



Finance and Accounting

An ICM Study Aid

Contents



Introduction	5	Part 4: The Construction of Financial Statements	86
Part 1: An introduction to Accounting	6	22. Financial Statements: The Calculation of profits	87
1. What is Accounting?	7	23. Adjustments: Accruals and Prepayments	92
2. Business organisations and sources of finance	10	24. Adjustments: Bad Debts and Provision for Debtors	97
3. Introducing Financial Statements	14	25. Depreciation of Fixed Assets	100
4. The Role of the Accountant	20	26. Partnership Accounts	103
Part 2: The Accounting Model	22	27. Company Accounts	107
5. Recording Financial Transactions: The ledger system	23	28. Cash Flow Statements	112
6. The Running Balance Method	28	29. Accounts of Clubs and Societies	116
7. The Sales Day Book	29	30. The Extended Trial Balance	118
8. The Purchases Day Book	34	Part 5: Using Accounting Information	122
9. The Returns Day Book	39	31. Accounting ratios and Preparing Reports	123
10. VAT and VAT Returns	43	32. Accounting Standards	129
11. Banking Services	46	33. Accounting for Stocks	134
12. The Cash Book	49	34. Incomplete records	138
13. Bank Reconciliation	53	35. Manufacturing Accounts	141
14. The Petty Cash Book	57	36. Marginal Costing	145
15. Capital Expenditure	59	37. Budgeting	149
16. The Trial Balance, Journal and Suspense Accounts	61	38. Capital Investment Appraisal	152
Part 3: Supply Information for Management Control	69	39. Exams and Exam Success	155
17. The Purpose of Management Information	70		
18. The Use of Cost Centres and Cost Coding	74		
19. Providing Comparison on Costs and Income	76		
20. A brief Introduction to Wages	79		
21. Control Accounts: Sales and Purchase Ledger Control	82		

Learning Log



Study Aid Page:	Key Learning Point:

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Introduction



The Finance and Accounting Unit covers a range of studies to help you better understand the fundamentals of finance and accounting in business. We will look at how financial information is recorded and then used by organisations to help them make better decisions and, ultimately, make more profit.

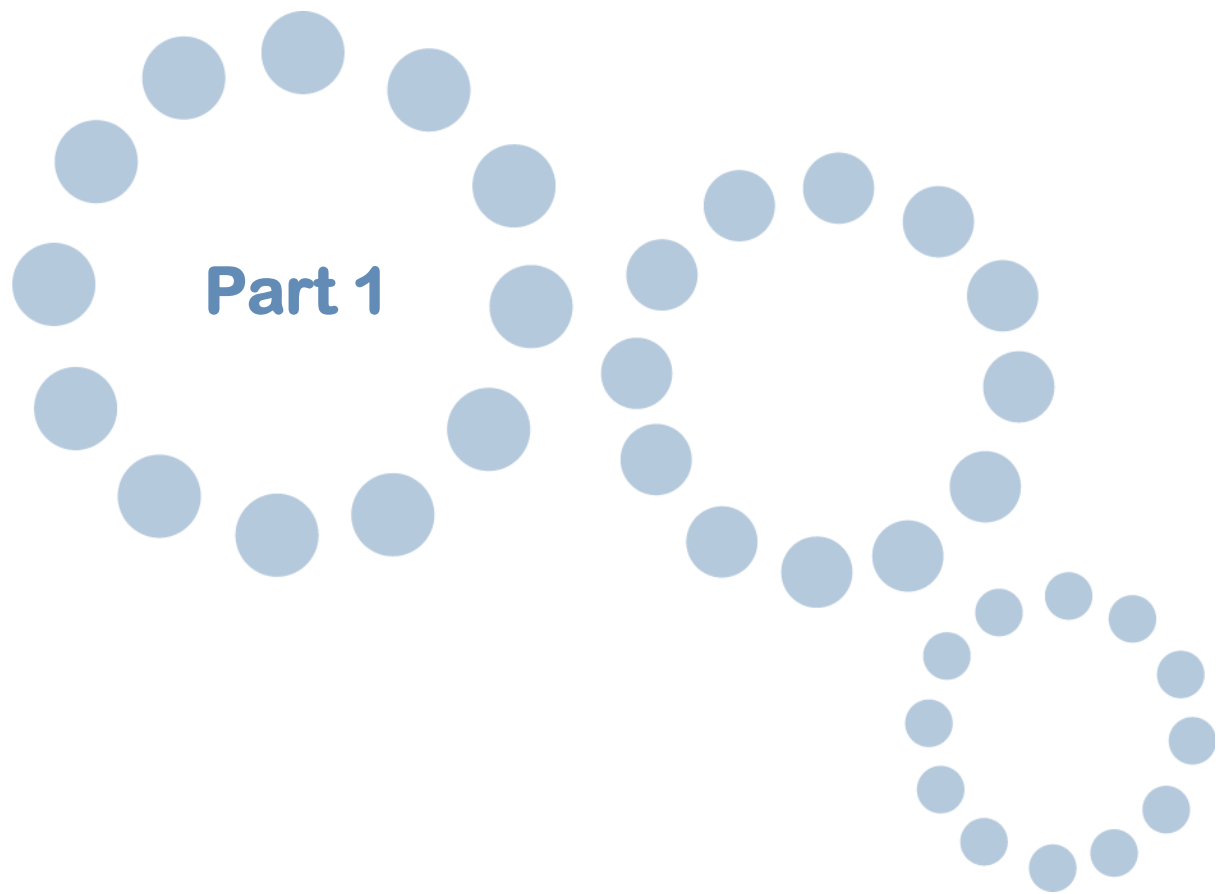
At the end of each chapter there is a sample of questions. A number of these will be past paper questions from previous exams (they will be marked to show you which ones are from past papers). It is essential that you attempt these questions and keep practicing until you have mastered them. It is the surest way to be successful in the exams. Making lots of notes from this study aid, or your textbooks, is useful. But you will not know for sure if you have truly learnt the information until you attempt a question.

If you find an area of accounting that is difficult, make sure you spend more time trying to understand it. The exam could test you on any area, but as you will see from past examination papers on the ICM website, there are some core question types that are likely to be asked again and again. Make sure you have learnt these.

One additional word of advice: it is vital to learn the concept of double entry. When you fully understand when a transaction is a credit and when it is a debit, you are in a great position to tackle any problem.

This self study aid acts as an introduction to the subject and will also help with your revision. However, we do recommend that you also use the ICM study book Finance & Accounting by Richard Giles (ISBN 978-1-903260-06-7) as this covers the subject in much more detail.

On pages 3 and 4 of this study aid you will find a learning log. You can use this to note key learning points or points you would like to study further. This will help you when you revise the subject for your examination.



An Introduction to Accounting

Chapter 1: What is Accounting?



Introduction

It is important we understand what we mean by accounting at the beginning of this journey into the financial world. The widely accepted version of accounting produced by the American Accounting Association states:

Accounting is the process of identifying, measuring and communicating economic information in order to permit informed judgements and decisions by users of that information.

Business enterprises are made up of commercial transactions i.e. buying and selling their goods and services. To do this requires money and a business must be adequately financed in order to survive.

Finance:

Finance is about having sufficient money in business in order to trade. Finance is essentially about money - the management of money, the control of it, the raising and spending of it and of course, the making of it. That is what business is all about, making profits.

From a business's point of view, finance wants to know two things:

- Where it gets its money from.
- What happens to its money. How it is used and whether the business is making a profit.



Accounting:

Every business organisation needs to maintain accurate accounting records to help it manage and control its finances more efficiently. Without day to day records it would be difficult to know if it was making a profit or a loss.

Bookkeeping:

The side of the business that ensures financial records such as receipts and payments, sales, purchases and expenses are maintained accurately. Allowing informed decisions to be made about the price to charge for goods and services.

Accounting is a step on from bookkeeping as it is used to communicate financial information to interested parties such as owners, managers and banks

Financial Statements:

The profit and loss account and the balance sheet represent the two key financial reports that show how a business is performing. The profit and loss shows exactly that, how much profit or loss a business has made. The balance sheet shows the value of the business's resources and how these resources are financed by the owner's capital and borrowed money (its liabilities).

There are three different types of accounting that need to be explained:

Financial Accounting

The recording of financial information and is the bookkeeping side of the business. By maintaining and monitoring daily financial records, accurate financial statements can be prepared for a period of time. Put simply: the better the quality of accounting records, the better control the business has.



Management Accounting

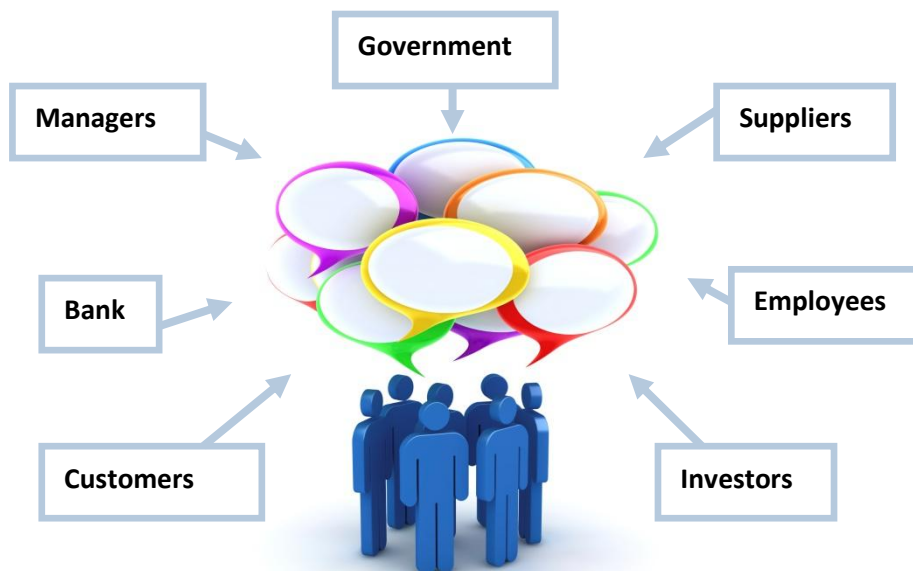
Financial and cost accounting will be used in management accounting to provide the business with essential information so it can target its objectives more effectively. Planning, control and the forecasting of results are important roles of management accounting.

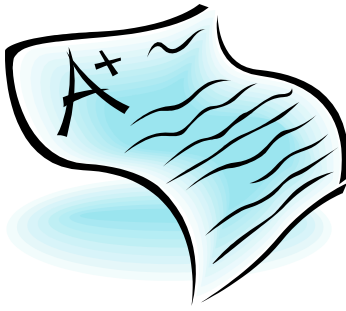
Cost Accounting

This is about how much things cost to make and providing that information to management to help inform better decision making. For example, would it cost the same to produce 100 television sets a week as it would 150?



Who needs accounting information?





End of Chapter 1 Test Questions:

1. How does bookkeeping assist in providing information for accounting?
2. What is meant by the term financial statements?
3. How do financial statements assist owners and manager in business?
4. How does the role of financial accounting differ from that of cost and management accounting?
5. How would you define the meaning of finance?
6. From 'Who needs accounting information' answer the following:
 - a) Who wants to know whether the business is profitable?
 - b) Who is concerned with taxes and VAT
 - c) Why does management need accounting information?
 - d) Why would a bank want accounting information?
7. Why are customers and suppliers interested in accounting information?

Chapter 2: Business Organisations Sources of Finance



Introduction

A country's economy is often mixed, where the production of goods and services is provided by both the **private** and **public** sectors of business.

Private Sector	Economic activity in the hands of individuals
Public Sector	Economic activity in the hands of government

The Private Sector:

There are three basic types of organisation, with the essential difference being the size of the business. This size is directly related to the initial investment in the business – that is, the provision of capital.

A Sole Trader	One-man business unit. Capital raised by the private resources of one person, who may also borrow from banks.
A Partnership	May have as many as 20 partners and therefore able to raise more capital.
A Limited Company (private or public)	Can either be public limited or private limited companies. Private – while no limit on the number of shareholders who contribute capital, a private limited company may not advertise its shares on the market. The number of shareholders, therefore, is likely to be limited to friends, family and acquaintances. Public – can raise large amounts of capital by issuing a prospectus (an invitation to the public to buy its shares). At least £50,000 of share capital must be registered with the company and 25% must be issued and paid for before allowed to operate.

Shareholders are part owners of their companies. People own shares for two reasons:

- To receive a dividend payment (a share of the company's profits)
- The shares increase in value (a capital gain)

Dividends are paid on the **nominal** value of shares (their face value), not the market value at the time.

Classes of Shares (two distinct classes):

Ordinary Shares – Often known as **equities**, the rate of dividend is dependent on the profit the company has made and how much the directors choose to pay as dividends and how much to retain in the business (reserves).

Preference Shares – Shareholders are entitled to a fixed rate of dividend (e.g. 8% preference shares). More suitable to the investor that wants a regular and fixed dividend, and much less common than ordinary shares.

Rights Issue – When a company wishes to expand its share capital, the existing shareholders are invited to buy the new issue first. If existing shareholders do not take up the offer, shares may be sold on the open market.

Limited companies have an advantage of other business forms as they have **‘limited liability’**. This means that if the company fails, shareholders are protected against the debts of the company. They will possibly lose their investment, but importantly will not be liable for the larger debts of the business.

Sole traders and partnerships do not have this legal protection, meaning they are personally liable for the debts of the company – sometimes meaning personal possessions have to be sold to settle business debts.

Sources of Finance

Starting a business takes money. For a large manufacturing business it may take millions of pounds, while for a small florist it may take just a few thousand pounds.

Finance can be a scarce resource and expensive, particularly if you want it quickly. Whether finance is short or long-term in nature depends on the end use of the money.

Short-term finance is about having sufficient **cash flow** in the business to pay for the basic things such as stock, wages and expenses – the day to day costs.

Financing is also often required to buy fixed assets (land, plant and machinery, vehicles etc). To buy fixed assets, known as **capital expenditure**, it is common to get a long-term loan from the bank.

Whether short or long, adequate financing of a business is critical. One of the major causes of business failure is lack of **solvency**, meaning not having sufficient liquidity (cash) to be able to pay debts when they fall due.

When a business can't pay its creditors (the people it owes money to) it is said to be **‘insolvent’**. This can quickly turn to bankruptcy where owners lose their capital and their business, employees lose their jobs and suppliers lose what is owed to them. Everyone loses out.

Maintaining adequate cash flow and keeping a tight control of its finances are essential for a business to survive.

When finance is needed, management must consider three things:

- How long the finance is required
- How much it will cost to repay (including interest charges)
- Whether the monthly repayments can be met

The Major Sources of Finance:

Owner's Capital	A sole trader's investment in the business (his net worth). Private limited company shareholders are the owners
Loan Capital	Short (e.g. within a year) or long-term loan from a bank for a specific period, repaid by regular instalments.
Bank Overdraft	The most important source of short-term finance for a business. A short-term loan because the bank can call it in at anytime.
Debentures	Issued to raise finance over a specific time period, usually secured with company assets. Interest to creditors is fixed percentage of the nominal value of the stock, independent of profit.
Profits	Sole traders and partners take profits throughout the year as part of their income, known as drawings. Companies retain profits as reserves (this is not cash), which are part of the overall net assets.
Leasing/Hiring of Fixed Assets	A business does not need to purchase fixed assets outright but can lease them. Two basic forms: a finance lease (gives advantage of acquiring asset but without legal ownership, depreciation and interest charges are written off against profits) and an operating lease (a form of rental where an asset is hired for a fixed charge, also written off against profits).
Leaseback of Assets	By selling property to raise finance and then leasing the property back from the buyer, a business can still use the asset while raising valuable funds. However, the advantages of property ownership (such as capital gains if the asset increases in value) are lost.
Mortgages	A long term loan (usually from a bank or building society) used to purchase property. The lender secures the mortgage on the value of the property so that any default in payment can lead to the sale of the asset to reimburse the loan.
Factor Finance	A business can send all their invoices to a debt factoring company who will immediately pay the business a major percentage of their value and the rest when the factoring company collects the full debt. The factoring company charges interest until the debt is collect and an administration charge. This allows a business to improve their cash flow by not having funds tied up in debtors and sometimes avoiding any losses due to bad debts.
Creditors	Suppliers of goods and services provide an important source of short-term finance or trade credit . Credit facilities are granted for the purpose of buying goods and services and are usually short-term.



End of Chapter 2 Test Questions:

1. What do you consider the main sources of finance are for:
 - a. A sole trader?
 - b. A Plc (public limited company)?
2. What is the essential difference between the private sector of business and the public sector?
3. Clearly differentiate between ordinary and preference shares.
4. Why should a company want to lease its fixed assets rather than purchase them? Compare this method of raising finance with the leaseback of fixed assets.
5. What are the economic objectives of the government? With regard to taxation, what is the difference between direct and indirect tax?

Chapter 3: Introducing Financial Statements



The Profit and Loss Account and the Balance Sheet

Introduction

Accounting has only FIVE distinct accounting groups:

1. Revenue
2. Expenses
3. Capital
4. Assets
5. Liabilities

A business may have hundreds of accounts recorded in its **ledgers** (where accounts are recorded) but all will belong to one of these groups.

An easy way to remember this is the word **“RECAL”**

Revenue – the income earned by a business when selling goods and services.

Expenses – the day-to-day expenses a business incurs such as stock, wages, advertising etc.

Capital – represents the owner’s investment in a business and is needed to begin trading. Capital may grow if the business is profitable.

Assets – the things of value which the business owns such as premises, equipment, stock, cash etc.

- Fixed assets (non-current assets) are used on more permanent basis, like premises and equipment.
- Current assets, like stock, cash and bank are used for daily trading purposes.

Liabilities – the things of value that the business owes

- Current Liabilities are debts expected to be repaid within one year e.g. trade creditors
- Long-term liabilities are debts expected to be repaid over more than one year e.g. a bank loan or mortgage.

In business there are TWO key financial statements:

The Profit and Loss Account:

The profit and loss account is a business’s statement of its earnings over a period of time. It shows its income less its expenses which determines whether the business has made a profit or a loss.

A simplified version of this account is below

G Harrison profit and loss account for the year ended 31 December

	£	£
Sales		75,000
less		
Cost of Sales		<u>50,000</u>
Gross Profit		25,000
less		
Expenses (overheads)		
wages	10,800	
advertising	2,100	
light, heat	850	
business rates	900	
stationery	400	
motor costs	2,150	
insurance	1,200	
telephone	550	
accountant's fees	700	
general expenses	<u>350</u>	<u>20,000</u>
Net Profit		<u>5,000</u>

Note that profit is divided into two parts:

- Gross Profit: (sales - cost of sales)
- Net profit: (gross profit - expenses)

The **gross profit** measures the trading profitability of buying or producing the business's goods or services. The margin of gross profit is very significant as it must be sufficient to cover all overheads, otherwise a loss will result.

The **net profit** is the final outcome of profit after all the other expenses are deducted from the gross profit. Later you will see that the net profit (or loss) is transferred to the capital account. Why? Because a profit increases capital and therefore net assets and a net loss has the reverse effect reducing net assets of the business.



The Balance Sheet:

The balance sheet is a major financial statement and lists the assets, liabilities and capital of a business. It is a snapshot of a business showing what it owns less what it owes. The difference between assets and liabilities represents the owner's capital.

Capital = assets less liabilities

A balance sheet is called that because it must always balance, no matter how many business transactions may occur. The value of assets will always equal the value of its capital and liabilities.

Example 1: A simplified balance sheet

G Harrison balance Sheet as at 31st December:

Assets	£	£
Premises	50,000	
Equipment	2,500	
Motor van	<u>7,500</u>	60,000
Stock	8,000	
Debtors	2,500	
Bank	1,400	
Cash	<u>100</u>	<u>12,000</u>
Total assets:		72,000
Less		
Liabilities	£	£
Creditors	5,700	
Bills unpaid	<u>300</u>	6,000
Mortgage	41,000	
Bank loan	<u>5,000</u>	<u>46,000</u>
Total liabilities:		52,000
Net assets: (A – L)		<u>20,000</u>

Note:

Debtors – are customers who owe money to the business.

Creditors – are people and organizations that the business owes money to.

The accounting equation:

A very simple rule links capital, assets and liabilities. The owner/s of a business is worth the value of assets less the value of liabilities. This is called the 'Accounting Equation'.

If in the example above G Harrison owned ALL the assets of the business:

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

$$20,000 = 72,000 - 52,000$$

Alternatively, the accounting equation can emphasise the business's point of view from the value of its assets:

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

$$72,000 = 20,000 + 52,000$$

Profits, drawings and Capital:

What would be the effect on the above balance sheet equation if G Harrison made a profit of £5,000?

$$\begin{array}{lcl} \text{Capital} & = & \text{Assets} - \text{Liabilities} \\ 25,000 & = & 77,000 - 52,000 \end{array}$$

And then withdrew £4,000 as personal drawings during the year?

$$\begin{array}{lcl} \text{Capital} & = & \text{Assets} - \text{Liabilities} \\ 21,000 & = & 73,000 - 52,000 \end{array}$$

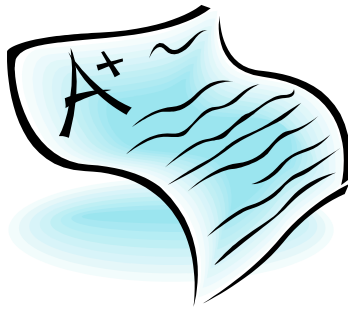
So while profits increase capital, personal drawings reduce it. A £5,000 profit with £4,000 of drawings therefore only increases capital by £1,000.

The dual effect of business transactions:

For every transaction in business there is always a **double entry** in the firm's accounts.

Take one simple transaction: paying £1,000 to your creditors. This will mean your bank balance decreases by £1,000 and that the amount you owe, your creditors account, will also decrease by £1,000.

This dual effect of accounting is why the balance sheet will always balance.



End of Chapter 3 Test Questions:

1. The accounts of a sole trader, Peter Jackson, as at 30 April were:

	£
Sales	48,850
Cost of sales	32,420
Wages	5,280
Motor expenses	3,624
Light, heat	2,100
Rates, insurance	3,400
Advertising	456
Telephone	195
Stationery	100
General costs	485

Required:

- a) Prepare a profit & loss account of Peter Jackson as at 30 April.
b) What do you think links the profit and loss account with the balance sheet?

2. The following accounts represent the financial interests of M Crooks on 1 June. He runs a small business associated with the building trade.

	£
Premises	33,500
Machinery and equipment	12,500
Tools	1,500
Motor vehicle	4,200
Furniture in the office	1,500
Stocks (at cost)	15,000
Debtors	1,275
Cash	100
Bank overdraft	1,750
Creditors for supplies	13,450
Bills outstanding	750
Interest payments due	125
Mortgage on premises	22,500
Hire-purchase loan on vehicle (2 years)	1,000
Bank loan (5 years)	10,000
Capital account	20,000

Required:

- a) Group the above accounts in their separate categories – e.g, current asset, fixed asset etc.
- b) Prepare the balance sheet of M Crooks as at 1 June.
- c) Show the accounting equation which would emphasise the ownership of M Crooks.
- d) The liabilities of the owner look rather excessive. Has he sufficient funds to meet his current debts?
- e) Crooks must find at least £2,000 by the end of the month to pay off bills and creditors outstanding. Suggest how he could pay them.

3. The following represents the financial figures of R. James at at year ended 30 June.

	£		£
ASSETS		LIABILITIES	
Land & building	25,000	Mortgage	15,500
Furniture & fittings	5,500	Bank loan (5 years)	10,500
Equipment	7,000	Interest owing	650
Motor van	6,500	Creditors	4,500
Bank	2,500	Bills outstanding	1,000
Cash	50	Capital account	?
Debtors	1,450		
Stock	8,000		
Profit from trading	8,250		
Proprietor's personal expenses	<u>4,500</u>		

Required:

Prepare the balance sheet of R James as at 30 June

Chapter 4: The Role of the Accountant and the Accounts Office



Introduction

The accountant's role is often varied, interesting and far-reaching in the business world. They are managers of finance: not only interested in recording financial information, they are also interested in planning and forecasting results.

