

FRANK WOOD'S **BUSINESS ACCOUNTING**

ALAN SANGSTER
LEWIS GORDON



An introduction to
FINANCIAL ACCOUNTING

 Pearson

15th edition

FRANK WOOD'S
BUSINESS ACCOUNTING



Frank Wood
1926–2000

FRANK WOOD'S **BUSINESS ACCOUNTING**

An Introduction to Financial Accounting

FIFTEENTH EDITION

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Lecturer Resources

For password-protected online resources tailored to support the use of this textbook in teaching, please visit

go.pearson.com/uk/he/resources



Notes for teachers and lecturers

This edition marks a major change in focus that reflects the consolidation of the previous two volumes into one. The emphasis is now exclusively on financial accounting. This change, and the resulting increased focus on company accounting and International GAAP within the text, were made in response to the comments of reviewers of the previous edition, who felt this was what we should be focusing on.

This textbook has been written to provide a very thorough introduction to accounting. Anyone seeking to obtain a good grounding in financial accounting will find this book suitable to their needs. This includes those studying accounting on courses at school, college or university; or studying for qualifications from the LCCE, Association of Accounting Technicians, the Institute of Secretaries and Administrators; or for qualifications of any of the six UK and Irish Chartered Accountancy bodies. The financial accounting requirements for National Vocational Qualifications and Scottish Vocational Qualifications are also fully covered.

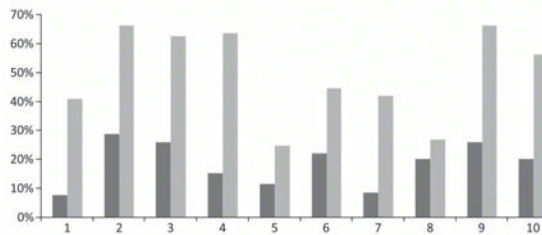
The book has the following features:

- 1 Each chapter:
 - starts with **Learning objectives**;
 - contains **activities** designed to broaden and reinforce students' understanding of the concepts being covered and, in some cases, to introduce new concepts in such a way that they do not come as a surprise when introduced formally later in the book;
 - ends with **Learning outcomes** that can be mapped back to the Learning objectives, reinforcing the major topics and concepts covered in the chapter;
 - contains **answers** to all the activities immediately after the Learning outcomes.
- 2 There is an alphabetical **Glossary** in Appendix 3 of all the significant terms introduced. Each entry is referenced back to the chapter in which it appeared.
- 3 Five sets of 20 **multiple-choice questions** are positioned in the book (at the end of Chapters 6, 16, 22, 30 and 40) at the point at which they should be attempted, rather than as a group at the end of the book. All the answers are at the back of the book in Appendix 2.
- 4 At the end of Part 5 (*Controls, checks and errors*), there are five **Scenario questions** designed to reinforce learning of the adjustments through their application in the preparation of financial statements previously learnt in Parts 1–5.
- 5 A set of **Notes for students** appears at the front of the book. This covers how to use this book, how to tackle the end-of-chapter **Review questions**, and how to study for and sit examinations. **It should be read by students before they start working through the main text.**
- 6 Blue is used in the text to enhance readability and bring out key points.

A new approach

For over 500 years, teachers of double entry have complained that students could not understand it and struggled to learn it. The solution throughout that period was to give students rules to guide them, but teachers continued to observe how difficult students found double entry. Comparing typical present-day comments with those of the mid-16th century reveals that little has changed. For many students, rules only work up to a point. In the 13th edition of this book, a different approach was adopted for the teaching of this topic. It does not use rules. Instead, it uses generalisable principles that provide a foundation from which the double entry for any

Exhibit 1 The result of a switch to a principles-based approach to double entry



transaction can be made. This principles-based approach to double entry has been fully adopted and is the focus of Chapter 2 (Recording transactions).

When a colleague and I used this principles-based approach with 250 students, their learning and understanding of double entry improved by more than 150 per cent; this is shown in Exhibit 1. The histogram shows the percentage of the 250 students who selected the correct answer to each of 10 multiple-choice questions compared with the percentage of another group of 250 students who had learnt double entry by rules, such as ‘debit the receiver and credit the giver’. The multiple-choice questions required them to identify the correct double entry for each of 10 transactions. This is why the approach adopted in this text has been changed: students find it far easier to learn!

The underlying truth behind this approach is that there are two elements to every transaction and *all* transactions involve at least one thing belonging to a business, either before, or as a result of the transaction. This is the *item exchanged*. The other thing involved in the transaction is the *form of settlement*, e.g. cash, bank, a debt, or capital. The approach adopted in this edition is simple: if you know how to record cash received or cash given, you can record receipts or givings of any *form of settlement*. **A form of settlement, e.g. cash, is credited when it is given and debited when it is received.** The entry for the *item exchanged* is the opposite.

It is a straightforward method. And it never fails to give the correct treatment for a transaction, not least because you only have to identify the *form of settlement* and the *item exchanged* in a transaction to know what to debit and what to credit.

The confusing language of bookkeeping

One of the most confusing aspects of double entry is the two meanings of the term ‘credit’: (1) as the opposite of ‘debit’; and, (2) as the granting of time in which to pay the amount due following a transaction. To address this, in the first 10 chapters when a transaction involves credit, the term ‘credit’ is *not* used to describe the transaction. Instead, as shown in examples 3 and 4 of Section 1.10 and in example 3 of Section 2.16, the transaction is described as being settled ‘on time’. Also, as discussed in Section 2.6, when a transaction is settled ‘on time’ the term ‘IOU’ is used as the *form of settlement*. In classes over the past six years, this approach has been found to make it easier for students to understand the principles of recording transactions.

In Chapter 11, the term ‘credit sale’ is introduced. Thereafter, ‘credit’ is used in place of ‘on time’. By delaying this use of ‘credit’ until that chapter, students find double entry much less confusing.

We hope that you will find these innovations of help in the teaching of this topic; and we are sure that your students will find it much easier to learn from it. Please let us know your views on this, and those of your students.

Changes made in this edition

Several changes, some major, others less so, have been made to the content of this textbook since the last edition. Some were made because of the switch from two volumes to one, others to enhance the suitability and usefulness of the book:

- There has been some restructuring and resequencing of the parts:
 - Part 3 (*Financial statements*) is now Part 2 and has been renamed ‘The financial statements of sole proprietors’.
 - Part 2 (*Books and transactions*) is now Part 3.
 - Part 4 (*Accounting today*) is now Part 10.
 - Part 8 (*Partnership accounts and company accounts*) has been split between Part 7 (*Accounting for partnerships*) and Part 8 (*Accounting for companies*).
 - Part 8 (*Accounting for companies*) is completely new to this edition. The three new chapters in this part significantly increase the book’s coverage of companies, including (for the first time) their *published* financial statements. IAS 1 *Presentation of Financial Statements*, IAS 10 *Events after the Reporting Period*, and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* also receive increased attention in this part of the book.
 - Part 10 (*An introduction to management accounting*) has been moved online.
- Chapter 29 (*Manufacturing accounts*) has been moved online.
- Chapters 30 (*Departmental accounts*), and 37 (*Purchase of existing partnership and sole proprietor businesses*) have been deleted. These are both available if you wish to include them in a customized version of this book, as are the chapters moved online.
- Chapter 38 (*Maths for accounting*) is now Chapter 17.
- Most people view financial accounting as a never-changing subject. This is wrong. Financial accounting is a dynamic subject with new and revised accounting standards as a constant reminder that this is the case. These changes impact how material is presented in this book. Six chapters have been rewritten to be consistent with the current requirements of IFRS:
 - Chapter 7 (*Accounting concepts and assumptions*), which is now Chapter 10 (*Accounting concepts and the conceptual framework*).
 - Chapter 9 (*Cash books*), which is now Chapter 12.
 - Chapter 18 (*Inventory valuation*).
 - Chapter 20, which is now Chapter 19, has been renamed ‘*Bad debts, allowances for doubtful debts, and allowances for prompt payment discounts*’.
 - Chapter 17 (*Capital expenditure and revenue expenditure*), which is now Chapter 20.
 - Chapter 21 (*Depreciation*).
- Coverage of the Statement of cash flows has been doubled in this edition:
 - Chapter 25, which is now Chapter 28, has been renamed ‘*Introduction to the statement of cash flows*’.
 - Chapter 37 (*The statement of cash flows for companies*) takes it further, and also introduces students to the interpretation of the statement.
- In response to many requests, the terms ‘accounts receivable’ and ‘accounts payable’ have been replaced with the terms ‘trade receivables’ and ‘trade payables’.
- Several other chapters have been revised in order to make some sections clearer, including Chapter 38 (*Accounting ratios*).
- There are over 100 new end of chapter Review questions in this edition, 37 of which are in Part 8 (*Accounting for companies*), reflecting the significantly increased emphasis on companies in this edition.
- Twenty-one of the 100 multiple-choice questions are new.
- The text is fully compliant with International GAAP.

We hope that you find these changes helpful and appropriate. We would welcome comments on these and any other changes you feel ought to be made in future editions. You can contact us by email at alan.j.a.sangster@gmail.com and L.W.Gordon@liverpool.ac.uk.

Finally, we would like to thank all those teachers and lecturers who offered us advice on the changes they would like to see incorporated in this edition. Above all, we would like to acknowledge the assistance received from Graeme C. Reid and Christopher Foo for all their help and advice over the past 29 years.

Alan Sangster and Lewis Gordon

Notes for students

This textbook presents your topics in what has been found to be the most appropriate sequencing to build the foundations of your accounting knowledge. You will find that a number of features of the book, properly used, will enhance your understanding and extend your ability to cope with what will possibly appear, at first, to be a mystifying array of rules and procedures.

To make best use of this resource, you should consider the following as being a proven path to success:

- At the start of each chapter, **read the Learning Objectives**. Then, while you work through the material, try to detect when you have achieved each of these objectives.
- At the end of each chapter, **check what you have learnt against the Learning Outcomes** that follow the main text.
- If you find that you cannot say ‘yes, I have learnt that’ to any of the Learning Outcomes, look back through the chapter and reread the topic you have not yet learnt.
- **Learn the meaning of each new term as it appears**. Do not leave learning what terms mean until you are revising for an exam. Accounting is best learnt as a series of building blocks. If you don’t remember what terms mean, your knowledge and ability to ‘do’ accounting will be very seriously undermined, in much the same way as a wall built without mortar is likely to collapse the first time someone leans against it.
- Attempt each of the **Activities** in the book **at the point at which they appear**. This is *very* important. They will reinforce your learning and help set in context some of the material that may otherwise appear very artificial and distant from the world you live in. The answers are at the end of each chapter. **Do not look at the answers before you attempt the questions – you’ll just be cheating yourself**. Once you have answered one, check your answer against the answer provided in the book and be sure you understand it before moving on.
- Attempt each of the sets of multiple-choice questions when you reach them in the book. There are five sets of 20 questions, one at the end of each of Chapters 6, 16, 22, 30 and 40. The answers are in Appendix 2 at the back of the book. **Do not look at the answers before you attempt the questions – you’ll just be cheating yourself**. If you get any wrong, be sure you understand why before moving on to new material.
- Attempt the Scenario Questions at the end of Part 5. They will help you see how the items covered in Parts 4 and 5 affect the preparation of financial statements.
- **Learn the accounting equation when you first come across it in Chapter 1**. It is *the* key to understanding many of the aspects of accounting that students find difficult. Make sure that you learn it in both the forms presented to you or that you can rearrange it to produce the alternative form when appropriate.
- Do not be disillusioned by the mystery of double entry. The technique has been in common use for over 700 years and is probably the most tried and trusted technique for doing anything you are ever likely to encounter. It really is not difficult, so long as you remember to identify what to do with the *form of settlement* you will learn about in Chapter 1. Like riding a bike, once you understand it, you’ll never forget it and, the more you do it, the easier it gets.
- Because of time pressure, some teachers and lecturers will need to omit Chapter 30 (*Joint ventures*). Make sure that you work through it on your own before you look at the material in Chapter 31, the first chapter on accounting for partnerships. This is very important, as accounting for joint ventures bridges the gap between accounting for sole proprietors and accounting for partnerships and will make it much easier for you to understand the differences between them.

- Above all, remember that accounting is a vehicle for providing financial information in a form that assists decision-making. Work hard at presenting your work as neatly as possible and remember that pictures (in this case, financial figures) only carry half the message. When you are asked for them, words of explanation and insight are essential in order to make an examiner appreciate what you know and that you actually understand what the figures mean.

There are two subjects we would like you to consider very carefully – making best use of the end-of-chapter Review Questions, and your examination technique.

Review questions: the best approach

Review questions are included at the end of most chapters. They are there for you to gauge how well you understand and can apply what you have learnt. **If you simply read the chapters without attempting the questions, you will not pass your examinations.** You should first attempt each question, then check your answer fully against the answers at the back of the book. **Do not simply compare the question with the answer and tick off the bits of the answer against the relevant part of the question.** No one ever learnt to do accounting properly that way. It is tempting to save time, but you will regret it eventually.

Need for practice

Try to find the time to answer as many exercises as possible. This is why:

- 1 Even though you may think you understand, when you come to answer the questions you may find you don't. The true test of understanding is whether or not you can tackle the questions competently.
- 2 Practice makes perfect. If you don't practice doing accounting questions, you will almost certainly not become good at accounting.
- 3 You need to be able to answer questions quickly: many students fail accounting exams because they run out of time. A lot is expected from you in an accounting exam in a very short time because examining boards believe, and have always believed, that an 'adequately prepared' student will be able to work quickly on the problems set. By an 'adequately prepared' student, they mean a student who not only has the knowledge, but has been trained to work quickly and, at the same time, maintain accuracy and neatness.
- 4 Speed is not enough. You also have to be neat and tidy and follow all the proper practices and procedures while working at speed. Fast, correct, but really scruffy and unreadable work can also cause you to fail the exam. Why? At this level, the accounting examiner is mainly concerned about your practical ability in the subject. Accounting is a practical subject, and your practical competence is being tested. The examiner will, therefore, expect the answers to be neat and well set out. Untidy work with numbers spread over the page in a haphazard way, badly written numbers, and columns of figures in which the vertical columns are not set down in straight lines, will be penalised and can easily mean the difference between a pass and a fail.
- 5 Appropriate presentation of information is important. Learn how to present the various financial statements you may need to produce in an examination. Examiners expect to see the items in statements of profit or loss, statements of financial position, and statements of cash flow in the correct order and will probably deduct marks if you don't do this. Practise by writing down examples of these statements without any numbers until you always get the layout correct. One exam trick most students overlook is that the layout of a financial statement is often included in an examination paper as part of one question while another question asks you to produce an answer using the format of that financial statement. **The one you need to produce will contain different numbers but the general layout should be very similar.**

Need for headings

Your work should not only be neat, it should be well presented. Headings should always be given, and any dates should be inserted. The test you should apply is to imagine that you are a partner in a firm of professional accountants and have taken a few weeks holiday. During that time your assistants have completed all sorts of work including reports, drafting final accounts, various forms of other computations, and so on. All of this is waiting for you when you return. When you return you look at each item in the pile. Suppose the first one looks like a balance sheet as at 31 December in respect of one of your clients. When you look at it you can see that it is a balance sheet, but you don't know for which client, neither do you know which year it is for. Would you be annoyed with your assistant who prepared it? Of course, you would. So, in an exam, why should the examiner give you high marks if you prepare a balance sheet answer without the date, or the name of the business, or the fact that it is a balance sheet position written clearly across the top? If proper headings are not given you will lose a lot of marks. Don't wait until your examination to do this. You also need to take similar care with sub-totals and sub-headings that need to be shown, such as those for non-current assets or for current liabilities.

The examiner

When answering an examination question, think about what you would say if you were employing an accounts assistant who gave you a sheet of paper with accounting entries written in the same style as your own efforts in answering the exam question. Would you have told your assistant to go back and do the work again because it is untidy? If you say that about your own work, why should the examiner think any differently?

Anyone who works in accounting knows that untidy work leads to completely unnecessary errors. This is why examiners penalise unclear, untidy, poorly-presented work. Examiners want to ensure that you are not going to mess up the work of an accounting department. Even today, accountants still write down many things on paper, so don't imagine that examiners will overlook such messy work just because most accounting is now done using a computer. Imagine going to the savings bank and the manager saying to you: 'We don't know whether you've got £5 in the account or £5,000. You see, the work of our clerks is so untidy that we can never sort out exactly how much is in anybody's account.' We would guess that you would not want to put a lot of money into an account at that bank. How would you feel if someone took you to court for not paying a debt of £100 when, in fact, you owed them nothing? This sort of thing would happen all the time if we simply allowed people to keep untidy accounts. The examiner is there to ensure that the person to whom they award a pass will be worthy of it and will not continually mess up the work of any firm at which they may work in the future.

If you want to pass your accounting exam, and your work is untidy, what can you do about it? Well, the answer is simple enough: start right now to be neat and tidy in your work. I did. My writing was so bad that my accounting teacher at school told me to print everything in capital letters. I thought he was mad, but my marks improved immediately, and so did my handwriting and my overall neatness in preparing answers. Start being neat now. You cannot suddenly become neat in an examination.

The structure of the questions

The review questions in each chapter generally start with the easiest and then get gradually more difficult. Some are very difficult and time consuming. If all the questions were easy, the shock of meeting more complicated questions for the first time in an examination could lead you to fail it. By giving you a mixture of straightforward and complicated questions, you will learn how to deal with the complex issues before meeting them in an exam. It's in your best interests not to ignore review questions you find hard. Put in the effort, the practice will increase your knowledge and understanding, and your performance in the exam will improve as a result.

The answers

At the back of the book, you will find answers to approximately half of the Review Questions. The answers to the other review questions (indicated by the letter 'A' after the question number) are only available to you from your teacher or lecturer. Don't worry if you are studying this subject on your own. There are still more than sufficient review questions with answers in the book to ensure you know and understand the material you are learning.

Examination technique

By the time you sit your first accounting exam, you will have spent a lot of hours trying to master such things as double entry, balance sheet and final adjustments. Learning accounting demands a lot of discipline and practice. Compared with the many hours learning the subject, most students spend very little time actually considering in detail how to tackle the examination. You may be one of them. Start changing this now by planning for the day when you will need to be able to demonstrate that you have learnt and understood, and can apply, the material in this book. Here are some of the things you should be thinking about:

Understanding examiners

If you want to understand anything about examinations, then you have to understand examiners. Let's look at what these peculiar creatures get up to in an examination. The first thing is that when they set an examination, they are looking at it on the basis that they want good students to pass. Obviously, anyone who doesn't achieve the pass mark will fail, but the object of the exercise is to find those who will pass, not find the failures. This means that if you have done your work properly, you should manage to pass. It is important to stress this: if you study and practice properly, you should pass, no matter what questions you are asked.

Unfortunately, some students who should pass will fail, not because they haven't put in enough hours on their studies, nor because they are unintelligent, but simply because they throw away marks unnecessarily by poor examination technique. If you can read the rest of this and then say honestly that you wouldn't have committed at least one of the mistakes that are mentioned, then you are certainly much more aware of how to approach an exam than most students we have met. These things appear obvious, but most students never think them through and prepare for them.

Punctuality

Before you even think about the examination paper and what you should do with it, think about how you are going to get to the exam room. Do you know where it is? How are you going to get there? If you are going by bus or train, do you know which bus or train to catch? Will it be the rush hour when it may well take you much longer than if it were held at midday? How much time will you allow for the journey in case anything should go wrong?

Quite a large proportion of students lose their way to the examination room, or else arrive, breathless and flustered, at the very last minute. They then start the exam anxious and nervous: a recipe for disaster for a lot of students. So, plan how you are going to get there and give yourself enough time.

Cramming

Trying to learn everything at the last minute rarely works. The last few days before the exam should not be spent cramming. You can look at past examination papers and rework some of them, but this is totally different from trying to cram new facts into your head. Worst of all,

don't try to learn anything during the night before the exam, especially if you don't get any sleep. You may get away with this a few times, but you will be found out eventually, fall asleep during the exam, or simply find that you cannot think straight. Apart from the risk of failing the exam because you are exhausted, it is well known that anything you learn before you go to bed the night before an exam will be remembered far better than anything you try to learn on the day of the exam. Studying through the night means you are learning things in the 'morning' of the exam. Your mind needs a rest, even if you don't.

On your way to the exam, try to relax. Try taking your mind off the exam by doing something else, such as chatting with friends, listening to music, or scanning Facebook, Twitter, or other social media for something entertaining to pass the time. Of course, everyone needs some adrenalin to spur them into action when they begin to answer an exam paper, but you do not want to waste your adrenalin before the examination by doing something stressful, like learning something important you've not yet looked at. Doing so will only make you more nervous and less able to cope in the exam. If you haven't learnt something when you leave home, it's not likely you'll be able to concentrate enough to do so on your way to the exam.

Read the rubric carefully and follow its instruction

The rubric appears at the start of the examination paper, and says something such as:

'Attempt five questions only: the *three* questions in Section A and *two* from Section B.'

That instruction from the examiner is to be followed *exactly*. You cannot change the instruction – it means what it says. You have to do what it says.

You may think that is so simple that it is not worthwhile my pointing it out to you, but I cannot remember an exam I have marked when at least some students did not fail to follow the instructions they were given. Let's look at two typical examples where students have ignored the rubric above and what will happen to their mark:

- (a) Instead of answering three questions from Section A and two from Section B, a student answered *two* questions from Section A and *three* from Section B. Here the examiners will mark the two Section A answers plus the first two answers shown on the student's script in respect of Section B. They will not read any part of the third answer to Section B. The student can therefore only get marks for four answers.
- (b) A student answered *three* questions from Section A and *three* from Section B. Here the examiners will mark the three answers to Section A plus the first two answers to Section B. They will not look at the third answer to Section B.

In the case of (b), the student may have done it that way deliberately, thinking that the examiner would mark all three Section B answers, and then award the student the marks from the best two answered questions. Examiners will not waste time marking an extra answer.

If you have time and want to give an extra answer, thinking that you will get better marks for it than one answered previously, then do. But, if you do, make certain that the examiner is fully aware that you have deleted the answer that you do not want to have marked. Strike lines right through it, and also write across the answer that you wish to delete it. Otherwise, it is possible that the first answers only will be marked and your new answer ignored.

Always remember in examinations that you should try to make life easier for the examiner. Give examiners what they want, in the way that they want it. If you do, you will get better marks.

Make their job harder than it needs to be and you will suffer. Examiners are only human. They do their job and their job is to mark what they asked you to do. Do something else and they will ignore it.

Time planning

Let's look at the way in which you should tackle the examination paper. One of the problems with accounting exams is that students are expected to do a lot of work in a relatively short time. It will be the same for every other student taking your exam, so it is not unfair so far as any one student is concerned. Working at speed does bring various disadvantages and makes the way you tackle the examination of even greater importance.

Time per question

The marks allotted to each question will indicate how long you should take in tackling it. Most exams are of two hours, i.e. 120 minutes. This means that in a normal examination, with 100 marks in total, a twenty-mark question should be allocated 20 per cent of the time, i.e. $20\% \times 120 = 24$ minutes. Similarly, a question worth 30 marks should take up 30 per cent of the time, i.e. $30\% \times 120 = 36$ minutes, and so on. Alternatively, in a 2-hour exam worth 100 marks, you have 1.2 minutes for each mark.

If the question is in parts, and the marks awarded are shown against each part, then that will tell you what time you should spend on each part. If part of the question asks for a description, for instance, and only three marks are awarded to that part, then you should not spend twenty minutes on a long and detailed description. Instead a brief description, taking about four minutes, is what is required.

If a question requires a discussion of something, you should spend the time indicated by the mark when you write your answer. A short answer to a discussion question worth 10 marks will not gain a good mark: the examiner expects you to write for $1.2 \text{ minutes per mark} = 12 \text{ minutes}$. In 12 minutes, most people can write more than 200 words.

Do the easiest questions first

Always tackle the easiest question first, then the next easiest question and so on. It is amazing how many students do not do this! Leave the most difficult question as the last one to be attempted. Why is this good advice? The fact is, most exams include what might be called 'warm-up' questions. These are usually fairly short, and not very difficult.

You may be able to do the easiest question in less than the time allocated. The examiner is trying to be kind to you. The examiner knows that there is a certain amount of nervousness on the part of a student taking an examination, and wants to give you the chance to calm down by letting you tackle these short, relatively easy questions first of all, and generally settle down to your work. The easiest question is usually *not* the first question in the exam paper.

Even where all the questions are worth equal marks, you are bound to find some easier than others. It is impossible for an examiner to set questions which are exactly equal in difficulty. So, remember, start with the easiest question. This will give you a feeling of confidence that will help you when you get to the more difficult questions later.

As mentioned above, *do not* expect that these 'warm-up' questions will be numbered 1 and 2 on your exam paper. Many accounting exams have a rather long question, worth quite a lot of marks, as the first question on the paper. A lot of students are fascinated by the fact that such a question is number 1, that it is worth a lot of marks, and their thinking runs: 'If I do this question first, and make a good job of it, then I am well on the way to passing the examination.'

There is no doubt that a speedy and successful attempt at such a question could possibly lead to a pass. The trouble is that this doesn't usually happen, and many students have admitted afterwards that their failure could be put down to simply ignoring our advice to start with the easy questions. What happens very often is that a student starts off on the long first question, things don't go very well, a few mistakes are made, the student then looks at the clock and sees that they are not 'beating the clock' in terms of possible marks, and then panic descends. Leaving that

question very hastily, the student then proceeds to the next question, which normally might have been well attempted but, because of the student's state of mind, a mess is made of that one as well, and so the student fails an exam that they ought to have passed.

Attempt every required question

Attempt each and every question you are required to do. If you are asked to do four questions, don't just do three. On each question, the first few marks are the easiest to get. For instance, on a 20-mark essay question it is reasonably easy to get the first five marks. Managing to produce a perfect answer to get the last five marks, from 15 to 20, is extremely difficult. This applies also to computational questions.

This means that in an examination of, say, five questions with 20 marks for each question, there is not much point in tackling only three questions and trying to make a good job of them. Your maximum possible mark would be 60, and if you had not achieved full marks for each question, in itself extremely unlikely, you could easily fail to reach the pass mark. It is better to leave questions unfinished when your allotted time for them, calculated as described above, has expired, and to then go on immediately to the other questions. It is so easy, especially in an accounting exam, to find you have exceeded the time allowed for a question by a considerable margin. Although you may find it difficult to persuade yourself to do so, *always* move on to the next question when your time for a question has expired.

Computations

When you sit an exam, you should be attempting to demonstrate how well you know the topics being examined. In accounting exams, there are three things in particular to remember. If you fail to do so, you will probably earn less marks than your knowledge deserves. One of these things has already been mentioned – be neat and tidy. The other two have to do with computations: *show all your workings* and *don't worry if your balance sheet does not balance*.

Workings

One golden rule which should *always* be observed is to **show all of your workings**. Suppose you have been asked to work out the Cost of Goods Sold, not simply as part of a Trading Account but for some other reason. Let's imagine that on the exam paper, or on a scrap of paper, you write down the (incorrect) calculation shown below:

	£
Opening inventory	4,000
Add Purchases	11,500
	<u>15,500</u>
Less Closing inventory	(3,800)
	<u><u>12,700</u></u>

You then use this wrong answer of £12,700 in your exam script. At the end of the exam, you take the exam paper home or crumple up the scrap of paper with your workings on it and throw it in a bin. This answer should have been £11,700 and not £12,700 and the examiner may well have allocated four marks for this bit of the question. What will the examiner do when marking your answer? Will the examiner think: 'I should imagine that the candidate mis-added to the extent of £1,000 and, as I am not unduly penalising students for poor arithmetic, I will give the candidate $3\frac{1}{2}$ marks'? Unfortunately, the examiner cannot do this. You will get a mark of zero. If you had attached the workings to your answer, then you could have got 3 or even $3\frac{1}{2}$ marks.

It is a good idea to put the workings of any calculated sum on the face of the any financial statements you have been asked to prepare. For instance, if rent paid is £1,900 and £300 of it has been paid in advance, you can show it on the face of the income statement as:

Rent (1,900 – 300)	£1,600
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By showing the workings in brackets you are demonstrating that you realise that they would not be shown on the published accounts. It also makes it easier for the examiner to mark, and it is always a good idea to make the examiner think you are trying to help.

Do balance sheets have to balance?

Many students ask: ‘What should I do if my balance sheet doesn’t balance?’ The answer is quite simple: leave it alone and get on with answering the rest of the exam paper.

One of the reasons for this is to try and ensure that you answer the required number of questions. You might take twenty minutes to find the error, which might save you one mark. If, instead, you had tackled the next question, in that time you might have gained, say, 10 marks, for which you would not have had time if you had wasted it by searching for the error(s). That assumes that you actually find the error(s)! Suppose you don’t, you have spent twenty minutes looking for it, have not found it, so how do you feel now? The answer is, of course: worried. You may make an even bigger mess of the rest of the paper than you would have done if you had simply ignored the fact that the balance sheet did not balance. In any case, it is quite possible to get, say, 29 marks out of 30 even though the balance sheet does not balance. The error may be a very minor one for which the examiner deducts one mark only.

Of course, if you have finished all the questions, then by all means spend the rest of your time tracing the error and correcting it. Be certain, however, that your corrections are carried out neatly. Untidy crossings-out can result in a loss of marks. So, sometimes, an error found can get back one mark, which is then lost again because your corrections made an untidy mess of your answer, and examiners often deduct marks for untidy work.

Essay questions

There are some basic things about essay questions that every student should know.

Typical questions

Let’s look at two typical exam questions. In doing so, visualise carefully what you would write when answering them.

- (a) You are employed as a bookkeeper by G. Jones, a trader. State briefly what use you would make of the following documents in relation to your bookkeeping records.
 - (i) A bank statement.
 - (ii) A credit note received to correct an overcharge on an invoice.
 - (iii) A pay-in slip.
 - (iv) A petty cash voucher.
- (b) Explain the term ‘depreciation’. Name and describe briefly two methods of providing for depreciation of non-current assets.

Now let’s see whether you would have made a reasonably good attempt at the questions. With question (a) a lot of students would have written down what a bank statement is, what a pay-in slip is, what a petty cash voucher is, and so on. Marks gained by you for an answer like that would be . . . virtually nil. Why is this? Well, you simply have not read the question properly. The question asked what *use* you would make of the documents, not to *describe* what the documents were. The bank statement would be used to check against the bank column in the Cash Book or cash records to see that the bank’s entries and your own are in accordance with one another, with

a bank reconciliation statement being drawn up to reconcile the two sets of records. The petty cash voucher would be used as a basis for entering up the payments columns in the Petty Cash Book. The *use* of the items was asked for, *not* the *descriptions* of the items.

Let us see if you have done better on question (b). Would you have written down how to calculate two methods of depreciation, probably the reducing balance method and the straight-line method? But have you remembered that the question also asked you to *explain the term depreciation*? In other words, what is depreciation generally? Some students will have omitted that part of the question. More students would have made a poor attempt at question (a), but some will have made the mistake described above with question (b).

Underline the key words

I have already described how a large percentage of students fail to answer the question set, instead answering the question they imagine it to be. Too many students write down everything they know about a topic, rather than what the examiner has asked for.

To remedy this defect, *underline the key words* in a question. This brings out the meaning so that it is difficult to misunderstand the question. For instance, let's look at the following question:

‘Discuss the usefulness of a statement of cash flows to a business.’

Many students will write down all they know about statements of cash flows, how to draw them up, what each section contains, how to reconcile them to the change in cash and cash equivalents in the balance sheet, etc.

Number of marks gained . . . virtually nil.

Now underline the key words. They will be:

Discuss usefulness statement of cash flows

The question is now seen to be concerned not with *describing* statements of cash flows, but instead discussing the *usefulness* of statements of cash flows.

Lastly, if the question says ‘Draft a report on . . .’ then the answer should be in the form of a *report*; if it says ‘List the . . .’ then the answer should consist of a *list*. Similarly ‘Discuss . . .’ asks for a *discussion*. ‘Describe . . .’ wants you to *describe* something, and so on.

You should ensure, therefore, that you are going to give the examiners

- (i) what they are asking for; *and*
- (ii) in the way that they want it.

If you do not comply with (i), you may lose all the marks. If you manage to fulfil (i) but do not satisfy the examiner on (ii), you will still lose a lot of marks.

It is also just as important in computational questions to underline the key words to get at the meaning of a question, and then answer it in the manner required by the examiner. With computational questions it is better to look at what is required first before reading the rest of the question. That way, when you are reading the rest of the question, you are able to decide how to tackle it.

Never write out the question

Often – too often – students spend time writing out the text of essay questions before they set about answering them. This is a complete waste of time. It will not gain marks and should *never* be done. It is probably the most common way that students waste time in an exam. Why waste time when you have only a limited amount of it available to you?

Running out of time?

If your plans don't work out, you may find yourself with a question you could answer, but simply do not have the time to do it properly. It is better to write a short note to the examiner to that effect, such as, 'out of time'; and put down what you can of the main points in an abbreviated fashion. This will show that you have the knowledge and should gain you some marks.

Summary

Remember:

- 1 Read the instructions.
- 2 Plan your time before you start.
- 3 Tackle the easiest questions first.
- 4 Finish off answering each question when your time allocation for the question is up.
- 5 Hand in all your workings.
- 6 Do remember to be neat, and to include all proper headings, dates, sub-totals, etc. A lot of marks can be lost if you don't.
- 7 Only answer as many questions as you are asked to tackle by the examiner. Extra answers will not normally be marked and certainly won't get credit.
- 8 Underline the *key* words in each question to ensure that you answer the question set, and *not* the question you wrongly take it to be.
- 9 Never copy the question onto your answer.

Good luck with your exam. We hope you get the rewards you deserve!

Alan Sangster and Lewis Gordon

The Last Lecture

*Our course is run, our harvest garnered in,
And taking stock of what we have, we note how life,
This strange, mysterious life which now we hold and now
eludes our grasp,
Is governed still by natural law, and its events
Tread on each other's heels, each one compelled to follow
where the first has led.
Noting all this, and judging by the past,
We form our plans, until we know at last
The treasure in the future's lap.*

*The man, the plant, the beast, must all obey this law,
Since in the early dawn of this old world
The law was given, and the stuff was made
Which still alone can hold the breath of life:
Whereby we know that grass and man are kin,
The bond a common substance which within
Controls their growth.*

*Can we know all? Nay, but the major part
Of all that is must still elude our grasp,
For life transcends itself, and slowly noting what it is,
Gathers but fragments from the stream of time.
Thus what we teach is only partly true.
Not knowing all, we act as if we knew,
Compelled to act or die.*

*Yet as we grow in wisdom and in skill
The upward path is steeper and each step
Comes higher unto heaven, piercing the clouds
Which heretofore have hid the stars from view.
The new-gained knowledge seems to fill the air,
It seems to us the soul of truth is there.
Our quest is won.*

*Bold climber, all that thou hast won
Lies still in shadow of the peaks above;
Yet in the morning hours the sun
Rewards thy work of love,
Resting a moment on thy lesser height,
Piercing the vault with rays too bright to face,
Strengthens thy soul and gives thee ample might
To serve thy human race.*

Theodore Dru Alison Cockerell (1866–1948)

Zöology: A Textbook for Colleges and Universities, Yonkers-on-Hudson, NY: World Book Company, 1920, pp. 538–9

Publisher's acknowledgements

To the memory of Frank Wood, who, in 1967, had a vision that changed the way accounting textbooks presented this subject, forever.

INTRODUCTION TO FINANCIAL ACCOUNTING

Introduction

This part is concerned with the basic principles underlying the double entry system of bookkeeping and the impact of each transaction upon the financial performance and financial position of a business.

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The background and the main features of financial accounting

Learning objectives

After you have studied this chapter, you should be able to:

- Explain what accounting is about.
- Describe briefly the history of accounting.
- Explain the relationship between bookkeeping and accounting.
- List the main users of accounting information and what accounting information they are interested in.
- Describe the main difference between financial accounting and management accounting.
- Present and explain the accounting equation.
- Explain the relationship between the accounting equation and the layout of the balance sheet.
- Explain the meaning of the terms 'assets', 'capital', 'liabilities', 'trade receivables' and 'trade payables'.
- Describe how accounting transactions affect the items in the accounting equation.
- Draw up balance sheets after different accounting transactions have occurred.

Introduction

In this chapter, you will learn: what accounting is; what led to its development into what it is today; who uses accounting information; and the relationship between the various components that, together, comprise what is known as the “**accounting equation**”.

1.1 What is accounting?

What do you think of when you read or hear the word, ‘accounting’? What do you believe it means or represents?

If you have already attended some accounting classes or if you have spoken to someone who knows something about accounting, you will probably have a fairly good idea of what accounting is and what it is used for. If not, you may find it useful to have this knowledge before you start studying the subject. During the course of the next few pages, let’s see if you can gain that knowledge and learn what accounting is.

Accounting can be defined as:

The process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of that information.

A bit of a mouthful really but, what it means is that accounting involves deciding what amounts of money are, were, or will be involved in transactions (often buying and selling transactions) and then organising the information obtained and presenting it in a way that is useful for decision-making.

Despite what some people think, accounting is not a branch of mathematics, although the man credited with writing the first book to be printed on the subject, Luca Pacioli (c. 1446/7–1517), was a mathematician and teacher. He wrote on the topic ‘because the deeply respectful subjects of your domain, serene, magnanimous Lord, have great need of all mercantile methods, . . . to give them sufficient and enough guidance to keep all their accounts and books in good order.’

What Pacioli wrote is contained in 27 pages of a textbook and reference manual for merchants on business and mathematics (*Summa de arithmetica, geometria, proportioni et proportionalita – Everything about Arithmetic, Geometry, Proportions and Proportionality*). It was first published in Italy in 1494. His bookkeeping treatise has been translated into many languages, including English, and is acknowledged as the chief reason why we maintain accounts in the way we do today.

Accounting may not require a knowledge of mathematics but you do need to be able to add, subtract, multiply and divide – things you need to be able to do in your daily life if you are not to make mistakes in your decision making. Otherwise, you would not know how much money you had with you, how much you would have if you spent some of it, or whether the change you received was correct. To help you with the mathematics you do need to be able to do, Chapter 17 (*Maths for accounting*) sets down the basics you will need to know. **It is very important that you complete this chapter before you begin any of the chapters that follow it.**

1.2 The history of accounting

Accounting began because people needed to:

- record business transactions; and
- know how much they owed others and how much others owed them.

It is known to have existed in one form or another for at least 10,000 years. (Records exist which indicate its use at that time in Mesopotamia – modern-day Iraq.) There is also considerable evidence of accounting being practised in ancient times in Egypt, China, India, Greece and Rome. In England, the ‘Pipe Roll’, the oldest surviving accounting record in the English language, contains an annual description of rents, fines and taxes due to the King of England, from 1130 to 1830.

In India, a system of accounting, called *Bahi-khata*, was developed many centuries ago but it did not spread beyond that region, probably because a description of it was never written down until the twentieth century. It spread by word of mouth and, even today, is a standardised method of keeping accounting records in parts of that region.

In the rest of the world, accounting appears to have developed slowly for thousands of years. The first known example of business records maintained for a whole business using what we call ‘double entry bookkeeping’ – the method described by Pacioli and the method used universally today – was in a branch of an Italian firm in southern France in 1299. It was another 150 years, however, before it became relatively commonly used by northern Italian partnerships and joint ventures. The rest of the world took considerably longer to adopt the method. It is due to Pacioli and what he wrote about it in 1494 that this system of double entry bookkeeping came to be universally adopted.

It has been suggested that no standard system for maintaining accounting records had been developed before this because the circumstances of the day did not make it practicable for anyone to do so – there was little point, for example, in anyone devising a formal system of accounting if the people who would be required to ‘do’ accounting did not know how to read or write.

One accounting scholar (A. C. Littleton) suggested that seven key ingredients were required before a formal system like double entry bookkeeping could be developed and that all seven existed when Pacioli wrote his treatise:

- **Private property.** The power to change ownership exists and there is a need to record the transaction.
- **Capital.** Wealth is productively employed such that transactions are sufficiently important to make their recording worthwhile and cost-effective.
- **Commerce.** The exchange of goods on a widespread level. The volume of transactions needs to be sufficiently high to motivate someone to devise a formal, organised system that could be applied universally to record transactions.
- **Credit.** The present use of future goods. Cash transactions, where money is exchanged for goods, do not require that any details be recorded of who the customer or supplier was. The existence of a system of buying and selling on time (i.e. paying later for goods and services purchased today) led to the need for a formal organised system that could be applied universally to record transactions of this type.
- **Writing.** A mechanism for making a permanent record in a common language. Writing had clearly been around for a long time prior to Pacioli but it was, nevertheless, an essential element required before accounting could be formalised.
- **Money.** There needs to be a common denominator for exchange. So long as barter was used rather than payment with currency, there was no need for a bookkeeping system based upon transactions undertaken using a uniform set of monetary values.
- **Arithmetic.** As with writing, this has clearly been in existence far longer than accounting. Nevertheless, it is clearly the case that without an ability to perform simple arithmetic, there was no possibility that a formal organised system of accounting could be devised.

Of these, the most important catalyst for the emergence of double entry bookkeeping was the use of credit in business. In the Middle Ages, a businessman who did not know how much was owed to him and how much he owed, could lose his business, his home and everything he owned.

During the Crusades (1096–1292), trade routes to the east were opened and merchants, many from Italian ports like Genoa and Venice, began to expand their activities along the new routes. Venice dominated trade and another Italian city, Florence, was the major banking centre in the western world up to at least the mid-fifteenth century.

This expansion of trade led merchants to start operating in joint ventures (where they shared costs and profits) with businessmen located elsewhere. They were heavily involved in importing raw materials and exporting finished goods, particularly in Florence. Many merchants also employed agents to conduct business on their behalf. The need to record details of these transactions and arrangements was obvious.

This did not transform into double entry bookkeeping for many years. In the Middle Ages, when accounting information was recorded it initially took the form of a note of the details of each credit transaction that had not been paid and each receipt and payment. These notes were used by the owner mainly in order to keep track of payments outstanding. However, in Florence, merchants were more accustomed to keeping details of their activities than elsewhere. Many of them already maintained a record of important personal events in a book called a *Ricordanze* – a book of memories. It was a very popular practice and Florentine merchants started to record transactions, receipts and payments in their *Ricordi*.

The larger the business, the greater the number of entries that were made. The entries were prepared when they occurred and it could be some time before the next transaction with the same person occurred. Even with these records in a *Ricordanze*, it became difficult to tell what total amounts were owed and due.

To address this problem, merchants started transferring details from the *Ricordanze* into another book and entries in that book were organised into what we now call ‘accounts’, one for each person or item. Merchants also started using a book for debtors (people who owed money)

and creditors (people who were owed money) and a separate book to record transactions involving cash; plus other books for special reasons, such as a wages book, and a book in which all the transactions of a venture were recorded. This had all developed in and around Florence by the end of the 13th century.

This was the beginning of the system of double entry bookkeeping. When Pacioli wrote his manual on double entry bookkeeping, he based it on the system that had developed in Venice. It was a more compact system than the one that developed elsewhere, though it included specialist books for things like wages and voyages. In Pacioli's description of the system, he focused on the core of the system. A book called a *Memorandum* replaced the *Ricordanze*. The details recorded in it were abbreviated, organised and transferred into another book called a *Journal*. Details from that book were then further summarised and entered into accounts maintained in a third book called a *Ledger*.

The accountant of the Middle Ages was someone who knew how to enter data relating to financial transactions into the accounting books. He was what we call a 'bookkeeper'. Often, it would be the owner of the business who performed all the accounting tasks. Otherwise, an employee would be given the job of maintaining the accounting records.

As businesses grew in size, it became less common for the owner to personally maintain the accounting records and more usual for someone to be employed as a bookkeeper. Then, as companies began to dominate the business environment, managers became separated from owners – the owners of companies (shareholders) often have no involvement in the day-to-day running of the business. This led to a need for some monitoring of the managers. Auditing of the financial records became the norm and this, effectively, established the accounting profession.

Long before that happened in the 19th century, the first association of accountants, the *Collegio dei Raxonati*, was formed in Venice in 1581. It was a body of government accountants and auditors. It took a long time before this was replicated in the private sector. When it did, it was on a regional rather than national basis. National bodies arose as these regional associations matured, towards the end of the 19th century.

If you wish to discover more about the history of accounting, you will find that it is readily available on the internet. Perform a search on either of the terms 'history of accounting' or 'accounting history' and you should find more information than you could ever realistically read on the subject.

1.3 Accountants

From its roots among the scribes of Mesopotamia, accounting is one of the oldest professions in the world. Today, there are around 200 professional accountancy bodies, each with its own requirements to be met before anyone can become a member. While there are notable exceptions, nowadays these generally consist of a series of examinations plus relevant work experience, the same requirement as applied to anyone seeking admission to the Venetian *Collegio dei Raxonati* in 1581.

Today, accountants go beyond the role of the bookkeepers of the Middle Ages. As they did then, accountants record and manipulate financial data in order to provide financial information. In addition, today's accountants are also expected to interpret the information they produce, all in order to assist in decision-making.

It is not necessary to be a member of a professional accountancy body in order to work as an accountant, although few who are not are likely today to rise above the level of a bookkeeper.

Being a member of a professional accountancy body indicates a minimum level of knowledge and expertise that would be expected and upon which employers and others using information provided by such accountants may rely. Because membership of such a body presents an image of professional expertise and understanding, it is important that accountants act in a manner that is consistent with what is expected of them. Any failure to do so places the image of the profession

at risk. In Chapter 40, you will learn that the accounting profession seeks to maintain this image by presenting its members with a Code of Ethics that they must follow.

1.4 The objectives of financial accounting

Financial accounting is the branch of accounting that is concerned with (i) recording business transactions, (ii) preparing financial statements that report on how an entity (a business, charity, club, society, government department, etc.) has performed and, (iii) reporting on its financial position. It has many objectives, including letting people and entities know:

- if they are making a profit or a loss;
- what the entity is worth;
- what a transaction was worth to them;
- how much cash they have;
- how wealthy they are;
- how much they are owed;
- how much they owe;
- enough information so that they can keep a financial check on the things they do.

However, the primary objective of financial accounting is to provide information for decision-making. The information is primarily financial, but it can include data on volumes, for instance the number of cars sold in a month by a car dealership or the number of cows in a farmer's herd.

So, for example, if a business recorded what it sold, to whom, the date it was sold, the price at which it was sold, and the date it received payment from the customer, along with similar data concerning the purchases it made, information could be produced summarising what had taken place. The profitability of the business and the financial status of the business could also be identified, at any time. It is the primary task of financial accounting to take such information and convert it into a form that is useful for decision-making.

People and businesses

Accounting is something that affects people in their personal lives just as much as it affects very large businesses. We all use accounting ideas when we plan what we are going to do with our money. We have to plan how much of it we will spend and how much we will save. We may write down a plan, known as a budget, or we may simply keep it in our minds.

Recording accounting data

However, when people talk about accounting, they are normally referring to financial accounting performed by businesses and other entities. No-one can remember all the details of what has taken place, so records of it have to be kept. These records contain the accounting data.

Entities not only record cash received and paid out. They will also record goods bought and sold, items bought to use rather than to sell, and so on. This part of accounting is usually called the *recording of data*.

Classifying and summarising

Once the accounting data has been recorded, it has to be organised so as to be most useful to the entity. In doing so, we *classify* and *summarise* the accounting data.

Once data has been classified and summarised, it is much easier to work out how much profit or loss has been made by the entity during a particular period. It is also much easier to show what resources are owned by it, and what it owes on the closing day of the period.

Communicating information

From this data and the information it can be used to produce, people skilled in financial accounting should be able to tell whether or not an entity is performing well financially. They should be able to ascertain the strengths and weaknesses of the business, and what it is worth.

Finally, they should be able to tell or *communicate* their results to the owners of the entity, or to others allowed to receive this information.

Financial accounting is, therefore, concerned with:

- recording data;
- classifying and summarising data;
- communicating what has been learnt from the data.

This is also the case for the other main branch of accounting, **Management accounting**, which is accounting undertaken to assist managers within a business to take effective decisions. We will return to this topic later in this chapter.

1.5 What is bookkeeping?

Until about 100 years ago, records of all accounting data was *kept* manually in *books*. This is why the part of accounting that is concerned with recording data is often known as **bookkeeping**.

- Nowadays, although handwritten books may sometimes be used (particularly by very small entities), most accounting data is recorded and stored electronically.

Bookkeeping is the process of recording data relating to accounting transactions in the accounting books. You'll learn more about this in Chapter 2.

1.6 Financial accounting is concerned with ...

Financial accounting is concerned with how accountants use bookkeeping data. This book will cover many such uses.

1.7 Users of financial accounting information

Possible users of financial accounting information include:

- **Managers.** These are the day-to-day decision-makers. They need to know how well things are progressing financially and about the financial status of the business.
- **Owner(s) of the business.** They want to be able to see whether or not the business is profitable. In addition they want to know what the financial resources of the business are.
- **A prospective buyer.** When the owner wants to sell a business the buyer will want to see such information.
- **The bank.** If the owner wants to borrow money for use in the business, then the bank will need such information.
- **Tax inspectors.** They need it to be able to calculate the taxes payable.
- **A prospective partner.** If the owner wants to share ownership with someone else, then the would-be partner will want such information.
- **Investors,** either existing ones or potential ones. They want to know whether or not to invest their money in the business.
- **Creditors.** They want to know if there is any risk of not being paid what they are due.

There are many other users of financial accounting information – suppliers and employees, for example. It is obvious that without properly recorded accounting data a business would have many difficulties providing the information these various users (often referred to as **stakeholders**) require.

Activity 1.1

Which two of these stakeholder groups do you think are considered to be the most important? Why?

However, the information produced by financial accounting needs to be a compromise – the existence of so many different groups of stakeholders make it impossible to produce accounting information at a reasonable cost in a form that suits them all. As a result, financial accounting focuses on producing information for owners and creditors. The other stakeholder groups often find the accounting information provided fails to tell them what they really want to know. As any accountant would tell you, if organisations made the effort to satisfy the information needs of all their stakeholders, financial accounting would be a very costly exercise indeed!

1.8 The two branches of accounting

So far, you have learned that financial accounting is accounting performed for the owners of a business. It is used to show them how much profit has been made and what their business is worth. There is also another branch of accounting that is used by managers and decision makers within a business. It is called **management accounting**. A management accountant produces reports that help managers *plan* and enable managers to *control* what the business is doing. Qualified accountants know how to do both forms of accounting, though some specialise more in financial accounting while others specialise in management accounting.

Financial accounting is concerned with what has already happened assessing performance and considering where we are now. Management accounting is interested in explaining what has happened and in looking into the future.

The reports produced by each of these two branches of accounting are mainly expressed in terms of money, though there are some exceptions, particularly in management accounting. For example, units of a product bought, manufactured, or sold may be the focus of a report on how much of a product to manufacture. However, even then, the amounts involved financially will also be presented and will be used to justify any conclusions drawn in the report.

Management accounting is beyond the scope of this book, but you can find out more about it very easily online.

Let's now look at the relationship upon which financial reporting is based: the **Accounting Equation**.

1.9 The accounting equation

By adding up what the accounting records say belongs to a business and deducting what they say the business owes, you can identify what a business is worth according to those accounting records. The whole of financial accounting is based upon this very simple idea. It is known as the *accounting equation*.

It can be explained by saying that if a business is to be set up and start trading, it will need resources. Let's assume first that it is the owner of the business who has supplied all of the resources. This can be shown as:

$$\text{Resources supplied by the owner} = \text{Resources in the business}$$

In accounting, special terms are used to describe many things. The amount of the resources supplied by the owner is called **capital**. The actual resources that are then in the business are called **assets**. This means that when the owner has supplied all of the resources, the accounting equation can be shown as:

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

Usually, however, people other than the owner have supplied some of the assets. **Liabilities** is the name given to the amounts owing to these people for these assets. The accounting equation has now changed to:

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

This is the most common way in which the accounting equation is presented. It can be seen that the two sides of the equation will have the same totals. This is because we are dealing with the same thing from two different points of view – the value of the owners' investment in the business and the value of what is owned by the owners.

Activity 1.2

What piece of useful information that is available from these three items is not directly shown by this equation? (*Hint: you were introduced to it at the start of this section.*)

Unfortunately, with this form of the accounting equation, we can no longer see at a glance what value is represented by the resources in the business. You can see this more clearly if you switch assets and capital around to produce the alternative form of the accounting equation:

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

This can then be replaced with words describing the resources of the business:

Resources: what they are	=	Resources: who supplied them
(Assets)		(Capital + Liabilities)

It is a fact that no matter how you present the accounting equation, the totals of both sides will *always* equal each other, and that this will *always* be true no matter how many transactions there may be. The actual assets, capital and liabilities may change, but the total of the assets will always equal the total of capital + liabilities. Or, reverting to the more common form of the accounting equation, the capital will always equal the assets of the business *minus* the liabilities.

Assets consist of property of all kinds, such as buildings, machinery, inventories of goods and motor vehicles. Other assets include debts owed by customers and the amount of money in the business's bank account.

Liabilities include amounts owed by the business for goods and services supplied to it and for expenses incurred by it that have not yet been paid for. Liabilities also include funds borrowed by the business.

Capital is often called the owner's **equity** or net worth. It comprises (i) the funds invested in the business by the owner *plus* (ii) any profits retained for use in the business *less* (iii) any share of profits paid out of the business to the owner.

Activity 1.3

What else would affect capital? (*Hint: this item causes the value of capital to fall.*)

1.10 The balance sheet and the effects of business transactions

The accounting equation is expressed in a financial report called the **balance sheet**.

Activity 1.4

Without looking back, write down the commonly used form of the accounting equation.

The balance sheet shows the financial position of an organisation *at a point in time*. In other words, it presents a snapshot of the organisation at the date for which it was prepared. The balance sheet is not the first accounting report to be prepared, nor the first that you will learn how to do, but it is a convenient place to start to consider accounting.

Let's now look at how a series of transactions affects the balance sheet.

1 The introduction of capital

On 1 May 2018, B. Blake started in business and deposited £60,000 into a bank account opened specially for the business. The balance sheet would show:

B. Blake Balance Sheet as at 1 May 2018	
	£
Assets: Cash at bank	<u>60,000</u>
Capital	<u>60,000</u>

Note how the top part of the balance sheet contains the assets and the bottom part contains the capital. This is always the way the information is presented in a balance sheet.

2 The purchase of an asset

On 3 May 2018, Blake buys a kiosk (a small shop) for £32,000 and pays for it by internet transfer from the business bank account. The effect of this transaction on the balance sheet is that the cash at the bank is decreased and the new asset, the shop, is added:

B. Blake Balance Sheet as at 3 May 2018	
	£
Assets	
Shop	32,000
Cash at bank	<u>28,000</u>
	<u>60,000</u>
Capital	<u>60,000</u>

Note how the two parts of the balance sheet 'balance'. That is, their totals are the same. This is always the case with balance sheets, and is why they have that name.

3 The purchase of an asset and the incurring of a liability

On 6 May 2018, Blake buys some goods on time for £7,000 from D. Smith. ‘On time’ means that Blake has not yet paid for them but will do so at some time in the future. The effect of this is that a new asset, **inventory**, is acquired, and a liability for the goods is created. A person to whom money is owed for goods is known as a **creditor**, and is described in the balance sheet as a **trade payable**. The balance sheet becomes:

B. Blake Balance Sheet as at 6 May 2018	
Assets	£
Shop	32,000
Inventory	7,000
Cash at bank	<u>28,000</u>
	67,000
Less: Trade payables	<u>(7,000)</u>
	<u>60,000</u>
Capital	<u>60,000</u>

Note how the liability (the trade payable) is shown as a deduction from the assets. This is exactly the same calculation as is presented in the most common form of the accounting equation.

Activity 1.5

Why do you think the £7,000 value for trade payables is shown in brackets?

Now, let's return to our example.

4 Sale of an asset on time

On 10 May 2018, goods that cost £600 were sold on time to J. Brown for the same amount. ‘On time’ means that Brown will pay for them later. The effect is a reduction in the amount of goods held, i.e. inventory, and the creation of a new asset. A person who owes the business money is a **debtor**, and is described in the balance sheet as a **trade receivable**. The balance sheet is now:

B. Blake Balance Sheet as at 10 May 2018	
Assets	£
Shop	32,000
Inventory	6,400
Trade receivables	600
Cash at bank	<u>28,000</u>
	67,000
Less: Trade payables	<u>(7,000)</u>
	<u>60,000</u>
Capital	<u>60,000</u>

5 Sale of an asset for immediate payment

On 13 May 2018, goods that cost £400 were sold to D. Daley for the same amount. Daley paid for them immediately by debit card. Here one asset, inventory, is reduced, while another asset, cash at bank, is increased. The balance sheet becomes:

B. Blake	
Balance Sheet as at 13 May 2018	
Assets	£
Shop	32,000
Inventory	6,000
Trade receivables	600
Cash at bank	<u>28,400</u>
	<u>67,000</u>
Less: Trade payables	<u>(7,000)</u>
	<u>60,000</u>
<i>Capital</i>	<u><u>60,000</u></u>

6 The payment of a liability

On 15 May 2018, Blake pays D. Smith with £3,000 by internet transfer in part payment of the amount owing. The asset of cash at bank is therefore reduced, and the liability to the creditor is also reduced. The balance sheet is now:

B. Blake	
Balance Sheet as at 15 May 2018	
Assets	£
Shop	32,000
Inventory	6,000
Trade receivables	600
Cash at bank	<u>25,400</u>
	<u>64,000</u>
Less: Trade payables	<u>(4,000)</u>
	<u>60,000</u>
<i>Capital</i>	<u><u>60,000</u></u>

Note how the total of each part of the balance sheet has not changed. The capital is still £60,000 and that is what the business is worth to the owner.

7 Collection of an asset

J. Brown, who owed Blake £600, makes a part payment of £200 by cheque on 31 May 2018. The effect is to reduce one asset, trade receivables, and to increase another asset, cash at bank. The balance sheet becomes:

B. Blake Balance Sheet as at 31 May 2018	
Assets	£
Shop	32,000
Inventory	6,000
Trade receivables	400
Cash at bank	25,600
	<u>64,000</u>
Less: Trade payables	(4,000)
	<u>60,000</u>
Capital	<u>60,000</u>

1.11 Equality of the accounting equation

It can be seen that every transaction has affected two items. Sometimes it has changed two assets by reducing one and increasing the other. In other cases, the effect has been different. However, in each case other than the very first (when the business was started by the owner injecting some cash into it), no change was made to the total of either section of the balance sheet and the equality between their two totals has been maintained. The accounting equation has held true throughout the example, and it always will. The effect of each of these seven accounting transactions upon the two sections of the balance sheet is shown below:

Number of transaction as above	Assets	Capital and Liabilities	Effect on balance sheet totals
1	+	+	Each side added to equally
2	+ –		A <i>plus</i> and a <i>minus</i> both on the assets side cancelling each other out
3	+	+	Each side has equal additions
4	+ –		A <i>plus</i> and a <i>minus</i> both on the assets side cancelling each other out
5	+ –		A <i>plus</i> and a <i>minus</i> both on the assets side cancelling each other out
6	–	–	Each side has equal deductions
7	+ –		A <i>plus</i> and a <i>minus</i> both on the assets side cancelling each other out

These are not the only types of accounting transactions that can take place. Two other examples arise when

- (8) the owner withdraws resources from the business for his or her own use; and where
- (9) the owner pays a business expense personally.

A summary of the effect upon assets, liabilities and capital of each type of transaction you've been introduced to so far is shown below:

Example of transaction	Effect	
(1) Owner pays capital into the bank	↑ Increase asset (Bank)	↑ Increase capital
(2) Buy inventory by cheque	↓ Decrease asset (Bank)	↑ Increase asset (Inventory)
(3) Buy inventory on time	↑ Increase asset (Inventory)	↑ Increase liability (Trade payables)
(4) Sale of inventory on time	↓ Decrease asset (Inventory)	↑ Increase asset (Trade receivables)
(5) Sale of inventory for cash (cheque)	↓ Decrease asset (Inventory)	↑ Increase asset (Bank)
(6) Pay creditor	↓ Decrease asset (Bank)	↓ Decrease liability (Trade payables)
(7) Debtor pays money owing by cheque	↑ Increase asset (Bank)	↓ Decrease asset (Trade receivables)
(8) Owner takes money out of the business bank account for own use	↓ Decrease asset (Bank)	↓ Decrease capital
(9) Owner pays creditor from private money outside the firm	↓ Decrease liability (Trade payables)	↑ Increase capital

Transactions (8) and (9) cause the totals of each part of the balance sheet to change (as did the very first, when capital was introduced to the business by the owner). When the capital changes, the totals of the two parts of the balance sheet both change.

1.12 More detailed presentation of the balance sheet

Let's now look at the balance sheet of B. Blake as at 31 May 2018, presented according to how you will learn to present the information later in this book:

B. Blake Balance Sheet as at 31 May 2018

<i>Non-current assets</i>	£	£
Shop		32,000
<i>Current assets</i>		
Inventory	6,000	
Trade receivables	400	
Cash at bank	<u>25,600</u>	
		32,000
Total assets		64,000
<i>Less: Current liabilities</i>		
Trade payables		(4,000)
Net assets		<u>60,000</u>
Capital		<u>60,000</u>

You will have noticed in this balance sheet the terms ‘non-current assets’, ‘current assets’ and ‘current liabilities’. **Chapter 8 contains a full explanation of these terms.** At this point we will simply say:

- **Non-current assets** are assets which have a long life bought with the intention to use them in the business and not with the intention to simply resell them, e.g. buildings, machinery, fixtures & fittings (e.g. shelves), motor vehicles.
- **Current assets** are assets consisting of cash, goods for resale or items having a short life (i.e. no more than a year remaining on the date of the balance sheet). For example, the amount (and so the value) of inventory goes up and down as it is bought and sold. Similarly, the amount of money owing to a business by debtors will change quickly, as the business sells more to them on time and when they pay their debts. The amount of money in the bank will also change when it is received or paid out.
- **Current liabilities** are those liabilities which have to be paid within no more than a year from the date on the balance sheet, e.g. trade payables for goods purchased.

Don't forget that there is a Glossary of accounting terms at the back of the book.

Learning outcomes

You should now have learnt:

- 1 Accounting is concerned with the recording, classifying and summarising of data, and then communicating what has been learnt from it.
- 2 Accounting has existed for at least 10,000 years but a formal, generally accepted method of recording accounting data has only been in existence for the last 700 years.
- 3 It may not only be the owner of a business who will need the accounting information. It may need to be shown to others, e.g. the bank or the Inspector of Taxes.
- 4 Accounting information can help the owner(s) of a business to plan for the future.
- 5 Financial accounting is performed for the owners of a business so that they can assess its performance and financial position. Management accounting is prepared for those running a business so that they can plan and control its activities.
- 6 The accounting equation is: $\text{Capital} = \text{Assets} - \text{Liabilities}$.
- 7 The two sides of the accounting equation are represented by the two parts of the balance sheet.
- 8 The total of one part of the balance sheet should always be equal to the total of the other part.
- 9 Every transaction affects two items in the accounting equation. Sometimes that may involve the same item being affected twice, once positively (going up) and once negatively (going down).
- 10 Every transaction affects two items in the balance sheet.

Note: Generally, the values used in exhibits and exercises are relatively small amounts. You may think this wrong, that it is unrealistic, and it is, but it has been done to make things easier for you. It means that you can concentrate on learning accounting rather than having to also cope with complex calculations. Constantly handling large figures does not add anything to the study of the principles of accounting. It simply wastes a lot of your time. This is especially true today because in the ‘real world’ most of what you are going to learn is done using computers, and they deal with all the complex mathematics for you, so you don't really need to learn that aspect at all.

Answers to activities

- 1.1 Owners and creditors are considered to be the most important stakeholders because they have most to lose if the business fails.
- 1.2 Who supplied the resources of the business.
- 1.3 Capital will be reduced if a business makes a loss. The loss means that assets have been reduced and capital is reduced by the same amount so as to maintain the balance in the accounting equation.
- 1.4 $\text{Capital} = \text{Assets} - \text{Liabilities}$.
- 1.5 It is a negative number. In accounting, we **always** use brackets to indicate negative numbers.

Review questions

If you haven't already started answering them, you now have a set of graded review questions to try. 'Graded' means that they get more difficult as you go through them. Ideally, they should be done in the sequence they appear. *However, don't forget that the questions with an 'A' after the question number do not have any answers provided in this book.* Your teacher or lecturer will be able to provide you with the answers to those questions but be sure to attempt them first before asking for the answers! The answers to the other questions can be found at the back of the book.

We realise that you would like to have *all* the answers in the book. However, teachers and lecturers would not then be able to test your knowledge with questions from this book, as you would already possess the answers. It is impossible to please everyone, and the compromise reached is that of putting a large number of review questions in the book.

This means that appropriate reinforcement of what you have learnt can take place, even if you are studying on your own and have to miss out all the 'A' questions because you have no access to the answers.

Multiple-choice questions. In addition to these Review questions, there are questions relating to the material in this chapter in a bank of multiple-choice questions at the end of Chapter 6. You should wait and attempt them when you reach them, not before.

- 1.1 Complete the gaps in the following table:

	Assets	Liabilities	Capital
	£	£	£
(a)	42,000	22,000	?
(b)	78,500	43,300	?
(c)	59,900	?	25,700
(d)	61,700	?	18,600
(e)	?	32,900	21,300
(f)	?	19,400	31,300

- 1.2A Complete the gaps in the following table:

	Assets	Liabilities	Capital
	£	£	£
(a)	89,000	38,000	?
(b)	?	42,900	37,700
(c)	96,500	?	42,200
(d)	103,800	61,300	?
(e)	119,100	?	61,400
(f)	?	49,100	51,300





1.3 Which of the items in the following list are liabilities and which of them are assets?

- | | |
|-------------------------------------|--------------------------------------|
| (a) Motor vehicle | (d) Bank overdraft |
| (b) Amounts owed to us by customers | (e) Inventory of goods held for sale |
| (c) Land | (f) Amounts owed by us to suppliers |

1.4A Classify the following items into liabilities and assets:

- | | |
|-----------------------|--------------------|
| (a) Computers | (f) Cash in bank |
| (b) Buildings | (g) Bank overdraft |
| (c) Trade payables | (h) Loan from bank |
| (d) Inventory | (i) Vans |
| (e) Trade receivables | |

1.5 State which of the following are wrongly classified:

<i>Assets</i>	<i>Liabilities</i>
Loan from K. Jones	Delivery van
Bank overdraft	Trade payables
Trade receivables	Computer equipment
Warehouse	Machinery
Office furniture	Cash in hand

1.6A Which of the following are shown under the wrong headings?

<i>Assets</i>	<i>Liabilities</i>
Cash at bank	Bank overdraft
Fixtures and fittings	Equipment
Trade payables	Computers
Premises	Loan from building society
Inventory	
Trade receivables	
Capital	

1.7 Winston is setting up a new business. Before selling anything, he bought a van for £9,995; a transportable market stall for £2,050; a computer for £495; and an inventory of goods for £11,720. He did not pay in full for his inventory of goods and still owes £2,380 for them. He borrowed £5,000 from G Orwell. After the events just described, and before trading starts, he has £100 cash in hand and £920 in the bank. Calculate the amount of his capital.

1.8A Danielle is starting a business. Before starting to sell anything, she bought fixtures for £4,100, a van for £5,950 and an inventory of goods for £3,620. Although she has paid in full for the fixtures and the van, she still owes £1,670 for some of the inventory. M Johnson lent her £3,000. After the above, Danielle has £780 in the business bank account and £50 cash in hand. You are required to calculate her capital.

1.9 Draw up Tom Galley's balance sheet from the following information as at 31 December 2024:

	£
Capital	37,650
Trade receivables	9,290
Motor vehicle	11,610
Trade payables	10,230
Equipment	14,160
Inventory	12,340
Cash at bank	480

1.10A Draw up Amy Banfield's balance sheet as at 30 June 2024 from the following items:

	£
Capital	22,960
Equipment	11,660
Trade payables	6,390
Inventory	7,920
Trade receivables	9,400
Cash at bank	370

1.11 Complete the columns to show the effects of the following transactions:

	<i>Effect upon</i>		
	<i>Assets</i>	<i>Liabilities</i>	<i>Capital</i>
(a) We pay a creditor £310 by cheque.			
(b) Bought fixtures £175 paying in cash.			
(c) Bought goods on time £630.			
(d) The proprietor introduces another £1,200 cash into the business.			
(e) J. Walker lends the business £2,500 in cash.			
(f) A debtor pays us £50 in cash.			
(g) We return goods costing £90 to a supplier whose bill we had not paid.			
(h) Bought an office computer paying £610 by cheque.			

1.12A Complete the columns to show the effects of the following transactions:

	<i>Effect upon</i>		
	<i>Assets</i>	<i>Liabilities</i>	<i>Capital</i>
(a) Bought a van on time £8,700.			
(b) Repaid by cash a loan owed to F. Duff £10,000.			
(c) Bought goods for £1,400 paying by cheque.			
(d) The owner puts a further £4,000 cash into the business.			
(e) A debtor returns to us goods worth £150. We agree to make an allowance for them.			
(f) Bought goods on time £760.			
(g) The owner takes out £200 cash for his personal use.			
(h) We pay a creditor £1,150 by cheque.			





1.13 T. Ross has the following items in his balance sheet on 30 April 2024: Capital £26,060; Trade payables £5,510; Fixtures £12,390; Motor vehicle £7,500; Inventory £4,210; Trade receivables £6,350; Cash at bank £920; Cash in hand £200.

During the first week of May 2024:

- (a) He bought extra inventory for £490 on time.
- (b) One of the debtors paid him £350 by cheque.
- (c) He bought a computer by cheque £720.

You are asked to draw up a balance sheet as at 7 May 2024 after the above transactions have been completed.

1.14A J. Hill has the following assets and liabilities on 30 November 2019: Trade payables £2,800; Equipment £6,200; Motor vehicle £7,300; Inventory £8,100; Trade receivables £4,050; Cash at bank £9,100; Cash in hand £195.

You are not given the capital amount at that date.

During the first week of December 2019:

- (a) Hill bought extra equipment on time for £110.
- (b) Hill bought extra inventory by cheque £380.
- (c) Hill paid creditors by cheque £1,150.
- (d) Debtors paid Hill £640 by cheque and £90 by cash.
- (e) Hill put an extra £1,500 into the business, £1,300 by cheque and £200 in cash.

You are to draw up a balance sheet as at 7 December 2019 after the above transactions have been completed.

Recording transactions

Learning objectives

After you have studied this chapter, you should know that:

- There are two elements to every transaction: an *Item exchanged* and a *Form of settlement*.
- Double entry bookkeeping requires that for each transaction, an entry is made once for the *Item exchanged*; and once for the *Form of settlement*.
- The treatment of the *Item exchanged* is always the opposite of the treatment of the *Form of settlement*.
- Debit means 'place on the left of the account called ...'.
- Credit means 'place on the right of the account called ...'.
- The total of the debit must always equal the total of the credit.
- Capital is what the owner contributes to a business.
- Capital does not belong to a business; it belongs to the owner of the business.
- Liabilities are all other items that do not belong to a business, such as loans from banks.
- Debtors are people who owe money to a business.
- Creditors are people who are owed money by a business; the owner of a business is not a creditor of the business; the owner is an investor in the business.
- Expenses are immediately used-up but, they belong to the business and are treated the same way as all other possessions.
- Possessions that last some time are called 'assets'.
- When the *Form of settlement* is given, it is a credit.
- When the *Form of settlement* is received, it is a debit.
- The entry for the *Item exchanged* is always the opposite of the entry for the *Form of settlement*.
- To identify the accounts to debit and credit, you *always* focus upon the *Form of settlement*.

Introduction

In this chapter, you will learn the *Principles of double entry*: how to do double entry bookkeeping. You will learn how double entry is used to record financial transactions. You will also learn how to use T-accounts, the traditional way to make such entries under the double entry system.

Part One The principles of double entry

2.1 The nature of a transaction

In Chapter 1, you saw how various events had each changed two items in the balance sheet. These events are known as ‘transactions’. Transaction involves two things: the **Item exchanged** and a **Form of settlement** that is either cash, an **IOU**, or capital. ‘IOU’ is usually called ‘credit,’ but ‘IOU’ is easier to learn to use at this stage of your studies. ‘Capital’ is what has been invested by the owner in a business. The *Item exchanged* and the *Form of settlement* are the two ‘*elements of a transaction*’. If there is no *Item exchanged* (i.e. bought or sold), there is no transaction:

- If a businessman asks the price of something, but does not buy it, there is no transaction.
- If a businessman asks the price of something and then buys it, that event is a transaction.

When we enter the data relating to a **transaction** in the accounting records, we need to ensure that the items that were affected by the transaction, *and only those items*, are shown as having changed. Bookkeeping is the first stage in doing so. It can take many forms, but the one that is most used is called **double entry bookkeeping**.

Activity 2.1

What do you think a likely name might be for other forms of bookkeeping?
(Hint: double beds and ____ beds.)

Double entry bookkeeping is therefore all about recording the financial results of transactions. Examples of transactions include a purchase of a machine, payment of an electricity bill, sale of a sandwich, and interest received from a bank for money deposited.

There is a wide range of possible transactions for any business, and we need a system of bookkeeping that is flexible enough to record any of them. We do this by having places where we record each entry. These are called **accounts**. We can add a new account whenever we want and there is no limit to the number of accounts we can have.

What we record in accounts are the two **elements of transactions**.

2.2 The elements of a transaction

As mentioned above, in accounts we record the outcome of transactions involving two elements: the *Item exchanged*, such as a car or a computer; and the *Form of settlement*, such as cash.

So, if you buy a computer with cash, the *Item exchanged* is the computer. You need to create an account called ‘computer account’. In that account, you record that you now own a computer, which means that the total value of the account has increased.

You also need an account for the *Form of settlement*, in this case ‘cash’. You call that account, ‘cash account’. In that account, you record that your cash has been reduced because you used some cash to become the owner of a computer.

Traditionally, each account has a left-hand side and a right-hand side. You can see one for a computer in Exhibit 2.1.

Exhibit 2.1

Computer account

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**Activity
2.2**

What do you think we call this form of account? (*Hint: what shape do the lines make?*)

The amount of each transaction is entered on one of those two sides in the account for the *Form of settlement*; and on the other side in the account for the *Item exchanged*. That is the **double entry**: one entry made in two different accounts for each transaction. When we make these entries, we describe one as a **debit** and the other as a **credit**. Let's see what these terms mean.

2.3 Debit and credit

Debit means '*place on the left of the account called . . .*' and credit means '*place on the right of the account called . . .*'. You can see why we just use the words 'debit' and 'credit', instead of the whole eight-word phrase each time, can't you?

These two words 'debit' and 'credit' are central to understanding double entry bookkeeping. Every time you record a transaction, you *debit* one account, and you *credit* another account. This is why we call this form of bookkeeping, 'double entry'. The amount you *debit* will always be equal to the amount you *credit*.

Debit ALWAYS equals Credit

**Activity
2.3**

Why do you think debit always equals credit?

Let's now look at what guides you in making these 'double entries': the *Principles of double entry bookkeeping*.

2.4 The principles of double entry bookkeeping

When recording a transaction, you need to decide which account to *debit* and which account to *credit* for each entry. In order to do so, there are three things that are always true:

- 1 A *Form of settlement* given is always a credit.
- 2 A *Form of settlement* received is always a debit.
- 3 The entry for the *Item exchanged* is always the opposite to the entry for the *Form of settlement*.

These are what ensure you make the correct entries *every* time.

Now that you know what an account is, what *debit* and *credit* mean, and the principles to follow, let's see what happens when we record the elements of a transaction.

If you remember these principles, you will always know which account to debit and which account to credit.

2.5 Recording the elements of a transaction

The amount of each transaction is entered in the accounts of the two elements of the transaction: on one side in the account for the *Form of settlement*, and on the other side in the account for the *Item exchanged*.

So, imagine that you entered into a transaction worth £100. After the entries for the transaction have been made, the two accounts would *either* look like this:

Exhibit 2.2

Item exchanged account	Form of settlement account
£100	£100

or like this:

Exhibit 2.3

Item exchanged account	Form of settlement account
£100	£100

These are the only two possibilities. **The *Form of settlement* will tell you which of these to use:**

- If you *purchased* something for cash, you would record the entries as in Exhibit 2.2: the *Form of settlement* was given, so it must be credit; the *Item exchanged* must be debit.
- If you *sold* something for cash, you would record the entries as in Exhibit 2.3: the form of settlement was received, so it must be debit; the *Item exchanged* must be a credit.

Do you see how the *Form of settlement* guides you in how to make these entries?

Always use the *Form of settlement* to guide you in what to debit and what to credit.

This is straightforward when cash is involved. And it is the same when it is not. When you purchase goods that you will pay for later, you have given the seller an IOU, i.e. a promise to pay later. So, you must credit the *Form of settlement* and debit the goods account. What account do you use to record this IOU?

2.6 When the form of settlement is an IOU

An IOU is a 'debt'. A 'debt' is created whenever a seller agrees to wait for the payment until some-time in the future. In the accounts of the seller, whenever a new debt is created, it is the *Form of Settlement* in the transaction.

Let's assume that the *Form of settlement* in both Exhibit 2.2 and Exhibit 2.3 is an IOU:

- In Exhibit 2.2 (a purchase): a *Form of settlement* has been given, so it is a credit. That is, the debt *due to the seller* is a credit.
- In the case of Exhibit 2.3 (a sale): a *Form of settlement* has been received so it is a debit. That is, the debt *due from the customer* must be a debit.

Activity 2.4

Describe the two entries in Exhibit 2.2 using 'debit' and 'credit'; and give an example of a transaction that fits this description.

Whenever a debt is repaid, it is the *Item exchanged*. This is because you pay a debt using a *Form of settlement*.

2.7 Balance

Once you have made some transactions, you may want to find out how much an account is worth. For example, how much a debtor owes you, or how much you owe someone else. You do this by calculating the difference between the totals of the debits and the total of the credits entered in that account. We call that difference, the **balance**. In Exhibit 2.2, the *Item exchanged* account has £100 more on the debit side: it has a ‘debit balance’ of £100; and the *Form of settlement* account has £100 more on the credit side: it has a ‘credit balance’ of £100.

Let’s now use the *Principles of double entry bookkeeping* to see what happens when you have a list of balances and want to know what your business is worth. We’ll use an example that involves ‘capital’. Capital is a *Form of settlement*.

2.8 Drawing-up a list of what a business is worth

Imagine you have been in business for a few months but, you have not kept any proper records of your transactions. You have decided to end that business and start a new one by transferring everything to the new business. You now also want to start using double entry bookkeeping.

The first step is to write down a list of everything belonging to the old business and everything the old business owes. Here is the list you prepared:

Exhibit 2.4

	£
1 Cash	600
2 Cash in US dollars’ worth	200
3 Cash in the bank	1,200
4 Cash in the bank in euros worth	430
5 Computer	500
6 Mobile phone	240
7 Sales register	320
8 Printer	150
9 Printing supplies	40
10 Goods for sale	18,000
11 Amount due by Fred Palmer	300
12 Amount due by Winnie Woo	370
13 Loan from bank	10,000

Activity 2.5

If you now enter these items in T-accounts of the new business, what do you think the *Form of settlement* will be for each one?

You are exchanging all of these items shown in Exhibit 2.4. That is, you are giving them to the new business and it will give you something in return for each of them. In each case, the *Form of settlement* account will be one called **capital account**. You, the business owner, have transferred all

these items from your old business into your new business. They are now all possessions of your new business. We use a capital account to record what the business owner has put into the business.

Once the business is active, making purchases and sales, we add any profits to that account, subtract any losses from it, and also subtract any items taken out of the business for the owner's own personal use. We call the balance on that account, **capital**. It is what the business is worth to the owner on the date when the balance is calculated. In other words, it is what the owner has invested in the business at that point in time.

'Capital' at any point in time is equal to the amount the owner has invested in the business plus any profits, less any losses, less everything taken out of the business by the owner, such as cash or goods.

Activity 2.6

What do you think the balance on the capital account will be once you have entered each of these 13 items into the correct accounts?

It is important to remember: it is the transactions of the business that you are recording. The business is *not* you. When you begin a business, you give it many things. It settles each of those transactions by giving you capital. The only exceptions are debts owing to someone else. When you give the new business a debt that you owe someone else, that transaction is settled by you giving the business back some of the capital it has given you. When you give back capital the business receives it and enters receipt of this *Form of settlement* as a debit.

Let's now look at how you make these 'double entries'.

2.9 Making double entries

You need to decide which account to debit and which account to credit for each entry. In order to do so, we consider the *Form of settlement*.

Activity 2.7

What is the entry to the capital account when it has decreased?
Is it a debit or a credit?

Let's see what the double entries are for the first four items you are transferring into the new business from your list in Exhibit 2.4. In each case, these things being transferred to the new business are the *Item exchanged*. You give them to the business and it settles each of these transactions using the *Form of settlement*, capital.

Exhibit 2.5

Item Exchanged	Debit	Credit
1 Cash	Cash account	Capital account
2 Cash in US dollars	Cash in US dollars account	Capital account
3 Cash in the bank	Cash in the bank account	Capital account
4 Cash in the bank in euros	Cash in the bank in euros account	Capital account

In each case, the *Form of settlement* (capital) is given to you by the business. That is why it is a credit. Do you see how the debit is always to a cash account? (You have four accounts in which ‘cash’ is kept: one for cash; one for cash held at your bank; one for cash in US dollars; and one for cash in euros.) These four entries are all debits because the *Form of settlement* is a credit.

What do you think the credit entry will be for items 5 to 12? Let’s see:

Exhibit 2.6

Item Exchanged	Debit	Credit
5 Computer	Computer account	Capital account
6 Mobile phone	Mobile phone account	Capital account
7 Sales register	Sales register account	Capital account
8 Printer	Printer account	Capital account
9 Printing supplies	Printing supplies account	Capital account
10 Goods for sale	Goods for sale account	Capital account
11 Amount due by Fred Palmer	Amount due by Fred Palmer account	Capital account
12 Amount due by Winnie Woo	Amount due by Winnie Woo account	Capital account

Capital given is always a credit.

Activity 2.8

What does the fact that capital is credited for each of these items tell you about the debits?

Items 5 to 12 confirm to you that **any increase in something that belongs to the business is a debit**. You should remember that in accounting we call all these items that belong to the business ‘assets’.

Activity 2.9

Look carefully at the wording of the debit entry for items 11 and 12. What is being debited, the amount due, or the people who owe the business these amounts? (*Hint: these are entries for the ‘item’ exchanged.*)

Think back to items 1 and 2 (‘cash’ and ‘cash in US dollars’). They are both items of **cash** but they each have their own account *because they are different types of cash* – you cannot spend the US dollars in a shop unless you are in the United States but, you can spend cash that is in your local currency in any shop in your country. For this reason, you need two accounts to record these different types of cash.

Similarly, items 11 and 12 are both **debts** owed by other people that have been transferred from the old business but *they are debts of different people* so each of them must have its own account. By including the identity of the person who owes you the money in the name of the account, you know who is in debt to you. We call a person who owes you money a ‘debtor’.

In Exhibit 2.7, we have entered the debt owed to us by Winnie Woo (Item 12) into her account.

Exhibit 2.7

Amount due by Winnie Woo	
£370	

You can see that the debit side of Winnie Woo's account (£370) is a higher amount than the credit side (£0). The account has a debit balance, so Winnie Woo is a debtor. **When a person's account has a debit balance, that person is a debtor.**

**Activity
2.10**

What do you think we call someone whose account has a credit balance?

Now let's look at the final item in your list: Loan from bank. What does this mean? Does it mean that you have £10,000 in the bank? Or, does it mean that you owe the bank £10,000?

It means that you owe the bank £10,000. So, this is an amount your old business owes the bank. **It is not a possession of the business.** The loan is the *Item exchanged*. It is being transferred into the new business and the *Form of settlement* is *capital*, just as it was with all the other items in Exhibit 2.4. But the business is not giving capital in exchange for the loan. It is receiving it so, the entry for the *Form of settlement* (capital) is a debit.

And, this loan is not a possession of the business, so it is treated in the opposite way to a possession of the business. That is, it is a credit.

The double entries for item 13 therefore go in the opposite direction to those for the 12 items that did belong to the business. It has reduced your investment in the new business, so you must settle this transaction with capital. Because the business receives the *Form of settlement* (capital), it is a debit, and the entry for the *Item exchanged* is a credit.

Exhibit 2.8

Item exchanged	Debit	Credit
13 Loan from bank	Capital account	Loan from bank account

As you learnt in Activity 2.10, we call a person or an organisation that we owe money a **creditor**. The credit side of their account is a higher amount than the debit side. You can confirm this by looking at the 'Loan from bank' account in Exhibit 2.9: the credit side (£10,000) is higher than the debit side (£0).

Exhibit 2.9

Loan from bank account	
	£10,000

All items that do *not* belong to the business are called **liabilities**. These are things the business *must* pay to its *creditors*. **The only exception is capital.** It is *not* a liability because it belongs to the owners of the business and the business does not have to pay its owners back what they have invested.

So far, you have only seen a few entries in **T-accounts**. Let's now look at two of these accounts with the amounts from Exhibit 2.4 entered on the correct side and then look at what happens when we make a new transaction involving those two accounts.

2.10 Making double entries into existing accounts

Exhibit 2.10 shows you the entries for the printing supplies and the cash from Exhibit 2.4 in their T-accounts.

Exhibit 2.10

Printing supplies account	Cash account
£40	£600

Now, let's imagine that you decide you need some more printing supplies for your new business. You go to a shop and pay £50 in cash for what you need. What would the double entries be?

The *Form of settlement* is cash. It has been given, so it is a credit. The *Item exchanged* is printing supplies (e.g. toner, ink, paper, etc.). It must be the opposite: a debit.

Debit Printing supplies account Credit Cash account

Let's now look at those two accounts with the amount of the purchase entered.

Exhibit 2.11

Printing supplies account	Cash account
£40	£600
50	£50

What are the balances on these two accounts?

The balance – the difference between the total of the debits and the total of the credits – on the Printing supplies account has now increased from £40 to £90. At the same time, the balance on the Cash account has reduced from £600 to £550. The total belonging to the business has not changed. You have simply entered a transaction where printing supplies were exchanged for cash: the supplier gave them to you, and you gave the supplier cash.

What would the double entries be if you now sold some of your goods? Let's see.

2.11 Recording a sale

Let's assume an old friend contacts you asking to buy some of your goods. You decide to sell him the goods at the same price as they cost you to purchase them. They cost you £60. You give him the goods and he gives you £60 in cash.

In Exhibit 2.11, you prepared the two T-accounts. Once you had entered the items from Exhibit 2.4 and the purchase of printing supplies for £50, they looked like this:

Goods for sale account	Cash account
£18,000	£600
	£50

The double entries for this sale transaction would be:

Debit Cash account Credit Goods for sale account

The *Form of settlement* (cash) has been received, so it must be debited. The *Item exchanged* ('Goods for sale') must be the opposite, so you must credit the Goods for sale account. The two accounts now contain:

Goods for sale account		Cash account	
£18,000	£60	£600	£50
		60	

Your Cash has increased and your Goods for sale have decreased. Your accounts continue 'in balance'. That is, the total of all the debits in all your accounts equals the total of all the credits in all your accounts.

Activity 2.11

Confirm that the total of all the debit balances of the accounts listed in Exhibits 2.5 and 2.6 is the same as the total of all the credit balances. Why is this?

Remember the Principles of double entry bookkeeping:

- 1 A *Form of settlement* given is always a credit.
- 2 A *Form of settlement* received is always a debit.
- 3 The entry for the *Item exchanged* is always the opposite to the entry for the *Form of settlement*.

These principles are all you need to know so that you *always* select the correct account to debit and the correct account to credit for any transaction. Apply them correctly to the *Form of settlement* and your debits and credits should always be in the correct account.

The examples above will guide you if you ever forget the principles.

Activity 2.12

What are the double entries if you repay a loan by paying the creditor in cash?

You can also be guided by the item received. Whenever something is received that belongs to the business, it is a debit. When something received does not belong to the business, like a loan from a bank, it is always a credit. This is very useful to know when you are recording adjustments to accounts. We will do that later in this book. When recording transactions, if you always use the principles, you should always make the correct decisions on the debits and credits.

So far, we have not mentioned expenses. Let's look at how they are recorded in double entry.

2.12 Expenses and double entry

When you incur an expense, *it belongs to the business* in the same way that a computer, a machine, or a building belongs to the business. The difference is that an expense is used-up immediately whereas a computer is used for a long time. (We call possessions that you keep for some time *assets*. We call possessions that are used-up immediately 'expenses'.)

For example, if you pay an electricity bill for £120 by cash, the *Item exchanged* is electricity. Cash was the *Form of settlement* and it was given, so must be a credit. The *Item exchanged* (the expense) must be the opposite, so you debit electricity. You will learn later that expenses are always debits.

2.13 Purchases accounts and Sales accounts

Instead of recording purchases and sales in an account for the *Item exchanged*, many businesses use accounts for purchases and accounts for sales. In that case, **if you purchase something to sell in your shop, you make the entry in the 'Purchases account'**. When you **sell it, you make the entry in the 'Sales account'**.

The purchases and the sales are kept apart. This is done because the balances on both these accounts are needed when you prepare an **Income Statement**, the report accountants produce that shows how profitable the business has been.

Purchases are possessions so, when they increase, the entry is a debit.

Sales are also possessions (that you have exchanged for money or a debt). When your possessions decrease (as they do when you make a sale), the entry is a credit.

2.14 Finally

You now know all you need to know about debits and credits. You will use this knowledge a lot during the rest of this book. If you ever get confused and cannot remember the *Principles of double entry* or how to record an entry, return to this chapter. You will soon know again how to do double entry.

Remember:

Always start by looking at the *Form of settlement*.

Remember:

When a *Form of settlement* is given, it is a credit.

Remember:

When a *Form of settlement* is received, it is a debit.

Remember:

The entry for the *Item exchanged* is always the opposite.

Remember:

The amount of the debit always equals the amount of the credit.

Part Two Some worked examples

Before showing you how a series of transactions are recorded, we'll first look at what else needs to be included when an entry is made in an account.

2.15 Completing the entry in an account

So far you have learnt how to decide which account to debit and which account to credit. You know where to enter the value of each transaction. Now, we shall add the other items that also need to be included when you make an entry:

- the date
- the name of the other account in which the transaction is being entered.

When you make your first entry in an account, you need to enter the year, month and day, plus the name of the other account involved in the transaction. Let's assume that you transferred all the items into the new business on 1 January 2019. To make the entries for Item 1 in Exhibit 2.4, you need to create an account for Cash and an account for Capital. Here is how the entries would look after you have made them.

Exhibit 2.12

Cash Account				Capital Account			
2019	£			2019	£		
January 1		Capital	600	January 1		Cash	600

You only enter the year when you make the first entry on each side. So, if on the same day you used £10 of the cash to buy some stamps, the entries would be made as shown in Exhibit 2.13.

Exhibit 2.13

Cash Account				Stamps Account			
2019	£			2019	£		
January 1		Capital	600	January 1		Stamps	10
				January 1		Cash	10

The year only appears once on each side of the account, no matter how many entries are made. Now we'll go through some worked examples.

2.16 Worked examples

- 1 Imagine that the owner of a new business has invested £10,000 in cash in the business on 1 August 2019. The result of this transaction is entered in the two accounts as follows. First, a debit entry is made in the Cash account. The entry includes the name of the other account involved. In this case, it is the Capital account:

Cash			
2019	£		
Aug 1		Capital	10,000

Similarly, the double entry to the item in the capital account is completed by an entry in the cash account, so the word 'Cash' will appear in the capital account:

Capital				
			2019	£
			Aug	1
		Cash		10,000

- 2 A van is bought for £4,500 cash on 2 August 2019.

Van				
2019			£	
Aug	2	Cash	4,500	

Cash				
2019			£	
Aug	1	Capital	10,000	
2019			£	
Aug	2	Van	4,500	

- 3 Fixtures (e.g. shelves) are bought on time from Shop Fitters for £1,250 on 3 August 2019.

Fixtures				
2019			£	
Aug	3	Shop Fitters	1,250	

Shop Fitters				
			2019	£
			Aug	3
		Fixtures		1,250

Note how a separate account is maintained for each person or organisation to whom you owe money. Each of these creditor accounts is known as a 'trade payable'.

- 4 Paid the amount owing to Shop Fitters in cash on 17 August 2019.

Shop Fitters				
2019			£	
Aug	17	Cash	1,250	
2019			£	
Aug	3	Fixtures	1,250	

Cash				
2019			£	
Aug	1	Capital	10,000	
2019			£	
Aug	2	Van	4,500	
	17	Shop Fitters	1,250	

Combining all four of these transactions, the accounts now contain:

Cash				
2019			£	
Aug	1	Capital	10,000	
2019			£	
Aug	2	Van	4,500	
	17	Shop Fitters	1,250	

Capital				
		2019		£
	Aug	1	Cash	10,000
Van				
2019				£
Aug	2		Cash	4,500
Shop Fitters				
2019				£
Aug	17		Cash	1,250
2019				£
Aug	3		Fixtures	1,250
Fixtures				
2019				£
Aug	3		Shop Fitters	1,250

Note how you enter each transaction in an account in date order and how, once you open an account (e.g. Shop Fitters), you continue to make entries in it rather than opening a new account for every entry.

Before you read further, work through Review questions 2.10 and 2.11A.

2.17 A further worked example

Have you noticed how each column of figures is headed by a '£' sign? This is important. You always need to indicate what the figures represent. In this case, it is pounds; in other cases you will meet during this book, the figures may be thousands of pounds (represented by '£000') or they could be in a different currency altogether. **Always include appropriate column headings.**

Let's now go carefully through the following example. Make certain you can understand every entry and, if you have any problems, reread Part One of this chapter until you are confident that you know and understand what you are doing.

First, here is a table showing a series of transactions of a new business and the double entry action to take:

Transactions		Debit	Credit
2019 May	1 Started a household machines business putting £25,000 into a bank account.	Bank account	Capital account
	3 Bought equipment on time from House Supplies £12,000.	Equipment account	House Supplies account
	4 Withdrew £150 cash from the bank and placed it in the cash box.	Cash account	Bank account

Transactions		Debit	Credit
7	Bought a van for £6,800 and paid by internet transfer from the bank account	Van account	Bank account
10	Sold some equipment that was not needed at cost of £1,100 on time to J. Rose	J. Rose account	Equipment account
21	Returned some of the equipment costing £2,300 to House Supplies	House Supplies account	Equipment account
23	J. Rose pays the amount owing of £1,100 by cheque	Bank account	J. Rose account
28	Bought another van for £4,300 paying by cheque.	Van account	Bank account
31	Paid £9,700 to House Supplies by internet transfer from the bank account.	House Supplies	Bank account

You may find it worthwhile trying to enter all these transactions in T-accounts before reading any further. You will need to know that, similarly to trade payables (i.e. accounts of creditors), a separate trade receivable account (i.e. debtor account) is kept for each debtor. You will need accounts for Bank, Cash, Capital, Equipment, Vans, House Supplies, and J. Rose.

In T-account form this is shown below:

Bank			
2019	£	2019	£
May 1	Capital 25,000	May 4	Cash 150
28	J. Rose 1,100	7	Van 6,800
		30	Van 4,300
		31	House Supplies 9,700
Cash			
2019	£		
May 4	Bank 150		
Capital			
		2019	£
		May 1	Bank 25,000
Equipment			
2019	£	2019	£
May 3	House Supplies 12,000	May 10	J. Rose 1,100
		21	House Supplies 2,300

Vans							
2019			£				
May	7	Bank	6,800				
	30	Bank	4,300				
House Supplies							
2019			£	2019			£
May	21	Equipment	2,300	May	3	Equipment	12,000
	31	Bank	9,700				
J. Rose							
2019			£	2019			£
May	10	Equipment	1,100	May	28	Bank	1,100

If you tried to do this before looking at the answer, be sure you understand any mistakes you made before going on.

2.18 Abbreviation of 'limited'

In this book, when we come across transactions with limited companies the letters 'Ltd' are used as the abbreviation for 'Limited Company'. So, if you see that the name of a business is 'W. Jones Ltd', it is a limited company. In our accounting books, transactions with W. Jones Ltd will be entered in the same way as for any other customer or supplier. It will be seen later that some limited companies use plc (which stands for 'public limited company') instead of Ltd.

2.19 Value added tax (VAT)

You may have noticed that VAT has not been mentioned in the examples covered so far. This is deliberate, so you are not confused as you learn the basic principles of accounting. In Chapter 16, you will be introduced to VAT and shown how to make the entries relating to it.

2.20 The mystery of making double entries

Double entry bookkeeping appears very simple: for every debit entry there is an equal credit entry. However, students often find that they cannot decide which account to debit and which account to credit. If you have this problem, you are not alone – virtually everyone struggles with this from time to time. But you don't need to find this difficult.

If you focus upon the *Form of settlement* and remember that, when it is given it is a credit and when it is received, it is a debit you'll get it right, time after time.

This approach was first proposed in 1494 by an Italian friar and teacher called Luca Pacioli. He did so in the first ever printed book to contain a detailed description of double entry bookkeeping. In his book, he describes double entry from three perspectives: capital of the owner; cash; and obligations (i.e. debt). All transactions involve at least one of these. **That is what to focus upon when you are deciding which account to debit and which account to credit.**

Learning outcomes

You should now have learnt that:

- 1 There are two elements to every transaction: an *Item exchanged* and a *Form of settlement*.
- 2 Double entry bookkeeping requires that for each transaction, an entry is made once for the *Item exchanged*; and once for the *Form of settlement*.
- 3 The treatment of the *Item exchanged* is always the opposite of the treatment of the *Form of settlement*.
- 4 Debit means 'place on the left of the account called ...'.
- 5 Credit means 'place on the right of the account called ...'.
- 6 The total of the debit must always equal the total of the credit.
- 7 Capital is what the owner contributes to a business.
- 8 Capital does not belong to a business. It belongs to the owner of the business.
- 9 Liabilities are all other items that do not belong to a business, such as loans from banks.
- 10 Expenses are immediately used-up but, they belong to the business and are treated the same way as all other possessions.
- 11 Possessions that last some time are called 'assets'.
- 12 Debtors (trade receivables) are people or organisations that owe money to a business.
- 13 Creditors (trade payables) are people or organisations that are owed money by a business. The owner of a business is *not* a creditor of the business. The owner is an investor in the business.
- 14 When the *Form of settlement* is given, it is a credit.
- 15 When the *Form of settlement* is received, it is a debit.
- 16 The entry for the *Item exchanged* is always the opposite of the entry for the *Form of settlement*.
- 17 To identify the accounts to debit and credit, you *always* focus upon the *Form of settlement*: identify whether it is a debit or a credit; the *Item exchanged* will be the opposite.

Answers to activities

- 2.1 Other forms of bookkeeping include 'single entry bookkeeping' and 'triple entry bookkeeping'. You will be told about single entry bookkeeping soon. Triple entry bookkeeping was a technique recommended a few years ago that records more information than double entry bookkeeping. It did not catch-on, accountants preferring to stick with what they knew.
- 2.2 This is known as a 'T-account'.
- 2.3 Each transaction you record involves two things, the *Item exchanged* and the *Form of settlement*. They have the same value because they are the two elements involved in the transaction. The amount debited will, therefore, always equal the amount credited.
- 2.4 Debit *Item exchanged* account £100. Credit *Form of settlement* account £100. An example would be the purchase of an external drive for a laptop computer, paid in cash, but many, many other items could have been exchanged. Instead of cash, another *Form of settlement* could be involved, such as doing so using an IOU.

- 2.5** The *Form of settlement* is 'capital'. These items all belong to you and you are now transferring them into your new business using double entry. When you do this, they become possessions of the business. The business pays for them by giving you capital. We call your account, the 'capital account'. **Your 'capital' does not belong to the business.** It belongs to you. So, every time you record one of these items, you are going to credit your Capital account. The capital account tells you how much you have invested in the business.
- 2.6** £12,350. You have added 12 items belonging to the business totalling £22,350 and one item worth £10,000 that is owed by the business. The balance on the capital account is therefore £22,350 minus £10,000 = £12,350. This is what your business is worth.
- 2.7** It is a debit. Your capital account decreases if you make a loss. It also decreases if you withdraw resources (cash or goods, for example) from the business for your own use. In Exhibit 2.4, you have transferred a loan you received from the bank to the business. This also reduces your investment in the business (see Activity 2.6) and so that item was entered as a debit to the capital account. Capital is a *Form of settlement*. It has been received from you when you gave the business your debt owing to the bank. By giving this capital back to the business, you compensated it for the debit it took over from you.
- 2.8** Whenever capital increases, the *Item exchanged* is debited. So, all items belonging to a business are debited when they increase, not just cash. The item exchanged now belongs to the business. This tells you that when a business receives something that belongs to it that it can use in the business, it will be a debit.
- 2.9** It is the amount due. We call this a 'debt'.
- 2.10** A 'creditor'.
- 2.11**

Cash account	Cash in US dollars account
£600 £50	£200
Cash in the bank account	Cash in the bank in euros account
£1,200	£430
Computer account	Mobile phone account
£500	£240
Sales register account	Printer account
£320	£150
Printing supplies account	Goods for sale account
£40	£18,000
50	
Amount due by Fred Palmer account	Amount due by Winnie Woo account
£300	£370

Loan from bank account		Capital account	
	£10,000	£10,000	£600
			200
			1,200
			430
			500
			240
			320
			150
			40
			18,000
			300
			370

£22,350. Yes. The total of the debit balances is the same as the total of the credit balances because each transaction is entered twice, once as a debit and once as a credit.

2.12 Debit loan from creditor account; credit cash account.

Review questions

2.1 Imagine you have been in business for a few months but you have not kept any proper records of your transactions. You have decided to end that business and start a new one by transferring everything to the new business. You now also want to start using double entry bookkeeping. The first step is to write down a list of everything belonging to the old business and everything the old business owes. Here is the list you prepared:

	£
1 Cash	400
2 Cash in US dollars' worth	280
3 Cash in the bank	900
4 Cash in the bank in Euros worth	350
5 Computer	710
6 Mobile phone	590
7 Office furniture	840
8 Printer	160
9 Delivery van	2,950
10 Goods for sale	12,300
11 Amount due from J. Gidman	560
12 Amount due from K. Bailey	230
13 Loan from bank	6,000





Required:

What is the debit and credit entry for each of these items? (Ignore the amounts.)

1	Cash	Debit	account	Credit	account
2	Cash in US dollars' worth	Debit	account	Credit	account
3	Cash in the bank	Debit	account	Credit	account
4	Cash in the bank in euros worth	Debit	account	Credit	account
5	Computer	Debit	account	Credit	account
6	Mobile phone	Debit	account	Credit	account
7	Office furniture	Debit	account	Credit	account
8	Printer	Debit	account	Credit	account
9	Delivery van	Debit	account	Credit	account
10	Goods for sale	Debit	account	Credit	account
11	Amount due from J. Gidman	Debit	account	Credit	account
12	Amount due from K. Bailey	Debit	account	Credit	account
13	Loan from bank	Debit	account	Credit	account

2.2 Make the entries in the T accounts for the items in question 2.1.

<div>Cash account</div> <div></div>	<div>Cash in US dollars account</div> <div></div>
<div>Cash in the bank account</div> <div></div>	<div>Cash in the bank in euros account</div> <div></div>
<div>Computer account</div> <div></div>	<div>Mobile phone account</div> <div></div>
<div>Office furniture account</div> <div></div>	<div>Printer account</div> <div></div>
<div>Delivery van account</div> <div></div>	<div>Goods for sale account</div> <div></div>
<div>Amount due from J. Gidman account</div> <div></div>	<div>Amount due from K. Bailey account</div> <div></div>
<div>Loan from bank account</div> <div></div>	<div>Capital account</div> <div></div>

2.3 What are the two elements of every transaction?

2.4 If a customer pays you the amount she owes in cash, what is the item exchanged?

2.5 If you use cash to pay a supplier of goods the amount you owe him for goods you purchased two months ago, what is the item exchanged?

2.6 If you obtain a loan of £5,000 from a bank, what is the item exchanged?

2.7 What is the form of settlement in each of questions 2.4, 2.5 and 2.6?

2.8 What are the principles of double entry bookkeeping?

2.9 What is the debit entry and the credit entry in each of questions 2.4, 2.5 and 2.6?

2.10 Complete the following table:

	<i>Account to be debited</i>	<i>Account to be credited</i>
(a) Bought laptop computer on time from Timeless Ltd.		
(b) The proprietor paid a creditor, B. Burt, from his private funds.		
(c) A debtor, T. Robb, paid us by cheque.		
(d) Repaid part of loan from I. Simms in cash.		
(e) Returned the computer to Timeless Ltd.		
(f) A debtor, P. Bell, pays us by cheque.		
(g) Bought van on time from Tangle Motors.		

2.11A Complete the following table:

	<i>Account to be debited</i>	<i>Account to be credited</i>
(a) Bought trailer for cash.		
(b) Paid creditor, J. Tough, by cheque.		
(c) Repaid W. Small's loan by cash.		
(d) Sold trailer for cash.		
(e) Bought office equipment on time from Dexter Ltd. It will be paid for later.		
(f) A debtor, T. Walls, pays us by cash.		
(g) A debtor, L. Tait, pays us by cheque.		
(h) Proprietor puts a further amount into the business by cheque.		
(i) A loan of £650 in cash is received from F. Burns.		
(j) Paid a creditor, J. Fife, by cash.		





2.12 Write up the asset, liability and capital accounts to record the following transactions in the records of B. Spector's business:

- July
- 1 Started business by putting £15,000 of his own money into a business bank account.
 - 2 Bought office furniture by internet transfer from bank account £2,800.
 - 3 Bought computer equipment £1,260 on time from TVC Ltd.
 - 5 Bought a car paying by cheque £4,950.
 - 8 Sold some of the office furniture – original cost £750 – for £750 on time to Jevons & Co.
 - 15 Paid the amount owing to TVC Ltd £1,260 by internet transfer from bank account.
 - 23 Received the amount due from Jevons & Co £750 by cheque.
 - 31 Bought machinery using the business's debit card £710.

2.13 You are required to open the asset and liability and capital accounts and record the following transactions for June in the records of P. Bernard:

- June
- 1 Started business with £17,500 in cash.
 - 2 Paid £9,400 of the opening cash into a bank account for the business.
 - 5 Bought office furniture on time from Dream Ltd for £2,100.
 - 8 Bought a van paying by internet transfer from the bank account £5,250.
 - 12 Bought equipment from Pearce & Sons on time £2,300.
 - 18 Returned faulty office furniture costing £260 to Dream Ltd.
 - 25 Sold some of the equipment for £200 cash (its original cost).
 - 26 Paid amount owing to Dream Ltd £1,840 by internet transfer from the bank account.
 - 28 Took £130 out of the bank and added to cash.
 - 30 F. Brown lent us £4,000 – sending us the money by internet transfer.

2.14A Write up the asset, capital and liability accounts in the books of D. Gough to record the following transactions:

- June
- 1 Started business with £16,000 in the bank.
 - 2 Bought van paying by cheque £6,400.
 - 5 Bought office fixtures £900 on time from Old Ltd.
 - 8 Bought van on time from Carton Cars Ltd £7,100.
 - 12 Took £180 out of the bank and put it into the cash till.
 - 15 Bought office fixtures paying by cash £120.
 - 19 Paid Carton Cars Ltd by internet transfer from the bank account.
 - 21 A loan of £500 cash is received from B. Berry.
 - 25 Paid £400 of the cash in hand into the bank account.
 - 30 Bought more office fixtures, paying with the business debit card £480.

2.15A Write up the accounts to record the following transactions:

- May
- 1 Started business with £1,500 cash and £18,000 in the bank.
 - 2 Received a loan of £4,000 from T. Fox by cheque.
 - 3 Bought a computer for cash £1,200.
 - 5 Bought display stands on time from Drop Ltd £840.
 - 8 Took £400 out of the bank and put it in the cash till.
 - 15 Repaid part of Fox's loan using the business debit card £1,000.
 - 17 Paid amount owing to Drop Ltd £840 by internet transfer from the bank account.
 - 24 Repaid part of Fox's loan by cash £500.
 - 31 Bought a colour laser printer on time from P. Blake for £400.

Learning objectives

After you have studied this chapter, you should be able to:

- Explain why it is inappropriate to use an inventory account to record increases and decreases in inventory of individual products.
- Describe the two causes of inventory increasing.
- Describe the two causes of inventory decreasing.
- Explain the difference between a purchase account and a returns inwards account.
- Explain the difference between a sales account and a returns outwards account.
- Explain how to record increases and decreases of inventory in the appropriate accounts.
- Explain the meanings of the terms 'purchases' and 'sales' as used in accounting.
- Explain what is meant when the term 'on time' is used to describe a purchase or a sale.
- Explain the differences in recording purchases on time as compared to recording purchases that are paid for immediately in cash.
- Explain the differences in recording sales on time as compared to recording sales that are paid for immediately in cash.

Introduction

In this chapter, you will learn how to record movements in inventory in the appropriate ledger accounts and how to record purchases and sales on time, as opposed to purchases and sales for cash.

3.1 Inventory movements

In the examples in Section 1.10 of Chapter 1, inventory was sold at the same price at which it was bought. When this happens and an inventory account is used rather than having separate accounts for purchases and sales (refer back to Section 2.12 if this is unclear), the difference between the two sides of the inventory account represents the cost of the goods unsold at that date. This is, of course, extremely unusual. In fact, any new business selling its inventory at 'cost' wouldn't last long. Businesses need to make profits to survive, as many 'dot.com' internet companies discovered a few years ago when their bubble burst and all the losses they had been making took effect.

**Activity
3.1**

Let's think about the double entry implications if all sales were at cost price. Fill in the blanks in the following using 'an increase', 'a decrease', 'debited', and 'credited':

As we did in Chapter 1, it would be possible to have an inventory account with goods purchased being _____ to the inventory account (as purchases represent _____ in the asset, inventory) and goods sold being _____ to it (as sales represent _____ in the possession, inventory).

When selling price is the same as cost, the balance on the inventory account would represent the cost of the inventory still held. When selling price is not the same as cost, maintaining an inventory account on this basis would no longer result in the balance representing the cost of the inventory still held. At face value, the account would serve no useful purpose. Or would it?

Let's assume that a supermarket had a separate inventory account for each product it sold – e.g. own brand skimmed milk, Cravendale skimmed milk, own brand semi-skimmed milk, Cravendale semi-skimmed milk, own brand whole cream milk, Cravendale whole cream milk. Each of these inventory accounts would serve a very useful purpose: they reveal the basic profit on each item of inventory once all the units of the item have been sold. This is very useful information for the managers of a business, which can be extended to be even more useful if the number of units of inventory involved in each transaction is also noted in the account.

**Activity
3.2**

How does adding the units to the entry in the account result in more useful information?

Normally, goods or services are sold at above cost price, so that the selling price includes elements of profit. When goods or services are sold for less than their cost, the difference is a loss.

Because businesses usually sell goods for more than their cost, the difference between the two sides of the inventory account would not represent the cost of the unsold goods. It would represent the cost of what remained *less* the profit earned on the goods that have been sold.

However, when preparing the financial statements of a business, we want the overall picture. We do not wish to know the profit on each type of good or service we have sold. (That is something management accountants would be involved in calculating so that the managers of the business know how profitable each item sold is.)

Thus, when preparing the financial statements of a business, we seek to identify the overall profit, on all items sold. Consequently, rather than using a separate account for each product, most businesses adopt what is known as the 'periodic inventory valuation' system. Under this approach, we subdivide the way inventory is reported into several accounts, each one showing a movement of inventory. As you will see, under this approach one account is used for all purchases of goods for resale and another account is used for all sales of those goods.

Firstly, we must distinguish between transactions that cause inventory to increase and those that cause it to decrease. Let's deal with each of these in turn.

1 Increase in inventory. This can be due to one of two causes:

- (a) The purchase of additional goods.
- (b) The return into the business of goods previously sold – there are many reasons why this may happen. For example, they may have been the wrong type, not required, or faulty.

To distinguish the two causes of an increase in inventory, two accounts are opened:

- (i) a **Purchases account** – in which purchases of goods are entered; and
- (ii) a **Returns Inwards account** – in which goods being returned into the business are entered.
(Another name for this account is the **Sales Returns account**.)

We then *debit* the appropriate one of these two accounts.

2 Decrease in inventory. Ignoring things like wastage and theft, this can be due to one of two causes:

- (a) The sale of goods.
- (b) Goods previously bought by the business now being returned to the supplier.

Once again, in order to distinguish the two causes of a decrease in inventory, two accounts are opened:

- (i) a **Sales account** – in which sales of goods are entered; and
- (ii) a **Returns Outwards account** – in which goods being returned out to a supplier are entered.
(This is also known as the **Purchases Returns account**.)

We then *credit* the account from these two alternatives that is the appropriate one to use in the context of what caused the inventory to decrease.

As inventory is a possession (and an asset), and these four accounts are all connected with this asset, the double entries are those used for possessions.

Activity 3.3

If assets are all possessions, what are the double entries for assets?

Accounts	To record	Entry in the account
Assets	an increase a decrease	_____ _____

Let's now look at some inventory entries in the following sections. We'll use the *Principles of double entry* to guide us.

3.2 Purchase of inventory to be paid for later

On 1 August 2019, goods for resale costing £165 are bought on time from D. Henry. (**Remember: when something is bought or sold 'on time' it means that it will be paid for later.**) First, the two elements of the transaction must be considered so that the bookkeeping entries can be made: the *Item exchanged* and the *Form of settlement*.

- 1 The *Form of settlement* is an IOU. It has been given, so it is a credit. The IOU is a debt owed to D. Henry, so it goes in that account.
- 2 The *Item exchanged* is goods for resale. Its entry is the opposite of the *Form of settlement*, which was a credit. So, the *Item exchanged* is a debit. Goods for resale received are purchases, so the entry goes in that account.

These two entries appear in the T-accounts as:

Purchases		
2019	£	
Aug 1 D. Henry	165	

D. Henry

	2019		£
	Aug 1	Purchases	165

Note that these entries are identical to those you would make if you were using an account for the goods rather than a purchases account. (If an account for the goods were being used, the name of the goods would replace 'Purchases'.)

3.3 Purchases of inventory for cash

On 2 August 2019, goods costing £310 are bought, cash being paid for them immediately at the time of purchase.

- 1 This time the *Form of settlement* is cash. It has been given, so it is a credit.
- 2 As before the *Item exchanged* is goods for resale. The movement of inventory is the result of a 'purchase', so the purchases account is used. The entry is the opposite of the entry for the *Form of settlement*, so it is a debit.

Purchases			
2019	£		
Aug 2	Cash	310	
Cash			
	2019		£
	Aug 2	Purchases	310

3.4 Sales of inventory on time

On 3 August 2019, goods were sold on time for £375 to J. Lee.

- 1 The *Form of settlement* is an IOU. It has been received, so it is a debit. The IOU is owed by J. Lee, so it goes in that account.
- 2 The *Item exchanged* is goods for resale. The movement of inventory is the result of a 'sale', so the sales account is used. The entry is the opposite of the entry for the *Form of settlement*, so it is a credit.

Sales			
	2019		£
	Aug 3	J. Lee	375
J. Lee			
2019	£		
Aug 3	Sales	375	

3.5 Sales of inventory for cash

On 4 August 2019, goods are sold for £55, cash being received immediately at the time of sale.

- 1 This time the *Form of settlement* is cash. It has been received, so it is a debit.
- 2 As before the *Item exchanged* is goods for resale. The movement of inventory is a 'sale', so the sales account is used. The entry is the opposite of the entry for the *Form of settlement*, so it is a credit.

Sales		
	2019	£
	Aug 4 Cash	55

Cash		
2019	£	
Aug 4 Sales	55	

So far, so good. Apart from replacing the account in the name of the goods with the purchases account when inventory increases and the sales account when it decreases, you've done nothing different in your entries to the accounts compared with what you learnt in Chapters 1 and 2.

Go back to Chapters 1 and 2 and refresh your understanding of account entries.

Let's now look at the other inventory-related transactions that cause inventory to increase and decrease – returns inwards (sales that are being returned) and returns outwards (purchases that are being returned to the supplier).

3.6 Returns inwards

On 5 August 2019, goods which had been previously sold to F. Lowe for £29 are now returned *to the business*. This could be for various reasons such as:

- you sent goods of the wrong size, the wrong colour, or the wrong model;
- the goods were damaged in transit;
- the goods are of poor quality.

As shown below, the account we use to record the return of the goods is the 'Returns inwards account':

- 1 The *Form of settlement* is an IOU. As the IOU has been given to F. Lowe, it is a credit in the account of F. Lowe.
- 2 The *Item exchanged* is goods for resale. The movement in inventory is that of a 'returns inwards', so it is made to that account. It is the opposite of the entry for the *Form of settlement*, so it is a debit.

Returns inwards		
2019	£	
Aug 5 F. Lowe	29	

F. Lowe		
	2019	£
	Aug 5 Returns inwards	29

(Remember, another name for the Returns Inwards account is the 'Sales Returns account'.)

3.7 Returns outwards

On 6 August 2019, goods previously bought for £96 are returned *by the business* to K. Hoff.

- 1 The *Form of settlement* is an IOU. As the IOU was received from K. Hoff, it is a debit in the account of K. Hoff.
- 2 The *Item exchanged* is goods for resale. The movement in inventory is that of a 'returns outwards', so it is made to that account. It is the opposite to the entry for the *Form of settlement*, so it is a credit.

Returns outwards			
	2019		£
	Aug 6	K. Hoff	96
K. Hoff			
2019	£		
Aug 6	Returns outwards	96	

(Remember, another name for the Returns Outwards account is the Purchases Returns account.)

You'll have seen how using the *Principles of double entry* made the selection of the accounts to debit and credit very easy. You only had to decide what to do with the account of the *Form of settlement*. The second part of the double entry is always the opposite of the first so, if the account of the *Form of settlement* is a debit, the account of the *Item exchanged* is a credit.

You may now be thinking this is all very straightforward. Check to see if that's the case by looking at two review questions. Once you've done that, we'll show you a worked example.

Before you read further, work through Review questions 3.1 and 3.2.

3.8 A worked example

2020		
May	1	Bought goods on time £220 from D. Small.
	2	Bought goods on time £410 from A. Lyon & Son.
	5	Sold goods on time to D. Hughes for £60.
	6	Sold goods on time to M. Spencer for £45.
	10	Returned goods £15 to D. Small.
	11	Goods sold for cash £210.
	12	Goods bought for cash £150.
	19	M. Spencer returned £16 goods to us.
	21	Goods sold for cash £175.
	22	Paid cash to D. Small £205.
	30	D. Hughes paid the amount owing by him £60 in cash.
	31	Bought goods on time £214 from A. Lyon & Son.

You may find it worthwhile trying to enter all these transactions in T-accounts before reading any further. You will need the following accounts: Purchases, Sales, Returns Outwards, Returns Inwards, D. Small, A. Lyon & Son, D. Hughes, M. Spencer and Cash.

Here are the entries in the T-accounts:

Purchases							
2020			£				
May	1	D. Small	220				
	2	A. Lyon & Son	410				
	12	Cash	150				
	31	A. Lyon & Son	214				
Sales							
		2020		£			
		May	5	D. Hughes	60		
			6	M. Spencer	45		
			11	Cash	210		
			21	Cash	175		
Returns outwards							
		2020		£			
		May	10	D. Small	15		
Returns inwards							
2020			£				
May	19	M. Spencer	16				
D. Small							
2020			£				
May	10	Returns outwards	15	2020	£		
	22	Cash	205	May	1	Purchases	220
A. Lyon & Son							
		2020		£			
		May	2	Purchases	410		
			31	Purchases	214		
D. Hughes							
2020			£				
May	5	Sales	60	2020	£		
				May	30	Cash	60
M. Spencer							
2020			£				
May	6	Sales	45	2020	£		
				May	19	Returns inwards	16
Cash							
2020			£				
May	11	Sales	210	2020	£		
	21	Sales	175	May	12	Purchases	150
	30	D. Hughes	60		22	D. Small	205

Did you get this right? Be sure you understand any mistakes you made before going on.

3.9 Special meaning of 'sales' and 'purchases'

You need to remember that 'sales' and 'purchases' have a special meaning in accounting when compared to their meaning in everyday English.

In accounting, **purchases** means the *purchase of those goods that the business buys with the sole intention of selling*. (i.e. goods for resale). Obviously, sometimes goods are altered, added to, or used in the manufacture of something else, but it is the intention of resale that is important. Thus, to a business that deals in computers, computers are treated as purchases. To most businesses, they are not: they treat them as assets *because they are bought to be kept*.

Thus, if something is bought *that the business does not intend to sell*, such as a van, it *cannot* be called a 'purchase', even though in ordinary language you would say that a van has been purchased. The van was bought to be used and *not* for resale. You *must* use an account for the van for any entries, *not* the purchases account.

Similarly, **sales** means the *sale of those goods in which the business normally deals and which were bought with the sole intention of resale*. The account for 'sales' must never be used to record the disposal of other items, such as vans or buildings that were purchased to be used and *not* to be sold.

If we did not keep to these meanings, we would find it very difficult to identify which of the items in the purchases and sales accounts were inventory and which were assets that had been bought to be kept and then sold once they were no longer of use to the business.

Learning outcomes

You should now have learnt:

- 1 That it is *not* appropriate to use individual inventory accounts for each product purchased with the intention of selling it.
- 2 That inventory increases either because some inventory has been purchased or because inventory that was sold has been returned by the buyer.
- 3 That inventory decreases either because some inventory has been sold or because inventory previously purchased has been returned to the supplier.
- 4 That a purchase account is used to record purchases of inventory (as debit entries in the account) and that a returns inwards account is used to record inventory returned by customers (as debit entries in the account).
- 5 That a sales account is used to record sales of inventory (as credit entries in the account) and that a returns outwards account is used to record inventory returned to suppliers (as credit entries in the account).
- 6 How to record increases and decreases of inventory in the appropriate accounts.
- 7 When an item is not paid for at the time when it is purchased (or sold), we can say that it was purchased (or sold) 'on time'.
- 8 That in accounting, the term 'purchases' refers to purchases of inventory. Acquisitions of any other assets, such as vans, equipment and buildings, are *never* entered in the purchases account.
- 9 That in accounting, the term 'sales' refers to sales of inventory. Disposals of any other assets, such as vans, equipment and buildings, are *never* entered in the sales account.
- 10 That purchases for cash are *never* entered in the supplier's account.

- 11 That purchases on time are *always* entered in the supplier's (i.e. creditor's) account.
- 12 That sales for cash are *never* entered in the customer's account.
- 13 That sales on time are *always* entered in the customer's (i.e. debtor's) account.

Answers to activities

- 3.1 As we did in Chapter 1, it would be possible to have an inventory account with goods purchased being DEBITED to the inventory account (as purchases represent AN INCREASE in the possession, inventory) and goods sold being CREDITED to it (as sales represent A DECREASE in the possession, inventory).
- 3.2 If the inventory account shows a debit of £100 and two credit entries totalling £120, the basic profit so far on the goods is £20. If there are no units left, the figure of £20 represents the basic profit earned from that good – a 20 per cent profit.

Assume that the debit entry includes a note that 5 units were purchased, and the credit entries include notes indicating that 1 unit was sold for £40 and then 2 units were sold for £80. Overall basic profit would still be £20 but there are still 2 units in inventory. This information about the units can be used to identify the profit earned on the units sold.

Managers know that 5 units cost £100, so the 2 remaining units cost £40. If they add this £40 to the balance, it would rise from £20 to £60. That is the profit earned to date. They may decide to sell off the remaining units at a lower price, or to increase the selling price, or to do nothing to the selling price. The point is that they have the information in the inventory account with which to make such a decision.

To add the units of inventory to an account, an extra column could be added on each side. This was often done during the 500 or so years when this method of recording inventory was widely used. This type of inventory account is no longer used in financial accounting. However, as you will see in Chapter 18, this detail is included in the data maintained for inventory control and other management accounting purposes.

3.3

Accounts	To record	Entry in the account
Assets	an increase	Debit
	a decrease	Credit

Review questions

- 3.1 Complete the following table:

	Account to be debited	Account to be credited
(1) Goods sold for cash.		
(2) Vehicles bought on time from F. Smith.		
(3) Computer sold for cash.		
(4) Goods sold on time to J. Lilly.		
(5) Goods purchased by us returned to supplier, M. Peel.		
(6) Goods bought on time from F. Day.		





	<i>Account to be debited</i>	<i>Account to be credited</i>
(7) Goods sold, a cheque being received immediately.		
(8) Goods we returned to W. Brown.		
(9) Goods returned to us by customer, I. Gray.		
(10) Goods bought on time from T. Gow.		

3.2A Complete the following table for a business that buys and sells cleaning products:

	<i>Account to be debited</i>	<i>Account to be credited</i>
(a) Goods bought on time from B. Cowan.		
(b) Goods returned to us by L. Keith.		
(c) Filing cabinets returned to C. Riddle Ltd.		
(d) Goods bought for cash.		
(e) Lorry bought on time from M. Davis Ltd.		
(f) Goods returned by us to J. Hicks.		
(g) N. Peters paid us his account by cheque.		
(h) Goods bought by cheque.		
(i) We paid creditor, F. Toms, by cheque.		
(j) Goods sold on time to S. Mulligan.		

3.3 You are to write up the following in the books:

July	1	Started in business with £3,800 cash.
	3	Bought goods for cash £480.
	7	Bought goods on time £1,200 from J. Gill.
	10	Sold goods for cash £172.
	14	Returned goods to J. Gill £240.
	18	Bought goods on time £1,460 from F. Genesis.
	21	Returned goods to F. Genesis £104.
	24	Sold goods to A. Prince £292 on time.
	25	Paid J. Gill's account by cash £960.
	31	A. Prince paid us his account in cash £292.

3.4A Enter the following transactions in the appropriate accounts:

Aug	1	Started in business with £7,400 cash.
	2	Paid £7,000 of the opening cash into the bank.
	4	Bought goods on time £410 from J. Watson.
	5	Bought a van by cheque £4,920.
	7	Bought goods for cash £362.
	10	Sold goods on time £218 to L. Less.
	12	Returned goods to J. Watson £42.
	19	Sold goods for cash £54.
	22	Bought fixtures on time from Firelighters Ltd £820.
	24	F. Holmes lent us £1,500, paying us the money by cheque.
	29	We paid J. Watson his account by cheque £368.
	31	We paid Firelighters Ltd by cheque £820.

3.5 Enter the following transactions in the accounts of L. Linda:

- July
- 1 Started in business with £20,000 in the bank.
 - 2 D. Rupert lent us £5,000 in cash.
 - 3 Bought goods on time from B. Brown £1,530 and I. Jess £4,162.
 - 4 Sold goods for cash £1,910.
 - 6 Took £200 of the cash and paid it into the bank.
 - 8 Sold goods on time to H. Rise £1,530.
 - 10 Sold goods on time to P. Taylor £341.
 - 11 Bought goods on time from B. Brown £560.
 - 12 H. Rise returned goods to us £65.
 - 14 Sold goods on time to G. Farm £535 and R. Sim £262.
 - 15 We returned goods to B. Brown £94.
 - 17 Bought van on time from Aberdeen Cars Ltd £9,100.
 - 18 Bought office furniture on time from J. Winter Ltd £1,800.
 - 19 We returned goods to I. Jess £130.
 - 20 Bought goods for cash £770.
 - 24 Goods sold for cash £110.
 - 25 Paid money owing to B. Brown by cheque £1,924.
 - 26 Goods returned to us by G. Farm £34.
 - 27 Returned some of office furniture costing £180 to J. Winter Ltd.
 - 28 L. Linda put a further £2,500 into the business in the form of cash.
 - 29 Paid Aberdeen Cars Ltd £9,100 by cheque.
 - 31 Bought office furniture for cash £365.

3.6A Enter the following transactions in T-accounts:

- May
- 1 Started in business with £18,000 in the bank.
 - 2 Bought goods on time from B. Hind £1,455.
 - 3 Bought goods on time from G. Smart £472.
 - 5 Sold goods for cash £210.
 - 6 We returned goods to B. Hind £82.
 - 8 Bought goods on time from G. Smart £370.
 - 10 Sold goods on time to P. Syme £483.
 - 12 Sold goods for cash £305.
 - 18 Took £250 of the cash and paid it into the bank.
 - 21 Bought a printer by cheque £620.
 - 22 Sold goods on time to H. Buchan £394.
 - 23 P. Syme returned goods to us £160.
 - 25 H. Buchan returned goods to us £18.
 - 28 We returned goods to G. Smart £47.
 - 29 We paid B. Hind by cheque £1,373.
 - 31 Bought machinery on time from A. Cobb £419.

The effect of profit or loss on capital and the double entry system for expenses and revenues

Learning objectives

After you have studied this chapter, you should be able to:

- Calculate profit by comparing revenue with costs.
- Explain how the *Principles of double entry* can guide you in identifying whether an account should be debited or credited.
- Explain how the accounting equation is used to show the effects of changes in assets and liabilities upon capital after goods or services have been traded.
- Explain why separate accounts are used for each type of expense and revenue.
- Explain why an expense is entered as a *debit* in the appropriate expense account.
- Explain why an item of revenue is entered as a *credit* in the appropriate revenue account.
- Explain how to identify the correct double entry for service revenue, such as commission received and rent received.
- Enter a series of expense and revenue transactions into the appropriate T-accounts.
- Explain how the use of business cash and business goods for the owner's own purposes are dealt with in the accounting records.

Introduction

In this chapter, you will learn how to calculate profits and losses and how to enter expense and revenue transactions into the ledger. You will also learn about **drawings** (i.e. amounts withdrawn from the business by the owner), and how to record them.

4.1 The nature of profit or loss

To an accountant, **profit** means the amount by which **revenue** is greater than the cost of a set of transactions. The term 'revenue' means the sales value of goods and services that have been supplied to customers. The 'cost' is the total monetary amount of all the possessions (assets and expenses) that were used up in obtaining those revenues – i.e. it is the cost incurred in generating the revenue.

For example, if our customers pay us £100,000 for goods and services, that is our revenue. If the cost we incurred in providing those goods and services was £70,000, that is our cost. The

difference between the revenue and the cost is £30,000. Because our revenue is greater than our cost, that is our profit:

		£
Revenue:	goods and services supplied to our customers for the sum of	100,000
Less Costs:	value of all the assets and expenses used up to enable us to supply these goods and services	(70,000)
Profit is therefore:		<u>30,000</u>

On the other hand, it is possible for our costs to exceed our revenues for a set of transactions. In this case the result is a **loss**. For example, a loss would be incurred given the following:

		£
Revenue:	what we have charged to our customers in respect of all the goods and services supplied to them	60,000
Less Costs:	value of all the assets and expenses used up to supply these goods and services to our customers	(80,000)
Loss is therefore:		<u>(20,000)</u>

Activity 4.1

In each of these two examples, a different explanation was given for the terms 'revenue' and 'costs'. What is the difference between the two explanations given for 'revenue'? What is the difference between the two explanations given for 'costs'?

4.2 The effect of profit and loss on capital

Businesses exist to make a profit and so increase their capital. Let's look at the relationship between profit and capital in an example.

On 1 January the assets and liabilities of a business are:

Assets:	Fixtures £10,000; Inventory £7,000; Cash at the bank £3,000.
Liabilities:	Trade payables £2,000.

The capital is found from the accounting equation:

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

In this case, capital is £10,000 + £7,000 + £3,000 – £2,000 = £18,000

During January, the whole of the £7,000 inventory is sold for £11,000 cash. On 31 January the assets and liabilities have become:

Assets:	Fixtures £10,000; Inventory nil; Cash at the bank £14,000.
Liabilities:	Trade payables £2,000.

The capital is now £22,000:

$$\text{Assets (£10,000 + £14,000)} - \text{Liabilities £2,000}$$

So capital has increased by £4,000 from £18,000 to £22,000. It has increased by £4,000 because the £7,000 inventory was sold (for £11,000) at a profit of £4,000. Profit, therefore, increases capital:

$$\text{Old capital} + \text{Profit} = \text{New capital}$$

$$£18,000 + £4,000 = £22,000$$

A loss, on the other hand, would reduce the capital:

$$\text{Old capital} - \text{Loss} = \text{New capital}$$

4.3 Profit or loss and sales

Profit will be made when goods or services are sold for more than they cost, while the opposite will result in a loss.

(You will learn later that there are different types of profit, some of which you may have heard of, such as 'gross profit' and 'net profit'. For now, we're not going to complicate things by going into that level of detail. So, whatever you may already know about these different types of profit, try to focus for the time being on the simple definition of profit presented here.)

4.4 Profit or loss and costs

Once profits or losses have been calculated, you can update the capital account. How often this will be done will depend on the business. Some only attempt to calculate their profits and losses once a year. Others do it at much more frequent intervals. Generally speaking, the larger the business, the more frequently profits are calculated.

In order to calculate profits and losses, revenues and costs must be entered into appropriate accounts. All the costs could be charged to one 'Costs Account', but you would be able to understand the calculations of profit better if full details of each type of cost were shown in those profit calculations. The same applies to each type of revenue.

For this reason, a separate account is opened for each type of revenue and each type of cost. For example, accounts relating to the costs of **expenses** may include:

Commissions account	Subscriptions account	Rent account
Bank overdraft interest account	Motor expenses account	Postages account
Royalties account	Telephone account	Stationery account
Business rates account	General expenses account	Wages account
Electricity account	Audit fees account	Insurance account

Note: The costs of assets used-up in generating revenue are known as 'depreciation'. Depreciation is also included in total costs when calculating profit. You will learn about depreciation costs later in this book.

The title of each cost or revenue account is a matter of choice – they can be called anything – but it is best to give them names that reflect what they are for. For example, an account for postage stamps could be called 'Postage stamps account', 'Postages account', 'Communication expenses account', and so on. Also, different businesses combine different types of expenses into one account, such as having a 'Rent and telephone account', or a 'Rent, telephone and insurance

account', Rare or small value items of expense are usually put into a 'Sundry expenses account' or a 'General expenses account'.

Most organisations do use names for their accounts that make it obvious which accounts are for revenue and which accounts are for expenses. However, some don't: an account for commission, for example, may be for commission income or for commission expenses. When in doubt as to whether an account is for revenue or expenses, you have two obvious indicators to consult. The first is on which side the entries are mainly appearing in the account. If it is the debit side, the account is almost certainly an expense account. The other indicator is the nature of the business. For example, a commission account in the accounting books of a firm of stockbrokers is almost certainly a revenue account.

Activity 4.2

Identify which of the accounts listed in the table could be either expense accounts or revenue accounts.

4.5 Debit or credit

You need to know whether cost accounts for expenses should be debited or credited with the amounts involved. You already know that an increase in any possession of the business is a debit. And you know from Section 2.11 that when you incur an expense, it belongs to you but, it is used-up immediately. So, you treat expenses the same way as you treat any other possession.

Before reading any further, answer Activity 4.3:

Activity 4.3

When you pay an expense using cash, which account do you debit? The expense account or the cash account?

As you found in Activity 4.3, expenses are *always* debited to the expense account. Apart from the guidance you have from what the *Principles of double entry* tell you about debits (and credits) for possessions, what other reason can you think of to explain this?

Well, if you think about how businesses obtain assets and incur expenses, transactions for them both have to be settled by giving something for the item received in the exchange (i.e. the asset or the expense). The *form of settlement*, for example cash or an IOU owed to the supplier (if the supplier allowed you time to pay), will always be the credit because they are given to the supplier in settlement of the transaction. You must, therefore, make the same type of entry in an expense account as you would in an account for an asset.

Putting it another way, looking at how businesses generate revenue, they use resources to pay for expenses and to pay for assets. These are then used to provide goods and services that are sold, so generating revenue. Expenses are used-up in the short term, while assets are used up in the long term. Because both expenses and assets are utilised in order to get revenue, the entries in their accounts are the same. Increases in assets and increases in expenses are entered on the debit side of the appropriate accounts and the form of settlement is credited.

So, for example, if you pay rent of £500 in cash, the rent account will be debited, because the total rent expense has increased by £500. The account for the *Form of settlement*, cash, will be credited. If you had not yet paid the £500, you would still debit the account for the item exchanged, the rent. The credit for the unpaid debit, i.e. an IOU, would be to the account of the creditor who you have not yet paid.

**Activity
4.4**

You can use the accounting equation to confirm this. Write down the accounting equation and see if you can work out what happens to it if (a) a business spends £30 in cash hiring a van for a day and (b) if a business hires a van for a day at a cost of £30 and is given 1 month to pay the bill. Assume in each case that the business has assets of £200, liabilities of £80 and capital of £120 before the transaction. What happens to capital in each case?

4.6 Revenue from services

You already know how to record revenue from Sections 3.4 and 3.5, where we looked at the double entries for sales. We entered the sales as credits into the sales account because they represented the value of the items exchanged with (i.e. sold to) your customers. Like costs, revenue is collected together in appropriately named accounts, such as a 'sales account', where it is shown as a credit until it is used in the profit calculations at the end of the period.

When revenue is from the sale of services, not from the sale of goods, the treatment of the debits and credits does not change. However, it can be difficult to understand why.

In the case of virtually all services, what is being paid for is the time of the seller: **time is the item exchanged**. If you want to think of this in terms of units, imagine that you have an inventory of units of time. You can only provide a few each day and, once provided, you have less units available to sell during the rest of that day. Think of an auctioneer. The auctioneer has only a certain amount of time each day in which to sell items on behalf of clients. When she sells one, the client pays commission to compensate the auctioneer for her time. Time is the item exchanged.

So, think of each unit of time you sell as being like a unit of a good. If you have 10 units and you sell one, you only have nine left. If you have sold one of your 10 units of time, you have less to offer, but only temporarily because services are provided 'against the clock' – an auctioneer can only auction so many things in a day, a plumber can only fix so many broken pipes in a day, an accountant can only do work for clients for so many hours in the day, taxi drivers can only drive their taxis for so many hours in the day, and so on.

The next day, the auctioneer, the plumber, the accountant, and the taxi driver are again able to provide a full day of services, no matter how many units of their time were sold the day before.

So, the sale of a service decreases your possession of time temporarily and this must be recorded. However, we do not record this in an account for time. When we record the units of service sold, we use account names that describe the type of service provided: 'commission received' for the auctioneer, 'plumbing fees' for the plumber, 'accountancy fees' for the accountant, 'taxi fares' for the taxi driver. This allows us to distinguish between the revenues and costs of providing or obtaining each form of service that our business sells or purchases. As a result of doing this, it is a straightforward process discovering if the services we sell are each being sold at a profit or at a loss.

Keep all this in mind and you will be able to apply the *Principles of double entry* to guide you in the double entry for any services you purchase or sell.

**Activity
4.5**

If they increase, which of the following items are debited and which are credited: expenses, revenue, assets, liabilities, capital, profits, and losses?

4.7 Double entries for expenses and for revenue from sale of services

Let's look at some examples that demonstrate the double entry required:

1 Rent of £200 is paid in cash.

(a) The *Form of settlement*, cash, is given so it is a credit.

(b) The total of the *Item exchanged* (the expense of rent) is increased, and so is a debit.

Summary: Debit the *rent account* with £200.

Credit the *cash account* with £200.

2 Motor expenses of £355 are paid by debit card.

(a) The *Form of settlement*, bank, is given so it is a credit.

(b) The total of the *Item exchanged* (motor expenses) has increased, and so is a debit.

Summary: Debit the *motor expenses account* with £355.

Credit the *bank account* with £355.

3 £60 cash is received for commission earned by the business. (This is revenue from sale of a service.)

(a) The *Form of settlement*, cash, is received so it is a debit.

(b) The *Item exchanged*, your time, has been decreased (see Section 4.6). The appropriate name for the revenue account is 'commission received', and it is a credit.

Summary: Debit the *cash account* with £60.

Credit the *commission received account* with £60.

Before you look at the next example, you need to know that if you rent out an asset of your business, the rent you receive is for the use of that asset of the business, such as a building, a storage unit in a warehouse, or an office. It is compensation for the service you have provided (i.e. temporary use of the asset). Providing the service (in this case renting out an asset) has decreased the availability of that asset to the business and is recorded in the same way as any other service you sell. So, when rent is received, the *Item exchanged* is the asset provided on loan to the customer. When recording rent received, we use a revenue account with the name 'Rent received'. No entries are ever made in the account of the asset you have rented out because, just like the auctioneer's units of time from Section 4.6, you will have the asset back and fully available to you very soon.

Now look at some more transactions and their effect upon the accounts in the following table:

		Form of settlement	Increase or Decrease	Account debited	Account credited
June 1	Paid for postage stamps by cash £50	Cash	Decrease	Postage stamps	Cash
2	Paid for electricity by debit card £229	Bank	Decrease	Electricity	Bank
3	Received rent in cash £138	Cash	Increase	Cash	Rent
4	Paid insurance by debit card £142	Bank	Decrease	Insurance	Bank

Entering these four examples into the appropriate accounts results in:

Cash			
June 3	Rent received	£ 138	June 1 Postage £ 50
Bank			
			June 2 Electricity £ 229
			4 Insurance 142
Electricity			
June 2	Bank	£ 229	
Insurance			
June 4	Bank	£ 142	
Postage			
June 1	Cash	£ 50	
Rent received			
			June 3 Cash £ 138

4.8 Drawings

Sometimes the owners of a business will want to take cash out of it for their private use. This is known as **drawings**. **Drawings are never expenses of a business.**

In the case of drawings, the *Form of settlement* is 'capital' but we use a 'drawings account' for the entry. The reason for this is that if we made the entry in the capital account, it could become very full with lots of small drawings transactions. As a result, it is normal practice to maintain a separate account for drawings and to deduct the total of the drawings account from capital at the end of each year.

The *Form of settlement* is, therefore, drawings. They are received by the business from the owner in exchange for the *Item exchanged*, which was cash. Drawings are debited and cash is credited.

The following example illustrates the entries for drawings:

On 25 August, the owner takes £50 cash out of the business for his own use.

Form of settlement and entry	Item exchanged and entry
Drawings; debit	Cash; credit

Cash			
		Aug 25	Drawings
			£ 50
Drawings			
Aug 25	Cash	£ 50	

Sometimes goods are taken for private use. This form of withdrawal by the owner is also known as *drawings*. In Sections 3.2 and 3.3, you learnt that when goods are purchased, the purchases account is debited. As a result, when goods are withdrawn it is the purchases account that should be credited.

The following example illustrates the entries for this form of drawings:

On 28 August, the owner takes £400 of goods out of the business for his own use.

<i>Form of settlement and entry</i>	<i>Item exchanged and entry</i>
Drawings; debit	Inventory; credit Purchases

Purchases			
		Aug 28	Drawings
			£ 400
Drawings			
Aug 28	Purchases	£ 400	

Learning outcomes

You should now have learnt:

- 1 How to calculate profit by comparing revenue with costs.
- 2 That the *Principles of double entry* can guide you to always know whether an account should be debited or credited.
- 3 That the accounting equation is central to any explanation of the effect of trading upon capital.
- 4 Why every different type of expense is shown in a separate expense account.
- 5 Why every different type of revenue is shown in a separate revenue account.
- 6 Why an expense is shown as a debit entry in the appropriate expense account.
- 7 Why revenue is shown as a credit entry in the appropriate revenue account.
- 8 How to identify the correct double entry for service revenue, such as commission received and rent received.

- 9 How to enter a series of expense and revenue transactions into the appropriate T-accounts.
- 10 What is meant by the term 'drawings'.
- 11 That drawings are *always* a reduction in capital and *never* an expense of a business.
- 12 How to record drawings of cash in the accounting books.
- 13 How to record drawings of inventory in the accounting books.

Answers to activities

4.1 There is no difference between either the two meanings given for revenue or the two meanings given for expenses. In each case, you are being given a slightly different wording so as to help you understand what the two terms mean.

4.2 In most businesses, these items would always be expense accounts:

Postages account, Stationery account, Business rates account, Wages account, Electricity account, Insurance account, Motor expenses account, Telephone account, General expenses account, Audit fees account.

The following could be either expense accounts or revenue accounts:

Bank interest account, Commissions account, Rent account, Royalties account, Subscriptions account.

Note that accounting practice is that as most accounts are for expenses, where there may be some confusion as to whether an account is for revenue or expenses, the name of the revenue account should make it clear that it is for revenue, not expenses. So, for example, if rent is income, the account would be called the Rental income account. Many businesses pay subscriptions for software they use and have no subscription income, so their subscription accounts will always be expenses. However, clubs, societies, and online businesses like *Sky*, *Netflix*, *Amazon Prime*, and the *Dotto Tech Patreon Scheme* charge subscriptions to their members. In those businesses, unless otherwise indicated, subscriptions would be a revenue account. Any subscriptions they paid would be distinguished by using a Subscription Expenses account. In most cases, you can tell whether accounts are for revenue or expenditure from the type of organisation whose accounting books you are looking at. A very obvious example would be Audit Fee accounts, which are only ever revenue accounts in the accounting books of a firm of accountants. In all other cases, they are expense accounts.

4.3 When your cash decreases, you credit the cash account. This means that you must debit the expense account. This will always be the case whenever you incur expenses. It does not matter how you settle the transaction. The expense account will always be debited because it has increased.

4.4 The accounting equation is $\text{Capital} = \text{Assets} - \text{Liabilities}$. In this example, it starts as $\text{£}120 = \text{£}200 - \text{£}80$. Each transaction is entered twice. In both cases, the debit entry is £30 to a van hire expense account. The credit in (a) is to the cash account. In (b) it is to the car hire company's account (the creditor's account). In order for the accounting equation to balance, in (a) an asset (i.e. cash) has been reduced by £30 so capital must be reduced by the same amount, £30. In the case of (b) liabilities (i.e. the van hire company's account) have increased by £30 and so capital must also be reduced by that amount, £30. In the case of (a) the accounting equation becomes $\text{£}90 = \text{£}170 - \text{£}80$. In (b) it becomes $\text{£}90 = \text{£}200 - \text{£}110$. The effect on capital in both cases is that it decreases by the amount of the expense.

4.5 Profit is a form of revenue, so an increase in profit is a credit.

Losses are a form of expense, so an increase in losses is a debit.

Increases in capital are always a credit.

Profits and losses are both entered in the capital account at the end of the period. So if there is a profit, capital increases and you know from the *Principles of double entry* that this means the capital account must be credited. If there is a loss, the *Principles of double entry* tell you that the capital account must be debited.

Liabilities, such as loans, are the opposite of *assets*, so they are treated the opposite way from assets: increases in liabilities are credited to the appropriate liability account, and decreases are debited.

In other words, when they increase, the following are the debits and credit for the seven items.

Debit	Credit
Expenses	Revenues
Losses	Profits
Assets	Liabilities
	Capital

Review questions

4.1 Enter the following transactions, completing the double entry in the books for the month of August:

- August
- 1 Started in business with £31,000 in the bank and £4,000 in cash.
 - 2 Purchased goods £1,160 on time from A. Cliff.
 - 3 Bought fixtures and fittings £4,600 paying by cheque.
 - 5 Sold goods for cash £600.
 - 6 Bought goods on time £1,300 from S. Bell.
 - 10 Paid rent by cash £800.
 - 12 Bought stationery £180, paying in cash.
 - 18 Goods returned to A. Cliff £164.
 - 21 Received rent of £480 by cheque for sublet of corner space.
 - 23 Sold goods on time to R. Coat for £3,200.
 - 24 Bought a van paying by cheque £16,400.
 - 30 Paid the month's wages by cash £1,220.
 - 31 The proprietor took cash for her own personal use £1,020.

4.2 Write up the following transactions in the books of J. Dunn:

- May
- 1 Started in business with cash £30,000.
 - 2 Bought goods on time from T. Lamb £700.
 - 3 Paid rent by cash £1,740.
 - 4 Paid £25,000 of the cash of the business into a business bank account.
 - 5 Sold goods on time to R. Still £384.
 - 7 Bought stationery £170 paying by cheque.
 - 11 Cash sales £624.
 - 14 Goods returned by us to T. Lamb £80.
 - 17 Sold goods on time to R. Davis £424.
 - 20 Paid for repairs to the building by cash £156.
 - 22 R. Still returned goods to us £62.
 - 27 Paid T. Lamb by cheque £620.
 - 28 Cash purchases £940.
 - 29 Bought a van paying by cheque £7,000.
 - 30 Paid motor expenses in cash £432.
 - 31 Bought a computer £1,460 on time from S. Tims.





4.3A Prepare the double entries (*not* the T accounts) for the following transactions using the format:

Date		Dr	Cr
	Account name	£x	
	Account name		£x
July	1 Started in business with £5,000 in the bank and £1,000 cash.		
	2 Bought stationery by cheque £75.		
	3 Bought goods on time from T. Smart £2,100.		
	4 Sold goods for cash £340.		
	5 Paid insurance by cash £290.		
	7 Bought a computer on time from J. Hott £700.		
	8 Paid electricity by cheque £32.		
	10 Sold goods on time to C. Biggins £630.		
	11 Returned goods to T. Smart £550.		
	14 Paid wages by cash £210.		
	17 Paid rent by cheque £225.		
	20 Received cheque £400 from C. Biggins.		
	21 Paid J. Hott by cheque £700.		
	23 Bought stationery on time from News Ltd £125.		
	25 Sold goods on time to F. Tank £645.		
	31 Paid News Ltd by cheque £125.		

4.4A Write up the following transactions in the T-accounts of F. Fernandes:

Feb	1 Started in business with £11,000 in the bank and £1,600 cash.
	2 Bought goods on time: J. Biggs £830; D. Martin £610; P. Lot £590.
	3 Bought goods for cash £370.
	4 Paid rent in cash £75.
	5 Bought stationery paying by cheque £62.
	6 Sold goods on time: D. Twigg £370; B. Hogan £290; K. Fletcher £410.
	7 Paid wages in cash £160.
	10 Returned goods to D. Martin £195.
	11 Paid rent in cash £75.
	13 B. Hogan returns goods to us £35.
	15 Sold goods on time to: T. Lee £205; F. Sharp £280; G. Rae £426.
	16 Paid business rates by cheque £970.
	18 Paid insurance in cash £280.
	19 Paid rent by cheque £75.
	20 Bought van on time from B. Black £6,100.
	21 Paid motor expenses in cash £24.
	23 Paid wages in cash £170.
	24 Received part of amount owing from K. Fletcher by cheque £250.
	28 Received refund of business rates £45 by cheque.
	28 Paid by cheque: J. Biggs £830; D. Martin £415; B. Black £6,100.

4.5 From the following statements which give the cumulative effects of individual transactions, you are required to state as fully as possible what transaction has taken place in each case. That is, write descriptions similar to those given in Review questions 4.1–4.4. There is no need to copy out the table. The first column of data gives the opening position. Each of the other columns represents a transaction. It is these transactions (A–I) that you are to describe.

Transaction:		A	B	C	D	E	F	G	H	I
Assets	£000	£000	£000	£000	£000	£000	£000	£000	£000	£000
Land and buildings	450	450	450	450	575	575	275	275	275	275
Motor vehicles	95	100	100	100	100	100	100	100	100	100
Office equipment	48	48	48	48	48	48	48	48	48	48
Inventory	110	110	110	110	110	110	110	110	110	93
Trade receivables	188	188	188	188	188	108	108	108	108	120
Bank	27	22	22	172	47	127	427	77	77	77
Cash	15	15	11	11	11	11	11	11	3	3
	<u>933</u>	<u>933</u>	<u>929</u>	<u>1,079</u>	<u>1,079</u>	<u>1,079</u>	<u>1,079</u>	<u>729</u>	<u>721</u>	<u>716</u>
Capital	621	621	621	621	621	621	621	621	621	616
Loan from Lee	200	200	200	350	350	350	350	–	–	–
Trade payables	<u>112</u>	<u>112</u>	<u>108</u>	<u>108</u>	<u>108</u>	<u>108</u>	<u>108</u>	<u>108</u>	<u>100</u>	<u>100</u>
	<u>933</u>	<u>933</u>	<u>929</u>	<u>1,079</u>	<u>1,079</u>	<u>1,079</u>	<u>1,079</u>	<u>729</u>	<u>721</u>	<u>716</u>

Note: The heading £000 means that all the figures shown underneath it are in thousands of pounds, e.g. Office equipment book value is £48,000. It saves constantly writing out 000 after each figure, and is done to save time and make comparison easier.

4.6A The following table shows the cumulative effects of a succession of separate transactions on the assets and liabilities of a business. The first column of data gives the opening position.

Transaction:		A	B	C	D	E	F	G	H	I
Assets	£000	£000	£000	£000	£000	£000	£000	£000	£000	£000
Land and buildings	500	500	535	535	535	535	535	535	535	535
Equipment	230	230	230	230	230	230	230	200	200	200
Inventory	113	140	140	120	120	120	120	120	119	119
Trade receivables	143	143	143	173	160	158	158	158	158	158
Prepaid expenses*	27	27	27	27	27	27	27	27	27	27
Cash at bank	37	37	37	37	50	50	42	63	63	63
Cash on hand	9	9	9	9	9	9	9	9	9	3
	<u>1,059</u>	<u>1,086</u>	<u>1,121</u>	<u>1,131</u>	<u>1,131</u>	<u>1,129</u>	<u>1,121</u>	<u>1,112</u>	<u>1,111</u>	<u>1,105</u>
Capital	730	730	730	740	740	738	733	724	723	717
Loan	120	120	155	155	155	155	155	155	155	155
Trade payables	168	195	195	195	195	195	195	195	195	195
Accrued expenses*	41	41	41	41	41	41	38	38	38	38
	<u>1,059</u>	<u>1,086</u>	<u>1,121</u>	<u>1,131</u>	<u>1,131</u>	<u>1,129</u>	<u>1,121</u>	<u>1,112</u>	<u>1,111</u>	<u>1,105</u>





Required:

Identify clearly and as fully as you can what transaction has taken place in each case. Give two possible explanations for transaction I. Do not copy out the table but use the reference letter for each transaction.

(Association of Accounting Technicians)

***Authors' Note:** You have not yet been told about 'prepaid expenses' and 'accrued expenses'. Prepaid expenses are expenses that have been paid in advance, the benefits of which will only be felt by the business in a later accounting period. Because the benefit of having incurred the expense will not be received until a future time period, the expense is not included in the calculation of profit for the period in which it was paid. As it was not treated as an expense of the period when profit was calculated, the debit in the account is treated as an asset when the balance sheet is prepared, hence the appearance of the term 'prepaid expenses' among the assets in the question. Accrued expenses, on the other hand, are expenses that have not yet been paid for benefits which have been received. In F, £8,000 was paid out of the bank account (50 to 42) of which £3,000 was used to pay off some of the accrued expenses (41 to 38).

chapter 5

Balancing-off accounts

Learning objectives

After you have studied this chapter, you should be able to:

- Close-off accounts when appropriate.
- Balance-off accounts at the end of a period and bring down the opening balance to the next period.
- Distinguish between a debit balance and a credit balance.
- Describe and prepare accounts in three-column format.

Introduction

In this chapter, you'll learn how to discover what the amount outstanding on an account is at a particular point in time. You'll also learn how to close accounts that are no longer needed and how to record appropriate entries in accounts at the end and beginning of periods. Finally, you'll learn that T-accounts are not the only way to record accounting transactions.

5.1 Accounts for debtors

Where debtors have paid their accounts

So far you have learnt how to record transactions in the accounting books by means of debit and credit entries. At the end of each accounting period the figures in each account are examined in order to summarise the situation they present. This will often, but not always, be once a year if you are calculating profit. If you want to see what is happening with respect to particular accounts, it will be more frequently done. For example, if you want to find out how much your customers owe you for goods you have sold to them, you would probably do this at the end of each month.

Activity 5.1

Why do you think we would want to look at the trade receivables in the account books as often as once a month?

Let's look at the account of one of our customers, K. Tandy, for transactions in August 2019:

K. Tandy							
2019			£	2019			£
Aug	1	Sales	144	Aug	22	Bank	144
	19	Sales	300		28	Bank	300

If you add up the figures on each side, you will find that they both sum to £444. In other words, during the month we sold a total of £444 worth of goods to Tandy, and we have been paid a total of £444 by her. This means that at the end of August she owes us nothing. As she owes us nothing, we do not need her account to prepare the balance sheet (there is no point in showing a figure for trade receivables of zero in the balance sheet). We can, therefore, **close off** her account on 31 August 2019. This is done by inserting the totals on each side:

K. Tandy						
2019			£	2019	£	
Aug	1	Sales	144	Aug	22 Bank	144
	19	Sales	300		28 Bank	300
			<u>444</u>			<u>444</u>

Notice that totals in accounting are always shown with a single line above them, and a double line underneath. As shown in the following completed account for C. Lee, totals on accounts at the end of a period are always shown on a level with one another, even when there are fewer entries on one side than on the other.

Now, let's look at the account for C. Lee.

C. Lee							
2019			£	2019			£
Aug	11	Sales	177	Aug	30	Bank	480
	19	Sales	203				
	22	Sales	100				
			<u>480</u>				<u>480</u>

In this account, C. Lee also owed us nothing at the end of August 2019, as he had paid us for all the sales we made to him.

Note: In handwritten accounts, you will often see this layout enhanced by two intersecting lines, one horizontal and one diagonal on the side which has less entries. If this were done, C. Lee's account would look like this:

C. Lee									
2019			£	2019				£	
Aug	11	Sales	177	Aug	30	Bank		480	
	19	Sales	203						
	22	Sales	100						
			<u>480</u>					<u>480</u>	

We won't use this layout in this book, but your teacher or lecturer may want you to use it when you are preparing T-accounts.

**Activity
5.2**

Why do you think we would want to draw these two extra lines onto the hand-written account?

If an account contains only one entry on each side and they are equal, you don't need to include totals. For example:

K. Wood					
2019		£	2019		£
Aug	6	Sales	Aug	12	Bank
		<u>214</u>			<u>214</u>

Now let's look at what happens when the two sides do not equal each other.

Where debtors still owe for goods

It is unlikely that everyone will have paid the amounts they owe us by the end of the month. In these cases, the totals of each side would not equal one another. Let's look at the account of D. Knight for August 2019:

D. Knight					
2019		£	2019		£
Aug	1	Sales	Aug	28	Bank
	15	Sales			158
	30	Sales			
		158			
		206			
		118			

If you add the figures you will see that the debit side adds up to £482 and the credit side adds up to £158. You should be able to see what the difference of £324 (i.e. £482 – £158) represents. It consists of the last two sales of £206 and £118. They have not been paid for and so are still owing to us on 31 August 2019.

In double entry, we only enter figures as totals if the totals on both sides of the account agree. We do, however, want to **balance-off** the account for August showing that Knight owes us £324. (While there would be nothing wrong in using the term 'close off', 'balance-off' is the more appropriate term to use when there is a difference between the two sides of an account.)

If Knight owes us £324 at close of business on 31 August 2019, then the same amount will be owed to us when the business opens on 1 September 2019.

Balancing the accounts is done in five stages:

- 1 Add up both sides to find out their totals. Note: do not write anything in the account at this stage.
- 2 Deduct the smaller total from the larger total to find the balance.
- 3 Now enter the balance on the side with the smallest total. This now means the totals will be equal.
- 4 Enter totals level with each other.
- 5 Now enter the balance on the line below the totals on the *opposite* side to the balance entered above the totals.

Against the balance above the totals, complete the date column by entering the last day of that period – for August, this will always be '31' even if the business was shut on that date because it fell on a weekend or was a holiday. Below the totals, show the first day of the next period against the balance – this will always be the day immediately after the last day of the previous period, in this case, September 1. The balance above the totals is described as the **balance carried down** (often abbreviated to 'balance c/d'). The balance below the total is described as the **balance brought down** (often abbreviated to 'balance b/d').

Knight's account when 'balanced-off' will appear as follows:

D. Knight			
2019	£	2019	£
Aug 1 Sales	158	Aug 28 Bank	158
15 Sales	206	31 Balance carried down	324
30 Sales	118		
	<u>482</u>		<u>482</u>
Sept 1 Balance brought down	324		

Stage 5: finally, enter balance to start off entries for following month.

Stage 4: now enter totals level with each other.

Stage 3: enter balance here so that totals will be equal.

Note for students

- From now on, we will use the abbreviations 'c/d' and 'b/d'.
- The date given to the balance c/d is the last day of the period which is finishing, and the balance b/d is given the opening date of the next period.
- As the total of the debit side originally exceeded the total of the credit side, **the balance is said to be a 'debit balance'**. Because this is a personal account (i.e. an account for a person), the person concerned is said to be a **debtor** – the accounting term for anyone who owes money to the business.

Just as when the two sides each have only one entry and the two sides are equal, if an account contains only one entry it is unnecessary to enter the total after entering the balance carried down (because the balance becomes the only entry on the other side and it is equal to the other entry). A double line ruled under the entry will mean that the entry is its own total. For example:

B. Walters			
2019	£	2019	£
Aug 18 Sales	51	Aug 31 Balance c/d	51
Sept 1 Balance b/d	<u>51</u>		

Note: T-accounts should *always* be balanced-off at the end of each period, even when they contain only one entry.

5.2 Accounts for creditors

Exactly the same principles will apply when the balances are brought down to the credit side. **This balance is known as a 'credit balance'**. We can look at the accounts of two of our suppliers which are to be balanced-off:

E. Williams			
2019	£	2019	£
Aug 21 Bank	100	Aug 2 Purchases	248
		18 Purchases	116

K. Patterson

2019			£	2019			£
Aug	14	Returns outwards	20	Aug	8	Purchases	620
	28	Bank	600		15	Purchases	200

We now add up the totals and find the balance, i.e. Stages 1 and 2. When balanced-off, these will appear as:

E. Williams							
2019			£	2019			£
Aug	21	Bank	100	Aug	2	Purchases	248
	31	Balance c/d	264		18	Purchases	116
			<u>364</u>				<u>364</u>
				Sept	1	Balance b/d	264

Stage 3: enter balance here so that totals will be equal.

Stage 4: now enter totals level with each other.

Stage 5: finally, enter balance to start off entries for following month.

K. Patterson

2019			£	2019			£
Aug	14	Returns outwards	20	Aug	8	Purchases	620
	28	Bank	600		15	Purchases	200
	31	Balance c/d	200				<u>820</u>
			<u>820</u>	Sept	1	Balance b/d	<u>200</u>

The accounts of E. Williams and K. Patterson have credit balances. They are 'creditors' – the accounting term for someone to whom money is owed.

Before you read further attempt Review questions 5.1 and 5.2.

5.3 Three-column accounts

Through the main part of this book, the type of account used is the T-account, where the left-hand side of the account is the debit side, and the right-hand side is the credit side. However, when computers are used the style of the ledger account is sometimes different. It appears as three columns of figures, one column for debit entries, another column for credit entries, and the last column for the balance. If you have an account at a bank, your bank statements will often be shown using this three-column format.

The accounts used in this chapter will now be redrafted to show the ledger accounts drawn up in this way.

K. Tandy

			<i>Debit</i>	<i>Credit</i>	<i>Balance (and whether debit or credit)</i>	
			£	£	£	
2019						
Aug	1	Sales	144		144	Dr
	19	Sales	300		444	Dr
	22	Bank		144	300	Dr
	28	Bank		300	0	

C. Lee

			<i>Debit</i>	<i>Credit</i>	<i>Balance</i>	
			£	£	£	
2019						
Aug	11	Sales	177		177	Dr
	19	Sales	203		380	Dr
	22	Sales	100		480	Dr
	30	Bank		480	0	

K. Wood

			<i>Debit</i>	<i>Credit</i>	<i>Balance</i>	
			£	£	£	
2019						
Aug	6	Sales	214		214	Dr
	12	Bank		214	0	

D. Knight

			<i>Debit</i>	<i>Credit</i>	<i>Balance</i>	
			£	£	£	
2019						
Aug	1	Sales	158		158	Dr
	15	Sales	206		364	Dr
	28	Bank		158	206	Dr
	31	Sales	118		324	Dr

B. Walters

			<i>Debit</i>	<i>Credit</i>	<i>Balance</i>	
			£	£	£	
2019						
Aug	18	Sales	51		51	Dr

E. Williams

			<i>Debit</i>	<i>Credit</i>	<i>Balance</i>	
			£	£	£	
2019						
Aug	2	Purchases		248	248	Cr
	18	Purchases		116	364	Cr
	21	Bank	100		264	Cr

K. Patterson

			<i>Debit</i>	<i>Credit</i>	<i>Balance</i>	
			£	£	£	
2019						
Aug	8	Purchases		620	620	Cr
	14	Returns	20		600	Cr
	15	Purchases		200	800	Cr
	28	Bank	600		200	Cr

Note how the balance is calculated after every entry. This can be done quite simply when using a computer because the software can automatically calculate the new balance as soon as an entry is made.

When manual methods are being used it is often too much work to have to calculate a new balance after each entry. Also, the greater the number of calculations, the greater the possibility of errors. For these reasons, it is usual for students to use T-accounts *except* when required to use three-column accounts in an exam! However, it is important to note that there is no difference in principle – the final balances are the same using either method.

Learning outcomes

You should now have learnt:

- 1 How to close-off accounts upon which there is no balance outstanding.
- 2 How to balance-off accounts at the end of a period.
- 3 How to bring down the opening balance on an account at the start of a new period.
- 4 That when an opening balance on an account is a debit, that account is said to have a debit balance. It also has a debit balance during a period whenever the total of the debit side before balancing exceeds the total of the credit side.
- 5 That when an opening balance on an account is a credit, that account is said to have a credit balance. It also has a credit balance during a period whenever the total of the credit side before balancing exceeds the total of the debit side.
- 6 That 'debtors' are people or organisations whose account in your account books has a greater value on the debit side. They owe you money. They are included in the amount shown for trade receivables in the balance sheet.
- 7 That 'creditors' are people or organisations whose account in your account books has a greater value on the credit side. You owe them money. They are included in the amount shown for trade payables in the balance sheet.
- 8 That T-accounts and three-column accounts disclose the same balance, given identical information about transactions.
- 9 That three-column accounts update and show the balance on the account after every transaction.
- 10 How to prepare three-column accounts.

Answers to activities

- 5.1** In order to survive, businesses must, in the long term, make profits. However, even profitable businesses go 'bust' if they do not have enough funds to pay their bills when they are due. Debtors represent a resource that is not yet in the form of funds (e.g. cash) that can be used to pay bills. By regularly monitoring the position on the account of each debtor, a business can tell which debtors are being slow to pay and, very importantly, do something about it.
- 5.2** The purpose is to prevent any more entries being made in the account. The entries would *always* be made in ink, so as to prevent their being erased and replaced with different entries. In a computerised accounting system, there is no need for measures such as these, because the controls and checks built into the computerised system prevent such things from happening.

Review questions

5.1 Enter the following items in the appropriate debtors' accounts (i.e. your customers' accounts) only; do *not* write up other accounts. Then balance-off each of these personal accounts at the end of the month. (Keep your answer; it will be used as a basis for Review question 5.3.)

- May
- 1 Sales on time to B. Flynn £810; F. Lane £1,100; T. Fey £413.
 - 4 Sales on time to F. Start £480; B. Flynn £134.
 - 10 Returns inwards from B. Flynn £124; T. Fey £62.
 - 18 F. Lane paid us by cheque £1,100.
 - 20 T. Fey paid us £351 by cheque.
 - 24 B. Flynn paid us £440 by cash.
 - 31 Sales on time to F. Start £240.

5.2 Enter the following in the appropriate creditors' accounts (i.e. your suppliers' accounts) only. Do *not* write up the other accounts. Then balance-off each of these personal accounts at the end of the month. (Keep your answer; it will be used as the basis for Review question 5.4.)

- June
- 1 Purchases on time from J. Wilson £240; P. Todd £390; J. Fry £1,620.
 - 3 Purchases on time from P. Todd £470; P. Rake £290.
 - 10 We returned goods to J. Fry £140; J. Wilson £65.
 - 15 Purchases on time from J. Wilson £210.
 - 19 We paid P. Rake by cash £290.
 - 28 We paid J. Wilson by cash £300.
 - 30 We returned goods to P. Todd £39.

5.3 Redraft each of the accounts given in your answer to Review question 5.1 in three-column style.

5.4 Redraft each of the accounts given in your answer to Review question 5.2 in three-column style.

5.5 Enter the following in the personal accounts (i.e. the creditor and debtor accounts) only. Do *not* write up the other accounts. Balance-off each personal account at the end of the month. After completing this, state which of the balances represent debtors and which represent creditors.

- Sept
- 1 Sales on time to J. Bee £1,040; T. Day £1,260; J. Soul £480.
 - 2 Purchases on time D. Blue £780; F. Rise £1,020; P. Lee £560.
 - 8 Sales on time to T. Day £340; L. Hope £480.
 - 10 Purchases on time from F. Rise £92; R. James £870.
 - 12 Returns inwards from J. Soul £25; T. Day £190.
 - 17 We returned goods to F. Rise £12; R. James £84.
 - 20 We paid D. Blue by cheque £780.
 - 24 J. Bee paid us by cheque £900.
 - 26 We paid R. James by cheque £766.
 - 28 J. Bee paid us by cash £80.
 - 30 L. Hope pays us by cheque £480.

5.6A Enter the following transactions in personal accounts only. Bring down the balances at the end of the month. After completing this, state which of the balances represent debtors and which represent creditors.

2024

May

- 1 Credit sales F. Black £620; G. Smith £84; L. Sime £1,200; J. Teel £608.
- 2 Credit purchases from P. Best £190; I. Donovan £63; G. Lime £210; T. Still £360.
- 8 Credit sales to G. Smith £322; L. Sime £448.
- 9 Credit purchases from I. Donovan £215; T. Still £164.
- 10 Goods returned to us by L. Sime £62; J. Teel £164.
- 12 Cash paid to us by J. Teel £444.
- 15 We returned goods to P. Best £25; T. Still £21.
- 19 We received cheques from L. Sime £180; F. Black £620.
- 21 We sold goods on time to F. Black £180; G. Smith £860.
- 28 We paid by cheque the following: P. Best £165; T. Still £100; G. Lime £180.
- 31 We returned goods to T. Still £40.

5.7A Redraft each of the accounts given in your answer to Review question 5.6A in three-column style.

chapter 6

The trial balance

Learning objectives

After you have studied this chapter, you should be able to:

- Prepare a trial balance from a set of accounts.
- Explain why the debit and credit trial balance totals should equal one another.
- Explain why some of the possible errors that can be made when double entries are being entered in the accounts do not prevent the trial balance from 'balancing'.
- Describe uses for a trial balance other than to check for double entry errors.

Introduction

In this chapter, you'll learn how to prepare a trial balance from the accounts in the account books. You'll discover that the alternative version of the accounting equation can be a useful guide to understanding why a trial balance must balance if all the double entries in the accounts are correct. You'll also learn that the trial balance is no guarantee that the double entries have all been recorded correctly. Finally, after this chapter, you'll have the opportunity to do 20 multiple-choice questions covering the material in Chapters 1–6.

6.1 Total debit entries = Total credit entries

You've learnt that under double entry bookkeeping:

- for each debit entry there is a credit entry
- for each credit entry there is a debit entry.

Let's see if you can remember the basics of double entry.

Activity 6.1

What is the double entry for each of the following transactions?

- (a) Purchase of a new van for £9,000 which was paid in full by cheque

Dr		£	
	Cr		£

- (b) Goods which cost £40 taken out by the owner for her own use

Dr		£	
	Cr		£

The total of all the items recorded in all the accounts on the debit side should equal the total of all the items recorded on the credit side of the accounts.

Activity 6.2

Do you remember the alternative form of the accounting equation you were shown in Chapter 1? What does it tell you has happened when it does not balance?

We need to check that for each debit entry there is also an equal credit entry. In order to check that there is a matching credit entry for every debit entry, we prepare something called a **trial balance**.

A type of trial balance could be drawn up by listing all the accounts and then entering the total of all the debit entries in each account in one column and the total of all the credit entries in each account into another column. Finally, you would add up the two columns of figures and ensure they are equal. Using the worked example in Section 3.8, this trial balance would be:

Trial balance as at 31 May 2020		
	Dr	Cr
	£	£
Purchases	994	
Sales		490
Returns outwards		15
Returns inwards	16	
D. Small	220	220
A. Lyon & Son		624
D. Hughes	60	60
M. Spencer	45	16
Cash	<u>445</u>	<u>355</u>
	<u>1,780</u>	<u>1,780</u>

6.2 Total debit balances = Total credit balances

The method described in Section 6.1 is *not* the usual method of drawing up a trial balance, but it is the easiest to understand at first. The form of trial balance used by accountants is a list of account balances arranged according to whether they have debit balances or credit balances.

Let's balance-off the accounts you saw in Section 3.8. The new entries are in blue so that you can see the entries required to arrive at the closing balances that are used in the trial balance.

Go back to Section 3.8 and balance all the accounts before you read any further.

The balanced accounts are shown below:

Purchases				
2020			£	
May	1	D. Small	220	
	2	A. Lyon & Son	410	
	12	Cash	150	
	31	A. Lyon & Son	214	
			<u>994</u>	
June	1	Balance b/d	<u>994</u>	<u>994</u>

Sales				
2020			£	
May	31	Balance c/d	<u>490</u>	
			<u>490</u>	
2020			£	
May	5	D. Hughes	60	
	6	M. Spencer	45	
	11	Cash	210	
	21	Cash	175	
			<u>490</u>	
June	11	Balance b/d	<u>490</u>	<u>490</u>

Returns outwards				
2020			£	
May	31	Balance c/d	<u>15</u>	
			<u>15</u>	
2020			£	
May	10	D. Small	15	
June	1	Balance b/d	<u>15</u>	<u>15</u>

Returns inwards				
2020			£	
May	19	M. Spencer	16	
June	1	Balance b/d	<u>16</u>	<u>16</u>
2020			£	
May	31	Balance c/d	<u>16</u>	

D. Small				
2020			£	
May	10	Returns outwards	15	
	22	Cash	205	
			<u>220</u>	
2020			£	
May	1	Purchases	220	
			<u>220</u>	

A. Lyon & Son				
2020			£	
May	31	Balance c/d	<u>624</u>	
			<u>624</u>	
2020			£	
May	2	Purchases	410	
	31	Purchases	214	
			<u>624</u>	
June	1	Balance b/d	<u>624</u>	<u>624</u>

D. Hughes				
2020			£	
May	5	Sales	60	
			<u>60</u>	
2020			£	
May	30	Cash	60	
			<u>60</u>	

M. Spencer				
2020			£	
May	6	Sales	45	
			<u>45</u>	
June	1	Balance b/d	<u>45</u>	<u>45</u>
2020			£	
May	19	Returns inwards	16	
	31	Balance c/d	<u>29</u>	
			<u>45</u>	

Cash									
2020			£		2020			£	
May	11	Sales	210		May	12	Purchases	150	
	21	Sales	175			22	D. Small	205	
	30	D. Hughes	60			31	Balance c/d	90	
			<u>445</u>					<u>445</u>	
June	1	Balance b/d	90						

If you attempted this before looking at the answer, be sure you understand any mistakes you made before going on.

If the trial balance was drawn up using these closing account balances, it would appear as follows:

Trial balance as at 31 May 2020		
	Dr	Cr
	£	£
Purchases	994	
Sales		490
Returns outwards		15
Returns inwards	16	
A. Lyon & Son		624
M. Spencer	29	
Cash	<u>90</u>	
	<u>1,129</u>	<u>1,129</u>

This is the usual way in which a trial balance is presented.

The trial balance always has the date of the last day of the accounting period to which it relates. It is a snapshot of the balances on the ledger accounts at that date.

Just like the trial balance you saw in Section 6.1, the two sides of this one also ‘balance’. However, the totals are lower. This is because the £220 in D. Small’s account, £60 in D. Hughes’ account, £16 in M. Spencer’s account and £355 in the cash account have been cancelled out from each side of these accounts by taking only the *balances* instead of the *totals*. As equal amounts have been cancelled from each side, £651 in all, the new totals should still equal one another, as in fact they do at £1,129. (You can verify this if you subtract the new total of £1,129 from the previous one of £1,780. The difference is £651 which is the amount cancelled out from both sides.)

This form of trial balance is the easiest to extract when there are more than a few transactions during the period, and it is the one accountants use.

Note that a trial balance can be drawn up at any time. However, it is normal practice to prepare one at the end of an accounting period before preparing an income statement and a ‘balance sheet’. The income statement shows what profit has been earned in a period. (You will be looking at income statements in the next chapter.) The balance sheet shows what the assets and liabilities of a business are at the end of a period.

Go back to Chapter 1 to refresh your understanding of the balance sheet.

**Activity
6.3**

What advantages are there in preparing a trial balance when you are about to prepare an income statement and balance sheet?

As you've just learnt from Activity 6.3, trial balances are not just done to find errors.

6.3 Trial balances and errors

Many students new to accounting assume that when the trial balance 'balances', the entries in the accounts must be correct. **This assumption is incorrect.** While it means that certain types of error have not been made (such as forgetting to enter the credit side of a transaction), there are several types of error that will not affect the balancing of a trial balance – omitting a transaction altogether, for example.

Examples of the errors which would be revealed, provided there are no compensating errors which cancel them out, are addition errors, using one figure for the debit entry and another figure for the credit entry, and entering only one side of a transaction.

We shall consider addition errors in greater detail in Chapter 26.

**Activity
6.4**

If a trial balance fails to agree, what steps would you take in order to find the cause of the difference?

6.4 Closing inventory

Inventory at the end of a period is not usually to be found in an account in the ledger but its amount is needed when preparing an income statement or a balance sheet. For that purpose, it has to be identified from inventory records and physical stocktaking. However, as it is typically not to be found in the ledger, it would not be among the balances in a trial balance. In contrast, the value of inventory at the beginning of a reporting period (opening inventory) is usually recorded in a ledger account, so it would be included in the trial balance prepared at the end of that period.

6.5 Multiple choice self-test questions

A common practice of examining boards is to set multiple-choice questions in accounting. In fact, this has become so popular with examiners that all the largest professional accounting bodies now use them, particularly in their first-level examinations.

Multiple-choice questions give an examiner the opportunity to cover large parts of the syllabus briefly, but in detail. Students who omit to study areas of the syllabus will be caught out by an examiner's use of multiple-choice questions. It is no longer possible to say that it is highly probable a certain topic will not be tested – the examiner can easily cover it with a multiple-choice question.

Rather than having a few multiple-choice questions at the end of each chapter, five different sets of 20 multiple-choice questions are presented, spread across this book: after Chapters 6, 16, 22, 30, and 40. This approach is adopted because multiple-choice questions are relatively easy to answer a few minutes after reading a chapter but, answering multiple-choice questions later is a far better test of your powers of recall and understanding. It also gives you practice at answering questions covering a range of topics in one block, as in an examination. Answers to all the multiple-choice questions are given in Appendix 2 at the end of this book.

Each multiple-choice question has a 'stem' (a part which poses the problem), a 'key' (which is the one correct answer), and a number of 'distractors', i.e. incorrect answers. The key plus the distractors are known as the 'options'.

If you do not know the answer, you should guess. You may be right by chance, or you may remember something subconsciously. In any event, unless the examiner warns otherwise, you will be expected to guess if you don't know the answer.

Read through the Learning outcomes for this chapter and the Review questions, and then attempt Multiple-choice Set 1.

Memory aid

The following diagram may help you to remember which accounts to debit and credit when they *increase* in value:

Debit	Credit
Expenses	Revenues
Losses	Profits
Assets	Liabilities
	Capital

Learning outcomes

You should now have learnt:

- 1 How to prepare a trial balance.
- 2 That trial balances are one form of checking the accuracy of entries in the accounts.
- 3 That errors can be made in the entries to the accounts that will not be shown up by the trial balance.
- 4 That the trial balance is used as the basis for preparing income statements and balance sheets.

Now attempt Set 3 of multiple-choice questions. (Answers to all the multiple-choice questions are given in Appendix 2 at the end of this book.)

Answers to activities

6.1	(a)	Dr	Van account	£9,000	
			Cr Bank account		£9,000
	(b)	Dr	Drawings account	£40	
			Cr Purchases account		£40

- 6.2 The alternative form of the accounting equation is $\text{Assets} = \text{Capital} + \text{Liabilities}$. All the accounts with debit balances are assets and all the accounts with credit balances are either capital or liabilities. This means that so long as you enter a debit for every credit, the alternative accounting equation must always balance. If the alternative accounting equation does not balance, you've made an error somewhere, either in your double entries, or in your arithmetic within the individual accounts. Virtually all occurrences where the accounting equation does not balance that arise in practice are the result of double entry errors.

- 6.3** Firstly, you can verify whether the total of the debit balances equals the total of the credit balances. They need to be equal, or your income statement and balance sheet will be incorrect *and* your balance sheet will not balance. (That is, the accounting equation will not balance.) Secondly, you need to know what the balance is on every account so that you can enter the appropriate figures into the income statement and balance sheet. If you don't prepare a trial balance, you will find it much more difficult to prepare these two accounting statements.
- 6.4** You need to check each entry to verify whether or not it is correct but firstly, it is best to start by checking that the totals in the trial balance have been correctly summed. Then, check that no account has been omitted from the trial balance. Then, check each account in turn.

Review questions

6.1 Darron starts his business on 1 May. He plans to buy plain T-shirts, print them with his own designs, and sell them to small retailers. The following transactions take place in his first month of trading, and you are asked to post them to T-accounts, balance-off the accounts and prepare a trial balance at 31 May:

- | | | |
|-----|----|--|
| May | 1 | Opens a business bank account with £800 of his own money. |
| | 3 | Borrows £2,000 from HBSC, repayable in four years' time. |
| | 5 | Buys screen printing machine (which he will use to produce the finished T-shirts) paying by cheque £2,500. |
| | 7 | Pays for online advertising, £75 using debit card. |
| | 9 | Buys plain T-shirts for £200, paying by bank transfer. |
| | 11 | Buys more plain T-shirts on time from M. Ball, £700. |
| | 13 | Sells some printed T-shirts; customer pays by cheque £380. |
| | 15 | Sells some printed T-shirts to N. Chadwick on time, £470. |
| | 17 | Sells some printed T-shirts to J. Vaughan on time, £550. |
| | 19 | Darron takes £110 from the business bank account for his own personal use. |
| | 21 | J. Vaughan returns unsatisfactory T-shirts (original sale value £60). |
| | 23 | Pays £300 cheque to M. Ball on account. |
| | 25 | Receives £170 cheque from N. Chadwick on account. |
| | 31 | Pays electricity charges for May, £145 direct debit. |

6.2 Nicola Burt started her own business on 1 August. The following is a list of her transactions in that month:

- | | | |
|-----|----|---|
| Aug | 1 | Started business with £3,850 of her own cash. |
| | 2 | Paid £3,500 of this opening cash into a business bank account. |
| | 4 | Bought goods for resale on time, £414 from D. Bellini. |
| | 5 | Bought machinery, paying by bank transfer £2,500. |
| | 7 | Bought goods for resale, paying cash £323. |
| | 10 | Sold goods on time, £595 to J. Adams. |
| | 11 | N. Burt took goods from inventory for her own use, cost £98. |
| | 12 | Returned goods (to the value of £70) to D. Bellini. |
| | 19 | Sold goods for cash, £328. |
| | 22 | Bought computer equipment on time from TVC Ltd, £1,450. |
| | 24 | Received loan from G. Plover, £2,000 cheque, repayable in 10 years. |
| | 29 | Made a payment to D. Bellini, £180 cheque. |
| | 30 | Paid wages £530 to employee by bank transfer. |
| | 31 | Paid TVC Ltd in full by cheque £1,450. |

Required:

- (a) Enter the transactions in T-accounts and balance-off your accounts as at 31 August.
 (b) Prepare a trial balance as at 31 August.

6.3A Record the following details relating to a carpet wholesaler for the month of November and extract a trial balance as at 30 November.

- Nov 1 Started in business with £15,000 in the bank.
 3 Bought goods on time from: J. Small £290; F. Brown £1,200; R. Charles £530; T. Rae £610.
 5 Cash sales £610.
 6 Paid rent by cheque £175.
 7 Paid business rates by cheque £130.
 11 Sold goods on time to: T. Potts £85; J. Field £48; T. Gray £1,640.
 17 Paid wages by cash £290.
 18 Returned goods to: J. Small £18; R. Charles £27.
 19 Bought goods on time from: R. Charles £110; T. Rae £320; F. Jack £165.
 20 Goods were returned to us by: J. Field £6; T. Potts £14.
 21 Bought van on time from Turnkey Motors £4,950.
 23 Paid the following by cheque: J. Small £272; F. Brown £1,200; T. Rae £500.
 25 Bought another van, paying by cheque immediately £6,200.
 26 Received a loan of £750 cash from B. Bennet.
 28 Received cheques from: T. Potts £71; J. Field £42.
 30 Proprietor brings a further £900 into the business, by a payment into the business bank account.

6.4A Record the following transactions for a new small business for the month of June, balance-off all the accounts, and then extract a trial balance as at 30 June.

- June 1 Started in business with £10,500 cash.
 2 Put £9,000 of the cash into a bank account.
 3 Bought goods for cash £550.
 4 Bought goods on time from: T. Dry £800; F. Hood £930; M. Smith £160; G. Low £510.
 5 Bought stationery on time from Buttons Ltd £89.
 6 Sold goods on time to: R. Tong £170; L. Fish £240; M. Singh £326; A. Tom £204.
 8 Paid rent by cheque £220.
 10 Bought fixtures on time from Chiefs Ltd £610.
 11 Paid salaries in cash £790.
 14 Returned goods to: F. Hood £30; M. Smith £42.
 15 Bought van by cheque £6,500.
 16 Received loan from B. Barclay by cheque £2,000.
 18 Goods returned to us by: R. Tong £5; M. Singh £20.
 21 Cash sales £145.
 24 Sold goods on time to: L. Fish £130; A. Tom £410; R. Pleat £158.
 26 Paid the following by cheque: F. Hood £900; M. Smith £118.
 29 Received cheques from: R. Pleat £158; L. Fish £370.
 30 Received a further loan from B. Barclay by cash £500.
 30 Received £614 cash from A. Tom.





6.5 Write up the accounts to record the following transactions in the books of M. Donnelly's business. Balance-off the accounts and prepare a trial balance at 30 April.

- April
- 1 Starts his business by investing £3,500 of his own money (£500 in cash and £3,000 in a business bank account).
 - 5 Bought goods for resale on time for £475 from P. Thomas.
 - 6 Bought machinery for £1,450, paying by cheque.
 - 7 Paid insurance, £120 by debit card.
 - 9 Bought goods for resale on time, £255 from M. Wilkinson.
 - 12 Sold goods on time to E. Grant £700.
 - 15 Sold goods for cash, £300.
 - 20 Paid the £475 due to P. Thomas with a cheque.
 - 22 Returned goods (original cost £50) to M. Wilkinson.
 - 24 Sold goods on time to E. Williams, £325.
 - 25 Paid wages to employee, £45 by bank transfer.
 - 27 E. Grant returned goods to M. Donnelly to the value of £80.
 - 30 M. Donnelly took business cash for his personal use, £80.

6.6 Rebecca starts a new business on 1 October, operating as a wholesaler of cleaning products. Record the following transactions in T-accounts for her, balance off her accounts, and produce a trial balance as at 31 October:

- Oct
- 1 Opens a business bank account with £825 of her own money.
 - 3 Borrows £1,500 from HCBS bank, repayable in five years' time.
 - 5 Pays £215 to hire a van for the month of October, using debit card.
 - 7 Buys IT equipment for the business, paying £1,450 by debit card.
 - 9 Buys goods for resale, paying by cheque £810 straight away.
 - 11 Buys goods for resale £730 on time (i.e. on credit terms) from G. Sharp.
 - 13 Pays business phone & broadband charges for October, £55 by direct debit.
 - 15 Pays rent on business premises for month of October, £340, by bank transfer.
 - 17 Sells goods for £1,100, customer pays by bank transfer straight away.
 - 19 Returns unsatisfactory goods to G. Sharp, original cost of which was £230.
 - 21 Buys goods for resale on time (i.e. on credit terms) from R. Kenyon, £640.
 - 23 Sells goods on time (i.e. on credit terms) £1,800 to P. Bracewell.
 - 25 Takes £425 from business bank account to use for her personal living expenses.
 - 27 Pays £500 cheque to G. Sharp.
 - 29 Pays staff wages for October, £180 by bank transfer.
 - 31 Receives £600 cheque from P. Bracewell.

Multiple-choice questions: Set 1

Each of these multiple-choice questions has four suggested answers, (A), (B), (C) and (D). You should read each question and then decide which choice is best, either (A) or (B) or (C) or (D). *Write down your answers on a separate piece of paper.* You will then be able to redo the set of questions later without having to try to ignore your answers.

Answers to all the multiple-choice questions are given in Appendix 2 at the end of this book.

MC1 Which of the following statements is **incorrect**?

- (A) Assets – Capital = Liabilities
- (B) Liabilities + Capital = Assets
- (C) Liabilities + Assets = Capital
- (D) Assets – Liabilities = Capital

MC2 Which of the following is **not** an asset?

- (A) Buildings
- (B) Cash balance
- (C) Trade receivables
- (D) Loan from K. Harris

MC3 Which of the following is a liability?

- (A) Machinery
- (B) Trade payables for goods
- (C) Motor vehicles
- (D) Cash at bank

MC4 Which of the following is **incorrect**?

	Assets	Liabilities	Capital
	£	£	£
(A)	7,850	1,250	6,600
(B)	8,200	2,800	5,400
(C)	9,550	1,150	8,200
(D)	6,540	1,120	5,420

MC5 Which of the following statements is correct?

	Effect upon	
	Assets	Liabilities
(A) We paid a creditor by cheque	– Bank	– Trade payables
(B) A debtor paid us £90 in cash	+ Cash	+ Trade receivables
(C) J. Hall lends us £500 by cheque	+ Bank	– Loan from Hall
(D) Bought goods on time	+ Inventory	+ Capital





MC6 Which of the following are correct?

	<i>Accounts</i>	<i>To record</i>	<i>Entry in the account</i>
(i)	Assets	an increase	Debit
		a decrease	Credit
(ii)	Capital	an increase	Debit
		a decrease	Credit
(iii)	Liabilities	an increase	Credit
		a decrease	Debit
(A)	(i) and (ii)		
(B)	(ii) and (iii)		
(C)	(i) and (iii)		
(D)	(i), (ii) and (iii)		

MC7 Which of the following are correct?

		<i>Account to be debited</i>	<i>Account to be credited</i>
(i)	Bought office furniture for cash	Office furniture	Cash
(ii)	A debtor, P. Sangster, pays us by cheque	Bank	P. Sangster
(iii)	Introduced capital by cheque	Capital	Bank
(iv)	Paid a creditor, B. Lee, by cash	B. Lee	Cash
(A)	(i), (ii) and (iii) only		
(B)	(ii), (iii) and (iv) only		
(C)	(i), (ii) and (iv) only		
(D)	(i) and (iv) only		

MC8 Which of the following are incorrect?

		<i>Account to be debited</i>	<i>Account to be credited</i>
(i)	Sold van for cash	Cash	Van
(ii)	Returned some of Office Equipment to Suppliers Ltd	Office Equipment	Suppliers Ltd
(iii)	Repaid part of loan from C. Charles by cheque	Loan from C. Charles	Bank
(iv)	Bought machinery on time from Betterways Ltd	Betterways Ltd	Machinery
(A)	(ii) and (iv) only		
(B)	(iii) and (iv) only		
(C)	(ii) and (iii) only		
(D)	(i) and (iii) only		

MC9 Which of the following best describes the meaning of 'Purchases'?

- (A) Items bought
- (B) Goods bought on time
- (C) Goods bought for resale
- (D) Goods paid for

MC10 Which of the following should not be called 'Sales'?

- (A) Office fixtures sold
- (B) Goods sold on time
- (C) Goods sold for cash
- (D) Sale of item previously included in 'Purchases'

MC11 Of the following, which are correct?

	<i>Account to be debited</i>	<i>Account to be credited</i>
(i) Goods sold on time to R. Williams	R. Williams	Sales
(ii) S. Johnson returns goods to us	Returns inwards	S. Johnson
(iii) Goods bought for cash	Cash	Purchases
(iv) We returned goods to A. Henry	A. Henry	Returns inwards
(A) (i) and (iii) only		
(B) (i) and (ii) only		
(C) (ii) and (iv) only		
(D) (iii) and (iv) only		

MC12 Which of the following are incorrect?

	<i>Account to be debited</i>	<i>Account to be credited</i>
(i) Goods sold for cash	Cash	Sales
(ii) Goods bought on time from T. Carter	Purchases	T. Carter
(iii) Goods returned by us to C. Barry	C. Barry	Returns outwards
(iv) Van bought for cash	Purchases	Cash
(A) (i) and (iii) only		
(B) (iii) only		
(C) (ii) and (iv) only		
(D) (iv) only		

MC13 Given the following, what is the amount of Capital? Assets: Premises £20,000; Inventory £8,500; Cash £100. Liabilities: Trade payables £3,000; Loan from A. Adams £4,000

- (A) £21,100
- (B) £21,600
- (C) £32,400
- (D) £21,400

MC14 Which of the following is correct?

- (A) Profit does not alter capital
- (B) Profit reduces capital
- (C) Capital can only come from profit
- (D) Profit increases capital

MC15 Which of the following are correct?

	<i>Account to be debited</i>	<i>Account to be credited</i>
(i) Received commission by cheque	Bank	Commission received
(ii) Paid business rates by cash	Rates	Cash
(iii) Paid motor expenses using debit card	Motor expenses	Bank
(iv) Received refund of insurance by cheque	Insurance	Bank





- (A) (i) and (ii) only
- (B) (i), (ii) and (iii) only
- (C) (ii), (iii) and (iv) only
- (D) (i), (ii) and (iv) only

MC16 Of the following, which are **incorrect**?

	<i>Account to be debited</i>	<i>Account to be credited</i>
(i) Sold van for cash	Cash	Sales
(ii) Bought stationery using debit card	Stationery	Bank
(iii) Took cash out of business for private use	Cash	Drawings
(iv) Paid general expenses by cheque	General expenses	Bank

- (A) (ii) and (iv) only
- (B) (i) and (ii) only
- (C) (i) and (iii) only
- (D) (ii) and (iii) only

MC17 What is the balance on the following account on 31 May 2020?

<i>C. De Freitas</i>					
2020		£	2020		£
May	1 Sales	205	May	17 Cash	300
	14 Sales	360		28 Returns	50
	30 Sales	180			

- (A) A credit balance of £395
- (B) A debit balance of £380
- (C) A debit balance of £395
- (D) There is a nil balance on the account

MC18 What would have been the balance on the account of C. De Freitas in MC17 on 19 May 2020?

- (A) A debit balance of £265
- (B) A credit balance of £95
- (C) A credit balance of £445
- (D) A credit balance of £265

MC19 Which of the following best describes a trial balance?

- (A) It shows the financial position of a business
- (B) It is a special account
- (C) It shows all the entries in the books
- (D) It is a list of balances on the books

MC20 Is it true that the trial balance totals should agree?

- (A) No, there are sometimes good reasons why they differ
- (B) Yes, except where the trial balance is extracted at the year end
- (C) Yes, always
- (D) No, because it is not a balance sheet

THE FINANCIAL STATEMENTS OF SOLE PROPRIETORS

Introduction

This part is concerned with preparing financial statements of sole proprietors from double entry records.

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Income statements

Learning objectives

After you have studied this chapter, you should be able to:

- Explain why income statements are not part of the double entry system.
- Explain why profit is calculated.
- Calculate cost of goods sold, gross profit, and net profit.
- Explain the difference between gross profit and net profit.
- Explain the relationship between the trading account and the profit and loss account.
- Explain how the trading account and the profit and loss account fit together to create the income statement.
- Explain how to deal with closing inventory when preparing the trading account section of an income statement.
- Close down the appropriate accounts and transfer the balances to the trading account.
- Close down the appropriate accounts and transfer the balances to the profit and loss account.
- Prepare an income statement from information given in a trial balance.
- Make appropriate double entries to incorporate net profit and drawings in the capital account.

Introduction

In this chapter, you will learn how to close down revenue and expenditure accounts in order to calculate profit and prepare an income statement. You will learn how to adjust purchases with inventory and arrive at the cost of goods sold; discover the difference between gross profit and net profit; how to prepare an income statement, and, finally, you will learn how to transfer net profit and drawings to the capital account at the end of a period.

7.1 Purpose of income statements

The main reason why people create a business is to make profits. Of course, if the business is not successful, it may incur losses. The calculation of such profits and losses is probably the most important objective of the accounting function. The owners will want to know how the actual profits compare with the profits they had hoped to make. Knowing what profits are being made helps businesses to do many things, including:

- 1 planning ahead
- 2 obtaining loans from banks, from other businesses, or from private individuals
- 3 showing prospective business partners how successful the business is
- 4 showing someone who may be interested in buying the business how successful the business is
- 5 calculating the tax due on the profits so that the correct amount of tax can be paid to the tax authorities.

Chapter 4 dealt with the grouping of revenue and expenses prior to bringing them together to compute profit. In the case of a trader (someone who is mainly concerned with buying and selling goods), the profits are calculated by drawing up an **income statement**.

When it is shown in detail rather than in summary form (as is the case for the published income statements of companies, something you will learn about in Chapters 35 to 37), it contains something called the **trading account**. The trading account is prepared in order to arrive at a figure for **gross profit**.

A summary of another account is shown below the trading account: the **profit and loss account**. The profit and loss account is prepared so as to arrive at the figure for **net profit**.

It is these two accounts that together comprise the income statement. Both the trading account and the profit and loss account *are* part of the double entry system. At the end of a financial period, they are closed off. They are then summarised and the information they contain is then copied into an income statement. **Income statements are not part of the double entry system.**

7.2 Gross profit

One of the most important uses of income statements is comparing the results obtained with the results expected. In a trading organisation, a lot of attention is paid to how much profit is made, before deducting expenses, for every £1 of sales revenue. As mentioned in Section 7.1, so that this can easily be seen in the profit calculation, the statement in which profit is calculated is split into two sections – one in which the gross profit is found (**this is the trading account section of the statement**), and the next section in which the **net profit** is calculated (**this is the 'profit and loss account' section of the statement**).

Gross profit is the excess of sales revenue over the **cost of goods sold**. Where the cost of goods sold is greater than the sales revenue, the result is a **gross loss**. By taking the figure of sales revenue less the cost of goods sold to generate that sales revenue, it can be seen that the accounting custom is to calculate a trader's profits **only on goods that have been sold**.

Activity 7.1

What does this tell you about the costs and revenues that are included in the calculation of gross profit? (*Hint: what do you not include in the calculation?*)

To summarise:

Gross profit (calculated in the trading account)	is the excess of sales revenue over the cost of goods sold in the period.
--	---

Activity 7.2

Calculate the gross profit or gross loss of each of the following businesses:

	<i>Cost of goods purchased</i>	<i>Sales</i>	<i>Gross profit/(Gross loss)</i>
	£	£	£
A	9,820	10,676	_____
B	7,530	14,307	_____
C	10,500	19,370	_____
D	9,580	9,350	_____
E	8,760	17,200	_____

7.3 Net profit

Net profit, which is found in the profit and loss account section of the income statement, consists of the gross profit plus any revenue other than that from sales (such as rents received or commissions earned) less the total costs used up during the period other than those already included in the 'cost of goods sold'. Where the costs used up exceed the gross profit plus other revenue, the result is said to be a **net loss**. Thus:

Net profit (calculated in the profit and loss account)	is what is left of the gross profit after all other expenses have been deducted.
--	--

Activity 7.3

Using the answer to Activity 7.2, complete the following:

	<i>Other revenues</i>	<i>Expenses</i>	<i>Net profit/(Net loss)</i>
	£	£	£
A	–	2,622	
B	4,280	2,800	
C	500	2,500	
D	–	1,780	
E	3,260	2,440	

7.4 Information needed

Before drawing up an income statement you should prepare the trial balance. This contains nearly all the information needed. (Later on in this book you will see that certain adjustments have to be made, but we will ignore these at this stage.)

We can now look at the trial balance of B. Swift, drawn up as on 31 December 2019 after the completion of his first year in business.

Exhibit 7.1

B. Swift Trial balance as at 31 December 2019		
	Dr	Cr
	£	£
Sales		38,500
Purchases	29,000	
Rent	2,400	
Lighting expenses	1,500	
General expenses	600	
Fixtures and fittings	5,000	
Trade receivables	6,800	
Trade payables		9,100
Bank	15,100	
Cash	200	
Drawings	7,000	
Capital		20,000
	<u>67,600</u>	<u>67,600</u>

Note: To make this easier to follow, we shall assume that purchases consist of goods that are resold without needing any further work. You'll learn later that these are known as 'finished goods' but, for now, we'll simply refer to them as 'goods'.

We have already seen that gross profit is calculated as follows:

$$\text{Sales} - \text{Cost of goods sold} = \text{Gross profit}$$

It would be easier if all purchases in a period were always sold by the end of the same period. In that case, cost of goods sold would always equal purchases. However, this is not normally the case and so we have to calculate the cost of goods sold as follows:

$$\begin{array}{l} \text{What we bought in the period:} \\ \text{Less Goods bought but not sold in the period:} \end{array} \quad \begin{array}{l} \text{Purchases} \\ \text{(Closing inventory)} \\ \hline = \text{Cost of goods sold} \end{array}$$

In Swift's case, there are goods unsold at the end of the period. However, there is no record in the accounting books of the value of this unsold inventory. The only way that Swift can find this figure is by checking his inventory at the close of business on 31 December 2019. To do this he would have to make a list of all the unsold goods and then find out their value. The value he would normally place on them would be the cost price of the goods, i.e. what he paid for them. Let's assume that this is £3,000.

The cost of goods sold figure will be:

	£
Purchases	29,000
Less Closing inventory	(3,000)
Cost of goods sold	<u>26,000</u>

Based on the sales revenue of £38,500 the gross profit can be calculated:

$$\begin{aligned}\text{Sales} - \text{Cost of goods sold} &= \text{Gross profit} \\ £38,500 - £26,000 &= £12,500\end{aligned}$$

We now have the information we need to complete the trading account section of the income statement. Next, we need to close off the sales and purchases accounts at the end of the period so that they start the next period with no balance. To do so, we need to create a trading account (this is *not* the same as the trading part of the income statement, though it does produce the same gross profit figure) and then make the following entries:

- (A) The balance of the sales account is transferred to the trading account by:
- 1 Debiting the sales account (thus closing it).
 - 2 Crediting the trading account.
- (B) The balance of the purchases account is transferred to the trading account by:
- 1 Debiting the trading account.
 - 2 Crediting the purchases account (thus closing it).
- (C) There is, as yet, no entry for the closing inventory in the double entry accounts. This is achieved as follows:
- 1 Debit a 'closing inventory' account with the value of the closing inventory.
 - 2 Credit the trading account (thus completing the double entry).

The trading account will look like this:

Trading									
2019					2019				
Dec	31	Purchases	(B)	£	Dec	31	Sales	(A)	£
				29,000					38,500
						31	Closing inventory	(C)	3,000

We now close off the trading account in the normal way. In this case, revenues exceed costs, so we describe the balance as 'gross profit'.

Trading									
2019					2019				
Dec	31	Purchases	(B)	£	Dec	31	Sales	(A)	£
				29,000					38,500
				12,500					3,000
				<u>41,500</u>					<u>41,500</u>
						31	Closing inventory	(C)	

Note that the balance shown on the trading account is described as 'gross profit' rather than being described as a balance. Also, note that the balance (i.e. the gross profit) is not brought down to the next period. The other accounts used in these double entries appear as shown below. (Note that there is no detail of the entries prior to the end of the period as all the information we have been given is the closing balances. These closing balances are simply described here as 'balance'.)

Sales									
2019					2019				
Dec	31	Trading		£	Dec	31	Balance		£
				<u>38,500</u>					<u>38,500</u>

Purchases									
2019					2019				
Dec	31	Balance		£	Dec	31	Trading		£
				<u>29,000</u>					<u>29,000</u>

Closing Inventory

2019				£	2019				£
Dec	31	Trading		<u>3,000</u>	Dec	31	Balance		<u>3,000</u>

The entry of the closing inventory on the credit side of the trading account is, in effect, a deduction from the purchases on the debit side. As you will see when we look later at the trading account part of the income statement, the closing inventory is shown as a deduction from the purchases and the figure then disclosed is described as ‘cost of goods sold’.

It must be remembered that we are concerned here with the very first year of trading when, for obvious reasons, there is no opening inventory. In Chapter 9, we will examine how to account for inventory in the later years of a business.

