixed assets have not been consumed, and do have a future benefit, as they will be used to earn profits in the following periods. This is why they are shown in the balance sheet rather than in the profit and loss account.

2.7.1 Capital transactions

The word 'capital' means different things in different contexts. You have already seen how the word is used to identify the investment by an owner in his business. Capital transactions are those that affect the organisation in the long term, as well as in the current period. Capital expenditure is expenditure on fixed or non-current assets, and capital receipts would result from the disposal of those assets. Other transactions that are regarded as capital transactions are the obtaining of and repayment of long-term finance. Capital transactions initially affect the figures in the balance sheet. Of course, fixed assets are used up over a number of years, and so eventually they will be consumed. We account

for this by including *depreciation* in the profit and loss account. You will look at this in detail in Chapter 6.

2.7.2 Revenue transactions

Revenue transactions are those that affect the organisation in the current period. Revenue receipts come from sales, and sometimes in the form of income from investments. Revenue expenditure is expenditure on items that are consumed in the period, for example the running expenses of the organisation, cost of sales, etc. Revenue transactions affect the figures in the profit and loss account. Some organisations also refer to it as an *income statement*.

2.8 Summary

In this chapter you have:

- seen how the separate entity concept works – for accounting purposes, a business is always regarded as an entity separate from its owners;
- seen how the accounting equation is defined as:

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

and how it changes as a result of financial transactions;

- learnt how to use the accounting equation to draw up a simple balance sheet after certain transactions have occurred and how to prepare a statement of profit, including a calculation of cost of goods sold;
- learnt that profit does not always result in an equivalent change in bank and cash balances;
- that transactions can be classified as either ‘capital’ or ‘revenue’ according to whether they affect the balance sheet or the profit and loss account.

Revision Questions

2



Question 1

- 1.1 Gross profit for 20X1 can be calculated from:
- (A) purchases for 20X1, plus stock at 31 December 20X1, less stock at 1 January 20X1.
 - (B) purchases for 20X1, less stock at 31 December 20X1, plus stock at 1 January 20X1.
 - (C) cost of goods sold during 20X1, plus sales during 20X1.
 - (D) net profit for 20X1, plus expenses for 20X1.
- 1.2 The capital of a sole trader would change as a result of:
- (A) a creditor being paid his account by cheque.
 - (B) raw materials being purchased on credit.
 - (C) fixed assets being purchased on credit.
 - (D) wages being paid in cash.
- 1.3 The 'accounting equation' can be rewritten as:
- (A) assets plus profit less drawings less liabilities equals closing capital.
 - (B) assets less liabilities less drawings equals opening capital plus profit.
 - (C) assets less liabilities less opening capital plus drawings equals profit.
 - (D) opening capital plus profit less drawings less liabilities equals assets.
- 1.4 An increase in stock of £250, a decrease in the bank balance of £400 and an increase in creditors of £1,200 results in:
- (A) a decrease in working capital of £1,350.
 - (B) an increase in working capital of £1,350.
 - (C) a decrease in working capital of £1,050.
 - (D) an increase in working capital of £1,050.
- 1.5 A sole trader had opening capital of £10,000 and closing capital of £4,500. During the period, the owner introduced capital of £4,000 and withdrew £8,000 for her own use. Her profit or loss during the period was:
- | Profit or loss | Amount |
|----------------|--------|
| | £ |
- 1.6 The accounting equation at the start of the month was:
- Assets £28,000 less liabilities £12,500

During the following month, the business purchased a fixed asset for £6,000, paying by cheque, a profit of £7,000 was made, and creditors of £5,500 were paid by cheque.

Capital at the end of the month would be:

£.....

- 1.7 The accounting equation can change as a result of certain transactions. Which *one* of the following transactions would *not* affect the accounting equation?
- (A) Selling goods for more than their cost.
 (B) Purchasing a fixed asset on credit.
 (C) The owner withdrawing cash.
 (D) Debtors paying their accounts in full, in cash.
- 1.8 The profit of a business may be calculated by using which one of the following formulae?
- (A) Opening capital – drawings + capital introduced – closing capital.
 (B) Closing capital + drawings – capital introduced – opening capital.
 (C) Opening capital + drawings – capital introduced – closing capital.
 (D) Closing capital – drawings + capital introduced – opening capital.



Question 2

The following table shows the cumulative effects of a series of separate transactions on the assets and liabilities of a sole trader's business. The transactions are labelled A to H, and the figures for each asset and liability in the column underneath represent values after the transaction has taken place.

| | £ | A (£) | B (£) | C (£) | D (£) | E (£) | F (£) | G (£) | H (£) |
|----------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Fixed assets | | | | | | | | | |
| Land and buildings | 45,000 | 65,000 | 65,000 | 65,000 | 65,000 | 65,000 | 65,000 | 65,000 | 65,000 |
| Equipment | 34,000 | 34,000 | 34,000 | 34,000 | 34,000 | 34,000 | 34,000 | 34,000 | 34,000 |
| Motor vehicles | 17,500 | 17,500 | 17,500 | 17,500 | 17,500 | 10,000 | 10,000 | 10,000 | 10,000 |
| Current assets | | | | | | | | | |
| Stock | 20,800 | 20,800 | 20,800 | 27,000 | 27,000 | 27,000 | 27,000 | 27,000 | 23,000 |
| Trade debtors | 34,700 | 34,700 | 24,700 | 24,700 | 24,700 | 24,700 | 23,350 | 23,350 | 23,350 |
| Prepaid expenses | 1,300 | 1,300 | 1,300 | 1,300 | 1,300 | 1,300 | 1,300 | 1,300 | 1,300 |
| Cash at bank | 2,150 | 2,150 | 11,150 | 11,150 | 6,400 | 13,200 | 13,200 | 10,200 | 10,200 |
| Cash on hand | 320 | 320 | 320 | 320 | 320 | 320 | 320 | 320 | 320 |
| | <u>155,770</u> | <u>175,770</u> | <u>174,770</u> | <u>180,970</u> | <u>176,220</u> | <u>175,520</u> | <u>174,170</u> | <u>171,170</u> | <u>167,170</u> |
| Capital | 85,620 | 85,620 | 84,620 | 84,620 | 84,870 | 84,170 | 82,820 | 79,820 | 75,820 |
| Loans | 50,000 | 70,000 | 70,000 | 70,000 | 70,000 | 70,000 | 70,000 | 70,000 | 70,000 |
| Current liabilities | | | | | | | | | |
| Trade creditors | 18,600 | 18,600 | 18,600 | 24,800 | 19,800 | 19,800 | 19,800 | 19,800 | 19,800 |
| Accrued expenses | 1,550 | 1,550 | 1,550 | 1,550 | 1,550 | 1,550 | 1,550 | 1,550 | 1,550 |
| | <u>155,770</u> | <u>175,770</u> | <u>174,770</u> | <u>180,970</u> | <u>176,220</u> | <u>175,520</u> | <u>174,170</u> | <u>171,170</u> | <u>167,170</u> |

Requirements

Identify, as clearly and as fully as the information permits, what transaction has taken place in each case by matching the transaction to the description below.

1. A supplier's invoice for £5,000 is paid by cheque; 5 per cent discount received.

2. An additional long-term loan of £20,000 is raised to finance the purchase of additions/improvements to buildings, costing £20,000.
3. £4,000 of stock at cost is written off for some reason.
4. A debt of £1,350 due from a customer is written off as bad.
5. £3,000 is withdrawn by the owner from the business bank account for personal use.
6. A customer pays off invoices totalling £10,000 by cheque, and receives 10 per cent discount.
7. Stock costing £6,200 is purchased on credit.
8. A motor vehicle with a book value of £7,500 is sold for £6,800 – the amount being received by cheque. The resulting loss of £700 reduces capital.



Question 3

You are given the following information relating to a business for the month of May 20XX.

| | |
|--|--------|
| | £ |
| Sales of goods for cash | 17,000 |
| Sales of goods on credit | 28,000 |
| Purchases of stocks on credit | 19,500 |
| Wages paid in cash | 2,000 |
| Fixed assets bought on credit | 12,000 |
| Cash withdrawn by the owner | 1,600 |
| Stocks of goods at the start of the period | 5,000 |
| Stocks of goods at the end of the period | 6,250 |

Requirement

Complete the following statement to determine the net profit for the period:

| | | | | | | | |
|----------------------|-------|--|---|-------|--|---|-------|
| | £ | | + | £ | | = | £ |
| Sales | ..... |  |  | ..... |  |  | ..... |
| Less cost of sales: | | | | | | | |
| Opening stock |  |  |  | ..... |  |  |  |
| Purchases |  |  |  | ..... |  |  |  |
| | | | | | | | |
| Closing stock |  |  |  | ..... |  |  |  |
| Cost of goods sold |  |  |  | ----- |  |  | ..... |
| Gross profit | | | | | | | ----- |
| Less expenses: wages |  |  |  |  |  |  | ..... |
| Net profit | | | | | | | ----- |



Question 4

As well as the information in Question 3, you are given the following information regarding assets and liabilities at the start of the period:

| | |
|---------------|--------|
| | £ |
| Fixed assets | 37,000 |
| Debtors | 7,000 |
| Bank and cash | 12,000 |
| Creditors | 7,300 |

Requirement

Insert the missing figures below to prepare a balance sheet at the end of the period.

| | |
|-------------------------------------|--------------|
| | £ |
| Capital at the start of the period: | |
| Fixed assets | ..... |
| Stock | ..... |
| Debtors | ..... |
| Bank and cash | ..... |
| Total assets | ..... |
| Less: creditors | ..... |
| Capital | <u>.....</u> |

Balance sheet at 31.5.XX

| | | |
|---|--------------|--------------|
| | £ | £ |
| Fixed assets |  | ..... |
| Current assets | | |
| Stocks | ..... |  |
| Debtors | ..... |  |
| Bank and cash | ..... |  |
| Subtotal | <u>.....</u> | |
| Less current liabilities: creditors | <u>.....</u> | |
| Net current assets |  | ..... |
| Total net assets | | <u>.....</u> |
| Capital at start of period (as per above) |  | ..... |
| Net profit (as per Question 3) |  | ..... |
| Subtotal | | <u>.....</u> |
| Less drawings | | <u>.....</u> |

Solutions to Revision Questions

2



Solution 1

1.1 Answer: (D)

Working backwards often confuses candidates. Try drawing up a short example of a trading and profit and loss account using simple figures of your own, to prove or disprove the options given.

For example:

| | | |
|--------------------------|---------------|--------------|
| | £ | £ |
| Sales | | 20,000 |
| Stock at 31.12.20X0 | 2,000 | |
| Purchases during 20X1 | 8,000 | |
| | <u>10,000</u> | |
| Less stock at 31.12.20X1 | <u>1,000</u> | |
| Cost of goods sold | | 9,000 |
| Gross profit | | 11,000 |
| Less expenses | | 4,000 |
| Net profit | | <u>7,000</u> |

Make all the figures different or you will make mistakes.

You can now see that options A, B and C will not give the correct answer.

1.2 Answer: (D)

Transactions that affect only assets and liabilities do not affect capital. Therefore options A, B and C are irrelevant.

1.3 Answer: (C)

The 'standard' accounting equation is

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

and capital equals opening capital plus profits less drawings. The only rearrangement of this equation that maintains the integrity of the accounting equation is C.

1.4 Answer: (A)

The effect on working capital is calculated as:

| | |
|---|----------------|
| Increase in stock = increase in working capital | £ |
| | 250 |
| Decrease in bank = decrease in working capital | (400) |
| Increase in creditors = decrease in working capital | <u>(1,200)</u> |
| Overall decrease in working capital | <u>(1,350)</u> |

1.5 Answer:

| | |
|-------------------------|----------------|
| | £ |
| Opening capital | 10,000 |
| Introduced | 4,000 |
| Drawings | (8,000) |
| Loss – balancing figure | <u>(1,500)</u> |
| Closing capital | <u>4,500</u> |

1.6 Only the profit affects the capital at the end of the month. The capital at the start was £15,500 (£28,000 assets, less £12,500 liabilities), so a profit of £7,000 increases this to £22,500. The purchase by cheque of a fixed asset affects only assets, and the payment of creditors by cheque affects assets and liabilities, but neither affects capital.

1.7 Answer: (D)

The accounting equation changes when one or more of assets, liabilities or capital changes. Selling goods at a profit would change capital; purchasing a fixed asset on credit would change assets and liabilities; the owner withdrawing cash would change assets and capital; debtors paying their accounts in cash would not affect any of these.

1.8 Answer: (B)



Solution 2

- This question requires you to ascertain the reason for changes in the assets and liabilities as a result of transactions that have occurred.
- Each column contains two changes that complement each other – because every transaction has two effects.

- (A) Answer: 2
 (B) Answer: 6
 (C) Answer: 7
 (D) Answer: 1
 (E) Answer: 8
 (F) Answer: 4
 (G) Answer: 5
 (H) Answer: 3



Solution 3

| | | |
|---------------------------|---------------|---------------|
| <i>May 20XX</i> | £ | £ |
| Sales (£17,000 + £28,000) | | 45,000 |
| Less cost of sales | | |
| Opening stock | 5,000 | |
| Purchases | 19,500 | |
| | <u>24,500</u> | |
| Less closing stock | <u>6,250</u> | |
| | | 18,250 |
| Gross profit | | <u>26,750</u> |
| Less expenses: | | |
| Wages | | <u>2,000</u> |
| Net profit | | <u>24,750</u> |



Solution 4

First of all calculate the capital at the start of the period (not forgetting the stock balance given in Question 3), then adjust the opening assets and liabilities for the changes given in Question 3. Finally, add the profit to the opening capital, and deduct drawings.

| | |
|-----------------|---------------|
| | £ |
| Fixed assets | 37,000 |
| Stock | 5,000 |
| Debtors | 7,000 |
| Bank and cash | <u>12,000</u> |
| | 61,000 |
| Less: creditors | <u>7,300</u> |
| Capital | <u>53,700</u> |

Balance sheet at 31.5.XX

| | | |
|---|---------------|---------------|
| | £ | £ |
| Fixed assets (37,000 + 12,000) | | 49,000 |
| Current assets | | |
| Stocks | 6,250 | |
| Debtors (7,000 + 28,000) | 35,000 | |
| Bank and cash (12,000 + 17,000 – 2,000 – 1,600) | <u>25,400</u> | |
| | 66,650 | |
| Less: current liabilities | | |
| Creditors (7,300 + 19,500 + 12,000) | <u>38,800</u> | |
| Net current assets | | <u>27,850</u> |
| | | <u>76,850</u> |
| Capital at start of period (as above) | | 53,700 |
| Net profit (as in Question 3) | | <u>24,750</u> |
| | | 78,450 |
| Less drawings | | <u>1,600</u> |
| | | <u>76,850</u> |

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The Accounting System in Action

3

LEARNING OUTCOMES

When you have completed this chapter, you should be able to:

- ▶ explain the purpose of accounting records and their role in the accounting system;
- ▶ prepare nominal ledger accounts;
- ▶ prepare accounts for sales and purchases, including personal accounts.

3.1 Introduction

In the last chapter, you were able to draw up a simple profit and loss account and balance sheet after considering a small number of transactions. Imagine an organisation with hundreds, or thousands, of transactions in a period, and how difficult (impossible, even) it would be to draw up the accounts from just a list of transactions.

This chapter introduces you to the system of maintaining ledger accounts, to enable the profit and loss account and balance sheet to be prepared. It is known as the system of *bookkeeping*. Although nowadays most organisations maintain their accounts on computer, the basic principles of bookkeeping have remained unchanged for centuries, and are still important if you are to understand how such systems work, especially if adjustments need to be made to the system or its records.

Some of these topics will also be covered in more detail in subsequent chapters.

3.2 What is a ledger account?

An *account* is a record of the transactions involving a particular item. You may have a bank account yourself, which provides you with a record of the transactions you make; or you may have received an electricity account, which details how much electricity you have consumed and any payments you have made towards it. A ledger account may be thought of as a record kept as a page in a book. The book contains many pages – many accounts – and is referred to as a ledger. In this chapter we are concerned with the *nominal ledger*, which is the ledger containing all of the accounts necessary to summarise an organisation's transactions and prepare a balance sheet and profit and loss account. (Some organisations

also maintain subsidiary ledgers in support of the nominal ledger: we shall look at this in Chapter 8.)

Each account comprises two sides: the left-hand side is referred to as the *debit* side, and the right-hand side is referred to as the *credit* side. The format is shown below:

| <i>Debit</i> | <i>Credits</i> |
|--------------|----------------|
| Date | Date |
| Details | Details |
| £ | £ |

3.3 What is double-entry bookkeeping?

According to the CIMA *Official Terminology*:



Double-entry bookkeeping: The most commonly used system of bookkeeping based on the principle that every financial transaction involves the simultaneous receiving and giving of value, and is therefore recorded twice.

Earlier in this text we saw how some transactions affected the accounting equation and the balance sheet. We saw that each transaction had two effects: this is referred to as the *dual aspect* or *duality* concept. For example, receiving payment from a debtor increases the asset ‘cash’, while reducing the asset ‘debtors’; paying a supplier reduces the asset ‘cash’ while reducing the liability ‘creditors’. In both cases, the accounting equation remains intact. The fact that every transaction has two effects – equal and opposite – means that each transaction must be recorded in two ledger accounts. This is double-entry bookkeeping.

Bookkeeping is the technique of recording financial transactions as they occur so that summaries may be made of the transactions and presented as a report to the users of accounts. The double-entry bookkeeping technique applies to the recording of transactions in ledger accounts.



Exercise 3.1

Explain what is meant by the term ‘double-entry bookkeeping’.



Solution

Double-entry bookkeeping is a system of keeping records of transactions in ledger accounts such that every transaction requires debit and credit entries of equal value. For example, there might be a debit entry of £100 equalled by two credit entries of £90 and £10, respectively. The result of this method is that the total of debit balances on ledger accounts equals the total of credit balances.

In the previous chapter, you learned the following terms:

- assets;
- liabilities (and capital);
- revenues;
- expenses.

These four items can be grouped in pairs, according to whether they appear on the balance sheet or in the profit and loss account.

- Assets and liabilities (and capital) appear on the balance sheet.
- Expenses and revenue appear in the profit and loss account.

If you compare these pairs you will see that they are, in effect, two pairs of opposites.

Each type of asset, liability, expense, or income is recorded separately. This is achieved by using separate ledger accounts for each of them. We shall look first of all at recording assets, liabilities and capital.



Transactions are recorded on either the debit or credit side of a ledger account according to the following table:

| <i>Debit</i> | <i>Credit</i> |
|----------------------------------|----------------------------------|
| Increases in assets | Decreases in assets |
| Decreases in liabilities/capital | Increases in liabilities/capital |

Entering transactions in ledger accounts is also called *posting* the transactions.

In the previous chapter, we saw how transactions would affect the accounting equation and the balance sheet. Example 2.B is reproduced here so that the double-entry bookkeeping entries (or postings) may be compared with the solution given in Chapter 2.

Example 3.A

John had the following assets and liabilities on 1 January:

| | |
|--------------|----------------|
| | £ |
| Land | 200,000 |
| Buildings | 60,000 |
| Stock | 10,000 |
| Debtors | 15,000 |
| Cash in hand | 5,000 |
| Bank balance | 32,000 |
| | <u>322,000</u> |
| Creditors | 17,000 |
| Bank loan | 240,000 |
| | <u>257,000</u> |

First of all we enter the opening balances into the ledger accounts. Assets have debit balances, and liabilities and capital have credit balances:

| | | Land |
|--------|-------------|---------|
| | | £ |
| 1 Jan. | Balance b/d | 200,000 |

| | | Buildings |
|--------|-------------|-----------|
| | | £ |
| 1 Jan. | Balance b/d | 60,000 |

| | | Stock |
|--------|-------------|--------|
| | | £ |
| 1 Jan. | Balance b/d | 10,000 |

| | | Debtors |
|--------|-------------|---------|
| | | £ |
| 1 Jan. | Balance b/d | 15,000 |

| Cash in hand | | | |
|--------------|-------------|-------------|---------|
| | | £ | |
| 1 Jan. | Balance b/d | 5,000 | |
| Bank balance | | | |
| | | £ | |
| 1 Jan. | Balance b/d | 32,000 | |
| Creditors | | | |
| | | £ | |
| | 1 Jan. | Balance b/d | 17,000 |
| Bank loan | | | |
| | | £ | |
| | 1 Jan. | Balance b/d | 240,000 |
| Capital | | | |
| | | £ | |
| | 1 Jan. | Balance b/d | 65,000 |

Notes

1. The capital account balance is the difference between assets and liabilities.
2. 'Balance b/d' is short for 'balance brought down'. It is sometimes also called 'balance brought forward' or 'balance b/fwd'.

Assume that John had the following transactions during the first week of January:

1. Bought office equipment costing £7,000, paying £2,000 deposit by cheque, the balance to be paid at the end of March.
2. Returned some office equipment to his supplier because it was faulty. John had originally been charged £3,000 for it.
3. Received £8,000 from his debtors. They all paid him by cheque.

We now want to enter the January transactions into the ledger accounts. First, though, let us look at each transaction to determine how we are going to record it.

1. Office equipment is an asset, and is increasing. Therefore we want to debit the *office equipment* account. A cheque for £2,000 has been paid. The bank account, an asset, is decreasing, so we want to credit the *bank* account. £5,000 is still owing to the supplier (creditor), so liabilities are increasing, leading us to credit *creditors*.
2. Office equipment is being returned, so the asset of office equipment is decreasing. Therefore we want to credit the *office equipment* account. As John has not yet paid for the goods, the amount will be included in the creditors figure. If we return goods, the amount owed to creditors decreases and, as creditors are liabilities, we therefore want to debit the *creditors* account.
3. Debtors are assets. If they pay their debts, the amount owed decreases, so we want to credit *debtors*. Bank is an asset. Paying money in increases the balance, so we want to debit *bank*.

These transactions can now be entered into the ledger accounts, as follows:

| Land | | | |
|-----------|-------------|---------|--|
| | | £ | |
| 1 Jan. | Balance b/d | 200,000 | |
| Buildings | | | |
| | | £ | |
| 1 Jan. | Balance b/d | 60,000 | |

| Stock | | | | | |
|------------------|------------------|---|--------|--------|------------------|
| 1 Jan. | Balance b/d | £ | 10,000 | | |
| Debtors | | | | | |
| 1 Jan. | Balance b/d | £ | 15,000 | Jan. | Bank |
| | | | | | £ |
| | | | | | 8,000 |
| Cash in hand | | | | | |
| 1 Jan. | Balance b/d | £ | 5,000 | | |
| Bank balance | | | | | |
| 1 Jan. | Balance b/d | £ | 32,000 | Jan. | Office equipment |
| Jan. | Debtors | | 8,000 | | £ |
| | | | | | 2,000 |
| Creditors | | | | | |
| Jan. | Office equipment | £ | 3,000 | 1 Jan. | Balance b/d |
| | | | | Jan. | Office equipment |
| | | | | | £ |
| | | | | | 17,000 |
| | | | | | 5,000 |
| Bank loan | | | | | |
| | | | | 1 Jan. | Balance b/d |
| | | | | | £ |
| | | | | | 240,000 |
| Capital | | | | | |
| | | | | 1 Jan. | Balance b/d |
| | | | | | £ |
| | | | | | 65,000 |
| Office equipment | | | | | |
| Jan. | Bank | £ | 2,000 | Jan. | Creditors |
| | Creditors | | 5,000 | | £ |
| | | | | | 3,000 |

3.4 Bookkeeping entries for expenses and revenue

An expense is a cost connected with the activities of the organisation. Examples of expenses include rent, business rates, light and heat, wages and salaries, postage, telephone, and the cost of items bought for resale.

Revenue is the term used to describe the activities that will eventually lead to the organisation receiving money. The most common source of revenue is that derived from the sale of its goods or services, but others include the receipt of interest on bank deposits.

The dual aspect of transactions referred to earlier applies to expenses and revenue in the same way that it did to transactions simply involving the movement of assets and liabilities.

For example, the employment of workers will cause an expense (wages and salaries) and will also create a liability to pay them. Later, when workers are paid, the liability is ended but the balance at bank is reduced.

Similarly, the sale of goods on credit will represent revenue and will create a debtor (the customer) until the customer has paid for them. When payment occurs the asset of debtor is reduced and the balance at bank increases.

The same double-entry bookkeeping principle applies to recording the expenses and income of an organisation. The table shown earlier can now be extended to include expenses and income as follows:



| <i>Debit</i> | <i>Credit</i> |
|----------------------------------|----------------------------------|
| Increases in assets | Decreases in assets |
| Decreases in liabilities/capital | Increases in liabilities/capital |
| Increases in expenses | Decreases in expenses |
| Decreases in revenue | Increases in revenue |

3.4.1 Bookkeeping entries for purchases and sales

We keep separate ledger accounts for the different types of stock movement. Purchases and sales of stocks must always be kept in separate accounts, because one is at cost price and the other at selling price. You might have difficulty in determining how to classify purchases and sales. You could regard purchases as being assets, or you could regard them as being expenses. It all depends on whether they are consumed during the period, and that is unknown at the time they are bought. Similarly, sales could be regarded as decreases in stock or as revenues. The fact is that *it does not matter* how you regard them. Both will result in the correct entry being made. For example, if you regard the purchase of stocks as an increase in an asset, you will make a debit entry; if you regard it as an increase in an expense, you will still make a debit entry. The same applies to sales – a decrease in stocks results in a credit entry, as does an increase in revenue. So, you will choose the right side for the entry, whichever way you classify these. The most important thing is to use the correct account – and *never* use the stock account for purchases and/or sales as the stock account is used only at the beginning and end of the accounting period.

Also note that you should *never* use either the purchases account or the sales account for anything other than the goods in which the business trades. Purchases of fixed assets, stationery, etc., should all be recorded in their own ledger accounts.



Exercise 3.2

Tick the correct box for each of the following:

| | | <i>Debit</i> | <i>Credit</i> |
|----|--------------------------|--------------|---------------|
| 1. | Increases in assets | ... | ... |
| 2. | Increases in liabilities | ... | ... |
| 3. | Increases in income | ... | ... |
| 4. | Decreases in liabilities | ... | ... |
| 5. | Increases in expenses | ... | ... |
| 6. | Decreases in assets | ... | ... |
| 7. | Increases in capital | ... | ... |
| 8. | Decreases in income | ... | ... |



Solution

The order of boxes should be: debit; credit; credit; debit; debit; credit; credit; debit.

Example 3.B

The following example includes transactions involving all the above types of accounts. It might help you to determine the correct ledger entries by completing a table before you start, like this (the first item is done for you):

| Date | Names of accounts involved | Type of accounts | Increase/decrease | Debit/credit |
|-------|----------------------------|------------------|-------------------|--------------|
| 1 May | Capital | Capital | Increase | Credit |
| | Cash | Asset | Increase | Debit |

- May
- 1 BR starts business as a sole proprietor with £20,000 in cash
- 2 Pays £15,000 cash into a business bank account
- 4 Purchases goods on credit from JM for £2,000
- 6 Purchases goods from ERD on credit for £3,000
- 7 Pays wages in cash £60
- 10 Pays rent by cheque £80
- 12 Sells goods for cash £210
- 16 Buys furniture for £1,500 paying by cheque
- 19 Sells goods on credit to SP for £580
- 22 Buys goods for cash £3,900
- 24 Buys fittings for cash £600
- 25 Pays wages by cash £110
- 25 Sells goods for cash £430
- 27 Receives part payment from SP of £330 by cheque
- 28 Pays advertising by cheque £25
- 28 Sells goods for cash £890
- 29 Sells goods on credit to KM for £8,090
- 30 Withdraws £100 cash for his personal use

Solution

| Capital | | | |
|---------|-------|------|--------|
| | | | £ |
| | 1 May | Cash | 20,000 |

| Cash | | | | | |
|-------|---------|--------|-------|-----------|--------|
| | | £ | | | £ |
| 1 May | Capital | 20,000 | 2 May | Bank | 15,000 |
| 12 | Sales | 210 | 7 | Wages | 60 |
| 25 | Sales | 430 | 19 | Purchases | 3,900 |
| 28 | Sales | 890 | 24 | Fittings | 600 |
| | | | 25 | Wages | 110 |
| | | | 30 | Cash | 100 |

| Bank | | | | | |
|-----------|-------|--------|--------|-------------|-------|
| | | £ | | | £ |
| 2 May | Cash | 15,000 | 10 May | Rent | 80 |
| 27 | SP | 330 | 16 | Furniture | 1,500 |
| | | | 28 | Advertising | 25 |
| Purchases | | | | | |
| | | £ | | | |
| 4 May | JM | 2,000 | | | |
| 6 | ERD | 3,000 | | | |
| 22 | Cash | 3,900 | | | |
| JM | | | | | |
| | | | | | £ |
| | | | 4 May | Purchases | 2,000 |
| ERD | | | | | |
| | | | | | £ |
| | | | 6 May | Purchases | 3,000 |
| Wages | | | | | |
| | | £ | | | |
| 7 May | Cash | 60 | | | |
| 25 | Cash | 110 | | | |
| Rent | | | | | |
| | | £ | | | |
| 10 May | Bank | 80 | | | |
| Sales | | | | | |
| | | | | | £ |
| | | | 12 May | Cash | 210 |
| | | | 19 | SP | 580 |
| | | | 25 | Cash | 430 |
| | | | 28 | Cash | 890 |
| | | | 29 | KM | 8,090 |
| Furniture | | | | | |
| | | £ | | | |
| 16 May | Bank | 1,500 | | | |
| SP | | | | | |
| | | £ | | | £ |
| 19 May | Sales | 580 | 27 May | Bank | 330 |
| Fittings | | | | | |
| | | £ | | | |
| 24 May | Cash | 600 | | | |

| Advertising | | |
|-------------|-------|---------|
| 28 May | Bank | £ 25 |
| KM | | |
| 29 May | Sales | £ 8,090 |
| Drawings | | |
| 30 May | Cash | £ 100 |



Exercise 3.3

A Thompson commenced business on 1 February 20X1, paying £500 into a business bank account.

During the next month the following transactions took place. All payments are made by cheque and all receipts are banked.

| February | | £ |
|----------|--------------------------|-----|
| 1 | Bought goods for resale | 150 |
| 5 | Paid rent | 50 |
| 10 | Business takings to date | 290 |
| 22 | Paid for advertising | 25 |
| 26 | A Thompson's drawings | 100 |
| 27 | Business takings | 240 |

You are required to:

- write up the bank account;
- write up all the other accounts.

Note: When you draw up your accounts, leave ten extra lines after the bank account, and four extra lines after all other ledger accounts – this exercise is continued in the next chapter.



Solution

| Bank | | | | | |
|---------|---------|-----|---------|-------------|-----|
| 20X1 | | £ | 20X1 | | £ |
| 1 Feb. | Capital | 500 | 1 Feb. | Purchases | 150 |
| 10 Feb. | Sales | 290 | 5 Feb. | Rent | 50 |
| 27 Feb. | Sales | 240 | 22 Feb. | Advertising | 25 |
| | | | 26 Feb. | Drawings | 100 |
| Capital | | | | | |
| | | | 20X1 | | £ |
| | | | 1 Feb. | Bank | 500 |

| Purchases | | | |
|-------------|------|---------|----------|
| 20X1 | | £ | |
| 1 Feb. | Bank | 150 | |
| Rent | | | |
| 20X1 | | £ | |
| 5 Feb. | Bank | 50 | |
| Advertising | | | |
| 20X1 | | £ | |
| 22 Feb. | Bank | 25 | |
| Drawings | | | |
| 20X1 | | £ | |
| 26 Feb. | Bank | 100 | |
| Sales | | | |
| | | 20X1 | £ |
| | | 10 Feb. | Bank 290 |
| | | 27 Feb. | Bank 240 |

3.4.2 Nominal ledger accounts

At this stage in your studies, all your ledger accounts are kept in a single 'book'. In later chapters you will see how the ledger accounts can be divided into several books. The main book used is called the *nominal ledger*.

3.5 Balancing the accounts

From time to time it is necessary to determine the end result of the transactions recorded in each ledger account. For example, the cash account will contain a number of debit and credit entries, but no clear indication of how much cash is remaining. The same applies to other accounts. Debtors' and creditors' accounts will have a number of debit and credit entries, but no indication of what is currently owed as a result of these entries.

3.5.1 Calculating the balance on the account

To determine the position on each account, each side is totalled: the difference between the two sides is called the *balance*. If the debit side is greater, the account has a 'debit balance', and *vice versa*.

As an example, look at the cash account that was produced in Example 3.B.

| Cash | | | | | |
|-------|---------|--------|-------|-----------|--------|
| | | £ | | | £ |
| 1 May | Capital | 20,000 | 2 May | Bank | 15,000 |
| 12 | Sales | 210 | 7 | Wages | 60 |
| 25 | Sales | 430 | 19 | Purchases | 3,900 |
| 28 | Sales | 890 | 24 | Fittings | 600 |
| | | | 25 | Wages | 110 |
| | | | 30 | Cash | 100 |

The debit side totals £21,530 (meaning that that amount has been received) and the credit side totals £19,770 (meaning that that amount has been paid out). The balance, therefore, is £1,760 debit, which means there is still that amount held in cash.

The purpose of this section is to introduce you to what is meant by the balance on an account – it is simply the difference between the totals of the two sides of the account; a debit balance means that there is more on the debit side, a credit balance means that there is more on the credit side. In the next chapter you will see how these balances are shown in the ledger accounts.



Exercise 3.4

Work out the balances on the other accounts in Example 3.B.



Solution

| | |
|-------------|----------------|
| Capital | £20,000 credit |
| Bank | £13,725 debit |
| Purchases | £8,900 debit |
| JM | £2,000 credit |
| ERD | £3,000 credit |
| Wages | £170 debit |
| Rent | £80 debit |
| Sales | £10,200 credit |
| Furniture | £1,500 debit |
| SP | £250 debit |
| Fittings | £600 debit |
| Advertising | £25 debit |
| KM | £8,090 debit |
| Drawings | £100 debit |



Exercise 3.5

Work out the balances on the accounts from Exercise 3.3.



Solution

| | |
|-------------|-------------|
| Bank | £705 debit |
| Capital | £500 credit |
| Purchases | £150 debit |
| Rent | £50 debit |
| Advertising | £25 debit |
| Drawings | £100 debit |
| Sales | £530 credit |

3.6 Summary

In this chapter you have:

- seen how financial transactions are recorded in ledger accounts, using double-entry principles;
- learned how to calculate the balance on an account at a point in time.

Double entry is the cornerstone of the entire accounting process. You will not get far in your studies of this subject unless you have a thorough grasp of its principles. Make sure

you can follow the steps involved in the examples given in this chapter, and memorise the table:

| <i>Debit</i> | <i>Credit</i> |
|----------------------------------|----------------------------------|
| Increases in assets | Decreases in assets |
| Decreases in liabilities/capital | Increases in liabilities/capital |
| Increases in expenses | Decreases in expenses |
| Decreases in revenue | Increases in revenue |

It is important that you fully understand the double-entry system, as it will enable you to understand how to record more complex transactions later on in your studies.

Try not to analyse the reason for the ‘left and right’ system for recording transactions. It is simply a rule that, if everyone abides by it, leads to a common system. It can be likened to the rule for driving a car. If the rule in a country is to drive on the left, then the system works as long as everyone abides by the rule.

Practise the examples in the chapter several times until you feel competent in them.

Revision Questions

3

? Question 1 Multiple choice

- 1.1 A credit balance of £917 brought down on Y Ltd's account in the books of X Ltd means that:
- (A) X Ltd owes Y Ltd £917.
 - (B) Y Ltd owes X Ltd £917.
 - (C) X Ltd has paid Y Ltd £917.
 - (D) X Ltd is owed £917 by Y Ltd.
- 1.2 Which *one* of the following statements is correct?
- (A) Assets and liabilities normally have credit balances.
 - (B) Liabilities and revenues normally have debit balances.
 - (C) Assets and revenues normally have credit balances.
 - (D) Assets and expenses normally have debit balances.
- 1.3 On 1 January, a business had a customer, J King, who owed £400. During January, J King bought goods for £700 and returned goods valued at £250. He also paid £320 in cash towards the outstanding balance. The balance on J King's account at 31 January is:
- (A) £530 debit.
 - (B) £530 credit.
 - (C) £270 debit.
 - (D) £270 credit.
- 1.4 Alice had the following assets and liabilities at 1 January:

| | |
|----------------|-----|
| | £ |
| Stocks | 350 |
| Creditors | 700 |
| Debtors | 400 |
| Bank overdraft | 125 |
| Motor vehicles | 880 |

Her capital at 1 January was: £.....

- 1.5 The correct entries needed to record the return of office equipment that had been bought on credit from P Young, and not yet paid for, are:

| | <i>Debit</i> | <i>Credit</i> |
|----------|------------------|------------------|
| A | Office equipment | Sales |
| B | Office equipment | P Young |
| C | P Young | Office equipment |
| D | Cash | Office equipment |

- 1.6 Which *one* of the following statements regarding the balance on a ledger account is *not* correct?
- (A) A credit balance exists where the total of credit entries is more than the total of debit entries.
 - (B) A debit balance exists where the total of debit entries is less than the total of credit entries.
 - (C) A credit balance exists where the total of debit entries is less than the total of credit entries.
 - (D) A debit balance exists where the total of debit entries is more than the total of credit entries.
- 1.7 Which of the following is the correct entry to record the purchase on credit of stocks intended for resale?

| | <i>Debit</i> | <i>Credit</i> |
|----------|--------------|---------------|
| A | Stock | Debtor |
| B | Stock | Creditor |
| C | Purchases | Creditor |
| D | Creditor | Purchases |

- 1.8 A receives goods from B on credit terms and A subsequently pays by cheque. A then discovers that the goods are faulty and cancels the cheque before it is cashed by B. How should A record the cancellation of the cheque in his books?

| | <i>Debit</i> | <i>Credit</i> |
|----------|------------------|------------------|
| A | Creditors | Returns outwards |
| B | Creditors | Bank |
| C | Bank | Creditors |
| D | Returns outwards | Creditors |

? Question 2

The table below shows a selection of financial transactions. Complete the columns to identify the accounts and the debit/credit entries to be made in the ledger to record each of the transactions.

| | <i>Transaction description</i> | <i>Account to be debited</i> | <i>Account to be credited</i> |
|-----|--|------------------------------|-------------------------------|
| 1. | Sold goods on credit to A Harris | | |
| 2. | Bought goods for sale on credit from P Walker | | |
| 3. | Paid carriage on the goods purchased, in cash | | |
| 4. | Returned goods to P Walker | | |
| 5. | Bought office machinery on credit from W Print | | |
| 6. | Returned office machinery to W Print | | |
| 7. | Received a cheque from P Wright | | |
| 8. | Received payment from T Wilkes by cheque | | |
| 9. | Owner's private car brought into the business | | |
| 10. | Cheque received from P Wright dishonoured | | |

? **Question 3**

S Smart commenced in business as a decorator on 1 January.

- 1 Jan. Commenced business by putting £1,000 of his own money into a business bank account.
- 3 Jan. Bought a motor van on credit from AB Garages for £3,000.
- 4 Jan. Bought decorating tools and equipment on credit from B&P Ltd for £650.
- 8 Jan. Bought paint for £250, paying by cheque.
- 10 Jan. Received £400 cash from a customer for work done.
- 12 Jan. Bought paint for £150, paying in cash.
- 14 Jan. Issued an invoice to a customer, K Orme, for £750 for work done.
- 18 Jan. Returned some of the decorating tools, value £80, to B&P Ltd.
- 23 Jan. Took £50 of the cash to buy a birthday present for his son.
- 28 Jan. K Orme paid £250 by cheque towards his bill.

Requirement

Calculate the balance on each account at 31 January, by completing the ledger accounts provided below:

| <i>Date</i> | <i>Description</i> | <i>Amount (£)</i> | <i>Date</i> | <i>Description</i> | <i>Amount (£)</i> |
|---------------------|--------------------|-------------------|-------------|--------------------|-------------------|
| Capital | | | | | |
| | | | | | |
| Bank | | | | | |
| | | | | | |
| | | | | | |
| Motor van | | | | | |
| | | | | | |
| AB Garages | | | | | |
| | | | | | |
| Tools and equipment | | | | | |
| | | | | | |
| B&P Ltd | | | | | |
| | | | | | |
| Purchases | | | | | |
| | | | | | |
| | | | | | |
| Sales | | | | | |
| | | | | | |
| | | | | | |

| | | | | | |
|----------|--|--|--|--|--|
| Cash | | | | | |
| | | | | | |
| | | | | | |
| K Orme | | | | | |
| | | | | | |
| | | | | | |
| Drawings | | | | | |
| | | | | | |
| | | | | | |

The balances on the accounts are as follows:

| | £ | <i>Debit/credit</i> |
|---------------------|---|---------------------|
| Capital | | |
| Bank | | |
| Motor van | | |
| AB Garages | | |
| Tools and equipment | | |
| B&P Ltd | | |
| Purchases | | |
| Sales | | |
| Cash | | |
| K Orme | | |
| Drawings | | |

? Question 4

B Baggins commenced in business as a market gardener on 1 March. Record the following transactions in the ledger accounts:

- 1 Mar. Paid £70 rent for land for the month of March, from his own funds.
- 4 Mar. Bought equipment on credit for £400 from JK Ltd.
- 8 Mar. Bought plants for £2,000, paying from his own funds.
- 10 Mar. Received £100 cash for a talk to the local horticultural society.
- 12 Mar. Sold plants for £1,200, being paid by cheque. He opened a business bank account with this amount.
- 15 Mar. Paid wages of £50 in cash.
- 18 Mar. Bought plants for £800 on credit from BH Horticultural Ltd.
- 20 Mar. Sold plants for £500 on credit to PB.
- 23 Mar. Paid £100 rates by cheque.
- 28 Mar. Paid wages of £20 in cash.
- 31 Mar. Sold plants for £240, being paid in cash.

Calculate the balance on each account at 31 March by completing the ledger accounts provided below:

| | | | |
|--------------|--|---|---|
| Rent payable | | | |
| | | £ | £ |
| | | | |

| | | | | | |
|----------------------|--|---|--|--|---|
| Capital | | | | | |
| | | | | | £ |
| | | | | | |
| JK Ltd | | | | | |
| | | | | | £ |
| Equipment | | | | | |
| | | £ | | | |
| | | | | | |
| Purchases | | | | | |
| | | £ | | | |
| | | | | | |
| Sales | | | | | |
| | | | | | £ |
| | | | | | |
| Cash | | | | | |
| | | £ | | | £ |
| | | | | | |
| Bank | | | | | |
| | | £ | | | £ |
| | | | | | |
| Wages | | | | | |
| | | £ | | | |
| | | | | | |
| BH Horticultural Ltd | | | | | |
| | | | | | £ |
| PB | | | | | |
| | | £ | | | |
| | | | | | |

| | | |
|-------|--|---|
| Rates | | |
| | | £ |
| | | |

The balances on the accounts are as follows:

| | £ | <i>Debit/credit</i> |
|-----------------------|---|---------------------|
| Rent payable | | |
| Capital | | |
| Equipment | | |
| JK Ltd | | |
| Purchases | | |
| Sales | | |
| Cash | | |
| Bank | | |
| Wages | | |
| BH Horticultural Ltd. | | |
| PB | | |
| Rates | | |

Solutions to Revision Questions

3



Solution 1

1.1 Answer: (A)

A credit balance in the books of X Ltd indicates that it owes money; none of the other distractors would result in a credit balance.

1.2 Answer: (D)

1.3 Answer: (A)

The ledger account would be as follows:

| J King | | | | | |
|---------|-------------|----------|------|----------------|----------|
| 1. Jan. | Balance b/f | £ 400 | Jan. | Returned goods | £ 250 |
| Jan. | Sales | 700 | | Cash | 320 |

The balance is the debit total (£1,100) less the credit total (£570): £530 debit.

1.4 Capital = Assets – Liabilities

$$= (£350 + £400 + £880) - (£700 + £125)$$

$$= £805$$

1.5 Answer: (C)

1.6 Answer: (B)

1.7 Answer: (C)

The stock account is never used to record purchases.

1.8 Answer: (C)



Solution 2

- This question tests your ability to determine the debit and credit entries of a range of simple transactions.
- It is common for students to reverse the entries at this stage in their studies. Keep referring to the table until you are sure of your accuracy.

| | |
|----------------------------------|----------------------------------|
| <i>Debit</i> | <i>Credit</i> |
| Increases in assets | Decreases in assets |
| Decreases in liabilities/capital | Increases in liabilities/capital |
| Increases in expenses | Decreases in expenses |
| Decreases in revenue | Increases in revenue |

| | |
|------------------------------|-------------------------------|
| <i>Account to be debited</i> | <i>Account to be credited</i> |
| 1. A Harris | Sales |
| 2. Purchases | P Walker |
| 3. Carriage inwards | Cash |
| 4. P Walker | Purchase returns |
| 5. Office machinery | W Print |
| 6. W Print | Office machinery |
| 7. Bank | P Wright |
| 8. Bank | T Wilkes |
| 9. Car | Capital |
| 10. P Wright | Bank |



Solution 3

| | | | |
|---------------------|------------|---------|-----------|
| Capital | | | |
| | | 1 Jan. | Bank |
| | | | £ 1,000 |
| Bank | | | |
| 1 Jan. | Capital | £ 1,000 | 8 Jan. |
| 28 Jan. | K Orme | 250 | Purchases |
| | | | £ 250 |
| Motor van | | | |
| 3 Jan. | AB Garages | £ 3,000 | |
| AB Garages | | | |
| | | 3 Jan. | Motor van |
| | | | £ 3,000 |
| Tools and equipment | | | |
| 4 Jan. | B&P Ltd | £ 650 | 18 Jan. |
| | | | BP Ltd |
| | | | £ 80 |
| B&P Ltd | | | |
| 18 Jan. | Tools | £ 80 | 4 Jan. |
| | | | Tools |
| | | | £ 650 |
| Purchases | | | |
| 8 Jan. | Bank | £ 250 | |
| 12 Jan. | Cash | 150 | |

| Sales | | | | | |
|----------|-------|-----|---------|-----------|-----|
| | | | | | £ |
| | | | 10 Jan. | Cash | 400 |
| | | | 14 Jan. | K Orme | 750 |
| Cash | | | | | |
| | | £ | | | £ |
| 10 Jan. | Sales | 400 | 12 Jan. | Purchases | 150 |
| | | | 23 Jan. | Drawings | 50 |
| K Orme | | | | | |
| | | £ | | | £ |
| 14 Jan. | Sales | 750 | 28 Jan. | Bank | 250 |
| Drawings | | | | | |
| | | £ | | | |
| 23 Jan. | Cash | 50 | ? | ? | ? |

The balances on the accounts are as follows:

| | | | |
|---------------------|-------|--------|--|
| | | £ | |
| Capital | 1,000 | Credit | |
| Bank | 1,000 | Debit | |
| Motor van | 3,000 | Debit | |
| AB Garages | 3,000 | Credit | |
| Tools and equipment | 570 | Debit | |
| B&P Ltd | 570 | Credit | |
| Purchases | 400 | Debit | |
| Sales | 1,150 | Credit | |
| Cash | 200 | Debit | |
| K Orme | 500 | Debit | |
| Drawings | 50 | Debit | |



Solution 4

| Rent payable | | | | | |
|--------------|---------|----|--------|-----------|-------|
| | | £ | | | |
| 1 Mar. | Capital | 70 | | | |
| Capital | | | | | |
| | | | | | £ |
| | | | 1 Mar. | Rent | 70 |
| | | | 8 Mar. | Purchases | 2,000 |
| JK Ltd | | | | | |
| | | | | | £ |
| | | | 4 Mar. | Equipment | 400 |

| Equipment | | | |
|-----------|--------|----------|--|
| 4 Mar. | JK Ltd | £ 400 | |

| Purchases | | | |
|-----------|----------------------|------------|--|
| 8 Mar. | Capital | £ 2,000 | |
| 18 Mar. | BH Horticultural Ltd | 800 | |

| Sales | | | |
|-------|--|---------|------------|
| | | | £ |
| | | 10 Mar. | Cash 100 |
| | | 12 Mar. | Bank 1,200 |
| | | 18 Mar. | PB 500 |
| | | 31 Mar. | Cash 240 |

| Cash | | | |
|---------|-------|----------|---------|
| 10 Mar. | Sales | £ 100 | |
| 31 Mar. | Sales | 240 | |
| 15 Mar. | Wages | | £ 50 |
| 28 Mar. | Wages | | 20 |

| Bank | | | |
|---------|-------|------------|----------|
| 12 Mar. | Sales | £ 1,200 | |
| 23 Mar. | Rates | | £ 100 |

| Wages | | | |
|---------|------|---------|--|
| 15 Mar. | Cash | £ 50 | |
| 28 Mar. | Cash | 20 | |

| BH Horticultural Ltd | | | |
|----------------------|--|---------|---------------|
| | | 18 Mar. | Purchases 800 |

| PB | | | |
|---------|-------|----------|--|
| 20 Mar. | Sales | £ 500 | |

| Rates | | | |
|---------|------|----------|--|
| 23 Mar. | Bank | £ 100 | |

The balances on the accounts are as follows:

| | £ | |
|----------------------|-------|--------|
| Rent payable | 70 | Debit |
| Capital | 2,070 | Credit |
| Equipment | 400 | Debit |
| JK Ltd | 400 | Credit |
| Purchases | 2,800 | Debit |
| Sales | 2,040 | Credit |
| Cash | 270 | Debit |
| Bank | 1,100 | Debit |
| Wages | 70 | Debit |
| BH Horticultural Ltd | 800 | Credit |
| PB | 500 | Debit |
| Rates | 100 | Debit |

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Summarising the Ledger Accounts

4

LEARNING OUTCOMES

When you have completed this chapter, you should be able to:

- ▶ prepare a trial balance;
- ▶ explain the nature of errors;
- ▶ prepare a trading account, profit and loss account and balance sheet from a trial balance.

4.1 Introduction

In this chapter, you will learn how the balances on the ledger accounts can be listed in a trial balance, where the total of the debits equals the total of the credits. This does not however prove that there are no errors, as a trial balance can still balance and yet contain errors. A trial balance is a useful step before a trading account, profit and loss account and balance sheet are prepared. After these financial statements have been prepared the ledger accounts can be balanced off.

4.2 Preparing the trial balance

One way of checking the accuracy of the ledger entries is by listing the balances on each account, and totalling them. Because of the 'double-entry' rule that has been employed, the total of all the accounts with debit balances should equal the total of all the accounts with credit balances. This list is known as a trial balance.

Using Example 3.B, the trial balance at 31 May would appear as follows:

| Trial balance | | |
|----------------------|-----------|------------|
| | Debit (£) | Credit (£) |
| x | | |
| Capital | | 20,000 |
| Cash | 1,760 | |
| Bank | 13,725 | |
| Purchases | 8,900 | |
| JM | | 2,000 |
| ERD | | 3,000 |
| Wages | 170 | |
| Rent | 80 | |
| Sales | | 10,200 |
| Furniture | 1,500 | |
| SP | 250 | |
| Fittings | 600 | |
| Advertising | 25 | |
| KM | 8,090 | |
| Drawings | 100 | |
| | 35,200 | 35,200 |

Notice that the accounts with debit balances are either assets or expenses, while the accounts with credit balances are liabilities, capital or revenue accounts (except for drawings, which represents a reduction in capital).

The trial balance: A list of account balances in a double-entry accounting system. The sum of the debit balances will equal the sum of the credit balances, although certain errors such as the omission of a transaction or erroneous entries will not be disclosed by a trial balance.

The trial balance is thus a list of the balances on the ledger accounts. If the totals of the debit and credit balances entered on the trial balance are not equal, then an error or errors have been made either:

1. in the posting of the transactions to the ledger accounts; or
2. in the balancing of the accounts; or
3. in the transferring of the balances from the ledger accounts to the trial balance.

4.2.1 Does the trial balance prove the accuracy of the ledger accounts?

Just because the trial balance totals agree does not mean that there are no errors within the ledger accounts. There are a number of errors that might have been made that do not prevent the trial balance from agreeing. These are:

- Errors of *omission*, where a transaction has been completely omitted from the ledger accounts.
- Errors of *commission*, where one side of a transaction has been entered in the wrong account (but of a similar type to the correct account, for example, entered in the wrong debtor's account, or in the wrong expense account). An error of commission would not affect the calculation of profit, or the position shown by the balance sheet.
- Errors of *principle*. As for errors of commission, but the correct and incorrect accounts are of different types, for example, entered in the purchases account instead of a fixed-asset account. This type of error would affect the calculation of profit, and the position shown by the balance sheet.

- Errors of *original entry*, where the wrong amount has been used for both the debit and the credit entries.
- *Reversal* of entries, where the debit has been made to the account that should have been credited, and vice versa.
- *Duplication* of entries, where the transaction has been posted twice.
- *Compensating errors*, where two or more transactions have been entered incorrectly, but cancelling each other out, for example, electricity debited with £100 too much, and sales credited with £100 too much.

In all these cases, an account has been debited and an account has been credited with the same amount, so the trial balance will still be in agreement, even though it contains incorrect entries. You will learn more about errors, and how to correct them, in Chapter 9.



Exercise 4.1

Explain the purpose of a trial balance.



Solution

The purpose of a trial balance is to check the arithmetical accuracy of the entries made to the ledger accounts, that is, that the total of debit entries equals the total of credit entries.



Exercise 4.2

Prepare a trial balance from the ledger accounts in Exercise 3.3.



Solution

| | | |
|-------------|-------|--------|
| Bank | £ 705 | Debit |
| Capital | £ 500 | Credit |
| Purchases | £ 150 | Debit |
| Rent | £ 50 | Debit |
| Advertising | £ 25 | Debit |
| Drawings | £ 100 | Debit |
| Sales | £ 530 | Credit |

A Thompson – trial balance at 28 February 20X1

| | <i>Debit (£)</i> | <i>Credit (£)</i> |
|-------------|------------------|-------------------|
| Bank | 705 | |
| Capital | | 500 |
| Purchases | 150 | |
| Rent | 50 | |
| Advertising | 25 | |
| Drawings | 100 | |
| Sales | | 530 |
| | <u>1,030</u> | <u>1,030</u> |

4.3 Preparing a statement of profit

When the trial balance has been successfully completed, it is reasonably safe to assume that profit can now be accurately calculated. So far we have referred to ‘the profit and loss account’. This is a common term for this financial statement and we shall continue to use it. But you should know that it is sometimes referred to more fully as ‘the trading and profit and loss account’. This reflects the fact that the statement is in two parts: the trading

account, followed by the profit and loss account. Other terms are also used to describe the profit statement, such as 'income statement'.

4.3.1 The trading account

The trading account is part of the double-entry bookkeeping system of an organisation that buys and sells goods with the intention of making a profit. It is one of the financial statements regularly produced by such an organisation during the year, often on a monthly basis.

The trading account compares the income derived from selling the goods with the costs of obtaining the goods sold. A typical trading account is as follows:

| Trading account for the year ending 31 December 20X1 | | | |
|--|-------|---------------------|-------|
| | £ | | £ |
| Opening stock | 500 | Sales | 9,400 |
| Purchases | 6,400 | Less: sales returns | (300) |
| | 6,900 | | |
| Less: closing stock | (430) | | |
| Cost of goods sold | 6,470 | | |
| Gross profit | 2,630 | | |
| | 9,100 | | 9,100 |

This presentation, as a ledger account, is known as the *horizontal format*.

Transferring the balances to the trading account

The trading account is a ledger account in the normal sense, and must conform to the double-entry rule. Therefore, every entry in it must have an opposite entry elsewhere in the ledger accounts. For example, the credit in the trading account for 'sales' of £9,400 will also be debited in the sales account. In effect, the balance on the sales account is transferred into the trading account. In the example above, the sales account might have appeared as follows:

| Sales | | | |
|-------|---------|------------|-------|
| | 20X1 | | £ |
| | 1 Jan. | B Nevitt | 1,000 |
| | 10 Jan. | A Turner | 5,400 |
| | 23 Jan. | G Fletcher | 2,600 |
| | 30 Jan. | P Bajwa | 400 |

Once the balance has been transferred to the trading account, the sales account will appear as follows:

| Sales | | | | |
|---------|-----------------|-------|---------|------------|
| 20X1 | | £ | 20X1 | |
| 31 Dec. | Trading account | 9,400 | 10 Jan. | B Nevitt |
| | | | 13 Mar. | A Turner |
| | | | 6 Jun. | G Fletcher |
| | | | 5 Dec. | P Bajwa |
| | | 9,400 | | |
| | | | | 9,400 |

Note that there is now no balance on the sales account, and so the two sides can be totalled to confirm that fact, and ruled off to prevent including them in the figures for the

following year. The account is now said to be ‘closed’, although it can still be used to record the sales for the next period, below the totals.

This process is repeated with all the other figures that appear in the trading account, but there are some transfers that are worthy of special mention.

(a) *The stock account.* In Chapter 3 you were told *never* to use the stock account for the purchase, sale or return of stocks, but that it was used only at the beginning and end of the period.

In a business that has been trading in the past, there will be a balance on the stock account at the start of the period, which will be a debit balance (representing an asset). In the example above, the stock account at the start of the period would appear as follows:

| | | Stock | | | |
|--------|---------|-------|------|--|---|
| 20X1 | | £ | 20X1 | | £ |
| 1 Jan. | Balance | 500 | | | |

As the trading account is being prepared, this balance is transferred into it, by crediting the stock account and debiting the trading account. The stock account then appears as follows:

| | | Stock | | | |
|--------|---------|-------|---------|-----------------|-----|
| 20X1 | | £ | 20X1 | | £ |
| 1 Jan. | Balance | 500 | 31 Dec. | Trading account | 500 |

The stock account now has no balance, so it can be ‘closed off’ as with the sales account you saw earlier.

As the preparation of the trading account continues, it will be necessary to determine the value of the stock at 31 December. This is often done by referring to a separate stock control system, which is maintained outside the bookkeeping system (you will learn more about the valuation of stock in Chapter 8). The figure is passed to the bookkeeper, who then debits the stock account with the new value, and credits the trading account.

The stock account now appears as follows:

| | | Stock | | | |
|---------|-----------------|------------|---------|-----------------|------------|
| 20X1 | | £ | 20X1 | | £ |
| 1 Jan. | Balance | <u>500</u> | 31 Dec. | Trading account | <u>500</u> |
| 31 Dec. | Trading account | 430 | | | |

However, notice that in the trading account above, the closing stock does not appear to have been credited to it, instead it has been *deducted* on the debit side of the account. This is not normal practice for most ledger accounts, but is commonplace when the trading account is being prepared, because it is then possible to show the cost of goods sold figure. An item deducted on the debit side of an account is equivalent to making a credit entry.

(b) *Sales and purchase returns.* The same type of entry is used with sales and purchase returns. In the trading account above, the sales returns have been deducted from the sales figure on the credit side of the account. This is the equivalent of making a debit entry. The opposite entry would be to credit the sales returns account.

The trading account thus brings together the revenue and costs of the trading function for a specified period of time, and by comparing them calculates the *gross profit*. It is common for the gross profit to be expressed as a percentage of the sales value, when it is

known as the *gross profit margin*, or as a percentage of the cost of sales, when it is known as the *gross profit mark-up*.

The balance on the trading account

We have seen that the revenue from the sale of goods is compared with the cost of those goods in the trading account and the resulting difference is referred to as gross profit. This figure is the balance on the trading account.

This balance is then transferred to the profit and loss account, by debiting the trading account and crediting the profit and loss account (assuming the balance is a credit balance), and the trading account is closed off.

Vertical presentation of the trading account

An alternative presentation of the trading account is shown below. This is known as the *vertical format*, and is more commonly used for profit statements and reporting.

Trading account for the year ending 31 December 20X1

| | | |
|----------------------|--------------|--------------|
| | £ | £ |
| Sales | | 9,400 |
| Less returns inwards | | <u>(300)</u> |
| | | 9,100 |
| Opening stock | 500 | |
| Purchases | <u>6,400</u> | |
| | 6,900 | |
| Less closing stock | <u>(430)</u> | |
| | | 6,470 |
| Gross profit | | <u>2,630</u> |



Exercise 4.3

Prepare the trading account (in *horizontal* format) for Example 3.B, given that closing stock was £1,200, and make the necessary entries in the ledger accounts.



Solution

Trading account for the month ending 31 May

| | | | |
|--------------------|---------------|-------|---------------|
| | £ | | £ |
| Opening stock | Nil | Sales | 10,200 |
| Purchases | 8,900 | | |
| | <u>8,900</u> | | |
| Less closing stock | 1,200 | | |
| Cost of goods sold | 7,700 | | |
| Gross profit | <u>2,500</u> | | |
| | <u>10,200</u> | | <u>10,200</u> |

Note: There was no opening stock in this case, as the company commenced trading only on 1 May.

| | | Sales | |
|-----|-----------------|-------|---------------|
| May | £ | May | £ |
| | | 12 | Cash 210 |
| | | 19 | SP 580 |
| | | 25 | Cash 430 |
| | | 28 | Cash 890 |
| 31 | Trading account | 29 | KM 8,090 |
| | <u>10,200</u> | | <u>10,200</u> |

| Purchases | | | | |
|-----------|-----------------|--------------|-----|-----------------|
| May | | £ | May | £ |
| 4 | JM | 2,000 | | |
| 6 | ERD | 3,000 | | |
| 22 | Cash | <u>3,900</u> | 31 | Trading account |
| | | <u>8,900</u> | | <u>8,900</u> |
| Stock | | | | |
| 31 | Trading account | <u>1,200</u> | | |



Exercise 4.4

Prepare the trading account for Exercise 3.3 (in *vertical* format), given that closing stock was £50.



Solution

Trading account for the month ending 28 February 20X1

| | | |
|--------------------|-------------|------------|
| Sales | £ | 530 |
| Opening stock | – | |
| Purchases | <u>150</u> | |
| | 150 | |
| Less closing stock | <u>(50)</u> | |
| Gross profit | | <u>100</u> |
| | | <u>430</u> |

4.3.2 The profit and loss account

The profit and loss account performs a similar function to the trading account by comparing (in the case of trading organisations) the other costs of operating the business and any non-trading revenue (such as interest received) with the gross profit to identify whether the business has been profitable overall or not. In the case of organisations that provide a service rather than selling goods a trading account is not normally prepared and thus the profit and loss account also includes the revenue from the services provided.

A typical profit and loss account, in *horizontal* format, is shown below:

| Profit and loss account for the year ending 31 December 20X1 | | | |
|--|--------------|------------------|--------------|
| | £ | | £ |
| Rent | 120 | Gross profit b/d | 2,630 |
| Business rates | 80 | | |
| Light and heat | 75 | | |
| Wages | 1,120 | | |
| Printing and stationery | 14 | | |
| Telephone | 37 | | |
| Net profit | <u>1,184</u> | | |
| | <u>2,630</u> | | <u>2,630</u> |

The profit and loss account thus summarises all the costs and revenues of the business for a specified period of time. The various expenses (and sundry revenues, if there are any) are transferred out of the nominal ledger, and into the profit and loss account. Those accounts are then closed off.

The resulting balance on the profit and loss account is referred to as a *net profit* (if it is a credit balance), or *net loss* (if it is a debit balance).

It is common for the net profit (or loss) to be expressed as a percentage of the sales value shown in the trading account, and this is known as the *net profit percentage*.

The profit and loss account may also be presented in a *vertical* format, and this too is more commonly used for financial reporting. This is shown below:

Profit and loss account for the year ending 31 December 20X1

| | | |
|-------------------------|-------|-------|
| | £ | £ |
| Gross profit b/d | | 2,630 |
| Rent | 120 | |
| Business rates | 80 | |
| Light and heat | 75 | |
| Wages | 1,120 | |
| Printing and stationery | 14 | |
| Telephone | 37 | |
| | | 1,446 |
| Net profit | | 1,184 |

It is quite common for the trading account and the profit and loss account to be combined into one statement, but still retaining its two distinct sections. The CIMA *Official Terminology* shows this in its definition:



Trading, profit and loss account: An account which shows the gross profit or loss generated by an entity for a period (trading account), and after adding other income and deducting various expenses shows the profit or loss of the business (the profit and loss account).



Exercise 4.5

Prepare the profit and loss account in horizontal format for Example 3.B, and make the necessary entries in the ledger accounts.



Solution

| Profit and loss account for the month ending 31 May | | | |
|---|-------|------------------|-------|
| | £ | | £ |
| Wages | 170 | Gross profit b/d | 2,500 |
| Rent | 80 | | |
| Advertising | 25 | | |
| Net profit | 2,225 | | |
| | 2,500 | | 2,500 |

| Wages | | | | | |
|------------|------|------------|------------|-------------------------|------------|
| <i>May</i> | | £ | <i>May</i> | | £ |
| 7 | Cash | 60 | | | |
| 25 | Cash | 110 | 31 | Profit and loss account | 170 |
| | | <u>170</u> | | | <u>170</u> |

| Rent | | | | | |
|------------|------|----|------------|-------------------------|----|
| <i>May</i> | | £ | <i>May</i> | | £ |
| 10 | Bank | 80 | 31 | Profit and loss account | 80 |

| Advertising | | | | | |
|-------------|------|----|------------|-------------------------|----|
| <i>Feb</i> | | £ | <i>May</i> | | £ |
| 22 | Bank | 25 | 31 | Profit and loss account | 25 |



Exercise 4.6

Prepare the profit and loss account in horizontal format for Exercise 3.3.



Solution

A Thompson: profit and loss account for the month ending 28 February 20X1

| | | | | |
|-------------|------------|------------------|--|------------|
| Rent | £ | | | £ |
| Advertising | 50 | Gross profit b/d | | 430 |
| Net profit | 25 | | | |
| | 355 | | | |
| | <u>430</u> | | | <u>430</u> |

4.3.3 The balance on the profit and loss account

The balance on the profit and loss account represents the owner’s profit and has thus increased his investment in the business. At the end of the year this is transferred to the owner’s capital account, by debiting the profit and loss account and crediting the capital account. If the balance on the profit and loss account is a debit balance, this represents a net loss, and the entries are reversed.

The capital account from Example 3.B would now appear as follows:

| Capital | | | |
|---------|------------|-------------------------|--------|
| | <i>May</i> | | £ |
| | 1 | Bank | 20,000 |
| | 31 | Profit and loss account | 2,225 |

4.3.4 Dealing with drawings

The balance on the capital account is increased by the net profit (or decreased by a net loss). The balance is also affected by any drawings that have occurred, and that have been debited to a separate drawings account. The balance on this account now needs to be transferred to the capital account, by means of the following entries:

- credit the drawings account;
- debit the capital account.

Using Example 3.B again, the drawings and capital account would now look like this:

| Capital | | | | | |
|------------|------------------|-----|------------|-------------------------|--------|
| <i>May</i> | | £ | <i>May</i> | | £ |
| 31 | Drawings account | 100 | 1 | Bank | 20,000 |
| | | | 31 | Profit and loss account | 2,225 |
| Drawings | | | | | |
| <i>May</i> | | £ | <i>May</i> | | £ |
| 30 | Cash | 100 | 31 | Capital | 100 |

4.4 Preparing the balance sheet

The next stage is to prepare the balance sheet. The balance sheet shows the assets, liabilities and capital that exist at the date at which it is drawn up. It will include *all* the ledger accounts that have balances on them.

The ledger accounts for expenses and revenues will all have no balance remaining, as they have been transferred to the trading and profit and loss account (but see the next chapter for occasions when this is not the case). The stock account will have a new balance, and the capital account will have had the net profit or net loss and drawings entered. The balances on the other assets and liabilities will be those used in order to prepare the trial balance. These, plus the stock account and revised capital account balance, can be presented in the balance sheet.

Refer Section 2.3 for the presentation of the balance sheet.



Exercise 4.7

Prepare the balance sheet for Example 3.B.



Solution

| Balance sheet at 31 May | | |
|--------------------------|---------------|---------------|
| | £ | £ |
| Fixed assets | | |
| Furniture | | 1,500 |
| Fittings | | 600 |
| | | <u>2,100</u> |
| Current assets | | |
| Stock | 1,200 | |
| Debtors | 8,340 | |
| Bank balance | 13,725 | |
| Cash in hand | 1,760 | |
| | <u>25,025</u> | |
| Current liabilities | | |
| Creditors | (5,000) | |
| Net current assets | | <u>20,025</u> |
| Net assets employed | | <u>22,125</u> |
| Financed by | | |
| Capital | | 20,000 |
| Net profit for the month | | 2,225 |
| | | <u>22,225</u> |
| Less drawings | | (100) |
| | | <u>22,125</u> |

4.5 Balancing off the accounts

The final task is to tidy up the remaining accounts in order to clearly show the final balance on each, in readiness for commencing posting the next period's transactions. This process is known as *balancing off* the accounts. In the previous chapter you saw how the balance is mathematically calculated in order to produce the trial balance, and to determine the amounts to be transferred to the profit and loss account and included in the balance sheet. Some accounts will now have no balance remaining, but those that appear on the balance sheet will have, and this needs to be clearly identified.

The procedure can be shown in the following steps:

- Step 1.* Calculate the balance (or take the figure already used in the trial balance).
- Step 2.* Enter the balance on the *opposite* side of the account, for example, if there is a debit balance, enter it on the credit side. (Imagine the account as a pair of scales that was out of balance; entering the item on the opposite side brings the scales into balance.) Use the date at which the balance sheet is prepared, and describe the balance as 'balance carried down', abbreviated to 'balance c/d'. This is, of course, making an entry in the ledger accounts, therefore an opposite entry needs to be made to conform to the double-entry rule – see step 4 for this.
- Step 3.* Total up each side, to confirm that the two sides now agree, and rule them off.
- Step 4.* Enter the balance on its *correct* side, beneath the totals. This completes the double entry from Step 2. Date the item as the first day of the next accounting period, for example, 1 January 20X2, and describe the balance as 'balance brought down', abbreviated to 'balance b/d'.
- Step 5.* Check that all accounts with debit balances are assets, and that all accounts with credit balances are either liabilities or capital, and compare them with the balance sheet figures.



Exercise 4.8

Balance off the asset, liability and capital accounts, from Example 3.B.



Solution

| Capital | | | | | |
|------------|-------------|---------------|-------------|-------------|---------------|
| <i>May</i> | | £ | <i>May</i> | | £ |
| 31 | Drawings | 100 | 1 | Cash | 20,000 |
| | Balance c/d | 22,125 | 31 | Net profit | 2,225 |
| | | <u>22,225</u> | | | <u>22,225</u> |
| | | | <i>June</i> | | |
| | | | 1 | Balance b/d | 22,125 |

| Cash | | | | | |
|------------|---------|--------|------------|-----------|--------|
| <i>May</i> | | £ | <i>May</i> | | £ |
| 1 | Capital | 20,000 | 2 | Bank | 15,000 |
| 12 | Sales | 210 | 7 | Wages | 60 |
| 25 | Sales | 430 | 19 | Purchases | 3,900 |
| 28 | Sales | 890 | 24 | Fittings | 600 |

| | | |
|----|-------------|---------------|
| 25 | Wages | 110 |
| 30 | Cash | 100 |
| 31 | Balance c/d | <u>1,760</u> |
| | | <u>21,530</u> |

| | | |
|-------------|-------------|---------------|
| <i>June</i> | | <u>21,530</u> |
| 1 | Balance b/d | 1,760 |

Bank

| | | | | | |
|------------|------|---------------|------------|-------------|---------------|
| <i>May</i> | | £ | <i>May</i> | | £ |
| 2 | Cash | 15,000 | 10 | Rent | 80 |
| 27 | SP | 330 | 16 | Furniture | 1,500 |
| | | | 28 | Advertising | 25 |
| | | | 31 | Balance c/d | <u>13,725</u> |
| | | <u>15,330</u> | | | <u>15,330</u> |

| | | |
|-------------|-------------|---------------|
| <i>June</i> | | <u>15,330</u> |
| 1 | Balance b/d | 13,725 |

JM

| | | |
|------------|-----------|-------|
| <i>May</i> | | £ |
| 4 | Purchases | 2,000 |

ERD

| | | | | | |
|------------|-------------|--------------|-------------|-------------|--------------|
| <i>May</i> | | £ | <i>May</i> | | £ |
| 10 | Bank | 80 | 6 | Purchases | 3,000 |
| 31 | Balance c/d | <u>2,920</u> | | | <u>3,000</u> |
| | | <u>3,000</u> | <i>June</i> | | |
| | | | 1 | Balance b/d | 2,920 |

Furniture

| | | |
|------------|------|-------|
| <i>May</i> | | £ |
| 16 | Bank | 1,500 |

SP

| | | | | | |
|-------------|-------------|------------|------------|-------------|------------|
| <i>May</i> | | £ | <i>May</i> | | £ |
| 19 | Sales | 580 | 27 | Bank | 330 |
| | | | 31 | Balance c/d | 250 |
| | | <u>580</u> | | | <u>580</u> |
| <i>June</i> | | | | | |
| 1 | Balance b/d | 250 | | | |

Fittings

| | | |
|------------|------|-----|
| <i>May</i> | | £ |
| 24 | Cash | 600 |

Advertising

| | | |
|------------|------|----|
| <i>May</i> | | £ |
| 28 | Bank | 25 |

KM

| | | |
|------------|-------|-------|
| <i>May</i> | | £ |
| 29 | Sales | 8,090 |

You should notice that the accounts that only have one entry have not been balanced off; this is because the balance on the account can easily be seen without balancing it. However, it is a good practice to balance off in the standard way at least once a year, to confirm that the account has been considered and included in the appropriate financial statement.

For example, the fittings account above would appear as follows:

| Fittings | | | | | |
|-------------|-------------|------------|--|------------|-------------|
| <i>May</i> | | £ | | <i>May</i> | £ |
| 24 | Cash | 600 | | 31 | Balance c/d |
| | | <u>600</u> | | | <u>600</u> |
| <i>June</i> | | | | | |
| 1 | Balance b/d | 600 | | | |

The balances brought down then become the first entries in each account for the following accounting period.



Exercise 4.9

Balance off the asset, liability and capital ledger accounts from Exercise 3.3, after transferring the net profit of £355 and the balance on the drawings account into the capital account. Remember that you also need to open a stock account.



Solution

| Bank | | | | | |
|-------------|-------------|--------------|--|-------------|--------------|
| <i>20X1</i> | | £ | | <i>20X1</i> | £ |
| 1 Feb. | Capital | 500 | | 1 Feb. | Purchases |
| 10 Feb. | Sales | 290 | | 5 Feb. | Rent |
| 27 Feb. | Sales | 240 | | 22 Feb. | Advertising |
| | | | | 26 Feb. | Drawings |
| | | | | 28 Feb. | Balance c/d |
| | | <u>1,030</u> | | | <u>705</u> |
| 1 Mar. | Balance b/d | 705 | | | <u>1,030</u> |

| Capital | | | | | |
|-------------|-------------|------------|--|-------------|-------------|
| <i>20X1</i> | | £ | | <i>20X1</i> | £ |
| 28 Feb. | Drawings | 100 | | 1 Feb. | Bank |
| 28 Feb. | Balance c/d | 755 | | 28 Feb. | Net profit |
| | | <u>855</u> | | | <u>855</u> |
| | | | | 1 Mar. | Balance b/d |
| | | | | | 755 |

| Stock | | |
|-------------|-----------------|----|
| <i>20X1</i> | | £ |
| 28 Feb. | Trading account | 50 |

**Exercise 4.10**

Continue with the ledger accounts from Exercise 3.3 at 1 March, and enter the following transactions for March:

| <i>March</i> | | £ |
|--------------|---|-----|
| 2 | Bought goods for resale, on credit from J Smith | 100 |
| 5 | Paid rent | 50 |
| 14 | Received a loan from L Lock | 450 |
| 16 | Business sales | 330 |
| 23 | A Thompson's drawings | 75 |
| 24 | Paid J Smith by cheque | 80 |
| 26 | Business sales, on credit to A Pitt | 180 |
| 29 | Paid for advertising leaflets | 30 |

Balance off the bank account at 31 March.

**Solution**

| Bank | | | | | |
|-------------|-------------|--------------|-------------|-------------|--------------|
| <i>20X1</i> | | £ | <i>20X1</i> | | £ |
| 1 Mar. | Balance b/d | 705 | 5 Mar. | Rent | 50 |
| 14 Mar. | Loan | 450 | 23 Mar. | Drawings | 75 |
| 16 Mar. | Sales | 330 | 24 Mar. | J Smith | 80 |
| | | | 29 Mar. | Advertising | 30 |
| | | | 31 Mar. | Balance c/d | <u>1,250</u> |
| | | <u>1,485</u> | | | <u>1,485</u> |
| 1 Apr. | Balance b/d | 1,250 | | | |

| Capital | | | | |
|---------|--|-------------|-------------|-----|
| | | <i>20X1</i> | £ | |
| | | 1 Mar. | Balance b/d | 755 |

| Stock | | |
|-------------|-----------------|----|
| <i>20X1</i> | | £ |
| 28 Feb. | Trading account | 50 |

| Purchases | | |
|-------------|---------|-----|
| <i>20X1</i> | | £ |
| 2 Mar. | J Smith | 100 |

| J Smith | | |
|-------------|-----------|-----|
| <i>20X1</i> | | £ |
| 24 Mar. | Bank | 80 |
| <i>20X1</i> | | £ |
| 2 Mar. | Purchases | 100 |

| Rent payable | | |
|--------------|------|----|
| <i>20X1</i> | | £ |
| 5 Mar. | Bank | 50 |

| L Lock | | |
|--------|------|-------------|
| | | <i>20X1</i> |
| | | 14 Mar. |
| | Bank | 450 |

| Sales | | | |
|-------------|-------|-------------|------------|
| | | <i>20X1</i> | £ |
| | | 16 Mar. | Bank 330 |
| | | 26 Mar. | A Pitt 180 |
| Drawings | | | |
| <i>20X1</i> | | | £ |
| 23 Mar. | Bank | | 75 |
| A Pitt | | | |
| <i>20X1</i> | | | £ |
| 26 Mar. | Sales | | 180 |
| Advertising | | | |
| <i>20X1</i> | | | £ |
| 29 Mar. | Bank | | 30 |

4.6 Columnar ledger accounts

As an alternative to the traditional ‘two-sided’ ledger account seen above, ledger accounts can also be prepared in columnar format. This format was originally devised with the introduction of mechanised bookkeeping systems, and is often the format used by computerised systems. Instead of having two ‘sides’ to the account, with the date and details column repeated on each, there is a single date and details column, a debit column, a credit column, and, usually, a balance column. The balance is calculated after each transaction, or perhaps each day’s transactions, so that it is always available at a glance.

To illustrate the layout and operation of columnar accounts (also called *three-column accounts*), the bank account for March in Exercise 4.10 would appear as follows:

| Bank | | | | | | |
|-------------|-----------------|-------------|------------------|-------------------|--------------------|-------|
| <i>Date</i> | <i>Details</i> | <i>Ref.</i> | <i>Debit (£)</i> | <i>Credit (£)</i> | <i>Balance (£)</i> | |
| 1 Mar. | Brought forward | | | | 705 | debit |
| 5 Mar. | Rent | 123 | | 50 | 655 | debit |
| 14 Mar. | Loan | | 450 | | 1,105 | debit |
| 16 Mar. | Sales | | 330 | | 1,435 | debit |
| 23 Mar. | Drawings | 124 | | 75 | 1,360 | debit |
| 24 Mar. | J Smith | 125 | | 80 | 1,280 | debit |
| 29 Mar. | Advertising | 126 | | 30 | 1,250 | debit |

With this layout, there is sufficient room to add other columns, for example, for cheque numbers, and the balance is readily visible every day.

4.7 Summary

In this chapter you have looked at:

- the preparation of the trial balance;
- the form and content of the trading and profit and loss account;

- the ledger entries needed to prepare a trading and a profit and loss account;
- the entries needed to record profit and drawings in the capital account;
- the preparation of the balance sheet;
- the balancing off of ledger accounts at the end of the period.

This chapter is one of the most ‘technical’ chapters you will study. Do practise the techniques you have learned here to ensure that you have a thorough understanding of them.

Revision Questions

4



Question 1 Multiple choice

- 1.1 Where a transaction is credited to the correct ledger account, but debited incorrectly to the repairs and renewals account instead of to the plant and machinery account, the error is known as an error of:
- (A) omission.
 - (B) commission.
 - (C) principle.
 - (D) original entry.
- 1.2 If a purchase return of £48 has been wrongly posted to the debit side of the sales returns account, but has been correctly entered in the supplier's account, the total of the trial balance would show:
- (A) the credit side to be £48 more than the debit side.
 - (B) the debit side to be £48 more than the credit side.
 - (C) the credit side to be £96 more than the debit side.
 - (D) the debit side to be £96 more than the credit side.
- 1.3 The debit side of a trial balance totals £50 more than the credit side. This could be due to:
- (A) a purchase of goods for £50 being omitted from the creditor's account.
 - (B) a sale of goods for £50 being omitted from the debtors' account.
 - (C) an invoice of £25 for electricity being credited to the electricity account.
 - (D) a receipt for £50 from a debtor being omitted from the cash book.
- 1.4 An invoice from a supplier of office equipment has been debited to the stationery account. This error is known as:
- (A) an error of commission.
 - (B) an error of original entry.
 - (C) a compensating error.
 - (D) an error of principle.
- 1.5 The double-entry system of bookkeeping normally results in which of the following balances on the ledger accounts?

| | <i>Debit balances</i> | <i>Credit balances</i> |
|----------|-----------------------------------|-----------------------------------|
| A | Assets and revenues | Liabilities, capital and expenses |
| B | Revenues, capital and liabilities | Assets and expenses |
| C | Assets and expenses | Liabilities, capital and revenues |
| D | Assets, expenses and capital | Liabilities and revenues |

- 1.6** Which one of the following is an error of principle?
- (A) A gas bill credited to the gas account and debited to the bank account.
 - (B) The purchase of a fixed asset credited to the asset at cost account and debited to the creditors' account.
 - (C) The purchase of a fixed asset debited to the purchases account and credited to the creditors' account.
 - (D) The payment of wages debited and credited to the correct accounts, but using the wrong amount.
- 1.7** Recording the purchase of computer stationery by debiting the computer equipment at cost account would result in:
- (A) an overstatement of profit and an overstatement of fixed assets.
 - (B) an understatement of profit and an overstatement of fixed assets.
 - (C) an overstatement of profit and an understatement of fixed assets.
 - (D) an understatement of profit and an understatement of fixed assets.

Question 2

On 1 January, P Roberts starts a business with £2,500 in the bank and £500 cash. The following transactions occur:

| | |
|---------|---|
| 2 Jan. | He buys raw materials on credit for £700 from J Martin. |
| 3 Jan. | He sells goods for £300 on credit to G Goddard. |
| 7 Jan. | He sells goods for £1,100 to K Lemon on credit. |
| 12 Jan. | He buys equipment for £3,000, paying by cheque. |
| 18 Jan. | He pays wages of £50 by cheque. |
| 20 Jan. | He buys raw materials for £350, paying by cheque. |
| | He takes £80 from the cash box for himself. |
| 28 Jan. | He pays J Martin £250 by cheque. |
| 30 Jan. | He transfers £200 cash into the bank from his cash box. |

Requirements

- (a) Record the above transactions in the ledger accounts provided below.

| Capital | | | | | |
|---------|-------------|------------|---------|-------------|------------|
| | | £ | | | £ |
| 31 Jan. | Drawings | ... | 1 Jan. | Bank | ... |
| | Balance c/d | ... | | Cash | ... |
| | | ... | 31 Jan. | Net profit | ... |
| | | <u>...</u> | 1 Feb. | Balance b/d | <u>...</u> |
| Bank | | | | | |
| | | £ | | | £ |
| 1 Jan. | Capital | ... | 12 Jan. | Equipment | ... |

| | | | | | |
|-----------|-------------|------------|---------|-------------------------|------------|
| 30 Jan. | Cash | ... | 18 Jan. | Wages | ... |
| 31 Jan. | Balance c/d | ... | 20 Jan. | Purchases | ... |
| | | ... | 28 Jan. | J Martin | ... |
| | | <u>...</u> | 1 Feb. | Balance b/d | ... |
| Cash | | | | | |
| 1 Jan. | Capital | £ | 20 Jan. | Drawings | £ |
| | | ... | 30 Jan. | Bank | ... |
| | | ... | 31 Jan. | Balance c/d | ... |
| | | <u>...</u> | | | <u>...</u> |
| 1 Feb. | Balance b/d | ... | | | ... |
| Purchases | | | | | |
| 2 Jan. | J Martin | £ | 31 Jan. | Trading a/c | £ |
| 20 Jan. | Bank | ... | | | ... |
| | | ... | | | ... |
| | | <u>...</u> | | | <u>...</u> |
| J Martin | | | | | |
| 28 Jan. | Bank | £ | 2 Jan. | Purchases | £ |
| 31 Jan. | Balance c/d | ... | | | ... |
| | | ... | | | ... |
| | | <u>...</u> | 1 Feb. | Balance b/d | ... |
| Sales | | | | | |
| 31 Jan. | Trading a/c | £ | 3 Jan. | G Goddard | £ |
| | | ... | 7 Jan. | K Lemon | ... |
| | | ... | | | ... |
| | | <u>...</u> | | | <u>...</u> |
| G Goddard | | | | | |
| 3 Jan. | Sales | £ | | | £ |
| | | ... | | | ... |
| K Lemon | | | | | |
| 7 Jan. | Sales | £ | | | £ |
| | | ... | | | ... |
| Equipment | | | | | |
| 12 Jan. | Bank | £ | | | £ |
| | | ... | | | ... |
| Wages | | | | | |
| 18 Jan. | Bank | £ | 31 Jan. | Profit and loss account | £ |
| | | ... | | | ... |
| | | <u>...</u> | | | <u>...</u> |
| Drawings | | | | | |
| 20 Jan. | Cash | £ | 31 Jan. | Capital account | £ |
| | | ... | | | ... |
| | | <u>...</u> | | | <u>...</u> |

(b) Insert the missing figures into the following trial balance.

P Roberts: trial balance at 31 January

| | <i>Debit (£)</i> | <i>Credit (£)</i> |
|-----------|------------------|-------------------|
| Capital | | ... |
| Bank | | ... |
| Cash | ... | |
| Purchases | ... | |
| Creditors | | ... |
| Sales | | ... |
| Debtors | ... | |
| Equipment | ... | |
| Wages | ... | |
| Drawings | ... | |
| | <u>...</u> | <u>...</u> |

(c) Insert the missing figures into the trading and profit and loss account for January, given that closing stock is £200.

P Roberts: trading and profit and loss account for the month ending 31 January

| | | |
|----------------------|------------|------------|
| | £ | £ |
| Sales | | ... |
| Less cost of sales: | | |
| Purchases | ... | |
| Closing stock | | ... |
| Cost of goods sold | <u>...</u> | |
| Gross profit | | <u>...</u> |
| Less expenses: wages | | <u>...</u> |
| Net profit | | <u>...</u> |

(d) Insert the missing figures into the balance sheet at 31 January.

P Roberts: balance sheet at 31 January

| | | | |
|---------------------------|----------|-----|------------|
| | £ | £ | £ |
| Fixed assets | | | |
| Equipment | | | ... |
| Current assets | | | |
| Stocks | ... | | |
| Debtors | ... | | |
| Cash | ... | | |
| | <u>—</u> | | |
| Less: current liabilities | | ... | |
| Creditors | ... | | |
| Bank overdraft | ... | | |
| | <u>—</u> | ... | |
| | | | <u>...</u> |
| | | | <u>...</u> |
| Financed by | | | |
| Opening capital | | | ... |
| Add: net profit | | | ... |
| | | | <u>...</u> |
| Less drawings | | | ... |
| | | | <u>—</u> |

Solutions to Revision Questions

4



Solution 1

1.1 Answer: (C)

This is a straightforward test of your knowledge of the types of errors that can exist. If the wrong account is used, and this results in an incorrect statement of profit, then an error of principle has been made. Debiting the repairs and renewals account results in an extra charge for expenses in the profit and loss account, when the item should be included as a fixed asset on the balance sheet.

1.2 Answer: (D)

A purchase return should be credited to the purchase returns account. If it has been debited to an account (whether the correct account or not), and also debited to the supplier's account (which is correct), then two debit entries will have been made with no corresponding credit. £96 ($2 \times £48$) will have been debited, and nothing credited. Thus, the debit side will exceed the credit side by £96.

1.3 Answer: (A)

(B) and (D) are incorrect as they would give a lower debit side. (C) is incorrect because it would give a higher credit side.

1.4 Answer: (D)

An error of principle occurs where an entry is made in the wrong account, and that account is of a different category from the correct account – thus affecting the view given by the final accounts. Office equipment is a fixed asset, while stationery is an expense, so both profit and fixed assets will be incorrect.

1.5 Answer: (C)

Assets and expenses have debit balances; liabilities, capital and revenue have credit balances.

1.6 Answer: (C)

An error of principle is where one side of an entry has been recorded in the wrong account, and where that account is classified differently to the correct account. In this case, debiting a fixed asset to the purchases account would result in the profit

calculation being incorrect, and the value of assets shown on the balance sheet being incorrect.

1.7 Answer: (A)

Stationery is an expense and should be used to reduce profits; therefore profits would be overstated. Computer equipment is shown in the balance sheet, and therefore the figure for fixed assets would be overstated.



Solution 2

(a)

| Capital | | | | | |
|---------|-------------|--------------|---------|-------------|--------------|
| 31 Jan. | Drawings | £ 80 | 1 Jan. | Bank | £ 2,500 |
| | Balance c/d | 3,420 | | Cash | 500 |
| | | <u>3,500</u> | 31 Jan. | Net profit | 500 |
| | | | 1 Feb. | Balance b/d | <u>3,420</u> |

| Bank | | | | | |
|---------|-------------|--------------|---------|-------------|--------------|
| 1 Jan. | Capital | £ 2,500 | 12 Jan. | Equipment | £ 3,000 |
| 30 Jan. | Cash | 200 | 18 Jan. | Wages | 50 |
| 31 Jan. | Balance c/d | 950 | 20 Jan. | Purchases | 350 |
| | | <u>3,650</u> | 28 Jan. | J Martin | 250 |
| | | | 1 Feb. | Balance b/d | <u>3,650</u> |
| | | | | | 950 |

| Cash | | | | | |
|--------|-------------|------------|---------|-------------|------------|
| 1 Jan. | Capital | £ 500 | 20 Jan. | Drawings | £ 80 |
| | | | 30 Jan. | Bank | 200 |
| | | | 31 Jan. | Balance c/d | 220 |
| | | <u>500</u> | | | <u>500</u> |
| 1 Feb. | Balance b/d | 220 | | | |

| Purchases | | | | | |
|-----------|----------|--------------|---------|-----------------|--------------|
| 2 Jan. | J Martin | £ 700 | 31 Jan. | Trading account | £ 1,050 |
| 20 Jan. | Bank | 350 | | | |
| | | <u>1,050</u> | | | <u>1,050</u> |

| J Martin | | | | | |
|----------|-------------|------------|--------|-------------|------------|
| 28 Jan. | Bank | £ 250 | 2 Jan. | Purchases | £ 700 |
| 31 Jan. | Balance c/d | 450 | | | |
| | | <u>700</u> | 1 Feb. | Balance b/d | <u>450</u> |

| Sales | | | | | |
|-----------|-----------------|--------------|--|---------|-------------------------|
| 31 Jan. | Trading account | £ | | 3 Jan. | G Goddard |
| | | 1,400 | | 7 Jan. | K Lemon |
| | | <u>1,400</u> | | | |
| | | | | | £ |
| | | | | | 300 |
| | | | | | <u>1,100</u> |
| | | | | | <u>1,400</u> |
| G Goddard | | | | | |
| 3 Jan. | Sales | £ | | | |
| | | 300 | | | |
| K Lemon | | | | | |
| 7 Jan. | Sales | £ | | | |
| | | 1,100 | | | |
| Equipment | | | | | |
| 12 Jan. | Bank | £ | | | |
| | | 3,000 | | | |
| Wages | | | | | |
| 18 Jan. | Bank | £ | | 31 Jan. | Profit and loss account |
| | | <u>50</u> | | | |
| | | 50 | | | |
| | | | | | £ |
| | | | | | <u>50</u> |
| | | | | | <u>50</u> |
| Drawings | | | | | |
| 20 Jan. | Cash | £ | | 31 Jan. | Capital account |
| | | <u>80</u> | | | |
| | | 80 | | | |
| | | | | | £ |
| | | | | | <u>80</u> |
| | | | | | <u>80</u> |

(b) P Roberts: trial balance at 31 January

| | Debit (£) | Credit (£) |
|-----------|--------------|--------------|
| | £ | £ |
| Capital | | 3,000 |
| Bank | | 950 |
| Cash | 220 | |
| Purchases | 1,050 | |
| Creditors | | 450 |
| Sales | | 1,400 |
| Debtors | 1,400 | |
| Equipment | 3,000 | |
| Wages | 50 | |
| Drawings | 80 | |
| | <u>5,800</u> | <u>5,800</u> |

(c) P Roberts: trading and profit and loss account for the month ending 31 January

| | | |
|--------------------------|------------|------------|
| Sales | £ | £ |
| | | 1,400 |
| Less cost of goods sold: | | |
| Purchases | 1,050 | |
| Less closing stock | <u>200</u> | |
| | | 850 |
| Gross profit | | <u>550</u> |
| Less expenses: wages | | 50 |
| Net profit | | <u>500</u> |

(d) P Roberts: balance sheet at 31 January

| | | | |
|--------------------------|------------|--------------|--------------|
| | £ | £ | £ |
| Fixed assets | | | |
| Equipment | | | 3,000 |
| Current assets | | | |
| Stocks | 200 | | |
| Debtors | 1,400 | | |
| Cash | <u>220</u> | | |
| | | 1,820 | |
| Less current liabilities | | | |
| Creditors | 450 | | |
| Bank overdraft | <u>950</u> | | |
| | | <u>1,400</u> | |
| | | | <u>420</u> |
| | | | <u>3,420</u> |
| Financed by | | | |
| Opening capital | | | 3,000 |
| Add net profit | | | <u>500</u> |
| | | | 3,500 |
| Less drawings | | | <u>80</u> |
| | | | <u>3,420</u> |

Further Aspects of Ledger Accounting

5

LEARNING OUTCOMES

When you have completed this chapter, you should be able to:

- ▶ prepare accounts for indirect taxes e.g. value added tax (VAT);
- ▶ prepare accounts for payroll;
- ▶ prepare accounts using accruals and prepayments;
- ▶ explain the difference between, and prepare accounts for, bad debts and provisions for doubtful debts.

5.1 Introduction

In this chapter we continue looking at ledger accounts, and look at ones of special significance. These are:

- carriage costs,
- VAT,
- wages and salaries,
- accruals and prepayments,
- bad and doubtful debts,
- the exchange of goods and services.

5.2 Accounting for specialised transactions

5.2.1 Carriage costs

Organisations may pay for carriage and delivery charges on items that they buy and/or sell.

Carriage and delivery charges on fixed assets are included with the cost of the fixed asset, and are debited to that fixed asset's account, along with the cost of the item. But carriage charges on the purchase and sale of goods in which the organisation trades are recorded separately, as follows.



- (a) *Carriage outwards*. This is carriage paid by the organisation on goods that it sells. It is debited to a separate ‘carriage outwards’ ledger account, and treated as any other expense, that is, it is transferred to the profit and loss account at the end of the period.
- (b) *Carriage inwards*. This is carriage paid by the organisation on goods that it buys. It is debited to a separate ‘carriage inwards’ ledger account. However, some purchases may have the carriage costs paid for by the supplier, and these costs will be included in the purchase price. This creates a situation where the purchases account is debited with some items already containing an element of carriage costs, and some that do not. So that all purchases are treated in the same way, the carriage costs borne by the organisation itself are transferred into the trading account at the end of the period, and added to the cost of purchases.

This additional cost does make the calculation of cost of goods sold a little more complicated, especially when there are purchase returns to consider as well. The following illustration (using imaginary figures) shows how the cost of goods sold calculation might look.

| | | |
|-----------------------|--------|--------|
| | £ | £ |
| Opening stock | | 2,600 |
| Purchases | 18,500 | |
| Carriage inwards | 500 | |
| | 19,000 | |
| Less purchase returns | 1,700 | |
| | | 17,300 |
| | | 19,900 |
| Less closing stock | | 2,150 |
| Cost of goods sold | | 17,750 |

5.2.2 Discounts

A discount is a reduction in the amount paid for goods and services. Discounts may be received from suppliers or allowed to customers. There are two types of discount: trade discounts and cash discounts.

Trade discounts. A trade discount may be offered to customers who are also traders, which is where the term ‘trade discount’ originates. However, nowadays it might be offered for a variety of other reasons, such as to existing customers, new customers, customers buying in bulk, etc. Once the discount has been offered, it cannot be taken away for whatever reason, so it simply means that a lower price is being charged. Trade discount is deducted from the quoted price (sometimes referred to as a ‘list’ price, or a ‘catalogue’ price), and only the net amount is recorded in the ledger accounts.

Example 5.A

On 1 January, AB buys goods for resale on credit from XY, with a list price of £250, subject to trade discount of 20 per cent. The trade discount is £50, and therefore the net amount payable is £200. The purchases account is debited with £200, and the account of XY is credited with £200.

Note: Once this net figure has been agreed, any further calculations (see below for cash discounts and VAT), are based on the *net* figure.

Cash discounts. A cash discount may be offered to encourage prompt payment. The term used to apply only to payments made in cash at the time of sale, but nowadays it applies to payments by many different methods, provided that payment is made within a certain time. If the payment is *not* made within that time, the discount is withdrawn.

The difficulty is that, at the time of sale, it will not be known whether the payment will be made in time (unless, of course, it is made at once), but the transaction still needs to be entered in the ledger accounts. Thus, at the time of sale, no account is taken of the cash discount.

Example 5.B

Continuing with Example 5.A, suppose that XY also offers cash discount of 5 per cent for payment within ten days. At the time of purchase, AB is not certain to pay within the 10 days, so the transaction is entered ignoring the cash discount (but after adjusting for the trade discount). The ledger accounts would appear as follows:

| Purchases | | | |
|-----------|----|-----|--|
| 20X1 | | £ | |
| 1 Jan. | XY | 200 | |

| XY | | | |
|----|--|--------|-----------|
| | | 20X1 | |
| | | 1 Jan. | Purchases |
| | | | £ 200 |

If the account is not settled in the 10 days, the full amount of £200 is payable. Let us suppose, however, that AB pays on 7 January. Five per cent is deductible, so only £190 is paid (by cheque). The bank account will be credited with £190, and the account of XY will be debited, thus:

| XY | | | | | |
|--------|------|-----|------|--------|-----------|
| 20X1 | | £ | | | £ |
| 7 Jan. | Bank | 190 | 20X1 | 1 Jan. | Purchases |
| | | | | | 200 |

The account has been settled, and yet there is still a balance of £10 credit in the ledger account, which gives the impression that there is still £10 owing to XY. This is not the case. The account needs to be cleared, to give a true impression, by debiting it with a further £10, and a credit is made to 'discounts received' account. This account is a form of revenue, and will be transferred to the profit and loss account at the end of the period, to increase profit.

The ledger accounts after recording the cash discount are as follows:

| XY | | | | | |
|--------|-------------------|-----|------|--------|-----------|
| 20X1 | | £ | | | £ |
| 7 Jan. | Bank | 190 | 20X1 | 1 Jan. | Purchases |
| | Discount received | 10 | | | 200 |

| Discount received | | | |
|-------------------|--|--------|------|
| | | 20X1 | |
| | | 7 Jan. | XY |
| | | | £ 10 |

Cash discount allowed will arise where an organisation allows its customers to deduct an amount for prompt payment. The debtor's account will be credited with the discount, and a 'discounts allowed' account will be debited. The balance on this is treated like any other expense and transferred to the profit and loss account at the end of the period.

5.3 Accounting for VAT

When organisations in the United Kingdom and other EU member states reach a certain size, measured by their level of annual sales, they are obliged to register (in the UK) with Her Majesty's Customs and Excise.

As a consequence the amount that they charge their customers for goods and services supplied will increase by the addition of VAT.

The 'standard rate' is currently 17.5 per cent of the good's value. This additional sum is collected by the organisation and remitted to HM Customs and Excise on a monthly, quarterly or annual basis depending on the organisation's size.



The VAT collected does not belong to the organisation that charges and collects it. This VAT is known as *output VAT*.

It is a tax that ultimately must be paid to the government via Customs and Excise. Because it does not belong to the organisation collecting it, it does not affect the value of its sales. However, it does mean that customers will have to pay to the organisation the full amount, including VAT.

The organisation may also have to pay VAT itself on goods and services that it buys in from registered traders. This VAT can be reclaimed by registered organisations. Even though the organisation has to pay the creditor the full amount, if the VAT is reclaimable then it does not affect the value of the item purchased.



Such organisations will, as a consequence, be both receiving and paying VAT. The amount that they pay to their suppliers is known as *input VAT*. It may be offset against the amount received from customers, and only the difference is payable to/by Customs and Excise. The VAT paid to suppliers is therefore an asset (debtor) and the amount received from customers is a liability (creditor), until they are offset when a net asset or (more likely) a net liability arises.

The double-entry bookkeeping records need to show the goods and VAT values separately so that the purchases, expenses, and sales are posted net (i.e. without the addition of VAT) and the VAT amounts are posted to a separate VAT account.

Similar taxes exist in other countries that require the same kind of treatment.

Example 5.C

During October, W had the following credit transactions:

| October | |
|---------|---|
| 1 | Purchased goods from H £360 subject to 20 per cent trade discount |
| 3 | Sold goods to HG for £80 |
| 5 | Sold goods to PL for £15 |
| 8 | Bought goods from KJ for £4,000 subject to 10 per cent trade discount |
| 12 | Received a credit note from KJ for goods returned valued at £1,200 list price |
| 15 | Sold goods to RW for £2,000 |
| 18 | Issued credit note for £500 to RW for goods returned |

All of these transactions are subject to VAT at the rate of 17.5 per cent.

Before entering these items in the ledger accounts, first calculate the relevant figures and determine the

entries to be made. The following table illustrates this:

| Date | Calculations | Debit entries | Credit entries |
|---------|---|----------------------------------|--|
| Oct. 1 | Trade discount £72 (deduct from list price) Net goods value £360 – £72 = £288 VAT 17.5% × £288 = £50.40 | Purchases £288 VAT £50.40 | H £338.40 |
| Oct. 3 | VAT 17.5% × £80 = £14 | HG £94 | Sales £80 VAT £14 |
| Oct. 5 | VAT 17.5% × £15 = £2.62 | PL £17.62 | Sales £15 VAT £2.62 |
| Oct. 8 | Trade discount £400 (deduct from list price) Net goods value £3,600 VAT 17.5% × £3,600 = £630 | Purchases £3,600 VAT £630 | KJ £4,230 |
| Oct. 12 | Trade discount £120 (deduct from list price) Net goods value £1,080 VAT 17.5% × £1,080 = £189 | KJ £1,269 | Purchase returns £1,080 VAT £189 |
| Oct. 15 | VAT 17.5% × £2,000 = £350 | PQ £2,350 | Sales £2,000 VAT £350 |
| Oct. 18 | VAT 17.5% × £500 = £87.50 | Sales returns £500 VAT £87.50 | RW £587.50 |

Notice that the amounts debited and credited to sales, purchases and returns accounts exclude the VAT.

The VAT account would appear as follows:

| VAT | | | | | | | |
|---------|-------------|--|---------------|---------|-------------|--|---------------|
| 20X1 | | | £ | 20X1 | | | £ |
| 1 Oct. | H | | 50.40 | 3 Oct. | HG | | 14.00 |
| 8 Oct. | KJ | | 630.00 | 5 Oct. | PL | | 2.62 |
| 18 Oct. | RW | | 87.50 | 12 Oct. | KJ | | 189.00 |
| | | | | 15 Oct. | PQ | | 350.00 |
| | | | | 31 Oct. | Balance c/d | | 212.28 |
| | | | <u>767.90</u> | | | | <u>767.90</u> |
| 1 Nov. | Balance b/d | | 212.28 | | | | |

The balance on the account is now £212.28 debit, which signifies that a refund of this amount is due from Customs and Excise. This amount will be shown as a current asset on the balance sheet at 31 October.



Exercise 5.1

Explain the meaning of the terms ‘input VAT’ and ‘output VAT’, and describe their treatment in the accounts.



Solution

Input VAT is the VAT that an organisation suffers on the goods and services that it buys. It can normally be reclaimed from Customs and Excise. It does not contribute towards the cost of the goods and services.

Output VAT is the VAT that an organisation must add to the goods and services that it sells. It must pay over this VAT to Customs and Excise. It does not contribute to the sales revenue earned by the organisation.

The treatment of VAT in the accounts is as follows:

- Input VAT is debited to the VAT account (or to a separate VAT input account if required). The value of the goods purchased is debited to the relevant account, while the total of the invoice is credited to the creditor’s account until paid.

- Output VAT is credited to the VAT account (or to a separate VAT output account). The value of the goods sold is credited to the sales account, while the total of the invoice is debited to the debtor's account, until paid.
- VAT on goods returned is debited or credited to the VAT account as appropriate: for returns inwards the VAT account is debited, for returns outwards it is credited.
- The balance on the VAT account is shown as an asset (if a debit balance) or a liability (if a credit balance) on the balance sheet. A credit balance must be paid over to Customs and Excise, while a debit balance can be reclaimed.
- Stock is valued excluding VAT.



Exercise 5.2

The following transactions relate to G Porter & Sons during December 20X1.

December

| | |
|----|---|
| 2 | Bought goods on credit from R Williams, list price £350, trade discount 20 per cent |
| 8 | Bought goods on credit from Samuel Ltd, list price £750, trade discount 30 per cent |
| 10 | Sold goods to Mary Smythe for £400, no discount, payment terms 30 days |
| 18 | Bought goods on credit from Don Winter, list price £1,000, trade discount 25 per cent |
| 26 | Sold goods on credit John Blair, £800, no discount |

All transactions are subject to VAT at 17.5 per cent.

Show the entries in the ledger accounts of G Porter & Sons.



Solution

| Purchases | | | | | |
|-----------|------------|--------|--|--|--|
| 20X1 | | £ | | | |
| 2 Dec. | R Williams | 280.00 | | | |
| 8 Dec. | Samuel Ltd | 525.00 | | | |
| 18 Dec. | D Winter | 750.00 | | | |

| VAT | | | | | |
|---------|------------|--------|---------|-------------|--------|
| 20X1 | | £ | 20X1 | | £ |
| 2 Dec. | R Williams | 49.00 | 10 Dec. | Mary Smythe | 70.00 |
| 8 Dec. | Samuel Ltd | 91.87 | 26 Dec. | John Blair | 140.00 |
| 18 Dec. | D Winter | 131.25 | | | |

| R Williams | | | |
|------------|--------|-----------|--------|
| | | 20X1 | £ |
| | 2 Dec. | Purchases | 329.00 |

| Samuel Ltd | | | |
|------------|--------|-----------|--------|
| | | 20X1 | £ |
| | 8 Dec. | Purchases | 616.87 |

| D Winter | | | |
|----------|---------|-----------|--------|
| | | 20X1 | £ |
| | 18 Dec. | Purchases | 881.25 |

| Sales | | | |
|-------------|-------|-------------|-----------------------|
| | | <i>20X1</i> | £ |
| | | 10 Dec. | Mary Smythe 400.00 |
| | | 26 Dec. | John Blair 800.00 |
| Mary Smythe | | | |
| <i>20X1</i> | | £ | |
| 10 Dec. | Sales | 470.00 | |
| John Blair | | | |
| <i>20X1</i> | | £ | |
| 26 Dec. | Sales | 940.00 | |

5.3.1 VAT on fixed assets and expenses

VAT is also suffered on the purchase of fixed assets and expenses, and can be reclaimed in the normal way. There are, however, some items on which VAT cannot be reclaimed. The ones you are likely to encounter at this stage in your studies are:

- VAT on passenger cars;
- VAT on entertainment expenses.

In both the above cases, the VAT cannot be reclaimed, so it is included with the cost of the item. For example, the purchase of a passenger car, costing £10,000, plus VAT of 17.5 per cent, in effect costs £11,750, and so the motor cars account would be debited with that amount.

5.3.2 VAT in separate accounts

When completing the VAT return to Customs and Excise, it is necessary to provide separate totals of input and output VAT. Therefore, some organisations may keep separate ledger accounts for these.

5.3.3 Non-registered businesses

Businesses that are below the threshold for compulsory registration need not register for VAT. In this case, they are not allowed to add VAT to their outputs, but on the other hand they cannot reclaim the VAT on their inputs either. However, they will probably suffer VAT on some of their inputs, when purchasing from registered suppliers. If that happens, the VAT suffered is included with the cost of the item in the ledger accounts.

For example, if a non-registered business purchases goods costing £100, plus VAT at 17.5 per cent, it will debit the purchases account with the full £117.50.

Businesses can register voluntarily, even if below the threshold. This is advantageous if they have a high value of inputs on which VAT is suffered, and the addition of VAT to their outputs will not upset their customers. If most of their customers are also registered traders who can reclaim the VAT, its addition will not affect them, but if their customers are non-registered, this may have an adverse effect on trade.

5.3.4 Zero-rated and exempt supplies



Supplies of some goods and services are ‘zero-rated’, which means that although they are taxable, the rate used is zero. Common examples include basic foodstuffs and children’s clothing. Businesses that make such supplies add zero VAT to their outputs, but are still able to reclaim the VAT on inputs in full.

Yet other goods and services are ‘exempt’ from VAT. Businesses supplying such goods cannot reclaim the VAT on their inputs.

Consider three businesses, A, B and C. All three make monthly cash sales of £10,000, before adding any applicable VAT. Company A’s supplies are all standard-rated, B’s supplies are all zero-rated, C’s supplies are all exempt. All three make monthly cash purchases of £4,000, plus VAT at 17.5 per cent. Their results for a month will be as follows:

| | A (£) | B (£) | C (£) |
|----------------------|---------------|---------------|---------------|
| Sales | 10,000 | 10,000 | 10,000 |
| VAT | 1,750 | – | – |
| Cash received | <u>11,750</u> | <u>10,000</u> | <u>10,000</u> |
| Purchases | 4,000 | 4,000 | 4,000 |
| VAT | 700 | 700 | 700 |
| Cash paid | <u>4,700</u> | <u>4,700</u> | <u>4,700</u> |
| VAT payable | 1,750 | – | – |
| VAT reclaimable | 700 | 700 | – |
| Net payment/(refund) | <u>1,050</u> | <u>(700)</u> | <u>–</u> |
| Total cash in | <u>6,000</u> | <u>6,000</u> | <u>5,300</u> |

You can see that C is at a disadvantage compared with A and B. This is because he has suffered VAT that he cannot reclaim. This will affect his profit. A and B can both reclaim their VAT, so their profit is not affected by the charging or suffering of VAT.

A and B’s profit can be calculated as sales (excluding VAT), minus purchases (excluding VAT), that is, £10,000 – £4,000 = £6,000, whereas C’s profit is sales minus purchases (including VAT), i.e. £10,000 – £4,700 = £5,300.

5.3.5 Mixed supplies

Problems can arise where a business makes a mixture of types of supply – some of the input VAT can be reclaimed, and some cannot. VAT that can be specifically identified with a particular type of supply must be allocated to that type. Any remaining VAT that cannot be identified is split according to the level of sales of each type.

Example 5.D

During 20X1, Sandra made supplies as follows:

- exempt supplies of £100,000;
- standard-rated supplies of £100,000.

Of her total inputs of £40,000 (all standard-rated), she can identify £8,000 as being specifically for exempt supplies, and £20,000 as being specifically for standard-rated supplies. The balance of £12,000 must be apportioned 50 per cent to exempt supplies and 50 per cent to standard-rated supplies.

Thus, she can reclaim the VAT on £26,000 of inputs (£20,000 identifiable and £6,000 of the balance). She cannot reclaim the VAT on the other £14,000 (£8,000 identifiable and £6,000 of the balance). As shown previously, any VAT that cannot be reclaimed is included with the cost of the item concerned.

5.3.6 Exports and imports

The rules regarding VAT on exports are extremely complex. Different rules apply to exports of goods and services, on transactions between EU and non-EU countries, and between registered and non-registered traders. For the purpose of your studies in this subject, you can assume that exports are zero-rated.

The rules regarding VAT on imports are even more complex. Questions will not be asked concerning VAT on imports in the *Financial Accounting Fundamentals* paper.

5.4 Accounting for wages and salaries

In this section we shall see how the wages cost is recorded in the ledger accounts of an organisation.

5.4.1 Gross pay and net pay

Example 5.E

George is paid £5.50 per hour for a basic 36-hour week. Any overtime is paid at basic rate plus 50 per cent. During a particular week George worked for 42 hours.

The first step is to calculate the amount of George's gross earnings:

| | |
|-----------------------------|---------------|
| | £ |
| 36 hours @ £5.50 per hour = | 198.00 |
| 6 hours @ £8.25 per hour = | 49.50 |
| | <u>247.50</u> |

Unfortunately for George, the system of income tax in the UK means that he will not receive the amount of £247.50.

Let us assume that he will be liable to pay income tax at 25 per cent on all his weekly earnings in excess of £75, and in addition he will be liable to pay National Insurance (NI) contributions of 9 per cent of his total earnings. In addition to George's NI, assume his employer is also liable to a further 10.5 per cent NI contribution based on George's gross earnings. The revised position is therefore:

| | | |
|---|--------------|---------------|
| | £ | £ |
| George's gross earnings | | 247.50 |
| Less income tax (25% × £172.50) | 43.13 | |
| NI (9% × £247.50) | <u>22.27</u> | |
| | | 65.40 |
| George's net earnings | | <u>182.10</u> |
| Employer's NI contribution: 10.5% × £247.50 | | <u>25.99</u> |

George's employer will deduct George's income tax and NI and pay George his net earnings. The employer will then pay George's income tax and all of the NI contributions over to the government. Thus it can be seen that the total cost of employing George during the week amounted to £273.49 (the total of George's gross earnings and the employer's NI contributions).

This wages cost will be recorded in the employer's ledger accounts as follows:

| Gross wages expense | |
|---------------------|--------|
| | £ |
| Wages creditor | 247.50 |

| NI and PAYE creditor | | | |
|----------------------|-------|----------------|--------|
| | | | £ |
| | | Wages creditor | 65.40 |
| | | Employer's NI | 25.99 |
| NI Expense | | | |
| | £ | | |
| PAYE creditor | 25.99 | | |
| Wages creditor | | | |
| | £ | | £ |
| PAYE creditor | 65.40 | Gross wages | 247.50 |

The liability on the wages creditor account will be eliminated when the wages are paid. The liability to pay the income tax and NI will be eliminated when the employer pays the government.

5.4.2 Other deductions

The deduction of income tax and national insurance from George's gross wages by his employer are referred to as *statutory* deductions. George is required to pay these by law. However, George may also authorise his employer to make other deductions from his wages – these *voluntary* deductions are made from George's net earnings, as they do not affect his liability to income tax and NI.

For example, George's employers may have a sports and social club with a weekly membership fee of £1.25. George may also ask his employer to pay £20.00 a week directly into a savings plan (SAYE scheme). The deductions will have the following effect:

| | | |
|----------------------------------|--------------|-------------------------------|
| | £ | £ |
| George's net earnings | | 182.10 |
| Less: | | |
| Sports and social club | 1.25 | |
| SAYE scheme | <u>20.00</u> | |
| Net pay to be received by George | | <u>21.25</u> <u>160.85</u> |

The wages creditor account would appear as follows:

| Wages creditor | | | |
|----------------------|-------|-------------|--------|
| | £ | | £ |
| PAYE creditor | 65.40 | Gross wages | 247.50 |
| Sports club creditor | 1.25 | | |
| SAYE scheme creditor | 20.00 | | |

Two further creditor accounts would be required:

| Sports club creditor | | | |
|----------------------|--|----------------|-------|
| | | Wages creditor | £ |
| | | | 1.25 |
| SAYE scheme creditor | | | |
| | | Wages creditor | £ |
| | | | 20.00 |

The liability to pay the sports club and SAYE scheme will be eliminated when the employer pays them, which may be weekly or monthly.

5.4.3 Pension contributions

Many employees contribute to pension schemes by allocating a percentage of their gross pay to the pension fund, typically 5 or 6 per cent. This amount is deducted from the employee's gross pay, and is payable to the pension-fund company.

Example 5.F

Lesley earns £200 gross in week 21. Pension contributions are 5 per cent. The ledger entries to record this are:

- debit wages creditor with £10;
- credit pension company with £10.



Exercise 5.3

List the ledger entries required to record the following pay details, and the subsequent payment to the employee by cheque:

| | |
|---------------------------------|------------------|
| Gross pay | £1,200 |
| National Insurance – employee's | 9% of gross pay |
| Pension | 6% of gross pay |
| Income tax | £185 |
| National Insurance – employer's | 10% of gross pay |
| Trade union subscription | £5 per week |



Solution

| | |
|--|--------------------------------------|
| Debit wages expense account | £1,200 (Gross wages) |
| Debit wages expense account | £120 (Employer's National Insurance) |
| Credit Inland Revenue creditor account | £108 (Employee's NI) |
| | £120 (Employer's NI) |
| | £185 (Income Tax) |
| Credit pension creditor account | £72 |
| Credit trade union creditor account | £5 |
| Credit wages creditor account | £830 (Net wages owing) |
| Debit wages creditor account | £830 (Net wages paid) |
| Credit bank | £830 |

5.5 Accruals and prepayments

The most common application of accruals and prepayments is in accounting for expenses.

Accrued expenses: charges that are brought into the financial statements at the end of a period because, although goods and services have been provided, they have not yet been charged for by the suppliers. For example, electricity, invoiced in arrears, generally requires an accrual at the end of each accounting period.

An accrued expense is a *liability* because it is owed to the relevant supplier of those goods and services, irrespective of the fact that an invoice has not yet been received. If the business were to close down at the end of the accounting period, the expense would still have to be paid.

The opposite of an accrual is a prepayment:

Prepayment: expenditure on goods or services for future benefit, which is to be charged to future operations, for example, rentals paid in advance. These amounts are included in current assets.

A prepayment is an *asset* because the business has yet to enjoy or utilise the benefit from it. Depending on the type of expense, if the business were to close down at the end of the accounting period, the amount prepaid may well be refunded. As an example, local authority rates are often levied annually, for the year to 31 March. A business with a year end of 31 December may have already paid in full for its rates for the year to 31 March following. If it closed down at 31 December, it would receive a refund of the 3 months' excess paid, for which it did not receive the services of the local authority.

So far, you have dealt with entries in expense ledger accounts on the basis of payments made during the period. It does happen, however, that some expenses that have been incurred or consumed during a period do not require to be paid during that accounting period, but are paid some time later. Hence, at the time that the trial balance is drawn up, they have not been entered in the ledger accounts.

On the other hand, there are sometimes expenses that have been paid during the accounting period that cover a future period, instead or as well as the period in which they have been paid.

However, the profit and loss account must be credited with all income earned during a period (we credit all sales to the sales account, irrespective of whether or not the bills have been paid), and it should be debited with all expenses incurred during the same period (irrespective of whether or not the bills have been paid – or even received).

This is known as the concept of *matching*, that is, comparing the revenue earned during a period with the expenditure incurred *in earning that revenue*. Thus, if a telephone has been used to make calls during a period, to help earn revenue, the cost of those calls should be included in the expenses of the period, even if the telephone bill has not yet been received.

In addition, the organisation must make sure that its balance sheet reflects all assets and liabilities at that date, and thus prepaid expenses will be shown as current assets, while accrued expenses will be shown as current liabilities.

In order to account for accrued expenses the organisation must make an estimate of the cost incurred during the accounting period. This is usually based on past records or in some cases may be calculated based on the consumption of a resource by metering the resource concerned, for example, gas and electricity. The extent of any prepayment is usually calculated by reference to time. It is normally assumed that the expense is incurred equally during the passage of time, thus the amount prepaid is simply a proportion of the total invoiced amount.

While adjustment for accruals and prepayments is most common with regard to expenses, it is also possible to have situations where *revenue* has been prepaid or should be accrued. The principles are the same as those of expenses, the intention being to make the adjustments necessary to ensure that the accounting statements produced show the extent of the revenue and costs that have arisen during the period being reported.

5.5.1 Recording accruals and prepayments in the ledger accounts

So far you have learned how to record income and expenditure on the basis of invoices issued and received, or payments made. However, there are a number of occasions when

this method does not fairly reflect the true revenue and expenditure that has arisen during the period, and adjustments therefore need to be made.

Example 5.G

Draw up the heat and light account from the following information:

| | |
|--------------------------------------|---|
| Owing at 1 Jan. 20X1 | £125 |
| Bills received and paid during 20X1: | |
| 28 Feb. | £460 |
| 31 May | £440 |
| 30 Aug. | £390 |
| 30 Nov. | £420 |
| Bill received 28 Feb. 20X2 | £450 (for the period 1 Dec. 20X1 to 28 Feb. 20X2) |

The year end is 31 December.

Solution

| Heat and light | | | | | |
|----------------|-------------|--------------|---------|-------------------------|--------------|
| 20X1 | | £ | 20X1 | | £ |
| 28 Feb. | Bank | 460 | 1 Jan. | Balance b/d | 125 |
| 31 May | Bank | 440 | | | |
| 30 Aug. | Bank | 390 | | | |
| 30 Nov. | Bank | 420 | | | |
| 31 Dec. | Balance c/d | 150 | 31 Dec. | Profit and loss account | 1,735 |
| | | <u>1,860</u> | | | <u>1,860</u> |
| | | | 20X2 | | |
| | | | 1 Jan. | Balance b/d | 150 |

The credit balance of £150 represents one-third of the bill received on 28 February 20X2 (i.e. the amount applicable to the month of December 20X1). This amount will appear on the balance sheet under current liabilities.

Example 5.H

Draw up the rent payable account from the following information.

Rent is payable quarterly in advance on 1 March, June, September and December. The current annual rental is £4,800.

| | |
|-----------------------------|-------------------------------------|
| | £ |
| Rent prepaid at 1 Jan. 20X1 | 800 (for January and February 20X0) |
| Rent paid during 20X1: | |
| 1 March | 1,200 |
| 1 June | 1,200 |
| 1 September | 1,200 |
| 1 December | 1,500 |

The annual rental is increased to £6,000 per annum with effect from 1 December 20X1, and the year end is 31 December.

Solution

| | | Rent payable | | | |
|--------|---------------|--------------|---------|-------------------------|--------------|
| | | £ | 20X1 | | £ |
| 20X1 | | | | | |
| 1 Jan. | Balance b/fwd | 800 | | | |
| 1 Mar. | Bank | 1,200 | | | |
| 1 June | Bank | 1,200 | | | |
| 1 Sep. | Bank | 1,200 | 31 Dec. | Profit and loss account | 4,900 |
| 1 Dec. | Bank | <u>1,500</u> | 31 Dec. | Prepaid c/d | <u>1,000</u> |
| | | <u>5,900</u> | | | <u>5,900</u> |
| 20X2 | | | | | |
| 1 Jan. | Balance b/d | 1,000 | | | |

The balance brought down represents the prepayment for January and February 20X2, which is at the new rate of £500 per month. The charge to the profit and loss account can be confirmed as being 11 months at the old rate of £400 per month, and one month at the new rate of £500 per month, that is, £4,900.

5.6 Bad debts and provisions for doubtful debts

When a business sells goods on credit, it assumes that the customer will pay up in full. However, it sometimes happens that a debtor does not pay in full, or even at all, and thus it is incorrect to retain his balance as an asset, or to treat the sale as having created profit.

There may also be occasions when an organisation feels that a proportion of debtors may fail to pay their debts, but is not certain who they are, or the amount that may become unpaid.

Both of these situations need to be considered in preparing the accounts.

5.6.1 Accounting for bad debts

When it becomes known that a debtor is unlikely to pay, the debtor's balance must be removed (since it is no longer an asset of the business) and transferred to the profit and loss account as an expense of the period in which the bad debt arises. This is done by debiting a bad debts account (sometimes called a bad and doubtful debts account) and crediting the debtor's account.

Example 5.1

X sold goods to Y on credit on 1 January 20X1 valued at £350. On 30 November 20X1, X was advised that Y was unable to pay the debt.

Prior to X receiving this information Y's account was as follows:

| Y | | |
|--------|-------|-----|
| | | £ |
| 1 Jan. | Sales | 350 |

But now it is necessary to remove the asset and instead treat the outstanding balance as an expense. The entries are shown below:

| Y | | | | | |
|------------------------|-------|-----|---------|------------------------|-----|
| | | £ | | £ | |
| 1 Jan. | Sales | 350 | 30 Nov. | Bad and doubtful debts | 350 |
| Bad and doubtful debts | | | | | |
| | | £ | | | |
| 30 Nov. | Y | 350 | | | |

There may be circumstances where only part of the debt needs to be written off as an expense. For example, if Y had paid £200 on 30 June 20X1 and only the balance was to be written off, then the accounts would appear as follows:

| Y | | | | | |
|------------------------|-------|------------|---------|------------------------|------------|
| | | £ | | | £ |
| 1 Jan. | Sales | 350 | 30 Jun. | Bank | 200 |
| | | | 30 Nov. | Bad and doubtful debts | 150 |
| | | <u>350</u> | | | <u>350</u> |
| Bad and doubtful debts | | | | | |
| | | £ | | | |
| 30 Nov. | Y | 150 | | | |

One bad debt account is used to record all bad debts occurring during a year. At the end of the year the balance on the bad and doubtful debts expense account is transferred to the profit and loss account.

5.6.2 Bad debts recovered

It is possible that debts that have previously been written off may later be paid. If this happens, then the entries made to write off the debt as an expense must be reversed before recording the receipt of the payment from the debtor.

Example 5.J

P sold goods to Q on credit valued at £500. Q did not pay and his debt was written off in 2X10. The original ledger account entries were as follows:

| Q | | | |
|------------------------|------------|-------------------------|------------|
| 2X10 | £ | 2X10 | £ |
| Balance b/d | <u>500</u> | Bad and doubtful debts | <u>500</u> |
| Bad and doubtful debts | | | |
| 2X10 | £ | 2X10 | £ |
| Q | <u>500</u> | Profit and loss account | <u>500</u> |

On 31 December 2X11, Q paid the debt in full. The entries required to record this in the ledger accounts are shown below:

| Q | | | |
|------------------------|------------|------------------------|------------|
| 2X10 | £ | 2X10 | £ |
| Balance b/d | <u>500</u> | Bad and doubtful debts | <u>500</u> |
| 2X11 | | 2X11 | |
| Bad and doubtful debts | <u>500</u> | Bank | <u>500</u> |
| Bad and doubtful debts | | | |
| | | | 2X11 |
| | | | Q |
| | | | £ |
| | | | <u>500</u> |

The credit balance on the bad and doubtful debts expense account will be credited to the profit and loss account at the end of 2X11.

Sometimes a part-payment of a debt previously written off is made. If Q had paid £200 as full and final settlement, then the entries made would have been:

| Q | | | |
|------------------------|------------|---------------------------|------------|
| | £ | | £ |
| Balance b/d | <u>500</u> | Bad and doubtful debts | <u>500</u> |
| Bad and doubtful debts | <u>500</u> | Bank | <u>200</u> |
| | | Bad and doubtful debts | <u>300</u> |
| | <u>500</u> | | <u>500</u> |
| Bad and doubtful debts | | | |
| 2X11 | £ | 2X11 | £ |
| Q | <u>300</u> | Q (bad debt brought back) | <u>500</u> |

The reason for reinstating the full amount of the original debt and then writing off the resulting £300 is so that if P were to trade with Q again in the future it would be clear that a bad debt arose from their previous trading activities. If only the part of the debt settled were reinstated it may appear that no bad debt occurred.

5.6.3 Providing for doubtful debts

While some debts are definitely bad – it is known for *certain* that the customer will not pay – others may be only *doubtful*. In this case it would not be appropriate to eliminate the debtor's balance because he may pay after all. But we have to recognise that the value of the asset 'debtors' is probably less than it appears to be. The technique used is to create a *provision for doubtful debts*. A provision is similar in principle to an accrual but it reflects the fact that it is an estimate of a possible liability rather than an estimate of a liability certain to arise but uncertain in amount.

Both writing off bad debts and providing for doubtful debts are in accordance with the concept of *prudence*, which you will learn more about in Chapter 10. Adopting a prudent approach is simply ensuring that profits and assets are not overstated, by estimating likely losses and decreases in assets as soon as they become apparent.

This estimate can be made using a number of different techniques. For example:

1. using experience and knowledge of customers and the economic climate;
2. listing all debtors and scrutinising them individually for their ability to pay;
3. calculating an overall percentage of the outstanding debtor balances;
4. preparing a schedule of debtors according to the length of time that their debt has been outstanding, and using different percentages depending on the age of the debt. This is known as an aged debtor schedule.

Example 5.K

| Age of debt | Amount (£) | % | Provision (£) |
|--------------------|---------------|----|---------------|
| Less than 1 month | 8,000 | 1 | 80 |
| 1–2 months | 3,000 | 2 | 60 |
| 2–3 months | 700 | 5 | 35 |
| More than 3 months | 140 | 20 | 28 |
| | <u>11,840</u> | | <u>203</u> |

This technique is based on the belief that the older the debt the more likely it is to become a bad debt. When the provision for doubtful debts is first created, the ledger account entries are as shown below:

| Bad and doubtful debts | |
|-------------------------|-----|
| 20X1x | £ |
| Doubtful debt provision | 203 |

| Doubtful debt provision | |
|-------------------------|------------------------|
| | 20X1 |
| | Bad and doubtful debts |
| | £ |
| | 203 |

The balance on the bad and doubtful debts account is transferred to the profit and loss account at the end of the period. Thus the balance on this account will be reduced to nil.

The balance on the provision account is used to decrease the value of debtors shown on the balance sheet at the end of the period. This balance will remain in the ledger accounts.

Note that no entries are made in the debtors' accounts for the provision.

Once the provision has been created it must be reviewed and increased or decreased depending on the circumstances of the business.

For example, if the above provision were to be decreased to £130 in 20X2, then the entries would appear as follows:

| Bad and doubtful debts | | | |
|-------------------------|------------|-------------------------|------------|
| | | 20X2 | £ |
| | | Doubtful debt provision | 73 |
| Doubtful debt provision | | | |
| 20X2 | £ | 20X2 | £ |
| Bad and doubtful debts | 73 | Balance b/d | 203 |
| Balance c/d | 130 | | |
| | <u>203</u> | | <u>203</u> |
| | | 20X3 | |
| | | Balance b/d | 130 |

Note that it is possible to avoid the use of the bad and doubtful debts account if the entry is only being made once a year, but most modern accounting systems provide monthly profit statements for internal management use, and in these circumstances it is common to use the accounts shown.



Exercise 5.4

The following information is given regarding the provision for doubtful debts:

| | |
|-----------------------------|---------|
| Debtors at 31 December 20X0 | £30,000 |
| Debtors at 31 December 20X1 | £25,000 |
| Debtors at 31 December 20X2 | £35,000 |
| Debtors at 31 December 20X3 | £40,000 |

The provision at each year end is to be 5 per cent of debtors, after writing off bad debts. Bad debts to be written off are as follows:

| | |
|------------------|--------|
| 31 December 20X1 | £3,000 |
| 31 December 20X2 | £2,000 |

Write up the provision for doubtful debts account for the years 20X0 to 20X3.