Accountants are financial consultants and an integral part of management – being part of a team which plans, controls and takes decisions. There are four main accounting qualifications:

- The Institute of Chartered Accountants (ACA)
- The Chartered Association of Certified Accountants (ACCA)
- The Chartered Institute of Public Finance and Accountancy (CIPFA)
- The Chartered Institute of Management Accountants (ACMA)

The purpose of auditing accounts

An audit is an examination of the accounts to check that everything is as it should be. Accounts are subject to annual audits by professional accountants like ACAs or ACCAs.

In the case of limited companies, the audit is a legal obligation. Auditors act as 'watchdogs' over the shareholders' interests.

The 1985 Companies Act states that limited companies must appoint an auditor (except small companies) to examine the books and accounts. This is to express an opinion as to whether the financial statements represent a '**true and fair**' of the financial position of the company, to the shareholders of the company.

The Accounts office

The recording of financial information is the key function of an accounts office. Customers' and suppliers' records must be accurately recorded in the sales and purchase ledgers, this information coming from key documents such as invoices and credit notes.

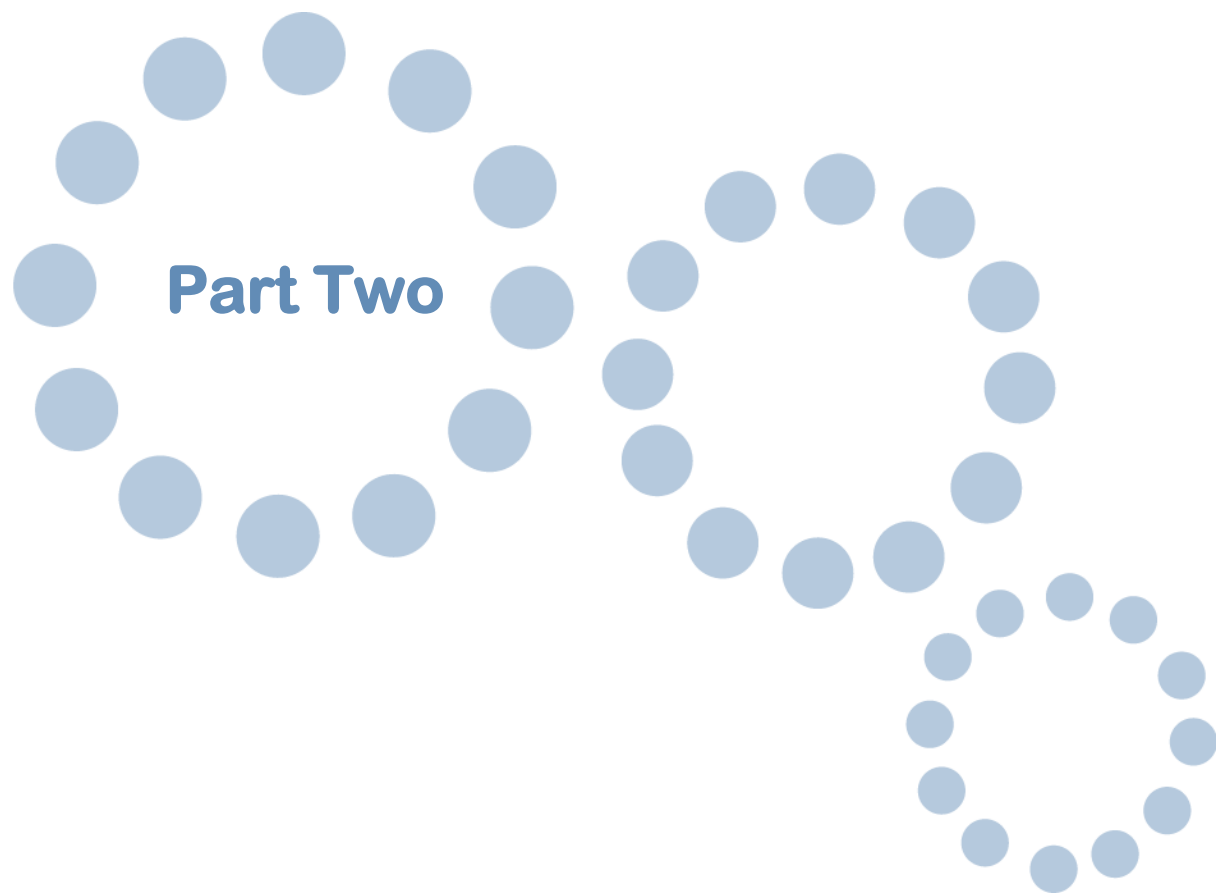
Finance is one the most important aspects of an organization because the whole operation is dependent on its expertise. The preparation of accounts helps to explain what is happening in the business: whether it is successful or not, whether it has sufficient cash to pay its way, whether it should make this decision or that.





End of Chapter 4 Test Questions:

1. People often think that an accountant's job is boring. Could you offer an alternative adjective(s)?
2. One of the accountant's functions is to act as an auditor. Find out what this service is.
3. In an accounts office, what may be considered a key function?
4. What would be the difference between working for an accountant in private practice or working in an organisation which has its own accounting department?
5. If you were employed as a wages clerk, find out what the following abbreviations mean: HMRC, PAYE, NIC. Why do you think returns of PAYE and NIC are made to HMRC?



The Accounting Model

Chapter 5: Recording Financial Transactions



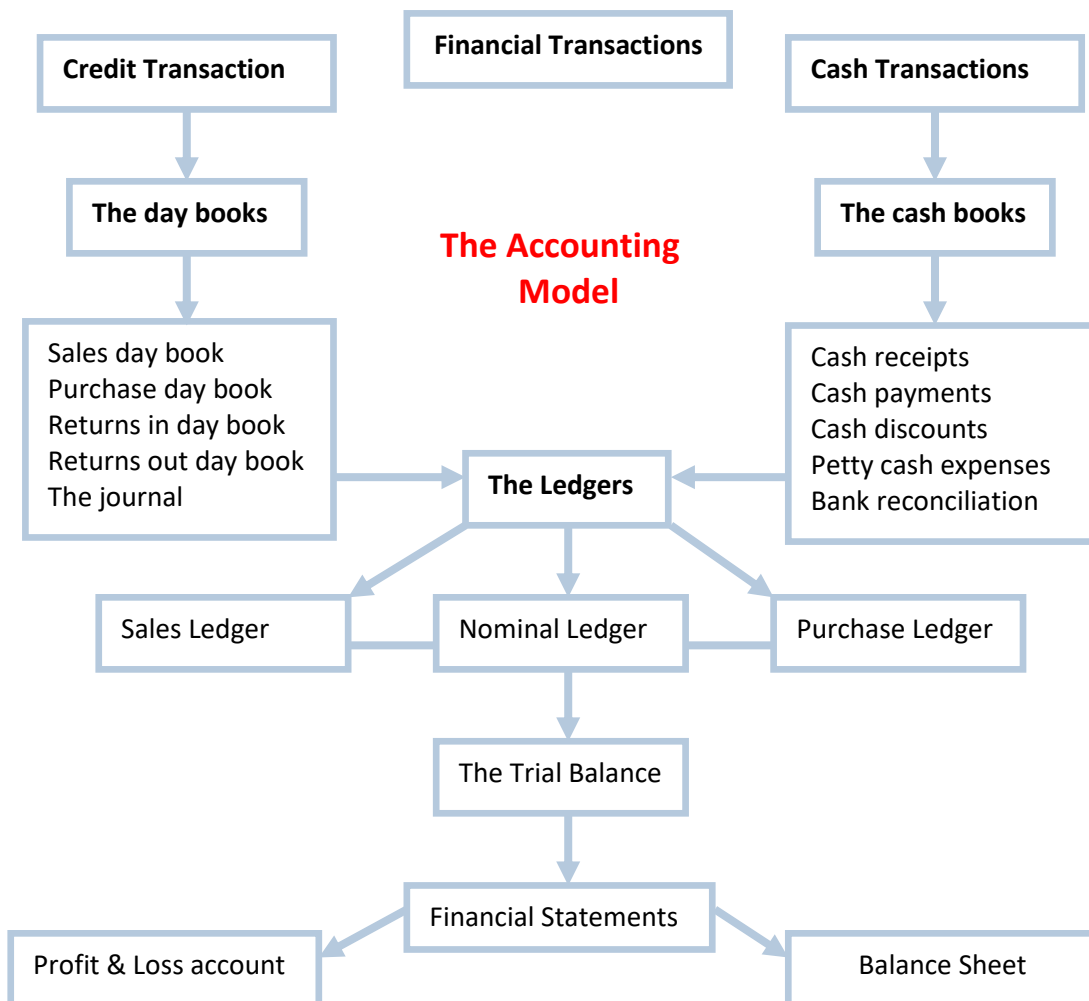
The Ledger System and Trial Balance

Introduction

The ledger is the integral part of the accounting system where business transactions are posted from documents into accounts. The principle of **double-entry bookkeeping** is essential to understand. The recording process is based on the principle that every transaction has TWO ASPECTS to record of equal value.

The Days Books record transactions on credit, helping to organise transactions before being posted to the ledgers. So a sale or purchase made on credit will first be recorded in either the sales day book or purchases day book.

The Cash Books record transactions by cash. When money is received or paid in the form of cash, cheques and credit cards or directly through the banking system, a cash book can be used.



Transactions recorded in the ledger via the double entry system are done so in date order. It is from these records that the financial affairs of the business can be revealed, monitored and controlled.

The ledger is a series of accounts, which are records of related transactions. For example, the sales account tells us the value of all sales. These accounts within the ledger are known as '**T**' accounts, and this format is the traditional layout of the ledger.

The '**debit**' is the left-hand side of an account; the '**credit**' is the right-hand side. When there are entries on both sides, the 'balance' is the difference between them.

Remember:

Debit: When an account RECEIVES money or value

Credit: when an account GIVES (or supplies) money or value

A basic example of a 'T' account transaction:

You buy a motor van for £3,000 paying by cheque. The van is RECEIVED and the van account is the debit entry. Money is GIVEN, therefore the bank account will be the credit entry. The double entry is:

Debit	Motor Van account	Credit
Bank	£3,000	

Debit	Bank account	Credit
	Motor Van	£3,000

It is essential that you grasp this fundamental concept of double entry. Take the time to understand this before you move onto the more complex applications of this recording system.

Recording the FIVE accounting groups:

Account Group	Type of Balance	To increase value in the account	To decrease value in the account
Revenue	Credit	Credit	Debit
Expenses	Debit	Debit	Credit
Capital	Credit	Credit	Debit
Assets	Debit	Debit	Credit
Liabilities	Credit	Credit	Debit

If a transaction includes an asset or an expense that has to be increased in value, the entry must be DEBITED. If their value is to be decreased, then the entry is CREDITED.

The reverse applies for revenue, liabilities and capital accounts. These are CREDITED when the accounts are to be increased in value and DEBITED when they are to be decreased in value.

The Trial Balance:

This is a list of balances taken from the ledger and placed in either the debit or credit column, depending on whether the account itself is a debit or credit.

It is an important test of the accuracy of the double entry principle. As there is always a debit and credit entry for every transaction, the resulting balances in the accounts should be equal. The balance of credits must equal the balance of debits. If they do not, you have made an error somewhere in the 'T' accounts of the ledger.

Trial Balance		
	Debit	Credit
	£	£
R sales		500
E purchases	1,800	
E rent	150	
C capital		2,000
A bank	1,350	
L F James (creditor)		800
	<u>3,300</u>	<u>3,300</u>

You will notice the example trial balance above is in the **RECAL** order. Doing this organises the accounts into a system and helps in the preparation of the profit and loss account and balance sheet when required.

The recording of stock and returns inward and outward

Stock:

When goods are purchased and then sold the stock account is not affected. Instead all purchase of stock during an accounting period are recorded in the purchase account at cost price and all stock sold is recorded in the sales account (as selling price).

At the end of an accounting period, the value of any unsold stock is recorded in the stock account. The closing stock of one period is the opening stock of the next.

Returns:

If a customer returns goods or is overcharged on an invoice, this is a return. The credit note is the document that is raised to process the return.

There are two types of return:

- **Returns inward** (sales returns) from customers
- **Returns outward** (purchases returns) to suppliers

The double entry for returns inwards is:

Debit: returns inward account

Credit: the customer's (debtors) account

The double entry for returns outward is:

Debit: the supplier's (creditors) account

Credit: returns outward account



End of Chapter 5 Test Questions:

Past Paper Question:

1. The following are the first month's transactions of a new business:
- Feb. 01 Put £28,000 into a business bank account, and £1,000 into a business cash box.
 - Feb. 01 Bought a vehicle for £10,000, paying by cheque.
 - Feb. 03 Purchased goods costing £5,000 for resale, paying by cheque.
 - Feb. 05 Paid rent £800, paying cash.
 - Feb. 08 Paid insurance premium £1,500, paying by cheque.
 - Feb. 12 Sold goods for £3,500, receiving a cheque for the full amount.
 - Feb. 14 Paid wages £1,000, paying by cheque.
 - Feb. 17 Purchased goods costing £7,000 for resale, paying by cheque.
 - Feb. 25 Bought office supplies costing £750, paying by cheque.
 - Feb. 25 Sold goods for £5,500, receiving full payment in cash.
 - Feb. 26 Paid wages £1,000, paying cash.
 - Feb. 27 Sold goods for £3,500, receiving a cheque for the full amount.
 - Feb. 28 Banked £4,000 of the cash.

Required:

- a) Write up the above transactions in the appropriate ledger accounts. [10]
 - b) Prepare a trial balance as at 28 February 2011. [4]
 - c) The above business carried out a stock check at the close of business on 28 February 2011 and valued the inventory (closing stock) at £3,600. Calculate the gross profit for the first month of trading. [2]
 - d) Explain briefly the accounting treatment of VAT. [4]
2. Mrs M Ward decided to commence business by opening a small retail shop in the high street on 1 May. Her finances on that day were: cash, £2,500 and a motor van valued at £1,500. Hire purchase still outstanding on the vehicle was £1,000. Calculate Mrs Ward's capital as at 1 May.

During the first month's trading, the following transactions took place:

- May
- 1 Deposited £2,000 into the business bank account, retaining £500 in cash
 - 2 Rented shop premises paying £250 cheque in advance
 - 4 Cash purchases of goods for resale £300
 - 5 Purchased £550 goods from Arthur Daley on credit
 - 7 Paid £40 cash on stationery items
 - 10 Cash sales £120
 - 12 Sold goods on credit to Jack Smith £180
 - 14 Purchased £750 goods on credit from Donna Steele

- 16 Paid motor expenses £30 cheque
- 17 Cash sales £235 into bank
- 18 Returned goods to Arthur £150 as stock damage
- 19 Paid £100 cheque on the hire purchase of van
- 20 Bought equipment on credit from Land Supplies Ltd £1,800, paying an initial 25% deposit by cheque, the balance on credit
- 24 Cash sales £130 into bank
- 26 Paid general expenses by cash £80
- 27 Received 50% of the sum due from Jack Smith, by cheque
- 28 Sold goods on credit by David Wheelbarrow £330
- 30 David Wheelbarrow returned 10% of goods to us as being unsuitable
- 31 Cash sales £225 into bank
- 31 Paid Donna Steele £500 on account
- 31 Paid Land Supplies Ltd on account £270 by cheque

Required:

- a) Enter all the above information in the ledger of Mrs M Ward for the month of May.
 - b) Extract a trial balance as on 31 May
3. a) What is the purpose of the ledger in business?
 b) Why are sales and purchase ledgers used in some businesses?
 c) What basic principle does the recording of accounts follow? What could happen if this principle was ignored?
4. What is the purpose of the trial balance?

5. The following represents the ledger accounts of Jack Jones on 1 April:

Debtors:		Creditors:	
Smith	£250	May	£85
Lillee	£115	Cowdrey	£172
Thomson	£25		
Capital a/c: Jack Jones £18			
Bank a/c: £115 (overdrawn)			

Transactions occurring during April

- April 2 Sold goods to Lillee £287 and to Smith £415
- 5 Bought goods from Cowdrey £150
- 10 Sold goods to Thomson £37
- 15 Settled May's account of 1 April
- 17 Smith settled his account of 1 April
- 21 Paid £75 to Cowdrey on account
- 22 Sold goods to Thomson £156
- 25 Thomson paid £62 on account
- 26 Bought goods from May £195
- 29 Paid Cowdrey a further £95 on account
- 30 Received £201 cheque from Lillee

Required:

- a) Enter all the above information in Jack's ledger
- b) Extract a trial balance for the month ending 30 April

Chapter 6: The Running Balance Method of Recording



Introduction

As you have seen the traditional style of recording ledger transactions is debit and credit entries separated by the centre line of the page – the 'T' account. The balance was the difference between the two columns of entries.

The running balance method differs in that its format is like a bank statement with debit and credit and balance columns adjacent to each other. The main advantage of this style of recording is that after each transaction, the balance is calculated, giving an immediate up-date of the account.

Example format of a running balance

Date	Details	Debit	Credit	Balance
1/6	Balance	9,000		9,000 Debit
10	Purchases		2,000	7,000
13	Sales	1,840		8,840
14	Rent		400	8,440
15	Wages		520	7,920
18	Stationery		280	7,640
20	Sales	1,800		9,440
24	Purchases		2,600	6,840
27	R Jones	700		7,540
30	H Bates		2,540	5,000

Different types of ledger

Sales Ledger	All customer accounts are recorded here, allowing the tracking of what individual debtors owe.
Purchase Ledger	All supplier accounts are recorded here, allowing the tracking of what individual creditors are owed.
Nominal Ledger	Used to track ALL other accounts, revenue expenses, capital, assets and liabilities. It's the main ledger and also known as the general ledger).

Personal Account	The individual debtors and creditors in the sales and purchase ledgers.
Nominal Account	The impersonal accounts of the business – all revenue and expenses.
Real Account	The assets of the business such as premises, equipment etc.

Chapter 7: Recording Transactions on Credit



The Sales Day Book

Introduction

A major function of the day books (also called journals), is to help classify and summarise information from data such as invoices and credit notes. This makes it easier to transfer details to the ledgers.

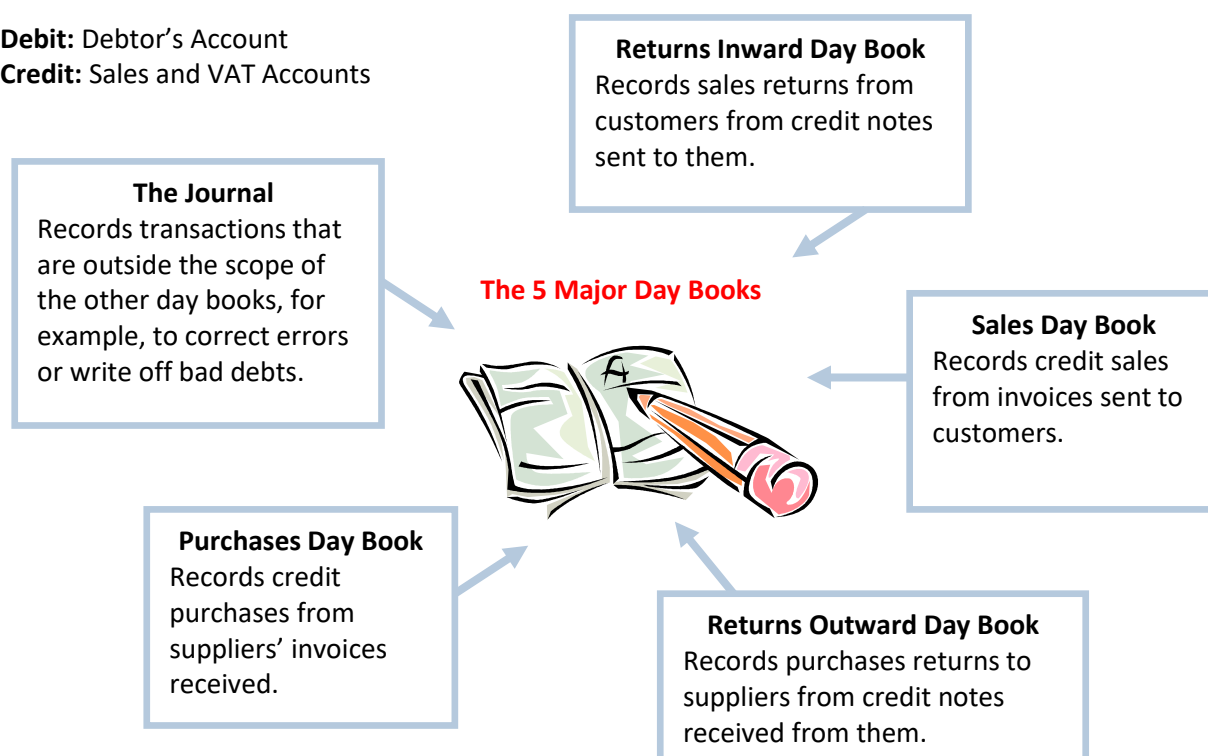
So when sales invoices (bills of sale) are sent to customers, they are first recorded in the sales day book before posting to the ledgers.

An example sales day book:

Date	Customer's Account	Invoice No.	Net Sales Account	VAT Account	Total Debtors
4/1	Jones, J	2501	200	35	235
5/1	Smith, R	2502	150	26.25	176.25
6/1	Taylor, C	2503	128	22.40	150.40
8/1	Lewis, D	2504	360	63.00	423.00
			838	146.65	984.65

Following this the ledger posting would be:

Debit: Debtor's Account
Credit: Sales and VAT Accounts



Sales Ledger Control Account:

The sales ledger control account (in the nominal ledger) is used as a cross-check with the debtors' balances in the sales ledger.

VAT

Value added tax is an indirect form of taxation charged on many goods and services. The current standard rate is 17.5% on the net value of any goods or services. This rate can vary depending on economic circumstances.

For example, if goods were sold for £200 (gross value) but were subject to a 20% trade discount, the VAT would be charged on the net value:

	£
Gross value of goods	200
Less 20% trade discount	<u>(40)</u>
Net value of goods	160
VAT (£160 x 17.5%)	<u>28</u>
Total value of invoice	188

Terms of payment:

Trade discount	A favourable rate to the buyer of goods off the list price, often in proportion to the amount of goods purchased. There is no double entry, the net sum payable is recorded, not the gross.
Cash discount	A discount to encourage prompt payment. E.g. 5% if invoice is paid with a specific number of days. Part of Double Entry.
Bulk discount	A larger trade discount is made available if more is purchased.
Carriage forward	When the buyer pays for the delivery cost. Known as carriage inwards as part of the buyer's cost of sales in their trading a/c.
Carriage paid	The seller pays for the delivery cost of goods.
Cash on delivery	Payment is made when goods are exchanged.
E&OE	Errors and omissions excepted. Indicates the supplier has the right to correct any error or omission on an invoice.
Ex stock	Goods will be supplied from stock.
Ex works	The buyer is responsible for the delivery cost from the factory.
VAT	Current standard rate is 17.5%. Other rates are discussed later.

This is an example to illustrate how a sale on credit to a customer is recorded via the sales day book into the ledger. Harrison has sent out invoices for goods purchased on credit and he has also received payment from debtors during June.

G Harrison's ledger balances as at 1 June

Sales	£	Nominal Ledger	£
Thomson	45 Dr	Sales a/c	8,500 Cr
Simpson	110 Dr	VAT a/c	350 Cr
Jackson	180 Dr	Sales Ledger control a/c	335 Dr
	335		

As you can see the sales ledger control account represents the total value of debtors in the sales ledger.