We can now draw up a profit and loss account (which is an ‘account’ opened so that the end-of-period double entries can be completed). Double entries are then prepared, firstly transferring the gross profit from the trading account to the credit of the profit and loss account. To do this, you would change the balancing entry in the trading account to read ‘Gross profit transferred to profit and loss’:

Trading

2019				£	2019				£
Dec	31	Purchases		29,000	Dec	31	Sales		38,500
	31	Gross profit transferred to Profit and loss		<u>12,500</u>		31	Closing inventory		<u>3,000</u>
				<u>41,500</u>					<u>41,500</u>

Then, any revenue account balances, other than sales (which have already been dealt with in the trading account), are transferred to the credit of the profit and loss account. Typical examples are commissions received and rent received. In the case of B. Swift, there are no such revenue accounts.

The costs used up in the year, in other words, the expenses of the year, are then transferred to the debit of the profit and loss account. (It may also be thought, quite rightly, that, as the fixtures and fittings have been used during the year and have deteriorated as a result, something should be charged for this use. **This charge is known as ‘depreciation’**, which is the topic of Chapter 21.)

The profit and loss account will now appear as follows:

Profit and Loss

2019				£	2019				£
Dec	31	Rent		2,400	Dec	31	Gross profit transferred from Trading		12,500
	31	Lighting expenses		1,500					
	31	General expenses		600					
	31	Net profit		<u>8,000</u>					
				<u>12,500</u>					<u>12,500</u>

The expense accounts closed off will now appear as:

Rent

2019				£	2019				£
Dec	31	Balance		<u>2,400</u>	Dec	31	Profit and loss		<u>2,400</u>

Lighting expenses

2019				£	2019				£
Dec	31	Balance		<u>1,500</u>	Dec	31	Profit and loss		<u>1,500</u>

General expenses									
2019			£		2019			£	
Dec	31	Balance	<u>600</u>		Dec	31	Profit and loss	<u>600</u>	

You now have all the information you need in order to prepare the income statement for the year ending 31 December 2019. It looks like this:

Exhibit 7.2

B. Swift			
Income Statement for the year ending 31 December 2019			
	£	£	
Sales		38,500	
Less Cost of goods sold:			
Purchases	29,000		
Less Closing inventory	<u>(3,000)</u>		
		(26,000)	
Gross profit		12,500	
Less Expenses			
Rent	2,400		
Lighting expenses	1,500		
General expenses	<u>600</u>		
		(4,500)	
Net profit		<u>8,000</u>	

Note: 'Revenue' is often used instead of 'Sales' in this statement.

7.5 Effect on the capital account

Although the net profit has been calculated at £8,000 and is shown as a balancing figure on the debit side of the profit and loss account (on the previous page), no credit entry has yet been made to complete the double entry. In other accounts, the credit entry would normally be the 'balance b/d' at the start of the next period. However, as net profit increases the capital of the owner, the credit entry must be made in the capital account by transferring the net profit from income statement. (You would change the entry in the income statement from 'net profit' to read 'net profit transferred to capital'.)

The trading account and the profit and loss account, and, indeed, all the revenue and expense accounts, can thus be seen to be devices whereby the capital account is saved from being concerned with unnecessary detail. Every sale made at a profit increases the capital of the proprietor, as does each item of revenue, such as rent received. On the other hand, each sale made at a loss, or each item of expense, decreases the capital of the proprietor.

Instead of altering the capital after each transaction, the respective bits of profit and loss, and of revenue and expense, are collected together using suitably described accounts. Then all the balances are brought together in one financial statement, the 'income statement', and the increase in the capital, i.e. the net profit, is determined. Alternatively, in the case of a net loss, the decrease in the capital is ascertained.

The fact that a separate drawings account has been in use can now also be seen to have been in keeping with the policy of avoiding unnecessary detail in the capital account. There will, therefore, only be one figure for drawings entered in the debit side of the capital account – the total of the drawings for the whole of the period.

The capital account, showing these transfers, and the drawings account now closed are as follows:

Capital							
2019			£	2019			£
Dec	31	Drawings	7,000	Jan	1	Cash	20,000
	31	Balance c/d	21,000	Dec	31	Net profit	8,000
			<u>28,000</u>				<u>28,000</u>
				2019			
				Jan	1	Balance b/d	21,000

Drawings							
2019			£	2019			£
Dec	31	Balance	7,000	Dec	31	Capital	7,000

Activity 7.4

Bertram Quigley opened a pet shop on 1 January 2019. He invested £10,000 in the business. The following information was obtained from his accounting records at the end of the year: Purchases of goods for resale £7,381; Sales £13,311; Expenses £1,172; Drawings £800; Inventory £410. What is the balance on Bertram Quigley's capital account at 31 December 2019?

7.6 The balances still in our books

It should be noticed that not all the items in the trial balance have been used in the income statement. The remaining balances are assets or liabilities or capital, they are not expenses or revenue. These will be used later when a balance sheet is drawn up. (You'll remember learning in Chapter 1 that assets, liabilities and capital are shown in balance sheets.)

Go back to Chapter 1 to refresh your understanding of assets, liabilities and capital.

Exhibit 7.3 shows the trial balance after the entries to the trading account and the profit and loss account have been made and the income statement prepared. All the accounts that were closed off in that process have been removed, and drawings and net profit have been transferred to the capital account. Notice also that the inventory account, which was not originally in the trial balance, is in the redrafted trial balance, as the item was not created as a balance in the books until the trading account was prepared. We will be using this trial balance when we start to look at balance sheets in the next chapter.

Exhibit 7.3

B. Swift Trial balance as at 31 December 2019 (after the trading account and the profit and loss account have been completed and the income statement prepared and the capital account adjusted for net profit and drawings)		
	<i>Dr</i>	<i>Cr</i>
	£	£
Fixtures and fittings	5,000	
Trade receivables	6,800	
Trade payables		9,100
Inventory	3,000	
Bank	15,100	
Cash	200	
Capital		21,000
	<u>30,100</u>	<u>30,100</u>

Note for students: Now that you have learnt how to prepare a T-account for the trading account and a T-account for the profit and loss account, we will only rarely ask you to prepare them again. You should remember how they are used to calculate gross profit and net profit and the typical entries they may contain. From now on, we will concentrate on producing the financial statement that combines these two accounts: the income statement.

Note also that under UK GAAP (i.e. UK accounting rules) the income statement was called the 'profit and loss account'. This confusing use of the same title for a financial statement and for an account in the ledger caused many problems. However, even though we now use the term 'income statement' for the financial statement you may sometimes see such a statement with the old title, or you may even be asked to prepare a financial statement using that title or 'profit or loss account'. If so, remember that it is the same as the one we call an 'income statement'.

Learning outcomes

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You should now have learnt:

- 1 Why income statements are not part of the double entry system.
- 2 Why profit is calculated.
- 3 How to calculate cost of goods sold, gross profit and net profit.
- 4 The double entries required in order to close off the relevant expense and revenue accounts at the end of a period and post the entries to the trading account and to the profit and loss account.
- 5 How to deal with inventory at the end of a period.
- 6 How to prepare an income statement from a trial balance.
- 7 How to transfer the net profit and drawings to the capital account at the end of a period.
- 8 That balances on accounts not closed off in order to prepare the income statement are carried down to the following period, that these balances represent assets, liabilities and capital, and that they are entered in the balance sheet.

Answers to activities

7.1 You only include the costs that were incurred in creating those goods that were sold. These costs include the cost of buying those goods and any costs incurred in converting goods purchased into the goods that were sold – for example, the costs of converting raw materials into finished goods. The only costs you include are those that relate to the goods sold. The costs relating to goods that have not yet been sold are not included. You do not include other costs of the business, such as postage, motor expenses, office expenses, salaries of managers, and advertising costs. Nor do you include any costs relating to the purchase or use of any assets, such as motor vehicles, computers, machinery, fixtures and fittings, and buildings.

7.2	Cost of goods purchased	Sales	Gross profit/(Gross loss)
	£	£	£
A	9,820	10,676	856
B	7,530	14,307	6,777
C	10,500	19,370	8,870
D	9,580	9,350	(230)
E	8,760	17,200	8,440

7.3	Other revenues	Expenses	Net profit/(Net loss)
	£	£	£
A	–	2,622	(1,766)
B	4,280	2,800	8,257
C	500	2,500	6,870
D	–	1,780	(2,010)
E	3,260	2,440	9,260

7.4 £14,368. That is, £10,000 + £13,311 – (£7,381 – £410) – £1,172 – £800.

Review questions

7.1 From the following trial balance of I. Lamb, extracted after one year's trading, prepare an income statement for the year ending 31 October 2023. A balance sheet is not required.

Trial balance as at 31 October 2023

	<i>Dr</i>	<i>Cr</i>
	£	£
Sales		100,250
Purchases	60,400	
Salaries	29,300	
Motor expenses	1,200	
Rent	950	
Insurance	150	
General expenses	85	
Premises	47,800	
Motor vehicles	8,600	
Trade receivables	13,400	
Trade payables		8,800
Cash at bank	8,200	
Cash in hand	300	
Drawings	4,200	
Capital		65,535
	<u>174,585</u>	<u>174,585</u>

Inventory at 31 October 2023 was £15,600.

(Keep your answer; it will be used later in Review question 8.1.)

7.2 From the following trial balance of G. Foot after his first year's trading, you are required to draw up an income statement for the year ending 30 June 2024. A balance sheet is not required.

Trial balance as at 30 June 2024

	<i>Dr</i>	<i>Cr</i>
	£	£
Sales		266,000
Purchases	154,000	
Rent	3,800	
Lighting and heating expenses	700	
Salaries and wages	52,000	
Insurance	3,000	
Buildings	84,800	
Fixtures	2,000	
Trade receivables	31,200	
Sundry expenses	300	
Trade payables		16,000
Cash at bank	15,000	
Drawings	28,600	
Vans	16,000	
Motor running expenses	4,600	
Capital		114,000
	<u>396,000</u>	<u>396,000</u>

Inventory at 30 June 2024 was £18,000.

(Keep your answer; it will be used later in Review question 8.2.)

7.3A From the following trial balance of F. Dover drawn-up on conclusion of his first year in business, draw up an income statement for the year ending 31 May 2020. A balance sheet is not required.

Trial balance as at 31 May 2020

	<i>Dr</i>	<i>Cr</i>
	£	£
General expenses	610	
Business rates	4,800	
Motor expenses	1,820	
Salaries	79,120	
Insurance	2,480	
Purchases	242,080	
Sales		471,624
Car	8,600	
Trade payables		22,400
Trade receivables	42,160	
Premises	106,000	
Cash at bank	5,430	
Cash in hand	650	
Capital		46,526
Drawings	46,800	
	<u>540,550</u>	<u>540,550</u>

Inventory at 31 May 2020 was £28,972.

(Keep your answer; it will be used later in Review question 8.3A.)





7.4A Extract an income statement for the year ending 30 June 2024 for G. Graham. The trial balance as at 30 June 2024 after his first year of trading was as follows:

	<i>Dr</i>	<i>Cr</i>
	<u>£</u>	<u>£</u>
Equipment rental	940	
Insurance	1,804	
Lighting and heating expenses	1,990	
Motor expenses	2,350	
Salaries and wages	48,580	
Sales		382,420
Purchases	245,950	
Sundry expenses	624	
Lorry	19,400	
Trade payables		23,408
Trade receivables	44,516	
Fixtures	4,600	
Land & buildings	174,000	
Cash at bank	11,346	
Drawings	44,000	
Capital		194,272
	<u>600,100</u>	<u>600,100</u>

Inventory at 30 June 2024 was £29,304.

(Keep your answer; it will be used later in Review question 8.4A.)

7.5 Royston starts his own business on 1 September, operating as a wholesaler of novelty goods. His transactions during September were as follows:

- Sep 1 Transfers £750 of his savings into a business bank account.
- 3 Borrows £3,000 from LloydWest Bank, repayable in three years' time.
- 5 Pays £320 to hire a van for September, using debit card.
- 7 Buys essential IT equipment for the business, paying £2,200 by debit card.
- 9 Buys goods for resale, paying by cheque £760.
- 11 Buys goods for resale £570 on time from J. Collins.
- 13 Sells goods for £930; customer pays by bank transfer.
- 15 Returns unsatisfactory goods to J. Collins, original cost of which was £120.
- 17 Buys goods for resale on time from M. Pembridge, £890.
- 19 Sells goods on time £1,770 to E. Barrett.
- 21 Pays £450 cheque to J. Collins.
- 23 Receives £590 cheque from E. Barrett on account.
- 25 Takes £280 from business bank account to pay for personal living expenses.
- 27 Pays staff wages for September, £410 by bank transfer.

Required:

- (a) Record all the transactions and balance-off the accounts.
- (b) Prepare a Trial Balance as at the end of the month.
- (c) Assuming that the closing inventory has been counted and valued at cost totalling £570, prepare an Income Statement for the month.

(Keep your answer; it will be used later in Review question 8.7.)

Balance sheets

Learning objectives

After you have studied this chapter, you should be able to:

- Explain why balance sheets are not part of the double entry system.
- Explain why it is important that account balances are shown under appropriate headings in the balance sheet.
- Explain the meanings of the terms non-current asset, current asset, current liability, and non-current liability.
- Describe the sequence in which each of the five main categories of items appear in the balance sheet.
- Describe the sequence in which each non-current asset is entered in the balance sheet.
- Describe the sequence in which each current asset is entered in the balance sheet.
- Draw up a balance sheet from information given in a trial balance.

Introduction

In this chapter, you'll learn how to present asset, liability and capital balances in a balance sheet and of the importance of adopting a consistent and meaningful layout.

8.1 Contents of the balance sheet

In Chapter 1, you learnt that balance sheets contain details of assets, liabilities and capital. The items and amounts to be entered in the balance sheet are found in the accounting books. As shown in the previous chapter, they comprise those **accounts with balances** that were *not* included in the income statement. All these accounts that continue to have balances must be assets, capital or liabilities.

Because it is these balances that are entered, it is called the 'balance sheet'. You should be aware of the other name it may be called: a **statement of financial position. You may meet this term in an examination question or in a textbook.**

Activity 8.1

Why have the accounts entered into the income statement been removed from the trial balance? (*Hint: it is **not** because they were entered in that statement.*)

8.2 Drawing up a balance sheet

Let's look again at the post-income statement trial balance of B. Swift (from Exhibit 7.3):

Exhibit 8.1

B. Swift Trial balance as at 31 December 2019 (after the trading account and the profit and loss account have been completed and the income statement prepared and the capital account adjusted for net profit and drawings)		
	<i>Dr</i>	<i>Cr</i>
	£	£
Fixtures and fittings	5,000	
Trade receivables	6,800	
Trade payables		9,100
Inventory	3,000	
Bank	15,100	
Cash	200	
Capital		21,000
	<u>30,100</u>	<u>30,100</u>

You'll probably remember seeing examples of balance sheets in Chapter 1. If not, this would be a good time to spend a few minutes reading that chapter again.

Based on what you learnt in Chapter 1, let's now draw up the balance sheet for B. Swift as at 31 December 2019.

Exhibit 8.2

B. Swift Balance Sheet as at 31 December 2019	
	£
<i>Assets</i>	
Fixtures and fittings	5,000
Inventory	3,000
Trade receivables	6,800
Bank	15,100
Cash	200
Total assets	<u>30,100</u>
<i>Liabilities</i>	
Trade payables	(9,100)
Net assets	<u>21,000</u>
Capital	<u>21,000</u>

8.3 No double entry in balance sheets

After the way we used the double entry system in the previous chapter to prepare the information we needed in order to draw up the income statement but, not to prepare the statement itself, it should not surprise you to learn that **balance sheets are also not part of the double entry system.**

Activity 8.2

Why do you think it is that the balance sheet is not part of the double entry system?

When we draw up accounts such as a cash account, a rent account, a sales account, a trading account, or a profit and loss account, we are preparing them as part of the double entry system. We make entries on the debit side and on the credit side of these accounts.

As with income statements, when we draw up a balance sheet, we do not enter anything in the various accounts. We do not actually *transfer* the fixtures and fittings balance or the Trade payables balance, or any of the other balances, to the balance sheet.

All we do is to *list* the asset, capital and liabilities balances so as to form a balance sheet. This means that none of these accounts have been closed off. *Nothing is entered in the ledger accounts.*

When the next accounting period starts, these accounts are still open. They all contain balances. As a result of future transactions, entries are then made in these accounts that add to or deduct from these opening balances using double entry.

If you see the word ‘account’, you will know that what you are looking at is part of the double entry system and will include debit and credit entries. If the word ‘account’ is not used, it is not part of double entry. For instance, the following items are not ‘accounts’, and are therefore *not* part of the double entry:

Trial balance:	this is a list of the debit balances and credit balances of the accounts.
Income statement:	this is a list of revenues and expenditures arranged so as to produce figures for gross profit and net profit for a specific period of time.
Balance sheet:	this is a list of balances arranged according to whether they are assets, capital or liabilities and so depict the financial situation on a specific date.

8.4 Layout of the balance sheet

Have you ever gone into a shop and found that the goods you were interested in were all mixed up and not laid out in a helpful or consistent way? You can see an example of this in most large shops specialising in selling CDs. They mix up some of their inventory, particularly anything on ‘special offer’, so that you need to search through everything in order to find what you want. In the process of doing so, the shop hopes that you will come across other things that you will buy that you would otherwise never have thought of. Some of Richard Branson’s first Virgin music shops in the early 1970s used this technique and it seems to have developed from there as an effective way to sell music.

Unfortunately, this mix-up presentation technique would be of no benefit to the users of a balance sheet. They would never find anything they didn’t set out to find, but they would still have to go through the hassle of sorting through all the information in order to produce a meaningful balance sheet for themselves. Because the balance sheet is intended to be helpful and informative, we take great care in ensuring that it portrays the information it contains in a consistent, meaningful, and helpful way.

As a result, a user who is only interested in looking at the balance sheet of one organisation will not only find it easy to find information within it, other users who look at lots of different

balance sheets, such as bank managers, accountants and investors, find it straightforward making comparisons between the contents of different balance sheets.

While the balance sheet layout used in Exhibit 8.2 could be considered useful, it can be improved. Let's look at how we can do this. Firstly, we'll look at how assets could be presented in a more helpful and more meaningful way.

Assets

We are going to show the assets under two headings, non-current assets and current assets.

Non-current assets

Non-current assets are assets that:

- 1 were not bought primarily to be sold; but
- 2 are to be used in the business; and
- 3 are expected to be of use to the business for a long time.

Examples: buildings, machinery, motor vehicles, fixtures and fittings.

Non-current assets are listed first in the balance sheet starting with those that the business will keep the longest, down to those which will be kept for the shortest time. For instance:

Non-current assets
1 Land and buildings
2 Fixtures and fittings
3 Machinery
4 Motor vehicles

Current assets

Current assets are assets that are likely to change in the short term and certain to change within twelve months of the date of the balance sheet. They include items held for resale at a profit, trade receivables, cash in the bank, and cash in hand.

These are listed in increasing order of liquidity – that is, starting with the asset furthest away from being turned into cash, and finishing with cash itself. For instance:

Current assets
1 Inventory
2 Trade receivables
3 Cash at bank
4 Cash in hand

Some students feel that trade receivables should appear before inventory because, at first sight, inventory would appear to be more easily realisable (i.e. convertible into cash) than trade receivables. In fact, trade receivables can normally be more quickly turned into cash – you can often 'factor' them by selling the rights to the amounts owed by debtors to a finance company for an agreed amount.

As all retailers would confirm, it is not so easy to quickly turn inventory into cash. Another advantage of using this sequence is that it follows the order in which full realisation of the assets in a business takes place: before there is a sale, there must be an inventory of goods which, when sold on time, turns into trade receivables and, when payment is made by the debtors, turns into cash.

Liabilities

There are two categories of liabilities, current liabilities and **non-current liabilities**.

Current liabilities: items that have to be paid within a year of the date of the balance sheet.

Examples: bank overdrafts, trade payables resulting from the purchase on time of goods for resale.

Non-current liabilities: items that have to be paid more than a year after the date of the balance sheet.

Examples: bank loans, loans from other businesses.

8.5 A properly drawn up balance sheet

Exhibit 8.3 shows Exhibit 8.2 drawn up in a more appropriate way. **You should also read the notes following the exhibit.**

Exhibit 8.3

B. Swift Balance Sheet as at 31 December 2019		
	£	£
<i>Non-current assets</i>		
Fixtures and fittings		5,000
<i>Current assets</i>		
Inventory	3,000	
Trade receivables	6,800	
Bank	15,100	
Cash	<u>200</u>	
		<u>25,100</u>
Total assets		30,100
<i>Current liabilities</i>		
Trade payables		<u>(9,100)</u>
Net assets		<u>21,000</u>
<i>Capital</i>		
Cash introduced		20,000
Add Net profit for the year		<u>8,000</u>
		28,000
Less Drawings		<u>(7,000)</u>
		<u>21,000</u>

Notes:

- There are four categories of entries shown in this balance sheet. In practice, the fifth, non-current liabilities, often appears. It is positioned after the current liabilities; and its total is added to the total of current liabilities to get the figure for total liabilities. Exhibit 8.4 shows where this would be if B. Swift had any non-current liabilities.
- The figure for each item within each category should be shown and a total for the category produced. An example of this is the £25,100 total of current assets. The figures for each asset are listed, and the total is shown below them.
- The total for non-current assets is added to the total for current assets and the total is labelled 'total assets'.

- (d) The total for current liabilities is added to the total for non-current liabilities and the total is labelled 'total liabilities'.
- (e) The total liabilities amount is subtracted from the total assets to get an amount labelled 'net assets'. This amount will be the same as the total capital (which, in company financial statements, is called 'total equity').
- (f) You do not write the word 'account' after each item.
- (g) The owners will be most interested in their capital and the reasons why it has changed during the period. To show only the final balance of £21,000 means that the owners will not know how it was calculated. So we show the full details of the capital account.
- (h) Look at the date on the balance sheet. Now compare it with the dates put on the top of the income statement in the previous chapter. The balance sheet is a position statement – it is shown as being at one point in time, e.g. 'as at 31 December 2019'. The income statement is different. It is for a period of time, in this case for a whole year, and so it uses the phrase 'for the year ending'.

Note: The difference between current assets and current liabilities is known as 'net current assets' or 'working capital' and is the amount of resources the business has in a form that is readily convertible into cash. This figure is not shown in the balance sheets in this chapter but, is easy to produce from a completed balance sheet.

Exhibit 8.4

B. Swift
Balance Sheet as at 31 December 2019
(showing the position of non-current liabilities)

	£	£
<i>Non-current assets</i>		
Fixtures and fittings		5,000
<i>Current assets</i>		
Inventory	3,000	
Trade receivables	6,800	
Bank	15,100	
Cash	<u>200</u>	
		<u>25,100</u>
Total assets		<u>30,100</u>
<i>Current liabilities</i>		
Trade payables	9,100	
<i>Non-current liabilities</i>	<u>—</u>	
Total liabilities		<u>(9,100)</u>
Net assets		<u>21,000</u>
<i>Capital</i>		
Cash introduced		20,000
Add Net profit for the year		<u>8,000</u>
		<u>28,000</u>
Less Drawings		<u>(7,000)</u>
Total capital		<u>21,000</u>

Learning outcomes

You should now have learnt:

- 1 That all balances remaining on a trial balance after the income statement for a period has been drawn up are displayed in a balance sheet dated 'as at' the last day of the period.
- 2 That the balance sheet is *not* part of double entry.
- 3 That the balance sheet starts with non-current assets at the top, then current assets, then current liabilities, then non-current liabilities, then capital.
- 4 The meanings of the terms non-current asset, current asset, current liability, and non-current liability.
- 5 That you list non-current assets in descending order starting with those that will remain in use in the business for the longest time.
- 6 That you list current assets from top to bottom in increasing order of liquidity, with cash as the final item.
- 7 That current assets *less* current liabilities are known as 'net current assets' or 'working capital'.
- 8 Why the figure for net current assets is very important.

Answers to activities

- 8.1** All these accounts should have been closed when the trading account and the profit and loss account were completed and the income statement prepared. Only accounts with balances appear in a trial balance.
- 8.2** A balance sheet is a statement that summarises the financial position at the end of a period. It contains all the balances on the accounts held in the accounting books at that time. As it is prepared after the income statement, all the accounts have already been balanced-off. All we do with the balance sheet is copy the balances carried forward from the accounts and place them in an appropriate position in the statement.

Review questions

- 8.1** Return to Review question 7.1 and prepare a balance sheet as at 31 October 2023.
- 8.2** Return to Review question 7.2 and prepare a balance sheet as at 30 June 2024.
- 8.3A** Return to Review question 7.3A and prepare a balance sheet as at 31 May 2020.
- 8.4A** Return to Review question 7.4A and prepare a balance sheet as at 30 June 2024.



→ **8.5** T. Smith started in business on 1 August 2023, with £60,000 capital in cash. During the first year he kept very few records of his transactions.

The assets and liabilities of the business at 31 July 2024 were:

	£
Freehold premises	160,000
Mortgage loan on the premises	120,000
Inventory	50,000
Trade receivables	4,000
Cash and bank balances	8,300
Trade payables	14,000

During the year, Smith withdrew £25,000 cash for his personal use, but he also paid £8,000 received from the sale of his private car into the business bank account.

Required:

From the above information, prepare a balance sheet showing the financial position of the business at 31 July 2024 and indicating the net profit for the year.

8.6A The following information relates to A. Trader's business:

Assets and liabilities at	1 January 2024	31 December 2024
	£	£
Fixtures	18,000	16,200
Trade receivables	4,800	5,800
Inventory	24,000	28,000
Trade payables	8,000	11,000
Cash	760	240
Balance at bank	15,600	4,600
Loan from B. Burton	6,000	2,000
Motor vehicle	–	16,000

During the year, Trader had sold some of his personal investments for £4,000 which he paid into the business bank account, and he had drawn out £200 weekly for private use.

Required:

Prepare a balance sheet as at 31 December 2024 and give the net profit as at that date.

8.7 Return to your answer to Review question 7.5 and prepare a balance sheet as at 30 September.

Income statements and balance sheets: further considerations

Learning objectives

After you have studied this chapter, you should be able to:

- Explain the terms returns inwards, returns outwards, carriage inwards and carriage outwards.
- Record returns inwards and returns outwards in the income statement.
- Explain the difference between the treatment of carriage inwards and carriage outwards in the income statement.
- Explain why carriage inwards is treated as part of the cost of purchasing goods.
- Explain why carriage outwards is *not* treated as part of the cost of purchasing goods.
- Prepare an inventory account showing the entries for opening and closing inventory.
- Prepare an income statement and balance sheet containing the appropriate adjustments for returns, carriage and other items that affect the calculation of the cost of goods sold.
- Explain why the costs of putting goods into a saleable condition should be charged to the trading account.

Introduction

This chapter contains material that many students get wrong in examinations. Take care as you work through it to understand and learn the points as they are presented to you.

In this chapter, you'll build on what you learnt in Chapter 3 and learn how to treat goods returned from customers and goods returned to suppliers in the trading account. You'll also learn how to deal with the costs of transporting goods into and out of a business. You will learn how to record inventory in an inventory account and then carry it forward in the account to the next period. You'll also learn how to enter opening inventory in the trading account. You'll learn that there are other costs that must be added to the cost of goods in the trading account. Finally, you'll learn how to prepare an income statement and balance sheet when any of these items are included in the list of balances at the end of a period.

9.1 Returns inwards and returns outwards

In Chapter 3, the idea of different accounts for different movements of inventory was introduced. There are four accounts involved. The sales account and the **returns inwards account** deal with goods sold and goods returned by customers. The purchases account and the **returns outwards account** deal with goods purchased and goods returned to the supplier respectively. In our first look at the preparation of a trading account in Chapter 7, returns inwards and returns outwards were omitted. This was done deliberately, so that your first sight of income statements would be as straightforward as possible.

Activity 9.1

Why do you think organisations bother with these two returns accounts? Why don't they just debit sales returned to the sales account and credit purchases returned to the purchases account?

Just as you may have done yourself, a large number of businesses return goods to their suppliers (**returns outwards**) and will have goods returned to them by their customers (**returns inwards**). When the gross profit is calculated, these returns will have to be included in the calculations.

Let's look at the first two lines of the trial balance you saw in Exhibit 7.1:

Exhibit 7.1 (extract)

B. Swift		
Trial balance as at 31 December 2019		
	<i>Dr</i>	<i>Cr</i>
	£	£
Sales		38,500
Purchases	29,000	

Now, suppose that in Exhibit 9.1 the trial balance of B. Swift, rather than simply containing a sales account balance of £38,500 and a purchases account balance of £29,000 the balances included those for returns inwards and outwards:

Exhibit 9.1

B. Swift		
Trial balance as at 31 December 2019 (extract)		
	<i>Dr</i>	<i>Cr</i>
	£	£
Sales		40,000
Purchases	31,200	
Returns inwards	1,500	
Returns outwards		2,200

Comparing these two exhibits reveals that, when combined together, they amount to the same thing so far as gross profit is concerned: i.e. sales were £38,500 in the original example because returns inwards had already been deducted in arriving at the amount shown in Exhibit 7.1. In the amended version, returns inwards should be shown separately in the trial balance and then deducted on the face of the income statement to get the correct figure for goods sold to customers and *kept* by them, i.e. £40,000 – £1,500 = £38,500. Purchases were originally shown as being £29,000. In the new version, returns outwards should be deducted to get the correct figure of purchases *kept* by Swift. Both the returns accounts are included in the calculation of gross profit, which now becomes:

$$(\text{Sales less Returns inwards}) - (\text{Cost of goods sold less Returns outwards}) = \text{Gross profit}$$

The trading account section of the income statement will appear as shown in Exhibit 9.2:

Exhibit 9.2

B. Swift		
Trading account section of the income statement for the year ending 31 December 2019		
	£	£
Sales		40,000
Less Returns inwards		(1,500)
		<u>38,500</u>
Less Cost of goods sold:		
Purchases	31,200	
Less Returns outwards	(2,200)	
	<u>29,000</u>	
Less Closing Inventory	(3,000)	
		(26,000)
Gross profit		<u><u>12,500</u></u>

The gross profit is therefore unaffected and is the same as in Chapter 7: £12,500.

9.2 Carriage

If you have ever purchased anything over the internet, you have probably been charged for ‘postage and packing’. When goods are delivered by suppliers or sent to customers, the cost of transporting the goods is often an additional charge to the buyer. This charge is called ‘carriage’. When it is charged for delivery of goods purchased, it is called **carriage inwards**. Carriage charged on goods sent out by a business to its customers is called **carriage outwards**.

When goods are purchased, the cost of carriage inwards may either be included as a hidden part of the purchase price, or charged separately. For example, suppose your business was buying exactly the same goods from two suppliers. One supplier might sell them for £100 and not charge anything for carriage. Another supplier might sell the goods for £95, but you would have to pay £5 to a courier for carriage inwards, i.e. a total cost of £100. In both cases, the same goods cost you the same total amount. It would not be appropriate to leave out the cost of carriage inwards from the ‘cheaper’ supplier in the calculation of gross profit, as the real cost to you having the goods available for resale is £100.

As a result, in order to ensure that the true cost of buying goods for resale is *always* included in the calculation of gross profit, carriage inwards **is always added to the cost of purchases in the trading account**.

Carriage outwards is not part of the selling price of goods. Customers could come and collect the goods themselves, in which case there would be no carriage outwards expense for the seller to pay or to recharge customers. You can see this on the websites of companies that offer online customers the option of 'click-and-collect' at no charge, or 'delivery' at a cost. **Carriage outwards is always entered in the profit and loss account section of the income statement. It is never included in the calculation of gross profit.**

Suppose that in the illustration shown in this chapter, the goods had been bought for the same total figure of £31,200 but, in fact, £29,200 was the figure for purchases and £2,000 for carriage inwards. The trial balance extract would appear as in Exhibit 9.3:

Exhibit 9.3

B. Swift		
Trial balance as at 31 December 2019 (extract)		
	<i>Dr</i>	<i>Cr</i>
	£	£
Sales		40,000
Purchases	29,200	
Returns inwards	1,500	
Returns outwards		2,200
Carriage inwards	2,000	

The trading account section of the income statement would then be as shown in Exhibit 9.4:

Exhibit 9.4

B. Swift		
Trading account section of the income statement for the year ending 31 December 2019		
	£	£
Sales		40,000
Less Returns inwards		(1,500)
		<u>38,500</u>
Less Cost of goods sold:		
Purchases	29,200	
Less Returns outwards	(2,200)	
	<u>27,000</u>	
Carriage inwards	<u>2,000</u>	
	<u>29,000</u>	
Less Closing inventory	(3,000)	
		<u>(26,000)</u>
Gross profit		<u><u>12,500</u></u>

It can be seen that these three versions of B. Swift's trial balance have all been concerned with the same overall amount of goods bought and sold by the business, at the same overall prices. Therefore, in each case, the same gross profit of £12,500 has been found.

Before you proceed further, attempt Review questions 9.1 and 9.2A.

9.3 The second year of a business

At the end of his second year of trading, on 31 December 2020, B. Swift draws up another trial balance, which is shown in Exhibit 9.5:

Exhibit 9.5

B. Swift Trial balance as at 31 December 2020		
	<i>Dr</i>	<i>Cr</i>
	£	£
Sales		67,000
Purchases	42,600	
Lighting and heating expenses	1,900	
Rent	2,400	
Wages: shop assistant	5,200	
General expenses	700	
Carriage outwards	1,100	
Buildings	20,000	
Fixtures and fittings	7,500	
Trade receivables	12,000	
Trade payables		9,000
Bank	1,200	
Cash	400	
Drawings	9,000	
Capital		31,000
Inventory (at 31 December 2019)	3,000	
	<u>107,000</u>	<u>107,000</u>

Adjustments needed for inventory

So far, we have been looking at new businesses only. When a business starts, it has no inventory brought forward. B. Swift started in business in 2019. Therefore, when we were preparing Swift's income statement for 2019, there was only closing inventory to worry about.

We can see the difference this makes when we prepare the income statement for the second year. If you look back to the income statement in Exhibit 9.4, you can see that there was closing inventory of £3,000. This is, therefore, the opening inventory figure for 2020. We will need to

incorporate in the trading account. It is also the figure for inventory that you can see in the trial balance at 31 December 2020.

The closing inventory for one period is always brought forward as the opening inventory for the next period.

Swift checked his inventory at 31 December 2020 and valued it at that date at £5,500.

We can summarise the opening and closing inventory account positions for Swift over the two years as follows:

Trading account for the period →	Year ending 31 December 2019	Year ending 31 December 2020
Opening inventory 1.1.2019	None	
Closing inventory 31.12.2019	£3,000	
Opening inventory 1.1.2020		£3,000
Closing inventory 31.12.2020		£5,500

Inventory account

Before going any further, let's look at the inventory account for both years:

Inventory							
2019				2019			
Dec	31	Trading	£ <u>3,000</u>	Dec	31	Balance c/d	£ <u>3,000</u>
2020				2020			
Jan	1	Balance b/d	3,000	Dec	31	Trading	3,000
Dec	31	Trading	<u>5,500</u>		31	Balance c/d	<u>5,500</u>
			<u>8,500</u>				<u>8,500</u>

You can see that in 2020 there is both a debit and a credit double entry made at the end of the period to the trading account. First, the inventory account is credited with the opening inventory amount of £3,000 and the trading account is debited with the same amount. Then, the inventory account is debited with the closing inventory amount of £5,500 and the trading account is credited with the same amount.

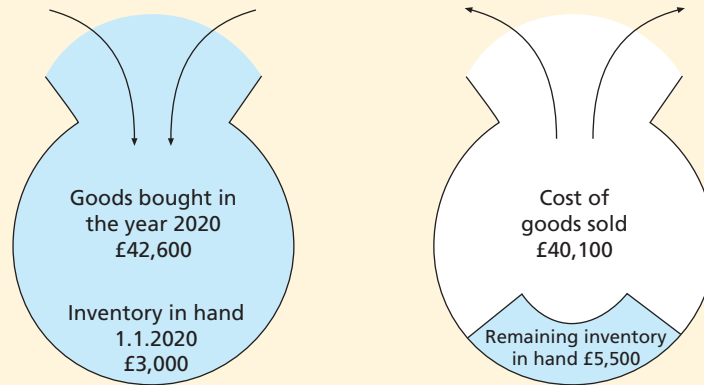
Thus, while the first year of trading only includes one inventory figure in the trading account, for the second year of trading both opening and closing inventory figures will be in the calculations.

Let's now calculate the cost of goods sold for 2020:

	£
Inventory of goods at start of year	3,000
Add Purchases	<u>42,600</u>
Total goods available for sale	45,600
Less What remains at the end of the year (i.e. closing inventory)	<u>(5,500)</u>
Therefore, the cost of goods that have been sold is	<u>40,100</u>

We can look at a diagram to illustrate this:

Exhibit 9.6



You can see that the left-hand container in the exhibit contains all the inventory available to be sold during the year. In the right-hand container, the closing inventory at the end of the year is now lying at the bottom and the empty space above it must, therefore, represent the inventory that has been sold.

The calculation of gross profit can now be done. You know from the trial balance that sales were £67,000 and from the calculation above that the cost of goods sold was £40,100. Gross profit is, therefore, £26,900.

Now the income statement and the balance sheet can be drawn up, as shown in Exhibits 9.7 and 9.8:

Exhibit 9.7

B. Swift		
Income Statement for the year ending 31 December 2020		
	£	£
Sales		67,000
Less Cost of goods sold:		
Opening inventory	3,000	
Add Purchases	<u>42,600</u>	
	45,600	
Less Closing inventory	<u>(5,500)</u>	
		(40,100)
Gross profit		26,900
Less Expenses:		
Wages	5,200	
Lighting and heating expenses	1,900	
Rent	2,400	
General expenses	700	
Carriage outwards	<u>1,100</u>	
		(11,300)
Net profit		<u>15,600</u>

Exhibit 9.8

B. Swift
Balance Sheet as at 31 December 2020

	£	£
<i>Non-current assets</i>		
Buildings		20,000
Fixtures and fittings		<u>7,500</u>
		27,500
<i>Current assets</i>		
Inventory	5,500	
Trade receivables	12,000	
Bank	1,200	
Cash	<u>400</u>	
		<u>19,100</u>
Total assets		46,600
<i>Current liabilities</i>		
Trade payables		<u>(9,000)</u>
Net assets		<u><u>37,600</u></u>
<i>Capital</i>		
Balance at 1 January 2020		31,000
Add Net profit for the year		<u>15,600</u>
		46,600
Less Drawings		<u>(9,000)</u>
Total capital		<u><u>37,600</u></u>

Financial statements

Financial statements is the term given to all the summary statements that accountants produce at the end of reporting periods. They are often called **final accounts**, but this term is misleading – none of the financial statements are ‘accounts’ in the accounting sense. Nevertheless, some people do still refer to them as the ‘final accounts’ or simply as the accounts of a business. You therefore, will, need to be aware of these terms, just in case you read something that uses these terms, or your teacher or lecturer, or an examiner, uses them.

Other expenses in the trading account

You already know that carriage inwards is added to the cost of purchases in the trading account. You also need to add to the cost of goods in the trading account any costs incurred in converting purchases into goods for resale. In the case of a trader, it is very unusual for any additional costs to be incurred getting the goods ready for sale.

Activity 9.2

What costs do you think a trader may incur that would need to be added to the cost of the goods in the trading account?

For goods imported from abroad it is usual to find that the costs of import duty and insurance are treated as part of the cost of the goods, along with any costs incurred in repackaging the goods. Any such additional costs incurred in getting goods ready for sale are debited to the trading account.

Note: Students often find it difficult to remember how to treat returns and carriage when preparing the income statement. You need to be sure to learn and remember that all returns, inwards and outwards, and carriage inwards appear in the calculation of gross profit. Carriage outwards appears as an expense in the profit and loss account section of the income statement.

9.4 A warning

Students lose a lot of marks on the topics covered in this chapter because they assume that the topics are easy and unlikely to be things that they will forget. Unfortunately, they are fairly easy to understand, and that is why they are easily forgotten and confused. You would be wise to make sure that you have understood and learnt everything presented to you in this chapter before you go any further in the book.

9.5 Review questions: the best approach

Before you attempt the review questions at the end of this chapter, you should read the section on review questions in the Notes for Students (pp. xii–xxi).

Learning outcomes

You should now have learnt:

- 1 That returns *inwards* should be deducted from sales in the *trading* account.
- 2 That returns *outwards* should be deducted from purchases in the *trading* account.
- 3 That carriage *inwards* is shown as an expense item in the *trading* account.
- 4 That carriage *outwards* is shown as an expense in the *profit and loss* account.
- 5 How to prepare the inventory account and carry forward the balance from one period to the next.
- 6 That in the second and later years of a business, both opening and closing inventory are brought into the trading account.
- 7 That it is normal practice to show cost of goods sold as a separate figure in the trading account.
- 8 How to prepare an income statement that includes the adjustments for carriage inwards and both opening and closing inventory in the trading section and carriage outwards as an expense in the profit and loss section.
- 9 That expense items concerned with getting goods into a saleable condition are charged in the trading account.
- 10 That where there is import duty or insurance charged on goods purchased, these costs are treated as part of the cost of goods sold.

Answers to activities

- 9.1** Organisations want to know how much they sold as a separate item from how much of those goods sold were returned. The same goes for purchases and the goods sent back to the supplier. It is useful to know what proportion of goods sold are returned and whether there is any pattern in which customers are returning them. On the purchases side, knowing how many times goods have been returned and the proportion of purchases from individual suppliers that are being returned helps with monitoring the quality of the goods being purchased. While this information could be gathered if returns accounts were not used, it would be a more complicated task obtaining it. Most of all, however, the sales account is a revenue account. Entering returns inwards amounts in the sales account is contrary to the nature of the sales account. The same holds for returns outwards and the purchases account, which is an expense account.
- 9.2** In the case of a trader, it is very unusual for any additional costs to be incurred getting the goods ready for sale. However, a trader who sells clocks packed in boxes might buy the clocks from one supplier, and the boxes from another. Both of these items would be charged in the trading account as purchases. In addition, if someone was paid to pack the clocks into the boxes, then the wages paid for that to be done would also be charged in the trading account as part of the cost of those goods. Be careful not to confuse this with the wages of shop assistants who sell the clocks. Those shop assistant wages *must* be charged in the profit and loss account because they are selling costs rather than extra costs incurred getting the goods ready for sale. The wages of the person packing the clocks would be the only wages in this case that were incurred while 'putting the goods into a saleable condition'.

Review questions

- 9.1** From the following information, draw up the trading account section of the income statement of H. Quiros for the year ending 31 January 2024, which was her first year in business:

	£
Carriage inwards	4,930
Returns outwards	3,250
Returns inwards	4,720
Sales	236,400
Purchases	164,010
Inventory of goods: 31 January 2024	23,680

- 9.2A** The following information is available for the year ending 31 December 2024. Draw up the trading account section of the income statement of R. Marin, who started trading in that year:

	£
Inventory: 31 December 2024	44,860
Returns inwards	18,660
Returns outwards	8,130
Purchases	312,730
Carriage inwards	9,440
Sales	467,290

9.3 From the following trial balance of G. Still, draw up an income statement for the year ending 30 September 2024, and a balance sheet as at that date.

	<i>Dr</i>	<i>Cr</i>
	£	£
Inventory: 1 October 2023	41,600	
Carriage outwards	2,100	
Carriage inwards	3,700	
Returns inwards	1,540	
Returns outwards		3,410
Purchases	188,430	
Sales		380,400
Salaries and wages	61,400	
Warehouse rent	3,700	
Insurance	1,356	
Motor expenses	1,910	
Office expenses	412	
Lighting and heating expenses	894	
General expenses	245	
Premises	92,000	
Motor vehicles	13,400	
Fixtures and fittings	1,900	
Trade receivables	42,560	
Trade payables		31,600
Cash at bank	5,106	
Drawings	22,000	
Capital		68,843
	<u>484,253</u>	<u>484,253</u>

Inventory at 30 September 2024 was £44,780.

9.4 The following trial balance was extracted from the books of F. Sorley on 30 April 2020. From it, and the note about inventory, prepare his income statement for the year ending 30 April 2020, and a balance sheet as at that date.

	<i>Dr</i>	<i>Cr</i>
	£	£
Sales		210,420
Purchases	108,680	
Inventory: 1 May 2019	9,410	
Carriage outwards	1,115	
Carriage inwards	840	
Returns inwards	4,900	
Returns outwards		3,720
Salaries and wages	41,800	
Motor expenses	912	
Rent	6,800	
Sundry expenses	318	
Motor vehicles	14,400	
Fixtures and fittings	912	
Trade receivables	23,200	
Trade payables		14,100
Cash at bank	4,100	
Cash in hand	240	
Drawings	29,440	
Capital		18,827
	<u>247,067</u>	<u>247,067</u>

Inventory at 30 April 2020 was £11,290.





9.5A The following is the trial balance of T. Agua as at 31 March 2023. Draw up a set of financial statements for the year ended 31 March 2023.

	<i>Dr</i>	<i>Cr</i>
	£	£
Inventory at 1 April 2022	52,800	
Sales		276,400
Purchases	141,300	
Carriage inwards	1,350	
Carriage outwards	5,840	
Returns outwards		2,408
Wages and salaries	63,400	
Business rates	3,800	
Communication expenses	714	
Commissions paid	1,930	
Insurance	1,830	
Sundry expenses	208	
Buildings	125,000	
Trade receivables	45,900	
Trade payables		24,870
Fixtures	1,106	
Cash at bank	31,420	
Cash in hand	276	
Drawings	37,320	
Capital at 1 April 2022		210,516
	<u>514,194</u>	<u>514,194</u>

Inventory at 31 March 2023 was £58,440.

9.6A F. Giannopoulos drew up the following trial balance as at 30 September 2020. You are to draft the income statement for the year ending 30 September 2020 and a balance sheet as at that date.

	<i>Dr</i>	<i>Cr</i>
	£	£
Capital as at 1 October 2019		49,675
Drawings	28,600	
Cash at bank	4,420	
Cash in hand	112	
Trade receivables	38,100	
Trade payables		26,300
Inventory: 30 September 2019	72,410	
Van	5,650	
Office equipment	7,470	
Sales		391,400
Purchases	254,810	
Returns inwards	2,110	
Carriage inwards	760	
Returns outwards		1,240
Carriage outwards	2,850	
Motor expenses	1,490	
Rent	8,200	
Telephone charges	680	
Wages and salaries	39,600	
Insurance	745	
Office expenses	392	
Sundry expenses	216	
	<u>468,615</u>	<u>468,615</u>

Inventory at 30 September 2020 was £89,404.

9.7 Andrew Joel is a market trader who started business on 1 August. The following is a list of his transactions in that month:

- Aug 1 Started business with £1,000 of his own cash.
- 2 Paid £900 of this opening cash into a business bank account.
- 4 Bought goods for resale on time, £78 from S. Holmes.
- 5 Bought a motor van, paying by bank transfer, £500.
- 7 Bought goods for resale, paying cash £55.
- 10 Sold goods on time, £98 to D. Moore.
- 11 A Joel took goods from inventory for his own use, cost £22.
- 12 Returned goods (to the value of £18) to S. Holmes.
- 19 Sold goods for cash, £28.
- 22 Bought fixtures & fittings on time from Kingston Equip Co, £150.
- 24 Received loan from D. Watson, £100 cheque, repayable in 5 years.
- 29 Paid S. Holmes by cheque, £24 on account.
- 30 Paid wages, £30 to employee, by bank transfer.
- 31 Paid Kingston Equipment Co in full by bank transfer £150.

Required:

- (a) Enter the transactions in T-accounts and balance-off your T-accounts as at 31 August.
- (b) Prepare a Trial Balance as at 31 August.
- (c) Assume that the closing inventory has been counted and valued at cost totalling £28. Prepare an Income Statement for the month ended 31 August.
- (d) Prepare a Balance Sheet as at 31 August.

9.8A Ms Bukoski's business position at 1 July was as follows:

	£
Inventory	5,000
Equipment	3,700
Creditor (OK Ltd)	500
Debtor (AB Ltd)	300
Money in business bank account	1,200

During July, she:

	£
Sold goods for cash – paid in to bank	3,200
Sold goods to AB Limited on time	600
Bought goods from OK Ltd on time	3,900
Paid OK Ltd by cheque	3,000
Paid general expenses by cheque	500
Received cheque from AB Ltd	300

Inventory at 31 July was £6,200.

Required:

- (a) Open ledger accounts (including capital) at 1 July.
- (b) Record all transactions.
- (c) Prepare a trial balance.
- (d) Prepare an income statement for the period.
- (e) Prepare a balance sheet as at 31 July.





9.9 From the following trial balance of Mr Tangle, extracted after one year of operations, prepare an income statement for the year ending 30 April 2024, together with a balance sheet as at that date.

Inventory on 30 April 2024 was £8,000.

	£	£
Sales		71,600
Purchases	29,050	
Salaries	14,650	
Motor expenses	1,860	
Rent and business rates	2,500	
Insurances – building	1,500	
– vehicles	2,400	
Motor vehicles	20,000	
Fixtures	35,000	
Cash in hand	1,000	
Cash at bank		2,500
Drawings	24,000	
Long-term loan		30,000
Capital		31,810
Trade receivables	23,450	
Trade payables		19,500
	<u>155,410</u>	<u>155,410</u>

Accounting concepts and the conceptual framework

Learning objectives

After you have studied this chapter, you should be able to:

- Understand that financial statements are prepared in accordance with a number of underlying concepts as well as a series of detailed rules (known as 'accounting standards').
- Explain what *accounting standards* are and specify the most important current source of these standards.
- Explain 14 of the most important underlying concepts in accounting.
- Outline the nature and purpose of the *Conceptual Framework for Financial Reporting* that has been issued by the International Accounting Standards Board (IASB).
- Describe the characteristics of useful financial information according to the IASB Framework.
- Specify the five elements of financial statements identified by the IASB Framework.

Introduction

So far in this book we've looked at how business transactions are recorded, and we've begun to see how the impact of all these transactions is summarised in an income statement and a balance sheet. You may have thought that these processes are quite mechanical, and that accountants are simply recording and summarising the facts in the only way it could possibly be done.

However, this is certainly not the case. Even the basics of accounting rely on a number of underlying concepts and assumptions. If these concepts and assumptions were changed, then our accounting methods would be quite different. In this chapter, we'll present an overview of the most important underlying concepts and assumptions.

In addition to these underlying concepts, a series of detailed rules (or 'standards') are also in force to help ensure that all businesses account for similar things in a similar way. We couldn't possibly cover all these rules in this chapter, but we'll introduce the most important source of accounting standards and identify some of the specific standards you'll learn about later in this book.

In recent decades, there have also been various attempts to incorporate the underlying concepts of accounting within a wider 'framework' of principles. This framework would then provide solid theoretical foundations to all financial accounting practice. We'll therefore also look at the most recent and important version of such a framework.

10.1 The need for uniformity in accounting methods

As we discussed in Chapter 1, several different types of user will rely on the information contained in financial statements to help them make decisions. With some of these decisions – such as whether to invest in or lend to a business – large amounts of money may be at stake. Users will only have the confidence to rely on financial statements if they know that the information has been produced in accordance with an agreed set of principles and practices.

After all, if businesses prepared their financial statements using whatever assumptions and methods they liked, then the information would be fairly worthless: businesses could potentially use a variety of peculiar accounting methods in order to present a distorted picture of how successful they were, perhaps to trick users to invest in them.

So, to help ensure the integrity of financial statements, a range of underlying concepts as well as a series of detailed rules have developed over a long period of time.

10.2 Accounting concepts and the development of a ‘conceptual framework’

Accounting is based on a number of longstanding assumptions and conventions, collectively known as ‘accounting concepts’. Many of these have been around for 100 years or more. We’ll discuss 14 of the most important of them in the first half of this chapter.

Since the 1970s, there have been various attempts to incorporate these concepts within a broader ‘framework of principles’ upon which all financial accounting could be firmly based. The detailed rules of accounting could be written in accordance with this framework, which should ensure that all rules follow the same logic and are consistent with each other. The most recent attempt at this is the *Conceptual Framework for Financial Reporting* produced by the International Accounting Standards Board (IASB). We’ll look at some of the key aspects of this framework in the second half of this chapter.

10.3 The need for detailed accounting rules

So far in this book we have only come across small businesses with routine, straightforward transactions. It may not yet be obvious to you why accountants need to follow a lot of detailed rules. However, as you make progress in your studies you will encounter larger businesses with more complex transactions.

For example, a British business might have some of its operations overseas. Which exchange rates should it use to translate the foreign transactions for inclusion in its UK financial statements?

Another business may offer a one-year guarantee (or ‘warranty’) on the products it sells. Under the terms of the warranty, the business promises to fix any defects in the first 12 months following the sale. Of course, some customers will end up claiming under this warranty, but it is difficult to predict how many, or how much it will cost to fix each fault. How should the liability for warranty claims be estimated?

There are many other examples like this. A series of detailed accounting rules is required to ensure that all businesses deal with these types of situations using similar methods. These detailed rules are called **accounting standards**. If all businesses follow these standards, users will have more confidence in the reliability of financial statements. They will also feel able to compare the performance of a particular business against that of other businesses, knowing that the comparisons are not being distorted by huge variations in accounting practice.

The first ever accounting standards were issued in the 1970s. Most developed countries began by producing their own accounting standards; therefore, there were various small (and sometimes quite large) differences between the accounting rules of different countries. However, following growing demand for large companies in different countries to all follow the same rules, the **International Accounting Standards Board (IASB)** has become the most important source of accounting standards.

Activity 10.1

Why do you think demand has increased for the harmonisation of accounting practice across the world, so much so that the International Accounting Standards Board is now the most important source of rules?

There are currently over 40 IASB standards in force. Initially, they were literally known as **International Accounting Standards (IASs)**. However, all new IASB standards issued after 2003 are known as **International Financial Reporting Standards (IFRSs)**. As a result, roughly two-thirds of the IASB standards are officially titled IASs and the other third are called IFRSs. The difference in name is purely cosmetic.

The profile of IASB standards was massively boosted when the European Union (EU) required very large companies in EU member countries to follow IASs/IFRSs from 2005 onwards. Smaller companies in the UK are still not required to follow IASB standards, but they may do so if they wish. It is quite possible that IASB standards will eventually be used by all UK companies.

Exhibit 10.1 indicates the countries in the world where large companies are required to use IASB standards.

Exhibit 10.1 Countries shown in blue indicate where large companies are required to use IASB standards



Source: IFRS.org

In this book, any references to accounting standards will be to IASB standards, because they are the highest-profile accounting rules. Moreover, if you take your studies of accounting further, then it is almost certain that you will focus on IASB rules.

Because this book provides only an *introduction* to financial accounting, it will cover just a small number of the 40 or so IASB standards. Examples of standards that you will encounter in this book are:

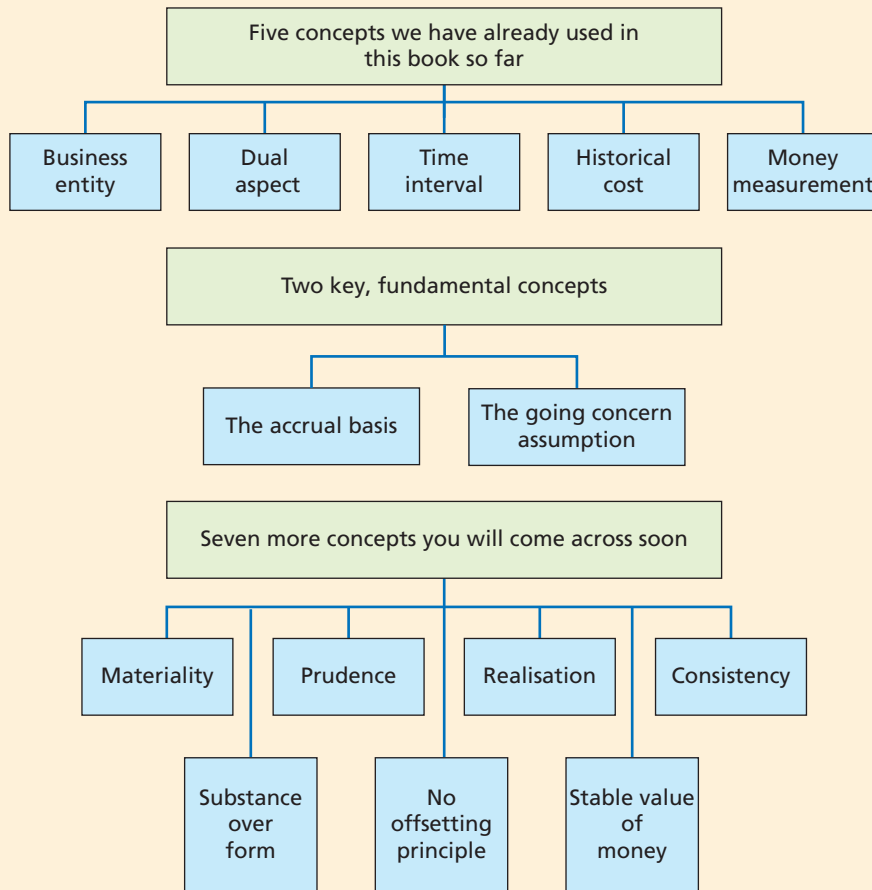
- IAS 1 *Presentation of Financial Statements*
- IAS 2 *Inventories*
- IAS 7 *Statement of Cash Flows*
- IAS 10 *Events after the Reporting Period*
- IAS 16 *Property, Plant and Equipment*
- IAS 23 *Borrowing Costs*
- IAS 36 *Impairment of Assets*
- IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- IFRS 15 *Revenue from Contracts with Customers*

It wouldn't make sense to start looking in any detail at the requirements of these standards in this chapter. It is far more sensible to look at them as and when they become relevant in the book. For example, in Chapter 18 Inventory valuation, we will cover IAS 2 *Inventories*. So, for the rest of this chapter, we will concentrate on 14 fundamental accounting concepts and then discuss the latest attempt to incorporate many of these within a wider conceptual framework.

10.4 Fourteen of the most important underlying accounting concepts

Purely to make them more manageable, we will break our 14 concepts down into three categories, as shown in Exhibit 10.2.

- The first five concepts in Exhibit 10.2 are relatively straightforward ideas that you have already applied in the first nine chapters of this book, even though you have only covered the absolute basics of financial accounting so far. When we discuss these five concepts in the next section, you should hopefully recognise that you have already been using them.
- The next two (the accrual basis and the **going concern assumption**) are two of the most important concepts. Whenever accounting bodies have attempted to establish a formal framework of principles, these two have generally been identified as the key, fundamental concepts.
- Some of the remaining seven may be a little harder to grasp, simply because you haven't come across any examples of them yet in this book. So far, you've only recorded routine business transactions and prepared simple financial statements for small, trading businesses. You haven't yet seen any situations where these concepts need to be considered. They will be explained in this chapter and you will come across them again later in the book.

Exhibit 10.2 Fourteen of the most important accounting concepts**10.5 Five concepts you have already used in this book****The business entity concept**

This concept implies that the business is treated as a separate entity from its owners. The only transactions recorded in the business's books are those of the business; the activities the owner gets up to outside the business are not reflected in the business records.

We have certainly applied this assumption in the first nine chapters of this book. For example, all the balance sheets you have prepared have only shown the assets of the *business*; the personal assets of the owner (their house, clothes, car, and so on) are not shown.

You might think this to be a fairly obvious idea, but, in fact, it is an assumption that is often different to the legal reality. In law, for example, there is no distinction between a sole proprietor and their business. As you will learn in Chapter 35, only if the business is set up as a company will it become, in the eyes of the law, a separate entity from its owners.

**Activity
10.2**

The *repairs* expense account in the books of a business includes £1,200 spent on repairing the proprietor's indoor swimming pool at home. What entry is required to correct this in the business's books, and which accounting concept explains why the adjustment must be made?

The dual aspect (or 'duality') concept

This states that every transaction has two effects, and both must be reflected in the business records.

The fact that a transaction has two effects is a fairly common-sense idea. For example, if you bought a new pair of shoes later today for £80, then this would affect you in two ways: you'd own a new asset (shoes worth £80) but you'd have £80 less money. When the transaction is more complicated, it may not always be quite so obvious what the two effects are, but the dual aspect concept will always apply.

Application of the dual aspect concept ensures that the accounting equation ($\text{Assets} = \text{Capital} + \text{Liabilities}$) always remains in balance. It also means, of course, that the totals of the two sections of a business's balance sheet will always be equal. The concept is further reflected in the double entry bookkeeping system: each transaction will have two effects, and these must be reflected in the books with equal debit and credit entries.

The time interval convention

Various different user groups want reasonably regular information about the financial performance of the business, so it is a widely accepted convention for businesses to produce *annual* financial statements.

Many businesses are somewhat seasonal (those in farming, retail, and tourism, for example) so there is a logic to producing financial statements that cover one annual trading cycle. Moreover, it would be unsatisfactory if each business produced its financial statements for different lengths of time. If Business A produced its income statement for a 9-month period and Business B for a 15-month period, then it would be much harder to compare their performance.

Very occasionally, a business might produce its financial statements for a period of more or less than one year, but 12 months is definitely the norm. The largest companies will also produce less detailed, interim financial statements every three or six months, but the full set of financial statements will be annual.

The time interval convention is therefore straightforward in principle, but it actually causes various headaches for accountants, as you will see as your studies progress. For example, accountants will need to take particular care to ensure that transactions around the 'cut-off' point at the end of the **financial year** are recorded in the correct period.

**Activity
10.3**

Can you think of an alternative to the time interval concept? (*Hint: it might have been used centuries ago and could still occasionally be used today.*)

Historical cost concept

This is the idea that the monetary value shown for items in the financial statements is normally their historical cost, i.e. the amount that the business paid for them. In other words, assets will normally be shown at their original cost price.

The major advantage of using historical cost is that the actual amount paid for assets is usually a straightforward matter of fact, and there is no room for argument. In theory, it might be more meaningful to show assets at their current value rather than their original cost, but it would probably be difficult to arrive at a valuation that everyone could agree on. Current values would also be likely to fluctuate continually.

If you take your studies of accounting further, you will learn that not all items in the financial statements will be measured at historical cost, but that it does remain the most widely used basis. And at the introductory level, historical cost will form the basis for almost all measurements in accounting.

Activity 10.4

A business buys a new piece of equipment. The business expects that it should last for 10 years. After using it for five years, at what amount could you argue that the equipment might be included in the balance sheet of this business? Think of as many alternatives as you can.

The money measurement concept

Accountants will only record items if they can be:

- (a) measured in monetary terms; and
- (b) measured with sufficient reliability.

Many important resources possessed by a business do not meet these two criteria. For example:

- the quality of the ideas, energy and attitude of the business's staff;
- the reputation of the business's products amongst the public; and
- the quality of the relationship between the business and its customers.

Resources such as these are certainly very valuable to a business, with the potential to bring great future benefits. However, it would be too difficult to put a monetary value on characteristics such as the three listed above. Any attempt to do so would involve a lot of guesswork, and it is highly likely that two independent opinions would produce very different valuations.

Intangible resources such as the three suggested above are therefore not included in the balance sheet because, under the money measurement concept, they do not meet the test of being able to be measured in monetary terms with sufficient reliability.

Activity 10.5

A restaurant business buys a new fridge to replace its old one. On the same day, the business also learns that its rating has improved significantly on TripAdvisor (a popular online customer review website). How will these events be recorded in the business's books? Which event is likely to bring greater future benefits to the business?

Activity 10.6

Look back at some of the examples and questions in the first nine chapters of this book. Can you see how you have been applying these first five concepts all along?

10.6 Two key, fundamental concepts: the accrual basis and the going concern assumption

The accrual basis

You have already seen in this book that income is recorded in the books when goods are sold, even if the customer will actually pay at a much later date. In the income statement for the period, this income is then matched against the cost of the goods that were sold, even if those goods were bought and paid for in a different period.

This is because financial statements are prepared on an **accrual basis**, which is one of the most important concepts in accounting. The accrual basis essentially states that income must be recorded when it is earned, not when cash is received from the customer. Similarly, expenses must be recorded in the period that they are incurred (or ‘used’), not when they are actually paid for.

The accrual basis is therefore sometimes known as the **matching concept**, in the sense that income earned during the period must be matched with the expenses incurred in earning that income in order to calculate the profit for the period.

The income earned by a business in the year will almost never be the same as the cash it received in the year, and the expenses incurred will almost never be the same as the cash paid. An implication of the accrual basis is therefore that a business’s profit for the year will almost never be the same as the amount of cash it generated in that year.

Another implication is that businesses have to make various adjustments at the end of the period to record any expenses used that have not yet been accounted for (such as gas, electricity and telephone usage for which no bills have yet been received). Such adjustments are actually called ‘accruals’ and we will look at them in detail in Chapter 22. However, be careful not to confuse ‘accruals’ (which are a specific type of accounting adjustment) with the wider ‘accrual basis’ (which is an underlying assumption about how financial statements as a whole are prepared).

Activity 10.7

If the income statement wasn’t prepared on an accrual basis, what do you think the alternative basis would be?

The going concern assumption

Producing a normal set of financial statements using normal accounting methods involves assuming that the business is a ‘going concern’. The term ‘going concern’ essentially describes a business that is likely to continue in operation for the foreseeable future with no intention of closing down nor any likelihood of being forced to do so. In other words, a ‘going concern’ is a financially healthy business that has no intention of ceasing to trade.

However, if a business is in serious financial difficulty and there is a significant risk that it will be forced to close down, then it is *not* a going concern. The going concern assumption would therefore not apply to such a business and normal accounting methods would no longer be used.

For example, if a business is likely to have to close down soon, it would be inappropriate to show its non-current assets at historical cost. It is highly likely that things like equipment and vehicles will have to be sold off quickly when the business closes, and the sale value of these assets is likely to be much less than their original cost.

Activity 10.8

Can you think of any other changes to the financial statements that might be needed when it is decided that a business is no longer a going concern?

If there is no evidence that the business intends to, or might have to, close down, then it is assumed to be a going concern, which means that ‘normal’ accounting methods will be used. In virtually every example in this book, we will assume that the business in question is a going concern and that normal accounting rules therefore apply.

10.7 Seven more concepts that you will come across soon

You may not have seen any examples of the application of these seven concepts yet, but you will do in the rest of this book, and you are also sure to come across them again if you take your accounting studies to the next level.

Materiality

A piece of accounting information is said to be **material** if leaving it out of the financial statements, or misstating it, could influence the decisions of users of those financial statements. In other words, materiality is largely a matter of the size of the item omitted or the size of the mistake.

The concept of materiality doesn't mean that accountants should deliberately leave small items out of the books, or that it is okay to be careless when recording small items. However, it does mean that accountants should not waste their time in elaborate accounting treatment of trivial items.

For example, suppose a business buys a stapler for the office. The stapler might be expected to be used in the business for several years, so, in theory, it could be shown on the balance sheet as a non-current asset. But under the materiality concept, the accountant will simply record the stapler as an expense in the period in which it was bought. To record it as a non-current asset would mean that time-consuming accounting adjustments would be required (such as depreciation, which you'll learn about soon). This extra work would add no value to the information given by the financial statements.

Another implication of the **materiality** concept is that there is no need for a business to be certain that every single, small item is 100 per cent correct before the financial statements can be published. Of course, bookkeepers should always make every effort to record all transactions accurately. But for a business with many thousands of transactions, it is impossible to guarantee that every individual entry in the books is 100 per cent correct before the financial statements are issued.

The materiality concept therefore reflects common sense: published financial statements are still useful to users if they present a reasonably fair and accurate picture of the business's financial performance and position. Minor mistakes and omissions will not adversely affect the usefulness of financial statements.

Activity 10.9

Do you think that the level at which an amount becomes 'material' will be the same for every business?

A final comment to make in relation to materiality is that, sometimes, items in the financial statements are 'material' not because of their size but because of their nature. An example is the salaries and bonuses paid to the directors of a company. There has been controversy in recent years over whether the rewards paid to some company bosses are excessive. It is therefore important to ensure that amounts paid to directors are reported with 100 per cent accuracy. Even a small mistake in reporting such sensitive figures could be deemed to be a 'material' error.

Prudence concept

The prudence concept means that accountants should apply a degree of caution whenever judgement is needed in deciding upon figures that will be included in the financial statements. An example would be the judgement needed in estimating which amounts due from customers will never be collected (these are known as 'bad debts'). The prudence concept implies that the accountant should, within reason, be a little bit pessimistic when estimating which customers might not pay.

The use of prudence in matters of judgement should ensure that assets and income are not overstated, and that liabilities and expenses are not understated in the financial statements. However, judgements should not be *excessively* prudent. If accountants were extremely pessimistic in making judgements, then assets and income would be significantly understated and liabilities and expenses would be overstated. This would mean that the financial statements would be misleading. Prudence should be balanced by the need to present a *fair* picture of the business's financial situation: the prudence concept cannot be misused to justify the deliberate overstatement or understatement of items.

Activity 10.10

Can you think of some examples of how some businesses might have abused the prudence concept in the past?

The prudence concept is also fundamental to the way in which expected profits and expected losses are treated in the financial statements. Expected profits must be virtually certain before they are recorded in the financial statements, but expected losses only need to be *probable* before they are included.

An example of how gains and losses are treated differently is in relation to inventory. You will learn a lot more about inventory in Chapter 18, but the following example should still make sense.

Suppose a business has 1,000 products currently in stock; 990 of these are very popular with customers and always sell very well, at high prices. But the other 10 are very unpopular and will probably have to be sold for less than they originally cost, i.e. at a loss. In the financial statements of this business, the 990 popular products will be included in the balance sheet at their cost price. The profits that the business confidently expects to make on them will not be recognised until the products are actually sold. But the 10 unpopular products will be shown at their expected selling price, which is less than their original cost. In other words, the expected loss on the unpopular products is recognised straight away, before they have been sold.

The fact that expected profits and losses are treated differently by accountants reflects the fact that prudence has been an underlying concept in accounting for centuries.

Activity 10.11

Why do you think prudence has been such a significant concept in accounting for so long?

The realisation concept

The realisation concept means that income should only be recorded when it is **realised**: income is said to be 'realised' once it becomes reasonably certain that the cash from the sale will be received.

Generally, the point at which income is realised is when the seller has transferred control of the goods to the buyer. In other words, for the simple trading businesses that we typically see in this book, it will be the point at which the goods have been delivered to the customer. At this point, the price will have been agreed, the customer will have accepted the goods, and it is therefore reasonably certain that they will pay.

However, for less ordinary transactions, the point at which income is realised may not be so obvious. Accountants describe this issue as the problem of when revenue can be **recognised**. If you take your studies of accounting further, you will encounter various scenarios where great care will be needed to identify the amount of revenue that can be recognised and when this is done. For example:

- Goods or services might be supplied over a long period of time. Suppose a construction company undertakes a contract to build a new hospital for a total price of £500m. It is expected to take four years to complete. The construction company can't just wait until the hospital is finished before recognising any of the £500m revenue. If it did, the company's financial statements during the first three years of the contract would give a misleading impression of its revenue-earning activity.
- Goods and services might be bundled together in one sale, and the total revenue may need to be split between the various elements and recognised separately. For example, suppose an IT business sells a new system to a customer for a single price of £600,000. This price includes IT support services for the next three years. How much of the £600,000 revenue should be recognised now from the sale of the system, and how much should be recognised over the next three years in relation to the support services?

If you take your studies of accounting further, you will come across various examples of this nature.

Activity 10.12

On 1 April 2021, a publisher launches a brand-new monthly magazine. During April, it receives £60,000 cash for annual subscriptions in advance. The new magazine proves to be very successful, but, as at the publisher's financial year end of 30 April 2021, it has only delivered the first issue of the magazine to its subscribers. How much revenue do you think the publisher should recognise in its income statement for the year ended 30 April 2021?

Consistency

The consistency concept means that:

- similar items should be treated in the same way within one set of financial statements; and
- once a business has chosen a particular method of accounting, it should stay the same from one period to the next unless there is a very good reason to change.

So far in this book, we have not covered any examples where a business can choose between one method and another. However, as your studies progress, you will come across several situations where businesses face such a choice. For example, in Chapter 18 you'll see that businesses can choose one of various different methods of valuing inventory, including FIFO or AVCO. Once a business has decided to use either FIFO or AVCO it should not keep changing from one year to the next. Occasionally, new circumstances might mean that it becomes appropriate to change methods, but this should be fairly rare.

Application of the consistency concept should make it easier for users to compare the performance of a business from one year to the next. If a business was constantly changing its accounting methods, then such comparisons would be much harder.

Substance over form

This is the principle that financial events should be presented in the financial statements in line with their real, actual impact rather than their technical or legal form.

At this stage in your learning, all the transactions you will come across are relatively straightforward and their substance (i.e. their real effect in practice) is likely to be the same as their legal form. But if you take your accounting studies further you will come across situations where this is not the case.

An example is where Business X is leasing a car over (say) a five-year period. From a legal point of view, the car will not belong to Business X during these five years: it is owned by the leasing company and X is simply renting it out. But in terms of economic substance, X has control of the car during those five years. The real impact of the transaction is the same as if X had bought the car outright and paid for it immediately. Therefore, under the 'substance over form' concept, the car will be included as one of X's non-current assets throughout the five-year period even though it doesn't legally own it.

The 'no offsetting' principle

An example of **offsetting** in accounting would be if a business reported an asset and a liability as a single net figure. For example, suppose a business has a positive cash balance in one of its bank accounts and a bank overdraft in another. If so, showing the positive bank balance minus the negative bank balance as a single figure in the balance sheet would be offsetting. Offsetting also describes the situation where a business reports an item of income and an item of expense as a single net figure.

In general, offsetting is not allowed in financial statements. Users need to be able to identify the total value of each of the business's assets, liabilities, income and expenses, and offsetting would make this impossible.

There are actually one or two instances where offsetting of certain items of income and expenses is permitted under IASB rules, but these are specific cases and, in general, the principle of ‘no offsetting’ applies.

Stable value of money

Businesses usually present their financial statements in their country’s own currency. For example, businesses in the UK will produce their financial statements in GB pounds. However, due to inflation, the purchasing power of £1 tends to decline each year so that £1 is worth slightly less than in the previous year.

This makes comparisons of a business’s performance over time more difficult. For example, suppose a UK business was making an annual profit of £50,000 five years ago and made a profit of £60,000 this year. In order to accurately judge whether its performance had improved or declined over the last five years, we would need to adjust for inflation, because the unit of measurement (GB pounds) will probably have fallen in value over the last five years.

Similarly, comparing one business to another becomes more difficult. Suppose Business A and Business B are very similar businesses in the same industry. Business A bought its premises 30 years ago. Business B has very similar premises but only bought them three years ago. Given the historical cost concept, B’s balance sheet will show a much higher figure for non-current assets than A’s simply because A’s were bought 30 years ago when property prices were much lower. Even though A and B are using very similar assets, the financial statements of the two businesses will paint a very different picture.

Financial statements in the UK and most western economies do not make any general adjustments for the fact that the value of the unit of measurement is constantly changing. In other words, financial statements effectively assume that it is safe to ignore the problem of changing price levels. Inflation has been low in recent years, so it is not currently a huge problem. In the 1970s though, when inflation in the UK was much higher, various methods were proposed for adjusting figures in financial statements to take account of changes in price level. These suggested alternatives are beyond the scope of this book.

Activity 10.13

A business runs a major advertising campaign towards the end of 2024. Much of the benefit from this advertising will probably come in 2025. Do you think that the advertising cost should be shown as an expense in the income statement of 2024 or 2025? Think about the 14 concepts we have discussed. Can you see a conflict between two of them here?

10.8 A conceptual framework for accounting

So far, you have looked at 14 underlying concepts in accounting. All 14 have been around for a long time and each one performs a role in determining how transactions are recorded and how financial statements are prepared.

In recent decades, there have been attempts to incorporate many of these concepts in a broader ‘conceptual framework’. This framework would establish a coherent set of principles to underpin the whole of financial accounting. All the detailed accounting rules could be written in accordance with these principles which should mean that those rules would all be logical and consistent with each other.

The latest and most significant version of such a framework is the IASB’s *Conceptual Framework for Financial Reporting*, which was last updated in 2018. This is an important document for students of financial accounting. If you take your studies further, you will come back to it again

and again. Much of the content is too advanced for an introductory book. But among many things, it addresses three questions which are certainly relevant at the introductory level:

- 1 What is the purpose of financial reporting?
- 2 What qualities must financial accounting information possess for it to be useful?
- 3 What are the five elements that are the ‘building blocks’ of financial statements?

We’ll look at how the IASB’s *Conceptual Framework for Financial Reporting* answers these questions in the next few sections. For the rest of this chapter we’ll just refer to it as ‘the Framework’.

10.9 What is the purpose of financial reporting?

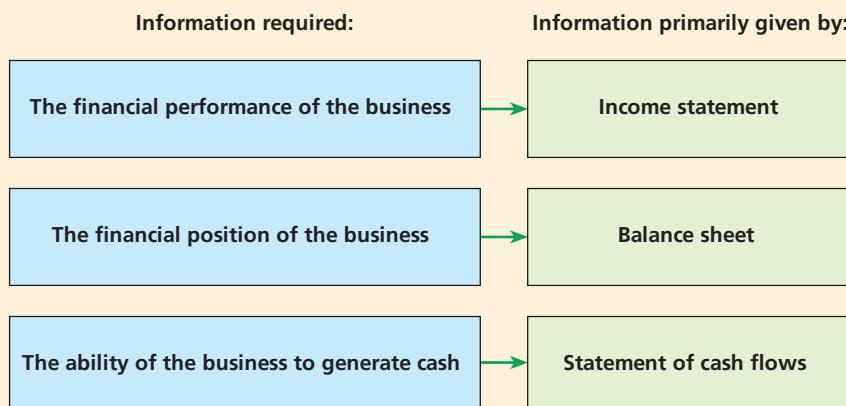
The Framework states that the objective of financial reporting is to give financial information about a business that existing and potential investors, lenders and other creditors can use to help them decide whether to provide (or continue to provide) finance to that business.

In other words, financial statements are primarily prepared for the benefit of people who currently or potentially invest in the business, lend to it, or supply goods and services to it on credit terms. As we explained in Chapter 1, there are various other user groups that are also likely to be interested in a business’s financial statements, such as employees, customers, the government and the general public. But the Framework makes clear that the information needs of those who provide finance to the business take priority.

The Framework goes on to explain that users require information about the business’s financial performance, its financial position, and its ability to generate cash. This information is essential to help users assess the financial prospects of the business. It will also help them to evaluate how effective the managers of the business have been at running it (which is known as assessing the quality of ‘management stewardship’).

The need for information about financial performance, position, and cash flows essentially explains why the three most important financial statements we cover in this book are the income statement, balance sheet, and statement of cash flows, as summarised in Exhibit 10.3.

Exhibit 10.3 Three key financial statements



The Framework also confirms that the income statement and balance sheet should be prepared on an **accrual basis**, which is one of the 14 concepts we discussed earlier in this chapter. Additionally, it explains that a normal set of financial statements is prepared on the assumption that the business is a going concern, which is another of the 14 concepts.

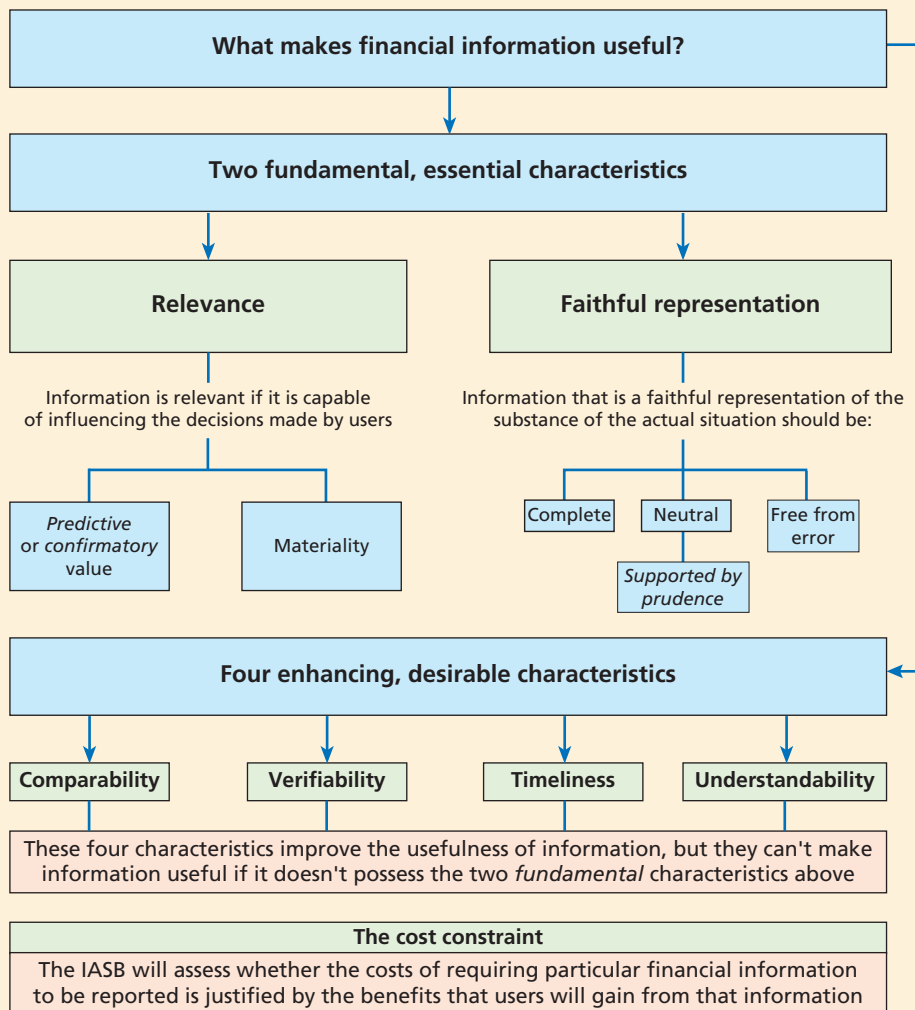
10.10 What qualities should financial accounting information possess for it to be useful?

The Framework sets out a hierarchy of characteristics that financial information should possess if it is to be useful. At the top, there are two fundamental qualities that useful financial information must always have: **relevance** and **faithful representation**.

Further down, there are four characteristics that are highly desirable. Information that is relevant and faithfully represented will be even more useful if it has these four ‘enhancing’ qualities: **comparability**, **verifiability**, **timeliness** and **understandability**.

All these characteristics can be summarised in the diagram shown in Exhibit 10.4. We will discuss the issues illustrated in Exhibit 10.4 in more detail over the next few sections.

Exhibit 10.4 The qualitative characteristics of useful financial information



10.11 The two fundamental characteristics of useful financial information: relevance and faithful representation

Relevance

Financial information is **relevant** if it can help the user of that information to make decisions. Information can help influence users' decisions if it has one or both of the following:

- **Confirmatory value:** for example, the information could reveal the business's profit for last year and this helps to confirm whether the business has performed in line with the user's expectations.
- **Predictive value:** for example, the business's profits over recent years could indicate trends that might help users to predict its future results.

By definition, financial information is only capable of helping users make decisions if it is *material*. Materiality was one of the 14 underlying concepts that we looked at earlier in this chapter.

Faithful representation

If financial information is to be useful, it must be prepared and presented in a way that is not misleading in any respect. In other words, it should be a **faithful representation** of the actual situation. For it to be a 'faithful representation', financial information should, to the maximum possible extent, be:

- 1 **Complete:** all the information needed for the user to understand the situation should be present.
- 2 **Neutral:** financial information should not be biased. In other words, it should not have been manipulated in order to try to influence the perceptions of users.
- 3 **Free from error:** in a perfect world, financial information would be 100% accurate. However, it is usually impossible to achieve this in practice. For example, financial information often includes estimated figures. In Chapter 19, you'll learn that businesses must predict which amounts due from customers might never be received ('bad debts'). Obviously, the future cannot be predicted with certainty and these forecasts will never be 100% accurate. So, in relation to estimates, the requirement for information to be 'free from error' means that there should be no errors in selecting or applying the most suitable process for arriving at them.

The Framework also explains that neutrality should be supported by **prudence** (one of the 14 underlying concepts that we discussed earlier in this chapter). In effect, the Framework is saying that information should be free from bias, but, at the same time, a degree of caution should be applied when making estimates. This appears to suggest a somewhat delicate balancing act, but the intention seems to be to require a degree of prudence whilst prohibiting excessive prudence.

The Framework also refers to the underlying concept of 'substance over form' in relation to 'faithful representation'. It explains that the idea of 'faithful representation' implies that the substance over form concept must always be applied: if information is to be a 'faithful representation' of the actual situation, then the economic reality of a transaction must be shown rather than its technical, legal form. **Substance over form** was another of the 14 underlying concepts that we looked at earlier in the chapter.

Activity 10.14

Can you think of any situations where there may have to be a trade-off between the two fundamental characteristics? For example, a situation where the information that would be most relevant to a user might not turn out to be a faithful representation?

10.12 The four enhancing characteristics

The four qualities that increase the usefulness of information that is relevant and faithfully represented are **comparability**, **verifiability**, **timeliness** and **understandability**. All four are desirable qualities, but they are secondary to the two fundamental characteristics. We discuss all four below:

Comparability

Financial information about a business is more useful if users are able to make fair comparisons with previous years. For example, users will want to assess whether the performance of the business is getting better or worse. To make these comparisons easier, the Framework requires that, for each item in the financial statements, the **corresponding amount for the previous year** must also be shown.

The ability to compare the business's performance from one year to the next will be enhanced by the **consistency** concept that we discussed earlier in this chapter: a business should use the same accounting methods from one year to the next, unless there is a very good reason to change them.

Users are also likely to want to compare the performance of the business with other, similar businesses. For example, is Supermarket X performing better than Supermarket Y? To help users make these comparisons, it is essential that financial statements state exactly what accounting methods have been used in preparing the information. Users can then make allowances for any differences in accounting methods when comparing one business with another. Financial statements must therefore always disclose the **accounting policies** that have been used.

Verifiability

Some financial information is easy to verify. For example, the price paid for a machine or a vehicle is normally a matter of straightforward fact. But where the information involves estimates, it can still be said to be verifiable if different, independent experts could largely agree that the information is a faithful representation. In other words, the estimates should not simply represent the subjective opinion of the preparer; instead, it should be possible to support them by a logical examination of the best available facts and evidence.

Timeliness

Generally speaking, the longer it takes for information to be made available the less useful it becomes. For example, if a user is deciding whether to invest in a business now, they will obviously prefer more recent financial information.

Note that there will often be a trade-off between timeliness and the two fundamental characteristics. If information is produced quickly, before all the facts are known, then it may not be complete or free from error, and therefore may not be a faithful representation. On the other hand, if the business waits to discover all the facts before publishing the information, then it may become too old to be relevant to users.

Understandability

It almost goes without saying that information can only be useful if the user can understand it! All financial information should therefore be presented in a way that is as clear and concise as possible.

As you might imagine, many large modern businesses are complex and it would be impossible to make their financial affairs understandable to everyone. It therefore must be assumed that users of financial statements do have a reasonable knowledge of business and accounting and that they are willing to take the time to study and digest the information carefully.

Finally, note that a piece of information should never be excluded from the financial statements because it is too complex to be understandable. To do so would make financial statements incomplete and therefore no longer a faithful representation, which is one of the essential, fundamental characteristics.

**Activity
10.15**

Can you think of any other situations where the requirement for information to possess the two fundamental characteristics could reduce its potential to have the four enhancing qualities?

10.13 The cost constraint on reporting financial information

The Framework acknowledges that there is a trade-off between the costs of reporting financial information and the benefits that the information brings.

All businesses will incur various costs in collecting, processing, checking and publishing their financial information. The main benefits are that good information should help investors and lenders make better decisions. The whole economy should function more efficiently as a result, which benefits everyone.

**Activity
10.16**

Can you think of any other costs and benefits that could be associated with requiring businesses to report an additional piece of financial information?

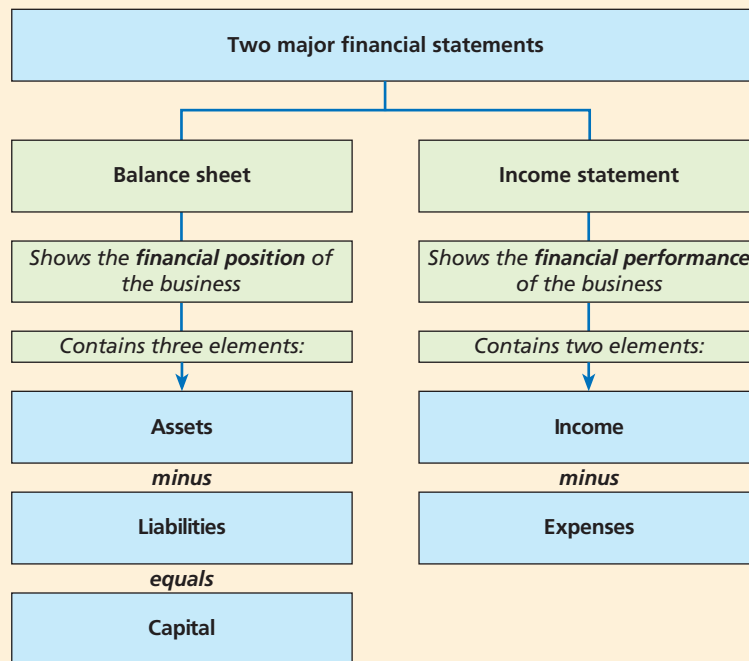
In practice, it is likely to be impossible to accurately quantify all the costs and benefits associated with reporting a particular piece of financial information. However, the Framework explains that when deciding whether to introduce a new rule that requires extra information to be reported, the IASB will always seek to assess whether the benefits of reporting it are likely to outweigh the costs of producing it.

10.14 What are the five elements that are the ‘building blocks’ of financial statements?

The Framework identifies five elements of financial statements: income, expenses, assets, liabilities and capital. (It actually uses the word ‘equity’ instead of ‘capital’, but the two terms mean the same thing.)

You should recognise these five elements from the double entry rules you learned in the early chapters of this book: if a transaction results in an increase in expenses or assets, then the relevant expense or asset account must be debited. If it results in an increase in income, liabilities or capital, then the relevant income, liability or capital account should be credited. The opposite applies to decreases in any of the five elements.

The five elements are represented in the financial statements as illustrated in Exhibit 10.5.

Exhibit 10.5 The five elements of financial statements and where they appear

The Framework goes on to provide detailed definitions of all five elements: it discusses when they should be included (or ‘recognised’) in the financial statements, and it describes the different methods for measuring each element, along with guidance on when each measurement method should be used. These issues will become very relevant to you if you take your accounting studies further, but they are a bit too advanced for the introductory level.

10.15 Concluding comments

Many aspects of this chapter will crop up again and again as you continue your studies in accounting. For example, you will come across instances where a particular accounting method is justified on the basis that it is in accordance with one or more accounting concepts. There will be other instances where a certain accounting approach is needed to achieve one or more of the qualitative characteristics of useful financial information.

At this early stage in your studies, you haven’t yet come across many of these instances, but this is a chapter that you will probably keep referring back to. In time, you will begin to appreciate the importance of many of the ideas introduced in this chapter.

Learning outcomes

You should now have learnt:

- 1 That accountants work in accordance with a set of underlying concepts as well as a series of detailed rules (known as 'accounting standards').
- 2 That the most important accounting standards are those issued by the International Accounting Standards Board (IASB).
- 3 14 of the most important underlying concepts in accounting.
- 4 That the IASB's *Conceptual Framework for Financial Reporting* ('the Framework') is the latest attempt to incorporate the underlying concepts of accounting within a broader structure that can be used as a consistent foundation on which to base the detailed rules of accounting.
- 5 The purpose of financial reporting as identified by the Framework.
- 6 That, according to the Framework, the two fundamental qualities that financial accounting information must possess if it is to be useful are that it must be *relevant* and be a *faithful representation* of the actual situation.
- 7 That four enhancing characteristics (*comparability, verifiability, timeliness and understandability*) can increase the usefulness of information that possesses the two fundamental qualities.
- 8 That the five elements of financial statements as specified by the Framework are income, expenses, assets, liabilities and equity (also known as 'capital').

Answers to activities

- 10.1** There are a few reasons for the increased demand for international accounting standards, such as:
- The increasing internationalisation of business and finance has meant that users of financial statements (especially potential investors and lenders) want to be able to directly compare the performance of businesses in different countries. Such comparisons are much easier if businesses in different countries all prepare their financial statements in accordance with the same rules.
 - There has been a growth in the number of multinational companies that have major operations in several different countries. These companies may therefore have to produce financial statements in different territories. International standardisation makes this much easier (and less costly) because multinational companies don't have to worry about following different accounting rules in different countries.
- 10.2** This transaction relates to the private living expenses of the owner, which are nothing to do with the business. Under the *business entity* concept, they should not be recorded as an expense in the business's books. The entry Debit Repairs £1,200, Credit Cash £1,200 appears to have been made so far. A payment of the private expenses of the owner by the business is effectively *drawings*, so the adjustment Debit Drawings £1,200, Credit Repairs £1,200 will cancel out the entry to repairs and record it correctly.
- 10.3** An alternative could be what we might call the 'venture concept'. Centuries ago, when merchants undertook trading expeditions across the seas, financial statements would be produced at the end of the voyage or 'venture'. Some expeditions might have lasted less than one year and some more, but the financial statements would simply cover the entire venture rather than an arbitrary time interval. We will effectively encounter a form of this in Chapter 30 when we look at small, short-term joint ventures between two sole proprietors. We will see that the net profit from these small-scale ventures is normally calculated for the period of the venture rather than at arbitrary time intervals.

10.4 A case could be made for various figures. For example:

- (i) The original price paid for the equipment, i.e. its historical cost.
- (ii) Half of its historical cost, following the logic that half of the useful life of the equipment has been used up by the business.
- (iii) The current cost of replacing the equipment with an identical model.
- (iv) The current cost of replacing the equipment with the latest model of this type of equipment, incorporating all the latest updates and improvements.
- (v) The 'realisable value' of the equipment, being the price that the business could get if it sold the equipment now, second-hand.
- (vi) The 'value in use' of the equipment, essentially being a valuation based on the profits that the equipment is expected to help the business generate in the remaining five years of its life.

There are arguments for and against each of these suggestions. The major advantage of historical cost is that it is easily verifiable, with no scope for argument. This cannot be said of the other options. The other options will all involve a degree of estimation and/or judgement.

Finally, you will soon learn that the figure that businesses *actually* use is usually some variation on the second suggestion above. Businesses will normally show their equipment in the balance sheet at its historical cost minus a figure called 'accumulated depreciation'. Accumulated depreciation is deducted to reflect the portion of the asset's original cost that has been 'used up' over time so far. You will learn all about depreciation in Chapter 21. Note, of course, that the need to estimate in advance how long a non-current asset will be used for somewhat undermines the 'verifiability' of using historical cost as the basis!

10.5 The new fridge will be recorded as a new non-current asset (i.e. a long-life asset) on the balance sheet of the business. However, the improved TripAdvisor rating will not be recorded in the business's books at all. This is somewhat ironic, because the improved online reviews probably reflect a far more significant asset in terms of bringing in new customers and boosting profits. The new fridge will probably not boost profits at all. Customers are unlikely to notice any difference from the old fridge. This is a shortcoming of financial statements. For this business, its reputation, the skill of the chef, and the attitude and friendliness of the waiters and waitresses are some of its most valuable assets, but they will not (because of the **money measurement** and historical cost concepts) appear on the balance sheet.

10.6 Hopefully you can see that we have been applying all five:

- *Business entity*: for example, the balance sheets we've produced have only shown the assets and liabilities of the business, not those of the business owner.
- *Dual aspect*: the system of double entry bookkeeping we have introduced, the two columns on every trial balance, and the structure of every balance sheet, are all evidence of this concept.
- *Time interval*: every income statement and balance sheet we have produced has related to a particular time period.
- *Historical cost*: we have always recorded financial events at their original transaction price. As a result, assets have always been shown at their original cost in all our balance sheets so far.
- *Money measurement*: things like the value of the business's reputation or the loyalty of its customers have never been reflected in any of the balance sheets we've produced.

10.7 The obvious alternative to the accrual basis would be to record income and expenses on a cash basis. An income statement prepared on a cash basis would simply show receipts from customers minus payments to suppliers and employees. Accounting would be a lot simpler if the cash basis was used, but unfortunately all but the very smallest businesses must adopt the accrual basis. (You will come across the 'cash basis' when we look at the accounts for small clubs and societies in Chapter 29.)

10.8 Examples of other changes include:

- (i) The financial statements would have to declare that the going concern assumption did not apply and give the reasons why the business is not considered to be a going concern. This would, of course, be essential information for anyone who read the financial statements of the business and wished to understand its financial situation.

- (ii) The classification of liabilities as current or non-current would probably no longer apply. All the business's liabilities would probably have to be paid within the next 12 months. Additionally, all non-current assets may have to be classified as current assets if they are expected to be turned into cash soon.
- (iii) Additional liabilities may need to be recorded. For example, if a business is likely to close down soon:
 - it may have to pay compensation/redundancy to its staff; and
 - the business's bank loans may have to be repaid earlier than originally agreed. There may be penalties for early repayment, which would add to the business's liabilities.

10.9 No. The size of the business will be a particularly important factor in determining whether an amount is material. For example, for a huge multinational company, an amount of £5,000 may be completely insignificant, and a mistake of this size would make no difference whatsoever to the users of that company's financial statements. But for a small business, an error of £5,000 could be very significant and therefore would be 'material'.

10.10 In the past, businesses occasionally abused the prudence concept in a cynical fashion. For example, in a year in which the business performed extremely well, its accountants might have used the prudence concept to justify some excessively pessimistic estimates that would cause reported profits to be artificially reduced. Reported profits could then be artificially boosted in a future year simply by abandoning these overly pessimistic estimates. In this way, businesses misused the prudence concept to manipulate their reported profits to show steady annual growth, perhaps to impress potential investors. This practice was known as 'earnings management'. Prudence remains an important concept in accounting, but it can never be used as an excuse to artificially manipulate the numbers in the financial statements.

10.11 There are various reasons:

- There has always been a risk that some business owners may be tempted to try to overstate their profits and assets to persuade investors and lenders to put money into the business. To protect the reputation of the accounting profession, it has always been important for accountants to prevent such overstatement. Application of the prudence concept is central to this objective.
- High-profile accounting scandals and corporate failures provide all-too-frequent reminders of the danger of neglecting prudence. For example, if the financial statements of banks and financial institutions had been more prudent in the run-up to the 2008–9 global financial crisis, then the crash may not have been so sudden and severe.
- Because of the nature of accounting work, the profession has always tended to attract people who are careful and analytical. In other words, accountants have tended towards caution and conservatism for centuries. This tendency is likely to have contributed to the general acceptance of prudence as a core concept amongst the profession.

10.12 The subscribers have each paid for 12 issues but (as at the year end) only one has been delivered. Therefore, the revenue that will be recognised in the income statement for the year ended 30 April 2021 will be $£60,000 \times 1/12 = £5,000$.

It is far too early in your studies to expect you to know the double entries for this situation, but (in the interest of completeness) they are essentially:

Debit Cash at bank	£60,000	
Credit Sales		£5,000
Credit Deferred income		£55,000

'Deferred income' of £55,000 will appear in the publisher's balance sheet as at 30 April 2021 and it will ultimately become recognised as sales revenue in the income statement for the year ended 30 April 2022, when the remaining 11 magazines are delivered.

This activity was admittedly a bit advanced for this early stage in your studies, but it is good for you to at least be aware that recognising income is not always a straightforward matter!

10.13 The advertising cost will be shown as an expense in the income statement of 2024. It does seem highly likely to bring some benefits in 2025, but it is impossible to estimate the value of these benefits with any certainty. For example, even if sales rise in 2025, it is impossible to prove the extent to which

the advertising was the cause of the increase. It is therefore **prudent** to record the entire expense in 2024. This is in conflict with the **accrual basis**: it is highly likely that the advertising will help generate extra income in 2025, so ideally the advertising costs incurred in producing that extra income would be matched against it in 2025. In this particular conflict, the prudence concept overrides the accrual basis.

10.14 An example might be financial information about a situation over which there is huge doubt and uncertainty. For instance, a company may be connected in some way to a recent environmental disaster, with the potential for huge (but unknown) clean-up costs. An estimate of potential future clean-up costs would be very **relevant** to users' decisions about the financial position of the company, but the estimate might be so uncertain that it becomes questionable whether the reported information could be said to be a **faithful representation**.

10.15 The four enhancing qualities should be maximised as far as possible, but (as their name suggests) the two fundamental characteristics always come first. Sometimes one or more of the enhancing characteristics must be diminished to achieve the two fundamental ones. For example, to ensure relevance and faithful representation, a business might have to:

- Apply a brand-new accounting rule and report a particular item in a different way than before. This will reduce **comparability** with previous years.
- Report financial information in relation to a situation where there are high levels of doubt and uncertainty. This will compromise its **verifiability**.
- Delay publication of the financial statements for a short period to gather necessary information and evidence. This will reduce their **timeliness**.
- Publish financial information in relation to an extremely complex set of transactions or events. It may be difficult to achieve a high level of **understandability**.

10.16 In addition to the costs to businesses of collecting, checking and publishing extra information, there is also an extra cost to users in terms of the additional time and effort that they will have to devote to analysing and understanding the new information.

On the other hand, a benefit of requiring additional information to be reported is that users won't have to carry out their own independent research to obtain the information from other sources, or to come up with their own estimates.

Review questions

10.1 Tom runs a business and his accountant, Claire, has recently prepared the business's annual financial statements. Tom doesn't know much about accounting, and Claire is explaining some of the figures in the statements. During the conversation, Claire makes the following comments:

- (i) 'Your assets are shown on the balance sheet based on what they originally cost, not what they're worth now.'
- (ii) 'Yes, I know your house is worth a lot of money, but we can't put it on your balance sheet!'
- (iii) 'Your profit for the year is based on the sales you made less the expenses you incurred. It's not the same as the cash you received minus the cash you paid!'
- (iv) 'Yes, I know your business has a really good reputation and lots of loyal customers, but I'm afraid we can't show these assets on your balance sheet.'
- (v) 'There's more than one way to calculate one or two things in your financial statements. But once we've chosen a particular accounting method, we need to stick with it from one year to the next, unless there's a good reason to change. We definitely can't just change it just to make your results look better!'

Required:

For each of the five comments, specify the accounting concept that Claire is referring to.

10.2A Carlos starts a business buying and selling a new type of foldaway commuter bike. In his first year of trading, he buys 100 bikes for £90 and sells 80 of them for £170 each. How should the 20 bikes in closing inventory be valued in his financial statements in each of the two following scenarios:

- (i) Carlos intends to continue trading as normal in his second year.
- (ii) The business is in serious financial difficulties and Carlos is unable to continue trading. The 20 remaining bikes will have to be sold to another business for £50 each?

Refer to any relevant accounting concepts in your answer.

10.3A The following questions all relate to the qualitative characteristics of useful financial information as defined by the IASB's *Conceptual Framework for Financial Reporting*:

- (i) To which characteristic is the concept of *materiality* most closely related?
- (ii) What three qualities would a piece of financial information possess if it was a perfectly *faithful representation*?
- (iii) The characteristic of *neutrality* should be supported by the application of which accounting concept?
- (iv) If a business applies a new accounting standard in its financial statements for the first time this year, which of the enhancing qualitative characteristics will almost certainly be diminished?
- (v) If different, independent experts can largely agree that a piece of information is a *faithful representation*, what enhancing characteristic is that information said to possess?
- (vi) To which of the enhancing characteristics is the accounting concept of *consistency* most closely related?

10.4 'The historical cost convention looks backwards but the going concern convention looks forwards.'

Required:

- (a) Explain clearly what is meant by:
 - (i) the historical cost convention;
 - (ii) the going concern convention.
- (b) Does traditional financial accounting, using the historical cost convention, make the going concern convention unnecessary? Explain your answer fully.
- (c) Which do you think a shareholder is likely to find more useful – a report on the past or an estimate of the future? Why?

(Association of Chartered Certified Accountants)

BOOKS AND TRANSACTIONS

Introduction

This part is concerned with the books into which transactions are first entered. It also includes a chapter on VAT. One important thing to realise is that most of what you will learn about in these chapters is now done using a computer. By learning how to make these entries yourself, you will be able to understand what has been done on a computer and use it effectively, just as if it had been done manually.

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Books of original entry and ledgers

Learning objectives

After you have studied this chapter, you should be able to:

- Justify the need for books of original entry.
- Explain what each book of original entry is used for.
- Describe the process of recording transactions in a book of original entry and then recording a summary of the transactions involving similar items in a ledger.
- Distinguish between personal and impersonal accounts.
- List the ledgers most commonly used and distinguish between those that are used for personal accounts and those that are used for impersonal accounts.
- Explain the broader role of an accountant, the communicator role that lies beyond the recording and processing of data about transactions.

Introduction

In this chapter, you will learn about the books in which details of accounting transactions are recorded. You will learn that Day Books are used to record all unpaid transactions made on credit and that the Cash Book is used to record all cash and bank transactions. Then, you will learn that these entries are transferred from the books of original entry to a set of books called Ledgers and that each Ledger is for a particular type of item and that, by having a set of Ledgers, entries in accounts of items of a similar nature are recorded in the same place.

11.1 The growth of the business

When a business is very small, all the double entry accounts can be kept in one book, which we would call a 'ledger'. As the business grows it would be impossible just to use one book, as the large number of pages needed for a lot of transactions would mean that the book would be too big to handle. Also, suppose we have several bookkeepers. They could not all do their work properly if there were only one ledger.

The answer to this problem was to use more books, with a book for each type of transaction; sales entered in one book, purchases in another book, cash in another book, and so on.

11.2 Books of original entry

When a transaction takes place, we need to record as much as possible of the details of the transaction. For example, if we sold four computers on time to a Mr De Souza for £1,000 per computer, we would want to record that we sold four computers for £1,000 each to Mr De Souza on time. We would also want to record the address and contact information of Mr De Souza and the date of the transaction. Some businesses would also record information like the identity of the person who sold them to Mr De Souza and the time of the sale.

Books of original entry are the books in which we first record transactions, such as the sale of the four computers. When we enter transactions in these books, we record:

- the date on which each transaction took place – the transactions should be entered in date order; and
- details relating to the sale (as listed in the computer example above), which are entered in a ‘details’ column.

Also,

- a folio column entry is made cross-referencing back to the original ‘source document’, e.g. the invoice; and
- the monetary amounts are entered in columns included in the books of original entry for that purpose.

11.3 Types of books of original entry

Books of original entry are known as **day books**. However, in the case of the last book of original entry shown below, it is always a **journal** and the second last is always known as the **cash book**. The term ‘day book’ is used for the others, as it more clearly indicates the nature of these books of original entry – entries are made to them every day. These commonly used books of original entry are:

- **Sales day book** – for credit sales.
- **Purchases day book** – for credit purchases.
- **Returns inwards day book** – for returns inwards.
- **Returns outwards day book** – for returns outwards.
- **Cash book** – for receipts and payments of cash and cheques.
- **Journal** – for other items.

Note: Some entities use the word ‘journal’ instead of ‘day book’. Be sure to remember this. Examiners may use either term in the name of the first four books listed above.

11.4 Using more than one ledger

Entries are made in the books of original entry. The entries are then summarised and the summary information is entered, using double entry, to accounts kept in the various ledgers of the business. One reason why a set of ledgers is used rather than just one big ledger is that this makes it easier to divide the work of recording all the entries between different bookkeepers.

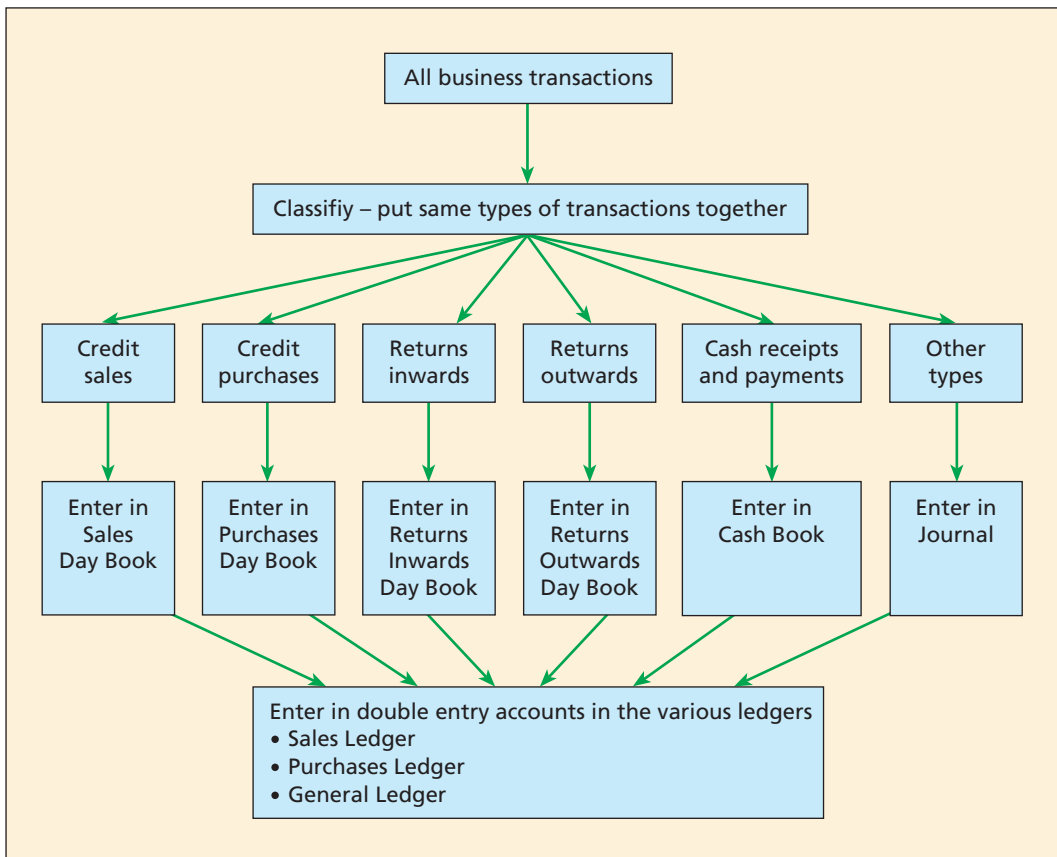
**Activity
11.1**

Why else do you think we have more than one ledger?

11.5 Types of ledgers

The different types of ledgers most businesses use are:

- **Sales ledger.** This is for customers' personal accounts – the trade receivables.
- **Purchases ledger.** This is for suppliers' personal accounts – the trade payables.
- **General ledger.** This contains the remaining double entry accounts, such as those relating to expenses, non-current assets, and capital.

11.6 A diagram of the books commonly used**11.7 Description of books used**

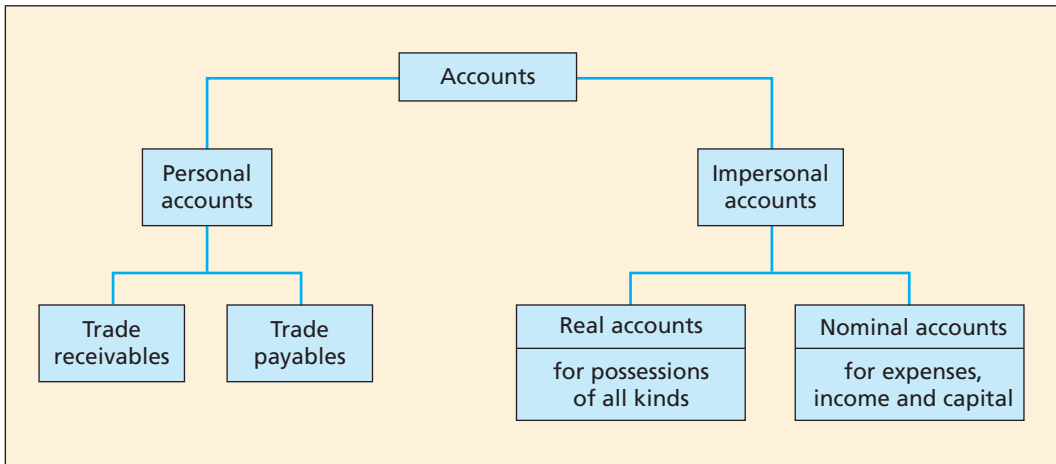
In the next few chapters we will look at the books used in more detail.

11.8 Types of accounts

Some people describe all accounts as personal accounts or as impersonal accounts.

- **Personal accounts** – these are for debtors and creditors (i.e. customers and suppliers).
- **Impersonal accounts** – divided between ‘real’ accounts and ‘nominal’ accounts:
 - Real accounts – accounts in which possessions are recorded. Examples are buildings, machinery, fixtures and inventory.
 - **Nominal accounts** – accounts in which expenses, income and capital are recorded.

A diagram may enable you to follow this better:



11.9 Nominal and private ledgers

The ledger in which the impersonal accounts are kept is known as the **Nominal** (or ‘General’) **Ledger**. In order to ensure privacy for the proprietor(s), the capital, drawings and other similar accounts are sometimes kept in a **Private Ledger**. This prevents office staff from seeing details of items which the proprietors want to keep secret.

Activity 11.2

Why bother with *books of original entry*? Why don’t we just enter transactions straight into the ledgers?

11.10 The accountant as a communicator

The impression is often given that all that an accountant does is produce figures arranged in various ways. This has led to a perception that accountants are boring, pragmatic people with no sense of humour. While it is true that such work does take up quite a lot of an accountant’s time, it does not account for all of a typical accountant’s work. **Accountants also need to be good communicators**, not just in the way they present accounting information on paper, but also in how they verbally communicate the significance of the information they prepare.

An accountant can obviously arrange the financial figures so as to present the information in as meaningful a way as possible for the people who are going to use that information. That is, after

all, what accountants are trained to do. If the financial figures are to be given to several people, all of whom are very knowledgeable about accounting, an accountant will simply apply all the conventions and regulations of accounting in order to present the information in the ‘normal’ accounting way, knowing full well that the recipients of the information will understand it.

On the other hand, accounting figures may well be needed by people who have absolutely no knowledge at all of accounting. In such a case, a typical accounting statement would be of little or no use to them. They would not understand it. In this case, an accountant might set out the figures in a completely different way to try to make it easy for them to grasp. For instance, instead of preparing a ‘normal’ income statement, the accountant might show the information as follows:

	£	£
In the year ended 31 December 2019 you sold goods for		100,000
Now, how much had those goods cost you to buy?		
At the start of the year you had inventory costing	12,000	
+ You bought some more goods in the year costing	<u>56,000</u>	
So altogether you had goods available to sell that cost	68,000	
– At the end of the year, you had inventory of goods unsold that cost	<u>(6,000)</u>	
So, the goods you had sold in the year had cost you	62,000	
Let us deduct this from what you had sold the goods for		<u>(62,000)</u>
This means that you had made a profit on buying and selling goods, before any other expenses had been paid, amounting to		38,000
(We call this type of profit the gross profit)		
But, during the year, you suffered other expenses such as wages, rent and electricity. The amount of these expenses, not including anything you took for yourself, amounted to		(18,000)
So, in this year your sales value exceeded all the costs involved in running the business (so that the sales could be made) by		<u>20,000</u>
(We call this type of profit the net profit)		

An accountant is failing to perform his or her role appropriately and effectively if the figures are not arranged so as to make them meaningful to the recipient. The accountant’s job is not just to produce figures for the accountant’s own consumption, it is to communicate the results to other people, many of whom know nothing about accounting.

Activity 11.3

Reconcile this observation with the fact (you will learn about in Chapters 35 to 37) that companies must follow the rules contained in accounting standards and the Companies Acts when preparing their financial statements.

Nowadays, communication skills are a very important part of the accountant’s role. Very often, the accountant will have to talk to people in order to explain the figures or send a letter or write a report about them. The accountant will also have to talk or write to people to find out exactly what sort of accounting information is needed by them, or to explain to them what sort of information could be provided.

If accounting examinations contained only computational questions, they would not test the ability of candidates to communicate in any way other than writing down accounting figures and, as a result, the examinations would fail to examine these other important aspects of the job.

In recent years much more attention has been paid by examining boards to these other aspects of an accountant’s work.

Learning outcomes

You should now have learnt:

- 1 That transactions are classified and details about them are entered in the appropriate book of original entry.
- 2 That the books of original entry are used as a basis for posting the transactions in summary form to the double entry accounts in the various ledgers.
- 3 That there is a set of books of original entry, each of which serves a specific purpose.
- 4 That there is a set of ledgers, each of which serves a specific purpose.
- 5 That accountants need to be good communicators.

Answers to activities

- 11.1** The most important reason is to aid analysis by keeping similar items together.
- 11.2** Books of original entry contain all the important information relating to a transaction. Ledgers just contain a summary. In fact, some of the entries in the ledgers are often just one-line entries covering an entire month of transactions.
- 11.3** There really is no conflict so far as financial information prepared for internal use is concerned, whether for companies, partnerships, or sole proprietors. Financial statements produced for consumption by users outside the business do have to conform to the conventions relating to content and layout. However, those prepared for internal use do not. There is no reason why they could not be prepared along the lines of the unconventionally laid-out income statement shown on p. 155. External stakeholders will never receive their financial statements in this highly user-friendly form. It is simply too much work to customise the financial statement for every class of stakeholder.

Learning objectives

After you have studied this chapter, you should be able to:

- Explain the format of two-column and three-column cash books.
- Enter up and balance-off cash books.
- Use folio columns for cross-referencing purposes.
- Make the entries for discounts allowed and discounts received both in the cash book and, at the end of a period, in the discount accounts in the general ledger.
- Make similar entries in separate columns in the cash book for other recurring items.

Introduction

In this chapter, you'll learn how businesses record cash and cheque transactions in the cash book. You'll learn that a memorandum column, called the 'folio column', is included in the cash book; and you'll learn the reasons why this is done. You will learn how to make the necessary entries in the cash book and how to include entries for discounts received from creditors and allowed to debtors, both in the cash book and in the general ledger.

12.1 Drawing up a cash book

The cash book consists of the cash account and the bank account put together in one book. We used to show these two accounts on different pages of the ledger. Now it is easier to put the two sets of account columns together. This means that we can record all money received and paid out on a particular date on the same page.

In the **cash book**, the debit column for cash is put next to the debit column for bank. The credit column for cash is put next to the credit column for bank.

Exhibit 12.1 shows how a cash account and a bank account would appear if they had been kept separately. In Exhibit 12.2, they are shown as if the transactions had, instead, been kept in a cash book.

The bank column contains details of the payments made by cheque and direct transfer from the bank account and of the money received and paid into the bank account. The bank will have a copy of the account in its own books.

Periodically, or on request from the business, the bank sends a copy of the account in its books to the business. This document is known as the **bank statement**. When the business receives the bank statement, it checks it against the bank columns in its cash book to ensure that there are no errors.

Exhibit 12.1

Cash							
2022			£	2022		£	
Aug	2	T. Moore	33	Aug	8	Printing	20
	5	K. Charles	25		12	C. Potts	19
	15	F. Hughes	37		28	Office stationery	25
	30	H. Howe	18		31	Balance c/d	49
			<u>113</u>				<u>113</u>
Sept	1	Balance b/d	49				
Bank							
2022			£	2022			£
Aug	1	Capital	10,000	Aug	7	Rent	205
	3	W. P. Ltd	244		12	F. Small Ltd	95
	16	K. Noone	408		26	K. French	268
	30	H. Sanders	20		31	Balance c/d	10,104
			<u>10,672</u>				<u>10,672</u>
Sept	1	Balance b/d	10,104				

Exhibit 12.2

Cash book								
			Cash	Bank			Cash	Bank
			£	£			£	£
2022					2022			
Aug	1	Capital		10,000	Aug	7	Rent	205
	2	T. Moore	33			8	Printing	20
	3	W. P. Ltd		244		12	C. Potts	19
	5	K. Charles	25			12	F. Small Ltd	95
	15	F. Hughes	37			26	K. French	268
	16	K. Noone		408		28	Office stationery	25
	30	H. Sanders		20		31	Balances c/d	49
	30	H. Howe	18					10,104
			<u>113</u>	<u>10,672</u>			<u>113</u>	<u>10,672</u>
Sept	1	Balances b/d	49	10,104				

12.2 Cash paid into the bank

In Exhibit 12.2, the payments into the bank were cheques received by the business. They have been banked immediately upon receipt. We must now consider cash being paid into the bank.

- 1 Let's look at the position when customers pay their account in cash and, later, a part of this cash is paid into the bank. The receipt of the cash is debited to the cash column on the date

received, the credit entry being in the customer's personal account. The cash banked has the following effect needing action:

Effect	Action
1 Asset of cash is decreased	Credit the asset account, i.e. the cash account which is represented by the cash column in the cash book.
2 Asset of bank is increased	Debit the asset account, i.e. the bank account which is represented by the bank column in the cash book.

A cash receipt of £100 from M. Davies on 1 August 2022 which was followed by the banking on 3 August of £80 of this amount would appear in the cash book as follows:

Cash book					
	Cash	Bank		Cash	Bank
2022	£	£	2022	£	£
Aug 1 M. Davies	100		Aug 3 Bank	80	
3 Cash		80			

The details column shows entries against each item stating the name of the account in which the completion of double entry has taken place. Against the cash payment of £80 appears the word 'bank', meaning that the debit of £80 is to be found in the bank column, and the opposite applies.

- Where the whole of the cash received is banked immediately the receipt can be treated in exactly the same manner as a cheque received, i.e. it can be entered directly into the bank column.
- If the business requires cash, it may withdraw cash from the bank. Assuming this is done by use of a cheque, the business would write out a cheque to pay itself a certain amount in cash. The bank will give cash in exchange for the cheque over the counter. It could also be done using a cash card. The effect on the accounts is the same.

The twofold effect and the action required is:

Effect	Action
1 Asset of bank is decreased	Credit the asset account, i.e. the bank column in the cash book.
2 Asset of cash is increased	Debit the asset account, i.e. the cash column in the cash book.

A withdrawal of £75 cash on 1 June 2022 from the bank would appear in the cash book as:

Cash book					
	Cash	Bank		Cash	Bank
2022	£	£	2022	£	£
June 1 Bank	75		June 1 Cash		75

Both the debit and credit entries for this item are in the same book. When this happens it is known as a **contra** item.

12.3 The use of folio columns

As you have already seen, the details column in an account contains the name of the account in which the other part of the double entry has been entered. Anyone looking through the books should, therefore, be able to find the other half of the double entry in the ledgers.

However, when many books are being used, just to mention the name of the other account may not be enough information to find the other account quickly. More information is needed, and this is given by using **folio columns**.

In each account and in each book being used, a folio column is added, always shown on the left of the money columns. In this column, the name of the other book and the number of the page in the other book where the other part of the double entry was made is stated against each and every entry.

So as to ensure that the double entry is completed, **the folio column should only be filled in when the double entry has been completed**.

An entry for receipt of cash from C. Kelly whose account was on page 45 of the sales ledger, and the cash recorded on page 37 of the cash book, would have the following folio column entries:

- in the cash book, the folio column entry would be SL 45
- in the sales ledger, the folio column entry would be CB 37.

Note how each of the titles of the books is abbreviated so that it can fit into the space available in the folio column. Each of any contra items (transfers between bank and cash) being shown on the same page of the cash book would use the letter 'c' (for 'contra') in the folio column. There is no need to also include a page number in this case.

The act of using one book as a means of entering transactions into the accounts, so as to perform or complete the double entry, is known as **posting**. For example, you 'post' items from the sales day book to the appropriate accounts in the sales ledger and to the sales account and you 'post' items from the cash book to the appropriate accounts in the sales ledger.

Activity 12.1

Why do you think only one account is posted to from the cash book rather than two, which is what happens with postings from the other day books (i.e. the other books of original entry)?

12.4 Advantages of folio columns

As described in Section 12.3, folio entries speed up the process of finding the other side of the double entry in the ledgers.

Activity 12.2

What other advantage can you think of for using a folio column?

12.5 Example of a cash book with folio columns

The following transactions are written up in the form of a cash book. The folio columns are filled in as though all the double entries had been completed to other accounts.

2022			£
Sept	1	Proprietor puts capital into a bank account for the business.	10,940
	2	Received cheque from M. Boon.	315
	4	Cash sales.	802
	6	Paid rent by cash.	135
	7	Banked £50 of the cash held by the business.	50
	15	Cash sales paid direct into the bank.	490
	23	Paid cheque to S. Wills.	277
	29	Withdrew cash from bank for business use.	120
	30	Paid wages in cash.	518

Cash book (page 1)							
2022		Folio	Cash £	Bank £	2022		Folio Cash £
Sept	1 Capital	GL1		10,940	Sept	6 Rent	GL65 135
	2 M. Boon	SL98		315		7 Bank	£ 50
	4 Sales	GL87	802			23 S. Wills	PL23 277
	7 Cash	£		50		29 Cash	£ 120
	15 Sales	GL87		490		30 Wages	GL39 518
	29 Bank	£	120			30 Balance	c/d 219 11,398
			<u>922</u>	<u>11,795</u>			<u>922</u> <u>11,795</u>
Oct	1 Balances	b/d	219	11,398			

The abbreviations used in the folio column are:

GL = general ledger SL = sales ledger £ = contra PL = purchases ledger

12.6 Prompt payment discounts

Businesses prefer to collect money from customers sooner rather than later. Some businesses therefore offer **prompt payment discounts** to their customers to encourage them to pay quickly. These are also known as **early settlement discounts** or **cash discounts**.

The rate of prompt payment discount is usually stated as a percentage. This percentage, along with the time limit within which payment must be made, will be stated on the sales documents issued by the seller.

12.7 Prompt payment discounts allowed and received

A business may have two types of prompt payment discounts in its books:

- Discounts allowed:** these are prompt payment discounts that the business allows its customers to deduct when they pay quickly.
- Discounts received:** these are prompt payment discounts that the business deducts when it pays its suppliers quickly.

Traditionally, when a business made a sale and offered a prompt payment discount, the sale would be permanently recorded at the full selling price. If the customer subsequently paid promptly then the discount would be shown as an expense in the income statement.

However, accounting standard IFRS 15 *Revenue from Contracts with Customers* has changed this. **Under IFRS 15, a business's sales revenue should be reported net of any discounts taken by its customers, including prompt payment discounts.**

This creates a difficulty because, when the sale is made, the seller doesn't know whether the buyer will pay quickly and take the discount.

If the guidance in IFRS 15 is followed to the letter, every time a business makes a sale and offers a prompt payment discount it should predict (on the basis of past experience) whether the customer is likely to take that discount. If it expects (for example) that the customer *will* take the discount then the sale should be recorded at the price minus the discount. If the customer then ends up not taking the discount then the sales account will subsequently need to be credited with the extra revenue.

This is a somewhat cumbersome system to expect a sole proprietor to adopt. Moreover, the prompt payment discounts offered by the simple trading businesses in this book will typically only be 1%–5% of the selling price, so the amounts involved will be very small. Therefore in this book we will adopt a simplified system that still ultimately complies with the requirements of IFRS 15.

When a sale is made on credit terms and a prompt payment discount is offered, we'll always assume that the discount is unlikely to be taken and simply record the sale at full price. The approach is illustrated in the two examples below:

Example 1: Prompt payment discounts offered to customers

A business makes a sale to W. Clarke on 28 August 2022, and a 5% discount is offered for payment within 7 days. Clarke pays £95 in cash on 2 September in full settlement (£100 – 5% = £95).

Event	Effect	Action
Sale made on 28 August 2022	Asset of trade receivables increases by £100	Debit W. Clarke £100
	Sales income increases by £100	Credit Sales £100
Cash received on 2 September 2022	Asset of cash increases by £95	Debit Cash (cash column of cash book) £95
	Asset of trade receivables decreases by £95	Credit W. Clarke £95
Discount allowed on 2 September 2022	Income earned from sales decreases by £5	Debit Discounts allowed £5
	Asset of trade receivables decreases by £5 (i.e. the original debt was cleared in full)	Credit W. Clarke £5

In the income statement, the balance on the discounts allowed account will be deducted from the figure for sales revenue in order to reflect the actual amount earned from sales (in this instance £95) in accordance with IFRS 15.

We will account for prompt payment discounts received from suppliers using an approach that is consistent with the treatment above. Example 2 illustrates.

Example 2: Prompt payment discounts received from suppliers

A business purchases goods from S. Small for £400 on 29 August 2022. Small offers a 2½ per cent discount for payment within 10 days. The business pays £390 by cheque on 3 September in full settlement (£400 – 2½% = £390).

Event	Effect	Action
<i>Purchase made on 29 August 2022</i>	Expense of purchases increases by £400	Debit Purchases £400
	Liability of trade payables increases by £400	Credit S. Small £400
<i>Cheque paid on 3 September 2022</i>	Liability of trade payables decreases by £390	Debit S. Small £390
	Asset of bank decreases by £390	Credit Bank (bank column of cash book) £390
<i>Discount received on 3 September 2022</i>	Liability of trade payables decreases by £10 (i.e. the original amount owed was settled in full)	Debit S. Small £10
	Expense of purchases decreases by £10	Credit Discounts received £10

In the income statement, the balance on the discounts received account will be deducted from the figure for purchases in order to reflect the actual cost of purchases (in this instance £390) consistent with the guidance of IFRS 15.

The entries in the business's books in relation to the cash received and paid in September 2022 will be:

Cash book (page 32)							
	Folio	Cash	Bank		Folio	Cash	Bank
2022		£	£	2022		£	£
Sept 2 W. Clarke	SL12	95		Sept 3 S. Small	PL75		390

Discounts received

(General Ledger page 18)

	Folio	£
2022 Sept 2 S. Small	PL75	10

Discounts allowed

(General Ledger page 17)

	Folio	£
2022 Sept 2 W. Clarke	SL12	5

W. Clarke

(Sales Ledger page 12)

	Folio	£		Folio	£
2022 Sept 1 Balance	b/d	100	2022 Sept 2 Cash	CB32	95
			2 Discount	GL17	5
		<u>100</u>			<u>100</u>

S. Small					(Purchases Ledger page 75)		
			Folio	£			
2022					2022		
Sept	3	Bank	CB32	390	Sept	1	Balance
	3	Discount	GL18	10			b/d
				<u>400</u>			<u>400</u>

It is the accounting custom to enter the word 'Discount' in the personal accounts without stating whether it is a discount received or a discount allowed.

Activity 12.3

Why do you think it is accounting custom only to enter the word 'Discount' in the personal accounts?

12.8 Discounts columns in cash book

The *discounts allowed account* and the *discounts received account* are in the general ledger along with all the other revenue and expense accounts. It has already been stated that every effort should be made to avoid too many entries in the general ledger. To avoid this, we add two columns for discount in the cash book.

An extra column is added on each side of the cash book in which the amounts of discounts are entered. Discounts received are entered in the discounts column on the credit side of the cash book, and discounts allowed in the discounts column on the debit side of the cash book.

The cash book entries for the two examples so far dealt with would be:

Cash book (page 32)									
	Folio	Discount	Cash	Bank		Folio	Discount	Cash	Bank
2022		£	£	£	2022		£	£	£
Sept 2 W. Clarke	SL12	5	95		Sept 3 S. Small	PL75	10		390

There is no alteration to the method of showing discounts in the personal accounts.

To make entries in the discounts accounts in the general ledger

At the end of the period:

Total of discounts column on receipts side of cash book } Enter on **debit** side of discounts allowed account.

Total of discounts column on payments side of cash book } Enter on **credit** side of discounts received account.

12.9 A worked example

2022				£
May	1	Balances brought down from April:		
		Cash balance		29
		Bank balance		654
		Trade receivable accounts:		
		B. King		120
		N. Campbell		280
		D. Shand		40
		Trade payable accounts:		
		U. Barrow		60
		A. Allen		440
		R. Long		100
	2	B. King pays us by cheque, having deducted 2.5% prompt payment discount £3.		117
	8	We pay R. Long his account by bank transfer, deducting 5% prompt payment discount £5.		95
	11	We withdrew £100 cash from the bank for business use.		100
	16	N. Campbell pays us his account by cheque, deducting 2.5% prompt payment discount £7.		273
	25	We paid office expenses in cash.		92
	28	D. Shand pays us in cash, deducting 5% prompt payment discount.		38
	29	We pay U. Barrow by bank transfer less 5% prompt payment discount £3.		57
	30	We pay A. Allen by cheque less 2.5% prompt payment discount £11.		429

Folio numbers have been included in the solution for completeness.

Cash book										(page 64)	
		Folio	Discount	Cash	Bank			Folio	Discount	Cash	Bank
2022			£	£	£	2022			£	£	£
May	1 Balance	b/d		29	654	May	8 R. Long	PL58	5		95
	2 B. King	SL13	3		117		11 Cash	¢			100
	11 Bank	¢		100			25 Office	GL77		92	
	16 N. Campbell	SL84	7		273		expenses				
	28 D. Shand	SL91	2	38			29 U. Barrow	PL15	3		57
							30 A. Allen	PL98	11		429
							31 Balances	c/d		75	363
			<u>12</u>	<u>167</u>	<u>1,044</u>				<u>19</u>	<u>167</u>	<u>1,044</u>
Jun	1 Balances	b/d		75	363						

Sales ledger (page 13)						
B. King						
		Folio	£		Folio	£
2022				2022		
May	1 Balance	b/d	120	May	2 Bank	CB64 117
					2 Discount	CB64 3
			<u>120</u>			<u>120</u>

*N. Campbell**(page 84)*

2022			<i>Folio</i>	£	2022		<i>Folio</i>	£
May	1	Balance	b/d	280	May	16	CB64	273
				<u>280</u>		16	CB64	<u>7</u>
								<u>280</u>

*D. Shand**(page 91)*

2022			<i>Folio</i>	£	2022		<i>Folio</i>	£
May	1	Balance	b/d	40	May	28	CB64	38
				<u>40</u>		28	CB64	<u>2</u>
								<u>40</u>

Purchases ledger*U. Barrow**(page 15)*

2022			<i>Folio</i>	£	2022		<i>Folio</i>	£
May	29	Bank	CB64	57	May	1	b/d	60
	29	Discount	CB64	<u>3</u>				<u>60</u>
				<u>60</u>				

*R. Long**(page 58)*

2022			<i>Folio</i>	£	2022		<i>Folio</i>	£
May	8	Bank	CB64	95	May	1	b/d	100
	8	Discount	CB64	<u>5</u>				<u>100</u>
				<u>100</u>				

*A. Allen**(page 98)*

2022			<i>Folio</i>	£	2022		<i>Folio</i>	£
May	30	Bank	CB64	429	May	1	b/d	440
	30	Discount	CB64	<u>11</u>				<u>440</u>
				<u>440</u>				

General ledger*Office expenses**(page 77)*

2022			<i>Folio</i>	£				
May	25	Cash	CB64	92				

*Discounts received**(page 88)*

				2022		<i>Folio</i>	£
				May	31	CB64	19

*Discounts allowed**(page 89)*

2022			<i>Folio</i>	£			
May	31	Total for the month	CB64	12			

Is the above method of entering discounts shown in the last two accounts correct?

You can easily check:

Discounts in ledger accounts	Debits	Credits
Discounts received	<div style="text-align: right;">£</div> <div style="text-align: right;">U. Barrow 3</div> <div style="text-align: right;">R. Long 5</div> <div style="text-align: right;">A. Allen <u>11</u></div> <div style="text-align: right;"><u>19</u></div>	<div style="text-align: right;">Discounts received <u>£19</u></div>
Discounts allowed	<div style="text-align: right;">Discounts allowed <u>£12</u></div>	<div style="text-align: right;"> <div style="text-align: right;">B. King 3</div> <div style="text-align: right;">N. Campbell 7</div> <div style="text-align: right;">D. Shand <u>2</u></div> <div style="text-align: right;"><u>12</u></div> </div>

You can see that proper double entry has been carried out. Equal amounts, in total, have been entered on each side of the two discount accounts.

12.10 Bank overdrafts

A business may borrow money from a bank by means of a bank **overdraft**. This means that the business is allowed to pay more out of its bank account than the total amount it has deposited in the account.

Up to this point, the bank balances have all been money at the bank, so they have all been assets, i.e. debit balances. When the bank account is overdrawn, the business owes money to the bank, so the account is a liability and the balance becomes a credit one.

Taking the cash book last shown, suppose that the amount payable to A. Allen was £1,429 instead of £429. The amount in the bank account, £1,044, is exceeded by the amount withdrawn. We will take the discount for Allen as being £11. The cash book would appear as follows:

Cash book								(page 64)
2022		Discount	Cash	Bank	2022	Discount	Cash	Bank
		£	£	£		£	£	£
May	1 Balances b/d		29	654	May	8 R. Long	5	95
	2 B. King	3		117		11 Cash		100
	11 Bank		100			25 Office		
	16 N. Campbell	7		273		expenses	92	
	28 D. Shand	2	38			29 U. Barrow	3	57
	31 Balance c/d					30 A. Allen	11	1,429
				637		31 Balance c/d		75
		<u>12</u>	<u>167</u>	<u>1,681</u>			<u>19</u>	<u>1,681</u>
Jun	1 Balance b/d		75		Jun	1 Balance b/d		637

On a balance sheet, a bank overdraft is included under the heading 'current liabilities'.

12.11 Bank cash books

In the United Kingdom, except for very small organisations, three-column cash books are not usually used. All receipts, whether of cash or cheques, will be banked daily. A 'petty cash book' will be used for payments of cash. As a result, there will be no need for cash columns in the cash book itself.

This move towards only recording bank transactions in the cash book is not yet evident in countries where banking systems are not as developed or as efficient as in the UK.

12.12 Multiple column cash book

In Chapter 13, you will learn how to prepare an analytical (or multiple column) petty cash book. Cash books are often prepared with multiple columns where additional columns are added for each ledger account to which many entries may be made in a period. As with columns for discount, this has the advantage of reducing the number of entries made in the accounts in the general ledger.

Learning outcomes

You should now have learnt:

- 1 That a cash book consists of a cash account and a bank account put together into one book.
- 2 How to enter up and balance a two-column cash book, i.e. one containing a debit and a credit column for the bank account, and a debit and a credit column for the cash account.
- 3 That the bank columns in the cash book are for cheques and any other transfers of funds that have been made into or out of the bank account.
- 4 That a folio column is included in the cash book so as to help trace entries made into accounts in the ledgers and so as to provide assurance that the double entries have been made.
- 5 That prompt payment discounts (also known as early settlement discounts or cash discounts) are sometimes offered to customers to encourage them to pay quickly, within a certain time limit.
- 6 That prompt payment discounts which a business allows its customers to deduct when they pay quickly are known as *discounts allowed*.
- 7 That prompt payment discounts which a business deducts when it pays its suppliers quickly are known as *discounts received*.
- 8 That the total discounts allowed to customers for the period should be deducted from the figure for 'sales' in the income statement.
- 9 That the total discounts received from suppliers in the period should be deducted from the figure for 'purchases' in the income statement.
- 10 How to enter up and balance a three-column cash book, i.e. one containing a debit and a credit column for the bank account, a debit and a credit column for the cash account, and a debit and a credit column for discount.

- 11 That the discounts columns in the cash book make it easier to enter up the books. They act as a collection point for discounts allowed and discounts received, for which double entry into the general ledger is completed when the totals are transferred to the discount accounts in the general ledger, usually at the end of the month.
- 12 That a multiple-column cash book is often used in order to further reduce the number of entries made in the general ledger.
- 13 How to add additional columns to the cash book for frequently recurring items and make the appropriate entries in them and in the general ledger.

Answers to activities

- 12.1 Although the cash book is a book of original entry, it is also where the cash account and bank account are recorded. In effect, it is both a book of original entry and a ledger dedicated to those two accounts. As a result, each transaction in the cash book is only posted once to another account, the first part of the entry having been made when the transaction was recorded in the cash book.
- 12.2 If an entry has not been filled in, i.e. if the folio column is blank against an entry, the double entry has not yet been made. As a result, looking through the entry lines in the folio columns to ensure they have all been filled in helps detect such errors quickly.
- 12.3 It should be quite obvious whether discount is received or allowed. And, more importantly, the double entry is with the cash book columns for discount, not with either the discount allowed account or the discount received account in the general ledger. At the end of the period (usually a month) the totals of the two discount columns in the cash book are posted to the discount allowed and discount received accounts in the general ledger.

Review questions

- 12.1 Write up a two-column cash book for a bedroom furniture shop from the following details, and balance it off as at the end of the month:

- July
- 1 Started in business with capital in cash £10,000.
 - 2 Paid rent by cash £1,000.
 - 3 G. Broad lent us £12,000, paid by cheque.
 - 4 We paid J. Fine by cheque £1,800.
 - 5 Cash sales £800.
 - 7 F. Love paid us by cheque £200.
 - 9 We paid A. Moore in cash £300.
 - 11 Cash sales paid direct into the bank £600.
 - 15 P. Hood paid us in cash £700.
 - 16 We took £4,000 out of the cash till and paid it into the bank account.
 - 19 We repaid G. Broad £2,000 by cheque.
 - 22 Cash sales paid direct into the bank £1,200.
 - 26 Paid motor expenses by cheque £460.
 - 30 Withdrew £320 cash from the bank for business use.
 - 31 Paid wages in cash £1,200.



→ **12.2A** Write up a two-column cash book for a second-hand bookshop from the following:

- Nov
- 1 Balance brought forward from last month: Cash £295; Bank £4,240.
 - 2 Cash sales £310.
 - 3 Took £200 out of the cash till and paid it into the bank.
 - 4 F. Bell paid us by cheque £194.
 - 5 We paid for postage stamps in cash £80.
 - 6 Bought office equipment by cheque £310.
 - 7 We paid L. Root by cheque £94.
 - 9 Received business rates refund by cheque £115.
 - 11 Withdrew £150 from the bank for business use.
 - 12 Paid wages in cash £400.
 - 13 Cash sales £430.
 - 14 Paid motor expenses by cheque £81.
 - 16 J. Bull lent us £1,500 in cash.
 - 20 K. Brown paid us by cheque £174.
 - 28 We paid general expenses in cash £35.
 - 30 Paid insurance by cheque £320.

12.3 A three-column cash book for a wine wholesaler is to be written up from the following details, balanced-off, and the relevant discount accounts in the general ledger shown.

- Mar
- 1 Balances brought forward: Cash £620; Bank £7,142.
 - 2 The following paid their accounts by cheque, in each case deducting 5% prompt payment discounts: G. Slick £260; P. Fish £320; T. Old £420 (all amounts are pre-discount).
 - 4 Paid rent by cheque £430.
 - 6 F. Black lent us £5,000 paying by cheque.
 - 8 We paid the following accounts by cheque in each case deducting a 2½% prompt payment discount: R. White £720; G. Green £960; L. Flip £1,600 (all amounts are pre-discount).
 - 10 Paid motor expenses in cash £81.
 - 12 J. Pie pays his account of £90, by cheque £88, deducting £2 prompt payment discount.
 - 15 Paid wages in cash £580.
 - 18 The following paid their accounts by cheque, in each case deducting 5% prompt payment discount: A. Pony £540; B. Line & Son £700; T. Owen £520 (all amounts are pre-discount).
 - 21 Cash withdrawn from the bank £400 for business use.
 - 24 Cash drawings £200.
 - 25 Paid W. Peat his account of £160, by cash £155, having deducted £5 prompt payment discount.
 - 29 Bought fixtures paying by cheque £720.
 - 31 Received commission by cheque £120.

12.4A Enter the following in the three-column cash book of an office supply shop. Balance-off the cash book at the end of the month and show the discount accounts in the general ledger.

- June
- 1 Balances brought forward: Cash £420; Bank £4,940.
 - 2 The following paid us by cheque, in each case deducting a 5% prompt payment discount: S. Braga £820; L. Pine £320; G. Hodd £440; M. Rae £1,040.
 - 3 Cash sales paid direct into the bank £740.
 - 5 Paid rent by cash £340.

- 6 We paid the following accounts by cheque, in each case deducting 2½% prompt payment discount: M. Peters £360; G. Graham £960; F. Bell £400.
- 8 Withdrew cash from the bank for business use £400.
- 10 Cash sales £1,260.
- 12 B. Age paid us their account of £280 less £4 prompt payment discount, by cheque.
- 14 Paid wages by cash £540.
- 16 We paid the following accounts by cheque: R. Todd £310 less prompt payment discount £15; F. Suniti £412 less prompt payment discount £12.
- 20 Bought fixtures by cheque £4,320.
- 24 Bought lorry paying by cheque £14,300.
- 29 Received £324 cheque from A. Line.
- 30 Cash sales £980.
- 30 Bought stationery paying by cash £56.

12.5 On 1 September, R. Macve, a club manager and entrepreneur, has the following financial position relating to her activities as a corporate function organiser:

	£
Balance at bank	40,000
Trade receivables – K. Hoskin	20,000
– G. Volmers	8,000
– G. Carnegie	4,000
Inventory	38,000
Trade payables – Real Fine Ales	32,800
– R. Goldthwaite	1,000

During September the following events occur:

- 1 K. Hoskin settles his account after taking a prompt payment discount of 10%.
- 2 G. Volmers is declared bankrupt and no payments are anticipated in respect of the debt.
- 3 G. Carnegie pays in full.
- 4 Both creditors are paid. Real Fine Ales had indicated that, because of the speed of payment, a 5 per cent quick settlement discount may be deducted from the payment.

Required:

- (a) Use T-accounts to open a bank account and the accounts for the trade receivables and trade payables at 1 September.
- (b) Record the above transactions for September.
- (c) Balance-off the accounts at the end of the month.

12.6A At 1 September the financial position of Sara Young's business was:

	£
Cash in hand	80
Balance at bank	900
Trade receivables: AB	200
CD	500
EF	300
Inventory	1,000
Trade payables: GH	600
IJ	1,400





During September:

- 1 The three debtors settled their accounts by cheque subject to a prompt payment discount of 4%.
- 2 A cheque for £100 was cashed for office use.
- 3 The amount owing to GH was paid by cheque less $7\frac{1}{2}\%$ prompt payment discount.
- 4 IJ's account was settled, subject to a prompt payment discount of 5%, by cheque.
- 5 Wages of £130 were paid in cash.

Required:

- (a) Open a three-column cash book and the accounts for the trade receivables and trade payables at 1 September.
- (b) Record the above transactions for September in the accounts you opened in (a).

The analytical petty cash book and the imprest system

Learning objectives

After you have studied this chapter, you should be able to:

- Explain why many organisations use a petty cash book.
- Make entries in a petty cash book.
- Transfer the appropriate amounts from the petty cash book to the ledgers at the end of each period.
- Explain and operate the imprest system for petty cash.

Introduction

You may remember that you learnt in Chapter 12 that there is a second type of cash book, called the **petty cash book**, which many businesses use to record small amounts paid for in cash. In this chapter, you'll learn of the type of items that are recorded in the petty cash book, and how to make the entries to it. You'll also learn how to transfer financial data from the petty cash book into the ledgers. Finally, you will learn about bank cash books and how they differ from the cash books you learnt about in Chapter 12.

13.1 Division of the cash book

As businesses continue to grow, some have a commercial value in excess of that of many smaller countries. For many, it has become necessary to have several books instead of just one ledger. In fact, if accounting was still done manually, nowadays all but the very smallest organisations would have multiple ledgers and day books.

Activity 13.1

Why do we have day books? Why don't we just enter every transaction directly into the appropriate ledger accounts?

The cash book became a book of original entry so that all cash and bank transactions could be separated from the rest of the accounts in the general ledger. It is for much the same reason that many organisations use a petty cash book. Every business has a number of transactions of very small value. If they were all recorded in the cash book, it would only make it more difficult to identify the important transactions in that book that businesses need to keep a close eye on. **Just like the cash book, the petty cash book is both a book of original entry and a ledger account.**

To create a trail of evidence, when a payment is made from petty cash, the recipient completes a voucher describing what the payment was for, attaches receipts, e.g. for petrol, to the voucher, and signs the voucher to confirm receipt of the cash.

The advantages of using a petty cash book are:

- 1 The cashier (the person responsible for recording entries in the cash book) can delegate these entries to a junior member of staff whose lower salary is less costly to the business.
- 2 If small cash payments were entered into the main cash book, these items would then need posting one by one to the ledgers. For example, if travelling expenses were paid to staff on a daily basis, this could mean approximately 250 postings to the staff travelling expenses account during the year, i.e. 5 days per working weeks per year. If a petty cash book is used, it would only be the entries for the 12 monthly totals that would be posted to the general ledger.

13.2 The imprest system

It is all very well having a petty cash book, but where does the money paid out from it come from? The **imprest system** is one where the cashier provides enough cash to meet the petty cash needs for the following period. At the end of the period, the cashier tops up the amount remaining in petty cash to bring it back up to the level it was at when the period started. This process is the imprest system and this topped-up amount is known as the petty cash **float**.

Exhibit 13.1 shows an example of this method.

Exhibit 13.1

		£
<i>Period 1</i>	The cashier gives the petty cashier	100
	The petty cashier pays out in the period	<u>(78)</u>
	Petty cash now in hand	22
	The cashier now gives the petty cashier the amount spent	<u>78</u>
	Petty cash in hand at the end of Period 1	100
<i>Period 2</i>	The petty cashier pays out in the period	<u>(84)</u>
	Petty cash now in hand	16
	The cashier now gives the petty cashier the amount spent	<u>84</u>
	Petty cash in hand at the end of Period 2	<u>100</u>

Over time, the float may need to be increased. For instance, if at the end of the second period above we wanted to increase the float to £120, an extra £20 would have been given added to the float, i.e. $£84 + £20 = £104$.

Sometimes no petty cash book is kept. Instead, at the end of each period, the amount left in petty cash is reconciled (i.e. checked and verified as correct) with the receipts held by the petty cashier. The amount spent is then given to the petty cashier in order to restore the float to its agreed level. However, this is not an ideal method to adopt. Businesses need to control the uses of all their resources, including petty cash, and so virtually every organisation that operates a petty cash float maintains a petty cash book. The most common format adopted is the ‘analytical petty cash book’.

13.3 Illustration of an analytical petty cash book

An analytical petty cash book is shown in Exhibit 13.2. This example shows one for a nursery school.

Exhibit 13.2

Petty Cash Book (page 31)											
Receipts	Folio	Date	Details	Voucher No.	Total	Motor Expenses	Staff Travelling Expenses	Postage	Cleaning	Ledger Folio	Ledger Accounts
£					£	£	£	£		£	
300	CB 19	Sept 1	Cash								
		2	Petrol	1	16	16					
		3	J. Green	2	23		23				
		3	Postage	3	12			12			
		4	D. Davies	4	32		32				
		7	Cleaning	5	11				11		
		9	Petrol	6	21	21					
		12	K. Jones	7	13		13				
		14	Petrol	8	23	23					
		15	L. Black	9	5		5				
		16	Cleaning	10	11				11		
		18	Petrol	11	22	22					
		20	Postage	12	12			12			
		22	Cleaning	13	11				11		
		24	G. Wood	14	7		7				
		27	C. Brown	15	13					PL18	13
		29	Postage	16	12	—	—	12	—		—
					244	82	80	36	33		13
						GL	GL	GL	GL		
244	CB 22	30	Cash			17	29	44	64		
		30	Balance	c/d	300						
544					544						
300		Oct 1	Balance	b/d							

The receipts column is the debit side of the petty cash book. On giving £300 to the petty cashier on 1 September, the credit entry is made in the cash book while the debit entry is made in the petty cash book. A similar entry is made on 30 September for the £244 paid by the headteacher to the petty cashier. As this amount covers all the expenses paid by the petty cashier, the float is now restored to its earlier level of £300. The credit side is used to record all the payments made by the petty cashier.

The transactions that were recorded in the petty cash book were:

2019	Voucher number			£
Sept	1	–	The head teacher gives £300 as float to the petty cashier	
			<i>Payments out of petty cash during September:</i>	
	2	1	Petrol: School bus	16
	3	2	J. Green – travelling expenses of staff	23
	3	3	Postage	12
	4	4	D. Davies – travelling expenses of staff	32
	7	5	Cleaning expenses	11
	9	6	Petrol: School bus	21
	12	7	K. Jones – travelling expenses of staff	13
	14	8	Petrol: School bus	23
	15	9	L. Black – travelling expenses of staff	5
	16	10	Cleaning expenses	11
	18	11	Petrol: School bus	22
	20	12	Postage	12
	22	13	Cleaning expenses	11
	24	14	G. Wood – travelling expenses of staff	7
	27	15	Settlement of C. Brown's account in the Purchases Ledger	13
	29	16	Postage	12
	30	–	The headteacher reimburses the petty cashier the amount spent in the month.	

The process followed during the period that led to these entries appearing in the petty cash book as shown in Exhibit 13.2 is:

- 1 Enter the date and details of each payment. Put the amount paid in the Total column.
- 2 Put the same amount in the column for that type of expense.
- 3 At the end of each period, add up the Total column.
- 4 Add up each of the expense columns. The total found in step 3 should equal the total of all the expense columns. In Exhibit 13.2 this is £244.
- 5 Enter the amount reimbursed to make up the float in the Receipts column.
- 6 Balance-off the petty cash book, carrying down the petty cash in hand balance to the next period.

To make the double entries in the ledger:

- 1 The total of each expense column is debited to the appropriate expense account.
- 2 The folio number of each expense account in the general ledger is entered under the appropriate expense column in the petty cash book. (This signifies that the double entry to the ledger account has been made.)
- 3 The last column in the petty cash book is a Ledger column. It contains entries for items paid out of petty cash that need posting to a ledger other than the general ledger. (This might arise, for example, if a purchases ledger account was settled out of petty cash.)

Activity 13.2

Where is the other side of the double entry for all these expense postings to the ledgers recorded?

The account entries in the cash book for the two additions to the float in Exhibit 13.2 are shown in Exhibit 13.3.

Exhibit 13.3

Cash Book (Bank and Folio columns only)				(page 19)	
	2019			Folio	£
	Sept	1	Petty cash	PCB 31	300
		30	Petty cash	PCB 31	244

Learning outcomes

You should now have learnt:

- 1 That the petty cash book saves (a) the cash book and (b) the ledger accounts from containing a lot of trivial detail.
- 2 That the use of the petty cash book enables the cashier or a senior member of staff to delegate this type of work to a more junior member of staff.
- 3 That the cashier should periodically check the work performed by the petty cashier.
- 4 That all payments made by the petty cashier should have petty cash vouchers as evidence of proof of expense.
- 5 How to enter petty cash transactions into the petty cash book.
- 6 How to transfer the totals for each expense recorded in the petty cash book to the appropriate ledger accounts.
- 7 How to operate a float system for petty cash.

Answers to activities

- 13.1** One reason why we have day books is to avoid too much detail being entered in the ledgers.
- 13.2** In the petty cash book. Like the cash book, the petty cash book is not only a book of original entry, it is also an account that would otherwise appear in the general ledger.

Review questions

13.1 The following is a summary of the petty cash transactions of a new business, Jockfield Ltd, for May 2024:

May	1	Received from Cashier £300 as petty cash float	£
	2	Postage	18
	3	Travelling	12
	4	Cleaning	15
	7	Petrol for delivery van	22
	8	Travelling	25
	9	Stationery	17
	11	Cleaning	18
	14	Postage	5
	15	Travelling	8
	18	Stationery	9
	18	Cleaning	23
	20	Postage	13
	24	Delivery van 5,000-mile service	43
	26	Petrol	18
	27	Cleaning	21
	29	Postage	5
	30	Petrol	14

You are required to:

- Rule up a suitable petty cash book with analysis columns for expenditure on cleaning, motor expenses, postage, stationery, travelling.
- Enter the month's transactions.
- Enter the receipt of the amount necessary to restore the imprest and carry down the balance for the commencement of the following month.
- State how the double entry for the expenditure is completed.

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13.2 Martin Battle runs a business and maintains a petty cash book using the imprest system. The cash float is £150. For June 2020 his petty cash transactions were as below:

			£
June	1	Petty cash balance	32.17
	2	Petty cashier presented vouchers for May 2020 to the cashier, receiving cash to restore the imprest	?
	5	Paid for postage stamps	17.57
	9	Paid for office coffee and biscuits	11.48
	13	Paid for taxi fares	18.00
	18	Paid for minor items of stationery	22.16
	22	Paid for cleaning materials	14.38
	23	Paid for herbal teabags for the office	9.95
	28	Paid for train fares	38.75
	30	Petty cashier presented vouchers for June 2020 to the cashier, receiving cash to restore the imprest	?

Required:

- Write up the petty cash book for June 2020, showing the balance carried down at the end of the month.
- Explain why most businesses maintain a petty cash book as well as a cash book.

- (c) Compared to the value of its other assets, the amount of petty cash held by a business is usually very small. However, the system for controlling petty cash is given a degree of care and attention that is out of proportion to the financial amounts involved. Why is this?
- (d) Explain the advantages of using the *imprest system* to control petty cash.

13.3A Rule up a petty cash book with analysis columns for office expenses, motor expenses, cleaning expenses and casual labour. The cash float is £450 and the amount spent is reimbursed on 30 November.

		£
November	1 T. Wise – casual labour	36
	2 Staples and tape dispenser	19
	2 Black Motors – motor repairs	42
	3 Cleaning materials	3
	6 Envelopes	10
	8 Petrol	18
	11 I. Dodds – casual labour	12
	12 J. Marsh – cleaner	7
	12 Paper clips	2
	14 Petrol	16
	16 Adhesive tape	1
	16 Petrol	24
	21 Car tyre	63
	22 T. Randall – casual labour	15
	23 J. Marsh – cleaner	16
	24 I. Gray – casual labour	21
	25 Paper	7
	26 Monday Cars – car puncture repairs	74
	29 Petrol	19
	30 T. Pointer – casual labour	20

13.4 Fine Teas operates its petty cash account on the imprest system. It is maintained at a figure of £140, with the balance being restored to that amount on the first day of each month. At 30 April the petty cash box held £24.37 in cash.

During May the following petty cash transactions arose:

		£
May	1 Cash received to restore imprest (to be derived)	?
	1 Bus fares	0.41
	2 Stationery	2.35
	4 Bus fares	0.30
	7 Postage stamps	6.50
	7 Trade journal	0.95
	8 Bus fares	0.64
	11 Highlighter pens	1.29
	12 Lightbulbs	5.42
	14 Parcel postage	3.45
	15 Paper clips	0.42
	15 Newspapers	2.00
	16 Photocopier repair	16.80
	19 Postage stamps	1.50
	20 Drawing pins	0.38
	21 Train fare	5.40





	22	Photocopier paper	5.63
	23	Display decorations	3.07
	23	Pencil sharpener	1.14
	25	Wrapping paper	0.78
	27	String	0.61
	27	Sellotape	0.75
	27	Biro pens	0.46
	28	Replacement part for printer	13.66
	31	Bus fares	2.09
June	1	Cash received to restore imprest (to be derived)	?

Required:

- (a) Open and post the company's analysed petty cash book for the period 1 May to 1 June inclusive.
- (b) Balance the account at 31 May.
- (c) Show the imprest reimbursement entry on June 1.

Accounting for sales, purchases and returns

Learning objectives

After you have studied this chapter, you should be able to:

- Distinguish between a cash sale and a sale 'on time' (otherwise known as a **credit** sale) and between the way they are recorded in the accounting books.
- Explain why, when credit card payments are received at the time of sale, details of the customer are not recorded even though a debtor is created at the same time.
- Draw up a sales invoice.
- Explain why multiple copies are often made of each sales invoice.
- Make the appropriate entries relating to sales 'on time' in a sales day book.
- Make the correct postings from the sales day book to the sales ledger and general ledger.
- Describe measures that may be taken to exercise credit control over debtors.
- Make the appropriate entries relating to credit purchases in a purchases day book.
- Make the correct postings from the purchases day book to the purchases ledger and general ledger.
- Explain the differences between the process of recording credit sales and credit purchases in the books.
- Make the appropriate entries relating to returns outwards and returns inwards in the appropriate day book and ledger.
- Explain the differences between a credit note and a debit note.
- Describe how a debtor should use statements received from suppliers.
- Enter up the accounts for credit card transactions.
- Explain the need for internal checks on all sales and purchases invoices and credit notes.
- Describe what use may be made of factoring.

Introduction

In Chapter 11, you learnt that, rather than having only one book of original entry and only one ledger, some businesses use a set of day books and a set of ledgers. In this chapter, you'll learn more about the sales day book, the purchases day book, the sales ledger, and the purchases ledger. You'll also learn how cash and credit sales and cash and credit purchases are entered in these books, about trade discounts and how to record them, and about how sales returns and purchases returns are recorded.

Part One Sales

14.1 Cash sales

As you have already learnt, when goods are paid for immediately, they are described as ‘cash sales’, even where the payment has been made by debit card, credit card, Paypal, cheque, or transfer of funds from the customer’s bank account into the seller’s bank account. For accounting purposes, in such cases we do not need to know the names and addresses of customers nor what has been sold to them. As a result, there is no need to enter such sales in the sales day book. **The sales day book (and all the other day books) are only used for transactions that are to be paid for at some future date.**

Activity 14.1

Other than for accounting purposes, can you think of anything a business might want to record somewhere outside the accounting records concerning these transactions?

Credit card payments and PayPal payments

When customers pay immediately by credit card, so far as recording details of the customer is concerned, this is treated as if it were a payment made by cash. No record is required for accounting purposes concerning the contact details of the customer. However, it is a credit transaction and so does result in a debtor being created – the credit card. The double entry would be a debit to the credit card company’s account in the sales ledger and a credit to the sales account.

PayPal payments

When customers pay immediately using PayPal, the entries are the same as when they use a credit card, with the PayPal account debited in the ledger instead of the credit card account.

14.2 Sales ‘on time’: credit sales

In all but the smallest business, most sales will be made ‘on time’. That is, they are not paid at the time of the sale, but at some future date. So far, we have referred to this form of settlement as an Iou. Sales of this type are usually called **credit sales** and **sales on credit**. These terms will be used throughout the rest of this book. The sales of many businesses will consist entirely of credit sales. The only major exceptions to this are internet businesses (such as Amazon) and retailers (e.g. corner shops and supermarkets), where all sales are paid for at the time of sale.

For each credit sale, the selling business will give or send a document to the buyer showing full details of the goods sold and the prices of the goods. This document is an ‘invoice’. It is known to the buyer as a ‘purchase invoice’ and to the seller as a ‘sales invoice’. The seller will keep one or more copies of each sales invoice for the business’s own use.

Activity 14.2

What uses would the seller have for these copies of the sales invoice?

Exhibit 14.1 is an example of an invoice:

Exhibit 14.1

Your Purchase Order: 10/A/980		J. Blake
Invoice no. 16554		7 Over Warehouse
		Leicester LE1 2AP
		1 September 2020
To: D. Poole & Co		
45 Charles Street		
Manchester M1 5ZN		
	Per unit	Total
21 cases McBrand Pears	£ 20	£ 420
5 cartons Kay's Flour	4	20
6 cases Joy's Vinegar	20	<u>120</u>
		<u>560</u>

You must not think that all invoices will look exactly like the one shown in Exhibit 14.1. Each business will have its own design. All invoices will be uniquely numbered, usually sequentially, and they will contain the names and addresses of both the supplier and the customer. In this case, the supplier is J. Blake and the customer is D. Poole. (A 'purchase order' – there's one referred to in the top left-hand corner of this sales invoice – is the record or document drawn up by the customer that the customer referred to or gave the seller when the order was placed with the seller. It is used by the buyer to check the details of the order against the invoice and against the goods delivered.)

14.3 Copies of sales invoices

As soon as the sales invoices for the goods being sold have been prepared, they are given or sent to the customer. The copies kept by the seller are created at the same time as the original.

14.4 Making entries in the sales day book

From the copy of the sales invoice, the seller enters up the transaction in the sales day book. This book is merely a list of details relating to each credit sale:

- date
- name of customer
- invoice number
- folio column
- final amount of invoice.

There is no need to show details of the goods sold in the sales day book. This can be found by looking at the copy invoice.

We can now look at Exhibit 14.2, which shows page 26 of a sales day book. It starts with the record of the sales invoice already shown in Exhibit 14.1. (These entries could have been made on any page of the sales day book. In this example, we are assuming they have been entered on page 26 as pages 1–25 have been filled with details of earlier transactions.)

Exhibit 14.2

Sales Day Book			(page 26)
	Invoice No.	Folio	Amount
2020			£
Sept	1 D. Poole	16554	560
	8 T. Cockburn	16555	1,640
	28 C. Carter	16556	220
	30 D. Stevens & Co	16557	1,100
			<u>3,520</u>

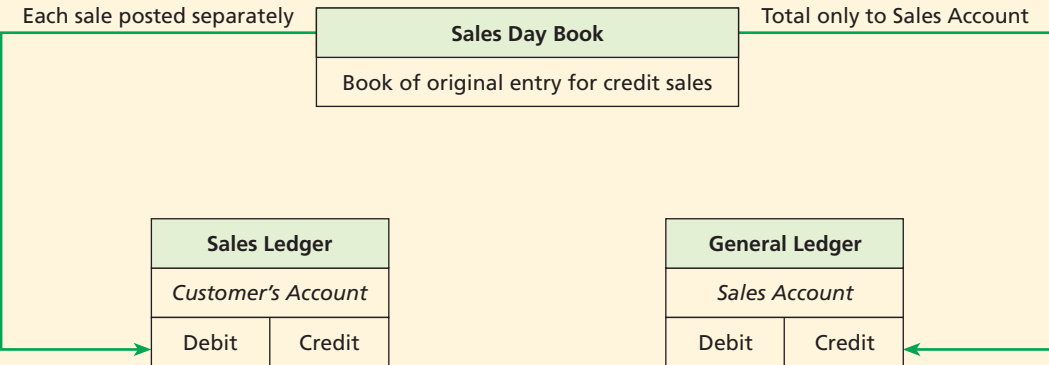
14.5 Posting credit sales to the sales ledger

Instead of having one ledger for all accounts, we now have a separate sales ledger for credit sale transactions. This was described in Chapter 11.

- 1 The credit sales are now posted, one by one, from the sales day book to the debit side of each customer's account in the sales ledger.
- 2 The total of the credit sales in the sales day book is posted to the credit of the sales account in the general ledger.

This is now illustrated in Exhibit 14.3.

Exhibit 14.3 Posting credit sales



14.6 An example of posting credit sales

The sales day book in Exhibit 14.2 is now shown again, followed by the entries made in the sales ledger and the general ledger. This time, the entries in the sales day book include the reference number of the location in the ledgers to which the individual entries and the total were posted. Notice the completion of the folio columns with the reference numbers. These are always inserted *after* the entry has been made in the relevant ledger.

Sales Day Book				(page 26)
		Invoice No.	Folio	Amount
2020				£
Sept	1 D. Poole	16554	SL 12	560
	8 T. Cockburn	16555	SL 39	1,640
	28 C. Carter	16556	SL 125	220
	30 D. Stevens & Co	16557	SL 249	1,100
	Transferred to Sales Account		GL 44	<u>3,520</u>

Sales Ledger D. Poole

(page 12)

2020		Folio	£	
Sept	1 Sales	SB 26	560	

T. Cockburn

(page 39)

2020		Folio	£	
Sept	8 Sales	SB 26	1,640	

C. Carter

(page 125)

2020		Folio	£	
Sept	28 Sales	SB 26	220	

D. Stevens & Co

(page 249)

2020		Folio	£	
Sept	30 Sales	SB 26	1,100	

General Ledger Sales

(page 44)

	2020		Folio	£
	Sept	30 Credit sales for the month	SB 26	3,520

Before you continue you should attempt Review question 14.1.

14.7 Trade discounts

Suppose you are the proprietor of a business. You are selling to three different kinds of customer:

- 1 Traders who buy a lot of goods from you
- 2 Traders who buy only a few items from you
- 3 The general public (direct).

The traders themselves have to sell the goods to the general public in their own areas. They have to make a profit to help finance their businesses, so they will want to pay you less than the retail price (i.e. the price at which the goods are sold to the general public). Traders who buy in larger quantities will want to pay less than you charge traders who buy in small quantities. As a result, you would normally sell at a different price to each of these three groups of customers.

Activity 14.3

Why would you be willing to sell goods at a lower price to these traders?

Let's use an example to illustrate this. You sell a food blender. The basic price is £100. The traders who buy in large quantities are given 25 per cent trade discount. The other traders are given 20 per cent, and the general public get no trade discount. The price paid by each type of customer would be:

		Trader 1		Trader 2	General Public
		£		£	£
Basic price		100		100	100
Less Trade discount	(25%)	(25)	(20%)	(20)	nil
Price to be paid by customer		<u>75</u>		<u>80</u>	<u>100</u>

You could deal with this by having three price lists, and many businesses do. However, some use trade discounts instead. This involves having only one price list but giving a **trade discount** to traders so that they are invoiced for the correct price.

Exhibit 14.4 is an example of an invoice for a food manufacturer and retailer that shows how trade discount is presented clearly and the trade discounted price easily identified. It is for the same items as were shown in Exhibit 14.1 as having been sold to D. Poole. In that example, the seller operated a different price list for each category of customer. This time the seller is R. Grant and trade discount is used to adjust the selling price to match the category of customer.

Exhibit 14.4

Your Purchase Order: 11/A/G80		Invoice no. 30756		R. Grant Higher Side Preston PR1 2NL 2 September 2020	
To: D. Poole & Co. 45 Charles Street Manchester M1 5ZN				Tel (01703) 33122 Fax (01703) 22331	
				Per unit	Total
				£	£
21 cases McBrand Pears				25	525
5 cartons Kay's Flour				5	25
6 cases Joy's Vinegar				25	150
					<u>700</u>
Less 20% trade discount					(140)
					<u>560</u>

By comparing Exhibits 14.1 and 14.4, you can see that the amount paid by D. Poole was the same. It is simply the method of calculating it and presenting it in the exhibit that is different.

14.8 No double entry for trade discounts

As trade discount is simply a way of calculating sales prices, no entry for trade discount should be made in the double entry records, nor in the sales day book. The recording of Exhibit 14.4 in R. Grant's sales day book and D. Poole's personal account will be:

Sales Day Book			(page 87)
	Invoice No.	Folio	Amount
2020			£
Sept 2 D. Poole	30756	SL 32	560

Sales Ledger D. Poole				(page 32)
2020		Folio	£	
Sept 2 Sales		SB 87	560	

14.9 Manufacturer's recommended retail price

Looking at an item displayed in a shop window, you will frequently see something like the following:

70-inch 4K ultra HD TV	
Manufacturer's Recommended Retail Price	£1,200
Less discount of 20 per cent	(240)
You pay only	<u>£ 960</u>

Very often the manufacturer's recommended retail price is a figure above what the manufacturer would expect the public to pay for its product. In the case of the TV, the manufacturer would probably have expected the public to pay around £960 for the TV.

The inflated figure used for the 'manufacturer's recommended retail price' is simply a sales gimmick. Most people like to believe they are getting a bargain. They feel happier about making a purchase like this if they are told they are getting '20 per cent discount' and pay £960 rather than being told that the price is £960 and that they cannot get any discount. When it is sold, the seller records the sale at the final selling price of £960.

14.10 Credit control

Any organisation that has credit sales (i.e. **sales on credit**) should keep a close check to ensure that debtors pay their accounts on time. If this is not done properly, the amount of trade receivables can grow to a level that will make the business short of cash. Businesses that grow too short of cash will fail, no matter how profitable they may be.

The following procedures should be carried out:

- 1 A credit limit should be set for each debtor. Debtors should not be allowed to owe more than their credit limit. The amount of the limit will depend on the circumstances. Such things as the size of the customer's business and the amount of business done with it, as well as its past record of payments, will help guide the choice of credit limit. Credit rating agencies may be used to assess the credit worthiness of customers before credit is granted.
- 2 As soon as the payment date set by the seller has been reached, a check should be made to verify whether the debtor has paid the amount due. Failure to pay on time may trigger a refusal to supply any more goods to the customer until payment is received, even if the customer's credit limit has not been reached.
- 3 Where payment is not forthcoming, after investigation it may be necessary to take legal action to sue the customer for the debt. This will depend on the circumstances.
- 4 It is important that the customer is aware of what will happen if the amount due is not paid by the deadline set by the seller.

Part Two Purchases

14.11 Purchases invoices and the purchases day book

When an invoice is entered in the books of the buyer, it is called a **purchases invoice**. For example, in Exhibit 14.1, the first invoice you looked at:

- in the books of J. Blake, the seller, it is a sales invoice; and
- in the books of D. Poole, the buyer, it is a purchases invoice.

As you know, transactions – sales or purchases – may be for cash or they may be ‘on time’. Just as we call sales made ‘on time’ ‘credit sales’ or ‘sales on credit’, so we call purchases made ‘on time’ **credit purchases** or **purchases on credit**. The details of credit purchases are entered in a purchases day book from purchases invoices in the same way as entries are made for sales in the sales day book.

Activity 14.4

Think back to what you learnt about the list of items contained in the sales day book. What do you think is the list of items recorded in the purchases day book?

There is no need to show details of the goods bought in the purchases day book. This can be found by looking at the invoices themselves. Exhibit 14.5 is an example of a purchases day book.

Exhibit 14.5

Purchases Day Book			(page 49)	
		Invoice No.	Folio	Amount
2020				£
Sept	1 J. Blake	9/101		560
	8 B. Hamilton	9/102		1,380
	19 C. Brown	9/103		230
	30 K. Gabriel	9/104		510
				<u>2,680</u>

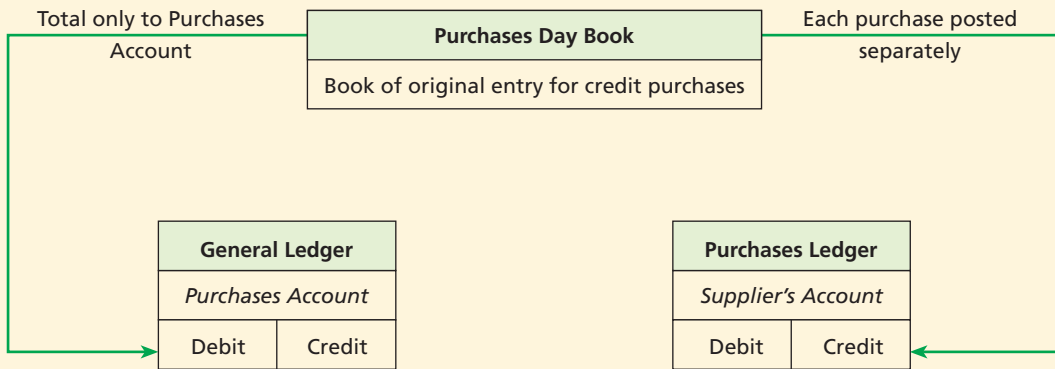
Activity 14.5

Note the entry for 1 September and compare it to the entry on the same date shown in the sales day book of J. Blake in Exhibit 14.2. What differences are there between the entries in the two day books? Why do you think these differences arise?

14.12 Posting credit purchases to the purchases ledger

We also have a separate purchases ledger. The double entry is as follows:

- 1 The credit purchases are posted one by one, to the credit of each supplier's account in the purchases ledger.
- 2 At the end of each period the total of the credit purchases is posted to the debit of the purchases account in the general ledger. This is now illustrated in Exhibit 14.6.

Exhibit 14.6 Posting credit purchases**Part Three Returns****14.13 Returns inwards and credit notes**

You know that businesses allow customers to return goods they've bought. You've probably done so yourself at some time or other. Some retail businesses give every customer the right to do so within a few days of the sale and won't ask why they are being returned. It is a way of assuring the customer that the seller believes that the goods are of good quality and will do what the customer wants. Whatever the rights of return granted by the seller, in the UK there are also legal rights of return that permit retail customers to return goods for a refund should the goods prove to have been unfit for the purpose that was intended.

Businesses that deal with trade customers may operate a similar policy, but that would be more unusual and would normally include a proviso that the customer had a justifiable and reasonable reason for returning the goods.

Activity 14.6

List as many reasons as you can think of why (a) retail customers and (b) trade customers may return goods to the seller.

Sometimes sellers may agree to keep the goods returned, even when they don't normally do so, but won't provide a full refund. Sometimes buyers will agree to keep goods they had wanted to return if the seller offers to refund some of the price they paid.

When the seller agrees to take back goods and refunds part or all of the amount the buyer paid, a document known as a **credit note** will be sent to the customer, showing the amount of the allowance given by the seller.

It is called a credit note because the customer's account will be credited with the amount of the allowance, to show the reduction in the amount owed.

Referring back to Exhibit 14.4, if D. Poole returns two of the cases of McBrand Pears, a credit note like the one shown in Exhibit 14.7 would be issued by R. Grant, the seller.

Exhibit 14.7

To: D. Poole & Co. 45 Charles Street Manchester M1 5ZN	R. Grant Higher Side Preston PR1 2NL 8 September 2020	
Credit note no. 9/37 2 cases McBrand Pears Less 20% trade discount	Tel. (01703) 33122 Fax (01703) 22331	
	Per unit	Total
	£ 25	£ 50 (10) <u>40</u>

To stop them being mistaken for invoices, credit notes are often printed in red.

14.14 Returns inwards day book

The credit notes are listed in a **returns inwards day book** (or returns inwards journal). This is then used for posting the items, as follows:

- 1 Sales ledger: credit the amount of credit notes, one by one, to the accounts of the customers in the ledger.
- 2 General ledger: at the end of the period the total of the returns inwards day book is posted to the debit of the returns inwards account.

14.15 Example of a returns inwards day book

Exhibit 14.8 presents an example of a returns inwards day book showing the items to be posted to the sales ledger and the general ledger followed by the entries in the ledger accounts.

Exhibit 14.8

Returns Inwards Day Book			(page 10)
	Note no.	Folio	Amount £
2020			
Sept 8 D. Poole	9/37	SL 12	40
17 A. Brewster	9/38	SL 58	120
19 C. Vickers	9/39	SL 99	290
29 M. Nelson	9/40	SL 112	<u>160</u>
Transferred to Returns Inwards Account		GL 114	<u>610</u>

Sales Ledger				
<i>D. Poole</i>				
(page 12)				
	2020		<i>Folio</i>	£
	Sept	8 Returns inwards	RI 10	40
<i>A. Brewster</i>				
(page 58)				
	2020		<i>Folio</i>	£
	Sept	17 Returns inwards	RI 10	120
<i>C. Vickers</i>				
(page 99)				
	2020		<i>Folio</i>	£
	Sept	19 Returns inwards	RI 10	290
<i>M. Nelson</i>				
(page 112)				
	2020		<i>Folio</i>	£
	Sept	29 Returns inwards	RI 10	160
General Ledger				
<i>Returns Inwards</i>				
(page 114)				
2020			<i>Folio</i>	£
Sept	30	Returns for the month	RI 10	610

The returns inwards day book is sometimes known as the sales returns day book, because it is goods that were sold that are being returned.

14.16 Returns outwards and debit notes

If the supplier agrees, goods bought previously may be returned. When this happens a **debit note** is sent by the customer to the supplier giving details of the goods and the reason for their return.

The credit note received from the supplier will simply be evidence of the supplier's agreement, and the amounts involved.

Also, an allowance might be given by the supplier for any faults in the goods. Here also, a debit note should be sent to the supplier. Referring back to Exhibit 14.7, Exhibit 14.9 shows an example of the debit note that Poole, the buyer, may have sent to Grant, the seller.

Exhibit 14.9

To: R. Grant Higher Side Preston PR1 2NL Debit note no. 9.22	D. Poole & Co. 45 Charles Street Manchester M1 5ZN 7 September 2017 Tel. (0161) 488 2142 Fax (0161) 488 2143	
	Per unit	Total
2 cases McBrand Pears damaged in transit Less 20% trade discount	£ 25	£ 50 (10) <u>40</u>

Note the differences between this debit note and the credit note in Exhibit 14.7: the names and addresses have swapped places and the document is described as ‘Debit note no. 9.22’ rather than ‘Credit note no. 9/37’, because Poole uses its own debit note numbering sequence. Also, the dates are different. In this case, it is assumed that Poole raised the debit note on 7 September and sent it and the goods to Grant. Grant received the goods on 8 September and raised the credit note on that date. Finally, the reason for the return of the goods is given.

14.17 Returns outwards day book

The debit notes are listed in a returns outwards day book. This is then used for posting the items, as follows:

- 1 Purchases ledger: debit the amounts of debit notes, one by one, to the personal accounts of the suppliers in the ledger.
- 2 General ledger: at the end of the period, the total of the returns outwards day book is posted to the credit of the returns outwards account.

The entries made in the returns outwards day book are made in the same way as in the returns inwards day book.

14.18 Example of a returns outwards day book

Exhibit 14.10 presents an example of a returns outwards day book showing the items to be posted to the purchases ledger and the general ledger. Those entries in the ledgers are on the opposite side to those for returns inwards.

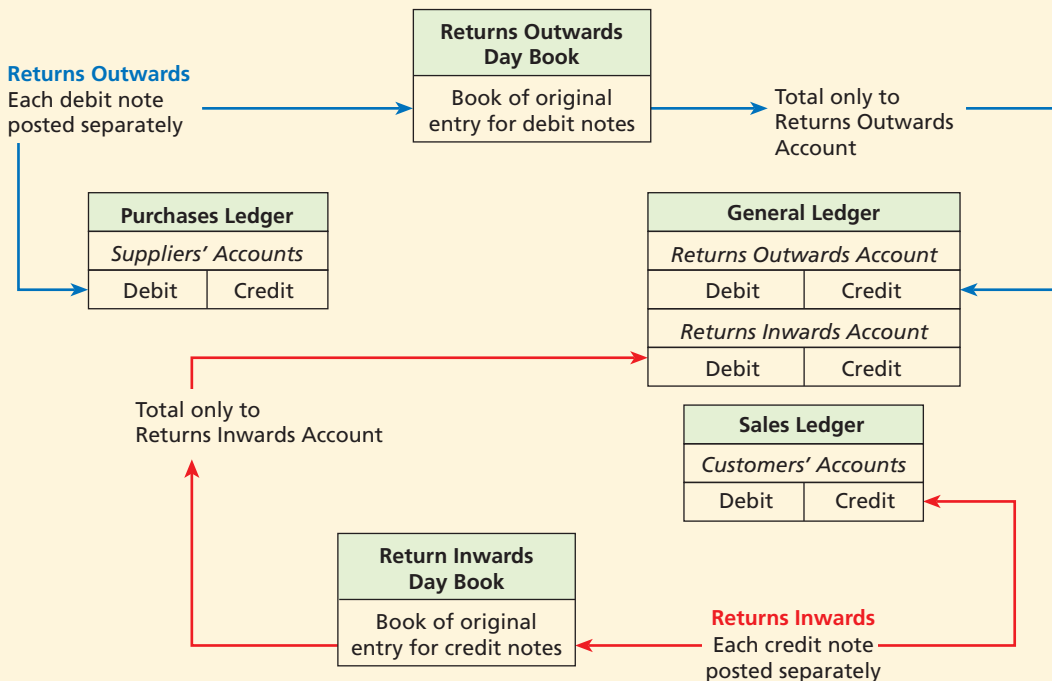
Exhibit 14.10

Returns Outwards Day Book			(page 7)
	Note no.	Folio	Amount
2020			£
Sept 7 R. Grant	9.22	PL 29	40
16 B. Rose	9.23	PL 46	240
28 C. Blake	9.24	PL 55	30
30 S. Saunders	9.25	PL 87	<u>360</u>
Transferred to Returns Outwards Account		GL 116	<u>670</u>

The returns outwards day book is sometimes known as the purchases returns day book because it is goods that were purchased that are being returned.

14.19 Double entry and returns

Exhibit 14.11 shows how the entries are made for returns inwards and returns outwards.

Exhibit 14.11 Posting returns inwards and returns outwards

Part Four Other matters

14.20 Statements

At the end of each month, a statement of account or, statement, should be sent to each debtor who owes money on the last day of the month. It is really a copy of the debtor's account in the seller's books. It should show:

- 1 the amount owing at the start of the month;
- 2 the amount of each sales invoice sent to the debtor during the month;
- 3 credit notes sent to the debtor in the month;
- 4 cash and cheques received from the debtor during the month; and, finally,
- 5 the amount due from the debtor at the end of the month.

Exhibit 14.12 shows an example of this statement.

Debtors will check to see if the account in their accounting records agrees with the statement. If the statement shows that they owe £520, but their records show a different amount due, they will investigate the difference in order to see whether either the statement or their records is incorrect. If they discover that there has been an error in their books, they will correct it. If they find that there is an error in the statement, they will contact the seller.

Activity 14.7

What sort of things could result in the statement and the account held in the books of the debtor showing different balances?

Exhibit 14.12

STATEMENT OF ACCOUNT R. GRANT Higher Side Preston PR1 2NL Tel. (01703) 33122 Fax (01703) 22331				
Accounts Dept D. Poole & Co 45 Charles Street Manchester M1 5ZN				
<i>Date</i>	<i>Details</i>	<i>Debit</i>	<i>Credit</i>	<i>Balance</i>
2020		£	£	£
Sept 1	Balance b/d			880
2	Invoice 30756	560		1,440
8	Returns 9/37		40	1,400
25	Bank		880	520
Sept 30	Balance owing c/d			520
All accounts due and payable within 1 month				

Apart from enabling debtors to check the amount due, the statement also acts as a reminder to debtors that they owe the seller money and shows the date by which they should make payment. Sellers who are contacted by a debtor querying a statement will benefit from having any errors identified in their records.

14.21 Sales and purchases via credit cards

Various banks, building societies and other financial institutions issue credit cards to their customers. The most common examples are Visa and MasterCard. The holder of the credit card purchases goods or services without giving cash or cheques, but simply signs a credit card voucher. The customer is given a copy and the other copy is filed by the seller. Such sales are very rarely sales to anyone other than the general public.

The seller is paid later by the credit card company for all the credit card transactions in the period since the last payment made to the seller. This payment is subject to a deduction of commission by the credit card company.

Once a month, the customer pays the credit card company for all of the payments charged to the credit card during the previous month.

As far as the purchaser is concerned, he has seen goods and has received them (or received the service he requested). In the eyes of the customer, they were paid for at the time of purchase and a loan has been granted by the credit card company in order to do so.

Once the customer has the goods, or has received the appropriate services, the customer does not become a debtor needing an entry in a sales ledger and so, similarly to a cash sale, no ledger account is maintained for the customer. All the selling company is then interested in, from a recording point of view, is collecting the money from the credit card company.

The double entry needed is:

Sale of items via credit cards:	Dr: Credit card company Cr: Sales
Receipt of money from credit card company:	Dr: Bank Cr: Credit card company
Commission charged by credit card company:	Dr: Selling expenses Cr: Credit card company

Note: The commission is not a deduction from the selling price. It is a selling expense and is entered in the profit and loss account section of the income statement.

14.22 Internal check

When sales invoices are prepared, they should be very carefully checked. A system is usually set up so that each stage of the preparation of an invoice is checked by someone other than the person whose job is to send out the invoice.

Activity 14.8

What sort of things could occur that make checking of all invoices, both those for sales and those for purchases, something that all businesses should do?

A system should, therefore, be set up whereby invoices are checked at each stage by someone other than the person who sends out the invoices or is responsible for paying them.

For purchase invoices, checks should be established, such as using a rubber stamp to stamp each incoming invoice with a mini form with spaces for ticks as each stage of the check on them is completed. The spaces in the stamp will be filled in by the people responsible for making each of the checks on the purchase invoices received, e.g.:

- one person certifying that the goods were actually received;
- a second person certifying that the goods were ordered;
- a third person certifying that the prices and calculations on the invoice are correct, and in accordance with the order originally placed and agreed;
- a fourth person certifying that the goods are in good condition and suitable for the purpose for which ordered.

Naturally, in a small business, simply because the office staff might be quite small, this cross-check may be in the hands of only one person other than the person who will pay the invoice.

A similar sort of check will be made in respect of sales invoices being sent out and on credit notes, both those being sent out and those being received.

14.23 Factoring

You've already learnt that one of the problems that many businesses face is the time taken by debtors to pay their accounts. Few businesses have so much cash available to them that they do not mind how long debtors take to pay. It is a rather surprising fact that a lot of businesses which fail do so not because the business is not making a profit, but because it has run out of cash funds. Once that happens, confidence in the business evaporates, and the business then finds that very few people will supply it with goods. It also cannot pay its employees. Closure of the business then happens fairly quickly in many cases.

In the case of trade receivables, the cash flow problem may be alleviated by using the services of a financial intermediary called a factor.

Factoring is a financial service designed to improve the cash flow of healthy, growing companies, enabling them to make better use of management time and the money tied up in trade credit to customers.

In essence, factors provide their clients with three closely integrated services: sales accounting and collection; credit management, which can include protection against bad debts; and the availability of finance against sales invoices.

14.24 Errors and Omissions Excepted (E&OE)

On some invoices and other documents, you will see 'E&OE' printed at the bottom, which stands for 'Errors and Omissions Excepted'. Basically, this is a warning that there may possibly be errors or omissions which could mean that the figures shown could be incorrect, and that the recipient should check carefully the figures before taking any action concerning them.

Learning outcomes

You should now have learnt:

- 1 That cash sales are not entered in the sales day book.
- 2 That when credit card payments are received at the time of sale, details of the customer are not recorded even though a debtor is created at the same time.
- 3 That sales made 'on time' are usually referred to as 'credit sales' or 'sales on credit'.
- 4 That the sales day book contains information relating to each credit sale made in each period.
- 5 That the sales day book is used for posting credit sales to the sales ledger.
- 6 That the total of the sales day book for the period is posted to the credit of the sales account in the general ledger.
- 7 How to make the appropriate entries relating to credit sales in a sales day book and make the correct postings from it to the sales ledger and general ledger.
- 8 How to prepare a sales invoice.
- 9 Why multiple copies are often made of each sales invoice.
- 10 That no entry is made for trade discounts in the double entry accounts.
- 11 That all businesses should operate a sound system of credit control over their debtors.
- 12 Some measures that may be taken to exercise credit control over debtors.
- 13 That cash purchases are not entered in the purchases day book.
- 14 That purchases made 'on time' are usually referred to as 'credit purchases' or 'purchases on credit'.
- 15 That the purchases day book is a list of all credit purchases.
- 16 That the purchases day book is used to post the items to the personal accounts in the purchases ledger.
- 17 That the total of credit purchases for the period is posted from the purchases day book to the debit of the purchases account in the general ledger.
- 18 How to make the appropriate entries relating to credit purchases in a purchases day book and make the correct postings from it to the purchases ledger and general ledger.
- 19 That the process of making entries in the books of the purchaser is very similar to that of making those in the books of the seller.
- 20 That 'returns inwards day book', 'returns inwards journal', 'sales returns journal' and 'sales returns day book' are different names for the same book.
- 21 That 'returns outwards day book' and 'purchases returns day book' are different names for the same book.
- 22 That goods returned by customers are all entered in a returns inwards day book.
- 23 That the returns inwards day book is used to post each item to the credit of the personal account of the customer in the sales ledger.
- 24 That the total of the returns inwards day book is debited at the end of the period to the returns inwards account in the general ledger.

- 25 That goods returned to suppliers are all entered in a returns outwards day book.
- 26 What the difference is between a credit note and a debit note.
- 27 That the returns outwards day book is used to debit the personal account of each supplier in the purchases ledger.
- 28 That the total of the returns outwards day book is credited at the end of the period to the returns outwards account in the general ledger.
- 29 How to make the appropriate entries relating to returns in the returns inwards and returns outwards day books and make the correct postings from them to the purchases ledger, sales ledger and general ledger.
- 30 That the process of making entries for returns in the books of purchasers and sellers is the mirror image of those made in their books for purchases and sales.
- 31 That statements are used by debtors to check the entries made in their books.
- 32 Of a range of causes for differences that can arise between statements and the seller's account in the debtor's purchases ledger and that such differences may not all be the result of an error.
- 33 How credit card transactions are recorded in the books and how commission charged to sellers by the credit card companies is treated in the income statement.
- 34 Why an effective system of invoice checking should be used by all businesses.
- 35 Why factoring is an attractive option for some businesses.

Answers to activities

- 14.1** A business may want to know the contact details of cash customers for marketing purposes. In fact, most businesses of any size would like to keep records in a database of all their cash customers for this reason. Businesses may also want to encourage cash customers to open credit accounts with the business so that they may be more likely to buy from the business in future. Also, where the goods sold are to be delivered to the customer, the customer's contact details will need to be recorded, but this will be in a record held elsewhere than in the accounting books.
- 14.2** Sellers keep copies of sales invoices for a number of reasons including: to prove that a sale took place; to enable the entries in the books to be correctly recorded and checked; to pass to the inventory department so that the correct goods can be selected for shipping to the customer; to pass to the delivery department, so that the correct goods will be shipped to the customer and to the correct address, and to enable the goods to be shipped accompanied by a copy of the sales invoice so that the customer can acknowledge receipt of the correct goods.
- 14.3** You want to attract large customers like these, so you are happy to sell to these traders at a lower price than the price you charge your other customers.
- 14.4** Similarly to the sales day book, the purchases day book is merely a list of details relating to each credit purchase. The list of items is virtually identical to those recorded in the sales day book, the only differences being that it is the name of the supplier that is recorded, not the purchaser, and that the invoice number is replaced with the buyer's own internally generated reference number:
- date
 - name of supplier
 - the reference number of the invoice
 - folio column
 - final amount of invoice.

14.5 Apart from the name of the day books, there are two differences. Firstly, the description of the entry in each case contains the name of the other party to the transaction. This is the personal account in the respective ledger (sales or purchases) where details of the transaction will be entered. The second difference is in the entry in the Invoice Number column. In the case of the seller, Blake, the number entered was the number of the invoice that Blake gave to the invoice and is the invoice number shown on the invoice in Exhibit 14.1. In the case of the buyer, Poole, the invoice number is one Poole gave the invoice when it was received from the seller, Blake. As with the number assigned to it by the seller, the buyer also gives each purchase invoice a unique number relating to its place in the sequence of purchase invoices that the buyer has received so far in the period. '9/101' probably means 'month nine' (9), 'purchase invoice' (1) 'number one' (01).

14.6 In either case, the reasons why goods may be returned include:

- they were of the wrong type (e.g. the wrong model number of replacement remote control for a TV);
- the item purchased was one that was already owned by the customer (e.g. a CD);
- they were the wrong colour (e.g. paint doesn't match the existing colour);
- they were the wrong size (e.g. a pair of trousers was too tight);
- they were faulty (e.g. a computer kept crashing);
- a customer bought more than was needed (newsagents returning unsold newspapers);
- a customer changed her mind (e.g. they were no longer needed because someone else had bought them for her);
- a customer saw the same goods elsewhere at a cheaper price;
- a customer found the goods too difficult to use (e.g. the instructions for setting up and operating a video recorder were too complicated);
- (for trade customers) a customer had returned a faulty item to them and they were now returning it to their supplier;
- items had been received in a damaged condition by the customer (e.g. fruit delivered to a supermarket);
- the seller had asked all customers to return a specific item (e.g. when an electrical good or a child's toy was found to be dangerous).

14.7 Differences could be due to a number of things having occurred, including the following:

- a purchase had been omitted from the books of either the seller or the debtor;
- a purchase had been incorrectly entered in the books of either the seller or the debtor;
- a purchase had been made at the end of the month but only entered in the books of either the seller or the debtor in the following month;
- goods returned had been entered in the books of the seller but not in the books of the debtor;
- goods returned had been incorrectly entered in the books of either the seller or the debtor;
- the debtor had entered goods as having been returned in the books when, in fact, the goods were not returned to the seller;
- a purchase had been recorded in the books of the seller in the debtor's account when it should have been entered in the account of another customer;
- a purchase had been recorded in the books of the debtor in the seller's account when it should have been entered in the account of another seller;
- a payment made to the supplier and entered in the books of the debtor had not yet been received by the seller;
- goods had been despatched by the seller and entered in the books of the seller but had not yet been received by the debtor.

14.8 If this were not done, it would be possible for someone inside a business to send out an invoice at a price less than the true price. Any difference could then be split between that person and the outside business. For example, if an invoice was sent to Ivor Twister & Co for £2,000 but the invoice clerk made it out deliberately for £200 then, if there was no cross-check, the difference of £1,800 could be split between the invoice clerk and Ivor Twister & Company.

Similarly, outside businesses could send invoices for goods which were never received by the business. This might be in collaboration with an employee within the business, but there are businesses sending false invoices which rely on the businesses receiving them being inefficient and paying for items never received. There have been cases of businesses sending invoices for such items as advertisements which have never been published. The cashier of the business receiving the invoice, if the business is an inefficient one, might possibly think that someone in the business had authorised the advertisements and would pay the bill. Besides these there are, of course, genuine errors that an invoice checking system helps to avoid.

Review questions

14.1 You are to enter up the Sales Day Book from the following details. Post the items to the relevant accounts in the Sales Ledger and then show the transfer to the sales account in the General Ledger.

2023			£
Mar	1	Credit sales to P. Ryan	700
	3	Credit sales to T. Lee	320
	6	Credit sales to B. Cox	50
	10	Credit sales to P. Ryan	220
	17	Credit sales to J. Lock	960
	19	Credit sales to M. Gore	220
	27	Credit sales to C. Chen	95
	31	Credit sales to G. West	365

14.2A Enter up the Sales Day Book from the following details. Post the items to the relevant accounts in the Sales Ledger and then show the transfer to the sales account in the General Ledger.

2024			£
January	1	Credit sales to S. Fry	970
	3	Credit sales to J. Hall	560
	5	Credit sales to R. Dunn	120
	7	Credit sales to P. Kay	430
	16	Credit sales to A. Dale	390
	23	Credit sales to D. Fu	240
	30	Credit sales to A. Cook	650

14.3 F. Benjamin of 10 Lower Street, Plymouth, is selling the following items at the recommended retail prices as shown: white tape £10 per roll, green felt at £4 per metre, blue cotton at £6 per sheet, black silk at £20 per dress length. He makes the following sales:

2023		
May	1	To F. Gray, 3 Keswick Road, Portsmouth: 3 rolls white tape, 5 sheets blue cotton, 1 dress length black silk. Less 25 per cent trade discount.
	4	To A. Gray, 1 Shilton Road, Preston: 6 rolls white tape, 30 metres green felt. Less $33\frac{1}{3}$ per cent trade discount.
	8	To E. Hines, 1 High Road, Malton: 1 dress length black silk. No trade discount.
	20	To M. Allen, 1 Knott Road, Southport: 10 rolls white tape, 6 sheets blue cotton, 3 dress lengths black silk, 11 metres green felt. Less 25 per cent trade discount.
	31	To B. Cooper, 1 Tops Lane, St. Andrews: 12 rolls white tape, 14 sheets blue cotton, 9 metres green felt. Less $33\frac{1}{3}$ per cent trade discount.

You are to (a) draw up a sales invoice for each of the above sales, (b) enter them up in the Sales Day Book and post to the personal accounts, and (c) transfer the total to the sales account in the General Ledger.





14.4A J. Fisher, White House, Bolton, is selling the following items at the prices as shown: plastic tubing at £1 per metre, polythene sheeting at £2 per length, vinyl padding at £5 per box, foam rubber at £3 per sheet. She makes the following sales:

- | | | |
|------|----|--|
| June | 1 | To A. Portsmouth, 5 Rockley Road, Worthing: 22 metres plastic tubing, 6 sheets foam rubber, 4 boxes vinyl padding. Less 25 per cent trade discount. |
| | 5 | To B. Butler, 1 Wembley Road, Colwyn Bay: 50 lengths polythene sheeting, 8 boxes vinyl padding, 20 sheets foam rubber. Less 20 per cent trade discount. |
| | 11 | To A. Gate, 1 Bristol Road, Hastings: 4 metres plastic tubing, 33 lengths of polythene sheeting, 30 sheets foam rubber. Less 25 per cent trade discount. |
| | 21 | To L. Mackeson, 5 Maine Road, Bath: 29 metres plastic tubing. No trade discount is given. |
| | 30 | To M. Alison, Daley Road, Box Hill: 32 metres plastic tubing, 24 lengths polythene sheeting, 20 boxes vinyl padding. Less $33\frac{1}{3}$ per cent trade discount. |

Required:

- (a) Draw up a sales invoice for each of the above sales.
- (b) Enter them up in the Sales Day Book and post to the personal accounts.
- (c) Transfer the total to the sales account in the General Ledger.

14.5 A. Jack has the following purchases for the month of May:

- | | | |
|-----|----|--|
| May | 1 | From A. Bell: 4 smart speakers at £30 each, 3 tablets at £180 each. Less 25 per cent trade discount. |
| | 3 | From C. Gray: 2 washing machines at £310 each, 5 vacuum cleaners at £60 each, 2 dishwashers at £190 each. Less 20 per cent trade discount. |
| | 15 | From C. Donald: 1 laptop at £400, 2 washing machines at £310 each. Less 25 per cent trade discount. |
| | 20 | From F. Perry: 6 external 1TB drives at £45 each. Less $33\frac{1}{3}$ per cent trade discount. |
| | 30 | From S. Turner: 4 dishwashers at £215 each Less 20 per cent trade discount. |

Required:

- (a) Draw up a purchases invoice for each of the above purchases.
- (b) Enter up the purchases day book for the month.
- (c) Post the transactions to the suppliers' accounts in the purchases ledger.
- (d) Transfer the total to the purchases account in the general ledger.

14.6A J. Glen has the following purchases for the month of June:

- June 2 From J. Ring: 3 sets golf clubs at £900 each, 6 footballs at £36 each. Less 25 per cent trade discount.
- 11 From F. Clark: 6 cricket bats at £70 each, 8 ice skates at £40 each, 5 rugby balls at £34 each. Less 20 per cent trade discount.
- 18 From A. Lane: 6 sets golf trophies at £55 each, 4 sets golf clubs at £720. Less $33\frac{1}{3}$ per cent trade discount.
- 25 From J. Jack: 5 cricket bats at £48 each. Less 25 per cent trade discount.
- 30 From J. Wood: 8 goal posts at £95 each. Less 40 per cent trade discount.

Required:

- (a) Enter up the purchases day book for the month.
- (b) Post the items to the suppliers' accounts in the purchases ledger.
- (c) Transfer the total to the purchases account in the general ledger.

14.7 C. Phillips, a sole trader specialising in material for Asian clothing, has the following purchases and sales for March 2023:

- Mar 1 Bought from Smith Stores: silk £40, cotton £80. All less 25 per cent trade discount.
- 8 Sold to A. Grantley: lycra goods £28, woollen items £44. No trade discount.
- 15 Sold to A. Henry: silk £36, lycra £144, cotton goods £120. All less 20 per cent trade discount.
- 23 Bought from C. Kelly: cotton £88, lycra £52. All less 25 per cent trade discount.
- 24 Sold to D. Sangster: lycra goods £42, cotton £48. Less 10 per cent trade discount.
- 31 Bought from J. Hamilton: lycra goods £270. Less $33\frac{1}{3}$ per cent trade discount.

Required:

- (a) Prepare the purchases and sales day books of C. Phillips from the above.
- (b) Post the items to the personal accounts.
- (c) Post the totals of the day books to the sales and purchases accounts.

14.8A A. Henriques has the following purchases and sales for May 2024:

- May 1 Sold to M. Marshall: brass goods £24, bronze items £36. Less 25 per cent trade discount.
- 7 Sold to R. Richards: tin goods £70, lead items £230. Less $33\frac{1}{3}$ per cent trade discount.
- 9 Bought from C. Clarke: tin goods £400. Less 40 per cent trade discount.
- 16 Bought from A. Charles: copper goods £320. Less 50 per cent trade discount.
- 23 Sold to T. Young: tin goods £50, brass items £70, lead figures £80. All less 20 per cent trade discount.
- 31 Bought from M. Nelson: brass figures £100. Less 50 per cent trade discount.

Required:

- (a) Write up the sales and purchases day books.
- (b) Post the items to the personal accounts.
- (c) Post the totals of the day books to the sales and purchases accounts in the general ledger.





14.9 You are to enter up the Purchases Day Book and the Returns Outwards Day Book from the following details, then to post the items to the relevant accounts in the Purchases Ledger and to show the transfers to the General Ledger at the end of the month.

2023

- May
- 1 Credit purchase from S. Dodd £216.
 - 4 Credit purchases from the following: B. Line £324; F. Town £322; R. Pace £64; T. Pang £130.
 - 7 Goods returned by us to the following: S. Dodd £58; B. Line £63.
 - 10 Credit purchase from F. Town £90.
 - 18 Credit purchases from the following: D. Ince £230; P. Tago £310; R. Scott £405; N. Auld £220.
 - 25 Goods returned by us to the following: P. Tago £140; F. Town £47.
 - 31 Credit purchases from: R. Pace £174; J. Marsh £170.