Solution

| Provision for doubtful debts account | | | | | |
|--------------------------------------|-----------------------|--------------|---------|-----------------------|--------------|
| 20X0 | | £ | 20X0 | | £ |
| 31 Dec. | Balance c/d | <u>1,500</u> | 31 Dec. | Increase in provision | <u>1,500</u> |
| 20X1 | | | 20X1 | | |
| 31 Dec. | Decrease in provision | 400 | 1 Jan. | Balance b/d | 1,500 |
| | Balance c/d | <u>1,100</u> | | | |
| | | <u>1,500</u> | | | <u>1,500</u> |
| 20X2 | | | 20X2 | | |
| 31 Dec. | Balance c/d | <u>1,650</u> | 1 Jan. | Balance b/d | 1,100 |
| | | <u>1,650</u> | 31 Dec. | Increase in provision | <u>550</u> |
| | | | | | <u>1,650</u> |
| 20X3 | | | 20X3 | | |
| 31 Dec. | Balance c/d | <u>2,000</u> | 1 Jan. | Balance b/d | 1,650 |
| | | <u>2,000</u> | 31 Dec. | Increase in provision | <u>350</u> |
| | | | | | <u>2,000</u> |
| | | | 20X4 | | |
| | | | 1 Jan. | Balance b/d | 2,000 |



Exercise 5.5

On 31 August 20X4, the sundry debtors of Henry Higgins stood at £10,000 and the balance on the provision for bad debts account at that date was £200. Of the debtors it was considered that £500 were irrecoverable and should be written off. It was decided that the provision for bad debts should be made equal to 5 per cent of the outstanding accounts.

At 31 August 20X5 the debtors' balances had fallen to £8,000, of which £100 were considered to be irrecoverable and should be written off. The provision for bad debts was to be at the same rate as in 20X4. You are required to:

1. show the bad and doubtful debts account at 31 August 20X4 and 20X5;
2. show the provision for doubtful debts account at 31 August 20X4 and 20X5;
3. show the relevant figures in the balance sheets for the 2 years 20X4 and 20X5.



Solution

| Bad and doubtful debts | | | | | |
|------------------------|------------------------------|------------|-------------|------------------------------|------------|
| <i>20X4</i> | | £ | <i>20X4</i> | | £ |
| 31 Aug. | Debtors | 500 | 31 Aug. | Profit and loss | 775 |
| | Provision for doubtful debts | 275 | | | |
| | | <u>775</u> | | | <u>775</u> |
| <i>20X5</i> | | | <i>20X5</i> | | |
| 31 Aug. | Debtors | 100 | 31 Aug. | Provision for doubtful debts | 80 |
| | | | | Profit and loss | 20 |
| | | <u>100</u> | | | <u>100</u> |

| Provision for doubtful debts | | | | | |
|------------------------------|------------------------|------------|-------------|------------------------|------------|
| <i>20X4</i> | | £ | <i>20X4</i> | | £ |
| 31 Aug. | Balance c/f | 475 | 31 Aug. | Balance b/f | 200 |
| | | <u>475</u> | | Bad and doubtful debts | 275 |
| | | | | | <u>475</u> |
| <i>20X5</i> | | | <i>20X5</i> | | |
| 31 Aug. | Bad and doubtful debts | 80 | 1 Sep. | Balance b/f | 475 |
| | Balance c/f | 395 | | | |
| | | <u>475</u> | | | <u>475</u> |
| | | | <i>20X6</i> | | |
| | | | 1 Sep. | Balance b/f | 395 |

Balance sheet extracts

| | | | |
|----------------|--|------------|-------|
| <i>20X4</i> | | £ | |
| Debtors | | 9,500 | |
| Less provision | | <u>475</u> | |
| | | | 9,025 |
| <i>20X5</i> | | £ | |
| Debtors | | 7,900 | |
| Less provision | | <u>395</u> | |
| | | | 7,505 |

Payments received from doubtful debts

Because there is no adjustment made in the account of the debtor, when a provision is made for doubtful debts there is no need to make any particular entries when that debtor eventually pays. The adjustment to the previous period's provision will take place when the current year's debts are assessed for the likelihood of being paid, and that debt will be ignored in the calculation of the provision for the current year. It is accepted that, in making provisions, there is some doubt as to the absolute accuracy of the estimates made. An overprovision or an underprovision can occur, but provided that these do not make a significant (material) difference to the view portrayed by the accounts, no action is taken.

Specific provisions

In some situations a 'specific provision' is made. This is where the identity of the debtor is known, but the amount of the likely bad debt is unknown. It particularly arises where a debtor is known to be in difficulties, but is making efforts to repay his or her debt. He might have agreed to pay in instalments, and he has paid some, but missed others. It is prudent to write off any known bad debts, but in this situation it is also prudent to consider the likelihood of only part of the debt being repaid. A specific provision is treated in the same way as a general provision, that is, it is debited to the bad and doubtful debts account, and credited to the provision for doubtful debts account.

5.7 The exchange of goods

When a business sells goods or services it will normally receive cash/cheques in exchange. However, it will sometimes occur that two businesses will exchange goods or services with each other. For example, an electrician may do some work for a plumber, and the plumber may do some work for the electrician. If the agreed value of the work is, say £100, then each will record in their books £100 sales and £100 purchases. It would be incorrect to just ignore this transaction and contra one against the other.

Sometimes the exchange may not be equal; for example, an accountant may have a client who is a printer, and the accountant may exchange his professional services for the supply of letterheads. If, for example, the accountant's fees are £500 and the letterheads are £200, then the printer will pay £300 to the accountant. The accountant will record fees of £500 in his books and the cost of stationery £200. The printer will record sales of £200 and accountancy fees £500. It would be incorrect for the accountant just to record fees of £300 and to ignore the stationery expense; it would be incorrect for the printer just to record accountancy fees of £300 and to ignore the sale of £200.

Thus these transactions are recorded in the books at the full amount; where there is a barter for the exchange of goods, these must not be ignored; where there is a difference in the value of the goods exchanged, and some cash changes hands, then this transaction is recorded at the gross amounts and is not netted off. Although the inclusion of these transactions in the accounts at the gross, as opposed to the net amount, does not affect profit, the sales and the expenses would not be correctly stated if no adjustment was made for the barter.

It is not always easy to place a value on the goods exchanged if a business sells goods but is negotiable on the price it charges. This is particularly important if the exchange involves a fixed asset. For example, a car dealer (C) may buy a second-hand car for £15,000 and advertise the car at £20,000, but expect to receive only £19,000 and may be

prepared to sell at £18,000, if it is a poor trading month (the customer will not know that C is prepared to do this). Suppose another business (G) has goods in stock which cost £16,000 which it normally sells for £18,500, which it is prepared to exchange for the car.

What is the profit G has made on exchanging the goods and how should the car be valued in its books? The cost of the goods to G is £16,000; the value of the car could be regarded as £20,000, or £19,000 or £18,000 or even £15,000. In the first two cases G would have made more profit than normal; in the third case, it would be less profit than normal; and in the last case it would be a loss. This is not therefore a very satisfactory approach to the problem.

The better solution to the problem is to look at what G gave up in exchange for the car. G gave up goods valued at £18,500 and this is therefore the value that he places on the car. The sale of the goods should therefore be recorded at £18,500 and the car should be included in fixed assets at a cost of £18,500.

However, suppose that G's normal selling price was £21,000, it does not follow that the car should be valued at £21,000. This would not be a sensible solution, as it would have been better for G to sell its stock for £21,000 in the normal course of business, and then pay £20,000 for the car, as it would have been better off by £1,000. In these circumstances, it must be assumed that the maximum price that G could have obtained for its goods is £20,000 and the car should be valued at this price.

The bartering of goods and services illustrates the prudence concept (see Chapter 10) which means that G should not overstate the profit that it has made on selling its goods.

5.8 Summary

In this chapter you have looked at the bookkeeping and accounting treatment of a number of different transactions.

- carriage costs,
- VAT,
- wages and salaries,
- accruals and prepayments,
- bad and doubtful debts,
- the exchange of goods and services.

All of these (especially accruals and prepayments, and bad and doubtful debts) are likely to appear in *every* examination involving either the preparation of ledger accounts or, more commonly, the preparation of financial statements.



The topics in this chapter are very important. The principles involved are discussed in more detail in Chapter 10 – it is suggested that you refer to that chapter now and attempt to apply the concepts and ideas it mentions to the topics of this chapter.

In particular, the adjustments made for accruals and prepayments, and for provisions for doubtful debts, involve the *accruals* and *matching* concepts. The idea is that the revenue earned during a period is 'matched' in the profit and loss account with the expense incurred in earning that revenue. So, the mere fact that something has been paid for during a period does not necessarily mean that it has been consumed during that period in earning

revenue, and therefore some adjustment is needed to the ledger accounts to fairly reflect what *has* been consumed.

Another important concept is the *realisation* concept, which states that we ‘recognise’ (i.e. account for) revenue when it is *earned*, not necessarily when it is *received*. A very important concept that affects accounting is the *prudence* concept, which states that revenue should never be recognised until it is *highly probable* to be realised, whereas expenses and losses should be recognised as soon as they become *probable* to occur. Perhaps it is this philosophy that has earned accountants the reputation of being ‘miserable’!

Some of the topics contained in this chapter involve a degree of ‘judgement’, rather than hard evidence and fact, and it is important that accountants have sufficient guidance as to how to exercise that judgement when drawing up the accounts. In other words, some items dealt with in the accounts are ‘subjective’, that is, subject to different measurement and interpretation: as accountants are human beings they may well differ in their degree of subjectivity. For this reason, Chapter 10 discusses various sources of guidance for accountants, and their importance. Some of these ideas will also be encountered in the next chapter.

Revision Questions

5



Question 1 Multiple choice

- 1.1 Which of the following transactions would result in an increase in capital employed?
- (A) Selling stocks at a profit.
 - (B) Writing off a bad debt.
 - (C) Paying a creditor in cash.
 - (D) Increasing the bank overdraft to purchase a fixed asset.
- 1.2 Rent paid on 1 October 1992 for the year to 30 September 1993 was £1,200 and rent paid on 1 October 1993 for the year to 30 September 1994 was £1,600. Rent payable, as shown in the profit and loss account for the year ended 31 December 1993, would be:
- (A) £1,200
 - (B) £1,600
 - (C) £1,300
 - (D) £1,500
- 1.3 A decrease in the provision for doubtful debts would result in:
- (A) an increase in liabilities.
 - (B) a decrease in working capital.
 - (C) a decrease in net profit.
 - (D) an increase in net profit.
- 1.4 At the end of the month, an organisation needs to accrue for one week's wages. The gross wages amount to £500, tax amounts to £100, employer's National Insurance is £50, employees' National Insurance is £40, and employees' contributions to a pension scheme amount to £30. The ledger entries to record this accrual would be:

| | | | |
|----------------------------------|----------|------------------------------------|---------|
| (A) Debit wages expense | £ 500 | Credit National Insurance creditor | £ 90 |
| | | Credit income tax creditor | 100 |
| | | Credit pension scheme creditor | 30 |
| | | Credit wages accrued | 280 |
| (B) Debit wages expense | 550 | Credit National Insurance creditor | 90 |
| | | Credit income tax creditor | 100 |
| | | Credit pension scheme creditor | 30 |
| | | Credit wages accrued | 330 |
| (C) Debit wages expense | 280 | Credit wages accrued | 500 |
| Debit National Insurance expense | 90 | | |
| Debit income tax expense | 100 | | |
| Debit pension scheme expense | 30 | | |

| | | | | |
|-----|----------------------------------|----------|----------------------|----------|
| (D) | Debit wages expense | £ 330 | Credit wages accrued | £ 550 |
| | Debit National Insurance expense | 90 | | |
| | Debit income tax expense | 100 | | |
| | Debit pension scheme expense | 30 | | |

1.5 The sales account is:

- (A) credited with the total of sales made, including VAT.
- (B) credited with the total of sales made, excluding VAT.
- (C) debited with the total of sales made, including VAT.
- (D) debited with the total of sales made, excluding VAT.

1.6 Stationery paid for during 1995 amounted to £1,350. At the beginning of 1995 there was a stock of stationery on hand of £165 and an outstanding stationery invoice for £80. At the end of 1995, there was a stock of stationery on hand of £140 and an outstanding stationery invoice for £70. The stationery figure to be shown in the profit and loss account for 1995 is:

£

1.7 A business had a balance at the bank of £2,500 at the start of the month. During the following month, it paid for materials invoiced at £1,000 less trade discount of 20 per cent and cash discount of 10 per cent. It received a cheque from a debtor in respect of an invoice for £200, subject to cash discount of 5 per cent. The balance at the bank at the end of the month was:

£

1.8 An error of commission is one where:

- (A) a transaction has not been recorded.
- (B) one side of a transaction has been recorded in the wrong account, and that account is of a different class from the correct account.
- (C) one side of a transaction has been recorded in the wrong account, and that account is of the same class as the correct account.
- (D) a transaction has been recorded using the wrong amount.

1.9 A business commenced with capital in cash of £1,000. Stock costing £800 is purchased on credit, and half is sold for £1,000 plus VAT, the customer paying in cash at once. The accounting equation after these transactions would show:

- (A) assets £1,775 less liabilities £175 equals capital £1,600.
- (B) assets £2,175 less liabilities £975 equals capital £1,200.
- (C) assets £2,575 less liabilities £800 equals capital £1,775.
- (D) assets £2,575 less liabilities £975 equals capital £1,600.

1.10 A sole trader's business made a profit of £32,500 during the year ended 31 March 1998. This figure was after deducting £100 per week wages for himself. In addition, he put his home telephone bill through the business books, amounting to £400 plus VAT at 17.5 per cent. He is registered for VAT and therefore has charged only the net amount to his profit and loss account.

His capital at 1 April 1997 was £6,500. His capital at 31 March 1998 was:

£

1.11 An employee is paid at the rate of £3.50 per hour. Earnings of more than £75 a week are taxed at 20 per cent. Employees' National Insurance is 7 per cent, and employer's National Insurance is 10 per cent. During week 24, the employee works for 36 hours. The amounts to be charged to the profit and loss account and paid to the employee are:

| | <i>Profit and loss account</i> | <i>Paid to employee</i> |
|----------|--------------------------------|-------------------------|
| A | £126.00 | £94.38 |
| B | £126.00 | £106.98 |
| C | £138.60 | £94.38 |
| D | £138.60 | £106.98 |

1.12 An organisation's year end is 30 September. On 1 January 1996 the organisation took out a loan of £100,000 with annual interest of 12 per cent. The interest is payable in equal instalments on the first day of April, July, October and January, in arrears. How much should be charged to the profit and loss account for the year ended 30 September 1996, and how much should be accrued on the balance sheet?

| <i>Profit and loss account</i> | <i>Balance sheet</i> |
|--------------------------------|----------------------|
| £..... | £..... |

1.13 The electricity account for the year ended 30 June 2000 was as follows:

| | |
|--|-----|
| | £ |
| Opening balance for electricity accrued at 1 July 1999 | 300 |
| Payments made during the year: | |
| 1 August 1999 for three months to 31 July 1999 | 600 |
| 1 November 1999 for three months to 31 October 1999 | 720 |
| 1 February 2000 for three months to 31 January 2000 | 900 |
| 30 June 2000 for three months to 30 April 2000 | 840 |

What is the appropriate entry for electricity?

| | |
|---------------------|--|
| <i>Accrued at</i> | <i>Charge to profit and loss account</i> |
| <i>30 June 2000</i> | <i>year ended 30 June 2000</i> |
| £..... | £..... |

1.14 The year-end of M plc is 30 November 2000. The company pays for its gas by a standing order of £600 per month. On 1 December 1999, the statement from the gas supplier showed that M plc had overpaid by £200. M plc received gas bills for the four quarters commencing on 1 December 1999 and ending on 30 November 2000 for £1,300, £1,400, £2,100 and £2,000, respectively.

What is the correct charge for gas in M plc's profit and loss account for the year ended 30 November 2000?

£.....

1.15 A company has been notified that a debtor has been declared bankrupt. The company had previously provided for this doubtful debt. Which of the following is the correct double entry?

| | <i>Debit</i> | <i>Credit</i> |
|----------|--------------------------------|--------------------------------|
| A | Bad and doubtful debts account | The debtor |
| B | The debtor | Bad and doubtful debts account |
| C | Provision for doubtful debts | The debtor |
| D | The debtor | Provision for doubtful debts |

1.16 An employee has a gross monthly salary of £1,000. In September the tax deducted was £200, the employee's National Insurance was £60, and the employer's National Insurance was £100. What was the charge for salaries in the profit and loss account?

£

1.17 The turnover in a company was £2 million and its debtors were 5 per cent of turnover. The company wishes to have a provision for doubtful debts of 4 per cent of debtors, which would make the provision 33 per cent higher than the current provision. What figure would appear in the profit and loss account in respect of doubtful debts?

Debit or Credit £
.....

1.18 A business purchases a machine on credit terms for £15,000 plus value added tax (VAT) at 15 per cent. The business is registered for VAT. How should this transaction be recorded in the books?

| | | <i>Debit (£)</i> | <i>Credit (£)</i> |
|----------|-----------|------------------|-------------------|
| A | Machinery | 15,000 | |
| | Creditors | | 15,000 |
| B | Machinery | 17,250 | |
| | Creditors | | 17,250 |
| C | Machinery | 15,000 | |
| | VAT | 2,250 | |
| | Creditors | | 17,250 |
| D | Machinery | 17,250 | |
| | VAT | | 2,250 |
| | Creditors | | 15,000 |

1.19 On 1 May 2000, A Ltd pays a rent bill of £1,800 for the period to 30 April 2001. What is the charge to the profit and loss account and the entry in the balance sheet for the year ended 30 November 2000?

| <i>Profit and Loss Account</i> | <i>Balance Sheet</i> | <i>Accrual or Prepayment</i> |
|---|---|---|
| £ <input style="width: 80px;" type="text"/> | £ <input style="width: 80px;" type="text"/> | £ <input style="width: 80px;" type="text"/> |

1.20 S Ltd exchanged stock for a delivery vehicle with T Ltd. The stock had cost S Ltd £10,000 and the normal selling price was £12,000; the delivery vehicle had cost T Ltd £9,000 and the normal selling price was £13,000.

How should S Ltd value the vehicle in its balance sheet?

£

1.21 B is a builder with a staff of ten employees. In April 2001 he paid the following amounts:

| | |
|--|--------|
| | £ |
| Net salaries after tax and National Insurance | 14,000 |
| Tax and employees' National Insurance for March 2001 | 5,000 |
| Employer's National Insurance for March 2001 | 1,400 |

He owes the following amounts in respect of tax and National Insurance for April 2001:

| | |
|---------------------------------------|-------|
| | £ |
| Tax and employees' National Insurance | 6,000 |
| Employer's National Insurance | 1,500 |

The correct expense for employee costs to be shown in the profit and loss account for April 2001 is:

£

- 1.22** X exchanged stock for a machine with Y. The stock had cost X £15,000 and the normal selling price was £17,000; the machine had cost Y £14,000 and the normal selling price was £18,000.

How should X value the machine in its balance sheet?

£

- 1.23** M Ltd exchanged stock for equipment with Z Ltd. The stock had cost M Ltd £10,000 and the normal selling price was £16,000; the equipment had cost Z Ltd £12,000 and the normal selling price was £14,000.

How should M Ltd value the machine in its balance sheet?

£

? Question 2

From the information given below *you are required* to show the rent, rates and insurance account in the ledger of CPF Ltd for the year ended 30 June 20X6, showing clearly the prepayments and accruals at that date and the transfer to profit and loss account for the year. The balances on the account at 1 July 20X5 were:

| | |
|-------------------|-----|
| | £ |
| Rent accrued | 200 |
| Rates prepaid | 150 |
| Insurance prepaid | 180 |

Payments made were as follows:

| | | |
|-------------|--|-----|
| | | £ |
| <i>20X5</i> | | |
| 10 Aug. | Rent, three months to 31 July 20X5 | 300 |
| 26 Oct. | Insurance, one year to 31 October 20X6 | 600 |
| 2 Nov. | Rates, six months to 31 March 20X6 | 350 |
| 12 Dec. | Rent, four months to 30 November 20X5 | 400 |
| <i>20X6</i> | | |
| 17 Apr. | Rent, four months to 31 March 20X6 | 400 |
| 9 May | Rates, six months to 30 September 20X6 | 350 |

Use the following proforma to enter your answer:

| Rents, rates and insurance | | | | | |
|----------------------------|-----------------------|---|-------------|----------------------------|---|
| | | £ | | | £ |
| <i>20X5</i> | | | <i>20X5</i> | | |
| 1 Jul. | Insurance prepaid b/d | █ | 1 Jul. | Rent accrued b/d | █ |
| | Rates prepaid b/d | █ | | | |
| 10 Aug. | Rent paid | █ | | | |
| 26 Oct. | Insurance paid | █ | | | |
| 2 Nov. | Rates paid | █ | | | |
| 12 Dec. | Rent paid | █ | | | |
| <i>20X6</i> | | | <i>20X6</i> | | |
| 17 Apr. | Rent paid | █ | 30 Jun. | Rent: profit and loss | █ |
| 9 May. | Rates paid | █ | | Rates: profit and loss | █ |
| 30 Jun. | Rent accrued c/d | █ | | Insurance: profit and loss | █ |
| | | | | Rates prepaid c/d | █ |
| | | | | Insurance prepaid c/d | █ |
| | | █ | | | █ |

? **Question 3**

PQR Ltd has a year end of 31 December. At 30 November 20XX, the following balances exist in the ledger for the VAT, bank and debtors' accounts:

| | |
|---------------------------------|---------|
| | £ |
| VAT owing to Customs and Excise | 3,250 |
| Bank overdraft | 6,250 |
| Debtors | 127,000 |

During December 20XX, the following transactions take place:

- (i) Sales of £85,000 plus VAT are made on credit.
- (ii) A motor car costing £8,000 plus VAT is bought and paid for by cheque.
- (iii) Materials are purchased on credit for £27,000 plus VAT.
- (iv) Materials costing £3,000 plus VAT are returned to the supplier and a refund given by cheque.
- (v) Administration expenses of £2,400 plus VAT are incurred and paid for by cheque.
- (vi) A VAT refund of £1,567 for the quarter ended 31 October 20XX is received by cheque from Customs and Excise.
- (vii) Debtors pay the balance outstanding at 30 November 20XX by cheque, deducting £2,000 cash discount.
- (viii) Creditors are paid £42,000 by cheque.

VAT is 17.5 per cent in all cases.

Requirements

- (a) Insert the missing figures into the VAT account for December 20XX, showing the closing balance.

| VAT | | | |
|-------------------------|---|-------------------|---|
| | £ | | £ |
| Purchases | █ | Balance b/f | █ |
| Administration expenses | █ | Sales | █ |
| Balance c/f | █ | Purchases returns | █ |
| | █ | VAT repayment | █ |
| | █ | | █ |

- (b) Insert the missing figures into the bank ledger account given below in order to calculate the bank balance at 31 December 20XX.

| Bank | | | |
|------------------|---|-------------------------|---|
| | £ | | £ |
| Materials refund | █ | Balance b/f | █ |
| VAT repayment | █ | Vehicle | █ |
| Debtors | █ | Administration expenses | █ |
| | █ | Creditors | █ |
| | █ | Balance c/f | █ |
| | █ | | █ |

- (c) Explain the purpose of a trial balance by completing the gaps in this sentence.
 Major purpose is to check _____accuracy of the _____system, i.e. each transaction has matching _____and _____entries. Total _____balances should equal total _____ balances.
- (d) Match the four different types of error that could occur in the trial balance, which would prevent its agreement, with the examples in the table below.

Type of error

- (A) Transposition
- (B) Posting one entry only
- (C) Posting both entries on the same side
- (D) Bringing the opening balance down on the wrong side

Example

1. A sale of £432 to Brown debited correctly in Brown's account, but recorded in the sales account as £423. The trial balance would have £9 more on the debit total.
2. If a debit balance on Brown's account was brought down on the credit side, the trial balance would not agree.
3. Again using the same transaction as in 1 – if the £432 was debited in the sales account as well as in Brown's account, the trial balance would disagree.
4. Using the same transaction as in 1 – if the credit entry was not posted, but the debit was, then the debit trial balance total would be £432 higher than the credit total.

**Question 4**

At 1 October 1995, the following balances were brought forward in the ledger accounts of XY:

| | <i>£</i> |
|--------------------------------------|---------------|
| Rent payable | £1,500 debit |
| Electricity account | £800 credit |
| Interest receivable | £300 debit |
| Provision for doubtful debts account | £4,800 credit |

You are told the following:

- Rent is payable quarterly in advance on the last day of November, February, May and August, at the rate of £6,000 per annum.

| | <i>£</i> |
|------------------|--|
| 5 November 1995 | £1,000 (for the period to 31 October 1995) |
| 10 February 1996 | £1,300 (for the period to 31 January 1996) |
| 8 May 1996 | £1,500 (for the period to 30 April 1996) |
| 7 August 1996 | £1,100 (for the period to 31 July 1996) |

- Electricity is paid as follows:
At 30 September 1996, the electricity meter shows that £900 has been consumed since the last bill was received.

| | |
|----------------|--|
| 2 October 1995 | £250 (for the six months to 30 September 1995) |
| 3 April 1996 | £600 (for the six months to 31 March 1996) |

- Interest was received during the years as follows:
You estimate that interest of £300 is accrued at 30 September 1996.
- At 30 September 1996, the balance of debtors amounts to £125,000. The provision for doubtful debts is to be amended to 5 per cent of debtors.

Requirements

(a) Insert the missing information into the following ledger accounts:

- (i) rent payable;
- (ii) electricity;
- (iii) interest receivable;
- (iv) provision for doubtful debts;

and bring down the balances at 30 September 1996.

| | | | | | | |
|-----------------------------------|---|----------|------|---|---|----------|
| (i) Rent payable | | | | | | |
| 1995 | | £ | | | | £ |
| █ | █ | █ | | | | |
| █ | █ | █ | | | | |
| 1996 | | | 1996 | | | |
| █ | █ | █ | █ | █ | █ | |
| █ | █ | █ | █ | █ | █ | |
| █ | █ | █ | | | | |
| █ | █ | <u>█</u> | | | | <u>█</u> |
| | | <u>█</u> | | | | <u>█</u> |
| (ii) Electricity | | | | | | |
| 1995 | | £ | 1995 | | | £ |
| █ | █ | █ | █ | █ | | █ |
| 1996 | | | 1996 | | | |
| █ | █ | █ | █ | █ | | █ |
| █ | █ | █ | | | | |
| █ | █ | █ | | | | |
| █ | █ | <u>█</u> | | | | <u>█</u> |
| | | <u>█</u> | █ | █ | | <u>█</u> |
| (iii) Interest receivable | | | | | | |
| 1995 | | £ | 1995 | | | £ |
| █ | █ | █ | █ | █ | | █ |
| 1996 | | | 1996 | | | |
| █ | █ | █ | █ | █ | | █ |
| | | █ | █ | █ | | █ |
| █ | █ | <u>█</u> | | | | <u>█</u> |
| | | <u>█</u> | | | | <u>█</u> |
| (iv) Provision for doubtful debts | | | | | | |
| | | £ | 1995 | | | £ |
| | | | █ | █ | | █ |
| 1996 | | | 1996 | | | |
| █ | █ | █ | █ | █ | | █ |
| | | █ | | | | █ |
| | | <u>█</u> | █ | █ | | <u>█</u> |
| | | <u>█</u> | | | | <u>█</u> |

(b) State *two* accounting concepts that govern treatment of the above items in the accounts of XY.

Concept 1

Concept 2

(c) Describe *each* of the four balances brought down on the accounts at 30 September 1996, and state under which heading they should be shown in the balance sheet at 30 September 1996.

| | | |
|------------------------------|-------------|-----------------------|
| | Description | Balance Sheet Heading |
| Rent payable | | |
| Electricity | | |
| Interest receivable | | |
| Provision for doubtful debts | | |

Solutions to Revision Questions

5



Solution 1

1.1 Answer: (A)

Capital employed is increased by making a profit, or by adding more capital. Writing off a bad debt is clearly the opposite of making a profit; transactions such as (B) and (C) merely adjust the split of assets and liabilities but do not add anything overall.

1.2 Answer: (C)

The year to 31 December 1993 includes $\frac{3}{4}$ of the rent for the year to 30 September 1993 and $\frac{1}{4}$ of the rent for the year to 30 September 1994, i.e.:

$$\frac{3}{4} \times \pounds 1,200 + \frac{1}{4} \times \pounds 1,600 = \pounds 1,300$$

1.3 Answer: (D)

The change in provision for doubtful debts is taken to the profit and loss account – an increase is debited and therefore decreases net profit, while a decrease is credited and therefore increases net profit. The resultant balance on the provision for doubtful debts account is deducted from debtors (current assets), which in turn affects working capital. A decrease in the provision would increase net profit, and would also increase current assets. The latter is not one of the options, therefore (D) is the answer.

1.4 Answer: (B)

A is incorrect, as the employer's National Insurance has been deducted from the net wages accrued. (C) is incorrect as there has been no deduction from wages accrued for tax, National Insurance or pension contributions. Nor is there any record of liability for these items. (D) is similar, with the added error of employer's NI being included with wages accrued.

1.5 Answer: (B)

VAT is excluded from sales and purchases accounts, so (A) and (C) are incorrect. Sales is revenue, and therefore the sales account is credited.

1.6 The stationery ledger account would appear as:

| | | | |
|------------------------------|--------------|----------------------------|--------------|
| Opening stock b/d | £ 165 | Outstanding invoice at 1.1 | £ 80 |
| Paid during year | 1,350 | Closing stock c/d | 140 |
| Outstanding invoice at 31.12 | <u>70</u> | Profit and loss account | <u>1,365</u> |
| | <u>1,585</u> | | <u>1,585</u> |

1.7 Reconstruction of the bank account:

| | | | |
|--------------------|--------------|-----------------------------|--------------|
| | £ | | £ |
| Balance b/fwd | 2,500 | Payment (1,000 – 20%) – 10% | 720 |
| Receipt (200 – 5%) | <u>190</u> | Balance c/fwd (diff) | <u>1,970</u> |
| | <u>2,690</u> | | <u>2,690</u> |

1.8 Answer: (C)

A is incorrect as this is an error of omission. (B) is incorrect as an error of principle occurs where the two accounts are of different classes. (D) is an example of an error of original entry.

1.9 Answer: (D)

Opening balance sheet and adjustments required:

| | | | |
|--|--------------|-------------------------|--------------|
| | £ | | £ |
| Assets (cash) | 1,000 | Liabilities (capital) | 1,000 |
| Transaction 1 (stock) | 800 | Creditor | 800 |
| Transaction 2 (cash) | 1,175 | VAT owing | 175 |
| Stock | (400) | Profit (add to capital) | 600 |
| Closing balance | <u>2,575</u> | | <u>2,575</u> |
| Assets (£2,575) less liabilities (£975) = capital (£1,600) | | | |

1.10

| | |
|------------------------------|---------------|
| | £ |
| Capital at 1/4/97 | 6,500 |
| Add: Profit (after drawings) | 32,500 |
| Less VAT element | (70) |
| Capital at 31/5/98 | <u>38,930</u> |

1.11 Answer: (D)

| | | | |
|--------------------------|---------------|-------------------|----------------|
| Profit and loss account: | | Paid to employee: | |
| | £ | | £ |
| 36 × £3.50 | 126.00 | Gross pay | 126.00 |
| Employer's NI (10%) | <u>12.60</u> | 7% NI | (8.82) |
| Gross wages cost | <u>138.60</u> | Tax | <u>(10.20)</u> |
| | | Net pay | <u>106.98</u> |

1.12 The charge to the profit and loss account is £9,000 for 9 months' interest, at an annual rate of £12,000 (12 per cent of £100,000). The payment for the third quarter ending 30 September 1996 is not paid until 1 October 1996, so three months' interest is accrued, that is, £3,000.

1.13

| | | | |
|-------------|----------------------------------|--------------|-------------------------|
| Electricity | | | |
| | | £ | £ |
| | | | Balance b/f |
| 1999 | | | 300 |
| 1 Aug. | Paid bank | 600 | |
| 1 Nov. | Paid bank | 720 | |
| 2000 | | | |
| 1 Feb. | Paid bank | 900 | |
| 30 Jun. | Paid bank | 840 | |
| 30 Jun. | Accrual c/d £840 × $\frac{2}{3}$ | <u>560</u> | Profit and loss account |
| | | <u>3,620</u> | <u>3,320</u> |
| | | | <u>3,620</u> |

1.14

| Gas supplier | | | | | | | |
|--------------|----------------|--|--------------|---------|-------------|--|--------------|
| | | | £ | | | | £ |
| | Balance b/f | | 200 | | | | |
| | Bank £600 × 12 | | 7,200 | 28 Feb. | Invoice | | 1,300 |
| | | | | 31 May | Invoice | | 1,400 |
| | | | | 31 Aug. | Invoice | | 2,100 |
| | | | | 30 Nov. | Invoice | | 2,000 |
| | | | | 30 Nov. | Balance c/d | | 600 |
| | | | <u>7,400</u> | | | | <u>7,400</u> |

| Gas | | | | | | | |
|---------|---------|--|--------------|---------|--------------|--|--------------|
| | | | £ | | | | £ |
| 28 Feb. | Invoice | | 1,300 | | | | |
| 31 May | Invoice | | 1,400 | | | | |
| 31 Aug. | Invoice | | 2,100 | | | | |
| 30 Nov. | Invoice | | 2,000 | 30 Nov. | Profit and | | 6,800 |
| | | | <u>6,800</u> | | loss account | | <u>6,800</u> |

1.15 Answer: (C)

1.16 The charge for the salary in the profit and loss account is the gross salary plus the employer's National Insurance contribution. This is £1,000 plus £100, a total of £1,100.

1.17 Debit £1,000

1.18 Answer: (C)

1.19 P&L A/c £1,050; Balance Sheet £750; Prepayment

1.20 £12,000

1.21 £21,500

1.22 £17,000

1.23 £14,000



Solution 2

- Start by entering the balances brought forward at 1 July 20X5.
- Enter the transactions in chronological (i.e. date) order.
- Calculate the amounts to be carried forward for accrued and/or prepaid expenses at 30 June 20X6.
- Calculate the amounts to be transferred to the profit and loss account.
- Carry down the balances at 1 July 20X6.

| Rents, rates and insurance | | | | | | | |
|----------------------------|-----------------------|--|-----|--------|------------------|--|-----|
| 20X5 | | | £ | 20X5 | | | £ |
| 1 July | Insurance prepaid b/d | | 180 | 1 July | Rent accrued b/d | | 200 |
| | Rates prepaid b/d | | 150 | | | | |

| | | | | | |
|----------|------------------|--------------|---------|---------------------------|--------------|
| 10 Aug. | Rent paid | 300 | | | |
| 26 Oct. | Insurance paid | 600 | | | |
| 2 Nov. | Rates paid | 350 | | | |
| 12 Dec. | Rent paid | 400 | | | |
| 20X6 | | | 20X6 | | |
| 17 April | Rent paid | 400 | 30 June | Rent profit and loss | 1,200 |
| 9 May | Rates paid | 350 | | Rates profit and loss | 675 |
| 30 June | Rent accrued c/d | 300 | | Insurance profit and loss | 580 |
| | | | | Rates prepaid c/d | 175 |
| | | | | Insurance prepaid c/d | 200 |
| | | <u>3,030</u> | | | <u>3,030</u> |
| 20X5 | | £ | 20X5 | | £ |
| 1 July | b/d | 175 | 1 July | b/d | 300 |
| 1 July | b/d | 200 | | | |

You should note how the account shows the extent of any balance to be carried forward and also the amount transferred to the profit and loss account.

The three individual figures for the profit and loss account could be combined in a single figure of £2,455.

The balance sheet at 30 June would include the following figures:

| | |
|---------------------|-----|
| | £ |
| Current assets | |
| Rates prepaid | 175 |
| Insurance prepaid | 200 |
| Current liabilities | |
| Rent accrued | 300 |



Solution 3

- Remember that VAT on sales is owed to Customs and Excise, while VAT on purchases is refundable from Customs and Excise.
- Remember that VAT is not reclaimable on passenger cars.

(a)

| | | | |
|-------------------------|---------------|-------------------|---------------|
| VAT | | | |
| | £ | | £ |
| Purchases | 4,725 | Balance b/f | 3,250 |
| Administration expenses | 420 | Sales | 14,875 |
| Balance c/f | 15,072 | Purchases returns | 525 |
| | | VAT repayment | 1,567 |
| | <u>20,217</u> | | <u>20,217</u> |

(b)

| | | | |
|------------------|----------------|----------------|----------------|
| Bank | | | |
| | £ | | £ |
| Materials refund | 3,525 | Balance b/f | 6,250 |
| VAT repayment | 1,567 | Vehicle | 9,400 |
| Debtors | 125,000 | Admin expenses | 2,820 |
| | | Creditors | 42,000 |
| | | Balance c/f | 69,622 |
| | <u>130,092</u> | | <u>130,092</u> |

- (c) Major purpose is to check arithmetical accuracy of the double-entry system, i.e. each transaction has matching debit and credit entries. Total debit balances should equal total credit balances.
- (d) (A) 1
(B) 4
(C) 3
(D) 2



Solution 4

- Deal with each ledger account in turn.
- Enter the balances at 1 October 1995, using the correct side, as given in the question.
- Record the payments or receipts in chronological (i.e. date) order.
- Calculate the balance to be carried forward at the end of the period.
- Calculate the amount to be transferred to the profit and loss account.
- Bring down the balances at 1 October 1996.
- For part (b), accounting concepts are covered in more detail in Chapter 10.

(a)

| (i) Rent payable | | | | | |
|------------------|----------------|--------------|-------------|-------------------------|--------------|
| | | £ | | | £ |
| <i>1995</i> | | | | | |
| 1 Oct. | Prepayment b/d | 1,500 | | | |
| 30 Nov. | Bank | 1,500 | | | |
| <i>1996</i> | | | <i>1996</i> | | |
| 29 Feb. | Bank | 1,500 | 30 Sep. | Profit and loss account | 6,000 |
| 31 May | Bank | 1,500 | 30 Sep. | Prepayment c/d | 1,500 |
| 31 Aug. | Bank | <u>1,500</u> | | | |
| | | <u>7,500</u> | | | <u>7,500</u> |
| 1 Oct. | Prepayment b/d | 1,500 | | | |

| (ii) Electricity | | | | | |
|------------------|-------------|--------------|-------------|-------------------------|--------------|
| | | £ | | | £ |
| <i>1995</i> | | | <i>1995</i> | | |
| 5 Nov. | Bank | 1,000 | 1 Oct. | Accrual b/d | 800 |
| <i>1996</i> | | | <i>1996</i> | | |
| 10 Feb. | Bank | 1,300 | 30 Sep. | Profit and loss account | 5,000 |
| 8 May. | Bank | 1,500 | | | |
| 7 Aug. | Bank | 1,100 | | | |
| 30 Sep. | Accrual c/d | <u>900</u> | | | |
| | | <u>5,800</u> | | | <u>5,800</u> |
| | | | 1 Oct. | Accrual b/d | <u>900</u> |

| (iii) Interest receivable | | | | | |
|---------------------------|-------------------------|--------------|-------------|-------------|--------------|
| | | £ | | | £ |
| <i>1995</i> | | | <i>1995</i> | | |
| 1 Oct. | Accrual b/d | 300 | 2 Oct. | Bank | 250 |
| <i>1996</i> | | | <i>1996</i> | | |
| 30 Sep. | Profit and loss account | <u>850</u> | 30 Apr. | Bank | 600 |
| | | | 30 Sep. | Accrual c/d | <u>300</u> |
| | | <u>1,150</u> | | | <u>1,150</u> |
| 1 Oct. | Accrual b/d | <u>300</u> | | | |

| (iv) Provision for doubtful debts | | | | |
|-----------------------------------|-------------|--------------|-------------|--------------|
| | | £ | <i>1995</i> | |
| | | | 1 Oct. | Balance b/f |
| | | | | £ 4,800 |
| <i>1996</i> | | | <i>1996</i> | |
| 30 Sep. | Balance c/d | 6,250 | 30 Sep. | Profit and |
| | | <u>6,250</u> | | loss account |
| | | | | 1,450 |
| | | | 1 Oct. | Balance b/f |
| | | | | <u>6,250</u> |

(b) Concept 1 Accruals
 Concept 2 Prudence (conservatism)

| Ledger Account | Description | Balance Sheet Heading |
|------------------------------|----------------|-------------------------------------|
| Rent payable | prepayment | Current assets |
| Electricity | accrual | Current liabilities |
| Interest receivable | accrued income | Current assets |
| Provision for doubtful debts | provision | Current assets (netted off debtors) |

Accounting for Fixed Assets



LEARNING OUTCOMES

When you have completed this chapter, you should be able to:

- ▶ explain the concepts of capital and revenue;
- ▶ identify the basic methods of valuing assets on current cost, fair value and economic value bases and demonstrate their impact on profit measures and balance sheet values;
- ▶ explain and calculate the methods of depreciation including straight line, reducing balance and revaluation, and prepare accounts using each method;
- ▶ prepare a fixed-asset register.

6.1 Introduction

We have already learned that a fixed asset is a resource acquired by an organisation with the intention of using it to earn revenue for a long period of time. Examples of tangible fixed assets include land, buildings, motor vehicles, machinery and equipment. In this chapter we shall look at the important distinction between capital expenditure and revenue expenditure, where capital expenditure is defined as expenditure on fixed assets. We shall also learn about the concept of depreciation and how this is applied in practice. The chapter also looks at the sale of fixed assets and how fixed assets are controlled.

The chapter concludes with a brief discussion on another class of fixed assets known as 'intangible fixed assets'.

6.2 Capital and revenue expenditure

Capital expenditure is expenditure likely to increase the future earning capability of the organisation, whereas revenue expenditure is that associated with maintaining the organisation's present earning capability.

Thus, new items of plant and machinery that are bought from external manufacturers, vehicles, buildings and purchases of land are clearly capital expenditure to be included in

a balance sheet. However, when assets are internally manufactured or when existing assets are modified or repaired, it is sometimes difficult to determine whether the expenditure is of a capital or revenue nature. The general principle to be followed is that if the expenditure significantly improves earnings capability, then it is to be treated as capital expenditure. When making this comparison in the context of expenditure on repairs, it is necessary to consider the effects in relation to the position prior to the need for repair.

Example 6.A

Consider the situation where a computer is repaired by replacing a faulty floppy disk drive and a faulty hard drive. The replacement floppy disk drive is identical to that which it replaced. The faulty hard drive had a storage capacity of 500 megabytes, its replacement is a 5 gigabyte (i.e. 5,000 megabyte) unit. At the same time a CD-ROM drive is fitted. How should these 'repair' costs be classified?

Solution

The replacement of the faulty floppy disk drive with an identical unit is clearly a repair, and as such will be treated as an expense.

The fitting of the CD-ROM drive is clearly not a repair because the computer did not have a CD-ROM drive previously. This is an addition to the asset, which should be capitalised.

It is the cost of the hard disk drive that presents the classification problem. To the extent that it replaced the original hard drive it is a repair, but the new drive has ten times the capacity of the original. As it enhances the storage capacity of the computer it is capital expenditure. Thus this cost must be divided, part of it treated as an expense and the remainder as capital expenditure.

The distinction between capital and revenue expenditure is important because of the implications for the financial statements. Revenue expenditure will be reflected in full in the measurement of profit in the period in which it is incurred. In contrast, capital expenditure will be reflected in an increase in asset values in the balance sheet. This will diminish over the life of the asset as it is depreciated (see later), with a corresponding reduction in the profit reported.



Exercise 6.1

Explain briefly the difference between capital and revenue transactions.



Solution

Capital transactions are those affecting the long-term operations of the organisation. They might affect fixed assets, long-term borrowing, etc. Revenue transactions are those affecting the immediate future of the organisation. They might include the purchase or sale of stocks, the incurring of expenses such as wages, heat and light, etc.

Revenue transactions would also include the repair and maintenance of fixed assets, even though the initial purchase of those assets was a capital transaction. Expenditure that does not provide any additional benefit is classed as revenue.

Capital transactions would also include the cost of acquisition of fixed assets, such as legal fees, carriage and delivery, and installation costs. If the equipment needs to be tested prior to use, these costs can also be included.



Exercise 6.2

Classify each of the following transactions into capital or revenue transactions:

- Complete repaint of existing building.
- Installation of a new central heating system.

- Repainting of a delivery van.
- Providing drainage for a new piece of water-extraction equipment.
- Legal fees on the acquisition of land.
- Carriage costs on a replacement part for a piece of machinery.



Solution

- Complete repaint: revenue.
- Installation of new heating system: capital.
- Repainting van: revenue.
- Drainage for new equipment: capital.
- Legal fees on acquisition of land: capital.
- Carriage costs on replacement part: revenue.

6.3 Depreciation

The cost of the fixed asset will contribute to the organisation's ability to earn revenue for a number of accounting periods. It would be unfair if the whole cost were treated as an expense in the profit and loss account in the year of acquisition. Instead, the cost is spread over all of the accounting periods in which the asset is expected to be making a contribution to earnings (this is known as the asset's *useful economic life*). The process by which this is achieved is called *depreciation*.

We shall look at the calculation of depreciation in detail in the next section. For now, we shall just focus on the main principles.

- When we acquire a fixed asset, we credit cash (or creditors), and debit an account called 'fixed assets' or 'plant and machinery' or another suitable description.
- If we were to prepare a set of accounts immediately afterwards we would display the balance on the asset account – the cost of the asset – on the balance sheet. It would not appear as an expense in the profit and loss account at all, because we have not yet begun to 'consume' it in earning revenue.
- During the periods that the asset is in use – its useful economic life – we must allocate its original cost on some fair basis. An appropriate proportion of the cost must be recorded as an expense – called depreciation – in the profit and loss account of each period concerned.
- We achieve this by, in effect, changing the balance in the asset account. Each year we decide that some proportion of the original cost has now been 'consumed' in operating the business. This proportion is transferred to the profit and loss account, where it is shown as an expense, and the amount remaining on the balance sheet is correspondingly reduced. (This remaining balance is referred to as the *net book value* of the asset.)
- Eventually we reach a point where the whole of the original cost has been consumed and the net book value for the asset on the balance sheet has declined to zero (or perhaps to some small residual value that it may realise on disposal).

It is extremely important to understand this basic notion of depreciation as a means of allocating the cost of a fixed asset over a number of accounting periods. It has nothing whatever to do with 'valuing' the asset, in the sense of estimating what its market value might be at the end of each accounting period. Indeed, it is not likely, in general, that the

net book value of a fixed asset is anything like an approximation to its market value. Nor does depreciation have anything to do with providing a fund for replacing the fixed asset when it is consumed. The process of transferring amounts from balance sheet to profit and loss account each year does not in any sense generate funds for the business. It may indeed be desirable to plan ahead for asset replacement by setting aside cash for the purpose, but this is an exercise quite separate from the process of charging depreciation.



Exercise 6.3

Explain what you understand by the term 'depreciation'.



Solution

Depreciation is the measure of the wearing out, consumption or other loss of value of a fixed asset whether arising from use, effluxion of time or obsolescence through technology and market changes. In practice, it is usually taken as being the original cost of the asset spread over its estimated useful life. The cost is reduced by any expected residual value. The depreciation might be an equal amount every year (the straight-line basis) or might be a percentage of its opening value each year (the reducing-balance basis). There are other methods, including revaluation for small items.

The amount of depreciation each year is charged against the profits, and reduces the asset's book value. Depreciation is not a method of providing for the replacement of the asset, and no cash movement is involved.

6.4 Calculating depreciation

There are a number of methods that accountants use to depreciate a fixed asset. The two most common methods that are used will each be examined in this section of the chapter using the same basic information about a single fixed asset:

| | |
|--|----------|
| Cost – 1 January 20X5 | £50,000 |
| Estimated useful economic life | 10 years |
| Estimated scrap value at the end of its economic life (residual value) | £1,280 |

6.4.1 The straight-line method

This method allows an equal amount to be charged as depreciation to each accounting period over the expected useful life of the asset. If the depreciation charge were to be shown on a graph it would be a straight line parallel to the horizontal axis (hence the name of the method). The amount to be charged to each accounting period is given by the formula:



$$\text{Depreciation per annum} = \frac{\text{Original cost} - \text{estimated residual value}}{\text{Estimated useful economic life}}$$

Using the data above, the annual depreciation charge would be:

$$\frac{£50,000 - £1,280}{10} = £4,872$$

The effect of the above would be that the net book value of the asset shown in the organisation's balance sheet would be reduced by £4,872 each year. The corresponding effect would be to reduce profits by the cost of the loss in value of the asset by the same amount.

The ledger entries to record the depreciation are:

- credit a provision for depreciation account;
- debit the profit and loss account with the annual depreciation.

As each year passes, the balance on the provision for depreciation account will increase, as follows:

| Provision for depreciation | | | |
|----------------------------|------------|-----------------------------|--------|
| | | £ | |
| | 31 Dec.X5 | Profit and loss a/c | 4,872 |
| | 31 Dec. X6 | Profit and loss a/c Balance | 4,872 |
| | | | 9,744 |
| | 31 Dec. X7 | Profit and loss a/c Balance | 4,872 |
| | | | 14,616 |

and the asset would be shown on the balance sheet as follows:

| | <i>Cost</i> | <i>Accumulated depreciation</i> | <i>Net book value</i> |
|-----------------------------|-------------|---------------------------------|-----------------------|
| (31 Dec. 20X5) fixed assets | £50,000 | £4,872 | £45,128 |
| (31 Dec. 20X6) fixed assets | £50,000 | £9,744 | £40,256 |
| (31 Dec. 20X7) fixed assets | £50,000 | £14,616 | £35,384 |

The example above shows the depreciation account in respect of the single asset used in the example; however, each asset would not normally have a separate ledger account. While it is necessary to calculate the depreciation of each asset separately, it is usual for the ledger accounts to summarise the depreciation charge and provision for depreciation in respect of different categories of assets such as buildings, motor vehicles, and plant and equipment.

6.4.2 The reducing-balance method



Some assets give a greater service – and therefore depreciate more – in their early years than they do in later years. For this reason, it is considered sensible to charge a higher amount of depreciation in the earlier years. This method of depreciation is known as the reducing-balance method. With this method a constant percentage is applied to the cost not yet treated as an expense at the end of the previous accounting period. This results in the depreciation charged as an expense being greater in the earlier years of an asset's life than in the later years.

This can be illustrated using the data from the previous example.

The first step is to calculate the percentage to be used. This is done using a mathematical formula that you are not required to know. In this case, the annual depreciation

rate works out as 30.7 per cent. For the purposes of illustration this will be rounded up to 31 per cent.

| | | |
|---------------------|---------------|-----------------|
| | £ | |
| Original cost | 50,000 | |
| Year 1 depreciation | 15,500 | (31% of 50,000) |
| | <u>34,500</u> | |
| Year 2 depreciation | 10,695 | (31% of 34,500) |
| | <u>23,805</u> | |
| Year 3 depreciation | 7,380 | (31% of 23,805) |
| | <u>16,425</u> | |

At the end of the asset's useful economic life the remaining value should equal its estimated scrap value of £1,280 subject to any difference caused by rounding the percentage to be used for the amounts of annual depreciation.

The double-entry bookkeeping will be the same in principle as that illustrated earlier for the straight-line method. Clearly, though, the amount charged as an expense and the corresponding reduction in the value of the asset will be different depending on the method of depreciation used, until the end of the asset's useful economic life.



Exercise 6.4

A machine is purchased on 1 May 1999 for £1000 cash. The financial year ends on 30 April each year.

Show the account or accounts in the ledger for the first 3 years assuming that the machine is depreciated by 20 per cent per annum on the reducing-balance method.

Profit and loss and balance sheet entries are not required.



Solution

| Machine at cost | | | | | |
|---|-------------|------------|-------------|-------------------------|------------|
| <i>1999</i> | | £ | | | |
| 1 May | Cash | 1,000 | | | |
| Provision for depreciation of machinery | | | | | |
| <i>2000</i> | | £ | <i>2000</i> | | £ |
| 30 Apr. | Balance c/f | <u>200</u> | 30 Apr. | Profit and loss account | <u>200</u> |
| | | | 1 May | Balance b/f | <u>200</u> |
| <i>2001</i> | | £ | <i>2001</i> | | £ |
| 30 Apr. | Balance c/f | <u>360</u> | 30 Apr. | Profit and loss account | <u>160</u> |
| | | <u>360</u> | | | <u>360</u> |
| | | | 1 May | Balance b/f | <u>360</u> |
| <i>2002</i> | | £ | <i>2002</i> | | £ |
| 30 Apr. | Balance c/f | <u>488</u> | 30 April | Profit and loss account | <u>128</u> |
| | | <u>488</u> | | | <u>488</u> |

6.4.3 The machine-hour method (rate of usage method)



Some fixed assets depreciate according to their usage. If the asset has a measurable 'life' in terms of the number of hours it is likely to be used, or the number of units of output it is likely to produce, it can be depreciated according to that rate.

For example, a computer printer might have an expected total output of 50,000 sheets. If it produces 10,000 sheets in a year, it can be said to have used up one-fifth of its cost in that year.

6.4.4 The revaluation method

This method of calculating depreciation differs from the straight-line and reducing-balance methods explained above by not being a calculation based on the original cost of the asset. Instead, the method relies on a valuation being made in respect of a group of similar small-value assets when preparing the accounting statements. The following example illustrates the principles involved.

Example 6.B

On 1 January 20X1, X commenced trading as a mobile mechanic, introducing small tools valued at £2,400 as part of the opening capital. During the year, small tools costing £980 were purchased. On 31 December 20X1, X valued the small tools at £3,150.

Using the revaluation method, the depreciation charge for the year is:

| | |
|-------------------------------|----------------|
| | £ |
| Opening valuation | 2,400 |
| Add: additional items costing | 980 |
| | <u>3,380</u> |
| Closing valuation | <u>(3,150)</u> |
| Depreciation | <u>230</u> |

This depreciation charge of £230 represents the total loss in value of 'fixed asset: small tools' in the period. If there had been any disposals during the year for which sale proceeds were received, the proceeds received would have been deducted in the above calculation.

6.4.5 Depreciation in the year of acquisition and disposal

Fixed assets are acquired at various dates throughout the year so, strictly speaking, if the asset has been owned for only part of a year, only that proportion of the annual depreciation should be provided for. This is known as depreciation on an 'actual time basis'. Conversely, when the asset is sold, only a proportion of the final year's depreciation should be charged.

However, it is common for organisations to charge a full year's depreciation in the year of acquisition, irrespective of the date of purchase, and to charge none in the year of disposal.

6.5 Accounting for the disposal of a fixed asset



At the end of the asset's life it will be either scrapped or sold. This is known as a 'disposal' in accounting terminology. At this time a comparison is made of the difference between the net book value of the asset at the date of its disposal and the proceeds received (if any). The difference is referred to as the *profit or loss arising on the*

disposal of the asset. It effectively represents the extent to which the depreciation charged during the life of the asset was incorrect.

If the proceeds received on disposal are less than the net book value at that date the difference is a loss on disposal, which is treated as an expense when calculating the organisation's profitability.

The following example will be used to show the calculation of the profit or loss arising on the disposal of an asset.

Example 6.C

X purchased a van on 1 January 20X5 for £10,000. He estimated that its resale value on 31 December 20Y0 after six years' use would be £400, and depreciated it on a straight-line basis. He sold it on 30 June 20X7 for £5,500.

The amount of depreciation to be charged each year was:

$$\frac{\text{Original cost} - \text{estimated residual value}}{\text{Estimated useful economic life}} = \frac{£10,000 - £400}{6} = £1,600$$

X owned the asset for 2 years and 6 months, thus the total depreciation charged since acquisition is $£1,600 \times 2.5 = £4,000$. This means that the net book value at the date of the disposal was $£10,000 - £4,000 = £6,000$.

Since the sale proceeds only amounted to £5,500 there has been a 'loss on disposal' of £500.

When there has been a disposal of an asset, entries must be made in the ledger accounts of the organisation so as to remove the original cost and accumulated depreciation of the asset disposed of. This is so that the balance on these accounts only relates to the assets owned by the business at that date. The bookkeeping entries related to this example are as follows:

| Van at cost | | | | | |
|----------------------------------|-------------|--------|---------|-----------------------------------|--------|
| | | £ | | | £ |
| 20X5 | | | 20X7 | | |
| 1 Jan. | Bank | 10,000 | 30 Jun. | Disposal | 10,000 |
| Provision for depreciation – van | | | | | |
| | | £ | 20X5 | | £ |
| | | | 31 Dec. | Depreciation | 1,600 |
| | | | 20X6 | | |
| | | | 31 Dec. | Depreciation | 1,600 |
| 20X7 | | | 20X7 | | |
| 30 Jun. | Disposal | 4,000 | 30 Jun. | Depreciation | 800 |
| | | 4,000 | | | 4,000 |
| Fixed asset disposal – van | | | | | |
| 20X7 | | £ | 20X7 | | £ |
| 30 Jun. | Van at cost | 10,000 | 30 Jun. | Provision for depreciation – van | 4,000 |
| | | | | Bank | 5,500 |
| | | 10,000 | | Loss (to profit and loss account) | 500 |
| | | | | | 10,000 |



Exercise 6.5

Write up the relevant accounts for a fixed asset that was purchased on 23 March 20X1 for £3,500. Its residual value is expected to be £200, and its expected useful life is 4 years. The

asset is sold on 18 January 20X4 for £1,300. A full year's depreciation is to be charged in the year of purchase. The organisation's year end is 31 December.



Solution

| Fixed assets at cost | | | | | |
|----------------------------|--------------------|--------------|---------|-------------------------|--------------|
| 20X1 | | £ | 20X4 | | £ |
| 23 Mar. | Cash | 3,500 | 18 Jan. | Disposals | 3,500 |
| Provision for depreciation | | | | | |
| | | £ | 20X1 | | £ |
| | | | 31 Dec. | Profit and loss account | 825 |
| | | | 20X2 | | |
| | | | 31 Dec. | Profit and loss account | 825 |
| 20X4 | | | 20X3 | | |
| 18 Jan. | Disposals a/c | 2,475 | 31 Dec. | Profit and loss account | 825 |
| | | <u>2,475</u> | | | <u>2,475</u> |
| Fixed-asset disposals | | | | | |
| 20X4 | | £ | 20X4 | | £ |
| 18 Jan. | Cost | 3,500 | 18 Jan. | Depreciation | 2,475 |
| 31 Dec. | Profit on disposal | 275 | | Proceeds | 1,300 |
| | | <u>3,775</u> | | | <u>3,775</u> |

6.6 A comprehensive example

A business bought the following machines:

- Machine A on 3 February 20X1, costing £1,000,
- Machine B on 18 March 20X2, costing £1,200,
- Machine C on 27 June 20X3, costing £2,000.

None of the machines has any expected residual value, and all are depreciated on the straight-line basis over 10 years, with a full year's depreciation in the year of purchase. Machine A is sold for £720 on 30 June 20X4. The business's year end is 31 December.

Annual depreciation is:

- Machine A £100,
- Machine B £120,
- Machine C £200.

Because there are three machines bought at different times, it is a good idea to tabulate the depreciation as follows:

| Year | Machine A | Machine B | Machine C | Total |
|------|-----------|-----------|-----------|-------|
| | £ | £ | £ | £ |
| 20X1 | 100 | Nil | Nil | 100 |
| 20X2 | 100 | 120 | Nil | 220 |
| 20X3 | 100 | 120 | 200 | 420 |
| 20X4 | Nil | 120 | 200 | 320 |

The total column gives the depreciation to be charged each year. Remember to dispose of machine A in 20X4. The ledger accounts are as follows:

| Machines at cost | | | | | |
|------------------|-------------|--------------|-------------|---------------|--------------|
| <i>20X1</i> | | £ | <i>20X1</i> | | £ |
| 3 Feb. | Cash | <u>1,000</u> | 31 Dec. | Balance c/d | <u>1,000</u> |
| <i>20X2</i> | | | <i>20X2</i> | | |
| 1 Jan. | Balance b/d | 1,000 | | | |
| 18 Mar. | Cash | <u>1,200</u> | 31 Dec. | Balance c/d | <u>2,200</u> |
| | | <u>2,200</u> | | | <u>2,200</u> |
| <i>20X3</i> | | | <i>20X3</i> | | |
| 1 Jan. | Balance b/d | 2,200 | | | |
| 27 Jun. | Cash | <u>2,000</u> | 31 Dec. | Balance c/d | <u>4,200</u> |
| | | <u>4,200</u> | | | <u>4,200</u> |
| <i>20X4</i> | | | <i>20X4</i> | | |
| 1 Jan. | Balance b/d | 4,200 | 30 Jun. | Disposals a/c | 1,000 |
| | | <u>4,200</u> | 31 Dec. | Balance c/d | <u>3,200</u> |
| | | | | | <u>4,200</u> |
| <i>20X5</i> | | | | | |
| 1 Jan. | Balance b/d | 3,200 | | | |

| Provision for depreciation on machines | | | | | |
|--|---------------|--------------|-------------|-------------------------|--------------|
| <i>20X1</i> | | £ | <i>20X1</i> | | £ |
| 31 Dec. | Balance c/d | <u>100</u> | 31 Dec. | Profit and loss account | <u>100</u> |
| <i>20X2</i> | | | <i>20X2</i> | | |
| 31 Dec. | Balance c/d | <u>320</u> | 1 Jan. | Balance b/d | 100 |
| | | <u>320</u> | 31 Dec. | Profit and loss account | <u>220</u> |
| | | | | | <u>320</u> |
| <i>20X3</i> | | | <i>20X3</i> | | |
| 31 Dec. | Balance c/d | <u>740</u> | 1 Jan. | Balance b/d | 320 |
| | | <u>740</u> | 31 Dec. | Profit and loss account | <u>420</u> |
| | | | | | <u>740</u> |
| <i>20X4</i> | | | <i>20X4</i> | | |
| 30 Jun. | Disposals a/c | 300 | 1 Jan. | Balance b/d | 740 |
| 31 Dec. | Balance c/d | <u>760</u> | 31 Dec. | Profit and loss account | <u>320</u> |
| | | <u>1,060</u> | | | <u>1,060</u> |
| <i>20X5</i> | | | <i>20X5</i> | | |
| | | | 1 Jan. | Balance b/d | 760 |

| Fixed-asset disposals | | | | | |
|-----------------------|-------------------------|--------------|-------------|----------------------------|--------------|
| <i>20X4</i> | | £ | <i>20X4</i> | | £ |
| 30 Jun. | Machines at cost | 1,000 | 30 Jun. | Provision for depreciation | 300 |
| 31 Dec. | Profit and loss account | <u>20</u> | 30 Jun. | Cash | <u>720</u> |
| | | <u>1,020</u> | | | <u>1,020</u> |

The profit on disposal is credited to the profit and loss account.

6.7 Controlling tangible fixed assets

Most organisations will own a number of fixed assets and in large organisations their control is vital to the efficient running of the organisation. Management will need to be aware of:

1. the location of each asset;
2. the extent to which it is being used;
3. the repairs that have been carried out on the asset and the cost of those repairs;
4. the expiry dates of any licences permitting the organisation to use the asset.

In addition, for accounting purposes, the following information is required:

1. the date of purchase;
2. the name and address of the asset's supplier;
3. the cost of the asset;
4. the estimated useful economic life of the asset;
5. the estimated scrap or resale value of the asset at the end of its useful economic life;
6. a description of the asset;
7. a code number for the asset so that it can be found easily on a computerised system;
8. the method of depreciation to be used for the asset;
9. whether any government grants have been obtained to assist in the purchase of the asset;
10. the accumulated depreciation of the asset;
11. details of the disposal of the asset when it has occurred.

This information is normally recorded in a *fixed-asset register*. The efficiency of the organisation can be greatly improved if the register is stored on a computer. Specialist computer packages exist for the recording of an organisation's fixed assets, but much the same effect can be obtained by using a database program, particularly in smaller organisations or where the information is recorded within each department.

In the context of a fixed-asset register, each asset would be given a code number. There would be a separate record on the computer file for each fixed asset, and within each record there would be a field for each data item to be recorded. The asset code would normally be used as the key field so that the record of any particular asset could be located easily.

The use of a computerised fixed-asset register would allow the calculation of depreciation to be automated and various reports could be produced showing, for example:

- the depreciation charge for the accounting period analysed by asset and by department as required;
- a list of assets requiring servicing;
- a list of assets at a particular location;
- the extent of any repair expenditure on each asset;
- a list of assets continuing in use beyond their estimated useful economic life.

The use of a computerised system greatly improves the speed and accuracy of reporting and allows management to design different reports specific to their needs. These needs will vary for different managers and the use of a computerised system means that the basic data needs to be entered only once, and the computer can then sort it in different ways in order to produce the report required.



Exercise 6.6

List the information that might be contained in a fixed-asset register.



Solution

The information that might be contained in a fixed-asset register is:

- description of asset;
- date of purchase;

- name of supplier;
- cost of asset;
- asset code number;
- location;
- estimated useful life;
- estimated residual value;
- method of depreciation;
- depreciation to date;
- current net book value;
- insurance details;
- maintenance details, for example, regular servicing;
- major amendments/refinements;
- disposal details (when disposed of).

6.8 Accounting for intangible fixed assets

An *intangible asset*: An asset that does not have a physical identity, for example trademarks and patents.

Assets of this type, although regarded as fixed assets for accounting purposes in the same way as are plant and equipment, are different because they cannot be touched. They do have a value, however. Examples of intangible assets include brands. A brand is a name given by an organisation to one of its products and which is used in the marketing of that product. For this reason, brand names are often more well known than the name of the organisation making the product. This familiarity may lead to customer brand loyalty, which will result in future sales. Clearly, this is valuable to the organisation and many regard it as an asset, either in its own right or as part of *goodwill*.

6.8.1 What is goodwill?



Goodwill: The difference between the value of a business as a whole and the aggregate of the fair values of the separable net assets.

This implies that it is not possible to identify it separately from the business, and this is largely because it is an intangible asset.

The definition above explains that goodwill is the value placed upon a business in excess of the sum of its individual assets; thus goodwill represents the value of the business continuing as a going concern, as compared with its assets being sold individually. However, it could be said to be more than that. All established businesses have some goodwill. Goodwill comprises business contacts, good staff relations, the right to occupy certain pieces of land, and so on. All of these have a value – the difficulty lies in placing a value on them.

Purchased and non-purchased goodwill

When a business first starts, it is either created by its owners or it is purchased from an existing business. In the latter case there will have been a certain amount of negotiation

over the purchase price. The vendors will obviously seek to obtain the highest price possible, whereas the purchaser will seek to minimise the price. It is likely, however, that the final price will be greater than the purchaser's valuation of the tangible assets taken over. This is accepted because the price includes the rights to the existing business's customer base, possibly its name, its staff, and their experience and expertise, etc. This difference is the goodwill and, more precisely, is said to be *purchased goodwill*.

However, whether the business is created anew or is the result of the acquisition of another business, new goodwill is earned or created by the new owners over a period of time. This is known as *non-purchased goodwill*.

Accounting treatment

The accounting treatment of purchased goodwill is for the purchaser to place a fair value on the net tangible assets of the business acquired and to consider the difference between the sum of these values and the total purchase price to be goodwill. However, as the new owners work in the business, the goodwill that was purchased diminishes and is replaced by the goodwill created by the new owners. It is therefore appropriate to *amortise* (i.e. write off) the cost of the purchased goodwill over the early periods of the new ownership, in the same manner in which depreciation is treated.

Example 6.D

X Ltd has recently acquired the assets and liabilities of A Ltd for £1,500,000. The assets and liabilities acquired were valued by X Ltd as follows:

| | |
|---------------------|------------------|
| | £ |
| Land and buildings | 750,000 |
| Plant and equipment | 240,000 |
| Stock | 65,000 |
| Debtors | 38,000 |
| Creditors | (41,000) |
| | <u>1,052,000</u> |

The difference between the sum of the individual assets and the purchase price is goodwill. In this example the value of goodwill is £448,000. X Ltd decides to write off this purchased goodwill against profits over the first four years of ownership. The annual amortisation charged will be £448,000/4, or £112,000.

Recent guidelines suggest that it would be wrong to recognise non-purchased goodwill in the accounts as its value would be subjective judgement. This area is one that is subject to considerable debate within the accounting profession.

6.9 Summary

In this chapter, we have looked at the accounting issues associated with fixed assets. These issues can be summarised as:

- the classification of expenditure as capital or revenue;
- the allocation of fixed asset cost to accounting periods using depreciation;
- accounting entries to record the acquisition, depreciation and disposal of fixed assets;
- the control of tangible fixed assets;
- accounting for intangible fixed assets, such as purchased goodwill.

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Revision Questions

6



Question 1 Multiple choice

- 1.1 A fixed-asset register showed a net book value of £67,460. A fixed asset costing £15,000 had been sold for £4,000, making a loss on disposal of £1,250. No entries had been made in the fixed-asset register for this disposal. The balance on the fixed-asset register is:
- (A) £42,710
(B) £51,210
(C) £53,710
(D) £62,210
- 1.2 Your firm bought a machine for £5,000 on 1 January 1991, which had an expected useful life of four years and an expected residual value of £1,000; the asset was to be depreciated on the straight-line basis. On 31 December 1993, the machine was sold for £1,600. The amount to be entered in the 1993 profit and loss account for profit or loss on disposal is:
£.....
- 1.3 An organisation's fixed-asset register shows a net book value of £125,600. The fixed-asset account in the nominal ledger shows a net book value of £135,600. The difference could be due to a disposed asset not having been deducted from the fixed-asset register:
- (A) with disposal proceeds of £15,000 and a profit on disposal of £5,000.
(B) with disposal proceeds of £15,000 and a net book value of £5,000.
(C) with disposal proceeds of £15,000 and a loss on disposal of £5,000.
(D) with disposal proceeds of £5,000 and a net book value of £5,000.
- 1.4 A fixed asset costing £12,500 was sold at a book loss of £4,500. Depreciation had been provided using the reducing balance, at 20 per cent per annum since its purchase. Which of the following correctly describes the sale proceeds and length of time for which the asset had been owned?

| | <i>Sale proceeds</i> | <i>Length of ownership</i> |
|---|----------------------|----------------------------|
| A | Cannot be calculated | Cannot be calculated |
| B | Cannot be calculated | 2 years |
| C | £8,000 | Cannot be calculated |
| D | £8,000 | 2 years |

- 1.5 A machine cost £9,000. It has an expected useful life of six years, and an expected residual value of £1,000. It is to be depreciated at 30 per cent per annum on the reducing-balance basis. A full year's depreciation is charged in the year of purchase, with none in the year of sale. During year 4, it is sold for £3,000. The profit or loss on disposal is:
£
- 1.6 The most appropriate definition of depreciation is:
- (A) a means of determining the decrease in market value of an asset over time.
 - (B) a means of allocating the cost of an asset over a number of accounting periods.
 - (C) a means of setting funds aside for the replacement of the asset.
 - (D) a means of estimating the current value of the asset.
- 1.7 A fixed asset was disposed of for £2,200 during the last accounting year. It had been purchased exactly 3 years earlier for £5,000, with an expected residual value of £500, and had been depreciated on the reducing-balance basis, at 20 per cent per annum. The profit or loss on disposal was:
£
- 1.8 The purpose of charging depreciation on fixed assets is:
- (A) to put money aside to replace the assets when required.
 - (B) to show the assets in the balance sheet at their current market value.
 - (C) to ensure that the profit is not understated.
 - (D) to spread the net cost of the assets over their estimated useful life.
- 1.9 The phrase 'net book value' when applied to fixed assets means that:
- (A) the assets are shown in the balance sheet at their original cost.
 - (B) the assets are valued at their likely selling price.
 - (C) the assets have been depreciated using the reducing-balance method.
 - (D) the assets are shown in the balance sheet at their cost less accumulated depreciation.
- 1.10 Which of the following statements regarding goodwill is *not* correct?
- (A) Goodwill is classed as an intangible fixed asset.
 - (B) Goodwill is the excess of the value of a business as a whole over the fair value of its separable net assets.
 - (C) Purchased goodwill may be shown on the balance sheet and amortised over a period of time.
 - (D) Non-purchased goodwill is a liability.
- 1.11 W Ltd bought a new printing machine from abroad. The cost of the machine was £80,000. The installation costs were £5,000 and the employees received specific training on how to use this particular machine, at a cost of £2,000. Before using the machine to print customers' orders, a test was undertaken and the paper and ink cost £1,000. What should be the cost of the machine in the company's balance sheet?
£

1.12 A car was purchased by a newsagent business in May 1997 for:

| | |
|----------|---------------|
| | £ |
| Cost | 10,000 |
| Road tax | 150 |
| Total | <u>10,150</u> |

The business adopts a date of 31 December as its year end.

The car was traded in for a replacement vehicle in August 2000 at an agreed value of £5,000.

It has been depreciated at 25 per cent per annum on the reducing-balance method, charging a full year's depreciation in the year of purchase and none in the year of sale.

What was the profit or loss on disposal of the vehicle during the year ended December 2000?

£

1.13 The net book value of a company's fixed assets was £200,000 at 1 August 1999. During the year ended 31 July 2000, the company sold fixed assets for £25,000 on which it made a loss of £5,000. The depreciation charge for the year was £20,000. What was the net book value of fixed assets at 31 July 2000?

£

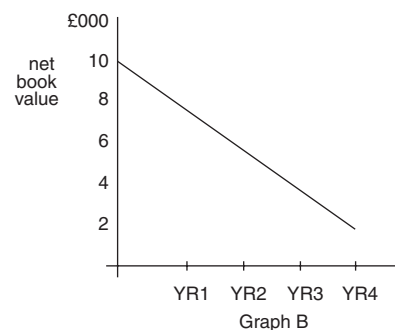
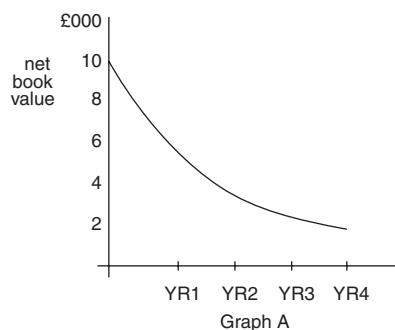
1.14 Which one of the following should be accounted for as capital expenditure?

- (A) The cost of painting a building.
- (B) The replacement of windows in a building.
- (C) The purchase of a car by a garage for resale.
- (D) Legal fees incurred on the purchase of a building.

1.15 A car was purchased for £12,000 on 1 April 1997 and has been depreciated at 20 per cent each year, straight line, assuming no residual value. The company policy is to charge a full year's depreciation in the year of purchase and no depreciation in the year of sale. The car was traded in for a replacement vehicle on 1 August 2000 for an agreed figure of £5,000. What was the profit or loss on the disposal of the vehicle for the year ended 31 December 2000?

£

1.16 Which of these two graphs illustrate the straight-line method of depreciation and the reducing-balance method?



| | |
|---------|--|
| Graph A | |
| Graph B | |

1.17 A fixed-asset register is:

- (A) an alternative name for the fixed-asset ledger account.
- (B) a list of the physical fixed assets rather than their financial cost.
- (C) a schedule of planned maintenance of fixed assets for use by the plant engineer.
- (D) a schedule of the cost and other information about each individual fixed asset.



Question 2

ABC Ltd had the following balances on its motor vehicles accounts at 30 September 1990:

| | | |
|--|-----------|--|
| | \pounds | |
| Motor vehicles at cost | 10,000 | |
| Provision for depreciation of motor vehicles | 4,000 | |

During the year to 30 September 1991, the following transactions occurred:

| | |
|-----------------|--|
| 31 January 1991 | Bought a motor van (plant number MV11) costing $\pounds 9,000$ |
| 24 April 1991 | Sold a motor van (plant number MV05) for $\pounds 500$, which had originally cost $\pounds 4,000$ in January 1988 |

During the year to 30 September 1992, the following transactions occurred:

| | |
|------------------|---|
| 20 February 1992 | Bought a motor van (plant number MV12) costing $\pounds 12,000$ |
| 31 August 1992 | Traded-in van bought on 31 January 1991 (plant number MV11) for a new van (plant number MV13) costing $\pounds 14,000$. The trade-in allowance was $\pounds 7,400$ |

ABC Ltd provides for depreciation on its motor vehicles at a rate of 25 per cent per annum using the reducing-balance method. It is company policy to make a full year's charge against all assets held at the end of its financial year (30 September).

Requirements

Insert the missing figures into the ledger accounts below to record the above transactions, showing the values that will be transferred to the company's profit and loss account and balance sheet at the end of each of the financial years to 30 September 1991 and 1992.

| Motor vehicles at cost | | | | | |
|------------------------|-------------|-----------|----------|-------------|-----------|
| | | \pounds | | | \pounds |
| 1.10.90 | Balance b/d | █ | 24.04.91 | Disposal | █ |
| 31.01.91 | Bank | █ | 30.09.91 | Balance c/d | █ |
| | | █ | | | █ |
| 1.10.91 | Balance b/d | █ | 31.08.92 | Disposal | █ |
| 20.02.92 | Bank | █ | | | |
| 31.08.92 | Bank | █ | | | |
| | Disposal | █ | 30.09.92 | Balance c/d | █ |
| | | █ | | | █ |
| 1.10.92 | Balance b/d | █ | | | |

| Motor vehicles – depreciation | | | | | |
|-------------------------------|-------------|---|----------|--------------------|---|
| | | £ | | | £ |
| 24.04.91 | Disposal W1 | | 1.10.90 | Balance b/d | |
| 30.09.91 | Balance c/d | | 30.09.91 | Profit and loss W2 | |
| | | | | | |
| 31.08.92 | Disposal W3 | | 1.10.91 | Balance b/d | |
| 30.09.92 | Balance c/d | | 30.09.92 | Profit and loss W4 | |
| | | | | | |
| | | | 1.10.92 | Balance b/d | |

| Workings | | | | | | |
|----------|--------------------------------------|---|---|---|---|---|
| | | £ | | % | = | £ |
| W1 | Year ended 30 September 1988 | | × | | = | |
| | Year ended 30 September 1989 | | × | | = | |
| | Year ended 30 September 1990 | | × | | = | |
| | Total | | | | | |
| W2 | Depreciation y/e 30.09.91 | | × | | = | |
| W3 | Depreciation (disposal) y/e 30.09.92 | | × | | = | |
| W4 | Depreciation y/e 30.09.92 | | × | | = | |

| Motor vehicles – disposal | | | | | |
|---------------------------|---------------------|---|----------|-------------------------------|---|
| | | £ | | | £ |
| 24.04.91 | Motor vehicles cost | | 24.04.91 | Motor vehicles – depreciation | |
| | | | | Bank | |
| | | | 30.09.91 | Profit and loss | |
| | | | | | |
| 31.08.92 | Motor vehicle cost | | 31.08.92 | Motor vehicle – depreciation | |
| 30.09.92 | Profit and loss | | | Motor vehicle cost | |
| | | | | | |

Question 3

ABC Ltd prepares accounts to 31 December each year. On 1 January 1990 it had the following balances on its fixed-assets accounts:

| | Debit £ | Credit £ |
|------------------------------------|------------|-------------|
| Motor vehicles at cost | 15,000 | |
| Plant and equipment at cost | 24,000 | |
| Motor vehicles – depreciation | | 9,000 |
| Plant and equipment – depreciation | | 10,500 |

During the year to 31 December 1990 the following transactions took place:

- (i) purchased a new machine on 1 February at a cost of £7,500;
- (ii) installed office equipment in its office building on 14 March at a cost of £11,500;
- (iii) sold equipment on 1 April for £2,000. It had originally been purchased on 1 January 1986 for £5,600;
- (iv) sold a motor vehicle on 31 July for £3,400 that had been purchased on 1 August 1987 for £9,400 including £100 road tax, and £300 warranty against mechanical defects for two years;
- (v) purchased a motor vehicle on 1 August for £10,000 including £500 delivery, £100 road tax and £400 extended warranty against mechanical defects for three years;
- (vi) carried out major repairs to some equipment on 1 October costing £15,000. This included a new motor costing £5,000, which increased the efficiency of the equipment by 200 per cent.

The company provides a full year's depreciation on fixed assets held at the end of each year using the following methods and rates:

| | |
|---------------------|---------------------------------|
| Motor vehicles | 25% per annum, reducing balance |
| Plant and equipment | 20% per annum, straight line |

Requirements

- (a) Insert the missing figures for the transactions numbered (i)–(vi) above in the ledger accounts of ABC Ltd and provide depreciation as appropriate for the year ended 31 December 1990.
- (b) Insert the missing figures in the extract from the profit and loss account for the year ended 31 December 1990 in respect of the above transactions.

(a)

| Motor vehicles at cost | | | | | |
|-----------------------------|---|---|---|---|---|
| | | £ | | | £ |
| █ | █ | █ | █ | █ | █ |
| █ | █ | █ | █ | █ | █ |
| | | █ | | | █ |
| █ | █ | █ | | | █ |
| | | █ | | | █ |
| Motor vehicles expenses | | | | | |
| | | £ | | | £ |
| █ | █ | █ | █ | █ | █ |
| █ | █ | █ | █ | █ | █ |
| | | █ | | | █ |
| █ | █ | █ | | | █ |
| | | █ | | | █ |
| Plant and equipment at cost | | | | | |
| | | £ | | | £ |
| █ | █ | █ | █ | █ | █ |
| █ | █ | █ | █ | █ | █ |
| █ | █ | █ | █ | █ | █ |
| █ | █ | █ | █ | █ | █ |
| | | █ | | | █ |
| █ | █ | █ | | | █ |
| | | █ | | | █ |

| Repairs and maintenance | | | | | |
|------------------------------------|---|---|---|---|---|
| | | £ | | | £ |
| █ | █ | █ | █ | █ | █ |
| | | | | | |
| Motor vehicles – depreciation | | | | | |
| | | £ | | | £ |
| █ | █ | █ | █ | █ | █ |
| █ | █ | █ | █ | █ | █ |
| | | █ | █ | █ | █ |
| | | | | | |
| Plant and equipment – depreciation | | | | | |
| | | £ | | | £ |
| █ | █ | █ | █ | █ | █ |
| █ | █ | █ | █ | █ | █ |
| | | █ | █ | █ | █ |
| | | | | | |
| Plant and equipment – disposal | | | | | |
| | | £ | | | £ |
| █ | █ | █ | █ | █ | █ |
| █ | █ | █ | █ | █ | █ |
| | | █ | █ | █ | █ |
| | | | | | |
| Motor vehicles – disposal | | | | | |
| | | £ | | | £ |
| █ | █ | █ | █ | █ | █ |
| | | █ | █ | █ | █ |
| | | | | | |

(b) Profit and loss extract – year ended December 1990

| | £ |
|---|---|
| █ | █ |
| █ | █ |
| █ | █ |
| █ | █ |
| █ | █ |

Question 4

SBJ’s fixed-asset register gives the cost and depreciation to date for every fixed asset held by the company. Prior to charging depreciation for 1994, the total net book value of all fixed assets on the register at 31 December 1994 was £147,500. At the same date, the fixed-asset accounts in the nominal ledger showed the following balances:

| | Cost to date (£) | Depreciation (£) |
|---------------------|---------------------|---------------------|
| Motor vehicles | 48,000 | 12,000 |
| Plant and machinery | 120,000 | 30,000 |
| Office equipment | 27,500 | 7,500 |

You are told that:

- (i) An item of plant costing £30,000 has been sold for £23,500 during 1994. The loss on disposal was £800. No entries have been made for this disposal in the nominal ledger, but the asset has been removed from the fixed-asset register.
- (ii) A motor car was purchased on 1 October 1994 and correctly recorded in the nominal ledger. Its cost was as follows:

| | |
|---------------------------------|---------------|
| List price of vehicle | £24,000 |
| Trade discount | 20% |
| VAT added at 17.5% | |
| Insurance | £360 |
| Vehicle licence (road fund) tax | £130 |
| Painting of company name | £100 (no VAT) |

The vehicle has not been entered in the fixed-asset register.

- (iii) Office equipment was purchased during 1994, and entered on the fixed-asset register but not in the nominal ledger. Until the omission can be investigated fully, its cost is deemed to be the difference between the balances on the fixed-asset register and the nominal ledger at 31 December 1994 (prior to charging depreciation for the year).
- (iv) Depreciation for 1994 is to be charged as follows:

| | |
|---------------------|---|
| Motor vehicles | 25% per annum straight line on an actual-time basis |
| Plant and machinery | 10% per annum straight line, with a full year's depreciation in the year of purchase |
| Office equipment | 10% per annum reducing balance, with a full year's depreciation in the year of purchase |

Requirements

- (a) Insert the balances at 31 December 1994 for cost and depreciation to date on the three fixed asset accounts in the nominal ledger (prior to the charging of depreciation for 1994).

| | | | |
|---------------------------------------|-----------------|-----------------------|----------------|
| <i>Motor vehicles</i> | £ | | |
| List price | | █ | |
| Less: 20% | | █ | |
| | | █ | |
| Add: VAT 17.5% | | █ | |
| | | █ | |
| Add: Cost of painting name | | █ | |
| Amount to add to fixed-asset register | | █ | |
| | | | |
| <i>Plant and machinery</i> | <i>Cost (£)</i> | <i>Cum. dep'n (£)</i> | |
| Balance as per nominal ledger | █ | █ | |
| Less: Disposal | █ | █ | |
| | █ | █ | |
| Office equipment | | | |
| Revised nominal ledger balances | <i>Cost (£)</i> | <i>Cum. dep'n (£)</i> | <i>Net (£)</i> |
| Motor vehicles | █ | █ | █ |
| Plant and machinery | █ | █ | █ |
| Office equipment | █ | █ | █ |
| | █ | █ | █ |
| Revised fixed-asset register | | | █ |

(b) Insert the depreciation for each class of fixed asset for 1994.

Depreciation for 1994

| | £ | |
|----------------------------|---|-----------|
| <i>Motor vehicles</i> | <div style="border: 1px solid black; width: 100%; height: 15px; margin-bottom: 2px;"></div> <div style="border: 1px solid black; width: 100%; height: 15px; margin-bottom: 2px;"></div> <div style="border: 1px solid black; width: 100%; height: 15px; margin-bottom: 2px;"></div> <div style="border: 1px solid black; width: 100%; height: 15px; margin-bottom: 2px;"></div> <div style="border: 1px solid black; width: 100%; height: 15px; margin-bottom: 2px;"></div> | (rounded) |
| <i>Plant and machinery</i> | <div style="border: 1px solid black; width: 100%; height: 15px; margin-bottom: 2px;"></div> <div style="border: 1px solid black; width: 100%; height: 15px; margin-bottom: 2px;"></div> <div style="border: 1px solid black; width: 100%; height: 15px; margin-bottom: 2px;"></div> | |
| <i>Office equipment</i> | <div style="border: 1px solid black; width: 100%; height: 15px; margin-bottom: 2px;"></div> <div style="border: 1px solid black; width: 100%; height: 15px; margin-bottom: 2px;"></div> | |



Question 5

Your organisation maintains a fixed-asset register that contained the following details at 1 April 1997:

| | <i>Cost/valuation at 1 April 1997</i> | <i>Accumulated depreciation at 1 April 1997</i> |
|-------------------|---|---|
| | (£) | (£) |
| Land | 120,000 | Nil |
| Buildings | 80,000 | 18,000 |
| Plant: | | |
| Machine A | 60,000 | 27,000 |
| Machine B | 40,000 | 24,000 |
| Machine C | 26,000 | 11,700 |
| Machine D | 18,000 | 13,500 |
| Office equipment: | | |
| Computer | 20,000 | 7,200 |
| Scanner | 1,000 | 600 |
| Printers (2) | 600 | 250 |
| Small tools | 1,200 | 300 |

Land is revalued every 3 years. The last revaluation took place on 31 March 1997.

Buildings are depreciated at 2.5 per cent per annum on cost. Small tools are revalued annually, the value at 31 March 1998 being £800. Plant is depreciated at 7.5 per cent per annum on cost, and office equipment is depreciated at 7.5 per cent per annum on cost.

During the year ended 31 March 1998, the following transactions occurred:

- (i) Machine E was purchased by cheque for £17,000.
- (ii) Machine C was sold for £13,000 to A Jones, on credit.
- (iii) The computer memory was upgraded by the manufacturer at a cost of £2,000.
- (iv) The scanner was repaired at a cost of £300.
- (v) Machine F was purchased by cheque for £42,300 including VAT at 17.5 per cent. The purchase price included delivery and installation of £1,200 plus VAT, and a 1-year maintenance contract of £2,000 plus VAT.
- (vi) The total on the fixed-asset register at 1 April 1997 was compared with the ledger accounts, and it was discovered that one of the printers had been passed to a supplier in part-payment of his debt during December 1996, but had never been

removed from the fixed-asset register. The cost of the printer was £400 and depreciation of £200 had been charged up to 1 April 1996.

Notes

- (1) Ignore VAT on all items except for those in transaction (v).
- (2) The organisation's policy is to charge a full year's depreciation in the year of purchase.

Requirements

- (a) Insert the figures in the fixed-asset accounts (at cost) and the provision for depreciation accounts for each of the above categories of fixed asset, commencing with the totals in the fixed-asset register on 1 April 1997. Make entries for additions, disposals, adjustments and depreciation for the year ended 31 March 1998.

| Accounts | | | | | | | |
|--------------------------|--|---|--|--|--|---|--|
| Land | | | | | | | |
| | | £ | | | | | |
| | | | | | | | |
| Buildings at cost | | | | | | | |
| | | £ | | | | | |
| | | | | | | | |
| Plant at cost | | | | | | | |
| | | £ | | | | £ | |
| | | | | | | | |
| Office equipment at cost | | | | | | | |
| | | £ | | | | £ | |
| | | | | | | | |
| Small tools at cost | | | | | | | |
| | | £ | | | | | |
| | | | | | | | |
| Buildings depreciation | | | | | | | |
| | | | | | | £ | |
| | | | | | | | |

| Plant depreciation | | | | | |
|-------------------------------|--------|--|--------|--------|--|
| | | £ | | | £ |
| █ | █ █ | █ █ █ | █ | █ █ | █ █ █ |
| | | <hr style="border-top: 1px solid black;"/> | | | <hr style="border-top: 1px solid black;"/> |
| <hr/> | | | | | |
| Office equipment depreciation | | | | | |
| | | £ | | | £ |
| █ | █ █ | █ █ █ | █ █ | █ █ | █ █ █ |
| | | <hr style="border-top: 1px solid black;"/> | | | <hr style="border-top: 1px solid black;"/> |
| <hr/> | | | | | |
| Small tools depreciation | | | | | |
| | | | | | £ |
| █ | █ | █ █ | █ █ | █ █ | █ █ █ |
| | | <hr style="border-top: 1px solid black;"/> | | | <hr style="border-top: 1px solid black;"/> |

(b) Insert the figures in the fixed-asset disposals account for the year ended 31 March 1998.

| Disposal of fixed assets | | | | | |
|--------------------------|---|--|---|-------------|--|
| | | £ | | | £ |
| █ | █ | █ | █ | █ █ █ | █ █ █ |
| | | <hr style="border-top: 1px solid black;"/> | | | <hr style="border-top: 1px solid black;"/> |

(c) Describe the information that could be held on a fixed-asset register.

- 1 _____
- 2 _____
- 3 _____
- 4 _____
- 5 _____
- 6 _____
- 7 _____
- 8 _____
- 9 _____
- 10 _____
- 11 _____
- 12 _____

? Question 6

(a) Depreciation is the measure of the _____ or the _____ of a tangible fixed asset consumed in a period. Consumption arises because of _____, _____ and _____.

- (b) The purpose of depreciation is to _____ the cost of a fixed asset over its _____ and thus match the _____ of an asset in a period with the _____. It is an example of the application of the _____ concept.
- (c) A transport company started business on 1 January 1998 and purchased truck A for £80,000. Truck A was destroyed in a road accident on 1 March 1999 and the insurance company paid out £60,000 to the transport company.
 On 1 April 1999, truck B was purchased for £90,000.
 On 1 July 1999, car C was purchased for £20,000.
 On 1 August 2000, car C was traded in for car D, which cost £25,000, less a part-exchange allowance on car C of £15,000.

The depreciation policy of the company is:

- depreciate trucks at 40 per cent each year on a reducing-balance basis;
- depreciate cars at 25 per cent each year using a straight-line basis;
- assume a residual value for cars of 10 per cent of the original cost;
- if a vehicle is owned for part of a year, calculate depreciation according to the number of months for which the vehicle is owned.

The year end of the company is 31 December.

Including entries for each relevant year, and working to the nearest £, write up the following accounts using the ledger accounts provided.

| Motor vehicles at cost | | | | | |
|------------------------|-------------|---|-------------|-------------|---|
| <i>1998</i> | | £ | <i>1998</i> | | £ |
| | | | | | |
| <i>1999</i> | | | <i>1999</i> | | |
| Jan. | Balance b/d | | Dec. | Balance c/d | |
| | | | | | |
| | | | | | |
| <i>2000</i> | | | <i>2000</i> | | |
| Jan. | Balance b/d | | Dec. | Balance c/d | |
| | | | | | |
| | | | | | |

| Provision for depreciation on motor vehicles | | | | | |
|--|-------------|---|-------------|-----------------------|---|
| <i>1998</i> | | £ | <i>1998</i> | | £ |
| Dec. | Balance c/d | | Dec. | Dep'n charge: P&L a/c | |
| <i>1999</i> | | | <i>1999</i> | | |
| | | | Jan. | Balance b/d | |
| Dec. | Balance c/d | | | | |
| | | | Dec. | Dep'n charge: P&L a/c | |
| | | | | | |
| <i>2000</i> | | | <i>2000</i> | | |
| | | | Jan. | Balance b/d | |
| Dec. | Balance c/d | | | | |
| | | | Dec. | Dep'n charge: P&L a/c | |
| | | | | | |

Disposal of motor vehicles

| 1999 | | £ | 1999 | | £ |
|------|--|---|------|--|---|
| | | | | | |
| | | | | | |
| | | | | | |
| 2000 | | | 2000 | | £ |
| | | | | | |
| | | | | | |
| | | | | | |

Workings: Depreciation

| Year acquired | <i>Truck A</i> | <i>Truck B</i> | <i>Car C</i> | <i>Car D</i> | Total (£) |
|--------------------------|----------------|----------------|---------------|---------------|-----------|
| | 1998 | 1999 | 1999 | 2000 | |
| | (£) | (£) | (£) | (£) | |
| | <u>80,000</u> | <u>90,000</u> | <u>20,000</u> | <u>25,000</u> | |
| Depreciation charge 1998 | | | | | |
| Depreciation charge 1999 | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| Written back on disposal | | | | | |
| Depreciation charge 2000 | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| Written back on disposal | | | | | |
| Balances c/d | | | | | |

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Solutions to Revision Questions



Solution 1

1.1 Answer: (D)

The net book value of the disposed asset needs to be deducted from the fixed-asset register. The asset was sold for £1,250 less than its net book value, thus its net book value must have been £4,000 + £1,250 = £5,250.

The balance can be calculated as follows:

| | | |
|---|----------------|--|
| | £ | |
| Balance on the register | 67,460 | |
| Less net book value of the disposed asset | <u>(5,250)</u> | |
| | <u>62,210</u> | |

1.2 The profit or loss on disposal is the difference between the net book value at the time of disposal and the disposal proceeds. An excess of disposal proceeds over net book value indicates a profit on disposal, while an excess of net book value over disposal proceeds indicates a loss on disposal.

The annual depreciation on the machine is calculated as:

$$\frac{\text{Cost} - \text{residual value}}{\text{Useful economic life}} = \frac{5,000 - 1,000}{4 \text{ years}} = 1,000 \text{ per year}$$

Depreciation by 31 December 1993 would be $3 \times £1,000 = £3,000$, therefore the net book value of the machine at the date of disposal would be £2,000. Disposal proceeds were £1,600, therefore there was a loss on disposal of £400.

1.3 Answer: (A)

The difference between the two records is £10,000, therefore the disposed asset must have had a net book value of this amount. B and D are clearly wrong, and C would produce a net book value of £20,000.

1.4 Answer: (A)

There is insufficient information to calculate the proceeds or the length of ownership.

1.5

| | | |
|--|----------------|-------|
| | £ | |
| $9,000 \times 0.7 \times 0.7 \times 0.7 =$ | 3,087 | (NBV) |
| Proceeds of sale | <u>(3,000)</u> | |
| Loss on disposal | <u>87</u> | |

1.6 Answer: (B)

Depreciation never provides a fund for the replacement of the asset, nor does it aim to show assets at their current or market values.

1.7

| | | |
|---|----------------|-------|
| | £ | |
| $£5,000 \times 0.8 \times 0.8 \times 0.8$ | 2,560 | (NBV) |
| Receipt | <u>(2,200)</u> | |
| Loss on disposal | <u>360</u> | |

1.8 Answer: (D)

Depreciation is not connected with the putting aside of money for the replacement of the asset, nor does it aim to show assets at their current or market values. The charging of depreciation ensures that profits are not overstated.

1.9 Answer: (D)

Fixed assets should, except in certain circumstances, be depreciated over their expected useful life. Answer A would almost never be appropriate. Assets are rarely valued at their expected selling price – if this is more than their cost, this would be imprudent, and if less than cost would contravene the ‘going concern’ concept, which is discussed in a later chapter. The method of depreciation is irrelevant.

1.10 Answer: (D)

(A), (B) and (C) are all correct, in most situations.

1.11

| | |
|-----------------|---------------|
| | £ |
| Cost of machine | 80,000 |
| Installation | 5,000 |
| Training | 2,000 |
| Testing | <u>1,000</u> |
| | <u>88,000</u> |

1.12

| | |
|--------------------|--------------|
| | £ |
| Cost | 10,000 |
| 1997 Depreciation | <u>2,500</u> |
| | 7,500 |
| 1998 Depreciation | <u>1,875</u> |
| | 5,625 |
| 1999 Depreciation | <u>1,406</u> |
| | 4,219 |
| 2000 Part-exchange | <u>5,000</u> |
| Profit | <u>781</u> |

1.13

| | | |
|---------------------------------|--------------|-----------------|
| | £ | £ |
| Net book value at 1 August 1999 | | 200,000 |
| Less depreciation | | <u>(20,000)</u> |
| Proceeds | 25,000 | |
| Loss | <u>5,000</u> | |
| Therefore net book value | | <u>(30,000)</u> |
| | | <u>150,000</u> |

1.14 Answer: (D)

1.15 Net book value = £12,000 less.

| | | |
|-----------------------|----------|--------------|
| | <u>£</u> | |
| (£12,000 × 20%) × 3 = | | 4,800 |
| Proceeds on disposal | | <u>5,000</u> |
| Profit | | <u>200</u> |

1.16 Graph A Reducing balance method of depreciation.

Graph B Straight line method of depreciation.

1.17 Answer: (D)

Solution 2

- This is a straight test of double-entry bookkeeping principles for fixed assets.
- It requires a calculation of the accumulated depreciation of the disposed asset up to the date of disposal in accordance with the method and policy stated in the question, and then to calculate the depreciation charge for each of the two years.
- The purchases and sales of vehicles do *not* involve purchases and sales accounts.
- The sale proceeds are part of the calculation of the profit or loss on disposal – do not use this figure in transferring the asset at cost out of its ledger account.

| Motor vehicles at cost | | | | | |
|------------------------|-------------|---------------|----------|-------------|---------------|
| | | <u>£</u> | | | <u>£</u> |
| 1.10.90 | Balance b/d | 10,000 | 24.04.91 | Disposal | 4,000 |
| 31.01.91 | Bank | 9,000 | 30.09.91 | Balance c/d | <u>15,000</u> |
| | | <u>19,000</u> | | | <u>19,000</u> |
| 1.10.91 | Balance b/d | 15,000 | 31.08.92 | Disposal | 9,000 |
| 20.02.92 | Bank | 12,000 | | | |
| 31.08.92 | Bank | 6,600 | | | |
| | Disposal | <u>7,400</u> | 30.09.92 | Balance c/d | <u>32,000</u> |
| | | <u>41,000</u> | | | <u>41,000</u> |
| 1.10.92 | Balance b/d | 32,000 | | | |

| Motor vehicles – depreciation | | | | | |
|-------------------------------|-------------|---------------|----------|--------------------|---------------|
| | | <u>£</u> | | | <u>£</u> |
| 24.04.91 | Disposal W1 | 2,313 | 1.10.90 | Balance b/d | 4,000 |
| 30.09.91 | Balance c/d | <u>5,015</u> | 30.09.91 | Profit and loss W2 | <u>3,328</u> |
| | | <u>7,328</u> | | | <u>7,328</u> |
| 31.08.92 | Disposal W3 | 2,250 | 1.10.91 | Balance b/d | 5,015 |
| 30.09.92 | Balance c/d | <u>10,074</u> | 30.09.92 | Profit and loss W4 | <u>7,309</u> |
| | | <u>12,324</u> | | | <u>12,324</u> |
| | | | 1.10.92 | Balance b/d | 10,074 |

Workings

| | | | | | |
|----|------------------------------|-------------------------------------|--|--|--------------|
| | | | | | <u>£</u> |
| W1 | Year ended 30 September 1988 | £4,000 @ 25% | | | 1,000 |
| | Year ended 30 September 1989 | £3,000 @ 25% | | | 750 |
| | Year ended 30 September 1990 | £2,250 @ 25% | | | 563 |
| | | | | | <u>2,313</u> |
| W2 | | (£15,000 – (£4,000 – £2,313)) @ 25% | | | 3,328 |
| W3 | Year ended 30 September 1991 | £9,000 × 25% | | | 2,250 |
| W4 | | (£32,000 – (£5,015 – £2,250)) @ 25% | | | 7,309 |

| Motor vehicles – disposal | | | | | |
|---------------------------|---------------------|--------------|----------|------------------------|--------------|
| 24.04.91 | Motor vehicles cost | £ 4,000 | 24.04.91 | Motor vehicles – dep'n | £ 2,313 |
| | | | | Bank | 500 |
| | | | 30.09.91 | Profit and loss | <u>1,187</u> |
| | | <u>4,000</u> | | | <u>4,000</u> |
| 31.08.92 | Motor vehicle cost | 9,000 | 31.08.92 | Motor vehicle – dep'n | 2,250 |
| 30.09.92 | Profit and loss | 650 | | Motor vehicle cost | 7,400 |
| | | <u>9,650</u> | | | <u>9,650</u> |

Solution 3

- Identify the revenue items, for example, tax and insurance, and exclude from the fixed-asset accounts.
- A full year's depreciation is to be charged on all assets in possession at the end of the year.

(a)

| Motor vehicles at cost | | | | | |
|------------------------|-------------|---------------|---------|-------------|---------------|
| 1 Jan. | Balance b/d | £ 15,000 | 31 Jul. | Disposal | £ 9,000 |
| 1 Aug. | Bank | 9,500 | 31 Dec. | Balance c/d | 15,500 |
| | | <u>24,500</u> | | | <u>24,500</u> |
| 1 Jan. | Balance b/d | 15,500 | | | |

| Motor vehicles expenses | | | | | |
|-------------------------|------|------------|---------|-----------------|------------|
| 1 Aug. | Bank | £ 500 | 31 Dec. | Profit and loss | £ 156 |
| | | <u>500</u> | | Balance c/f | <u>344</u> |
| | | | | | <u>500</u> |

| Plant and equipment at cost | | | | | |
|-----------------------------|-------------|---------------|---------|-------------|---------------|
| 1 Jan. | Balance b/d | £ 24,000 | 1 Apr. | Disposal | £ 5,600 |
| 1 Feb. | Bank | 7,500 | | | |
| 14 Mar. | Bank | 11,500 | | | |
| 1 Oct. | Bank | 5,000 | 31 Dec. | Balance c/d | <u>42,400</u> |
| | | <u>48,000</u> | | | <u>48,000</u> |
| 1 Jan. | Balance b/d | 42,400 | | | |

| Repairs and maintenance | | | | | |
|-------------------------|------|-------------|---------|-----------------|-------------|
| 1 Oct. | Bank | £ 10,000 | 31 Dec. | Profit and loss | £ 10,000 |

| Motor vehicles – depreciation | | | | | |
|-------------------------------|-------------|---------------|---------|-----------------|---------------|
| 31 Jul. | Disposal | £ 5,203 | 1 Jan. | Balance b/d | £ 9,000 |
| 31 Dec. | Balance c/d | <u>6,723</u> | 31 Dec. | Profit and loss | <u>2,926</u> |
| | | <u>11,926</u> | | | <u>11,926</u> |
| | | | 1 Jan. | Balance b/d | <u>6,723</u> |

| Plant and equipment – depreciation | | | | | |
|------------------------------------|-------------|---------------|---------|-----------------|---------------|
| | | £ | | | £ |
| 1 Apr. | Disposal | 4,480 | 1 Jan. | Balance b/d | 10,500 |
| 31 Dec. | Balance c/d | <u>14,500</u> | 31 Dec. | Profit and loss | <u>8,480</u> |
| | | <u>18,980</u> | | | <u>18,980</u> |
| | | | 1 Jan. | Balance b/d | 14,500 |

| Plant and equipment – disposal | | | | | |
|--------------------------------|-----------------------------|--------------|--------|---------------------------|--------------|
| | | £ | | | £ |
| 1 Apr. | Plant and equipment at cost | 5,600 | 1 Apr. | Plant and equipment dep'n | 4,480 |
| 31 Dec. | P & L | <u>880</u> | 1 Apr. | Bank | <u>2,000</u> |
| | | <u>6,480</u> | | | <u>6,480</u> |

| Motor vehicles – disposal | | | | | |
|---------------------------|------------------------|--------------|---------|-----------------------------|--------------|
| | | £ | | | £ |
| 31 Jul. | Motor vehicles at cost | 9,000 | 31 Jul. | Motor vehicles depreciation | 5,203 |
| | | | 31 Jul. | Bank | 3,400 |
| | | <u>9,000</u> | 31 Dec. | Profit and loss | <u>397</u> |
| | | | | | <u>9,000</u> |

(b) Profit and loss extract – year ended December 1990

| | |
|----------------------------------|--------|
| | £ |
| Depreciation charge for the year | 11,406 |
| Net profit on disposal of assets | (483) |
| Equipment repairs | 10,000 |
| Vehicle road tax | 100 |
| Vehicle warranty (5/36 × £ 400) | 56 |

 **Solution 4**

- Set aside a separate page for workings, and label them clearly.
- Remember to deduct the discount on the motor vehicle before calculating the amount of VAT to be added; remember also that the tax and insurance are revenue expenses, and should not be included with the cost of the vehicle. The resulting total needs to be added to the fixed-asset register, *not* to the ledger accounts.
- Deduct the cost and depreciation of the disposed plant from the ledger.
- Calculate the value of office equipment purchased by comparing the ledger total with the fixed-asset register total.
- In part (b), note that the motor vehicle is depreciated on an actual-time basis.

(a)

| | |
|---------------------------------------|----------------|
| <i>Motor vehicles</i> | £ |
| List price | 24,000 |
| Less: 20% | <u>(4,800)</u> |
| | 19,200 |
| Add: VAT 17.5% | <u>3,360</u> |
| | 22,560 |
| Add: Cost of painting name | <u>100</u> |
| Amount to add to fixed-asset register | <u>22,660</u> |

| | | | |
|-------------------------------|-----------------|-----------------------|---------------------------|
| <i>Plant and machinery</i> | <i>Cost (£)</i> | <i>Cum. dep'n (£)</i> | |
| Balance as per nominal ledger | 120,000 | 30,000 | |
| Less: Disposal | <u>(30,000)</u> | <u>(5,700)*</u> | *i.e. (£30,000 – £24,300) |
| | <u>90,000</u> | <u>24,300</u> | |

Office equipment

| | | | |
|---|----------------|-------------------|----------------|
| <i>Revised nominal ledger balances</i> | <i>Cost</i> | <i>Cum. dep'n</i> | <i>Net</i> |
| | £ | £ | £ |
| Motor vehicles | 48,000 | 12,000 | 36,000 |
| Plant and machinery | 90,000 | 24,300 | 65,700 |
| Office equipment | <u>27,500</u> | <u>7,500</u> | <u>20,000</u> |
| | <u>165,500</u> | <u>43,800</u> | 121,700 |
| Revised fixed-asset register (£147,500 + £22,660) | | | <u>170,160</u> |
| Therefore purchase of office equipment was | | | <u>48,460</u> |

(b) Depreciation for 1994

| | | |
|----------------------------|---------------|-----------|
| | £ | |
| <i>Motor vehicles</i> | | |
| 25% × £48,000 | 12,000 | |
| 25% × £22,660 × 3/12 | <u>1,416</u> | (rounded) |
| | <u>13,416</u> | |
| <i>Plant and machinery</i> | | |
| 10% × £90,000 | <u>9,000</u> | |
| <i>Office equipment</i> | | |
| 10% × £68,460 | <u>6,846</u> | |

**Solution 5**

- Remember to deduct the VAT that is included in the price of machine F, as well as the cost of the maintenance agreement (which is a revenue expense).

(a) Accounts

| | | | | | |
|--------------------------|---------------|----------------|---------|---------------|----------------|
| Land | | | | | |
| 1/4/97 | Balance b/fwd | £ | | | |
| | | 120,000 | | | |
| Buildings at cost | | | | | |
| 1/4/97 | Balance b/fwd | £ | | | |
| | | 80,000 | | | |
| Plant at cost | | | | | |
| 1/4/97 | Balance b/fwd | £ | | | £ |
| | Bank a/c | 17,000 | 31/3/97 | Disposal a/c | 26,000 |
| | Bank a/c | <u>34,000</u> | | Balance c/fwd | <u>169,000</u> |
| | | <u>195,000</u> | | | <u>195,000</u> |
| Office equipment at cost | | | | | |
| 1/4/97 | Balance b/fwd | £ | | | £ |
| | Bank | <u>2,000</u> | 31/3/98 | Adjustment | 400 |
| | | <u>23,600</u> | | Balance c/fwd | <u>23,200</u> |
| | | | | | <u>23,600</u> |

| Small tools at cost | | | | | |
|-------------------------------|---------------|---------------|---------|---------------------|---------------|
| 1/4/97 | Balance b/fwd | £ | | | 1,200 |
| <hr/> | | | | | |
| Buildings depreciation | | | | | |
| 31/3/98 | Balance c/d | £ | 1/4/97 | Balance b/fwd | 18,000 |
| | | 20,000 | 31/3/98 | Profit and loss a/c | 2,000 |
| | | <u>20,000</u> | | | <u>20,000</u> |
| <hr/> | | | | | |
| Plant depreciation | | | | | |
| 31/3/98 | Disposal a/c | £ | 1/4/97 | Balance b/fwd | 76,200 |
| | Balance c/fwd | 11,700 | | Profit and loss a/c | 12,675 |
| | | <u>77,175</u> | | | <u>88,875</u> |
| | | <u>88,875</u> | | | <u>88,875</u> |
| <hr/> | | | | | |
| Office equipment depreciation | | | | | |
| 31/3/98 | Adjustment | £ | 1/4/97 | Balance b/fwd | 8,050 |
| | Balance c/fwd | 200 | 31/3/98 | Profit and loss a/c | 1,740 |
| | | <u>9,590</u> | | | <u>9,790</u> |
| | | <u>9,790</u> | | | <u>9,790</u> |
| <hr/> | | | | | |
| Small tools depreciation | | | | | |
| 31/3/98 | Balance c/d | £ | 1/4/97 | Balance b/fwd | 300 |
| | | 400 | 31/3/98 | Profit and loss a/c | 100 |
| | | <u>400</u> | | | <u>400</u> |

Workings

| | |
|------------------|----------------|
| <i>Machine F</i> | £ |
| Total cost | 42,300 |
| Inc. VAT | <u>(6,300)</u> |
| Exc. VAT | 36,000 |
| Less maintenance | <u>(2,000)</u> |
| Plant a/c | <u>34,000</u> |

(b)

| Disposal of fixed assets | | | | | |
|--------------------------|-------------------|---------------|---------|------------------------|---------------|
| 31/3/97 | Plant at cost a/c | £ | 31/3/97 | Plant depreciation a/c | £ |
| | | 26,000 | | A Jones | 13,000 |
| | | | | Loss on disposal | 1,300 |
| | | <u>26,000</u> | | | <u>26,000</u> |

The office equipment at cost and depreciation accounts could commence with the balances after adjusting for the disposed printer, that is, £21,200 (office equipment at cost) and £7,850 (office equipment depreciation).

(c) A fixed-asset register should normally include:

1. a description of the asset;
2. the location of the asset;

3. the original cost of the asset;
4. the date of acquisition;
5. the purchase order reference;
6. the supplier's name and address;
7. the estimated life of the asset;
8. the estimated residual value of the asset;
9. the rate and method of depreciation to be used;
10. the cumulative depreciation charged to date;
11. maintenance agreements and history;
12. insurance details.



Solution 6

- (a) Depreciation is the measure of the cost or the economic benefit of a tangible fixed asset consumed in a period. Consumption arises because of wearing out, time and obsolescence.
- (b) The purpose of depreciation is to allocate the cost of a fixed asset over its useful economic life and thus match the cost of an asset in a period with the benefit from its use. It is an example of the application of the accruals concept.
- (c)

| Motor vehicles at cost | | | | | |
|------------------------|--|----------------|-------------|---------------------------|----------------|
| <i>1998</i> | | £ | <i>1998</i> | | £ |
| Jan. | Bank – Truck A | <u>80,000</u> | Dec. | Balance c/d | <u>80,000</u> |
| <i>1999</i> | | | <i>1999</i> | | |
| Jan. | Balance b/d | 80,000 | Mar. | Disposal a/c – Truck A | 80,000 |
| Apr. | Bank – Truck B | 90,000 | | | |
| July | Bank – Car C | <u>20,000</u> | Dec. | Balance c/d | <u>110,000</u> |
| | | <u>190,000</u> | | | <u>190,000</u> |
| <i>2000</i> | | | <i>2000</i> | | |
| Jan. | Balance b/d | 110,000 | Aug. | Disposal a/c – Car C | 20,000 |
| Aug. | Disposal a/c re Car C part- exchange Car D | 15,000 | | | |
| | Bank – Car D | <u>10,000</u> | Dec. | Balance c/d | <u>115,000</u> |
| | | <u>135,000</u> | | | <u>135,000</u> |

| Provision for depreciation on motor vehicles | | | | | |
|--|------------------------|---------------|-------------|--|---------------|
| <i>1998</i> | | £ | <i>1998</i> | | £ |
| Dec. | Balance c/d | <u>32,000</u> | Dec. | Depreciation charge – P&L a/c | <u>32,000</u> |
| <i>1999</i> | | | <i>1999</i> | | |
| Mar. | Disposal a/c – Truck A | 35,200 | Jan. | Balance b/d | 32,000 |
| | | | Mar. | Depreciation charge Truck A – P&L a/c | 3,200 |
| Dec. | Balance c/d | <u>29,250</u> | Dec. | Depreciation charge – P&L a/c | <u>29,250</u> |
| | | <u>64,450</u> | | | <u>64,450</u> |

| | | | | | |
|------|----------------------|---------------|------|--|---------------|
| 2000 | | | 2000 | | |
| Aug. | Disposal a/c – Car C | 4,875 | Jan. | Balance b/d | 29,250 |
| Dec. | Balance c/d | 54,544 | Aug. | Depreciation charge Car C – P&L a/c | 2,625 |
| | | <u>59,419</u> | Dec. | Depreciation charge – P&L a/c | <u>27,544</u> |
| | | | | | <u>59,419</u> |

Disposal of motor vehicles

| | | | | | |
|------|------------------------------|---------------|------|--|---------------|
| 1999 | | £ | 1999 | | £ |
| Mar. | Vehicle cost a/c – Truck A | 80,000 | Mar. | Provision for depreciation on vehicle a/c – Truck A | 35,200 |
| Dec. | Profit and loss a/c | 15,200 | Mar. | Bank – proceeds from Truck A | 60,000 |
| | | <u>95,200</u> | | | <u>95,200</u> |
| 2000 | | | 2000 | | |
| Aug. | Vehicle cost account – Car C | 20,000 | Aug. | Provision for depreciation on vehicle a/c – Car C | 4,875 |
| | | | Aug. | Vehicle cost account – Car C part-exchange Car D | 15,000 |
| | | <u>20,000</u> | Dec. | Profit and loss a/c | 125 |
| | | | | | <u>20,000</u> |

Working: Depreciation

| Year acquired | Truck A 1998 (£) | Truck B 1999 (£) | Car C 1999 (£) | Car D 2000 (£) | Total (£) |
|--|------------------------|------------------------|----------------------|----------------------|-----------------|
| | <u>80,000</u> | <u>90,000</u> | <u>20,000</u> | <u>25,000</u> | |
| Depreciation charge 1998 £80,000 × 40% | (32,000) | | | | <u>(32,000)</u> |
| Depreciation charge 1999 (£80,000 – £32,000) × 40% × 2/12 | (3,200) | | | | <u>(3,200)</u> |
| £90,000 × 40% × 9/12 | | (27,000) | | | <u>(27,000)</u> |
| £20,000 × 90% × 25% × 6/12 | | | (2,250) | | <u>(2,250)</u> |
| | <u>35,200</u> | | | | <u>(29,250)</u> |
| Written back on disposal | | | | | |
| Depreciation charge 2000 £20,000 × 90% × 25% × 7/12 | | | (2,625) | | <u>(2,625)</u> |
| (£90,000 – £27,000) × 40% | | (25,200) | | | <u>(25,200)</u> |
| £25,000 × 90% × 25% × 5/12 | | | | (2,344) | <u>(2,344)</u> |
| | | | | | <u>(27,544)</u> |
| Written back on disposal | | | <u>4,875</u> | | |
| Balance c/d | | <u>(52,200)</u> | | <u>(2,344)</u> | <u>(54,544)</u> |

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Final Accounts with Adjustments

7

LEARNING OUTCOME

When you have completed this chapter, you should be able to:

- ▶ prepare trading accounts, profit and loss accounts and balance sheets from trial balances and adjustments.

7.1 Introduction

This chapter looks at the preparation of accounts (i.e. the trading account, profit and loss account and balance sheet) from a trial balance, with various adjustments to be made.

These adjustments include:

- closing stock at the end of the period,
- accruals,
- prepayments,
- bad and doubtful debts,
- depreciation.

The trial balance is often extracted from the ledger accounts prior to the consideration of adjustments for accruals and prepayments, provisions for depreciation and doubtful debts, etc., and these are given as notes following the trial balance.

The chapter contains a complete worked example.

7.2 The trial balance

The following trial balance has been extracted from the nominal ledger of John Smith on 30 November 20X3.

Trial balance of John Smith at 30 November 20X3

| | £ | £ |
|---------------------------------|----------------|----------------|
| Sales | | 125,658 |
| Returns | 6,341 | 1,902 |
| Debtors and creditors | 11,257 | 7,983 |
| Office equipment | | |
| Cost | 10,000 | |
| Depreciation at 1 December 20X2 | | 1,550 |
| Vehicles | | |
| Cost | 3,500 | |
| Depreciation at 1 December 20X2 | | 700 |
| Purchases | 64,726 | |
| Stock at 1 December 20X2 | 5,000 | |
| Carriage inwards | 908 | |
| Carriage outwards | 272 | |
| Vehicle expenses | 1,349 | |
| Electricity | 1,803 | |
| Wages and salaries | 11,550 | |
| Rent and business rates | 8,800 | |
| Stationery and postages | 2,681 | |
| Bank deposit account | 10,000 | |
| Bank | 4,797 | |
| Discount allowed and received | 5,652 | 3,765 |
| VAT creditor | | 1,325 |
| PAYE creditor | | 453 |
| Capital at 1 December 20X2 | | 4,300 |
| Drawings | 15,000 | |
| Loan | | 16,000 |
| | <u>164,336</u> | <u>164,336</u> |

7.3 The adjustments

Following the extraction of the above trial balance from the ledgers and an examination of the accounting records, the following additional information was obtained:

1. The value of the stock on hand at 30 November 20X3 was £5,700.
2. The bank deposit was made on 1 June 20X3. This account earns interest at 8 per cent per annum. The balance shown in the ledgers is the only deposit made into this account. Interest is credited on 31 December annually.
3. Bank charges accrued to 30 November 20X3 are estimated to be £60.
4. Vehicle expenses include road tax of £125 per annum for a vehicle, which expires on 31 December 20X3, and vehicle insurance of £360 per annum which was paid on 1 July 20X3.
5. There is one employee whose gross wage is £1,050 per month. The wage for November 20X3 has not yet been entered in the ledgers.
6. The balance of the rent and rates account includes a payment of rent for the 3 months to 31 December 20X3 of £1,200 and a payment of rates for the six months to 31 March 20X3 of £4,000.
7. Following a review of debtors at the year end, it is decided that a bad debt of £1,207 should be written off, and a provision for doubtful debts made, of 2 per cent of debtors.
8. Office equipment is to be depreciated at 10 per cent per annum on cost, and motor vehicles are to be depreciated at 20 per cent per annum on cost.
9. Loan interest of 10 per cent per annum is to be accrued.

Requirements

Using the above information, prepare a trading and profit and loss account of John Smith for the period ended 30 November 20X3 together with his balance sheet at that date.

7.4 Step 1: Labelling the trial balance

The trial balance contains all of the account balances from the ledger of John Smith. It therefore includes assets, liabilities, capital, expenses and income. You should remember that the assets, liabilities and capital are shown in the balance sheet, and the expenses and income in the trading and profit and loss accounts where they are used to calculate net profit, which is then also transferred to the balance sheet. If you are unsure about the correct category for any of the items in the trial balance it might help to remember the following:

Debit balances usually represent either assets or expenses and these are always shown in the left-hand column of a trial balance. Therefore credit balances (shown in the right-hand column) are usually either income, liabilities or capital.

You should also remember that values shown in the trial balance have, by definition, been posted to the ledger accounts and that, therefore, the double entry is complete. Other pieces of information given by way of a note have not been recorded in the ledger accounts and consequently will require both a debit and a credit entry (which is usually effected by entering them in both the trading/profit and loss account and the balance sheet).

The first step, then, is to identify the items in the trial balance that are to be entered in the trading account, that are to be entered in the profit and loss account, and that are to be entered in the balance sheet. These are shown below marked with 'T', 'P', or 'B'. In addition, it is useful to mark those values that are to be affected by the additional information. This has been done with an asterisk (*) and the note number in the layout below.

| | | | |
|---------------------------------|---|----------------|----------------|
| Sales | T | £ | £ |
| Returns | T | 6,341 | 1,902 |
| Debtors and creditors | B | 11,257 | 7,983 |
| Office equipment | | | |
| Cost | B | 10,000 | |
| Depreciation at 1 December 20X2 | B | *8 | 1,550 |
| Vehicles | | | |
| Cost | B | 3,500 | |
| Depreciation at 1 December 20X2 | B | *8 | 700 |
| Purchases | T | 64,726 | |
| Stock at 1 December 20X2 | T | 5,000 | |
| Carriage inwards | T | 908 | |
| Carriage outwards | P | 272 | |
| Vehicle expenses | P | *4 | 1,349 |
| Electricity | P | 1,803 | |
| Wages and salaries | P | *5 | 11,550 |
| Rent and business rates | P | *6 | 8,800 |
| Stationery and postages | P | 2,681 | |
| Bank deposit account | B | *2 | 10,000 |
| Bank | B | 4,797 | |
| Discount allowed and received | P | 5,652 | 3,765 |
| VAT creditor | B | | 1,325 |
| PAYE creditor | B | | 453 |
| Capital at 1 December 20X2 | B | | 4,300 |
| Drawings | B | 15,000 | |
| Loan | B | *9 | 16,000 |
| | | <u>163,636</u> | <u>163,636</u> |

7.5 Step 2: Preparing workings

Each of the notes should be considered in turn, and you should head up a page entitled 'workings' on which any calculations and adjustments should be clearly shown and labelled.

1. Closing stock of £5,700 is to be entered in the trading account and the balance sheet.
2. There will be an entry in the profit and loss account for accrued interest received and the outstanding amount will be shown on the balance sheet as an asset. The deposit was made on 1 June 20X3, so that the interest earned to 30 November is:

$$\begin{aligned} & \text{£}10,000 \times 8\% \times 6 \text{ months}/12 \text{ months} \\ & = \text{£}400 \text{ profit and loss account / balance sheet assets} \end{aligned}$$

3. These will be shown as an additional expense to the profit and loss account and as a liability in the balance sheet.
4. This account includes prepayment as follows:

$$\begin{aligned} \text{Road tax: 1 month, therefore } & \text{£}125 \times \frac{1}{12} \approx \text{£}10 \\ \text{Insurance: 7 months, therefore } & \text{£}360 \times \frac{7}{12} = \text{£}210 \end{aligned}$$

| | | |
|------------------------------------|--------------|-------------------------|
| Vehicle expenses per trial balance | £ | |
| | 1,349 | |
| Less prepaid expenses | <u>(220)</u> | (Balance sheet: assets) |
| Profit and loss account | <u>1,129</u> | |

5. The wages for November are a cost of the period, so the value shown in the trial balance should be increased by this amount.

| | | |
|-------------------------|---------------|------------------------------|
| Wages per trial balance | £ | |
| | 11,550 | |
| Accrued wages | <u>1,050</u> | (Balance sheet: liabilities) |
| Profit and loss account | <u>12,600</u> | |

6. Rent and rates includes prepayments as follows:

$$\begin{aligned} \text{Rent: 1 month, therefore } & \text{£}1,200 \times \frac{1}{3} = \text{£}400 \\ \text{Rates: 4 months, therefore } & \text{£}4,000 \times \frac{4}{6} = \text{£}2,667 \end{aligned}$$

| | | |
|----------------------------------|----------------|-------------------------|
| Rent and rates per trial balance | £ | |
| | 8,800 | |
| Less prepayments | <u>(3,067)</u> | (Balance sheet: assets) |
| Profit and loss account | <u>5,733</u> | |

7. Bad debts to be written off: £1,207 (profit and loss account).
New debtors figure: £11,257 - £1,207 written off = £10,050.
Provision for doubtful debts to be made: 2% × £10,050 = £201 (profit and loss account).
Deduct from debtors figure: £201 (balance sheet).
8. Depreciation on office equipment:

| | | |
|------------------------------------|--------------|---------------------------|
| 10 per cent × £10,000 | £ | |
| | 1,000 | (Profit and loss account) |
| Depreciation per the trial balance | <u>1,550</u> | |
| Cumulative depreciation | <u>2,550</u> | (Balance sheet) |

Depreciation on vehicles:

| | | |
|------------------------------------|--------------|---------------------------|
| | £ | |
| 20% × £3,500 | 700 | (Profit and loss account) |
| Depreciation per the trial balance | <u>700</u> | |
| Cumulative depreciation | <u>1,400</u> | (Balance sheet) |

9. Loan interest accrued:

| | | |
|---------------|---------------|--------------------------------------|
| 10% × £16,000 | £1,600 | (Profit and loss account) |
| | <u>£1,600</u> | (Balance sheet: current liabilities) |

Total accruals for the balance sheet comprise item 3 (£60), item 5 (£1,050) and item 9 (£1,600), totalling £2,710.

We can now prepare the accounts.

7.6 Step 3: Preparing the accounts

- *Hint.* Tick each item in the trial balance and/or workings as it is entered.
- *Hint.* Enter the reference number of the ‘workings’ where relevant. If you have made a mistake, the examiner can check your workings and you may be awarded part marks for that item.

Trading and profit and loss account of John Smith for the period ended 30 November 20X3

| | £ | £ | £ |
|-----------------------------------|--------------|---------------|---------------|
| Sales | | | 125,658 |
| Less returns | | | <u>6,341</u> |
| Net sales | | | 119,317 |
| Opening stock | | 5,000 | |
| Purchases | 64,726 | | |
| Carriage inwards | <u>908</u> | | |
| | 65,634 | | |
| Less returns | <u>1,902</u> | | |
| Net purchases | | <u>63,732</u> | |
| | | 68,732 | |
| Less closing stock (W1) | | <u>5,700</u> | |
| Cost of goods sold | | | 63,032 |
| Gross profit | | | 56,285 |
| Bank deposit interest (W2) | | | 400 |
| Discount received | | | <u>3,765</u> |
| | | | 60,450 |
| Bank charges | | 60 | |
| Carriage outwards | | 272 | |
| Vehicle expenses (W4) | | 1,129 | |
| Electricity | | 1,803 | |
| Wages and salaries (W5) | | 12,600 | |
| Rent and business rates (W6) | | 5,733 | |
| Bad debts (W7) | | 1,207 | |
| Provision for doubtful debts (W7) | | 201 | |
| Stationery and postages | | 2,681 | |
| Discount allowed | | 5,652 | |
| Depreciation | | | |
| Office equipment (W8) | | 1,000 | |
| Vehicles (W8) | | 700 | |
| Loan interest (W9) | | <u>1,600</u> | |
| | | | 34,638 |
| Net profit | | | <u>25,812</u> |

Balance sheet of John Smith at 30 November 20X3

| | <i>Cost (£)</i> | <i>Depreciation (£)</i> | <i>Net book value (£)</i> |
|-----------------------------------|-----------------|-------------------------|---------------------------|
| Fixed assets | | | |
| Office equipment | 10,000 | 2,550 | 7,450 |
| Vehicles | <u>3,500</u> | <u>1,400</u> | <u>2,100</u> |
| | 13,500 | 3,950 | 9,550 |
| Current assets | | | |
| Stock | | 5,700 | |
| Debtors | 10,050 | | |
| Less provision for doubtful debts | <u>201</u> | | |
| | | 9,849 | |
| Prepayments | | 3,287 | |
| Accrued interest receivable | | 400 | |
| Bank deposit | | 10,000 | |
| Bank | | <u>4,797</u> | |
| | | <u>34,033</u> | |
| Current liabilities | | | |
| Creditors | | 7,983 | |
| Accruals (£60 + £1,050 + £1,600) | | 2,710 | |
| VAT creditor | | 1,325 | |
| PAYE creditor | | 453 | |
| | | <u>12,471</u> | |
| Net current assets | | | 21,562 |
| | | | <u>31,112</u> |
| Long-term liabilities | | | |
| Loan | | | <u>16,000</u> |
| | | | <u>15,112</u> |
| Financed by | | | |
| Capital at start of year | | | 4,300 |
| Add net profit | | | <u>25,812</u> |
| | | | 30,112 |
| Less drawings | | | <u>15,000</u> |
| Capital at end of year | | | <u>15,112</u> |

**Exercise 7.1**

From the following trial balance:

- (a) distinguish between assets, liabilities, capital, income and expenditure;
- (b) distinguish between items to be found in the trading account, profit and loss account or balance sheet; and
- (c) prepare a trading and profit and loss account for the year ended 31 December 20X3 and a balance sheet at that date.

XYZ: trial balance as at 31 December 20X3

| | <i>Debit (£)</i> | <i>Credit (£)</i> |
|--------------------------------|------------------|-------------------|
| Sales | | 126,500 |
| Purchases | 99,850 | |
| Premises | | |
| Cost | 100,000 | |
| Depreciation at 1 January 20X3 | | 25,000 |
| Plant | | |
| Cost | 18,000 | |
| Depreciation at 1 January 20X3 | | 2,300 |
| Wages and salaries | 8,900 | |
| Rent and rates | 7,500 | |
| Stock at 1 January 20X3 | 5,000 | |
| Capital at 1 January 20X3 | | 80,000 |
| Drawings | 25,000 | |
| Carriage inwards | 4,000 | |
| Debtors | 27,500 | |
| Creditors | | 16,000 |
| Bad debts written off | 5,000 | |
| Rent receivable | | 2,000 |
| Bank balance | | 18,950 |
| Mortgage | | 30,000 |
| | <hr/> | <hr/> |

1. Closing stock is £12,500.
2. Wages and salaries accrued amount to £700.
3. Rent prepaid amounts to £300.
4. Mortgage interest of 10 per cent per annum is outstanding.
5. Provision for doubtful debts of 2 per cent is to be made.
6. Depreciation is to be provided at 2 per cent of cost on premises, and at 10 per cent of cost on plant.