Sales Invoices sent in June:

Customer a/c	Invoice No.	Date	Net Sales £
Thomson	1136	4/6	180
Simpson	1137	10/6	200
Jackson	1139	15/6	360
Simpson	1140	20/6	160

Cheques received from customers in June

Thomson	£300
Simpson	£450
Jackson	<u>£500</u>
	£1250

Sales Day Book: Harrison

Customer a/c	Invoice No.	Date	Net Sales £	VAT £	Total Debtors
Thomson	1136	4/6	180	31.5	211.50 Dr
Simpson	1137	10/6	200	35	235 Dr
Thomson	1138	11/6	100	17.5	117.50 Dr
Jackson	1139	15/6	360	63	423 Dr
Simpson	1140	20/6	160	28	188 Dr
			<u>1,000</u>	<u>175</u>	<u>1,175</u>
			(Cr)	(Cr)	(Dr)

Sales Ledger: Harrison

Date	Particulars	Debit	Credit	Balance
		£	£	£
Thomson a/c				
1/6	Balance			45 Dr
1/6	Sales & VAT	211.50		256.50
11/6	Sales & VAT	117.50		374
30/6	Bank		300	<u>74</u>
1/7	Balance			74 Dr
Simpson a/c				
1/6	Balance			110 Dr
10/6	Sales & VAT	235		345
20/6	Sales & VAT	188		533
30/6	Bank		450	<u>83</u>
1/7	Balance			83 Dr
Jackson a/c				
1/6	Balance			180 Dr
15/6	Sales & VAT	423		603
30/6	Bank		500	<u>103</u>
1/7	Balance			103 Dr

Nominal Ledger: Harrison				
Date	Particulars	Debit	Credit	Balance
Sales a/c		£	£	£
1/6	Balance			8,500 Cr
30/6	Debtors		1000	<u>9,500</u>
1/7	Balance			9,500 Cr
VAT a/c				
1/6	Balance			350 Cr
30/6	Debtors		175	<u>525</u>
1/7	Balance			525 Cr
S/L Control a/c				
1/6	Balance			335 Dr
30/6	Sales	1,000		
	VAT	175		1,510
30/6	Bank		1,250	<u>260</u>
1/7	Balance			260 Dr

Computerised Accounts:

Using a computer to process accounting transaction is a much more efficient method. Postings to the ledger can be automated and the double entry transactions completed for you. For example, an invoice added to the system will debit a customer's account and credit the sales and VAT accounts.

Computerised accounts also give you the benefit of instant analysis – invoices, credit notes, customer statements and anything else can be printed at the press of a key.

Credit Control:

It is vital for a business to restrict the outstanding debt of any one customer. The credit control system is in place to:

- Ensure customers pay their accounts on time
- Provide a credit rating for customers based on historical trading
- Limit goods to customers who do not pay debts on time
- Provide more generous credit terms with customers who do pay debts on time
- Create an **aged debtors' schedule** to show how old debts are in months

Bad debts are expenses and reduce profits. If a large customer fails to pay its debts, it could trigger bankruptcy with the seller.



End of Chapter 7 Test Questions:

1. The following credit sales (excluding VAT) took place during February 2011:

			£	
Feb.	01	Invoice for goods	500	to Alex
	02	Invoice for goods	600	to Bella
	06	Invoice for goods	400	to Conrad
	07	Invoice for goods	800	to Alex
	12	Invoice for goods	700	to Bella
	17	Invoice for goods	1,100	to Alex
	22	Invoice for goods	900	to Conrad
	24	Invoice for goods	500	to Alex
	27	Invoice for goods	300	to Bella
	28	Invoice for goods	1,200	to Conrad

All the above invoices are subject to VAT at the standard rate (20%).

Required:

- Fully record the above transactions in the sales day book. [10]
- State the amount which should be posted to the sales account. [2]
- State the amount which should be posted to the VAT account, AND state whether it should be recorded as a debit or a credit. [2]
- Explain the purposes of day books. [6]

2. Debtor's balances on 1 June in G Harrison's sales ledger were:

	£
Arthur	100 Dr
Brian	120 Dr
Colin	150 Dr

During the month of June, Harrison sold on credit:

		Invoice	£
5/6	Arthur	421	250
8/6	Brian	422	160
15/6	Arthur	423	200
20/6	Colin	424	280

On 28 June, Harrison received cheques from Arthur, Brian and Colin settling their accounts as stated on 1 June

Required:

- The sales day book for the month of June
- Sales ledger accounts of Arthur, Brian and Colin for June
- The sales account as it would appear in the nominal ledger (opening balance £1,240 Cr)

Chapter 8: The Purchases Day Book



Introduction

The purchase day book records invoices received from suppliers before posting to the purchase and nominal ledger.



An example purchases day book:

Date	Supplier's Account	Invoice No.	Net Purchase Account	VAT Account	Total Creditors
5/1	Metro	7845	200	35	235
7/1	Slazenger	367339	280	49	329
7/1	Auto	1995	400	70	470
8/1	Slazenger	367443	160	28	188
			<u>1,040</u>	<u>182</u>	<u>1,222</u>

Following this the ledger posting would be:

Debit: Purchases and VAT accounts

Credit: Creditor's account

The supplier's account is credited in the purchase ledger with the invoice total, for example Metro £235 credit. The double entry would be completed with debit entries to the purchases account £1,040 and VAT £182, in the nominal ledger.

Working capital - Checking Documents:

Working capital is having sufficient finance to meet day to day costs. The purchase day book has a vital role in providing information about the purchases that the business has made. For example, if the business purchases too much stock, it may not be able to pay other vital bills, such as overheads and wages.

If too little stock was acquired the business may run out of certain items and valuable orders could be lost. Businesses, therefore, need to pay close attention to the way they record supplies so they can track stock levels, ensure they buy exactly the amount they want and that the invoices received agree with the terms and conditions of the order.

Goods Received Notes (GRN)

The goods are checked and a GRN created. Copy sent to buying office to check against original invoice.

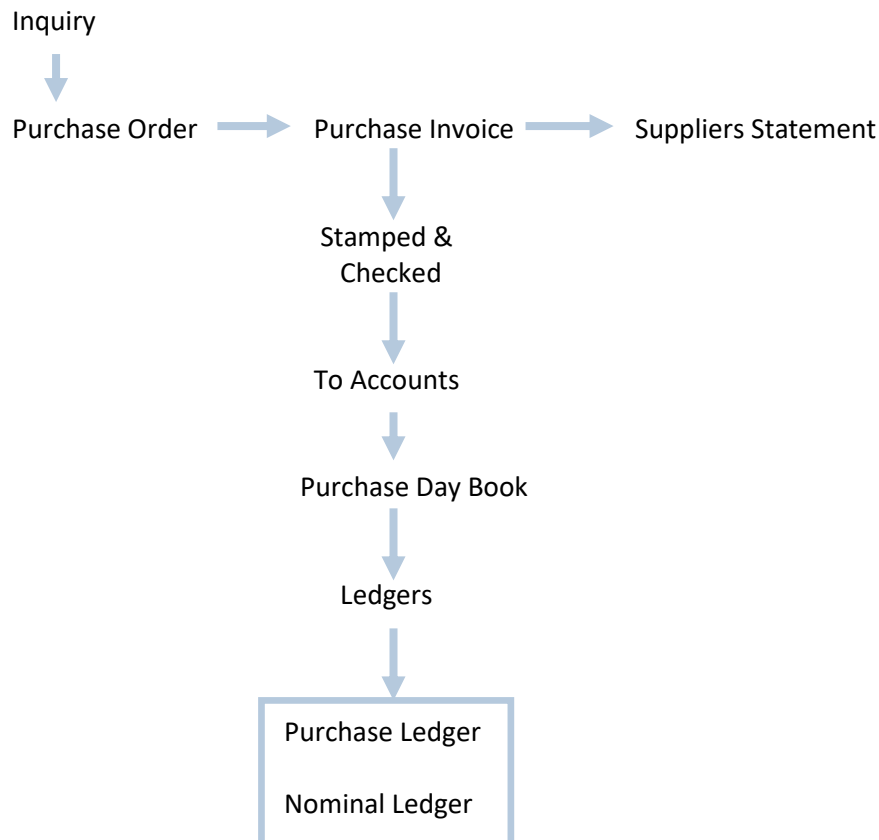
Delivery Notes

A record that delivery driver uses to prove that the items have been delivered as agreed.



An invoice that agrees with the purchase order and the GRN can be passed to accounts for recording and paying. But any errors need to be identified (whether an arithmetic error, or the quantities received differs from those charged for), helping to make the process a key purchasing control.

Procedure for purchases on credit:



Invoice Control:

When a business has thousands of invoices, it is essential that a full check on each invoice is made. Invoices are, therefore, stamped with a control grid, like the diagram below:

Control Grid	Initials
Date invoice received	
Internal reference no	
Order price check	
Extensions check	
Goods received check	

Each check above should be initialled by the person authorised to do so. Any errors need to be investigated. Only when the check is complete and satisfactory can the invoice be passed to the accounts office for entry into the purchase day book and be authorised for payment.

The Purchase Ledger Control Account:

Put simply, it is an account to cross-check the accuracy of the purchase ledger. An example follows.

Information relating to the account of G Harrison on 1 June:

Balance on 1 June:

Nominal Ledger	Purchases account	(debit)	3,576.50
	VAT account	(credit)	421.25
	Purchase Ledger control account	(credit)	5,646.50
Purchase Ledger	Decca	(credit)	3,465.00
	EMI	(credit)	1,572.50
	Jacksons	(credit)	609.00

G Harrison's purchase day book:

Date	Supplier	Invoice No.	Purchases £	VAT £	Total Creditors
4/6	Decca	4242	450	78.75	528.75 Cr
8/6	Decca	5789	200	35.00	235.00 Cr
15/6	EMI	687	360	63.00	423.00 Cr
22/6	Jacksons	1425	120	21.00	141.00 Cr
			<u>1,130.00</u>	<u>197.75</u>	<u>1,327.75</u>
			Dr	Dr	Cr P/L control

Now we must enter the above balances on 1 June into the ledger of G Harrison and post the month's details from the day book to the appropriate ledger accounts. We will also enter the payment details of cheques paid on 30 June: £1,500 to Decca a/c, £1,000 to EMI a/c and £200 to Jackson's a/c.

Nominal Ledger: Harrison

Date	Particulars	Debit	Credit	Balance
		£	£	£
Purchases a/c				
June 1	Balance			3,567.50 Dr
30	Creditors	1,130.00		4,697.50
VAT a/c				
June 1	Balance			421.25 Cr
30	Creditors	197.75		223.50
P/L Control a/c				
June 1	Balance			5,646.50 Cr
30	Purchases		1,130.00	
	VAT		197.50	6,974.25
	Bank	2,700.00		4,274.25

Purchase Ledger: Harrison				
Date	Particulars	Debit	Credit	Balance
		£	£	£
Decca a/c				
June 1	Balance			3,465.00 Cr
4	Purchases & VAT		528.75	3,993.75
8	Purchases & VAT		235.00	4,228.75
30	Bank	1,500		2,728.75
EMI a/c				
June 1	Balance			1,572.50 Cr
15	Purchases & VAT		423.00	1,995.50
30	Bank	1,000		995.50
Jackson a/c				
June 1	Balance			609 Cr
22	Purchases & VAT		141.00	750.00
30	Bank	200		550.00

Finally, we must check that the purchase ledger control account matches the total of the balances in the purchase ledger.

June 30 P/L control account		£4,274.25 Cr
30	Purchase ledger: £	
	Decca	2,728.75
	EMI	995.50
	Jackson	<u>550.00</u>
		£4,274.25 Cr

When preparing the trial balance, the control accounts show the totals of both debtors and creditors. If the control accounts cross-check with personal ledgers it's assumed that double-entry recording is correct. This is useful in the event the trial balance failed to balance. We would not need to check all the personal accounts to locate the error(s) if they already agree with the control account.



End of Chapter 8 Test Questions:

1. The following credit purchases took place during April 2011:

April 01	Invoice for goods £600 from Arnald
April 01	Invoice for goods £400 from Bruno
April 04	Invoice for goods £500 from Clive
April 06	Invoice for goods £700 from Arnald
April 09	Invoice for goods £300 from Arnald
April 13	Invoice for goods £800 from Clive
April 18	Invoice for goods £500 from Bruno
April 19	Invoice for goods £900 from Clive
April 28	Invoice for goods £1,000 from Bruno
April 29	Invoice for goods £800 from Arnald

All of the above purchase invoices need 20% VAT (sales tax) added to the goods values.

On 1 April 2011 there was £1,420 owing to Arnald.

On 28 April a cheque amounting to £2,100 was sent to Arnald.

Required:

- Fully record the above transactions in the purchase day book. [10]
- State the amount to be debited to the purchases account. [2]
- Explain the purpose of day books. [4]
- Write up the ledger account of Arnald for the month of April. [4]

2. The following information concerns the analysed purchase day book of Harriet Prince for the first fortnight of January:

Date	Supplier a/c	Footwear a/c	Leisure a/c	Sports a/c	VAT a/c	Total a/c
7/1	Foulkes Ltd	850	70			
8/1	Johnson		350			
9/1	Foulkes Ltd	436	164	80		
10/1	Hardcastle	200		325		
11/1	Johnson	236	164			
12/1	Douglass Ltd		346			
12/1	Just Sport	140		825		

Required:

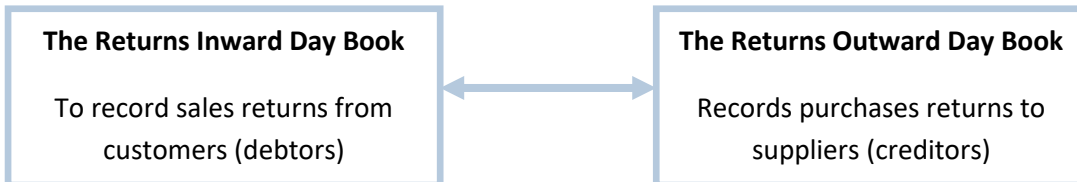
- Complete the totals across including the calculation of VAT at the 17.5% standard rate
- Total the figures down and cross-check for accuracy
- Explain how the individual accounts are posted
- Post the totals to the nominal ledger

Chapter 9: The Returns Day Book



Introduction

There are two books to record returns:

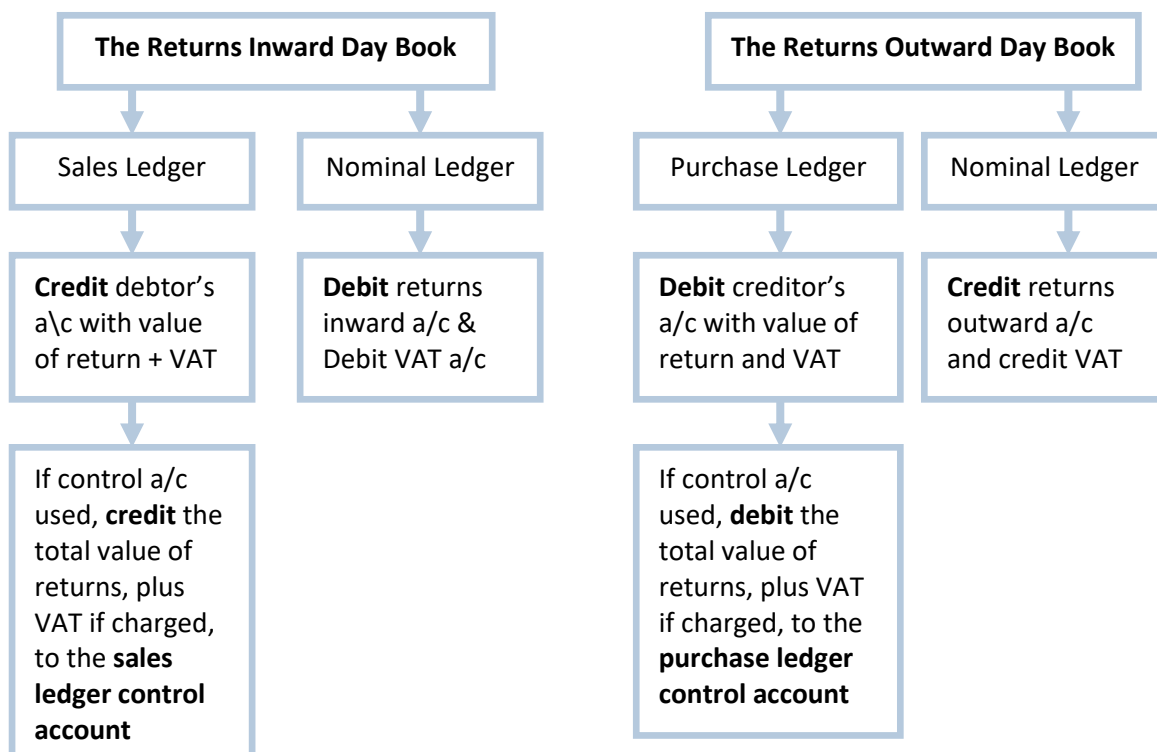


There are many situations when goods may be returned to the seller:

- Goods may have been damaged in transit
- The wrong product delivered
- The buyer may have changed his mind
- The invoice may have been added incorrectly
- There may be crates or barrels that receive a credit for safe return

The **credit note** is the documentary evidence for any type of return. It simply means that a reduction is to be made from the account where the credit note is sent.

Credit notes received and sent to customers to cover the returns are listed in sequence and in date order. Posting to the ledgers will include:



Let's look at an example for both returns inward and returns outward. These will affect the sales and purchase ledger and we will also show the nominal ledger entries. The opening debtor and creditor balances on June 1 are:

Debtor Balances

J Jones	£156 Dr
T Smith	£385 Dr
T Dooley	£224 Dr

Creditor Balances

Dunlop Sports	£96.21 Cr
Sondico	£124.62 Cr
Arena Sports	£150.00 Cr

Returns Inward Day Book: (June)

Date	Customer's A/c	C/N No.	Returns Inward a/c	VAT a/c	Total Debtor's a/c	
			£	£	£	
June 15	T Smith	427	24	4.20	28.20	Cr
23	T Dooley	428	60	10.50	70.50	Cr
30	T Jones	429	10	1.75	11.75	Cr
			94	16.45	110.45	
			(Dr)	(Dr)	(Cr S/L control a/c)	

Returns Outward Day Book: (June)

Date	Customer's A/c	C/N No.	Returns Outward	VAT a/c	Total Creditor's a/c	
			£	£	£	
June 4	Dunlop Sports	142	16.82	2.94	19.76	Dr
18	Sondico	234/C	10.86	1.90	12.76	Dr
26	Arena	67	24.60	4.30	28.90	Dr
			52.28	9.14	61.42	
			(Cr)	(Cr)	(Dr P/L control a/c)	

Sales Ledger

Date	Particulars	Debit	Credit	Balance
		£	£	£
J Jones a/c				
June 1	Balance			156.00
30	Returns In		11.75	144.25 Dr
T Smith a/c				
June 1	Balance			385.00 Dr
15	Returns In		28.20	356.80
T Dooley a/c				
June 1	Balance			224.00 Dr
23	Returns In		70.50	153.50

Purchase Ledger

Date	Particulars	Debit	Credit	Balance
		£	£	£
Dunlop Sports a/c				
June 1	Balance			96.21 Cr
4	Returns Out	19.76		76.45
Sondico a/c				
June 1	Balance			124.62 Cr
18	Returns Out	12.76		111.86
Arena a/c				
June 1	Balance			150.00 Cr
26	Returns Out	28.90		121.10

Nominal Ledger				
Date	Particulars	Debit	Credit	Balance
Returns Inward a/c		£	£	£
June 1	Balance			
30	Debtors	94.00		94.00 Dr
VAT a/c				
June 1	Balance			
30	Debtors	16.45		16.45 Dr
30	Creditors		9.14	7.31
Sales Ledger Control a/c				
June 1	Balance			765.00 Dr
30	Returns In + VAT		110.45	654.55
Returns Outward a/c				
June 1	Balance			
30	Creditors		52.28	52.28 Cr
Purchase Ledger Control a/c				
June 1	Balance			942.50 Cr
30	Returns Out + VAT	61.42		881.08

Statements:

Statements are normally sent once a month to remind customers of their outstanding balances. Statements are also received from creditors, it is important they are checked with the purchase ledger control account to check the balances agree. If they do, the statement is passed to the Cashier for payment. If not, they must be checked and reconciled before any payment is made.

Document Check:

Purchase Order	Issued to seller by buyer, lists what is to be bought
Delivery Note	Delivered with the goods, signed by customer as evidence of receipt of order
Goods Received Note	Itemises goods checked in to store, copy sent to buying office
Invoice	A bill of sale for goods or services sent from seller to the buyer
Control Grid	Used to stamp invoices as a way of checking their authenticity and accuracy
Pro Forma Invoice	Used for special cases e.g. cash on delivery where goods must be paid for before they are handed over
Credit Note	A document sent by the seller to the buyer usually to reduce the amount of an original invoice due to an overcharge or return of goods
Statement	A document sent by the seller to the buyer showing the amount to be paid for goods purchased, usually over a monthly period
Trade Discount	Given by the seller to the buyer during trading to reduce goods from the list price, usually shown as a % e.g. 20% off gross value
Bulk Discount	Similar to trade discount, but linked to the size of the order. The more bought, the larger the trade discount offered
Cash discount	Settlement discount to encourage buyer to settle debt early



End of Chapter 9 Test Questions:

1. Debtor's balances on 1 June in the books of G Harrison were:

Sales ledger	£
Arthur	100 Dr
Brian	120 Dr
Colin	150 Dr

Nominal ledger	£
Returns inward a/c	257 Dr
VAT a/c	125 Dr
Sales ledger control a/c	370 Dr

Harrison sent credit notes to customers who had returned goods during June (VAT at 17.5%)

	£	Credit Note No
12/6 Brian	60 + VAT	261
20/6 Arthur	20 + VAT	262
24/6 Colin	50 + VAT	263

Required:

- a) The returns inward day book for June
- b) Sales ledger accounts of Arthur, Brian and Colin for June
- c) Nominal ledger accounts for June

2. M Crooks has the following accounts in his ledgers on 1 May (VAT at 17.5%)

Sales ledger:		Purchase ledger:	
J Hunt	£600 Dr	R Ball	£500 Cr
R Speedie	£240 Dr	J Carlson	£400 Cr
J Milton	£400 Dr	D Smith	£150 Cr

Invoices issued during May:

	£
Hunt	130 + VAT
Milton	200 + VAT
Speedie	180 + VAT

Invoices received during May:

	£
Ball	250 + VAT
Smith	120 + VAT
Carlson	360 + VAT

Credit note received during May:

Carlson	£200 + VAT
---------	------------

Cheques received during May:

Hunt	£580 in settlement of a/c of 1 May
Milton	£390 in settlement of a/c of 1 May
Speedie	£200 on account

Cheques paid during May: settled all creditors accounts due 1 May less 2.5% cash discount

Required:

- a) Enter the opening personal accounts in the ledgers of M Crooks
- b) Post all the above transactions to these ledger accounts and balance off at the month end.

Chapter 10: VAT and VAT Returns



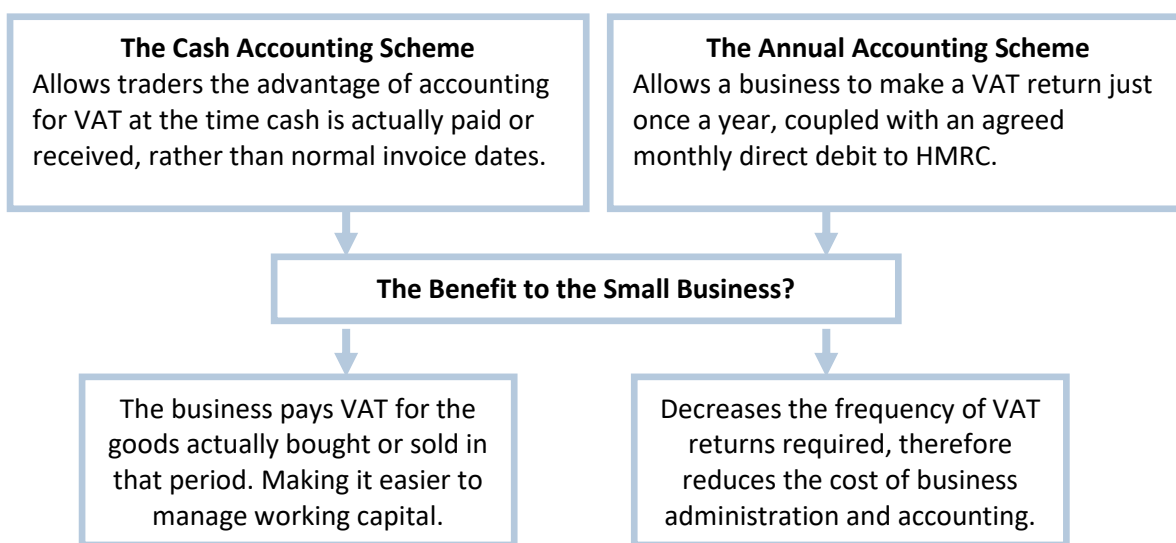
Introduction

VAT is a charge on most goods and services in the UK. It is an indirect source of taxation for the government. The key point to remember is that the collection of this tax which is charged between traders, eventually falls to us, the consumers who purchase the product.