14.10A Enter up the Sales Day Book and the returns inwards day book from the following details. Then post to the customers' accounts and show the transfers to the General Ledger.

2024

- June
- 1 Credit sales to: B. Dock £240; M. Ryan £126; G. Soul £94; F. Trip £107.
 - 6 Credit sales to: P. Coates £182; L. Job £203; T. Mann £99.
 - 10 Goods returned to us by: B. Dock £19; F. Trip £32.
 - 20 Credit sales to B. Uphill £1,790.
 - 24 Goods returned to us by L. Job £16.
 - 30 Credit sales to T. Kane £302.

14.11 You are to enter up the sales, purchases, returns inwards and returns outwards day books from the following details, then to post the items to the relevant accounts in the sales and purchases ledgers. The totals from the day books are then to be transferred to the accounts in the General Ledger.

2023

- May
- 1 Credit sales: T. Thompson £56; L. Rodriguez £148; K. Barton £145.
 - 3 Credit purchases: P. Potter £144; H. Harris £25; B. Spencer £76.
 - 7 Credit sales: K. Kelly £89; N. Mendes £78; N. Lee £257.
 - 9 Credit purchases: B. Perkins £24; H. Harris £58; H. Miles £123.
 - 11 Goods returned by us to: P. Potter £12; B. Spencer £22.
 - 14 Goods returned to us by: T. Thompson £5; K. Barton £11; K. Kelly £14.
 - 17 Credit purchases: H. Harris £54; B. Perkins £65; L. Nixon £75.
 - 20 Goods returned by us to B. Spencer £14.
 - 24 Credit sales: K. Mohammed £57; K. Kelly £65; O. Green £112.
 - 28 Goods returned to us by N. Mendes £24.
 - 31 Credit sales: N. Lee £55.

14.12A You are to enter the following items in the relevant day books, post to the personal accounts, and show the transfers to the General Ledger.

2024

- | | | |
|------|----|--|
| July | 1 | Credit purchases from: K. Hill £380; M. Norman £500; N. Senior £106. |
| | 3 | Credit sales to: E. Rigby £510; E. Phillips £246; F. Thompson £356. |
| | 5 | Credit purchases from: R. Morton £200; J. Cook £180; D. Edwards £410; C. Davies £66. |
| | 8 | Credit sales to: A. Green £307; H. George £250; J. Ferguson £185. |
| | 12 | Returns outwards to: M. Norman £30; N. Senior £16. |
| | 14 | Returns inwards from: E. Phillips £18; F. Thompson £22. |
| | 20 | Credit sales to: E. Phillips £188; F. Powell £310; E. Lee £420. |
| | 24 | Credit purchases from: C. Ferguson £550; K. Ennevor £900. |
| | 31 | Returns inwards from: E. Phillips £27; E. Rigby £30. |
| | 31 | Returns outwards to: J. Cook £13; C. Davies £11. |

Learning objectives

After you have studied this chapter, you should be able to:

- Explain the purpose of having a journal.
- Enter up the journal.
- Post from the journal to the ledgers.
- Complete opening entries for a new set of accounting books in the journal and make the appropriate entries in the ledgers.
- Describe and explain the accounting cycle.

Introduction

In this chapter, you will learn about the book of original entry that sweeps up all the transactions that have not been entered fully in the other five books of original entry: the journal. You'll learn about the sort of transactions that are entered in the journal and how to make those entries. You'll also learn how to transfer those entries to the accounts in the ledgers. Finally, you will learn what the accounting cycle consists of and see how it links all the material you have learnt so far in this book.

15.1 Main books of original entry

We have seen in earlier chapters that most transactions are entered in one of the following books of original entry:

- cash book
- sales day book
- purchases day book
- returns inwards day book
- returns outwards day book.

These books are each devoted to a particular form of transaction. For example, all credit sales are in the sales day book. To trace any of the transactions entered in these five books would be relatively easy, as we know exactly which book of original entry would contain the information we are looking for. The journal is not like these other books of original entry.

15.2 The journal: the other book of original entry

Items that do not pass through these five books are much less common than those that do; and they are sometimes much more complicated. It would be easy for a bookkeeper to forget the details of these transactions if they were made directly into the ledger accounts from the source documents and, if the bookkeeper left the business, it could be impossible to understand such bookkeeping entries. This is why all businesses should maintain a journal.

Activity 15.1

If these five books are used to record all cash and bank transactions, and all credit purchase and sales items, what are these other items that need to be recorded in a sixth book of original entry?

What is needed is a form of diary to record these 'different' transactions, before the entries are made in the double entry accounts. This book is called the **journal**. For each transaction it will contain:

- the date
- the name of the account(s) to be debited and the amount(s)
- the name of the account(s) to be credited and the amount(s)
- a description and explanation of the transaction (this is called a **narrative**)
- a folio reference to the accounts in the ledger where the debit and credit entries are recorded.

The use of a journal makes fraud by bookkeepers more difficult. It also reduces the risk of entering the item once only instead of having double entry. Despite these advantages there are many businesses that do not have such a book.

15.3 Typical uses of the journal

Some of the main uses of the journal are listed below. It must not be thought that this is a complete list.

- 1 The purchase and sale of non-current assets on credit.
- 2 Writing-off of bad debts.
- 3 The correction of errors in the ledger accounts.
- 4 Opening entries. These are the entries needed to open a new set of books.
- 5 Adjustments to any of the entries in the ledgers.

The layout of the journal is:

The Journal				
Date	Details	Folio	Dr	Cr
	The name of the account to be debited. The name of the account to be credited. The narrative.			

On the first line in the entry is the account to be debited. The second line gives the account to be credited. It is indented so as to make it obvious that it is the credit part of the double entry.

The final line is a description of what is being done and provides a permanent record of the reason(s) for the entry.

You should remember that the journal is not a double entry account. It is a form of diary, just as are the day books you learnt about in Chapter 14. Entering an item in the journal is not the same as recording an item in an account. Once the journal entry is made, the entry in the double entry accounts can then be made.

Note for students: The vertical lines have been included above in order to illustrate how the paper within the journal may be printed. You may find it useful to rule your paper according to this layout when attempting examples and questions on this topic.

15.4 Journal entries in examination questions

If you were to ask examiners what type of bookkeeping and accounting questions are always answered badly by students, they would certainly include ‘questions involving journal entries’. This is not because they are difficult, but because many students seem to suffer some sort of mental block when doing such questions. The authors, who have been examiners for a large number of accounting bodies around the world, believe that this occurs because students fail to view the journal as a document containing instructions, three per transaction:

- 1 The account(s) to be debited.
- 2 The account(s) to be credited.
- 3 A description of the transaction.

To help you avoid this sort of problem with journal entries in exams, you’ll first of all see what the entries are in the accounts and will then be shown how to write up the journal for each of these entries. Let’s now look at a few examples.

In practice, the folio reference entered in the T-accounts is usually that of the other account involved in the transaction. However, when a journal entry has been prepared, it is always the journal entry folio reference that appears in the T-accounts.

Purchase and sale on credit of non-current assets

- 1 A milling machine is bought on credit from Toolmakers Ltd for £10,550 on 1 July 2019.

The transaction involves the acquisition of an asset matched by a new liability. From what you have learnt in earlier chapters, you will know that the acquisition of an asset is represented by a debit entry in the asset account. You will also know that a new liability is recorded by crediting a liability account. The double entries in the accounts would be:

Machinery					Folio	GL1
2019				£		
July	1	Toolmakers Ltd	J1	10,550		

Toolmakers Ltd					Folio	PL55
	2019			£		
	July	1	Machinery	J1		10,550

**Activity
15.2**

All the folio numbers have been entered in these ledger accounts. You do need to enter them at some time so that you can trace the other side of the entries, but why have they already been entered?

Now what we have to do is to record those entries in the journal. Remember, the journal is simply a kind of diary, not in account form but in ordinary written form. It says which account has to be debited, which account has been credited, and then gives the narrative which simply describes the nature of the transaction. For the transaction above, the journal entry will appear as follows:

The Journal (page 1)				
Date	Details	Folio	Dr	Cr
2019 July 1	Machinery Toolmakers Ltd Purchase of milling machine on credit, Purchases invoice No 7/159	GL1 PL55	£ 10,550	£ 10,550

2 Sale of van no longer required for £800 on credit to K. Lamb on 2 July 2019.

Here again it is not difficult to work out what entries are needed in the double entry accounts. The *Form of settlement* is an IOU from K. Lamb and the *item exchanged* is the van. The entries are:

K. Lamb					Folio	SL79
2019 July	2	Van	J2	£ 800		
Van					Folio	GL51
	2019 July	2	K. Lamb	J2	£ 800	

The journal entry will appear as follows:

The Journal (page 2)				
Date	Details	Folio	Dr	Cr
2019 July 2	K. Lamb Van Sales of van no longer required. See letter ref. KL3X8g	SL79 GL51	£ 800	£ 800

Bad debts

A debt of £78 owing to us from H. Mander is written-off as a bad debt on 31 August 2019.

As the debt is now of no value, we have to stop showing it as an asset. This means that we will credit H. Mander to cancel it out of his account. A bad debt is the *form of settlement*,

(and it is treated as an expense), so we will debit it to a bad debts account. The double entry for this is shown as:

				Bad Debts	Folio	GL16
2019				£		
Aug	31	H. Mander	J3	78		

				H. Mander	Folio	SL99
				2019		£
	Aug	31	Bad debts	J3		78

The journal entry is:

The Journal (page 3)				
Date	Details	Folio	Dr	Cr
2019 Aug 31	Bad debts H. Mander Debt written-off as bad. See letter in file HM2X8	GL16 SL99	£ 78	£ 78

Correction of errors

This is explained in detail in Chapters 25 and 26.

The same procedures are followed as in the case of these other types of journal entries.

Opening entries

J. Brew, after being in business for some years without keeping proper records, now decides to keep a double entry set of books. On 1 July 2019 he establishes that his assets and liabilities are as follows:

Assets: Van £3,700; Fixtures £1,800; Inventory £4,200;
Trade receivables – B. Young £95, D. Blake £45; Bank £860; Cash £65.

Liabilities: Trade payables – M. Quinn £129, C. Walters £410.

The Assets therefore total $£3,700 + £1,800 + £4,200 + £95 + £45 + £860 + £65 = £10,765$; and the Liabilities total $£129 + £410 = £539$.

The Capital consists of Assets – Liabilities, i.e. $£10,765 - £539 = £10,226$.

1 July 2019 will be the first day of the accounting period, as that is the date on which all the asset and liability values were established.

We start the writing-up of the books on 1 July 2019. To do this we:

- 1 Open the journal and make the journal entries to record the opening assets, liabilities and capital.
- 2 Open asset accounts, one for each asset. Each opening asset is shown as a debit balance.
- 3 Open liability accounts, one for each liability. Each opening liability is shown as a credit balance.
- 4 Open an account for the capital. Show it as a credit balance.

The journal records what you are doing, and why. Exhibit 15.1 shows:

- the journal
- the opening entries in the double entry accounts.

Exhibit 15.1

The Journal (page 5)				
Date	Details	Folio	Dr	Cr
2019			£	£
July 1	Van	GL1	3,700	
	Fixtures	GL2	1,800	
	Inventory	GL3	4,200	
	Trade receivables – B. Young	SL1	95	
	D. Blake	SL2	45	
	Bank	CB1	860	
	Cash	CB1	65	
	Trade payables – M. Quinn	PL1		129
	C. Walters	PL2		410
	Capital	GL4		10,226
	Assets and liabilities at this date entered to open the books		<u>10,765</u>	<u>10,765</u>

General Ledger

Van

(page 1)

2019			Folio	£	
July	1	Balance	J 5	3,700	

Fixtures

(page 2)

2019			Folio	£	
July	1	Balance	J 5	1,800	

Inventory

(page 3)

2019			Folio	£	
July	1	Balance	J 5	4,200	

Capital

(page 4)

			2019			Folio	£
	July	1	Balance			J 5	10,226

Sales Ledger

B. Young

(page 1)

2019			Folio	£			
July	1	Balance	J 5	95			

<i>D. Blake</i>					<i>(page 2)</i>	
2019			<i>Folio</i>	<i>£</i>		
July	1	Balance	J 5	45		
Purchases Ledger						
<i>M. Quinn</i>					<i>(page 1)</i>	
			2019		<i>Folio</i>	<i>£</i>
	July	1	Balance		J 5	129
<i>C. Walters</i>					<i>(page 2)</i>	
			2019		<i>Folio</i>	<i>£</i>
	July	1	Balance		J 5	410
Cash Book						
			<i>Cash</i>	<i>Bank</i>	<i>(page 1)</i>	
2019			<i>Folio</i>	<i>£</i>	<i>£</i>	
July	1	Balances	J 5	65	860	

Once these opening balances have been recorded in the books, the day-to-day transactions can be entered in the normal manner.

At the elementary level of examinations in bookkeeping, questions are often asked which require you to open a set of books and record the day-by-day entries for the ensuing period.

Activity 15.3

Do you think you will ever need to do this again for this business? (*Hint: think about the entries to be made at the start of the next accounting period.*)

Adjustments to any of the entries in the ledgers

These can be of many types and it is impossible to write out a complete list. Several examples are now shown:

- 1 K. Young, a debtor, owed £2,000 on 1 July 2020. She was unable to pay her account in cash but offers a five-year-old car in full settlement of the debt. The offer is accepted on 5 July 2020.

The personal account has now been settled and needs to be credited with the £2,000. On the other hand, the business now has an extra asset, a car, resulting in the car account needing to be debited with the £2,000 value that has been placed upon the new car.

The double entry recorded in the ledgers is:

Car					GL171	
2020			<i>£</i>			
July	5	K. Young	J6	2,000		

K. Young					SL333	
2020			£		2020	£
July	1	Balance b/d	2,000		July	5
					Motor car	J6
						2,000

The journal entry is:

The Journal					(page 6)	
Date	Details			Folio	Dr	Cr
2020 July 5	Car K. Young Accepted car in full settlement of debt per letter dated 5/7/2020			GL171 SL333	£ 2,000	£ 2,000

- 2 T. Jones is a creditor. On 10 July 2020 his business is taken over by A. Lee to whom the debt of £150 is now to be paid.

Here one creditor is just being exchanged for another one. The action needed is to cancel the amount owing to T. Jones by debiting his account, and to show it owing to Lee by opening an account for Lee and crediting it.

The entries in the ledger accounts are:

T. Jones					SL92	
2020			£		2020	£
July	10	A. Lee	J7	150	July	1
					Balance b/d	150
A. Lee					SL244	
					2020	£
					July	10
					T. Jones	J7
						150

The journal entry is:

The Journal					(page 7)	
Date	Details			Folio	Dr	Cr
2020 July 10	T. Jones A. Lee Transfer of indebtedness as per letter ref G/1335			SL92 SL244	£ 150	£ 150

- 3 We had not yet paid for an office printer we bought on credit for £310 because it was not working properly when installed. On 12 July 2020 we returned it to the supplier, RS Ltd. An allowance of £310 was offered by the supplier and accepted. As a result, we no longer owe the supplier anything for the printer.

The double entry in the ledger accounts is:

RS Ltd					PL124				
2020				£	2020				£
July	12	Office machinery	J8	310	July	1	Balance b/d		310
Office Machinery					GL288				
2020				£	2020				£
July	1	Balance b/d		310	July	12	RS Ltd	J8	310

The journal entry is:

The Journal					(page)
Date	Details		Folio	Dr	Cr
2020 July 12	RS Ltd Office machinery Faulty printer returned to supplier. Full allowance given. See letter 10/7/2020.		PL124 GL288	£ 310	£ 310

15.5 Examination guidance

Later on in your studies, you may find that some of the journal entries are more complicated than those you have seen so far. The best plan for you is to follow this advice:

- 1 On your examination answer paper write a heading 'Workings'. Then show the double entry accounts under that heading.
- 2 Now put a heading 'Answer' and show the answer in the form of the journal, as shown in this chapter.

If the question asks for journal entries, you must *not* fall into the trap of just showing the double entry accounts, as you could get no marks at all *even though your double entry records are correct*. The examiner wants to see the journal entries, and you *must* show those in your answer.

15.6 The basic accounting cycle

Now that we have covered all aspects of bookkeeping entries, we can show the whole **accounting cycle** in the form of the diagram in Exhibit 15.2.

Note that the 'accounting cycle' refers to the sequence in which data is recorded and processed until it becomes part of the financial statements at the end of the period.

Exhibit 15.2 The accounting cycle for a profit-making organisation

Source documents

Where original information is to be found

- Sales and purchases invoices
- Debit and credit notes for returns
- Bank pay-in slips and cheque counterfoils
- Receipts for cash paid out and received
- Correspondence containing other financial information

Original entry

What happens to it

Classified and then entered in books of original entry:

- The cash books^{Note}
- Sales and purchases day books
- Returns inwards and outwards day books
- The journal

Double entry

How the dual aspect of each transaction is recorded

Double entry accounts

General ledger	Sales ledger	Purchases ledger	Cash books*
Real and nominal accounts	Trade receivables	Trade payables	Cash book and petty cash book

(Note: Cash books fulfil the roles both of books of original entry and double entry accounts)

Check arithmetic

Checking the arithmetical accuracy of double entry accounts

Profit or loss

Calculation of profit or loss for the reporting period shown in a financial statement

Closing balance sheet

Financial statement showing liabilities, assets and capital at the end of the reporting period

Trial balance

Income statement

Balance sheet

Activity 15.4

What are the six books of original entry?

Learning outcomes

You should now have learnt:

- 1 What the journal is used for.
- 2 That the journal is the collection place for items that do not pass fully through the other five books of original entry.
- 3 That there is a range of possible types of transactions that must be entered in the journal.
- 4 That the opening double entries made on starting a set of books for the first time are done using the journal.
- 5 How to make the opening entries for a new set of books in the journal and in the ledger accounts.
- 6 That the main parts of the accounting cycle are as follows:
 - (a) Collect source documents.
 - (b) Enter transactions in the books of original entry.
 - (c) Post to ledgers.
 - (d) Extract trial balance.
 - (e) Prepare the income statement.
 - (f) Draw up the balance sheet.

Answers to activities

- 15.1** All transactions relating to non-current assets. Also, entries have to be recorded somewhere when errors in the books have to be corrected, or when any figures in the ledger accounts need to be changed. Also, any transfers involving the Capital Account, such as when funds are set aside from the Capital Account to provide resources should a building need to be repaired or replaced.
- 15.2** You are looking at the ledger accounts after the details have been entered in them from the journal and you always enter the folio number in the ledger account as you make each entry, not afterwards. The check that the entries has been completed is made by only entering the folio numbers *in the journal* as each entry is written in the appropriate ledger account. You could, therefore, see an entry in the journal that has no folio numbers entered against it. This would signify that the journal entry has not yet been fully recorded in the appropriate ledger accounts. As mentioned above, you should *never* see this in a ledger account as the folio number is always entered *at the same time* as the rest of the details from the journal are entered.
- 15.3** The need for opening entries will not occur very often. They will not be needed each year as the balances from the previous period will have been brought forward. They will only be required a second time if the business goes through a change in status, for example, if it becomes a limited company.
- 15.4** Cash book, sales day book, purchases day book, returns inwards day book, returns outwards day book, and the journal. The petty cash book is also considered to be a book of original entry.

Review questions

15.1 You are to show the journal entries necessary to record the following items which occurred in May:

- (a) May 1 Bought a motor bike on credit from Lakeside Garage for £5,500.
- (b) May 3 A debt of £347 owing from T. Reason was written off as a bad debt.
- (c) May 8 Office chairs bought by us for £600 were returned to the supplier UL Furniture Ltd, as they were unsuitable. Full allowance will be given to us.
- (d) May 12 We are owed £300 by J. Day. He is declared bankrupt and we received £190 in full settlement of the debt.
- (e) May 14 We take goods costing £60 out of the business inventory without paying for them.
- (f) May 28 Some time ago we paid an insurance bill thinking that it was all in respect of the business. We now discover that £40 of the amount paid was in fact insurance of our private house.
- (g) May 28 Bought a trailer for £1,700 on credit from C-Land Ltd.

15.2A Show the journal entries necessary to record the following items:

- Apr 1 Bought office furniture on credit from Durham Brothers Ltd £1,400.
- 4 We take goods costing £270 out of the business inventory without paying for them.
- 9 £90 of the goods taken by us on 4 April are returned back into inventory by us.
 We do not take any money for the return of the goods.
- 12 M. Sharp owes us £460. He is unable to pay his debt. We agree to take some display cabinets from him at that value and so cancel the debt.
- 18 Some of the items of office furniture bought from Durham Brothers Ltd, £36 worth, are found to be unsuitable and are returned to them for full allowance.
- 24 A debt owing to us by T. Lyle of £80 is written off as a bad debt.
- 30 Computers bought on credit from OTF Ltd for £2,300.

15.3 You are to open the books of F. Polk, a trader, via the journal to record the assets and liabilities, and are then to record the daily transactions for the month of May 2024. A trial balance is to be extracted as on 31 May 2024.

2024

- May 1 Assets: Premises £34,000; Van £5,125; Fixtures £810; Inventory £6,390; Trade receivables: P. Mullen £140, F. Lane £310; Cash at bank £6,240; Cash in hand £560.
 Liabilities: Trade payables: S. Hood £215, J. Brown £640.
- 1 Paid storage costs by cheque £40.
- 2 Goods bought on credit from: S. Hood £145; D. Main £206; W. Tone £96; R. Foot £66.
- 3 Goods sold on credit to: J. Wilson £112; T. Cole £164; F. Syme £208; J. Allen £91; P. White £242; F. Lane £90.
- 4 Paid for motor expenses in cash £60.
- 7 Cash drawings by proprietor £150.
- 9 Goods sold on credit to: T. Cole £68; J. Fox £131.
- 11 Goods returned to Polk by: J. Wilson £32; F. Syme £48.
- 14 Bought another van on credit from Abel Motors Ltd £4,850.
- 16 The following paid Polk their accounts by bank transfer less 5% prompt payment discount: P. Mullen; F. Lane; J. Wilson; F. Syme.
- 19 Goods returned by Polk to R. Foot £6.
- 22 Goods bought on credit from: L. Mole £183; W. Wright £191.
- 24 The following accounts were settled by Polk by cheque less 5% prompt payment discount: S. Hood; J. Brown; R. Foot.
- 27 Salaries paid by bank transfer £740.
- 30 Paid business rates by cheque £140.
- 31 Paid Abel Motors Ltd a cheque for £4,850.

Learning objectives

After you have studied this chapter you should be able to:

- Describe the key principles of VAT and how it must be accounted for.
- Distinguish between VAT-registered businesses and unregistered businesses.
- Make entries for VAT in the books and accounts.
- Create sales invoices including VAT.
- Explain the purpose of the VAT return form and what it shows.

Introduction

Most countries have a 'sales tax' of some sort and, in the UK, it is called value added tax (VAT). VAT is a tax that is charged on the supply of most goods and services in the UK. The majority of businesses must therefore keep account of all the VAT they charge on their sales, as well as all the VAT they pay on the goods and services they buy. The detailed rules of VAT are remarkably complex but in this chapter you'll learn the key principles regarding which businesses must charge VAT on their sales, how VAT must be accounted for, and how businesses must ultimately pay the VAT they have collected to the government.

16.1 What is VAT?

Value added tax (VAT) is a tax charged on the supply of most goods and services in the UK. Some goods and services (such as insurance) are not taxable but most are. VAT is administered in the UK by HM Revenue & Customs (HMRC). HMRC is the government department responsible for collecting all UK taxes. The rules of VAT are highly detailed and complicated and so are beyond the scope of this book. This chapter covers the basic principles only.

16.2 The different rates of VAT

Goods and services essentially fall into one of four categories in relation to VAT in the UK:

- 1 **Standard rate:** this applies to the majority of goods and services and at the time of writing the standard rate is 20 per cent.
- 2 **Reduced rate:** there are a *small* number of goods and services that are subject to a reduced rate of 5 per cent. Examples include domestic fuel (not business fuel), children's car seats, and nicotine patches. Since most businesses will very rarely buy or sell reduced rate items we will not see any examples of the reduced rate in this chapter.

- 3 **Zero-rate:** certain items (such as most food, printed books, and young children's clothes) are subject to VAT at a rate of 0 per cent.
- 4 **Exempt items:** some specific types of goods and services are not subject to VAT at all. Examples include banking and insurance services, betting, gaming and lotteries, and most healthcare services.

Standard rate VAT applies to the majority of goods and services that businesses deal in, so most of the sales and purchases in this chapter will be subject to VAT at 20 per cent.

16.3 Do all businesses have to add VAT to their selling prices?

The answer is no, but most do. Most businesses must 'register for VAT' with HMRC which means they will have to add VAT to the prices of the goods and services they sell. There are two types of business that do not have to register and these are categorised under two headings:

- 1 **Nature of business:** some specific types of goods and services are **exempt** and not subject to VAT at all. If a business only sells *exempt* items (such as banking and insurance services) then they will not be able to register for VAT. (Note that a business that only sells *zero-rated* items must still register for VAT unless it falls under the second heading below.)
- 2 **Size of business:** UK businesses only have to register for VAT if their annual sales exceed £85,000 (£85,000 is the 'registration limit' at the time of writing, although it can potentially change each year). Very small businesses therefore do not have to add VAT to their prices (although they are allowed to register voluntarily).

Activity 16.1

You have just learnt that small businesses do not have to register for VAT until their sales exceed a certain limit. Why does the government have this rule?

16.4 VAT-registered businesses: accounting for VAT

Suppose that Business A is registered for VAT and sells goods priced at £200 to Business B. The sales invoice issued by Business A will essentially show:

	£
Goods price ('net')	200
VAT at 20%	40
Invoice total including VAT ('gross')	<u>240</u>

Business A will receive the total amount of £240 from Business B. £40 of this represents VAT that Business A is collecting on behalf of HMRC. Business A will therefore have to hand over this £40 to HMRC in due course.

Suppose that Business B is also VAT-registered. Business B takes the goods, modifies them in some way and sells them to a member of the general public (Jane Smith) for £300 plus VAT. The sales invoice issued by Business B will show:

	£
Goods price ('net')	300
VAT at 20%	60
Invoice total including VAT ('gross')	<u>360</u>

Business B therefore receives £360 from Jane Smith and owes the £60 VAT element of this to HMRC. However, because Business B is VAT-registered it is also able to claim a refund of the £40 VAT it paid to Business A. It will therefore pay only £20 to HMRC (i.e. the £60 VAT collected on its sales minus the £40 VAT reclaimed on its purchases).

In this example, we can see that HMRC will receive £40 from Business A and £20 from Business B. The total tax collected is therefore £60, which ultimately has all been borne by Jane Smith (who paid £300 + VAT £60 for her goods). The final consumer of the goods (normally a member of the general public) is not registered for VAT so cannot reclaim it. Businesses A and B have effectively acted as collectors of the tax, the entire burden of which ultimately falls on the final customer.

This is the fundamental principle underlying how VAT works. VAT is collected and reclaimed by each business at each stage in the supply chain and it is the final consumer at the end of the chain that ultimately bears the tax in full.

Activity 16.2

A forestry business (X) sells timber to a carpentry business (Y) for £1,000 plus VAT at 20 per cent. With this wood, the carpenter makes furniture which it sells to a retail business (Z) for £1,500 plus VAT at 20 per cent. The retail business sells the furniture to customers for £2,200 plus VAT at 20 per cent. How much VAT will be received by HMRC from this chain of transactions, and from whom will it be collected?

16.5 VAT invoices

If a VAT-registered business supplies goods or services to another VAT-registered business it must issue a 'VAT invoice'. (If the business is a retailer it must issue a VAT invoice if the customer asks for one.)

A VAT invoice is required by law to show certain information. The principal requirements are that it must show:

- name, address and VAT-registration number of the business supplying the goods or services (when a business registers for VAT it will be given a unique VAT registration number by HMRC)
- customer's name and address
- invoice number and invoice date
- description of the goods or services supplied
- price before VAT is added
- total cost before VAT
- rate of VAT and the total VAT charged
- invoice total including VAT.

Exhibit 16.1 shows an example of a VAT invoice. Note that if the value of the sale is below a certain amount (£250 at the time of writing) then a simplified VAT invoice can be issued.

16.6 VAT and discounts

On an invoice, VAT is added to the price of goods or services sold after deducting trade discount but not prompt payment discount.

Exhibit 16.1 shows an example of a VAT invoice featuring both trade discount and prompt payment discount.

Exhibit 16.1

P. Wilson & Co 51 Church Street London WC4 2NA VAT registration no.: 741 852 963 INVOICE			
To:	D. Murray 22 Green Lane Manchester M13 6BA	Invoice date: Invoice no.:	23 May 2022 15984
<i>Description</i>	<i>Quantity</i>	<i>Unit price</i>	<i>Total £</i>
Paper dispensers	10	£100	1,000
Less Trade discount of 10%			(100)
			900
Add VAT at 20%			180
Invoice total including VAT			<u><u>1,080</u></u>
Terms: Prompt payment discount of 5% available if paid within 14 days			

In the case of Exhibit 16.1, if Murray settles his account within 14 days then he will deduct prompt payment discount of £54 ($£1,080 \times 5\%$), and therefore only pay £1,026 ($£1,080 - £54$). Wilson would then issue a credit note to Murray for:

	£
Goods	45
VAT at 20%	<u>9</u>
Credit note total including VAT	<u><u>54</u></u>

16.7 Accounting entries for VAT-registered businesses

VAT on sales

Suppose J. Cuttle & Co., a VAT-registered business, only made three credit sales during March 2022:

		Price of goods sold before VAT is added	VAT at 20%
2022		£	£
March	7 D. Knowles	100	20
	13 B. Grimes	300	60
	24 N. Parkes	170	34

Businesses record their sales in a sales day book (see Chapter 14). If a business is VAT-registered this day book will now require an extra column for VAT. The sales day book for March will therefore appear as follows:

Sales Day Book						(page 862)
		Invoice number	Folio	Gross	VAT	Net
2022				£	£	£
March	7 D. Knowles	8436	SL189	120	20	100
	13 B. Grimes	8437	SL296	360	60	300
	24 N. Parkes	8438	SL73	204	34	170
Transferred to General Ledger				<u>684</u>	<u>114</u>	<u>570</u>
					GL67	GL101

Each invoice must be entered in the individual customers' accounts in the sales ledger. The customers owe the total amount of the invoice including VAT, so it is the gross amounts that must be entered in the individual accounts, as shown below:

Sales Ledger						(page 189)
D. Knowles						
2022		Folio	£			
March	7	Sales	SB862	120		
B. Grimes						(page 296)
2022		Folio	£			
March	13	Sales	SB862	360		
N. Parkes						(page 73)
2022		Folio	£			
March	24	Sales	SB862	204		

The personal accounts have been debited with a total of £684, being the sum of the amounts that the customers will have to pay. These are debit entries because they are recording an increase in the assets of the business (amounts due from customers).

The actual value of the goods sold before VAT is added was only £570, so it is this amount that must be credited to the sales account in the general ledger. The £114 VAT on these sales is known as **Output VAT**. It is owed to HMRC so will be credited to the *Output VAT* account in the general ledger:

General Ledger						(page 101)
Sales						
	2022		Folio	£		
	March	31	Sales	SB862	570	
Output VAT						(page 67)
	2022		Folio	£		
	March	31	Sales	SB862	114	

Let's assume that all J. Cuttle & Co.'s sales in March were made on credit. However, if it had also made cash sales then these would be recorded in the business's cash book. The net value of the sales and the output VAT on those sales would still need to be recorded in the general ledger in the same manner as the two entries shown above.

VAT on purchases

A VAT-registered business like J. Cuttle & Co. has to add VAT to their sales prices but is able to reclaim the VAT it pays on the goods and services it buys. Periodically the business will submit a 'VAT return' (normally every three months) to HMRC which will show:

	£
VAT on sales invoices (Output VAT)	A
Less VAT on goods & services bought (Input VAT)	<u>(B)</u>
Amount to be paid to HMRC	<u>C</u>

Normally A will be greater than B so the business will pay amount C to HMRC. Very occasionally A will be less than B, in which case HMRC will refund C to the business.

Businesses must therefore record the **input VAT** on all goods and services that they buy. Let's look at the credit purchases of J. Cuttle & Co (the same business whose sales we dealt with earlier in this section). Suppose J. Cuttle & Co made only three credit purchases in March 2022:

	Price of goods purchased before VAT is added	VAT at 20%
2022	£	£
March 5 P. Surtees	50	10
17 L. Gower	160	32
29 J. Cropper	120	24

Credit purchases are recorded in a purchases day book (see Chapter 14). As with the sales day book, an extra column for VAT will be required. The purchases day book for March will therefore be completed as follows:

Purchases Day Book (page 943)					
	Invoice number	Folio	Gross	VAT	Net
2022			£	£	£
March 5 P. Surtees	3/301	PL169	60	10	50
17 L. Gower	3/302	PL94	192	32	160
29 J. Cropper	3/303	PL183	144	24	120
Transferred to General Ledger			<u>396</u>	<u>66</u>	<u>330</u>
				GL68	GL111

These transactions must be entered in the individual accounts in the purchases ledger. J. Cuttle & Co owes the total amounts including VAT to its suppliers so it is the gross amounts that are entered in the personal accounts, as shown below:

Purchases Ledger

P. Surtees

(page 169)

2022	Folio	£
March 5 Purchases	PB943	60

L. Gower

(page 94)

2022	Folio	£
March 17 Purchases	PB943	192

J. Cropper

(page 183)

2022	Folio	£
March 29 Purchases	PB943	144

The personal accounts have been credited with a total of £396, being the sum of the three amounts that J. Cuttle & Co will have to pay its suppliers.

But the actual cost of the goods purchased in this example is only £330. Being an increase in the business's possessions, £330 will be debited to the purchases account. The VAT of £66 is an asset because it can be reclaimed from HMRC, so this implies a debit to the *Input VAT* account:

General Ledger					
Purchases					(page 111)
2022			Folio	£	
March	31	Purchases	PB943	330	
Input VAT					(page 68)
2022			Folio	£	
March	31	Purchases	PB943	66	

Again, we'll assume that all J. Cuttle & Co.'s purchases in March were made on credit. However, if it also made cash purchases then these would be recorded in the business's cash book. The net value of the purchases and the input VAT on those purchases would still need to be recorded in the general ledger in the same manner as the two entries shown above.

VAT in the financial statements

To conclude our example for J. Cuttle & Co., an income statement for this business for the month ended 31 March 2022 would show a sales figure of £570 and a purchases figure of £330. In other words, the income and expenses in the income statement of a VAT-registered business do *not* include VAT.

In the balance sheet of J. Cuttle & Co. as at 31 March 2022 the total figure for trade receivables will be the total amounts due from customers, which will include VAT. Likewise, the figure for trade payables will be the total amounts due to suppliers, which will include VAT.

Additionally, in J. Cuttle & Co.'s balance sheet as at 31 March 2022 the amount of VAT owed to HMRC will be shown as a current liability. In this very simple example (assuming there were no opening balances on the Input VAT and Output VAT accounts brought down at 1 March 2022) the current liability will be £48:

	£
Output VAT account (<i>a credit balance</i>)	114
Input VAT account (<i>a debit balance</i>)	<u>66</u>
VAT owed to HMRC (<i>a current liability</i>)	<u>48</u>

16.8 Accounting entries for businesses that are not VAT-registered

Businesses that are not VAT-registered will not add VAT to their sales prices so there will be no entries in their books whatsoever in relation to Output VAT.

Neither can such businesses reclaim input VAT on the goods and services they buy. Any VAT on goods and services bought will simply be included as part of the cost of whatever has been bought.

For example, if a business that is not VAT-registered buys goods in March 2022 for £200 plus £40 VAT then this will lead to £240 being debited to the purchases account in the general ledger, and the income statement for March 2022 will show purchases of £240.

16.9 VAT on expenses and on the purchase of non-current assets

Input VAT is not just paid on purchases of raw materials and goods for resale. It is also payable on many expenses and on the purchase of most non-current assets.

VAT-registered businesses can reclaim the VAT paid on expenses and the purchase of non-current assets. They will therefore not include the VAT as part of the amount recorded in the ledger account for that expense or non-current asset.

Businesses that are not VAT-registered cannot reclaim any VAT paid on such items. They will therefore record the total amount *including* VAT as the figure in the ledger account for every expense or non-current asset.

In other words, two different businesses, buying exactly the same items, would make the following entries in their ledger accounts:

	<i>Business X: VAT-registered</i>	<i>Business Y: not registered for VAT</i>
Buy machinery, paying £200 + VAT £40	Debit Machinery £200 Debit Input VAT £40 Credit Bank £240	Debit Machinery £240 Credit Bank £240
Buy advertising, paying £150 + VAT £30	Debit Advertising expense £150 Debit Input VAT £30 Credit Bank £180	Debit Advertising expense £180 Credit Bank £180

Business X has an advantage in that it will be able to reclaim, in due course, the total of £70 input VAT from HMRC whereas Business Y cannot. But remember that Business X will also have to add VAT at 20% to its sales prices, which might hand a significant competitive advantage to Business Y.

Activity 16.3

In Section 16.3 of this chapter you learnt that small businesses (with annual sales below a certain limit) do not have to register for VAT. Now that you know how VAT works, can you suggest why a small business might wish to register for VAT voluntarily?

16.10 Calculating the VAT included in a gross amount

Sometimes you will only know the gross amount of a transaction that includes VAT and you may be required to calculate the VAT amount.

Suppose the gross amount of a sale is £420 including VAT. VAT is calculated as 20% of the net amount, meaning that the gross amount is 120% of the net amount.

Since £420 represents 120% of the net amount, the net amount can be calculated by multiplying the gross amount by 100%/120% (which is the same, mathematically, as multiplying by 5/6, or dividing by 1.2, whichever you prefer!).

$$£420 \times 100\%/120\% = £350, \text{ so } £350 \text{ is the net amount of the sale}$$

Subtracting £350 from £420 gives us £70, which is the VAT amount. This makes sense, because a net amount of £350 \times 20% = £70, which is the VAT amount.

Accountants tend to use the 'VAT fraction' of 1/6 as a shortcut to arrive at the VAT included in a gross amount. In the example above, $£420 \times 1/6 = £70$, which is the VAT amount. The VAT fraction of 1/6 comes from a simplification of 20%/120%, so 1/6 will always work when the VAT rate is 20%.

If the rate of VAT changes then the VAT fraction will change. A ‘formula’ for the VAT fraction for any rate of VAT will be:

$$\frac{\% \text{ rate of VAT}}{100 + \% \text{ rate of VAT}}$$

So if the standard rate of VAT increased to 25% then the new VAT fraction would be 25%/125%. This would simplify to 1/5: in order to calculate the VAT element of a gross amount that included VAT at 25%, accountants would simply multiply the gross amount by 1/5.

16.11 VAT on bad debts

Most business-to-business sales are on credit and there is always the risk that a few customers will never pay what they owe. These are known as ‘bad debts’ and are covered in detail in Chapter 19. But bad debts present a particular problem from a VAT perspective, as illustrated by the following example:

Suppose Mrs Scoggins (a VAT-registered trader) makes a sale on credit to Mr Carker on 15 March for £400 + VAT £80 = £480. The sum of £80 will be recorded in the Output VAT account of Scoggins, and this will form part of the payment that she must make to HMRC at the end of her VAT quarter.

However, suppose Carker’s business collapses and Scoggins never receives the £480. The situation is now quite unfair to Scoggins because she must hand over £80 VAT to HMRC but she never actually collected this money from the customer. In principle, Scoggins should act merely as a tax collector for HMRC, but in this case she has had to pay £80 out of her business’s own money!

Because of this problem, the VAT rules allow Scoggins to subsequently get her £80 back from HMRC if she can demonstrate that the debt due from Carker will almost certainly never be received (i.e. that it is a ‘bad debt’).

Activity 16.4

Smaller businesses are actually allowed to account for VAT using an alternative method that means this problem would never arise. Do you have any ideas about what that alternative method might be?

16.12 Input VAT that cannot be reclaimed by any business

There are a few instances where input VAT cannot be reclaimed, regardless of whether the business is VAT-registered. The two most common examples are:

- Normally the VAT on cars purchased and used in the business is not reclaimable.
- The input VAT on business entertainment costs is not reclaimable (apart from VAT on the costs of entertaining staff).

16.13 The VAT return

At the end of each period (normally every three months), VAT-registered businesses must complete a ‘VAT return’ and submit it online to HMRC.

A VAT return essentially shows:

- (a) the total output VAT charged on the business’s sales for the period; minus
- (b) the total input VAT incurred on goods and services bought by the business during the period.

If (a) is greater than (b) then the balance must be paid to HMRC. Businesses must submit the return and electronically pay any tax due within about a month of the end of the quarter.

Occasionally, for some businesses (b) may be greater than (a) so HMRC will refund the difference to the business.

The figures entered on a business's VAT return must be checked very carefully because the potential penalties for any errors can be very severe.

Smaller businesses are allowed to submit their VAT returns annually rather than quarterly. This reduces the administrative burden on small businesses.

Activity 16.5

Why do you think that it is rare for a business's Input VAT (i.e. VAT on goods and services bought) for the period to be greater than its Output VAT (i.e. VAT on goods and services sold)? Can you think of any circumstances where it might happen?

16.14 HM Revenue and Customs (HMRC) VAT Guides and Notices

The detailed rules surrounding VAT are exceptionally complex and are beyond the scope of this book. However, all the rules (as well as introductory guidance) are available online and (at the time of writing) can be found from the GOV.UK website. Searching online for 'HMRC VAT videos' might be a good place to start.

Learning outcomes

You should now have learnt:

- 1 VAT is a tax charged on the supply of the majority of goods and services in the UK and the standard rate of VAT is 20%.
- 2 Most businesses must 'register' for VAT, which means they must charge VAT on their sales and (in due course) pay this 'Output VAT' to HMRC.
- 3 VAT-registered businesses are also allowed to reclaim from HMRC the VAT they pay on the goods and services they buy.
- 4 Amounts excluding VAT are known as 'net' and those including VAT are referred to as 'gross'.
- 5 The VAT on every credit sale must be separately recorded in a separate column in the sales day book. The total amount due from each customer will be debited to the personal accounts; the net amount of the sales made will be credited to the sales account; and the VAT on these sales is credited to the Output VAT account.
- 6 A VAT-registered business must record the VAT on credit purchases in a separate column in the purchases day book. The total amount owed to each supplier will be credited to the personal accounts; the net amount of the purchases will be debited to the purchases account; and the VAT on the purchases made is debited to the Input VAT account.
- 7 At the end of each period (normally every three months) VAT-registered businesses must submit a VAT return to HMRC which states (a) the total Output VAT charged on sales for

the period; and (b) the total Input VAT incurred on goods and services bought during the period. Usually (a) will exceed (b) and this excess must be paid to HMRC.

- 8 To calculate the VAT included in a gross amount you can simply multiply the gross amount by $1/6$ ($1/6$ being the 'VAT fraction' when the rate of VAT is 20%).

Now attempt Set 2 of multiple-choice questions. (Answers to all the multiple-choice questions are given in Appendix 2 at the end of this book.)

Answers to activities

- 16.1** There are various reasons. Above all, it will ease the administrative burden on small firms. Many small businesses are 'sole traders' who have to perform virtually all business tasks on their own, and VAT record-keeping means a lot of extra work. Second, it will potentially give small businesses a competitive advantage because their prices will be 20 per cent lower than those of larger rivals who must add VAT. This is good for encouraging small businesses and is also beneficial for consumers. Finally, it makes life simpler for HMRC. HMRC's resources are not unlimited, so exempting small businesses means that HMRC can focus its efforts on checking that larger businesses are accounting for VAT correctly.
- 16.2** The simple answer is that the final consumers pay $£2,200 \times 20\% = £440$ in VAT for their furniture and this will be the total that is collected by HMRC. However, the actual chain of events can be quite confusing:
- X receives £1,200 (i.e. $£1,000 + 20\%$ VAT) from Y and X must hand over the **£200** VAT on this transaction to HMRC.
 - Y receives £1,800 (i.e. $£1,500 + 20\%$ VAT) from Z and Y owes the **£300** VAT on this transaction to HMRC. But Y can also reclaim the **£200** VAT it paid on its purchase from X, so only actually hands over the difference (**£100**) to HMRC.
 - Z receives £2,640 (i.e. $£2,200 + 20\%$ VAT) from its customers. Z therefore collects **£440** in VAT on these sales which it owes to HMRC, but it can also reclaim the **£300** VAT it paid to Y, so only hands over the difference (**£140**) to HMRC.

So the customers have paid a total of **£440** in VAT and cannot reclaim it. But this VAT has actually been collected by HMRC by way of **£200** from X, **£100** from Y and **£140** from Z as described above!

- 16.3** The advantage of registration would be that all the input VAT paid on the goods and services that the business buys can be reclaimed from HMRC. In the early stages of a new business, this could be advantageous if it is investing a lot in inventory and non-current assets. Another possible advantage is that registering for VAT may help the business appear big and reputable. The final (and perhaps most important) factor is whether most of the small business's customers are themselves VAT-registered. If they are, they will be able to reclaim all the VAT that the small business charges on its sales. Such customers won't be affected by whether the small business adds 20 per cent VAT to its prices. In these circumstances voluntary registration would probably be a good idea.
- 16.4** Smaller businesses are allowed to account for VAT on a 'cash basis' rather than the standard method described in this chapter. The 'cash basis' means that the small business only has to pay the output VAT on its sales to HMRC after the money has been received from the customer. If a few credit customers don't pay their bills (i.e. there are 'bad debts') then the VAT on these sales will never have to be paid to HMRC. It is usually a good idea for eligible small businesses to adopt the 'cash basis' for VAT because this method will generally be better for the business's cash flow.
- 16.5** Businesses normally aim to make a profit, so the sales revenue of the business will normally exceed the cost of goods and services purchased in the period. The output VAT at 20 percent on sales will therefore be greater than the input VAT at 20 per cent on goods and services purchased. However, input VAT might exceed output VAT for a new business in its first few months of trading: a new business might buy large quantities of inventory, equipment and advertising but sales may be very low initially.
- Another example might be a highly seasonal business. Some businesses may make the bulk of their annual sales in one particular quarter of the year. In preparation, such businesses may purchase large quantities of inventory

in the preceding quarter. For such a business, input VAT could therefore exceed output VAT during that preceding quarter.

A third example would be a trader that only sold zero-rated goods (such as young children's clothes). The output VAT on sales would be zero but the business could still reclaim input VAT on many of its expenses.

Review questions

16.1 On 1 March 2024, A. Cook, 7 Down Road, Middlefield, sold the following goods on credit to B. Pitt, Ballano Golf Club, Ringlee, Yorkshire:

Order No. B/162
 5 sets golf clubs at £1,250 per set.
 500 golf balls at £25 per 10 balls.
 5 golf bags at £370 per bag.

Trade discount is given at the rate of 30%.

All goods are subject to VAT at 20%.

- Prepare the sales invoice. The invoice number will be 4231.
- Show the entries in the personal ledgers of A. Cook and B. Pitt.

16.2A On 1 March 2020, B. Cox, Middle Road, Paisley, a VAT-registered business, sold the following goods on credit to T. Ross, 24 Peter Street, Loughborough, Order No. 9841:

20,000 Coils Sealing Tape	@ £6.70 per 1,000 coils
40,000 Sheets Bank A5	@ £5.20 per 1,000 sheets
24,000 Sheets Bank A4	@ £9.00 per 1,000 sheets

All goods are subject to VAT at 20%.

- Prepare the sales invoice (the invoice number will be 4632).
- Show the entries in the personal ledgers of B. Cox and T. Ross.

16.3 The following sales have been made by C. Rice during the month of March 2024. All the figures are shown net after deducting trade discount, but before adding VAT at the rate of 20%.

		£
March	2 to G. Bush	430
	6 to A. Gray	290
	14 to L. Rowe	560
	31 to S. Pegg	320

You are required to enter up the Sales Day Book, Sales Ledger and General Ledger in respect of the above items for the month.

16.4 The following sales and purchases were made by C. West during the month of May 2024.

		Net	VAT added
		£	£
May	1 Sold goods on credit to J. Royce	290	58
	4 Sold goods on credit to D. Player and Co	440	88
	10 Bought goods on credit from:		
	B. Hunter	360	72
	R. Dixon Ltd	230	46





		<i>Net</i>	<i>VAT added</i>
		£	£
14	Bought goods on credit from G. Melly	80	16
16	Sold goods on credit to D. Player and Co	170	34
23	Bought goods on credit from G. Gooch	120	24
31	Sold goods on credit to N. Foster	110	22

Enter up the Sales and Purchases Day Books, Sales and Purchases Ledgers and the General Ledger for the month of May 2024.

16.5 You are informed that J. Beckham is a VAT-registered retailer. Her total sales for the week just ended amounted to £14,540 excluding VAT. All the business's sales are subject to VAT at 20%. Beckham deposited the entire week's takings in the business bank account. What will be the entries in the business's general ledger that record this information?

16.6 Ghadiali & Co is a VAT-registered business. In the three months ended 31 July the business sold goods with a net value of £143,200, all of which were subject to VAT at standard rate (20%). In the same quarter, the business bought goods and services (all of which were subject to VAT at standard rate) totalling £104,550 including VAT.

After preparing its VAT return for the quarter ending 31 July, how much VAT must the business pay to HMRC?

16.7A Robles & Co is a VAT-registered business. During the quarter just ended, it bought goods and services to the value of £51,690 excluding VAT, and its sales were £81,906 including VAT. All of the business's sales are subject to VAT at 20%. However, only two-thirds of the goods and services it buys are subject to VAT at 20%. The other third are either zero-rated or exempt.

After preparing its VAT return for the quarter just ended, how much must the business pay to HMRC?

16.8 Up until December 2020, K. Heitinga sold T-shirts for £12 including VAT at 20%.

Suppose that the government announces a reduction in the rate of VAT to 15%, effective from 1 January 2021 onwards.

If Heitinga reduces her selling price to exactly reflect the change in VAT rate, what will the selling price of her T-shirts be in 2021?

16.9A G. Brown's sales including VAT were £130,000 in November 2020, then £150,000 in December 2020, and £110,000 during January 2021.

Suppose that the rate of VAT was 20% until 31 December 2020 and 22.5% from 1 January 2021. Exactly three-fifths of Brown's net sales are subject to VAT, the rest being zero-rated.

What is the correct total credit to Output VAT in Brown's general ledger for the quarter to 31 January 2021?

16.10 Louise Baldwin commenced business as a wholesaler on 1 March 2019.

Her sales on credit during March 2019 were:

March 9	Neville's Electrical
	4 computer monitors list price £180 each, less 20% trade discount
March 17	Maltby plc
	20 computer printers list price £200 each, less 25% trade discount
March 29	Neville's Electrical
	Assorted software list price £460, less 20% trade discount

All transactions are subject to Value Added Tax at 10%.

- (a) Rule up a Sales Day Book and head the main columns as follows.

<i>Date</i>	<i>Name and Details</i>	<i>List price less trade discount</i>	<i>VAT</i>	<i>Total</i>
		<i>£-p</i>		<i>£-p £-p</i>

Enter the above information in the Sales Day Book, totalling and ruling off at the end of March 2019.

- (b) Make the necessary postings from the Sales Day Book to the personal and nominal accounts in the ledger.
- (c) Prepare a trial balance as at 31 March 2019.

(Edexcel Foundation, London Examinations: GCSE)

16.11A Mudgee Ltd issued the following invoices to customers in respect of credit sales made during the last week of May 2020. The amounts stated are all net of Value Added Tax. All sales made by Mudgee Ltd are subject to VAT at 15%.

<i>Invoice no.</i>	<i>Date</i>	<i>Customer</i>	<i>Amount</i>
			<i>£</i>
3045	25 May	Laira Brand	1,060.00
3046	27 May	Brown Bros	2,200.00
3047	28 May	Penfold's	170.00
3048	29 May	T. Tyrrell	460.00
3049	30 May	Laira Brand	1,450.00
			<u>£5,340.00</u>

On 29 May Laira Brand returned half the goods (in value) purchased on 25 May. An allowance was made the same day to this customer for the appropriate amount.

On 1 May 2020 Laira Brand owed Mudgee Ltd £2,100.47. Other than the purchases detailed above Laira Brand made credit purchases (including VAT) of £680.23 from Mudgee Ltd on 15 May. On 21 May, Mudgee Ltd received a cheque for £2,500 from Laira Brand.

Required:

- (a) Show how the above transactions would be recorded in Mudgee Ltd's Sales Day Book for the week ended 30 May 2020.
- (b) Describe how the information in the Sales Day Book would be incorporated into Mudgee Ltd's double entry system.
- (c) Reconstruct the personal account of Laira Brand as it would appear in Mudgee Ltd's ledger for May 2020.

(Association of Accounting Technicians)

Multiple-choice questions: Set 2

Each of these multiple-choice questions has four suggested answers, (A), (B), (C) and (D). You should read each question and then decide which choice is best, either (A) or (B) or (C) or (D). *Write down your answers on a separate piece of paper.* You will then be able to redo the set of questions later without having to try to ignore your answers from previous attempts.

MC21 Gross profit is

- (A) Excess of sales over cost of goods sold
- (B) Sales less purchases
- (C) Cost of goods sold + opening inventory
- (D) Net profit less expenses of the period

MC22 Net profit is calculated in the

- (A) Trading account
- (B) Profit and loss account
- (C) Trial balance
- (D) Balance sheet

MC23 To find the value of closing inventory at the end of a period we

- (A) Do this by physically counting the inventory (i.e. stocktaking)
- (B) Look in the inventory account
- (C) Deduct opening inventory from cost of goods sold
- (D) Deduct cost of goods sold from sales

MC24 The credit entry for net profit is on the credit side of

- (A) The trading account
- (B) The profit and loss account
- (C) The drawings account
- (D) The capital account

MC25 Which of these best describes a balance sheet?

- (A) An account proving the books balance
- (B) A record of closing entries
- (C) A listing of balances
- (D) A statement of assets

MC26 The descending order in which current assets should be shown in the balance sheet is

- (A) Inventory, Trade receivables, Bank, Cash
- (B) Cash, Bank, Trade receivables, Inventory
- (C) Trade receivables, Inventory, Bank, Cash
- (D) Inventory, Trade receivables, Cash, Bank

MC27 Which of these best describes non-current assets?

- (A) Items bought to be used in the business
- (B) Items which will not wear out quickly
- (C) Expensive items bought for the business
- (D) Items having a long life and not bought specifically for resale

MC28 Carriage inwards is charged to the trading account because

- (A) It is an expense connected with buying goods
- (B) It should not go in the balance sheet
- (C) It is not part of motor expenses
- (D) Carriage outwards goes in the profit and loss account

MC29 Given figures showing: Sales £8,200, Opening inventory £1,300, Closing inventory £900, Purchases £6,400, Carriage inwards £200, the cost of goods sold figure is

- (A) £6,800
- (B) £6,200
- (C) £7,000
- (D) Another figure

MC30 A normal set of financial statements is prepared on the assumption that the business will continue trading for the foreseeable future, with no intention, nor any need to close down. What name is given to this assumption?

- (A) Going concern
- (B) Prudence
- (C) Consistency
- (D) Perpetual succession

MC31 Suppliers' personal accounts are found in the

- (A) Nominal ledger
- (B) General ledger
- (C) Purchases ledger
- (D) Sales ledger

MC32 The sales day book is best described as

- (A) Part of the double entry system
- (B) Containing customers' accounts
- (C) Containing real accounts
- (D) A list of credit sales

MC33 Which of the following are personal accounts?

- (i) Buildings
- (ii) Wages
- (iii) Trade receivables
- (iv) Trade payables
- (A) (i) and (iv) only
- (B) (ii) and (iii) only
- (C) (iii) and (iv) only
- (D) (ii) and (iv) only

MC34 If you sell a book to J. Flood on eBay and the buyer pays using PayPal, what are the accounts to debit and credit?

- (A) Dr Bank Cr Sales
- (B) Dr J. Flood Cr Sales
- (C) Dr PayPal Cr Sales
- (D) Dr Cash Cr Sales





MC35 Transactions involve two elements. Which one guides you to identify the accounts to debit and credit?

- (A) The item exchanged
- (B) The buyer
- (C) The seller
- (D) The form of settlement

MC36 What are the journal entries if you exchange a van for a car from a second-hand motor dealer called R. Main?

- (A) Dr R. Main Cr Van
- (B) Dr Car Cr Van
- (C) Dr Car Cr R Main
- (D) Dr Van Cr Car

MC37 A debit balance of £100 in a cash account shows that

- (A) There was £100 cash in hand
- (B) Cash has been overspent by £100
- (C) £100 was the total of cash paid out
- (D) The total of cash received was less than £100

MC38 £50 cash taken from the cash till and banked is entered

- (A) Debit cash column £50: Credit bank column £50
- (B) Debit bank column £50: Credit cash column £50
- (C) Debit cash column £50: Credit cash column £50
- (D) Debit bank column £50: Credit bank column £50

MC39 What are the two fundamental characteristics of useful financial information according to the IASB's Conceptual Framework for Financial Reporting?

- (A) Completeness and neutrality
- (B) Comparability and understandability
- (C) Timeliness and verifiability
- (D) Relevance and faithful representation

MC40 'Posting' the transactions in bookkeeping means

- (A) Making the first entry of a double entry transaction
- (B) Entering items in a cash book
- (C) Making the second entry of a double entry transaction
- (D) Something other than the above

ADJUSTMENTS TO FINANCIAL STATEMENTS

Introduction

This part deals with the identification of unknown figures needed in order to prepare financial statements, the maths all accountants need to know, and the adjustments that have to be made before financial statements can be prepared.

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Learning objectives

After you have studied this chapter, you should be able to:

- Explain why knowing how to do arithmetic and algebra is an essential skill in accounting.
- Describe a list of mathematical calculations that an accountant may make.
- Explain why it is important to always check the answer to any calculation.
- Explain the mathematics used for opening and closing adjustments to accounts.
- Explain the mathematics used for bad debts and allowances for doubtful debts.
- Explain the mathematics used for depreciation.
- Explain how to manipulate a formula to find a missing value for a variable in the formula.
- Explain why calculating a ratio is only the first step towards evaluating it.
- Explain how to calculate net revenue from a sales figure that includes VAT.

Introduction

The ability to perform calculations is an essential skill of an accountant. The mathematics of accounting is mainly arithmetic and algebra. This chapter describes many of the common uses of this mathematics in financial accounting and shows how to do so efficiently and with success. It is essential that you can perform all the calculations in this chapter before you go further in this book. If you do not, your trial balances will not balance, nor will your balance sheets; your profit calculations will be incorrect; several of the amounts shown in your balance sheet will be incorrect; and any ratios you calculate may be meaningless.

17.1 Why is it important that you know mathematics for accounting?

The answer to this question is very simple: mathematics is inseparable from accounting. Without mathematics, there would be no accounting as we know it. The need for accountants to know how to perform arithmetic is obvious. They need to know how to add, subtract, multiply, and divide. These are digital times, where computers are the accountant's principal tool and calculators are not far behind in second place. It is more the case now than ever before that accountants need to know when accounting information does not make sense, when a total is incorrect, when a calculation looks wrong. So, not only must accountants be very good at arithmetic, they also need to be good at mental arithmetic. They must be able to spot a possible error simply by looking at the numbers presented to them.

Is it assumed that simply by looking at the result of a calculation, an accountant can confirm that it is correct or that it is wrong? No, that would be impossible. Yet, we expect accountants to ensure the accuracy of the information they prepare for decision makers. A sole proprietor may ask his accountant what the depreciation on his non-current assets would be if he switched from straight line to reducing balance, and he expects a correct answer. The accountant opens her spreadsheet, enters the relevant data, selects the appropriate spreadsheet calculation functions, enters her own formulas, and out pops the answer. Simple, but is the answer correct? Maybe. . .

There are many ways in which it could be wrong. For example:

- the original data may have been entered into the spreadsheet incorrectly
- a wrong selection may have been made from the spreadsheet's list of available mathematical functions
- perhaps there is an error in one of the calculation formulas she wrote, a positive number may be being treated in calculations as though it is negative, a number may have been rounded to a whole number too early in the calculation process.

Errors may be caused by a human mistake. They may also occur because the software being used is not as reliable as it appears.

Spreadsheet software looks infallible but, sometimes, it uses algorithms (i.e. ways of performing calculations) that result in very small errors. For example, the correct answer may be 24,987 but the spreadsheet shows it to be 24,991. It is a small difference and probably not important. But, take the example of the mark on an exam. A correct answer of 49.501334 might be shown as 49.499976 by the spreadsheet and then rounded down to 49 by the spreadsheet instead of being rounded-up to 50, resulting in an exam being failed when it should have been passed, and no one knows because everyone assumes that the spreadsheet performed the calculation correctly. It is the same in the world in which accountants practise their profession: sometimes apparently trivial amounts may be important.

17.2 What mathematics do accountants need to know?

There is a long list of both general and specific mathematical calculations that accountants must be able to do. This requires that they are good at both arithmetic and algebra. Accountants need to be able to:

- add, subtract, multiply, and divide, ideally in their heads when the numbers are small
- calculate percentages, and know how to ensure that any rounding is done correctly
- calculate mark-ups and margins and not mix them up
- convert amounts from one currency to another
- discount amounts to provide an estimate of the current value of future cash flows
- perform calculations of depreciation, amortisation, impairment, revaluation, doubtful debts, accruals, prepayments, materiality, inventory valuation, discount, VAT, royalties, commissions, fair value, taxation, financial instruments, pensions, ratios, earnings per share, direct cost, indirect cost, allocation of cost, apportionment of cost, standard cost, variances from budgets, and many others.

And, for all the calculations they perform and for all the calculated numbers they look at, accountants must be able to interpret the answer, break it down into its constituent parts; and know where all the numbers used to calculate it come from – what they represent.

For example, if an accountant looks at an income statement prepared for a partnership by her trainee accountant, she needs to be able to tell if all the calculations that were made to produce it are correct; and she needs to know if the numbers in the income statement make sense. Let's assume she knows that gross profit should be around 55 per cent of revenue, does a rough calculation in her head, and realises that it is over 60 per cent. It looks to her as if it is too high, so she

investigates the elements within the cost of goods sold and discovers that the trainee has entered the opening inventory as £12,900 instead of £19,200. This leads her to look at the balance sheet.

Activity 17.1

Why would the accountant then look at the balance sheet?

If that reveals nothing, the accountant will look at the trial balance to see if the difference of £6,300 between what should have been entered (£19,200) and what was entered (£12,900) appears as one of the account balances. If it doesn't, the accountant may need to check all the account balances, one by one, until it is found.

Activity 17.2

What other obvious check could the accountant make?

These are some of the things an accountant must be able to do using mathematics. In some cases, they are beyond the scope of this book; for example, the last six items in the final bullet point above refer to things done in management accounting. However, all financial accountants at one time or another will be faced with having to deal with virtually all of the others.

Let's begin with the most basic mathematical skill needed by accountants: arithmetic.

17.3 Arithmetic

There is no possibility of anyone who cannot correctly perform basic arithmetic ever being a very successful accountant. Calculators, spreadsheets, and ERP systems like *SAP* will hide the weakness but, when mistakes are made and not identified, it will soon be revealed. The arithmetic needed is on two levels: performing the calculation and checking the answer.

Doing the calculation

Firstly, you must be able to add, subtract, multiply, and divide. You must know how to do each of these quickly without any tools to help you: 5 times 8; 9 minus 13; 4 plus 7; 25 divided by 3. Most of us can do these pretty easily in our heads and know that the answer is correct. But accountants deal in much larger numbers:

- (i) 2 million shares of 10p each – how much is that?
- (ii) A dividend is declared of 7p on each of 675,000 shares – how much is that?
- (iii) What proportion of a partnership do you own if you contributed £64,000 of the total capital of £185,000?
- (iv) If you purchase inventory at different times for £3 per kilo, £3.20 per kilo, and £2.76 per kilo, what is the average cost of the inventory held at the end of the reporting period?

These four examples are of straightforward multiplication and division calculations that accountants are expected to do. The first three provide all the information needed. The fourth needs information about quantities before any calculations can be made. As well as doing the calculations and checking calculations, accountants need to be aware of the data required for every calculation they perform or check.

Addition and subtraction are much more straightforward, but everyone makes mistakes keying in long lists of numbers on a calculator or a keyboard.

Checking the answer

Here is a list of numbers you entered into your calculator and the total you can see on the screen:

2,473.90
1,526.81
3,488.20
7,823.18
Total: 15,315.09

It is not correct. You have keyed 2,476.90 into the calculator, hitting the '6' key instead of the '3'. It is a very easy mistake to make. Remember, you cannot see what you entered in the calculator. All you can see is the answer.

Activity 17.3

How do you avoid making mistakes of this type?

Let's assume the only tool available to you is your calculator. If it is a short list like the one above, first add up the final digits of the numbers to check that the final digit in the answer is correct. Do that in your head. Then, work from right to left across the columns, checking the arithmetic. Again, do it in your head. Alternatively, after checking mentally the columns you find easy to check, rekey the calculation into your calculator and see if the same answer is produced. If you have made a mistake, the chances of making the same mistake again are low, especially if you have a long list of numbers – more than maybe 10. When recounting or rekeying longer lists of numbers, switch the sequence when you repeat the calculation. Count bottom-up instead of top-down, or vice versa. Do this both when doing them in your head and when using a calculator. Always write down the answer. You are hoping to get the same answer as you had in one of your other attempts. You won't know you have done so if you do not have a note of the answers you get.

Many people have a habit of miskeying certain numbers, such as 6 instead of 3. Anyone who does so needs to recognise the problem and be careful to hit those problematic keys correctly. If you rekey everything a number of times and each time get a different answer, leave it and do something else for a while, or ask someone else to add up the list and then compare answers.

Activity 17.4

What is a far easier way to check your arithmetic with longer lists?

You can total short lists manually or in a calculator and check the answers mentally, or on paper, or by rekeying them. However, you will find it hard to do this with longer lists. So, in terms of addition and subtraction, if you have a short list of numbers, do it manually or use a calculator. If you have a longer list of numbers, use a spreadsheet. But, always, when you have an answer to any calculation **think for a moment and consider whether it looks sensible**.

If the total shown on your calculator for the small addition performed above was £25,312.09, your common sense should have told you that it was impossible for that number to be correct. Many accountants would notice such strangeness in the answer even if it were much closer to the correct answer. The scale of the answer needs to be correct and when you see a series of numbers that add to roughly £15,000 as these do, even an answer under £14,000 or just over £16,000 should start to ring alarm bells. The way to set yourself an estimate is to round each number to the nearest thousand. So, anything below 500 goes down and anything of 500 or more goes up. When this is done, the list of numbers goes mentally from:

$$2,473.90 + 1,526.81 + 3,488.20 + 7,823.18$$

to:

$$2 + 2 + 3 + 8 = 15$$

So, you would expect the answer to be around 15,000 and it is: 15,312.09.

17.4 Mathematics for opening and closing expense adjustments

One of the most frequent calculations you will do in accounting is an adjusting entry for opening and closing accruals and prepayments (which is the topic of Chapter 22), but there are many others. There are a few things that interfere with attempts to find the correct amount. The most common occurs when you get confused with the debits and the credits. Try to ignore them. Instead, consider what you are doing. Whatever you are doing, the adjustment will increase or decrease the balance on the account. **Think ARITHMETIC, not debits and credits.**

If the adjustment is one that involves *increasing* the balance, calculate the adjustment and then enter it in the appropriate place in the account. **Now, you have done the calculation, you can think debits and credits.** If it is an account for an expense or an asset, the entry will be a debit. If it is for anything else, the entry for the adjustment will be a credit.

If it is an adjustment that *decreases* a balance, the entries will be the opposite.

Activity 17.5

Would the entry for an increase in a liability account be a debit or a credit?

Imagine that you are given a list of adjustments to make to a trial balance. You may be given a variety of different adjustments to make. What you need to remember is that every adjustment is a simple arithmetical calculation. Try to focus on that. Logically, if you need to accrue an amount for an expense, the expense must be increased. If you need to make an adjustment for a prepayment, the expense must be decreased. Most adjustments are of one of these two types. Let's look at some examples.

Accrued expense adjustments

- (i) Rent unpaid at the period end is £400; you are told the amount. No calculation is needed.
- (ii) Two months rent is unpaid at the period end. The annual rent bill is £2,400. You need to calculate the amount of the accrual. If the rent for a year is £2,400 then the rent for one month is $\frac{1}{12}$ of the annual amount = £200. You must accrue 2 months' rent = $2 \times £200 = £400$.

You need to be careful when calculating the amount of the accrual. It is easy to press the wrong key on your calculator. Check the answer shown mentally. Does it look right?

Accrual adjustments are not difficult. They just take a bit of care. The balance on the above rent account will need to be increased by £400. It is an expense account, so the entry is a debit in the account and a credit to an account for accrued rent.

Alternatively, an accrued expense is a *Form of settlement*. The *item exchanged* is rent and it is increasing so it is a debit. The *Form of settlement* – the accrual – is the opposite: it is a credit.

For accrued expenses recognised at the end of a period, the entry in the accrual account will always be a credit.

Prepaid expense adjustments

These can often be straightforward to do, but sometimes they are more complicated.

- 1 You are told the amount of the adjustment. For example, that business rates paid in advance at the period end are £300. No calculation is needed. (Business rates are a local tax set by the local government for a fixed amount each year. They are treated as a business expense.)
- 2 When it becomes more complicated, you need to know (i) what the financial period is for the business and, (ii) what period is covered by the amount paid. For example, if the year end for the business is 30 June and the period covered by the amount paid is for 3 months – June, July, and August – you know that the payment for 1 month should be included in your expense and that the payment for the 2 months after the period end should be treated as a prepayment.

For example, assume that the annual business rates bill is £900. The local government's year-end is 31 March. This means that the bill is for the 12 months ending on 31 March next year. You paid the whole amount due of £900 on 1 June. Your reporting period ends on 31 December. This means that you paid for 12 months but only nine of those months (April to December) are included in your reporting period. So, you must treat $\frac{9}{12}$ of the payment as an expense and $\frac{3}{12}$ of the payment as a prepayment.

Looked at from another perspective, you should include $\frac{9}{12}$ of the payment as an expense in this year's income statement because 9 is the number of months that have passed of the 12-month period for which the payment was made. That means that you have prepaid the rest = $1 - \frac{9}{12} = \frac{3}{12}$ of the amount you paid. That is, the prepayment is for $\frac{3}{12}$ of £900 = £225.

You should double check that you have identified the correct period to be used to calculate the prepayment. In this case, an easy check is to identify the months for which payment was made that occur after the end of the reporting period. In this case, they are January, February, and March = 3 months, which confirms you have used the correct number of months in your calculation of the prepayment.

You should have noticed that these accrual and prepayment adjustments are not complicated. They only need you to think and then use very basic arithmetic to calculate the amounts involved. Once you have calculated the amount of an accrual, you debit the expense account (which increases the balance to the correct amount) and credit the account for that accrued expense, e.g. the accrued rent account. Accrual accounts go in the balance sheet under current liabilities. The treatment of a prepayment is the opposite: you credit the expense account (which reduces the balance to the correct amount) and you debit the prepaid expense account, e.g. the prepaid business rates account. Prepayment accounts go under the current assets in the balance sheet.

An alternative explanation using 'form of settlement' and 'item exchanged'

Recognising a prepayment of an expense involves reducing the expense shown in the income statement. The amount by which it is reduced is the prepayment. The prepayment is then carried forward to the next accounting period.

Prepayments of expenses are a *form of settlement* that reduce the amount previously recorded for an *item exchanged*. The *item exchanged* – in this example, the business rates expense – is therefore reducing, so it is a credit.

For prepaid expenses recognised at the end of a period, the entry in the prepayment account for the prepayment will always be a debit.

If an accrual or a prepayment is for income, you do the opposite to what you do if they are for expenses.

Opening accrual and prepayment account balances

This is where most students begin to find making adjustments for accruals and prepayments confusing. The trick is to treat this adjustment as a separate exercise from any period-end accrual or prepayment adjustment that you are making. Often, you can ignore these opening accruals and prepayments, apart from entering them into your T-account for the expense. In most of these examples, we'll use prepayments. **The approach for accruals is the opposite.**

- a) The opening balance on a business rates account is a debit of £280. This entry reverses an entry for a prepayment of business rates in the previous reporting period. It belongs in the total of this year's expense. You do not need to do any calculations. Once the opening prepayment has been entered in the account, you will discover how much has been paid for business rates that may relate to this period. If there are no accruals or prepayments on the account at the end of the current period, the balance on the account is the amount that is included for business rates in the income statement.

Note: In examples like this, you need to discover whether the opening prepayment (or accrual) has been included in the account balance that you have been given. It will be obvious from the question.

- b) The opening balance on a rent account is a credit for £150. This entry reverses an accrual for rent unpaid at the end of the previous reporting period. It means that, of the payments made in this reporting period, £150 was paid to settle the amount due from the previous period. That £150 is not included in the total expense for this period. You do not need to do any calculation. However, you must enter the opening accrual as a credit in the account. By doing so, you ensure that the £150 is not included in this period's overall rent expense. If you then balance the account, you will discover how much has been paid for rent that may relate to this period. If there are no accrual or prepayments on the account *at the end of the current period*, the balance on the account is the amount that is included for rent in the income statement.

Most opening entries for accruals and prepayments are absorbed into the balance of the account at the end of the period. Once they have been entered into the T-account, you need only concern yourself with the resulting balance. For example:

- c) Assume you have an opening prepayment of £600 on a rent account and that after you make the debit entry for the prepayment in the rent account the account has a balance of £1,500. Once you have made the entry for that opening prepayment, which is a debit in the expense account, you can then ignore it because it is included in the balance. If the rent for the year is £1,200 this is £300 less than your balance, so you have paid £300 in advance for next year. Your prepayment for this period is, therefore, £300.
- d) Assume you have an opening prepayment of £300 on a rent account and the account has a balance of £1,700 after you make the debit entry in the T-account for the expense. This time, you are told that in the final month of the accounting period, rent totalling £1,200 was paid for 3 months. That is, it covered the rent due for the final month of this period and the first 2 months of the next period. To find the prepayment, you divide that payment (£1,200) by the number of months (3) and multiply the answer (£400) by the number of months in the next period for which you have already paid the rent (2). This gives you a closing prepayment of £800.

Note: In this example, you did not make any use of either the opening prepayment or the balance on the account when calculating the closing prepayment.

- e) Assume that you have an opening prepayment of £450 on a rent account and the account has a balance before entering that prepayment of £1,650. Again, once you have made the

entry for the opening prepayment, which is a debit in the expense account, you can ignore it. However, this time, you do not know what the annual rent should be. Instead, you are told that 2 months' rent has been paid in advance at the end of the reporting period. That is, the balance on the rent expense account is for 14 months, not 12. To discover the amount of the prepayment, you must first ensure that you have entered the opening prepayment into the T-account for the expense. Then, you divide the balance (£2,100) by the number of months it relates to (14). This gives a monthly rental expense of £150. You then multiply that by 2 to identify the amount of the prepayment, £300.

The important thing about involving opening accruals and prepayments in your calculations is to ensure that they have been entered in the appropriate expense account before the balance is calculated. If you do that, they should not affect your ability to perform calculations of closing accruals and prepayments.

Always remember that in adjusting transactions for accruals and prepayments the accrual or prepayment is a *form of settlement*. If you get confused, you can use the change in the *item exchanged* – the expense or the income – to guide you in deciding which account to debit and which account to credit. For example, expenses are debits. If an expense recorded in an account is reduced, the reduction is made by crediting the expense account. That tells you that the entry for the prepayment, that led to the recorded expense being reduced, is a debit. When you make the opening entries at the beginning of the next period, you reverse those two entries.

Remember, an opening debit balance on an expense account is a prepayment – that is, an amount that was overpaid in the previous reporting period; and an opening credit entry on an expense account is an accrual – that is, an amount underpaid in the previous accounting period.

Period-end accrual and prepayment adjustments are not difficult to process. They just take a bit of care. If the adjustment is one that involves increasing the balance on the account, calculate the adjustment and then enter it in the appropriate place in the account. If it is an account for an expense or an asset, the entry will be a debit. If it is to any other type of account, the entry for the adjustment will be a credit. And, if the accrual or prepayment adjustment reduces the balance, you make a credit entry in expense accounts and asset accounts; and a debit entry if it is to any other type of account. The other side of each entry is to either an accrual account or a prepayment account, for example an accrued rent account or a prepaid rent account.

17.5 Mathematics for adjustments to trade receivables

Another common adjusting entry performed by accountants is an adjustment to the amount shown in the balance sheet for trade receivables, that is, debtors. There are two types: bad debt adjustments and allowance for doubtful debt adjustments.

- **Bad debt:** This is permanent; it reduces the balance on the debtor account, usually to zero.
- **Allowance for doubtful debts:** This is temporary; it adjusts the balance in a special purpose account called 'the allowance for doubtful debts account'. That adjustment made to that

account may be an increase or a decrease. The resulting balance on the allowance account reduces the overall total of all trade receivables in the balance sheet. No debtor account balance is changed.

Students often get these two types of adjustments mixed-up. Just as opening accrual and prepayment adjustments should be thought of separately from closing accrual and prepayment adjustments, so bad debts and changes in allowances for doubtful debts should be treated separately. **You always do the bad debt adjustment first.**

Bad debt adjustments

The calculations to be made for bad debts are usually very simple and easy to calculate. A bad debt means that the debt must be removed. This means that the debtor's account balance is reduced, usually to zero, by a credit entry for the bad debt. Obviously, the total amount of all the trade receivables reduces by the same amount. The other side of the entry is a debit in an expense account: the 'bad debts account'. If only part of a debt is to be written-off as bad, you will be told the amount, e.g. £200. You simply reduce the balance on the account (and on the total trade receivables) by that amount of £200 (by crediting the account of the debtor). And you debit the bad debt account with £200.

Note: a bad debt is a *form of settlement*. It is being received, so it is a debit. Alternatively, the *item exchanged* is the amount being written-off the debtor's account: it is being given away by the business. As the balance on the debtor's account, which is an asset, is being reduced, the debtor's account must be credited, which means that the entry in the bad debt account is a debit.

Doubtful debt adjustments

Doubtful debts are more complicated and often require that you calculate the amount to be used in the adjustment. However, there is very little variety in the range of calculations to be carried out. For example, assume that you are told that you must provide an allowance for 5% of outstanding trade receivables at the period end.

Step 1: Write-off any bad debts.

Step 2: Calculate 5% of the remaining balance.

Let's say that is £500. This is the amount that should be the balance on the *Allowance for Doubtful Debts account*. You must then do another calculation.

Step 3: Discover what the balance on the allowance was at the end of the previous period. Let's assume it was £300.

Step 4: Calculate whether the new allowance of £500 is greater than or less than the previous allowance (£300).

Step 5: Make an adjusting entry to change the balance on the *Allowance for Doubtful Debts account* to the new balance (which you calculated in Step 2).

Step 6: Make a contra entry for that entry in an account called either the *Increase in Allowance for Doubtful Debts account* (an expense, therefore a debit entry) or in the *Decrease in Allowance for Doubtful Debts account* (a gain, therefore a credit entry).

In this case, the new allowance is greater by £200. It is an expense for the business, so you must make a debit entry for £200 in the *Increase in Allowance for Doubtful Debts account*. The other side of the entry is an adjusting entry to increase the balance on the *Allowance for Doubtful Debts account* by making a credit entry in that account for £200. **This account is a provision account – you are setting aside resources of the business in case some debtors fail to pay the amounts due.**

Sometimes you are not told the opening balance on the *Allowance for Doubtful Debts account*. Instead, you will be told the percentage allowance used previously (e.g. 3%) and the opening trade receivables balance (e.g. £24,000). You will then need to calculate what the opening balance on the *Allowance for Doubtful Debts account* was. You do this by calculating 3% of £24,000 = £720.

This may be made more complex by telling you that the opening trade receivables balance provided to you is *after* deducting the opening allowance for doubtful debts. In this case, you will need to do the following stepped calculation:

- Opening allowance divided by $(1 - \% \text{ allowance}) = \text{opening trade receivables before reducing it by the allowance.}$

For example, if the opening trade receivables balance after reduction for the allowance for doubtful debts was £190,000 and the allowance was 5%, you divide £190,000 by $(1 - 0.05) = £190,000 \div 0.95 = £200,000$.

- To calculate the figure for the opening allowance, you then either subtract the opening trade receivables balance amount from the one you have just calculated or multiply that answer by the percentage allowance (5%). To avoid mistakes, you should do both.

In the above example, £200,000 minus the original figure you received of £190,000 leaves £10,000. That is the opening allowance for doubtful debts. You can confirm it by calculating 5% of £200,000 = £10,000.

17.6 Mathematics for depreciation

Every business is required to depreciate its non-current assets. There are two main methods: straight line and reducing balance.

- **Straight line:** annual depreciation = $(\text{cost} - \text{scrap value}) \div \text{years of useful economic life.}$
- **Reducing balance:** annual depreciation = $\text{cost} \times \text{the percentage that reduces the carrying amount to the scrap value of the asset over its useful economic life.}$

Straight line

There are variants on the formula for the **straight line** method. For example, depreciation of a machine may be based on its estimated useful economic life; or it could be based on the estimated total number of units it will be able to produce before it has to be scrapped. Alternatively, it may, for example, be based on the total time in actual use that it is estimated will be possible before it has to be scrapped. Irrespective of the basis used, the approach is a simple one to use and requires only that you are able to add, subtract, divide, and multiply; and that you remember to subtract the scrap value from the cost before doing the second stage of the calculation.

Sometimes you are told the depreciation percentage instead of the base for the measure – years, units, hours, and so on. When this happens, the annual depreciation = $(\text{cost} - \text{scrap value}) \times \text{the percentage.}$ So, a 20% depreciation rate on a machine that cost £3,000 and has a scrap value of £400 – $(£3,000 - £400) \times 20\% = £2,600 \times 20\% = £2,600 \times 0.20 = £520$.

It is the same answer as the one you would get if you converted the percentage into the number of years of estimated useful economic life: 5. You can do this with any percentage if you find it easier to divide by the number of years than multiply by the percentage. All you need to do to convert the percentage to number of years is to calculate how many times the percentage divides into 100. For example, 25% is equivalent to $(100 \div 25) \text{ years} = 4 \text{ years.}$

Straight line involves very simple calculations. However, many students struggle when calculating percentage rates. They do so even more when calculating reducing balance depreciation.

Reducing balance

Reducing balance requires that you know how to calculate percentages. And that you know how to combine the percentage with the carrying amount. The problems faced can be separated into stages that may be encountered depending on the details of the calculation you are doing:

- 1 First, you need to know how to calculate a percentage.
- 2 You then need to know what to do with the answer.
- 3 You then need to know how to arrive at the total depreciation over a specific period.
- 4 And you need to know how to arrive at the carrying amount at the end of the same period.

Some find it difficult to use percentages and, instead of learning how to do it mentally, key the numbers into a calculator, press the % key when they think it is correct to do so, and blindly accept the result. When using a calculator, it is essential that you first estimate in your head what the answer should be and then consider whether the answer showing in the calculator could be correct. Many students put the decimal place in the wrong place, some make typos. **Failing to check a calculation you have done on a calculator is never a good idea.**

1 How to calculate a percentage

To calculate a percentage, you can adopt one of two approaches, as set out in Method A and B below. Let's illustrate them with an example. Imagine you had to calculate 36.5% of £5,700. **Note that in order to convert the 36.5% to a decimal, we move the decimal point two places to the left:**

$$(A) (36.5 \times 5,700) \div 100$$

$$(B) 0.365 \times 5,700$$

When students do this calculation on paper, many use Method A. Someone who has been taught to calculate percentages manually usually performs percentage calculations more accurately than someone who has not been taught to do so. Their most common error is to move the decimal place in the answer one step left instead of two, for example converting 208050 to 20805 instead of 2080.5.

When we do percentage calculations on a calculator, it is better to use Method B.

Unfortunately, many only learn to do the calculation on a calculator, which creates a false sense of confidence in the answer it produces. When Method A is used on a calculator, many students divide by 10 instead of 100, often because they miskey the number 100.

Another problem is that some students do not know that 36.5% is equivalent to 0.365 and enter 3.65 into the calculator. Finally, some do not know how to use the % button on the calculator and use it, blindly assuming what they are doing must be correct.

The easiest way to calculate a percentage on a calculator is to first convert the percentage to a decimal. So, 36.5% is 0.365. Press the 'C' button to clear the memory of the calculator. Then enter 0.365, press the '×' key, and then enter 5700 followed by the '=' key. The correct answer of 2080.5 will be shown.

Whichever method you use, you must always stop to consider whether the answer it produces makes sense. That means you need an idea in your head of what the answer ought to be. A percentage of something cannot be greater than the number you start with; 50% is half the number you start with; and 10% is the same as the number you started with but with the decimal place moved one position to the left. These rules of thumb should help you to judge whether the answer of your calculation looks wrong.

2 What to do with the answer

On most occasions when you are asked to calculate reducing balance depreciation, it is not for the first year of ownership of the non-current asset. If you are asked to calculate the depreciation for a later year, the calculation involves reversing the percentage in the final step. Let's assume you are asked to calculate the depreciation for Year 3 on a machine that cost £4,000 and is being depreciated by 40% reducing balance. The steps to take are:

(a) Multiply £4,000 by $(1 - 0.4) = £4,000 \times 0.6 = £2,400$ = Year 1 carrying amount

(b) Multiply £2,400 by $(1 - 0.4) = £2,400 \times 0.6 = £1,440$ = Year 2 carrying amount

You now have the amount you need to depreciate by 40% in Year 3. (You have reversed the 60% by replacing it with $1 - .6 = 0.4 = 40\%$.)

(c) Multiply £1,440 by $0.4 = £576$ = Year 3 depreciation.

3 How to calculate the accumulated depreciation

You may have been asked to calculate the depreciation for Year 3 and also identify the total of the accumulated depreciation for the machine at the end of that year. To find that amount, you subtract the carrying amount at the end of the previous year (Year 2) from the cost of the machine. Then, add the Year 3 depreciation to that amount:

$$£4,000 - £1,440 = £2,560$$

$$£2,560 + £576 = £3,136 = \text{the accumulated depreciation on the machine at the end of Year 3.}$$

4 How to calculate the carrying amount

You may have been asked to calculate the depreciation for Year 3 and also calculate the carrying amount at the end of that year. You can do this by subtracting the Year 3 depreciation from the carrying amount at the end of the previous year (Year 2):

$$£1,440 - £576 = £864 = \text{the carrying amount at the end of Year 3.}$$

5 How to check the answers to (3) and (4)

If you add the accumulated depreciation to the carrying amount, you will find the original cost.

$$£3,136 + £864 = £4,000$$

17.7 Mathematics for analysis

The last line of the previous section is a formula. It shows the relationship between three things: accumulated provision for depreciation, carrying amount, and cost.

$$\text{Accumulated depreciation} + \text{Carrying amount} = \text{Cost}$$

This formula can be rearranged, either as:

$$\text{Cost} - \text{Accumulated depreciation} = \text{Carrying amount}$$

or as:

$$\text{Cost} - \text{Carrying amount} = \text{Accumulated depreciation}$$

If you know two of these three values, you can identify the third. There are many examples of this type of relationship between accounting variables. You need to know how to manipulate formulas like this, so that you can find the numbers you do not have.

Activity 17.6

Write down three formulas like these, each for a different group of accounting variables. One formula should include current assets; one should include gross profit; and one should include equity. (*Hint: think about the sections of the income statement and the sections of the balance sheet.*)

Did you notice the difference between the first four items in the solution to Activity 17.6 and the last two? The last two are ratios. You will learn about many different ratios in Chapters 38 and 39. Let's look at the two you have just seen:

$$\text{Current assets} \div \text{Current liabilities} = \text{Current ratio}$$

$$(\text{Current assets} - \text{Inventory}) \div \text{Current liabilities} = \text{Acid test ratio}$$

When accountants analyse accounting information, they usually begin with the balance sheet and the income statement. The accounting variables in these two ratios are all shown in the balance sheet. (You can also see the same figure for inventory in the trading account section of an income statement produced for internal use.) Calculating a ratio is not difficult, as long as you know what the ratio formula is, know where to obtain the appropriate data, and know how to add, subtract, divide and, less often, multiply. **What is difficult about calculating ratios is not the calculation, it is knowing what the answer from your calculation of a ratio is telling you.**

Activity 17.7

Why is knowing how to interpret a ratio difficult?

This is where you begin to see how an accountant uses financial information. It involves a lot of factors that are not all numerical. Another word for 'numerical' is 'quantitative'. The other factors that an accountant considers may be 'qualitative'. Qualitative factors are descriptive; they can, for example, be good or neutral or bad or a mixture of these, and an accountant needs to know how to evaluate them in relation to the ratio results. They include things like how strong the competition is in the market, how price sensitive the market is, what competing goods/services you face in the market, and an assessment of what they imply for your ability to sell your goods and services. Combined, all the qualitative factors tell you whether the ratios you have calculated are good or bad.

Note: You cannot tell this immediately after you obtain the result of your ratio calculation. After finishing the calculation, you must consider any other relevant factors before drawing your conclusions about the goodness or badness of the result of your calculation.

In addition, you need to know how the value shown for each current asset and each liability was calculated – whether the value is itself a calculation; for example, trade receivables will be shown in the balance sheet after deducting bad debts and then making an adjustment for any change in the allowance for doubtful debts. As you will learn in Chapter 18, inventory may be valued at cost, or at net realisable value; it may be an estimate, it may be based on first-in-first-out (FIFO) or on average cost; it may include older items that may be close to becoming obsolete

or deteriorating. Perhaps these adjustments were appropriate, perhaps they were not. Perhaps the method of calculation of the values was appropriate, perhaps it was not. Perhaps it is different from the method used by your competitors. If it is, it makes comparisons of the values and ratio results much more difficult.

In short, you need to consider a lot of things before drawing any conclusions about a ratio, including what is 'normal' in your industry and in your geographical location. It is, therefore, very important that you calculate each ratio correctly.

An accountant who can only calculate ratios but cannot interpret them is not a very good accountant. In fact, no-one can qualify as an accountant unless they can demonstrate this ability. It is one of the things that makes an accountant worth employing. This is why you often find that accounting exams include essays and a request that you tell the examiner what a ratio is telling you. Ignoring those questions will not help you pass an exam.

Always attempt to answer these essay questions. In doing so, don't panic. Think about things that may be useful to consider in evaluating a ratio, list some, and then discuss how you would discover them and what you need to be careful about when you use them in any assessment you may make of a ratio. The answer to Activity 17.7 should give you sufficient things to think about in most cases.

When interpreting a ratio, think about the context of the business – products/services, industry, competition, markets, and so on – and about the characteristics of each of the variables in the ratio. If you do that, you should be able to score well in the essay you have been asked to write.

17.8 Mathematics for VAT

Another calculation that is often needed involves VAT. You will sometimes know only the gross amount of an item sold or purchased, but you need the net amount in order to arrive at the figure to include in the income statement. This figure is made up of the net amount plus VAT. To find the amount of VAT that has been added to the net amount, a formula capable of being used with any rate of VAT can be used.

$$\frac{\% \text{ rate of VAT}}{100 + \% \text{ rate of VAT}} \times \text{Gross amount} = \text{VAT}$$

Suppose that the gross amount of sales was £3,300 and the rate of VAT was 20%. To find the amount of VAT and the net amount before VAT was added, you insert this information into the formula:

$$\frac{20}{100 + 20} \times £3,300 = \text{VAT} = £550$$

What I've done here is show you the calculation for the VAT included in the sale price. How do you calculate the net amount, which is the amount you will include in the revenue line of your income statement?

Using what you see in the two boxes above, you can express the relationship between the gross amount of the sale, the VAT, and the net amount of the sale as a formula:

$$\text{Gross amount of a sale} - \text{VAT} = \text{Net amount of the sale}$$

If you then enter the values you know into the equation, you will be able to arrive at the answer:

$$£3,300 - £550 = £2,750$$

Therefore, the net amount was £2,750. To check your calculation is correct, add the VAT to the net amount of the sale. Your answer should be the gross amount of the sale.

17.9 In conclusion

Accounting depends on calculations: primarily arithmetic (add, subtract, divide, and multiply) and algebra (to help you manipulate a formula into a form that helps you discover what you are missing). But knowing how to do these calculations is only the beginning. You also need to ensure your data entry was correct, that the correct calculations were done, and that the answer makes sense. **Keeping a note of any working calculations you perform is essential.** Accountants will do that, and so should students. Accountants do it because they must ensure their answers are correct. So must you.

In addition, whenever you are asked to comment on something that has been calculated, you need to consider many other factors that may be relevant to your analysis. Only if you do that can you begin to draw sensible and relevant conclusions.

Learning outcomes

You should now have learnt:

- 1 Why knowing how to do arithmetic and algebra is an essential skill in accounting.
- 2 That there are many mathematical calculations that an accountant may make.
- 3 Why it is important to always check the answer to any calculation.
- 4 The mathematics used for opening and closing adjustments to accounts.
- 5 The mathematics used for bad debts and allowances for doubtful debts.
- 6 The mathematics used for depreciation.
- 7 How to manipulate a formula to find a missing value for a variable in the formula.
- 8 Why calculating a ratio is only the first step towards evaluating it.
- 9 How to calculate net revenue from a sales figure that includes VAT.

Answers to activities

- 17.1** The balance sheet cannot be in balance if an opening balance is incorrectly entered in this way. The only way the balance sheet could balance would be if a compensating error had occurred. That is, an error for the same amount but the opposite in kind, a debit as opposed to a credit. If that has not occurred, and the balance sheet is in balance, then the trainee must have done something else, such as using a suspense account to make it balance.
- 17.2** The accountant would also check to see if the amounts shown in the trial balance had been entered correctly in the financial statements. The trainee accountant may, for example, have realised that the balance sheet did not balance and simply changed one of the amounts in either the income statement or the balance sheet so that it did.
- 17.3** You could try being more careful and taking much longer, checking each number is correctly keyed before proceeding. However, that is not sensible use of your expensive time. It is much quicker to check the answers and then investigate any that are wrong.
- 17.4** If you need to check the arithmetic of a long list, rather than using a calculator, use a spreadsheet, where you can check each of the numbers you have entered. It is much easier to ensure you have the correct answer if you use a spreadsheet to sum lists of more than a few numbers.

17.5 It would be a credit.

17.6 There are many possibilities, including:

- (i) $\text{Gross profit} = \text{Revenue} - \text{Cost of good sold}$
- (ii) $\text{Net profit} = \text{Gross profit} - \text{Expenses}$
- (iii) $\text{Owner's equity} = \text{Assets} - \text{Liabilities}$
- (iv) $\text{Current assets} - \text{Current liabilities} = \text{Working capital}$
- (v) $\text{Current assets} \div \text{Current liabilities} = \text{Current ratio}$
- (vi) $(\text{Current assets} - \text{Inventory}) \div \text{Current liabilities} = \text{Acid test ratio}$

17.7 To interpret a ratio, you need to know what each variable or amount in the ratio represents. You also need to be able to set the ratio result in the context of the environment in which the entity operates. You need to know how the value shown for each item included in the ratio was calculated. In sum, you need to consider a lot of things before drawing any conclusions about a ratio, including what is 'normal' in your industry and in your geographical location.

Review questions

17.1 Why is being able to do arithmetic and algebra an essential skill for an accountant?

17.2A Explain how to calculate depreciation using the reducing balance method.

17.3 Explain what information you would want in order to interpret some financial ratios you had calculated.

17.4A Explain why it is important to keep notes of all the workings you use in a financial calculation.

17.5 Explain how to calculate the adjustments required to update an allowance for doubtful debts at the end of a reporting period.

17.6 Express the following relationships as formulas:

- (a) Revenue, gross profit, and net profit.
- (b) Opening inventory, closing inventory, purchases, and cost of sales.
- (c) The balance brought forward on an expense account, the other transactions recorded in the expense account, the balance carried forward on the account, and the amount treated as an expense in the income statement.
- (d) The opening balance on a sole proprietor's capital account, drawings, net profit, and the closing balance on the capital account.

Inventory valuation

Learning objectives

After you have studied this chapter, you should be able to:

- Specify the three different categories of inventory that a business can potentially hold.
- Apply the rule that inventory must be valued at the lower of its *cost* and its *net realisable value* (NRV).
- Calculate the NRV of inventory.
- Specify what is included in the *cost* of inventory.
- Calculate the value of inventory using the FIFO, LIFO and AVCO methods.
- Explain the potential effects of using either FIFO, LIFO or AVCO on the profit reported by a business.
- Identify which two of FIFO, LIFO and AVCO are acceptable under IAS 2 *Inventories* and which one is not.
- Outline the basic principles behind the *standard cost method* and the *retail method* for measuring the cost of inventory.
- Use both mark-up and margin percentages to calculate the cost of inventory.
- Identify the purpose of an inventory count (or 'stocktake') at the end of the financial year.
- Calculate the figure for closing inventory in the financial statements when the stocktake is carried out a few days either side of the year end.
- Account for inventory held on a 'sale or return' basis at the end of the financial year.

Introduction

The value of a business's inventory as at the end of its financial year is a particularly important figure in the financial statements. Any change in the valuation placed on closing inventory will have a direct impact on the profit reported by the business. It is therefore essential that accountants have clear guidance on how inventory should be valued. This guidance comes from IAS 2 *Inventories*.

In this chapter, you'll learn the key aspects of IAS 2, including the fact that inventory must be valued at the lower of its *cost* and its *net realisable value*. You'll also learn three assumptions that could be applied to calculate the cost of inventory when a business trades in large numbers of identical items (but be careful: one of these assumptions is not allowed under IAS 2).

Additionally, you'll learn the difference between mark-up and margin percentages, how inventory counted at a stocktake might need to be adjusted, and how to account for inventory held on a 'sale or return' basis.

18.1 The nature of inventory

In all the examples in this book so far, the inventory of the business has simply been the stock of goods held for resale to customers. However, the inventory of a business can actually include up to three broad categories:

- 1 'Finished goods': products that are ready to be sold to customers
- 2 'Work in progress': part-finished goods that are in the process of being produced
- 3 'Raw materials': materials that are ready to be used by the business in the production of its goods

The types of inventory that a business holds will depend on the nature of that business. For example, a sportswear retailer will only have the first category from the list above, that is, all the footwear and clothing it holds ready to sell to customers.

In contrast, a car manufacturer will, at any particular point in time, hold all three types: it will have some vehicles that are fully finished and ready to be sold to customers ('finished goods'); it will also have some cars that are partly complete (**work in progress**); and it will have parts and components that can be used to start building new vehicles ('raw materials').

Meanwhile, a business that only sells services (such as a law firm or an advertising agency) may have no inventory whatsoever.

For most of this book, we concentrate on straightforward trading businesses: those that simply buy in goods and sell them on to customers, aiming to make a profit by doing so. Accounting for the costs of *manufacturing* inventory (i.e. converting raw materials into finished goods) is rather more complicated and we won't look at it in any detail in this chapter.

18.2 The importance of valuing inventory correctly

The value of closing inventory at the end of the year will be a particularly important figure in a business's financial statements. To illustrate this, think about how the gross profit of a business is calculated. An example is shown in Exhibit 18.1.

Exhibit 18.1 Example of the calculation of the gross profit of a business

	£	£
Sales		19,000
Less Cost of goods sold		
Opening inventory	2,000	
Add Purchases	13,000	
Less Closing inventory	(4,000)	
		(11,000)
Gross profit		<u>8,000</u>

In Exhibit 18.1, the value placed on closing inventory at the end of the year is £4,000. If it had instead been valued at (say) £5,000, then *cost of goods sold* would become £10,000 and the gross profit would increase to £9,000.

Alternatively, if the inventory had been valued at only £3,000, then *cost of goods sold* would become £12,000 and the gross profit would fall to £7,000.

In other words, the valuation placed on closing inventory has a direct impact on the profit calculated by the business. In order to achieve some consistency between different businesses there

are rules which govern how inventory must be valued in the financial statements. These rules are set out in IAS 2 *Inventories*.

18.3 IAS 2 *Inventories*

As you saw in Chapter 10, there are rules (or ‘standards’) that accountants follow when preparing financial statements. The most important rules for you to be aware of are those issued by the International Accounting Standards Board (IASB). The IASB issues standards known as IASs and IFRSs and one of these is IAS 2 *Inventories*. In summary, IAS 2 tells us:

- 1 that inventory must be valued in the financial statements at the lower of its *cost* and its *net realisable value*; and
- 2 how the *cost* and the *net realisable value* of inventory should be measured.

We’ll spend most of this chapter looking into these two issues in some detail.

18.4 Inventory must be valued at the lower of its cost and its net realisable value (NRV)

As you’ve seen in this book, the most common basis for valuing items in the financial statements is **historical cost**. Inventory is no exception, so it should normally be valued at its original cost. The only situation where cost is *not* used is when certain inventory items have become so damaged, obsolete or unpopular that they are expected to be sold for less than their original cost.

If the expected selling price of an item of inventory falls below its original cost, then it would not be acceptable to value it at cost in the financial statements. Showing such an item at cost would overstate its true value. Overstating the true value of an asset would go against the **prudence** concept that we covered in Chapter 10. Instead, the item must be shown at its **net realisable value**. The net realisable value, or NRV, of an item is its expected selling price minus any costs that are expected to be incurred to make the sale.

$$\text{Net realisable value (NRV)} = \text{expected selling price} - \text{costs expected to be incurred to make the sale}$$

Typical expenses expected to be incurred to make the sale might include the costs of repairing or modifying the item before it can be sold, or the costs of packaging it and delivering it to the customer.

Activity 18.1

A business has 100 units of Product X in inventory at the end of its financial year. Each unit originally cost £27. However, all 100 units are damaged and need to be repaired at a cost of £5 per unit before they can be sold for £30 each. What value should be placed on the inventory of Product X in the financial statements of this business?

For most businesses, the vast majority of items in inventory will be expected to be sold for more than cost price, so these will be valued at cost in the financial statements. After all, any business that sold most of its goods for less than cost would soon go bust! However, most businesses *will* have a few items of inventory that are damaged, obsolete, or for some other reason are likely to be sold for less than cost: these must be valued at their net realisable value.

**Activity
18.2**

If goods are damaged or obsolete, then their net realisable value (NRV) may fall below their cost. Can you think of any other reasons why the NRV of inventory may fall below its cost?

18.5 Valuing inventory at the lower of cost and net realisable value (NRV) in practice

As far as possible, the business should compare the cost of each item in inventory with its net realisable value (NRV). For a real business with millions of units in stock, this might not be physically possible in practice, but certainly in textbook and exam questions you should follow the principle of comparing cost and NRV in as much detail as the information allows, ideally on an item by item basis. Exhibit 18.2 illustrates this principle.

Exhibit 18.2 Valuing inventory at the lower of cost and NRV on an item by item basis

Suppose a business has five items of inventory at the end of its financial year. The cost and net realisable value (NRV) of each item is given below:

	Cost	NRV
	£	£
Item A	100	150
Item B	120	90
Item C	180	250
Item D	150	130
Item E	90	140
	<u>640</u>	<u>760</u>

Overall, the total cost of inventory is £640 and its total NRV is £760. **It is not acceptable to conclude that total cost is lower than total NRV and that inventory can therefore be valued at £640.** Doing this would overstate the value of items B and D: looking at the table above, the business is expecting to make a loss on these two items and this loss must be recognised straight away.

In other words, we should compare the cost and NRV on an item by item basis, as shown below:

	Cost	NRV	Lower of cost and NRV
	£	£	£
Item A	100	150	100
Item B	120	90	90
Item C	180	250	180
Item D	150	130	130
Item E	90	140	90
	<u>640</u>	<u>760</u>	<u>590</u>

Closing inventory in the financial statements should therefore be shown at £590. You should always apply the rule of valuing inventory at the lower of cost and NRV in as much detail as the information allows.

18.6 Inventory write-downs and write-offs

As you've seen, the expected saleable value of an item could (for various reasons) fall below its original cost. If so, it should be shown in the financial statements at its net realisable value (NRV). When this happens, the cost of the item is said to be written down to its NRV. If the item is completely worthless (i.e. if its NRV is zero) then the cost of the item is said to be written off completely.

Once they have been identified, accounting for such write-downs and write-offs is quite straightforward. The value of closing inventory will be determined by applying the 'lower of cost and NRV' rule on an item-by-item basis. This value for closing inventory will then be shown as a current asset on the balance sheet, and it will also appear within the calculation of cost of goods sold in the income statement. No additional entries or journals are required to record the write-down or write-off. Exhibit 18.3 illustrates this.

Exhibit 18.3 Accounting for an inventory write-down

The opening inventory of a business on 1 June 2023 was valued at a cost of £6,800. During its financial year ended 31 May 2024, the business purchased goods for resale totalling £39,000 and made sales amounting to £56,700. On 31 May 2024, the business's inventory, valued at cost price, amounted to £7,300. However, this figure included certain items that originally cost £1,900 but are damaged and are expected to be sold for only £700.

Solution:

	£
Original cost of damaged items	1,900
Net realisable value (NRV) of damaged items	<u>700</u>
Inventory write-down required	<u>1,200</u>

The correct figure for closing inventory can therefore be calculated:

	£
Closing inventory at cost price	7,300
Less Inventory write-down	<u>1,200</u>
Closing inventory value in financial statements	<u>6,100</u>

We can then look at the impact of the write-down on the calculation of gross profit:

	Gross profit calculation <u>before</u> inventory write-down		Gross profit calculation <u>after</u> inventory write-down	
	£	£	£	£
Sales		56,700		56,700
Less Cost of goods sold				
Opening inventory	6,800		6,800	
Add Purchases	39,000		39,000	
Less Closing inventory	<u>(7,300)</u>	<u>(38,500)</u>	<u>(6,100)</u>	<u>(39,700)</u>
Gross profit		<u>18,200</u>		<u>17,000</u>

In Exhibit 18.3, note how including the correct figure of £6,100 for closing inventory *automatically* reduces the gross profit by the amount of the inventory write-down of £1,200. This is because the figure for closing inventory is always subtracted within the calculation of cost of goods sold. Any reduction in the figure for closing inventory will *automatically* increase the cost of goods sold and reduce the gross profit. In other words, valuing inventory at the lower of cost and NRV will automatically ensure that the gross profit figure takes account of any inventory write-downs or write-offs. No further adjustments or journals are necessary.

Activity 18.3

A business has 100 units of Product Y in inventory at its financial year end, valued at their original cost of £99 each. Because of increased competition, the selling price of Product Y has recently fallen to £130 per unit. The business pays its salespeople 20% commission on each unit sold, and distribution costs are £12 per unit. What inventory write-down is required?

18.7 Establishing the cost of inventory

You've seen that inventory must be valued at the lower of cost and net realisable value (NRV), and we've explained what is meant by NRV and how it is calculated. But there can also be issues surrounding how the *cost* of inventory is determined. We'll consider these issues in the next few sections.

18.8 What is included in the cost of inventory?

The cost of inventory must include all costs incurred in bringing that inventory to its present location and condition. This includes:

- the purchase price
- carriage inwards (i.e. the costs of getting the goods delivered to the business)
- import taxes and duties
- the costs of converting raw materials into finished goods.

The need to include carriage inwards as part of the cost of purchasing inventory was explained in Chapter 9. For the same reasons, import taxes and duties incurred when buying goods from abroad also need to be included in the cost of inventory.

The costs of converting raw materials into finished goods will include the wages of staff working directly on the products as well as a share of general production costs (or 'factory overheads'). The calculations required to allocate a share of factory overheads to the cost of manufactured products can get quite complicated. If you go on to study management accounting, you'll cover techniques for calculating the costs of manufactured products in detail. In this book, we'll focus on relatively simple trading businesses which buy goods that are ready for resale; we won't look closely at how the costs of conversion are accounted for.

Activity 18.4

Which two of the following costs do you think would be included in the cost of the inventory of a manufacturing business, and why?

- | | |
|---|-------------------------------------|
| (a) Carriage inwards | (c) Costs of storing finished goods |
| (b) Maintenance of production machinery | (d) Carriage outwards |

18.9 Measuring the cost of large numbers of the same item of inventory

Some businesses will be able to identify the actual cost of each individual item in inventory. For example, an art dealer will probably have several original paintings in stock at their year end, and they will be able to identify the exact price they paid for each individual painting.

But other businesses might buy and sell thousands or even millions of units of the same line of inventory each year. One unit may be almost identical to another: such units are effectively *interchangeable*.

The purchase price of such an item is quite likely to fluctuate up and down over the course of the year due to inflation, changes in supplier, and other factors.

The business will store these goods in whatever system is most efficient and practical. Units that arrive at different times during the year will end up being mixed together on the shelves. When goods need to be despatched to customers, warehouse staff will probably just pick the units that are most readily available. This could end up being units that arrived recently, or it might be ones that came in several months ago.

At the end of the year, it will therefore be impossible to tell whether the units remaining in stock were those bought recently at the latest prices, or if they had been bought several months ago at old prices.

An example will illustrate the problem. Suppose a business buys and sells just one type of item. The business has just finished its first year of trading. A record of its purchases and sales during the year is given in Exhibit 18.4.

Exhibit 18.4 Purchases and sales

BOUGHT				SOLD			
	Units	Purchase price	Total £		Units	Selling price	Total £
January	20	£30 each	600	May	24	£60 each	1,440
April	20	£34 each	680	November	12	£62 each	744
October	20	£41 each	820				
	<u>60</u>		<u>2,100</u>		<u>36</u>		<u>2,184</u>

A quick count by the storekeeper confirms that there are indeed 24 units in inventory as at 31 December, which agrees with the records shown in the Exhibit: 60 units bought minus 36 sold equals 24 remaining.

The 24 units left might be mostly old units that were bought in January for £30 each, or they might be mainly the newer units bought in October for £41 each. Alternatively, they could be a random mixture: some that were bought in January, some in April and some October. **The key point is that it is usually not possible to know for sure, so an assumption regarding the ‘flow’ of inventory must be made.** We’ll look at three ‘flow’ assumptions that might be used to determine the cost of closing inventory: FIFO, LIFO and AVCO.

18.10 The FIFO (‘first in, first out’) method

The **FIFO** method assumes that the first items to arrive are the first to be used. In other words, the oldest items are assumed to be sold first. **This means that any goods remaining in inventory must represent the most recent purchases.**

From the example in Exhibit 18.4, 24 units remain in inventory. The most recent purchase was of 20 units, so all of these must be assumed to be in closing inventory. The other four must be from the next-most recent purchase, which was the batch priced at £34 each in April. Under the FIFO assumption, the 24 units in closing inventory are therefore valued as follows.

20 units	from the most recent purchases at £41 each	£ 820
4 units	from the next-most recent purchases at £34 each	136
<u>24 units</u>		<u>956</u>

So, closing inventory will be valued at £956 if the FIFO method is used. A complete picture of the movements in inventory during the year using the FIFO assumption could be presented as follows.

Date	Units in	Units out	Inventory after each transaction	
			£	£
January	20 at £30 each		20 units at £30	600
April	20 at £34 each		20 units at £30 20 units at £34	600 680 1,280
May		20 at £30 each 4 at £34 each <u>24</u>	16 units at £34	544
October	20 at £41 each		16 units at £34 20 units at £41	544 820 1,364
November		12 at £34 each	4 units at £34 20 units at £41	136 820 956

Activity 18.5

On 1 May, a business has 10 units in inventory valued at a cost of £8 per unit. On 7 May, it buys 10 more units for £9 each. On 14 May, it buys another 10 for £11 each. Finally, on 21 May, the business sells 14 units at £19.99 each. What is the value of closing inventory at 31 May using the FIFO assumption?

18.11 The LIFO ('last in, first out') method

The **LIFO** method assumes that the units that arrived most recently are the first to be sold. Unfortunately, LIFO is not as straightforward as FIFO in that we can't simply assume that the units remaining in stock will always be the ones that arrived earliest. To apply the LIFO method, you need to track each movement in inventory carefully, and each time units are sold you need to assume that the last units to arrive are the first to leave.

Activity 18.6

Under LIFO, why can't you simply assume that the units remaining in inventory will be those that arrived first?

Using the earlier example from Exhibit 18.4, a complete picture of the movements in inventory during the year under the LIFO assumption could be presented as follows.

Date	Units in	Units out	Inventory after each transaction	
			£	£
January	20 at £30 each		20 units at £30	600
April	20 at £34 each		20 units at £30 20 units at £34	600 <u>680</u> 1,280
May		20 at £34 each 4 at £30 each <u>24</u>	16 units at £30	480
October	20 at £41 each		16 units at £30 20 units at £41	480 <u>820</u> 1,300
November		12 at £41 each	16 units at £30 8 units at £41	480 <u>328</u> 808

The closing inventory will therefore be valued at £808 if the LIFO assumption is used.

A criticism of the LIFO method is that a ‘last in, first out’ assumption is unlikely to match the actual flow of units within the business. For most businesses it would be quite odd if they always sold the most recent arrivals first and allowed the oldest units remaining in stock to get older and older.

Another problem with LIFO is that the value of the units in closing inventory will largely be based on old prices which might bear little relation to the current cost price of that line of inventory. **For these reasons, IAS 2 Inventories does not allow the LIFO assumption to be used for the valuation of inventory in the financial statements.**

Because LIFO is prohibited by international accounting standards it probably won’t feature very often in textbook and exam questions. However, you may still come across it occasionally.

18.12 The average cost (AVCO) method

Given that LIFO is not allowed by IAS 2, the only acceptable alternative to the FIFO assumption is **average cost (AVCO)**. This approach effectively assumes that the goods in closing inventory will be a random mixture of older and newer units, and therefore it values them at an average cost price per unit.

In practice, there are different methods of determining this average cost price and IAS 2 does not specify exactly how it must be calculated. **However, the most common approach is to calculate a new average cost price every time new units are received.** This is logical, because the average cost price is likely to change every time a new batch of units arrives. Under AVCO, units out will be valued at the most recent average cost price, and units remaining in inventory will also be valued at this price. As soon as a new batch of units arrives, a new average cost price will be calculated.

Calculating a new average cost price every time new units are received makes AVCO more complicated than FIFO when answering questions. You need to be organised and methodical in your workings, tracking the number of units in and out and recalculating a new average cost price every time new units arrive. Using the example from Exhibit 18.4, the calculations under the AVCO method would be as follows.

		Number of units		Running total £	New average cost calculated
January	Bought	20	at £30 each	600.00	
April	Bought	<u>20</u>	at £34 each	<u>680.00</u>	
<i>Subtotal</i>		40		1,280.00	£32.00*
May	Sold	<u>(24)</u>	at £32.00 AVCO	<u>(768.00)</u>	
<i>Subtotal</i>		16	at £32.00 AVCO	512.00	
October	Bought	<u>20</u>	at £41 each	<u>820.00</u>	
<i>Subtotal</i>		36		1,332.00	£37.00**
November	Sold	<u>(12)</u>	at £37.00 AVCO	<u>(444.00)</u>	
Closing inventory		<u>24</u>	at £37.00 AVCO	<u>888.00</u>	

* Total cost £1,280.00/Total units 40 = £32.00 average cost

** Total cost £1,332.00/Total units 36 = £37.00 average cost

As shown above, the approach is to recalculate the average cost price every time new units are received, and to use that latest average cost price to value units in stock until another new batch arrives.

Activity 18.7

On 1 June, a business has 20 units in inventory valued at a cost of £7 per unit. On 5 June, it sells 10 units at £16.99 each. On 13 June, the business buys 20 more units for £10 each, and on 25 June, it sells 10 units at £16.99 each. What is the value of closing inventory on 30 June using the AVCO method?

18.13 Inventory valuation and the calculation of profit

Each of the three alternative methods makes a different assumption about which units have been sold and which ones remain in inventory. The choice of method therefore affects the calculation of cost of goods sold, thereby changing the gross profit figure. Based on the example in Exhibit 18.4, you can calculate the gross profit under each of the methods. As explained earlier, LIFO is not allowed by IAS 2, but it is included for the purposes of comparison.

	FIFO method		LIFO method		AVCO method	
	£	£	£	£	£	£
Sales		2,184		2,184		2,184
Less Cost of goods sold						
Opening inventory	–		–		–	
Add Purchases	2,100		2,100		2,100	
Less Closing inventory	<u>(956)</u>	<u>(1,144)</u>	<u>(808)</u>	<u>(1,292)</u>	<u>(888)</u>	<u>(1,212)</u>
Gross profit		<u>1,040</u>		<u>892</u>		<u>972</u>

This was a new business so there was no opening inventory, and hence the difference in gross profit is entirely due to the valuation of closing inventory. In this example, the purchase price of goods *increased* over the course of the year. Under the FIFO method, closing inventory is valued

at the most recent prices, so, in this example, FIFO gives the highest value of closing inventory and therefore the highest profit.

If the purchase price of the goods had instead *fallen* over the course of the year, then the FIFO method would result in the lowest value of closing inventory and therefore the lowest profit.

So, the choice of method will affect the reported profit each year. However, over the entire life of the business, total profits will be the same. This is because the closing inventory of one year becomes the opening inventory of the next. For example, a particular method may result in a higher valuation of closing inventory and therefore a higher profit in Year 1. Under this method, the opening inventory of Year 2 will be higher, and this will have the effect of reducing the profit of Year 2.

Be clear that FIFO, LIFO and AVCO are merely *assumptions* about the physical flow of inventories through the business. They do not seek to represent the order in which items are *actually* sold.

Businesses that deal in large numbers of very similar units of inventory should choose either the FIFO or AVCO method and stick with it from one year to the next, unless there is a very good reason to change. This is in accordance with the **consistency** concept that we discussed in Chapter 10. If businesses kept switching from one method to another, then it would be harder to accurately compare the real performance of the business from one year to the next.

18.14 Other techniques for measuring the cost of inventory that are allowed by IAS 2

In accounting exams at this stage in your studies, the FIFO and AVCO assumptions are likely to be the two most common methods you will encounter. However, IAS 2 does permit certain other approaches for measuring the cost of inventory, and specifically mentions two: **standard cost** and the **retail method**.

Standard costing is typically used by manufacturers. Under the **standard cost** method, the business decides at the start of the year what the normal, typical cost of making an item is expected to be. All units of that item will be valued at this standard cost throughout the year. If the cost actually incurred in making units of that item during the year deviates from the standard cost, then the difference is recorded as a 'variance' in the income statement. For example, if units end up costing a little bit more than expected, then the total of all the differences (the 'variance') will be an extra cost in the income statement.

You'll learn more about standard costing if you go on to study management accounting. It would be rare to encounter standard costing in a financial accounting exam at this stage in your learning.

As its name suggests, the **retail method** is only used by retail businesses, i.e. those that sell directly to the public. Such businesses typically keep their inventory records showing each item at its expected selling price. Under the retail method, the valuation of inventory in the financial statements will be based on the expected selling price of items minus the normal profit margin that the business expects to achieve on them.

Because the retail method is a 'specialist' method that only applies to one type of business, it is unlikely that the method will feature in a textbook or exam question. However, it is certainly possible that you could sometimes be given the expected selling price of inventory and be required to adjust it in order to arrive at the cost price. If so, you need to be very careful not to confuse 'margin' and 'mark-up' percentages:

- 1 The **margin percentage** (also known as the gross profit or gross margin percentage) is the profit per unit calculated as a percentage of the selling price.
- 2 The **mark-up percentage** is the profit per unit calculated as a percentage of the cost price.

For example, suppose you are told that the expected selling price of an item is £140.

- If you are told that the **margin** percentage is 25%, then the profit per unit would be $£140 \times 25\% = £35$. The cost price of this item is therefore £105 (£140 selling price – £35 profit).
- But, instead, if you were told that the **mark-up** percentage is 25%, then this means that the selling price represents 125% of the cost price. The profit per unit would therefore be $£140 \times 25/125 = £28$, so the cost price of this item must be £112 (£140 selling price – £28 profit). (You can check that this is correct by calculating: $£112 \text{ cost price} \times (1 + 0.25) = £140$.)

**Activity
18.8**

The value of a business's closing inventory at its expected selling price is £980. What is the cost of its inventory if the business sets all its selling prices to achieve: (i) a margin of 40%; or (ii) a mark-up of 40%?

18.15 'Stocktaking': counting inventory at the year end

As we explained in Chapter 3, there is normally no account in the nominal ledger that tracks all the increases and decreases in inventory over the course of the year. To establish the quantity of inventory held by a business as at the end of the financial year, it is therefore often necessary to physically count it. This is commonly known as **stocktaking**.

Many businesses *will* actually monitor their inventory movements during the year using some sort of inventory management software. But even these businesses will still need to carry out some physical counting to gain confidence that their computerised records are accurate. Given that closing inventory is such an important figure in the financial statements, carrying out these physical checks will be particularly important at the end of the year.

For a reasonably small business, it may be possible to count its entire inventory on the last day of its financial year. However, in larger businesses, there may be so many items that stocktaking has to be carried out over several days around the time of the year end. If so, the quantities counted may need to be adjusted for all the known movements of inventory between the count date(s) and the year-end date.

Exhibit 18.5 illustrates an example of these adjustments.

Exhibit 18.5 Adjustments to inventory counted at stocktake

A business's financial year ends on 31 December 2024. The inventory count (or 'stocktake') does not take place until 7 January 2025. The inventory counted is valued at a cost price of £28,850. The following information is available about inventory movements between 31 December and 7 January:

- Purchases during the week amounted to £2,370 at cost.
- Returns inwards during the week were £350 at selling price.
- Sales for the week totalled £3,800 at selling price.

The business's selling prices are always equal to cost price plus a mark-up of 25%.

Solution:

This business's selling prices are equal to 125% of cost price, so we can calculate:

- Cost price of inventory sold = $£3,800 \times 100/125 = £3,040$
- Cost price of inventory returned inwards = $£350 \times 100/125 = £280$

The value of inventory at cost price as at 31 December 2024 can then be deduced:

	£	£
Inventory counted on 7 January 2025, at cost		28,850
Add Goods in inventory on 31 December that were sold before 7 Jan, at cost		3,040
Less Goods in inventory on 7 January that arrived after 31 December		
Purchases after 31 December, at cost	2,370	
Returns inwards after 31 December, at cost	<u>280</u>	<u>(2,650)</u>
Value of inventory at cost on 31 December 2024		<u><u>29,240</u></u>

Inventory will therefore be valued at £29,240 in the financial statements.

Activity 18.9

A business sets all its selling prices to achieve a gross profit margin of 30%. Its financial year ended on 31 May, but the stocktake did not take place until 5 June. The inventory counted on that day was valued at a cost of £73,100. Purchases in the five days after 31 May were £2,300 at cost, and sales in the same period were £6,000 at selling price. What was the closing inventory on 31 May?

18.16 Inventory held on a 'sale or return' basis

Sometimes a business (typically a manufacturer or a wholesaler) will send its goods to another business (usually a retailer) on a 'sale or return' basis.

For example, suppose Business A sends some of its goods to Business B under a sale or return arrangement. This means that the goods remain the property of Business A until Business B either manages to sell them or (for some other reason) decides to purchase them outright.

At the end of the financial year, any of these goods held by Business B on a sale or return basis must be included in the closing inventory of Business A and excluded from the inventory of Business B. They will be valued in the normal way, at the lower of their cost and their net realisable value.

Similarly, the cost price of goods held by Business B on a sale or return basis at the end of the financial year should not be included in the figures for *purchases* and *trade payables* in the financial statements of Business B. The sales value of such goods should not be included in the figures for *sales* and *trade receivables* in the financial statements of Business A.

Learning outcomes

You should now have learnt:

- 1 That a business can potentially hold up to three broad categories of inventory: finished goods, work in progress, and raw materials.
- 2 That inventory must be valued at the lower of its cost and its net realisable value (NRV).
- 3 That the NRV of inventory is its expected selling price minus any costs that are expected to be incurred in order to make the sale.
- 4 That the cost and NRV of inventory should, to the maximum extent possible, be compared on an item-by-item basis.

- 5 That the cost of inventory must include all costs incurred so far in bringing it to its present location and condition.
- 6 That, where a business deals in large numbers of identical items of inventory, an assumption must be made regarding which units have been sold and which ones remain in stock.
- 7 That the three possible assumptions are FIFO, LIFO and AVCO, but that LIFO is not allowed under international accounting standards.
- 8 How to apply the FIFO, LIFO and AVCO methods of inventory valuation.
- 9 That the reported profit of a business will change depending on whether it uses either FIFO, LIFO or AVCO.
- 10 That IAS 2 *Inventories* also permits other methods for measuring the cost of inventory, including the standard cost system and the retail method.
- 11 That stocktaking is often carried out over a period of days around the end of the financial year.
- 12 How to adjust the level of inventory counted at a stocktake to the level it would have been if the stocktake had taken place on the balance sheet date.
- 13 How to account for inventory that is being held on a 'sale or return' basis as at the balance sheet date.

Answers to activities

- 18.1** The net realisable value (NRV) of each unit is £25 (£30 expected selling price minus £5 repair costs required). This is lower than the cost price of £27 per unit. Inventory must be valued at the lower of cost and NRV, so Product X must be valued at £25 per unit in the financial statements: $£25 \times 100 \text{ units} = £2,500$.
- 18.2** There may be various reasons, such as:
- The goods may have suddenly become very unpopular with customers due to a change in fashion. For example, a trend for skinny jeans could switch to (say) flared jeans quite quickly, and a business with a lot of skinny jeans in inventory might have to sell them off very cheaply.
 - A business might make a strategic decision to sell certain items at a loss. For example, a business might sell printers for less than they cost with the aim of making profits by selling replacement ink for those printers in the future.
 - A serious error may have been made in production or purchasing. Owing to poor planning, the business might be left with far too many units of a particular item and they will have to be sold off very cheaply.
 - The expected selling price of the item may have fallen dramatically, perhaps because a competitor has just started selling a very similar item at a much lower price.
- 18.3** The write-down is £700, calculated as follows:

	£
Cost ($£99 \times 100 \text{ units}$)	9,900
NRV ($((£130 \times (1 - 0.2)) - £12) \times 100 \text{ units}$)	9,200
Write-down	<u>700</u>

In other words, the NRV of each unit is £92 ($(£100 \times (1 - 0.2)) - £12$) so the write-down is £7 per unit.

- 18.4** The answer is (a) and (b). Option (a) will form part of the cost of its raw materials. And (b) is the expense of maintaining equipment used in the process of converting raw materials into finished goods, so this will be one of the many 'factory overheads' that will have to be allocated to the cost of the business's products. But (c) is simply the expense of storing completed products, and therefore does not form part of the cost of making those goods. Similarly, (d) is the cost of delivering finished goods to customers, so it is a cost of selling the goods, not part of the cost of the goods themselves.
- 18.5** The answer is £164. There are 16 units in closing inventory at the end of May (10 opening units + 10 bought + 10 bought – 14 sold = 16 units). Under FIFO ('First in, first out') the first units that arrived in stock are assumed to be the first units that were sold. Therefore the 16 units left in stock represent the most recent purchases:

	£
10 units bought most recently (on 14 May) at £11 each	110
6 units bought next-most recently (on 7 May) at £9 each	<u>54</u>
Value of closing inventory at 31 May using FIFO	<u>164</u>

- 18.6** It's easiest to illustrate the reason with an example. Suppose a new business buys 9 units in January, then sells 7 units in February, and then buys 6 more units in March. Under the LIFO assumption, the 7 units sold in February will come from the batch of 9 bought in January (because at the time that the sale was made, these 9 units were the 'last in'). The 8 units in this business's closing inventory at the end of March under the LIFO assumption will therefore comprise 2 units from January and 6 units from March.

In other words, with LIFO it is not possible to make a shortcut assumption that closing inventory will always be made up of the units that were purchased first. If a question asks you to use LIFO, then you must track each movement in inventory carefully and logically.

- 18.7** The answer is £180, as calculated below:

		Units	Cost per unit	Total £	New AVCO
1 June	Opening inventory	20	at £7	140	
5 June	Sells	(10)	at £7	(70)	
		10	at £7	70	
13 June	Buys	20	at £10	200	
		30		270	£9
25 June	Sells	(10)	at £9	(90)	
30 June	Closing inventory	<u>20</u>	at £9	<u>180</u>	

- 18.8** (i) £980 selling price × 40% margin = £392, so the expected profit on the inventory is £392. The cost price is therefore £980 – £392 = £588.
- (ii) In this case, cost price plus 40% mark-up equals the selling price. £980 therefore represents 140% of the cost price. The profit element is therefore $£980 \times 40/140 = £280$, so the cost price is $£980 - £280 = £700$. (You can check that this is correct by calculating $£700 \text{ cost price} \times (1 + 0.4) = £980$.)

- 18.9** The answer is £75,000, calculated below:

	£
Inventory counted on 5 June, at cost	73,100
Less Goods counted on 5 June that arrived after 31 May, at cost	(2,300)
Add Goods in stock on 31 May, sold before stocktake, at cost (£6,000 × (1 – 30%))	4,200
Inventory on 31 May, at cost	<u>75,000</u>

Review questions

18.1 From the following figures, calculate the closing inventory that would be shown using the (i) FIFO, (ii) LIFO, (iii) AVCO methods.

<i>Bought</i>		<i>Sold</i>	
March	400 at £30 each	December	420 for £40 each
September	300 at £32 each		

18.2 For Review question 18.1, draw up the trading account part of the income statement for the year showing the gross profits that would have been reported using the (i) FIFO, (ii) LIFO, (iii) AVCO methods.

18.3A From the following figures, calculate the closing inventory that would be shown using the (i) FIFO, (ii) LIFO, (iii) AVCO methods on a perpetual inventory basis.

<i>Bought</i>		<i>Sold</i>	
January	120 at £16 each	June	125 at £22 each
April	80 at £18 each	November	210 at £25 each
October	150 at £19 each		

18.4A Draw up trading account parts of the income statement using each of the three methods from the details in Review question 18.3A.

18.5 You are required to answer the following five questions:

- (a) Vinny's business only sells one product, and his opening inventory at 1 June is 23 units valued at £12 each. The following movements then occur:

4 June	7 units sold for £19.95 each
10 June	12 units bought for £14 each
16 June	13 units sold for £19.95 each

What is the value of this business's closing inventory at 30 June using the FIFO method?

- (b) Andrei is a wholesaler of electrical goods. The opening inventory of one his business's products at 1 April is 53 units valued at £6.00 each. The following movements in this product then occur in April:

9 April	29 units sold for £12.99 each
16 April	36 units bought for £7.50 each
25 April	41 units sold for £12.99 each

What is the value of the units of this product in the business's closing inventory at the end of the month using the average cost (AVCO) method?

- (c) After the draft financial statements of Alfie's business had been prepared, some inventory was found in a corner of his warehouse which had not been included in the year-end inventory count. On checking the records, it is found that this inventory originally cost £420, but it is thought that it can only be sold for £150. What will be the effect of this discovery on the business's profit for the year? Explain your answer.
- (d) Bert started business on 1 January, buying and selling a single item (Product X). The business traded very successfully in its first year, although the purchase price of Product X did rise steadily and continuously over the course of the 12 months. Bert used the FIFO method of inventory

valuation in his first set of financial statements. What would have been the effect on his net profit if he had used the average cost (AVCO) method? Explain your answer.

- (e) Cynthia runs a wholesaling business. She always sets her selling prices by adding a 35% mark up on cost. During her financial year just ended, she took goods from inventory with a total selling price of £540 to give as Christmas presents to her friends. Before making any entries or adjustments for this in her books, she calculated a draft net profit for the year of £22,000. What is her correct profit?

18.6 Thomas Brown and Partners, a business of practising accountants, have several clients who are retail distributors of the Allgush Paint Spray guns.

The current price list of Gushing Sprayers Limited, manufacturers, quotes the following wholesale prices for the Allgush Paint Spray guns:

Grade A distributors	£500 each
Grade B distributors	£560 each
Grade C distributors	£600 each

The current normal retail price of the Allgush Paint Spray gun is £750.

Thomas Brown and Partners are currently advising some of their clients concerning the valuation of stock in trade of Allgush Paint Spray guns.

1 Charles Gray – Grade B distributor

On 30 April 2019, 15 Allgush Paint Spray guns were in inventory, including one gun which was slightly damaged and expected to sell at half the normal retail price. Charles Gray considers that this gun should remain in inventory at cost price until it is sold.

K. Peacock, a customer of Charles Gray, was expected to purchase a spray gun on 30 April 2019, but no agreement was reached owing to the customer being involved in a road accident and expected to remain in hospital until late May 2019.

Charles Gray argues that he is entitled to regard this as a sale during the year ended 30 April 2019.

2 Jean Kim – Grade C distributor

On 31 May 2019, 22 Allgush Paint Spray guns were in inventory. Unfortunately, Jean Kim's business is suffering a serious cash flow crisis. It is very doubtful that the business will survive and therefore a public auction of the inventory-in-trade is likely. Reliable sources suggest that the spray guns may be auctioned for £510 each; auction fees and expenses are expected to total £300.

Jean Kim has requested advice as to the basis upon which her inventory should be valued at 31 May 2019.

3 Peter Fox – Grade A distributor

Peter Fox now considers that inventory valuations should be related to selling prices because of the growing uncertainties of the market for spray guns.

Alternatively, Peter Fox has suggested that he uses the cost prices applicable to Grade C distributors as the basis for inventory valuations – 'after all, this will establish consistency with Grade C distributors'.

Required:

A brief report to each of Charles Gray, Jean Kim and Peter Fox concerning the valuation of their inventories-in-trade.

Note: Answers should include references to appropriate accounting concepts.

(Association of Accounting Technicians)





18.7A Please answer the following five questions:

- (a) Tomasz's business buys and sells various products, including Product J. The business has 100 units of J in stock at 1 February valued (using the FIFO assumption) at £4 each. Calculate the value of inventory at the end of February using the FIFO method based on the following information:

<i>Purchases of product J</i>		<i>Sales of product J</i>	
10 Feb	95 units at £4.20 each	6 Feb	67 units for £9.99 each
20 Feb	75 units at £4.30 each	24 Feb	83 units for £9.99 each

- (b) Denise's business has just three lines of inventory (products P, Q and R) at the end of its financial year:

	<i>Product P</i>	<i>Product Q</i>	<i>Product R</i>
Number of units in stock	200	100	150
Original purchase price per unit	£3.25	£5.75	£4.50
Estimated future selling price per unit	£4.95	£7.95	£5.95
Expected selling & distribution costs per unit	£2.00	£1.50	£1.75

What should be the value of closing inventory in Denise's financial statements?

- (c) Emily runs a wholesaling business. She has decided to repack one of her least popular products in new boxes and offer a discount on the selling price. Details of the product are:

	<i>Per unit</i>
Original cost	£48
Repackaging cost to be incurred	£3
Normal selling price	£70
Discount to be offered on normal selling price	35%

At what amount should each unit be included in Emily's inventory?

- (d) Farhad is a wholesaler of sports equipment. The closing inventory of the business as at 31 August amounted to £365,700 at cost. The following items were included at cost in this total:
- 300 tennis rackets which had cost £50 each and normally sell for £90. However, owing to minor defects they were sold on 19 September at 50% of their normal price. Selling expenses were incurred which amounted to £2 per racket.
 - 500 cricket bats which had originally cost £70 each and usually sell at £120. These bats had been stored outdoors all summer and had deteriorated significantly. Remedial work in September cost £10 per bat and they were sold in October for £75 each.

What should the value of closing inventory be in the financial statements as at 31 August?

- (e) Georgia runs a trading business and sets all her prices to ensure a gross profit margin of 45%. For her year ended 31 May, she performed a stocktake on 5 June which resulted in an inventory valuation of £123,600 at cost. During the five days from 1 to 5 June, the following transactions occurred:

	<i>£</i>
Purchases of goods at cost price	7,300
Sales of goods at selling price	9,500
Goods returned to suppliers, at cost price	600
Goods returned from customers, at selling price	1,300

What figure for closing inventory should be included in Georgia's financial statements?

18.8 'The idea that inventory should be included in accounts at the lower of historical cost and net realisable value follows the prudence convention but not the consistency convention.'

Required:

- Do you agree with the quotation?
- Explain, with reasons, whether you think this idea (that inventory should be included in accounts at the lower of historical cost and net realisable value) is a useful one. Refer to at least two classes of user of financial accounting reports in your answer.

(Association of Chartered Certified Accountants)

18.9 After stocktaking for the year ended 31 May 2019 had taken place, the closing inventory of Cobden Ltd was aggregated to a figure of £87,612.

During the course of the audit which followed, the undernoted facts were discovered:

- Some goods stored outside had been included at their normal cost price of £570. They had, however, deteriorated and would require an estimated £120 to be spent to restore them to their original condition, after which they could be sold for £800.
- Some goods had been damaged and were now unsaleable. They could, however, be sold for £110 as spares after repairs estimated at £40 had been carried out. They had originally cost £200.
- One inventory sheet had been over-added by £126 and another under-added by £72.
- Cobden Ltd had received goods costing £2,010 during the last week of May 2019 but, because the invoices did not arrive until June 2019, they have not been included in inventory.
- An inventory sheet total of £1,234 had been transferred to the summary sheet as £1,243.
- Invoices totalling £638 arrived during the last week of May 2019 (and were included in purchases and in trade payables) but, because of transport delays, the goods did not arrive until late June 2019 and were not included in closing inventory.
- Portable generators on hire from another company at a charge of £347 were included, at this figure, in inventory.
- Free samples sent to Cobden Ltd by various suppliers had been included in inventory at the catalogue price of £63.
- Goods costing £418 sent to customers on a sale or return basis had been included in inventory by Cobden Ltd at their selling price, £602.
- Goods sent on a sale or return basis to Cobden Ltd had been included in inventory at the amount payable (£267) if retained. No decision to retain had been made.

Required:

Using such of the above information as is relevant, prepare a schedule amending the inventory figure as at 31 May 2019. State your reason for each amendment or for not making an amendment.

(Association of Chartered Certified Accountants)

18.10A Ameer purchased a business that buys and sells electrical household goods. When taking over the business, Ameer realised that the existing inventory was obsolete. He therefore decided to have a clearance sale of the existing inventory and replace it with a new, up-to-date inventory.

The following information is available for July:

1 Inventory on 1 July

	Cost	Clearance sale price
	£	£
5 Cookers	180 each	190 each
8 Fridges	90 each	60 each
10 Washing machines	160 each	170 each





2 Purchases of new inventory during July

	Cost £
12 Cookers	200 each
10 Fridges	100 each
15 Washing machines	200 each

Ameer will 'mark-up' all **new inventory** for resale by 20%.

3 Sales for July

	Clearance inventory Number sold	New inventory Number sold
Cookers	3	8
Fridges	5	6
Washing machines	4	12

Required:

- (a) Explain the following as they relate to inventory:
 - net realisable value
 - the accounting concept of historic cost
 - the accounting concept of realisation.
- (b) Calculate the value of the inventory on 1 July.
- (c) Calculate the total value of the inventory on 31 July.
- (d) Calculate the gross profit for the month ended 31 July.
- (e) Evaluate the use of accounting concepts and conventions in the preparation of financial statements.

(Edexcel A level)

Bad debts, allowances for doubtful debts, and allowances for prompt payment discounts

Learning objectives

After you have studied this chapter, you should be able to:

- Explain how and why bad debts are written off.
- Explain why allowances for doubtful debts are made.
- Make the necessary entries to set up or adjust an allowance for doubtful debts.
- Account for cash received in relation to debts that had previously been written off.
- Explain why an allowance for prompt payment discounts might be required.
- Make the necessary entries to set up or adjust an allowance for prompt payment discounts.
- Present the impact of bad and doubtful debts, and the allowance for prompt payment discounts, in the income statement and balance sheet.

Introduction

Many businesses sell on credit terms, so there is always a risk that some customers might not pay for the goods and services they have received. The cost of these 'bad debts' is therefore a regular expense for many businesses. In this chapter, you'll learn what needs to be recorded when a business decides that a particular debt is highly unlikely to ever be collected. You'll also learn how to account for the situation where there is some doubt over whether debts might be recovered. Finally, you'll learn a method of accounting for the fact that some amounts due from customers might be expected to be collected net of prompt payment discounts.

19.1 Bad debts

For most businesses other than retailers, the majority of sales will be on credit terms. In other words, the business will supply goods or services to the customer and will then have to wait (often 30 days or more) to be paid.

There is therefore a risk that some customers will never pay. Some of these customers might have gone bankrupt, some could simply be dishonest, or others might be so dissatisfied with the quality of goods or services supplied that they refuse to pay.

When a business realises that it is highly unlikely to ever receive a certain amount due from a particular customer, the debt must be removed from the records. The debt is said to be **bad** or **irrecoverable** and must be **written off**.

To write off a **bad debt**, the customer's account will be credited in order to remove the asset from the books and the **bad debts expense** account will be debited to record the cost of this to the business. An example of the entries is given in Exhibit 19.1.

Exhibit 19.1 Writing off bad debts

At the end of its financial year ending 31 December 2024, Sue's business has trade receivables totalling £52,000. Of these, it is discovered that C. Smith (who bought goods from Sue for £1,300 on 23 October and has not paid) has been declared bankrupt and T. Jones (who bought goods for £600 on 17 September and has not paid) has disappeared without trace. These are the only two irrecoverable debts Sue has identified this year.

Solution:

C. Smith					
2024		£	2024		£
23 Oct	Sales	<u>1,300</u>	31 Dec	Bad debts expense	<u>1,300</u>
T. Jones					
2024		£	2024		£
17 Sep	Sales	<u>600</u>	31 Dec	Bad debts expense	<u>600</u>
Bad debts expense					
2024		£	2024		£
31 Dec	C. Smith	1,300	31 Dec	Profit and loss	<u>1,900</u>
31 Dec	T. Jones	<u>600</u>			<u>1,900</u>
		<u>1,900</u>			

- Bad debts expense of £1,900 will appear in Sue's income statement for the year ended 31 December 2024 (alongside all her other expenses such as wages, rent, electricity, and so on).
- Trade receivables in Sue's balance sheet as at 31 December 2024 will be £50,100 (i.e. £52,000 – £1,900 written off).

Activity 19.1

Zoe's business starts trading on 1 January and makes total sales during the year to 31 December of £700,000. However, this revenue includes a sale of £30,000 to Mr Fox, who has disappeared without trace and hasn't paid for his goods. Zoe has trade receivables totalling £140,000 as at 31 December. No adjustments have yet been made as a result of the disappearance of Mr Fox. What figure will be shown for *sales* in Zoe's income statement for the year ended 31 December, and for *trade receivables* in her balance sheet as at that date?

19.2 Doubtful debts

You've seen that specific amounts due from customers that are believed (with reasonable certainty) to be uncollectable must be written off. They will be removed from the records and the business will essentially give up on any attempt to chase the money.

However, it is unlikely that the business will be able to identify all the specific debts that won't be collected. Amounts are only written off when the business is fairly certain that the money will

not be received, and there will be other amounts over which there is merely **doubt**. These **doubtful debts** arise for a combination of two reasons:

- 1 The business may be worried about particular debts due from certain customers. It may believe that there is still some chance of collecting the money, but there is definitely cause for concern. The business is not ready to give up on these debts and write them off yet.
- 2 The business may have debts due from hundreds of different customers and cannot predict exactly which ones won't be collected. However, it knows from experience that a certain proportion of them will not be paid.

For both of these reasons, an **allowance for doubtful debts** is required. The amount of the allowance needs to cover any specific debts over which there is cause for concern as well as the proportion of trade receivables that experience indicates is likely to turn out to be bad.

Activity 19.2

Think back to Chapter 10. Suggest which two fundamental accounting concepts are necessary for explaining why an allowance for doubtful debts must be created.

Businesses often use a report commonly known as an **Aged Debtors Report** to help establish the size of the allowance. This report lists all the business's customers, how much they owe and how long the business has been waiting for the money. The business can review the report to identify specific amounts over which there is doubt and also apply percentages derived from experience to estimate the proportion of debts that may not be recovered. The longer an amount has been owing, the more likely it is to become a bad debt, so businesses often apply different percentages to the total amounts that have been outstanding for different periods of time.

Exhibit 19.2 shows an example of how this might be done.

Exhibit 19.2 An example of the calculation of the allowance for doubtful debts based on totals from an Aged Debtors Report

Period of time that debts have been owing	Total amounts receivable £	Percentage doubtful based on analysis of experience	Allowance for doubtful debts £
0–30 days	5,000	1%	50
31–60 days	3,000	2%	60
61–90 days	1,100	4%	44
Over 90 days	<u>540</u>	10%	<u>54</u>
	<u>9,640</u>		<u>208</u>

In Exhibit 19.2, the allowance for doubtful debts required is £208. In the balance sheet of this business, this allowance will be offset against the figure for trade receivables, to reflect the net amount that is expected to be received from customers:

	£	£
Trade receivables	9,640	
Less Allowance for doubtful debts	<u>(208)</u>	9,432

For simplicity, in textbook and exam questions you will often be given a single percentage to be applied to total trade receivables rather than a breakdown of the age of the amounts outstanding.

Of course, any percentages must be applied to figures for trade receivables *after* bad debts have already been written off. If percentages were applied to trade receivables *before* bad debts are written off, then a proportion of *bad* debts would also be counted as *doubtful*, which would make no sense.

Finally, be clear that any percentages used in calculating the allowance for doubtful debts must reflect the actual pattern of bad debts that the business has suffered in the past. Other factors such as industry averages and the current economic climate should also be considered. All estimates in the financial statements must always be logically derived and evidence based, and this includes estimating the allowance for doubtful debts.

**Activity
19.3**

At its year end, a business has total trade receivables of £270,000. Of these, it is decided that specific debts totalling £13,000 should be written off because the amounts are considered uncollectable. The business's experience indicates that 3% of the remaining debts are likely to be irrecoverable. What figures will appear in the business's balance sheet in relation to trade receivables?

19.3 Setting up an allowance for doubtful debts for the first time

When a business sets up an allowance for doubtful debts for the first time, the entire allowance will be entered in the accounts as follows:

Debit Bad debts expense	£x	
Credit Allowance for doubtful debts		£x

The allowance for doubtful debts account is credited because it will ultimately be offset against the figure for trade receivables in the balance sheet. The allowance will therefore ultimately reduce the value of an asset, which always requires a credit entry.

The bad debts expense account is debited because the business is recognising the fact that this amount may never be received. This represents a business expense, so it must be a debit entry.

Exhibit 19.3 shows a worked example of how an allowance for doubtful debts is set up for the first time.

Exhibit 19.3 Setting up an allowance for doubtful debts for the first time

At his financial year end of 31 December 2024, J. Bakir's trade receivables were £40,000. This was after writing off bad debts of £5,400 during the year. For the first time, Bakir carefully analysed his business's experience with bad debts. The evidence indicated that 3% of his outstanding trade receivables are unlikely to be collected. Bakir has never set up an allowance for doubtful debts before.

Solution:

$£40,000 \times 3\% = £1,200$, so Bakir is estimating that £1,200 may never be recovered. He has never set up an allowance for doubtful debts before, so the journal entry will be:

Debit Bad debts expense	£1,200	
Credit Allowance for doubtful debts		£1,200

The ledger accounts will appear as follows:

Bad debts expense			
2024		£	
Various	Various	5,400	
31 Dec	Allowance for doubtful debts	<u>1,200</u>	
		<u>6,600</u>	
2024			£
31 Dec	Profit and loss		<u>6,600</u>
			<u>6,600</u>

Allowance for doubtful debts			
2024		£	
31 Dec	Balance c/d	<u>1,200</u>	
		<u>1,200</u>	
2024			£
31 Dec	Bad debts expense		<u>1,200</u>
			<u>1,200</u>
2025			
1 Jan	Balance b/d		1,200

In the financial statements, the impact of bad and doubtful debts will ultimately be presented as follows:

Extract from the income statement for the year ended 31 December 2024

	£
Expenses	
Bad debts written off*	5,400
Increase in allowance for doubtful debts*	1,200

*It is equally acceptable to show these two items as a single expense of £6,600, being the balance on the bad debts expense account. However, it is quite common to show the two elements separately in the income statement, and for consistency we will do so throughout this book.

Extract from the current assets section of the balance sheet as at 31 December 2024

	£	£
Trade receivables	40,000	
Less Allowance for doubtful debts	<u>(1,200)</u>	38,800

19.4 Increasing the allowance for doubtful debts

At the end of their financial year, businesses must assess what allowance for doubtful debts is needed. If the business already has an allowance for doubtful debts in its books, then the existing allowance simply needs to be adjusted to the new figure. If the allowance needs to be increased:

- **The allowance for doubtful debts account must be credited with the amount of the increase.** It is a credit entry because the business is increasing the amount that will ultimately be offset against the asset of trade receivables in the balance sheet.
- **The bad debts expense account must be debited with the amount of the increase in the allowance.** This is logical because the business is recognising that the value of trade receivables over which there is doubt has risen; this 'bad news' is an extra business expense and is therefore a debit entry.

Exhibit 19.4 gives an illustration of dealing with an increase in the allowance for doubtful debts, using the same business (J. Bakir), as the previous example (Exhibit 19.3).

Exhibit 19.4 Increasing the allowance for doubtful debts

On 31 December 2025, J. Bakir's trade receivables were £50,000. This was after writing off bad debts of £5,600 during the year. Once again Bakir carefully analysed his business's experience with debt collection. The evidence continued to indicate that 3% of his outstanding trade receivables are unlikely to be recovered.

Solution:

$£50,000 \times 3\% = £1,500$, so Bakir is estimating that £1,500 may never be recovered. An allowance for doubtful debts of £1,200 already exists from the previous year, so the journal entry will be:

Debit Bad debts expense	£300	
Credit Allowance for doubtful debts		£300

The ledger accounts will appear as follows:

Bad debts expense			
2025		£	
Various	Various	5,600	
31 Dec	Allowance for doubtful debts	300	
		<u>5,900</u>	
2025		£	
31 Dec	Profit and loss	5,900	
		<u>5,900</u>	

Allowance for doubtful debts			
2025		£	
31 Dec	Balance c/d	1,500	
		<u>1,500</u>	
2025		£	
1 Jan	Balance b/d	1,200	
31 Dec	Bad debts expense	300	
		<u>1,500</u>	
2026			
1 Jan	Balance b/d	1,500	

In the financial statements, the impact of bad and doubtful debts will ultimately be presented as follows:

Extract from the income statement for the year ended 31 December 2025

	£
Expenses	
Bad debts written off*	5,600
Increase in allowance for doubtful debts*	300

*It is equally acceptable to show these two items as a single expense of £5,900, being the balance on the bad debts expense account.

Extract from the current assets section of the balance sheet as at 31 December 2025

	£	£
Trade receivables	50,000	
Less Allowance for doubtful debts	<u>(1,500)</u>	48,500

**Activity
19.4**

At 1 January 2024 a business's allowance for doubtful debts was £20,000. During 2024 the business wrote off bad debts of £70,000. At 31 December 2024, the business requires an allowance for doubtful debts of £23,000. What is the total expense in relation to bad and doubtful debts in the business's income statement for 2024?

19.5 Reducing the allowance for doubtful debts

Sometimes a business will assess what allowance for doubtful debts is needed and find that it is lower than the allowance that already exists. If the allowance needs to be reduced:

- **The allowance for doubtful debts account must be debited with the amount of the reduction.**
- **The bad debts expense account must be credited with the amount of the reduction.** This is logical, because the business is essentially recognising that the value of trade receivables over which there is doubt has fallen. This 'good news' is reflected with a reduction in the expense of bad debts, which requires a credit entry.

Exhibit 19.5 demonstrates how to account for a decrease in the allowance for doubtful debts, using the same business (J. Bakir) as the previous exhibits.

Exhibit 19.5 Reducing the allowance for doubtful debts

On 31 December 2026, J. Bakir's trade receivables were £44,000. This was after writing off bad debts of £6,300 during the year. Once again Bakir analysed his business's experience with bad debts and the evidence continued to indicate that 3% of his outstanding trade receivables are unlikely to be collected.

Solution:

$£44,000 \times 3\% = £1,320$, so Bakir is estimating that £1,320 may never be recovered. An allowance for doubtful debts of £1,500 already exists from the previous year, so the reduction required is £180:

Debit Allowance for doubtful debts	£180	
Credit Bad debts expense		£180

The ledger accounts will appear as follows:

Bad debts expense					
2026		£	2026		£
Various	Various	6,300	31 Dec	Allowance for doubtful debts	180
			31 Dec	Profit and loss	6,120
		<u>6,300</u>			<u>6,300</u>

Allowance for doubtful debts					
2026		£	2026		£
31 Dec	Bad debts expense	180	1 Jan	Balance b/d	1,500
31 Dec	Balance c/d	1,320			<u>1,500</u>
		<u>1,500</u>	2027		
			1 Jan	Balance b/d	1,320

➔ In the financial statements the impact of bad and doubtful debts will ultimately be presented as follows:

Extract from the income statement for the year ended 31 December 2026

	£
Expenses	
Bad debts written off*	6,300
Decrease in the allowance for doubtful debts*	(180)

*It is equally acceptable to show these two items as a single expense of £6,120, being the balance on the bad debts expense account.

Extract from the current assets section of the balance sheet as at 31 December 2026

	£	£
Trade receivables	44,000	
Less Allowance for doubtful debts	<u>(1,320)</u>	42,680

In Exhibit 19.5, note that the decrease in the allowance for doubtful debts will be included as a 'negative expense' in the income statement, to be offset against the cost of bad debts written off. Some textbooks choose to show a decrease in the allowance for doubtful debts as an item of *other income*. This is somewhat dubious, because a business cannot generate income simply by adjusting its allowance for doubtful debts!

Moreover, the change in the allowance for doubtful debts and the value of debts written off during the year fundamentally arise from the same issue. Both doubtful debts and bad debts relate to trade receivables that may be, with varying degrees of certainty, irrecoverable. It therefore makes sense that the change in the allowance for doubtful debts and bad debts written off both appear in the same place in the income statement.

Activity 19.5

The balance on a business's allowance for doubtful debts account at 1 January 2023 was £17,000. During 2023 the business wrote off **irrecoverable debts** of £54,000. A detailed review indicates that an allowance for doubtful debts of £13,000 is required at 31 December 2023. What will be the net total charge in connection with bad and doubtful debts in this business's income statement for 2023?

19.6

An alternative approach to making the double entries for the allowance for doubtful debts

As you've seen, if the allowance for doubtful debts is to be increased (for example) then the double entry is as follows:

Debit Bad debts expense	£x	
Credit Allowance for doubtful debts		£x

In Chapter 7, we explained that the balances on income and expense accounts are transferred to a profit and loss ledger account at the end of the year. Since the balance on the bad debts expense account will end up in the profit and loss ledger account, some textbooks and examiners simply debit the profit and loss ledger account with the increase in the allowance instead of first debiting the bad debts expense account.

This alternative approach is perfectly correct, and it is possible that your teacher or lecturer may prefer to do it this way. When accounts were kept manually, it was quicker to debit the profit and loss ledger account directly rather than using a separate bad debts expense account.

However, most businesses now keep their records using an accounting software package, and it would be very rare to debit the profit and loss ledger account directly with a particular item of expense. For clarity and transparency, it is normal to post each expense to the appropriate expense account in the software. Since the software will automatically make the transfers to the profit and loss ledger account at the end of the period, there is no difference in the time or effort required.

In any case, the impact of both approaches on the income statement and balance sheet will ultimately be exactly the same.

19.7 Bad debts written off that are later recovered

Occasionally a debt is written off as bad but is actually recovered (in whole or in part) in a later year. The double entries in the ledger to record the receipt of an amount that had previously been written off will be:

- 1 Reinstate the amount recovered as a debt in the customer's account:

Debit Customer's account	£x	
Credit Bad debts recovered		£x

- 2 Record the receipt of the amount in the normal way:

Debit Cash at bank	£x	
Credit Customer's account		£x

The increase in cash at bank is a debit entry because it represents an increase in an asset. The amount recovered represents a small amount of unexpected income and is, therefore, a credit entry. The two entries to the customer's account will simply cancel each other out.

Activity 19.6

Why do you think businesses reinstate the debt only to cancel it out again straight away? Why don't they simply debit cash at bank and credit bad debts recovered?

If the balance on the bad debts recovered account at the end of the year is reasonably significant (i.e. if it is *material*), then it may be shown separately as an item of *other income* in the income statement. If the amount is small (i.e. if it is *immaterial*) then it may instead be netted off against the bad debts expense for the year.

The receipt of debts that have previously been written off will probably be a fairly rare event, and the amounts involved will usually be quite small. For this reason, some businesses will simply credit their *bad debts expense* account rather than maintaining a separate *bad debts recovered* ledger account.

19.8 The total impact of bad and doubtful debts in the income statement

At this stage, it might be useful to summarise the effect of bad and doubtful debts on a business's income statement.

The total impact in relation to bad and doubtful debts in the income statement of a business will potentially be made up of:

Bad debts written off during the year	£
Increase/(decrease) in the allowance for doubtful debts	A
Bad debts recovered that had previously been written off	B/(C)
<i>Total charge in relation to bad and doubtful debts</i>	<u>(D)</u>
	<u>E</u>

Item A in the above table (bad debts written off during the year) will always represent an expense. The allowance for doubtful debts will have increased or decreased: an increase represents an extra expense while a decrease represents a reduction in the expense. Item D (bad debts recovered) are small amounts of unexpected income, so they always reduce the net charge in relation to bad and doubtful debts in the income statement.

Activity 19.7

A business's allowance for doubtful debts was £10,000 at 1 January 2024, and at 31 December 2024 it was decided that this needed to be adjusted to £8,000. During 2024, the business had written off bad debts of £61,000, and a debt of £400 that had been written off in 2023 was recovered. What is the resulting net total charge in the income statement for 2024?

19.9 Allowances for prompt payment discounts on receivables

In Chapter 12, we explained how businesses sometimes offer **prompt payment discounts** to their customers to encourage them to pay quickly. These are also known as **settlement discounts** or **cash discounts**. Under accounting standard IFRS 15 *Revenue from Contracts with Customers*, a business's sales revenue must be reported net of any such discounts.

If the guidance in IFRS 15 is followed to the letter, every time a business makes a sale and offers a prompt payment discount it should predict (on the basis of past experience) whether the customer is likely to take that discount. If it expects that the customer *will* take the discount, then the sale should be recorded at the price minus the discount. If the customer then ends up not taking the discount, then the sales account will subsequently need to be credited with the extra revenue.

This is a somewhat cumbersome system to expect a sole proprietor to adopt. Moreover, the prompt payment discounts offered by the simple trading businesses in this book will typically only be 1–3% of the selling price, so the amounts involved will be very small. Therefore, in this book, we adopt a simplified system that still complies with the requirements of IFRS 15:

- 1 When a sale is made on credit terms and a prompt payment discount is offered, we'll assume that the discount is unlikely to be taken and simply record the sale at full price. For example, suppose a business sells goods on credit terms to the value of £100 to P Johnson and offers a prompt payment discount of 3%. The double entry impact will be:

Debit P Johnson receivable	£100
Credit Sales	£100

- 2 If Johnson does pay quickly and takes the 3% prompt payment discount, then the debt will be cleared and the *discounts allowed* account will be debited:

Debit Cash at bank	£97	
Debit Discounts allowed	£3	
Credit P Johnson receivable		£100

- 3 In the income statement, the balance on the *discounts allowed* account will be deducted from the figure for sales revenue in order to reflect the actual amount earned from sales, in accordance with IFRS 15.
- 4 At the end of the year, all amounts due from customers can be reviewed. The business can use its past experience to estimate which debts are likely to be paid early and will therefore be received net of prompt payment discounts. An allowance can then be set up for the total value of prompt payment discounts that are likely to be taken in relation to trade receivables as at the year end:

Debit Discounts allowed	£x	
Credit Allowance for prompt payment discounts		£x

The balance on the *allowance for prompt payment discounts* account will be deducted from the figure for trade receivables in the balance sheet. And, as noted above, the balance on the *discounts allowed* account will be deducted from the sales figure in the income statement.

Accounting for this allowance each year will be similar to the allowance for doubtful debts:

- The first time the allowance is set up, the full amount of the allowance will be debited to the discounts allowed account.
- If the allowance *increases* in a subsequent year, then the increase in the allowance will be debited to the discounts allowed account.
- If the allowance *decreases* in a subsequent year, then the decrease in the allowance will be credited to the discounts allowed account.

Finally, note that any estimate of prompt payment discounts in relation to amounts receivable from customers as at the year end must obviously exclude any amounts that are considered bad or doubtful. After all, a business cannot logically identify debts as being bad or doubtful and simultaneously predict that they will be paid promptly!

An example of accounting for an allowance for prompt payment discounts is given in Exhibit 19.6.

Exhibit 19.6 Accounting for an allowance for prompt payment discounts

Suppose a certain business never suffers from any bad or doubtful debts. However, it does offer prompt payment discounts to its customers. The business has never set up an allowance for prompt payment discounts before and will be doing so for the first time as at its year ended 31 December 2024. The following information is available:

Year ended 31 December	Total sales (before any prompt payment discounts) during year	Prompt payment discounts taken by customers during year	Trade receivables as at end of year	Allowance for prompt payment discounts required at year end
	£	£	£	£
2024	77,000	1,150	9,600	140
2025	92,000	1,310	11,400	170
2026	86,000	1,240	10,900	150



**Solution:****Allowance for prompt payment discounts**

2024		£	2024		£
31 Dec	Balance c/d	<u>140</u>	31 Dec	Discounts allowed	<u>140</u>
2025			2025		
31 Dec	Balance c/d	<u>170</u>	1 Jan	Balance b/d	140
		<u>170</u>	31 Dec	Discounts allowed	<u>30</u>
2026					<u>170</u>
31 Dec	Discounts allowed	20	2026		
31 Dec	Balance c/d	<u>150</u>	1 Jan	Balance b/d	170
		<u>170</u>			<u>170</u>
			2027		
			1 Jan	Balance b/d	150

Extracts from the income statements for years ending 31 December

		£
2024	Sales (77,000 – 1,150 – 140)	75,710
2025	Sales (92,000 – 1,310 – 30)	90,660
2026	Sales (86,000 – 1,240 + 20)	84,780

Extracts from the current assets section of the balance sheets as at 31 December

		£	£
2024	Trade receivables	9,600	
	Less Allowance for prompt payment discounts	<u>(140)</u>	9,460
<hr/>			
2025	Trade receivables	11,400	
	Less Allowance for prompt payment discounts	<u>(170)</u>	11,230
<hr/>			
2026	Trade receivables	10,900	
	Less Allowance for prompt payment discounts	<u>(150)</u>	10,750

Finally, note that many businesses do not offer discounts for prompt payment, in which case there would obviously be no need to create an allowance for them. Even if a business *does* offer them, the amounts involved might be so small that any allowance would be immaterial. In text-book and exam questions, and indeed in the real world, allowances for doubtful debts will be far more common than allowances for prompt payment discounts.

Activity 19.8

On all its credit sales, a business offers a prompt payment discount of 2% for payment within 10 days. At its year end, it has total trade receivables of £530,000. £190,000 of these debts are less than 10 days old. Following an analysis of customers' past behaviour, it is found that 40% of the amount that is less than 10 days old is due from customers who normally take advantage of the discount. What figure for trade receivables will be shown in the balance sheet?

Learning outcomes

You should now have learnt:

- 1 That amounts due from customers that a business is unable to collect are called bad or irrecoverable debts.
- 2 That when a business decides that a particular debt is bad, it must be written off.
- 3 That writing off a bad debt involves debiting the bad debts expense account and crediting the customer's account.
- 4 That there may also be amounts due from customers over which there is cause for concern but which the business is not ready to write off and give up trying to collect, and an allowance for doubtful debts is needed in relation to these.
- 5 That the business may know from experience that a certain proportion of its debts will not be paid but it cannot predict which ones, so an allowance for doubtful debts will also be needed in respect of these.
- 6 That the amount of any allowance must be based on evidence, such as an analysis of the business's debt collection experience, industry averages, the economic climate, and concerns over specific debts.
- 7 That the entire allowance for doubtful debts will be offset against the figure for trade receivables in the balance sheet.
- 8 That an increase in the allowance for doubtful debts will be debited to the bad debts expense account.
- 9 That a reduction in the allowance for doubtful debts will be credited to the bad debts expense account.
- 10 That it is also acceptable to debit or credit the change in the allowance directly to the profit and loss ledger account.
- 11 That if a bad debt that had previously been written off is unexpectedly recovered, then the amount received will be credited to a bad debts recovered account.
- 12 That allowances for prompt payment discounts can be made at the end of the year in relation to discounts that are expected to be deducted by customers when outstanding debts are paid.
- 13 How to record bad debts, allowances for doubtful debts, and allowances for prompt payment discounts in the books and how they will be reflected in the business's income statement and balance sheet.

Answers to activities

- 19.1** The figure for sales in the income statement will be £700,000 and trade receivables will be £110,000. In other words, the £30,000 due from Fox will be written off and removed from trade receivables, and it will appear as a bad debt expense in the income statement. The figure for sales will be unaffected; after all, Zoe's business *did* make sales of £700,000 during the year. The fact that this figure includes £30,000 that will never be collected is simply a business expense arising from her policy of making sales on credit terms.
- 19.2** The two concepts are the *prudence concept* and the *accrual basis*. The prudence concept states that accounting estimates should be made with a degree of caution, which will help ensure that assets are

not overstated and expenses are not understated. If there is doubt over whether some debts will be recovered, then an allowance for doubtful debts is necessary to ensure that (following the prudence concept) the asset of trade receivables is not overstated in the balance sheet.

The accrual basis implies that income earned in the year must be matched with the expenses incurred in earning that income. For example, suppose a business makes sales on credit during Year 1. These sales will, of course, be reported as income in Year 1. If there is doubt over whether some of the amounts still due from customers in relation to these sales as at the end of Year 1 will ever be collected then this doubt should be recognised in Year 1, so that the cost of the potential bad debts is matched with the associated revenue.

19.3 In the current assets section of the balance sheet, trade receivables will appear as follows:

	£	£
Trade receivables (270,000 – 13,000 written off)	257,000	
Less Allowance for doubtful debts (257,000 × 3%)	<u>(7,710)</u>	<u>249,290</u>

19.4 The answer is £73,000, as follows:

	£
Bad debts written off	70,000
Increase in allowance for doubtful debts (£23,000 – £20,000)	<u>3,000</u>
Total expense in income statement in relation to bad and doubtful debts	<u>73,000</u>

19.5 The answer is £50,000, as follows:

	£
Bad debts written off	54,000
Decrease in allowance for doubtful debts (£13,000 – £17,000)	<u>(4,000)</u>
Total charge in income statement in connection with bad and doubtful debts	<u>50,000</u>

19.6 The reason is so that the business will have a complete history of all transactions with that customer on the customer's account. This might be helpful when deciding whether to give credit to that customer in the future. It will also reduce the chances of misunderstandings when communicating with the customer. However, it is also true that (for speed and simplicity) some businesses will indeed simply debit cash at bank and credit bad debts recovered and won't bother making the entries to the customer's account.

19.7 The answer is £58,600, as follows:

	£
Bad debts written off	61,000
Decrease in allowance for doubtful debts (£8,000 – £10,000)	<u>(2,000)</u>
Bad debt recovered that had previously been written off	<u>(400)</u>
Total expense in income statement in relation to bad and doubtful debts	<u>58,600</u>

19.8 Only debts less than 10 days old are still within the timeframe to take advantage of the discount. 40% of this amount is due from customers who normally take the discount, so an allowance for prompt payment discounts of (£190,000 × 40% × 2% = £1,520) is required. The figure for trade receivables in the balance sheet will therefore be:

	£	£
Trade receivables	530,000	
Less Allowance for prompt payment discounts	<u>(1,520)</u>	<u>528,480</u>

Review questions

19.1 In a new business during its first year of trading (the year ended 31 December 2024), the following debts are found to be bad, and are written off on the dates shown:

31 May	C. Wood	£730
30 September	L. Shaw	£810
30 November	J. Cole	£620

On 31 December 2024, the schedule of remaining trade receivables totalling £43,620 is examined and it is decided to make an allowance for doubtful debts of £940.

You are required to show:

- The allowance for doubtful debts account and the bad debts expense account.
- The charge to the income statement for the year ended 31 December 2024.
- The relevant extracts from the balance sheet as at 31 December 2024.

19.2 On 1 January 2024, a business's allowance for doubtful debts, brought forward from the previous year, was £1,250.

During the year to 31 December 2024, bad debts written off amounted to £9,140.

On 31 December 2024 the trade receivables balance was £50,700. On the basis of a careful analysis of past experience, an allowance for doubtful debts of 3% of trade receivables is required.

You are to show:

- The allowance for doubtful debts account for the year ended 31 December 2024.
- The bad debts expense account for the year ended 31 December 2024.
- The total charge to the income statement for the year.
- The relevant extract from the balance sheet as at 31 December 2024.

19.3 A business started trading on 1 January 2022. During the two years ended 31 December 2022 and 2023, the following debts were written off to the bad debts expense account on the dates stated:

31 May 2022	J. Gray	£350
31 October 2022	P. King	£560
31 January 2023	T. Ryan	£680
30 June 2023	D. Simms	£290
31 October 2023	B. Hall	£470

On 31 December 2022, the total trade receivables were £97,100. It was decided to make an allowance for doubtful debts of £3,230.

On 31 December 2023, the total trade receivables were £106,200. It was decided to make an allowance for doubtful debts of £4,010.

You are required to show:

- The allowance for doubtful debts account and the bad debts expense account for each of the two years.
- The relevant extracts from the balance sheets as at 31 December 2022 and 2023.

19.4A A business, which started trading on 1 January 2022, adjusted its allowance for doubtful debts at the end of each year on a percentage basis, but each year the percentage rate is adjusted in





accordance with an analysis of the business's actual debt collection experience. The following details are available for the three years ended 31 December 2022, 2023 and 2024:

	<i>Bad debts written off year to 31 December</i>	<i>Trade receivables at 31 December after bad debts written off</i>	<i>Percentage allowance for doubtful debts</i>
	£	£	
2022	12,380	92,000	4%
2023	22,640	136,000	5%
2024	31,700	169,000	2.5%

You are required to show:

- The allowance for doubtful debts accounts and bad debts expense accounts for each of the three years.
- Balance sheet extracts as at 31 December 2022, 2023 and 2024.

19.5 A business which prepares its financial statements annually to 31 December suffered bad debts which were written off:

2021	£4,570
2022	£3,260
2023	£5,080

The business had a balance of £740 on the allowance for doubtful debts account on 1 January 2021.

At the end of each year, the business carefully considered which of its debtors appeared doubtful and decided to carry forward an allowance of:

2021	£830
2022	£970
2023	£690

For each of the three years, prepare the allowance for doubtful debts account and state the total charge in relation to bad and doubtful debts in the income statements.

19.6A

- As at 31 October 2024, a balance of £12,900 on the allowance for doubtful debts account of Daisy's business had been brought forward from the previous year end. It was then decided that specific debts totalling £14,300 were to be written off as the cash was considered to be irrecoverable, and that the allowance for doubtful debts was to be adjusted to £13,800.

On the basis of this information, what is the net total expense in connection with bad and doubtful debts that should appear in the income statement of Daisy's business for her financial year ended 31 October 2024?

- At 30 April 2020 Becky's business had an allowance for doubtful debts of £22,700. During her year ended 30 April 2021, debts totalling £29,400 were written off. Becky then decided to adjust the allowance for doubtful debts to £21,000 as at 30 April 2021.

Given this information, what is the net total impact of bad and doubtful debts to be reflected in Becky's Income Statement for her year ended 30 April 2021?

- As at 31 December 2018, Charlotte's business had an allowance for doubtful debts of £2,250. During the year to 31 December 2019 the following occurred:

- Irrecoverable debts of £3,960 were written off.

- Charlotte received £261 in respect of a debt that had been written off completely during 2017. At 31 December 2019 the total of Charlotte's trade receivables was £94,000. Charlotte has reviewed these carefully and determined that an allowance for doubtful debts of £2,100 is required.

What is the impact of all this information on Charlotte's income statement for 2019 in relation to bad and doubtful debts?

- (d) On the morning of 31 December 2020 the total trade receivables of Parvati's business amount to £97,000. However, in the afternoon the following events transpire:
- (i) Parvati discovers that a credit customer (D. Lucas) has ceased trading and it becomes apparent that the £1,375 owed by Lucas is virtually certain to be irrecoverable.
 - (ii) Parvati also learns that another customer (Adrian Webb) may be experiencing some financial difficulties and she now believes that an allowance should be set up for the £1,268 owed by Webb.
 - (iii) A cheque for £1,523 is received from S. Miller, a debt against which a specific allowance had been created in October 2020.
 - (iv) A cheque for £1,472 is received from T. Cook. This amount had been written off in November 2019.

What is the revised total of Parvati's trade receivables after dealing with the four items above?

19.7 Ebony's business establishes an allowance for doubtful debts at the end of each financial year based on both a review of individual debts and a careful analysis of her recent debt collection experience.

Her business also offers a prompt payment discount of 2% for payment within 14 days. She records every sale at its full price, and records discounts allowed if and when her customers take advantage of them. At the end of the year, she makes an allowance for prompt payment discounts in relation to amounts outstanding from those customers she expects to take advantage of the discount.

On 1 January 2021, the balances brought down on the accounts for the allowance for doubtful debts and the allowance for prompt payment discounts were £3,290 and £809 respectively.

During 2021, Ebony made sales (before deducting any prompt payment discounts) totalling £837,000, she wrote off bad debts of £26,310, and her customers took prompt payment discounts of £5,020. On 31 December 2021, her trade receivables amounted to £104,000. Of these, £43,000 had been owing for less than 14 days, and 70% of this £43,000 was due from customers that normally take up the discount. After a careful review, she also determined that an allowance for doubtful debts of £3,830 was needed.

Required:

- (a) Draw up the following accounts for Ebony's year ended 31 December 2021:
 - (i) Allowance for doubtful debts;
 - (ii) Allowance for prompt payment discounts;
 - (iii) Bad debts expense;
 - (iv) Discounts allowed.
- (b) On the basis of the information available, show extracts from the income statement for the year ended 31 December 2021.

19.8A Lohit is in business buying and selling goods on credit. The following information relates to his bad and doubtful debts for the year ended 31 August 2024.

- 1 Balance of Allowance for Doubtful Debts Accounts on 1 September 2023 was £1,100
- 2 Bad debts

	Customer	Balance owed	Payment received
4 January 2024	Jegan	£800	£300
30 March 2024	Smith and Sons	£3,000	£0.60 in the £
19 May 2024	Nuri	£500	£0.30 in the £
3 June 2024	Ng	£250	Nil





- 3 Bad debts recovered
The balance of £400 owed by Arca had been written off on 20 July 2022. A cheque for part payment of the debt was received for £250 on 15 June 2024.
- 4 Schedule of trade receivables 31 August 2024

Age of debt	Amount	Allowance for doubtful debts
Up to 30 days	£12,500	2%
31–60 days	£6,000	5%
Over 60 days	£1,500	20%

Required:

- (a) Prepare the following at 31 August 2024, including year-end transfers where appropriate.
 - (i) Journal entries, **including** narratives and bank entries:
 - bad debt of Smith and Sons
 - recovery of part of the debt written off from Arca.
 - (ii) Bad Debts Account
 - (iii) Bad Debts Recovered Account
 - (iv) Allowance for Doubtful Debts Account.
- (b) Explain **four** elements of good credit control.
A friend of Lohit stated, 'I do not know why you use an allowance for doubtful debts account. It is better to write off the bad debts when they actually occur.'
- (c) Evaluate the friend's statement.

(Edexcel A level)

19.9 Molly West commenced business on 1 January 2021 and prepares her financial statements to 31 December every year. For the year ended 31 December 2021, bad debts written off amounted to £15,510. It was also found necessary to create an allowance for doubtful debts of £2,590.

In 2022, debts amounting to £17,430 proved bad and were written off. J. Kane, whose debt of £175 was written off as bad in 2021, settled his account in full on 30 November 2022. As at 31 December 2022, total debts outstanding were £116,600. It was judged necessary to bring the allowance up to 3% of this figure on that date.

In 2023, £19,740 of debts were written off during the year, and another recovery of £202 was made in respect of an amount due from B. Azam that had been written off in 2021. As at 31 December 2023, total debts outstanding were £79,200. The allowance for doubtful debts needs to be changed to be equal to 4% of this figure.

Required:

Show, for the years 2021, 2022 and 2023, the:

- (a) Allowance for doubtful debts account
- (b) Bad debts recovered account
- (c) Bad debts expense account
- (d) Net total charge to the income statement.

19.10A The balance sheet of Tyrone's business as at 31 December 2021 included an allowance for doubtful debts of £4,010 and an allowance for prompt payment discounts of £288. Tyrone is now in the process of preparing his financial statements for the year ended 31 December 2022.

He offers a prompt payment discount of 2.5% for payment within 10 days. Every sale is recorded in his books at its full amount, and discounts allowed are subsequently recorded if and when his customers take them. At the end of the year, he also makes an allowance for prompt payment discounts in respect of amounts outstanding from those customers that he predicts will take advantage of them.

During the year ended 31 December 2022 Tyrone made sales (before deducting any prompt payment discounts) amounting to £564,000; he wrote off irrecoverable debts of £16,290; and prompt payment discounts deducted by customers totalled £8,640. On 31 December 2022, his trade receivables amounted to £70,780, of which £23,400 had been outstanding for under 10 days. Tyrone calculated that 60% of this £23,400 was due from customers that he would normally expect to take the discount. Finally, after a thorough review, he also decided that an allowance for doubtful debts of £3,120 was appropriate.

Required:

- For the year ended 31 December 2022, write up the *allowance for doubtful debts*, *allowance for prompt payment discounts*, *bad debts expense*, and *discounts allowed* accounts.
- Prepare extracts from the income statement for the year ended 31 December 2022 as far as the information allows.

19.11A The following balances appeared in the trial balance of Dave Bainbridge's business as at 30 June 2024:

	£
Trade receivables	117,000
Bad debts expense	18,720
Bad debts recovered	690
Allowance for doubtful debts at 1 July 2023	2,950

After this trial balance had been constructed, Bainbridge decided to write off further debts amounting to £4,100, which were deemed to be irrecoverable.

He also decided to carry forward at 30 June 2024 an allowance equal to (based on an analysis of his business's recent experience and history) 3% of remaining trade receivables.

What is the impact of all this information on the net profit of Bainbridge's business for the year ended 30 June 2024?

Capital expenditure and revenue expenditure

Learning objectives

After you have studied this chapter you should be able to:

- Explain what is meant by the terms *capital expenditure* and *revenue expenditure*.
- Specify the different items of expenditure that must be included within the cost of non-current assets on the balance sheet.
- Identify expenditure that is capital in nature and that which is revenue expenditure.
- Explain the circumstances in which interest costs incurred must be treated as capital expenditure.
- Explain the effects on the income statement and balance sheet if revenue expenditure is wrongly classified as capital expenditure, or vice versa.

Introduction

Over the next two chapters, we turn our attention to non-current assets (such as buildings, machinery and equipment). Spending on non-current assets is known as *capital expenditure*, and, in this chapter, we will explain exactly what spending should be treated as capital expenditure. You'll learn that it is vital to be able to distinguish capital expenditure from revenue expenditure in order to ensure that profit is calculated correctly.

In Chapter 21, we'll look at how the cost of non-current assets must then be apportioned over their useful lives using an accounting technique known as *depreciation*. Because we're looking at non-current assets, the main source of the rules we'll be covering in these two chapters is IAS 16 *Property, Plant and Equipment*.

20.1 The use of the word 'capital' in accounting

Whenever a business buys **non-current** assets (such as machinery, equipment or vehicles) this is known as **capital expenditure**.

Activity 20.1

Can you remember the three key characteristics of non-current assets?

Of course, we have already used the word ‘capital’ many times in this book: for example, when a sole proprietor invests his or her own money or resources into their business, this is recorded as the **owner’s capital**.

You therefore need to be clear that the **owner’s capital** and the **capital expenditure** of the business are two entirely different things and you must not confuse the two.

Activity 20.2

Why do you think the word ‘capital’ is used in the terms ‘owner’s capital’ and ‘capital expenditure’, even though these terms refer to completely different things?

20.2 What exactly is included in capital expenditure?

Capital expenditure is incurred when a business spends money either to:

- buy non-current assets; or
- improve existing non-current assets or enhance their earning capacity.

The cost of buying a **non-current asset** will include the purchase price of the asset as well as any costs incurred in getting it to the location and condition needed for the business to start using it successfully for the first time, and from which the business will then benefit for several years. This could include things like:

- the basic purchase price of the asset, net of any discounts
- the costs of having it delivered to the business
- taxes (such as import duty or stamp duty) that need to be paid to acquire the asset and that cannot be reclaimed by the business
- any costs of having the asset assembled, installed or tested before it is used for the first time
- professional fees essential to the acquisition of the asset, such as legal costs incurred when buying land and buildings.

Activity 20.3

Can you think of any other initial costs that a business might incur in bringing a non-current asset into operation from which it will benefit in the long term, and which will therefore be included as part of the cost of that asset?

If the business spends money on an existing non-current asset to improve or enhance it over and above its original level, then this is also capital expenditure. Such spending will be added to the cost of that asset.

In contrast, the cost of repairs, servicing or maintenance that is carried out simply to maintain the asset’s existing performance is *not* capital expenditure. Such costs are instead treated as an expense of the period in which they are incurred, and they will appear in the income statement as one of the expenses for the period.

Activity 20.4

A business bought a new warehouse for £250,000. Six months later, it paid a further £80,000 to build an extension to this warehouse. Following some bad weather, the warehouse roof suffered damage and the business spent £4,000 to have it repaired. What was the total capital expenditure?

20.3 What is revenue expenditure?

Revenue expenditure is incurred in either:

- running the business on a day-to-day basis; or
- maintaining the existing capacity of non-current assets.

The costs of running the business on a day-to-day basis will include those of purchasing goods for resale, wages and salaries, electricity, water, gas, rent, advertising and so on. All these costs are normally classed as revenue expenditure.

Maintaining the existing earning capacity of non-current assets will include the cost of repairs, maintenance and regular servicing, and (as explained in the previous section) this is revenue, not capital, expenditure.

A very simple example to illustrate the difference between capital and revenue expenditure is to consider the cost to a business of owning and using a delivery van. The purchase price of the van is capital expenditure: the van itself will (presumably) be used by the business for several years and is therefore a non-current asset. But buying petrol for the van is revenue expenditure. This is because the petrol will be used up in a short period of time and it does not improve or enhance the long-term earning capacity of the van.

Activity 20.5

The word 'revenue' is normally used to refer to the sales income of a business. Why do you think we use the word 'revenue' in the term 'revenue expenditure'?

20.4 Distinguishing between capital and revenue expenditure

The examples listed in Exhibit 20.1 illustrate the difference in classification.

Exhibit 20.1 Distinguishing between capital and revenue expenditure

<i>Expenditure</i>	<i>Type of expenditure</i>
1 Buying a delivery van	Capital
2 Buying petrol for van	Revenue
3 Repairs to van	Revenue
4 Putting extra headlights on van	Capital
5 Buying machinery	Capital
6 Electricity costs of using machinery	Revenue
7 £1,500 spent on the machinery: £1,000 for an item added to the machine to improve its performance and £500 for repairs	Capital £1,000 Revenue £500
8 Painting outside of brand-new building	Capital
9 Repainting the same building three years later	Revenue

Revenue expenditure will be debited to the relevant expense account in the nominal ledger and will ultimately appear in the income statement as an expense in the year in which it is incurred.

Capital expenditure will be debited to the appropriate non-current asset account in the nominal ledger and it will ultimately increase the figures for non-current assets in the balance sheet.

Note that when an item of spending is treated as capital expenditure, then the amount in question is said to have been **capitalised**: this just means that it has been added to the cost of a non-current asset in the balance sheet instead of being treated as an expense.

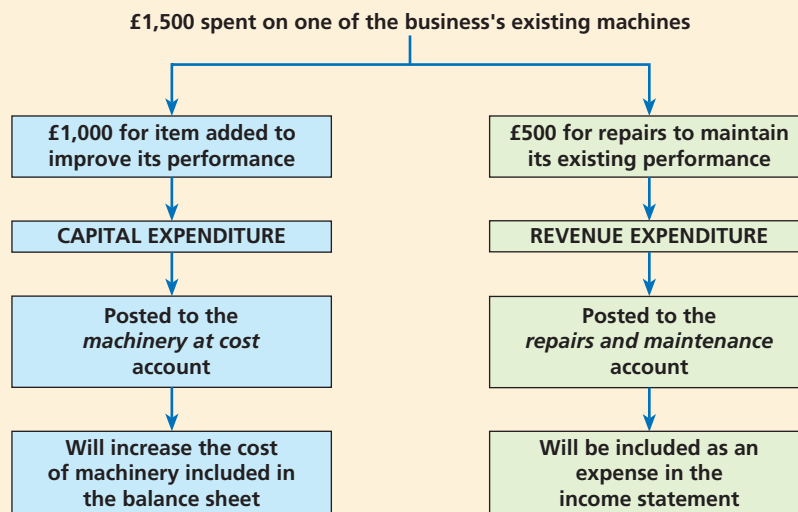
Activity 20.6

At the beginning of the financial year, a business buys a new piece of equipment priced at £8,900. It pays an additional £700 to have the equipment delivered and £1,600 on having it assembled and installed. After two months' use the equipment breaks down and it costs £1,100 to repair. What total amount will be debited to the *equipment at cost* account this year?

20.5 Spending that includes a mix of both capital and revenue expenditure

Sometimes a particular amount spent by the business will need to be divided between capital and revenue expenditure. There was an example of this in Exhibit 20.1 when £1,500 spent on machinery needed to be split. Exhibit 20.2 illustrates exactly how this £1,500 will be treated in the business's books.

Exhibit 20.2 Splitting an amount spent between capital and revenue expenditure



**Activity
20.7**

On 1 January, a business bought a new delivery van from a dealership, paying a total of £20,200. This amount included insurance and road tax for the year of £870 and £240, respectively, and a full tank of petrol costing £90. How much is capital expenditure and how much is revenue expenditure, and where will these amounts ultimately appear in the financial statements for the year ended 31 December?

20.6 The impact of classifying expenditure incorrectly

If a business gets the classification between revenue and capital expenditure wrong, then both its reported profits *and* the figures on its balance sheet will be incorrect:

- If revenue expenditure is mistakenly treated as capital expenditure, then non-current assets will be overstated and net profit will be overstated (because expenses will be understated).
- If capital expenditure is mistakenly treated as revenue expenditure, then net profit will be understated (because expenses will be overstated) and non-current assets will be understated.

It is therefore essential that an accountant can correctly distinguish between the two types of expenditure.

20.7 The replacement of major parts contained within a complex non-current asset

In this chapter, we've explained the general rule that spending to simply restore the performance of a non-current asset to its original level will be treated as revenue expenditure.

If you take your accounting studies further, you will find that things are not always quite so simple. For example, some large non-current assets can be complex because they are made up of several major parts. For instance, an aircraft is made up of parts such as the body, the engines and the passenger seats. The seats may have to be replaced several times over the life of the aircraft. In this situation, the cost of the new seats should be capitalised provided that the cost of the old seats is removed from the books: i.e. the old seats will be treated as having been disposed of. We'll look at how to account for disposals in the next chapter.

At this stage in your studies, you are very unlikely to come across the replacement of major parts of a complex non-current asset (such as the seats in an aircraft). You can just follow the general rule that expenditure that merely restores the performance of the asset to its original levels should be treated as revenue expenditure.

20.8 Interest costs incurred in financing the construction of a non-current asset

As you know, when a business borrows money it has to pay interest on the loan. The cost of this interest is normally an expense in the income statement: in other words, it is usually revenue expenditure.

If an asset takes a long time to get ready for use, then the business could incur significant interest costs during that time in financing the cost of getting it ready. The most obvious situation in

which an asset will take a long time to get ready is when the business constructs a non-current asset for its own use (for example, if it builds a new factory or office block for itself). It is likely that the business will need to borrow money to pay for this construction work.

As we've seen already, the cost at which a non-current asset is recorded should include all the costs incurred in bringing that asset to the location and condition necessary for it to be used by the business. If the business borrows money to finance the self-construction of a new building, then it could be argued that the interest costs meet this definition and they should therefore be treated as capital expenditure.

IAS 23 *Borrowing Costs* does indeed adopt this logic and requires that all borrowing costs that are directly attributable to financing the construction of a non-current asset should be treated as part of the cost of that asset.

Activity 20.8

There has been considerable debate about whether borrowing costs incurred in financing the construction of an asset should be treated as part of the cost of that asset. What arguments for and against doing so can you think of?

Be clear that borrowing costs can only be capitalised under IAS 23 if the asset takes a long time to get ready for use. This effectively means that the business must be constructing the asset itself. If the business simply buys an asset that is ready for use soon after it is acquired, then any interest costs associated with financing the purchase price cannot be capitalised.

IAS 23 sets out rules regarding the interest costs that should be capitalised. Interest costs incurred should only be capitalised from the point at which both expenditure and activity have begun on the construction project, and must end when the asset is ready for use.

Finally, note that the borrowing costs must be directly attributable to the construction of the asset; in other words, that the interest costs would have been avoided if the construction hadn't taken place.

Activity 20.9

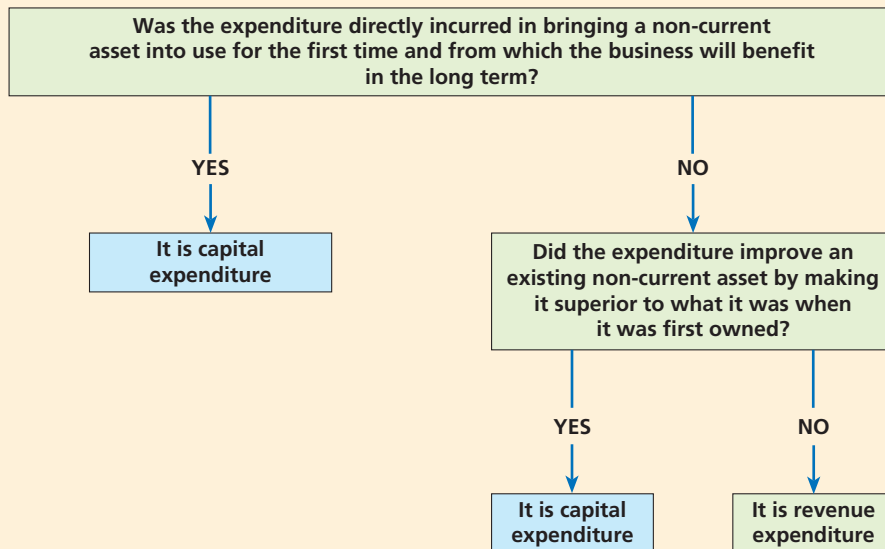
A business started construction of its new factory on 1 March. On 1 April it borrowed £1.5m at an annual interest rate of 6% to finance the construction. Building work was completed on 30 November and the factory was ready for use from 1 December. The total construction cost (including the cost of the land, building materials and architects' fees, but excluding any interest) amounted to £1.74m. What will be the cost of the building in the balance sheet as at 31 December?

20.9

A summary of the difference between capital and revenue expenditure

Some students can find it difficult to distinguish capital expenditure from revenue expenditure. Indeed, in the real world, some businesses can occasionally struggle to be sure whether a particular item is capital or revenue. But at this introductory stage in your studies, the basic principles you need to follow are fairly straightforward, as the flowchart in Exhibit 20.3 summarises.

Exhibit 20.3 A simple flowchart to help distinguish capital from revenue expenditure



Learning outcomes

You should now have learnt:

- 1 That capital expenditure is spending that results in either the acquisition of non-current assets or an improvement in their earning capacity.
- 2 That the cost of acquisition of non-current assets can include any costs incurred in getting them to the location and condition needed for them to be brought into use for the first time (such as delivery costs, legal costs associated with the purchase, and costs of assembly, installation and testing).
- 3 That revenue expenditure is spending on the running costs of the business (such as buying goods for resale and the cost of things like wages, rent, electricity and advertising) and it also includes spending to maintain the existing earning capacity of non-current assets (such as repairs and maintenance costs).
- 4 That if revenue expenditure is mistakenly treated as capital expenditure, then non-current assets in the balance sheet will be overstated and net profit in the income statement will be overstated (and vice versa).
- 5 That if a business constructs a non-current asset itself and must borrow money to finance the construction, then the borrowing costs incurred during the period of construction should be included as part of the cost of that asset.

Answers to activities

- 20.1** Non-current assets are i) long-life assets; ii) that are to be used in the business; and iii) have not been bought for the purposes of resale. Examples include land, buildings, machinery, equipment, fixtures & fittings, motor vehicles and computers.
- 20.2** The original meaning of the word *capital* relates to things that are 'major' or 'important': a capital city or capital letter, for example. When the owner puts resources into their business, this is normally (from the point of view of the owner) a major investment. Similarly, when a business buys new buildings, machinery or equipment, this usually represents fairly major spending by the business. This is ultimately why the word capital is used in both terms, even though they refer to completely different things.
- 20.3** Other such costs include:
- The site where the asset is to be located may have to be made ready in some way. For example, the business may incur demolition costs to remove something before new building can begin. Costs of this nature are commonly described as 'site preparation' costs.
 - The business might use its own staff to construct the new non-current asset. If so, the cost of employees' wages directly associated with their time spent on constructing the asset will be treated as capital expenditure.
 - The costs of planning permission for a new building.
 - Architects' fees for the design of a new building.

All these costs are directly attributable to getting a non-current asset ready for its intended use, so (if they are incurred) they can all be included in the cost of a non-current asset.

- 20.4** The extension enhances/improves the warehouse above its original value to the business. The repairs merely restore the warehouse to its original condition. Capital expenditure is therefore £330,000 (£250,000 + £80,000). This will be the cost of the warehouse included in the balance sheet. The repair costs of £4,000 will be an expense in the income statement in the year in which the damage occurred.
- 20.5** It is always difficult to be certain about the origins of a particular term or phrase, but we can consider two plausible explanations. First, revenue expenditure represents the running costs of the business that will be matched against the *revenue* (i.e. the income) that the business earned in the year when calculating its profit.
- A second possible explanation is that the word revenue comes from the French word 'revenir' which means to return or to come back. 'Revenue expenditure' could be said to be spending that returns over and over again: spending on things like wages, electricity, rent and advertising represents ongoing expenditure that will recur continuously, month after month. In contrast, the purchase price of a delivery van is a one-off cost. Once the van has been bought, the business can use it for several years and won't have to pay for it again. Capital expenditure is thus relatively intermittent and does not recur continuously.
- 20.6** Capital expenditure in relation to this equipment amounts to £8,900 purchase price + £700 delivery + £1,600 assembly & installation = £11,200. This is the total amount that will be debited to the equipment at cost account, the balance on which will ultimately be included in the balance sheet as at the end of the year.
- The repair costs of £1,100 will be debited to the repairs and maintenance expense account, the balance on which will ultimately appear in the income statement for the year.
- 20.7** The benefits from the insurance and road tax will expire at the end of the year. They therefore represent revenue expenditure of this year. The petrol will be used up even sooner, so this is also revenue expenditure. $£870 + £240 + £90 = £1,200$, so these costs will be included in full as expenses in the income statement for the year. The remainder of the amount paid must represent the cost of the van itself ($£20,200 - £1,200 = £19,000$) so the cost of the van will be recorded as £19,000 and this will be included within the figure for motor vehicles at cost in the balance sheet as at the end of the year.
- 20.8** Arguments for include:

- If the business can't afford to construct the asset without borrowing money, then logically the interest costs can be said to be a *necessary* cost of getting the asset ready for use.

- Capitalisation makes the cost of a self-constructed asset more comparable with assets that are purchased: with purchased assets, the supplier will (presumably) incur their own borrowing costs to finance the manufacture of the asset, and these costs will be factored into the purchase price.

Arguments against include:

- In practice, the identification and calculation of the borrowing costs to be capitalised may be a time consuming and costly exercise that does not provide helpful information to users of financial statements. For example, potential investors and lenders may look at the income statement to assess how capable the business is at generating enough profits to cover its interest charges. Showing some interest costs on the balance sheet instead of the income statement could make it harder for users to make this assessment.
- At any time, a business might be borrowing money from various sources at different rates of interest. It may be difficult or impossible to say for sure that a particular loan was specifically used to finance the construction of a particular asset. (IAS 23 addresses this issue by explaining that a business with a mix of borrowings should use a weighted average of the different interest rates.)

The capitalisation of interest costs on self-constructed assets is a relatively advanced topic to consider at the introductory stage of your accounting studies, but it is good to get a flavour of the type of issues you will encounter if you go on to study at the next level.

- 20.9** The interest to be capitalised as part of the cost of the asset will cover the period in the year when the business was getting the asset ready for use (i.e. when construction was in progress) and borrowing was in place to finance it. The period 1 April to 30 November is exactly 8 months. $\text{£}1.5\text{m} \times 6\% \times 8/12 \text{ months} = \text{£}60,000$, so the total cost of the factory will be $\text{£}1,740,000$ construction cost + $\text{£}60,000$ interest = $\text{£}1,800,000$.

Review questions

20.1

- What is meant by 'capital expenditure' and by 'revenue expenditure'?
- Some of the following items should be treated as capital and some as revenue. For each of them state which classification applies:
 - The purchase of machinery for use in the business.
 - Carriage paid to bring the machinery in (i) to the works.
 - Complete redecoration of the premises at a cost of $\text{£}1,500$.
 - A quarterly account for heating.
 - The purchase of a soft drinks vending machine for the canteen with a stock of soft drinks.
 - Wages paid by a building contractor to his own workmen for the erection of an office in the builder's stockyard.

- 20.2A** Indicate which of the following would be revenue items and which would be capital items in a wholesale bakery:

- Purchase of a new van.
- Purchase of replacement engine for existing van.
- Cost of altering the interior of the new van to increase carrying capacity.
- Cost of motor tax for new van.
- Cost of motor tax for existing van.
- Cost of painting business's name on new van.
- Repair and maintenance of existing van.

- 20.3** State the type of expenditure, capital or revenue, incurred in the following transactions:

- Breakdown van purchased by a garage.
- Repairs to a fruiterer's van.
- The cost of installing a new machine.

- (d) Cost of hiring refrigeration plant in a butcher's shop.
- (e) Twelve dozen sets of cutlery, purchased by a catering firm for a new dining-room.
- (f) A motor vehicle bought for resale by a motor dealer.
- (g) The cost of acquiring patent rights.

20.4A On what principles would you distinguish between capital and revenue expenditure? Illustrate your answer by reference to the following:

- (a) The cost of repairs and an extension to the premises.
- (b) Installation of a gas central heating boiler in place of an oil-fired central heating boiler.
- (c) Small but expensive alterations to a cigarette manufacturing machine which increased the machine's output by 20 per cent.

20.5 State which of the following you would classify as capital expenditure:

- (a) Cost of building extension to warehouse.
- (b) Purchase of extra filing cabinets for accounts office.
- (c) Cost of repairs to computer equipment.
- (d) Cost of installing reconditioned engine in delivery truck.
- (e) Legal fees paid in connection with warehouse extension.

20.6A The data which follows was extracted from the books of account of H. Kassab, an engineer, on 31 March 2024, his financial year end.

	£
(a) Purchase of extra milling machine (includes £300 for repair of an old machine)	2,900
(b) Rent	750
(c) Electrical expenses (includes new wiring £600, part of premises improvement)	3,280
(d) Carriage inwards (includes £150 carriage on new cement mixer)	1,260
(e) Purchase of extra drilling machine	4,100

You are required to allocate each or part of the items above to either 'capital' or 'revenue' expenditure.

20.7 During its year ended 31 December 2020, Landon's business acquired a new machine from China. The business incurred the following costs in relation to this machine in 2020:

	£
Purchase price	25,000
Costs of testing the machine before its first use	240
One-year licence to operate the machine	360
Assembly of the machine	430
Delivery costs	510
Cost of preparatory modifications necessary for the installation of the machine	670
Installation of the machine	750
One-year maintenance cover for the machine	890
Import duties	920

In Landon's balance sheet, what amount should appear for the cost of this machine as at 31 December 2020?





20.8A X Co constructed a new factory for itself. The costs incurred on the construction project were as follows:

	£'000
Architect's fees (including £75,000 for an initial design that was rejected and discarded by X Co)	415
Costs of applying for and obtaining planning permission	22
Purchase of the site	9,500
Cost of demolishing the existing building that was on the site	600
Sundry income earned while the site was used as a car park before construction began	(45)
Building materials (including £374,000 of recoverable VAT)	2,244
Construction labour costs (including £0.4m incurred when staff were on strike from 1 to 30 June 2024, during which time no construction work whatsoever took place)	3,100
Consultancy fees for testing factory processes before the building was completed	380
Revenue from sale of products produced as a result of the testing process	(70)
Costs of relocating staff who are to work in the new factory	568
Loan interest (see note (i))	495
Costs of the formal ceremony to mark the opening of the new factory, attended by local dignitaries	31

Additional information:

- (i) Construction work actually began on 1 February 2024, and a loan of £9m was taken out on the same date specifically to help finance the project. Interest on the loan is payable at a fixed annual rate of 6%. The loan is repayable in full on 31 January 2029.
- (ii) Building work was completed on 31 October 2024, at which point the factory was ready for use by X Co.

Required:

Calculate the total capital expenditure in relation to the new factory.

20.9 A. Bloggs, a building contractor, had a wooden store shed and a brick-built office which have balances b/d in the books of £850 and £179,500, respectively. During the year, the wooden shed was pulled down at a cost of £265 and replaced by a brick building. Some of the timber from the old store shed was sold for £180 and the remainder, valued at £100, was used in making door frames, etc., for the new store. The new brick-built store was constructed by the builder's own employees, the expenditure thereon being materials (excluding timber from the old store shed) £4,750; wages £3,510; and direct expenses of £85.

At about the same time, certain repairs and alterations were carried out to the office, again using the builder's own materials, the cost of which was: wages £290 and materials £460. It was estimated that £218 of this expenditure, being mainly that incurred on providing additional windows, represented improvements, 50% of this being wages, 50% materials.

Required:

Prepare the following four ledger accounts as they would appear after giving effect to all the above matters:

- (a) Wooden store shed account
- (b) Office buildings account
- (c) New brick-built store account
- (d) Office buildings repairs account

20.10A Sema plc, a company in the heavy engineering industry, carried out an expansion programme during its most recent financial year, in order to meet a permanent increase in contracts.

The company selected a suitable site and commissioned a survey and valuation report, for which the fee was £1,500. On the basis of the report, the site was acquired for £90,000.

Solicitors' fees for drawing up the contract and conveyancing were £3,000.

Fees of £8,700 were paid to the architects for preparing the building plans and overseeing the building work. This was carried out partly by the company's own workforce (at a wages cost of £11,600), using company building materials (cost £76,800), and partly by subcontractors who charged £69,400, of which £4,700 related to the demolition of an existing building on the same site.

The completed building housed two hydraulic presses.

The cost of press A was £97,000 (ex-works), payable in a single lump sum two months after installation. Sema was given a trade discount of 10% and a cash discount for prompt payment of 2%. Hire of a transporter to collect the press and to convey it to the new building was £2,900. Installation costs were £2,310, including hire of lifting gear, £1,400.

Press B would have cost £105,800 (delivered) if it had been paid in one lump sum. However, Sema opted to pay three equal annual instalments of £40,000, starting on the date of acquisition. Installation costs were £2,550, including hire of lifting gear, £1,750.

The whole of the above expenditure was financed by the issue of £500,000 7% loan notes (on which the annual interest payable was £35,000).

Before the above acquisitions were taken into account, the balances (at cost) on the non-current asset accounts for premises and plant were £521,100 and £407,500, respectively.

Required:

- Using such of the above information as is relevant, post and balance the premises and plant accounts for the company's most recent financial year.
- State, with reasons, which of the given information you have not used in your answer to (a) above.

(Association of Chartered Certified Accountants)

20.11 Why is the distinction between classifying something as capital expenditure and classifying it as revenue expenditure so important to the users of financial statements?

20.12A On 18 August 2024, J. Barton purchased a new machine from Delfalco Ltd. Barton paid the following amounts in relation to this acquisition:

	£
List price of machine	195,000
Costs of preparing the site for installation	8,700
Assembly costs	3,000
Installation costs	4,400
Three-year maintenance contract with Delfalco Ltd	6,000
One year's insurance on the machine	2,450
Pre-production testing	5,800

Barton was able to negotiate a trade discount of 15% on the list price of the machine as well as a settlement discount of 2% if payment was received within 21 days of purchase. Barton paid for the machine on 4 September 2024.

Required:

- How will the above information be treated in the financial statements of J. Barton?
- 'Materiality' is a concept that sometimes has an impact on the capitalisation of amounts in the balance sheet. Explain why this is the case and illustrate your answer with an example.