**Solution**

If you have successfully completed parts (a) and (b) of the exercise, you should be able to complete part (c) as follows:

XYZ: trading and profit and loss account for the year ended 31 December 20X3

| | | | |
|------------------------------|--------------|----------------|---------------|
| | £ | £ | £ |
| Sales | | | 126,500 |
| Less cost of sales | | | |
| Opening stock | | 5,000 | |
| Purchases | 99,850 | | |
| Carriage inwards | <u>4,000</u> | | |
| | | 103,850 | |
| | | <u>108,850</u> | |
| Less closing stock | | <u>12,500</u> | |
| | | | <u>96,350</u> |
| Gross profit | | | 30,150 |
| Rent receivable | | | <u>2,000</u> |
| | | | 32,150 |
| Wages and salaries | | 9,600 | |
| Rent and rates | | 7,200 | |
| Bad debts written off | | 5,000 | |
| Mortgage interest | | 3,000 | |
| Provision for doubtful debts | | 550 | |
| Depreciation | | | |
| premises | | 2,000 | |
| plant | | <u>1,800</u> | |
| | | | <u>29,150</u> |
| Net profit | | | <u>3,000</u> |

XYZ: balance sheet at 31 December 20X3

| | <i>Cost (£)</i> | <i>Depreciation (£)</i> | <i>Net book value (£)</i> |
|--------------------------|-----------------|-------------------------|---------------------------|
| Fixed assets | | | |
| Premises at cost | 100,000 | 27,000 | 73,000 |
| Plant at cost | <u>18,000</u> | <u>4,100</u> | <u>13,900</u> |
| | 118,000 | 31,100 | 86,900 |
| Current assets | | | |
| Stocks | | 12,500 | |
| Debtors | 27,500 | | |
| Less provision | <u>550</u> | | |
| | | 26,950 | |
| Prepayments | | <u>300</u> | |
| | | 39,750 | |
| Current liabilities | | | |
| Creditors | 16,000 | | |
| Accruals | 3,700 | | |
| Bank overdraft | <u>18,950</u> | | |
| | | 38,650 | |
| Net current assets | | | <u>1,100</u> |
| | | | 88,000 |
| Long-term liabilities | | | |
| Mortgage | | | <u>30,000</u> |
| | | | <u>58,000</u> |
| Financed by | | | |
| Capital at start of year | | | 80,000 |
| Add net profit | | | <u>3,000</u> |
| | | | 83,000 |
| Less drawings | | | <u>25,000</u> |
| Capital at end of year | | | <u>58,000</u> |



Exercise 7.2

JW Ltd had, among others, the following balances in the books at 30 June 1999

| | <i>Debit (£)</i> | <i>Credit (£)</i> |
|--|------------------|-------------------|
| Motor vehicles at cost | 200 | |
| Motor vehicles – depreciation at 1 July 1998 | | 70 |
| Fixtures at cost | 60 | |
| Fixtures – depreciation at 1 July 1998 | | 20 |
| Office equipment at cost | 125 | |
| Office equipment – depreciation at 1 July 1998 | | 45 |
| Trade debtors | 580 | |
| Provision for doubtful debts at 1 July 1998 | | 10 |
| Insurance | 90 | |

The following adjustments have not yet been made in the books:

- (i) Motor vehicles are depreciated over four years on the straight-line basis. On 31 March 1999 a motor vehicle that had cost £20,000 on 1 July 1996 was disposed of for £8,000. It is the company's policy to charge a full year's depreciation in the year of purchase, and hence none in the year of disposal. No entries have been made for the disposal.
- (ii) Fixtures are depreciated on the straight-line basis over 10 years, on an actual-time basis (i.e. from the date of acquisition). On 1 September 1998 fixtures were purchased for £40,000, which have not been entered in the books.
- (iii) Office equipment is depreciated at 20 per cent per annum on the reducing-balance basis.
- (iv) At 30 June 1999 it was decided to write off a bad debt of £80,000 and to make a provision for doubtful debts of 3 per cent of the remaining debtors.
- (v) The insurance figure above covers the period 1 July 1998 to 30 September 1999.
- (vi) Sales representatives are paid commission, which amounts to 5 per cent of the previous month's sales. The commission is due for payment on the 15th of the following month. During June 1999, sales amounted to £120,000.

Requirements

- (a) Prepare ledger accounts for all the above items, showing clearly all calculations, transfers to the profit and loss account for the year ending 30 June 1999, and balance to be carried down at 30 June 1999. **(12 marks)**
- (b) Show the 'expenses' section of the profit and loss account for the year ending 30 June 1999, to include all the items above. **(2 marks)**
- (c) Show the extracts from the fixed assets, current assets and current liabilities sections of the balance sheet at 30 June 1999, which includes balances for the above items. **(2 marks)**
- (d) Explain briefly why depreciation is charged in the profit and loss account, but does not affect cash balances. **(4 marks)**

(Total marks = 20)

**Solution**

This solution does not utilise a 'depreciation expense' account or a 'bad debts expense' account. Although many businesses do maintain such accounts, it is considered unnecessary and time-consuming to produce them in an examination answer. Instead of transferring the annual provision to such an expense account, the amount is transferred directly to the profit and loss account.

(a)

| Motor vehicles at cost | | | | | |
|------------------------|---------------|------------|------------|---------------|------------|
| 1 Jul. 98 | Balance b/fwd | 200 | 31 Mar. 99 | Disposals a/c | 20 |
| | | | 30 Jun. 99 | Balance c/fwd | 180 |
| | | <u>200</u> | | | <u>200</u> |

| Motor vehicles – provision for depreciation | | | | | |
|---|----------------|------------|------------|---------------|------------|
| 31 Mar. 99 | Disposals (W1) | 10 | 1 Jul. 98 | Balance b/fwd | 70 |
| 30 Jun. 99 | Balance c/fwd | 105 | 30 Jun. 99 | P&L a/c (W2) | 45 |
| | | <u>115</u> | | | <u>115</u> |

| Disposal of fixed assets | | | | | |
|--------------------------|------------------------|-----------|------------|--|-----------|
| 31 Mar. 99 | Motor vehicles at cost | 20 | 31 Mar. 99 | Motor vehicle provision for depreciation | 10 |
| | | | | Cash | 8 |
| | | <u>20</u> | | Loss on disposal (P&L a/c) | 2 |
| | | | | | <u>20</u> |

| Fixtures at cost | | | | | |
|------------------|-----------------|------------|------------|---------------|------------|
| 1 Jul. 98 | Balance b/fwd | 60 | 30 Jun. 99 | Balance c/fwd | 100 |
| 1 Sep. 98 | Purchase (bank) | 40 | | | |
| | | <u>100</u> | | | <u>100</u> |

| Fixtures – provision for depreciation | | | | | |
|---------------------------------------|---------------|-----------|------------|---------------|-----------|
| 30 Jun. 99 | Balance c/fwd | 29 | 1 Jul. 98 | Balance b/fwd | 20 |
| | | | 30 Jun. 99 | P&L a/c (W3) | 9 |
| | | <u>29</u> | | | <u>29</u> |

| Office equipment at cost | | | | | |
|--------------------------|---------------|------------|------------|---------------|------------|
| 1 Jul. 98 | Balance b/fwd | 125 | 30 Jun. 99 | Balance c/fwd | 125 |
| | | <u>125</u> | | | <u>125</u> |

| Office equipment – provision for depreciation | | | | | |
|---|-------------|-----------|------------|---------------|-----------|
| 30 Jun. 99 | Balance c/d | 61 | 1 Jul. 98 | Balance b/fwd | 45 |
| | | | 30 Jun. 99 | P&L a/c (W4) | 16 |
| | | <u>61</u> | | | <u>61</u> |

| Bad debts written off | | | | | |
|------------------------------|--------------------|------------|------------|---------------------|------------|
| 30 Jun. 99 | Debtors | <u>80</u> | 30 Jun. 99 | P&L a/c | <u>80</u> |
| | | <u>80</u> | | | <u>80</u> |
| Trade debtors | | | | | |
| 30 Jun. 99 | Balance c/fwd | 580 | 30 Jun. 99 | Bad debts (P&L a/c) | 80 |
| | | <u>580</u> | | Balance c/fwd | <u>500</u> |
| | | | | | <u>580</u> |
| Provision for doubtful debts | | | | | |
| 30 Jun. 99 | Balance c/fwd | 15 | 1 Jul. 98 | Balance b/fwd | 10 |
| | | <u>15</u> | | P&L a/c (W5) | <u>5</u> |
| | | | | | <u>15</u> |
| Insurance | | | | | |
| 1 Jul. 98 | Bank | 90 | 30 Jun. 99 | Prepaid c/fwd (W6) | 18 |
| | | <u>90</u> | | P&L a/c | <u>72</u> |
| | | | | | <u>90</u> |
| Sales commission payable | | | | | |
| 30 Jun. 99 | Bank (during year) | 40 | 30 Jun. 99 | P&L a/c | 46 |
| | Accrued c/fwd (W7) | <u>6</u> | | | <u>46</u> |
| | | <u>46</u> | | | <u>46</u> |

Workings**(W1) Motor vehicles – depreciation on disposed vehicle**

| | |
|--|-------------|
| | <i>£000</i> |
| Cost on 1 July 1996 | <u>20</u> |
| Depreciation y/e 30 June 1997: $20 \div 4$ | 5 |
| Depreciation y/e 30 June 1998: $20 \div 4$ | <u>5</u> |
| Total depreciation to be removed | <u>10</u> |

(W2) Motor vehicles – depreciation

| | |
|---------------------------------------|------------|
| Motor vehicles – cost at 30 June 1999 | <u>180</u> |
| Depreciation = $180 \div 4$ years = | <u>45</u> |

Note: the depreciation rate could also be expressed as 25% on cost

(W3) Fixtures – depreciation on existing items:

| | | |
|---|------|----------|
| | £000 | £000 |
| Cost at 1 July 1998 | 60 | |
| Depreciation = $60 \div 10$ | | 6 |
| Depreciation on new items: | | |
| Cost at 1 September 1998 | 40 | |
| Depreciation = $40 \div 10 \times 9/12 =$ | | <u>3</u> |

(W4) Office equipment – depreciation

| | |
|----------------------|-----------|
| | £000 |
| Cost b/fwd | 125 |
| Depreciation b/fwd | <u>45</u> |
| Net book value b/fwd | <u>80</u> |

(W5) Provision for doubtful debts

| | |
|------------------------------|------------|
| | £000 |
| Debtors (prior to bad debts) | 580 |
| Bad debts written off | <u>80</u> |
| Revised debtors | <u>500</u> |
| Provision $3\% \times 500 =$ | 15 |
| Less existing provision | <u>10</u> |

(W6) Insurance prepaid

| | |
|------------------------------|-----------|
| | £000 |
| Insurance paid for 15 months | 90 |
| Prepaid = $3/15 \times 90$ | <u>18</u> |
| Profit and account charge | <u>72</u> |

(W7) Sales commission accrued

| | |
|--------------------------------|-----------|
| | £000 |
| Sales commission paid | 40 |
| Accrued = $5\% \times 120$ | <u>6</u> |
| Profit and loss account charge | <u>46</u> |

(b) Profit and loss account for the year ended 30 June 1999 (extract)

| | |
|----------------------------------|------|
| <i>Expenses</i> | £000 |
| Depreciation | |
| Motor vehicles | 45 |
| Fixtures | 9 |
| Office equipment | 16 |
| Loss on disposal of fixed assets | 2 |
| Bad debts written off | 80 |
| Provision for bad debts | 5 |
| Insurance | 72 |
| Sales commission | 46 |

(c) Balance sheet at 30 June 1999 (extract)

| | <i>Cost (£000)</i> | <i>Dep'n (£000)</i> | <i>NBV (£000)</i> |
|-----------------------------------|--------------------|---------------------|-------------------|
| Fixed assets | | | |
| Motor vehicles | 180 | 105 | 75 |
| Fixtures | 100 | 29 | 71 |
| Office equipment | 125 | 61 | 64 |
| | <u>405</u> | <u>195</u> | <u>210</u> |
| Current assets | | | |
| Debtors | | 500 | |
| Less provision for doubtful debts | | <u>15</u> | |
| | | | 485 |
| Prepaid insurance | | | 18 |
| Current liabilities | | | |
| Accrued commission | | | 6 |

(d) Depreciation is a means of spreading the cost of fixed assets (less any expected sale proceeds) over their expected useful life, so as to charge the profit and loss account with a portion of their cost to reflect the usage of assets in earning revenue.

If depreciation were not charged then the profits would be overstated. There is a danger that these profits would be paid out as dividends (or as drawings in the case of a sole trader), thereby depleting the cash balances and the capital employed in the business. When the asset was disposed of the whole of the decrease in value since purchase would appear as a charge in that period's profit and loss account, thereby distorting the profits.

Cash is paid out when a fixed asset is paid for, not when depreciated. Cash comes in when the asset is disposed of. Providing for depreciation does not involve any movement of funds and does not provide a means of replacing fixed assets at the end of their lives, unless cash is set aside as a separate transaction.

7.7 Summary

This chapter has shown how:

- a transaction can be traced from a ledger account to a trial balance, and from there to the accounts – either trading account, profit and loss account or balance sheet;
- accounts are prepared from a trial balance and a list of adjustments, which need to be made to finalise the accounts.



The whole of this chapter should be regarded as a 'must know' topic if one is to be successful in passing the examination. This chapter has brought together much of what has been learnt in Chapters 2–6 inclusive. It is a good point to consolidate your studies before moving on to Chapter 8 and the remaining chapters in this study system.

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Revision Questions

7

? Question 1 Multiple choice

1.1 The following is an extract from the trial balance of ABC Ltd at 31 December 1994:

| | <i>Debit (£)</i> | <i>Credit (£)</i> |
|-----------|------------------|-------------------|
| Sales | | 73,716 |
| Returns | 5,863 | 3,492 |
| Discounts | 871 | 1,267 |

The figure to be shown in the trading account for net sales is:

- (A) £66,586
 - (B) £66,982
 - (C) £67,853
 - (D) £70,224
- 1.2 A company's working capital was £43,200. Subsequently, the following transactions occurred:
- creditors were paid £3,000 by cheque;
 - a bad debt of £250 was written off;
 - stock valued at £100 was sold for £230 on credit.
- Working capital is now:
£.....
- 1.3 Working capital will reduce by £500 if:
- (A) goods costing £3,000 are sold for £3,500 on credit.
 - (B) goods costing £3,000 are sold for £3,500 cash.
 - (C) fixed assets costing £500 are purchased on credit.
 - (D) fixed assets with a net book value of £750 are sold for £250 cash.
- 1.4 A business has opening stock of £12,000 and closing stock of £18,000. Purchase returns were £5,000. The cost of goods sold was £111,000. Purchases were:
£.....
- 1.5 At the beginning of the year, the balance on the provision for doubtful debts account was £6,000, representing 4 per cent of debtors. At the end of the year, debtors

amounted to £150,000, but it was decided that the provision should be increased to 5 per cent of debtors. Which of the following is correct?

| <i>Account entry</i> | <i>Profit and loss</i> | | |
|----------------------|-------------------------------------|-------------------------------------|----------------|
| | <i>Net debtors on balance sheet</i> | <i>Balance on provision account</i> | |
| A | £1,500 credit | £142,500 | £7,500 credit |
| B | £1,500 debit | £148,500 | £1,500 debit |
| C | £1,500 debit | £142,500 | £7,500 credit |
| D | £7,500 debit | £142,500 | £13,500 credit |

1.6 The following is an extract from the trial balance of a business for its most recent year.

| | <i>Debit (£)</i> | <i>Credit (£)</i> |
|-------------------|------------------|-------------------|
| Opening stock | 28,000 | |
| Sales | | 310,000 |
| Purchases | 225,000 | |
| Returns | 22,000 | 26,000 |
| Carriage inwards | 7,000 | |
| Carriage outwards | 8,000 | |

You are also told that closing stock was £23,000.

Using some or all of the figures above, the correct gross profit is:

£

1.7 The following is an extract from the trial balance of a business for its most recent year:

| | <i>Debit (£)</i> | <i>Credit (£)</i> |
|------------------------------|------------------|-------------------|
| Heat and light | 22,000 | |
| Rent and rates | 27,000 | |
| Fixed assets at cost | 80,000 | |
| Depreciation on fixed assets | | 20,000 |

Gross profit has already been calculated as being £85,000. Depreciation is to be provided at 25 per cent on the reducing balance. At the end of the year, heat and light accrued is £4,000, and rent and rates prepaid is £2,500.

The correct net profit is:

£

? Question 2

GBA is a sole trader, supplying building materials to local builders. He prepares his accounts to 30 June each year. At 30 June 1995, his trial balance was as follows:

| | <i>Debit (£)</i> | <i>Credit (£)</i> |
|---|------------------|-------------------|
| Capital at 1 July 1994 | | 55,550 |
| Purchases and sales | 324,500 | 625,000 |
| Returns | 2,300 | 1,700 |
| Discounts | 1,500 | 2,500 |
| Stock of building materials at 1 July 1994 | 98,200 | |
| Packing materials purchased | 12,900 | |
| Distribution costs | 17,000 | |
| Rent, rates and insurance | 5,100 | |
| Telephone | 3,200 | |
| Car expenses | 2,400 | |
| Wages | 71,700 | |
| | | |
| Provision for doubtful debts at 1 July 1994 | | 1,000 |
| Heat and light | 1,850 | |
| Sundry expenses | 6,700 | |
| Delivery vehicles cost | 112,500 | |
| Delivery vehicles depreciation at 1 July 1994 | | 35,000 |
| Equipment cost | 15,000 | |
| Equipment depreciation at 1 July 1994 | | 5,000 |
| Debtors and creditors | 95,000 | 82,000 |
| Loan | | 10,000 |
| Loan repayments | 6,400 | |
| Bank deposit account | 15,000 | |
| Bank current account | 26,500 | |
| | <u>817,750</u> | <u>817,750</u> |

The following additional information at 30 June 1995 is available:

1. Closing stocks:

| | |
|--------------------|-------------|
| Building materials | £ 75,300 |
| Packing materials | 700 |

There was also an unpaid invoice of £200 for packing materials received and consumed during the year.

2. Prepayments:

| | |
|---------------------------|----------|
| Rent, rates and insurance | £ 450 |
|---------------------------|----------|

3. Accrued expenses:

| | |
|----------------|----------|
| Heat and light | £ 400 |
| Telephone | 500 |

4. Wages includes £23,800 cash withdrawn by GBA.

5. Debtors have been analysed as follows:

| | |
|---------------|--------|
| | £ |
| Current month | 60,000 |
| 30 to 60 days | 20,000 |
| 60 to 90 days | 12,000 |
| Over 90 days | 3,000 |

Provision is to be made for doubtful debts as follows:

| | |
|---------------|-----------------------------|
| 30 to 60 days | 1% |
| 60 to 90 days | 2.5% |
| Over 90 days | 5% (after writing off £600) |

6. Sundry expenses includes £3,500 for GBA's personal tax bill.
7. The loan was taken out some years ago, and is due for repayment on 31 March 1996. The figure shown in the trial balance for loan repayments includes interest of £800 for the year.
8. The bank deposit account was opened on 1 January 1995 as a short-term investment; interest is credited at 31 December annually; the average rate of interest since opening the account has been 6 per cent per annum.
9. At 1 July 1994, GBA decided to bring one of his family cars, valued at £8,000, into the business. No entries have been made in the business books for its introduction.
10. Depreciation is to be provided as follows:
 - 20 per cent on cost for delivery vehicles;
 - at 25 per cent on the reducing balance for the car;
 - at 25 per cent on the reducing balance for equipment.

Requirements

- (a) Insert the missing items into the trading and profit and loss account for the year ended 30 June 1995, set out below.

| GBA: trading and profit and loss account 30 June 1995 | | | |
|--|---------|--------|---------|
| | £ | £ | £ |
| Sales | | | 625,000 |
| Returns inwards | | | ... |
| | | | ... |
| Cost of sales | | | |
| Opening stock | | 98,200 | |
| Purchases | 324,500 | | |
| Returns outwards | ... | | |
| | | ... | |
| Closing stock | | ... | |
| | | ... | |
| | | | ... |
| Gross profit | | | ... |
| Add: | | | ... |
| Interest on deposit account | | | ... |
| Discounts received | | | ... |
| Decrease in provision for doubtful debts | | | ... |
| | | | ... |
| Less | | | |
| Discounts allowed | | ... | |
| Packing materials consumed | | ... | |
| Distribution costs | | 17,000 | |
| Rent, rates and insurance | | ... | |
| Telephone | | ... | |
| Car expenses | | 2,400 | |
| Wages | | ... | |
| Heat and light | | ... | |
| Sundry expenses | | ... | |
| Interest on loan | | ... | |
| Bad debts written off in year | | ... | |
| Depreciation of delivery vehicles | | ... | |
| Depreciation of cars | | ... | |
| Depreciation of equipment | | ... | |
| | | | ... |
| Profit | | | ... |

(b) Insert the missing figures into the balance sheet set out below.

GBA: balance sheet at 30 June 1995

| | <i>Cost (£)</i> | <i>Depreciation (£)</i> | <i>Net (£)</i> |
|------------------------|-----------------|-------------------------|----------------|
| Fixed assets | | | |
| Delivery vehicles | 112,500 | ... | ... |
| Cars | ... | ... | ... |
| Equipment | 15,000 | ... | ... |
| | <u>...</u> | <u>...</u> | <u>...</u> |
| Current assets | | | |
| Stocks | | ... | |
| Debtors | ... | | |
| Less: provision | <u>...</u> | | |
| Prepayments | | ... | |
| Accrued income | | ... | |
| Bank deposit account | | 15,000 | |
| Bank current account | | <u>26,500</u> | |
| | | ... | |
| Current liabilities | | | |
| Creditors | ... | | |
| Accruals | ... | | |
| Loan | <u>...</u> | | |
| | | <u>...</u> | |
| | | | ... |
| | | | <u>...</u> |
| Financed by | | | |
| Capital at 1 July 1994 | | | 55,550 |
| Capital introduced | | | ... |
| Profit for the year | | | ... |
| Less: drawings | | | <u>...</u> |
| | | | <u>...</u> |

(c) With regard to the transaction in the business of GBA, which of the following transactions affect:

- profit
- cash at bank

| | <i>Affects Profit</i> | <i>Affects cash at Bank</i> |
|-----------------------------|--------------------------|-----------------------------|
| Payments to suppliers | <input type="checkbox"/> | <input type="checkbox"/> |
| Depreciation | <input type="checkbox"/> | <input type="checkbox"/> |
| Sales invoiced to customers | <input type="checkbox"/> | <input type="checkbox"/> |
| Drawings in cash | <input type="checkbox"/> | <input type="checkbox"/> |
| Loan repayment | <input type="checkbox"/> | <input type="checkbox"/> |
| Bad debts written off | <input type="checkbox"/> | <input type="checkbox"/> |

? Question 3

PLJ has been in business for some years and has kept her drawings slightly below the level of profits each year. She has never made a loss, and therefore feels that her business is growing steadily. You act as her accountant, and she has passed you the following list of balances at 30 April 1997.

| | |
|---|-------------|
| | <i>£000</i> |
| Capital at 1 May 1996 | 228 |
| Drawings | 14 |
| Plant at cost | 83 |
| Plant depreciation at 1 May 1996 | 13 |
| Office equipment at cost | 31 |
| Office equipment depreciation at 1 May 1996 | 8 |
| Debtors | 198 |
| Creditors | 52 |
| Sales | 813 |
| Purchases | 516 |
| Returns inwards | 47 |
| Discounts allowed | 4 |
| Provision for doubtful debts at 1 May 1996 | 23 |
| Administration costs | 38 |
| Salaries | 44 |
| Research costs | 26 |
| Loan to a friend, repayable in six months | 25 |
| Bank | 50 |
| Bad debts written off | 77 |

You ascertain that stock at 1 May 1996 was £84,000 and stock at 30 April 1997 was £74,000. On 1 November 1996, she brought her personal computer, valued at £2,000, from home into the office; no entries have been made for this.

You are also given the following information at 30 April 1997:

- (i) Depreciation on plant is charged at 10 per cent per annum on cost. Depreciation on office equipment is charged at 20 per cent per annum on the net book value at the year end.
- (ii) Administration costs include insurance prepaid of £3,000.
- (iii) Salaries accrued amount to £2,000.
- (iv) The research costs are all in relation to pure research.
- (v) It is agreed that the provision for doubtful debts figure is to remain at £23,000.

Requirements

- (a) Insert the missing items into the trial balance at 30 April 1997, set out below, after adjusting for the computer that PLJ has brought from home, but prior to making any other adjustments.

PLJ – trial balance at 30 April 1997

| | <i>Debit (£)</i> | | <i>Credit (£)</i> |
|---|------------------|----|-------------------|
| Capital at 1.5.96 | ... | or | ... |
| Capital introduced | ... | or | ... |
| Drawings | ... | or | ... |
| Plant at cost | ... | or | ... |
| Plant depreciation at 1.5.96 | ... | or | ... |
| Office equipment at cost or value | ... | or | ... |
| Office equipment depreciation at 1.5.96 | ... | or | ... |
| Debtors | ... | or | ... |
| Creditors | ... | or | ... |
| Sales | ... | or | ... |
| Purchases | ... | or | ... |
| Returns inwards | ... | or | ... |
| Discount allowed | ... | or | ... |
| Provision for doubtful debts at 1.5.96 | ... | or | ... |
| Administration costs | ... | or | ... |
| Salaries | ... | or | ... |
| Research costs | ... | or | ... |
| Loan to friend | ... | or | ... |
| Bank | ... | or | ... |
| Bad debts written off | ... | or | ... |
| Stocks at [insert date] ... | ... | or | ... |
| | <u>...</u> | | <u>...</u> |

- (b) Insert the missing figures into the trading and profit and loss account set out below.
Note: Expenditure on pure research is to be treated as a revenue expense.

| | | |
|----------------------------------|-------------|-------------|
| | <i>£000</i> | <i>£000</i> |
| Sales | | 813 |
| Less: returns inwards | | <u>...</u> |
| | | ... |
| Less cost of goods sold | | |
| Opening stock | ... | |
| Purchases | <u>516</u> | |
| | ... | |
| Closing stock | <u>...</u> | |
| | | <u>...</u> |
| Gross profit | | ... |
| Less expenses | | |
| Discount allowed | ... | |
| Administration costs | ... | |
| Salaries | ... | |
| Research costs | 26 | |
| Bad debts written off | 77 | |
| Depreciation of plant | ... | |
| Depreciation of office equipment | <u>...</u> | |
| | | <u>...</u> |
| Net profit | | <u>...</u> |

(c) Insert the missing figures into the balance sheet set out below.

| | <i>Cost (£000)</i> | <i>Depreciation (£000)</i> | <i>Net book value (£000)</i> |
|---------------------------|--------------------|----------------------------|------------------------------|
| Fixed assets | | | |
| Plant and machinery | 83 | ... | ... |
| Office equipment | ... | ... | ... |
| | <u>...</u> | <u>...</u> | <u>...</u> |
| Current assets | | | |
| Stocks | | ... | |
| Debtors | 198 | | |
| Less provisions | ... | | |
| | <u>...</u> | | |
| Loan | | ... | |
| Prepayments | | ... | |
| | | <u>...</u> | |
| Less: current liabilities | | | |
| Creditors | 52 | | |
| Accruals | ... | | |
| Bank overdraft | ... | | |
| | <u>...</u> | | |
| | | <u>...</u> | |
| | | | <u>...</u> |
| Financed by | | | <i>£000</i> |
| Capital | | | ... |
| Net profit | | | ... |
| Less drawings | | | (14.0) |
| | | | <u>...</u> |



Question 4

The following trial balance was extracted from the ledger of Stella Parkinson at the end of her most recent year.

| | £ | £ |
|------------------------------|------------------|------------------|
| Buildings at cost | 240,000 | |
| Plant at cost | 160,000 | |
| Provision for depreciation | | |
| at start of year | | |
| On buildings | | 40,000 |
| On plant | | 76,000 |
| Purchases and sales | 500,000 | 808,800 |
| Stock at start of year | 100,000 | |
| Discounts | 36,000 | 9,600 |
| Returns | 4,400 | 30,000 |
| Wages and salaries | 117,600 | |
| Bad debts written off | 9,200 | |
| Other expenses | 45,600 | |
| Debtors and creditors | 76,000 | 72,000 |
| Bank and cash | 3,200 | |
| Drawings | 48,000 | |
| Provision for doubtful debts | | 1,000 |
| Opening capital | | 302,600 |
| | <u>1,340,000</u> | <u>1,340,000</u> |

The following information is also given at the end of the year:

- (a) Closing stock is £84,000.
- (b) Wages and salaries accrued amount to £1,600.
- (c) Other expenses prepaid amount to £600.
- (d) The provision for doubtful debts is to be adjusted to 2 per cent of debtors.
- (e) Depreciation for the year is to be provided at:
 - 1.5 per cent per annum straight line on buildings;
 - 25 per cent per annum reducing balance on plant.

Requirements

- (a) Prepare the profit and loss account for the year by inserting the missing figures below.

Stella Parkinson: trading and profit and loss account for the year ended . . .

| | £ | £ | £ |
|------------------------------|---|---|---|
| Sales | | | █ |
| Less returns | | | █ |
| Net sales | | | █ |
| Less cost of sales: | | | |
| Opening stock | | █ | |
| Purchases | █ | | |
| Less returns | █ | | |
| | | █ | |
| | | █ | |
| Less closing stock | | █ | █ |
| Gross profit | | | █ |
| Add: discounts received | | | █ |
| | | | █ |
| Less expenses: | | | |
| Discounts allowed | | █ | |
| Wages and salaries | | █ | |
| Bad debts written off | | █ | |
| Other expenses | | █ | |
| Provision for doubtful debts | | █ | |
| Depreciation: | | | |
| Buildings (1.5% × 240,000) | | █ | |
| Plant (25% × 84,000) | | █ | |
| | | █ | █ |
| Net profit | | | █ |

(b) Prepare the balance sheet at the end of the year by inserting the missing figures below.

Stella Parkinson: balance sheet at . .

| | <i>Cost (£)</i> | <i>Depreciation (£)</i> | <i>Net book value (£)</i> |
|--------------------------|-----------------|-------------------------|---------------------------|
| Fixed assets | | | |
| Buildings | █ | █ | █ |
| Plant | █ | █ | █ |
| | <hr/> | <hr/> | <hr/> |
| Current assets | | | |
| Stocks | | █ | |
| Debtors | █ | | |
| Less provision | █ | | |
| | <hr/> | | |
| Prepayments | | █ | |
| Bank and cash | | █ | |
| | | <hr/> | |
| Less current liabilities | | | |
| Creditors | █ | | |
| Accruals | █ | | |
| | <hr/> | | |
| Net current assets | | █ | █ |
| | | | <hr/> |
| Financed by | | | |
| Opening capital | | | █ |
| Net profit for the year | | | █ |
| | | | <hr/> |
| Less drawings | | | █ |
| | | | <hr/> |
| | | | <hr/> |

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Solutions to Revision Questions

7



Solution 1

1.1 Answer: (C)

Net sales is calculated as follows:

| | | |
|----------------------|---|----------------|
| Sales | £ | 73,716 |
| Less returns inwards | | <u>(5,863)</u> |
| Net sales | | <u>67,853</u> |

Discounts are those arising from prompt payment (i.e. cash discounts) and do not appear in the trading account section of the accounts, but are brought into the profit and loss account after the calculation of gross profit.

1.2 Working capital is not affected by movements between current assets and current liabilities, so the payment of creditors by cheque would result in a lower bank balance and lower creditors, but would have no effect on working capital. The writing off of a bad debt of £250 would reduce debtors, and hence working capital. The sale of stock would increase debtors by £230, but only decrease stock by £100, so working capital would be increased by £130. The net effect of these items on working capital would be to decrease working capital by £120, so the final result would be £43,200 – £120 = £43,080.

1.3 Answer: (C)

(A) and (B) both involved the exchange of an asset (stock) with another asset of £500 more. This would result in an increase in working capital of £500. (D) would result in an increase in working capital of £250. Only (C) will result in a decrease in working capital, as a fixed asset is acquired by increasing creditors.

1.4 Reconstruction of cost of goods sold to establish the purchases figure:

| | | |
|--------------------|----------------|-----------------|
| Opening stock | £ | 12,000 |
| Add purchases* | 122,000 | |
| Less returns | <u>(5,000)</u> | |
| | | 117,000 |
| Closing stock | | <u>(18,000)</u> |
| Cost of goods sold | | <u>111,000</u> |

*Found by difference

1.5 Answer: (C)

The final provision must be 5 per cent of debtors of £150,000, that is, £7,500. This will provide the balance for the provision account, to be deducted from the debtors figure. Therefore debtors are £142,500. Thus, only answers (A) or (C) can be considered. The change in the provision from £6,000 to £7,500 is an additional charge to the profit and loss account, thus (C) is the correct answer.

1.6 Draw up the following:

| | £ | £ | £ |
|--------------------|---------------|----------------|----------------------|
| Sales | | | 310,000 |
| Less: returns | | | <u>22,000</u> |
| Net sales | | | 288,000 |
| Less cost of sales | | | |
| Opening stock | | 28,000 | |
| Purchases | 225,000 | | |
| Carriage inwards | <u>7,000</u> | | |
| | 232,000 | | |
| Less: returns | <u>26,000</u> | | |
| Net purchases | | <u>206,000</u> | |
| | | 234,000 | |
| Less closing stock | | <u>23,000</u> | |
| | | | <u>211,000</u> |
| Gross profit | | | <u><u>77,000</u></u> |

Common errors include:

- reversing returns;
- not adding carriage inwards to the cost of purchases (or deducting it);
- adding carriage outwards to the cost of purchases.

1.7 The profit and loss account would be:

| | £ | £ |
|---------------------------------|---------------|----------------------|
| Gross profit as calculated | | 85,000 |
| Less expenses | | |
| Heat and light (22,000 + 4,000) | 26,000 | |
| Rent and rates (27,000 – 2,500) | 24,500 | |
| Depreciation (25% of £60,000) | <u>15,000</u> | |
| | | <u>65,500</u> |
| Net profit | | <u><u>19,500</u></u> |

Common errors include not adjusting for accruals and prepayments, or adjusting the wrong way round, and calculating depreciation on the straight-line basis, where the question stipulates the reducing-balance basis.

**Solution 2**

- You will find it helpful to set out workings for most of the adjustments; although the workings themselves will not earn marks (unless otherwise indicated), they will help you to derive the correct figures to enter into the boxes provided.
- Remember there is already a balance on the provision for doubtful debts account.

- Notice that the deposit account has been open for only part of the year, and calculate interest accordingly.
- Make sure you deal correctly with returns and discounts.
- Remember to adjust for the cash taken by the proprietor.
- Divide the loan repayment figure between interest (for the profit and loss account) and the repayment of capital (to be deducted from the opening loan figure); notice also the repayment date of the loan.

(a) GBA – trading and profit and loss account for year ended 30 June 1995

| | £ | £ | £ |
|---|----------------|-----------------|-----------------------|
| Sales | | | 625,000 |
| Returns inwards | | | <u>(2,300)</u> |
| | | | 622,700 |
| Cost of sales | | | |
| Opening stock | | 98,200 | |
| Purchases | 324,500 | | |
| Returns outwards | <u>(1,700)</u> | | |
| | | <u>322,800</u> | |
| | | 421,000 | |
| Closing stock | | <u>(75,300)</u> | |
| | | | <u>(345,700)</u> |
| Gross profit | | | 277,000 |
| Add interest on deposit account (£15,000 × 6% × 6/12) | | | 450 |
| Add discounts received | | | 2,500 |
| Add decrease in provision for doubtful debts (£1,000 – £620) | | | <u>380</u> |
| | | | 280,330 |
| Discounts allowed | | 1,500 | |
| Packing materials consumed | | 12,400 | |
| Distribution costs | | 17,000 | |
| Rent, rates and insurance (£5,100 – £450) | | 4,650 | |
| Telephone (£3,200 + £500) | | 3,700 | |
| Car expenses | | 2,400 | |
| Wages (£71,700 – £23,800) | | 47,900 | |
| Heat and light (£1,850 + £400) | | 2,250 | |
| Sundry expenses (£6,700 – £3,500) | | 3,200 | |
| Interest on loan | | 800 | |
| Bad debts written off in year | | 600 | |
| Depreciation of delivery vehicles | | 22,500 | |
| Depreciation of cars | | 2,000 | |
| Depreciation of equipment | | <u>2,500</u> | |
| | | | <u>(123,400)</u> |
| Profit | | | <u><u>156,930</u></u> |

(b) GBA – balance sheet at 30 June 1995

| | <i>Cost (£)</i> | <i>Cum. Dep'n (£)</i> | <i>Net (£)</i> |
|-----------------------------------|-----------------|-----------------------|-----------------|
| Fixed assets | | | |
| Delivery vehicles | 112,500 | 57,500 | 55,000 |
| Cars | 8,000 | 2,000 | 6,000 |
| Office equipment | 15,000 | 7,500 | 7,500 |
| | <u>135,500</u> | <u>67,000</u> | <u>68,500</u> |
| Current assets | | | |
| Stocks (£75,300 + £700) | | 76,000 | |
| Debtors | 94,400 | | |
| Less provision | <u>(620)</u> | | |
| | | 93,780 | |
| Prepayments | | 450 | |
| Accrued income | | 450 | |
| Bank deposit account | | 15,000 | |
| Bank current account | | <u>26,500</u> | |
| | | 212,180 | |
| Current liabilities | | | |
| Creditors | 82,000 | | |
| Accruals (£400 + £500 + £200) | 1,100 | | |
| Loan (£10,000 – £5,600) | <u>4,400</u> | | |
| | | <u>(87,500)</u> | |
| | | | 124,680 |
| | | | <u>193,180</u> |
| Financed by | | | |
| Capital at 1 July 1994 | | | 55,550 |
| Add: capital introduced | | | 8,000 |
| Add: profit for the year | | | 156,930 |
| Less: drawings (£23,800 + £3,500) | | | <u>(27,300)</u> |
| | | | <u>193,180</u> |

(c) With regard to the transactions in the business of GBA, which of the following transactions affect:

- profit
- cash at bank

| | <i>Affects profit</i> | <i>Affects cash at bank</i> |
|-----------------------------|--------------------------|-----------------------------|
| Payments to suppliers | <input type="checkbox"/> | <input type="checkbox"/> |
| Depreciation | <input type="checkbox"/> | <input type="checkbox"/> |
| Sales invoiced to customers | <input type="checkbox"/> | <input type="checkbox"/> |
| Drawings in cash | <input type="checkbox"/> | <input type="checkbox"/> |
| Loan repayment | <input type="checkbox"/> | <input type="checkbox"/> |
| Bad debts written off | <input type="checkbox"/> | <input type="checkbox"/> |



Solution 3

- Take care to choose the correct side for the items in the trial balance, in particular returns, discounts and provision for doubtful debts.
- Remember to add in the computer that the proprietor has introduced, and to depreciate it.
- Notice that there is no change in the provision for doubtful debts, so there is no charge to the profit and loss account, but remember to deduct the balance from debtors on the balance sheet.

(a) PLJ: trial balance at 30 April 1997

| | <i>Debit</i> | <i>Credit</i> |
|---|--------------|---------------|
| | <i>£000</i> | <i>£000</i> |
| Capital at 1.5.96 | | 228 |
| Capital introduced | | 2 |
| Drawings | 14 | |
| Plant at cost | 83 | |
| Plant depreciation at 1.5.96 | | 13 |
| Office equipment at cost or value | 33 | |
| Office equipment depreciation at 1.5.96 | | 8 |
| Debtors | 198 | |
| Creditors | | 52 |
| Sales | | 813 |
| Purchases | 516 | |
| Returns inwards | 47 | |
| Discount allowed | 4 | |
| Provision for doubtful debts at 1.5.96 | | 23 |
| Administration costs | 38 | |
| Salaries | 44 | |
| Research costs | 26 | |
| Loan to friend, repayable in six months | 25 | |
| Bank | | 50 |
| Bad debts written off | 77 | |
| Stocks at 1.5.96 | 84 | |
| | <u>1,189</u> | <u>1,189</u> |

(b) PLJ: trading and profit and loss account for the year ended 30 April 1997

| | | |
|-------------------------------|-------------|----------------|
| | <i>£000</i> | <i>£000</i> |
| Sales | | 813 |
| Less returns inwards | | <u>(47)</u> |
| | | 766 |
| Less cost of goods sold | | |
| Opening stock | 84 | |
| Purchases | <u>516</u> | |
| | 600 | |
| Closing stock | <u>(74)</u> | |
| Cost of sales | | <u>(526)</u> |
| Gross profit | | 240 |
| Less expenses | | |
| Discount allowed | 4 | |
| Administration costs | 35 | |
| Salaries | 46 | |
| Research costs | 26 | |
| Bad debts written off | 77 | |
| Depreciation of plant | 8.3 | |
| Depreciation of office equip. | <u>5</u> | |
| | | <u>(201.3)</u> |
| Net profit | | <u>38.7</u> |

(c) PLJ – balance sheet at 30 April 1996

| | <i>Cost (£000)</i> | <i>Depreciation (£000)</i> | <i>Net book value (£000)</i> |
|---------------------|--------------------|----------------------------|------------------------------|
| Fixed assets | | | |
| Plant | 83 | 21.3 | 61.7 |
| Office equipment | <u>33</u> | <u>13.0</u> | <u>20.0</u> |
| | 116 | 34.3 | 81.7 |
| Current assets | | | |
| Stock | | 74 | |
| Debtors | 198 | | |
| Less provisions | <u>23</u> | | |
| | | 175 | |
| Loan | | 25 | |
| Prepayment | | <u>3</u> | |
| | | 277 | |
| Current liabilities | | | |
| Creditors | 52 | | |
| Accruals | 2 | | |
| Bank overdraft | <u>50</u> | | |
| | | <u>(104)</u> | |
| Net current assets | | | 173.0 |
| | | | <u>254.7</u> |
| Financed by | | | |
| Capital | | | 230.0 |
| Net profit | | | 38.7 |
| Less drawings | | | <u>(14.0)</u> |
| | | | <u>254.7</u> |



Solution 4

- Tick off each item on the trial balance as you use it.
- Calculate adjustments from the additional information carefully.
- Take care with provision for doubtful debts.
- Take care with returns and discounts.

(a) Stella Parkinson – trading and profit and loss account for the year ended . . .

| | £ | £ | £ |
|---|---------------|----------------|---------------|
| Sales | | | 808,800 |
| Less returns | | | <u>4,400</u> |
| Net sales | | | 804,400 |
| Less cost of sales | | | |
| Opening stock | | 100,000 | |
| Purchases | 500,000 | | |
| Less returns | <u>30,000</u> | | |
| | | 470,000 | |
| | | <u>570,000</u> | |
| Less closing stock | | <u>84,000</u> | |
| | | | 486,000 |
| Gross profit | | | 318,400 |
| Add: discounts received | | | <u>9,600</u> |
| | | | 328,000 |
| Less expenses | | | |
| Discounts allowed | | 36,000 | |
| Wages and salaries (117,600 + 1,600) | | 119,200 | |
| Bad debts written off | | 9,200 | |
| Other expenses (45,600 – 600) | | 45,000 | |
| Provision for doubtful debts (2% × 76,000) – 1,000 already provided | | 520 | |
| Depreciation | | | |
| Buildings (1.5% × 240,000) | | 3,600 | |
| Plant (25% × 84,000) | | <u>21,000</u> | |
| | | | 234,520 |
| Net profit | | | <u>93,480</u> |

(b) Stella Parkinson – balance sheet at . . .

| | <i>Cost (£)</i> | <i>Depreciation (£)</i> | <i>Net book value (£)</i> |
|--------------------------|-----------------|-------------------------|---------------------------|
| Fixed assets | | | |
| Buildings | 240,000 | 43,600 | 196,400 |
| Plant | <u>160,000</u> | <u>97,000</u> | <u>63,000</u> |
| | <u>400,000</u> | <u>140,600</u> | 259,400 |
| Current assets | | | |
| Stocks | | 84,000 | |
| Debtors | 76,000 | | |
| Less provision | <u>1,520</u> | | |
| | | 74,480 | |
| Prepayments | | 600 | |
| Bank and cash | | <u>3,200</u> | |
| | | <u>162,280</u> | |
| Less current liabilities | | | |
| Creditors | 72,000 | | |
| Accruals | <u>1,600</u> | | |
| | | <u>73,600</u> | |
| Net current assets | | | <u>88,680</u> |
| | | | <u>348,080</u> |
| Financed by | | | |
| Opening capital | | | 302,600 |
| Net profit for the year | | | <u>93,480</u> |
| | | | 396,080 |
| Less drawings | | | <u>48,000</u> |
| | | | <u>348,080</u> |

Organising the Bookkeeping System

8

LEARNING OUTCOMES

When you have completed this chapter, you should be able to:

- ▶ explain the purpose of accounting records and their role in the accounting system;
- ▶ prepare accounts for sales and purchases, including personal accounts;
- ▶ prepare cash and bank accounts;
- ▶ prepare petty cash statements under an imprest system;
- ▶ prepare nominal ledger accounts;
- ▶ prepare journal entries;
- ▶ prepare accounts for indirect taxes (e.g. VAT);
- ▶ explain, calculate and prepare accounts for stock.

8.1 Introduction

So far, the bookkeeping exercises you have seen and tried for yourself have involved only a small number of transactions, and you have therefore been able to keep all your ledger accounts in one place (even on one page!), with no difficulty in locating a particular ledger account or transaction if you wanted to check it again. Furthermore, producing a trial balance from a small number of ledger accounts is fairly quick, and any errors can easily be located by tracing through the entries again.

In this chapter we look at ways of organising the bookkeeping system for organisations with a larger number of transactions, where the ledger accounts may be too numerous to keep in one place, and where the number of transactions is too great for one person to handle. We also look at some of the supporting books and systems that help to maintain accuracy, security and control over the accounting records. A final section in this chapter deals with the stock records and the valuation of stock.

8.2 Organising the ledger accounts

In larger organisations, a single ledger may not be sufficient to hold all the ledger accounts, there may be too many transactions for one person to maintain, and it might become

difficult to trace individual accounts. It is common for the ledger accounts to be divided into sections, known as ‘divisions of the ledger’. Double entry is still maintained as before, but ledger accounts of the same type are grouped together.

A common division of the ledger is as follows:

- all debtors’ accounts kept in the *sales ledger* (also known as the *debtors ledger*);
- all creditors’ accounts kept in the *purchase ledger* (also known as the *creditors ledger* or *bought ledger*);
- all bank and cash accounts kept in a *cash book* with perhaps a separate *petty-cash book* as well;
- all others accounts kept in the *nominal ledger* (also known as the *general ledger*).

Other divisions are possible, if the organisation has additional requirements. Do note that the sales and purchase ledgers are for personal accounts. They do not contain the sales and purchases accounts – these are found in the nominal ledger.

8.2.1 Advantages of dividing the ledger

The advantages of dividing the ledger are the following:

- individual ledger accounts can be located more easily;
- the workload can be shared among several members of the staff;
- by having one person entering one ‘half’ of a transaction (e.g. crediting the sales account), and another person entering the other ‘half’ of the transaction (e.g. debiting the debtor’s account), it is possible to reduce the chance of errors and fraud;
- staff who maintain one of the divisions, for example, the sales ledger, can become experts in that area;
- additional controls can be built into the bookkeeping system to check accuracy.

We shall look at this last advantage in more detail in Chapter 9.

8.3 Supporting books and records

With a larger number of transactions, more errors are likely to occur, and with the ledger now divided into sections, with different people maintaining them, it is possible that there may be delays in keeping the accounts up to date, or that transactions may be omitted.

It is possible to maintain other books, records, lists, etc., that, although not part of the ledger, help in recording and controlling the transactions in the ledger. These books are known by various names:

- *daybooks* (because they are intended to be written up on a daily basis);
- *journals* (another word for ‘diary’ which also means ‘a daily record’);
- *books of prime entry* (‘prime’ means ‘first’) – and the transactions are ‘captured’ here first, before being entered in the ledger accounts.

These books are part of ‘the classification of monetary transactions’ that we mentioned in Chapter 1. We begin by classifying accounting transactions in a number of categories – sales to credit customers, purchases from suppliers, receipts of cash, payments of cash and so on. We keep a separate record for each of these categories, and we log each transaction as it arises in the appropriate record.

Most businesses of any size maintain records of their transactions in the following books of prime entry:

- *sales daybook* – which records goods sold to credit customers;
- *purchases daybook* – which records goods purchased on credit from suppliers (e.g. finished goods for resale in the case of a retail business; or raw materials for use in a manufacturing business). Traditionally, the purchases daybook was used only for such purchases, as businesses had few other types of purchase on credit – nowadays businesses have a much wider variety of expenses, and thus the purchases daybook is often used for all credit purchases and expenses. In practice, this usually means all purchases and expenses, as few businesses buy things for immediate payment;
- *returns inwards daybook* (or *sales returns daybook*) – which records goods returned by customers, perhaps because they were defective;
- *returns outwards daybook* (or *purchases returns daybook*) – which records goods returned to suppliers;
- *cash book* – which records payments made from the business bank account, and receipts of money into the business bank account;
- *petty-cash book* – which records small payments made in cash (i.e. notes and coins);
- *journal* – which records ‘unusual’ items, not falling into any of the categories above. The journal is also used for rectifying errors in the accounting entries.

Notice that the cash book and petty-cash book are also mentioned as ‘divisions of the ledger’ in Section 8.1. This is because these books fulfil a dual role. They are ‘books of prime entry’ because it is important that cash and bank accounts are kept as up to date as possible, so we want no delays in capturing such transactions, and they are also ledger accounts because they record the movements in cash and bank.

8.3.1 Source documents

Every transaction should be evidenced by a document showing the details of the transaction. These are known as ‘source documents’. There are different kinds for different types of transaction. Some originate outside the organisation (such as invoices received from suppliers), some originate inside the organisation but are sent to outsiders (such as invoices sent to customers), and others originate inside and remain inside the organisation (such as details of accruals at the end of the period).

We shall look at the cash books and the journal later in this chapter. First, we shall look at the first four daybooks described above – those that deal with credit sales and purchases.

8.4 Sales, purchases and returns daybooks

The source document for sales and purchases is known as an invoice; for returns, the source document is a credit note. A typical invoice (or credit note) will contain the following details:

- invoice (credit note) number and date;
- name and address of the supplier;
- name and address of the customer;
- quantity and description of the goods supplied;
- the price per unit for the goods, with details of any trade discount given;

- the total price charged for the goods, excluding VAT;
- the amount of VAT;
- the total payable, before any cash discounts;
- the amount and terms of cash discount available;
- the due date for payment.

You should note that the content of the invoice is the same for both purchases and sales. When the business sells goods to a customer, it prepares a *sales invoice* requesting payment; when the business purchases goods from a supplier it receives a *purchase invoice* from that supplier.

Credit notes should show the same information as an invoice.

8.4.1 Recording transactions in the daybooks

The four types of transaction identified earlier in this chapter are each recorded in their own specialist daybook.

Each of the books can be thought of as a listing device. They each contain columns to record the facts of the transaction. At regular intervals, they are totalled as part of the summarising process.

Such a daybook will have the following headings:

| <i>Date</i> | <i>Doc. no.</i> | <i>Personal details</i> | <i>Goods value (£)</i> | <i>VAT (£)</i> | <i>Total invoice/credit note value (£)</i> |
|-------------|-----------------|-------------------------|------------------------|----------------|--|
|-------------|-----------------|-------------------------|------------------------|----------------|--|

The personal details would be the name of the supplier or customer as appropriate.

The use of daybooks will enable the recording of such transactions to be delegated to junior staff who may not even be considered to be part of the accounts department. This will reduce the burden of work placed on the accounts department of the organisation.

Example 8.A

ABC Ltd had the following transactions during the first week of July 20X2:

| <i>July</i> | |
|-------------|---|
| 1 | Bought goods on credit from JB cost £1000 Sold goods on credit to JSA & Co. for £800 |
| 2 | Sold goods on credit to PB Ltd for £80 Returned goods to JB because they were faulty £80 |
| 3 | Bought goods from AL Ltd cost £600 |
| 4 | JSA & Co. returned unwanted goods £200 |
| 5 | Returned goods to AL Ltd £120 |
| 6 | Sold goods to CAL for £400 |
| 7 | CAL returned goods as unsuitable £120 Sold goods to BC for £240 |

All items are subject to VAT at 17.5 per cent.

Purchases daybook

| <i>Date</i> | <i>Doc. no.</i> | <i>Personal details</i> | <i>Goods value (£)</i> | <i>VAT (£)</i> | <i>Total invoice/credit note value (£)</i> |
|-------------|-----------------|-------------------------|------------------------|----------------|--|
| July | | | | | |
| 1 | 001 | JB | 1,000 | 175 | 1,175 |
| 3 | 002 | AL Ltd | 600 | 105 | 705 |
| | | | <u>1,600</u> | <u>280</u> | <u>1,880</u> |

Sales daybook

| Date | Doc. no. | Personal details | Goods value (£) | VAT (£) | Total invoice/credit note value (£) |
|------|----------|------------------|-----------------|------------|-------------------------------------|
| July | | | | | |
| 1 | 101 | JSA & Co. | 800 | 140 | 940 |
| 2 | 102 | PB Ltd | 80 | 14 | 94 |
| 6 | 103 | CAL | 400 | 70 | 470 |
| 7 | 104 | BC | 240 | 42 | 282 |
| | | | <u>1,520</u> | <u>266</u> | <u>1,786</u> |

Returns inwards daybook

| Date | Doc. no. | Personal details | Goods value (£) | VAT (£) | Total invoice/credit note value (£) |
|------|----------|------------------|-----------------|-----------|-------------------------------------|
| July | | | | | |
| 4 | 901 | JSA & Co. | 200 | 35 | 235 |
| 7 | 902 | CAL | 120 | 21 | 141 |
| | | | <u>320</u> | <u>56</u> | <u>376</u> |

Returns outwards daybook

| Date | Doc. no. | Personal details | Goods value (£) | VAT (£) | Total invoice/credit note value (£) |
|------|----------|------------------|-----------------|-----------|-------------------------------------|
| July | | | | | |
| 2 | 9001 | JB | 80 | 14 | 94 |
| 5 | 9002 | AL Ltd | 120 | 21 | 141 |
| | | | <u>200</u> | <u>35</u> | <u>235</u> |

Remember that if there was trade discount given on any of the above transactions, it would be deducted prior to calculating the VAT, and the net amount would be recorded in the 'goods value' column.

8.4.2 Making the ledger entries

It is important that the ledger accounts of debtors and creditors are kept up to date, otherwise the organisation could make incorrect decisions, such as allowing a customer to have further goods when he has not yet paid for the previous delivery, or not knowing that a creditor's account has been reduced by a credit note. Therefore, the ledger entries are made *at once* to the debtors and creditors accounts, probably by passing over the invoices and credit notes to the relevant ledger clerk. Remember that it is the total of the invoice or credit note that is entered in the personal accounts.

The entries to the sales, purchases, returns and VAT accounts are not so urgent. They will probably only be required to be up to date on a monthly basis. In addition, as the daybooks contain a complete list of all sales, purchases and returns (and the VAT thereon), there is no need to repeat all this in those ledger accounts. Thus, the daybooks can be totalled (and cross-checked for accuracy), and the totals entered in the nominal ledger accounts periodically.

Cross-referencing the entries

To enable the source of the ledger entries to be traced, a system of cross-referencing can be used. Each page in the daybooks is given a reference, for example, sales daybook page 23 (abbreviated to SD23), and each page in the ledger accounts is given a reference, for example, SLC3 might indicate the sales ledger, Section C, p. 3, where CAL's ledger account can be found. Extra columns can be added to the daybooks and ledger accounts to show these cross-references. These columns are called 'folio columns'.

Thus the ledger entries for all of the above items can be shown as follows:

| Sales ledger | | | | | |
|------------------------|--------|------------|--------|--------|------------|
| BC (B22) | | | | | |
| 4 July | 104 | £ 282 | | | |
| CAL (C14) | | | | | |
| 6 July | 103 | £ 470 | 7 July | 902 | £ 141 |
| JSA & Co. (J4) | | | | | |
| 1 July | 101 | £ 940 | 4 July | 901 | £ 235 |
| PB Ltd (P35) | | | | | |
| 2 July | 102 | £ 94 | | | |
| Purchase Ledger | | | | | |
| AL Ltd (A42) | | | | | |
| 5 July | 9002 | £ 141 | 3 July | 002 | £ 705 |
| JB (J7) | | | | | |
| 2 July | 9001 | £ 94 | 1 July | 001 | £ 1,175 |
| Nominal Ledger | | | | | |
| Purchases (01) | | | | | |
| 7 July | PDB97 | £ 1,600 | | | |
| Sales (02) | | | | | |
| | | | 7 July | SDB118 | £ 1,520 |
| Returns outwards (03) | | | | | |
| | | | 7 July | RODB25 | £ 200 |
| Returns inwards (04) | | | | | |
| 7 July | RIDB28 | £ 320 | | | |
| VAT (99) | | | | | |
| 7 July | PDB97 | £ 280 | 7 July | SDB118 | £ 266 |
| | RIDB28 | 56 | | RODB25 | 35 |

The double entry is now complete.

**Exercise 8.1**

Describe briefly the purpose, contents and use of the sales daybook.

**Solution**

The purpose of the sales daybook is to list all the normal sales of the organisation made on credit prior to recording the transactions in the ledger accounts. The sales daybook is a book of original or prime entry. The book can be totalled periodically, say monthly, and the totals can be used to credit the sales and VAT accounts instead of crediting them with each sale as it is made.

The book normally contains the invoice number and date, the total of the goods or services, the VAT thereon and the total invoice value. Sometimes trade discount is also recorded. If the organisation uses a customer numbering system, this will be listed and/or the name of the customer. Some organisations also break down the invoice into the various goods and services sold.

The sales daybook can be used to credit the sales and VAT accounts in total, to provide a complete list of sales on credit, and to provide a means of preventing and locating errors.

**Exercise 8.2**

List as many books of prime entry as you can.

**Solution**

Books of prime entry include:

- sales daybook;
- sales returns daybook;
- purchase daybook;
- purchase returns daybook;
- journal;
- cash book;
- petty-cash book.

**Exercise 8.3**

Enter the following transactions for the month of March in the appropriate daybooks and ledgers of PQR, an office equipment retailer.

March

- | | |
|----|--|
| 1 | Sold four typewriters to Office Services, list price £80 each, allowing 10% trade discount |
| 4 | Bought six calculators from Webb & Co. at £12 each net |
| 12 | Sold duplicating machine to J. Hoy for £350 |
| 16 | Sold four calculators to E. Mark, list price £20 each, allowing 10% trade discount |
| 17 | Office Services returned one damaged typewriter |
| 20 | Bought six typewriters from Ace Co., list price £40 each. Allowed 15% trade discount |
| 25 | Sold two duplicating machines to Mills & Co., list price £350, allowing 10% trade discount |

All items carry VAT at 17.5 per cent.

**Solution****Sales daybook**

| <i>Date</i> | <i>Doc. no.</i> | <i>Personal details</i> | <i>Goods value (£)</i> | <i>VAT (£)</i> | <i>Total invoice/credit note value (£)</i> |
|-------------|-----------------|-------------------------|------------------------|----------------|--|
| March | | | | | |
| 1 | 001 | Office Services | 288.00 | 50.40 | 338.40 |
| 12 | 002 | J. Hoy | 350.00 | 61.25 | 411.25 |
| 16 | 003 | E. Mark | 72.00 | 12.60 | 84.60 |
| 25 | 004 | Mills & Co. | <u>630.00</u> | <u>110.25</u> | <u>740.25</u> |
| | | | <u>1,340.00</u> | <u>234.50</u> | <u>2,914.50</u> |

Purchases daybook

| <i>Date</i> | <i>Doc. no.</i> | <i>Personal details</i> | <i>Goods value (£)</i> | <i>VAT (£)</i> | <i>Total invoice/credit note value (£)</i> |
|-------------|-----------------|-------------------------|------------------------|----------------|--|
| March | | | | | |
| 4 | 101 | Webb & Co. | 72.00 | 12.60 | 84.60 |
| 20 | 102 | Ace Co. | <u>204.00</u> | <u>35.70</u> | <u>239.70</u> |
| | | | <u>276.00</u> | <u>48.30</u> | <u>324.30</u> |

Sales returns daybook

| <i>Date</i> | <i>Doc. no.</i> | <i>Personal details</i> | <i>Goods value (£)</i> | <i>VAT (£)</i> | <i>Total invoice/credit note value (£)</i> |
|-------------|-----------------|-------------------------|------------------------|----------------|--|
| March | | | | | |
| 17 | 999 | Office Services | <u>72.00</u> | <u>12.60</u> | <u>84.60</u> |
| | | | <u>72.00</u> | <u>12.60</u> | <u>84.60</u> |

Sales ledger

| Office Services | | | | | | | |
|-----------------|---------|---|--------|----------|-----|---|-------|
| 1 March | Inv 001 | £ | 338.40 | 17 March | 999 | £ | 84.60 |
| J. Hoy | | | | | | | |
| 12 March | Inv 002 | £ | 411.25 | | | | |
| E. Mark | | | | | | | |
| 16 March | Inv 003 | £ | 84.60 | | | | |
| Mills & Co. | | | | | | | |
| 25 March | Inv 004 | £ | 740–25 | | | | |

Purchase Ledger

| Webb & Co. | | | | | | | |
|------------|--|--|--|----------|---------|---|--------|
| | | | | 4 March | Inv 101 | £ | 84.60 |
| Ace Co. | | | | | | | |
| | | | | 20 March | Inv 102 | £ | 239.70 |

| Nominal Ledger | | | | | | |
|----------------|--|-----------------------|--|-------------|---------------|---------------|
| Sales | | | | | | |
| 31 March | | | | | | |
| | | | | | Sales daybook | £ 1,340.00 |
| Purchases | | | | | | |
| 31 March | | | | | | |
| | | Purchases daybook | | £ 276.00 | | |
| Sales returns | | | | | | |
| 31 March | | | | | | |
| | | Sales returns daybook | | £ 72.00 | | |
| VAT | | | | | | |
| 31 March | | | | | | |
| | | Purchases daybook | | £ 48.30 | | |
| | | Sales returns daybook | | £ 12.60 | | |
| | | | | 31 March | | |
| | | | | | Sales daybook | £ 234.50 |

8.4.3 Extending the use of daybooks

The examples above assumed that only sales of the organisation's products, and purchases of its goods for sale or raw materials, were entered in the daybooks. This used to be the case when most of an organisation's transactions were in goods for sale. Nowadays, organisations have a wide range of expenses and services too, and the daybooks can be extended to cater for these also. As an example, consider a purchase daybook that is used to record all an organisation's purchases on credit, as follows:

| <i>Date</i> | <i>Doc. no.</i> | <i>Details</i> | <i>Purchases</i> (£) | <i>Stationery</i> (£) | <i>Heat and light</i> (£) | <i>Motor expenses</i> (£) | <i>VAT</i> (£) | <i>Total</i> (£) |
|-------------|-----------------|----------------|-------------------------|--------------------------|------------------------------|------------------------------|-------------------|---------------------|
| 1 Jan. | 001 | ABC Ltd | 1,000 | | | | 175 | 1,175 |
| 2 Jan. | 002 | XYZ | | 400 | | | 70 | 470 |
| 3 Jan. | 003 | PQ Ltd | 2,000 | | | | 350 | 2,350 |
| 4 Jan. | 004 | GL Motors | | | | 120 | 21 | 141 |
| | 005 | ABC Ltd | 4,000 | | | | 700 | 4,700 |
| 5 Jan. | 006 | XYZ | | 200 | | | 35 | 235 |
| | 007 | Genlec | | | 600 | | 105 | 705 |
| 6 Jan. | 008 | RS Motors | | | | 240 | 42 | 282 |
| 7 Jan. | 009 | Goodgas | | | 400 | | 70 | 470 |
| | | Totals | <u>7,000</u> | <u>600</u> | <u>1,000</u> | <u>360</u> | <u>1,568</u> | <u>9,828</u> |

The credit entries to the creditors accounts would be made immediately, but the nominal ledger entries to purchases, stationery, heat and light, motor expenses and VAT would be made in total at the end of the period.

8.5 The cash books

Again, the term 'cash book' dates back to the days when organisations dealt only in actual cash transactions. Nowadays businesses rarely deal in cash, and so the term 'cash book' refers to any book that records monies received and paid.

It was stated earlier that the cash books have a dual purpose, both as books of prime entry and as part of the ledger. As part of the ledger, they are used to maintain the bank

and cash ledger accounts, but because of the importance of keeping bank and cash records up to date they are the first place of entry for *all* bank and cash transactions.

8.5.1 The banking system

Today's banking system is highly automated, with large numbers of transactions being conducted electronically. However, many organisations still use cheques to make payments, and paying-in slips to make deposits to their accounts. Some common methods of transacting business through a bank account are as follows:

- *By cheque.* The *drawer* makes out a cheque to the person being paid (the *payee*). The cheque is entered in the drawer's ledger accounts at once, and sent to the payee. The payee pays it into his own bank account some days later, using a paying-in slip to record its details and that of other cheques paid in at the same time. The bank *clearing system* passes it to the drawer's bank for approval and payment, with the result that it is taken out of the drawer's bank account. This is known as *presenting a cheque* for payment. Until the cheque is accepted by the drawer's bank, it is considered to be *uncleared* and the bank has the right to return it as *dishonoured* if there is something amiss with it, or there are insufficient funds in the drawer's account. The time delay between making out a cheque and it being cleared depends on various factors, such as postal delays, administrative delays, holiday periods, etc. Each cheque has a reference number by which it can be identified.
- *By bankers automated clearing system (BACS).* This avoids the use of the postal system and the writing of numerous cheques by creating a transfer between the bank accounts of different organisations. It is a faster means of payment and it is also more cost-effective when there are regular payments to the same people. The account holder produces a list of the payments to be made at any particular time. There are also specialised types of automated payments suitable for the immediate transfer of funds both within the country and outside.
- *By direct debit or standing order.* These work in a similar manner to each other, and are suitable for regular payments to a particular person. The bank makes the transfer automatically.
- *By bank-initiated transactions,* such as the charging of fees for maintaining the account (bank charges), interest paid on overdrawn balances, interest received, charges for dealing with dishonoured cheques, etc.

An organisation may both make and receive payments by any of these methods.

Tight control of cash and bank balances is vital, and it is important to take account of the fact that some methods of transaction involve delays, and organisations may not be aware of, or may forget, automated transactions.

8.5.2 The cash book

At its simplest, the cash book is no more than an ordinary ledger account, used to record the movements in the bank account. Some organisations use it to record cash movements as well as bank movements, by using two 'money' columns on each side, as follows:

| <i>Date</i> | <i>Details</i> | <i>Ref</i> | <i>Bank (£)</i> | <i>Cash (£)</i> | <i>Date</i> | <i>Details</i> | <i>Ref</i> | <i>Bank (£)</i> | <i>Cash (£)</i> |
|-------------|----------------|------------|-----------------|-----------------|-------------|------------------|------------|-----------------|-----------------|
| 1 Jan. | Balance b/fwd | | 400 | 50 | 3 Jan. | ABC Ltd | 000123 | 100 | |
| 4 Jan. | XYZ Ltd | 101 | 200 | | 5 Jan. | Wages | | | 20 |
| 8 Jan. | Cash sales | | | 120 | 7 Jan. | Office equipment | 000124 | 300 | |
| 10 Jan. | PQR Ltd | 102 | 150 | | 8 Jan. | Advertising | 000125 | 125 | |
| | RST Ltd | 102 | 170 | | 12 Jan. | Wages | | | 30 |
| 14 Jan. | Cash banked | 103 | 50 | | 14 Jan. | Cash banked | | | 50 |
| | | | | | 14 Jan. | Balance c/d | | 445 | 70 |
| | | | <u>970</u> | <u>170</u> | | | | <u>970</u> | <u>170</u> |
| 15 Jan. | Balance b/d | | 445 | 70 | | | | | |

Discount columns

The cash book can also be used to indicate cash discount that has been given or received. We looked at the recording of cash discount in Chapter 5. We saw how, when cash discount is received or given, the amount is credited/debited to discounts received/discounts allowed account. Cash discount often involves a large number of small-value transactions, so it is possible that the nominal ledger (which contains the discount accounts), would soon fill up with the detail of a large number of small-value transactions. By adding an extra column to each side of the cashbook, the discount can be identified at the point of payment (which is when it becomes known), and the total of those columns used to make the entries in the discount accounts.

Example 8.B

Galaxy Traders Ltd had a favourable balance of £216 in its business bank account as at the start of business on 2 May 20X8. The following is a list of bank transactions for the week ending 7 May 20X8:

| | |
|-------|--|
| 2 May | Paid an insurance premium of £130 by cheque |
| 3 May | Paid an invoice for £110 from Goodies Ltd in full after deducting 10% for prompt settlement |
| 4 May | Received a cheque for £314 from Freda Dexter, a credit customer. Ms Dexter was settling an invoice for £320 and had been entitled to £6 discount |
| 6 May | Paid employees their week's wages of £182 by cheque |

You are required to record these transactions in the cashbook of Galaxy Traders Ltd below.

Solution

| Date | Details | Bank (£) | Disc.all'd (£) | Total (£) | Date | Details | Bank (£) | Disc.all'd (£) | Total (£) |
|-------|-------------|------------|----------------|------------|-------|-------------|------------|----------------|------------|
| 1 May | Balance b/f | 216 | | | 2 May | Insurance | 130 | | 130 |
| 4 May | Dexter | 314 | 6 | 320 | 3 May | Goodies | 99 | 11 | 110 |
| | | | | | 6 May | Wages | 182 | | 182 |
| | | | | | | Balance c/d | 119 | | |
| | | <u>530</u> | <u>6</u> | <u>320</u> | | | <u>530</u> | <u>11</u> | <u>422</u> |
| 7 May | Balance b/d | 119 | | | | | | | |

For the transaction on 3 May, Goodies will be debited with £110, and for the transaction on 4 May, Dexter will be credited with £320, whereas the bank account has only been debited/credited with the amount received/paid. The discount accounts have yet to have their entries made, and this can be done at the end of the period by totalling the discount columns and debiting discount allowed with £6, and crediting discount received with £11.

Analysed cash books

It is common for cash books to have a number of columns, called *analysis columns*, in which receipts and payments of a similar nature may be collected together and eventually totalled. An example is given below.

| Date | Details | Rec from dbtrs | Other income | Total rec'd | Date | Details | Paid to credtrs | Petty cash | Wages | VAT | Sundry | Total paid |
|------|---------|----------------|--------------|-------------|------|---------|-----------------|------------|-------|-----|--------|------------|
|------|---------|----------------|--------------|-------------|------|---------|-----------------|------------|-------|-----|--------|------------|

As well as entering the amount of each payment and receipt in the total columns, the amount would also be entered in one or other of the analysis columns. This means that when the book is totalled, at regular intervals, it will be immediately apparent how much

cash has been received from debtors, how much paid to creditors, how much paid in wages, etc. The totals can be used to make ledger entries, but can also be used in the control process covered in Chapter 9.



Exercise 8.4

N Ramrod keeps cash and bank records. At the close of business on 29 May 20X1 he reached the bottom of a page and carried forward the following:

| | <i>Discount (£)</i> | <i>Cash (£)</i> | <i>Bank (£)</i> | |
|-----------|---------------------|-----------------|-----------------|-------------|
| Total b/f | 27.40 | 114.10 | 214.30 | Debit side |
| Total b/f | 40.10 | 74.50 | 210.00 | Credit side |

The following sums were received on 30 May 20X1:

Cheque from J Cuthbertson for £120 in settlement of an account for £125

Cash from N Green £40

Cheque from Brian Way for £75 in settlement of an account for £76.50

The following payments were made on 30 May 20X1:

Cheque to Morris Brown for £140.40

Cheque to local council in payment of rates for the half-year £150.40

N Ramrod cashed a cheque for private drawings £50, and took £50 from the office cash for the same purpose.

Write up N Ramrod's cash and bank records and balance them at close of business on 30 May 20X1.



Solution

| <i>Date</i> | <i>Details (£)</i> | <i>Disc.all'd (£)</i> | <i>Cash (£)</i> | <i>Bank (£)</i> | <i>Date</i> | <i>Details (£)</i> | <i>Disc.all'd (£)</i> | <i>Cash (£)</i> | <i>Bank (£)</i> |
|-------------|--------------------|-----------------------|-----------------|-----------------|-------------|--------------------|-----------------------|-----------------|-----------------|
| 29 May | Balance b/f | 27.40 | 114.10 | 214.30 | 29 May | Balance b/f | 40.10 | 74.50 | 210.00 |
| 30 May | J Cuthbertson | 5.00 | | 120.00 | 30 May | Morris Brown | | | 140.40 |
| | N Green | | 40.00 | | | Rates | | | 150.40 |
| | Brian Way | 1.50 | | 75.00 | | Drawings | | 50.00 | 50.00 |
| | Balance c/f | | | 141.50 | | Balance c/f | | 29.60 | |
| | | <u>33.90</u> | <u>154.10</u> | <u>550.80</u> | | | <u>40.10</u> | <u>154.10</u> | <u>550.80</u> |

Authorising bank payments

All payments out of the bank account should be authorised by a senior member of staff. Two signatories may be required for amounts of more than a certain, fixed figure. All items to be paid should be evidenced by source documents, for example, invoices, that have been approved for payment.

8.5.3 The petty-cash book

The petty-cash book is similar in many ways to the cash books described earlier in this chapter except that it is intended to be used for small payments made in cash.



It usually operates on an *imprest* system whereby an agreed balance of cash is held by an individual nominated as the petty cashier. This person can often be a junior member of staff due to the fact that he or she is responsible only for small sums of money that are tightly controlled. Small payments of cash and reimbursements of expenses to employees are then made via the petty-cash system and at the end of each week (or other agreed period) the amount paid out of petty cash is reimbursed from the main cash book to restore the imprest (balance) to its agreed level. The amount to be reimbursed is evidenced by *petty-cash vouchers* raised by the petty cashier, and signed by the person receiving the cash, as evidence of receipt. The cash itself can be counted and compared to the balance in the petty-cash book.

The petty-cash book would not normally receive income other than from the main cashier, although such a possibility does exist, and so its design concentrates on the analysis of expenditure by using a columnar approach as illustrated by the example below.

At the end of each accounting period the columns are totalled. The balance on the petty-cash account is carried forward to the next accounting period.

Example 8.C

Beechfield Ltd make use of a petty-cash book as part of their bookkeeping system. The following is a summary of the petty-cash transactions for the month of November 20X9.

| November | | £ |
|----------|---|-----|
| 1 | Opening petty-cash book float received from cashier | 350 |
| 2 | Cleaning materials | 5 |
| 3 | Postage stamps | 10 |
| 6 | Envelopes | 12 |
| 8 | Taxi fare | 32 |
| 10 | Petrol for company car | 17 |
| 14 | Typing paper | 25 |
| 15 | Cleaning materials | 4 |
| 16 | Bus fare | 2 |
| 20 | Visitors' lunches | 56 |
| 21 | Mops and brushes for cleaning | 41 |
| 23 | Postage stamps | 35 |
| 27 | Envelopes | 12 |
| 29 | Visitors' lunches | 30 |
| 30 | Photocopying paper | 40 |

You are required to draw up a petty-cash book for the month using analysis columns for stationery, cleaning, entertainment, travelling and postages. Show clearly the receipt of the amount necessary to restore the float and the balance brought forward for the start of the following month.

Solution

| £ | Date | Details | Total £ | Stat'y £ | Cleaning £ | Ent'ment £ | Travel £ | Post £ |
|------------|---------|-------------|------------|-------------|---------------|---------------|-------------|-----------|
| 350 | 1 Nov. | Cashier | | | | | | |
| | 2 Nov. | Materials | 5 | | 5 | | | |
| | 3 Nov. | Stamps | 10 | | | | | 10 |
| | 6 Nov. | Envelopes | 12 | 12 | | | | |
| | 8 Nov. | Taxi | 32 | | | | 32 | |
| | 10 Nov. | Petrol | 17 | | | | 17 | |
| | 14 Nov. | Paper | 25 | 25 | | | | |
| | 15 Nov. | Materials | 4 | | 4 | | | |
| | 16 Nov. | Bus fare | 2 | | | | 2 | |
| | 20 Nov. | Lunches | 56 | | | 56 | | |
| | 21 Nov. | Mops, etc. | 41 | | 41 | | | |
| | 23 Nov. | Stamps | 35 | | | | | 35 |
| | 27 Nov. | Envelopes | 12 | 12 | | | | |
| | 29 Nov. | Lunches | 30 | | | 30 | | |
| | 30 Nov. | Paper | 40 | 40 | | | | |
| 321 | 30 Nov. | Cashier | | | | | | |
| | 30 Nov. | Balance c/d | 350 | | | | | |
| <u>671</u> | | | <u>671</u> | <u>89</u> | <u>50</u> | <u>86</u> | <u>51</u> | <u>45</u> |

The totals of the various expense columns are then debited to those accounts in the nominal ledger.

**Exercise 8.5**

Explain briefly the operation of the imprest system of controlling petty cash.

**Solution**

The imprest system of controlling petty cash is based on a set 'float' of cash that the petty cashier commences with. This amount is used to pay for small items during the coming week or month, for which a petty-cash voucher should be prepared. At the end of the period (or when the cash runs out), the vouchers can be totalled and the amount spent is reimbursed to the petty cashier so as to commence the next period with the same 'float'.

8.6 The journal

In a bookkeeping system involving the use of books of prime entry, it is inevitable that there will be transactions that do not correspond with the main books of prime entry used, that is, the daybooks and cash books. In order to complete the system, another book is needed in which to capture sundry items prior to entering them in the ledger. This book is called 'the journal', and is used for a wide variety of transactions, such as:

- the purchase and sale of fixed assets on credit;
- the write-off of bad debts;
- provisions for depreciation and doubtful debts;
- accruals and prepayments;
- transfers between accounts, such as the transfers to profit and loss account at year end;
- the correction of errors.

The correction of errors will be considered in the next chapter.

The journal is used to record any transaction that does not fit into any of the other books of prime entry, that is, transactions that are not sales or purchases on credit, and transactions not involving cash.



It is common for an exam question to ask for the journal entries for a transaction. This is sometimes as an alternative to asking for the ledger entries. You must therefore know how to layout a journal and record the debits and credits of a transaction.

8.6.1 The layout of the journal

The basic layout is as follows:

| <i>Date</i> | <i>Account name/details</i> | <i>Debit (£)</i> | <i>Credit (£)</i> | <i>Explanation</i> |
|-------------|-----------------------------|------------------|-------------------|--------------------|
|-------------|-----------------------------|------------------|-------------------|--------------------|

8.6.2 Using the journal for miscellaneous transactions

The following transactions are to be entered in the journal:

| | | | | |
|-------|--|--|--|------|
| 1 May | Purchased plant on credit from J Smith for £1,000 plus VAT at 17.5% | | | |
| 3 May | Wrote off the following bad debts | | | |
| | P Taylor | | | £500 |
| | M Morris | | | £300 |
| | Y Bhatti | | | £100 |
| 4 May | Sold office machinery for £800 to A Bell on credit. The machinery had cost £1,000 and had been depreciated by £400 | | | |

Solution

| <i>Date</i> | <i>Account name/details</i> | <i>Debit (£)</i> | <i>Credit (£)</i> | <i>Explanation</i> |
|-------------|-------------------------------|------------------|-------------------|---|
| 1 May | Plant | 1,000 | | Purchase of plant on credit, see invoice No. X123 |
| | VAT | 175 | | |
| | J Smith | | 1,175 | |
| 3 May | Bad debts written off | 900 | | Bad debts – see bad-debt file, reference May 003 |
| | Taylor | | 500 | |
| | Morris | | 300 | |
| | Bhatti | | 100 | |
| 4 May | Office machinery at cost | | 1,000 | Office machinery sold on credit, see invoice No. Y345 |
| | Office machinery depreciation | 400 | | |
| | A Bell | 800 | | |
| | Disposals account | | 200 | |
| | | | | (Profit on disposal) |

8.6.3 Using the journal for end-of-year transactions

The following year-end adjustments are to be made to the accounts:

| | | | |
|----|------------------------------|--------|----------------------------------|
| | | £ | |
| 1. | Depreciation of fixtures | 500 | |
| 2. | Electricity accrued | 150 | |
| 3. | Provision for doubtful debts | 240 | |
| 4. | Transfer of balances | | |
| | (a) sales | 12,000 | |
| | (b) opening stock | 1,500 | |
| | (c) purchases | 8,000 | |
| | (d) closing stock | 1,200 | |
| | (e) heat and light | 700 | (excluding the adjustment above) |
| | (f) wages | 4,300 | |

The journal entries would be as follows:

| <i>Date</i> | <i>Account name/details</i> | <i>Debit (£)</i> | <i>Credit (£)</i> | <i>Explanation</i> |
|-------------|------------------------------|------------------|-------------------|-----------------------------------|
| (1) | Profit and loss account | 500 | | |
| | Provision for depreciation | | 500 | |
| (2) | Profit and loss account | 150 | | |
| | Heat and light account | | 150 | |
| (3) | Profit and loss account | 240 | | |
| | Provision for doubtful debts | | 240 | |
| (4) | Sales account | 12,000 | | |
| | Trading account | | 12,000 | |
| | Trading account | 1,500 | | Balances transferred at year end. |
| | Stock account | | 1,500 | |
| | Trading account | 8,000 | | |
| | Purchases account | | 8,000 | |
| | Stock account | 1,200 | | |
| | Trading account | | 1,200 | |
| | Profit and loss account | 700 | | |
| | Heat and light | | 700 | |
| | Profit and loss account | 4,300 | | |
| | Wages account | | 4,300 | |

Authorisation of journal entries

Because journal entries involving adjustments and transfer have no source documents to support them, it is vital that all such entries are authorised by a senior member of staff. This can be done by signing the journal entries, or by referencing them to other forms of authorisation, for example, letters, minutes, etc.

8.7 Stock records and valuation methods

The valuation of stock is important because, as we have already learned, it is part of the overall value of an organisation shown in the balance sheet. From your work in preparing a trading and profit and loss account it should already be clear that the value placed on stock affects the amount of profit or loss made by an organisation during a period of time.

This apparent ability to alter the profit of an organisation by changing its stock valuation explains the need to regulate the methods to be used when valuing stock.



Stock should be valued at the lower of cost and net realisable value (NRV).

- Cost is the total cost incurred in bringing the product to its present location and condition. For bought-in items this will be the cost of the items themselves plus the costs of carriage associated with obtaining them.
- NRV is the selling price of the item less any costs to be incurred in making the item suitable for sale. These might include packaging and costs of delivering the items to customers.



For example, if some items have been bought at a cost of £5 each but, owing to market conditions, they can be sold for just £6 each and the cost of packaging and delivering them to customers is £1.50 each, it can be seen that:

| | |
|----------------------|-------|
| Cost | £5.00 |
| Net realisable value | £4.50 |

In other words, when the items are eventually sold for £6 each there will be a loss of £0.50 per item.

| | | |
|-------------------------|-------------|-------------|
| | £ | £ |
| Selling price | | 6.00 |
| Purchase cost | 5.00 | |
| Packaging/delivery cost | <u>1.50</u> | |
| | | (6.50) |
| Loss | | <u>0.50</u> |

By valuing the stock at its net realisable value of £4.50 we are recognising the foreseeable loss of £0.50 per item.

The fall in value should be recognised as soon as it is known about. Suppose that we bought 100 of the above items, and sold 60 in the first month, with the remainder being carried forward to the next month. The calculation of the loss in the first month would be as follows:

| | | |
|----------------------------------|---------------|----------------|
| | £ | £ |
| Sales (60 × £6.00) | | 360.00 |
| Less cost of sales: | | |
| Purchases (100 × £5.00) | 500.00 | |
| Packaging costs: (60 × £1.50) | <u>90.00</u> | |
| | | 590.00 |
| Less: closing stock (40 × £4.50) | <u>180.00</u> | |
| | | 410.00 |
| Profit/(Loss) | | <u>(50.00)</u> |

The whole of the loss is accounted for in the first month, not just the loss on those sold. In the second month, assuming the remaining items were all sold, the calculation would be as follows:

| | | |
|------------------------------|--------|---------------|
| | £ | £ |
| Sales (40 × £6.00) | | 240.00 |
| Less cost of sales: | | |
| Opening stock (as above) | 180.00 | |
| Packaging costs (40 × £1.50) | 60.00 | |
| | | <u>240.00</u> |
| Profit/(Loss) | | <u>—</u> |

This treatment is an example of applying the concept of ‘prudence’, which is explained more fully in Chapter 10.

8.7.1 The process of stock valuation

The value of stock is obtained at a particular point in time – there are two ways to achieve this: either physically measure the quantity of stock held at that time and then value it, or record the movement of stock on a regular basis and verify such records randomly over a period of time. These stock records are then used as the basis of the valuation.

Stocktaking

The physical measurement of the quantity of stock held at a particular time is known as stocktaking. It is not always possible to take stock at the time required and in these circumstances cut-off procedures are applied to adjust the quantity actually measured to that which would have been measured had the stock been measured at the appropriate time.

Example 8.D

On 3 June, a physical stocktake was carried out that revealed that XYZ Ltd held 405 units of stock. According to the company's records they had received a delivery of 250 units on 2 June and had sold 110 units since 31 May.

Solution

The stock that existed on 31 May was therefore:

| | |
|--|--------------|
| | <i>Units</i> |
| Quantity as per stocktake | 405 |
| Add units sold/used before stocktake | <u>110</u> |
| | 515 |
| Less units received before the stocktake | <u>(250)</u> |
| Theoretical stock on 31 May | <u>265</u> |

The cost valuation of these items is then obtained by multiplying the quantity by the cost price per unit.

This technique is most common in small organisations. Larger organisations keep records of the movement of stocks using *bin cards* or *stores ledger cards*, but even so they should physically check their stock from time to time and compare it with the stock recorded on the bin or stores ledger card, and make any necessary investigations and/or adjustments.

A bin card is a document, traditionally made of cardboard, on which is manually recorded the movement of stock. It is called a bin card because in storekeeping terminology a 'bin' is the location of an item in the stores. This record is usually kept with the items in the stores so that any movement of the stock is recorded as it occurs.

The stores ledger card is similar except that in addition to recording quantities, cost values are also recorded so that the value of stock can be seen at any time.

Each item of stock has its own stock reference code and bin card/stores ledger card.

8.7.2 Application of cost-valuation techniques

Consider the following information regarding the movements of stock during March:

| <i>March</i> | |
|--------------|---------------------------|
| 1 | Opening stock Nil |
| 2 | Bought 10 units @ £3 each |
| 4 | Sold 5 units @ £8 each |
| 7 | Bought 20 units @ £4 each |
| 10 | Sold 15 units @ £8 each |
| 13 | Bought 20 units @ £5 each |
| 17 | Sold 5 units @ £8 each |

Using these figures we can calculate that the stock remaining after these transactions had occurred was 25 units. The difficulty is in valuing those units. Is the remaining stock made up of items bought recently, or is it made up of items bought earlier? Or is a mixture of the two? How do we know?

Well, in practice, we do not know. It is up to the storekeeper to exercise good management of stocks, but it is up to the accountant to determine the value of those stocks.

Three valuation techniques are commonly used in financial accounting. Each of them gives different valuations of the closing stock. Each of these methods will now be considered.



First in, first out (FIFO). This method assumes, for valuation purposes, that the items bought earliest are those used (or sold) first. This assumption is made only for valuation purposes, it does not have any connection with the physical usage of the stock.

Stores ledger card – FIFO

| Date | Receipts | | | Issues | | | Balance | | |
|---------|-----------|--------|------------|-----------|--------|-----------|-----------|--------|------------|
| | Units | £/unit | £ | Units | £/unit | £ | Units | £/unit | £ |
| March 1 | | | | | | | Nil | – | Nil |
| 2 | 10 | 3 | 30 | | | | 10 | 3 | 30 |
| 4 | | | | 5 | 3 | 15 | 5 | 3 | 15 |
| 7 | 20 | 4 | 80 | | | | 20 | 4 | 80 |
| 10 | | | | 5 | 3 | 15 | | | |
| | | | | 10 | 4 | 40 | 10 | 4 | 40 |
| 13 | 20 | 5 | 100 | | | | 20 | 5 | 100 |
| 17 | | | | 5 | 4 | 20 | 5 | 4 | 20 |
| | | | | | | | 20 | 5 | 100 |
| Totals | <u>50</u> | | <u>210</u> | <u>25</u> | | <u>90</u> | <u>25</u> | | <u>120</u> |

Note that the card is ‘ruled off’ each time there is an ‘issue’ of stocks.

This method gives a closing stock valuation of £120 and the cost of sales (obtained by totalling the cost of each issue) amounted to £90. This method is acceptable for external accounting statements in the UK.

Using this method, the trading account would be as follows:

| | | |
|-----------------------|--------------|-------------|
| | £ | £ |
| Sales (25 units @ £8) | | 200 |
| Opening stock | – | |
| Purchases | <u>210</u> | |
| | 210 | |
| Closing stock | <u>(120)</u> | |
| Cost of sales | | <u>(90)</u> |
| Gross profit | | <u>110</u> |



Last in, first out (LIFO). This method assumes, for valuation purposes, that the items bought most recently are those used first. Again, this assumption is made only for valuation purposes, it does not have any connection with the physical usage of the stock.

Stores ledger card – LIFO

| Date | Receipts | | | Issues | | | Balance | | |
|---------|-----------|--------|------------|-----------|--------|------------|-----------|--------|------------|
| | Units | £/unit | £ | Units | £/unit | £ | Units | £/unit | £ |
| March 1 | | | | | | | Nil | – | Nil |
| 2 | 10 | 3 | 30 | | | | 10 | 3 | 30 |
| 4 | | | | 5 | 3 | 15 | 5 | 3 | 15 |
| 7 | 20 | 4 | 80 | | | | 20 | 4 | 80 |
| 10 | | | | 15 | 4 | 60 | 5 | 3 | 15 |
| | | | | | | | 5 | 4 | 20 |
| 13 | 20 | 5 | 100 | | | | 20 | 5 | 100 |
| 17 | | | | 5 | 5 | 25 | 5 | 3 | 15 |
| | | | | | | | 5 | 4 | 20 |
| | | | | | | | 15 | 5 | 75 |
| Totals | <u>50</u> | | <u>210</u> | <u>25</u> | | <u>100</u> | <u>25</u> | | <u>110</u> |

This method gives a closing stock valuation of £110 and the cost of sales (obtained by totalling the cost of each issue) amounted to £100. Using this method, the trading account would be as follows:

| | | |
|-----------------------|------------|--------------|
| | £ | £ |
| Sales (25 units @ £8) | | 200 |
| Opening stock | Nil | |
| Purchases | <u>210</u> | |
| | 210 | |
| Closing stock | (110) | |
| Cost of sales | | <u>(100)</u> |
| Gross profit | | <u>100</u> |

You can see that this results in a higher cost of sales total than with the FIFO method, and hence a lower gross profit, in times of inflation. It also results in a lower closing stock figure, as the stock is valued at earlier prices. The method is not acceptable in the UK for external accounting statements. It can be argued, however, that the profit is more realistic than with the FIFO method, as it values cost of sales at a value nearer to the current cost of replacing the stocks sold with new stocks.



Weighted average cost method (AVCO). This method recalculates a new weighted average cost each time a new delivery of units is received using the formula:

$$\frac{\text{Previous balance value} + \text{new receipts value}}{\text{Previous units} + \text{new units}}$$

Issues are then valued at the new weighted average cost.

Stores ledger card – Weighted average

| Date | Units | Receipts £/unit | £ | Units | Issues £/unit | £ | Units | Balance £/unit | £ |
|--------|-------|--------------------|------------|-------|------------------|-----------|-------|-------------------|-----|
| March | | | | | | | | | |
| 1 | | | | | | | Nil | – | Nil |
| 2 | 10 | 3 | 30 | | | | 10 | 3 | 30 |
| 4 | | | | 5 | 3 | 15 | 5 | 3 | 15 |
| 7 | 20 | 4 | 80 | | | | 25 | 3.8 | 95 |
| 10 | | | | 15 | 3.8 | 57 | 10 | 3.8 | 38 |
| 13 | 20 | 5 | 100 | | | | 30 | 4.6 | 138 |
| 17 | | | | 5 | 4.6 | <u>23</u> | 25 | 4.6 | 115 |
| Totals | | | <u>210</u> | | | <u>95</u> | | | |

This method gives a closing stock valuation of £115 and the cost of sales (obtained by totalling the cost of each issue) amounted to £95.

Using this method the trading account would be as follows:

| | | |
|-----------------------|------------|-------------|
| | £ | £ |
| Sales (25 units @ £8) | | 200 |
| Opening stock | Nil | |
| Purchases | <u>210</u> | |
| | 210 | |
| Closing stock | (115) | |
| Cost of sales | | <u>(95)</u> |
| Gross profit | | <u>105</u> |

You can see from this example that, in times of rising prices, the weighted average method gives a lower closing stock valuation than FIFO and, consequently, a lower profit, but a higher closing stock valuation than the LIFO methods, and consequently a higher profit. It is an acceptable method of reporting in financial accounts in the UK.

It might be useful for you to see the profit calculation of the three methods together, to compare them:

| | <i>FIFO</i> | <i>LIFO</i> | <i>AVCO</i> |
|--------------------|--------------|--------------|--------------|
| | £ | £ | £ |
| Sales | <u>200</u> | <u>200</u> | <u>200</u> |
| Less cost of sales | | | |
| Opening stock | Nil | Nil | Nil |
| Purchases | 210 | 210 | 210 |
| Less closing stock | <u>(120)</u> | <u>(110)</u> | <u>(115)</u> |
| | <u>90</u> | <u>100</u> | <u>95</u> |
| Gross profit | <u>110</u> | <u>100</u> | <u>105</u> |

8.7.3 Issues and receipts

The three examples above used the words ‘receipts’ to mean ‘purchases’ and ‘issues’ to mean ‘sales’, but note that ‘receipts’ could also include stocks returned by customers, and ‘issues’ could also include stocks returned to suppliers. ‘Issues’ could also mean stocks taken out of the general store and sent to another department, for example, a production department.

Take care when doing exercises that require you to calculate the value of cost of sales and purchases, as well as the closing stock, if your receipts and issues columns contain items other than sales and purchases. Remember also that the sales column indicates the cost of sales, not the selling price.



Exercise 8.6

Explain what is meant by stock valuation using FIFO, LIFO and AVCO.



Solution

Stock valuation using FIFO is a method of valuing stocks on the assumption that those received first are used first. This results in those stocks remaining being valued at more recent prices. In times of rising prices, this method gives lower cost of sales figures and hence a higher gross profit, and a higher closing stock valuation than might otherwise be the case. Stock valuation using LIFO values stocks on the assumption that those received most recently are used first, and hence those remaining are valued at earlier prices. The result is a lower profit figure and a lower stock valuation. The AVCO method incorporates each new purchase with the existing stock, weighted according to the quantity purchased. The result is a profit figure and a stock valuation of somewhere in between the other two methods.



Exercise 8.7

M Lord had a stock on 1 January 20X1 consisting of 400 articles bought at £4 each. His purchases during the month of January consisted of 800 at £4.20 each purchased on 8 January, and 2,000 at £3.80 each on 18 January. He sold 2,400 at £5.00 each on 28 January. Forty of those sold were returned in perfect condition on 31 January.

You are required:

- to ascertain, by means of a stock account:
 - the number of articles held in stock on 31 January 20X1;
 - the unit price and total value of that stock.
- to show the trading account for the month ended 31 January 20X1;
- to calculate the gross profit as a percentage of cost of sales.

Note: Lord uses the FIFO method of stock valuation.



Solution

| Date | Receipts | | | Issues | | | Balance | | |
|---------|----------|--------|-------|--------|--------|-------|--------------|-------------|--------------|
| | Units | £/unit | £ | Units | £/unit | £ | Units | £/unit | £ |
| 1 Jan. | | | | | | | 400 | 4.00 | 1,600 |
| 8 Jan. | 800 | 4.20 | 3,360 | | | | 800 | 4.20 | 3,360 |
| 18 Jan. | 2,000 | 3.80 | 7,600 | | | | <u>2,000</u> | <u>3.80</u> | <u>7,600</u> |
| 28 Jan. | | | | 400 | 4.00 | 1,600 | | | |
| | | | | 800 | 4.20 | 3,360 | | | |
| | | | | 1,200 | 3.80 | 4,560 | 800 | 3.80 | 3,040 |
| 31 Jan. | 40 | 3.80 | 152 | | | | 840 | 3.80 | 3,192 |

- Stock at 31 January – 840 articles.
- Unit price £3.80, total value £3,192.
- Trading account for January:

| | | |
|--------------------|---------------|--------------|
| | £ | £ |
| Sales | | 12,000 |
| Less returns | | <u>200</u> |
| | | 11,800 |
| Opening stock | 1,600 | |
| Purchases | <u>10,960</u> | |
| | 12,560 | |
| Less closing stock | <u>3,192</u> | |
| Cost of sales | | <u>9,368</u> |
| Gross profit | | <u>2,432</u> |

Gross profit percentage $2,432/11,800 = 20.6\%$

8.8 Summary

This chapter introduced you to a variety of books, records and documents that can assist in the recording of financial transactions, especially applicable to larger organisations. These include:

- daybooks (books of prime entry);
- the use of the journal;

- divisions of the ledger;
- cash books;
- stock records.

Much of the chapter is concerned with the physical maintenance of these books and records, but you should also appreciate how they fit into the overall system of control of the bookkeeping system.

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Revision Questions

8



Question 1 Multiple choice

- 1.1 An organisation's cash book has an opening balance in the bank column of £485 credit. The following transactions then took place:
- cash sales £1,450 including VAT of £150;
 - receipts from customers of debts of £2,400;
 - payments to creditors of debts of £1,800 less 5 per cent cash discount;
 - dishonoured cheques from customers amounting to £250.

The resulting balance in the bank column of the cash book should be:

£.....

- 1.2 An organisation restores its petty-cash balance to £500 at the end of each month. During January, the total column in the petty-cash book was recorded as being £420, and hence the imprest was restored by this amount. The analysis columns, which had been posted to the nominal ledger, totalled only £400.

This error would result in:

- (A) no imbalance in the trial balance.
 - (B) the trial balance being £20 higher on the debit side.
 - (C) the trial balance being £20 higher on the credit side.
 - (D) the petty-cash balance being £20 lower than it should be.
- 1.3 A book of prime entry is one in which:
- (A) the rules of double-entry bookkeeping do not apply.
 - (B) ledger accounts are maintained.
 - (C) transactions are entered prior to being recorded in the ledger accounts.
 - (D) subsidiary accounts are kept.
- 1.4 The following totals appear in the daybooks for March 1998:

| | <i>Goods exc. VAT</i> | <i>VAT</i> |
|--------------------------|-----------------------|------------|
| | £ | £ |
| Sales daybook | 40,000 | 7,000 |
| Purchases daybook | 20,000 | 3,500 |
| Returns inwards daybook | 2,000 | 350 |
| Returns outwards daybook | 4,000 | 700 |

Opening and closing stocks are both £3,000. The gross profit for March 1998 is:

£.....

1.5 The petty-cash imprest is restored to £100 at the end of each week. The following amounts are paid out of petty cash during week 23:

| | |
|---------------------|-------------------------------|
| Stationery | £14.10 including VAT at 17.5% |
| Travelling costs | £25.50 |
| Office refreshments | £12.90 |
| Sundry creditors | £24.00 plus VAT at 17.5% |

The amount required to restore the imprest to £100 is:

£

1.6 Stock is valued using FIFO. Opening stock was 10 units at £2 each. Purchases were 30 units at £3 each, then issues of 12 units were made, followed by issues of 8 units. Closing stock is valued at:

£

1.7 In times of rising prices, the FIFO method of stock valuation, when compared with the average cost method of stock valuation, will usually produce:

- (A) a higher profit and a lower closing stock value.
- (B) a higher profit and a higher closing stock value.
- (C) a lower profit and a lower closing stock value.
- (D) a lower profit and a higher closing stock value.

1.8 Your firm values stock using the weighted average cost method. At 1 October 1998, there were 60 units in stock valued at £12 each. On 8 October, 40 units were purchased for £15 each, and a further 50 units were purchased for £18 each on 14 October. On 21 October, 75 units were sold for £1,200. The value of closing stock at 31 October 1998 was:

£

1.9 Stock movements for product X during the last quarter were as follows:

| | | |
|----------|-----------|-------------------------|
| January | Purchases | 10 items at £19.80 each |
| February | Sales | 10 items at £30 each |
| March | Purchases | 20 items at £24.50 each |
| | Sales | 5 items at £30 each |

Opening stock at 1 January was six items valued at £15 each.

Gross profit for the quarter, using the weighted average cost method, would be:

£

1.10 A firm uses the LIFO method of stock valuation. Information regarding stock movements during a particular month are as follows:

| | | |
|----|-----------------|----------------------------|
| 1 | Opening balance | 200 units valued at £1,600 |
| 10 | Purchases | 800 units for £8,000 |
| 14 | Sales | 400 units for £4,800 |
| 21 | Purchases | 800 units for £10,000 |
| 23 | Sales | 600 units for £9,000 |

The value of stock at the end of the month would be:

£

1.11 S & Co. sells three products – Basic, Super and Luxury. The following information was available at the year end:

| | <i>Basic</i> £ per unit | <i>Super</i> £ per unit | <i>Luxury</i> £ per unit |
|--------------------------------|----------------------------|----------------------------|-----------------------------|
| Original cost | 6 | 9 | 18 |
| Estimated selling price | 9 | 12 | 15 |
| Selling and distribution costs | 1 | 4 | 5 |
| | <i>Units</i> | <i>Units</i> | <i>Units</i> |
| Units in stock | 200 | 250 | 150 |

The value of stock at the year end should be:

£

1.12 A stock record card shows the following details:

| | | |
|----------|----|---|
| February | 1 | 50 units in stock at a cost of £40 per unit |
| | 7 | 100 units purchased at a cost of £45 per unit |
| | 14 | 80 units sold |
| | 21 | 50 units purchased at a cost of £50 per unit |
| | 28 | 60 units sold |

What is the value of stock at 28 February using the FIFO method?

£

1.13 W Ltd is registered for VAT. The managing director has asked four staff in the accounts department why the output tax for the last quarter does not equal 17.5 per cent of sales (17.5 per cent is the rate of VAT). Which one of the following four replies she received was not correct?

- (A) The company had some exports that were not liable to VAT.
- (B) The company made some sales of zero-rated products.
- (C) The company made some sales of exempt products.
- (D) The company sold some products to businesses not registered for VAT.

1.14 When valuing stock at cost, which of the following shows the correct method of arriving at cost?

| | <i>Include inward transport costs</i> | <i>Include production overheads</i> |
|---|---------------------------------------|-------------------------------------|
| A | Yes | No |
| B | No | Yes |
| C | Yes | Yes |
| D | No | No |

Question 2

Shown below is the sales and returns inwards daybook of XY, a sole trader, who employs a bookkeeper to maintain her personal account records but maintains the nominal ledger herself.

| <i>Date</i> | <i>Customer</i> | <i>Goods (£)</i> | <i>VAT (£)</i> | <i>Total (£)</i> |
|-------------|-----------------|------------------|----------------|------------------|
| 1992 | | | | |
| 7 Feb. | ANG Ltd | 4,600 | 805 | 5,405 |
| 10 Feb. | John's Stores | 2,800 | 490 | 3,290 |
| 14 Feb. | ML Ltd | 1,000 | 175 | 1,175 |
| 17 Feb. | ML Ltd | (600) | (105) | (705) |
| 25 Feb. | ANG Ltd | 1,200 | 210 | 1,410 |
| | | <u>9,000</u> | <u>1,575</u> | <u>10,575</u> |

Requirements

- (a) Is the transaction on the 17 February:
- (A) The payment for goods by ML Ltd
 (B) The purchase of goods from ML Ltd by XY
 (C) The return of goods by ML Ltd
 (D) The writing off of the debt from ML Ltd
- (b) Using the data in the sales and returns inwards daybook, insert the missing figures into the ledger accounts set out below:

| ANG Ltd | | | |
|----------------|-----|---|---------------|
| | | £ | |
| 7 Feb. | SDB | █ | |
| 25 Feb. | SDB | █ | |
| Sales | | | |
| | | | £ |
| | | | █ |
| | | | 28 Feb. SDB |
| John's Stores | | | |
| | | £ | |
| 10 Feb. | SDB | █ | |
| Returns inward | | | |
| | | £ | |
| 28 Feb. | SDB | █ | |
| ML Ltd | | | |
| | | £ | £ |
| 14 Feb. | SDB | █ | 16 Feb. SDB █ |
| VAT | | | |
| | | | £ |
| | | | █ |
| | | | 28 Feb. SDB |

**Question 3**

Your organisation had the following transactions during the last month:

- | | |
|---------------|---|
| Transaction 1 | Purchase of raw materials on credit from J Smith, list price £3,000, trade discount 25 per cent, rate of VAT 17.5 per cent. |
| Transaction 2 | Payment by cheque to a creditor, L Taylor, outstanding amount £2,400 less cash discount of 5 per cent. |
| Transaction 3 | Contra entry between sales and purchase ledgers of £300, re K Green. |
| Transaction 4 | Motor vehicle worth £2,000 received in part-payment of a debt due from a customer, S Long. |
| Transaction 5 | Staff wages earned during the month of £3,000 gross, with PAYE of £450, employee's National Insurance contributions of £120 and employer's National Insurance contributions of £130. All payments are to be made after the month end. |

Requirements

Complete the table below for each transaction.

| Item | Book of prime entry | Debit entries: | | Credit entries: | |
|------|---------------------|----------------|---|-----------------|---|
| | | Account name | £ | Account name | £ |
| 1. | | | | | |
| 2. | | | | | |
| 3. | | | | | |
| 4. | | | | | |
| 5. | | | | | |



Question 4

The following information is to be recorded:

- | | | |
|-----|---|------|
| 1. | Opening balances are: | |
| | Cash | £50 |
| | Bank | £100 |
| 2. | Cash sales | £500 |
| 3. | Credit purchases from P | £400 |
| 4. | Wages paid in cash | £100 |
| 5. | Cash banked | £200 |
| 6. | Credit sales to Q | £300 |
| 7. | Paid P £250 less 10% discount, by cheque | |
| 8. | Received cash from Q, £200 less 5% discount | |
| 9. | Sent goods to R on approval (i.e. on sale or return) costing £60 with selling price £135 | |
| 10. | Wages paid by cheque | £100 |
| 11. | R returns one-third of the goods sent on approval, accepts one-third and delays a decision on the remainder | |
| 12. | Bank charges notified | £30 |
| 13. | Receive balance due from Q, less discount of 4%, in cash. | |

Requirements

Enter the missing figures in the three-column cash book.

| Cash book | | | | | | | |
|-----------|-----------|----------|----------|------|-----------|----------|----------|
| Item | Disc. (£) | Cash (£) | Bank (£) | Item | Disc. (£) | Cash (£) | Bank (£) |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
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| | | | | | | | |
| | | | | | | | |
| | | | | | | | |

| | | | | | |
|-------|---|---|---|---|---|
| (iii) | █ | █ | █ | █ | █ |
| (iv) | █ | █ | █ | █ | █ |
| (v) | █ | █ | █ | █ | █ |
| (vi) | █ | █ | █ | █ | █ |

(b) Rates are paid annually on 1 April, to cover the following 12 months. The rates for 1998/99 are £1,800, and for 1999/2000 are increased by 20 per cent. Rent is paid quarterly on the first day of May, August, November and February, in arrears. The rent has been £1,200 per annum for some time, but increases to £1,600 per annum from 1 February 1999. Complete the missing figures in the rent and rates account for the year ended 30 April 1999, given below.

| Rent and rates account | | | | | |
|------------------------|-------------|----------|---------|---------------------|----------|
| 1998 | | | 1998 | | |
| | | £ | | | £ |
| May 1 | Balance b/f | █ | May 1 | Balance b/f | █ |
| May 1 | Bank | █ | | | |
| Aug. 1 | Bank | █ | | | |
| Nov. 1 | Bank | █ | | | |
| 1999 | | | 1999 | | |
| Feb. 1 | Bank | █ | Apr. 30 | Profit and loss a/c | █ |
| Apr. 1 | Bank | █ | Apr. 30 | Balance c/f | █ |
| Apr. 30 | Balance c/f | █ | | | |
| May 1 | Balance b/f | █ | May 1 | Balance b/f | █ |
| | | <u>█</u> | | | <u>█</u> |

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Solutions to Revision Questions

8



Solution 1

1.1 The calculation is as follows:

| | |
|------------------------------|----------------|
| | £ |
| Opening overdraft | (485) |
| Add receipts, inc. VAT | <u>3,850</u> |
| | 3,365 |
| Less payments after discount | <u>(1,710)</u> |
| | 1,655 |
| Less dishonoured cheques | <u>(250)</u> |
| | <u>1,405</u> |

1.2 Answer: (C)

The petty-cash book will have been credited with £420 to restore the imprest, whereas the expense accounts will have been debited with only £400. Therefore, the credit side of the trial balance will be £20 higher than the debit side.

1.3 Answer: (C)

(A) is incorrect as the journal is one of the books of prime entry in which double-entry rules do apply. (B) is incorrect – ledger accounts are not maintained in books of prime entry. (D) is incorrect as subsidiary accounts are ledger accounts that are maintained outside the main ledgers.

1.4 Reconstruction of the trading account:

| | | |
|------------------|----------------|-----------------|
| | £ | £ |
| Sales | | 40,000 |
| Returns inwards | | <u>(2,000)</u> |
| | | 38,000 |
| Opening stock | 3,000 | |
| Purchases | 20,000 | |
| Returns outwards | <u>(4,000)</u> | |
| Closing stock | <u>(3,000)</u> | |
| | | <u>(16,000)</u> |
| Gross profit | | <u>22,000</u> |

1.5

| | | |
|--|--------------|--|
| | \pounds | |
| Stationery | 14.10 | |
| Travel | 25.50 | |
| Refreshments | 12.90 | |
| Sundry creditors ($\pounds 24 \times 1.175$) | 28.20 | |
| | <u>80.70</u> | |

1.6 The first issues (twelve units) would use up the opening stock of ten units and two units of the purchases at $\pounds 3$ each, leaving 28 units at $\pounds 3$ each. The next issues would be of $\pounds 3$ units, leaving twenty units at $\pounds 3$ each, i.e. $\pounds 60$.

1.7 Answer: (B)

The closing stock figure reduces the cost of goods sold figure, which in turn increases the gross profit.

Therefore, a higher closing stock figure means a lower cost of goods sold figure, and hence a higher gross profit. In times of rising prices, the FIFO method of stock valuation will produce higher closing stock values, and therefore a higher gross profit figure.

1.8

| | <i>Qty</i> | <i>Value (£)</i> | |
|--|------------|------------------|--------------------------------------|
| 1 October ($60 \times \pounds 12$) | 60 | 720 | |
| 8 October ($40 \times \pounds 15$) | 100 | 1,320 | |
| 14 October ($50 \times \pounds 18$) | 150 | 2,220 | |
| 21 October ($75 \times \pounds 14.80$) | 75 | 1,110 | (i.e. average cost $\pounds 14.80$) |

1.9 Summarised stock card

| | | | |
|---------------------------|------------|------------|----------------------|
| | <i>Qty</i> | \pounds | |
| $6 \times \pounds 15$ | 6 | 90 | |
| $10 \times \pounds 19.80$ | 10 | 198 | |
| | <u>16</u> | <u>288</u> | ($\pounds 18$ each) |
| $10 \times \pounds 18$ | (10) | (180) | |
| | 6 | 108 | |
| $20 \times \pounds 24.50$ | 20 | 490 | |
| | <u>26</u> | <u>598</u> | ($\pounds 23$ each) |
| $5 \times \pounds 23$ | (5) | (115) | |
| | <u>21</u> | <u>483</u> | |

Note: Issues are shown in brackets.

Trading account

| | | |
|------------------------------|------------|------------|
| | \pounds | \pounds |
| Sales $15 \times \pounds 30$ | | 450 |
| Opening stock | 90 | |
| Purchases | 688 | |
| | <u>778</u> | |
| Closing stock | (483) | |
| | | (295) |
| Profit | | <u>155</u> |

1.10 The sale of 400 units on the 14th will take up 400 of those purchased on the 10th, leaving 400 of those (£4,000) and the opening stock of 200 (£1,600). Value of stock remaining at that point is £5,600. The sale of 600 units on the 23rd will take up 600 of those purchased on the 21st, leaving 200 of those (£2,500), plus the previous balance of £5,600: total £8,100.

1.11

| | <i>Cost (£)</i> | <i>Net realisable value (£)</i> | <i>Lower of cost & NRV (£)</i> | <i>Units</i> | <i>Value (£)</i> |
|--------|-----------------|---------------------------------|------------------------------------|--------------|------------------|
| Basic | 6 | 8 | 6 | 200 | 1,200 |
| Super | 9 | 8 | 8 | 250 | 2,000 |
| Luxury | 18 | 10 | 10 | 150 | 1,500 |
| | | | | | <u>4,700</u> |

1.12 There are 60 units in stock at 28 February. These are deemed to comprise the 50 units purchased on 21 February at £50 per unit = £2,500, and ten units from the units purchased on 7 February at £45 per unit = £450, which is £2,950 in total.

1.13 Answer: (D)

1.14 Answer: (C)



Solution 2

- Part (b) is a straightforward double-entry question involving daybooks and ledger accounts.

(a) Answer: (C)

(b)

| ANG | | | | | |
|----------------|-----|--|---------|-----|-------|
| | | | | | £ |
| 7 Feb. | SDB | | | | 5,405 |
| 25 Feb. | SDB | | | | 1,410 |
| Sales | | | | | |
| | | | | | £ |
| | | | 28 Feb. | SDB | 9,600 |
| John's Stores | | | | | |
| | | | | | £ |
| 10 Feb. | SDB | | | | 3,290 |
| Returns inward | | | | | |
| | | | | | £ |
| 28 Feb. | SDB | | | | 600 |
| ML Ltd | | | | | |
| | | | | | £ |
| 14 Feb. | SDB | | | | 1,175 |
| | | | 16 Feb. | SDB | 705 |
| VAT | | | | | |
| | | | | | £ |
| | | | 28 Feb. | SDB | 1,575 |

**Solution 3**

- This is another test of knowledge of books of prime entry and of the double-entry principles, but using a table rather than asking for the accounts to be drawn up.
- Remember to deduct trade discount before calculating VAT.
- Remember that it is the total invoice price that is entered in the personal accounts, but the net amount in the purchases account.
- In Transaction 5, make clear that there are liabilities outstanding in respect of wages.

| Item | Book of prime entry | Debit entries | | Credit entries | |
|------|------------------------|--------------------|----------|-------------------|----------|
| | | Account name | £ | Account name | £ |
| 1. | Purchases daybook | Purchases | 2,250.00 | J Smith | 2,643.75 |
| | | VAT | 393.75 | | |
| 2. | Cash book | L Taylor | 2,400.00 | Bank | 2,280.00 |
| | | | | Discount received | 120.00 |
| 3. | Journal | K Green (creditor) | 300.00 | K Green (debtor) | 300.00 |
| 4. | Journal | Motor vehicles | 2,000.00 | S Long | 2,000.00 |
| 5. | Journal | Wages expense | 3,000.00 | PAYE creditor | 450.00 |
| | | NI expense | 130.00 | Wages creditor | 2,430.00 |
| | | | | NI creditor | 250.00 |

**Solution 4**

- This question covers basic double-entry bookkeeping and at this stage in your studies should pose no particular problems.
- The only difficult area concerns the sales to R on approval, which requires you to consider the realisation concept – the sale should not be recognised in the accounts until it is certain – and in this example only one-third is certain by the end of the period. Therefore, only one-third of the total sales (£45) should be included with sales, with the remainder in stock, valued at £40.

Cash book

| Item | Disc. (£) | Cash (£) | Bank (£) | Item | Disc. (£) | Cash (£) | Bank (£) |
|---------|-----------|------------|------------|---------|-----------|------------|------------|
| (1) | | 50 | 100 | (4) | | 100 | |
| (2) | | 500 | | (5) | | 200 | |
| (5) | | | 200 | (7) | 25 | | 225 |
| (8) | 10 | 190 | | (10) | | | 100 |
| (13) | 4 | 96 | | (12) | | | 30 |
| Balance | | | 55 | Balance | | 536 | |
| | <u>14</u> | <u>836</u> | <u>355</u> | | <u>25</u> | <u>836</u> | <u>355</u> |

Note: The remaining 'sale or return' goods are taken out of sales (at selling price); their cost, £20, must be debited to 'stock on sale or return' account when preparing the trading account, and accounted for as current assets in preparing the balance sheet.

Trial balance

| | <i>Debit (£)</i> | <i>Credit (£)</i> |
|---------------|------------------|-------------------|
| Capital | | 150 |
| Cash | 536 | |
| Bank | | 55 |
| Discounts | 14 | 25 |
| Sales | | 890 |
| Purchases | 400 | |
| Creditors | | 150 |
| Wages | 200 | |
| Debtors | 45 | |
| Bank charges | 30 | |
| Sales returns | 45 | |
| | <u>1,270</u> | <u>1,270</u> |



Solution 5

- Notice that it is the ‘book of prime entry’ that is asked for, not the ledger.
- For the debit and credit entries, be sure to state the name of the ledger accounts.
- In part (b) a single rent and rates account is required.

| (a) | <i>Book of prime entry</i> | <i>Debit entries</i> | <i>£</i> | <i>Credit entries</i> | <i>£</i> |
|-------------|----------------------------|----------------------|----------|-----------------------|----------|
| <i>Item</i> | <i>prime entry</i> | <i>Account name</i> | | <i>Account name</i> | |
| (i) | Purchase daybook | Purchases | 18,000 | J Burgess | 21,150 |
| | | VAT | 3,150 | | |
| (ii) | Cash book | P Barton | 14,000 | Bank | 13,720 |
| | | | | Discount received | 280 |
| (iii) | Journal | Office equipment | 2,500 | J Smithers | 2,500 |
| (iv) | Journal | Bad debts | 500 | A Scholes | 500 |
| (v) | Returns inwards daybook | Returns inwards | 400 | J Lockley | 470 |
| | | VAT | 70 | | |
| (vi) | Journal | Vehicle at cost | 1,325 | A Jackson | 1,400 |
| | | Motor expenses | 75 | | |

(b)

| Rent and rates | | | | | |
|----------------|----------------------------|--------------|-------------|----------------------------|--------------|
| <i>1998</i> | | <i>£</i> | <i>1998</i> | | <i>£</i> |
| 1 May | Balance b/fwd ¹ | 1,650 | 1 May | Balance b/fwd ² | 300 |
| 1 May | Bank | 300 | | | |
| 1 Aug. | Bank | 300 | | | |
| 1 Nov. | Bank | 300 | | | |
| <i>1999</i> | | | <i>1999</i> | | |
| 1 Feb. | Bank | 300 | 30 Apr. | Profit and loss a/c | 3,130 |
| 1 Apr. | Bank | 2,160 | 30 Apr. | Balance c/fwd | 1,980 |
| 30 Apr. | Balance c/fwd | 400 | | | |
| | | <u>5,410</u> | | | <u>5,410</u> |
| 1 May | Balance b/fwd | 1,980 | 1 May | Balance b/fwd | 400 |

Notes:

- Rates prepaid = $\frac{11}{12}$ of £1,800
- Rent accrued = $\frac{1}{4}$ of £1,200

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Controlling the Bookkeeping System

9

LEARNING OUTCOMES

When you have completed this chapter, you should be able to:

- ▶ explain the need for financial controls;
- ▶ explain the nature of fraud and basic ideas of prevention;
- ▶ prepare bank reconciliation statements;
- ▶ prepare accounts for sales and purchases, including personal accounts and control accounts;
- ▶ prepare journal entries;
- ▶ explain the nature of errors and be able to make accounting entries for them;
- ▶ identify the necessity for financial accounting codes and construct a simple coding system.

9.1 Introduction

No bookkeeping system can be guaranteed to be entirely free of errors. Human beings are fallible, and even automated and computerised systems are less than perfect. For example, a computer cannot possibly know that a supplier has sent you an invoice that never arrived.

In this chapter we look at a number of ways in which the bookkeeping system can be checked for accuracy, and ways in which errors and omissions can be rectified.

Specific topics which are covered include:

- bank reconciliations
- control accounts
- suspense accounts

9.2 Preventing errors

There are a number of ways in which errors can be prevented, or at least limited in their number and effect. Many of these also prevent deliberate fraud.

9.2.1 Authorisation procedures

Transactions should be authorised at an appropriate level. For example,

- the purchase of major fixed assets should be justified/agreed by senior management and recorded in the minutes of meetings;
- cheques for large amounts should require two signatures;
- new debtor and creditor accounts should be authorised by a senior person;
- all purchase orders should be authorised by a responsible officer;
- all payments made should be approved. In particular:
 - payments to suppliers should be checked against goods received, invoices and credit notes;
 - refunds to customers should be authorised;
 - payrolls should be checked and authorised prior to making payment.

9.2.2 Documentation



Documentation should be used to give evidence of transactions, and should be properly filed and referenced. This helps to provide an 'audit trail' of transactions through the system. As an example, consider the ordering of goods for resale, and the documentation involved.

- *Raising of the order* – On official order forms, properly authorised, after obtaining several quotations.
- *Receipt of goods* – checked on arrival, checked with order, shortages and breakages recorded.
- *Receipt of invoice* – checked with order and receipt of goods; prices, discounts and calculations checked.
- *Payment of invoice* – only after all credit notes have been received, and checked with purchase ledger account prior to payment.

9.2.3 Organisation of staff



Staff should be properly recruited, trained and supervised. No one person should have complete control over any section of the bookkeeping system. Duties should be shared out between different members of staff. This is known as *segregation of duties*.

This can be illustrated by considering the procedures arising from selling goods on credit. In summary the tasks involved are:

- issuing sales invoices;
- issuing credit notes;
- credit control;
- banking receipts from customers.

If one person were to be solely responsible for all (or even more than one) of these tasks, it would be easy for money to be diverted and the corresponding paperwork destroyed or falsified. Staff should also rotate their duties from time to time.

9.2.4 Safeguarding assets

Assets should be properly maintained, insured, utilised, valued and recorded.

9.3 Detecting errors

Some errors may come to light purely by chance, and some are never found at all. For example, if you receive a cheque from a customer who has no outstanding balance on his account, it is possible that an invoice has been omitted from the books. If you never receive the cheque, the error might never come to light.

It would be extremely unwise to trust to chance, and therefore there are several checks that can be incorporated to help detect errors.

9.3.1 Spot checks

These are particularly useful in detecting fraud. For example, spot checks on petty-cash balances may uncover ‘teeming and lading’ activities, whereby an employee borrows money from the petty cash on a regular basis, but puts it back when the imprest is being checked, only to remove it again afterwards.

Spot checks are also commonly carried out on bank balances, ledger accounts and stocks.

9.3.2 Comparison with external evidence

External evidence is among the most useful in determining the reliability of records. Examples include:

- confirmation of balances with debtors and creditors;
- confirmation of bank balances with the bank.

9.3.3 Reconciliations

A reconciliation is a comparison of records to identify differences and to effect agreement. There are several types of reconciliation that can be carried out.

- Producing a trial balance. If the debit and credit totals do not agree, it is obvious that an error has been made.
- Reconciling the accounts of the organisation with records received from other organisations. Two common reconciliations of this type are:
 - *bank reconciliations*, where the bank account maintained by the organisation is reconciled with the statement issued by the bank
 - *supplier reconciliations*, where the ledger account maintained by the organisation is reconciled with a statement of the ledger account in the supplier’s books.

Both of these types of reconciliation are considered in more detail later in this chapter.

- Reconciling groups of ledger accounts with a *control account*. Control accounts are considered in more detail later in this chapter.

9.3.4 Carrying out an audit

An audit is a check on the accounting records of the organisation. It does not entail a complete check on every bookkeeping entry, but rather examines the systems and procedures in place that should contribute to the reliability of the accounting records. The role of audit is discussed in more detail in Chapter 10.

9.4 Bank reconciliation statements



Bank reconciliations are an essential must know topic.

The purpose of a bank reconciliation statement is to check the accuracy of an organisation's bank account record by comparing it with the record of the account held by the bank. In Chapter 8 we saw that there is often a timing delay between the transaction occurring (and therefore being recorded in the cash book) and it being processed by the bank. It is this timing difference that is usually the cause of any difference between the balances. However, there are some transactions of which the organisation will not be aware until they receive their bank statement. These include bank charges, commissions and dishonoured cheques (where the drawer's bank has refused to honour the cheque drawn upon it), and may also include direct debits and standing orders if the account holder has not been separately notified of their being paid.

In order to ensure that both the bank's and the organisation's records are correct a comparison is made of the two sets of records and a reconciliation statement produced.

Example 9.A

The following extract from the cash book of ABX Limited for the month of June shows the company's bank transactions:

| | | | |
|--------------|---------------|-----------------|---------------|
| | £ | | £ |
| Balance b/f | 9,167 | Purchase ledger | 1,392 |
| Sales ledger | 4,023 | PAYE | 2,613 |
| Cash sales | 2,194 | VAT creditor | 981 |
| Sales ledger | 7,249 | Cheques cashed | 3,290 |
| | | Balance c/f | 14,357 |
| | <u>22,633</u> | | <u>22,633</u> |

The company's bank statement for the same period is as follows:

| | Debit (£) | Credit (£) | Balance (£) |
|------------------|-----------|------------|-------------|
| Opening balance | | | 7,645 |
| Lodgement 000212 | | 2,491 | 10,136 |
| Cheque 000148 | 969 | | 9,167 |
| Insurance D/D | 2,413 | | 6,754 |
| Lodgement 000213 | | 4,023 | 10,777 |
| Cheque 000149 | 1,392 | | 9,385 |
| Cheque 000150 | 2,613 | | 6,772 |
| Cheque 000152 | 3,290 | | 3,482 |
| Lodgement 000214 | | 2,194 | 5,676 |
| Bank charges | 563 | | 5,113 |

You are required to reconcile the balances shown in the cash book and the bank statement.

Solution

The first step is to compare the entries shown in the cash book with those on the bank statement and match them. This is shown below where letters have been used to match the items together.

| | | | |
|------------------|---------------|---------------------|---------------|
| | £ | | £ |
| Balance b/fwd | 9,167 | Purchase ledger (c) | 1,392 |
| Sales ledger (a) | 4,023 | PAYE (d) | 2,613 |
| Cash sales (b) | 2,194 | VAT creditor | 981 |
| Sales ledger | 7,249 | Cheques cashed (e) | 3,290 |
| | | Balance c/f | 14,357 |
| | <u>22,633</u> | | <u>22,633</u> |

| | <i>Debit (£)</i> | <i>Credit (£)</i> | <i>Balance (£)</i> |
|------------------|------------------|-------------------|--------------------|
| Opening balance | | | 7,645 |
| Lodgement 000212 | | 2,491 | 10,136 |
| Cheque 000148 | 969 | | 9,167 |
| Insurance D/D | 2,413 | | 6,754 |
| Lodgement 000213 | | 4,023 (a) | 10,777 |
| Cheque 000149 | 1,392 (c) | | 9,385 |
| Cheque 000150 | 2,613 (d) | | 6,772 |
| Cheque 000152 | 3,290 (e) | | 3,482 |
| Lodgement 000214 | | 2,194 (b) | 5,676 |
| Bank charges | 563 | | 5,113 |

When the matching is complete there will usually be items on the bank statement that are not shown in the cash book, and items entered in the cash book that are not shown on the bank statement.

Some of these may relate to the previous period – in this example the opening balances were not the same. There is a lodgement (reference 000212) and a cheque (number 000148) that are not in the cash book of the period. A simple calculation shows that these items represent the difference between the opening balances. These are, therefore, timing differences that do not affect the bank reconciliation at 30 June.

There are some items on the bank statement that have not been entered in the cash book. These are the direct debit for insurance and the bank charges. The cash book balance needs to be amended for these:

| | | |
|-------------------------------|------------|---------------|
| | £ | £ |
| Balance as shown in cash book | | 14,357 |
| Less | | |
| Insurance | 2,413 | |
| Bank charges | <u>563</u> | |
| | | <u>2,976</u> |
| Amended cash book balance | | <u>11,381</u> |

The remaining difference between the amended cash book balance and the bank statement balance is caused by timing differences on those items not matched above:

| | |
|-------------------------------|---------------|
| | £ |
| Balance as per bank statement | 5,113 |
| Add uncleared lodgement | <u>7,249</u> |
| | 12,362 |
| Less unpresented cheque | <u>981</u> |
| Balance as per cash book | <u>11,381</u> |

You should note that this statement commenced with the balance as per the bank statement and reconciled it to the balance shown in the cash book. A less common alternative is to commence with the balance as per the cash book and reconcile it to the bank statement. To do this, the mathematical additions and subtractions must be reversed. Try it!



Exercise 9.1

From the following information, prepare a statement that shows any necessary corrections to the cash book balance and a statement that reconciles the bank statement balance with the corrected cash book balance.

| | |
|---|-------|
| | £ |
| Balance per cash book | 1,245 |
| Unpresented cheques | 890 |
| Bank charges not entered in cash book | 100 |
| Receipts not yet credited by bank | 465 |
| Dishonoured cheque not entered in cash book | 170 |
| Balance per bank statement | 1,400 |

**Solution**

| | |
|---------------------------------|--------------|
| Original cash book balances | £ 1,245 |
| Less amounts not yet entered | |
| Bank charges | (100) |
| Dishonoured cheque | <u>(170)</u> |
| Corrected cash book balance | <u>975</u> |
| Balance per bank statement | 1,400 |
| Add outstanding lodgements | 465 |
| Less unrepresented cheques | <u>(890)</u> |
| Balance per corrected cash book | <u>975</u> |

**Exercise 9.2**

Cash book (bank columns only)

| | | | | | |
|---------|-----------|----------|---------|------------|----------|
| 1 Jan. | Balance | £ 600 | 18 Jan. | D Anderson | £ 145 |
| 13 Jan. | T Francis | 224 | 28 Jan. | R Patrick | 72 |
| 31 Jan. | L Bond | 186 | 30 Jan. | B Thompson | 109 |

Bank statement

| | | <i>Debit (£)</i> | <i>Credit (£)</i> | <i>Balance (£)</i> |
|---------|----------------|------------------|-------------------|--------------------|
| 1 Jan. | Balance | | | 635 |
| 3 Jan. | H Turner | 35 | | 600 |
| 13 Jan. | T Francis | | 224 | 824 |
| 23 Jan. | D Anderson | 145 | | 679 |
| 31 Jan. | Standing order | 30 | | 649 |

Using the information given above:

- prepare a corrected cash book;
- draw up a bank reconciliation statement.

**Solution**

Cash book

| | | | | | |
|---------|-------------|--------------|---------|----------------|--------------|
| 1 Jan. | Balance b/f | £ 600 | 18 Jan. | D Anderson | £ 145 |
| 13 Jan. | T Francis | 224 | 28 Jan. | R Patrick | 72 |
| 31 Jan. | L Bond | 186 | 30 Jan. | B Thompson | 109 |
| | | | 31 Jan. | Standing order | 30 |
| | | | 31 Jan. | Balance c/f | <u>654</u> |
| | | <u>1,010</u> | | | <u>1,010</u> |
| 1 Feb. | Balance b/f | 654 | | | |

Bank reconciliation statement at 31 January

| | |
|---------------------------------------|--------------|
| | £ |
| Balance as per bank statement | 649 |
| Add receipts not lodged | 186 |
| Less unrepresented cheques (109 + 72) | <u>(181)</u> |
| Balance per cash book | <u>654</u> |

9.5 Reconciliation of suppliers' statements

Many suppliers send monthly statements to their customers, showing the position of that customer's account in their own records, and this provides an ideal opportunity to check the accuracy of the organisation's records with those of another. A reconciliation of creditor balances to supplier statements is no different from carrying out a bank reconciliation, as shown below.