Businesses, therefore, are the collectors of the tax, while we, the consumers, pay for it.

Basically, a business charges VAT on sales (output tax) and deducts what it pays on purchases (input tax). The balance between these two figures is paid quarterly to Her Majesty's Revenue & Customs (HMRC).

Registration for VAT is compulsory if taxable sales exceed a certain annual limit (which can change depending on economic conditions). A business that is registered for VAT has a unique registration number.



Input Tax:

Input tax offsets the amount deductible to the VAT office. Most capital and revenue expenditure is allowable for VAT inputs, if they are for business purposes. Sometimes a business can't reclaim the VAT it has paid, e.g:

- Motor cars (except when the vehicle is used to directly generate income e.g taxis)
- Non-business expenses, such as entertainment, meals etc
- The purchase of luxury items for business promotion e.g. racehorses

Output Tax:

Output tax is collected on sales or any other form of taxable supplies. However, other sales may include:

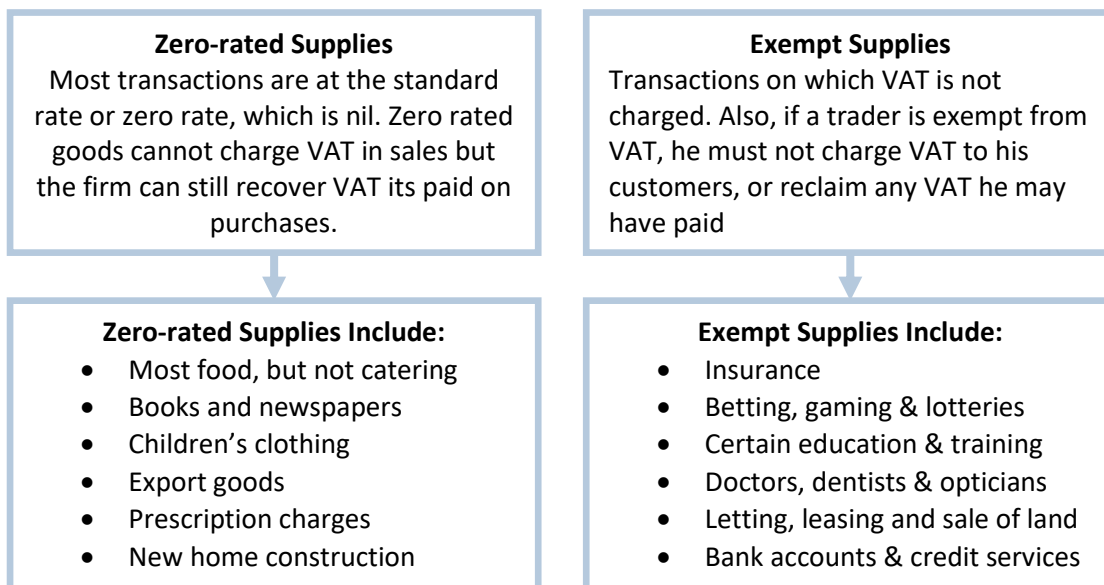
- Goods that are taken for the proprietor's own use
- Any sales to staff
- Sales of any business assets where VAT is charged

Standard, Zero rate and exempt:

Remember, when sales are made, VAT is charged at the standard rate and is **the output tax**.

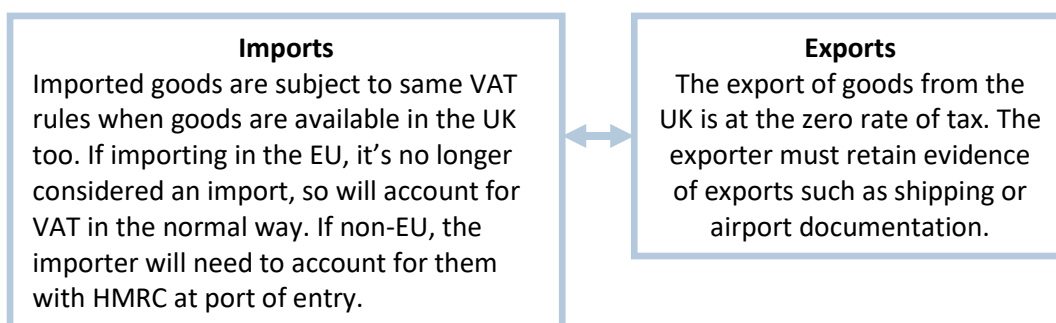
On purchases of goods or services supplied to the trader, the VAT is the **input tax**.

The VAT account records these outputs (sales) as credit entries, and inputs (purchases) as debit entries. If outputs in a tax period are greater than inputs, the difference in VAT is owed to the VAT office. If inputs are greater than outputs, the VAT office will pay the trader the difference.



Foreign Trade - VAT Imports Vs VAT Exports:

Imports and exports are treated differently in terms of VAT.



Bad Debts:

If a bad debt occurs for a VAT registered trader, HMRC offers bad debt relief, which can be claimed as a VAT input when the debt has been owing for a minimum of 6 months AND the debt has been written off as bad in the accounts.



End of Chapter 10 Test Questions:

1. Explain the accounting treatment of VAT [5 marks]
2. Janet Jones provides you with the following information for her last quarter for VAT purposes.

Sales (taxable outputs) £393,390 (inclusive of VAT at standard rate)

Purchases (taxable inputs) £281,060 (inclusive of VAT at standard rate)

During this period, Janet paid £9,875 in settlement of the previous quarter's return. (Open the VAT account with this as a credit.) Draft the VAT account to record these entries for the quarter.

3. The following data refers to the accounts of Susan Brambles Ltd for the VAT tax period April-June. Note that all the figures are inclusive of VAT.

	£
Sales	14,570
Purchases	11,327
Credits allowed to customers	940
Credits received from suppliers	799
Equipment purchases	987
New motor car for finance chief	8,850
Operating lease allowable by VAT office	846

There was also an overpayment made to the VAT office of £62 in the previous period. Note that credits refer to returns inward and outward.

Required:

- a) Produce the VAT account for the period to 30 June
 - b) The sales and purchase figures to June (returns inclusive in these)
 - c) The amounts that will be posted to equipment, vehicles and operating expenses accounts.
4. Answer the following questions in brief:
 - a) Although VAT is normally collected on a quarterly basis, what are some of the other methods allowed by the VAT office?
 - b) At what date is the tax point normally identified?
 - c) When can bad debt relief be taken as a taxable input?
 - d) How does a business, which is exempt from VAT, record VAT when it is charged against them?
 - e) How does a business that is zero-rated deal with VAT in its accounts?

Chapter 11: Banking Services



Introduction

The major **clearing banks** in England and Wales are:

- Barclays
- Lloyds TSB
- National Westminster
- HSBC



These clearing banks receive deposits of money from individuals and business on one hand and provide overdrafts and loans on the other. This is their traditional function.

Nowadays, however, they provide a wide range of financial services:

- Home mortgages
- Foreign currency
- Night safe deposit
- Insurance schemes
- Pension plans
- Investment brokers
- Financial consultants



Clearing banks provide **TWO** major types of accounts:

Deposit Accounts

Also known as an investment account, this account is used to safely invest money at higher interest rates. These rates are higher because you agree to give the bank longer notice before withdrawing any funds and will vary depending on size of deposit and length of withdrawal notice.



Current Accounts

Used for processing cheques and making payments through the bank. The bank can arrange payments by direct debit or standing order for regular expenses. Current accounts often pay interest on balances in credit. A current a/c is essential for a business, helping it to organise finances professionally.

Going to the bank:

It is important not to hold too much cash on a business premises as it is a security risk. Many businesses go to the bank every day to deposit their takings.

A bank form, the **paying-in-slip**, is used to enter the details of the cash and cheques to be deposited at the bank. But before the money is taken from the business to go to the bank, it must be recorded in the business books. The person responsible (often the cashier) counts the sales and will record details on a daily sales sheet. The paying-in-slip will then be completed and taken to the bank so that the business bank account can be credited.

Payments through the bank:

The main means of payment through a bank, other than by cheque, or by direct debit and credit cards are **standing orders**, **direct debits** and **credit transfers** (bank giro credit):

Credit Transfer System (BGC)

The bank giro credit system (BGC) is where payments can be made between debtors and creditors.

- Many household bills can be paid by completing the giro credit slip on the bill. The bank debits your account and credits the account of the payee e.g. British Gas.
- A business can also pay its employees in this way, by sending a list of names, wages to be paid and individual bank details.
- Trade creditors of a business can also be paid this way. The firm provides the list of creditors to be paid, the amount and bank details. The system saves time and effort as individual cheques are not required.



Direct Debits

These differ from standing orders as it is the creditor that claims the amount due from the customer. The supplier asks the customer to sign a direct debit form that will instruct the bank to pay the amount agreed on the dates required. The supplier sends the direct debit form to the bank. Useful for varying amounts, such as rates and goods from suppliers.

Standing Orders

This is an authorisation to the bank to make a payment on your behalf for regular expenses. The sum is usually a fixed amount and is a safe (as payment is digital, nothing needs to be sent through the post) and convenient way to make payments such as mortgage fees and insurance premiums.

Bank Overdrafts:

A trader can apply for a bank overdraft that lets him have money on credit. Meaning he can spend more money than he has in his current account.

Many firms are dependent on overdraft facilities to enable them to meet their day to day expenses. However, interest is charged on a daily basis, so overdrafts can be expensive. Although, not as expensive as spending more money than your overdraft allows (an unauthorised overdraft), which can occur fines and payments can 'bounce' meaning the payee is not paid - bad news for any business.

Inter-bank transfers:

BACS (Banker Automated Clearing Service)	A system set up by the banks to allow electronic payments. It's an efficient way to make many payments.
CHAPS (Clearing House Automated Payments System)	Another electronic payment systems but this time used for high value transactions such as motor vehicles.
Bank Drafts	This is a bank cheque, used for large payments and offering a guarantee the cheque will be paid.
Debit and Credit Cards	Once a card is swiped through a machine or PIN entered, the payment is directly debited to the customer's account via a computer link up (EFTPOS – electronic funds transfer at point of sale). Retailers pay credit companies a set percentage charge on sales, usually up to 5%.

Using the internet for payments:

With the rise of the internet in business, many firms now use websites as a means of selling their goods and services. Debit or credit cards are used to purchase goods. This is known as 'e-commerce'.

There are some concerns with consumers and businesses about using the internet to make payments, namely fraud. However, the authorities work continuously to minimise the risk to users, and it is now considered a relatively safe environment for financial transactions.



End of Chapter 11 Test Questions:

1. What is the main difference between a deposit account and a current account?
2. Why should you make variations to your journey when going to the bank?
3. Briefly explain why a bank overdraft can be more than useful to a business?
4. Explain briefly the similarities and differences of using BACS and CHAPS as banking services.
5. What is the difference between a direct debit and a standing order?

Chapter 12: The Cash Book



Introduction

The cash book is used to record all cash and banking transactions.

It is an extension of the ledger itself. Therefore, instead of having a separate bank and cash account in the nominal ledger (as we had before), a cash book can be used to keep bank and cash entries together, making it more convenient.

Below is an example cash book:

Debit				Credit			
Receipts				Payments			
	Discount Allowed	Cash	Bank		Discounts Received	Cash	Bank
	£	£	£		£	£	£
Jones	3		57	Fox	4		76

Cash discounts may take one of two forms:

- **Discount Allowed:** Entered on the left side of the cash book and is given to debtors for prompt payment of their accounts – treated as an expense.
- **Discount Received:** Entered on the right side of the cash book and is received from creditors for prompt payment – treated as revenue.

In practice cash books rarely look the same, but we will work through an example to show you how to take the raw data, enter it into the cash book and finally make the ledger postings.

January	Debit	Credit
1 Balances in cash £25, bank £900	cash £25 Bank £900	
4 Paid Stationery, by cash £20	stationery £20	cash £20
5 Cash sales £72	cash £72	sales £72
13 Paid rates £125 by cheque	rates £125	bank £125
15 Cash sales £15	cash £15	sales £15
25 Paid cash to creditor, James £115 on a/c	James £115	cash £115
26 Cash sales £80	cash £80	sales £80
28 Paid Fox, another creditor, a cheque £76 In settlement of an £80 account (£4 discount rec'd)	Fox £80	(bank £76 (disc. £4
28 Received £57 cheque from Jones (debtor) in settlement of a £60 account (£3 discount allowed)	(bank £57 (disc allow £3	Jones £60
29 Received from Smith (debtor) cheque for £152 in settlement of £160 owing (£8 discount allowed)	(bank £152 (discount allow £8	Smith £160

Important: Ledger posting from the Cash Book.

To complete double-entry, the 'opposite side' rule applies. Entries on debit side are posted on credit side of respective ledger a/c. However, when posting cash discounts to the ledger, the totals posted remain on the same side.

Dr

Note:

Cash Sales:	Debit – cash column as above	(Asset +)
	Credit – sales a/c in the ledger	(Revenue +)
Rates:	Credit – bank column as above	(Asset -)
	Debit – rates a/c in ledger	(Expense +)

Sales Ledger				
Date	Particulars	Debit	Credit	Balance
J Jones a/c		£	£	£
1/1	Balance			60 Dr
28/1	Bank		57	
	Discount Allowed		3	0
R Smith a/c				
1/1	Balance			160 Dr
29/1	Bank		152	
	Discount Allowed		8	0

Purchase Ledger				
<u>Date</u>	<u>Particulars</u>	<u>Debit</u>	<u>Credit</u>	<u>Balance</u>
N Fox a/c		£	£	£
1/1	Balance			80 Cr
28/1	Bank	76		
	Discount Rec'd	4		0
R Jones a/c				
1/1	Balance			115 Cr
25/1	Cash	115		0



End of Chapter 12

Test Questions:

Past Paper Question:

1. The following transactions need to be written up in a three-column cash book:

01/11 Debit balances brought forward bank £5,000 cash £500.

03/11 Paid rent £1,000 (cheque).

05/11 Received the following cheques: Arun £285, Bruno £475 and Calvin £665.

All three debtors have ALREADY been allowed a 5% cash discount.

06/11 Cash sales £2,400.

09/11 Paid wages £900 (cash).

10/11 Paid cheques to the following suppliers: Dune £190, Emirin £475 and Franco £570.

All three suppliers have ALREADY allowed a 5% cash discount.

13/11 Bought equipment £13,000 (cheque).

20/11 Cash sales £3,900.

24/11 Paid £2,800 of the cash into the bank.

28/11 Paid wages £900 (cash).

29/11 Paid rent £1,000 (cheque).

Note – the balance on the discounts allowed account as at 1 April was £790, and the balance on the discounts received account as at 1 April was £1,100.

Required:

a) Write up the three-column cash book to record the above transactions. [15]

b) Update the discounts allowed and discounts received accounts. [5]

2. Why, when posting entries from the cash book, do cash discounts remain on the same side in their respective nominal ledger accounts?

3. A wine shop owned by R Lees kept an analysis Cash Book using extra columns. The daily takings are banked each day at the local branch. The cash register calculates the VAT separately when a sale goes through the till. The takings over four days were as follows:

June	Wine	Beer	Spirits	Other Sales	Total	Bank
	£	£	£	£	£	£
2 Takings	200	250	80	30		
VAT	30	37.5	12	4.5		
3 Takings	150	200	50	20		
VAT	22.5	30	7.5	3		
4 Takings	180	240	60	24		
VAT	27	36	9	3.60		
5 Takings	300	340	100	60		
VAT	45	51	15	9		

Required:

a) Prepare a suitable Cash Book using the above columns to analyse the different sale categories.

b) Post the sales and VAT to the ledger

c) Why is it sometimes useful to make analysis columns?

Chapter 13: The Bank Reconciliation



Introduction

Bank reconciliation is a method of bringing together the bank balance as shown on the bank statement with the balance as shown in the cash book.

These balances may not agree, because:

Items in the cash book not yet recorded in the bank statement:

- Cheque payments entered on the credit side of the cash book but not yet presented for payment at the bank – these are ‘un-presented cheques’.
- Cheques, cash entered on the debit side of the cash book, but not yet deposited at the bank – these are ‘un-deposited cheques, cash’

(These items will then be recorded in the bank reconciliation statement)

Items in the bank statement not yet recorded in the cash book:

a) Payments and charges made by the bank and charged against the business:

- Standing orders
- Direct debits
- Interest and bank charges
- Cheques R/D (referred to drawer, due to insufficient funds)

(These items will be entered on the credit side of the cash book – the payments side)

b) Receipts by the bank on the business’s behalf and not yet recorded in the cash book:

- Cheques from customers paid through Bank Giro
- Interest received on deposits at the bank
- Dividends received from investments

(These items will be entered on the debit side of the cash book – the receipts side)

Procedure for bank reconciliation:

Checking must be made in some systematic order.

1. Tick off all the items that appear on both sets of records (both receipts and payments). Entries that appear on both sets of records require no further action. It is only those entries that do not appear on both records (the cash book and the bank statement) that require further action. Also check the opening balances in the cash book and bank statement for any differences because these also need action.
2. If there are any un-ticked items on the bank statement, such as bank charges, standing orders, direct debits or interest received, these need to be first entered in the cash book. The cash book balance will then have been updated. Once the cash book has been adjusted the final stage is set for the reconciliation.
3. The bank reconciliation statement is then prepared usually in this format:
 - a. Balance as per bank statement (end of month balance)
 - b. Add any un-deposited cheques/cash (from debit side cash book)
 - c. Deduct any un-presented cheques (from credit side cash book)
 - d. This should equal the balance as per cash book

Let's work through an example. Here you will see a bank statement and the company cash book. Each item that appears in both documents will be ticked off, and the items in just one document will then form the basis of the reconciliation statement.

Bank Reconciliation Statement for K McDonald:

National Bank Plc K McDonald Statement of Account				
Date	Details	Debits £	Credits £	Balance £
Oct 30	Balance			841
Oct 31	606218	23 ✓		818
Nov 5	Sundry Credit		46 ✓	864
Nov 7	606219	161 ✓		703
Nov 9	Direct Debit	18		685
Nov 12	606222	93 ✓		592
Nov 15	Sundry Credit		207 ✓	799
Nov 19	606223	246 ✓		553
Nov 19	Bank Giro Credit		146 ✓	699
Nov 20	Bank Giro Credit		246	945
Nov 21	606221	43 ✓		902
Nov 21	Sundry Credit		63 ✓	965
Nov 22	Bank Giro Credit		79 ✓	1,044
Nov 23	Loan Interest	391		653
Nov 26	606220	87 ✓		566
Nov 26	Deposit a/c interest		84	650
Nov 27	606226	74 ✓		576
Nov 28	Sundry Credit		88 ✓	664
Nov 30	606225	185 ✓		479

Her **cash book** showed the following details:

	£		Cheque No	£
Nov 1 Balance b/d	818 ✓	Nov 2 Rent	219	161 ✓
Nov 5 B Mason	46 ✓	Nov 5 H Gibson	220	87 ✓
Nov 8 K Dean	146 ✓	Nov 7 G Wise	221	43 ✓
Nov 14 G Hunt 1	207 ✓	Nov 8 T Allen	222	93 ✓
Nov 16 C Charlton	79 ✓	Nov 12 Gas	223	246 ✓
Nov 19 D Banks	63 ✓	Nov 15 F Chaucer	224	692
Nov 26 P Perry	88 ✓	Nov 19 M Lewis	225	185 ✓
Nov 28 A Palmer	29	Nov 23 G Bridges	226	74 ✓
Nov 30 J Dixon	17	Nov 29 L Wilson	227	27
Nov 30 Balance c/d	206	Nov 29 P Brown	228	91
	<u>1,699</u>			<u>1,699</u>

Cash Book

Dr			Cr		
Dec 1	Deposit interest	84	Dec 1	Balance b/d	206 (o/d)
	Bank giro credit	246		Direct Debit	18
	Balance c/d	<u>285</u>		Loan interest	<u>391</u>
		615			<u>615</u>
				Balance b/d	285

Bank Reconciliation Statement as at November 30

		£
1 Balance as per bank statement (30/11)		479 Credit
2 Add deposits not yet credited:		
Palmer	29	
Dixon	<u>17</u>	<u>46</u>
		525
3 Less un-presented cheques:		
Chaucer	692	
Wilson	27	
Brown	<u>91</u>	<u>(810)</u>
4 Balance as per cash book		285 (o/d)

Overdrafts:

It is vital to remember that an overdraft is a debit balance in the bank statement and is a credit balance in the bank account or cash book. Therefore, when preparing a bank reconciliation the additions and subtractions need to be reversed, e.g:

		£
Balance as per bank statement		479 Dr
Less deposits not yet credited:		
Palmer	29	
Dixon	<u>17</u>	<u>46</u>
		433
Add un-presented cheques:		
Chaucer	692	
Wilson	27	
Brown	<u>91</u>	<u>810</u>
Balance as per cash book		1243 (o/d)



End of Chapter 13 Test Questions:

1. The following represents the Cash Book and bank statement figures of J Jones for the month of June:

Cash Book (bank columns only)

	£		£
1/6 Balance b/d	469	6/6 Jones, F	130
14/6 Doyle, C	393	9/6 Singleton, S	63
17/6 Cronin, A	200	20/6 Jackson, J	292
28/6 Smith, W	205	27/6 Hemming R	78
	—	Balance c/d	—?