Learning objectives

After you have studied this chapter, you should be able to:

- Explain the purpose of charging depreciation on non-current assets.
- Explain the concepts of a non-current asset's *estimated useful life*, *estimated residual value*, and *depreciable amount*.
- Define the terms *depreciation expense*, *accumulated depreciation*, and *carrying amount*.
- Calculate depreciation using both the straight line and reducing balance methods, as well as using two other, less common methods.
- Compute the depreciation on assets bought or sold part way through the financial year.
- Make the accounting entries to record depreciation.
- Calculate the profit or loss on the disposal of non-current assets, including part-exchange disposals.
- Make the accounting entries to record the disposal of non-current assets.
- Calculate the depreciation on a non-current asset when there is a change in its estimated useful life, its residual value and/or when there is a change in depreciation method.
- Write down a non-current asset to its new value when it becomes apparent that the asset has suffered an *impairment loss*.
- Explain the nature and purpose of the non-current asset register.

Introduction

Suppose you buy a brand-new phone for £600 cash and expect to use it for three years, after which you plan to replace it with the latest model. You could reasonably argue that your new phone will effectively be costing you £200 per year. In cash terms you may have paid the entire £600 up front, but you will get the benefit from using the phone over three years, at a theoretical cost of £200 per year.

Businesses apply precisely this principle with their non-current assets. The entire cost of a new machine is not treated as an expense in the period in which it is bought. Instead, the total cost of the machine is spread over its expected life of several years. This process is called accounting for *depreciation*. In this chapter, you'll learn the two main methods of calculating depreciation, how it is recorded in the books, and the adjustments required when a non-current asset is sold.

21.1 The nature of non-current assets

You have already learnt that non-current assets are long-life assets that are expected to be used in the business for several years and have not been bought for the purposes of resale. Non-current assets can be tangible or intangible:

- 1 Tangible non-current assets have a physical existence, so they can be seen and touched. Examples include land, buildings, machinery, equipment, furniture, motor vehicles and computers.
- 2 Intangible non-current assets do not have a physical substance. Examples include a patent or a brand name.

'Intangibles' such as patents and brand names can be valuable assets that will be used in the business for several years, so they meet the definition of being non-current assets. However, accounting for intangibles is somewhat different to dealing with tangible non-current assets, so, in this chapter, we'll focus on the tangible category only. The main international accounting standard that covers tangible non-current assets is IAS 16 *Property, Plant and Equipment* so we'll refer to IAS 16 on several occasions.

21.2 The need to account for depreciation

In Chapter 10, you learnt about the accrual basis of accounting, which means that the income statement for the year must match the income earned in the year against the expenses incurred in earning that income. The accrual basis is fundamental to the need to account for depreciation. We can illustrate this with the following example.

Suppose a business buys a machine for £1,200 on 1 January 2021. It expects to use the machine in the business for three years, after which it will have to be scrapped. In this example, the machine is expected to help the business generate income for three years, so (under the accrual basis) the cost of the machine should be matched against the income of those three years.

The simplest approach would be to assume that the machine will be equally productive in each of its three years of use, so an expense of £400 would appear in the income statement for 2021, another £400 in 2022, and £400 again in 2023. In this way, the total original cost of £1,200 will be recognised as an expense in the income statement over a period of three years.

You might be reading this and thinking: 'When a business buys a machine, how on earth would it know, in advance, how long it will be used for? It might end up lasting 2, 5 or 10 years!' The answer is that you are absolutely right! Businesses cannot possibly know with certainty how long a new non-current asset will be used for. But if the business waited until the end of an asset's life to find out how long it had been used for, then it would be too late. The allocation of the cost of the asset over its useful life *has* to start in the year it is first used, so the expected useful life *must* be estimated in advance.

Activity 21.1

In addition to the accrual basis, can you think of any other accounting concepts that are particularly relevant to accounting for depreciation?

21.3 The useful life and the actual life of a non-current asset

With enough servicing, repairs and maintenance, most non-current assets may have an actual life of many years before they are finally dismantled, destroyed or demolished. For example, many vans will physically exist for 10–15 years before they are finally crushed in a scrapyard.

However, most businesses will not keep non-current assets for the duration of their entire, actual lives. This is because, for example, machines will suffer wear and tear, and become prone to breaking down; IT equipment is likely to become slow and inefficient relative to newer versions of the technology; and so on.

Most businesses will, therefore, expect their assets to be effective in helping generate income for a shorter period than the duration of that asset's physical existence. For example, most businesses will typically expect to use a delivery van for 4–5 years, even though it might have a physical existence of 10–15 years.

Depreciation is a method of spreading the cost of a non-current asset over the number of years it is expected to be used productively by the business, not over the number of years it will physically exist.

Activity 21.2

One particular type of tangible non-current asset usually has an unlimited useful life so is not normally depreciated. Can you think which one?

21.4 The estimated residual value of non-current assets

In Section 21.2, you saw the example of a machine that originally cost £1,200 and was expected to be used for three years. The total expense of using the machine could be said to be £400 in the first year, £400 in the second and £400 in the third.

However, suppose the business also expected that the machine could be sold for £200 at the end of the third year. This is what is known as its **residual value**: the estimated amount that the asset can be sold for at the end of its useful life. In this case, the *net cost* of using this machine over its life is only £1,000: i.e. the original purchase price of £1,200 minus the £200 that the business expects to get back after three years.

This £1,000 is known as the **depreciable amount**, and it represents the total amount that must be spread over the asset's useful life. The simplest method would be to spread it evenly, in which case the depreciation expense of using the machine would be £333.33 in each of the three years of its life.

Note that the estimated residual value will sometimes be described as the estimated sale, disposal, scrap, or salvage value.

Activity 21.3

A business buys a new piece of equipment priced at £2,500 and pays an additional £130 to have it delivered. The business estimates that the equipment will be used for five years after which it should have a residual value of £400. What is the total amount to be depreciated?

Because the estimated residual value will often be an insignificant ('immaterial') amount, many businesses just assume that their non-current assets will have residual values of zero. **If a textbook or exam question tells you an estimated residual value, then you must use it in your answer. But if a question does not refer to a residual value, then you should simply assume that it is zero!**

21.5 The dual effect of depreciation

Early on in this book, you saw that all transactions have two effects and that this enables the accounting equation to remain in balance. Depreciation is no exception. Depreciation has two effects: one on the income statement, and one on the balance sheet.

Suppose a business buys a machine for £10,000 and expects to use it for five years after which it will have no residual value. The simplest approach would be to spread the original cost evenly over five years, so that $\frac{1}{5}$ of the machine's original cost will be used up in the first year. The **depreciation expense** in the income statement for year 1 would, therefore, be £2,000, and this is one of the two effects.

The other effect is that £2,000 of the machine's original cost is said to have been 'used up' or 'consumed' in year 1, so the machine will be shown in the balance sheet at the end of year 1 at £8,000 (i.e. £10,000 original cost minus £2,000 consumed). This figure of £8,000 is known as the machine's **carrying amount** (i.e. the amount at which it will be shown (or 'carried') in the balance sheet).

In year 2, the income statement will include another depreciation expense of £2,000 because another $\frac{1}{5}$ of the machine's original cost will be used up during year 2. At the end of year 2, the machine will be shown in the balance sheet at a carrying amount of £6,000, which is the original cost of £10,000 minus the £2,000 that was used up in year 1 and the £2,000 that was used up in year 2.

This £4,000 (£2,000 + £2,000) is known as the **accumulated depreciation** on the asset; it is the total amount of the asset's original cost that is said to have been used up so far.

Note that there are different terms for the carrying amount of a non-current asset. Different businesses use terms such as *carrying value*, *net book value*, *written down value* and *net book amount*. All these names mean exactly the same thing. IAS 16 *Property, Plant and Equipment* uses the term **carrying amount**, so this is the one that we will mostly adopt in this book.

Activity 21.4

Even though the terms refer to exactly the same thing, why do you think that international accounting standards prefer the term *carrying amount* rather than *net book value* or *carrying value*?

Finally, be clear that the carrying amount of a non-current asset does **not** seek to represent the current market value of the machine. The market value of any particular non-current asset is indeed likely to change over time, and it can go up or down. But depreciation purely seeks to allocate the asset's original cost (minus any residual value) over its useful life in a systematic fashion, with no reference whatsoever to market value. Any similarity between a particular non-current asset's carrying amount and its current market value is just a coincidence!

21.6 The two main methods of calculating depreciation

In all our examples so far, we have simply spread the original cost of the non-current asset evenly over its estimated useful life. However, there are actually a few different ways of doing it. IAS 16 does not specify which depreciation method should be used. But the two most common methods by far are:

- 1 **The straight-line method**
- 2 **The reducing balance method**

We will look at each of these in the next two sections.

21.7 The straight-line method of depreciation

Under the straight-line method, the cost of the asset (minus any residual value) is simply divided by its estimated useful life (in years) to arrive at the depreciation expense per year. An equal portion

of the asset's original cost is, therefore, deemed to be used up each year, and so its carrying amount in the balance sheet will fall by the same amount each year (i.e. in a straight line). Exhibit 21.1 gives an example of the straight-line method.

Exhibit 21.1 The straight-line method of depreciation

Suppose a business buys a van for £22,000 and expects to use it for four years, after which it will be sold for £2,000. Using the straight-line method, the depreciation expense each year will be:

$$\frac{\text{Cost } £22,000 - \text{estimated residual value } £2,000}{\text{Number of expected years of use}} = \frac{£20,000}{4}$$

= £5,000 depreciation expense in the income statement each year for four years

In the balance sheet as at the end of each of the four years, the asset will be shown at its carrying amount:

Extracts from the balance sheet:

	<i>At end of year 1</i>	<i>At end of year 2</i>	<i>At end of year 3</i>	<i>At end of year 4</i>
	£	£	£	£
Cost	22,000	22,000	22,000	22,000
Less Accumulated depreciation	(5,000)	(10,000)	(15,000)	(20,000)
Carrying amount	<u>17,000</u>	<u>12,000</u>	<u>7,000</u>	<u>2,000</u>

Activity 21.5

A business buys a car for £20,000 which it expects to use for five years, after which it can probably be sold for £5,000. Using the straight-line method of depreciation, what will be the car's carrying amount after exactly three years of use?

As mentioned earlier, the residual value of many assets will be insignificant and will therefore be assumed to be zero. If so, the depreciation charge under the straight-line method will simply be equal to the asset's original cost divided by its estimated useful life. In this situation, the annual depreciation expense under the straight-line method can be expressed as a percentage of the cost of the asset:

- A useful life of 4 years would equate to 25% straight line.
- A useful life of 5 years would imply 20% straight line.
- A useful life of 25 years would be 4% straight line, and so on.

If a textbook or exam question gives you a straight-line percentage rate, this simply implies that the business is assuming residual values of zero.

21.8 The reducing balance method of depreciation

This is the main alternative to the straight-line approach. **Under the reducing balance method, the depreciation expense for the first year of use is calculated by multiplying the original cost of the asset by a certain percentage. In the second and later years, the depreciation charge is calculated by multiplying the same percentage by the carrying amount of the asset as at the start of that year.**

Exhibit 21.2 illustrates the reducing balance method.

Exhibit 21.2 The reducing balance method of depreciation

Suppose a machine is bought for £10,000 and depreciation is to be charged at 20% per year on a reducing balance basis:

	£
Original cost	10,000
Depreciation expense in the 1st year at 20% of cost	(2,000)
Carrying amount at the end of the first year	8,000
Depreciation expense in the 2nd year at 20% of £8,000 carrying amount	(1,600)
Carrying amount at the end of the second year	6,400
Depreciation expense in the 3rd year at 20% of £6,400 carrying amount	(1,280)
Carrying amount at the end of the third year	<u>5,120</u>

The asset will continue to be depreciated in the manner shown above until it is scrapped or sold.

In Exhibit 21.2, notice that the annual depreciation expense is higher in the early years (£2,000 in the first year) than the later years (£1,280 in the third year). In other words, the reducing balance method essentially assumes that the benefits obtained from using the asset are greatest in the early years and decline over time.

If this pattern of expected benefits is indeed likely to apply to a particular asset, the *accrual basis* of accounting would indicate the reducing balance method would be more appropriate: if an asset is likely to generate greater revenues in its early years, then a greater chunk of its cost should be matched against those higher benefits in those early years.

Textbook and exam questions involving the reducing balance method will always tell you what percentage is to be applied.

Activity 21.6

A business buys a piece of equipment for £100,000 and depreciates it at 10% per year using the reducing balance method. What is the depreciation expense in the third year of use?

21.9 Which method should be used? Straight line or reducing balance?

In textbooks and exams, the answer is simple: questions will just tell you which method to use! But in the real world, businesses should choose whichever method they believe best reflects the pattern of benefits that they expect to gain from the assets in question.

For example, if a business invests in new technology, it may initially gain an advantage over rival businesses and, therefore, get more benefit from the asset in its early years of use. Machinery might also be more efficient when it is new and become slower and more prone to breaking down in later years. Again, a business might expect to gain more benefit from such a machine in the early years. In these examples, the reducing balance method would probably be more appropriate.

However, the straight-line method is by far the most commonly used in the real world. One reason might be that depreciation figures are based on a huge amount of guesswork. How long will the asset be used for? What will it be worth at the end of its useful life? The guesswork inherent in depreciation calculations weakens any arguments that the reducing balance method is somehow

‘more accurate’. The straight-line method is certainly simpler and (given all the uncertainty) simplicity is a big advantage.

In practice, businesses will usually adopt a policy of depreciating each different category (or ‘class’) of non-current asset in a particular way. For example, a business might decide to depreciate all its buildings over 50 years on a straight-line basis, its vehicles over 5 years on a straight-line basis, and its machinery at 30% per year on a reducing balance basis. Textbooks and exams will tell you the depreciation policies of the business in question.

Activity 21.7

Before calculating the depreciation charges on its non-current assets for the year ended 30 April 2024, a business has the following figures in its trial balance:

Buildings at cost	£450,000	
Buildings: accumulated depreciation at 1 May 2023		£117,000
Equipment at cost	£330,000	
Equipment: accumulated depreciation at 1 May 2023		£190,000

The business’s policy is to charge depreciation on buildings at 2% per year using the straight-line method, and at 30% per year on equipment using the reducing balance approach. What is the total depreciation expense for the year ended 30 April 2024?

Finally, note that once a business has decided which depreciation method to use then the same method should be used from one year to the next unless there is a very good reason to change. This is an example of the *consistency* concept that we discussed in Chapter 10. If businesses constantly switched from one method to another, then it would make it harder to compare the real performance of the business over time.

21.10 Two other, less common depreciation methods

The straight-line and reducing balance methods are by far the most common, both in exams and in the real world. Various other methods do exist but are relatively rare. We will briefly consider two alternative methods in this section:

- the **units of production method**
- the **sum of the years’ digits method**.

The units of production method

Under this method, the annual depreciation expense on a non-current asset varies from one period to the next depending on how much that asset is actually used.

Just like the straight-line method, the depreciable amount of the asset (i.e. original cost minus estimated residual value) must first be calculated. But, in addition, the estimated number of units of usage or output from the asset over its expected useful life must also be forecast.

The nature of ‘the units of usage or output’ will depend on the type of asset. For example, for an aircraft it could be the number of miles or kilometres that the plane is expected to fly over its useful life; for a goldmine it might be the number of grams of gold expected to be extracted; for an oil refinery it could be the number of barrels of crude oil to be processed.

The depreciable amount is then divided by the expected total usage to arrive at the depreciation expense per unit of production. This rate per unit can then be multiplied by the actual usage in

any particular year to calculate the depreciation expense for that year. A worked example of this is given in Exhibit 21.3.

Exhibit 21.3 The units of production method of depreciation

A machine is purchased for £66,000 and has an expected useful life and residual value of 10 years and £6,000, respectively. The machine is expected to produce 20,000 widgets over the course of its 10-year life.

1,300 widgets were actually produced by the machine in its first year of use, 3,200 widgets in the second year and 2,100 in the third.

Calculate the depreciation expense in each of the first three years of use, and the carrying amount of the machine at the end of each of the three years.

Solution:

Depreciable amount = £66,000 – £6,000 = £60,000

Depreciation per unit of production = £60,000/20,000 widgets = £3 per widget

		Annual depreciation expense £	Accumulated depreciation at end of year £	Carrying amount as at end of year £
Year 1	1,300 actual widgets × £3 =	3,900	3,900	62,100
Year 2	3,200 actual widgets × £3 =	9,600	13,500	52,500
Year 3	2,100 actual widgets × £3 =	6,300	19,800	46,200

The units of production method is often said to be the ‘most accurate’ depreciation system, because the depreciation expense varies in direct proportion to the usage or output from the asset, which is likely to be a good measure of the benefit obtained from it. However, the calculations require more time and attention, so it is generally only used for very expensive assets (such as an aircraft or a goldmine).

Activity 21.8

A business buys an aircraft for £800,000 which it expects to use for five years after which its estimated residual value is £50,000. The business expects to fly the aircraft for a total of 300,000 miles over its five-year life. If the plane actually travels a total of 70,000 miles in its first year of use, what is the depreciation expense in Year 1 under the units of production method?

The sum of the years' digits method

Like the reducing balance method, this approach ensures that the depreciation expense is higher in the early years of use. The sum of the years' digits method is best explained with an example, such as in Exhibit 21.4.

Exhibit 21.4 The sum of the years' digits method of depreciation

Suppose a machine is purchased for £3,000 and is expected to last for five years, with no residual value. In other words, you could say that the machine is expected to be used in years 1, 2, 3, 4 and 5. The sum of these digits is $1 + 2 + 3 + 4 + 5 = 15$.

Under this method, the depreciation expense would then be calculated as 5/15ths of the cost in year 1, 4/15ths in year 2, and so on:

	£
Depreciation expense in the 1st year of use ($5/15\text{ths} \times £3,000$)	1,000
Depreciation expense in the 2nd year of use ($4/15\text{ths} \times £3,000$)	800
Depreciation expense in the 3rd year of use ($3/15\text{ths} \times £3,000$)	600
Depreciation expense in the 4th year of use ($2/15\text{ths} \times £3,000$)	400
Depreciation expense in the 5th year of use ($1/15\text{th} \times £3,000$)	200
Total depreciation charged over all five years	<u>3,000</u>

Activity 21.9

A piece of equipment is purchased for £12,000 and its expected useful life is three years, with no residual value. Under the sum of the years' digits method, what is the depreciation expense in the first year of the asset's life?

The units of production and sum of the years' digits methods are rarely used by UK businesses. You don't tend to come across them very often in textbook and exam questions either. For the remaining sections of this chapter, we will therefore only use the straight-line and reducing balance approaches.

21.11 Depreciation on assets bought or sold part way through a year

So far, we have only calculated the depreciation expense for whole years of use. In reality, of course, most assets are likely to be bought at some point part way through the business's financial year. They will therefore be used for less than 12 months in the year in which they are bought. In this situation, businesses can choose one of the following two approaches:

- 1 Calculate depreciation 'pro rata' based on the number of months that the asset was in use during the financial year. For example, if a machine is bought on 1 July 2024, then the depreciation expense for the financial year ended 31 December 2024 will be 6/12 of the full annual charge; or
- 2 Charge a full year's depreciation in the year of purchase but none in the year of disposal. This policy can also be described as simply calculating a full year of depreciation on all assets in use as at the end of the year.

In the past, the second option tended to be more popular in the real world just because it made the calculations simpler. These days, computerised accounting software handles monthly depreciation calculations with ease, so the first method is now more common in practice.

Textbook and exam questions will usually tell you which of the two methods to use so you can simply follow the guidance in the question. On the rare occasions that the question doesn't tell you which method to use:

- If the exact dates that the assets are bought and sold are given in the question, then the inclusion of this information implies that you should use the first method ('monthly depreciation').

To avoid confusion, the dates of purchase and sale given will nearly always be the first or last day of a month.

- If no exact dates of purchase and sale are given, then their absence implies that you should use the second method ('a full year's charge in the year of purchase and none in the year of disposal').

Activity 21.10

A business buys Machine A for £24,000 on 1 November 2024 and Machine B for £19,200 on 1 February 2025. The business's policy is to charge depreciation on machinery at a rate of 25% straight line per year. What will be the total depreciation expense for this business's financial year ended 31 May 2025 if it:

- records a full year's charge in the year of acquisition and none in the year of disposal; or
- calculates depreciation on a monthly basis?

21.12 Recording depreciation in the ledger accounts

Whichever method is used to calculate the depreciation charge on an asset, it will always have two effects in the financial statements and both must be recorded:

Debit Depreciation expense	£x
Credit Accumulated depreciation	£x

The depreciation expense must be recorded because the income statement for the year must reflect the portion of the original cost of the asset that is deemed to have been 'used up' or 'consumed' this year. From your knowledge of bookkeeping, you know that expenses are recorded with debit entries.

The entry to accumulated depreciation must also be made because the cumulative total of the asset's cost that has been 'used up' so far must be offset against the original cost of that asset in the balance sheet. With each year that passes, the cumulative amount of depreciation charged on an asset builds up, meaning that the carrying amount of the asset in the balance sheet decreases each year. From your knowledge of bookkeeping, you know that a decrease in an asset is recorded with a credit entry.

Exhibit 21.5 shows an example of how these entries are made.

Exhibit 21.5 Recording depreciation entries in the ledger accounts

A business has a financial year end of 31 December. It buys a vehicle for £10,000 on 1 January 2021, paying immediately by bank transfer. The vehicle is to be depreciated at 20% per year using the straight-line method, and the business does not own any other vehicles. Show:

- the relevant accounts for the first three years of use; and
- extracts from the income statements and balance sheets for the first three years.

Solution:

Motor vehicles at cost					
2021		£	2021		£
1 Jan	Cash at bank	<u>10,000</u>	31 Dec	Balance c/d	<u>10,000</u>



**Motor vehicles at cost**

2022		£	2022		£
1 Jan	Balance b/d	<u>10,000</u>	31 Dec	Balance c/d	<u>10,000</u>
2023		£	2023		£
1 Jan	Balance b/d	<u>10,000</u>	31 Dec	Balance c/d	<u>10,000</u>

Depreciation expense

2021		£	2021		£
31 Dec	Accumulated depreciation	<u>2,000</u>	31 Dec	Profit and loss	<u>2,000</u>
2022		£	2022		£
31 Dec	Accumulated depreciation	<u>2,000</u>	31 Dec	Profit and loss	<u>2,000</u>
2023		£	2023		£
31 Dec	Accumulated depreciation	<u>2,000</u>	31 Dec	Profit and loss	<u>2,000</u>

Accumulated depreciation on motor vehicles

2021		£	2021		£
31 Dec	Balance c/d	<u>2,000</u>	31 Dec	Depreciation expense	<u>2,000</u>
2022		£	2022		£
31 Dec	Balance c/d	<u>4,000</u>	1 Jan	Balance b/d	2,000
		<u>4,000</u>	31 Dec	Depreciation expense	<u>2,000</u>
2023		£			<u>4,000</u>
31 Dec	Balance c/d	<u>6,000</u>	2023		£
		<u>6,000</u>	1 Jan	Balance b/d	4,000
			31 Dec	Depreciation expense	<u>2,000</u>
					<u>6,000</u>

Extracts from the income statements for the years ending 31 December:

		£
2021	Depreciation expense	2,000
2022	Depreciation expense	2,000
2023	Depreciation expense	2,000

Extracts from the balance sheets as at 31 December

	2021	2022	2023
	£	£	£
Motor vehicles at cost	10,000	10,000	10,000
Less Accumulated depreciation	(2,000)	(4,000)	(6,000)
Carrying amount	<u>8,000</u>	<u>6,000</u>	<u>4,000</u>

**Activity
21.11**

A business buys its first and only non-current asset for £39,500 on the first day of Year 1. The estimated useful life and residual value of the asset are five years and £8,000, respectively, and the straight-line method of depreciation is to be used. What is the journal entry for the depreciation charge for Year 3? What will be the final balance on the accumulated depreciation account as at the end of Year 3?

21.13 An alternative approach to making the double entries for depreciation

As we have seen, the double entry for the depreciation charge for the year is as follows:

Debit Depreciation expense	£x	
Credit Accumulated depreciation		£x

In Chapter 7, you learnt that the balances on income and expense accounts are transferred to the *profit and loss* ledger account at the end of the year. Since the balance on the depreciation expense account will end up in the profit and loss ledger account, some textbooks and examiners simply debit the *profit and loss* ledger account directly rather than using a separate *depreciation expense* ledger account.

This alternative approach is perfectly correct, and it is possible that your teacher or lecturer may prefer to do it this way. When accounts were kept manually, there was an advantage to this approach because it is quicker to debit the profit and loss account directly rather than first using a depreciation expense account.

However, most businesses now keep their books using accounting software, and it would be very unusual to debit the profit and loss ledger account directly with a particular item of expense. For clarity and transparency, it is normal to post each expense to the appropriate expense account in the software. Since the software will automatically make the transfers to the profit and loss ledger account at the end of the period, there is no difference in the time or effort required.

In any case, the impact of both approaches will ultimately be exactly the same in the income statement and balance sheet.

21.14 Calculating the profit or loss on the disposal of non-current assets

As you've seen, non-current assets are shown on the business's balance sheet at their carrying amount, which is equal to their original cost minus the accumulated depreciation that has been charged on those assets so far.

Occasionally, a business will sell one of its old non-current assets. As we've explained, depreciation is simply a method of allocating the original cost of an asset as an expense over the course of its useful life. Depreciation calculations do not in any way attempt to estimate the current market value of an asset. So, when a business sells one of its old non-current assets, it is almost certain that it will be sold for a price that is different from its carrying amount.

When a non-current asset is sold, a profit or loss will therefore arise which can be calculated as follows:

Amount received on disposal (the 'sale' or 'disposal' proceeds)	£
Less Carrying amount of the asset on the date of disposal	X
Profit/(loss) on disposal	(X)
	<u>X/(X)</u>

- If the disposal proceeds are greater than the carrying amount, then a profit arises. This will be shown as an item of 'other income' (immediately after gross profit) in the income statement.
- If the disposal proceeds are less than the carrying amount, then a loss arises. The loss will be included as one of the expenses that are listed after gross profit in the income statement.

Exhibit 21.6 gives a worked example of the disposal of a non-current asset.

Exhibit 21.6 Calculating the profit or loss on disposal of a non-current asset

On 1 January 2021, a business buys a machine for £19,000. It has an expected useful life of five years and an estimated residual value of £4,000. The business uses the straight-line method of depreciation. On 1 January 2024, the machine is sold for £12,000. Calculate the profit or loss on disposal.

Solution:

$$\text{Annual depreciation expense} = \frac{(\text{£}19,000 - \text{£}4,000)}{5 \text{ years}} = \text{£}3,000 \text{ per year}$$

Exactly three years have passed since the machine was purchased. Therefore, the carrying amount of the machine as at the date of disposal is:

	£
Original cost	19,000
Less Accumulated depreciation (3 years × £3,000 per year)	(9,000)
Carrying amount	<u>10,000</u>

We can therefore calculate the profit or loss on disposal:

	£
Disposal proceeds	12,000
Less Carrying amount of the asset on the date of disposal (from above)	(10,000)
Profit on disposal	<u>2,000</u>

Activity 21.12

A business buys a machine for £30,000 and depreciates it at 20% per year straight line. After exactly two years, the machine is sold for £17,000. What is the profit or loss on disposal?

21.15 Accounting for the disposal of non-current assets

The accounting entries for the disposal of a non-current asset can be quite daunting for anyone new to the subject. As you've already seen, the profit or loss on disposal will be the difference between the sale proceeds and the carrying amount of the asset as at the date of disposal. In the ledger accounts, this profit or loss will be calculated in a disposals account.

Following the sale of a non-current asset, three sets of entries must be made. Suppose a machine has been sold:

(A) The disposal takes place and the sale proceeds are received:

Debit Cash at bank	£x	
Credit Disposals		£x

- (B) The machine has been sold so must be removed from the business's books. The original cost of the machine is, therefore, transferred to the *disposals* account:

Debit Disposals	£x	
Credit Machinery at cost		£x

- (C) Having been sold, the accumulated depreciation on the machine must also be removed from the business's books. The accumulated depreciation on the machine as at the date of disposal is, therefore, also transferred to the *disposals* account:

Debit Accumulated depreciation on machinery	£x	
Credit Disposals		£x

The balance that results on the disposals account represents the profit or loss on the disposal which will be transferred to the profit and loss ledger account and will ultimately appear in the income statement:

- If the balance is entered on the debit side of the disposals account, then logically it must be credited to profit and loss. From your knowledge of double entry bookkeeping, you know that a credit to profit and loss represents a gain.
- If the balance is entered on the credit side of the disposals account, then logically it must be debited to profit and loss. From your knowledge of double entry bookkeeping, you know that a debit to profit and loss represents a loss.

To double check the correctness of the profit or loss on disposal calculated on the disposals account, it is usually a good idea to also calculate it using the method we used in the previous section of this chapter.

The double entries for the disposal of a non-current asset are illustrated in Exhibit 21.7. The three sets of entries outlined above ((A), (B) and (C)) are indicated in the accounts in the Exhibit.

Exhibit 21.7 Recording the disposal of a non-current asset in the ledger accounts

On 1 January 2024, a business owns various pieces of equipment that originally cost a total of £90,000. The depreciation policy is 10% per year on a straight-line basis. The total accumulated depreciation on this equipment on the same date is £50,000. On 2 January 2024, the business sells a piece of equipment for £11,000 which had originally been purchased on 1 January 2018 for £20,000. There were no other acquisitions or disposals of equipment during 2024.

Prepare the ledger accounts for the cost and accumulated depreciation of equipment, as well as the disposals account, balancing them off at the end of 2024.

Solution:

Equipment at cost					
2024		£	2024		£
1 Jan	Balance b/d	90,000	2 Jan	Disposals (B)	20,000
			31 Dec	Balance c/d	70,000
		<u>90,000</u>			<u>90,000</u>
Accumulated depreciation on equipment					
2024		£	2024		£
2 Jan	Disposals (C)	12,000 ¹	1 Jan	Balance b/d	50,000
31 Dec	Balance c/d	45,000	31 Dec	Depreciation expense	7,000 ²
		<u>57,000</u>			<u>57,000</u>





Disposals

2024				£	2024				£
2 Jan	Equipment at cost	(B)	20,000		2 Jan	Cash at bank	(A)	11,000	
31 Dec	Profit and loss (<i>gain</i>)		<u>3,000</u>		2 Jan	Acc dep on equipment	(C)	<u>12,000</u>	
			<u>23,000</u>					<u>23,000</u>	

¹The machine had been owned for exactly six years, so the accumulated depreciation on it at the date of disposal is $\text{£}20,000 \times 10\% \times 6 \text{ years} = \text{£}12,000$.

²The annual depreciation charge for 2024 is $\text{£}70,000 \times 10\% \text{ straight line} = \text{£}7,000$.

We can double check that the profit on disposal is indeed $\text{£}3,000$ by calculating it without using ledger accounts:

	£
Sale proceeds	11,000
Less Carrying amount of asset at date of disposal ($\text{£}20,000 - (6 \text{ yrs} \times \text{£}20,000 \times 10\%)$)	<u>(8,000)</u>
Profit on disposal	<u>3,000</u>

Instead of being sold, sometimes an asset might be damaged in an accident and cannot be repaired. If the asset was insured, then the 'disposal proceeds' will be equal to the pay-out from the insurance company.

Alternatively, another asset might be so old that it has no sale or scrap value and it is simply thrown away or destroyed. If there are no disposal proceeds, then the loss on disposal of such an asset will simply be equal to its carrying amount.

Finally, an old asset might be disposed of by trading it in for a new one. We'll look at this in the next section.

21.16 Disposing of a non-current asset by part-exchange

As you probably know, it is sometimes possible to trade in your old phone in exchange for a discount on a new one. Businesses often do the same. They might trade in (or 'part exchange') an old machine or vehicle when they buy a new one. The old asset is being disposed of by part-exchange, and the disposal proceeds in this situation are equal to the trade-in value.

For example, suppose a new van priced at $\text{£}16,000$ is bought by paying $\text{£}12,000$ cash plus the trade-in of an old van. If so, the effective 'disposal proceeds' for the old van would be the trade-in value of $\text{£}4,000$ ($\text{£}16,000 - \text{£}12,000$). The profit or loss on disposal can then be calculated in the normal way.

Exhibit 21.8 illustrates how a disposal by part-exchange is accounted for.

Exhibit 21.8 Disposing of a non-current asset by part-exchange

Vehicle A was purchased for $\text{£}25,000$ on 1 January 2021 and was depreciated at 20% per year straight line. On 1 January 2024, it is part exchanged for a new car, Vehicle B. The list price of Vehicle B is $\text{£}40,000$, and it is paid for with a bank transfer of $\text{£}32,000$ plus the trade-in of Vehicle A.

- What was the profit or loss on the disposal of Vehicle A?
- Record this disposal in the form of journal entries.
- Show the entries in the *disposals* account.

Solution:

(i)

	£
Disposal proceeds/trade-in value (£40,000 normal price – £32,000 paid)	8,000
Less Carrying amount of Vehicle A on date of disposal	
(£25,000 cost – (£25,000 × 20% × 3 years) accumulated depreciation)	(10,000)
Loss on disposal	<u>(2,000)</u>

(ii) The journal entries for the transaction:

Debit Vehicles at cost	£40,000	
Credit Cash at bank		£32,000
Credit Disposals		£8,000

which is the purchase of Vehicle B costing £40,000, paid for by bank transfer plus trade-in of Vehicle A

Debit Disposals	£25,000	
Credit Vehicles at cost		£25,000

which is the removal of the cost of Vehicle A from the ledger accounts following its disposal by part-exchange

Debit Accumulated depreciation on vehicles	£15,000	
Credit Disposals		£15,000

which is the removal of the accumulated depreciation on Vehicle A from the ledger accounts following its disposal by part-exchange

(iii)

Disposals					
2024		£	2024		£
1 Jan	Vehicles at cost	25,000	1 Jan	Part-exchange value	8,000
			1 Jan	Acc dep on vehicles	15,000
			31 Dec	Profit and loss (loss)	2,000
		<u>25,000</u>			<u>25,000</u>

**Activity
21.13**

A business bought Machine Y on 1 January 2018 for £20,000. The business depreciates machinery at 10% straight line. On 1 January 2025, it traded in Machine Y for a brand-new Machine Z priced at £30,000. The business gave the dealer the old Machine Y plus a cheque for £23,000 in full settlement. What was the profit or loss on disposal of Machine Y?

21.17 Changing the method of depreciation

IAS 16 states that the depreciation methods chosen by the business should be reviewed every year. If there has been a significant change in the expected pattern of benefits expected from an asset, then it may become appropriate to change to a different method. **If so, the carrying amount of the asset as at the date of the change will, going forward, be depreciated in accordance with the new method. The depreciation already charged so far under the old method will remain unaffected.**

Exhibit 21.9 provides an example of a change in depreciation method.

Exhibit 21.9 A change in depreciation method

A business bought a machine for £160,000 on 1 January 2021. Depreciation was initially charged using the straight-line method based on an estimated useful life of eight years and no residual value.

The business reviews its depreciation methods annually and decides that, from 1 January 2024, the reducing balance method at 40% would be more appropriate.

For each of the years ended 31 December 2021 to 2026, show the depreciation expense on this machine, and state the accumulated depreciation and carrying amount of the machine as at the end of each year.

Solution:

Year ended 31 Dec		Annual depreciation expense £	Accumulated depreciation at end of year £	Carrying amount as at end of year £
2021	$£160,000/8 \text{ years} =$	20,000	20,000	140,000
2022	$£160,000/8 \text{ years} =$	20,000	40,000	120,000
2023	$£160,000/8 \text{ years} =$	20,000	60,000	100,000
2024	$£100,000 \text{ carrying amount} \times 40\%$	40,000	100,000	60,000
2025	$£60,000 \text{ carrying amount} \times 40\%$	24,000	124,000	36,000
2026	$£36,000 \text{ carrying amount} \times 40\%$	14,400	138,400	21,600

If the depreciation method is changed, then the reason for the change as well as the effect on the annual depreciation expense must be given in a note to the financial statements.

Activity 21.14

A business purchased new machinery on 1 September 2021 for £96,000 and charged depreciation at 30% reducing balance. On 1 September 2024, the business decided that the straight-line method at 25% would be a better reflection of the pattern of benefits expected from its machinery. What is the depreciation expense for each of the business's financial years ended 31 August 2025 and 2026?

21.18 Changes to the expected useful life and/or estimated residual value of an asset

IAS 16 also states that both the estimated useful life and residual value of assets should be reviewed every year and amended if expectations have changed. Again, the carrying amount as at the date of the change will simply be depreciated in accordance with the new estimates. The depreciation already charged prior to the change will not be affected.

Exhibit 21.10 gives a worked example of a change in expected useful life.

Exhibit 21.10 A change in the estimated useful life of a non-current asset

A business that uses the straight-line method of depreciation buys a piece of equipment for £21,000. It initially estimates that the equipment has a useful life of seven years with no residual value. After exactly three years, the business decides that the equipment is likely to give a further six years of use from that date, with no residual value.

For the first five years of use, show the depreciation expense on this equipment, and state the accumulated depreciation and carrying amount of the equipment as at the end of each year.

Solution:

	Annual depreciation expense £	Accumulated depreciation at end of year £	Carrying amount as at end of year £
Year 1 £21,000/7 years =	3,000	3,000	18,000
Year 2 £21,000/7 years =	3,000	6,000	15,000
Year 3 £21,000/7 years =	3,000	9,000	12,000
Year 4 £12,000/6 years =	2,000	11,000	10,000
Year 5 £12,000/6 years =	2,000	13,000	8,000

Exhibit 21.11 shows the impact of a change in estimated residual value. Once again, the carrying amount as at the date of the change is depreciated in accordance with the revised expectations.

Exhibit 21.11 A change in the estimated residual value of a non-current asset

A business buys a machine for £27,000 and estimates that it will have a useful life of five years and a residual value of £7,000, and that the straight-line method of depreciation is appropriate. At the start of the third year, a review determines that the estimated useful life is unchanged and that the straight-line method is still the most appropriate. However, the expected residual value has fallen to £1,000.

For the first five years of use, show the depreciation expense on this machine, and state the accumulated depreciation and carrying amount of the machine as at the end of each year.





Solution:

		Annual depreciation expense £	Accumulated depreciation at end of year £	Carrying amount as at end of year £
Year 1	$(£27,000 - £7,000)/5 \text{ years} =$	4,000	4,000	23,000
Year 2	$(£27,000 - £7,000)/5 \text{ years} =$	4,000	8,000	19,000
Year 3	$(£19,000 - £1,000)/3 \text{ years} =$	6,000	14,000	13,000
Year 4	$(£19,000 - £1,000)/3 \text{ years} =$	6,000	20,000	7,000
Year 5	$(£19,000 - £1,000)/3 \text{ years} =$	6,000	26,000	1,000

**Activity
21.15**

A business buys a machine for £78,000 on the first day of Year 1 and initially estimates its useful life and residual value to be six years and £18,000, respectively. The business uses the straight-line method of depreciation. On the first day of Year 4, it determines that the machine has a remaining life of five years from that date, and a residual value of £6,000. What is the carrying amount of the machine as at the end of Year 4?

21.19 'Impairment losses': falls in the value of an asset below its carrying amount

Sometimes it becomes apparent that the value of one of a business's non-current assets has fallen significantly below its carrying amount.

For example, suppose that a business is forced to stop producing one of its products because of changes in product safety laws. The value to the business of specialist machinery that it had previously used to make the banned product will probably fall dramatically.

If the value to the business of one of its non-current assets falls significantly below its carrying amount, then the asset is said to be **impaired**, and it has suffered an **impairment loss**. In accordance with IAS 36 *Impairment of Assets*, this loss needs to be recognised as an expense in the income statement.

The detailed requirements of IAS 36 are beyond the scope of this book, but the basic idea is fairly straightforward and can be illustrated with a worked example such as in Exhibit 21.12.

Exhibit 21.12 Accounting for an impairment loss on a non-current asset

A business has a financial year end of 31 December. It purchased a building on 1 January 2022 for £200,000. The business uses the straight-line method of depreciation, and a useful life of 25 years and residual value of zero were initially estimated.

At the end of December 2027, the business determines that the building is now only worth £95,000 because a severe recession has had a major impact, both on property prices and on the business's ability to generate profits. There is no change to the estimated useful life or residual value. Calculate:

- The carrying amount of the building as at 31 December 2027 before accounting for the impairment loss.
- The total charge in the income statement for the year ended 31 December 2027 in relation to this building.

- (iii) The depreciation expense on the building for each of the years ended 31 December 2028 and 2029.

Solution:

- (i) The annual depreciation charge for the years ended 31 December 2022, 23, 24, 25, 26 and 27 will be $\text{£}200,000/25 \text{ years} = \text{£}8,000$ per year.

The carrying amount of the building at 31 December 2027 before taking account of the impairment loss will therefore be $\text{£}152,000$ ($\text{£}200,000$ cost – (6 years \times $\text{£}8,000$) accumulated depreciation).

- (ii) The impairment loss to be recognised in the income statement for the year ended 31 December 2027 will be $\text{£}57,000$, calculated below:

	£
Carrying amount at 31 December 2027 before impairment loss ((i) above)	152,000
Value to the business assessed on 31 December 2027	<u>95,000</u>
Impairment loss	<u>57,000</u>

The total charge in the income statement for the year ending 31 December 2027 is therefore $\text{£}65,000$ (i.e. $\text{£}8,000$ depreciation expense from (i) above + $\text{£}57,000$ impairment loss).

- (iii) The depreciation charge for the years ended 31 December 2028 and 2029 will be $\text{£}5,000$ in each year, being the new carrying amount of $\text{£}95,000$ divided by the remaining useful life of 19 years.

Activity 21.16

On the first day of Year 1, a business bought an item of plant for $\text{£}84,000$ and estimated its useful life to be 10 years with no residual value. The straight-line method of depreciation is in use. An impairment review, as at the end of Year 2, reveals that the value of the plant to the business is only $\text{£}50,000$. There is no change to the estimated useful life or residual value. What is the impairment loss to be recognised in the income statement of Year 2?

21.20 Increases in the value of non-current assets

As you have seen, non-current assets are initially recorded in the books at their historical cost. They are then depreciated over their estimated useful lives. Occasionally, one or two might suffer an impairment loss, as explained in the previous section.

However, the value of some of the business's non-current assets may actually *increase* significantly over time. This is especially the case with land and buildings. In many countries, property prices generally rise over time so the current value of a building that was bought 20 years ago may be much higher than its original cost.

In this situation, IAS 16 permits businesses to **choose** whether to revalue non-current assets to their current market value (also known as their 'fair value'). If a business chooses to do this, then IAS 16 explains:

- The annual depreciation expense will increase because the charge will be based on the new, revalued amount.
- If a business decides to show one of its buildings at fair value, then it must do the same with all its other buildings. In other words, all its non-current assets of the same class must be shown using the same valuation method.

- The market value of assets that have been revalued must be reassessed reasonably regularly to ensure that the fair values in the balance sheet are sufficiently up to date.

Most small, sole proprietor businesses will not tend to show their non-current assets at fair value, so we won't look at any adjustments for revaluations in this chapter.

However, sometimes *companies* do adopt the revaluation approach. We will therefore introduce the accounting entries for revaluations in Chapter 35.

21.21 The non-current asset register

As well as recording non-current assets at cost in the ledger accounts, many businesses will also keep another, separate list of their non-current assets, known as the **non-current asset register** (often known as the fixed asset register or simply the asset register).

There are various reasons for maintaining a non-current asset register, including:

- 1 The ledger accounts for non-current assets record, via a series of debit and credit entries, all the acquisitions and disposals of non-current assets that take place each year. The balances on these accounts do not provide a straightforward list of exactly what cars, computers and so on that the business owns at any time.

For example, it may own several cars, each one of which is being driven by a different employee. The ledger account for *motor vehicles at cost* will not provide a user-friendly list of all these different cars, their make and model, registration number, and who is driving them. All this information will be needed for various reasons, most obviously for insurance purposes.

- 2 The non-current asset register can be used to record the estimated useful life, residual value, and depreciation method for each asset. Nearly all businesses use computerised accounting software for their bookkeeping, so the asset register module in the software will then be able to automatically post the entries for depreciation to the ledger accounts each period.

Similarly, when an asset is sold, this can be recorded in the register and the software will automatically make the correct debits and credits to the various accounts in the nominal ledger. In other words, the use of a computerised non-current asset register makes the recording of depreciation and disposals much quicker and easier.

Activity 21.17

Can you think of any other reasons why most businesses keep a separate register of their non-current assets?

Learning outcomes

You should now have learnt:

- 1 That depreciation is a way of systematically allocating the original cost of an asset (minus its residual value) over its estimated useful life.
- 2 That the portion of an asset's original cost that is deemed to have been used up over the last 12 months is known as the *depreciation expense* for the year.
- 3 That *accumulated depreciation* in the balance sheet is the total amount of an asset's original cost that is deemed to have been used up since it was first bought, and that this figure is offset against the cost of the asset in the balance sheet.

- 4 That the cost minus the accumulated depreciation on an asset is known as its *carrying amount* (or 'net book value').
- 5 How to calculate depreciation using the straight line and reducing balance methods, as well as two other, less commonly used methods.
- 6 That the depreciation charge on an asset for the year is debited to the *depreciation expense* account and credited to the *accumulated depreciation* account.
- 7 That the depreciation charge for the year can, alternatively, be debited directly to the profit and loss ledger account instead of debiting the depreciation expense account.
- 8 That there are two possible approaches to calculating the depreciation on assets that are bought or sold part way through a financial year.
- 9 That the profit or loss on the disposal of a non-current asset is calculated by comparing the sale proceeds with the carrying amount of the asset on the date of disposal.
- 10 That when a non-current asset is sold, it must be removed from the books and the profit or loss on disposal will be calculated in a *disposals* account.
- 11 That if an asset is disposed of by trading it in for a new one (in 'part-exchange'), then the 'disposal proceeds' are equal to the trade-in value.
- 12 That following a change in the estimated useful life or residual value of an asset, or in the method of depreciation, the carrying amount of the asset as at the date of the change will be depreciated on the new basis, but the depreciation already charged before the change will be unaffected.
- 13 That if the value to the business of a non-current asset falls below its carrying amount, then this *impairment loss* must be recognised in the income statement immediately.
- 14 That, for various good reasons, most businesses also keep a separate *register* of their non-current assets.

Answers to activities

21.1 The accrual basis is the concept that is central to the way we account for depreciation, but certain others are also relevant, such as:

- (i) The *going concern* assumption: this means that, in the absence of evidence to the contrary, it is assumed that the business will continue trading for the foreseeable future. If this assumption did not apply, then it would make no sense to estimate the useful lives of non-current assets and expect to spread their original cost over several future years.
- (ii) The *historical cost* concept: Depreciation is the systematic allocation of an asset's historical cost over its estimated useful life. It in no way seeks to reflect the current market value of the asset.

For example, it would be possible for a business to search online to find the market value of its vehicles each year and calculate the fall in value that each of its cars had suffered in the last 12 months. In normal conversation, people talk about this fall in value as being a vehicle's 'depreciation'. But this is *not* what accountants mean by depreciation! Accounting depreciation is simply a way of allocating the asset's historical cost over several years, with no reference to market values.

- (iii) The *prudence* concept: this means that accountants should be somewhat cautious when making judgements that involve uncertainty. For example, if a business buys a new asset, it cannot be sure whether it will be very reliable and give 9–10 years of good service, or whether it will be prone to breaking down and only last 3–4 years. In the face of this

uncertainty, the prudence concept implies that the accountant should be somewhat pessimistic and make an estimate that is towards the lower end of the range of possible useful lives.

- 21.2** Land: land owned by the business usually has an indefinite useful life so is not normally depreciated. All other tangible non-current assets, including buildings, have limited useful lives, so are subject to depreciation.
- 21.3** The answer is £2,230. The total cost of the equipment is $£2,500 + £130 = £2,630$ (you saw in the previous chapter that the cost of a non-current asset includes any associated costs of acquisition such as delivery, assembly, installation and testing). The business estimates that it will get £400 back when it is sold after five years, so the total amount to be depreciated ('the depreciable amount') is $£2,630 - £400 = £2,230$.
- 21.4** The term *carrying amount* is preferable because it doesn't contain the word 'value'. As we have seen, depreciation is a means of spreading the original cost of an asset over its useful life, with no reference whatsoever to the current market value of the asset. Nevertheless, terms such as *net book value* are widely used and are perfectly acceptable.
- 21.5** The answer is £11,000. (Annual depreciation expense = $(£20,000 - £5,000)/5$ years = £3,000 per year; after three years of use $3 \times £3,000 = £9,000$ of depreciation will have accumulated; carrying amount after three years will, therefore, be £11,000 (cost £20,000 – accumulated depreciation £9,000).)
- 21.6** The depreciation expense in the third year will be £8,100, as calculated below:

	£
Original cost	100,000
Depreciation expense in the 1st year at 10% of £100,000 cost	(10,000)
Carrying amount at end of the 1st year	90,000
Depreciation expense in the 2nd year at 10% of £90,000 carrying amount	(9,000)
Carrying amount at end of the 2nd year	81,000
Depreciation expense in the 3rd year at 10% of £81,000 carrying amount	(8,100)

- 21.7** The answer is £51,000 ($£9,000 + £42,000$). The depreciation expense on the buildings is $£450,000 \times 2\% = £9,000$, and the charge on the equipment will be $(£330,000 - £190,000) \times 30\% = £42,000$.
- 21.8** The answer is £175,000. (Depreciable amount = $£800,000 - £50,000 = £750,000$; depreciation per mile = $£750,000/300,000 = £2.50$ per mile; so depreciation expense in year 1 will be $70,000$ actual miles $\times £2.50 = £175,000$.)
- 21.9** The answer is £6,000: the expected useful life of the asset is three years, so the 'sum of the years' digits' is $1 + 2 + 3 = 6$; the depreciation charge in the first year of use will therefore be $£12,000 \times 3/6 = £6,000$.
- 21.10** (a) £10,800. (Both machines were acquired during the financial year ended 31 May 2025 and a full year of depreciation is to be charged: $(£24,000 + £19,200) \times 25\% = £10,800$.)
- (b) £5,100. (Machine A annual depreciation = $£24,000 \times 25\% = £6,000$ per year; A was owned for 7 months of the financial year so $£6,000 \times 7/12 = £3,500$; Machine B annual depreciation = $£19,200 \times 25\% = £4,800$ per year; B was owned for 4 months of the financial year so $£4,800 \times 4/12 = £1,600$; i.e. total depreciation expense of $£3,500 + £1,600 = £5,100$.)
- 21.11** The journal entry will be Debit Depreciation expense £6,300, Credit Accumulated depreciation £6,300. The final balance on the accumulated depreciation account as at the end of Year 3 will be £18,900 credit. (This is because the annual charge = $(£39,500 - £8,000)/5 = £6,300$, and three years' worth of depreciation will have accumulated by the end of Year 3.)
- 21.12** The loss on disposal is £1,000 calculated as follows:
- Annual depreciation expense = $£30,000 \times 20\% = £6,000$ per year; so accumulated depreciation after two years = $£6,000 \times 2 = £12,000$; therefore the carrying amount after two years = $£30,000 - £12,000 = £18,000$. Hence:

	£
Sale proceeds	17,000
Less Carrying amount at date of disposal (<i>from above</i>)	(18,000)
Loss on disposal	<u>(1,000)</u>

21.13 The answer is a profit of £1,000, calculated below:

	£
Disposal proceeds (<i>i.e. trade-in value: £ 30,000 normal price – £23,000 paid</i>)	7,000
Less Carrying amount of Y on disposal date (£20,000 – (7 yrs × £20,000 × 10%))	(6,000)
Profit on disposal	<u>1,000</u>

21.14 The answer is £8,232 in each year, calculated below:

Year ended 31 Aug		Annual depreciation expense	Accumulated depreciation at end of year	Carrying amount as at end of year
2022	£96,000 × 30% =	28,800	28,800	67,200
2023	£67,200 × 30% =	20,160	48,960	47,040
2024	£47,040 × 30% =	14,112	63,072	32,928
2025	£32,928 × 25% =	8,232	71,304	24,696
2026	£32,928 × 25% =	8,232	79,536	16,464

21.15 The answer is £39,600. (Depreciation expense in years 1, 2 and 3 = (£78,000 – £18,000)/6 years = £10,000 per year; carrying amount at the end of Year 3 = £78,000 – (3 years × £10,000) = £48,000; depreciation expense in Year 4 = (£48,000 – £6,000)/5 years = £8,400; carrying amount at the end of year 4 = £78,000 – (3 years × £10,000) – £8,400 = £39,600.)

21.16 The impairment loss is £17,200. (Annual depreciation expense in each of Year 1 and 2 will be £84,000/10 = £8,400; carrying amount before impairment loss at the end of Year 2 = cost £84,000 – accumulated depreciation (2 years × £8,400) = £67,200; £67,200 – £50,000 new value = £17,200 impairment loss.)

21.17 Other reasons include:

- (i) The register can include extra information about each asset (such as its location, serial number and reference number) that won't be recorded in the ledger accounts. This extra information is useful for various reasons, such as:
 - The serial number of each asset could be needed in case it breaks down and the business wishes to claim under the manufacturer's warranty.
 - Most assets will be given internal reference numbers by the business so that they can be individually identified. For example, a business may own hundreds of similar PCs. Only by using a reference number will the business be able to identify each one individually, its age, and when it is due for replacement.
- (ii) The various non-current assets owned by a business may, in total, be of considerable value. If the owner wants to sell his or her business, a clear and accurate register of the details of its non-current assets may be an important factor in justifying the sale value of the business to potential buyers.

Review questions

21.1 Kalinda's business purchased a laptop for £950. It has an estimated useful life of three years and a scrap value of £200.

She is not certain whether she should use the straight-line or the reducing balance basis for the purpose of calculating depreciation.



→ You are required to calculate the depreciation (to the nearest £) using both methods, showing clearly the balance of cost minus accumulated depreciation at the end of each year under each method. (Assume that 40% per year is to be used for the reducing balance method.)

21.2 A machine was originally purchased for £30,000. It is planned to be used for four years, and then sold for an estimated figure of £7,000. Show the calculations of the figures for depreciation (to the nearest £) for each year using (a) the straight-line method; and (b) the reducing balance method at 30% per year.

21.3 A vehicle originally cost £64,000. It is expected to be used for three years, and then sold for £17,500. Calculate the depreciation for each year using (a) the reducing balance method, using a depreciation rate of 35%; and (b) the straight-line method.

21.4A A photocopier was bought for £32,000. It is predicted to be used for four years, and then traded in for £10,000. Show the calculations of the figures for depreciation for each year using (a) the straight-line method; and (b) the reducing balance method at 25% per year.

21.5A A piece of equipment originally cost £80,000. It is expected to be used for five years and then sold for £800. Show your calculations of the amount of depreciation each year using (a) the reducing balance method at 60% per year; and (b) the straight-line method.

21.6A A bus is bought for £60,000. It will be used for four years, and then sold back to the supplier for £15,000. Show the depreciation calculations for each year using (a) the reducing balance method at 30% per year; and (b) the straight-line method.

21.7 A business (which makes up its financial statements annually to 31 December) charges depreciation on its machinery at the rate of 12% per year using the reducing balance method.

On 31 December 2018, the machinery consisted of three items purchased as shown:

	£
On 1 January 2016 Machine A	Cost 4,000
On 1 September 2017 Machine B	Cost 7,000
On 1 May 2018 Machine C	Cost 2,000

Required:

Your calculations showing the depreciation expense for the year 2018.

21.8 A business bought a motor vehicle for £16,800 on 1 January 2023, paying in full immediately by bank transfer. Financial statements are prepared annually to 31 December and depreciation of vehicles is charged at 25% per year under the reducing balance method.

Required:

Prepare the motor vehicles at cost account and the accumulated depreciation account for the first two years of the motor vehicle's working life.

21.9 Varsini Transport delivers goods nationwide. The following information relates to the delivery vehicles owned by Varsini Transport.

1 April 2021	Purchased delivery vehicle A £20,000
1 July 2022	Purchased delivery vehicle B £18,000
1 April 2023	Purchased delivery vehicle C £25,000
30 June 2023	Purchased delivery vehicle D for £28,000 giving delivery vehicle A in part exchange

Varsini Transport has the following depreciation policy:

- Delivery vehicles are depreciated at the rate of 20% per annum using the straight line method
- Depreciation is charged on delivery vehicles purchased and sold during the year on a pro rata basis according to the months of ownership
- All sales of delivery vehicles are recorded through a disposal account
- All payments and receipts for delivery vehicles are by cheque

Required:

- (a) Calculate the depreciation charged on delivery vehicles in **each** of the years ending 31 March 2023 and 31 March 2024.
- (b) Prepare for the years ended 31 March 2023 and 31 March 2024 the:
 - (i) Delivery Vehicles at Cost Account
 - (ii) Accumulated Depreciation of Delivery Vehicles Account.

Varsini Transport had the following costs in the year ended 31 March 2024:

- 1 Writing the sign of the business on new delivery vehicles
 - 2 Replacement tyres
 - 3 Installing satellite navigation into each delivery vehicle
- (c) Identify whether **each** of the costs above is capital expenditure or revenue expenditure. State the reason for your answer.
 - (d) Evaluate the suitability of the straight line method when depreciating delivery vehicles.

(Edexcel A level)

21.10A Vinny purchased some new equipment on 28 February 2016 for £240,000. Vinny's policy is to depreciate equipment at 30% per year using the reducing balance method. He calculates a full year's charge in the year of acquisition and none in the year of disposal.

- (a) What will be the depreciation expense in respect of this equipment in Vinny's financial year ended 31 August 2020?
- (b) Suggest why it might be more appropriate to use the reducing balance method of depreciation for certain assets.

21.11A C. Hassan, a sole proprietor, purchased a delivery van on 1 March 2024 for £11,360 and some new equipment on 1 September 2024 for £7,000.

He expects that the van will have a useful life of four years, after which it should have a trade-in value of £2,000. The scrap value of the equipment after ten years' use is estimated to be £1,000. Hassan charges depreciation using the straight-line method.

Required:

What should the depreciation expense be in relation to these two items for Hassan's financial year ended 30 November 2024 assuming that:

- (a) he charges a full year's depreciation in the year of purchase and none in the year of sale
- (b) he charges depreciation on a monthly basis.

21.12 You are required to answer the following four questions:

- (a) Royston's business purchased a new machine (with a purchase price of £18,000) on 1 January 2024. The cost of delivery was £500 and Royston also spent £1,700 on its installation. On 1 July 2024, the machine broke down and it cost £900 to repair. Royston charges depreciation at the rate of 20% per year using the straight-line method, on a monthly basis. What will be the carrying amount of the machine in Royston's balance sheet as at his financial year ended 31 December 2024?
- (b) On 1 September 2025, Imre's business traded in a car which it had originally bought for £24,000 on 1 September 2023. The business had been depreciating the car using the reducing balance method at the rate of 35% per year. The list price of the new car was £29,950 and Imre paid the garage with a cheque for £19,500 in full settlement. His business's financial year end is 31 August. What was the profit or loss on the disposal of the old car?
- (c) On 5 December 2025, R. Gough's business sold a machine for £20,000 cash. The machine had originally cost £37,750. Gough reported a loss of £6,425 on the disposal. What was the accumulated depreciation on the machine as at the date of disposal?
- (d) Hinchcliffe's business produces its financial statements to 31 May each year. On 1 June 2023, he purchased a machine for £200,000 and started to depreciate it at 15% per annum on the reducing balance basis. As of 1 June 2026, he estimated the machine's remaining useful life to be eight years, with no residual value, and changed the basis of depreciation to the straight-line method. What will be the depreciation charge (to the nearest £1) on this machine in the financial statements of Hinchcliffe's business for the year ended 31 May 2027?



→ **21.13A** Fast Response is a business delivering goods to customers. The following information is available:

- (1) Extract from the Balance Sheet at 31 December 2024.
Non-current assets

	Cost	Accumulated depreciation	Carrying amount
	£	£	£
Delivery vehicles	31 000	4 600	26 400

- (2) History of delivery vehicle purchases and sales.

1 January 2024	Purchased vehicle A	£15 000
1 July 2024	Purchased vehicle B	£16 000
1 April 2025	Purchased vehicle C	£18 000
1 July 2025	Purchased vehicle D	£20 000
1 July 2025	Sold vehicle A	£11 000

- (3) Fast Response has the following depreciation policy:
- delivery vehicles are depreciated at the rate of 20% per annum using the straight line method
 - depreciation is charged on delivery vehicle purchases and sales on a pro rata basis to the months of ownership
 - all sales of delivery vehicles are recorded through a disposal account.
- (4) All purchases and sales of delivery vehicles were by cheque.

Required:

- (a) Calculate the depreciation charged on **each** delivery vehicle for the year ended 31 December 2025.
- (b) Prepare the journal entries to record the sale of delivery vehicle A on 1 July 2025.
- (c) Prepare, for the year ending 31 December 2025, the:
- (i) Delivery Vehicles at cost Account
 - (ii) Delivery Vehicles Disposal Account.
- (d) Explain the difference between the accounting concepts of **going concern** and **consistency** when applied to the depreciation of non-current assets.
- (e) Identify whether **each** of the following costs is a **capital expenditure** or a **revenue expenditure** for a new delivery vehicle purchased.
- (1) Delivery cost of vehicle
 - (2) Road licence
 - (3) Insurance
 - (4) Sign writing of business name on delivery vehicle

(Edexcel A level)

21.14 A company starts in business on 1 January 2024. You are to write up the vans at cost account and the accumulated depreciation account for the year ended 31 December 2024 from the information given below. Depreciation is at the rate of 25% per annum, using the basis that one complete month's ownership needs one month's depreciation.

2024	Bought one van for £69,000 on 1 January
	Bought two vans for £72,000 each on 1 August

21.15 A company starts in business on 1 January 2017, the financial year end being 31 December. You are to show:

- The machinery at cost account.
- The accumulated depreciation on machinery account.
- The relevant balance sheet extracts for each of the years 2017, 2018, 2019, 2020.

The machinery bought was:

2017	1 January	1 machine costing £800
2018	1 July	2 machines costing £1,200 each
	1 October	1 machine costing £600
2020	1 April	1 machine costing £1,400

The machines are depreciated for the proportion of the year that they are owned. Depreciation is over 10 years, using the straight line method.

21.16A A company maintains its non-current assets at cost. A separate accumulated depreciation account is used for each type of asset. Machinery is to be depreciated at the rate of 15% per annum, and fixtures depreciated at the rate of 5% per annum, using the reducing balance method. Depreciation is to be calculated on assets in existence at the end of each year, giving a full year's depreciation even though the asset was bought part of the way through the year. The following transactions in assets have taken place:

2019	1 January	Bought machinery £2,800, fixtures £290
	1 July	Bought fixtures £620
2020	1 October	Bought machinery £3,500
	1 December	Bought fixtures £130

The financial year end of the business is 31 December.

You are to show:

- The machinery at cost account.
- The fixtures at cost account.
- The two separate accumulated depreciation accounts.
- The non-current assets section of the balance sheet at the end of each year, for the years ended 31 December 2019 and 2020.

21.17 A company depreciates its plant at the rate of 25% per annum, straight-line method, for each month of ownership. From the following details, draw up the plant at cost account and the accumulated depreciation account for each of the years 2017, 2018, 2019 and 2020.

2017	Bought plant costing £2,600 on 1 January.
	Bought plant costing £2,100 on 1 October.
2019	Bought plant costing £2,800 on 1 September.
2020	Sold plant which had been bought for £2,600 on 1 January 2017 for the sum of £810 on 31 August 2020.

You are also required to draw up the plant disposal account and relevant extracts from the balance sheet as at the end of each year.

21.18 A company maintains its non-current assets at cost. Accumulated depreciation accounts for each asset are kept.

At 31 December 2018, the position was as follows:

	<i>Total cost to date</i>	<i>Total depreciation to date</i>
	£	£
Machinery	94,500	28,350
Office furniture	3,200	1,280





The following additions were made during the financial year ended 31 December 2019:

Machinery £16,000, office furniture £460.

A machine bought in 2015 for £1,600 was sold for £360 during the year.

The rates of depreciation are:

Machinery 20%, office furniture 10%, using the straight-line basis, calculated on the assets in existence at the end of each financial year irrespective of the date of purchase.

You are required to show the asset, accumulated depreciation and disposal accounts for the year ended 31 December 2019 and the balance sheet extracts at that date.

21.19A Distance Limited owned three lorries at 1 April 2019:

Lorry A: purchased on 21 May 2015 for £31,200

Lorry B: purchased on 20 June 2017 for £19,600

Lorry C: purchased on 1 January 2019 for £48,800

Depreciation is charged annually at 20 per cent of cost on all vehicles in use at the end of the year.

During the year ended 31 March 2020, the following transactions occurred:

- (i) 1 June 2019: Lorry B was involved in an accident and considered to be a write-off by the insurance company, which paid £10,500 in settlement.
- (ii) 7 June 2019: Lorry D was purchased for £32,800.
- (iii) 21 August 2019: Lorry A was sold for £7,000.
- (iv) 30 October 2019: Lorry E was purchased for £39,000.
- (v) 6 March 2020: Lorry E was considered not to be suitable for carrying the type of goods required and was exchanged for lorry F. The value of lorry F was deemed to be £37,600.

Required:

Prepare the ledger T-accounts recording these transactions for the year ending 31 March 2020 and bring down the balances at 1 April.

21.20 Baba is the owner of a delivery business. The following balances were in her books on 1 March 2023:

	£
Non-current assets (at cost)	
Delivery vehicles	98,000
Office fixtures	61,000
Accumulated depreciation:	
Delivery vehicles	33,000
Office fixtures	17,800

Baba's depreciation policy is:

- Delivery vehicles at the rate of 20% per annum reducing balance
- Office fixtures at the rate of 15% per annum straight line
- A full year's depreciation is charged in the year of purchase
- No depreciation is charged in the year of sale
- All disposals are recorded in a single non-current asset disposal account.

Additional information for the year ended 29 February 2024:

- (1) Delivery vehicles with a cost of £18,000, and accumulated depreciation of £9,000, were sold by cheque for £8,400 during the year.
- (2) Delivery vehicles costing £24,000 were purchased during the year, paying by cheque.

- (3) Office fixtures costing £12,000, and with an accumulated depreciation of £5,400, were sold for £400 cash.
- (4) Additional office fixtures were purchased at a cost of £21,000, paying by cheque.

Required:

- (a) Explain why Baba needs to charge depreciation on non-current assets for the year.
- (b) Calculate, for the year ended 29 February 2024, the depreciation of the:
 - (i) Delivery vehicles
 - (ii) Office fixtures.
- (c) Prepare, for the year ended 29 February 2024, the:
 - (i) Delivery Vehicles Account
 - (ii) Delivery Vehicles - Accumulated Depreciation Account
 - (iii) Disposal Account for all non-current assets.

Baba records computers in her office fixtures account. She is concerned that each year she scraps computers that still have a significant book value.

- (d) Evaluate Baba's current policy of including computers as office fixtures.

(Edexcel A level)

21.21A Please answer the following three questions:

- (a) Jack's business has a financial year end of 31 May. He bought an item of plant for £225,000 on 1 June 2022 and estimated its useful life to be six years and its residual value to be £45,000. He believed that the straight-line method of depreciation would best reflect the pattern of benefits expected from the plant.

He reviews the estimated useful lives and residual values of his assets each year, and, as of 1 June 2026, his assessment was that the plant had a remaining useful life of five years and a residual value of £10,000. He still believed that the straight-line method would best reflect the pattern in which the plant's benefits would be consumed by his business.

What is the depreciation expense on this plant for the year ended 31 May 2027?

- (b) Noah's business has a financial year end of 31 December. He bought a piece of equipment for £180,000 on 1 April 2021 and charged depreciation at 20% per year straight line on a monthly basis.

He reviews his depreciation methods annually and, as of 1 January 2025, he judged that the reducing balance basis, at a rate of 40% per year, would provide a better reflection of the pattern of consumption of benefits expected from the equipment.

For this asset, show for each of the years ended 31 December 2021, 22, 23, 24, 25, 26 and 27:

- (i) the depreciation expense for the year;
 - (ii) the accumulated depreciation as at the end of the year; and
 - (iii) the carrying amount as at the end of the year.
- (c) Dylan's business has a financial year end of 31 December and uses the straight-line method of depreciation for machinery. He purchased a new machine for £250,000 on 1 January 2022. Its estimated useful life was 10 years with a residual value of zero.

On 1 January 2026 the machine was damaged in an accident. It can still be operated following the accident, but at reduced capacity and with a remaining useful life of only three years. An impairment review was conducted which concluded that the value of the machine to the business following the accident on 1 January is now only £120,000. The estimated residual value remains zero.

What is the total charge to be recognised in the income statement for the year ended 31 December 2026 in relation to this machine (i.e. the impairment loss and the depreciation expense)?

21.22 A business buys a non-current asset for £10,000. The business estimates that the asset will be used for five years. After exactly two and a half years, however, the asset is suddenly sold for £5,000. The business always provides a full year's depreciation in the year of purchase and no depreciation in the year of disposal.



**Required:**

- (a) Write up the relevant accounts (including disposal account but not profit and loss account) for each of Years 1, 2 and 3:
 - (i) using the straight-line depreciation method (assume 20% pa);
 - (ii) using the reducing balance depreciation method (assume 40% pa).
- (b) (i) What is the purpose of depreciation? In what circumstances would each of the two methods you have used be preferable?
 (ii) What is the meaning of the net figure for the non-current asset in the balance sheet at the end of Year 2?
- (c) If the asset was bought at the beginning of Year 1 but was not used at all until Year 2 (and it is confidently anticipated to last until Year 6), state under each method the appropriate depreciation charge in Year 1, and briefly justify your answer.

(Association of Chartered Certified Accountants)

21.23A Contractors Ltd was formed on 1 January 2019 and the following purchases and sales of machinery were made during the first 3 years of operations.

Date	Asset	Transaction	Price
1 January 2019	Machines 1 and 2	purchase	£40,000 each
1 October 2019	Machines 3 and 4	purchase	£15,200 each
30 June 2021	Machine 3	sale	£12,640
1 July 2021	Machine 5	purchase	£20,000

Each machine was estimated to last 10 years and to have a residual value of 5 per cent of its cost price. Depreciation was by equal instalments, and it is company policy to charge depreciation for every month an asset is owned.

Required:

- (a) Calculate:
 - (i) the total depreciation on Machinery for each of the years 2019, 2020 and 2021;
 - (ii) the profit or loss on the sale of Machine 3 in 2021.
- (b) Contractors Ltd depreciates its vehicles by 30 per cent per annum using the diminishing balance method. What difference would it have made to annual reported profits over the life of a vehicle if it had decided instead to depreciate this asset by 20 per cent straight line?

(Scottish Qualifications Authority)

21.24 A friend of the family believes that depreciation provides him with a reserve to purchase new assets. His secretary has blown up his computer, but he knows he has the funds to replace it in the accumulated depreciation account. You know that he is wrong and have grown tired of listening to him going on about it, but he won't listen to what you have to say. You decide to put him out of his misery by writing a letter to him about it that he may actually read before he realises that it is telling him things he does not want to hear.

Write him a letter, using fictitious names and addresses, which defines depreciation and explains why his view is incorrect.

21.25A On 31 March 2019, Dixie's business traded-in a machine (a Z-15 model) which it had originally purchased on 1 April 2016 for £19,000. Dixie had depreciated the Z-15 at 10 per cent per annum using the straight-line method.

Dixie part-exchanged the Z-15 for a newer model (the Z-18). The vendor's list price for the Z-18 was £32,000 but Dixie only paid £20,000 plus the trade-in in full settlement.

Required:

What was the profit or loss on the disposal of the Z-15 in Dixie's income statement for the financial year to 31 March 2019?

21.26 XY Ltd provides for depreciation of its machinery at 20% per annum on cost; it charges for a full year in the year of purchase but none in the year of sale/disposal.

Financial statements are prepared annually to 31 December.

2018

January 1 Bought machine 'A' £10,000
 July 1 Bought machine 'B' £6,000.

2019

March 31 Bought machine 'C' £8,000

2020

October 7 Sold machine 'A' – proceeds £5,500
 November 5 Bought machine 'D' £12,000

2021

February 4 Sold machine 'B' – proceeds £3,000
 February 6 Bought machine 'E' £9,000
 October 11 Exchanged machine 'D' for machinery valued at £7,000

Prepare

- The machinery at cost account for the period 1 January 2018 to 31 December 2021.
- The accumulated depreciation on machinery account, for the period 1 January 2018 to 31 December 2021.
- The disposal of machinery accounts showing the profit/loss on sale for each year.
- The balance sheet extract for machinery at (i) 31 December 2020 and (ii) 31 December 2021.

21.27A A company maintains its non-current assets at cost. Separate accumulated depreciation accounts are kept for each class of asset.

At 31 December 2018 the position was as follows:

	<i>Total cost to date</i> £	<i>Total depreciation to date</i> £
Machinery	52,950	25,670
Office furniture	2,860	1,490

The following transactions were made in the year ended 31 December 2019:

- Purchased – machinery £2,480 and office furniture £320
- Sold – machinery which had cost £2,800 in 2015 for £800

Depreciation is charged, on a straight-line basis, at 10 per cent on machinery and at 5 per cent on office furniture on the basis of assets in use at the end of the year irrespective of the date of purchase.

Required:

Show the asset and accumulated depreciation accounts for the year to 31 December 2019 and the relevant balance sheet extracts at that date.

21.28A

- The following trial balance was extracted from the books of Peter Mackie on 30 April 2024. From this, and the note below it, prepare his income statement for the year ending 30 April 2024, and a balance sheet as at that date.





	<i>Dr</i> £	<i>Cr</i> £
Sales		26,200
Purchases	16,450	
Inventory 1 May 2023	2,266	
Carriage outwards	534	
Carriage inwards	295	
Motor Vehicles: accumulated depreciation		3,800
Fixtures and Fittings: accumulated depreciation		240
Returns inwards	670	
Returns outwards		392
Salaries and wages	2,692	
Motor expenses	729	
Rent	843	
Sundry expenses	1,390	
Motor vehicles	7,600	
Fixtures and fittings	800	
Trade receivables	4,965	
Trade payables		3,277
Cash at bank	1,648	
Cash in hand	150	
Drawings	8,400	
Capital		15,523
	<u>49,432</u>	<u>49,432</u>

Note:

Closing inventory amounted to £2,860. Depreciation is to be charged at rates of 10 per cent on cost for fixtures and fittings and 25 per cent on cost for motor vehicles. Bad debts of £365 are to be written off.

- (b) Peter has indicated that he thinks that the trade receivable amounts that have been written off will be paid eventually. He is also querying why adjustments are made in the financial statements for bad debts and depreciation. Write a short note to him, making appropriate references to accounting concepts, outlining why these adjustments are made.

21.29 Carole's business buys a delivery van on 1 January 2022 for £27,000. She estimates that the van will be used for four years, after which she believes it will have a trade-in value of £5,000. She also predicts that the van will travel a total of 50,000 miles over the course of its four years of use.

The van was actually driven for 15,000 miles during 2022, 11,000 miles in 2023 and 13,000 miles in 2024.

Required:

- (a) Calculate the depreciation expense on the van for each of Carole's financial years ending 31 December 2022, 2023 and 2024 using:
- the straight-line method;
 - the reducing balance method at a rate of 40% per year;
 - the units of production method.
- (b) On 1 July 2025, it becomes clear that the van needs some major repairs, so Carole decides to sell it to a garage for a cash price of £2,000. The van had been driven for 7,000 miles during the first six months of 2025. Assuming Carole had adopted the units of production method of depreciation, calculate:
- the depreciation expense on the van for the year ended 31 December 2025;
 - the profit or loss on disposal of the van.

21.30A Richard runs a small publishing business. He buys a new XP27 printing machine on 1 January 2021 for £100,000 which he expects to use for five years. He predicts that the machine will then have a residual value of £10,000. Richard expects to print a total of 600,000 pages over the machine's five-year life.

The actual output from the XP27 printing machine was as follows:

<i>Year</i>	<i>Pages printed</i>
2021	123,000
2022	147,000
2023	101,000
2024	117,000

Required:

- (a) Calculate the depreciation charge on the XP27 printing machine for each of Richard's financial years ending 31 December 2021, 2022, 2023 and 2024 using:
 - (iii) the straight-line method;
 - (iv) the reducing balance method at a rate of 30% per year;
 - (v) the units of production method;
 - (vi) the sum of the years' digits method.
- (b) On 1 January 2025, Richard traded in the XP27 printing machine for a new XP44 model priced at £79,000. Richard paid £54,000 in full settlement for the new machine. For each of the four depreciation methods in part a), calculate the profit or loss that would arise on the disposal of the XP27.

Accruals and prepayments

Learning objectives

After you have studied this chapter, you should be able to:

- Adjust expense accounts for accruals and prepayments.
- Adjust revenue accounts for amounts owing.
- Show accruals, prepayments and revenue accounts receivable trade receivables in the balance sheet.
- Ascertain the amounts of expense and revenue items to be shown in the income statement after making adjustments for accruals and prepayments.
- Make the necessary end-of-period adjustments relating to drawings that have not yet been entered in the books.
- Explain what an extended trial balance is and describe what it looks like.
- Prepare accrual and prepayment entries to the accounts using two different methods.

Introduction

In this chapter, you'll continue to learn about adjustments made to the ledger accounts at the end of a period. You'll learn how to make the appropriate entries in the accounts for outstanding balances on expense and income accounts and make the appropriate entries in the income statement and the balance sheet.

22.1 Financial statements so far

The income statements that you have looked at so far have taken the sales for a period and deducted all the expenses for that period, the result being a net profit or a net loss.

Up to this part of the book it has always been assumed that the expenses incurred belong to the period of the income statement when they took place. If the income statement for the year ending 31 December 2022 was being prepared, then the rent paid as shown in the trial balance was all treated as relating to 2022. There was no rent owing at the beginning of 2022 nor any owing at the end of 2022, nor had any rent been paid in advance relating to 2023.

This was done to make your first encounter with financial statements as straightforward as possible.

22.2 Adjustments needed

Let's look at two businesses which pay rent for buildings in Oxford. The rent for each building is £6,000 a year.

- 1 Business A pays £5,000 in the year. At the year end it owes £1,000 for rent.

Rent expense used up = £6,000

Rent paid for = £5,000

- 2 Business B pays £6,500 in the year. This figure includes £500 paid in advance for the following year.

Rent expense used up = £6,000

Rent paid for = £6,500

An income statement for 12 months needs 12 months' rent as an expense = £6,000. This means that in both 1 and 2 the double entry accounts will have to be adjusted.

Activity 22.1

From your knowledge of double entry, you should be able to work out what the double entry required is in these two cases. What do you think it is? If you don't know what names to give the accounts, have a guess. (*Hint:* in the first case, there will be a credit balance in the balance sheet and in the other, it will be a debit balance.)

In all the examples in this chapter the income statements are for the year ending 31 December 2021. Unless otherwise indicated, all entries in the income statement are in the profit and loss section of the statement. **All mentions of 'profit and loss' in this chapter refer to the ledger account of that name which is summarised in the income statement.**

22.3 Accrued expenses

Assume that rent of £4,000 per year is payable at the end of every three months. The rent was paid on time in March, but this is not always the case.

Amount	Rent due	Rent paid
£1,000	31 March 2021	31 March 2021
£1,000	30 June 2021	2 July 2021
£1,000	30 September 2021	4 October 2021
£1,000	31 December 2021	5 January 2022

Rent			
2021		£	
Mar	31	Cash	1,000
Jul	2	Cash	1,000
Oct	4	Cash	1,000

The rent for the last quarter was paid on 5 January 2022 and so will appear in the books of the year 2022 as the result of a double entry made on that date.

The expense for 2021 is obviously £4,000 as that is the year's rent, and this is the amount needed to be transferred to the profit and loss account. But, if £4,000 was put on the credit side

of the rent account (the debit being in the profit and loss account) the account would be out of balance by £1,000 because the payment due on 31 December 2021 was not made until 5 January 2022. That is, if we posted £4,000 to profit and loss on 31 December, we would have £4,000 on the credit side of the account and only £3,000 on the debit side:

Rent			
2021		£	
Mar	31	Cash	1,000
Jul	2	Cash	1,000
Oct	4	Cash	1,000
2021		£	
Dec	31	Profit and loss	4,000

This cannot be right.

To make the account balance the £1,000 rent owing for 2021, but paid in 2022, must be carried down to 2022 as a credit balance because it is a liability on 31 December 2021. Instead of rent owing it could be called rent accrued or just simply an 'accrual'.

The completed account can now be shown:

Rent			
2021		£	
Mar	31	Cash	1,000
Jul	2	Cash	1,000
Oct	4	Cash	1,000
Dec	31	Accrued c/d	1,000
			<u>4,000</u>
2021		£	
Dec	31	Profit and loss	4,000
			<u>4,000</u>
2022			
Jan	1	Accrued b/d	1,000

The balance c/d has been described as 'accrued c/d', rather than as 'balance c/d'. This is to explain what the balance is for. It is for an **accrued expense**.

22.4 Prepaid expenses

Insurance for a business is at the rate of £840 a year, starting from 1 January 2021. The business has agreed to pay this at the rate of £210 every three months. However, payments were not made at the correct times. Details were:

Amount	Insurance due	Insurance paid
£210	31 March 2021	£210 28 February 2021
£210	30 June 2021	£420 31 August 2021
£210	30 September 2021	
£210	31 December 2021	£420 18 November 2021

The insurance account in the ledger for the year ended 31 December 2021 is:

Insurance			
2021		£	
Feb	28	Bank	210
Aug	31	Bank	420
Nov	18	Bank	420
2021		£	
Dec	31	Profit and loss	840

The last payment of £420 is not just for 2021. It can be split as £210 for the three months to 31 December 2021 and £210 for the three months ended 31 March 2022. For a period of 12 months the cost of insurance is £840 and this is, therefore, the figure needing to be transferred to the income statement.

If £840 is posted to the debit of profit and loss at 31 December 2021, the insurance account will still have a debit balance of £210. This is a benefit paid for but not used up at the end of the period. It is an asset and needs carrying forward as such to 2022, i.e. as a debit balance. Items like this are called **prepaid expenses**, 'prepayments' or 'amounts paid in advance'.

The account can now be completed:

Insurance			
2021		2021	
Feb 28 Bank	£ 210	Dec 31 Profit and loss	£ 840
Aug 31 Bank	420	31 Prepaid c/d	210
Nov 18 Bank	420		
	<u>1,050</u>		<u>1,050</u>
2022			
Jan 1 Prepaid b/d	210		

Prepayments happen when items other than purchases are bought for use in the business but are not fully used up in the period.

For instance, packing materials are normally not entirely used up over the period in which they are bought. There is usually an inventory of packing materials in hand at the end of the period. This is a form of prepayment and needs carrying down to the period in which it will be used.

This can be seen in the following example:

Year ended 31 December 2021:

Packing materials bought in the year = £2,200.

Inventory of packing materials in hand as at 31 December 2021 = £400.

Looking at the example, it can be seen that in 2021 the packing materials used up will have been £2,200 – £400 = £1,800. (We are assuming that there was no inventory of packing materials at the start of 2021.) We have an inventory of £400 packing materials at 31 December 2021 to be carried forward to 2022. The £400 inventory of packing materials will be carried forward as an asset balance (i.e. a debit balance) to 2022:

Packing Materials			
2021		2021	
Dec 31 Bank	£ 2,200	Dec 31 Profit and loss	£ 1,800
		31 Inventory c/d	400
	<u>2,200</u>		<u>2,200</u>
2022			
Jan 1 Inventory b/d	400		

The inventory of packing materials is *not* added to the inventory of unsold goods in hand in the balance sheet: it is added to the other prepaid expenses in that statement.

22.5 Revenue owing at the end of period

The revenue owing for sales is already shown in the books as the debit balances on customers' accounts, i.e. trade receivables. There may be other kinds of revenue, all of which has not been received by the end of the period, e.g. rent receivable. An example now follows.

Example

Our warehouse is larger than we need. We rent part of it to another business for £1,800 per annum. Details for the year ended 31 December were as follows:

Amount	Rent due	Rent received
£450	31 March 2021	4 April 2021
£450	30 June 2021	6 July 2021
£450	30 September 2021	9 October 2021
£450	31 December 2021	7 January 2022

The *Rent Receivable Account* entries for 2021 will appear as:

Rent Receivable			
	2021		£
	Apr	4 Bank	450
	Jul	6 Bank	450
	Oct	9 Bank	450

The rent received of £450 on 7 January 2022 will be entered in the accounting records in 2022.

Any rent paid by the business would be charged as a debit to the profit and loss account. Any rent received, being the opposite, is transferred to the credit of the profit and loss account, as it is a revenue.

The amount to be transferred for 2021 is that earned for the 12 months, i.e. £1,800. The rent received account is completed by carrying down the balance owing as a debit balance to 2022. The £450 owing is an asset on 31 December 2021.

The rent receivable account can now be completed:

Rent Receivable			
2021		2021	£
Dec	31 Profit and loss	Apr	4 Bank 450
		Jul	6 Bank 450
		Oct	9 Bank 450
		Dec	31 Accrued c/d 450
			<u>1,800</u>
2022			
Jan	1 Accrued b/d		450

22.6 Expenses and revenue account balances and the balance sheet

In all cases dealing with adjustments in the financial statements, there will still be a balance on each account after the preparation of the income statement. All such balances remaining should appear in the balance sheet. The only question left is where and how they should be shown.

The amounts owing for expenses could be called expenses payable, expenses owing or accrued expenses. However, we'll use the term **accruals**. They represent *very* current liabilities – they will have to be paid in the *very* near future.

The items prepaid could be called prepaid expenses or payments in advance, but we'll call them **prepayments**. Similarly, to accruals, they represent *very* current assets as they should be received *very* soon.

Activity 22.2

From your knowledge of accounting, how should all accruals and all the prepayments appear in the balance sheet – as one debit entry and one credit entry or as a separate entry for each item? Why?

Activity 22.3

- (a) In the balance sheet, where in the current asset sequence do you place prepayments?
- (b) In the balance sheet, where in the current liability sequence do you place accruals?
- (c) Why?

Amounts owing for rents receivable or other revenue owing are a special case. If you look back at the T-account in Section 22.5, you'll see that they are described as 'accrued'. However, they are not accrued expenses, as they represent amounts receivable. They are, therefore, **accrued income**.

Activity 22.4

Where do you think these items of accrued income go in the balance sheet?

The part of the balance sheet in respect of the accounts so far seen in this chapter is therefore:

Balance Sheet as at 31 December 2021 (extract)

	£	£
Current assets		
Inventory	xxx	
Trade receivables	450	
Prepayments (400 + 210)	610	
Bank	xxx	
Cash	<u>xxx</u>	
		x,xxx
Current liabilities		
Trade payables	xxx	
Accrued expenses	<u>1,000</u>	
		<u>(x,xxx)</u>

22.7 Expenses and revenue accounts covering more than one period

So far we've only looked at accounts where there were closing accruals or prepayments. In real life, you will also expect to see some opening accruals and prepayments, such as that shown in the final version of the *Rent Receivable Account* in Section 22.5. This is something that students are often asked to deal with in examinations as it tests their knowledge and ability to distinguish the treatment of these items at the beginning and end of a period. Typically, they may be asked to draw up an expense or revenue account for a full year which has amounts owing or prepaid at both the beginning and end of the year. We can now see how this is done.

Example A

The following details are available:

- (A) On 31 December 2020, three months' rent amounting to a total of £3,000 was owing.
- (B) The rent chargeable per year was £12,000.
- (C) The following rent payments were made in the year 2021: 6 January £3,000; 4 April £3,000; 7 July £3,000; 18 October £3,000.
- (D) The final three months' rent for 2021 is still owing.

Now we can look at the completed rent account. The letters (A) to (D) give reference to the details above.

Rent									
2021			£	2021	£				
Jan	6	Bank	(C)	3,000	Jan	1	Accrued b/d	(A)	3,000
Apr	4	Bank	(C)	3,000	Dec	31	Profit and loss	(B)	12,000
Jul	7	Bank	(C)	3,000					
Oct	18	Bank	(C)	3,000					
Dec	31	Accrued c/d	(D)	3,000					
				<u>15,000</u>					<u>15,000</u>
					2022				
					Jan	1	Accrued b/d		3,000

Example B

The following details are available:

- (A) On 31 December 2020, packing materials in hand amounted to £1,850.
- (B) During the year to 31 December 2021, we paid £27,480 for packing materials.
- (C) There was no inventory of packing materials on 31 December 2021.
- (D) On 31 December 2021, we still owed £2,750 for packing materials already received and used.

The packing materials account will appear as:

Packing Materials								
2021				£	2021			£
Jan	1	Inventory b/d	(A)	1,850	Dec	31	Profit and loss	32,080
Dec	31	Bank	(B)	27,480				
	31	Owing c/d	(D)	2,750				
				<u>32,080</u>				<u>32,080</u>
					2022			
					Jan	1	Owing b/d	2,750

The figure of **£32,080** is the difference on the account. It is transferred to the profit and loss account.

We can prove it is correct:

	£	£
Inventory at start of year		1,850
Add Bought and used:		
Paid for	27,480	
Still owed for	<u>2,750</u>	
Cost of packing materials bought and used in the year		30,230
Cost of packing materials used in the year		<u>32,080</u>

Example C

Where different expenses are put together in one account, it can get even more confusing. Let us look at where rent and business rates are joined together. Here are the details for the year ended 31 December 2021:

- (A) Rent is payable of £6,000 per annum.
- (B) Business rates of £4,000 per annum are payable by instalments.
- (C) At 1 January 2021, rent of £1,000 had been prepaid in 2020.
- (D) On 1 January 2021, business rates of £400 were owed.
- (E) During 2021, rent of £4,500 was paid.
- (F) During 2021, business rates of £5,000 were paid.
- (G) On 31 December 2021, rent of £500 was owing.
- (H) On 31 December 2021, business rates of £600 had been prepaid.

A combined rent and business rates account is to be drawn up for the year 2021 showing the transfer to profit and loss, and the balances to be carried down to 2022.

Rent and Business Rates							
2021				£	2021		
Jan	1	Rent prepaid b/d	(C)	1,000	Jan	1	Business rates owing b/d
							(D) 400
Dec	31	Bank: rent	(E)	4,500	Dec	31	Profit and loss
	31	Bank: business rates	(F)	5,000			A + B 10,000
	31	Rent accrued c/d	(G)	<u>500</u>			
				11,000			
2022					2022		
Jan	1	Business rates prepaid b/d	(H)	600	Jan	1	Rent accrued b/d
							(G) 500

To enter the correct figures, you need to keep the two items separate in your own mind. This is easiest if you produce a schedule like the one we produced above for packing materials inventory.

The one for rent would look like this:

	£	£
Rent due during the year		6,000
Less:		
Rent prepaid at start of year	1,000	
Rent paid during the year	<u>4,500</u>	
		(5,500)
Rent accrued at the end of the year		<u>500</u>

Activity 22.5

Prepare a similar schedule for business rates.

22.8 Goods for own use

Traders will often take inventory out of their business for their own use without paying for them. There is nothing wrong about their doing this, but an entry should be made to record that this has happened. This is done by:

- 1 Debit drawings account, to show that the owner has taken the goods for private use.
- 2 Credit purchases account, to reduce cost of goods available for sale.

In the United Kingdom, an adjustment may be needed for Value Added Tax. If goods supplied to a trader's customers have VAT added to their price, then any such goods taken for own use will need such an adjustment. This is because the VAT regulations state that VAT should be added to the cost of goods taken. The double entry for the VAT amount would be:

- 1 Debit drawings account.
- 2 Credit VAT account.

Adjustments may also be needed for other private items. For instance, if a trader's private insurance (e.g. insurance premiums for the contents of the trader's home) had been incorrectly charged to the business insurance account, then the correction would be:

- 1 Debit drawings account.
- 2 Credit insurance account.

22.9 Distinctions between various kinds of capital

The capital account represents the claim the owner has against the assets of the business at a point in time. That is, the amount of the business that belongs to the owner. The word **capital** is, however, often used in a specific sense. The main meanings are listed below.

Capital invested

This means the total monetary value of everything brought into the business by the owners from their outside interests. The amount of capital invested is not affected by the amount of profits made by the business or losses incurred.

Capital employed

Students at an early stage in their studies are often asked to define this term. In fact, the term is often used quite loosely. If you progress to a more advanced stage in your studies, you will learn that capital employed could have several meanings. At its simplest, it is taken to mean the monetary value of the resources that are being used in the business. Thus, if all the assets were added together and the liabilities of the business deducted, the answer would be that the difference is the amount of money employed in the business. You will by now realise that this is the same as the closing balance of the capital account. It is also sometimes called 'net assets' or 'net worth'.

Working capital

This is a term for the excess of the current assets over the current liabilities of a business and is the same as **net current assets**.

22.10 Financial statements in the services sector

So far we have only looked at financial statements for businesses trading in some sort of goods. We drew up a trading account for some of these businesses because we wanted to identify the gross profit on goods sold.

There are, however, many businesses which do not deal in ‘goods’ but instead supply ‘services’. This will include professional businesses such as accountants, solicitors, doctors, dentists, vets, management consultants, advertising agencies, estate agents and internet service providers. Other examples include businesses specialising in computer repairs, window cleaning, gardening, hairdressing, chimney sweeping, piano tuning, and banks, football clubs, health clubs, gyms and leisure centres.

As they do not deal in ‘goods’ there is no point in their attempting to draw up trading accounts. While it is quite possible for, say, a dentist to treat depreciation on equipment, the costs of materials consumed, and the dental assistant’s salary as deductions from income in order to arrive at a figure for gross profit, such information is likely to be of little benefit in terms of decision-making.

The first item in the income statement of a service organisation will be the revenue. It might be called ‘work done’, ‘fees’, ‘charges’, ‘accounts rendered’, ‘takings’, etc., depending on the nature of the organisation. Any other items of income will be added, e.g. rent receivable, and then the expenses will be listed and deducted to arrive at a net profit or net loss.

An example of the income statement of a solicitor might be as shown in Exhibit 22.1:

Exhibit 22.1

J. Plunkett, Solicitor		
Income Statement for the year ending 31 December 2021		
	£	£
Revenue:		
Fees charged		87,500
Insurance commissions		<u>1,300</u>
		88,800
Less Expenses:		
Wages and salaries	29,470	
Rent and rates	11,290	
Office expenses	3,140	
Motor expenses	2,115	
General expenses	1,975	
Depreciation	<u>2,720</u>	
		(50,710)
Net profit		<u><u>38,090</u></u>

Other than for the descriptions given in the revenue section, it doesn’t look very different from the ones you’ve prepared for traders. In effect, if you can prepare an income statement for a trader, you can do so for a service organisation. You just need to remember that it will contain no trading account items and that the income will need to be appropriately described.

22.11 Extended trial balances

Instead of drafting a set of financial statements in the way shown so far in this textbook, you could prepare an **extended trial balance**, or ‘worksheet’. It can be very useful when there are a large number of adjustments to be made. Professional accountants use them a lot for that very reason.

Extended trial balances are usually drawn up on specially preprinted types of stationery with suitable vertical columns printed across the page. You start with the trial balance extracted from the ledgers and then enter adjustments in the columns to the right. Columns for the trading account, income statement, and the balance sheet then follow.

Exhibit 22.2 shows an example of the extended trial balance that could have been drawn up as an answer to Review question 22.11. Once you have attempted the question yourself, compare your answer to the one shown in Exhibit 22.2. The gross profits and net profits are the same; it is simply the method of displaying the information that is different.

If you look carefully, you will notice that all the journal entries are dealt with in one double column. That column has been split vertically in two. On the left is a sub-column for debit entries and, on the right, is a sub-column for credit entries. The reference number of each journal entry is placed to the right of each debit entry and each credit entry.

This makes it easy to detect errors in each entry, such as where a debit entry is for a different total amount than that shown in the relevant credit entry.

Activity 22.6

Why is identifying errors of this type easier when using an extended trial balance than when preparing the financial statements without using one?

Sometimes, students confuse their debits and their credits and switch the entries to the accounts, the one that should have been debited being credited, and vice versa. If this happens, the trial balance and the balance sheet will still balance, but the information contained in the balance sheet will be incorrect. This is no different from what may occur with journal entries being processed in 'the books', rather than in an extended trial balance. However, if the extended trial balance is prepared using a spreadsheet, correcting the entries and producing correct financial statements may be done considerably faster, which is one reason why it is wise to use a spreadsheet rather than paper to prepare an extended trial balance.

Another advantage of the use of a spreadsheet relates to how easy it is to amend adjustments. If profit is too high or too low, some businessmen will seek ways of using journal entries to adjust it down or up. If their accountant has an extended trial balance on a spreadsheet, this makes such sensitivity analysis very easy. Thankfully for everyone else, there are rules and regulations governing the adjustments that can be made (Chapter 7). However, there are times when for genuinely honest reasons, tinkering with the figures in this way may be appropriate.

Activity 22.7

List three examples of situations where this may be appropriate.

If you were an accountant, the financial statements you prepare and give to the owner and to anyone else who was an interested party, such as the Inspector of Taxes or a bank, would not be in the style of an extended trial balance. Instead, having completed the extended trial balance, the figures for the trading account, profit and loss, and balance sheet would be transferred to financial statements prepared using the conventional style of presentation.

To provide such special stationery in an examination is unusual, although it has been known to happen. For students to draw-up an extended trial balance from scratch could be very time-consuming. Therefore, it is very rare for examiners to ask for one to be prepared. However, the examiner may ask you something about extended trial balances (or worksheets) or provide a partially completed one to work on, if this topic is included in the syllabus. You should note, however, that nowadays spreadsheets are often used to produce financial statements in this way. If your course includes use of spreadsheets to prepare financial statements, you are more likely to be asked to prepare an extended trial balance in your examination or as part of your assessed coursework.

Exhibit 22.2

JOHN BROWN WORKSHEET See Review Question 22.11	Trial Balance		Adjustments		Trading Account		Profit and Loss Account		Balance Sheet	
	1	2	3	4	5	6	7	8	9	10
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Sales		400,000				400,000				
Purchases	350,000				350,000					
Sales returns	5,000				5,000					
Purchases returns		6,200				6,200				
Inventory 1.1.2023	100,000				100,000					
Allowance for doubtful debts		800		180 (iv)						980
Wages and salaries	30,000		5,000 (ii)				35,000			
Rates	6,000			500 (iii)			5,500			
Telephone	1,000		220 (v)				1,220			
Shop fittings	40,000			4,000 (vi)					36,000	
Van	30,000			6,000 (vi)					24,000	
Trade receivables	9,800								9,800	
Trade payables		7,000								7,000
Bad debts	200						200			
Capital		179,000								179,000
Bank	3,000								3,000	
Drawings	18,000								18,000	
	<u>593,000</u>	<u>593,000</u>							<u>120,000</u>	
Inventory 31.12.2023 – Asset			120,000 (i)	120,000 (i)		120,000				
Inventory 31.12.2023 – Cost of goods sold										
Accrued expenses				5,000 (ii)						5,000
				220 (v)						220
Allowance for doubtful debts			180 (iv)				180			
Prepaid expenses			500 (iii)							500
Depreciation shop fittings			4,000 (vi)				4,000			
Depreciation van			6,000 (vi)				6,000			
			<u>135,900</u>	<u>135,900</u>						
Gross profit (balancing figure)					71,200			71,200		
					<u>526,200</u>	<u>526,200</u>				
Net profit (balancing figure)							19,100			19,100
							<u>71,200</u>	<u>71,200</u>	<u>211,300</u>	<u>211,300</u>

22.12 Definition of accounting

In Chapter 1, you were given a definition of bookkeeping as being concerned with the work of entering information into accounting records and afterwards maintaining such records properly. This definition does not need to be amended.

However, **accounting** was not fully defined in Chapter 1. It would probably not have meant much to you at that stage in your studies. The following is a commonly used definition: ‘The process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information.’

22.13 An alternative way to record accruals and prepayments

You will have realised by now that there is sometimes more than one way to do something in accounting. If so, it will come as no surprise to you to learn that there is a second commonly used way to record accruals and prepayments. The alternative way to record accruals and prepayments requires that you create additional ledger accounts. You open an accruals account and a prepayments account and post any balances on expense accounts at the period end to the appropriate one of the two new accounts.

The balance carried down in an expense account under the method you learnt earlier in this chapter is described as either ‘accrued c/d’ or ‘prepaid c/d’. Under the alternative method, there would be no balance in the expense account after the double entry to the accruals account or prepayments account. Instead, there will be a balance on these two accounts which is then entered in the balance sheet in exactly the same way as you did under the other method.

At the start of the next period, you reverse the entry by crediting the prepayments account and debiting each of the expense accounts that had debit balances. Similarly, the accruals account is debited and the expense accounts that had credit balances are credited with the appropriate amounts.

For example, in the insurance account from Section 22.4, the entries in the insurance account were:

Insurance			
2021		£	
Feb 28	Bank	210	
Aug 31	Bank	420	
Nov 18	Bank	420	
		<u>1,050</u>	
2022			
Jan 1	Prepaid b/d	210	

2021		£	
Dec 31	Profit and loss	840	
	31 Prepaid c/d		<u>210</u>
			<u>1,050</u>

The same information if a prepayments account were used would be entered:

Insurance			
2021		£	
Feb 28	Bank	210	
Aug 31	Bank	420	
Nov 18	Bank	420	
		<u>1,050</u>	
2022			
Jan 1	Prepayments	210	

2021		£	
Dec 31	Profit and loss	840	
	31 Prepayments		<u>210</u>
			<u>1,050</u>

Prepayments					
2021		£		2021	£
Dec 31 Insurance		210		Dec 31 Balance c/d	210
2022				2022	
Jan 1 Balance b/d		210		Jan 1 Insurance	210

In reality, it doesn't matter which of these two methods you use. Examiners will accept them both unless they specifically ask for one of them to be used. Your teacher or lecturer will know whether this is likely to happen. Follow the guidance of your teacher or lecturer and use whichever method he or she indicates is more appropriate.

In order not to confuse things by switching back and forth between the two methods, all examples of accruals and prepayments and all questions involving accruals and prepayments in the rest of this textbook will use the first method that has been covered in detail in this chapter. Should you be using the second method, as you will have seen above, it is very obvious what the equivalent entries would be when you look at examples prepared using the method adopted in this textbook.

Mnemonic

The following acronyms may help you to remember the treatment of accruals and prepayments in the balance sheet:

PAPA and ALLA

Prepaid			<i>Treated as current</i>
Accrued	Expense	Asset	Liability
Prepaid	Revenue	Liability	Asset
Accrued			

Learning outcomes

You should now have learnt:

- 1 That adjustments are needed so that the expenses and income shown in the financial statements equal the expenses incurred in the period and the revenue that has arisen in the period.
- 2 That the balances relating to the adjustments will be shown on the balance sheet at the end of the period as current assets and current liabilities.
- 3 That goods taken for the owner's own use without anything being recorded in the books will necessitate a transfer from purchases to the drawings account, plus an adjustment for VAT if appropriate.
- 4 How to record appropriate entries in the accounts and financial statements at the end of a period for accrued expenses, prepaid expenses, accrued income, and drawings.
- 5 That private expenses should not be charged as an expense in the income statement but should be charged to the drawings account.





- 6 That an extended trial balance is an alternative way of arriving at the figures to be included in the financial statements.
- 7 That there are two common ways to prepare accruals and prepayments.

Now attempt Set 3 of multiple-choice questions. (Answers to all the multiple-choice questions are given in Appendix 2 at the end of this book.)

Answers to activities

22.1 Don't worry if you didn't know what names to give the accounts other than the rent account. What is important is that you thought about it and that you knew which side the entries should be in the rent account.

- | | |
|--|-----------------------------------|
| (a) <i>Dr</i> Rent account £1,000 | <i>Cr</i> Accruals account £1,000 |
| (b) <i>Dr</i> Prepayments account £500 | <i>Cr</i> Rent account £500 |

Note how the two entries in the rent account are on opposite sides. The £200 rent owing at the end of the year is an expense that has not yet been entered in the books, but it must be as it relates to the current year. The £100 paid in advance for next year is not an expense of the current year, so you need to reduce the amount you have currently in the rent account so that the correct expense will be included in the income statement. The accruals account is similar to a creditor's account, but it is used for expenses unpaid at the year end. Similarly, the prepayments account is like a debtor's account, but it is used to record amounts paid for expenses in advance of the accounting period in which the benefit (i.e. what was paid for) is received.

22.2 All the debit entries should be added together and shown as one entry called 'prepayments' within current assets. Similarly, all the credit entries should be added together and shown as one entry called 'accruals' under current liabilities. This is done so as to minimise the clutter in the balance sheet while providing enough information for anyone looking at the financial statement to be able to identify the figure for accruals and the figure for prepayments.

- 22.3** (a) Between trade receivables and bank.
 (b) Between trade payables and bank overdraft.
 (c) Their degree of liquidity.

22.4 They are usually added to trade receivables. This is because these represent a regular source of income and, even though the income has nothing to do with the goods or services that form the main activity of the business, they are in every other sense another form of customer account. It makes sense, therefore, to include them in the trade receivables balance shown in the balance sheet.

22.5

	£
Business rates due during the year	4,000
Add: Business rates accrued at the start of the year	<u>400</u>
	4,400
Less: Business rates paid during the year	<u>(5,000)</u>
Business rates prepaid at the end of the year	<u>(600)</u>

22.6 Under a conventional manual approach, the journal entries will be made in the accounts in the ledger, so changing the balances as shown in that book. If the amount debited is different from the amount credited, the ledger accounts used for these entries will need to be inspected in order to discover what the error was. Looking at the note of the journal entry in the journal is not likely to be of help. It will almost certainly show the same amounts in the debit and the credit parts of the entry. Errors in posting journal entries are usually made at the point of completion rather than at the point of origin.

With an extended trial balance, you take the balance on the ledger account before it was changed by the journal entry. You know that the balance on the ledger account is likely to be correct because your trial balance has balanced. In producing your financial statements, you do not first enter the

adjustments in your ledger. First, you complete your extended trial balance. You can then make the appropriate entries in the ledger and check the resulting balances against the figures shown in the extended trial balance.

Of course, you can take a similar approach using a conventional approach and make the adjustments to your trial balance on a piece of paper before entering numbers in your financial statements. However, it will lack the neatness and internal checks that are built into the matrix of the extended trial balance.

- 22.7** You could list a number of situations where this may be appropriate. For example, if sole proprietors are unhappy with the amount set aside as an allowance for doubtful debts, they could suggest a more appropriate figure and see if it was worth making the change. Another example would be where an error was found in the accounts that required changes to be made to some of the adjustments, such as depreciation or bad debts. Despite what many people believe, merchants do not generally adjust their accounting numbers simply to look better but, they do adjust them when it is believed to be appropriate to do so. Sometimes, things come to light after an extended trial balance has been prepared that should have been included in it.

Review questions

22.1 The financial year of S. Smith ended on 31 December 2016. Show the ledger accounts for the following items including the balance transferred to the necessary part of the financial statements, also the balances carried down to the next year:

- (a) Motor expenses: Paid in 2016 £1,400; Owing at 31 December 2016 £200.
- (b) Insurance: Paid in 2016 £1,700; Prepaid as at 31 December 2016 £130.
- (c) Computer supplies: Paid during 2016 £900; Owing as at 31 December 2015 £300; Owing as at 31 December 2016 £400.
- (d) Business rates: Paid during 2016 £5,600; Prepaid as at 31 December 2015 £580; Prepaid as at 31 December 2016 £560.
- (e) Smith sublets part of the premises. He receives £3,800 during the year ended 31 December 2016. West, the tenant, owed Smith £380 on 31 December 2015 and £420 on 31 December 2016.

22.2A W. Hope's year ended on 30 June 2020. Write up the ledger accounts, showing the transfers to the financial statements and the balances carried down to the next year for the following:

- (a) Stationery: Paid in the year to 30 June 2020 £240; Inventory of stationery at 30 June 2019 £60; at 30 June 2020 £95.
- (b) General expenses: Paid in the year to 30 June 2020 £470; Owing at 30 June 2019 £32; Owing at 30 June 2020 £60.
- (c) Rent and business rates (combined account): Paid in the year to 30 June 2020 £5,410; Rent owing at 30 June 2019 £220; Rent paid in advance at 30 June 2020 £370; Business rates owing 30 June 2019 £191; Business rates owing 30 June 2020 £393.
- (d) Motor expenses: Paid in the year to 30 June 2020 £1,410; Owing as at 30 June 2019 £92; Owing as at 30 June 2020 £67.
- (e) Hope earns commission from the sales of one item. Received in the year to 30 June 2020 £1,100; Owing at 30 June 2019 £50; Owing at 30 June 2020 £82.

22.3 On 1 January 2018 the following balances, among others, stood in the books of A. Cook, a sole proprietor:

- (a) Business rates, £600 (Dr);
- (b) Packing materials, £1,400 (Dr).





During the year ended 31 December 2018 the information related to these two accounts is as follows:

- (i) Business rates of £6,200 were paid to cover the period 1 April 2018 to 31 March 2019;
- (ii) £4,000 was paid for packing materials bought;
- (iii) £900 was owing on 31 December 2018 in respect of packing materials bought on credit;
- (iv) Old materials amounting to £300 were sold as scrap for £300 cash;
- (v) Closing inventory of packing materials was valued at £2,400.

You are required to write up the two accounts showing the appropriate amounts transferred to the income statement at 31 December 2018, the end of the financial year of the trader.

Note: Individual accounts are not opened for trade payables for packing materials bought on credit.

22.4A On 1 January 2019 the following balances, among others, stood in the books of B. Baxter:

- (a) Lighting and heating, (Dr) £192.
- (b) Insurance, (Dr) £1,410.

During the year ended 31 December 2019 the information related to these two accounts is as follows:

- (i) Fire insurance, £1,164 covering the year ended 31 May 2020 was paid.
- (ii) General insurance, £1,464 covering the year ended 31 July 2020 was paid.
- (iii) An insurance rebate of £82 was received on 30 June 2019.
- (iv) Electricity bills of £1,300 were paid.
- (v) An electricity bill of £162 for December 2019 was unpaid as on 31 December 2019.
- (vi) Oil bills of £810 were paid.
- (vii) Inventory of oil as on 31 December 2019 was £205.

You are required to write up the accounts for lighting and heating, and for insurance, for the year to 31 December 2019. Carry forward necessary balances to 2020.

22.5 Three of the accounts in the ledger of Charlotte Williams indicated the following balances at 1 January 2020:

Insurance paid in advance £562;
 Wages outstanding £306;
 Rent receivable, received in advance £36.

During 2020 Charlotte:

Paid for insurance £1,019, by bank standing order;
 Paid £15,000 wages, in cash;
 Received £2,600 rent, by cheque, from the tenant.

At 31 December 2020, insurance prepaid was £345. On the same day rent receivable in arrears was £105 and wages accrued amounted to £419.

- (a) Prepare the insurance, wages and rent receivable accounts for the year ended 31 December 2020, showing the year end transfers and the balances brought down.
- (b) Prepare the income statement extract showing clearly the amounts transferred from each of the above accounts for the year ending 31 December 2020.
- (c) Explain the effects on the financial statements of accounting for (i) expenses accrued and (ii) income received in advance at year end.
- (d) What are the purposes of accounting for (i) expenses accrued and (ii) income received in advance at year end?

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22.6A

- (a) Angela's business pays for its lighting and heating usage in arrears. The business's books showed an accrual in connection with lighting & heating expenses of £840 as at 1 January 2020 and an accrual of £910 as at 31 December 2020. The cash book revealed that the business made payments totalling £2,930 for lighting & heating during 2020. What figure should appear for 'lighting & heating expense' in Angela's Income Statement for the year ended 31 December 2020?
- (b) Lamb is a sole trader. His business's financial year ends on 31 July each year. Machine maintenance costs accrued of £325 as at 31 July 2019 were treated as prepaid in his Income Statement for the year ended 31 July 2019. Was his net profit for the year understated or overstated as a result, and by how much?
- (c) The annual insurance premium for Claire's business premises (covering the period 1 September 2018 to 31 August 2019) is £7,200, which is exactly 20% more than her previous year's premium. Claire paid the £7,200 in full on 15 August 2018. What will be the expense reported for premises insurance in Claire's Income Statement for her financial year ended 31 March 2019?
- (d) Denise's business pays £1,440 rent on 15 April 2018 in respect of the quarter ended 30 June 2018. She also pays an electricity bill of £864 covering energy used in the three months to 31 May 2018. The electricity bill was received on 10 June 2018, and Denise paid it on 20 June. Her financial year ends on 30 April 2018. What is the correct figure for accruals in Denise's Balance Sheet as at that date?
- (e) Erica's business produces its financial statements for the year to 31 August. The business pays its rent quarterly in advance on 1 January, 1 April, 1 July and 1 October each year. The annual rent was increased from £45,600 to £51,600 per year with effect from 1 April 2020. In Erica's business's financial statements for the year ended 31 August 2020, what figures should appear in the Income Statement and Balance Sheet in relation to rent?
- (f) Fiona runs a business which owns three delivery vans. As at 1 April, there were five months' van insurance prepaid totalling £565 and diesel costs accrued of £367. During April, the outstanding diesel costs were paid as well as additional bills of £886. At 30 April there are further outstanding unpaid diesel costs of £291. What is the total amount to be disclosed in Fiona's Income Statement for April in connection with van expenses?

22.7A The owner of a small business selling and repairing cars which you patronise has just received a copy of his financial statements for the current year.

He is rather baffled by some of the items and as he regards you as a financial expert, he has asked you to explain certain points of difficulty to him. This you have readily agreed to do. His questions are as follows:

- (a) 'What is meant by the term "assets"? My mechanical knowledge and skill is an asset to the business but it does not seem to have been included.'
- (b) 'The house I live in cost £130,000 five years ago and is now worth £360,000, but that is not included either.'
- (c) 'What is the difference between "non-current assets" and "current assets"?'
- (d) 'Why do amounts for "vehicles" appear under both non-current asset and current asset headings?'
- (e) 'Why is the "bank and cash" figure in the balance sheet different from the profit for the year shown in the income statement?'
- (f) 'I see the income statement has been charged with depreciation on equipment, etc. I bought all these things several years ago and paid for them in cash. Does this mean that I am being charged for them again?'



**Required:**

Answer each of his questions in terms which he will be able to understand.

(Association of Chartered Certified Accountants)

22.8 D. Staunton is a sole proprietor and you are given the following information relating to her business:

Trial balance as at 30 September 2024		Dr	Cr
		£	£
Trade receivables		73,200	
Business rates		19,978	
Trade payables			62,165
Returns outwards			2,064
Drawings		34,792	
Inventory as at 1 October 2023		25,967	
Utilities		18,603	
Wages & salaries		136,163	
Sales			592,013
Equipment:	at cost	188,760	
Delivery vans:	at cost	92,220	
Equipment:	accumulated depreciation at 1 Oct 2023		74,100
Delivery vans:	accumulated depreciation at 1 Oct 2023		60,720
Purchases		307,847	
Bank		1,337	
Bad debts expense		13,192	
Allowance for doubtful debts at 1 October 2023			2,240
Capital			118,757
		<u>912,059</u>	<u>912,059</u>

Additional information:

- 1 The inventory was counted at 30 September 2024 and was valued at £26,424.
- 2 Depreciation is to be applied at the following rates:

Equipment:	(reducing balance)	30%
Delivery vans:	(straight line)	20%

- 3 The amount shown for business rates on the trial balance includes a payment of £11,760, which represents twelve months' business rates to 31 January 2025.
- 4 Utilities charges incurred for which no invoices have yet been received amount to a total of £4,167.
- 5 Based on a careful analysis of the business's debt collection experience, the allowance for doubtful debts is to be set at 4% of trade receivables.

Required:

Prepare the following financial statements for D. Staunton's business:

- (a) An income statement for the year ended 30 September 2024.
- (b) A balance sheet as at 30 September 2024.

22.9 The trial balance for a small business at 31 August 2018 is as follows:

	£	£
Inventory 1 September 2017	8,200	
Purchases and sales	26,000	40,900
Rent	4,400	
Business rates	1,600	
Sundry expenses	340	
Motor vehicle at cost	9,000	
Trade receivables and payables	1,160	2,100
Bank	1,500	
Accumulated depreciation on motor vehicle at 1 September 2017		1,200
Capital at 1 September 2017		19,700
Drawings	11,700	
	<u>63,900</u>	<u>63,900</u>

As at 31 August 2018 the following matters also need to be addressed:

- Inventory valued at cost prices was £9,100
- Accrued rent of £400
- Prepaid business rates of £300
- The motor vehicle is to be depreciated at 20% of cost

Required:

- 1 The adjustments to the ledger accounts for rent and business rates for the year to 31 August 2018.
- 2 An income statement for the year ending 31 August 2018, together with a balance sheet as at that date.

22.10A Danielle is a sole proprietor and you are given the following information relating to her business:**Trial balance as at 30 April 2024**

	<i>Dr</i>	<i>Cr</i>
	£	£
Allowance for doubtful debts at 1 May 2023		4,184
Bad debts expense	24,856	
Bank		1,961
Capital		236,862
Carriage inwards	1,871	
Drawings	32,129	
Inventory as at 1 May 2023	23,130	
Machinery at cost	226,500	
Machinery: accumulated depreciation at 1 May 2023		80,220
Maintenance	20,544	
Motor expenses	18,837	
Motor vehicles at cost	169,140	
Motor vehicles: accumulated depreciation at 1 May 2023		54,360
Purchases	274,278	
Sales		548,555
Trade payables		63,140
Trade receivables	82,800	
Wages & salaries	115,197	
	<u>989,282</u>	<u>989,282</u>



**Additional information:**

- (i) The inventory was counted at 30 April 2024 and was valued at a cost of £24,010.
- (ii) Depreciation is to be applied at the following annual rates:
 - Machinery 20% (reducing balance)
 - Motor vehicles 25% (straight line)
- (iii) The amount shown for maintenance on the trial balance includes a payment of £9,480 which represents an annual maintenance contract to 30 June 2024.
- (iv) Motor expenses incurred for which no invoices have yet been received amount to a total of £5,348.
- (v) Based on an analysis of the business's experience with debt collection, the allowance for doubtful debts is to be set at 4% of trade receivables.

Required:

Prepare an income statement for Danielle's business for the year ended 30 April 2024 as well as a balance sheet as at that date.

22.11 *This question also relates to extended trial balances (see Exhibit 22.2).*

From the trial balance below of John Brown, store owner, prepare an income statement for the year ending 31 December 2023, and a balance sheet as at that date, also taking into consideration the six adjustments shown underneath:

Trial balance at 31 December 2023

	Dr	Cr
	£	£
Sales		400,000
Purchases	350,000	
Returns inwards	5,000	
Returns outwards		6,200
Inventory at 1 January 2023	100,000	
Allowance for doubtful debts at 1 January 2023		800
Wages & salaries	30,000	
Rates	6,000	
Telephone	1,000	
Shop fittings at carrying amount at 1 January 2023	40,000	
Van at carrying amount at 1 January 2023	30,000	
Trade receivables and trade payables	9,800	7,000
Bad debts expense	200	
Capital		179,000
Cash at bank	3,000	
Drawings	18,000	
	<u>593,000</u>	<u>593,000</u>

Adjustments needed:

- (i) Closing inventory on 31 December 2023 was £120,000 at cost.
- (ii) Accrued wages £5,000.
- (iii) Rates prepaid £500.
- (iv) The allowance for doubtful debts is to be set at 10% of trade receivables.
- (v) Telephone charges accrued £220.
- (vi) Depreciate shop fittings at 10% per annum, and van at 20% per annum, on carrying amount.

22.12A The following trial balance has been extracted from the ledger of Mr Yousef, a sole trader.

Trial Balance as at 31 May 2019

	<i>Dr</i>	<i>Cr</i>
	<i>£</i>	<i>£</i>
Sales		138,078
Purchases	82,350	
Carriage	5,144	
Drawings	7,800	
Rent, rates and insurance	6,622	
Postage and stationery	3,001	
Advertising	1,330	
Salaries and wages	26,420	
Bad debts	877	
Allowance for doubtful debts		130
Trade receivables	12,120	
Trade payables		6,471
Cash in hand	177	
Cash at bank	1,002	
Inventory as at 1 June 2018	11,927	
Equipment		
at cost	58,000	
accumulated depreciation as at 1 June 2018		19,000
Capital		53,091
	<u>216,770</u>	<u>216,770</u>

The following additional information as at 31 May 2019 is available:

- (a) Rent is accrued by £210.
- (b) Rates have been prepaid by £880.
- (c) £2,211 of carriage represents carriage inwards on purchases.
- (d) Equipment is to be depreciated at 15% per annum using the straight-line method.
- (e) The allowance for doubtful debts is to be increased by £40.
- (f) Inventory at the close of business has been valued at £13,551.

Required:

Prepare an income statement for the year ending 31 May 2019 and a balance sheet as at that date.

(Association of Accounting Technicians)

Multiple-choice questions: Set 3

Each of these multiple-choice questions has four suggested answers, (A), (B), (C) and (D). You should read each question and then decide which choice is best, either (A) or (B) or (C) or (D). Write down your answers on a separate piece of paper. You will then be able to redo the set of questions later without having to try to ignore your answers.

MC41 Which of the following do *not* affect trial balance agreement?

- (i) Sales £105 to A. Henry entered in P. Henry account
- (ii) Cheque payment of £134 for Motor expenses entered only in Cash Book
- (iii) Purchases £440 from C. Browne entered in both accounts as £404
- (iv) Wages account added up incorrectly, being totalled £10 too much
- (A) (i) and (iv)
- (B) (i) and (iii)
- (C) (ii) and (iii)
- (D) (iii) and (iv)

MC42 A business has an item in inventory that originally cost £140 and usually sells for £200. But it is damaged, and before it can be sold for £200 it must be repaired at a cost of £50. Selling costs are expected to amount to 10% of selling price. The item should be valued in inventory at:

- (A) £135
- (B) £90
- (C) £130
- (D) £140

MC43 A business has just completed its first year of trading. The cost of its closing inventory valued using the AVCO method is £7,300. If the FIFO method had been used it would have been £8,100. The effect of adopting FIFO instead of AVCO on this business's first set of annual financial statements would be:

- (A) To increase total assets, with no effect on profit
- (B) To increase current assets and increase gross profit
- (C) To increase net assets and reduce net profit
- (D) To increase non-current assets and increase net profit

MC44 At the start of the year, a business's allowance for doubtful debts was £19,000. The business wrote off bad debts of £92,000 during the year. At the end of the year the business requires an allowance of £23,000. What is the total charge in relation to bad and doubtful debts in the income statement for the year?

- (A) £92,000
- (B) £88,000
- (C) £115,000
- (D) £96,000

MC45 At its year end, a business has outstanding trade receivables totalling £90,000. The balance on the allowance for doubtful debts account brought forward from the previous year is £4,000. Based on an analysis of the business's debt collection experience, an allowance for doubtful debts equal to 4% of trade receivables is required. What is the correct entry to record this?

- (A) Dr Bad debt expense £400, Cr Allowance for doubtful debts £400
- (B) Dr Allowance for doubtful debts £400, Cr Bad debt expense £400
- (C) Dr Bad debt expense £3,600, Cr Allowance for doubtful debts £3,600
- (D) Dr Allowance for doubtful debts £3,600, Cr Bad debt expense £3,600

MC46 A business acquires some new equipment, incurring a total cost of £33,000. This amount is made up of purchase price £31,180, delivery costs £570, installation charges £440, and one year's maintenance cover £810. What is the total capital expenditure?

- (A) £32,190
- (B) £31,750
- (C) £32,430
- (D) £32,560

MC47 A business buys a machine for £45,000 which it believes will last for ten years, after which it will be worth £5,000. Using the straight line method of depreciation, what will be the machine's carrying amount (or 'net book value') after three years of use?

- (A) £30,000
- (B) £31,500
- (C) £33,000
- (D) £28,000

MC48 A business buys a piece of equipment for £72,000 and depreciates it at 25% per year using the reducing balance method. What is the depreciation expense in the third year of use?

- (A) £10,125
- (B) £18,000
- (C) £30,375
- (D) £13,500

MC49 A business buys a machine for £40,000 and depreciates it at 20% per year on a straight line basis. After exactly three years it is sold for £19,000. What is the profit or loss on disposal?

- (A) £3,000 loss
- (B) £3,000 profit
- (C) £1,480 profit
- (D) £1,480 loss

MC50 Credit notes issued by us will be entered in our

- (A) Sales Account
- (B) Returns Inwards Account
- (C) Returns Inwards Book
- (D) Returns Outwards Book

MC51 The total of the Returns Outwards Book is transferred to

- (A) The credit side of the Returns Outwards Account
- (B) The debit side of the Returns Outwards Account
- (C) The credit side of the Returns Outwards Book
- (D) The debit side of the Purchases Returns Journal

MC52 We originally sold 25 items at £12 each, less $33\frac{1}{3}$ per cent trade discount. Our customer now returns 4 of them to us. What is the amount of credit note to be issued?

- (A) £48
- (B) £36
- (C) £30
- (D) £32





MC53 Depreciation is

- (A) The amount spent to buy a non-current asset
- (B) The salvage value of a non-current asset
- (C) The part of the cost of the non-current asset consumed during its period of use by the firm
- (D) The amount of money spent replacing non-current assets

MC54 A firm bought a machine for £3,200. It is to be depreciated at a rate of 25 per cent using the reducing balance method. What would be the carrying amount after two years?

- (A) £1,600
- (B) £2,400
- (C) £1,800
- (D) Some other figure

MC55 A firm bought a machine for £16,000. It is expected to be used for five years then sold for £1,000. What is the annual amount of depreciation if the straight line method is used?

- (A) £3,200
- (B) £3,100
- (C) £3,750
- (D) £3,000

MC56 At the balance sheet date the balance on the Accumulated Depreciation Account is

- (A) Transferred to the Depreciation account
- (B) Transferred to Profit and Loss
- (C) Simply deducted from the asset in the Balance Sheet
- (D) Transferred to the Asset account

MC57 In the trial balance the balance on the Accumulated Depreciation Account is

- (A) Shown as a credit item
- (B) Not shown, as it is part of depreciation
- (C) Shown as a debit item
- (D) Sometimes shown as a credit, sometimes as a debit

MC58 If an accumulated depreciation account is in use then the entries for the year's depreciation would be

- (A) Credit Accumulated Depreciation Account, debit Depreciation expense
- (B) Debit Asset Account, credit Depreciation expense
- (C) Credit Asset Account, debit Accumulated Depreciation Account
- (D) Credit Depreciation expense, debit Accumulated Depreciation Account

MC59 When the financial statements are prepared, the Bad Debts Account is closed by a transfer to the

- (A) Balance Sheet
- (B) Profit and Loss Account
- (C) Trading Account
- (D) Allowance for Doubtful Debts Account

MC60 An Allowance for Doubtful Debts is created

- (A) When debtors become bankrupt
- (B) When debtors cease to be in business
- (C) To provide for possible bad debts
- (D) To write-off bad debts

CONTROLS, CHECKS AND ERRORS

Introduction

This part presents an overview of the methods used to check for and correct errors in the accounting records. The preparation of financial statements when the underlying records are incomplete is also considered.

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The Scenario questions take the knowledge you have acquired in Parts 1 to 4 and apply it to what you have learnt in Part 5.

Control accounts

Learning objectives

After you have studied this chapter, you should be able to:

- Explain why control accounts can be useful.
- Draw up sales ledger control accounts.
- Draw up purchases ledger control accounts.
- Reconcile the purchases ledger and the sales ledger with their respective control accounts.

Introduction

In this chapter, you'll learn about the benefits of using control accounts in manual accounting systems and the process involved in both preparing control accounts and reconciling them to the ledgers.

23.1 The benefits of accounting controls

In any but the smallest business, the accounting information system is set up so as to include controls that help ensure that errors are minimised and that nothing occurs that shouldn't, such as the cashier embezzling funds. One of the tasks undertaken by auditors is to check the various controls that are in place to ensure they are working satisfactorily and one of the things they will look out for is segregation of duties. So, for example, the same person will not both invoice customers and act as cashier when payment is received; and, if someone claims reimbursement of an expense, it will be authorised for payment by someone else. Another form of control you've already learnt about involves whether or not customers are allowed to purchase goods on credit.

All these controls are 'organisational'. That is, they do not directly impose controls over the accounting data, nor do they ensure that accounting entries are correct. One control measure that does these things will be covered in Chapter 24 – the process of bank reconciliation. In this chapter, we'll look at another type of accounting control which is used mainly in manual accounting systems, **control accounts**.

When all the accounts were kept in one ledger, a trial balance could be drawn up as a test of the arithmetical accuracy of the accounts. If the trial balance totals disagree, the books of a small business could easily and quickly be checked so as to find the errors. Of course, as you know, even when the totals do agree, certain types of error may still have occurred, the nature of which makes it impossible for them to be detected in this way. Nevertheless, using a trial balance ensures that all the double entries appear, at least, to have been recorded correctly.

Activity 23.1

How do you find errors of the types that a trial balance cannot detect?

When a business has grown and the accounting work has been spread across several ledgers, the debits and credits would only balance when you combined them all together. Any errors could be very difficult to find if a trial balance was the only device used to try to detect errors. Every item in every ledger may need to be checked just to find one error that caused the trial balance not to balance. What is required is a type of trial balance for each ledger, and this requirement is met by control accounts. A control account is a summary account that enables you to see at a glance whether the general ledger account balance for the ledger to which that control account belongs agrees with the total of all the individual accounts held within that ledger.

If you use control accounts, only the ledgers where the control accounts do not balance need detailed checking to find errors.

23.2 Principle of control accounts

The principle on which the control account is based is simple and is as follows: if the opening balance of an account is known, together with information of the additions and deductions entered in the account, the closing balance can be calculated.

Applying this to a complete ledger, the total of opening balances together with the additions and deductions during the period should give the total of closing balances. This can be illustrated by reference to a sales ledger for entries for a month:

	£
Total of opening balances, 1 January 2019	3,000
Add Total of entries which have increased the balances	9,500
	<u>12,500</u>
Less Total of entries which have reduced the balances	(8,000)
Total of closing balances should be	<u><u>4,500</u></u>

Because totals are used, control accounts are sometimes known as **total accounts**. Thus, a control account for a sales ledger could be known as either a **sales ledger control account** or as a **total trade receivables account**.

Similarly, a control account for a purchases ledger could be known either as a **purchases ledger control account** or as a **total trade payables account**.

A control account is a memorandum account. It is not part of the double entry system. It will be prepared either in the general ledger or in the ledger to which it relates, i.e. the purchases ledger or the sales ledger.

A control account looks like any other T-account:

Sales Ledger Control									
2019			£		2019			£	
Jan	1	Balances b/d	x,xxx		Jan	31	Returns Inwards Day Book (total of all goods returned from debtors in the period)	xxx	
	31	Sales day book (total of sales invoiced in the period)	xx,xxx			31	Cash book (total of all cash received from debtors in the period)	x,xxx	
						31	Cash book (total of all cheques received from debtors in the period)	xx,xxx	
						31	Balances c/d	x,xxx	
			<u><u>xx,xxx</u></u>					<u><u>xx,xxx</u></u>	

23.3 Information for control accounts

Exhibits 23.1 and 23.2 list the sources of information used to draw up control accounts.

Exhibit 23.1

Sales Ledger Control	Source
1 Opening trade receivables	List of debtor balances drawn up at the end of the previous period
2 Credit sales	Total from the Sales Day Book
3 Returns inwards	Total of the Returns Inwards Day Book
4 Cheques received	Cash Book: bank column on received side. List extracted or the total of a special column for cheques which has been included in the Cash Book
5 Cash received	Cash Book: cash column on received side. List extracted or the total of a special column for cash which has been included in the Cash Book
6 Discounts allowed	Total of discounts allowed column in the Cash Book
7 Closing trade receivables	List of debtor balances drawn up at the end of the period

Exhibit 23.2

Purchases Ledger Control	Source
1 Opening trade payables	List of creditor balances drawn up at the end of the previous period
2 Credit purchases	Total from Purchases Day Book
3 Returns outwards	Total of Returns Outwards Day Book
4 Cheques paid	Cash Book: bank column on payments side. List extracted or total of a special column for cheques which has been included in the Cash Book
5 Cash paid	Cash Book: cash column on payments side. List extracted or total of a special column for cash which has been included in the Cash Book
6 Discounts received	Total of discounts received column in the Cash Book
7 Closing trade payables	List of creditor balances drawn up at the end of the period

23.4 Form of control accounts

As shown in Section 23.2, control accounts kept in the general ledger are normally prepared in the same form as an account, with the totals of the debit entries in the ledger on the left-hand side of the control account, and the totals of the various credit entries in the ledger on the right-hand side.

The process is very straightforward. Take the sales ledger as an example. The first two steps are identical to those you learnt in Chapters 12 and 14.

- 1 Individual amounts received from debtors are transferred from the cash book into the personal accounts in the sales ledger. (The double entry is completed automatically in the normal way, because the cash book is, in itself, a ledger account.)
- 2 Individual invoice amounts are transferred from the sales day book into the personal accounts in the sales ledger. (You would complete the double entry in the normal way, by crediting the sales account.)
- 3 The sales ledger control account would open each period with the total of the trade receivables balances at the start of the period.
- 4 Then, post the total of the returns inwards day book to the credit side of the sales ledger control account. **(This is new.)**
- 5 At the end of the period, you post the totals of all the payments from debtors received during the period from the cash book to the credit side of the sales ledger control account. **(This is new.)**
- 6 This is followed by posting to the debit side of the sales ledger control account the totals of all new sales during the period shown in the sales day book. **(This is new.)**
- 7 Balance-off the control account.
- 8 Check whether the balance on the control account is equal to the total of all the trade receivables balances in the sales ledger.

If the balance is not the same as the total of all the balances in the sales ledger, there is an error either in the totals entered in the control account from the books of original entry or, more likely, somewhere in the sales ledger.

Note: You do not enter the total of the balances from the sales ledger in the control account. Instead, you balance-off the control account and check whether the balance c/d is the same as the total of all the individual balances in the sales ledger.

Activity 23.2

If you look at these eight steps, you can see that the first three are those you learnt to do earlier in the book, so you know that the other part of the double entry has been completed in the normal way. However, what about the double entries for (4), (5) and (6)? What is the other side of the double entry in each case?

Exhibit 23.3 shows an example of a sales ledger control account for a sales ledger in which all the entries are arithmetically correct and the totals transferred from the books of original entry are correct.

Exhibit 23.3

Sales Ledger Control Account data:	£
Trade receivables balances on 1 January 2019	1,894
Total credit sales for the month	10,290
Cheques received from customers in the month	7,284
Cash received from customers in the month	1,236
Returns inwards from customers during the month	296
Trade receivables balances on 31 January as extracted from the Sales Ledger	3,368

Sales Ledger Control

2019	£	2019	£
Jan 1 Balances b/d	1,894	Jan 31 Bank	7,284
31 Sales	10,290	31 Cash	1,236
		31 Returns inwards	296
		31 Balances c/d	3,368
	<u>12,184</u>		<u>12,184</u>

We have proved the ledger to be arithmetically correct, because the control account balances with the amount equalling the total of the balances extracted from the sales ledger.

Like a trial balance, if the totals of a control account are not equal and the entries made to it were correct (i.e. the amounts transferred to it from the books of original entry have been correctly summed), this shows that there is an error somewhere in the ledger.

Exhibit 23.4 shows an example where an error is found to exist in a purchases ledger. The ledger will have to be checked in detail, the error found, and the control account then corrected.

Exhibit 23.4

Purchases Ledger Control Account data:	£
Trade payables balances on 1 January 2019	3,890
Cheques paid to suppliers during the month	3,620
Returns outwards to suppliers in the month	95
Bought from suppliers in the month	4,936
Trade payables balances on 31 January as extracted from the Purchases Ledger	5,151

Purchases Ledger Control

2019	£	2019	£
Jan 31 Bank	3,620	Jan 1 Balances b/d	3,890
31 Returns outwards	95	31 Purchases	4,936
31 Balances c/d	5,151		
	<u>8,866*</u>		<u>8,826^(Note)</u>

***Providing all the totals transferred into the Purchases Ledger Control Account from the books of original entry were correct, there is a £40 difference between the debit and credit entries in the Purchases Ledger.**

We will have to check the purchases ledger in detail to find the error. A double line has not yet been drawn under the totals. We will do this (known as 'ruling off the account') when the error has been found and the totals corrected.

Note: You need to be sure that the totals transferred from the books of original entry were correct before assuming that an out-of-balance control account means that the ledger is incorrect.

23.5 Other advantages of control accounts in a manual accounting system

Control accounts are usually only maintained in a manual accounting system. They are not normally maintained in a computerised accounting system.

Control accounts have merits other than that of locating errors. When used, control accounts are normally under the charge of a responsible official, and fraud is made more difficult because transfers made (in an effort) to disguise frauds will have to pass the scrutiny of this person.

The balances on the control account can always be taken to equal trade receivables and trade payables without waiting for an extraction of individual balances. Management control is thereby aided, for the speed at which information is obtained is one of the prerequisites of efficient control.

23.6 Other sources of information for control accounts

With a large organisation there may well be more than one sales ledger or purchases ledger. The accounts in the sales ledgers may be divided up in ways such as:

- alphabetically: thus we may have three sales sub-ledgers split A–F, G–O and P–Z;
- geographically: this could be split: Europe, Far East, Africa, Asia, Australia, North America and South America.

For each of these sub-ledgers we must have a separate control account. An example of a columnar sales day book is shown as Exhibit 23.5:

Exhibit 23.5

Date	Details	Columnar Sales Day Book		Ledgers		
		Total	A–F	G–O	P–Z	
2019		£	£	£	£	
Feb	1 J. Archer	58	58			
	3 G. Gaunt	103		103		
	4 T. Brown	116	116			
	8 C. Dunn	205	205			
	10 A. Smith	16				16
	12 P. Smith	114				114
	15 D. Owen	88		88		
	18 B. Blake	17	17			
	22 T. Green	1,396		1,396		
	27 C. Males	48		48		
		<u>2,161</u>	<u>396</u>	<u>1,635</u>		<u>130</u>

The total of the A–F column will be the total sales figures for the Sales Ledger A–F control account, the total of the G–O column for the G–O control account, and so on.

A similar form of analysis can be used in the purchases day book, the returns inwards day book, the returns outwards day book and the cash book. The *totals* necessary for each of the control accounts can be obtained from the appropriate columns in these books.

Other items, such as bad debts written off or transfers from one ledger to another, will be recorded in the journal.

23.7 Other transfers

Transfers to bad debt accounts will have to be recorded in the sales ledger control account as they involve entries in the sales ledger.

Similarly, a contra account, whereby the same entity is both a supplier and a customer, and inter-indebtedness is offset, will also need to be entered in the control accounts. An example of this follows:

- (A) The business has sold A. Hughes £600 goods.
- (B) Hughes has supplied the business with £880 goods.
- (C) The £600 owing by Hughes is offset against £880 owing to him.
- (D) This leaves £280 owing to Hughes.

Sales Ledger A. Hughes			
Sales	(A)	£ 600	

Purchases Ledger A. Hughes			
		Purchases	(B) £ 880

The offset now takes place following the preparation of a journal entry in the journal:

Sales Ledger A. Hughes			
Sales	(A)	£ <u>600</u>	Offset: Purchases ledger (C) £ 600

Purchases Ledger A. Hughes			
Offset: Sales ledger (C)		£ 600	Purchases (B) £ 880
Balance c/d (D)		280	
		<u>880</u>	
			Balance b/d (D) <u>280</u>

The offset will be posted from the journal to the credit side of the sales ledger control account and to the debit side of the purchases ledger control account.

23.8 A more complicated example

Exhibit 23.6 shows a worked example of a more complicated control account.

The balances in the sales ledger are usually debit balances. However, there are sometimes credit balances in the sales ledger as well as debit balances. Suppose for instance we sold £500 goods to W. Young, he then paid in full for them, and then afterwards he returned £40 goods to us. This would leave a credit balance of £40 on the account.

Exhibit 23.6

2019		£
Aug	1 Sales ledger – debit balances	3,816
	1 Sales ledger – credit balances	22
	31 Transactions for the month:	
	Cash received	104
	Cheques received	6,239
	Sales	7,090
	Bad debts written off	306
	Discounts allowed	298
	Returns inwards	664
	Cash refunded to a customer who had overpaid his account	37
	Dishonoured cheques	29
	Interest charged by us on overdue debt	50
	At the end of the month:	
	Sales ledger – debit balances	3,429
	Sales ledger – credit balances	40
Sales Ledger Control Account		
2019		£
Aug	1 Balances b/d	3,816
	31 Sales	7,090
	Cash refunded	37
	Bank: dishonoured cheques	29
	Interest on debt	50
	Balances c/d	40
		<u>11,062</u>
2019		£
Aug	1 Balances b/d	22
	31 Cash	104
	Bank	6,239
	Bad debts	306
	Discounts allowed	298
	Returns inwards	664
	Balances c/d	3,429
		<u>11,062</u>

Note that you do *not* offset the debit and credit balances in the Sales Ledger.

23.9 Control accounts as part of a double entry system

Many students find control accounts confusing. This is because, as shown in Section 23.4, the existence of a control account requires extra entries to be made in the accounts over and above those that would be made were a control account not being used.

What you need to realise is that the double entry belongs to the original entries in the accounts. For example, if a debtor pays the amount due on his account, you credit the account of the debtor and debit the bank account. No entry is made in the sales ledger control account at this stage. As a result, the double entry is the same, irrespective of whether or not there is a control account.

When an entry is made to the control account, it includes all movements on the personal accounts, not just the amount in the single debtor example above. There may be payments from 5 debtors or 50 or 500 included in the amount posted to the control account. And, the posting is from the Cash Book for payments received from debtors; and from the Sales Day Book for sales to debtors. It is not from the individual debtor accounts.

It is at this point that confusion sets in – where is the second part of this ‘double entry’? The answer is: there isn’t one. **The posting to the control account is not part of a double entry.** Think of it as equivalent of posting each receipt from each debtor to the debtor’s account and then writing the total cash received from all the debtors on a piece of paper. The control account is that ‘piece of paper’. It is a note, a helpful piece of information.

If the control account is kept in the subsidiary ledger – the Sales Ledger in this example – all it shows is the total of all the amounts received from debtors, the total of all credit sales to debtors, plus the opening balance. You can then take these three numbers and discover the closing balance on your Sales Ledger:

Opening Balance + Credit Sales to Debtors – Amounts received from Debtors

When preparing a trial balance, you can include that balance rather than all the individual debtor account balances.

If the control account is kept in the General Ledger, it is considered to be part of the double entry system **because the General Ledger will balance without any need to include balances on accounts held in subsidiary ledgers.**

Activity 23.3

Why may some people consider this to be incorrect? That is, why is the fact that the control account is kept in the General Ledger *not* enough to justify saying that the control account is part of the double entry system?

This is not strictly correct. Yet, organisations that operate control accounts for their subsidiary ledgers often keep them in the General Ledger and view them as an integral part of the double entry system. When a trial balance is extracted, it is always the balances on the control accounts that are used rather than the balances on all the individual personal accounts.

When this is the case, the Sales Ledger and the Purchases Ledger are described as ‘memorandum books’ lying outside the double entry system.

This is technically incorrect but, when control accounts are kept in the General Ledger, it is ‘normal’ practice to describe the subsidiary ledgers in this way. **You need to be aware of this and to use the terminology in this way because it is what your examiners expect.**

In organisations **where the control accounts are kept in the subsidiary ledgers, the control accounts are not considered to be part of the double entry system.** In this case, the control account is normally described as a ‘memorandum entry’ in the individual subsidiary ledgers. The individual personal accounts in those subsidiary entries *are* considered to be part of the double entry system; and the subsidiary ledgers *are not* considered to be memorandum books.

Despite this difference in terminology, the same entries are made to control accounts kept in a General Ledger as are made to control accounts kept in subsidiary ledgers. In addition, it is the balance on the control account that is used in a trial balance, irrespective of whether it is kept in the General Ledger or in a subsidiary ledger.

Summing-up, it does not matter where a control account is kept. It is compiled in the same way and it is used in the same way. The artificial distinction concerning its place inside or outside the double entry system attributed to it depending upon the ledger in which it appears developed through custom and practice over many centuries. Control accounts are not part of a double entry system because the entries within them are not made using double entry principles. If you remember this point, you should find it relatively easy to understand the principles of control accounts.

Finally, do not confuse control accounts, which are used in order to operate subsidiary ledgers more efficiently, with wage control accounts which are used to maintain an element of control over the amounts paid relating to wages and salaries. Control accounts relate to subsidiary ledgers. Wages control accounts relate solely to wages and salaries. The two items both contain the word, 'control' in their title, but that is the only thing they have in common.

23.10 Self-balancing ledgers and adjustment accounts

Because ledgers which have a control account system are proved to be correct as far as the double entry is concerned, they used to be called **self-balancing ledgers**. The control accounts were often called **adjustment accounts**. These terms are very rarely used nowadays, but you should remember them in case an examiner uses them.

23.11 Reconciliation of control accounts

Errors and omissions can occur when entering information into the accounting records. You will see in Chapter 24 how these are identified and used to reconcile differences between the bank account and the bank statement balances. When a ledger control account is not in balance, it indicates that something has gone wrong with the entries made to the accounting records. This leads to an investigation which (hopefully) reveals the cause(s). Then, in order to verify whether the identified item(s) caused the failure to balance the control account, a reconciliation is carried out.

Exhibit 23.7 shows an example of a **purchases ledger control account reconciliation**. It takes the original control account balance and adjusts it to arrive at an amended balance which should equal the revised total of the source amounts that, together, equal the control account balance.

You will see in Chapter 24 that this general approach is similar to that adopted for bank reconciliation statements. However, as each control account may be constructed using information from a number of sources (see Section 23.3) the extent of the investigation to identify the cause of the control account imbalance is likely to be far greater than that undertaken when performing a bank reconciliation.

Exhibit 23.7

An example of a Purchases Ledger Control Account Reconciliation

	£
Original purchases ledger control account balance	xxx
Add Invoice omitted from control account, but entered in Purchases Ledger	xxx
Supplier balance excluded from Purchases Ledger total because the account had been included in the Sales Ledger by mistake	xxx
Credit sale posted in error to the debit of a Purchases Ledger account instead of the debit of an account in the Sales Ledger	xxx
Undercasting error in calculation of total end of period creditors' balances	xxx
	xxx

Less	Customer account with a credit balance included in the Purchases Ledger that should have been included in the Sales Ledger	(xxx)
	Return inwards posted in error to the credit of a Purchases Ledger account instead of the credit of an account in the Sales Ledger	(xxx)
	Credit note entered in error in the Returns Outwards Day Book as £223 instead of £332	(xxx)
	Revised purchases ledger control account balance obtained from revised source amounts	<u>xxx</u>

23.12 A cautionary note

Students often get the following wrong: **only credit purchases are recorded in a Purchases Ledger control account**. Also, **in Sales Ledger control accounts, do not include cash sales or allowances for doubtful debts**.

23.13 Finally

Control accounts are used in manual accounting systems. Most computerised accounting systems automatically provide all the benefits of using control accounts without the necessity of actually maintaining them. This is because computerised accounting systems automatically ensure that all double entries are completed, so ensuring that all the ledgers balance. Of course, errors can still arise, such as a posting made to the wrong ledger account, but not errors of the type that control accounts can detect.

Learning outcomes

You should now have learnt:

- 1 How to prepare control accounts.
- 2 How to prepare a control account reconciliation.
- 3 That control accounts enable errors to be traced down to the ledger that does not balance. Thus, there will be no need to check all the books in full to find an error.
- 4 That transfers between sales and purchases ledgers should be prepared in the journal and shown in the control accounts.
- 5 That control accounts for most businesses are outside the double entry system and are kept as memorandum accounts in the general ledger or in the individual ledgers.
- 6 That control accounts of large organisations may be part of the double entry system, which means that the sales ledger and purchases ledger are treated as memorandum books outside the double entry system. The entries to such control accounts are the same as for control accounts that lie outside the double entry system.
- 7 That control accounts are normally only used in manual accounting systems.

Answers to activities

23.1 These errors tend to be detected either as the result of someone drawing attention to an entry that appears to be incorrect or as the result of sample checking of the entries that have been made in the accounting books. A debtor may, for example, question whether the amount on an invoice is correctly summed or suggest that one of the invoices listed in the debtor's monthly statement had nothing to do with the debtor. One of the tasks that auditors carry out involves checking a sample of the transactions during a period so as to determine the level of errors within the entries made relating to them. If the level of error detected is considered material, a more extensive check will be carried out.

23.2 The other side of these three double entries are:

- (4) A debit to the returns inwards account.
- (5) The other side of this double entry was done earlier at the time when the individual amounts received from debtors were posted as credits to the individual debtor accounts in the sales ledger. That is, *the other side of this double entry was all the debit entries to the cash book* (see Chapter 12). The posting of each receipt as a credit to the individual debtor accounts done in step (1) is actually a memorandum entry and does not form part of the double entry system. So, in effect, the sales ledger has been taken out of the double entry system and is now a memorandum book. *To summarise, step (5) is actually the credit side of the double entry whose debit side is all the debit entries in the cash book.*
- (6) The other side of the double entry was done earlier at the time when each sale was posted from the sales day book to the individual trade receivables accounts in the sales ledger. That is, *the other side of this double entry was the credit entry made when the total of the sales shown in the sales day book was posted to the sales account in the general ledger* (see Chapter 14). The posting of each sale as a debit to the individual trade receivables accounts done in step (2) is actually a memorandum entry and does not form part of the double entry system. *To summarise, step (6) is actually the debit side of the double entry whose credit side is all the credit entries in the sales account.*

23.3 The double entry system involves the entry of financial transactions into accounts using the principle of at least one debit entry for every credit entry, and vice versa. Entries into control accounts are **supplementary one-sided entries** for which there is no debit to match the credit or credit to match the debit. They are simply summary statements constructed in the form of an account.

The balance they produce does reflect the balance on the subsidiary ledger to which they relate, but only because the totals of all the entries into the subsidiary ledgers have been calculated and inserted into the control accounts. They are not, and never could be, 'part of the double entry system'. However, for simplicity, when control accounts are kept in the General Ledger, they are referred to in this (incorrect) way.

Review questions

23.1 You are required to prepare a sales ledger control account from the following information for the month of June:

		£
June	1 Sales ledger balances	51,700
	Totals for June:	
	Sales day book	39,600
	Returns inwards day book	1,200
	Cheques and cash received from customers	40,100
	Discounts allowed	700

23.2A You are required to prepare a purchases ledger control account from the following information for the month of July:

			£
July	1	Purchases ledger balances	31,278
		Totals for July:	
		Purchases day book	22,451
		Returns outwards day book	898
		Cheques paid to suppliers	23,710
		Discounts received from suppliers	224

23.3 Prepare a sales ledger control account for the month of July from the following information:

	£
Total trade receivables at 1 July	27,890
Totals for July:	
Sales daybook	24,200
Returns inwards daybook	1,700
Cheques and bank transfers received from credit customers	23,500
Bad debts written off	620
Debit balances on the sales ledger set-off against credit balances on the purchases ledger	230

23.4A Prepare a sales ledger control account from the following information for May, carrying down the balance at 31 May:

			£
May	1	Sales ledger balances	39,953
		<i>Totals for May:</i>	
		Sales day book	28,487
		Bad debts written off	854
		Cheques received from debtors	25,224
		Discounts allowed	282
		Cheques dishonoured	178
		Returns inwards	1,435
		Set-offs against balances in purchases ledger	502

23.5 The trial balance of Outsize Books Ltd revealed a difference in the books. In order that the error(s) could be located it was decided to prepare purchases and sales ledger control accounts.

From the following information prepare the control accounts and show where an error may have been made:

2024			£
Jan	1	Purchases ledger balances	19,420
		Sales ledger balances	28,227
		Totals for the year 2024	
		Purchases journal	210,416
		Sales journal	305,824
		Returns outwards journal	1,452
		Returns inwards journal	3,618
		Cheques paid to suppliers	205,419





		Petty cash paid to suppliers	62
		Cheques and cash received from customers	287,317
		Discounts allowed	4,102
		Discounts received	1,721
		Balances on the sales ledger set off against balances in the purchases ledger	640
Dec	31	The list of balances from the purchases ledger shows a total of £20,210 and that from the sales ledger a total of £38,374	

23.6 The following information relates to the business of Romelu for the year ended 31 December 2020:

	£
Doubtful debts to be allowed for (in addition to those written-off)	660
Discounts received	1,310
Cash sales	1,490
Returns outwards (of goods previously bought on credit)	2,330
Discounts allowed	3,160
Bad debts written-off during 2020	4,770
Returns inwards (of goods previously sold on credit)	8,150
Total trade payables at 1.1.2020	16,400
Total trade receivables at 1.1.2020	23,220
Amounts paid to credit suppliers	109,040
Credit purchases	114,800
Cash from credit customers (including £370 from a customer whose debt was written off in 2019)	146,980
Credit sales	162,540

Required:

Prepare the sales ledger control account and purchases ledger control account for 2020.

23.7A The following information relates to the business of Amit Juneja for the year ended 31 December 2019:

	£
Amounts paid to credit suppliers	223,990
Bad debts written-off	7,220
Cheques and bank transfers received from credit customers	213,420
Contras (set-offs) between trade receivables and payables	3,230
Credit purchases	243,920
Credit sales	240,740
Discounts allowed	4,860
Discounts received	4,870
Dishonoured cheques received from credit customers	810
Interest charged to customers for late payment	1,340
Refunds of credit balances paid to customers	2,150
Refunds of debit balances received from suppliers	610
Returns inwards	12,280
Returns outwards	9,780
Total trade payables at 1.1.2019	30,490
Total trade receivables at 1.1.2019	40,290

Required:

Prepare the sales ledger control account and purchases ledger control account for 2019.

23.8A The details below have been taken from the books of Sue Sprung's business in connection with the quarter ended 30 June 2020:

	£
Trade payables as at 1/4/2020	48,261
Trade receivables as at 1/4/2020	80,436
Credit purchases	96,255
Discounts allowed	3,441
Interest charged to customers in respect of overdue debts	1,895
Total of cheques and bank transfers received from trade receivables	147,593
Returns inwards (all from credit customers)	8,606
Allowance for doubtful debts as at 1/4/2020	2,415
Credit sales	172,139
Contras (set-offs) between trade receivables and trade payables	479
Refunds of credit balances paid to customers	797
Dishonoured cheques received from credit customers	488
Cash purchases	9,011
Returns outwards (all to credit suppliers)	3,850
Refunds of debit balances received from suppliers	242
Discounts received	1,925
Allowance for doubtful debts as at 30/6/2020	2,779
Payments to trade payables	95,242
Bad debts written-off	5,164
Cash sales	17,213

Required:

- Construct Sue's sales ledger control account and purchases ledger control account for the quarter ended 30 June 2020.
- State the source documents which will have been used for making entries in the:
 - Sales day book
 - Returns inwards day book.
- Explain three benefits of maintaining a purchases ledger control account.

23.9 The financial year of The Better Trading Company ended on 30 November 2024. You have been asked to prepare a Total Trade Receivables Account and a Total Trade Payables Account in order to produce end-of-year figures for Trade Receivables and Trade Payables for the draft final accounts.

You are able to obtain the following information for the financial year from the books of original entry:

	£
Sales – cash	344,890
– credit	268,187
Purchases – cash	14,440
– credit	496,600
Total receipts from customers	600,570
Total payments to suppliers	503,970
Discounts allowed (all to credit customers)	5,520
Discounts received (all from credit suppliers)	3,510
Refunds given to cash customers	5,070
Balance in the sales ledger set off against balance in the purchases ledger	70
Bad debts written off	780
Increase in the allowance for doubtful debts	90
Credit notes issued to credit customers	4,140
Credit notes received from credit suppliers	1,480





According to the audited financial statements for the previous year, trade receivables and trade payables as at 1 December 2023 were £26,555 and £43,450 respectively.

Required:

Draw up the relevant Total Accounts, entering end-of-year totals for trade receivables and trade payables.

(Association of Accounting Technicians)

23.10

- (a) Why are many accounting systems designed with a purchases ledger control account, as well as with a purchases ledger?
- (b) The following errors have been discovered:
 - (i) An invoice for £654 has been entered in the purchases day book as £456;
 - (ii) A prompt payment discount of £100 from a creditor had been completely omitted from the accounting records;
 - (iii) Purchases of £250 had been entered on the wrong side of a supplier's account in the purchases ledger;
 - (iv) No entry had been made to record an agreement to contra an amount owed to X of £600 against an amount owed by X of £400;
 - (v) A credit note for £60 had been entered as if it was an invoice.
 State the numerical effect on the purchases ledger control account balance of correcting each of these items (treating each item separately).
- (c) Information technology and computerised systems are rapidly increasing in importance in data recording. Do you consider that this trend will eventually remove the need for control accounts to be incorporated in the design of accounting systems? Explain your answer briefly.

(Association of Chartered Certified Accountants)

23.11 Control Accounts are used mainly for trade receivables and trade payables. Explain:

- (a) why it may be appropriate to use control accounts;
- (b) the advantages of using them.

Bank reconciliations

Learning objectives

After you have studied this chapter, you should be able to:

- Explain why bank reconciliations are prepared.
- Reconcile ledger accounts to suppliers' statements.
- Make the necessary entries in the accounts for dishonoured cheques.

Introduction

In this chapter, you'll learn how to prepare a bank reconciliation statement and why you need to do this when a bank statement is received from the bank. You will also learn how to deal with dishonoured cheques in the ledger accounts.

24.1 Completing entries in the cash book

In the books of a business, funds paid into and out of the bank are entered into the bank columns of the cash book. At the same time, the bank will also be recording the flows of funds into and out of the business bank account.

If all the items entered in the cash book were the same as those entered in the records held by the bank, the balance on the business bank account as shown in the cash book and the balance on the account as shown by the bank's records would be the same. When the balances are the same, reconciliation is pointless. A reconciliation is only done between two balances when they are different.

Unfortunately, it isn't usually that simple, particularly in the case of a bank current account. There may be items paid into or out of the business bank account which have not been recorded in the cash book. And there may be items entered in the cash book that have not yet been entered in the bank's records of the account. To see if any of these have happened, the cash book entries need to be compared to the record of the account held by the bank. Banks usually send a copy of that record, called a bank statement, to their customers on a regular basis, either physically or electronically. If not, or if one is lost, a bank statement can be requested by a customer of a bank at any time.

Bank statements should *a/ways* be checked against the cash book entries. (You would be wise to do so yourself with your own bank account!)

**Activity
24.1**

What might cause the two balances to be different? Spend two minutes making a list.

Let's look at an example of a cash book and a bank statement in Exhibit 24.1. Note that, when you compare them, you should mark each entry you find in both the account and on the bank statement with a tick (✓):

Exhibit 24.1**Cash Book (bank columns only: before balancing on 31.12.2022)**

2022				£	2022				£
Dec	1	Balance b/d	✓	250	Dec	5	J. Atanasov	✓	65
	20	P. Robles	✓	100		27	K. Papageorgiou	✓	175
	28	D. Chaudhary	✓	190					

Bank Statement

				Withdrawals	Deposits	Balance
2022				£	£	£
Dec	1	Balance b/d	✓			250
	8	10625 ^{Note}	✓	65		185
	21	Deposit	✓		100	285
	28	Deposit	✓		190	475
	29	10626*	✓	175		300
	30	Bank Giro credit: P. Fonseca			70	370
	31	Bank charges		50		320

Note: * 10625 and 10626 refer to the serial numbers on the cheques paid out.

Two items in the bank statement have not been ticked. This means that they have not been entered into the cash book:

Bank Giro credit: P. Fonseca	£70
Bank charges	£50

P. Fonseca had paid £70 but, instead of sending a cheque, he paid the money by bank giro credit transfer, i.e. bank transfer, direct into the business bank account. The business did not know of this until it received the bank statement.

The other item was for bank charges. The bank has charged £50 for keeping the bank account and all the work connected with it. Instead of sending an invoice, the bank has simply taken the money out of the bank account.

**Activity
24.2**

What sensible rule does this give you relating to when you should balance-off the bank account in the cash book at the end of the accounting period?

As we have now identified the items missing from the cash book, we can now complete writing it up by entering the two items we have identified:

Cash Book (bank columns only: after balancing on 31.12.2022)

2022				£	2022				£
Dec	1	Balance b/d		250	Dec	5	J. Atanasov		65
	20	P. Robles		100		27	K. Papageorgiou		175
	28	D. Chaudhary		190		31	Bank charges		50
	30	P. Fonseca		70		31	Balance c/d		320
				<u>610</u>					<u>610</u>
2023									
Jan	1	Balance b/d		320					

Both the bank statement and cash book closing balances are now shown as being £320.

24.2 Where closing balances differ

Although a cash book may be kept up to date by a business, it obviously cannot alter the bank's own records. Even after adding entries to the cash book, there may still be a difference between the cash book balance and the balance on the bank statement. Exhibit 24.2 shows such a case.

Exhibit 24.2

Cash Book (after being completed to date)

2023				£	2023				£
Jan	1	Balance b/d		320	Jan	10	C. Babatunde		110
	16	R. Lomas		160		20	M. McCarthy		90
	24	V. Kader		140		28	Delhi Local Government rates		180
	31	J. Pelayo		470		30	M. Romero		200
	31	R. Atanas		90		31	Balance c/d		600
				<u>1,180</u>					<u>1,180</u>
Feb	1	Balance b/d		600					

Bank Statement

				Withdrawals	Deposits	Balance
				£	£	£
2023						
Jan	1	Balance b/d				320
	12	10627		110		210
	16	Deposit			160	370
	23	10628		90		280
	24	Deposit			140	420
	28	Direct debit: Delhi Local Government rates		180		240
	31	Bank Giro credit: R. Atanas			90	330

**Activity
24.3**

Try to identify which items are causing the two balances in Exhibit 24.2 to be different even after the bank statement has been checked against the cash book and the necessary additional entries have been made in the cash book. (Hint: there are two items involved.)

You can see that two items are in the cash book but are not shown on the bank statement. These are:

- (i) A cheque had been paid to M. Romero on 30 January. He deposited it in his bank account on 31 January but, his bank didn't collect the money from the business's bank until 2 February. So far as the business knew, at 31 January this cheque was still an **unpresented cheque**.
- (ii) Although a cheque for £470 was received from J. Pelayo on 31 January and the business deposited it with the bank on that date, the bank did not receive the funds from Pelayo bank until February. This is known as a 'bank lodgement not yet credited' (or, a 'pending payment') to the business bank account.

The cash book balance on 31 January was £600, whereas the bank statement shows a balance of £330. To verify the accuracy of the two balances, they can be 'reconciled' (i.e. made to agree) with each other. When we do this, we prepare a **bank reconciliation statement**. The reconciliation will either start with the bank statement balance and then reconcile it to the cash book balance; or, it will start with the cash book balance and then reconcile it to the bank statement balance. If the second approach is adopted, it would appear as:

Bank Reconciliation Statement as at 31 January 2023

	£
Balance as per cash book	600
Add Unpresented cheque	(i) 200
	800
Less Bank lodgement not on statement	(ii) (470)
Balance per bank statement	<u>330</u>

If the two balances cannot be reconciled, there is an error somewhere, almost certainly in the reconciliation, such as a wrong amount having been entered. Whatever has caused the error must be located and corrected.

This reconciliation technique is also used when dealing with other statements drawn up outside the firm: for example, when reconciling purchase ledger accounts to suppliers' statements.

24.3 The bank balance in the balance sheet

The balance to be shown in the balance sheet is the one in the cash book after it has been updated for entries omitted that were identified in the reconciliation process. In Exhibit 24.2, the balance sheet figure would be £600.

This is an important point, and one that students often get wrong! The bank reconciliation shown in the last section is simply verifying that you know why there is a difference between the two balances. It is *not* calculating what the bank account figure in the balance sheet should be because it starts with the balance in the cash book *after* adjusting it for items revealed in the bank statement.

24.4 An alternative approach to bank reconciliations

In order to avoid the confusion that may arise concerning what figure to include in the balance sheet, many accountants use a slightly different form of bank reconciliation. In this approach, you take the balance as shown on the bank statement and the balance in the cash book *before* making any adjustments that are identified when it is compared to the bank statement. You then reconcile each of them in turn to arrive at the balance that should appear in the balance sheet.

Having completed the reconciliation, you then update the cash book **so that it balances at the correct amount, i.e. the amount that will be shown in the balance sheet**. An example is shown in Exhibit 24.3.

Exhibit 24.3

Cash Book (bank columns only: before balancing on 31.12.2022)										
2022					£	2022				£
Dec	1	Balance b/d	✓	160	Dec	8	V. O'Connor	✓	115	
	12	D. Tyrrell	✓	80		21	G. Francis	✓	35	
	23	P. McCarthy	✓	130		31	D. Barnes		25	
	31	S. Aisbitt		72						

Bank Statement									
					Withdrawals	Deposits	Balance		
2022					£	£	£		
Dec	1	Balance b/d		✓					160
	11	24621		✓		115			45
	14	Deposit		✓			80		125
	23	24622		✓		35			90
	29	Deposit		✓			130		220
	30	Bank Giro credit: A Parkinson					24		244
	31	Bank charges				40			204

You can see that the following are missing from the cash book:

- (a) A bank giro credit of £24 made on December 30 by A. Parkinson.
- (b) Bank charges of £40.

And you can see that the following are missing from the bank statement:

- (c) A cheque paid to D. Barnes for £25 on December 31 has not yet been presented.
- (d) A bank lodgement has not yet been credited – the cheque for £72 received from S. Aisbitt on 31 December.

The bank reconciliation statement would be:

Bank Reconciliation Statement as at 31 December 2022			£
Balance as per cash book			267
Add Bank giro credit not yet entered	(a)		24
			291
Less Bank charges not yet entered	(b)		(40)
Balance in balance sheet			251
Add Cheque not yet presented	(c)		25
			276
Less Bank lodgement not on statement	(d)		(72)
Balance per bank statement			204

When you have adjustments to make to both the cash book and the bank account balances in order to reconcile them, this form of bank reconciliation statement is more useful than one that simply shows that you know why their balances are different (which is all the bank reconciliation statement in Section 24.2 shows).

An alternative approach that is often used in practice is to start with the balance as per the cash book and adjust it to arrive at the balance per the balance sheet (i.e. the same as in the first half of the bank reconciliation statement shown above). You then have a second section that starts with the balance as per the bank statement and adjust it to once again arrive at the balance per the balance sheet. Either of these two approaches is perfectly acceptable and both provide the same information.

24.5 Other terms used in banking

- 1 Standing Orders.** A firm can instruct its bank to pay regular amounts of money at stated dates to persons or firms. For instance, you may ask your bank to pay £200 a month to a building society to repay a mortgage.
- 2 Direct Debits.** These are payments which have to be made, such as gas bills, electricity bills, telephone bills, rates and insurance premiums. Instead of asking the bank to pay the money, as with standing orders, you give permission to the creditor to obtain the money directly from your bank account. This is particularly useful if the trade payables may vary from time to time, as it is the creditor who changes the payments, not you. With standing orders, if the amount is ever to be changed, *you* have to inform the bank. With direct debits it is *the creditor* who informs the bank.

Just as with anything else omitted from the cash book, items of these types need to be included in the reconciliation and entered in the cash book before balancing it off at the end of the period.

24.6 Bank overdrafts

The adjustment needed to reconcile a bank overdraft according to the firm's books (shown by a credit balance in the cash book) with that shown in the bank's records are the same as those needed when the account is not overdrawn.

Exhibit 24.4 is of a cash book and a bank statement both showing an overdraft. Only the cheque for G. Serrano (A) £106 and the cheque paid to J. Kelly (B) £63 need adjusting. Work through the reconciliation statement and then read the note after it. Because the balance shown by the cash book is correct (and, therefore, the balance that will appear in the balance sheet), you can use the form of bank reconciliation statement shown in Section 24.2.

Exhibit 24.4

Cash Book							
2022				2022			
			£				£
Dec	5	I. Suero	308	Dec	1	Balance b/d	709
	24	L. Mason	120		9	P. Arce	140
	29	K. Gonzalo	124		27	J. Kelly (B)	63
	31	G. Serrano (A)	106		29	United Trust	77
	31	Balance c/d	380		31	Bank charges	49
			<u>1,038</u>				<u>1,038</u>

Bank Statement

		<i>Dr</i>	<i>Cr</i>	<i>Balance</i>
		£	£	£
2022				
Dec	1			709 O/D
	5			401 O/D
	14	140		541 O/D
	24		120	421 O/D
	29		124	297 O/D
	29	77		374 O/D
	31	49		423 O/D

Note: An overdraft is often shown with the letters 'O/D' following the amount. Alternatively, some banks use 'Dr' and 'Cr' after every balance entry to indicate whether the account is overdrawn.

Activity
24.4

Will the bank statement show 'Dr' or 'Cr' if an account is overdrawn?

Bank Reconciliation Statement as at 31 December 2022

	£
Overdraft as per cash book	(380)
Add Unpresented cheque	63
	<u>(317)</u>
Less Bank lodgement not on bank statement	(106)
Overdraft per bank statement	<u>(423)</u>

Note: You may find it confusing looking at this bank reconciliation statement because the opening entry is an overdraft, i.e. a negative number. However, the adjusting entries are the same as those you make when it is positive:

	£
Balance/(overdraft) per cash book	xxxx
Adjustments	
Unpresented cheque	Plus
Bank lodgement not on bank statement	Less
Balance/(overdraft) per bank statement	xxxx

24.7 Dishonoured cheques

When a cheque is received from a customer and paid into the bank, it is recorded on the debit side of the cash book. It is also shown on the bank statement as a deposit increasing the balance on the account. However, at a later date it may be found that the customer's bank will not pay the amount due on the cheque. The customer's bank has failed to 'honour' the cheque. The cheque is described as a **dishonoured cheque**.

There are several possible reasons for this. Imagine that K. Gonzalo paid a business with a cheque for £5,000 on 20 May 2023. The business deposits it at the bank but, a few days later,

the bank contacts the business and informs it that the cheque has been dishonoured. Typical reasons are:

- 1 Gonzalo had put £5,000 in figures on the cheque but had written it in words as ‘five thousand *five hundred* pounds’. A new cheque correctly completed will need to be provided by Gonzalo.
- 2 Normally, cheques are considered *stale* six months after the date on the cheque. In other words, banks will not honour cheques that are more than six months old. If Gonzalo had put the year 2021 on the cheque instead of 2023, then Gonzalo’s bank would dishonour the cheque and Gonzalo would need to be asked for a correctly dated replacement.
- 3 Gonzalo simply did not have sufficient funds in her bank account. Suppose she had previously a balance of only £2,000 and yet she has made out a cheque for £5,000. Her bank has not allowed her an overdraft in order to honour the cheque. As a result, the cheque has been dishonoured. The bank informs the business that this has happened and the business would have to contact Gonzalo, explain what has happened, and ask for valid payment of the amount due.

In all of these cases, the bank would record the original entry in its records as being reversed. This is shown on the bank statement, for example, by the entry ‘dishonoured cheque £5,000’. The business then makes the equivalent credit entry in the cash book while, at the same time, debiting Gonzalo’s account by the same amount.

When Gonzalo originally paid the £5,000 the accounts in the ledger and cash book would have appeared as:

K. Gonzalo							
2023			£	2023		£	
May	1	Balance b/d	<u>5,000</u>	May	20	Bank	<u>5,000</u>
Bank Account							
2023			£				
May	20	K. Gonzalo	<u>5,000</u>				

After recording the dishonoured cheque, the accounts would be:

K. Gonzalo							
2023			£	2023		£	
May	1	Balance b/d	<u>5,000</u>	May	20	Bank	<u>5,000</u>
May	25	Bank: cheque dishonoured	<u>5,000</u>				
Bank Account							
2023			£	2023			£
May	20	K. Gonzalo	<u>5,000</u>	May	25	K. Gonzalo: cheque dishonoured	<u>5,000</u>

In other words, Gonzalo is once again shown as owing the business £5,000.

Learning outcomes

You should now have learnt:

- 1 Why it is important to perform a bank reconciliation when a bank statement is received.
- 2 That a bank reconciliation statement should show whether or not errors have been made either in the bank columns of the cash book or on the bank statement.
- 3 That a bank reconciliation statement can be prepared either before or after updating the cash book with items omitted from it that are shown on the bank statement.
- 4 That a bank reconciliation statement prepared after updating the cash book with items omitted from it that are shown on the bank statement shows that you know why the bank statement balance is different from that shown in the cash book and the balance sheet.
- 5 That a bank reconciliation statement prepared before updating the cash book with items omitted from it that are shown on the bank statement is reconciled from cash book to the balance sheet amount and then to the bank statement. It shows the amount to be entered in the balance sheet and also shows that you know why the bank statement balance is different from the balances shown in the cash book and in the balance sheet.
- 6 That in the case of bank overdrafts, the reconciliation statement adjustments are the same as those shown when there is a positive bank balance, but the opening and closing balances are negative.
- 7 How to prepare a bank reconciliation statement after updating the cash book with items omitted from it that are shown on the bank statement.
- 8 How to prepare a bank reconciliation statement before updating the cash book with items omitted from it that are shown on the bank statement.
- 9 Why cheques may be dishonoured and what the effect is upon the bank balance.
- 10 How to make the appropriate entries to the accounts when a cheque is dishonoured.

Answers to activities

24.1 There is quite a long list of possible causes, including:

- A business may take a day or two to deposit some cheques that it has already entered in the cash book.
- A cheque may take a few days to be entered in the account of the business held at the bank after it is deposited (because the bank won't recognise the amount received until a few days later, in case there is a problem with it);
- Bank interest paid and bank charges often aren't known by a business until a bank statement is received.
- Bank interest received won't be known by a business until it receives a bank statement.
- Standing orders may not be written up in the cash book of the business until they are identified on the bank statement.
- The amount of a direct debit is sometimes not known and so should not be entered in the cash book until it is confirmed how much was paid out of the bank account.
- Customers may pay their accounts by direct transfer from their bank account or by paying cash directly into the business bank account and the business may only learn of their having done so later.
- There may have been an error made in the cash book entries.
- The bank may have made an error in operating the account, such as adding funds to it instead of to the account of the person depositing the funds.
- A cheque paid into the bank may have 'bounced' (i.e. there were insufficient funds in the writer of the cheque's bank account to make the payment).

24.2 It is wise to wait until receiving the bank statement before balancing-off the bank account in the cash book at the end of the accounting period. In a manual accounting system, if a cash book is balanced on a regular basis, balancing-off is usually done at the end of the time period selected and any additional entries are recorded along with the other entries made in the following day, week, month or quarter. However, at the end of the accounting year, the balancing-off is often done in pencil (so that financial statements can be drafted) and then done in ink after any missing entries and corrections of errors have been entered following receipt of the bank statement.

24.3 M. Romero £200 and J. Pelayo £470.

24.4 'Dr' indicates an overdraft. The customer is a debtor of the bank. In the customer's balance sheet, the overdraft is included in the current liabilities, indicating that the bank is a creditor. Always remember that a bank is looking at the relationship from the opposite side to the view seen by the customer.

Review questions

24.1 From the following, draw up a bank reconciliation statement from details as on 31 December 2024 for P. Sheeran:

	£
Cash at bank as per bank column of the cash book	4,210
Unpresented cheques	2,116
Cheques received and paid into the bank, but not yet appeared on the bank statement	1,238
Bank transfers received from customers according to the bank statement but not yet entered in the cash book	369
Cash at bank as per bank statement	5,457

24.2A Draw up a bank reconciliation statement, after writing the cash book up to date, ascertaining the balance on the bank statement, from the following as on 31 March 2024:

	£
Cash at bank as per bank column of the cash book (Dr)	3,028
Deposits made but not yet appeared on bank statement	909
Bank charges on bank statement but not yet in cash book	30
Unpresented cheques	1,471
Standing order to VVS Ltd on bank statement, but not in cash book	192
Bank transfer received from S. Dawkins on bank statement, but not yet in cash book	570

24.3 The following are extracts from the cash book and the bank statement of P. Oluwaseun's business.

You are required to:

- Write the cash book up to date, showing the new balance as on 31 December 2019, and
- Draw up a bank reconciliation statement as on 31 December 2019.

Cash Book					
2019	Dr	£	2019	Cr	£
Dec	1 Balance b/d	1,234	Dec	8 S. Fry	678
	7 M. Fox	236		15 S. Mall	99
	22 L. Shaw	189		28 A. Cole	125
	31 L. Gonzalo	366		31 Balance c/d	1,535
	31 L. Ross	412			
		<u>2,437</u>			<u>2,437</u>

Bank Statement			Dr	Cr	Balance
2019			£	£	£
Dec	1	Balance b/d			1,234
	7	Deposit		236	1,470
	11	Cheque payment	678		792
	20	Cheque payment	99		693
	22	Deposit		189	882
	31	Credit transfer: J. Watt		251	1,133
	31	Bank charges	49		1,084

24.4A The bank columns in the cash book for June 2024 and the bank statement for that month for D. Hogan are as follows:

Cash Book					
2024			Dr	£	
Jun	1	Balance b/d		1,410	
	7	J. May		62	
	16	T. Oluwaseun		75	
	28	F. Slack		224	
	30	G. Baker		582	
				<u>2,353</u>	
2024			Cr	£	
Jun	5	L. Holmes		180	
	12	J. Rebus		519	
	16	T. Silver		41	
	29	Blister Disco		22	
	30	Balance c/d		1,591	
				<u>2,353</u>	

Bank Statement			Dr	Cr	Balance
2024			£	£	£
Jun	1	Balance b/d			1,410
	7	Cheque		62	1,472
	8	L. Holmes	180		1,292
	16	Cheque		75	1,367
	17	J. Rebus	519		848
	18	T. Silver	41		807
	28	Cheque		224	1,031
	29	SLM standing order	52		979
	30	Flynn: trader's credit		64	1,043
	30	Bank charges	43		1,000

You are required to:

- Write the cash book up to date to take the above into account, and then
- Draw up a bank reconciliation statement as on 30 June 2024.

24.5 Read the following and answer the questions below.

On 31 December 2018 the bank column of C. Tench's cash book showed a debit balance of £1,500.

The monthly bank statement written up to 31 December 2018 showed a credit balance of £2,950.

On checking the cash book with the bank statement, it was discovered that the following transactions had not been entered in the cash book:





Dividends of £240 had been paid directly to the bank.

A credit transfer – HM Revenue & Customs VAT refund of £260 – had been collected by the bank.
Bank charges £30.

A direct debit of £70 for the RAC subscription had been paid by the bank.

A standing order of £200 for C. Tench's loan repayment had been paid by the bank.

Tench's deposit account balance of £1,400 was transferred into his bank current account.

A further check revealed the following items:

Two cheques drawn in favour of T. Cod £250 and F. Haddock £290 had been entered in the cash book but had not been presented for payment.

Cash and cheques amounting to £690 had been paid into the bank on 31 December 2018 but were not credited by the bank until 2 January 2019.

- (a) Starting with the debit balance of £1,500, bring the cash book (bank columns) up to date and then balance the bank account.
- (b) Prepare a bank reconciliation statement as at 31 December 2018.

(Midland Examining Group: GCSE)

24.6A In the draft accounts for the year ended 31 October 2019 of Thomas P. Lee, garage proprietor, the balance at bank according to the cash book was £894.68 in hand.

Subsequently the following discoveries were made:

- (1) Cheque number 176276 dated 3 September 2019 for £310.84 in favour of G. Lowe Limited has been correctly recorded in the bank statement but included in the cash book payments as £301.84.
- (2) Bank commission charged of £169.56 and bank interest charged of £109.10 have been entered in the bank statement on 23 October 2019, but not included in the cash book.
- (3) The recently received bank statement shows that a cheque for £29.31 received from T. Andrews and credited in the bank statements on 9 October 2019 has now been dishonoured and debited in the bank statement on 26 October 2019. The only entry in the cash book for this cheque records its receipt on 8 October 2019.
- (4) Cheque number 177145 for £15.10 has been recorded twice as a credit in the cash book.
- (5) Amounts received in the last few days of October 2019 totalling £1,895.60 and recorded in the cash book have not been included in the bank statements until 2 November 2019.
- (6) Cheques paid according to the cash book during October 2019 and totalling £395.80 were not presented for payment to the bank until November 2019.
- (7) Traders' credits totalling £210.10 have been credited in the bank statement on 26 October 2019, but not yet recorded in the cash book.
- (8) A standing order payment of £15.00 on 17 October 2019 to Countryside Publications has been recorded in the bank statement but is not mentioned in the cash book.

Required:

- (a) Prepare a computation of the balance at bank to be included in Thomas P. Lee's balance sheet as at 31 October 2019.
- (b) Prepare a bank reconciliation statement as at 31 October 2019 for Thomas P. Lee.
- (c) Briefly explain why it is necessary to prepare bank reconciliation statements at accounting year ends.

(Association of Accounting Technicians)

24.7 The bank statement for R. Hood for the month of March 2024 is:

		<i>Dr</i>	<i>Cr</i>	<i>Balance</i>
		£	£	£
Mar	1	Balance		4,200 O/D
	8	T. Marinos	184	4,384 O/D
	16	Cheque	292	4,092 O/D
	20	W. Ahmed	160	4,252 O/D
	21	Cheque	369	3,883 O/D
	31	G. Frank: trader's credit	88	3,795 O/D
	31	TYF: standing order	32	3,827 O/D
	31	Bank charges	19	3,846 O/D

The cash book for March 2024 is:

2024			2024				
		Dr			Cr		
		£			£		
Mar	16	G. Philip	292	Mar	1	Balance b/d	4,200
	21	J. Forker	369		6	T. Marinos	184
	31	S. Espina	192		30	W. Ahmed	160
	31	Balance c/d	4,195		30	S. Porter	504
			<u>5,048</u>				<u>5,048</u>

You are required to:

- Write the cash book up to date, and
- Draw up a bank reconciliation statement as on 31 March 2024.

24.8A The following is the cash book (bank columns) of F. King for December 2020:

2020		Dr	£	2020		Cr	£
Dec	6	P. Pan	230	Dec	1	Balance b/d	1,900
	20	C. Hook	265		10	J. Tinashe	304
	31	W. Britten	325		19	P. Oluwaseun	261
	31	Balance c/d	1,682		29	K. Coull	37
			<u>2,502</u>				<u>2,502</u>

The bank statement for the month is:

2020		<i>Dr</i>	<i>Cr</i>	<i>Balance</i>
Dec		£	£	£
	1	Balance		1,900 O/D
	6	Cheque	230	1,670 O/D
	13	J. Tinashe	304	1,974 O/D
	20	Cheque	265	1,709 O/D
	22	P. Oluwaseun	261	1,970 O/D
	30	Tox: standing order	94	2,064 O/D
	31	F. Ray: trader's credit	102	1,962 O/D
	31	Bank charges	72	2,034 O/D

You are required to:

- Write the cash book up to date to take the necessary items into account, and
- Draw up a bank reconciliation statement as on 31 December 2020.





24.9 The following is a summary of a cash book as presented by George Ltd for the month of October:

	£		£
Receipts	1,469	Balance b/d	761
Balance c/d	<u>554</u>	Payments	<u>1,262</u>
	<u>2,023</u>		<u>2,023</u>

All receipts are banked and all payments are made by cheque.

On investigation you discover:

- (1) Bank charges of £136 entered on the bank statement have not been entered in the cash book.
- (2) Cheques drawn amounting to £267 had not been presented to the bank for payment.
- (3) Cheques received totalling £762 had been entered in the cash book and paid into the bank but had not been credited by the bank until 3 November.
- (4) A cheque for £22 for sundries had been entered in the cash book as a receipt instead of as a payment.
- (5) A cheque received from K. Jones for £80 had been returned by the bank and marked 'No funds available'. No adjustment has been made in the cash book.
- (6) A standing order for a business rates instalment of £150 on 30 October had not been entered in the cash book.
- (7) All dividends received are credited directly to the bank account. During October amounts totalling £62 were credited by the bank but no entries were made in the cash book.
- (8) A cheque drawn for £66 for stationery had been incorrectly entered in the cash book as £60.
- (9) The balance brought forward in the cash book should have been £711, not £761.

Required:

- (a) Show the adjustments required to the cash book balance.
- (b) Prepare a bank reconciliation statement as at 31 October.

Errors not affecting the balancing of the trial balance

Learning objectives

After you have studied this chapter, you should be able to:

- Correct errors that are not revealed by a trial balance.
- Distinguish between the different kinds of errors that may arise.

Introduction

In this chapter, you'll learn how to identify and correct a range of errors that can arise when financial transactions are entered in the ledger accounts.

25.1 Types of error

In Chapter 6 it was seen that if we ensure that:

- every debit entry has a corresponding credit entry;
- every credit entry has a corresponding debit entry;

and entered transactions in our ledgers on this basis then, when we extracted the trial balance, the totals of the two columns would be the same, i.e. it would 'balance'.

Suppose we correctly entered cash sales £70 to the debit of the Cash Book but, did not enter the £70 to the credit of the sales account. If this were the only error in the books, the trial balance totals would differ by £70. However, there are several types of error which would not affect the agreement of the trial balance totals, including:

- 1 **Errors of commission** – this type of error occurs when the correct amount is entered but in the wrong account, e.g. where a sale of £11 to C. Green is entered in the account of K. Green.
- 2 **Complete reversal of entries** – where the correct accounts are used but each item is shown on the wrong side of the account. Suppose we had paid a cheque to D. Williams for £200, the double entry of which should be debit D. Williams £200, credit Bank £200. In error, it is entered as debit Bank £200, credit D. Williams £200. The trial balance totals will still agree.
- 3 **Errors of omission** – where a transaction is completely omitted from the books. If we sold £90 goods to J. Brewer but, did not enter it in either the sales account or in Brewer's personal account, or anywhere else, the trial balance would still 'balance'.
- 4 **Errors of principle** – where an item is entered in the wrong class of account, e.g. if purchase of a fixed asset, such as a van, is debited to an expenses account, such as motor expenses account.
- 5 **Compensating errors** – where errors cancel each other out. If the sales account was added up to be £10 too much and the purchases account was also added up to be £10 too much, then these two errors would cancel out in the trial balance. This is because the totals of both the debit side and the credit side of the trial balance will be overstated by £10.

- 6 Errors of original entry** – where the original figure is incorrect, yet double entry is correctly done using the incorrect figure. For example, where a sale should have totalled £150 but an error is made in calculating the total on the sales invoice. If it were calculated as £130, and £130 were credited as sales and £130 were debited to the personal account of the customer, the trial balance would still balance.
- 7 Transposition errors** – where the wrong sequence of the individual characters within a number was entered (for example, £142 entered instead of £124). This is a common type of error and is very difficult to spot when the error has occurred in both the debit and the credit entries, as the trial balance would still balance. It is, however, more common for this error to occur on one side of the double entry only. When it does, it is easier to find.

25.2 Correction of errors

Most errors are found after the date on which they are made. When we correct errors, we should not do so by crossing out items, tearing out accounts and throwing them away, or using chemicals to make the writing disappear.

Activity 25.1

In which book should all the correcting double entries first be entered?

We make corrections to double entry accounts by preparing journal entries. We should:

- 1 prepare the corrections by means of journal entries; then
- 2 post the journal entries to the appropriate ledger accounts.

1 Error of COMMISSION

A credit purchase of £44 worth of goods from C. Simons on 4 September was entered in error in C. Simpson's account. The error was found on 30 September. To correct this, it must be cancelled out of C. Simpson's account and entered where it should be (in C. Simons' account). The journal entry will be:

The Journal		Dr	Cr
		£	£
C. Simpson		44	
C. Simons			44
Purchase Invoice Number . . . entered in wrong personal account, now corrected			

The entries in the ledger accounts would be:

C. Simpson				C. Simons			
			£				£
Sept	30	C. Simons (error corrected)	<u>44</u>	Sept	4	Purchases	<u>44</u>

C. Simons

			£
	Sept 30	Purchases (error corrected)	44

Note: 'Purchases' is used for the entry in C. Simons' account because that is what the entry would have been if it had been made correctly when first recorded in the ledger. While the convention is to use the name of the contra entry – in this case, that would be 'C. Simpson' – doing so would be misleading; the purpose of the credit entry in C. Simons' account is to record a purchase made on credit from C. Simons'.

2 Complete REVERSAL of entries

A payment of cash of £16 to M. Dickson was entered on the receipts side of the Cash Book in error and credited to M. Dickson's account. This is more difficult to adjust. You must first remove the incorrect entry and then make the correct entry, both of which adjustments would be for the same amount and made to the same side of the account. Because of this, the correcting entry is double the actual amount first recorded.

We should have had:

Cash			
			£
		M. Dickson	16

M. Dickson			
	£		
Cash	16		

This was entered wrongly as:

Cash			
	£		
M. Dickson	16		

M. Dickson			
			£
		Cash	16

The entries in these accounts to reverse these entries and record the correct entries are shown below:

Cash			
	£		£
M. Dickson	16	M. Dickson (error corrected)	32

M. Dickson			
	£		£
Cash (error corrected)	32	M. Dickson	16

Overall, when corrected, the £16 debit and £32 credit in the cash account means there is a net credit of £16. Similarly, Dickson's account shows £32 debit and £16 credit, a net debit of £16. As the final (net) amount is the same as what should have been entered originally, the error is now corrected.

The Journal entry would be:

The Journal		
	Dr	Cr
	£	£
M. Dickson	32	
Cash		32
Payment of cash £16 debited to cash and credited to M. Dickson in error on . . . Error now corrected		

3 Error of OMISSION

A credit sale of £59 worth of goods to E. George has been completely omitted from the books. We must correct this by entering the sale in the books. The journal entry for the correction is: ^{Note}

The Journal		
	Dr	Cr
	£	£
E. George	59	
Sales		59

Correction of omission of Sales Invoice Number . . . from Sales day book

Note: in all these examples, the folio column has been omitted so as to make the example clearer.

4 Error of PRINCIPLE

The purchase of a machine for £200 is debited to the purchases account instead of being debited to a machinery account. We therefore cancel the item out of the purchases account by crediting that account. It is then entered where it should be by debiting the machinery account.

The Journal		
	Dr	Cr
	£	£
Machinery	200	
Purchases		200

Correction of error: purchase of fixed asset debited to purchases account

5 COMPENSATING error

In the cash book, the amount of cash sales transferred to the sales account was overstated by £20 and the amount transferred to the wages account was also overstated by £20. The trial balance therefore still balances.

The Journal		
	Dr	Cr
	£	£
Sales	20	
Wages		20

Correction of two overcasts of £20 posted from the cash book to the sales account and to the wages account which compensated for each other

6 Error of ORIGINAL entry

A credit sale of £38 to A. Smailes was entered in the books as £28. The other £10 must be entered:

The Journal		Dr	Cr
		£	£
A. Smailes		10	
Sales			10

Correction of error whereby sales were understated by £10

7 TRANSPOSITION error

A credit purchase from P. Maclaran costing £56 was entered in the books as £65. The £9 error needs to be removed.

The Journal		Dr	Cr
		£	£
P. Maclaran		9	
Purchases			9

Correction of error whereby purchases were overstated by £9

Mnemonic

The following acronym may help you to remember which types of errors do not affect the balancing of a trial balance:

CROP COT

C – Commission

R – Reversal

O – Omission

P – Principle

C – Compensating

O – Original entry

T – Transposition

25.3 Casting

You will sometimes notice the use of the term **casting**, which means adding up. ‘Overcasting’ means incorrectly adding up a column of figures to give an answer which is greater than it should be. ‘Undercasting’ means incorrectly adding up a column of figures to give an answer which is less than it should be.

Learning outcomes

You should now have learnt:

- 1 How to describe each of a range of possible errors that can be made when recording financial transactions in the accounts that will not be detected by producing a trial balance.
- 2 How to identify and correct each of these types of errors.
- 3 That when errors are found, they should be amended by using proper double entry procedures.
- 4 That all corrections of errors should take place via the Journal, where entries are first recorded before being posted to the appropriate ledger accounts.

Answer to activity

25.1 The Journal.

Review questions

25.1 Give an example of each of the different types of error which are *not* revealed by a trial balance.

25.2 Show the journal entries necessary to correct the following errors:

- (a) A sale of goods for £630 to J. Trees had been entered in J. Tees's account.
- (b) The purchase of a printer on credit from D. Hogg for £846 had been completely omitted from our books.
- (c) The purchase of a laptop for £389 had been entered in error in the Office Expenses account.
- (d) A sale of £260 to G. Lee had been entered in the books, both debit and credit, as £206.
- (e) Commission received £340 had been entered in error in the Sales account.
- (f) A receipt of cash from A. Salmond £130 had been entered on the credit side of the cash book and the debit side of A. Salmond's account.
- (g) A purchase of goods for £410 had been entered in error on the debit side of the Drawings account.
- (h) Discounts Allowed £46 had been entered in error on the debit side of the Discounts Received account.

25.3A Show the journal entries needed to correct the following errors:

- (a) Purchases £1,410 on credit from A. Ray had been entered in B. Roy's account.
- (b) A cheque of £94 paid for printing had been entered in the cash column of the cash book instead of in the bank column.
- (c) Sale of goods £734 on credit to D. Rolls had been entered in error in D. Rollo's account.
- (d) Purchase of goods on credit L. Hand £819 entered in the correct accounts in error as £891.
- (e) Cash paid to G. Boyd £64 entered on the debit side of the cash book and the credit side of G. Boyd's account.

- (f) A sale of fittings £320 had been entered in the Sales account.
- (g) Cash withdrawn from bank £200 had been entered in the cash column on the credit side of the cash book, and in the bank column on the debit side.
- (h) Purchase of goods £1,182 has been entered in error in the Furnishings account.

25.4 After preparing its draft income statement for the year ended 31 March 2024 and draft balance sheet as at the same date, a business discovered that the inventory lists used to compute the value of inventory as at 31 March 2024 contained the following entry:

<i>Inventory item</i>	<i>Number</i>	<i>Cost per unit</i>	<i>Total cost</i>
K604	200	£2.62	£5,240

Required:

- (a) What is wrong with this particular entry?
- (b) What would the effect of the error have been on
 - (i) the value of inventory as at 31 March 2024?
 - (ii) the cost of goods sold for the year ended 31 March 2024?
 - (iii) the net profit for the year ended 31 March 2024?
 - (iv) the total for Current Assets as at 31 March 2024?
 - (v) the Owner's Capital as at 31 March 2024?

25.5 Give the journal entries needed to record the corrections of the following. Narratives are not required.

- (a) Extra capital of £12,000 paid into the bank had been credited to Sales account.
- (b) Goods taken for own use £140 had been debited to Sundry Expenses.
- (c) Private rent £740 had been debited to the Rent account.
- (d) A purchase of goods from F. Smith £530 had been entered in the books as £350.
- (e) Cash banked £620 had been credited to the bank column and debited to the cash column in the cash book.
- (f) Cash drawings of £270 had been credited to the bank column of the cash book.
- (g) Returns inwards £205 from N. Sturgeon had been entered in error in G. Milne's account.
- (h) A sale of an old printer for £70 had been credited to Office Expenses.

25.6A Journal entries to correct the following are required, but the narratives can be omitted.

- (a) Rent Received £430 has been credited to the Commissions Received account.
- (b) Bank charges £34 have been debited to the Business Rates account.
- (c) Completely omitted from the books is a payment of Motor Expenses by cheque £37.
- (d) A purchase of a fax machine £242 has been entered in the Purchases account.
- (e) Returns inwards £216 have been entered on the debit side of the Returns Outwards account.
- (f) A loan from G. Bain £2,000 has been entered on the credit side of the Capital account.
- (g) Loan interest of £400 has been debited to the Van account.
- (h) Goods taken for own use £84 have been debited to the Purchases account and credited to Drawings.





25.7A Thomas Smith, a retail trader, has very limited accounting knowledge. In the absence of his accounting technician, he extracted the following trial balance as at 31 March 2018 from his business's accounting records:

	£	£
Inventory-in-trade at 1 April 2017		10,700
Inventory-in-trade at 31 March 2018	7,800	
Discounts allowed		310
Discounts received	450	
Allowance for doubtful debts	960	
Purchases	94,000	
Purchases returns	1,400	
Sales		132,100
Sales returns	1,100	
Freehold property: at cost	70,000	
Provision for depreciation	3,500	
Motor vehicles: at cost	15,000	
Provision for depreciation	4,500	
Capital – Thomas Smith		84,600
Balance at bank	7,100	
Trade receivables		11,300
Trade payables	7,600	
Establishment and administrative expenditure	16,600	
Drawings	9,000	
	<u>239,010</u>	<u>239,010</u>

Required:

- (a) Prepare a corrected trial balance as at 31 March 2018.
After the preparation of the above trial balance, but before the completion of the final accounts for the year ended 31 March 2018, the following discoveries were made:
- (i) The correct valuation of the inventory-in-trade at 1 April 2017 is £12,000; apparently some inventory lists had been mislaid.
 - (ii) A credit note for £210 has now been received from J. Hardwell Limited; this relates to goods returned in December 2017 by Thomas Smith. However, up to now J. Hardwell Limited had not accepted that the goods were not of merchantable quality and Thomas Smith's accounting records did not record the return of the goods.
 - (iii) Trade sample goods were sent to John Grey in February 2018. These were free samples, but were charged wrongly at £1,000 to John Grey. A credit note is now being prepared to rectify the error.
 - (iv) In March 2018, Thomas Smith painted the inside walls of his stockroom using materials costing £150 which were included in the purchases figure in the above trial balance. Thomas Smith estimates that he saved £800 by doing all the painting himself.
- (b) Prepare the journal entries necessary to amend the accounts for the above discoveries.
Note: narratives are required.

(Association of Accounting Technicians)

Suspense accounts and errors

Learning objectives

After you have studied this chapter, you should be able to:

- Explain why a suspense account may be used.
- Create a suspense account in order to balance the trial balance.
- Correct errors using a suspense account.
- Recalculate profits after errors have been corrected.
- Explain why using a suspense account is generally inappropriate.

Introduction

In this chapter, you'll learn how to use suspense accounts to temporarily balance an out-of-balance trial balance. You'll also learn that this is usually *not* a wise thing to do, even temporarily.

26.1 Errors and the trial balance

In the previous chapter, we looked at errors that do not affect the trial balance. However, many errors will mean that trial balance totals will not be equal. These include:

- incorrect additions in any account;
- making an entry on only one side of the accounts, e.g. a debit but no credit; a credit but no debit;
- entering a different amount on the debit side from the amount on the credit side.

26.2 Suspense account

We should try very hard to find errors when the trial balance totals are not equal. When such errors cannot be found, the trial balance totals can be made to agree with each other by recording the amount of the difference between the two totals in a **suspense account**. This is shown in Exhibit 26.1 using an example of a £40 difference.

Exhibit 26.1**Trial Balance as at 31 December 2021**

	<i>Dr</i>	<i>Cr</i>
	£	£
Totals after all the accounts have been listed	100,000	99,960
Suspense		40
	<u>100,000</u>	<u>100,000</u>

To make the two totals the same, a figure of £40 for the suspense account has been shown on the credit side of the trial balance. A suspense account is opened and the £40 difference is also shown there on the credit side:

Suspense			
	2021		£
	Dec	31	Difference per trial balance
			40

Activity 26.1

Where is the debit side of this entry made?

26.3 Suspense accounts and the balance sheet

If the errors are not found before the financial statements are prepared, the suspense account balance will be included in the balance sheet. The balance should be included shown just before the figure for net assets, either as a negative amount (credit balance) or a positive amount (debit balance) (see Exhibit 26.5).

Activity 26.2

Does the use of a suspense account in financial statements affect the true and fair view that they are meant to portray?

26.4 Correction of errors

When errors are found, they must be corrected using double entry. Each correction must first be recorded in the journal, and then be posted to the accounts concerned.

One error only

Let's look at two examples:

Example 1

Assume that the cause of the error of £40 in Exhibit 26.1 is found 3 months into the next accounting period, on 31 March 2022. The error was that the sales account was undercast by £40. The action taken to correct this is:

Debit suspense account to close it: £40.

Credit sales account to show item where it should have been: £40.

The accounts now appear as Exhibit 26.2:

Exhibit 26.2

Suspense					
2022			£	2022	£
Mar	31	Sales	<u>40</u>	Jan	1
					Balance b/d
					<u>40</u>
Sales					
				2022	£
				Mar	31
					Suspense
					<u>40</u>

This can be shown in journal form as:

The Journal					
				Dr	Cr
2022			£	£	
Mar	31	Suspense	40		
		Sales			40
		Correction of undercasting of sales by £40 last year			

Here's another example.

Example 2

The trial balance on 31 December 2022 had a difference of £168. It was a shortage on the debit side.

A suspense account is opened, and the difference of £168 is entered on the debit side in the account. On 31 May 2023 the error was found. We had made a payment of £168 to K. Leek to close his account. It was correctly entered in the cash book but, was not entered in K. Leek's account.

First of all, the account of K. Leek is debited with £168, as it should have been in 2022. Second, the suspense account is credited with £168 so that the account can be closed.

Exhibit 26.3

K. Leek					
2023			£	2023	£
May	31	Bank	<u>168</u>	Jan	1
					Balance b/d
					<u>168</u>
Suspense					
2023			£	2023	£
Jan	1	Balance b/d	<u>168</u>	May	31
					K. Leek
					<u>168</u>

The account of K. Leek is now correct.





The Journal entry is:

The Journal				Dr	Cr
2023				£	£
May	31	K. Leek		168	
		Suspense			168
Correction of non-entry of payment last year in K. Leek's account					

More than one error

Let's now look at Example 3 where the suspense account difference was caused by more than one error.

Example 3

The trial balance at 31 December 2020 showed a difference of £77, being a shortage on the debit side. A suspense account is opened, and the difference of £77 is entered on the debit side of the account. On 28 February 2021 all the errors from the previous year were found.

- (A) A cheque of £150 paid to L. Stefanov had been correctly entered in the cash book but, it had not been entered in Stefanov's account.
- (B) The purchases account had been undercast by £20.
- (C) A cheque of £93 received from K. Sand had been correctly entered in the cash book but had not been entered in Sand's account.

These three errors resulted in an overall error of £77, shown by a debit of £77 on the debit side of the suspense account. These are corrected as follows:

- (a) Make correcting entries in accounts for (A), (B) and (C).
- (b) Record double entry for these items in the suspense account.

Exhibit 26.4

L. Stefanov									
2021				£					
Feb	28	Suspense	(A)	150					
Purchases									
2021				£					
Feb	28	Suspense	(B)	20					
K. Sand									
					2021			£	
					Feb	28	Suspense	(C)	93
Suspense									
2021				£	2021			£	
Jan	1	Balance b/d		77	Feb	28	L. Stefanov	(A)	150
Feb	28	K. Sand	(C)	93		28	Purchases	(B)	20
				<u>170</u>					<u>170</u>

The Journal

			Dr	Cr
2021			£	£
Feb	28	L. Stefanov	150	
		Suspense		150
		Cheque paid omitted from Stefanov's account		
	28	Purchases	20	
		Suspense		20
		Undercasting of purchases by £20 in last year's accounts		
	28	Suspense	93	
		K. Sand		93
		Cheque received omitted from Sand's account		

Note: Only errors which make the trial balance totals different from each other can be corrected using a suspense account.

26.5 The effect of errors on profits

Some of the errors will have meant that profit reported was wrong. Other errors will have no effect upon profits. In Exhibit 26.5, we'll illustrate different types of errors that have this effect.

Exhibit 26.5

K. Anjali Income Statement for the year ending 31 December 2021

		£	£
Sales			180,000
Less	Cost of goods sold:		
	Opening inventory	15,000	
	Add Purchases	92,000	
		<u>107,000</u>	
	Less Closing inventory	<u>(18,000)</u>	
			(89,000)
	Gross profit		91,000
	Add Royalties received		1,400
			<u>92,400</u>
Less	Expenses:		
	Rent	8,400	
	Insurance	1,850	
	Lighting	1,920	
	Depreciation	<u>28,200</u>	
			(40,370)
	Net profit		<u>52,030</u>





Balance Sheet as at 31 December 2021

	£	£
<i>Non-current assets</i>		
Equipment at cost		62,000
Less Depreciation to date		(41,500)
		<u>20,500</u>
<i>Current assets</i>		
Inventory	18,000	
Trade receivables	23,000	
Bank	<u>19,000</u>	
	60,000	
<i>Less Current liabilities</i>		
Trade payables	(14,000)	
		46,000
Suspense account		80
Net assets		<u>66,580</u>
Capital		
Balance as at 1.1.2021		46,250
Add Net profit		<u>52,030</u>
		98,280
Less Drawings		(31,700)
		<u>66,580</u>

The errors that have been made may be of three types.