Example 9.B

Included in the creditors ledger of J Cross, a shopkeeper, is the following account that disclosed that the amount owing to one of his suppliers at 31 May 20X4 was £472.13.

| Creditors ledger | | | | | |
|------------------|-------------------------|-----------------|-------|--------------------------|-----------------|
| 20X4 | | | 20X4 | | |
| | | £ | | | £ |
| 18 May | Purchase returns | 36.67 | 1 May | Balance b/d | 862.07 |
| 27 | Purchase returns | 18.15 | 16 | Purchases | 439.85 |
| 27 | Adjustment (overcharge) | 5.80 | 25 | Purchases | 464.45 |
| 31 | Discount rec'd | 24.94 | 25 | Adjustment (undercharge) | 13.48 |
| 31 | Bank | 1,222.16 | | | |
| 31 | Balance c/d | 472.13 | | | |
| | | <u>1,779.85</u> | | | <u>1,779.85</u> |

J Cross in account with Nala Merchandising Company: Statement of account

| 20X4 | | Debit (£) | Credit (£) | Balance (£) |
|-------|-------|-----------|------------|-------------|
| 1 May | BCE | | | 1,538.70 Dr |
| 3 | DISC | | 13.40 | 1,525.30 Dr |
| | CHQ | | 634.11 | 891.19 Dr |
| 5 | ALLCE | | 29.12 | 862.07 Dr |
| 7 | GDS | 256.72 | | 1,118.79 Dr |
| 10 | GDS | 108.33 | | 1,227.12 Dr |
| 11 | GDS | 74.80 | | 1,301.92 Dr |
| 14 | ADJ | 13.48 | | 1,315.40 Dr |
| 18 | GDS | 162.55 | | 1,477.95 Dr |
| 23 | GDS | 301.90 | | 1,779.85 Dr |
| 25 | ALLCE | | 36.67 | 1,743.18 Dr |
| 28 | GDS | 134.07 | | 1,877.25 Dr |
| 29 | GDS | 251.12 | | 2,128.37 Dr |
| 30 | GDS | 204.80 | | 2,333.17 Dr |
| 31 | GDS | 91.36 | | 2,424.53 Dr |
| 31 | BCE | | | 2,424.53 Dr |

Abbreviations: BCE – balance; CHQ – cheque; GDS – goods; ALLCE – allowance; DISC – discount; ADJ – adjustment.

You are required to prepare a statement reconciling the closing balance on the supplier's account in the creditors ledger with the closing balance shown on the statement of account submitted by the supplier.

Solution

As we saw with bank reconciliation statements the technique is to match the items first and then construct a reconciliation statement.

| Creditors ledger | | | | | |
|------------------|-----------------------------|-----------------|-------|---------------------------------|-----------------|
| 20X4 | | | 20X4 | | |
| | | £ | | | £ |
| 18 May | Purchase returns (a) | 36.67 | 1 May | Balance b/d | 862.07 |
| 27 | Purchase returns (r) | 18.15 | 16 | Purchases (b) | 439.85 |
| 27 | Adjustment (overcharge) (t) | 5.80 | 25 | Purchases (c) | 464.45 |
| 31 | Discount rec'd (s) | 24.94 | 25 | Adjustment (undercharge) (d) | 13.48 |
| 31 | Bank (s) | 1,222.16 | | | |
| 31 | Balance c/d | 472.13 | | | |
| | | <u>1,779.85</u> | | | <u>1,779.85</u> |

J Cross in account with Nala Merchandising Company – Statement of account

| 20X4 | | Debit (£) | Credit (£) | Balance (£) |
|-------|-------|-----------|------------|-------------|
| 1 May | BCE | | | 1,538.70 Dr |
| 3 | DISC | | p 13.40 | 1,525.30 Dr |
| | CHQ | | p 634.11 | 891.19 Dr |
| 5 | ALLCE | | p 29.12 | 862.07 Dr |
| 7 | GDS | b 256.72 | | 118.79 Dr |
| 10 | GDS | b 108.33 | | 1,227.12 Dr |
| 11 | GDS | b 74.80 | | 1,301.92 Dr |
| 14 | ADJ | d 13.48 | | 1,315.40 Dr |
| 18 | GDS | c 162.55 | | 1,477.95 Dr |
| 23 | GDS | c 301.90 | | 1,779.85 Dr |
| 25 | ALLCE | | a 36.67 | 1,743.18 Dr |
| 28 | GDS | q 134.07 | | 1,877.25 Dr |
| 29 | GDS | q 251.12 | | 2,128.37 Dr |
| 30 | GDS | q 204.80 | | 2,333.17 Dr |
| 31 | GDS | q 91.36 | | 2,424.53 Dr |
| 31 | BCE | | | 2,424.53 Dr |

The items marked 'p' reconcile the opening balances.

Reconciliation statement

| | | |
|--|-------------|-----------------|
| Balance as per creditors ledger | £ | £ |
| Add | | 472.13 |
| Goods despatched by supplier not entered in ledger ('q') | 681.35 | |
| Returns not yet recognised by supplier ('r') | 18.15 | |
| Payments/Discounts not yet recognised by supplier ('s') | 1,247.10 | |
| Adjustment not yet recognised by supplier ('t') | <u>5.80</u> | |
| | | 1,952.40 |
| Balance as per supplier's statement | | <u>2,424.53</u> |

9.6 Control accounts

Control accounts are an essential must know topic.

When the ledger accounts are divided into sections, it is possible to introduce an additional control on each section, known as a *control account*. Common control accounts include the

sales ledger control account and the *purchase ledger control account*. A control account contains exactly the same information as in the individual accounts in the ledger that it controls, but using totals rather than individual transactions. In fact, they are sometimes referred to as *total accounts*.

As we saw in Chapter 8, transactions are first entered into the appropriate books of prime entry, as follows:

- daybooks – sales, purchases and returns on credit;
- cash book – receipts, payments, discounts and dishonoured cheques;
- journal – bad debts written off.

Debtors and creditors accounts are always kept up to date, with transactions being entered immediately as they arise. The daybooks, etc., are totalled periodically, and the ‘opposite’ entries made in the nominal ledger accounts at the end of the period.

These totals in these books of prime entry can be used to create a ‘copy’ of the debtors and creditors accounts, which can be used as a control mechanism.

Example 9.C

An organisation has four debtors, with the following balances at 1 January 20X1:

| | |
|----------|--------------|
| | £ |
| A Smith | 437 |
| P Binns | 1,046 |
| J Harris | 93 |
| C Bloggs | <u>294</u> |
| Total | <u>1,870</u> |

The sales daybook for January is as follows:

| Sales daybook | | | | |
|---------------|----------|--------------|------------|--------------|
| Date 20X1 | Customer | Goods (£) | VAT (£) | Total (£) |
| 10 Jan. | J Harris | 200 | 35 | 235 |
| 17 Jan. | P Binns | 400 | 70 | 470 |
| 23 Jan. | A Smith | <u>600</u> | <u>105</u> | <u>705</u> |
| | | <u>1,200</u> | <u>210</u> | <u>1,410</u> |

The sales returns daybook for January is as follows:

| Sales returns daybook | | | | |
|-----------------------|----------|------------|-----------|------------|
| Date 20X1 | Customer | Goods (£) | VAT (£) | Total (£) |
| 12 Jan. | J Harris | 80 | 14 | 94 |
| 20 Jan. | P Binns | <u>120</u> | <u>21</u> | <u>141</u> |
| | | <u>200</u> | <u>35</u> | <u>235</u> |

The cash book (debit side) for the same day includes the following entries:

| Date 20X1 | Details | Received from debtors (£) | Discount (£) |
|--------------|----------|---------------------------|--------------|
| 14 Jan. | C Bloggs | 125 | 5 |
| 16 Jan. | P Binns | <u>570</u> | <u>30</u> |
| | | <u>695</u> | <u>35</u> |

You are required to write up the personal accounts in the sales ledger and the control account, and to reconcile the control account to the total of the sales ledger balances.

Solution

Sales ledger accounts

| A Smith | | | | | |
|---------|-------------|--------------|---------|-------------|--------------|
| 20X1 | | £ | 20X1 | | £ |
| 1 Jan. | Balance b/f | 437 | 31 Jan. | Balance c/d | 1,142 |
| 12 Jan. | Invoice | 705 | | | <u>1,142</u> |
| | | <u>1,142</u> | | | <u>1,142</u> |
| 1 Feb. | Balance b/d | 1,142 | | | |

| P Binns | | | | | |
|---------|-------------|--------------|---------|---------------|--------------|
| 20X1 | | £ | 20X1 | | £ |
| 1 Jan. | Balance b/f | 1,046 | 16 Jan. | Cash | 570 |
| 17 Jan. | Invoice | 470 | 16 Jan. | Discount | 30 |
| | | | 20 Jan. | Sales returns | 141 |
| | | | 31 Jan. | Balance c/d | 775 |
| | | <u>1,516</u> | | | <u>1,516</u> |
| 1 Feb. | Balance b/d | 775 | | | |

| J Harris | | | | | |
|----------|-------------|------------|---------|---------------|------------|
| 20X1 | | £ | 20X1 | | £ |
| 1 Jan. | Balance b/f | 93 | 12 Jan. | Sales returns | 94 |
| 10 Jan. | Invoice | 235 | 31 Jan. | Balance c/d | 234 |
| | | <u>328</u> | | | <u>328</u> |
| 1 Feb. | Balance b/d | 234 | | | |

| C Bloggs | | | | | |
|----------|-------------|------------|---------|-------------|------------|
| 20X1 | | £ | 20X1 | | £ |
| 1 Jan. | Balance b/f | 294 | 1 Jan. | Cash | 125 |
| | | | | Discount | 5 |
| | | | 31 Jan. | Balance c/d | 164 |
| | | <u>294</u> | | | <u>294</u> |
| 1 Feb. | Balance b/d | 164 | | | |

A list of debtors' balances extracted at 31 January 20X1 is as follows:


| | |
|--------|--------------|
| | £ |
| Smith | 1,142 |
| Binns | 775 |
| Harris | 234 |
| Bloggs | 164 |
| Total | <u>2,315</u> |

The sales ledger control account can be compiled from the total of the entries made to the individual debtors accounts, using the totals in the various books of prime entry, as follows:

| Sales ledger control account | | | | | |
|------------------------------|---------------|--------------|---------|-----------------------|--------------|
| 20X1 | | £ | 20X1 | | £ |
| 1 Jan. | Balance b/f | 1,870 | 31 Jan. | Sales returns daybook | 235 |
| 31 Jan. | Sales daybook | 1,410 | 31 Jan. | Cash book Received | 695 |
| | | | | Discount allowed | 35 |
| | | | 31 Jan. | Balance c/d | <u>2,315</u> |
| | | <u>3,280</u> | | | <u>3,280</u> |
| 1 Feb. | Balance b/d | 2,315 | | | |

If all has gone well, the individual postings to the sales ledger should exactly equal the total postings made to the nominal ledger. It follows that if we add up the balances on all the personal accounts in the sales ledger we should reach a total that exactly equals the balance on the debtors control account in the nominal ledger. The same applies in the case of the purchase ledger. By performing this exercise at regular intervals we are, in effect, checking that postings to the ledgers are accurate. The exercise is sometimes seen as performing a 'trial balance' on the ledgers.

9.6.1 The status of the control account

 The status of a control account is not an easy concept to grasp. Particular care should be made in ensuring that you understand this issue as it is the basis of many exam questions.

So far we have considered that the double entry is completed by entering each transaction in the debtors personal accounts in the sales ledger, and entering the totals of sales, returns, VAT, cash received and discounts allowed in the nominal ledger. Now that we have introduced a control account, it might appear that we are duplicating the entries in the sales ledger. Obviously, this cannot happen, as the ledger accounts will be out of balance. We cannot have *both* the debtors accounts *and* the control account as part of the double-entry system. Therefore, one or other of these must be treated as being outside the double-entry system. The records that are outside the double-entry system are known as *memorandum accounts*.

In computerised systems, it is common for the sales ledger to be a separate component of the bookkeeping system, and for the control account to exist in the nominal ledger. But it is also acceptable to regard the control account as a memorandum account.

Exercise 9.3

Briefly explain the meaning of each of the entries in the following debtors account:

| P Richmond | | | | | |
|------------|---------|-------|---------|----------|-------|
| 1 Jan. | Balance | £ 465 | 13 Jan. | Cheque | £ 450 |
| 6 Jan. | Sales | 240 | | Discount | 15 |
| 8 Jan. | Sales | 360 | 17 Jan. | Returns | 40 |
| 31 Jan. | Balance | 560 | | | |

**Solution**

- 1 January: balance. P Richmond owes this amount at 1 Jan.
- 6/8 January: sales. P Richmond has been sold these amounts on credit.
- 13 January: cheque and discount. P Richmond has paid £450 by cheque to clear a debt of £465, having been allowed a cash discount of £15. It is likely that this was in payment of the opening balance on 1 January.
- 17 January: P Richmond has returned goods and been allocated a credit of £40 to be offset against the amount owing.
- 31 January: balance £560. P Richmond owes this amount at 31 January.

Example 9.D

You have been asked to prepare control accounts in order to produce end-of-year figures for debtors and creditors for inclusion in the draft final accounts of Korrinna Company for the year ended 30 November 20X8.

You obtain the following totals for the financial year from the books of original entry:

| <i>Cash book</i> | |
|------------------------------------|---------|
| | £ |
| Discounts allowed | 6,805 |
| Cash and cheques from customers | 287,601 |
| Discounts received | 3,415 |
| Cash and cheques paid to suppliers | 233,078 |
| Customer's cheque dishonoured | 251 |

The following totals have been extracted from the daybooks for the year:

| | £ |
|--------------------------|---------|
| Purchases daybook | 247,084 |
| Sales daybook | 306,580 |
| Returns inwards daybook | 6,508 |
| Returns outwards daybook | 4,720 |

According to the audited financial statements for the previous year, debtors and creditors as at the close of business on 30 November 20X7 were £44,040 and £63,289, respectively.

You are required to draw up the relevant control accounts for the year ending 30 November 20X8, entering the closing balances for debtors and creditors.

Solution

Sales ledger control account

| | £ | | £ |
|--------------------|----------------|-------------------|----------------|
| Balance b/d | 44,040 | Discounts allowed | 6,805 |
| Sales | 306,580 | Cash and cheques | 287,601 |
| Cheque dishonoured | 251 | Returns inwards | 6,508 |
| | | Balance c/d | 49,957 |
| | <u>350,871</u> | | <u>350,871</u> |

Purchase ledger control account

| | £ | | £ |
|--------------------|----------------|-------------|----------------|
| Discounts received | 3,415 | Balance b/d | 63,289 |
| Cash and cheques | 233,078 | Purchases | 247,084 |
| Returns outwards | 4,720 | | |
| Balance c/d | 69,160 | | |
| | <u>310,373</u> | | <u>310,373</u> |

The entries in the control accounts reflect respectively the effect of the transactions on the value of Korrinna Company's debtors (sales ledger control account) and creditors (purchase ledger control account).

In the sales ledger control account the debit entries are those transactions that cause the asset of debtors to increase, whereas decreases are recorded on the credit side of the control account.

In the purchase ledger control account the debit entries are those transactions that cause the liability of creditors to decrease, whereas increases are recorded on the credit side of the control account.

| <i>Debit</i> | <i>Credit</i> |
|--------------------------|--------------------------|
| Increases in assets | Decreases in assets |
| Decreases in liabilities | Increases in liabilities |

Note that the transactions are entered individually in the personal accounts of the customers and also entered in total in the control account.

You should also note that every entry in the personal accounts should also be included in the control account and vice versa – if the control account balance agrees with the total of the individual account balances it is highly likely that the double-entry has been posted correctly. Note, however, that if a transaction is posted to the wrong personal account this will not be found by the reconciliation of the control account balance.



Exercise 9.4

Explain the purpose of control accounts. Describe the contents of a sales ledger control account and state the source of the main items of information contained therein.



Solution

Control accounts are a means of controlling a complete ledger or group of ledger accounts, by containing duplicate information in total or summary form. The balance on the control account should equal the balances on the individual ledger accounts that it controls. It can be used as a means of checking the accuracy of the entries, and assists in the speedy production of final accounts.

A sales ledger control account would contain summary information regarding debtors' ledger accounts. Debit entries would include opening balances, sales made on credit, dishonoured cheques; credit entries would include sales returns, monies received and cash discount allowed, bad debts written off, transfers to other ledgers, closing balances.

The sources of the main items would be the sales daybook, sales returns daybook and cash book.



Exercise 9.5

Ascertain the value of sales from the following information:

| | |
|-----------------------|---------|
| | £ |
| Opening debtors | 23,750 |
| Closing debtors | 22,400 |
| Cash sales | 14,000 |
| Receipts from debtors | 215,000 |
| Discounts allowed | 4,500 |
| Bad debts written off | 2,250 |
| Dishonoured cheques | 2,500 |

**Solution**

| Sales ledger control account | | | |
|------------------------------|----------------|-----------------|----------------|
| | £ | | £ |
| Opening debtors | 23,750 | Receipts | 215,000 |
| Sales | ? | Discounts | 4,500 |
| Dishonoured cheques | 2,500 | Bad debts w/o | 2,250 |
| | <u>244,150</u> | Closing debtors | <u>22,400</u> |
| | | | <u>244,150</u> |

The sales figure is the balancing figure required, i.e. $£244,150 - £23,750 - £2,500 = £217,900$.

9.6.2 Contra entries

When a business is both a supplier and a customer of your business it is common for an agreement to be made to set off the sums receivable and payable, and for a single cheque to be sent between the parties to settle the net balance. The entry to record the setting off of the balances is known as a *contra entry*.

Example 9.E

The following accounts are taken from the accounting records of Z Ltd:

| Sales ledger | |
|--------------|-------|
| AP Ltd | |
| | £ |
| Balance b/d | 1,815 |

| Purchase ledger | |
|-----------------|-----|
| AP Ltd | |
| | £ |
| Balance b/d | 792 |

The balance of £792 in the purchase ledger is set off against the sales ledger balance using a contra entry:

| Sales ledger | | | |
|--------------|-------|------------|-----|
| AP Ltd | | | |
| | £ | | £ |
| Balance b/d | 1,815 | P/L contra | 792 |

| Purchase ledger | | | |
|-----------------|-----|-------------|-----|
| AP Ltd | | | |
| | £ | | £ |
| S/L contra | 792 | Balance b/d | 792 |

AP Ltd would send a cheque to Z Ltd for £1,023 to clear its sales ledger balance.

The same entries must be made in the control accounts, i.e. debit the purchase ledger control account with £792, and credit the sales ledger control account with £792. Note that it is always the *smaller* of the two balances that is transferred, but the entries of 'debit purchase ledger' and 'credit sales ledger' always occur.

The contra would also be entered in the journal (as its book of prime entry), but remember that the journal is not part of the double-entry system.

9.6.3 Credit balances in the sales ledger; debit balances in the purchase ledger

Normally, sales ledger accounts have debit balances, and purchase ledger accounts have credit balances. But it can happen that the reverse occurs. For example, a debtor may have paid his invoice, and then returns some goods that are faulty. The entries on the return would be to debit returns inwards and credit the debtor – which means that he acquires a credit balance. The same might occur with a supplier, whereby you have paid his invoice and later return goods. Strictly speaking, debtors with credit balances are creditors, and vice versa, but it is not normal to move them from one ledger to the other.

Thus it is possible to have credit balances in the sales ledger and debit balances in the purchase ledger. Very often, these balances are wiped out when the debtor orders more goods, or we order goods from the creditor. But sometimes it happens that there are no further orders, and a refund is required. With debtors, the entries are debit the debtor and credit bank, and with creditors the entries are credit the creditor and debit bank.



Exercise 9.6

Compile a sales ledger control account from the following information:

| | | |
|---------------------------------|---|--------------------------|
| Opening balances | £ | Debit 14,500, credit 125 |
| Sales on credit | | 27,500 |
| Sales return | | 850 |
| Bad debts written off | | 500 |
| Cash sales | | 420 |
| Cheques received from debtors | | 19,800 |
| Cash discount allowed | | 480 |
| Dishonoured cheques | | 700 |
| Contras to the purchases ledger | | 340 |
| Refunds to credit customers | | 125 |



Solution

| Sales ledger control account | | | |
|------------------------------|---------------|----------------------------|---------------|
| | £ | | £ |
| Opening balances | 14,500 | Opening balances | 125 |
| Sales on credit | 27,500 | Sales returns | 850 |
| Dishonoured cheques | 750 | Bad debts w/o | 500 |
| Refunds | 125 | Cheques received | 19,800 |
| | | Cash discount allowed | 480 |
| | | Contras to purchase ledger | 340 |
| | | Closing balances | <u>20,780</u> |
| | <u>42,875</u> | | <u>42,875</u> |

9.6.4 The control account and provision for doubtful debts

A provision for doubtful debts is made when it is felt that a proportion of debtors may not honour their debts in full, but the identity of the individual debtors is not known. Refer back to Chapter 5 to refresh your memory on the bookkeeping treatment of these provisions.

The important point to remember is that *no entries are made in the debtors ledger accounts* for provisions for doubtful debts, and therefore no entry is made in the sales ledger control account either.

9.6.5 Advantages of control accounts

- They check the accuracy of the ledger accounts that they control.
- They enable ‘segregation of duties’ by allocating the job of maintaining the sales/purchase ledger to one person, and the job of maintaining the control account to another person, thereby reducing the risk of fraud.
- They enable the trial balance to be prepared more speedily, as the debtors and creditors total can be extracted from the control accounts rather than waiting for the individual accounts to be balanced and totalled.
- They enable speedier identification of reasons why the trial balance may not balance – if the control account disagrees with its ledger balances, it prompts investigation into the entries in that area.

9.6.6 Reconciling control accounts and ledger accounts

The control account must be checked against the total of balances in the relevant ledger, on a regular basis, and any difference between the two must be investigated. Assuming that the control account has been prepared using totals from the books of prime entry, it is usual to ‘work backwards’ through the tasks that have been carried out, before checking individual entries. The sequence for a sales ledger control account could be as follows:

- (i) Rework the balance on the control account; check that bad debts have been entered, contras have been properly recorded, and that the account does not contain the provision for doubtful debts.
- (ii) Check that all totals have been correctly transferred from the books of prime entry to the control account (look especially for discounts allowed, which may have been omitted).
- (iii) Recalculate the list of debtors’ balances (look especially for credit balances listed as debits, check contras and bad debts written off).
- (iv) Recalculate the columns in the books of prime entry (look at the sequence of invoice numbers to see if one is missing; look also in the cash book for refunds made to debtors).
- (v) If the balances are still incorrect, it will be necessary to start looking at entries in detail:
 - cross-check the net, VAT and totals for each invoice/credit note in the daybooks;
 - cross-check the net, discount and total for each receipt in the cash book;
 - cross-check the calculation of the balances on the individual debtors accounts;
 - cross-check the entry of each invoice, credit note, receipt, etc., in the debtors accounts.

In computerised systems there is much less chance of arithmetical error, but omissions and mispostings can still occur.

Once the errors have been identified, corrections must be made to the sales ledger accounts, the control account or both.

Example 9.F

Cathy maintains a sales ledger control account. At 31 March 20X1, the balance on the control account was calculated as being £128,545, while the total of individual balances extracted from the sales ledger was £128,106. An examination of the books and records revealed the following:

- (i) The total of £29,450 for sales in the sales daybook had been posted as £29,540.
- (ii) The credit balance of £128 on a debtors account had been listed as a debit balance.
- (iii) A bad debt of £240 had been correctly written off in the debtors account, but no entry had been made in the control account.
- (iv) Discounts allowed totalling £185 had been entered on the wrong side of the control account.
- (v) A credit balance of £95 in the purchase ledger had been set off against the same person's balance in the sales ledger, but no entries had been made in the control accounts.
- (vi) The total on the debit side of a debtors account had been overcast by £100.

You are required to reconcile the two totals.

Solution

Each adjustment is likely to affect either the control account or the individual balances; it is possible that an error affects both.

| <i>Adjustments to debtors' balances</i> | £ |
|---|----------------|
| Total per original list | 128,106 |
| (ii) credit balance listed as debit | (256) |
| (vi) debit side overcast | (100) |
| Revised total | <u>127,750</u> |

Adjustments to control account (probably easiest to show this as a ledger account):

| | £ | | £ |
|-------------|----------------|-----------------------------|----------------|
| Balance b/d | 128,545 | (i) error in sales daybook | 90 |
| | | (iii) bad debts written off | 240 |
| | | (iv) discounts allowed | 370 |
| | | (v) contra | 95 |
| | | Revised balance | <u>127,750</u> |
| | <u>128,545</u> | | <u>128,545</u> |

9.7 Suspense accounts and the correction of errors



The nature of a suspense account is not an easy concept to grasp. Particular care should be made in ensuring that you understand this issue as it is the basis of many exam questions. To record transactions is difficult enough; to put right a transaction which has already been recorded incorrectly is more difficult. This ability to correct errors is a good test of bookkeeping competence and thus is a common exam question.

We have already seen that since every transaction has debit and credit entries of equal value, then when the accounts are balanced and a trial balance extracted the sum of the debit and credit balances are equal. However, this is to assume that all of the transactions are correctly posted to the ledger accounts and that the ledger account balances are correctly calculated. If the trial balance does not balance, then an error or errors have been made.

There are many different reasons why a trial balance may not balance:

- (a) incorrect additions in individual ledger accounts;
- (b) only one side of the transaction has been posted;
- (c) different values have been entered to the debit and credit sides of the respective ledger accounts.

When the trial balance does not balance, every effort should be made to find the errors and correct them, but occasionally they cannot be found quickly and in these circumstances a *suspense account* is opened and used to record the difference until the errors can be found. The use of the suspense account allows a set of accounts to be prepared subject to the correction of the errors. The prudent approach is to treat the suspense account balance as an expense (rather than an asset) if it is a debit balance and as a liability (rather than as revenue) if it is a credit balance. When the errors are found they should be corrected and an explanation given.

The corrections are made through the journal in the first instance, and then in the ledger accounts. If the error is one that has affected the agreement of the trial balance, then the suspense account will be involved in the correction of the error.

Example 9.G

On 31 December 20X1 a trial balance was extracted from the ledgers of Jake and the total of the debit side was found to be £77 less than the total of the credit side. A suspense account was opened to record the difference. Later, the following errors were discovered:

- (1) A cheque for £150 paid to Bond had been correctly entered in the cash book but not in Bond's account or the control account.
- (2) The purchases account had been undercast by £20.
- (3) A cheque received for £93 from Smith had been correctly entered in the cash book but had not been entered in Smith's account or the control account.

Solution

The journal entry and resulting entries in the suspense account are as follows:

| <i>Journal</i> | <i>Debtor</i> | <i>Creditor</i> |
|--|---------------|-----------------|
| | £ | £ |
| Bond | 150 | |
| Suspense | | 150 |
| Being correction of an error whereby only one entry was posted | | |
| Purchases | 20 | |
| Suspense | | 20 |
| Being correction of an error of addition in the purchases account | | |
| Suspense | 93 | |
| Smith | | 93 |
| Being correction of an error whereby only one entry was posted | | |

| Suspense | | | |
|--------------------|------------|-----------|------------|
| | £ | | £ |
| From trial balance | 77 | Bond | 150 |
| Smith | <u>93</u> | Purchases | <u>20</u> |
| | <u>170</u> | | <u>170</u> |



Exercise 9.7

The following trial balance was extracted from the books of Jane Smith on 31 March 20X1:

| | <i>Debtor</i> | <i>Creditor</i> |
|------------------|----------------|-----------------|
| | £ | £ |
| Premises | 50,000 | |
| Motor vans | 7,400 | |
| Sundry debtors | 1,680 | |
| Sundry creditors | | 2,385 |
| Purchases | 160,260 | |
| Sales | | 200,490 |
| Wages | 12,000 | |
| Drawings | 1,600 | |
| Capital | | <u>30,000</u> |
| | <u>232,940</u> | <u>232,875</u> |

As the trial balance totals did not agree, the difference was posted to a suspense account. The following errors were discovered:

1. The purchase of a motor van had been entered in the motor van account as £3,860 instead of £3,680.
2. The total of the purchases book £32,543 had been posted to the purchases account as £32,453.
3. The proprietress had withdrawn £140 for private use during March that had been debited to the wages account.
4. A cash discount of £25 allowed by Diane Jones, a creditor, had not been entered in Diane Jones's account.

You are required to take the above information into account and show:

- (a) journal entries to correct the errors;
- (b) the suspense account written up and balanced;
- (c) the corrected trial balance.



Solution

| <i>Journal entries</i> | | <i>Debtor (£)</i> | <i>Creditor (£)</i> |
|------------------------|------------------------|-------------------|---------------------|
| Item 1 | Suspense account | 180 | |
| | Motor vans | | 180 |
| Item 2 | Purchases | 90 | |
| | Suspense account | | 90 |
| Item 3 | Drawings | 140 | |
| | Wages | | 140 |
| Item 4 | Diane Jones (creditor) | 25 | |
| | Suspense account | | 25 |

| Suspense account | | | |
|------------------|------------|------------------|------------|
| | £ | | £ |
| Motor van | 180 | Balance b/f | 65 |
| | | Purchases | 90 |
| | | Sundry creditors | 25 |
| | <u>180</u> | | <u>180</u> |

Trial balance

| | <i>Debtor (£)</i> | <i>Creditor (£)</i> |
|------------------|-------------------|---------------------|
| Premises | 50,000 | |
| Motor vans | 7,220 | |
| Sundry debtors | 1,680 | |
| Sundry creditors | | 2,360 |
| Purchases | 160,350 | |
| Sales | | 200,490 |
| Wages | 11,860 | |
| Drawings | 1,740 | |
| Capital | | <u>30,000</u> |
| | <u>232,850</u> | <u>232,850</u> |

9.8 Computers in accounting

The use of computers to maintain bookkeeping records and produce financial statements is now widespread, even in small organisations. The use of computers is not specifically part of your syllabus, but no accounting textbook would be complete without mentioning some of the features and problems that such systems possess.

It is important, however, that you recognise that computers must perform the same bookkeeping tasks that have been described manually in this book. The double-entry system must still be maintained, and adequate controls must be in place to ensure its accuracy. In examination questions, you will normally be required to answer questions on the assumption that the system is a manual one, so if you work in an organisation that has a sophisticated computerised accounting system, try to relate the principles of bookkeeping described here to those that take place in the computerised system.

Using computers provides a range of benefits such as:

- speed of input and processing of data;
- speed and flexibility of producing information;
- ability to manage large numbers of accounts and transactions;
- improved accuracy;
- automatic update of all related accounts in a transaction, with a single entry;
- less storage space required;
- additional checks on the input of data, for example, dates (31 November is not allowed), limits (no person can work more than 100 hours in a week), ranges (hourly wage rates are between £7.60 and £12.50), etc.

However, the biggest single drawback of computerised systems is that the user cannot physically see what is happening to the bookkeeping system and errors and omissions cannot be readily identified.

Of course, many computerised accounting systems are ‘self-balancing’, in that a single transaction is input, and is used to update the ledger accounts, the daybooks, the control accounts, perhaps even the stock records, and it is all too easy to assume that everything has been done correctly. Unfortunately, this is not always the case.

9.8.1 Aspects of computerised accounting systems

There are many different types of computerised system. Some lend themselves to large organisations, others to smaller organisations. Typical configurations are:

- (i) a mainframe computer that has a very large capacity, supported by a minicomputer (slightly smaller) and perhaps several personal computers for individual users. Such a system might involve the users in entering data into the system, and accessing the results directly.
- (ii) Networked computers, where the files are held centrally, but updated and accessed from remote locations by users.
- (iii) Stand-alone computers, where files are held on individual computers, updated by those users.

All of these configurations have security implications. For example, some may allow individual users to update the accounts. It is important that there is sufficient segregation of duties in this situation. Others may only allow access to the balances, but not the facility to amend those balances.

In all cases, the ledger accounts will have to balance and a trial balance will be produced. This may be part of the ‘month-end routine’, which typically produces totals of the transactions during, and balances at the end of, the month. The month-end routine would provide lists and totals of invoices issued and received, payments made, expenses incurred, as well as end-of-month balances of debtors, creditors, stocks, bank and cash, and expenses.

The computer system will also be capable of making adjustments to the accounts for accruals, prepayments, provisions, etc. These will normally be input via a journal entry, as in a manual system.

9.9 Accounting coding systems

By now you will realise that a busy organisation will have a large number of ledger accounts and subsidiary records within and outside the accounting system. Using the titles of accounts to locate and cross-reference transactions could be difficult in such situations. Imagine the UK Inland Revenue maintaining all the records of UK taxpayers according to their names. There will be hundreds of thousands of taxpayers with the surnames Smith, or Brown or Jones – and thousands called John Smith or Helen Brown. Each needs a unique code to identify them from the others. The same applies to accounting systems. The ledger accounts require unique codes, as do stock items, employees on the payroll, etc.

We could simply number them 1, 2, 3, etc., but that would not be particularly helpful in locating an individual item. Some kind of coding system is needed. This is particularly important in computerised systems, which use codes to transfer data throughout the system.

Organisations could perhaps start with the five main categories of ledger account, for example,

- Assets Code 1
- Liabilities Code 2
- Capital Code 3
- Expenses Code 4
- Revenues Code 5

and then further subdivide them into more minor categories, for example,

- Fixed assets Code 12
- Current assets Code 13

Fixed assets could be further divided into types, for example, plant (1), motor vehicles (2), office equipment (3), etc.

Codes could be included to identify the location of such items within the organisation, e.g. sales department, purchasing department, wages department, factory locations. This would enable depreciation to be charged to the department that utilises the item.

The following structure illustrates how a coding system may be used for a nominal ledger in a large organisation.

A six-digit code is used: the first digit represents the functional analysis; digits 2 and 3 represent the cost centre (i.e. the department); and digits 4–6 the type of expense involved.

| <i>Function</i> | <i>Cost centre (within production)</i> | <i>Nominal ledger expense analysis</i> |
|------------------|--|--|
| 1 Production | 10 Machining | 100 Raw material X |
| 2 Sales | 11 Assembly | 101 Raw material Y |
| 3 Administration | 12 Finishing | 201 Skilled-labour wages |
| | | 202 Unskilled-labour wages |
| | | 203 Salaries |
| | | 301 Rent |
| | | 601 Postage |
| | | 602 Stationery |

An example code could be 110202, which represents unskilled-labour wage cost incurred in the machining cost centre of the production function.

It is generally accepted that codes should be:

- (a) *Unique*. In order to avoid ambiguity each item must have only one possible code.
- (b) *Useful*. There is no point in using a code if there is to be no benefit from its use. The code will have to be learned by the users of the system so that it may be both applied and understood.
- (c) *Compact*. It is generally accepted that the shorter the code the easier it is to learn and therefore the likelihood of mistakes and confusion is reduced. Thus, a code should be as short and compact as possible.
- (d) *Meaningful*. If the code can be made meaningful by the characters of the code being connected in some way to the item that the code represents, the code will be more easily remembered and understood.
- (e) *Self-checking*. The biggest problem with the use of codes is that users of the codes remember them incorrectly. To ensure that the information to be provided by the system is of value, each of the codes used must be validated. If a numeric code is used

it can be designed in such a way as to be self-checking – this will help in identifying coding mistakes and avoid the production of incorrect information.

- (f) *Expandable*. When designing a coding system it is important to consider the requirements of the organisation in the future. The design of accounting systems often involves a large amount of time and this is then followed by a period when the users are learning the system. If the code is not expandable, then it is likely that the system will have to be changed sooner rather than later. This will be costly in design time and will cause difficulties because the users of the system will have to learn the new system.
- (g) *Standard size*. If codes are of varying size, then different users may write the same code differently. For example, if a part of a coding system comprises up to four characters, then the three-digit code AB1 could be written in a number of ways, with spaces and dashes in different places. Using AB01 would prevent this.

9.10 Summary

This chapter has outlined a variety of controls and checks that can be incorporated into or alongside the bookkeeping system to:

- help prevent errors and fraud;
- detect errors if they do occur;
- correct errors, often via the journal, once they have been discovered.

These controls and checks include:

- bank reconciliations,
- control accounts,
- suspense accounts.

The chapter concluded with an explanation of:

- computers in accounting,
- coding systems.

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Revision Questions

9

? Question 1 Multiple choice

1.1 Following the preparation of the profit and loss account, it is discovered that accrued expenses of £1,000 have been ignored and that closing stock has been overvalued by £1,300. This will have resulted in:

£

1.2 The cash book shows a bank balance of £5,675 overdrawn at 31 August 1995. It is subsequently discovered that a standing order for £125 has been entered twice, and that a dishonoured cheque for £450 has been debited in the cash book instead of credited.

The correct bank balance should be:

£

1.3 A supplier sends you a statement showing a balance outstanding of £14,350. Your own records show a balance outstanding of £14,500.

The reason for this difference could be that:

- (A) the supplier sent an invoice for £150 that you have not yet received.
- (B) the supplier has allowed you £150 cash discount that you had omitted to enter in your ledgers.
- (C) you have paid the supplier £150 that he has not yet accounted for.
- (D) you have returned goods worth £150 that the supplier has not yet accounted for.

1.4 From the following information, calculate the value of purchases:

| | |
|--------------------|---------|
| | £ |
| Opening creditors | 142,600 |
| Cash paid | 542,300 |
| Discounts received | 13,200 |
| Goods returned | 27,500 |
| Closing creditors | 137,800 |

£

1.5 A suspense account shows a credit balance of £130. This could be due to:

- (A) omitting a sale of £130 from the sales ledger.

- (B) recording a purchase of £130 twice in the purchases account.
- (C) failing to write off a bad debt of £130.
- (D) recording an electricity bill paid of £65 by debiting the bank account and crediting the electricity account.

1.6 You are given the following information:

| | |
|--|--------|
| | £ |
| Debtors at 1 January 1993 | 10,000 |
| Debtors at 31 December 1993 | 9,000 |
| Total receipts during 1993 (including cash sales of £5,000) | 85,000 |

Sales on credit during 1993 amount to:

£

1.7 Your cash book at 31 December 1993 shows a bank balance of £565 overdrawn. On comparing this with your bank statement at the same date, you discover that:

- a cheque for £57 drawn by you on 29 December 1993 has not yet been presented for payment;
- a cheque for £92 from a customer, which was paid into the bank on 24 December 1993, has been dishonoured on 31 December 1993.

The correct bank balance to be shown in the balance sheet at 31 December 1993 is:

£

1.8 After calculating your company's profit for 1993, you discover that:

- a fixed asset costing £50,000 has been included in the purchases account;
- stationery costing £10,000 has been included as closing stock of raw materials, instead of as stock of stationery.

These two errors have had the effect of:

- (A) understating gross profit by £40,000 and understating net profit by £50,000.
- (B) understating both gross profit and net profit by £40,000.
- (C) understating gross profit by £60,000 and understating net profit by £50,000.
- (D) overstating both gross profit and net profit by £60,000.

1.9 The sales ledger control account at 1 May had balances of £32,750 debit and £1,275 credit. During May, sales of £125,000 were made on credit. Receipts from debtors amounted to £122,500 and cash discounts of £550 were allowed. Refunds of £1,300 were made to customers.

The closing balances at 31 May could be:

| | |
|--------------|---------------|
| <i>Debit</i> | <i>Credit</i> |
| £ | £ |

1.10 Your firm's cash book at 30 April 1998 shows a balance at the bank of £2,490. Comparison with the bank statement at the same date reveals the

following differences:

| | |
|---------------------------------------|-----|
| | £ |
| Unpresented cheques | 840 |
| Bank charges not in cash book | 50 |
| Receipts not yet credited by the bank | 470 |
| Dishonoured cheque not in cash book | 140 |

The correct bank balance at 30 April 1998 is:

£.....

1.11 The following information relates to a bank reconciliation.

- (i) The bank balance in the cash book before taking the items below into account was £8,970 overdrawn.
- (ii) Bank charges of £550 on the bank statement have not been entered in the cash book.
- (iii) The bank has credited the account in error with £425, which belongs to another customer.
- (iv) Cheque payments totalling £3,275 have been entered in the cash book but have not been presented for payment.
- (v) Cheques totalling £5,380 have been correctly entered on the debit side of the cash book but have not been paid in at the bank.

What was the balance as shown by the bank statement *before* taking the items above into account?

£.....

1.12 Which of the following is *not* the purpose of a sales ledger control account?

- (A) A sales ledger control account provides a check on the arithmetic accuracy of the personal ledger.
- (B) A sales ledger control account helps to locate errors in the trial balance.
- (C) A sales ledger control account ensures that there are no errors in the personal ledger.
- (D) Control accounts deter fraud.

1.13 When reconciling the creditors ledger control account with the list of creditors ledger balances of M, the following errors were found:

- the purchase daybook had been overstated by £500;
- the personal ledger of a supplier had been understated by £400.

What adjustment must be made to correct these errors?

| | <i>Control account</i> | <i>List of creditor balances</i> |
|----------|------------------------|----------------------------------|
| A | Cr £500 | Decrease by £400 |
| B | Dr £500 | Increase by £400 |
| C | Dr £400 | Increase by £500 |
| D | Cr £400 | Decrease by £500 |

1.14 In a debtors' report, which *one* of the following would you *not* expect to see?

- (A) Total debtor balances outstanding for current and previous months.
- (B) Debtor balances excluding VAT.

- (C) Credit limit.
- (D) Sales to date.

1.15 Z's bank statement shows a balance of £825 overdrawn. The bank statement includes bank charges of £50, which have not been entered in the cash book. There are unpresented cheques totalling £475 and deposits not yet credited of £600. The bank statement incorrectly shows a direct debit payment of £160, which belongs to another customer.

The figure for the bank balance in the balance sheet should be:
£overdrawn

1.16 I Ltd operates the imprest system for petty cash. At 1 July there was a float of £150, but it was decided to increase this to £200 from 1 August onwards. During July, the petty cashier received £25 from staff for using the photocopier and a cheque for £90 was cashed for an employee. In July, cheques were drawn for £500 for petty cash.

How much cash was paid out as cash expenses by the petty cashier in July?
£

?

Question 2

A business had the following transactions from 1 March 20X1 to 31 May 20X1:

| <i>Purchases</i> | | | | <i>Sales</i> | | | |
|------------------|----------------|----------------|------------------|---------------------|----------------|----------------|------------------|
| <i>Supplier</i> | <i>Net (£)</i> | <i>VAT (£)</i> | <i>Gross (£)</i> | <i>Customer (£)</i> | <i>Net (£)</i> | <i>VAT (£)</i> | <i>Gross (£)</i> |
| A | 300 | 52.50 | 352.50 | V | 700 | 122.50 | 822.50 |
| B | 200 | 35.00 | 235.00 | W | 400 | 70.00 | 470.00 |
| C | 800 | 140.00 | 940.00 | X | 1,200 | 210.00 | 1,410.00 |
| D | 1,000 | 175.00 | 1,175.00 | Y | 200 | 35.00 | 235.00 |
| E | 100 | 17.50 | 117.50 | Z | 500 | 87.50 | 587.50 |
| | <u>2,400</u> | <u>420.00</u> | <u>2,820.00</u> | | <u>3,000</u> | <u>525.00</u> | <u>3,525.00</u> |

| <i>Payments</i> | | <i>Receipts</i> | |
|-----------------|--------------|-----------------|--------------|
| <i>Supplier</i> | <i>£</i> | <i>Customer</i> | <i>£</i> |
| A | 300 | V | 600 |
| B | 180 | W | - |
| C | 920 | X | 1,000 |
| D | 700 | Y | 115 |
| E | 85 | Z | 475 |
| | <u>2,185</u> | | <u>2,190</u> |

Brought-forward balances at 1 March 20X1 were £470 for trade debtors and £600 for trade creditors.

Requirements

Write up the following accounts:

| Debtors control | | | |
|-----------------|----------|-------------|----------|
| | £ | | £ |
| Balance b/f | █ | Cash | █ |
| Sales | █ | Balance c/f | █ |
| VAT | █ | | |
| | <u>█</u> | | <u>█</u> |

| Creditors control | | | |
|-------------------------|---|-------------------------|---|
| | £ | | £ |
| Cash | | Balance b/f | |
| Balance c/f | | Purchases | |
| | | VAT | |
| | | | |
| VAT | | | |
| | £ | | £ |
| Creditors | | Debtors | |
| Balance c/f | | | |
| | | | |
| Sales | | | |
| | £ | | £ |
| Profit and loss account | | Debtors | |
| | | | |
| | | | |
| Purchases | | | |
| | £ | | £ |
| Creditors | | Profit and loss account | |
| | | | |
| | | | |

? Question 3

The assistant accountant of BC Ltd has prepared a sales ledger control account at 30 September 1995 for you to reconcile with the list of sales ledger balances at that date. The control account balances are:

| | |
|-----------------|----------|
| Debit balances | £226,415 |
| Credit balances | £1,250 |

The list of balances extracted from the sales ledger totals £225,890. You discover the following:

- (i) The credit balances have been included on the list of debtors as debit balances.
- (ii) A sales invoice for £6,400 plus VAT at 17.5 per cent has been recorded in the sales day book as £4,600 plus VAT at 17.5 per cent. It has been entered correctly in the sales ledger.
- (iii) Cash discounts allowed amounted to £840 and cash discounts received amounted to £560; the only entry in the control account for discounts is a debit for cash discounts received.
- (iv) A dishonoured cheque for £450 from a customer has been recorded correctly in the control account, but no entry has been made in the debtor's personal account.
- (v) A contra entry between the sales and purchase ledgers of £750 has been omitted from the control account.
- (vi) The control account contains receipts from cash sales of £860 but does not contain the invoices to which these receipts refer; no entries have been made in the sales ledger for these invoices or receipts.
- (vii) No entries have been made in the control account for bad debts written off (£2,150) and provision for doubtful debts (£2,400). Ignore VAT.

Requirements

- (a) Complete the table below to show the entries needed in the sales ledger control account to correct the present balance; consider each of the seven items mentioned – if no entry is required in the control account, write ‘N/E’ in the ‘Description’ column and ignore the other columns.

| Item | Description (max. 4 words each) | Debit or credit? | Amount (£) |
|-------|---------------------------------|------------------|------------|
| (i) | | | |
| (ii) | | | |
| (iii) | | | |
| (iv) | | | |
| (v) | | | |
| (vi) | | | |
| (vii) | | | |

- (b) Complete the missing figures given below to calculate the revised sales ledger control account balance:

| | |
|--------------------------------|--------------|
| Original balance | £ 226,415 |
| Add debit entries required | █ |
| Deduct credit entries required | █ |
| Revised balance | █ |

- (c) Two of the seven items noted above required adjustment to the list of sales ledger balances. Insert the missing entries into the statement given below:

| Item no. | Description (max. two words each) | Adjustment £ | + or - |
|------------------|-----------------------------------|-----------------|--------|
| █ | | █ | █ |
| █ | | █ | █ |
| Total adjustment | | █ | █ |
| Corrected total | | █ | █ |

Original sales ledger balances 225,890 £

Items requiring adjustment:

- (d) State four facilities that a computerised sales ledger system might offer to BC Ltd (max. 30 words each).

- (i) █
- (ii) █
- (iii) █
- (iv) █

? Question 4

BH commenced in business some years ago, maintaining a single ledger for all accounts, plus a cash book. His business has now expanded to the extent that he now needs to consider improving his accounting system by dividing the ledger into sections and introducing a petty-cash system.

Requirements

- (a) Complete the missing word in this sentence.
A system for recording petty cash payment is the _____ system.

(b) State the names of 4 day books.

- (i) [REDACTED]
- (ii) [REDACTED]
- (iii) [REDACTED]
- (iv) [REDACTED]

(c) From the following information, draw up a sales ledger control account for the month of February 1997 by entering the missing figures in the control account below.

| | |
|---------------------------------------|---------|
| | £ |
| Owing by customers at 1 February 1997 | 103,670 |
| Owing to customers at 1 February 1997 | 1,400 |
| Sales, excluding VAT | 175,860 |
| VAT on sales | 10,350 |
| Returns inwards, including VAT | 9,500 |
| VAT on returns inwards | 1,300 |
| Refunds to customers | 800 |
| Cash sales, including VAT | 12,950 |
| Cheques received from debtors | 126,750 |
| Discounts allowed to customers | 1,150 |
| Contra entries to purchase ledger | 750 |
| Bad debts written off | 2,300 |
| Dishonoured cheques from debtors | 1,580 |

In addition, BH has been notified that he will receive a dividend of 10p in the pound from a previously written-off bad debt of £3,000. The amount has not yet been received.

At 28 February 1997, a provision for doubtful debts is to be made of 2 per cent of the net balance that existed at 1 February 1997.

Amounts owing to customers at 28 February 1997 amounted to £840.

| BH – Sales ledger control account | | | |
|-----------------------------------|------------|------------|------------|
| | £ | | £ |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |
| [REDACTED] | [REDACTED] | [REDACTED] | [REDACTED] |

? **Question 5**

The following balances appeared in your company’s sales ledger at 1 April 1998:

| | | |
|----------|--------|-------|
| | | £ |
| Debtor P | Debit | 5,000 |
| Debtor Q | Debit | 1,200 |
| Debtor R | Debit | 1,045 |
| Debtor S | Debit | 8,750 |
| Debtor T | Credit | 140 |
| Debtor U | Credit | 900 |
| Debtor V | Debit | 400 |

During April 1998, the following transactions occurred:

| <i>Debtor</i> | | £ | |
|---------------|---|-------|---|
| Sales | P | 4,700 | |
| | Q | 1,175 | |
| | R | 3,520 | |
| | U | 9,400 | |
| Returns | P | 1,400 | |
| | R | 800 | |
| | S | 750 | |
| Receipts | P | 9,740 | |
| | Q | | Balance at 1 April 1998 less 5 per cent cash discount |
| | R | 1,520 | (cheque dishonoured later in the month) |
| | S | 7,500 | |
| Refunds | T | | Balance at 1 April 1998 |

The balance on V's account is written off as bad. The remaining balance on S's account is offset against his balance in the purchase ledger. A provision for doubtful debts of 5 per cent of closing balances is to be made.

Requirements

- (a) Complete the missing figures in the following table in order to calculate the total of debtors' balances at 30 April 1998. Where a figure is to be deducted from the balance, show it in brackets. If no figure is required in a particular box, leave it blank.

| | <i>P (£)</i> | <i>Q (£)</i> | <i>R (£)</i> | <i>S (£)</i> | <i>T (£)</i> | <i>U (£)</i> | <i>V (£)</i> | <i>Total (£)</i> |
|--------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|------------------|
| Balance 1/4/98 | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ |
| Credit sales | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ |
| Returns | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ |
| Receipts | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ |
| Discount allowed | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ |
| Dishonoured cheque | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ |
| Refund | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ |
| Bad debt w/off | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ |
| Set off | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ |
| Balance 30/4/98 | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ |

- (b) Complete the missing figures in the sales ledger control account given below.

| Sales ledger control account | | | |
|------------------------------|---|-----------------------|---|
| | £ | | £ |
| Balance b/f | ■ | Balance b/f | ■ |
| Sales | ■ | Receipts | ■ |
| Dishonoured cheque | ■ | Returns | ■ |
| Refund | ■ | Discounts allowed | ■ |
| Balance c/f | ■ | Bad debts written off | ■ |
| | | Set off/contra | ■ |
| | | Balance c/f | ■ |
| | ■ | | ■ |
| Balance b/f | ■ | Balance b/f | ■ |

- (c) Insert the missing word in this sentence:

- (i) The principle purpose of a control account is to check on the accuracy of the _____ accounts in the relevant ledger that it controls.

- (ii) It is called a 'total account' because it contains the total of all transactions posted to the _____ accounts, taken from summary day books, cash books etc.

? Question 6

After calculating net profit for the year ended 31 March 1998, WL has the following trial balance:

| | <i>Debit (£)</i> | <i>Credit (£)</i> |
|--|------------------|-------------------|
| Land and buildings – cost | 10,000 | |
| Land and buildings – depreciation at 31 March 1998 | | 2,000 |
| Plant – cost | 12,000 | |
| Plant – depreciation at 31 March 1998 | | 3,000 |
| Stocks | 2,500 | |
| Debtors | 1,500 | |
| Bank | 8,250 | |
| Creditors | | 1,700 |
| Rent prepaid | 400 | |
| Wages accrued | | 300 |
| Capital account | | 19,400 |
| Profit for the year ended 31 March 1998 | | 9,750 |
| | <u>34,650</u> | <u>36,150</u> |

A suspense account was opened for the difference in the trial balance.

Immediately after production of the above, the following errors were discovered:

- (i) A creditor's account had been debited with a £300 sales invoice (which had been correctly recorded in the sales account).
- (ii) The heat and light account had been credited with gas paid £150.
- (iii) G Gordon had been credited with a cheque received from G Goldman for £800. Both are debtors.
- (iv) The insurance account contained a credit entry for insurance prepaid of £500, but the balance had not been carried down and hence had been omitted from the above trial balance.
- (v) Purchase returns had been overcast by £700.

Requirements

- (a) Complete the table below to indicate the journal entries necessary to correct each of the above errors.

| <i>Item</i> | <i>Name of account</i> | <i>Debit amount (£)</i> | <i>Credit amount (£)</i> |
|-------------|------------------------|-------------------------|--------------------------|
| (i) | ████████████████████ | ████ | |
| | ████████████████████ | | ████ |
| (ii) | ████████████████████ | ████ | |
| | ████████████████████ | | ████ |
| (iii) | ████████████████████ | ████ | |
| | ████████████████████ | | ████ |
| (iv) | ████████████████████ | ████ | |
| | ████████████████████ | | ████ |
| (v) | ████████████████████ | ████ | |
| | ████████████████████ | | ████ |

- (b) Insert the missing items into the suspense account given below, in respect of any errors that you have identified in (a), and total the account:

| Suspense account | | | | |
|------------------------------|---|-------------|----------|---|
| | £ | Description | Item no. | £ |
| Balance as per trial balance | █ | █ | █ | █ |
| | | █ | █ | █ |
| | | █ | █ | █ |
| | █ | | | █ |
| | █ | | | █ |

- (c) Name the type of error that has occurred in each of items (i)–(iii) (*max. five words each*).

- (i) █
(ii) █
(iii) █

- (d) Insert the missing items into the boxes below to show the recalculated net profit for the year to 31 March 1998:

| | | |
|--------------------|---|-------|
| First draft profit | | £ |
| Adjustment re: | █ | 9,750 |
| Adjustment re: | █ | █ |
| Revised net profit | | █ |

- (e) Insert the missing figures into the balance sheet of WL at 31 March 1998, given below:

| | Cost (£) | Depreciation (£) | NBV (£) |
|---------------------------|---------------|------------------|---------|
| Fixed assets | | | |
| Land and buildings | 10,000 | 2,000 | █ |
| Plant | 12,000 | 3,000 | █ |
| | <u>22,000</u> | <u>5,000</u> | █ |
| Current assets | | | |
| Stock | | █ | |
| Debtors | | █ | |
| Prepayments | | █ | |
| Bank | | █ | |
| | | █ | |
| Less: current liabilities | | | |
| Creditors | █ | | |
| Accrual | █ | | |
| | █ | | |
| Net current assets | | █ | █ |
| Financed by | | | █ |
| Capital | | | █ |
| Profit for the year | | | █ |



Question 7

You are the payroll administrator in your organisation, and your responsibilities include the preparation of the monthly payroll for 100 employees.

Each employee is paid a basic monthly wage, with overtime at time and a third. Employees complete an overtime report form that they submit direct to you each month. You input the necessary data to a computerised payroll system, in batches, which are processed as a single run at the end of each month.

The system produces a monthly summary of payroll data. You then journalise the totals to provide input to the nominal ledger.

You make out cheques in the following month for employees' net wages.

The highest-paid employee earns £2,000 basic pay per month gross.

An extract from the payroll printout for the month ended 31 October 1998 was as follows:

| <i>Employee number</i> | <i>Gross wages (£)</i> | <i>Tax (£)</i> | <i>Employees' NI (£)</i> | <i>Pension payments</i> | <i>Employer's NI (£)</i> |
|------------------------|------------------------|----------------|--------------------------|-------------------------|--------------------------|
| 1 | 6,000 | 1,000 | 200 | 360 | 520 |
| 2 | 2,222 | 360 | 200 | 132 | 160 |
| 3 | 2,160 | 340 | 180 | 125 | 150 |
| 4 | 1,760 | 300 | 160 | 105 | 120 |
| etc | | | | | |
| 100 | 600 | 72 | 48 | 40 | 60 |
| Totals | <u>78,000</u> | <u>12,800</u> | <u>5,600</u> | <u>4,600</u> | <u>5,250</u> |

Requirements

(a) Insert the missing items into the boxes given below in respect of the ledger entries to be made for wages:

(i) *DR or CR?* *Amount (£)*
 Total wages expense account

This is made up of the figures from the following columns in the question:

| <i>Column heading</i> | <i>Amount (£)</i> |
|-----------------------|----------------------|
| <input type="text"/> | <input type="text"/> |
| <input type="text"/> | <input type="text"/> |

(ii) *DR or CR?* *Amount (£)*
 PAYE creditor account

This is made up of the figures from the following columns in the question:

| <i>Column heading</i> | <i>Amount (£)</i> |
|-----------------------|----------------------|
| <input type="text"/> | <input type="text"/> |
| <input type="text"/> | <input type="text"/> |
| <input type="text"/> | <input type="text"/> |

(iii) *DR or CR?* *Amount (£)*
 Pension scheme creditor account

(iv) *DR or CR?* *Amount (£)*
 Wages creditor account
 (i.e. net wages payable)

(b) Insert into the box the amount to be debited to the profit and loss account for the month of October, in respect of wages costs: £



Question 8

The trial balance of E Ltd did not balance and the following errors have been discovered:

- (i) A cheque for £1,000 received from a debtor had been credited to the sales account and debited to the bank account.
- (ii) The cash book had been undercast by £250.
- (iii) A machine costing £5,000 had been debited to the machinery repairs account. Machinery is depreciated at 10 per cent on cost and no residual value is assumed.

Requirements

- (a) Insert the missing items into the table below to show the correction of the above errors.

| <i>Item</i> | <i>Account</i> | <i>Debit or Credit?</i> | <i>Amount (£)</i> |
|-------------|----------------|-------------------------|-------------------|
| (i) | | | |
| (ii) | | | |
| (iii) | | | |

- (b) (i) Insert the missing words in this sentence.
Financial control is important to prevent _____ and _____ .
- (ii) Insert the missing words:
 - An example of financial control is the _____ ledger _____ account.
 - An example of financial control is the bank _____ .

Solutions to Revision Questions

9



Solution 1

- 1.1 Ignoring accrued expenses means that insufficient expense has been charged against profits, thus making profits too high (i.e. overstated); overvaluing closing stock will have resulted in cost of goods sold that is too low, hence gross profit will be too high (i.e. overstated). Both errors result in an overstatement of profit, so the correct answer is an overstatement of $\pounds 1,000 + \pounds 1,300 = \pounds 2,300$.
- 1.2 The correct bank balance can be found as follows:

| | | |
|-------------------------------------|--------------|--------------------|
| Cash book balance | £ | |
| | 5,675 | overdrawn (credit) |
| Correct standing order error | 125 | debit |
| Reverse error of dishonoured cheque | 450 | credit |
| Enter dishonoured cheque correctly | 450 | credit |
| Correct balance | <u>6,450</u> | overdrawn |

- 1.3 Answer: (B)

The supplier's records show a smaller amount owing than your own records. This could not be due to an invoice not received as this would further increase the amount owing according to your records. If you have paid the supplier, this would further reduce the balance in his records. If you have returned goods, this would also reduce the balance in his records. If you are to account for cash discount in your records, this would reduce the balance in your records to agree to the supplier's.

- 1.4 Purchases can be found by constructing a control account:

| | | | |
|-------------------|----------------|-------------------|----------------|
| Cash paid | £ | Opening creditors | £ |
| | 542,300 | | 142,600 |
| Discount received | 13,200 | Purchases | ? |
| Goods returned | 27,500 | | |
| Closing creditors | <u>137,800</u> | | |
| | <u>720,800</u> | | <u>720,800</u> |

$$\text{Purchases} = \pounds 720,800 - \pounds 142,600 = \pounds 578,200$$

- 1.5 Answer: (B)

A credit balance on the suspense account indicates that the debit total of the trial balance was higher than the credit total. An error that could cause this would involve

either too great a value having been debited, too little a value having been credited, or a combination of these where an item has been recorded as a debit when it ought to have been a credit.

- (A) would result in too little having been debited to the customer's account.
- (B) would result in an additional debit entry, therefore this is the correct answer.
- (C) would not cause any imbalance in the trial balance as both the debit and credit entries will have been omitted.
- (D) would not cause any imbalance in the trial balance as both a debit and a credit entry have been made even though they were the wrong way round.

1.6 Sales can be found by constructing a mini sales control account:

| | | | |
|-------------------|--------|---------------------------|--------|
| | £ | | £ |
| Debtors at 1.1.93 | 10,000 | Receipts, less cash sales | 80,000 |
| Sales | ? | Debtors at 31.12.93 | 9,000 |
| | 89,000 | | 89,000 |

Sales = £79,000

1.7 The cash book balance needs adjusting for the dishonoured cheque, and the bank balance needs adjusting for the unrepresented cheque. The correct balance for the balance sheet is therefore:

£565 overdrawn – dishonoured cheque £92 = £657 overdrawn

1.8 Answer: (A)

Including a fixed asset in the purchases account has overstated purchases, and hence has overstated cost of goods sold; this has the effect of understating gross profit. Including stationery stocks with closing stocks of raw materials has the effect of increasing closing stocks of raw materials, which then understates the cost of goods sold, and hence overstates gross profit. So, gross profit has been understated by £50,000 and overstated by £10,000 – a net understatement of £40,000.

Stock of stationery should reduce the total of stationery expenses in the profit and loss account. Omitting to consider the closing stock will have overstated the expenses. An overstatement of gross profit and an overstatement of expenses by the same amount (because of the stationery error) will have no effect on net profit. Therefore, the only effect on net profit will be the understatement due to the fixed-asset error.

The result, therefore, is that gross profit has been understated by £40,000 and the net profit understated by £50,000.

1.9 The closing balance is calculated as:

| | | |
|----------------------------------|-----------|--------|
| | £ | |
| Opening balance (32,750 – 1,275) | 31,475 | debit |
| Sales | 125,000 | debit |
| Receipts | (122,500) | credit |
| Cash discounts | (550) | credit |
| Refunds | 1,300 | debit |
| Closing balance | 34,725 | debit |

1.10

| | |
|-----------------------------------|--------------|
| | £ |
| Original cash book figure | 2,490 |
| Adjustment re: charges | (50) |
| Adjustment re: dishonoured cheque | (140) |
| | <u>2,300</u> |

1.11

| | | | |
|------------------|----------------|-----------------------|----------------|
| <i>Cash book</i> | £ | <i>Bank statement</i> | £ |
| Balance | (8,970) | Balance | (11,200) |
| Bank charges | (550) | Credit in error | (425) |
| | | Unpresented cheques | (3,275) |
| | | Outstanding deposits | (5,380) |
| | <u>(9,520)</u> | | <u>(9,520)</u> |

1.12 Answer: (C)

1.13 Answer: (B)

1.14 Answer: (B)

1.15

| | |
|----------------------------|--------------|
| | £ |
| Bank statement – overdrawn | (825) |
| Unpresented cheques | (475) |
| Deposits outstanding | 600 |
| Direct debit error | 160 |
| Bank balance – overdrawn | <u>(540)</u> |

1.16

| | |
|-----------------------------|------------|
| | £ |
| Petty cash balance 1 July | 150 |
| Photocopies receipts | 25 |
| Cheque cashed | (90) |
| | <u>85</u> |
| Cheques drawn for cash | 500 |
| | <u>585</u> |
| Petty cash balance 1 August | (200) |
| Cash paid out for expenses | <u>385</u> |



Solution 2

This question involves the ledger entries to be made from sales and purchase daybooks (journals). The total invoice values are debited/credited to the debtors/creditors accounts (and hence to the control accounts), while the sales and purchases accounts contain only the net amounts. Input VAT is debited to the VAT control, and output VAT is credited.

| Debtors control | | | |
|-------------------|--------------|-------------|--------------|
| | £ | | £ |
| Balance b/f | 470 | Cash | 2,190 |
| Sales | 3,000 | Balance c/f | 1,805 |
| VAT | 525 | | |
| | <u>3,995</u> | | <u>3,995</u> |
| Creditors control | | | |
| | £ | | £ |
| Cash | 2,185 | Balance b/f | 600 |
| Balance c/f | 1,235 | Purchases | 2,400 |
| | <u>3,420</u> | VAT | 420 |
| | | | <u>3,420</u> |

| VAT | | | |
|-------------------------|--------------|-------------------------|--------------|
| | £ | | £ |
| Creditors | 420 | Debtors | 525 |
| Balance c/f | <u>105</u> | | |
| | <u>525</u> | | <u>525</u> |
| Sales | | | |
| | £ | | £ |
| Profit and loss account | 3,000 | Debtors | 3,000 |
| | <u>3,000</u> | | <u>3,000</u> |
| Purchases | | | |
| | £ | | £ |
| Creditors | 2,400 | Profit and loss account | 2,400 |
| | <u>2,400</u> | | <u>2,400</u> |



Solution 3

- Remember to include the VAT element in the incorrect sales invoice.
- Provision for doubtful debts never appears in the control account, nor is it adjusted for in the individual's account.

(a)

| <i>Description</i> | <i>Debit/Credit?</i> | <i>Amount</i> £ |
|-----------------------------|----------------------|--------------------|
| (i) N/E | | |
| (ii) Error in daybook | Debit | 2,115 |
| (iii) Discount allowed | Credit | 560 |
| Discount received | Credit | 840 |
| (iv) N/E | | |
| (v) Contra | Credit | 750 |
| (vi) Cash sales | Debit | 860 |
| (vii) Bad debts written off | Credit | 2,150 |

(b)

| | |
|--------------------------------|----------------|
| | £ |
| Original balance | 225,165 |
| Add debit entries required | 2,975 |
| Deduct credit entries required | <u>(4,300)</u> |
| Revised balance | <u>223,840</u> |

(c)

| | | |
|-------------------------|----------------|----------------------|
| | £ | |
| Sales ledger balances | 225,890 | |
| (i) Credit balances | (2,500) | (This is a reversal) |
| (iv) Dishonoured cheque | 450 | |
| | <u>223,840</u> | |

- (d) (i) Speed.
 (ii) Accuracy.
 (iii) Control accounts.
 (iv) Aged debtor analysis.



Solution 4

- In part (c), take care with the opening and closing balances, and the inclusion of VAT on credit sales.
- Cash sales should be ignored, as they are not entered into any sales ledger account.
- Refunds and contras to the purchase ledger often cause difficulties.
- Dishonoured cheques and bad debts recovered also need careful attention.
- The provision for doubtful debts can be ignored, as no entries are made in the sales ledger for this provision.

(a) A system for recording petty cash payments is the imprest system.

- (b) (i) Sales day book.
 (ii) Purchase day book.
 (iii) Sales returns day book.
 (iv) Purchase returns day book.

(c)

| BH – Sales ledger control account | | | |
|-----------------------------------|----------------|---------------------------|----------------|
| | £ | | £ |
| Opening debtors b/d | 103,670 | Credit balances b/d | 1,400 |
| Sales | 175,860 | Returns inwards | 9,500 |
| VAT on sales | 10,350 | Payments received | 126,750 |
| Refunds | 800 | Discounts allowed | 1,150 |
| Dishonoured cheques | 1,589 | Contra to purchase ledger | 750 |
| Bad debts written back | 300 | Bad debts written off | 2,300 |
| Credit balances c/d | 840 | Closing debtors c/d | 151,550 |
| | <u>293,400</u> | | <u>293,400</u> |



Solution 5

- Take your time with part (a) – accuracy will improve your chances of answering part (b).
- If you also add a ‘total’ column at the end of your table, this will assist in answering part (b).

(a) Debtors’ balances

| | Debtor | | | | | | | Total |
|--------------------|----------------|--------------|--------------|----------------|----------|--------------|----------|---------------|
| | P | Q | R | S | T | U | V | |
| | £ | £ | £ | £ | £ | £ | £ | £ |
| Balance 1/4/98 | 5,000 | 1,200 | 1,045 | 8,750 | (140) | (900) | 400 | 15,355 |
| Credit sales | 4,700 | 1,175 | 3,520 | – | – | 9,400 | – | 18,795 |
| Returns | (1,400) | – | (800) | (750) | – | – | – | (2,950) |
| Receipts | (9,740) | (1,140) | (1,520) | (7,500) | – | – | – | (19,900) |
| Discount allowed | – | (60) | – | – | – | – | – | (60) |
| Dishonoured cheque | – | – | 1,520 | – | – | – | – | 1,520 |
| Refund | – | – | – | – | 140 | – | – | 140 |
| Bad debt w/off | – | – | – | – | – | – | (400) | (400) |
| Set off | – | – | – | (500) | – | – | – | (500) |
| Balance 30/4/98 | <u>(1,440)</u> | <u>1,175</u> | <u>3,765</u> | <u>(7,500)</u> | <u>–</u> | <u>8,500</u> | <u>–</u> | <u>12,000</u> |

List of balances

| | | |
|---|--------|----|
| | £ | |
| P | 1,440 | Cr |
| Q | 1,175 | Dr |
| R | 3,765 | Dr |
| S | – | |
| T | – | |
| U | 8,500 | Dr |
| V | – | |
| | 12,000 | Dr |

(b)

| Sales ledger control account | | | |
|------------------------------|--------|-----------------------|--------|
| | £ | | £ |
| Balance b/f | 16,395 | Balance b/d | 1,040 |
| Sales | 18,795 | Receipts | 19,900 |
| Dishonoured cheque | 1,520 | Returns | 2,950 |
| Refund | 140 | Discounts allowed | 60 |
| Balance c/d | 1,440 | Bad debts written off | 400 |
| | | Set off/contra | 500 |
| | | Balance c/d | 13,440 |
| | 38,290 | | 38,290 |
| Balance b/d | 13,440 | Balance b/d | 1,440 |

- (c) (i) The principal purpose of a control account is to check on the accuracy of the personal accounts in the relevant ledger that it controls.
- (ii) It is called a ‘total account’ because it contains the total of all transactions posted to the individual accounts, taken from summary day books, cash books, etc.



Solution 6

- Part (a) is straightforward, but take care to identify those corrections that involve the suspense account.
- To assist with part (d), examine the journal entries; identify those that affect profit (i.e. revenue or expense accounts); if they are being debited, this will reduce profit; if they are being credited this will increase profit.

(a) Journal entries

| | <i>Debit</i> | <i>Credit</i> |
|----------------------|--------------|---------------|
| | £ | £ |
| (i) Debtor | 300 | |
| Creditor | | 300 |
| (ii) Heat and light | 300 | |
| Suspense account | | 300 |
| (iii) G Gordon | 800 | |
| G Goldman | | 800 |
| (iv) Insurance | 500 | |
| Suspense account | | 500 |
| (v) Purchase returns | 700 | |
| Suspense account | | 700 |

| Suspense account | | | |
|------------------------------|--------------|---------------------|--------------|
| | £ | | £ |
| Balance as per trial balance | 1,500 | Heat and light (ii) | 300 |
| | | Insurance (iv) | 500 |
| | | Purchase return (v) | 700 |
| | <u>1,500</u> | | <u>1,500</u> |

- (c) (i) Error of principle.
(ii) Reversal of entries.
(iii) Error of commission.

| | £ |
|---------------------------------|--------------|
| First draft profit | 9,750 |
| Adjustment re: heat and light | (300) |
| Adjustment re: purchase returns | (700) |
| Revised net profit | <u>8,750</u> |

(e) Balance sheet of WL at 31 March 1998

| | <i>Cost</i> £ | <i>Depn.</i> £ | <i>NBV</i> £ |
|--------------------------|------------------|-------------------|-----------------|
| Fixed assets | | | |
| Land and buildings | 10,000 | 2,000 | 8,000 |
| Plant | <u>12,000</u> | <u>3,000</u> | <u>9,000</u> |
| | <u>22,000</u> | <u>5,000</u> | 17,000 |
| Current assets | | | |
| Stock | | 2,500 | |
| Debtors (1,500 + 300) | | 1,800 | |
| Prepayments (400 + 500) | | 900 | |
| Bank | | <u>8,250</u> | |
| | | 13,450 | |
| Current liabilities | | | |
| Creditors (1,700 + 300) | 2,000 | | |
| Accrual | 300 | | |
| | | <u>(2,300)</u> | |
| Net current assets | | | <u>11,150</u> |
| | | | <u>28,150</u> |
| Financed by | | | |
| Capital | | | 19,400 |
| Add: Profit for the year | | | <u>8,750</u> |
| | | | <u>28,150</u> |



Solution 7

- In part (a), there are several alternative ways of journalising wages entries, but all should end up with the same final balance on each account.
- Remember that PAYE, employees' National Insurance, and employee contributions to a pension scheme are all deducted from their gross wages, and therefore reduce the balance on the wages creditor account.
- Remember that employer's National Insurance is an additional charge to the wages expense account.

- The question states that employees are paid in the following month; therefore do not include any payments in your journal entries.

(a) Journal entries

| | | | |
|---------------------------------------|----|--------|--|
| | | £ | |
| (i) Total wages expense account | DR | 83,250 | |
| This comprises | | | |
| Gross wages | | 78,000 | |
| Employers' NI | | 5,250 | |
| (ii) PAYE creditor account | CR | 23,650 | |
| This comprises: | | | |
| Tax | | 12,800 | |
| Employees' NI | | 5,600 | |
| Employers' NI | | 5,250 | |
| (iii) Pension scheme creditor account | CR | 4,600 | |
| (iv) Wages creditor account | CR | 55,000 | |

- (b) The amount to be debited to the profit and loss account for October is £83,250, made up as follows:

| | |
|---------------|--------|
| | £ |
| Gross wages | 78,000 |
| Employer's NI | 5,250 |
| | 83,250 |



Solution 8

(a)

| | <i>Dr</i> | <i>Cr</i> | |
|---|-----------|-----------|--|
| | £ | £ | |
| (i) Sales | 1,000 | | |
| Debtors | | 1,000 | |
| (ii) Bank | 250 | | |
| (iii) Machinery | 5,000 | | |
| Machinery repairs | | 5,000 | |
| Charge for depreciation of machinery | 500 | | |
| Provision for depreciation on machinery | | 500 | |

- (b) (i) Financial control is important to prevent error and fraud.
- (ii) • An example of financial control is the sales ledger control account.
• An example of financial control is the bank reconciliation.

The Regulatory Framework of Accounting

10

LEARNING OUTCOMES

When you have completed this chapter, you should be able to:

- ▶ identify and explain the fundamental accounting concepts, bases and policies;
- ▶ explain the historical cost convention;
- ▶ identify the basic methods of valuing assets on current cost, fair value and economic value bases and demonstrate their impact on profit measures and balance sheet values;
- ▶ explain the influence of legislation (e.g. Companies Acts) and accounting standards on the production of published accounting information for organisations;
- ▶ identify the requirements for external audit and the basic processes undertaken;
- ▶ explain the purpose and basic procedures of internal audit;
- ▶ explain the meaning of 'true and fair view';
- ▶ explain the purpose of audit checks and audit trails.

10.1 Introduction

The aim of accounting is to present financial information to users, as we saw in Chapter 1. Users need to be able to rely on the information provided in those accounts to enable them to make appropriate decisions.

You have perhaps realised by now that there are often several alternative ways of valuing items entered in the bookkeeping system, and different methods of determining how much of an item should be shown in the profit and loss account and how much in the balance sheet. You will probably also realise that some of these depend entirely on judgement and opinion.

For example, you have seen how depreciation is an estimate of the cost of a fixed asset consumed during a period. It depends on judgement as to how long it is likely to be in use,

what its residual value may be, and whether it should be depreciated on a straight-line, reducing-balance, or some other basis. You have looked at three different ways of valuing stocks. You have seen how estimates of accruals and prepayments are entered into the accounts. All of these ‘estimates’ affect the profit and the position shown by the balance sheet.

Surely accountants need some guidance in the way in which they prepare the accounts? The answer is, yes, they do. This chapter looks at some of the ways in which accountants make decisions on methods of accounting and valuation for certain items. This chapter also looks at the role of auditors, who check that the rules on accounting have been followed.

10.2 Accounting concepts

There is no agreed list of accounting concepts. Authors differ in the relative importance they attribute to each of the possible concepts that can be identified. But there is a fair degree of consensus that the concepts discussed below are of particular importance.



The list of concepts below are all key terms.

10.2.1 The business entity concept

This concept separates the individuals behind a business from the business itself, and only records transactions in the accounts that affect the business. This concept can be interpreted in two ways:

- in the case of a sole trader or partnership, the entity is viewed as a vehicle through which the owner(s) engage in economic activity with a view to profit;
- in the case of a company, the entity is viewed as having a separate identity with its own objectives, the owners merely being other interested parties having claims against the entity.

10.2.2 The money measurement concept

This limits the recognition of accounting events to those that can be expressed in money terms. This concept thus excludes the recording of many other economic factors that are being debated under the title of social responsibility accounting. For example, no value is attributed to key employees within the organisation. Monetary measurements are used because if all the items covered by an accounting statement are stated as an amount of money, then the relative cost or value of the items can be seen and their aggregate cost or value determined. There is thus a unity of meaning that makes accounts readily understood when communicated as information and provides a common denominator for financial analysis.

10.2.3 The cost concept

The cost concept provides uniformity in the treatment of inputs and provides a reliable valuation under conditions of stable money values. The validity of the concept is undermined in times of instability of money values because of the measurement of profitability by the comparison of input and output values. It simply means that transactions are recorded at their cost values as evidenced by cash flow or agreed liability of the parties.

10.2.4 The objectivity concept

An accounting statement should not, as far as is possible, be influenced by the personal bias of the person preparing it. Thus, figures used in accounting statements should be objective. The most objective value that can be placed on an asset is the historical cost actually paid for it, which can be proved by an invoice and verified as the market value on the date of acquisition. In certain respects changes in values of assets need to be recognised and at these times the accountant must make an objective estimate of the new value.

10.2.5 The dual aspect concept

This concept is the basis of double-entry bookkeeping and identifies with the fact that every transaction entered into has a double effect on the position of the entity as recorded in the accounts at the time of that transaction.

10.2.6 The realisation concept

This concept dictates that we recognise sales revenue as having been earned at the time when goods or services have been supplied and an invoice issued. Take particular care with goods sold on a 'sale-or-return' basis – the goods are not strictly 'sold' until they have been accepted by the buyer or the deadline for return has passed. If the full sales value of the goods has been included with sales and debtors (and the full cost taken out of stock), the amounts that could still be returned should be taken out of sales/debtors and added back into stock. The profit is then automatically included in the period in which it was actually earned.

10.2.7 The periodicity concept

It can be argued that the only correct measurement of an organisation's profitability is that which is made at the end of the organisation's life. However, there is a need to assess the financial position and performance of an organisation during its life by producing periodic financial statements.

This assumes that transactions can be identified with a particular period, but in reality a number of other concepts (such as matching, realisation, prudence and accrual) are used to determine the treatment required.

The convention also leads to comparisons being made between one period and another. Such comparisons assume both a consistent business activity pattern and a smooth profit trend over time. As there is no evidence to suggest that these occur, such comparisons can be misleading.

10.2.8 The accruals and matching concepts

There are two concepts combined here, but they interrelate. They arise from the periodicity concept and the need to identify transactions with particular accounting periods.

The accruals concept states that expenditure incurred in a particular accounting period should be accounted for in that period, irrespective of whether or not it has been invoiced

or paid for. Similarly, income that has been earned in that period should be accounted for in that period irrespective of the date of invoice or the receipt of monies from the transaction. The concept applies equally to all transactions, whether involving revenue, expenses, assets or liabilities. If the transaction has occurred during the period, then it should be accounted for.

The matching concept is similar, but goes one step further, in that it attempts to match the income earned in a period with the expenses consumed *in earning that income*. It may happen that expenditure has been incurred in a period, but it has not been used to generate income during that same period. An example of this is stocks purchased that remain unused at the end of the period. They have not been used to generate income in the period of purchase, so they are not included as part of the cost of goods sold in that period; on the assumption that they will be used to generate income in the future, they are carried forward and matched with the income of the future.

This creates a problem in that the accruals concept states that the expense should be accounted for in that period, but the matching concept states that expense should be matched to income.

Generally, a prudent view is taken of expenses. If they have been incurred during the period, they are taken into that period's profit and loss account, even though they *may* have been incurred to provide future income. It is only where they can be reasonably identified with future earning potential that they are carried forward to future periods, and so most expenses are charged to the profit and loss account for the period in which they were incurred.

Similarly, a prudent view must also be taken of income. If monies have been received during a period in respect of income that has not yet been earned (e.g. the receipt of a deposit for a customer's order that has not yet been fulfilled), this must not be treated as income in that period, but carried forward until the order has been satisfied, and matched with the relevant expense incurred.

10.2.9 The materiality concept

Accounting statements are prepared for the benefit of various user groups. It is essential that the information provided is both significant and easily understood. The materiality concept ensures that the information provided is clear by omitting items that are not significant to the user in understanding the overall financial position of the organisation. The distinction between what is significant and what is not varies depending on the size of the organisation, and is a matter for judgement. Determining at what point an item becomes material depends partly on value, partly on the nature of the item concerned, and partly on its effect on the results that will be reported.

As a general rule, items with a relatively small (5 per cent) monetary value are not significant unless they change a profit into a loss or vice versa or affect sensitive issues. The concept can be applied to the classification of items as 'revenue' rather than 'capital'. For example, the purchase of storage boxes for floppy disks is strictly capital expenditure as the boxes will be used over several years (and therefore they should be depreciated over their estimated useful life). However, their value is very small and therefore it is justifiable to treat them as revenue expenditure and included in the profit and loss account in the period in which they were bought. Another example is the treatment of stocks of stationery at the end of a period – the matching concept dictates that the cost of unused stock should be carried forward as an asset, but most organisations would find this

cumbersome, and the effect on profit minimal, and therefore many would choose to make no adjustment for such stocks, unless their value is material.

10.2.10 The fairness concept

The fairness concept follows from the objectivity concept and states that, in preparing the financial statements, the accountant (and in auditing them, the auditor) must serve all interested user groups equitably and not be biased towards any particular users.

10.2.11 The going concern concept

Unless there is good evidence to the contrary, accounting assumes that the business will operate for the foreseeable future. The assumption is of importance because it means that the business is viewed as a mechanism for adding value to the resources it uses. The success of the business can be measured by the difference between output values and input values. Output values are sales values obtained from the sale of the product/service provided from the resources of the organisation. Input values are the costs incurred in obtaining those resources. Therefore all resources not yet used can be reported at cost rather than at market value. If it is believed that a business is not a going concern in the long term, then accounts must be drawn up on the basis of current or exit values of assets and liabilities. Exit values, when applied to assets, are the values that would be obtained from a forced sale of those assets. In respect of liabilities, exit values are those that would apply if immediate settlement were to be made. This would probably give very different results than if the going concern concept is used.

10.2.12 The consistency concept

The consistency concept is that the accounting treatment of like items should be consistently applied from one accounting period to the next. The usefulness of financial accounting lies to a considerable extent in the conclusions that may be drawn from the comparison of the financial statements of one year with those of a preceding year, or of one company with another. Much of the information thus derived would be useless if the choice of accounting methods were not applied consistently year by year. If a change in an accounting method is required, then comparative information should also be given. An example of an area where consistency is important is the method of valuing stock.

The concept is also applied to the treatment of groups of similar items. For example, the same depreciation method should be used for similar types of fixed asset, and the same stock valuation method should be used for similar types of stock.

10.2.13 The prudence concept

The concept of prudence or conservatism is that a business should not lay claim to any profits before they have been earned with reasonable certainty and, on the other hand, it should anticipate fully any losses that it expects to incur in future periods, that is, losses should be written off in full as soon as they are anticipated. Whenever a subjective judgement must be included in the accounts, the figure that gives the lower profit should be chosen. This prevents profits being overstated. Similarly, assets should not be overstated for balance sheet purposes, but liabilities are generally recognised even where

their likelihood is only possible, provided that they arise from a past event and their value can be estimated with sufficient reliability.



Exercise 10.1

Explain briefly the meaning of the following terms:

- going concern;
- consistency;
- the accruals concept;
- prudence;
- the concept of duality;
- the realisation concept;
- the matching concept.



Solution

- *Going concern.* The accounts are prepared on the basis that the business is to continue for the foreseeable future and therefore assets, etc., are valued at cost (less accumulated depreciation) as if they will continue to be used, and are not valued as if they are to be disposed of at their market value.
- *Consistency.* The accounting treatment of like items is consistently applied from one period to the next. This enables comparisons between periods to be made.
- *The accruals concept.* Revenues and expenses are recognised (recorded) as they are earned or incurred (irrespective of whether or not they are paid for). Revenues are matched with the expenses incurred in earning them to arrive at a figure of profit.
- *Prudence.* A business should not claim to have made profits or gains before they have been earned with reasonable certainty, but should anticipate fully any losses that are expected to occur. This prevents overstating of assets or profits.
- *Duality.* Every transaction has two effects, hence ‘double-entry bookkeeping’.
- *Realisation.* Profits and gains should only be recognised once there is a legal right to receive them.
- *Matching.* Revenues and expenses are ‘matched’ with the period in which they are earned or consumed; they are also matched with each other, in that the revenue from a transaction is matched with the expense incurred in producing that revenue.

10.3 Accounting policies and estimation techniques

Accounting policies are the principles, conventions, rules etc. applied by a company when calculating the assets and liabilities, revenue and expenses, which will appear in the balance sheet and profit and loss account. The management should use those policies which it believes will be most useful to those who rely on the financial statements. These users will include, for example, shareholders and creditors, as discussed in Chapter 1. The management can assess which policies will be most useful by considering the characteristics of useful information, as discussed in Chapter 1. These include, for example, relevance and reliability.

We have seen that the preparation of accounts relies on judgement and that not all figures can be called ‘accurate’. Accountants have developed a number of techniques to arrive at figures which have to be estimated. For example, we have seen that companies calculate a provision for bad debts, but this is only a guess as to which debtors will not pay. This provision may be calculated as a percentage of total debtors or as a provision for specific customers. Either way, both of these are techniques to estimate bad debts. Another example is depreciation, where the straight-line method and the reducing-balance method are two techniques used to estimate the consumption of a fixed asset in a specific period.

10.4 The historical cost convention and its alternatives

Traditionally, accounts have been prepared using the *historical cost convention* – and, indeed, still are.

Historical cost accounting: A system of accounting in which all values are based on the historical costs incurred.

This means that all of the assets, liabilities, expenses and income are recorded using the costs and prices ruling at the time of the transaction as the basis of any accounting entries or valuations. This method is extremely objective as each value can be supported by the value paid to the third party at the time of the transaction.

However, it is accepted that this convention has many shortcomings, and over the years many attempts have been made by accountants to develop alternative valuation methods. The main difficulty with the convention is that in times of changing price levels, it has the effect of overstating profits and understating asset values.

Consider the purchase of a machine for £5,000, which has an expected life of 5 years. Two years later a similar machine is bought for £6,000. Using the historical cost convention, the balance sheet will show the total cost of these machines as £11,000. Indeed, this is the sum of money paid, but the value of the money used differs. On the basis that each machine will last 5 years we might calculate that the annual cost of using the first machine is £1,000, whereas for the second machine it is £1,200. But is this the real cost of using the machines? If they were to be replaced they would presumably cost at least £6,000 each. Using this value, the real cost of 1 year’s use is

$$20\% \times £6,000 \times 2 \text{ machines} = £2,400$$

The same principle also applies to stocks and any other items where there is a time period that elapses between acquiring the resource and matching the cost of that resource against the income it generates. It can be seen that the use of the historical cost convention thereby overstates profits and understates balance sheet asset values. This reduces the usefulness of accounting reports produced using this convention.

10.4.1 The theory of capital maintenance

If the historical cost convention is used to prepare accounts, the resulting profit could be mistakenly regarded as satisfactory, especially if it equals or exceeds that of the previous year. But in inflationary times, the profit may only be sufficient to replace stocks, assets and pay for expenses, if the same level of activity is to be maintained. In that case, it is not really a ‘profit’ at all, as we think of profits as being an improvement. Indeed, the profit may not even

be sufficient to maintain that level of activity, and – even worse – if some or all of the profits are paid out to the owners of the business, the level of activity may have to be reduced. In this case, the organisation has failed to maintain sufficient capital to support the level of activity.

Two methods have been used as the basis of solving this problem: *current purchasing power accounting* and *current cost accounting*.

10.4.2 Current purchasing power (CPP) accounting

This method of accounting considers the effects of changing price levels by reference to movements in the retail price index (RPI). It distinguishes between monetary and non-monetary items.

Retail price index

The RPI is a measure of inflation published each month by the UK government. It is based on the prices of items bought by the average family. Consequently, it reflects the buying power of the currency unit to the domestic family/individual investor. It may bear little resemblance to the effects of inflation on the costs incurred by an organisation.

Monetary items

Examples of monetary items include cash and bank balances, debtors and creditors. In the UK, these are valued in sterling, regardless of the changes in the price level. In a period of inflation, the holders of monetary assets suffer a loss in the real value of those assets because of a reduction in purchasing power over time. Holders of monetary liabilities make similar holding gains.

Non-monetary assets

These are items that do not suffer a loss in value in a period of changing price levels. They include fixed assets, stock and shareholders' equity (ordinary shares and reserves). This assumption presumes that when items are sold, the price charged will compensate for any changes in price level.

Holding gains and losses

The holding of monetary items will, in periods of inflation, give rise to holding gains or losses.

Example 10.A

Assume that inflation is 1 per cent per month.

The asset of a debtor balance in respect of a credit sale made today is valued at £1,000. In two months' time the debtor pays the account in full. Although £1,000 is received, with inflation of 1 per cent per month, the money needed to buy the same items as could be bought with £1,000 today is:

$$£1,000 \times 1.01^2 = £1,020$$

Since only £1,000 is received there is a holding loss of £20.

The customer, who had a liability of £1,000, has made a holding gain because the value of the money paid in two months' time is less than the value of £1,000 today. The calculation is as shown above, but for the customer there is a holding gain of £20.

The principle behind CPP accounting is that the accounts should be adjusted to reflect the inflationary gain or loss on monetary items. The amount of this gain or loss is calculated by reference to the RPI.

10.4.3 Current cost accounting (CCA)

Current cost accounting is a method of adjusting historical cost accounts for the effects of changing price levels by using indices specific to the organisation.

10.4.4 Market value (fair value)

Fixed assets may also be valued at their market, or fair, value. The fair value may be defined as the value of an asset which would be agreed between a buyer and a seller of that asset. For example, if A is selling his car and B wishes to buy the car, A may initially ask for a high price and B may offer a low price. After a period of bargaining a price will be agreed at which the car changes hands, and this price is its 'fair value'. The advantage of valuing assets at fair value is that this provides relevant and up-to-date information to those using the accounts; the disadvantage is that the information may not be reliable. Until an asset is actually sold, it is not possible to be precise about its fair value. It can be argued that valuing assets at fair value is contrary to the concept of prudence, which states that gains should not be anticipated.

10.4.5 Economic value (value in use)

The economic value of assets is the future benefit that will be derived from their ownership expressed using today's money values.

This value is difficult to determine, but the logic of using this technique to value assets is that their worth to the business is measured by the benefits derived from their continued use in the business; thus their economic value is a measure of this benefit.

The value could be interpreted as being what the business would pay for that asset in order to retain it for future use. An organisation would presumably be willing to pay at least the amount of money that would result in additional profits, discounted to allow for the effects of inflation, the declining value of money over time, and the probability of risk incurred (which tends to be greater over long periods of time). Alternatively, that value could be its *replacement cost* (i.e. market value of an equivalent item, also known as the *entry value*) or *realisable value* (i.e. current likely sale proceeds, also referred to as the *exit value*).

The economic value of an asset could be determined in much the same way as the valuation of goodwill, as discussed in Section 10.4.6.

Figure 10.1 illustrates the possible choices when determining the value to the business of an asset.

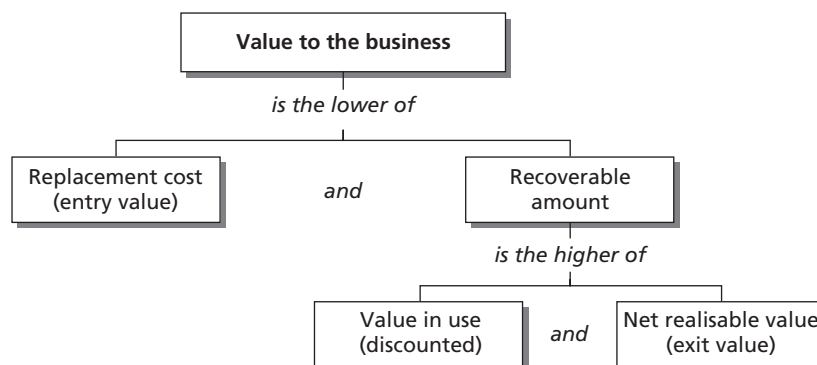


Figure 10.1 Value to the business

10.4.6 The valuation of intangible assets

An intangible asset is one that does not have a physical identity. Examples include:

- patents;
- trademarks;
- goodwill;
- research and development costs;
- intellectual capital (the value of employees' knowledge and skills).

Your syllabus does not specifically include these items, but there is no doubt that they affect the value of a business and challenge some of the theories of the historical cost convention. They are all items that cause accountants difficulty in their valuation, mainly because of the subjective nature of the value of such items. The general principle on which all are valued is whether or not they have the potential to earn profits in the future. In other words, do they have an economic value, and can it be quantified with a reasonable degree of accuracy?

We shall look at two of the above in order to appreciate the difficulties involved and the approach to be taken in their valuation.

The valuation of goodwill

Goodwill: The difference between the value of a business as a whole and the aggregate of the fair values of the entity's identifiable assets and liabilities.

Goodwill is therefore the additional sum of money that is paid by the purchaser of the business over and above the value of the assets, in order to secure future profits. A purchaser would be prepared to pay for this if the business had a good customer base, loyal employees, a prime location, a secure reputation, etc.

The currently accepted treatment of goodwill is that it is not recognised at all in the accounts unless it arises on the purchase of a business. A currently successful business may indeed be worth more to a prospective buyer than the value of its assets in its balance sheet, but this is not considered a good enough reason for including goodwill in the accounts.

An amount of money has to be paid in order for goodwill to be recognised in the accounts. The goodwill should be written off to the profit and loss account over the period in which the business benefits from it. This is generally regarded as not exceeding 20 years, as most purchased goodwill declines in value as the new owners become established and develop their own customer base, relationships with employees, reputation, etc. The writing-off of goodwill is similar to depreciation, but is termed *amortisation*. The value of goodwill, and the period over which it is written off, should be regularly reviewed. This is known as conducting an *impairment review*.

Goodwill is shown in the balance sheet as an intangible fixed asset.

The valuation of research and development costs

Some businesses spend money on research and development (R&D), and this too gives difficulties for accountants. General R&D costs, which do not lead to a specific new product or method of production, are always written off to the profit and loss account in the period in which the costs are incurred. However, there is an argument for regarding some development costs as capital expenditure if they comply with the following criteria:

- they are directed towards the development of a specific product or production method;

- the outcome of the research is known with reasonable certainty;
- the future income is likely to exceed the costs.

If these three criteria are met, the expenditure can be included in the balance sheet, and is written off when the product or production method commences.



Exercise 10.2

List and briefly describe as many examples as you can of different methods of valuing assets.



Solution

- Original cost/historical cost – as evidenced on invoice.
- Net book value – cost less accumulated depreciation (i.e. original cost, less reduction due to proportion of asset used up).
- Revaluation – professional or other valuation of asset, often used where asset value has increased, or where there are several small items.
- Market value, resale value – amount that could be obtained on open market.
- Replacement cost – of replacing asset with current equivalent used asset.
- Current cost accounting – original cost adjusted by an industry-specific index, less accumulated depreciation.
- Current purchasing power accounting – original cost adjusted by a general index, less accumulated depreciation.
- Net realisable value – amount expected to be received from the sale of the item, less costs of selling.



Exercise 10.3

Make brief notes on the shortcomings of the historical cost convention, and briefly describe two alternative methods of accounting that attempt to recognise changing price levels.



Solution

Shortcomings of historical cost convention. Asset values are out of date, perhaps too low. This prevents comparison between businesses with newer assets, and return on capital employed is distorted by inflation. No account is taken of gains that arise until they are realised, even though they may have occurred during previous periods. Profit is the increase in net assets during the period, but this figure cannot be fully determined using historical costs.

Current cost accounting applies industry-/asset-specific price indices to the costs of goods sold and assets consumed, to produce values that are based on the cost at the time of consumption. Because assets consumed are valued at a current value, profits are lower and are said to more accurately represent the increase (or decrease) in the capital of the organisation.

Current purchasing power accounting applies a general price index to the non-monetary items in the prepared historical accounts, thus showing the change in the general purchasing

power of money. The value of the net assets is therefore restated according to the index applied; only if this results in an increase in net assets over the previous period is there said to be a 'real' profit for the period.

In a current value system of accounting, assets and liabilities are remeasured regularly so that changes in value are recorded as they occur; this results in the computation of a profit that reflects the organisation's ability to continue to operate at the same, or an improved, level of activity as in the past (or at a reduced level, if a loss occurs).



Exercise 10.4

Explain briefly what is meant by the term *capital maintenance*.



Solution

Capital maintenance is the concept that profit is earned only if the value of the organisation's net assets – or, alternatively, the organisation's operating capability, that is, its physical productive capacity – is greater at the end of the accounting period than it was at the beginning. Under this concept, the amount of profit earned is the amount of this increase.

One of the criticisms of historical cost accounts is that they fail to comply with this concept. Under historical cost accounting (HCA), profit is measured as the increase in net assets valued in terms of a monetary unit – say, the pound sterling – which is not stable over time. The result is that HCA profits often do not represent true increases in the worth of a business, because apparent increases in asset values may be nothing more than the effect of inflation on the unit used to value them.

If accounts are prepared under the historical cost convention, the profit reported may not be sufficient to support the organisation at the same level of activity in the future, especially if this profit is then paid out to the owner(s) of the organisation.

10.5 Regulations in accounting

In the UK there is little regulation regarding the preparation of accounts for sole traders and partnerships, other than to satisfy the Inland Revenue of the profits made in each accounting period and HM Customs and Excise of VAT owing. However, with regard to the accounts of limited companies, charities, etc., there are several types of regulation and guidance to assist the accountant in preparing such accounts, and most of the principles they encompass can and should be equally applied to other organisations.

10.5.1 The Companies Act

The primary legislative document in the UK is the Companies Act 1985 (amended 1989), which lays down certain requirements for the format and layout of company accounts and their content. It also includes some guidance on approaches to certain transactions, and states that companies above a certain size are required to have their accounts audited by a registered auditor. However, it is widely accepted that the Companies Act does not cover many issues in sufficient detail, and as a result there are a number of other sets of guidance available.

The Companies Act identifies four principles which should be applied in the preparation and presentation of financial accounts. These are:

- going concern;
- accruals/matching;
- consistency;
- prudence.

These were discussed in more detail earlier in this chapter. Whilst these principles still apply, more recent accounting standards and guidelines have added further principles and have suggested that, although ‘consistency’ aids comparability, accounting policies should be reviewed to ensure their continued appropriateness.

10.5.2 The accountancy profession

Qualified accountants in the UK and the Republic of Ireland belong to one or more of the following bodies:

- The Chartered Institute of Management Accountants (CIMA),
- The Association of Chartered Certified Accountants (ACCA),
- The Institute of Chartered Accountants in England and Wales (ICAEW),
- The Institute of Chartered Accountants of Scotland (ICAS),
- The Institute of Chartered Accountants in Ireland (ICAI),
- The Chartered Institute of Public Finance and Accountancy (CIPFA).

In addition, there are other bodies, such as the Institute of Internal Auditors and the Institute of Taxation, to which many accountants belong.

All of these bodies insist on their members being properly qualified, not only by passing examinations but also by obtaining appropriate practical experience, updating their skills and knowledge on a regular basis and maintaining certain professional standards.

Some members of the above bodies, mainly those belonging to the ACCA and the Institutes of Chartered Accountants, are also registered auditors.

10.5.3 Accounting standards

The Financial Reporting Council (FRC) is a body consisting of government representatives, with the aim of guiding the accounting profession in the setting of standards. The Accounting Standards Board (ASB) is an organisation consisting of representatives of the various UK accounting bodies and government, with the prime task of issuing guidance to accountants. The Financial Reporting Review Panel (FRRP) has powers to force organisations to comply with its guidelines in the production of their accounts. The ASB produces statements, known as *Financial Reporting Standards* (FRSs) on a variety of topics, and these are backed up by some older *Statements of Standard Accounting Practice* (SSAPs), many of which it intends to replace with new FRSs in the near future. The Auditing Practices Board (APB) issues *Statements of Auditing Standards* (SASs) with

which auditors must comply. In addition, the International Accounting Standards Board (the IASB) also issues international standards.

The ASB's Statement of Principles

The ASB has published a *Statement of Principles for Financial Reporting*, which has had a considerable effect on the way in which accounts are presented. It contains eight chapters of guidance as follows:

1. The objective of financial statements is to provide information about the reporting entity's financial performance and financial position that is useful to a wide range of users for assessing the stewardship of management and for making economic decisions.

Stewardship refers to the responsibility of directors to safeguard the assets of a business, to ensure that they are properly managed and controlled to produce the most favourable trading conditions, including the making of profit in both the short and longer term. It includes the requirement of directors to produce annual accounts, and to protect the interests of shareholders, customers, suppliers and employees.

This chapter identifies some of the needs of users, in particular those of investors, and implies that other users will obtain benefit from the same information that is needed by investors.

2. The reporting entity should be required to prepare financial statements if there is a legitimate demand for the information. This chapter also describes the criteria for determining which entities are a 'cohesive economic unit' and therefore should prepare financial statements.
3. Financial statements have qualitative characteristics that make the information useful. These include materiality, relevance, reliability, comparability and understanding.
4. The elements of financial statements are assets, liabilities, ownership interests, gains, losses, contributions from owners and distributions to owners.
5. An item should be recognised in the accounts if it is one of the elements above and if there is sufficient evidence that a change has occurred which can be measured at a monetary amount with sufficient reliability.
6. Measurement of items in financial statements will use a variety of methods depending on the nature of the item, any physical evidence, past or present experience, other entities' treatment of similar items, and the objectives of the financial statements containing these items. Initial measurement may be historic cost or current value, but re-measurement should occur where necessary.
7. The presentation of financial information is primarily intended to communicate information clearly, effectively and simply. The four primary components of financial statements are:
 - the profit and loss account and the statement of total recognised gains and losses (STRGL);
 - the balance sheet;
 - the cash-flow statement;
 - supporting notes.

You do not need to be able to prepare a statement of total recognised gains and losses (STRGL) for this paper. You will learn about cash-flow statements later in the text.

8. The method of accounting for interests in other entities should be appropriate to the level of interest and control held in those entities.

The IASB Framework for the Preparation and Presentation of Financial Statements

The IASB has also published a similar document, which is rather more conceptual in its approach, and introduces alternative terminology to that used by the ASB, such as *income statement* for the profit and loss account, *non-current assets* for fixed assets, etc., and is intended to be more acceptable worldwide.

The document indicates that there are a number of principles and conventions that should be followed in the preparation of financial statements. These include:

- fair presentation;
- going concern;
- accruals basis;
- consistency.

The conceptual framework set down by the IASB states that:

- providing useful information to investors is the main objective of financial reporting;
- understandability, relevance, reliability and comparability are the principal qualities of useful information;
- assets (resources controlled by the firm) and liabilities (obligations to transfer such resources) are the key elements of financial statements;
- assets and liabilities should be recognised in financial statements only if it is probable that a resource or obligation exists and it can be measured reliably.

Although the first of these statements mentions only investors as users of financial information, it implies that if the needs of investors are fully met, then the needs of other users will automatically also be met.

The *Framework* does not specifically refer to the recognition of gains and losses, only assets and liabilities, but as gains and losses result in changes in assets and liabilities, it can be presumed that the same criteria for their recognition applies. It identifies gains, losses and ownership interests, as well as assets and liabilities.

The *Framework* may also assist preparers, auditors and users of financial statements in interpreting the treatment of items covered by International Financial Reporting Standards, or where no such standard has yet been issued.

You can see that many of the items mentioned in the IASB's Framework are mirrored in the ASB's Statement of Principles and in the Companies Acts.

10.6 The role of the auditor

As we have seen, accounting statements are prepared to provide information to a variety of different user groups. If the statements are to be useful they must be reliable and reasonably accurate. Accounting systems must therefore be designed to ensure that sufficient accuracy exists. In accounting terms we refer to the *true and fair* concept. It is the role of the auditor to ascertain that the accounts are properly prepared in accordance with the Companies Acts and the accepted accounting standards.

It is not, however, the responsibility of the auditor to actually prepare the accounts – this is the responsibility of management (the directors in a limited company). In some cases, the auditors *are* engaged to prepare the accounts, but this is in addition to their audit duties, and is still the responsibility of management. There is more about this in Section 10.7.

Some organisations are required by law to have their accounts audited by an independent, qualified accountant. Others choose to have their accounts audited on a voluntary basis, as the existence of an audit report may be beneficial to them.

10.6.1 The true and fair concept

This is the concept that financial accounts prepared for external publication should fairly reflect the financial position of the organisation. They should be free of serious errors arising from negligence or deliberate manipulation. It may not be economically viable to test every single transaction, or to ensure 100 per cent accuracy, but the concept assumes that the financial accounts do not contain any significant errors that would affect the actions of those reading them. This is based on the materiality concept discussed below. It is the duty of the registered auditor to test the accounts for material misstatement and to report on whether they show a true and fair view.

The materiality concept and the auditor

The purpose of an audit is to allow the auditor to form an opinion and to report accordingly on whether or not the accounting statements present a true and fair view of the company.

In doing this the auditor will perform various tests based on the accounting records and other information gained from minutes of board meetings and discussions with the directors. In doing so, the auditor will not be able to check everything in the minutest detail. Instead, the implications of potential errors will be considered – if they would not affect the overall true and fair view of the reports they are not significant, that is, not material. If it were not for the materiality concept, then accounts would always be required to be 100 per cent accurate, which would be very expensive and impractical, and the extra accuracy would be of limited extra benefit to the users of the accounts.

There are two main types of tests that the auditor may choose to carry out. The first is known as *compliance testing*, which involves assessing the reliability of accounting systems, procedures and controls. If these appear to be working satisfactorily, the auditor can place a degree of reliance on them that means that he does not need to test those areas in detail. If there are areas of doubt, areas of high risk, or items of a material nature, the auditor may choose to carry out more detailed testing, known as *substantive testing*.



Exercise 10.5

Explain what is meant by the concept of materiality as used by accountants. Give examples of occasions where materiality might affect the treatment of an item in the accounts of an organisation.



Solution

Materiality is concerned with the importance of information to its users. Items that might affect the decisions made by a user should be clearly stated; items that are insignificant need not be highlighted. Small items of miscellaneous expense can be grouped together under general headings; larger items should be identified separately.

An example might be to treat sundry stationery items as expenses as soon as they are purchased, or to value the stock of stationery remaining at the end of a period and include it as an asset on the balance sheet. Another example might be to regard ashtrays as

expenses because of their low value, or as fixed assets to be depreciated because of their long useful life. A third example might be to disclose the sale of a section of the business, even though the proceeds were small – the amount might be insignificant but the effect on the future of the business might materially affect someone’s opinion. The degree of materiality of items in the accounts will affect the level of testing carried out by the auditor.



Exercise 10.6

Explain what is meant by a ‘true and fair view’ when applied to the audit of an organisation’s accounts.



Solution

A true and fair view exists if the accounts as presented enable the users and potential users to gain a picture of the affairs of the organisation that is sufficient to make proper judgements. It does not mean that the accounts are completely accurate, but that any inaccuracies that exist would not affect the view of the accounts. The audit does not guarantee to uncover every error or possible fraud, but does imply that the systems in use by the organisation would have a reasonable chance of preventing errors and fraud.

10.6.2 The role of the external auditor

The purpose of the external audit is to form an opinion on the accounting reports. The role of the external auditor will vary depending on the size of the organisation and whether or not it has its own internal audit department. The work can be divided into two categories:

1. testing the reliability of the systems and procedures used (compliance testing);
2. testing specific transactions to ensure that they have been accounted for accurately (substantive testing).

On the basis of the above, together with their findings and tests carried out by internal audit (if appropriate), an opinion will be formed and expressed in an audit report.

The auditor does not check every entry in the ledger accounts. He designs his audit programme primarily to test that there are proper control systems and procedures in place to accurately record the financial position of the organisation. Depending on his opinion of the systems and procedures in place, he will conduct additional, more detailed tests in some areas, such as tracing particular transactions through the system (*testing the audit trail*, as mentioned in Section 9.2.2). He will also perform tests on the control systems, such as reconciliations, the segregation of duties, authorisation procedures and documentation, and will check the existence of fixed assets.

He is also concerned to ensure that items are properly valued in accordance with accepted accounting practice, as discussed earlier in this chapter.

At the conclusion of the audit, an audit report is produced, summarising his findings.

The auditor and fraud

It is not the auditor’s duty to detect fraud. The auditor should structure his audit tests in such a way that instances of fraud are likely to be brought to his attention, but the discovery of fraud has no more importance to him than the discovery of errors and omissions.

10.6.3 The role of the internal auditor

Many larger organisations have their own internal audit department. The work of internal audit falls into two categories:

- advising on accounting systems;
- carrying out tests that may be relied upon by external auditors.

10.6.4 The value-for-money audit

The audit of an organisation does not have to be strictly confined to the legal requirements. Audits can be carried out on a number of other areas, such as the efficiency of management, the design and implementation of computerised systems, etc. One increasingly popular type of audit is the *value-for-money audit*, in which the organisation's expenditure is scrutinised to ensure its maximum effectiveness in earning profits. Expenditure could include that on fixed assets, current assets or expenses.

Such audits can be carried out by either internal or external auditors.

10.7 The role of management

In a sole trader's business it is entirely up to the sole trader to manage his or her business affairs as he wishes. If he does not make a good job of it, there is only himself to suffer as a result, and only himself to answer to.

In a limited company, however (and in other types of organisation, such as charities, clubs and societies), management are not necessarily the same people who provide its capital, nor will they be the prime beneficiaries of the organisation's continued success. In a limited company it is the shareholders who provide the capital, and who expect that capital to be used properly and wisely, to produce profits, or to enable them to sell their shares successfully in the future. In a charity, club or society, the beneficiaries are those who enjoy the rewards of membership or other benefits derived from the organisation.

However, the shareholders/members/beneficiaries often are not involved in the running of the organisation; they appoint (or elect) others to manage things for them. In a company, those people are the directors; in a charity, club or society, they are the trustees or the members of the committee.

It is the responsibility of *management*, whoever they are, to ensure that the assets of the organisation are safeguarded. This might involve ensuring that:

- all assets are recorded correctly, exist, and are properly maintained and insured;
- procedures are in place to prevent misappropriation or misuse of assets;
- the accounting system is efficient and effective;
- no expenditure is undertaken, or liability incurred, without proper procedures for its authorisation and control;
- the accounts are prepared in accordance with current legislation, accounting standards, concepts and conventions.

The term often given to these responsibilities is 'the stewardship function'. Management act as stewards on behalf of shareholders, members and other beneficiaries, and may be answerable if they fail in this duty. That is not to say that it is their responsibility to make as much profit as possible, or even that they are to blame if losses are made, but they must take appropriate steps to minimise the risks, within the confines of the business world.

10.8 Summary

In this chapter we have looked at:

- the main accounting concepts underlying the preparation of accounts;
- the limitations of the historical cost convention and the methods suggested for remedying them;
- the regulatory framework, which includes company law and accounting standards;
- an outline of the purpose of internal and external audit;
- the stewardship role of management.

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Revision Questions

10



Question 1 Multiple choice

- 1.1 If, at the end of the financial year, a company makes a charge against the profits for stationery consumed but not yet invoiced, this adjustment is in accordance with the concept of:
- (A) materiality.
 - (B) accruals.
 - (C) consistency.
 - (D) objectivity.
- 1.2 You are the accountant of ABC Ltd and have extracted a trial balance at 31 October 1994. The sum of the debit column of the trial balance exceeds the sum of the credit column by £829. A suspense account has been opened to record the difference. After preliminary investigations failed to locate any errors you have decided to prepare draft final accounts in accordance with the prudence concept.
- The suspense account balance would be treated as:
- (A) an expense in the profit and loss account.
 - (B) additional income in the profit and loss account.
 - (C) an asset in the balance sheet.
 - (D) a liability in the balance sheet.
- 1.3 A 'true and fair view' is one that:
- (A) presents the accounts in such a way as to exclude errors that would affect the actions of those reading them.
 - (B) occurs when the accounts have been audited.
 - (C) shows the accounts of an organisation in an understandable format.
 - (D) shows the assets on the balance sheet at their current market price.
- 1.4 The historical cost convention:
- (A) fails to take account of changing price levels over time.
 - (B) records only past transactions.
 - (C) values all assets at their cost to the business, without any adjustment for depreciation.
 - (D) has been replaced in accounting records by a system of current cost accounting.
- 1.5 Your company sells goods on 29 December 1993 on sale or return; the final date for return or payment in full is 10 January 1994. The costs of manufacturing the product

are all incurred and paid for in 1993 except for an outstanding bill for carriage outwards that is still unpaid.

The associated revenues and expenses of the transaction should be dealt with in the profit and loss account by:

- (A) including all revenues and all expenses in 1993.
- (B) including all revenues and all expenses in 1994.
- (C) including expenses in 1993 and revenues in 1994.
- (D) including the revenue and the carriage outwards in 1994, and the other expenses in 1993.

1.6 In times of rising prices, the historical cost convention has the effect of:

- (A) valuing all assets at their cost to the business.
- (B) recording goods sold at their cost price, even if they are worth less than that cost.
- (C) understating profits and overstating balance sheet asset values.
- (D) overstating profits and understating balance sheet asset values.

1.7 If the owner of a business takes goods from stock for his own personal use, the accounting concept to be considered is the:

- (A) prudence concept.
- (B) capitalisation concept.
- (C) money measurement concept.
- (D) separate entity concept.

1.8 Sales revenue should be recognised when goods and services have been supplied; costs are incurred when goods and services have been received. The accounting concept that governs the above is the

- (A) accruals concept.
- (B) materiality concept.
- (C) realisation concept.
- (D) dual aspect concept.

1.9 The capital maintenance concept implies that:

- (A) the capital of a business should be kept intact by not paying out dividends.
- (B) a business should invest its profits in the purchase of capital assets.
- (C) fixed assets should be properly maintained.
- (D) profit is earned only if the value of an organisation's net assets or its operating capability has increased during the accounting period.

1.10 In times of rising prices, the historical cost convention:

- (A) understates asset values and profits.
- (B) understates asset values and overstates profits.
- (C) overstates asset values and profits.
- (D) overstates asset values and understates profits.

1.11 The accounting concept that dictates that fixed assets should be valued at cost, less accumulated depreciation, rather than their enforced saleable value, is the:

- (A) net realisable value concept.
- (B) prudence concept.
- (C) realisation concept.
- (D) going concern concept.

- 1.12 Net profit was calculated as being £10,200. It was later discovered that capital expenditure of £3,000 had been treated as revenue expenditure, and revenue receipts of £1,400 had been treated as capital receipts.
The correct net profit should have been:
£.....
- 1.13 Goodwill is most appropriately classed as:
- (A) a fixed asset.
 - (B) an intangible asset.
 - (C) a fictitious liability.
 - (D) a semi-fixed asset.
- 1.14 A major aim of the internal auditors is to:
- (A) reduce the costs of the external auditors by carrying out some of their duties.
 - (B) support the work of the external auditors.
 - (C) prepare the financial accounts.
 - (D) report to shareholders on the accuracy of the accounts.
- 1.15 Which one of the following is *not* a necessary part of the stewardship function?
- (A) To maximise profits.
 - (B) To safeguard assets.
 - (C) To ensure adequate controls exist to prevent or detect fraud.
 - (D) To prepare the financial accounts.
- 1.16 Who issues Financial Reporting Standards?
- (A) The Auditing Practices Board.
 - (B) The Stock Exchange.
 - (C) The Accounting Standards Board.
 - (D) The government.
- 1.17 Which of the following is *not* an accounting concept?
- (A) Prudence.
 - (B) Consistency.
 - (C) Depreciation.
 - (D) Accruals.
- 1.18 When preparing financial statements in periods of inflation, directors:
- (A) must reduce asset values.
 - (B) must increase asset values.
 - (C) must reduce dividends.
 - (D) need make no adjustments.
- 1.19 Which of the following statements is correct?
- (A) External auditors report to the directors.
 - (B) External auditors are appointed by the directors.
 - (C) External auditors are required to give a report to shareholders.
 - (D) External auditors correct errors in financial statements.

- 1.20** What is an audit trail in a computerised accounting system?
- (A) A list of all the transactions in a period.
 - (B) A list of all the transactions in a ledger account in a period.
 - (C) A list of all the items checked by the auditor.
 - (D) A list of all the nominal ledger codes.
- 1.21** The concept of capital maintenance is important for:
- (A) the sources of finance.
 - (B) the measurement of profit.
 - (C) the relationship of debt to equity.
 - (D) the purchase of fixed assets.
- 1.22** Internal control includes ‘detect’ controls and ‘prevent’ controls. Which of the following is a detect control?
- (A) Signing overtime claim forms.
 - (B) Matching purchase invoices with goods received notes.
 - (C) Preparing bank reconciliations.
 - (D) Matching sales invoices with delivery notes.
- 1.23** Which of the following statements is *not* correct?
- (A) Internal auditors review value for money.
 - (B) Internal auditors should not liaise with external auditors.
 - (C) Internal audit is part of internal control.
 - (D) Internal audit should be independent of the activities it audits.
- 1.24** The fundamental objective of an external audit of a limited company is to:
- (A) give advice to shareholders.
 - (B) detect fraud and errors.
 - (C) measure the performance and financial position of a company.
 - (D) provide an opinion on the financial statements.
- 1.25** Which *one* of the following statements most closely expresses the meaning of ‘true and fair’?
- (A) There is only one true and fair view of a company’s financial statements.
 - (B) True and fair is determined by compliance with accounting standards.
 - (C) True and fair is determined by compliance with company law.
 - (D) True and fair is largely determined by reference to generally accepted accounting practice.
- 1.26** A company includes in stock goods received before the year end, but for which invoices are not received until after the year end. This is in accordance with:
- (A) the historical cost convention.
 - (B) the accruals concept.
 - (C) the consistency concept.
 - (D) the materiality concept.
- 1.27** When there is inflation, the historical cost convention has the effect of:
- (A) overstating profits and understating balance sheet values.

- (B) understating profits and overstating balance sheet values.
 (C) understating cash flow and overstating cash in the balance sheet.
 (D) overstating cash flow and understating cash in the balance sheet.
- 1.28 Which of the following is *not* a reason for providing depreciation on tangible fixed assets?
- (A) They have a limited useful life, wearing out over time due to use or effluxion of time or by becoming obsolete.
 (B) They are part of the cost of generating the revenue for a period, and that cost should be matched with the revenue.
 (C) They usually decrease in value over time, hence the balance sheet should reflect this decrease in asset values.
 (D) It is a means of valuing an asset.
- 1.29 Which of the following is *not* correct?
- (A) Depreciation reduces the net profit of an organisation.
 (B) Providing depreciation generates cash.
 (C) If depreciation is not charged, capital will not be maintained.
 (D) By not charging depreciation, it might appear that profits have risen in line with inflation.



Question 2

The external auditors of OBJ plc have identified several areas of weakness in the company's accounting procedures. One area of weakness is the classification of capital and revenue transactions. They feel that incorrect classification of material items could result in the failure of the accounts to show a true and fair view.

Requirements

Insert the missing word in these sentences:

- (a) _____ expenditure is expenditure on items that are not intended to be sold but are intended to be retained in the business for some time to enable additional profits to be made.
- (b) _____ expenditure is expenditure on items that are either intended to be sold or are used up in a short space of time and have no lasting effect on the business.
- (c) The auditors have also identified that the following transactions have been omitted from the accounts:
1. Plant purchased for £18,800 cash including £500 for delivery and £2,800 VAT.
 2. Motor vehicle purchased at the beginning of the accounting period for £16,355 cash, including £140 for vehicle licence tax and VAT of £2,415.
 3. Replacement engine for a commercial vehicle, costing £1,300 cash.
 4. Sale of a fixed asset for £12,000 cash. This asset had cost £30,000 and it had been depreciated by £20,000.

OBJ plc's accountant has calculated the following figures at the year end of 30 April 1997:

| | |
|--------------|----------|
| Net profit | £475,350 |
| Fixed assets | £272,330 |

(i) Complete the table below to indicate the journal entries necessary to correct each of the above errors

| <i>Item</i> | <i>Name of account</i> | <i>Debit amount (£)</i> | <i>Credit amount (£)</i> |
|-------------|------------------------|-------------------------|--------------------------|
| 1. | █ | █ | █ |
| | █ | █ | █ |
| | █ | █ | █ |
| 2. | █ | █ | █ |
| | █ | █ | █ |
| | █ | █ | █ |
| 3. | █ | █ | █ |
| | █ | █ | █ |
| | █ | █ | █ |
| 4. | █ | █ | █ |
| | █ | █ | █ |
| | █ | █ | █ |
| | █ | █ | █ |

(ii) Insert the missing items into the table below in order to recalculate net profit and fixed assets after adjusting for the above transactions. Ignore any depreciation on the fixed assets purchased:

| Revised net profit | | |
|---------------------------|------------------------|---------|
| | <i>Item</i> | £ |
| | Original profit figure | 475,350 |
| Add: | █ | █ |
| | | █ |
| Less: | █ | █ |
| | █ | █ |
| | Revised net profit | █ |

| Revised fixed assets | | |
|-----------------------------|------------------------------|---------|
| | <i>Item</i> | £ |
| | Original fixed-assets figure | 272,330 |
| Add: | █ | █ |
| | █ | █ |
| | | █ |
| Less: | █ | █ |
| | █ | █ |
| | Revised fixed-assets total | █ |

? Question 3

- (a) Which concept affects the treatment of sales on credit in an organisation's ledger accounts?
- (b) Which concept justifies a provision for doubtful debts?

Solutions to Revision Questions

10



Solution 1

1.1 Answer: (B)

The accruals concept implies that the profits must be charged with expenses consumed, irrespective of whether or not an invoice has been received.

1.2 Answer: (D)

The suspense account balance is a credit one; this represents either a revenue item or an expense. As it would be imprudent to assume the difference is due to an item of revenue, the only course open is to include the balance as a liability on the balance sheet.

1.3 Answer: (A)

Part of an audit involves determining that the accounts show a true and fair view, but it does not guarantee that this is the case; in addition, many organisations who do not have an audit performed still produce accounts that show a true and fair view. Thus answer B is not wholly correct.

1.4 Answer: (A)

Transactions are normally included at their original cost to the business, but that does not preclude reductions in these figures for depreciation and other adjustments, therefore C is incorrect. The accounting professions have attempted to introduce systems of current cost accounting in the past, but these have never replaced the historical cost convention. Accounting transactions are always past transactions but not necessarily using the historical cost convention.

1.5 Answer: (B)

Revenues must be matched with the expenses incurred in earning those revenues. Goods sold on sale or return are not officially sold until the date for returning them has passed without event. The costs should not be included until that same date.

The associated revenues and expenses are therefore dealt with in 1994. The carriage outwards will be dealt with as it is incurred – which is also 1994 in this case.

1.6 Answer: (D)

A is incorrect because assets can be revalued upwards or downwards from their original cost, and depreciated, even under the historical cost convention. (B) is incorrect as goods should be recorded at the lower of their cost or their net realisable

value. (C) is incorrect because profits are calculated without adjustment for the increased cost of replacement stocks, and asset values would be lower than their current value.

1.7 Answer: (D)

The separate entity concept states that the transactions of the business and those of the owner should be kept separate. Therefore, any money, goods or services taken out of the business by the owner should be treated as private transactions.

1.8 Answer: (C)

1.9 Answer: (D)

1.10 Answer: (B)

1.11 Answer: (D)

1.12 Treating capital expenditure as revenue will have reduced profits; treating revenue receipts as capital will have reduced revenue. Thus the profit should have been higher by both of these items.

$$£10,200 + £3,000 + £1,400 = £14,600$$

1.13 Answer: (B)

Goodwill arises when more is paid for the assets of a business than their fair value. Thus, an additional asset is acquired; it is intangible and should be written off over the period during which the organisation is expected to benefit from it.

1.14 Answer: (B)

1.15 Answer: (A)

Stewardship is concerned with ensuring that there is a procedure in place to safeguard assets, provide properly for liabilities, protect against misuse of assets, and report adequately to the shareholders or stakeholders of the organisation.

1.16 Answer: (C)

1.17 Answer: (C)

1.18 Answer: (D)

1.19 Answer: (C)

1.20 Answer: (A)

1.21 Answer: (B)

1.22 Answer: (C)

1.23 Answer: (B)

1.24 Answer: (D)

1.25 Answer: (D)

1.26 Answer: (B)

1.27 Answer: (A)

1.28 Answer: (D)

1.29 Answer: (B)



Solution 2

- Parts (a) and (b) require an explanation of the meanings of ‘capital’ and ‘revenue’ expenditure.
- Part (c)(i) requires journal entries for four transactions. Take care to take the VAT on plant to the VAT account and not to include it with the cost of plant. But in the case of the motor vehicles, VAT should be included with the cost as it cannot be reclaimed. The vehicle licence tax is an expense and should not be included with the cost. For the disposed asset, the ledger entries can be made in various ways and the examiner will allow any reasonable combination of entries that achieves the result of removing the asset cost and depreciation from the accounts so that the profit or loss on disposal can be calculated.
- Part (c)(ii) requires a recalculation of net profit and fixed assets after the adjustments have been made. Take each adjustment in turn and determine whether or not it has any effect on either of these items.
 - (a) (i) Capital expenditure is expenditure on items that are not intended to be sold but are intended to be retained in the business for some time to enable additional profits to be made.
 - (ii) Revenue expenditure is expenditure on items that are either intended to be sold or are used up in a short space of time and have no lasting effect on the business.
 - (b) Accounts show a true and fair view if they do not affect decisions made by their users. Nonmaterial inaccuracies would not affect the true and fair view.
 - (c) (i) Journal entries

| | <i>Debit (£)</i> | <i>Credit (£)</i> |
|----------------|------------------|-------------------|
| Plant at cost | 16,000 | |
| VAT | 2,800 | |
| Cash book | | 18,800 |
| Motor vehicles | 16,215 | |
| Motor expenses | 140 | |
| Cash | | 16,355 |
| Engine repairs | 1,300 | |
| Cash | | 1,300 |
| Fixed assets | | 10,000 (NBV) |
| Cash | 12,000 | |
| Disposals | 10,000 | |
| Disposals | | 12,000 |

(ii) Revised net profit

| | |
|------------------------|----------------|
| | £ |
| Original figure | 475,350 |
| Add profit on disposal | <u>2,000</u> |
| | 477,350 |
| Less | |
| Motor expenses | (140) |
| Engine repairs | <u>(1,300)</u> |
| Revised net profit | <u>475,910</u> |

Revised fixed assets

| | |
|----------------------------|-----------------|
| | £ |
| Original figure | 272,330 |
| Add | |
| Plant at cost | 16,000 |
| Motor vehicles | <u>16,215</u> |
| | 304,545 |
| Less disposed asset | <u>(10,000)</u> |
| Revised fixed-assets total | <u>294,545</u> |

**Solution 3**

- (a) Realisation concept
- (b) Prudence concept.

Incomplete Records; Income and Expenditure Accounts



LEARNING OUTCOMES

When you have completed this chapter, you should be able to:

- ▶ prepare accounts from incomplete records;
- ▶ prepare income and expenditure accounts.

11.1 Introduction

So far, we have been looking at the preparation of final accounts from a ledger, with the results summarised in the trial balance. But not every business uses the full system of daybooks, ledger accounts and so on. Particularly in small businesses, there may not be the management time or the financial expertise available. Even in larger businesses, it occasionally happens that accounting records are lost, damaged or destroyed. For all these reasons it may sometimes be necessary to prepare a profit and loss account and balance sheet from more limited information than we have been given in previous chapters. The same difficulties may apply to records maintained by non-profit-making bodies, such as clubs and societies, and many of the techniques covered in this chapter apply to both.



All the contents of this chapter should be considered important for the examination, as it provides a good test of your knowledge of bookkeeping, which is essential to pass the examination. The ability to prepare accounts from incomplete records may be regarded as more difficult than from complete records, which you have studied in the previous chapters.

11.2 Calculating 'missing figures'

If an organisation does not keep its records in double-entry form, with the production of a trial balance, the preparation of the profit and loss account and balance sheet may require some figures to be ascertained from other records and information. For example, a common situation is where the owner of a business has not kept records of his drawings

from the business, but there are other figures available that would enable the drawings figure to be determined.

The accounting equation is usefully employed in this situation:

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

From this the value of capital can be calculated at any time. A change in the value of capital can be caused by only three things:

1. an introduction/withdrawal of capital;
2. net profit or loss for the period;
3. drawings.

Thus, if the opening and closing values of capital are known then, provided that the value of profit and of capital introductions/withdrawals are known, the value of drawings can be calculated.

In an organisation that does not keep full ledger accounts, there may be several figures that need to be determined with the aid of other figures that can be verified. There are several techniques to identify these missing figures.

11.2.1 Sales figures

It is common in organisations that do not keep full bookkeeping records to find that some figures regarding sales are unavailable. It might be that opening debtors' lists have been mislaid, or cash sales have not been recorded, or discounts given to customers might have been overlooked. Drawing up the equivalent of a sales ledger control account will enable the missing figure to be determined. Of course, it will not be a 'proper' sales ledger control account, because there is unlikely to be a sales ledger, but the technique is the same.

The idea is to insert in the accounts all known information, and then to derive the missing information as a balancing figure.

To take sales as an example:

- we probably know our opening figure for debtors – it is the figure that appeared in last year's balance sheet;
- we probably know our closing debtors – they are the people who owe us money *now*;
- bank statements should indicate the amount received from customers in the form of cheques and other types of receipts (though we may have to look back through all the statements for the period in order to derive this information);
- we may have records of cash sales (e.g. till rolls) that will indicate the amounts received from cash customers;
- by entering all these known amounts into the sales total account we can derive a sales figure for the period as a balancing figure.

Note that, although we normally exclude cash sales from the sales ledger control account, it is permissible to include them in the 'sales total account' in order to get a complete total of sales, whether for cash or on credit.

Example 11.A

Jaswinder knows that his debtors at 1 January 20X1 were £27,000, and during the year he received £140,000 in cheques from customers, after allowing £2,000 in cash discounts for prompt payment. He wrote off a bad debt of £5,000 during the year, and his closing debtors at 31 December 20X1 amount to £24,500. Calculate the value of his sales for the year.

Solution

This can be done by drawing up a sales ledger control account, and inserting the known figures. The unknown figure for sales can then be determined as the figure required to balance the account.

| Sales ledger control account | | | | | |
|------------------------------|---------------|---------|---------|------------------------|---------|
| <u>20X1</u> | | £ | | <u>20X1</u> | £ |
| 1 Jan. | Balance b/fwd | 27,000 | In year | Bank | 140,000 |
| In year | Sales | ? | In year | Cash discounts allowed | 2,000 |
| | | | In year | Bad debts written off | 5,000 |
| | | | 31 Dec. | Balance c/fwd | 24,500 |
| | | 171,500 | | | 171,500 |

The missing figure of sales is the figure required to make the control account balance, that is, £144,500. This technique can be used to identify any figure missing in respect of sales or debtors.

11.2.2 Purchases figures

These are calculated in the same way as sales figures.

11.2.3 Expenses figures

As with purchases, a ledger account is drawn up that is entered up with the known figures, and the missing figure is deduced as the figure required to make the account balance.

Example 11.B

Jaswinder paid an electricity bill during the year of £550. At 1 January, he knew that £120 was owing for electricity consumed in the previous year, and at 31 December he knew that £140 had been consumed in the current year, but not yet billed.

The ledger account for electricity would appear as follows:

| Electricity | | | | | |
|-------------|---------------|-----|---------|-------------------------|-----|
| <u>20X1</u> | | £ | | <u>20X1</u> | £ |
| In year | Bank | 550 | 1 Jan. | Balance b/fwd | 120 |
| 31 Dec. | Balance c/fwd | 140 | 31 Dec. | Profit and loss account | ? |
| | | 690 | | | 690 |

The missing profit and loss account figure is £570.