Bank of Education Statement of J Jones – for month of June

	Dr £	Cr £	Balance £
1/6 Balance			469 Cr
5/6 Credit		393	862 Cr
12/6 123971	130		732 Cr
19/6 123972	63		669 Cr
20/6 Credit		200	869 Cr
26/6 Credit (Smith, R)		100	969 Cr
28/6 SO (Leicester BSC)	86		883 Cr
29/6 Charges	19		864 Cr

Required:

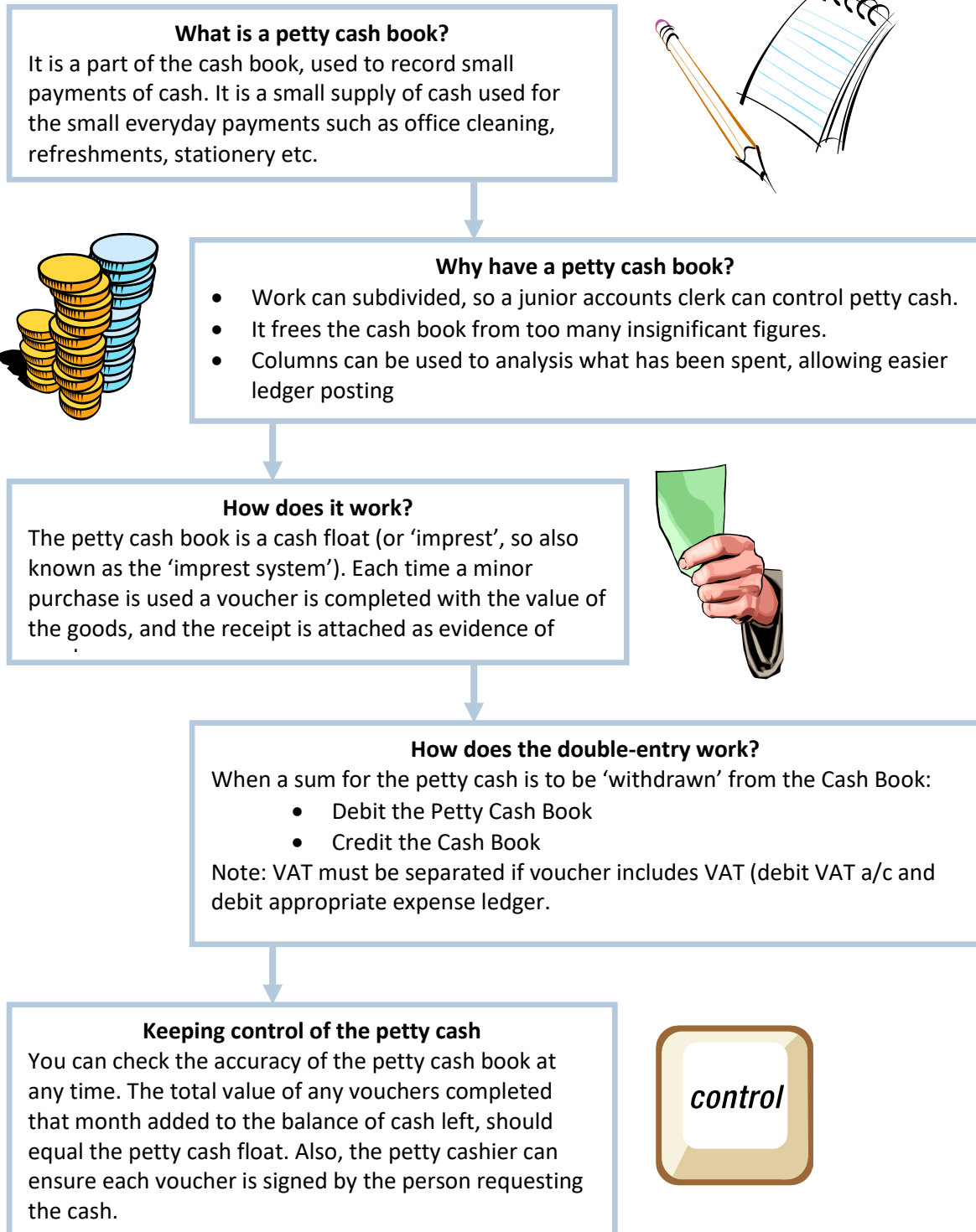
- Bring down the balance of J Jones's Cash Book and check both sets of records and action any un-ticked items.
- Adjust the Cash Book
- Prepare the bank reconciliation statement as at 30 June

Chapter 14: The Petty Cash Book



Introduction

The Petty Cash Book is easy to understand. This diagram shows you what a petty cash book is, how it works and how the ledger postings work:





End of Chapter 14 Test Questions:

1. Why is the petty cash book part of the accounting system?
2. Gill Graham runs her petty cash on the imprest system, having a float of £200 per month. She uses analysis columns for VAT, postage, travel, cleaning, refreshments, stationery and sundries. At the end of August, she had £28.75 to carry forward to the new month. During the first three weeks of September, the following transactions occurred:

September

- 1 Enter the balance brought down from August in the petty cash book
- 2 Cashier reimburses Gill to bring up to required float
- 3 Purchased stamps £12.50
- 5 Rail fares to Bristol £13.60
- 6 Typing paper, biros, etc. £14.10 (inc. VAT 17.5%)
- 8 New kettle and cups £18.80 (inc. VAT 17.5%)
- 11 Window cleaner £10.50
- 12 Postage stamps £8.75
- 15 Taxi expenses £7.80
- 16 Repairs to typewriter £12.80 + VAT 17.5%
- 18 Window cleaner £10.50
- 20 Donation for Poppy Appeal £2.00
- 20 Milk money £6.25
- 21 Tea, coffee, etc. £4.80

For the remainder of September, there are eight further vouchers to record.

Required:

- a) Enter the above petty cash transactions in the Petty Cash Book for Gill Graham and record the remaining eight petty cash vouchers overleaf.
- b) Balance the petty cash book as at 30 September. Post the individual expense columns to the nominal ledger.

Chapter 15: Capital and Revenue Expenditure



Introduction

A business spends money on two types of expenditure:

Capital Expenditure:

This is the purchase of fixed assets, such as vehicles and equipment. Money spent on improving an asset (and therefore its value) is also considered to be capital expenditure.

Revenue Expenditure:

This is the money spent on running the business with expenses such as purchases of stock, wages and salaries, light and heat, stationery etc.

The key difference to remember is how these two types of expenditure are treated in the financial statements. Capital expenditure is listed in the balance sheet under fixed assets, whereas all revenue expenditure appears in the profit and loss account.

Why is this important? If for example, machinery was purchased and it was wrongly treated as revenue expenditure, this would have the effect of under-stating the value of fixed assets and over-stating the value of chargeable expenses. Result: profits are understated and fixed assets are understated, meaning the tax paid to HMRC is incorrect (too low) and the company's balance sheet would not accurately represent the value of assets held.

The distinction between capital and revenue income:

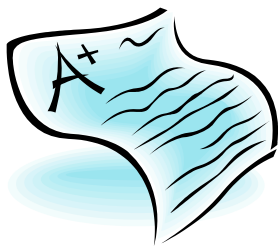
Capital Income:

When fixed assets are sold, the sale value of them is known as capital income. The profit (treated as revenue) or loss (treated as an expense) from the sale is recorded in the profit & loss a/c.

Revenue Income:

This is the income from normal trading activities of the business when it sells its goods or services. This includes income such as rent and interest received.

Transaction	Revenue Expenditure Profit and Loss Account	Capital Expenditure Balance Sheet
New computer £2,500		2,500
Installation of computer £1,000		1,000
Gas and electricity £450	450	
Modernisation of premises £8,000		8,000
Office buildings painted £6,000	6,000	
Wages and salaries £17,500	17,500	
New vehicle for manager £9,500		9,500
Stock for resale £3,200	3,200	
Motor expenses £800	800	
Purchase of land £20,000		20,000
Solicitor's fees for purchase £550		550
Running costs of computer £600	600	



End of Chapter 15 Test Questions:

1. Classify the following items as to whether they are capital or revenue expenditure:
 - a) The purchase of a new IBM computer for the office.
 - b) Cost of software for the use of the new computer.
 - c) Cost of computer paper.
 - d) A refit of the stockroom with new shelving.
 - e) The payment of gas and electricity bill.
 - f) The purchase of stock for resale.
 - g) Discounts allowed on the sale of stock.
 - h) The acquisition of a new motor vehicle for the supervisor's use.
 - i) The road tax and insurance of the vehicle.
 - j) The repairs and maintenance of the motor vehicle.
 - k) The cost of new floppy disks for the use of the computer.
 - l) The complete decoration of the offices to last a number of years.

2. In the setting-up of a new business for Jack Ramsgate, classify the following between capital and revenue expenditure:
 - a) The purchase price of premises.
 - b) The estate and solicitor's fees.
 - c) The cost of a computer system.
 - d) The cost of delivery charges and installation fees of the new computer.
 - e) The cost of training of personnel on the computer system.
 - f) Running repairs to the computer.
 - g) Oil and petrol for the motor vehicle.
 - h) An extension built on the premises.
 - i) The extension is painted on completion.
 - j) The extension is repainted six months later.
 - k) Improved roofing of the premises is installed two years later.
 - l) The cost of an advertising campaign which is expected to benefit a number of accounting periods.

Chapter 16: The Trial Balance, Journal



The Trial Balance

The **trial balance** is used to check the arithmetical accuracy of the double-entry system. At frequent intervals, ledger account balances are listed to check that total debits equal total credits.

If the trial balance fails to balance the ledger accounts need to be checked to locate the errors.

However, the trial balance is not fool-proof. Some errors can occur that will not be detected with this system. It's important to understand these types of error:

Errors of compensation	Where the error has been made to both sides of the transaction e.g. a cheque rec'd for £451 incorrectly entered as £415 on both sides of the ledger.
Errors of principle	Where a transaction has been posted to the wrong group of accounts e.g. office equipment posted to 'purchases a/c' instead of 'office equipment'.
Errors of omission	An error where a transaction has been omitted altogether e.g. a sales or purchase invoice mislaid.
Errors of commission	Where an entry is posted to the correct group of accounts, but the wrong account within the group e.g. a nominal a/c like a gas bill posted to another nominal a/c like office expenses.
Errors of original entry	An error that first appeared on an original document such as an invoice. The error would be posted to both credit and debit sides, meaning the trial balance would not identify the mistake.
Errors of reverse entry	An entry made the opposite way round to what it should be e.g. cash sales entered on the credit side of the cash book.

Locating the errors:

If the trial balance fails to balance, then the errors must be identified, however small the error (as a small error could be hiding a big one). Depending on the error, it may be necessary to comb through the ledgers carefully to check for any arithmetical inaccuracies or any obvious double entry error.

The Journal

The journal is used for those transactions that are normally outside the scope of the other subsidiary books. It provides a system of original entry for those miscellaneous types of transaction that do not quite 'fit in' to the other subsidiary books.

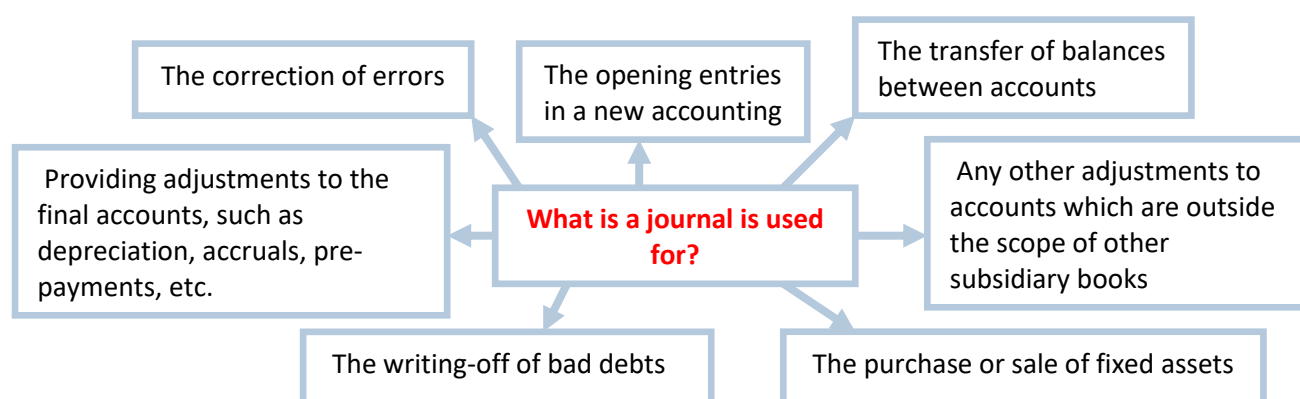
The journal is ideal to use when making corrections of errors. So let us use a series of errors, corrected using the journal, and then posted to the sales and nominal ledger:

Journal			
Date	Particulars	Debit	Credit
		£	£
8	Bank T Smith (error of compensation, £451 cheque entered as £415)	36	36
10	Office Equipment Purchases (error of principle, asset recorded as an expense)	2,500	2,500
14	J Jackson Sales VAT (error of omission, invoice No. 2176 had been omitted)	235	200 35
26	Light & Heat Office expenses (error of commission, gas bill entered in office expenses)	185	185
30	F Jones VAT (error of original entry, sales VAT charged at 15%, instead of 17.5%)	9.50	9.50
30	Bank (cash book) Sales (error of reverse entry, cash sales £480 entered as debit in bank)	960	960

Error Correction: Sales Ledger				
Date	Particulars	Debit	Credit	Balance
		£	£	£
T Smith a/c				
June 1	Balance			451 Dr
2	Bank		415	36
8	Bank		36	0
J Jackson a/c				
June 1	Balance			50 Dr
14	Sales	235		285
F Jones a/c				
June 1	Balance			120 Dr
15	Sales, VAT	437		557
30	VAT	9.50		566.50

Error Correction: Nominal Ledger

Date	Particulars	Debit	Credit	Balance
	Office Equipment a/c	£	£	£
June 1	Balance			1,000 Dr
10	Purchases	2,500		3,500
	Purchases a/c			
June 1	Balance			2,850 Dr
10	Office equipment		2,500	350
	Light & Heat a/c			
June 1	Balance			350 Dr
26	Office expenses	185		535 Dr
	Office Expenses a/c			
June 1	Balance			595 Dr
26	Light & heat		185	410
	VAT a/c			
June 1	Balance			40 Cr
14	Sales		35	75
15	Sales		57	132
30	Sales		9.50	141.50
	Sales a/c			
June 1	Balance			590 Cr
14	Jackson		200	790
15	Jones		380	1,170
30	Bank	480		690
30	Bank		960	1,650



The Suspense Account

The purpose of a suspense account is to balance the trial balance temporarily. If the credit and debit sides do not match, a suspense account can be created by inserting the difference between the trial balance totals.

A suspense account is then opened in the nominal ledger and is written off when the error(s) are located. The journal (mentioned above) is then used to process the corrections. Using a suspense account in a trial balance looks like this:

Extract of trial balance taken from the books of G Harrison 30 June

Account	Debits £	Credits £
Sales		18,600
Purchases	12,500	
Furniture and fittings	4,200	
General expenses	150	
Discount		35
Returns	750	
	17,600	18,635
Suspense	1,035	
	18,635	18,635

How profit can be affected:

Before errors in the trial balance can be corrected via the suspense and journal entries, it is possible the profit and loss account has been prepared. If so, the corrected errors will change the value of net profit. To correct this:

- Start with the net profit figure before the errors
- **Add** the corrected errors that would have increased net profit e.g. sales (under-cast), discounts received, returns, etc.
- **Less** the corrected errors that would have decreased net profit e.g. expenses not previously counted.
- You end with a correct net profit figure.

Foundation Accounting: Revision Section



Ok, now is the time to pause and review this section by testing yourself. If you want to do well in the exams, this stage is critical. It will test your knowledge and make sure that you understand all the key points so far.



If you skip this stage, you will almost certainly get a lower mark in the exams. It will be hard, but your hard work will pay off.

Now answer each of these questions, if you are unsure, try to write an answer before looking up the solution. You may need to refer to your original text book for those questions you find most difficult.

1. Write down the accounting equation
2. Briefly explain the principle of double entry
3. How would the following be recorded in the nominal ledger?
 - a. Cash sales into the bank
 - b. Purchased goods on credit from XYZ Ltd
 - c. Owner takes cash for his own use
 - d. A debtor pays off his outstanding balance (4 marks)
4. How are transactions processed either on credit terms or by cash through an accounting system to the ledgers?
5. State the posting procedure from the sales journal, including VAT
6. State the posting procedure from the returns outward journal
7. Calculate an invoice that has goods gross £800 less trade discount 30% + VAT
8. Calculate an invoice that has goods gross £1,200 less trade discount 25% and offers 5% cash discount for early payment. (2 marks)
9. What is the basic rule applied when posting from a cash book to the ledgers?
10. If the total cash paid to creditors was £1,860 and discount received was £40 how is this posted to the control account? How is the discount posted? (2 marks)
11. How are the following accounts classified under RECAL:
 - a. Returns in
 - b. Returns out
 - c. Drawings
 - d. Discount received
 - e. Discount allowed and cash (2 marks)
12. When a bank statement arrives from the bank, why does it rarely agree with the business's cash book? (2 marks)
13. Briefly explain the procedure to prepare a bank reconciliation. Also, on a bank statement, which side would record DDs, STOs and bank charges and how would these be recorded in the cash book? (2 marks)
14. Why is it an advantage to use multi-columns in journals and cash book records? (2 marks)
15. Write down two functions of the journal. (2 marks)
16. Explain the following briefly:
 - a. Error of principle
 - b. Error of commission
 - c. Error of compensation
 - d. Error of original entry (4 marks)

17. Provide two reasons why control accounts are used. (2 marks)
18. When using the petty cash system:
 - a. How is a reimbursement recorded?
 - b. How are analysis columns posted to the ledger?
 - c. What kind of evidence is required before giving out petty cash?
 - d. What is the difference between petty cash and petty cash expenses? (4 marks)
19. When is the stock account recorded in the ledger? And when stock is purchased or sold or goods returned, which accounts are used? (2 marks)
20. How is a bad debt written off?
21. What is the basic function of a trial balance? Explain why it is not fool-proof. (2 marks)

Total = 40 marks

How did you do? If you struggled with certain areas, it is best to go back and revisit those sections. Now you are going to attempt a full exam type question. You will be given a large amount of starting information and you have to then prepare the accounts up to the trial balance.

AAT Processing Question:

The following transactions take place on 1 June and have yet to be entered in the ledger system. The bank statement was received on 2 June but contains some items for the bank account relating to 1 June. You work as an accounts assistant for Motormart Ltd and have been made responsible for keeping the ledgers up to date and producing the trial balance. The following entries are for you to process.

Sales invoices sent:

Customer	Total	VAT	Net Sales
	£	£	£
Auto Ltd	5,492	818	4,674
Salfords Ltd	3,396	506	2,890
Ford Motors Ltd	6,156	917	5,239
Other customers	22,696	3,380	19,316
	37,740	5,621	32,119

Purchase invoices received:

Supplier	Total	VAT	Net purchases
	£	£	£
Carmart Ltd	8,371	1,247	7,124
Lombards Ltd	7,727	1,151	6,576
Lucas & Co	5,820	867	4,953
Other suppliers	12,676	1,888	10,788
	34,594	5,153	29,441

Credit note issued:

Customer	Total	VAT	Net Sales
	£	£	£
Ford Motors Ltd	168	25	143

Journal	Debit £	Credit £
Creditors control a/c	1,450	
Debtors control a/c		1,450
Transfer of balances (relating to other customers/other suppliers)		

Cheque issued:	£
Lombards Ltd	2,817
(Full repayment of debt for £2958)	
Cash purchases	1,363
(Inclusive of £203 VAT)	

Cheques received:	£
Ford Motors Ltd	1,472
(Full repayment of debt for £1,550)	

Bank Statement received:	
The only items relating to 1 June were:	
Bank interest received	£122
Bank charges	£210

The following balances are available to you at the start of the day on 1 June:

£

Sales ledger

Auto Ltd	24,617
Salfords Ltd	41,561
Ford Motors Ltd	27,124
Other customer balances	627,341

Purchase ledger

Carmart Ltd	28,413
Lombards Ltd	56,987
Lucas & Co	33,792
Other supplier balances	492,853

Nominal ledger

Purchases	2,652,194
Sales	3,122,786
Returns in	6,225
Bank (debit)	4,120
Bank charges	261
Bank interest received	103
VAT (credit)	71,089
Discount allowed	21,408
Discount received	15,194
Debtors control	720,643
Creditors control	612,045

Task 1:

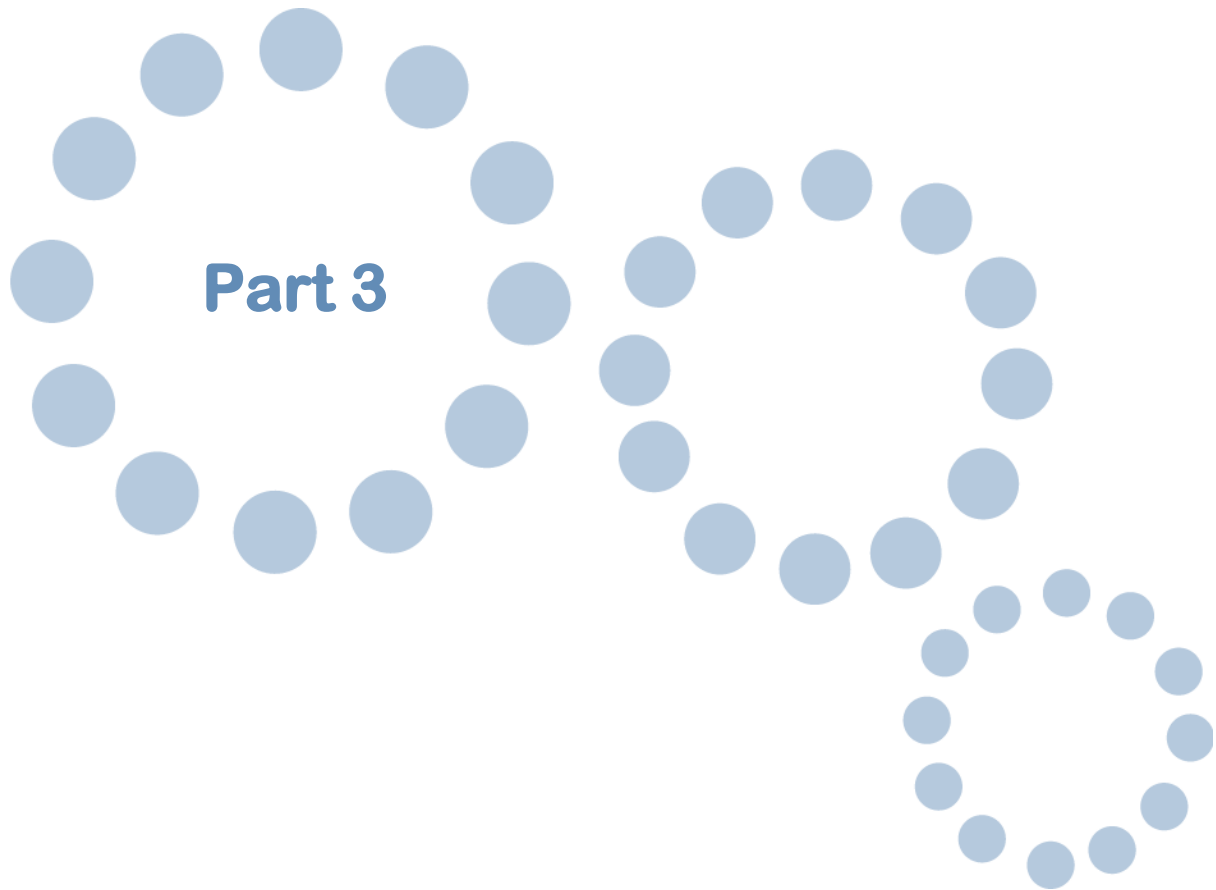
Draw up the sales and purchase ledger accounts (including other customer and supplier account balances) and balance at the end of the day 1 June.

Task 2:

Draw up the nominal ledger accounts and post all relevant data from the prime books. Balance at the end of the day 1 June. Ensure that your sales and purchase ledger totals equal your control account balances.

Task 3:

Prepare a trial balance as at 1 June (include other debit and credit balances).