1 Errors that do not affect profit calculations

If an error affects items only in the balance sheet, then the original calculated profit will not need to be changed. Example 4 shows this.

Example 4

Assume that the £80 debit balance on the suspense account in Exhibit 26.5 was because of the following error:

On 1 November 2021, we paid £80 to a creditor, T. Arendse. It was correctly entered in the cash book. It was not entered anywhere else. The error was identified on 1 June 2022.

The journal entries to correct it will be:

The Journal

			Dr	Cr
2022			£	£
June	1	T. Arendse	80	
		Suspense		80
		Payment to T. Arendse on 1 November 2021 not entered in his account. Correction now made.		

Both of these accounts appeared in the balance sheet only with T. Arendse as part of trade payables. The net profit of £52,030 does not have to be changed.

2 Errors that do affect profit calculations

If the error is in one of the figures shown in the income statement, then the original profit will need to be amended. Example 5 shows this.

Example 5

Assume that the £80 debit balance on the suspense account in Exhibit 26.5 was because the rent account was added up incorrectly. It should be shown as £8,480 instead of £8,400. The error was identified on 1 June 2022. The journal entries to correct it are:

The Journal				Dr	Cr
				£	£
2022					
Jun	1	Rent		80	
		Suspense			80
		Correction of rent undercast last year			

Rent last year should have been increased by £80. This would have reduced net profit by £80. A statement of corrected profit for the year is now shown.

K. Anjali		
Statement of Corrected Net Profit for the year ending 31 December 2021		
		£
Net profit per the financial statements		52,030
Less Rent understated		(80)
Corrected net profit for the year		<u>51,950</u>

3 Where there have been several errors

Let's assume that in Exhibit 26.5 there had been four errors in the ledger accounts that were all identified on 31 March 2022:

(A) Sales overcast by	£90
(B) Insurance undercast by	£40
(C) Cash received from a debtor, E. Silva, entered in the Cash Book only	£50
(D) A purchase of £59 is entered in the books, debit and credit entries as	£95

Note: Error (D) is an 'error of transposition', as the correct numbers have been included but in the wrong order, i.e. they have been 'transposed'. It did not affect the trial balance so, it is not included in the £80 adjustment made by opening the suspense account.

The entries in the suspense account and the journal entries to correct these four errors will be:

Suspense Account									
				£	2022				£
2022					Mar	31	Sales	(A)	90
Jan	1	Balance b/d		80			Insurance	(B)	40
Mar	31	E. Silva	(C)	50					
				<u>130</u>					<u>130</u>

The Journal

			Dr	Cr
			£	£
2022				
1	Mar 31	Sales	90	
		Suspense		90
		Sales overcast of £90 in 2021		
2	Mar 31	Insurance	40	
		Suspense		40
		Insurance expense undercast by £40 in 2021		
3	Mar 31	Suspense	50	
		E. Silva		50
		Cash received omitted from trade receivables account in 2021		
4	Mar 31	Creditor's account	36	
		Purchases		36
		Credit purchase of £59 entered both as debit and credit as £95 in 2021		

Note: Remember that in (D), the correction of the overstatement of purchases does *not* pass through the suspense account because it did not affect the balancing of the trial balance.

Now we can calculate the corrected net profit for the year 2021. Only items (A), (B) and (D) affect figures in the income statement. Error (C), the cash not posted to a debtor's account, did not affect the profit calculation. Only for (A), (B) and (D) do adjustments need to be made to profit.

K. Anjali
Statement of Corrected Net Profit for the year ending 31 December 2021

			£
Net profit per the financial statements			52,030
Add Purchases overstated	(D)		36
			<u>52,066</u>
Less Sales overcast	(A)	90	
Insurance undercast	(B)	<u>40</u>	
			(130)
Corrected net profit for the year			<u><u>51,936</u></u>

26.6 Suspense accounts: businesses and examinations

Businesses

Every attempt should be made to find errors. A suspense account should be opened only if all other efforts have failed, and they *never* should!

Examinations

Unless it is part of a question, *do not* make your balance sheet totals agree by using a suspense account. The same applies to trial balances. Examiners are very likely to penalise you for showing a suspense account when it should not be required.

Overall

Suspense accounts have probably been used ever since people first started keeping accounts and using them to produce financial statements. However, just because suspense accounts have been used for a very long time does not mean that they should still be used today.

Long ago, accounting records were very poorly maintained. The people maintaining them were frequently untrained. Errors were fairly common, and no one was very concerned when it proved difficult to find out what had caused a trial balance not to balance, if they even went to the extent of preparing one.

Businesses were largely owned by one person who would often also prepare the financial statements, more out of interest than in order to make much use of what they showed which, before there was some regulation concerning what they presented, was frequently little more than the excess or shortfall of revenue over expenditure.

Nowadays, accounting is far more sophisticated and the people maintaining the accounting records are much better trained. Almost all organisations use computerised accounting systems and very few organisations of any complexity continue to do everything manually. When they do, their records will be good enough to make tracing an error reasonably straightforward.

Errors of the types that cause trial balances not to balance are, therefore, much less common and much easier to detect. As a result, it is inconceivable that a suspense account will ever be needed in practice when an accountant is involved in preparing or auditing (i.e. checking the validity of) the financial statements.

Nevertheless, circumstances may make it impossible for a sole trader's financial statements to be ready in time, for example, to show the bank manager when asking for a loan. It is probably only in circumstances of this type that you may find suspense accounts still in use, albeit rarely because the inclusion of a suspense accounts casts doubt on the accuracy of *all* the information in the financial statements. An example may be when money is received by post or credited into the business's bank account with no explanation and no information. It needs to be put somewhere in the ledger accounts, so a suspense account is used while the reason it was sent to the business is identified.

Learning outcomes

You should now have learnt:

- 1 How to make the appropriate entries in setting up a suspense account.
- 2 How to make the correcting entries involving the suspense account when the cause of an error is identified.
- 3 That some errors may cause the profits originally calculated to have been incorrect.
- 4 That errors that do not affect profit calculations will have an effect only on items in the balance sheet.
- 5 That nowadays suspense accounts very rarely need to be used, if at all.

Answers to activities

- 26.1** This is a major problem in the use of suspense accounts. There is no double entry and, therefore, no debit to match the credit of £40! The justification for this is that there is either a £40 hidden credit somewhere in the accounts that has been omitted when the balances were extracted for the trial balance, or that an extra £40 has been added by mistake to the debit entries in the trial balance. As a result, making this single entry is only completing the existing double entry, the other side being the mistake. Many accountants believe that it is bad practice to open a suspense account as it contravenes the basic principles of double entry. You would be wise to follow that advice and only open a suspense account if an examiner requires you to do so.

26.2 If it is material, definitely. If it is not material, it could be argued that no one will be concerned. However, the appearance of a suspense account in the balance sheet is, by definition, material – you don't include anything in the financial statements as a separate entry that is not of interest to the users of the financial statements. There has been *at least* one error made in the accounting entries and the fact that it cannot be found may indicate a much more serious problem with the accounting system. This is of concern to anyone with a knowledge of accounting for, nowadays, when all complex accounting systems are computerised, *no* error should be that difficult to find, no matter how large or complicated the financial system or the organisation.

Review questions

26.1 A trial balance was extracted from the books of S Boulos, and it was found that the debit side exceeded the credit side by £57. This amount was entered in the suspense account. The following errors were later discovered and corrected:

- (i) Purchases were over-summed by £72.
- (ii) The balance on the drawings account of £60 has been omitted from the trial balance.
- (iii) Sales were under-summed by £45.

Required:

Write up and rule off the suspense account as it would appear in the ledger.

26.2 Your bookkeeper extracted a trial balance on 31 December 2019 which failed to agree by £860, a shortage on the credit side of the trial balance. A suspense account was opened for the difference.

In January 2020 the following errors made in 2019 were found:

- (i) Sales day book had been undercast by £1,205.
- (ii) Sales of £980 to I. Blane had been debited in error to I. Blank's account.
- (iii) Rent account had been undercast by £404.
- (iv) Discounts allowed account had been overcast by £59.
- (v) The sale of a computer at its carrying amount had been credited in error to the Sales account £200.

Required:

- (a) Show the journal entries necessary to correct the errors.
- (b) Draw up the suspense account after the errors described have been corrected.
- (c) If the net profit had previously been calculated at £58,600 for the year ending 31 December 2019, show the calculations of the corrected net profit.

26.3A You have extracted a trial balance and drawn up accounts for the year ended 31 December 2017. There was a shortage of £78 on the credit side of the trial balance, a suspense account being opened for that amount.

During 2018 the following errors made in 2017 were found:

- (i) £125 received from sales of old office equipment has been entered in the sales account.
- (ii) Purchases day book had been overcast by £10.
- (iii) A private purchase of £140 had been included in the business purchases.
- (iv) Bank charges £22 entered in the cash book have not been posted to the bank charges account.
- (v) A sale of goods to K. Sefa £230 was correctly entered in the sales book but entered in the personal account as £320.

Required:

- (a) Show the requisite journal entries to correct the errors.
- (b) Write up the suspense account showing the correction of the errors.
- (c) The net profit originally calculated for 2017 was £28,400. Show your calculation of the correct figure.

26.4 Show how each of the following errors would affect trial balance agreement:

- (i) Computer repairs £184 was debited to the computer account.
- (ii) £918 discounts received credited to discounts allowed account.
- (iii) Inventory at close undervalued by £2,050.
- (iv) £260 commission received was debited to the sales account.
- (v) Drawings £106 credited to the capital account.
- (vi) Cheque paying £380 to M. Wilson entered in the cash book but not in the personal account.
- (vii) Cheque £264 from T. Pane credited to T. Pain.

Use the following format for your answer:

<i>Item</i>	<i>If no effect state 'No'</i>	<i>Debit side exceeds credit side by amount shown</i>	<i>Credit side exceeds debit side by amount shown</i>
(i)			
(ii)			
(iii)			
(iv)			
(v)			
(vi)			
(vii)			

26.5 The following is a trial balance which has been incorrectly drawn up:**Trial Balance at 31 January 2019**

	£	£
Capital 1 February 2018	7,845	
Drawings	19,500	
Inventory 1 February 2018		8,410
Trade receivables		34,517
Furniture and fittings	2,400	
Cash in hand	836	
Trade payables		6,890
Sales		127,510
Returns inwards		2,438
Discount received	1,419	
Business expenses	3,204	
Purchases	72,100	
	<u>107,304</u>	<u>179,765</u>

In addition to the mistakes evident above, the following errors were also discovered:

- 1 A payment of £315 made to a creditor had not been posted from the cash book into the purchases ledger.
- 2 A cheque for £188 received from a customer had been correctly entered in the cash book but posted to the customer's account as £180.
- 3 A purchase of fittings £407 had been included in the purchases account.
- 4 The total of the discounts allowed column in the cash book of £42 had not been posted into the general ledger.
- 5 A page of the sales day book was correctly totalled as £765 but carried forward as £675.

Show the trial balance as it would appear after all the errors had been corrected. Show all your workings.





26.6 Study the following and answer the questions below.

The trial balance of Mary Harris (Gowns) as at 31 December 2018 showed a difference which was posted to a suspense account. Draft final accounts for the year ended 31 December 2018 were prepared showing a net profit of £47,240. The following errors were subsequently discovered:

- Sales of £450 to C. Thomas had been debited to Thomasson Manufacturing Ltd.
- A payment of £275 for telephone charges had been entered on the debit side of the Telephone account as £375.
- The sales journal had been undercast by £2,000.
- Repairs to a machine, amounting to £390, had been charged to Machinery account.
- A cheque for £1,500, being rent received from Atlas Ltd, had only been entered in the cash book.
- Purchases from P. Brooks, amounting to £765, had been received on 31 December 2018 and included in the closing inventory at that date, but the invoice had not been entered in the purchases journal.

Questions:

- (a) (i) Give the journal entries, without narratives, necessary to correct the above errors.
(ii) Show the effect of each of these adjustments on the net profit in the draft financial statements and the correct profit for the year ended 31 December 2018.
- (b) (i) State briefly the purpose of the journal, giving a suitable example of its use.
(ii) State why it is necessary to distinguish between capital and revenue expenditure.

(Midland Examining Group: GCSE)

26.7A Lee Crosby has just completed his first year of trading selling cookery equipment. He attempted to prepare a balance sheet from his trial balance before seeking expert help as he was having difficulty getting the balance sheet totals to agree. The trial balance included a suspense account balance of £10,000. This amount has not been entered on the balance sheet.

Balance sheet for Lee Crosby for the year ended 31 March 2018

Capital at 1 April 2017			136,175
Shop fittings			38,000
Drawings			<u>71,201</u>
<i>Current liabilities</i>			
Loan payable 2023	52,000		
Trade receivables	3,740		
Accrual of expenses	160		
Cash at bank	<u>2,140</u>		
		58,040	
<i>Current assets</i>			
Property	108,000		
Trade payables	4,220		
Prepayment of expenses	<u>225</u>		
		112,445	
			<u>56,405</u>
			<u>190,971</u>
Closing inventories			31,517
Cash in hand			155
Profit for the year			<u>52,423</u>
			<u>84,095</u>

Additional information at 31 March 2018

- 1 During the year cookery equipment purchased for resale that had cost £3,500 has been entered in error into the shop fittings account.
- 2 Lee believes the shop fittings will have an economic life of 5 years and have an estimated residual value of £2,000.
- 3 The property should be depreciated by 5% using the straight-line method.
- 4 Lee had withdrawn £75 in cash from the business for his own personal use. This transaction has not yet been accounted for.
- 5 A credit customer has ceased trading owing Lee £1,040 that will never be received.
- 6 The wages account has been overstated by £10,000.
- 7 A credit supplier has issued a credit note of £55 for goods that have been damaged and this has not been entered into the books of account.

Required

Prepare a corrected balance sheet at 31 March 2018 taking into account the additional information in points 1–7.

(AQA AS Level)

26.8 The trial balance as at 30 April 2019 of Timber Products Limited was balanced by the inclusion of the following debit balance:

Difference on trial balance suspense account £2,513.

Subsequent investigations revealed the following errors:

- (i) Discounts received of £324 in January 2019 have been posted to the debit of the discounts allowed account.
- (ii) Wages of £2,963 paid in February 2019 have not been posted from the cash book.
- (iii) A remittance of £940 received from K. Mitcham in November 2018 has been posted to the credit of B. Mansell Limited.
- (iv) In December 2018, the company took advantage of an opportunity to purchase a large quantity of stationery at a bargain price of £2,000. No adjustments have been made in the accounts for the fact that three-quarters, in value, of this stationery was in the inventory on 30 April 2019.
- (v) A payment of £341 to J. Winters in January 2019 has been posted in the personal account as £143.
- (vi) A remittance of £3,000 received from D. North, a credit customer, in April 2019 has been credited to sales.

The draft accounts for the year ended 30 April 2019 of Timber Products Limited show a net profit of £24,760.

Timber Products Limited has very few personal accounts and therefore does not maintain either a purchases ledger control account or a sales ledger control account.

Required:

- (a) Prepare the difference on trial balance suspense account showing, where appropriate, the entries necessary to correct the accounting errors.
- (b) Prepare a computation of the corrected net profit for the year ended 30 April 2019 following corrections for the above accounting errors.
- (c) Outline the principal uses of trial balances.

(Association of Accounting Technicians)





26.9A Chi Knitwear Ltd is an old-fashioned business with a handwritten set of books. A trial balance is extracted at the end of each month, and an income statement and a balance sheet are computed. This month, however, the trial balance will not balance, the credits exceeding debits by £1,536.

You are asked to help and after inspection of the ledgers discover the following errors.

- (i) A balance of £87 on a debtor's account has been omitted from the schedule of debtors, the total of which was entered as trade receivables in the trial balance.
- (ii) A small piece of machinery purchased for £1,200 had been written off to repairs.
- (iii) The receipts side of the cash book had been undercast by £720.
- (iv) The total of one page of the sales day book had been carried forward as £8,154, whereas the correct amount was £8,514.
- (v) A credit note for £179 received from a supplier had been posted to the wrong side of his account.
- (vi) An electricity bill in the sum of £152, not yet accrued for, is discovered in a filing tray.
- (vii) Mr Smith, whose past debts to the company had been the subject of an allowance, at last paid £731 to clear his account. His personal account has been credited but the cheque has not yet passed through the cash book.

Required:

- (a) Write up the suspense account to clear the difference, and
- (b) State the effect on the accounts of correcting each error.

(Association of Chartered Certified Accountants)

26.10A Waban prepared draft financial statements for the year ended 31 March 2024, which showed a draft profit for the year of £43,750. His draft financial statements were prepared by a Trainee Accountant. The trial balance failed to agree and contained ledger accounts with the following errors:

- (1) Cash sales of £850 had not been recorded in the books.
- (2) A purchase invoice for £490 had been correctly recorded in the account of Chitta Products, but had been recorded in the Purchases Day Book as £940.
- (3) A motor vehicle, purchased during the year for £8,000, had been debited to the Motor Expenses Account. Depreciation on the motor vehicle should have been charged at the rate of 25% using the straight line method.
- (4) Interest received, £630, was correctly entered in the Cash Book, but had been debited to the Interest Received Account.
- (5) Electricity supplied by Dalha Electric, £345, had been recorded in the Electricity Account and Dalha Electric Account as £145.
- (6) No debit entry had been made for general expenses of £65.
- (7) The debt of Habib, £4,100, was now considered irrecoverable. No entries had been made in the books.
- (8) Purchases returns to Taj, £85, had been entered in the account of Raj.

Required:

- (a) Briefly explain **two** actions that Waban could take when his trial balance failed to balance.
- (b) Prepare the Journal entries to correct the errors in (1) to (8) above. Narratives are **not** required.
- (c) Prepare the Suspense Account showing the original difference in the trial balance on 31 March 2024.
- (d) Starting with the draft profit for the year of £43,750, calculate the revised profit for the year showing the effect of **each** error.
- (e) Evaluate preparing draft financial statements from books containing errors.

(Edexcel A level)

26.11 The following points were discovered in the books of a small building business before the closing entries had been made. Draft financial statements had already been prepared and showed a net profit of £23,120.

- (i) The purchase of a new van for £6,000 was included in the motor vehicle expenses account.
- (ii) The drawings account included £250 for the purchase of fuel which was used to heat the business offices.
- (iii) £300 paid by a customer, B. Burton Ltd, had been credited to B. Struton's account in error.
- (iv) The water rates on the proprietor's home of £750 has been paid by the business and debited to the business rates account.
- (v) £720 included in the wages account was paid to workmen for building a greenhouse in the proprietor's garden.
- (vi) Building materials bought on credit from K. Jarman for £500, has been delivered to the business on the balance sheet date and had been included in the inventory figure at that date, but the invoice for these goods had not been entered in the purchases day book.

Required:

- (a) The journal entries to record the necessary adjustments arising from the above.
- (b) A statement showing the effect of these adjustments on the profit shown in the draft financial statements.

26.12 At the end of a financial year, the trial balance of a small company failed to agree and the difference was entered in a suspense account. Subsequently, the following errors were discovered:

- (i) The sales day book had been undercast by £10.
- (ii) A customer's personal account has been correctly credited with £2 discount, but no corresponding entry was made in the discount column of the cash book.
- (iii) Discounts allowed for July amounting to £70 were credited instead of being debited to the discount account.
- (iv) A debit balance on the account of D. Bird, a customer, was carried forward £10 short.
- (v) An old credit balance of £3 on a customer's account (J. Flyn) had been entirely overlooked when extracting the balances.

Required:

- (a) Prepare, where necessary, the journal entries to correct the errors.
- (b) Draw up a statement showing the impact of these errors upon the trial balance.

26.13A Journalise the matters arising from the following items in the books of B. Danby, including the narrative in each case. Note that for this purpose cash and bank items may be journalised.

In the case of those items which gave rise to a difference in the trial balance you are to assume that the difference was previously recorded in a suspense account.

- (a) Discounts allowed during March amounting to £62 were posted to the credit of the discounts received account.
- (b) The sales day book was overcast by £100.
- (c) The motor van standing in the ledger at £1,800 was exchanged for fittings valued at £1,400 plus a cheque for £700.
- (d) £470 has been included in the wages account and £340 in the purchases account. These amounts represent expenditure on an extension to the business premises.
- (e) A cheque for £86 received from C. Blimp and discount of £4 allowed to him were correctly recorded but, when the cheque was subsequently dishonoured, no further entries were recorded.
- (f) A cheque for £76 paid to D. Hood was correctly recorded in the cash book but was posted in error to D. I. Hoade's account as £67.





26.14 The bookkeeper of a firm failed to agree the trial balance at 30 June, the end of the financial year. She opened a suspense account into which she entered the amount she was out of balance and carried this amount to a draft balance sheet that she prepared.

The following errors were subsequently discovered in the books:

- (i) The purchase day book had been undercast by £10.
- (ii) Goods bought on credit from A. Supplier for £5 had been posted to his account as £50.
- (iii) A new machine costing £70 had been posted to the debit of the repairs to machinery account.
- (iv) S. Kane, a customer, returned goods valued at £10. This had been entered in the sales returns day book and posted to the debit of the customer's account.
- (v) The sale on credit of various items of plant and machinery at their book value of £300 had been recorded in the sales day book.
- (vi) £60 owed by D. Clarke, a customer, had been overlooked when drawing up a schedule of trade receivables from the ledger.
- (vii) An item of prompt payment discount allowed £2 had been correctly entered in the cash book but had not been posted to the account of B. Luckwood, the customer.
- (viii) Business rates, treated as having been paid in advance in the previous accounting period, amounting to £45 had not been brought down as a balance on the business rates account at the start of the accounting period. Instead it was included in the prepayments account.

As a result of posting these errors to the suspense account, the balance on the suspense account was reduced to zero.

Required:

- (a) Prepare the suspense account, including the initial opening entry made by the bookkeeper, along with all the necessary adjusting entries identified above.
- (b) Explain clearly the effect of correcting the above errors:
 - (i) on the net profit shown in the draft income statement
 - (ii) on any of the items in the draft balance sheet

Note: You will find this question easier if you prepare journal entries for each item before answering (a) and (b).

Single entry and incomplete records

Learning objectives

After you have studied this chapter, you should be able to:

- Deduce the figure of profits where only the increase in capital and details of drawings are known.
- Draw up an income statement and a balance sheet from records not kept on a double entry system.
- Deduce the figure for cash drawings when all other cash receipts and cash payments are known.
- Deduce the figures of sales and purchases from incomplete records.

Introduction

In this chapter, you'll learn about single entry and incomplete records. You will learn how to use the accounting equation to identify the profit for a period when only the opening and closing capital figures and drawings made during the year are known. You will also learn how to find the figure for cash drawings or the figure for cash expenses when all other cash receipts and payments are known. And you will learn how to find the figures for purchases and sales from incomplete records.

27.1 Why double entry is not used

For every small shopkeeper, market stall, café, or other small business to keep its books using a full double entry system would be ridiculous. Apart from anything else, a large number of the owners of such businesses would not know how to maintain double entry records, even if they wanted to.

It is more likely that they would enter details of a transaction once only, using a single-entry system. Many of them don't even do that, resulting in incomplete records.

It is, perhaps, only fair to remember that accounting is supposed to be an aid to management – accounting *is not* something to be done as an end in itself. Therefore, many small firms, especially retail shops, can have all the information they want by merely keeping a cash book and having some form of record, not necessarily in double entry form, of their debtors and creditors.

However, despite many small businesses not having any need for accounting records, most do have to prepare financial statements or, at least, calculate their sales or profits once a year. How can these be calculated if the bookkeeping records are inadequate or incomplete?

**Activity
27.1**

What may cause these accounting statements and figures to need to be calculated?

- (i) Profits
- (ii) Sales
- (iii) Financial statements

27.2 Profit as an increase in capital

From your knowledge of the accounting equation, you know that unless there has been an introduction of extra cash or resources into a business, the only way that capital can be increased is by making profits.

Identifying profits when opening and closing capital are known

If you know the capital at the start of a period and the capital at the end of the period, profit is the figure found by subtracting capital at the start of the period from that at the end of the period.

Let's look at a business where capital at the end of 2020 was £20,000. During 2021 there have been no drawings, and no extra capital has been brought in by the owner. At the end of 2021 the capital was £30,000.

$$\begin{array}{rcccl} & \text{This year's} & & \text{Last year's} & \\ & \text{capital} & & \text{capital} & \\ \text{Net profit} = & £30,000 & - & £20,000 & = £10,000 \end{array}$$

If drawings had been £7,000, the profits must have been £17,000:

$$\begin{array}{rcccl} \text{Last year's Capital} & + & \text{Profits} & - & \text{Drawings} & = & \text{This year's Capital} \\ £20,000 & + & ? & - & £7,000 & = & £30,000 \end{array}$$

We can see that £17,000 profits is the figure needed to complete the formula:

$$£20,000 + £17,000 - £7,000 = £30,000$$

Identifying profits when you only have a list of the opening and closing assets and liabilities

In this case, you use the accounting equation.

**Activity
27.2**

What is the formula for the accounting equation? Write down both (a) the normal form and (b) the alternative form.

Exhibit 27.1 shows the calculation of profit where insufficient information is available to draft an income statement. The only information available is about the assets and liabilities.

Exhibit 27.1

H. Taylor has not kept proper bookkeeping records, but she has kept notes in diary form of the transactions of her business. She is able to give you details of her assets and liabilities as at 31 December 2021 and 31 December 2022:

At 31 December 2021

Assets: Van £6,000; Fixtures £1,800; Inventory £3,000; Trade receivables £4,100; Bank £4,800; Cash £200.

Liabilities: Trade payables £1,200; Loan from J. Ogden £3,500.

At 31 December 2022

Assets: Van (after depreciation) £5,000; Fixtures (after depreciation) £1,600; Inventory £3,800; Trade receivables £6,200; Bank £7,500; Cash £300.

Liabilities: Trade payables £1,800; Loan from J. Ogden £2,000.

Drawings during 2022 were £5,200.

You need to put all these figures into a format that will enable you to identify the profit. Firstly, you need to draw up a **statement of affairs** as at 31 December 2021. This is really just a balance sheet, but this is the name normally used when you are dealing with incomplete records.

From the accounting equation, you know that capital is the difference between the assets and liabilities.

H. Taylor
Statement of Affairs as at 31 December 2021

	£	£
<i>Non-current assets</i>		
Van		6,000
Fixtures		<u>1,800</u>
		7,800
<i>Current assets</i>		
Inventory	3,000	
Trade receivables	4,100	
Bank	4,800	
Cash	<u>200</u>	
		12,100
Total assets		19,900
<i>Current liabilities</i>		
Trade payables	1,200	
<i>Non-current liability</i>		
Loan from J. Ogden	<u>3,500</u>	
Total liabilities		<u>(4,700)</u>
Net assets		<u>15,200</u>
Capital*		<u><u>15,200</u></u>

Note:* The accounting equation tells you that this must be the figure to use.

You now draw up a second statement of affairs, this time as at the end of 2022. The formula of *Opening Capital + Profit – Drawings = Closing Capital* is then used to deduce the figure of profit.





H. Taylor
Statement of Affairs as at 31 December 2022

	£	£
<i>Non-current assets</i>		
Van		5,000
Fixtures		<u>1,600</u>
		6,600
<i>Current assets</i>		
Inventory	3,800	
Trade receivables	6,200	
Bank	7,500	
Cash	<u>300</u>	
		17,800
Total assets		24,400
<i>Current liabilities</i>		
Trade payables	1,800	
<i>Non-current liability</i>		
Loan from J. Ogden	<u>2,000</u>	
Total liabilities		<u>(3,800)</u>
Net assets		<u>20,600</u>
Capital		
Balance at 1.1.2022		15,200
Add Net profit	(C)	<u>?</u>
	(B)	<u>?</u>
Less Drawings		<u>(5,200)</u>
	(A)	<u><u> </u></u>

Deduction of net profit:

Opening Capital + Net Profit – Drawings = Closing Capital. Finding the missing figures (A), (B) and (C) by deduction:

(A) is the same as the total of the top half of the statement of affairs, i.e. £20,600;

(B) is therefore £20,600 + £5,200 = £25,800;

(C) is therefore £25,800 – £15,200 = £10,600.

To check:

Capital		
Balance at 1.1.2022		15,200
Add Net profit	(C)	<u>10,600</u>
	(B)	<u>25,800</u>
Less Drawings		<u>(5,200)</u>
	(A)	<u><u>20,600</u></u>

Obviously, this method of calculating profit is very unsatisfactory. It is much more informative when an income statement can be drawn up. Therefore, whenever possible, this ‘comparisons of capital method’ of ascertaining profit should be avoided and a full set of financial statements should be drawn up from the available records.

It is important to realise that businesses should have exactly the same income statements and balance sheets whether they keep their books by single entry or double entry. However, as you will see, whereas the double entry system uses the trial balance in preparing the financial statements, the single-entry system has to arrive at the same answer by different means.

27.3 Drawing up the financial statements

The following example shows the various stages of drawing up financial statements from a single entry set of records.

The accountant has found the following details of transactions for J. Yunus's shop for the year ended 31 December 2021.

- (a) The sales are mostly on credit. No record of sales has been kept, but £61,500 has been received from persons to whom goods have been sold – £48,000 by cheque and £13,500 in cash.
- (b) Amount paid by cheque to suppliers during the year = £31,600.
- (c) Expenses paid during the year: by cheque: Rent £3,800; General Expenses £310; by cash: Rent £400.
- (d) J. Yunus took £250 cash per week (for 52 weeks) as drawings.
- (e) Other information is available:

	At 31.12.2020	At 31.12.2021
	£	£
Trade receivables	5,500	6,600
Trade payables for goods	1,600	2,600
Rent owing	–	350
Bank balance	5,650	17,940
Cash balance	320	420
Inventory	6,360	6,800

- (f) The only non-current asset consists of fixtures which were valued at 31 December 2020 at £3,300. These are to be depreciated at 10 per cent per annum.

We'll now prepare the financial statements in five stages.

Stage 1

Draw up a Statement of Affairs on the closing day of the earlier accounting period:

J. Yunus Statement of Affairs as at 31 December 2020

	£	£
<i>Non-current assets</i>		
Fixtures		3,300
<i>Current assets</i>		
Inventory	6,360	
Trade receivables	5,500	
Bank	5,650	
Cash	<u>320</u>	
		<u>17,830</u>
Total assets		21,130
<i>Current liabilities</i>		
Trade payables		<u>(1,600)</u>
Net assets		<u>19,530</u>
<i>Financed by:</i>		
Capital (difference)		<u>19,530</u>

All of these opening figures are then taken into account when drawing up the financial statements for 2021.

Stage 2

Prepare a cash and bank summary, showing the totals of each separate item, plus opening and closing balances.

	Cash	Bank		Cash	Bank
	£	£		£	£
Balances 31.12.2020	320	5,650	Suppliers		31,600
Receipts from debtors	13,500	48,000	Rent	400	3,800
			General expenses		310
			Drawings	13,000	
			Balances 31.12.2021	420	17,940
	<u>13,820</u>	<u>53,650</u>		<u>13,820</u>	<u>53,650</u>

Stage 3

Calculate the figures for purchases and sales to be shown in the trading account. Remember that the figures needed are the same as those which would have been found if double entry records had been kept.

Purchases: In double entry, 'purchases' are the goods that have been bought in the period irrespective of whether they have been paid for or not during the period. The figure of payments to suppliers must, therefore, be adjusted to find the figure for purchases.

	£
Paid during the year	31,600
Less Payments made, but which were for goods purchased in a previous year (trade payables at 31.12.2020)	(1,600)
	<u>30,000</u>
Add Purchases made in the current year for which payment has not yet been made (trade payables at 31.12.2021)	2,600
Goods bought in this year, i.e. purchases	<u>32,600</u>

The same answer could have been obtained if the information had been shown in the form of a total trade payables account, the figure for purchases being the amount required to make the account totals agree.

Total trade payables			
	£		£
Cash paid to suppliers	31,600	Balances b/d	1,600
Balances c/d	2,600	Purchases (missing figure)	<u>32,600</u>
	<u>34,200</u>		<u>34,200</u>

Sales: The sales figure will only equal receipts where all the sales are for cash. Therefore, the receipts figures need adjusting to find sales. This can only be done by constructing a total trade receivables account, the sales figure being the one needed to make the totals agree.

Total trade receivables			
	£		£
Balances b/d	5,500	Receipts: Cash	13,500
Sales (missing figure)	<u>62,600</u>	Cheque	48,000
		Balances c/d	6,600
	<u>68,100</u>		<u>68,100</u>

Stage 4

Expenses. Where there are no accruals or prepayments either at the beginning or end of the accounting period, then expenses paid will equal expenses used up during the period. These figures will be charged to the income statement.

On the other hand, where such prepayments or accruals exist, an expense account should be drawn up for that particular item. When all known items are entered, the missing figure will be the expenses to be charged for the accounting period. In this case, only the rent account needs to be drawn up.

Rent			
	£		£
Bank	3,800	Profit and loss (missing figure)	4,550
Cash	400		
Accrued c/d	350		
	<u>4,550</u>		<u>4,550</u>

Stage 5

Now draw up the financial statements.

J. Yunus Income Statement for the year ending 31 December 2021

	£	£
Sales (Stage 3)		62,600
Less Cost of goods sold:		
Inventory at 1.1.2021	6,360	
Add Purchases (Stage 3)	32,600	
	38,960	
Less Inventory at 31.12.2021	<u>(6,800)</u>	(32,160)
Gross profit		30,440
Less Expenses:		
Rent (Stage 4)	4,550	
General expenses	310	
Depreciation: Fixtures	<u>330</u>	(5,190)
Net profit		<u>25,250</u>

Balance sheet as at 31 December 2021

	£	£
Non-current assets		
Fixtures at 1.1.2021		3,300
Less Depreciation		<u>(330)</u>
		2,970
Current assets		
Inventory	6,800	
Trade receivables	6,600	
Bank	17,940	
Cash	<u>420</u>	31,760
Total assets		<u>34,730</u>
Current liabilities		
Trade payables	2,600	
Rent owing	<u>350</u>	(2,950)
Total liabilities		(2,950)
Net assets		<u>31,780</u>
Financed by:		
Capital		
Balance 1.1.2021 (per Opening Statement of Affairs, Stage 1)		19,530
Add Net profit		<u>25,250</u>
		44,780
Less Drawings		<u>(13,000)</u>
Total capital		<u>31,780</u>

27.4 Incomplete records and missing figures

In practice, part of the information relating to *cash* receipts or payments is often missing. If the missing information is in respect of one type of payment, then it is normal to assume that the missing figure is the amount required to make both totals agree in the *cash* column of the cash and bank summary. (This does not happen with bank items because another copy of the bank statement can always be obtained from the bank.)

Exhibit 27.2 shows an example where the figure for Drawings is unknown. The exhibit also shows the contra entry made in the cash book when cash receipts are banked.

Exhibit 27.2

The following information on cash and bank receipts and payments is available:

	Cash	Bank
	£	£
Cash paid into the bank during the year	35,500	
Receipts from debtors	47,250	46,800
Paid to suppliers	1,320	44,930
Drawings during the year	?	–
Expenses paid	150	3,900
Balances at 1.1.2020	235	11,200
Balances at 31.12.2020	250	44,670

Now, you need to enter this information in a cash book:

	Cash		Bank	Cash		Bank
	£	£		£	£	
Balances 1.1.2020	235	11,200	Bank ¢	35,500		
Received from debtors	47,250	46,800	Suppliers	1,320	44,930	
Cash ¢		35,500	Expenses	150	3,900	
			Drawings	?		
			Balances 31.12.2020	250	44,670	
	<u>47,485</u>	<u>93,500</u>		<u>47,485</u>	<u>93,500</u>	

The amount needed to make the two sides of the cash columns agree is £10,265, i.e. £47,485 minus £(35,500 + 1,320 + 150 + 250). This is the figure for drawings.

Exhibit 27.3 shows an example where the amount of cash received from debtors is unknown.

Exhibit 27.3

Information on cash and bank transactions is available as follows:

	Cash	Bank
	£	£
Receipts from debtors	?	78,080
Cash withdrawn from the bank for business use (this is the amount which is used besides cash receipts from debtors to pay drawings and expenses)		10,920
Paid to suppliers	–	65,800
Expenses paid	640	2,230
Drawings	21,180	315
Balances at 1.1.2020	40	1,560
Balances at 31.12.2020	70	375

	Cash	Bank		Cash	Bank
	£	£		£	£
Balances 1.1.2020	40	1,560	Suppliers		65,800
Received from debtors	?	78,080	Expenses	640	2,230
Withdrawn from Bank ¢	10,920		Withdrawn from Bank ¢		10,920
			Drawings	21,180	315
			Balances 31.12.2020	70	375
	<u>21,890</u>	<u>79,640</u>		<u>21,890</u>	<u>79,640</u>

As it is the only missing item, receipts from debtors is, therefore, the amount needed to make each side of the cash column agree, £10,930, i.e. £21,890 minus £(10,920 + 40).

It must be emphasised that the use of balancing figures is acceptable only when all the other figures have been verified. Should, for instance, a cash expense be omitted when cash received from debtors is being calculated, this would result in an understatement not only of expenses but also, ultimately, of sales.

27.5 Where there are two missing pieces of information

Quite often, the only cash item for which there is some doubt is drawings. Receipts will normally have been retained for all the others.

If both cash drawings and cash receipts from debtors (or from cash sales) were not known, it would not be possible to deduce both of these figures separately. The only course available would be to estimate whichever figure was more capable of being accurately assessed, use this as if it were a 'known' figure, then deduce the other figure. However, this is a most unsatisfactory position as both of the figures are estimates, the accuracy of each one relying entirely upon the accuracy of the other.

Activity 27.3

Why is arriving at a figure for drawings that is as accurate as possible very important for the owner of a business?

27.6 Cash sales and purchases for cash

Where there are cash sales as well as sales on credit terms, then the cash sales must be added to sales on credit to give the total sales for the year. This total figure of sales will be the one shown in the trading account part of the income statement.

Similarly, purchases for cash will need to be added to credit purchases in order to produce the figure of total purchases for the trading account.

27.7 Inventory stolen, lost or destroyed

When inventory is stolen, lost or destroyed, its value will have to be calculated. This could be needed to justify an insurance claim or to settle problems concerning taxation, etc.

If the inventory had been valued immediately before the fire, burglary, etc., then the value of the inventory lost would obviously be known. Also, if a full and detailed system of inventory records were kept, then the value would also be known. However, as the occurrence of fires or burglaries cannot be foreseen, and many small businesses do not keep full and proper inventory records, the value of the inventory lost has to be calculated in some other way.

The methods described in this chapter and some you will learn about in Chapter 38 are used. Bear in mind that you are going to be calculating figures as at the time of the fire or theft, not at the end of the accounting period.

Let's now look at Exhibits 27.4 and 27.5. The first exhibit involves a very simple case, where figures of purchases and sales are known and all goods are sold at the same gross profit margin. The second exhibit is rather more complicated.

Exhibit 27.4

J. Belmonte lost the whole of his inventory in a fire on 17 March 2022. The last time stocktaking had been done was on 31 December 2021, the date of the last balance sheet, when the inventory was valued at cost at £19,500. Purchases from then until 17 March 2022 amounted to £68,700 and sales in that period were £96,000. All sales were made at a uniform gross profit margin of 20 per cent, i.e. the cost of sales was $100\% - 20\% = 80\%$ of the selling price.

First, the trading account section of the income statement can be drawn up with the known figures included. Then the missing figures can be deduced.

J. Belmonte Trading Account section of the income statement for the period 1 January 2022 to 17 March 2022			
	£		£
Sales			96,000
Less Cost of goods sold:			
Opening inventory	19,500		
Add Purchases	68,700		
	88,200		
Less Closing inventory	(C) () ?	(B) () ?	
Gross profit		(A) <u> ?</u>	

Now the missing figures can be deduced:

It is known that the gross profit margin is 20 per cent, therefore gross profit (A) is 20% of £96,000 = £19,200.

Now $(B) + (A) = £96,000$ and $(A) = £19,200$ so, (B) is the difference, i.e. £76,800.

Now that (B) is known, (C) can be deduced: $£88,200 - (C) = £76,800$, so (C) is the difference, i.e. £11,400.

The figure for inventory destroyed by fire, at cost, is therefore £11,400.

Note: You should always do this calculation in the sequence shown (i.e. A then B then C).

Exhibit 27.5

T. Scott had all his inventory stolen from his warehouse on the night of 20 August 2023 along with many of his accounting records including his sales and purchases day books. The sales and purchases ledgers were found in the car park. The following facts are known:

- Inventory at the last balance sheet date, 31 March 2023, was £12,480 at cost.
- Receipts from debtors during the period 1 April to 20 August 2023 amounted to £31,745. Trade receivables were: at 31 March 2023 £14,278, at 20 August 2023 £12,333.
- Payments to creditors during the period 1 April to 20 August 2023 amounted to £17,270. Trade payables were: at 31 March 2023 £7,633, at 20 August 2023 £6,289.
- The gross profit margin on all sales has been constant at 25 per cent.

Before we can start to construct a trading account for the period, we need to identify the figures for sales and purchases. These can be found by drawing up total trade receivables and total trade payables accounts, sales and purchases figures being the difference on the accounts.

Total trade receivables			
	£		£
Balances b/d	14,278	Cash and bank	31,745
Sales (difference)	29,800	Balances c/d	12,333
	<u>44,078</u>		<u>44,078</u>

Total trade payables			
	£		£
Cash and bank	17,270	Balances b/d	7,633
Balances c/d	6,289	Purchases (difference)	15,926
	<u>23,559</u>		<u>23,559</u>

Activity 27.4

You already did this for another example earlier in this chapter. Where?

The trading account section of the income statement can now show the figures so far known:

Trading Account section of the income statement for the period 1 April to 20 August 2023			
	£		£
Sales			29,800
Less Cost of goods sold:			
Opening inventory	12,480		
Add Purchases	15,926		
	<u>28,406</u>		
Less Closing inventory	(C) (?)	(B) (?)	
Gross profit		(A) ?	<u> ?</u>

Gross profit can be found, as the margin on sales is known to be 25%, therefore (A) = 25% of £29,800 = £7,450.

Cost of goods sold (B) + Gross profit £7,450 = £29,800 therefore (B) is £22,350.

£28,406 – (C) = (B) £22,350 therefore (C) is £6,056.

The figure for cost of goods stolen is therefore £6,056.

The completed trading account is, therefore:

Trading Account section of the income statement for the period 1 April to 20 August 2023			
	£		£
Sales			29,800
Less Cost of goods sold:			
Opening inventory	12,480		
Add Purchases	15,926		
	<u>28,406</u>		
Less Closing inventory	(C) (6,056)	(B) (22,350)	
Gross profit		(A) ?	<u>7,450</u>

Learning outcomes

You should now have learnt:

- 1 The difference between a single entry system and a double entry system.
- 2 How to calculate net profit for a sole proprietor when you know the change in capital over a period and the amount of drawings during the period.
- 3 How to prepare an income statement and a balance sheet from records not kept on a double entry system.
- 4 How to deduce the figures for purchases and sales from a total trade payables account and a total trade receivables account.

Answers to activities

- 27.1** There is a range of possible reasons. Of the three examples shown here, the first must be done once a year, the second must be done from time to time, and the third is done on demand:
- (i) Profits need to be calculated so that the owners can prepare their personal (not the business's) income tax returns. (Only companies prepare tax returns.)
 - (ii) Turnover (i.e. sales) needs to be calculated in order to know whether or not a business needs to register for VAT.
 - (iii) Financial statements may be required by the bank.
- 27.2** (a) $\text{Capital} = \text{Assets} - \text{Liabilities}$
 (b) $\text{Assets} = \text{Capital} + \text{Liabilities}$
- 27.3** Normal practice would be to try to get the owner to list all the cash withdrawn as accurately as possible and then use that figure for drawings. However, care needs to be taken to make this as accurate as possible because the HM Revenue and Customs (the UK tax authority) has very sophisticated data on the relationship between business income and expenditure and profitability, and also on level of income and standard of living enjoyed by a taxpayer. If the drawings are underestimated, this could have very serious repercussions for the owner.
- 27.4** This is exactly the same as what you did in Section 27.3 Stage 3.

Review questions

27.1 N. Alphonso started in business on 1 January 2024 with £10,000 in a bank account. Unfortunately, he did not keep proper books.

He must submit a calculation of profit for the year ending 31 December 2024 to the Inspector of Taxes. At 31 December 2024 he had inventory valued at cost £8,300; a van which had cost £9,000 during the year and which had depreciated during the year by 25%; trade receivables of £11,620; expenses prepaid of £1,360; a bank balance of £4,110; a cash balance £50; trade payables £9,470; and expenses owing £1,630.

His drawings were £600 cash each week. Calculate his profit or loss for the year.

27.2 Stephanie Duke is a wholesaler whose accounting records are chaotic. You ascertain the following information:

- (i) She draws £2,000 a month from the business for her living expenses.
- (ii) In June 2024 her grandfather died and left her £5,500 in his will. Stephanie put the entire amount into her business.

(iii) The assets and liabilities of her business were as follows:

	31 December 2023	31 December 2024
	£	£
Non-current assets at valuation	140,000	154,000
Inventory at cost	53,200	59,100
Trade receivables	68,500	70,400
Cash at bank	1,700	2,900
Trade payables	72,300	80,600

Calculate the net profit for 2024 made by Stephanie.

27.3A B. Barnes is a dealer who has not kept proper books of account. At 31 October 2019 his state of affairs was as follows:

	£
Cash	210
Bank balance (not overdrawn)	4,700
Fixtures	2,800
Inventory	18,200
Trade receivables	26,600
Trade payables	12,700
Van (at valuation)	6,800

During the year to 31 October 2020 his drawings amounted to £32,200. Winnings from the Lottery of £7,600 were put into the business. Extra fixtures were bought for £900.

At 31 October 2020 his assets and liabilities were: Cash £190; Bank overdraft £1,810; Inventory £23,900; Trade payables for goods £9,100; Trade payables for expenses £320; Fixtures to be depreciated £370; Van to be valued at £5,440; Trade receivables £29,400; Prepaid expenses £460.

Calculate the profit or loss made by Barnes for the year ending 31 October 2020.

27.4 The following is a summary of Ellie's bank account for the year ended 31 December 2019:

	£		£
Balance 1.1.2019	8,200	Payments to creditors for goods	136,200
Receipts from debtors	182,000	Rent	7,800
Balance 31.12.2019	12,800	Insurance	2,940
		Sundry expenses	1,260
		Drawings	54,800
	<u>203,000</u>		<u>203,000</u>

All of the business takings have been paid into the bank with the exception of £34,900. Out of this, Ellie has paid wages of £22,800, drawings of £2,800 and purchase of goods £9,300.

The following additional information is available:

	31.12.2018	31.12.2019
Inventory	20,600	23,000
Trade payables for goods	23,400	26,200
Trade receivables for goods	40,600	37,700
Insurance prepaid	910	1,020
Rent owing	570	—
Fixtures at valuation	3,700	3,400

You are to draw up a set of financial statements for the year ended 31 December 2019. Show all of your workings.





27.5A A. Bell has kept records of his business transactions in a single entry form, but he did not realise that he had to record cash drawings. His bank account for the year 2018 is as follows:

	£		£
Balance 1.1.2018	920	Cash withdrawn from bank	12,600
Receipts from debtors	94,200	Trade payables	63,400
Loan from F. Tung	2,500	Rent	3,200
		Insurance	1,900
		Drawings	11,400
		Sundry expenses	820
		Balance 31.12.2018	4,300
	<u>97,620</u>		<u>97,620</u>

Records of cash paid were: Sundry expenses £180; Trade payables £1,310. Cash sales amounted to £1,540.

The following information is also available:

	31.12.2017	31.12.2018
	£	£
Cash in hand	194	272
Trade payables	7,300	8,100
Trade receivables	9,200	11,400
Rent owing	–	360
Insurance paid in advance	340	400
Van (at valuation)	5,500	4,600
Inventory	24,200	27,100

You are to draw up an income statement for the year ending 31 December 2018, and a balance sheet as at that date. Show all of your workings.

27.6 Carlos is a trader buying and selling goods. He does not maintain a full set of double accounting records but has provided the following information at 31 December 2024:

1	<i>Bank Account</i>			
	£		£	
Balance b/d	1,700	Cheques to trade payables	42,500	
Cheques from trade receivables	45,300	Rent	2,500	
Sale of non-current asset	2,500	Refund to trade receivable	900	
Commission received	2,700	Premises maintenance	7,200	
Cash banked from sales	9,000	Advertising	4,800	
Balance c/d	3,400	General expenses	6,700	
	<u>64,600</u>		<u>64,600</u>	
		Balance b/d	3,400	

2 Balances:

	1 January 2024	31 December 2024
	£	£
Non-current assets (at valuation)	20,000	18,000
Trade receivables	15,400	27,900
Trade payables	29,800	21,000
Prepaid rent	500	1,000
Accrued wages	1,200	1,600
Inventory	32,000	25,700

- 3 During the year ending 31 December 2024, Carlos made the following payments in cash before banking the cash from sales:

	£
Drawings	11,000
Wages	8,900
Purchase of non-current asset	4,000
Inventory purchase	5,300

Required:

- Prepare the balance sheet at 1 January 2024 showing the opening capital.
- Calculate for the year ended 31 December 2024 the:
 - revenue for the year
 - purchases for the year.
- Prepare the income statement for the year ended 31 December 2024.
- Evaluate Carlos' decision **not** to maintain a full set of books.

(Edexcel A level)

27.7A Bill Smithson runs a second-hand furniture business from a shop which he rents. He does not keep complete accounting records, but is able to provide you with the following information about his financial position at 1 April 2018: Inventory of furniture £3,210; Trade receivables £2,643; Trade payables £1,598; Motor vehicle £5,100; Shop fittings £4,200; Motor vehicle expenses owing £432.

He has also provided the following summary of his bank account for the year ended 31 March 2019:

	£		£
Balance at 1 April 2018	2,420	Payments to trade payables	22,177
Cheques received from trade debtors	44,846	Electricity	1,090
Cash sales	3,921	Telephone	360
		Rent	2,000
		Advertising	1,430
		Shop fittings	2,550
		Insurance	946
		Motor vehicle expenses	2,116
		Drawings	16,743
		Balance at 31 March 2019	1,775
	<u>51,187</u>		<u>51,187</u>

All cash and cheques received were paid into the bank account immediately.

You find that the following must also be taken into account:

- Depreciation is to be charged on the motor vehicle at 20% and off the shop fittings at 10%, calculated on the book values at 1 April 2018 plus additions during the year.
- At 31 March 2019 motor vehicle expenses owing were £291 and insurance paid in advance was £177.
- Included in the amount paid for shop fittings were:

a table bought for £300, which Smithson resold during the year at cost, some wooden shelving (cost £250), which Smithson used in building an extension to his house.





Other balances at 31 March 2019 were:

	£
Trade receivables	4,012
Trade payables	2,445
Inventory of furniture	4,063

Required:

- (a) For the year ended 31 March 2019:
 - (i) calculate Smithson's sales and purchases,
 - (ii) prepare his income statement.
- (b) Prepare Smithson's balance sheet as at 31 March 2019.

(Midland Examining Group: GCSE)

27.8 Although Janet Lambert has run a small business for many years, she has never kept adequate accounting records. However, a need to obtain a bank loan for the expansion of the business has necessitated the preparation of 'final' accounts for the year ended 31 August 2019. As a result, the following information has been obtained after much careful research:

- 1 Janet Lambert's business assets and liabilities are as follows:

As at	1 September 2018	31 August 2019
	£	£
Inventory	8,600	16,800
Trade receivables for sales	3,900	4,300
Trade payables for purchases	7,400	8,900
Rent prepaid	300	420
Electricity accrued due	210	160
Balance at bank	2,300	1,650

- 2 All takings have been banked after deducting the following payments:

Cash drawings – Janet Lambert has not kept a record of cash drawings, but suggests these will be in the region of	£8,000
Casual labour	£1,200
Purchase of goods for resale	£1,800

Note: Takings have been the source of all amounts banked.

- 3 Bank payments during the year ended 31 August 2019 have been summarised as follows:

	£
Purchases	101,500
Rent	5,040
Electricity	1,390
Delivery costs (to customers)	3,000
Casual labour	6,620

- 4 It has been established that a gross profit of $33\frac{1}{3}\%$ on cost has been obtained on all goods sold.
- 5 Despite her apparent lack of precise accounting records, Janet Lambert is able to confirm that she has taken out of the business during the year under review goods for her own use costing £600.

Required:

- (a) Prepare a computation of total purchases for the year ending 31 August 2019.
- (b) Prepare an income statement for the year ending 31 August 2019 and a balance sheet as at that date, both in as much detail as possible.
- (c) Explain why it is necessary to introduce accruals and prepayments into accounting.

(Association of Accounting Technicians)

27.9A Jean Smith, who retails wooden ornaments, has been so busy since she commenced business on 1 April 2018 that she has neglected to keep adequate accounting records. Jean's opening capital consisted of her life savings of £15,000 which she used to open a business bank account. The transactions in this bank account during the year ended 31 March 2019 have been summarised from the bank account as follows:

<i>Receipts:</i>	£
Loan from John Peacock, uncle	10,000
Takings	42,000
<i>Payments:</i>	
Purchases of goods for resale	26,400
Electricity for period to 31 December 2018	760
Rent of premises for 15 months to 30 June 2019	3,500
Rates of premises for the year ended 31 March 2019	1,200
Wages of assistants	14,700
Purchase of van, 1 October 2018	7,600
Purchase of holiday caravan for Jean Smith's private use	8,500
Van licence and insurance, payments covering a year	250

According to the bank account, the balance in hand on 31 March 2019 was £4,090 in Jean Smith's favour.

While the intention was to bank all takings intact, it now transpires that, in addition to cash drawings, the following payments were made out of takings before bankings:

	£
Van running expenses	890
Postages, stationery and other sundry expenses	355

On 31 March 2019, takings of £640 awaited banking; this was done on 1 April 2019. It has been discovered that amounts paid into the bank of £340 on 29 March 2019 were not credited to Jean's bank account until 2 April 2019 and a cheque of £120, drawn on 28 March 2019 for purchases, was not paid until 10 April 2019. The normal rate of gross profit on the goods sold by Jean Smith is 50% on sales. However, during the year a purchase of ornamental goldfish costing £600 proved to be unpopular with customers and therefore the entire inventory had to be sold at cost price.

Interest at the rate of 5% per annum is payable on each anniversary of the loan from John Peacock on 1 January 2019.

Depreciation is to be provided on the van on the straight-line basis; it is estimated that the van will be disposed of after five years' use for £100.

The inventory of goods for resale at 31 March 2019 has been valued at cost at £1,900.

Trade payables for purchases at 31 March 2019 amounted to £880 and electricity charges accrued due at that date were £180.

Trade receivables at 31 March 2019 totalled £2,300.

Required:

Prepare an income statement for the year ending 31 March 2019 and a balance sheet as at that date.

(Association of Accounting Technicians)

27.10 David Denton set up in business as a plumber a year ago, and he has asked you to act as his accountant. His instructions to you are in the form of the following letter.

Dear Henry,

I was pleased when you agreed to act as my accountant and look forward to your first visit to check my records. The proposed fee of £250 p.a. is acceptable. I regret that the paperwork for the work done during the year is incomplete. I started my business on 1 January last, and put £6,500 into a business bank account on that date. I brought my van into the firm at that time, and reckon that





it was worth £3,600 then. I think it will last another three years after the end of the first year of business use. I have drawn £90 per week from the business bank account during the year. In my trade it is difficult to take a holiday, but my wife managed to get away for a while. The travel agent's bill for £280 was paid out of the business account. I bought the lease of the yard and office for £6,500. The lease has ten years to run, and the rent is only £300 a year payable in advance on the anniversary of the date of purchase, which was 1 April. I borrowed £4,000 on that day from Aunt Jane to help pay for the lease. I have agreed to pay her 10 per cent interest per annum but have been too busy to do anything about this yet.

I was lucky enough to meet Miss Prism shortly before I set up on my own, and she has worked for me as an office organiser right from the start. She is paid a salary of £3,000 p.a. All the bills for the year have been carefully preserved in a toolbox and we analysed them last week. The materials I have bought cost me £9,600, but I reckon there was £580 worth left in the yard on 31 December. I have not yet paid for them all yet, I think we owed £714 to the suppliers on 31 December. I was surprised to see that I had spent £4,800 on plumbing equipment, but it should last me five years or so. Electricity bills received up to 30 September came to £1,122; but motor expenses were £912, and general expenses £1,349 for the year. The insurance premium for the year to 31 March next was £800. All these have been paid by cheque, but Miss Prism has lost the rate demand. I expect the Local Authority will send a reminder soon since I have not yet paid. I seem to remember that rates came to £180 for the year to 31 March next.

Miss Prism sent out bills to my customers for work done, but some of them are very slow to pay. Altogether the charges made were £29,863, but only £25,613 had been received by 31 December. Miss Prism thinks that 10 per cent of the remaining bills are not likely to be paid. Other customers for jobs too small to bill have paid £3,418 in cash for work done, but I only managed to bank £2,600 of this money. I used £400 of the difference to pay the family's grocery bills, and Miss Prism used the rest for general expenses, except for £123 which was left over in a drawer in the office on 31 December.

Kind regards,
Yours sincerely,
David.

You are required to draw up an income statement for the year ending 31 December 2023, and a balance sheet as at that date.

(Association of Chartered Certified Accountants)

27.11 The following are summaries of the cash book and bank accounts of J. Duncan who does not keep his books using the double entry system.

Bank Summary	£	£
Balance on 1 January 2018		8,000
Receipts		
Trade receivables	26,000	
Cash banked	<u>4,100</u>	30,100
		<u>38,100</u>
Payments		
Trade payables	18,500	
Rent	1,400	
Machinery	7,500	
Wages	6,100	
Insurance	1,450	
Trade receivable (dishonoured cheque)	250	
Loan interest	<u>300</u>	35,500
Balance on 31 December 2018		<u><u>2,600</u></u>

Cash Summary	£	£
Balance on 1 January 2018		300
Receipts		
Cash sales	14,000	
Trade receivables	<u>400</u>	<u>14,400</u>
		14,700
Payments		
Drawings	9,500	
Repairs	300	
Electricity	750	
Cash banked	<u>4,100</u>	<u>14,650</u>
Balance on 31 December 2018		<u>50</u>
The following referred to 2018	£	
Bad debts written-off	400	
Discount received	350	
Goods withdrawn by J. Duncan for own use	300	
Credit note issued	1,200	
The following additional information is available.	<i>1 January 2018</i>	<i>31 December 2018</i>
	£	£
Inventory	4,100	3,200
Machinery	12,600	15,900
Rent prepaid	200	
Rent owing		250
Trade receivables	6,300	5,000
Trade payables	2,400	2,500
Loan from bank at 8%	5,000	5,000
Loan interest owing		100

You are required to:

- Calculate the value of J. Duncan's capital on 1 January 2018.
- Prepare the Income Statement for the year ending 31 December 2018.

(Scottish Qualifications Authority)

27.12 Using the information in Review Question 27.11, prepare J. Duncan's balance sheet as at 31 December 2018.

27.13A The following are summaries of the cash book and bank accounts of P. Maclaran who does not keep her books using the double entry system.

Bank Summary	£	£
Balance on 1 January 2018		6,000
Receipts		
Trade receivables	35,000	
Cash banked	<u>2,200</u>	<u>37,200</u>
		43,200
Payments		
Trade payables	31,000	
Rent	1,100	
Machinery	3,400	
Wages	9,200	





Insurance	850	
Trade receivable (dishonoured cheque)	80	
Loan interest	<u>500</u>	(46,130)
Balance on 31 December 2018		<u>(2,930)</u>
Cash Summary	£	£
Balance on 1 January 2018		60
Receipts		
Cash sales	9,700	
Trade receivables	<u>1,100</u>	<u>10,800</u>
		10,860
Payments		
Drawings	6,600	
Repairs	1,400	
Electricity	570	
Cash banked	<u>2,200</u>	<u>(10,770)</u>
Balance on 31 December 2018		<u>90</u>
The following referred to 2018		£
Bad debts written-off		240
Discount received		600
Goods withdrawn by P. Maclaran for own use		1,200
Credit note issued		640

The following additional information is available.	<i>1 January 2018</i>	<i>31 December 2018</i>
	£	£
Inventory	2,300	5,400
Machinery	9,800	10,400
Rent prepaid		100
Rent owing	150	
Trade receivables	8,100	9,200
Trade payables	5,700	4,800
Loan from bank at 10%	7,000	7,000
Loan interest owing		200

You are required to:

- Calculate the value of P. Maclaran's capital on 1 January 2018.
- Prepare the Income Statement for the year ending 31 December 2018.

27.14A Using the information in Review question 40.13, prepare P. Maclaran's balance sheet as at 31 December 2018.

Scenario questions

The following questions are designed to reinforce learning of the adjustments covered in Parts 4–6 through their application in the preparation of financial statements up to the end of Chapter 27.

The answers to these questions are to be found on pp. 758–760.

SQ1

Michael Angelo owns Picta Simpla, a company specialising in selling painting by numbers packs by mail order. The packs are purchased from a wholesaler and then resold. The public have no access to the wholesaler and so there is no competition.

During the year ended 30 June 2023 Michael sold 2,900 units at £89 each, having started the year with £19,250 of inventory (600 units). During the year, he purchased a total of 3,150 packs from the wholesaler at £59 each. Michael wants to value his inventory using the FIFO basis.

Staff have been paid wages totalling £14,500, which is only slightly less than the advertising bills paid of £15,000. Michael is upset since the advertising agency has yet to send a final bill, estimated to be £500. Postage per unit sent out was £2. The packing costs were £0.50 per unit.

Rent was £1,000 per month. Insurance of £3,500 has been paid but £650 of this relates to the year ending 30 June 2024. Electricity bills amounted to £2,900, but the bill for the final quarter is still outstanding and is expected to be approximately £500.

The business has a computer which was purchased about two years ago and which Michael reckons has about another three years of useful life left, at which point it will be worthless. It cost £4,000 and Michael uses the straight-line method when calculating the depreciation charge. He also has a fax machine which he uses to communicate with his suppliers.

Stationery charges have amounted to £1,350 and he has had telephone bills of £3,500, of which £200 relates to July and August 2023. In the year ending 30 June 2022, he paid £150 for July and August 2022.

Michael has also paid £5,000 from the business bank account for a month-long holiday in Florida. He has asked you whether he can class this as business expenses since it has enabled him to recover from the stresses and strain of running his own business.

Required:

- (a) Prepare an income statement for the year ending 30 June 2023.
- (b) Write a brief letter to Michael explaining what drawings are in relation to a small business and answering his query concerning his holiday.

SQ2

The following balance sheet has been prepared by your client, Mr Conman, proprietor of the Sleasy Cars second-hand car dealership:

Balance Sheet as at 31 December 2022		
	£	£
<i>Non-current Assets</i>		
Freehold land, at valuation		10,000
Offices		1,000
Breakdown truck		<u>5,000</u>
		16,000
<i>Current Assets</i>		
Inventory	23,000	
Trade receivables and prepayments	3,500	
Cash in hand	<u>100</u>	
		26,600
Total assets		<u>42,600</u>
<i>Current Liabilities</i>		
Trade payables and accruals	8,200	
Bank Overdraft	<u>6,400</u>	
Total liabilities		(14,600)
Net assets		<u>28,000</u>
<i>Capital</i>		
Capital Introduced		15,500
Add Profit for the year		<u>23,500</u>
		39,000
Less Drawings		(11,000)
Total capital		<u>28,000</u>

This was the first year of trading for Sleasy Cars. Mr Conman acquired a field in Hull (which had previously been used for a rubbish tip and then filled in) for £5,000 on 1 January 2022 and erected a portacabin on the site to be used as an office at a cost of £500. He then bought ten second hand cars from a national dealership for £10,000. He has some accountancy training and has taken a lot of care in producing the balance sheet but confesses that he did not produce an income statement. Instead, as it must be the correct figure, the amount shown for profit in the balance sheet was the amount required to make it balance.

The following points have come to light in your discussion:

- (i) The office was bought at a discount from a friend who had acquired it from a builder's yard and Conman has included it in the balance sheet at the proper price as he knows that accountants like original costs to be shown. The office should last for five years and Conman agrees that maybe that thing called depreciation should be included at straight line. The office will be worthless at the end of the five years.
- (ii) The land was a bargain. Conman heard on the grapevine that the council were going to take the previous owners to court as it was an environmental hazard. The owners put it up for sale at £10,000 so he made an offer to the owners of £5,000 which was accepted. He is ignoring the court order to clean up the site since this would cost approximately £3,000. His reason for ignoring it is that although the order was made in December 2021 (i.e. before he bought the land), he did not receive the notice until January 2023 (i.e. after he had bought the land).
- (iii) The breakdown truck is very old and was bought at the start of the year. It has been shown at cost although it is probably only going to last another year and will have no residual value.
- (iv) Inventory has all been valued at cost although on one car there is a good chance that it will sell at a loss of £500. Another one was sold in January 2023 for £3,000 but the new owner has not picked it up yet – the profit was £1,500 so this has been included in the valuation of the car. As he has included the car, Conman has not included the debtor in the balance sheet.
- (v) A customer has owed £2,000 for six months and Mr Conman is becoming slightly bothered. The customer has moved away from the address she gave Mr Conman and he thinks that this debt might not be recoverable.

- (vi) After hearing the above, you have decided to check the figures and have found that the cash, overdraft and drawings figures are correct and also that there has been no adjustment for the fact that he has not paid his electricity bill of £250 nor his telephone bill of £150. The reason for this is that he is subletting part of the field and is owed £400 in rent and, therefore, the two cancel each other out.

Required

- (a) A revised balance sheet after taking into account all of the above.
 (b) A description of each of the adjustments that have been made and why each of them is necessary.

SQ3

The following represents the trial balance extracted from the books of Mr Jones, a small businessman based in Aboyne, Scotland. The books are well-maintained and there is no reason to doubt the accuracy of the entries.

	£	£
Sales		430,000
Purchases	293,500	
Carriage in	2,100	
Drawings	31,000	
Rent	5,200	
Business rates	2,600	
Insurance	550	
Postage	250	
Stationery	986	
Advertising	250	
Wages	10,500	
Bad debts	400	
Allowance for doubtful debts	400	
Trade receivables	5,120	
Trade payables		3,600
Cash in hand	120	
Cash at bank	3,257	
Inventory	6,520	
Equipment at cost	150,000	
Accumulated depreciation – equipment		35,000
Capital		43,353
	<u>512,353</u>	<u>512,353</u>

Following a discussion with Mr Jones, the following points have come to light:

- (a) Accruals are necessary for rent (£150), business rates (£200), and stationery (£16).
 (b) Insurance has been prepaid by £150, advertising by £50.
 (c) Inventory at the year-end is £7,000.
 (d) Depreciation is to be charged on the equipment at a rate of 10 per cent on cost.
 (e) The allowance for doubtful debts is to be increased to 10 per cent of the year-end balance.
 (f) Purchase invoices to the value of £12,000 were found in a desk drawer the day before the meeting with Mr Jones. Half of them have been paid by cheque (but no record made in the cash book) and the rest are outstanding.

Required

- (a) Prepare an income statement for the year ending on the date of extraction of the trial balance together with a balance sheet as at that date.
 (b) Mr Jones has kept accurate records (with the exception of point (f)) and yet the accountant must still adjust the figures in the trial balance before preparing the financial statements. As the accountant, write a letter to Mr Jones outlining why the accountant must adjust the figures to convey meaningful information.

SQ4

The following balances were extracted from the books of Mr Try, a window cleaner. He has no knowledge of double entry bookkeeping but records everything correctly. His year end is 30 June and the following balances relate to the year ended 30 June 2023:

	£
Accounts to be paid	100
Cleaning income	17,644
Cash balance	35
Own wages	10,600
Ladders and equipment	750
Repairs to customers' houses due to damage	230
Miscellaneous expenses	110
Owed by customers	220
Insurances	350
Accountancy fees (relating to year ended 30 June 2022 – paid in this year)	250
Postage and stationery	50
Bank	2,345
Cleaning materials and cloths	3,400

He has not included the following items as he is not sure how to record them:

- (i) Bank charges of £45 are to be levied for the year – they are to be processed by the bank in September 2023.
- (ii) Insurances have been prepaid by £50.
- (iii) None of the amounts owed by customers can be realistically recovered but Mr Try wants to keep on trying and therefore wants an allowance to be made of 50 per cent of the balances.
- (iv) Accountancy charges for the current year ended 2023 are to be £275.
- (v) The ladders, including the ones bought in the year, will only last until the end of 2024 and are to be depreciated using the straight line method with no residual value.

Required

- (a) Prepare an income statement for the year ending 30 June 2023.
- (b) Prepare a balance sheet at that date.
- (c) Mr Try has heard about a treatment of non-current assets which he thinks is 'consumables'. He wonders if his ladders could be treated as consumables and not depreciated. Write a letter to Mr Try, using fictitious names and addresses, to answer his query.

SQ5

Michael Baldwin owns B's Casuals, a company specialising in low-quality, high-priced clothing. The material is purchased from Canada, made up into the finished garments in his own factory, and then sold in the local markets through stallholders.

During the year ended 30 June 2023 Baldwin had sales of £260,040.

Inventory levels have remained relatively consistent over the years, the starting inventory being £21,500 and the closing inventory £22,500.

Baldwin is not very generous to his staff. This is reflected in the wages paid during the year of only £24,500.

Business rates are a problem, since there is a dispute with the local council. He has paid a total of £7,500 but there is a good chance that he will have to pay a further £2,450.

Postage and advertising is another problem area. For the imports from Canada it is necessary to pay all of the flight costs. These amounted to £5,200 over the year.

He delivers all of his invoices to the stallholders in person and is paid promptly, with the exception of one debtor who owes £2,000 and who has been declared bankrupt. This amount is to be written off.

Advertising is minimal and is done in the local pub: £20 per week is paid to the landlord in return for permission to pin leaflets on the walls and an agreement that the landlord will place a leaflet every day on each table in the bar.

Insurance of £3,500 has been paid, but £650 of this relates to the year ending 30 June 2024.

Electricity bills amounted to £2,900, but the bill for the final quarter is still outstanding and is expected to be approximately £500. Purchases of cloth from Canada for the year are currently recorded as being £65,000, but there is an outstanding bill of £3,500 which is not yet included in that figure.

The factory and the machinery were bought at the same time and originally cost £400,000. Depreciation has accumulated to the sum of £100,000. The current year charge is 5 per cent on the reducing balance basis.

The business had a computer which was purchased about three years ago and which Michael reckons has about another two years of life left. It cost £4,000 and Baldwin uses the straight line method of calculating the depreciation charge. The computer will be worthless at the end of that time.

Stationery charges amounted to £1,350 and he had telephone bills of £3,500, £200 of which relates to July and August 2023. In the year ending 30 June 2023, he had paid £150 which related to telephone charges in the year ending 30 June 2023.

Baldwin has also paid £5,000 for a top-of-the-range digital home cinema system. He has enquired as to whether he can class this as a business expense as it has enabled him to unwind after long days at the office.

His salary for the year was £50,000.

Cash in hand at 30 June 2023 was £600 which he borrowed from his wife temporarily on 30 June when he realised that there was no cash available to pay any expenses.

Required

- (a) Prepare an income statement for the year ending 30 June 2023.
- (b) Prepare a balance sheet as at 30 June 2023 showing clearly Mr Baldwin's opening capital, net assets and the profit for the year.
- (c) Baldwin has enquired why he should include the amounts owing to both the council and the Canadians in the current year's financial statements and also why he cannot include his own wages within expenses since they have been paid out from the business. Write a letter to Baldwin explaining these points and answering his query concerning the home cinema system.

FURTHER ACCOUNTING PROCEDURES

Introduction

In this part we'll look at three specific sets of accounting procedures: constructing a statement of cash flows for a sole proprietor; maintaining the accounts of small clubs and societies; and recordkeeping for small 'joint ventures' where two sole proprietors join forces on a business project.

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Introduction to the statement of cash flows

Learning objectives

After you have studied this chapter, you should be able to:

- Explain the vital importance of cash to any business.
- Explain the merits of the statement of cash flows and why it is an important addition to the financial statements of a business.
- Prepare relevant extracts from the *operating*, *investing* and *financing* sections of the statement of cash flows for a sole proprietor's business.
- Prepare a statement of cash flows for a sole proprietor in accordance with the requirements of IAS 7 *Statement of Cash Flows*.

Introduction

In this chapter, we'll highlight how important cash is to the success of any business. Profit is not the same as cash, so, as well as the income statement, businesses can prepare a *statement of cash flows* to show how successful they have been at generating cash and how that cash has been used. You'll learn that the statement of cash flows presents the sources and uses of cash classified under three headings: operating activities, investing activities and financing activities. After completing the chapter, you'll be able to produce a statement of cash flows for a simple sole proprietor's business.

28.1 The difference between profit and cash flow

For a long time, the income statement and balance sheet were essentially the only two financial statements. The income statement revealed how the business had performed over the last year, and the balance sheet showed its financial position as at the end of the year. Accompanying notes provided additional details regarding each item shown in the two statements.

However, in the 1970s and 80s, demand grew for more information to be reported about a business's cash flows. Remember that the income statement does not reveal the amount of cash that came into and went out of the business. The income statement is prepared on an *accrual basis*, which means that it shows the income that the business *earned* during the year (regardless of whether the cash was received in that year) minus the expenses *incurred* in earning that income (regardless of whether cash was paid for those expenses during the year).

In other words, the profit for the year revealed by the income statement won't necessarily bear any relation to the amount of cash that was generated by the business in that year. It is quite possible that the income statement might report a profit even though the business may be running extremely short of cash and its very survival could be at risk.

Activity
28.1

Can you think of any reasons why a profitable business could be running out of cash?

Profit alone is therefore not the only indicator of whether a business is performing well. As well as an income statement, businesses can produce a **statement of cash flows** which details all the money that the business received in the last year from various sources, minus all the money it paid out for various purposes.

28.2 The need for a statement of cash flows

The statement of cash flows is vital in helping to give a fuller picture of business performance for several reasons:

- 1 The survival of a business depends on its ability to pay its debts. Businesses 'go bust' when they run out of cash to pay their bills, not when their income statement reports a loss for the year. (Making losses is generally not good for cash flows, but it doesn't automatically mean that the business won't survive.)
- 2 Even if the survival of the business is not in question, all businesses need cash if they want to thrive, expand and pay money to their owners. Anyone reading a business's financial statements will therefore be very interested in the state of the business's cash flows in order to assess its future prospects.
- 3 A statement of cash flows will give users crucial information on the business's ability to generate cash and on the cash needs of the business. This should help users to estimate its likely future cash flows. As you will no doubt learn in your future studies, estimates of how much cash a business is expected to generate in the future are extremely important when evaluating how much that business is worth.
- 4 There is much less scope to manipulate the figures in the statement of cash flows compared with those in the income statement. Even at this introductory stage in your studies, you've already seen that certain figures in the income statement (such as rates of depreciation of the size of allowances for bad debts) are dependent on accounting assumptions and estimates. A statement of cash received minus cash paid is not reliant on any such estimates. Comparisons of the cash flows of one business with another will therefore not be distorted by different accounting policies and assumptions.

For all these reasons, the statement of cash flows joined the income statement and balance sheet as one of the primary financial statements in the early 1990s. The current format of the statement is defined by IAS 7 *Statements of Cash Flows*.

28.3 The format of the statement of cash flows

Under IAS 7, the statement of cash flows is presented in three sections:

- Cash flows from **operating activities**
- Cash flows from **investing activities**
- Cash flows from **financing activities**

Within each section, the main sources and destinations of cash received and paid are reported. **Cash received is shown as positive and cash payments are shown as negative (i.e. in brackets).** The net total of all three sections represents the overall increase or decrease in the business's cash for the year. This overall increase or decrease in cash must be equal to the difference between:

- the total of the business's cash at the start of the year (shown on last year's balance sheet); and
- the total of the business's cash at the end of the year (shown on this year's balance sheet).

In the rest of this chapter, we'll look at the basic techniques for producing a statement of cash flows. All the examples in this chapter will be for a sole proprietor's business. In Chapter 37, we'll then build on these basic techniques and look at how the statement would be prepared for a company.

Activity 28.2

For its financial year just ended, a business reported a cash inflow from operating activities of £90,000, a net cash outflow from investing activities of £70,000, and a net inflow from financing activities of £30,000. If the only figure for cash in last year's balance sheet was a current asset of £10,000 cash at bank, what is the cash balance in this year's balance sheet?

28.4 The meaning of 'cash' in the statement of cash flows

When we talk about 'cash' in the statement of cash flows we are essentially referring to:

- petty cash held by the business (i.e. notes and coins)
- cash in the business's bank accounts.

IAS 7 actually has a slightly more technical definition of 'cash' than this. It gives a definition of **cash and cash equivalents** which is a little more complicated. However, at this stage of your studies you really just need to understand that the statement of cash flows summarises all receipts and payments into and out of the business's petty cash and its bank accounts.

28.5 Preparing a statement of cash flows

You might expect that the statement of cash flows for a business would be prepared by analysing its cash book for the year and summarising all the different types of receipts and payments that had occurred. However, this is not usually the approach. Analysing the cash book for the whole year would be very time consuming.

Furthermore, most businesses have more than one bank account and therefore more than one cash book, so producing an accurate summary of all the different receipts and payments for the year would be a major task.

Instead, it is usually quicker in practice to produce the statement of cash flows largely from information that is already contained in the balance sheets for this year and last year, and in this year's income statement. It is generally much more efficient to do it this way.

Using this approach, we'll look at how each of the three sections of the statement of cash flows is produced, starting with cash flows from operating activities.

28.6 Cash flows from operating activities

Cash flows from operating activities are essentially those changes in cash that arise as a result of the business's normal trading operations, such as buying and selling goods and services, and paying for its running costs. As explained above, it is usually more efficient to *derive* the business's operating cash flow by using figures that are already contained in the income statement and balance sheets. This is known as the **indirect method** of reporting the cash flows from operating activities.

An alternative approach, known as the **direct method**, can also be used and we'll look at it later in this chapter. However, the indirect method tends to be far more common in both the real world and in exam questions, so this is the method we will focus on first.

The indirect method takes its name from the fact that the various payments and receipts arising from the business's normal operations are not directly presented. **Instead, the indirect method takes the profit figure that the business achieved according to the income statement and makes various adjustments to it in order to convert it into the cash that was generated from operating activities.**

The operating activities section of a statement of cash flows for a simple sole proprietor business using the indirect method will typically look like that shown in Exhibit 28.1.

Exhibit 28.1 Cash flows from operating activities for a sole proprietor using the indirect method

Cash flows from operating activities	£	£
Net profit for the year	X	
Add Depreciation expense	X	
(Profit)/loss on disposal of non-current assets	(X)/X	
(Increase)/decrease in inventory	(X)/X	
(Increase)/decrease in trade receivables	(X)/X	
Increase/(decrease) in trade payables	<u>X/(X)</u>	
<i>Net cash from operating activities</i>		X

In the following sections, we will look more closely at the five adjustments shown in Exhibit 28.1 that are needed to convert the profit figure into a cash flow.

28.7 Adjustments to the profit figure to convert it into the net cash from operating activities

Making a profit will usually (but not always) result in an increase in cash for the business. After all, for a typical business, the majority of sales result in inflows of cash, and most expenses result in outflows of cash. So, if a business makes a profit each year, then this will generally tend to generate cash. We can use this basic relationship to convert the profit figure into the net cash from operating activities by making a few adjustments. The most common of these adjustments are for:

- Depreciation
- Profits or losses on the disposal of non-current assets
- Changes in inventory, trade receivables and trade payables.

We will look at each of these below.

Depreciation

As you learned in Chapter 21, depreciation charges do not represent a cash flow. Depreciation is a method of accounting that notionally spreads the original cost of a non-current asset over its useful life of several years. No cash changes hands as a result of depreciation entries. **The depreciation expense in the income statement will therefore have had the effect of reducing the profit for the year without involving any cash. So, to convert the profit figure into a cash flow, the depreciation expense must always be added back.**

Profits or losses on the disposal of non-current assets

In Chapter 21, you also learned that the profit or loss on the disposal of a non-current asset can be calculated as follows:

	£
Disposal proceeds	X
Less Carrying amount (i.e. cost minus accumulated depreciation) at the date of disposal	(X)
Profit/(loss) on disposal	<u>X</u>

In other words, the profit or loss on disposal is not itself a cash flow. It is simply the result of a calculation. The only cash inflow arising from a disposal of a non-current asset is the proceeds themselves, and these will appear in the *investing* section of the statement, not the operating section.

Like depreciation, profits or losses on disposal of non-current assets are therefore items included in the income statement that do not represent flows of cash. So, to convert the profit figure into a cash flow:

- A **loss on disposal** of a non-current asset must always be **added back** to the profit figure, because it has reduced profits without itself being a cash flow.
- A **profit on disposal** of a non-current asset must always be **deducted** from the profit figure, because it has boosted profits without itself being a cash flow.

Changes in inventory, trade receivables and trade payables

Under the indirect method, the profit figure must also be adjusted for changes in inventory, trade receivables and trade payables over the course of the year. These three items are all components of what is known as **working capital**. The easiest way to demonstrate how adjusting for changes in working capital can help convert profit into cash flow is with an example such as that in Exhibit 28.2.

Exhibit 28.2 Converting a profit figure into a cash flow by adjusting for changes in working capital

Suppose a brand-new business bought a total of £6,000 of inventory on credit terms from various suppliers during its first year of trading, and by the year end it had paid for £4,200 of it. During the year, the business sold all the inventory for £10,000 on credit terms to various customers, and by the year end it had received £7,300 cash from those customers. There were no other transactions.

Therefore, for this business:

<i>Profit for year:</i>	£	<i>Cash flow for year:</i>	£
Sales	10,000	Cash received	7,300
Less Cost of goods sold	(6,000)	Cash paid	(4,200)
Profit for year	<u>4,000</u>	Net cash flow for year	<u>3,100</u>

It is demonstrated below that the profit figure can be converted into the cash flow for the year by adjusting for the changes in the components of working capital that occurred over the 12-month period:

	£
<i>Profit for year</i>	4,000
Increase in inventory ⁽¹⁾	–
Increase in trade receivables ⁽²⁾	(2,700)
Increase in trade payables ⁽³⁾	<u>1,800</u>
<i>Net cash flow for year</i>	<u>3,100</u>





Notes

- (1) The value of inventory did not change between the start and end of the year. It was a brand-new business so it started with no inventory and by the end of the year it had sold all its purchases.
- (2) It was a brand-new business, so it started with no trade receivables. At the end of the year, £2,700 was owed by customers (i.e. £10,000 sales made minus £7,300 cash received from customers). Trade receivables therefore increased by £2,700.
- (3) It was a brand-new business, so it started with no trade payables. At the end of the year, £1,800 was owed to suppliers (i.e. £6,000 total purchases minus £4,200 cash paid to suppliers). Trade payables therefore increased by £1,800.

**Activity
28.3**

Why is it that adjusting for changes in inventory, receivables and payables will help to convert the profit figure into a cash flow?

Obviously, a business's inventory, receivables or payables could each either increase or decrease over the course of a year. Whenever you prepare a statement of cash flows it is essential to think whether each change in working capital would have had a positive or negative impact on the business's cash. If you think logically, then this shouldn't be a big problem. Exhibit 28.3 summarises how and why the effects of changes in each item of working capital must be shown in the statement of cash flows.

Exhibit 28.3 Treatment of changes in working capital in the statement of cash flows using the indirect method

Change	Add or deduct?	Explanation
Increase in inventory	DEDUCT	An increase in inventory implies that the business has spent money on building up its stocks of goods. This will have had a negative effect on its cash, so the increase must be deducted in the statement of cash flows.
Decrease in inventory	ADD	A decrease in inventory implies that the business has sold more goods than it bought during the year, which will have had a positive effect on its cash. The decrease should therefore be added in the statement of cash flows.
Increase in receivables	DEDUCT	An increase in receivables implies that the business is waiting for more money from its customers (customers may be taking longer to pay, for example). This will have had a negative effect on its cash so the increase should be deducted in the statement of cash flows.
Decrease in receivables	ADD	A decrease in receivables implies that the business has collected cash more efficiently from customers (customers have paid more promptly, for example). This will have had a positive effect on its cash, so the decrease should be added in the statement of cash flows.

Increase in payables	ADD	An increase in payables implies that the business has held on to more of its money, perhaps by taking a longer time to pay suppliers. This will have had a positive effect on its cash so the increase should be added in the statement of cash flows.
Decrease in payables	DEDUCT	A decrease in payables implies that the business has paid more money to its suppliers (it may have paid its bills faster, for example). This will have had a negative impact on its cash so the decrease must be deducted in the statement of cash flows.

If you understand the logic of the impact that the change in each item of working capital will have had on the business's cash (as described in Exhibit 28.3), then you should have no problem adjusting the profit figure correctly.

Finally, note that it is best to show the change in the receivables figures stated *after* any allowances for doubtful debts have been deducted. If you calculate the change in trade receivables *before* deducting allowances for doubtful debts, then you will just create extra work for yourself. Moreover, real companies will always show the change in trade receivables stated *after* any allowances, so you will be consistent with how things are done in the real world.

Activity 28.4

The income statement of a sole proprietor reports a final net profit for the year of £97,000. The depreciation expense for the year was £29,000 and the business made a profit of £800 when it disposed of a piece of old equipment. Over the course of the year, its inventory increased by £13,000, trade receivables fell by £7,000 and trade payables rose by £5,000. What was the business's net cash from operating activities?

28.8 An alternative approach: cash flows from operating activities using the direct method

The 'direct method' is an alternative to the 'indirect method' that we've looked at so far. The direct method takes its name from the fact that it calculates the net cash from operating activities by directly listing the actual cash inflows from customers and the various outflows to suppliers and employees. Under the direct method, the operating activities section of the statement for a sole proprietor would look something like that shown in Exhibit 28.4.

Exhibit 28.4 Cash flows from operating activities using the direct method

Cash flows from operating activities	£	£
Cash received from customers	X	
Cash paid to suppliers	(X)	
Cash paid to employees	(X)	
<i>Net cash from operating activities</i>		X

Be clear that the total of the section (i.e. the net cash from operating activities) will be exactly the same whether the business uses the direct method or the indirect method. They are simply two different approaches to calculating the same overall figure.

IAS 7 encourages the use of the direct method because it shows exactly what operating cash inflows and outflows have occurred. This information may be helpful to users of the financial statements. In contrast, the indirect method merely *derives* the net cash from operating activities by converting a profit figure into a cash flow.

However, the indirect method is a quicker and easier approach for most businesses so is more popular in the real world. The indirect method is also more commonly examined. In questions, you should assume that the indirect method is to be used unless you are specifically asked for the direct method.

28.9 Cash flows from investing activities

Cash flows from investing activities is the second section of the statement. The cash flows in this section essentially represent money spent on buying long-term assets and money received from selling such assets. For a relatively simple sole proprietor's business, this means that the investing section may consist of just two items, as shown in Exhibit 28.5.

Exhibit 28.5 The investing activities section for a sole proprietor

Cash flows from investing activities	£	£
Payments to acquire non-current assets	(X)	
Proceeds from the disposal of non-current assets	X	
<i>Net cash from/(used in) investing activities</i>		X/(X)

However, calculating these two items can sometimes be one of the trickier aspects of questions on the statement of cash flows. You may have to take the information given in the question and reconstruct the movements in non-current assets in order to deduce the information that you need. Exhibit 28.6 works through a difficult example of such a problem.

Exhibit 28.6 Calculating the cash flows from buying and selling non-current assets

You are given the following information:

Extract from the income statement for the year ended 31 December 2022:		£
Depreciation expense		490
Loss on disposal of non-current assets		60
Extracts from the balance sheets as at 31 December:		
	2022	2021
	£	£
Non-current assets at cost	1,970	1,720
Less Accumulated depreciation	(1,010)	(880)
	<u>960</u>	<u>840</u>

In July 2022 a piece of machinery was sold for £250. What payments were made to acquire non-current assets during 2022?

Solution:

In this question we have enough information to construct an accumulated depreciation account:

Working 1:

Accumulated depreciation			
	£		£
Acc dep on disposals (<i>missing figure</i>)	360	Opening balance	880
Closing balance	<u>1,010</u>	Depreciation charge for year	<u>490</u>
	<u>1,370</u>		<u>1,370</u>

We can also deduce the carrying amount of the machinery that was sold:

Working 2:

	£
Disposal proceeds (<i>given in question</i>)	250
Less Carrying amount of machinery sold (<i>the missing figure deduced</i>)	<u>(310)</u>
Loss on disposal (<i>given in question</i>)	<u>(60)</u>

Since the carrying amount of the machinery sold was £310 (*working 2*) and the accumulated depreciation on it was £360 (*working 1*) we can deduce the original cost of the asset that was sold:

Working 3:

	£
Cost of machinery sold (<i>the missing figure deduced</i>)	670
Less Accumulated depreciation on machinery sold (<i>working 1</i>)	<u>(360)</u>
Carrying amount of machinery sold (<i>working 2</i>)	<u>310</u>

Finally, we can construct a non-current assets at cost account to deduce the cost of assets acquired during the year:

Working 4:

Non-current assets at cost			
	£		£
Opening balance	1,720	Cost of machinery sold (<i>working 3</i>)	670
Acquisitions (<i>missing figure deduced</i>)	<u>920</u>	Closing balance	<u>1,970</u>
	<u>2,640</u>		<u>2,640</u>

Note that an alternative approach would have been to avoid workings 1, 3 and 4 above and instead construct a T account working of *non-current assets at carrying amount*:

Working 5:

Non-current assets at carrying amount T account working			
	£		£
Opening balance	840	Carrying amount disposed of (<i>working 2</i>)	310
Acquisitions (<i>missing figure deduced</i>)	<u>920</u>	Depreciation charge for year	<u>490</u>
	<u>1,760</u>	Closing balance	<u>1,760</u>





Whichever approach is taken, the 'investing activities' section of the statement of cash flows will appear as follows:

Cash flows from investing activities	£	£
Payments to acquire non-current assets	(920)	
Proceeds from the disposal of non-current assets	<u>250</u>	
<i>Net cash used in investing activities</i>		(670)

Exhibit 28.6 is a difficult example and questions won't always be so hard. However, you certainly need to be ready to work with whatever information the question provides and to use your accounting know-how to deduce the figures required. Different questions will give you different information in relation to the movements in non-current assets during the year. You must be ready to 'think on your feet' and use accounting logic to deduce the missing numbers.

Activity 28.5

The carrying amount of a business's non-current assets at the start of the year was £54,300. During the year, the business disposed of equipment that had a carrying amount of £4,800. The depreciation expense for the year was £14,700 and the carrying amount of non-current assets at the end of the year was £58,800. What were the cash payments to acquire non-current assets during the year?

28.10 Cash flows from financing activities

Cash flows from financing activities is the third section of the statement. These cash flows essentially represent payments or receipts to or from providers of long-term finance to the business. For a relatively simple sole proprietor business, this is likely to be a combination of some or all of the four items shown in Exhibit 28.7.

Exhibit 28.7 The financing activities section for a sole proprietor

Cash flows from financing activities	£	£
Cash introduced by owner	X	
Cash withdrawn by owner	(X)	
Cash received from new loans	X	
Repayment of loans	<u>(X)</u>	
<i>Net cash from/(used in) financing activities</i>		X/(X)

As usual in accounting, if any of the four items shown in Exhibit 28.7 are 'zero' for the year, then they will simply not appear at all in the statement.

In questions on this topic, you will typically be given the business's balance sheets for this year and last year, so it is usually straightforward to identify the information required:

- Any cash introduced by the owner during the year will normally be shown as a separate item within the 'capital' section of this year's balance sheet.

- Any cash withdrawn by the owner during the year will be shown as ‘drawings’ in the ‘capital’ section of this year’s balance sheet (unless the question tells you otherwise, you have to assume that the owner only withdrew cash, and not inventory).
- If figures for ‘loans’ in this year’s balance sheet have increased compared with last year, then (in the absence of any other information) you should assume that the increase represents a cash inflow from new borrowing.
- If figures for ‘loans’ in this year’s balance sheet have fallen compared with last year, then (in the absence of any other information) you should assume that the decrease represents a cash outflow to repay loans.

Activity 28.6

During the year, a sole proprietor transferred exactly £500 every week from the business bank account to her personal bank account to cover her private living expenses. Her great uncle died at the beginning of the year and left her £4,000 cash, which she invested into her business. She also took out a new business loan of £10,000 from HCB Bank, repayable in five years’ time. What was the *net cash used in financing activities* for her business?

Activity 28.7

Can you think of any other cash flows that might occur in a simple sole proprietor’s business that we haven’t yet mentioned in this chapter?

28.11 Cash at the beginning and the end of the year

The net total of the cash flows from each of the three sections of the statement will represent the overall increase or decrease in the business’s cash for the year. **The overall change in cash must agree with the difference between total ‘cash’ in last year’s balance sheet and the total ‘cash’ shown in this year’s balance sheet.**

As explained earlier, the definition of ‘cash’ in the statement of cash flows is essentially petty cash held by the business and cash in its bank accounts. Of course, for many businesses, the balance on some of its bank accounts may go into overdraft from time to time.

In other words, a business’s total ‘cash’ may be represented by more than one figure in its balance sheet. A business might show a figure for *cash at bank and in hand* in the current assets section as well as a figure for *bank overdrafts* in the current liabilities section. When this is the case, IAS 7 requires the separate components of ‘cash’ to be summarised as a note to the statement. This will help users of the financial statements check the figures in the statement of cash flows against those in the balance sheets.

IAS 7 describes this note as a ‘reconciliation of the components of cash and cash equivalents’ and an example is shown in Exhibit 28.8.

Exhibit 28.8 Reconciliation of the components of cash and cash equivalents**Note: Components of cash and cash equivalents**

	This year's balance sheet	Last year's balance sheet
	£	£
Cash at bank and in hand	A	D
Bank overdrafts	(B)	(E)
<i>Cash and cash equivalents</i>	<u>C</u>	<u>F</u>

The net increase or decrease in cash according to the statement of cash flows must be equal to the difference between 'C' and 'F' shown in Exhibit 28.8.

**Activity
28.8**

The balance sheet of a business as at the end of its most recent financial year shows cash at bank and in hand of £2,250 and bank overdrafts of £27,300. The balance sheet for the previous year reported cash at bank and in hand of £1,500 and bank overdrafts of £32,800. What is the net increase or decrease in cash of this business shown by its statement of cash flows for the year just ended?

As explained earlier in this chapter, the IAS 7 definition of 'cash and cash equivalents' is actually a little more complicated than we have covered here, because the IAS 7 definition also includes cash held in the form of very short-term investments. However, it is unlikely that you will come across very short-term investments at this introductory stage in your studies.

28.12 Preparing the statement of cash flows for a sole proprietor: two examples

We can now look at a couple of examples of how a full statement of cash flows is prepared for a sole proprietor's business. Both will use the indirect method. Our first example, in Exhibit 28.9, is simpler.

Exhibit 28.9 Statement of cash flows for a sole proprietor: example 1

You are given the following balance sheets for R Watson's business as at 31 December:

	31 December 2024		31 December 2023	
	£	£	£	£
<i>Non-current assets</i>				
Equipment at cost		31,000		25,000
Less Accumulated depreciation		(11,300)		(7,000)
		19,700		18,000

	31 December 2024	31 December 2023
<i>Current assets</i>		
Inventory	9,700	10,600
Trade receivables	8,500	7,900
Cash at bank	<u>5,200</u>	<u>3,000</u>
Total assets	<u>23,400</u>	<u>21,500</u>
	43,100	39,500
<i>Current liabilities</i>		
Trade payables	(11,700)	(12,400)
Net assets	<u>31,400</u>	<u>27,100</u>
<i>Capital</i>		
Opening capital	27,100	24,800
Add Net profit for year	17,200	13,700
Less Drawings	(12,900)	(11,400)
Closing capital	<u>31,400</u>	<u>27,100</u>

There were no disposals of non-current assets during 2024.

Required:

In accordance with the requirements of IAS 7, prepare the statement of cash flows for the year ended 31 December 2024 using the indirect method.

Solution:

R Watson		
Statement of Cash Flows for the year ended 31 December 2024		
	£	£
<i>Cash flows from operating activities</i>		
Net profit for the year	17,200	
Add Depreciation (<i>working 1</i>)	4,300	
Decrease in inventory	900	
Increase in trade receivables	(600)	
Decrease in trade payables	<u>(700)</u>	
Net cash from operating activities		21,100
<i>Cash flows from investing activities</i>		
Purchase of non-current assets (<i>working 2</i>)		(6,000)
<i>Cash flows from financing activities</i>		
Drawings		<u>(12,900)</u>
Net increase in cash		2,200
Cash at beginning of year		<u>3,000</u>
Cash at end of year		<u>5,200</u>





Working 1:

Accumulated depreciation on equipment

	£		£
Closing balance	<u>11,300</u>	Opening balance	7,000
	<u>11,300</u>	Depreciation expense (<i>missing figure</i>)	<u>4,300</u>
			<u>11,300</u>

Working 2:

Equipment at cost

	£		£
Opening balance	25,000	Closing balance	<u>31,000</u>
Acquisitions (<i>missing figure deduced</i>)	<u>6,000</u>		<u>31,000</u>
	<u>31,000</u>		

Next, in Exhibit 28.10, we look at a more complicated example of the statement of cash flows for a sole proprietor.

Exhibit 28.10 Statement of cash flows for a sole proprietor: example 2

The balance sheets for K. Atherton's business as at 31 December are as follows:

	31 December 2024		31 December 2023	
	£	£	£	£
<i>Non-current assets</i>				
Machinery at cost		34,900		33,200
Less Accumulated depreciation		<u>(14,020)</u>		<u>(11,570)</u>
		20,880		21,630
<i>Current assets</i>				
Inventory	18,500		16,200	
Trade receivables	12,200		14,300	
Cash at bank and in hand	<u>420</u>	<u>31,120</u>	<u>170</u>	<u>30,670</u>
Total assets		52,000		52,300
<i>Current liabilities</i>				
Bank overdrafts	2,630		1,900	
Trade payables	<u>9,100</u>	<u>(11,730)</u>	<u>8,300</u>	<u>(10,200)</u>
<i>Non-current liabilities</i>				
Bank loan		<u>(6,000)</u>		<u>(10,000)</u>
Net assets		<u>34,270</u>		<u>32,100</u>
<i>Capital</i>				
Opening capital		32,100		29,190
Add Net profit for year		12,510		13,120
Add Cash introduced by owner		1,950		650
Less Drawings		<u>(12,290)</u>		<u>(10,860)</u>
Closing capital		<u>34,270</u>		<u>32,100</u>

Additional information:

- (i) The depreciation expense for the year ended 31 December 2024 was £3,160.
- (ii) During 2024 new machinery was purchased for £4,440, paid for immediately by bank transfer.
- (iii) During 2024 a machine was disposed of for cash, realising a loss on disposal of £730.
- (iv) The figures given for trade receivables in the balance sheets are stated after the deduction of the allowance for doubtful debts.

Required:

In accordance with the requirements of IAS 7, prepare the statement of cash flows for the year ended 31 December 2024 using the indirect method.

Solution:

K Atherton

Statement of Cash Flows for the year ended 31 December 2024

	£	£
<i>Cash flows from operating activities</i>		
Net profit for the year	12,510	
Add Depreciation	3,160	
Add Loss on disposal of non-current assets	730	
Increase in inventory	(2,300)	
Decrease in trade receivables	2,100	
Increase in trade payables	800	
Net cash from operating activities		17,000
<i>Cash flows from investing activities</i>		
Purchase of non-current assets	(4,440)	
Proceeds from sale of non-current assets (see workings)	1,300	
Net cash used in investing activities		(3,140)
<i>Cash flows from financing activities</i>		
Repayment of bank loan	(4,000)	
Cash introduced by owner	1,950	
Drawings	(12,290)	
Net cash used in financing activities		(14,340)
Net decrease in cash and cash equivalents		(480)
Cash and cash equivalents at beginning of year		(1,730)
Cash and cash equivalents at end of year		<u>(2,210)</u>
Note: Components of cash and cash equivalents	31/12/24	31/12/23
	£	£
Cash at bank and in hand	420	170
Bank overdrafts	(2,630)	(1,900)
<i>Cash and cash equivalents</i>	<u>(2,210)</u>	<u>(1,730)</u>

Workings:

Machinery at cost

	£		£
Opening balance	33,200	Cost of machine sold (<i>missing figure</i>)	2,740
Acquisitions	4,440	Closing balance	34,900
	<u>37,640</u>		<u>37,640</u>





Accumulated depreciation on machinery

	£		£
Acc dep on asset sold (<i>missing figure</i>)	710	Opening balance	11,570
Closing balance	<u>14,020</u>	Depreciation charge for year	<u>3,160</u>
	<u>14,730</u>		<u>14,730</u>

Based on the above, the carrying amount of the machine disposed of was £2,740 cost - £710 accumulated depreciation = £2,030. We can therefore calculate the proceeds that must have been received on the disposal:

	£
Disposal proceeds (<i>missing figure in this calculation</i>)	1,300
Less Carrying amount of machine sold (<i>calculated immediately above</i>)	<u>(2,030)</u>
Loss on disposal of machine (<i>given in question</i>)	<u>(730)</u>

Finally, note that the business may have paid interest during 2024, in which case the income statement would have included a figure for interest expense. However, the question did not give us any information in relation to interest. We will consider the treatment of interest paid and received in the statement of cash flows when we look at the preparation of this statement for *companies* in Chapter 37.

28.13 Final comments on the statement of cash flows for sole proprietors

The statement of cash flows is an important addition to the financial statements of a business. It can therefore tend to feature quite regularly in accounting exams, even at the introductory level. As ever, it is crucial to practise as many questions as possible to familiarise yourself with both the format of the statement and the calculations required. Students who practise lots of examples generally find that there is nothing to fear from exam questions on this topic!

Learning outcomes

You should now have learnt:

- 1 That profit is not the same as cash.
- 2 That cash is of vital importance to any business for it to survive and prosper.
- 3 That the statement of cash flows is an important addition to the financial statements of a business because it gives information on the business's ability to generate cash and on its cash needs.
- 4 That the statement of cash flows classifies the business's cash flows under three headings: operating activities, investing activities and financing activities.
- 5 That the overall total of these three sections amounts to the net increase or decrease in the business's cash for the year.
- 6 That there are two methods of presenting the cash flows from operating activities: the indirect method and the direct method.

- 7 That the indirect method is more commonly used and involves adjusting a profit figure in order to convert it into the cash flow from operating activities.
- 8 That the most common items that appear in the investing section of the statement of cash flows for a sole proprietor include payments to buy, and receipts from selling, non-current assets.
- 9 That the most common items that appear in the financing section of the statement of cash flows for a sole proprietor include cash introduced or withdrawn by the owner, cash received from new loans, and cash repayments of loans.
- 10 That the business's 'cash' as at the start and end of the year may be made up of balances of cash at bank and in hand minus bank overdraft balances.
- 11 How to prepare a statement of cash flows for a sole proprietor in accordance with the requirements of IAS 7 *Statement of Cash Flows*.

Answers to activities

28.1 There could be various explanations. Here are three:

- A business is expanding rapidly, attracting new customers by offering very generous credit terms. The new customers are being given a lengthy period to pay, so the cash received in the year by the business may be much less than the sales revenue reported in its income statement.
- Another business is investing heavily in new equipment, involving significant payments of cash. But these cash payments will not appear in the income statement because they represent the purchase of non-current assets rather than being expenses.
- A sole proprietor consistently makes annual profits of around (say) £40,000 but she takes cash drawings each year of some £60,000.

28.2 The answer is £60,000. (Operating activities £90,000 – investing activities £70,000 + financing activities £30,000 = £50,000 net increase in cash for the year. If cash at bank was £10,000 last year, it must be £10,000 + £50,000 = £60,000 this year.)

28.3 The answer is that changes in working capital will convert certain key figures in the income statement into cash flows. For example, suppose that the sales for the year in the income statement were £60,000, and that trade receivables were £7,000 in last year's balance sheet and £9,000 in this year's.

Therefore, during the year, the business will have received the amounts it was owed at the start of the year (£7,000) plus the sales for the year excluding any amounts unpaid as at the end of the year (£60,000 – £9,000). In other words, the cash received from customers will have been £7,000 + £60,000 – £9,000 = £58,000.

In other words, note how the sales figure of £60,000 in the income statement is *converted* into cash received from customers *by deducting the increase in receivables*.

The same logic applies to inventory and trade payables: adding or deducting the changes in these items will convert particular figures in the income statement into cash flows.

28.4 The answer is £124,200, as calculated below:

	£
Net profit for the year	97,000
Add Depreciation expense	29,000
Less Profit on disposal of non-current assets	(800)
Increase in inventory	(13,000)
Decrease in trade receivables	7,000
Increase in trade payables	5,000
<i>Net cash from operating activities</i>	<u>124,200</u>

- 28.5** The answer is £24,000. This is an example of a question that doesn't give you figures for cost and accumulated depreciation separately. The only option is to do a working for non-current assets at carrying amount:

<i>Non-current assets at carrying amount</i>			
	£		£
Opening balance	54,300	Depreciation expense	14,700
Acquisitions (<i>the missing figure</i>)	24,000	Carrying amount of assets sold	4,800
		Closing balance	<u>58,800</u>
	<u>78,300</u>		<u>78,300</u>

In the absence of any other information, we can only assume that the acquisitions of £24,000 were all paid for in cash during the year. The figure of £24,000 will therefore be shown as a cash outflow in the investing section of the statement of cash flows.

- 28.6** The answer is a net outflow of £12,000, as calculated below:

	£	£
Cash introduced by the owner	4,000	
Cash withdrawn by the owner (£500 × 52)	(26,000)	
Cash received from new loans	<u>10,000</u>	
<i>Net cash used in financing activities</i>		<u>(12,000)</u>

- 28.7** We haven't yet considered interest received and paid. It would seem logical to show interest received in the *investing* section, because it arises as a result of investing surplus business funds. However, IAS 7 actually allows businesses to show interest received in either the *operating* or *investing* sections.

The business may also have paid interest on its bank loans and overdrafts. There would be some logic in showing interest paid in the *financing* section, on the basis that it represents a cost of obtaining loan finance. However, IAS 7 actually allows businesses to show interest paid in either the *operating* or *financing* sections.

As this chapter is only an introduction to the statement of cash flows, we won't look at any examples of interest received or paid. We'll deal with interest received and paid when we look at the statement of cash flows for companies in Chapter 37.

- 28.8** The answer is an increase of £6,250, as calculated below:

	<i>This year's balance sheet</i>	<i>Last year's balance sheet</i>
	£	£
Cash at bank and in hand	2,250	1,500
Bank overdrafts	(27,300)	(32,800)
<i>Cash and cash equivalents</i>	<u>(25,050)</u>	<u>(31,300)</u>

Cash and cash equivalents have improved from a net negative position of £31,300 to £25,050, so the increase in cash reported by the statement of cash flows must be equal to the difference: £6,250.

Review questions

28.1 Reema Yasin is preparing her business's statement of cash flows for the 12 months to 30 September 2024, and you determine the following details in relation to that financial year:

	£'000
Net profit for the year	278
Depreciation expense	69
Increase in inventory	43
Decrease in trade receivables	57
Decrease in trade payables	38

On the basis of the above information, what is the net cash flow from operating activities?

28.2A Martin Petty is in the process of preparing a statement of cash flows for his business for the year to 30 April 2023. You establish the following facts in connection with that financial year:

	£'000
Net profit for the year	429
Depreciation expense	107
Profit on disposal of non-current assets	22
Decrease in inventory	44
Increase in trade receivables	51
Decrease in trade payables	35

Given the above information, what net cash will have been generated from operating activities according to the statement of cash flows?

28.3 You establish the following details in connection with the non-current assets of Charlotte's business for the year ended 31 December 2024:

	£'000
1 January 2024, non-current assets at cost less accumulated depreciation	635
Proceeds from the sale of non-current assets during the year	60
Depreciation expense for the year	96
Profit on the disposal of non-current assets during the year	7
31 December 2024, non-current assets at cost less accumulated depreciation	587

What figure for *payments to acquire non-current assets* will appear in the *investing activities* section of the statement of cash flows for Charlotte's business for the year ended 31 December 2024?

28.4A You are given the following details in connection with the non-current assets of Roy Snell's business for the year ended 31 July 2023:

	£'000
1 August 2022, non-current assets at cost minus accumulated depreciation	777
Acquisitions of non-current assets during the year	133
Depreciation expense for the year	157
Loss on the disposal of non-current assets during the year	13
31 July 2023, non-current assets at cost minus accumulated depreciation	696

What figure for *proceeds from disposal of non-current assets* will appear in the *investing activities* section of the statement of cash flows for Snell's business for the year ended 31 July 2023?




28.5 You are given the following balance sheets of Deepak Sharma's business as at 31 December:

	31 December 2025		31 December 2024	
	£	£	£	£
<i>Non-current assets</i>				
Property, plant & equipment at cost		71,590		61,140
Less Accumulated depreciation		<u>(32,710)</u>		<u>(26,350)</u>
		38,880		34,790
<i>Current assets</i>				
Inventory	11,950		9,920	
Trade receivables	12,640		13,310	
Cash at bank and in hand	<u>1,840</u>	<u>26,430</u>	<u>1,070</u>	<u>24,300</u>
Total assets		65,310		59,090
<i>Current liabilities</i>				
Trade payables		<u>(16,320)</u>		<u>(19,840)</u>
Net assets		<u>48,990</u>		<u>39,250</u>
<i>Capital</i>				
Opening capital		39,250		33,830
Add Net profit for year		16,560		15,290
Add Cash introduced by owner		7,500		4,000
Less Drawings		<u>(14,320)</u>		<u>(13,870)</u>
Closing capital		<u>48,990</u>		<u>39,250</u>

There were no disposals of non-current assets during 2025.

Required:

In accordance with the requirements of IAS 7, prepare the statement of cash flows for the year ended 31 December 2025 using the indirect method.

28.6A The balance sheets of Ruth Byrde's business as at the end of its two most recent financial years are presented below:

	31 October 2024		31 October 2023	
	£	£	£	£
<i>Non-current assets</i>				
Property, plant & equipment at cost		43,425		53,420
Less Accumulated depreciation		<u>(21,505)</u>		<u>(19,070)</u>
		21,920		34,350
<i>Current assets</i>				
Inventory	9,760		10,720	
Trade receivables	<u>17,685</u>	<u>27,445</u>	<u>15,430</u>	<u>26,150</u>
Total assets		49,365		60,500
<i>Current liabilities</i>				
Bank overdraft	(460)		(2,610)	
Trade payables	<u>(12,260)</u>	<u>(12,720)</u>	<u>(11,670)</u>	<u>(14,280)</u>
<i>Non-current liabilities</i>				
Bank loans		<u>(19,700)</u>		<u>(25,500)</u>
Net assets		<u>16,945</u>		<u>20,720</u>

	31 October 2024		31 October 2023	
	£	£	£	£
<i>Capital</i>				
Opening capital		20,720		15,960
Add Net profit for year		13,890		14,360
Add Cash introduced by owner		775		2,650
Less Drawings		(18,440)		(12,250)
Closing capital		<u>16,945</u>		<u>20,720</u>

There were no acquisitions of non-current assets during the year ended 31 October 2024, but a delivery van that had a carrying amount of £4,310 was disposed of in June 2024. The loss recorded on this disposal was £315.

Required:

In accordance with the requirements of IAS 7, prepare the statement of cash flows for the year ended 31 October 2024 using the indirect method.

28.7 You are presented with the following balance sheets of S. Ahmed's business as at 31 March:

	31 March 2024		31 March 2023	
	£	£	£	£
<i>Non-current assets</i>				
Property, plant & equipment at cost		98,460		87,380
Less Accumulated depreciation		<u>(39,320)</u>		<u>(33,020)</u>
		59,140		54,360
<i>Current assets</i>				
Inventory	29,410		28,150	
Trade receivables	36,590		37,920	
Cash at bank and in hand	<u>170</u>	<u>66,170</u>	<u>250</u>	<u>66,320</u>
Total assets		125,310		120,680
<i>Current liabilities</i>				
Bank overdrafts	(3,390)		(8,730)	
Trade payables	<u>(32,460)</u>	<u>(35,850)</u>	<u>(31,280)</u>	<u>(40,010)</u>
<i>Non-current liabilities</i>				
Bank loans		<u>(12,500)</u>		<u>(8,750)</u>
Net assets		<u>76,960</u>		<u>71,920</u>
<i>Capital</i>				
Opening capital		71,920		71,350
Add Net profit for year		20,980		17,040
Add Cash introduced by owner		2,700		–
Less Drawings		<u>(18,640)</u>		<u>(16,470)</u>
Closing capital		<u>76,960</u>		<u>71,920</u>

Further information:

- The depreciation expense for the year ended 31 March 2024 was £7,490.
- In February 2024, a piece of equipment was sold for £1,900 cash, realising a profit on disposal of £230.
- The figures given for trade receivables in the balance sheets are stated after the deduction of the allowance for doubtful debts.



**Required:**

In accordance with the requirements of IAS 7, prepare the statement of cash flows for the year ended 31 March 2024 using the indirect method.

28.8A The balance sheets of Wendy Langmore's business as at the end of its two most recent financial years are given to you below:

	31 July 2023		31 July 2022	
	£	£	£	£
<i>Non-current assets</i>				
Property, plant & equipment at cost		109,600		101,440
Less Accumulated depreciation		(48,920)		(40,210)
		<u>60,680</u>		<u>61,230</u>
<i>Current assets</i>				
Inventory	31,090		32,470	
Trade receivables	42,510		41,680	
Cash at bank	—	73,600	410	74,560
Total assets		<u>134,280</u>		<u>135,790</u>
<i>Current liabilities</i>				
Bank overdrafts	(3,585)		—	
Trade payables	(35,150)	(38,735)	(36,230)	(36,230)
<i>Non-current liabilities</i>				
Bank loans		(11,000)		(13,750)
Net assets		<u>84,545</u>		<u>85,810</u>
<i>Capital</i>				
Opening capital		85,810		86,420
Add Net profit for year		20,380		19,310
Add Cash introduced by owner		1,975		2,300
Less Drawings		(23,620)		(22,220)
Closing capital		<u>84,545</u>		<u>85,810</u>

- (i) In December 2022, a delivery van was purchased for £18,950, paid for immediately by bank transfer.
- (ii) In April 2023, an item of machinery that had a carrying amount of £2,970 was disposed of for £2,500 cash.
- (iii) The figures given for trade receivables in the balance sheets are stated after the deduction of the allowance for doubtful debts.

Required:

In accordance with the requirements of IAS 7, prepare the statement of cash flows for the year ended 31 July 2023 using the indirect method.

Receipts and payments accounts and income and expenditure accounts

Learning objectives

After you have studied this chapter, you should be able to:

- Explain the main differences between the financial statements of non-profit-oriented organisations and those of profit-oriented organisations.
- Prepare receipts and payments accounts.
- Prepare income and expenditure accounts and balance sheets for non-profit-oriented organisations.
- Calculate profits and losses from special activities and incorporate them into the financial statements,
- Make appropriate entries relating to subscriptions, life membership and donations.

Introduction

In this chapter, you'll learn about the financial statements prepared by non-profit-oriented organisations, and about how they differ from those prepared for profit-oriented organisations.

29.1 Non-profit-oriented organisations

As their main purpose is not trading or profit-making, charities, clubs, associations and other non-profit-oriented organisations do not prepare income statements. They are run so that their members can do things such as play tennis, bridge, football, chess, role playing games, etc. Rather than producing income statements they prepare either 'receipts and payments accounts' or 'income and expenditure accounts'.

29.2 Receipts and payments accounts

Receipts and payments accounts are a summary of the cash book for the period. For an organisation with no assets (other than cash) and no liabilities, a summary of the cash book reveals everything about what has happened financially during a period.

Exhibit 29.1 is an example:

Exhibit 29.1

Haven Running Club			
Receipts and Payments Account for the year ended 31 December 2021			
<i>Receipts</i>	£	<i>Payments</i>	£
Bank balance at 1.1.2021	2,360	Groundsman's wages	7,280
Subscriptions received in 2021	11,480	Sports ground rental	2,960
Rent received	1,160	Committee expenses	580
		Printing and stationery	330
		Bank balance at 31.12.2021	3,850
	<u>15,000</u>		<u>15,000</u>

Activity 29.1

Why do you think non-profit-oriented organisations prepare receipts and payments accounts when they have all this information in the cash book already?

29.3 Income and expenditure accounts

When assets are owned and/or there are liabilities, the receipts and payments account is not sufficient. Other than the cash received and paid out, it shows only the cash balances. The other assets and liabilities are not shown at all. What is required is:

- 1 a balance sheet; and
- 2 a statement showing whether the association's capital has changed.

In a profit-oriented organisation, **2** would be an income statement. In a non-profit-oriented organisation, **2** would be an **income and expenditure account**.

An income and expenditure account follows the same rules as an income statement for a sole proprietor. The only differences are the terms used.

A comparison between the terminology of financial statements produced by profit-oriented and non-profit-oriented organisations now follows.

Terms used

Profit-oriented organisation	Non-profit-oriented organisation
1 Income Statement	1 Income and Expenditure Account
2 Net Profit	2 Surplus of Income over Expenditure
3 Net Loss	3 Deficit of Income over Expenditure

29.4 Profit or loss for a special purpose

Sometimes there are reasons why a non-profit-oriented organisation would want to prepare either a trading account or a full income statement.

This is where something is done by it in order to make a profit. The profit is not to be kept but, to use to pay for the main purpose of the organisation.

For instance, a football club may organise and run dinner-dances or barbeques. Any profit from these helps to pay the club's expenses. For these events, either a trading account or a full income statement would be drawn up. Any profit (or loss) would be transferred to the income and expenditure account.

29.5 Accumulated fund

A sole proprietor has a capital account. A non-profit-oriented organisation has an **accumulated fund**. In effect, it is the same as a capital account, as it is the difference between the assets and liabilities.

For a sole proprietor:

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

For a non-profit-oriented organisation:

$$\text{Accumulated Fund} = \text{Assets} - \text{Liabilities}$$

29.6 Drawing up income and expenditure accounts

We can now look at the preparation of an income and expenditure account and a balance sheet of a club in Exhibit 29.2. A separate trading account is to be prepared for a bar, where refreshments are sold to make a profit.

Most clubs and associations keep their accounts using single entry. This example will therefore be from single entry records.

Exhibit 29.2

The treasurer of the Long Lane Football Club has prepared a receipts and payments account, but members have complained about the inadequacy of a financial statement of this type. In response, she asked an accountant to prepare a trading account for the bar, and an income and expenditure account and a balance sheet. The treasurer gives the accountant a copy of the receipts and payments account together with information on assets and liabilities at the beginning and end of the year:

Long Lane Football Club			
Receipts and Payments Account for the year ended 31 December 2022			
Receipts	£	Payments	£
Bank balance at 1.1.2022	524	Payment for bar supplies	38,620
Subscriptions received for		Wages:	
2021 (arrears)	1,400	Groundsman and assistant	19,939
2022	14,350	Bar staff	8,624
2023 (in advance)	1,200	Bar expenses	234
Bar sales	61,280	Repairs to stands	740
Donations received	800	Ground upkeep	1,829
		Secretary's expenses	938
		Transport costs	2,420
		Bank balance at 31.12.2022	6,210
	<u>79,554</u>		<u>79,554</u>



<i>Additional information:</i>		31.12.2021	31.12.2022
		£	£
1	Inventory in the bar – at cost	4,496	5,558
	Owing for bar supplies	3,294	4,340
	Bar expenses owing	225	336
	Transport costs	–	265
2	The land and football stands were valued at 31 December 2021 at: land £40,000; football stands £20,000; the stands are to be depreciated by 10 per cent per annum.		
3	The equipment at 31 December 2021 was valued at £2,500 and is to be depreciated at 20 per cent per annum.		
4	Subscriptions owing by members amounted to £1,400 on 31 December 2021, and £1,750 on 31 December 2022.		

From this information, in the following three stages, the accountant drew up the appropriate accounts and statements:

Stage 1

Draw up a Statement of Affairs at the end of the previous period in order to identify the balance on the Accumulated Fund brought forward to 2022.

Statement of Affairs as at 31 December 2021

	£	£
<i>Non-current assets</i>		
Land		40,000
Stands		20,000
Equipment		<u>2,500</u>
		62,500
<i>Current assets</i>		
Inventory in bar	4,496	
Trade receivables for subscriptions	1,400	
Cash at bank	<u>524</u>	
		6,420
Total assets		71,920
<i>Current liabilities</i>		
Trade payables	3,294	
Bar expenses owing	<u>225</u>	
Total liabilities		(3,519)
Net assets		<u>65,401</u>
Accumulated fund (difference)		<u>65,401</u>

Activity 29.2

Why do you think this statement was described as being a 'statement of affairs' rather than a 'balance sheet'?

Stage 2

Draw up a Bar Trading Account.

Long Lane Football Club
Bar Trading Account for the year ending 31 December 2022

	£	£
Sales		
Less Cost of goods sold:		61,280
Inventory 1.1.2022	4,496	
Add Purchases ¹	39,666	
	44,162	
Less Inventory 31.12.2022	<u>(5,558)</u>	
		(38,604)
Gross profit		22,676
Less Bar expenses ²	345	
Bar staff's wages	<u>8,624</u>	
		(8,969)
Net profit to income and expenditure account		<u><u>13,707</u></u>

Notes:**1****Purchases Control**

	£		£
Cash	38,620	Balances (creditors) b/d	3,294
Balances c/d	4,340	Trading account (difference)	39,666
	<u>42,960</u>		<u>42,960</u>

2**Bar Expenses**

	£		£
Cash	234	Balance b/d	225
Balance c/d	336	Trading account (difference)	345
	<u>570</u>		<u>570</u>

Stage 3

Draw up the financial statements.

Long Lane Football Club
Income and Expenditure Account for the year ending 31 December 2022

	£	£	£
Income			
Subscriptions for 2022 ¹			16,100
Profit from the bar			13,707
Donations received			800
			<u>30,607</u>
Less Expenditure			
Wages – Groundsman and assistant		19,939	
Repairs to stands		740	
Ground upkeep		1,829	
Secretary's expenses		938	
Transport costs ²		2,685	
Depreciation			
Stands	2,000		
Equipment	<u>500</u>		
		<u>2,500</u>	
			(28,631)
Surplus of income over expenditure			<u><u>1,976</u></u>

Notes:

1 Subscriptions received			
	£		£
Balance (trade receivables) b/d	1,400	Cash 2021	1,400
Income and expenditure (difference)	16,100	2022	14,350
		2023	1,200
Balance (in advance) c/d	1,200	Balance (trade receivables) c/d	1,750
	<u>18,700</u>		<u>18,700</u>
2 Transport Costs			
	£		£
Cash	2,420	Income and expenditure (difference)	2,685
Accrued c/d	265		
	<u>2,685</u>		<u>2,685</u>

Note that subscriptions received in advance are carried down as a credit balance to the following period.

Long Lane Football Club
Balance Sheet as at 31 December 2022

	£	£
<i>Non-current assets</i>		
Land at valuation		40,000
Football stands at valuation	20,000	
Less Depreciation	<u>(2,000)</u>	
		18,000
Equipment at valuation	2,500	
Less Depreciation	<u>(500)</u>	
		2,000
<i>Current assets</i>		60,000
Inventory of bar supplies	5,558	
Trade receivables for subscriptions	1,750	
Cash at bank	<u>6,210</u>	
		13,518
Total assets		<u>73,518</u>
<i>Current liabilities</i>		
Trade payables for bar supplies	4,340	
Bar expenses owing	336	
Transport costs owing	265	
Subscriptions received in advance	<u>1,200</u>	
Total liabilities		<u>(6,141)</u>
<i>Net assets</i>		<u>67,377</u>
Accumulated fund		
Balance as at 1.1.2022		65,401
Add Surplus of income over expenditure		<u>1,976</u>
		<u>67,377</u>

29.7 Outstanding subscriptions and the prudence concept

So far, we have treated subscriptions owing as being an asset. However, as any treasurer of a club would tell you, most subscriptions that have been owing for a long time are never paid – members lose interest or simply go somewhere else. As a result, many clubs do not include unpaid subscriptions as an asset in the balance sheet.

Activity 29.3

Does this policy of ignoring subscriptions due when preparing the financial statements comply with the prudence concept? Why/why not?

In an examination, you should assume that subscriptions owing are to be brought into the financial statements, unless instructions to the contrary are given.

Exhibit 29.3 shows an instance where subscriptions in arrears and in advance occur at the beginning and end of a period.

Exhibit 29.3

An amateur theatrical group charges its members an annual subscription of £20 per member. It accrues for subscriptions owing at the end of each year and also adjusts for subscriptions received in advance.

- (A) On 1 January 2023, 18 members had not yet paid their subscriptions for the year 2022.
 (B) In December 2022, 4 members paid £80 for the year 2023.
 (C) During the year 2023 it received £7,420 in cash for subscriptions:

	£
For 2022	360
For 2023	6,920
For 2021	<u>140</u>
	<u>7,420</u>

- (D) At 31 December 2023, 11 members had not paid their 2023 subscriptions.

Subscriptions											
2023					£	2023				£	
Jan	1	Owing b/d	(A)	360		Jan	1	Prepaid b/d	(B)	80	
Dec	31	Income and expenditure*		7,220		Dec	31	Bank	(C)	7,420	
	31	Prepaid c/d	(C)	140			31	Owing c/d	(D)	220	
				<u>7,720</u>						<u>7,720</u>	
2021						2021					
Jan	1	Owing b/d	(D)	220		Jan	1	Prepaid b/d	(C)	140	

*This is the difference between the two sides of the account.

29.8 Life membership

In some clubs and societies, members can purchase a life membership. This means that by paying a fairly large amount once, members can enjoy the facilities of the club for the rest of their lives.

Some clubs and societies treat life memberships as income in the income and expenditure account in the year in which the member paid the money but that would not comply with the accruals concept. Instead, it should be credited to a life membership account, and transfers should be made from that account to the credit of the income and expenditure account of an appropriate amount annually.

Exactly what is meant by ‘an appropriate amount’ to transfer each year is decided by the committee of the club or society. The usual basis is to establish, on average, how long members will continue to use the benefits of the club. To take an extreme case, if a club was in existence which could not be joined below the age of 70, then the expected number of years’ use of the club on average per member would be relatively few. Another club, such as a golf club, where a fair proportion of the members joined when reasonably young, and where the game is capable of being played by members until and during old age, would expect a much higher average of years of use per member. In the end, the club has to decide for itself.

As a club has to provide amenities for life members without any further payment, the credit balance remaining on the account, after the transfer of the agreed amount has been made to the credit of the income and expenditure account, should be shown on the balance sheet as a liability.

In an examination, be sure to follow the instructions set by the examiner. The examiner may, for example, tell you to recognise all the life membership fees received in a year as income for that year. If so, there will be no liability for the unrecognised in the balance sheet.

29.9 Donations

Any donations received are usually shown as income in the year that they are received.

29.10 Entrance fees

When they first join a club, in addition to the membership fee for that year new members often have to pay an entrance fee. Entrance fees are normally included as income in the year that they are received. A club could, however, decide to treat them differently, perhaps by spreading the income over a number of years. It all depends on the circumstances.

Learning outcomes

You should now have learnt:

- 1 That a receipts and payments account does not show the full financial position of an organisation, except for one where the only asset is cash and there are no liabilities.
- 2 That an income and expenditure account is drawn up to show either the surplus of income over expenditure or the excess of expenditure over income. These are the same as ‘profit’ or ‘loss’ in a profit-oriented organisation.
- 3 That the accumulated fund is basically the same as a capital account.
- 4 That although the main object of the organisation is non-profit-oriented, certain activities may be run at a profit (or may lose money) in order to help finance the main objectives of the organisation.
- 5 That in an examination you should treat subscriptions owing at the end of a period in the same way as trade receivables, unless told otherwise.
- 6 That donations are usually treated as income in the period in which they are received.
- 7 That the treatment of life membership fees is purely at the discretion of the organisation, but that they are usually amortised over an appropriate period.
- 8 That entrance fees are usually treated as income in the year in which they are received.

Answers to activities

- 29.1** Just as you would prepare a balance sheet for a profit-oriented organisation in order to summarise its financial position at a specific point in time, so non-profit-oriented organisations that deal only in cash, own no assets and have no liabilities, may prepare a receipts and payments account in order to show what happened over a period and the amount of funds left at the end. Non-profit-oriented organisations with assets and liabilities may also prepare them, but only normally in order to help prepare their main financial statements.
- 29.2** You could just as easily draw up a balance sheet but you're trying to summarise the financial statement even more than in a balance sheet. You would not, for example, show an allowance for doubtful debts being subtracted from debtors in a statement of affairs, but you might in the balance sheet of a sole trader. To avoid confusion, the title 'statement of affairs' is used when performing any preparatory work prior to preparing the balance sheet. (It must be said, however, that you would not be wrong if you called the statement of affairs a balance sheet.)
- 29.3** It does not comply with the prudence concept. You will remember from your coverage of the prudence concept in Chapter 10 that you should not overstate or understate income and expenditure. While this practice ensures the figure for subscriptions due is not overstated, it does understate them.

Review questions

29.1 A summary of the Balgreen Bowling Club's cash book is shown below. From it, and the additional information, you are to construct an income and expenditure account for the year ending 31 December 2024, and a balance sheet as at that date.

Cash Book Summary			
	£		£
Balance at 1.1.2024	5,600	Purchase of equipment	1,200
Collections at matches	17,200	Rent for green	4,800
Profit on sale of refreshments	22,000	Printing and stationery	200
		Secretary's expenses	320
		Repairs to equipment	280
		Groundsman's wages	16,000
		Miscellaneous expenses	240
		Balance at 31.12.2024	21,760
	<u>44,800</u>		<u>44,800</u>

Further information:

- (i) At 1.1.2024 equipment was valued at £6,000.
- (ii) Depreciate the value of all equipment at a rate of 10% for the year.
- (iii) At 31.12.2024 rent paid in advance was £1,200.
- (iv) At 31.12.2024 there was £80 owing for printing.

29.2A The following trial balance of the Grampian Golf Club was extracted from the books as on 31 December 2019:

	Dr	Cr
	£	£
Clubhouse	284,000	
Equipment	37,200	
Profits from raffles		13,016



	<i>Dr</i>	<i>Cr</i>
Subscriptions received		366,800
Wages of bar staff	58,400	
Bar inventory 1 January 2019	18,800	
Bar purchases and sales	82,600	169,200
Greenkeepers' wages	43,000	
Golf professional's salary	74,000	
General expenses	1,820	
Cash at bank	7,848	
Accumulated fund at 1 January 2019		58,652
	<u>607,668</u>	<u>607,668</u>

Notes:

- (i) Bar purchases and sales were on a cash basis. Bar inventory at 31 December 2019 was valued at £12,820.
- (ii) Subscriptions paid in advance by members at 31 December 2019 amounted to £3,740.
- (iii) Provide for depreciation of equipment £4,800.

Required:

- (a) Draw up the bar trading account for the year ending 31 December 2019.
- (b) Draw up the income and expenditure account for the year ending 31 December 2019, and a balance sheet as at 31 December 2019.

29.3 Read the following and answer the questions below.

On 1 January 2018 the Happy Haddock Angling Club had the following assets:

	£
Cash at bank	200
Snack bar inventory	800
Club house buildings	12,500

During the year to 31 December 2018, the Club received and paid the following amounts:

<i>Receipts</i>	£	<i>Payments</i>	£
Subscriptions 2018	3,500	Rent and rates	1,500
Subscriptions 2019	380	Extension to club house	8,000
Snack bar income	6,000	Snack bar purchases	3,750
Visitors' fees	650	Secretarial expenses	240
Loan from bank	5,500	Interest on loan	260
Competition fees	820	Snack bar expenses	600
		Games equipment	2,000

Notes: The snack bar inventory on 31 December 2018 was £900.

The games equipment should be depreciated by 20%.

- (a) Prepare an income and expenditure account for the year ending 31 December 2018. Show, either in this account or separately, the snack bar profit or loss.
- (b) Prepare a balance sheet as at 31 December 2018.

(Midland Examining Group: GCSE)

29.4A The treasurer of the Plumpton Leisure Centre has produced the following receipts and payments account for the year ended 31 December 2020:

<i>Receipts</i>	£	<i>Payments</i>	£
Balance at bank 1 January 2020	3,900	Refreshment supplies bought	4,320
Subscriptions received	45,060	Wages of attendants and cleaners	31,400
Profits from dances	4,116	Rent of building	8,700
Profit on exhibition	890	New equipment bought	18,200
Refreshment takings	16,290	Travelling expenses of teams	1,900
Sale of equipment	340	Balance at bank 31 December 2020	6,076
	<u>70,596</u>		<u>70,596</u>

Notes:

- (i) Refreshment inventory was valued: 31 December 2019 £680; 31 December 2020 £920. There was nothing owing for refreshment inventory on either of these dates.
- (ii) On 1 January 2020 the club's equipment was valued at £32,400. Included in this figure, valued at £420, was the equipment sold during the year for £340.
- (iii) The amount to be charged for depreciation of equipment for the year is £5,200. This is in addition to the loss on equipment sold during the year.
- (iv) Subscriptions owing by members at 31 December 2019 nil; at 31 December 2020 £860.

Required:

- (a) Draw up the refreshment trading account for the year ending 31 December 2020. For this purpose £4,680 of the wages is to be charged to this account; the remainder is to be charged in the income and expenditure account.
- (b) Calculate the accumulated fund as at 1 January 2020.
- (c) Draw up the income and expenditure account for the year ending 31 December 2020, and a balance sheet as at 31 December 2020.

29.5 The following is a summary of the receipts and payments of the Miniville Rotary Club during the year ended 31 July 2023.

Miniville Rotary Club
Receipts and Payments Account for the year ended 31 July 2023

	£		£
Cash and bank balances b/d	210	Secretarial expenses	163
Sales of competition tickets	437	Rent	1,402
Members' subscriptions	1,987	Visiting speakers' expenses	1,275
Donations	177	Donations to charities	35
Refund of rent	500	Prizes for competitions	270
Balance c/d	13	Stationery and printing	179
	<u>3,324</u>		<u>3,324</u>

The following valuations are also available:

<i>as at 31 July</i>	2022	2023
	£	£
Equipment (original cost £1,420)	975	780
Subscriptions in arrears	65	85
Subscriptions in advance	10	37
Owing to suppliers of competition prizes	58	68
Inventory of competition prizes	38	46

**Required:**

- (a) Calculate the value of the accumulated fund of the Miniville Rotary Club as at 1 August 2022.
- (b) Reconstruct the following accounts for the year ended 31 July 2023:
 - (i) the subscriptions account,
 - (ii) the competition prizes account.
- (c) Prepare an income and expenditure account for the Miniville Rotary Club for the year ending 31 July 2023 and a balance sheet as at that date.

(Association of Accounting Technicians)

29.6 The accounting records of the Happy Tickers Sports and Social Club are in a mess. You manage to find the following information to help you prepare the accounts for the year to 31 December 2018.

Summarised Balance Sheet as at 31 December 2017

	£
Half-share in motorised roller	600
New sports equipment unsold	1,000
Used sports equipment at valuation	700
Rent prepaid (2 months)	200
Subscriptions 2017	60
Café inventory	800
Cash and bank	1,210
	<u>4,570</u>
Life subscriptions	<u>1,400</u>
Subscriptions 2018	120
Insurance accrued (3 months)	150
Accumulated fund	2,900
	<u>4,570</u>
Receipts in the year to 31 December 2018:	£
Subscriptions – 2017	40
– 2018	1,100
– 2019	80
– Life	200
From sales of new sports equipment	900
From sales of used sports equipment	14
Café takings	4,660
	<u>6,994</u>
Payments in the year to 31 December 2018:	
Rent (for 12 months)	1,200
Insurance (for 18 months)	900
To suppliers of sports equipment	1,000
To café suppliers	1,900
Wages of café manager	2,000
Total cost of repairing motorised roller	450
	<u>7,450</u>

Notes:

- (i) Ownership and all expenses of the motorised roller are agreed to be shared equally with the Carefree Conveyancers Sports and Social Club which occupies a nearby site. The roller cost a total of £2,000 on 1 January 2014 and had an estimated life of 10 years.
- (ii) Life subscriptions are brought into income equally over 10 years, in a scheme begun 5 years ago in 2014. Since the scheme began the cost of £200 per person has been constant. Prior to 31 December 2017, 10 life subscriptions had been received.

- (iii) Four more annual subscriptions of £20 each had been promised relating to 2018, but not yet received. Annual subscriptions promised but unpaid are carried forward for a maximum of 12 months.
- (iv) New sports equipment is sold to members at cost plus 50%. Used equipment is sold off to members at book valuation. Half the sports equipment bought in the year (all from a cash and carry supplier) has been used within the club, and half made available for sale, new, to members. The 'used equipment at valuation' figure in the 31 December 2018 balance sheet is to remain at £700.
- (v) Closing café inventory is £850, and £80 is owed to suppliers at 31 December 2018.

Required:

- (a) Calculate the profit on café operations and the profit on sale of sports equipment.
- (b) Prepare a statement of subscription income for 2018.
- (c) Prepare an income and expenditure statement for the year ending 31 December 2018, and balance sheet as at 31 December 2018.
- (d) Why do life subscriptions appear as a liability?

(Association of Chartered Certified Accountants)

Learning objectives

After you have studied this chapter, you should be able to:

- Explain what is meant by the term 'joint venture'.
- Explain why separate joint venture accounts are kept by each of the parties to a joint venture.
- Make the entries in the accounts for a joint venture.
- Calculate and enter the profits of the joint venture into the accounts of the parties to the joint venture.
- Identify the amount owing to or owed by each of the parties to the other parties in the joint venture and make the appropriate entries in the joint venture accounts when payment is made and received.
- Name two accounting standards relating to joint ventures.

Introduction

Joint ventures have existed since Roman times but for the last 200–300 years they have tended to be used for small-scale activities. This has changed in recent years and they are becoming increasingly commonly used for larger-scale business projects. In this chapter, you'll learn how to record joint ventures in the books of the parties to a joint venture. You'll learn how to calculate profits and identify how much each of the parties must pay to the other parties at the end of the joint venture. Finally, you'll learn that accounting standards have been issued to regulate accounting for longer-term and larger joint ventures.

30.1 Nature of joint ventures

Sometimes a particular business venture can best be done by two or more businesses joining together to do it instead of doing it separately. The joining together is for that one venture only, it is not joining together to create a continuing business.

Such projects are known as **joint ventures**. For instance, a merchant might provide the capital, the transport to the markets and the selling skills. The farmer grows the produce. The profits or losses are then shared between them in agreed ratios. It is like a partnership, but only for this one venture. There may be several joint ventures between the same businesses, but each one is a separate venture. The agreements for each venture may be different from each of the others.

30.2 Accounting for large joint ventures

For large-scale or long-term joint ventures, a separate bank account and separate set of books are kept. In such cases, the calculation of profit is not difficult. It is similar to preparing a set of financial statements for an ordinary business.

30.3 Accounting for smaller joint ventures

Usually, no separate set of books or separate bank accounts are kept for smaller joint ventures. Each of the parties will record in their own books only those transactions with which they have been concerned. Exhibit 30.1 gives an example of such a joint venture.

Exhibit 30.1

White of London and Green of Glasgow enter into a joint venture. White is to supply the goods and pay some of the expenses. Green is to sell the goods and receive the cash and pay the remainder of the expenses. Profits are to be shared equally.

Details of the transactions are as follows:

	£
White supplied the goods costing	1,800
White paid wages	200
White paid for storage expenses	160
Green paid transport expenses	120
Green paid selling expenses	320
Green received cash from sales of all the goods	3,200

Stage 1

White and Green will each have entered up their own part of the transactions. White will have opened an account named 'Joint Venture with Green'. Similarly, Green will have opened a 'Joint Venture with White' account. The double entry to these joint venture accounts will be:

In White's books:

Payments by White:	Debit Joint venture with Green Credit Cash Book
Goods supplied to Green:	Debit Joint venture with Green Credit purchases

In Green's books:

Payments by Green:	Debit Joint venture with White Credit Cash Book
Cash received by Green:	Debit Cash Book Credit Joint venture with White

At this point the joint venture accounts in each of their books will appear as follows:

White's books (in London):

Joint Venture with Green	
	£
Purchases	1,800
Cash: wages	200
Cash: storage expenses	160

Green's books (in Glasgow):

Joint Venture with White			
	£		£
Cash: transport expenses	120	Cash: sales	3,200
Cash: selling expenses	320		

Stage 2

At this stage, White and Green know only the details in their own set of books. They do not yet know what the details are in the other person's books.

This means that, from their own records, they cannot yet calculate the venture profit. Nor can they find out how much cash has to be paid or received to close the venture. To do this they must each send a copy of their joint venture accounts to the other person.

Each person will then draw up a **memorandum joint venture account**, to include all the details from each joint venture account. The memorandum joint venture account is not a double entry account. It is drawn up only (a) to find out the shares of net profit or loss of each party to the joint venture, and (b) to help calculate the amounts payable and receivable to close the venture. White and Green's memorandum joint venture account is now shown:

White and Green				
Memorandum Joint Venture Account				
	£	£	£	
Purchases		1,800	Sales	3,200
Wages		200		
Storage expenses		160		
Transport expenses		120		
Selling expenses		320		
Net profit:				
White (one-half)	300			
Green (one-half)	300			
		600		
		3,200		3,200

Note: The profit is the difference between the two sides of the account. You find out what the balancing figure is. In this case, it is £600. Then you split it in the profit-sharing ratio. In this example, profits are shared equally. White and Green, therefore, each receive half the profit, £300 each. Now you enter the figures, £300 to White, £300 to Green, and the total of £600, which balances and closes off the account.

Activity 30.1

Look closely at the Memorandum Joint Venture account. Where does each entry in the Memorandum Joint Venture account appear in the Joint Venture with Green and Joint Venture with White T-accounts? Are they on the same side in each case, or the opposite side? What does this tell you about making entries in the Memorandum Joint Venture account?

Stage 3

The net profit shares for White and Green need to be brought into their own books. This is done as follows:

White's books:

Debit share of profit to Joint Venture with Green account

Credit White's profit and loss account

The Joint Venture account in White's books now looks like this:

White's books (in London):

Joint Venture with Green	
	£
Purchases	1,800
Cash: wages	200
Cash: storage expenses	160
Profit and loss: share of profit	300

You then do the same in Green's books:

Green's books:

Debit share of profit to Joint Venture with White account

Credit Green's profit and loss account

Green's books (in Glasgow):

Joint Venture with White	
	£
Cash: transport expenses	120
Cash: selling expenses	320
Profit and loss: share of profit	300

It won't come as a surprise to see that you have now copied the profit share entries from the Memorandum Joint Venture account into the Joint Venture accounts held by White and Green. Now you need to balance-off the two Joint Venture accounts:

White's books (in London):

Joint Venture with Green	
	£
Purchases	1,800
Cash: wages	200
Cash: storage expenses	160
Profit and loss: share of profit	300
	<u>2,460</u>
Balance b/d	<u>2,460</u>

Green's books (in Glasgow):

Joint Venture with White	
	£
Cash: transport expenses	120
Cash: selling expenses	320
Profit and loss: share of profit	300
Balance c/d	<u>2,460</u>
	<u>3,200</u>
	Balance b/d

**Activity
30.2**

Can you remember what is meant by a debit balance? Is it where the balance c/d is a debit or where the balance b/d is a debit?

Finally, the parties in the joint venture need to settle their debts to each other. They know whether they are to pay money or receive money when they look at the side of their copy of the joint venture account and see whether the balance is a debit or a credit:

- (a) If the balance brought down is a credit balance, money is owing to the other party in the joint venture. In this case, Green owes White the amount shown by the credit balance, £2,460.
- (b) If the balance brought down is a debit balance, money is due from the other party in the joint venture. In this case, White can see that Green owes her the amount of the balance, £2,460.

The payment is now made by Green to White and the final entry is made in each of the joint venture accounts, closing off the accounts.

White's books (in London):

Joint Venture with Green			
	£		£
Purchases	1,800	Balance c/d	2,460
Cash: wages	200		
Cash: storage expenses	160		
Profit and loss: share of profit	300		
	<u>2,460</u>		<u>2,460</u>
Balance b/d	<u>2,460</u>	Cash: settlement from Green	<u>2,460</u>

Green's books (in Glasgow):

Joint Venture with White			
	£		£
Cash: transport expenses	120	Cash: sales	3,200
Cash: selling expenses	320		
Profit and loss: share of profit	300		
Balance c/d	<u>2,460</u>		
	<u>3,200</u>		<u>3,200</u>
Cash: settlement to White	<u>2,460</u>	Balance b/d	<u>2,460</u>

30.4 Joint venture reporting: IFRS 11 and IAS 28

Currently, joint ventures are defined in IFRS 11 (*Joint Arrangements*) and their treatment is described in IAS 28 (*Investments in Associates and Joint Ventures*).

Learning outcomes

You should now have learnt:

- 1 That when two or more businesses join together for a particular business venture, and do not form a permanent business entity, they have entered into a joint venture.
- 2 That larger and long-term joint ventures operate a separate bank account and books dedicated to the project.
- 3 That the participants in smaller joint ventures rely on their own bank accounts and account books to run and record their part of the venture, using a *memorandum joint venture account* to combine the details of both their part and the other party's part.
- 4 Why separate joint venture accounts are kept by each party to smaller and short-term joint ventures.
- 5 How to make the appropriate entries in the books of the parties to the joint venture, calculate the profit, share that profit among the parties to the joint ventures and close off the joint venture accounts at the end of the joint venture.
- 6 That IFRS 11 and IAS 28 regulate accounting for joint ventures.

Now attempt Set 4 of multiple-choice questions. (Answers to all the multiple-choice questions are given in Appendix 2 at the end of this book.)

Answers to activities

- 30.1** It's quite simple really, isn't it? You take each debit entry in the first of the T-accounts (Joint Venture with Green) and copy it as a debit entry into the Memorandum Joint Venture account. You then do the same with the debits in the second T-account (Joint Venture with White). Then you do exactly the same with the credit entries. The order you do this in doesn't matter. All you need to ensure is that you have replicated all the T-account entries from the individual joint venture accounts in the Memorandum Joint Venture account. You have to do this because the Memorandum Joint Venture account lies outside the double entry system.
- 30.2** An account with a debit balance has more value on the debit side. It is the side on which the balance b/d figure lies that tells you whether the balance is a debit or a credit. In this case, the Joint Venture account in White's books has a debit balance. The one in Green's books has a credit balance. Therefore, Green owes White £2,460.

Review questions

30.1 Jack and Wellie enter a joint venture to share profits or losses equally resulting from dealings in second-hand TVs. Both parties take an active part in the business, each recording their own transactions. They have no joint banking account or separate set of books.

2022

- | | | |
|------|----|--|
| July | 1 | Jack buys four TVs for a total of £3,000. |
| | 3 | Jack pays for repairs £1,600. |
| | 4 | Wellie pays office rent £900 and advertising expenses £300. |
| | 6 | Wellie pays for packaging materials £90. |
| | 7 | Wellie buys a TV in excellent condition for £1,600. |
| | 31 | Jack sells the five TVs to various customers, the sales being completed on this date and totalling £8,300. |

Show the relevant accounts in the books of both joint venturers.





30.2A Frank entered into a joint venture with Graham for the purchase and sale of robot mowers. They agreed that profits and losses should be shared equally.

The following transactions took place:

- (a) Frank purchased mowers for £120,400 and paid carriage £320.
- (b) Graham purchased mowers for £14,860 and paid carriage £84.
- (c) Graham paid to Frank £70,000.
- (d) Frank sold mowers for £104,590 and sent a cheque for £50,000 to Graham.
- (e) Graham sold for £19,200 all the mowers he had purchased.
- (f) The unsold mowers in the possession of Frank were taken over by him at a valuation of £40,000.
- (g) The amount due from one venturer to the other was paid and the joint venture was dissolved.

You are required to prepare:

- (i) a statement to show the net profit or loss of the joint venture; and
- (ii) the accounts for the joint venture in the books of Frank and Graham.

30.3 Bull, Craig and Finch entered into a joint venture for dealing in strawberries. The transactions connected with this venture were:

2023

- | | | |
|------|----|--|
| May | 1 | Bull rented land for two months for £600. |
| | 2 | Craig supplied plants cost £510. |
| | 3 | Bull employed labour for planting £260. |
| | 16 | Craig charged motor expenses £49. |
| | 19 | Bull employed labour for fertilising £180. |
| | 29 | Bull paid the following expenses: Sundries £19, Labour £210, Fertiliser £74. |
| June | 11 | Finch employed labour for lifting strawberries £416. |
| | 24 | Sale expenses paid by Finch £318. |
| | 26 | Finch received cash from sale £2,916. |

Required:

Show the joint venture accounts in the books of Bull, Craig and Finch. Also show in full the method of arriving at the profit on the venture which is to be apportioned: Bull four-sevenths; Craig two-sevenths; Finch one-seventh.

Any outstanding balances between the parties are settled by cheque on 31 July.

30.4A Rock, Hill and Pine enter into a joint venture for dealing in paintings. The following transactions took place:

2024

- | | | |
|------|----|--|
| May | 1 | Rock rented a shop paying three months' rent £2,100. |
| | 3 | Hill bought a van for £2,200. |
| | 5 | Hill bought paintings for £8,000. |
| | 17 | Pine received cash from sale of paintings £31,410. |
| | 23 | Rock bought paintings for £17,000. |
| June | 9 | Van broke down. Pine agreed to use his own van for the job until cessation of the joint venture at an agreed charge of £600. |
| | 14 | Van bought on May 3 was sold for £1,700. Proceeds were kept by Rock. |
| | 17 | Sales of paintings, cash being received by Hill £4,220. |

- | | | |
|------|----|---|
| | 25 | Lighting bills paid for shop by Pine £86. |
| | 29 | Pine bought paintings for £1,700. |
| July | 3 | General expenses of shop paid for £1,090, Pine and Rock paying half each. |
| | 16 | Paintings sold by Pine £2,300, proceeds being kept by him. |
| | 31 | Joint venture ended. The paintings still in inventory were taken over at an agreed valuation of £6,200 by Hill. |

Required:

Show the joint venture accounts in the books of the three parties. Show in full the workings needed to arrive at the profit on the venture. The profit or loss was to be split: Hill one-half; Rock $\frac{3}{8}$, Pine $\frac{1}{8}$. Any outstanding balances between the parties were settled on 31 July.

Multiple-choice questions: Set 4

Each of these multiple-choice questions has four suggested answers, (A), (B), (C) and (D). You should read each question and then decide which choice is best, either (A) or (B) or (C) or (D). *Write down your answers on a separate piece of paper.* You will then be able to redo the set of questions later without having to try to ignore your answers.

MC61 Working Capital is a term meaning

- (A) The amount of capital invested by the proprietor
- (B) The excess of the current assets over the current liabilities
- (C) The capital less drawings
- (D) The total of Non-current Assets – Current Assets

MC62 A credit balance brought down on a Rent Account means

- (A) We owe that rent at that date
- (B) We have paid that rent in advance at that date
- (C) We have paid too much rent
- (D) We have paid too little in rent

MC63 A debit balance brought down on a Packing Materials Account means

- (A) We owe for packing materials
- (B) We are owed for packing materials
- (C) We have lost money on packing materials
- (D) We have an inventory of packing materials unused

MC64 If we take goods for own use we should

- (A) Debit Drawings Account: Credit Purchases Account
- (B) Debit Purchases Account: Credit Drawings Account
- (C) Debit Drawings Account: Credit Inventory Account
- (D) Debit Sales Account: Credit Inventory Account

MC65 Capital Expenditure is

- (A) The extra capital paid in by the proprietor
- (B) The costs of running the business on a day-to-day basis
- (C) Money spent on buying non-current assets or adding value to them
- (D) Money spent on selling non-current assets

MC66 In the business of C. Sangster, who owns a clothing store, which of the following are Capital Expenditure?

- (i) Shop fixtures bought
- (ii) Wages of assistants
- (iii) New van bought
- (iv) Petrol for van
- (A) (i) and (iii)
- (B) (i) and (ii)
- (C) (ii) and (iii)
- (D) (ii) and (iv)

MC67 If £500 was shown added to Purchases instead of being added to a non-current asset

- (A) Net profit only would be understated
- (B) Net profit only would be overstated
- (C) It would not affect net profit
- (D) Both gross profit and net profit would be understated

MC68 A cheque paid by you, but not yet passed through the banking system, is

- (A) A standing order
- (B) A dishonoured cheque
- (C) A credit transfer
- (D) An unpresented cheque

MC69 Given opening trade receivables of £11,500, Sales £48,000 and receipts from debtors £45,000, the closing trade receivables total should be

- (A) £8,500
- (B) £14,500
- (C) £83,500
- (D) £18,500

MC70 In a Sales Ledger Control Account the Bad Debts written off should be shown in the account:

- (A) As a debit
- (B) As a credit
- (C) Both as a debit and a credit
- (D) As a balance carried down

MC71 Which of the following should be charged in the income statement?

- (A) Office rent
- (B) Work-in-progress
- (C) Direct materials
- (D) Carriage on raw materials

MC72 The Journal is

- (A) Part of the double entry system
- (B) A supplement to the Cash Book
- (C) Not part of the double entry system
- (D) Used when other journals have been mislaid

MC73 If trade payables at 1 January 2019 were £2,500, trade payables at 31 December 2019 £4,200 and payments to creditors £32,000, then purchases for 2019 are

- (A) £30,300
- (B) £33,700
- (C) £31,600
- (D) £38,700

MC74 Given opening capital of £16,500; closing capital as £11,350; and drawings of £3,300, then

- (A) Loss for the year was £1,850
- (B) Profit for the year was £1,850
- (C) Loss for the year was £8,450
- (D) Profit for the year was £8,450





MC75 A Receipts and Payments Account is one

- (A) Which is accompanied by a balance sheet
- (B) In which the profit is calculated
- (C) In which the opening and closing cash balances are shown
- (D) In which the surplus of income over expenditure is calculated

MC76 Which of the following are *not* errors of principle?

- (i) Motor expenses entered in Motor Vehicles account
 - (ii) Purchases of machinery entered in Purchases account
 - (iii) Sale of £250 to C. Phillips completely omitted from books
 - (iv) Sale to A. Henriques entered in A. Henry's account
- (A) (ii) and (iii)
 - (B) (i) and (ii)
 - (C) (iii) and (iv)
 - (D) (i) and (iv)

MC77 Errors are corrected via the Journal because

- (A) It saves the bookkeeper's time
- (B) It saves entering them in the ledger
- (C) It is much easier to do
- (D) It provides a good record explaining the double entry records

MC78 Which of these errors would be disclosed by the trial balance?

- (A) Cheque £95 from C. Smith entered in Smiths' account as £59
- (B) Selling expenses had been debited to Sales Account
- (C) Credit sales of £300 entered in both double entry accounts as £30
- (D) A purchase of £250 was omitted entirely from the books

MC79 If the two totals of a trial balance do *not* agree, the difference must be entered in

- (A) The Income Statement
- (B) A Suspense Account
- (C) A Nominal Account
- (D) The Capital Account

MC80 What should happen if the balance on a Suspense Account is of a material amount?

- (A) Should be written off to the Balance Sheet
- (B) Carry forward the balance to the next period
- (C) Find the error(s) before publishing the final accounts
- (D) Write it off in the Income Statement

ACCOUNTING FOR PARTNERSHIPS

Introduction

This part is concerned with accounting for business partnerships; and it gives an introduction to goodwill in relation to partnerships and other business organisations. It is concerned with ordinary partnerships. Limited liability partnerships (LLPs) are *not* within the focus of this book, though most of the material in these four chapters would apply to them. Under the Limited Liability Partnerships Act 2000, the liability of members of an LLP is limited to the amount of capital they contributed to the LLP. In ordinary partnerships, any liability is shared by the partners.

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Partnerships

Learning objectives

After you have studied this chapter, you should be able to:

- Explain what a partnership is and how it differs from a joint venture.
- Explain the rules relating to the number of partners.
- Distinguish between limited partners and general partners.
- Describe the main features of a partnership agreement.
- Explain what will happen if no agreement exists on how to share profits or losses.
- Draw up the ledger accounts and financial statements for a partnership.

Introduction

In this chapter, you'll learn about the nature of partnerships and the regulations governing them. You'll learn that there are two types of partner, limited and general, and about the difference between them, and about the difference between partnerships that are limited partnerships and those that are not. Finally, you'll learn how to prepare partnership ledger accounts and how to prepare partnership financial statements.

31.1 The need for partnerships

So far, we have mainly considered businesses owned by only one person. We've also looked at joint ventures, which are one-off projects involving two or more parties working together to make a profit and then disband the venture. When a more permanent possibility exists, two or more people may form themselves into a **partnership**. This is a long-term commitment to operate in business together. The people who own a partnership are called **partners**. They do not have to be based or work in the same place, though they do in most cases. However, they maintain one set of accounting records and share the profits and losses.

Activity 31.1

From your general knowledge, can you think of any well-known partnerships where the partners are located, not just in different cities, but in different countries? What line of business are they in?

There are various reasons for multiple ownership of a business.

**Activity
31.2**

Think about this for a minute and then write down as many reasons as you can for people wanting to form a partnership.

In addition to the reasons suggested in the answer, there is also the fact that many business ventures carry financial risk should they fail. When a partnership is formed, the level of risk is reduced because it is shared. Firstly, any loss can be shared by all the partners and, secondly, when more than one person's expertise is involved, the chances of failure are reduced.

There are two types of multiple ownership: **partnerships** and **limited companies**. This chapter deals only with partnerships. Limited companies are the subject of Chapters 35 to 37.

31.2 Nature of a partnership

A partnership has the following characteristics:

- 1 It is formed to make profits.
- 2 It must obey the law as given in the Partnership Act 1890. If there is a **limited partner** (as described in Section 31.3 below), it must also comply with the Limited Partnership Act of 1907.
- 3 Normally there can be a minimum of two partners and a maximum of twenty partners. Exceptions are banks, where there cannot be more than ten partners; and there is no maximum for firms of accountants, solicitors, stock exchange members, surveyors, auctioneers, valuers, estate agents, land agents, estate managers or insurance brokers.
- 4 Each partner (except for limited partners, described below) must pay their share of any debts that the partnership could not pay. If necessary, they could be forced to sell all their private possessions to pay their share of the debts. This can be said to be unlimited liability.
- 5 Partners, who are not limited partners, are known as **general partners**.

31.3 Limited partnerships

Limited partnerships are partnerships containing one or more **limited partners**. Limited partnerships must be registered with the Registrar of Companies. Limited partners are not liable for the debts as in Section 31.2 (4) above. Limited partners have the following characteristics and restrictions on their role in the partnership:

- 1 Their liability for the debts of the partnership is limited to the capital they have put in. They can lose that capital, but they cannot be asked for any more money to pay the debts unless they contravene the regulations relating to their involvement in the partnership (see 2 and 3 below).
- 2 They are not allowed to take out or receive back any part of their contribution to the partnership during its lifetime.
- 3 They are not allowed to take part in the management of the partnership or to have the power to make the partnership take a decision. If they do, they become liable for all the debts and obligations of the partnership up to the amount taken out or received back or incurred while they were taking part in the management of the partnership.
- 4 All the partners cannot be limited partners, so there must be at least one general partner with unlimited liability.

**Activity
31.3**

What advantages do you think there might be to general partners in having a limited partner?

31.4 Limited liability partnerships

This form of partnership was first introduced in 2000. They differ from limited partnerships (Section 31.3) in that partners are liable only to the extent of their capital invested. Also, all partners are permitted to take part in the management of the partnership.

31.5 Partnership agreements

Agreements in writing are not necessary. However, it is better if a written agreement is drawn up by a lawyer or an accountant. Where there is a proper written agreement there will be fewer problems between partners. A written agreement eliminates confusion about what has been agreed.

31.6 Contents of partnership agreements

The written agreement can contain as much, or as little, as the partners want. The law does not say what it must contain. The usual accounting contents are:

- 1 the capital to be contributed by each partner;
- 2 the ratio in which profits (or losses) are to be shared;
- 3 the rate of interest, if any, to be paid on capital before the profits are shared;
- 4 the rate of interest, if any, to be charged on partners' drawings;
- 5 salaries to be paid to partners;
- 6 arrangements for the admission of new partners;
- 7 procedures to be carried out when a partner retires or dies.

**Activity
31.4**

Some partnerships don't bother drawing up a partnership agreement. How do you think the partners in those partnerships know what rights and responsibilities they have? (You have not been told about this yet, but it should be obvious if you think about it.)

Points 1 to 5 in the list above are considered below. Points 6 and 7 will be taken up in later chapters.

1 Capital contributions

Partners need not contribute equal amounts of capital. What matters is how much capital each partner *agrees* to contribute. It is not unusual for partners to increase the amount of capital they have invested in the partnership.

2 Profit (or loss) sharing ratios

Partners can agree to share profits/losses in any ratio or any way that they may wish. However, it is often thought by students that profits should be shared in the same ratio as that in which capital

is contributed. For example, suppose the capitals were Allen £40,000 and Beet £20,000. Some would assume that the partners would share the profits in the ratio of two-thirds to one-third, even though the work to be done by each partner is similar. The division of the profits of the first few years on such a basis might be:

Years	1	2	3	4	5	Total
	£	£	£	£	£	£
Net profits	36,000	48,000	60,000	60,000	72,000	276,000
Shared:						
Allen $\frac{2}{3}$	24,000	32,000	40,000	40,000	48,000	184,000
Beet $\frac{1}{3}$	12,000	16,000	20,000	20,000	24,000	92,000

Overall, Allen would receive £184,000, i.e. £92,000 more than Beet. As the duties of the partners are the same, in order to treat each partner fairly, the difference between the two shares of profit should be adequate to compensate Allen for putting extra capital into the firm. It should not be excessive. It is obvious that £92,000 extra profits is excessive, as Allen only put in an extra £20,000 as capital.

Consider too the position of capital ratio sharing of profits if one partner puts in £99,000 and the other puts in £1,000 as capital.

To overcome the difficulty of compensating fairly for the investment of extra capital, the concept of **interest on capital** was devised.

3 Interest on capital

If the work to be done by each partner is of equal value but the capital contributed is unequal, it is reasonable to pay interest on the partners' capitals out of partnership profits. This interest is treated as a deduction prior to the calculation of profits and their distribution among the partners according to the profit sharing ratio.

The rate of interest is a matter of agreement between the partners. Often it will be based upon the return which they would have received if they had invested the capital elsewhere.

Taking Allen and Beet's partnership again, but sharing the profits equally after charging 5 per cent per annum interest on capital, the division of profits would become:

Years	1	2	3	4	5		Total
	£	£	£	£	£		£
Net profit	36,000	48,000	60,000	60,000	72,000		276,000
Interest on capitals							
Allen	2,000	2,000	2,000	2,000	2,000	=	10,000
Beet	1,000	1,000	1,000	1,000	1,000	=	5,000
Remainder shared:							
Allen $\frac{1}{2}$	16,500	22,500	28,500	28,500	34,500	=	130,500
Beet $\frac{1}{2}$	16,500	22,500	28,500	28,500	34,500	=	130,500
<i>Summary</i>	<i>Allen</i>	<i>Beet</i>					
	£	£					
Interest on capital	10,000	5,000					
Balance of profits	<u>130,500</u>	<u>130,500</u>					
	<u>140,500</u>	<u>135,500</u>					

Allen has thus received £5,000 more than Beet, this being adequate return (in the partners' estimation) for having invested an extra £20,000 in the partnership for five years.

4 Interest on drawings

It is obviously in the best interests of the partnership if cash is withdrawn from it by the partners in accordance with the two basic principles of (a) as little as possible, and (b) as late as possible. The more cash that is left in the partnership, the more both everyday activities of the partnership and expansion of the partnership business can be financed internally. Also, the more cash is retained in the business, the greater are the economies that can be obtained by having sufficient cash to take advantage of bargains and of not missing cash discounts for prompt payment of debt because cash is not available, and so on.

To deter the partners from taking out cash unnecessarily, the partners can be charged interest on each withdrawal, calculated from the date of withdrawal to the end of the financial year. The amount charged to them helps to swell the profits divisible between the partners. The rate of interest should be sufficient to achieve this without being too harsh.

For example, assume that Allen and Beet decided to charge **interest on drawings** at 5 per cent per annum, and that their year-end was 31 December. The following drawings are made:

Allen			
<i>Drawings</i>			<i>Interest</i>
	£		£
1 January	2,000	$£2,000 \times 5\% \times 12 \text{ months}$	= 100
1 March	4,800	$£4,800 \times 5\% \times 10 \text{ months}$	= 200
1 May	2,400	$£2,400 \times 5\% \times 8 \text{ months}$	= 80
1 July	4,800	$£4,800 \times 5\% \times 6 \text{ months}$	= 120
1 October	1,600	$£1,600 \times 5\% \times 3 \text{ months}$	= 20
		Interest charged to Allen	= <u>520</u>
Beet			
<i>Drawings</i>			<i>Interest</i>
	£		£
1 January	1,200	$£1,200 \times 5\% \times 12 \text{ months}$	= 60
1 August	9,600	$£9,600 \times 5\% \times 5 \text{ months}$	= 200
1 December	4,800	$£4,800 \times 5\% \times 1 \text{ months}$	= 20
		Interest charged to Beet	= <u>280</u>

5 Partnership salaries

One partner may have more responsibility or tasks than the others. As compensation, rather than change the profit and loss sharing ratio, the partner may have a **partnership salary**. If that is done, the salary is deducted from net profit before distributing the profit between the partners.

Performance-related payments to partners

Partners may agree that commission or performance-related bonuses be payable to some or all of the partners linked to their individual performance. As with salaries, these would be deducted before sharing the balance of profits.

31.7 An example of the distribution of profits

Taylor and Clarke have been in partnership for one year sharing profits and losses in the ratio of Taylor $\frac{3}{5}$, Clarke $\frac{2}{5}$. They are entitled to 5 per cent per annum interest on capitals, Taylor invested £20,000 capital and Clarke £60,000. Clarke has a salary of £15,000. They charge interest on drawings, with Taylor being charged £500 and Clarke £1,000. The net profit, before any distributions to the partners, was £50,000 for the year ended 31 December 2020.

The way in which the net profit is distributed among the partners can be shown as:

	£	£	£
Net profit			50,000
Add Charged for interest on drawings:			
Taylor		500	
Clarke		<u>1,000</u>	
			1,500
			<u>51,500</u>
Less Salary: Clarke		15,000	
Interest on capital:			
Taylor	1,000		
Clarke	<u>3,000</u>		
		<u>4,000</u>	
			(19,000)
Balance of profits			<u>32,500</u>
Shared:			
Taylor $\frac{3}{5}$		19,500	
Clarke $\frac{2}{5}$		<u>13,000</u>	
			<u>32,500</u>
The £50,000 net profits have therefore been shared:			
		<i>Taylor</i>	<i>Clarke</i>
		£	£
Balance of profits	19,500		13,000
Interest on capital	1,000		3,000
Salary	–		<u>15,000</u>
	<u>20,500</u>		31,000
Less Interest on drawings	(500)		(1,000)
	<u>20,000</u>		<u>30,000</u>
		<u>£50,000</u>	

31.8 The financial statements

If the sales, inventory and expenses of a partnership were exactly the same as those of a sole trader, then the income statement would be identical with that prepared for the sole trader. However, a partnership would have an extra section at the end of the income statement. This section is called the **profit and loss appropriation account**, and it is in this account that the distribution of profits is shown. The heading to the income statement for a partnership does not normally include the words ‘appropriation account’. It is purely an accounting custom not to include it in the heading. (Sometimes examiners ask for it to be included in the heading, in which case, you need to do so!)

The profit and loss appropriation account of Taylor and Clarke from the details given would be:

Taylor and Clarke Income Statement for the year ending 31 December 2020			
(Trading Account section – same as for sole proprietor) (Profit and Loss Account section – same as for sole proprietor) Profit and Loss Appropriation Account			
	£	£	£
Net profit (<i>from the Profit and Loss Account section</i>)			50,000
Interest on drawings:			
Taylor		500	
Clarke		<u>1,000</u>	
			1,500
			<u>51,500</u>
Less: Salary: Clarke		15,000	
Interest on capitals			
Taylor	1,000		
Clarke	<u>3,000</u>		
		<u>4,000</u>	(19,000)
			<u>32,500</u>
Balance of profits shared:			
Taylor $\frac{3}{5}$		19,500	
Clarke $\frac{2}{5}$		<u>13,000</u>	
			<u>32,500</u>

31.9 Fixed and fluctuating capital accounts

There are two choices open to partnerships: **fixed capital accounts** plus current accounts, and **fluctuating capital accounts**.

1 Fixed capital accounts plus current accounts

Under this approach, the capital account for each partner remains year by year at the figure of capital put into the partnership by the partners. The profits, interest on capital, and the salaries to which the partner may be entitled are then credited to a separate current account for the partner. The drawings and the interest on drawings are debited to it. The balance of the current account at the end of each financial year will then represent the amount of undrawn (or withdrawn) profits. A credit balance will be undrawn profits, while a debit balance will be drawings in excess of the profits to which the partner was entitled.

For Taylor and Clarke, capital and current accounts, assuming drawings of £15,000 for Taylor and £26,000 for Clarke will be:

Taylor – Capital			
	2020		£
	Jan	1	Bank
			20,000
Clarke – Capital			
	2020		£
	Jan	1	Bank
			60,000

Taylor – Current Account

2020			£	2020			£
Dec	31	Cash: Drawings	15,000	Dec	31	Profit and loss	
	31	Profit and loss				appropriation account:	
		Interest on drawings	500			Interest on capital	1,000
	31	Balance c/d	5,000			Share of profits	19,500
			<u>20,500</u>				<u>20,500</u>
				2021			
				Jan	1	Balance b/d	5,000

Clarke – Current Account

2020			£	2020			£
Dec	31	Cash: Drawings	26,000	Dec	31	Profit and loss	
	31	Profit and loss				appropriation account:	
		Interest on drawings	1,000			Salary	
	31	Balance c/d	<u>4,000</u>			Interest on capital	3,000
			<u>31,000</u>			Share of profits	<u>13,000</u>
							<u>31,000</u>
				2021			
				Jan	1	Balance b/d	4,000

Notice that the salary of Clarke was not paid to him, it was merely credited to his current account. If instead it was paid in addition to his drawings, the £15,000 cash paid would have been debited to the current account, changing the £4,000 credit balance into a £11,000 debit balance.

Note also that the drawings have been posted to the current accounts at the end of the year. The amounts withdrawn which add up to these amounts were initially recorded in the Cash Book. Only the totals for the year are posted to the current account, rather than each individual withdrawal.

Examiners often ask for the capital accounts and current accounts to be shown in columnar form rather than as T-accounts. For Taylor and Clarke, these would appear in columnar form as follows:

Capital Accounts

	<i>Taylor</i>	<i>Clarke</i>		<i>Taylor</i>	<i>Clarke</i>
	£	£	2020	£	£
			Jan 1 Bank	20,000	60,000

Current Accounts

			<i>Taylor</i>	<i>Clarke</i>				<i>Taylor</i>	<i>Clarke</i>
2020			£	£	2020			£	£
Dec	31	Cash:	15,000	26,000	Dec	31	Salary	19,500	15,000
		Drawings							
	31	Interest on	500	1,000		31	Interest on	1,000	3,000
		drawings					capital		
	31	Balances c/d	5,000	4,000		31	Share of		13,000
							profits		
			<u>20,500</u>	<u>31,000</u>				<u>20,500</u>	<u>31,000</u>
					2021				
					Jan	1	Balances b/d	5,000	4,000

2 Fluctuating capital accounts

Under this approach, the distribution of profits would be credited to the capital account, and the drawings and interest on drawings debited. The balance on the capital account will, therefore, change or, 'fluctuate', each year.

If fluctuating capital accounts had been kept for Taylor and Clarke they would have appeared as follows:

Taylor – Capital							
2020			£	2020			£
Dec	31	Cash: Drawings	15,000	Jan	1	Bank	20,000
	31	Profit and loss		Dec	31	Profit and loss	
		appropriation account:				appropriation account:	
		Interest on drawings	500			Interest on capital	1,000
	31	Balance c/d	<u>25,000</u>			Share of profits	<u>19,500</u>
			<u>40,500</u>				<u>40,500</u>
				2021			
				Jan	1	Balance b/d	25,000

Clarke – Capital							
2020			£	2020			£
Dec	31	Cash: Drawings	26,000	Jan	1	Bank	60,000
	31	Profit and loss		Dec	31	Profit and loss	
		appropriation account:				appropriation account:	
		Interest on drawings	1,000			Salary	15,000
	31	Balance c/d	<u>64,000</u>			Interest on capital	3,000
			<u>91,000</u>			Share of profit	<u>13,000</u>
							<u>91,000</u>
				2021			
				Jan	1	Balance b/d	64,000

Fixed capital accounts preferred

The keeping of fixed capital accounts plus current accounts is considered preferable to fluctuating capital accounts. When partners are taking out greater amounts than the share of the profits that they are entitled to, this is shown up by a debit balance on the current account and so acts as a warning.

31.10 Where no partnership agreement exists

As mentioned in the answer to Activity 31.4, where no partnership agreement exists, express or implied, Section 24 of the Partnership Act 1890 governs the situation. The accounting content of this section states:

- Profits and losses are to be shared equally.
- There is to be no interest allowed on capital.
- No interest is to be charged on drawings.
- Salaries are not allowed.
- Partners who put a sum of money into a partnership in excess of the capital they have agreed to subscribe are entitled to interest at the rate of 5 per cent per annum on such an advance.

Section 24 applies where there is no agreement. There may be an agreement, not by a partnership deed but, in a letter. Alternatively, it may be implied by conduct, for instance when a partner signs a balance sheet which shows profits shared in some other ratio than equally. Where a dispute

arises as to whether or not an agreement exists, and this cannot be resolved by the partners, only the courts are competent to decide.

31.11 The balance sheet

For the partnership, the capital part of the balance sheet will appear in this form:

Taylor and Clarke Balance Sheet as at 31 December 2020 (extract)					
				£	£
Capital accounts	Taylor			20,000	
	Clarke			<u>60,000</u>	
					80,000
Current accounts		Taylor	Clarke		
		£	£	£	£
Salary			–	15,000	
Interest on capital			1,000	3,000	
Share of profits			<u>19,500</u>	<u>13,000</u>	
			20,500	31,000	
Less Drawings	15,000		26,000		
Interest on drawings	<u>500</u>		<u>1,000</u>		
		(15,500)		(27,000)	
		<u>5,000</u>		<u>4,000</u>	
					9,000

If one of the current accounts had finished in debit, for instance if the current account of Clarke had finished with a debit balance of £400, the figure of £400 would appear in brackets and the balances would appear net in the totals column:

	Taylor	Clarke	
	£	£	£
Closing balance	5,000	(400)	4,600

If the net figure turned out to be a debit figure, then this would be deducted from the total of the capital account.

Learning outcomes

You should now have learnt:

- 1 That there is no limited liability in partnerships except for 'limited partners'.
- 2 That limited partners cannot withdraw any of the capital they invested in the partnership or take part in the management of the partnership.
- 3 That apart from some professions, if more than twenty owners of an organisation are needed, a limited company would need to be formed, not a partnership.
- 4 That the contents of a partnership agreement will override anything written in this chapter. Partners can agree to anything they want to, in as much or as little detail as they wish.
- 5 That if there is no partnership agreement, then the provisions of the Partnership Act 1890 (details shown in Section 31.10) will apply.
- 6 That partners can agree to show their capital accounts using either the fixed capital or fluctuating capital methods.
- 7 How to prepare the ledger accounts and financial statements of partnerships.

Answers to activities

31.1 The best example is accounting partnerships. Some of them have offices all over the world.

31.2 Your answer could have included some of the following:

- The capital required is more than one person can provide.
- The experience or ability required to manage the business cannot be found in one person alone.
- Many people want to share management instead of doing everything on their own.
- Very often the partners will be members of the same family.

31.3 Limited partners contribute capital. They may also contribute expertise. Either of these is a benefit to the general partners – they have to contribute less capital and they can rely on the additional expertise when appropriate without needing to seek assistance from people outside the partnership. Also, because limited partners cannot be involved in the management of the partnership, general partners can take decisions without consulting a limited partner, thus saving time and effort when, in many instances, the limited partner will be busy doing other things that have nothing to do with the partnership business.

31.4 The Partnership Act 1890 imposes a standard partnership agreement upon partnerships that do not draw up a partnership agreement. See Section 31.10.

Review questions

31.1 Gow, Short and Hill are partners. They share profits and losses in the ratios of $\frac{3}{11}$, $\frac{4}{11}$ and $\frac{4}{11}$ respectively.

For the year ending 31 July 2024, their capital accounts remained fixed at the following amounts:

	£
Gow	120,000
Short	80,000
Hill	50,000

They have agreed to give each other 4 per cent interest per annum on their capital accounts.





In addition to the above, partnership salaries of £70,000 for Short and £40,000 for Hill are to be charged.

The net profit of the partnership, before taking any of the above into account was £230,000.

You are required to draw up the appropriation account of the partnership for the year ending 31 July 2024.

31.2A George, Henry and Lee are partners. They share profits and losses in the ratios of 5:3:2 respectively.

For the year ending 31 December 2024 their capital accounts remained fixed at the following amounts:

	£
George	120,000
Henry	80,000
Lee	60,000

They have agreed to give each other 4% interest per annum on their capital accounts.

In addition to the above, partnership salaries of £50,000 for Henry and £30,000 for Lee are to be charged.

The net profit of the partnership before taking any of the above into account was £215,400.

Required:

Draw up the appropriation account of the partnership for the year ending 31 December 2024.

31.3 Dunn and Outram sell toys. Their individual investments in the business on 1 January 2018 were: Dunn £160,000; Outram £70,000.

For the year to 31 December 2018, the net profit was £90,000 and the partners' drawings were: Dunn £26,000; Outram £32,000.

For 2018 (their first year), the partners agreed to share profits and losses equally, but they decided that from 1 January 2019:

- (i) The partners should be entitled to annual salaries of: Dunn £20,000; Outram £30,000.
- (ii) Interest should be allowed on capital at 5 per cent per annum.
- (iii) The profit remaining should be shared equally (as should losses).

		<i>Drawings</i>	
Net trading profit before dealing with partners' items		Dunn	Outram
£		£	£
2019	110,000	24,000	28,000
2020	50,000	22,000	34,000

Required:

Prepare the profit and loss appropriation accounts and the partners' current accounts for the three years.

31.4 Draw up a profit and loss appropriation account for the year ending 31 December 2020 and balance sheet extract at that date, from the following:

- (i) Net profits £111,100.
- (ii) Interest to be charged on capitals: Steel £3,000; Blair £2,000; Short £1,500.
- (iii) Interest to be charged on drawings: Steel £400; Blair £300; Short £200.
- (iv) Salaries to be credited: Blair £20,000; Short £25,000.
- (v) Profits to be shared: Steel 70%; Blair 20%; Short 10%.
- (vi) Current accounts: balances b/d Steel £18,600; Blair £9,460; Short £8,200.
- (vii) Capital accounts: balances b/d Steel £100,000; Blair £50,000; Short £25,000.
- (viii) Drawings: Steel £39,000; Blair £27,100; Short £16,800.

31.5A Draw up a profit and loss appropriation account for Cole, Knox and Lamb for the year ending 31 December 2024, and a balance sheet extract at that date, from the following:

- (i) Net profits £184,800.
- (ii) Interest to be charged on capitals: Cole £3,600; Knox £2,700; Lamb £2,100.
- (iii) Interest to be charged on drawings: Cole £1,200; Knox £900; Lamb £500.
- (iv) Salaries to be credited: Knox £22,000; Lamb £28,000.
- (v) Profits to be shared: Cole 55 per cent; Knox 25 per cent; Lamb 20 per cent.
- (vi) Current accounts: Cole £18,000; Knox £8,000; Lamb £6,000.
- (vii) Capital accounts: Cole £60,000; Knox £45,000; Lamb £35,000.
- (viii) Drawings: Cole £27,000; Knox £23,000; Lamb £17,000.

31.6A Smith and Tolhurst are in partnership, sharing profits and losses in the ratio 5:3. The following information has been taken from the partnership records for the year ended 31 October 2019:

- (i) According to its Income Statement, the net profit of the partnership for the year ended 31 October 2019 was £79,600.
- (ii) Interest to be charged on drawings taken by the partners has been correctly calculated as:

Smith	£1,360
Tolhurst	£1,520

- (iii) Tolhurst is to be allowed a salary of £20,000 per year.
- (iv) Interest is to be paid on capital account balances at the rate of 4% per year.
- (v) The partners' capital account balances throughout the year were:

Smith	£160,000
Tolhurst	£90,000

- (vi) The balances as at 1 November 2018 on the partners' current accounts were:

Smith	£12,400 Cr
Tolhurst	£9,200 Dr

- (vii) During the year ended 31 October 2019 Smith's and Tolhurst drawings were £37,300 and £49,800 respectively.

Required

- (a) Prepare the appropriation account for the year ended 31 October 2019.
- (b) Calculate the balance on each partner's current account as at 31 October 2019.
- (c) At 1 November 2018 there was a debit balance on Tolhurst's current account. What does this signify?
- (d) Why do many partnerships take account of 'interest on capital' and 'interest on drawings'?

31.7A A and B are in partnership sharing profits and losses 3:2. Under the terms of the partnership agreement, the partners are entitled to interest on capital at 5 per cent per annum and B is entitled to a salary of £4,500. Interest is charged on drawings at 5 per cent per annum and the amounts of interest are given below. No interest is charged or allowed on current account balances.

The partners' capitals at 1 July 2019 were: A £30,000 and B £10,000.

The net trading profit of the firm before dealing with partners' interest or B's salary for the year ended 30 June 2020 was £25,800. Interest on drawings for the year amounted to A £400, B £300.

At 1 July 2019, there was a credit balance of £1,280 on B's current account, while A's current account balance was a debit of £500. Drawings for the year to 30 June 2020 amounted to £12,000 for A and £15,000 for B.



**Required:**

Prepare, for the year to 30 June 2020:

- (a) The profit and loss appropriation account.
- (b) The partners' current accounts.

31.8 Bee, Cee and Dee have been holding preliminary discussions with a view to forming a partnership to buy and sell antiques.

The position has now been reached where the prospective partners have agreed the basic arrangements under which the partnership will operate.

Bee will contribute £40,000 as capital, and up to £10,000 as a long-term loan to the partnership, if needed. He has extensive other business interests and will not therefore be taking an active part in the running of the business.

Cee is unable to bring in more than £2,000 as capital initially, but, because he has an expert knowledge of the antique trade, will act as the manager of the business on a full-time basis.

Dee is willing to contribute £10,000 as capital. He will also assist in running the business as the need arises. In particular, he is prepared to attend auctions anywhere within the United Kingdom in order to acquire trading inventory which he will transport back to the firm's premises in his van. On occasions he may also help Cee to restore the articles prior to sale to the public.

At the meeting, the three prospective partners intend to decide upon the financial arrangements for sharing out the profits (or losses) made by the firm and have approached you for advice.

You are required to prepare a set of explanatory notes, under suitable headings, of the considerations which the prospective partners should take into account in arriving at their decisions at the next meeting.

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31.9 Frame and French are in partnership sharing profits and losses in the ratio 3:2. The following is their trial balance as at 30 September 2023:

	<i>Dr</i>	<i>Cr</i>
	£	£
Buildings (cost £210,000)	210,000	
Accumulated depreciation: Buildings at 30.9.2022		50,000
Fixtures at cost	8,200	
Accumulated depreciation: Fixtures at 30.9.2022		4,200
Trade receivables	61,400	
Trade payables		26,590
Cash at bank	6,130	
Inventory at 30 September 2022	62,740	
Sales		363,111
Purchases	210,000	
Carriage outwards	3,410	
Advertising	620	
Loan interest: P. Prince	3,900	
Office expenses	4,760	
Salaries and wages	57,809	
Bad debts	1,632	
Allowance for doubtful debts as at 30.9.2022		1,400
Loan from P. Prince		65,000
Capitals: Frame		100,000
French		75,000
Current accounts: Frame		4,100
French		1,200
Drawings: Frame	31,800	
French	28,200	
	<u>690,601</u>	<u>690,601</u>

- (a) Inventory at the end of the year was £74,210.
- (b) Expenses to be accrued: Office Expenses £215; Wages £720.
- (c) Depreciate fixtures 15 per cent on reducing balance basis, buildings £5,000.
- (d) Reduce allowance for doubtful debts to £1,250.
- (e) Partnership salary: £30,000 to Frame. Not yet entered.
- (f) Interest on drawings: Frame £900; French £600.
- (g) Interest on capital account balances at 5 per cent.

Required:

Prepare an income statement and profit and loss appropriation account for the year ending 30 September 2023 and a balance sheet as at that date.

31.10A Scot and Joplin are in partnership. They share profits in the ratio: Scot 70 per cent; Joplin 30 per cent. The following trial balance was extracted as at 31 December 2020:

	<i>Dr</i>	<i>Cr</i>
	£	£
Office equipment at cost	9,200	
Motor vehicles at cost	21,400	
Accumulated depreciation at 31.12.2019:		
Motor vehicles		12,800
Office equipment		3,600
Inventory at 31 December 2019	38,410	
Trade receivables and trade payables	41,940	32,216
Cash at bank	2,118	
Cash in hand	317	
Sales		180,400
Purchases	136,680	
Salaries	27,400	
Office expenses	2,130	
Electricity, gas & water	312	
Current accounts at 31.12.2019		
Scot		7,382
Joplin		7,009
Capital accounts: Scot		50,000
Joplin		20,000
Drawings: Scot	17,500	
Joplin	16,000	
	<u>313,407</u>	<u>313,407</u>

The following notes are applicable at 31 December 2020:

- (a) Inventory, 31 December 2020 £41,312.
- (b) Office expenses owing £240.
- (c) Provide for depreciation: motor 25 per cent of cost, office equipment 20 per cent of cost.
- (d) Charge interest on capitals at 5 per cent.
- (e) Charge interest on drawings: Scot £300; Joplin £200.

Required:

Draw up a set of financial statements for the year ending 31 December 2020 for the partnership.





31.11 Sage and Onion are trading in partnership, sharing profits and losses equally. Interest at 5% per annum is allowed or charged on both the capital account and the current account balances at the beginning of the year. Interest is charged on drawings at 5% per annum. The partners are entitled to annual salaries of: Sage £12,000; Onion £8,000.

Sage and Onion
Trial Balance as at 31 December 2020

	<i>Dr</i>	<i>Cr</i>
	£	£
Capital accounts: Sage		100,000
Onion		50,000
Current accounts: Sage		2,000
Onion	600	
Cash drawings for the year: Sage	15,000	
Onion	10,000	
Freehold premises at cost	50,000	
Inventory at 1 January 2020	75,000	
Fixtures and fittings at cost	15,000	
Purchases and purchase returns	380,000	12,000
Bank	31,600	
Sales and sales returns	6,000	508,000
Trade receivables and trade payables	52,400	33,300
Carriage inwards	21,500	
Carriage outwards	3,000	
Staff salaries	42,000	
VAT		8,700
Office expenses	7,500	
Allowance for doubtful debts		2,000
Advertising	5,000	
Royalties received		1,000
Electricity	1,200	
Bad debts	1,400	
Rent and business rates	2,800	
Accumulated depreciation of fixtures and fittings at 1.1.2020		3,000
	<u>720,000</u>	<u>720,000</u>

At 31 December 2020:

- (a) Inventory was valued at £68,000.
- (b) Purchase invoices amounting to £3,000 for goods included in the inventory valuation at (a) above had not been recorded.
- (c) Staff salaries owing £900.
- (d) Business rates paid in advance £200.
- (e) Allowance for doubtful debts to be increased to £2,400.
- (f) Goods withdrawn by partners for private use had not been recorded and were valued at: Sage £500, Onion £630. No interest is to be charged on these amounts.
- (g) Provision is to be made for depreciation of fixtures and fittings at 10% on cost.
- (h) Interest on drawings for the year is to be charged: Sage £360, Onion £280.

Required:

From the information given, prepare the partnership income statement and profit and loss appropriation account for the year ending 31 December 2020, and the balance sheet as at that date.

31.12A Bush, Home and Wilson share profits and losses in the ratios 4:1:3 respectively. Their trial balance as at 30 April 2020 was as follows:

	<i>Dr</i>	<i>Cr</i>
	£	£
Sales		334,618
Returns inwards	10,200	
Purchases	196,239	
Carriage inwards	3,100	
Inventory 30 April 2019	68,127	
Electricity, gas & water	190	
Salaries and wages	54,117	
Bad debts	1,620	
Allowance for doubtful debts 30 April 2019		950
General expenses	1,017	
Business rates	2,900	
Postage	845	
Computers at cost	8,400	
Office equipment at cost	5,700	
Accumulated depreciation at 30 April 2019:		
Computers		3,600
Office equipment		2,900
Trade payables		36,480
Trade receivables	51,320	
Cash at bank	5,214	
Drawings: Bush	39,000	
Home	16,000	
Wilson	28,000	
Current accounts: Bush		5,940
Home	2,117	
Wilson		9,618
Capital accounts: Bush		60,000
Home		10,000
Wilson		30,000
	<u>494,106</u>	<u>494,106</u>

Draw up a set of financial statements for the year ending 30 April 2020. The following notes are relevant at 30 April 2020:

- (i) Inventory 30 April 2020, £74,223.
- (ii) Business rates in advance £200; Inventory of postage stamps £68.
- (iii) Increase Allowance for doubtful debts to £1,400.
- (iv) Salaries: Home £18,000; Wilson £14,000. Not yet recorded.
- (v) Interest on Drawings: Bush £300; Home £200; Wilson £240.
- (vi) Interest on Capitals at 8 per cent.
- (vii) Depreciate Computers £2,800; Office equipment £1,100.





31.13 Kendall and Harvey are in partnership as wholesalers of novelty products. They share residual profits in the ratio 5:3. The trial balance exhibited below was extracted from the nominal ledger of their business as at 31 July 2024:

	<i>Dr</i>	<i>Cr</i>
	£	£
Allowance for doubtful debts as at 1 August 2023		1,669
Bad debts written off	13,400	
Electricity, water & gas	9,480	
Purchases	266,500	
Rent & rates	27,120	
Sales		434,000
Staff wages	51,300	
Sundry expenses	3,726	
Premises at cost	225,000	
Accumulated depreciation on premises at 1 August 2023		36,000
Delivery van at cost	42,000	
Accumulated depreciation on delivery van at 1 August 2023		21,420
Trade payables		48,700
Trade receivables	72,300	
Cash at bank	1,080	
Inventory at 1 August 2023	38,300	
Loan from Kendall		20,000
Capital account: Kendall		140,000
Capital account: Harvey		80,000
Drawings: Kendall	37,500	
Drawings: Harvey	26,700	
Current account as at 1 August 2023: Kendall		22,939
Current account as at 1 August 2023: Harvey		9,678
	<u>814,406</u>	<u>814,406</u>

The following nine matters also need to be considered before preparing the financial statements of the partnership:

- (i) Inventory was counted on 31 July 2024 and was valued at a cost of £42,900.
- (ii) Depreciation needs to be charged on the premises at 2% straight line and on the delivery van at 30% reducing balance.
- (iii) The costs of electricity, water and gas used in July 2024 for which no invoices have yet been received are estimated to total £4,200.
- (iv) The amount for rent and rates on the trial balance includes a payment of £3,300 which represented three months' rent for the quarter ending 30 September 2024.
- (v) The allowance for doubtful debts is, based on an analysis of the business's experience in recent years, to be set at 3% of trade receivables.
- (vi) Kendall's loan to the partnership is repayable in seven years' time and attracts interest at a rate of 6% per year.
- (vii) Interest on drawings for the year have been calculated to amount to £170 for Kendall and £130 for Harvey.
- (viii) Both partners are entitled to interest on capital at an annual rate of 5%.
- (ix) Kendall and Harvey are entitled to annual salaries of £15,000 and £10,000 respectively.

Required:

Prepare an income statement and appropriation account for the year ended 31 July 2024 as well as a balance sheet as at that date.

Goodwill for sole proprietors and partnerships

Learning objectives

After you have studied this chapter, you should be able to:

- Describe a range of methods for arriving at the selling price of a business.
- Explain and calculate super profits.
- Explain why goodwill exists.
- Explain why goodwill has a monetary value.
- Distinguish between purchased and non-purchased goodwill.
- Calculate purchased goodwill.
- Calculate the adjustments needed when a partnership changes.

Introduction

In this chapter, you'll learn about purchased goodwill and its treatment in the books and financial statements of sole proprietors and partnerships. You will also learn how to make adjustments to the partnership capital accounts when circumstances change.

32.1 Nature of goodwill

Suppose you have been running a business for some years and you want to sell it. How much would you ask as the total sale price of the business? You decide to list how much you could get for each asset if sold separately. This list might be as follows:

	£
Buildings	295,000
Machinery	75,000
Trade receivables	60,000
Inventory	40,000
	<u>470,000</u>

From this amount of £470,000 you must subtract any liabilities to arrive at the amount of the net assets. Let's assume there are £70,000 trade payables. The net assets would then be £400,000.

In this example, if you sold off everything separately and paid the creditors, you would expect to receive £400,000.

**Activity
32.1**

If you were running a successful business, would you be willing to sell it for the value of its net assets? Why/why not?

As the business is successful, a prospective buyer has been found who is willing to pay more than the £400,000 net asset value. As a result, you sell the whole of the business as a going concern to Mr Lee for £450,000. He has, therefore, paid £50,000 more than the total value of all the assets. This extra payment of £50,000 is called **goodwill**. He has paid this because he wanted to take over the business as a going concern, and so benefit from the product and customer base that already exists. Thus:

$$\text{Purchased Goodwill} = \text{Total Price less value of net identifiable assets}$$

Goodwill is an intangible asset. It can only exist if the business was purchased and the amount paid was greater than the value of the net assets. Goodwill is traditionally viewed as the value of the reputation of the business at the time it was purchased.

32.2 Reasons for payment of goodwill

In buying an existing business, there may be quite a few advantages, such as:

- The business has a large number of regular customers who will continue to deal with the new owner.
- The business has a good reputation.
- It has experienced, efficient and reliable employees.
- The business is situated in a good location.
- It has good contacts with suppliers.
- It has well-known brand names that have not been valued and recognised as assets.

None of these advantages is available to completely new businesses. For this reason, buyers are willing to pay an additional amount for goodwill when they purchase an existing business.

32.3 Existence of goodwill

Goodwill does not necessarily exist in a business. If a business has a bad reputation, an inefficient labour force or other negative characteristics, it is unlikely that the owner would be paid for goodwill on selling the business.

**Activity
32.2**

In the example in Section 32.1, goodwill was a positive figure of £50,000. If, instead, it had been a negative figure of £100,000 (being the estimated cost of a marketing campaign that would be necessary to restore customers' faith in the business) at what price would the business be most likely to be sold? Why?

32.4 Methods of calculating goodwill

There is no single way of calculating goodwill on which everyone can agree. The seller will probably want more for the goodwill than the buyer will want to pay. All that is certain is that when agreement is reached between buyer and seller concerning how much is to be paid for a business, the amount by which the agreed price exceeds the value of the net assets represents the goodwill. Various methods are used to help buyer and seller come to an agreed figure for a business. The calculations give the buyer and the seller a figure with which to begin discussions of the value.

Very often an industry or occupation has its own customary way of calculating goodwill:

- (a) In many retail businesses it has been the custom to value goodwill at the average weekly sales for the past year multiplied by a given figure. The given figure will, of course, differ between different types of businesses, and often changes gradually in the same type of business in the long term.
- (b) With many professional firms, such as accountants in public practice, it is the custom to value goodwill as being the gross annual fees times a given number. For instance, what is termed a two years' purchase of a firm with gross fees of £300,000 means goodwill = $2 \times £300,000 = £600,000$.
- (c) The average net annual profit for a specified past number of years multiplied by an agreed number. This is often said to be x years' purchase of the net profits.
- (d) The super-profits method.

Let's consider the last of these, the super-profits method. It may be argued, as in the case of a sole trader for example, that the net profits are not 'true profits'. This is because the sole trader has not charged for the following expenses:

- (a) Services of the proprietor. He has worked in the business, but he has not charged for such services. Any drawings he makes are charged to a capital account, not to the profit and loss account.
- (b) The use of the money he has invested in the business. If he had invested his money elsewhere he could have earned interest or dividends on such investments.

Super profits are what an accountant would call what is left of the net profits after allowances have been made for (a) services of the proprietor and (b) the use of the capital.

They are usually calculated as:

	£	£
Annual net profits		80,000
Less (i) Remuneration proprietor would have earned for similar work elsewhere	36,000	
(ii) Interest that would have been earned if capital had been invested elsewhere	<u>7,000</u>	
Annual super profits		<u>(43,000)</u> <u>37,000</u>

The annual super profits are then multiplied by a number agreed by seller and purchaser of the business in order to arrive at the selling price.

32.5 Sole proprietor's books

Goodwill is only entered in a sole proprietor's accounts when it has been purchased. The existence of goodwill in the financial statements usually means that the business was purchased as a going concern by the owner. That is, the owner did not start the business from scratch.

**Activity
32.3**

There is another possible explanation for purchased goodwill appearing in a sole proprietor's balance sheet. What do you think it might be?

32.6 Partnership books

Although goodwill is not *normally* entered in the financial statements unless it has been purchased, sometimes it is necessary where partnerships are concerned.

Unless it has been agreed differently, partners own a share in the goodwill in the same ratio in which they share profits. For instance, if A receives one-quarter of the profits, A will be the owner of one-quarter of the goodwill. This is true even if there is no goodwill account.

This means that when something happens such as:

- (a) existing partners deciding to change profit and loss sharing ratios; or
- (b) a new partner being introduced; or
- (c) a partner retiring or dying;

then the ownership of goodwill by partners changes in some way.

The change may involve cash passing from one partner to another, or an adjustment in the books, so that the changes in ownership do not lead to a partner (or partners) giving away their share of ownership for nothing.

32.7 Change in profit sharing ratios of existing partners

Sometimes the profit and loss sharing ratios have to be changed. Typical reasons are:

- A partner may now not work as much as in the past, possibly because of old age or ill-health.
- A partner's skills and ability may have changed, perhaps after attending a course or following an illness.
- A partner may now be doing much more for the business than in the past.

If the partners decide to change their profit sharing ratios, an adjustment will be needed.

To illustrate why this is so, let's look at the following example of a partnership in which goodwill is not already shown in a goodwill account at its correct value.

- (a) A, B and C are in partnership, sharing profits and losses equally.
- (b) On 31 December 2022 they decide to change this to A one-half, B one-quarter and C one-quarter.
- (c) On 31 December 2022 the goodwill, which had never been shown in the books, was valued at £60,000. If, just before the change in the profit-sharing ratio, the business had been sold and £60,000 received for goodwill, then each partner would have received £20,000 as they shared profits equally.
- (d) At any time after 31 December 2022, once the profit-sharing ratio has changed, their ownership of goodwill is worth A £30,000, B £15,000 and C £15,000. If goodwill is sold for that amount, then those figures will be received by the partners for goodwill.
- (e) If, when (b) above happened, there had been no change in activity or commitment to the business by A, B, or C, or no other form of adjustment, then B and C would each have given away a £5,000 share of the goodwill for nothing. This would not be sensible.

We can now look at how the adjustments can be made when a goodwill account with the correct valuation does not already exist.

Exhibit 32.1

E, F and G have been in business for 10 years. They have always shared profits equally. No goodwill account has ever existed in the books. On 31 December 2022 they agree that G will take only a one-fifth share of the profits as from 1 January 2023, because he will be devoting less of his time to the business in the future. E and F will each take two-fifths of the profits. The summarised balance sheet of the business on 31 December 2022 appears as follows:

Balance Sheet as at 31 December 2022	
	£
Net Assets	<u>70,000</u>
Capital: E	<u>30,000</u>
F	18,000
G	<u>22,000</u>
	<u>70,000</u>

The partners agree that the goodwill should be valued at £30,000. Answer (1) shows the solution when a goodwill account is opened. Answer (2) is the solution when a goodwill account is not opened.

1 Goodwill account opened

Open a goodwill account. Then make the following entries: Debit goodwill account: total value of goodwill.

Credit partners' capital accounts: each one with his share of goodwill in old profit-sharing ratio. The goodwill account will appear as:

Goodwill			
	£		£
Capitals: valuation shared		Balance c/d	30,000
E	10,000		
F	10,000		
G	10,000		
	<u>30,000</u>		<u>30,000</u>

The capital accounts may be shown in columnar fashion as:

Capital Accounts							
	E £	F £	G £		E £	F £	G £
Balances c/d	40,000	28,000	32,000	Balances b/d	30,000	18,000	22,000
				Goodwill: old ratios	10,000	10,000	10,000
	<u>40,000</u>	<u>28,000</u>	<u>32,000</u>		<u>40,000</u>	<u>28,000</u>	<u>32,000</u>

The balance sheet items before and after the adjustments will appear as:

	Before	After		Before	After
	£	£		£	£
Goodwill		– 30,000	Capitals: E	30,000	40,000
Other assets	70,000	70,000	F	18,000	28,000
			G	<u>22,000</u>	<u>32,000</u>
	<u>70,000</u>	<u>100,000</u>		<u>70,000</u>	<u>100,000</u>

2 Goodwill account not opened

The effect of the change of ownership of goodwill may be shown in the following form:

<i>Before</i>		<i>After</i>		<i>Loss or Gain</i>		<i>Action Required</i>
	£		£			
E One-third	10,000	Two-fifths	12,000	Gain	£2,000	Debit E's capital account £2,000
F One-third	10,000	Two-fifths	12,000	Gain	£2,000	Debit F's capital account £2,000
G One-third	10,000	One-fifth	6,000	Loss	£4,000	Credit G's capital account £4,000
	<u>30,000</u>		<u>30,000</u>			

The column headed '*Action Required*' shows that a partner who has gained goodwill because of the change must be charged for it by having his capital account debited with the value of the gain. A partner who has lost goodwill must be compensated for it by having his capital account credited.

The capital accounts will appear as:

Capital Accounts

	E £	F £	G £		E £	F £	G £
Goodwill adjustments	2,000	2,000		Balances b/d	30,000	18,000	22,000
Balances c/d	28,000	16,000	26,000	Goodwill adjustments			4,000
	<u>30,000</u>	<u>18,000</u>	<u>26,000</u>		<u>30,000</u>	<u>18,000</u>	<u>26,000</u>

As there is no goodwill account, the balance sheet items before and after the adjustments will therefore appear as:

	<i>Before</i>	<i>After</i>		<i>Before</i>	<i>After</i>
	£	£		£	£
Net assets	70,000	70,000	Capitals: E	30,000	28,000
			F	18,000	16,000
			G	<u>22,000</u>	<u>26,000</u>
	<u>70,000</u>	<u>70,000</u>		<u>70,000</u>	<u>70,000</u>

Comparison of methods 1 and 2

Let's compare the methods. Assume that shortly afterwards the assets in 1 and 2 are sold for £70,000 and the goodwill for £30,000. The total of £100,000 would be distributed:

Method 1. The £100,000 is exactly the amount needed to pay the partners according to the balances on their capital accounts. The payments are therefore made of

	£
Capitals paid to E	40,000
F	28,000
G	32,000
Total cash paid	<u>100,000</u>

Method 2. First of all, the balances on capital accounts, totalling £70,000, are to be paid. Then the £30,000 received for goodwill will be split between the partners in their profit and loss ratios. This will result in payments as follows:

	Capitals		Goodwill Shared	Total Paid
	£		£	£
E	28,000	(2/5)	12,000	40,000
F	16,000	(2/5)	12,000	28,000
G	26,000	(1/5)	6,000	32,000
	<u>70,000</u>		<u>30,000</u>	<u>100,000</u>

You can see that the final amounts paid to the partners are the same whether a goodwill account is opened or not.

32.8 Admission of new partners

New partners may be admitted, usually for one of two reasons:

- 1 As an extra partner, either because the firm has grown or because someone is needed with different skills.
- 2 To replace partners who are leaving the firm. This might be because of retirement or the death of a partner.

32.9 Goodwill on admission of new partners

The new partner will be entitled to a share in the profits, and, normally, also to the same share of the value of goodwill. It is correct to charge the new partner for taking over that share of the goodwill.