11.2.4 Opening capital

It is also common for the opening capital figure to be missing. This can be determined by drawing up an opening balance sheet and using the accounting equation to calculate the capital. You will remember the accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

If you can list the opening assets and liabilities, you can calculate the opening capital, or indeed any other opening figure that is missing.

11.2.5 Cash and bank summaries

It is common for incomplete records questions to commence with a summary of the cash and bank transactions. Such a summary is called a *receipts and payments account*. Very often, there is a missing figure in these – commonly the figure for owner's drawings. Drawing up such a summary (which is in effect just a copy of the cash book) enables the missing figure to be determined.

Example 11.C

Since commencing business several years ago as a cloth dealer, Tom Smith has relied on annual receipts and payments accounts for assessing progress. These accounts have been prepared from his business bank account through which all business receipts and payments are passed.

Tom Smith's receipts and payments account for the year ended 31 March year 10 is as follows:

| Receipts and payments account | | | |
|---------------------------------------|---------------|--------------------|---------------|
| | £ | | £ |
| Opening balance | 1,680 | Drawings | 6,300 |
| Sales receipts | 42,310 | Purchases payments | 37,700 |
| Proceeds of sale of grandfather clock | 870 | Motor van expenses | 2,900 |
| Loan from John Scott | 5,000 | Rates | 570 |
| Closing balance | 1,510 | Wages – John Jones | 3,200 |
| | | Workshop: rent | 700 |
| | <u>51,370</u> | | <u>51,370</u> |

Additional information

- The grandfather clock sold during the year ended 31 March year 10 was a legacy received by Tom Smith from the estate of his late father.
- The loan from John Scott was received on 1 January year 10. Interest is payable on the loan at the rate of 10 per cent per annum.
- In May year 10 Tom Smith received from his suppliers a special commission of 5 per cent of the cost of purchases during the year ended 31 March year 10.
- On 1 October year 9 Tom Smith engaged John Jones as a salesman. In addition to his wages, Jones receives a bonus of 2 per cent of the business's sales during the period of his employment; the bonus is payable on 1 April and 1 October in respect of the immediately preceding 6-month period.

Note: It can be assumed that sales have been at a uniform level throughout the year ended 31 March year 10.

- In addition to the items mentioned above, the assets and liabilities of Tom Smith were as follows:

| At 31 March | Year 9 (£) | Year 10 (£) |
|--------------------------------|------------|-------------|
| Motor van at cost | 4,000 | 4,000 |
| Stock in trade at cost | 5,000 | 8,000 |
| Trade debtors | 4,600 | 12,290 |
| Motor vehicle expenses prepaid | – | 100 |
| Workshop rent accrued due | – | 200 |
| Trade creditors | 2,900 | 2,200 |

- It can be assumed that the opening and closing balances in the above receipts and payments account require no adjustment for the purposes of Tom Smith's accounts.

(g) As from 1 April year 9, it has been decided to provide for depreciation on the motor van annually at the rate of 20 per cent of the cost. (It is assumed that the motor van will have no residual value.)

You are required to produce the trading and profit and loss account for the year ended 31 March year 10 and a balance sheet at that date of Tom Smith.

Solution

The value of sales and purchases can be found by using total accounts:

| Sales total account | | | |
|---------------------|---------------|----------------|---------------|
| | £ | | £ |
| Balance b/d | 4,600 | Sales receipts | 42,310 |
| Sales | 50,000 | Balance c/d | 12,290 |
| | <u>54,600</u> | | <u>54,600</u> |

| Purchases total account | | | |
|-------------------------|---------------|-------------|---------------|
| | £ | | £ |
| Purchases payments | 37,700 | Balance b/d | 2,900 |
| Balance c/d | 2,200 | Purchases | 37,000 |
| | <u>39,900</u> | | <u>39,900</u> |

It is then a fairly simple matter to complete the trading and profit and loss account.

Tom Smith: trading and profit and loss account for the year ended 31 March year 10

| | | |
|-----------------------|---------------|-----------------|
| | £ | £ |
| Sales | | 50,000 |
| Opening stock | 5,000 | |
| Purchases | 37,000 | |
| | <u>42,000</u> | |
| Closing stock | (8,000) | |
| | | <u>(34,000)</u> |
| Gross profit | | 16,000 |
| Motor van expenses | 2,800 | |
| Workshop rent | 900 | |
| Workshop rates | 570 | |
| Wages – John Jones | 3,700 | |
| Loan interest | 125 | |
| Depreciation | 800 | |
| | <u>8,895</u> | |
| Commission receivable | (1,850) | |
| | | <u>(7,045)</u> |
| Net profit | | <u>8,955</u> |

The opening capital value can be calculated by applying the accounting equation to the values of assets and liabilities at 31 March year 9.

| | |
|----------------------------|---------------|
| Assets | £ |
| Motor van | 4,000 |
| Stock in trade | 5,000 |
| Trade debtors | 4,600 |
| Bank | 1,680 |
| | <u>15,280</u> |
| Liabilities | |
| Creditors | 2,900 |
| Capital at 31 March year 9 | 12,380 |
| | <u>15,280</u> |

Tom Smith: balance sheet at 31 March year 10

| | Cost (£) | Depreciation (£) | Net (£) |
|-----------------------------|--------------|------------------|---------------|
| <i>Fixed assets</i> | | | |
| Motor van | <u>4,000</u> | <u>800</u> | 3,200 |
| <i>Current assets</i> | | | |
| Stock | | 8,000 | |
| Debtors | | 12,290 | |
| Prepayments | | 100 | |
| Commission receivable | | <u>1,850</u> | |
| | | <u>22,240</u> | |
| <i>Current liabilities</i> | | | |
| Trade creditors | | 2,200 | |
| Accrued rent | | 200 | |
| Wage bonus | | 500 | |
| Loan interest | | 125 | |
| Bank overdraft | | <u>1,510</u> | |
| | | <u>4,535</u> | |
| Net current assets | | | 17,705 |
| Net assets | | | <u>20,905</u> |
| <i>Financed by</i> | | | |
| Capital at start of year 10 | | | 12,380 |
| Capital introduced | | | 870 |
| Net profit | | | <u>8,955</u> |
| | | | <u>22,205</u> |
| Less drawings | | | 6,300 |
| Capital at end of year 10 | | | <u>15,905</u> |
| Loan from John Scott | | | 5,000 |
| | | | <u>20,905</u> |

The approach taken in this solution is typical of what is needed.

- Head up a sheet of paper for the profit and loss account and another for the balance sheet.
- Work line by line through the standard profit and loss account format – sales, opening stock, purchases and so on – entering the details given in the question. Workings may be needed for some of the figures, particularly sales and purchases. If so, do them on a separate sheet of paper and cross-reference as appropriate.
- Work through the balance sheet in the same way, if necessary calculating as a working the opening balance of capital brought forward.

You should now attempt to put this into practice by attempting the following example.

Example 11.D

Angela is in business but does not keep full accounting records. For the year ended 31 December 19X5 she is able to provide you with the following information:

| | At 1 January (£) | At 31 December (£) |
|-------------------------|------------------|--------------------|
| Stock | 2,950 | 3,271 |
| Debtors | 325 | 501 |
| Creditors for purchases | 736 | 1,014 |
| Accrued wages payable | 74 | 83 |

You are able to prepare the following summary of her cash and bank transactions for the year:

| Cash | £ | Bank | £ |
|-----------------|--------------|------------------------|--------------|
| Opening balance | 49 | Opening balance | 920 |
| Receipts | | Receipts | |
| Shop takings | 5,360 | Cheques from customers | 1,733 |
| Cheques cashed | 260 | Shop takings paid in | 3,995 |
| | <u>5,669</u> | | <u>6,648</u> |

| | | | |
|-----------------|----------------|-----------------|--------------|
| Payments | | Payments | |
| Purchases | (340) | Purchases | (2,950) |
| Wages | (102) | Wages | (371) |
| Other expenses | (226) | Other expenses | (770) |
| Drawings | (820) | Purchase of van | (1,250) |
| Paid into bank | <u>(3,995)</u> | Cash withdrawn | <u>(260)</u> |
| Closing balance | <u>186</u> | Closing balance | <u>1,047</u> |

Angela believes that one customer owing £27 will definitely not pay. On the basis of past experience, she believes that about 4 per cent of the remaining debtors are doubtful. The van is to be depreciated at the rate of 20 per cent per annum, straight line.

You are required to prepare Angela's profit and loss account and balance sheet for 19X5.

Solution

Begin with the profit and loss account, using total accounts to calculate sales and purchases.

Profit and loss account for the year ended 31 December 19X5

| | | |
|--------------------------------|--------------|--------------|
| | £ | £ |
| Sales (W1) | | 7,269 |
| Opening stock | 2,950 | |
| Purchases (W2) | <u>3,568</u> | |
| | 6,518 | |
| Less closing stock | <u>3,271</u> | |
| Cost of goods sold | | 3,247 |
| Gross profit | | <u>4,022</u> |
| Wages (W3) | 482 | |
| Other expenses (226 + 770) | 996 | |
| Bad debts | 27 | |
| Doubtful debts (501 – 27) × 4% | 19 | |
| Depreciation (20% × 1,250) | <u>250</u> | |
| | | 1,774 |
| Net profit for the year | | <u>2,248</u> |

Balance sheet as at 31 December 19X5

| | Cost (£) | Depreciation (£) | NBV (£) |
|---------------------------------------|--------------|------------------|--------------|
| Fixed assets | | | |
| Van | <u>1,250</u> | <u>250</u> | 1,000 |
| Current assets | | | |
| Stock | | 3,271 | |
| Debtors less provision (474 – 19) | | 455 | |
| Bank | | 1,047 | |
| Cash | | 186 | |
| | | <u>4,959</u> | |
| Current liabilities | | | |
| Creditors | | 1,014 | |
| Accrued wages | | 83 | |
| | | <u>1,097</u> | |
| Net current assets | | | 3,862 |
| Total assets less current liabilities | | | <u>4,862</u> |
| Capital | | | |
| Balance at 1 January 19X5 (W4) | | | 3,434 |
| Net profit for the year | | 2,248 | |
| Less drawings | | <u>820</u> | |
| Retained profit for the year | | | <u>1,428</u> |
| | | | <u>4,862</u> |

Workings

1. Sales

| Sales total account | | | |
|--------------------------|--------------|----------------------|--------------|
| | £ | | £ |
| Balance b/f | 325 | Cash—shop takings | 5,360 |
| Sales (balancing figure) | 7,269 | Bank | 1,733 |
| | | Bad debt | 27 |
| | | Balance c/d (501–27) | 474 |
| | <u>7,594</u> | | <u>7,594</u> |

2. Purchases

| Purchases total account | | | |
|-------------------------|--------------|------------------------------|--------------|
| | £ | | £ |
| Cash | 340 | Balance b/f | 736 |
| Bank | 2,950 | Purchases (balancing figure) | 3,568 |
| Balance c/d | 1,014 | | |
| | <u>4,304</u> | | <u>4,304</u> |

3. Wages

| Wages account | | | |
|---------------|------------|-------------------------|------------|
| | £ | | £ |
| Cash | 102 | Balance b/f | 74 |
| Bank | 371 | Profit and loss account | 482 |
| Balance c/d | 83 | | |
| | <u>556</u> | | <u>556</u> |

4. Capital at 1 January 19X5

| | |
|-----------------------------|--------------|
| | £ |
| Stock | 2,950 |
| Debtors | 325 |
| Bank | 920 |
| Cash | 49 |
| | <u>4,244</u> |
| Less liabilities (736 + 74) | 810 |
| | <u>3,434</u> |

11.3 Accounts of non-profit-making bodies

In this section we look at the accounts of organisations such as clubs and societies, which are not primarily set up for the purpose of trading and making a profit (although they may engage in some trading activities, for example, running a bar for the use of members and visitors).

11.3.1 Accounting terminology for non-profit-making bodies

In Chapter 1, we learned that some organisations exist, not with the main intention of making profits in the long term, but with the objective of providing facilities to their

members or others who may benefit from their activities. These organisations are often clubs and societies. They may have trading activities, and they will often engage in profitable activities that increase the net assets of the organisation. However, this increase in net assets is not attributed directly to the members, but is used to expand and improve the organisation, or to provide benefits for those whom the organisation exists to support.

Local government is another example of a non-profit-making organisation, but the accounts of local government are outside the scope of your syllabus.

The accounts prepared for these organisations are similar to those prepared for other trading organisations described earlier in this text, and they utilise the same accounting concepts and principles, but some of the terminology used is different. It is usual for the following accounts to be prepared for these organisations.



Receipts and payments account. This is a summary of the organisation's cash and bank transactions for a period. It is common for these organisations to operate a single-entry accounting system and thus the receipts and payments account is the starting point for the preparation of other accounting statements.



Income and expenditure account. This is similar to the profit and loss account of a trading organisation. It shows the income and expenditure of a particular period and follows the same accounting principles as described for trading organisations earlier in this text. However, instead of using the terms *profit* and *loss*, the difference between the income and expenditure of the period is referred to as *surplus* or *deficit*. The reason for this is that the organisation does not, in principle, exist in order to make a profit. Sometimes, however, the organisation has sections within itself or holds specific events with the deliberate intent of making profits that are used to subsidise the costs of the organisation's other activities: for example, it may have a bar selling drinks at a profit, or might hold a dinner-dance for which tickets are sold. In these circumstances a separate 'trading account' is prepared for each such activity. The profit or loss arising is transferred to the income and expenditure account.

Balance sheet

The balance sheet of a non-trading organisation is similar to that of a sole trader, showing assets and liabilities at the balance sheet date. However, the organisation does not have an owner. The equivalent of the owner's capital is referred to as the *accumulated fund*.

11.3.2 Accounting for membership fees and subscriptions

Another significant difference between these organisations and the trading organisation is that their income is mainly derived from their members in membership fees. Different organisations have different membership schemes but the most common are as follows.

Annual membership fees

This type of scheme requires members to pay a fee annually in order to retain membership. In accounting terms this normally coincides with the date for preparing the annual accounting statements, but care must be taken to adjust appropriately for subscriptions in advance (a liability) and for subscriptions in arrears (an asset). If a member has outstanding subscriptions it is unlikely that legal action will be taken to recover them

(because of the legal costs involved and the difficulty of proving the debt), so it is common for them to be written off as a bad debt. However, each organisation will have its own policy.

Example 11.E

A club receives subscriptions during 1998 of £17,400. At the start of 1998, £100 was owing for fees in respect of 1997, and £300 had been paid during the previous year in respect of 1998 fees. At the end of 1998, £150 was still owing for 1998 fees, and £250 had been paid in advance for 1999. The subscriptions account would appear as follows:

| Subscriptions receivable | | | | | |
|--------------------------|----------------------------|---------------|---------|------------|---------------|
| 1998 | | £ | 1998 | | £ |
| 1 Jan. | In arrears | 100 | 1 Jan. | In advance | 300 |
| | | | | Received | 17,400 |
| 31 Dec. | In advance | 250 | 31 Dec. | In arrears | 150 |
| | Income and expenditure a/c | 17,500 | | | |
| | | <u>17,850</u> | | | <u>17,850</u> |
| 1999 | | | 1999 | | |
| 1 Jan. | In arrears | 150 | 1 Jan. | In advance | 250 |

Entrance fees

These are fees payable in addition to the annual subscription when a person first joins the organisation as a member (they may also be referred to as joining fees). For accounting purposes they are normally considered to relate to a number of years and credit is taken for them gradually in the income and expenditure account. The time period used is a matter for the organisation to decide but, for example, if a period of 5 years were used and the entrance fee paid were £50, then £10 would be treated as income in each of the five years' income and expenditure accounts following the admission to membership. The accounting treatment would be to create a liability in the balance sheet on receipt of the £50 and then to transfer £10 from this account each year. This is shown below:

| Entrance fees | | | |
|------------------------|----|------|----|
| | £ | | £ |
| Income and expenditure | 10 | Bank | 50 |

Life-membership fees

As its name suggests, this means that a member only makes one payment and for this receives membership for life. In accounting terms this is treated similarly to the entrance fees described above: a balance sheet liability is created on receipt of the fee, and a proportion of it is transferred to the income and expenditure account over a period of time in accordance with the policy of the organisation.

Example 11.F

A club received the following life-membership fees in each of its first 2 years:

| | |
|--------|-------|
| | £ |
| Year 1 | 1,500 |
| Year 2 | 800 |

The club's policy is to take credit for life-membership fees in equal amounts over 10 years. The entries in the ledger accounts would appear as follows:

| Life-membership fees | | | |
|------------------------|--------------|-------------|--------------|
| | £ | | £ |
| Income and expenditure | 150 | Bank | 1,500 |
| Balance c/d | <u>1,350</u> | | <u>1,500</u> |
| | <u>1,500</u> | | |
| Income and expenditure | 230 | Balance b/d | 1,350 |
| Balance c/d | <u>1,920</u> | Bank | 800 |
| | <u>2,150</u> | | <u>2,150</u> |

The amount transferred to income and expenditure in year 2 is made up of:

| | |
|--|------------|
| | £ |
| 10% of year 1 fees = $10\% \times \text{£}1,500$ | 150 |
| 10% of year 2 fees = $10\% \times \text{£}800$ | 80 |
| | <u>230</u> |

You should note that some organisations will offer their members a choice of these schemes, so that different techniques will be required for different membership schemes. In each case the policy of the organisation must be used to determine the accounting treatment required.

11.3.3 The accounts of non-trading organisations

Example 11.G

The following receipts and payments account for the year ended 31 March year 11 for the Green Bank Sports Club has been prepared by the treasurer, Andrew Swann.

| Receipts and payments account | | | |
|--|---------------|---|---------------|
| | £ | | £ |
| Receipts | | Payments | |
| Balances brought forward, 1 April year 10 | | Painting of clubhouse | 580 |
| Cash in hand | 196 | Maintenance of grounds | 1,310 |
| Bank current account | 5,250 | Bar steward's salary | 5,800 |
| Members' subscriptions | | Insurances | 240 |
| Ordinary | 1,575 | General expenses | 1,100 |
| Life | 800 | Building society investment account | 1,500 |
| Annual dinner ticket sales | 560 | Secretary's honorarium | 200 |
| Bar takings | 21,790 | Annual dinner expenses | 610 |
| | | New furniture & fittings | 1,870 |
| | | Bar purchases | 13,100 |
| | | Rent of clubhouse | 520 |
| | | Balances carried forward, 31 March year 11 | |
| | | Bank current account | 3,102 |
| | | Cash in hand | 239 |
| | <u>30,171</u> | | <u>30,171</u> |

The following additional information has been given:

- (i) Ordinary membership subscriptions received in advance at 31 March year 10 were £200. The subscriptions received during the year ended 31 March year 11 included £150 in advance for the following year.

- (ii) A life-membership scheme was introduced on 1 April year 9. Under the scheme, life-membership subscriptions are £100 and are apportioned to revenue over a 10-year period. Life-membership subscriptions totalling £1,100 were received during the first year of the scheme.
- (iii) The club's building society investment account balance at 31 March year 10 was £2,676. During the year ended 31 March year 11 interest of £278 was credited to the account.
- (iv) All the furniture and fittings in the club's accounts at 31 March year 10 were bought in January year 8 at a total cost of £8,000. It is the club's policy to provide depreciation annually on fixed assets at 10 per cent of the cost of such assets held at the relevant year end. The furniture and fittings are not expected to have any residual value.
- (v) Other assets and liabilities of the club were:

| At 31 March | Year 10 | Year 11 |
|-------------------------|---------|---------|
| | £ | £ |
| Bar stocks | 1,860 | 2,110 |
| Insurances prepaid | 70 | 40 |
| Rent accrued due | 130 | 140 |
| Bar purchases creditors | 370 | 460 |

You are required:

- (a) to draw up the bar trading and profit and loss account for the year ended 31 March year 11;
- (b) to draw up the club's income and expenditure account for the year ended 31 March year 11 and a balance sheet at that date;
- (c) to outline the advantages and disadvantages of receipts and payments accounts for organisations such as the Green Bank Sports Club.

Solution

- (a) Green Bank Sports Club: bar trading and profit and loss account for the year ended 31 March year 11

| | | |
|----------------------|----------------|--------------|
| | £ | £ |
| Bar takings | | 21,790 |
| Opening stock | 1,860 | |
| Purchases | 13,190 | |
| | <u>15,050</u> | |
| Closing stock | <u>(2,110)</u> | |
| | | 12,940 |
| Gross profit | | 8,850 |
| Bar steward's salary | | <u>5,800</u> |
| Net profit | | <u>3,050</u> |

- (b) Income and expenditure account for the year ended 31 March year 11

| | |
|--------------------------------------|--------------|
| | £ |
| Income | |
| Ordinary subscriptions | 1,625 |
| Life subscriptions | 190 |
| Building society interest | 278 |
| Bar profit | <u>3,050</u> |
| | <u>5,143</u> |
| Expenditure | |
| Painting of clubhouse | 580 |
| Maintenance of grounds | 1,310 |
| Insurances | 270 |
| General expenses | 1,100 |
| Secretary's honorarium | 200 |
| Loss on annual dinner | 50 |
| Rent of clubhouse | 530 |
| Depreciation of furniture & fittings | <u>987</u> |
| | <u>5,027</u> |
| Surplus for the year | <u>116</u> |

Balance sheet at 31 March year 11

| | Cost (£) | Depreciation (£) | NBV (£) |
|---------------------------------------|--------------|------------------|---------------|
| Fixed assets | | | |
| Furniture and fittings | <u>9,870</u> | <u>3,387</u> | 6,483 |
| Current assets | | | |
| Bar stocks | | 2,110 | |
| Insurance prepaid | | 40 | |
| Building society investment | | 4,454 | |
| Bank current account | | 3,102 | |
| Cash in hand | | 239 | |
| | | <u>9,945</u> | |
| Current liabilities | | | |
| Bar purchase creditors | | 460 | |
| Subscriptions in advance | | 150 | |
| Rent accrual | | 140 | |
| | | <u>750</u> | |
| Net current assets | | | 9,195 |
| Total assets less current liabilities | | | <u>15,678</u> |
| Financed by | | | |
| Accumulated fund b/f | | | 13,962 |
| Surplus for the year | | | 116 |
| | | | <u>14,078</u> |
| Life-membership fund | | | 1,600 |
| | | | <u>15,678</u> |

(c) The receipts and payments account provides a summary of the cash and bank transactions that have occurred during year 11.

Advantages

- It can easily be reconciled to bank statements and balances of cash in hand.
- It is easy to understand.

Disadvantages

- It does not recognise income and costs as they arise, only as monies are received and paid. As such it does not conform to the matching concept.
- It does not show the assets/liabilities of the club, and does not differentiate between capital and revenue expenditure.

**Exercise 11.1**

The Teesdon Tennis Club had the following assets and liabilities on 1 January 20X1:

| | |
|-----------------------------------|--------|
| | £ |
| Land and buildings | 45,000 |
| Equipment | 7,000 |
| Cash in bank | 1,360 |
| Subscriptions in arrear | 190 |
| Subscriptions in advance for 20X1 | 70 |
| Rates paid in advance | 60 |

During the year ended 31 December 20X1 the club had the following receipts:

| | |
|-----------------------------------|-------|
| | £ |
| Subscriptions for the year 20X1 | 9,000 |
| Subscriptions from previous years | 190 |
| Subscriptions in advance for 20X2 | 70 |
| Hire of courts | 750 |
| Loan from club members | 5,000 |

and made the following payments:

| | |
|--|-------|
| | £ |
| General expenses | 5,400 |
| Rates (for 12 months 1 April 20X1–31 March 20X2) | 360 |
| New furniture (cost £5,000 balance payable 20X2) | 2,500 |
| Repaid loan in part | 1,500 |

You are required:

- (a) to calculate the accumulated fund on 1 January 20X1;
- (b) to prepare the subscriptions account;
- (c) allowing for depreciation of equipment by £2000, to prepare:
 - (i) the receipts and payments account;
 - (ii) the income and expenditure account for the year ended 31 December 20X1 and a balance sheet on that date.



Solution

- (a) Accumulated fund on 1 January 1985

$$£45,000 + £7,000 + £1,360 + £190 - £70 + £60 = £53,540$$

- (b)

| Subscriptions | | | |
|----------------------------|--------------|-------------|--------------|
| <i>20X1</i> | £ | <i>20X1</i> | £ |
| Balance b/f | 190 | Balance b/f | 70 |
| Income and expenditure a/c | 9,070 | Bank | 9,260 |
| Balance c/f | 70 | | |
| | <u>9,330</u> | | <u>9,330</u> |
| | | <i>20X2</i> | |
| | | Balance b/f | 70 |

- (c) (i) Receipts and payments account: year ended 31.12.20X1

| <i>20X1</i> | £ | <i>20X1</i> | £ |
|------------------------|---------------|------------------|---------------|
| Balance b/f | 1,360 | General expenses | 5,400 |
| Subscriptions | 9,260 | Rates | 360 |
| Hire of courts | 750 | Furniture | 2,500 |
| Loan from club members | 5,000 | Loan repayment | 1,500 |
| | | Balance c/f | 6,610 |
| | <u>16,370</u> | | <u>16,370</u> |

- (ii) Income and expenditure account: year ended 31.12.20X1

| | £ | £ |
|------------------------------------|--------------|--------------|
| Subscriptions | 9,070 | |
| Hire of courts | 750 | |
| | <u>9,820</u> | 9,820 |
| General expenses | 5,400 | |
| Rates | 330 | |
| | <u>5,730</u> | |
| Surplus of income over expenditure | | <u>4,090</u> |

| Balance sheet at 31.12.20X1 | | |
|---------------------------------------|--------------|---------------|
| | £ | £ |
| Fixed assets | | |
| Land and buildings | | 45,000 |
| Equipment | | <u>12,000</u> |
| | | 57,000 |
| Current assets | | |
| Rates paid in advance | 90 | |
| Cash at bank | <u>6,610</u> | |
| | | <u>6,700</u> |
| Current liabilities | | |
| Subscriptions paid in advance | 70 | |
| Creditors for furniture | <u>2,500</u> | |
| | | <u>2,570</u> |
| Net current assets | | 4,130 |
| Total assets less current liabilities | | <u>61,130</u> |
| Accumulated fund | | |
| Balance b/f | | 53,540 |
| Surplus for the year | | <u>4,090</u> |
| | | 57,630 |
| Loan from club members | | <u>3,500</u> |
| | | <u>61,130</u> |

11.4 Summary

In this chapter we have looked at the main techniques involved in preparing accounts:

- from incomplete records;
- for non-profit-making organisations.

Apart from the use of some new terminology in the accounts of non-profit-making organisations, this chapter builds on the knowledge and skills of previous chapters, in particular:

- the preparation of control accounts;
- the distinction between capital and revenue transactions;
- adjustments for accruals and prepayments.
- the accounting equation $\text{Assets} = \text{Liabilities} + \text{Capital}$.

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Revision Questions



? Question 1 Multiple choice

- 1.1 In a not-for-profit organisation, the accumulated fund is:
- (A) long-term liabilities plus current liabilities plus current assets.
 - (B) fixed assets less current liabilities less long-term liabilities.
 - (C) the balance on the general reserves account.
 - (D) fixed assets plus net current assets less long-term liabilities.
- 1.2 An income and expenditure account is:
- (A) a summary of the cash and bank transactions for a period.
 - (B) another name for a receipts and payments account.
 - (C) similar to a profit and loss account in reflecting revenue earned and expenses incurred during a period.
 - (D) a balance sheet as prepared for a non-profit-making organisation.
- 1.3 A club received subscriptions during 1995 totalling £12,500. Of these, £800 related to 1994 and £400 related to 1996. There were subscriptions in arrears at the end of 1995 of £250. The subscriptions to be included in the income and expenditure account for 1995 amount to:
- £.....
- 1.4 Life-membership fees payable to a club are usually dealt with by:
- (A) crediting the total received to a life-membership fees account and transferring a proportion each year to the income and expenditure account.
 - (B) crediting the total received to the income and expenditure account in the year in which these fees are received.
 - (C) debiting the total received to a life-membership fees account and transferring a proportion each year to the income and expenditure account.
 - (D) debiting the total received to the income and expenditure account in the year in which these fees are received.
- 1.5 A club's membership-fees account shows a debit balance of £150 and a credit balance of £90 at 1 June 1997. During the year ending 31 May 1998, subscriptions received amounted to £4,750. Subscriptions overdue from the year ended 31 May 1997, of £40, are to be written off. At 31 May 1998, subscriptions paid in advance amount to £75.
- The amount to be transferred to the income and expenditure account for the year ending 31 May 1998 is:
- £.....
- 1.6 A receipts and payments account is similar to:
- (A) an income and expenditure account.
 - (B) a profit and loss account.

- (C) a trading account.
 (D) a cash book summary.
- 1.7 The subscriptions receivable account of a club commenced the year with subscriptions in arrears of £50 and subscriptions in advance of £75. During the year, £12,450 was received in subscriptions, including all of the arrears and £120 for next year's subscriptions. The amount to be taken to the income and expenditure account for the year is:
 £.....
- 1.8 The difference between a profit and loss account (which may also be referred to as an 'income statement') and an income and expenditure account is that:
- (A) an income and expenditure account is an international term for a profit and loss account.
 (B) a profit and loss account is prepared for a business and an income and expenditure account is prepared for a non-profit-making organisation.
 (C) a profit and loss account is prepared on an accruals basis and an income and expenditure account is prepared on a cash-flow basis.
 (D) a profit and loss account is prepared for a manufacturing business and an income and expenditure account is prepared for a non-manufacturing business.



Question 2

Potter has always kept his accounts in proper double-entry form, but they were all destroyed following a fire at his offices on 31 December 1995. His accountants had the following balance sheet as at 31 December 1994:

| | £ | £ |
|--|---------------|---------------|
| <i>Fixed assets</i> (net book value) | | |
| Land and buildings | | 80,000 |
| Motor vehicles | | 8,000 |
| Fixtures | | <u>7,500</u> |
| | | 95,500 |
| <i>Current assets</i> | | |
| Stock | 18,800 | |
| Debtors | 16,200 | |
| Bank | <u>9,600</u> | |
| | <u>44,600</u> | |
| <i>Less: current liabilities</i> | | |
| Trade creditors | 11,000 | |
| Accrued expenses: | | |
| loan interest | 1,500 | |
| rates | <u>400</u> | |
| | <u>12,900</u> | |
| Net current assets | | <u>31,700</u> |
| | | 127,200 |
| <i>Less: long-term liabilities</i> | | |
| 10% loan | | <u>30,000</u> |
| | | <u>97,200</u> |
| <i>Financed by Capital</i> | | <u>97,200</u> |

You obtain the following additional information:

- (i) Cheques received from debtors during the year were £78,900; sales amounted to £80,500 and cash discount was allowed to some debtors.
 (ii) Purchases during the year were £45,250 and creditors at 31 December 1995 were £9,550.

- (iii) Payments made by cheque during the year included wages £9,600, motor expenses £2,250, general expenses £2,550, loan interest £3,000, drawings £4,000 and rates for the 18 months to 31 March 1996 £2,400.
- (iv) A bill of £500 for motor expenses was awaited at 31 December 1995.
- (v) At 31 December 1995, stock was £16,000 and debtors £17,300.
- (vi) Depreciation is to be charged on the net book value at 25 per cent on motor vehicles and at 20 per cent on fixtures.

Requirements

Prepare final accounts for 1995 by inserting the missing figures in the workings, profit and loss account and balance sheet.

Workings

| | | | |
|-------------------|---|---|--|
| | £ | | |
| Purchases | | | |
| Opening creditors | | | |
| | | | |
| Closing creditors | | | |
| Paid to creditors | | | |
| | £ | | |
| Sales | | | |
| Opening debtors | | | |
| | | | |
| Cheques received | | | |
| | | | |
| Closing debtors | | | |
| Cash discount | | | |
| | £ | | |
| Rates | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | £ | £ | |
| Bank summary | | | |
| | | | |
| | | | |
| Payments: | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | £ | | |
| Depreciation | | | |
| | | | |

INCOMPLETE RECORDS; INCOME AND EXPENDITURE ACCOUNTS

Potter: trading and profit and loss account for the year ended 31 December 1995

| | £ | £ |
|-------------------------|---|---|
| Sales | | █ |
| Less cost of sales: | | |
| Opening stock | █ | |
| Purchases | █ | |
| | █ | |
| Less closing stock | █ | |
| | █ | |
| Gross profit | | █ |
| Less expenses: | | |
| Discounts allowed | █ | |
| Wages and salaries | █ | |
| Rates | █ | |
| Motor expenses | █ | |
| General expenses | █ | |
| Loan interest | █ | |
| Depreciation | █ | |
| | | █ |
| Net profit for the year | | █ |

Potter: balance sheet at 31 December 1995

| | Cost (£) | Accumulated dep'n (£) | NBV (£) |
|-----------------------------------|----------|-----------------------|---------|
| <i>Fixed assets</i> | | | |
| █ | █ | █ | █ |
| █ | █ | █ | █ |
| █ | █ | █ | █ |
| | █ | █ | █ |
| | █ | █ | █ |
| <i>Current assets</i> | | | |
| █ | | █ | |
| █ | | █ | |
| █ | | █ | |
| | | █ | |
| | | █ | |
| <i>Less current liabilities</i> | | | |
| █ | █ | | |
| █ | █ | | |
| █ | █ | | |
| | █ | | |
| | | █ | |
| | | █ | |
| <i>Less long-term liabilities</i> | | | |
| █ | | | █ |
| | | | █ |
| <i>Financed by:</i> | | | |
| █ | | | █ |
| █ | | | █ |
| | | | █ |
| █ | | | █ |
| | | | █ |

? Question 3

The following is the receipts and payments account of the Long Lane Social Club, for the year ended 31 December 1995:

| <i>Receipts</i> | <i>£</i> | <i>Payments</i> | <i>£</i> |
|------------------------|----------------|------------------------------|----------------|
| Balance at 1 January | 2,300 | Bar licence fees | 2,000 |
| Bar takings | 139,050 | Cleaner's wages | 4,340 |
| Sales of refreshments | 5,400 | Refreshments purchased | 2,890 |
| Sales of dance tickets | 1,880 | Secretary's expenses | 3,690 |
| Sale of equipment | 2,400 | General expenses | 2,090 |
| Subscriptions | 4,120 | Creditors for bar supplies | 93,030 |
| | | Invested in building society | 16,000 |
| | | Barperson's wages | 9,500 |
| | | New equipment | 8,000 |
| | | Rates | 3,620 |
| | | Dance expenses | 2,700 |
| | | Balance at 31 December | 7,290 |
| | <u>155,150</u> | | <u>155,150</u> |

Other assets and liabilities at 1 January and 31 December were as follows:

| | <i>1 Jan.</i> | <i>31 Dec.</i> |
|----------------------------|---------------|----------------|
| | <i>£</i> | <i>£</i> |
| Premises at cost | 105,000 | 105,000 |
| Equipment at cost | 5,400 | ? |
| Creditors for bar supplies | 2,270 | 1,960 |
| Subscriptions in advance | 480 | 350 |
| Subscriptions in arrears | – | 280 |
| Stocks of bar supplies | 9,500 | 8,350 |
| Rates prepaid | 1,000 | 1,100 |

You are also told that:

- (i) All the equipment owned at the start of the year was sold and replaced during the year. Depreciation of 10 per cent per annum is to be provided on the new equipment. It is assumed that the equipment will have no residual value.
- (ii) The building society had credited £1,000 interest to the investment account at 31 December 1995.

Requirements

- (a) Prepare a bar trading account for the year ended 31 December 1995.
- (b) Prepare an income and expenditure account for the year to 31 December 1995.
- (c) Prepare a balance sheet at 31 December 1995 by inserting the missing figures in the workings, profit and loss account and balance sheet.

Workings

| | |
|----------------------|---|
| <i>Purchases</i> | £ |
| | |
| | |
| | |
| <i>Equipment</i> | |
| | |
| | |
| | |
| <i>Subscriptions</i> | |
| | |
| | |
| | |
| | |
| | |

(a) Long Lane Social Club: bar trading account for the year ended 31 December 1995

| | | |
|---------------------|---|---|
| | £ | £ |
| Sales | | |
| Less cost of sales: | | |
| Opening stock | | |
| Purchases | | |
| | | |
| Less closing stock | | |
| Gross profit | | |
| Less expenses: | | |
| Barperson's wages | | |
| Bar licence fees | | |
| | | |
| Net profit | | |

(b) Long Lane Social Club: income and expenditure account for the year ended 31 December 1995

| | £ | £ | £ |
|-------------------------|-------------------|-------------------|-------------------|
| <i>Income</i> | | | |
| ██████████ | | ██████████ | |
| Profit on refreshments: | | | |
| ██████████ | ██████████ | | |
| ██████████ | ██████████ | | |
| | <u>██████████</u> | | |
| ██████████ | | ██████████ | |
| ██████████ | | ██████████ | |
| | | <u>██████████</u> | |
| | | | ██████████ |
| <i>Expenditure:</i> | | | |
| ██████████ | ██████████ | | |
| ██████████ | ██████████ | | |
| | <u>██████████</u> | | |
| ██████████ | | ██████████ | |
| ██████████ | | ██████████ | |
| ██████████ | | ██████████ | |
| ██████████ | | ██████████ | |
| ██████████ | | ██████████ | |
| | | <u>██████████</u> | |
| Surplus for the year | | | <u>██████████</u> |
| | | | <u>██████████</u> |

(c) Long Lane Social Club: balance sheet at 31 December 1995

| | Cost (£) | Accumulated dep'n (£) | NBV (£) |
|----------------------------|-------------------|-----------------------|-------------------|
| <i>Fixed assets</i> | | | |
| ██████████ | ██████████ | ██████████ | ██████████ |
| ██████████ | ██████████ | ██████████ | ██████████ |
| | <u>██████████</u> | <u>██████████</u> | <u>██████████</u> |
| ██████████ | | | ██████████ |
| <i>Current assets</i> | | | |
| ██████████ | | ██████████ | |
| ██████████ | | ██████████ | |
| ██████████ | | ██████████ | |
| ██████████ | | ██████████ | |
| | | <u>██████████</u> | |
| <i>Current liabilities</i> | | | |
| ██████████ | ██████████ | | |
| ██████████ | ██████████ | | |
| | <u>██████████</u> | | |
| | | <u>██████████</u> | |
| <i>Accumulated fund</i> | | | |
| ██████████ | | | ██████████ |
| ██████████ | | | ██████████ |
| | | | <u>██████████</u> |
| | | | ██████████ |
| | | | <u>██████████</u> |

Long Lane Social Club: statement of affairs at 1 January 1995

| | £ | £ |
|-------------------------|---|---|
| <i>Assets</i> | | |
| █ | | █ |
| █ | | █ |
| █ | | █ |
| █ | | █ |
| █ | | █ |
| <i>Less liabilities</i> | | |
| █ | █ | |
| █ | █ | |
| | █ | █ |
| | | █ |
| | | █ |
| | | █ |



Question 4

The HB tennis club was formed on 1 April 1990 and has the following receipts and payments account for the six months ended 30 September 1990:

| <i>Receipts</i> | £ | <i>Payments</i> | £ |
|----------------------|---------------|-------------------------|---------------|
| Subscriptions | 12,600 | Purchase of equipment | 4,080 |
| Tournament fees | 465 | Groundsperson's wages | 4,520 |
| Bank interest | 43 | Rent and business rates | 636 |
| Sale of club ties | 373 | Heating and lighting | 674 |
| Life-membership fees | 4,200 | Postage and stationery | 41 |
| | | Court maintenance | 1,000 |
| | | Tournament prizes | 132 |
| | | Purchase of club ties | 450 |
| | | Balance c/d | 6,148 |
| | <u>17,681</u> | | <u>17,681</u> |

Notes:

1. The annual subscription fee is £300. On 30 September there were five members who had not paid their subscriptions, but this money was received on 4 October 1990.
2. The equipment is expected to be used by the club for five years, after which time it will need to be replaced. Its estimated scrap value at that time is £50.
3. During the six months, the club purchased 100 ties printed with its own design. Forty of these ties remained unsold at 30 September 1990.
4. The club has paid business rates in advance on 30 September 1990 of £68.
5. The club treasurer estimates that the following amounts should be accrued for expenses:

| | £ |
|------------------------|----|
| Groundsperson's wages | 40 |
| Postage and stationery | 12 |
| Heating and lighting | 53 |

6. The life-membership fees received relate to payments made by four families. The scheme allows families to pay £1,050, which entitles them to membership for life without further payment. It has been agreed that such receipts would be credited to income and expenditure in equal instalments over ten years.

Requirements

(a) Calculate the following items to be included in the income and expenditure account for the period, using the boxes provided.

(i) Subscriptions

| | |
|-------------------------------------|------------|
| | £ |
| Subscriptions received for the year | █ |
| Subscriptions accrued for the year | █ |
| Total subscriptions for the year | █ ----- |
| Subscriptions for the six months | █ ----- |

(ii) Profit from the sale of club ties:

| | | | |
|--------------------|------------|--|------------|
| | £ | | £ |
| Sales of ties | █ | | █ |
| Purchases of ties | █ | | |
| Less closing stock | █ ----- | | █ ----- |
| Profit | | | █ ----- |

(iii) Life-membership fees:

| | |
|-------------------------------|---|
| | £ |
| Amounts received | █ |
| Annual equivalent | █ |
| Amount to include in accounts | █ |

(iv) Depreciation of equipment:

| | |
|-------------------------------|---|
| | £ |
| Cost | █ |
| Annual depreciation | █ |
| Amount to include in accounts | █ |

(b) Insert the missing items into the income and expenditure account given below.

HB Tennis Club: income and expenditure account for the six months ended 30 September 1990

| | | | | | | | |
|-----------------------------------|---|--|---|---|------------|---|------------|
| | £ | | ± | | £ | | £ |
| Income | | | | | | | |
| Subscriptions | | | | | | | █ |
| Income from tournaments | █ | | █ | | | = | █ |
| Bank interest received | | | | | | | 43 |
| Profit from sale of club ties | | | | | | | █ |
| Life memberships | | | | | | | █ ----- |
| Expenditure | | | | | | | |
| Groundsperson's wages | █ | | █ | = | █ | | |
| Rent and business rates | █ | | █ | = | █ | | |
| Heat and light | █ | | █ | = | █ | | |
| Post and stationery | █ | | █ | = | █ | | |
| Court maintenance | | | | | 1,000 | | |
| Depreciation | | | | | █ ----- | | █ |
| Excess of income over expenditure | | | | | | | █ ----- |



Question 5

The Questing Theatre Club is an amateur dramatic club that rents premises in which it has established a theatre and bar for the use of its members. The club's treasurer has produced the following summary of the club's receipts and payments during the year ended 31 May 1992:

| Receipts and payments account for the year ended 31 May 1992 | | | |
|--|--------|----------------------------------|--------|
| | £ | | £ |
| Cash and bank balances b/f | 1,120 | Secretarial expenses | 550 |
| Members' subscriptions | 4,460 | Rent of premises | 1,990 |
| Donations | 500 | Production expenses | 18,800 |
| Bar takings | 25,900 | Bar suppliers | 14,700 |
| Ticket sales | 17,320 | Bar expenses | 4,180 |
| Grants and subsidies | 13,800 | Fees of guest artists | 900 |
| | | Stationery, printing & publicity | 1,100 |
| | | Purchase of theatre equipment | 15,100 |
| | | Other expenses | 4,820 |
| | | Cash and bank balances c/f | 960 |
| | 63,100 | | 63,100 |

The treasurer has also been able to supply the following valuations:

| | <i>1 June 1991</i> | <i>31 May 1992</i> |
|--|--------------------|--------------------|
| | £ | £ |
| Subscriptions in arrears | 350 | 460 |
| Subscriptions in advance | 160 | 60 |
| Owing to bar suppliers | 1,300 | 1,650 |
| Bar stocks | 2,670 | 2,330 |
| Production expenses owing | 2,490 | 1,540 |
| Stationery, printing & publicity prepaid | 400 | 300 |
| Valuation of bar equipment | 14,500 | 11,500 |
| Valuation of theatre equipment | 35,000 | 46,000 |

The club's chairman is keen that the report given to members should bring out the profit or loss made by the bar and the surplus or deficit made on theatre productions. Only those items that can be directly allocated to the bar or the theatre productions are to be included.

Requirements

(a) Prepare the club's subscriptions account using the ledger account below:

| Subscriptions | | | |
|---------------|---|--|---|
| | £ | | £ |
| | | | |
| | | | |
| | | | |
| | | | |

(b) Prepare the bar trading account by completing the boxes in the statements below:

(i) Bar purchases

| | £ | | £ |
|--|---|--|---|
| | | | |
| | | | |
| | | | |

(ii) Bar trading account for the year ended 31 May 1992

| | | |
|---------------------------|-------|---|
| | £ | £ |
| Sales | | █ |
| Less cost of goods sold: | | |
| Stock at start of year | █ | |
| Purchases | █ | |
| | █ | |
| Stock at end of year | █ | |
| | █ | █ |
| Gross profit | | █ |
| Less expenses: | | |
| Bar expenses | 4,180 | |
| Depreciation: £ █ - £ █ = | █ | |
| | | █ |
| Net profit | | █ |

(c) Prepare the productions trading account by inserting the missing items into the boxes in the statements below:

(i) Productions expenses

| | | | |
|---|---|---|---|
| | £ | | £ |
| █ | █ | █ | █ |
| █ | █ | █ | █ |
| | █ | | █ |

(ii) Depreciation of theatre equipment

| | | | |
|---|---|---|---|
| | £ | | £ |
| █ | █ | █ | █ |
| █ | █ | █ | █ |
| | █ | | █ |

(iii) Productions trading account for the year ended 31 May 1992

| | | |
|-----------------------------------|-----|---|
| | £ | £ |
| Ticket sales | | █ |
| Less cost of productions: | | |
| Productions expenses | █ | |
| Fees of guest artists | 900 | |
| Depreciation of theatre equipment | █ | |
| | █ | █ |
| Deficit on productions | | █ |

(d) Prepare the Questing Theatre Club's income and expenditure account for the year ended 31 May 1992 by inserting the missing items into the statements below.

(i) Stationery, printing and publicity

| | | | |
|---|---|---|---|
| | £ | | £ |
| █ | █ | █ | █ |
| █ | █ | █ | █ |
| | █ | | █ |

- (ii) Questing Theatre Club: income and expenditure account for the year ended 31 May 1992

| | £ | £ |
|------------------------------------|--------------|---------------|
| Income | | |
| Member subscriptions | | █ |
| Donations | | 500 |
| Surplus on bar | | █ |
| Grants and subsidies | | <u>13,800</u> |
| | | █ |
| Expenditure | | |
| Deficit on productions | █ | |
| Secretarial expenses | 550 | |
| Rent of premises | 1,990 | |
| Stationery, printing and publicity | █ | |
| Other expenses | <u>4,820</u> | |
| | | █ |
| Surplus | | <u>█</u> |

Solutions to Revision Questions



Solution 1

1.1 Answer: (D)

Accumulated fund is equivalent to capital, so answer D is correct.

1.2 Answer: (C)

An income and expenditure account is commonly prepared by a not-for-profit organisation as an alternative to a profit and loss account (as such organisations do not exist to make profits). A summary of cash and bank transactions, and a receipts and payments account, are one and the same thing: they both include capital transactions, for example, payments for fixed assets, and neither takes account of accrued and prepaid income or expenses. Thus answers A and B are incorrect. A balance sheet is a statement of assets, liabilities and capital or accumulated fund.

1.3 The calculation is:

| | |
|--------------------------------|--------|
| | £ |
| Subscriptions received in 1995 | 12,500 |
| Less relating to 1994 | (800) |
| Less relating to 1996 | (400) |
| | 11,300 |
| Add subscriptions in arrears | 250 |
| | 11,550 |

1.4 Answer: (A)

Life membership represents income in advance and this is credited to a life-membership fees account. A proportion of income is transferred to the income and expenditure account over the assumed life of the membership.

1.5

| Subscriptions account | | | | | |
|-----------------------|---------------------------------|-------|--------|-------------|-------|
| | | £ | | | £ |
| 1/6/97 | Balance b/f | 150 | 1/6/97 | Balance b/f | 90 |
| 31/5/98 | Balance c/f | 75 | | Bank | 4,750 |
| 31/5/98 | Income and expenditure account* | 4,655 | | Bad debts | 40 |
| | | 4,880 | | | 4,880 |

*That is, balancing figure.

1.6 Answer: (D)

A receipts and payments account is a summary of the cash and bank transactions.

1.7

| | |
|---------------------------------|---------------|
| | £ |
| Received in year | 12,450 |
| Arrears at beginning | (50) |
| In advance at beginning | 75 |
| In advance at end | (120) |
| Total to income and expenditure | <u>12,355</u> |

1.8 Answer: (B)



Solution 2

- This is a straightforward incomplete records question, involving the calculation of several missing figures. The preparation of a 'workings' section, clearly labelled, is essential in providing these figures.
- This question also requires you to prepare a bank summary to determine the end-of-year bank balance.

Workings

| | | |
|-----------------------------|---------------|---------------|
| | £ | |
| Purchases | 45,250 | |
| Opening creditors | <u>11,000</u> | |
| | 56,250 | |
| Closing creditors | <u>9,550</u> | |
| Paid to creditors | <u>46,700</u> | |
| Sales | 80,500 | |
| Opening debtors | <u>16,200</u> | |
| | 96,700 | |
| Cheques received | <u>78,900</u> | |
| | 17,800 | |
| Closing debtors | <u>17,300</u> | |
| Cash discount | <u>500</u> | |
| Rates | | |
| Paid | 2,400 | |
| Accrued at start | <u>(400)</u> | |
| | 2,000 | |
| Prepaid at end | <u>400</u> | |
| | £ | £ |
| Bank summary | | |
| Opening balance | | 9,600 |
| Receipts | | |
| Debtors | | <u>78,900</u> |
| | | <u>88,500</u> |
| Payments | | |
| Creditors | 46,700 | |
| Wages | 9,600 | |
| Motor expenses | 2,250 | |
| General expenses | 2,550 | |
| Loan interest | 3,000 | |
| Drawings | 4,000 | |
| Rates | <u>2,400</u> | |
| | | <u>70,500</u> |
| Closing bank balance | | <u>18,000</u> |
| Depreciation | | |
| Motor vehicles 25% × £8,000 | 2,000 | |
| Fixtures 20% × £7,500 | 1,500 | |

Potter: trading and profit and loss account for the year ended 31 December 1995

| | | |
|-------------------------|---------------|---------------------|
| | £ | £ |
| Sales | | 80,500 |
| Less cost of sales | | |
| Opening stock | 18,800 | |
| Purchases | 45,250 | |
| | 64,050 | |
| Less closing stock | <u>16,000</u> | |
| | | 48,050 |
| Gross profit | | <u>32,450</u> |
| Less expenses | | |
| Discounts allowed | 500 | |
| Wages and salaries | 9,600 | |
| Rates | 1,600 | |
| Motor expenses | 2,750 | |
| General expenses | 2,550 | |
| Loan interest | 3,000 | |
| Depreciation | <u>3,500</u> | |
| | | 23,500 |
| Net profit for the year | | <u><u>8,950</u></u> |

Potter: balance sheet at 31 December 1995

| | <i>Cost (£)</i> | <i>Accumulated dep'n (£)</i> | <i>NBV (£)</i> |
|-----------------------------------|-----------------|------------------------------|-----------------------|
| <i>Fixed assets</i> | | | |
| Land and buildings | 80,000 | – | 80,000 |
| Motor vehicles | 20,000 | 14,000 | 6,000 |
| Fixtures | 13,500 | 7,500 | 6,000 |
| | <u>113,500</u> | <u>21,500</u> | <u>92,000</u> |
| <i>Current assets</i> | | | |
| Stocks | | 16,000 | |
| Debtors | | 17,300 | |
| Prepayments | | 400 | |
| Bank | | 18,000 | |
| | | <u>51,700</u> | |
| <i>Less current liabilities</i> | | | |
| Creditors | 9,550 | | |
| Accrued expenses | | | |
| Motor expenses | 500 | | |
| Loan interest | <u>1,500</u> | | |
| | | <u>11,550</u> | |
| | | | 40,150 |
| | | | <u>132,150</u> |
| <i>Less long-term liabilities</i> | | | |
| Loan | | | 30,000 |
| | | | <u>102,150</u> |
| <i>Financed by</i> | | | |
| Capital at 1 January | | | 97,200 |
| Profit for the year | | | 8,950 |
| | | | <u>106,150</u> |
| Less drawings | | | 4,000 |
| | | | <u><u>102,150</u></u> |

**Solution 3**

- Prepare workings for missing figures.
- Take care with subscriptions in advance and in arrears.
- An income and expenditure account is drawn up using the same principles as a profit and loss account. Revenue is earned during the period, irrespective of its receipt or non-receipt, and expenditure includes expenses incurred during the period, irrespective of payment.

| Workings | |
|--------------------------------|---------------|
| <i>Purchases</i> | |
| | £ |
| Paid to creditors | 93,030 |
| Less opening creditors | <u>2,270</u> |
| | <u>90,760</u> |
| <i>Equipment</i> | |
| Book value at 1 January | 5,400 |
| Proceeds of sale | <u>2,400</u> |
| Loss on disposal | <u>3,000</u> |
| <i>Subscriptions</i> | |
| Received during year | 4,120 |
| In advance at start of year | 480 |
| In arrears at end of year | <u>280</u> |
| | 4,880 |
| Less in advance at end of year | <u>350</u> |
| Income and expenditure account | <u>4,530</u> |

(a) Long Lane Social Club: bar trading account for the year ended 31 December 1995

| | | |
|--------------------|---------------|---------------|
| | £ | £ |
| Sales | | 139,050 |
| Less cost of sales | | |
| Opening stock | 9,500 | |
| Purchases | <u>92,720</u> | |
| | 102,220 | |
| Less closing stock | <u>8,350</u> | |
| | | <u>93,870</u> |
| Gross profit | | 45,180 |
| Less expenses: | | |
| Barperson's wages | 9,500 | |
| Bar licence fees | <u>2,000</u> | |
| | | <u>11,500</u> |
| Net profit | | <u>33,680</u> |

(b) Long Lane Social Club: income and expenditure account for the year ended 31 December 1995

| | £ | £ | £ |
|-----------------------------|--------------|--------------|----------------------|
| Income | | | |
| Bar profit | | 33,680 | |
| Profit on refreshments: | | | |
| Sales | 5,400 | | |
| Purchases | <u>2,890</u> | | |
| | | 2,510 | |
| Subscriptions | | 4,530 | |
| Interest receivable | | <u>1,000</u> | |
| | | | 41,720 |
| <i>Expenditure:</i> | | | |
| Loss on dance: ticket sales | 1,880 | | |
| Expenses | <u>2,700</u> | | |
| | | 820 | |
| Cleaner's wages | | 4,340 | |
| Secretary's expenses | | 3,690 | |
| General expenses | | 2,090 | |
| Rates | | 3,520 | |
| Loss on sale of equipment | | 3,000 | |
| Depreciation | | <u>800</u> | |
| | | | 18,260 |
| Surplus for the year | | | <u><u>23,460</u></u> |

(c) Long Lane Social Club: balance sheet at 31 December 1995

| | Cost (£) | Accumulated dep'n (£) | NBV (£) |
|--|----------------|-----------------------|----------------|
| <i>Fixed assets</i> | | | |
| Premises | 105,000 | – | 105,000 |
| Equipment | 8,000 | 800 | 7,200 |
| | <u>113,000</u> | <u>800</u> | 112,200 |
| Building society investment | | | 17,000 |
| <i>Current assets</i> | | | |
| Bar stocks | | 8,350 | |
| Subscriptions in arrears | | 280 | |
| Rates prepaid | | 1,100 | |
| Bank | | <u>7,290</u> | |
| | | 17,020 | |
| <i>Current liabilities</i> | | | |
| Creditors | 1,960 | | |
| Subscriptions in advance | <u>350</u> | | |
| | | <u>2,310</u> | |
| | | | 14,710 |
| | | | <u>143,910</u> |
| <i>Accumulated fund</i> | | | |
| Balance at 1 January 1995 (see note i) | | | 120,450 |
| Surplus for the year | | | <u>23,460</u> |
| | | | <u>143,910</u> |

Note:

(i) The opening accumulated fund can be taken as the balancing figure, as the question does not specifically ask for a separate calculation of this. However, if you wish to check the accuracy of the figure, then an opening statement of affairs can be produced.

Long Lane Social Club: statement of affairs at 1 January 1995

| | £ | £ |
|--------------------------|------------|-----------------------|
| <i>Assets</i> | | |
| Premises | | 105,000 |
| Equipment | | 5,400 |
| Bar stocks | | 9,500 |
| Rates prepaid | | 1,000 |
| Bank | | <u>2,300</u> |
| | | 123,200 |
| <i>Less liabilities</i> | | |
| Creditors | 2,270 | |
| Subscriptions in advance | <u>480</u> | |
| | | <u>2,750</u> |
| | | <u><u>120,450</u></u> |

**Solution 4**

- Identify the capital and revenue receipts/payments.
- Adjust the receipts and payments for the effects the notes produce.
- Prepare the accounts in good format.

(a) (i) Subscriptions:

| | | |
|-------------------------------------|---|---------------------|
| | £ | |
| Subscriptions received for the year | | 12,600 |
| Subscriptions accrued for the year | | <u>1,500</u> |
| Total subscriptions for the year | | <u>14,100</u> |
| Subscriptions for the 6 months | | <u><u>7,050</u></u> |

(ii) Profit from the sale of club ties:

| | | |
|--------------------|------------|-------------------|
| | £ | £ |
| Sales of ties | | 373 |
| Purchases of ties | 450 | |
| Less closing stock | <u>180</u> | |
| | | <u>270</u> |
| Profit | | <u><u>103</u></u> |

(iii) Life-membership fees:

| | | |
|-------------------------------|---|-------|
| | £ | |
| Amounts received | | 4,200 |
| Annual equivalent | | 420 |
| Amount to include in accounts | | 210 |

(iv) Depreciation of equipment:

| | | |
|-------------------------------|---|-------|
| | £ | |
| Cost | | 4,080 |
| Annual depreciation: | | 806 |
| Amount to include in accounts | | 403 |

- (b) HB Tennis Club: income and expenditure account – six months ended 30 September 1990

| | £ | £ |
|---|------------|-------------------|
| Income | | |
| Subscriptions | | 7,050 |
| Income from tournaments (465–132) | | 333 |
| Bank interest received | | 43 |
| Profit from sale of club ties | | 103 |
| Life membership ($4 \times \pounds^{1,050}_{10} \times \frac{6}{12}$) | | <u>210</u> |
| | | 7,739 |
| Expenditure | | |
| Groundsperson's wages ($\pounds 4,520 + \pounds 40$) | 4,560 | |
| Rent and business rates ($\pounds 636 - \pounds 68$) | 568 | |
| Heat and light ($\pounds 674 + \pounds 53$) | 727 | |
| Postage and stationery ($\pounds 41 + \pounds 12$) | 53 | |
| Court maintenance | 1,000 | |
| Depreciation of equipment | <u>403</u> | |
| | | 7,311 |
| Excess of income over expenditure | | <u><u>428</u></u> |



Solution 5

- The bar trading account requires a calculation of bar purchases.
- A separate 'surplus on theatre productions' calculation is required.
- The theatre productions deficit includes depreciation of the theatre equipment (but not the cost of the equipment, as this is a capital item). The value of the theatre equipment has gone up during the year owing to the new purchases, but has then fallen to take account of depreciation.
- The income and expenditure account follows the normal accounting rules involved in the preparation of profit and loss accounts, that is, it should include the income earned and the expenses consumed during the period, with relevant adjustments for accruals and prepayments.
- Grants and subsidies are to be treated as revenue receipts on the assumption that they were received in respect of revenue expenditure.

- (a) Subscriptions

| | | | |
|------------------------------|---------------------|------------------------------|---------------------|
| | £ | | £ |
| Subscriptions in arrears b/f | 350 | Subscriptions in advance b/f | 160 |
| Subscriptions in advance c/f | 60 | Receipts | <u>4,460</u> |
| Income and expenditure | <u>4,670</u> | Subscriptions in arrears c/f | <u>460</u> |
| | <u><u>5,080</u></u> | | <u><u>5,080</u></u> |

(b) (i) Bar purchases

| | | | |
|-----------------------|---------------|-----------------|---------------|
| Payments to suppliers | £ 14,700 | Owing at 1.6.91 | £ 1,300 |
| Owing at 31.5.92 | <u>1,650</u> | Purchases | <u>15,050</u> |
| | <u>16,350</u> | | <u>16,350</u> |

(ii) Bar trading account for the year ended 31 May 1992

| | | |
|--------------------------------|----------------|---------------|
| Sales | £ | £ 25,900 |
| Less: cost of goods sold | | |
| Stock at start of year | 2,670 | |
| Purchases | <u>15,050</u> | |
| | 17,720 | |
| Stock at end of year | <u>(2,330)</u> | |
| | | 15,390 |
| Gross profit | | <u>10,510</u> |
| Less | | |
| Bar expenses | 4,180 | |
| Depreciation (14,500 – 11,500) | <u>3,000</u> | |
| | | 7,180 |
| Bar profit | | <u>3,330</u> |

(c) (i) Productions expenses

| | | | |
|------------------|---------------|-----------------|---------------|
| Payments | £ 18,800 | Owing at 1.6.91 | £ 2,490 |
| Owing at 31.5.92 | <u>1,540</u> | Purchases | <u>17,850</u> |
| | <u>20,340</u> | | <u>20,340</u> |

(ii) Depreciation of theatre equipment

| | | | |
|-----------------|---------------|------------------|---------------|
| Value at 1.6.91 | £ 35,000 | Value at 31.5.92 | £ 46,000 |
| Purchases | <u>15,100</u> | Depreciation | <u>4,100</u> |
| | <u>50,100</u> | | <u>50,100</u> |

(iii) Productions trading account for the year ended 31 May 1992

| | | |
|----------------------------|--------------|----------------|
| Ticket sales | £ | £ 17,320 |
| Less cost of productions: | | |
| Productions expenses | 17,850 | |
| Fees of guest artists | 900 | |
| Dep'n of theatre equipment | <u>4,100</u> | |
| | | 22,850 |
| Deficit on productions | | <u>(5,530)</u> |

(d) (i) Stationery, publicity and printing

| | | | |
|--------------------|--------------|--------------------|--------------|
| Prepaid at 31.5.91 | £ 400 | Prepaid at 31.5.92 | £ 300 |
| Payments | <u>1,100</u> | Expenditure | <u>1,200</u> |
| | <u>1,500</u> | | <u>1,500</u> |

(ii) Questing Theatre Club: income and expenditure account, year ended 31 May 1992

| | | |
|------------------------------------|--------------|---------------|
| | £ | £ |
| Income | | |
| Member subscriptions | | 4,670 |
| Donations | | 500 |
| Surplus on bar | | 3,330 |
| Grants and subsidies* | | <u>13,800</u> |
| | | 22,300 |
| Expenditure: | | |
| Deficit on productions | 5,530 | |
| Secretarial expenses | 550 | |
| Rent of premises | 1,990 | |
| Stationery, printing and publicity | 1,200 | |
| Other expenses | <u>4,820</u> | |
| | | 14,090 |
| Surplus | | <u>8,210</u> |

*Grants and subsidies have been treated as revenue receipts.

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The Manufacturing Account

12

LEARNING OUTCOME

When you have completed this chapter, you should be able to:

- ▶ prepare manufacturing accounts.

12.1 Introduction

In our examples so far we have been dealing with businesses that purchase goods for onward sale to customers – in other words, with retail and wholesale businesses. We now turn our attention to manufacturing businesses.

In most respects the accounts of a manufacturing business show no differences from what we have already learned. Its balance sheet will be identical, though it is worth noting that the asset of stock in a manufacturing company will be made up of three separate items: *finished goods* (those already manufactured and ready for sale to customers), *work in progress* (i.e. partly completed goods), and *raw materials* purchased from suppliers and not yet used in production.

The trading and profit and loss account will be almost identical. The one exception is that instead of the cost of finished goods purchased in the year, the trading account will show the cost of finished goods manufactured in the year.

It is this final item that leads to the one major difference in the accounts of a manufacturing business. Establishing the cost of finished goods manufactured in the year is not such a simple process as finding the total of finished goods purchased by a retailer. Indeed, it requires a whole new accounting statement – the *manufacturing account* – to arrive at this cost.

12.2 Why is a manufacturing account needed?

Manufacturers may sell their finished product directly to the public, or may sell it to a wholesaler/retailer or to another trading organisation. The trading and profit and loss accounts are used to bring together the income and costs of trading and operating the business, and this still applies to a manufacturing business. However, the calculation of the cost of goods sold by a retail or wholesale organisation is fairly straightforward, that is,

opening stock, plus purchases, less closing stock. Calculating the costs of manufacturing products is often more complex than this, as the firm will incur not only the cost of materials but also labour costs and other expenses incurred in manufacturing. The manufacturing account is used to bring together the costs of manufacturing during the period.

12.2.1 Stocks in manufacturing organisations

The manufacturing process will involve three stages:

Stage 1. The acquisition of raw materials.

Stage 2. The modification or processing of those materials, with the addition of labour and other expenses.

Stage 3. The production of finished goods.

However, some raw materials purchased during a period will still be unmodified at the end of the period, while some will only be partly modified. In addition, there will be some finished goods produced during the period that remain unsold. The organisation might also buy in ready-made items for sale. Therefore, at the beginning and end of a period, there could be four types of stock on the balance sheet:

- raw materials;
- work in progress (partly finished goods);
- finished goods;
- bought-in goods.

It is important to remember that the trading account must still be used to show the sales revenue earned and the cost of goods sold, not the cost of goods manufactured. The trading account will therefore bring together opening stocks of finished goods, cost of completed goods manufactured during the period, less closing stocks of finished goods. The manufacturing account will contain all of the manufacturing costs, with adjustments for opening and closing stocks of raw materials and work in progress.

It is also important to appreciate that the manufacturing account is used solely to bring together *costs* – it does not include any revenue from sales.

12.3 Costs to include in the manufacturing account

We have already mentioned that the costs of raw materials will be contained within the manufacturing account. The calculation of raw materials consumed in the manufacturing process is exactly the same as the calculations you have previously used in the trading account of retail and wholesale organisations, that is:

- opening stock of raw materials;
- *plus* purchases of raw materials (including carriage inwards and less returns);
- *less* closing stock of raw materials.

However, other manufacturing costs must also be considered.



The following terms are considered key to understanding the manufacturing account.

12.3.1 Other direct costs

A direct cost is one that can be identified with units of production; very often it is a cost that varies according to the level of production. You will learn more about this cost behaviour in your studies of *Management Accounting Fundamentals*. Obviously, raw materials are direct costs in that they directly vary with the level of production.

Examples of other direct costs are:

- direct labour (also known as production labour) – the wages and associated costs of those producing the goods;
- direct expenses – other costs that can be identified with units of production. These are more difficult to establish, as most expenses are more general in nature, but examples of direct expenses might be equipment hire for a special production run, power costs for a particular machine, and royalties payable on the production of certain products. You will not encounter direct expenses very often, however, and such expenses are likely to be highlighted if they are to be regarded as such.

12.3.2 Prime cost

The prime cost is the total of direct costs, that is, direct materials consumed, direct labour and direct expenses (if any). It should be clearly shown as a subtotal in the manufacturing account.

12.3.3 Indirect costs

These include all the other costs of manufacturing that are not part of prime cost. They are also referred to as *manufacturing overheads*, *production overheads* or *factory overheads*. Examples include:

- factory rent and rates;
- factory heating, lighting, insurance;
- wages and salaries paid to factory supervisors and maintenance engineers (also known as *indirect factory labour*);
- depreciation of fixed assets used in manufacturing.

Note that only costs associated with manufacturing are included. Do not include costs associated with selling, distribution of goods sold, or general administrative costs.

12.3.4 Factory cost of production

Factory cost of production is the total of prime cost and indirect costs consumed in the factory, and is another important subtotal to be shown in the manufacturing account.

12.3.5 Work in progress

The factory cost of production is the total of new costs introduced to the factory. However, there may already be some work in progress in the factory system at the start of the period. Some of this will be completed during the period, but there will probably still be some unfinished, and some new work in progress at the end of the period. We need to adjust the factory cost of production to add in the opening work in progress and deduct the closing work in progress. This is shown in the final section of the manufacturing account.

12.3.6 Factory cost of goods completed

This is the end result of the manufacturing account, and its balance is transferred to the trading account in the same way as the purchase of raw materials is transferred there in the accounts of a retailer or wholesaler.

12.4 Layout of a manufacturing account

Here is an example of a manufacturing account layout.

Manufacturing account for the year ended 31 December 20X1

| | | |
|-------------------------------------|-----------------|-----------------------|
| | £ | £ |
| Opening stock of raw materials | | 12,000 |
| Purchases of raw materials | | 235,000 |
| | | <u>247,000</u> |
| Closing stock of raw materials | | (14,000) |
| Raw materials consumed | | <u>233,000</u> |
| Direct manufacturing wages | | 153,000 |
| Direct factory power | | <u>15,000</u> |
| Prime costs | | 401,000 |
| Production overhead | | |
| Factory supervisors' wages | 30,000 | |
| Heating and lighting | 16,000 | |
| Rates | <u>12,000</u> | |
| | | <u>58,000</u> |
| Factory costs incurred | | 459,000 |
| Opening work in progress | 26,000 | |
| Closing work in progress | <u>(21,000)</u> | |
| | | <u>5,000</u> |
| Factory cost of goods completed c/d | | <u><u>465,000</u></u> |

12.5 Trading accounts for manufacturing organisations

As stated earlier, the trading account is the place to show the sales revenue earned and the cost of goods sold. In manufacturing organisations, however, the calculation of cost of goods sold will not include purchases and stocks of raw materials, but will instead include the factory cost of goods completed and opening and closing stocks of finished goods.

The example below uses the factory cost of goods derived in the sample layout in section 12.3:

Trading account for the year ended 31 December 20X1

| | | |
|--------------------------------------|----------------|-----------------------|
| | £ | £ |
| Sales | | 645,000 |
| Less cost of goods sold | | |
| Opening stock of finished goods | 55,000 | |
| Factory cost of goods completed | <u>465,000</u> | |
| | | <u>520,000</u> |
| Less closing stock of finished goods | <u>35,000</u> | |
| | | 485,000 |
| Gross profit | | <u><u>160,000</u></u> |

12.6 Profit and loss accounts for manufacturing organisations

These are exactly as for other organisations. They will contain sundry revenues and all other expenses incurred in running the business that have not already been accounted for in the manufacturing and trading accounts.

12.7 Balance sheets for manufacturing organisations

These are also prepared as for other organisations, except that there is likely to be three or four types of stocks to be shown, that is:

- raw materials;
- work in progress;
- finished goods (manufactured goods);
- bought-in goods for resale.

12.8 The accounting system for manufacturing organisations

Ledger accounts will be prepared in the same way as for other organisations, except that there will be additional ledger accounts for items connected with manufacturing, such as direct factory labour, indirect factory labour, and stocks of work in progress and finished goods. Some items of expense, however, may not be separately established or invoiced. For example, premises insurance might consist of a single invoice covering all the buildings. In such cases, it is necessary to apportion the expenses between manufacturing and other elements (often described as ‘factory’ and ‘office’). In examination questions, you will be told what proportions to apply.

The manufacturing account is a ledger account, and therefore forms part of the double-entry system. The items that appear in it will all have an equivalent opposite entry in either the nominal ledger or the trading account.

The key to questions in this area is to adopt a methodical approach. Remember that your aim in the manufacturing account is to arrive at the total cost of manufacturing the finished goods completed in the year. This can be regarded as comprising three elements:

- the costs directly attributable to the goods produced (such as the raw materials they contain, and the wages of personnel directly involved in manufacturing);
- the indirect factory costs (sometimes called factory overheads). These might include the costs of heating and lighting the factory, the rent on factory premises, and the wages of factory supervisors;
- an adjustment for opening and closing work in progress, similar to the treatment of opening and closing stock of finished goods in a trading account.

Example 12.A

G Club is a manufacturer of spare parts and the following balances were some of those appearing in his books at 31 December year 4.

| | |
|------------------------------|---------|
| | £ |
| Capital | 56,932 |
| Stocks at 1 January year 4 | |
| Raw materials | 11,000 |
| Work in progress | 16,000 |
| Finished goods | 20,090 |
| Stocks at 31 December year 4 | |
| Raw materials | 17,000 |
| Work in progress | 18,000 |
| Finished goods | 18,040 |
| Wages | |
| Direct manufacturing | 203,080 |
| Factory supervisors | 13,325 |
| General office | 10,200 |
| Warehouse | 19,300 |
| Direct factory power | 95,000 |
| Heating and lighting | 9,000 |
| Purchase of raw materials | 256,000 |
| Carriage outwards | 986 |
| Plant and machinery | 80,000 |
| Premises | 120,000 |
| Returns inwards | 420 |
| Office equipment | 15,000 |
| Rates | 6,000 |
| Administrative expenses | 1,800 |
| Debtors | 14,000 |
| Creditors | 12,000 |
| Cash in hand | 3,662 |
| Sales | 800,290 |
| Bank overdraft | 25,641 |

For the year ended 31 December year 4, you are required to prepare:

- the manufacturing account of G Club;
- the trading account of G Club;
- the profit and loss account of G Club;
- the closing balance sheet of G Club.

The costs of heating and lighting, and rates, are to be apportioned as follows: factory $\frac{1}{2}$; warehouse $\frac{1}{3}$; offices $\frac{1}{6}$.

Solution

(a) Manufacturing account of G Club for the year ended 31 December year 4

| | | |
|-------------------------------------|-----------------|----------------|
| | £ | £ |
| Opening stock of raw materials | | 11,000 |
| Purchases of raw materials | | 256,000 |
| | | <u>267,000</u> |
| Closing stock of raw materials | | (17,000) |
| Raw materials consumed | | <u>250,000</u> |
| Direct manufacturing wages | | 203,080 |
| Direct factory power | | <u>95,000</u> |
| Prime cost | | 548,080 |
| Production overhead: | | |
| Factory supervisors' wages | 13,325 | |
| Heating and lighting | 4,500 | |
| Rates | <u>3,000</u> | |
| | | 20,825 |
| | | <u>568,905</u> |
| Factory costs incurred | | |
| Opening work in progress | 16,000 | |
| Closing work in progress | <u>(18,000)</u> | |
| | | (2,000) |
| Factory cost of goods completed c/d | | <u>566,905</u> |

(b) Trading account of G Club for the year ended 31 December year 4

| | | |
|-------------------------------------|-----------------|----------------|
| | £ | £ |
| Sales | | 800,290 |
| Less returns inwards | | (420) |
| | | <u>799,870</u> |
| Opening stock of finished goods | 20,090 | |
| Factory cost of goods completed b/d | <u>566,905</u> | |
| | 586,995 | |
| Closing stock of finished goods | <u>(18,040)</u> | |
| | | (568,955) |
| Gross profit c/d | | <u>230,915</u> |

(c) Profit and loss account of G Club for the year ended 31 December year 4

| | | | |
|--------------------------------|--------------|------------|----------------|
| | £ | £ | £ |
| Gross profit b/d | | | 230,915 |
| Warehouse costs | | | |
| Wages | 19,300 | | |
| Heating and lighting | 3,000 | | |
| Rates | <u>2,000</u> | | |
| | | 24,300 | |
| Office costs | | | |
| Wages | 10,200 | | |
| Heating and lighting | 1,500 | | |
| Rates | 1,000 | | |
| Administration expenses | <u>1,800</u> | | |
| | | 14,500 | |
| Selling and distribution costs | | | |
| Carriage outwards | | <u>986</u> | |
| | | | 39,786 |
| Net profit for the year | | | <u>191,129</u> |

(d) Balance sheet of G Club at 31 December year 4

| | £ | £ | £ |
|----------------------------|---------------|---------------|----------------|
| <i>Fixed assets</i> | | | |
| Premises | 120,000 | | |
| Plant and machinery | | | 80,000 |
| Office equipment | | | <u>15,000</u> |
| | | | 215,000 |
| <i>Current assets</i> | | | |
| Stocks | | | |
| Raw materials | 17,000 | | |
| Work in progress | 18,000 | | |
| Finished goods | <u>18,040</u> | | |
| | | 53,040 | |
| Debtors | | 14,000 | |
| Cash in hand | | <u>3,662</u> | |
| | | <u>70,702</u> | |
| <i>Current liabilities</i> | | | |
| Creditors | 12,000 | | |
| Bank overdraft | <u>25,641</u> | | |
| | | (37,641) | |
| <i>Net current assets</i> | | | <u>33,061</u> |
| <i>Net assets</i> | | | <u>248,061</u> |
| <i>Financed by</i> | | | |
| Capital b/f | | | 56,932 |
| Add net profit | | | <u>191,129</u> |
| Capital employed | | | <u>248,061</u> |



Exercise 12.1

What are the component parts of prime cost?



Solution

The component parts of prime cost are direct materials, direct labour and direct expenses (overheads).

12.9 Summary

In this chapter we have looked at the production of a manufacturing, trading and profit and loss account and balance sheet for a manufacturing organisation. You should be able to identify the items that are to be included in the manufacturing account, in particular:

- the calculation of prime cost;
- factory cost of production;
- factory cost of goods completed;
- the adjustment for work in progress at the beginning and end of the period.

You should appreciate that the only difference in the trading account from that of a non-manufacturing organisation is the substitution of 'factory cost of goods completed' instead of 'purchases', and that the balance sheet may contain up to four different types of stock.

Manufacturing accounts are quite straightforward if you take care with your workings, and adopt a methodical approach. Make sure that you clearly label workings, and refer to them in your final answer: this is much clearer to the examiner than attempting to squash them on to the face of the accounts themselves, as some of them may involve several elements to their calculation. A suggested approach is as follows:

- *Step 1.* Read the question completely before starting. Note particularly if a balance sheet is required or not.
- *Step 2.* Label the trial balance with the destination of the various items – remember that some items will appear both in the manufacturing account and in the profit and loss account. Again, if a balance sheet is not required, you will not need all of the items on the balance sheet (e.g. bank balances, debtors, creditors).
- *Step 3.* Set out a page of workings before you start. Work through the notes to the accounts, in the order given, and make the necessary adjustments:
 - adjust the trial balance figures for any accruals and prepayments, then split between manufacturing and profit and loss accounts;
 - calculate depreciation, and split between manufacturing and profit and loss accounts;
 - calculate any other adjustments, for example, bad debts, provision for bad debts;
 - adjust for any other items, such as goods on sale or return, errors and corrections.
- *Step 4.* Commence your manufacturing account, and enter all relevant figures, using your workings where necessary:
 - raw materials opening stocks, plus purchases, less closing stocks (remember to adjust for returns outwards and carriage inwards);
 - other direct costs, for example, wages, direct power, to give prime cost;
 - indirect factory costs (production overheads);
 - adjust for work in progress (add opening stock, deduct closing stock);
 - the final result is the factory cost of goods completed, which goes to your trading account.
- *Step 5.* Prepare the trading account:
 - sales, less returns inwards;
 - less cost of goods sold;
 - opening stock of finished goods, plus factory cost of goods completed, less closing stock of finished goods;
 - the result is gross profit.
- *Step 6.* Prepare the profit and loss account, using your workings where necessary.
- *Step 7.* Prepare the balance sheet (if required), remembering that you are likely to have several types of closing stock to show.

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Revision Questions

12

? Question 1 Multiple choice

1.1 The following information relates to a company at its year end:

| | |
|----------------------------|---------|
| Stock at beginning of year | £ |
| Raw materials | 10,000 |
| Work in progress | 2,000 |
| Finished goods | 34,000 |
| Stock at end of year | |
| Raw materials | 11,000 |
| Work in progress | 4,000 |
| Finished goods | 30,000 |
| Purchases of raw materials | 50,000 |
| Direct wages | 40,000 |
| Royalties on goods sold | 3,000 |
| Production overheads | 60,000 |
| Distribution costs | 55,000 |
| Administration expenses | 70,000 |
| Sales | 300,000 |

The cost of goods manufactured during the year is:

£.....

1.2 If work in progress decreases during the period, then:

- (A) prime cost will decrease.
- (B) prime cost will increase.
- (C) the factory cost of goods completed will decrease.
- (D) the factory cost of goods completed will increase.

1.3 An increase in the figure for work in progress will:

- (A) increase the prime cost.
- (B) decrease the prime cost.
- (C) increase the cost of goods sold.
- (D) decrease the factory cost of goods completed.

1.4 Your firm has the following manufacturing figures:

| | |
|---------------------------------|--------|
| Prime cost | £ |
| Factory overheads | 56,000 |
| Opening work in progress | 4,500 |
| Factory cost of goods completed | 6,200 |
| | 57,000 |

Closing work in progress is:

£.....

- 1.5 The prime cost of goods manufactured is the total of:
- (A) all factory costs before adjusting for work in progress.
 - (B) all factory costs of goods completed.
 - (C) all materials and labour.
 - (D) direct factory costs.

- 1.6 The following information relates to M Ltd:

| <i>At 30 September</i> | <i>2000</i> | <i>1999</i> |
|------------------------------|--------------|--------------|
| | <i>£,000</i> | <i>£,000</i> |
| Stock of raw materials | 75 | 45 |
| Work in progress stock | 60 | 70 |
| Stock of finished goods | 100 | 90 |
| <i>For the year ended 30</i> | | |
| Purchases of raw materials | 150,000 | |
| Manufacturing wages | 50,000 | |
| Factory overheads | 40,000 | |

The prime cost of production in the manufacturing account for the year ended 30 September 2000 is:

£.....



Question 2

M makes agricultural machinery, for sale to major suppliers in the industry. The following figures are extracted from his trial balance at the end of the most recent year.

| | |
|---------------------------------------|--------------|
| | <i>£,000</i> |
| Sales | 2,200 |
| Purchases of parts | 650 |
| Carriage inwards | 40 |
| Carriage outwards | 100 |
| Returns inwards | 80 |
| Returns outwards | 60 |
| Manufacturing labour | 200 |
| Factory supervisory labour | 75 |
| Office salaries | 108 |
| Other costs | |
| Heating and lighting | 165 |
| Rent, rates and insurance | 122 |
| Factory machinery at cost | 1,000 |
| Depreciation of factory machinery b/f | 400 |
| Delivery vehicles at cost | 300 |
| Depreciation of vehicles b/f | 100 |
| Office machinery at cost | 120 |
| Depreciation of office machinery b/f | 80 |
| Opening stocks | |
| Raw materials | 175 |
| Work in progress | 425 |
| Finished goods | 115 |

At the end of the year, the following information is also available:

(a)

| | |
|------------------|--------------|
| | <i>£,000</i> |
| Closing stocks | |
| Raw materials | 147 |
| Work in progress | 392 |
| Finished goods | 138 |

(b)

| | |
|------------------------|-------------|
| | <i>£000</i> |
| Heat and light accrued | 15 |
| Rent and rates prepaid | 22 |

- (c) Seventy-five per cent of heat, light, rent, rates and insurance is considered to be applicable to the manufacturing processes.
- (d) Depreciation is to be provided as follows:
- factory machinery, 10 per cent, straight line;
 - delivery vehicles, 20 per cent, reducing balance;
 - office machinery, 25 per cent, reducing balance.
- (e) Delivery vehicles are used entirely for the delivery of finished goods.
- (f) Office machinery is used 25 per cent for the operation of factory information systems.

Requirements

(a) Insert the missing items into the manufacturing account below:

M: manufacturing account for the year ended ...

| | <i>£000</i> | <i>£000</i> |
|---|---------------|-------------|
| Opening stocks of raw materials | | 175 |
| Purchases | 650 | |
| Carriage inwards/outwards* | <u> </u> | |
| | <u> </u> | |
| Less: returns inwards/outwards* | <u> </u> | <u> </u> |
| | | <u> </u> |
| Less closing stock of raw materials | | <u>147</u> |
| Direct materials | | <u> </u> |
| Direct labour | | <u> </u> |
| Factory indirect overheads | <u> </u> | <u> </u> |
| Heat and light <u> </u> % × £ <u> </u> | = <u> </u> | |
| Rent, rates & insurance <u> </u> % × £ <u> </u> | = <u> </u> | |
| Depreciation | | |
| Factory machinery <u> </u> % × £ <u> </u> | = <u> </u> | |
| Factory cost of production | | <u> </u> |
| Opening work in progress | 425 | |
| Add/less*: closing work in progress | <u>392</u> | |
| | | <u> </u> |
| Factory cost of goods completed | | <u> </u> |

*Delete where appropriate.

THE MANUFACTURING ACCOUNT

(b) Insert the missing items into the trading and profit and loss account below:

M: trading and profit and loss account for the year ended . . .

| | £000 | £000 |
|---|---------------------|-------------------|
| Sales | | 2,200 |
| Less: returns inwards/outwards* | | <u> </u> |
| | | <u> </u> |
| Less cost of goods sold: | | |
| Opening stock of finished goods | 115 | |
| <u> </u> | <u> </u> | |
| Less: closing stock of finished goods | <u> </u> | <u> </u> |
| | | <u> </u> |
| Gross profit | | <u> </u> |
| Expenses | | |
| Carriage inwards/outwards* | <u> </u> | |
| Office salaries | 108 | |
| Heat and light % × £ <u> </u> | = <u> </u> | |
| Rent, rates & insurance % × £ <u> </u> | = <u> </u> | |
| Depreciation | | |
| Delivery vehicles % × £ <u> </u> | = <u> </u> | |
| Office machinery % × £ <u> </u> | = <u> </u> | |
| | | <u> </u> |
| Net profit | | <u> </u> |

*Delete where appropriate.

Solutions to Revision Questions

12



Solution 1

1.1 Cost of goods manufactured is found as follows:

| | |
|-------------------------------------|-----------------------|
| | £ |
| Opening stock of raw materials | 10,000 |
| Purchases of raw materials | 50,000 |
| Less closing stock of raw materials | <u>(11,000)</u> |
| | 49,000 |
| Direct wages | 40,000 |
| Prime cost | <u>89,000</u> |
| Production overheads | 60,000 |
| | <u>149,000</u> |
| Less increase in work in progress | <u>(2,000)</u> |
| Cost of goods manufactured | <u><u>147,000</u></u> |

1.2 Answer: (D)

A decrease in work in progress means fewer goods are partly complete, thus the value of completed goods will be higher.

1.3 Answer: (D)

(A) and (B) are incorrect as work in progress has no effect on prime cost. The change in work in progress has no effect on cost of goods sold, as this depends on stock of finished goods, therefore (C) is incorrect. An increase in work in progress means that more production is in a partly finished state and therefore less has been completed.

1.4

| | |
|---------------------------------|---------------------|
| | £ |
| Prime cost | 56,000 |
| Factory overheads | 4,500 |
| Opening WIP | 6,200 |
| Factory cost of goods completed | <u>(57,000)</u> |
| Therefore closing WIP is | <u><u>9,700</u></u> |

1.5 Answer: (D)

1.6 £170,000



Solution 2

- Categorise items before you start into manufacturing account, trading account, and profit and loss account.
- Remember to make adjustments for accruals and prepayments, and the calculation of depreciation, before splitting items between manufacturing, trading, and profit and loss accounts.
- Some items in the question might not be required for your answer.

(a) M: manufacturing account for the year ended ...

| | | |
|---|------------|--------------|
| | £000 | £000 |
| Opening stocks of raw materials | | 175 |
| Purchases | 650 | |
| Carriage inwards | <u>40</u> | |
| | 690 | |
| Less: returns outwards | <u>60</u> | |
| | | <u>630</u> |
| | | 805 |
| Less closing stock of raw materials | | <u>147</u> |
| Direct materials | | 658 |
| Direct labour | | <u>200</u> |
| Prime cost | | 858 |
| Factory indirect overheads | | |
| Supervisory labour | 75 | |
| Heat and light: $75\% \times (165 + 15)$ | 135 | |
| Rent, rates and insurance: $75\% \times (122 - 22)$ | 75 | |
| Depreciation | | |
| Factory machinery: $10\% \times \text{£}1,000$ | <u>100</u> | |
| | | <u>385</u> |
| Factory cost of production | | 1,243 |
| Opening work in progress | 425 | |
| Less: closing work in progress | <u>392</u> | |
| | | <u>33</u> |
| Factory cost of goods completed | | <u>1,276</u> |

(b) M: trading and profit and loss account for the year ended ...

| | | |
|---|--------------|--------------|
| | £000 | £000 |
| Sales | | 2,200 |
| Less returns inwards | | <u>80</u> |
| | | 2,120 |
| Less cost of goods sold | | |
| Opening stock of finished goods | 115 | |
| Factory cost of goods completed | <u>1,276</u> | |
| | 1,391 | |
| Less closing stock of finished goods | <u>138</u> | |
| | | <u>1,253</u> |
| Gross profit | | 867 |
| Expenses | | |
| Carriage outwards | 100 | |
| Office salaries | 108 | |
| Heat and light $25\% \times (165 + 15)$ | 45 | |
| Rent, rates and insurance: $25\% \times (122 - 22)$ | 25 | |
| Depreciation | | |
| Delivery vehicles $20\% \times \text{£}200$ | 40 | |
| Office machinery $25\% \times (120 - 80)$ | <u>10</u> | |
| | | <u>328</u> |
| Net profit | | <u>539</u> |

The Accounts of Limited Companies and Cash-Flow Statements

13

LEARNING OUTCOMES

When you have completed this chapter, you should be able to:

- ▶ prepare a trading account, profit and loss account, appropriations of profit, and a balance sheet, from a trial balance, for limited companies;
- ▶ prepare cash-flow statements.

13.1 Introduction

Many businesses are constituted in the form of limited companies. The nature of limited companies was mentioned very briefly in Chapter 1 and you should refer back to refresh your memory. In this chapter we look at some of the features of limited companies that have an impact on the content and presentation of their financial accounts.

We also look at a further accounting statement that many companies are required to include in their accounts – the cash-flow statement.

13.2 Limited companies

As trading organisations grow in size the limited financial resources of their owners often restrict the organisation's ability to grow any further. In order to avoid this difficulty many larger organisations use a company structure. A company is a separate legal entity that may sue and be sued under English law. It may have many owners who may or may not be directly involved in the day-to-day running of the business. Each of these owners is known as a shareholder or member of the company; they buy shares in the company that when first issued form the company's capital. The liability of the members to the company is usually limited to the nominal value of their shares. This contrasts with the position of sole traders. In law, the business of a sole trader and the individual owning the business are the same person. Thus the business obligations must be met by its owner even if this means selling private assets or leads to the individual being declared bankrupt.

The accounts of a company must be filed with the Registrar of Companies annually, in a form prescribed by the Companies Acts (this is not within your syllabus and is not included in this text). However, the internal accounts of companies are within your syllabus and use the same principles as have already been learned to prepare the accounts of sole traders.

13.2.1 The accounting statements of companies

The accounting statements of companies comprise:

1. a manufacturing account (if appropriate, depending on the organisation's activities) – dealt with in Chapter 12;
2. a trading account;
3. a profit and loss account;
4. an appropriation account;
5. a balance sheet;
6. a cash-flow statement.

The only statements different from those of a sole trader are the appropriation account and cash-flow statement. The *appropriation account* can be defined as:

In trading and not-for-profit entities, the record of how the profit/loss or surplus/deficit has been allocated to distributions/reserves/funds.

In a sole trader's accounts, all of the profit belongs to that sole trader, and is available for withdrawal by him/her, if they so wish. There is, therefore, no need for an appropriation account. In a limited company, the amount of profit available to be withdrawn by the owners (in the form of dividends), and the amount retained for future use, is at the discretion of the directors (managers) of the company. The purpose of the appropriation account is to show these allocations of profit.

An additional item that appears in the accounts of companies is that of taxation. In a sole trader's business, this is a personal charge, and so does not appear in the accounts. But in the case of a limited company, corporation tax is a charge on the company and is a direct result of its activities, and so it does appear in the accounts, immediately after the calculation of net profit. Strictly speaking, taxation is simply another expense that has to be paid, and so it is not really part of the allocation of profits to distributions/reserves/funds as stated in the above definition. However, it is common to assume that the taxation is part of the appropriation account, rather than the profit and loss account.

13.2.2 Published accounts and terminology in company Accounts

In the UK, most limited companies are required to publish their annual accounts for the benefit of their users. The presentation of the accounts of limited companies is laid down in the Companies Acts, supplemented by Financial Reporting Standards and Statements of Standard Accounting Practice. Some of these dictate particular terminology for certain items, but it is recognised that other acceptable descriptions exist in other countries, and in the *Financial Accounting Fundamentals* examination you will not be required to produce accounts in published format, or to comply with particular descriptions.

Nevertheless, it is useful to appreciate the alternative descriptions and terminologies that exist, and that you will encounter if you examine the published accounts of companies, or read other textbooks on the subject. Examples of different

terminologies include:

- trading and profit and loss account; profit and loss account; income statement; income and expenditure account;
- fixed assets; non-current assets; long-term assets;
- debtors; accounts receivable; receivables;
- creditors; accounts payable; payables;
- current liabilities; creditors: amounts due within one year; short-term liabilities;
- long-term liabilities; creditors: amounts due after one year;
- working capital; net current assets (or net current liabilities);
- net assets; shareholders' funds; equity.

Other acceptable terminologies also exist.

13.2.3 Taxation in company accounts

A company is a separate legal entity and as such is liable to pay corporation tax on its profits. At the end of each year an estimate is made by the company of the amount of its taxation liability and a provision is made in its accounts by debiting the expense to the profit and loss account and crediting a liability account in its balance sheet. When the liability is finally agreed with the Inland Revenue there may be a difference compared with the estimate: the difference is compensated for when preparing the estimate for the following year's tax liability.

13.2.4 Directors of limited companies

Limited companies are owned by the shareholders, but it is not common, especially in larger companies, for the shareholders to be involved in the day-to-day running of the company. Instead, the shareholders appoint directors to carry out those duties. Directors are merely employees of the company, and their duties are remunerated by salaries, fees, commission, etc., all of which are regarded in the same way as wages paid to any other employee, and appear in the profit and loss account as an expense. Of course, in some companies, directors also own shares, but the two roles (as director and shareholder) are separate, and are recorded separately.

13.2.5 Sources of finance for a limited company

The balance sheet of a company is similar to that of a sole trader, but there are usually a number of different sources of finance. Many companies raise their own loan finance in the form of debentures.

Debentures

Debenture: The written acknowledgement of a debt by a company, usually given under its seal, and normally containing provisions as to payment of interest and the terms of repayment of principal.

A debenture may be secured on some or all of the assets of the company.

In accounting terms a debenture is the same as a loan; it may be a short- or long-term liability depending on the date of repayment of the principal. The last sentence of the definition above means that if the company fails to repay the loan, or cannot keep up with

the interest payments, the debenture holders can seize the assets on which their loan is secured and sell them to recover their money. The interest payments are compulsory, irrespective of the level of profits, and are a normal trading expense, accounted for on an accruals basis (i.e. the full amount of interest arising during the accounting period must be charged in the profit and loss account, regardless of the date of payment of that interest).

Share capital

The owners' investment is in the form of shares. The most common forms of share are ordinary shares and preference shares.

Ordinary shares: Shares that entitle the holders to the remaining divisible profits (and, in a liquidation, the assets) after prior interests, for example, creditors and prior-charge capital, have been satisfied.

Preference Shares: Shares carrying a fixed rate of dividend, the holders of which, subject to the conditions of issue, have a prior claim to any company profits available for distribution. Preference shareholders may also have a prior claim to the repayment of capital in the event of a winding-up.

When presenting a company balance sheet, each of these types of share capital should be shown as a separate source of finance.

When a company is formed, the legal documents state the authorised share capital of the company. This is analysed into a number of shares, each having a *nominal* value. The *authorised share capital* is the amount of capital that may be issued without obtaining permission from the company's shareholders. The nominal value is also known as the *par value*.

Issues of shares by a company may be at nominal value or at a higher price. If they are issued at the higher price, the difference between this and the nominal value is known as the *share premium*.

When shares are issued, there are a number of stages before the share certificates are issued to their owners. Often, part of the issue price is payable on application for the shares, with further payments being requested later.

Example 13.A

Z Ltd plans to issue 100,000 ordinary shares of £1 nominal value at an issue price of £1.50 each. £0.75 per share is payable on application, £0.25 per share on confirmation that the shares have been issued and the balance of £0.50 per share on first call by Z Ltd in three months' time. This is for the share premium.

The double-entry to record the receipt of the application monies is as follows:

| | Debit (£) | Credit (£) |
|--|-----------|------------|
| Bank | 75,000 | |
| Application a/c | | 75,000 |
| Being cash received from applicants | | |
| Allotment a/c | 25,000 | |
| Application a/c | 75,000 | |
| Share capital | | 100,000 |
| Being the creation of share capital from successful applications and the recording of amounts due on allotment | | |

When the allotment monies are received the entry is:

| | <i>Debit (£)</i> | <i>Credit (£)</i> |
|---------------|------------------|-------------------|
| Bank | 25,000 | |
| Allotment a/c | | 25,000 |

In 3 months' time, Z Ltd will request the final payment of £0.50 per share. This is known as a call for payment. In this example, this represents the share premium. The double-entry would be:

| | <i>Debit (£)</i> | <i>Credit (£)</i> |
|---------------|------------------|-------------------|
| Bank | 50,000 | |
| Share premium | | 50,000 |

Share premiums are also a type of reserve. Reserves are explained in more detail below. When the balance sheet is drawn up, the 'Financed by:' section will show:

| | £ |
|----------------------------|---------|
| Ordinary shares of £1 each | 100,000 |
| Share premium | 50,000 |

13.2.6 Dividends

The amount paid to the company's shareholders as a return for investing in the company is known as a dividend. Dividends are often paid in two instalments: one during the year is known as an *interim dividend*, the other, which is paid after the end of the financial year, is known as a *final dividend*. The total amount of the dividends for the year is shown as a debit in the appropriation account and a current liability for the unpaid final dividend is shown on the balance sheet. If dividends have already been paid during the year, they will appear in the trial balance at the end of the period, whereas the proposed final dividend will not. Dividends are paid out only if the directors decide to declare them. If they do not wish to declare dividends, they need not do so.

Dividends on ordinary shares

Ordinary shareholders are also known as *equity shareholders*. Their shares do not qualify for any special benefits, although they are often entitled to vote at general meetings. An ordinary shareholder is not entitled to any particular dividend payment, although if the directors decide to declare a dividend it can be as small or as large as they see fit. The ordinary shareholders are regarded as the 'main' shareholders in a company. The profits that are retained in the company belong to them, and would be repaid to them in the event that the company ceases to exist.

Do take care, when computing dividends, to read the question carefully. If the question states that the ordinary dividend is to be 10p per share, you need to calculate how many shares are in issue.

Dividends on preference shares

Preference shareholders are so known because they received preferential treatment in the payment of dividends, and in the repayment of capital in the event that the company ceases to exist. A preference share often carries a fixed rate of dividend. The important point to remember is that if the ordinary shareholders are to receive a dividend, then the preference shareholders must receive theirs first. In examination questions, the ordinary dividend is often identified, but without reference to the preference dividend. Remember to accrue for the preference dividend if an ordinary dividend is to be paid too.

13.2.7 Reserves

There are two types of reserves: *capital reserves* and *revenue reserves*. The difference between these is that capital reserves may not be distributed as dividends. Examples of capital reserves are share premium (see above) and revaluation reserves – created when a company revalues its assets (often land and buildings). Since the increase in value is based on a professional valuation and has not been realised by a sale, the increase in value (or profit) cannot be distributed to shareholders.

Revenue reserves are the accumulated and undistributed profits of a company. The most common is the balance remaining on the profit and loss account after all appropriations have been made. This is credited to a separate profit and loss account, to increase the previous credit balance of undistributed profits (or it is debited if a loss arises). However, the directors may decide to set aside a portion of the remaining profits into a separate reserve account, for either general or specific purposes. A specific reserve is used to identify the accumulation of profits for a specific future purpose. Despite the fact that several revenue reserve accounts may exist, they are all available to be used for the payment of dividends if required.

It is important to realise that the existence of reserves does not indicate a fund of cash. The creation of a reserve may well be simply a bookkeeping transaction, debiting the profit and loss account and crediting the reserve account.

These points are brought together in the following example.

Example 13.B

The trial balance of ABC Ltd at 30 September year 1 is set out below:

| | Debit (£000) | Credit (£000) |
|--|--------------|---------------|
| Premises at cost | 800 | |
| Plant and equipment at cost | 460 | |
| Motor vehicles at cost | 124 | |
| Accumulated depreciation at 1.10 year 0: | | |
| Premises | | 160 |
| Plant and equipment | | 210 |
| Motor vehicles | | 63 |
| Stocks at 1.10 year 0 | | |
| Raw materials | 41 | |
| Work in progress | 27 | |
| Finished goods | 76 | |
| Sales of finished goods | | 2,702 |
| Purchase of raw materials | 837 | |
| Carriage inwards | 24 | |
| Direct wages | 658 | |
| Heat, light and power | 379 | |
| Salaries | 96 | |
| Advertising | 45 | |
| Telephone, postage, stationery | 23 | |
| Trade debtors and creditors | 256 | 113 |
| PAYE creditor | | 57 |
| Balance at bank | 363 | |
| Ordinary shares of £1 each | | 650 |
| 5% preference shares of £1 each | | 100 |
| Share premium | | 250 |
| Retained profits | | 432 |

| | | |
|------------------------------------|--------------|--------------|
| 10% debentures (repayable year 20) | | 200 |
| Bank deposit account | 496 | |
| Bank interest received | | 19 |
| Interim ordinary dividend paid | 36 | |
| Rent and rates | 215 | |
| | <u>4,956</u> | <u>4,956</u> |

Notes:

1. The closing stocks at 30 September year 1 valued at cost were as follows:

| | |
|------------------|--------|
| | £ |
| Raw materials | 37,000 |
| Work in progress | 18,000 |
| Finished goods | 39,000 |

2. An analysis of the raw materials consumed during the year shows that £73,000 related to the use of indirect materials.
3. The following amounts had been prepaid on 30 September year 1:

| | |
|-----------|--------|
| | £ |
| Rates | 25,000 |
| Telephone | 2,000 |

4. The following amounts should be accrued for expenses at 30 September year 1:

| | |
|-----------------------|--------|
| | £ |
| Direct wages | 57,000 |
| Salaries | 14,000 |
| Heat, light and power | 61,000 |

5. An analysis of the salaries cost for the year is:

| | |
|--------------------------|--------|
| | £ |
| Production | 49,000 |
| Selling and distribution | 30,000 |
| Administration | 31,000 |

6. A provision for doubtful debts is to be created equal to 5 per cent of closing debtors after writing off a bad debt of £16,000. These expenses are to be treated as selling and distribution items.
7. Interest receivable is to be treated as an administrative item.
8. During the year, a motor vehicle was sold for £13,000 when it had a net book value of £14,000. Its original cost was £24,000. The only entry made in respect of this transaction was to credit sales of finished goods and debit bank with the proceeds.
9. Depreciation is to be provided on all fixed assets held on 30 September year 1, at the following rates:

| | |
|---------------------|---------------------------|
| Premises | 5% p.a. on cost |
| Plant and equipment | 20% p.a. reducing balance |
| Motor vehicles | 20% p.a. on cost |

It is assumed that none of the fixed assets has any expected residual value.
The depreciation charge for the year is to be apportioned as follows:

| | | | |
|---------------------|------------|---------|--------|
| | Production | Selling | Admin. |
| Premises | 80% | 10% | 10% |
| Plant and equipment | 70% | 10% | 20% |
| Motor vehicles | 20% | 60% | 20% |

10. Other expenses are to be apportioned as follows:

| | <i>Production</i> | <i>Selling</i> | <i>Admin.</i> |
|-----------------------------------|-------------------|----------------|---------------|
| Heat, light and power | 80% | 10% | 10% |
| Telephone, postage and stationery | 10% | 60% | 30% |
| Rent and rates | 70% | 10% | 20% |

11. Corporation tax of £39,000 is to be provided on the profit for the year.
 12. The directors propose to pay a final dividend of 10p per ordinary share.
 13. It is proposed to transfer £100,000 into general reserves.

You are required:

- (a) to prepare the company's manufacturing, trading, profit and loss and appropriation accounts for the year ended 30 September year 1, in vertical form;
 (b) to prepare the company's balance sheet at 30 September year 1, in vertical form.

Solution

- (a) ABC Ltd: manufacturing, trading, profit and loss and appropriation account for the year ended 30 September year 1

| | | |
|---|----------------|----------------|
| | £000 | £000 |
| Opening stock of raw materials | | 41 |
| Purchases of raw materials | 837 | |
| Carriage inwards | <u>24</u> | |
| | | 861 |
| | | <u>902</u> |
| Closing stock of raw materials | | (37) |
| | | <u>865</u> |
| Indirect materials consumed | | (73) |
| Direct materials consumed | | <u>792</u> |
| Direct wages (658 + 57) | | 715 |
| Prime cost | | <u>1,507</u> |
| Production overhead | | |
| Indirect materials consumed | 73 | |
| Heat, light and power $((379 + 61) \times 80\%)$ | 352 | |
| Telephone, postage, stationery $((23 - 2) \times 10\%)$ | 2.1 | |
| Salaries | 49 | |
| Rent and rates $((215 - 25) \times 70\%)$ | 133 | |
| Depreciation | | |
| Premises $((5\% \times 800) \times 80\%)$ | 32 | |
| Plant $((20\% \times 250) \times 70\%)$ | 35 | |
| Motor vehicle $((20\% \times 100) \times 20\%)*$ | 4 | |
| Loss on disposal of vehicle $(1 \times 20\%)$ | <u>0.2</u> | |
| | | 680.3 |
| | | <u>2,187.3</u> |
| Opening work in progress | 27 | |
| Closing work in progress | <u>(18)</u> | |
| | | 9 |
| Goods completed c/d | | <u>2,196.3</u> |
| Sales 2,702 – 13 | | 2,689 |
| Opening stock of finished goods | 76 | |
| Cost of goods completed b/d | <u>2,196.3</u> | |
| | 2,272.3 | |
| Closing stock of finished goods | <u>39</u> | |
| | | 2,233.3 |
| Gross profit c/f | | <u>455.7</u> |

| | | |
|--|-------------------|----------------|
| *Working: motor vehicles cost | | £ |
| Cost per trial balance | | 124,000 |
| Less disposal | | (24,000) |
| Cost | | <u>100,000</u> |
| | £000 | £000 |
| Gross profit b/f | | 455.7 |
| Selling and distribution | | |
| Heat, light and power (440 × 10%) | 44 | |
| Telephone, postage and stationery (21 × 60%) | 12.6 | |
| Advertising | 45 | |
| Salaries | 30 | |
| Rent and rates (190 × 10%) | 19 | |
| Depreciation | | |
| Premises (40 × 10%) | 4 | |
| Plant (50 × 10%) | 5 | |
| Motor vehicle (20 × 60%) | 12 | |
| Loss on disposal of vehicle (1 × 60%) | 0.6 | |
| Bad debt written off | 16 | |
| Provision for doubtful debts ((256 – 16) × 5%) | 12 | |
| | <u> </u> | (200.2) |
| Administration | | |
| Heat, light and power (440 × 10%) | 44 | |
| Telephone, postage and stationery (21 × 30%) | 6.3 | |
| Salaries | 31 | |
| Rent and rates (190 × 20%) | 38 | |
| Depreciation | | |
| Premises (40 × 10%) | 4 | |
| Plant (50 × 20%) | 10 | |
| Motor vehicle (20 × 20%) | 4 | |
| Loss on disposal of vehicle (1 × 20%) | 0.2 | |
| | <u> </u> | (137.5) |
| Operating profit | | <u>118.0</u> |
| Interest received | 19 | |
| Interest paid (10% × £200) | <u>(20)</u> | |
| | | (1) |
| Profit before taxation | | <u>117</u> |
| Taxation | | <u>(39)</u> |
| Profit after taxation | | 78 |
| Dividends | | |
| Paid – ordinary | 36 | |
| Proposed | | |
| ordinary | 65 | |
| preference | <u>5</u> | |
| | | (106) |
| Retained loss for the year | | <u>(28)</u> |
| Retained profit b/f | | 432 |
| | | 404 |
| Transfer to general reserves | | 100 |
| Retained profit c/f | | <u>304</u> |

(b) ABC Limited: balance sheet at 30 September year 1

| | Cost (£000) | | NBV (£000) |
|---------------------------------------|--------------|--------------|--------------|
| Fixed assets | | | |
| Premises | 800 | 200 | 600 |
| Plant and equipment | 460 | 260 | 200 |
| Motor vehicles | 100 | 73 | 27 |
| | <u>1,360</u> | <u>533</u> | <u>827</u> |
| Current assets | | | |
| Stocks | | | |
| Raw materials | 37 | | |
| Work in progress | 18 | | |
| Finished goods | 39 | | |
| | | 94 | |
| Debtors | 240 | | |
| Less provision | <u>12</u> | | |
| | | 228 | |
| Prepayments | | 27 | |
| Bank deposits | | 496 | |
| Balance at bank | | 363 | |
| | | <u>1,208</u> | |
| Current liabilities | | | |
| Trade creditors | | 113 | |
| PAYE creditor | | 57 | |
| Accruals | | 132 | |
| Debenture interest | | 20 | |
| Corporation tax | | 39 | |
| Dividends | | 70 | |
| | | <u>431</u> | |
| Working capital | | | 777 |
| Total assets less current liabilities | | | <u>1,604</u> |
| Long-term liabilities | | | |
| 10% debentures | | | (200) |
| Net assets | | | <u>1,404</u> |
| Financed by | | | |
| Ordinary shares of £1 each | | | 650 |
| Preference shares of £1 each | | | 100 |
| Share premium | | | 250 |
| General reserves | | | 100 |
| Retained profits | | | 304 |
| Capital employed | | | <u>1,404</u> |

Notes:

- On the assumption that the debentures have been in issue throughout the year, it is necessary to provide for a full year's interest, and to show a liability for that interest on the balance sheet.
- As the directors are paying dividends to ordinary shareholders, the preference shareholders must also receive their 5 per cent. Both categories of unpaid dividend are included with current liabilities on the balance sheet.
- The net profit for the year is insufficient to cover the paid and proposed dividends, resulting in a retained loss for the year; however, previous years' undistributed profits can be utilised to cover the dividends.
- The shareholders' funds amount £1,404,000, of which £100,000 is held in preference shares. Equity capital is therefore £1,304,000.



Exercise 13.1

Draw up an outline profit and loss account and balance sheet to show the position of the following items:

1. gross profit,
2. net profit before tax,
3. fixed assets,
4. current liabilities,
5. taxation for the year,
6. proposed dividends,
7. transfers to reserves,
8. net profit after tax,
9. intangible assets,
10. retained profit b/fwd,
11. retained profit c/fwd,
12. current assets,
13. long-term liabilities due after one year,
14. net current assets,
15. total assets less current liabilities.



Solution

Profit and loss account

Gross profit
 Less expenses
 Net profit before tax
 Taxation for the year
 Net profit after tax
 Retained profit b/fwd
 Proposed dividends
 Transfers to reserves
 Retained profit c/fwd

Balance sheet

Fixed assets
 Intangible assets
 Current assets
 Less current liabilities
 Net current assets
 Total assets less current liabilities
 Less long-term liabilities due after 1 year

13.3 Cash-flow statements

In this section we shall illustrate the preparation of a cash-flow statement, which is often prepared for limited companies but may also be prepared for other types of organisation.

13.3.1 What is a cash-flow statement?

A cash-flow statement recognises the importance of liquidity to a business by reporting the effect of the transactions of the business during the period on the bank, cash and

similar liquid assets. At its simplest, it is a summary of receipts and payments during the period, but this method of presentation does not answer a common question asked by the readers of accounts: ‘Why does the profit made during the period not equate to an increase in cash and bank balances?’ What is needed, therefore, is a statement that commences with the profit made during the period, and shows how that profit, and other transactions during the same period, have affected the flow of cash into and out of the company.

UK companies are obliged to prepare their cash-flow statements in accordance with Financial Reporting Standard 1 Cash Flow Statements (FRS 1). While this is not necessary for the *Financial Accounting Fundamentals* paper, it is sensible to adopt an approach that is similar to that given in FRS 1.

13.3.2 Why does the profit earned not equal the change in bank and cash balances?

There are three main reasons why this does not occur:

1. Profit is calculated on an accruals basis, which means that revenue is taken when it is earned, not when it is received, and expenses are deducted on the same basis, to match with that revenue. Bank and cash balances change when monies are received and paid out. Thus the bank balance will be different from profit due to items such as stock balances, unpaid debtors and creditors, accruals and prepayments, both at the start of the period and at the end. For example, an increase in stocks means more cash has flowed out; an increase in debtors means less cash has flowed in; an increase in creditors means less cash has flowed out.
2. The calculation of profit includes some items that do not affect cash at all, or affect it differently. For example, profit is after deducting depreciation, which involves no movement in cash. The profit or loss on disposal of a fixed asset will be taken into the profit calculation, but it is the *proceeds of sale* that affect cash. In addition, there may be other provisions in the profit and loss account, such as for doubtful debts, taxation, and proposed dividends. These do not affect cash at the same time as the provision is made, for example, taxation may be paid after the year end, thus the amount of tax paid out during a period will be the bill for the previous year, not that for the current year.
3. Bank and cash balances are affected by some items that do not affect profit, such as the purchase of fixed assets (only depreciation affects profit), the raising of additional capital, or the repayment of loans.

13.3.3 Net cash flow from operating activities

The starting point for a cash-flow statement is the net cash flow from operating activities. ‘Operating activities’ are the normal, everyday activities of the company that earn it profit, and that result in cash flow. The ‘operating profit’ is that which arises from these activities, and does not include profits or losses from financing or investing.

However, this figure is not always apparent from the profit and loss account. First, operating activities does not include taxation or interest paid and received, thus these need to be adjusted for in arriving at ‘net operating profit’. Second, as explained in the previous paragraph, not all items included in the net operating profit result in cash flows at the same time.

The first stage, therefore, is to identify the net operating profit and adjust it for these items. The result will be as follows:

| | | |
|---|-----------------|-----------------|
| Net operating profit (i.e. profit before taxation and interest) | £ | £ |
| | | x |
| Add back | | |
| Depreciation charges for the period | x | |
| Loss on disposal of fixed assets | x | |
| Decreases in stock levels | x | |
| Decreases in debtors | x | |
| Increases in creditors | x | |
| | <u> </u> | |
| | | x |
| Or, deduct | | |
| Profit on disposal of fixed assets | x | |
| Increases in stock levels | x | |
| Increases in debtors | x | |
| Decreases in creditors | x | |
| | <u> </u> | |
| | | (x) |
| Net cash flow from operating activities | | <u> </u> |

Example 13.C

A company had the following items on its balance sheets at the end of year 1 and year 2:

| | Year 1 (£) | Year 2 (£) |
|-----------|------------|------------|
| Stocks | 35,000 | 25,000 |
| Debtors | 24,000 | 28,000 |
| Creditors | 31,000 | 33,000 |

In addition, the profit and loss account for year 2 included the following items:

| | | |
|---------------------------|-----------------|---------------|
| | £ | £ |
| Gross trading profit | | 90,000 |
| Less | | |
| General expenses | 17,000 | |
| Depreciation on plant | 10,000 | |
| Loss on disposal of plant | 4,000 | |
| | <u> </u> | |
| | | 31,000 |
| Net operating profit | | <u>59,000</u> |
| Add interest receivable | | 13,000 |
| Less interest payable | | (3,000) |
| Net profit before tax | | <u>69,000</u> |

Solution

Its net cash flow from operating activities for year 2 would be as follows:

| | |
|---|-----------------|
| | £ |
| Net profit | 69,000 |
| Add back interest payable | 3,000 |
| Deduct interest receivable | <u>(13,000)</u> |
| Net operating profit | 59,000 |
| Add | |
| Depreciation | 10,000 |
| Loss on disposal of fixed assets | 4,000 |
| Decrease in stocks | 10,000 |
| Increase in creditors | 2,000 |
| Less increase in debtors | <u>(4,000)</u> |
| Net cash flow from operating activities | <u>81,000</u> |

This gives us the starting point for the cash-flow statement.

13.3.4 The cash-flow statement

We now adjust the net cash flow from operating activities by adding (or deducting) the following items:

- (a) interest received/(interest paid);
- (b) (dividends paid);
- (c) (tax paid);
- (d) proceeds of sale of fixed assets/(payments made to acquire fixed assets);
- (e) capital raised/(capital repaid, e.g. loans).

Note that, in all cases, it is the sum actually received or paid during the period that is included. In the case of dividends and tax, this will often be last year's dividends declared and tax provision.

In order to establish the proceeds of sale of fixed assets and/or payments to acquire fixed assets, you may need to perform workings to ascertain these figures, especially if there have been disposals during the year. Drawing up control accounts is a useful way of locating the figures you need.

Example 13.D

Continuing from Example 13.C, suppose that other items on the balance sheets were as follows:

| | Year 1 (£) | Year 2 (£) |
|-----------------------|---------------|---------------|
| Fixed assets | | |
| Plant at cost | 100,000 | 120,000 |
| Depreciation | <u>20,000</u> | <u>22,000</u> |
| | 80,000 | 98,000 |
| Current assets | | |
| Bank and cash | 63,000 | 101,000 |
| Current liabilities | | |
| Taxation | 12,000 | 16,000 |
| Dividends | 20,000 | 30,000 |
| Long-term liabilities | | |
| Debenture | 30,000 | 21,000 |
| Share capital | 100,000 | 120,000 |

Notice that the depreciation given in the profit and loss account was £10,000 – and yet the depreciation in the balance sheet has increased by only £2,000. This is because there was an asset sold during the year, and its cost and depreciation will have been taken out of the ledger accounts. Refer back to Chapter 6 to revise the ledger accounts for disposals of fixed assets. We need some additional information on this, so let us assume that the asset disposed of cost £15,000 and had been depreciated by £8,000 (we already know from the profit and loss account that there was a loss on disposal of £4,000). We can reconstruct the relevant fixed-asset accounts, as follows:

| Plant at cost | | | |
|------------------------------|----------------|---------------------|----------------|
| | £ | | £ |
| Opening balance b/d | 100,000 | Disposal | 15,000 |
| Purchases (balancing figure) | <u>35,000</u> | Closing balance c/d | <u>120,000</u> |
| | <u>135,000</u> | | <u>135,000</u> |

| Plant disposals | | | |
|-----------------|---------------|-------------------------------------|---------------|
| | £ | | £ |
| Plant at cost | 15,000 | Plant depreciation | 8,000 |
| | | Loss on disposal | 4,000 |
| | | Proceeds of sale (balancing figure) | <u>3,000</u> |
| | <u>15,000</u> | | <u>15,000</u> |

We can now prepare the cash-flow statement, as follows:

| | | |
|--|-----------------|---------------|
| | £ | £ |
| Net cash flow from operating activities | | 81,000 |
| Interest received | 13,000 | |
| Less interest paid | <u>3,000</u> | |
| | | 10,000 |
| Tax paid (i.e. last year's) | | (12,000) |
| Proceeds of sale of fixed assets | 3,000 | |
| Less payments to acquire fixed assets | <u>(35,000)</u> | |
| | | (32,000) |
| Equity dividends paid (i.e. last year's) | | (20,000) |
| Funds raised from issue of shares | 20,000 | |
| Less repayment of debentures | <u>(9,000)</u> | |
| | | 11,000 |
| Net increase in bank and cash | | <u>38,000</u> |

Check that the figures in the right-hand column come to £38,000, and that this equates with the change in the bank balances as shown on the balance sheets.



Exercise 13.2

From the following information, construct a cash-flow statement:

| | |
|---|---------|
| | £ |
| Profit for the year, after charging depreciation of £22,300 | 215,500 |
| Purchase of fixed assets during the year | 80,000 |
| Repayment of long-term loan | 45,000 |
| Issue of shares at par | 100,000 |
| Changes in working capital during the year | |
| Increase in stocks | 22,500 |
| Decrease in debtors | 18,000 |
| Decrease in creditors | 14,500 |
| Taxation paid | 25,000 |
| Dividends paid | 5,000 |



Solution

| | | |
|---|----------|----------------|
| Net profit | £ | 215,500 |
| Add | | |
| Depreciation | 22,300 | |
| Decrease in debtors | 18,000 | |
| Less | | |
| Increase in stocks | (22,500) | |
| Decrease in creditors | (14,500) | |
| Net cash flow from operating activities | | <u>218,800</u> |

Cash-flow statement

| | | |
|---|-----------------|----------------|
| Net cash flow from operating activities | | 218,800 |
| Dividends paid | | (5,000) |
| Taxation paid | | (25,000) |
| Purchase of fixed assets | | (80,000) |
| Issue of shares | 100,000 | |
| Loan repaid | <u>(45,000)</u> | |
| | | 55,000 |
| Net increase in cash | | <u>163,800</u> |



Exercise 13.3

List as many examples as you can of cash flows in or out of a business that do not affect profit.



Solution

- Cash flows in – capital introduced by owner, shares issued, loans received, proceeds of sale of fixed assets (as opposed to profit on disposal), reduction in debtors' balances due to monies being received.
- Cash flows out – capital withdrawn by owner, dividends paid, loans repaid, fixed assets purchased, reduction in creditors' balances due to monies being paid out.

13.3.5 Cash-flow statements for sole traders

The preparation of cash-flow statements is not restricted to limited companies. Indeed, the statement is a useful source of information for any kind of organisation.

For sole traders, dividends would be replaced by cash drawings, and share capital issued would be replaced by cash introduced by the owner. Taxation would not appear at all, being a private transaction. Otherwise, the preparation of the cash-flow statement would follow the same principles as for limited companies.

13.4 Summary

In this chapter we have looked at:

- the preparation of accounts for limited companies, which include an appropriation account;

- the treatment of certain transactions in the accounts of companies:
 - taxation,
 - dividends,
 - debentures,
 - reserves;
- the bookkeeping entries to record the issue of shares;
- the preparation of a cash-flow statement;
- why profit does not equal cash flow.

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Revision Questions

13



Question 1 Multiple choice

- 1.1 Revenue reserves are:
- (A) accumulated and undistributed profits of a company.
 - (B) amounts that cannot be distributed as dividends.
 - (C) amounts set aside out of profits to replace revenue items.
 - (D) amounts set aside out of profits for a specific purpose.
- 1.2 A company has £100,000 of ordinary shares at a par value of 10 pence each and 100,000 5 per cent preference shares at a par value of 50 pence each. The directors decide to declare a dividend of 5 pence per ordinary share.
- The total amount to be paid out in dividends amounts to:
£.....
- 1.3 The correct ledger entries needed to record the issue of 200,000 £1 shares at a premium of 30 pence, and paid for by cheque, in full, would be:

| | <i>Debit</i> | <i>Credit</i> |
|---------------|--------------|---------------|
| | £ | £ |
| Share premium | | |
| Share capital | | |
| Bank | | |

- 1.4 A company has authorised share capital of one million ordinary shares of £1 each, of which 800,000 have been issued at a premium of 50p each, raising capital of £1,200,000. The directors are considering allocating £120,000 for dividend payments this year. This amounts to a dividend of:
£.....
- 1.5 Which one of the following would you expect to find in the appropriation account of a limited company, for the current year?
- (A) Preference dividend proposed during the previous year, but paid in the current year.
 - (B) Preference dividend proposed during the current year, but paid in the following year.
 - (C) Directors' fees.
 - (D) Auditors' fees.

- 1.6** A business has made a profit of £8,000 but its bank balance has fallen by £5,000. This could be due to:
- (A) depreciation of £3,000 and an increase in stocks of £10,000.
 - (B) depreciation of £6,000 and the repayment of a loan of £7,000.
 - (C) depreciation of £12,000 and the purchase of new fixed assets for £25,000.
 - (D) the disposal of a fixed asset for £13,000 less than its book value.
- 1.7** A company has authorised capital of 50,000 5 per cent preference shares of £2 each and 500,000 ordinary shares with a par value of 20p each. All of the preference shares have been issued, and 400,000 ordinary shares have been issued at a premium of 30p each. Interim dividends of 5p per ordinary share plus half the preference dividend have been paid during the current year. A final dividend of 15p per ordinary share is declared. The total of dividends payable for the year is:
£
- 1.8** A business's bank balance increased by £750,000 during its last financial year. During the same period it issued shares of £1 million and repaid a debenture of £750,000. It purchased fixed assets for £200,000 and charged depreciation of £100,000. Working capital (other than the bank balance) increased by £575,000. Its profit for the year was:
£
- 1.9** The record of how the profit or loss of a company has been allocated to distributions and reserves is found in the:
- (A) capital account.
 - (B) profit and loss account.
 - (C) reserves account.
 - (D) appropriation account.
- 1.10** Revenue reserves would decrease if a company:
- (A) sets aside profits to pay future dividends.
 - (B) transfers amounts into 'general reserves'.
 - (C) issues shares at a premium.
 - (D) pays dividends.
- 1.11** A business can make a profit and yet have a reduction in its bank balance. Which one of the following might cause this to happen?
- (A) The sale of fixed assets at a loss.
 - (B) The charging of depreciation in the profit and loss account.
 - (C) The lengthening of the period of credit given to customers.
 - (D) The lengthening of the period of credit taken from suppliers.
- 1.12** Which one of the following does not form part of the equity capital of a limited company?
- (A) Preference share capital.
 - (B) Share premium.
 - (C) Revaluation reserve.
 - (D) Ordinary share capital.

- 1.13 A particular source of finance has the following characteristics: a fixed return, a fixed repayment date, it is secured and the return is classified as an expense.
Identify the source of finance:

- (A) ordinary share.
(B) hire purchase.
(C) debenture.
(D) preference share.

- 1.14 Extracts from the financial statements of CFS Ltd are set out below.

| Profit and loss account for the year ended 31 December 2000 | | | |
|--|-------------|-------------|-----------------------------------|
| | <i>£000</i> | <i>£000</i> | |
| Turnover | | 300 | |
| Cost of sales | | <u>150</u> | |
| Gross profit | | 150 | |
| Profit on sale of fixed asset | | <u>75</u> | |
| | | 225 | |
| Expenses | 15 | | |
| Depreciation | <u>30</u> | | |
| | | <u>45</u> | |
| Net profit | | <u>180</u> | |
| | | | <i>Balances at 31 December</i> |
| | | | <i>1999 2000</i> |
| | | | <i>£000 £000</i> |
| Stock, debtors, current liabilities (net) | | 40 | 50 |

What figure would appear in the cash-flow statement of CFS Ltd for the year ended 31 December 2000 in respect of net cash flow for cash from operating activities?

£.....

- 1.15 The movement on the plant and machinery account for X Ltd is shown below:

| | <i>£</i> | |
|---------------------|----------------|--|
| Cost b/f | 10,000 | |
| Additions | 2,000 | |
| Disposals | <u>(3,000)</u> | |
| Cost c/f | <u>9,000</u> | |
| Depreciation b/f | 2,000 | |
| Charge for the year | 1,000 | |
| Disposals | <u>(1,500)</u> | |
| Depreciation c/f | <u>1,500</u> | |
| Net book value b/f | <u>8,000</u> | |
| Net book value c/f | <u>7,500</u> | |

The profit on the sale of the machine was £500. What figures would appear in the cash-flow statement of X Ltd?

- (A) Movement on plant account £500 and profit on disposal of £500.
(B) Movement on plant account £500 and proceeds on sale of plant £2,000.
(C) Purchase of plant £2,000 and profit on disposal of £500.
(D) Purchase of plant £2,000 and proceeds on sale of plant £2,000.



Question 2

Omit Ltd has the following trading and profit and loss account for the year ended 31 December 20X1 (draft):

| | |
|-------------------------|------------------|
| | £ |
| Sales | 1,210,213 |
| Cost of sales | <u>(943,000)</u> |
| | 267,213 |
| Administrative salaries | (110,100) |
| Other expenses | <u>(28,956)</u> |
| Net profit | <u>128,157</u> |

Omit Ltd has the following balance sheet as at 31 December 20X1 (draft):

| | | | |
|--|---------------|------------------|----------------|
| | £ | £ | £ |
| Fixed assets | | | 596,294 |
| Current assets | | | |
| Stock | 186,200 | | |
| Debtors | 252,111 | | |
| Cash | <u>87,800</u> | | |
| | | 526,111 | |
| Creditors: amounts falling due in less than one year | | | |
| Trade creditors | 120,290 | | |
| PAYE | 13,205 | | |
| National insurance | <u>10,568</u> | | |
| | | <u>(144,063)</u> | |
| | | | 382,048 |
| | | | <u>978,342</u> |
| Share capital | | | 100,000 |
| Profit and loss | | | <u>878,342</u> |
| | | | <u>978,342</u> |

Analytical review has revealed that the accounts have shown a marked and unexpected improvement over last year's figures in certain key areas. You ascertain that the main reason for this is that the December payroll journal and cheques paid to the Inland Revenue have not been processed.

| | | |
|------------------|----------------------------|-----------------------------|
| | <i>Manufacturing staff</i> | <i>Administration staff</i> |
| | £ | £ |
| Net pay | 29,799 | 5,999 |
| PAYE | 10,800 | 2,286 |
| NICs – employees | 4,212 | 859 |
| NICs – employers | 4,683 | 956 |

Taxes deducted in one month are paid to the Inland Revenue in the following month.

Requirements

(a) Insert the missing items into the journals given below.

| | <i>Debit or credit?</i> | £ |
|---|-------------------------|---|
| Payment journal | | |
| PAYE creditor | ■ | ■ |
| NI creditor | ■ | ■ |
| Cash | ■ | ■ |
| December payroll journal – manufacturing staff | | |
| Cost of sales | ■ | ■ |
| Cash | ■ | ■ |
| PAYE creditor | ■ | ■ |
| NI creditor | ■ | ■ |
| December payroll journal – administration staff | | |
| Profit and loss | ■ | ■ |
| Cash | ■ | ■ |
| PAYE creditor | ■ | ■ |
| NI creditor | ■ | ■ |

(b) Complete the following boxes in order to calculate the revised cash balance at 31 December 20X1.

| | | |
|---|---|--------|
| | ± | £ |
| Cash balance per original balance sheet | | 87,800 |
| | ■ | ■ |
| | ■ | ■ |
| | ■ | ■ |
| Revised cash balance | | ■ |

(c) Insert the missing items into the financial statements below, to take account of the necessary adjustments in part (a):

Trading and profit and loss account for the year ended 31 December 19X1 (draft)

| | £ | ± | £ | = | £ |
|-----------------|---------|---|---|---|-----------|
| Sales | | | | | 1,210,213 |
| Cost of sales | 943,000 | ■ | ■ | = | ■ |
| Gross profit | | | | | ■ |
| Admin. salaries | 110,100 | ■ | ■ | = | ■ |
| Other expenses | | | | | (28,956) |
| Net profit | | | | | ■ |

Balance sheet at 31 December 19X1 (draft)

| | £ | £ |
|--|-------------------|-------------------|
| Fixed assets | | 596,294 |
| Current assets | | |
| Stocks | 186,200 | |
| Debtors | 252,111 | |
| Cash | <u> </u> | |
| Creditors: amounts falling due in less than one year | | |
| Trade creditors | 120,290 | |
| PAYE | <u> </u> | |
| NI | <u> </u> | |
| Capital and reserves | | |
| Share capital | | 100,000 |
| Profit and loss | | <u> </u> |



Question 3

The following list of balances as at 30 April 1992 has been extracted from the books of River Garages Ltd after the preparation of the draft final accounts for the year ended on that date.

| | £ | |
|--|---------------|-------|
| Freehold land and buildings | | |
| At cost | 100,000 | |
| Provision for depreciation | 20,000 | |
| Plant and machinery | | |
| At cost | 58,000 | |
| Provision for depreciation | 16,400 | |
| Motor vehicles | | |
| At cost | 36,000 | |
| Provision for depreciation | 8,500 | |
| Stock at cost | 24,700 | |
| Trade debtors | 4,500 | |
| Amounts prepaid | 1,600 | |
| Balance at bank | 4,300 | |
| Trade creditors | 7,900 | |
| Ordinary shares of £1 each, fully paid | 100,000 | |
| Retained earnings | | |
| At 1 May 1991 | 7,600 | |
| Year ended 30 April 1992 | <u>40,000</u> | |
| 8% loan stock | 47,600 | |
| Suspense account | 30,000 | |
| | 1,300 | debit |

Subsequently, the following discoveries have been made:

- The company's stock at 30 April 1992 of £24,700 includes a motor car (J168 MRK) at £10,000. However, this vehicle was taken out of stock on 1 February 1992 for the use of the company's workshop manager.