Supply Information for Management Control

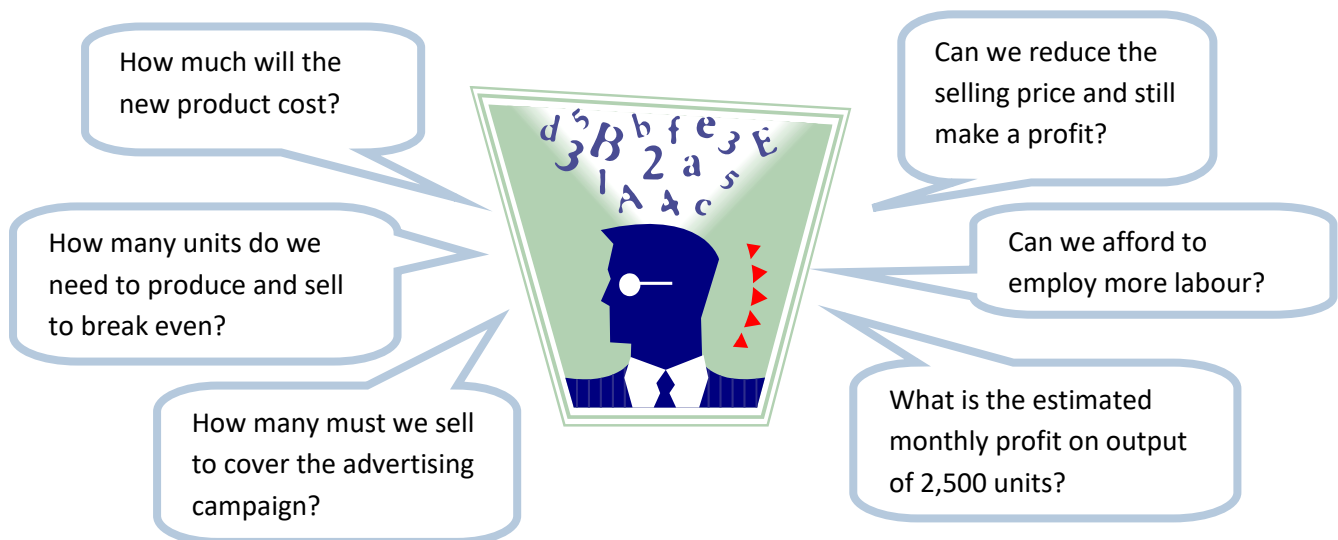
Chapter 17: The Purpose of Management



Introduction

The management of a business need to know information to help them make good decisions. It is not just about the quantity of information that is important. Good management information is:

- Relevant
- Reliable
- Timely (better to have imperfect information in time to make a decision than perfect information that arrives too late)



Businesses of all sizes require information. Even the sole trader must have knowledge of how sales are moving and the type of costs the business is incurring. But it is in larger organisations (particularly manufacturing) where good management information becomes critical.

Management must know the different types of direct and indirect costs which make up the factory cost. This information allows them to decide what mark-up of profit should be added in order to decide on the selling price.

The **break-even point** is an important measurement. It is the point where all costs are covered and above the break-even point is when profit is made.

Costing:

Where managers need information, costing helps to provide it. **Cost accounting** is often referred to as **management accounting**, because of the information it supplies to help management make better, more informed decisions.

The most common costing question is: “how much does it cost to make?”

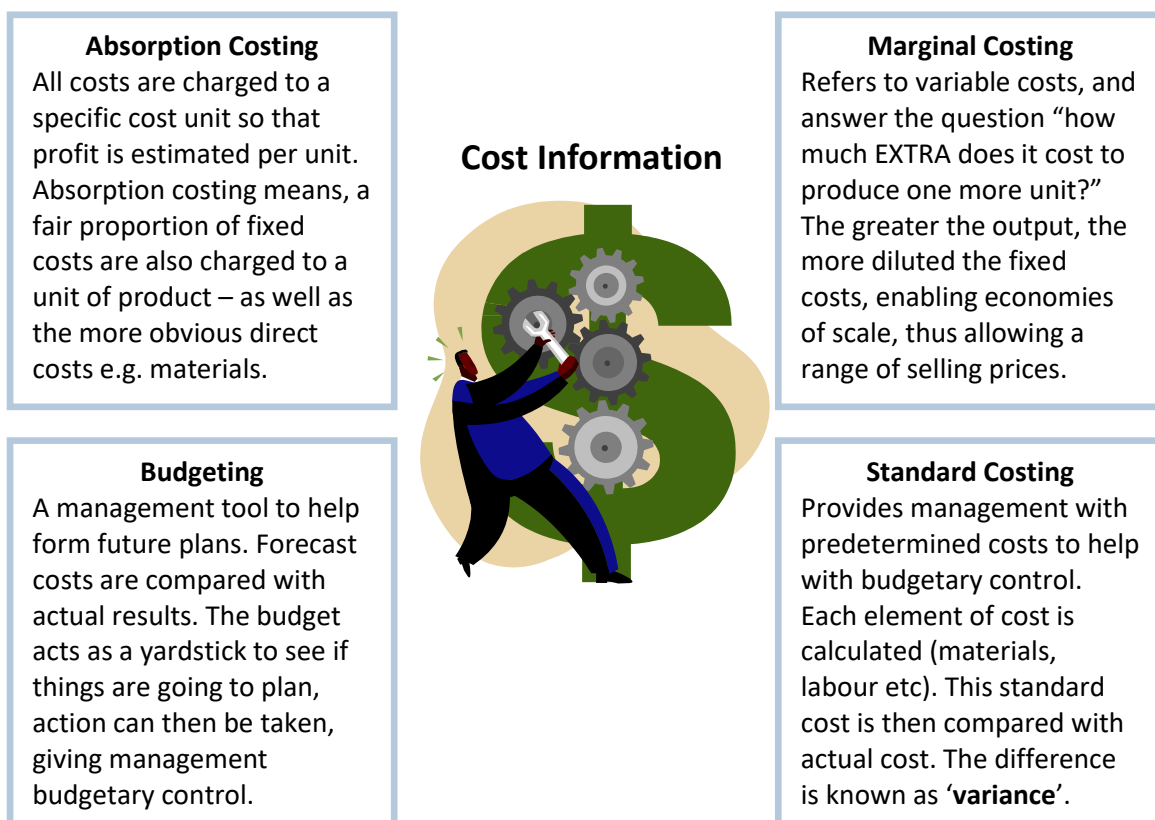
It often depends on the type of information required that determines the costing method used. For example:

- To know the full cost of making a specific unit, **absorption costing** is used.
- To know the break-even point of the product, then **marginal costing** is used.
- To predict future costs and compare them with actual results, the technique of **budgetary control** is used.
- To compare predetermined costs against actual costs, **standard costing** is used.

Before we look at the four costing methods, it is important to understand the difference between fixed and variable costing:

Fixed costs such as rent, rates and insurance costs are relatively insensitive to output change i.e. if the units produced or sold varied fixed costs remain about the same.

Variable costs are those that ARE sensitive to output change and so will vary with the level of activity.



The analysis of the variance between what was predicted and what actually occurred is an important function of management accounting. Variances from the standard costs will sometimes be adverse i.e. actual costs exceeded the predicted standard cost. Or, favourable i.e. actual costs are less than the standard, e.g.:

	Standard cost per unit	Actual cost per unit	Variance
Direct labour	2.40	2.50	10p Adverse
Direct materials	5.25	5.00	(25p) Favourable
Factory overheads	8.75	9.35	60p Adverse
Administration overheads	12.55	12.90	35p Adverse

Costing Methods



Job Costing

A method used to satisfy customers who have their own specifications (different parts, measurements etc), often requiring a bespoke production run.

Contract Costing

Often used for large jobs, costly to produce and likely to take a long time to complete. Contract price estimated in advance often with clauses to allow additional charges.

Batch Costing

Method used to produce quantities of output for similar or identical products. Unit cost is the total cost of the batch, divided by the output of the batch.

Process Costing

A series of continuous production processes. At each stage the output of one process goes on to form the input of the next. Each stage is costed to give a total cost.

Cost classification:

There is a real need in industry to classify all costs carefully in their own categories so that the precise nature of what something costs can be estimated in terms of labour, materials and overheads. Below is an example of a cost classification: the unit cost of a pair of jeans

	£	£
Direct materials		
Cotton	1.40	
Zip	.30	
Embroidery	<u>.20</u>	1.90
Direct Labour		
Machinists	.20	
Cutters	.15	
Assemblers	<u>.05</u>	0.40
Prime cost		2.30
Indirect costs		
Factory indirect wages	.12	
Rent, rates, insurance	.03	
Depreciation of plant	.20	
Factory general expenses	<u>.10</u>	
Factory overheads		.45
Production Cost		2.75
Profit and loss expenses		
Admin & distribution overheads		<u>1.25</u>
Total cost		4.00

If management wanted to make a profit of 25% on the total cost (a mark-up) the selling price would be £5.00 per unit (£4.00 + £1 profit).



End of Chapter 17 Test Questions:

1. Why is there a need for cost accounting?
2. Briefly explain the difference between absorption and marginal costing?
3. How would you classify the following costs of a car manufacturer?
 - a) component parts
 - b) factory foreman's wages
 - c) assembly worker
 - d) sheet metal body worker
 - e) factory rent, rates and insurance
 - f) sales staff salaries
 - g) administration officer's wages
 - h) lubricants for plant & machinery
 - i) warehouse costs
 - j) manufacturing cleaner's wages

4. The following information concerns a small manufacturing business:

	£
Direct wages	40,000
Direct materials	60,000
Business rates	1,600
Advertising	1,500
Administration	18,500
Rent and Insurance	6,200

- a) If it was estimated that 8,000 units were to be produced, calculate the total (absorption cost) per unit.
 - b) Which of the above would you consider as being the variable costs?
 - c) What would be the total fixed costs?
5. A batch of 5000 units are produced and you have been asked to calculate costs:

	£
Materials & components	8,000
Direct wages	7,500
Factory overheads	4,200
Sales & distribution expenses	6,250
Administration expenses	4,650

You have been asked to calculate: (only materials and wages are variable)

- a) The direct cost per unit
- b) The factory overheads per unit
- c) The production cost per unit
- d) The total cost per unit
- e) If a mark-up was added, what is the unit selling price?
- f) What is the break-even point?

Chapter 18: The Use of Cost Centres and Coding of Costs



Introduction

What is a cost centre?

It is a part of the business – a production or service location, function or activity – that incurs costs and where those costs can be attributed to cost units.



Why have cost centres?

The monitoring of costs to the sections of the business that will use them helps to maintain a control of costs and allow management to operate with budgetary control.

To find the cost of anything, the direct costs can normally be traced to a cost centre quite easily. The indirect costs such as rent, rates, insurance, light and heat may not be so easily traceable and may benefit a number of cost centres.

It is important to have a fair way of apportioning these overheads to various cost centres so that accurate costs are attributed to them.

Allocating and apportioning of costs

Some costs are easier to allocate than others. Direct costs and some indirect costs (such as indirect labour and materials) are normally straightforward allocation.

The apportioning of costs applies when a cost is incurred for the benefit of two or more cost centres. Overheads such as rent, rates and insurance are typical indirect costs that require a fair apportionment as they benefit more than one cost centre.

Bases of apportionment:

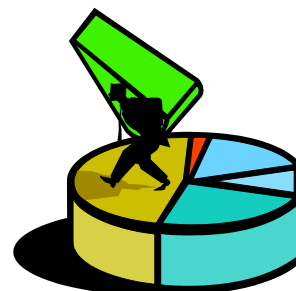
There are a number of ways a cost attributable to multiple cost centres can be apportioned:

Cost type

Rent, rates
Insurance (buildings)
Insurance (employees)
Light, heat, power
Canteen expenses
Wages, office expenses
Distribution costs

Basis of apportionment

Floor area
Floor area
Number of employees
Floor area of metered units
Number of employees
Number of employees
Value of sales



For example:

The canteen expenses of a factory were £150,000, with four cost centres:

Cost centre 1	50 employees
Cost centre 2	30 employees
Cost centre 3	10 employees
Cost centre 4	10 employees

Now we can apportion the canteen costs:

Cost centre 1	£75,000
Cost centre 2	£45,000
Cost centre 3	£15,000
Cost centre 4	<u>£15,000</u> £150,000

The coding of accounts for income and costs:

Each income and cost account needs to have a code number so that it can be properly classified into its own specific areas or locations. By using a code of numbers for various categories of sales, purchases, stocks, overheads and any other type of account used, an integrated accounting system (using computer software) can be built up.

Each account in the nominal, sales and purchase ledgers should have a code number to identify the type of account it is. For example:

0 – 250	Sales ledger accounts
251 – 750	Purchase ledger accounts
751 – 1000	Nominal ledger accounts

Almost all coding of accounts is based on a numerical system whereby the break-down of numbers used relates to specific elements such as location, type and description of item coded. Where cost centres are used, the first two numbers often identify the cost centre. For example:

Code number **01445502**

01	Cost centre 1 = administration
44	Stationery
55	Photocopying paper
02	Revenue expenditure

Key point: a coding system needs to be simple and easy to use and easy to recognise. It also needs to be flexible to be able to meet the changing needs of the business.



End of Chapter 18 Test

Questions:

1. Define a cost centre.
2. Define a cost code
3. Why are overheads more difficult to apportion than direct costs?
4. The floor area of 4 production centres are:
Centre A 150 sq metres
Centre B 75 sq metres
Centre C 25 sq metres
Centre D 50 sq metres

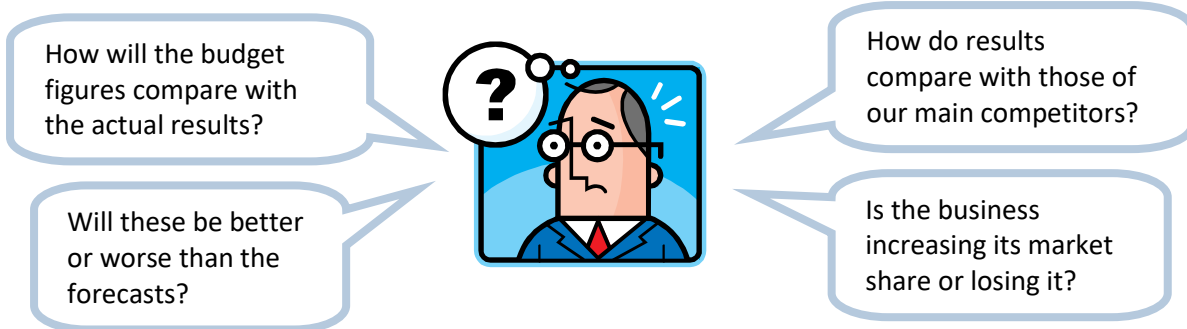
The cost of rent and rates is £240,000. How could this be apportioned to the 4 centres?

Chapter 19: Providing Comparisons on Costs and Income



Introduction

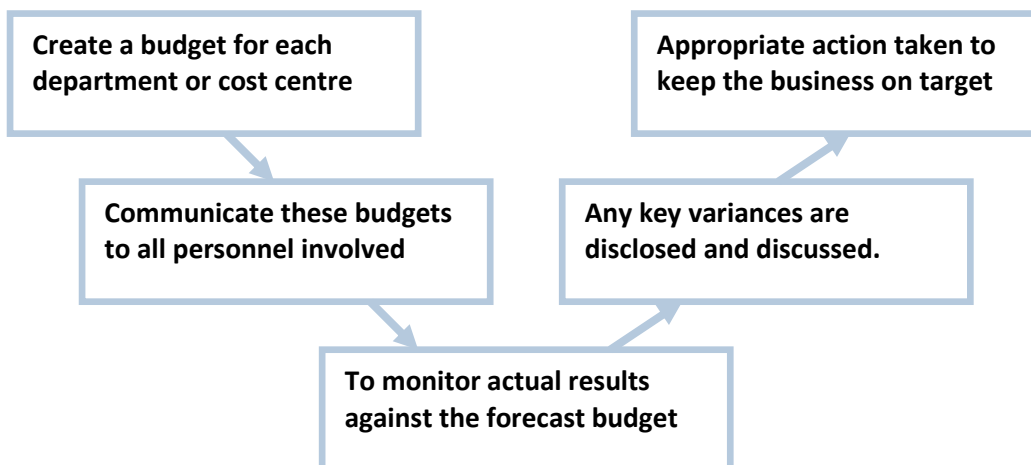
A business prepares a budget to ensure that its financial resources are used in the best possible way. The budget, therefore, is a management tool used to establish a business's aims and objectives.



It is questions like this that require the comparison of costs and income.

Budgetary Control:

The key stages of budgetary control are:



Comparing results:

In chapter 17 we looked at standard costs and the concept of **variance**. Management need to compare forecast with actual results but then ask questions about any variance. For example, these were a month's cost (per unit) comparison for producing 2000 units of an electronic component:

	Budget	Actual	Variance
	£	£	£
Direct labour	5.67	5.56	0.11p Favourable
Direct materials	23.81	23.85	(0.04p) Adverse
Factory overheads	7.55	7.70	(0.15p) Adverse
Admin overheads	<u>11.67</u>	<u>11.70</u>	<u>(0.03p)</u> Adverse
Total costs	48.70	48.81	(0.11p) Adverse

These results could prompt a number of questions and provide a number of insights into the operation of the business, for example:

- Was labour more efficient, taking less time to produce 2000 units? Or was it that a pay settlement was lower than expected?
- Direct materials were 4p per unit more. Was this simply an increase in the purchase price or could it mean there was more wastage than usual in production?
- Factory overheads were the most adverse. Could it have been a higher cost in factory rent, rates and insurance? Or could it be with factory indirect labour increasing higher than expected?

A business may not want to investigate every single tiny variance, due to the cost of doing this. Often particular limits will be set in place, so if the variance exceeds that limit it is investigated and acted upon. This is known as **exception reporting**.

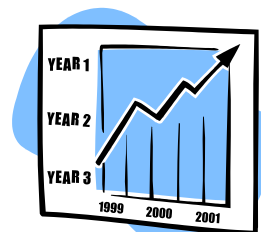
Some variances are internal and controllable. Other variances are external and beyond the control of management (for example, the price of inflation). It is measuring these variances and then explaining them that gives business crucial operational information and, therefore, control of finances.

The comparison of profit and loss:

A business needs to compare its trading performance in order to check whether it's improving, deteriorating or staying at a consistent level. And also needs to compare this with its competitor's performance.

Example:

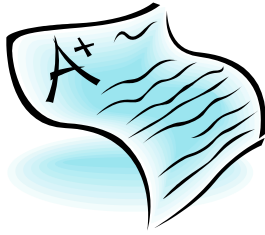
	Year 1 (£000s)	Year 2 (£000s)	Year 3 (£000s)
Sales	120	180	270
Cost of sales	80	135	216
Gross profit	40	45	54
Less expenses:			
Distribution costs	18	27	30
Administration costs	10	10	20
Net profit	12	8	4
Net profit % (net profit/sales)	10%	4.4%	1.48%



At a glance, while gross profit has steadily increased the net profit has fallen steeply from £12,000 in year 1 to £4,000 in year 3. As you can see the major reason for this is the doubling of administration expenses by year 3.

Management needs to compare year end figures like this as, in the case, it may highlight inefficiencies in administration costs. However, this increase in admin costs may have been planned e.g. an extra employee was hired.

If the company's major competitors were averaging 12% net profit, serious questions need to be asked. If the current pattern continued, the business would face an uncertain future.



End of Chapter 19 Test Questions:

1. What is meant by the term 'variance' including those found to be favourable and adverse?
2. Provide examples of external factors which would be out of management's control.
3. What is reporting by exception? Provide an example to clarify.

4. Study the following figures based on production of 5000 units:

	Budget £	Actual £
Direct labour	24,000	24,350
Direct materials	32,500	32,250
Fixed overheads	28,500	28,250

Required:

- a) Based on costs per unit, calculate the 3 elements of cost for both the budget and actual figures.
- b) Compare the 2 sets of figures, calculating the appropriate variances.
- c) Provide possible explanations to these variances which could assist management.

5. A key aspect of budgetary control is to monitor progress. What does this mean?

6. The trading results between two companies in the same line of business were as follows:

	Big Ltd (£000s)	Little Ltd (£000s)
Sales	300	360
Cost of sales	200	240
Distribution costs	45	48
Administration expenses	35	40
Interest charges	3	10

Required:

Compare the performance of the two companies in terms of revenue and costs and provide a brief explanation of which company has performed the better of the two.

Chapter 20: A Brief Introduction to Wages



Introduction

Wages and salaries are a reward for labour. Wages are usually for those paid weekly, whereas a salary is normally for someone who is paid monthly. Pay is often referred to as **remuneration**.

There are two distinct ways in which pay can be calculated:

1. Time rates

This is by far the most common way of being paid. People are often paid a certain sum of money to work a certain number of hours. For example, 37 hours a week, basic pay £250. Any hours worked overtime, i.e. over 37 hours, are often paid at a premium rate – say time and a half, or double time.



2. Payment by results

This is an alternative method of payment that offers an incentive to workers to work harder for more pay. Sales people are often paid like this, earning more commission the more they sell. Factory workers that produce more output can often receive more pay. This is known as **piece work**.

Gross and net pay:

Gross pay is simply all earnings before any deductions from pay are made, net pay is the gross pay less all deductions. There are two types of deductions – voluntary and statutory.

Statutory Deductions:

These are deductions legally required by government and refer to **income tax** and **National Insurance Contributions (NIC)**. Both of these are automatically collected from your pay if you are an employee. If you are self-employed, then you are required to send your personal tax return to the local tax office at the end of your trading period.

Income Tax

In the UK income tax is progressive, meaning that the more you earn, the more you pay. There are also tax bands, which means earnings up to a certain value are taxed at one percentage, then earnings beyond this hit a higher tax band and are subject to a larger percentage.



National Insurance Contributions

Another form of tax an employee has to pay, but in return this money goes to provide funds for benefits like unemployment, sick pay, pension, child support etc. People on low income do not pay the current rate of 11% of taxable income.

Voluntary Deductions:

These are deductions agreed to by the employee, e.g. voluntary savings scheme, pension fund, trade union subscriptions, social club funds etc. Employees contribute to a government pension through NIC, but many employers also offer a company pension scheme.

Example of net pay:	£	£
Gross pay for the year		25,915.00
Less deductions:		
Taxation	4,585.70	
NIC	3,971.60	
Trade Union subs	130	
Pension fund	400	<u>9,087.30</u>
Net pay		16,827.70

Recording payroll details in the nominal ledger

When recording payroll data in the nominal ledger, the entries could include the use of a **wages control account** ensuring all relevant entries are recorded.

Remember: a control account is a cross checking device to make sure that all the double entry transactions are recorded. The control account debit entries should balance with the credit entries when all entries are completed.

The double entry for the above salary figures would look like this:

Debit	Credit
Wages account:	Wages control account:
Wages £25,915	Wages account £25,915
Employer's NIC £4,927.85	Employer's NIC £4,927.85

The payments due to the tax office (Inland Revenue) are credited to the Inland Revenue account and debited to the wages control account:

Wages control account:	Inland Revenue account:
Tax £4,585.70	Tax £4,585.70
Employee's NIC £3,971.60	Employee's NIC £3,971.60
Employer's NIC £4,927.85	Employer's NIC £4,927.85

The bank account is credited with net wages to be paid & debited to wages control account:

Wages control account:	Bank account:
Net pay £16,827.70	Net pay £16,827.70

The pension fund and trade union subscriptions accounts are credited with the sums due to them and the wages control account debited:

Wages control account:	TU subscriptions and pension funds accounts:
TU subscriptions £130	TU subscriptions account £130
Pension funds £400	Pension funds account £400

In summary the wages control account would look like this:

Wages Control Account					
31/10	Tax	4,585.70	31/10	Wages	25,915.00
	NIC (Employer)	4,927.85		NIC (Employer)	4,927.85
	NIC (Employee)	3,971.60			
	TU subs	130			
	Pension funds	400			
	Bank (net pay)	<u>16,827.70</u>			
		30,842.85			30,842.85



End of Chapter 20 Test Questions:

1. Calculate the following gross weekly wages for Harry, Jack and Fred:
 - a) Harry Jones has a basic week of 36 hours paid at a flat rate of £4.00 per hour. Overtime is at time and a half. How much will he earn working 39 hours in a week?
 - b) Jack works 46 hours and Fred 43 hours per week at only £2.80 per hour. Overtime starts after 38 hours and is paid at time and a quarter. Calculate their gross pay.

2. Charlie is on piece work where the attendance retainer is £1.25 per hour. The piece work is at the following rates:

0 – 1000 units, 2p unit; 1001 – 1500 units, 3p unit; over 1500 units 2.5p unit.

How much will he earn during a 42 hour week in which he produces 1825 units?

3. Calculate Arthur's net pay for the week:
Gross pay £226.80. Deductions: pension fund £14 tax free; NIC £16.34; Tax to be deducted. Arthur has £110 per week as his personal tax allowance on top of his tax free pension. The basic rate of tax is 20% and there is £3 to be deducted to take account of the lower starter rate. (Calculate the tax on whole £s only)

4. The details from the month's payroll week ending 31 December, were:

Gross Pay	Tax	Employee NIC	Pension Funds	Employer NIC	Net Pay
£138,815	£18,981.55	£12,500.40	£1,055	£13,000.55	£106,278.05

You supervisor has asked you to enter the details from the month's payroll, ending 31 December in the nominal ledger.