32.10 Goodwill adjustments when new partners are admitted

This calculation is done in four stages:

- 1 Show value of goodwill divided between old partners in the old profit and loss sharing ratios.
- 2 Then show value of goodwill divided between partners (including new partner) in the new profit and loss sharing ratio.
- 3 Goodwill gain shown: charge these partners for the gain.
- 4 Goodwill loss shown: give these partners an allowance for their losses.

This is illustrated in Exhibits 32.2 and 32.3.

Exhibit 32.2

A and B are in partnership, sharing profits and losses equally. C is admitted as a new partner. The three partners will share profits and losses one-third each.

Total goodwill is valued at £60,000.

Stage 1			Stage 2		Stage 3	
Partners	Old profit shares	Share of goodwill	New profit shares	Share of goodwill	Gain or loss	Adjustment needed
		£		£	£	
A	$\frac{1}{2}$	30,000	$\frac{1}{3}$	20,000	10,000	Cr A
B	$\frac{1}{2}$	30,000	$\frac{1}{3}$	20,000	10,000	Cr B
C		–	$\frac{1}{3}$	20,000	20,000	Dr C
		<u>60,000</u>		<u>60,000</u>	Gain	Capital

This means that A and B need to have their capitals increased by £10,000 each. C's capital needs to be reduced by £20,000.

Note that A and B have kept their profits in the same ratio to each other. While they used to have one-half each, now they have one-third each.

We will now see in Exhibit 32.3 that the method shown is the same even when existing partners take a different share of the profit to that before the change.

Exhibit 32.3

D and E are in partnership sharing profits one-half each. A new partner F is admitted. Profits will now be shared D one-fifth, and E and F two-fifths each. D and E, therefore, have not kept their shares equal to each other. Goodwill is valued at £60,000.

Stage 1			Stage 2		Stage 3	
Partners	Old profit shares	Share of goodwill	New profit shares	Share of goodwill	Gain or loss	Adjustment needed
		£		£	£	
D	$\frac{1}{2}$	30,000	$\frac{1}{5}$	12,000	18,000	Cr D
E	$\frac{1}{2}$	30,000	$\frac{2}{5}$	24,000	6,000	Cr E
F		–	$\frac{2}{5}$	24,000	24,000	Dr F
		<u>60,000</u>		<u>60,000</u>	Gain	Capital

D needs his capital increased by £18,000. E's capital is to be increased by £6,000. F's capital needs to be reduced by £24,000.

32.11 Accounting entries for goodwill adjustments

These depend on how the partners wish to arrange the adjustment. Three methods are usually used:

- 1 Cash is paid by the new partner privately to the old partners for his/her share of the goodwill. No goodwill account is to be opened.

In Exhibit 32.3, F would therefore give £24,000 in cash, being £18,000 to D and £6,000 to E. They would bank these amounts in their private bank accounts. No entry is made for this in the accounts of the partnership.

- 2 Cash is paid by the new partner into the business bank account for his/her share of the goodwill. No goodwill account is to be opened. Assume that the capital balances before F was admitted were D £50,000, E £50,000, and F was to pay in £50,000 as capital plus £24,000 for goodwill.

The £24,000 payment is made in order to secure a share of the £60,000 existing goodwill. The £24,000 is shared between the two existing partners by increasing their capital accounts by the amounts shown in Stage 3 of Exhibit 32.3. The debit entry is to the bank account. The entries in the capital accounts are:

Capital Accounts							
	D £	E £	F £		D £	E £	F £
Adjustments for goodwill			24,000	Balances b/d	50,000	50,000	
				Cash for capital			50,000
				Cash for goodwill			24,000
				Loss of goodwill	18,000	6,000	
Balances c/d	68,000	56,000	50,000				
	68,000	56,000	74,000		68,000	56,000	74,000

- 3 Goodwill account to be opened. No extra cash to be paid in by the new partner for goodwill.

In Exhibit 32.3, the opening capitals were D £50,000, E £50,000. F paid in £50,000 as capital.

Here, the situation is different from under the second method. The new partner is not paying anything in order to secure a share of the £60,000 of existing goodwill. As a result, it is shared now among the two original partners in their original profit sharing ratio (half each) and the new partner's capital account is credited only with the £50,000 he/she is investing. This is done because the new partner is not entitled to any of the previously established goodwill and the only way to prevent that permanently is to recognise all the goodwill now and credit it to the existing partners' capital accounts.

The action required is:

- Debit goodwill account: with total value of goodwill;
- Credit capitals of old partners: with their shares of goodwill in old profit sharing ratios.

No adjustments for goodwill gains and losses are required as the capital accounts of D and E have been increased by the full value of the goodwill at the time of F's admission to partnership.

For Exhibit 32.3, the entries would appear as:

Goodwill			
Value divided: D Capital	£		£
E Capital	30,000	Balance c/d	60,000
	30,000		
	<u>60,000</u>		<u>60,000</u>

Capital Accounts							
Balances c/d	D £	E £	F £	Balances b/d Cash for capital Goodwill	D £	E £	F £
	80,000	80,000	50,000		50,000	50,000	50,000
	80,000	80,000	50,000		30,000	30,000	
	80,000	80,000	50,000		80,000	80,000	50,000

As shown in Section 32.7, if the partnership was dissolved and realised the £210,000 it was valued at when F was admitted, this would first be used to repay the capital account balances. D and F would, therefore, be fully compensated for the value of the goodwill at the time of F's admission to partnership, and F would receive exactly the amount of his/her investment.

32.12 Where new partners pay for share of goodwill

The last section looked at how the partners' capital accounts are adjusted to account for goodwill when a new partner is admitted. In the second case, £24,000 was paid for goodwill by the new partner. Total goodwill at that time was £60,000. The profit share of the new partner is $\frac{2}{5}$. If you divide £24,000 by $\frac{2}{5}$ you get £60,000. Therefore, if you didn't know that the total goodwill was £60,000 you can calculate it by dividing the amount a new partner pays for goodwill by that new partner's profit-sharing ratio.

Unless otherwise agreed, the assumption is that the total value of goodwill is directly proportionate to the amount paid by the new partner for the share of profit the new partner will receive in future. If a new partner pays £12,000 for a one-fifth share of future profits, goodwill is taken to be £60,000. A sum of £18,000 for a one-quarter share of future profits would, therefore, be taken to imply a total value of £72,000 for goodwill.

32.13 Goodwill on withdrawal or death of partners

This depends on whether or not a goodwill account exists.

If there was no goodwill account

If no goodwill account already existed, the partnership goodwill should be valued because the outgoing partner is entitled to his/her share of its value. This value is entered in double entry accounts:

- Debit goodwill account with valuation.
- Credit each old partner's capital account in profit sharing ratios.

Exhibit 32.4

H, I and J have been in partnership for many years sharing profit and losses equally. No goodwill account has ever existed.

J is leaving the partnership. The other two partners are to take over his share of profits equally. Each partner's capital before entering goodwill was £50,000. The goodwill is valued at £45,000.

Goodwill

	£		£
Valuation: Capital H	15,000	Balance c/d	45,000
Capital I	15,000		
Capital J	15,000		
	<u>45,000</u>		<u>45,000</u>
Balance b/d	45,000		

Capital Accounts

	H £	I £	J £		H £	I £	J £
Balances c/d	65,000	65,000	65,000	Balances b/d	50,000	50,000	50,000
	<u>65,000</u>	<u>65,000</u>	<u>65,000</u>	Goodwill shares	<u>15,000</u>	<u>15,000</u>	<u>15,000</u>
					<u>65,000</u>	<u>65,000</u>	<u>65,000</u>
				Balances b/d	65,000	65,000	65,000

When J leaves the partnership, his capital balance of £65,000 will be paid to him.

If a goodwill account exists

- 1 If a goodwill account exists with the correct valuation of goodwill entered in it, no further action is needed.
- 2 If the valuation in the goodwill account needs to be changed, the following will apply:

Goodwill undervalued:	Debit increase needed to goodwill account. Credit increase to old partners' capital accounts in their old profit sharing ratios.
Goodwill overvalued:	Debit reduction to old partners' capital accounts in their old profit sharing ratios. Credit reduction needed to goodwill account.

Learning outcomes

You should now have learnt:

- 1 What is meant by the term 'goodwill'.
- 2 What is meant by the term 'purchased goodwill', and how to calculate it.
- 3 How to calculate super profits.
- 4 How to record goodwill in the accounts of a partnership.
- 5 That the true value of goodwill can be established only when the business is sold, but for various reasons of fairness between partners it is valued the best way possible when there is no imminent sale of a business.
- 6 That if the old partners agree, a new partner can be admitted without paying anything in as capital.
- 7 That goodwill is usually owned by the partners in the ratio in which they share profits.
- 8 That if there is a change in partnership without adjustments for goodwill, then some partners will make an unfair gain while others will quite unfairly lose money.
- 9 That if a new partner pays a specific amount for his or her share of the goodwill, then that payment is said to be a 'premium'.

Answers to activities

- 32.1** What if someone wanted to buy the business so that they could run it for themselves? Would they not be willing to pay a bit extra so as to benefit from the customer and product base you've built up? When a business is sold as a 'going concern', the owners can usually receive more than simply the value of the assets or, to be more accurate, the value of its net assets (i.e. all assets less all liabilities). This difference is known as 'goodwill'.
- 32.2** It is unlikely that a potential buyer would be willing to pay more than £300,000 for the business and so it would most likely be broken-up and sold, asset by asset, for £400,000.
- 32.3** The business may have been founded by the present owner who, at some time after starting the business, bought another business and combined the two businesses into one. For example, a newsagent may take over another newsagent and run both shops as one business. The purchased goodwill included in the amount paid for the second business would appear in the balance sheet of the combined business.

Review questions

32.1 Vantuir, Aparecida and Fraga are in partnership. They have always shared their profits in the ratios of Vantuir 3: Aparecida 2: Fraga 5. They are to alter their profit ratios to Vantuir 4: Aparecida 1: Fraga 3. The last balance sheet before the change was:

Balance Sheet as at 31 March 2024	
	£
Net Assets (not including goodwill)	100,000
	<u>100,000</u>
Capitals:	
Vantuir	30,000
Aparecida	20,000
Fraga	50,000
	<u>100,000</u>

The partners agree to bring in goodwill, being valued at £24,000 on the change.

Show the balance sheet on 1 April 2024 after goodwill has been taken into account if:

- (a) Goodwill account was opened.
- (b) Goodwill account was not opened.

32.2A Abel, Burt, Cole and Dodds are in partnership. They are to change their profit ratios as shown:

	Old ratio	New ratio
Abel	1	2
Burt	4	3
Cole	2	4
Dodds	3	1

They decide to bring in a goodwill amount of £72,000 on the change. The last balance sheet before any element of goodwill has been introduced was:

Balance Sheet as at 30 September 2023	
	£
Net assets (not including goodwill)	330,000
	<u>330,000</u>
Capitals:	
Abel	55,000
Burt	120,000
Cole	65,000
Dodds	90,000
	<u>330,000</u>

Show the balance sheet on 1 October 2023 after necessary adjustments have been made if:

- (a) Goodwill account was opened.
- (b) Goodwill account was not opened.

32.3 Black and Smart are in partnership, sharing profits and losses equally. They decide to admit King. By agreement, goodwill valued at £40,000 is to be introduced into the business books. King is required to provide capital equal to that of Smart after she has been credited with her share of goodwill. The new profit-sharing ratio is to be 8:3:5 respectively for Black, Smart and King.





The balance sheet before admission of King showed:

	£
Non-current and current assets (other than cash)	160,000
Cash	1,000
Total assets	161,000
Current liabilities	(41,000)
Net assets	<u>120,000</u>
Capital: Black	70,000
Capital: Smart	50,000
	<u>120,000</u>

Show:

- Journal entries for admission of King.
- Opening balance sheet of new business.
- Journal entries for writing off the goodwill which the new partners decided to do soon after the start of the new business.

32.4A Blunt, Dodds and Fuller are in partnership. They shared profits in the ratio 1:3:2. It is decided to admit Baxter. It is agreed that goodwill is worth £60,000, but that this is not to be brought into the business records. Baxter will bring £24,000 cash into the business for capital. The new profit-sharing ratio is to be Blunt 4: Dodds 5: Fuller 2: Baxter 1.

The balance sheet before Baxter was introduced was as follows:

	£
Assets (other than in cash)	66,000
Cash	1,200
Total assets	67,200
Trade payables	(8,400)
Net assets	<u>58,800</u>
Capitals: Blunt	14,000
Dodds	24,400
Fuller	20,400
	<u>58,800</u>

Show:

- The entries in the capital accounts of Blunt, Dodds, Fuller and Baxter, the accounts to be in columnar form.
- The balance sheet after Baxter has been introduced.

32.5 Wilson, Player and Sharp are in partnership. They shared profits in the ratio 2:4:3. It is decided to admit Titmus. It is agreed that goodwill is worth £72,000 and that it is to be brought into the business records. Titmus will bring £30,000 cash into the business for capital. The new profit-sharing ratio is to be Wilson 5: Player 8: Sharp 4: Titmus 3.

The balance sheet before Titmus was introduced was as follows:

	£
Assets (other than in cash)	200,000
Cash	2,000
Total assets	202,000
Liabilities	(31,000)
Net assets	<u>171,000</u>
Capitals: Wilson	57,000
Player	76,000
Sharp	38,000
	<u>171,000</u>

Show:

- The entries in the capital accounts of Wilson, Player, Sharp and Titmus, the accounts to be in columnar form.
- The balance sheet after Titmus has been introduced.

32.6 A new partner has joined the business during the year and has paid in £10,000 for 'goodwill'. This £10,000 has been credited by the bookkeeper to the account of the new partner. The senior partner had objected to this, but the bookkeeper had replied: 'Why not credit the £10,000 to the account of the new partner? It is his money after all.'

Required:

Give your advice as to the proper treatment of this £10,000. Explain your reasons fully.

(Association of Chartered Certified Accountants)

32.7 Owing to staff illnesses, the draft final accounts for the year ended 31 March 2019 of Messrs Stone, Pebble and Brick, trading in partnership as the Bigtime Building Supply Company, have been prepared by an inexperienced, but keen, clerk. The draft summarised balance sheet as at 31 March 2019 is as follows:

				£
Tangible non-current assets: At cost less depreciation to date				45,400
Current assets				32,290
Total assets				77,690
Trade payables				(6,390)
Net assets				<u>71,300</u>
<i>Represented by:</i>				
	<i>Stone</i>	<i>Pebble</i>	<i>Brick</i>	<i>Total</i>
	£	£	£	£
Capital accounts: at 1 April 2018	<u>26,000</u>	<u>18,000</u>	<u>16,000</u>	60,000
Current accounts:				
Share of net profit for the year ended 31 March 2019	12,100	12,100	12,100	
Drawings year ended 31 March 2019	(8,200)	(9,600)	(7,200)	
At 31 March 2019	<u>3,900</u>	<u>2,500</u>	<u>4,900</u>	11,300
				<u>71,300</u>

The partnership commenced on 1 April 2018 when each of the partners introduced, as their partnership capital, the net tangible non-current and current assets of their previously separate businesses. However, it has now been discovered that, contrary to what was agreed, no adjustments were made in the partnership books for the goodwill of the partners' former businesses now incorporated in the partnership. The agreed valuations of goodwill at 1 April 2018 are as follows:

	£
Stone's business	30,000
Pebble's business	20,000
Brick's business	16,000

It is agreed that a goodwill account should not be opened in the partnership's books.

It has now been discovered that effect has not been given in the accounts to the following provisions in the partnership agreement effective from 1 January 2019:

- Stone's capital to be reduced to £20,000, the balance being transferred to a loan account upon which interest at the rate of 11% per annum will be paid on 31 December each year.





- 2 Partners to be credited with interest on their capital account balances at the rate of 5% per annum.
- 3 Brick to be credited with a partner's salary at the rate of £8,500 per annum.
- 4 The balance of the net profit or loss to be shared between Stone, Pebble and Brick in the ratio 5:3:2 respectively.

Notes:

- 1 It can be assumed that the net profit indicated in the draft accounts accrued uniformly throughout the year.
- 2 It has been agreed between the partners that no adjustments should be made for any partnership goodwill as at 1 January 2019.

Required:

- (a) Prepare the profit and loss appropriation account for the year ended 31 March 2019.
- (b) Prepare a corrected statement of the partners' capital and current accounts for inclusion in the partnership balance sheet as at 31 March 2019.

(Association of Accounting Technicians)

Revaluation of partnership assets

Learning objectives

After you have studied this chapter, you should be able to:

- Explain why there may be a need for revaluation of assets in a partnership.
- Calculate the amount of asset revaluation gain or loss attributable to each partner.
- Make the necessary entries to the ledger accounts when assets are revalued.

Introduction

In this chapter, you'll learn about the events that make it necessary to revalue the assets of a partnership. You'll learn the journal entries required to record asset revaluations in the ledger accounts of the partnership and how to apportion gains and losses on revaluation between the partners.

33.1 Need for revaluation

When a business is sold and the sale price of the assets differs from their book values, there will be a profit or loss on the sale. This profit or loss will be shared between the partners in their profit and loss sharing ratios.

This sharing of profits and losses that result from changing asset values doesn't just need to be done when a partnership is sold. It should also be done whenever any of the following happens:

- a new partner is admitted;
- a partner leaves the firm;
- the partners change profit and loss sharing ratios.

As no sale has taken place in any of these circumstances, the assets will have to be revalued to reflect what they are worth at the date when the change occurs. Once they are revalued, the gains and losses can be identified.

Activity 33.1

Why do the assets need to be revalued in these cases? The business has not been sold. (*Hint:* there is no legal requirement to do so; consider this question in the light of what you learnt in Chapter 32 about goodwill when new partners are admitted.)

Once the assets have been revalued, you need to record the changes and gains and losses in the ledger accounts of the partnership.

33.2 Profit or loss on revaluation

If the revaluation shows no difference in asset values, no further action is needed. This will not happen very often, especially if assets include buildings. These are normally shown at cost less accumulated depreciation, but this is very rarely the actual value of buildings after they have been owned for a few years.

		£
If:	New total valuation of assets	90,000
Is <i>more</i> than:	Old total valuation of assets	(60,000)
The result is:	Gain on revaluation	<u>30,000</u>
		£
If:	New total valuation of assets	40,000
Is <i>less</i> than:	Old total valuation of assets	(50,000)
The result is:	Loss on revaluation	<u>(10,000)</u>

33.3 Accounting for revaluation

The first thing you do upon revaluing partnership assets is to open a **revaluation account** and make the appropriate entries:

- 1 *For each asset showing a gain on revaluation:*
Debit asset account with gain.
Credit revaluation account.
- 2 *For each asset showing a loss on revaluation:*
Debit revaluation account.
Credit asset account with loss.
- 3 *If there is an increase in total valuation of assets:*
Debit gain to revaluation account.
Credit **old** partners' capital accounts in **old** profit and loss sharing ratios.*
- 4 *If there is a fall in total valuations of assets:*
Debit **old** partners' capital accounts in **old** profit and loss sharing ratios.*
Credit loss to revaluation account.

***Note:** If current accounts are kept for the partners, the entries should be made in their current accounts.

Activity 33.2

When you were looking at goodwill in the previous chapter, you were interested in the difference between the amount received and the value of *net* assets. Why do we consider *only the assets* when there is a change in partners or a change in the profit-sharing ratio?

Exhibit 33.1

Following is the balance sheet as at 31 December 2022 of W and Y, who shared profits and losses in the ratios: W two-thirds; Y one-third. From 1 January 2023 the profit and loss sharing ratio is to be altered to W one-half; Y one-half.

Balance Sheet as at 31 December 2022

	£	£
Premises (at cost)		65,000
Equipment (at cost less depreciation)		<u>15,000</u>
		80,000
Inventory	20,000	
Trade receivables	12,000	
Bank	<u>8,000</u>	
		40,000
Total assets		<u>120,000</u>
Capitals: W		70,000
Y		50,000
		<u>120,000</u>

The assets were revalued on 1 January 2023 to be: Premises £90,000; Equipment £11,000. Other asset values were unchanged.

Accounts to show the assets at revalued amounts show:

Revaluation

	£	£		£
Assets reduced in value:			Assets increased in value:	
Equipment		4,000	Premises	25,000
Gain on revaluation carried to Capital accounts:				
W two-thirds	14,000			
Y one-third	<u>7,000</u>			
		21,000		
		<u>25,000</u>		<u>25,000</u>

Premises

£	£
Balance b/d	65,000
Revaluation: Increase	<u>25,000</u>
	<u>90,000</u>
Balance b/d	90,000

Equipment

£	£
Balance b/d	15,000
	<u>15,000</u>
Balance b/d	11,000

Revaluation: Reduction	4,000
Balance c/d	<u>11,000</u>
	<u>15,000</u>



Capital: W			
	£		£
Balance c/d	84,000	Balance b/d	70,000
	<u>84,000</u>	Revaluation: Share of gain	<u>14,000</u>
			<u>84,000</u>
		Balance b/d	84,000

Capital: Y			
	£		£
Balance c/d	57,000	Balance b/d	50,000
	<u>57,000</u>	Revaluation: Share of gain	<u>7,000</u>
			<u>57,000</u>
		Balance b/d	57,000

33.4 Revaluation of goodwill

This chapter deals with the revaluation of all assets other than goodwill. The revaluation of goodwill has already been dealt with in Chapter 32.

Learning outcomes

You should now have learnt:

- 1 How to make the entries arising from revaluations of partnership assets.
- 2 That when a new partner joins a firm, or a partner retires or dies, the partnership assets should be revalued.
- 3 That revaluation of assets should also occur when there is a change in the profit and loss sharing ratios of partners.
- 4 That profits on revaluation of assets are credited to the old partners' capital accounts in the old profit and loss sharing ratios.
- 5 That losses on revaluation of assets are debited to the old partners' capital accounts in the old profit and loss sharing ratios.
- 6 That the asset accounts also show the revalued amounts. Losses will have been credited to them and profits debited.

Answers to activities

- 33.1** When partners join or partners leave a partnership, there is, in effect, a new partnership. You learnt in Chapter 32, that when a new partner is admitted, the existing partners generally seek to ensure that they retain their share of the goodwill that has built up to that date. It should be fairly obvious,

therefore, that the existing partners will also want to maintain the true value of their share of the business at that date in their capital accounts, rather than some historically-based figure.

If this were not done, new partners admitted would benefit from increases in value before they joined the business, without having to pay anything for them. Similarly, if the value of assets had fallen before they had joined the business, and no revaluation took place, they would share that loss of value without any adjustment being made for it. Partners who leave or change their profit and loss sharing ratios would also be affected if there were no payments or allowances for such gains or losses.

- 33.2** In this case, you are only concerned about whether the assets are stated at their true values. You assume that the liabilities are correctly stated and ignore them because they are already included in the calculation of capital. In other words, when considering goodwill, you are comparing the amount received with the total of the partners' account balances, i.e. the net worth of the business (assets less liabilities). In this case, you are only concerned in the first instance with what the true value is of *part* of the other side of the accounting equation, assets, and not with the true value of the net worth. When you make the entries in the ledger accounts, you effectively bring in the liabilities and calculate a new net worth, which is reflected in the new balances on the partners' account balances. The overall effect is the same, only you don't need to calculate net worth to know whether there has been a gain or loss on revaluation of the assets. You do need to do that in order to calculate goodwill.

Review questions

33.1

Cox, Fox and Lock Balance Sheet as at 31 December 2023

	£	£
Buildings (at cost <i>less</i> accumulated depreciation)		175,000
Motor vehicles (at cost <i>less</i> accumulated depreciation)		43,000
Office fittings (at cost <i>less</i> accumulated depreciation)		<u>4,700</u>
		222,700
Inventory	15,900	
Trade receivables	22,200	
Bank	<u>3,600</u>	
		41,700
Net assets		<u><u>264,400</u></u>
		£
Capitals:		
Cox		140,000
Fox		80,000
Lock		<u>44,400</u>
Total capital		<u><u>264,400</u></u>

The above partners have always shared profits and losses in the ratio: Cox 5: Fox 3: Lock 2.

From 1 January the assets were to be revalued as the profit-sharing ratios are to be altered soon. The following assets are to be revalued to the figures shown: Buildings £250,000; Motor vehicles £30,000; Inventory £14,000; Office fittings £3,000.

Required:

- (a) You are required to show all the ledger accounts necessary to record the revaluation.
- (b) Draw up a balance sheet as at 1 January 2024.





33.2A Fitch and Wall have been in partnership for many years sharing profits and losses in the ratio 5:3 respectively. The following was their balance sheet as at 31 December 2023:

	£	£
Goodwill		12,400
Plant and machinery		<u>16,320</u>
		28,720
Inventory	6,420	
Trade receivables	4,100	
Cash at bank	<u>626</u>	
		11,146
Total assets		<u>39,866</u>
Trade payables		<u>(5,928)</u>
		33,938
Capital: Fitch		19,461
Wall		<u>14,477</u>
Total capital		<u>33,938</u>

On 1 January 2024, they decided to admit Home as a partner on the condition that she contributed £12,000 as her capital but that the plant and machinery and inventory should be revalued at £16,800 and £6,100 respectively, with the other assets, excepting goodwill, remaining at their book values. The goodwill was agreed to be valueless.

You are required to show:

- (a) The ledger entries dealing with the above in the following accounts:
 - (i) Goodwill account;
 - (ii) Revaluation accounts; and
 - (iii) Capital accounts.
- (b) The balance sheet of the partnership immediately after the admission of Home.

33.3 Alan, Bob and Charles are in partnership sharing profits and losses in the ratio 3:2:1 respectively. The balance sheet for the partnership as at 30 June 2019 is as follows:

	£	£
<i>Non-current assets</i>		
Premises		90,000
Plant		37,000
Vehicles		15,000
Fixtures		<u>2,000</u>
		144,000
<i>Current assets</i>		
Inventory	62,379	
Trade receivables	34,980	
Cash	<u>760</u>	
		98,119
Total assets		<u>242,119</u>
<i>Current liabilities</i>		
Trade payables	19,036	
Bank overdraft	<u>4,200</u>	
	23,236	
<i>Loan – Charles</i>	<u>28,000</u>	
Total liabilities		(51,236)
Net assets		<u>190,883</u>
<i>Capital</i>		
Alan		85,000
Bob		65,000
Charles		<u>35,000</u>
		185,000

<i>Current account</i>		
Alan	3,714	
Bob	(2,509)	
Charles	<u>4,678</u>	
		5,883
Total capital		<u>190,883</u>

Charles decides to retire from the business on 30 June 2019, and Don is admitted as a partner on that date. The following matters are agreed:

- Certain assets were revalued: Premises £120,000; Plant £35,000; Inventory £54,179.
- Allowance is to be made for doubtful debts in the sum of £3,000.
- Goodwill is to be recorded in the books on the day Charles retires in the sum of £42,000. The partners in the new firm do not wish to maintain a goodwill account so that amount is to be written back against the new partners' capital accounts.
- Alan and Bob are to share profits in the same ratio as before, and Don is to have the same share of profits as Bob.
- Charles is to take his car at its carrying amount of £3,900 in part payment, and the balance of all he is owed by the firm in cash except £20,000 which he is willing to leave as a loan account.
- The partners in the new firm are to start on an equal footing so far as capital and current accounts are concerned. Don is to contribute cash to bring his capital and current accounts to the same amount as the original partner from the old firm who has the lower investment in the business.

The original partner in the old firm who has the higher investment will draw out cash so that his capital and current account balances equal those of his new partners.

Required:

- Account for the above transactions, including goodwill and retiring partners' accounts.
- Draft a balance sheet for the partnership of Alan, Bob and Don as at 30 June 2019.

(Association of Accounting Technicians)

33.4A The balance sheet of A. Barnes and C. Darwin at 31 March 2022 is as follows:

	£	£
<i>Non-current assets</i>		
Building		51,000
Fittings		<u>29,000</u>
		80,000
<i>Current assets</i>		
Inventory	16,000	
Trade receivables	<u>5,000</u>	
		21,000
Total assets		101,000
<i>Current liabilities</i>		
Bank	3,000	
Trade payables	<u>8,000</u>	
Total liabilities		(11,000)
Net assets		<u>90,000</u>
<i>Capital accounts</i>		
Barnes		60,000
Darwin		<u>30,000</u>
Total capital		<u>90,000</u>





The partners share profits and losses: Barnes three-fifths and Darwin two-fifths. At the date of the above balance sheet, it was agreed to admit E. Fox who was to bring cash of £25,000 into the firm as capital. The new profit and loss ratio would be Barnes, one-half; Darwin, one-third; and Fox, one-sixth.

Barnes and Darwin agreed the following revaluation amounts prior to the admission of Fox. Any goodwill arising is to remain in the ledger.

	£
Buildings	55,000
Fittings	27,000
Inventory	15,500
Trade receivables	4,800
Goodwill	12,000
Accrued expenses (previously omitted)	300

Required:

- Prepare the journal entries to record the above.
- Prepare the balance sheet of the new business.
- Show by journal entry how the necessary adjustment would be made if the partners agreed that goodwill should *not* remain in the ledger.

33.5 At 31 December 2020, the balance sheet of A, B and C, who are equal partners, was as follows:

	£	£
<i>Non-current assets</i>		
Freehold premises		16,000
Machinery and tools		15,100
Investment, at cost		<u>4,000</u>
		35,100
<i>Current assets</i>		
Inventory	16,000	
Trade receivables	12,800	
Bank	<u>12,100</u>	
		40,900
Total assets		<u>76,000</u>
<i>Current liabilities</i>		
Trade payables		(14,000)
Net assets		<u>62,000</u>
Capital accounts		
A		20,000
B		17,000
C		<u>25,000</u>
Total capital		<u>62,000</u>

A retired at that date. In order to determine the amount due to him the following revaluations were made: Freehold premises £18,000; machinery and tools £16,000; investments £5,100.

The value of the goodwill was agreed at £8,000. It was arranged that A should take over the investments in part payment of the amount due to him, the balance to be settled in cash. B and C would increase their capitals by paying in £10,000 and £6,000 respectively. These changes were all carried out.

Required:

- Prepare the revaluation account, bank account and capital accounts.
- Prepare the opening balance sheet of B and C.

Chapter 34

Partnership dissolution

Learning objectives

After you have studied this chapter, you should be able to:

- Explain what happens upon dissolution of a partnership.
- Record the entries relating to the dissolution of a partnership.
- Explain the differences between recording a partnership dissolution and making the entries when one partner leaves a partnership.
- Explain the Partnership Act 1890 rules relating to partnership dissolutions.
- Explain the *Garner v Murray* rule.

Introduction

In this chapter, you'll learn how to calculate and record the necessary entries when a partnership is dissolved. You'll learn that the process is laid down in the Partnership Act 1890 and what to do under the *Garner v Murray* rule when partners are unable to pay the amount they owe the partnership. Finally, you'll learn how to deal with a situation where the partnership assets are being disposed of over a long period of time.

34.1 Need for dissolution

You will recall from Chapter 30 that joint ventures are often short-term and that when the project they were formed to do has ended, the joint venture is terminated. You learnt in Chapter 31 that partnerships are long-term ventures that are formed with a long-term commitment on the part of the partners to operate in business together. In Chapter 32, you learnt that new partners are admitted from time to time; and, in Chapter 33, you learnt that partners can also leave partnerships. So, you'll have realised by now that partnerships really are not as permanent as they may at first appear.

Activity 34.1

Can you think of any partnership you know of where a partner left? How do you think the change in the partnership was treated in the ledgers?

In fact, so far as the UK tax authorities are concerned, every time a partner joins or leaves a partnership, a new partnership is brought into existence. Intuitively, this does make sense. Partnerships exist because of the desire to merge the skills, resources and expertise of the partners. Imagine a band whose lead singer leaves. The replacement is never quite the same. As another example,

if two people are in a partnership running a restaurant and the one that does the cooking leaves, the replacement isn't going to want to prepare exactly the same meals.

Partnerships do change when a partner leaves. And they do change when a new partner joins. However, for accounting purposes, we only consider partnerships as changing sufficiently to merit treating them as ceasing to exist when the partners go their separate ways. When they do, this is known as partnership **dissolution** – the partnership has been dissolved.

Reasons for dissolution include:

- (a) The partnership is no longer profitable, and there is no longer any reason to carry on trading.
- (b) The partners cannot agree between themselves how to operate the partnership. They therefore decide to finish the partnership.
- (c) Factors such as ill-health or old age may bring about the close of the partnership.

Activity 34.2

What is the difference between these events and partners simply leaving a partnership? For example, if there are three partners in a dental practice and two leave, why can't the third continue the business with new partners?

34.2 What happens upon dissolution

Upon **dissolution** the partnership firm stops trading or operating. Then, in accordance with the Partnership Act 1890:

- (a) the assets are disposed of;
- (b) the liabilities of the firm to everyone other than partners are paid;
- (c) the partners are repaid their advances and current balances – advances are the amounts they have put in above and beyond the capital;
- (d) the partners are paid the final amounts due to them on their capital accounts.

Any profit or loss on dissolution would be shared by all the partners in their profit and loss sharing ratios. Profits would increase capitals repayable to partners. Losses would reduce the capitals repayable.

If the final balance on a partner's capital and current accounts is in deficit, the partner will have to pay that amount into the partnership bank account.

34.3 Disposal of assets

The assets do not have to be sold to external parties. Quite often one or more existing partners will take assets at values agreed by all the partners. In such a case the partner may not pay in cash for such assets; instead they will be charged to that partner's capital account.

34.4 Accounting for partnership dissolution

The main account around which the dissolution entries are made is known as the **realisation account**. It is this account in which the profit or loss on the realisation of the assets is calculated.

Exhibit 34.1 shows the simplest of partnership dissolutions. We will then look at a more difficult example in Exhibit 34.2.

Exhibit 34.1

The last balance sheet of X and Y, who share profits X two-thirds: Y one-third is shown below. On this date they are to dissolve the partnership.

Balance Sheet at 31 December 2023

	£	£
<i>Non-current assets</i>		
Buildings		100,000
Motor vehicle		12,000
		<u>112,000</u>
<i>Current assets</i>		
Inventory	6,000	
Trade receivables	8,000	
Bank	<u>2,000</u>	
		16,000
Total assets		<u>128,000</u>
<i>Current liabilities</i>		
Trade payables		<u>(5,000)</u>
Net assets		<u>123,000</u>
Capitals: X		82,000
Y		41,000
Total capital		<u>123,000</u>

The buildings were sold for £105,000 and the inventory for £4,600. £6,800 was collected from debtors. The motor vehicle was taken over by X at an agreed value of £9,400, but he did not pay any cash for it. £5,000 was paid to settle the trade payables. The £400 cost of the dissolution was paid.

The accounting entries needed are:

- (A) Transfer book values of all assets to the realisation account:
 - Debit realisation account
 - Credit asset accounts
- (B) Amounts received from disposal of assets:
 - Debit bank
 - Credit realisation account
- (C) Values of assets taken over by partner without payment:
 - Debit partner's capital account
 - Credit realisation account
- (D) Creditors paid:
 - Debit trade payables
 - Credit bank
- (E) Costs of dissolution:
 - Debit realisation account
 - Credit bank
- (F) Profit or loss on realisation to be shared between partners in profit and loss sharing ratios:
 - If a profit: Debit realisation account
 - Credit partners' capital accounts

If a loss: Debit partners' capital accounts
Credit realisation account

(G) Pay to the partners their final balances on their capital accounts:
Debit capital accounts
Credit bank

The entries are now shown. The letters (A) to (G) as above are shown against each entry:

Buildings			
Balance b/d	£ <u>100,000</u>	Realisation (A)	£ <u>100,000</u>
Motor Vehicle			
Balance b/d	£ <u>12,000</u>	Realisation (A)	£ <u>12,000</u>
Inventory			
Balance b/d	£ <u>6,000</u>	Realisation (A)	£ <u>6,000</u>
Trade receivables			
Balance b/d	£ <u>8,000</u>	Realisation (A)	£ <u>8,000</u>
Realisation			
Assets to be realised:	£	Bank: Assets sold	£
Buildings (A)	100,000	Buildings (B)	105,000
Motor vehicle (A)	12,000	Inventory (B)	4,600
Inventory (A)	6,000	Trade receivables (B)	6,800
Trade receivables (A)	8,000	Taken over by partner A:	
Bank:		Motor vehicle (C)	9,400
Dissolution costs (E)	400	Loss on realisation	
		X $\frac{2}{3}$ (F)	£ 400
		Y $\frac{1}{3}$ (F)	<u>200</u>
	<u>126,400</u>		<u>600</u>
			<u>126,400</u>
Trade payables			
Bank (D)	£ <u>5,000</u>	Balance b/d	£ <u>5,000</u>
X: Capital			
Realisation: Motor (C)	£ 9,400	Balance b/d	£ 82,000
Realisation: Share of loss (F)	400		
Bank: to close (G)	<u>72,200</u>		
	<u>82,000</u>		<u>82,000</u>

Y: Capital				
		£		£
Realisation: Share of loss	(F)	200	Balance b/d	41,000
Bank: to close	(G)	<u>40,800</u>		
		<u>41,000</u>		<u>41,000</u>

Bank				
		£		£
Balance b/d		2,000	Trade payables	(D) 5,000
Realisation: Assets sold			Realisation: Costs	(E) 400
Buildings	(B)	105,000	Capitals: to close	
Inventory	(B)	4,600	X	(G) 72,200
Trade receivables	(B)	<u>6,800</u>	Y	(G) <u>40,800</u>
		<u>118,400</u>		<u>118,400</u>

The final balances on the partners' capital accounts should always equal the amount in the bank account from which they are to be paid. For instance, in the above exhibit there was £113,000 in the bank from which to pay X £72,200 and Y £40,800. **You should always complete the capital account entries before you can complete the bank account entries. If the final bank balance does not pay out the partners' capital accounts exactly, you will have made a mistake somewhere.**

34.5 A more detailed example

Exhibit 34.1 did not show the more difficult accounting entries. A more difficult example appears in Exhibit 34.2.

The extra complexities are:

- Any allowance such as doubtful debts or depreciation is to be transferred to the credit of the asset account: see entries (A) in Exhibit 34.2.
- Discounts on trade payables – to balance the trade payables, transfer the discounts on trade payables to the credit of the realisation account: see entries (F) in the exhibit.
- Transfer the balances on the partners' current accounts to their capital accounts: see entries (I) of the exhibit.
- A partner who owes the partnership money because his capital account is in deficit must now pay the money owing: see entries (J) of the exhibit.

As a result, you will see that the list of accounting entries to be made is extended to run from A to K, compared with A to G.

Exhibit 34.2

On 31 December 2022, P, Q and R decided to dissolve their partnership. They had always shared profits in the ratio of P3 : Q2 : R1.

Their goodwill was sold for £30,000, the machinery for £24,000 and the inventory for £12,000. There were three cars, all taken over by the partners at agreed values, P taking one for £4,000, Q one for £6,000 and R one for £3,000. The premises were taken over by R at an agreed value of £162,000. The amounts collected from debtors amounted to £7,400 after bad debts and discounts had been deducted. The creditors were discharged for £6,280, the difference being due to discounts received. The costs of dissolution amounted to £700.





Their last balance sheet prior to dissolution of the partnership is summarised as:

Balance Sheet as at 31 December 2022

	£	£	£
<i>Non-current assets</i>			
Premises			150,000
Machinery			36,000
Motor vehicles			14,000
			<u>200,000</u>
<i>Current assets</i>			
Inventory		11,000	
Trade receivables	8,000		
Less Allowance for doubtful debts	<u>(400)</u>		
		7,600	
Bank		<u>1,200</u>	
			19,800
Total assets			<u>219,800</u>
<i>Current liabilities</i>			
Trade payables			<u>(6,400)</u>
Net assets			<u>213,400</u>
Capital accounts: P			70,000
Q			60,000
R			<u>50,000</u>
			180,000
Current accounts: P		9,700	
Q		7,500	
R		<u>16,200</u>	
			33,400
Total capital			<u>213,400</u>

Description of transactions:

- (A) The provision accounts are transferred to the relevant asset accounts so that the net balance on the asset accounts may be transferred to the realisation account. Debit provision accounts. Credit asset accounts.
- (B) The carrying amounts of the assets are transferred to the realisation account. Debit realisation account. Credit asset accounts.
- (C) Assets sold. Debit bank account. Credit realisation account.
- (D) Assets taken over by partners. Debit partners' capital accounts. Credit realisation account.
- (E) Liabilities discharged. Credit bank account. Debit liability accounts.
- (F) Discounts on trade payables. Debit trade payables account. Credit realisation account.
- (G) Costs of dissolution. Credit bank account. Debit realisation account.
- (H) Profit or loss split in profit/loss sharing ratio. Profit – debit realisation account. Credit partners' capital accounts. The opposite if a loss.
- (I) Transfer the balances on the partners' current accounts to their capital accounts.
- (J) Any partner with a capital account in deficit, i.e. debits exceeding credits, must now pay in the amount needed to cancel his/her indebtedness to the partnership. Credit capital account. Debit bank account.
- (K) The credit balances on the partners' capital accounts can now be paid to them. Debit partners' capital accounts. Credit bank account.

The payments made under (K) should complete the payment of all the balances in the partnership books.

The accounts recording the dissolution are shown below. The letters (A) to (K) against each entry indicate the relevant descriptions.

Premises					
		£			£
Balance b/d		<u>150,000</u>	Realisation	(B)	<u>150,000</u>
Machinery					
		£			£
Balance b/d		<u>36,000</u>	Realisation	(B)	<u>36,000</u>
Motor Vehicles					
		£			£
Balance b/d		<u>14,000</u>	Realisation	(B)	<u>14,000</u>
Inventory					
		£			£
Balance b/d		<u>11,000</u>	Realisation	(B)	<u>11,000</u>
Trade receivables					
		£			£
Balance b/d		8,000	Allowance for doubtful debts	(A)	400
		<u>8,000</u>	Realisation	(B)	<u>7,600</u>
					<u>8,000</u>
Realisation					
		£			£
Assets to be realised:			Bank: Assets sold		
Premises (B)		150,000	Goodwill (C)		30,000
Machinery (B)		36,000	Machinery (C)		24,000
Motor vehicles (B)		14,000	Inventory (C)		12,000
Inventory (B)		11,000	Trade receivables (C)		7,400
Trade receivables (B)		7,600	Taken over by partners:		
Bank: Dissolution costs (G)		700	P: Car (D)		4,000
Profit on realisation: (H)			Q: Car (D)		6,000
			R: Car (D)		3,000
			R: Premises (D)		162,000
			Trade payables: Discounts (F)		120
P		14,610			
Q		9,740			
R		<u>4,870</u>			
		29,220			
		<u>248,520</u>			<u>248,520</u>
Trade payables					
		£			£
Bank (E)		6,280	Balance b/d		6,400
Realisation: Discounts (F)		<u>120</u>			<u>6,400</u>
		<u>6,400</u>			<u>6,400</u>
Allowance for Doubtful Debts					
		£			£
Trade receivables (A)		<u>400</u>	Balance b/d		<u>400</u>





P Capital					
		£			£
Realisation: Car	(D)	4,000	Balance b/d		70,000
Bank	(K)	90,310	Current account transferred	(I)	9,700
		<u>94,310</u>	Realisation: Share of profit	(H)	14,610
					<u>94,310</u>
P Current					
		£			£
P: Capital	(I)	<u>9,700</u>	Balance b/d		<u>9,700</u>
Q Capital					
		£			£
Realisation: Car	(D)	6,000	Balance b/d		60,000
Bank	(K)	71,240	Current account transferred	(I)	7,500
		<u>77,240</u>	Realisation: Share of profit	(H)	9,740
					<u>77,240</u>
Q Current					
		£			£
Q: Capital	(I)	<u>7,500</u>	Balance b/d		<u>7,500</u>
R Capital					
		£			£
Realisation: Car	(D)	3,000	Balance b/d		50,000
Realisation: Premises	(D)	162,000	Current account transferred	(I)	16,200
		<u>165,000</u>	Realisation: Share of profit	(H)	4,870
			Bank	(J)	93,930
					<u>165,000</u>
R Current					
		£			£
R: Capital	(I)	<u>16,200</u>	Balance b/d		<u>16,200</u>
Bank					
		£			£
Balance b/d		1,200	Trade payables	(E)	6,280
Realisation: Assets sold			Realisation: Costs	(G)	700
Goodwill	(C)	30,000	P: Capital	(K)	90,310
Machinery	(C)	24,000	Q: Capital	(K)	71,240
Inventory	(C)	12,000			
Trade receivables	(C)	7,400			
R: Capital	(J)	<u>93,930</u>			
		<u>168,530</u>			<u>168,530</u>

34.6 The *Garner v Murray* rule

It sometimes happens that a partner's capital account finishes up with a debit balance. Normally the partner will pay in an amount to clear his/her indebtedness to the firm. However, sometimes the partner will be unable to pay all, or part, of such a balance. In the case of *Garner v Murray* in 1904 (a case in England) the court ruled that, subject to any agreement to the contrary, such a deficiency was to be shared by the other partners *not* in their profit and loss sharing ratios but in the ratio of their 'last agreed capitals'. By 'their last agreed capitals' is meant the credit balances on their capital accounts in the normal balance sheet drawn up at the end of their last accounting period.

It must be borne in mind that the balances on their capital accounts after the assets have been realised may be far different from those on the last balance sheet. Where a partnership deed is drawn up it is commonly found that agreement is made to use normal profit and loss sharing ratios instead, thus rendering the *Garner v Murray* rule inoperative. **The *Garner v Murray* rule does not apply to partnerships in Scotland.**

Before reading further you should check whether or not this topic is in the requirements for your examinations.

Exhibit 34.3

After completing the realisation of all the assets, in respect of which a loss of £14,000 was incurred, but before making the final payments to the partners, the balance sheet shows:

Balance Sheet		
	£	£
Cash at bank		<u>91,000</u>
Capitals: <i>R</i>	66,000	
<i>S</i>	18,000	
<i>T</i>	<u>8,000</u>	
	92,000	
Less <i>Q</i> (debit balance)	<u>(1,000)</u>	
		<u>91,000</u>

According to the last balance sheet drawn up before the dissolution, the partners' capital account credit balances were: *Q* £5,000; *R* £70,000; *S* £20,000; *T* £10,000; while the profits and losses were shared *Q*3 : *R*2 : *S*1 : *T*1.

Q is unable to meet any part of his deficiency. Under the *Garner v Murray* rule, each of the other partners suffers the deficiency as follows:

$$\frac{\text{Own capital per balance sheet before dissolution}}{\text{Total of all solvent partners' capitals per same balance sheet}} \times \text{Deficiency}$$

This can now be calculated.

$$\begin{array}{l}
 R \quad \frac{£70,000}{£70,000 + £20,000 + £10,000} \times 1,000 = £700 \\
 S \quad \frac{£20,000}{£70,000 + £20,000 + £10,000} \times 1,000 = £200 \\
 T \quad \frac{£10,000}{£70,000 + £20,000 + £10,000} \times 1,000 = £100 \\
 \hline
 \qquad \qquad \qquad \underline{\underline{£1,000}}
 \end{array}$$

When these amounts have been charged to the capital accounts, the balances remaining on them will equal the amount of the bank balance. Payments may therefore be made to clear their capital accounts.

	Credit balance b/d		Share of deficiency now debited		Final credit balances
	£		£		£
R	66,000	—	700	=	65,300
S	18,000	—	200	=	17,800
T	8,000	—	100	=	7,900
Equals the bank balance					<u>91,000</u>

34.7 Piecemeal realisation of assets

Frequently the assets may take a long time to be turned into cash (i.e. ‘realised’). The partners will naturally want payments made to them on account as cash is received. They will not want to wait for payments until the dissolution is completed just for the convenience of the accountant. There is, however, a danger that if too much is paid to a partner, and he is unable to repay it, then the person handling the dissolution could be placed in a very awkward position.

To counteract this, the concept of prudence is brought into play. This is done as follows:

- Each receipt of sale money is treated as being the final receipt, even though more could be received.
- Any loss then calculated so far to be shared between partners in profit and loss sharing ratios.
- Should any partner’s capital account after each receipt show a debit balance, then he is assumed to be unable to pay in the deficiency. This deficit will be shared (failing any other agreement) between the partners using the *Garner v Murray* rule.
- After payments of liabilities and the costs of dissolution the remainder of the cash is then paid to the partners.
- In this manner, even if no further money were received, or should a partner become insolvent, the division of the available cash would be strictly in accordance with the legal requirements. Exhibit 34.4 shows such a series of calculations.

Exhibit 34.4

The following is the summarised balance sheet of H, I, J and K as at 31 December 2022. The partners had shared profits in the ratios H6 : I4 : J1 : K1.

Balance Sheet as at 31 December 2022	
	£
Assets	84,000
Trade payables	(18,000)
	<u>66,000</u>
Capitals:	
H	6,000
I	30,000
J	20,000
K	10,000
	<u>66,000</u>

On 1 March 2023 some of the assets were sold for cash £50,000. Out of this the creditors’ £18,000 and the cost of dissolution £800 are paid, leaving £31,200 distributable to the partners.

On 1 July 2023 some more assets are sold for £21,000. As all of the liabilities and the costs of dissolution have already been paid, the whole of the £21,000 is available for distribution between the partners.

On 1 October 2023 the final sale of the assets realised £12,000.

First distribution: 1 March 2023

	<i>H</i>	<i>I</i>	<i>J</i>	<i>K</i>	Total
	£	£	£	£	£
Capital balances before dissolution	6,000	30,000	20,000	10,000	66,000
Loss if no further assets realised: Assets £84,000 – Sales £50,000 = £34,000 + Costs £800 = £34,800 loss					
Loss shared in profit/loss Ratios	(17,400)	(11,600)	(2,900)	(2,900)	(34,800)
	<u>11,400Dr</u>	<u>18,400Cr</u>	<u>17,100Cr</u>	<u>7,100Cr</u>	<u>31,200</u>
H's deficiency shared in <i>Garner v Murray</i> ratios		$\frac{3}{6}$ (5,700)	$\frac{2}{6}$ (3,800)	$\frac{1}{6}$ (1,900)	
Cash paid to partners		<u>12,700</u>	<u>13,300</u>	<u>5,200</u>	<u>31,200</u>

Second distribution: 1 July 2023

	<i>H</i>	<i>I</i>	<i>J</i>	<i>K</i>	Total
	£	£	£	£	£
Capital balances before dissolution	6,000	30,000	20,000	10,000	66,000
Loss if no further assets realised: Assets £84,000 – Sales (£50,000 + £21,000) = £13,000 + Costs £800 = £13,800 loss					
Loss shared in profit/loss Ratios	(6,900)	(4,600)	(1,150)	(1,150)	(13,800)
	<u>900Dr</u>	<u>25,400Cr</u>	<u>18,850Cr</u>	<u>8,850Cr</u>	<u>52,200</u>
H's deficiency shared in <i>Garner v Murray</i> ratios		$\frac{3}{6}$ (450)	$\frac{2}{6}$ (300)	$\frac{1}{6}$ (150)	
		24,950	18,550	8,700	
Less First distribution already paid		(12,700)	(13,300)	(5,200)	31,200
Cash now paid to partners		<u>12,250</u>	<u>5,250</u>	<u>3,500</u>	<u>21,000</u>
					<u>52,200</u>

Third and final distribution:

	<i>H</i>	<i>I</i>	<i>J</i>	<i>K</i>	Total
	£	£	£	£	£
1 October 2023					
Capital balances before Dissolution	6,000	30,000	20,000	10,000	66,000
Loss finally ascertained: Assets £84,000 – Sales (£50,000 + 21,000 + £12,000) = £1,000 + Costs £800 = £1,800 loss					
Loss shared in profit/loss Ratios	(900)	(600)	(150)	(150)	(1,800)
	<u>5,100Cr</u>	<u>29,400Cr</u>	<u>19,850Cr</u>	<u>9,850Cr</u>	<u>64,200</u>
(No deficiency now exists on any capital account)					
Less First and second distributions	–	(24,950)	(18,550)	(8,700)	52,200
Cash now paid to partners	<u>5,100</u>	<u>4,450</u>	<u>1,300</u>	<u>1,150</u>	<u>12,000</u>
					<u>64,200</u>

In any subsequent distribution following that in which all the partners have shared (i.e. no partners could then have had a deficiency left on their capital accounts) all receipts of cash are divided between the partners in their profit and loss sharing ratios. Following the above method would give the same answer for these subsequent distributions but obviously an immediate division in the profit and loss sharing ratios would be quicker. Try it for yourself and you'll see that the same answer would result.

34.8 A final word

The partnership income and profit and loss appropriation account which you have headed-up using that rather long-winded heading is often simply referred to and headed-up as ‘Income statement’.

Learning outcomes

You should now have learnt:

- 1 How to calculate the amounts due to and from each partner when a partnership is dissolved.
- 2 How to record partnership dissolution in the ledger accounts.
- 3 That upon dissolution, a partnership stops trading or operating, any profit or loss on dissolution being shared by the partners in their profit-sharing ratio.
- 4 That the *Garner v Murray* rule does not apply to partnerships in Scotland.

Answers to activities

34.1 There is obviously no ‘right’ answer to this question. You may have noticed partnership changes at your local doctor’s or dental practice. They can have quite an impact upon some of the patients. Similarly, there have been famous partnerships in ice skating, the theatre, music, and in sport, especially tennis, where switching partners creates a very different visual effect and level of satisfaction for the audience.

Many of these examples are really short-term joint ventures rather than partnerships. The doctors and dentists are most definitely partnerships. In many cases where one of *these* examples of joint ventures or partnerships change, a new one tends to develop in its place. In the case of partnerships where the business is continuing with new partners, you can apply the techniques you’ve already learnt to apply when a partner leaves a partnership and when a partner joins and make the necessary entries in the partnership ledger accounts.

34.2 That may happen, in which case it could be argued that it should be treated as simply a change of membership of the partnership. There’s nothing wrong with doing so if the business is continuing as before but, even in those cases, you will probably find it easier to treat it as a partnership dissolution, close off all the books and start afresh with the new partnership. This is because if only one partner is left in the business, you would need to remove each of the partners who have left from the accounts anyway before adding in the new one(s).

Review questions

34.1 Adrian and Thomas, who share profits and losses equally, decide to dissolve their partnership as at 30 June 2024. Their balance sheet on that date was as follows:

	£	£
Buildings		150,000
Tools and fixtures		<u>11,600</u>
		161,600
Trade receivables	22,300	
Cash	<u>1,800</u>	
		24,100
		<u>185,700</u>
Trade payables		<u>18,400</u>
		167,300
Capital account: Adrian		<u>108,000</u>
Thomas		<u>59,300</u>
		<u>167,300</u>

The trade receivables realised £20,900, the buildings £139,000 and the tools and fixtures £5,000. The expenses of dissolution were £1,950 and discounts totalling £700 were received from creditors.

Required:

Prepare the accounts necessary to show the results of the realisation and of the disposal of the cash.

34.2 Mears, Pugh and Stafford were in partnership sharing profits and losses in the ratio 5:3:2 respectively.

The partners had agreed that the partnership would be dissolved on 1 April 2023.

The partnership balance sheet at 31 March 2023 was as follows:

<i>Mears, Pugh and Stafford</i>		
<i>Balance sheet at 31 March 2023</i>		
	£	£
<i>Non-current assets</i>		185,000
<i>Current assets</i>		
Inventory	31,600	
Trade receivables	<u>14,850</u>	<u>46,450</u>
		231,450
<i>Current liabilities</i>		
Bank overdraft	9,210	
Trade payables	<u>8,900</u>	<u>18,110</u>
		<u>213,340</u>
<i>Capital accounts</i>		
Mears	25,000	
Pugh	84,000	
Stafford	<u>56,000</u>	165,000
<i>Current accounts</i>		
Mears	(19,500)	
Pugh	31,704	
Stafford	<u>36,136</u>	<u>48,340</u>
		<u>213,340</u>





Additional information

- 1 A vehicle could have been sold for £18,800. However, because this would have generated a loss of £3,200, it was decided instead that Pugh would take the vehicle at its carrying amount as part of his settlement.
- 2 All other non-current assets were found to be impaired. They could only be disposed of for the recoverable amount. The fair value of these assets was £150,000 and the value in use was £125,000.
- 3 Inventory would usually be sold at a mark-up of 25% on cost price. However, because the inventory was damaged, it was actually sold for £14,220 less than this amount.
- 4 A bankrupt customer owed £2,350. All other trade receivables paid in full after being given a 5% settlement discount.
- 5 The partnership is owed a refund of £100 from a supplier and this has not been accounted for. All other trade payables were settled in full after receiving a 2% discount.
- 6 The costs of dissolving the partnership of £1,951 were paid by cheque.

Mears was bankrupt and so was unable to repay any amounts owing to the partnership from her own personal finance.

Required:

- (a) Prepare the realisation account for the partnership at 1 April 2023.
- (b) Prepare the partnership capital accounts for Mears, Pugh and Stafford at 1 April 2023.
- (c) Prepare the partnership bank account at 1 April 2023 to show all transactions relating to the dissolution of the partnership.

(AQA A Level)

34.3A The following trial balance has been extracted from the books of Gain and Main as at 31 March 2022; Gain and Main are in partnership sharing profits and losses in the ratio 3 to 2:

	£	£
Capital accounts:		
Gain		10,000
Main		5,000
Cash at bank	1,550	
Trade payables		500
Current accounts:		
Gain		1,000
Main	2,000	
Trade receivables	2,000	
Accumulated depreciation: Fixtures and fittings		1,000
Accumulated depreciation: Motor vehicles		1,300
Fixtures and fittings	2,000	
Land and buildings	30,000	
Motor vehicles	4,500	
Net profit (for the year to 31 March 2022)		26,250
Inventory, at cost	3,000	
	<u>45,050</u>	<u>45,050</u>

In appropriating the net profit for the year, it has been agreed that Main should be entitled to a salary of £9,750. Each partner is also entitled to interest on his opening capital account balance at the rate of 10% per annum.

Gain and Main have decided to convert the partnership into a limited company, Plain Limited, as from 1 April 2022. The company is to take over all the assets and liabilities of the partnership, except that Gain is to retain for his personal use one of the motor vehicles at an agreed transfer price of £1,000.

The purchase consideration will consist of 40,000 ordinary shares of £1 each in Plain Limited, to be divided between the partners in profit-sharing ratio. Any balance on the partners' current accounts is to be settled in cash.

Required:

Prepare the main ledger accounts of the partnership in order to close off the books as at 31 March 2022.

(Association of Accounting Technicians)

34.4A A, B and C are partners sharing profits and losses in the ratio 2 : 2 : 1. The balance sheet of the partnership as at 30 September 2020 was as follows:

	£	£
Freehold premises		18,000
Equipment and machinery		12,000
Cars		<u>3,000</u>
		33,000
Inventory	11,000	
Trade receivables	14,000	
Bank	<u>9,000</u>	
		34,000
		<u>67,000</u>
Trade payables	10,000	
Loan account – A	<u>7,000</u>	
Total liabilities		(17,000)
Net assets		<u>50,000</u>
Capital accounts		
A		22,000
B		18,000
C		<u>10,000</u>
		<u>50,000</u>

The partners agreed to dispose of the business to CNO Limited with effect from 1 October 2020 under the following conditions and terms:

- CNO Limited will acquire the goodwill, all non-current assets and the inventory for the purchase consideration of £58,000. This consideration will include a payment of £10,000 in cash and the issue of 12,000 10% preference shares of £1 each at par, and the balance by the issue of £1 ordinary shares at £1.25 per share.
- The partnership business will settle amounts owing to creditors.
- CNO Limited will collect the debts on behalf of the vendors.

Purchase consideration payments and allotments of shares were made on 1 October 2020.

The partnership trade payables were paid off by 31 October 2020 after the taking of settlement discounts of £190.

CNO Limited collected and paid over all partnership debts by 30 November 2020 except for bad debts amounting to £800. Discounts allowed to debtors amounted to £400.

Required:

- Journal entries (including those relating to cash) necessary to close the books of the partnership, and
- Set out the basis on which the shares in CNO Limited are allotted to partners. Ignore interest.

(Institute of Chartered Secretaries and Administrators)





34.5 Amis, Lodge and Pym were in partnership sharing profits and losses in the ratio 5 : 3 : 2. The following trial balance has been extracted from their books of account as at 31 March 2020:

	£	£
Bank interest received		750
Capital accounts (as at 1 April 2019):		
Amis		80,000
Lodge		15,000
Pym		5,000
Carriage inwards	4,000	
Carriage outwards	12,000	
Cash at bank	4,900	
Current accounts:		
Amis	1,000	
Lodge	500	
Pym	400	
Advertising	10,000	
Royalties received		4,530
Drawings:		
Amis	25,000	
Lodge	22,000	
Pym	15,000	
Motor vehicles:		
at cost	80,000	
accumulated depreciation (at 1 April 2019)		20,000
Office expenses	30,400	
Plant and machinery:		
at cost	100,000	
accumulated depreciation (at 1 April 2019)		36,600
Allowance for doubtful debts (at 1 April 2019)		420
Purchases	225,000	
Rent, rates, heat and light	8,800	
Sales		404,500
Inventory (at 1 April 2019)	30,000	
Trade payables		16,500
Trade receivables	14,300	
	<u>583,300</u>	<u>583,300</u>

Additional information:

- Inventory at 31 March 2020 was valued at £35,000.
- Depreciation on the non-current assets is to be charged as follows:
 Motor vehicles – 25% on the reduced balance.
 Plant and machinery – 20% on the original cost.
 There were no purchases or sales of non-current assets during the year to 31 March 2020.
- The allowance for doubtful debts is to be maintained at a level equivalent to 5% of the total trade receivables as at 31 March 2020.
- An office expense of £405 was owing at 31 March 2020, and some rent amounting to £1,500 had been paid in advance as at that date. These items had not been included in the list of balances shown in the trial balance.
- Interest on drawings and on the debit balance on each partner's current account is to be charged as follows:

	£
Amis	1,000
Lodge	900
Pym	720

- (f) According to the partnership agreement, Pym is allowed a salary of £13,000 per annum. This amount was owing to Pym for the year to 31 March 2020 and needs to be accounted for.
- (g) The partnership agreement also allows each partner interest on his capital account at a rate of 10% per annum. There were no movements on the respective partners' capital accounts during the year to 31 March 2020, and the interest had not been credited to them as at that date.

Note: The information given above is sufficient to answer part (a) (i) and (ii) of the question, and notes (h) and (i) below are pertinent to requirements (b) (i), (ii) and (iii) of the question.

- (h) On 1 April 2020, Fowles Limited agreed to purchase the business on the following terms:
 - (i) Amis to purchase one of the partnership's motor vehicles at an agreed value of £5,000, the remaining vehicles being taken over by the company at an agreed value of £30,000;
 - (ii) the company agreed to purchase the plant and machinery at a value of £35,000 and the inventory at a value of £38,500;
 - (iii) the partners to settle the trade payables: the total amount agreed with the creditors being £16,000;
 - (iv) the trade receivables were not to be taken over by the company, the partners receiving cheques on 1 April 2020 amounting to £12,985 in total from the trade debtors in settlement of the outstanding debts;
 - (v) the partners paid the outstanding office expense on 1 April 2020, and the landlord returned the rent paid in advance by cheque on the same day;
 - (vi) as consideration for the sale of the partnership, the partners were to be paid £63,500 in cash by Fowles Limited, and to receive £75,000 in £1 ordinary shares in the company, the shares to be apportioned equally amongst the partners.
- (i) Assume that all the matters relating to the dissolution of the partnership and its sales to the company took place on 1 April 2020.

Required:

- (a) Prepare:
 - (i) Amis, Lodge and Pym's income statement and profit and loss appropriation account for the year ending 31 March 2020;
 - (ii) Amis, Lodge and Pym's current accounts (in columnar format) for the year to 31 March 2020 (the final balance on each account is to be then transferred to each partner's respective capital account);
 and
- (b) Compile the following accounts:
 - (i) the partnership realisation account for the period up to and including 1 April 2020;
 - (ii) the partners' bank account for the period up to and including 1 April 2020; and
 - (iii) the partners' capital accounts (in columnar format) for the period up to and including 1 April 2020.

Note: Detailed workings should be submitted with your answer.

(Association of Accounting Technicians)





34.6A Proudie, Slope and Thorne were in partnership sharing profits and losses in the ratio 3 : 1 : 1. The draft balance sheet of the partnership as at 31 May 2019 is shown below:

	£000	£000	£000
	<i>Cost</i>	<i>Depreciation</i>	
<i>Non-current assets</i>			
Land and buildings	200	40	160
Furniture	30	18	12
Motor vehicles	60	40	20
	<u>290</u>	<u>98</u>	<u>192</u>
<i>Current assets</i>			
Inventory		23	
Trade receivables	42		
Less Allowance for doubtful debts	<u>(1)</u>		
		41	
Prepayments		2	
Cash		<u>10</u>	
			<u>76</u>
Total assets			<u>268</u>
<i>Current liabilities</i>			
Trade payables	15		
Accruals	<u>3</u>		
		18	
<i>Non-current liabilities</i>			
Loan – Proudie		<u>8</u>	
Total liabilities			<u>(26)</u>
Net assets			<u>242</u>
<i>Capital accounts</i>			
Proudie		100	
Slope		60	
Thorne		<u>40</u>	
			200
<i>Current accounts</i>			
Proudie		24	
Slope		10	
Thorne		<u>8</u>	
			<u>42</u>
Total capital			<u>242</u>

Additional information:

- Proudie decided to retire on 31 May 2019. However, Slope and Thorne agreed to form a new partnership out of the old one, as from 1 June 2019. They agreed to share profits and losses in the same ratio as in the old partnership.
- Upon the dissolution of the old partnership, it was agreed that the following adjustments were to be made to the partnership balance sheet as at 31 May 2019.
 - Land and buildings were to be revalued at £200,000.
 - Furniture was to be revalued at £5,000.
 - Proudie agreed to take over one of the motor vehicles at a value of £4,000, the remaining motor vehicles being revalued at £10,000.
 - Inventory was to be written down by £5,000.
 - A bad debt of £2,000 was to be written off, and the allowance for doubtful debts was then to be adjusted so that it represented 5% of the then outstanding trade receivables as at 31 May 2019.
 - A further accrual of £3,000 for office expenses was to be made.
 - Professional charges relating to the dissolution were estimated to be £1,000.

- 3 It has not been the practice of the partners to carry goodwill in the books of the partnership, but on the retirement of a partner it had been agreed that goodwill should be taken into account. Goodwill was to be valued at an amount equal to the average annual profits of the three years expiring on the retirement. For the purpose of including goodwill in the dissolution arrangement when Proudie retired, the net profits for the last three years were as follows:

	£000
Year to 31 May 2017	130
Year to 31 May 2018	150
Year to 31 May 2019	181

The net profit for the year to 31 May 2019 had been calculated before any of the items listed in 2 above were taken into account. The net profit was only to be adjusted for items listed in 2(d), 2(e) and 2(f) above.

- 4 Goodwill is not to be carried in the books of the new partnership.
- 5 It was agreed that Proudie's old loan of £8,000 should be repaid to him on 31 May 2019, but any further amount owing to him as a result of the dissolution of the partnership should be left as a long-term loan in the books of the new partnership.
- 6 The partners' current accounts were to be closed and any balances on them as at 31 May 2019 were to be transferred to their respective capital accounts.

Required:

- (a) Prepare the revaluation account as at 31 May 2019.
- (b) Prepare the partners' capital accounts as at the date of dissolution of the partnership and bring down any balances on them in the books of the new partnership.
- (c) Prepare Slope and Thorne's balance sheet as at 1 June 2019.

(Association of Accounting Technicians)

ACCOUNTING FOR COMPANIES

Introduction

In this part, we'll look at various ways in which accounting for limited companies differs from sole proprietors and partnerships. At the end of these three chapters you'll be able to prepare four financial statements for companies: the balance sheet, income statement, statement of changes in equity and statement of cash flows.

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Introduction to accounting for companies

Learning objectives

After you have studied this chapter, you should be able to:

- Describe the key features of limited companies, including shares, shareholders and dividends, limited liability, public and private companies, directors, and auditors.
- Explain the differences between ordinary shares and preference shares.
- Account for dividends paid on both ordinary shares and preference shares.
- Explain the differences between issued, called-up, and paid-up share capital.
- Account for various components of a company's equity, including share capital, share premium, revaluation reserve, general reserve, and retained earnings.
- Account for rights issues and bonus issues of shares.
- Prepare a simple statement of changes in equity for an individual company.
- Account for corporation tax charges on company profits.
- Make the necessary entries when a company borrows money by issuing loan notes.

Introduction

So far in this book, you have produced financial statements for sole proprietors and partnerships. The third main type of business organisation you'll look at is limited companies, commonly known simply as 'companies'.

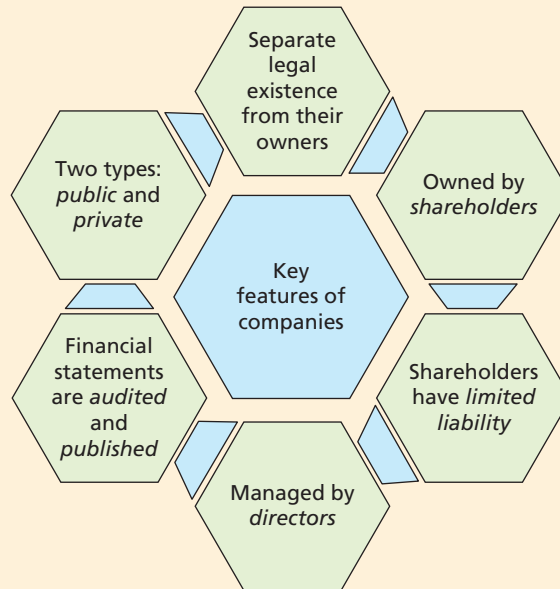
In this chapter, you'll cover the background and key features of companies. You'll then look at various areas where accounting for companies differs from sole proprietors and partnerships. You'll see that the main differences lie in the capital (or 'equity') section of the company balance sheet, as well as in two other items that are unique to companies: corporation tax and loan notes.

35.1 The importance of accounting for companies

Preparing the financial statements of companies is an extremely important aspect of financial accounting, for several reasons. Firstly, companies are the most common type of business. Moreover, sole proprietors and partnerships are usually fairly small businesses. The vast majority of *larger* businesses are companies. Students of accounting are far more likely to find employment in the future with a company than with a sole proprietor. In fact, if you take your studies of accounting further, then companies will probably be the only form of business that you'll look at.

For all these reasons and more, it is essential that you start to develop a good understanding of the nature of companies and the various ways in which accounting for them differs from sole proprietors and partnerships. Exhibit 35.1 illustrates some of the key features of limited companies, which we discuss over the next few sections.

Exhibit 35.1 Some of the key features of limited companies



35.2 A company is a separate legal entity from its owners

A company has a **separate legal existence** from the people who own it. In law, it is like an ‘artificial person’ that is created by the people who decide to run their business as a company. Being a separate legal entity means that the company itself can enter into contracts, own property, sue and be sued in a court of law, and so on. This is quite different to the situation for sole proprietors and partnerships: a sole proprietor and his or her business are exactly the same thing in legal terms.

There are therefore various legal formalities involved in setting up and registering as a company. In contrast, a sole proprietor or partnership can simply start trading without any such procedures.

35.3 Companies are owned by their shareholders

The ownership of a company is divided into **shares**. Everyone who owns at least one share is a **shareholder** and is, therefore, one of the owners of that company. A company can be owned by just one individual, but most have several shareholders. Large companies often have thousands of different shareholders.

35.4 The shareholders have limited liability for their company's debts

Running a business as a sole proprietor or a partnership can potentially be quite risky for the owners. If their business fails, the owner(s) may end up having to pay the debts of the business out of their own pocket. The owner's liability for their business's debts is said to be unlimited. In other words, the owner(s) could potentially lose their home, all their money, and ultimately be made bankrupt if their business fails. Understandably, sole proprietors and partnerships may be reluctant to grow too big, because the price of failure could literally ruin their lives.

In the UK during the 1800s, it became clear that a system of limiting the personal liability of business owners was needed to encourage them to take on the risks of major investment and expansion. The idea of 'limited liability companies' was therefore created.

Activity 35.1

Why do you think it was in the 1800s that a system for limiting the personal liability of business owners became so essential?

However badly a limited liability company performs, the owners cannot be asked to contribute anything more than what they have paid (or promised to pay) for their shares. In other words, if a limited liability company collapses, millions of pounds in debt, the owners lose their original investment but nothing more. Their shares will become worthless, but they won't have to pay anything extra.

This means that anyone who deals with a limited liability company (such as lenders and suppliers) could potentially lose out because of its status: if the company fails, lenders and suppliers might end up not being paid. For this reason, companies are subject to a range of regulations and controls. One such regulation is that companies must make their financial statements available to the public. Anyone who does business with a company is entitled to be able to check whether that company is in any sort of financial trouble.

Activity 35.2

Having the protection of limited liability is a major advantage for owners who run their business as a company rather than a sole proprietor or partnership. Can you think of any other potential advantages?

35.5 Companies are managed by the directors on behalf of the shareholders

The shareholders are usually allowed to vote once or twice a year on just a few major issues affecting the company. However, they do not manage the company on a day-to-day basis. Instead, the shareholders elect a team of senior managers, known as **directors**, to run the company on their behalf.

The directors are therefore employees of the company and are normally paid for their services. They will often be paid a combination of a salary and bonuses, and sometimes a variety of other incentives too. In other words, the directors' total pay is often more than just a salary, so it is commonly described as **directors' remuneration** in the accounts of a company. Like any other employee's pay, directors' remuneration will be included as an expense in the income statement.

35.6 The auditors of company financial statements

The financial statements of most companies must be **audited** by independent, external accountants. This means that a firm of professional accountants from outside the company will carry out a series of checks and tests each year on the company's financial records and financial statements. Following these checks and tests, the auditors must give an opinion on whether they believe the financial statements give a **true and fair view** of the financial position and performance of the company. This opinion will be included alongside the financial statements.

Activity 35.3

Why do you think the financial statements of most companies have to be checked (or 'audited') by independent accountants?

The company will pay the **auditors** a fee for doing this work, so the **audit fee** will be another expense that you will often come across in a company's income statement.

Small companies are exempt from the requirement to have their financial statements audited.

35.7 Public and private companies

There are two main types of company: **public limited companies** and **private limited companies**. There are far more private companies in existence than public ones. However, large, well-known companies are nearly always public companies.

The main difference is that public companies can offer their shares for sale to the general public. Private companies are restricted from doing this. Public companies therefore have a major advantage because they can potentially raise substantial new funds for expansion by offering new shares for sale to a huge pool of potential investors. However, to help protect these potential investors, public companies are subject to much tighter regulation than private companies. Public companies must also indicate their status by including the letters **plc** at the end of their name.

Any company that is not a public company is a private company. Private companies must indicate their status by ending their name with the word Limited or just Ltd.

Because public companies are entitled to offer their shares to the general public, this makes them eligible to apply to have their shares bought and sold on (or 'listed on') a stock market (or 'stock exchange'). **However, be clear that not all public companies have their shares traded on a stock exchange.** Some public companies will either choose not to or might not have been allowed to. Companies that are 'listed' or 'quoted' on a stock market must comply with the stringent rules and requirements of that stock exchange. Some companies may prefer not to worry about complying, or they might be unable to comply.

Activity 35.4

Apart from not having to worry about complying with the strict rules of the stock exchange, can you think of any other reasons why a public company might not want its shares to be listed on a stock market?

At this stage of your studies, the financial statements of a company are essentially the same whether it is public or private. In other words, if you are asked to prepare financial statements for a company in a textbook or exam question at this stage in your learning, then your answer will be the same regardless of whether the company in the question is a 'plc' or an 'Ltd'.

35.8 The differences in accounting for companies compared with sole proprietors and partnerships

Having introduced some of the main features of limited companies, we can now turn to the main differences in accounting for them. Three key areas of difference are:

- The capital section of a company balance sheet (known as the **equity** section) is completely different.
- Companies pay **corporation tax** on their profits.
- Companies can borrow money by issuing **loan notes**.

We'll look at these three areas in the rest of this chapter.

35.9 The 'capital' or 'equity' section of a company balance sheet

The asset and liability sections of a company balance sheet are fairly similar to those of a sole proprietor or partnership. There are one or two differences (which we'll look at later in this chapter), but it is the capital section that is very different.

You will recall that the capital section of the balance sheet of a sole proprietor typically looks something like this:

	£
Opening capital at start of year	X
Add Net profit for the year	X
Less Drawings for the year	(X)
Closing capital at end of year	<u>X</u>

But in the balance sheet of a company this section looks very different. First, the word 'equity' is used instead of 'capital'. This is essentially because a sole proprietor's entire business is owned by one person; their stake in the business is not shared with anyone. In contrast, the ownership of a company is usually shared between several people. The concept of the ownership being broken down into shares of *equal* size, with each share giving its holder an *equal* stake in the company, ultimately gives us the name *equity*.

The second major difference is that, unlike sole proprietors, companies can't just maintain a single account for equity, adding the profit each year and deducting any payments to the owners. The reason for this comes from the fact that a sole proprietor can take whatever drawings they want out of their business. There are no legal restrictions. But companies face strict rules about how much can be paid to shareholders. Dividends (the equivalent of drawings for companies) can only be paid if sufficient profits have been made by the company.

Therefore, the equity section of a company balance sheet must be broken down into various different components. These components separate, for example, the amounts originally invested by the shareholders (which cannot be paid out as dividends) from the accumulated profits that the company has made since it started trading (which can).

The equity (or 'capital') section of a company balance sheet will therefore look more like the following:

<i>Equity:</i>	£
Share capital	X
Share premium	X
Revaluation reserve	X
General reserve	X
Retained earnings	X
Total equity	<u>X</u>

Real companies will often have more components of equity than the five shown above but these are the main ones you will see in this book. We'll consider each one in turn over the next few sections.

Before we start, remember that the *equity* section of a company balance sheet is just another name for *capital* section. The normal rules of double entry bookkeeping in relation to capital therefore apply: **any transaction that results in an increase in equity must be credited to the account for whichever component of equity has increased; and any transaction that results in a decrease in equity will be debited to the relevant component.**

35.10 Share capital

We have explained that the ownership of the company is divided into **shares**. The owners of the company (i.e. the shareholders) cannot take drawings out of the company but are instead entitled to receive **dividends**.

All shares have a fixed **par value** (also known as 'nominal value'), such as 5p, 10p, 25p, 50p or £1. The company gets to decide what this fixed value is going to be. A company may have more than one type of share, but all its shares of the same type (or 'class') will each have the same par value.

The par value of a share can sometimes be different from the issue price of that share. The **issue price** is the price paid for each share when it is first issued by the company. The issue price has a direct impact on the company's accounting records because it represents the cash that the company ultimately receives when new shares are issued.

Companies will decide on the issue price based on the directors' estimate of what investors will be prepared to pay for the shares. If an existing, successful company issues a new batch of shares, then it may well be able to charge an issue price that is significantly greater than par value. However, note that companies are not allowed to issue shares for *less* than their par value.

After shares have been issued, their market value will go up or down depending on various factors, the most obvious one being how successful the company is at generating profits and cash. However, the changing market price of shares has no impact on the company's accounting records. The market price of a company's shares is the price at which one investor sells an existing share to another investor. Such transactions are completely external to the company and thus have no effect on the company's books.

35.11 Authorised, issued, called-up and paid-up share capital

Traditionally, in the UK, each company had an authorised level of share capital, being the maximum amount of share capital that it was allowed to issue. The figure was never hugely important anyway, because companies could always increase the authorised level if they wanted to. In any case, new companies in the UK no longer have to specify an authorised share capital.

Of greater significance is the value of shares that have been issued and paid for by the shareholders:

- 1 A company's **issued share capital** is the total par value of shares that has actually been issued to shareholders. It is also known as the 'allotted share capital'.
- 2 If the company issues shares but only asks for payment in instalments, then its **called-up share capital** represents the instalments it has asked for so far. Therefore, this could be less than the issued share capital. **The figure for share capital in the equity section of the balance sheet will be the company's called-up share capital.**
- 3 The company's **paid-up share capital** is the total par value of shares that has actually been paid for by the shareholders so far. If the company has called-up share capital but hasn't yet received all the instalments it has asked for, then its paid-up capital may be less than its called-up capital.

In most textbook and exam questions, the figures for 1, 2, and 3 above will be the same: the issued share capital will have been called up in full by the company and paid for in full by the shareholders. Unless the question tells you otherwise, you should assume that this is the case. However, occasionally the figures for issued, called-up, and paid-up capital will differ. Exhibit 35.2 illustrates such a situation.

Exhibit 35.2 Issued, called-up and paid-up share capital

A company is formed (or 'incorporated') and immediately issues 750,000 shares of £1 each at par. The company initially only asks for payment of 80p in respect of each share. As at the balance sheet date, all the calls have been paid except for £4,000 due from one shareholder.

What is the issued, called-up and paid-up share capital, and what figures will appear in the balance sheet in connection with the shares?

Solution:

- Issued share capital = $750,000 \times £1 = £750,000$
- Called-up share capital = $750,000 \times £0.80 = £600,000$
- Paid-up share capital = $£600,000 - £4,000 = £596,000$
- In the *equity* section of the balance sheet, the figure for share capital will be shown as £600,000. Meanwhile £4,000 will be included in the *current assets* section under 'other receivables'.

For simplicity, in all the examples in the rest of this chapter, there will be no differences between the issued, called-up and paid-up share capital.

35.12 Be careful when calculating the number of shares that have been issued by a company

If the par value of each share is £1, then it is usually straightforward to determine how many shares are in issue. For example, suppose the balance on the share capital account of a company is £200,000, comprising fully-paid ordinary shares of £1 each. If so, then the number of shares in issue must be 200,000 ($£200,000/£1 = 200,000$ shares).

However, if the par value of each share is not £1 then you need to be careful. For example:

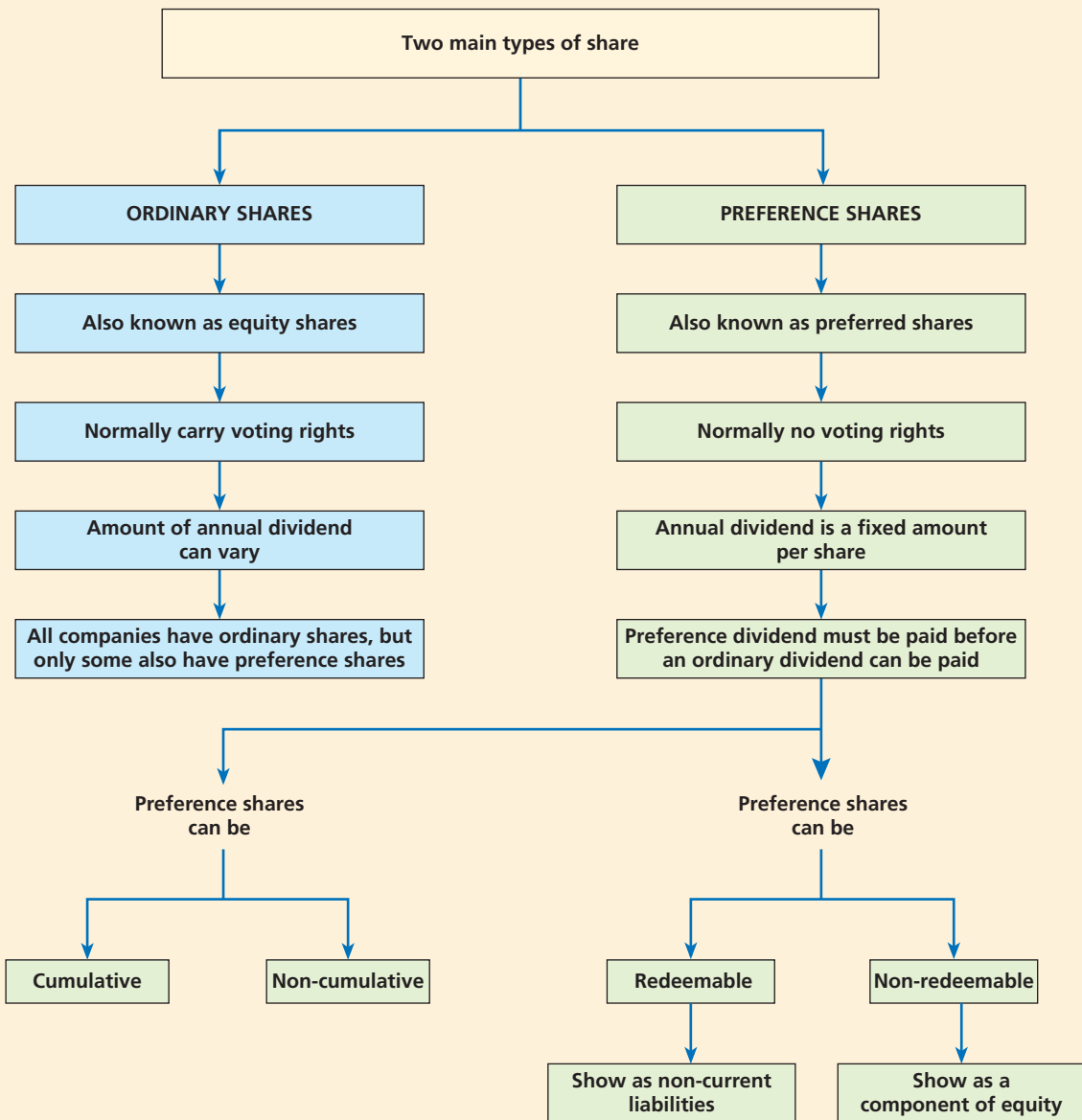
- If the balance on the share capital account is £200,000 comprising fully-paid ordinary shares of 50p each, then the number of shares in issue is 400,000 ($£200,000/£0.50 = 400,000$ shares)
- If the balance on the share capital account is £200,000 comprising fully-paid ordinary shares of 25p each, then the number of shares in issue is 800,000 ($£200,000/£0.25 = 800,000$ shares)
- If the balance on the share capital account is £200,000 comprising fully-paid ordinary shares of £2 each, then the number of shares in issue is 100,000 ($£200,000/£2 = 100,000$ shares)

Activity 35.5

The balance on the share capital account of a company is £75,000. How many shares are in issue if the par value of each share is (i) £1; (ii) 10p; (iii) 5p or (iv) 1p?

35.13 The two main categories of share

There are two main categories of share: **ordinary shares** and **preference shares**. All companies have ordinary shares, but some also have preference shares. We'll discuss the two categories below, and a summary of key differences is shown in Exhibit 35.3.

Exhibit 35.3 Typical features of ordinary shares and preference shares**Ordinary shares**

Ordinary shares are also known as 'equity shares' or sometimes just 'equities'. Each equity share gives its owner an equal stake in the company. For example, if a company has only issued 100 ordinary shares in total, then each share gives its holder a 1% stake in the company.

The amount of the dividend paid to ordinary shareholders will tend to go up or down depending on various factors. One of the main factors will be the performance of the company: if it is very profitable, then the ordinary shareholders may share in that success by receiving large dividend payouts. But if the company struggles, then the directors might decide to pay no ordinary dividends at all.

Ordinary shareholders therefore bear the risk of dividend payouts going up or down. This implies that the market value of their shares is likely to go up or down too. Given that they are taking such risk, it is only fair that ordinary shareholders are normally entitled to vote from time to time on certain major issues affecting their company.

Preference shares

Preference shares will sometimes also be issued by a company, although they are much less common than they used to be. Preference shareholders receive their dividend 'in preference' to the ordinary shareholders: in other words, a dividend cannot be paid to the ordinary shareholders unless the annual preference dividend has been paid first.

The annual dividend payable on a preference share is normally a fixed percentage of the par value of that share, and it doesn't go up even if the company is extremely profitable. For example, the holder of a single 7% preference share of £1 par value is entitled to a maximum dividend of 7 pence each year. Even if the company is hugely successful this dividend will not increase.

Preference shares, therefore, offer a lower risk and lower reward compared with ordinary shares. Because they involve far less risk, preference shares do not normally entitle the holder to vote on company matters.

The preference shares of different companies may have different characteristics. For example, preference shares can be **cumulative** or **non-cumulative**:

- 1 *Cumulative preference shares* have a specified rate of annual dividend. However, if the company chooses not to pay this dividend in any particular year, then the shortfall will be rolled over into the next year. For example, if no dividend is paid on 8% cumulative preference shares of £1 in 2024, then the holder of one of these shares could potentially receive 16 pence (i.e. 8p + 8p) in 2025.
- 2 *Non-cumulative preference shares* also have a specified rate of annual dividend. However, if the amount paid for a particular year is less than the specified rate, then the shortfall is not rolled over into the next year. For example, if no dividend is paid on 8% non-cumulative preference shares of £1 in 2024, then the holder of one of these shares can still only receive a maximum of 8 pence in 2025.

Activity 35.6

A company has an issued share capital of 180,000 ordinary shares of 50 pence each and 10,000 6% preference shares of £1 each. The directors wish to pay an ordinary dividend of 13 pence per share for the year ended 31 December 2024. The company failed to pay a preference dividend for 2023, but in 2024 the company can meet its obligations in full. What total dividends will be paid in connection with the year ended 31 December 2024 if the preference shares are (i) non-cumulative; or (ii) cumulative?

Even more significant is the fact that preference shares can also be **redeemable** or **irredeemable**:

- 1 Redeemable preference shares will be bought back (or 'redeemed') by the company on a certain date in the future.
- 2 Irredeemable preference shares will not be bought back by the company in the future.

In effect, redeemable preference shares are very much like a form of long-term borrowing. If a company issues redeemable preference shares, then it initially receives money from the investors, pays them a fixed annual percentage rate for several years, and eventually repays the original sum to the investors. The real economic impact is very much like that of a long-term loan, so (in accordance with the **substance over form** concept that you saw in Chapter 10) **redeemable preference shares are classed as non-current liabilities in the balance sheet, not as equity**.

Irredeemable preference shares can potentially be classified either as a non-current liability or as a component of equity, depending on the specific characteristics of the particular shares.

However, for simplicity and consistency, in this book we will always show irredeemable preference shares as a component of equity.

35.14 The share premium account

Suppose a company issues 200,000 ordinary shares of £1 each at par (i.e. at an issue price of £1 per share) and the shareholders pay in full immediately. The impact on the company's books will be:

Debit Cash at bank	£200,000	
Credit Share capital		£200,000

However, when an existing, successful company issues new shares, it will usually do so at a price that is greater than par value. If so, a UK company must only record the par value in the share capital account. The excess of the issue price above par value must be credited to a separate component of equity known as **share premium**.

For example, suppose a company issues 200,000 ordinary shares of £1 each at an issue price of £4 and the shareholders pay in full immediately. The impact on the company's books will be:

Debit Cash at bank (200,000 shares at a price of £4 each)	£800,000	
Credit Share capital (200,000 shares at £1 par value each)		£200,000
Credit Share premium (200,000 shares at £3 premium each)		£600,000

Activity 35.7

A company issues 600,000 ordinary shares of 25p each for cash at a price of £1.60 and the issue is fully paid. What will be the double entry impact in the company's accounting records?

35.15 Retained earnings

In the balance sheet of a sole proprietor, you saw that the owner's capital increases each year by the value of the net profit for the year minus any drawings taken. The same principle applies to companies: their capital (or 'equity') increases each year by the amount of the profit for the year minus any dividends paid to the owners during the year. This is recorded in a separate component of equity known as **retained earnings**.

The retained earnings at the end of the year can be calculated as shown in Exhibit 35.4.

Exhibit 35.4 Calculation of retained earnings at the end of the financial year

	£
Retained earnings at start of year (<i>from the equity section of last year's balance sheet</i>)	X
Add Profit for the year (<i>the final figure in the company's income statement</i>)	X
Less Transfers to general reserve ¹	(X)
Less Dividends paid during the year ¹	(X)
Retained earnings at end of year (<i>shown in the equity section of this year's balance sheet</i>)	<u>X</u>

¹We will look at transfers to general reserve and dividends paid in the next two sections.

Of course, if the company makes a loss for the year, then this will reduce rather than increase the balance of retained earnings.

**Activity
35.8**

A company's issued share capital comprises ordinary shares only. Its retained earnings were £240,000 as at the start of the year and £290,000 at the end of the year. Dividends paid during the year amounted to £30,000 and there were no transfers to or from general reserve. What was the profit for the year?

35.16 Transfers to general reserve

The directors might decide to transfer a portion of the balance on the retained earnings account to a separate component of equity known as a **general reserve**.

The main reason for doing this stems from the fact that companies cannot pay dividends greater than the value of their accumulated retained profits. The directors may wish to indicate to the shareholders that a certain portion of accumulated profits are unlikely to be paid out as dividends. They could choose to indicate this by making a transfer from retained earnings to general reserve. The double entry for such a transfer would be:

Debit Retained earnings	£x	
Credit General reserve		£x

Be clear that no money is actually being moved. This is simply a book entry to reduce one component of equity (retained earnings) and increase another (general reserve). Remember that profit is simply the outcome of the calculation *income earned minus expenses incurred*. Profit is not the same as cash, so neither retained earnings nor general reserve represent reserves of cash!

Finally, note that general **reserves** are fairly rare in practice these days, but you still sometimes come across them in textbook and exam questions.

35.17 Dividends

The dividends on ordinary shares differ from those paid on preference shares, so we will consider the two types of dividend separately.

Ordinary dividends

Each year, the directors of the company will decide whether dividends are to be paid to the ordinary shareholders and, if so, how much.

Dividends on ordinary shares (i.e. 'ordinary dividends') are normally expressed in terms of pence per share. Like drawings, ordinary dividends are not business expenses, so they do not appear in the income statement. Instead, they are deducted from retained earnings, as illustrated in Exhibit 35.5.

Exhibit 35.5 Accounting for ordinary dividends

A company has 100,000 ordinary shares of 25p each in issue. It pays a dividend of 7p per share. What is the double entry impact in the company's books?

Solution:

The total dividend payment is 100,000 shares \times £0.07 = £7,000, and the double entry impact will be:

Debit Retained earnings	£7,000	
Credit Cash at bank		£7,000

Ordinary dividends are often paid in two stages each year: an **interim dividend** is paid mid-way through the year, and a **final dividend** is paid after the financial year has ended.

Activity 35.9

A company has 400,000 ordinary shares with a par value of 25p each in issue. Its financial year ends on 31 December each year. A final dividend in respect of 2023 of 15p per share was paid in March 2024, and an interim dividend of 5p per share was paid in August 2024. A final dividend for 2024 of 17p per share has been proposed by the directors. What was the total of the dividends paid during 2024?

Ordinary dividends are essentially accounted for when they are paid, not when the directors recommend (or 'propose') what the dividend payment is likely to be. For example, the directors might have **proposed** to pay a final dividend of 9 pence per ordinary share but this dividend has not been paid as at the company's financial year end date. This proposed dividend is **not** shown as a liability in the company's balance sheet as at the year end.

The reason is because there is no legal obligation for the company to pay the proposed dividend until it has been approved by the shareholders. Approval of the final dividend is only given by the shareholders after the financial year has ended, so no legal obligation to pay it exists (and therefore no liability) as at the balance sheet date.

Preference dividends

If a company has issued preference shares, then the preference dividend must be paid before an ordinary dividend can be paid. The rate of preference dividend is normally expressed as a percentage of the par value of a share.

As discussed earlier in this chapter, for simplicity and consistency, in this book **we will assume that all irredeemable preference shares are a component of equity and dividends on those shares will, therefore, be a deduction from retained earnings, just like ordinary dividends.** They will not appear in the income statement.

In contrast, redeemable preference shares are treated in the financial statements as if they are a form of loan finance. This is in accordance with the substance over form concept. **Dividends on redeemable preference shares will, therefore, be shown as an expense in the income statement** (under the heading 'finance costs') together with other interest charges. If dividends on redeemable preference shares are unpaid as at the year end, then they will normally be shown as a liability on the balance sheet under the heading 'other payables'.

Exhibit 35.6 Accounting for dividends paid on preference shares

A company has 50,000 6% preference shares of 50p each in issue. The annual dividend on these shares has just been paid, in one instalment. What is the double entry impact of the dividend in the company's books, assuming that the shares are:

- (i) redeemable
- (ii) irredeemable?

Solution:

The total dividend payment is $50,000 \times £0.50 \times 6\% = £1,500$.

- (i) If the preference shares are redeemable:

Debit Finance costs (<i>an income statement account</i>)	£1,500	
Credit Cash at bank		£1,500

(ii) If the preference shares are irredeemable:

Debit Retained earnings	£1,500	
Credit Cash at bank		£1,500

35.18 Two specific methods of issuing new shares: rights issues and bonus issues

Companies can issue new shares in a number of different ways. Two particular methods are seen quite commonly at the introductory level: rights issues and bonus issues. You'll look at each of these in this section.

Rights issues of shares

Rights issues are a particularly common method of issuing new shares.

A rights issue is where new shares are offered for sale to the existing shareholders in proportion to their current shareholdings. To encourage the existing shareholders to take up their rights to buy new shares, they are usually offered at a price that is lower than the current market value of the shares. Exhibit 35.7 illustrates the accounting entries to record a rights issue.

Exhibit 35.7 Accounting for a rights issue of shares

A company had 20,000 ordinary shares of £1 each in issue. It then makes a 1-for-5 rights issue for cash, fully-paid, at an issue price of £2.40 per share. The rights are taken up in full by the existing shareholders. What will be the double entry to reflect this in the company's books?

Solution:

- $20,000 \text{ shares} \times \frac{1}{5} = 4,000$ new shares of par value £1 each will be issued.
- The total amount of cash raised for the company will be $4,000 \text{ new shares} \times £2.40 = £9,600$.

The double entry impact will be:

Debit Cash at bank	£9,600	
Credit Share capital ($4,000 \text{ shares} \times £1 \text{ par value}$)		£4,000
Credit Share premium ($4,000 \text{ shares} \times £1.40 \text{ premium}$)		£5,600

Activity 35.10

A company has 300,000 ordinary shares of 25p each in issue, and a balance on its share premium account of £130,000. It then makes a 1-for-3 rights issue at a price of £1.15 per share which is taken up in full. What will be the balances on the share capital and share premium accounts after the rights issue?

Bonus issues of shares

A **bonus issue** is where new shares are given away free to the existing shareholders in proportion to their current shareholdings. No cash changes hands and no money is raised for the company.

Activity 35.11

Since the company raises no money from a bonus issue, why would it make one?

Because no cash changes hands when a bonus issue is made, the company's assets and liabilities remain unchanged. The accounting equation tells us that assets minus liabilities equals equity, so the total equity of the company is also unchanged. In other words, the increase in the share capital component of equity created by the bonus issue must be matched by an equal decrease in another component.

Most commonly, the share premium account will be used for this decrease. If the balance on the share premium account is insufficient to cover the bonus issue, the retained earnings account will normally be used for the remainder. In textbook and exam questions, you will usually be told which component of equity is to be used.

Exhibit 35.8 illustrates how a bonus issue is accounted for.

Exhibit 35.8 Accounting for a bonus issue of shares

The equity section of a company's balance sheet showed the following:

<i>Equity:</i>	£
Share capital (ordinary shares of £1 each)	10,000
Share premium	35,000
Retained earnings	<u>47,000</u>
Total equity	<u>92,000</u>

This company then makes a 1-for-4 bonus issue of shares using the share premium account. Show the equity section of the balance sheet immediately after the bonus issue.

Solution:

The company will issue $10,000 \times \frac{1}{4} = 2,500$ new ordinary shares of £1 each to the existing shareholders, for free. The double entry will be:

Debit Share premium	£2,500	
Credit Share capital		£2,500

The equity section of the balance sheet immediately after this bonus issue will therefore show:

<i>Equity:</i>	£
Share capital (10,000 + 2,500)	12,500
Share premium (35,000 – 2,500)	32,500
Retained earnings	<u>47,000</u>
Total equity	<u>92,000</u>

In Exhibit 35.8, you can see that the total equity of the company does not change after a bonus issue. One component of equity (in this case share premium) is simply converted into another (share capital). Bonus issues are sometimes known as **capitalisation issues**, because they 'capitalise' a component of equity by turning it into share capital.

Activity 35.12

A company has 200,000 50p ordinary shares in issue and a balance on its share premium account of £170,000. If this company then makes a 1-for-8 bonus issue of ordinary shares using the share premium account, what will be the balances on share capital and premium immediately afterwards?

35.19 Revaluation reserve

In Chapter 21, we discussed how the value of some of a business's non-current assets may increase significantly over time. This is especially true in the case of land and buildings. In many countries, property prices have tended to rise over time and the current market value of a building that was bought 30 years ago may be much greater than its original cost.

The accounting standard IAS 16 *Property, Plant and Equipment* allows businesses to revalue non-current assets to their **fair value**, which is essentially their current market value. If a business chooses to do this, then the annual depreciation expense on the revalued assets will increase because the charge will be based on the new, revalued amounts.

In this book, we are merely *introducing* the idea of revaluing non-current assets. For simplicity, therefore, you'll only see examples where freehold land is revalued. As you've learnt already, freehold land normally has an unlimited useful life, so it is not depreciated. Hence, in all our revaluation examples, there will be no impact on depreciation charges.

If a company wishes to show its land at its current market value, then the valuation will usually be carried out by professional valuers. Any increase in the value will not be shown in the income statement. The land has not yet been sold, so no profit has yet been made. The gain is said to be 'unrealised' and does not form part of the profit for the year. Instead, it will be credited to a separate component of equity known as **revaluation reserve**.

Exhibit 35.9 gives an illustration of accounting for an upwards revaluation of a company's freehold land.

Exhibit 35.9 A gain on the revaluation of land

A company purchased freehold land for £75,000 six years ago and it has always been recorded in the books at this historical cost. The land has recently been appraised by professional valuers and its current market value is estimated to be £200,000. The directors wish to report the land at its fair value in this year's financial statements. What journal entry is required to record the revaluation?

Solution:

Debit Freehold land	£125,000	
Credit Revaluation reserve		£125,000

Activity 35.13

Do you think that reporting some non-current assets at current value rather than historical cost is a good idea? What arguments for and against it can you think of?

If you take your studies of accounting to the next level, you will learn how to account for revaluations where the assets in question are subject to depreciation; how to account for revaluations that result in a *decrease* in value; and how to account for the disposal of an asset that had previously been revalued. These situations are all beyond the scope of this book.

Finally, note that gains on the revaluation of non-current assets will also be reported in the company's **statement of other comprehensive income**. This statement is largely beyond the scope of this book, although we will look at it briefly in the next chapter.

35.20 The statement of changes in equity

You've now looked at various aspects of several components of the equity section of a company's balance sheet. As part of their annual financial statements, companies must include a table that summarises all the changes in each component that occurred during the financial year. This table is known as a **statement of changes in equity**.

The statement is presented in a series of columns, with each column representing a component of the company's equity. The statement is best illustrated with an example, as shown in Exhibit 35.10. Real companies will often have more than the five components shown in this exhibit, but these are the ones we will cover in this book.

Exhibit 35.10 The statement of changes in equity: a worked example

You are given the equity section of the balance sheet of FW Ltd as at 31 December 2023 as follows:

	£
<i>Equity:</i>	
Ordinary share capital (160,000 shares of £1 each)	160,000
Irredeemable preference share capital (60,000 3% preference shares of 50p each)	30,000
Share premium	75,000
Revaluation reserve	48,000
General reserve	29,000
Retained earnings	254,000
Total equity	<u>596,000</u>

During the year ended 31 December 2024, the following events took place:

- (i) A 1-for-4 bonus issue of ordinary shares was made in March 2024 using the share premium account.
- (ii) A 1-for-10 rights issue of ordinary shares was made in August 2024 at an issue price of £1.90. The rights were taken up in full.
- (iii) In November 2024, the company's freehold land was appraised by professional valuers and valued at £0.6m. The previous valuation (carried out three years ago) had valued the land at £0.5m. The company's policy is to show all its freehold land at current valuation in the financial statements.
- (iv) In December 2024, total ordinary dividends of £29,000 were paid, and the dividend on the preference shares for the year ended 31 December 2024 was paid in full.
- (v) The final profit after tax for the year ended 31 December 2024 was £66,000.
- (vi) The directors made a transfer from retained earnings to general reserve of £7,000.

Required:

Prepare a statement of changes in equity for FW Ltd for the year ended 31 December 2024.

FW Ltd
Statement of changes in equity for the year ended 31 December 2024

	Ordinary share capital	Irredeemable preference share capital	Share premium	Revaluation reserve	General reserve	Retained earnings	Total equity
	£	£	£	£	£	£	£
Balance at 1 January 2024	160,000	30,000	75,000	48,000	29,000	254,000	596,000
Bonus issue of ordinary shares ¹	40,000	–	(40,000)	–	–	–	–
Rights issue of ordinary shares ²	20,000	–	18,000	–	–	–	38,000
Gain on revaluation ³	–	–	–	100,000	–	–	100,000
Profit for the year ³	–	–	–	–	–	66,000	66,000
Transfer to general reserve	–	–	–	–	7,000	(7,000)	–
Preference dividends paid ⁴	–	–	–	–	–	(900)	(900)
Ordinary dividends paid	–	–	–	–	–	(29,000)	(29,000)
Balance at 31 December 2024	<u>220,000</u>	<u>30,000</u>	<u>53,000</u>	<u>148,000</u>	<u>36,000</u>	<u>283,100</u>	<u>770,100</u>

Notes

- ¹ Bonus issue = $160,000 \times \frac{1}{4} = 40,000$ new ordinary shares of £1 each.
- ² Immediately after the bonus issue, there were 200,000 ordinary shares in issue. The rights issue is therefore $200,000 \times \frac{1}{10} = 20,000$ new £1 ordinary shares issued at a premium of 90 pence each: $20,000 \times £0.90 = £18,000$.
- ³ In practice, the profit for the year and the revaluation gain would be shown on one row on this statement, described as 'total comprehensive income for the year'. For simplicity, we show these items on two separate rows.
- ⁴ The par value of preference share capital is £30,000; annual preference dividends, therefore, total $£30,000 \times 3\% = £900$.

35.21 Two other items in company accounts: corporation tax and loan notes

So far, we've looked in some detail at the equity section of a company balance sheet. We'll end this chapter by looking at two items in the liabilities sections that are unique to companies: **corporation tax** and **loan notes**.

Corporation tax

As we have explained, a company is a separate legal entity from its owners. If the company makes a profit, then the company itself is liable to pay tax on that profit. In the UK, this tax is called **corporation tax**, and the corporation tax charge on this year's profits will appear as an expense in the company's income statement.

The situation is different for sole proprietors and partnerships. These businesses are not separate legal entities from their owners, so if the business makes a profit, then the *owner* is liable for the tax, not the business. The amount of tax to be paid will depend on the personal circumstances of the owner and will be a figure ultimately agreed upon between the owner and the tax authorities. This is why any tax charge on profits does not appear in the income statements of sole proprietors and partnerships.

The calculations needed to determine how much corporation tax must be paid on a company's profits is a specialist subject. At this stage, you won't be expected to know how it is calculated. Questions will simply tend to tell you the corporation tax charge on the profit for the year.

The double entry to record this corporation tax charge will be:

Debit Corporation tax expense (an income statement account)	£x	
Credit Corporation tax payable (a balance sheet account)		£x

The entry to corporation tax payable is a credit because it represents a liability, being the amount owed to the tax authorities. The other side is a debit because it is an expense for the year.

Whenever a payment of corporation tax is made to the tax authorities, the double entry will be:

Debit Corporation tax payable	£x	
Credit Cash at bank		£x

The final balance on the corporation tax payable account at the end of the financial year will be included in the balance sheet as a current liability. Since the final profit for the year cannot be calculated until after the financial year has ended, the tax charge on that profit cannot be calculated until then either. Some or all of this year's tax charge will, therefore, nearly always appear as a current liability in the year-end balance sheet.

Activity 35.14

A company owed a total of £39,000 in corporation tax as at the start of the year. The corporation tax expense in the income statement for the year is £43,000 and the company paid £47,000 in corporation tax to the tax authorities during the year. What is the current liability for corporation tax payable as at the end of the year?

Loan notes

Like any other business, companies can borrow money by taking out a loan from a bank. However, unlike sole proprietors and partnerships, companies can also borrow money by issuing **loan notes**.

Loan notes are essentially certificates that a company can issue in return for cash. The company will then pay interest to the holders of these certificates each year, just as it would on any other loan.

Most loan notes will also be redeemable, which means that the loan will eventually end and the original amount will be repaid to the holder of the **loan note**. The rate of interest and date of redemption will be specified on the loan note. For example, a company could borrow a total of £100,000 by issuing 1,000 4% loan notes 2034 of £100 each. '4% loan notes 2034' implies that the company will pay £4 interest (i.e. $£100 \times 4\%$) on each loan note every year until 2034. In 2034, every person who holds one of these loan notes will be repaid the original £100.

Confusingly, loan notes go by various different names. For example, they are sometimes known as debt securities, **loan stock**, **corporate bonds**, or **debentures**. For consistency, as far as possible we will just use the term 'loan notes' in this book.

Borrowing money by issuing loan notes potentially gives companies access to a much wider pool of potential lenders. For example, if a company wished to borrow (say) £100,000, it could issue 1,000 loan notes of £100 each and find a large number of different individuals and financial institutions who were each willing to buy a small number of these loan notes. This might be easier than persuading a single bank to give them a bank loan of £100,000.

Activity 35.15

Can you think of any other reasons why companies might prefer to borrow money by issuing loan notes instead of taking out a bank loan?

If you continue to study accounting and finance in the future, you will find that loan notes issued by different companies can take on a variety of different forms. For example, loan notes can be *secured* or *unsecured*. They can be issued at a *premium* or a *discount*. Or they can be *convertible*, which means that the holder has the right to convert them into shares in the future.

At this introductory stage of your studies, all loan notes in this book will be redeemable and non-convertible. They will also be both issued and redeemed at par, which means that if the company issues a batch of £100 loan notes, it will receive £100 for each one when it is issued and will repay £100 when it is redeemed.

Interest on loan notes must be paid each year regardless of whether the company is making profits. The interest due on all loan notes in issue will be included in the income statement as an expense. Interest on loan notes is typically paid in two equal instalments each year, so, as at the end of the period, the company may not have paid all the interest due. Any interest due on loan notes for the year that is unpaid at the year end must be included in the balance sheet as an accrual in the current liabilities section.

The total amount of loan notes in issue as at the balance sheet date will nearly always be shown within the non-current liabilities section. The only exception is where some loan notes are due for redemption within 12 months of the balance sheet date, in which case, these will be shown as a current liability.

Activity 35.16

At its most recent year end, a company's trial balance includes £600,000 4.5% loan notes that were originally issued four years' ago and are redeemable in six years' time. Loan note interest paid shown in the same trial balance is £13,500. How will all this information be reflected in the company's income statement, and in the current and non-current liabilities sections of its balance sheet?

Learning outcomes:

You should now have learnt:

- 1 The key features of limited companies, including the nature of shares and shareholders, limited liability, directors and auditors.
- 2 That there are two main types of company ('public' and 'private'), and the key difference between them.
- 3 That the 'capital' section of a company's balance sheet is called the equity section.
- 4 That the equity section is broken down into several different components, such as share capital, share premium, revaluation reserve, general reserve, and retained earnings.
- 5 The differences between ordinary shares and preference shares.
- 6 The differences between issued, called-up and paid-up share capital.
- 7 How to account for a share issue when the shares are issued at a price greater than their par value, with the excess being credited to the share premium account.
- 8 That a company's profit for the year is added to its retained earnings, minus dividends paid and any transfers to other reserves.
- 9 How to account for a rights issue, where new shares are offered for sale to the existing shareholders in proportion to their current holdings.
- 10 How to account for a bonus issue, where new shares are given away free to the existing shareholders in proportion to their current holdings.
- 11 How to account for an upwards revaluation of land, which involves crediting the increase in value to a revaluation reserve.
- 12 How to prepare a statement of changes in equity for an individual company, showing all the changes in each component of equity that occurred during the year.
- 13 That the corporation tax charge on the company's profit for the year will appear as an expense in the income statement, and the corporation tax owed to the tax authorities as at the end of the year will be a current liability in the balance sheet.
- 14 That, as well as bank loans, companies can borrow money by issuing loan notes.
- 15 How loan notes, and the interest due on them, will be shown in the income statement and balance sheet.

Answers to activities:

35.1 The timing is really due to the Industrial Revolution which took place around 1770 to 1830. It brought about massive developments in terms of engines, machinery, and other new inventions. The UK was transformed from an economy based on farming to one built on manufacturing. Huge investment was needed in the new technologies. For the benefit of the whole country, a system of limiting the personal liability of business owners was needed to encourage them to take the risks involved in such investment.

The idea of limited liability was not entirely new to the 1800s, but limited companies didn't become widespread until then.

35.2 There can be various advantages, such as:

- Any number of different people can potentially become shareholders of the company. This can make it easier for companies to raise money for expansion because there is a straightforward mechanism for widening its ownership to a large pool of potential investors.

- A company has a potentially unlimited life. The shares may change hands many times over the years, but the company itself can carry on forever. In contrast, if a sole proprietor dies or retires then their business effectively ends.
- Running a small business as a company rather than as a sole proprietor can sometimes help the business appear more credible and reputable to potential customers, suppliers and lenders.
- It is easier to protect the trading name of the business (and thereby protect its brand and reputation) if it is registered as a company.
- In some countries (such as the UK), there can be tax advantages of operating as a company rather than as a sole proprietor or partnership.

35.3 The reason stems from the fact that the people who run the company (the directors) are often different from those who own it (the shareholders). The shareholders therefore need to be confident that the annual financial statements are a fair reflection of the financial affairs of the company, so that they can properly assess whether the directors are doing a good job of running their company.

Other users of financial statements (such as lenders and suppliers) will also have more confidence in the reliability of the financial statements if they have been audited, but (legally) the primary responsibility of the auditors is normally to the shareholders.

35.4 There are various possible reasons, such as:

- A stock market listing makes it easier for a company's shares to be bought and sold, so the directors might worry that it will make the company more vulnerable to a takeover by another business.
- The owners might postpone applying for a listing until economic conditions improve. They might be waiting until the time is right so that they can maximise the price at which the shares are initially sold when the company is listed for the first time.
- Listed companies are generally subject to greater scrutiny from financial analysts, journalists and commentators. For various reasons, some companies may wish to avoid this scrutiny, and conduct their business away from the spotlight.

35.5

- 75,000 shares (i.e. $£75,000/£1 = 75,000$)
- 750,000 shares (i.e. $£75,000/£0.10 = 750,000$)
- 1,500,000 shares (i.e. $£75,000/£0.05 = 1,500,000$)
- 7,500,000 shares (i.e. $£75,000/£0.01 = 7,500,000$)

35.6

- If the preference shares are non-cumulative, then the company is only obliged to pay the dividend for 2024: $10,000 \times £1 \times 0.06 = £600$. The ordinary dividends in connection with the 2024 year are £23,400 ($180,000 \text{ shares} \times £0.13 \text{ each}$) so total dividends = £24,000.
- If the preference shares are cumulative and no dividend was paid last year, then the company is obliged to pay the preference dividend for both 2024 and 2023: $10,000 \times £1 \times 0.06 \times 2 \text{ years} = £1,200$. Ordinary dividends are £23,400 (as above) so total dividends = £24,600.

35.7

Debit Cash at bank ($600,000 \text{ shares} \times £1.60 \text{ each}$)	£960,000	
Credit Share capital ($600,000 \text{ shares} \times £0.25 \text{ par value}$)		£150,000
Credit Share premium ($600,000 \text{ shares} \times £1.35 \text{ premium}$)		£810,000

35.8 The answer is £80,000, as calculated below:

	£
Retained earnings as at start of the year	240,000
Add Profit for the year (<i>the missing figure to make this calculation correct</i>)	80,000
Less Dividends paid during the year	(30,000)
Retained earnings as at end of the year	<u>290,000</u>

35.9 $400,000 \times (15p + 5p) = £80,000$ total dividends were paid during 2024. The directors will usually decide on the final dividend for 2024 largely on the basis of the profit that the company makes in

the year ended 31 December 2024. This final profit can only be calculated *after* 31 December 2024, so the final dividend for 2024 will inevitably be paid in 2025.

35.10 The answer is £100,000 and £220,000, respectively, which can be calculated as follows:

	Ordinary share capital	Share premium
	£	£
Opening balances	75,000*	130,000
<i>Rights issue:</i>		
300,000 shares $\times \frac{1}{3} \times £0.25$ par value	25,000	
300,000 shares $\times \frac{1}{3} \times £0.90$ premium**		90,000
Balances after rights issue	<u>100,000</u>	<u>220,000</u>

*300,000 shares \times £0.25 par value = £75,000

**£1.15 issue price – £0.25 par value = £0.90 premium per share

35.11 Issuing bonus shares for free will increase the number of shares in the company without changing its assets or liabilities in any way. The value of the company as a whole, therefore, stays the same, so the market value of each individual share will be reduced. This could make the shares easier to buy and sell. After all, if a company is very successful but only has a small number of shares in issue, then the market value of each share will be very high. The price might be so high that it could deter some potential investors. In other words, a lower market price might make the shares more 'tradeable'.

Another reason might simply be that the company cannot afford to pay a dividend and is trying to keep the shareholders happy by giving away *something*. The 'giveaway' is rather an illusion, because the value of the company as a whole remains exactly the same after a bonus issue. Although each shareholder will own a greater *number* of shares, the total *value* of their shareholding will be unchanged after a bonus issue.

35.12 The answer is £112,500 and £157,500, respectively, which can be calculated as follows:

	Ordinary share capital	Share premium
	£	£
Opening balances	100,000*	170,000
<i>Bonus issue:</i>		
200,000 shares $\times \frac{1}{8} \times £0.50$ par value	12,500	(12,500)
Balances after bonus issue	<u>112,500</u>	<u>157,500</u>

*200,000 shares \times £0.50 par value = £100,000

35.13 Two arguments in favour of the revaluation approach could be:

- Businesses might wish to show their land and buildings at current value because this is likely to increase the total value of their assets. The balance sheet of the business will therefore tend to suggest that the business is in a stronger financial position than if historical cost was used.
- Some users of financial statements might prefer it if non-current assets are shown at their current value because it will provide more relevant information about their 'true' value than the original cost (which may have been incurred many years ago).

Arguments against could include:

- The original, historical cost of a non-current asset is a matter of objective, verifiable fact. In contrast, its current market value is a matter of opinion. Different professional valuers may not agree on the valuation.
- Businesses may be reluctant to revalue buildings because depreciation charges must be based on the revised value. Higher depreciation charges mean lower profits, so the income statement of the business will suggest that it is performing worse than if buildings had remained valued at historical cost.

- (iii) If a business revalues its non-current assets, then the valuations need to be updated reasonably regularly, sometimes even on an annual basis. The costs of having to carry out regular valuations may deter some businesses from adopting the revaluation approach.
- (iv) Allowing businesses to *choose* whether to show certain classes of non-current asset at historical cost or current value will:
 - reduce the ability of users to compare the financial statements of different businesses. As discussed in Chapter 10, comparability is an important characteristic that financial statements should ideally possess; and
 - mean that the figure for total non-current assets in the balance sheet of some businesses will be a mixture of historical costs and current values. Such a 'mixed measurement system' could be argued to be illogical and inconsistent.

35.14 The answer is £35,000. This can be calculated as follows:

Corporation tax payable			
	£		£
Cash at bank	47,000	Opening balance at start of year	39,000
Closing balance at end of year	35,000	Tax expense for the year	43,000
	<u>82,000</u>		<u>82,000</u>

35.15 There may be various reasons, such as:

- (i) Loan notes can potentially allow the company to borrow for longer periods. Loan notes might be redeemable in 10 or 20 years or even more, while banks will tend to want their loans to be repaid sooner than this.
- (ii) Bank loans tend to restrict the company in various ways, because the bank will usually insist that the company agrees to certain conditions (or 'covenants') for the period of the loan. Loan notes generally do not tend to have as many strings attached.
- (iii) The interest rate on loan notes may be lower than that on bank loans. There are various reasons for this, such as the fact that loan notes are issued direct to the lenders. In contrast, the rate charged on a bank loan essentially needs to be sufficient to cover the running costs of the bank as well as providing a return to the bank's shareholders.
- (iv) With loan notes, companies may be able to borrow at a fixed interest rate for longer periods than with a bank loan. Understandably, companies like to know in advance exactly how much interest they are going to have to pay each year, but banks may be reluctant to lend at a fixed rate for long periods.

35.16 The loan note interest expense for the year will be £27,000 ($£600,000 \times 0.045$). Companies will typically include this expense under the heading 'finance costs' in their income statement. The current liabilities section of the balance sheet will include an accrual for unpaid interest of £13,500 (i.e. only £13,500 of the annual interest expense of £27,000 has been paid, so £13,500 must still be owed). Loan note borrowing of £600,000 will appear in the non-current liabilities section of the balance sheet, because it is repayable in more than one year's time.

Review questions

35.1 The equity section of the balance sheet of Plenti Ltd as at 31 December 2023 was as follows:

	£
Ordinary share capital	175,000
6% preference share capital	40,000
Share premium	98,000
Retained earnings	364,000
<i>Total equity</i>	<u>677,000</u>

**Additional information:**

- (i) The ordinary shares have a par (or 'nominal') value of 25 pence each.
- (ii) The preference shares have a par ('or nominal') value of £2 each.
- (iii) All the share capital that has been issued has been both called up and paid in full.

Required:

- (a) How many ordinary shares are in issue?
- (b) How many preference shares are in issue?
- (c) Are the preference shares redeemable or irredeemable? How do you know?
- (d) If the preference dividend for the year ended 31 December 2024 is paid in two equal instalments, what payments will be made in respect of each share and what will be the total preference dividends paid by the company?
- (e) If the company makes a profit for the year ended 31 December 2024 of £104,000 and pays total dividends (ordinary and preference) of £51,400 during the year ended 31 December 2024, what will be the balance of retained earnings in the balance sheet as at 31 December 2024?
- (f) Now suppose that the preference shares are cumulative and that no preference dividends were paid for either of the years ending 31 December 2022 or 2023. The directors wish to pay an ordinary dividend of 9 pence per share for the year ended 31 December 2024. To achieve this, what total dividends must be paid by the company?
- (g) If the company issues a further 150,000 ordinary shares for cash at an issue price of 95 pence per share, what double entry would be required to record the issue?

35.2 The equity section of the balance sheet of Gasparo Ltd as at 31 December 2023 showed the following:

	£'000
Share capital (200,000 ordinary shares of 25p each)	50
Share premium	97
General reserve	42
Retained earnings	198
<i>Total equity</i>	<u>387</u>

The following events subsequently occurred:

- In May 2024, the company paid the final dividend of 11 pence per share in relation to the year ended 31 December 2023.
- In September 2024, it paid an interim dividend of 3 pence per share.
- In November 2024, the company issued 60,000 new ordinary shares at a premium of 90 pence per share.

The company reported a final profit after tax of £61,000 for the year ended 31 December 2024 and made a transfer of £10,000 to general reserve. A final dividend of 15 pence per share for the year ended 31 December 2024 is proposed.

Required:

Prepare the statement of changes in equity for Gasparo Ltd for the year ended 31 December 2024.

35.3A On 31 January 2023, the equity section of the balance sheet of Depper plc was as follows:

	£
Share capital (300,000 ordinary shares of 10p each)	30,000
Share premium	92,000
General reserve	17,000
Retained earnings	249,000
<i>Total equity</i>	<u>388,000</u>

During the year ended 31 January 2024, the company:

- made a 1 for 6 bonus issue of shares, making use of the share premium account
- reported a final profit for the year, after tax, of £71,000
- paid dividends totalling £29,000
- made a transfer to general reserve of £3,000.

Required:

Prepare a statement of changes in equity for Depper plc for the year ended 31 January 2024.

35.4 You are required to answer the following four questions:

- (a) The balance of retained earnings in the balance sheets of Mankara Ltd as at 31 December 2023 and 31 December 2024 was £278,000 and £319,000, respectively. Total ordinary dividends paid during 2024 amounted to £33,000. What was the company's profit for the year ended 31 December 2024?
- (b) Wawrinka Ltd has a balance on its ordinary share capital account of £100,000, consisting of fully-paid ordinary shares with a par value of 10 pence each. The company also has 100,000 5% irredeemable preference shares with a par value of 50 pence each in issue. No dividends whatsoever have yet been paid in relation to the year ended 31 December 2024 but the directors wish to pay a dividend of 5 pence per ordinary share. What total dividend payment would be required to achieve this?
- (c) On 1 January 2024, Badara plc had an issued ordinary share capital of £160,000 (comprising 50p ordinary shares) and a balance on its share premium account of £690,000. On 16 January 2024, the company made a 1-for-4 bonus issue of ordinary shares, making use of the share premium account. What double entry records this bonus issue?
- (d) You are given the following information extracted from the financial statements of Iwobi plc:

	<i>Year ended</i> <i>31 May 2024</i>	<i>Year ended</i> <i>31 May 2023</i>
	£	£
<i>Balance sheet:</i>		
Corporation tax payable	154,000	143,000
<i>Income statement:</i>		
Corporation tax expense	167,000	149,000

What was the total corporation tax paid by this company during its year ended 31 May 2024?

35.5 On 1 June 2023, Debuque plc had £7.2m 4.5% loan notes in issue, interest being paid annually in two instalments on 31 August and 28 February. On 1 October 2023, the company then issued a further £2.2m 3.0% loan notes at par, interest being paid in two instalments on 31 March and 30 September each year. Finally, on 31 March 2024, Debuque plc redeemed £3m 4.5% loan notes at par, paying the interest due to that date.

On the basis of the above, what interest expense (or 'finance costs') should appear in the company's income statement for its year ended 31 May 2024?

35.6A As at 31 December 2023, Pointor plc had £400,000 6% loan notes in issue, interest being paid in two annual instalments on 31 March and 30 September each year. On 31 August 2024, the company then redeemed £300,000 of these loan notes at par, paying the interest due up to that date. Finally, on 31 October 2024, the company issued £300,000 5% loan notes at par. Interest on these loan notes is payable in two annual instalments on 30 April and 31 October each year.



**Required:**

- What interest expense (or 'finance costs') in connection with these loan notes will be included in the income statement of Pointor plc for its year ended 31 December 2024?
- What amount of accrued interest payable will be included as a current liability in its balance sheet as at 31 December 2024?

35.7A The equity section of the balance sheet of Halmera Ltd as at 31 March 2023 was as follows:

	£'000
Ordinary share capital (240,000 shares of 50p each)	120
Preference share capital (20,000 5% irredeemable preference shares of £1 each)	20
Share premium	59
Revaluation reserve	76
Retained earnings	<u>207</u>
Total equity	<u>482</u>

During the year ended 31 March 2024, the following events took place:

- A 1-for-3 rights issue of ordinary shares was made in May 2023 at a price of £1.80. The rights were taken up in full.
- A 1-for-5 bonus issue of ordinary shares was made in September 2023 using the share premium account.
- In December 2023, ordinary dividends totalling £23,000 were paid, and the preference dividend for the year ended 31 March 2024 was paid in full.
- In February 2024, the company's freehold land was appraised by professional valuers and valued at £250,000. The previous valuation (carried out two years ago) had valued the land at £190,000. The company uses the 'revaluation model' for freehold land in its financial statements.
- The final profit after tax reported in the income statement for the year ended 31 March 2024 was £57,000.

Required:

Prepare the statement of changes in equity for Halmera Ltd for the year ended 31 March 2024.

35.8A You are required to answer the following five questions:

- The share capital of Fogarino Ltd consists of 250,000 fully-paid ordinary (or 'equity') shares of 10 pence each, all of which were issued at a premium of 30 pence per share. The current market value of the company's shares is 95 pence each. What is the balance on the *share capital* account of this company?
- Heidinga Ltd reported a profit after tax of £2.8m for its financial year ended 31 October 2024. During the year, the company paid ordinary dividends of £1.1m and made a transfer to general reserve of £0.5m. If the closing balance of retained earnings at 31 October 2024 was £34.3m, what was the opening balance as at 1 November 2023?
- Ashwar Ltd issued 75,000 ordinary shares of 50p each at a price of £1.20 per share, fully paid. The debit entry to *cash at bank* was correctly recorded but the total amount received was credited to the *share capital* account. What double entry is required to correct this error?
- Sheldy plc has always recorded its freehold land at its historical cost of £115,000. The company has recently had its land valued by a professional firm of specialist valuers, and they have advised that the land is now worth £395,000. The directors propose to include this current valuation in the financial statements. What double entry would be required to record this?
- The following balances have been extracted from the balance sheet of Coleman plc as at 30 April 2022:

	£m
Share capital (ordinary shares of £1 each)	60
Share premium	145

During the year ended 30 April 2023, the following transactions took place:

- On 18 August 2022, there was a 1-for-3 bonus issue of ordinary shares, using the share premium account.
- On 24 February 2023, there was a 3-for-10 rights issue of ordinary shares at 250p per share, taken-up fully paid.

What are the balances on Coleman plc's share capital and share premium accounts as at 30 April 2023?

35.9 The equity section of the balance sheet of Skipe Ltd as at 31 July 2024 is as follows:

	£'000
Ordinary share capital (504,000 shares of 25p each)	126
Preference share capital (50,000 6% irredeemable preference shares of £1 each)	50
Share premium	73
General reserve	35
Retained earnings	<u>219</u>
<i>Total equity</i>	<u><u>503</u></u>

During the year ended 31 July 2024, the following events had taken place:

- (i) A 1-for-6 rights issue of ordinary shares had been made in September 2023 at a price of £1.05 per share. The rights had been taken up in full.
- (ii) A 1-for-5 bonus issue of ordinary shares had been made in November 2023 using the share premium account.
- (iii) In February 2024 ordinary dividends totalling £19,000 had been paid, and the preference dividend for the year ended 31 July 2024 had been paid in full.
- (iv) The final profit after tax, reported in the income statement for the year ended 31 July 2024, was £66,000.
- (v) The directors transferred £15,000 from retained earnings to general reserve.

Required:

Prepare the statement of changes in equity for Skipe Ltd for the year ended 31 July 2024.

The published financial statements of companies

Learning objectives

After you have studied this chapter you should be able to:

- Describe the main requirements of IAS 1 *Presentation of Financial Statements*.
- Identify what is contained in a complete set of the published financial statements of a company.
- Produce the income statement and balance sheet of a company in a form suitable for publication.
- Identify whether an event occurring after the balance sheet date but before the financial statements are finalised will require the figures in the income statement and balance sheet to be adjusted.
- Describe what a **provision** is and make the accounting entries when a provision is required.

Introduction

In this chapter, you'll learn about the contents and format of the set of financial statements that companies must publish each year. IAS 1 *Presentation of Financial Statements* doesn't specify exact layouts for the published income statement and balance sheet, but we'll introduce suggested formats that are in accordance with the guidance of IAS 1. We'll also take a look at two other accounting standards that are sometimes relevant at the introductory level: IAS 10 *Events after the Reporting Period* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

36.1 The importance of ensuring that all companies publish their financial statements following the same rules

In the previous chapter, we explained how companies are owned by their shareholders. The shareholders elect a team of directors to manage the company on their behalf. Each year, the directors are responsible for preparing a set of financial statements that are a faithful representation of the financial position and performance of the company. A copy of these financial statements is sent to every shareholder. The shareholders can then read the financial statements and judge how well their company is being managed.

Companies must also send a copy of their annual financial statements to a government agency (called 'Companies House' in the UK) and any member of the public is entitled to look at them. Therefore, existing and potential investors, lenders, suppliers, employees and other groups all have access to the published financial statements of companies, and these users may make significant economic decisions on the basis of what the statements reveal.

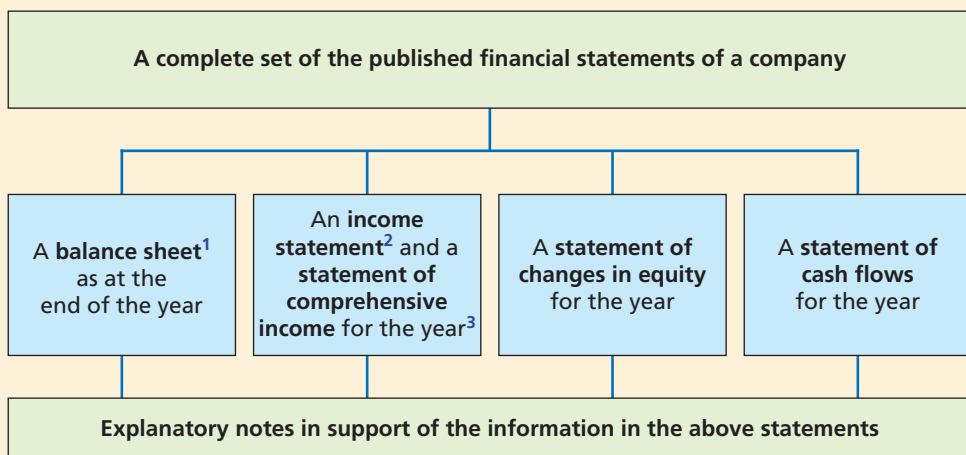
All of these various users of published financial statements need to be able to trust that the statements are a fair representation of the actual financial performance and position of the company. One of the best ways of helping to ensure this is to require that financial statements are produced in accordance with a generally accepted set of rules. Users also need to be able to compare the performance of the company against previous years, or against the performance of other businesses. This will also be much easier if all companies produce their financial statements each year in a similar format and follow the same rules.

The published financial statements of companies are therefore subject to a lot of rules (or ‘standards’) surrounding how they must be prepared and presented. One particularly important standard is IAS 1 *Presentation of Financial Statements*. IAS 1 describes the contents and format of a set of published company financial statements. We’ll begin this chapter by looking at the key points from that standard.

36.2 IAS 1 *Presentation of Financial Statements*

Exhibit 36.1 sets out what a complete set of published company financial statements contains according to IAS 1.

Exhibit 36.1 The contents of a set of published financial statements



¹ IAS 1 actually uses the name **statement of financial position** instead of **balance sheet**. The two names mean exactly the same thing and are interchangeable. However, the name **balance sheet** is far more widely used in practice, so we use that name throughout this book.

² IAS 1 actually uses the name **statement of profit or loss** instead of **income statement**. The two names mean exactly the same thing and are interchangeable. However, the name **income statement** is very commonly used in the UK and elsewhere, so we use that name throughout this book.

³ The **income statement** and **statement of comprehensive income** can be combined in one statement or split into two.

As you can see, Exhibit 36.1 shows that a set of published company financial statements is made up of four (or five!) statements plus a set of explanatory notes. In this book, we aren’t particularly concerned with either the statement of comprehensive income or the notes. We looked at the statement of changes in equity in the previous chapter, and we’ll cover the statement of cash flows in the next one. So, in this chapter, our main focus will be on the published **balance sheet** and **income statement** of a company.

36.3 The published balance sheet of a company

IAS 1 does not set rigid rules about precisely how the balance sheet must be presented. For example, companies may choose to present their balance sheet in either of the following orders:

- 1 Assets – Liabilities = Equity
- 2 Assets = Equity + Liabilities

Other orders are also permitted by IAS 1, although the two above are the most common in practice. For consistency, in this book we will always use the first one (Assets – Liabilities = Equity) because it is frequently used in the real world. It also reflects the definition of equity itself: equity (or ‘capital’) is effectively defined as being equal to total assets minus total liabilities, so there is a logic in presenting the balance sheet in this way.

In Exhibit 36.2, we show a suggested format for a published balance sheet that would be suitable for you to use at this stage in your studies. Real companies will typically have so many items to report that they will present their balance sheet in a slightly more summarised form than this. However, note that IAS 1 only gives *minimum* requirements for what needs to appear on the face of the balance sheet. Companies can always show more detail if they want.

If you look at sets of real company financial statements online (you should be able to find the financial statements of almost any well-known UK company with a simple Google search) you will find a reasonable amount of variation in the presentation of their balance sheets.

Exhibit 36.2 A suggested format for a company's published balance sheet

ExampleCo Ltd Balance Sheet as at 31 December 2024				
	Note	£	£	£
Non-current assets				
Property, plant and equipment	A.			549,000
Current assets				
Inventory			58,000	
Trade receivables	B.		114,000	
Prepayments	C.		17,000	
Cash at bank and in hand	D.		<u>9,000</u>	
				<u>198,000</u>
Total assets				<u>747,000</u>
Current liabilities				
Bank overdrafts		42,000		
Trade payables	E.	61,000		
Accruals	F.	13,000		
Corporation tax payable	G.	29,000		
Provisions	H.	<u>30,000</u>		
			175,000	
Non-current liabilities				
Long-term borrowing	I.		<u>168,000</u>	
Total liabilities				(343,000)
Net assets				<u>404,000</u>

ExampleCo Ltd
Balance Sheet as at 31 December 2024

<i>Equity</i>		
Ordinary share capital	J.	80,000
Irredeemable preference share capital	J.	20,000
Share premium	K.	101,000
Revaluation reserve	K.	37,000
General reserve	K.	22,000
Retained earnings	K.	144,000
Total equity		<u>404,000</u>

Notes:

- (A) The carrying amount (i.e. the cost minus accumulated depreciation) of all the company's tangible non-current assets will typically be shown as a single figure under the heading 'Property, plant and equipment'. The detail of the cost and accumulated depreciation for each separate class of non-current asset (such as land & buildings, plant & machinery, motor vehicles, and so on) will then be shown in the notes. Real companies will tend to present it this way. However, since IAS 1 only specifies a *minimum* level of presentation, it wouldn't be incorrect to show more detail on the face of the balance sheet, just as we did for sole proprietors and partnerships earlier in the book.
- (B) Trade receivables will normally be shown as a single figure, so the allowance for doubtful debts will not usually be shown separately on the face of the balance sheet. Additionally, many companies will also have amounts due from sources that are not customers, so this figure will often be described as 'Trade and other receivables'.
- (C) To keep their balance sheet to a manageable size, many companies will include the figure for prepayments within 'Trade and other receivables'. The breakdown will then be shown in the notes. However, at this stage in your studies, it is probably easier (and perfectly acceptable) to show prepayments as a separate item.
- (D) Real companies might instead use the heading 'Cash and cash equivalents' because they might hold some cash in the form of very short-term investments rather than just in regular bank accounts. 'Cash at bank and in hand' (i.e. positive bank balances plus any petty cash) will normally be an acceptable heading for our purposes.
- (E) Most real companies will also owe money to businesses that are not suppliers, so they will often use the heading 'Trade and other payables' here.
- (F) Real companies are likely to include accruals within the figure for 'Trade and other payables'. The breakdown will be shown in the notes. However, at this stage in your studies, it is probably easier (and perfectly acceptable) to show accruals as a separate item.
- (G) The amount of corporation tax owed by the company to the tax authorities as at the end of the year is shown separately as a current liability.
- (H) *Provisions* are liabilities over which there is significant uncertainty about the amount that will have to be paid and when. You haven't seen provisions in this book yet, but we'll look at them later in this chapter.
- (I) Real companies are likely to have more than one source of long-term borrowings: bank loans, loan notes in issue, and amounts owed in relation to assets that the company is leasing, for example. The breakdown of these various borrowings will be shown in the notes.
- (J) Remember that the figure on the balance sheet for share capital is the called-up share capital. IAS 1 requires various details to be disclosed in relation to the different classes of share capital, the par value per share and the number of shares issued, fully paid and partly paid. These details will normally be found in the notes; it would be unusual to show them on the face of the balance sheet.
- Recall also that only *irredeemable* preference shares will be shown in the equity section; *redeemable* preference shares will be shown as a liability.
- (K) Real companies are likely to have more than just these particular four components of equity (or 'reserves'). However, these are the only four you will come across in this book.

Finally, remember that real companies will summarise all the changes in each component of equity during the year just ended in a *statement of changes in equity*. Because this detail will be provided in a separate statement, the equity section of a real company balance sheet is often more summarised than the format suggested here.

**Activity
36.1**

At the end of its most recent financial year, a company reports non-current liabilities of £107m, non-current assets of £184m, total equity of £121m, and current assets of £93m. What were its current liabilities?

36.4 The published income statement of a company

Under IAS 1, the income statement can be presented as a separate statement or it can be combined together with any items of 'other comprehensive income'. We are not particularly concerned with 'other comprehensive income' in this book, so we will mainly consider the format of a company's published income statement on its own.

As with the balance sheet, IAS 1 does not lay down rigid rules about precisely how the income statement must be presented. It specifies the minimum information that must be shown, and each company then has a certain amount of flexibility to adopt the presentation that suits them best.

The income statement of a company is fundamentally the same, in principle, as that of a sole proprietor. In other words, it starts with the business's main source of income, deducts the cost of the goods or services that were sold, then deducts the various running costs of the business. Two key differences for the published income statement of a company are:

- Much less detail will be given about the nature of the various expenses on the face of the income statement. Real companies will incur a huge range of different expenses, and if each one was listed separately, then the statement would be far too long.
- You'll see some new subtotals on the face of a company income statement that are not used by sole proprietors and partnerships.

A suggested format for a published income statement of a company that would be suitable at this stage in your studies is presented in Exhibit 36.3.

Exhibit 36.3 A suggested format for a company's published income statement

ExampleCo Ltd
Income Statement for the year ended 31 December 2024

	See note	£
Sales revenue	A.	970,000
Cost of sales	B.	(560,000)
<i>Gross profit</i>		410,000
Other operating income	C.	23,000
Operating expenses	D.	(317,000)
<i>Operating profit</i>	E.	116,000
Investment income	F.	5,000
Finance costs	G.	(11,000)
<i>Profit before tax</i>	H.	110,000
Corporation tax expense	I.	(26,000)
<i>Profit for the year</i>	J.	<u>84,000</u>

Notes:

- (A) In sole proprietor and partnership income statements, we tended to just call this figure 'sales'. IAS 1 prefers the word 'revenue', and most real companies will call it 'revenue' rather than 'sales revenue'.

- (B) In sole proprietor and partnership income statements, we tended to call this figure 'cost of goods sold'. IAS 1 prefers the phrase '**cost of sales**'. The two terms essentially mean the same thing, and you will certainly calculate them in the same way. However, in the interest of avoiding clutter, the *calculation* of cost of sales is not shown on the face of the published income statement.
- (C) Other operating income will include any sources of income that are secondary to the business's sales revenue. This might typically include things like:
- rent received;
 - royalties received; and
 - profit on the disposal of non-current assets.

However, note that if the value of 'other income' is very small (i.e. if it is 'immaterial'), then it may instead be included as a 'negative expense' within the operating expenses figure. IAS 1 explains that immaterial items do not have to be listed separately in the financial statements.

- (D) The operating expenses of the company will be quite similar to those of a sole proprietor or partnership: wages & salaries, advertising, rent, depreciation and so on. However, this breakdown will not be shown on the face of the published income statement. Instead, details of the nature of the expenses will be given in the notes.

Some companies split the figure for operating expenses into two rows on the face of their income statement: *distribution costs* and *administrative expenses*. This is suggested by IAS 1 as a possible classification, but it is not essential. In any case, decisions regarding what percentage of a particular expense should be classed as distribution costs and how much as administrative expenses are often rather arbitrary. And, at this stage of your studies, splitting the operating expenses into two creates a lot of mechanical work that distracts students from more important matters, while not even being required by IAS 1!

In this book, therefore, we will just show one figure for operating expenses. If a question does ask you to split the operating expenses into two, then you should do so; the question will instruct you on how the expenses are to be apportioned between 'distribution' and 'administrative'.

- (E) The subtotal of *operating profit* is not currently a requirement of IAS 1. However, it is extremely common for companies to use this term to indicate the profit that the business has made from its normal operations. In fact, it is used so widely that the IASB are planning to introduce guidance to define precisely how the *operating profit* subtotal must be calculated.
- (F) *Investment income* will include any interest earned or dividends received by the company during the year. Under IAS 1, investment income does not have to be disclosed separately on the face of the income statement. It could, instead, simply be included within the figure for 'other income'. However, given that most companies will draw a subtotal for operating profit, it is logical that investment income will be shown separately. The term 'finance income' would also be acceptable.
- (G) *Finance costs* must be disclosed separately on the face of the income statement. The figure will include interest incurred on bank loans, overdrafts, loan notes and other borrowings. The term 'finance costs' is often used because it may also include similar costs that are not technically interest charges: dividends paid on *redeemable* preference shares, for example.
- (H) The *profit before tax* subtotal is self-explanatory. In sole proprietor and partnership income statements the tax charge on profits is not shown, so this subtotal is unique to company income statements.
- (I) The *corporation tax expense* is essentially the estimated tax charge on this year's profit. Questions will normally tell you what this tax charge is, and you won't have to calculate it.
- (J) The income statement ends with the profit for the year (or profit for the period, in the rare event that the period covered is not 12 months).

Note that ordinary dividends paid never appear anywhere in a company's income statement: ordinary dividends are paid out of profits, and therefore cannot form part of the *calculation* of those profits. Dividends paid on ordinary shares (and on irredeemable preference shares) will instead be shown in the statement of changes in equity.

**Activity
36.2**

A company reports a profit for the year of £120m after incurring finance costs of £26m and a corporation tax expense of £44m. The company did not receive any interest or dividends during the year. What was the company's *operating profit* and its *profit before tax*?

36.5 Other comprehensive income

Items of 'other comprehensive income' can either be added at the bottom of the income statement to create a single 'statement of comprehensive income', or they can be shown in a separate statement. 'Other comprehensive income' is essentially other gains and losses that the company has recognised during the year but which are not included in the income statement itself.

At this stage in your studies, you won't have come across many such items. In fact, the only one you'll see in this book is the gain that arises when a company revalues its land and buildings upwards to current market value. Such a gain is said to be *unrealised* because the land and buildings have not yet been sold; no profit has yet been made. It is therefore not included in the income statement, but instead will be shown as an item of other comprehensive income.

If the company chooses to show its other comprehensive income in a separate statement, then it will start with the profit for the year (the final figure in the income statement) and will then list its various other gains and losses underneath, ultimately arriving at the total comprehensive income for the year. A simple example of this is shown in Exhibit 36.4.

Exhibit 36.4 A separate statement of comprehensive income

ExampleCo Ltd Statement of Comprehensive Income for the year ended 31 December 2024	
	£
Profit for the year	84,000
<i>Other comprehensive income:</i>	
Gain on property revaluation	21,000
Total comprehensive income for the year	<u>105,000</u>

Given that only one possible item of other comprehensive income appears in this book, we won't look at any further examples.

36.6 The notes to the financial statements

IAS 1 makes clear that a complete set of financial statements must include fairly detailed explanatory notes. These notes should provide, among other things:

- a summary of the specific accounting policies that the company has used
- additional details needed to help the reader understand the figures shown in the balance sheet, income statement, statement of changes in equity and statement of cash flows

- further information about matters that are not reflected in the four statements. This could include quite a wide range of things, but one example is proposed dividends. As we explained in the previous chapter, the proposed (i.e. planned) final ordinary dividend for the year is not included as a liability in the balance sheet, but it *will* be disclosed in the notes.

As you might imagine, the notes to the financial statements of real companies tend to be quite lengthy, often occupying dozens of pages.

Activity 36.3

Notes to the financial statements are required by IAS 1, and almost every accounting standard specifies exactly what information various notes should contain. Why do you think the notes are so important? Why don't accounting standards just focus on the information that must be included on the face of the financial statements?

36.7 Other important guidance contained in IAS 1

IAS 1 contains other important guidance in relation to published financial statements, including the following six points:

- 1 **The reporting period will normally be one year:** IAS 1 states that the financial statements will normally be produced annually; reporting periods of more or less than 12 months should be quite rare.
- 2 **Essential information must be shown at the top of every financial statement:** The name of the company, the name of the particular financial statement, the date/period covered, the currency, and the level of rounding (i.e. £ or £'000 or £m) should be displayed prominently at the top of each financial statement.
- 3 **Comparative information must be provided:** For every item in a set of financial statements (whether on the face of the statements or in the notes), the corresponding figure for the previous year must be shown. In other words, the published financial statements of companies will essentially show two columns of figures throughout: one for this year, and one for last year. This is a simple way of making it easier for users to compare this year's performance with last year.
- 4 **Each item on the face of the financial statements should be cross-referenced to the relevant note, and the notes should be organised in a logical sequence:** this should make it easier for users to find the specific note that will give them more information about a particular item in the financial statements.
- 5 **Five key accounting concepts are reinforced:** IAS 1 specifically refers to five accounting concepts, which further emphasises their importance: the going concern assumption, the accrual basis, consistency, materiality, and the 'no offsetting' principle. You can read more about these concepts in Chapter 10.
- 6 **Certain additional information published together with the financial statements is not covered by IAS 1:** Companies will often publish their financial statements as part of an 'Annual Report' that includes a range of other information, such as management's review of the year, or coverage of the company's work in helping the community or the environment. IAS 1 explains that such additional information falls outside the scope of IASB standards.

Activity 36.4

Of the six pieces of additional guidance listed above, which one is virtually *guaranteed* to be directly relevant to your answers *every time* you take a financial accounting exam?

36.8 Company financial statements for 'internal use' and 'external use'

In this chapter, our main focus is on the *published* financial statements of companies. We've explained that company financial statements must be published so that people outside the company can access them; and, to protect these users, there are many rules about how financial statements must be prepared and presented. Published financial statements are therefore sometimes described as being for **external use**. If a question asks you to prepare a company income statement or balance sheet for external use, then you should aim to present it in a fashion similar to the suggested formats given in this chapter.

Of course, a company may also prepare an income statement and balance sheet for its own, **internal use**. If so, the company is free to produce them in whatever format it chooses. It doesn't have to follow any rules. If you are asked to produce an income statement and balance sheet for 'internal use', then this is commonly taken to mean a less summarised format: for example, the individual expenses (wages, rent, advertising and so on) would be listed separately on the face of the income statement.

Generally speaking, the 'published' or 'external use' format is more important, and this is reflected in most of the Review questions at the end of this chapter. However, there are also a few Review questions that ask for an 'internal use' format. If you practise both types of question, you will find that the differences are quite cosmetic and the issue should not cause major difficulty.

36.9 Two other relevant accounting standards: IAS 10 and IAS 37

So far, in this chapter, we've looked quite closely at IAS 1 *Presentation of Financial Statements*. In addition to IAS 1, a considerable number of other accounting standards will have an impact on many of the figures in a real company's balance sheet and income statement. If you take your accounting studies to the next level, you will look in detail at many more of these standards. At the introductory stage, there are two standards that you haven't yet looked at in this book but which may sometimes become relevant:

- IAS 10 *Events after the Reporting Period*
- IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

We'll discuss some key points from these two standards in the next two sections.

36.10 IAS 10 *Events after the Reporting Period*

The financial statements are supposed to faithfully represent the financial position and performance of the business for the reporting period. However, it will normally take several weeks (or often longer) to finalise and publish the company's annual financial statements. This means that significant events could occur between the balance sheet date and the date on which the financial statements are finalised. If so, such events may need to be disclosed in the notes, and sometimes the figures in the financial statements will need to be changed.

Events after the reporting period can therefore be divided into two categories:

- 1 **Adjusting events:** these are events that provide more evidence of conditions that existed as at the balance sheet date. Figures in the financial statements will need to be adjusted to reflect this new evidence.
- 2 **Non-adjusting events:** these are events that do not alter the conditions that existed as at the balance sheet date. The figures in the financial statements are therefore not changed as a result of these events. However, if the effect of an event on the company is significant, then it should be disclosed in the notes. The nature of the event and an estimate of its possible financial effect should be given.

The table in Exhibit 36.5 gives some examples of events that could occur after the reporting period has ended and whether they would be classed as adjusting or non-adjusting. Note that all five events occur after the reporting period has ended but only three give evidence of conditions that existed at the balance sheet date, so only these three are adjusting events.

Exhibit 36.5 Adjusting and non-adjusting events after the reporting period

Event occurring after the balance sheet date but before the financial statements are finalised many weeks later	Adjusting or non-adjusting?
A customer who owed money to the company as at the balance sheet date is declared bankrupt	<i>Adjusting:</i> Financial problems do not tend to occur overnight, so the usual assumption would be that the customer must already have been in some difficulty as at the year end. The event therefore indicates that the amount receivable from this customer as at the balance sheet date was uncollectable and must be written off in the financial statements.
The company makes a major new issue of shares	<i>Non-adjusting:</i> the new shares did not exist as at the end of the reporting period, so the figures in the year-end balance sheet will not be changed. However, details of the share issue would be disclosed in the notes.
Certain items of inventory included in the balance sheet at their original cost price are sold for less than this	<i>Adjusting:</i> Inventory does not tend to suddenly deteriorate overnight, so the usual assumption would be that the net realisable value (NRV) of these items as at the balance sheet date was less than cost. The value of these items of inventory in the financial statements must be reduced (or 'written down') accordingly.
One of the company's factories is destroyed by a fire	<i>Non-adjusting:</i> the fire happened after the end of the reporting period, so the condition of the factory as at the balance sheet date could not be said to be affected by the fire. However, the details of the fire and its potential impact on the business should be disclosed in the notes.
A fraud is uncovered, and it is found that trade receivables in the year-end balance sheet were overstated as a result	<i>Adjusting:</i> The discovery of the fraud provides new evidence of the conditions that existed as at the year end, so the figure for trade receivables in the balance sheet will need to be adjusted.

Finally, note that any event occurring after the balance sheet date will be an **adjusting event** if it casts doubt over whether the company is going to be able to continue trading. This would mean that the **going concern** assumption would no longer apply and various adjustments to the financial statements would be needed.

For example, in Exhibit 36.5, the destruction of one of the company's factories after the end of the year was a non-adjusting event, but if it meant that the whole company might have to close down, then the going concern assumption would cease to apply. We looked briefly at some of the adjustments that are required when a business is no longer a going concern in Chapter 10.

**Activity
36.5**

The three events below occurred between the balance sheet date and the date on which the financial statements were authorised for issue. Which of them would be adjusting events under IAS 10?

- (i) A company makes a major purchase of some new equipment costing £200,000.
- (ii) A long-running court case is settled, with the company being required to pay £150,000 in damages.
- (iii) A company announces a plan to stop making one of its most profitable products.

36.11 IAS 37 Provisions, contingent liabilities and contingent assets

A company might find that there is a high degree of uncertainty in relation to a particular situation, and it may be difficult to judge how the possible financial outcome should be reflected in the financial statements. Most obviously, for example, a company could be involved in an ongoing legal case. The company might win or lose the case, with significant financial consequences one way or the other. IAS 37 gives guidance on the accounting treatment where there is significant doubt and uncertainty over future events.

Provisions

A **provision** is a type of liability. But provisions differ from other liabilities because of the existence of significant uncertainty over the *amount* that the company will have to pay and *when* it will have to be paid. With liabilities such as trade payables, accruals and bank loans, the company will be fairly certain about how much will have to be paid and when. In contrast, provisions will require a significant degree of judgement and estimation.

IAS 37 states that provisions must be recognised in the financial statements when:

- a potential liability exists as a result of events that have already happened;
- payment is probable (i.e. more than 50% likely); and
- a reliable estimate of the amount can be made.

Accounting for provisions

When a company decides that a provision is required in the financial statements (let's say as at the end of Year 1), the expected cost is charged to the income statement and the liability is recorded in the balance sheet:

Debit Expenses (an income statement account)	£x	
Credit Provision (a balance sheet account)		£x

During Year 2, the company might start to make the payments in connection with the matter that has been provided for. The liability will therefore logically reduce:

Debit Provision (a balance sheet account)	£x	
Credit Cash at bank		£x

At the end of Year 2, the company will review the situation. If the actual payments turned out to be less than the original provision and no further liability is estimated to exist, then the excess provision can be eliminated and credited to the income statement:

Debit Provision (a balance sheet account)	£x	
Credit Expenses (an income statement account)		£x

On the other hand, if the matter is resolved but the actual payments turned out to be more than the original provision, then the excess will need to be debited to the income statement as additional expense in Year 2. Exhibit 36.6 gives an example of accounting for a provision.

Exhibit 36.6 A worked example of accounting for a provision

During its year ended 31 December 2023, XHJ Ltd is sued by a customer for damages. As at the year end, the lawyers of XHJ Ltd believe that the customer has a 75% chance of winning the case, which would mean that XHJ Ltd would have to pay £300,000, probably within the next 12 months.

Solution:

The liability is uncertain but is probable (i.e. over 50% likely). In the financial statements for the year ended 31 December 2023, a provision is therefore required:

Debit Legal damages expense	£300,000	
Credit Provision (a current liability)		£300,000

We can then consider two possible scenarios:

Scenario 1:

In October 2024, the case is settled, with XHJ Ltd paying the customer £375,000. There is no further liability. The double entry during the year ended 31 December 2024 will be:

Debit Provision	£300,000	
Debit Legal damages expense	£75,000	
Credit Cash at bank		£375,000

Scenario 2:

In October 2024, the case is settled, with XHJ Ltd paying the customer £210,000. There is no further liability. The double entry during the year ended 31 December 2024 will be:

Debit Provision	£300,000	
Credit Cash at bank		£210,000
Credit Legal damages expense		£90,000

Activity 36.6

A company's financial year ends on 31 July each year. As at 31 July 2023, the company had a provision of £30,000 in its balance sheet in relation to an ongoing court case. In April 2024, the case was settled at a cost of £34,000. What expense will be included in the company's income statement for the year ended 31 July 2024 in connection with the court case?

Of course, in the real world, uncertain issues (such as legal cases) can drag on for several years, so a particular provision may need to be adjusted up or down from one year to the next depending on the current best estimate of the likely liability. An adjustment to increase a provision implies an extra cost in the income statement, while an adjustment to reduce a provision results in a credit to the income statement.

A common example of where a company might require an ongoing provision for the same issue year after year is when it offers a warranty (i.e. a guarantee) on its products.

For example, a company might promise to fix any faults in any of the products it sells within 12 months of sale. In this situation, it is clear that a liability exists, because some customers who have bought goods are certain to claim under the warranty. And, under the **accrual basis**, the costs of repairing goods sold under warranty this year should be matched with the sales income of this year. But the number of claims, and how much each fault will cost to repair, is uncertain. Analysing the best available evidence, the company will have to estimate the expected cost of meeting warranty claims.

When the company sets up the warranty provision for the first time, the expected cost of future claims in connection with goods sold to date will be charged as an expense:

Debit Repairs under warranty expense	£x
Credit Provision (a current liability)	£x

At the end of each subsequent year, the company will perform an up-to-date analysis of the expected value of future warranty claims in respect of the products it has sold and adjust the balance on the provision account accordingly. If the provision required is *greater* than the existing balance on the provision account, then the amount of the increase will be entered as follows:

Debit Repairs under warranty expense	£x
Credit Provision	£x

But if the provision required is *less* than the existing balance on the provision account, then the amount of the decrease will be entered as follows:

Debit Provision	£x
Credit Repairs under warranty expense	£x

Activity 36.7

A company sells goods with a 12-month warranty. Its balance sheet as at 31 March 2023 included a provision of £41,000 for warranty claims. During the year ended 31 March 2024, the company actually spent £36,000 in repairing or replacing goods under warranty. As at 31 March 2024, the company estimates that further warranty claims would be made against 3% of goods sold to date and that the expected cost of these claims would amount to £52,000. What will be the charge in the income statement for the year ended 31 March 2024 in relation to warranty claims?

Contingent assets and liabilities

The exact definition of a contingent liability under IAS 37 isn't entirely straightforward. But for our purposes, a **contingent liability** is a term that is effectively used to describe a potential liability arising from events that have already happened where there is significant uncertainty and where the probability of payment is less than 50%. These possible liabilities will not be included in the income statement or balance sheet. Instead, they will (if material) be disclosed in the notes.

Of course, if the probability of payment associated with the uncertain liability is believed to be greater than 50%, then it would be included in the financial statements as a provision, as we discussed earlier. On the other hand, if the probability of payment is extremely low (such as only 5% likely), then it will not be included anywhere at all in the financial statements.

Activity 36.8

A company supplies chicken to a range of hotels and restaurants. Before the company's year end, there is an outbreak of food poisoning at one of these hotels and the hotel takes legal action against the company as a result. A team of legal experts agree that if the company loses the case, then it will have to pay £250,000. How will this information be reflected in the company's financial statements if the legal experts believe the chances of losing the case are:

- (i) 80%;
- (ii) 30%; or
- (iii) 3%?

A **contingent asset** is a possible asset arising from events that have already happened but whose existence will only be confirmed by the outcome of uncertain future events.

An example would be an ongoing legal case that the company might win. Under the **prudence** concept, contingent assets are treated more cautiously than contingent liabilities. They are not included in the balance sheet even if the uncertain future events are believed to be (say) 75% likely in the company's favour. Such an asset would only be disclosed in the notes. And if the probability is less than 50%, then the contingent asset would not appear anywhere at all in the financial statements.

36.12 Preparing the income statement and balance sheet for a company

At the introductory level, it is common for questions to give you a company's trial balance followed by a series of adjustments. From this information, you are then often asked to prepare the income statement and balance sheet. Occasionally an 'internal use' format might be acceptable, but the published (or 'external use') formats that we have seen in this chapter are more frequently required.

This remains a common style of question at the next level too, albeit you will be expected to deal with a wider range of more complex adjustments.

Practising the Review questions at the end of this chapter is therefore especially important, in terms of both getting used to the IAS 1 published formats and familiarising yourself with the range of different adjustments that you may come across at this level.

Learning outcomes

You should now have learnt:

- 1 That IAS 1 *Presentation of Financial Statements* is a key source of guidance in relation to the structure and contents of a complete set of published financial statements.
- 2 That the format of the published balance sheet of a company is typically more summarised than that of a sole proprietor.
- 3 A suggested format for the published balance sheet of a company that is in accordance with the requirements of IAS 1.
- 4 That the format of the published income statement of a company is more summarised and contains certain additional subheadings compared to that of a sole proprietor.
- 5 A suggested format for the published income statement of a company that is in accordance with the requirements of IAS 1.
- 6 That a company's published financial statements must be accompanied by a set of detailed notes which provide users with additional relevant information.
- 7 That income statements and balance sheets prepared for 'internal use' do not have to comply with the requirements of IAS 1, and generally contain more detail than those produced for 'external use'.
- 8 That certain events occurring after the reporting period has ended but before the financial statements are finalised may sometimes provide evidence that figures in the income statement or balance sheet need to be adjusted.
- 9 How to distinguish between events that occur after the balance sheet date that will require the financial statements to be adjusted and those that won't.
- 10 That a provision is a liability where there is significant uncertainty over how much will have to be paid and when.
- 11 The key principles involved in accounting for provisions.

Answers to activities

36.1 You know that assets minus liabilities must always equal equity, so $£184\text{m} + £93\text{m} - ? - £107\text{m} = £121\text{m}$. Current liabilities (the missing figure) must therefore be £49m.

36.2 The *operating profit* and *profit before tax* can be deduced as the missing figures in the calculation below:

	£m
Operating profit (<i>second missing figure deduced</i>)	190
Finance costs (<i>given in question</i>)	(26)
Profit before tax (<i>first missing figure deduced</i>)	164
Corporation tax expense (<i>given in question</i>)	(44)
Profit for the year (<i>given in question</i>)	<u>120</u>

36.3 As you have seen, the formats of the published income statement and balance sheet of a company are more summarised than the formats we used for sole proprietors and partnerships. Because of this, users will need more detail than just the figures on the face of the statements to get a full picture of the financial affairs of the company.

Moreover, companies are often large and complex organisations and the statements alone (even if they weren't so summarised) couldn't tell users everything they need to know about the company to be able to make informed economic decisions. Many of the notes will expand significantly upon the figures shown on the face of the statements.

Finally, it is essential that accounting standards specify exactly what must be disclosed in the notes, otherwise some companies might leave out certain information in an attempt to present themselves in the most favourable possible light.

At this stage in your learning, we will not be too concerned with the contents of the notes, but they will certainly begin to feature more prominently as your studies progress.

36.4 Whenever you sit a financial accounting exam, you will need to make sure you follow the guidance of IAS 1 in showing the essential information at the top of every financial statement you produce: the name of the business, the name of the statement, the date/period covered, the currency, and the level of rounding (i.e. £ or £'000 or £m). If you don't do this, you will usually miss out on some 'easy' presentation marks.

On the subject of the level of rounding, it is usually a good idea to present your answer in the same units as those given in the question. For example, if a question gives you a trial balance with the figures in £'000, it would be safest to produce your income statement and balance sheet in £'000. Students who decide to present their answers in £ or £m are simply increasing their potential to make errors.

36.5 Event (ii) is adjusting: the financial outcome of the case is now known and the liability that existed as at the balance sheet date can now be recorded accurately. (Liabilities that could exist as a result of ongoing court cases is a topic closely linked with the next standard (IAS 37) that we look at in this chapter. If a court case is not settled before the financial statements are finalised, then any potential liability must be estimated, and this will be known as a *provision*.)

Events (i) and (iii) are non-adjusting: they do not impact the conditions that existed as at the balance sheet date. However, they are both potentially significant events that users of the financial statements may need to be aware of, so they may need to be disclosed in the notes.

36.6 The answer is £4,000. £30,000 of the total cost has already been provided for (i.e. the double entry Dr Lawsuit expense £30,000, Cr Provision £30,000 had already been recorded.) The expense recognised in the year ended 31 July 2024 is the excess of £4,000 that has not yet been accounted for.

36.7 The answer is £47,000, which can be calculated using a T account as follows:

Warranty provision			
Cash at bank	36,000	Opening balance	41,000
Closing balance	52,000	Expense for the year (<i>balancing figure</i>)	47,000
	<u>88,000</u>		<u>88,000</u>

In other words, the warranty repairs expense this year is equal to the expected cost of claims in relation to goods sold this year (£52,000) minus the £5,000 over-provision from the previous year (£41,000 previously provided – £36,000 actual costs).

- 36.8** (i) If the chance of losing the case is believed to be 80%, then payment is probable and a *provision* for £250,000 will be required in the balance sheet.
- (ii) 30% is obviously less than 50%, so it would be described as a *contingent liability* and would not be included in the balance sheet. It would merely be disclosed in the notes to the financial statements.
- (iii) A probability of only 3% is so remote that the case wouldn't be disclosed anywhere at all in the financial statements.

Review questions

36.1 You are given the following information for Rinchi Ltd in relation to its financial year ended 31 May 2024:

Trial balance as at 31 May 2024:	Dr £	Cr £
Trade receivables	93,600	
Business rates	19,987	
Trade payables		51,463
Carriage inwards	2,015	
Dividends paid	14,720	
Inventory as at 1 June 2023	18,543	
Gas	19,914	
Sundry operating expenses	77,904	
Sales		556,456
Plant & equipment	397,140	
IT equipment	276,120	
Plant & equipment: accumulated depreciation at 1 June 2023		94,500
IT equipment: accumulated depreciation at 1 June 2023		70,440
Purchases	228,147	
Cash at bank	357	
3% loan notes 2030–2032		97,000
Loan note interest paid	1,455	
Bad debt expense	11,062	
Allowance for doubtful debts at 1 June 2023		1,885
Ordinary shares of 10p each		133,000
Retained earnings at 1 June 2023		156,220
	<u>1,160,964</u>	<u>1,160,964</u>

Further information:

- (i) The company's inventory was counted on 31 May 2024 and was valued at a cost of £19,994.
- (ii) Depreciation is to be charged at the following rates per annum:
- | | | |
|-------------------|--------------------|-----|
| Plant & equipment | (straight line) | 20% |
| IT equipment | (reducing balance) | 35% |
- (iii) The amount shown for business rates on the trial balance includes a payment of £11,340 which represents twelve months' rates to 30 September 2024.
- (iv) Gas charges incurred before the end of the financial year for which no invoices have yet been received amount to a total of £3,956.
- (v) Following a detailed analysis of the company's experience with collections from credit customers, the allowance for doubtful debts is to be set at 3% of trade receivables.
- (vi) The loan note interest is paid in two annual instalments and the second instalment needs to be provided for.
- (vii) The corporation tax charge on the profit for the year is estimated to be £10,000.

**Required**

Prepare an income statement for Rinchi Ltd for the year ended 31 May 2024 and a balance sheet as at that date:

- (a) for internal use; and
- (b) in a form suitable for publication (or 'external use').

36.2A The following details concern Oshada plc in connection with its financial year ended 31 March 2024:

Trial balance as at 31 March 2024:	Debit £	Credit £
4% loan notes 2034-2036		57,000
Allowance for doubtful debts at 1 April 2023		4,393
Bad debt expense	26,110	
Carriage inwards	1,960	
Cash at bank	2,091	
Directors' remuneration	26,085	
Dividends paid	18,060	
Electricity	22,256	
General operating expenses	85,200	
Inventory as at 1 April 2023	37,045	
Loan note interest paid	1,140	
Machinery	467,460	
Machinery: accumulated depreciation at 1 April 2023		97,920
Motor vehicles	281,580	
Motor vehicles: accumulated depreciation at 1 April 2023		65,940
Ordinary share capital		88,000
Purchases	371,781	
Insurance	25,003	
Retained earnings at 1 April 2023		251,102
Sales		774,544
Share premium account		59,000
Trade payables		55,472
Trade receivables	87,600	
	<u>1,453,371</u>	<u>1,453,371</u>

Note the following additional information:

- (i) Inventory at the year end was counted and valued at a cost of £38,319.
- (ii) Depreciation is to be charged at the following annual rates:

Machinery	(reducing balance)	25%
Motor vehicles	(straight line)	25%

- (iii) The amount shown for insurance on the trial balance includes a payment of £10,020, which represents twelve months' insurance to 31 January 2025.
- (iv) The cost of electricity used before the end of the financial year for which no invoices have yet been received amounts to a total of £6,805.
- (v) On the basis of a thorough analysis of the company's experience with credit sales, the allowance for doubtful debts is to be revised to 6% of trade receivables.
- (vi) Interest on the loan notes is paid in two instalments each year, and the second instalment has not yet been paid.
- (vii) The corporation tax charge on this year's profit is estimated to be £12,000.

Required:

Produce an income statement for Oshada plc for its year ended 31 March 2024 and a balance sheet as at that date, in both:

- (a) an 'internal use' format; and
- (b) an 'external use' format (i.e. suitable for publication).

36.3 The following details concern Nartje Ltd in relation to its financial year ended 31 May 2024:

Trial balance as at 31 May 2024:	Dr £	Cr £
Trade receivables	80,400	
Business rates	20,383	
Sales		504,079
Carriage inwards	2,171	
Dividends paid	19,140	
Inventory as at 1 June 2023	16,955	
Electricity	25,142	
General operating expenses	70,571	
Trade payables		76,049
Equipment at cost	378,780	
Delivery vans at cost	276,960	
Equipment: accumulated depreciation at 1 June 2023		92,280
Delivery vans: accumulated depreciation at 1 June 2023		61,980
Purchases	211,713	
Cash at bank	1,680	
6% loan notes 2028–2029		73,000
Loan note interest paid	2,190	
Bad debt expense	14,302	
Allowance for doubtful debts at 1 June 2023		2,425
Ordinary shares of 10p each		58,000
Retained earnings at 1 June 2023		252,574
	<u>1,120,387</u>	<u>1,120,387</u>

Additional information:

- (i) The company's inventory was counted on 31 May 2024 and was valued at a cost of £17,300.
- (ii) Depreciation is to be charged at the following annual rates:

Equipment:	15%	reducing balance
Delivery vans:	20%	straight line

- (iii) The amount shown for business rates on the trial balance includes a payment of £8,100, which represents twelve months' business rates to 31 January 2025.
- (iv) The cost of electricity used for which no invoices have yet been received amounts to £6,512.
- (v) Based on a careful analysis of the company's experience with its credit customers, the allowance for doubtful debts is to be set at 4% of trade receivables.
- (vi) The loan note interest is paid in two annual instalments and the second instalment needs to be provided for.
- (vii) The corporation tax charge on the profit for the year is estimated to be £12,000.

Required:

In a form suitable for publication, prepare an income statement for Nartje Ltd for the year ended 31 May 2024 and a balance sheet as at that date.



→ **36.4A** The following information regarding Mashra Ltd relates to its year ended 30 June 2024:

Trial balance as at 30 June 2024:

	£	£
Trade receivables	90,000	
Business rates	24,953	
Sales		886,093
Returns outwards		1,302
Dividends paid	43,560	
Inventory as at 1 July 2023	41,655	
Utilities	23,786	
Sundry operating expenses	97,470	
Trade payables		71,872
Plant & equipment at cost	514,440	
Plant & equipment: accumulated depreciation at 1 July 2023		106,380
IT equipment at cost	250,260	
IT equipment: accumulated depreciation at 1 July 2023		66,060
Allowance for doubtful debts at 1 July 2023		3,613
Purchases	416,464	
Cash at bank	2,208	
4% loan notes 2027–2029		87,000
Ordinary share capital		79,000
Share premium		86,000
Loan note interest paid	1,740	
Retained earnings at 1 July 2023		174,679
General reserve		32,200
Bad debt expense	21,430	
Licensing fees received		4,657
Directors' remuneration	70,890	
	<u>1,598,856</u>	<u>1,598,856</u>

Additional information:

- (i) The inventory was counted at 30 June 2024 and was valued at a cost of £44,767.
- (ii) Depreciation is to be charged at the following annual rates:

Plant & equipment	(straight line)	10%
IT equipment	(reducing balance)	30%
- (iii) The amount shown for business rates on the trial balance includes a payment of £9,240, which represents twelve months' rates to 30 September 2024.
- (iv) Utilities charges incurred before the year end for which no invoices have yet been received amount to a total of £6,203.
- (v) After a detailed review of collections from credit customers, it has been determined that the allowance for doubtful debts is to be changed to 3% of trade receivables.
- (vi) The loan note interest is paid in two annual instalments and the second instalment needs to be provided for.
- (vii) The corporation tax charge on the profit for the year is estimated to be £28,000.
- (viii) The directors wish to transfer £6,000 to general reserve.

Required:

Prepare an income statement for Mashra Ltd for the year ended 30 June 2024 as well as a balance sheet as at that date. Both statements should be in a form appropriate for publication.

36.5 The following information concerns Bishroo Ltd in relation to its year ended 30 June 2024:

<i>Trial balance as at 30 June 2024:</i>	Dr	Cr
	£	£
Motor expenses	27,758	
Dividends paid	56,050	
Sales		1,152,126
Purchases	529,978	
Wages & salaries	149,776	
Trade receivables	103,200	
Rent	22,145	
Trade payables		89,260
Machinery at cost	520,560	
Computers at cost	287,100	
Machinery: accumulated depreciation as at 1 July 2023		105,300
Computers: accumulated depreciation as at 1 July 2023		60,960
Inventory as at 1 July 2023	52,814	
Cash at bank	1,711	
5% loan notes 2034–2036		105,000
Loan note interest paid	2,625	
Bad debt expense	18,406	
Share premium account		49,000
Allowance for doubtful debts at 1 July 2023		3,109
Premises at cost	687,850	
Premises: accumulated depreciation as at 1 July 2023		178,841
Equity shares of 50p each		115,000
4% irredeemable preference shares of £1 each		55,000
Royalties received		4,808
Directors' remuneration	92,170	
Retained earnings at 1 July 2023		633,739
	<u>2,552,143</u>	<u>2,552,143</u>

In addition to the above trial balance you are given the following information:

- (i) The inventory was counted at 30 June 2024 and was valued at a cost of £51,727.
- (ii) Depreciation needs to be charged at the following annual rates:

Premises	(straight line)	2%
Machinery	(reducing balance)	15%
Computers	(straight line)	20%
- (iii) The amount shown for rent on the trial balance includes a payment of £6,900, which represents twelve months' rent to 30 April 2024.
- (iv) Motor expenses incurred for which no invoices have yet been received amount to a total of £6,675.
- (v) The audit fee for the year has been agreed at £11,000 and this needs to be provided for.
- (vi) Based on a detailed analysis of the company's experience with credit sales, the allowance for doubtful debts is to be set at 4% of trade receivables.
- (vii) The interest on the loan notes is paid in two instalments each year, and the second instalment has not yet been paid.
- (viii) The corporation tax charge on this year's profit is estimated to be £36,000. (You should assume that this estimate is unaffected by the seven matters above.)

Required:

Prepare, in a publishable format, an income statement for Bishroo Ltd for the year ended 30 June 2024 and a balance sheet as at that date.



36.6A The following information concerns Zarman plc in relation to its year ended 30 April 2024:

Trial balance as at 30 April 2024:	Debit £	Credit £
3% irredeemable preference shares of £1 each		44,000
8% loan notes 2027–2029		153,000
Allowance for doubtful debts at 1 May 2023		6,133
Bad debt expense	36,550	
Bank		2,540
Commissions received		8,455
Directors' remuneration	90,770	
Dividends paid	22,810	
General reserve		36,600
Inventory as at 1 May 2023	54,507	
IT equipment at cost	287,700	
IT equipment: accumulated depreciation at 1 May 2023		67,320
Loan note interest paid	6,120	
Maintenance	26,646	
Ordinary shares of 50p each		119,000
Overdraft interest paid	165	
Plant & machinery at cost	453,900	
Plant & machinery: accumulated depreciation at 1 May 2023		102,240
Premises at cost	625,400	
Premises: accumulated depreciation at 1 May 2023		162,604
Purchases	544,622	
Retained earnings at 1 May 2023		466,193
Returns outwards		2,858
Sales		1,134,629
Share premium		70,000
Trade payables		60,589
Trade receivables	102,000	
Utilities	26,123	
Wages & salaries	158,848	
	<u>2,436,161</u>	<u>2,436,161</u>

The following additional information is relevant:

- (i) The inventory was counted at 30 April 2024 and was valued at a cost of £55,820.
- (ii) Depreciation needs to be charged at the following rates per year:

Premises:	(straight line)	2%
Plant & machinery:	(reducing balance)	25%
IT equipment:	(straight line)	25%
- (iii) The amount shown for maintenance on the trial balance includes a payment of £7,860, which represents an annual maintenance contract to 28 February 2025.
- (iv) Utilities charges incurred up to the end of the financial year for which no invoices have yet been received amount to a total of £5,682.
- (v) The audit fee has been agreed at £14,000 and this needs to be provided for.
- (vi) An extensive review of the company's irrecoverable debt history indicates that the allowance for doubtful debts should be set at 5% of trade receivables.
- (vii) The interest on the loan notes is paid in two instalments each year and the second instalment needs to be accrued.
- (viii) The corporation tax charge on this year's profit is estimated to be £15,000.
- (ix) The directors also want to transfer £14,000 to general reserve.

Required:

An income statement for Zarman plc for the year ended 30 April 2024 and a balance sheet as at that date, both in an external use format (i.e. suitable for publication).

36.7 The trial balance for Rambaldi Ltd at 31 December 2024 is as follows:

	Dr £'000	Cr £'000
Allowance for doubtful debts at 1 January 2024		82
Bad debt expense	211	
Bank		137
Bank loan		600
Buildings at cost	2,640	
Buildings: accumulated depreciation at 1 January 2024		506
Cash in hand	6	
Dividends paid	194	
Gas, electricity and water	418	
Insurance	107	
Inventory at 1 January 2024	519	
Land at cost	800	
Ordinary shares of 50p each		1,200
Other operating expenses	909	
Overdraft interest paid	14	
Plant & equipment at cost	1,774	
Plant & equipment: accumulated depreciation at 1 January 2024		794
Purchases	6,190	
Retained earnings at 1 January 2024		963
Returns inwards	172	
Returns outwards		69
Rent received		131
Sales		9,078
Share premium account		955
Trade payables		519
Trade receivables	1,080	
	<u>15,034</u>	<u>15,034</u>

The figures in the above trial balance include all transactions processed to date. The following issues also need to be considered before preparing the financial statements:

- (i) Inventory at 31 December 2024 was counted and valued at a cost of £466,000.
- (ii) Depreciation is to be charged as follows:
 - Buildings – 5% straight line
 - Plant & equipment – 25% reducing balance
- (iii) Insurance includes an annual premium of £57,000 paid that covers the twelve months to 30 April 2025.
- (iv) Gas, electricity and water charges for December 2024, for which no bills have yet been received, are estimated to total £62,000.
- (v) Based on a meticulous analysis of the company's experience with debt collection, the allowance for doubtful debts is to be set to 5% of trade receivables.
- (vi) On 28 December 2024, a supplier paid the £11,000 it owed for goods returned by Rambaldi Ltd in November. The supplier paid this £11,000 directly into Rambaldi Ltd's bank account. The bank reconciliation at 31 December 2024 revealed that this receipt has yet to be entered in Rambaldi Ltd's accounting records, although the original return was correctly recorded.
- (vii) The bank loan was received on 1 October 2024 and is repayable in full on 1 September 2029. Interest is charged at a fixed rate of 6% per year and is payable in two annual instalments, the first of which will be paid on 31 March 2025.
- (viii) During December 2024, the land was valued at £1.5m by a professional firm of valuers. The directors of Rambaldi Ltd wish to incorporate this valuation in the year-end financial statements.
- (ix) Corporation tax due on the profit for the year is estimated to be £248,000 (this estimate is unaffected by the eight matters above).

Required:

Prepare, in a format appropriate for external use, the income statement for the year ended 31 December 2024 for Rambaldi Ltd followed by its balance sheet as at that date.

36.8A You are presented with the trial balance of Finnax Ltd at 30 November 2025 below:

	£'000	£'000
7% loan notes (repayable in 2030)		400
Allowance for doubtful debts as at 1 December 2024		35
Bad debt expense	8	
Bank	71	
Bank interest received		1
Carriage inwards	37	
Delivery vans at cost	130	
Delivery vans: accumulated depreciation at 1 December 2024		60
Inventory as at 1 December 2024	355	
Land at cost	300	
Loan note interest paid	14	
Office equipment at cost	85	
Office equipment: accumulated depreciation at 1 December 2024		35
Ordinary dividends paid	27	
Ordinary shares of £1 each		500
Purchases	2,424	
Rent	223	
Retained earnings at 1 December 2024		173
Returns outwards		47
Sales		3,400
Sundry expenses	84	
Suspense account		4
Telephone, postage & stationery	29	
Trade payables		310
Trade receivables	800	
Wages & salaries	378	
TOTALS	<u>4,965</u>	<u>4,965</u>

You are also provided with the following additional information:

- (i) Inventory at 30 November 2025 was counted and valued at a cost of £399,000.
- (ii) Towards the end of the year, the company's land was valued by a firm of professional valuers at £0.75m. The directors of Finnax Ltd wish to recognise this valuation in the financial statements.
- (iii) The suspense account represents £4,000 received from the sale of a delivery van on 1 December 2024. The van had originally cost £14,000 many years ago and had been fully depreciated. No adjustment has yet been made to the *delivery vans* or *accumulated depreciation* accounts in respect of this disposal.
- (iv) Depreciation is to be provided for the year at 25% straight line on delivery vans and at 30% reducing balance on office equipment.
- (v) Telephone charges incurred by Finnax Ltd up to 30 November 2025, for which no bill has yet been received, were estimated to be £3,000.
- (vi) Rent includes a payment of £54,000 made on 15 October 2025 paid in respect of the three months to 31 December 2025.
- (vii) The company has recently learnt that a credit customer who owed £20,000 as at the end of the year has gone bankrupt and it is not now expected that any of this debt will be recovered. Furthermore, based on the evidence of its history of debt collection, Finnax Ltd requires an allowance for doubtful debts equal to 5% of outstanding trade receivables.
- (viii) Interest on the loan notes is paid in twice-yearly instalments and the outstanding payment for the year needs to be provided for.
- (ix) Corporation tax due on the profit for the year is estimated to be £72,000.

Required:

In a publishable format, prepare an income statement for Finnax Ltd for the year ended 30 November 2025 as well as a balance sheet as at that date.

36.9 The trial balance for Unsworton plc as at 31 December 2025 is as follows:

	Dr £'000	Cr £'000
6% loan notes (2025)		600
Bad debt expense	147	
Balance at bank		222
Carriage inwards	81	
Directors' remuneration	852	
Dividends paid	108	
Freehold buildings at cost	1,640	
Freehold buildings: accumulated depreciation at 1 January 2025		760
Freehold land at cost	692	
Inventory at 1 January 2025	478	
Loan note interest paid	28	
Machinery at cost	1,728	
Machinery: accumulated depreciation at 1 January 2025		948
Marketing & advertising	639	
Sundry operating expenses	599	
Overdraft interest paid	19	
Purchases	5,203	
Rent and business rates	853	
Retained earnings at 1 January 2025		924
Returns inwards	308	
Returns outwards		157
Royalties received		378
Sales		9,585
Share capital: ordinary shares of 10p each		300
Share premium account		643
Staff wages & salaries	1,086	
Trade payables		866
Trade receivables	922	
	<u>15,383</u>	<u>15,383</u>

Additional information:

- (i) Two accounting errors have just been discovered that have not yet been corrected:
- A purchase credit note for £16,000 from a supplier has been recorded twice by mistake during December 2025.
 - A contra (or 'set-off') of £7,000 needed between a receivable and a payable has not been recorded in the nominal ledger.
- (ii) Inventory at 31 December 2025 was counted and valued at a cost of £517,000.
- (iii) Depreciation is to be charged at the following annual rates:
- freehold buildings – 2.5% straight line
 - machinery – 15% reducing balance.
- (iv) Rent and business rates include a payment of £195,000 in respect of rent for the quarter ending 31 January 2026.
- (v) The audit fee for 2025 has been agreed at £95,000 and this needs to be provided for.
- (vi) On 1 January 2025, Unsworton plc had £500,000 8% loan notes in issue, interest being paid half-yearly on 30 June and 31 December. On 31 March 2025, the company redeemed all £500,000 of these loan notes at par, paying the interest due up to that date. On 1 April 2025, the company then issued £600,000 6% loan notes at par, interest being payable half-yearly on 30 September and 31 March.
- (vii) During October 2025, the company made a 1-for-4 bonus issue of its 10p ordinary shares. The directors had intended to use the share premium account for this. However, no entries whatsoever have yet been made in respect of the issue.



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- (viii) During November 2025, the freehold land was valued at £1.1m by a professional firm of valuers. The directors of Unsworton plc wish to incorporate this valuation in the financial statements.
 - (ix) The corporation tax due on the profit for the year is estimated to be £41,000 (this estimate is unaffected by the various matters above).

Required:

Prepare, in a publishable format, the income statement for Unsworton plc for the year ended 31 December 2025 and the balance sheet as at that date.

36.10A The following balances have been taken from the nominal ledger of Pandar plc as at 31 December 2024:

	Dr £	Cr £
Bank loan		600,000
Sales		8,240,600
Returns inwards	174,800	
Purchases	5,593,000	
Returns outwards		109,600
Inventory at 1 January 2024	682,800	
Trade receivables	992,570	
Trade payables		610,380
Carriage outwards	150,000	
Share premium		126,000
Plant & equipment at cost	1,873,600	
Motor vehicles at cost	361,400	
Plant & equipment: accumulated depreciation at 1/1/2024		988,900
Motor vehicles: accumulated depreciation at 1/1/2024		144,560
Retained earnings at 1 January 2024		530,110
Repairs & maintenance	143,290	
Bank loan interest paid	7,125	
Overdraft interest paid	21,435	
Rent & business rates	220,380	
Wages & salaries	756,210	
Bad debts expense	202,280	
Allowance for doubtful debts at 1 January 2024		35,450
General operating expenses	560,410	
Ordinary shares of £1 each		230,000
5% irredeemable preference shares of £1 each		180,000
Preference dividends paid	4,500	
Ordinary dividends paid	32,200	
Bank	19,600	
	<u>11,795,600</u>	<u>11,795,600</u>

The following points also need to be considered before preparation of the financial statements:

- (i) After producing the above trial balance, the following two mistakes have been detected in the accounting records:
 - A repair bill totalling £15,600 (dated 12 August 2024) for the Chairman's company car has been posted to the *motor vehicles* account; and
 - A credit note correctly given to a customer for £12,560 in November 2024 has been posted twice in the books.
- (ii) Inventory as at 31 December 2024 was counted and valued at a cost of £703,820.
- (iii) During the year, Pandar plc renewed its annual contract with Freightmax Ltd, the company that delivers the goods to Pandar plc's customers. The renewal date of the contract was 1 November 2024 and the agreed renewal fee totalled £192,000. This amount will be paid in four quarterly instalments beginning on 1 February 2025. No entries have yet been made in the books in relation to this renewal.

- (iv) The company's depreciation policy is as follows:
- plant & equipment – $33\frac{1}{3}\%$ reducing balance
 - motor vehicles – 25% straight line.
- (v) On 12 January 2025, Pickram Ltd (one of the company's customers) went into liquidation. Trade receivables at 31 December 2024 include a total of £45,130 due from Pickram Ltd. The directors of Pandar plc have been advised that they are extremely unlikely to receive any of this amount. Additionally, the directors believe that an allowance for doubtful debts of 3% of remaining trade receivables is required, based on a detailed review of the company's experience with debt collection.
- (vi) The bank loan was received on 1 August 2024. The loan is repayable in five equal annual instalments commencing on 31 July 2025. Interest is charged at a fixed rate of 4.75% per annum, and the interest is payable in quarterly instalments beginning on 31 October 2024.
- (vii) The preference dividend is payable in two annual instalments. The second instalment has not been paid as at the year end and (under the specific terms of the company's preference shares) must be provided for.
- (viii) In February 2025, the directors decided to propose a final ordinary dividend for 2024 of 18 pence per share.
- (ix) The corporation tax charge on the profit for the year is estimated to be £16,670 (you should assume that this estimate is unaffected by the eight points above).

Required:

Prepare, in a publishable format, the income statement for the year ended 31 December 2024 for Pandar plc, followed by its balance sheet as at the same date.

36.11 The following trial balance has been extracted from the nominal ledger of Archara Ltd as at 31 December 2024:

	Dr £	Cr £
3.75% loan notes (redeemable 31 August 2028)		600,000
Advertising & marketing	173,400	
Bad debts	76,900	
Balance at bank		64,800
Directors' remuneration	220,100	
Dividends paid	14,000	
Freehold land & buildings at cost	940,000	
Freehold land & buildings: accumulated depreciation at 1/1/2024		96,600
Gas, electricity & water	78,300	
Insurance	37,600	
Inventory at 1 January 2024	211,200	
Ordinary shares of £1 each		100,000
Overdraft interest paid	24,200	
Plant & equipment at cost	764,000	
Plant & equipment: accumulated depreciation at 1/1/2024		320,000
Purchases	2,534,400	
Retained earnings at 1 January 2024		434,450
Returns inwards	76,300	
Returns outwards		50,700
Sales		3,804,900
Share premium		202,300
Sundry operating expenses	32,400	
Suspense		29,950
Trade payables		356,800
Trade receivables	475,600	
Wages & salaries	402,100	
	<u>6,060,500</u>	<u>6,060,500</u>



The following matters also need to be considered before preparing the financial statements:

- (i) It has subsequently been discovered that a credit note received from a supplier for £2,970 has been posted to the correct accounts but as £9,720.
- (ii) Inventory at 31 December 2024 was counted and valued at a cost of £229,000. The company's inventory comprises just five products, as follows:

	Product A	Product B	Product C	Product D	Product E
	£	£	£	£	£
Original cost price	23,000	57,000	39,000	49,000	61,000
Expected selling price	34,000	80,000	62,000	40,000	90,000

- (iii) The company paid an insurance premium of £22,800 on 15 June 2024 in respect of insurance for the 12-month period ending 31 July 2025.
- (iv) Bharami Ltd is one of the company's customers and it owed £22,000 to Archara Ltd as at 31 December 2024. However, Bharami Ltd ceased trading on 14 January 2025 as a result of severe financial difficulties. The liquidators of Bharami Ltd do not expect to pay any money to creditors.
- (v) The company's depreciation policy is as follows:
 - buildings – straight line over 50 years
 - plant & equipment – 25% reducing balance.

The company's non-current assets include freehold land which originally cost £250,000.

- (vi) Archara Ltd employed the services of a new marketing agency for a six-month period commencing 1 December 2024. The total fee for the six months was agreed at £108,000. 50% of this fee is to be paid on 28 February 2025 with the rest payable on 31 May 2025. No entries whatsoever have yet been made in the books of Archara Ltd in relation to this deal.
- (vii) A cheque for £29,950 was received by the company on 27 December. The cheque was banked by the cashier but the source of the cheque was unknown, so she posted it to suspense. It has now been discovered that it was in respect of a bad debt that had been written off in 2022.
- (viii) The 3.75% loan notes were first issued on 1 September 2024. The interest is payable in two annual instalments on 28 February and 31 August each year.
- (ix) The directors are planning to propose a final dividend of 22p per share for 2024.
- (x) The corporation tax charge on the profit for the year is estimated to be £17,600 (this estimate is unaffected by the various matters above).

Required:

Adopting a presentation appropriate for publication, prepare an income statement for Archara Ltd for the year ended 31 December 2024 along with a balance sheet as at the same date.

36.12A Minellan Ltd has extracted the following trial balance from its nominal ledger as at 31 March 2024:

	£'000	£'000
6% redeemable preference shares of £1 each		100
Allowance for doubtful debts as at 1 April 2023		7
Bad debt expense	13	
Bank	78	
Bank loan		90
Business rates	133	
Carriage inwards	64	
Computer equipment at cost	112	
Fixed & mobile phone charges	52	
Interest paid	9	
Interest received		5
Inventory as at 1 April 2023	155	
Freehold land at cost	166	
Ordinary dividends paid	44	
Ordinary shares of £1 each		150

Sundry operating expenses	488	
Preference dividends paid	6	
Purchases	1,315	
Rent paid	66	
Retained earnings as at 1 April 2023		260
Returns inwards	20	
Returns outwards		45
Royalties received		49
Sales		2,287
Salespeople's cars – accumulated depreciation at 1 April 2023		50
Salespeople's cars at cost	80	
Share premium account		90
Trade payables		77
Trade receivables	409	
	<u>3,210</u>	<u>3,210</u>

Additional information:

- (i) Inventory at 31 March 2024 was counted and valued at a cost of £181,000. Included in this figure, at a cost of £17,000, was damaged inventory. This damaged inventory was sold off cheaply in May 2024 for £5,000.
- (ii) In March 2024, the land was professionally valued at £300,000. The directors wish to recognise this current market value in the financial statements.
- (iii) On 1 November 2023, the company acquired new computer equipment, paying a total of £112,000. This total comprised the following:

	£
Purchase price	95,000
Installation	2,000
Costs of testing before first use	3,000
One-year service contract	12,000
	<u>112,000</u>

The company did not buy any other non-current assets during the year and neither were there any disposals of non-current assets.

- (iv) Depreciation is to be provided for the year on the salespeople's cars at 40% using the reducing balance method and on computer equipment at 25% straight line. The company's policy is to charge a full year's depreciation in the year of acquisition and none in the year of disposal.
- (v) On 15 March 2024, the company paid its rent for the quarter ending 31 May 2024. However, the cheque for £18,000 has been debited to the *business rates* account instead of the *rent paid* account.
- (vi) Telephone charges of £8,000 were incurred before the year end but have not yet been accounted for.
- (vii) A bank reconciliation as at 31 March 2024 has revealed the following two discrepancies:
 - Bank charges of £1,000 appearing on the company's March 2024 bank statement have been omitted from the accounting records.
 - A cheque for £32,000 received from a credit customer on 24 March 2024 has been incorrectly recorded as £23,000.
- (viii) Based on a thorough examination of the company's experience of debt collection, the allowance for doubtful debts is to be set at 4% of trade receivables.
- (ix) At the year end the company was subject to a legal action from a former employee who claims she was unfairly dismissed. The legal advisers of Minellan Ltd estimate that there is a 70% chance that the claim will be successful and that the company will have to pay £30,000 as a result, probably within the next six months.
- (x) The bank loan of £90,000 was originally received on 1 April 2022 and is repayable in full on 31 March 2027. Interest is paid at a fixed rate of 10% in two annual instalments on 31 March and 30 September.



- (xi) The annual dividend on the redeemable preference shares is paid in two equal instalments on 31 March and 30 September each year.
- (xii) The corporation tax due on the profit for the year is estimated to be £32,000.

Required:

In a form suitable for publication, prepare the income statement for Minellan Ltd for the year ended 31 March 2024 as well as the balance sheet at that date.

36.13 Manuvra plc is a wholesaler of homeware products. The company's trial balance as at 31 December 2024 is exhibited below:

	Dr £'000	Cr £'000
Bad debt expense	127	
Bank		187
Buildings at cost	1,350	
Buildings: accumulated depreciation at 1 January 2024		378
Commissions received		196
Directors' remuneration	562	
Dividends paid	85	
Fixtures & fittings at cost	983	
Fixtures & fittings: accumulated depreciation at 1 January 2024		603
HCBS bank loan		800
Inventory at 1 January 2024	266	
Ordinary shares of 25p each		80
Land at cost	601	
Loan interest paid	12	
Motor vehicle disposal proceeds		25
Motor vehicles at cost	624	
Motor vehicles: accumulated depreciation at 1 January 2024		347
Sundry operating expenses	995	
Overdraft interest paid	70	
Purchases	3,469	
Retained earnings at 1 January 2024		727
Sales		6,448
Share premium account		322
Staff wages & salaries	680	
Trade payables		442
Trade receivables	731	
	<u>10,555</u>	<u>10,555</u>

The following matters also need to be considered before preparing the financial statements:

- (i) Inventory at 31 December 2024 was counted and valued at a cost of £283,000.
- (ii) The audit fee for 2024 has been agreed at £114,000 and this needs to be accrued.
- (iii) The company sold one of its motor vehicles (a sports car) on 1 June 2024 for £25,000. This car had originally been purchased on 1 November 2021 for £48,000. The only entry made for the disposal so far has been to debit *bank* £25,000 and credit *motor vehicle disposal proceeds* with £25,000. There were no other purchases or disposals of non-current assets during the year.
- (iv) Depreciation is to be charged as follows:
 - buildings – 4% straight line
 - fixtures & fittings – 20% reducing balance
 - motor vehicles – 25% straight line.

For assets purchased or disposed of part-way through a financial year, the company's policy is to charge monthly depreciation based on the number of months the asset was owned.

- (v) Manuvra Ltd rented extra warehousing space (for the storage of goods prior to their sale) for a period of three months from 1 November 2024 to 31 January 2025. The invoice for the full

three months of £123,000 was paid on 9 January 2025. No accounting entries whatsoever have yet been made in relation to this deal.

- (vi) A cheque for £28,000 received from a customer (Halgate Ltd) on 23 December (which was recorded in the books of Manuvra Ltd) has been returned by the bank as unpaid. No adjustment has been made in the records for the fact that this cheque has been dishonoured. A liquidator was appointed to Halgate Ltd on 2 January and he has confirmed that the cheque will not be reissued. Management at Manuvra Ltd have decided that the total amount still owed by Halgate Ltd (£43,000) should be written-off as a bad debt.
- (vii) The bank reconciliation performed on 31 December 2024 revealed that a cheque for £12,000 was issued to a supplier on 18 December 2024 but this was not recorded at all in the books of Manuvra Ltd.
- (viii) The bank loan of £800,000 was borrowed from HCBS on 1 May 2024. The loan is repayable in five equal annual instalments starting on 30 April 2025. Interest is charged on the loan at a fixed rate of 3% per annum. The interest must be paid in two equal annual instalments on 30 April and 31 October each year.
- (ix) On 3 December 2024, the land was valued at £1.3m by a professional firm of valuers. The directors of Manuvra plc wish to incorporate this valuation in the year-end financial statements.
- (x) The corporation tax due on the profit for the year is estimated to be £66,000 (this estimate is unaffected by the various matters above).

Required:

In a form suitable for publication, prepare the income statement for Manuvra plc for the year ended 31 December 2024 followed by the balance sheet as at that date.

36.14A The following trial balance has been extracted from the nominal ledger of Epicteta Ltd on 31 July 2024:

	£'000	£'000
7% redeemable preference shares of £1 each		100
Advertising	258	
Allowance for doubtful debts as at 1 August 2023		21
Share premium account		202
Bad debt expense	192	
5% bank loan (repayable 2028)		320
Buildings at cost	1,100	
Buildings: accumulated depreciation at 1 August 2023		242
Cash at bank	14	
Communication expenses	74	
General operating expenses	123	
Insurance	101	
Loan interest paid	16	
Inventory at 1 August 2023	288	
Freehold land at cost	339	
Lighting and heating expense	89	
Ordinary dividends paid	77	
Ordinary shares of 50p each		380
Petty cash	1	
Plant & equipment at cost	1,471	
Plant & equipment: accumulated depreciation at 1 August 2023		691
Preference dividends paid	7	
Purchases	2,935	
Repairs and maintenance	149	
Retained earnings as at 1 August 2023		978
Warranty repairs expense	44	
Sales		5,152
Trade payables		382
Trade receivables	767	
Wages and salaries	423	
	<u>8,468</u>	<u>8,468</u>



In addition to the above trial balance, you are given the following information:

- (i) Closing inventory at 31 July 2024 was valued at a cost of £267,000. This valuation does not take account of the fact that, at the year-end physical inventory count, it was discovered that certain goods with an original cost of £38,000 had been very badly damaged. The scrap value of these goods is thought to be only £5,000.
- (ii) The trade receivables figure in the above trial balance includes a debt of £17,000 which is considered irrecoverable. Based on an analysis of the company's debt collection experience, the allowance for doubtful debts requires adjustment to 4% of trade receivables.
- (iii) The bank reconciliation reveals that bank charges of £4,000 appearing on the company's July 2024 bank statement have been omitted from the accounting records.
- (iv) Depreciation is to be provided for the year on the buildings at 2% straight line and on plant & equipment at 35% using the reducing balance method.
- (v) Repairs and maintenance includes a payment for a maintenance contract of £57,000, which covers the six months to 30 November 2024.
- (vi) Advertising expenses of £23,000 were incurred before the year end but have not yet been accounted for.
- (vii) In June 2024, the land was professionally valued at £595,000. The directors wish to recognise this valuation in the financial statements.
- (viii) As of 1 August 2023, the company started offering a 12-month warranty on the goods it sells. The trial balance indicates that costs of £44,000 to repair goods under these warranties have already been incurred during the financial year. Management estimate that 2% of all warranties will ultimately be exercised and that the future costs of further repairs in relation to goods already sold will amount to £66,000.
- (ix) During July 2024, the company made a 1-for-4 bonus issue of its 50p ordinary shares. Management had intended to use the share premium account for this. However, no entries whatsoever have yet been made in the books in respect of the issue.
- (x) Corporation tax due on the profit for the year is calculated to be £82,000. (This estimate is unaffected by the various matters above.)

Required:

In a publishable format, produce an income statement for Epicteta Ltd for the year ended 31 July 2024 and a balance sheet as at that date.

36.15 Xzibita Ltd is a wholesaler of women's clothing. The trial balance below has been extracted from the nominal ledger of the company as at 31 December 2024:

	Dr £	Cr £
Bad debt expense	157,080	
Bank		19,490
Bank loan		800,000
Dividends paid	280,300	
Insurance	136,630	
Inventory as at 1 January 2024	534,100	
Legal expenses	81,000	
Loan interest	35,000	
Marketing & advertising	235,620	
Ordinary shares of 5 pence each		50,000
Overdraft interest	12,520	
Plant & equipment at cost	3,823,100	
Plant & equipment: accumulated depreciation as at 1/1/2024		2,012,400
Property at cost	2,390,900	
Property: accumulated depreciation as at 1/1/2024		445,692
Purchases	4,761,450	
Rent expense	33,120	
Rent received		26,230
Retained earnings at 1 January 2024		2,829,380

Sales		7,854,270
Share premium account		299,540
Sundry operating expenses	350,744	
Trade payables		726,150
Trade receivables	1,321,895	
Wages & salaries	909,693	
	<u>15,063,152</u>	<u>15,063,152</u>

No adjustments have yet been made in relation to the following matters:

- (i) Inventory was counted on 31 December 2024 and valued at a total cost of £588,390. This total includes a batch of 700 coats which had originally cost £90 each and are normally sold by Xzibita Ltd for £160 each. Due to a defect in manufacture, they were all sold on 14 January 2025 at 50% of their normal price. Selling expenses amounted to 10% of the proceeds.
- (ii) Included in the balance for *insurance* in the above trial balance is an insurance premium of £53,472 paid on 15 April 2024, which represented 12 months' insurance to 31 May 2025.
- (iii) The company acquired a new building during the year, the purchase price of which is included in the figure for *property at cost* on the above trial balance. Legal fees of £81,000 were incurred in direct connection with this acquisition and these have been debited to the *legal expenses* account.
- (iv) Company policy is to depreciate property on a straight-line basis over 50 years assuming a zero residual value. Plant & equipment is to be depreciated at 25% using the reducing balance method. A full year's charge is applied in the year of acquisition and none in the year of disposal.
- (v) Rent paid of £11,040 has been debited to the *rent received* account in error.
- (vi) Xzibita Ltd employs the services of an external marketing agency. During December 2024, marketing expenses amounting to £29,740 were incurred for which no invoices have yet been received.
- (vii) Various old debit balances on the purchases ledger totalling £3,890 need to be written off.
- (viii) Cheque payments amounting to £13,310 had been correctly entered in the books in December but did not appear on the business's bank statements until January 2025. Cheques received from customers totalling £7,560 were correctly entered in the cash book on 30 December 2024 and banked on the same day but these did not appear on the bank statement until 2 January 2025.
- (ix) The bank loan of £800,000 was originally received on 1 June 2023 and is due to be repaid in full on 31 May 2028. Interest, at a fixed annual rate of 5.25%, is paid in arrears on a quarterly basis on 1 March, 1 June, 1 September and 1 November each year. Interest accrued but not yet paid has not yet been accounted for.
- (x) The corporation tax charge on the profit for the year is estimated to be £158,090 (this estimate is unaffected by the various matters above).