Note: It is company policy to provide for depreciation on motor vehicles at the rate of 25 per cent per annum on cost. Depreciation is to be time-apportioned from the

- date of bringing the car into use as a fixed asset. Assume that there is no expected residual value.
2. A receipt of £1,000 from J Green, debtor, in February 1992, was credited to sales as £1,400.
 3. Interest on the 8 per cent loan stock is paid annually in arrears on 1 May. No provision for the loan interest has been made in the draft final accounts for the year ended 30 April 1992.
 4. No entry has been made in the company's books for a credit purchase of raw materials costing £2,000 on 14 April 1992 from T Conway. However, a debit balance of £2,000 at 30 April 1992 on T Conway's account in the company's books arises from a payment made to T Conway on that date.
 5. The remaining balance of the suspense account arises from a prepayment at 30 April 1992 for insurance, being omitted from the company's list of balances on that date.
- Note:* River Garages Limited does not maintain either a sales ledger total (or control account) or a purchases ledger total (or control account).

Requirements

(a) Insert the missing items into the journal given below, to correct items 1–4 above.

| Item | Account name | Debit or credit? | £ |
|------|--------------|------------------|---|
| 1. | | | |
| | | | |
| | | | |
| | | | |
| 2. | | | |
| | | | |
| | | | |
| | | | |
| 3. | | | |
| | | | |
| | | | |
| | | | |
| 4. | | | |
| | | | |
| | | | |
| | | | |

(b) Insert the missing items into the following boxes in order to calculate the remaining balance on the suspense account, after correcting the four errors in the journal above.

| | Debit or credit? | £ |
|--|------------------|---|
| Suspense account balance arising per list of balances at 30 April 1992 | | |
| Correction required re item number | | |
| Remaining balance on suspense account | | |

(c) Insert the missing items into the journal given below, to correct item 5.

| Item | Account name | Debit or credit? | £ |
|------|--------------|------------------|---|
| 5. | | | |
| | | | |

- (d) Complete the table below to recalculate the retained earnings for the year ended 30 April 1992, after adjusting for all the above items:

| | |
|---------------------------------------|---|
| | £ 40,000 |
| Per list of balances at 30 April 1992 | █ |
| █ | █ |
| █ | █ |
| █ | █ |
| Revised balance | █ <hr style="border-top: 1px solid black;"/> |

- (e) Insert the missing items into the revised balance sheet at 30 April 1992, given below, after taking account of the necessary adjustments

Balance sheet at 30 April 1992

| | Cost (£) | Provision for depreciation (£) | Net bookvalue (£) |
|---|--|--|--|
| Fixed assets | | | |
| Land and buildings | 100,000 | 20,000 | 80,000 |
| Plant and machinery | 58,000 | 16,400 | 41,600 |
| Motor vehicles | █ | █ | █ |
| | <hr style="border-top: 1px solid black;"/> | <hr style="border-top: 1px solid black;"/> | <hr style="border-top: 1px solid black;"/> |
| Current assets | | | |
| Stock | | █ | |
| Trade debtors | | █ | |
| Amounts prepaid | | █ | |
| Balance at bank | | █ | |
| | | <hr style="border-top: 1px solid black;"/> | |
| Less: creditors: amounts falling due within one year | | | |
| Trade creditors | █ | | |
| Accrued charges | █ | | |
| | <hr style="border-top: 1px solid black;"/> | <hr style="border-top: 1px solid black;"/> | <hr style="border-top: 1px solid black;"/> |
| | | | █ |
| | | | <hr style="border-top: 1px solid black;"/> |
| Less: creditors: amounts falling due after more than one year | | | |
| 8% loan stock | | | 30,000 |
| | | | <hr style="border-top: 1px solid black;"/> |
| Represented by | | | |
| Ordinary shares of £1 each fully paid | | | 100,000 |
| Retained earnings: | | | |
| At 1 May 1991 | | 7,600 | |
| Year ended 30 April 1992 | | █ | |
| | | <hr style="border-top: 1px solid black;"/> | <hr style="border-top: 1px solid black;"/> |
| | | | █ |
| | | | <hr style="border-top: 1px solid black;"/> |

? Question 4

The accountant of Fiddles plc has begun preparing final accounts, but the work is not yet complete. At this stage, the items included in the trial balance are as follows:

| | |
|------------------------------|-------------|
| | <i>£000</i> |
| Land | 100 |
| Buildings | 120 |
| Plant and machinery | 170 |
| Depreciation provision | 120 |
| Share capital | 100 |
| Profit and loss balance b/f | 200 |
| Debtors | 200 |
| Creditors | 110 |
| Stock | 190 |
| Operating profit | 80 |
| Debentures (16%) | 180 |
| Provision for doubtful debts | 3 |
| Bank balance (asset) | 12 |
| Suspense | 1 |

Notes (i)–(vii) are to be taken into account.

- (i) The debtors control account figure, which is used in the trial balance, does not agree with the total of the debtors ledger. A contra of £5,000 has been entered correctly in the individual ledger accounts but has been entered on the wrong side of both control accounts.
A batch total of sales of £12,345 has been entered in the double-entry system as £13,345, although individual ledger account entries for these sales were correct. The balance of £4,000 on sales returns account has inadvertently been omitted from the trial balance, though correctly entered in the ledger records.
- (ii) A standing order of receipt from a regular customer for £2,000, and bank charges of £1,000, have been completely omitted from the records.
- (iii) A debtor for £1,000 is to be written off. The provision for doubtful debts balance is to be adjusted to 1 per cent of debtors.
- (iv) The opening stock figure had been overstated by £1,000 and the closing stock figure understated by £2,000.
- (v) Any remaining balance on suspense account should be treated as purchases if a debit balance and as sales if a credit balance.
- (vi) The debentures were issued three months before the year end. No entries have been made as regards interest.
- (vii) A dividend of 10 per cent of share capital is to be proposed.

Requirements

- (a) Insert the missing items in the journal entries to cover items in notes (i) to (v) above. You are not to open any new accounts and may use only those accounts included in the trial balance as given.

| | | Journal | |
|-------|-----|---------------------|----------------------|
| | | <i>Debit (£000)</i> | <i>Credit (£000)</i> |
| (i) | [] | [] | |
| | [] | | [] |
| | [] | [] | |
| | [] | | [] |
| | [] | [] | |
| (ii) | [] | [] | |
| | [] | [] | |
| (iii) | [] | [] | |
| | [] | | [] |
| | [] | [] | |
| (iv) | [] | [] | |
| | [] | | [] |
| | [] | [] | |
| | [] | | [] |
| (v) | [] | [] | |
| | [] | | [] |
| | [] | [] | |

(b) Insert the missing items in the final accounts.

Revised operating profit

| | <i>£</i> |
|---------------------------|----------|
| Original operating profit | [] |
| [] | [] |
| [] | [] |
| [] | [] |
| [] | [] |
| [] | [] |
| [] | [] |
| [] | [] |
| [] | [] |
| Revised operating profit | [] |

Fiddles plc: profit and loss account

| | <i>£</i> |
|------------------|----------|
| Operating profit | [] |
| [] | [] |
| [] | [] |
| [] | [] |
| [] | [] |
| b/fwd [] | [] |
| c/fwd | [] |

Fiddles plc: balance sheet

| | £ | £ | £ |
|----------------------------|-------------------|-------------------|-------------------|
| Fixed assets | | | |
| ██████████ | | | ██████████ |
| ██████████ | | | ██████████ |
| Plant and machinery | | | |
| ██████████ | | ██████████ | |
| ██████████ | | ██████████ | |
| | | <u> </u> | ██████████ |
| | | | <u> </u> |
| Current assets | | | |
| ██████████ | | ██████████ | |
| ██████████ | ██████████ | | |
| ██████████ | ██████████ | | |
| | <u> </u> | | |
| Bank | | ██████████ | |
| | | <u> </u> | |
| | | ██████████ | |
| Less current liabilities | | | |
| ██████████ | ██████████ | | |
| ██████████ | ██████████ | | |
| ██████████ | ██████████ | | |
| | <u> </u> | | |
| | | ██████████ | |
| | | <u> </u> | ██████████ |
| | | | <u> </u> |
| Less long-term liabilities | | | |
| ██████████ | | | ██████████ |
| | | | <u> </u> |
| | | | ██████████ |
| Financed by | | | |
| ██████████ | | | ██████████ |
| ██████████ | | | ██████████ |
| | | | <u> </u> |
| | | | ██████████ |
| | | | <u> </u> |

? Question 5

The balance sheet of OGN Ltd at 31 December 1994 was as follows:

| | £000 | £000 | £000 |
|----------------------------------|--------------|--------------|--------------|
| Fixed assets | | | 7,500 |
| Current assets | | | |
| Stocks | 2,000 | | |
| Debtors | <u>5,000</u> | | |
| | | 7,000 | |
| Less current liabilities | | | |
| Trade creditors | 4,000 | | |
| Bank overdraft | <u>1,000</u> | | |
| | | <u>5,000</u> | |
| Net current assets | | | <u>2,000</u> |
| | | | <u>9,500</u> |
| Financed by | | | |
| 7,000 ordinary shares of £1 each | | | 7,000 |
| General reserves | | | 1,500 |
| Profit and loss account | | | <u>1,000</u> |
| | | | <u>9,500</u> |

During 1995 a net profit of £1.5 million is made, after charging depreciation of £750,000. £1 million is transferred to general reserves. Closing stock at 31 December 1995 is £1.8 million and debtors are reduced by £1.5 million. Creditors at 31 December 1995 amount to £3 million.

During the year, two million additional ordinary shares are issued at a premium of 50p each, paid for immediately in cash. No dividends are declared for the year and no fixed assets are purchased.

Requirements

- (a) Insert the missing items into the boxes below to calculate the bank balance at 31 December 1995 by establishing the movement in cash during the period.

| | |
|--|---------|
| | £000 |
| Profit for the year | 1,500 |
| Add/less* depreciation | █ |
| Add/less* increase/decrease* in stock | █ |
| Add/less* increase/decrease* in debtors | █ |
| Add/less* increase/decrease* in creditors | █ |
| Cash inflow from operations | █ |
| Add/less* █ | █ |
| Increase/decrease* in cash and bank | █ |
| Add/less* opening bank balance (overdraft) | (1,000) |
| Closing bank balance | █ |

*Delete as appropriate.

- (b) Insert the missing items into the balance sheet at 31 December 1985, provided below.

Balance sheet at 31 December 1985

| | | |
|------------------------------|-------|-------|
| | £ | £ |
| Fixed assets | | 7,500 |
| Less depreciation | | █ |
| | | █ |
| Current assets | | |
| Stocks | 1,800 | |
| Debtors | █ | |
| Bank | █ | |
| | █ | |
| Current liabilities | | |
| Creditors | 3,000 | |
| | | █ |
| | | █ |
| Financed by | | |
| █ ordinary shares of £1 each | | █ |
| Share premium account | | █ |
| General reserves | | █ |
| Profit and loss account | | █ |
| | | █ |

- (c) Complete the missing words in the following sentences
- (i) _____ is that ascribed to shares when authorised, appears on the share certificate and used for _____ calculations.
 - (ii) _____ are long-term loans with a _____ interest rate, payable irrespective of profits. They may be _____ in the future, and _____ on fixed assets.

- (iii) Profits are transferred to _____ to limit the profits available for payment of current/future dividends.
- (iv) _____ are proposed by the directors, but are not payable until approved by _____ at the annual general meeting. The amount proposed is held as a _____.

? Question 6

ABC Ltd prepares its accounts to 31 October each year. Its trial balance at 31 October 1993 was as follows:

| | <i>Debit (£000)</i> | <i>Credit (£000)</i> |
|---|---------------------|----------------------|
| Premises – cost | 600 | |
| Manufacturing plant – cost | 350 | |
| Office equipment – cost | 125 | |
| Accumulated depreciation at 1 November 1992 | | |
| Premises | | 195 |
| Manufacturing plant | | 140 |
| Office equipment | | 35 |
| Stocks at 1 November 1992 | | |
| Raw materials | 27 | |
| Work in progress | 18 | |
| Finished goods | 255 | |
| Sales of finished goods | | 2,350 |
| Purchases of raw materials | 826 | |
| Returns inwards and outwards | 38 | 18 |
| Direct wages | 575 | |
| Heat, light and power | 242 | |
| Salaries | 122 | |
| Printing, postage and stationery | 32 | |
| Rent, rates and insurances | 114 | |
| Loan interest payable | 12 | |
| Loan | | 250 |
| Trade debtors and creditors | 287 | 75 |
| Provision for doubtful debts | | 11 |
| VAT account | | 26 |
| Interim dividend paid | 10 | |
| Ordinary shares of £1 each | | 500 |
| Share premium account | | 100 |
| Profit and loss account balance | | 442 |
| Bank balance | <u>509</u> | |
| | <u>4,142</u> | <u>4,142</u> |

The following additional information at 31 October 1993 is available:

| | |
|--|----------|
| (i) Closing stocks | |
| Raw materials | £24,000 |
| Work in progress | £19,000 |
| Finished goods | £147,000 |
| (ii) Prepayments | |
| Rates | £17,000 |
| Insurances | £4,000 |
| (iii) Accruals | |
| Direct wages | £15,000 |
| Salaries | £8,000 |
| (iv) Salaries are to be apportioned as follows | |
| Manufacturing | 20% |
| Administration | 80% |

- (v) Specific bad debts to be written off amount to £47,000, including VAT at 17.5 per cent. The company maintains a separate bad debts account. The debts have all been outstanding for more than six months.

Note: In the case of bad debts that have been outstanding for more than six months, the VAT (which will already have been accounted for on the sale of the goods) can be reclaimed from Customs and Excise.

- (vi) The provision for doubtful debts is to be amended to 2.5 per cent of debtors, after adjusting for bad debts written off.
- (vii) Depreciation of fixed assets is to be provided as follows:

| | |
|------------------|---------------------------------|
| Premises | 2 per cent on cost |
| Plant | 10 per cent on cost |
| Office equipment | 20 per cent on reducing balance |

Twenty-five per cent of premises depreciation is to be apportioned to the manufacturing account.

Note: It is to be assumed that there is no expected residual value.

- (viii) The loan was taken out on 1 November 1992, and the capital is to be repaid as follows:

| | |
|----------------|----------|
| 1 January 1994 | £100,000 |
| 1 January 1995 | £100,000 |
| 1 January 1996 | £50,000 |

Interest is to be charged on the outstanding capital at 20 per cent per annum.

- (ix) Other expenses are to be apportioned as follows:

| | |
|---------------------------|---|
| Heat, light and power | $\frac{1}{2}$ manufacturing $\frac{1}{2}$ selling and administration |
| Rent, rates and insurance | $\frac{1}{3}$ manufacturing $\frac{2}{3}$ administration |

- (x) One line of finished goods stock, currently recorded at £8,000, has a net realisable value of £3,000.
- (xi) A final dividend of 10p per share is to be proposed.
- (xii) A provision for corporation tax of £35,000 is to be made on the profits of the year.

Requirements

(a) Insert the missing items into the manufacturing account for the year ended 31 October 1993.

ABC Ltd: manufacturing account for the year ended 31 December 1993

| | £000 | £000 | £000 |
|-----------------------------------|-------------------|-------------------|-------------------|
| _____ | | _____ | |
| _____ | _____ | | |
| _____ | _____ | | |
| | <u> </u> | _____ | |
| | | _____ | |
| _____ | | _____ | |
| Direct materials | | | _____ |
| Direct labour | | | _____ |
| Prime cost | | | <u> </u> |
| Indirect factory costs | | | |
| _____ | | _____ | |
| _____ | | _____ | |
| _____ | | _____ | |
| _____ | | _____ | |
| _____ | | <u> </u> | |
| Total factory cost | | | _____ |
| Change in work in progress | | | |
| _____ | | _____ | |
| _____ | | <u> </u> | |
| Factory cost of goods transferred | | | <u> </u> |

(b) Insert the missing items into the trading and profit and loss account for the year ended 31 October 1993.

ABC Ltd: trading and profit and loss account for the year ended 31 October 1993

| | £000 | £000 |
|-------------------------------------|-----------------------------|-----------------------------|
| Sales | | <input type="text"/> |
| <input type="text"/> | | <input type="text"/> |
| | | <u><input type="text"/></u> |
| Less cost of goods sold | | |
| <input type="text"/> | <input type="text"/> | |
| <input type="text"/> | <input type="text"/> | |
| | <u><input type="text"/></u> | |
| <input type="text"/> | <input type="text"/> | |
| | <u><input type="text"/></u> | <input type="text"/> |
| Gross profit | | <input type="text"/> |
| Less expenses | | |
| <input type="text"/> | <input type="text"/> | |
| <input type="text"/> | <input type="text"/> | |
| <input type="text"/> | <input type="text"/> | |
| <input type="text"/> | <input type="text"/> | |
| <input type="text"/> | <input type="text"/> | |
| <input type="text"/> | <input type="text"/> | |
| <input type="text"/> | <input type="text"/> | |
| <input type="text"/> | <input type="text"/> | |
| <input type="text"/> | <input type="text"/> | |
| <input type="text"/> | <input type="text"/> | |
| | <u><input type="text"/></u> | <input type="text"/> |
| Net profit before tax | | <input type="text"/> |
| Provision for taxation | | <input type="text"/> |
| Net profit after tax | | <input type="text"/> |
| Proposed dividends | | |
| <input type="text"/> | <input type="text"/> | |
| <input type="text"/> | <input type="text"/> | |
| | <u><input type="text"/></u> | <input type="text"/> |
| | | <input type="text"/> |
| | | <input type="text"/> |
| Profit and loss account balance b/f | | <input type="text"/> |
| Profit and loss account balance c/f | | <u><input type="text"/></u> |

(c) Insert the missing items into the balance sheet at 31 October 1993.

ABC Ltd: balance sheet at 31 October 1993

| | <i>Cost (£000)</i> | <i>Dep'n (£000)</i> | <i>NBV (£000)</i> |
|---------------------|--------------------|---------------------|-------------------|
| Fixed assets | | | |
| █ | █ | █ | █ |
| █ | █ | █ | █ |
| █ | █ | █ | █ |
| | <u>█</u> | <u>█</u> | <u>█</u> |
| Current assets | | | |
| Stocks | | | |
| █ | █ | | |
| █ | █ | | |
| █ | <u>█</u> | | |
| █ | █ | █ | |
| █ | <u>█</u> | | |
| | | █ | |
| | | █ | |
| | | <u>█</u> | |
| Current liabilities | | | |
| █ | | █ | |
| █ | | █ | |
| █ | | █ | |
| █ | | █ | |
| █ | | █ | |
| █ | | <u>█</u> | |
| Working capital | | | <u>█</u> |
| █ | | | █ |
| Financed by | | | <u>█</u> |
| █ | | | █ |
| █ | | | █ |
| █ | | | <u>█</u> |



Question 7

FPC Ltd is a manufacturing company that sells its goods to wholesalers. Its trial balance at 31 March 1996 was as follows:

| | <i>Debit (£)</i> | <i>Credit (£)</i> |
|---|------------------|-------------------|
| Issued share capital, £1 ordinary shares | | 750,000 |
| 10% debentures, repayable 2005 | | 200,000 |
| Profit and loss account at 1 April 1995 | | 98,000 |
| Premises – at cost | 900,000 | |
| Premises – provision for depreciation at 1 April 1995 | | 360,000 |
| Plant – at cost | 150,000 | |
| Plant – provision for depreciation at 1 April 1995 | | 75,000 |
| Sales | | 2,960,000 |
| Raw materials purchased | 1,500,000 | |
| Carriage outwards | 10,000 | |
| Carriage inwards | 15,000 | |
| Returns outwards | | 22,000 |
| Returns inwards | 14,000 | |
| Debtors | 220,000 | |
| Creditors | | 300,000 |
| Bank balance | 500,000 | |
| Stock at 1 April 1995 | | |
| Raw materials | 60,000 | |
| Work in progress | 30,000 | |
| Finished goods | 70,000 | |
| Direct labour | 600,000 | |
| Discounts allowed | 4,000 | |
| Discounts received | | 2,500 |
| Rent and rates | 120,000 | |
| Insurance | 100,000 | |
| Factory supervisors' salaries | 150,000 | |
| Office wages and salaries | 175,000 | |
| Sales officers' commission | 113,500 | |
| Administration expenses | 45,000 | |
| Value added tax account | | 8,500 |
| Provision for doubtful debts at 1 April 1995 | | 7,000 |
| Bad debts written off | 6,500 | |
| | <u>4,783,000</u> | <u>4,783,000</u> |

The following additional information at 31 March 1996 is available:

(i) Closing stocks:

| | |
|------------------|---------|
| | £ |
| Raw materials | 80,000 |
| Work in progress | 42,500 |
| Finished goods | 100,000 |

(ii) Rent and rates prepaid amount to £10,000.

Insurance prepaid amounts to £20,000.

Twenty per cent of rent and rates and insurance is to be regarded as factory cost.

(iii) Direct labour accrued amounts to £17,500.

(iv) Included in the above trial balance are finished goods sold on a sale or return basis, which must be accepted or rejected by 15 April 1996. Their selling price is £35,000 and their cost price is £27,000. VAT is not applicable on these goods.

- (v) The premises are to be depreciated at 2 per cent per annum, straight line. The plant is to be depreciated at 10 per cent per annum straight line. Twenty-five per cent of premises depreciation is to be regarded as factory cost. Seventy-five per cent of plant depreciation is to be regarded as factory cost.
- (vi) The provision for doubtful debts is to be amended to 5 per cent of debtors.
- (vii) Sales officers' commission for the year is to be 5 per cent of net sales.
- (viii) Administration expenses includes stationery, which has been recorded at its total invoice value of £9,400, including VAT at 17.5 per cent. The VAT is reclaimable.
- (ix) The debentures were issued on 1 October 1995. Interest is due on 1 April and 1 October annually in arrears.
- (x) Corporation tax of £22,000 is to be provided for the year.
- (xi) A dividend of 3p per share is proposed.

Requirements

- (a) Insert the missing items into the manufacturing account for the year ended 31 March 1996.

FPC Ltd: manufacturing account for year ended 31 March 1996

| | £ | £ | |
|--|---|---|--|
| | | | |
| | | | |
| | | | |
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- (b) Insert the missing items into the trading and profit and loss appropriation account for the year ended 31 March 1996.

FPC Ltd: trading and profit and loss account for year ended 31 March 1996

| | £ | £ |
|--------------------------------------|---|---|
| Sales | | █ |
| Less returns | | █ |
| Net sales | | █ |
| Less cost of goods sold | | |
| Opening stock of finished goods | █ | |
| Factory cost of goods completed | █ | |
| | █ | |
| Less closing stock of finished goods | █ | |
| | █ | █ |
| Gross profit | | █ |
| Discount received | | █ |
| | | █ |
| Less expenses | | |
| Carriage outwards | █ | |
| Discount allowed | █ | |
| Rent and rates | █ | |
| Insurance | █ | |
| Office wages and salaries | █ | |
| Sales officer's commission | █ | |
| Administration expenses | █ | |
| Provision for doubtful debts | █ | |
| Bad debts written off | █ | |
| Debenture interest | █ | |
| Depreciation – premises | █ | |
| Depreciation – plant and machinery | █ | |
| | █ | █ |
| Net profit before tax | | █ |
| Provision for taxation | | █ |
| Net profit/(loss) after tax | | █ |
| Proposed dividends | | █ |
| Retained profit for the year | | █ |
| Profit and loss account b/fwd | | █ |
| Profit and loss account c/fwd | | █ |

- (c) For each of the following items that appear in the accounts of FPC Ltd, state an accounting concept which affects its treatment:

- (i) stocks of raw materials.
- (ii) goods on sale or return.
- (iii) provision for doubtful debts.

- (i) █
- (ii) █
- (iii) █

? Question 8

Avtar Ltd had the following balance sheets at 31 March 2001 and 2002:

| | 2001 (£000) | 2002 (£000) |
|----------------------------|--------------|--------------|
| Fixed assets at cost | 1,000 | 1,300 |
| Accumulated depreciation | <u>400</u> | <u>600</u> |
| | 600 | 700 |
| Current assets | | |
| Stock | 800 | 1,400 |
| Debtors | 2,700 | 3,100 |
| Bank | <u>200</u> | <u>–</u> |
| | 3,700 | 4,500 |
| Less current liabilities | | |
| Creditors | 1,300 | 1,580 |
| Proposed ordinary dividend | 300 | 260 |
| Bank overdraft | <u>–</u> | <u>120</u> |
| | 1,600 | 1,960 |
| Net current assets | <u>2,100</u> | <u>2,540</u> |
| Total net assets | <u>2,700</u> | <u>3,240</u> |
| Financed by | | |
| Share capital | 1,000 | 1,300 |
| Share premium account | 500 | 700 |
| Profit and loss account | <u>1,200</u> | <u>1,240</u> |
| | 2,700 | 3,240 |

During the year to 31 March 2002, fixed assets costing £50,000 were sold for £40,000 cash. Accumulated depreciation on these to 31 March 2001 was £20,000.

Requirements

- (a) Insert the missing figures into the ledger accounts below in order to calculate the additions to fixed assets, the profit or loss on sale of fixed assets, and the depreciation charge in the profit and loss account for the year to 31 March 2002.

| Fixed assets at cost | | | |
|--------------------------------|----------|---------------------------|----------|
| | £000 | | £000 |
| Balance b/f | █ | Disposals a/c | █ |
| Additions | <u>█</u> | Balance c/f | <u>█</u> |
| | █ | | █ |
| | <u>█</u> | | <u>█</u> |
| Fixed assets – depreciation | | | |
| | £000 | | £000 |
| Disposals a/c | █ | Balance b/f | █ |
| Balance c/f | <u>█</u> | Provision for the year | <u>█</u> |
| | █ | | █ |
| | <u>█</u> | | <u>█</u> |
| Fixed assets – disposals | | | |
| | £000 | | £000 |
| Fixed assets at cost | █ | Fixed assets depreciation | █ |
| Profit on sale of fixed assets | <u>█</u> | Disposal proceeds | <u>█</u> |
| | █ | | █ |
| | <u>█</u> | | <u>█</u> |

(b) Insert the missing items into the cash-flow statement given below for the year ending 31 March 2002.

| | £000 | | £000 | | £000 |
|---|------|---|------|---|------|
| Increase in profit and loss account | █ | - | █ | = | █ |
| Add dividends proposed | | | | | █ |
| Add depreciation charge for the year | | | | | █ |
| Deduct profit on sale of fixed assets | | | | | █ |
| | | | | | █ |
| Add/less* increase/decrease* in stock | | | | | █ |
| Add/less* increase/decrease* in debtors | | | | | █ |
| Add/less* increase/decrease* in creditors | | | | | █ |
| Cash outflow from operations | | | | | █ |
| █ | | | | | █ |
| █ | | | | | █ |
| █ | | | | | █ |
| █ | | | | | █ |
| Increase/decrease* in cash and bank | | | | | █ |

*Delete as appropriate.

Solutions to Revision Questions

13



Solution 1

1.1 Answer: (A)

Revenue reserves can be distributed as dividends, so (B) is incorrect. Revenue reserves are not set aside to replace revenue items; they could be set aside for a specific purpose but this is only one use of revenue reserves.

1.2 The share capital consists of:

| | |
|-----------------------------------|---------|
| | £ |
| Preference shares, 100,000 at 50p | 50,000 |
| Ordinary shares, 1,000,000 at 10p | 100,000 |

Thus the preference dividend amounts to 5 per cent of £50,000, i.e. £2,500, and the ordinary dividend amounts to 5p × 1 million shares = £50,000, giving a total dividend of £52,500.

1.3

| | <i>Debit</i> | <i>Credit</i> |
|---------------|--------------|---------------|
| Share premium | | 60,000 |
| Share capital | | 200,000 |
| Bank | 260,000 | |

1.4 Dividends are declared only on issued shares, and are based on the par value. A dividend of £120,000 on par value shares of £800,000 is 15p per share.

1.5 Answer: (B)

Dividends proposed are shown in the appropriation account, for payment following the annual general meeting. Directors' and auditors' fees are normal business expenses and appear in the profit and loss account.

1.6 Answer: (C)

| | |
|--------------------------|-----------------|
| | £ |
| Profit | 8,000 |
| Add back depreciation | <u>12,000</u> |
| Net cash inflow | 20,000 |
| Purchase of fixed assets | <u>(25,000)</u> |
| Decrease | <u>(5,000)</u> |

1.7

| | |
|--|---------------|
| | £ |
| Preference dividend for year (5 per cent × £100,000) | 5,000 |
| Ordinary dividend for year (20p × 400,000 shares) | <u>80,000</u> |
| Total dividend | <u>85,000</u> |

1.8

| | |
|----------------------------------|--------------|
| | £000 |
| Profit for the year | 1,175 |
| Add back depreciation | 100 |
| Less increase in working capital | <u>(575)</u> |
| | 700 |
| Add issue of shares | 1,000 |
| Less repayment of debentures | (750) |
| Less purchase of fixed assets | <u>(200)</u> |
| Increase in bank balance | <u>750</u> |

1.9 Answer: (D)

A company does not have a single capital account – its capital consists of several accounts. If you answered (B), you are partly right, as the appropriation account is part of the profit and loss account, but is a separate section.

1.10 Answer (D)

(A) and (B) are both forms of revenue reserve. Issuing shares at a premium increases reserves, but they are capital reserves anyway.

1.11 Answer: (C)

Lengthening the period of credit given to customers reduces the amount of cash coming in. Lengthening the period of credit taken from suppliers has the opposite effect. The sale of fixed assets at whatever value results in cash coming in, while depreciation has no effect on cash at all.

1.12 Answer: (A)

All the others are part of the equity capital.

1.13 Answer: (C)

1.14

| | |
|------------------------------------|-------------|
| | £000 |
| Net profit | 180 |
| Add depreciation | 30 |
| Less profit on sale of fixed asset | (75) |
| Less change in working capital | <u>(10)</u> |
| | <u>125</u> |

1.15 Answer: (D)



Solution 2

- Part (a) involves payroll entries. Remember that employers' National Insurance is not deducted from employees' wages but is an additional expense of the firm. The gross wages represent the amount to be charged in the profit and loss account in addition to

the employers' National Insurance. The amount to be paid over to the Inland Revenue will include both types of National Insurance and the PAYE deducted. Any amounts still outstanding at the year end will be included with current liabilities on the balance sheet.

- Part (b) requires you to prepare corrected final accounts. If you have dealt incorrectly with the items in part (a) you may not be able to complete this section correctly.

(a)

Omit Ltd: payment journal

| | | <i>Debit (£)</i> | <i>Credit (£)</i> |
|----|---------------|------------------|-------------------|
| Dr | PAYE creditor | 13,205 | |
| Dr | NI creditor | 10,568 | |
| Cr | Cash | | 23,773 |

Payroll journals

| | | <i>Debit (£)</i> | <i>Credit (£)</i> |
|-----------------------------|--|------------------|-------------------|
| <i>Manufacturing staff</i> | | | |
| Dr | Cost of sales: (29,799 + 10,800 + 4,212 + 4,683) | 49,494 | |
| Cr | Cash | | 29,799 |
| Cr | PAYE creditor | | 10,800 |
| Cr | NI creditor | | 8,895 |
| <i>Administration staff</i> | | | |
| Dr | Profit and loss (5,999 + 2,286 + 859 + 956) | 10,100 | |
| Cr | Cash | | 5,999 |
| Cr | PAYE creditor | | 2,286 |
| Cr | NI creditor (859 + 956) | | 1,815 |

(b)

| | | |
|---|---|---------------|
| | ± | £ |
| Cash balance per original balance sheet | | 87,800 |
| | – | 23,773 |
| | – | 29,799 |
| | – | <u>5,999</u> |
| Revised cash balance | | <u>28,229</u> |

(c)

Trading and profit and loss account for the year ended 31 December 19X1 (draft)

| | |
|--|------------------|
| | £ |
| Sales | 1,210,213 |
| Cost of sales (943,000 + 49,494) | <u>(992,494)</u> |
| Gross profit | 217,719 |
| Administrative salaries (110,100 + 10,100) | (120,200) |
| Other expenses | <u>(28,956)</u> |
| Net profit | <u>68,563</u> |

Balance sheet as at 31 December 19X1 (draft)

| | £ | £ |
|--|------------------|----------------|
| Fixed assets | | 596,294 |
| Current assets | | |
| Stock | 186,200 | |
| Debtors | 252,111 | |
| Cash | 28,229 | |
| | <u>466,540</u> | |
| Creditors: amounts falling due in less than one year | | |
| Trade creditors | 120,290 | |
| PAYE (% + 10,800 + 2,286) | 13,086 | |
| NICs (% + 8,895 + 1,815) | 10,710 | |
| | <u>(144,086)</u> | |
| | | <u>322,454</u> |
| | | <u>918,748</u> |
| Capital and reserves | | |
| Share capital | | 100,000 |
| Profit and loss (878,342 – 49,494 – 10,100) | | 818,748 |
| | | <u>918,748</u> |

**Solution 3**

- This question involves consideration of a range of errors that have occurred prior to the preparation of final accounts as presented. Item 1 requires the motor car to be taken out of the stock figure and to be included with fixed assets and depreciated as appropriate. Item 2 requires amendment of the sales figure and the suspense account. Item 4 arises because the purchase has been omitted from the books – the resulting debit balance on T Conway's account in the purchase ledger would highlight this omission.

(a) Item

| | | £ |
|----------------------------|--------|------------------------------|
| 1. Motor vehicles | Debit | 10,000 |
| Stock | Credit | 10,000 |
| Retained earnings | Debit | 625* = (10,000 × 25% × 3/12) |
| Provision for depreciation | Credit | 625 |
| 2. Retained earnings | Debit | 1,400 |
| Debtors | Credit | 1,000 |
| Suspense account | Credit | 400 |
| 3. Retained earnings | Debit | 2,400 |
| Accrued interest | Credit | 2,400 |
| 4. Retained earnings | Debit | 2,000 |
| Creditors | Credit | 2,000 |

| | | |
|--|--------|------------|
| (b) Suspense account balance at 30.04.92 | Debit | 1,300 |
| Correction required re item no. 2 | Credit | <u>400</u> |
| Remaining balance on suspense account | Debit | <u>900</u> |

(c) Item

| | | £ |
|-----------------------|--------|-----|
| 5. Insurance prepaid* | Debit | 900 |
| Suspense account | Credit | 900 |

*No actual entry is needed in the insurance a/c, but the amount must be included with amounts prepaid on the balance sheet.

(d) **Retained earnings year ended 30 April 1992**

| | | |
|--|--------------|---------------|
| | £ | £ |
| Per list of balances at 30 April 1992 | | 40,000 |
| Less | | |
| Motor car depreciation (25% × (25% × £10,000)) | 625 | |
| Receipt wrongly credited to sales | 1,400 | |
| Loan interest accrued due | 2,400 | |
| Raw material purchase omitted | <u>2,000</u> | |
| | | <u>6,425</u> |
| | | <u>33,575</u> |

(e) **Balance sheet as at 30 April 1992**

| | <i>At Cost (£)</i> | <i>Provision for depreciation (£)</i> | <i>NBV (£)</i> |
|--|------------------------|---|--------------------|
| Fixed assets | | | |
| Freehold land and buildings | 100,000 | 20,000 | 80,000 |
| Plant and machinery | 58,000 | 16,400 | 41,600 |
| Motor vehicles | <u>46,000</u> | <u>9,125</u> | <u>36,875</u> |
| | <u>204,000</u> | <u>45,525</u> | 158,475 |
| Current assets | | | |
| Stock (£24,700 – £10,000) | | 14,700 | |
| Trade debtors (£4,500 – £1,000 – £2,000) | | 1,500 | |
| Amounts prepaid (£1,600 + £900) | | 2,500 | |
| Balance at bank | | <u>4,300</u> | |
| | | 23,000 | |
| Less: creditors: amounts falling due within one year | | | |
| Trade creditors | 7,900 | | |
| Accrued charges | <u>2,400</u> | | |
| | | <u>10,300</u> | |
| | | | <u>12,700</u> |
| | | | 171,175 |
| Creditors: amounts falling due after more than one year: 8% loan stock | | | <u>30,000</u> |
| | | | <u>141,175</u> |
| Represented by | | | |
| Ordinary shares of £1 each fully paid | | | 100,000 |
| Retained earnings | | | |
| At 1 May 1991 | | 7,600 | |
| Year ended 30 April 1992 | | <u>33,575</u> | |
| | | | <u>41,175</u> |
| | | | <u>141,175</u> |

 **Solution 4**

- This is quite a complex question involving the correction of errors and adjustments to the figures contained in the accounts, prior to the preparation of final accounts.
- The correction of the control account is particularly important as it is part of the trial balance.
- The adjustments to opening and closing stock also require careful consideration: the error in opening stock means that the profit and loss account balance brought forward is overstated and the operating profit for the period is understated; the error in closing stock means that the operating profit figure in the list of balances is understated and the stock figure is understated.

- The debenture interest should be calculated as one-quarter of the annual figure, as they have been issued for only 3 months.

(a) Journal

| | <i>Debit (£)</i> | <i>Credit (£)</i> |
|--|------------------|-------------------|
| (i) Creditors | 10,000 | |
| Debtors | | 10,000 |
| Operating profit (sales) | 1,000 | |
| Debtors | | 1,000 |
| Operating profit (sales returns) | 4,000 | |
| Suspense account | | 4,000 |
| (ii) Bank (£2,000 – £1,000) | 1,000 | |
| Operating profit (bank charges) | 1,000 | |
| Debtors | | 2,000 |
| (iii) Operating profit (bad debts w/o) | 1,000 | |
| Debtors | | 1,000 |
| Provision for doubtful debts (Note 1) | 1,140 | |
| Operating profit (reduction in prov'n) | | 1,140 |
| (iv) Stocks | 2,000 | |
| Operating profit (closing stock) | | 2,000 |
| Profit and loss balance b/fwd | 1,000 | |
| Operating profit | | 1,000 |
| (v) Suspense (balance) (Note 2) | 3,000 | |
| Operating profit (sales) | | 3,000 |

Notes:

1. The provision for doubtful debts is to become 1 per cent of £186,000 = £1,860 (a reduction of £1,140).
2. The balance of the suspense account was £1,000 debit (found by adding up the balances given in the question); transaction (i) above credited the suspense account with £4,000, therefore the final balance was £3,000 credit – and as per the instruction in note (v), this is to be added to the sales account.

(b) Revised operating profit

| | |
|------------------------------|--------------|
| | <i>£</i> |
| Original operating profit | 80,000 |
| (i) Debtors | (1,000) |
| Suspense | (4,000) |
| (ii) Bank | (1,000) |
| (iii) Debtors | (1,000) |
| Provision for doubtful debts | 1,140 |
| (iv) Stocks | 2,000 |
| P&L b/fwd | 1,000 |
| (v) Suspense | <u>3,000</u> |
| Revised operating profit | 80,140 |

Fiddles plc: profit and loss account

| | |
|-------------------------|-----------------------|
| | <i>£</i> |
| Operating profit | 80,140 |
| Debenture interest | <u>(7,200)</u> |
| Net profit | 72,940 |
| Dividend | <u>10,000</u> |
| | 62,940 |
| b/fwd (200,000 – 1,000) | <u>199,000</u> |
| c/fwd | <u><u>261,940</u></u> |

Fiddles plc: balance sheet

| | £ | £ | £ |
|---------------------------------|---------------|----------------|----------------|
| Fixed assets | | | |
| Land | | | 100,000 |
| Buildings | | | 120,000 |
| Plant and machinery | | | |
| Cost | | 170,000 | |
| Depreciation | | <u>120,000</u> | |
| | | | <u>50,000</u> |
| | | | <u>270,000</u> |
| Current assets | | | |
| Stocks | | 192,000 | |
| Debtors | 186,000 | | |
| Less provisions | <u>1,860</u> | | |
| | | 184,140 | |
| Bank | | <u>13,000</u> | |
| | | <u>389,140</u> | |
| Less current liabilities | | | |
| Creditors | 100,000 | | |
| Debenture interest | 7,200 | | |
| Dividends proposed | <u>10,000</u> | | |
| | | <u>117,200</u> | |
| | | | <u>271,940</u> |
| | | | <u>541,940</u> |
| Less long-term liabilities | | | |
| Debentures | | | <u>180,000</u> |
| | | | <u>361,940</u> |
| Financed by | | | |
| Share capital | | | 100,000 |
| Profit and loss account balance | | | <u>261,940</u> |
| | | | <u>361,940</u> |

**Solution 5**

- This question involves the preparation of a cash-flow statement by analysing changes in the balance sheet, together with the adjustment of profit for items that do not affect cash.
- Transfers to reserves must be added back before arriving at operating profit; this must then be adjusted by adding back depreciation for the year.

(a)

| | |
|-----------------------------|----------------|
| | £,000 |
| Profit for the year | 1,500 |
| Add back depreciation | 750 |
| Add decrease in stock | 200 |
| Add decrease in debtors | 1,500 |
| Less decrease in creditors | <u>(1,000)</u> |
| Cash inflow from operations | 2,950 |
| Issue of shares | <u>3,000</u> |
| Increase in cash and bank | 5,950 |
| Opening bank balance | <u>(1,000)</u> |
| Closing bank balance | <u>4,950</u> |

(b) OGN Ltd: balance sheet at 31 December 1995

| | <i>£000</i> | <i>£000</i> |
|----------------------------------|--------------|---------------|
| Fixed assets | | 7,500 |
| Less depreciation | | <u>750</u> |
| | | 6,750 |
| Current assets | | |
| Stocks | 1,800 | |
| Debtors | 3,500 | |
| Bank | <u>4,950</u> | |
| | 10,250 | |
| Current liabilities | | |
| Trade creditors | <u>3,000</u> | |
| | | <u>7,250</u> |
| | | <u>14,000</u> |
| Financed by | | |
| 9,000 ordinary shares of £1 each | | 9,000 |
| Share premium account | | 1,000 |
| General reserves | | 2,500 |
| Profit and loss account | | <u>1,500</u> |
| | | <u>14,000</u> |

- (c) (i) Par value is that ascribed to shares when authorised, appears on the share certificate and used for dividend calculations.
- (ii) Debentures are long-term loans with a fixed interest rate, payable irrespective of profits. They may be redeemable in the future, and secured on fixed assets.
- (iii) Profits are transferred to general reserves to limit the profits available for payment of current/future dividends. They may be reversed in the future.
- (iv) Dividends are proposed by the directors, but are not payable until approved by members at the annual general meeting. The amount proposed is held as a current liability.



Solution 6

- Commence this question by preparing a workings section, adjusting for the various points given to you in the notes, with adjustments and apportionments clearly labelled.
- It might also help to label the figures in the trial balance according to their destination, that is, manufacturing account, trading account, profit and loss account, balance sheet – and a note of items to be apportioned between different accounts.

(a) ABC Ltd: manufacturing account for the year ended 31 October 1993

| | £000 | £000 | £000 |
|--|-------------|-------------|--------------|
| Opening stock of raw materials | | 27 | |
| Purchases of raw materials | 826 | | |
| Less returns | <u>(18)</u> | | |
| | | 808 | |
| | | 835 | |
| Less closing stock of raw materials | | <u>(24)</u> | |
| Direct materials | | | 811 |
| Direct labour (575 + 15) | | | <u>590</u> |
| Prime cost | | | 1,401 |
| Indirect factory costs | | | |
| Heat, light and power (50% × £242) | | 121 | |
| Salaries (20% × (122 + 8)) | | 26 | |
| Rent, rates, insurance ($\frac{1}{3}$ × (114 – 21)) | | 31 | |
| Depreciation of plant (10% × £350) | | 35 | |
| Depreciation of premises (25% × (2% × 600)) | | <u>3</u> | |
| | | | 216 |
| Total factory cost | | | 1,617 |
| Change in work in progress | | | |
| Opening stock | | 18 | |
| Less closing stock | | <u>19</u> | |
| | | | (1) |
| Factory cost of goods transferred | | | <u>1,616</u> |

(b) ABC Ltd: trading and profit and loss account for the year ended 31 October 1993

| | £000 | £000 |
|--------------------------------------|--------------|-------------|
| Sales | | 2,350 |
| Less returns | | <u>(38)</u> |
| | | 2,312 |
| Less cost of goods sold | | |
| Opening stock of finished goods | 255 | |
| Factory cost of goods transferred | <u>1,616</u> | |
| | 1,871 | |
| Less closing stock of finished goods | <u>(147)</u> | |
| | | 1,724 |
| Gross profit | | 588 |
| Less expenses | | |
| Heat, light and power | 121 | |
| Salaries | 104 | |
| Printing, post and stationery | 32 | |
| Rent, rates and insurance | 62 | |
| Loan interest payable | 50 | |
| Provision for doubtful debts | (5) | |
| Bad debts written off | 40 | |
| Stock written down | 5 | |
| Depreciation | | |
| Premises | 9 | |
| Office equipment | <u>18</u> | |
| | | 436 |
| Net profit before tax | | 152 |
| Provision for taxation | | <u>(35)</u> |
| Net profit after tax | | 117 |
| Proposed dividends | | |
| Interim | (10) | |
| Final | <u>(50)</u> | |
| | | (60) |
| | | 57 |
| Profit and loss account balance b/f | | <u>442</u> |
| Profit and loss account balance c/f | | <u>499</u> |

(c) ABC Ltd: balance sheet at 31 October 1993

| | <i>Cost</i> (£000) | <i>Dep'n</i> (£000) | <i>NBV</i> (£000) |
|---|-----------------------|------------------------|----------------------|
| Fixed assets | | | |
| Premises | 600 | (207) | 393 |
| Plant | 350 | (175) | 175 |
| Office equipment | 125 | (53) | 72 |
| | <u>1,075</u> | <u>435</u> | 640 |
| Current assets | | | |
| Stocks | | | |
| Raw materials | 24 | | |
| Work in progress | 19 | | |
| Finished goods | 142 | | |
| | | 185 | |
| Debtors | 240 | | |
| Less provisions | <u>(6)</u> | | |
| | | 234 | |
| Prepayments | | 21 | |
| Bank balance | | <u>509</u> | |
| | | <u>949</u> | |
| Current liabilities | | | |
| Trade creditors | | (75) | |
| Accruals | | (61) | |
| VAT liability | | (19) | |
| Taxation | | (35) | |
| Proposed dividends | | (50) | |
| Loan repayable in twelve months | | <u>(100)</u> | |
| | | <u>(340)</u> | |
| Working capital | | | 609 |
| | | | 1,249 |
| Less loan repayable after twelve months | | | <u>(150)</u> |
| | | | <u>1,099</u> |
| Financed by | | | |
| Ordinary share capital | | | 500 |
| Share premium account | | | 100 |
| Profit and loss account | | | 499 |
| | | | <u>1,099</u> |



Solution 7

- This is a very straightforward question involving a manufacturer, with all the usual adjustments and apportionments required.
- Prepare a workings section, with adjustments and apportionments clearly labelled.
- It might also help to label the figures in the trial balance according to their destination, that is, manufacturing account, trading account, profit and loss account, balance sheet.

(a) FPC Ltd: manufacturing account for year ended 31 March 1996

| | | |
|------------------------------------|------------------|-------------------------|
| | £ | £ |
| Opening stock of raw material | | 60,000 |
| Purchases | 1,500,000 | |
| Carriage inwards | 15,000 | |
| | <u>1,515,000</u> | |
| Less returns outwards | <u>(22,000)</u> | |
| Net purchases | | 1,493,000 |
| | | <u>1,553,000</u> |
| Less closing stock of raw material | | <u>(80,000)</u> |
| Direct material | | 1,473,000 |
| Direct labour | | <u>617,500</u> |
| Prime cost | | 2,090,500 |
| Factory indirect expenses | | |
| Rent and rates | 22,000 | |
| Insurance | 16,000 | |
| Factory supervisors' salaries | 150,000 | |
| Depreciation – premises | 4,500 | |
| Depreciation – plant | <u>11,250</u> | |
| | | <u>203,750</u> |
| | | 2,294,250 |
| Opening work in progress | 30,000 | |
| Less closing work in progress | <u>(42,500)</u> | |
| | | <u>(12,500)</u> |
| Factory cost of goods completed | | <u><u>2,281,750</u></u> |

(b) FPC Ltd: trading and profit and loss account for year ended 31 March 1996

| | £ | £ |
|--------------------------------------|------------------|-----------------------|
| Sales | | 2,925,000 |
| Less returns | | <u>(14,000)</u> |
| Net sales | | 2,911,000 |
| Less cost of goods sold | | |
| Opening stock of finished goods | 70,000 | |
| Factory cost of goods completed | <u>2,281,750</u> | |
| | 2,351,750 | |
| Less closing stock of finished goods | <u>(127,000)</u> | |
| | | <u>(2,224,750)</u> |
| Gross profit | | 686,250 |
| Discount received | | <u>2,500</u> |
| | | 688,750 |
| Less expenses | | |
| Carriage outwards | 10,000 | |
| Discount allowed | 4,000 | |
| Rent and rates | 88,000 | |
| Insurance | 64,000 | |
| Office wages and salaries | 175,000 | |
| Sales officers' commission | 145,550 | |
| Administration expenses | 43,600 | |
| Provision for doubtful debts | 2,250 | |
| Bad debts written off | 6,500 | |
| Debenture interest | 10,000 | |
| Depreciation – premises | 13,500 | |
| Depreciation – plant and machinery | <u>3,750</u> | |
| | | <u>566,150</u> |
| Net profit before tax | | 122,600 |
| Provision for taxation | | <u>22,000</u> |
| Net profit/(loss) after tax | | 100,600 |
| Proposed dividends | | <u>22,500</u> |
| Retained profit for the year | | 78,100 |
| Profit and loss account b/fwd | | <u>98,000</u> |
| Profit and loss account c/fwd | | <u><u>176,100</u></u> |

Workings

| | |
|------------------------------|--|
| Rent and rates | per trial balance £120,000, less prepaid £10,000 = £110,000 20% factory = £22,000; 80% administration = £88,000 |
| Insurance | per trial balance £100,000, less prepaid £20,000 = £80,000 20% factory = £16,000; 80% administration = £64,000 |
| Direct labour | per trial balance £600,000, add accrued £17,500 = £617,500 |
| Sales | per trial balance £2,960,000, less sale or return £35,000 = £2,925,000 |
| Debtors | per trial balance £220,000, less sale or return £35,000 = £185,000 |
| Depreciation | plant: 10% of £150,000 = £15,000 75% factory = £11,250; 25% administration = £3,750 premises: 2% of £900,000 = £18,000 25% factory = £4,500; 75% administration = £13,500 |
| Provision for doubtful debts | 5% of £185,000 = £9,250 less previous balance £7,000 = £2,250 |
| Sales officers' commission | 5% of £2,911,000 = £145,550, less already paid £113,500 = £32,050 accrued |
| Administration expenses | per trial balance £45,000 less incorrect VAT £1,400 = £43,600 |
| Dividend | £750,000 × 3p = £22,500 |

- (c) (i) consistency concept
(ii) matching concept
(iii) prudence concept



Solution 8

(a)

| Fixed assets at cost | | | |
|--------------------------------|--------------|---------------------------|--------------|
| | <i>£000</i> | | <i>£000</i> |
| Balance b/f | 1,000 | Disposals a/c | 50 |
| Additions | <u>350</u> | Balance c/f | <u>1,300</u> |
| | <u>1,350</u> | | <u>1,350</u> |
| Fixed asset – depreciation | | | |
| | <i>£000</i> | | <i>£000</i> |
| Disposals a/c | 20 | Balance b/f | 400 |
| Balance c/f | <u>600</u> | Provision for the year | <u>220</u> |
| | <u>620</u> | | <u>620</u> |
| Fixed assets – disposals | | | |
| | <i>£000</i> | | <i>£000</i> |
| Fixed assets at cost | 50 | Fixed assets depreciation | 20 |
| Profit on sale of fixed assets | <u>10</u> | Disposal proceeds | <u>40</u> |
| | <u>60</u> | | <u>60</u> |

(b) Cash-flow statement for the year ended 31 March 2002

| | |
|---|--------------|
| | <i>£000</i> |
| Increase in profit and loss account (1,240 – 1,200) | 40 |
| Add dividends proposed | 260 |
| Add depreciation | 220 |
| Less profit on sale of fixed assets | <u>(10)</u> |
| | 510 |
| Less increase in stock | (600) |
| Less increase in debtors | (400) |
| Add increase in creditors | 280 |
| Cash outflow from operations | <u>(210)</u> |
| Dividends paid | (300) |
| Fixed assets purchased | (350) |
| Proceeds of sale of fixed assets | 40 |
| Shares issued | <u>500</u> |
| Decrease in bank balance | <u>(320)</u> |

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The Interpretation of Accounts

14

LEARNING OUTCOME

When you have completed this chapter, you should be able to:

- ▶ calculate and explain basic ratios.

14.1 Introduction

You have now reached one of the most important areas of study in this subject – the use and interpretation of accounting information. You now know how to prepare accounts for various organisations, from a variety of different sources of data, but now we return to the content of Chapter 1 and the questions it posed: *What is accounting, who uses accounts and for what purpose, and what makes accounts useful?* The mechanics of the preparation of accounts form only the start of the accounting process, the end result of which is to provide users with information to enable them to make decisions. The mere presentation of a set of accounts does not necessarily achieve that objective, and this chapter looks at ways of making that information more meaningful.



Understanding the whole of this chapter should be regarded as essential for examination success.

14.2 What is meant by ‘interpretation of accounts’?

Financial statements provide a great deal of information. However, one difficulty with these statements is that they show only absolute figures for a particular period, and at the end of that period. To enable users to make informed decisions, the statements on their own do not always provide sufficient information, even though they have been prepared in accordance with accounting standards.

Example 14.A

Suppose that Company A has a trading account that shows sales revenue of £100,000 and the net profit is £5,000. What does this tell you? It tells you that the sales revenue is £100,000 and the net profit is £5,000. Is this good or bad? Is this to be expected? Is this comparable with other organisations? Can a user of the accounts make decisions on the basis of this information?

The answer is no. That information on its own is not of use. Let us consider two other companies as well. Company B has sales revenue of £200,000 and net profit of £6,000. Company C has sales revenue of £300,000 and net profit of £4,500. Which of the three organisations is best? That depends on what the user is looking for.

If the user is looking for the organisation with the highest revenue, that is Company C. If (s)he is looking for the organisation with the highest profit, that is Company B. Which organisation is most successful, in terms of its profit? You might think it is Company B, with its higher profit. But Company B achieved that profit from sales of £200,000, whereas Company A had only half that level of sales yet achieved a profit of only £1,000 less than Company B.

We are now embarking on an important area of accounting, that of *comparison*. We are starting to compare profit with sales revenue, and we are comparing one firm with another. That is the key technique of the interpretation of accounts – comparison of one with another.

Let us tabulate the information given above:

| Company | Sales revenue | Net profit |
|---------|---------------|------------|
| A | £100,000 | £5,000 |
| B | £200,000 | £6,000 |
| C | £300,000 | £4,500 |

There are comparisons we can make here. Although Company B had the highest profit, it was only 3 per cent of its sales revenue. That is found by the following formula:

$$\frac{\text{Net profit}}{\text{Sales}} \times 100$$

Company A achieved a net profit of 5 per cent of sales, and Company C achieved a net profit of only 1.5 per cent. So Company C looks poor.

But that is taking only one year as information. It would be useful to look at last year's results and see if any of the companies have improved their profits.

It might also be useful to compare the profit with other figures, apart from sales. Suppose that the capital employed in Company A is £50,000. A profit of £5,000 is a 10 per cent return on that capital. Suppose that Company C's capital employed is only £30,000. Its return on that capital is 15 per cent – so an investor might prefer to choose Company C, while a lender might prefer Company B.

The point is that different users are looking for different information, which a set of accounts on its own does not necessarily provide. Comparing figures with other figures is a useful additional tool in providing information to support decision-making. These tools are known as the techniques of ratio analysis.

14.3 Calculating ratios

A ratio is simply a comparison of one figure with another. In the above examples, we calculated the *percentage* of profit compared with sales revenue for each year.

Using the formula above, for Company A the calculation is:

$$\frac{5,000}{100,000} \times 100 = 5\%$$

Calculating a percentage is only one method of presenting a ratio. The same figures could be presented as a fraction:

$$\frac{5,000}{100,000} = \frac{1}{20}$$

which means that profit was $\frac{1}{20}$ of sales revenue. The figures could also be shown as a simple comparison:

5,000 : 100,000, or 1 : 20

which means that each £1 of profit required £20 of sales revenue.

There are other types of ratios, which will be explained later in the chapter.

14.3.1 Using the ratios

Calculating the ratios is only one step in the analysis process. Once that is done, the results must be compared with other results. Comparison is commonly made between:

- previous accounting periods;
- other companies (perhaps in the same type of business);
- budgets and expectations;
- government statistics;
- other ratios.

14.4 Types of ratios

Ratios can be classified into various groupings, according to the type of information they convey. The main groupings are as follows:

- profitability (performance) ratios;
- liquidity (solvency) ratios;
- efficiency (use of assets) ratios;
- capital structure (gearing) ratios;
- security (investors) ratios.

The last group, security ratios, is not part of your syllabus for this subject. The above list is not exhaustive – a ratio can be compiled from any data if it can be usefully interpreted.

The following trading and profit and loss account and balance sheet will be used to illustrate the calculation of simple accounting ratios and interpret them.

Trading and profit and loss account for the year ended 31 December year 8

| | | |
|-------------------------------|----------------|---------------------|
| | £ | £ |
| Sales | | 23,636 |
| Opening stock | 1,225 | |
| Purchases | 8,999 | |
| | <u>10,224</u> | |
| Closing stock | <u>(1,425)</u> | |
| | | 8,799 |
| Gross profit | | 14,837 |
| Expenses | | 5,737 |
| Operating profit | | <u>9,100</u> |
| Interest payable on bank loan | | 450 |
| Net profit before tax | | 8,650 |
| Taxation | | <u>1,000</u> |
| Net profit retained | | <u><u>7,650</u></u> |

Balance sheet at 31 December year 8

| | | |
|---------------------|--------------|---------------|
| | £ | £ |
| Fixed assets | | 14,135 |
| Current assets | | |
| Stock | 1,425 | |
| Debtors | 542 | |
| Bank | 7,037 | |
| Cash in hand | 697 | |
| | <u>9,701</u> | |
| Current liabilities | | |
| Creditors | 1,086 | |
| | | <u>8,615</u> |
| | | <u>22,750</u> |
| Financed by | | |
| Capital | | 18,250 |
| Bank loan | | 4,500 |
| | | <u>22,750</u> |

14.5 Profitability ratios

These are also known as *performance ratios*. They compare profit at different levels with other figures, and are often presented as percentages.

14.5.1 Gross profit margin

This ratio (also known as the *gross profit: sales ratio*) is calculated by:

$$\frac{\text{Gross profit}}{\text{Sales}} \times 100 = \frac{14,837}{23,636} \times 100 = 62.8\%$$

It is normally expressed as a percentage, but do try to understand the meaning of the percentage. The calculation shows that for every £1 of sales revenue, 62.8 pence was available to support the remaining expenses, the possible payment of dividends, and the retention of profits for the future. While its value is useful for comparing the results of similar businesses, the trend of profit margins over time is a more appropriate use of the ratio.

Suppose the ratio in the previous year had been 64.3 per cent. How can we interpret the decline over the year?

There are several possibilities:

- sales revenue declined;
- sales revenue remained the same, but costs have increased;
- sales revenue increased, but costs increased by a greater proportion;
- it was necessary to keep sales prices steady, despite rising costs, in order to retain market share;
- suppliers increased their prices, or perhaps the firm lost the advantage of trade discounts;
- the sales mix changed: if several different products are being sold they will not all be equally profitable. It is possible that in the current year we sold a higher proportion of the less profitable products.

You can perhaps see that the above changes can be classified as either *volume changes* or *price changes*.

The gross profit margin could be a measure of the effectiveness of the sales team, pricing policies, purchasing methods, and (in a manufacturing organisation) the production processes.

The decline will not be as a result of holding stocks, as this is adjusted for in the cost of sales calculation.

14.5.2 Gross profit mark-up

This ratio is an alternative measure of profitability. It is calculated by:

$$\frac{\text{Gross profit}}{\text{Cost of sales}} \times 100 = \frac{14,387}{8,799} \times 100 = 168.6\%$$

It shows us that the selling price of the goods was equal to the cost of those goods, plus 168.6 per cent of the cost. In other words, for every £1 we spent on the cost of goods, we added £1.69 (approximately) to arrive at a selling price of £2.69.

Similar comments apply to this ratio as were applied to the gross profit margin.

14.5.3 Net profit margin

This is calculated by:

$$\frac{\text{Net profit}}{\text{Sales}} \times 100 = \frac{8,650}{23,636} \times 100 = 36.6\%$$

The value of this ratio lies in its comparison over time and with other organisations and the industry average. In this example the net profit percentage was 36.6 per cent. In itself, this has no meaning – only by comparing it as stated is it possible to derive any benefit from the calculation. To interpret this percentage fully would involve an examination of its components. Given that net profit is equal to gross profit less expenses, a change in this percentage could arise either from a change in gross profit or from a change in one or more of the expenses deducted from gross profit. Further analysis would be needed.

The net profit figure taken into the calculation could be the net profit before tax or the net profit after tax. As the taxation figure is not always directly related to the profit shown in the accounts, it is more reliable to use the net profit before tax figure, if it is available, to enable comparison between other periods and companies.

14.5.4 Return on capital employed (ROCE)

People who invest their money in a business are interested in the return the business is earning on that capital. Expressing this return in the form of a ratio enables comparison with other possible investment opportunities.

This ratio is a key measure of return. It measures the amount of earnings generated per £1 of capital, and is usually stated as a percentage. The ratio can be calculated in several different ways, according to the information required of it, and depending on what is meant by the two terms ‘capital employed’ and ‘return’.

- *Capital employed* can consist of total capital employed, shareholders’ funds only (i.e. including preference share capital), or equity capital only (i.e. ordinary shares plus

reserves). In using *total capital employed* we include long-term loans as well as shareholders' funds. Furthermore, it is more correct to use the average of capital employed during the year, as the profit has been earned throughout the year. The capital at the start of the year will have been different, having been affected by share issues and the addition of profit for the year.

- *Return* is another way of describing net profit. As mentioned above, net profit can be taken to be before or after taxation, and it can also be taken before accounting for interest on long-term loans. The net profit figure to be taken will depend on which figure is taken for capital employed. If capital employed is taken as being total capital employed, then it is the operating profit figure that is required to be used as the 'return', as this is the profit available to finance the total investment in the business.

The basic formula for return on capital employed is:

$$\frac{\text{Net profit}}{\text{Average capital employed}} \times 100$$

There are several possible calculations, but the two most commonly used are:

$$1. \frac{\text{Net profit before tax and interest (operating profit)}}{\text{Average capital employed by shareholders and lenders}} \times 100$$

This expresses the profit that is available to all providers of long-term capital, as a percentage of that capital. Using the figures from the accounts above, the calculation is:

$$\frac{9,100}{18,925} \times 100 = 48\%$$

Net profit before tax and interest is arrived at by adding back the interest (if it has been deducted), that is, 8,650 + 450.

Average capital employed is arrived at by taking the average of:

| | | |
|--|---------------|----------------------|
| Closing capital employed | £ 22,750 | |
| Opening capital employed (22,750 – 7,650 profit) | 15,100 | |
| | <u>37,850</u> | ÷ 2 = <u>£18,925</u> |

Overdrafts are specifically excluded from capital employed. This assumes that overdrafts are temporary and are not considered to be a source of permanent finance for the business.

$$2. \frac{\text{Net profit before tax but after interest}}{\text{Average shareholders' funds}} \times 100$$

This expresses the profit that is available only to shareholders, as a percentage of their funds. The calculation is also known as return on net assets, as the total capital employed figure is equal to net assets.

Using the figures in the accounts above, the calculation is:

$$\frac{8,650}{14,425} \times 100 = 60\%$$

Average shareholders' funds is arrived at by taking the average of:

| | | |
|---|---------------|----------------------|
| Closing shareholders' funds | £ 18,250 | |
| Opening shareholders' funds (18,250 – 7,650 profit) | 10,600 | |
| | <u>28,850</u> | ÷ 2 = <u>£14,425</u> |

If it is not possible to calculate the average capital employed, then use the closing capital figure, but bear in mind that it may not be representative of the capital employed throughout the year.

14.6 Liquidity ratios

These are also known as *solvency ratios*, as they refer to the ability of the business to pay its creditors in the short term.

There are two main liquidity ratios.

14.6.1 The current ratio

This is also known as the *working capital* ratio, as it is based on working capital or net current assets. It is a measure of the liquidity of a business that compares its current assets with those creditors due to be paid within one year of the balance sheet date (otherwise known as current liabilities). It is calculated as:

$$\frac{\text{Current assets}}{\text{Current liabilities}} = \frac{9,701}{1,086} = 8.9:1$$

Notice how the ratio is expressed, as a comparison of assets with liabilities. The ratio can also be stated as:

Current assets : current liabilities

The importance of this ratio is the information it gives about the liquidity of a business. Current liabilities all have to be settled in cash within a reasonably short space of time. Does the company have sufficient liquid resources to do this? Clearly its cash and bank balances are liquid; debtors should convert into cash quite soon; and stock will presumably soon be sold, again eventually generating cash. The calculation tells us that the company has £8.90 in current assets with which to pay every £1 of its current liabilities.

A high ratio, such as the one in our example, means that current assets are easily sufficient to cover current liabilities. A ratio of below one – meaning that current liabilities exceed current assets – could imply danger of insolvency. It used to be thought that a ratio of 2:1 was ideal, but this depends on the type of business and its reliance on credit transactions.

Although a high ratio gives comfort to creditors, it may mean that the company is holding more in current assets than it requires in the short term. This is wasteful, as current assets rarely earn income – stocks need to be sold in order to produce profits, debtors will not pay more than the amount outstanding, and bank balances may earn only very small amounts of interest. Indeed, a company with a high level of stocks might indicate difficulty in selling them, while a high level of debtors might indicate poor credit control.

14.6.2 The quick ratio

This is also known as the *acid test ratio* and is calculated by:

$$\frac{\text{Current assets excluding stocks}}{\text{Current liabilities}} = \frac{8,276}{8,799} \times 100 = 7.6:1$$

or it can be expressed as:

Current assets excluding stocks : current liabilities

This is similar to the current ratio, but takes the more prudent view that stocks may take some time to convert into cash, and therefore the true liquidity position is measured by the relationship of debtors and cash only to current liabilities. The calculation tells us that the company has £7.60 in 'quick' assets with which to pay its current liabilities. Again, a very high ratio is very comforting, but may be wasteful as mentioned above. Generally, a ratio of 1:1 is considered 'ideal' but many retail companies with very regular cash sales have very low ratios, due to their lack of debtors.

A low ratio might need further investigation before conclusions can be drawn, for example, if the current liabilities figure includes creditors not due for payment until well into the next accounting period (e.g. corporation tax and dividend liabilities), the figure may be distorted.

14.7 Efficiency ratios

These are also referred to as *use of assets ratios*. They measure the efficiency of the management of assets, both fixed and current.

14.7.1 Asset turnover ratios

These ratios compare the assets with the sales revenue (turnover) that they have earned. The end result is often expressed in money value, to represent the value of sales revenue for each £1 invested in those assets. The formula is:

$$\frac{\text{Sales revenue}}{\text{Assets}} = \text{£}x$$

The calculation can be performed on any combination of assets, from total net assets to individual groups of assets, such as plant and machinery.

Sales: capital employed (net asset turnover)

This is the sales revenue generated per £1 of capital employed, using the net assets figure to determine capital employed.

$$\frac{\text{Sales revenue}}{\text{Average net assets}} = \frac{23,636}{14,425} = \text{£}1.638$$

(See Section 14.5.4 for the calculation of average net assets – it is the same as average capital employed.)

The result tells us that we generated £1.638 in sales for every £1 invested in net assets.

Sales: fixed assets (fixed asset turnover)

This is the sales revenue generated per £1 of fixed assets.

$$\frac{\text{Sales revenue}}{\text{Assets}} = \frac{23,636}{14,135} = \text{£}1.672$$

This tells us that for every £1 invested in fixed assets, sales revenue of £1.672 was earned. This figure is meaningless on its own – it is commonly compared with previous years' results, as comparison between firms is less useful.

14.7.2 Stock turnover

This is a measure of the number of times that stock is bought and sold during a year. It is calculated by:

$$\frac{\text{Cost of sales}}{\text{Average stock}} = \frac{8,799}{1,325} = 6.6 \text{ times}$$

This tells us that, on average, stock was bought and sold 6.6 times throughout the year, which equates to approximately once every two months. Average stock is found by adding together the opening and closing stock and dividing the total by 2.

Again, comparison with the rate of stock turnover in previous periods is important. If the rate of turnover is slowing down, it might be that the firm is holding more stock than it needs, which is wasteful of resources. A slow rate of turnover will also affect the cash position of the firm – cash has to be paid out when stock is purchased, but it does not come in until the stocks have been converted to saleable items, sold (often on credit) and the debtors have paid up. This could have a considerable impact on the cash-flow situation.

Another way of looking at stock turnover (similar to the debtors' collection and creditors' payment periods considered below) is to ask how many days' worth of stock do we hold? If the cost of goods sold in the year is £8,799, that implies that on average we get through stock costing £24.11 each day (£8,799 ÷ 365). A closing stock level of £1,425 therefore represents stock for 59 days (£1,425 ÷ £24.11). It is worth asking whether we really need to hold so much stock. If we do not, it would be preferable to cut down on stock purchases for the next few weeks to conserve our cash resources.

It is also sometimes useful to calculate the *average* number of days stock held during the past year, rather than the amount on hand at the end of the year. (After all, the rate of turnover of year-end stock will be determined by next year's level of activity.) This can be found by dividing the average usage (£24.11 per day) into the average stock held (£1,325) during the year.

The average number of days that stock was held for over the past year was:

$$\frac{1,325}{24.11} = 55 \text{ days}$$

The calculation can be performed in one stage as:

$$\frac{\text{Average stock}}{\text{Cost of sales}} \times 365 = \frac{1325}{8799} \times 365 = 55 \text{ days}$$

14.7.3 Debtors collection period

This is a measure of the average time taken by customers to settle their debts. It is calculated by:

$$\frac{\text{Debtors}}{\text{Sales}} \times 365 = \frac{542}{23,636} \times 365 = 8 \text{ days}$$

Where details are available, credit sales only should be considered.

The result of this calculation should be compared with the number of days' credit normally allowed by the business to its customers. If it appears that customers are taking longer to pay than they should do, it may be necessary to take remedial action.

As with stock turnover, a slowing down in the speed of collecting debts will have a detrimental effect on cash flow. On the other hand, it may be that the business has deliberately offered extended credit in order to increase demand.

14.7.4 Creditors payment period

This is a measure of the average time taken to pay suppliers. Although it is not strictly a measure of asset efficiency on its own, it is part of the overall management of net current assets. It is calculated by:

$$\frac{\text{Creditors}}{\text{Purchases}} \times 365 = \frac{1,086}{8,999} \times 365 = 44 \text{ days}$$

The purchases figure should exclude any cash purchases, if this information is available; where there is no purchases figure available the best alternative is to use cost of sales as the denominator. Similarly, creditors should include only trade creditors, not creditors for expenses or fixed assets.

The result of this ratio can also be compared with the debtors collection period. A firm does not normally want to offer its customers more time to pay than it gets from its own suppliers, otherwise this could affect cash flow. Generally, the longer the creditors payment period, the better, as the firm holds on to its cash for longer, but care must be taken not to upset suppliers by delaying payment, which could result in the loss of discounts and reliability.

It is important to recognise when using these ratios that it is the trend of ratios that is important, not the individual values. Payment periods are longer in some types of organisation than in others.

14.7.5 Total working capital ratio

This measures the total length of time for which working capital is tied up in stocks, debtors and creditors, before becoming available for use. It is the total of the number of days' stock, the debtors' collection period, less the creditors' payment period. From the preceding three sections, you can see that this is:

| | |
|---------------------------------|-------------|
| Number of days' stock on hand | 59 |
| Number of days – debtors | 8 |
| Less number of days – creditors | <u>(44)</u> |
| Total working capital days | <u>23</u> |

This tells us that it takes, on average, 23 days in which to sell the stock, receive payment from debtors, and pay the creditors. The total of 23 days may not seem too lengthy for a manufacturing business, but it does indicate the level of working capital needed in order to finance the ordinary activities of the business, which may result in the need for an overdraft, or other sources of finance.

14.8 Capital structure ratios

Different firms have different methods of financing their activities. Some rely mainly on the issue of share capital and the retention of profits; others rely heavily on loan finance; most have a combination of the two.

14.8.1 The gearing ratio

Gearing is a measure of the relationship between the amount of finance provided by external parties (e.g. loan capital) to the total capital employed. It is calculated by:

$$\frac{\text{Loan capital}}{\text{Total capital employed}} \times 100 = \frac{4,500}{22,750} \times 100 = 20\%$$

This ratio has been calculated based on the capital employed at the date of the balance sheet. An alternative would be to use the average capital employed and average loan capital during the year. It is also common to include preference share capital with the loan capital, as both are examples of financing methods that carry a fixed rate of return.

The more highly geared a business, the more profits that have to be earned to pay the interest cost of the borrowing. Consequently, the higher the gearing, the more risky is the owner's investment. Remember that dividends do not have to be paid out if the directors decide not to declare them, so there is reduced risk with low-g geared companies, especially in times when profits are falling. On the other hand, a highly geared company might be more attractive to shareholders when profits are rising, because there are fewer of them to share out those profits!

An alternative method of calculating gearing is known as the *debt:equity ratio*. In this case, the total of loan capital and preference share capital is expressed as a percentage of equity capital. Again, it is common to include preference share capital as a source of 'debt'. In the sample accounts above, suppose that the capital figure on the balance sheet included preference shares of £2,000. The debt : equity ratio would then be:

$$\frac{\text{Loan capital} + \text{preference shares}}{\text{Equity capital}} \times 100 = \frac{6,500}{16,250} \times 100 = 40\%$$

A third alternative is the *debt:debt + equity ratio*, which compares fixed-interest capital with total capital. Using the above figures, this would be as follows:

$$\frac{\text{Loan capital} + \text{preference shares}}{\text{Total capital employed}} \times 100 = \frac{6,500}{22,750} \times 100 = 28.6\%$$

14.8.2 Interest cover

Connected to the gearing ratio is a measure of the number of times that the profit is able to 'cover' the fixed interest due on long-term loans. It provides lenders with an idea of the level of security for the payment. The formula is:

$$\frac{\text{Net profit before interest and tax}}{\text{Interest payable}} = \frac{9,100}{450} = 20 \text{ times}$$

This shows lenders that their interest is covered 20 times by the current profits. This would normally be a fairly comfortable level, but of course, it is *future* profits that will determine the actual level of cover.

14.9 Ratio analysis for sole traders

All of the above ratios can be calculated for sole traders, as well as for limited companies.



Exercise 14.1

Give the formulae for the following ratios:

- (a) Return on capital employed,
- (b) Gross profit percentage,
- (c) Net profit percentage,
- (d) Cost to sales percentage,
- (e) Fixed assets to sales percentage,
- (f) Rate of stock turnover,
- (g) Number of days debtors,
- (h) Number of days creditors,
- (i) Current ratio,
- (j) Quick ratio,
- (k) Gearing ratio.



Solution

Refer to the formulae above for the solutions.

14.10 Summary

This very important chapter is one worth spending time over. In an examination, not only will you be expected to calculate ratios, but you may need to be able to do any or all of the following:

- explain what the ratio attempts to show;
- discuss the results of your calculations;
- suggest possible reasons for good/poor results or differences from previous years, other companies or expectations.

Although ratios are a useful additional guide to decision-making, they are also very difficult to interpret fully without additional information.

Before calculating any ratios the nature of the business should be considered. The following list of questions is a useful starting point:

- What is the nature of its business?
- Does it need a lot of assets and capital to operate?
- How has it obtained its funding (shareholders' capital, loan capital or internally generated profits)?

- Does it have a high or low profit margin on its business?
- Does it have high or low turnover in relation to the amount of capital that is tied up in the organisation? (High-margin companies will normally have slower rates of sales/turnover because they usually charge higher prices and/or operate in premium segments of a market.)
- Does the company appear to be financially unstable (i.e. does it have excessive debts in relation to its assets)?
- Does the level of stock or any other asset such as capital employed or number of employees appear to be too high or too low to support the organisation's level of activity/turnover/sales?
- Is there any information to tell whether the business is more or less efficient/profitable than other competitors in the same industry?

The answers to these questions and to others that are naturally associated with them are key to understanding how an organisation is currently performing and how it is likely to perform in the future. Trends in these indicators are of interest to internal managers and accountants, and also to external users. Examples of external users are:

- investors and potential investors use this type of information to decide whether or buy, sell or hold shares in a particular company;
- lenders and suppliers wish to know about the solvency of an enterprise and its ability to repay loans or debts incurred in relation to the supply of materials or services;
- governments charged with the responsibility for framing fiscal policy or industrial policy in different sectors of the economy will find much of interest in them. Many of the accounting figures are used to compile national statistics on industrial output, gross national product (GNP), wage levels and inflation trends.

External sources of comparative information will usually be industry averages compiled by government agencies or independent industry groups. These are readily available in local libraries.

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Revision Questions

14



Question 1 Multiple choice

- 1.1 Given a selling price of £350 and a gross profit mark-up of 40 per cent, the cost price would be:
£.....
- 1.2 Sales are £110,000. Purchases are £80,000. Opening stock is £12,000. Closing stock is £10,000. The rate of stock turnover is
 times
- 1.3 A business commenced with a bank balance of £3,250; it subsequently purchased goods on credit for £10,000; gross profit mark-up was 120 per cent; half the goods were sold for cash, less cash discount of 5 per cent; all takings were banked. The resulting net profit was:
£.....
- 1.4 The rate of stock turnover is six times where:
(A) sales are £120,000 and average stock at selling price is £20,000.
(B) purchases are £240,000 and average stock at cost is £40,000.
(C) cost of goods sold is £180,000 and average stock at cost is £30,000.
(D) net purchases are £90,000 and closing stock at cost is £15,000.
- 1.5 The formula for calculating the rate of stock turnover is:
(A) average stock at cost divided by cost of goods sold.
(B) sales divided by average stock at cost.
(C) sales divided by average stock at selling price.
(D) cost of goods sold divided by average stock at cost.
- 1.6 A business operates on a gross profit margin of $33\frac{1}{3}$ per cent. Gross profit on a sale was £800, and expenses were £680. The net profit percentage is
 per cent.

1.7 A business has the following trading account for the year ending 31 May 1998:

| | | |
|--------------------|---------------|---------------|
| | £ | £ |
| Sales turnover | | 45,000 |
| Opening stock | 4,000 | |
| Purchases | <u>26,500</u> | |
| | 30,500 | |
| Less closing stock | <u>6,000</u> | |
| | | <u>24,500</u> |
| Gross profit | | <u>20,500</u> |

Its rate of stock turnover for the year is:

times

1.8 A company's gearing ratio would rise if:

- (A) a decrease in long-term loans is less than a decrease in shareholders' funds.
- (B) a decrease in long-term loans is more than a decrease in shareholders' funds.
- (C) interest rates rose.
- (D) dividends were paid.

1.9 A company has the following details extracted from its balance sheet:

| | |
|----------------|-------|
| | £,000 |
| Stocks | 1,900 |
| Debtors | 1,000 |
| Bank overdraft | 100 |
| Creditors | 1,000 |

Its liquidity position could be said to be:

- (A) very well controlled, because its current assets far outweigh its current liabilities.
- (B) poorly controlled, because its quick assets are less than its current liabilities.
- (C) poorly controlled, because its current ratio is significantly higher than the industry norm of 1.8.
- (D) poorly controlled, because it has a bank overdraft.

1.10 The gross profit mark-up is 40 per cent where:

- (A) sales are £120,000 and gross profit is £48,000.
- (B) sales are £120,000 and cost of sales is £72,000.
- (C) sales are £100,800 and cost of sales is £72,000.
- (D) sales are £100,800 and cost of sales is £60,480.

1.11 Revenue reserves would decrease if a company:

- (A) sets aside profits to pay future dividends.
- (B) transfers amounts into 'general reserves'.
- (C) issues shares at a premium.
- (D) pays dividends.

1.12 A company has the following current assets and liabilities at 31 October 1998:

| | |
|---------------------|--------------|
| | <i>£,000</i> |
| Current assets | |
| Stock | 970 |
| Debtors | 380 |
| Bank | 40 |
| | <u>1,390</u> |
| Current liabilities | |
| Creditors | 420 |

When measured against accepted 'norms', the company can be said to have:

- (A) a high current ratio and an ideal acid test ratio.
- (B) an ideal current ratio and a low acid test ratio.
- (C) a high current ratio and a low acid test ratio.
- (D) ideal current and acid test ratios.

1.13 Your company's profit and loss account for the year ended 30 September 1998 showed the following:

| | |
|------------------------------------|-------------------|
| | <i>£,000</i> |
| Net profit before interest and tax | 1,200 |
| Interest | <u>200</u> |
| | 1,000 |
| Corporation tax | <u>400</u> |
| Retained profit for the year | <u><u>600</u></u> |

Its balance sheet at 30 September 1997 showed the following capital:

| | |
|---------------------------------|----------------------|
| | <i>£,000</i> |
| Share capital | 8,000 |
| Profit and loss account balance | <u>1,200</u> |
| | 9,200 |
| 10% debenture | <u>2,000</u> |
| | <u><u>11,200</u></u> |

Return on average capital employed for the year ended 30 September 1998 is:

per cent

1.14 A summary of the balance sheet of M Ltd at 31 March 2000 was as follows:

| | |
|---------------------------------------|-------------------|
| | <i>£,000</i> |
| Total assets less current liabilities | <u>120</u> |
| Ordinary share capital | 40 |
| Share premium account | 10 |
| Profit and loss account | 10 |
| 5% debentures 2010 | <u>60</u> |
| | <u><u>120</u></u> |

If the operating profit for the year ended 31 March 2000 was £15,000, what is the return on capital employed?

per cent

1.15 The annual sales of a company are £235,000 including VAT at 17.5 per cent. Half of the sales are on credit terms; half are cash sales. The debtors in the balance sheet are £23,500.

What are the debtor days (to the nearest day)?

days

1.16 The draft balance sheet of B Ltd at 31 March 2000 is set out below.

| | | | |
|-------------------------|------------|-------------|--|
| | £ | £ | |
| Fixed assets | | 450 | |
| Current assets | | | |
| Stock | 65 | | |
| Debtors | 110 | | |
| Prepayments | <u>30</u> | | |
| | <u>205</u> | | |
| Current liabilities | | | |
| Creditors | 30 | | |
| Bank overdraft (note 1) | <u>50</u> | | |
| | <u>80</u> | | |
| | | <u>125</u> | |
| | | 575 | |
| Long-term liability | | | |
| Loan | | <u>(75)</u> | |
| | | <u>500</u> | |
| Ordinary share capital | | 400 | |
| Profit and loss account | | <u>100</u> | |
| | | <u>500</u> | |

Note 1: The bank overdraft first occurred on 30 September 1999.

What is the gearing of the company?

per cent



Question 2

The following information relates to PK, a sole trader.

During the year ended 30 June 1996, he sold goods to the value of £240,000, which were all sold at a mark-up of 20 per cent. His administration costs during the year amounted to £32,000.

At 1 July 1996 his opening stock was £55,000 and at 30 June 1996 the number of days' stock on hand was 40. His debtors collection period was 30 days and his creditors payment period was 50 days.

His acid test ratio was 1.2 : 1 and his fixed assets turnover ratio was 4 : 1. His return on capital employed was 10 per cent. There was a long-term loan with an outstanding balance of £3,438 at 30 June 1996.

Requirements

Insert the missing items in the workings, PK's profit and loss account and balance sheet for the year ended 30 June 1996.

| Workings | |
|--------------------|-------|
| Cost of sales | _____ |
| | _____ |
| Closing stock | _____ |
| Debtors | _____ |
| Purchases | _____ |
| | _____ |
| = | _____ |
| Creditors | _____ |
| Fixed assets | _____ |
| Gross profit | _____ |
| Net profit | _____ |
| Capital employed | _____ |
| | _____ |
| | _____ |
| Net current assets | _____ |
| = | _____ |
| Current assets | _____ |
| | _____ |
| | _____ |
| = | _____ |
| Bank balance | _____ |
| | _____ |

PK: trading and profit and loss account for the year ended 30 June 1996

| | £ | £ |
|-------------------------|-------|-------|
| Sales | | _____ |
| Less cost of sales | | |
| Opening stock | _____ | |
| Purchases | _____ | |
| | _____ | |
| Less closing stock | _____ | |
| | _____ | _____ |
| Gross profit | | _____ |
| Administration costs | | _____ |
| Net profit for the year | | _____ |

PK: balance sheet at 30 June 1996

| | £ | £ | £ |
|---------------------|----------------------------|----------------------------|----------------------------|
| Fixed assets | | | █ |
| Current assets | | | |
| Stocks | █ | | |
| Debtors | █ | | |
| Bank | █ | | |
| | <hr style="width: 100%;"/> | | |
| Current liabilities | | █ | |
| Creditors | | █ | |
| Net current assets | | <hr style="width: 100%;"/> | █ |
| | | | <hr style="width: 100%;"/> |
| Less long-term loan | | | █ |
| | | | <hr style="width: 100%;"/> |
| Financed by | | | |
| Opening capital | | | █ |
| Profit for the year | | | █ |
| Closing capital | | | <hr style="width: 100%;"/> |

? Question 3

DEX Stores sells three different types of product. The business is made up of three different departments, each having its own manager, who is responsible for buying/selling a particular type of product. The owner determines the pricing policy of the entire operation and adds the following percentages to the cost of the goods to arrive at the selling prices:

| | |
|--------------|------|
| Department A | 40% |
| Department B | 25% |
| Department C | 100% |

The takings during April 1992 were:

| | |
|--------------|-----------|
| Department A | £ 18,750 |
| Department B | £ 11,750 |
| Department C | £ 147,000 |

The opening stock on 1 April 1992, which the owner verified by a stocktake, was valued at cost:

| | |
|--------------|---------|
| Department A | £4,200 |
| Department B | £7,800 |
| Department C | £22,500 |

At the end of April, the owner decided to carry out a stocktake, but unfortunately could not do this until Sunday 3 May 1992. The physical stock held on that day, valued at cost, was:

| | |
|--------------|---------|
| Department A | £3,700 |
| Department B | £8,100 |
| Department C | £21,600 |

The following transactions occurred between the end of April and the physical stocktake:

| | <i>Department A (£)</i> | <i>Department B (£)</i> | <i>Department C (£)</i> |
|------------------|-------------------------|-------------------------|-------------------------|
| Sales | 420 | 250 | 1,500 |
| Purchases | – | 1,500 | – |
| Returns inwards | – | – | 300 |
| Returns outwards | 270 | – | 800 |

Purchases during April 1992 amounted to:

| | |
|--------------|---------|
| Department A | £14,200 |
| Department B | £8,400 |
| Department C | £74,000 |

The owner has recently become concerned that the gross profit shown by the accounts does not reconcile with these percentage profit mark-ups and suspects that some of the stock may be stolen.

Requirements

- (a) Insert the missing items into the following table in order to determine the value of stock at 30 April 1992.

| | <i>Department A (£)</i> | <i>Department B (£)</i> | <i>Department C (£)</i> |
|------------------------------|-------------------------|-------------------------|-------------------------|
| Physical stock at 3 May 1992 | <input type="text"/> | <input type="text"/> | <input type="text"/> |
| Add back sales at cost | <input type="text"/> | <input type="text"/> | <input type="text"/> |
| Less purchases | <input type="text"/> | <input type="text"/> | <input type="text"/> |
| Less returns inwards | <input type="text"/> | <input type="text"/> | <input type="text"/> |
| Add returns outwards | <input type="text"/> | <input type="text"/> | <input type="text"/> |
| Theoretical stock | <input type="text"/> | <input type="text"/> | <input type="text"/> |

- (b) Insert the missing items into the following table in order to determine the amount of stock lost.

| | <i>Department A (£)</i> | <i>Department B (£)</i> | <i>Department C (£)</i> |
|------------------------------|-------------------------|-------------------------|-------------------------|
| Opening stock (1 April 1992) | <input type="text"/> | <input type="text"/> | <input type="text"/> |
| Purchases in April 1992 | <input type="text"/> | <input type="text"/> | <input type="text"/> |
| Closing stock (3 May 1992) | <input type="text"/> | <input type="text"/> | <input type="text"/> |
| Cost of sales | <input type="text"/> | <input type="text"/> | <input type="text"/> |
| Add mark-up | <input type="text"/> | <input type="text"/> | <input type="text"/> |
| Sales | <input type="text"/> | <input type="text"/> | <input type="text"/> |
| Actual takings | <input type="text"/> | <input type="text"/> | <input type="text"/> |
| Difference | <input type="text"/> | <input type="text"/> | <input type="text"/> |



Question 4

GH has the following balance sheet at 30 April 1995, with corresponding figures for the previous year:

| | | | 1995 | | 1994 | |
|-------------------------|---------------|---------------|----------------|---------------|---------------|----------------|
| | £ | £ | £ | £ | £ | £ |
| Fixed assets | | | 277,000 | | | 206,000 |
| Current assets | | | | | | |
| Stocks | 46,000 | | | 42,000 | | |
| Debtors | 37,500 | | | 36,000 | | |
| Cash and bank | <u>12,500</u> | | | <u>54,000</u> | | |
| | | 96,000 | | | 132,000 | |
| Current liabilities | | | | | | |
| Creditors | | <u>16,000</u> | | | <u>23,000</u> | |
| | | | 80,000 | | | 109,000 |
| | | | <u>357,000</u> | | | <u>315,000</u> |
| Long-term liabilities | | | 10,000 | | | 50,000 |
| | | | <u>347,000</u> | | | <u>265,000</u> |
| | | | | | | |
| | | | 1995 | | | 1994 |
| | | | £ | | | £ |
| Financed by | | | | | | |
| Capital at start | | | 265,000 | | | 214,000 |
| Capital introduced | | | 20,000 | | | — |
| Net profit for the year | | | <u>92,000</u> | | | <u>78,000</u> |
| | | | <u>377,000</u> | | | <u>292,000</u> |
| Drawings | | | 30,000 | | | 27,000 |
| | | | <u>347,000</u> | | | <u>265,000</u> |

The following information concerning the year to 30 April 1995 is also available:

- (i) Fixed assets were sold for £30,000. Their original cost had been £48,000 and depreciation of £12,000 had been charged in previous years.
- (ii) Fixed assets costing £120,000 were purchased during the year.

Requirements

Insert the missing items in the workings and a cash-flow statement for the year to 30 April 1995.

(a) Initial workings:

| | |
|---------------------------------------|---------|
| | £ |
| (i) Profit for year | █ |
| █ loss on disposal | █ |
| Operating profit | █ |
| (ii) NBV 1 May 1994 | 206,000 |
| █ | █ |
| █ | █ |
| █ | █ |
| █ | █ |
| Depreciation charge for year | █ |
| Net inflow from operating activities: | |
| Operating profit | █ |
| Add depreciation charge | █ |
| █ in stock | █ |
| █ in debtors | █ |
| █ in creditors | █ |
| | █ |

GH: cash-flow statement for year ended 30 April 1995

| | | |
|---|---|---|
| | £ | £ |
| Net cash inflow from operating activities | | █ |
| Purchases of fixed assets | █ | |
| Sale of fixed assets | █ | |
| | | █ |
| Net cash inflow before financing | | █ |
| Long-term loan paid off | █ | |
| Capital introduced | █ | |
| Capital withdrawn | █ | |
| | | █ |
| Net decrease in cash equivalents | | █ |



Question 5

The following trial balance has been extracted from the ledgers of JK Ltd at 31 March 1993:

| | | |
|---|----------------|----------------|
| | £ | £ |
| Sales (all on credit) | | 647,400 |
| Stock (1 April 1992) | 15,400 | |
| Trade debtors and creditors | 82,851 | 41,936 |
| Purchases (all on credit) | 321,874 | |
| Carriage in | 13,256 | |
| Carriage out | 32,460 | |
| Electricity | 6,994 | |
| Business rates | 8,940 | |
| Wages and salaries | 138,292 | |
| Postages and stationery | 6,984 | |
| Rent | 14,600 | |
| VAT control | | 16,382 |
| PAYE control | | 4,736 |
| Motor vehicles | | |
| At cost | 49,400 | |
| Depreciation | | 21,240 |
| Bank deposit account | 90,000 | |
| Bank current account | 77,240 | |
| Ordinary shares of £1 each | | 50,000 |
| Profit and loss – unappropriated profit | | 76,597 |
| | <u>858,291</u> | <u>858,291</u> |

The following notes are also relevant:

- (i) Stock at 31 March 1993, valued at cost, was £19,473.
- (ii) Prepaid rent amounted to £2,800.
- (iii) Accruals are estimated as follows:

| | |
|--------------------|--------|
| Electricity | £946 |
| Wages and salaries | £2,464 |

- (iv) Depreciation on motor vehicles is to be provided at 25 per cent per annum using the reducing-balance method.
- (v) Accrued interest on the bank deposit account amounts to £7,200.
- (vi) A provision for corporation tax of £30,000 is to be made on the profits of the year.
- (vii) No interim dividend was paid but the directors propose a final dividend of £0.05 per share.

Requirements

- (a) Insert the missing items in: JK Ltd's trading, profit and loss and appropriation account for the year ended 31 March 1993.
- (b) Insert the missing items in: JK Ltd's balance sheet at 31 March 1993.
- (c) Calculate the:

| | | |
|--------------------------|----------------------|------|
| Debtors payment period | <input type="text"/> | days |
| Creditors payment period | <input type="text"/> | days |
| Stockholding period | <input type="text"/> | days |

(a) JK Ltd: trading and profit and loss account for the year ended 31 March 1993

| | £000 | £000 | £000 |
|-------------------------------|------|-------|-------|
| _____ | | | _____ |
| _____ | | _____ | |
| _____ | | _____ | |
| _____ | | _____ | |
| _____ | | _____ | |
| | | _____ | _____ |
| Gross profit | | | _____ |
| _____ | | _____ | |
| _____ | | _____ | |
| _____ | | _____ | |
| _____ | | _____ | |
| _____ | | _____ | |
| _____ | | _____ | _____ |
| | | | _____ |
| _____ | | | _____ |
| Profit for year before tax | | | _____ |
| Provision for corporation tax | | | _____ |
| Profit for year after tax | | | _____ |
| Proposed final dividend | | | _____ |
| Retained profit for the year | | | _____ |
| Retained profit b/f | | | _____ |
| Retained profit c/f | | | _____ |

(b) JK Ltd: balance sheet as at 31 March 1993

| | <i>Cost (£,000)</i> | <i>Depreciation (£,000)</i> | <i>Net (£,000)</i> |
|---------------------|---------------------|-----------------------------|--------------------|
| Fixed assets | <u> </u> | <u> </u> | |
| Current assets | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | <u> </u> | | |
| | | | |
| Current liabilities | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | <u> </u> | | |
| | | | |
| | | | <u> </u> |
| Financed by | | | |
| | | | |
| | | | <u> </u> |
| | | | |

? Question 6

The following figures have been extracted from the published accounts of MBC plc, at 31 October 1995:

| | |
|------------------------|-----------|
| | <i>£m</i> |
| Ordinary share capital | 30 |
| Share premium | 3 |
| Reserves | <u>5</u> |
| | 38 |
| 6% debentures | <u>10</u> |
| | <u>48</u> |

The net profit (after tax of £1m) for the year to 31 October 1995, was £4m and dividends amounted to £0.5m. The company is considering raising a further £10m in the next financial year to finance research and development.

Requirements

(a) Insert the missing words, phrases or figures into the following:

(i) The gearing ratio formula is:

$$\frac{\pounds \text{ []}}{\pounds \text{ []}} \times 100 =$$

(ii) The gearing ratio for MBC plc is:

$$\frac{\pounds \text{ []}}{\pounds \text{ []}} \times 100 = \text{ [] } \%$$

(iii) The return on capital employed formula is:

$$\frac{\pounds \text{ []}}{\pounds \text{ []}} \times 100 =$$

(iv) The return on capital employed for MBC plc is:

$$\frac{\pounds \text{ []}}{\pounds \text{ []}} \times 100 = \text{ [] } \%$$

(b) If the company raises an additional £10m through the issue of shares:

(i) Calculate the gearing ratio for the next year:

$$\frac{\pounds \text{ []}}{\pounds \text{ []}} \times 100 = \text{ [] } \%$$

(ii) Calculate the ROCE for the next year:

$$\frac{\pounds \text{ []}}{\pounds \text{ []}} \times 100 = \text{ [] } \%$$

(c) If the company raises an additional £10m through the issue of 6 per cent debentures:

(i) Calculate the gearing ratio for the next year:

$$\frac{\pounds \text{ []}}{\pounds \text{ []}} \times 100 = \text{ [] } \%$$

(ii) Calculate the ROCE for the next year:

$$\frac{\pounds \text{ []}}{\pounds \text{ []}} \times 100 = \text{ [] } \%$$

(d) Insert the missing word in these sentences:

- (i) _____ research is into new scientific or technological principles.
- (ii) _____ research infers a more practical nature, but not necessarily leading to a practical application.
- (iii) _____ expenditure is where there is a clearly defined outcome and which is expected to produce profits.



Question 7

DWS Ltd prepares its accounts to 30 September each year. At 30 September 1994 its trial balance was as follows:

| | <i>Debit (£)</i> | <i>Credit (£)</i> |
|---|------------------|-------------------|
| Plant and machinery | | |
| Cost | 125,000 | |
| Depreciation at 1 October 1993 | | 28,000 |
| Office equipment: | | |
| Cost | 45,000 | |
| Depreciation at 1 October 1993 | | 15,000 |
| Stocks at 1 October 1993 | 31,000 | |
| Purchases and sales | 115,000 | 188,000 |
| Returns inwards and outwards | 8,000 | 6,000 |
| Selling expenses | 12,000 | |
| Heat and light | 8,000 | |
| Wages and salaries | 14,000 | |
| Directors' fees | 5,000 | |
| Printing and stationery | 6,000 | |
| Telephone and fax | 6,000 | |
| Rent, rates and insurances | 4,000 | |
| Trade debtors and creditors | 35,000 | 33,000 |
| Provision for doubtful debts at 1 October 1993 | | 4,000 |
| Bank | 3,000 | |
| Petty cash | 1,000 | |
| Interim dividend paid | 2,000 | |
| Ordinary shares of 50p each | | 100,000 |
| Share premium account | | 8,000 |
| General reserve | | 7,000 |
| Profit and loss account balance at 1 October 1993 | | 34,000 |
| Suspense account | 3,000 | |
| | <u>423,000</u> | <u>423,000</u> |

The following additional information at 30 September 1994 is available:

- (i) Closing stocks of goods for resale amount to £53,000.
(ii) Prepayments:

| | |
|--------------------------|--------|
| Telephone and fax rental | £1,000 |
| Rates and insurance | £1,000 |

- (iii) Accruals:

| | |
|--------------------|--------------------|
| Wages and salaries | £1,500 |
| Directors' fees | 2% of net turnover |
| Auditor's fees | £3,500 |

- (iv) Specific bad debts to be written off amount to £3,000.
(v) Provision for doubtful debts is to be amended to 5 per cent of debtors, after adjusting for bad debts written off.
(vi) The following bookkeeping errors are discovered:
 - The purchase of an item of stock has been debited to the office equipment account, cost £1,200.
 - The payment of £1,300 to a creditor has been recorded by debiting the bank account and crediting the creditor's account.
Any remazinging balance on the suspense account is to be added to prepayments or accruals, as appropriate, on the balance sheet.

(b) Insert the missing items in the balance sheet at 30 September 1994.

DWS Ltd: balance sheet at 30 September 1994

| | <i>Cost (£)</i> | <i>Depreciation (£)</i> | <i>NBV (£)</i> |
|--|-----------------|-------------------------|----------------|
| Fixed assets | | | |
| _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ |
| | _____ | _____ | _____ |
| Current assets | | | |
| _____ | _____ | | |
| _____ | _____ | | |
| _____ | _____ | | |
| _____ | _____ | | |
| | _____ | | |
| Current liabilities | | | |
| _____ | _____ | | |
| _____ | _____ | | |
| _____ | _____ | | |
| _____ | _____ | | |
| | _____ | | |
| <i>Current assets less current liabilities</i> | | _____ | 42,800 |
| Capital and reserves | | | |
| _____ | | | _____ |
| _____ | | | _____ |
| _____ | | | _____ |
| _____ | | | _____ |
| | | | _____ |

(c) Calculate the current ratio and the quick ratio.

Current ratio

| | | | | | | | |
|---------|-------|---|-------|---|-------|---|-------|
| Ratio | _____ | : | _____ | | | | |
| Figures | _____ | : | _____ | = | _____ | : | _____ |

Quick ratio

| | | | | | | | |
|---------|-------|---|-------|---|-------|---|-------|
| Ratio | _____ | : | _____ | | | | |
| Figures | _____ | : | _____ | = | _____ | : | _____ |

? Question 8

You are considering the purchase of a small business, JK, and have managed to obtain a copy of its accounts for the last complete accounting year to 30 September 1993. These appear as follows:

Trading and profit and loss account for the year to 30 September 1993

| | | |
|----------------------------|-----------------|----------------|
| | £ | £ |
| Sales | | 385,200 |
| Less cost of goods sold: | | |
| Opening stocks | 93,250 | |
| Purchases | 174,340 | |
| Less closing stocks | <u>(84,630)</u> | |
| | | <u>182,960</u> |
| Gross profit | | 202,240 |
| Less expenses | | |
| Selling and delivery costs | 83,500 | |
| Administration costs | 51,420 | |
| Depreciation | <u>36,760</u> | |
| | | <u>171,680</u> |
| Net profit | | <u>30,560</u> |

Balance sheet at 30 September 1993

| | | |
|---------------------------|-----------------|-----------------|
| | £ | £ |
| Fixed assets | | |
| Assets at cost | 235,070 | |
| Less depreciation to date | <u>(88,030)</u> | |
| | | 147,040 |
| Current assets | | |
| Stocks | 84,630 | |
| Debtors and prepayments | 36,825 | |
| Bank and cash | <u>9,120</u> | |
| | | 130,575 |
| Current liabilities | | |
| Creditors and accruals | <u>(62,385)</u> | |
| | | <u>68,190</u> |
| | | <u>215,230</u> |
| Financed by | | |
| Capital at 1 October 1992 | | 197,075 |
| Net profit for the year | | 30,560 |
| Proprietor's drawings | | <u>(12,405)</u> |
| | | <u>215,230</u> |

Requirements

Calculate the following accounting ratios from the accounts presented above:

- (i) Net profit percentage

$$\frac{\pounds \text{ []}}{\pounds \text{ []}} \times 100 = \text{ [] } \%$$

- (ii) Return on capital employed

$$\frac{\pounds \text{ []}}{\pounds \text{ []}} \times 100 = \text{ [] } \%$$

- (iii) Current ratio

$$\frac{\pounds \text{ []}}{\pounds \text{ []}} \times 100 = \text{ []}$$

- (iv) Quick (acid test) ratio

$$\frac{\pounds \text{ []}}{\pounds \text{ []}} \times 100 = \text{ []}$$

? Question 9

The draft financial statements for B Ltd are set out below.

B Ltd: profit and loss account for the year ended 30 September 2000

| | |
|-------------------------------|--------------|
| | <i>£000</i> |
| Turnover | 600 |
| Cost of sales | <u>(410)</u> |
| Gross profit | 190 |
| Profit on sale of fixed asset | <u>10</u> |
| | 200 |
| Operating expenses | (70) |
| Depreciation | <u>(30)</u> |
| Operating profit | 100 |
| Interest | (15) |
| Dividends | <u>(50)</u> |
| Retained profit | <u>35</u> |

B Ltd: balance sheet at 30 September

| | £,000 | £,000 | 2000 £,000 | 1999 £,000 |
|-------------------------|-----------|-------------|---------------|---------------|
| Fixed assets (see note) | | 450 | | 520 |
| Current assets | | | | |
| Stock | 65 | | 50 | |
| Debtors | 80 | | 30 | |
| Bank and cash | <u>30</u> | | <u>15</u> | |
| | 175 | | 95 | |
| Current liabilities | | | | |
| Creditors | 60 | | 20 | |
| Dividends | <u>50</u> | | <u>35</u> | |
| | 110 | | 55 | |
| | | <u>65</u> | | <u>40</u> |
| | | 515 | | 560 |
| Long-term liability | | | | |
| Loan | | <u>(20)</u> | | <u>(100)</u> |
| | | 495 | | 460 |
| Share capital | | 400 | | 400 |
| Profit and loss account | | <u>95</u> | | <u>60</u> |
| | | 495 | | 460 |

Note: B Ltd purchased fixed assets for £40,000 during the year ended 30 September 2000.

Requirements

Insert the missing items into the cash-flow statement and workings below.

B Ltd: cash-flow statement for the year ended 30 September 2000

| | ± | £,000 |
|-------------------------------------|---|----------|
| Operating activities (see workings) | | █ |
| Sale of fixed assets (see workings) | █ | █ |
| Interest | █ | █ |
| Purchase of fixed asset | █ | █ |
| Dividends | █ | █ |
| Repayment of loan | █ | █ |
| | | <u>█</u> |
| Opening bank and cash | | 15 |
| Closing bank and cash | | 30 |
| Increase/decrease* in cash | | <u>█</u> |

*Delete as appropriate.

Workings

| | ± | £,000 |
|------------------------------------|---|----------|
| Operating activities | | |
| Operating profit | | 100 |
| Adjustment for non-cash-flow items | | |
| █ | █ | █ |
| █ | █ | █ |
| | | <u>█</u> |
| Adjustment for working capital | | |
| Stock | █ | █ |
| Debtors | █ | █ |
| Creditors | █ | █ |
| | | <u>█</u> |
| Sale of fixed assets | | |
| Net book value | | █ |
| [workings █] | | █ |
| Profit on sale | | 10 |
| Proceeds on sale | | <u>█</u> |

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Solutions to Revision Questions

14



Solution 1

- 1.1 Mark-up is gross profit as a percentage of cost of sales, so a mark-up of 40 per cent will result in a selling price of 140 per cent of cost of sales. Thus, if the selling price is £350, this represents 140 per cent of the cost of sales, therefore 100 per cent would be $\frac{350}{140} \times 100 = £250 = \text{cost price}$.

This can be confirmed by checking that 40 per cent of £250 gives a mark-up of £100, and hence a selling price of £350.

A common mistake is for candidates simply to calculate 40 per cent of £350, and to arrive at £140 as the mark-up (and hence £210 as the cost of sales); this is obviously incorrect as the markup is *not* 40 per cent of sales, but 40 per cent of cost of sales.

- 1.2 Rate of stock turnover is found by dividing cost of goods sold by average stock. Average stock is:

$$\left(\frac{12,000 + 19,000}{2} \right) = £11,000.$$

Cost of goods sold is found as follows:

| | |
|--------------------|---------------|
| Opening stock | £ 12,000 |
| Purchases | 80,000 |
| | <u>92,000</u> |
| Less closing stock | 10,000 |
| Cost of goods sold | <u>82,000</u> |

Rate of stock turnover is therefore $\frac{82,000}{11,000} = 7.45$ times.

- 1.3 The answer can be found as follows:

| | |
|--|---------------|
| Cost of goods purchased | £ 10,000 |
| Cost of half the goods that have been sold | 5,000 |
| Gross profit mark-up on these goods = $5,000 \times 120\%$ | 6,000 |
| Therefore, selling price = | <u>11,000</u> |
| Cash discount given = 5% of £11,000 | 550 |
| Therefore, net profit = gross profit less discount | 5,450 |

1.4 Answer: (C)

The rate of stock turnover is found by dividing cost of goods sold by average stock at cost. Only (C) gives the correct answer of 6 times.

1.5 Answer: (D)

You need only know the correct formula here.

1.6 Reconstruction of trading and profit and loss account:

| | | |
|---------------|--------------|---------|
| | £ | |
| Sales | 2,400 | 100% |
| Cost of sales | <u>1,600</u> | 66% |
| Gross profit | 800 | 33% |
| Expenses | <u>680</u> | |
| Net profit | <u>120</u> | i.e. 5% |

1.7 Rate of stock turnover is found by dividing cost of goods sold by average stock. Average stock is: $(4,000+6,000)/2 = \text{£}5,000$.

Cost of goods sold is $\text{£}24,500$.

Rate of stock turnover is therefore $24,500/5,000 = 4.9$ times.

1.8 Answer: (A)

The gearing ratio is the proportion of long-term loans to shareholders' funds, thus it follows that if long-term loans decrease less than shareholders' funds, the gearing ratio will rise.

1.9 Answer: (A)

The current ratio is current assets:current liabilities, that is $2,900:1,100 = 2.6:1$. The quick ratio is current assets minus stock:current liabilities, that is $1,000:1,100 = 0.9:1$. The current ratio is high compared with the industry standard of $1.8:1$, while the quick ratio is within acceptable limits of the 'norm' of $1:1$. Without any evidence of the reason for the high stock levels, its current ratio would appear to be higher than is required, and hence liquidity is poorly controlled.

1.10 Answer: (C)

| | |
|-------------------|-----------------|
| | £ |
| Sales were | 100,800 |
| Cost of sales was | <u>(72,000)</u> |
| Gross profit | <u>28,800</u> |

$$\text{Gross profit mark-up} = \frac{\text{Gross profit}}{\text{Cost of sales}} \times 100 = \frac{28,000}{72,000} \times 100 = 40\%$$

1.11 Answer: (D)

Transfers between revenue reserves, as mentioned in (A) and (B), have no effect on the overall total of revenue reserves; issuing shares at a premium increases capital reserves; the paying of dividends must be from revenue reserves, so these will decrease.

1.12 Answer: (A)

| | | |
|-----------------|---------------------|--------------|
| Current ratio | $1,390:420 = 3.3:1$ | (i.e. high) |
| Acid test ratio | $420:420 = 1:1$ | (i.e. ideal) |

$$1.13 \text{ ROCE} = \frac{\text{Profit before interest and tax}}{\text{Average capital employed}} \times 100$$

$$\text{Average capital employed} = \frac{\text{Opening capital} + \text{closing capital}}{2}$$

$$\text{Closing capital employed} = \text{Opening capital plus profit for the year} = 11,200 + 600 = \pounds 11,800$$

$$\text{Average capital employed} = \frac{11,200 + 11,800}{2} = \pounds 11,500$$

$$\text{Thus ROCE} = \frac{1,200}{11,500} \times 100 = 10.43\%$$

$$1.14 \text{ Operating profit} / \text{Capital employed} = \frac{\pounds 15,000}{\pounds 120,000} \times 100 = 12.5\%$$

$$1.15 \text{ Debtors including VAT} / \text{Credit sales including VAT} = \frac{\pounds 23,500}{\pounds 117,500} \times 365 \text{ days} = 73 \text{ days}$$

$$1.16 \text{ Gearing} = \frac{\text{Debt}}{\text{Debt} + \text{equity}} = \frac{75}{75 + 500} = 13\%$$



Solution 2

Workings

| | |
|--------------------|---|
| Cost of sales | Sales = 120% of cost of sales Cost of sales = $\pounds 240,000 \times \frac{120}{100} = \pounds 200,000$ |
| Closing stock | $\pounds 200,000 \times \frac{40}{365} = \pounds 21,918$ |
| Debtors | $\pounds 240,000 \times \frac{30}{365} = \pounds 19,716$ |
| Purchases | Opening stock + purchases – closing stock = cost of sales, therefore Purchases = cost of sales – opening stock + closing stock = $\pounds 200,000 - \pounds 55,000 + \pounds 21,918 = \pounds 166,918$ |
| Creditors | $\pounds 166,918 \times \frac{50}{365} = \pounds 22,865$ |
| Fixed assets | $\frac{\text{Sales}}{4} = \frac{\pounds 240,000}{4} = \pounds 60,000$ |
| Gross profit | Sales – cost of sales = $\pounds 240,000 - \pounds 200,000 = \pounds 40,000$ |
| Net profit | Gross profit – administration expenses = $\pounds 40,000 - \pounds 32,000 = \pounds 8,000$ |
| Capital employed | Return on capital employed = 10%, therefore average capital employed = $\pounds 8,000 \times 10 = \pounds 80,000$. If a net profit of $\pounds 8,000$ has been made, then opening capital employed must be $\pounds 4,000$ lower than the average (76,000), and closing capital employed must be $\pounds 4,000$ higher than the average (84,000). |
| Net current assets | Capital employed – Fixed assets + long term loans = $\pounds 84,000 - \pounds 60,000 + \pounds 3,438 = \pounds 27,438$ |
| Current assets | Stocks + debtors = $\pounds 21,918 + \pounds 19,726 = \pounds 41,644$ The current ratio is 2.2:1, thus the bank balance cannot be overdrawn. Current assets must be Current liabilities $\times 2.2 = \pounds 22,865 \times 2.2 = \pounds 50,303$ |
| Bank balance | Total current assets – stock – debtors = $\pounds 50,303 - \pounds 41,644 = \pounds 8,659$ |

PK: trading and profit and loss account for the year ended 30 June 1996

| | | |
|-------------------------|----------------|----------------|
| | £ | £ |
| Sales | | 240,000 |
| Less cost of sales | | |
| Opening stock | 55,000 | |
| Purchases | 166,918 | |
| | <u>221,918</u> | |
| Less closing stock | 21,918 | |
| | | <u>200,000</u> |
| Gross profit | | 40,000 |
| Administration costs | | <u>32,000</u> |
| Net profit for the year | | <u>8,000</u> |

PK: balance sheet at 30 June 1996

| | | | |
|---------------------|--------------|---------------|---------------|
| | £ | £ | £ |
| Fixed assets | | | 60,000 |
| Current assets | | | |
| Stocks | 21,918 | | |
| Debtors | 19,726 | | |
| Bank | <u>8,659</u> | | |
| | | 50,303 | |
| Current liabilities | | | |
| Creditors | | <u>22,865</u> | |
| Net current assets | | | <u>27,438</u> |
| | | | 87,438 |
| Less long-term loan | | | <u>3,438</u> |
| | | | <u>84,000</u> |
| Financed by | | | |
| Opening capital | | | 76,000 |
| Profit for the year | | | 8,000 |
| Closing capital | | | <u>84,000</u> |

**Solution 3**

(a)

| | <i>Department A (£)</i> | <i>Department B (£)</i> | <i>Department C (£)</i> |
|-----------------------------|-------------------------|-------------------------|-------------------------|
| Physical stock (3 May 1992) | 3,700 | 8,100 | 21,600 |
| Add back sales at cost | 300 | 200 | 750 |
| Less purchases | – | (1,500) | – |
| Less returns inwards | – | – | (150) |
| Add returns outwards | <u>270</u> | – | <u>800</u> |
| Theoretical stock | <u>4,270</u> | <u>6,800</u> | <u>23,000</u> |

(b)

Calculation of theoretical sales value

| | <i>Department A (£)</i> | <i>Department B (£)</i> | <i>Department C (£)</i> |
|------------------------------|-------------------------|-------------------------|-------------------------|
| Opening stock (1 April 1992) | 4,200 | 7,800 | 22,500 |
| Purchases in April | <u>14,200</u> | <u>8,400</u> | <u>74,000</u> |
| | 18,400 | 16,200 | 96,500 |
| Closing stock (from above) | <u>(4,270)</u> | <u>(6,800)</u> | <u>(23,000)</u> |
| Cost of sales | 14,130 | 9,400 | 73,500 |
| Add mark-up | <u>5,652</u> | <u>2,350</u> | <u>73,500</u> |
| ∴ Sales | 19,782 | 11,750 | 147,000 |
| Actual takings | <u>(18,750)</u> | <u>(11,750)</u> | <u>(147,000)</u> |
| Difference | <u>1,032</u> | <u>Nil</u> | <u>Nil</u> |

The owner's suspicions justify investigation in respect of Department A.



Solution 4

(a) Initial workings:

| | | |
|------|---------------------------------------|----------------|
| | | £ |
| (i) | Profit for year | 92,000 |
| | Add loss on disposal | 6,000 |
| | Operating profit | <u>98,000</u> |
| (ii) | NBV 1 May 1994 | 206,000 |
| | Less disposal (£48,000 – £12,000) | (36,000) |
| | Add additions | 120,000 |
| | | <u>290,000</u> |
| | NBV 30 April 1995 | 277,000 |
| | Depreciation charge for year | <u>13,000</u> |
| | Net inflow from operating activities: | |
| | Operating profit | 98,000 |
| | Add depreciation charge | 13,000 |
| | Increase in stock | (4,000) |
| | Increase in debtors | (1,500) |
| | Decrease in creditors | <u>(7,000)</u> |
| | | <u>98,500</u> |

GH: cash-flow statement for year ended 30 April 1995

| | | |
|---|-----------------|-----------------|
| | £ | £ |
| Net cash inflow from operating activities | | 98,500 |
| Purchases of fixed assets | (120,000) | |
| Sale of fixed assets | <u>30,000</u> | |
| | | <u>(90,000)</u> |
| Net cash inflow before financing | | 8,500 |
| Long-term loan paid off | (40,000) | |
| Capital introduced | 20,000 | |
| Capital withdrawn | <u>(30,000)</u> | |
| | | <u>(50,000)</u> |
| Net decrease in cash equivalents | | <u>(41,500)</u> |

**Solution 5**

(a) JK Ltd: trading and profit and loss account for the year ended 31 March 1993

| | <i>£000</i> | <i>£000</i> | <i>£000</i> |
|-------------------------------|----------------|-----------------|------------------|
| Sales | | | 647,400 |
| Opening stock | | 15,400 | |
| Purchases | | 321,874 | |
| Carriage inwards | | 13,256 | |
| Closing stock | | <u>(19,473)</u> | |
| | | | <u>(331,057)</u> |
| Gross profit | | | 316,343 |
| Carriage outwards | | 32,460 | |
| Electricity | 6,994 | | |
| Add accrual | <u>946</u> | | |
| | | 7,940 | |
| Business rates | | 8,940 | |
| Wages and salaries | 138,292 | | |
| Add accrual | <u>2,464</u> | | |
| | | 140,756 | |
| Postage and stationery | | 6,984 | |
| Rent | 14,600 | | |
| Less prepaid | <u>(2,800)</u> | | |
| | | 11,800 | |
| Depreciation of vehicles | | <u>7,040</u> | |
| | | | <u>(215,920)</u> |
| | | | 100,423 |
| Interest receivable | | | 7,200 |
| Profit for year before tax | | | 107,623 |
| Provision for corporation tax | | | <u>(30,000)</u> |
| Profit for year after tax | | | 77,623 |
| Proposed final dividend | | | <u>(2,500)</u> |
| Retained profit for the year | | | 75,123 |
| Retained profit b/f | | | <u>76,597</u> |
| Retained profit c/f | | | <u>151,720</u> |

(b) JK Ltd: balance sheet as at 31 March 1993

| | <i>Cost (£000)</i> | <i>Depreciation (£000)</i> | <i>Net (£000)</i> |
|----------------------------|--------------------|----------------------------|-------------------|
| Fixed assets | | | |
| Motor vehicles | <u>49,400</u> | <u>28,280</u> | 21,120 |
| Current assets | | | |
| Stock | 19,473 | | |
| Debtors | 82,851 | | |
| Interest receivable | 7,200 | | |
| Prepayment | 2,800 | | |
| Bank deposit account | 90,000 | | |
| Bank current account | <u>77,240</u> | | |
| | | 279,564 | |
| Current liabilities | | | |
| Creditors | 41,936 | | |
| Accruals for expenses | 3,410 | | |
| Provision for tax | 30,000 | | |
| Proposed final dividend | 2,500 | | |
| VAT owing | 16,382 | | |
| PAYE owing | <u>4,736</u> | | |
| | | <u>(98,964)</u> | |
| | | | <u>180,600</u> |
| | | | <u>201,720</u> |
| Financed by | | | |
| Ordinary shares of £1 each | | | 50,000 |
| Profit and loss | | | <u>151,720</u> |
| Capital employed | | | <u>201,720</u> |

(c) Debtor collection period:

$$\frac{\text{Closing debtors} \times 365}{\text{Credit sales}} = \frac{82,851 \times 365}{647,400} = 48 \text{ days}$$

Creditor payment period:

$$\frac{\text{Closing creditors} \times 365}{\text{Credit purchases}} = \frac{41,936 \times 365}{321,874} = 48 \text{ days}$$

Stockholding period:

$$\frac{\text{Cost of sales} \times 365}{\text{Average stock}} = \frac{331,057 \times 365}{17,437} = 19 \text{ days}$$



Solution 6

(a) (i) Gearing ratio

$$\frac{\text{Debt}}{\text{Total capital}} \times 100$$

(ii) MBC gearing ratio

$$\frac{10}{48} \times 100 = 20.8\%$$

(iii) ROCE

$$\frac{\text{Profit before interest and tax}}{\text{Average capital employed}} \times 100$$

(iv) MBC ROCE

$$\frac{\pounds 4\text{m} + \pounds 0.6\text{m} + \pounds 1\text{m}}{(\pounds 48\text{m} + \pounds 44.5\text{m}) \div 2} \times 100 = 12.1\%$$

(b) (i) $\frac{10}{58} \times 100 = 17.2\%$

(ii) $\frac{5.6}{53} \times 100 = 10.6\%$

(c) (i) $\frac{20}{58} \times 100 = 34.5\%$

(ii) $\frac{5.6}{53} \times 100 = 10.6\%$

- (d) (i) Pure research is into new scientific or technological principles.
 (ii) Applied research infers a more practical nature, but not necessarily leading to a practical application.
 (iii) Development expenditure is where there is a clearly defined outcome and which is expected to produce profits.



Solution 7

(a) DWS Ltd: trading and profit and loss account for year ended 30 September 1994

| | | |
|---|----------------|----------------------|
| | £ | £ |
| Sales | | 188,000 |
| Less returns inwards | | <u>(8,000)</u> |
| | | 180,000 |
| Opening stock | 31,000 | |
| Purchases (115,000 + 1,200) | 116,200 | |
| Returns outward | <u>(6,000)</u> | |
| Closing stock | (53,000) | |
| | | <u>(88,200)</u> |
| | | 91,800 |
| Selling expenses | 12,000 | |
| Heat and light | 8,000 | |
| Wages and salaries (14,000 + 1,500) | 15,500 | |
| Directors' fees (5,000 + 3,600) | 8,600 | |
| Printing and stationery | 6,000 | |
| Telephone and fax (6,000 – 1,000) | 5,000 | |
| Rent, rates and insurance (4,000 – 1,000) | 3,000 | |
| Auditor's fees | 3,500 | |
| Bad debts written off | 3,000 | |
| Decrease in provision for bad debts (see workings) | (2,400) | |
| Bank charges accrued | 4,000 | |
| Depreciation of plant and machinery | 12,500 | |
| Depreciation of office equipment | <u>9,600</u> | |
| | | <u>(88,300)</u> |
| Profit for the year before tax | | 3,500 |
| Provision for corporation tax | | <u>(1,000)</u> |
| Net profit after tax | | 2,500 |
| Interim dividend paid | 2,000 | |
| Proposed dividend | <u>3,000</u> | |
| | | (5,000) |
| Transfer to general reserves | | <u>(10,000)</u> |
| | | (12,500) |
| Profit and loss account b/f | | 34,000 |
| Profit and loss account c/f | | <u><u>21,500</u></u> |

(b) DWS Ltd: balance sheet at 30 September 1994

| | <i>Cost (£)</i> | <i>Depreciation (£)</i> | <i>NBV (£)</i> |
|--|-----------------|-------------------------|----------------|
| Fixed assets | | | |
| Plant and machinery | 125,000 | 40,500 | 84,500 |
| Office equipment | 43,800 | 24,600 | 19,200 |
| | <u>168,800</u> | <u>65,100</u> | 103,700 |
| Current assets | | | |
| Stock | 53,000 | | |
| Debtors (32,000 – 1,600) | 30,400 | | |
| Prepayments (3,000 + 2,000) | 5,000 | | |
| Petty cash | <u>1,000</u> | | |
| | | 89,400 | |
| Current liabilities | | | |
| Creditors (33,000 – 2,600) | 30,400 | | |
| Accruals (1,500 + 3,600 + 3,500) | 8,600 | | |
| Overdraft | 3,600 | | |
| Provision for corporation tax | 1,000 | | |
| Proposed final dividend | <u>3,000</u> | | |
| | | 46,600 | |
| Current assets less current liabilities | | | <u>42,800</u> |
| Capital and reserves | | | <u>146,500</u> |
| Ordinary shares of 50p each | | | 100,000 |
| Share premium account | | | 8,000 |
| General reserve account (7,000 + 10,000) | | | 17,000 |
| Profit and loss account balance | | | <u>21,500</u> |
| | | | <u>146,500</u> |

(c) Current ratio

Current assets: Current liabilities

$$89,400 : 46,600 = 1.92 : 1$$

Quick ratio

Current assets less stock: Current liabilities

$$(89,400 - 53,000) : 46,600 = 0.78 : 1$$

Workings:

Re note (vi)

| | |
|------------------------------|-------|
| | £ |
| Increase purchases by | 1,200 |
| Decrease office equipment by | 1,200 |
| Decrease bank by | 2,600 |
| Decrease creditors by | 2,600 |

This leaves the £3,000 suspense account balance ‘untouched’. Therefore, increase prepayments by £3,000 as instructed.

Re notes (iv) and (v)

| | |
|--------------------------|---------------|
| | £ |
| Debtors in trial balance | 35,000 |
| Bad debt written off | (3,000) |
| | <u>32,000</u> |

Five per cent of £32,000 is £1,600; therefore decrease provision by £2,400.

Depreciation calculations:

Plant and machinery: 10% of £125,000 = £12,500

Office equipment: $((£45,000 - £1,200) - £15,000) \times 33.33\% = £9,600$



Solution 8

(i) $\frac{\text{Net profit}}{\text{sales}} \times 100$

$$\frac{30,560}{385,200} \times 100 = 7.93\%$$

(ii) Either

$$\frac{\text{Net profit}}{\text{average capital employed}} \times 100$$

$$\frac{30,560}{206,152.5} \times 100 = 14.82\%$$

or

$$\frac{\text{Net profit}}{\text{closing capital employed}} \times 100$$

$$\frac{30,560}{215,230} \times 100 = 14.20\%$$

(iii) $\frac{\text{Current assets}}{\text{current liabilities}}$

$$\frac{130,575}{62,385} = 2.09$$

(iv) $\frac{\text{Quick assets}}{\text{current liabilities}}$

$$\frac{45,945}{62,385} = 0.74$$



Solution 9

B Ltd: cash-flow statement for the year ended 30 September 2000

| | |
|-------------------------------------|-----------|
| | £'000 |
| Operating activities – see workings | 95 |
| Sale of fixed assets – see workings | 90 |
| Interest | (15) |
| Purchase of fixed asset | (40) |
| Dividends | (35) |
| Repayment of loan | (80) |
| | <u>15</u> |
| Opening bank and cash | 15 |
| Closing bank and cash | <u>30</u> |
| Increase in cash | <u>15</u> |

| Workings | | £ |
|--------------------------------------|--|------------|
| Operating activities | | |
| Operating profit | | 100 |
| Adjustment for non-cash-flow items | | |
| Profit sale of fixed asset | | (10) |
| Depreciation | | 30 |
| | | <u>120</u> |
| Adjustment for working capital | | |
| Stock | | (15) |
| Debtors | | (50) |
| Creditors | | 40 |
| | | <u>95</u> |
| Sale of fixed assets | | |
| Net book value (520 + 40 – 30 – 450) | | 80 |
| Profit on sale | | 10 |
| Proceeds on sale | | <u>90</u> |

Preparing for the Assessment

This section is intended for use when you are ready to start revising for your examination. It contains:

- a summary of useful revision techniques;
- details of the format of the assessment;
- a bank of examination-standard revision questions and suggested solutions;
- an illustrative computer-based assessment.

This should be attempted when you consider yourself to be ready for the assessment.

Revision technique

Planning

The first thing to say about revision is that it is an addition to your initial studies, not a substitute for them. In other words, do not coast along early in your course in the hope of catching up during the revision phase. On the contrary, you should be studying and revising concurrently from the outset. At the end of each week, and at the end of each month, get into the habit of summarising the material you have covered to refresh your memory of it.

As with your initial studies, planning is important to maximise the value of your revision work. You need to balance the demands for study, professional work, family life and other commitments. To make this work, you will need to think carefully about how to make best use of your time.

Begin as before by comparing the estimated hours you will need to devote to revision. Prepare a written schedule setting out the areas you intend to cover during particular weeks, and break that down further into topics for each day's revision. To help focus on the key areas try to establish:

- which areas you are weakest on, so that you can concentrate on the topics where effort is particularly needed;
- which areas are especially significant for the assessment – the topics that are tested frequently.

Do not forget the need for relaxation, and for family commitments. Sustained intellectual effort is only possible for limited periods, and must be broken up at intervals by lighter activities. And do not continue your revision timetable right up to the moment when you enter the exam room: you should aim to stop work a day or even two days before the

exam. Beyond this point the most you should attempt is an occasional brief look at your notes to refresh your memory.

Getting down to work

By the time you begin your revision you should already have settled into a fixed work pattern: a regular time of day for doing the work, a particular location where you sit, particular equipment that you assemble before you begin and so on.

You should have notes summarising the main points of each topic you have covered. Begin each session by reading through the relevant notes and trying to commit the important points to memory.

Usually this will be just your starting point. Unless the area is one where you already feel very confident, you will need to track back from your notes to the relevant chapter(s) in the *Study System*. This will refresh your memory on points not covered by your notes and fill in the detail that inevitably gets lost in the process of summarisation.

Tips for the final revision phase

As the assessment approaches, consider the following list of techniques and make use of those that work for you.

- Summarise your notes into more concise form, perhaps on index cards that you can carry with you for revision on the way into work.
- Go through your notes with a highlighter pen, marking key concepts and definitions.
- Summarise the main points in a key area by producing a wordlist, mind map or other mnemonic device.
- On areas that you find difficult, rework questions that you have already attempted, and compare your answers in detail with those provided in the *Study System*.
- Rework questions you attempted earlier in your studies.

Format of the Assessment

Structure of the assessment

The computer-based assessment is 90 min and comprises 40 questions with one or more parts.

Single part questions are generally worth 2 marks each but two and three part questions may be worth 4 or 6 marks. There will be no choice and all questions should be attempted if time permits.

Weighting of subjects

The current weightings for the syllabus sections are:

- Conceptual and regulatory framework – 20%
- Accounting systems – 20%
- Control of accounting systems – 15%
- Preparation of accounts – 45%

In broad terms, the entire syllabus will be covered in each assessment.