5. Explain clearly what is meant by statutory deductions from pay.
6. The following information relates to the time sheet of Julie Harris:

	Basic time	Overtime
Monday	8 hours	1.5 hours
Tuesday	8 hours	0.5 hours
Wednesday	8 hours	2.5 hours
Thursday	8 hours	2.0 hours
Friday	6 hours	0.5 hours
Saturday		3.0 hours
Sunday		2.0 hours

Julie earns a basic rate of £4.80 per hour and is paid time and a quarter for weekend-days, time and a half for Saturdays and double time on Sundays. Calculate Julie's gross pay for the week.

Chapter 21: Control Accounts: Sales and Purchase Ledger



Introduction

The sales and purchase ledger control accounts represent the totals of debtors' and creditors' balances. So the sales ledger control account is often referred to as the debtors' **control account**, while the purchase ledger as the **creditors' control account**.

From a management viewpoint, it is essential to know how much is owed by debtors as well as how much is owed to creditors. When can a business expect to receive its cash? When can it be in a position to pay its creditors? These are two vital questions affect the future cash flow of the business.

The location of errors:

If either of the two control accounts does not verify the total balances of the sales and purchase ledgers, a detailed check is required to locate any errors. Both the individual balances of customers and suppliers need to be checked for errors, as well as the control accounts.

It could be a simple incorrect addition of figures, or an entry posted to the wrong side of the account, e.g. a returns inward on the debit side of a debtor's account instead of the credit.

Terms used with control accounts:

Some entries in the control accounts may need clarification:

- Cheques dishonoured – refer to customer's cheques that have been stopped by the bank, usually because the customer has insufficient funds to pay the debt. (These are debited in the sales ledger control and debited in the individual customer a/c.)
- Contra entries – are sums offset between debtors' and creditors' balances when a business both sells and buys goods from the same organisation. (Debit the purchase ledger control and credit sales ledger control accounts, as well as debiting the individual accounts in the purchase ledger and crediting them in the sales ledger.)
- Bills receivable are notes from customers promising to pay at a future date. (They are treated like a post dated cheque and are credited to the sales ledger control account.)
- Bills payable are the reverse of bills receivable in that the business promises to pay its suppliers at a future date. (These are debited to the purchase ledger control a/c.)

Example 1: Sales Ledger Control (Debtors control account)

The following are balances from the ledger of ABC Ltd:

	£
Sales ledger Dr balances at 1 June	7,300
Credit sales (June)	12,500
Cash sales	2,840
Cash/cheque received from debtors	11,500
Returns from customers	400
Discounts allowed to customers	280
Debtors' cheques returned from bank	
Marked 'R/D' – cheque dishonoured	330
Sales ledger Dr balances at 30 June	7,950

Debtors Control Account				
		Dr	Cr	Balance
June 1	Balance			7,300 Dr
30	Sales	12,500		19,300
	Bank/cash		11,500	8,300
	Discounts		280	8,020
	Returns inward		400	7,620
	Cheques dishonoured	330		7,950

Note:

- The 30 June balance of £7,950 is verified with the sales ledger control account.
- The cash sales £2,840 are not included because they are not associated with selling goods to debtors, that is, on credit.

Example 2: Purchases Ledger Control (Creditors control account)

	£
Purchases ledger Cr balances at 1 June	12,500
Credit purchases for June	19,750
Cheques paid to suppliers	18,200
Discounts received	478
Returns to suppliers	545
Debit note from suppliers, resulting from under-charge	50
 Credit balances from purchase ledger at 30 June	 13,427

Creditors Control Account				
		Dr	Cr	Balance
June 1	Balance			12,500
30	Purchases		19,750	32,250
	Bank	18,200		14,050
	Discounts received	478		13,572
	Returns outward	545		13,027
	Debit note, under-charge		50	13,077

Note: There is a discrepancy of £350 between the purchase ledger (13,427) and the control account (13,077). Somewhere an error has occurred and records must be checked to locate it.

Correcting Errors: (continuing our example)

The above discrepancy of £350 has had the errors located for you:

- A cheque to a supplier £200 has not been recorded in the purchase ledger, but the total cheques payable to suppliers had been posted to the P/L control account.
 - Correction: Debit supplier's account £200
- A supplier's balance brought forward £75 debit (due to overpayment) had been incorrectly brought forward as £75 credit.
 - Correction: Debit supplier's account £150

Finally, we need to reconcile the purchase ledger control account and the purchase ledger:

	£	£
Purchase ledger balances		13,427 credit
Less		
Cheque to supplier	200 debit	
Balance brought forward	150 debit	(350)
Balance as per P/L control account		13,077



End of Chapter 21 Test Questions:

Past Paper Question:

1. The following balances relate to the accounts of Karina who has many credit customers, and will shortly be preparing the annual final accounts:

	£
1 April total debtors (accounts receivable)	126,000
1 April opening debit balance – Rhona	900
1 April credit balance – provision for doubtful debts	6,600

Transactions in April:

Cash sales	79,000
Credit sales	139,000
Cash purchases	8,600
Credit purchases	4,000
Discounts allowed	2,000
Returns inwards	800
Bad debt (Rhona) written off in April	900
Receipts from debtors (accounts receivable)	114,000
Payments to creditors (accounts payable)	51,000
Contras (set offs)	2,400
Increase in provision for doubtful debts	600

Required:

- Write up the sales ledger control account for April. [8]
- Write up the account for Rhona as at the end of April. [3]
- Write up the provision for doubtful debts as at the end of April. [4]
- Explain why Karina maintains a provision for doubtful debts account. [5]

2. The following information has been taken from the books of Harry Jones relating to the month ended 31 January:

	£
Sales ledger control balance 1 Jan	2,246
P/L control balance 1 Jan	1,608
Transactions for the month:	
Credit sales	38,127
Cash sales	9,750
Purchases on credit	27,121
Receipts from customers	27,560
Payments to suppliers	19,422
Discount allowed	810
Dishonoured cheques from customers	925
Returns outward	316
Returns inward	1,427

Required:

Prepare the sales and purchase ledger control accounts for the month ended 31 January.

3. You have the following details re. the sales and purchase ledgers of a medium-sized business.

	£
Feb. 01	
Total creditors	149,000
Total debtors	278,000
Transactions in February:	
Cash sales	13,000
Credit sales	279,000
Credit purchases	89,000
Cash purchases	9,000
Discounts received	4,000
Discounts allowed	6,000
Returns to suppliers	1,000
Returns from customers	2,500
Set offs (contras)	3,500
Bad debts written off in the month	1,000
Increase in provision for bad debts	1,500
Payments to creditors	152,000
Receipts from debtors	285,000

Required:

- Prepare the sales ledger control account as at 28 February 2011. [8]
- Prepare the purchase ledger control account as at 28 February 2011. [7]
- Explain the purpose of maintaining control accounts. [5]

4. You work as an accountant's assistant for a manufacturing company, Rock Ltd, and have to write up the control accounts for the month of February. Details of transactions are as follows:

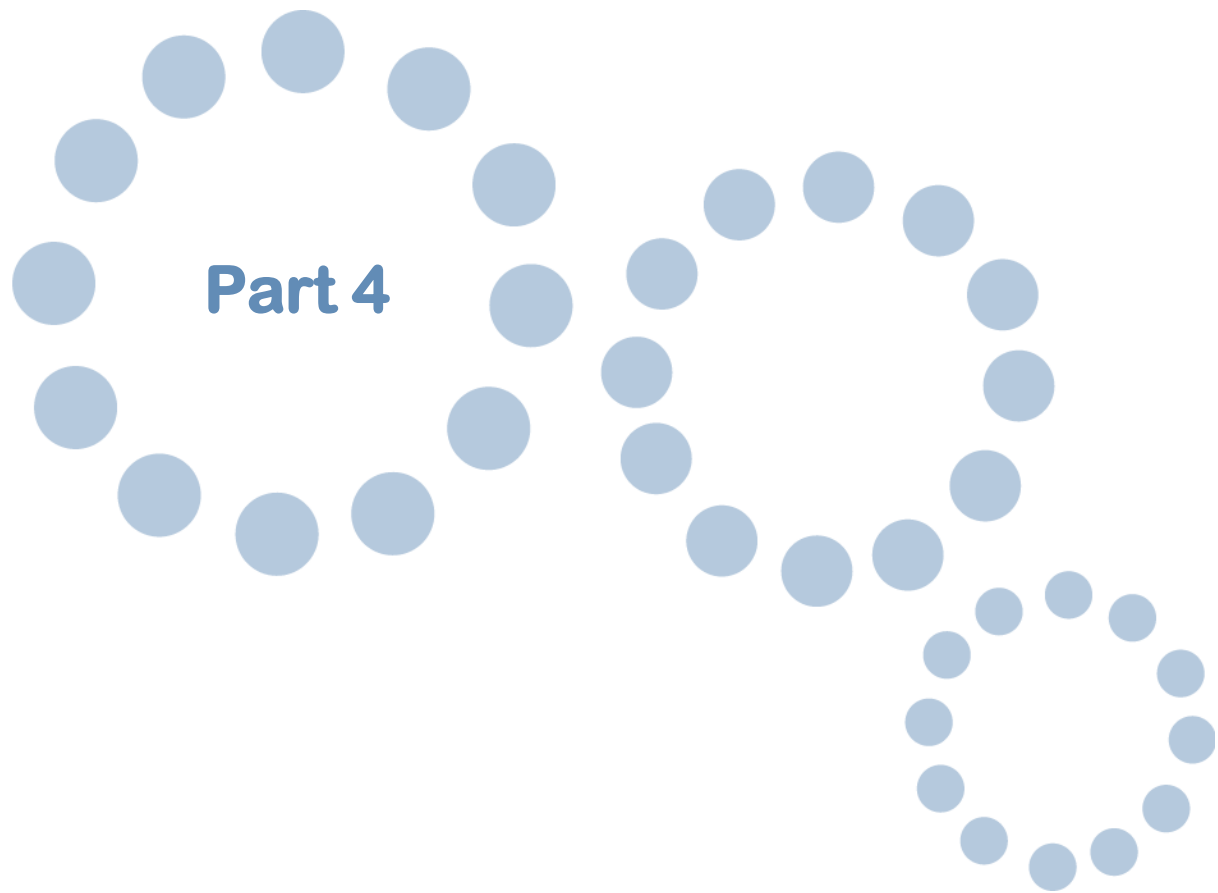
	£
February 1	
P/L control (credit balance)	26,100
Sales ledger control (debit balance)	41,400

Total transactions in the month of February:

Bad debts written off	420
Credit purchases	37,590
Cash purchases	5,200
Returns outwards	510
Returns inwards	1,480
Cheques paid to creditors	24,270
Cheques received from debtors	47,360
Contras between s/l & p/l	800
Dishonoured cheques (from debtors)	140
Credit sales	74,900
Cash sales	9,250
Discount allowed	1,840
Discount received	960
Cheque received from a supplier	460

Required:

- Prepare the sales ledger control a/c for Feb. (The sales ledger schedule total was £74,540)
- Prepare the purchase ledger control a/c for Feb. (The purchase ledger schedule total was £37,510)
- Which of the two control accounts agreed? How much was the discrepancy in the account that did not balance?



The Construction of Financial Statements

Chapter 22: Financial Statements: The Calculation of Profits



Introduction

Financial statements states what has occurred in a business's financial period. Has it made a profit or suffered a loss? Is the business financially secure?

The financial period:

A financial period is seen as the business's financial year. This could be from 1 January to 31 December, or any twelve month period. Many businesses match their financial year with the government's tax year which is April to March.

The need to make profits:

Businesses need to calculate profit or loss on a frequent basis; therefore an accounting period could be seen as monthly as well as annually. If a forecast of monthly profit is prepared, the actual results can be compared with them to see if any corrective action is required.

Making profits is the most significant part of any business, without profits there is no return on the owner's investment and the business would have difficulty surviving.

VAT and the Profit and Loss account:

For a VAT registered business, both revenue and expenses must be recorded excluding VAT because it belongs to HMRC. Any VAT owing (a credit balance) is recorded in the balance sheet as a current liability (or a current asset if VAT is a debit balance).

Recap: A profit and loss account is the difference between revenue and expenses. The balance sheet identifies the business's assets, liabilities and capital.

In this example we will calculate George Harrison's final accounts (the profit and loss and balance sheet) from a trial balance.

G Harrison's Trial Balance as at 31 December

Account	£	£
Capital: G Harrison		10,000
Drawings	2,600	
Premises	12,000	
Fixtures and Fittings	2,000	
Equipment	3,000	
Motor Van	1,250	
Building society Mortgage		8,000
Bank Loan		1,000
Stock (1 January)	1,000	
Bank/Cash	400	
Debtors	850	
Creditors		950
Sales		11,000
Returns Inward	250	
Purchases	5,000	
Returns Outward		350
Salaries	850	

Light and Heat	300	
Printing and Stationery	100	
Telephone	155	
Delivery expense	125	
Advertising	300	
Packing materials	340	
Discount allowed	65	
Rates and Water	285	
Motor Expenses	500	
Interest paid	140	
Discount received		125
Commission received		85
	<u>31,510</u>	<u>31,510</u>

Required:

- Prepare the trading profit and loss account of G Harrison for the year ended 31 December
- Prepare a balance sheet as at that date, 31 December

Solution:

G Harrison		
Trading and profit and loss account for the year ended 31 December		
	£	£
Sales	11,000	
- returns inward	<u>250</u>	10,750
Less cost of sales		
Stock (1/1)	1,000	
+ purchases	<u>5,000</u>	
	6,000	
- returns outward	<u>350</u>	
	5,650	
- stock (31/12)	<u>1,500</u>	<u>4,150</u>
Gross profit		6,600
Less other expenses		
Salaries	850	
Printing and stationery	100	
Telephone	155	
Delivery expenses	125	
Advertising	300	
Packing materials	340	
Discount allowed	65	
Rates and water	285	
Motor expenses	500	
Interest paid	140	
Light and heat	<u>300</u>	<u>3,160</u>
		3,440
Add other revenue		
Discount received	125	
Commission	<u>85</u>	<u>210</u>
Net profit		3,650

(transferred to Capital account)

Note: The balance of the closing unsold stock 31 December is also entered in the balance sheet as a current asset.

G Harrison			
Balance sheet as at 31 December			
	£	£	£
Fixed Assets (as cost)			
Premises	12,000		
Fixtures and fittings	2,000		
Equipment	3,000		
Motor van	<u>1,250</u>		18,250
Current Assets			
Stock (at cost) 31/12	1,500		
Debtors	850		
Bank/cash	<u>400</u>	2,750	
Less Current Liabilities			
Creditors	950	<u>950</u>	
Working Capital (net current assets)			<u>1,800</u>
Capital Employed			20,050
Less Long-term Liabilities			
Mortgage (Building Society)	8,000		
Bank loan	<u>1,000</u>		<u>9,000</u>
Net Assets			<u>11,050</u>
Finance by:			
Capital: G Harrison (1/1)	10,000		
+ Net profit	<u>3,650</u>	13,650	
- Drawings		<u>(2,600)</u>	<u>11,050</u>

Transfer of nominal ledger accounts to the profit and loss account:

All revenue and expense balances are transferred to the profit and loss account at the end of an accounting period. Once profit and loss has been calculated, revenue and expense accounts will start the new accounting period with zero balances.



End of Chapter 22 Test Questions:

1. The following represents the trial balance of Jack Armstrong as at 31 December.

	Dr	Cr
	£	£
Premises	27,000	
Motor van	2,000	
Fixtures and fittings	5,300	
Bank	4,250	
Cash	250	
Stock (1 Jan)	8,000	
Debtors	3,100	
Mortgage on premises		20,000
Interest owing		1,000
Creditors		9,000
Capital: J Armstrong		7,000
Sales		71,000
Discount		300
Returns outward		<u>1,000</u>
Rate and water	500	
Motor and travel expenses	2,500	
Purchases	34,000	
Returns inward	2,250	
Light and heat	600	
Advertising	590	
Wages	16,500	
Insurance	360	
General expenses	<u>2,100</u>	
	<u>109,300</u>	<u>109,300</u>

Note: The value of closing stock on 31 December was £4,200 at stock-taking.

Required:

- Prepare the trading and profit and loss account of J Armstrong for the period ended 31 December.
 - Prepare the balance sheet as at 31 December, and clearly show working capital.
- What is the basic difference between gross and net profit?
 - Why is sufficient working capital important to the well being of a business?

4. James Roberts has a small business enterprise. The following trial balance was extracted from his ledgers at the financial year end 30 April:

	Dr	Cr
	£	£
Capital: J Robert		18,000
Drawings	2,800	
Bank overdraft		725
Premises	15,700	
Motor van	1,000	
Equipment	1,400	
Debtors	2,900	
Creditors		3,850
Stock (beg.)	3,500	
Purchases	28,400	
Sales		42,650
Rent received		750
Wages	8,500	
Rates and insurance	270	
Light and heat	195	
Administrative expenses	325	
Selling and distribution costs	500	
VAT	275	
Returns inward	400	
Returns outward		<u>190</u>
	<u>66,165</u>	<u>66,165</u>

Note: Stock unsold on 30 April was valued £5,280

VAT is not an expense. HMRC owe the money to J Robert and is entered as a current asset in the balance sheet.

Required:

- The profit and loss account for the year ended 30 April.
- A balance sheet as at this date.

5. Complete the following accounting equations:

	C	=	A	-	L
a)	8,000		96,000		
b)	1,500				22,500
c)	14,700		104,500		
d)			16,740		14,340
e)	100				1,000

Chapter 23: Adjustments, Prepayments



Introduction

For financial transactions which specifically belong to an accounting period, whether paid or incurred (due to be paid), they must be included within the accounts of that period. This is known as the '**accruals**' concept and can often lead to adjustments to the final accounts.

For example, if wages of £2,500 are owed at year end, this sum must be included in the accounts for the year, even though they are yet to be paid. The benefit of this labour was received in the financial year, so the cost of it (the wages) should also be included in the same accounting period.

Similarly, if an expense was paid in advance of the accounting period, the sum prepaid for the next financial period must be deducted from the accounts of the current financial year.

These adjustments are part of the **matching concept** in accounting, which attempts to match as exactly as possible the revenue earned in one period with the expenses incurred in the same period, in order to arrive at a 'true and fair' assessment of profit (or loss).

Types of adjustment:

- | | |
|---------------------|--|
| 1. Closing stock | - value of stock still unsold |
| 2. Accrued expenses | - expenses still owing |
| 3. Prepaid expenses | - expenses paid in advance |
| 4. Revenue accrued | - income owed to the business |
| 5. Revenue prepaid | - income paid in advance |
| 6. Owners drawings | - value taken for personal use such as stock |

Each of these adjustments will have a TWO-FOLD effect as they will affect the profit and loss account and they are included in the balance sheet as they affect the value of assets, liabilities or capital.

How do these adjustments affect the profit and loss account and balance sheet?

Type of adjustment	Profit and loss account	Balance sheet
1. Closing stock	reduced cost of sales	current asset
2. Accrued expenses	increase expenses	current liability
3. Prepaid expenses	reduce expenses	current asset
4. Revenue accrued	increase revenues	current asset
5. Revenue prepaid	reduce revenues	current liability
6. Owners drawings	reduce expenses	reduce capital

Closing Stock:

If at the end of a financial period the business has any unsold stock, it first needs to be valued and then deducted from the cost of sales in the trading account. Any unsold stock is not an expense in the current accounting period, but is an expense as the opening stock in the new period, when it is part of the new period's cost of sales.

This is part of the matching process between revenue and expenses.

We will now work through example adjustments to the final accounts of G Harrison that we looked at in the previous chapter.

Adjustments as at 31 December:

- The value of closing stock was £1,500
- Accrued expenses: gas owing £54, salaries owing £34
- Prepaid expenses: rates and water £40, stationery unused £20, packing materials unused £60
- Revenue accrued: commission due £120, rent received in advance £240
- Revenue prepaid: commission paid in advance £25
- Drawings: owner takes £500 stock and £50 for personal telephone calls

Accrued Expenses:

These are expenses incurred in the financial period but not yet paid for. Any outstanding expenses must be charged to the profit and loss account for the year in which they were used.

So we need to adjust the accounts for a gas bill (£54) and salaries (£34) owing. We will use the same trial balance as the previous chapter.

Profit & loss account and balance sheet (extract)

	£	£
Profit & loss account		
Light and heat	300	
Accrued expense	<u>54</u>	354
Salaries	850	
Accrued expense	<u>34</u>	884
Balance sheet		
Current liabilities		
Accrued expense		88

Nominal ledger – accrued expenses

	Dr	Cr	Balance
Light and heat a/c			
31/12 Balance			300 Dr
Accrued	54		354
Profit & loss		354	0
1/1 Accrued		54	54 Cr
Salaries a/c			
31/12 Balance			850 Dr
Accrued	34		884
Profit & loss		884	0
1/1 Accrued		34	34 Cr

Note: the accrued expenses are brought down as credit entries in the new accounting period as these expenses are still to be paid.

Prepaid Expenses (prepayments):

These are expenses that are paid in advance of the current financial period. Expenses that are likely to be paid in advance are rent, rates, insurance premiums and advertising.

Profit & loss account and balance sheet (extract)

	£	£
Profit & loss account		
Rates and water	285	
Prepaid	<u>(40)</u>	245
Printing & stationery	100	
Prepaid	<u>(20)</u>	80
Packing materials	340	
Prepaid	<u>(60)</u>	280

Balance sheet

Current assets	
Prepaid expenses	120

Nominal ledger – recording prepaid expenses

	Dr	Cr	Balance
Rates and water a/c			
31/12 Balance			285 Dr
Prepaid		40	245
Profit & loss		245	0
1/1 Prepaid	40		40 Dr
Printing and stationery a/c			
31/12 Balance			100 Dr
Prepaid		20	80
Profit & loss		884	0
1/1 Prepaid	20		20 Dr
Packing materials a/c			
31/12 Balance			340 Dr
Prepaid		60	280
Profit & loss		280	0
1/1 Prepaid	60		60 Dr

Note: The prepayment is brought down as a debit entry in the new period to indicate that this expense belongs to the new financial period.

Revenue Accrued:

If any income is owing to the business at the end of the financial period, this must be included just like in the previous adjustments. Revenue accrued (or income accrued) should be added to the appropriate revenue account in the profit and loss account.

Profit & loss account and balance sheet (extract)

	£	£
Profit & loss account		
Other income:		
Commission	85	
Revenue accrued	<u>120</u>	205
Rent rec'd accrued		240
Balance sheet		
Current assets		
Prepaid expenses		120
Revenue accrued		360

Nominal ledger – recording revenue accrued

		Dr	Cr	Balance
Commission received a/c				
31/12	Balance			85 Cr
	Revenue accrued		120	205
	Profit & loss	205		0
1/1	Revenue accrued	120		120 Dr
Rent received a/c				
31/12	Balance			125 Cr
	Revenue accrued		240	365
	Profit & Loss	365		0
1/1	Revenue accrued	240		240 Dr

Revenue Prepaid:

Revenue prepaid is the exact opposite to revenue accrued. In this case, income is paid in advance of the current accounting period and should therefore be deducted from the income already received.

Debit: Commission received £25 (revenue decrease)

Credit: Revenue prepaid £25 (current liability)

Nominal ledger – accrued expenses

		Dr	Cr	Balance
Commission received a/c				
31/12	Balance			85 Cr
	Revenue accrued		120	205
	Revenue prepaid	25		180
	Profit & loss	180		0
1/1	Revenue accrued	120		120 Dr
	Revenue accrued		25	95 Dr

The owner's drawings:

When the owner of the business takes out cash for his benefit, the sum withdrawn is debited to the drawings account and the bank or cash account is credited. The same principle applies if the owner takes anything of value, including stock and telephone calls as in our example.

Task: Now prepare the final profit and loss account and the balance sheet from the workings we have gone through in this chapter. Each step is now just a logical placement of the accrual, prepayment and additional drawings.