Required:

In a form fit for publication, prepare the income statement for Xzibita Ltd for its year ended 31 December 2024 and a balance sheet as at that date.

36.16A The trial balance below represents a summary of the balances on the nominal ledger of Banega Ltd (a wholesaler of hats and headwear) as at 31 December 2024:

	Dr £	Cr £
Allowance for doubtful debts as at 1 January 2024		6,800
Bad debts expense	8,390	
Bank	15,250	
Bank loan		200,000
Bank loan interest	11,250	
Dividends paid	32,300	
Fixtures & fittings at cost	536,000	
Fixtures & fittings: accumulated depreciation at 1 January 2024		253,800
Heat, light & water	30,520	
Inventory as at 1 January 2024	79,710	

Insurance	8,690	
Marketing & advertising	11,750	
Motor vehicles at cost	169,000	
Motor vehicles: accumulated depreciation at 1 January 2024		134,900
Purchases	526,395	
Rent	60,000	
Retained earnings as at 1 January 2024		109,325
Sales		949,400
Share capital		47,500
Staff salaries	101,670	
Trade payables		65,300
Trade receivables	161,630	
Transport expenses	14,470	
	<u>1,767,025</u>	<u>1,767,025</u>

The following issues also need to be dealt with in preparing the financial statements:

- (i) The following two errors require correction: i) a cheque payment to a supplier for £9,300 has been recorded in the books as £3,900; and ii) a purchase invoice for 200 top hats totalling £7,700 has been posted twice by mistake.
- (ii) On 31 December 2024, the company's inventory was counted and valued at its cost price of £87,600. Included in this total is a batch of bowler hats that have proved very difficult to sell. The batch originally cost £7,900. Management have recently identified a buyer for these hats who has agreed to pay 75% of cost price for the entire batch. Delivery costs will have to be paid for by Banega Ltd and are expected to amount to £550.
- (iii) The rent on the business premises has been £48,000 per year for several years, which is payable half-yearly in advance on 31 March and 30 September. Both instalments were indeed paid in 2024, but the adjustment for the prepaid element of the second instalment has not yet been posted. Furthermore, negotiations with the landlord regarding the level of rent have been protracted and ongoing, and only in January 2025 was it finally agreed that the annual rent would rise by 10% effective as of 30 June 2024.
- (iv) The auditors' fees and expenses for the year are expected to be £21,000.
- (v) On 23 December 2024, one of the directors traded-in her company car (an MPV) for a new SUV. The MPV had originally been purchased by the company for £75,000 on 1 August 2021. The list price of new SUV was £96,000 but the part-exchange value of the MPV meant that the company will only pay £61,000 in full settlement to acquire the new vehicle. This £61,000 will be payable on 23 January 2025. However, no aspect of this transaction has yet been reflected in the books of the company.
- (vi) Depreciation is to be charged at:
 - 20% reducing balance on the fixtures and fittings
 - 20% straight line on the motor vehicles.

Company policy is to calculate a full year's charge in the year of acquisition and none in the year of disposal.

- (vii) The company's credit controller has carefully reviewed all the trade receivables balances as at the year end and she has determined that debts of £13,400 need to be written off and that the allowance for doubtful debts should be set at £5,900.
- (viii) During the year, 50,000 new ordinary shares of par (or 'nominal') value 5p each were issued for 75p each, paid in full on issue. This transaction has been accounted for by posting the entire proceeds to the *share capital* account.
- (ix) The bank loan was taken out on 1 August 2022 and is repayable in full on 31 July 2027. Interest is charged at a fixed annual rate of 6.75% and is paid in quarterly instalments.
- (x) The corporation tax charge on the profit for the year is estimated to be £29,500 (you should assume that this estimate is unaffected by the various matters above).

Required:

Prepare, in a publishable format, the income statement for Banega Ltd for the year ended 31 December 2024 followed by the balance sheet as at that date.

The statement of cash flows for companies

Learning objectives

After you have studied this chapter, you should be able to:

- Prepare relevant extracts from the *operating*, *investing* and *financing* sections of the statement of cash flows for an individual company.
- Produce a full statement of cash flows for an individual company in accordance with IAS 7 *Statement of Cash Flows*.
- Interpret the statement of cash flows of an individual company.

Introduction

In Chapter 28, we emphasised how important cash flow is to any business for it to survive and prosper. The statement of cash flows therefore provides vital information to users about how effective the business has been at generating cash and how that cash was used. In Chapter 28, you learnt how to prepare a statement of cash flows for a sole proprietor's business in accordance with IAS 7 *Statement of Cash Flows*. In this chapter, you'll build on that knowledge in order to be able to produce a statement of cash flows for a company. We'll also introduce how users can begin to interpret the information contained in the statement of cash flows of a company.

37.1

The statement of cash flows for a company is similar to that of a sole proprietor

In Chapter 28, we introduced the **statement of cash flows**, which is the third major financial statement. You may want to look back at that chapter to refresh your memory of the basic format and the principles involved in producing this statement. In this chapter, we will build on those fundamentals so that you are able to produce the statement of cash flows for a company.

The essential idea is the same as for a sole proprietor. The statement of cash flows for a company will present a summary of that company's receipts and payments of cash for the last twelve months, categorised under three headings: **operating activities**, **investing activities** and **financing activities**. The overall total of the cash flows from all three sections must equal the net increase or decrease in the company's cash for the year. The relevant accounting standard to be followed is IAS 7 *Statement of Cash Flows*, which we'll simply refer to as IAS 7 throughout this chapter.

37.2 The operating activities section for a company

As discussed in Chapter 28, the majority of both exam questions and real businesses will use the **indirect method** to calculate the net cash from operating activities. Therefore, this is the only method that we will focus on in this chapter.

The operating activities section of the statement for a company will look something like that shown in Exhibit 37.1.

Exhibit 37.1 The operating activities section for a company

	See note	£	£
Cash flows from operating activities			
Operating profit	A.	X	
Add Depreciation expense	B.	X	
(Profit)/Loss on disposal of non-current assets	C.	(X)/X	
(Increase)/decrease in inventory	D.	(X)/X	
(Increase)/decrease in trade receivables	D.	(X)/X	
Increase/(decrease) in trade payables	D.	X/(X)	
Cash generated from operations	E.	X	
Corporation tax paid	F.	(X)	
Net cash from operating activities			X

Note A.

The indirect method converts the company's profit into the net cash from operating activities by making various adjustments. Since we are looking at operating activities, it would seem logical to start with the company's operating profit (effectively the company's profit before interest and tax). We can then adjust it (in the same way that we did in Chapter 28) for non-cash items and for changes in working capital.

Note B.

For the same reason as for a sole proprietor, the depreciation expense for the year must always be added back to the profit figure. This is because depreciation charges reduce operating profit without involving any movement in cash. Because we want to *convert* the operating profit figure into a cash flow, the depreciation expense must always be added back.

Note C.

Losses on the disposal of non-current assets must always be added back to the profit figure. A loss on disposal reduces operating profit but does not, in itself, represent a flow of cash. In order to *convert* the operating profit figure into a cash flow, losses on disposal must therefore be added back. Following the same logic, a profit on disposal must always be deducted.

Note D.

With the changes in working capital, remember:

- An increase in inventory implies that the company has spent money on building up its stocks of goods, which will have had a negative effect on its cash. **An increase in inventory must therefore always be deducted.**
- An increase in trade receivables implies that the company has been slower to collect debts from its customers, which will have had a negative effect on its cash. **An increase in receivables must therefore always be deducted.**

- An increase in trade payables implies that the company has held on to its money for longer and paid its suppliers more slowly, which will have had a positive effect on its cash. **An increase in payables must therefore always be added.**

The opposite logic can be applied to decreases in the above three items.

In addition to inventory, receivables and payables, there may also have been changes in prepayments, accruals and provisions:

- Changes in prepayments should be treated in the same way as changes in receivables (i.e. an increase must be deducted and a decrease added).
- Changes in accruals and provisions will follow the same logic as payables (i.e. an increase must be added and a decrease deducted).

Note E.

This new subheading ('cash generated from operations') is used by companies to indicate the cash flow from operating activities before deducting any corporation tax payments. Companies have little control over the amount of tax that they must pay, so *cash generated from operations* is an important subtotal to indicate how effective the company's managers have been at running the business in terms of producing cash.

Activity 37.1

The income statement of a company reports an operating profit of £148,000. The depreciation expense for the year was £57,000. Over the course of the year, inventory increased by £21,000, trade receivables fell by £9,000, prepayments grew by £4,000, trade payables rose by £14,000 and accruals dropped by £3,000. What was the cash generated from operations?

Note F.

This item is required at the end of a company's operating activities section because they must pay corporation tax on their profits. It is logical to include the corporation tax paid during the year in the operating activities section because corporation tax mainly arises as a charge on operating profits.

The corporation tax expense in the company's income statement is essentially the tax charge calculated on the profit for the year. For UK companies, some or all of this tax charge will be paid *after* the company's financial year end. **In other words, the corporation tax expense in the income statement for the year is not the same as the corporation tax that was actually paid during the year.** You will therefore normally have to do a calculation to deduce the amount of corporation tax that was paid during the year. Exhibit 37.2 shows an example of this.

Exhibit 37.2 Calculating the corporation tax paid during the year

A company's financial statements include the following figures:

Extract from this year's income statement:	£	
Corporation tax expense	1,370	
Extracts from balance sheets:	This year	Last year
	£	£
Corporation tax payable	1,240	950



➔ What figure for *corporation tax paid* will be shown in the statement of cash flows for this year?

Solution:

The answer is £1,080, which can be calculated by drawing up an account for corporation tax payable. This is a liability account, so the opening balance (from last year's balance sheet) will be on the credit side. The tax charge on the profit for the year is owed to the tax authorities, so it represents an increase in the liability and is therefore a credit entry. The liability as at the end of the year will be the figure from this year's balance sheet, and the missing figure to balance the account must represent the corporation tax that was paid (thereby reducing the liability) during the year:

Corporation tax payable

	£		£
Corporation tax paid (<i>missing figure</i>)	1,080	Opening balance	950
Closing balance	<u>1,240</u>	Corporation tax expense	<u>1,370</u>
	<u>2,320</u>		<u>2,320</u>

**Activity
37.2**

A company reports an operating profit for the year in its income statement of £137,000. The depreciation expense for the year was £81,000 and the company made a loss on disposal of £2,000 when it sold a piece of old equipment. Over the course of the year, the company's inventory fell by £17,000, its trade receivables rose by £13,000 and its trade payables declined by £7,000. The company paid £29,000 in corporation tax in the year. What was the net cash from operating activities?

37.3 The investing activities section for a company

Just as for a sole proprietor, the investing activities section of the statement of cash flows for a company will show any payments to buy, and any receipts from selling, non-current assets. As you saw in Chapter 28, the workings needed to deduce these pieces of information can often be one of the more difficult aspects of preparing a statement of cash flows.

**Activity
37.3**

A company disposes of a non-current asset that has a carrying amount of £33,000 for £40,000 cash. What amounts will appear in the statement of cash flows in relation to this transaction, and in which sections?

The investing section may also show interest received by the company during the year. Perhaps surprisingly, IAS 7 does not specify exactly where interest received should appear in the statement. Companies are allowed to show it in either the *operating* or the *investing* sections, as long as they show it in the same place from one year to the next. Given that interest received could be said to be a result of money being invested, for consistency, in this book we will always show interest received in the investing section.

Note that the interest income (or 'investment income') shown in the income statement is not necessarily the same as the interest received during the year. The income statement is prepared on an accrual basis, which means that it will disclose interest *earned* during the year, regardless of whether it has been received yet. It may therefore be necessary to adjust the interest

income figure in the income statement for any amounts outstanding (i.e. receivable) according to the balance sheets for this year and last year. At the introductory level, this adjustment will be fairly rare.

At this stage in your studies, the investing section of the statement of cash flows for a company will therefore typically only contain three items, as illustrated in Exhibit 37.3.

Exhibit 37.3 The investing activities section for a company

	£	£
Cash flows from investing activities		
Payments to acquire property, plant & equipment	(X)	
Proceeds from the disposal of property, plant & equipment	X	
Interest received	X	
Net cash from/(used in) investing activities		X/(X)

Finally, note that in the real world there may be several other items in the investing activities section of a company's statement of cash flows. For example, the company might have bought shares in another company, which would be an investing cash outflow. It may have received dividends on those shares, resulting in an investing cash inflow. However, at this stage in your learning, these two cash flows will be uncommon.

37.4 The financing activities section for a company

Some of the biggest differences between the statement of cash flows of a company and that of a sole proprietor are in the financing activities section. Remember that the financing section essentially shows payments and receipts to and from those who provide long-term finance to the business. Therefore, the typical cash flows that will appear in this section for a company will be as shown in Exhibit 37.4.

Exhibit 37.4 The financing activities section for a company

	See note	£	£
Cash flows from financing activities			
Interest paid	a.	(X)	
Dividends paid	b.	(X)	
Proceeds from the issue of shares	c.	X	
Cash received from new borrowings	d.	X	
Repayment of borrowings	d.	(X)	
Net cash from/(used in) financing activities			X/(X)

Note a.

IAS 7 actually allows interest paid to be shown in either the *operating* or *financing* activities section. Companies can choose to show this cash outflow in whichever of those two sections they believe is most appropriate, as long as they show it in the same place from one year to the next. For consistency, in this book we will show interest paid in the financing activities section in all our examples. After all, interest payments are made to providers of finance, so there is some logic to including them in this section.

The interest expense for the year will be shown in the income statement where it will often be described as ‘finance costs’. But remember that the income statement is prepared on an accrual basis, so the interest expense that was incurred in the year is not necessarily the same as the interest that was actually paid. In many questions, no other information will be given and therefore you’d simply assume that the interest paid was the same as the interest expense.

But in other questions, the balance sheets for this year and last year might include liabilities for *interest payable*. If so, you would need to do a calculation in order to deduce the interest that had actually been paid. Exhibit 37.5 shows an example of this.

Exhibit 37.5 Calculating the cash flow for interest paid during the year

Last year’s balance sheet includes a current liability for interest payable of £70. This year’s balance sheet shows an equivalent figure of £90. The interest expense (shown under ‘finance costs’) in the income statement for this year is £330. What interest was paid during the year?

Solution:

The answer is £310, which can be calculated as follows:

Interest payable (<i>a liability account</i>)			
	£		£
Interest paid (<i>the missing figure</i>)	310	Opening balance	70
Closing balance	<u>90</u>	Interest expense	<u>330</u>
	<u>400</u>		<u>400</u>

Note b.

IAS 7 also permits dividends paid to be shown in either the *operating* or *financing* activities section. Companies can choose to show this cash outflow in whichever of the two sections they believe is most appropriate, as long as they show it in the same place from one year to the next. For consistency, in this book we will show dividends paid in the financing activities section in all our examples. After all, dividends are paid to providers of finance, so there is a logic to including them in this section.

Activity 37.4

Why do you think that IAS 7 allows companies to choose whether to show dividends paid in either the operating or financing section of the statement of cash flows? Do you think it is a good idea to offer this choice?

As you have learnt, ordinary dividends are essentially only accounted for when they are paid. The balance sheets of a company will not show any liabilities for ordinary dividends payable. The ordinary dividends paid during the year will sometimes simply be given to you by the question. On other occasions, you may need to deduce the dividends that were paid by constructing a working for the movement in retained earnings. Exhibit 37.6 shows an example of this.

Exhibit 37.6 Calculating the cash flow for dividends paid during the year

A company's retained earnings were reported to be £492,000 in its most recent balance sheet, and £435,000 in the balance sheet of the previous year. The income statement for the year just ended reported a final profit for the year of £119,000. Given this information, what dividends were paid during the year?

Solution:

The answer is £62,000, which can be calculated as follows:

Retained earnings working			
	£		£
Dividends paid (<i>the missing figure</i>)	62,000	Opening balance	435,000
Closing balance	<u>492,000</u>	Profit for the year	<u>119,000</u>
	<u>554,000</u>		<u>554,000</u>

Note c.

The proceeds from the issue of shares represents the cash inflow that arose if new shares were issued by the company during the year. As you saw in Chapter 35, all shares have a 'par' (or 'nominal') value, such as 5p, 10p or £1. When an existing company issues new shares, they are usually issued at a price that is greater than the par value. The par value will be credited to the share capital account and the excess above par value will be credited to the share premium account.

Logically, it follows that the cash inflow from the issue of new shares can normally be calculated as the difference between the total of the figures for both share capital and share premium in this year's balance sheet and the same total for last year. It is possible in your future studies that the situation may get a bit more complicated than this, but at this stage in your learning the calculation should be straightforward.

Activity 37.5

A company's balance sheets at the end of this year and last year show the following figures:

	This year	Last year
	£	£
Share capital	72,000	42,000
Share premium	157,000	107,000

What was the cash inflow from the issue of shares during the year?

Note d.

Any cash received from new borrowings, or cash repayments of borrowings, can be deduced by comparing the figures for bank loans and loan notes in this year's balance sheet with the same figures in last year's:

- If figures for borrowing in this year's balance sheet have increased compared with last year, then (in the absence of any other information) you should assume that the increase represents a cash inflow from new loans/loan notes.

- If figures for borrowing in this year's balance sheet have fallen compared with last year, then (in the absence of any other information) you should assume that the decrease represents a cash outflow to repay loans/loan notes.

Note that, when identifying the level of borrowings, you need to look for all bank loans and loan notes in the company's balance sheets. These will normally appear in the non-current liabilities section. However, occasionally, some borrowing will be due for repayment within 12 months of the balance sheet date so this will appear in the current liabilities section.

Finally, remember that changes in bank overdrafts do not normally appear in the financing activities section. For most companies, bank overdraft balances tend to fluctuate constantly as a result of day to day transactions. Changes in bank overdraft balances, therefore, normally form part of the company's overall net increase or decrease in cash for the year rather than being a separate financing cash flow.

Activity 37.6

At the start of its financial year on 1 January, a company had 300,000 ordinary shares of 25p each in issue. In March, the company made a 1-for-3 rights issue of ordinary shares for cash, fully paid, at an issue price of £1.60 per share. In June, it redeemed £250,000 of loan notes at par. In November, it paid an ordinary dividend of 13 pence per share. During the year, the company paid loan note interest of £37,000 and corporation tax of £84,000. What was the net cash used in financing activities?

37.5 Preparing the statement of cash flows for a company: a worked example

Exhibit 37.7 gives an example of the preparation of a full statement of cash flows for a company, using the indirect method.

Exhibit 37.7 Preparing the statement of cash flows for an individual company

You are given the following information in relation to Pinkwich Ltd:

Pinkwich Ltd Income statement for the year ended 31 December 2024	
	£
Sales revenue	141,900
Cost of sales	(88,500)
Gross profit	53,400
Operating expenses	(41,300)
Operating profit	12,100
Interest income	200
Finance costs	(1,600)
Profit before tax	10,700
Corporation tax expense	(3,200)
Profit for the year	<u>7,500</u>

Balance sheets as at 31 December

	31/12/2024	31/12/2023
	£	£
<i>Non-current assets</i>		
Property, plant & equipment at cost	175,500	160,500
Less Accumulated depreciation	(70,200)	(69,100)
	<u>105,300</u>	<u>91,400</u>
<i>Current assets</i>		
Inventory	26,300	20,300
Trade and other receivables	14,800	15,800
Cash at bank and in hand	1,100	300
	<u>42,200</u>	<u>36,400</u>
Total assets	<u>147,500</u>	<u>127,800</u>
<i>Current liabilities</i>		
Trade and other payables	17,600	19,600
Corporation tax payable	3,100	2,800
	<u>20,700</u>	<u>22,400</u>
<i>Non-current liabilities</i>		
Bank loans	31,600	21,600
Net assets	<u>95,200</u>	<u>83,800</u>
<i>Equity</i>		
Share capital	29,100	26,100
Share premium	16,500	11,500
Retained earnings	49,600	46,200
Total equity	<u>95,200</u>	<u>83,800</u>

Additional information:

- (i) There were no amounts outstanding in respect of interest payable or receivable as at either year end date.
- (ii) Operating profit is stated after charging depreciation of £10,400.
- (iii) During 2024, the company sold a piece of equipment for £9,500 cash, making a profit on disposal of £800.
- (iv) The share capital of Pinkwich Ltd comprises ordinary shares only. In 2024, the company made a successful rights issue of shares at a price above par (or 'nominal') value.
- (v) The company paid ordinary dividends amounting to £4,100 during 2024.

Required

Using the indirect method, prepare the statement of cash flows for Pinkwich Ltd for the year ended 31 December 2024 in accordance with IAS 7 *Statement of Cash Flows*.





Solution:

Pinkwich Ltd
Statement of cash flows for the year ended 31 December 2024

	£	£
Cash flows from operating activities		
Operating profit	12,100	
Add: Depreciation	10,400	
Less: Profit on sale of property, plant & equipment	(800)	
Increase in inventory	(6,000)	
Decrease in trade and other receivables	1,000	
Decrease in trade and other payables	(2,000)	
Cash generated from operations	14,700	
Corporation tax paid (see working 1)	<u>(2,900)</u>	
Net cash from operating activities		11,800
Cash flows from investing activities		
Purchases of property, plant & equipment (see workings 2 to 6)	(33,000)	
Proceeds from sale of property, plant & equipment	9,500	
Interest received	<u>200</u>	
Net cash used in investing activities		(23,300)
Cash flows from financing activities		
Proceeds from issue of share capital	8,000	
Proceeds from long-term borrowing	10,000	
Interest paid	(1,600)	
Dividends paid	<u>(4,100)</u>	
Net cash from financing activities		12,300
Net increase in cash		<u>800</u>
Cash at beginning of year		<u>300</u>
Cash at end of year		<u><u>1,100</u></u>

Working 1:

Corporation tax payable

	£		£
Corporation tax paid (<i>missing figure</i>)	2,900	Opening balance	2,800
Closing balance	<u>3,100</u>	Corporation tax expense	<u>3,200</u>
	<u><u>6,000</u></u>		<u><u>6,000</u></u>

Working 2:

We can deduce the carrying amount of the equipment sold during the year:

	£
Disposal proceeds (<i>given in question</i>)	9,500
Less Carrying amount of equipment sold (<i>missing figure deduced in this calculation</i>)	<u>(8,700)</u>
Profit on disposal (<i>given in question</i>)	<u><u>800</u></u>

We can use the carrying amount of equipment sold in a working for non-current assets at carrying amount:

Working 3:**Property, plant & equipment at carrying amount working**

	£		£
Opening balance	91,400	Carrying amount of asset sold (working 2)	8,700
Acquisitions (<i>the missing figure</i>)	33,000	Depreciation charge for year	10,400
	<u>124,400</u>	Closing balance	<u>105,300</u>
			<u>124,400</u>

Alternatively, instead of working 3 we could reconstruct separate accounts for the cost and accumulated depreciation of property plant and equipment:

Working 4:**Accumulated depreciation on property, plant & equipment working**

	£		£
Acc dep on asset sold (<i>missing figure</i>)	9,300	Opening balance	69,100
Closing balance	<u>70,200</u>	Depreciation charge for year	<u>10,400</u>
	<u>79,500</u>		<u>79,500</u>

Working 5:

We know from working 2 that the carrying amount of the equipment sold was £8,700, so we can deduce the original cost of the asset that was sold:

	£
Cost of equipment sold (<i>the missing figure in this calculation</i>)	18,000
Less Accumulated depreciation on equipment sold (<i>from working 4</i>)	<u>(9,300)</u>
Carrying amount of equipment sold (<i>from working 2</i>)	<u>8,700</u>

Working 6:**Property, plant & equipment at cost working**

	£		£
Opening balance	160,500	Cost of equipment sold (<i>working 5</i>)	18,000
Acquisitions (<i>missing figure deduced</i>)	<u>33,000</u>	Closing balance	<u>175,500</u>
	<u>193,500</u>		<u>193,500</u>

37.6 What does the statement of cash flows tell us about a company?

Information about a business's cash flows will be of great significance to users. As we explained in Chapter 28, struggling businesses go 'bust' when they run out of cash, not necessarily when they report losses in their income statements. Equally, successful companies need cash if they want to expand, take on new staff, invest in new equipment, and pay dividends to shareholders. Good cash flow is of vital importance to all businesses.

Users will therefore look closely at a company's statement of cash flows in order to evaluate how successful it is at generating cash and the ways in which that cash is being used. In questions, you might be asked to prepare a statement of cash flows for a company and then to make some

comments on what your statement indicates about the company. Below are some general observations about what you might look for in each of the three sections of the statement. If you take your studies further, then you will learn to analyse the statement in greater depth.

Commenting on the operating activities section

The total of this section (i.e. the net cash from operating activities) should be positive (i.e. a net inflow of cash). A negative total would be a very worrying sign. A company can't depend on selling non-current assets every year to generate its cash, and neither can it always rely on issuing shares or borrowing more money. In the long run, operating activities are the only sustainable source of cash inflows. A negative cash flow from operating activities is an obvious indicator that the company could be in serious financial trouble.

The cash generated from operations subtotal can be compared with the operating profit figure in order to evaluate the 'quality' of the company's profits. For example, if all the changes in working capital have had an adverse effect on operating cash flows, then this could be cause for concern. The company may be suffering from poor management, with little control over inventory levels and debt collection, and experiencing liquidity problems as a result. But, alternatively, the company could simply be expanding rapidly and making significant investments in its working capital.

The net cash from operating activities can also be compared with the cash outflows for interest and dividends paid. Interest payments to the company's lenders *must* always be made each year. Dividends do not *have* to be paid, but shareholders generally prefer it if the current level of annual dividend is maintained or increased. So, if the net cash from operating activities does not comfortably exceed the current levels of interest and dividend payments, then this could be a worry.

Activity 37.7

Company A and Company B are both manufacturers of household products. The following figures are taken from the statement of cash flows of each company for the year just ended:

	Company A	Company B
Operating profit	<u>£100,000</u>	<u>£75,000</u>
Cash generated from operations	<u>£40,000</u>	<u>£5,000</u>

Company A has been trading for over 20 years but B has only just finished its first year of trading. Based on this small amount of information, what comments might you make about the performance of these two companies?

Commenting on the investing activities section

The total of this section (i.e. the net cash from investing activities) is often negative. This is perfectly normal, because new non-current assets will generally be purchased at current prices for new items, whereas old assets will typically be disposed of for lower, second-hand values.

Furthermore, significant cash outflows caused by buying new property, plant and equipment could be a positive sign for the company, because the new assets may help produce enhanced cash flows from operating activities in the years to come.

A difficulty for users is that the expenditure on new non-current assets may indeed represent an increase in productive capacity that will contribute to improved operating cash flows in the future. But, alternatively, the spending may have been needed to simply *replace* existing assets and *maintain* current production levels. Users would certainly be interested to learn whether capacity will merely be maintained or if it will be enhanced, but the statement does not give this information.

Some users apply a rule of thumb that if expenditure on new property, plant and equipment is roughly equal to the depreciation expense for the year, then it is more likely to be for the mere

replacement of assets and maintaining existing levels of capacity. If capital expenditure is far more than the depreciation charge, then there is a greater chance that it represents an increase in operating capacity.

Commenting on the financing activities section

The total of this section (i.e. the net cash from financing activities) may be positive or negative and the figures need to be considered with care.

The total will typically be positive if new shares have been issued and/or new borrowings received. If these receipts have been used to fund significant investment in new non-current assets (which would be apparent from the investing activities section), then this *could* be a good sign for the company, to the extent that the new assets might be expected to boost future profits and operating cash flows.

However, if new shares have been issued and/or new borrowings received in order to compensate for weak operating cash flows, then this would be unsustainable. Companies won't be able to continue borrowing and issuing new shares if they are operating unsuccessfully.

Cash inflows from new borrowing indicate that interest payments will probably increase in the future, whilst cash outflows to repay loans signal that interest payments should fall. Likewise, if new ordinary shares have been issued and the company wishes to maintain the annual dividend paid per share, then total dividend payments will have to increase in the future. As always, users of the financial statements will be keen to identify pieces of information like this that can help to predict the future cash flows of the company.

Activity 37.8

On 1 April 2023, a company issued £600,000 6% loan notes, interest being payable half-yearly. As a result, by how much will interest paid increase in the company's statement of cash flows for its year ended 31 December 2024 compared with the previous year?

Commenting on the overall increase or decrease in cash

The net increase or decrease in cash for the year is also worth commenting on. An increase in cash is naturally a positive sign. However, if the company is building up large cash surpluses, then the money should be put to good use soon. Either the funds should be used to expand and develop the business, loans should be repaid to minimise future interest charges, or the cash should be returned to investors via dividend payments.

Alternatively, if cash has decreased significantly during the year, then this could be cause for concern, particularly if operating cash flows are weak. If the company has a large bank overdraft, then it should aim to reduce this as a priority. Bank overdrafts are normally an expensive form of borrowing and the company should, ideally, find less costly forms of finance.

Finally, note that evaluating the performance of a company by looking at its statement of cash flows for just one year may be of limited value and could even be misleading. The pattern of a business's cash flows over time can be erratic, and the cash flows for one year might not be indicative of the company's long-term performance. Observations will be far more meaningful if the financial statements for more than one year can be examined.

Activity 37.9

What problems do you think might be encountered when comparing the statement of cash flows of one company with that of another?

Learning outcomes

You should now have learnt:

- 1 How to calculate the net cash from operating activities for a company using the indirect method.
- 2 The main items that appear in the *investing activities* section of the statement of cash flows for a company and how to calculate them.
- 3 The main items that appear in the *financing activities* section of the statement of cash flows for a company and how to calculate them.
- 4 How to prepare a statement of cash flows for a company using the indirect method in accordance with IAS 7 *Statement of Cash Flows*.
- 5 Some key points to consider when analysing and interpreting the statement of cash flows for a company.

Answers to activities

37.1 The answer is £200,000 as calculated below:

	£
Operating profit	148,000
Add Depreciation expense	57,000
Increase in inventory	(21,000)
Decrease in trade receivables	9,000
Increase in prepayments	(4,000)
Increase in trade payables	14,000
Decrease in accruals	(3,000)
<i>Cash generated from operations</i>	<u>200,000</u>

37.2 The answer is £188,000, calculated below:

	£
Operating profit	137,000
Add Depreciation expense	81,000
Add Loss on disposal of non-current assets	2,000
Decrease in inventory	17,000
Increase in trade receivables	(13,000)
Decrease in trade payables	(7,000)
Cash generated from operations	217,000
Corporation tax paid	(29,000)
<i>Net cash from operating activities</i>	<u>188,000</u>

37.3 In the operating activities section, the profit on disposal of £7,000 will be deducted from the profit figure to help convert it into the cash generated from operations. In the investing section, the £40,000 will appear as an inflow, being the proceeds from disposal of property, plant & equipment.

37.4 IAS 7 explains that dividends paid can be classified as a financing cash flow because they represent a cost of obtaining finance from shareholders. The financing section would certainly seem to be the more obvious place to show them. However, IAS 7 states that they can alternatively be shown as an operating cash flow to help users assess the company's ability to afford its dividend payments out of its operating cash flows.

Whilst users will certainly be interested in making this assessment, it seems an odd reasoning for IAS 7 to adopt. Dividend payments aren't really an operating cash flow, and it is a little peculiar that IAS 7

allows them to be classified in the 'wrong' place just to make it slightly easier for users to make a comparison. Users make lots of comparisons of one figure in the financial statements with another figure elsewhere. They should be perfectly capable of comparing the figure for dividends paid with the level of operating cash flows without needing to artificially classify dividends as an operating cash flow!

Moreover, giving companies the choice over how they classify interest and dividends doesn't help to achieve *comparability* between companies. As you saw in Chapter 10, according to the IASB's own Conceptual Framework, comparability is one of the characteristics that enhances the usefulness of financial information!

- 37.5** The answer is £80,000. The par value of all the ordinary shares issued during the year was £30,000 (because the balance on the share capital account increased from £42,000 to £72,000). They were issued at a price greater than par value, because the balance on the share premium account increased by £50,000 (from £107,000 to £157,000). The total cash inflow from the issue of shares must therefore have been £80,000 (being the total share capital and premium in this year's balance sheet (£229,000) minus total share capital and premium in last year's (£149,000)).

- 37.6** The answer is £179,000, as calculated below:

	£	£
Proceeds from the issue of shares*	160,000	
Repayment of borrowings	(250,000)	
Interest paid	(37,000)	
Dividends paid (400,000 shares in issue in Nov × £0.13)	(52,000)	
<i>Net cash used in financing activities</i>		<u>(179,000)</u>

$$*300,000 \times \frac{1}{3} = 100,000 \text{ new shares issued; } 100,000 \times £1.60 = £160,000.$$

Remember that corporation tax paid is shown in the operating activities section, not financing.

- 37.7** Company A may have made a greater operating profit than B, but it has been established for over 20 years. For B to achieve 75% of A's profit in its very first year of trading seems, at face value, quite impressive.

The fact that A's cash generated from operations is less than half of its operating profit is a potential concern. Given that depreciation charges will have been added back to its profit figure, there have probably been significant adverse movements in working capital. It is possible that A needs much better control over its inventory levels and debt collection.

In contrast, the fact that B's cash generated from operations is so low is more understandable. A new manufacturing company will inevitably experience a big increase in inventory and receivables in its first year of trading. This is not necessarily a big problem as long as B has sufficient finance in place.

Admittedly, you have only been given a tiny amount of information but, based on what is available, the performance of A seems a greater cause for concern.

- 37.8** The answer is £18,000. Interest is paid in two equal annual instalments; only the first instalment will be paid (on 1 October 2023) during the year ended 31 December 2023. In the year ended 31 December 2024, two instalments will be paid (on 1 April 2024 and 1 October 2024). Each instalment is $£600,000 \times 6\% \times 6/12 = £18,000$, so interest paid will increase by £18,000 in the year following the issue.

- 37.9** First, you saw that interest paid and received, as well as dividends paid, can be shown in different sections by different companies. Users will need to be careful to check how these items have been classified when comparing the statement of cash flows of one company with another.

Second, one company might use the direct method to calculate cash flows from operating activities while the other might use the indirect method. IAS 7 encourages the use of the direct method because it provides clarity regarding exactly what operating cash receipts and payments have occurred. However, it is rarely used in practice, making it more difficult to draw comparisons on the rare occasions that a company *does* choose to adopt it.

Finally, the pattern of a business's cash flows over time is often erratic and the statement of cash flows for one year may not be indicative of a company's long-term performance. Comparisons between companies will be far more meaningful if more than one year's financial statements for both businesses can be examined.

Review questions

37.1 You determine the following information in respect of Debbrell Ltd for the year ended 30 September 2024:

	£
Operating profit	80,000
Depreciation expense	22,000
Increase in inventory	8,000
Decrease in receivables	11,000
Decrease in payables	6,000

On the basis of the above information, what cash will have been generated from operations according to the company's statement of cash flows?

37.2A The following details are provided to you regarding Southwall Ltd:

- (i) The company reported an operating profit of £432,000 for the year ended 31 December 2024.
- (ii) The depreciation expense for 2024 was £79,000.
- (iii) Extracts from the company's balance sheets as at 31 December 2024 and 2023 reveal:

	31 December 2024	31 December 2023
	£'000	£'000
Inventory	158	186
Trade receivables	217	201
Trade payables	193	210

Given the above, what is the cash generated from operations in the statement of cash flows of Southwall Ltd for the year ended 31 December 2024?

37.3 The balance sheets of Cadamarteri Ltd as at 31 December 2024 and 2025 showed *corporation tax payable* of £12,200 and £13,600, respectively. The income statements for 2024 and 2025 disclosed figures for *corporation tax expense* of £12,700 and £14,500, respectively.

What amount for *corporation tax paid* will appear in the statement of cash flows for this company for its year ended 31 December 2025?

37.4 You establish the following details in connection with the property, plant & equipment of Kagisa Ltd for the year ended 31 December 2025:

	£
Carrying amount at 1 January 2025	826,800
Proceeds from the sale of property, plant & equipment during the year	85,000
Depreciation expense for the year	129,700
Loss on the disposal of property, plant & equipment during the year	12,400
Carrying amount at 31 December 2025	746,200

What figure for *payments to acquire property, plant and equipment* will appear in the statement of cash flows of this company for its year ended 31 December 2025?

37.5A You establish the following details in connection with the property, plant & equipment of Snoding Ltd for the year ended 30 June 2024:

	£
Carrying amount as at 1 July 2023	366,000
Purchases of property, plant and equipment during the year	79,000
Profit on the disposal of property, plant and equipment during the year	3,000
Depreciation expense for the year	58,000
Carrying amount as at 30 June 2024	486,000

Freehold land that originally cost £50,000 was revalued for the first time during May 2024 to reflect its current market value of £170,000. This new valuation is incorporated within the closing balance of £486,000 above.

What figure for *proceeds from the disposal of property, plant & equipment* will appear in the statement of cash flows of this company for its year ended 30 June 2024?

37.6 During its year ended 31 May 2024, Algard plc undertook the following transactions:

- (i) Issued 50,000 50p ordinary shares at a price of 80p per share.
- (ii) Redeemed £200,000 5% loan notes at par.
- (iii) Paid corporation tax of £29,000.
- (iv) Made a bonus issue of 20,000 new 50p ordinary shares.
- (v) Issued £300,000 of new 4% loan notes at par.
- (vi) Paid loan note interest totalling £18,000.

Based on the above, what is the *net cash from financing activities* for this company in its statement of cash flows for the year ended 31 May 2024?

37.7A At 30 November 2023, Wandigo Ltd had the following capital structure:

	£
Share capital (500,000 ordinary shares of 25p each)	125,000
Share premium account	376,000

In January 2024, the company made a 1-for-4 rights issue at a price of 85p per share. The rights were fully taken-up. Then, in May 2024, the company made a 1-for-10 bonus issue using the share premium account. What figure will appear in respect of *proceeds from issue of shares* in the statement of cash flows for the year ended 30 November 2024?

37.8 You are given the balance sheets of Sibir Ltd as at 31 March 2024 and 31 March 2023:

	31/3/2024 £	31/3/2023 £
<i>Non-current assets</i>		
Property, plant & equipment at cost	133,190	95,580
Less Accumulated depreciation	(32,500)	(22,230)
	<u>100,690</u>	<u>73,350</u>
<i>Current assets</i>		
Inventory	29,490	22,880
Trade receivables	17,850	16,960
Cash at bank	2,990	750
	<u>50,330</u>	<u>40,590</u>
Total assets	<u>151,020</u>	<u>113,940</u>
<i>Current liabilities</i>		
Trade payables	17,070	21,440
Corporation tax payable	7,680	7,040
	<u>24,750</u>	<u>28,480</u>
<i>Non-current liabilities</i>		
Bank loans	46,060	21,480
Net assets	<u>80,210</u>	<u>63,980</u>
<i>Equity</i>		
Share capital	26,500	24,630
Share premium	11,730	10,830
Retained earnings	41,980	28,520
Total equity	<u>80,210</u>	<u>63,980</u>



You are also given the income statement of the company for the year ended 31 March 2024:

	£
Sales revenue	235,500
Cost of sales	(126,300)
<i>Gross profit</i>	<u>109,200</u>
Operating expenses	(73,160)
<i>Operating profit</i>	<u>36,040</u>
Interest income	50
Finance costs	(1,290)
<i>Profit before tax</i>	<u>34,800</u>
Corporation tax expense	(9,400)
<i>Profit for the year</i>	<u><u>25,400</u></u>

The following additional information is relevant:

- (i) The depreciation expense for the year ended 31 March 2024 was £10,270.
- (ii) There were no disposals of property, plant and equipment during the year ended 31 March 2024.
- (iii) There were no amounts outstanding in respect of interest payable or receivable as at either year end date.
- (iv) In January 2024, the company issued new ordinary shares for cash.

Required:

Following the requirements of IAS 7, prepare the statement of cash flows for Sibir Ltd for the year ended 31 March 2024 using the indirect method.

37.9A Wilton Felder Ltd is finalising its financial statements for the year ended 31 October 2024. You are presented with the following information:

Income statement for the year ended 31 October 2024

	£
Sales revenue	175,900
Cost of sales	(99,370)
<i>Gross profit</i>	<u>76,530</u>
Operating expenses	(51,280)
<i>Operating profit</i>	<u>25,250</u>
Interest income	40
Finance costs	(1,400)
<i>Profit before tax</i>	<u>23,890</u>
Corporation tax expense	(6,450)
<i>Profit for the year</i>	<u><u>17,440</u></u>

Balance sheets as at 31 October

	31/10/2024 £	31/10/2023 £
<i>Non-current assets</i>		
Property, plant & equipment at cost	132,040	111,580
Less Accumulated depreciation	(32,210)	(28,870)
	<u>99,830</u>	<u>82,710</u>
<i>Current assets</i>		
Inventory	24,130	27,220
Trade receivables	17,520	11,740
Cash at bank and in hand	4,220	2,140
	<u>45,870</u>	<u>41,100</u>
Total assets	<u>145,700</u>	<u>123,810</u>

Balance sheets as at 31 October

	31/10/2024 £	31/10/2023 £
<i>Current liabilities</i>		
Trade and other payables	20,060	17,860
Corporation tax payable	5,270	4,830
	<u>25,330</u>	<u>22,690</u>
<i>Non-current liabilities</i>		
Bank loans	28,320	23,320
Net assets	<u><u>92,050</u></u>	<u><u>77,800</u></u>
<i>Equity</i>		
Share capital	24,410	21,760
Share premium	13,800	11,440
Retained earnings	53,840	44,600
Total equity	<u><u>92,050</u></u>	<u><u>77,800</u></u>

Additional information:

- (i) There were no amounts outstanding in relation to interest payable or receivable as at either year end date.
- (ii) The operating profit figure above is stated after charging depreciation of £10,320.
- (iii) In June 2024, the company sold a piece of machinery for £10,000, realising a profit on disposal of £5,160.
- (iv) The share capital of the company comprises ordinary shares only. In August 2024, the company made a successful rights issue of shares at a price greater than par value.
- (v) The company paid ordinary dividends amounting to £8,200 during the year ended 31 October 2024.

Required:

Using the indirect method, prepare the statement of cash flows for Wilton Felder Ltd for the year ended 31 October 2024 in accordance with IAS 7 *Statement of Cash Flows*.

37.10A The balance sheets of Banton Ltd as at 31 August 2024 and 31 August 2023 are shown below:

	31/8/2024 £	31/8/2023 £
<i>Non-current assets</i>		
Property, plant & equipment	470,200	350,400
Less Accumulated depreciation	(124,400)	(90,320)
	<u>345,800</u>	<u>260,080</u>
<i>Current assets</i>		
Inventory	102,760	85,000
Trade and other receivables	72,400	64,040
Cash at bank and in hand	–	920
	<u>175,160</u>	<u>149,960</u>
Total assets	<u><u>520,960</u></u>	<u><u>410,040</u></u>





	31/8/2024 £	31/8/2023 £
<i>Current liabilities</i>		
Bank overdraft	14,910	–
Trade and other payables	69,760	78,040
Corporation tax payable	12,560	11,520
	<u>97,230</u>	<u>89,560</u>
<i>Non-current liabilities</i>		
Long-term borrowings	89,130	96,960
Net assets	<u>334,600</u>	<u>223,520</u>
<i>Equity</i>		
Ordinary share capital	121,360	107,800
Share premium	53,840	44,000
Revaluation reserve	65,680	–
Retained earnings	93,720	71,720
Total equity	<u>334,600</u>	<u>223,520</u>

You are also given the income statement of Banton Ltd for the year ended 31 August 2024:

	£
Sales revenue	506,000
Cost of sales	(317,480)
Gross profit	188,520
Operating expenses	(126,320)
Operating profit	62,200
Interest income	440
Finance costs	(5,800)
Profit before tax	56,840
Corporation tax expense	(15,360)
Profit for the year	<u>41,480</u>

Further information is given below:

- (i) There were no amounts outstanding in connection with interest payable or receivable as at either year end date.
- (ii) The figure for operating profit in the income statement above is stated after charging depreciation of £59,320.
- (iii) In April 2024, the company sold equipment that had a carrying amount of £49,390, realising a loss on disposal of £4,390.
- (iv) In July 2024, the freehold land owned by Banton Ltd was appraised by a firm of professional valuers, and the new valuation has been incorporated in the above financial statements.
- (v) The company issued new ordinary shares for cash during May 2024.

Required:

Following the guidance of IAS 7, prepare the statement of cash flows for Banton Ltd for the year ended 31 August 2024 using the indirect method.

37.11 Rabada Ltd needs to prepare its statement of cash flows for the year ended 31 January 2024. You are furnished with the following information:

Income statement for the year ended 31 January 2024

	£
Sales revenue	901,600
Cost of sales	(520,750)
Gross profit	380,850
Operating expenses	(298,150)
Operating profit	82,700
Interest income	460
Finance costs	(8,190)
Profit before tax	74,970
Corporation tax expense	(18,730)
Profit for the year	<u>56,240</u>

Balance sheets as at 31 January

	31/1/2024 £	31/1/2023 £
<i>Non-current assets</i>		
Property, plant & equipment at cost	943,520	776,250
Less Accumulated depreciation	(241,350)	(183,650)
	<u>702,170</u>	<u>592,600</u>
<i>Current assets</i>		
Inventory	172,200	120,700
Trade receivables	113,200	73,070
Cash at bank and in hand	1,150	2,100
	<u>286,550</u>	<u>195,870</u>
Total assets	<u>988,720</u>	<u>788,470</u>
<i>Current liabilities</i>		
Bank overdraft	36,420	–
Trade payables	91,850	84,450
Accrued interest payable	2,040	1,370
Corporation tax payable	17,850	15,550
	<u>148,160</u>	<u>101,370</u>
<i>Non-current liabilities</i>		
Long-term borrowings	201,520	114,300
Net assets	<u>639,040</u>	<u>572,800</u>
<i>Equity</i>		
Ordinary share capital	90,570	81,960
Share premium	22,710	21,320
Retained earnings	525,760	469,520
Total equity	<u>639,040</u>	<u>572,800</u>

Additional information:

- The figure for operating profit above is stated after charging depreciation of £78,030.
- In June 2023, the company disposed of equipment for £75,950 cash. The equipment had a carrying amount of £62,270 as at the date of disposal.





- (iii) There were no amounts outstanding in respect of interest receivable as at either year end date.
 (iv) The company issued new ordinary shares for cash during September 2023.

Required:

- (a) Using the indirect method, prepare the statement of cash flows for Rabada Ltd for the year ended 31 January 2024 in accordance with the requirements of IAS 7.
 (b) Comment of the performance of Rabada Ltd on the basis of the statement of cash flows you have produced in a).

37.12A As at 31 May 2024 and 31 May 2023, Dendry Ltd had the following balance sheets:

	31/5/2024 £	31/5/2023 £
<i>Non-current assets</i>		
Property, plant & equipment	9,646,200	8,654,700
Less Accumulated depreciation	(3,495,100)	(2,701,300)
	<u>6,151,100</u>	<u>5,953,400</u>
<i>Current assets</i>		
Inventory	1,027,300	942,300
Trade receivables	969,800	1,010,900
Prepayments	104,100	111,700
Cash at bank and in hand	14,300	8,900
	<u>2,115,500</u>	<u>2,073,800</u>
Total assets	<u>8,266,600</u>	<u>8,027,200</u>
<i>Current liabilities</i>		
Bank overdrafts	367,800	189,600
Trade payables	1,412,600	1,216,500
Accruals	239,300	278,400
Corporation tax payable	162,700	155,800
	<u>2,182,400</u>	<u>1,840,300</u>
<i>Non-current liabilities</i>		
Loan notes	3,200,000	4,150,000
Redeemable preference shares	250,000	-
	<u>3,450,000</u>	<u>4,150,000</u>
Net assets	<u>2,634,200</u>	<u>2,036,900</u>
<i>Equity</i>		
Ordinary share capital	326,000	276,000
Share premium	602,300	549,700
Revaluation reserve	298,600	-
Retained earnings	1,407,300	1,211,200
Total equity	<u>2,634,200</u>	<u>2,036,900</u>

The company's income statement for the year ended 31 May 2024 was as follows:

	£
Sales revenue	8,757,800
Cost of sales	(5,114,300)
<i>Gross profit</i>	<u>3,643,500</u>
Operating expenses	(2,693,200)
<i>Operating profit</i>	<u>950,300</u>
Interest income	11,600
Finance costs	<u>(297,200)</u>

	£
<i>Profit before tax</i>	664,700
<i>Corporation tax expense</i>	<u>(174,500)</u>
<i>Profit for the year</i>	<u><u>490,200</u></u>

Note also the following additional information:

- (i) The operating profit shown above is stated after charging depreciation of £836,200.
- (ii) During the year ended 31 May 2024, Dendry Ltd acquired new plant and equipment for £780,000 cash. The company also disposed of plant and equipment for £39,500 cash.
- (iii) In April 2024, the freehold land owned by the company was valued at £500,000, and this new value has been incorporated in the above financial statements.
- (iv) There were no amounts outstanding in respect of interest receivable as at either year end date.
- (v) Included within the figure for accruals at 31 May 2024 is £59,400 for interest payable. The corresponding figure for 2023 was £47,300.
- (vi) In October 2023, the company issued 250,000 £1 redeemable preference shares at par.
- (vii) In August 2023, Dendry Ltd made a 1-for-10 bonus issue of ordinary shares using the share premium account. In February 2024, the company made a successful rights issue of ordinary shares at a price above par value.

Required:

Using the indirect method, prepare the statement of cash flows for Dendry Ltd for the year ended 31 May 2024, in accordance with IAS 7 *Statement of Cash Flows*.

AN INTRODUCTION TO FINANCIAL ANALYSIS

Introduction

This part deals with how to analyse and interpret financial statements.

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39	Analysis and interpretation of financial statements	658

Learning objectives

After you have studied this chapter, you should be able to:

- Calculate some basic accounting ratios.
- Use accounting ratios to calculate missing figures in financial statements.
- Offer some explanations for changes in these ratios over time.

Introduction

In this chapter, you'll learn more about the relationship between mark-up and margin and how to use the relationship between them and sales revenue and gross profit to find figures that are missing in the trading account. You will also learn how to calculate the inventory turnover ratio and some explanations for why these ratios change over time.

38.1 The need for accounting ratios

In Chapter 27, you learnt that ratios are used when drawing-up financial statements from incomplete records. And, in Chapter 39, you will learn that ratios are used to enable us to analyse and interpret accounting statements. Ratios are, therefore, useful both in constructing and in deconstructing financial statements.

Activity 38.1

What is meant by the term 'incomplete records'?

The ability to interpret the result of a ratio calculation is a key skill of accountants. It requires understanding of double entry, financial reporting, and the context surrounding the entity involved, such as its products or services, market, competitors, strengths, weaknesses, opportunities, and threats. When all these and other relevant factors are taken into account, the overall process is known as 'fundamental analysis'.

Fundamental analysis is impossible without ratio analysis and, in order to understand what a calculated ratio means or implies, fundamental analysis is essential. Ratio analysis and fundamental analysis are inseparable: you can do the mechanical calculation of a ratio but you cannot interpret it unless you bring other factors into account.

Unfortunately, most students who are asked to comment on a ratio they have calculated do not go beyond the result of the calculation. Instead, they describe the formula used to calculate the

ratio or they state that the result of the calculation is higher or lower or equal to what you would expect for that ratio. **You will never get good marks in an exam for doing this. Examiners expect you to discuss ratios that have been calculated in the context of the entity whose ratios have been calculated.** You will learn how to do so in Chapter 39. First, let's consider some ratios that not only help anyone assess the performance of an entity, they are of fundamental importance to the management of the day-to-day running of any business.

38.2 Mark-up and margin

The purchase cost, gross profit and selling price of goods or services may be shown as:

$$\text{Cost Price} + \text{Gross Profit} = \text{Selling Price}$$

When shown as a fraction or percentage of the *cost price*, the gross profit is known as the **mark-up**.

When shown as a fraction or percentage of the *selling price*, gross profit is known as the **margin**.

We can calculate mark-up and margin using this example:

$$\text{Cost Price} + \text{Gross Profit} = \text{Selling Price}$$

$$£4 + £1 = £5$$

Mark-up = $\frac{\text{Gross Profit}}{\text{Cost Price}}$ as a fraction, or if required as a percentage, multiply by 100:

$$\frac{£1}{£4} = \frac{1}{4} \quad \text{or} \quad \frac{1}{4} \times 100 = 25\%$$

Margin = $\frac{\text{Gross Profit}}{\text{Selling Price}}$ as a fraction, or if required as a percentage, multiply by 100:

$$\frac{£1}{£5} = \frac{1}{5} \quad \text{or} \quad \frac{1}{5} \times 100 = 20\%$$

Activity 38.2

Can you see a simple rule connecting mark-up to margin?

38.3 Calculating missing figures

Now we can use these ratios to complete trading accounts where some of the figures are missing. In all the examples in this chapter, we shall:

- assume that all the inventory in a business has the same rate of mark-up; and
- ignore wastages and theft of inventory.

Example 1

The following figures are for the year 2022:

	£
Inventory 1.1.2022	400
Inventory 31.12.2022	600
Purchases	5,200

A **mark-up** of 25 per cent is applied.

Required: find the gross profit and the sales figures.

Firstly, you prepare the trading account section of the income statement with the various missing figures shown as blank (or highlighted with a highlight pen, or with '?' inserted where the missing number should go):

Trading Account section of the Income Statement for the year ending 31 December 2022

	£	£
Sales		?
Less Cost of goods sold:		
Inventory 1.1.2022	400	
Add Purchases	5,200	
	5,600	
Less Inventory 31.12.2022	(600)	
		(5,000)
Gross profit		<u>?</u>
<i>Answer:</i>		
It is known that: and you know	Cost of goods sold	+ Gross profit
that you can use mark-up to		= Sales
find the profit, because:		
So:	Cost of goods sold	+ Percentage mark-up
	£5,000	+ 25%
		= Sales
and Sales =	£5,000	+ £1,250
		= £6,250

The trading account section of the income statement can be completed by inserting the Gross Profit £1,000 and £6,000 for Sales.

Trading Account section of the Income Statement for the year ending 31 December 2022

	£	£
Sales		6,250
Less Cost of goods sold:		
Inventory 1.1.2022	400	
Add Purchases	5,200	
	5,600	
Less Inventory 31.12.2022	(600)	
		(5,000)
Gross profit		<u>1,250</u>

Example 2

Another business has the following figures for 2023:

	£
Inventory 1.1.2023	400
Inventory 31.12.2023	600
Sales	6,250

Instead of the mark-up of 25 per cent used by the first business, this business uses a **margin** of 20 per cent.

Required: find the gross profit and the figure for purchases.

Trading Account section of the Income Statement for the year ending 31 December 2023

	£	£
Sales		6,250
Less Cost of goods sold:		
Inventory 1.1.2023	400	
Add Purchases	<u>?</u>	
	<u>?</u>	
Less Inventory 31.12.2023	<u>600</u>	<u>?</u>
Gross profit		<u>?</u>
Answer:		
Moving items about:	Cost of goods sold + Gross Profit = Sales	
	Sales – Gross Profit = Cost of goods sold	
	Sales – 20% margin = Cost of goods sold	
	£6,250 – £1,250 = £5,000	

Now the following figures are known:

	£	£
Sales		6,250
Less Cost of goods sold:		
Inventory 1.1.2023	400	
Add Purchases	(1) <u>?</u>	
	(2) <u>?</u>	
Less Inventory 31.12.2023	<u>(600)</u>	<u>(5,000)</u>
Gross profit		<u><u>1,250</u></u>

The two missing figures are found by normal arithmetical deduction:

	(2) less £600	= £5,000
	Therefore (2)	= £5,600
So that:	£400 opening inventory + (1)	= £5,600
	Therefore purchases (1)	= £5,200

The completed trading account section of the income statement can now be shown:

Trading Account section of the Income Statement for the year ending 31 December 2023

	£	£
Sales		6,250
Less Cost of goods sold:		
Inventory 1.1.2023	400	
Add Purchases	<u>5,200</u>	
	<u>5,600</u>	
Less Inventory 31.12.2023	<u>(600)</u>	<u>(5,000)</u>
Gross profit		<u><u>1,250</u></u>

This technique is found very useful by retailers when estimating the amount to be bought if a certain sales target is to be achieved. Alternatively, inventory levels or sales figures can be estimated given information as to purchases and opening inventory figures.

38.4 The relationship between mark-up and margin

You learnt in Activity 38.2 that both the mark-up and the margin refer to the same gross profit, but they express it as a fraction or a percentage of different figures. You can see an illustration of this in the two examples in Section 38.3 where the trading account is the same in both examples. The difference between the two examples was that the first one used a mark-up of 25% while the second used a margin of 20%.

In addition to being able to fill-in the gaps in a trading account using either of these ratios, this connection through gross profit means that if you know one of the two (*mark-up* or *margin*) you will be able to determine the other.

You learnt a simple definition of this relationship in Activity 38.2. Now we'll take it further so that you can use the relationship in any situation.

If the mark-up is known, to find the margin take the same numerator to be numerator of the margin, then for the denominator of the margin take the total of the mark-up's denominator plus the numerator. For example:

<i>Mark-up</i>		<i>Margin</i>
$\frac{1}{4}$	$\frac{1}{4 + 1} =$	$\frac{1}{5}$
$\frac{2}{11}$	$\frac{2}{11 + 2} =$	$\frac{2}{13}$

If the margin is known, to find the mark-up take the same numerator to be the numerator of the mark-up, then for the denominator of the mark-up use the margin's denominator less the numerator:

<i>Margin</i>		<i>Mark-up</i>
$\frac{1}{5}$	$\frac{1}{5 - 1} =$	$\frac{1}{4}$
$\frac{2}{13}$	$\frac{2}{13 - 2} =$	$\frac{2}{11}$

If you are given one of these ratios as a percentage and asked to state what the other one is, always convert it to a fraction. After identifying the other ratio, convert its fraction to a percentage before giving your answer.

Be sure that you learn the relationship between these two ratios. It is very often required in examinations.

38.5 Manager's commission

Managers of businesses are very often remunerated by a basic salary plus a percentage of profits. It is quite common to find the percentage expressed, not as a percentage of profits *before* this commission has been deducted but, as a percentage of the amount remaining *after* deduction of the commission.

For example, assume that profits before the manager's commission was deducted amounted to £8,400 and that the manager was entitled to 5% of the profits remaining after the commission was deducted. If 5% of £8,400 was taken, this amounts to £420, and the profits remaining

would amount to £7,980. However, 5% of £7,980 equals £399 so, the answer of £420 is wrong. To identify the correct answer:
Use the formula,

$$\frac{\text{Percentage commission}}{100 + \text{Percentage commission}} \times \text{Profit before commission}$$

In this example, this would be:

$$\frac{5}{100 + 5} \times £8,400 = £400 \text{ manager's commission.}$$

The profits remaining are £8,000. Of that amount, £400 is 5%. The answer of £400 is correct.

**Activity
38.3**

The same approach is taken when you want to know the VAT included in a bill you've paid. Assuming a VAT rate of 20%, what is the VAT when the total bill is £240?

38.6 Commonly used accounting ratios

There are some ratios that are in common use for the purpose of comparing one period's results with those of a previous period. Two of those most in use are the ratio of gross profit to sales, and the rate of **inventory turnover** (also known as 'stockturn', or 'stock turnover' ratio).

Gross profit as percentage of sales

This is the same as the gross margin. The basic formula is:

$$\frac{\text{Gross profit}}{\text{Sales}} \times \frac{100}{1} = \text{Gross profit as percentage of sales}$$

This represents the amount of gross profit for every £100 of sales revenue. If the answer turned out to be 15%, this would mean that for every £100 of sales revenue £15 gross profit was made before any expenses were paid.

This ratio is used as a test of the profitability of the sales. Just because sales revenue has increased does not, of itself, mean that gross profit will increase.

**Activity
38.4**

Spend a minute thinking about this and then write down why you think gross profit won't always increase if sales revenue increases.

Exhibit 38.1 illustrates this.

Exhibit 38.1

Trading account sections of the income statements for the years ending 31 December 2020 and 2021

	2020	2021
	£	£
Sales	7,000	8,000
Less Cost of goods sold:		
Opening inventory	500	900
Add Purchases	6,000	7,200
	<u>6,500</u>	<u>8,100</u>
Less Closing inventory	<u>(900)</u>	<u>(1,100)</u>
Gross profit	<u>(5,600)</u> <u>1,400</u>	<u>(7,000)</u> <u>1,000</u>

In the year 2020 the gross profit as a percentage of sales was

$$\frac{1,400}{7,000} \times \frac{100}{1} = 20\%$$

In the year 2021 it became

$$\frac{1,000}{8,000} \times \frac{100}{1} = 12\frac{1}{2}\%$$

Sales had increased but, as the gross profit percentage had fallen by a relatively greater amount, the gross profit has fallen. There can be many reasons for such a fall in the gross profit percentage, including:

- 1 Perhaps the goods being sold have cost more, but the selling price of the goods has not risen to the same extent.
- 2 There may have been a greater wastage or theft of goods.
- 3 There could be a difference in how much has been sold of each sort of goods, called the sales mix, between the two years, with different kinds of goods carrying different rates of gross profit per £100 of sales.
- 4 Perhaps in order to increase sales, reductions have been made in the selling price of goods.

The last reason was given in the answer to Activity 38.4, but any of these possible causes could have been included instead, along with several others. The idea of calculating the ratio is to show that the profitability per £100 of sales has changed. The business would then try to find out why and how such a change has taken place.

As the figure of sales revenue less returns inwards is also known as 'turnover', the ratio is sometimes referred to as 'gross profit percentage on turnover'. However, the most frequently used names for it are 'gross profit on sales' and 'gross margin'.

Inventory turnover

If we always kept just £100 of inventory at cost which, when we sold it, would always sell for £125, and we sold this amount eight times in a year, we would make $8 \times £25 = £200$ gross profit. The quicker we sell our inventory (i.e. the quicker we turn over our inventory) the more gross profit we will make, so long as our gross profit percentage is maintained. If it falls, there will come a point where less gross profit will be made even though sales have increased.

To check on how quickly we are turning over our inventory we can use the formula:

$$\frac{\text{Cost of goods sold}}{\text{Average inventory}} = \text{Number of times inventory is turned over within a period}$$

Activity 38.5

Spend a minute thinking about this and then write down why you think it might be useful to know how many times we turn over our inventory in a period.

It would be best if the average inventory held could be calculated by valuing the inventory quite a few times each year, then dividing the totals of the figures obtained by the number of valuations. For instance, monthly inventory figures could be added up and then divided by twelve. This would provide a far more meaningful figure for 'average' inventory. However, it is quite common, especially in examinations or in cases where no other information is available, to calculate the average inventory by using the figures for the opening inventory plus the closing inventory divided by two. Using the figures in Exhibit 38.1 we can calculate the inventory turnover for 2020 and 2021:

$$\begin{aligned} 2020 \quad & \frac{5,600}{(500 + 900) \div 2} = 8 \text{ times per year} \\ 2021 \quad & \frac{7,000}{(900 + 1,100) \div 2} = 7 \text{ times per year} \end{aligned}$$

Instead of saying that the inventory turnover is so many times per year, we could say on average how long we keep inventory before we sell it. We do this by the formula:

$$\text{To express it in months: } 12 \div \text{Inventory turnover} = x \text{ months}$$

$$\text{To express it in days: } 365 \div \text{Inventory turnover} = x \text{ days}$$

From Exhibit 38.1:

	2020	2021
In months	$\frac{12}{8} = 1.5 \text{ months}$	$\frac{12}{7} = 1.7 \text{ months}$
In days	$\frac{365}{8} = 45.6 \text{ days}$	$\frac{365}{7} = 52.1 \text{ days}$

All the above figures are rounded to one decimal place.

When the rate of inventory turnover is falling it can be due to many factors, including a slowing down of sales activity, or keeping a higher amount of inventory than is necessary. The ratio does not prove anything by itself, it merely prompts enquiries as to why it should be changing.

Current ratio

This ratio is current assets:current liabilities. It indicates whether there are sufficient relatively liquid (i.e. convertible to cash) assets to meet short-term debts when due. This is discussed in greater detail in Chapter 39.

Chapter 39 presents a more advanced and detailed overview of how a range of ratios can be used, and how to interpret what they tell you.

Learning outcomes

You should now have learnt:

- 1 That accounting ratios can be used to deduce missing figures, given certain assumptions.
- 2 That if the mark-up is known, the margin can easily be calculated.
- 3 That if the margin is known, the mark-up can easily be calculated.
- 4 How to calculate the gross profit on sales and inventory turnover ratios.
- 5 What may cause these ratios to change over time.

Answers to activities

38.1 Incomplete records exist where a business does not keep detailed accounting records. Perhaps it only operates a cash book, maybe not even that. In these circumstances, accountants have to construct the records that would have existed had a proper set of books been maintained, so that they can then prepare the financial statements. This involves working through invoices, receipts and bank records, plus any records the business has actually kept, and trying to identify and record what actually occurred during the period. Because of the logical relationships that exist between many of the items in financial statements, and because of the unambiguous rule of double entry, ratios defining the relationship between various items can be used to assist in this investigation. So, for example, if you know what inventory was held at the start, what was purchased and what inventory is left at the end, you can easily work out what was sold.

38.2 If you take mark-up and add the numerator (the top part of the fraction) to the denominator (the bottom part of the fraction), you get the margin. This is *always* the case.

38.3 You use the same formula but replace both the '5s' in the example with '20' and 'Profit before commission' with the total amount of the bill:

$$\frac{20}{100 + 20} \times £240 = £40$$

38.4 Gross profit may increase at the same rate as sales revenue because demand absorbed more units at the original price. This is normally the case if you make relatively small increases in the volume offered for sale when demand is currently exceeding supply. However, when sales volume increases, it is **often** partly because selling price has been reduced. Even though total sales volume has increased, sales revenue per unit is less than previously and so gross profit as a percentage of sales revenue will be lower than previously. Unless enough additional units are sold to recover the profit lost as a result of cutting the selling price, total gross profit will fall, not increase.

When a business is in trouble and cutting selling prices to try to make more profits by selling more units, it can often look as if it is doing much better if you only look at the sales revenue and gross profit figures. However, when you calculate the gross profit as a percentage of sales (i.e. the gross margin) and compare it with the previous gross margin, you can see that the business is possibly doing less well than before in terms of overall profitability.

38.5 It is useful to know as you can compare how quickly inventory is turning over now compared to the past. If it is turning over more slowly now (i.e. less times in a period than before), inventory levels may have grown higher, which may mean that the costs of holding inventory have risen. This rise in inventory levels may be due to our now buying more inventory every time we place an order – perhaps suppliers are offering discounts for larger orders.

This may be good, or it may be bad. You need to investigate the situation and find out. Hence, checking the trend in inventory turnover alerts you to the possibility that costs may be rising and that they may exceed any savings being made. You can also check your rate of inventory turnover with those of your competitors, enabling you to detect whether your ordering and storing practices are significantly different from theirs. If they are, you would then investigate what is happening so as to ensure that you are not wasting resources unnecessarily.

Review questions

38.1 Abby Lee is a trader who sells all of her goods at 35% above cost. Her books give the following information at 31 December 2024:

	£
Inventory 1 January 2024	10,670
Inventory 31 December 2024	11,830
Sales for year	95,850

You are required to:

Prepare the trading account section of the Income Statement for Abby Lee for 2024.

38.2A Darius Lowe gives you the following information as at 31 March 2024:

	£
Inventory 1 April 2023	12,000
Purchases	72,000

His mark-up is 40% on 'cost of goods sold'. His average inventory during the year was £14,000. Draw up an income statement for the year ending 31 March 2024 assuming his net profit amounts to 15% of his sales.

38.3 Tim Watt's business has a rate of inventory turnover of 8 times per year. Average inventory is £29,000. Mark-up is 30%. Expenses are 65% of gross profit.

You are to calculate:

- Cost of goods sold.
- Gross profit.
- Turnover.
- Total expenses.
- Net profit.

38.4A The following figures relate to the retail business of Daisy King for the month of July. Goods sold fall into two categories, X and Y.

	Category X	Category Y
Sales	£31,000	£21,000
Gross profit margin	35%	45%
Total expenses as a percentage of sales	20%	20%
Annual rate of inventory turnover	10	7

You are to calculate for each category of goods:

- Cost of goods sold.
- Gross profit.
- Total expenses.
- Net profit.
- Average inventory at cost.

38.5 The following trading account is extracted from the income statement for the year ending 31 December 2018 and is given to you by the owner of the business, Mr. Malik:

	£	£
Sales		260,000
Less Cost of goods sold:		
Opening inventory	41,000	
Add Purchases	218,000	
	259,000	
Less Closing inventory	<u>(49,000)</u>	
		(210,000)
Gross profit		<u>50,000</u>

Mr. Malik says that he normally adds 30% to the cost of goods to fix the sales price. However, this year there were some arithmetical errors in these calculations.

- Calculate what his sales would have been if he had not made any errors.
- Given that his expenses remain constant at 9% of his sales, calculate his net profit for the year 2018.
- Work out the rate of inventory turnover for 2018.
- He thinks that next year he can increase his mark-up to 40%, selling goods which will cost him £240,000. If he does not make any more errors in calculating selling prices, you are to calculate the expected gross and net profits for 2019.

38.6A

Trading Account for the year ending 31 December 2019

	£		£
Inventory 1 January 2019	3,000	Sales	60,000
Purchases	47,000		
	50,000		
Inventory 31 December 2019	<u>(4,500)</u>		
Cost of sales	45,500		
Gross profit	14,500		
	<u>60,000</u>		<u>60,000</u>

R. Sheldon presents you with the trading account set out above. *Author's note* He always calculates his selling price by adding $33\frac{1}{3}\%$ of cost on to the cost price.

- If he has adhered strictly to the statement above, what should be the percentage of gross profit to sales?
- Calculate his actual percentage of gross profit to sales.
- Give two reasons for the difference between the figures you have calculated above.
- His suppliers are proposing to increase their prices by 5%, but R. Sheldon considers that he would be unwise to increase his selling price. To obtain some impression of the effect on gross profit if his costs should be increased by 5% he asks you to reconstruct his trading account to show the gross profit if the increase had applied from 1 January 2019.
- Using the figures given in the trading account at the beginning of the question, calculate R. Sheldon's rate of inventory turnover.
- R. Sheldon's expenses amount to 10% of his sales. Calculate his net profit for the year ending 31 December 2019.
- If all expenses remained unchanged, but suppliers of inventory increased their prices by 5% as in (d) above, calculate the percentage reduction in the amount of net profit which R. Sheldon's accounts would have shown.

(Edexcel, London Examinations: GCSE)

Author's note: The trading account shown in the question has been prepared in an unconventional way. It is, in effect, a different form of presentation of the trading account section of the income statement. Do not, yourself, ever use this format when preparing an income statement.





38.7 L. Mann started business with £5,000 in the bank on 1 April. The business transactions during the month were as follows:

- (i) Took £300 out of the bank for petty cash
- (ii) Bought a second-hand van and paid by cheque £3,500
- (iii) Bought goods on credit from A. Supplier for £2,500
- (iv) Sold goods for cash for £300
- (v) Sold goods on credit for £1,000 to B. Safe
- (vi) Returned faulty goods to A. Supplier £500
- (vii) Paid sundry expenses of £50 in cash
- (viii) Paid the rent of £500 by cheque
- (ix) Withdrew cash drawings of £500

Inventory at cost at 30 April was £1,250.

Required:

- (a) Prepare the ledger accounts recording the transactions.
- (b) Prepare the trial balance at 30 April.
- (c) Prepare an income statement for the month ending 30 April.
- (d) Prepare a balance sheet as at 30 April.
- (e) Calculate the percentages of:
 - (i) gross profit to sales
 - (ii) net profit to opening capital.
- (f) Comment on:
 - (i) the relationship between drawings and net profit and why it is important that Mann keeps an eye on it
 - (ii) working capital.

38.8A Arthur deals in bicycles. His business position at 1 October was as follows:

Capital £3,369

Inventory £306 (3 × Model A bicycles @ £54 and 3 × Model B @ £48)

Balance at bank £3,063

Having established good relations with his supplier he is able to obtain bicycles on credit. He kept notes of all transactions during October which he then summarised as follows:

- (i) Purchased on credit from Mr Raleigh: 12 Model A at £54 and 10 Model B at £48. Total purchase £1,128.
- (ii) Sales for cash were: 11 Model A at £81 and 8 Model B at £72.
- (iii) Paid rent by cheque £60, advertising £66 and miscellaneous expenses £12.
- (iv) Drawings were £150.

Arthur's valuation of the closing inventory was £456 as at 31 October.

Required:

- (a) Prepare a statement showing the bank transactions during October.
- (b) Check the closing inventory valuation.
- (c) Prepare a statement showing the gross profit and net profit for October and calculate the percentages of gross profit to sales and net profit to sales.
- (d) Prepare an income statement for the month of October together with a balance sheet as at 31 October.

38.9 The following information is available for the years 2017, 2018 and 2019:

	2017	2018	2019
	£	£	£
Opening inventory	10,000	20,000	28,000
Purchases	70,000	86,000	77,000
	<u>80,000</u>	<u>106,000</u>	<u>105,000</u>
Less Closing inventory	(20,000)	(28,000)	(23,000)
Cost of sales	<u>60,000</u>	<u>78,000</u>	<u>82,000</u>
Sales	<u>90,000</u>	<u>125,000</u>	<u>120,000</u>
Gross profit	<u>30,000</u>	<u>47,000</u>	<u>38,000</u>

The inventory valuations used above at the end of 2017 and at the end of 2018 were inaccurate. The inventory at 31 December 2017 had been under-valued by £1,000, whilst that at 31 December 2018 had been over-valued by £3,000.

Required:

- (a) Give the corrected figures of gross profit for each of the years affected by the errors in inventory valuation.
- (b) Using the figures in the revised trading accounts, calculate for each year:
 - (i) the percentage of gross profit to sales, and
 - (ii) the rate of turnover of inventory.

Analysis and interpretation of financial statements

Learning objectives

After you have studied this chapter, you should be able to:

- Explain how the use of ratios can help in analysing the profitability, liquidity, efficiency and capital structure of businesses.
- Calculate the main accounting ratios.
- Interpret the results of calculating accounting ratios.
- Explain the advantages and disadvantages of the gearing of an organisation being high or low.
- Explain how the proportion of costs that are fixed and variable impacts profit at different levels of activity.
- Outline the key aspects of accounting standards IAS 8 and IAS 38.

Introduction

In this chapter, you'll learn how to calculate and interpret the most commonly used accounting ratios. You'll learn how to assess an organisation's profitability, liquidity, efficiency, and capital structure using ratio analysis. In addition, you'll learn more about IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and IAS 38 *Intangible Assets*.

39.1 The need for ratios

Without ratios, financial statements would be largely uninformative to all but the very skilled. With ratios, financial statements can be interpreted and usefully applied to satisfy the needs of the reader.

For example, let's take the performance of four companies, all dealing in the same type of goods:

	Gross profit	Sales
	£	£
Company A	200,000	848,000
Company B	300,000	1,252,000
Company C	500,000	1,927,500
Company D	350,000	1,468,400

Suppose you want to know which company gets the 'best' profit. Simply inspecting these figures and trying to decide which performance was the best, and which was the worst, is virtually impossible. To bring the same basis of comparison to each company we need some form of common

measure. As you have already seen in Chapter 38, one measure commonly used is a ratio – the gross margin, i.e. the amount of gross profit on sales as a percentage. Applying this to these four companies, we find that their margins are:

	%
Company A	23.58
Company B	23.96
Company C	25.94
Company D	23.84

On this basis, Company C with a gross margin of 25.94% or, in other words, £25.94 gross profit per £100 sales, has performed better than the other companies.

39.2 How to use ratios

You can only sensibly compare like with like. There is not much point, for example, in comparing the gross profit percentage of a wholesale chemist with that of a restaurant.

Similarly, figures are only comparable if they have been built up on a similar basis. The sales figures of Company X, which treats items as sales *only when cash is received*, **cannot** be properly compared with those of Company Z, which treats items as sales *as soon as they are invoiced*.

Another instance of this could be that of inventory turnover, which you learnt about in Chapter 38. Let's compare two companies, Company K and Company L. They are both toy shops so would seem to be comparable. Both companies have annual sales revenue of £400,000. However, the average inventory of K is £50,000 whilst that of L is £20,000. Cost of sales for both companies is £200,000, so their inventory turnover ratios are:

$$\frac{\text{Cost of sales}}{\text{Average inventory}} \quad \frac{200,000}{50,000} = 4 \quad \frac{200,000}{20,000} = 10$$

It looks as though L has managed to turn its inventory over 10 times during the year compared with K, four times. Is this true? Well, it depends. Let's imagine that K had a financial year end of 30 November, just before Christmas, so toy inventory would be extremely high; that L had a year end of 31 January when, following the Christmas sales, its inventory had dropped to the year's lowest level; and that at 30 November both this year and last year L also had inventory valued at £50,000. Can you see how the difference in the timing of the year end can affect this ratio significantly?

Ratios therefore need very careful handling. They are extremely useful if used and interpreted appropriately, and very misleading otherwise.

39.3 Users of ratios

As you know, there are a great many parties interested in analysing financial statements, including shareholders, lenders, customers, suppliers, employees, government agencies and competitors. Yet, in many respects, they will be interested in different things. There is not, therefore, any definitive, all-encompassing list of points for analysis that would be useful to all these stakeholder groups.

Nevertheless, it is possible to construct a series of ratios that together will provide all of them with something that they will find relevant and from which they can investigate further if necessary.

Ratio analysis is a first step in financially assessing an entity. It removes some of the mystique surrounding the financial statements and makes it easier to pinpoint items which it would be interesting to investigate further.

Exhibit 39.1 shows some categories of ratios and indicates some of the stakeholder groups that would be interested in them.

Exhibit 39.1

Ratio category	Examples of interested groups
Profitability	Shareholders, management, employees, creditors, competitors, potential investors
Liquidity	Shareholders, suppliers, creditors, competitors
Efficiency	Shareholders, potential purchasers, competitors
Shareholder	Shareholders, potential investors
Capital structure	Shareholders, lenders, creditors, potential investors

As you will see, **some ratios belong in more than one of these categories.**

39.4 Categories of ratio

Profitability ratios

1 Return on capital employed (ROCE)

This is one of the most important profitability ratios, as it encompasses all the other ratios, and because an adequate return on capital employed is why people invest their money in a business in the first place.

(a) *Sole proprietors*

In this chapter, we will use the average of the capital account as the figure for capital employed, i.e. (opening balance + closing balance) ÷ 2.

In Businesses C and D in Exhibit 39.2, both businesses have made the same amount of net profit, but the capitals employed are different.

Exhibit 39.2

Balance Sheets		
	C	D
	£	£
Non-current assets + Current assets – Current liabilities	<u>100,000</u>	<u>160,000</u>
Capital accounts		
Opening balance	80,000	140,000
Add Net profit	<u>36,000</u>	<u>36,000</u>
	116,000	176,000
Less Drawings	<u>(16,000)</u>	<u>(16,000)</u>
	<u>100,000</u>	<u>160,000</u>

$$\text{Return on capital employed (ROCE)} = \frac{\text{Net profit}}{\text{Capital employed}} \times 100$$

therefore,

$$\frac{36,000}{(80,000 + 100,000) \div 2} \times \frac{100}{1} = 40\% \quad \text{C} \qquad \frac{36,000}{(140,000 + 160,000) \div 2} \times \frac{100}{1} = 24\% \quad \text{D}$$

The ratio illustrates that what is important is not simply how much profit has been made but how well the capital has been employed. Business C has made far better use of its capital, achieving a return of £40 net profit for every £100 invested, whereas D has received only a net profit of £24 per £100.

(b) *Limited companies*

There is no universally agreed definition of return on capital employed for companies. The main ones used are:

- (i) return on capital employed sourced from ordinary shareholders;
- (ii) return on capital employed sourced from all long-term suppliers of capital.

Let's now look at each of these:

- (i) In a limited company this is known as **Return on Owners' Equity (ROOE)** or, more commonly, **Return on Shareholders' Funds (ROSF)**. From now on, we shall use the second of these terms, 'Return on Shareholders' Funds', but you will need to remember that when you see 'Return on Owners' Equity', it is the same as ROSF.

The 'Return' is the net profit for the period. The term 'Shareholders' Funds' means the total equity of the company (i.e. share capital and all the reserves).

- (ii) This is often known simply as 'Return on Capital Employed' (ROCE). The word 'Return' in this case means net profit + any preference share dividends + loan notes and long-term loan interest. The word 'Capital' means Total equity + Redeemable preference shares + Loan notes + Long-term Loans.

Given the following balance sheets and income statements of two companies, P Ltd and Q Ltd, the calculations of ROSF and ROCE can be attempted:

Balance Sheets as at 31 December

	P Ltd		Q Ltd	
	£	£	£	£
	2021	2022	2021	2022
Non-current assets	520,000	560,000	840,000	930,000
Net current assets	280,000	340,000	160,000	270,000
	800,000	900,000	1,000,000	1,200,000
10% loan notes	—	—	(120,000)	(120,000)
Net assets	800,000	900,000	880,000	1,080,000
Share capital (ordinary)	300,000	300,000	500,000	500,000
Reserves	500,000	600,000	380,000	580,000
Total equity	800,000	900,000	880,000	1,080,000

Income Statements for the year ending 31 December 2022 (extracts)

	<i>P Ltd</i> £	<i>Q Ltd</i> £
Net profit	<u>220,000</u>	<u>380,000</u>

Return on Shareholders' Funds (ROSF)

$$\frac{220,000}{(800,000) + 900,000 \div 2} \times \frac{100}{1} = 25.9\% \quad \frac{380,000}{(800,000 + 1,080,000) \div 2} \times \frac{100}{1} = 38.8\%$$

Return on Capital Employed (ROCE)

$$\text{Same as ROF}^1 = 25.9\% \quad \frac{380,000 + 12,000^2}{(1,000,000 + 1,200,000) \div 2} \times \frac{100}{1} = 35.6\%$$

Notes:

- 1 The return on capital employed by all long-term sources of capital (in *Q Ltd*'s case, the shareholders' funds and the loan notes) is the same as the ROSF in the case of *P Ltd*, as it has no loan notes.
- 2 The loan note interest (i.e. 10% of £120,000 = £12,000) must be added back, as it was an expense in calculating the £380,000 net profit.

2 Gross profit as a percentage of sales

The formula is:

$$\frac{\text{Gross profit}}{\text{Sales}} \times 100$$

Go back to Chapter 38 to refresh your understanding of gross profit as a percentage of sales

3 Net profit as a percentage of sales

The formula is:

$$\frac{\text{Net profit}}{\text{Sales}} \times 100$$

Liquidity ratios

You saw earlier in this section that the ratio called 'return on capital employed' is used to provide an overall picture of profitability. It cannot always be assumed, however, that profitability is everything that is desirable. It must be stressed that **accounting is used, not just to calculate profitability, but also to provide information that indicates whether or not the business will be able to pay its creditors, expenses, loans falling due, etc. at the correct times.** Failure to ensure that these payments are covered effectively could mean that the business would have to be closed down. Being able to pay one's debts as they fall due is known as being 'liquid'.

It is also essential that a business is aware if a customer or borrower is at risk of not repaying the amount due. New customers are usually vetted prior to being allowed to trade on credit rather than by cash. For private individuals, there are credit rating agencies with extensive records of the credit histories of many individuals. For a small fee, a company can receive a report indicating

whether a new customer might be a credit risk. Similarly, information can be purchased concerning companies that indicates their solvency, i.e. whether they are liable to be bad credit risks.

The difference between these two sources of information is that, while the information on private individuals is based on their previous credit record, that of the companies is generally based on a ratio analysis of their financial statements.

When it comes to the liquidity of a business, both its own ability to pay its debts when due and the ability of its debtors to pay the amount they owe to the business are of great importance. Ratio analysis that focuses upon liquidity (or solvency) of the business generally starts with a look at two ratios (**liquidity ratios**) that are affected most by these two aspects of liquidity, the **current ratio** and the **acid test ratio**.

1 Current ratio

This compares assets which will become liquid within approximately 12 months (i.e. total current assets) with liabilities which will be due for payment in the same period (i.e. total current liabilities) and is intended to indicate whether there are sufficient short-term assets to meet the short-term liabilities.

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

When calculated, the ratio may be expressed as either a ratio to 1, with current liabilities being set to 1, or as a 'number of times', representing the relative size of the amount of total current assets compared with total current liabilities.

With all ratios, once you have performed the calculation, you need to decide what it tells you. To do so, there is no point in using a universal guide, such as 'the ratio should always lie between 1:1 and 2:1'. Any such guidance is at best useless and at worst misleading. Instead, you need to consider the result in its context.

For example:

- What is the norm in this industrial sector? (For example, retailers are often below 1:1.)
- Is this company significantly above or below that norm?
- If so, can this be justified after an analysis of the nature of these assets and liabilities, and of the reasons for the amounts of each held?

You need to contextualise every ratio you calculate when you are trying to understand what the result means, not just this one.

2 Acid test ratio

This shows that, provided creditors and debtors are paid at approximately the same time, a view might be made as to whether the business has sufficient liquid resources to meet its current liabilities.

$$\text{Acid test ratio} = \frac{\text{Current assets} - \text{inventory}}{\text{Current liabilities}}$$

Activity 39.1

What is the difference between the formulae for the current ratio and the acid test ratio?

Exhibit 39.3 shows how two businesses may have similar profitability, yet their liquidity positions may be quite different.

Exhibit 39.3

	<i>E</i>		<i>F</i>	
	£	£	£	£
<i>Non-current assets</i>		40,000		70,000
<i>Current assets</i>				
Inventory	30,000		50,000	
Trade receivables	45,000		9,000	
Bank	<u>15,000</u>		<u>1,000</u>	
		<u>90,000</u>		<u>60,000</u>
Total assets		130,000		130,000
Current liabilities: Trade payables		<u>(30,000)</u>		<u>(30,000)</u>
Net assets		<u>100,000</u>		<u>100,000</u>
<i>Capital</i>				
Opening capital		80,000		80,000
Add Net profit		<u>36,000</u>		<u>36,000</u>
		116,000		116,000
Less Drawings		<u>(16,000)</u>		<u>(16,000)</u>
		<u>100,000</u>		<u>100,000</u>

Note: Sales for both *E* and *F* amounted to £144,000. Gross profits for *E* and *F* were identical at £48,000.

Profitability is the same for both businesses. However, there is a vast difference in the liquidity of the two businesses.

Current ratios

$$E = \frac{90,000}{30,000} = 3$$

$$F = \frac{60,000}{30,000} = 2$$

This looks adequate on the face of it, but let's look at the acid test ratio:

Acid test ratios

$$E = \frac{60,000}{30,000} = 2$$

$$F = \frac{10,000}{30,000} = 0.33$$

This reveals that *F* may be in trouble, as it will probably find it difficult to pay its current liabilities on time. **No matter how profitable a business is, unless it is adequately liquid it may fail.**

However, although a business should be adequately liquid, it is possible for it to have too high a current ratio or acid test ratio. If too many resources are being held as current assets, it would make these two ratios appear healthy, but those resources could have been used more profitably – you don't get any interest on inventory! Too high a balance in a current account at the bank also means that resources are being wasted.

Activity 39.2

Why is inventory omitted from the acid test ratio?

Efficiency ratios

1 Inventory turnover

Inventory turnover measures how efficient a business is at maintaining an appropriate level of inventory. When it is not being as efficient as it used to be, or is being less efficient than its competitors, this may indicate that control over inventory levels is being undermined.

A reduction in inventory turnover can mean that the business is slowing down. Inventory may be piling up and not being sold. This could lead to a liquidity crisis, as money may be being taken out of the bank simply to increase inventory which is not then sold quickly enough.

Note: In this chapter, we are classifying inventory turnover as an efficiency ratio. It is often also classified as a liquidity ratio.

For Exhibit 39.3 the cost of sales for each company was £144,000 – £48,000 = £96,000. If opening inventory had been *E* £34,000 and *F* £46,000 then, using the average of the opening and closing inventory, the inventory turnovers would have been:

	<i>E</i>	<i>F</i>
Cost of sales	96,000	96,000
Average inventory	$(34,000 + 30,000) \div 2$	$(46,000 + 50,000) \div 2$
	$= \frac{96,000}{32,000} = 3 \text{ times}$	$= \frac{96,000}{48,000} = 2 \text{ times}$

It appears that *F*'s inventory may be too high, perhaps because it is having difficulty selling it compared with *E*. Or perhaps it is *E* that has a problem obtaining enough inventory. Either way, further investigation is needed.

2 Trade receivables/sales ratio

The resources tied up in trade receivables is an important ratio subject. Money tied up unnecessarily in trade receivables is unproductive money. In the example in Exhibit 39.3 the **trade receivables/sales ratio** can be calculated for the two companies as:

	<i>E</i>	<i>F</i>
Trade receivables/sales	$45,000/144,000 = 1 : 3.2$	$9,000/144,000 = 1 : 16$

This relationship is often translated into the length of time a debtor takes to pay:

$$365 \times \frac{1}{3.2} = 114 \text{ days} \qquad 365 \times \frac{1}{16} = 22.8 \text{ days}$$

Why Company *E* should have allowed so much time for its debtors to pay is a matter for investigation. Possibly the company was finding it harder to sell goods, and to sell at all was eventually forced to sell to customers on long credit terms. It could well be that *E* has no proper credit control system, whereas *F* has an extremely efficient one.

When this ratio is deteriorating (i.e. the number of days is rising) it may signal liquidity problems.

Note: In this chapter, we are classifying trade receivables/sales as an efficiency ratio. Like inventory turnover, it is often also classified as a 'liquidity ratio', as it can reveal both efficiency and liquidity issues. The next ratio, trade payables/purchases, also provides this double aspect view.

3 Trade payables/purchases ratio

Assuming that purchases for *E* amounted to £92,000 and for *F* £100,000 then the **trade payables/purchases ratio** can be calculated for each as:

$$\begin{array}{ccc} \text{Trade payables/purchases} & \overset{E}{30,000/92,000} = 1:3.07 & \overset{F}{30,000/100,000} = 1:3.3 \end{array}$$

This also is often translated into the length of time we take to pay our creditors. This turns out to be:

$$365 \times \frac{1}{3.07} = 119 \text{ days} \qquad 365 \times \frac{1}{3.3} = 110 \text{ days}$$

Shareholder ratios

These will include the following ratios. **Note that 'price' means the price of the shares on the Stock Exchange.**

1 Earnings per share (EPS)

The formula is:

$$\text{Earnings per share} = \frac{\text{Net profit after interest and tax and preference dividends}}{\text{Number of ordinary shares issued}}$$

This gives the shareholder (or prospective shareholder) a chance to compare one year's earnings with another in terms easily understood. Many people consider EPS to be *the* most important ratio that can be calculated from the financial statements.

2 Price/earnings ratio (P/E)

The formula is:

$$\text{Price/earnings ratio} = \frac{\text{Market price per share}}{\text{Earnings per share}}$$

This puts the price into context as a multiple of the earnings. The greater the P/E ratio, the greater the demand for the shares.

3 Dividend yield

This is found by the formula:

$$\text{Dividend yield} = \frac{\text{Gross dividend per share}}{\text{Market price per share}}$$

This measures the real rate of return by comparing the dividend paid to the market price of a share.

4 Dividend cover

This is found by the formula:

$$\text{Dividend cover} = \frac{\text{Net profit after tax and preference dividends}}{\text{Ordinary dividends paid and proposed}}$$

This gives the shareholder some idea as to the proportion that the ordinary dividends bear to the amount available for distribution to ordinary shareholders. Usually, the dividend is described as being so many times covered by profits made. If, therefore, the dividend is said to be *three times covered*, it means that one-third of the available profits is being distributed as dividends.

Capital structure ratios

Gearing

The relationship of equity shares (ordinary shares) to other forms of long-term financing (long-term loans plus preference shares) can be extremely important. Analysts are, therefore, keen to ascertain a ratio to express this relationship.

There is more than one way of calculating **gearing**. The most widely used method is as follows:

$$\frac{\text{Long-term loans} + \text{Preference shares}}{\text{Ordinary share capital} + \text{Reserves} + \text{Preference shares} + \text{Long-term liabilities}} \times 100$$

This formula is sometimes abbreviated to:

$$\frac{\text{Prior charge capital}}{\text{Total capital}} \times 100$$

which is exactly the same.

Long-term loans include loan notes. Total capital includes preference shares and ordinary shares, all the reserves and long-term loans.

Let's look at the calculations of the gearing of two small companies, *A Ltd* and *B Ltd* in Exhibit 39.4. Both have been trading for five years.

Exhibit 39.4

Year 5: items per balance sheet	<i>A Ltd</i>	<i>B Ltd</i>
	£	£
10% loan notes	20,000	200,000
10% preference shares	40,000	100,000
Ordinary shares	200,000	40,000
Reserves	140,000	60,000
	<u>400,000</u>	<u>400,000</u>

Gearing ratios:

$$\text{A Ltd: } \frac{20,000 + 40,000}{20,000 + 40,000 + 200,000 + 140,000} \times \frac{100}{1} = 15\% \text{ (low gearing) } \checkmark$$

$$\text{B Ltd: } \frac{20,000 + 40,000}{20,000 + 200,000 + 40,000 + 60,000} \times \frac{100}{1} = 75\% \text{ (high gearing)}$$





Now let us look at how dividends are affected, given the same level of profits made before payment of loan note interest and preference dividends. All the profits made in these years are to be distributed.

<i>A Ltd: Low gearing</i>		Year 6	Year 7	Year 8	Year 9
		£	£	£	£
Profits before deducting the following:		40,000	30,000	60,000	80,000
Loan note interest	2,000				
Preference dividend	<u>4,000</u>				
		(6,000)	(6,000)	(6,000)	(6,000)
Profits left for ordinary dividend		<u>34,000</u>	<u>24,000</u>	<u>54,000</u>	<u>74,000</u>
Rate of ordinary dividend		17%	12%	27%	37%
<i>B Ltd: High gearing</i>		Year 6	Year 7	Year 8	Year 9
		£	£	£	£
Profits before deducting the following:		40,000	30,000	60,000	80,000
Loan note interest	20,000				
Preference dividend	<u>10,000</u>				
		(30,000)	(30,000)	(30,000)	(30,000)
Profits left for ordinary dividend		<u>10,000</u>	<u>—</u>	<u>30,000</u>	<u>50,000</u>
Rate of ordinary dividend		25%	—	75%	125%

A company with a high percentage gearing ratio is said to be *high geared*, whereas one with a low percentage gearing is said to be *low geared*. As you can see from the above example, the proportionate effect gearing has upon ordinary shareholders is far greater in a high geared company, ranging from 0 to 125 per cent dividend for B Ltd, whilst the range of ordinary dividends for A Ltd varied far less and lay between 17 and 37 per cent.

A high rate of debt (i.e. long-term loans and preference shares) means that in bad times very little might be left over for ordinary shareholders after payment of interest on the debt items and also preference dividends. In good times, however, the ordinary shareholders will enjoy a far higher return than in a low geared company.

This means that people investing in ordinary shares in a high geared company are taking a far greater risk with their money than if they had invested instead in a low geared company. It would have only required a drop of profits of £10,000 in Year 6 for B Ltd to find that there would be no ordinary dividends at all for Years 6 and 7. Such a drop in Year 6 for A Ltd would still have allowed a dividend of more than 12 per cent in both Years 6 and 7. Investors therefore who are prepared to risk their money in the hope of large dividends would have chosen B Ltd, whilst those who wanted to cut down on their risk and be more certain about receiving dividends would choose A Ltd.

Changing the gearing of a company

The management might decide that for various reasons it would like to change the gearing of the company. It can do this as follows:

To reduce gearing

- 1 By issuing new ordinary shares
- 2 By redeeming loan notes
- 3 By retaining profits

To increase gearing

- 1 By issuing loan notes
- 2 By buying back ordinary shares in issue
- 3 By issuing new preference shares

Such changes will be influenced by what kinds of investors the company wishes to attract. A highly geared company will attract risk-taking buyers of ordinary shares, whilst a low geared company will be more attractive to potential ordinary shareholders who wish to minimise risk.

Other ratios

There are a large number of other ratios which could be used, far more than can be mentioned in a textbook such as this. It will depend on the type of company exactly as to which ratios are the most important and it is difficult to generalise too much.

Different users of the financial statements will want to use the ratio analysis which is of vital concern to them. If we can take as an example a bank which lends money to a company, it will want to ensure two things:

- (a) that the company will be able to pay interest on the loan as it falls due; *and*
- (b) that it will be able to repay the loan on the agreed date.

The bank is therefore interested in:

- (a) short-term liquidity, concerning payment of loan interest; and
- (b) long-term solvency for eventual repayment of the loan.

Possible ratios for each of these could be:

- (a) *Short-term liquidity ratios*, mainly the acid test ratio and the current ratio, already described.
- (b) *Long-term solvency ratios*, which might include:
 - (i) *Operating profit/loan interest*. This indicates how much of the profits are taken up by paying loan interest. Too great a proportion would mean that the company was borrowing more than was sensible, as a small fall in profits could mean the company operating at a loss with the consequent effect upon long-term solvency.
 - (ii) *Total external liabilities/shareholders' funds*. This ratio measures how much financing is done via share capital and retained profits, and how much is from external sources. Too high a proportion of external liabilities could bring about long-term solvency problems if the company's profit-making capacity falls by a relatively small amount, as outside liabilities still have to be met.
 - (iii) *Shareholders' funds/total assets (excluding intangibles)*. This highlights the proportion of assets financed by the company's own funds. Large falls in this ratio will tend to show a difficulty with long-term solvency. Similarly, investors will want to see ratios suitable for their purposes, which are not the same as those for the bank. These will not only be used on a single company comparison, but probably with the average of the same type of ratios for other companies in the same industry.

39.5 The investor: choosing between shares and loan notes

The choice of an investor will always be related to the amount of acceptable risk. We can list the possible investments under the headings of risk.

Lowest risk

Loan note holders have their interest paid to them whether or not profits are made. This contrasts with shares, both preference and ordinary, where there have to be profits available for distribution as dividends.

In addition, should there be insufficient cash funds available to pay loan note interest, many loan notes give their holders the right to sell off some or all of the assets of the company, and to recoup the amount of their loan notes before anyone else has a claim. Such an investment does not have as much security as, say, government stocks, but it certainly ranks above the shares of that same company.

Medium risk

Preference shareholders have their dividends paid after the loan note interest has been paid, but before the ordinary shareholders. They still are dependent upon profits being available for distribution. If they are of the cumulative variety then any shortfall can be carried forward to future years and paid before any ordinary dividends are taken.

Highest risk

Ordinary shareholders have the highest risk. They must give way to both loan note holders and to preference shareholders for interest and dividends. However, should the remaining profits for distribution be very high then they may get a high return on their money.

39.6 Trend figures

In exams, a student is often given just one year's accounting figures and asked to comment on them. Obviously, lack of space on an exam paper may preclude several years' figures being given; also, the student lacks the time to prepare a comprehensive survey of several years' financial statements.

In real life, however, it would be extremely stupid for anyone to base decisions on just one year's financial statements, if more information was available. What is important for a business is not just what, say, accounting ratios are for one year, but what the trend has been.

Given two similar types of businesses *G* and *H*, both having existed for five years, if both of them had exactly the same ratios in Year 5, are they both equally desirable as investments? Given one year's accounts it may appear so, but if one had all the five years' figures it may not give the same picture, as Exhibit 39.5 illustrates.

Exhibit 39.5

	Years					
	1	2	3	4	5	(current)
Gross profit as % of sales	<i>G</i> 40	38	36	35	34	
	<i>H</i> 30	32	33	33	34	
Net profit as % of sales	<i>G</i> 15	13	12	12	11	
	<i>H</i> 10	10	10	11	11	
Net profit as % of capital employed	<i>G</i> 13	12	11	11	10	
	<i>H</i> 8	8	9	9	10	
Current ratio	<i>G</i> 3	2.8	2.6	2.3	2.0	
	<i>H</i> 1.5	1.7	1.9	1.0	2.0	

From these figures *G* appears to be the worse investment for the future, as the trend appears to be downwards. If the trend for *G* is continued it could be in a very dangerous financial situation in a year or two. Business *H*, on the other hand, is strengthening its position all the time.

Of course, it would be ridiculous to assert that *H* will continue on an upward trend. One would have to know more about the business to be able to judge whether or not that could be true.

However, given all other desirable information, trend figures would be an extra important indicator.

39.7 Fixed and variable costs

Some costs will remain constant whether activity increases or falls, at least within a given range of change of activity. These costs are called **fixed costs**. An example of this would be the rent of a shop which would remain at the same figure whether sales increased 10 per cent or fell 10 per cent. The same would remain true of such things as rates, fire insurance and so on.

Wages of shop assistants could also remain constant in such a case. If, for instance, the shop employed two assistants, then it would probably keep the same two assistants, on the same wages, whether sales increased or fell by 10 per cent.

Of course, such fixed costs can only be viewed as fixed in the short term. If sales doubled, then the business might well need a larger shop or more assistants. A larger shop would also certainly mean higher rates, higher fire insurance and so on, and with more assistants the total wage bill would be larger.

Variable costs, on the other hand, will change with swings in activity. Suppose that wrapping materials are used in the shop, then an increase in sales of 10 per cent should see 10 per cent more wrapping materials used. Similarly an increase of 10 per cent of sales, if all sales are despatched by parcel post, should see delivery charges increase by 10 per cent.

Some costs could be part fixed and part variable. Suppose that because of an increase in sales of 10 per cent, telephone calls made increased by 10 per cent. With telephone bills the cost is often in two parts, one for the rent of the phone line and the second part corresponding to the actual number of calls made. The rental charge would not change in such a case, and therefore this part of telephone expense would be 'fixed' whereas the calls part of the cost could increase by 10 per cent.

This means that the effect of a percentage change in activity could result in a greater or lesser percentage change in net profit, because the fixed costs (within that range of activity) may not alter.

Exhibit 39.6 shows the change in net profit in Business A, which has a low proportion of its expenses as 'fixed' costs, and in Business B, in which the 'fixed' costs are a relatively high proportion of its expenses.

Exhibit 39.6

<i>Business A</i>		(a) If sales fell 10%		(b) If sales rose 10%	
	£	£	£	£	£
Sales		500,000	450,000		550,000
Less Cost of goods sold		(300,000)	(270,000)		(330,000)
Gross profit		200,000	180,000		220,000
Less Expenses:					
Fixed	30,000	30,000		30,000	
Variable	130,000	117,000		143,000	
		(160,000)	(147,000)		(173,000)
Net profit		<u>40,000</u>	<u>33,000</u>		<u>47,000</u>
<i>Business B</i>		(a) If sales fell 10%		(b) If sales rose 10%	
	£	£	£	£	£
Sales		500,000	450,000		550,000
Less Cost of goods sold		(300,000)	(270,000)		(330,000)
Gross profit		200,000	180,000		220,000
Less Expenses:					
Fixed	120,000	120,000		120,000	
Variable	40,000	36,000		44,000	
		(160,000)	(156,000)		(164,000)
Net profit		<u>40,000</u>	<u>24,000</u>		<u>56,000</u>





The comparison of percentage changes in net profit therefore works out as follows:

	<i>Business A</i>	<i>Business B</i>
Decrease of 10% sales:		
$\frac{\text{Reduction in profit}}{\text{Original profit}} \times \frac{100}{1}$	$\frac{7,000}{40,000} \times \frac{100}{1} = 17.5\%$	$\frac{16,000}{40,000} \times \frac{100}{1} = 40\%$
Increase of 10% sales:		
$\frac{\text{Increase in profit}}{\text{Original profit}} \times \frac{100}{1}$	$\frac{7,000}{40,000} \times \frac{100}{1} = 17.5\%$	$\frac{16,000}{40,000} \times \frac{100}{1} = 40\%$

You can see that a change in activity in Business B, which has a higher fixed expense content, results in greater percentage changes in profit: 40% in B compared with 17.5% in A.

39.8 Limitations of financial statements

Financial statements are only partial information. They show, in financial terms, what has happened in the past. This is better than having no information at all, but much more information is needed to fully understand the present situation.

First, it is impossible to sensibly compare two businesses which are completely unlike one another solely by looking at their financial statements. To compare a supermarket's figures with those of a chemical factory would be rather pointless. It would be like comparing a lion with a lizard.

Second, there are a whole lot of factors that the past-focused financial statements do not disclose. The desire to keep to the money measurement concept, and the desire to be objective, both dealt with in Chapter 10, exclude a great deal of desirable information.

Go back to Chapter 10 to refresh your understanding of the money measurement concept.

Some typical desirable information can be listed but, beware, the list is indicative rather than exhaustive.

- What are the future plans of the business? Without knowing this, making an investment in a business would be sheer guesswork.
- Has the firm got good quality staff?
- Is the business situated in a location desirable for such a business? A shipbuilding business situated a long way up a river which was becoming unnavigable, to use an extreme example, could soon be in trouble.
- What is its position as compared with its competitors? A business manufacturing a single product, which has a foreign competitor which has just invented a much-improved product which will capture the whole market, is obviously in for a bad time.
- Will future government regulations affect it? Suppose that an EU-based business which is an importer of goods from Country X, which is outside the EU, finds that the EU is to ban all imports from Country X?
- Is its plant and machinery obsolete? If so, the business may not have sufficient funds to be able to replace it.
- Is the business of a high-risk type or in a relatively stable industry?
- Has the business got good customers? A business selling largely to Country Y, which is getting into trouble because of shortage of foreign exchange, could soon lose most of its trade. Also, if one customer was responsible for, say, 60 per cent of sales, then the loss of that one customer would be calamitous.

- (i) Has the business got good suppliers of its needs? A business in wholesaling could, for example, be forced to close down if manufacturers decided to sell direct to the general public.
- (j) Problems concerned with the effects of distortion of accounting figures caused by inflation (or deflation).

You can see that the list would have to be an extremely long one if it was intended to cover all possibilities.

39.9 IAS 8 Accounting policies, Changes in Accounting Estimates and Errors

Users of financial statements issued by organisations want to analyse and evaluate the figures contained within them. They cannot do this effectively unless they know which **accounting policies** have been used when preparing such statements.

Accounting policies

Accounting policies are the particular rules and methods that the business has used in producing and presenting its financial statements. They therefore define the processes whereby transactions and other events are reflected in the financial statements. The accounting policies selected should enable the financial statements to give a **true and fair** view and should be consistent with accounting standards and with relevant legislation.

When selecting an accounting policy, its appropriateness should be considered in the context of characteristics that financial information must possess:

- **Relevance** – Does it produce information that is useful for assessing stewardship and for making economic decisions?
- **Reliability** – Does it reflect the substance of the transaction and other events that have occurred? Is it free of bias, i.e. neutral? Is it free of material error? If produced under conditions of uncertainty, has prudence been exercised?

In addition, accounting policies must be applied consistently to ‘similar transactions, events and conditions’.

Changes to accounting policies

Changes can only be made if required by a standard or if they result in reliable and more relevant information. Where the change is voluntary, it must be applied retrospectively and items restated.

Estimation techniques

Estimation techniques are the methods adopted in order to arrive at estimated monetary amounts for items that appear in the financial statements. Changes in accounting estimates relate to the carrying amount of an asset or liability or the amount of the periodic consumption of an asset. Where a change in an accounting estimate gives rise to changes in assets or liabilities, or relates to an item of equity, it is recognised by adjusting the carrying amount of the asset, liability or equity item in the period in which the change of estimate occurred.

Activity 39.3

From your knowledge of accounting, what do you think these methods may include? Think about this for a minute and then write down as many examples of estimation techniques as you can think of.

Identifying whether an accounting policy has changed

This is done by considering whether any of three aspects have changed:

- **Recognition** – some items may be recognised in more than one way. For example, expenditure on developing new products may be recognised either as a profit and loss expense or as an asset in the balance sheet.
- **Presentation** – how something is presented in the financial statements. For example, where certain indirect costs appear in the income statement.
- **Measurement basis** – the monetary aspects of the items in the financial statements, such as the basis of valuation of inventory, say FIFO or AVCO.

If any of these three aspects have changed, this represents a change in accounting policy. If they haven't, something else has occurred, for example, the estimation technique in use. If depreciation was changed from straight line to reducing balance this would be a **change in estimation technique**, not a change in accounting policy. On the other hand, a decision to switch from valuing inventory using FIFO to AVCO would constitute a **change in accounting policy** as the measurement basis would have changed.

39.10 Further thoughts on concepts and conventions

In Chapter 10, you were introduced to the concepts and conventions used in accounting. Since then, further chapters have consolidated your knowledge on specific points.

In recent years there has been a considerable change in the style of exams in accounting at all levels. At one time nearly every exam question was purely computational, requiring you to prepare financial statements, draft journal entries, extract a trial balance and so on. Now, in addition to all that (which is still important) there are quite a lot of questions asking such things as:

- **Why do we do it?**
- **What does it mean?**
- **How does it relate to the concepts and conventions of accounting?**

Such questions depend very much on the interests and ingenuity of examiners. They like to set questions worded to find out those who can understand and interpret financial information and eliminate those who cannot and simply try to repeat information learned by rote.

The examiners will often draw on knowledge from any part of the syllabus. It is therefore impossible for a student (or an author) to guess exactly how examiners will select questions and how they will word them.

An example of this is where the examiner could ask you to show how different concepts contradict one another. Someone who has just read about the concepts, and memorised them, could not answer this unless they had thought further about it. **Think about whether or not you could have answered that question before you read further.**

One instance is the use of the concept of consistency. Basically, it says that one should keep to the same method of accounting for an item each year. Yet if the net realisable value of inventory is less than cost, then the normal method of showing it at cost should be abandoned and the net realisable value used instead. Thus, at the end of one period, inventory may be shown at cost and at the end of the next period it will be shown at net realisable value. In this case the concept of prudence has overridden the concept of consistency.

Another instance of this is the practice of calculating profit based on sales whether they have been paid for or not. If the prudence concept were taken to extremes, then profit would only be calculated on a sale when the sale had been paid for. Instead, the realisation concept has overridden the prudence concept so you recognise a sale when it is reasonably certain that it will be paid for.

39.11 One other accounting standard

In addition to the various accounting standards that you have already read about in this book, there is one other standard which sometimes features in exams at this level. We will cover it briefly here.

IAS 38 *Intangible Assets*

Money spent on research and development presents a problem for accountants. You could argue that:

- Such costs are incurred so that profits can be earned in the future and should therefore be carried forward to those future periods.
- Just because you have incurred such costs, you cannot be certain about future profitability occurring. It should therefore be written off as an expense in the period when the costs are incurred.

The costs can be divided between:

- **Research.** This is carried out to advance knowledge or application of knowledge. Examples include:
 - searching for new knowledge;
 - the search for, evaluation of, and final selection of, applications of research findings or other knowledge;
 - the search for alternative materials, devices, products, processes, systems or services;
 - the formulation, design, evaluation and final selection of possible alternatives for new and improved materials, devices, products, processes, systems or services.
- **Development.** Work undertaken to develop research that creates an asset that will generate probable future economic benefits.

IAS 38 requires that all research expenditure must be recognised as an expense when it is incurred. However, development costs, subject to several stringent conditions being met, may be capitalised as an intangible asset and carried forward to future periods.

Learning outcomes

You should now have learnt:

- 1 That comparing the trends to see if the ratios are getting better or worse as each period passes is essential for proper control. Prompt action needs to be taken where the trend in a ratio is deteriorating.
- 2 The importance of interpreting ratios in their context: that is, against those of other similar businesses or against the same ratios calculated for the same organisation using data from other time periods.
- 3 That a business must be both profitable *and* sufficiently liquid to be successful. One factor without the other can lead to serious trouble.
- 4 That careful credit control to ensure that the **trade receivables/sales ratio** is not too high is usually essential to the well-being of any business.





- 5 That gearing affects the risk factor for ordinary share investors. High gearing means greater risk whilst low gearing means lower risk.
- 6 How to calculate and interpret the most commonly-used ratios.
- 7 The relevance of ratio analysis to an assessment of liquidity, efficiency, profitability and capital structure.
- 8 That the relative amounts of fixed and variable costs can affect profit significantly when there are swings in business activity.

Answers to activities

- 39.1** The only difference in the items involved between the two ratios is that the acid test (or 'quick') ratio does not include inventory. Otherwise, it is identical to the current ratio, comparing current assets *other than inventory* to current liabilities.
- 39.2** Inventory is omitted as it is considered to be relatively illiquid, because, depending on prevailing and future market forces, it may be impossible to convert it to cash in a relatively short time.
- 39.3** All depreciation methods and methods used to estimate doubtful debts are the main ones we have encountered so far in this book. However, we've also looked at asset revaluation, another aspect of accounting for which the methods adopted in arriving at the valuation would be considered estimation techniques. Basically, any method used to arrive at an *estimated* figure shown in the financial statements is an estimation technique. So, to answer the question fully, you need to make a list of all those items that appear in financial statements that are estimates. The methods used to arrive at the value used for those figures are all estimation techniques. This would include, for example, the method used in order to arrive at the proportion of an electricity bill spanning the period end that belongs in the period for which the financial statements are being prepared. More obviously estimates may be required for bad debts, inventory **obsolescence**, and the useful lives or consumption pattern of non-current assets.

Review questions

- 39.1** Calculate the inventory turnover ratio if average inventory is £85,000 and cost of sales is £595,000.
- 39.2** Calculate return on capital employed for a sole proprietor whose net profit was £49,000 and whose capital employed was £245,000.
- 39.3** Calculate gross profit as a percentage of sales if gross profit was £159,800 and sales were £470,000.
- 39.4** Calculate net profit as a percentage of sales if net profit was £31,520 and sales were £394,000.

39.5 A business's latest balance sheet contains the following assets and liabilities:

Assets	£'000	Liabilities	£'000
Non-current assets	82	Trade payables	57
Inventory	39	Accruals	9
Trade receivables	63	Loan repayable in 5 years	40
Cash at bank	11		
	<u>195</u>		<u>106</u>

Calculate both the current ratio and the acid test (or 'quick') ratio.

39.6 If trade receivables are £78,000 and sales are £493,000, how many days does the average debtor take to pay?

39.7 If trade payables are £49,000 and purchases are £396,000, how many days does the business take on average to pay its creditors?

39.8 From the following information, calculate:

- (a) Earnings per share;
- (b) Price/earnings ratio;
- (c) Dividend yield; and
- (d) Dividend cover.
- (i) Net profit after interest and tax = £248,000.
- (ii) Number of ordinary shares issued = 800,000.
- (iii) Market price per share = £3.72.
- (iv) Dividend per share = 16p.
- (v) Ordinary dividends for the £year = £128,000.

39.9 The following figures have been extracted from the most recent financial statements of a business:

Extracted from income statement:	£	Extracted from balance sheet:	£
Sales	<u>355,200</u>	Inventory	<u>29,900</u>
Purchases	<u>223,600</u>	Trade receivables	<u>43,300</u>
Cost of goods sold	<u>220,100</u>	Trade payables	<u>32,800</u>

On the basis of the information available, calculate:

- (i) The average time taken to collect money from customers (in days);
- (ii) The average time taken to sell inventory (in days);
- (iii) The average time taken to pay suppliers (in days); and
- (iv) The gross profit % (gross profit as a percentage of sales).





39.10 You are to study the following financial statements for two businesses that operate in the same industry and then answer the questions which follow.

Financial Statements				
	Business J		Business K	
	£	£	£	£
Income Statements				
Sales		472,000		695,000
Less Cost of goods sold				
Opening inventory	51,000		62,000	
Add Purchases	264,000		401,000	
Less Closing inventory	(64,000)	(251,000)	(50,000)	(413,000)
Gross profit		221,000		282,000
Less Depreciation	12,000		16,000	
Wages, salaries and commission	135,000		151,000	
Other expenses	36,000	(183,000)	47,000	(214,000)
Net profit		<u>38,000</u>		<u>68,000</u>
Balance Sheets				
<i>Non-current assets</i>				
Equipment at cost	120,000		160,000	
Less Accumulated depreciation	(50,000)	70,000	(30,000)	130,000
<i>Current assets</i>				
Inventory	64,000		50,000	
Trade receivables	68,000		123,000	
Bank	15,000	147,000	5,000	178,000
Total assets		<u>217,000</u>		<u>308,000</u>
<i>Current liabilities</i>				
Trade payables		(66,000)		(99,000)
Net assets		<u>151,000</u>		<u>209,000</u>
<i>Financed by:</i>				
<i>Capitals</i>				
Balance at start of year		148,000		221,000
Add Net profit		38,000		68,000
Less Drawings		(35,000)		(80,000)
Total capital		<u>151,000</u>		<u>209,000</u>

Required:

- (a) Calculate the following ratios for each business:
- gross profit as percentage of sales;
 - net profit as percentage of sales;
 - expenses as percentage of sales;
 - inventory turnover;
 - rate of return of net profit on capital employed (use the average of the capital account for this purpose);
 - current ratio;
 - acid test ratio;
 - trade receivable days;
 - trade payable days.
- (b) Comment on the ratios you have calculated in (a) and suggest some possible reasons for the differences and similarities between the businesses indicated by your figures.

39.11A Study the following financial statements of two companies and then answer the questions which follow. Both companies are wholesalers of household products. The values shown are in £000s.

	<i>Abraxas Ltd</i>		<i>Buscema Ltd</i>	
	£000	£000	£000	£000
Income Statements				
Sales		3,300		2,700
Less Cost of goods sold				
Opening inventory	410		216	
Add Purchases	2,340		1,697	
Less Closing inventory	<u>(460)</u>		<u>(233)</u>	
		(2,290)		(1,680)
Gross profit		1,010		1,020
Less Expenses				
Wages and salaries	712		569	
Directors' remuneration	85		175	
Other expenses	<u>147</u>		<u>168</u>	
		(944)		(912)
Net profit		<u>66</u>		<u>108</u>
Balance Sheets				
<i>Non-current assets</i>				
Equipment at cost	474		210	
Less Accumulated depreciation	<u>(212)</u>		<u>(52)</u>	
		262		158
Vans	213		117	
Less Accumulated depreciation	<u>(85)</u>		<u>(55)</u>	
		128		62
		<u>390</u>		<u>220</u>
<i>Current assets</i>				
Inventory	460		233	
Trade receivables	524		106	
Bank	<u>8</u>		<u>21</u>	
		992		360
Total assets		<u>1,382</u>		<u>580</u>
Less Current liabilities				
Trade payables		(744)		(179)
Net assets		<u>638</u>		<u>401</u>
Equity				
Issued share capital		260		80
Retained earnings		<u>378</u>		<u>321</u>
Total equity		<u>638</u>		<u>401</u>

Required:

- (a) Calculate the following ratios for both Abraxas Ltd and Buscema Ltd:
 - (i) gross profit as percentage of sales;
 - (ii) net profit as percentage of sales;
 - (iii) expenses as percentage of sales;
 - (iv) inventory turnover;
 - (v) rate of return of net profit on capital employed (for the purpose of this question only, take capital as being total of share capitals + reserves at the date of the balance sheet);
 - (vi) current ratio;
 - (vii) acid test ratio;
 - (viii) trade receivable days;
 - (ix) trade payable days.
- (b) Comment briefly on the performance of the two companies based on the ratios you have calculated, suggesting possible reasons for your observations.





39.12 Ng has been in business for many years buying and selling goods on credit. He is having difficulty in meeting the payments to his trade payables and the bank refuses to allow him an overdraft. The following information relates to the last two trading years ended 30 September 2023 and 30 September 2024.

	30 September 2023	30 September 2024
	£	£
Revenue	300,000	420,000
Cost of sales	150,000	210,000
Expenses (including loan interest)	130,000	170,000
Net profit for the year	20,000	40,000
Non-current assets	60,000	95,000
Inventory	30,000	24,000
Trade receivables	20,000	40,000
Bank	20,000	1,000
Trade payables	30,000	50,000
10% loan (long term)	50,000	40,000
Capital	50,000	70,000

Additional information

Inventory at 1 October 2022, £20,000

Required:

- (a) Calculate for the years ended 30 September 2023 and 30 September 2024 the:
- percentage gross profit to revenue
 - rate of inventory turnover
 - return on capital employed
 - trade receivables collection period in days
 - current ratio
 - liquid (acid test) ratio.
- (b) State **four** ways in which Ng could improve his bank balance.
- (c) Evaluate the financial position of Ng.

(Edexcel A level)

39.13 The summarised accounts of Hope (Eternal Springs) Ltd for the years 2022 and 2023 are given below.

Income Statements for the years ending 31 December

	2022		2023	
	£000	£000	£000	£000
Sales		200		280
Less Cost of sales		(150)		(210)
Gross profit		50		70
Less				
Administration expenses	38		46	
Loan note interest	—		4	
		(38)		(50)
Net profit		<u>12</u>		<u>20</u>

Balance Sheets as at 31 December

	2022		2023	
	£000	£000	£000	£000
Non-current assets at cost <i>less</i> accumulated depreciation		110		140
<i>Current assets</i>				
Inventory	20		30	
Trade receivables	25		28	
Bank	—		5	
		45		63
Total assets		155		203
<i>Current liabilities</i>				
Trade payables	15		12	
Bank	10		—	
	25		12	
<i>Non-current liabilities</i>				
8% loan notes	—		50	
Total liabilities		(25)		(62)
Net assets		130		141
<i>Equity</i>				
Ordinary share capital		100		100
Retained earnings		30		41
Total equity		130		141

Inventory at 1 January 2022 was £50,000.

Required:

- (a) Calculate the following ratios for 2022 and 2023:
- (i) Gross profit: Sales
 - (ii) Inventory turnover
 - (iii) Net profit: Sales
 - (iv) Quick ('acid test')
 - (v) Working capital
 - (vi) Net profit: Capital employed
- (b) State the possible reasons for and significance of any changes in the ratios shown by your calculations.

(Midland Examining Group: GCSE)

39.14A Laura has recently inherited £50,000 and has been investigating the possibility of buying shares as an investment. She is, initially, looking to maximise her income.

She has researched two companies and has provided the following information based on the latest financial statements for the year ended 30 April 2023:

	Stabilo plc	Gogro plc
Current market price	£2.40	£1.40
Share price high-low last 52 weeks*	High – Low £2.50 – £2.35	High – Low £1.45 – £0.60
Dividend per share	9.6p	10.5p
Dividend yield	4%	7.5%
Dividend cover	4 times	0.8 times
Earnings per share	25p	10p
Price earnings ratio	9.6	14
ROCE	6.8%	10.4%
Gearing	40%	125%

* This shows the highest and lowest price that the shares were bought and sold in the previous 52 weeks.





Balance sheet extracts for property, plant and equipment:

	Cost £m	Acc dep'n £m	Carrying amt £m
Stabilo plc	250	50	200
Gogro plc	45	30	15

Required:

Evaluate both businesses from an investor's point of view and advise Laura which company would be best for her to buy shares in.

(AQA A Level)

39.15A Alistair is concerned about the performance of his business. He has decided to assess the performance using ratio analysis.

He is able to provide the following information extracted from his income statement for the year ended 30 April 2018 in order to calculate ratios relating to profitability.

	£
Cash sales	10,000
Credit sales	185,000
Cash purchases	45,000
Credit purchases	80,000
Cost of sales	130,000
Gross profit	65,000
Operating expenses	55,250
Profit for the year	9,750

Required:

- Calculate the gross profit mark-up.
- Calculate the gross profit margin.
- Calculate the profit in relation to revenue ratio.

Alistair is particularly concerned about the liquidity of his business. He allows his credit customers 30 days' credit. On average his suppliers also give him 30 days' credit. He has calculated the following ratios for the accounting years 2015–2018:

Ratio	2015	2016	2017	2018
Receivable days	60 days	50 days	45 days	40 days
Payable days	20 days	25 days	30 days	33 days
Inventory turnover	12 times	11 times	8 times	5 times

- Assess the performance of Alistair's business in relation to liquidity. Use the ratios provided by Alistair above.

(AQA AS Level)

39.16 The trading inventory of Joan Street, retailer, has been reduced during the year ending 31 March 2020 by £6,000 from its commencing figure of £21,000.

A number of financial ratios and related statistics have been compiled relating to the business of Joan Street for the year ending 31 March 2020. These are shown below alongside comparative figures for a number of retailers who are members of the trade association to which Joan Street belongs:

	<i>Joan Street</i>	<i>Trade association</i>
Net profit as % net capital employed*	%	%
Net profit	15	16
$\frac{\text{Net profit}}{\text{Sales}}$	9	8
Net capital employed		
$\frac{\text{Sales}}{\text{Net capital employed}}$	$166\frac{2}{3}$	200
Non-current assets	45	35
$\frac{\text{Non-current assets}}{\text{Sales}}$		
Working capital ratio:		
$\frac{\text{Current assets}}{\text{Current liabilities}}$	400	$287\frac{1}{2}$
Acid test ratio:		
$\frac{\text{Bank} + \text{Trade receivables}}{\text{Current liabilities}}$	275	$187\frac{1}{2}$
Gross profit	25	26
$\frac{\text{Gross profit}}{\text{Sales}}$		
Trade receivables collection period:		
$\frac{\text{Trade receivables} \times 365}{\text{Sales}}$	$36\frac{1}{2}$ days	$32\frac{17}{20}$ days
Inventory turnover (based on average inventory for the year)	10 times	8 times

Joan Street has supplied all the capital for her business and has had no drawings from the business during the year ending 31 March 2020.

Required:

- Prepare the income statement for the year ending 31 March 2020 and balance sheet as at that date of Joan Street in as much detail as possible.
- Identify two aspects of Joan Street's results for the year ending 31 March 2020 which compare favourably with the trade association's figures and identify two aspects which compare unfavourably.
- Outline two drawbacks of the type of comparison used in this question.

(Association of Accounting Technicians)

***Authors' note: take the closing figure at 31 March 2020.**

39.17A Yaso is in business buying and selling goods on credit. He is concerned that although his business is making a good profit, his balance at the bank is not increasing. The following information is available:

- At 1 September 2022, the bank balance was £40,000, and the inventory was £35,000
- Summarised bank transactions for the year ended 31 August 2023.

	£
Receipts from trade receivables	625,000
Payments to trade payables	580,000
Non-current assets purchased	250,000
6% loan taken out by Yaso	300,000
Expenses paid	125,000
Drawings	40,000



3 Asset and liabilities at 31 August 2023.

	£
Trade receivables	160,000
Trade payables	60,000
Inventory	45,000
Expenses prepaid	20,000
Non-current assets	320,000
6% bank loan	300,000
(repayable in 5 years time)	
Bank	To be calculated

4 Credit transactions in the year ended 31 August 2023.

	£
Purchases	570,000
Revenue	800,000

Required

- (a) Explain the accounting terms:
- (i) profitability
 - (ii) liquidity.
- (b) Calculate the bank balance at 31 August 2023.
- (c) Calculate, for the year ended 31 August 2023, the:
- (i) Inventory turnover (times)
 - (ii) current ratio
 - (iii) liquid (acid test) ratio
 - (iv) trade payables payment period (in days)
 - (v) trade receivables collection period (in days)
 - (vi) revenue to non-current assets.

The following information is available for Yaso's business for the previous year, ended 31 August 2022, and for the sector average for the year.

	Yaso For the year ended 31 August 2022	Sector average For the year ended 31 August 2022
Inventory turnover	11 times	12 times
Current ratio	1.9:1	2:1
Liquid (acid test) ratio	1.1:1	1:1
Trade payables payment period (in days)	40 days	45 days
Trade receivables collection period (in days)	50 days	35 days
Revenue to non-current assets	2:1	2.5:1

- (d) Evaluate the liquidity of Yaso's business at 31 August 2023.
A friend of Yaso's stated that you cannot judge the success of a business by financial factors alone. You must also consider non-financial factors.
- (e) Identify **four** non-financial factors that could be important when judging the success of Yaso's business.

(Edexcel A level)

39.18 Business A and Business B are both engaged in retailing, but seem to take a different approach to this trade according to the information available. This information consists of a table of ratios, shown below:

Ratio	Business A	Business B
Current ratio	2 : 1	1.5 : 1
Quick assets (acid test) ratio	1.7 : 1	0.7 : 1
Return on capital employed (ROCE)	20%	17%
Return on shareholders' funds (ROSF)	30%	18%
Trade receivable turnover	63 days	21 days
Trade payable turnover	50 days	45 days
Gross profit percentage	40%	15%
Net profit percentage	10%	10%
Inventory turnover	52 days	25 days

Required:

- Explain briefly how each ratio is calculated.
- Describe what this information indicates about the differences in approach between the two businesses. If one of them prides itself on personal service and one of them on competitive prices, which do you think is which and why?

(Association of Chartered Certified Accountants)

39.19A You are given summarised information about two firms in the same line of business, A and B, as follows.

Balance Sheets at 30 June		A		B	
	£000	£000		£000	£000
Land		80		260	
Buildings	120		200		
Less: Accumulated depreciation	(40)	80	—		200
Plant	90		150		
Less: Accumulated depreciation	(70)	20	(40)		110
		180			570
Inventory	80		100		
Trade receivables	100		90		
Bank	—	180	10		200
		360			770
Trade payables	110		120		
Bank	50		—		
	160		120		
Loan (10% p.a.)	100	(260)	130	(250)	
		100		520	
Capital at start of year		100		300	
Add: Profit for year		30		100	
		130		400	
Less: Drawings		(30)		(40)	
		100		360	
Land revaluation		—		160	
		100		520	
Sales		1,000		3,000	
Cost of sales		400		2,000	



**Required:**

- (a) Produce a table of eight ratios calculated for both businesses.
- (b) Write a report briefly outlining the strengths and weaknesses of the two businesses. Include comment on any major areas where the simple use of the figures could be misleading.

(Association of Chartered Certified Accountants)

39.20 The following letter has been received from a client. 'I gave my bank manager those audited accounts you prepared for last year. But he says he needs more information before he will agree to increase my overdraft. What could he possibly want to know that he can't get from those accounts? If they are not good enough why bother to prepare them?'

Required:

Outline the major points which should be included in a reply to this letter.

(Association of Chartered Certified Accountants)

39.21 You are the accountant for Yau Tong Marketing plc and have to report on the financial statements of the company to the Board of Directors meeting.

Information concerning the performance of the company for the financial year ended 31 December 2024 is as follows:

Issued share capital	8 million £0.75 Ordinary shares 4 million 6% Redeemable preference shares of £0.50
Profit for the year before tax	£412,000
Tax on profit for the year	£92,000
8% loan notes 2029	£1,200,000
Reserves	£800,000
Interim ordinary dividend paid for year	£40,000
Final ordinary dividend paid for year	£140,000
Market price per share	£0.90

Required

- (a) Calculate, for the year ended 31 December 2024, the:

- (i) return on capital employed
- (ii) earnings per ordinary share
- (iii) dividend per share
- (iv) dividend cover
- (v) price/earnings ratio
- (vi) dividend yield.

At a Board meeting, the Chief Executive stated, "Last year, the dividend per share was 2.5 pence per share. It is important that the dividend per share increases every year".

- (b) Evaluate the statement made by the Chief Executive.

(Edexcel A level)

39.22 The annual final accounts of businesses are normally prepared on the assumption that the business is a going concern.

Required:

Explain and give a simple illustration of:

- (a) the effect of this convention on the figures which appear in those final accounts.
- (b) the implications for the final accounts figures, if this convention were deemed to be inoperative.

(Association of Chartered Certified Accountants)

39.23 One of the well-known accounting concepts is that of materiality.**Required:**

- Explain what is meant by this concept.
- State and explain three types of situation to which this concept might be applicable.
- State and explain two specific difficulties in applying this concept.

(Association of Chartered Certified Accountants)

39.24 Fu Wong has a sum of money, which he wishes to invest in shares. He has decided to invest in one of two companies, Chinoso plc or Paxorient plc. Fu Wong has carried out research on the internet and found the following information.

	<i>Chinoso plc</i>	<i>Paxorient plc</i>
Number of £0.50 (50 pence) ordinary shares issued	15,000,000	20,000,000
5% Bank loan repayable in 3 years time	£5,000,000	
6% loan notes redeemable in 5 years time		£2,500,000
Net profit before interest and tax for year	£2,800,000	£3,600,000
Corporation tax expense	£300,000	£450,000
Earnings per ordinary share	£0.15 (15 pence)	To be calculated
Total ordinary dividend paid for the year	To be calculated	£1,000,000
Dividend cover	2.5 times	To be calculated
Market price of shares	To be calculated	£0.90 (90 pence)
Price earnings ratio	8.4 times	To be calculated
Dividend paid per share	£0.06 (6 pence)	To be calculated
Dividend yield	To be calculated	5.55%

Fu Wong knows you are an accountant and asks you for advice. He would like your assistance in calculating the missing information in the table.

Required

- Calculate, for Chinoso plc, the:
 - total ordinary dividend paid for the year
 - market price of shares
 - dividend yield.
- Calculate, for Paxorient plc, the:
 - earnings per ordinary share
 - dividend cover
 - price earnings ratio
 - dividend paid per share.
- Evaluate the relevant information available and recommend to Fu Wong which company he should invest in.

(Edexcel A level)

39.25 Bradwich plc is a medium-sized engineering company whose shares are listed on a major Stock Exchange.

It has recently applied to its bankers for a 7-year loan of £500,000 to finance a modernisation and expansion programme.

Mr Whitehall, a recently retired civil servant, is contemplating investing £10,000 of his lump sum pension in the company's ordinary shares in order to provide both an income during his retirement and a legacy to his grandchildren after his death.

The bank and Mr Whitehall have each acquired copies of the company's most recent annual report and accounts.





Required:

- (a) State, separately for each of the two parties, those aspects of the company's performance and financial position which would be of particular interest and relevance to their respective interests.
- (b) State, separately for each of the two parties, the formula of four ratios which would assist in measuring or assessing the matters raised in your answer to (a).

(Association of Chartered Certified Accountants)

39.26 Explain what you understand by the accounting term 'capital gearing', showing clearly the benefits of, and the potential problems associated with, high gearing.

(Scottish Qualifications Authority)

39.27A What benefits can result through the use of ratios and what limitations should be imposed on any conclusions drawn from their use?

ACCOUNTING TODAY

Introduction

If you are reading this book it is quite possible that you are considering a future career as an accountant. So, in this final part, we take a look at the skills you might need, the different routes into the profession, and some of the different types of roles that accountants actually perform in practice.

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Multiple-choice questions: Set 5	710

Learning objectives

After you have studied this chapter you should be able to:

- Outline in general some of the principal attractions of working as an accountant today.
- Discuss some common preconceptions about careers in accountancy and assess how accurate they might be.
- Explain the range of skills required to be a successful accountant.
- Describe the different pathways to becoming a qualified professional accountant in the UK.
- Outline what it's actually like to work in accounting today (for some of the common job roles available to qualified accountants).
- Describe some of the issues which might affect the work of the accountants of tomorrow.

Introduction

You may be considering a career as a professional accountant in the future. In this chapter, you'll learn about some of the potential attractions of working as an accountant. We'll also look at three negative preconceptions concerning the career and assess how accurate they might be. Next you'll learn that the best accountants possess a range of skills and attributes that extends way beyond just technical expertise: if you wish to build a successful career in accountancy you would be wise to start thinking about developing some of these skills now.

We'll go on to examine the various routes you can take to become a qualified accountant in the UK and get a feel for what it's actually like to work as an accountant today. Finally, this chapter will consider a sample of the developments that may have an impact on the accountants of tomorrow.

40.1

Is accountancy a good career choice for you?

Whether accounting is a suitable profession for you depends very much on your attributes and personality, and the priorities you have for your life. However, we can make some general observations about the benefits of a career as an accountant that might help you begin to consider whether it may be a good choice.

The earning potential is excellent

This is probably the most well-known advantage. It is, of course, very easy to search online for the average salary of an accountant, but your results will probably indicate a range of different 'average' figures. Different sources evidently have alternative ways of calculating the average. In any case, the 'average' can be quite misleading because there is such a wide range.

In the UK there will be a fair number of qualified accountants earning six-figure salaries, but many others in the £40,000–£60,000 bracket. However, what is clear is that qualified accountants command very decent salaries, significantly more than national average earnings. In Section 40.11 we'll start looking a bit closer at some of the different job roles in accountancy and Exhibit 40.1 gives an indication of the range of UK salaries for those jobs.

There are accounting jobs everywhere

All sizes and types of organisation require accounting services of some kind. This means that there are opportunities for accountants to find work everywhere, in large cities or small towns throughout the country. This gives accountants flexibility in choosing where they want to work. It also holds true internationally: organisations all over the world require accounting services and professional accounting qualifications are recognised internationally, so there may be scope to live and work overseas in your career too.

Demand for accountants is growing

Accountants have been needed for centuries and there is no indication that this demand is diminishing. All types of organisations require some sort of accounting services so the demand for accountants typically increases in line with economic growth. One implication of this is that there will always be more job opportunities for accountants in more prosperous areas of a country compared to struggling regions. But all over the country, there is always likely to be a reasonable number of job opportunities for qualified accountants.

You can aim to work in an industry that interests you

Again, because organisations of all types require accountants this means you can seek to work in an industry in which you have a real interest. The fashion, music, media, film, sport and automotive industries, as well as the charitable sector, might be areas that could interest you.

David Gill (former CEO of Manchester United), Barry Hearn (the snooker and boxing promoter), David Ross (co-founder of Carphone Warehouse), and David Bernstein (former chairman of the English Football Association) are just a few examples of chartered accountants who have built successful careers in sectors they have a real passion for.

There is great potential for career development

The professional accounting qualification is an outstanding business qualification that can form the platform for a variety of lucrative career paths. The most senior accounting roles (such as the chief financial officer of a company, or partner in an accounting firm) are very well-paid. Another option is to start your own accounting firm and work for yourself, which has its own attractions.

The qualification can also form the basis for branching out into a career in the city: companies like Goldman Sachs and JP Morgan commonly recruit newly qualified accountants for roles in finance and investment analysis. Finally, if your aim is the top job in a company (the chief executive officer, or CEO) then, of all business backgrounds, an accountancy qualification gives you the best chance of achieving this: the ICAEW magazine *Economia* reported in 2018 that nearly

a fifth of CEOs of FTSE100 companies were chartered accountants, and over half came from a finance background.

40.2 Negative preconceptions about careers in accountancy

It's possible that you might have one or more of the following three reservations about a career in accounting. We'll consider all three, and consider how accurate they might be:

'Accountancy is boring'

There is a fairly widely held view, particularly in the UK, that accounting is a dull profession. A single sketch by Monty Python (the popular British comedy group) in 1969 is partially credited for creating the popular stereotype of accountants being boring (search YouTube for 'Monty Python Vocational Guidance Counsellor'). It is a reputation that has endured for decades.

However, the stereotype is not necessarily realistic: a day in the life of an accountant tends to consist of meetings, phone calls, paperwork and emails, which may not be particularly glamorous but neither is it very different from the vast majority of other office-based careers. Certainly the image of an accountant as a lonely 'number cruncher' tapping figures into his or her calculator for hours on end is completely outdated. Modern technology has meant that most basic bookkeeping tasks are completely automated, and the role of today's accountant is more about analysing, interpreting, communicating and acting upon the information that the computer systems provide.

Accountants have therefore become integral to the management team of the business, working alongside colleagues from marketing, purchasing and production with the aim of driving the business forward. They typically have an overview of the entire organisation, which is one of the reasons why it isn't unusual for the CEO of a company to be an accountant.

Accordingly, the image of accountants is definitely changing: ICAEW magazine *Economia* reported a 2017 UK survey that found accountants were the fourth most desirable professionals that people would most like to date (after doctors, emergency service workers and artists)! If you watch the original Monty Python sketch it will quickly become apparent that the business world has changed dramatically since 1969, and so has accountancy.

'Accountancy is a stressful profession'

Accountants are typically responsible for large sums of money, need to be constantly vigilant that no significant mistakes are going undetected, and can sometimes feel that they are on a treadmill of meeting a series of monthly deadlines. At face value, the advance of technology might be assumed to have made accountants' jobs easier, but in reality technology tends to increase the requirements to produce and communicate results quicker and more accurately than ever before.

Additionally, the majority of working accountants find themselves in middle-management, needing to meet their bosses' demands at the same time as supervising a team of staff beneath them. In 2019, the Chartered Accountants Benevolent Association in the UK reported research that 31%2 of accountants feel stressed by their work. However, to put that statistic in context, two points seem relevant:

- 1 Stress is a fairly subjective concept that is not easy to measure, but there is little evidence that accountancy is one of the most stressful careers today. Surveys suggest that soldiers, firefighters and airline pilots have the most stressful jobs by far. This is understandable: people in such roles face the risk of personal injury (or even death) to themselves or others. These are not hazards typically faced by accountants, so it's important to keep the stress experienced by accountants in perspective.

- 2 To a certain extent, the level of stress that an employee experiences can depend on their personality type as well as the actual job itself. In the face of busy schedules, multiple deadlines and high expectations from bosses or clients, some accountants unfortunately struggle with stress while others might thrive under the pressure. In other words, it can be the response of the individual, as well as the job itself, that determines how much stress someone experiences. Those who are able to adopt a positive, resilient and optimistic mindset may suffer less from stress, while others might unfortunately be susceptible to it whatever career they choose to pursue.

'Accountants work very long hours'

It is difficult to report 'typical' working hours because of the many different types of accountancy jobs. A 2014 survey by recruitment firm Robert Walters reported that the 'average' working week of a UK accountant was just over 44 hours, but that 30 per cent of accountants worked more than 50 hours a week. There will also be peaks and troughs over the course of the year: for example, some financial accountants might work weekends around their company's year-end date; tax accountants will be extremely busy around the time of annual tax return deadlines, and so on.

So some accountants do sometimes work long hours, but it is important to note that this is a trend in all professional occupations. The world is becoming more competitive and this pressure affects all professions. The same Robert Walters survey indicated that professionals in financial services, sales and legal all work a longer average working week than accountants. When it comes to working long hours, accountancy does not seem to be worse than many other professions.

40.3 The skills required to be a successful professional accountant

Having considered some of the potential pros and cons of careers in accountancy it would now be appropriate to consider whether you possess (or at least have the potential to acquire) the qualities required to build a successful career in the profession. It is impossible to specify the exact mix of skills you'll need because of the wide range of different roles, specialisms, organisations and industries. But the following is a list of 10 qualities that the majority of successful accountants should possess to some degree:

- 1 *Technical expertise*: this is the knowledge of a range of accounting methods and regulations and the ability to apply that knowledge appropriately in any given scenario. Acquiring and applying this expertise will require a high degree of 'academic' intelligence; the judgement to apply it appropriately will also develop as you gain experience as an accountant.

All accountants are expected to master the fundamental technical elements of accounting (such as the material covered in this book). But it is understood that no single accountant can know everything: the range and complexity of modern accounting work means that specialisation is essential.

A high degree of technical expertise will be essential in your chosen area. Furthermore, qualified accountants are required to undertake continuing professional development (CPD) activity on an annual basis to ensure that their technical expertise remains up to date.

- 2 *Numeracy skills*: many students study accounting because they feel they are good at maths and believe that accounting is 'all about numbers'. It is absolutely true that accountants must be good with numbers and it is certainly important that they avoid arithmetical mistakes. They also need to be able to analyse data, detect errors and anomalies, spot trends in the numbers, and explain accounting information to people who have little understanding of finance. Simply being able to use a calculator or a spreadsheet is not enough. Chapter 17, *Maths for accounting*, focuses on some of the key mathematical concepts and tools you will need.

- 3 *Attention to detail*: it has traditionally been important that accountants are dedicated to checking and reconciling figures precisely so that no mistakes go undetected. After all, the most minor discrepancy in the accounts could be the result of two huge errors (in opposite directions) so it is vital that accountants are meticulous in balancing figures to the penny.

Some observers suggest that the importance of *attention to detail* will diminish as more and more basic accounting tasks become completely automated. To give just one example: the bank reconciliation statement (Chapter 24) will often be produced automatically, because the company's accounting software is able to import the business's bank statements and automatically match them against the payments and receipts recorded in the company's books.

Nevertheless, computerisation cannot eliminate absolutely all errors so a need for attention to detail will surely remain.

- 4 *Problem-solving skills*: in studying for accounting exams you learn a set of rules, techniques and practices that form an essential foundation of knowledge of the subject. But you will quickly learn that in the real-world situations continually arise that you have not encountered before. These problems will have to be solved by thinking and reasoning with intelligence and imagination.

Your own levels of intelligence and creativity will be key drivers of your problem-solving potential, but it's also a skill that will develop as you gain experience as an accountant. A 2015 survey by financial recruitment firm Robert Half indicated that *solving problems* was the most popular answer given by accountants when asked what part of their job they most enjoyed.

- 5 *Communication skills*: the most important skill of an accountant is the ability to communicate. Survey after survey over the past 40 years has ranked this skill at the top. Yet accountants have an image of being shy and introverted, so many who embark on an accounting career get a shock when they discover that they must talk frequently with clients, managers and colleagues, and even make public presentations, particularly if they work for large firms or multinational companies.

- 6 *Interpersonal skills*: these are of immense importance to accountants. All accountants need to work effectively with colleagues as part of a team. For those that work for firms of accountants, the ability to build good relationships with clients is crucial. And as an accountant's career progresses, the capacity to lead and motivate their team of staff will become increasingly necessary.

- 7 *Writing skills*: accountants should be able to write well. They will often be called upon to write-up analyses and reports as well as emails and letters. Trainee auditors, for example, will need to write accurate reports of their audit findings almost every day. The writing must be clear, coherent and professional. Some students consider a career in accountancy because they are 'good with numbers' and prefer to avoid writing. This is a mistake: a successful accountant needs to be strong in both departments.

- 8 *IT skills*: all but the very smallest organisations will use computer software to maintain their accounts. Most modern accounting software is very user-friendly, so bookkeeping and accounting knowledge tends to be more important than IT skills in order to make effective use of it. Computerised accounting systems simply mimic manual accounting systems, which is why the basics of manual accounting (such as those covered in this book) remain a universal requirement.

However, the advance of technology means that accountants have to get to grips with developments beyond just their accounting software. Cloud computing, digital currencies, online payment mechanisms, new methods of investment (e.g. crowdfunding), and the use of graphics and video tools to produce effective, user-friendly reports are some current examples. The accountant of today must be flexible and receptive to new technologies and be ready to learn how they can be used most effectively.

In addition, some ‘old-school’ IT competencies are still highly valued by employers. The most obvious of these is spreadsheet skills. Spreadsheets remain widely used by accountants today. A common complaint of employers who take on business undergraduates for work placements is that their spreadsheet skills (usually Microsoft Excel) are not great. **There is no doubt that improving your spreadsheet skills remains an excellent investment for an accounting career.**

If your school, college or university offers any Excel courses you would be wise to take advantage of them. Alternatively, you can find a range of training resources online. Many accomplished Excel users are largely self-taught. If you are logical and numerate you will probably get the hang of the basics quite quickly. But Excel is a large, powerful package with a huge number of functions and you will need to use it repeatedly in order to develop more advanced skills.

- 9 *Emotional intelligence*: the concept of emotional intelligence was first popularised by Daniel Goleman in his 1995 book of the same name. The book became an international bestseller and the concept soon became recognised as essential to success in any profession. Goleman explains that emotional intelligence includes abilities such as *‘being able to motivate oneself and persist in the face of frustrations; to control impulse and delay gratification; to regulate one’s moods and keep distress from swamping the ability to think.’*

It certainly seems intuitively true that these sorts of qualities will be necessary to succeed in any modern career. Goleman presents the case that emotional intelligence is actually more important than both academic record and traditional measures of intelligence (IQ) as a predictor of how well a person will perform in their working life, and his arguments have a strong statistical and scientific basis.

- 10 *Ethics and integrity*: more than ever, accountants are expected to behave (and be seen to behave) with honesty, objectivity and fidelity. The 2007–8 financial crisis, as well as high-profile accounting scandals in recent years (involving companies such as Enron in the US, Satyam in India, or Tesco in the UK), have tended to contribute to the public’s perception that many finance professionals are greedy, unethical and out of control.

As a result, professional accountancy bodies have worked hard to raise the profile of the principles and codes of conduct that accountants are expected to abide by. Modern professional training seeks to implant these principles and guidelines within accountants, but clearly it is preferable if those entering the profession are by nature inclined to behave with honesty and integrity in the first place.

Activity 40.1

You could encounter ethical dilemmas in your capacity as a student of accounting. Can you suggest any?

Assuming you have read some of this book already it will be apparent to you that of the 10 attributes listed above *technical expertise* is emphasised more than the other nine. Your numeracy skills will certainly be developed, and the need for attention to detail is implicit in much of the material, but some of the other skills aren’t covered at all. Competencies like ‘interpersonal skills’ and ‘emotional intelligence’ are entirely absent from this (and virtually all) accounting textbooks. This is arguably a shortcoming of accounting education in general. Many schools, colleges and universities have tended to emphasise teaching traditional, academic knowledge, and the ‘soft skills’ receive less coverage.

In fairness, many schools and universities now run courses in ‘personal development’ and ‘skills for accountants’ but they usually make up only a small percentage of the curriculum. Moreover, things like ‘interpersonal skills’ and ‘emotional intelligence’ include a broad range of qualities that are not so easy to teach and develop. And some of these ‘soft skills’ are genetically predetermined to a certain extent, which means developing them may take a lot of practice.

Whatever your future career you would be wise to invest in developing your soft skills as much as possible. Suggestions could include getting as much as you can out of any ‘personal development’ or ‘skills’ courses that are available wherever you are studying; gaining work experience, especially working in teams; getting involved in a range of clubs and societies; competing in team sports; and cultivating your network of real, face-to-face friends.

Some employers fear that some members of Generation Z are at risk of being ‘socially awkward’, preferring to communicate using SMS and social media, and uncomfortable communicating and collaborating face-to-face. If this fear is justified then those who invest in developing their soft skills will have an even greater advantage in their future careers than ever before.

40.4 The vital importance of professional ethics

As we saw in the previous section, it is now recognised that accountants have a professional responsibility to be ‘ethical’. This is a relatively new development. For many years, ethics were merely an informal element of accountancy training. However, a regular stream of high-profile financial scandals since the 1960s has threatened the reputation of the profession. As a result, the informal approach to ethics has been formalised in an attempt to stop such events occurring.

It is for this reason that some accountancy bodies now include a separate ethics course in their training. Others have embedded ethics into some of their existing courses and exams. But what does it mean to be ‘ethical’?

Being ethical involves showing integrity, fairness, respect and openness in behaviour and attitude, in all situations. Members of all professions have a responsibility to society because they have the specialist knowledge and expertise to deal with certain situations in a more informed way than those who are not so qualified. For accountants, their professional ethics are not just concerned with how an accountant should be in the workplace, they relate to how accountants should behave in all aspects of their public life.

Ethics apply not only to what an accountant does, and to their interactions with those who are not accountants. Ethics also apply to how accountants conduct themselves with each other and with those aspiring to be accountants. Managers and trainers of accountants have an ethical responsibility to present themselves as respectful, honest and trustworthy, and to ensure that their accounting trainees embrace those same values.

The International Federation of Accountants (IFAC) is the world umbrella organisation for professional accountancy bodies. It has over 175 member and associate bodies in 130 countries representing nearly 3 million accountants in public practice, education, government service, industry and commerce. Its 2018 *Code of Ethics for Professional Accountants* forms the basis for many of the ethical codes that are developed and enforced by its member bodies. To read the full code, simply search for ‘IFAC Code of Ethics’ online.

In the IFAC Code, it is stated that a professional accountant must comply with the following five fundamental principles:

- (a) *Integrity* – to be straightforward and honest in all professional and business relationships.
- (b) *Objectivity* – to not allow bias, conflict of interest, or undue influence of others to override professional or business judgements.
- (c) *Professional competence and due care* – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques, and to act diligently and in accordance with applicable technical and professional standards.
- (d) *Confidentiality* – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor to use the information for the personal advantage of themselves or third parties.

- (e) *Professional behaviour* – to comply with relevant laws and regulations and to avoid any action that discredits the profession.

To supplement their ethical codes, accountancy bodies worldwide operate their own disciplinary codes which establish what steps may be taken should a member act unethically. These disciplinary codes are designed to protect non-accountants and to maintain the reputation of the profession and the demand for its services. Accountants found guilty of unethical behaviour risk the possibility of fines or even expulsion from their professional body.

**Activity
40.2**

Do you think that such a system of self-regulation is appropriate?

40.5 The scope of the accounting profession

You may be considering a career in accounting in the future. Before looking at the different pathways into the profession we need to clarify that accountants essentially work in one of three areas. Broadly speaking, accountants work:

- 1 *'In practice'*: Those 'in practice' work for professional firms of accountants that provide accounting, taxation and other services to their clients, who will be a range of different individuals and businesses. You may have heard of the 'Big Four' accounting firms (PwC, Deloitte, EY and KPMG). These are large, multinational firms that hire significant numbers of trainees every year around the world. But there are many other small- and medium-sized accounting firms that also recruit annually.
- 2 *'In industry'*: Accountants 'in industry' work for businesses across all sectors of the economy: retail, manufacturing, construction, financial services, and so on. All businesses above a certain size will usually employ at least one professional accountant. Larger businesses will have a team of accountants, each with different specialisms, roles and levels of seniority. Many of these larger businesses recruit trainee accountants each year.
- 3 *'In the public sector'*: Accountants in the public sector work for organisations such as the National Health Service (NHS), the government or the armed forces. The primary objectives of organisations in the public and private sectors differ: in the private sector the main objective of most businesses is to make a profit, whereas public sector organisations principally exist to provide services to the public. This fundamental difference means that the financial statements of public sector organisations are somewhat different to those in the private sector.

Many public sector organisations recruit accounting trainees every year, and there are plenty of opportunities for career development in that sector. However, be aware that it can be difficult to transfer to the private sector later in your career because of the differences.

40.6 The pathways to becoming a qualified professional accountant

Professional accountants (whether they work in practice, in industry or in the public sector) usually possess a professional accounting qualification. The majority (but certainly not all) will also have a university degree (although the degree does not have to be in accounting; it can be in any reputable subject).

Activity 40.3

To become a doctor, you must study a degree in medicine, but to become an accountant your degree does not have to be in accounting. What is the point, therefore, of studying for a degree in accounting?

To become qualified as a professional accountant you must pass a set of professional exams and also gain 3–4 years' work experience. This involves obtaining a job as a trainee and working as a junior accountant while at the same time sitting the exams. The exams are notoriously difficult and not all trainees will manage to pass them. Once a trainee has passed all the exams and has gained sufficient work experience, they will become a qualified member of their professional body. At this point their salary will typically rise quite sharply.

The majority of trainee vacancies are aimed at graduates, but some organisations also recruit non-graduates to work in accounting. Non-graduate routes include first qualifying as an 'accounting technician'. The Association of Accounting Technicians (AAT) qualification, for example, is widely respected and internationally recognised. Moreover, professional accountancy bodies typically offer a generous level of exemptions from several of their exams to those who are already AAT-qualified.

40.7 The different professional accountancy bodies in the UK

Rather confusingly there are six major professional accountancy bodies in the UK and each has its own set of exams:

- 1 ICAEW: the Institute of Chartered Accountants in England and Wales (members have the letters ACA or FCA after their names).
- 2 ICAS: the Institute of Chartered Accountants of Scotland (members have the letters CA after their names).
- 3 CAI: now known simply as 'Chartered Accountants Ireland' (members have the letters ACA or FCA after their names).
- 4 ACCA: the Association of Chartered Certified Accountants (members have the letters ACCA or FCCA after their names).
- 5 CIMA: the Chartered Institute of Management Accountants (members have the letters ACMA or FCMA after their names).
- 6 CIPFA: the Chartered Institute of Public Finance and Accountancy (members have the letters CPFA after their names).

All six are internationally recognised and highly respected qualifications. Which body you qualify with generally depends on what type of organisation you work for and the preferences of your employer:

- If you are training 'in practice' with a firm of accountants you will typically study for either the ICAEW, ICAS, CAI or ACCA qualification.
- If you are employed 'in industry' by a company you will normally work towards either CIMA or ACCA.
- Trainees in the public sector will commonly study either the CIPFA or CIMA exams.

Once qualified, many members of ICAEW, ICAS, CAI and ACCA who have trained with an accountancy firm subsequently move into careers ‘in industry’.

40.8 Obtaining a position as a graduate trainee in accountancy

Regardless of which body you train with, there are some important general points in relation to what is necessary to obtain a position as an accountancy graduate trainee:

- 1 For the most desirable graduate trainee positions in the UK, organisations will sometimes look for a high number of UCAS points as well as a good degree. **Competition for places can be stiff and the selection process rigorous.** If you are studying at university you should definitely take advantage of the support that your careers service can offer in relation to selection tests, assessment centres and interview practice.
- 2 Many positions are first advertised in the autumn, so undergraduates should start applying at the beginning of their final year in order to maximise their chances. **Every year, a surprisingly large proportion of final year undergraduates fail to apply for jobs until far later than this, which usually proves to be a costly error.**
- 3 It is highly advantageous to have relevant work experience such as shadowing, vacation work or a formal work placement. **A year's work placement is perhaps the single best thing that undergraduates can do to their CV in order to enhance their employability.** If you are an undergraduate and your university runs a ‘placement’ year scheme you would be wise to consider undertaking one.
- 4 Your starting salary as a trainee accountant may be a little lower than (say) some graduate roles in general management. This is because your employer will instead invest several thousands of pounds in your professional training and exams. Once you qualify, rest assured that your salary will more than catch up.

40.9 The differences between training with the different professional accountancy bodies

The professional accountancy exams will develop extensive understanding across a wide range of accountancy, finance and business areas. But the exact syllabus you study will differ depending on which body you qualify with. The CIMA exams, for example, will place greater emphasis on *management accounting* than the others. All six bodies update their syllabuses regularly. The websites of each will, of course, give full details of exactly what you would study.

40.10 Career options after qualifying with one of the professional accountancy bodies

Once qualified with a professional body there are a wide range of career options, but some general points can be made:

- 1 Those who train in an accountancy firm can remain employed in that sector (with career progression to the level of manager or even partner). Alternatively, they might set up their own accounting practice and work for themselves. A third option would be to move into ‘industry’, where becoming the chief financial officer (CFO) of a company might be their ultimate aim. Finally, there is also the option of using the qualification to move into a field like banking, finance or consultancy.

- 2 Those who train in industry will typically stay in industry, with potential to progress to the level of CFO or even chief executive officer (CEO). There also may be opportunities to move into areas such as business analysis, project management or management consultancy.
- 3 The careers of those who train in the public sector will often remain connected to the public sector because of the specialist nature of their experience and qualifications.

40.11 What is it like to work as a trainee accountant?

Owing to the varying specialisms of trainees, different sizes of organisations, and other factors, it is impossible to describe the 'typical' working life of a trainee accountant. However, the following three general comments can be made:

- 1 Those who train with a firm of accountants will work in one of the firm's departments: audit, tax or one of various others. The majority of vacancies are usually in audit (which is also sometimes known as 'assurance'). An 'audit' essentially involves reviewing the annual financial statements (and the underlying financial records) of a company. On the basis of that review, the auditors give an opinion on whether the financial statements provide a true and fair view of that company's financial position and performance.

As a trainee auditor the majority of your time will be spent at clients' premises. This will entail quite a bit of travelling, and overnight stays will sometimes be necessary. Following instructions from more senior members of the audit team, you will carry out 'audit tests' to check the accuracy of the client's financial records and the reliability of their systems and controls. You will also be expected to identify any weaknesses in their procedures and suggest solutions.

- 2 If you train 'in industry' you will be employed full-time by one company so will normally commute to the same place of work each day. It is possible that there could be some travel if your organisation is based across various sites; overseas travel or secondment could be possible if you work for a multinational company. Your time will typically involve a combination of analytical work at your desk, formal and informal meetings with colleagues, and emails and phone calls. With the help of guidance and advice from senior colleagues, you will be involved in a range of accounting work that could include:

- assisting with the preparation of monthly financial statements for use by management within the company
- analysing financial reports to identify where actual performance is deviating from the plan, and determine trends or detect anomalies that need to be investigated
- analysing financial data and summarising it in report form
- working on projects to improve the company's financial systems or processes.

- 3 Regardless of whether they are working in practice or in industry, trainees will need to balance their workload with studying for the professional exams. The best employers will pay for all your tuition and give you time off to attend classes as well as some additional study leave to revise. Tuition modes vary and can include day-release, block-release or evening classes.

Before accepting a job it is advisable to find out what the training and study package is: it is extremely difficult to pass the professional exams without good support. And regardless of the level of support, you will also need to undertake your own regular private study in evenings and at weekends if you wish to be successful.

40.12 What's it like to work in accounting once you are qualified?

If you search 'accountancy jobs' online your results will include a huge range of different job titles. This reflects the fact that there are many different types of accountant, with different levels of seniority for each type. There are so many different roles that it is impossible to describe the typical

working day of a modern accountant. Instead, we'll look at just six of the many different job titles in accountancy and present a brief outline of what each might generally involve doing. The six roles are:

- 1 Audit manager
- 2 Audit partner
- 3 Tax adviser
- 4 Management accountant
- 5 Financial controller
- 6 Chief Financial Officer (CFO or 'Finance Director')

Before we begin, three general points about these six may be useful:

- 1 The first three jobs on the list involve working 'in practice' (for a firm of accountants), while the other three represent 'accountants in industry' (working for a company in any sector of the economy). In general, those in practice will travel more because client visits will be necessary.

In contrast, accountants 'in industry' will generally commute to and from the same place of work every day, although some travel may be necessary if the company operates from different sites. Regardless, an accountant working in industry will generally not be confined to their desk all day: there will be regular formal and informal meetings throughout the organisation.

- 2 It is difficult to be specific about the working hours of each of the six jobs. The actual hours worked in any accounting job will largely depend on the demands of that particular role and the culture in the organisation.
- 3 You may be interested to know the salaries earned by professional accountants. Exhibit 40.1 shows the results of a UK salary survey in relation to some of the jobs we look at in this chapter. The wide ranges indicated exist because the actual salary earned within each range shown will depend on the size, location and business sector of the organisation, and the seniority and responsibilities of the specific role.

Note that the ranges also appear to exclude some of those at the very top end: for example, a senior audit partner at a Big Four firm or the CFO of a FTSE 100 company would typically earn a seven-figure income.

Exhibit 40.1 Results of a UK accountants' salary survey

Job title	UK salary range 2017
Audit trainee	£18,250–£27,250
Audit manager	£33,500–£98,750
Audit partner	£100,000–£447,500
Assistant accountant (i.e. trainee in industry)	£18,750–£33,500
Management accountant	£36,000–£72,000
Financial controller	£49,000–£93,000
Chief Financial Officer (or 'Finance Director')	£64,500–£163,000

Source: figures extracted from the Robert Half 2017 UK Salary Guide, accessed from www.roberthalf.co.uk

40.13 What does an 'audit manager' do?

For those who train as auditors with an accounting firm then 2–4 years after qualifying they can expect to be promoted to 'audit manager'. Their role will be to plan and manage the audits of a set of clients, and they may act as line manager to a group of audit staff. Managers will typically spend some time out on site visiting clients and audit teams. This is necessary both to review the work the audit teams have done and to meet with the client.

When not on-site, audit managers will be based in the accounting firm's office and will be occupied with a variety of activities such as liaising with their on-site audit teams over the phone, planning upcoming audits, reviewing audit budgets, drafting reports to clients, and liaising with partners and other managers to deal with queries and resolve issues.

40.14 What does an 'audit partner' do?

After around 10–20 years as an auditor for an accounting firm there may be the possibility of being promoted to partner. Partnership is the pinnacle of the profession for those who work 'in practice'. A partner in a reasonably sized firm in the UK may expect to earn a six-figure income; the most senior partners in a 'Big Four' firm will receive a seven-figure income.

Each partner will look after a set of audit clients and they may be line manager to a number of audit managers. Activities will vary from day to day but will typically involve a mixture of:

- Meeting clients to discuss the issues that arose during the audit and agree the client's final financial statements.
- Offering general business guidance to clients. In addition to audit skills, partners will be expected to fulfil the role of 'trusted business adviser' to their clients.
- Meeting with audit managers and fellow partners to discuss technical and operational issues that need to be resolved.
- Networking in business circles to help maintain and raise the profile of the firm.

Achieving promotion to partner is not easy. Accounting firms will have plenty of staff with outstanding technical expertise: what makes them stand out is the ability to build the trust and confidence of existing clients as well as being able to generate new fee income for the firm. The potential to win new clients and grow the firm is key to becoming partner. This means interpersonal, communication and networking skills are perhaps the most important in determining who will succeed.

40.15 What does a 'tax adviser' do?

Tax advisers work for firms of accountants and provide tax 'compliance' and 'consultancy' services to their clients. Clients may include companies, partnerships and wealthy individuals. 'Compliance' involves ensuring that the client has calculated their tax correctly and submitted their tax returns. 'Consultancy' involves advising clients on how to legally minimise the tax they pay.

There are several different types of tax in the UK and tax legislation is enormously complicated. It is therefore impossible for one person to master all aspects of tax. The larger accountancy firms are able to deal with this by employing specialists in particular areas, but in smaller firms the advisers may be expected to cover the range of different taxes.

The daily tasks of a tax adviser might typically include:

- communicating with clients to gather information and resolve queries
- completing and submitting tax returns on behalf of clients
- communicating and negotiating with the tax authorities (HM Revenue & Customs in the UK)

- studying and interpreting tax legislation
- working on tax planning schemes that will minimise the tax liabilities of clients within the bounds of current legislation.

Tax advisers in the UK must pass a series of exams that culminate in them becoming a Chartered Tax Adviser (CTA). As with the audit profession, qualified advisers can expect to progress to manager within a few years. After that there is the potential to become a tax partner in the firm.

40.16 What does a 'management accountant' do?

As you learnt in Chapter 1, the main two branches of accounting are *financial accounting* and *management accounting*. The distinction between the two is convenient for textbooks and accounting courses, but in the workplace it is often far less clear. Companies above a certain size might employ both a 'financial accountant' and a 'management accountant': the 'financial accountant' will sometimes perform bits of 'management accounting' (such as being involved with preparing the annual budget) while the 'management accountant' will occasionally do some 'financial accounting' (such as posting the accruals and prepayments each month).

However, generally the role of a 'management accountant' is to produce and analyse financial information to help the business's managers plan, make better decisions, and monitor whether its spending and finances are under control. The management accountant will have various responsibilities but daily activities might include:

- preparing monthly financial statements, with a focus on monitoring how actual performance compares against the same month last year and with the budget
- liaising with non-financial managers across the organisation on various matters including the investigation of why actual performance may be worse than budget and what corrective action can be taken
- compiling the annual budget on the basis of information received from managers throughout the company
- providing an essential support service by supplying whatever financial information may be needed to assist management in making decisions.

There will be variations in the management accountant's role depending on the size of the business and the way that it has decided to organise itself. For example, in a large company there may be several management accountants, each with a particular focus. In a smaller organisation there may be only one qualified accountant and that person will see to all the management and financial accounting needs of the company.

40.17 What does a 'financial controller' do?

The financial controller in a company is the person responsible for overseeing all operations in the accounting department. He or she may have been a more junior accountant in the business and been promoted to the position; alternatively, the post is sometimes filled by an accountant making the move from practice into industry.

The controller oversees the accounts department and will have a wide variety of tasks and responsibilities, which might include:

- managing the team of accounts staff
- maintaining and improving the system of checks and controls to minimise the risk of errors and fraud
- dealing with queries from members of the accounts team, and endeavouring to solve any problems that arise
- preparing the annual financial statements and liaising with the auditors.

There will be a lot of communication between the financial controller and members of the accounting department as well as with other managers in the company. Typically, the controller will report directly to the company's chief financial officer (CFO, also known as the 'Finance Director' in the UK) and this will be a particularly important relationship. The financial controller will often have their eye on becoming a CFO themselves in the future.

40.18 What does the Chief Financial Officer do? (also known as the CFO, or 'Finance Director' or 'FD' in the UK)

For an accountant working in industry, after several years of post-qualification experience, the role of CFO may be the ultimate goal. The CFO will sit on the company's Board of Directors and they will typically:

- play a key role in formulating the company's strategy and making major business decisions
- regularly report the company's recent financial performance to the Board, and provide it with the latest financial forecasts and projections
- negotiate with lenders when raising funds for the organisation, and deal with the financial aspects of major business deals
- work closely with the financial controller, keeping informed of any significant issues or problems in the accounts department and helping to identify solutions.

A successful CFO needs outstanding technical expertise, intelligence and experience. They need to be able to think strategically and understand the implications of business decisions on every aspect of their organisation. Leadership, interpersonal and communication skills are also key, as are energy and sound judgement. To possess this combination of skills is rare, which is one of the reasons that the CFOs at the UK's biggest companies will earn seven-figure salaries.

40.19 Some of the potential issues and developments faced by the accountants of tomorrow

Progress and change are constant features of modern life. In the last 50 or so years, the world of accounting has changed immensely. For example, in 1967 there was virtually no accounting software, the electronic spreadsheet did not exist, and no accounting standards had been issued. The profession will continue to change in the coming years, but it is always difficult to predict exactly what those changes will be.

To give you a flavour of the developments that the accountants of tomorrow may have to deal with, we will look at just three examples. You are at the first stage in your studies of accounting so you don't require an *in-depth* understanding of these issues yet. However, a chapter on accounting today would not be complete without considering a sample of the changes that may impact upon the accountants of tomorrow:

An increased focus on reporting non-financial information

You will learn in Chapter 36 that companies must publish annual financial statements (supported by detailed notes) that summarise their financial position and performance for the past year. This financial information forms the core of a company's 'Annual Report'. This report also contains some narrative commentaries on the company's performance more generally, but the main emphasis tends to be the financial results.

In recent years this emphasis has been criticised for various reasons:

- 1 In order to properly assess a company's performance, shareholders need a broader picture of the company, ranging from the satisfaction levels of its customers to its social and environmental sustainability record. Investors need a holistic picture of the company in order to make fully informed investment decisions. Its financial performance over the last 12 months is only one piece of the jigsaw.
- 2 The disproportionate emphasis on last year's financial results reflects an excessive focus on the short-term. In contrast, long-term success requires qualities such as the ability to innovate new products, to build a good reputation, and to manage environmental risks. These sorts of issues are not reflected in the annual financial results. Requiring companies to report more fully on these long-term factors should focus the directors' attention towards the creation of long-term value.
- 3 The growing power of large multinational companies (as well as the chequered history of some companies in relation to their social or environmental impact) has led various pressure groups (and the public in general) to demand that companies be required to disclose more information about their activities, way beyond merely their financial performance.

There is therefore a growing movement advocating that companies produce an 'Integrated Report'. These are not yet compulsory, and there is no universally agreed standard format, but many observers believe that *Integrated Reporting* is likely to become a requirement for large companies in many countries over the coming decade. An 'Integrated Report' aims to provide a complete picture of a company's financial and non-financial performance, together with its strategy, governance and future prospects.

Within a company, the CFO tends to take the lead in producing the Annual Report, and professional firms of accountants are the experts in providing assurance that the information in Annual Reports is true and fair. Annual reporting, therefore, is primarily the field of accountants.

So *Integrated Reporting* is likely to present both challenges and opportunities for the accounting profession. The accountants of tomorrow may need to develop new expertise to be able to report on a diverse range of non-financial measures from greenhouse gas emissions to employee satisfaction rates. Professional firms of accountants will require new skills in checking such non-financial information to be able to provide independent assurance to users with regard to its accuracy.

A need for more advanced maths skills

Contrary to popular belief, most traditional accounting only required a relatively basic level of maths skills. Accountants certainly needed to be 'good with numbers' but largely in terms of being good at arithmetic and being adept at identifying what the numbers signify, spotting trends and identifying anomalies. However, for some accountants, things may be different in the future.

Large companies in many parts of the world (including the UK) must comply with international accounting rules (or 'standards'). These standards are known as IASs and IFRSs. There is a trend for some of the more recently issued standards to require some fairly complex maths. IFRS 9 *Financial Instruments* is an example. The detail of IFRS 9 is well beyond the scope of this book but many observers are worried that the existing levels of understanding of financial maths amongst some current accountants are insufficient for them to properly apply this and some other recent standards.

This is a deficiency that may have to be addressed in the next generation of accountants. It is also another reason for the inclusion in this book of Chapter 17, *Maths for accounting*.

The impact of cloud computing on accountancy

Another development that is impacting the business landscape quite significantly is cloud computing. For businesses, cloud computing refers to the already common practice of using computer resources that are not physically based on the company premises but essentially reside on the internet. Anyone with a computing device and internet access can access software and their data

in the cloud from wherever they happen to be working. And instead of purchasing costly hardware and software, users pay a relatively small monthly subscription for this access.

This is particularly attractive for small- and medium-sized enterprises (SMEs) because they are now able to use powerful accounting systems that previously were only available to large organisations with extensive financial resources and large IT departments. Many SMEs have already adopted cloud computing for their accounting data and many more are likely to follow. The impact on the accounting profession could include:

- 1 Access to more sophisticated software means that even more basic accounting tasks will become automated than before. This will further reduce demand within SMEs for basic bookkeeping skills and the role of the accountant will become that of a financial expert, analysing and interpreting the data, and predicting what is going to happen.
- 2 In theory, any manager in the business can access the same accounting information, wherever they are. This could lead to faster, more collaborative decision-making. However, non-financial managers may access financial data that they don't fully understand. The role of the accountant in explaining and clarifying the information could become more important than ever.
- 3 Firms of accountants that provide services to SMEs may find that their roles will change. Firms will be able to access their clients' accounting data from the office rather than having to visit the client. Demand for basic accounting services will diminish, because the more sophisticated software will take care of them. Instead, firms should be able to offer valuable business advice on planning, strategy, controls and financial analysis.

For decades, accountants have liked to think of themselves as 'trusted business advisers' because of the role they play in understanding and assessing the financial performance of a business. More than ever, it may be time for them to start fully living up to this role as more and more basic accounting tasks become automated.

Learning outcomes

You should now have learnt that:

- 1 There are several attractions of a career in accounting.
- 2 Some of the reservations that you may have about careers in accounting are not necessarily entirely accurate.
- 3 Successful accountants require a range of attributes: technical expertise, numeracy skills, attention to detail, problem-solving skills, communication skills, interpersonal skills, writing skills, IT skills, emotional intelligence, and ethics and integrity.
- 4 Broadly speaking, accountants work in practice, in industry or in the public sector.
- 5 A university degree is not always needed to become a professional accountant, but many trainee positions are aimed at graduates.
- 6 There are six main professional accountancy bodies in the UK and which body you qualify with depends on what type of organisation you train with and the preferences of your employer.
- 7 The work of a trainee accountant is varied and depends on whether you train in practice, industry or the public sector.
- 8 Once you are qualified there are a wide range of different job roles and career paths that you can pursue.
- 9 The accounting profession has seen significant changes in the last 50 years and there will be more changes in the coming decades.

Answers to activities

40.1 You could become aware, for example, that one of your friends on your accounting course:

- bought their latest essay online and has been awarded a very high mark
- has hidden a library book (one that is particularly useful for an upcoming assignment) somewhere in the library
- plans to sneak revision notes into a forthcoming exam and refer to them.

In each case, the fact that your friend's behaviour is 'wrong' is clear. However, your relationship with your friend might make you hesitant to take action. There is also the practical problem of it likely to be 'your word against theirs' if you report it to those in authority.

40.2 As with all professions, enforcement of a code of ethics in a manner which encourages outsiders to believe that accountancy bodies are serious about the issue is not simply a case of having a disciplinary code in place. Outsiders can be very sceptical about self-regulation, especially if accountants found guilty of unethical conduct are let off with a warning or a minor fine. This is a difficult situation to address: non-accountants lack the technical knowledge and expertise to interpret accounting practice and so are incapable of truly understanding many of the situations that may arise. Finding something more appropriate is difficult, if not impossible.

40.3 There are several good reasons. Here are just three:

- 1 Exemptions from future professional exams: if you have a degree in accounting (commonly in 'accounting & finance') and you decide to become a professional accountant you will usually be exempt from several professional exams. For example, a graduate with a degree in chemistry might have to pass (say) 14 professional exams while an accounting graduate might be exempted from the first (say) nine and would only sit the final five.

Some UK accounting degrees have even higher levels of accreditation than this. The professional exams are notoriously challenging: passing them all at the first time of asking is tough. To be exempt from so many is therefore typically seen as a major advantage of getting an accounting degree.

- 2 Accounting is a reputable, rigorous academic degree subject that will be respected by employers. A good degree in accounting signifies that you are an intelligent all-rounder: you are good with numbers and can also write well.
- 3 Universities often offer the opportunity of a year in industry work placement on 'vocational' degree courses like accounting. Undertaking one of these will be major asset on your CV when it comes to getting a graduate job. With high numbers of students attending university, a degree alone is not enough to make you stand out. A year of relevant work experience is invaluable.

Review questions

Author's note: It is felt that these review questions might best be covered in the context of a tutorial/classroom discussion, so the suggested solutions can all be found in the Instructor's Manual.

40.1A Electronic spreadsheets (such as Microsoft Excel) are extensively used by accountants today and have been for decades. With reference to some of the various topics covered in this book, can you suggest some specific purposes for which accountants might use spreadsheets?

40.2A There have been several high-profile scandals in accounting in recent times, which have contributed to the raised profile of ethics and integrity in accounting. The details of many of these scandals might be difficult to understand at this stage in your studies. However, search online for 'WorldCom scandal 2002' and read about what happened in that case. Can you relate a key element of the WorldCom affair to one particular chapter in this book?

40.3A There is now growing disapproval from some sections of the public of the elaborate tax planning arrangements that tax advisers at some accounting firms have recommended to their clients. These arrangements may be entirely legal but are often highly complex schemes that exploit loopholes in the legislation. Critics argue that they go against the spirit, if not the letter, of the law.

In response, successive governments have promised to crackdown on the more extreme tax planning schemes, with limited success to date. Recent public interest in the social acceptability of some of these tax planning schemes has increased debate about the ethics of the activity.

What do you think? Is it ethically acceptable for accounting firms to advise their wealthy clients to adopt complex tax planning schemes to massively reduce their tax bills, as long as those schemes are completely legal?

40.4A For simplicity and convenience, this chapter discusses accountants as working 'in practice', 'in industry' or 'in the public sector'. However, some organisations might not fall neatly into one of these three categories but will still require accounting services. Can you suggest any such organisations?

40.5A In this chapter you've learnt about some specific roles and areas of accountancy, such as 'financial controller' or 'tax adviser'. Can you suggest any other particular areas of accounting in which you can specialise?

40.6A Some students who want to train with an accountancy practice tend to focus exclusively on trying to get a job with one of the 'Big Four' (PwC, Deloitte, EY and KPMG) and ignore smaller accounting firms altogether.

Required:

- (a) What do you think are the advantages of training with a 'Big Four' firm?
- (b) Can you suggest any disadvantages of focusing exclusively on the 'Big Four'?
- (c) Are you able to identify any potential benefits of training with a smaller firm?

40.7A You may have no plans to become an accountant in the future. Why is it still important for you to study the basics of accounting, such as those covered in this book?

40.8A The rate of progress in technology is so rapid that it is very difficult to predict exactly how new technology will affect accounting in the future. Can you suggest any developments in technology that could have a significant impact on accounting in the future?

Multiple-choice questions: Set 5

Each of these multiple choice questions has four suggested answers, (A), (B), (C) and (D). You should read each question and then decide which choice is best, either (A) or (B) or (C) or (D). *Write down your answers on a separate piece of paper.* You will then be able to redo the set of questions later without having to try to ignore your answers.

MC81 During the year a business sold one of its old delivery vans, realising a profit on disposal of £1,100. The van had a carrying amount as at the date of disposal of £8,000. What figure for proceeds from the disposal of non-current assets will appear in this business's statement of cash flows?

- (A) £8,000
- (B) £6,900
- (C) £9,100
- (D) £1,100

MC82 A company reports an operating profit of £142,900 for the year after charging depreciation of £18,200. Over the course of the year the company's inventory increased by £22,800, its trade receivables decreased by £14,300 and its trade payables went up by £17,600. Given the above, what was the cash generated from operations according to the company's statement of cash flows?

- (A) £152,000
- (B) £135,000
- (C) £170,000
- (D) £187,000

MC83 If cost price is £90 and selling price is £120, then

- (i) Mark-up is 25 per cent
 - (ii) Margin is $33\frac{1}{3}$ per cent
 - (iii) Margin is 25 per cent
 - (iv) Mark-up is $33\frac{1}{3}$ per cent
- (A) (i) and (ii)
 - (B) (i) and (iii)
 - (C) (iii) and (iv)
 - (D) (ii) and (iv)

MC84 Given cost of goods sold £16,000 and margin of 20 per cent, then sales figure is

- (A) £20,160
- (B) £13,600
- (C) £21,000
- (D) £20,000

MC85 If opening inventory is £3,000, closing inventory £5,000, sales £40,000 and margin 20 per cent, then inventory turnover is

- (A) 8 times
- (B) $7\frac{1}{2}$ times
- (C) 5 times
- (D) 6 times

MC86 A company has always previously recorded its freehold land at its historical cost of £129,000. It has recently had its land valued by a firm of professional valuers who advise that the land is now worth £0.6m. The directors wish to incorporate this new value in the financial statements. What entries are required to do this?

- (A) Dr Freehold land £600,000, Cr Revaluation reserve £600,000
- (B) Dr Freehold land £471,000, Cr Revaluation reserve £471,000
- (C) Dr Revaluation reserve £600,000, Cr Freehold land £600,000
- (D) Dr Revaluation reserve £471,000, Cr Freehold land £471,000

MC87 At the start of the year, a company had 60,000 ordinary shares of 50p each in issue, fully paid, and there was a balance of £170,000 on the share premium account. During the year, the company made a bonus issue of one share for every five held, using the share premium account. What are the correct balances after the bonus issue?

- (A) Ordinary share capital £72,000, Share premium £158,000
- (B) Ordinary share capital £36,000, Share premium £164,000
- (C) Ordinary share capital £42,000, Share premium £158,000
- (D) Ordinary share capital £66,000, Share premium £164,000

MC88 A company reported a corporation tax expense of £19,900 in its income statement for this year, and it actually paid £18,700 corporation tax to the tax authorities during the year. The previous year's balance sheet had included a current liability for corporation tax payable of £17,300. The liability for corporation tax payable in the balance sheet as at the end of this year is:

- (A) £16,100
- (B) £18,500
- (C) £19,900
- (D) £21,300

MC89 A company issues 200,000 ordinary shares with a par value of 50 pence each at an issue price of £1.40 per share, fully paid. Which of the following journal entries correctly records this issue?

- (A) Dr Cash at bank £280,000, Cr Ordinary share capital £100,000, Cr Share premium £180,000
- (B) Dr Cash at bank £280,000, Cr Ordinary share capital £200,000, Cr Share premium £80,000
- (C) Dr Ordinary share capital £100,000, Dr Share premium £180,000, Cr Cash at bank £280,000
- (D) Dr Ordinary share capital £200,000, Dr Share premium £80,000, Cr Cash at bank £280,000

MC90 In a statement of cash flows, which of the following would be added to the business's profit when using the indirect method to calculate the net cash from operating activities?

- (i) Decrease in inventory
 - (ii) Increase in trade receivables
 - (iii) Profit on disposal of non-current assets
 - (iv) Increase in trade payables
- (A) (i) and (ii)
 - (B) (ii) and (iii)
 - (C) (iii) and (iv)
 - (D) (i) and (iv)





MC91 A company's ordinary shares have a par value of 5 pence each. Its balance sheet reports issued ordinary share capital, fully paid, of £90,000. If the company pays an ordinary dividend of 8 pence per share, this amounts to total dividends paid of:

- (A) £144,000
- (B) £36,000
- (C) £7,200
- (D) £14,400

MC92 At the start of the year the balance sheet of a company included retained earnings of £143,000 and at the end of the year the figure was £151,000. The company reported a profit for the year, after tax, of £37,000 and made a transfer of £10,000 from retained earnings to general reserve. Given this information, what ordinary dividends were paid during the year?

- (A) £29,000
- (B) £35,000
- (C) £19,000
- (D) £39,000

MC93 In what order are the three sections of a statement of cash flows normally presented?

- (A) Investing activities, financing activities, operating activities
- (B) Investing activities, operating activities, financing activities
- (C) Operating activities, financing activities, investing activities
- (D) Operating activities, investing activities, financing activities

MC94 If it is required to maintain fixed capitals then the partners' shares of profits must be

- (A) Debited to capital accounts
- (B) Credited to capital accounts
- (C) Debited to partners' current accounts
- (D) Credited to partners' current accounts

MC95 You are to buy an existing business which has assets valued at Buildings £50,000, Motor vehicles £15,000, Fixtures £5,000 and Inventory £40,000. You are to pay £140,000 for the business. This means that

- (A) You are paying £40,000 for Goodwill
- (B) Buildings are costing you £30,000 more than their value
- (C) You are paying £30,000 for Goodwill
- (D) You have made an arithmetical mistake

MC96 During the year a company revalued its freehold land from its original cost of £295,000 to its current market value of £1.1m. In the company's statement of cash flows, this revaluation will:

- (A) Be included within investing activities
- (B) Be included within financing activities
- (C) Be included within operating activities
- (D) Not appear

MC97 Any loss on revaluation is

- (A) Credited to old partners in old profit-sharing ratios
- (B) Credited to new partners in new profit-sharing ratios
- (C) Debited to old partners in old profit-sharing ratios
- (D) Debited to new partners in new profit-sharing ratios

MC98 In a limited company which of the following is shown in the statement of changes in equity?

- (i) Loan note interest
- (ii) Dividends paid
- (iii) Transfers to reserves
- (iv) Directors' remuneration

- (A) (i) and (ii)
- (B) (ii) and (iii)
- (C) (i) and (iv)
- (D) (ii) and (iv)

MC99 The Issued Capital of a company is

- (A) Always the same as the Authorised Capital
- (B) The same as Preference Share Capital
- (C) Equal to the reserves of the company
- (D) None of the above

MC100 A company wishes to pay out all available profits as dividends. Net profit is £26,600. There are 20,000 8% Preference shares of £1 each, and 50,000 Ordinary shares of £1 each. £5,000 is to be transferred to General Reserve. What Ordinary dividends are to be paid, in percentage terms?

- (A) 20 per cent
- (B) 40 per cent
- (C) 10 per cent
- (D) 60 per cent

Answers to review questions

Note: All the answers are the work of the author. None has been supplied by an examining body. The examining bodies accept no responsibility whatsoever for the accuracy or method of working in the answers given.

Note: In order to save space, in most cases brackets have not been entered to indicate negative numbers. Also, £ signs have been omitted from columns of figures, except where the figures refer to £000, or where the denomination needs to be specified.

1.1	(a) 20,000 (e) 54,200	(b) 35,200 (f) 50,700	(c) 34,200	(d) 43,100
1.3	(a) Asset (e) Asset	(b) Asset (f) Liability	(c) Asset	(d) Liability
1.5	Wrong Assets: Loan from K. Jones; Bank overdraft; Wrong Liabilities: Delivery van; Computer equipment; Machinery; Cash in hand.			
1.7	Assets: Van 9,995; Market stall 2,050; Computer 495; Inventory 11,720; Bank 920; Cash 100 = total 25,280 Liabilities: Loan 5,000; Trade payables 2,380 = total 7,380 Capital: 25,280 – 7,380 = 17,900.			

1.9 Tom Galley
Balance Sheet as at 31 December 2024

<i>Non-current assets</i>	
Equipment	14,160
Motor vehicle	11,610
<i>Current assets</i>	25,770
Inventory	12,340
Trade receivables	9,290
Cash at bank	480
	<u>22,110</u>
	47,880
<i>Current liabilities</i>	(10,230)
Trade payables	<u>37,650</u>
Capital	<u>37,650</u>

1.11	<i>Assets</i>	<i>Liabilities</i>	<i>Capital</i>
	(a) – Bank	– Trade payables	
	(b) – Cash		
	+ Fixtures		
	(c) + Inventory	+ Trade payables	
	(d) + Cash		
	(e) + Cash	+ Loan from J. Walker	
	(f) + Cash		+ Capital
	– Trade receivables		
	(g) – Inventory	– Trade payables	
	(h) + Computer equipment		
	– Bank		
1.13	<i>Non-current assets</i>	Ross	
	Fixtures	Balance Sheet as at 7 May 2024	
	Motor vehicle		12,390
	Computer		7,500
	<i>Current assets</i>		<u>720</u>
	Inventory		4,700
	Trade receivables		6,000
	Bank		550
	Cash		<u>200</u>
			11,450
			<u>32,060</u>
	<i>Current liabilities</i>		(6,000)
	Trade payables		<u>26,060</u>
	Capital		<u>26,060</u>

2.1

1	Cash	Debit Cash	account	Credit Capital	account
2	Cash in US dollars	Debit Cash US\$	account	Credit Capital	account
3	Cash in the bank	Debit Bank	account	Credit Capital	account
4	Cash in the bank in euros	Debit Bank €	account	Credit Capital	account
5	Computer	Debit Computer	account	Credit Capital	account
6	Mobile phone	Debit Mobile phone	account	Credit Capital	account
7	Office furniture	Debit Office furniture	account	Credit Capital	account
8	Printer	Debit Printer	account	Credit Capital	account
9	Delivery van	Debit Delivery van	account	Credit Capital	account
10	Goods for sale	Debit Goods for sale	account	Credit Capital	account
11	Amount due from J. Gidman	Debit J. Gidman	account	Credit Capital	account
12	Amount due from K. Bailey	Debit K. Bailey	account	Credit Capital	account
13	Loan from bank	Debit Capital	account	Credit Loan from bank	account

2.2

	Cash account	Cash in US dollars account
	400	280
	Cash in the bank account	Cash in the bank in euros account
	900	350
	Computer account	Mobile phone account
	710	590
	Office furniture account	Printer account
	840	160
	Delivery van account	Goods for sale account
	2,950	12,300
	Amount due from J. Gidman account	Amount due from K. Bailey account
	560	230

	Loan from bank account	Capital account
	6,000	6,000
		400
		280
		900
		350
		710
		590
		840
		160
		2,950
		12,300
		560
		230

2.3 The *Item exchanged* and the *Form of settlement*.

2.4 The debt owed to the business by the customer.

2.5 The debt you owe the supplier.

2.6 The loan from the bank [i.e. the debt you owe the bank].

2.7 Cash, cash, cash at bank.

2.8 (1) A Form of settlement given is a credit.

(2) A Form of settlement received is a debit.

(3) The entry for the Item exchanged is the opposite to the entry for the Form of settlement.

2.9

Debit Cash account	Credit Customer receivable account
Debit Supplier payable account	Credit Cash account
Debit Bank account	Credit Loan from bank account

2.10

	Debited	Credited	Debited	Credited
(a) Computers	Timeless	(b) B. Burt	Capital	
(c) Bank	T. Robb	(d) Loan: I. Simms	Cash	
(e) Timeless	Computers	(f) Bank	P. Bell	
(g) Van	Tangle Motors			

3.3

[illegible]

(17)

3.1			
<i>Debited</i>	<i>Credited</i>	<i>Debited</i>	<i>Credited</i>
(1) Cash	Sales	(2) Vehicles	F. Smith
(3) Cash	Computer	(4) J. Lilly	Sales
(5) M. Peel	Returns outwards	(6) Purchases	F. Day
(7) Bank	Sales	(8) W. Brown	Returns outwards
(9) Returns inwards	I. Gray	(10) Purchases	T. Gow

4.1

Bank		Capital	
(1) Capital	31,000	(1) Bank	31,000
(21) Rent received	480	(1) Cash	4,000
Cash		A. Cliff	
(1) Capital	4,000	(18) Returns out	164
(5) Sales	600	(2) Purchases	1,160
		S. Bell	
		(6) Purchases	1,300
Purchases		R. Coat	
(2) A. Cliff	1,160	(23) Sales	3,200
(6) S. Bell	1,300	Rent received	
Sales		(21) Bank	480
(5) Cash	600	Stationery	
(23) R. Coat	3,200	(12) Cash	180
Fixtures		Returns out	
(3) Bank	4,600	(18) A. Cliff	164
(10) Cash	800	Van	
		(24) Bank	16,400
		Wages	
		(30) Cash	1,220
		Drawings	
		(31) Cash	1,020

4.2

Cash		Capital	
(1) Capital	30,000	(3) Rent	1,740
(11) Sales	624	(4) Bank	25,000
		(20) B repairs	156
		(28) Purchases	940
		(30) Motor exps	432
Bank		Motor expenses	
(4) Cash	25,000	(7) Stationery	170
		(27) T. Lamb	620
		(29) Van	7,000
Purchases		(29) Bank	700
(2) T. Lamb	700	(14) Returns out	80
(28) Cash	940	(27) Bank	620
		R. Still	
		(5) Sales	384
		(11) Cash	624
		(17) R. Davis	424
		Stationery	
(7) Bank	170	(22) R. Still	62
		Returns outwards	
		(14) T. Lamb	80
		Computer	
(31) S. Tims	1,460	(31) Computer	1,460

4.5

- (A) Bought motor vehicle £5,000, paying by cheque or bank transfer.
 (B) Paid off £4,000 creditors in cash.
 (C) Lee lent us £150,000, this being paid into the bank.
 (D) Bought land and buildings £125,000, paying by cheque or bank transfer.
 (E) Debtors paid £80,000, being paid into bank.
 (F) Land and buildings worth £300,000 were sold for £300,000, the proceeds being paid into the bank.
 (G) Loan from Lee repaid out of the bank.
 (H) Creditors £8,000 paid in cash.
 (I) Inventory costing £17,000 sold for £12,000 on credit. Loss of £5,000 shown deducted from Capital.

5.1

B. Flynn		F. Lane	
(1) Sales	810	(10) Returns	124
(4) Sales	134	(24) Cash	440
		(31) Balance c/d	380
	<u>944</u>		<u>944</u>
(1) Balance b/d	380		<u>413</u>
		E. Start	
(4) Sales	480	(31) Balance c/d	720
(31) Sales	240		<u>720</u>
	<u>720</u>		<u>720</u>
(1) Balance b/d	720		

5.2

J. Wilson		P. Todd	
(10) Returns	65	(1) Purchases	39
(28) Cash	300	(15) Purchases	210
(30) Balance c/d	85	(30) Balance c/d	860
	<u>450</u>		<u>860</u>
		(1) Balance b/d	85
		J. Fry	
(10) Returns	140	(19) Cash	290
(30) Balance c/d	1,480		<u>290</u>
	<u>1,620</u>		<u>1,620</u>
		(1) Balance b/d	1,480

5.3	May	1 4 10 24	Sales Sales Returns Cash	Cr 124 440	Balance 810 944 820 380	Dr Dr Dr Dr	<i>B. Flynn</i>		<i>J. Bee</i>		<i>D. Blue</i>	
	May	1 18	Sales Bank	Cr 1,100	Balance 1,100 0	Dr Dr	<i>F. Lane</i>		<i>T. Day</i>		<i>P. Lee</i>	
	May	1 10 20	Sales Returns Bank	Cr 62 351	Balance 413 351 0	Dr Dr Dr	<i>T. Fry</i>		<i>J. Soul</i>		<i>R. James</i>	
	May	4 31	Sales Sales	Cr Cr	Balance 480 720	Dr Dr Dr	<i>F. Start</i>		<i>L. Hope</i>		<i>J. James</i>	
5.4	Jun	1 10 15 28	Purchases Returns Purchases Cash	Cr 240 210 Cr	Balance 240 175 385 85	Cr Cr Cr Cr	<i>J. Wilson</i>		<i>Capital</i>		<i>Sales</i>	
	Jun	1 3 30	Purchases Purchases Returns	Cr 390 470 Cr	Balance 390 860 821	Cr Cr Cr	<i>P. Todd</i>		<i>Loan – HBSC</i>		<i>J. Vaughan</i>	
	Jun	1 10	Purchases Returns	Cr 1,620 Cr	Balance 1,620 1,480	Cr Cr	<i>J. Fry</i>		<i>Machinery</i>		<i>Returns inwards</i>	
	Jun	3 19	Purchases Cash	Cr 290 Cr	Balance 290 0	Cr Cr	<i>P. Rake</i>		<i>Purchases</i>		<i>21.5 J. Vaughan</i>	

J. Bee, T. Day and J. Soul are debtors.
F. Rise, P. Lee and R. James are creditors.

6.1

6.1 (Cont'd)

[illegible]

Trial balance as at 31 May

Capital		800
Loan – HBSC		2,000
Bank	20	
Machinery	2,500	
Advertising	75	
Purchases	900	
M. Ball		400
Sales		1,400
N. Chadwick	300	
J. Vaughan	490	
Drawings	110	
Returns inwards	60	
Electricity	145	
		<u>4,600</u>

b) Trial balance as at 31 August

Cash	£	355	£
Capital			3,850
Bank	840		
D. Bellini			164
Purchases	639		
Machinery	2,500		
Sales		923	
J. Adams	595		
Computer equipment	1,450		
Loan: G. Plover			2,000
Returns outwards			70
Drawings	98		
Wages	530		
			<u><u>7,007</u></u>

M. Donnelly

	Debit	Credit
	£	£
Capital		3,500
Bank	910	
Cash	720	
Purchases	730	
Machinery	1,450	
Insurance	120	
M Wilkinson		205
E Grant	620	
Sales		1,325
Returns outwards		50
E Williams	325	
Wages	45	
Returns inwards	80	
Drawings	80	
	<u>5,080</u>	<u>5,080</u>

Capital		Cash at bank	
31/10 Balance c/d	825	1/10 Capital	825
825	<u>825</u>	3/10 Loan – HCBS	1,500
1/11 Balance b/d	825	7/10 IT equipment	1,450
		9/10 Purchases	810
		31/10 P. Bracewell	600
		13/10 Phone	55
		15/10 Rent	340
		25/10 Drawings	425
		27/10 G. Sharp	500
		29/10 Wages	180
		31/10 Balance c/d	50
			<u>4,025</u>
		1/11 Balance b/d	50
			<u>4,025</u>
Van hire		IT equipment	
5/10 Bank	215	7/10 Bank	1,450
11/10 G. Sharp	215		<u>1,450</u>
21/10 R. Kenyon	215	1/11 Balance b/d	1,450
	<u>215</u>		
1/11 Balance b/d			
Purchases		G. Sharp (payable)	
9/10 Bank	810	19/10 Returns out	230
11/10 G. Sharp	730	27/10 Bank	500
21/10 R. Kenyon	640		
	<u>2,180</u>		
1/11 Balance b/d	2,180		
	<u>2,180</u>		
			<u>730</u>
			<u>730</u>

6.6 (Cont'd)

Phone & broadband				Rent			
13/10 Bank	55	31/10 Balance c/d	55	15/10 Bank	340	31/10 Balance c/d	340
1/11 Balance b/d	55		55	1/11 Balance b/d	340		340
Sales				Returns outwards			
31/10 Balance c/d	2,900	17/10 Bank	1,100	31/10 Balance c/d	230	19/10 G Sharp	230
	2,900	23/10 P. Bracewell	1,800		230		230
1/11 Balance b/d	2,900	1/11 Balance b/d	2,900			1/11 Balance b/d	230
R. Kenyon (payable)				P. Bracewell (receivable)			
23/10 Purchases	640	23/10 Sales	1,800	31/10 Bank	600		
31/10 Balance c/d	640	1/11 Balance b/d	640	31/10 Balance c/d	1,200		
					1,800		
					1,200		
Drawings				Wages			
25/10 Bank	425	31/10 Balance c/d	425	29/10 Bank	180	31/10 Balance c/d	180
1/11 Balance b/d	425		425	1/11 Balance b/d	180		180

Trial balance as at 31 October

	Debit	Credit
Capital	£	£
Cash at bank		825
Loan – HCBS	50	
Van hire	215	1,500
IT equipment	1,450	
Purchases	2,180	
Phone & broadband	55	
Rent	340	
Sales		2,900
Returns outwards		230
R. Kenyon (payable)		640
P. Bracewell (receivable)	1,200	
Drawings	425	
Wages	180	
	<u>6,095</u>	<u>6,095</u>

7.1

I. Lamb

Income Statement for the year ended 31 October 2023

Sales	100,250
Less Cost of goods sold:	
Purchases	60,400
Less Closing inventory	15,600
Gross profit	44,800
Less Expenses:	55,450
Salaries	29,300
Motor expenses	1,200
Rent	950
Insurance	150
General expenses	85
Net profit	<u>31,685</u>
	<u>23,765</u>

7.2

G. Foot

Income Statement for the year ended 30 June 2024

Sales	266,000
Less Cost of goods sold:	
Purchases	154,000
Less Closing inventory	18,000
Gross profit	136,000
Less Expenses:	130,000
Salaries and wages	52,000
Rent	3,800
Lighting and heating	700
Insurance	3,000
Motor expenses	4,600
Sundry expenses	300
Net profit	<u>64,400</u>
	<u>65,600</u>

Trial Balance at 30 September

[illegible]

8.1 I. Lamb
Balance Sheet as at 31 October 2023

<i>Non-current assets</i>	
Premises	47,800
Motor vehicles	8,600
	<u>56,400</u>
<i>Current assets</i>	
Inventory	15,600
Trade receivables	13,400
Bank	8,200
Cash	300
	<u>37,500</u>
	93,900
<i>Current liabilities</i>	
Trade payables	8,800
	<u>85,100</u>
<i>Capital</i>	
Opening balance	65,535
Add Net profit	23,765
	<u>89,300</u>
<i>Less Drawings</i>	<u>4,200</u>
	<u>85,100</u>

8.5 T. Smith
Balance Sheet as at 31 July 2024

<i>Non-current assets</i>	
Premises	160,000
<i>Current assets</i>	
Inventory	50,000
Trade receivables	4,000
Cash and bank	8,300
	<u>62,300</u>
	222,300
<i>Current liabilities</i>	
Trade payables	14,000
<i>Non-current liability</i>	
Mortgage loan	120,000
	<u>(134,000)</u>
	88,300
<i>Capital</i>	
Opening balance	60,000
Capital introduced	8,000
Net profit	45,300
	<u>113,300</u>
<i>Less Drawings</i>	<u>25,000</u>
	<u>88,300</u>

8.2 G. Foot
Balance Sheet as at 30 June 2024

<i>Non-current assets</i>	
Buildings	84,800
Fixtures	2,000
Vans	16,000
	<u>102,800</u>
<i>Current assets</i>	
Inventory	18,000
Trade receivables	31,200
Bank	15,000
	<u>64,200</u>
	167,000
<i>Less Current liabilities</i>	
Trade payables	16,000
	<u>151,000</u>
<i>Capital</i>	
Opening balance	114,000
Add Net profit	65,600
	<u>179,600</u>
<i>Less Drawings</i>	<u>28,600</u>
	<u>151,000</u>

8.7 Royston
Balance Sheet as at 30 September

<i>Non-current assets</i>	
IT equipment	2,200
<i>Current assets</i>	
Inventory	570
Trade receivables	1,180
Bank	850
	<u>2,600</u>
	4,800
<i>Current liabilities</i>	
Trade payables	(890)
<i>Non-current liabilities</i>	
Loan	(3,000)
Net assets	<u>910</u>
Opening capital	750
Add Profit for the month	440
Less Drawings for the month	<u>(280)</u>
Closing capital	<u>910</u>

Balance Sheet as at 30 September 2024

Balance Sheet as at 30 September 2024

Non-current assets

Premises

Capital

Opening balance

Capital

9.4 F. Sorley

Income Statement for the year ending 30 April 2020

Income Statement for the year ending 30 April 2020Income Statement for the year ending 30 April 2020

9.4 (Cont'd)

Balance Sheet as at 30 April 2020

<i>Non-current assets</i>		
Fixtures and fittings	912	
Motor vehicles	14,400	15,312
<i>Current assets</i>		
Inventory	11,290	
Trade receivables	23,200	
Bank	4,100	
Cash	240	
		<u>38,830</u>
		<u>54,142</u>
<i>Less Current liabilities</i>		
Trade payables	14,100	
	<u>40,042</u>	
<i>Capital</i>		
Opening balance	18,827	
Add Net profit	50,655	
	<u>69,482</u>	
<i>Less Drawings</i>	29,440	
	<u>40,042</u>	

9.7 (a)

	Cash			Sales		
1.8 Capital	1,000	2.8 Bank	900	10.8 D. Moore	98	
19.8 Sales	28	7.8 Purchs	55	31.8 Bal c/d	126	28
	<u>1,028</u>	31.8 Bal c/d	73		126	126
1.9 Bal b/d	73			Fixtures & fittings	1.9 Bal b/d	126
				22.8 Kingston	150	31.8 Bal c/d
					150	150
				1.9 Bal b/d	150	
				Kingston Equip Co		
				31.8 Bank	150	22.8 F&C
					150	150
				Drawings		
				11.8 Purchases	22	31.8 Bal c/d
					22	22
				1.9 Bal b/d	22	
				Capital		
				31.8 Bal c/d	1,000	1.8 Cash
					1,000	1,000
						1.9 Bal b/d
						1,000
				Purchases		
				4.8 S. Holmes	78	11.8 Drawings
						22
				7.8 Cash	55	31.8 Bal c/d
					133	111
				1.9 Bal b/d	111	

Loan a/c: D. Watson

31.8 Bal c/d	100	24.8 Bank	100
	<u>100</u>		100
1.9 Bal b/d			<u>100</u>

Returns outwards

31.8 Bal c/d	18	12.8 S. Holmes	18
	<u>18</u>		18
1.9 Bal b/d			<u>18</u>

Wages

30.8 Bank	30	31.8 Bal c/d	30
	<u>30</u>		30
1.9 Bal b/d			<u>30</u>

(b)
Trial balance as at 31 August:
 Cash
 Capital
 Bank
 S. Holmes
 Purchases
 Motor vehicles
 Sales
 D. Moore
 Fixtures & fittings
 Loan a/c: D. Watson
 Returns outwards
 Drawings
 Wages

Debit	Credit
73	
296	1,000
111	36
500	
	126
98	
150	
	100
22	18
30	
<u>1,280</u>	<u>1,280</u>

A. Joel

Income Statement for the month ended 31 August

Sales		
Less Cost of goods sold:		
Opening inventory	—	
Add Purchases	111	
less Returns outwards	(18)	
less Closing inventory	(28)	
Gross profit		(65)
Less Expenses:		
Wages	61	
Net profit		(30)
		<u>31</u>

Answers to review questions

9.7 (Cont'd)

(d)

A. Joel Balance Sheet as at 31 August

<i>Non-current assets</i>		
Fixtures	150	
Vehicles	<u>500</u>	
	650	
<i>Current assets</i>		
Inventory	28	
Trade receivables	98	
Bank	<u>296</u>	
Cash	73	
Total assets		
<i>Current liabilities</i>		
Trade payables	495	
<i>Non-current liabilities: Loan</i>	<u>1,145</u>	
Net assets		
	(36)	
	<u>(100)</u>	
Opening capital	<u>1,009</u>	
Add Net profit for the month	1,000	
Less Drawings	31	
Closing capital	<u>(22)</u>	
	<u>1,009</u>	

9.9 Tangle

Income Statement for the year ending 30 April 2024

Sales	71,600	
Less Cost of sales		
Purchases	29,050	
Less Closing inventory	<u>8,000</u>	
Gross profit	14,650	
Less Expenses		
Salaries	1,860	
Motor expenses	2,500	
Rent and business rates	1,500	
Insurance – Buildings	<u>2,400</u>	
– Vehicles		
Net profit	22,910	
	<u>27,640</u>	

Appendix 1

Balance Sheet as at 30 April 2024

<i>Non-current assets</i>		
Motor vehicles		20,000
Fixtures		<u>35,000</u>
		55,000
<i>Current assets</i>		
Inventory	8,000	
Trade receivables	23,450	
Cash	<u>1,000</u>	
		32,450
		<u>87,450</u>
<i>Less Current liabilities</i>		
Trade payables	19,500	
Bank	<u>2,500</u>	
		22,000
<i>Non-current liabilities:</i>		
Loan	<u>30,000</u>	
		(52,000)
		<u>35,450</u>
<i>Capital</i>		
Opening balance	31,810	
Net profit	<u>27,640</u>	
		59,450
Less Drawings	<u>24,000</u>	
		35,450

10.1 (i) Historical cost; (ii) Business entity; (iii) Accrual basis; (iv) Money measurement; (v) Consistency.