Revision Questions

The following table links the learning outcomes in the syllabus to the revision questions found within this section.

| Learning Outcome | Questions |
|---|--|
| <i>1(i) Conceptual and regulatory framework – 20%</i> | |
| Identify the various user groups which need accounting information and the characteristics of such information necessary to meet their objectives | 1.12, 1.13 |
| Explain the function of and differences between financial and management accounting systems | 1.14 |
| Identify and explain the fundamental accounting concepts, bases and policies | 2.4 |
| Explain the concepts of capital and revenue, cash and profit, income and expenditure and assets and liabilities | 1.7, 2.6, 3.1, 3.2, 5.11 |
| Explain the historical cost convention | 5.1 |
| Identify the basic methods of valuing assets on current cost, market value and economic value bases, and demonstrate their impact on profit measures and balance sheet values | 1.4 |
| Explain the influence of legislation (e.g. Companies Acts) and accounting standards on the production of published accounting information for organisations | 1.15 |
| <i>1(ii) Accounting systems – 20%</i> | |
| Explain the purpose of accounting records and their role in the accounting system | 2.9 |
| Prepare cash and bank accounts; prepare bank reconciliation statements | 1.9, 1.10, 3.4, 22 |
| Prepare petty cash statements under an imprest system | 5.3 |
| Prepare accounts for sales and purchases, including personal accounts and control accounts | 1.8, 2.11, 2.14, 3.5, 3.10, 4.7, 4.11, 7, 15, 24, 33 |
| Identify the necessity for financial accounting codes and construct a simple coding system | 1.16 |
| Prepare nominal ledger accounts; prepare journal entries; prepare a trial balance | 1.1, 1.2, 2.1, 2.12, 3.7, 4.3, 4.10, 28, 34 |
| Prepare accounts for indirect taxes (e.g. VAT) | 2.3 |
| Prepare accounts for payroll | 4.6 |
| <i>1(iii) Control of accounting systems – 15%</i> | |
| Identify the requirements for external audit and the basic processes undertaken | 3.6, 5.4 |
| Explain the purpose and basic procedures of internal audit | 1.6 |
| Explain the meaning of true and fair view | 1.17 |
| Explain the need for financial controls | 1.11 |
| Explain the purpose of audit checks and audit trails | 8 |
| Explain the nature of errors, and be able to make accounting entries for them | 1.3, 2.2, 2.15, 3.8, 4.4, 4.9, 6, 9, 32 |
| Explain the nature of fraud and basic ideas of prevention | 18 |

Learning Outcome

1(iv) Preparation of accounts – 45%

- Prepare accounts using accruals and prepayments
 Explain the difference between and prepare accounts for
 bad debts and provisions for doubtful debts
 Explain and calculate the methods of depreciation,
 including straight line, reducing balance and revaluation, and
 prepare accounts using each method
 Prepare a fixed asset register
 Explain, calculate and prepare accounts for stock
 Prepare trading accounts, profit and loss accounts,
 appropriations of profit and balance sheets from trial balance
 Prepare manufacturing accounts
 Prepare income and expenditure accounts
 Prepare accounts from incomplete records
 Calculate and explain basic ratios
- Prepare cash-flow statements

Questions

- 2.5, 3.9
 5.13
 2.7, 3.11, 4.5, 5.12
 3.3, 5.2
 2.8, 3.13, 5.10, 11.29
 1.5, 3.14, 4.1, 5.5, 5.15, 12, 13,
 17, 20, 23, 25, 27, 30, 31
 2.10, 3.12, 4.12, 5.9
 4.2, 5.6, 5.7, 26
 5.8, 14
 2.13, 3.15, 4.13, 4.14, 4.15,
 5.14, 10, 19
 4.8, 16, 21

**Question 1**

- 1.1 A company received an invoice from ABC Ltd for 40 units at £10 each, less 25 per cent trade discount, these being items purchased on credit and for resale. It paid this invoice minus a cash discount of 2 per cent. Which of the following journal entries correctly records the effect of the whole transaction in the company's books?

| | | | |
|-----|-------------------|--------------|---------------|
| (A) | | <i>Debit</i> | <i>Credit</i> |
| | ABC Ltd | 300 | |
| | Purchases | | 300 |
| | Cash | 292 | |
| | Discount allowed | 8 | |
| | ABC Ltd | | 300 |
| (B) | | <i>Debit</i> | <i>Credit</i> |
| | Purchases | 300 | |
| | ABC Ltd | | 300 |
| | ABC Ltd | 300 | |
| | Discount allowed | | 8 |
| | Cash | | 292 |
| (C) | | <i>Debit</i> | <i>Credit</i> |
| | Purchases | 300 | |
| | ABC Ltd | | 300 |
| | ABC Ltd | 300 | |
| | Discount received | | 6 |
| | Cash | | 294 |
| (D) | | <i>Debit</i> | <i>Credit</i> |
| | ABC Ltd | 400 | |
| | Purchases | | 400 |
| | Cash | 294 | |
| | Discount received | 106 | |
| | ABC Ltd | | 400 |

- 1.2 For which one of the following accounting uses is a spreadsheet least suitable?
- (A) Preparing budgets and forecasts.
 - (B) Recording the dual aspect of accounting transactions.
 - (C) The preparation of final accounts from a trial balance.
 - (D) Entering sales invoices in a sales daybook.
- 1.3 The suspense account shows a debit balance of £100. This could be due to:
- (A) entering £50 received from A Turner on the debit side of A Turner's account.
 - (B) entering £50 received from A Turner on the credit side of A Turner's account.
 - (C) undercasting the sales daybook by £100.
 - (D) undercasting the purchases daybook by £100.
- 1.4 The purchase of a business for more than the aggregate of the fair value of its separable identifiable assets results in the creation of a:
- (A) share premium account.
 - (B) reserve account.
 - (C) suspense account.
 - (D) goodwill account.
- 1.5 A business has opening stock of £12,000 and closing stock of £18,000. Purchase returns were £5,000. The cost of goods sold was £111,000.
- Purchases were:
£.....
- 1.6 The responsibility for ensuring that all accounting transactions are properly recorded and summarised in the final accounts lies with:
- (A) the external auditors.
 - (B) the internal auditors.
 - (C) the shareholders.
 - (D) the directors.
- 1.7 A business incurs expenditure on the following research and development activities:
- £120,000 on pure research;
 - £200,000 on applied research;
 - £350,000 on product development.
- The amount that could be capitalised is:
£.....
- 1.8 Your purchase ledger control account has a balance at 1 October 1998 of £34,500 credit. During October, credit purchases were £78,400, cash purchases were £2,400, and payments made to suppliers, excluding cash purchases and after deducting cash discounts of £1,200, were £68,900. Purchase returns were £4,700.
- The closing balance was:
£.....

1.9 Your firm's bank statement at 31 October 1998 shows a balance of £13,400. You subsequently discover that the bank has dishonoured a customer's cheque for £300 and has charged bank charges of £50, neither of which is recorded in your cash book. There are unpresented cheques totalling £1,400. You further discover that an automatic receipt from a customer of £195 has been recorded as a credit in your cash book.

Your cash book balance, prior to correcting the errors and omissions, was:
£.....

1.10 Your firm's cash book shows a credit bank balance of £1,240 at 30 April 1999. Upon comparison with the bank statement, you determine that there are unpresented cheques totalling £450, and a receipt of £140 that has not yet been passed through the bank account. The bank statement shows bank charges of £75 that have not been entered in the cash book.

The balance on the bank statement is:
£.....

1.11 Ensuring that the assets of a company are properly safeguarded and utilised efficiently and effectively is part of:

- (A) the stewardship function exercised by the directors.
- (B) the external auditor's responsibility.
- (C) the function of the financial accountant.
- (D) the internal auditor's responsibility.

1.12 Match the following users with their information requirements:

| <i>User</i> | <i>Requirements</i> |
|-------------------|--|
| 1. The public | A. The ability of the company to continue, and to pay pensions in the future. |
| 2. The government | B. The use of information for taking operational decisions in running the company |
| 3. Employees | C. The policies of a company and how those policies affect the community, for example, health and safety |
| 4. Internal users | D. The performance and financial position of a company and its ability to pay dividends. |
| 5. Shareholders | E. The ability of a company to pay taxes, and administer other taxes, for example, value added tax |

1.13 A new student at a college asked the caretaker when and where the accounting exam would take place. The caretaker replied that he thought the economics exam was on a Monday in C/42.

State four characteristics of useful information which are breached by the caretaker's reply.

1. _____
2. _____
3. _____
4. _____

1.14 Management accounts differ from financial accounts because they:

- (A) are forecasts of future income and expenditure.
- (B) contain more detailed information.

- (C) they are never shown to the external auditors.
- (D) not prepared from the bookkeeping system.

Which of the above statements is TRUE?

- 1.15** The management accounts within a limited company are determined by:
- (A) company law.
 - (B) company law and accounting standards.
 - (C) the shareholders.
 - (D) the directors.
- 1.16** Which one of the following attributes is the most important for any code to possess in order to be of use in an accounting system?
- (A) easy to change the code number.
 - (B) each code is a unique number.
 - (C) a combination of letters and digits to ensure input accuracy.
 - (D) linked to assets, liabilities, income, expenditure and capital.
- 1.17** A 'true and fair view' occurs when:
- (A) the accounts are correct.
 - (B) the accounts have been approved by the auditors.
 - (C) the accounts have been approved by the shareholders.
 - (D) the accounts have been prepared in accordance with generally accepted accounting practice.

(Total marks = 34)



Question 2

- 2.1** A credit balance on a ledger account indicates:
- (A) an asset or an expense.
 - (B) a liability or an expense.
 - (C) an amount owing to the organisation.
 - (D) a liability or a revenue.
- 2.2** An error of principle would occur if:
- (A) plant and machinery purchased was credited to a fixed-assets account.
 - (B) plant and machinery purchased was debited to the purchases account.
 - (C) plant and machinery purchased was debited to the equipment account.
 - (D) plant and machinery purchased was debited to the correct account but with the wrong amount.
- 2.3** If sales (including VAT) amounted to £27,612.50, and purchases (excluding VAT) amounted to £18,000, the balance on the VAT account, assuming all items are subject to VAT at 17.5 per cent, would be:

| | | |
|-------|-------|--|
| Dr/Cr | £ | |
| | | |

2.4 The accounting concept or convention that, in times of rising prices, tends to understate asset values and overstate profits, is the:

- (A) going concern concept.
- (B) prudence concept.
- (C) realisation concept.
- (D) historical cost convention.

2.5 An organisation's year end is 30 September. On 1 January 1996 the organisation took out a loan of £100,000 with annual interest of 12 per cent. The interest is payable in equal instalments on the first day of April, July, October and January in arrears.

How much should be charged to the profit and loss account for the year ended 30 September 1996, and how much should be accrued on the balance sheet?

| | |
|---------------------|---------------|
| Profit and loss a/c | Balance sheet |
| £ | £ |

2.6 Recording the purchase of computer stationery by debiting the computer equipment account would result in:

- (A) an overstatement of profit and an overstatement of fixed assets.
- (B) an understatement of profit and an overstatement of fixed assets.
- (C) an overstatement of profit and an understatement of fixed assets.
- (D) an understatement of profit and an understatement of fixed assets.

2.7 Depreciation is best described as:

- (A) a means of spreading the payment for fixed assets over a period of years.
- (B) a decline in the market value of the assets.
- (C) a means of spreading the net cost of fixed assets over their estimated useful life.
- (D) a means of estimating the amount of money needed to replace the assets.

2.8 An organisation's stock at 1 July was 15 units @ £3.00 each. The following movements occur:

| | |
|--------------|-------------------------------|
| 3 July 1996 | 5 units sold at £3.30 each |
| 8 July 1996 | 10 units bought at £3.50 each |
| 12 July 1996 | 8 units sold at £4.00 each |

Closing stock 31 July, using the FIFO method of stock valuation, would be:
£.....

2.9 Which *one* of the following is a book of prime entry *and* part of the double-entry system?

- (A) The journal.
- (B) The petty-cash book.
- (C) The sales daybook.
- (D) The purchase ledger.

2.10 A manufacturer has the following figures for the year ended 30 September 1996:

| | |
|------------------------------|---------|
| Direct materials | £8,000 |
| Factory overheads | £12,000 |
| Direct labour | £10,000 |
| Increase in work in progress | £4,000 |

Prime cost is:

£.....

2.11 A sales ledger control account had a closing balance of £8,500. It contained a contra to the purchase ledger of £400, but this had been entered on the wrong side of the control account.

The correct balance on the control account should be:

Dr £.....

2.12 Working capital will reduce by £500 if:

- (A) goods costing £3,000 are sold for £3,500 on credit.
- (B) goods costing £3,000 are sold for £3,500 cash.
- (C) fixed assets costing £500 are purchased on credit.
- (D) fixed assets with a net book value of £750 are sold for £250 cash.

2.13 From the following information regarding the year to 31 August 1996, what is the creditors payment period?

| | |
|-----------------------------|--------|
| | £ |
| Sales | 43,000 |
| Cost of sales | 32,500 |
| Opening stock | 6,000 |
| Closing stock | 3,800 |
| Creditors at 31 August 1996 | 4,750 |

..... days

2.14 A trader who is not registered for VAT purposes buys goods on credit. These goods have a list price of £2,000 and the trader is given a trade discount of 20 per cent. The goods carry VAT at 17.5 per cent.

The correct ledger entries to record this purchase are to debit the purchases account and to credit the supplier's account with:

£.....

2.15 A suspense account was opened when a trial balance failed to agree. The following errors were later discovered:

- A gas bill of £420 had been recorded in the gas account as £240.
- Discount of £50 given to a customer had been credited to discounts received.
- Interest received of £70 had been entered in the bank account only.

The original balance on the suspense account was:

Dr/Cr £

(Total marks = 30)



Question 3

- 3.1** Your company auditor insists that it is necessary to record items of plant separately and to depreciate them over several years, but that items of office equipment, such as hand-held stapling machines, can be grouped together and written off against profits immediately.

The main reason for this difference in treatment between the two items is because:

- (A) treatments of the two items must be consistent with treatment in previous years.
- (B) items of plant last for several years, whereas hand-held stapling machines last only for months.
- (C) hand-held stapling machines are not regarded as material items.
- (D) items of plant are revalued from time to time, whereas hand-held stapling machines are recorded at historical cost.

- 3.2** Which of the following best explains what is meant by ‘capital expenditure’? Capital expenditure is expenditure:

- (A) on fixed assets, including repairs and maintenance.
- (B) on expensive assets.
- (C) relating to the issue of share capital.
- (D) relating to the acquisition or improvement of fixed assets.

- 3.3** On 1 July 1997, your fixed-asset register showed a net book value of £47,500. The ledger accounts showed fixed assets at cost of £60,000 and provision for depreciation of £15,000. It was discovered that the disposal of an asset for £4,000, giving rise to a loss on disposal of £15,000, had not been recorded in the fixed-asset register.

After correcting this omission, the fixed-asset register would show a balance that was:

- (A) £3,000 lower than the ledger accounts.
- (B) £1,500 lower than the ledger accounts.
- (C) equal to the ledger accounts.
- (D) £1,000 higher than the ledger accounts.

- 3.4** The bank statement at 31 October 1997 showed an overdraft of £800. On reconciling the bank statement, it was discovered that a cheque drawn for £80 had not been presented for payment, and that a cheque for £130 from a customer had been dishonoured on 30 October 1997, but that this had not been notified to you by the bank.

The correct bank balance to be shown in the balance sheet at 31 October 1997 is:

Overdrawn £.....

- 3.5** A credit entry of £450 on X’s account in the books of Y could have arisen by:

- (A) X buying goods on credit from Y.
- (B) Y paying X £450.
- (C) Y returning goods to X.
- (D) X returning goods to Y.

- 3.6** The main purpose of an audit is to:
- (A) detect errors and fraud.
 - (B) ensure that the accounts are accurate.
 - (C) determine that the accounts show a true and fair view of the financial state of the organisation.
 - (D) ensure that all transactions have been recorded in the books of account.
- 3.7** A computerised spreadsheet package is *most* suitable for:
- (A) recording the dual effect of accounting transactions.
 - (B) maintaining an audit trail of transactions.
 - (C) performing bank reconciliations.
 - (D) preparing a cash budget.
- 3.8** Where a transaction is entered into the correct ledger accounts, but the wrong amount is used, the error is known as an error of:
- (A) omission.
 - (B) original entry.
 - (C) commission.
 - (D) principle.
- 3.9** At 1 September, the motor expenses account showed four months' insurance prepaid of £80 and petrol accrued of £95. During September, the outstanding petrol bill is paid, plus further bills of £245. At 30 September there is a further outstanding bill of £120.
- The amount to be shown in the profit and loss account for motor expenses for September is:
 £.....
- 3.10** Your organisation sold goods to PQ Ltd for £800 less trade discount of 20 per cent and cash discount of 5 per cent for payment within 14 days. The invoice was settled by cheque five days later. The entries required to record *both* of these transactions are:

| | | <i>Debit (£)</i> | <i>Credit (£)</i> |
|----------|-------------------|------------------|-------------------|
| A | PQ Ltd | 640 | |
| | Sales | | 640 |
| | Bank | 608 | |
| | Discount allowed | 32 | |
| | PQ Ltd | | 640 |
| B | PQ Ltd | 640 | |
| | Sales | | 640 |
| | Bank | 600 | |
| | Discount allowed | 40 | |
| C | PQ Ltd | 640 | |
| | Sales | | 640 |
| | Bank | 608 | |
| | Discount received | 32 | |
| | PQ Ltd | | 640 |
| D | PQ Ltd | 800 | |
| | Sales | | 800 |
| | Bank | 608 | |
| | Discount allowed | 182 | |
| | PQ Ltd | | 800 |

- 3.11 A fixed asset was purchased at the beginning of year 1 for £2,400 and depreciated by 20 per cent per annum by the reducing-balance method. At the beginning of year 4 it was sold for £1,200. The result of this was:

| | |
|-----------------|---|
| Profit/loss a/c | £ |
| | |

- 3.12 You are given the following information for the year ended 31 October 1997:

| | |
|-------------------------------------|---------|
| | £ |
| Purchases of raw materials | 112,000 |
| Returns inwards | 8,000 |
| Decrease in stocks of raw materials | 8,000 |
| Direct wages | 42,000 |
| Carriage outwards | 4,000 |
| Carriage inwards | 3,000 |
| Production overheads | 27,000 |
| Increase in work in progress | 10,000 |

The value of factory cost of goods completed is:

£.....

- 3.13 Your organisation uses the weighted average cost method of valuing stocks. During August 1997, the following stock details were recorded:

| | |
|-----------------|------------------------------------|
| Opening balance | 30 units valued at £2 each |
| 5 August | purchase of 50 units at £2.40 each |
| 10 August | issue of 40 units |
| 18 August | purchase of 60 units at £2.50 each |
| 23 August | issue of 25 units |

The value of the balance at 31 August 1997 was:

£.....

- 3.14 During September, your organisation had sales of £148,000, which made a gross profit of £40,000. Purchases amounted to £100,000 and opening stock was £34,000.

The value of closing stock was:

£.....

- 3.15 During the year ended 31 October 1997, your organisation made a gross profit of £60,000, which represented a mark-up of 50 per cent. Opening stock was £12,000 and closing stock was £18,000.

The rate of stock turnover was:

.....times

(Total marks = 30)



Question 4

- 4.1 It is important to produce a trial balance prior to preparing the final accounts because:

- (A) it confirms the accuracy of the ledger accounts.
 (B) it provides all the figures necessary to prepare the final accounts.

- (C) it shows that the ledger accounts contain debit and credit entries of an equal value.
- (D) it enables the accountant to calculate any adjustments required.
- 4.2** The accumulated fund represents:
- (A) the total of the shareholders' investment in a company.
- (B) the book value of net assets in a not-for-profit organisation.
- (C) the excess of income over expenditure in a not-for-profit organisation.
- (D) the bank balances of an organisation.
- 4.3** A computerised accounts package would be *most* useful in maintaining:
- (A) the ledger accounts.
- (B) the books of prime entry.
- (C) a register of fixed assets.
- (D) the stock records.
- 4.4** An error of original entry would occur if the purchase of goods for resale was:
- (A) debited and credited to the correct accounts using the incorrect amount in both cases.
- (B) credited to the purchases account and debited to the supplier's account.
- (C) debited to a fixed-assets account.
- (D) entered correctly in the purchases account, but entered in the supplier's account using the wrong amount.
- 4.5** The reducing-balance method of depreciating fixed assets is more appropriate than the straight-line method when:
- (A) there is no expected residual value for the asset.
- (B) the expected life of the asset is not capable of being estimated.
- (C) the asset is expected to be replaced in a short period of time.
- (D) the asset decreases in value less in later years than in the early years of use.
- 4.6** Your organisation paid £240,500 in net wages to its employees during the year. Employees' tax and National Insurance amounted to £64,000 and employer's National Insurance was £22,000. Employees had contributed £12,500 to a pension scheme.
- The amount to be charged against profits for the year, in respect of wages, is:
£.....
- 4.7** Your organisation has received a statement of account from one of its suppliers, showing an outstanding balance due to them of £1,350. On comparison with your ledger account, the following is determined:
- your ledger account shows a credit balance of £260;
 - the supplier has disallowed cash discount of £80 due to late payment of an invoice;
 - the supplier has not yet allowed for goods returned at the end of the period of £270;
 - cash in transit of £830 has not been received by the supplier.

Following consideration of these items, the unreconciled difference between the two records is:

£.....

4.8 A cash-flow statement can *best* be described as:

- (A) a statement showing the effects of profit on cash resources.
- (B) a statement of cash inflows and outflows from operating activities.
- (C) a statement showing the movement in working capital.
- (D) a statement showing the inflows and outflows of cash and cash equivalents.

4.9 Your organisation’s trial balance at 31 October 1999 is out of agreement, with the debit side totalling £500 less than the credit side. During November, the following errors are discovered:

- the sales journal for October had been undercast by £150;
- rent received of £240 had been credited to the rent payable account;
- the provision for bad debts, which decreased by £420, had been recorded in the provision for bad debts account as an increase.

Following the correction of these errors, the balance on the suspense account would be:

Dr/Cr £

4.10 On 1 November 1999, your organisation purchased, on credit from XYZ Ltd, office equipment with a catalogue price of £1,000, less trade discount of 20 per cent and cash discount of 5 per cent, if paid for within 14 days. The correct journal entry to record the purchase on 1 November (ignoring VAT) is:

| | | <i>Debit (£)</i> | <i>Credit (£)</i> |
|----------|-------------------|------------------|-------------------|
| A | Office equipment | 1,000 | |
| | XYZ Ltd | | 750 |
| | Discount received | | 250 |
| B | Office equipment | 1,000 | |
| | XYZ Ltd | | 760 |
| | Discount received | | 240 |
| C | Office equipment | 800 | |
| | XYZ Ltd | | 800 |
| D | Office equipment | 800 | |
| | XYZ Ltd | | 760 |
| | Discount received | | 40 |

4.11 The following sales ledger control account contains some inaccurate entries:

| Sales ledger control account | | | |
|------------------------------|--------|-----------------------------|--------|
| | £ | | £ |
| Opening debtors | 14,500 | Credit sales | 53,500 |
| Discounts allowed | 350 | Returns | 1,400 |
| Receipts from debtors | 51,200 | Contra to purchasing ledger | 500 |

The correct closing debtors figure should be:
 £.....

4.12 The following information relates to a business at its year end:

| | |
|-----------------------------|------|
| | £000 |
| Sales | 600 |
| Stocks at beginning of year | |
| Raw materials | 20 |
| Work in progress | 4 |
| Finished goods | 68 |
| Stocks at end of year | |
| Raw materials | 22 |
| Work in progress | 8 |
| Finished goods | 60 |
| Purchases of raw materials | 100 |
| Returns inwards | 10 |
| Returns outwards | 15 |
| Carriage inwards | 8 |
| Carriage outwards | 12 |
| Direct labour | 80 |

The prime cost of goods manufactured during the year is:
£.....

4.13 An increase in the gross profit margin of a business is most likely to be due to which *one* of the following combinations:

| | <i>Selling price per unit</i> | <i>Quantity sold</i> | <i>Cost per unit</i> |
|----------|-------------------------------|----------------------|----------------------|
| A | increased | no change | increased |
| B | no change | increased | no change |
| C | no change | no change | decreased |
| D | decreased | increased | increased |

4.14 A business has the following capital and long-term liabilities:

| | 31.10.98 (£m) | 31.10.99 (£m) |
|----------------------|---------------|---------------|
| 12% debentures | 20 | 40 |
| Issued share capital | 15 | 30 |
| Share premium | 3 | 18 |
| Retained profits | 22 | 12 |

At 31 October 1999, its gearing ratio, compared with that at 31 October 1998, has:

- (A) risen, resulting in greater risk for shareholders.
- (B) risen, resulting in greater security for shareholders.
- (C) fallen, resulting in greater security for shareholders.
- (D) remained the same.

4.15 A business has the following trading accounts:

| | Year ended 31 October 1998 | Year ended 31 October 1999 |
|--------------------|-------------------------------|-------------------------------|
| | £000 | £000 |
| Sales | 2,000 | 2,650 |
| Less cost of sales | | |
| Opening stock | 75 | 85 |
| Purchases | 1,260 | 1,330 |
| | 1,335 | 1,415 |
| Less closing stock | 85 | 115 |
| | 1,250 | 1,300 |
| Gross profit | <u>750</u> | <u>1,350</u> |

During the year ended 31 October 1999, its rate of stock turnover, compared with that for the year ended 31 October 1998, has:

- (A) decreased, with a possible beneficial effect on liquidity.
- (B) decreased, with a possible detrimental effect on liquidity.
- (C) increased, with a possible detrimental effect on liquidity.
- (D) increased, with a possible beneficial effect on liquidity.

(Total marks = 30)



Question 5

- 5.1 In times of rising prices, the historical cost convention results in:
- (A) stocks being valued at cost price if this is higher than their net realisable value.
 - (B) fixed assets being valued at their original cost, with no adjustment for depreciation.
 - (C) profits being overstated and balance sheet values being understated.
 - (D) profits being understated and balance sheet values being overstated.
- 5.2 An organisation's fixed-asset register showed a net book value of £271,200. The fixed-asset account in the nominal ledger showed a net book value of £251,200. The difference could be due to not having removed from the fixed-asset register a disposed asset that had:
- (A) disposal proceeds of £30,000 and a profit on disposal of £10,000.
 - (B) disposal proceeds of £30,000 and a net book value of £10,000.
 - (C) disposal proceeds of £30,000 and a loss on disposal of £10,000.
 - (D) disposal proceeds of £10,000 and a net book value of £10,000.
- 5.3 An organisation restores its petty-cash balance to £250 at the end of each month. During October, the total expenditure column in the petty-cash book was calculated as being £210, and hence the imprest was restored by this amount. The analysis columns, which had been posted to the nominal ledger, totalled only £200. This error would result in:
- (A) the trial balance being £10 higher on the debit side.
 - (B) the trial balance being £10 higher on the credit side.
 - (C) no imbalance in the trial balance.
 - (D) the petty-cash balance being £10 lower than it should be.
- 5.4 The *stewardship function* is carried out by:
- (A) the internal auditors.
 - (B) the external auditors.
 - (C) the treasurer of a not-for-profit organisation.
 - (D) the management of an organisation.
- 5.5 An increase in stock of £500, a decrease in the bank balance of £800 and an increase in creditors of £2,400, will result in:
- (A) an increase in working capital of £2,700.
 - (B) a decrease in working capital of £2,700.

- (C) an increase in working capital of £2,100.
- (D) a decrease in working capital of £2,100.

5.6 At 1 November 1999, a club’s membership subscriptions account showed a debit balance of £200 and a credit balance of £90. During the year ended 31 October 2000, subscriptions received amounted to £4,800. At 31 October 2000, subscriptions paid in advance amounted to £85, and subscriptions in arrears, and expected to be collected, amounted to £50.

The amount to be transferred to the income and expenditure account in respect of subscriptions for the year ended 31 October 2000 is:

£.....

5.7 The *accumulated fund* represents:

- (A) the bank balances of an organisation.
- (B) the book value of net assets in a not-for-profit organisation.
- (C) the excess of receipts over payments in a not-for-profit organisation.
- (D) the total of shareholders’ funds.

5.8 A sole trader’s profit and loss account for the year ended 31 October 2000 was drawn up as follows:

| | | |
|-------------------|---------------|---------------|
| | £ | £ |
| Gross profit | | 87,000 |
| Less expenses | | |
| Own wages | 18,000 | |
| Assistant’s wages | 8,000 | |
| General expenses | <u>16,000</u> | |
| | | 42,000 |
| Net profit | | <u>45,000</u> |

All wages were paid by cheque from the business bank account. During the year, the sole trader had paid his private telephone bills of £800 from the business bank account, and recorded these as ‘drawings’. He had also paid £2,700 from his private funds for petrol (of which one-third was for private use), but had made no entries in his accounts for these payments.

His capital at 1 November 1999 was £28,000. His capital at 31 October 2000 is:
£.....

5.9 The following information is given for the year ended 31 October 2000:

| | |
|-------------------------------------|--------|
| | £ |
| Purchases of raw materials | 56,000 |
| Returns inwards | 4,000 |
| Increase in stocks of raw materials | 1,700 |
| Direct wages | 21,000 |
| Carriage inwards | 2,500 |
| Production overheads | 14,000 |
| Decrease in work in progress | 5,000 |

The value of factory cost of goods completed is:

£.....

- 5.10 Your organisation uses the weighted average cost method of valuing stocks. During September 2000, the following stock details were recorded:

| | |
|-----------------|-------------------------------------|
| Opening balance | 60 units valued at £4 each |
| 6 September | Purchase of 100 units at £4.80 each |
| 9 September | Sale of 80 units |
| 12 September | Purchase of 120 units at £5 each |
| 23 September | Sale of 50 units |

The value of the stock at 30 September 2000 was:

£.....

- 5.11 Goodwill is most appropriately classed as:
- (A) a fictitious asset.
 - (B) a semi-fixed asset.
 - (C) a tangible asset.
 - (D) an intangible asset.
- 5.12 The reducing-balance method of depreciating fixed assets is more appropriate than the straight-line method when:
- (A) the expected life of the asset is short.
 - (B) the asset is expected to decrease in value by a fixed percentage of cost each year.
 - (C) the expected life of the asset cannot be estimated accurately.
 - (D) the asset is expected to decrease in value less in later years than in the early years of its life.
- 5.13 An increase in the provision for doubtful debts would result in:
- (A) a decrease in working capital.
 - (B) an increase in working capital.
 - (C) an increase in liabilities.
 - (D) an increase in net profit.
- 5.14 The gross profit mark-up is 60 per cent where sales are £240,000 and:
- (A) cost of sales is £96,000.
 - (B) gross profit is £144,000.
 - (C) gross profit is £150,000.
 - (D) cost of sales is £150,000.
- 5.15 Revenue reserves would increase if a company:
- (A) issues shares at a premium.
 - (B) makes a transfer from retained profit reserve to general reserves.
 - (C) retains profits.
 - (D) increases its current bank balances.
- (Total marks = 30)**



Question 6

The trial balance of OBX plc at 30 April 1996 showed the following totals:

| | | | |
|-------|----------|--------|----------|
| Debit | £723,626 | Credit | £721,405 |
|-------|----------|--------|----------|

The totals included the sales ledger control account balance of £104,637.

A suspense account was opened for the difference. The profit for the year ended 30 April 1996 was then calculated as being £227,642 and the suspense account balance was dealt with by including it on the balance sheet as appropriate.

Later investigation revealed the following:

1. An invoice of £46 for stationery had been entered in the stationery account as £64, but was correctly entered in the creditor's account.
2. One of the pages of the sales daybook had been incorrectly totalled as £2,463 instead of £2,643, and a credit sale of £325 had been omitted from another page.
3. Discounts allowed of £950 had been omitted from the sales ledger control account.
4. Bank interest received of £220 had been correctly entered in the revenue account but had not been entered in the cash book.
5. A contra entry between the sales and purchase ledgers of £426 had been debited to the sales ledger control account and credited to the purchase ledger control account.
6. During the year, a fixed asset costing £3,000 was sold for £750. Its net book value at the date of disposal was £920. The proceeds were entered in the cash book, but no other entries regarding the disposal were made.

Requirements

- (a) Insert the missing items into the suspense account given below to record the correction of the above errors, carrying down any unresolved balance.

| Suspense account | | | |
|------------------|---|--|---|
| | £ | | £ |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

(7 marks)

- (b) Insert the missing items into the sales ledger control account given below in order to calculate the corrected balance after the adjustment for the errors now discovered.

| Sales ledger control account | | | |
|------------------------------|---------|--|---|
| | £ | | £ |
| Balance at 30 April 1996 | 104,637 | | |
| | | | |
| | | | |
| | | | |

(7 marks)

- (c) Insert the missing items below in order to calculate the revised net profit after the correction of the errors.

| | £ |
|---------------------------------|---------|
| Profit as originally calculated | 227,642 |
| | |
| | |
| | |
| | |
| Revised net profit | |

(6 marks)**(Total marks = 20)**

Question 7

M Kingston & Co. Ltd received the following statement of account from L Potts & Son on 31 January 1996:

L Potts & Son Statement of account

Date: 31 January 1996
 To: M Kingston & Co. Ltd
 Spot Lane
 Blotchford
 Kent KE3 2DE

| <i>Date</i> | <i>Reference</i> | <i>Debits</i> | <i>Credits</i> | <i>Balance</i> |
|-------------|----------------------|---------------|----------------|----------------|
| 1996 | | £ | £ | £ |
| Jan. 1 | Balance b/f | | | 3,000 Dr |
| Jan. 13 | (a) Invoice 01256 | 1,000 | | 4,000 Dr |
| Jan. 15 | (b) Cash received | | 2,800 | |
| | (c) Invoice 01287 | 3,600 | | 4,800 Dr |
| Jan. 16 | (d) Credit Note 0062 | | 50 | 4,750 Dr |
| Jan. 20 | (e) Invoice 01364 | 500 | | 5,250 Dr |
| Jan. 28 | (f) Invoice 01395 | 800 | | 6,050 Dr |
| Jan. 30 | (g) Credit Note 0070 | | 100 | 5,950 Dr |

The account of L Potts & Son in the ledger of M Kingston & Co. Ltd is as follows:

| L Potts & Son | | | | | |
|---------------|----------------------|----------|-------------|---------------|----------|
| <i>1996</i> | | <i>£</i> | <i>1996</i> | | <i>£</i> |
| Jan. 13 | (h) Cash | 2,800 | Jan. 1 | Balance b/f | 3,000 |
| | (i) Discount | 200 | Jan. 15 | Invoice 01256 | 1,000 |
| Jan. 18 | (j) Credit Note 0062 | 150 | Jan. 17 | Invoice 01287 | 3,600 |
| Jan. 30 | (k) Cash | 1,400 | Jan. 22 | Invoice 01364 | 500 |
| Jan. 31 | (l) Debit Note 65 | 300 | | | |
| | Balance c/d | 3,250 | | | |
| | | 8,100 | | | 8,100 |

Requirements

(a) Insert the missing items below in order to reconcile the two balances.

| | |
|----------------------------------|----------------------|
| | £ |
| Balance per supplier's statement | 5,950 |
| Adjustments: | |
| Add/less* <input type="text"/> | <input type="text"/> |
| Add/less* <input type="text"/> | <input type="text"/> |
| Corrected balance | <input type="text"/> |
| Balance per ledger | 3,250 |
| Add/less* <input type="text"/> | <input type="text"/> |
| Add/less* <input type="text"/> | <input type="text"/> |
| Add/less* <input type="text"/> | <input type="text"/> |
| Add/less* <input type="text"/> | <input type="text"/> |
| Correct balance | <input type="text"/> |

*Delete as appropriate.

(8 marks)

(b) Match the following descriptions to the letters (a) to (l)

- (i) This is an invoice from Potts to Kingston. It will have been entered in Potts's records as soon as it was issued, but has not yet been received by Kingston. letter _____
- (ii) This is a credit note issued by Potts and entered in its records at once; it has not yet been received by Kingston. letter _____
- (iii) This is cash discount that has been deducted by Kingston upon payment of the outstanding balance at the beginning of January, ignored or disallowed by Potts. letter _____
- (iv) This is cash paid by Kingston at the end of the month, and entered in its ledger account at once; it has not yet been received by Potts. letter _____
- (v) This is a debit note issued by Kingston perhaps due to goods returned; credit note not yet received by Potts. letter _____

(10 marks)

(c) The correct figure to be shown in the balance sheet of M Kingston & Co. Ltd is £ and is a current **asset/liability** (delete as appropriate). **(2 marks)**

(Total marks = 20)

? Question 8

In connection with controls over accounting documents and records that would help to prevent errors or fraud in the operation of the computerised ledger, complete the missing words in these sentences:

- (i) invoices relate to a properly authorised _____;
- (ii) numbered _____ should be raised, e.g. by storekeeper, to ensure that goods have been inspected and taken into stores;
- (iii) adequate _____ of duties exists;
- (iv) purchase ledger records should be checked against _____ statements.

(8 marks)

? **Question 9**

At the year end of TD, an imbalance in the trial balance was revealed that resulted in the creation of a suspense account with a credit balance of £1,040.

Investigations revealed the following errors:

- (i) A sale of goods on credit for £1,000 had been omitted from the sales account.
- (ii) Delivery and installation costs of £240 on a new item of plant had been recorded as a revenue expense.
- (iii) Cash discount of £150 on paying a creditor, JW, had been taken, even though the payment was made outside the time limit.
- (iv) Stock of stationery at the end of the period of £240 had been ignored.
- (v) A purchase of raw materials of £350 had been recorded in the purchases account as £850.
- (vi) The purchase returns daybook included a sales credit note for £230 that had been entered correctly in the account of the debtor concerned, but included with purchase returns in the nominal ledger.

Requirements

- (a) Insert the missing items into the table below to show the journal entries required to correct each of the above errors.

| <i>Item</i> | <i>Account name</i> | <i>Debit or credit?</i> | <i>£</i> |
|-------------|---------------------|-------------------------|----------|
| (i) | | | |
| (ii) | | | |
| (iii) | | | |
| (iv) | | | |
| (v) | | | |
| (vi) | | | |

(12 marks)

- (b) Insert the missing items into the suspense account given below to show the corrections to be made.

| Suspense account | | | |
|------------------|---|--|---|
| | £ | | £ |
| | | | |
| | | | |
| | | | |

(3 marks)

- (c) Prior to the discovery of the errors, TD’s gross profit for the year was calculated at £35,750 and the net profit for the year at £18,500.

Insert the missing items below in order to calculate the revised gross and net profit figures after the correction of the errors.

| | | | |
|-------------------------|--|--------|--------|
| Gross profit – original | | £ | 35,750 |
| Add/less* | | | |
| Add/less* | | | |
| Add/less* | | | |
| Revised gross profit | | | |
| | | | |
| Net profit – original | | 18,500 | |
| Add/less* | | | |
| Add/less* | | | |
| Add/less* | | | |
| Add/less* | | | |
| Revised net profit | | | |

(5 marks)

(Total marks = 20)

? Question 10

ARH plc has the following results for the last two years of trading:

ARH plc: trading and profit and loss account

| <i>For the year ended:</i> | <i>31.12.94</i> | <i>31.12.95</i> |
|------------------------------|-----------------|-----------------|
| | <i>£000</i> | <i>£000</i> |
| Sales | 14,400 | 17,000 |
| Less cost of sales | <u>11,800</u> | <u>12,600</u> |
| Gross profit | 2,600 | 4,400 |
| Less expenses | <u>1,200</u> | <u>2,000</u> |
| Net profit for the year | 1,400 | 2,400 |
| Dividends proposed | <u>520</u> | <u>780</u> |
| Retained profit for the year | <u>880</u> | <u>1,620</u> |

ARH plc: balance sheet

| | <i>At 31 December 1994</i> | | <i>At 31 December 1995</i> | |
|--|----------------------------|--------------|----------------------------|--------------|
| | £000 | £000 | £000 | £000 |
| Fixed assets | | 2,500 | | 4,000 |
| Current assets | | | | |
| Stocks | 1,300 | | 2,000 | |
| Debtors | 2,000 | | 1,600 | |
| Bank balances | <u>2,400</u> | | <u>820</u> | |
| | 5,700 | | 4,420 | |
| Less: Current liabilities | | | | |
| Creditors | <u>1,500</u> | | <u>2,700</u> | |
| Net current assets | | <u>4,200</u> | | <u>1,720</u> |
| | | 6,700 | | 5,720 |
| Less: Long-term liabilities | | | | |
| 10% debentures | | <u>2,600</u> | | <u>—</u> |
| | | <u>4,100</u> | | <u>5,720</u> |
| Financed by | | | | |
| 2.4 million ordinary shares of £1 each | | 2,400 | | 2,400 |
| Revaluation reserves | | 500 | | 500 |
| Retained profits | | <u>1,200</u> | | <u>2,820</u> |
| | | <u>4,100</u> | | <u>5,720</u> |

Requirements

Calculate for 1994 and 1995 the:

- (i) gross profit percentage,
- (ii) net profit percentage,
- (iii) return on capital employed.

(6 marks)



Question 11

(a) You are given the following details regarding stock movements during April 1996:

| | |
|----------|---|
| 1 April | 100 units on hand, valued at £10 each |
| 8 April | Stock sold for £360, with a mark-up of 50% |
| 18 April | 38 units purchased for £480 less trade discount of 5% |
| 20 April | 50 units sold |
| 23 April | 35 units sold |
| 28 April | 20 units purchased for £260 |

You are required to insert the missing items into the stock record cards given below, using the first in, first out (FIFO), last in, first out (LIFO) and average cost (AVCO) methods, in order to determine the quantity and value of closing stock at 30 April 1996.

Stock record card – FIFO

| <i>Date</i> | <i>Receipts</i> | | | <i>Issues</i> | | | <i>Balance</i> | | |
|-------------|-----------------|---------------|----------|---------------|---------------|----------|----------------|---------------|----------|
| | <i>Units</i> | <i>£/unit</i> | <i>£</i> | <i>Units</i> | <i>£/unit</i> | <i>£</i> | <i>Units</i> | <i>£/unit</i> | <i>£</i> |
| 1 April | | | | | | | 100 | 10 | 1000 |
| 8 April | | | | | | | | | |
| 18 April | | | | | | | | | |
| 20 April | | | | | | | | | |
| 23 April | | | | | | | | | |
| 28 April | | | | | | | | | |
| Totals | | | | | | | | | |

Stock record card – LIFO

| Date | Receipts | | | Issues | | | Balance | | |
|----------|----------|--------|---|--------|--------|---|---------|--------|-------|
| | Units | £/unit | £ | Units | £/unit | £ | Units | £/unit | £ |
| 1 April | | | | | | | 100 | 10 | 1,000 |
| 8 April | | | | | | | | | |
| 18 April | | | | | | | | | |
| 20 April | | | | | | | | | |
| 23 April | | | | | | | | | |
| 28 April | | | | | | | | | |
| Totals | | | | | | | | | |

Stock record card – AVCO

| Date | Receipts | | | Issues | | | Balance | | |
|----------|----------|--------|---|--------|--------|---|---------|--------|-------|
| | Units | £/unit | £ | Units | £/unit | £ | Units | £/unit | £ |
| 1 April | | | | | | | 100 | | 1,000 |
| 8 April | | | | | | | | | |
| 18 April | | | | | | | | | |
| 20 April | | | | | | | | | |
| 23 April | | | | | | | | | |
| 28 April | | | | | | | | | |
| Totals | | | | | | | | | |

(10 marks)

(b) If the physical stock check carried out at 30 April revealed a closing stock quantity of 50 units, which of the following could be possible reasons for the discrepancy.

- (i) Recording of an issue at too high a level
- (ii) Recording of a receipt at too high a level
- (iii) Recording of a receipt at too low a level
- (iv) Recording of an issue at too low a level.

(2 marks)

(Total marks = 12)

Question 12

The directors of R Ltd are hoping to negotiate an overdraft to provide working capital for a proposed expansion of business. The bank manager has called for accounts for the last 3 years and the directors have produced the following extracts:

| Balance sheets at 31 December | 1994 | | 1995 | | 1996 | |
|---|-----------|------------|------------|------------|------------|------------|
| | £000 | £000 | £000 | £000 | £000 | £000 |
| Fixed assets | | 147 | | 163 | | 153 |
| Current assets | | | | | | |
| Stocks | 27 | | 40 | | 46 | |
| Debtors | 40 | | 45 | | 52 | |
| Bank | 6 | | 15 | | 8 | |
| | <u>73</u> | | <u>100</u> | | <u>106</u> | |
| Current liabilities (including tax and dividends) | 33 | | 45 | | 43 | |
| | | <u>40</u> | | <u>55</u> | | <u>63</u> |
| | | <u>187</u> | | <u>218</u> | | <u>216</u> |

| | 1994 (£000) | 1995 (£000) | 1996 (£000) |
|-----------------------|-------------|-------------|-------------|
| Credit sales | 360 | 375 | 390 |
| Credit purchases | 230 | 250 | 280 |
| Net profit before tax | 32 | 46 | 14 |

The bank manager has obtained the following additional information:

- (i) The company commenced on 1 January 1994 with an issued capital of 100,000 £1 ordinary shares issued at a premium of 60 pence each.
- (ii) Corporation tax amounted to £5,000 in 1995 and £6,000 in 1996. There was no corporation tax for 1994.
- (iii) Dividends were declared of 5p per share in 1994, and 10p per share in each of 1995 and 1996.
- (iv) £18,000 was transferred to general reserves in 1995.

Requirements

- (a) Insert the missing items into the table below to show the appropriation accounts for each of the 3 years.

| Description | 1994 (£000) | 1995 (£000) | 1996 (£000) |
|-----------------------|-------------|-------------|-------------|
| Net profit before tax | 32 | 46 | 14 |
| | | | |
| Net profit after tax | | | |
| | | | |
| Profit/(loss) | | | |

(6 marks)

- (b) Insert the missing items into the table below to show the capital section of the balance sheet for each of the 3 years.

| Description | 1994 (£000) | 1995 (£000) | 1996 (£000) |
|-------------|-------------|-------------|-------------|
| | | | |
| | | | |
| | | | |
| Totals | | | |

(4 marks)

- (c) (i) The formula for debtors collection period is:

$$\frac{\text{Debtors}}{\text{Sales}} \times 365$$

- (ii) The debtors collection periods in each of the three years is:

| | | |
|-------|----------------------|------|
| 1994: | <input type="text"/> | days |
| 1995: | <input type="text"/> | days |
| 1996: | <input type="text"/> | days |

- (iii) The formula for creditors payment period is:

$$\frac{\text{}}{\text{}} \times \text{}$$

- (iv) The creditors payment period in each of the three years is (*note*: remember to exclude taxation and dividend creditors):

| | | |
|-------|----------------------|------|
| 1994: | <input type="text"/> | days |
| 1995: | <input type="text"/> | days |
| 1996: | <input type="text"/> | days |

(6 marks)

- (d) Deleting text as appropriate, complete the following paragraph, which discusses how the above changes in debtor and creditor days might affect the proposed overdraft.

The company appears to be *increasing/decreasing* the length of credit given to customers, which *slows down/speeds up* the receipt of cash. At the same time it is *increasing/decreasing* the length of credit from suppliers, which *slows down/speeds up* the payment of cash. These two actions combined will cause the amount of cash available to *increase/decrease*. If these payment periods could be brought more into line with each other, the amount of overdraft required will be *higher/lower*.

(6 marks)

(Total marks = 22)



Question 13

APW Ltd has the following trial balance at 30 April 1998:

| | <i>Debit (£000)</i> | <i>Credit (£000)</i> |
|--|---------------------|----------------------|
| Ordinary shares, 50p each | | 1,500 |
| Preference shares, 7% | | 400 |
| Share premium account | | 200 |
| Profit and loss account 1 May 1997 | | 580 |
| 8% debentures | | 500 |
| Buildings – at valuation | 3,500 | |
| Buildings – depreciation at 1 May 1997 | | 1,300 |
| Factory plant – cost | 1,200 | |
| Factory plant – depreciation at 1 May 1997 | | 200 |
| Office equipment – cost | 250 | |
| Office equipment – depreciation at 1 May 1997 | | 50 |
| Delivery vehicles – cost | 600 | |
| Delivery vehicles – depreciation at 1 May 1997 | | 360 |
| Stocks at 1 May 1997 | | |
| Raw materials | 234 | |
| Work in progress | 182 | |
| Finished goods | 98 | |
| Debtors and creditors | 240 | 124 |
| VAT account | | 74 |
| PAYE and NI creditor | | 62 |
| Bank | | 248 |
| Sales | | 2,660 |
| Purchases of raw materials | 785 | |
| Carriage outwards | 20 | |
| Carriage inwards | 40 | |
| Returns | 104 | 65 |
| Direct labour | 372 | |
| Indirect factory labour | 118 | |
| Office salaries | 130 | |
| Indirect factory overheads | 63 | |
| Heat, light and power | 120 | |
| Rent, rates and insurance | 130 | |
| Administration expenses | 55 | |
| Debenture interest | 20 | |
| Dividends paid – preference | 14 | |
| Dividends paid – ordinary | 50 | |
| Bank interest received | | 12 |
| Bank interest paid | 10 | |
| | <u>8,335</u> | <u>8,335</u> |

You are given the following information at 30 April 1998:

(i) Stocks are as follows:

| | |
|------------------|----------|
| Raw materials | £256,000 |
| Work in progress | £118,000 |
| Finished goods | £123,000 |

You ascertain that finished goods included in these valuations consist of three products:

| <i>Product</i> | <i>Cost included in above valuation (£)</i> | <i>Net realisable value (£)</i> |
|----------------|---|---------------------------------|
| Alpha | 71,000 | 75,000 |
| Beta | 31,000 | 23,000 |
| Delta | 21,000 | 23,000 |

(ii) Depreciation is to be provided:

| | |
|-------------------|--|
| Buildings | 5% on valuation (of which 40% is to be apportioned to the factory) |
| Factory plant | 10% on cost |
| Office equipment | 20% on the reducing balance |
| Delivery vehicles | 20% on cost |

(iii) Wages and salaries costs accrued are:

| | <i>Direct labour (£)</i> | <i>Indirect factory labour (£)</i> | <i>Office salaries (£)</i> |
|---------------------|--------------------------|------------------------------------|----------------------------|
| Gross wages | 34,000 | 14,000 | 25,000 |
| Tax and NI deducted | 6,700 | 2,800 | 3,900 |
| Employer's NI | 3,000 | 1,000 | 2,000 |

(iv) Corporation tax of £80,000 for the year is to be provided.

(v) Heat, light and power accrued amounts to £15,000. Forty per cent of heat, light and power is to be apportioned to the factory.

(vi) Rent, rates and insurance prepaid amounts to £10,000. Thirty per cent of rent, rates and insurance is to be apportioned to the factory.

(vii) The debentures were issued in 1994, and are due for repayment in 2020.

(viii) A final ordinary dividend of 3p per share is to be declared.

Requirements

(a) Insert the missing items in the manufacturing account for the year ended 30 April 1998.

APW Ltd: manufacturing account for year ended 30 April 1998

| | <i>£000</i> | <i>£000</i> |
|--|-------------|-------------|
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| Cost of raw material consumed | | |
| Prime cost | | |
| | | |
| | | |
| Cost of production transferred to finished goods stock | | |

(10 marks)

(b) Insert the missing items in the trading and profit and loss appropriation account for the year ended 30 April 1998.

APW Ltd: trading and profit and loss appropriation account for year ended 30 April 1998

| | £,000 | £,000 |
|-----------------------------|-------|-------|
| Returns inwards | | |
| | | |
| | | |
| | | |
| Gross profit | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| Profit before tax | | |
| Profit after tax | | |
| Profit and loss account b/f | | |
| | | |
| | | |
| Balance c/f | | |

(13 marks)

(c) Which are the two principal accounting concepts that affect the valuation of stock.

- (i) _____
- (ii) _____

(7 marks)

(Total marks = 30)

? **Question 14**

The computerised accounting system used by FLS Ltd developed a program error during the production of the trial balance at 30 September 1998. The accountant presented you with the following balances and supporting information:

- Authorised share capital comprised 10 million ordinary shares with a par value of 50p each, of which 6 million had been issued at a premium of 5 pence per share, and 1 million 5 per cent preference shares issued at par, at £1 each.

- The balance sheet at 30 September 1997 included the following balances:

| | |
|---|-------------|
| | <i>£000</i> |
| Profit and loss account balance | 600 |
| Revaluation reserve | 1,250 |
| Stocks | 1,250 |
| Land at valuation | 5,800 |
| Buildings at cost | 3,800 |
| Plant at cost | 2,800 |
| Provision for depreciation on buildings | 800 |
| Provision for depreciation on plant | 600 |
| Goodwill | 2,000 |
| Long-term loan | 8,000 |
| Administration costs prepaid | 100 |
| Dividends owing | 300 |
| Debtors | 1,850 |
| Provision for doubtful debts | 80 |
| Creditors | 1,050 |
| Bank overdraft | 520 |
| Corporation tax owing | 100 |

During the year to 30 September 1998, the following transactions had been recorded:

| | |
|--|-------------|
| | <i>£000</i> |
| Sales | 14,000 |
| Purchases | 7,400 |
| Returns outwards | 75 |
| Selling and distribution costs paid | 2,750 |
| Administration costs paid | 2,400 |
| Bad debts written off | 200 |
| Ordinary interim dividend paid | 200 |
| Final dividend from previous year paid | 300 |
| Half-year's loan interest paid | 400 |
| Corporation tax paid | 100 |
| Receipts from debtors | 13,300 |
| Payments to creditors | 7,525 |

At 30 September 1998, the following additional figures were extracted:

| | |
|-----------------|-------------|
| | <i>£000</i> |
| Trade debtors | 2,350 |
| Trade creditors | 850 |
| Stock | 1,450 |

Requirements

- (a) Insert the missing items in the bank account for the year ended 30 September 1998.

| FLS Ltd – bank account for the year ended 30 September 1998 | | | |
|---|-------------|---------------|-------------|
| | <i>£000</i> | | <i>£000</i> |
| Balance c/fwd | | Balance b/fwd | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

(3 marks)

(b) Insert the missing items in a trial balance at 30 September 1998.

FLS Ltd: trial balance at 30 September 1998

| | <i>Debit (£,000)</i> | <i>Credit (£,000)</i> |
|---|----------------------|-----------------------|
| Profit and loss account balance | | |
| Revaluation reserve | | |
| Stock at 30 September 1997 | | |
| Land at valuation | | |
| Buildings at cost | | |
| Plant at cost | | |
| Provision for depreciation of buildings at 30 September 1997 | | |
| Provision for depreciation of plant at 30 September 1997 | | |
| Goodwill | | |
| Long-term loan | | |
| Provision for doubtful debts at 30 September 1997 | | |
| Sales | | |
| Purchases | | |
| Returns outwards | | |
| Selling and distribution costs | | |
| Administration costs | | |
| Bad debts written off | | |
| Dividends | | |
| Loan interest (half year) | | |
| Debtors | | |
| Creditors | | |
| Bank account | | |
| Share capital – ordinary | | |
| Share premium account | | |
| Share capital – preference | | |
| | | |

(10 marks)

(c) Insert the missing items in a trading and profit and loss account for the year ended 30 September 1998, to include the following adjustments:

- the sales figure above includes £100,000 cash received with an order on 28 September 1998; the goods were not despatched until 14 October 1998;
- selling and distribution costs prepaid were £50,000 and administration costs accrued were £25,000;
- the provision for doubtful debts figure is to be amended to 2 per cent of trade debtors;
- provision for depreciation is to be made of 2 per cent on cost for buildings, and 5 per cent on the reducing balance for plant;
- provision of £140,000 is to be made for corporation tax on the year's profits;
- a final dividend of 10p per ordinary share is proposed.

FLS Ltd: trading and profit and loss account for year ended 30 September 1998

| | £000 | £000 | £000 |
|--|-------|-------|-------|
| [] | | | [] |
| [] | | [] | |
| [] | [] | | |
| [] | [] | | |
| | <hr/> | [] | |
| [] | | <hr/> | |
| [] | | [] | |
| [] | | [] | |
| [] | | [] | |
| [] | | [] | |
| [] | | <hr/> | [] |
| Gross profit | | | <hr/> |
| [] | | [] | |
| [] | | [] | |
| [] | | [] | |
| [] | | [] | |
| [] | | [] | |
| [] | | [] | |
| [] | | <hr/> | [] |
| | | | <hr/> |
| | | | [] |
| | | | [] |
| Add reduction in provision for bad debts | | | [] |
| Profit before tax | | | [] |
| [] | | | [] |
| Profit after tax | | | [] |
| [] | | [] | |
| [] | [] | | |
| [] | [] | | |
| | <hr/> | [] | |
| | | <hr/> | [] |
| | | | [] |
| | | | [] |
| Retained loss for the year | | | [] |
| Profit and loss a/c brought forward | | | [] |
| Profit and loss a/c carried forward | | | <hr/> |

(10 marks)

(d) Calculate the gearing ratio at 30 September 1998.

Analysis of total capital employed

| | £ |
|---------------------|-------|
| [] | [] |
| [] | [] |
| [] | [] |
| [] | [] |
| [] | [] |
| [] | [] |
| Shareholders' funds | [] |
| [] | [] |
| [] | [] |
| | <hr/> |
| | [] |
| | <hr/> |
| | [] |

(7 marks)
(Total marks = 30)

Gearing ratio = $\frac{\text{[]}}{\text{[]}}$ × 100 = [] %



Question 15

You are responsible for maintaining the journals and ledger accounts for your organisation. Sales are currently all for cash, but the managers plan to offer credit to customers in the future, in order to increase business activity.

At 1 October 1998, there are the following balances on creditors accounts:

| | |
|---------|--------|
| P Blunt | £1,250 |
| J Hall | £150 |

During the month of October 1998, you compile the following journals:

Purchases daybook

| Date | Name | Net (£) | VAT (£) | Gross (£) |
|---------|--------------|---------------|--------------|---------------|
| 1998 | | | | |
| 4 Oct. | P Blunt | 6,000 | 1,050 | 7,050 |
| 11 Oct. | J Bolton | 30,000 | 5,250 | 35,250 |
| 13 Oct. | Z Rhawandala | 5,000 | 875 | 5,875 |
| 15 Oct. | P Blunt | <u>12,000</u> | <u>2,100</u> | <u>14,100</u> |
| 31 Oct. | Totals | <u>53,000</u> | <u>9,275</u> | <u>62,275</u> |

Returns outwards daybook

| Date | Name | Net (£) | VAT (£) | Gross (£) |
|---------|----------|--------------|------------|--------------|
| 1998 | | | | |
| 3 Oct. | J Bolton | 2,000 | 350 | 2,350 |
| 28 Oct. | P Blunt | <u>600</u> | <u>105</u> | <u>705</u> |
| 31 Oct. | Totals | <u>2,600</u> | <u>455</u> | <u>3,055</u> |

Petty cash book

| Date | Debit (£) | Details | Total (£) | Postage (£) | Travel (£) | Ledger (£) |
|---------|--------------|-----------------------|--------------|-------------|------------|------------|
| 1 Oct. | 600 | Balance b/f | | | | |
| 6 Oct. | | Parcel post | 65 | 65 | | |
| 10 Oct. | | Bus fares | 20 | | 20 | |
| 12 Oct. | | G Hall (train ticket) | 125 | | 125 | |
| 14 Oct. | | Post Office Counters | 24 | 24 | | |
| 16 Oct. | | Travel reimbursed | 85 | | 85 | |
| 18 Oct. | | Post Office Counters | 27 | 27 | | |
| 21 Oct. | | J Hall | <u>150</u> | | | <u>150</u> |
| | | | 496 | <u>116</u> | <u>230</u> | <u>150</u> |
| 31 Oct | 496 | Bank | | | | |
| | | Balance c/f | <u>600</u> | | | |
| | <u>1,096</u> | | <u>1,096</u> | | | |

You have extracted the following details from the cash book for October:

- Cash sales in the month were £61,100, including VAT at 17.5 per cent.
- Paid to P Blunt on 4 October, his opening balance less cash discount of 2 per cent.

Requirements

(a) Insert the missing items into the following ledger accounts.

Note: in the 'Transactions' columns only *one* of the debit or credit columns is to be completed for each transaction. All other boxes must be completed.

| Date | Description | Transactions | | Balance (£) | Debit or credit? |
|------------------|-------------|--------------|------------|-------------|------------------|
| | | Debit (£) | Credit (£) | | |
| P Blunt | | | | | |
| 1. Oct | Balance b/f | | | 1,250 | Cr |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| J Hall | | | | | |
| 1. Oct | Balance b/f | | | 150 | Cr |
| | | | | | |
| J Bolton | | | | | |
| | | | | | |
| | | | | | |
| Z Rhawandala | | | | | |
| | | | | | |
| VAT | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| Sales | | | | | |
| | | | | | |
| Purchases | | | | | |
| | | | | | |
| Returns outwards | | | | | |
| | | | | | |
| Postage | | | | | |
| | | | | | |

| | | | | | |
|--------------------|--|--|--|--|--|
| Discounts received | | | | | |
| | | | | | |
| Travel | | | | | |
| | | | | | |

(11 marks)

(b) You later realise that the purchase from Z Rhawandala is for office equipment. Insert the missing words in these sentences

- (i) Office equipment should have been debited to a _____.
- (ii) The profit will have been _____ by £5,000 less any depreciation charge.

(3 marks)**(Total marks = 14)**

Question 16

AMS Ltd made a gross profit of £239,000 in the year to 31 August 1998. Expenses amounted to £159,000, which included interest of £30,000 payable on a long-term loan, depreciation on plant of £50,000, and depreciation on premises of £25,000. Corporation tax in the profit and loss account was £10,000 and dividends declared were £45,000.

The balance sheets of AMS Ltd at 31 August 1998 and 1997 were as follows:

| | 1998 | | 1997 | |
|---|------------|--------------|-----------|--------------|
| | £000 | £000 | £000 | £000 |
| Fixed assets | | | | |
| Premises | | 1,200 | | 1,170 |
| Plant and machinery | | <u>800</u> | | <u>700</u> |
| | | 2,000 | | 1,870 |
| Current assets | | | | |
| Stock | 450 | | 550 | |
| Debtors | 700 | | 680 | |
| Bank and cash | <u>300</u> | | <u>—</u> | |
| | 1,450 | | 1,230 | |
| Current liabilities | | | | |
| Creditors | 603 | | 670 | |
| Taxation | 10 | | 12 | |
| Dividends | 45 | | 11 | |
| Bank overdraft | <u>—</u> | | <u>40</u> | |
| | 658 | | 733 | |
| Net current assets | | <u>792</u> | | <u>497</u> |
| Total net assets less current liabilities | | 2,792 | | 2,367 |
| Long-term liabilities | | | | |
| Loan | | <u>200</u> | | <u>400</u> |
| Total net assets | | <u>2,592</u> | | <u>1,967</u> |
| Financed by | | | | |
| Ordinary shares of £1 each | | 1,800 | | 1,300 |
| Share premium | | 400 | | 300 |
| Profit and loss account | | <u>392</u> | | <u>367</u> |
| | | <u>2,592</u> | | <u>1,967</u> |

During the year ended 31 August 1998, plant that had cost £85,000 was sold at a loss of £10,000. The sale proceeds were £50,000. The loss was deducted in the profit and loss account.

Requirements

- (a) Insert the missing items into the cash-flow statement, and supporting workings, given below.

The order of items on the cash-flow statement is not necessarily in accordance with the relevant financial reporting standard.

Workings

Calculation of operating profit

| | |
|----------------------|----------------------|
| | <i>£000</i> |
| Gross profit | 239 |
| <input type="text"/> | <input type="text"/> |
| Net profit | <input type="text"/> |
| <input type="text"/> | <input type="text"/> |
| Operating profit | <input type="text"/> |

Net cash flow from operating activities

| | |
|----------------------|----------------------|
| | <i>£000</i> |
| Operating profit | <input type="text"/> |
| <input type="text"/> | <input type="text"/> |
| <input type="text"/> | <input type="text"/> |
| <input type="text"/> | <input type="text"/> |
| <input type="text"/> | <input type="text"/> |
| <input type="text"/> | <input type="text"/> |

Purchase cost of fixed assets

| | | |
|--------------------------------|-------------------------|----------------------|
| | <i>Premises (£,000)</i> | <i>Plant (£,000)</i> |
| Book value at 31 December 1998 | <input type="text"/> | <input type="text"/> |
| Book value at 31 December 1997 | <input type="text"/> | <input type="text"/> |
| <input type="text"/> | <input type="text"/> | <input type="text"/> |
| <input type="text"/> | <input type="text"/> | <input type="text"/> |
| <input type="text"/> | <input type="text"/> | <input type="text"/> |
| Purchases | <input type="text"/> | <input type="text"/> |

AMS Ltd: cash-flow statement for the year ended 31 August 1998

| | <i>£,000</i> | <i>£,000</i> |
|---|--------------|--------------|
| Net cash inflow from operating activities | | |
| Returns on investments and servicing of finance | | |
| Corporation tax paid | | |
| Capital expenditure | | |
| | | |
| | | |
| Equity dividends paid | | |
| Financing | | |
| | | |
| | | |
| Increase in cash | | |

(14 marks)

(b) In connection with a cash flow statement complete the missing words in the following sentences.

- (i) The cash flow statement shows _____ and _____ of cash during the period. It reconciles opening and closing _____ balances.
- (ii) The profit and loss account includes _____ items and excludes cash involved in _____ transactions.

(3 marks)

(Total marks = 17)



Question 17

BAK plc has the following trial balance at 30 April 1999:

| | <i>Debit (£000)</i> | <i>Credit (£000)</i> |
|---|---------------------|----------------------|
| Ordinary shares, 50p | | 3,200 |
| 5% preference shares, £1 | | 800 |
| Share premium | | 640 |
| General reserves | | 700 |
| Profit and loss account 1 May 1998 | | 420 |
| Motor vehicles – cost | 6,000 | |
| Motor vehicles – depreciation at 1 May 1998 | | 1,000 |
| Office equipment – cost | 1,200 | |
| Office equipment – depreciation at 1 May 1998 | | 360 |
| Goodwill | 1,000 | |
| Research and development expenditure | 846 | |
| Stock at 1 May 1998 | 1,420 | |
| Debtors | 3,100 | |
| Creditors | | 1,770 |
| Provision for doubtful debts at 1 May 1998 | | 102 |
| Bank balance | 2,476 | |
| Dividends | 120 | |
| Purchases | 7,390 | |
| Sales | | 19,620 |
| Returns inwards | 320 | |
| Carriage inwards | 240 | |
| Distribution costs | 2,860 | |
| Administration costs | 970 | |
| Salaries and wages | 1,310 | |
| Printing, stationery and advertising | 900 | |
| Premises costs | 310 | |
| Loan | | 2,000 |
| Loan interest | 100 | |
| Loss on disposal of fixed assets | 50 | |
| | <u>30,612</u> | <u>30,612</u> |

You are given the following information at 30 April 1999:

- (i) Closing stock was £1,280,000.
- (ii) Provision for doubtful debts is to be amended to 2 per cent of debtors.
- (iii) Sales representatives are to receive a bonus of 2 per cent of net sales.
- (iv) Auditors' fees accrued amount to £115,000.
- (v) Printing, stationery and advertising costs include the purchase of a stock of advertising literature that cost £200,000. Twenty-five per cent of this is unusable, but the remainder is to be distributed during May 1999.
- (vi) Premises costs includes insurance prepaid of £80,000.
- (vii) Research and development expenditure includes £396,000, which the directors feel should be carried forward in the balance sheet; the remainder is to be written off against profits during the year.
- (viii) The loan carries interest at 10 per cent per annum. The capital sum is due for repayment in two equal instalments, on 31 December 1999 and on 31 December 2000.
- (ix) Depreciation is to be charged as follows:
 - on motor vehicles, at 20 per cent on cost;
 - on office equipment, at 10 per cent on cost.

- (x) Goodwill is to be amortised over four years.
- (xi) Provision is to be made for corporation tax of £900,000.
- (xii) A final ordinary dividend of 3.5p per share is to be declared.
- (xiii) £1,000,000 is to be transferred to general reserves.

Requirements

(a) Insert the missing items into the following trading and profit and loss account.

BAK plc: trading and profit and loss account for the year ended 30 April 1999

| | £000 | £000 | £000 |
|---|-----------------|-------|-------|
| Sales | | | |
| Returns inwards/outwards* | | | |
| Cost of sales | | | |
| Opening stock | | | |
| Purchases | | | |
| Carriage inwards/outwards* | | | |
| | | | |
| | | | |
| Closing stock | | | |
| Gross profit | | | |
| Less expenses | <i>Workings</i> | | |
| R&D | | | |
| Distribution costs | | 2,860 | |
| Administration costs | | 970 | |
| Salaries and wages | | 1,310 | |
| Printing, staty & adverts | | | |
| Premises costs | | | |
| Loan interest | | | |
| Loss on disposal of fixed assets | | 50 | |
| Reduction in provision for doubtful debts | | | |
| Bonuses owing | | | |
| Depreciation of vehicles | | | |
| Depreciation of office equipment | | | |
| Amortisation of goodwill | | | |
| Auditor's fees | | | |
| Profit for the year before taxation | | | |
| Provision for corporation tax | | | (900) |
| Profit for the year after taxation | | | |
| Dividends | | | |
| Ordinary – paid | | | |
| Ordinary – proposed | | | |
| Preference – proposed | | | |
| Transfer to general reserves | | | |
| Retained profit for the year | | | |
| Profit and loss account balance b/f | | | 420 |
| Profit and loss account balance c/f | | | |

*Delete as appropriate.

(12 marks)

(b) Insert the missing items into the following balance sheet.

| BAK plc: balance sheet at 30 April 1999 | | | |
|---|---------------------|----------------------|--------------------|
| | <i>Cost (£,000)</i> | <i>Dep'n (£,000)</i> | <i>NBV (£,000)</i> |
| Fixed assets | | | |
| Tangibles | | | |
| Office equipment | 1,200 | | |
| Vehicles | 6,000 | | |
| | <u>7,200</u> | | |
| Intangibles | | | |
| Goodwill | | 750 | |
| Development expenditure | | <u>396</u> | |
| | | | <u>1,146</u> |
| Current assets | | | |
| Stock of goods | 1,280 | | |
| Stock of advertising materials | 150 | | |
| Debtors: [] | [] | | |
| Prepayments | [] | | |
| Bank | <u>2,476</u> | | |
| | | | |
| Creditors: amounts due within one year | | | |
| Creditors | 1,770 | | |
| Loan | [] | | |
| Accruals: [] | [] | | |
| Corporation tax owing | [] | | |
| Dividends owing: [] | [] | | |
| | | | |
| Net current assets | | | |
| Creditors: amounts due after more than one year | | | |
| Loan | | | |
| Capital and reserves | | | |
| [] | | | |
| [] | | | |
| [] | | | |
| [] | | | |
| Profit and loss account balance | | | |

(10 marks)
(Total marks = 22)

Question 18

The computerised sales and purchase ledger shows the following totals at 30 April 1999:

| | |
|-------------------------------------|---------|
| | £ |
| Debtors outstanding | 204,580 |
| Credit balances on debtors accounts | 12,460 |
| Creditors outstanding | 134,290 |

At 1 April 1999, the sales ledger control account showed a balance of £184,650, and the purchase ledger control account showed a balance of £142,320.

At the end of April the following totals are extracted from the subsidiary books for April:

| | |
|--|---------|
| | £ |
| Sales daybook (including cash sales of £3,450) | 333,895 |
| Purchases daybook | 183,800 |
| Returns outwards daybook | 27,490 |
| Returns inwards daybook | 13,240 |
| Refunds paid to debtors | 8,255 |
| Receipts from debtors, after deducting £2,115 cash discount | 320,045 |
| Dishonoured cheques from debtors | 8,395 |
| Bad debts written off | 3,450 |
| Payments to creditors, after deducting £1,430 cash discount | 196,360 |

It is also discovered that:

- (i) the purchase daybook figure is net of VAT at 17.5 per cent; the other figures all include VAT.
- (ii) a debtor's balance of £2,420 has been offset against his balance of £3,650 in the purchase ledger.
- (iii) provision is to be made for doubtful debts of 2.5 per cent of the net closing balance at 30 April 1999.
- (iv) a debtor has queried an invoice sent to him during the month for £1,400 plus VAT at 17.5 per cent. It is found to be a duplicate of a previous invoice. It has been posted to his account in the sales ledger, but has not been included in the sales daybook.
- (v) a supplier's account in the purchase ledger, with a debit balance of £800, has been included on the list of creditors as a credit balance.

Requirements

- (a) Insert the missing items into the following sales and purchase ledger control accounts for April 1999.

| Sales ledger control account | | | |
|------------------------------|---------|-------------|---|
| | £ | | £ |
| Balance b/f | 184,650 | | |
| | █ | | █ |
| | █ | | █ |
| | █ | | █ |
| | █ | | █ |
| | █ | | █ |
| | █ | | █ |
| | █ | | █ |
| | █ | Balance c/f | █ |
| | █ | | █ |
| | █ | | █ |
| Balance b/f | █ | | █ |

| Purchase ledger control account | | | |
|---------------------------------|---|-------------|---------|
| | £ | | £ |
| | | Balance b/f | 142,320 |
| | | | |
| | | | |
| | | | |
| Balance c/f | | | |
| | | Balance b/f | |

(11 marks)

(b) Insert the missing items below, to identify the ledger that is out of balance with its control account.

| <i>Debtors</i> | £ | <i>Creditors</i> | £ |
|------------------------------|---------|------------------------------|---------|
| Control account total | | Control account total | |
| Ledger account total | 192,120 | Ledger account total | 134,290 |
| Adjustment: | | Adjustment: | |
| Revised ledger account total | | Revised ledger account total | |

The ledger that is out of balance with its control account is the _____ ledger.

(3 marks)

(c) In connection with controls within the accounting system that can reduce the risk of error and fraud, complete the missing words in these sentences.

- (i) Independent preparation of a _____ reconciliation statement on a regular basis;
- (ii) Regular preparation of a _____ to confirm arithmetical accuracy of the ledger accounts;
- (iii) _____ of duties so that no one person is involved in a complete process;

(6 marks)

(Total marks = 20)



Question 19

AJ Ltd has produced the following accounts:

Trading and profit and loss accounts for the year ended 31 December

| | 1997 | | 1998 | |
|---|---------------|---------------|---------------|---------------|
| | £000 | £000 | £000 | £000 |
| Sales | | 25,000 | | 28,000 |
| Cost of sales | | | | |
| Opening stock | 2,200 | | 2,300 | |
| Purchases | 18,400 | | 16,200 | |
| | <u>20,600</u> | | <u>18,500</u> | |
| Less: Closing stock | 2,300 | | 2,800 | |
| | | <u>18,300</u> | | <u>15,700</u> |
| Gross profit | | 6,700 | | 12,300 |
| Less: Expenses | | 4,200 | | 6,200 |
| Net profit | | 2,500 | | 6,100 |
| Less: Corporation tax | | 500 | | 1,000 |
| Net profit after tax | | 2,000 | | 5,100 |
| Profit and loss account balance brought forward | | 5,000 | | 7,000 |
| Profit and loss account balance carried forward | | <u>7,000</u> | | <u>12,100</u> |

Balance sheets at 31 December

| | 1997 | | 1995 | |
|---------------------------------|--------------|---------------|--------------|---------------|
| | £000 | £000 | £000 | £000 |
| Fixed assets | | 18,000 | | 23,000 |
| Current assets | | | | |
| Stocks | 2,300 | | 4,800 | |
| Debtors | 2,500 | | 3,200 | |
| Bank and cash | 1,300 | | – | |
| | <u>6,100</u> | | <u>8,000</u> | |
| Current liabilities | | | | |
| Creditors | 3,900 | | 3,600 | |
| Bank overdraft | – | | 1,100 | |
| | <u>3,900</u> | | <u>4,700</u> | |
| Net current assets | | <u>2,200</u> | | <u>3,300</u> |
| | | <u>20,200</u> | | <u>26,300</u> |
| Financed by | | | | |
| Ordinary shares of £1 each | | 13,200 | | 14,200 |
| Profit and loss account balance | | 7,000 | | 12,100 |
| | | <u>20,200</u> | | <u>26,300</u> |

Requirements

(i) State the formulae for and calculate *three* profitability ratios for each of the two years.

- Formula 1:

$$\frac{\text{Net Profit}}{\text{Sales}} \times 100$$

1997

$$\frac{\text{Net Profit}}{\text{Sales}} \times 100 = \text{ } \%$$

1998

$$\frac{\text{Net Profit}}{\text{Sales}} \times 100 = \text{ } \%$$

- Formula 2:

$$\frac{\text{[Blank]}}{\text{[Blank]}} \times 100$$

1997

$$\frac{\text{[Blank]}}{\text{[Blank]}} \times 100 = \text{[Blank]} \%$$

1998

$$\frac{\text{[Blank]}}{\text{[Blank]}} \times 100 = \text{[Blank]} \%$$

- Formula 3:

$$\frac{\text{[Blank]}}{\text{[Blank]}} \times 100$$

1997

$$\frac{\text{[Blank]}}{\text{[Blank]}} \times 100 = \text{[Blank]} \%$$

1998

$$\frac{\text{[Blank]}}{\text{[Blank]}} \times 100 = \text{[Blank]} \%$$

- (ii) State the formulae for and calculate *two* liquidity and *two* efficiency ratios for each of the two years.

Liquidity ratios

- Formula 1:

$$\text{[Blank]} : \text{[Blank]}$$

1997

$$\text{[Blank]} : \text{[Blank]} = \text{[Blank]}$$

1998

$$\text{[Blank]} : \text{[Blank]} = \text{[Blank]}$$

- Formula 2:

$$\text{[Blank]} : \text{[Blank]}$$

1997

$$\text{[Blank]} : \text{[Blank]} = \text{[Blank]}$$

1998

$$\text{[Blank]} : \text{[Blank]} = \text{[Blank]}$$

- (iii) Efficiency ratios

- Formula 1:

$$\frac{\text{[Blank]}}{\text{[Blank]}} \times \text{[Blank]}$$

1997

$$\frac{\text{[Blank]}}{\text{[Blank]}} \times \text{[Blank]} = \text{[Blank]}$$

1998

$$\frac{\text{[Blank]}}{\text{[Blank]}} \times \text{[Blank]} = \text{[Blank]}$$

- Formula 2:

$$\frac{\text{[Blank]}}{\text{[Blank]}} \times \text{[Blank]}$$

1997

$$\frac{\text{[Blank]}}{\text{[Blank]}} \times \text{[Blank]} = \text{[Blank]}$$

1998

$$\frac{\text{[Blank]}}{\text{[Blank]}} \times \text{[Blank]} = \text{[Blank]}$$

(21 marks)

? Question 20

On 31 December 1995 the accounting records of JB were partly destroyed by fire. Her accountant has provided the following list of assets, liabilities and capital at 31 December 1994:

| | |
|-------------------------------|---------|
| | £ |
| Plant and machinery | 128,000 |
| Office equipment | 45,000 |
| Stocks | 30,500 |
| Debtors and prepayments | 35,000 |
| Creditors and accruals | 17,600 |
| Bank overdraft | 8,850 |
| Loan (interest 10% per annum) | 95,000 |
| Capital | 117,050 |

A summary of her receipts and payments during 1995 can be extracted from the bank statements, as follows:

| | |
|-----------------------|---------|
| | £ |
| Receipts | |
| Capital paid in | 22,000 |
| Received from debtors | 427,500 |
| Payments | |
| Cash withdrawn | 22,450 |
| Loan repayments | 20,000 |
| Paid to creditors | 175,600 |
| Rent paid | 22,000 |
| Wages | 90,000 |
| General expenses paid | 12,500 |

The following additional information is obtained:

- (i) At 31 December 1994, the debtors figure included £2,500 for rent paid in advance, and the creditors figure included £4,300 for wages accrued for the last week of 1994.
- (ii) The plant and machinery had been purchased for £200,000 in 1993 and was being depreciated at 20 per cent per annum on the reducing-balance basis.
The office equipment was bought during 1994 and was being depreciated over ten years on the straight-line basis, with a full year's depreciation in the year of purchase.
- (iii) During 1995, JB transferred a private motor vehicle worth £5,000 to her business. It is to be depreciated over four years on the straight-line basis, with a full year's depreciation in the year of acquisition.
- (iv) Of the cash withdrawn from the bank during 1995, £6,750 was for wages, £4,200 was for cash payments to suppliers, £2,600 was for printing of advertising leaflets (of which half are still to be distributed), and the remainder was taken by JB for her own use.
- (v) The bank balance 31 December 1995, according to the bank statement, after adjusting for unpresented cheques, was £106,700. Any difference is assumed to be cash sales banked, after deducting £30 per week wages paid to JB's daughter, who assists in the office.
- (vi) The loan repayments from the bank account include £9,500.
- (vii) Other balances at 31 December 1995 are:

| | |
|------------------------|--------|
| | £ |
| Stock | 27,850 |
| Rent paid in advance | 2,700 |
| Wages owing | 5,250 |
| Creditors for supplies | 12,200 |
| Debtors | 22,300 |

- (viii) It is subsequently discovered that a debtor owing £16,000 has gone into liquidation, and a dividend of 20p in the £ is expected.

Requirements

- (a) Insert the missing items into the trading and profit and loss account for JB for the year ended 31 December 1995, given below.

You will need to calculate several figures for inclusion in the trading and profit and loss account before you commence. In an examination, this question would probably be examined in smaller sections.

JB: trading and profit and loss account for the year ended 31 December 1995

| | £ | £ | £ |
|-----------------------|-----|----------|-----|
| Credit sales | | | [] |
| Cash sales | | | [] |
| | | | [] |
| Less: cost of sales | | | |
| Opening stock | | 30,500 | |
| Credit purchases | [] | | |
| Cash purchases | [] | | |
| | | [] | |
| | | [] | |
| Closing stock | | (27,850) | [] |
| | | | [] |
| Gross profit | | | [] |
| Less expenses | | | |
| Wages | | [] | |
| Advertising expenses | | [] | |
| Loan interest | | 9,500 | |
| Rent | | [] | |
| General expenses | | 12,500 | |
| Bad debts written off | | [] | |
| Depreciation | | | |
| Plant and machinery | | [] | |
| Vehicle | | [] | |
| Office equipment | | [] | |
| | | | [] |
| Net profit | | | [] |

(15 marks)

(b) Insert the missing figures into the balance sheet for JB for 31 December 1995, given below.

JB: balance sheet at 31 December 1995

| | | | <i>NBV (£)</i> |
|---------------------------|----------------------|--|--|
| Fixed assets | | | |
| Plant and machinery | | | <input type="text"/> |
| Office equipment | | | <input type="text"/> |
| Vehicle | | | <input type="text"/> |
| | | | <hr style="border-top: 1px solid black;"/> |
| Current assets | | | |
| Stocks | | 27,850 | |
| Debtors | | <input type="text"/> | |
| Prepayments | | <input type="text"/> | |
| Bank | | <input type="text"/> | |
| | | <hr style="border-top: 1px solid black;"/> | |
| Less current liabilities | | | |
| Creditors | <input type="text"/> | | |
| Accruals | <input type="text"/> | | |
| | | <hr style="border-top: 1px solid black;"/> | |
| | | | <input type="text"/> |
| | | | <hr style="border-top: 1px solid black;"/> |
| Long-term liabilities | | | |
| Long-term loan | | | <input type="text"/> |
| | | | <hr style="border-top: 1px solid black;"/> |
| Financed by | | | |
| Capital at 1 January 1995 | | | <input type="text"/> |
| Add capital introduced | | | <input type="text"/> |
| Add profit | | | <input type="text"/> |
| Less drawings | | | <input type="text"/> |
| | | | <hr style="border-top: 1px solid black;"/> |
| | | | <hr style="border-top: 1px solid black;"/> |

(10 marks)
(Total marks = 25)

? Question 21

You are presented with the following information relating to SH Ltd:

Profit and loss account for the year ended 30 June 1996

| | |
|------------------------------|-------------|
| | <i>£000</i> |
| Gross profit | 980 |
| Trading expenses | 475 |
| Depreciation | <u>255</u> |
| Net profit | 250 |
| Dividends | <u>80</u> |
| Retained profit for the year | <u>170</u> |

Balance sheets at 30 June

| | <i>1995 (£,000)</i> | <i>1996 (£,000)</i> |
|--------------------------------|---------------------|---------------------|
| Fixed assets at cost | 3,000 | 3,500 |
| Less: Accumulated depreciation | <u>2,100</u> | <u>2,300</u> |
| Net book value | <u>900</u> | <u>1,200</u> |
| Current assets | | |
| Stocks | 825 | 1,175 |
| Debtors | 5,200 | 5,065 |
| Bank and cash | <u>2,350</u> | <u>2,160</u> |
| | <u>8,375</u> | <u>8,400</u> |
| Less: Current liabilities | | |
| Creditors | 5,000 | 4,350 |
| Dividends | <u>75</u> | <u>80</u> |
| | <u>5,075</u> | <u>4,430</u> |
| Net current assets | <u>3,300</u> | <u>3,970</u> |
| Total net assets | <u>4,200</u> | <u>5,170</u> |
| Financed by | | |
| Ordinary shares of £1 each | 2,800 | 3,200 |
| Share premium | — | 400 |
| Profit and loss account | <u>1,400</u> | <u>1,570</u> |
| | <u>4,200</u> | <u>5,170</u> |

During the year ended 30 June 1996, fixed assets that had cost £230,000 were sold for £145,000. The loss on this disposal had been included in the trading expenses in the profit and loss account.

Requirements

(a) Insert the missing items below in order to calculate the loss on disposal of fixed assets.

| | <i>£,000</i> |
|--|-----------------------------|
| Accumulated depreciation at 30 June 1995/1996* | <input type="text"/> |
| Add/less* charge for the year | <u>255</u> |
| | <input type="text"/> |
| Accumulated depreciation at 30 June 1995/1996* | <input type="text"/> |
| Accumulated depreciation relating to disposal | <u><input type="text"/></u> |
| Proceeds | 145 |
| Net book value | <input type="text"/> |
| Loss on disposal | <u><input type="text"/></u> |

*Delete as appropriate.

(3 marks)

(b) Insert the missing items below to calculate the net cash outflow from operating activities during the year ended 30 June 1996.

| | <i>£,000</i> |
|---------------------------------|-----------------------------|
| Operating profit | <input type="text"/> |
| Add/less* depreciation for year | 255 |
| Add/less* increase in stocks | <input type="text"/> |
| Add/less* decrease in debtors | <input type="text"/> |
| Add/less* decrease in creditors | <input type="text"/> |
| | <u><input type="text"/></u> |

*Delete as appropriate.

(4 marks)

(c) Insert the missing items below to produce the cash-flow statement for the year ended 30 June 1996.

Note: show figures to be deducted in brackets.

| | | <i>£,000</i> |
|--|-----|--------------|
| Net cash outflow from operating activities | [] | [] |
| Dividends paid | [] | [] |
| Purchase of fixed assets | [] | [] |
| Sales of fixed assets | [] | [] |
| Proceeds from share issue | [] | [] |
| Decrease in cash | [] | [] |

(5 marks)

(d) Calculate the current ratio and the liquid (or quick) ratio for *each* of the 2 years

Current ratio

Formula

[] : []

1995

[] : [] = []

1996

[] : [] = []

Liquid (or quick) ratio

Formula

[] : []

1995

[] : [] = []

1996

[] : [] = []

(4 marks)

(Total marks = 16)

? Question 22

From the following information, prepare a statement reconciling the present bank balance as shown in the cash book with that shown on the bank statement at 16 November 1996:

| Cashbook | | | | | |
|-------------|---------------|----------|-------------|-----------------|----------|
| <i>Date</i> | | <i>£</i> | <i>Date</i> | | <i>£</i> |
| 10 Nov. | Balance b/fwd | 5,327 | 11 Nov. | Purchase ledger | 1,406 |
| 12 Nov. | Sales ledger | 2,804 | 12 Nov. | PAYE | 603 |
| 13 Nov. | Cash sales | 543 | 14 Nov. | VAT | 435 |
| 15 Nov. | Sales ledger | 1,480 | 16 Nov. | Cheques cashed | 1,342 |
| | | | | Balance c/fwd | 6,368 |
| | | 10,154 | | | 10,154 |

| | | Bank statement | | |
|-------------|--------------------|-----------------------|-------------------|--------------------|
| <i>Date</i> | | <i>Debit (£)</i> | <i>Credit (£)</i> | <i>Balance (£)</i> |
| 10 Nov. | Balance | | | 6,049 |
| 11 Nov. | Cheque 101204 | 420 | | 5,629 |
| 12 Nov. | Cheque 101206 | 1,406 | | 4,223 |
| 13 Nov. | Cheque 101205 | 302 | | |
| | Rates DD | 844 | | 3,077 |
| 14 Nov. | Paid in – cheques | | 2,804 | |
| | Paid in – cash | | 543 | 6,424 |
| 15 Nov. | Credit transfer | | 685 | |
| | Bank charges | 130 | | |
| | Dishonoured cheque | 425 | | |
| | Cheque 101207 | 603 | | 5,951 |
| 16 Nov. | Cheque 101209 | 1,342 | | 4,609 |

Insert the missing items in the schedules below.

Updating the cash book for items found on the bank statement not entered in books of MTR:

| | | | | |
|----------|----------------------|----------------------|----------------------|----------------------|
| | | £ | | £ |
| 16/11/96 | <input type="text"/> | <input type="text"/> | <input type="text"/> | <input type="text"/> |
| | <input type="text"/> | <input type="text"/> | <input type="text"/> | <input type="text"/> |
| | | | <input type="text"/> | <input type="text"/> |
| | | | <input type="text"/> | <input type="text"/> |
| | | | <input type="text"/> | <input type="text"/> |
| | | | <input type="text"/> | <input type="text"/> |
| | | | <input type="text"/> | <input type="text"/> |
| | | | <input type="text"/> | <input type="text"/> |
| | | | <input type="text"/> | <u>7,053</u> |

Bank reconciliation at 16 November 1996

| | |
|----------------------------------|-----------------------------|
| | £ |
| Balance as per updated cash book | <input type="text"/> |
| <input type="text"/> | <input type="text"/> |
| <input type="text"/> | <input type="text"/> |
| <input type="text"/> | <u><input type="text"/></u> |

(8 marks)



Question 23

TYR Ltd produced the following trial balance at 31 October 1997:

| | <i>Debit (£,000)</i> | <i>Credit (£,000)</i> |
|-----------------------------------|----------------------|-----------------------|
| Share capital | | 1,000 |
| Reserves | | 425 |
| 12% debentures, repayable 2010 | | 250 |
| Land at valuation | 495 | |
| Premises at cost | 350 | |
| Depreciation to 1 November 1996 | | 20 |
| Plant and machinery at cost | 220 | |
| Depreciation to 1 November 1996 | | 30 |
| Patents and trademarks | 200 | |
| Stock at 1 November 1996 | 210 | |
| Debtors | 875 | |
| Cash in hand | 12 | |
| Creditors | | 318 |
| Bank | | 85 |
| Administration expenses | 264 | |
| Selling and distribution expenses | 292 | |
| Dividends | 20 | |
| Debenture interest | 15 | |
| Sales | | 2,569 |
| Purchases | 1,745 | |
| Carriage inwards | 15 | |
| Carriage outwards | 18 | |
| Returns outward | | 34 |
| | <u>4,731</u> | <u>4,731</u> |

The following additional information at 31 October is available:

- (i) A physical stock check reveals stocks at cost of £194,000.
- (ii) Prepaid administration expenses amount to £12,000 and prepaid selling and delivery expenses amount to £28,000. Accrued administration expenses amount to £17,000.
- (iii) During October 1997 goods were sold on a 'sale or return' basis, with the final date for return being 25 November. The sale has been recorded as normal in the sales daybook and debtors' account, and the stock has been excluded from the stock count. The goods cost £7,000 and had a selling price of £12,000.
- (iv) The land is to be revalued at £550,000.
- (v) The share capital account comprises 200,000 5 per cent preference shares of £1 each with the balance made up of 50p ordinary shares.
- (vi) The reserves account consists of share premium of £100,000 and revaluation reserve of £135,000, with the balance representing undistributed profits.
- (vii) The premises are to be depreciated at 4 per cent per annum straight line. The plant and machinery is to be depreciated at 10 per cent per annum straight line.
- (viii) Corporation tax of £40,000 is to be provided for the year.
- (ix) The dividends account represents a half-year's preference dividend and an interim ordinary dividend. A final dividend of 5p per ordinary share is proposed.

(b) Insert the missing items in the balance sheet at 31 October 1997.

TYR Ltd: balance sheet at 31 October 1997

| | <i>Cost or valuation (£000)</i> | <i>Dep'n (£000)</i> | <i>NBV (£000)</i> |
|--|---|-------------------------|-----------------------|
| Tangible fixed assets | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| Intangible fixed assets | | | |
| | | | |
| | | | |
| Current assets | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| Creditors – amount falling due for payment within 12 months | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| Net current assets | | | |
| Creditors – amount falling due for payment after 12 months | | | |
| | | | |
| | | | |
| Capital and reserves | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

(10 marks)

(c) Calculate the following ratios for the current year.

(i) Gross profit mark-up

Formula

$$\frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 = \text{[]}$$

(ii) Net profit percentage

Formula

$$\frac{\text{Net Profit}}{\text{Net Sales}} \times 100 = \frac{\text{Net Profit}}{\text{Net Sales}} \times 100 = \text{[]}$$

(iii) Current ratio:

Formula

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \text{[]} : \text{[]}$$

(iv) Acid test ratio

Formula

$$\frac{\text{Current Assets (excluding stock)}}{\text{Current Liabilities}} = \frac{\text{Current Assets (excluding stock)}}{\text{Current Liabilities}} = \text{[]} : \text{[]}$$

(10 marks)

(Total marks = 30)



Question 24

At the beginning of September 1997, GL had the following balances on the accounts of three of his debtors:

| | |
|----------|--------|
| A Barton | £400 |
| C Dodd | £1,200 |
| F Gray | £340 |

During September, the following sales and returns took place for the above debtors:

Sales

| | |
|----------------------------|--|
| On 3 September to A Barton | goods £200 less trade discount of 20%, plus VAT at 17.5% |
| On 8 September to C Dodd | goods £800, plus VAT at 17.5% |
| On 12 September to C Dodd | goods £360 plus VAT at 17.5% |

Sales returns

| | |
|------------------------------|---|
| On 5 September from A Barton | 25% of the goods sold to him on 3 September |
|------------------------------|---|

The balance at the bank was £347 overdrawn on 1 September 1997.

The following bank transactions took place during September 1997:

| | |
|--------------|---|
| 4 September | A Barton paid the amount outstanding at 1 September, less 5% cash discount. |
| 8 September | C Dodd paid the amount outstanding at 1 September, less 2.5% cash discount. |
| 10 September | Paid J Swinburn, a creditor, for an invoice of £1,200, less 5% cash discount. |
| 15 September | Paid VAT of £832 to Customs & Excise, re the quarter ended 31 August 1997. |
| 17 September | Paid P Taylor, a creditor, £400 less 5% cash discount. |
| 20 September | Paid by cheque for a motor car costing £9,550, including £150 vehicle licence tax and VAT at 17.5%. |

| | | |
|--------------|--|---------|
| 22 September | C Dodd paid the invoice of 8 September, less the credit note of 18 September. There was no cash discount allowed on this payment. | |
| 25 September | Received a cheque from F Gray for 50% of his debt; the remainder is to be written off as a bad debt. | |
| 30 September | Paid wages to employees, made up as follows: | |
| | Gross wages | £2,500 |
| | Employees' National Insurance | £200 |
| | Employer's National Insurance | £200 |
| | Income tax deducted under PAYE | £300 |
| 30 September | Banked receipts from debtors | £10,500 |
| | Paid cheques to creditor | £11,200 |

GL has a computerised sales ledger system, which produced the following aged debtors' printout at 30 September 1997:

| | |
|---------------|---------|
| Current month | £12,000 |
| 30 to 60 days | £7,500 |
| 60 to 90 days | £3,600 |
| over 90 days | £1,100 |

The balance on the provision for doubtful debts account at 1 September 1997 was £450 credit. No further provisions against debtors have been made since that date. You are given the following additional information:

- (i) The 'current month' total includes £60 for discounts allowed to debtors not recorded in the sales ledger.
- (ii) The '30 to 60 days' total includes a balance of £200 to be taken as a contra entry in the purchase ledger.
- (iii) The 'over 90 days' total includes a debt of £240 to be written off as bad.
- (iv) The company decides to amend the provision for doubtful debts to the following amounts:

| | |
|---------------|-----|
| Over 90 days | 20% |
| 60 to 90 days | 10% |
| 30 to 60 days | 5% |
| Current month | nil |

Requirements

- (a) Insert the missing items in the cash book for September 1997.

| Cash book | | | | | | | |
|-------------|----------------|-------------|---|-------------|----------------|-------------|---|
| <i>Date</i> | <i>Details</i> | <i>Disc</i> | £ | <i>Date</i> | <i>Details</i> | <i>Disc</i> | £ |
| | | | | | | | |
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| | | | | | | | |

(7 marks)

(b) Insert the missing items in the ledger accounts (in date order) for A Barton, C Dodd and F Gray.

| A Barton | | | | | |
|-------------|--|---|-------------|--|-----|
| <i>Date</i> | | £ | <i>Date</i> | | £ |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | 141 |

| C Dodd | | | | | |
|-------------|--|---|-------------|--|---|
| <i>Date</i> | | £ | <i>Date</i> | | £ |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |

| F Gray | | | | | |
|-------------|--|---|-------------|--|---|
| <i>Date</i> | | £ | <i>Date</i> | | £ |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |

(6 marks)

(c) Insert the missing items in the change in the provision for doubtful debts.

Calculation of the provision for doubtful debts on 30 September 1997

| | <i>Total debtors as per schedule</i> | <i>Adjustments</i> | <i>Revised balances</i> | <i>Provision</i> |
|------------------------------|--|--------------------|-----------------------------|------------------|
| | £ | £ | £ | £ |
| Current | | | at 0% | |
| 30–60 days | | | at 5% | |
| 60–90 days | | | at 10% | |
| 90+ days | | | at 20% | |
| Revised cumulative provision | | | | |

The provision for doubtful debts account will need to be increased by **(4 marks)**

(d) Which is the principal accounting concept that governs the provision for doubtful debts?

(3 marks)
(Total marks = 20)

? Question 25

You are required to state, for *each* of the transactions below whether there will be an **increase**, a **decrease**, or **no change** to each of: *fixed assets*, *working capital* and *profit*.

- (i) dividends for the year just ended have been paid by cheque;
- (ii) fixed assets have been disposed of on credit, for more than their net book value;
- (iii) a long-term bank loan has been repaid by increasing the overdraft;
- (iv) goods sold on credit have been returned and the original sales value has been credited to the debtors' account.

| | <i>Fixed Assets</i> | <i>Working Capital</i> | <i>Profit</i> |
|-------|---------------------|------------------------|---------------|
| (i) | _____ | _____ | _____ |
| (ii) | _____ | _____ | _____ |
| (iii) | _____ | _____ | _____ |
| (iv) | _____ | _____ | _____ |

(8 marks)

? Question 26

The Monarch Sports Club has the following summary of its cash book for the year ended 30 June 1997:

| | | |
|-----------------------------|---------------|---------------------|
| | £ | £ |
| Opening bank balance | | 12,500 |
| Receipts | | |
| Subscriptions | 18,000 | |
| Life membership fees | 3,000 | |
| Competition receipts | 7,500 | |
| Entrance fees | 2,500 | |
| Equipment sold | <u>1,000</u> | |
| | | <u>32,000</u> |
| | | 44,500 |
| Payments | | |
| Transport to matches | 3,700 | |
| Competition prizes | 4,300 | |
| Coaching fees | 2,100 | |
| Repairs to equipment | 800 | |
| Purchase of new equipment | 4,000 | |
| Purchase of sports pavilion | <u>35,000</u> | |
| | | <u>49,900</u> |
| Closing balance (overdrawn) | | <u><u>5,400</u></u> |

The following information is available regarding the position at the beginning and end of the accounting year:

| | 1 July 1996 | 30 June 1997 |
|---------------------------|-------------|--------------|
| | £ | £ |
| Subscriptions in advance | 1,100 | 900 |
| Subscriptions in arrears | 200 | 300 |
| Coaching fees outstanding | 150 | 450 |

Of the subscriptions outstanding at the beginning of the year, only half were eventually received.

The equipment sold during the year had a net book value of £1,200 at 1 July 1996. Equipment is to be depreciated at 20 per cent per annum straight line. Life-membership fees are taken to cover 10 years.

The treasurer insists that no depreciation needs to be charged to the sports pavilion, as buildings do not decrease in value. He says that the last club of which he was treasurer did charge depreciation on its buildings but that when the club came to replace them, there was still insufficient money in the bank to pay for the new building.

Requirements

(a) Insert the missing words in the following sentences

A _____ and _____ account is a summary of the cash and bank transactions for the relevant period; in essence, it is a summarised cash book.

An _____ and _____ account is essentially the same as a profit and loss account. It takes into account prepayments and accruals and distinguishes between capital and revenue items. **(4 marks)**

(b) Insert the missing items in the income and expenditure account for the Monarch Sports Club for the year ended 30 June 1997.

Monarch Sports Club: income and expenditure account for the year ended 30 June 1997

| | £ | £ |
|------------------------------|-----|-----|
| Income | | |
| Annual subscriptions | [] | |
| Receipts in year | [] | |
| Add: Subs in advance at [] | [] | |
| Less: Subs in arrears at [] | [] | |
| Less: Subs in advance at [] | [] | |
| Add: Subs in arrears at [] | [] | |
| | | [] |
| [] | | [] |
| [] | | [] |
| [] | | [] |
| | | [] |
| | | [] |
| Expenses | | |
| [] | [] | |
| [] | [] | |
| [] | [] | |
| [] | [] | |
| [] | [] | |
| [] | [] | |
| | | |
| | | [] |
| Surplus for year | | [] |

(8 marks)
(Total marks = 12)

? Question 27

Robert Costello is a sole trader. His business mainly involves the sale of computer systems to small businesses and home users, including hardware and pre-loaded software. He also sells individual items of equipment from his shop. At 30 September 1999, he extracts the following trial balance from his accounting records:

| | <i>Debit</i> | <i>Credit</i> |
|---|----------------|----------------|
| | £ | £ |
| Capital at 1 October 1998 | | 26,600 |
| Loan from bank | | 40,000 |
| Loan repayments made | 12,600 | |
| Stocks at 1 October 1998 | 42,500 | |
| Sales of computer systems | | 305,000 |
| Other sales | | 5,500 |
| Purchases | 180,300 | |
| General office expenses | 8,800 | |
| Car tax and insurance | 400 | |
| Shop rental | 24,000 | |
| Rates | 3,500 | |
| Heating and lighting | 2,400 | |
| Wages | 18,500 | |
| Fixtures and fittings – cost | 10,000 | |
| Fixtures and fittings – depreciation 1 October 1998 | | 3,600 |
| Motor vehicle – cost | 21,000 | |
| Motor vehicle – depreciation 1 October 1998 | | 5,000 |
| Debtors | 62,900 | |
| Creditors | | 15,200 |
| VAT | | 4,500 |
| Bank balance | 18,500 | |
| | <u>405,400</u> | <u>405,400</u> |

You are given the following information at 30 September 1999:

- (i) Closing stocks of hardware and software were £45,200.
- (ii) The figure in the accounts for shop rental includes £6,000 for the period from 1 October 1999 to 31 December 1999.
- (iii) Rates for the year ending 31 March 2000 have been paid in full, amounting to £2,400.
- (iv) Heating and lighting to be accrued is £350.
- (v) The wages total recorded in the books consists of £15,000 that Robert paid to himself, and £3,500 paid to his father for assistance with bookkeeping.
- (vi) During the year, sales of sundry items amounting to £5,640 (including VAT at 17.5 per cent) were made for cash, and have not been recorded in the books. The cash was used to pay for stationery (£470 including VAT), shop assistant's wages (£3,760), and petrol (£1,410 including VAT).
- (vii) During the year, a motor vehicle that had cost £8,000, and on which depreciation of £5,000 had been charged, was given in part exchange for a new vehicle costing £15,000. The part-exchange valuation was £2,000. The ledger accounts in the above trial balance contain the cost and depreciation of the disposed vehicle, and the balance paid by cheque for the new vehicle.
- (viii) Fixtures and fittings are to be depreciated at the rate of 20 per cent per annum on the reducing-balance basis; motor vehicles are to be depreciated at the rate of 20 per cent per annum, straight line, with a full year's depreciation provided in the year of acquisition.

- (ix) One of Robert's business customers is in financial difficulties, and is unable to pay the whole of his debt of £6,000. He offered to pay in six equal instalments, starting August 1999, but so far has made no payment. Robert feels that he is likely to get half the money back. Other debtors are also showing signs of difficulties, and he thinks it might be prudent to make a provision of 5 per cent for doubtful debts.
- (x) The bank loan was taken out on 1 January 1999. The loan is being repaid in 40 monthly instalments of £1,400, including flat-rate interest of 12 per cent per annum on the amount borrowed.

Requirements

- (a) Insert the missing items in Robert's trading and profit and loss account for the year 30 September 1999.

Robert Costello: trading and profit and loss account for the year ended 30 September 1999

| | £ | £ |
|--------------|---|---|
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| Gross profit | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| | | |
| Net profit | | |

(12 marks)

(b) Insert the missing items in Robert's balance sheet 30 September 1999

Robert Costello: balance sheet at 30 September 1999

| | £ <i>Cost</i> | £ <i>Dep'n</i> | £ <i>NBV</i> |
|--|------------------|-------------------|-----------------|
| Fixed assets | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| Current assets | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| Creditors: amounts falling due for payment within one year | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| Creditors: amounts falling due for payment after one year | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| Capital | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

(12 marks)
(Total marks = 24)

? Question 28

Tanwir commenced in business on 1 October 1999, with capital in the bank of £20,000. During his first month of trading, his transactions were as follows:

- 2 October Purchased stocks for £3,500 on credit from A Jones
- 3 October Paid £1,200 rental of premises, by cheque
- 5 October Paid £5,000 for office equipment, by cheque
- 10 October Sold goods costing £1,000, for £1,750, on credit to P Duncan
- 15 October Returned stocks costing £500 to A Jones
- 18 October Purchased stocks for £2,400 on credit from A Jones
- 25 October Paid A Jones for the net purchases of 2 October, by cheque
- 28 October P Duncan paid £500 on account, by cheque

Requirements

(a) Insert the missing items in the ledger accounts for the above transactions.

| | | | | | |
|------------------|---|---|---|---|---|
| Capital | | | | | |
| | | £ | | | £ |
| | | | █ | █ | █ |
| Bank | | | | | |
| | | £ | | | £ |
| █ | █ | █ | █ | █ | █ |
| █ | █ | █ | █ | █ | █ |
| Purchases | | | | | |
| | | £ | | | £ |
| █ | █ | █ | | | |
| █ | █ | █ | | | |
| A Jones | | | | | |
| | | £ | | | £ |
| █ | █ | █ | █ | █ | █ |
| █ | █ | █ | █ | █ | █ |
| █ | █ | █ | | | █ |
| | | █ | █ | █ | █ |
| Rent payable | | | | | |
| | | £ | | | £ |
| █ | █ | █ | | | |
| Office equipment | | | | | |
| | | £ | | | £ |
| █ | █ | █ | | | |
| Sales | | | | | |
| | | £ | | | £ |
| | | | █ | █ | █ |
| P Duncan | | | | | |
| | | £ | | | £ |
| █ | █ | █ | █ | █ | █ |
| █ | █ | █ | █ | █ | █ |
| █ | █ | █ | | | █ |
| | | █ | █ | █ | █ |
| Returns outwards | | | | | |
| | | £ | | | £ |
| | | | █ | █ | █ |

(12 marks)

Requirements

(a) Insert the missing items in the stores ledger card for Product A for October 1999 using the FIFO method.

Note: Goods returned inwards are valued at the latest issue price.

| Date | Quantity | Receipts | | Quantity | Issues | | Balance | |
|-----------|----------|------------|------------|----------|------------|------------|----------|------------|
| | | Price £ | Value £ | | Price £ | Value £ | Quantity | Value £ |
| October 1 | | | | | | | | |
| 3 | | | | | | | | |
| 4 | | | | | | | | |
| | | | | | | | | |
| 8 | | | | | | | | |
| 12 | | | | | | | | |
| 18 | | | | | | | | |
| 22 | | | | | | | | |
| | | | | | | | | |
| 28 | | | | | | | | |

(4 marks)

(b) Insert the missing items in the stores ledger card for Product A for October 1999 using the AVCO (weighted average cost) method.

| Date | Quantity | Receipts | | Quantity | Issues | | Balance | |
|------|----------|------------|------------|----------|------------|------------|----------|------------|
| | | Price £ | Value £ | | Price £ | Value £ | Quantity | Value £ |
| 1 | | | | | | | | |
| 3 | | | | | | | | |
| 4 | | | | | | | | |
| 8 | | | | | | | | |
| 12 | | | | | | | | |
| 18 | | | | | | | | |
| 22 | | | | | | | | |
| 28 | | | | | | | | |

(4 marks)

(c) Calculate the gross profit for October using *both* methods of stock valuation by inserting the missing items in the schedule below.

Jay Ltd: trading accounts:

| | FIFO £ | AVCO £ |
|---------------|-----------|-----------|
| Opening stock | | |
| Purchases | | |
| Closing stock | | |
| Cost of sales | | |
| Sales | | |
| Gross profit | | |

(4 marks)

(Total marks = 12)

? Question 30

MMM Ltd is a recently formed company, which provides training and educational services. The company was formed with an authorised share capital of 1,000,000 £1 shares. The three shareholders, who are also directors, each purchased 120,000 shares at £1.40 per share. It is expected that the business will grow rapidly during the first two years, and that funds for that expansion will be sought by issuing shares to family members and obtaining bank finance.

During the first year of trading, a net profit (before tax) of £48,800 was made, after deducting salaries to the three directors of £60,000 in total. Corporation tax of £6,500 was provided for the year. As well as the salaries, the three directors declared dividends for themselves of 5p per share. They also decided to transfer £5,000 into general reserves.

During the second year of trading, net profit (before tax) was £55,000. Family members purchased a further 30,000 shares at £1.50 per share, at the start of the year. Salaries were as in the first year. Interim dividends of 3p per share were paid. Corporation tax of £8,000 was provided for the year, and a further £5,000 transferred into general reserves. A final dividend of 5p per share is proposed.

Requirements

- (a) Insert the missing items in the appropriation accounts for each of years 1 and 2.

MMM Ltd: profit and loss appropriation accounts

| | £ Year 1 | £ Year 2 |
|-------------------|-------------|-------------|
| Profit before tax | [] | [] |
| [] | [] | [] |
| [] | [] | [] |
| [] | [] | [] |
| [] | [] | [] |
| Retained profit | [] | [] |

(4 marks)

- (b) Insert the missing items in the capital section of the balance sheet for each of years 1 and 2.

MMM Ltd: capital and reserves

| | £ Year 1 | £ Year 2 |
|-----|-------------|-------------|
| [] | [] | [] |
| [] | [] | [] |
| [] | [] | [] |
| [] | [] | [] |

(5 marks)

(Total marks = 9)



Question 31

EMP plc is a retail organisation, with the following trial balance at 31 October 2000:

| | <i>Debit</i> | <i>Credit</i> |
|--|--------------|---------------|
| | <i>£m</i> | <i>£m</i> |
| Ordinary shares of 50p each | | 200 |
| Share premium account | | 16 |
| General reserves | | 14 |
| Profit and loss account balance at 1 November 1999 | | 62 |
| Plant and machinery | | |
| Cost | 250 | |
| Depreciation at 1 November 1999 | | 56 |
| Office equipment | | |
| Cost | 90 | |
| Depreciation at 1 November 1999 | | 30 |
| Stocks at 1 November 1999 | 62 | |
| Debtors and creditors | 84 | 80 |
| Provision for doubtful debts at 1 November 1999 | | 8 |
| Bank balance | 8 | |
| Purchases and sales | 230 | 376 |
| Returns inwards and outwards | 16 | 12 |
| Administrative expenses | | |
| Wages and salaries | 28 | |
| Directors' fees | 10 | |
| Telephone costs | 12 | |
| Rent, rates and insurances | 8 | |
| Heat and light | 16 | |
| Printing and stationery | 12 | |
| Distribution expenses | 24 | |
| Interim dividend paid | 4 | |
| | <u>854</u> | <u>854</u> |

The following additional information at 31 October 2000 is available:

- (i) Closing stocks of goods for resale are valued at £106m.
- (ii) Distribution expenses include £1m carriage inwards and £3m carriage outwards.
- (iii) Prepayments:

| | <i>£m</i> |
|---------------------|-----------|
| Telephone rental | 1 |
| Rates and insurance | 2 |

- (iv) Accruals:

| | <i>£m</i> |
|------------------------|-----------|
| Wages and salaries | 3 |
| Telephone call charges | 4 |
| Directors' fees | 2 |
| Auditors' fees | 1 |

- (v) The figure in the trial balance for the bank balance is the balance appearing in the cash book prior to conducting the bank reconciliation. On receipt of the bank statement, it is discovered that:
 - unpresented cheques amount to £3m;
 - bank charges and interest not recorded in the cash book amount to £2m;
 - a cheque for £1m from a customer has been dishonoured and not recorded in the ledgers.
- (vi) Bad debts to be written off amount to £5m (including the dishonoured cheque referred to in note (v) above), and the provision for doubtful debts is to be amended to 2.5 per cent of debtors.

- (vii) Depreciation on fixed assets is to be provided as follows:
 - plant and machinery, 10 per cent on cost;
 - office equipment, 33¹/₃ per cent on the reducing balance.
- (viii) Provision of £2m is to be made for corporation tax.
- (ix) A final dividend of 1.5p per share is to be proposed.
- (x) £20m is to be transferred to general reserves.

Requirements

- (a) Insert the missing items in the trading and profit and loss account for the year ended 31 October 2000.

EMP plc: trading and profit and loss account for the year ended 31 October 2000

| | <i>£m</i> | <i>£m</i> | <i>£m</i> |
|---|-----------|-----------|-----------|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| Cost of sales: | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| Gross profit | | | |
| Administrative expenses: | | | |
| | | | |
| | | | |
| | | | |
| | | | |
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| | | | |
| | | | |
| | | | |
| | | | |
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| | | | |
| | | | |
| | | | |
| | | | |
| Net profit before tax | | | |
| | | | |
| Net profit after tax | | | |
| Dividends | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| Profit and loss account brought forward | | | |
| Profit and loss account carried forward | | | |

(12 marks)

PREPARING FOR THE ASSESSMENT

(b) Insert the missing items in the balance sheet at 31 October 2000.

EMP plc: balance sheet at 31 October 2000

| | £ ^m | £ ^m Cost | £ ^m Depreciation | £ ^m Net |
|---|----------------|------------------------|--------------------------------|-----------------------|
| Fixed assets | | | | |
| [] | | [] | [] | [] |
| [] | | [] | [] | [] |
| | | <hr/> | <hr/> | <hr/> |
| Current assets | | | | |
| [] | | [] | | |
| [] | [] | | | |
| [] | [] | | | |
| | <hr/> | | | |
| [] | | [] | | |
| [] | | [] | | |
| | | <hr/> | [] | |
| Creditors – amounts falling due within one year | | | | |
| [] | | [] | | |
| [] | | [] | | |
| [] | | [] | | |
| | | <hr/> | | |
| Net current assets | | | <hr/> | [] |
| | | | | <hr/> |
| Capital and reserves | | | | |
| [] | | | | [] |
| [] | | | | [] |
| [] | | | [] | |
| [] | | | [] | |
| | | | <hr/> | [] |
| | | | | <hr/> |
| | | | | <hr/> |

(8 marks)

(c) State the formulae for and calculate the following ratios by inserting the missing items.

(i) *Acid test or quick ratio*

Formula [] : []
 Figures [] : [] = [] : []

(ii) *Rate of stock turnover*

Formula [] ÷ []
 Figures [] ÷ $\frac{[]}{2}$
 [] = [] ([] days)

(4 marks)

(Total marks = 24)



Question 32

Your organisation's year end is 31 October. Prior to producing the trial balance at 31 October 2000, your supervisor has passed you the following list of errors and omissions

that have been discovered:

- (i) Purchase of raw materials on credit from J Brown had been completely omitted. The list price was £9,000, less trade discount of $33\frac{1}{3}$ per cent, with cash discount of 2 per cent offered for payment before 31 October 2000. The invoice is still outstanding at the end of the month.
- (ii) Office equipment valued at £4,000 was received in part payment of a debt of £4,500 from P Turner. The balance of P Turner's debt is to be written off. No entries have been made for either of these transactions. No depreciation is to be charged on the office equipment.
- (iii) Administration expenses paid, of £5,300, had been credited to administration expenses and debited to the bank account.
- (iv) Office equipment had been disposed of during the year. The cost (£4,200) and depreciation (£3,320) had been correctly transferred to the disposals account, but no other entries had been made. The disposal proceeds of £720 have not yet been received.
- (v) Staff wages accrued of £3,000 gross had been omitted. PAYE was £450, employees' National Insurance contributions were £120 and employer's National Insurance contributions were £130.
All payments will be made after 31 October 2000.

Requirements

- (a) Insert the missing items in the journal entries to correct the above errors and omissions.

Journal entries

| | | <i>Debit</i> | <i>Credit</i> |
|-------|-------|--------------|---------------|
| | | £ | £ |
| (i) | _____ | _____ | _____ |
| | _____ | | |
| (ii) | _____ | _____ | |
| | _____ | _____ | |
| | _____ | | _____ |
| (iii) | _____ | _____ | |
| | _____ | | _____ |
| (iv) | _____ | _____ | |
| | _____ | | _____ |
| (v) | _____ | _____ | |
| | _____ | _____ | |
| | _____ | | _____ |
| | _____ | | _____ |
| | _____ | | _____ |

(7 marks)

- (b) If the above errors had not been corrected, the profit for the year ended 31 October 2000 would have been £37,500. Recalculate the net profit after taking into account the above corrections, by inserting the missing figures in the schedule below.

| Recalculated net profit | |
|--------------------------------|-------------|
| Net profit before adjustments | £ 37,500 |
| | |
| | |
| | |
| | |
| | |
| | |
| Amended net profit | |

(4 marks)

- (c) A replacement engine had been purchased for a machine during the year. The whole cost of £25,000 had been charged to the machinery at cost account, and depreciation of 10 per cent on the full amount had been charged. You are now informed that £10,000 of the cost was deemed to be in respect of an improvement in the productive capacity of the machine.

You are required to:

- (i) complete the missing words in the following sentences;
 ____ expenditure is the acquisition, production or enhancement of ____ assets.
 ____ expenditure includes the purchase of goods for resale, and expenditure on goods and services to be ____ during the reporting period. **(6 marks)**
- (ii) calculate the effect that the incorrect treatment of this expenditure will have had on the profit for the year, by inserting the missing figures in the schedule below.

| Effect of incorrect treatment | |
|--------------------------------------|-------|
| | £ |
| | |
| | |
| | |
| | |

(3 marks)**(Total marks = 20)**

Question 33

You are given the following information relating to PB's business for the month of October 2000:

| | |
|---|-------------|
| Owing by customers at 1 October 2000 | £ 95,760 |
| Owing to customers at 1 October 2000 | 3,400 |
| Owing to customers at 31 October 2000 | 5,750 |
| Sales during the month: | |
| Cash sales (including VAT at 17.5%) | 9,400 |
| Credit sales (including VAT at 17.5%) | 757,875 |
| Receipts from customers (including cash sales) | 739,000 |
| Discounts allowed to credit customers | 2,450 |
| Refunds made to credit customers | 4,385 |
| Returns inwards (excluding VAT at 17.5%), all on credit | 25,800 |
| Bad debts written off | 2,875 |
| Dishonoured cheques from credit customers | 15,215 |

The provision for doubtful debts is 2 per cent of net balance at 31 October 2000.

In addition, PB was notified on 30 October 2000 that she would be receiving a dividend of 20p in the pound from a previously written-off bad debt of £6,000. The amount was received in November 2000.

She also has a customer owing £5,400, who is also a supplier of hers. The balance in the purchase ledger is £8,200, and she agreed to offset the balances.

You are required to prepare a sales ledger control account for PB for the month of October 2000, using the information above, by inserting the missing items below.

| Sales ledger control account | | | |
|------------------------------|---|-------------|---|
| | £ | | £ |
| Balance b/f | █ | Balance b/f | █ |
| █ | █ | █ | █ |
| █ | █ | █ | █ |
| █ | █ | █ | █ |
| █ | █ | █ | █ |
| Balance c/f | █ | Balance c/f | █ |
| | █ | | █ |
| | █ | | █ |

(7 marks)

? Question 34

Your organisation maintains a single ledger account for rent, rates and insurance.

At 1 November 1999, the following balances were to be brought forward on the account:

| | |
|---------------------------------------|-----|
| | £ |
| Rent accrued for October 1999 | 700 |
| Rates prepaid to 31 March 2000 | 550 |
| Insurance prepaid to 31 December 1999 | 400 |

During the next year, the following payments were made:

- *Rent.* £2,100 per quarter, payable on 1 November, 1 February, 1 May and 1 August. The May payment was made with the August payment.
- *Rates.* £1,200, for the year ending 31 March 2001, paid on 8 April 2000.
- *Insurance.* £3,000, for the year ending 31 December 2000, paid on 28 December 1999. In addition, a refund of insurance for the year ended 31 December 1999, of £80, was received on 3 January 2000.

Requirements

- (a) Insert the missing items in the ledger account for rent, rates and insurance for the year ended 31 October 2000, showing clearly the amount to be transferred to the profit and loss account for the year, and the amounts accrued and/or prepaid at the end of the year.

| Rent, rates and insurance | | | | | |
|---------------------------|----------------|---|-------------|----------------|---|
| <i>Date</i> | <i>Account</i> | £ | <i>Date</i> | <i>Account</i> | £ |
| | | | | | |
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(8 marks)

- (b) Insert the missing words in these sentences relating to the concepts of prudence and accruals.

The ____ *concept* stipulates that ____ and ____ should not be anticipated. However, ____, ____ and ____ should be provided for as soon as it is known that an ____ has been incurred that relates to the accounting period, or the possibility of a ____ or ____ exists.





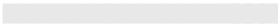

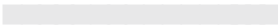





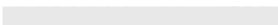

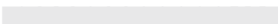

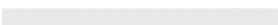




The ____ (or ____) *concept* stipulates that ____ and ____ are matched with each other in accordance with the period to which they relate, regardless of the period in which the ____ or ____ occurs.

(5 marks)

- (c) Your organisation made a net profit of £47,500 for the year ended 31 October 2000. This was after charging depreciation of £8,200 and a loss on disposal of fixed assets of £1,200. The proceeds of sale of the fixed asset were £5,400.

During the year, the net book value of fixed assets rose by £18,000; debtors increased by £2,500; stocks decreased by £5,200 and creditors increased by £1,800. The proprietor withdrew £7,000 of the profits for his own use, and paid off a long-term loan of £8,000.

Insert the missing items in the schedule for the change in the bank balance as a result of the above transactions.

| Change in bank balance | |
|---|--|
| | £ |
| Profit for the year | 47,500 |
|  |  |
|  |  |
|  |  |
|  |  |
|  |  |
|  |  |
|  |  |
|  |  |
|  |  |
|  |  |
| Increase in bank balance |  |

(7 marks)
(Total marks = 20)

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Solutions to Revision Questions



Solution 1

1.1 Answer: (C)

There are several ways a candidate could identify the correct answer here, including the process of elimination. Answers (A) and (D) cannot be right as they both include a debit to the cash account, and as the company is making a payment a credit to the cash account is required. The difference between answers (B) and (C) is the amount of cash discount given. This should be calculated as 2 per cent of the net goods value, that is, the value after deducting the trade discount. The net goods value is £400 less £100 trade discount = £300, therefore the cash discount is £6 and answer (C) is correct.

Taking the question in order of action, the initial purchase should be recorded ignoring the cash discount, as it is not known at the time of purchase whether payment will be made in time to become entitled to the cash discount. Trade discount is always deducted at once, and thus the initial entries are Debit Purchases, Credit ABC Ltd with £300. On payment, ABC Ltd is debited with £300, the amount paid out (and credited to the bank) is £300 – £6 cash discount, and the discount is credited to Discount Received (being an item of revenue).

1.2 Answer: (B)

A spreadsheet is ideal for preparing budgets and forecasts, using a columnar format with the accounting periods across the top and the items of income/expense, etc., down the columns. It is also ideal for use as a daybook, again with a columnar format with the invoice numbers, etc., listed vertically and the columns headed 'Gross', 'VAT' and 'Net' (perhaps with further analysis columns). An extended trial balance could also be prepared using a spreadsheet, with the accounts listed vertically and the columns used for the trial balance figures, adjustments, profit and loss account items and, finally, balance sheet items. Double-entry records would require several spreadsheets, one for each account, and recording the dual aspect would mean locating the two relevant spreadsheets and the appropriate cells, making this application much more difficult.

1.3 Answer: (D)

The suspense account is debited or credited as a result of an imbalance in the trial balance. A debit balance would arise if the credit side of the trial balance were greater

than the debit side. Option (A) would result in the debit side being greater than the credit side. Option (B) is a correct entry. Option (C) would make the credit side less than the debit side.

1.4 Answer: (D)

Share premium arises where shares are issued for more than their par value. Reserves are created from profits retained in the business or from the upward revaluation of fixed assets. The suspense account is created when there is an imbalance in the ledger accounts. Goodwill arises when the value of the assets purchased is less than the purchase price.

1.5 Reconstruction of cost of goods sold to establish the purchases figure:

| | | |
|--------------------|----------------|-----------------|
| | £ | £ |
| Opening stock | | 12,000 |
| Add: Purchases | 122,000* | |
| Less: Returns | <u>(5,000)</u> | |
| | | 117,000 |
| Closing stock | | <u>(18,000)</u> |
| Cost of goods sold | | <u>111,000</u> |

* Found by difference.

1.6 Answer: (D)

1.7 Answer: £350,000

1.8

| | |
|------------------|----------------|
| | £ |
| Opening balance | 34,500 |
| Credit purchases | 78,400 |
| Discounts | (1,200) |
| Payments | (68,900) |
| Purchase returns | <u>(4,700)</u> |
| | <u>38,100</u> |

1.9

| | | |
|-----------------------------|---------------|----------------|
| | £ | |
| Statement balance | 13,400 | |
| Add back dishonoured cheque | 300 | |
| Add back bank charges | 50 | |
| Less: Unpresented cheques | (1,400) | |
| Adjustment re error | <u>(390)</u> | |
| | <u>11,960</u> | i.e. twice 195 |

1.10

| | |
|---------------------------|----------------|
| | £ |
| Cash book balance | (1,240) |
| Unpresented cheques | 450 |
| Receipt not yet processed | (140) |
| Bank charges | <u>(75)</u> |
| As per statement | <u>(1,005)</u> |

1.11 Answer: (A)

1.12 Answers: 1C, 2E, 3A, 4B, 5D

- 1.13 Reliable – the caretaker is not likely to know; the office staff should know.
Relevance – the economics exam is not likely to be relevant.
Complete – the student needs to know the precise date.
Understandable – C/42 is probably not understandable to the new student – this might be Block C, Room 42, or room C, block 42.
- 1.14 Answer: (B)
- 1.15 Answer: (D)
- 1.16 Answer: (B)
- 1.17 Answer: (D)



Solution 2

- 2.1 Answer: (D)
- 2.2 Answer: (B)
- 2.3 Credit £962.50
- 2.4 Answer: (D)
- 2.5 P&L A/c £9000 Balance Sheet £3,000
- 2.6 Answer: (A)
- 2.7 Answer: (C)
- 2.8 £41.00
- 2.9 Answer: (B)
- 2.10 £18,000
- 2.11 Debit £7,700
- 2.12 Answer: (C)
- 2.13 57 days
- 2.14 £1,880
- 2.15 Debit £210



Solution 3

- 3.1 Answer: (C)
- 3.2 Answer: (D)
- 3.3 Answer: (A)
- 3.4 Overdrawn £880
- 3.5 Answer: (D)
- 3.6 Answer: (C)

3.7 Answer: (D)

3.8 Answer: (B)

3.9 £385

3.10 Answer: (A)

3.11 Loss £28.80

3.12 £182,000

3.13 £180.00

3.14 £26,000

3.15 8 times

**Solution 4**

4.1 Answer: (C)

4.2 Answer: (B)

4.3 Answer: (A)

4.4 Answer: (A)

4.5 Answer: (D)

4.6 £339,000

4.7 £90

4.8 Answer: (D)

4.9 Credit £190

4.10 Answer: (C)

4.11 £14,550

4.12 £171,000

4.13 Answer: (C)

4.14 Answer: (A)

4.15 Answer: (B)

**Solution 5**

5.1 Answer: (C)

5.2 Answer: (A)

| | |
|---------------------------------|---------------|
| Disposal proceeds | £ 30,000 |
| Less: profit | (10,000) |
| Net book value | <u>20,000</u> |
| $£271,200 - £20,000 = £251,200$ | |

5.3 Answer: (B)

5.4 Answer: (D)

5.5 Answer: (B)

| | |
|-----------------------------|----------------|
| | £ |
| Increase in stock | 500 |
| Decrease in bank | (800) |
| Increase in creditors | <u>(2,400)</u> |
| Decrease in working capital | <u>(2,700)</u> |

5.6

| Subscription account | | | |
|-----------------------------------|--------------|-----------------|--------------|
| | <i>Dr</i> | | <i>Cr</i> |
| | £ | | £ |
| Balance b/f | 200 | Balance b/f | 90 |
| Paid in advance c/f | 85 | Receipts | 4,800 |
| To income and expenditure account | <u>4,655</u> | Outstanding c/f | 50 |
| | <u>4,940</u> | | <u>4,940</u> |

5.7 Answer: (B)

5.8

| | | |
|-----------------------------|----------------|---------------|
| | £ | £ |
| Opening capital | | 28,000 |
| Capital introduced (petrol) | | 1,800 |
| Add profit | | |
| Per accounts | 45,000 | |
| Add back own wages | 18,000 | |
| Less: petrol | <u>(1,800)</u> | |
| | | 61,200 |
| | | <u>91,000</u> |
| Less: drawings | | |
| Wages | 18,000 | |
| Telephone | <u>800</u> | |
| | | (18,800) |
| Closing capital | | <u>72,200</u> |

5.9

| | |
|------------------------------|----------------|
| | £ |
| Purchase of raw material | 56,000 |
| Carriage inwards | 2,500 |
| Increase in stock | <u>(1,700)</u> |
| Cost of material consumed | 56,800 |
| Direct wages | <u>21,000</u> |
| Prime cost | 77,800 |
| Production overhead | 14,000 |
| Decrease in work in progress | <u>5,000</u> |
| Production cost | <u>96,800</u> |

5.10

| | <i>Qty</i> | <i>Price</i> | <i>Total</i> |
|---------------|------------|--------------|--------------|
| | | £ | £ |
| Opening stock | 60 | 4.00 | 240 |
| Purchases | <u>100</u> | 4.80 | <u>480</u> |
| Balance | 160 | 4.50 | <u>720</u> |
| Sales | <u>80</u> | 4.50 | <u>360</u> |
| Balance | 80 | 4.50 | <u>360</u> |
| Purchases | <u>120</u> | 5.00 | <u>600</u> |
| Balance | 200 | 4.80 | <u>960</u> |
| Sales | <u>50</u> | 4.80 | <u>240</u> |
| Balance | <u>150</u> | 4.80 | <u>720</u> |

5.11 Answer: (D)

5.12 Answer: (D)

5.13 Answer: (A)

5.14 Answer: (D)

$$60\% \text{ of } \pounds 150,000 = \pounds 90,000$$

$$\pounds 150,000 + \pounds 90,000 = \pounds 240,000$$

5.15 Answer: (C)



Solution 6

(a)

| Suspense account | | | |
|--|--------------|--------------------------|--------------|
| | £ | | £ |
| Stationery error | 18 | Trial balance difference | 2,221 |
| Discount allowed omitted | 950 | Sales daybook error | 180 |
| Proceeds of sale of fixed asset not entered in disposal account | 750 | Bank interest omitted | 220 |
| Balance carried down | <u>903</u> | | |
| | <u>2,621</u> | | <u>2,621</u> |

(b)

| Sales ledger control account | | | |
|------------------------------|----------------|---------------------------|----------------|
| | £ | | £ |
| Balance at 30 April 1996 | 104,637 | Discount allowed | 950 |
| Error in sales daybook | 180 | Contra to purchase ledger | 426 |
| Credit sale omitted | 325 | Contra to purchase ledger | 426 |
| | <u>105,142</u> | Balance carried down | <u>103,340</u> |
| | | | <u>105,142</u> |

| | | |
|-----|----------------------------------|----------------|
| (c) | | £ |
| | Profit as originally calculated | 227,642 |
| | Add stationery error | 18 |
| | Add error in sales daybook total | 180 |
| | Add credit sale omitted | 325 |
| | Less loss on sale of fixed asset | (170) |
| | Revised net profit | <u>229,995</u> |



Solution 7

This question involves the comparison of the statement received from a supplier with the ledger account maintained in the firm's purchase ledger. Remember that debits on one should appear as credits on the other. The technique is similar to that of bank reconciliations but there are added complications in the form of discounts assumed to be taken by the firm but not allowed by the supplier, and debit notes issued by the firm that have not yet been raised as credit notes by the supplier. The items to appear on the reconciliation will include items from both the statement and the ledger account; both are likely to be incorrect, and therefore the simplest way of reconciling the two is to prepare a calculation of the corrected balance for each and ensure that they agree.

| | | |
|-----|--|--------------|
| (a) | | £ |
| | Balance per supplier's statement | 5,950 |
| | Less cash in transit | (1,400) |
| | Less Debit Note 65 | (300) |
| | Corrected balance | <u>4,250</u> |
| | Balance per ledger | 3,250 |
| | Add back discount disallowed | 200 |
| | Amend Credit Note 0062 | 100 |
| | Invoice 01395 not yet received | 800 |
| | Less Credit Note 0070 not yet received | (100) |
| | Correct balance | <u>4,250</u> |

- (b)
- (i) This is an invoice from Potts to Kingston. It will have been entered in Potts's records as soon as it was issued, but has not yet been received by Kingston. (f)
 - (ii) This is a credit note issued by Potts and entered in its records at once; it has not yet been received by Kingston. (g)
 - (iii) This is cash discount that has been deducted by Kingston upon payment of the outstanding balance at the beginning of January, ignored or disallowed by Potts. (i)
 - (iv) This is cash paid by Kingston at the end of the month, and entered in its ledger account at once; it has not yet been received by Potts. (k)
 - (v) This is a debit note issued by Kingston perhaps due to goods returned; credit note not yet received by Potts. (l)
- (c) £4,250 current liability.