10.4

(a) See text.

(b) The historical cost convention does not make the going concern convention unnecessary. Several instances illustrate this:

- (i) Non-current assets are depreciated over the useful economic life of the assets. This presupposes that the business will continue to operate during the years of the assumed useful economic life of the assets.
- (ii) Prepayments also assume that the benefits available in the future will be able to be claimed, because the business is expected to continue.
- (iii) Inventory is also valued on the basis that it will be disposed of during the future ordinary running of the business.

All of this shows that the two complement each other. The examples indicate that financial statements prepared using the historical cost convention still require the going concern assumption too. There is no conflict between the two conventions.

(c) Shareholders want financial statements so that they can decide what to do with their shareholdings, whether they should sell their shares or hold on to them.

If they had a choice, it would be to receive a report on the future provided that it could be relied upon. The obvious problem with future estimates is that the future is unpredictable, so all forecasts will be inherently subjective and thus could not be relied upon.

Cash book

12.3

(31) Total for month

Bank

K. Hoskin

G. CarnegieG. Volmers

Real Fine Ales

Bad debts expense

13.1

(a)–(c)
Receipts

Petty Cash Book (June 2020)				
Receipts	Petty Cash Book		Receipts	
	Total	Cleaning Motor Expenses	Postage Stationery Travelling	
300	(1) Cash 18			
	(2) Postage 12		18	
	(3) Travelling 15			12
	(4) Cleaning 22	15		
	(7) Petrol 25	22		
	(8) Travelling 17			25
	(9) Stationery 18		17	
	(11) Cleaning 5			
	(14) Postage 8		5	
	(15) Travelling 9			8
	(18) Stationery 23			
	(20) Cleaning 13	23		
	(23) Postage 43		13	
	(24) Motor service 18			
	(26) Petrol 21	18		
	(27) Cleaning 5	21		
	(29) Postage 14		5	
	(30) Petrol 286	77	41	45
	(31) Cash 300			
	(31) Balance c/d 586			
		586		

(d) See text.

13.2

(a)

Petty Cash Book (June 2020)

Receipts	Petty Cash Book (June 2020)		
	Total	Travel Postage stationery	Cleaning Refreshments
32.17	(1) Balance b/d		
117.83	(2) Cash		
	(5) Postage stamps 17.57	17.57	
	(9) Coffee and biscuits 11.48		11.48
	(13) Taxi fares 18.00	18.00	

(b) Briefly: to keep detail out of the cash book, to reduce the number of postings to expense accounts, and to enable the task of handling petty cash to be delegated to someone other than the main cashier. See text for more details.

(c) Notes and coins held on the premises will be extremely tempting to employees who may be inclined towards theft and fraud. If petty cash is not carefully monitored and controlled there will be a high risk of money being stolen; repeated thefts (even of small amounts) could amount to significant losses for the business.

(d) Advantages include:

- (i) At any point in time, it is possible to check whether the amount of petty cash held plus the vouchers is equal to the imprest. If this is checked daily, for example, then if any cash is unaccounted for it will be detected immediately.
- (ii) Total petty cash expenditure can be 'capped' because the petty cashier cannot disburse more than the float amount during any given period.
- (iii) It helps ensure that the petty cash book will be kept up to date because the float amount should not be reimbursed until the vouchers for the period have been analysed and the petty cash book has been written-up.
- (iv) The imprest system normally accommodates further controls such as specifying a maximum amount for any individual cash payment; ensuring that all vouchers are signed by a responsible person to authorise each payment; and (after the cash has been spent) attaching the receipt/bill for the payment to support each item of expenditure.

Receipts	Date	Details	Total	Travel	Stationery	Postage	Miscellaneous	Repairs/ Replacement
24.37	May 1	Balance b/d						
115.63		1 Cash						
		1 Bus fares	0.41	0.41				
		2 Stationery	2.35		2.35			
		4 Bus fares	0.30	0.30				
		7 Postage	6.50			6.50		
		7 Trade journal	0.95				0.95	
		8 Bus fares	0.64	0.64				
		11 Highlighter pens	1.29		1.29			
		12 Lightbulbs	5.42					5.42
		14 Parcel	3.45			3.45		
		15 Paper-clips	0.42		0.42			
		15 Newspaper	2.00				2.00	
		16 Photocopier repair	16.80					16.80
		19 Postage	1.50		1.50			
		20 Drawing pins	0.38		0.38			
		21 Train fare	5.40	5.40				
		22 Photo-paper	5.63		5.63			
		23 Display decorations	3.07				3.07	
		23 Pencil sharpener	1.14		1.14			
		25 Wrapping paper	0.78					
		27 String	0.61				0.78	
		27 Sellotape	0.75		0.75		0.61	
		27 Pens	0.46		0.46			
		28 Replacement part for printer	13.66					13.66
		31 Bus fares	2.09	2.09				
			76.00	8.84	12.42	11.45	7.41	35.88
	31	Balance c/d	64.00					
			140.00					
	June 1	Balance b/d						
76.00		1 Cash						

14.1

(1) P. Ryan	700	
(3) T. Lee	320	(1) Sales
(6) B. Cox	50	(10) Sales
(10) P. Ryan	220	
(17) J. Lock	960	(3) Sales
(19) M. Gore	220	
(27) C. Chen	95	(6) Sales
(31) G. West	<u>365</u>	(17) Sales
	<u><u>2,930</u></u>	
General Ledger		
<i>Sales Account</i>		
(31) Total for month	2,930	(27) Sales
		(31) Sales

14.3

Workings of invoices:

(1) F. Gray	3 rolls white tape $\times 10 =$	30
	5 sheets blue cotton $\times 6 =$	30
	1 dress length $\times 20 =$	<u>20</u>
	<i>Less</i> trade discount 25%	
	6 rolls white tape $\times 10 =$	60
	30 metres green felt $\times 4 =$	<u>120</u>
	<i>Less</i> trade discount $33\frac{1}{3}\%$	
(8) E. Hines	1 dress length black silk $\times 20 =$	20
(20) M. Allen	10 rolls white tape $\times 10 =$	100
	6 sheets blue cotton $\times 6 =$	36
	3 dress lengths black silk $\times 20 =$	60
	11 metres green felt $\times 4 =$	<u>44</u>
	<i>Less</i> trade discount 25%	
(31) B. Cooper	12 rolls white tape $\times 10 =$	120
	14 sheets blue cotton $\times 6 =$	84
	9 metres green felt $\times 4 =$	<u>36</u>
	<i>Less</i> trade discount $33\frac{1}{3}\%$	
		240
		<u>80</u>
		180

Sales Ledger

<i>P. Ryan</i>	700
	220
<i>T. Lee</i>	320
<i>B. Cox</i>	50
<i>J. Lock</i>	960
<i>M. Gore</i>	220
<i>C. Chen</i>	95
<i>G. West</i>	365

14.3 (Cont'd)

Sales Day Book		Sales Ledger
(1) F. Gray	60	F. Gray
(4) A. Gray	120	60
(8) E. Hines	20	A. Gray
(20) M. Allen	180	120
(31) B. Cooper	160	E. Hines
	<u>540</u>	20
General Ledger		M. Allen
<i>Sales Account</i>		180
(31) Total for month	540	B. Cooper
		160

14.5

Workings of purchases invoices

(1) A. Bell	4 smart speakers \times 30 =	120
	3 tablets \times 180 =	<u>540</u>
	Less trade discount 25%	660
		<u>165</u>
(3) C. Gray	2 washing machines \times 310 =	620
	5 vacuum cleaners \times 60 =	300
	2 dishwashers \times 190 =	<u>380</u>
	Less trade discount 20%	1,300
		<u>260</u>
(15) C. Donald	1 laptop \times 400 =	400
	2 washing machines \times 310 =	<u>620</u>
	Less trade discount 25%	1,020
	6 external 1TB drives \times 45	<u>255</u>
	Less trade discount $33\frac{1}{3}\%$	270
(20) F. Perry	4 dishwashers \times 215	<u>90</u>
	Less trade discount 20%	860
(30) S. Turner		<u>172</u>
		688

Purchases Day Book

(1) A. Bell	495	Purchases Ledger
(3) C. Gray	1,040	
(15) C. Donald	765	
(20) F. Perry	180	
(30) S. Turner	<u>688</u>	
	<u>3,168</u>	
General Ledger		
<i>Purchases Account</i>		
(31) Total for month	3,168	

14.7 Purchases Day Book

(1) Smith Stores	90
(23) C. Kelly	105
(31) J. Hamilton	180
	<u>375</u>

Purchases Ledger

<i>Smith Stores</i>	
(1) Purchases	90
C. Kelly	(8) Sales
(23) Purchases	105
J. Hamilton	(15) Sales
(31) Purchases	180
General Ledger	(24) Sales
<i>Sales Account</i>	
(31) Total for month	393

Purchases Account

(31) Total for Month	375
----------------------	-----

14.9 Purchases Day Book

(1) S. Dodd	216
(4) B. Line	324
(4) F. Town	322
(4) R. Pace	64
(4) T. Pang	130
(10) F. Town	90
(18) D. Ince	230
(18) P. Tago	310
(18) R. Scott	405
(18) N. Auld	220
(31) R. Pace	174
(31) J. Marsh	<u>170</u>
	<u>2,655</u>

Purchases Ledger

(1) Returns	58
(7) Returns	63
(7) Returns	64
(25) Returns	47
(10) Purchases	90
(18) Purchases	310
(4) Purchases	405
(31) Purchases	174
(4) Purchases	130
(18) Purchases	230

Returns Outwards Day Book

(7) S. Dodd	58
(7) B. Line	63
(25) P. Tago	140
(25) F. Town	47
	<u>308</u>
General Ledger	
(31) Total for month	2,655

14.11 Sales Day Book

(1) T. Thompson	56	(3) P. Potter	144
(1) L. Rodriguez	148	(3) H. Harris	25
(1) K. Barton	145	(3) B. Spencer	76
(7) K. Kelly	89	(9) B. Perkins	24
(7) N. Mendes	78	(9) H. Harris	58
(7) N. Lee	257	(9) H. Miles	123
(24) K. Mohammed	57	(17) H. Harris	54
(24) K. Kelly	65	(17) B. Perkins	65
(24) O. Green	112	(17) L. Nixon	75
(31) N. Lee	55		
	<u>1,062</u>		<u>644</u>

Purchases Day Book

(14) T. Thompson	5	(11) P. Potter	12
(14) K. Barton	11	(11) B. Spencer	22
(14) K. Kelly	14	(20) B. Spencer	14
(28) N. Mendes	24		<u>48</u>
	<u>54</u>		

Returns Inwards Day Book

(14) T. Thompson	5	(11) P. Potter	12
(14) K. Barton	11	(11) B. Spencer	22
(14) K. Kelly	14	(20) B. Spencer	14
(28) N. Mendes	24		<u>48</u>
	<u>54</u>		

Returns Outwards Day Book

(14) T. Thompson	5	(11) P. Potter	12
(14) K. Barton	11	(11) B. Spencer	22
(14) K. Kelly	14	(20) B. Spencer	14
(28) N. Mendes	24		<u>48</u>
	<u>54</u>		

Sales Ledger

<i>T. Thompson</i>		<i>P. Potter</i>	
(1) Sales	56	(14) Returns	12
	(14) Returns	<i>H. Harris</i>	(3) Purchases
(1) Sales	148		(3) Purchases
	(14) Returns	<i>K. Barton</i>	(9) Purchases
(1) Sales	145		(17) Purchases
	(14) Returns	<i>K. Kelly</i>	<i>B. Spencer</i>
(7) Sales	89	(14) Returns	22
(24) Sales	65	(20) Returns	14
	(14) Returns	<i>N. Mendes</i>	(9) Purchases
(7) Sales	78	(28) Returns	24
	(28) Returns	<i>N. Lee</i>	(17) Purchases
(7) Sales	257		<i>H. Miles</i>
(31) Sales	55		(9) Purchases
	(14) Returns	<i>K. Mohammed</i>	<i>L. Nixon</i>
(24) Sales	57		(17) Purchases
	(28) Returns	<i>O. Green</i>	
(24) Sales	112		

General Ledger

<i>Purchases</i>		<i>Sales</i>	
(31) Total for month	644	(31) Total for month	1,062
		<i>Returns Outwards</i>	
(31) Total for month	54	(31) Total for month	48

15.1

(a) Motorbike	Dr	5,500	:	Lakeside Garage	Cr	5,500
(b) Bad debts	Dr	347	:	T. Reason	Cr	347
(c) UL Furniture Ltd	Dr	600	:	Office chairs	Cr	600
(d) (i) Bank	Dr	190	:	J. Day	Cr	190
(d) (ii) Bad debts	Dr	110	:	J. Day	Cr	110
(e) Drawings	Dr	60	:	Purchases	Cr	60
(f) Drawings	Dr	40	:	Insurance	Cr	40
(g) Trailer	Dr	1,700	:	C-Land Ltd	Cr	1,700

15.3 The Journal

(1) Premises	34,000						Purchases Day Book
Van	5,125						(2) S. Hood
Fixtures	810						(2) D. Main
Inventory	6,390						(2) W. Tone
Trade receivables:							(2) R. Foot
P. Mullen	140						(22) L. Mole
F. Lane	310						(22) W. Wright
Bank	6,240						
Cash	560						<u>887</u>

Sales Day Book

Trade payables:									
S. Hood	215								
J. Brown	640								
Capital	52,720								
	<u>53,575</u>								
(14) Van	4,850								
Abel Motors	4,850								
	<u>131</u>								
	<u>1,106</u>								

Returns Inwards Day Book

(11) J. Wilson	32								
(11) F. Syme	48								
	<u>80</u>								

Returns Outwards Day Book

(19) R. Foot	6								
	<u>6</u>								

edger
al
(1) Bal b/d 52,720
ge

[illegible]

16.1

(a) Style of invoice will vary.

Calculations:

5 sets of golf clubs \times £1,250

500 golf balls at £25 per 10 balls

5 golf bags at £370 per bag

Less trade discount 30%

Add VAT 20%

£
6,250
1,250
1,850
9,350
(2,805)
6,545
1,309
<u>7,854</u>

(b)

Sales ledger of A. Cook B. Pitt

2024	£
March 1 Sales	7,854

Purchases ledger of B. Pitt A. Cook

2024	£
March 1 Purchases	7,854

16.3

Sales Day Book

2024	Net	VAT
March 2 G. Bush	430	86
6 A. Gray	290	58
14 L. Rowe	560	112
31 S. Pegg	320	64
	<u>1,600</u>	<u>320</u>

Sales Ledger

(1) Sales	G. Bush	516
(8) Sales	A. Gray	348
(19) Sales	L. Rowe	672
(31) Sales	S. Pegg	384

General Ledger

Sales	(31) Credit sales for the month	1,600
Output VAT	(31) Sales Day Book: VAT content	320

16.4

Sales Day Book

(1) J. Royce	Net	VAT
(4) D. Player and Co	290	58
(16) D. Player and Co	440	88
(31) N. Foster	170	34
	110	22
	<u>1,010</u>	<u>202</u>

Purchases Day Book

(10) B. Hunter	Net	VAT
(10) R. Dixon Ltd	360	72
(14) G. Melly	230	46
(23) G. Gooch	80	16
	120	24
	<u>790</u>	<u>158</u>

Sales Ledger

(1) Sales	J. Royce	348
(4) Sales	D. Player and Co	528
(16) Sales		204
(31) Sales	N. Foster	132

Purchases Ledger

(10) Purchases	B. Hunter	432
(10) Purchases	R. Dixon Ltd	276
(14) Purchases	G. Melly	96
(23) Purchases	G. Gooch	144

General Ledger

(31) Credit purchases for month	Sales	(31) Credit sales for month	1,010
	Purchases		
	790		
Output VAT	(31) VAT in Sales		202
	Day Book		
Input VAT			
(31) VAT in Purchases			158
	Day Book		

Answers to review questions

Debit Bank

16.6

Amount to be paid by the business to HMRC

$\pounds 12 \times 5/6 = \pounds 10.00$ is net price excluding VAT at 20%.
Therefore $\pounds 10.00 \times 1.15 = \pounds 11.50$ is the new price.

(a) Sales Day Book

(b)

Maltby plc

18.2 Trading Account for the year ending 31 December

Sales			
Less Cost of sales			
Purchases	21,600	21,600	21,600
Less Closing inventory	<u>8,960</u>	<u>8,400</u>	<u>8,641</u>
	(12,640)	(13,200)	(12,959)
Gross profit	<u>4,160</u>	<u>3,600</u>	<u>3,841</u>
			AVCO
			16,800
			16,800

17.1 See Section 17.1.

17.3 See Section 17.7.

17.5 See Section 17.5.

17.6 See Section 17.7.

(i) FIFO Closing Inventory $280 \times £32 = £8,960$

$$\left(\begin{array}{c} II \\ \vdots \\ I \end{array} \right)$$
$$(iii)$$

AVCO	Received	Issued	Average cost per unit inventory held	No. of units in inventory	Total value of inventory
Mar	$400 \times \pounds 30$		$\pounds 30$	400	$\pounds 12,000$
Sept	$300 \times \pounds 32$		$\pounds 30.86$	700	$\pounds 21,600$
Dec		420	$\pounds 30.86$	280	$\pounds 8,641^*$

*rounded to nearest £

18.2 Trading Account for the year ending 31 December

18.5

(a) The answer is £204 ($23 - 7 + 12 - 13 = 15$ units remain in stock at end of period; FIFO assumes that the oldest units have been sold first, so the most recent purchases are the ones that remain in stock. Therefore 12 of the closing units must be valued at £14 (the most recent purchases) and the other 3 must be recorded at £12 (the next-most recent) = £204).

(b)

	Units	Running total	AVCO calculated
Opening inventory	53		£ 318.00
9th April sell	(29)		(174.00)
Subtotal	24		144.00
16th April buy	36		270.00
Subtotal	60		414.00
25th April sell	(41)		(282.90)
Closing inventory	19		<u>131.10</u>

(c) The discovery will increase the total value of Alfie's closing inventory; it must be valued at the lower of cost (£420) and NRV (£150); closing inventory will therefore increase by £150; closing inventory is a deduction within *cost of goods sold*, so *cost of goods sold* will be reduced by £150; gross profit and net profit will therefore both increase by £150.

(d) Bert's profit would have been lower under AVCO. Under FIFO, closing inventory will be deemed to comprise the most recent purchases. Since prices have been rising, the closing inventory will be valued at the latest, highest prices, so cost of goods sold will be lower. Under AVCO, the closing inventory would be valued at an average of recent and older prices, so its value would be lower than under FIFO. Cynthia's correct profit is £22,400. (Cost price of goods taken = $£540 \times 100/135 = £400$; the entry Dr Drawings £400, Cr Purchases £400 must be made; profit therefore will increase by £400.)

18.6 (This is a brief answer showing the main points to be covered. In an exam the answer should be in report form and elaborated.)

(1) For Charles Gray

(i) The concept of prudence says that inventory should be valued at lower of cost or net realisable value. As 50% of the retail price £375 is lower than cost £560, then £375 will be taken as net realisable value and used for inventory valuation.

(ii) The sale has not taken place by 30 April 2019. The prudence concept does not anticipate profits and therefore the sale will not be assumed. The gun should therefore be included in inventory, at cost price £560.

(2) For Jean Kim

It appears that it is doubtful if the business can still be treated as a going concern.

If the final decision is that the business cannot continue, then the inventory valuation should be £510 each, as this is less than cost, with a further overall deduction of auction fees and expenses £300.

(3) For Peter Fox

Inventory must be valued at the lower of cost or net realisable value in this case.

The cost to be used is the *cost* for Peter Fox. The historical cost concept requires that businesses use the actual original cost incurred by them in the past, not a cost that similar businesses might have paid for similar items. It is irrelevant what the cost may be for other distributors.

It would also be against the convention of consistency to adopt a different method. The consistency applies to Peter Fox, it is not a case of consistency with other businesses. Using selling prices as a basis is not acceptable to the vast majority of businesses.

18.8

(a) In one respect the consistency convention is not applied, as at one year end the inventory may be shown at cost whereas the next year end may see inventory valued at net realisable value.

On the other hand, as it is prudent to take the lower of cost or net realisable value, it can be said to be consistently prudent to consistently take the lower figure. Being prudent can be said to be an advantage. For instance, a shareholder can know that inventory is not overvalued: if it were, it would give him a false picture of their investment.

Someone to whom money is owed, such as a creditor, will know that the inventory in the balance sheet is realisable at least at that figure.

It is the knowledge that profits are not being overstated as a result of excessive values placed on inventory that gives outside parties confidence to rely on reported profits.

18.9

Cobden Ltd

Computation of inventory as at 31 May 2019

	Increase	Decrease
(a) No adjustment needed		–
Cost lower than net realisable value		130
(b) Reduction to net realisable value		126
(c) Arithmetic corrected	72	
(d) Omitted items	2,010	
(e) Transposition error		9
(f) Goods omitted	638	
(g) Hired item not to be included		347
(h) Samples to be excluded		63
(i) Sale or return items reduced to cost		184
(j) Goods held simply on sale or return		<u>267</u>
	<u>2,720</u>	<u>1,126</u>
Net increase		1,594
Inventory as originally computed		<u>87,612</u>
		<u>89,206</u>

19.1 (a)	<i>Allowance for doubtful debts</i>				(c)				
2024		2024			Bad debts written off				9,140
Dec 31	Balance c/d	940	Dec 31	Bad debts expense	Increase in the allowance for doubtful debts				271
		<u>940</u>			<i>Total charge to income statement</i>				<u>9,411</u>
					(d)				
					<i>Balance sheet extract at 31 December 2024</i>				
					Trade receivables				50,700
					Less Allowance for doubtful debts				<u>(1,521)</u>
									49,179
19.3 (i)	<i>Allowance for doubtful debts</i>								
2022		2022							
Dec 31	Balance c/d	3,230	Dec 31	Bad debts expense					3,230
		<u>3,230</u>							<u>3,230</u>
2023		2023							
Dec 31	Balance c/d	4,010	Jan 1	Balance b/d					3,230
		<u>4,010</u>	Dec 31	Bad debts expense					780
									<u>4,010</u>
					<i>Bad debts expense</i>				
2022		2022							
May 31	J Gray	350							
Oct 31	P King	560							
Dec 31	Allowance for doubtful debts	<u>3,230</u>	Dec 31	Profit and loss					4,140
									<u>4,140</u>
2023		2023							
Jan 31	T Ryan	680							
Jun 30	D Simms	290							
Oct 31	B Hall	470							
Dec 31	Allowance for doubtful debts	<u>780</u>	Dec 31	Profit and loss					2,220
									<u>2,220</u>
					(ii)				
					<i>Balance sheet extracts at 31 December</i>				
					Trade receivables				2022
					Less Allowance for doubtful debts				97,100
									106,200
									<u>(3,230)</u>
									93,870
									<u>102,190</u>

19.5				Allowance for doubtful debts				Bad debts expense			
2021	Dec 31	Balance c/d	830	2021	Jan 1	Balance b/d	740	2021	Various	Various	26,310
				Dec 31	Bad debts expense	90	Dec 31	Allowance for doubtful debts	540	Dec 31	Profit and loss
2022			<u>830</u>	2022			<u>830</u>				<u>26,850</u>
Dec 31		Balance c/d	<u>970</u>	2022	Jan 1	Balance b/d	830				
2023			<u>970</u>	2023	Dec 31	Bad debts expense	140				
Dec 31		Balance c/d	<u>970</u>				<u>970</u>				
Dec 31		Bad debts expense	280	2023	Jan 1	Balance b/d	970				
Dec 31		Balance c/d	<u>690</u>				<u>970</u>				
			<u>970</u>				<u>970</u>				
(b) Extracts from income statements for year ended 31 December 2023											
Bad debts written off											
Increase/(decrease) in the allowance for doubtful debts											
Total charge											
19.7											
(a)											
Allowance for doubtful debts											
2021				2021	Jan 1	Balance b/d	3,290	2021	Dec 31	Bad debts expense	2,590
Dec 31		Balance c/d	3,830	2021	Dec 31	Bad debts expense	540	2022	Jan 1	Balance b/d	2,590
			<u>3,830</u>				<u>3,830</u>		Dec 31	Bad debts expense	908
Allowance for prompt payment discounts											
2021				2021	Jan 1	Balance b/d	809	2023	Jan 1	Balance b/d	3,498
Dec 31		Discounts allowed	207				<u>809</u>		Dec 31	Bad debts expense	3,498
Dec 31		Balance c/d*	602				<u>809</u>		Dec 31	Balance c/d	3,498
			<u>809</u>				<u>809</u>				<u>3,498</u>
*£43,000 × 70% × 2%											

(b)

	<i>Bad debts recovered</i>					
(a)	2022 Dec 31 2023	Profit and loss	175	2022 Nov 30 2023	J Kane	175
	2022 Dec 31	Profit and loss	202	?	B Azam	202
(c)	<i>Bad debts expense</i>					
	2021 Various Dec 31	Various Allowance for doubtful debts	15,510	2021 Dec 31	Profit and loss	18,100
	2022 Various Dec 31	Various Allowance for doubtful debts	17,430	2022 Dec 31	Profit and loss	18,100
	2023 Various	Various	908	2023 Dec 31	Profit and loss	18,338
	2023 Various	Various	19,740	2023 Dec 31	Allowance for doubtful debts	330
	2023 Various	Various	19,740	2023 Dec 31	Profit and loss	19,410
(d)	<i>Included in income statements for year ended</i>					
	31 December			2021	2022	2023
	Bad debts written-off			15,510	17,430	19,740
	Increase/(decrease) in the allowance for doubtful debts			2,590	908	(330)
	Bad debts recovered			-	(175)	(202)
	Net total charge to income statement			18,100	18,163	19,208

(a) Per text.

- (b) Capital: (i), (ii), machine part of (v) , (vi).
Revenue: (iii), (iv), drinks part of (v) .

20.3 Capital: (a), (c), (e), (g); Revenue: (b), (d), (f).

20.5 Capital: (a), (b), (e).

20.7 £25,000 + 510 + 920 + 670 + 430 + 750 + 240 = £28,520

20.9

Wooden store shed

Balance b/d	850	Wooden store shed disposal	850
<i>Office buildings</i>			
Balance b/d	179,500		
Wages	109		
Materials	109		
<i>Office buildings repairs</i>			
Wages	181		
Materials	351		
<i>New brick-built store</i>			
Wooden store shed disposal	100		
Materials	4,750		
Wages	3,510		
Direct expenses	85		
<i>Wooden store shed disposal</i>			
Wooden store shed	850	Bank	180
Bank	265	New store	100

20.11

Classifying something as a capital expense rather than a revenue expense increases non-current assets, reduces expenses and so increases net profit (and so also increases capital). This makes the business look more profitable than it would have been had the expenditure been classified instead as revenue expenditure. It also makes it look in a better financial state than it would have been (as non-current assets have increased). Misclassifying revenue expenditure as capital expenditure is misleading to users of the financial statements.

21.1

Straight Line

Cost	950
Yr 1 Depreciation*	<u>250</u>
Yr 2 Depreciation	<u>250</u>
Yr 3 Depreciation	<u>250</u>
* 950 - 200 = 750 ÷ 3 = 250	

Reducing Balance

Cost	950
Yr 1 Depn 40% of 950	<u>380</u>
Yr 2 Depn 40% of 570	<u>228</u>
Yr 3 Depn 40% of 342	<u>137</u>
	<u>205</u>

21.2

(a) Straight Line

Cost	30,000
Yr 1 Depreciation*	<u>5,750</u>
Yr 2 Depreciation	<u>24,250</u>
Yr 3 Depreciation	<u>18,500</u>
Yr 4 Depreciation	<u>12,750</u>
	<u>7,000</u>

(b) Reducing Balance

Cost	30,000
Yr 1 Depn 30% of 30,000	<u>9,000</u>
Yr 2 Depn 30% of 21,000	<u>6,300</u>
Yr 3 Depn 30% of 14,700	<u>4,410</u>
Yr 4 Depn 30% of 10,290	<u>3,087</u>
	<u>7,203</u>

$$* \frac{30,000 - 7,000}{4} = 5,750$$

21.3

(a) Reducing Balance

Cost	64,000
Yr 1 Depn 35% of 64,000	<u>22,400</u>
Yr 2 Depn 35% of 41,600	<u>14,560</u>
Yr 3 Depn 35% of 27,040	<u>9,464</u>
	<u>17,576</u>

(b) Straight Line

Cost	64,000
Yr 1 Depreciation*	<u>15,500</u>
Yr 2 Depreciation	<u>48,500</u>
Yr 3 Depreciation	<u>33,000</u>
	<u>15,500</u>
	<u>17,500</u>

$$* \frac{64,000 - 17,500}{3} = 15,500$$

21.7

		<i>Machines</i>		
		A	B	C
2016	Bought 1.1.2016 Depreciation	4,000 <u>480</u>		
		3,520		
2017	Bought 1.9.2017 Depreciation		7,000	
			<u>280</u>	
			6,720	
2018	Bought 1.5.2018 Depreciation			2,000
				<u>160</u>
				1,840
2018	Total depreciation expense 372 + 806 + 160 = 1,338			

21.8

		<i>Motor Vehicles at cost</i>		
2023	Jan 1 Cash at bank			
			16,800	
			<u>16,800</u>	
2023	Dec 31 Balance c/d			4,200
2024	Jan 1 Balance b/d			3,150
				<u>7,350</u>

Accumulated depreciation on motor vehicles

2023	Dec 31 Balance c/d			4,200
2024	Jan 1 Balance b/d			3,150
				<u>7,350</u>

21.9
(a)

	Year ended 31/3/23	Year ended 31/3/24
Vehicle A	$£20,000 \times 20\% = 4,000$	$£20,000 \times 20\% \times 3/12 \text{ months} = 1,000$
Vehicle B	$£18,000 \times 20\% \times 9/12 \text{ months} = 2,700$	$£18,000 \times 20\% = 3,600$
Vehicle C	Not yet purchased	$£25,000 \times 20\% = 5,000$
Vehicle D	Not yet purchased	$£28,000 \times 20\% \times 9/12 \text{ months} = 4,200$
Total depreciation charged on delivery vehicles	<u>6,700</u>	<u>13,800</u>

(b) (i)

Delivery vehicles at cost			
1/4/22	Balance b/d	20,000	
1/7/22	Cash at bank	18,000	31/3/23 Balance c/d
		<u>38,000</u>	<u>38,000</u>
1/4/23	Balance b/d	38,000	30/6/23 Disposal
1/4/23	Cash at bank	25,000	
30/6/23	Cash at bank/Disposal	28,000	31/3/24 Balance c/d
		<u>91,000</u>	<u>91,000</u>

(ii)

Delivery vehicles accumulated depreciation			
31/3/23	Balance c/d	10,700	1/4/22 Balance b/d
		<u>10,700</u>	31/3/23 Depreciation expense
30/6/23	Disposal	9,000	
31/3/24	Balance c/d	15,500	1/4/23 Balance b/d
		<u>24,500</u>	31/3/24 Depreciation expense
			<u>24,500</u>

(c) (1) is capital expenditure; it is part of the cost of getting the new vehicles into the condition necessary for them to be used as intended by management, and from which the business will benefit for several years.

(2) is revenue expenditure; this spending is simply a repair cost that maintains the existing performance of the vehicle.

(3) is capital expenditure; this cost should add to the earning capacity of the vehicles for years to come (i.e. it should allow drivers to get to their destinations quicker, saving the business time and money).

(d) The straight-line basis is the simplest method of allocating the cost of a non-current asset over its estimated useful life. It essentially assumes that the business obtains equal benefit from the asset in each year of use. However, this may not actually be the case. For example, delivery vehicles may be more prone to breakdown and require greater maintenance after a few years, so the benefits may actually diminish over time. The reducing balance method might perhaps therefore be a more appropriate reflection of the actual pattern of benefits derived from the vehicles.

Another reason why the reducing balance method may sometimes be more suitable is if the asset in question gives the business a particular competitive advantage in the early years of use, such as if the asset is the very latest technology. However, this reason is unlikely to apply to delivery vehicles. In conclusion, the choice of the straight-line method for these assets is fairly uncontroversial.

21.12

(a)

Cost of asset $(18,000 + 500 + 1,700)$ 20,200
 Less Accumulated depreciation as at 31/12/24 $(20,200 \times 20\%)$ (4,040)

Carrying amount at 31 December 2024

16,160

(b)

Original cost 24,000
 Depreciation charge for year ended 31 August 2024 at 35% of cost (8,400)
 Carrying amount at 31 August 2024 15,600
 Depreciation charge for year ended 31 August 2025 at 35% of carrying amount (5,460)
 Carrying amount at 31 August 2025 10,140

Disposal proceeds (i.e. trade in value received for old car: 29,950 – 19,500)

10,450

Less Carrying amount on date of disposal (from above)
 Profit on disposal 310

(c) The answer is £11,325, as follows:

Disposal proceeds (given in question) 20,000
 Less Carrying amount at disposal date (missing figure in this calculation) (26,425)
 Loss on disposal (6,425)
 Original cost of machine (given in question) 37,750
 Less Accumulated depreciation at disposal date (missing figure in this calculation) (11,325)
 Carrying amount on date of disposal (calculated above) 26,425

(d) Original cost 1 June 2023 200,000
 Depreciation charge for year ended 31 May 2024 at 15% of cost (30,000)
 Carrying amount at 31 May 2024 170,000
 Depreciation charge for year ended 31 May 2025 at 15% of carrying amount (25,500)
 Carrying amount at 31 May 2025 144,500
 Depreciation charge for year ended 31 May 2026 at 15% of carrying amount (21,675)
 Carrying amount at 31 May 2026 122,825

$\pounds 122,825 / 8 \text{ years remaining useful life} = \pounds 15,353 \text{ depreciation charge for year ended 31 May 2027.}$

21.14

Vans at cost	
2024	2024
Jan 1 Bank 69,000	Dec 31 Balance c/d 213,000
Aug 1 Bank 144,000	
	<u>213,000</u>
	213,000

Accumulated Depreciation: Vans

2024	2024
Dec 31 Balance c/d 32,250	Dec 31 Dep'n expense 32,250*

$$\begin{aligned} *69,000 \times 25\% &= 17,250 \\ 144,000 \times 2.5\% \times 5/12 &= 15,000 \\ &\underline{32,250} \end{aligned}$$

21.15

<i>Machinery at cost</i>	
2017	2017
Jan 1 Bank 800	Dec 31 Balance c/d 800
2018	2018
Jan 1 Balance b/d 800	Dec 31 Balance c/d 3,800
Jul 1 Bank 2,400	
Oct 1 Bank 600	
	<u>3,800</u>
	3,800
2019	2019
Jan 1 Balance b/d 3,800	Dec 31 Balance c/d 3,800
2020	2020
Jan 1 Balance b/d 3,800	Dec 31 Balance c/d 5,200
Apr 1 Bank 1,400	
	<u>5,200</u>
	5,200

(b) *Accumulated Depreciation: Machinery*

2017	2017
Dec 31 Balance c/d 80	Dec 31 Dep'n expense 80
2018	2018
Dec 31 Balance c/d 295	Jan 1 Balance b/d 80
	Dec 31 Dep'n expense 215*
	<u>295</u>
	295
2019	2019
Dec 31 Balance c/d 675	Jan 1 Balance b/d 295
	Dec 31 Dep'n expense 380
	<u>675</u>
	675
2020	2020
Dec 31 Balance c/d 1,160	Jan 1 Balance b/d 675
	Dec 31 Dep'n expense 485**
	<u>1,160</u>
	1,160

$$\begin{aligned} *800 \times 10\% &= 80 \\ 2,400 \times 10\% \times 1/2 &= 120 \\ 600 \times 10\% \times 1/4 &= 15 \\ &\underline{215} \\ **3,800 \times 10\% &= 380 \\ 1,400 \times 10\% \times 3/4 &= 105 \\ &\underline{485} \end{aligned}$$

(c) *Balance Sheet Extracts*

31 December 2017	31 December 2019
Machinery 800	Machinery 3,800
Less Acc dep'n 80	Less Acc dep'n 675
31 December 2018	31 December 2020
Machinery 3,800	Machinery 5,200
Less Acc dep'n 295	Less Acc dep'n 1,160
	<u>4,040</u>
	4,040
21.17	
	<i>Plant at cost</i>
2017	2017
Jan 1 Bank 2,600	Dec 31 Balance c/d 4,700
Oct 1 Bank 2,100	
	<u>4,700</u>
	4,700
2018	2018
Jan 1 Balance b/d 4,700	Dec 31 Balance c/d 4,700
	<u>4,700</u>
	4,700

Balance Sheet extract as at 31 December 2019

21.20

(a) The purchase of non-current assets clearly represents a cost to a business. Under the accrual basis of accounting, the income of the year must be matched against the costs incurred in earning that income. Non-current assets will, by definition, be used for several years, so their cost must be matched against the revenue of several years. Depreciation is therefore the method that must be used to systematically apportion the original cost of assets against the revenue that they are expected to help generate over the course of their predicted useful lives.

(b) (i) Vehicles Cost $(98,000 - 18,000 \text{ disposed} + 24,000 \text{ bought})$ 104,000
Less Accumulated depreciation
 $(33,000 - 9,000 \text{ disposed})$ (24,000)
80,000
16,000

Depreciation expense $(80,000 \times 20\%)$

(ii) Fixtures Cost 70,000
 $(61,000 - 12,000 \text{ disposed} + 21,000 \text{ bought})$
Depreciation expense $(70,000 \times 15\%)$ 10,500
10,500

(c) (i) *Delivery vehicles at cost*

1/3/23	Balance b/d	98,000	?	Disposal	18,000
?	Cash at bank	24,000	29/2/24	Balance c/d	104,000
		<u>122,000</u>			<u>122,000</u>

(ii) *Delivery vehicles accumulated depreciation*

?	Disposal	9,000	1/3/23	Balance b/d	33,000
29/2/24	Balance c/d	40,000	29/2/24	Depreciation expense	16,000
		<u>49,000</u>			<u>49,000</u>

(iii) *Disposal account*

?	Delivery vehicles at cost	18,000	?	Cash at bank	8,400
?	Office fixtures at cost	12,000	?	Delivery vehicles acc dep'n	9,000
			?	Cash	400
			?	Office fixtures acc dep'n	5,400
			29/2/24	Loss on disposal	6,800
					<u>30,000</u>

(d) It is very common practice for a business to decide upon a certain depreciation method and rate for each *class* of its non-current assets. For example, all its motor vehicles might be depreciated at 20% reducing balance, and all its office fixtures at 15% straight-line. This saves a lot of time and effort compared to deciding upon a specific rate and method for every individual asset that the business buys.

However, it can be problematic if the classes are too broad. For example, office desks and chairs may well be used for 6-7 years or more, so a policy of 15% straight-line would be appropriate for these office fixtures. But computers are more likely to last 3-4 years, so a rate of $25-33\frac{1}{3}\%$ would be more suitable. In other words, if a business wishes to apply a blanket depreciation rate to all assets within a particular class then it is essential that the estimated useful lives of all assets within that class are broadly similar, otherwise the blanket rate will be inappropriate for some items.

In Baba's case, she should probably record her computers in a separate account from the rest of her office fixtures and apply a depreciation rate to her computers that reflects the average useful life of her IT equipment.

21.22

(a) (i) Straight line depreciation method

	Non-current Asset at cost	
Year 1 Bank	<u>10,000</u>	Year 3 Asset disposals <u>10,000</u>
<i>Accumulated Depreciation</i>		
Year 2 Balance c/d	4,000	Year 1 Dep'n expense 2,000
	<u>4,000</u>	Year 2 Dep'n expense <u>2,000</u>
Year 3 Asset disposals	<u>4,000</u>	Year 3 Balance b/d <u>4,000</u>
<i>Asset Disposals</i>		
Year 3 Non-current asset	10,000	Year 3 Bank 5,000
		Year 3 Acc. depn <u>4,000</u>
	<u>10,000</u>	Year 3 Loss on disposal <u>1,000</u>
		<u>10,000</u>

(ii) Reducing balance method

	Non-current Asset at cost	
Year 1 Bank	<u>10,000</u>	Year 3 Asset disposals <u>10,000</u>
<i>Accumulated Depreciation</i>		
Year 2 Balance c/d	6,400	Year 1 Dep'n expense 4,000
	<u>6,400</u>	Year 2 Dep'n expense <u>2,400</u>
Year 3 Asset disposals	<u>6,400</u>	Year 3 Balance b/d <u>6,400</u>
<i>Asset Disposals</i>		
Year 3 Non-current asset	10,000	Year 3 Bank 5,000
Year 3 Profit on disposal	<u>1,400</u>	Year 3 Acc. depn <u>6,400</u>
	<u>11,400</u>	<u>11,400</u>

- (b) (i) The purpose of depreciation is to apportion the cost of a non-current asset over the useful years of its life to the organisation.
 The matching concept concerns the matching of costs against the revenues which those costs generate. If the benefit to be gained is equal in each year then the straight line method is to be preferred. If the benefits are greatest in Year 1 and then falling year by year, then the reducing balance method would be preferred.
 (ii) The net figure at the end of Year 2 (i.e. the carrying amount) is the amount of original cost not yet expensed against revenue.

- (c) The charge in Year 1 should be nil regardless of the depreciation method. The matching concept concerns matching costs against revenues. There have been no revenues in Year 1, therefore there should be no costs.

21.24 Your letter should include the following:

- Depreciation is an expense.
- It allows the expense of an asset to be spread over its useful economic life.
- It is only a book adjustment and therefore 'real' money is not set aside when you depreciate an asset.
- It is not a reserve, and never can be as there are no assets of the business underpinning it.

21.26

<i>Machinery at cost</i>			
2018			
Jan 1 Bank	10,000	Dec 31 Balance c/d	16,000
July 1 Bank	6,000		
	<u>16,000</u>		<u>16,000</u>
2019			
Jan 1 Balance b/d	16,000	Dec 31 Balance c/d	24,000
Mar 31 Bank	8,000		
	<u>24,000</u>		<u>24,000</u>
2020			
Jan 1 Balance b/d	24,000	Oct 7 Machinery disposal	10,000
Nov 5 Bank	12,000	Dec 31 Balance c/d	26,000
	<u>36,000</u>		<u>36,000</u>
2021			
Jan 1 Balance b/d	26,000	Feb 4 Machinery disposal	6,000
Feb 6 Bank	9,000	Oct 11 Machinery disposal	12,000
Oct 11 Machinery disposal	7,000	Dec 31 Balance c/d	24,000
	<u>42,000</u>		<u>42,000</u>

Accumulated depreciation			
2018			
2018			
Dec 31 Balance c/d	3,200	Dec 31 Depreciation expense	3,200
2019		2019	
Dec 31 Balance c/d	8,000	Jan 1 Balance b/d	3,200
	<u>8,000</u>	Dec 31 Depreciation expense	4,800
2020		2020	<u>8,000</u>
Oct 7 Machinery disposal	4,000	Jan 1 Balance b/d	8,000
Dec 31 Balance c/d	9,200	Dec 31 Depreciation expense	5,200
	<u>13,200</u>		<u>13,200</u>
2021		2021	
Feb 4 Machinery disposal	3,600	Jan 1 Balance b/d	9,200
Oct 11 Machinery disposal	2,400	Dec 31 Depreciation expense	4,800
Dec 31 Balance c/d	8,000		<u>4,800</u>
	<u>14,000</u>		<u>14,000</u>
Machinery Disposal			
2020		2020	
Oct 7 Machinery	10,000	Oct 7 Acc. depn	4,000
		7 Bank	5,500
		Dec 31 Profit and loss (loss on sale)	500
	<u>10,000</u>		<u>10,000</u>
2021		2021	
Feb 4 Machinery	6,000	Feb 4 Acc. depn	3,600
Oct 11 Machinery	12,000	4 Bank	3,000
		Oct 11 Acc. depn	2,400
		11 Machinery	7,000
		Dec 31 Profit and loss (loss on disposal)	2,000
	<u>18,000</u>		<u>18,000</u>
XY Ltd			
Balance Sheet extracts as at 31 December			
2020			
Machinery at cost			26,000
Less: Accumulated depreciation			9,200
			<u>16,800</u>
2021			
Machinery at cost			24,000
Less: Accumulated depreciation			8,000
			<u>16,000</u>

21.29

- (a) (i) Straight line method = $(£27,000 - £5,000)/4$ years = £5,500 per year.
Therefore depreciation expense = £5,500 in each of 2022, 2023 and 2024.
(ii) Reducing balance method:

Cost	27,000
<i>Depreciation expense for 2022 at 40%</i>	10,800
Carrying amount at the end of 2022	16,200
<i>Depreciation expense for 2023 at 40% of carrying amount</i>	6,480
Carrying amount at the end of 2023	9,720
<i>Depreciation expense for 2024 at 40% of carrying amount</i>	3,888
(iii) Units of production method: $(£27,000 - £5,000)/50,000$ miles = £0.44 per mile	

2022 depreciation expense =	$15,000 \times £0.44 =$	6,600
2023 depreciation expense =	$11,000 \times £0.44 =$	4,840
2024 depreciation expense =	$13,000 \times £0.44 =$	5,720

- (b) (i) 2025 depreciation expense = 7,000 miles \times £0.44 = £3,080
(ii)

Disposal proceeds	2,000
Less Carrying amount at date of disposal (cost	(6,760)
$£27,000 - £20,240$ acc dep *)	<u>(4,760)</u>
Loss on disposal	

*Accumulated depreciation at date of disposal = 6,600 + 4,840 + 5,720 + 3,080 = 20,240

22.1

(a)

<i>Motor Expenses</i>	
2016	2016
Dec 31 Cash and bank	Dec 31 Profit and loss
31 Owing c/d	
	1,400
	<u>200</u>
	<u>1,600</u>
	1,600

(b)

<i>Insurance</i>	
2016	2016
Dec 31 Cash and bank	Dec 31 Prepaid c/d
	31 Profit and loss
	1,700
	<u>130</u>
	<u>1,570</u>
	<u>1,700</u>

(c)

<i>Computer Supplies</i>	
2016	2016
Dec 31 Cash and bank	Jan 1 Owing b/d
31 Owing c/d	Dec 31 Profit and loss
	900
	<u>400</u>
	<u>1,300</u>
	1,300
<i>Business Rates</i>	
2016	2016
Jan 1 Prepaid b/d	Dec 31 Prepaid c/d
Dec 31 Cash and bank	31 Profit and loss
	580
	<u>5,600</u>
	<u>6,180</u>
	<u>6,180</u>
<i>Rent Received</i>	
2016	2016
Jan 1 Owing b/d	Dec 31 Cash and bank
Dec 31 Profit and loss	31 Owing c/d
	380
	<u>3,840</u>
	<u>4,220</u>
	<u>4,220</u>
<i>Business Rates</i>	
2018	2018
Jan 1 Balance b/d	Dec 31 Profit and loss
Dec 31 Bank	31 Prepaid c/d
	600
	<u>6,200</u>
	<u>6,800</u>
	<u>6,800</u>
<i>Packing Materials</i>	
2018	2018
Jan 1 Balance b/d	Dec 31 Profit and loss
Dec 31 Bank	31 Cash: Scrap
31 Owing c/d	31 Balance c/d
	1,400
	<u>4,000</u>
	<u>900</u>
	<u>6,300</u>
	<u>6,300</u>
<i>Insurance</i>	
2020	2020
Jan 1 Prepaid b/d	Dec 31 Profit and loss
Dec 31 Bank	31 Prepaid c/d
	562
	<u>1,019</u>
	<u>1,581</u>
	<u>1,581</u>
2021	345
Jan 1 Prepaid b/d	

22.8 (a)	D. Staunton	
	Income Statement for the year ended 30 September 2024	
Sales		592,013
Less Cost of goods sold:		
Opening inventory	25,967	
Add Purchases	307,847	
Less Returns outwards	(2,064)	
Less Closing inventory	(26,424)	
		(305,326)
Gross profit		286,687
Less Expenses:		
Utilities	(18,603 + 4,167)	22,770
Business rates	(19,978 – 3,920)	16,058
Wages & salaries		136,163
Bad debt expense		13,192
Increase in allowance for doubtful debts		688
Depreciation expense:		
Equipment	(188,760 – 74,100) × 0.3	34,398
Delivery vans	(92,220 × 0.2)	18,444
Net profit		(241,713)
		<u>44,974</u>

<i>Wages</i>		
2020	2020	306
Dec 31 Cash	Jan 1 Accrued b/d	15,113
31 Accrued c/d	Dec 31 Profit and loss	<u>15,419</u>
	2021	419
	Jan 1 Accrued b/d	
<i>Rent Receivable</i>		
2020	2020	36
Dec 31 Profit and loss	Jan 1 In advance b/d	2,600
	Dec 31 Bank	<u>105</u>
	31 Arrears c/d	<u>2,741</u>
2021		
Jan 1 Arrears b/d		105
(b)		
<i>Income Statement (extract)</i>		
Insurance	1,236	
Wages	15,113	
Rental income	(2,741)	
(c) (i)	Expenses accrued increases the amount charged as expense for that period. It reduces the recorded net profit. It shows as a current liability in the balance sheet.	
(ii)	Income received in advance reduces the revenue to be recorded for that period. It reduces the recorded net profit. It shows as a current liability in the balance sheet.	
(d) (i)	To match-up expenses charged in the income statement with the expense cost used up in the period.	
(ii)	To match-up revenue credited to the income statement with revenue earned for the period.	

22.11	(a)	John Brown	23.1		
Income Statement for the year ended 31 December 2023		Sales Ledger Control			
Sales (400,000 – 5,000)	395,000	Balances b/d	51,700	Returns inwards	1,200
Less Cost of goods sold		Sales Day Book		Cheques and cash	40,100
Opening inventory	100,000			Discounts allowed	700
Add Purchases (350,000 – 6,200)	343,800			Balances c/d	<u>49,300</u>
Less Closing inventory	<u>120,000</u>				<u>91,300</u>
Gross profit	323,800				
Less Operating expenses	<u>71,200</u>				
Rates (6,000 – 500)	5,500				
Telephone (1,000 + 220)	1,220				
Wages and salaries (30,000 + 5,000)	35,000				
Bad debts expense	200				
Increase in allowance for doubtful debts (980 – 800)	180				
Depreciation:					
Shop fittings (40,000 × 10%)	4,000				
Van (30,000 × 20%)	<u>6,000</u>				
Net profit	<u>52,100</u>				
Balance Sheet as at 31 December 2023		23.3			
Non-current assets				Sales Ledger Control Account	
Shop fittings (40,000 – 4,000)	36,000			July 1	27,890
Van (30,000 – 6,000)	<u>24,000</u>			Balance b/d	
	60,000			Sales	24,200
Current assets					
Inventory	120,000				
Trade receivables					
Less Allowance for doubtful debts (980)	<u>9,800</u>				
Prepayments	500				
Cash at bank	<u>3,000</u>				
Total assets	<u>192,320</u>				
Current liabilities					
Trade payables	7,000				
Accruals (5,000 + 220)	<u>5,220</u>				
Total liabilities	12,220				
Net assets	<u>180,100</u>				
Opening capital	179,000				
Add Net profit for the year	19,100				
Less Drawings during the year	<u>(18,000)</u>				
Closing capital	<u>180,100</u>				
					</

23.6

Sales Ledger Control Account

Jan 1 Bal b/d	23,220	Cash from customers (excl £370)	146,610
Credit sales	162,540	Bad debt write-offs	4,770
		Discounts allowed	3,160
		Returns inwards	8,150
		Dec 31 Bal c/d	23,070
	<u>185,760</u>		<u>185,760</u>

Purchases Ledger Control Account

Discounts received	1,310	Jan 1 Bal b/d	16,400
Paid to credit suppliers	109,040	Credit purchases	114,800
Returns outwards	2,330		
Dec 31 Bal c/d	18,520		
	<u>131,200</u>		<u>131,200</u>

23.9

Total Trade Receivables Account

Balance b/d	26,555	Cash (600,570 – 344,890)	255,680
Credit sales	268,187	Discounts allowed	5,520
		Set-offs against payables	70
		Bad debts	780
		Returns inwards	4,140
		Balances c/d	28,552
	<u>294,742</u>		<u>294,742</u>
Balances b/d	28,552		

Total Trade Payables Account

Cash (503,970 – 14,440)	489,530	Balances b/d	43,450
Discounts received	3,510	Credit purchases	496,600
Set-offs against receivables	70		
Returns outwards	1,480		
Balances c/d	45,460		
	<u>540,050</u>	Balances b/d	<u>540,050</u>
			<u>45,460</u>

Note: The allowance for doubtful debts does not affect the control accounts.

23.10

(a) To ensure an arithmetical check on the accounting records. The agreement of the total of individual trade payable balances with that of the balance on the control account provides that check.

If the control account and the ledger are kept by separate personnel, then a check on their work and honesty is provided.

- (b) (i) Increase £198 (ii) Decrease £100 (iii) No effect
(iv) Decrease £400 (v) Decrease £120.

(c) Accounting software will automatically enter two figures in different directions and will then confirm it in total fashion. As such there may seem at first sight to be no need for control accounts.

However, there is still the need to check on the accuracy of data input. Users will also still expect to see accounts for 'total receivables' and 'total payables' rather than having to add together the individual personal accounts on each ledger. Control accounts provide convenient 'at a glance' totals.

Accordingly there will still be a need for control accounts.

23.11

(a) See Section 23.1.

(b) See Section 23.5.

24.1

Bank Reconciliation as at 31 December 2024

Cash at bank as per cash book	4,210
Add: Bank transfers	369
Cash at bank per balance sheet	<u>4,579</u>
Less: uncredited bank deposits	1,238
	<u>3,341</u>
Add: unpresented cheques	2,116
Cash at bank per bank statement	<u>5,457</u>

Note for students:

Both in theory and in practice you can start with the cash book balance working to the bank statement balance, or you can reverse this method. Many teachers have their preferences, but this is a personal matter only. Examiners sometimes ask for them using one way, sometimes the other. Students should therefore be able to tackle them both ways.

24.3 (a)		<i>Bank Reconciliation Statement as at 31 March 2024</i>	
	<i>Cash Book</i>	Overdraft per cash book	(4,158)
2019	2019	Less Bankings not yet in bank statement	(192)
Dec 31 Balance b/d	1,535	Add Unpresented cheques	504
Dec 31 J. Watt	251	Overdraft per bank statement	<u>(3,846)</u>
	<u>1,786</u>		
24.3 (b)		<i>Bank Reconciliation Statement as on 31 December 2019</i>	
		Balance per cash book	136
Add Unpresented cheque	1,737	Less: Bank charges	44
Less Bankings not yet on bank statement (366 + 412)	125	Sundries cheque	80
Balance per bank statement	<u>(778)</u>	Cheque returned – Jones	150
	<u>1,084</u>	Rates standing order	6
		Incorrect entry	<u>(416)</u>
			<u>(970)</u>
24.5		Add Dividends received not entered	62
		Error in calculation of opening balance	50
		Corrected Cash Book balance	<u>112</u>
			<u>(858)</u>
24.5 (a)		<i>George Ltd</i>	
2018		<i>Bank Reconciliation Statement as at 31 October</i>	
Dec 31 Balance b/d	1,500	Balance per bank statement*	(1,353)
31 Dividends	240	Add Outstanding lodgements	762
31 HM Revenue & Customs	260	Less Unpresented cheques	(591)
31 Deposit account	1,400	Balance per cash book	<u>(267)</u>
	<u>3,400</u>	* This is the balancing figure.	<u>(858)</u>
	<u>3,400</u>		
24.5 (b)		<i>Bank Reconciliation Statement as on 31 December 2018</i>	
		Balance per cash book	3,100
Add Unpresented cheques (250 + 290)	540	Error of omission – a credit purchase omitted from the books.	540
Less Bankings not on statement	3,640	(b) Error of commission – a credit sale to J. Briggs entered in the account of H. Briggs.	3,640
Balance per bank statement	690	(c) Error of principle – repairs debited to the asset account.	690
	<u>2,950</u>	(d) Compensating errors – prepayments £15 too high and accruals £15 too high.	2,950
		(e) Errors of original entry – a credit purchase for £100 recorded in the books as £10.	
24.7		(f) Complete reversal of entries – payment of advertising debited to bank and credited to advertising.	
		(g) Transposition error – sales invoice for £236 entered as £236 in both ledger accounts.	
	<i>Cash Book</i>		
Mar 31 G. Frank	Balance b/d		4,195
31 Balance c/d	88 Mar 31 TYF		32
	4,158 31 Bank charges		19
	<u>4,246</u>		<u>4,246</u>

To economise on space, all narratives for journal entries are omitted.

25.4

(a) 200 units \times £2.62 = £524 not £5,240.
(b) (i) Inventory overstated by £4,716 (i.e. 5,240 – 524).

(a) $200 \text{ units} \times £2.62 = £524$ not £5,240.

- ## 25.5

26.1

Suspense

Suspense

(a) The Journal (narratives omitted)

(b)	Suspense Account
Sales	1,205
Discounts allowed	59
	<u>1,264</u>

- (c) Net profit per financial statements

Note: (*v*) has no effect on net profit. Sales are reduced by £125 but the loss on disposal of office equipment is reduced by £125 too.

<i>Item</i>	<i>If no effect State 'No'</i>	<i>Debit side exceeds credit side by</i>	<i>Credit side exceeds debit side by</i>
<i>(i)</i>	No		
<i>(ii)</i>	No		
<i>(iii)</i>	No		
<i>(iv)</i>		£520	
<i>(v)</i>	No		£212
<i>(vi)</i>			£380
<i>(vii)</i>	No		

<i>Item</i>	<i>If no effect State 'No'</i>	<i>Debit side exceeds credit side by</i>	<i>Credit side exceeds debit side by</i>
<i>(i)</i>	No		
<i>(ii)</i>	No		
<i>(iii)</i>	No		
<i>(iv)</i>		£520	
<i>(v)</i>	No		£212
<i>(vi)</i>			£380
<i>(vii)</i>	No		

26.5 Trial Balance as at 31 January 2019

	Dr	Cr
Drawings	19,500	
Inventory	8,410	
Trade receivables (34,517 – 8)	34,509	
Furniture (2,400 + 407)	2,807	
Cash	836	
Returns inwards	2,438	
Business expenses	3,204	
Purchases (72,100 – 407)	71,693	
Discounts allowed	42	
Capital		7,845
Trade payables (6,890 – 315)		6,575
Sales (127,510 + 90)		127,600
Discounts received		1,419
	<u>143,439</u>	<u>143,439</u>

26.6

(a) (i) The Journal

	Dr	Cr
C. Thomas		
Thomasson Manufacturing Ltd		
Suspense	450	
Telephone	100	
Suspense	2,000	
Sales account		100
Machine repairs		2,000
Machinery		390
Suspense	1,500	
Rent received*		1,500
Purchases account		765
P Brooks		765

* Assumed not invoiced to Atlas Ltd

(ii) Computation of Corrected Profit for year ending 31 December 2018

Profit as originally reported	47,240
Add Telephone expense overstated	100
Sales understated	2,000
Rent received omitted	<u>1,500</u>
	<u>3,600</u>
	<u>50,840</u>
Less Machinery repairs understated	390
Purchases omitted	<u>765</u>
Corrected profit figure	<u>1,155</u>
(b) (i) Per text	<u>49,685</u>

(ii) Per text

26.8

(a) Difference on Trial Balance Suspense

Per trial balance	2,513	J. Winters	198
Discounts received	324	Wages	2,963
Discounts allowed	<u>324</u>		
	<u>3,161</u>		<u>3,161</u>

(b) Computation of Corrected Net Profit for year ending 30 April 2019

Net profit per draft accounts	–	+	24,760
(i) Discounts		648	
(ii) Wages	2,963		
(iv) Stationery prepaid		1,500	
(v) Remittance	<u>3,000</u>		
	<u>5,963</u>		
		<u>2,148</u>	
		<u>3,815</u>	
		<u>20,945</u>	

Correct net profit

(iii) and (v) did not affect profit

(c) Per text

26.11

(a) (i) Van

Motor vehicle expenses	6,000
(ii) Fuel	250
Drawings	
(iii) B. Struton	300
B. Burton Ltd	
(iv) Drawings	750
Business rates	
(v) Drawings	720
Wages	
(vi) Purchases	500
K. Jarman	500

(b) Net profit per draft financial statements

Add (i)	6,000	23,120
(iv)	750	
(v)	<u>720</u>	
		<u>7,470</u>
		<u>30,590</u>
Less (ii)	250	
(vi)	<u>500</u>	
		<u>750</u>
		<u>29,840</u>

<i>(d)</i>			
<i>(i)</i>	Suspense Sales	10	10
<i>(ii)</i>	Discount allowed Suspense	2	2
<i>(iii)</i>	Discount allowed Suspense	140	140
<i>(iv)</i>	D. Bird Suspense	10	10
<i>(v)</i>	Suspense	3	3

(b) The overall effect on the trial balance is that the following changes have been made:

(i)	Purchases	10	10
(ii)	Suspense A. Supplier	45	10
(iii)	Suspense Plant and Machinery	70	45
(iv)	Repairs Suspense	20	70
(v)	S. Kane Sales	300	20
(vi)	Plant and Machinery disposals Trade receivables	60	300
(vii)	Suspense Suspense	2	60
(viii)	B. Luckwood Business rates Prepayments	45	2
			45

Balance	93	Purchases	10
(iv) S. Kane	20	(ii) A. Supplier	45
(vii) B. Luckwood	<u>2</u>	(vi) Trade receivables	<u>60</u>
	<u>115</u>		<u>115</u>

Missing figures (A), (B) and (C) deduced in that order. (A) to balance is 21,090, thus (B) has to be 52,290 and (C) becomes 42,290.

(b)	(i)	The suspense account is shown in the balance sheet, not the income statement. The following item increases net profit:	70
	(iii)	The following items reduce net profit:	
	(i)		10
	(viii)		<u>45</u>
		Overall, net profit is increased by	(55)
		Note: (v) has no effect on net profit. Sales are reduced by 300 and the loss on disposal of the plant and machinery is reduced by 300.	<u>15</u>
	(ii)	The following items are changed in the balance sheet:	
		Suspense	Cr 93
	(i)	Trade payables	45
	(ii)	Plant and Machinery	70
	(iv), (vi), (vii)	Trade receivables (60 – 20 – 2)	38
	(viii)	Prepayments	45
		Net profit for the year	<u>153</u>
			<u>153</u>

N. Alphonso
Balance Sheet as at 31 December 2024

<i>Non-current assets</i>		
Van at cost	9,000	
Less Accumulated depreciation	<u>(2,250)</u>	6,750
<i>Current assets</i>		
Inventory	8,300	
Trade receivables	11,620	
Prepaid expenses	1,360	
Bank	4,110	
Cash	<u>50</u>	25,440
<i>Less Current liabilities</i>		
Trade payables	9,470	
Accruals	<u>1,630</u>	(11,100)
		<u><u>21,090</u></u>
Capital		10,000
Cash introduced		<u>(C)</u>
Add Net profit for the year		(B)
Less Drawings ((600 × 52))		(31,200)

Missing figures (A), (B) and (C) deduced in that order. (A) to balance is 21,090, thus (B) has to be 52,290 and (C) becomes 42,290.

27.2

$\text{Opening capital} = 140,000 + 53,200 + 68,500 + 1,700 - 72,300 = 191,100$
 $\text{Closing capital} = 154,000 + 59,100 + 70,400 + 2,900 - 80,600 = 205,800$
 Therefore:

Opening capital	191,100
Add Capital introduced	5,500
Add Net profit for year (balancing figure)	33,200
Less Drawings	<u>(24,000)</u>
Closing capital	<u>205,800</u>

27.4

Workings:

Purchases Bank	136,200	Sales Banked	182,000
Cash	<u>9,300</u>	Cash	<u>34,900</u>
	145,500		216,900
– Opening creditors	<u>23,400</u>	– Opening debtors	<u>40,600</u>
	122,100		176,300
+ Closing creditors	<u>26,200</u>	+ Closing debtors	<u>37,700</u>
Purchases for year	<u>148,300</u>	Sales for year	<u>214,000</u>

Opening Capital:	Bank	8,200
	Inventory	20,600
	Trade receivables	40,600
	Insurance prepaid	910
	Fixtures	<u>3,700</u>
	Less Trade payables	<u>23,400</u>
	Accruals	<u>570</u>
		23,970
		<u>50,040</u>

Ellie
Income Statement for the year ending 31 December 2019

Sales		214,000
Less	Cost of goods sold:	
	Opening inventory	20,600
	Add Purchases	<u>148,300</u>
		168,900
	Less Closing inventory	<u>23,000</u>
Gross profit		145,900
Less Expenses:		<u>68,100</u>
	Wages	22,800
	Rent (7,800 – 570)	7,230
	Insurance (2,940 + 910 – 1,020)	2,830
	Sundry expenses	1,260
	Depreciation: Fixtures	<u>300</u>
Net profit		<u>34,420</u>
		<u>33,680</u>

Balance Sheet as at 31 December 2019

<i>Non-current assets</i>	
Fixtures at valuation	3,700
Less Accumulated depreciation	<u>300</u>
	3,400
<i>Current assets</i>	
Inventory	23,000
Trade receivables	37,700
Prepayments	<u>1,020</u>
	61,720
	<u>65,120</u>
<i>Current liabilities</i>	
Trade payables	26,200
Bank overdraft	<u>12,800</u>
	(39,000)
	<u>26,120</u>
<i>Capital</i>	
Opening balance	50,040
Add Net profit	<u>33,680</u>
	83,720
Less Drawings (2,800 + 54,800)	<u>57,600</u>
	<u>26,120</u>

27.6

(a)

Carlos's business
Balance Sheet as at 1 January 2024

<i>Non-current assets</i>		20,000
<i>Current assets</i>		
Inventory	32,000	
Trade receivables	15,400	
Prepayments	500	
Cash at bank	<u>1,700</u>	
Total assets		49,600
		<u>69,600</u>
<i>Current liabilities</i>		
Trade payables	29,800	
Accruals	<u>1,200</u>	
Total liabilities		(31,000)
Net assets		<u>38,600</u>
Carlos's capital		<u>38,600</u>

(b) (i)

Trade receivables working

Opening balance	15,400	Cheques from credit customers	45,300
Refunds to credit customers	900		
Credit sales (<i>missing figure</i>)	56,900	Closing balance	27,900
	<u>73,200</u>		<u>73,200</u>
Credit sales (<i>from working above</i>)	56,900		
Cash banked from sales	9,000		
Cash sales that were not banked (11,000 + 8,900 + 4,000 + 5,300)	29,200		
<i>Total sales revenue for year</i>	<u>95,100</u>		

(ii)

Trade payables working

Paid to credit suppliers	42,500	Opening balance	29,800
Closing balance	21,000	Purchases on credit (<i>missing figure</i>)	33,700
	<u>63,500</u>		<u>63,500</u>
Purchases on credit (<i>from working above</i>)	33,700		
Cash purchases	5,300		
<i>Total purchases for year</i>	<u>39,000</u>		

(c)

Carlos's business

Income Statement for the year ended 31 December 2024

Sales		95,100
Less Cost of goods sold		
Opening inventory	32,000	
Add Purchases	39,000	
Less Closing inventory	<u>25,700</u>	
Gross profit		(45,300)
Add Other income		49,800
Commission received		
Less Operating expenses		2,700
Rent (2,500 + 500 – 1,000)	2,000	
Maintenance	7,200	
Advertising	4,800	
General expenses	6,700	

Carlos's business

Income Statement for the year ended 31 December 2024

Wages (8,900 + 1,600 – 1,200)	9,300
Losses relation to non-current assets*	<u>3,500</u>
(20,000 + 4,000 – 2,500 – 18,000)	(33,500)
Net profit	<u>19,000</u>

*Due to insufficient data, the profit or loss on disposal cannot be separated from the depreciation expense for the year.

(d) Carlos is likely to already be very busy running his business and may feel he is unable to devote enough time to keeping detailed records. In any case, he may not have sufficient bookkeeping knowledge to do so. He also might feel unable to afford to pay a bookkeeper or accountant to do it for him. For all these reasons, he may believe that he is not capable of maintaining a full set of books.

However, he still has a legal responsibility to ensure that his records are sufficient to allow his profits for tax purposes to be accurately calculated: his revenue must not be understated and his expenses must not be overstated. There are many simple accounting software packages available that are reasonably easy to learn and are fairly inexpensive, so Carlos should perhaps consider buying one of these.

Such software will give him more accurate, up to date information about how his business is doing: for example, it will help him monitor amounts due from customers more effectively and allow him to keep a closer eye on his overhead spending. A proper set of books will also give third parties more confidence if he wishes to apply for a bank loan or wants to sell his business to a potential buyer.

27.8

(a)

Trade payables working

Bank	101,500	Balances b/d	7,400
Cash	1,800		
Balances c/d	<u>8,900</u>	Purchases (difference)	104,800
	<u>112,200</u>		<u>112,200</u>

Step (B) find cash banked. Balance b/d 2,300 + cash received? – payments 117,550 = *balance c/d* 1,650. Therefore, cash banked? = 116,900. Step (C) draw up cash account:

Sales (deduced – as margin is 25% = $4 \times$ gross profit)	128,000
Opening inventory	8,600
Add Purchases (104,800 – 600 drawings)	104,200
	112,800
Less Closing inventory	16,800
Cost of goods sold	96,000
Gross profit ($33\frac{1}{3}\%$ of Cost of goods sold)	32,000
Less: Casual labour (1,200 + 6,200)	7,820
Rent (5,040 + 300 – 420)	4,920
Delivery costs	3,000
Electricity (1,390 + 160 – 210)	1,340
Net profit	17,080
	14,920

Balance Sheet as at 31 August 2019

<i>Current assets</i>	
Inventory	16,800
Trade receivables	4,300
Prepayments	420
Bank	1,650
Cash	330
<i>Current liabilities</i>	23,500
Trade payables	8,900
Accruals	160
	(9,060)
	14,440

Capital:
Opening balance (Working 1)
Add Net profit
Less Drawings (Working 2 + 600)

	7,850
	14,920
	22,770
	8,330
	14,440

Workings:

- (1) Opening capital. Inventory 8,600 + Trade receivables 3,900 + Prepaid 300 + Bank 2,300 + Cash 360 = 15,460 – Trade payables 7,400 – Accruals 210 = 7,850.
- (2) Cash drawings. Step (A) find cash received from sales. Trade receivables b/d 3,900 + Sales 128,000 – Trade receivables c/d 4,300 = 127,600 cash received.

Janet Lambert
Income Statement for the year ending 31 August 2019

Balance b/d		Labour	1,200
Sales receipts	360	Purchases	1,800
	127,600	Banked	116,900
		Drawings (difference)	7,730
		Balance c/d	330
	127,960		127,960

(c) Per text.

27.10	David Denton
	Income Statement for the year ending 31 December 2023
Work done: Credit accounts	29,863
For cash	3,418
	33,281
Less Expenses:	
Materials (9,600 – 580)	9,020
Secretarial salary	3,000
Rent (300 – 75)	225
Rates (180 – 45)	135
Insurance (800 – 200)	600
Electricity (1,122 + 374 estimated)	1,496
Motor expenses	912
General expenses (1,349 + 295)	1,644
Loan interest ($4,000 \times 10\% \times \frac{3}{4}$)	300
Increase in allowance for doubtful debts	425
Accounting fee	250
Depreciation of lease ($650 \times \frac{3}{4}$)	487
Depreciation: Equipment	960
Van (3,600/4)	900
Net profit	1,860
	20,354
	12,927

Balance Sheet as at 31 December 2023

<i>Non-current assets</i>	<i>Cost</i>	<i>Acc dep'n</i>
Lease	6,500	487
Equipment	4,800	960
Vehicle	3,600	900
	14,900	2,347
<i>Current assets</i>		
Inventory		580

Balance Sheet as at 31 December 2023 (continued)

Trade receivables (29,863 – 25,613)	4,250	
Less Allowance for doubtful debts	<u>425</u>	
Prepayments (75 + 200)	3,825	
Bank (see workings)	6,084	
Cash	<u>123</u>	10,887
		<u>23,440</u>
<i>Less Current liabilities</i>		
Trade payables	714	
Interest owing	300	
Accountancy fee owing	250	
Rates owing	135	
Electricity owing	<u>374</u>	1,773
Less Loan	<u>4,000</u>	<u>4,000</u>
		<u>(5,773)</u>
		<u>17,667</u>
<i>Financed by:</i>		
Capital		
Introduced (6,500 + 3,600)		10,100
Add Net profit		<u>12,927</u>
		<u>23,027</u>
Less Drawings (4,680 + 280 + 400)		<u>5,360</u>
		<u>17,667</u>
<i>Workings:</i>		
Bank (6,500 + 25,613 + 2,600 + 4,000) = 38,713 – 4,680 – 280 – 6,500		
– 300 – 3,000 – 8,886 – 4,800 – 1,122 – 912 – 1,349 – 800 = 6,084		

27.11
(a)

J. Duncan
Capital on 1 January 2018

Bank	8,000
Cash	300
Inventory	4,100
Machinery	12,600
Prepayments	200
Trade receivables	<u>6,300</u>
	<u>31,500</u>
Trade payables	2,400
Loan	<u>5,000</u>
	<u>(7,400)</u>
	<u>24,100</u>

(b)

J. Duncan
Income Statement for the year ending 31 December 2018

Sales	40,450
Less: Sales returns	<u>1,200</u>
	39,250
Less: Cost of Sales	
Opening inventory	4,100
Add: Purchases (18950 – 350 discounts)	<u>18,600</u>
	<u>22,700</u>
Less: Withdrawn by the owner	300
Less: Closing inventory	<u>3,200</u>
	<u>3,500</u>
	<u>19,200</u>
Gross profit	<u>20,050</u>
Less: Expenses	
Rent (1,400 + 200 + 250)	1,850
Bad debts written off	400
Wages	6,100
Insurance	1,450
Loan interest (300 + 100)	400
Depreciation	4,200
Repairs	300
Electricity	<u>750</u>
	<u>15,450</u>
Net profit	<u>4,600</u>

27.12

Workings:
Sales 26,000 – 250 + 14,000 + 400 – 6,300 + 5,000 + 1,200 + 400 = 40,450
Purchases 18,500 – 2,400 + 2,500 + 350 = 18,950
Depreciation = balancing figure.

J. Duncan
Balance Sheet as at 31 December 2018

<i>Non-current assets</i>	
Machinery at 1 January 2018	12,600
Add: Additions	7,500
Less: Depreciation (balancing figure)	<u>4,200</u>

J. Duncan
Balance Sheet as at 31 December 2018 (continued)

<i>Current assets</i>		
Inventory	3,200	15,900
Trade receivables	5,000	
Bank	2,600	
Cash	<u>50</u>	<u>10,850</u>
		<u>26,750</u>
<i>Current liabilities</i>		
Trade payables	2,500	
Accruals:		
Loan interest	100	
Rent	<u>250</u>	
	<u>350</u>	
<i>Non-current liabilities</i>		
Bank loan 8%	2,850	
	<u>5,000</u>	<u>(7,850)</u>
		<u>18,900</u>
<i>Capital account</i>		
Opening balance	24,100	
Add: Net profit	4,600	
Less: Drawings (9,500 + 300)	<u>9,800</u>	<u>18,900</u>

Answers to Scenario Questions

SQ1 (a)	Picta Simpla
<i>Income Statement for the year ending 30 June 2023</i>	
Sales	258,100
Less Cost of goods sold	
Opening inventory	19,250
Purchases	<u>185,850</u>
	<u>205,100</u>
Less: Closing inventory	<u>50,150</u>
Gross profit	154,950
Less Expenses	<u>103,150</u>
Wages	14,500
Advertising	15,500
Postage and packing	7,250
Rent	<u>12,000</u>
Insurance	2,850
Electricity	3,400
Depreciation	800
Stationery	<u>1,350</u>
Telephone	<u>3,450</u>
Net profit	<u>61,100</u>
	<u>42,050</u>

Appendix 1

(b) Your note should explain that the business is a separate entity from him and so the cost of having a holiday has nothing to do with the business, but must be treated as drawings. It should also explain that drawings represent the amount of business assets taken out of the business by the owner for the owner's, not the business's, use. Drawings are *never* an expense of the business.

SQ2	Sleazy Cars
(a)	<i>Balance Sheet as at 31 December 2022</i>
<i>Non-current assets</i>	
Land	5,000
Offices	500
Less Depreciation	<u>100</u>
Truck	<u>5,000</u>
Less Depreciation	<u>2,500</u>
	<u>7,900</u>
<i>Current assets</i>	
Inventory	21,000
Trade receivables and prepayments	1,900
Cash	<u>100</u>
	<u>23,000</u>
	<u>30,900</u>
<i>Current liabilities</i>	
Trade payables and accruals	8,600
Bank overdraft	<u>6,400</u>
	<u>15,000</u>
<i>Non-current liability</i>	
Net assets	<u>3,000</u>
<i>Capital</i>	
Opening balance*	15,500
Add Net profit*	<u>8,400</u>
	<u>23,900</u>
Less Drawings	<u>11,000</u>
	<u>12,900</u>
	<u>(18,000)</u>
	<u>12,900</u>
	<u>30,900</u>

*5,000 + 10,000 + 500 = 15,500

*23,500 – 500 – 100 – 3,000 – 2,500 – 500 – 2,000 – 400 – 5,000 – 1,500 + 400 = 8,400

[illegible]

(b) *Balance Sheet as at 30 June 2023*

<i>Non-current assets</i>	
Ladders and equipment	750
Less: Accumulated depreciation	<u>375</u>
	375
<i>Current assets</i>	
Cleaning materials and cloths	3,400
Trade receivables	110
Prepayments	50
Bank	<u>2,345</u>
Cash	<u>35</u>
	5,940
	<u>6,315</u>
<i>Current liabilities</i>	
Trade payables	100
Accruals	<u>320</u>
	(420)
	<u>5,895</u>
Capital	346
Opening Balance	<u>16,149</u>
Net profit	<u>16,495</u>
	10,600
	<u>5,895</u>
Less Drawings	

(c) Your letter should explain that consumables are items purchased with the intention of using them in the short term, after which they will either have been used up (e.g. printer ink) or no longer usable (e.g. carbon paper). The ladders do not fall into the category of consumables. They were purchased for use in the long term, in this case, more than one accounting period. As such, they are non-current assets and must be depreciated.

SQ5 (a)	B's Casuals
	<i>Income Statement for the year ending 30 June 2023</i>
Sales	260,040
Less: Cost of goods sold	
Opening inventory	21,500
Purchases	<u>68,500</u>
Carriage in	5,200
	<u>95,200</u>
Less: Closing inventory	<u>22,500</u>
	72,700
Gross profit	<u>187,340</u>

Less: Expenses	
Wages	24,500
Business rates	9,950
Bad debt	2,000
Advertising	1,040
Insurance	2,850
Electricity	3,400
Depreciation	15,800
Stationery	1,350
Telephone	<u>3,450</u>
	64,340
	<u>123,000</u>

(b) *Balance Sheet as at 30 June 2023*

<i>Non-current assets</i>	
Factory and Machinery	400,000
Less Acc dep'n	<u>115,000</u>
Computer	4,000
Less Acc dep'n	<u>2,400</u>
	285,000
	<u>1,600</u>
	286,600
<i>Current assets</i>	
Prepayments:	
Insurance	650
Telephone	200
Cash in hand	<u>600</u>
	1,450
	<u>288,050</u>
<i>Current liabilities</i>	
Trade payables	3,500
Rates Accrual	2,450
Electricity Accrual	500
Loan from Mrs Baldwin	<u>600</u>
	(7,050)
	<u>281,000</u>

<i>Capital</i>	
Opening balance	213,000*
Net profit	123,000
Less Drawings	<u>(55,000)</u>
	281,000
	<u>281,000</u>
*balancing figure	

(c) You need to explain how the accrual system operates and why it is used (see text Chapter 10). You also need to explain that drawings are assets withdrawn from the business for the owner's personal use, which is what his 'wages' and his home cinema system purchase are. Drawings are *never* expenses of a business.

28.1

Net profit for the year	278
Depreciation	69
Increase in inventory	(43)
Decrease in trade receivables	57
Decrease in trade payables	(38)
Net cash flow from operating activities	323

28.3

Disposal working:	£'000
Sale proceeds	60
Less Carrying amount disposed of (<i>balancing figure</i>)	(53)
Profit on disposal	7

Non-current assets at carrying amount working

Opening balance	635	Carrying amount disposed of (<i>above</i>)	53
Acquisitions (<i>the missing figure</i>)	101	Depreciation expense for year	96
	<u>736</u>	Closing balance	587
			<u>736</u>

28.5

Deepak Sharma

Statement of Cash Flows for the year ended 31 December 2025

<i>Cash flows from operating activities</i>	
Net profit for the year	16,560
Add Depreciation (<i>see working</i>)	6,360
Increase in inventory	(2,030)
Decrease in trade receivables	670
Decrease in trade payables	(3,320)
Net cash from operating activities	18,040
<i>Cash flows from investing activities</i>	
Purchase of property, plant & equipment (<i>see working</i>)	(10,450)
<i>Cash flows from financing activities</i>	
Drawings	(14,320)
Cash introduced by owner	<u>7,500</u>
Net cash used in financing activities	(6,820)
Net increase in cash	<u>770</u>
Cash at beginning of year	1,070
Cash at end of year	1,840

Workings:

	<i>Property, plant & equipment at cost</i>
Opening balance	61,140
Acquisitions (<i>the missing figure</i>)	<u>10,450</u>
	<u>71,590</u>
<i>Accumulated depreciation on property, plant & equipment</i>	
Opening balance	26,350
Closing balance	32,710
	<u>32,710</u>
	<u>32,710</u>

28.7

S. Ahmed

Statement of Cash Flows for the year ended 31 March 2024

<i>Cash flows from operating activities</i>	
Net profit for the year	20,980
Add Depreciation	7,490
Less Profit on disposal of non-current assets	(230)
Increase in inventory	(1,260)
Decrease in trade receivables	1,330
Increase in trade payables	<u>1,180</u>
Net cash from operating activities	29,490
<i>Cash flows from investing activities</i>	
Purchase of property, plant & equipment (<i>see workings</i>)	(13,940)
Proceeds from sale of property, plant & equipment	<u>1,900</u>
Net cash used in investing activities	(12,040)
<i>Cash flows from financing activities</i>	
Cash received from bank loan	3,750
Cash introduced by owner	<u>2,700</u>
Drawings	(18,640)
Net cash used in financing activities	(12,190)
Net increase in cash and cash equivalents	<u>5,260</u>
Cash and cash equivalents at beginning of year	(8,480)
Cash and cash equivalents at end of year	<u>(3,220)</u>
Note: Components of cash and cash equivalents	
Cash at bank and in hand	31/3/24 170
Bank overdrafts	(3,390)
Cash and cash equivalents	(3,220)

Workings:Disposal proceeds (*given in question*)Less Carrying amount of equipment sold (*missing figure in this calculation*)1,900
(1,670)Profit on disposal of equipment (*given in question*)230*Property, plant & equipment at carrying amount working*

Opening balance

1,670

Less Carrying amount of equipment sold

7,490

Depreciation charge for year

59,140

Closing balance

68,300**29.1 Balmgreen Bowling Club****Income and Expenditure Account for the year ending 31 December 2024**

Income

Collections at matches

17,200

Profit on refreshments

22,000

39,200

Less Expenditure

Rent for green (4,800 – 1,200)

3,600

Printing and stationery (200 + 80)

280

Secretary's expenses

320

Repairs to equipment

280

Groundsman's wages

16,000

Miscellaneous expenses

240

Depreciation of equipment (7,200 × 10%)

720

Surplus of income over expenditure

21,440

17,760**Balance Sheet as at 31 December 2024***Non-current assets*

Equipment (6000 + 1200 – 720)

6480

Current assets

Prepayment

1,200

Cash

21,76029,440*Current liabilities*

Expenses owing

(80)

Net assets

29,360*Financed by:*

Accumulated fund

Opening balance (6,000 + 5,600)

11,600

Add Surplus of income over expenditure

17,76029,360**29.3***(a)***Happy Haddock Angling Club****Income and Expenditure Account for the year ending 31 December 2018***Income:*

Subscriptions

3,500

Visitors' fees

650

Competition fees

820

Snack bar profit (see workings)

1,7506,720*Less Expenditure:*

Rent and rates

1,500

Secretarial expenses

240

Loan interest

260

Depreciation on games equipment

400

Surplus of income over expenditure

2,4004,320*Workings:* Snack bar profit: 6,000 – (800 + 3,750 – 900) – 600 = 1,750**(b) Balance Sheet as at 31 December 2018***Non-current assets*

Clubhouse buildings (12,500 + 8,000)

20,500

Games equipment

2,000

Less Depreciation

4001,60022,100*Current assets*

Snack bar inventory

900

Bank

7001,60023,700*Current liabilities*

Subscriptions received in advance

380

Loan from bank

5,500

(5,880)17,82017,82017,82017,82017,82017,82017,82017,82017,82017,82017,82017,82017,82017,82017,82017,82017,82017,820*Financed by:*

Accumulated fund

Opening balance (see workings)

13,500

Add Surplus for year

4,320*Workings:* 200 + 800 + 12,500 = 13,500

29.5		Balance Sheet as at 31 July 2023	
<i>(a)</i> Accumulated fund 1 August 2022		Non-current assets	
Equipment	975	Equipment at cost	1,420
Inventory of prizes	38	Less Accumulated depreciation	<u>640</u>
Arrears of subscriptions	65		780
Cash and bank	<u>210</u>	Current assets	
	1,288	Inventory of prizes	46
Less Subscriptions in advance	10	Arrears of subscriptions	<u>85</u>
Prizes suppliers	<u>58</u>		131
			<u>911</u>
<i>(b)</i>		Current liabilities	
<i>(i)</i>		Payable for prizes	68
In arrears b/d	10	Advance subscriptions	37
In advance c/d	1,987	Bank overdraft	<u>13</u>
Income and expenditure	<u>85</u>		(118)
	<u>2,082</u>	Accumulated fund	<u>793</u>
		Balance at start of year	1,220
		Less Excess of expenditure over income	<u>427</u>
<i>(ii)</i>			<u>793</u>
Competition prizes			
Inventory b/d	58	29.6	
Cash	46	<i>(a)</i>	
Payable c/d	<u>272</u>	Café operations:	
	<u>376</u>	Takings	4,660
		Less Cost of supplies:	
<i>(c)</i>		Opening inventory	800
Income and Expenditure Account for the year ending 31 July 2023		Add Purchases (1,900 + 80)	<u>1,980</u>
Income			2,780
Subscriptions	1,980	Less Closing inventory	<u>850</u>
Ticket sales	437		1,930
Less Cost of prizes	<u>272</u>	Wages	2,730
Donations received	165	Profit	<u>2,000</u>
	<u>2,322</u>	Sports equipment:	<u>730</u>
		Sales	900
Less Expenditure		Less Cost of goods sold:	
Rent (1,402 – 500)	902	Opening inventory	1,000
Visiting speakers' expenses	1,275	Add Purchases (1,000 × 50%)	<u>500</u>
Secretarial expenses	163		1,500
Stationery and printing	179	Less Closing inventory (<i>see note</i>)	<u>600</u>
Donations to charities	35	Profit	<u>300</u>
Depreciation	<u>195</u>		
Excess of expenditure over income	<u>427</u>		

Note: To find closing sports equipment inventory: 900 is sales at 50% mark-up on cost so cost of sales is 600. By arithmetical deduction closing inventory is found to be 900.

29.6 (cont'd)
(b)

<i>Subscriptions</i>		
Owing b/d	In advance b/d	120
	Cash: 2017	40
Income and expenditure	2018	1,100
	2019	80
In advance c/d	Owing c/d	80
		<u>1,420</u>
<i>Life Subscriptions</i>		
Income and expenditure	Balance b/d	1,400
(11 × 20)	Cash	200
Balance c/d		<u>1,380</u>
		<u>1,600</u>

(c) **Happy Tickers Sports & Social Club**
Income and Expenditure Account for the year ending 31 December 2018

<i>Income:</i>		
Subscriptions (1,280 + 220)		1,500
Profit on café operations		730
Profit on sports equipment		<u>300</u>
		<u>2,530</u>
<i>Less Expenditure</i>		
Rent		1,200
Insurance ($900 \times \frac{12}{18}$)		600
Repairs to roller ($\frac{1}{2} \times 450$)		225
Sports equipment net cost (see note 1)		486
Depreciation of roller ($\frac{1}{2} \times 200$)		<u>100</u>
Excess of expenditure over income		<u>2,611</u>
		<u>81</u>

Balance Sheet as at 31 December 2018

<i>Non-current assets</i>		
Share in motor roller at cost		1,000
Less Accumulated depreciation		<u>500</u>
Used sports equipment at valuation		<u>700</u>
		<u>1,200</u>
<i>Current assets</i>		
Inventory of new sports equipment (see note 2)		900
Inventory of café supplies		850
Subscriptions owing		80
Carefree Conveyancers: owing for expenses		225
Prepaid expenses (200 rent + 150 insurance)		<u>350</u>

Appendix 1

Balance Sheet as at 31 December 2018 (continued)

Cash and bank (see note 3)	754	<u>3,159</u>
		<u>4,359</u>
<i>Current liabilities</i>		
Café suppliers	80	
Advance subscriptions	<u>80</u>	160
<i>Non-current liabilities</i>		
Life subscriptions	<u>1,380</u>	(1,540)
		<u>2,819</u>
<i>Accumulated fund</i>		
Opening balance	2,900	
Less Excess of expenditure	<u>81</u>	
		<u>2,819</u>

Notes: Used Sports Equipment

1 Inventory b/d	700	Cash	14
Transferred from purchases	500	Income and expenditure a/c	486
		Inventory c/d	<u>700</u>
	<u>1,200</u>		<u>1,200</u>

2 b/d 1,000 + bought ($1,000 \times \frac{1}{2}$) 500 = 1,500 – sold 600 = 900

3 b/d 1,210 + receipts 6,994 – paid 7,450 = 754

(d) To most people probably the best description of the item would be 'deferred income', i.e. income paid in advance for future benefits.

It could, however, be described as a liability of the club. The club in future will have to provide and finance amenities for life members, but those members do not have to pay any more money for them. This is therefore the future liability to provide these services without further payment.

30.1

Jack's Books (dates ignored)
Joint Venture with Wellie

TVs	3,000	Sales	8,300
Repairs	1,600		
Profit and loss	405		
Cash to Wellie	<u>3,295</u>		
	<u>8,300</u>		<u>8,300</u>

31.1

31.3

Dunn and Outram		Current Account – Dunn		Current Account – Outram	
Profit and Loss Appropriation Account 2018		2018		2018	
Net profit	Dunn	Profit share	32,000	Profit share	45,000
Profit shared	Outram	Drawings	13,000	Bal b/d	13,000
		Bal c/d	45,000	Salary	30,000
				Interest on capital	3,500
				Profit share	24,250
					<u>70,750</u>
Profit and Loss Appropriation Account 2019		2019		2019	
Net profit	Dunn	Bal b/d	28,000	Bal b/d	13,000
Salaries	Outram	Drawings	42,750	Salary	30,000
		Bal c/d	45,000	Interest on capital	3,500
				Profit share	24,250
					<u>70,750</u>
Profit and Loss Appropriation Account 2020		2020		2020	
Net profit	Dunn	Bal b/d	5,750	Bal b/d	42,750
Salaries	Outram	Drawings	34,000	Salary	30,000
		Bal c/d	36,500	Interest on capital	3,500
				Profit share	76,250
					<u>110,000</u>
Profit and Loss Appropriation Account 2021		2021		2021	
Net profit	Dunn	Bal b/d	47,500	Bal b/d	36,500
Salaries	Outram	Drawings			
		Bal c/d			

31.4

Blair, Short and Steel		Appropriation Account for the year ending 31 December 2020	
Net profit b/d			111,100
Add Interest on drawings: Blair		400	
Short		300	
Steel		200	
			<u>900</u>
			112,000
Less Interest on capitals: Blair			
Short		3,000	
Steel		2,000	
		<u>1,500</u>	
			6,500
Salaries:			
Short		20,000	
Steel		<u>25,000</u>	
			45,000
Balance of profits			
Shared: Blair 70%		42,350	
Short 20%		12,100	
Steel 10%		<u>6,050</u>	
			60,500
			<u>60,500</u>
Balance sheet as at 31 December 2020 (extracts)			
Capital Accounts: Blair		100,000	
Short		50,000	
Steel		<u>25,000</u>	
			175,000
Current Accounts:			
Opening balances:	Blair	Short	Steel
Add Interest on capital	18,600	9,460	8,200
Salaries	3,000	2,000	1,500
Share of profits	20,000	25,000	25,000
	42,350	12,100	6,050
	<u>63,950</u>	<u>43,560</u>	<u>40,750</u>
Less Interest on drawings	400	300	200
Drawings	39,000	27,100	16,800
	<u>24,550</u>	<u>16,160</u>	<u>23,750</u>
			64,460

31.8

Considerations

(a) *Legal position re Partnership Act 1890*: Partners can agree to anything. The main thing is that of mutual agreement. The agreement can either be very formal in a partnership deed drawn up by a lawyer or else it can be evidenced in other ways. The Act lays down the provisions for profit sharing if agreement has not been reached, written or otherwise.

(b) As Bee is not taking an active part in the running of the business he could be registered as a limited partner under the 1907 Limited Partnership Act. This has the advantage that his liability is limited to the amount of capital invested by him; he can lose that but his personal possessions cannot be taken to pay any debts of the firm.

As Bee is a 'sleeping partner' you will have to decide whether his reward should be in the form of a fixed amount, or should vary according to the profits made. In this context you should also bear in mind whether or not he would suffer a share of losses if they occurred.

If he were to have a fixed amount, irrespective as to whether profits had been made or not, then the question arises as to the amount required. This is obviously a more risky investment than, say, government securities. He therefore would naturally expect to get a higher return.

Bee would probably feel aggrieved if the profits rose sharply, but he was still limited to the amounts already described. There could be an arrangement for extra payments if the profits exceeded a given figure.

Cee is the expert conducting the operations of the business. He will consequently expect a major share of the profits.

One possibility would be to give him a salary, similar to his current salary, before dividing whatever profits then remain.

(c) Dee is making himself available, as well as bringing in some capital. Because of this active involvement he will affect the profits made. It would seem appropriate to give him a salary commensurate with such work, plus a share of the profits.

(d) *Interest on capital:* Whatever is decided about profit sharing, it would seem appropriate for each of the partners to be given interest on their capitals before sharing the balance of the profits.

(e) Finally, it would be sensible to consider charging each partner interest on any drawings they take. This should deter partners from taking unnecessary drawings, and compensate the others if one partner takes out far more than the rest.

31.9

Frame and French

Income Statement and Profit and Loss Appropriation Account for the year ending 30 September 2023

Sales		363,111
Less Cost of goods sold:		
Opening inventory	62,740	
Add Purchases	210,000	
	<u>272,740</u>	
Less Closing inventory	74,210	198,530
Gross profit		<u>164,581</u>
Less Salaries and wages (57,809 + 720)	58,529	
Office expenses (4,760 + 215)	4,975	
Carriage outwards	3,410	
Advertising	620	
Bad and doubtful debts (1632 – 150)	1,482	
Loan interest	3,900	
Depreciation: Fixtures	600	
Buildings	<u>5,000</u>	78,516
Net profit		<u>86,065</u>
Add Interest on drawings: Frame	900	
French	<u>600</u>	1,500
Less Interest on capitals: Frame	5,000	87,565
French	<u>3,750</u>	
Salary: Frame	8,750	38,750
Balance of profits	<u>30,000</u>	<u>48,815</u>
Shared: Frame	29,289	
French	<u>19,526</u>	<u>48,815</u>

Balance Sheet as at 30 September 2023

<i>Non-current assets</i>	<i>Cost</i>	<i>Depn</i>
Buildings	210,000	55,000
Fixtures	<u>8,200</u>	<u>4,800</u>
	<u>218,200</u>	<u>59,800</u>
<i>Current assets</i>		
Inventory		74,210
Trade receivables	61,400	
Less Allowance for doubtful debts	<u>1,250</u>	<u>60,150</u>
Bank		<u>6,130</u>
		<u>140,490</u>
		298,890
<i>Current liabilities</i>		
Trade payables	26,590	
Accruals (215 + 720)	<u>935</u>	<u>27,525</u>
<i>Non-current liabilities</i>		
Loan from P. Prince		<u>65,000</u>
		<u>(92,525)</u>
		<u>206,365</u>
<i>Financed by</i>		
Capital Accounts: Frame	100,000	
French	<u>75,000</u>	<u>175,000</u>
<i>Current Accounts</i>		
Opening balances	<i>Frame</i> 4,100	<i>French</i> 1,200
Add Interest on capital	5,000	3,750
Salary	30,000	–
Balance of profit	<u>29,289</u>	<u>19,526</u>
	68,389	24,476
Less Drawings	31,800	28,200
Interest on drawings	<u>900</u>	<u>600</u>
	<u>35,689</u>	<u>(4,324)</u>
		<u>31,365</u>
		<u>206,365</u>

Sage and Onion

Balance Sheet as at 31 December 2020

<i>Non-current assets</i>			
Freehold – Cost			50,000
Fixtures and fittings – Cost			15,000
– Acc dep'n			<u>4,500</u>
			60,500
<i>Current assets</i>			
Inventory		68,000	
Trade receivables (52,400 – 2,400)		50,000	
Prepayments		200	
Bank		<u>31,600</u>	
			149,800
			<u>210,300</u>
<i>Current liabilities</i>			
Trade payables (33,300 + 3,000)		36,300	
Accruals		900	
VAT payable		<u>8,700</u>	
			(45,900)
			<u><u>164,400</u></u>
<i>Financed by</i>			
<i>Capital Accounts</i>			
Sage		100,000	
Onion		<u>50,000</u>	
			150,000
<i>Current Accounts</i>			
Balance b/d	Sage		
	Onion		
Interest on capital	2,000	(600)	
Interest on current account	5,000	2,500	
	100	(30)	
Salaries	12,000	8,000	
Profit	6,100	6,100	
Drawings/Int/Goods	(15,860)	(10,910)	
	<u>9,340</u>	<u>5,060</u>	
			14,400
			<u><u>164,400</u></u>

31.13

Kendall & Harvey
Income Statement and Appropriation Account for the year ended
31 July 2024

Sales	434,000
Less Cost of goods sold	
Opening inventory	38,300
Add Purchases	266,500
Less Closing inventory	42,900
Gross profit	261,900
Less Operating expenses	172,100
Staff wages	51,300
Electricity, water & gas (9,480 + 4,200)	13,680
Rent & rates (27,120 – 2,200)	24,920
Sundry expenses	3,726
Bad debts written off	13,400
Increase in allowance for doubtful debts (2,169 – 1,669)	500
Depreciation expense – Premises (225,000 × 2%)	4,500
Depreciation expense – Van ((42,000 – 21,420) × 30%)	6,174
Interest on loan (20,000 × 6%)	1,200
Net profit before appropriation	119,400
Add Interest on drawings	52,700
Kendall	170
Harvey	130
Less Salaries	300
Kendall	15,000
Harvey	10,000
Less Interest on capital	25,000
Kendall (140,000 × 5%)	7,000
Harvey (80,000 × 5%)	4,000
Residual profit shared:	11,000
Kendall ($\frac{5}{8}$)	17,000
Harvey ($\frac{3}{8}$)	6,375
	17,000

Kendall & Harvey
Balance Sheet as at 31 July 2024

	Cost	Acc Dep
<i>Non-current assets</i>		
Premises	225,000	40,500
Delivery van	42,000	27,594
	<u>267,000</u>	<u>68,094</u>
184,500		
14,406		
198,906		
<i>Current assets</i>		
Inventory	72,300	42,900
Trade receivables	2,169	70,131
Less Allowance for doubtful debts		2,200
Prepayments ($3,300 \times \frac{2}{3}$)		1,080
Cash at bank		<u>116,311</u>
Total assets		<u>315,217</u>
<i>Current liabilities</i>		
Trade payables	48,700	
Accruals	4,200	52,900
<i>Non-current liabilities</i>		
Loan		20,000
Total liabilities		<u>72,900</u>
		<u>242,317</u>
<i>Financed by:</i>		
<i>Capital accounts:</i>		
Kendall	140,000	Harvey
	<u>80,000</u>	<u>220,000</u>
<i>Current accounts:</i>		
Opening balances	22,939	9,678
Add Interest on loan	1,200	–
Add Interest on capital	7,000	4,000
Add Salaries	15,000	10,000
Add Share of residual profits	10,625	6,375
Less Drawings	(37,500)	(26,700)
Less Interest on drawings	(170)	(130)
Closing balances	<u>19,094</u>	<u>3,223</u>
		<u>22,317</u>
		<u>242,317</u>

32.1 (a)	Balance Sheet as at 31 March 2024			
Goodwill				
Other assets				24,000
				<u>100,000</u>
				<u>124,000</u>
				<u>37,200</u>
Capitals: Vantuira (30,000 + 7,200)				24,800
Aparecida (20,000 + 4,800)				<u>62,000</u>
Fraga (50,000 + 12,000)				<u>124,000</u>
(b)				
	Goodwill Workings			
Before	After	Loss or Gain	Action needed	
Vantuira $\frac{3}{10}$	7,200 $\frac{1}{2}$	12,000	Gain 4,800	Debit Vantuira 4,800
Aparecida $\frac{1}{5}$	4,800 $\frac{1}{8}$	3,000	Loss 1,800	Credit Aparecida 1,800
Fraga $\frac{1}{2}$	12,000 $\frac{3}{8}$	9,000	Loss 3,000	Credit Fraga 3,000
	<u>24,000</u>	<u>24,000</u>		
	Balance Sheet as at 1 April 2024			
Net assets				<u>100,000</u>
				<u>100,000</u>
				<u>25,200</u>
Capitals Vantuira (30,000 – 4,800)				21,800
Aparecida (20,000 + 1,800)				<u>53,000</u>
Fraga (50,000 + 3,000)				<u>100,000</u>
32.3 (a)				
Goodwill				
Capitals	Black	Dr	40,000	
	Smart	Cr		
		Cr		
Cash				
Capital	King	Dr	70,000	
		Cr		
(b)	Balance Sheet			
Goodwill				40,000
Non-current and current assets (other than cash)				<u>160,000</u>
Cash				<u>71,000</u>
				<u>271,000</u>
				<u>(41,000)</u>
Current liabilities				<u>230,000</u>
				<u>90,000</u>
Capitals	Black			70,000
	Smart			<u>70,000</u>
	King			<u>230,000</u>
(c)				
Capitals	Black	Dr	20,000	
	Smart	Dr	7,500	
	King	Dr	12,500	
Goodwill		Cr		40,000
32.5 (a)				
	Capital Accounts (£000)			
	Wilson	Player	Sharp	Titmus
	Bal b/d	57	76	38
	Cash			30
	Bal c/d	73	108	62
		<u>73</u>	<u>108</u>	<u>62</u>
		30	32	24
		<u>30</u>	<u>108</u>	<u>62</u>
				<u>30</u>
(b)	Goodwill 72,000; Other assets except cash 200,000; Cash 32,000; Capital as in (a); Trade payables 31,000.			
32.6	The senior partner's objection is a correct response. The money does not belong to the new partner once it has been paid.			
	This is because a new partner becomes an owner of part of the business, and this includes a part of the goodwill. This payment is specifically for that part of the goodwill. The goodwill was created by previous partners, and this is where the new partner buys his share from them. The £10,000 will be credited to the old partners in their old profit-sharing ratio.			
	If C, the new partner, has paid £10,000 for one-fifth of the goodwill, then total goodwill is £50,000. Should the business be sold at a future date, and the goodwill realise £50,000, then C would receive one-fifth of the proceeds, i.e. £10,000, thus getting his money back. This illustrates the fairness of the accounting treatment of his original payment for goodwill. If anything had been credited to his account from this original payment for goodwill then he would have received that in addition. Obviously this would be unfair.			
32.7 (a)				
	Stone, Pebble & Brick trading as Bigtime Building Supply Company			
	Profit and Loss Appropriation Account for the year ending 31 March 2019			
		Apr–Dec	Jan–Mar	
Net profit		27,225	9,075	
Less Interest on Stone's loan			385	
		<u>27,225</u>	<u>8,690</u>	
Less Interest on capitals: Stone			250	
Pebble			200	
Brick			125	
Less Salary: Brick			2,125	
			<u>5,990</u>	
Balance of profits shared:				
Stone		$\frac{1}{3}$ 9,075	$\frac{1}{2}$ 2,995	
Pebble		$\frac{1}{3}$ 9,075	$\frac{3}{10}$ 1,797	
Brick		$\frac{1}{3}$ 9,075	$\frac{1}{5}$ 1,198	
		<u>27,225</u>	<u>5,990</u>	

<i>(b)</i>		<i>Capitals</i>			
		<i>Stone</i>	<i>Pebble</i>	<i>Brick</i>	<i>Brick</i>
Goodwill adjustment*	2,000	6,000	Balances b/d	26,000	18,000
Transfer to loan	14,000	Goodwill adjustment*	8,000		
Balances c/d	20,000	16,000	10,000		
	<u>34,000</u>	<u>18,000</u>	<u>16,000</u>	<u>34,000</u>	<u>18,000</u>
		<i>Current Accounts</i>			
		<i>Stone</i>	<i>Pebble</i>	<i>Brick</i>	<i>Brick</i>
Drawings	8,200	9,600	7,200	Interest on capital	125
Balances c/d	4,120	1,472	5,323	Salary	2,125
				Share of profits:	
				Apr–Dec	9,075
				Jan–Mar	2,995
		<u>12,320</u>	<u>11,072</u>	<u>12,523</u>	<u>12,523</u>
<i>*Note:</i>		<i>Goodwill:</i>	<i>Value of goodwill taken over</i>	<i>Elimination of goodwill</i>	<i>Net effect</i>
		Stone	30,000	22,000	8,000 Cr
		Pebble	20,000	22,000	2,000 Dr
		Brick	16,000	22,000	6,000 Dr
			<u>66,000</u>	<u>66,000</u>	<u>–</u>
33.1		<i>Buildings</i>			
<i>(a)</i>		175,000	Balance c/d	250,000	
Balance b/d		75,000			
Revaluation: Increase		<u>250,000</u>		<u>250,000</u>	
		<i>Motor Vehicles</i>			
		43,000	Revaluation: Reduction	13,000	
Balance b/d		<u>43,000</u>	Balance c/d	30,000	
				<u>43,000</u>	
		<i>Inventory</i>			
		15,900	Revaluation: Reduction	1,900	
Balance b/d		<u>15,900</u>	Balance c/d	14,000	
				<u>15,900</u>	

<i>Office Fittings</i>					
Balance b/d	4,700	Revaluation: Reduction	1,700		
	<u>4,700</u>	Balance c/d	3,000		
			<u>4,700</u>		
		<i>Revaluation</i>			
Motor vehicles	13,000	Buildings	75,000		
Inventory	1,900				
Office fittings	1,700				
Profit on revaluation					
Cox	29,200				
Fox	17,520				
Lock	11,680				
	<u>75,000</u>				
		<i>Capitals</i>			
		<i>Cox</i>	<i>Lock</i>	<i>Cox</i>	<i>Lock</i>
Balances c/d	169,200	97,520	56,080	Balances b/d	140,000
					80,000
					44,400
		<i>Profit on revaluation</i>			
		29,200	17,520	11,680	
		<u>169,200</u>	<u>97,520</u>	<u>56,080</u>	
<i>(b)</i>		<i>Balance Sheet as at 1 January 2024</i>			
		<i>Non-current assets</i>			
Buildings at valuation				250,000	
Motor vehicles at valuation				30,000	
Office fittings at valuation				3,000	
				<u>283,000</u>	
		<i>Current assets</i>			
Inventory at valuation				14,000	
Trade receivables				22,200	
Bank				3,600	
				<u>39,800</u>	
				<u>322,800</u>	
		<i>Capitals:</i>			
Cox				169,200	
Fox				97,520	
Lock				56,080	
				<u>322,800</u>	

33.3

(a)		<i>Revaluation</i> *	
Premises	90,000	Premises	120,000
Plant	37,000	Plant	35,000
Inventory	62,379	Inventory	54,179
Allowance for doubtful debts	3,000		
Profit on revaluation			
Alan $\frac{1}{2}$	8,400		
Bob $\frac{1}{3}$	5,600		
Charles $\frac{1}{6}$	<u>2,800</u>		
		16,800	
		<u>209,179</u>	<u>209,179</u>

* Just the net increases/decreases could have been recorded. Either method is acceptable.

Goodwill			
Capitals: Alan	$\frac{1}{2}$	21,000	18,000
Bob	$\frac{1}{3}$	14,000	12,000
Charles	$\frac{1}{6}$	7,000	12,000
		<u>42,000</u>	<u>42,000</u>

Capitals

	<i>Alan</i>	<i>Bob</i>	<i>Charles</i>	<i>Don</i>		<i>Alan</i>	<i>Bob</i>	<i>Charles</i>	<i>Don</i>
Goodwill	18,000	12,000	-	12,000	Balances b/d	85,000	65,000	35,000	-
Retirement Cash					Goodwill	21,000	14,000	7,000	-
	21,000				Cash				79,000
Balances b/d	67,000	67,000		67,000					
	<u>106,000</u>	<u>79,000</u>	<u>42,000</u>	<u>79,000</u>		<u>106,000</u>	<u>79,000</u>	<u>42,000</u>	<u>79,000</u>

Current Accounts

Balance b/d	Alan	Bob	Charles	Don
Retirement		2,509		
Cash	9,023		7,478	
Balances c/d	<u>3,091</u>	<u>3,091</u>	<u>7,478</u>	<u>3,091</u>
	12,114	5,600	3,091	3,091

Charles: Retirement

Car	3,900	Capital	42,000
Cash	53,578	Current	7,478
Balance c/d	20,000	Loan	28,000
	<u>77,478</u>		<u>77,478</u>

		<i>Bank</i>	
Don: Capital	79,000	Balance b/d	4,200
Don: Current	3,091	Retirement – Charles	53,578
Balance c/d	5,710	Repaid Alan – Capital	21,000
	<u>87,801</u>	Current	9,023
			<u>87,801</u>
(b)			
Alan, Bob and Don			
Balance Sheet as at 30 June 2019			
<i>Non-current assets</i>			
Premises			120,000
Plant			35,000
Vehicles (15,000 – 3,900)			11,100
Fixtures			<u>2,000</u>
			168,100
<i>Current assets</i>			
Inventory		54,179	
Trade receivables (34,980 – 3,000)		31,980	
Cash		<u>760</u>	
			86,919
			<u>255,019</u>
<i>Current liabilities</i>			
Trade payables		19,036	
Bank overdraft		<u>5,710</u>	
		24,746	
Loan – Charles		<u>20,000</u>	
			44,746
			<u>210,273</u>
<i>Capital</i>			
Alan		67,000	
Bob		67,000	
Don		<u>67,000</u>	
			201,000
<i>Current account</i>			
Alan		3,091	
Bob		3,091	
Don		<u>3,091</u>	
			9,273
			<u>210,273</u>

33.5

(a)		Revaluation		
Capital account:		Freehold premises	2,000	
Gain on revaluation		Machinery and tools	900	
A	4,000	Investments	1,100	
B	4,000	Goodwill	8,000	
C	4,000		<u>12,000</u>	
	<u>12,000</u>			
		Bank		
Balance b/d	12,100	Capital account: A	18,900	
Capital account:		Balance c/d	9,200	
B	10,000			
C	6,000			
	<u>28,100</u>		<u>28,100</u>	
		Capital Accounts		
		A	B	C
Balance b/d	20,000	17,000	25,000	
Revaluation	4,000	4,000	4,000	
New capital		10,000	6,000	
Investment	(5,100)			
Bank	<u>(18,900)</u>			
			<u>31,000</u>	<u>35,000</u>
			NIL	

B and C

Balance Sheet as at 31 December 2020

<i>Non-current assets</i>			
Goodwill		16,000	8,000
Freehold premises		12,800	18,000
Machinery and tools		<u>9,200</u>	<u>16,000</u>
			<u>42,000</u>
<i>Current assets</i>			
Inventory			
Trade receivables			
Bank			
			<u>38,000</u>
			<u>80,000</u>
<i>Current liabilities</i>			
Trade payables			
			<u>(14,000)</u>
			<u>66,000</u>
<i>Financed by:</i>			
Capital Accounts – B			31,000
– C			<u>35,000</u>
			<u>66,000</u>

34.1

<i>Realisation</i>			
Buildings	150,000	Cash: Trade receivables	20,900
Tools and fixtures	11,600	Buildings	139,000
Trade receivables	22,300	Tools and fixtures	5,000
Cash: Expenses	1,950	Discounts	700
		Loss on realisation: Adrian	10,125
		Thomas	10,125
	<u>185,850</u>		<u>185,850</u>
<i>Capital Accounts</i>			
	<i>Adrian</i>	<i>Adrian</i>	<i>Thomas</i>
Loss on realisation	10,125	Balance b/d	108,000
Cash	97,875		
	<u>108,000</u>		<u>108,000</u>
<i>Cash</i>			
Balance b/d	1,800	Realisation expenses	1,950
Trade receivables	20,900	Trade payables	17,700
Buildings	139,000	Capitals: Adrian	97,875
Tools	5,000	Thomas	49,175
	<u>166,700</u>		<u>166,700</u>

34.2

<i>(a)</i>	<i>Realisation account</i>		
Non-current assets	185,000	Trade payables	8,900
Inventory	31,600	Pugh: vehicle taken over	22,000
Trade receivables	14,850	Bank (non-current assets)*	150,000
Bank (paid to payables)	8,624	Bank (inventory)	25,280
Bank (dissolution expenses)	1,951	Bank (receivables)	11,875
		Loss on realisation to capital a/cs:	
		Mears ^{5/10}	11,985
		Pugh ^{3/10}	7,191
		Stafford ^{2/10}	<u>4,794</u>
			<u>242,025</u>

*The 'fair value' of a non-current asset is essentially the price it could be sold for, which implies that £150,000 is the amount that would have been received. The 'value in use' is clearly not relevant here because the partnership is dissolving and the assets will definitely not be in use by the business!

(b)	Partners' capital accounts			
	Mears	Pugh	Stafford	
Current a/cs	19,500	-	-	Mears 25,000
Pugh: vehicle	-	22,000	-	Balances b/d 84,000
Loss on realisation	11,985	7,191	4,794	Current a/cs 31,704
M's deficiency cleared**	-	3,891	2,594	M's deficiency 6,485
Bank: to close	-	82,622	84,748	to be cleared -
	<u>31,485</u>	<u>115,704</u>	<u>92,136</u>	<u>31,485</u>
				<u>115,704</u>
				<u>92,136</u>

**Pugh 6,485 x 84/140 = 3,891; Stafford 6,485 x 56/140 = 2,594 (proportions based on the ratio of Pugh & Stafford's capitals as on the most recent balance sheet, as in *Garner v Murray*).

774

35.1

- (a) £175,000/£0.25 = 700,000 ordinary shares
 (b) £40,000/£2 = 20,000 preference shares
 (c) They must be irredeemable, because redeemable preference shares are always shown as a liability, not as equity.
 (d) £2 par value \times 6% = £0.12 annual dividend per share, paid in two instalments of 6p each; total dividend payment = £0.12 \times 20,000 shares = £2,400
 (e) Opening balance £364,000 + profit £104,000 – dividends £51,400 = £416,600
 (f) Preference dividends must be paid before ordinary dividends, in this case for 2022, 2023 & 2024; £2,400 \times 3 years = £7,200; total ordinary dividends = 700,000 shares \times £0.09 = £63,000; total dividend payments = £7,200 + £63,000 = £70,200
 (g) Dr Cash at bank £142,500, Cr Share capital £37,500, Cr Share premium £105,000

35.2

Gaspardo Ltd: Statement of Changes in Equity for the year ended 31 December 2024

	Share capital	Share premium	General reserve	Retained earnings	Total equity
Opening balance	50	97	42	198	387
Issue of shares	15	54	-	-	69
Profit for the year	-	-	-	61	61
Dividends paid	-	-	-	(28)	(28)
Transfer to general reserve	-	-	10	(10)	-
Closing balance	<u>65</u>	<u>151</u>	<u>52</u>	<u>221</u>	<u>489</u>

35.4

- (a)
 Opening balance of retained earnings
 + Profit for year (*missing figure deduced*)
 – Dividends paid
 Closing balance of retained earnings
 278,000
 74,000
 (33,000)
319,000
- (b) No. of ordinary shares = £100,000/£0.10 = 1,000,000; total ordinary dividend = 1,000,000 \times £0.05 = £50,000; preference dividend must be paid first = 100,000 \times £0.50 \times 5% = £2,500; total dividend payment of £50,000 + £2,500 = £52,500.
 (c) Dr Share premium £40,000, Cr Share capital £40,000
 (No. of ordinary shares before bonus issue = £160,000/£0.50 = 320,000; Bonus issue is 1-for-4 = 320,000 \times $\frac{1}{4}$ = 80,000 new shares of 50p each; 80,000 \times £0.50 = £40,000.)

(d)

Corporation tax payable

Tax paid in year (<i>missing figure</i>)	156,000	Opening balance	143,000
Closing balance	<u>154,000</u>	Tax expense for year	<u>167,000</u>
	<u>310,000</u>		<u>310,000</u>

35.5

	Loan notes in issue	Annual interest rate	Prorate by number of months in issue	Interest expense £
1 Jun 23 – 31 Mar 24	£7.2m	4.5%	\times 10/12	270,000
1 Oct 23 – 31 May 24	£2.2m	3.0%	\times 8/12	44,000
1 Apr 24 – 31 May 24	£4.2m	4.5%	\times 2/12	31,500
Total interest expense (or 'finance costs') in income statement for the year				<u>345,500</u>

35.9

Skipe plc: Statement of Changes in Equity for the year ended 31 July 2024

	Ordinary share capital	Preference share capital	Share premium	General reserve	Retained earnings	Total equity
Opening balance	90	50	46	20	190	396
Rights issue of shares ²	15	-	48	-	-	63
Bonus issue of shares ¹	21	-	(21)	-	-	-
Profit for the year	-	-	-	-	66	66
Transfer	-	-	-	15	(15)	-
Preference dividend paid ³	-	-	-	-	(3)	(3)
Ordinary dividends paid	-	-	-	-	(19)	(19)
Closing balance	<u>126</u>	<u>50</u>	<u>73</u>	<u>35</u>	<u>219</u>	<u>503</u>

¹Bonus issue was 1-for-5, so number of ordinary shares in issue immediately before bonus issue must have been $\frac{5}{6}$ ths of 504,000. Bonus issue was therefore 504,000 \times $\frac{1}{6}$ = 84,000 shares of 25p each = £21,000 new share capital.

²Immediately before bonus issue there were 504,000 – 84,000 = 420,000 ordinary shares in issue. Rights issue was 1-for-6, so number of ordinary shares before rights issue must have been $\frac{6}{7}$ ths of 420,000. Rights issue was therefore 420,000 \times $\frac{1}{7}$ = 60,000 ordinary shares of 25p each: 60,000 \times £0.25 = £15,000 share capital and 60,000 \times £0.80 = £48,000 share premium.

³Preference dividend = 50,000 shares \times £1 par value \times 6% = £3,000

Gas (19,914 + 3,956 accrual)
Business rates (19,987 – 3,780 prepayment)

Sundry operating expenses
Bad debt expense
Increase in allowance for doubtful debts
(2,808 *new allowance* – 1,885 *TB*)
Depreciation on plant & equipment (397,140 × 0.2)
Depreciation on IT equipment (227,120 – 70,440) × 0.35)

<i>Non-current assets</i>	
Plant & equipment	223,212
(397,140 – 94,500 – 79,428)	
IT equipment (276,120 – 70,440 – 71,988)	133,692

<i>Current assets</i>	
Inventory	19,994
Trade receivables ($93,600 - 2,808$)	90,792
Prepayments ($11,340 \times 4/12\ mths$)	3,780
Cash at bank	<u>357</u>
	114,923
Total assets	<u>471,827</u>

<i>Current liabilities</i>	
Trade payables	51,463
Accruals (1,455 interest + 3,956 gas)	5,411
Corporation tax payable	10,000

<i>Non-current liabilities</i>	
Loan notes	97,000
Total liabilities	<u>97,000</u>
	(163,874)

Net assets

307,953

<i>Equity</i>	
Ordinary share capital	133,000
Retained earnings	174,953
<i>(156,220 + 33,453 – 14,720 dividends)</i>	
Total equity	<u>307,953</u>

Sales revenue	504,079
Cost of sales (<i>working</i>)	<u>(213,539)</u>
Gross profit	290,540
Operating expenses (<i>working</i>)	<u>(230,668)</u>
Operating profit	59,872
Finance costs ($2,190 + 2,190$ <i>accrual</i>)	<u>(4,380)</u>
Profit before tax	55,492
Corporation tax expense	<u>(12,000)</u>
Profit for the year	<u>43,492</u>

<i>Working: Cost of sales</i>	
Opening inventory	16,955
Add Purchases	211,713
Add Carriage inwards	2,171
Less Closing inventory	(17,300)
	<u>213,539</u>

<i>Working: Operating expenses</i>	
Electricity (25,142 + 6,512 accrual)	31,654
Business rates (20,383 – 5,400 prepayment)	14,983
General operating expenses	70,571
Bad debt expense	14,302
Increase in allowance for doubtful debts (3,216 – 2,425)	791
Depreciation on equipment ((378,780 – 92,280) × 0.15)	42,975
Depreciation on delivery vans (276,960 × 0.2)	55,392
	<u>230,668</u>

<i>Non-current assets</i>	
Equipment (378,780 – 92,280 – 42,975)	243,525
Delivery vans	159,588
(276,960 – 61,980 – 55,392)	

<i>Current assets</i>	
Inventories	17,300
Trade receivables	77,184
$(80,400 - 3,216 \text{ allowance})$	
Prepayments $(8,100 \times 8/12 \text{ months})$	5,400
Cash at bank and in hand	<u>1,680</u>
Total assets	<u>101,564</u>
	<u>504,677</u>

Nartje Ltd
Balance sheet as at 31 May 2024

<i>Current liabilities</i>	
Trade payables	76,049
Accruals	8,702
(2,190 interest + 6,512 electricity)	
Corporation tax payable	12,000
	96,751
<i>Non-current liabilities</i>	
Loan notes	73,000
Total liabilities	(169,751)
Net assets	334,926
<i>Equity</i>	
Share capital	58,000
Retained earnings	276,926
(252,574 + 43,492 – 19,140 dividends)	
Total equity	334,926

36.5

Bishroo Ltd
Income statement for the year ended 30 June 2024

Sales revenue	1,152,126
Cost of sales (Note 1)	(531,065)
Gross profit	621,061
Other operating income	4,808
Operating expenses (Note 2)	(456,665)
Operating profit	169,204
Finance costs (105,000 × 0.05)	(5,250)
Profit before tax	163,954
Corporation tax expense	(36,000)
Profit for the year	127,954
Note 1: Cost of sales	
Opening inventory	52,814
Add Purchases	529,978
Less Closing inventory	(51,727)
	531,065
Note 2: Operating expenses	
Motor expenses (27,758 + 6,675 accrual)	34,433
Rent (22,145 – 5,750 prepayment)	16,395
Wages & salaries	149,776
Directors' remuneration	92,170

Audit fee	11,000
Bad debt expense	18,406
Increase in allowance for doubtful debts (4,128 new allowance – 3,109 TB)	1,019
Depreciation on premises (687,850 × 0.02)	13,757
Depreciation on machinery ((520,560 – 105,300) × 0.15)	62,289
Depreciation on computers (287,100 × 0.2)	57,420
	456,665

Bishroo Ltd

Balance sheet as at 30 June 2024

<i>Non-current assets</i>	
Premises (687,850 – 178,841 – 13,757)	495,252
Machinery	352,971
(520,560 – 105,300 – 62,289)	
Computers	168,720
(287,100 – 60,960 – 57,420)	
	1,016,943
<i>Current assets</i>	
Inventory	51,727
Trade receivables (103,200 – 4,128)	99,072
Prepayments (6,900 × 10/12 mths)	5,750
Cash at bank and in hand	1,711
Total assets	158,260
	1,175,203
<i>Current liabilities</i>	
Trade payables	89,260
Accruals	20,300
(2,625 interest + 6,675 + 11,000)	
Corporation tax payable	36,000
	145,560
<i>Non-current liabilities</i>	
Loan notes	105,000
Total liabilities	(250,560)
Net assets	924,643
<i>Equity</i>	
Ordinary share capital	115,000
Preference share capital	55,000
Share premium	49,000
Retained earnings	705,643
(633,739 + 127,954 – 56,050 divs)	
Total equity	924,643

36.7

Rambaldi Ltd
Income Statement for the year ended 31 December 2024

Sales revenue (9,078 – 172 returns inwards)	8,906
Cost of sales (Note 1)	(6,174)
Gross profit	2,732
Other operating income	131
Operating expenses (Note 2)	(2,037)
Operating profit	826
Finance costs (14 o/d int + 9 loan int (600 × 0.06 × 3/12 mths))	(23)
Profit before tax	803
Corporation tax expense	(248)
Profit for the year	555
Note 1: Cost of sales	
Opening inventory	519
Add Purchases	6,190
Less Returns outwards	(69)
Less Closing inventory	(466)
	6,174

Note 2: Operating expenses

Depreciation expense: buildings (2,640 × 0.05)	132
Depreciation expense: plant & equipment ((1,774 – 794) × 0.25)	245
Gas, electricity & water (418 + 62)	480
Insurance (107 – (57 × 4/12) prepaid)	88
Other operating expenses	909
Bad debts per TB	211
Decrease in allowance for doubtful debts (54 – 82, where 54 = 1,080 × 0.05)	(28)
	2,037

Rambaldi Ltd
Balance Sheet as at 31 December 2024

Non-current assets	
Land (800 TB + 700 increase in value)	1,500
Buildings (2,640 – 506 – 132)	2,002
Plant & equipment (1,774 – 794 – 245)	735
	4,237
Current assets	
Inventory	466
Trade receivables	1,026
(1,080 – 54 (54 being 5% of receivables))	
Prepayments (57 × 4/12 mths prepaid)	19
Cash in hand	6
	1,517
Total assets	5,754

Current liabilities	
Bank overdraft	126
(137 per TB – 11 receipt unrecorded)	
Trade payables	530
(519 per TB + 11 debit balance recovered)	
Accruals	71
(62 utilities + 9 int (600 × 0.06 × 3/12 mths))	
Corporation tax payable	248
	975
Non-current liabilities	
Bank loan	600
Total liabilities	(1,575)
Net assets	4,179
Equity	
Ordinary share capital	1,200
Share premium	955
Revaluation reserve (land cost 800; value 1,500; i.e. 700 increase)	700
Retained earnings (963 per TB + 555 profit – 194 divis)	1,324
Total equity	4,179

36.9

Unsworton plc

Income Statement for the year ended 31 December 2025

Revenue (9,585 – 308 returns inwards)	9,277
Cost of sales (Note 1)	(5,104)
Gross profit	4,173
Other operating income	378
Operating expenses (Note 2)	(4,364)
Operating profit	187
Finance costs (37 loan note int (Note 3) + 19 overdraft int)	(56)
Profit before tax	131
Corporation tax expense	(41)
Profit for the year	90
Note 1: Cost of Sales	
Opening inventory	478
Add Purchases	5,203
Add Carriage inwards	81
Less Returns outwards	(141)
(157 per TB – 16 credit note posted twice in error)	
Less Closing inventory	(517)
	5,104

<i>Note 2: Operating expenses</i>	
Staff wages & salaries	1,086
Marketing & advertising	639
Directors' remuneration	852
Depreciation expense: Buildings ($1,640 \times 0.025$)	41
Depreciation expense: Machinery ($((1,728 - 948) \times 0.15)$)	117
Audit fee	95
Rent & rates	788
($853 - 65$ prepaid (prepayment = $195 \times \frac{1}{3}$ mths = 65))	
Sundry operating expenses	599
Bad debts	147
	<u>4,364</u>
<i>Note 3: Loan note interest</i>	
1/1/25 to 31/3/25: $500 \times 0.08 \times 3/12$ months	10
1/4/25 to 31/12/25: $600 \times 0.06 \times 9/12$ months	27
<i>Total interest expense on loan notes incurred in financial year</i>	<u>37</u>
Loan note interest paid per TB	(28)
<i>Accrued loan note interest</i>	<u>9</u>

Unsworton plc
Balance Sheet as at 31 December 2025

<i>Non-current assets</i>		
Land	1,100	
Buildings ($1,640 - 760 - 41$)	839	
Machinery ($1,728 - 948 - 117$)	663	
	<u>2,602</u>	
<i>Current assets</i>		
Inventory	517	
Trade receivables ($922 - 7$ contra)	915	
Prepayments ($195 \times \frac{1}{3}$ mths paid in advance)	<u>65</u>	
Total assets		
<i>Current liabilities</i>		
Bank overdraft	222	
Trade payables	875	
(866 per TB + 16 credit note – 7 contra)		
Accruals (audit 95 + interest 9 (see Note 3))	104	
Corporation tax payable	<u>41</u>	
	1,242	
<i>Non-current liabilities</i>		
6% loan notes	600	
Total liabilities		(1,842)
Net assets		<u>2,257</u>

<i>Equity:</i>	
Ordinary share capital ($300 + 75$ bonus issue)	375
Share premium ($643 - 75$ bonus issue)	568
Revaluation reserve (land cost 692; valuation 1,100; i.e. increase 408)	408
Retained earnings (924 per TB + 90 profit – 108 divis)	<u>906</u>
Total equity	<u>2,257</u>
36.11	

Archara Ltd
Income Statement for the year ended 31 December 2024

Revenue ($3,804,900 - 76,300$)	3,728,600
Cost of sales (Note 1)	<u>(2,481,650)</u>
Gross profit	1,246,950
Other operating income	29,950
Operating expenses (Note 2)	<u>(1,172,300)</u>
Operating profit	104,600
Finance costs (Note 3)	<u>(31,700)</u>
Profit before tax	72,900
Corporation tax	<u>(17,600)</u>
Profit for the year	<u>55,300</u>
<i>Note 1: Cost of sales</i>	
Opening inventory	211,200
Purchases	2,534,400
Less Returns outwards ($50,700 - 6,750$ credit note overstated)	<u>(43,950)</u>
Less Closing inventory ($23 + 57 + 39 + 61$ at cost + 40 at NRV)	<u>(220,000)</u>
	<u>2,481,650</u>

<i>Note 2: Operating expenses</i>	
Sundry operating expenses	32,400
Wages & salaries	402,100
Directors' remuneration	220,100
Gas, electricity & water	78,300
Advertising & marketing ($173,400 + 18,000$ ($108,000/6$ months))	191,400
Insurance ($37,600 - 13,300$ ($22,800 \times 7/12$ months))	24,300
Bad debts expense	76,900
Additional bad debt write-off	22,000
Depreciation expense: Buildings ($(940,000 - 250,000$ land** ÷ 50 years))	<u>13,800</u>
Depreciation expense: Plant & equipment ($(764,000 - 320,000) \times 0.25$)	111,000
	<u>1,172,300</u>

** Freehold land is not depreciated.

36.13

Note 3: Finance costs
Overdraft interest paid
Interest expense on loan notes
(1/9/24 to 31/12/24: $600,000 \times 0.0375 \times 4/12$)

Archara Ltd
Balance Sheet as at 31 December 2024

Non-current assets		
Land & buildings		24,200
($940,000 - 96,600 - 13,800$)		7,500
Plant & equipment		<u>31,700</u>
($764,000 - 320,000 - 111,000$)		
		829,600
		333,000
		<u>1,162,600</u>
Current assets		
Inventory	220,000	
Trade receivables ($475,600 - 22,000$)	453,600	
Prepayments	13,300	
		<u>686,900</u>
Total assets		<u>1,849,500</u>
Current liabilities		
Bank overdraft	64,800	
Trade payables	363,550	
($356,800 + 6,750$ credit note overstated)	25,500	
Accruals	17,600	
($18,000$ marketing + $7,500$ interest)		471,450
Corporation tax payable		<u>600,000</u>
		(1,071,450)
Non-current liabilities		
Loan notes		<u>778,050</u>
Total liabilities		100,000
		202,300
		<u>475,750</u>
Net assets		
Equity		<u>778,050</u>
Share capital		
Share premium		
Retained earnings		
($434,450 + 55,300$ profit – $14,000$ dividends)		
Total equity		

Manuvra plc
Income Statement for the year ended 31 December 2024

Revenue	6,448
Cost of sales (Note 1)	<u>(3,452)</u>
Gross profit	2,996
Other operating income ($196 + 8$ profit on disposal (Note 2))	204
Operating expenses (Note 3)	<u>(2,882)</u>
Operating profit	318
Finance costs (Note 4)	<u>(86)</u>
Profit before tax	232
Corporation tax expense	<u>(66)</u>
Profit for the year	<u>166</u>
Note 1: Cost of sales	
Opening inventory	266
Add Purchases	3,469
Less Closing inventory	<u>(283)</u>
	<u>3,452</u>
Note 2: Profit on disposal	
Sales proceeds	25
Less Carrying amount at date of disposal	<u>(17)</u>
(48 cost – 31 acc dep ($48 \times 31/48$ mths = 31))	
Profit on disposal	<u>8</u>
Note 3: Operating expenses	
Staff wages	680
Bad debts per TB	127
Additional bad debt write-off (amount due from Halgate Ltd)	43
Directors' remuneration	562
Sundry operating expenses	995
Depreciation expense: Buildings ($1,350 \times 0.04$)	54
Depreciation expense: Fixtures & fittings	76
($(983 - 603) \times 0.2$)	
Depreciation expense: Vehicles (excl. sports car)	144
($(624 - 48) \times 0.25$)	
Depreciation expense: Sports car sold	5
($48 \times 0.25 \times 5/12$ mths))	<u>149</u>
Audit fee	114
Extra warehousing space ($123 \times 2/3$ mths)	<u>82</u>
	<u>2,882</u>

Note 4: Finance costs

Overdraft interest paid

Loan interest paid

Bank loan interest to be accrued:

1/11/24 – 31/12/24: $800 \times 0.03 \times 2/12 \text{ months}$

Manuvra plc

Balance Sheet as at 31 December 2024

Non-current assets

Property, plant & equipment (Note 5)

2,633

Current assets

Inventory

283

Trade receivables (731 + 28 cheque – 43 write off)

716

Total assets

999

Current liabilities

Bank overdraft (187 + 28 Halgate + 12 cheque)

227

Bank loan (first instalment)

160

Trade payables (442 – 12)

430

Accruals (audit 114 + rent 82 + int 4 (see Note 4))

200

Corporation tax payable

66

1,083

Non-current liabilities

Bank loan (final four instalments)

640

Total liabilities

(1,723)

Net assets

1,909

Equity:

Ordinary share capital

80

Share premium

322

Revaluation reserve (land cost 601; value 1,300; i.e. increase 699)

699

Retained earnings (727 per TB + 166 profit – 85 divis)

808

Total equity

1,909

Note 5: Property, plant & equipment

	Land	Buildings	F&F	Vehicles	Total
Cost at 1/1/2024	601	1,350	983	624	3,558
Disposals	-	-	-	(48)	(48)
Revaluation gain	699	-	-	-	699
Cost/valuation at 31/12/24	1,300	1,350	983	576	4,209
Accumulated dep'n at 1/1/2024	-	378	603	347	1,328
Dep'n expense for year (Note 3)	-	54	76	149	279
Acc dep on disposals*	-	-	-	(31)*	(31)
Accumulated dep'n at 31/12/2024	-	432	679	465	1,576
Carrying amount at 31/12/24	1,300	918	304	111	2,633

*Sports car owned 1 Nov 2021 to 1 June 2024 = 31 months; cost $48 \times 0.25/12 \text{ mths} \times 31 = 31$.

36.15

Xzibita Ltd

Income Statement for the year ended 31 December 2024

Sales revenue	7,854,270
Cost of sales (Note 1)	(4,719,760)
Gross profit	3,134,510
Other operating income (26,230 + 11,040 rent received error)	37,270
Operating expenses (Note 2)	(2,347,390)
Operating profit	824,390
Finance costs	(54,520)
(12,520 + 35,000 loan int paid + 7,000 accrued (Note 3))	
Profit before tax	769,870
Corporation tax expense	(158,090)
Profit for the year	611,780

Note 1: Cost of sales

Opening inventory	534,100
Purchases	4,761,450
Less Closing inventory (588,390 – 12,600 write-down*)	(575,790)
	4,719,760

* Inventory write-down:

Original cost	(700 coats × £90)	63,000
NRV	(700 coats × £160 normal price × 50% × 90%)	50,400
Write-down	(i.e. 700 coats × £18 write-down on each one)	12,600

Note 2: Operating expenses

Sundry operating expenses	350,744
Wages & salaries	909,693
Marketing (235,620 + 29,740 accrual)	265,360
Insurance (136,630 – 22,280 (53,472 × 5/12 months))	114,350
Bad debt expense	157,080
Debit balances on payables ledger written-off	3,890
Rent expense (33,120 + 11,040 rent received error)	44,160
Dep'n expense: property ((2,390,900 + 81,000) × 0.02)	49,438
Dep'n expense: plant & equipt ((3,823,100 – 2,012,400) × 0.25)	452,675
	2,347,390

Note 3: Unpaid loan interest to be accrued: $\text{£}800,000 \times 0.0525 \times 2/12 \text{ months} = \text{£}7,000$

37.1		Xzibita Ltd		
Balance Sheet as at 31 December 2024				
<i>Non-current assets</i>				
Property, plant & equipment (Note 4)				
<i>Current assets</i>				
Inventory (588,390 – 12,600)	575,790			
Trade receivables	1,321,895			
Prepayments (53,472 × 5/12 months)	22,280			
				3,334,795
Total assets				5,254,760
<i>Current liabilities</i>				
Bank overdraft	19,490			
Trade payables	730,040			
(726,150 + 3,890 debit b/ds w/o)				
Accruals	36,740			
(29,740 marketing + 7,000 interest)				
Corporation tax payable	158,090			
				944,360
Total liabilities				800,000
				(1,744,360)
Net assets				3,510,400
<i>Equity:</i>				
Share capital	50,000			
Share premium	299,540			
Retained earnings	3,160,860			
(2,829,380 + 611,780 – 280,300 divs)				
Total equity				3,510,400
Note 4: Property, plant & equipment	Property	Plant & equip't	Total	
Cost per trial balance	2,390,900	3,823,100	6,214,000	
Legal fees in connection with acquisition	81,000	-	81,000	
Cost as at 31/12/24	2,471,900	3,823,100	6,295,000	
Accumulated depreciation at 1/1/24	445,692	2,012,400	2,458,092	
Charge/expense for year	49,438	452,675	502,113	
Accumulated depreciation at 31/12/24	495,130	2,465,075	2,960,205	
Carrying amount at 31/12/24	1,976,770	1,358,025	3,334,795	
37.2		Sibir Ltd		
Statement of cash flows for the year ended 31 March 2024				
<i>Cash flows from operating activities</i>				
Operating profit	36,040			
Add Depreciation	10,270			
Increase in inventory	(6,610)			
Increase in trade receivables	(890)			
Decrease in trade payables	(4,370)			
Cash generated from operations	34,440			
Corporation tax paid (see working 1)	(8,760)			
Net cash from operating activities				25,680
37.3				
Corporation tax payable				
Corporation tax paid (missing figure)	13,100	Opening balance	12,200	
Closing balance	13,600	Corporation tax expense	14,500	
			26,700	
37.4				
Calculation of the carrying amount of the assets sold during the year:				
Disposal proceeds (given in question)	85,000			
Less Carrying amount of assets sold (missing figure deducted)	(97,400)			
Loss on disposal (given in question)	(12,400)			
Property, plant & equipment at carrying amount working sold (above)				
Opening balance	826,800	Carrying amount of assets	97,400	
Acquisitions (missing figure)	146,500	Depreciation charge for year	129,700	
		Closing balance	746,200	
			973,300	
37.5				
Proceeds from issue of shares (50,000 new shares × £0.80)	40			
Payments to redeem loan notes	(200)			
Proceeds from issue of loan notes	300			
Interest paid	(18)			
Net cash from financing activities				122
37.6				
Statement of cash flows for the year ended 31 March 2024				
<i>Cash flows from operating activities</i>				
Operating profit	36,040			
Add Depreciation	10,270			
Increase in inventory	(6,610)			
Increase in trade receivables	(890)			
Decrease in trade payables	(4,370)			
Cash generated from operations	34,440			
Corporation tax paid (see working 1)	(8,760)			
Net cash from operating activities				25,680

Sibir Ltd

Statement of cash flows for the year ended 31 March 2024

<i>Cash flows from investing activities</i>	
Payments to acquire property, plant & equipment (see working 2)	(37,610)
Interest received	50
Net cash used in investing activities	(37,560)
<i>Cash flows from financing activities</i>	
Proceeds from issue of share capital	2,770
Proceeds from new long-term borrowing	24,580
Interest paid	(1,290)
Dividends paid (see working 3)	(11,940)
Net cash from financing activities	14,120
<i>Net increase in cash</i>	2,240
Cash at beginning of year	750
Cash at end of year	2,990
<i>Working 1:</i>	
<i>Corporation tax payable</i>	
Corporation tax paid (missing figure)	8,760
Opening balance	7,040
Closing balance	9,400
	16,440

Working 2:

<i>Property, plant & equipment at carrying amount working</i>	
Opening balance	10,270
Acquisitions (missing figure)	73,350
Depreciation charge for year	100,690
Closing balance	110,960

Working 3:

<i>Retained earnings</i>	
Dividends paid (missing figure)	11,940
Opening balance	28,520
Closing balance	41,980
Profit for the year	25,400
	53,920

37.11

(a)

Rabada Ltd

Statement of cash flows for the year ended 31 January 2024

<i>Cash flows from operating activities</i>	
Operating profit	82,700
Add Depreciation	78,030
Less Profit on sale of property, plant & equipment (working 1)	(13,680)
Increase in inventory	(51,500)

Increase in trade receivables	(40,130)
Increase in trade payables	7,400
Cash generated from operations	62,820
Corporation tax paid (working 2)	(16,430)
Net cash from operating activities	46,390
<i>Cash flows from investing activities</i>	
Payments to acquire property, plant & equipment (working 3)	(249,870)
Proceeds from sale of property, plant & equipment	75,950
Interest received	460
Net cash used in investing activities	(173,460)
<i>Cash flows from financing activities</i>	
Proceeds from issue of share capital	10,000
Receipts from new long-term borrowings	87,220
Interest paid (working 4)	(7,520)
Net cash from financing activities	89,700
<i>Net decrease in cash and cash equivalents</i>	(37,370)
Cash and cash equivalents at beginning of year	2,100
Cash and cash equivalents at end of year	(35,270)
Note: Components of cash and cash equivalents	31/1/23
Cash at bank and in hand	1,150
Bank overdrafts	(36,420)
<i>Cash and cash equivalents</i>	<i>(35,270)</i>
<i>Working 1:</i>	
<i>Calculation of the profit/(loss) on the disposal from the equipment sold during the year:</i>	£
Disposal proceeds (given in question)	75,950
Less Carrying amount of equipment sold (given in question)	(62,270)
Profit on disposal	13,680
<i>Working 2:</i>	
<i>Corporation tax payable</i>	
Corporation tax paid (missing figure)	16,430
Opening balance	15,550
Closing balance	17,850
Corporation tax expense	34,280
<i>Working 3:</i>	
<i>Property, plant & equipment at carrying amount working</i>	
Opening balance	592,600
Carrying amount disposed of	62,270
Acquisitions (missing figure)	249,870
Depreciation charge for year	78,030
Closing balance	702,170
	842,470

Working 4:

<i>Accrued interest payable</i>	
Interest paid (<i>missing figure</i>)	7,520
Closing balance	1,370
	<u>8,190</u>
	<u>9,560</u>

Working 5:

<i>Retained earnings</i>	
Closing balance	469,520
	<u>56,240</u>
	<u>525,760</u>

(b) The picture presented by the statement of cash flows of Rabada Ltd gives possible cause for concern. The company appears to have expanded significantly during the year to 31 January 2024 and this has placed a significant strain on its cash position.

The cash generated from operations is less than the operating profit, despite a significant depreciation charge. Increases in inventory and trade receivables have been a major drain on the cash resources of the company. To a certain extent these increases presumably reflect an expansion in activity. More information is needed in relation to the revenue of previous years in order to understand the company's growth rate.

However, the expansion in inventory levels is so dramatic that there must be concern over the soundness of the purchasing policy and how quickly the goods can be sold. There may be an increased risk of obsolete stock that will ultimately need to be written down.

Similarly, the increase in trade receivables is huge. It is possible that the company has offered excessively generous credit terms in order to gain new customers, and there could be an increased risk of bad debts.

Even more troublingly, the increase in trade payables is very small compared to the movement in inventory and receivables. Trade payables are, of course, a free source of finance and it is mysterious why they have not increased in closer proportion with the increase in inventory. It is possible that the company's suppliers have insisted on more prompt payment, perhaps because they are aware that Rabada Ltd is having some liquidity issues.

Whatever the background reasons, the changes in working capital suggest a significant deterioration in the operating cash cycle of the company.

There has also been major investment in new property, plant and equipment. This investment should lead to the maintenance or enhancement of operating cash flows in the future. The sheer size of the investment would perhaps suggest that the new assets will indeed *enhance* future operating cash flows. Together with the changes in working capital, it does seem that Rabada Ltd is undertaking significant expansion.

The investment in new non-current assets has been mitigated by the sale of equipment for £75,950. Again, this suggests that the company is undertaking a major revamp of its operations and the new equipment will presumably be more efficient than the old. Further information regarding the nature of the assets bought and sold would be useful.

New shares were issued raising only £10,000. This is a relatively minor amount in the context of the company's cash flows, and may indicate some reluctance on the part of shareholders to invest further in this company. In contrast, £87,220 was raised from new long-term borrowing. This borrowing funded approximately half of the net investment in new non-current assets. It will cause interest payments to increase next year and beyond. It would be useful to know the rates of interest and repayment dates of the borrowing.

Interest paid in the year was covered several times by operating cash flows. As noted above, interest payments will increase next year; interest payments must always be met, regardless of whether the company can afford them. However, it seems likely that interest payments will continue to be comfortably covered by operating cash flows, especially if the rate of expansion slows and the movements in working capital become less of a drain on cash.

No dividends were paid in the year. This may cause some dissatisfaction amongst the shareholders, and a zero-dividend policy may not be sustainable in the future. However, more information is needed in relation to the past dividend policy of the company. It is possible that the absence of a dividend was a one-off this year because cash resources were low due to business expansion. Alternatively, it could be the policy of the company to not pay dividends and instead reinvest profits back into the business. Retained earnings make up a significant proportion of the company's equity, suggesting that it may possibly be the latter.

Overall, there has been a significant decrease in the company's cash and it ended the year with a bank overdraft of £36,420. This is concerning because overdrafts are an expensive form of borrowing, and it will further increase the interest burden next year. It must be hoped that the overdraft is being used for short-term cash management only.

It is difficult to draw firm conclusions purely based on one year's results. However, the prospects for Rabada Ltd seem uncertain. The company appears to have expanded rapidly and invested heavily in new non-current assets. If the expansion has been planned and judged wisely, then the company may still prosper in the years ahead. However, some of the trends indicated by this statement of cash flows, particularly in relation to working capital management, suggest that there may be underlying issues that need to be addressed.

38.1

Abby Lee

**Trading Account part of the Income Statement for the year ending
31 December 2024**

Sales	95,850
Less Cost of goods sold:	
Opening inventory	10,670
Add Purchases	<u>72,160</u>
	(D)
	<u>82,830</u>
	(C)
Less Closing inventory	<u>11,830</u>
	(B)
Gross profit	<u>71,000</u>
	(A)
	<u>24,850</u>

Missing figures found in the order (A) to (D).

(A) Mark-up is 35%. So sales represent 135% of cost.

$$95,850 \times \frac{35}{135} = 24,850$$

(B) $95,850 - 24,850 = 71,000$

(C) $71,000 + 11,830 = 82,830$

(D) $82,830 - 10,670 = 72,160$

38.3

(a) We know that

$$\frac{\text{Cost of goods sold}}{\text{Average inventory}} = \text{Rate of inventory turnover}$$

$$\text{Substituting } \frac{x}{29,000} = 8$$

$$x = \text{Cost of goods sold} = 232,000.$$

(b) If mark-up is 30%, gross profit is 30% of the cost of sales = 69,600.

(c) Turnover is (a) + (b) = 232,000 + 69,600 = 301,600.

(d) $65\% \times 69,600 = 45,240$.

(e) Gross Profit – Expenses = Net Profit = 24,360.

38.5

(a) Sales = 210,000 + (30% × 210,000) = 273,000.

(b) $50,000 - (9\% \times 260,000) = 26,600$.

$$(c) \frac{210,000}{(41,000 + 49,000) \div 2} = 4.67.$$

(d) Gross profit is 40% × 240,000 = 96,000.

Sales are 240,000 + 96,000 = 336,000.

Expenses are 9% of sales = 30,240.

Net profit = 96,000 – 30,240 = 65,760.

38.7

(a)

Capital		
Balance c/d	<div>5,000</div> <div>5,000</div>	Bank
		Balance b/d
		<div>5,000</div> <div>5,000</div>

Bank		
Capital	<div>5,000</div>	Cash
		Van
		Rent
		Balance c/d
	<div>5,000</div> <div>700</div>	
Balance b/d		<div>300</div> <div>3,500</div> <div>500</div> <div>700</div> <div>5,000</div>

Cash		
Bank	300	Sundry Expenses
Sales	300	Drawings
		Balance c/d
	<div>600</div> <div>50</div>	
Balance b/d		<div>50</div> <div>500</div> <div>50</div> <div>600</div>

Van		
Bank	<div>3,500</div> <div>3,500</div>	Balance c/d
Balance b/d	<div>3,500</div>	<div>3,500</div>

Purchases		
A. Supplier	<div>2,500</div>	Balance c/d
Balance b/d	<div>2,500</div> <div>2,500</div>	<div>2,500</div> <div>2,500</div>

A. Supplier		
Returns out	500	Purchases
Balance c/d	<div>2,000</div> <div>2,500</div>	
		Balance b/d
		<div>2,500</div> <div>2,000</div>

Sales		
Balance c/d	<div>1,300</div>	Cash
	<div>1,300</div>	B. Safe
		Balance b/d
		<div>300</div> <div>1,000</div> <div>1,300</div> <div>1,300</div>

B. Safe		
Sales	<div>1,000</div> <div>1,000</div>	Balance c/d
Balance b/d	<div>1,000</div>	<div>1,000</div> <div>1,000</div>

Returns out

Balance c/d	<u>500</u>	A. Supplier	<u>500</u>
	<u>500</u>	Balance b/d	<u>500</u>
		<i>Sundry Expenses</i>	
Cash	<u>50</u>	Balance c/d	<u>50</u>
	<u>50</u>		<u>50</u>
Balance b/d	<u>50</u>		
		<i>Rent</i>	
Bank	<u>500</u>	Balance c/d	<u>500</u>
	<u>500</u>		<u>500</u>
Balance b/d	<u>500</u>		
		<i>Drawings</i>	
Cash	<u>500</u>	Balance c/d	<u>500</u>
	<u>500</u>		<u>500</u>
Balance b/d	<u>500</u>		

(b)

L. Mann
Trial Balance as at 30 April

Bank	700	
Cash	50	
Van	3,500	
Purchases	2,500	
Trade receivables	1,000	
Sundry expenses	50	
Rent	500	
Drawings	500	
Capital		5,000
Trade payables		2,000
Sales		1,300
Returns out		<u>500</u>
		<u>8,800</u>

(c)

Income Statement for the month ending 30 April

Sales	1,300
Purchases	2,500
– Returns out	<u>500</u>
	2,000
– Closing inventory	<u>1,250</u>
Cost of sales	750
Gross profit	<u>550</u>
Less Expenses	
Sundry expenses	50
Rent	<u>500</u>
Net profit	<u>550</u>
	<u>0</u>

(d)

Balance Sheet as at 30 April

<i>Non-current assets</i>	
Van	3,500
<i>Current assets</i>	
Inventory	1,250
Trade receivables	1,000
Bank	700
Cash	<u>50</u>
	<u>3,000</u>
	<u>6,500</u>
<i>Current liabilities</i>	
Trade payables	(2,000)
	<u>4,500</u>
Capital	<u>5,000</u>
Less Drawings	<u>500</u>
	<u>4,500</u>

(e)(i) $\frac{550}{1,300} = 42.3\%$

(ii) $\frac{0}{5,000} = 0\%$

- (f) (i) As there has been neither a profit nor a loss, the £500 drawings are eating into capital. This is not a good sign. Drawings must not exceed net profit in the long term, or the business will fail.
- (ii) Working capital is £1,000. The current ratio is 1.5, which ought to be adequate, though this would need to be confirmed by comparison with other businesses operating in the same sector.

38.9 (a)

	2017	2018	2019
Opening inventory	10,000	21,000	25,000
Purchases	<u>70,000</u>	<u>86,000</u>	<u>77,000</u>
	80,000	107,000	102,000
Less Closing inventory	<u>21,000</u>	<u>25,000</u>	<u>23,000</u>
Cost of goods sold	<u>(59,000)</u>	<u>(82,000)</u>	<u>(79,000)</u>
Sales	<u>90,000</u>	<u>125,000</u>	<u>120,000</u>
Gross profit	<u>31,000</u>	<u>43,000</u>	<u>41,000</u>

(b) (i)

Gross profit/sales

2017	
$\frac{31,000}{90,000} = 34\%$	
2018	
$\frac{43,000}{125,000} = 34\%$	
2019	
$\frac{41,000}{120,000} = 34\%$	

(ii)

Inventory turnover = $\frac{\text{Cost of goods sold}}{\text{Average inventory}}$

2017	
$\frac{59,000}{(10,000 + 21,000) \div 2} = 3.8 \text{ times}$	
2018	
$\frac{82,000}{(21,000 + 25,000) \div 2} = 3.6 \text{ times}$	
2019	
$\frac{79,000}{(25,000 + 23,000) \div 2} = 3.3 \text{ times}$	

39.1 $\frac{595,000}{85,000} = 7 \text{ times}$

39.2 $\frac{49,000}{245,000} \times 100 = 20\%$

39.3 $\frac{159,800}{470,000} \times 100 = 34\%$

39.4 $\frac{31,520}{394,000} \times 100 = 8\%$

39.5 Current ratio = $(39 + 63 + 11)/(57 + 9) = 1.71:1$;
Acid test = $(63 + 11)/(57 + 9) = 1.12:1$

39.6 $\frac{78,000}{493,000} \times 365 = 57.7 \text{ days}$

39.7 $\frac{49,000}{396,000} \times 365 = 45.2 \text{ days}$

39.8

(a) $\frac{(i)}{(ii)} = \frac{248,000}{800,000} = 31 \text{ p}$

(b) $\frac{(iii)}{(a)} = \frac{3.72}{0.31} = 12$

(c) $\frac{(iv)}{(iii)} = \frac{0.16}{3.72} = 4.3\%$

(d) $\frac{(i)}{(v)} = \frac{248,000}{128,000} = 1.94 \text{ times}$

39.9

- (i) $43,300/355,200 \times 365 = 44.5 \text{ days}$
- (ii) $29,900/220,100 \times 365 = 49.6 \text{ days}$
- (iii) $30,800/223,600 \times 365 = 53.5 \text{ days}$
- (iv) Gross profit % = 38.0% ($355,200 - 220,100 = 135,100$;
 $135,100/355,200 = 38.0\%$)

39.10 Business J

(a) (i) Gross profit % $\frac{221,000}{472,000} \times 100 = 46.8\%$

(ii) Net profit % $\frac{38,000}{472,000} \times 100 = 8.1\%$

(iii) Expenses % $\frac{183,000}{472,000} \times 100 = 38.8\%$

Business K

$\frac{282,000}{695,000} \times 100 = 40.6\%$

$\frac{68,000}{695,000} \times 100 = 9.8\%$

$\frac{214,000}{695,000} \times 100 = 30.8\%$

(iv) Inventory turnover

$$\frac{251000}{(64000 + 51000) \div 2} = 4.4 \text{ times} \quad \frac{413000}{(62000 + 50000) \div 2} = 7.4 \text{ times}$$

(v) Return on capital

$$\frac{38,000}{(148,000 + 15,000) \div 2} = 25.4\% \quad \frac{68,000}{(221,000 + 209,000) \div 2} = 31.6\%$$

(vi) Current ratio

$$\frac{147,000}{66,000} = 2.23:1$$

(vii) Acid test ratio

$$\frac{83,000}{66,000} = 1.26:1$$

(viii) Trade receivable days

$$\frac{68,000}{472,000} \times 365 = 52.6 \text{ days} \quad \frac{123,000}{695,000} \times 365 = 64.6 \text{ days}$$

(ix) Trade payable days

$$\frac{66,000}{264,000} \times 365 = 91.3 \text{ days} \quad \frac{99,000}{401,000} \times 365 = 90.1 \text{ days}$$

(b) J earns a higher gross margin. Perhaps it sells higher price, premium or branded products, while K's strategy may be higher volume, lower price goods.

But K converts a higher percentage of sales into net profit, indicating that it has much better control of its running costs. K appears to own higher value equipment, which might be helping it operate more efficiently.

K turns over its inventory much faster again indicating it may be selling popular, low margin products. J's inventory level is also increasing, which suggests it is possible that it has some rather slow-moving items in stock. The current and acid test ratios for both businesses are fairly high. The high current ratio of J in particular again suggests that its inventory level may be excessive.

J is collecting money from customers in less than 2 months. Perhaps K has offered more generous credit terms in order to attract customers and boost sales.

But both companies appear to be taking 3 months to pay suppliers. If so, there is a danger that some suppliers might become disgruntled and refuse to sell to these businesses.

It would certainly help to know exactly what industry these two businesses operate in. Historic information concerning their performance over recent years would also be useful.

39.12

(a)

	2023	2024
Gross profit	150,000	210,000
Revenue	300,000	420,000
Cost of sales	150,000	210,000
Average inventory	$\frac{150,000}{(20,000 + 30,000)/2} = 6 \text{ times}$	$\frac{210,000}{(30,000 + 24,000)/2} = 7.8 \text{ times}$

2023

2024

Net profit*	$\frac{(20,000 + 5,000 \text{ int})}{(50,000 + 50,000)} = 25\%$	$\frac{(40,000 + 4,500 \text{ int}^{**})}{(70,000 + 40,000)} = 40.5\%$
Capital employed	$\frac{20,000 \times 365}{300,000} = 24 \text{ days}$	$\frac{40,000 \times 365}{420,000} = 35 \text{ days}$
Trade receivables	30,000	24,000
Sales	30,000	50,000
Current assets	30,000	50,000
Current liabilities	30,000	50,000
Current assets - inventory	$\frac{(20,000 + 20,000)}{30,000} = 1.3:1$	$\frac{(40,000 + 1,000)}{50,000} = 0.8:1$
Current liabilities	30,000	50,000

*This ratio has no single definition that is universally agreed upon; certain alternative answers may be acceptable.

**Assumes repayment of £10,000 was made halfway through the year.

(b) Methods Ng could adopt include:

- Collecting debts from customers faster
- Delaying payments to credit suppliers
- Reducing inventory levels
- Cost-cutting (i.e. reducing the level of various operating expenses)
- Postponing purchases of non-current assets
- Taking out additional long-term loans
- Investing more of his own money into the business

(c) Ng appears to have performed well in terms of profitability. For example, he has increased his sales by 40%, which has in turn enabled him to double his annual profit.

However, he has done less well in terms of liquidity. His trade receivables have doubled, and he also appears to have invested heavily in new non-current assets. This has put a significant strain on his cash flow, as evidenced by the sharp fall in his bank balance. The fact that he is struggling to pay his suppliers is a serious concern which could ultimately put him out of business.

It is possible that Ng has expanded too rapidly without having the necessary finance in place. He should postpone any further expansion of his business, consider using some of the methods described in (b) above to get his cash flow under control, and arrest the worrying decline in his liquidity.

39.13

(a) (i) Gross profit: Sales

$$\frac{50}{200} \times \frac{100}{1} = 25\%$$

$$\frac{70}{280} \times \frac{100}{1} = 25\%$$

(ii) Inventory turnover

$$\frac{150}{(50 + 20) \div 2} = 4.29$$

$$\frac{210}{(20 + 30) \div 2} = 8.4$$

(iii) Net profit: Sales

$$\frac{12}{200} \times \frac{100}{1} = 6\% \qquad \frac{20}{280} \times \frac{100}{1} = 7.14\%$$

(iv) Quick ratio

$$\frac{25}{25} = 1 \qquad \frac{33}{12} = 2.75$$

(v) Working capital (current ratio)

$$\frac{45}{25} = 1.8 \qquad \frac{63}{12} = 5.25$$

(vi) Net profit: Capital employed

$$\frac{12}{130} \times \frac{100}{1} = 9.23\% \qquad \frac{20}{191} \times \frac{100}{1} = 10.47\%$$

(b) (Brief answer, but you should write more in an exam)

- (i) No change.
(ii) Increase caused by lowering average inventory; also probably better sales management.
(iii) An increase in sales, without a larger increase in expenses, has led to a better return.
(iv) Issue of loan notes has improved the cash situation and therefore the quick ratio.
(v) Net current assets have increased largely due to issue of loan notes, although partly offset by non-current assets bought.
(vi) Increasing sales, good control of expenses, and better inventory turnover brought about better ROCE.

39.16

Joan Street
Income Statement for the year ending 31 March 2020

Sales		(W3)	240,000
Cost of sales			
Opening inventory	21,000		
Add Purchases	(W6)	174,000	
	(W7)	195,000	

Less Closing inventory	15,000	(W1)	180,000
Gross profit		(W2)	60,000
Sundry expenses		(W5)	38,400
Net profit		(W4)	21,600

Balance Sheet as at 31 March 2020

<i>Non-current assets</i>		(W9)	108,000
<i>Current assets</i>			
Inventory	15,000		
Trade receivables	(W8)	24,000	
Bank	(W14)	9,000	
		(W13)	48,000
			156,000
<i>Current liabilities</i>			
Net assets		(W13)	12,000
<i>Financed by:</i>		(W12)	144,000
Capital:			
Opening balance		(W11)	122,400
Add Net profit		(W10)	21,600
			144,000

Workings (could possibly find alternatives)

- (W1) As average inventory $21,000 + 15,000 \div 2 = 18,000$ and inventory turnover is 10, this means that cost of sales $= 18,000 \times 10 = 180,000$
(W2) As gross profit is 25% of sales, it must therefore be $33\frac{1}{3}\%$ of cost of sales
(W3) As (W1) is 180,000 and (W2) is 60,000 therefore sales $= (W1) + (W2) = 240,000$

(W4) Net profit $= 9\%$ of sales $= 21,600$

(W5) Missing figure, found by arithmetical deduction

(W6) and (W7) Missing figures – found by arithmetical deduction

(W8) $\frac{\text{Trade receivables (?)} \times 365}{\text{Sales}} = 36\frac{1}{2}, \text{ i.e.}$

$$\frac{? \times 365}{240,000} = 36\frac{1}{2}, \text{ by arithmetic}$$

$$\text{Trade receivables} = 24,000. \text{ Proof } \frac{24,000 \times 365}{240,000} = 36\frac{1}{2}$$

(W9) $45\% \times 240,000 = 108,000$

(W10) Knowing that net profit 21,600 is 15% of W10, so $W10 = 21,600 \times 100/15 = 144,000$

(W11) Missing figure

(W12) Put in after (W11)

(W13) If Net current assets ratio is 4, it means a factor of current assets 4, current liabilities 1 = Net current assets 3 which is $(W12 - W9) = 36,000$, current assets therefore:

$$4/3 \times 36,000 = 48,000$$

and current liabilities

$$1/3 \times 36,000 = 12,000$$

(W14) Is new missing figure.

(b) Question asked for two favourable aspects and two unfavourable aspects but four of each are given here

Favourable: Inventory turnover, liquidity, net current assets, net profit on sales

Unfavourable: Gross profit to sales, trade receivable collection, return on

capital employed, turnover to net capital employed.

(c) Drawbacks include:

- (i) No access to trends over recent years.
- (ii) No future plans etc. given.
- (iii) Each business is often somewhat different.
- (iv) Size of businesses not known.

39.18

- (a)
 - (i) Current ratio: by dividing current assets by current liabilities.
 - (ii) Quick assets ratio: by dividing current assets less inventory by current liabilities.
 - (iii) Return on capital employed (ROCE): can have more than one meaning. One in common use is net profit divided by capital plus long-term liabilities (e.g. loans), and shown as a percentage.
 - (iv) Return on shareholders' funds (ROSF): net profit divided by total equity, shown as a percentage.
 - (v) Trade receivable turnover: Trade receivables divided by sales multiplied by 365.
 - (vi) Trade payable turnover: Trade payables divided by purchases multiplied by 365.
 - (vii) Gross profit percentage: Gross profit divided by sales, expressed as a percentage.
 - (viii) Net profit percentage: Net profit divided by sales.
 - (ix) Inventory turnover: Cost of goods sold, divided by average inventory, expressed in days.

(b) This part of the question tests your ability to be able to deduce some conclusions from the information given. You have to use your imagination.)

First, an assumption, we do not know relative sizes of these two businesses. We will assume that they are approximately of the same size.

A has a higher current ratio, 2 to 1.5, but the quick assets ratio shows a much greater disparity, 1.7 to 0.7. As inventory is not included in the quick assets ratio, it can be deduced that B has relatively greater inventory. Expected also from these ratios is that A has high amounts of trade receivables, this being seen because trade receivable turnover is three times as great for A as for B. We are told that both businesses are retailers so it is somewhat surprising that both appear to be selling significant amounts on credit.

The return on shareholders' funds (ROSF) is much greater for A than for B, 30 per cent to 18 per cent, but the ROCE is not that different, 20 per cent to 17 per cent. This shows that A has far more in long-term borrowings than B. The ROCE indicates that A is somewhat more efficient than B, but not by a considerable amount.

Gross profit percentage is far greater for A than B, but net profit percentage is the same. Obviously, A has extremely high operating expenses per £100 of sales.

The last ratio shows that inventory in A lies unsold for twice as long a period as for B.

A summary of the above shows that A has lower inventory, a higher figure for trade receivables, sells at a slower rate, and has high operating expenses. B has more inventory, and sells its goods much quicker but at lower prices as shown by the gross profit percentage.

All the evidence points to A being a firm which gives emphasis to personal service to its customers. B on the other hand emphasises cheap prices and high turnover, with not as much concentration on personal service.

39.20 (There is no set answer. In addition, as a large number of points could be mentioned, the examiner cannot expect every aspect to be covered.)

The main points which could be covered are:

- (i) The financial statements are for last year whereas, in fact, the bank is more interested in what might happen to the business in the future.
- (ii) The financial statements are usually prepared on a historical cost basis. These therefore do not reflect current values.
- (iii) The bank manager would want a cash budget to be drawn up for the ensuing periods. This would give the manager an indication as to whether or not the business will be able to meet its commitments as they fall due.
- (iv) The bank manager wants to ensure that bank charges and interest can be paid promptly, also that a bank loan or overdraft will be able to be paid off. He will want to see that these commitments can still be met if the business has to cease operations. This means that the market value of assets on cessation, rather than the cost of them, is of much more interest to the bank manager.

To say that the financial statements are 'not good enough' is misleading. What the manager is saying is that the financial statements do not provide him with what he would really like to know. One could argue that there should be other types of financial statements drawn up in addition to those drawn up on a historic basis.

(c) The P/E ratio for Chinoso (C) is higher than for Paxorient (P). This suggests that the market may believe that shares in C are worth more than those of P relative to the profits that the companies are *currently* making. In other words, there may be a belief that the profits of C will rise in the next few years, or that those of P will fall. This is perhaps the single most important factor that might influence an investment decision.

However, the dividend yield for C is lower than P. In other words, for every £1 that Fu invests in shares, based on the current level of dividends he will earn a greater return by buying shares in P.

The dividend cover of P is also superior to C. If the profits of both companies were to fall then P has more headroom to be able to maintain the current level of dividend. However, the dividend cover of both companies is quite high so the fact that P's is slightly greater may not be hugely significant.

Annual interest payments for C appear to be £250,000 ($£5m \times 5\%$) but only £150,000 ($£2.5m \times 6\%$) for P. Interest must always be paid regardless of the level of profits, so the fact that P has a lesser commitment to interest charges is a positive sign: if the profits of both companies fall then it is less likely that P's reduced profits will be eaten up by interest payments. This is another indicator that future dividends from P are less at risk. However, the interest cover of both companies is reasonably good, so the difference is unlikely to be a major factor in the decision.

In conclusion, more research is necessary. Several of the indicators are in favour of P, but the higher P/E ratio of C suggests that the market believes that the future prospects for C may be better. It would be rash to make an investment recommendation based on such limited information.

39.25

(a) *The bank*

The bank will be interested in two main aspects. The first is the ability to repay the loan as and when it falls due. The second is the ability to pay interest on the due dates.

Mr Whitehall

He will be interested in the expected return on his investment. This means that recent performance of the company and its plans will be important to him. In addition the possible capital growth of his investment would be desirable.

(b) *Note:* For your information; more than four ratios for bank are given below despite you having being asked for four.

Bank

Long-term ability to repay loan

- (i) Shareholders' equity/Total assets
- (ii) Loan capital/Shareholders' equity
- (iii) Total liabilities/Shareholders' equity
- (iv) Operating profit/Loan interest.

Short-term liquidity

- (i) Liquid assets/Current liabilities.
- (ii) Current assets/Current liabilities.

Mr Whitehall

Return on investment

- (i) Price per share/Earnings per share
- (ii) Dividend per share/Market price per share
- (iii) Profit for the year/Dividends paid.
- (iv) Profit for the year/Number of ordinary shares in issue.

39.26

See text.

Answers to multiple-choice questions

Set 1 (pp. 85–88)

1 (C)	2 (D)	3 (B)	4 (C)	5 (A)
6 (C)	7 (C)	8 (A)	9 (C)	10 (A)
11 (B)	12 (D)	13 (B)	14 (D)	15 (B)
16 (C)	17 (C)	18 (A)	19 (D)	20 (C)

Set 2 (pp. 230–232)

21 (A)	22 (B)	23 (A)	24 (D)	25 (C)
26 (A)	27 (D)	28 (A)	29 (C)	30 (A)
31 (C)	32 (D)	33 (C)	34 (C)	35 (D)
36 (B)	37 (A)	38 (B)	39 (D)	40 (C)

Set 3 (pp. 358–360)

41 (B)	42 (C)	43 (B)	44 (D)	45 (B)
46 (A)	47 (C)	48 (A)	49 (B)	50 (C)
51 (A)	52 (D)	53 (C)	54 (C)	55 (D)
56 (C)	57 (A)	58 (A)	59 (B)	60 (C)

Set 4 (pp. 488–490)

61 (B)	62 (A)	63 (D)	64 (A)	65 (C)
66 (A)	67 (D)	68 (D)	69 (B)	70 (B)
71 (A)	72 (C)	73 (B)	74 (A)	75 (C)
76 (C)	77 (D)	78 (A)	79 (B)	80 (C)

Set 5 (pp. 715–717)

81 (C)	82 (C)	83 (C)	84 (D)	85 (A)
86 (B)	87 (B)	88 (B)	89 (A)	90 (D)
91 (A)	92 (C)	93 (D)	94 (D)	95 (C)
96 (D)	97 (C)	98 (B)	99 (D)	100 (B)

Glossary

Account (Chapter 2): Part of double entry records, containing details of transactions for a specific item.

Account payable (or creditor) (Chapter 1): A person or business to whom money is owed for goods or services. Also known as a trade payable.

Account receivable (or debtor) (Chapter 1): A person or business who owes money for goods or services. Also known as a trade receivable.

Accounting (Chapter 1): The process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information.

Accounting cycle (Chapter 15): The sequence in which data is recorded and processed until it becomes part of the financial statements at the end of the period.

Accounting equation (Chapter 1): A business's assets minus its liabilities must always be equal to its capital (or 'equity').

Accounting policies (Chapter 39): The principles, bases, conventions, rules and practices applied by a business that specify how the effects of transactions and other events are to be reflected in its financial statements.

Accounting standards (Chapter 10): The rules used by companies when preparing financial statements. Known as IASs and IFRSs.

Accounts (or final accounts) (Chapter 9): This is a term that was previously used to refer to statements produced at the end of accounting periods, such as the income statement and balance sheet. Nowadays, the term 'financial statements' is more commonly used.

Accrual basis (or Accruals concept) (Chapter 10): The concept that profit is the difference between income earned in the period and the expenses incurred in generating that income.

Accrued expense (Chapter 22): An expense for which the benefit has been received but which has not been paid for by the end of the period. It is included in the balance sheet under current liabilities as 'accruals'.

Accrued income (Chapter 22): Income (normally) from a source other than the main source of business income, such as rent receivable on an unused office in the company headquarters, that was due to be received by the end of the period but which has not been received by that date. It is added to trade receivables in the balance sheet.

Accumulated depreciation (Chapter 21): The total amount of depreciation that has been charged on a non-current asset since it was first acquired.

Accumulated fund (Chapter 29): A form of capital account for a non-profit-oriented organisation.

Acid test ratio (Chapter 39): A ratio comparing current assets excluding inventory with current liabilities.

Adjusting event (Chapter 36): A event that occurs after the end of the reporting period (but before the financial statements are finalized for issue) that provides additional evidence of conditions that existed at the balance sheet date, and therefore requires figures in the financial statements to be changed.

Allowance for doubtful debts (Chapter 19): An account representing an estimate of the expected amount of debts at the date of the balance sheet which may not be collected.

- Assets** (Chapter 1): Resources owned/controlled by a business.
- Audit fee** (Chapter 35): The fee paid by a company to the external auditors for carrying out the annual audit.
- Auditors (external)** (Chapter 35): Independent accountants who review a company's financial statements and its underlying financial records each year, and give an opinion on whether they believe the financial statements give a true and fair view of the company's financial affairs.
- Average cost method (AVCO)** (Chapter 18): A system of valuing items in a business's inventory at their average cost price, i.e. based on a mix of older and newer prices.
- Bad debt** (Chapter 19): A debt that a business will not be able to collect.
- Balance brought down** (Chapter 5): The difference between the two sides of an account that is entered below the totals on the opposite side to the one on which the balance carried down was entered. (Normally abbreviated to 'balance b/d'.)
- Balance carried down** (Chapter 5): The difference between the two sides of an account that is entered above the totals and makes the total of both sides equal each other. (Normally abbreviated to 'balance c/d'.)
- Balance sheet** (Chapter 1): A statement showing the assets, liabilities and capital of a business. Sometimes known as a statement of financial position.
- Balance-off the account** (Chapter 5): Insert the difference (called a 'balance') between the two sides of an account and then total and rule off the account. Normally done at the end of a period (usually a month, a quarter or a year).
- Bank cash book** (Chapter 12): A cash book that only contains entries relating to payments into and out of the business's bank account.
- Bank reconciliation statement** (Chapter 24): A calculation comparing the business's cash book balance with its bank statement balance.
- Bank statement** (Chapter 12): A document produced by a bank for a customer showing the receipts and payments in and out of that customer's bank account.
- Bonus issue** (Chapter 35): Where a component of a company's equity is converted into share capital, and the new shares that are created are then given away free to the existing shareholders in proportion to their current shareholdings.
- Bookkeeping** (Chapter 1): The process of recording data relating to business transactions in the accounting records.
- Books of original entry** (Chapter 11): Books where the first entry recording a transaction is made. (Sometimes referred to as 'books of prime entry'.)
- Business entity concept** (Chapter 10): Assumption that only transactions that affect the business, and not the owner's private transactions, will be recorded in the business records.
- Called-up share capital** (Chapter 35): The element of the issued share capital that the shareholders have, so far, been asked by the company to pay for.
- Capital** (Chapter 1): The total of resources invested and left in a business by its owner. Always equal to its assets minus its liabilities.
- Capital expenditure** (Chapter 20): When a business spends money to either buy, or enhance the earning capacity of, non-current assets.
- Carriage inwards** (Chapter 9): Cost of transporting goods into a business.
- Carriage outwards** (Chapter 9): Cost of transporting goods out to the customers of a business.
- Carrying amount** (Chapter 21): The amount at which an item is shown (or 'carried') in the financial statements. Most commonly used in the context of non-current assets, where an asset's carrying amount is its cost minus the accumulated depreciation that has so far been charged on that asset.

- Cash and cash equivalents** (Chapter 28): A business's cash in hand, balances in its bank accounts, plus cash held in the form of very short-term investments.
- Cash book** (Chapter 12): A book of original entry for cash and bank receipts and payments.
- Cash discount** (Chapter 12): Prompt payment discount.
- Casting** (Chapter 25): Adding up figures.
- Close off the account** (Chapter 5): Totalling and ruling off an account on which there is no outstanding balance.
- Compensating error** (Chapter 25): Where two separate errors of equal amount cancel each other out.
- Confirmatory value** (Chapter 10): The ability of information to provide feedback to users regarding the accuracy of their previous expectations and assessments.
- Consistency** (Chapter 10): The idea that similar items should be accounted for in a similar way in one set of financial statements, and from one period to the next.
- Contra** (Chapter 12): A contra, for cash book items, is where both the debit and the credit entries are shown in the cash book, such as when cash is paid into the bank.
- Control account** (Chapter 23): An account which checks the arithmetical accuracy of a ledger.
- Corporate bonds** (Chapter 35): Loan notes.
- Corporation tax** (Chapter 35): The tax that a UK company must pay on its profits.
- Cost of sales** (Chapter 7): The cost of the goods sold during a period. For a simple trading business, it is equal to its opening inventory plus its purchases during the period minus its closing inventory.
- Credit** (Chapter 2): The right-hand side of an account in double entry.
- Credit note** (Chapter 14): A document sent to a customer showing the allowance given by a supplier in respect of unsatisfactory or returned goods.
- Creditor** (or **trade payable**) (Chapter 1): A person or business to whom money is owed for goods or services supplied.
- Current assets** (Chapter 1): Short-term assets of a business that continuously fluctuate as a result of trading activity, such as inventory, trade receivables, prepayments, and cash.
- Current liabilities** (Chapter 1): Liabilities to be paid for within a year of the date of the balance sheet.
- Current ratio** (Chapter 39): A ratio comparing current assets with current liabilities.
- Day books** (Chapter 11): Books in which credit sales, purchases, and returns inwards and outwards of goods are first recorded. The details are then posted from the day books to the ledger accounts.
- Debentures** (Chapter 35): Loan notes.
- Debit** (Chapter 2): The left-hand side of an account in double entry.
- Debit note** (Chapter 14): A document sent to a supplier showing the allowance to be given for unsatisfactory/returned goods.
- Debtor** (or **trade receivable**) (Chapter 1): A person or business who owes money to a business for goods or services supplied to them.
- Depreciable amount** (Chapter 21): The total amount that is to be expensed over a non-current asset's useful life, normally being equal to its original cost minus its estimated residual value.
- Depreciation** (Chapter 21): The systematic allocation of a non-current asset's original cost minus its residual value over its estimated useful life.
- Diminishing balance method** (Chapter 21): Reducing balance method.

- Direct method** (Chapter 28): The presentation of the operating activities section of a statement of cash flows which shows the cash received from customers minus the cash paid to suppliers and employees.
- Directors** (Chapter 35): Senior managers appointed by shareholders to run the company for them.
- Directors' remuneration** (Chapter 35): The value of salary and benefits paid to the directors of a company.
- Discounts allowed** (Chapter 12): A deduction from the amount due, given by a business to customers who pay their accounts promptly, within a certain time period.
- Discounts received** (Chapter 12): A deduction from the amount due, given to a business by a supplier when an invoice is paid promptly, within a certain time period.
- Dishonoured cheque** (Chapter 24): A cheque which the writer's bank has refused to make payment upon.
- Dissolution** (Chapter 34): When a partnership firm ceases operations and its assets are disposed of.
- Dividend cover** (Chapter 39): The number of times that the dividends for the year could be covered by the net profit for the year that was available for distribution.
- Dividend yield** (Chapter 39): The percentage annual return earned by shareholders on their shares, measured as the annual dividend divided by the current share price.
- Dividends** (Chapter 35): The amount given to shareholders as their share of the profits of the company.
- Double entry bookkeeping** (or **Double entry**) (Chapter 2): A system where each transaction is entered twice, once on the debit side and once on the credit side.
- Drawings** (Chapter 4): Funds or goods taken out of a business by the owners for their private use.
- Dual aspect concept** (Chapter 10): The idea that every transaction has two effects, and these must be represented in the business's books with equal debit and credit entries.
- Earnings per share** (Chapter 39): The net profit for the year available for distribution to the ordinary shareholders divided by the number of ordinary shares in issue.
- Equity** (Chapter 1): Another name for the capital of the owner.
- Equity shares** (Chapter 35): Ordinary shares.
- Error of commission** (Chapter 25): Where a correct amount is entered, but in the wrong person's account.
- Error of omission** (Chapter 25): Where a transaction is completely left out of the books.
- Error of original entry** (Chapter 25): Where an item is entered, but both the debit and credit entries are the same incorrect amount.
- Error of principle** (Chapter 25): Where an item is entered in the wrong type of account, e.g. an asset is recorded in an expense account.
- Estimation techniques** (Chapter 39): The methods adopted in order to arrive at estimated monetary amounts for items that appear in the financial statements.
- Exempted businesses** (Chapter 16): Businesses which do not have to add VAT to the price of goods and services supplied by them. They cannot obtain a refund of VAT paid on goods and services purchased by them.
- Expenses** (Chapter 4): The value of all the assets that have been used up during the period in the pursuit of earning income.
- Extended trial balance** (Chapter 22): A document that begins with the business's initial trial balance and adds additional columns to record all the necessary adjustments and show the final trial balance. Usually produced using spreadsheet software.

- Factoring** (Chapter 14): Selling the rights to the amounts owing by debtors to a finance company for an agreed amount (which is less than the figure at which they are recorded in the accounting books because the finance company needs to be paid for providing the service).
- FIFO** (Chapter 18): A method of inventory valuation in which the first items to be received are assumed to be the first to be sold.
- Final accounts** (or **accounts**) (Chapter 9): This is a term previously used to refer to statements produced at the end of accounting periods, such as the income statement and the balance sheet. Nowadays, the term 'financial statements' is more commonly used.
- Financial statements** (Chapter 9): The more common term used to refer to statements produced at the end of accounting periods, such as the income statement and the balance sheet (sometimes referred to as 'final accounts' or simply 'the accounts').
- Financial year** (Chapter 10): The period for which the financial statements of a business have been prepared. Also known as the reporting period.
- Financing activities** (Chapter 28): The third section of the statement of cash flows, representing payments and receipts to and from providers of the business's long-term finance.
- Fixed capital accounts** (Chapter 31): Partners' capital accounts which consist only of the amounts of capital actually paid into the partnership.
- Fixed costs** (Chapter 39): Expenses which remain constant whether activity rises or falls, within a given range of activity.
- Float** (Chapter 13): The opening balance of a business's petty cash at the start of each period, normally fixed at a specific amount (such as £50, £100 or £200).
- Fluctuating capital accounts** (Chapter 31): Partners' capital accounts where the balances change from one period to the next.
- Folio columns** (Chapter 12): Columns used for entering reference numbers.
- Garner v Murray rule** (Chapter 34): If one partner is unable to make good a deficit on his/her capital account, the remaining partners will share the loss in proportion to their last agreed capitals, not in the profit/loss sharing ratio.
- Gearing** (Chapter 39): The ratio of long-term loans and preference shares shown as a percentage of total shareholders' funds, long-term loans, and preference shares.
- General ledger** (Chapter 11): A ledger for all accounts other than those for customers and suppliers. Also known as the nominal ledger.
- Going concern assumption** (Chapter 10): The assumption that a business is to continue for the foreseeable future, with no intention, or need, to close down.
- Goodwill** (Chapter 32): An amount representing the added value to a business of such factors as its customer loyalty, its reputation, and the skill of its staff.
- Gross loss** (Chapter 7): Where the cost of goods sold exceeds the sales revenue.
- Gross profit** (Chapter 7): Where the sales revenue exceeds the cost of goods sold.
- Historical cost concept** (Chapter 18): Transactions are recorded at their original transaction price, which means that assets will normally be shown at their original cost price in the balance sheet.
- IASB** (Chapter 10): The International Accounting Standards Board. The body that issues IASs and IFRSs.
- Impairment loss** (Chapter 21): The amount by which the carrying amount of an asset exceeds its value to the business.
- Impersonal accounts** (Chapter 11): All accounts other than debtors' and creditors' accounts.
- Imprest system** (Chapter 13): A system where a refund is made of the total petty cash paid out in a period in order to restore the float to its original agreed level.

- Income and expenditure account** (Chapter 29): An account for a non-profit-oriented organisation to find the surplus or loss made during a period.
- Income statement** (Chapter 7): The financial statement in which the calculations of gross profit and then net profit are presented.
- Incomplete records** (Chapter 27): A general term used to describe any situation where a full set of double entry records does not exist for a particular business.
- Indirect method** (Chapter 28): The presentation of the operating activities section of a statement of cash flows that converts a business's profit figure into its net cash from operating activities by means of various adjustments.
- Input VAT** (Chapter 16): VAT incurred on goods and services purchased by a business.
- Intangible non-current assets** (Chapter 21): Long-life assets used by a business that cannot be seen or touched, such as patents, trademarks, and the business's reputation.
- Interest on capital** (Chapter 31): An amount at an agreed rate of interest which is credited to a partner based on the amount of capital contributed by him/her.
- Interest on drawings** (Chapter 31): An amount at an agreed rate of interest, based on the drawings taken out, which is debited to the partners.
- Inventory** (Chapter 1): Goods in which the business normally deals that are held with the intention of resale. They may be finished goods, partly finished goods, or raw materials awaiting conversion into finished goods which will then be sold.
- Inventory turnover** (Chapter 38): The number of times inventory is sold in an accounting period. (Also known as 'stockturn'.)
- Investing activities** (Chapter 28): The second section of the statement of cash flows, representing payments to acquire, and receipts from selling, long-term assets.
- Invoice** (Chapter 14): A document produced by the selling business, sent to the buyer, detailing the goods/services provided and the amount to be paid.
- Irrecoverable debts** (Chapter 19): Bad debts.
- Issued share capital** (Chapter 35): The share capital that has been issued to shareholders. Also known as the allotted share capital.
- Joint ventures** (Chapter 30): Business agreements under which two businesses join together for a set of activities and agree to share the profits.
- Journal** (Chapter 15): A book of original entry for all transactions that are not contained in the other books of original entry.
- Liabilities** (Chapter 1): The amounts owed by a business at any particular point in time.
- LIFO** (Chapter 18): A method of inventory valuation by which goods sold are assumed to have come from the last batch of goods received.
- Limited company** (Chapter 35): An organisation owned by its shareholders, whose liability is limited to their share capital.
- Limited partner** (Chapter 31): A partner whose liability is limited to the capital he or she has put into the firm.
- Liquidity ratios** (Chapter 39): Those ratios that relate to the assessment of a business's ability to pay its liabilities when due.
- Loan note** (Chapter 35): Loan made to a company for which a formal certificate has been issued to the lender by the company.
- Loan stock** (Chapter 35): Loan notes.
- Margin** (Chapter 38): Profit stated as a percentage of selling price.
- Mark-up** (Chapter 38): Profit stated as a percentage of cost price.

- Matching concept** (Chapter 10): The idea that the profit for the period is calculated by matching the income earned in the period against the expenses incurred earning that income. Also known as the accrual basis.
- Materiality** (Chapter 10): A piece of accounting information is material if leaving it out of the financial statements, or misstating it, could influence the decisions of users of those financial statements. Materiality therefore largely depends on the size of the item omitted or the size of the mistake.
- Memorandum joint venture account** (Chapter 30): A memorandum account outside the double entry system where the information contained in all the joint venture accounts held by the parties to the joint ventures are collated, the joint venture profit is calculated and the share of profit of each party is recorded in order to close off the account.
- Money measurement concept** (Chapter 10): The concept that accountants will only record items if they can be measured in monetary terms, and if those measurements can be made with a sufficient degree of reliability.
- Narrative** (Chapter 15): A description and explanation of a transaction recorded in the journal.
- Net book value** (Chapter 21): The cost of a non-current asset minus the accumulated depreciation on that asset. Also known as carrying amount.
- Net current assets** (Chapter 22): Current assets minus current liabilities. The figure represents the net amount of resources the business has in a form that is readily convertible into cash. Also known as working capital.
- Net loss** (Chapter 7): Where the cost of goods sold plus expenses is greater than the revenue.
- Net profit** (Chapter 7): Where sales revenue plus other income, such as rent received, exceeds the sum of cost of goods sold plus other expenses.
- Net realisable value** (Chapter 18): The value of assets calculated as their expected selling price minus any expenses expected to be incurred before their sale is completed.
- Nominal accounts** (Chapter 11): The accounts in the nominal (or general) ledger.
- Nominal ledger** (Chapter 11): Another name for the general ledger.
- Non-adjusting event** (Chapter 36): A significant event that occurs after the end of the reporting period (but before the financial statements are finalized for issue) that doesn't provide additional evidence of conditions that existed at the balance sheet date, and therefore doesn't require figures in the financial statements to be changed.
- Non-current asset register** (Chapter 21): A detailed list, maintained separately from the ledger accounts, of all the business's non-current assets. Also known as the fixed asset register or the asset register.
- Non-current assets** (Chapter 1): Assets which have a long life bought with the intention to use them in the business and not with the intention to simply resell them.
- Non-current liabilities** (Chapter 8): Liabilities that do not have to be paid within 12 months of the date of the balance sheet.
- Notes to the financial statements** (Chapter 36): A series of pieces of information, organized in a logical fashion, that give additional detail in relation to the figures in the financial statements.
- Obsolescence** (Chapter 39): Becoming out-of-date and no longer useful.
- Offsetting** (Chapter 10): Reporting an asset and a liability (or an item of income and an expense) as a single net figure in the financial statements. In general, offsetting should be avoided in financial statements.
- Operating activities** (Chapter 28): The first section of the statement of cash flows, representing the net cash generated as a result of the main revenue-producing activities of the company.
- Ordinary shares** (Chapter 35): Shares entitled to dividends after the preference shareholders have been paid their dividends. Also known as equity shares.

- Output VAT** (Chapter 16): VAT charged by a business on the goods and services it sells.
- P/E (price-earnings) ratio** (Chapter 39): For any particular company, the current market price of one of its shares divided by the earnings per share.
- Paid-up share capital** (Chapter 35): The element of the called-up share capital that the shareholders have, so far, paid.
- Par value** (Chapter 35): The face value on a share in a company (such 5p, 25p or £1) which does not change. Also known as the nominal value.
- Partnership** (Chapter 31): A business in which two or more people are working together as owners with a view to making profits.
- Partnership salaries** (Chapter 31): Agreed amounts payable to partners in respect of duties undertaken by them.
- Personal accounts** (Chapter 11): Accounts for each of the business's individual credit suppliers and credit customers.
- Petty cash book** (Chapter 13): A book that records the business's payments and receipts of notes and coins.
- Posting** (Chapter 12): The act of transferring information into ledger accounts from books of original entry.
- Predictive value** (Chapter 10): The ability of information to help users to improve their predictions of future outcomes.
- Preference shares** (Chapter 35): Shares that are entitled to an agreed rate of dividend before the ordinary shareholders receive anything.
- Prepaid expense** (Chapter 22): An expense which has been paid in advance, the benefits from which will be received in the next period. Included in the balance sheet under current assets as 'prepayments'.
- Private limited company** (Chapter 35): A limited company that must issue its shares privately, i.e. not to the general public.
- Profit** (Chapter 3): The result of income exceeding expenses.
- Profit and loss account** (Chapter 7): A ledger account in which net profit is calculated.
- Provision** (Chapter 36): A liability where there is significant uncertainty over how much will have to be paid and when.
- Prudence concept** (Chapter 18): A certain degree of caution should be applied when making accounting estimates. This will help ensure that profits and assets are not overstated in the financial statements.
- Public limited company** (Chapter 35): A company that can issue its shares to the wider public, and for which there is no maximum number of shareholders.
- Purchased goodwill** (Chapter 32): The difference between the amount paid to acquire a business as a going concern and the book value of the net assets of that business.
- Purchases** (Chapter 3): Goods bought by the business with the prime purpose of selling them again.
- Purchases day book** (Chapter 11): Book of original entry for credit purchases. Also called the purchases journal.
- Purchases ledger** (Chapter 11): A ledger containing an account for each one of a business's credit suppliers.
- Realisation concept** (Chapter 10): Only profits and gains realised at the date of the balance sheet should be included in the income statement. For a gain to be realised, it must be possible to be reasonably certain that it exists and that it can be measured with sufficient reliability.

- Receipts and payments account** (Chapter 29): A summary of the cash book of a non-profit-oriented organisation.
- Reduced rate (of VAT)** (Chapter 16): A lower VAT rate applicable to certain goods and services.
- Reducing balance method** (Chapter 21): A method of calculating depreciation based on the principle that the annual charge is equal to a fixed percentage of the carrying amount of the non-current asset in question.
- Reporting period** (Chapter 36): The period of time for which a set of financial statements is produced. Often known as the business's financial year.
- Reserves** (Chapter 35): Components of a company's equity other than its share capital.
- Residual value** (Chapter 21): The net amount expected to be received when a non-current asset is put out of use by the business.
- Retained earnings** (Chapter 35): A component of a company's equity that records the accumulated profits it has made, minus the accumulated amount of dividends that have been paid to its shareholders, since it began trading. Also known as retained profits.
- Return on capital employed** (Chapter 39): Net profit as a percentage of capital employed, often abbreviated as ROCE.
- Return on owners' equity** (Chapter 39): Net profit as a percentage of a company's total equity (ordinary share capital plus all reserves) often abbreviated as ROOE. Also known as 'return on shareholders' funds'.
- Return on shareholders' funds** (Chapter 39): Net profit as a percentage of a company's total equity (ordinary share capital plus all reserves) often abbreviated as ROSF. Also known as return on owners' equity.
- Returns inwards** (Chapter 9): Goods returned to the business by its customers. (Also known as 'sales returns'.)
- Returns inwards day book** (Chapter 14): Book of original entry for goods returned by customers. Also called the returns inwards journal or the sales returns book.
- Returns outwards** (Chapter 9): Goods returned by a business to its suppliers. (Also known as 'purchases returns'.)
- Returns outwards day book** (Chapter 11): Book of original entry for goods returned to suppliers. Also called the returns outwards journal or the purchases returns book.
- Revaluation account** (Chapter 33): An account used to record gains and losses when a partnership's assets are revalued.
- Revaluation reserve** (Chapter 35): A component of a company's equity that records the gain that is recognized if a company's non-current assets are revalued upwards and recorded at their current market value (or 'fair value').
- Revenue** (Chapter 4): The financial value of goods and services sold to customers.
- Revenue expenditure** (Chapter 20): Expenses incurred on the day-to-day running costs of the business, such as wages, salaries, rent, advertising, and repairs & maintenance.
- Rights issue** (Chapter 35): An issue of new shares for cash to the existing shareholders in proportion to their current shareholdings.
- Sale or return** (Chapter 18): Goods passed to a customer on the understanding that a sale will not occur until they are paid for.
- Sales** (Chapter 3): The value of goods and services sold by the business in the course of its regular trading operations.
- Sales day book** (Chapter 11): Book of original entry for credit sales. Also called the sales journal.
- Sales ledger** (Chapter 11): The set of all the individual accounts for each of a business's credit customers.

- Share premium** (Chapter 35): The excess above par value that was paid for shares when they were issued by a company.
- Shareholders** (Chapter 35): Individuals or entities holding one or more shares in a company.
- Shares** (Chapter 35): The division of the ownership of a limited company into parts.
- Sole proprietor** (Chapter 1): A business that is owned by a single individual and is not a company. Usually a small business.
- Sole trader** (Chapter 1): Sole proprietor.
- Stakeholders** (Chapter 1): The range of groups, entities or individuals who have some sort of interest in a particular business and will therefore read its financial statements.
- Standard cost** (Chapter 18): What the business expects an item of inventory to cost.
- Standard rate** (of VAT) (Chapter 16): The VAT rate usually used.
- Standard-rated business** (Chapter 16): A business that charges VAT at the standard rate on its sales.
- Statement of affairs** (Chapter 27): A statement from which the capital of the owner can be found by estimating its assets and liabilities.
- Statement of cash flows** (Chapter 28): A financial statement showing how cash has been generated and spent by the business. Layout is regulated by IAS 7.
- Statement of changes in equity** (Chapter 35): A statement reconciling the opening and closing carrying amounts of each component of a company's equity.
- Statement of comprehensive income** (Chapter 36): A financial statement that builds upon the profit reported by a company in its income statement by adding or subtracting unrealized gains and losses (such as gains on the revaluation of its property).
- Statement of financial position** (Chapter 8): Balance sheet.
- Statement of profit or loss** (Chapter 6): Income statement.
- Stocktaking** (Chapter 18): The process of physically identifying the inventory on hand at a given point in time.
- Straight line method** (Chapter 21): A system of charging the same amount of depreciation every period over the estimated useful life of a non-current asset.
- Substance over form** (Chapter 10): Financial events should be presented in the financial statements in line with their actual impact rather than their technical or legal form.
- Sum of the years' digits method** (Chapter 21): A system of calculating depreciation whereby the charge for the year is determined using a formula that includes the sum of the digits that represent each year of the asset's estimated useful life (e.g. a three-year life would be $1 + 2 + 3 = 6$).
- Super profits** (Chapter 32): Net profit less the opportunity costs of alternative earnings and alternative returns on capital invested that have been foregone.
- Suspense account** (Chapter 26): An account that is used temporarily, either to force the trial balance to agree or when the bookkeeper doesn't yet know where to post one side of a transaction.
- T-account** (Chapter 2): A common format for presenting each account in the ledgers.
- Time interval concept** (Chapter 10): Financial statements are prepared at regular intervals.
- Trade discount** (Chapter 14): A discount off the full selling price given when one business sells to another. Trade discounts never appear anywhere in the ledger accounts.
- Trade payables** (Chapter 1): Amounts owed to credit suppliers. Also known as trade creditors or accounts payable.
- Trade payables/purchases ratio** (Chapter 39): A ratio assessing how long a business takes to pay its credit suppliers.

- Trade receivables** (Chapter 1): Amounts due from credit customers. Also known as trade debtors or accounts receivable.
- Trade receivables/sales ratio** (Chapter 39): A ratio assessing how long it takes a business's credit customers to pay their debts.
- Trading account** (Chapter 7): An account in which gross profit is calculated that is part of the income statement.
- Transposition error** (Chapter 25): Where the digits within a number are entered in the wrong sequence by mistake.
- Trial balance** (Chapter 6): A list of account titles and their balances in the ledgers, on a specific date, shown in debit and credit columns.
- True and fair view** (Chapter 39): The expression that is used by auditors to indicate whether, in their opinion, the financial statements fairly represent the financial performance and position of a company.
- Uncredited lodgements** (Chapter 24): Money that has been received by the business and entered in its cash book but which hasn't yet been processed through the banking system and therefore hasn't yet appeared on the business's bank statements. Also known as uncredited deposits.
- Units of production method** (Chapter 21): A system of calculating depreciation whereby the charge for the period is determined in proportion to some measure of the actual usage or output from the non-current asset in question.
- Unpresented cheques** (Chapter 24): Cheque payments that have been made by the business and entered in its cash book but which haven't yet been processed through the banking system and therefore haven't yet appeared on the business's bank statements.
- Value added tax (VAT)** (Chapter 16): A tax charged in the UK on the supply of most goods and services.
- Variable costs** (Chapter 39): Expenses which change in response to changes in the level of activity.
- Working capital** (Chapter 22): Current assets minus current liabilities. The figure represents the net amount of resources the business has in a form that is readily convertible into cash. Same as net current assets.
- Work in progress** (Chapter 18): Goods being manufactured by a business that it has not completed at the end of a period.
- Zero rate** (of VAT) (Chapter 16): The VAT rate (of zero) that applies to the supply of certain goods and services.
- Zero-rated business** (Chapter 16): A business that only supplies zero-rated goods and services. It does not charge VAT to its customers but it receives a refund of VAT on goods and services it purchases.

Index

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