Solution 8

- (i) invoices relate to a properly authorised order;
- (ii) numbered GRNs should be raised, e.g. by storekeeper, to ensure that goods have been inspected and taken into stores;

- (iii) adequate segregation of duties exists;
 (iv) purchase ledger records should be checked against suppliers' statements.



Solution 9

(a) TD: journal entries

| | | <i>Debit</i> | <i>Credit</i> |
|-------|----------------------------|--------------|---------------|
| | | £ | £ |
| (i) | Suspense account | 1,000 | |
| | Sales | | 1,000 |
| (ii) | Plant at cost | 240 | |
| | Delivery costs | | 240 |
| (iii) | Discounts received | 150 | |
| | JW | | 150 |
| (iv) | Stationery stock (balance) | 240 | |
| | Stationery account | | 240 |
| (v) | Suspense account | 500 | |
| | Purchases | | 500 |
| (vi) | Returns outwards | 230 | |
| | Returns inwards | 230 | |
| | Suspense | | 460 |

(b)

 Suspense account

| | | | | | |
|-----|-----------|--------------|------|---------------------------|--------------|
| | | £ | | | £ |
| (i) | Sales | 1,000 | | Balance per trial balance | 1,040 |
| (v) | Purchases | <u>500</u> | (vi) | Returns in and out | <u>460</u> |
| | | <u>1,500</u> | | | <u>1,500</u> |

(c) Revised gross and net profit figures

| | |
|-------------------------------|---------------|
| | £ |
| Gross profit – original | 35,750 |
| Add: (i) | 1,000 |
| Add: (v) | 500 |
| Less: (vi) | 460 |
| Revised gross profit | <u>36,790</u> |
| Net profit – original | 18,500 |
| Add: increase in gross profit | 1,040 |
| Add: (ii) | 240 |
| Less: (iii) | 150 |
| Add: (iv) | 240 |
| Revised net profit | <u>19,870</u> |



Solution 10

Ratios

| | | 1994 | 1995 |
|-------|---|--|--|
| (i) | <i>Gross profit percentage</i> | | |
| | $\frac{\text{Gross profit}}{\text{Sales}} \times 100$ | $\frac{2,600}{14,400} \times 100 = 18.1\%$ | $\frac{4,400}{17,000} \times 100 = 25.9\%$ |
| (ii) | <i>Net profit percentage</i> | | |
| | $\frac{\text{Net profit}}{\text{Sales}} \times 100$ | $\frac{1,400}{14,400} \times 100 = 9.7\%$ | $\frac{2,400}{17,000} \times 100 = 14.1\%$ |
| (iii) | <i>Return on capital employed</i> | | |
| | $\frac{\text{Net profit}}{\text{Average total capital}} \times 100$ | $\frac{1,400}{6,260} \times 100 = 22.4\%$ | $\frac{2,400}{6,210} \times 100 = 38.6\%$ |



Solution 11

(a) Stock record card – FIFO

| Date | Receipts | | | Issues | | | Balance | | |
|----------|----------|--------|-----|--------|--------|-------|---------|--------|-------|
| | Units | £/unit | £ | Units | £/unit | £ | Units | £/unit | £ |
| 1 April | | | | | | | 100 | 10 | 1,000 |
| 8 April | | | | 24 | 10 | 240 | 76 | 10 | 760 |
| 18 April | 38 | 12 | 456 | | | | 38 | 12 | 456 |
| 20 April | | | | 50 | 10 | 500 | 26 | 10 | 260 |
| | | | | | | | 38 | 12 | 456 |
| 23 April | | | | 26 | 10 | 260 | | | |
| | | | | 9 | 12 | 108 | 29 | 12 | 348 |
| 28 April | 20 | 13 | 260 | | | | 20 | 13 | 260 |
| Totals | 58 | | 716 | 109 | | 1,108 | 49 | | 608 |

Stock record card – LIFO

| Date | Receipts | | | Issues | | | Balance | | |
|----------|----------|--------|-----|--------|--------|-------|---------|--------|-------|
| | Units | £/unit | £ | Units | £/unit | £ | Units | £/unit | £ |
| 1 April | | | | | | | 100 | 10 | 1,000 |
| 8 April | | | | 24 | 10 | 240 | 76 | 10 | 760 |
| 18 April | 38 | 12 | 456 | | | | 38 | 12 | 456 |
| 20 April | | | | 38 | 12 | 456 | | | |
| | | | | 12 | 10 | 120 | 64 | 10 | 640 |
| 23 April | | | | 35 | 10 | 350 | 29 | 10 | 290 |
| 28 April | 20 | 13 | 260 | | | | 20 | 13 | 260 |
| Totals | 58 | | 716 | 109 | | 1,166 | 49 | | 550 |

Stock record card – AVCO

| Date | Receipts | | | Issues | | | Balance | | |
|----------|----------|--------|-----|--------|--------|-------|---------|--------|-------|
| | Units | £/unit | £ | Units | £/unit | £ | Units | £/unit | £ |
| 1 April | | | | | | | 100 | 10 | 1,000 |
| 8 April | | | | 24 | 10 | 240 | 76 | 10 | 760 |
| 18 April | 38 | 12 | 456 | | | | 114 | 10.67 | 1,216 |
| 20 April | | | | 50 | 10.67 | 533 | 64 | 10.67 | 683 |
| 23 April | | | | 35 | 10.67 | 373 | 29 | 10.67 | 310 |
| 28 April | 20 | 13 | 260 | | | | 49 | 11.63 | 570 |
| Totals | 58 | | 716 | 109 | | 1,146 | 49 | | 570 |

- (b) (i) recording of an issue at too high a level.
 (iii) recording of a receipt at too low a level.



Solution 12

- (a) R Ltd: profit and loss and appropriation accounts for years ended 31 December

| | <i>1994</i> | <i>1995</i> | <i>1996</i> |
|-----------------------|-------------|-------------|-------------|
| | <i>£000</i> | <i>£000</i> | <i>£000</i> |
| Net profit before tax | 32 | 46 | 14 |
| Taxation | <u>—</u> | <u>(5)</u> | <u>(6)</u> |
| Net profit after tax | 32 | 41 | 8 |
| Transfers to reserves | — | (18) | — |
| Dividends | <u>(5)</u> | <u>(10)</u> | <u>(10)</u> |
| Profit/(loss) | <u>27</u> | <u>13</u> | <u>(2)</u> |

- (b) R Ltd: capital sections of balance sheets at years ended 31 December

| | <i>1994</i> | <i>1995</i> | <i>1996</i> |
|---------------------------------|-------------|-------------|-------------|
| | <i>£000</i> | <i>£000</i> | <i>£000</i> |
| Share capital | 100 | 100 | 100 |
| Share premium account | 60 | 60 | 60 |
| General reserve account | — | 18 | 18 |
| Profit and loss account balance | <u>27</u> | <u>40</u> | <u>38</u> |
| | <u>187</u> | <u>218</u> | <u>216</u> |

- (c) Debtors collection periods:

$$(i) \text{ Debtors' collection period} = \frac{\text{Closing debtors}}{\text{Credit sales}} \times 365$$

$$(ii) \text{ For 1994: } \frac{40}{360} \times 365 = 41 \text{ days}$$

$$\text{For 1995: } \frac{45}{325} \times 365 = 44 \text{ days}$$

$$\text{For 1996: } \frac{52}{390} \times 365 = 49 \text{ days}$$

Creditors' payment periods:

$$(iii) \text{ Creditors' payment period} = \frac{\text{Closing creditors}}{\text{Credit purchases}} \times 365$$

$$(iv) \text{ For 1994: } \frac{33 - 5}{230} \times 365 = 44 \text{ days}$$

$$\text{For 1995: } \frac{45 - 5 - 10}{250} \times 365 = 44 \text{ days}$$

$$\text{For 1996: } \frac{43 - 6 - 10}{280} \times 365 = 36 \text{ days}$$

- (d) The company appears to be *increasing* the length of credit given to customers, which *slows down* the receipt of cash. At the same time it is *decreasing* the length of credit from suppliers, which *speeds up* the payment of cash. These two actions combined will cause the amount of cash available to *decrease*. If these payment periods could be brought more into line with each other, the amount of overdraft required will be *lower*.



Solution 13

- (a) APW Ltd: manufacturing account for year ended 30 April 1998

| | | |
|--|--------------|--------------|
| | £000 | £000 |
| Opening stock of raw material | | 234 |
| Purchases of raw material | 785 | |
| Carriage inwards | 40 | |
| Returns outwards | <u>(65)</u> | |
| | | 760 |
| | | <u>994</u> |
| Closing stock of raw material | | <u>(256)</u> |
| Cost of raw material consumed | | 738 |
| Direct wages (372 + 37) | | 409 |
| Prime cost | | 1,147 |
| Indirect factory labour (118 + 15) | 133 | |
| Indirect factory overheads | 63 | |
| Heat, light and power 40% (120 + 15) | 54 | |
| Rent, rates and insurance 30% (130 - 10) | 36 | |
| Depreciation of factory plant (10% × 1,200) | 120 | |
| Depreciation of buildings 40% (3,500 × 5%) | <u>70</u> | |
| | | 476 |
| | | <u>1,623</u> |
| Add: Opening work in progress | 182 | |
| Less: Closing work in progress | <u>(118)</u> | |
| | | 64 |
| Cost of production transferred to finished goods stock | | <u>1,687</u> |

(b) APW Ltd: trading and profit and loss appropriation account for year ended 30 April 1998

| | | |
|---|--------------|----------------|
| | £000 | £000 |
| Sales | | 2,660 |
| Returns inwards | | <u>(104)</u> |
| | | 2,556 |
| Opening stock of finished goods | 98 | |
| Production costs | <u>1,687</u> | |
| | 1,785 | |
| Closing stock of finished goods (123 – 8) | <u>(115)</u> | |
| | | <u>(1,670)</u> |
| Gross profit | | 886 |
| Interest received | | <u>12</u> |
| | | 898 |
| Carriage outwards | 20 | |
| Administration expenses | 55 | |
| Debenture interest (20 + 20) | 40 | |
| Bank interest paid | 10 | |
| Office salaries (130 + 27) | 157 | |
| Heat, light and power (60% × 135) | 81 | |
| Rent, rates and insurance (70% × 120) | 84 | |
| Depreciation of buildings 60% (5% × 3,500) | 105 | |
| Depreciation of office equipment (20% × 200) | 40 | |
| Depreciation of delivery vehicles (20% × 600) | <u>120</u> | |
| | | <u>(712)</u> |
| Profit before tax | | 186 |
| Provision for taxation | | <u>(80)</u> |
| Profit after tax | | 106 |
| Profit and loss account b/f | | <u>580</u> |
| | | 686 |
| Dividends – Preference paid | 14 | |
| Dividends – Preference proposed | 14 | |
| Ordinary paid | 50 | |
| Ordinary proposed | <u>90</u> | |
| | | <u>(168)</u> |
| Balance c/f | | <u>518</u> |

(c) The two principal accounting concepts that affect the valuation of stock are the prudence and the matching (or accruals) concepts.

As regards the prudence concept, it is generally accepted that stock should be valued at the lower of cost or realisable value. Thus, one of the products (Beta) in the stock list has been valued at less than original cost. Therefore, APW Ltd is expected under the prudence concept to make provision for the loss, via a stock write-down, that is, anticipate losses, but not take profits until they are reasonably certain. In accordance with the matching concept, the cost of stock sold in the accounting period is matched against the revenue generated from the sale of such stock. Any stock unsold in the period is carried forward as a current asset into the next period. In fact, the concept also applies to the valuation of such stock, that is, it is to be valued at the cost of getting the stock into a saleable condition, which in the case of a manufacturing company such as APW Ltd will include both variable and fixed production costs. While the above two concepts are the main ones involved, the consistency concept would also apply. The stock valuation method used by APW Ltd should be applied consistently from one period to another. In most cases, such a company would use the FIFO stock valuation method.



Solution 14

(a)

| FLS Ltd – bank account for the year ended 30 September 1998 | | | |
|---|---------------|-------------------------------------|---------------|
| | <i>£000</i> | | <i>£000</i> |
| Receipts | 13,300 | Balance b/fwd | 520 |
| Balance c/fwd | 895 | Payments | 7,525 |
| | | Selling and distribution costs paid | 2,750 |
| | | Administration costs paid | 2,400 |
| | | Ordinary dividend paid | 200 |
| | | Last year's dividend paid | 300 |
| | | Loan interest paid | 400 |
| | | Corporation tax paid | 100 |
| | <u>14,195</u> | | <u>14,195</u> |

(b) FLS Ltd: trial balance at 30 September 1998

| | <i>£000</i> <i>Debit</i> | <i>£000</i> <i>Credit</i> |
|--|-----------------------------|------------------------------|
| Profit and loss account balance | | 600 |
| Revaluation reserve | | 1,250 |
| Stock at 30 September 1997 | 1,250 | |
| Land at valuation | 5,800 | |
| Buildings at cost | 3,800 | |
| Plant at cost | 2,800 | |
| Provision for depreciation of buildings at 30 September 1997 | | 800 |
| Provision for depreciation of plant at 30 September 1997 | | 600 |
| Goodwill | 2,000 | |
| Long-term loan | | 8,000 |
| Provision for doubtful debts at 30 September 1997 | | 80 |
| Sales | | 14,000 |
| Purchases | 7,400 | |
| Returns outwards | | 75 |
| Selling and distribution costs | 2,750 | |
| Administration costs (2,400 + 100) | 2,500 | |
| Bad debts written off | 200 | |
| Dividends | 200 | |
| Loan interest (half year) | 400 | |
| Debtors | 2,350 | |
| Creditors | | 850 |
| Bank account | | 895 |
| Share capital – ordinary | | 3,000 |
| Share premium account | | 300 |
| Share capital – preference | | 1,000 |
| | <u>31,450</u> | <u>31,450</u> |

(c) FLS Ltd: trading and profit and loss account for year ended 30 September 1998

| | £000 | £000 | £000 |
|--|-------------|----------------|----------------|
| Sales (14,000 – 100) | | | 13,900 |
| Opening stock | | 1,250 | |
| Purchases | 7,400 | | |
| Returns outwards | <u>(75)</u> | | |
| | | 7,325 | |
| | | <u>8,575</u> | |
| Closing stock | | <u>(1,450)</u> | |
| | | | <u>(7,125)</u> |
| Gross profit | | | 6,775 |
| Selling and distribution costs (2,750 – 50) | | 2,700 | |
| Administration costs (2,500 + 25) | | 2,525 | |
| Bad debts written off | | 200 | |
| Loan interest (400 + 400) | | 800 | |
| Depreciation of buildings (2% of 3,800) | | 76 | |
| Depreciation of plant 5% (2,800 – 600) | | <u>110</u> | |
| | | | <u>(6,411)</u> |
| | | | 364 |
| Add reduction in provision for bad debts (80 – 47) | | | <u>33</u> |
| Profit before tax | | | 397 |
| Provision for corporation tax | | | <u>(140)</u> |
| Profit after tax | | | 257 |
| Provision for preference dividend | | 50 | |
| Interim ordinary dividend paid | 200 | | |
| Provision for final ordinary dividend | <u>600</u> | | |
| | | <u>800</u> | |
| | | | <u>(850)</u> |
| Retained loss for the year | | | <u>(593)</u> |
| Profit and loss a/c brought forward | | | 600 |
| Profit and loss a/c carried forward | | | <u>7</u> |

(d) Analysis of total capital employed

| | £ |
|--------------------------|---------------|
| Ordinary share capital | 3,000 |
| Share premium | 300 |
| Preference share capital | 1,000 |
| Revaluation reserve | 1,250 |
| Profit and loss account | <u>7</u> |
| Shareholders' funds | <u>5,557</u> |
| Long-term loan | 8,000 |
| Total capital employed | <u>13,557</u> |

$$\text{Gearing ratio} = \frac{\text{Loan capital}}{\text{Total capital}} \times 100 = \frac{8,000}{13,557} \times 100 = 59\%$$

**Solution 15**

(a) Ledger accounts

| | | <i>Debit</i> | <i>Credit</i> | <i>Balance</i> |
|--------------------------|-------------------|--------------|---------------|----------------|
| | | £ | £ | £ |
| <i>P Blunt</i> | | | | |
| October 1 | Balance b/f | | | 1,250 cr |
| October 4 | Purchase daybook | | 7,050 | 8,300 cr |
| October 4 | Cash book | 1,225 | | 7,075 cr |
| October 4 | Discount received | 25 | | 7,050 cr |
| October 15 | Purchase daybook | | 14,100 | 21,150 cr |
| October 28 | Returns out book | 705 | | 20,445 cr |
| <i>J Hall</i> | | | | |
| October 1 | Balance b/f | | | 150 cr |
| October 21 | Petty-cash book | 150 | | NIL |
| <i>J Bolton</i> | | | | |
| October 3 | Returns out book | 2,350 | | 2,350 dr |
| October 11 | Purchase daybook | | 35,250 | 32,900 cr |
| <i>Z Rhawandala</i> | | | | |
| October 13 | Purchase daybook | | 5,875 | 5,875 cr |
| <i>VAT</i> | | | | |
| October 31 | Purchase daybook | 9,275 | | 9,275 dr |
| October 31 | Returns out book | | 455 | 8,820 dr |
| October 31 | Cash sales | | 9,100 | 280 cr |
| <i>Sales</i> | | | | |
| October 31 | Cash sales | | 52,000 | 52,000 cr |
| <i>Purchases</i> | | | | |
| October 31 | Purchase daybook | 53,000 | | 53,000 dr |
| <i>Returns outwards</i> | | | | |
| October 31 | Returns out book | | 2,600 | 2,600 cr |
| <i>Postage</i> | | | | |
| October 31 | Petty-cash book | 116 | | 116 dr |
| <i>Discount received</i> | | | | |
| October 4 | P Blunt | | 25 | 25 cr |
| <i>Travel</i> | | | | |
| October 31 | Petty-cash book | 230 | | 230 dr |

- (b) (i) Office equipment should have been debited to a fixed-asset account.
(ii) The profit will have been understated by £5,000 less any depreciation charge.

**Solution 16**

(a) Calculation of operating profit

| | |
|----------------------------|-------------------|
| | <i>£000</i> |
| Gross profit | 239 |
| Expenses | (159) |
| Net profit | <u>80</u> |
| Add back interest | 30 |
| Add back loss on disposal | 10 |
| Therefore operating profit | <u><u>120</u></u> |

Net cash inflow from operating activities

| | |
|---------------------------------|-------------|
| | <i>£000</i> |
| Operating profit | 120 |
| Add back depreciation (50 + 25) | 75 |
| Decrease in stock | 100 |
| Increase in debtors | (20) |
| Decrease in creditors | <u>(67)</u> |
| | <u>208</u> |

Purchase cost of fixed assets

| | | | |
|-----------------------------|-----------------|--------------|------------------|
| | <i>Premises</i> | <i>Plant</i> | |
| | <i>£000</i> | <i>£000</i> | |
| Book value 31 December 1998 | 1,200 | 800 | |
| Book value 31 December 1997 | (1,170) | (700) | |
| Depreciation charge | 25 | 50 | |
| Disposal – cost | – | 85 | |
| Disposal – accum. depn | – | <u>(25)</u> | |
| Purchases | <u>55</u> | <u>210</u> | (total £265,000) |

AMS Ltd: cash-flow statement for the year ended 31 August 1998

| | | |
|--|--------------|--------------|
| | <i>£000</i> | <i>£000</i> |
| Net cash inflow from operating activities (note 1) | | 208 |
| Returns on investments and servicing of finance | | |
| Interest paid | | (30) |
| Corporation tax paid | | (12) |
| Capital expenditure | | |
| Payments to acquire tangible fixed assets | (265) | |
| Receipts from sale of tangible fixed assets | <u>50</u> | |
| | | <u>(215)</u> |
| | | (49) |
| Equity dividends paid | | (11) |
| Financing | | |
| Issue of ordinary shares (500 + 100) | 600 | |
| Repayment of long-term loans | <u>(200)</u> | |
| | | <u>400</u> |
| Increase in cash | | <u>340</u> |

- (b) (i) It shows inflows and outflows of cash during the period. It reconciles opening and closing cash balances.
- (ii) The profit and loss account includes non-cash items, and excludes cash involved in capital transactions.



Solution 17

(a) BAK plc: trading and profit and loss account for the year ended 30 April 1999

| | | | |
|--|------------|----------------|----------------|
| | £000 | £000 | £000 |
| Sales | | | 19,620 |
| Returns inwards | | | <u>(320)</u> |
| | | | 19,300 |
| Cost of sales | | | |
| Opening stock | | 1,420 | |
| Purchases | 7,390 | | |
| Carriage inwards | <u>240</u> | | |
| | | 7,630 | |
| | | <u>9,050</u> | |
| Closing stock | | <u>(1,280)</u> | |
| | | | <u>(7,770)</u> |
| Gross profit | | | 11,530 |
| Research and development expenses (846 – 396) | 450 | | |
| Distribution costs | 2,860 | | |
| Administration costs | 970 | | |
| Salaries and wages | 1,310 | | |
| Printing, stationery and adverts (900 – 150) | 750 | | |
| Premises costs (310 – 80) | 230 | | |
| Loan interest (100 + 100) | 200 | | |
| Loss on disposal of fixed assets | 50 | | |
| Reduction in provision for doubtful debts (102 – 62) | (40) | | |
| Bonuses owing (2% of 19,300) | 386 | | |
| Depreciation of vehicles (20% of 6,000) | 1,200 | | |
| Depreciation of office equipment (10% of 1,200) | 120 | | |
| Amortisation of goodwill | 250 | | |
| Auditors' fees (accrual) | <u>115</u> | | |
| | | | <u>(8,851)</u> |
| Profit for the year before taxation | | | 2,679 |
| Provision for corporation tax | | | <u>(900)</u> |
| Profit for the year after taxation | | | 1,779 |
| Dividends: | | | |
| Ordinary – paid | 120 | | |
| – proposed | 224 | | |
| Preference – proposed | <u>40</u> | | |
| | | | (384) |
| Transfer to general reserves | | | <u>(1,000)</u> |
| Retained profit for the year | | | 395 |
| Profit and loss account balance b/f | | | 420 |
| Profit and loss account balance c/f | | | <u>815</u> |

(b) BAK plc: balance sheet at 30 April 1999

| | <i>£000</i> <i>Cost</i> | <i>£000</i> <i>Depreciation</i> | <i>£000</i> <i>NBV</i> |
|---|----------------------------|------------------------------------|---------------------------|
| Fixed assets | | | |
| Tangibles | | | |
| Office equipment | 1,200 | 480 | 720 |
| Vehicles | 6,000 | 2,200 | 3,800 |
| | <u>7,200</u> | <u>2,680</u> | 4,520 |
| Intangibles | | | |
| Goodwill | | 750 | |
| Development expenditure | | <u>396</u> | |
| | | | 1,146 |
| | | | <u>5,666</u> |
| Current assets | | | |
| Stock of goods | 1,280 | | |
| Stock of advertising material | 150 | | |
| Debtors (3,100 – 62) | 3,038 | | |
| Prepayments | 80 | | |
| Bank | <u>2,476</u> | | |
| | | 7,024 | |
| Creditors: amounts due within one year | | | |
| Creditors | 1,770 | | |
| Loan | 1,000 | | |
| Accruals (115 + 100 + 386) | 601 | | |
| Corporation tax owing | 900 | | |
| Dividends owing (224 + 40) | <u>264</u> | | |
| | | <u>(4,535)</u> | |
| Net current assets | | | 2,489 |
| | | | <u>8,155</u> |
| Creditors: amounts due after more than one year | | | |
| Loan | | | <u>(1,000)</u> |
| | | | <u>7,155</u> |
| Capital and reserves | | | |
| Ordinary share capital | | | 3,200 |
| Preference share capital | | | 800 |
| Share premium account | | | 640 |
| General reserves (700 + 1,000) | | | 1,700 |
| Profit and loss account balance | | | <u>815</u> |
| | | | <u>7,155</u> |



Solution 18

(a)

Sales ledger control account

| | | | |
|---------------------|----------------|-----------------------|----------------|
| Balance b/fwd | £ 184,650 | Returns inwards | £ 13,240 |
| Credit sales | 330,445 | Received from debtors | 320,045 |
| Refunds to debtors | 8,255 | Discounts allowed | 2,115 |
| Dishonoured cheques | 8,395 | Bad debts written off | 3,450 |
| | | Contras | 2,420 |
| | | Balance c/fwd | <u>190,475</u> |
| | <u>531,745</u> | | <u>531,745</u> |
| Balance b/fwd | 190,475 | | |

| Purchase ledger control account | | | |
|---------------------------------|----------------|------------------|----------------|
| | £ | | £ |
| Returns outwards | 27,490 | Balance b/fwd | 142,320 |
| Payments to creditors | 196,360 | Credit purchases | 215,965 |
| Discounts received | 1,430 | | |
| Contras | 2,420 | | |
| Balance c/fwd | <u>130,585</u> | | |
| | <u>358,285</u> | | <u>358,285</u> |
| | | Balance b/fwd | 130,585 |

(b) Reconciliation

| | <i>Debtors</i> | | <i>Creditors</i> |
|-------------------------|----------------|------------------------|------------------|
| | £ | | £ |
| Control account totals | <u>190,475</u> | | <u>130,585</u> |
| Ledger account totals | 192,120 | | 134,290 |
| Adjustment re note (iv) | <u>(1,645)</u> | Adjustment re note (v) | <u>(1,600)</u> |
| | <u>190,475</u> | | <u>132,690</u> |

From this we can see that there would appear to be an error within the purchase ledger or its control account, as they do not agree.

(c) Other internal controls that could be used are:

- (i) Independent preparation of a bank reconciliation statement on a regular basis;
- (ii) Regular preparation of a trial balance to confirm arithmetical accuracy of the ledger accounts;
- (iii) Segregation of duties so that no one person is involved in a complete process.

**Solution 19**

(i) Profit ratios

| | | |
|---|--|---|
| $\frac{\text{Gross profit}}{\text{Sales}} \times 100$ | $\frac{6,700}{25,000} \times 100 = 26.8\%$ | $\frac{12,300}{28,000} \times 100 = 43.9\%$ |
| $\frac{\text{Gross profit}}{\text{Cost of sales}} \times 100$ | $\frac{6,700}{18,300} \times 100 = 36.6\%$ | $\frac{12,300}{15,700} \times 100 = 78.3\%$ |
| $\frac{\text{Net profit}}{\text{Sales}} \times 100$ | $\frac{2,500}{25,000} \times 100 = 10\%$ | $\frac{6,100}{28,000} \times 100 = 21.8\%$ |
| $\frac{\text{Gross profit}}{\text{Average capital}} \times 100$ | $\frac{2,500}{19,200} \times 100 = 13\%$ | $\frac{6,100}{23,250} \times 100 = 26.2\%$ |

(ii) Liquidity ratios

| | | |
|---|--------------------------|--------------------------|
| Current assets : current liabilities | 6,100 : 3,900 = 1.6 : 1 | 8,000 : 4,700 = 1.7 : 1 |
| Current assets less stock : current liabilities | 3,800 : 3,900 = 0.97 : 1 | 3,200 : 4,700 = 0.68 : 1 |

(iii) Efficiency ratios

Stockturn in days:

$$\frac{\text{Average stock}}{\text{Cost of sales}} \times 365 \quad \frac{2,250}{18,300} \times 365 = 45 \text{ days} \quad \frac{2,550}{15,700} \times 365 = 59 \text{ days}$$

Debtor collection period:

$$\frac{\text{Debtors}}{\text{Sales}} \times 365 \quad \frac{2,500}{25,000} \times 365 = 37 \text{ days} \quad \frac{3,200}{28,000} \times 365 = 42 \text{ days}$$

Creditor payment period:

$$\frac{\text{Creditors}}{\text{Purchases}} \times 365 \quad \frac{3,900}{18,400} \times 365 = 77 \text{ days} \quad \frac{3,600}{16,200} \times 365 = 81 \text{ days}$$

$$\frac{\text{Expenses}}{\text{Sales}} \times 100 \quad \frac{4,200}{25,000} \times 100 = 16.8\% \quad \frac{6,200}{28,000} \times 100 = 22.1\%$$

**Solution 20****Workings**

1.

| Reconstruction of JB cash book | | | |
|--------------------------------|----------------|-----------------------|----------------|
| | £ | | £ |
| Capital introduced | 22,000 | Balance b/f | 8,850 |
| Receipts from debtors | 427,500 | Cash withdrawn: Wages | 6,750 |
| | <u>449,500</u> | Purchases | 4,200 |
| | | Advertising | 2,600 |
| | | Drawings | 8,900 |
| Therefore, balancing figure | | Loan repayments | 20,000 |
| Cash sales | 10,160 | Payments to creditors | 175,600 |
| Less: wages | <u>(1,560)</u> | | |
| | 8,600 | Rent | 22,000 |
| | | Wages | 90,000 |
| | | General expenses | 12,500 |
| | | Balance c/d | <u>106,700</u> |
| | <u>458,100</u> | | <u>458,100</u> |

2. Calculation of credit sales

| | £ | |
|----------------------|----------------|------------------|
| Receipts | 427,500 | |
| Less opening debtors | (32,500) | (35,000 – 2,500) |
| Add closing debtors | <u>22,300</u> | |
| | <u>417,300</u> | |

3. Calculation of credit purchases

| | £ | |
|------------------------|----------------|------------------|
| Payments | 175,600 | |
| Less opening creditors | (13,300) | (17,600 – 4,300) |
| Add closing creditors | <u>12,200</u> | |
| | <u>174,500</u> | |

4. Calculation of closing debtors

| | |
|------------------------------|-----------------|
| | £ |
| | 22,300 |
| Less bad debt 80% of £16,000 | <u>(12,800)</u> |
| | <u>9,500</u> |

5. Office equipment:

Original cost $\frac{45,000}{100} \times 10 = 50,000$

Therefore depreciation = £5,000 p.a.

(a) JB: trading and profit and loss account for the year ended 31 December 1995

| | £ | £ | £ |
|--|--------------|-----------------|------------------|
| Credit sales (W2) | | | 417,300 |
| Cash sales | | | <u>10,160</u> |
| | | | 427,460 |
| Opening stock | | 30,500 | |
| Credit purchases (W3) | 174,500 | | |
| Cash purchases | <u>4,200</u> | | |
| | | 178,700 | |
| | | <u>209,200</u> | |
| Closing stock | | <u>(27,850)</u> | |
| | | | <u>(181,350)</u> |
| Gross profit | | | 246,110 |
| Wages (6,750 + 90,000 + 1,560 - 4,300 + 5,250) | | 99,260 | |
| Advertising expenses ($\frac{£2,600}{21}$) | | 1,300 | |
| Loan interest | | 9,500 | |
| Rent (22,000 + 2,500 - 2,700) | | 21,800 | |
| General expenses | | 12,500 | |
| Bad debt written off (W4) | | 12,800 | |
| Depreciation | | | |
| P&E (20% × 128,000) | | 25,600 | |
| Vehicle (25% × 5,000) | | 1,250 | |
| Office equipment (W5) | | <u>5,000</u> | |
| | | | <u>(189,010)</u> |
| | | | <u>57,100</u> |

(b) JB: balance sheet at 31 December 1995

| | | | |
|-----------------------------|----------------|-----------------|-----------------|
| Fixed assets | £ | £ | £ |
| Plant and machinery | | | 102,400 |
| Office equipment | | | 40,000 |
| Vehicle | | | <u>3,750</u> |
| | | | 146,150 |
| Current assets | | | |
| Stock | 27,850 | | |
| Debtors (W4) | 9,500 | | |
| Prepayments (2,700 + 1,300) | 4,000 | | |
| Bank (W1) | <u>106,700</u> | | |
| | | 148,050 | |
| Current liabilities | | | |
| Creditors | 12,200 | | |
| Accruals | <u>5,250</u> | | |
| | | <u>(17,450)</u> | |
| | | | 130,600 |
| | | | <u>276,750</u> |
| Long-term loan | | | <u>(84,500)</u> |
| | | | <u>192,250</u> |
| Financed by | | | |
| Capital at 1 January 1995 | | | 117,050 |
| Add: Capital introduced | | | 27,000 |
| Add: profit | | | 57,100 |
| Less: drawings | | | <u>(8,900)</u> |
| | | | <u>192,250</u> |



Solution 21

(a) Calculation of loss on disposal

| | |
|---|----------------|
| | £000 |
| Calculation of loss/profit on disposal: | |
| Cumulative depreciation at 30 June 1996 | 2,300 |
| Less: Charge for the year | <u>(255)</u> |
| | 2,045 |
| Cumulative depreciation at 30 June 1995 | <u>(2,100)</u> |
| Therefore, cumulative depreciation relating to disposal | <u>(55)</u> |
| Proceeds | 145 |
| NBV (230 – 55) | 175 |
| Therefore, loss on disposal | <u>(30)</u> |

(b) Calculation of net cash outflow from operating activities

| | |
|---------------------------------|--------------|
| | £000 |
| Operating profit (250 + 30) | 280 |
| Add back: Depreciation for year | 255 |
| Increase in stocks | <u>(350)</u> |
| Decrease in debtors | 135 |
| Decrease in creditors | <u>(650)</u> |
| | <u>(330)</u> |

(c) SH Ltd: cash-flow statement for year ended 30 June 1996

| | | |
|--|-------|--------------|
| | £000 | £000 |
| Net cash outflow from operating activities | | (330) |
| Returns on investment and service of finance | | |
| Dividends paid | | (75) |
| Investing activities | | |
| Purchase of fixed assets (3,000 – 230) – 3,500 | (730) | |
| Sale of fixed assets | 145 | |
| | | <u>(585)</u> |
| Net cash outflow before financing | | (990) |
| Financing | | |
| Proceeds from share issue | | 800 |
| Decrease in cash or cash equivalents | | <u>(190)</u> |

(d) Calculation of ratios

| | | | | |
|------------------------------|---------------|-------------|---------------|-------------|
| | | <i>1995</i> | | <i>1996</i> |
| <i>Current ratio</i> | | | | |
| CA : CL | 8,375 : 5,075 | 1.65 : 1 | 8,400 : 4,430 | 1.90 : 1 |
| <i>Liquid or quick ratio</i> | | | | |
| CA less stock : CL | 7,550 : 5,075 | 1.49 : 1 | 7,225 : 4,430 | 1.63 : 1 |



Solution 22

Updating the cash book for items found on the bank statement not entered in books of MTR:

| | | | | |
|----------|---------------------------|--------------|-----------------------------|--------------|
| 16/11/96 | Balance b/fwd | £ 6,368 | Rates | £ 844 |
| | Receipt (credit transfer) | 685 | Bank charges | 130 |
| | | | Debtor a/c (dishon. cheque) | 425 |
| | | | Amended balance | 5,654 |
| | | <u>7,053</u> | | <u>7,053</u> |

Bank reconciliation at 16 November 1996

| | |
|---------------------------------------|--------------|
| | £ |
| Balance as per updated cash book | 5,654 |
| Add: Unpresented cheque | 435 |
| Less: Deposit not yet entered by bank | (1,480) |
| Balance as per bank statement | <u>4,609</u> |

**Solution 23**

(a) TYR Ltd: trading and profit and loss account for the year ended 31 October 1997

| | | | |
|--|-------------|--------------|-------------------|
| | <i>£000</i> | <i>£000</i> | <i>£000</i> |
| Sales (2,569 – 12) | | | 2,557 |
| Cost of sales | | | |
| Opening stock | | 210 | |
| Purchases | 1,745 | | |
| Returns outward | (34) | | |
| Carriage inwards | <u>15</u> | <u>1,726</u> | |
| | | 1,936 | |
| Closing stock (194 + 7) | | <u>(201)</u> | <u>(1,735)</u> |
| Gross profit | | | 822 |
| Administration expenses (264 – 12 + 17) | | 269 | |
| Selling and distribution expenses (292 – 28) | | 264 | |
| Carriage outwards | | 18 | |
| Debenture interest (15 + 15) | | 30 | |
| Depreciation | | | |
| premises (4% of 350) | | 14 | |
| plant & equipment (10% of 220) | | <u>22</u> | <u>(617)</u> |
| Net profit before tax | | | 205 |
| Provision for tax | | | <u>(40)</u> |
| Net profit after tax | | | 165 |
| Dividends | | | |
| Preference paid | 5 | | |
| Preference proposed | <u>5</u> | 10 | |
| Ordinary paid | 15 | | |
| Ordinary proposed | <u>80</u> | <u>95</u> | <u>(105)</u> |
| Retained profit for the year | | | 60 |
| Profit & loss account balance b/d | | | <u>190</u> |
| Profit & loss account balance c/d | | | <u><u>250</u></u> |

(b) TYR Ltd: balance sheet at 31 October 1997

| | <i>£000</i> <i>Cost or valuation</i> | <i>£000</i> <i>Dep'n</i> | <i>£000</i> <i>NBV</i> |
|---|---|-----------------------------|---------------------------|
| Tangible fixed assets | | | |
| Land | 550 | – | 550 |
| Premises | 350 | 34 | 316 |
| Plant and equipment | 220 | 52 | 168 |
| | <u>1,120</u> | <u>86</u> | <u>1,034</u> |
| Intangible fixed assets | | | |
| Patents and trademarks | 200 | – | 200 |
| | <u>1,320</u> | <u>86</u> | <u>1,234</u> |
| Current assets | | | |
| Stock (194 + 7) | 201 | | |
| Debtors (875 – 12) | 863 | | |
| Prepayments (12 + 28) | 40 | | |
| Cash | <u>12</u> | | |
| | | 1,116 | |
| Creditors – amount falling due for payment within 12 months | | | |
| Creditors | 318 | | |
| Bank | 85 | | |
| Accrued expenses (17 + 15) | 32 | | |
| Provision for tax | 40 | | |
| Proposed dividends (5 + 80) | <u>85</u> | | |
| | | <u>(560)</u> | |
| Net current assets | | | 556 |
| Creditors – amount falling due for payment after 12 months | | | 1,790 |
| 12% debentures (2010) | | | <u>(250)</u> |
| | | | <u>1,540</u> |
| Capital and reserves | | | |
| Share capital | | | 1,000 |
| Share premium | | | 100 |
| Revaluation reserve account (135 + 55) | | | 190 |
| Profit and loss account | | | <u>250</u> |
| | | | <u>1,540</u> |

(c) (i) Gross profit mark-up:

$$\frac{\text{Gross profit}}{\text{Cost of sales}} \times 100 = \frac{822}{1,735} \times 100 = 47.4\%$$

This is lower than in the previous year. It may be due to increased price competition in the marketplace; a deliberate policy of offering tighter margins to improve volume of sales; or that the company has been less efficient in purchasing.

(ii) Net profit percentage:

$$\frac{\text{Net profit}}{\text{Sales}} \times 100 = \frac{205}{2,557} \times 100 = 8\%$$

This is much better than last year and would suggest that the company is deriving the benefits of economies of scale. Quite clearly, costs have risen at a lower rate than that of the revenue.

(iii) Current ratio:

$$\text{Current assets} : \text{current liabilities} = 1,116 : 560 = 2:1$$

This is lower than last year's ratio and perhaps is a sign of increased efficiency in terms of managing the cash-flow cycle. The calculations of the relevant efficiency ratios would give us more information on which to draw conclusions.

(iv) Acid test ratio:

$$\text{Current assets minus stock} : \text{current liabilities} = (1,116 - 201) : 560 = 1.63 : 1$$

This is lower than last year, but may be considered to be unnecessarily high. The company appears to have a high proportion of debtors in relation to the turnover. As stated above, the calculation of the debtor collection period would assist in this evaluation.



Solution 24

(a)

| Cash book | | | | | | | |
|-------------|----------------|-------------|---------------|-------------|-------------------|-------------|---------------|
| <i>Date</i> | <i>Details</i> | <i>Disc</i> | £ | <i>Date</i> | <i>Details</i> | <i>Disc</i> | £ |
| 4/9/97 | A Barton | 20 | 380 | 1/9/97 | Balance b/f | | 347 |
| 8/9/97 | C Dodd | 30 | 1,170 | 10/9/97 | J Swinburn | 60 | 1,140 |
| 22/9/97 | C Dodd | | 799 | 15/9/97 | VAT | | 832 |
| 25/9/97 | F Gray | | 170 | 17/9/97 | P Taylor | 20 | 380 |
| 30/9/97 | Debtors | | 10,500 | 20/9/97 | Motor vehicle a/c | | 9,400 |
| 30/9/97 | Balance c/f | | 12,430 | 20/9/97 | Motor expenses | | 150 |
| | | | | 30/9/97 | Wages | | 2,000 |
| | | | | 30/9/97 | Creditors | | 11,200 |
| | | <u>50</u> | <u>25,449</u> | | | <u>80</u> | <u>25,449</u> |

(b)

| A Barton | | | | | |
|-------------|-------------|------------|-------------|------------------|------------|
| <i>Date</i> | | £ | <i>Date</i> | | £ |
| 1/9/97 | Balance b/f | 400 | 4/9/97 | Bank | 380 |
| 3/9/97 | Sales | 188 | 4/9/97 | Discount allowed | 20 |
| | | | 5/9/97 | Returns inward | 47 |
| | | | 30/9/97 | Balance c/f | 141 |
| | | <u>588</u> | | | <u>588</u> |
| | | | 1/10/97 | Balance b/f | 141 |

| C Dodd | | | | | |
|-------------|-------------|--------------|-------------|------------------|--------------|
| <i>Date</i> | | £ | <i>Date</i> | | £ |
| 1/9/97 | Balance b/f | 1,200 | 8/9/97 | Bank | 1,170 |
| 8/9/97 | Sales | 940 | 8/9/97 | Discount allowed | 30 |
| 12/9/97 | Sales | 423 | 18/9/97 | Returns inward | 141 |
| | | | 22/9/97 | Bank | 799 |
| | | | 30/9/97 | Balance c/f | 423 |
| | | <u>2,563</u> | | | <u>2,563</u> |
| 1/10/97 | Balance b/f | 423 | | | |

| F Gray | | | | | |
|-------------|-------------|------------|-------------|---------------|------------|
| <i>Date</i> | | £ | <i>Date</i> | | £ |
| 1/9/97 | Balance b/f | 340 | 25/9/97 | Bank | 170 |
| | | | 25/9/97 | Bad debts a/c | 170 |
| | | <u>340</u> | | | <u>340</u> |

- (c) Calculation of the provision for doubtful debts on 30 September 1997

| | <i>Total debtors as per schedule</i> | <i>Adjustments</i> | <i>Revised balances</i> | <i>Provision</i> |
|------------------------------|--------------------------------------|--------------------|-------------------------|------------------|
| | £ | £ | £ | £ |
| Current | 12,000 | (60) | 11,940 at 0% | Nil |
| 30–60 days | 7,500 | (200) | 7,300 at 5% | 365 |
| 60–90 days | 3,600 | – | 3,600 at 10% | 360 |
| 90+ days | 1,100 | (240) | 860 at 20% | 172 |
| Revised cumulative provision | | | | <u>897</u> |

Therefore, the provision for doubtful debts account will need to be increased by (credited with) £447 (897 – 450).

- (d) The principal accounting concept involved is the prudence concept.



Solution 25

| | <i>Fixed assets</i> | <i>Working capital</i> | <i>Profit</i> |
|-------|---------------------|------------------------|---------------|
| (i) | No change | No change | No change |
| (ii) | Decrease | Increase | Increase |
| (iii) | No change | Decrease | No change |
| (iv) | No change | Decrease | Decrease |



Solution 26

- (a) A receipts and payments account is a summary of the cash and bank transactions for the relevant period; in essence, it is a summarised cash book.

An income and expenditure account is essentially the same as a profit and loss account. It takes into account prepayments and accruals and distinguishes between capital and revenue items.

- (b) Monarch Sports Club: income and expenditure account for the year ended 30 June 1997

| | | |
|---|------------|---------------|
| Income | £ | £ |
| Annual subscriptions: | | |
| Receipts in year | 18,000 | |
| Add: Subs in advance at 1/7/96 | 1,100 | |
| Less: Subs in arrears at 1/7/96 | (100) | |
| Less: Subs in advance at 30/6/97 | (900) | |
| Add: Subs in arrears at 30/6/97 | <u>300</u> | |
| | | 18,400 |
| Life membership (10% of 3,000) | | 300 |
| Surplus on competitions (7,500 – 4,300) | | 3,200 |
| Entrance fees | | <u>2,500</u> |
| | | 24,400 |
| Expenses | | |
| Bad debts written off (subs from previous year) | 100 | |
| Transport to matches | 3,700 | |
| Coaching fees (2,100 – 150 + 450) | 2,400 | |
| Repairs to equipment | 800 | |
| Loss on disposal of equipment (1,200 – 1,000) | 200 | |
| Depreciation of new equipment (20% of 4,000) | <u>800</u> | |
| | | (8,000) |
| Surplus for year | | <u>16,400</u> |

**Solution 27**

(a) Robert Costello: trading and profit and loss account for the year ended 30 September 1999

| | | |
|--|----------------|------------------|
| | £ | £ |
| Sales (305,000 + 5,500 + 4,800) | | 315,300 |
| Opening stock | 42,500 | |
| Purchases | 180,300 | |
| | <u>222,800</u> | |
| Closing stock | (45,200) | |
| Cost of sales | | <u>(177,600)</u> |
| Gross profit | | 137,700 |
| Loan interest | 3,600 | |
| Rental of shop (24,000 – 6,000) | 18,000 | |
| Rates (3,500 – 1,200) | 2,300 | |
| General office expenses | 8,800 | |
| Heating and lighting (2,400 + 350) | 2,750 | |
| Car tax and insurance | 400 | |
| Wages (18,500 – 15,000 + 3,760) | 7,260 | |
| Depreciation of fixtures and fittings | 1,280 | |
| Depreciation of motor vehicle | 3,000 | |
| Loss on disposal | 1,000 | |
| Stationery | 400 | |
| Petrol | 1,200 | |
| Provision for doubtful debts (3,000 + 2,845) | <u>5,845</u> | |
| | | <u>(55,835)</u> |
| Net profit | | <u>81,865</u> |

(b) Robert Costello: balance sheet at 30 September 1999

| | | | |
|--|---------------|-----------------|-----------------|
| | £ | £ | £ |
| | <i>Cost</i> | <i>Dep'n</i> | <i>NBV</i> |
| Fixed assets | | | |
| Fixtures and fittings | 10,000 | 4,880 | 5,120 |
| Motor vehicle | 15,000 | 3,000 | 12,000 |
| | <u>25,000</u> | <u>7,880</u> | 17,120 |
| Current assets | | | |
| Stock | 45,200 | | |
| Debtors (62,900 – 5,845) | 57,055 | | |
| Payments (6,000 + 1,200) | 7,200 | | |
| Bank | <u>18,500</u> | | |
| | | 127,955 | |
| Creditors: amounts falling due for payment within one year | | | |
| Creditors | 15,200 | | |
| Accrued expenses | 350 | | |
| VAT creditor (4,500 + 840 – 70 – 210) | 5,060 | | |
| Bank loan | <u>12,000</u> | | |
| | | <u>(32,610)</u> | |
| | | | 95,345 |
| | | | <u>112,465</u> |
| Creditors: amounts falling due for payment after one year | | | |
| Bank loan (40,000 – 9,000 – 12,000) | | | <u>(19,000)</u> |
| | | | <u>93,465</u> |
| Capital | | | |
| Balance on 1 October 1998 | | | 26,600 |
| Profit for year | | | 81,865 |
| Drawings | | | <u>(15,000)</u> |
| | | | <u>93,465</u> |

Workings

- (i) Closing stock of £45,200 appears in the trading account as part of the cost of goods sold calculation and in the balance sheet under current assets.
- (ii) Deduct £6,000 from shop rental and include as a prepayment.
- (iii) Half the £2,400 represents a prepayment.
- (iv) Add £350 to heating and lighting and include as an accrual.
- (v) Deduct £15,000 from wages and treat as drawings.
- (vi) Increase sales by £4,800
 Increase VAT a/c by £840
 Increase stationery by £400
 Reduce VAT a/c by £70
 Increase wages by £3,760
 Increase petrol by £1,200
 Reduce VAT a/c by £210.
- (vii) Motor vehicle at cost a/c will now be (21,000 – 8,000 + 2,000), i.e. £15,000.
 The trial balance depreciation figure is to be eliminated.
 There is a loss on disposal of £3,000 – £2,000, i.e. £1,000.
- (viii) The depreciation charge re fixtures and fittings is 20% (£10,000 – £3,600) = £1,280.
 The depreciation charge re the new motor vehicle is 20% of £15,000 = £3,000.
- (ix) Write off £3,000 as a specific provision for doubtful debts and a further 5% (62,900 – 6,000) = £2,845.
- (x) The £12,600 is £9,000 capital repayment, and £3,600 interest paid. Also, next year’s capital repayments of £12,000 are to be treated as a current liability.



Solution 28

(a)

| Capital | | | | | |
|-----------|------------------|--------------|----------|------------------|--------------|
| | | £ | 1/10/99 | Bank | £ |
| | | | | | 20,000 |
| Bank | | | | | |
| 1/10/99 | Capital | £ | 3/10/99 | Rent payable | £ |
| 28/10/99 | P Duncan | 20,000 | 5/10/99 | Office equipment | 1,200 |
| | | 500 | 25/10/99 | A Jones | 5,000 |
| | | | | | 3,000 |
| Purchases | | | | | |
| 2/10/99 | A Jones | £ | | | £ |
| 18/10/99 | A Jones | 3,500 | | | |
| | | 2,400 | | | |
| A Jones | | | | | |
| 15/10/99 | Returns outwards | £ | 2/10/99 | Purchases | £ |
| 25/10/99 | Bank | 500 | 18/10/99 | Purchases | 3,500 |
| 31/10/99 | Balance c/d | 3,000 | | | 2,400 |
| | | 2,400 | | | |
| | | <u>5,900</u> | | | <u>5,900</u> |
| | | | 1/11/99 | Balance b/d | 2,400 |

| Rent payable | | | | | |
|------------------|-------------|--------------|----------|-------------|--------------|
| 3/10/99 | Bank | £ 1,200 | | £ | |
| Office equipment | | | | | |
| 5/10/99 | Bank | £ 5,000 | | £ | |
| Sales | | | | | |
| | | £ | 10/10/99 | P Duncan | |
| | | | | £ 1,750 | |
| P Duncan | | | | | |
| 10/10/99 | Sales | £ 1,750 | 28/10/99 | Bank | |
| | | | 31/10/99 | Balance c/d | |
| | | <u>1,750</u> | | | £ 500 |
| 1/11/99 | Balance b/d | <u>1,250</u> | | | <u>1,250</u> |
| Returns outwards | | | | | |
| | | £ | 15/10/99 | A Jones | |
| | | | | | £ 500 |

(b) Calculation of Tanwir’s closing capital

| | |
|----------------------------|--------------|
| | £ |
| Initial bank deposit | 20,000 |
| Vehicle introduced | 6,000 |
| Petrol payments | 650 |
| Profit for the year | 17,500 |
| Drawings | |
| Cash | (5,000) |
| Private telephone expenses | <u>(450)</u> |

(c) The accounting concept involved is the business entity concept.



Solution 29

(a)

| Date | Quantity | Receipts | | Quantity | Issues | | Balance Quantity | Value |
|---------|----------|----------|---------|------------|---------|--------------|------------------|--------------|
| | | Price £ | Value £ | | Price £ | Value £ | | |
| October | | | | | | | | |
| 1 | 120 | 8 | 960 | | | | 120 | 960 |
| 3 | 180 | 9 | 1,620 | | | | 300 | 2,580 |
| 4 | | | | 120 | 8 | 960 | | |
| | | | | 30 | 9 | 270 | | |
| | | | | <u>150</u> | | <u>1,230</u> | 150 | 1,350 |
| 8 | | | | 80 | 9 | 720 | 70 | 630 |
| 12 | | | | 30 | 9 | 270 | 40 | 360 |
| 18 | 300 | 10 | 3,000 | | | | 340 | 3,360 |
| 22 | | | | 40 | 9 | 360 | | |
| | | | | 60 | 10 | 600 | | |
| | | | | <u>100</u> | | <u>960</u> | 240 | 2,400 |
| 28 | 20 | 10 | 200 | | | | <u>260</u> | <u>2,600</u> |

(b)

| Date | Quantity | Receipts | | Quantity | Issues | | Balance Quantity | Value |
|------|----------|------------|------------|----------|------------|------------|---------------------|--------------|
| | | Price £ | Value £ | | Price £ | Value £ | | |
| 1 | 120 | 8 | 960 | | | | 120 | 960 |
| 3 | 180 | 9 | 1,620 | | | | 300 | 2,580 |
| 4 | | | | 150 | 8.6 | 1,290 | 150 | 1,290 |
| 8 | | | | 80 | 8.6 | 688 | 70 | 602 |
| 12 | | | | 30 | 9.0 | 270 | 40 | 332 |
| 18 | 300 | 10 | 3,000 | | | | 340 | 3,332 |
| 22 | | | | 100 | 9.8 | 980 | 240 | 2,352 |
| 28 | 20 | 9.8 | 196 | | | | <u>260</u> | <u>2,548</u> |

(c) Jay Ltd: trading accounts:

| | FIFO £ | AVCO £ |
|-------------------------------------|--------------|--------------|
| Opening stock | 960 | 960 |
| Purchases (1,620 + 3,000 – 270) | 4,350 | 4,350 |
| | <u>5,310</u> | <u>5,310</u> |
| Closing stock | (2,600) | (2,548) |
| Cost of sales | 2,710 | 2,762 |
| Sales (1,800 + 1,200 + 1,500 – 300) | 4,200 | 4,200 |
| Gross profit | <u>1,490</u> | <u>1,438</u> |



Solution 30

(a) MMM Ltd: profit and loss appropriation accounts

| | £ Year 1 | £ Year 2 |
|----------------------|---------------|---------------|
| Profit before tax | 48,800 | 55,000 |
| Corporation tax | (6,500) | (8,000) |
| Profit after tax | 42,300 | 47,000 |
| Interim dividend | – | (11,700) |
| Final dividend | (18,000) | (19,500) |
| Transfer to reserves | (5,000) | (5,000) |
| Retained profit | <u>19,300</u> | <u>10,800</u> |

(b) MMM Ltd: capital and reserves

| | £ Year 1 | £ Year 2 |
|-------------------------|----------------|----------------|
| Issued share capital | 360,000 | 390,000 |
| Share premium | 144,000 | 159,000 |
| General reserve | 5,000 | 10,000 |
| Profit and loss account | 19,300 | 30,100 |
| | <u>528,300</u> | <u>589,100</u> |

**Solution 31**

(a) EMP plc: trading and profit and loss account for the year ended 31 October 2000

| | <i>£m</i> | <i>£m</i> | <i>£m</i> |
|--|-------------|--------------|--------------|
| Sales | | | 376 |
| Less: returns inwards | | | <u>(16)</u> |
| | | | 360 |
| Cost of sales: | | | |
| Opening stock | | 62 | |
| Purchases | 230 | | |
| Carriage inwards | 1 | | |
| Returns outwards | <u>(12)</u> | | |
| | | 219 | |
| | | <u>281</u> | |
| Closing stock | | <u>(106)</u> | |
| | | | <u>(175)</u> |
| Gross profit | | | 185 |
| Administrative expenses: | | | |
| Wages and salaries (28 + 3) | | 31 | |
| Directors' fees (10 + 2) | | 12 | |
| Telephone costs (12 + 4 - 1) | | 15 | |
| Rent, rates and insurance (8 - 2) | | 6 | |
| Heat and light | | 16 | |
| Printing and stationery | | 12 | |
| Audit fee | | 1 | |
| Bank charges and interest | | 2 | |
| Distribution expenses (24 - 1) | | 23 | |
| Bad debts written off | | 5 | |
| Provision for doubtful debts (decrease)* | | (6) | |
| Depreciation | | | |
| Plant (10% of 250) | | 25 | |
| Office equipment 33.3% (90 - 30) | | <u>20</u> | |
| | | | <u>(162)</u> |
| Net profit before tax | | | 23 |
| Provision for corporation tax | | | <u>(2)</u> |
| Net profit after tax | | | 21 |
| Dividends | | | |
| Interim paid | | 4 | |
| Proposed final | | <u>6</u> | |
| | | | <u>(10)</u> |
| Transfer to general reserves | | | <u>(20)</u> |
| | | | <u>(9)</u> |
| Profit and loss account brought forward | | | 62 |
| Profit and loss account carried forward | | | <u>53</u> |

* Calculation of the decrease in provision for doubtful debts:

| | |
|-------------------------|------------|
| | <i>£m</i> |
| 2.5% of (84 + 1 - 5) = | 2 |
| Brought forward figure | <u>(8)</u> |
| Therefore a decrease of | <u>(6)</u> |

(b) EMP plc: balance sheet at 31 October 2000

| | <i>£m</i> | <i>£m</i> | <i>£m</i> | <i>£m</i> |
|---|------------|-------------|---------------------|------------|
| | | <i>Cost</i> | <i>Depreciation</i> | <i>Net</i> |
| Fixed assets | | | | |
| Plant and machinery | | 250 | 81 | 169 |
| Office equipment | | 90 | 50 | 40 |
| | | <u>340</u> | <u>131</u> | <u>209</u> |
| Current assets | | | | |
| Stock | | 106 | | |
| Debtors | 80 | | | |
| Less: provision | <u>(2)</u> | | | |
| | | 78 | | |
| Prepayments | | 3 | | |
| Bank | | <u>5</u> | | |
| | | | 192 | |
| Creditors – amounts falling due within one year | | | | |
| Trade creditors | | 80 | | |
| Accruals | | 10 | | |
| Corporation tax | | 2 | | |
| Dividends proposed | | <u>6</u> | | |
| | | | <u>(98)</u> | |
| Net current assets | | | | <u>94</u> |
| | | | | <u>303</u> |
| Capital and reserves | | | | |
| Share capital | | | | 200 |
| Share premium | | | | 16 |
| General reserves (14 + 20) | | | 34 | |
| Profit and loss account | | | <u>53</u> | |
| | | | | <u>87</u> |
| | | | | <u>303</u> |

(c) (i) *Acid test or quick ratio:*

Current assets minus stock : current liabilities

$$(192 - 106) : 98 = 0.88 : 1$$

(ii) *Rate of stock turnover:*Cost of sales \div average stock

$$175 \div \frac{62 + 106}{2}$$

$$175 /_{84} = 2.08(175 \text{ days})$$

**Solution 32**

(a) Journal entries

| | | <i>Dr</i> | <i>Cr</i> |
|-------|-------------------------|-----------|-----------|
| | | <i>£</i> | <i>£</i> |
| (i) | Purchases | 6,000 | |
| | J Brown (creditor) | | 6,000 |
| (ii) | Office equipment | 4,000 | |
| | Bad debts | 500 | |
| | P Turner (debtor) | | 4,500 |
| (iii) | Administration expenses | 10,600 | |
| | Bank | | 10,600 |
| (iv) | Debtors | 720 | |
| | Disposal account | | 720 |
| (v) | Wages account | 3,000 | |
| | Wages account (emp. NI) | 130 | |
| | PAYE creditor | | 450 |
| | NI creditor | | 250 |
| | Wages creditor | | 2,430 |

(b) Recalculated net profit

| | |
|-------------------------------|---------------|
| | <i>£</i> |
| Net profit before adjustments | 37,500 |
| Less | |
| Purchases | (6,000) |
| Bad debts | (500) |
| Administration expenses | (10,600) |
| Loss on disposal | (160) |
| Wages accrual | (3,130) |
| Amended net profit | <u>17,110</u> |

(c) (i) Capital expenditure is the acquisition, production or enhancement of fixed assets. Revenue expenditure includes the purchase of goods for resale, and expenditure on goods and services to be consumed during the reporting period.

(ii) **Effect of incorrect treatment**

| | |
|---|----------------|
| | <i>£</i> |
| Amount now deemed to be revenue expenditure | 15,000 |
| Adjustment to depreciation charge * | <u>(1,500)</u> |
| | <u>13,500</u> |

that is, the profit will be £13,500 less than the original amount.

| | |
|---|----------------|
| | <i>£</i> |
| *Original depreciation charge 10% of 25,000 | 2,500 |
| Revised amount 10% of 10,000 | <u>(1,000)</u> |
| | <u>1,500</u> |



Solution 33

| Sales ledger control account | | | |
|------------------------------|----------------|-----------------------|----------------|
| | £ | | £ |
| Balance b/f | 95,760 | Balance b/f | 3,400 |
| Credit sales | 757,875 | Receipts | 729,600 |
| Refunds | 4,385 | Discounts allowed | 2,450 |
| Dishonoured cheques | 15,215 | Returns inwards | 30,315 |
| Bad debt written back | 1,200 | Bad debts written off | 2,875 |
| | | Contra | 5,400 |
| Balance c/f | 5,750 | Balance c/f | 106,145 |
| | <u>880,185</u> | | <u>880,185</u> |



Solution 34

(a)

| Rent, rates and insurance | | | | | |
|---------------------------|-----------------------|---------------|-------|-------------------------|---------------|
| | | £ | | | £ |
| 1/11 | Rates prepaid b/f | 550 | 1/11 | Rent accrued b/f | 700 |
| 1/11 | Insurance prepaid b/f | 400 | 3/1 | Bank – insurance | 80 |
| 1/11 | Bank – rent | 2,100 | 31/10 | Rates prepaid c/f* | 500 |
| 28/12 | Bank – insurance | 3,000 | | Insurance prepaid c/f* | 500 |
| 1/2 | Bank – rent | 2,100 | | Profit and loss account | 12,470 |
| 8/4 | Bank – rates | 1,200 | | | |
| 1/8 | Bank – rent | 4,200 | | | |
| 31/10 | Rent accrued c/f | 700 | | | |
| | | <u>14,250</u> | | | <u>14,250</u> |

* Calculations:

$$\text{Rates prepaid} = \frac{1,200}{12} \times 5 = \text{£}500$$

$$\text{Insurance prepaid} = \frac{3,000}{12} \times 2 = \text{£}500$$

(b) The *prudence concept* stipulates that revenue and profits should not be anticipated. However, expenses, liabilities and losses should be provided for as soon as it is known that an expense has been incurred that relates to the accounting period, or the possibility of a liability or loss exists.

The *accruals (or matching) concept* stipulates that costs and revenues are matched with each other in accordance with the period to which they relate, regardless of the period in which the receipt or payment occurs.

(c) Change in bank balance

| | |
|---------------------------------|----------------------|
| | £ |
| Profit for the year | 47,500 |
| Add back depreciation charge | 8,200 |
| Add back loss on disposal | 1,200 |
| Less: purchase of fixed assets* | (32,800) |
| Sale of fixed assets | 5,400 |
| Increase in debtors | (2,500) |
| Decrease in stocks | 5,200 |
| Increase in creditors | 1,800 |
| Less: drawings | (7,000) |
| Long-term loan paid off | (8,000) |
| Increase in bank balance | <u>19,000</u> |
| *Increase in fixed assets | 18,000 |
| Add back depreciation | 8,200 |
| Add back NBV of disposed assets | <u>6,600</u> |
| Therefore, purchases must be | <u><u>32,800</u></u> |

Certificate Level

Financial Accounting Fundamentals

Mock assessment 1

Illustrative Computer-based Assessment

Instructions: attempt all 40 questions

Time allowed 1½ hours

Do not look at or attempt this illustrative computer-based assessment until you have fully completed your revision and are about to sit your computer-based assessment.

Illustrative computer-based assessment: Questions



Question 1

The fundamental objective of an external audit of a limited company is to:

- (A) give advice to shareholders.
- (B) detect fraud and errors.
- (C) measure the performance and financial position of a company.
- (D) provide an opinion on the financial statements.



Question 2

A receives goods from B on credit terms and A subsequently pays by cheque. A then discovers that the goods are faulty and cancels the cheque before it is cashed by B.

How should A record the cancellation of the cheque in his books?

- (A) Debit creditors, credit returns outwards.
- (B) Credit bank, debit creditors.
- (C) Debit bank, credit creditors.
- (D) Credit creditors, debit returns outwards.



Question 3

The profit of a business may be calculated by using which of the following formulae?

- (A) Opening capital – drawings + capital introduced – closing capital.
- (B) Closing capital + drawings – capital introduced – opening capital.
- (C) Opening capital + drawings – capital introduced – closing capital.
- (D) Closing capital – drawings + capital introduced – opening capital.



Question 4

The turnover in a company was \$3 million and its debtors were 5% of turnover. The company wishes to have a provision for doubtful debts of 4% of debtors, which would make the provision 33% higher than the current provision. What figure would appear in the profit and loss account?

| | |
|---------------|----|
| Debit /Credit | \$ |
|---------------|----|



Question 5

Which of the following should be accounted for as capital expenditure?

- (A) the cost of painting a building.
- (B) the replacement of windows in a building.
- (C) the purchase of a car by a garage for re-sale.
- (D) legal fees on the purchase of a building.

? Question 6

A business purchases a machine on credit terms for \$18,000 plus vat at 15%. The business is registered for VAT. How should this transaction be recorded in the books?

| | <i>Debit</i> | <i>Credit</i> |
|--------------------|--------------|---------------|
| A Machinery | 18,000 | |
| Creditors | | 18,000 |
| B Machinery | 20,700 | |
| Creditors | | 20,700 |
| C Machinery | 18,000 | |
| Vat | 2,700 | |
| Creditors | | 20,700 |
| D Machinery | 20,700 | |
| Vat | | 2,700 |
| Creditors | | 18,000 |

? Question 7

Which of the following statements most closely expresses the meaning of ‘true and fair’?

- (A) There is only one true and fair view of a company’s financial statements
- (B) True and fair is determined by compliance with accounting standards
- (C) True and fair is determined by compliance with company law
- (D) True and fair is largely determined by reference to generally accepted accounting practice.

? Question 8

On 1st May 2000 A Ltd pays a rent bill of \$2,400 for the period to 30th April 2001. What is the charge to the profit and loss account and the entry in the balance sheet for the year ended 30th November 2000?

| Profit and loss account | Accrual or Prepayment | Balance sheet |
|-------------------------|-----------------------|---------------|
| \$ | | \$ |

? Question 9

S Ltd exchanged stock for a delivery vehicle with T Ltd. The stock had cost S Ltd \$12,000 and the normal selling price was \$14,000; the delivery vehicle had cost T Ltd \$11,000 and the normal selling price was \$15,000.

How should S Ltd value the vehicle in its balance sheet?

\$

? Question 10

Z’s bank statement shows a balance of \$1,650 overdrawn. The bank statement includes bank charges of \$100 which have not been entered in the cash book. There are

unpresented cheques totalling \$950 and deposits not yet credited of \$1,200. The bank statement incorrectly shows a direct debit payment of \$320 which belongs to another customer.

The figure in the balance sheet should be:

Overdrawn \$

? Question 11

There is \$200 in the till at the year end at F Ltd but the accountant suspects that some cash has been stolen. At the beginning of the year there was \$100 in the till and debtors were \$2000. Total sales in the year were \$230,000. Debtors at the end of the year were \$3,000. Cheques banked from credit sales were \$160,000 and cash sales of \$50,000 have been banked.

How much cash was stolen during the year?

\$.....

? Question 12

A car was purchased for \$10,000 on 1st April 1997 and has been depreciated at 20% per annum straight line. The company policy is to charge depreciation, once a year at the end of the year, on the cost of an asset in use at the year end. Assume there is no residual value. The car was traded in for a replacement vehicle on 1st August 2000 for an agreed figure of \$4,900. What was the profit or loss on the disposal of the vehicle for the year ended 31st December 2000?

| | |
|----------------|----|
| Profit or Loss | \$ |
|----------------|----|

? Question 13

A company includes in stock goods received before the year end but for which invoices are not received until after the year end. Is this in accordance with:

- (A) the historical cost convention?
- (B) the accruals concept?
- (C) the consistency concept?
- (D) the materiality concept?

? Question 14

I Ltd operates the imprest system for petty cash. At 1st July there was a float of \$250. During July the petty cashier received \$50 from staff for using the photocopier and a cheque for \$100 was cashed for an employee. In July cheques were drawn for \$600 for petty cash. It was decided to increase the cash float to \$180 from the 1st August. How much cash was paid out by the petty cashier in July?

\$.....

? Question 15

Which of the following sentences does NOT explain the distinction between financial and management accounts?

- (A) Financial accounts are primarily for external users and management accounts are primarily for internal users.
- (B) Financial accounts are normally produced annually and management accounts are normally produced monthly.
- (C) Financial accounts are more accurate than management accounts.
- (D) Financial accounts are audited by an external audit and management accounts do not normally have an external audit.

? Question 16

When there is inflation, the historical cost convention has the effect of:

- (A) overstating profits and understating balance sheet values.
- (B) understating profit and overstating balance sheet values.
- (C) understating cash flow and overstating cash in the balance sheet.
- (D) overstating cash flow and understating cash in the balance sheet.

? Question 17

When reconciling the creditors ledger control account with the list of creditors ledger balances of M, the following errors were found: the purchase day book had been overstated by \$600 and the personal ledger of a supplier had been understated by \$200.

What adjustment must be made to correct these errors?

| Control Account | | List of Creditor Balances | |
|-----------------|----|---------------------------|----|
| Debit or Credit | \$ | Increase or Decrease | \$ |
| | | | |

? Question 18

B is a builder with a staff of ten employees. In April 2000 he paid the following amounts:

| | |
|--|----------|
| Net salaries after tax and national insurance | \$16,000 |
| Tax and employees' national insurance for March 2000 | \$7,000 |
| Employer's national insurance for March 2000 | \$3,000 |

He owes \$8,000 for April's tax and employees' national insurance and \$3,500 for April's employer's national insurance. What is the correct expense to be included in April's profit and loss account?

\$.....

? Question 19

The following information relates to M Ltd

| | <i>At 30th September</i> | |
|--|--------------------------|--------------|
| | <i>2000</i> | <i>1999</i> |
| | <i>\$000</i> | <i>\$000</i> |
| Stock of raw materials | 70 | 50 |
| Work in progress | 60 | 70 |
| Stock of finished goods | 100 | 90 |
| For the year ended 30th September 2000 | | |
| Purchases of raw materials | \$165,000 | |
| Manufacturing wages | \$30,000 | |
| Factory overheads | \$40,000 | |

The prime cost of production in the manufacturing account for the year ended 30th September 2000 is:

\$.....

? Question 20

When valuing stock at cost, which of the following shows the correct method of arriving at cost?

| Include Inward Transport Costs | Include Production Overheads |
|--------------------------------|------------------------------|
| Yes or No | Yes or No |

? Question 21

At 30 June 2000 an electricity ledger account had an accrual of \$400 and a credit balance was brought down at 1 July 2000. During the financial year electricity invoices totalling \$5,000 were paid, including an invoice for \$900 for the quarter ended 31 May 2001.

What is the profit and loss account charge for electricity payable for the year ended 30 June 2001?

\$.....

? Question 22

The provision for doubtful debts in the ledger of B Ltd at 31 October 2000 was \$11,000. During the year ended 31 October 2001 bad debts of \$7,000 were written off. Debtor balances at 31 October 2001 were \$140,000 and the company policy is to have a general provision of 5%.

What is the charge for bad and doubtful debts in the profit and loss account for the year ended 31 October 2001?

\$.....

? Question 23

The following is an extract from the balance sheets of IAS plc for the years ended 31 July 2000 and 2001.

| | 2001 | 2000 |
|-----------|-------|-------|
| | \$000 | \$000 |
| Stock | 40 | 90 |
| Debtors | 55 | 10 |
| Creditors | 45 | 30 |
| Accruals | 15 | 20 |

What figure would appear in the cash flow statement of IAS plc for the year ended 31 July 2001 as part of the cash flow from operations?

? Question 24

The stock at SOR Ltd was valued at \$14,000 and excludes goods supplied to a customer on a sale or return basis. The customer still has 30 days within which to return the stock. The goods on sale or return were purchased by SOR Ltd for \$4,000 and were invoiced at a mark-up of 25%.

The value stock at SOR Ltd should be:

\$.....

? Question 25

A trial balance does not balance. Which of the following errors may be the cause of this failure to balance?

- (A) The purchase of a machine had been debited to the machine repairs account.
- (B) A cheque from a customer had been credited to the purchase ledger account of the customer.
- (C) Goods returned inwards had been debited to the sales ledger account of the customer.
- (D) The depreciation charge on machinery had been credited to the cost of machinery account.

? Question 26

S is employed by T Ltd. His pay details for January and February are as follows:

| | | | | |
|-----------|-----------------------|------------|---------------------------|------------------|
| January: | Gross Salary \$2,200; | Tax \$500; | National insurance \$100; | Net pay \$1,600 |
| February: | Gross Salary \$2,500; | Tax \$550; | National insurance \$110; | Net pay \$1,840. |

Tax and national insurance are payable to the government one month after they are deducted from employees' salaries.

How much cash did T Ltd pay out in February in connection with S's wages?

\$.....

? Question 27

Which of the following provides the best definition of an 'audit trail'?

- (A) the marks left by an auditor when a document has been inspected.
- (B) the working papers of an auditor.
- (C) the pursuit of a fraud by an auditor.
- (D) the trail of a transaction from source document to financial statement.

? Question 28

N plc purchased a machine for \$18,000. The transportation costs were \$1,700 and installation costs were \$500. The machine broke down at the end of the first month in use and cost \$400 to repair. N plc depreciates machinery at 10% per annum on cost, assuming no residual value.

What is the net book value of the machine after one year, to the nearest pound?

\$.....

? Question 29

Which of the following might explain the debit balance on a purchase ledger account?

- (A) the company took a cash discount to which they were not entitled and paid less than the amount due.
- (B) the company mistakenly paid too much.
- (C) the book-keeper failed to enter a contra with the sales ledger.
- (D) the book-keeper failed to post a cheque paid to the account.

? Question 30

In a period of inflation, which of the following methods of charging stock issues to production will give the lowest profit figure?

- (A) Average cost.
- (B) LIFO.
- (C) FIFO.
- (D) Replacement cost.

? Question 31

Which of the following provides the best explanation of the objective of an internal audit?

- (A) The objective is to assist the directors of a company in the effective discharge of their financial responsibilities towards the members.
- (B) The objective is to provide support to the external auditor.
- (C) The objective is to detect fraud and error.
- (D) The objective is to audit the financial statements.

? Question 32

The following information at 5 January 2001 relates to a club which has a year end of 31 December 2000

| | |
|--|-------|
| | \$ |
| Subscriptions for 1999 unpaid at January 2000 | 400 |
| Subscriptions for 1999 paid during the year ended 31 December 2000 | 550 |
| Subscriptions for 2000 paid during the year ended 31 December 2000 | 7,000 |
| Subscriptions for 2001 paid during the year ended 31 December 2000 | 2,000 |
| Subscriptions for 2000 unpaid at 31 December 2000 | 850 |

It is the club's policy to write off overdue subscriptions after 1 year.

What amount should be credited to the income and expenditure account for the year ended 31 December 2000?

\$.....

? Question 33

Extracts from the financial statements of ASB Ltd are set out below.

Profit & Loss Account Year Ended 31st December 2000

| | | |
|-------------------------------------|---------------------------|------------|
| | | \$000 |
| Turnover | | 400 |
| Cost of sales | | (175) |
| Gross profit | | 225 |
| Profit on sale of fixed asset | | 80 |
| | | <u>305</u> |
| Expenses | 35 | |
| Depreciation | 40 | 75 |
| Net profit | | <u>230</u> |
| <i>31st December 1999</i> | <i>31st December 2000</i> | |
| | \$000 | \$000 |
| Stock, debtors, current liabilities | 50 | 65 |

What figure would appear in the cash flow statement of ASB Ltd for the year ended 31st December 2000 for cash from operations?

? Question 34

The correct ledger entries to record the issue of 200,000 \$1 Ordinary Shares at a premium of 20% and paid by cheque is:

| | | | |
|----------|---------------|-----------|-----------|
| | | <i>DR</i> | <i>CR</i> |
| | | \$ | \$ |
| A | Bank | 240,000 | |
| | Share capital | | 200,000 |
| | Share premium | | 40,000 |
| B | Bank | 240,000 | |
| | Share premium | | 240,000 |
| C | Bank | 240,000 | |
| | Share capital | | 240,000 |
| D | Bank | 200,000 | |
| | Share premium | | 40,000 |
| | Share capital | | 160,000 |

? Question 35

M plc's trial balance did not balance at 31 May 2001. The following errors were discovered: insurance of \$700 prepaid at 31 May 2000 had not been brought down as an opening balance on the insurance account; wages of \$6,000 had been incorrectly debited to the purchases account; the book-keeper had failed to accrue for the telephone invoice owing at 31 May 2001 of \$400.

What was the difference on the trial balance?

\$.....

? Question 36

S is a builder who has numerous small items of equipment. He calculates his depreciation using the revaluation method. At the beginning of his financial year he valued his equipment at \$11,475; he bought equipment costing \$4,360 and he sold equipment for \$3,257. At the end of his financial year he valued his equipment at \$9,000.

What is his depreciation charge on equipment for the year?

\$.....

? Question 37

The net profit percentage in a company is 9% and the turnover to asset ratio is 3.

What is the return on capital employed?

%

? Question 38

The accounts for SPA plc are set out below.

SPA plc Profit and Loss Account for the Year Ended 30 November 2002

| | | |
|--------------------------|--------------|----------------|
| | <i>\$000</i> | <i>\$000</i> |
| Turnover | | 6,000 |
| Opening stock | 200 | |
| Purchases | 3,100 | |
| Closing stock | <u>(400)</u> | |
| Cost of sales | | <u>(2,900)</u> |
| Gross profit | | 3,100 |
| Operating expenses | | <u>(400)</u> |
| Operating profit | | 2,700 |
| Interest | | <u>(200)</u> |
| Retained profit for year | | <u>2,500</u> |

| SPA plc Balance Sheet at 30 November 2002 | | |
|--|--------------|--------------|
| | <i>\$000</i> | <i>\$000</i> |
| Fixed assets | | 3,500 |
| Current assets | | |
| Stock | 300 | |
| Debtors | 900 | |
| Bank | 50 | |
| | <u>1,250</u> | |
| Current liabilities | | |
| Trade creditors | <u>(450)</u> | <u>800</u> |
| | | <u>4,300</u> |
| Share capital | | 2,200 |
| Profit and loss account | | <u>2,100</u> |
| | | <u>4,300</u> |

The return on capital employed in SPA is:

%

? Question 39

The net asset turnover ratio in SPA is:

: 1

? Question 40

The quick ratio in SPA is:

: 1

Illustrative computer-based assessment: Solutions



Solution 1

Answer: (D)



Solution 2

Answer: (C)



Solution 3

Answer: (B)



Solution 4

| | |
|--|-----------------|
| Turnover \$3 million × 5% gives debtors of | \$150,000 |
| Provision for doubtful debts is 4% × \$150,000 | = \$6,000 |
| Existing provision is \$6,000 × 3/4 | = \$4,500 |
| Change in provision to profit and loss account | = debit \$1,500 |



Solution 5

Answer: (D)



Solution 6

Answer: (C)



Solution 7

Answer: (D)



Solution 8

| | |
|---|---------------------|
| \$2,400 for one year is \$200 per month | |
| Charge to profit and loss account | 7 × \$200 = \$1,400 |
| Prepaid in balance sheet | 5 × \$200 = \$1,000 |



Solution 9

\$14,000



Solution 10

| | | |
|--------------------------|-----------|------------------|
| Bank statement balance | overdrawn | \$(1,650) |
| Unpresented cheques | | \$(950) |
| Outstanding deposits | | \$1,200 |
| Bank error | | \$320 |
| Cash book—credit balance | | <u>\$(1,080)</u> |



Solution 11

| Sales Ledger Control | | | |
|----------------------|----------------|-----------------------------|----------------|
| Opening debtors | 2,000 | Cheques banked credit sales | 160,000 |
| Credit sales | 161,000 | | |
| (balancing figure) | | Closing debtors | 3,000 |
| | <u>163,000</u> | | <u>163,000</u> |

| Cash Account | | | |
|-----------------------|---------------|-----------------|---------------|
| Opening balance | 100 | Cash banked | 50,000 |
| Cash sales | 69,000 | Cash missing | 18,900 |
| (\$230,000—\$161,000) | | Closing balance | 200 |
| | <u>69,100</u> | | <u>69,100</u> |

Cash missing is \$18,900



Solution 12

| | |
|--------------------------------|--------------|
| 1st April 1997 Cost | 10,000 |
| Depreciation charge at 20% | |
| 1997 | 2,000 |
| 1998 | 2,000 |
| 1999 | 2,000 |
| | <u>6,000</u> |
| Net book value 1st August 2000 | 4,000 |
| Proceeds 1st August 2000 | 4,900 |
| Profit | <u>900</u> |



Solution 13

Answer: (B)



Solution 14

| Cash Account | | | |
|------------------|------------|--------------------------------------|------------|
| 1st July bal b/d | 250 | Cash cheque | 100 |
| Photocopying | 50 | Cash paid out | 620 |
| Cash from bank | 600 | (balancing figure) 31st July bal c/d | 180 |
| | <u>900</u> | | <u>900</u> |

Cash paid out \$620

 **Solution 15**

Answer: (C)

 **Solution 16**

Answer: (A)

 **Solution 17**

| Control Account | | List of Creditor Balances | |
|-----------------|-----|---------------------------|-----|
| Debit or Credit | \$ | Increase or Decrease | \$ |
| Debit | 600 | Increase | 200 |

 **Solution 18**

| | |
|---|-----------------|
| Net salaries for April | \$16,000 |
| Employees' national insurance and tax for April | \$8,000 |
| Employer's national insurance | <u>\$3,500</u> |
| | <u>\$27,500</u> |

 **Solution 19**

| | |
|--|-------------------|
| Prime cost is direct materials and direct labour | |
| Opening stock of raw materials | \$50,000 |
| Purchases | \$165,000 |
| Closing stock of raw materials | <u>\$(70,000)</u> |
| Raw materials consumed | \$145,000 |
| Manufacturing wages | <u>\$30,000</u> |
| | <u>\$175,000</u> |

 **Solution 20**

| Include Inward Transport Costs | | Include Production Overheads | |
|--------------------------------|--|------------------------------|--|
| Yes or No | | Yes or No | |
| Yes | | Yes | |

 **Solution 21**

| Electricity Account | | | | | | | |
|---------------------|-----------------------|----|--------------|-------------|---------|----|--------------|
| 31 May 2001 | Invoices | \$ | 5,000 | 1 July 2000 | bal b/d | \$ | 400 |
| 31 May 2001 | Accrual – \$900 × 1/3 | | <u>300</u> | 31 May 2001 | P&L a/c | | <u>4,900</u> |
| | | | <u>5,300</u> | | | | <u>5,300</u> |

Answer is \$4,900

**Solution 22**

| | |
|--|-----------------|
| Debtors $\$140,000 \times 5\% =$ | \$7,000 |
| Provision for doubtful debts at 31 October 2000 | <u>\$11,000</u> |
| Change in provision | (\$4,000) |
| Bad debts written off | <u>\$7,000</u> |
| Profit and loss account | <u>\$3,000</u> |

**Solution 23**

| | |
|---------------------------|--------------|
| | <i>\$000</i> |
| Stock | 50 |
| Debtors | (45) |
| Creditors | 15 |
| Accruals | <u>(5)</u> |
| Cash flow from operations | <u>15</u> |

**Solution 24**

| | |
|---------------------------------|-----------------|
| Stock at valuation | \$14,000 |
| Goods on sale or return at cost | <u>\$4,000</u> |
| Stock valuation | <u>\$18,000</u> |

**Solution 25**

Answer: (C)

**Solution 26**

| | |
|----------------------------|----------------|
| Net pay February | \$1,840 |
| Tax January | \$500 |
| National insurance January | <u>\$100</u> |
| | <u>\$2,440</u> |

**Solution 27**

Answer: (D)

**Solution 28**

| | |
|---------------------|-----------------|
| Cost of machine | \$18,000 |
| Transportation | \$1,700 |
| Installation | <u>\$500</u> |
| | <u>\$20,200</u> |
| Depreciation at 10% | <u>\$2,020</u> |
| Net book value | <u>\$18,180</u> |

**Solution 29**

Answer: (B)

**Solution 30**

Answer: (D)

**Solution 31**

Answer: (A)

**Solution 32**

| | |
|------------------------------|----------------|
| Subscriptions paid for 2000 | \$7,000 |
| Subscriptions owing for 2000 | <u>\$850</u> |
| | <u>\$7,850</u> |

**Solution 33**

| | |
|---------------------------|-------------|
| Net profit | 230 |
| add back: depreciation | 40 |
| less: profit on sale | <u>(80)</u> |
| | 190 |
| Increase working capital | <u>(15)</u> |
| Cash flow from operations | <u>175</u> |

**Solution 34**

Answer: (A)

**Solution 35**

| | |
|---|-------|
| Insurance balance omitted | \$700 |
| Wages mis-posted – not affect trial balance | Nil |
| Accrual omitted – not affect trial balance | Nil |
| Answer is \$700 | |

**Solution 36**

| | |
|--------------------------------|------------------|
| Valuation at beginning of year | \$11,475 |
| Purchases | \$4,360 |
| Disposals | <u>(\$3,257)</u> |
| | \$12,578 |
| Valuation at end of year | <u>(\$9,000)</u> |
| Depreciation | <u>\$3,578</u> |

**Solution 37**

Net profit % \times asset turnover ratio = return on capital employed

$$9\% \times 3 = 27\%$$

**Solution 38**

$$\frac{\text{Operating profit}}{\text{Capital}} = \frac{\pounds 2,700,000}{\pounds 4,300,000} \times 100 = 63\%$$

**Solution 39**

$$\frac{\text{Turnover}}{\text{Net assets}} = \frac{\pounds 6,000,000}{\pounds 4,300,000} \times 100 = 1.39:1$$

**Solution 40**

$$\frac{\text{Debtors} + \text{Bank}}{\text{Current liabilities}} = \frac{\pounds 900,000 + \pounds 50,000}{\pounds 450,000} = 2.11:1$$

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Certificate Level

Financial Accounting Fundamentals

Mock assessment 2

Illustrative Computer-based Assessment

Instructions: attempt all 40 questions

Time allowed 1½ hours

Do not look at or attempt this illustrative computer-based assessment until you have fully completed your revision and are about to sit your computer-based assessment.

Illustrative computer-based assessment: Questions



Question 1

A credit balance of \$800 brought down on X Limited's account in the books of Y Limited means that

- (A) X Limited owes Y Limited \$800.
- (B) Y Limited owes X Limited \$800.
- (C) Y Limited has paid X Limited \$800.
- (D) Y Limited has overpaid X by \$800.



Question 2

The responsibility for ensuring that all accounting transactions are properly recorded and summarised in the accounts lies with

- (A) the government.
- (B) the shareholders.
- (C) the internal auditors.
- (D) the directors.



Question 3

The following information relates to a company at its year end:

| | \$ |
|----------------------------|-----------|
| Stock at beginning of year | |
| Raw materials | 22,000 |
| Work-in-progress | 4,000 |
| Finished goods | 63,000 |
| Stock at end of year | |
| Raw materials | 25,000 |
| Work-in-progress | 1,000 |
| Finished goods | 72,000 |
| Purchases of raw materials | 220,000 |
| Direct wages | 300,000 |
| Royalties on goods sold | 45,000 |
| Production overheads | 360,000 |
| Distribution costs | 70,000 |
| Administration expenses | 290,000 |
| Sales | 1,400,000 |

The cost of goods manufactured during the year is

\$.....



Question 4

Your sales ledger control account has a balance at 1 November 20X1 of \$30,000 debit. During November, credit sales were \$67,000, cash sales were \$15,000 and receipts from customers, excluding cash receipts, and after deducting cash discounts of \$1,400 were \$60,000. Sales returns were \$4,000.

The closing balance on the sales ledger control account was

\$

? Question 5

In a not-for-profit organisation, the accumulated fund is:

- (A) fixed assets plus net current assets less long-term liabilities.
- (B) the balance on the general reserve.
- (C) fixed assets plus working capital.
- (D) long-term liabilities plus current liabilities minus current assets.

? Question 6

Your company's bank statement at 31 July 20X1 shows a favourable balance of \$10,300. You subsequently discover that the bank has dishonoured a customer's cheque for \$500 and has charged bank charges of \$150, neither of which is recorded in your cash book. There are unpresented cheques totalling \$1,700. You further discover that a receipt from a customer of \$400 has been recorded as a credit in your cash book.

Your cash book balance, prior to correcting the errors and omissions, was

\$

? Question 7

Stock is valued using FIFO. Opening stock was 12 units at \$4 each. Purchases were 60 units at \$5 each, then issues of 18 units were made, followed by issues of 23 units.

Closing stock is valued at

\$

? Question 8

A book of prime entry is one in which:

- (A) transactions are entered prior to being recorded in ledger accounts.
- (B) ledger accounts are maintained.
- (C) the rules of double-entry book-keeping do not apply.
- (D) memorandum accounts are kept.

? Question 9

Sales are \$310,000. Purchases are \$165,000. Opening stock is \$21,000. Closing stock is \$18,000.

The rate of stock turnover is

\$

? Question 10

Which ONE of the following statements is true?

- (A) Sales less factory cost of goods completed equals gross profit.
- (B) Prime cost is recorded in the trading account.
- (C) Factory cost of goods completed is recorded in the trading account.
- (D) Closing work in progress is not included in the balance sheet.

? Question 11

A Receipts and Payments account is similar to:

- (A) an income and expenditure account
- (B) a trading account
- (C) a profit and loss account
- (D) a cash book summary

? Question 12

Revenue reserves would decrease if a company:

- (A) paid dividends
- (B) issued shares at a premium
- (C) set aside profits to pay future dividends
- (D) transferred amounts into 'general reserves'

? Question 13

A machine cost \$16,000. It had an expected useful life of 4 years and an expected residual value of \$4,000. It was depreciated at 25% per annum on the reducing balance basis. A full year's depreciation was charged in the year of purchase, with none in the year of sale. During year 4, it was sold for \$3,000.

The profit or loss on disposal was:

| | |
|----------------|----|
| Profit or Loss | \$ |
|----------------|----|

? Question 14

The major aim of the internal auditors is to

- (A) report to the directors.
- (B) prepare draft financial statements.
- (C) report to shareholders on the accounts.
- (D) reduce the costs of the external auditors by carrying out some of their duties.

? Question 15

At 1 February, the telephone expenses account showed 2 months' rental prepaid of \$250 and 2 months' telephone calls accrued of \$450. During February, a fixed standing order payment of \$375 was paid.

What is the balance on the telephone ledger account at 28 February?

\$

? Question 16

Your company's profit and loss account for the year ended 30 June 20X1 showed the following:

| | |
|------------------------------------|--------------|
| | <i>\$000</i> |
| Net profit before interest and tax | 2,300 |
| Interest | <u>700</u> |
| Profit before tax | 1,600 |
| Tax | <u>400</u> |
| Profit after tax | 1,200 |
| Dividends | <u>200</u> |
| Retained profit for the year | <u>1,000</u> |

Its balance sheet at 30 June 20X1 showed the following

| | |
|---------------------------------|---------------|
| | <i>\$000</i> |
| Share capital | 11,000 |
| Profit and loss account balance | <u>3,000</u> |
| | 14,000 |
| 10% debenture | <u>4,000</u> |
| | <u>18,000</u> |

No new loans or shares were raised, repaid or issued during the year.

Return on average capital employed for the year ended 30 June 20X1 is

\$

? Question 17

Insurance paid on 1 April 20X0 for the year to 31 March 20X1 was \$6,200, and insurance paid on 1 April 20X1 to 31 March 20X2 was \$6,400.

Insurance in the profit and loss account for the year ended 30 September 20X1 would be

\$

? Question 18

A business has made a profit of \$45,000 but its bank balance has fallen by \$8,000. This could be due to:

- (A) depreciation of \$32,000 and the purchase of new fixed assets of \$85,000.
- (B) depreciation of \$32,000 and the repayment of a loan of \$21,000.
- (C) the disposal of a fixed asset for \$53,000 less than its book value.
- (D) depreciation of \$40,000 and an increase in stocks of \$13,000.

**Question 19**

A company's fixed asset register shows a net book value of \$250,000. The fixed asset account in the nominal ledger shows a net book value of \$190,000. The difference could be due to a disposed asset not having been deducted from the fixed asset register:

- (A) with disposal proceeds of \$75,000 and a net book value of \$15,000.
- (B) with disposal proceeds of \$75,000 and a loss on disposal of \$15,000.
- (C) with disposal proceeds of \$40,000 and a net book value of \$20,000.
- (D) with disposal proceeds of \$75,000 and a profit on disposal of \$15,000.

**Question 20**

A fixed asset costing \$80,000 was sold at a book loss of \$20,000. Depreciation had been provided using the reducing balance method, at 25% per annum since its purchase.

Which of the following correctly describes the sale proceeds and length of time for which the asset had been owned:

| | <i>Sale Proceeds</i> | <i>Length of Ownership</i> |
|---|----------------------|----------------------------|
| A | \$60,000 | cannot be calculated |
| B | cannot be calculated | 3 years |
| C | \$60,000 | 3 years |
| D | cannot be calculated | cannot be calculated |

**Question 21**

A company's gearing ratio would rise if

- (A) profits increased.
- (B) interest rates on loans increased.
- (C) a decrease in long-term loans is proportionately LESS than a decrease in shareholders' funds.
- (D) a decrease in long-term loans is proportionately MORE than a decrease in shareholders' funds.

**Question 22**

The following totals appear in a company's day books and nominal ledger in February 20X2

| | <i>Goods excluding VAT</i> | <i>VAT</i> |
|---------------------------|----------------------------|------------|
| | \$ | \$ |
| Sales day book | 42,000 | 4,200 |
| Purchases day book | 26,000 | 2,000 |
| Returns inwards day book | 3,200 | 320 |
| Returns outwards day book | 700 | 35 |
| Opening stock | 7,000 | 550 |
| Closing stock | 8,300 | 765 |

The gross profit for February 20X2 is

\$

? Question 23

In times of rising prices, the FIFO method of stock valuation, when compared to the Average Cost method of stock valuation, will usually produce:

- (A) a lower profit and a lower closing stock value.
- (B) a higher profit and a lower closing stock value.
- (C) a lower profit and a higher closing stock value.
- (D) a higher profit and a higher closing stock value.

? Question 24

An employee is paid at the rate of \$12 per hour. The earnings in excess of \$150 a week are taxed at 25 per cent. Employee’s national insurance is 10 per cent and employer’s national insurance is 15 per cent of gross salary. During week 15, the employee worked 40 hours.

The amount to be charged to the profit and loss account is

\$

? Question 25

The following is an extract from the balance sheets of EZ Ltd for the years ended 31 March 20X1 and 20X2.

| | <i>20X1</i> | <i>20X2</i> |
|-----------|--------------|--------------|
| | <i>\$000</i> | <i>\$000</i> |
| Stock | 85 | 60 |
| Debtors | 80 | 95 |
| Creditors | 45 | 75 |
| Accruals | 20 | 10 |

What figure would appear in the cash flow statement of EZ Ltd for the year ended 31 March 20X2 as part of the cash flow from operations?

| | |
|----------------------|----|
| Increase or Decrease | \$ |
|----------------------|----|

? Question 26

An imprest system is:

- (A) a method of controlling petty cash.
- (B) an audit process.
- (C) accounting computer software.
- (D) automatic agreement of the cash book and bank statement.

? Question 27

Which of the following is correct?

- (A) only public limited companies are required by law to have an external audit.
- (B) all limited companies are required by law to have an external audit.
- (C) an external audit for a limited company is voluntary.
- (D) only companies above a certain size are required by law to have an external audit.

**Question 28**

Which of the following expenses should be included in prime cost in a manufacturing account?

- (A) Office salaries.
- (B) Factory insurance.
- (C) Repairs to factory machinery.
- (D) Direct production wages.

**Question 29**

A Ltd has an item in stock which cost \$1,500 and can be sold for \$1,800. However, before it can be sold it will require to be modified at a cost of \$275. The expected selling costs of the unit are an additional \$140. How should this item be valued in stock?

\$

**Question 30**

A 'value for money audit' is:

- (A) a review of expenditure to ensure effectiveness, efficiency and economy.
- (B) an external audit with limited scope.
- (C) a voluntary audit by an unregistered auditor.
- (D) none of these.

**Question 31**

Which of the following statements regarding a fixed assets register is NOT correct?

- (A) A fixed assets register records the physical location of an asset.
- (B) A fixed assets register agrees with the fixed asset nominal ledger account.
- (C) A fixed assets register enables depreciation charges to be posted to the nominal ledger.
- (D) A fixed assets register enables reconciliations to be made with the nominal ledger.

**Question 32**

S Ltd purchased a car for \$24,000 on 1 January 20X1. The estimated useful life is 4 years with a residual value of \$6,000. B Ltd uses the straight line method for depreciation and charges depreciation on a monthly basis. What is the charge for depreciation for the year ended 31 March 20X1?

\$

? Question 33

Which of the following statements concerning a ‘true and fair’ view is correct?

- (A) True and fair is mainly determined by compliance with generally accepted accounting practice.
- (B) True and fair means the financial statements are accurate.
- (C) There can only be one true and fair view of a company’s financial statements.
- (D) True and fair has a precise definition which is universally accepted.

? Question 34

The H Club discloses the following note to its Income and Expenditure Account.

‘Subscriptions in arrears are accounted for when received; subscriptions in advance are accounted for on a matching basis.’

At 31 May 20X3 there were subscriptions owing of \$750 and subscriptions in advance of \$1,300. During the year ended 31 May 20X4 subscriptions of \$12,000 were received, including subscriptions relating to the previous year of \$650 and subscriptions in advance of \$900.

What amount should be included for subscriptions in the year ended 31 May 20X4?

\$

? Question 35

The net profit percentage in a company is 9% and the asset turnover ratio is 3.

What is the return on capital employed?

%

? Question 36

GAAP Ltd provides the following note to fixed assets in its balance sheet.

Plant and Machinery

| | <i>Cost</i> | <i>Depreciation</i> |
|------------------|--------------|---------------------|
| | <i>\$000</i> | <i>\$000</i> |
| Opening Balance | 32 | 18 |
| Additions/charge | 22 | 6 |
| Disposals | (15) | (10) |
| Closing Balance | 39 | 14 |

The additional machinery was purchased for cash. A machine was sold for cash at a profit of \$3,000.

What is the net cash flow for plant and machinery?

| | |
|----------------|--|
| Inflow/outflow | |
| \$ | |

**Question 37**

Which of the following errors will cause the trial balance totals to be unequal?

- (A) errors of omission.
- (B) errors of principle.
- (C) errors of transposition.
- (D) all the above.

**Question 38**

P is a sole proprietor whose accounting records are incomplete. All the sales are cash sales and during the year \$20,000 was banked, including \$3,000 from the sale of a business car. He paid \$5,000 wages in cash from the till and withdrew \$1,000 per month as drawings. The cash in the till at the beginning and end of the year was \$200 and \$300, respectively.

What were the sales for the year?

\$

**Question 39**

Which of the following is an appropriation by a limited company?

- (A) donation to a charity.
- (B) loan interest.
- (C) directors' salaries.
- (D) dividends.

**Question 40**

Which of the following is a record of prime entry?

- (A) the nominal ledger.
- (B) the sales ledger.
- (C) the trial balance.
- (D) the sales day book.

Illustrative computer-based assessment: Solutions



Solution 1

Answer: (B)



Solution 2

Answer: (D)



Solution 3

| | |
|---|----------------|
| | \$,000 |
| Stock at beginning of year – raw materials | 22,000 |
| Purchases | 220,000 |
| Stock at end of year – raw materials | (25,000) |
| Direct wages | 300,000 |
| Production overheads | 360,000 |
| Stock at beginning of year – work-in-progress | 4,000 |
| Stock at end of year – work-in-progress | (1,000) |
| | <u>880,000</u> |



Solution 4

| Sales ledger control account | | | | |
|------------------------------|--------------|---------------|----------------|---------------|
| | | \$ | | \$ |
| 1 Nov 20X1 | Balance b/d | 30,000 | Bank | 60,000 |
| | Credit sales | 67,000 | Cash discounts | 1,400 |
| | | | Sales returns | 4,000 |
| | | | Bal c/d | <u>31,600</u> |
| | | <u>97,000</u> | 31 Nov 20X1 | <u>97,000</u> |



Solution 5

Answer: (A)



Solution 6

| | |
|---|----------------|
| Bank reconciliation | \$ |
| Balance at bank 31 July 20X1 | 10,300 |
| unpresented cheques | <u>(1,700)</u> |
| | <u>8,600</u> |
| Opening balance in cash book – balancing figure | 8,450 |
| Dishonoured cheque | (500) |
| Bank charges | (150) |
| Error \$600 × 2 | 800 |
| | <u>8,600</u> |

**Solution 7**

| | <i>units</i> | <i>unit \$</i> | <i>Total \$</i> |
|---------------|--------------|----------------|-----------------|
| Opening stock | 12 | 4 | 48 |
| Purchases | 60 | 5 | 300 |
| Issue | { (12) | { (4)} | (48) |
| Issue | { (6) | { (5)} | (30) |
| Issue | (23) | (5) | (115) |
| Closing stock | <u>31</u> | <u>5</u> | <u>155</u> |

**Solution 8**

Answer: (A)

**Solution 9**

Average stock is opening stock \$21,000 + closing stock \$18,000 = \$39,000/2 = \$19,500

Cost of goods sold is opening stock \$21,000 + purchases \$165,000 – closing stock \$18,000 = \$168,000

Stock turnover is cost of goods sold/average stock \$168,000/\$19,500 = 8.6

**Solution 10**

Answer: (C)

**Solution 11**

Answer: (D)

**Solution 12**

Answer: (A)

**Solution 13**

| | | |
|----------------------|--|------------------|
| Cost | $\$16,000 \times 75\% \times 75\% \times 75\%$ | = \$6,750 |
| Proceeds on disposal | | = \$3,000 |
| Loss on disposal | | <u>= \$3,750</u> |

**Solution 14**

Answer: (A)

 **Solution 15**

| Telephone Expense Account | | | |
|---------------------------|------------|---------------------|------------|
| | Debit | | Credit |
| 1 February bal b/d | 250 | 1 February bal b/d | 450 |
| Bank | 375 | 28 February p&l a/c | 275 |
| 28 February bal c/d | <u>225</u> | 28 February bal c/d | <u>125</u> |
| | <u>850</u> | | <u>850</u> |

 **Solution 16**

| | | |
|----------|--|-----------------|
| Capital: | 30 June 20X1 | \$18,000 |
| | 30 June 20X0 (\$18,000 less retained profit \$1,000) | <u>\$17,000</u> |
| | | <u>\$35,000</u> |

Average capital $\$35,000/2 = \$17,500$
 Profit before interest and taxes = \$2,300
 Return on average capital employed = $\$2,300/\$17,500 = 13.1\%$

 **Solution 17**

| | | |
|-------------------------------|-----------------------|----------------|
| 1 April 20X0 to 31 March 20X1 | $6/12 \times \$6,200$ | \$3,100 |
| 1 April 20X1 to 31 March 20X2 | $6/12 \times \$6,400$ | <u>\$3,200</u> |
| | | <u>\$6,300</u> |

 **Solution 18**

Answer: (A)

 **Solution 19**

Answer: (D)

 **Solution 20**

Answer: (D)

 **Solution 21**

Answer: (C)

 **Solution 22**

| | | |
|------------------------|----------------|---------------|
| | | \$ |
| Sales less returns | | 38,800 |
| Opening stock | 7,000 | |
| Purchases less returns | 25,300 | |
| Closing stock | <u>(8,300)</u> | <u>24,000</u> |
| Gross profit | | <u>14,800</u> |



Solution 23

Answer: (D)



Solution 24

| | |
|--|--------------|
| Gross salary 40 hours @ \$12 per hour | \$480 |
| Employers national insurance 15% × \$480 | <u>\$72</u> |
| | <u>\$552</u> |



Solution 25

| | |
|-----------|--------------|
| | <i>\$000</i> |
| Stock | 25 |
| Debtors | (15) |
| Creditors | 30 |
| Accruals | <u>(10)</u> |
| Increase | <u>30</u> |



Solution 26

Answer: (A)



Solution 27

Answer: (D)



Solution 28

Answer: (D)



Solution 29

| | |
|----------------------|---|
| Selling price | \$1,800 |
| Cost of modification | (\$275) |
| Selling costs | <u>(\$140)</u> |
| | <u>\$1,385, which is less than cost</u> |



Solution 30

Answer: (A)



Solution 31

Answer: (B)



Solution 32

Cost less residual value is \$24,000 less \$6,000 = \$18,000
 Depreciation charge is \$18,000/4 years = \$4,500
 Depreciation charge for year ended 31 March 20X1 \$4,500 × 3/12 = \$1,125

**Solution 33**

Answer: (A)

**Solution 34**

| | |
|-------------------------------|---------------|
| | \$ |
| Subscriptions in advance | 1,300 |
| Subscriptions received | 12,000 |
| Less subscriptions in advance | <u>(900)</u> |
| Subscriptions | <u>12,400</u> |

**Solution 35**Net profit % \times asset turnover ratio = return on capital employed $9\% \times 3 = 27\%$ **Solution 36**

| | | |
|--|----------------|-------------------|
| Plant and machinery purchased | | (\$22,000) |
| Plant and machinery sold net book value (cost \$15,000 less provision for depreciation \$10,000) | = \$5,000 | |
| profit on disposal | <u>\$3,000</u> | <u>\$8,000</u> |
| net cash outflow | | <u>\$(14,000)</u> |

**Solution 37**

Answer: (C)

**Solution 38**

| | |
|--|-----------------|
| Cash banked | \$20,000 |
| Less cash from sale of car | \$(3,000) |
| Add wages | \$5,000 |
| Add drawings (\$1,000 \times 12) | \$12,000 |
| Closing cash less opening cash (\$300 – 200) | <u>\$100</u> |
| | <u>\$34,100</u> |

**Solution 39**

Answer: (D)

**Solution 40**

Answer: (D)

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Index

- accounting
 - computerised systems, 248–9
 - concepts, 5, 93–4, 98, 103, 274–8
 - definition, 1–2, 5
 - equation, 14–21, 304
 - policies, 278
 - principles, 5, 285
 - regulatory framework, 273–302
 - scene, 1–12
 - standards, 2–3, 4, 5, 285–7
- accounting information system (AIS), 2
- Accounting Standards Board (ASB), 2, 4, 285–7
- accounts
 - balancing off the accounts, 5, 69–74
 - debits/credits, 36–46, 59–60, 69
 - definition, 35
 - users, 3–4
- accruals, 93–6, 275–6, 285
- accumulated fund, 311
- acid test ratio, 409–10
- acquisitions, fixed assets, 125
- adjustments, final accounts, 157–90
- advisers, use of accounts, 3
- AIS *see* accounting information system
- amortisation charges, goodwill, 131
- analysed cash books, 201–2
- annual statements, 6
- appropriation account, 350, 354
- ASB *see* Accounting Standards Board
- assessment *see* examination
- assets
 - see also* fixed assets; intangible assets
 - accounting equation, 14–15
 - balance sheet, 17–21, 68, 159–90
 - balancing off the accounts, 5, 69–72
 - cash-flow statement, 360
 - current purchasing power accounting, 280, 284
 - double-entry bookkeeping, 36–46
 - historical cost accounting, 279, 283
 - prepayments, 94–6
 - ratios, 410–11
 - safeguards, 230, 290
 - trial balance, 60
 - valuation, 275, 281–3
- asset turnover ratios, 410–11
- auditors, 287–90
- audits, 231, 284–5, 287–90
- audit trails, 230, 289
- authorisation procedures, 230
 - bank accounts, 202
 - bank payments, 202
 - journal entries, 206
- authorised share capital, 352
- AVCO *see* weighted average cost method
- BACS *see* Bankers Automated Clearing System
- bad debts
 - journal entries, 204–5
 - ledger accounts, 96–102
 - non-profit-making bodies, 311–12
 - specific provisions, 101–2
- bad and doubtful debts account, 96–102
- balance b/d, concepts, 69–71
- balance c/d, concepts, 69–71
- balance sheet, 15, 17–21, 157–90
 - accruals and prepayments, 94
 - adjustments, 157–62
 - capital expenditure, 120
 - concepts, 17–21, 68
 - contents, 18–20
 - current assets, 18–21
 - double-entry bookkeeping, 36–46
 - fixed assets, 18–21, 121
 - incomplete records, 303
 - limited companies, 351–3
 - manufacturing companies, 338
 - non-profit-making bodies, 311
 - preparation, 18–21, 68, 161–9
 - profit and loss account, 22
 - vertical presentations, 20–1, 68
- balance transfers, trading account, 62–4
- balancing the accounts, 5, 44–5
- balancing off the accounts, 5, 69–74
- bank accounts, 43–5, 68–71
 - authorisations, 202
 - bank reconciliation statements, 231, 232–4
 - cash books, 199–200
 - divisions of the ledger, 192
- bank balance
 - cash-flow statement, 359–60
 - profits, 25
- Bankers Automated Clearing System (BACS), 200
- banking system, 200
- bank-initiated transactions, 200
- bank reconciliations, 231, 232–4
- bartering, 102–3
- bin cards, 208
- boards of directors, 4
- bookkeeping, 2, 5, 35–57, 191–227
 - see also* double-entry bookkeeping
 - control, 229–72
 - definition, 5
 - organisation, 191–227
 - supporting books, 192–206
 - transactions, 5, 36–7, 194–207

- books of prime entry, 192–3, 197, 237
- bought ledger, 192
- brands, intangible fixed assets, 130
- business entity concept, 274
- business organisations, 7–8

- capital
 - accounting equation, 14–15
 - balance sheet, 17–21, 159–90
 - balancing off the accounts, 69–74
 - definition, 15
 - double-entry bookkeeping, 36–46
 - employed, 407–9
 - expenditure, 25, 119–21
 - incomplete records, 304, 305–6
 - maintenance, 279
 - opening capital, 305–6
 - ratios, 412–14
 - reserves, 354
 - revenue, 25
 - share capital, 352–3
 - statement of movements on capital, 22–3
 - structure ratios, 413–14
 - transactions, 25, 120–1
- capital account
 - balance, 68
 - concepts, 67–8
 - drawings, 67–8
 - profit and loss account, 67
 - trial balance, 59–60
- carriage costs, 83–4, 206–7
- cash
 - discounts, 85, 201
 - profits, 25, 360
 - summaries, 306–10
- cash accounts
 - cash books, 199–201
 - divisions of the ledger, 192
- cash balance, cash-flow statement, 359–60
- cash books, 192, 193, 199–204
 - analysed cash books, 201–2
 - concepts, 199–204
 - control accounts, 237
- cash-flow statement, 350, 359–64
- CBA *see* computer based assessment
- CCA *see* current cost accounting
- CCP *see* current purchasing power
- charities, 8
- cheques, 200
- clearing system, cheques, 200
- clubs and societies, 7, 310–17
- coding systems, 249–51
- columnar ledger accounts, 73
- commission errors, trial balance, 60
- Companies Acts, 7, 284–5, 349–50
- compensating errors, trial balance, 61
- compliance testing, 288, 289
- computer based assessment (CBA), xiv–xv, 563–95
- computerised systems, control, 239, 248–9
- consistency concept, 277–8, 285
- consumers
 - see also* customers
 - use of accounts, 3
- contra entries, 242–3
- controls, 229–72
 - accounts, 63, 236–45
 - fixed assets, 128–30
 - fraud, 229–31, 289
- corporation tax, 350, 351
- cost concept, 274
- cost of goods sold, 21–4, 63, 206–7, 336
- costs
 - carriage, 83–4
 - depreciation, 25, 121–5, 161–90
 - direct costs, 337
 - factory costs, 337
 - indirect costs, 337
 - manufacturing account, 336–9
 - prime costs, 337
 - profit and loss account, 21–4, 157–90
 - R&D, 282–3
 - stock, 206–7
 - tangible fixed assets, 121–5
- credit notes, 193–4
- creditors
 - definition, 14–15
 - use of accounts, 3
- creditors' accounts
 - control accounts, 237
 - daybooks, 195
 - divisions of the ledger, 192
- creditors' ledger, 192
 - see also* purchase ledger
 - reconciliations, 235–6
- creditors' payment period, 412
- credits, accounts, 36–46, 59–60, 69
- cross-referenced entries, 195–9
- current assets, 18–21
 - definition, 18
 - net, 20, 68
- current cost accounting (CCA), 281, 283
- current liabilities, definition, 18
- current purchasing power (CPP)
 - accounting, 280, 283–4
- current ratio, 409
- customers
 - contra entries, 242
 - use of accounts, 3

- daybooks, 192–9, 237
- debentures, 351–2
- debits, accounts, 36–46, 59–60, 69
- debtors
 - bad debts, 96–102
 - definition, 14
 - incomplete records, 304–5
- debtors' accounts
 - control accounts, 237
 - daybooks, 195
 - divisions of the ledger, 192
- debtors' collection period, 411–12
- debtors' ledger, 192
 - see also* sales ledger
- debts
 - see also* bad debts; doubtful debts
 - ledger accounts, 96–102
 - separate entity concept, 13–14
- delivery charges, 83–4
- depreciation, 25, 121–5, 161–90, 360–4
 - asset acquisitions/disposals, 125
 - calculation methods, 122–5
 - concepts, 121–5

- diminishing-balance method of depreciation, 123–4
 - direct costs, 337
 - direct debits, 200
 - directors, 4, 351
 - see also* management
 - discounts
 - cash books, 201
 - cash discounts, 85, 201
 - ledger accounts, 84–5
 - trade discounts, 84, 195–7
 - dishonoured cheques, 200
 - disposals, fixed assets, 125–7
 - dividends, 353
 - divisions of the ledger, 44, 191–2
 - documentation, control, 230
 - double-entry bookkeeping, 36–46
 - control accounts, 239
 - dual aspect concept, 275
 - summarising ledger accounts, 59–82
 - doubtful debts
 - control account, 244
 - ledger accounts, 96, 98–102
 - drawer, cheques, 200
 - drawings, 67–8
 - account, 67–8
 - accounting equation, 15
 - incomplete records, 304, 306
 - profit and loss account, 21–4
 - dual aspect concept, 36, 275
 - duplication errors, trial balance, 60
-
- economic value, 281
 - efficiency ratios, 410–12
 - employees
 - controls, 230
 - use of accounts, 3
 - wages and salaries, 91–3
 - entertainment expenses, 89
 - entrance fees, 312
 - equity investor group, 3
 - equity shares, 352–3
 - errors
 - corrections, 204–5
 - detection methods, 231
 - ledger accounts, 60–1, 204–5, 229–51
 - trial balance, 60–1, 245–8
 - examination, 342, 457–568
 - computer based assessment, 569–601
 - format, 450
 - preparation, 449–561
 - questions, 451–523
 - solutions, 525–61
 - tips, 450
 - exception reports, 5
 - exchange of goods, 102–3
 - exempt supplies, VAT, 90
 - expenses, 21–4
 - see also* costs
 - accrued, 93–6, 275–6
 - bad and doubtful debts, 96–102
 - double-entry bookkeeping, 36–7, 39–46
 - exchange of goods, 102–3
 - fixed assets, 119–21
 - incomplete records, 305
 - ledger accounts, 94–6
 - manufacturing account, 337
 - matching, 276, 285
 - prepayment, 94–6
 - trial balance, 60
 - VAT, 89
 - exports, VAT, 91
 - extended-use daybooks, 199
 - external auditor, 289
 - external information, 6
 - external users, 415
-
- factory costs, 337–8
 - fairness concept, 277
 - FIFO *see* first in, first out
 - final accounts
 - see also* balance sheet; profit and loss account
 - adjustments, 157–90
 - incomplete records, 303–33
 - workings, 160–1, 342
 - financial accounting
 - definition, 5
 - framework, 13–33
 - Financial Reporting Council (FRC), 285
 - Financial Reporting Standards (FRSs), 285, 360
 - financial statements, 2–5, 120, 284–7, 403
 - capital expenditure, 120
 - interpretation, 403
 - needs, 4–5
 - qualitative characteristics, 4
 - regulations, 284–7
 - revenue expenditure, 120
 - finished goods, 335, 336, 339
 - first in, first out (FIFO), 209–12
 - fixed assets, 18–21, 119–55
 - acquisitions, 125
 - carriage costs, 83
 - controls, 128–30
 - definition, 18
 - depreciation, 25, 121–5, 161–90, 360–4
 - disposals, 125–7
 - exchange of goods, 102–3
 - intangible fixed assets, 130–1
 - register, 129–30
 - turnover, 410–11
 - useful economic life, 121
 - valuation, 281–3
 - VAT, 89
 - folio columns, 195–6
 - forecasts, 2
 - fraud
 - auditors, 289
 - controls, 229–31, 289
 - FRC *see* Financial Reporting Council
 - FRSs *see* Financial Reporting Standards
-
- gearing ratio, 413
 - general ledger, 192
 - see also* nominal ledger
 - going concern concept, 277, 281, 285
 - goods
 - carriage costs, 83–4
 - discounts, 84–5
 - exchange, 102–3
 - goodwill, 14, 130–1, 282
 - government
 - non-profit-making organisations, 8
 - use of accounts, 3
 - gross pay, 91–2

- gross profits, 21–4, 62–5, 157–90
 - margin, 64, 406–7
 - mark-up, 64, 407
 - trading account, 63–4
- historical cost accounting, 279–84
- HM Customs and Excise, 284
- holding gains or losses, 280
- IASB *see* International Accounting Standards Board
- illustrative computer based assessment, 563–95
- imports, VAT, 91
- imprest system, 203–4
- income
 - see also* revenue
 - accruals, 94–5, 276
 - double-entry bookkeeping, 36–7, 39–46
 - prepayments, 94–5
 - profit and loss account, 21–4, 159–90
- income and expenditure account, 62, 303–33
- income statement *see* profit and loss account
- income tax, 91–2
- incomplete records, 303–33
- indirect costs, 337
- inflation, 279, 280
- information
 - see also* knowledge
 - characteristics, 4–5
 - external/internal contrasts, 6
 - useful characteristics, 4–5
- Inland Revenue, 284
- input VAT, 86–91
- intangible assets, 14, 130–1, 282–3
- intellectual capital, 130, 282–3
- interest cover, 413–14
- interim statements, 6
- internal auditors, 290
- internal information, 6
- International Accounting Standards Board (IASB), 287
- interpretation of accounts, 403–48
- invoices
 - daybooks, 193–4, 197
 - format, 193–4, 197
- issues, stock, 209–12
- the journal, 192–3, 204–6
 - authorisation procedures, 206
 - concepts, 204–6
 - contra entries, 243
 - control accounts, 237
 - corrections, 204–5, 246
 - end-of-year transactions, 205–6
- knowledge, 282–3
 - see also* information
- labour costs, 337
- last in, first out (LIFO), 209–11
- ledger accounts, 35–46
 - balancing off, 5, 69–74
 - carriage costs, 83–4
 - columnar ledger accounts, 73
 - control, 229–72
 - cross-referencing, 195–9
 - discounts, 84–5
 - divisions of the ledger, 44, 191–2
 - errors, 60–1, 204–5
 - further aspects, 83–118
 - incomplete records, 303–33
 - manufacturing companies, 338–42
 - organisation, 191–227
 - summaries, 59–82
 - VAT, 89
- liabilities
 - see also* creditors. . .
 - accounting equation, 14–15
 - accruals, 93–6
 - balance sheet, 17–21, 68, 159–90
 - balancing off the accounts, 69–74
 - definition, 14
 - double-entry bookkeeping, 36–46
 - trial balance, 60
- life-membership fees, 312–13
- LIFO *see* last in, first out
- limited companies, 349–401
 - definition, 7
 - external information, 6
 - finance issues, 351–3
 - regulations, 284–90
 - separate entity concept, 13–14
 - types, 7
- liquidity ratios, 409–10
- listed companies, 7
- loan capital, gearing ratio, 413
- long-term liabilities, definition, 18
- losses, 66
 - see also* profit and loss account
- machine-hour method of depreciation, 124–5
- management, 4, 290, 351
 - levels, 4
 - roles, 290
 - stewardship function, 290
 - use of accounts, 4
- management accounting, definition, 6
- management information system (MIS), 2
- manufacturing account, 335–48
- margin *see* gross profits
- market values, 281
- mark-up *see* gross profits
- matching concept, 94, 103, 275–6, 285
- materiality concept, 276–7, 288
- membership fees, 311–13
- memorandum accounts, 239
- middle management, 4
- MIS *see* management information system
- missing figures, calculations, 303–10
- mixed supplies, VAT, 90–1
- mock assessments, 563–95
- monetary items, 280
- money measurement concept, 274
- motor cars, VAT, 89
- National Insurance (NI), 91–2
- negative working capital, 20
- net assets, 20, 68, 162–90
- net asset turnover, 410
- net cash flow from operating activities, 360–2
- net current assets, 20, 68, 162–90
- net losses, 66
- net pay, 91–2
- net profit margin, 407

- net profits, 66
 - profit and loss account, 21–4, 66, 161–90
 - ratios, 407–8
- net realisable value (NRV), 206, 281
- net worth, 20
- NI *see* National Insurance
- nominal ledger, 35–6, 44, 192, 239
- non-profit-making bodies, 7–8, 303, 310–17
- NRV *see* net realisable value

- objectivity concept, 275
- omission errors, trial balance, 60
- opening capital, incomplete records, 305–6
- operating activities, net cash flow from, 360–2
- operational management, use of accounts, 4, 6
- ordinary shares, 352, 353
- organisations, types, 7–8
- organising bookkeeping system, 191–227
- original-entry errors, trial balance, 60
- output VAT, 86–91
- overtime, ledger accounts, 91–2

- partnerships
 - business entity concept, 274
 - definition, 7
 - drawings, 15
 - regulations, 284
 - separate entity concept, 14
- par value, 352
- patents, 14, 130, 282–3
- pension contributions, 93
- percentage profits, 404
- performance ratios, 406–9
- periodicity concept, 275
- petty-cash books, 192, 193, 203–4
- petty-cash fraud, 231
- preference shares, 352, 353
- preparing for the examination, 457–568
- prepayments, 93–6
- presenting cheques, 200
- prices
 - discounts, 84–5
 - gross profit mark-up, 407
 - inflation, 279, 280
- prime costs, 337, 341
- principle errors, trial balance, 60
- private limited companies, 7
 - see also* limited companies
- production costs, 337
- professional bodies, 285
- profitability ratios, 406–9
- profit and loss account, 21–6, 36–46, 61–8, 157–90
 - accruals and prepayments, 94
 - adjustments, 157–90
 - bad and doubtful debts, 96–8, 99
 - capital account, 67
 - carriage costs, 84
 - concepts, 21–6, 61–8
 - depreciation, 25, 121–5, 161–90
 - disposal of fixed assets, 125–6
 - incomplete records, 303
 - manufacturing companies, 335, 338, 340
 - matching, 94, 103
 - non-profit-making bodies, 311
 - preparation, 21–4, 61–8, 161–9
 - revenue expenditure, 120
 - statement of profit, 61, 65–7
 - vertical presentations, 66
- profit-making organisations, 7
- profits, 15, 21–5, 62–5, 66, 157–90
 - see also* gross profits; net profits
 - accounting equation, 15
 - cash, 25, 360
 - cash-flow statement, 360
 - historical cost accounting, 279
 - ratios, 404–5, 406–9
 - statement of, 61–8
 - provision for doubtful debts, 98–102
- prudence concept, 98, 102, 103, 277–8, 281, 285
- public limited companies, 7
 - see also* limited companies
- public use of accounts, 4
- published accounts, 350–1
- purchase ledger, 192
 - contra entries, 242–3
 - control accounts, 237
 - debit balances, 243
- purchase returns, 63–4, 84, 212
- purchases
 - cost of goods sold, 23–4
 - incomplete records, 305
 - ledger accounts, 40–5
- purchases account, 192–3
- purchases daybook, 193–9

- quick ratio, 409–10

- R&D *see* research and development
- rate-of-usage method of depreciation, 124–5
- ratios, 404–14
- raw materials, 335, 336
- realisation concept, 103, 275, 281
- receipts, stock, 209–12
- receipts and payments account
 - incomplete records, 306
 - non-profit-making bodies, 311
- reconciliations, 231, 232–6, 244–5
- recording issues, 1–5
- reducing-balance method of depreciation, 123–4
- regulations, 7, 273–302, 349–50, 360
- regulatory framework, 273–302
- repairs, fixed assets, 120
- replacement costs, 281
- reporting issues, 2–6
- research and development (R&D) costs, 282–3
- reserves, 354–8
- retail price index, 280
- return on capital employed (ROCE), 407–9
- returns
 - daybooks, 193–9
 - realisation concept, 275
- revaluation method of depreciation, 125
- revenue, 36, 39–46, 119–21
 - see also* income
 - accounts, 59–60
 - expenditure, 25, 119–21
 - reserves, 354
 - transactions, 21–6
- revenue statement *see* profit and loss account
- reversal errors, trial balance, 60
- revision techniques, 449–50
- ROCE *see* return on capital employed

- safeguards, assets, 230, 290
- salaries *see* wages and salaries
- sale-or-return basis, 275
- sales
 - account, 62–3
 - bad debts, 96–102
 - daybooks, 193–9
 - exchange of goods, 102–3
 - incomplete records, 304–5
 - ledger accounts, 40–5
 - profit and loss account, 21–5, 158–90
 - returns, 63–4, 193, 212
 - sale-or-return basis, 275
- sales ledger, 192
 - contra entries, 242–3
 - control accounts, 237–9, 244–5
 - credit balances, 243
 - incomplete records, 304–5
- sales and purchase returns account, 63–4
- sales returns daybook, 193
- sales to capital employed, 410
- sales to fixed assets, 410–11
- SASs *see* Statements of Auditing Standards
- segregation of duties, 230, 249
- separate entity concept, 13–14
- services, exchange of goods, 102–3
- share capital, 352–3
- shareholders, 290, 349, 352–3, 354
 - separate entity concept, 13, 290
 - use of accounts, 3
- share premiums, 352
- social responsibility accounting, 274
- societies, 7, 310–17
- sole traders
 - business entity concept, 274
 - cash-flow statement, 364
 - definition, 7
 - drawings, 15
 - legal status, 349
 - ratios, 414
 - regulations, 284
 - separate entity concept, 13–14
- solvency ratios, 409–10
- source documents, 193
- specialised transactions, 83–5
- specific provisions, bad debts, 101–2
- spot checks, 231
- SSAPs *see* Statements of Standard Accounting Practice
- staff *see* employees
- standing orders, 200
- statement of movements on capital, 22–3
- Statement of Principles*, ASB, 2–3, 4, 286
- statement of profit, 61–8
- Statements of Auditing Standards (SASs), 285
- Statements of Standard Accounting Practice (SSAPs), 285
- statutory deductions, 92
- stewardship function, management, 290
- stock
 - account, 40, 63, 68
 - carriage costs, 84
 - control system, 63
 - cost of goods sold, 23–4, 206–7
 - exchange of goods, 102–3
 - historical cost accounting, 279
 - manufacturing companies, 336, 338
 - movement, 40
 - ratios, 411
 - records, 206–13
 - trading account, 62–5
 - turnover ratio, 411
 - valuations, 63, 206–13
- Stock Exchange, 6
- stocktaking, 207–8
- stores ledger cards, 208
- straight-line method of depreciation, 122–3
- strategic management, use of accounts, 4
- subscriptions, 311–12
- substantive testing, 288, 289
- superannuation contributions, 93
- suppliers
 - account reconciliations, 231, 235–6
 - contra entries, 242
 - statement reconciliations, 231, 235–6
 - use of accounts, 3
- supporting books, 192–206
- suspense accounts, 245–8

- tactical management, use of accounts, 4
- tangible assets, 14, 119–55
- taxation
 - corporation tax, 350, 351
 - income tax, 91–2
 - limited companies, 350, 351
 - VAT, 86–91, 194–9, 284
- teeming and lading activities, 231
- terminology, 5–6, 350–1
- three-column accounts, 73
- total accounts, 237
- total working capital ratio, 412
- trade discounts, 84, 195–7
- trade marks, 14, 130, 282–3
- trading account, 62–5
 - adjustments, 157–62
 - balance transfers, 62–4
 - carriage costs, 84
 - concepts, 62–5
 - manufacturing companies, 335–6, 338, 340–2
 - non-profit-making bodies, 311
 - statement of profit, 62–5
 - stock valuation, 63, 209–12
 - vertical presentations, 64–5
- trading and profit and loss account, 61–5, 66, 157–90
 - concepts, 61–5
 - definition, 66
- transactions
 - bookkeeping, 5, 36–7, 194–207
 - capital, 25–6, 120–1
 - control, 230
 - double-entry bookkeeping, 36–7
 - exchange of goods, 102–3
 - revenue, 21–6, 120–1
- trial balance, 5, 59–61
- errors, 60–1, 245–8
 - final accounts adjustments, 157–62
 - incomplete records, 303
 - labelling processes, 159
 - manufacturing companies, 342
- true and fair concept, 287–9

- uncleared cheques, 200
- useful economic life, concepts, 121
- use-of-assets ratios, 410–12
- users, accounts, 3–4

- valuations
 - assets, 275, 280–3
 - revaluations, 125
 - stock valuation, 63, 206–13
- value added tax (VAT), 86–91, 194–9, 284
- value-for-money audit, 290
- value in use *see* economic value
- VAT *see* value added tax
- vertical presentations
 - balance sheet, 20–1, 68
 - profit and loss account, 66
 - trading account, 64–5
- voluntary deductions, 92–3
- wages and salaries, 91–3
- weighted average cost method (AVCO), 210–11
- working capital
 - balance sheet, 20
 - ratios, 409, 412
- workings, final accounts, 160–1, 342
- work-in-progress, 335, 336, 337

- zero-rated supplies, VAT, 90

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