Remember that after making these adjustments the new profit (or loss) figure must be entered into the 'financed by' section of the balance sheet and the balance sheet itself must balance.



End of Chapter 23 Test Questions:

Past Paper Question:

1. You work as an accountant to Sammi and the following trial balance has been extracted on 28 February 2011:

	Dr	Cr
	£	£
Sales		541,000
Purchases	227,000	
Rent, rates and insurances	49,000	
Returns inwards	2,000	
Carriage inwards	3,000	
Advertising costs	38,000	
Energy costs	34,000	
Inventory (stock as at 01 03 10)	24,000	
Wages and salaries	146,000	
Communication expenses	27,000	
Discounts allowed	6,000	
Discounts received		1,000
Interest paid	3,000	
Owner's drawings	28,000	
Equipment at cost	60,000	
Premises	300,000	
Depreciation (equip. at 01 03 10)		25,000
Capital (at 01 03 10)		334,000
Long-term loan		60,000
Accounts receivable (debtors)	48,000	
Accounts payable (creditors)		30,000
Bank overdraft		4,000
Totals	995,000	995,000

Notes at 28 February 2011:

- Inventory (stock) was valued at £28,000.
- Salaries owing amounted to £7,000.
- Advertising costs prepaid amounted to £3,000.
- Equipment is to be depreciated at 20% on cost.

Required:

- a) Prepare the income statement (trading and profit and loss account) of Sammi for the year ended 28 February 2011. [11]
- b) Prepare the position statement (balance sheet) of Sammi as at 28 February 2011. [9]

Chapter 24: Adjustments – Bad Debts and Provisions for Debtors



Introduction

Any business that offers credit to its customers and therefore creates debtors must make every effort to ensure debts are paid. This means having an effective credit control system. Accounts must be monitored on a regular basis and customers chased if they are late making payments.

A large number of businesses do have to write off some of their debt from time to time. This is costly because a debtor (asset) is written off as an expense. The double entry is:

Debit:	bad debts account (expense +)
Credit:	debtor's account (asset -)

Types of Adjustment:

- Provisions for bad debts
- Recovery of bad debts
- Provisions for cash discounts

How do these adjustments affect the profit and loss account and balance sheet?

Type of adjustment

1. Create provision for bad debts
2. Increase provision for bad debts
3. Reduce provision for bad debts
4. Recovery of bad debts
5. Create provision for discounts
6. Increase provision for discounts
7. Reduce provision for discounts

Profit and loss account

increase expense
increase expense
reduce expense
reduce expense
increase expense
increase expense
reduce expense

Balance sheet

debtors – provision
debtors – provision
debtors – provision
increase banks
debtors – provision
debtors – provision
debtors – provision

Provisions for bad and doubtful debts

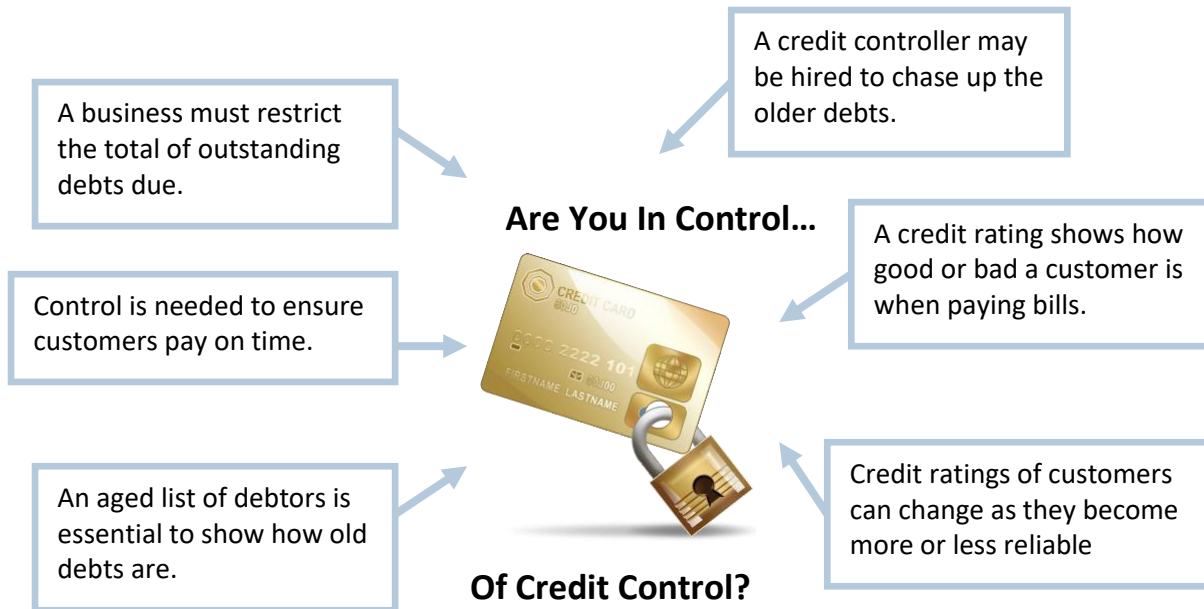
Accountants should be prudent (cautious) when it comes to valuing a business's assets. If some customers in the sales ledger are slow in paying their bills, it is normal procedure to make an allowance against debtors in the event they fail to pay their debts.

The recovery of bad debts

If a customer pays back a debt that had previously been written off, either in part or in full, the debt must first be reinstated in the customer's sales ledger a/c. Once the cheque has been received and banked, the posting to the ledger account clears the debt.

The provision of debtors discounts

If it is the policy of the business to allow customers to have cash discounts on their sales, it may be prudent to make a provision, similar to a provision for doubtful debts. The provision must be calculated on the net value of debtors: that is, after deducting the provision for bad debts.





End of Chapter 24 Test Questions:

1. It has been said that if a customer is written off as 'bad' it is recognised that an asset has changed to an expense. Explain this and use the double entry principle to clarify your point.
2. The following information represents the accounts of James Hunt on 31 December:

Account	£
Capital: J Hunt	8,000
Drawings	2,500
Cash	100
Bank	400
Equipment	400
Motor Vehicle	1,500
Stock (1/1)	4,800
Debtors	2,500
Creditors	3,130
Sales	12,200
Purchases	7,000
Returns outward	250
Rent	160
Discount received	20
Stationery	90
Wages	3,000
General expenses	1,000
Rates	150

Adjustments: 31 December

- Stock unsold £4,300
- Rates pre-paid £38
- A provision for bad debts is to be made to equal 5% of debtors
- Wages outstanding £120
- Stationery unused £40

Required:

- a) A profit and loss account for the year ended 31 December
 - b) A balance sheet as at that date.
3. Explain the double entry principle on the occasion that a customer once written off as a bad debt, repays half the sum which was owed.
 4. Given a business has a high value of debtors, why should an accountant be prudent and on what basis would he/she make his/her calculations?
 5. At the end of a financial year, the balance of bad debts account could be transferred to the provision for bad debts account. Would this have an effect on what is transferred to the profit and loss account?

Chapter 25: Depreciation of Fixed Assets



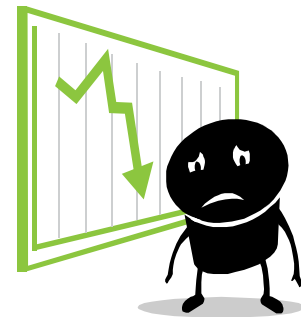
Introduction

The concept of **depreciation** is that fixed assets lose their value over periods of time and that loss is recorded as an expense (charged to the profit and loss account)

A fixed asset will have a '**useful life**', that is the time that it is useful to the business.

What would happen if a business did not depreciate their fixed assets?

Imagine a business buys a new delivery truck. There will come a point (due to wear and tear) when this truck will become so old that it will have very little re-sale value. But without depreciating the value of the asset in the accounts the business is still recording the truck at the price it paid for it new. Clearly, then, this business is overstating the value of its fixed assets. This is why depreciation is so important.



Depreciation is, therefore, a charge against the fixed asset spread over its useful life. The measurement of the depreciation charge is not an exact science and will depend on:

- The type of fixed asset
- The method chosen to depreciate it
- An estimation of how long the fixed asset will last over its useful life
- An estimation of how much the residual (or scrap) value of the fixed asset will be when it is disposed of.

Note: Fixed assets should be depreciated on an equitable and consistent basis. Once a suitable method has been adopted, the same method should be used throughout its useful life.

Methods of Depreciation:

There are a number of methods, but the two main ways to depreciate fixed assets:

The Straight Line Method

This charges the same amount of depreciation each year, because a fixed percentage is calculated on the cost price.

Furniture, fixtures and fittings are often depreciated in this way as it is seen as equitable.

$$\text{Straight Line} = \frac{\text{Cost} - \text{Residual Value}}{\text{Estimated life (years)}}$$

The Reducing Balance Method

This is when a fixed percentage rate is applied on the net book value of the asset each year.

This means the depreciation charge gets less over the life of the asset.

$$\text{Rate \%} = 1 - \sqrt[n]{\frac{\text{Residual Value}}{\text{Cost of Asset}}}$$

Which method to depreciate?

The key principle is an **equitable** charge must be made. That means the fairest way of depreciating the asset over its useful life.

If the benefit of using a fixed asset is highest in the earlier years and less so in the later years, then the depreciation charge should be greater during that earlier period.

The reducing balance method is often used for assets such as plant, machinery, equipment and motor vehicles. These assets often reduce in value more in the first years of their life.



Additionally, as these types of asset become older and more wear and tear occurs, the cost of servicing and maintaining them increase. Therefore charging higher depreciation in the early years, and reducing this in the latter years, spreads the overall cost of operating the asset more evenly throughout its useful life.

If the asset brings benefit more or less equally throughout its useful life, then the straight line method is best.

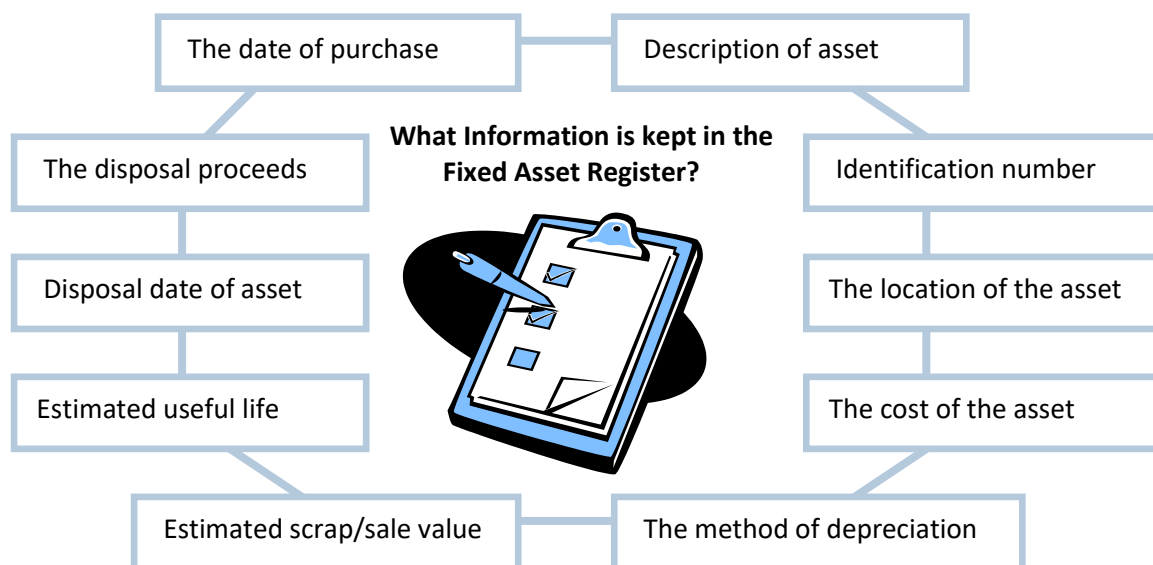
Disposal of Fixed Assets + The use of a Fixed Asset Register:

When an asset is sold or scrapped, the fixed asset account and its corresponding depreciation can be transferred to a 'disposal of fixed asset' account.

The purchase of capital transactions can cost a business large sums of money. We can use the journal as a book of prime entry to record the buying of the assets, but this is not the best way to monitor fixed assets across a large business. There may be a long list of valuable fixed assets across the company, in various departments and buildings.



What is required is a **fixed asset register** which lists all fixed assets and keeps other important information.





End of Chapter 25 Test Questions:

Past Paper Question:

1. The following fixed asset transactions took place during the period January 2007 to 31 December 2010:

- 1 January 2007 purchased vehicle A for £12,000.
- 1 January 2008 purchased vehicle B for £16,000.
- 3 March 2010 purchased vehicle C for £18,000.
- 3 March 2010 sold vehicle A for £2,800.

Notes

- Vehicles are depreciated at 25% per year using the straight line method.
- In the year of purchase a full year of depreciation is to be provided.
- In the year of disposal no depreciation is to be provided.

Required:

- a) Write up the vehicles at cost account for the period ended 31 December 2010. [4]
- b) Write up a provision for vehicle depreciation account for the period ended 31 December. [9]
- c) Write up the vehicle disposal account. [4]
- d) Explain briefly the purpose of maintaining depreciation accounts. [3]

Past Paper Question:

2. The following are the fixed assets purchased by a new business between 1 January 2007 and 31 December 2009:

- 01 01 07 Machine costing £20,000 (no estimated residual value)
- 10 01 07 Vehicle costing £16,000 (no estimated residual value)
- 05 02 07 Computer equipment costing £60,000 (no estimated residual value)

The policy is to apply a full year's depreciation charge in the year of purchases and none in the year of disposal.

- Machinery is written off at 25% pa. on cost.
- Vehicles are written off at 25% pa. on cost.
- Computer equipment is written off at 30% pa. on cost.

Required:

- a) Write up the three relevant depreciation accounts for the three-year period to 31 December. [9]
- b) Show the tangible fixed asset (non-current assets) section of the balance sheet (position statement) as at 31 December 2009. [3]
- c) Explain the role of:
 - i) an auditor
 - ii) a trial balance [4 each]

3. What purpose does the journal serve relating to capital transactions?

4. Outline the need the a business to maintain a fixed asset register.

Chapter 26: Partnership Accounts



Introduction

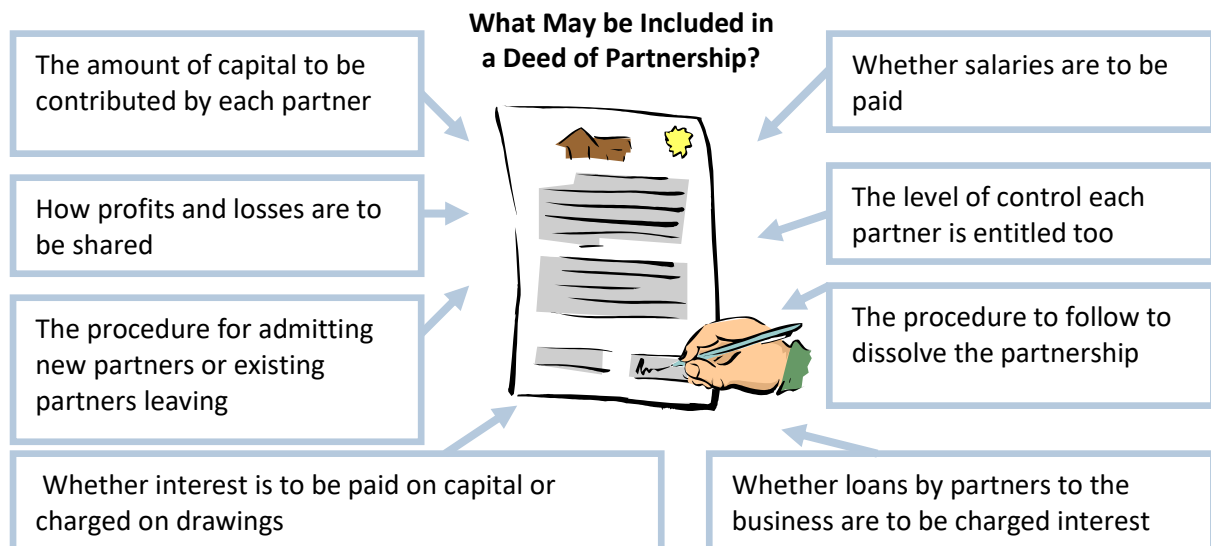
A partnership is defined as two or more persons in business with a view to making profit. There is little legal constraint and a partnership can be set up without complex documentation.

The 1890 Partnership Act and the 1907 Partnership Act apply to all partners and limited partners respectively.

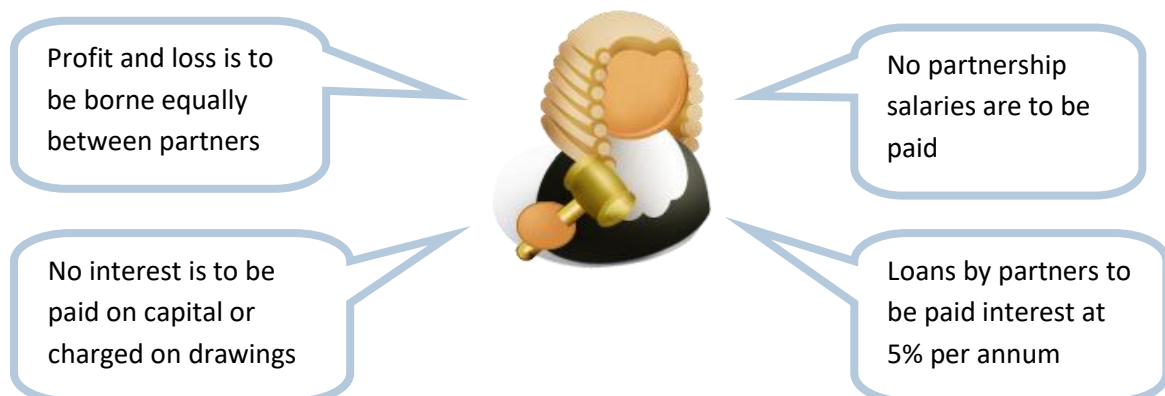


Written Agreements:

While there is no obligation to have a written agreement, it is advisable. A '**Deeds of Partnership**' is such an agreement, where a contract is signed by each partner and witnessed.



If there is no partnership agreement then the 1890 Partnership Act comes into play. It states:



Partnership Appropriation account:

The final accounts of a partnership are prepared identically to a normal business as far as the calculation of profit and the preparation of a balance sheet are concerned – the principles are exactly the same.

However, partnerships are different as they have an 'appropriation account', which simply shows how profits (or losses) are to be shared between partners.

Example:

Peter and Jane agreed to share profits of £7,500 equally. Other items: salaries £1,500 each, 5% interest paid on capital accounts (£5,000 capital each) and interest charged on drawings £200 for Peter and £150 for Jane, are to be accounted for.

Profit and Loss Appropriation Account of Peter and Jane Year Ended 31 December				
		£	£	£
Net Profit				7,500
Less:				
Salary:	Peter	1,500		
	Jane	1,500	3,000	
Interest on Capital (5%):				
	Peter	250		
	Jane	250	<u>500</u>	<u>3,500</u>
				4,000
Add:				
Interest charged on drawings:				
	Peter	200		
	Jane	150		<u>350</u>
				4,350
Share of Profits:				
	Peter	2,175		
	Jane	2,175		4,350

Partner's Current Accounts:

A current account is a record of a partner's personal finances in the business. Additions to the account are things such as: share of profits, interest paid on capital, salary awarded. Deductions are mainly drawings of cash or stock and the interest charged on drawings.

Example Nominal Ledger entries:			
	Dr	Cr	Balance
Current a/c: Peter			
Dec 31 Balance			200 Cr
Salary		1,500	1,700
Interest on capital		250	1,950
Profit		2,175	4,125
Drawings	2,000		2,125
Interest charged	200		1,925 Cr

Balance sheet (extract) of Peter and Jane as at 31 December

	£	£	£
Net Assets			<u>13,700</u>
Financed by:			
Capital accounts:			
Peter	5,000		
Jane	<u>5,000</u>	10,000	
Current accounts:			
Peter	1,925		
Jane	1,775	3,700	<u>13,700</u>

Goodwill

The term 'goodwill' in business is used to describe the value that a good name or reputation built up over time has. When a business is sold goodwill is the value paid over and above the net value of the total assets. It recognises that the business is more than a collection of assets – it has a customer base and brand, for example.

The Writing Off of Goodwill

It has been standard practice to write off the goodwill arising from the purchase or commencement of a new business partnership. It's recognised in FRS 10 (a financial reporting standard) that it is difficult to separate goodwill from the business as a whole. If there is an agreed sum for goodwill, it should be written off based on the profit- sharing ratio.



End of Chapter 26 Test

Questions:

Past Paper Question:

- Arinda and Birinda are in partnership. Interest is allowed on capital and on the opening current account balances at 5% pa. Arinda is to be credited with a salary of £15,000 in recognition of extra duties. Interest is charged on drawings (see note). Arinda and Birinda agree to share profits equally. The following trial balance was drawn up on 30 August 2010:

	£	£
Capital accounts – Arinda		50,000
Birinda		50,000
Current accounts – Arinda		10,000
Birinda		10,000
Drawings – Arinda	22,000	
Birinda	21,000	
Purchases	350,000	
Sales		549,000
Returns	2,000	1,000
Carriage inwards	3,000	
Staff wages	85,000	
Rent and insurance	20,000	
General expenses	12,000	
Bad debts written off	3,000	
Stock (inventory) (01 09 09)	46,000	
Equipment at cost	90,000	
Debtors (accounts receivable)	45,000	
Creditors		32,000
Cash and bank	4,000	
Prov. for doubtful debts	1,000	
	-----	-----
	703,000	703,000
	=====	=====

Notes at 30 August 2010:

- Stock (inventory) was valued at £50,000.
- Staff wages owing amounted to £4,000.
- Insurance prepaid amounted to £2,000.
- Equipment is to be depreciated at 20% on cost.
- The provision for doubtful debts is to be increased to £3,000.
- BOTH partners are to be charged £500 re. interest on drawings.

Required:

- Prepare the firm's trading and profit and loss account (income statement), including the appropriation section for the year ended 30 August 2010. [9]
- Prepare the partners' current accounts for the year ended 30 August 2010. [4]
- Prepare the firm's balance sheet (position statement) as at 30 August 2010. [7]

Chapter 27: Company Accounts



Introduction

The most important difference between a limited company and other forms of business is the concept of **limited liability**. The owners of limited companies have the advantage that they are not personally liable for the debts of the business.

There are two distinct types of company:

- Private Limited Company (Ltd)
- Public Limited Company (Plc)

The formation of a company only needs a minimum of two founder members who are willing to subscribe to share capital. Companies are regulated by the Companies Act 1985.

The key difference between the two is that a private company can only sell its shares privately, where a public company can issue a prospectus to the public and freely advertise its shares.

A limited company is restricted, by law, from advertising to sell its shares and, therefore, has a limited ability to raise share capital. Most limited companies are small ventures with a small number of members – rarely employing more than 20 people.

A public company, on the other hand, can raise vast amounts of share capital. They can have thousands of members and employees and are listed on the Stock Exchange.

Company Documentation:

To form a company (whether private or public) it requires a greater amount of paperwork and cost than, say, a sole trader (who has virtually no legal constraint).

A limited company must prepare two key documents:

Memorandum of Association

This document gives the external view of the company to the public, including name, address, registered office, share capital and, most important, its objectives (i.e. what it proposes to do).



Articles of Association

This document gives the internal view of the company, it details the rules and regulations governing the internal organisation of the company, such as voting rights, power of directors, etc.

Once these documents are approved, a company is issued a **Certificate of Incorporation**. This gives the company a **separate legal identity** from the owners (i.e. the shareholders).

For a public company, a **Certificate of Trading** is issued once the minimum amount of share capital is raised.

The preparation of company accounts:

The 1985 Companies Act gives guidance as to the format of financial accounts relating to companies. You have seen this format in the shape of the trading, profit and loss account and balance sheet.

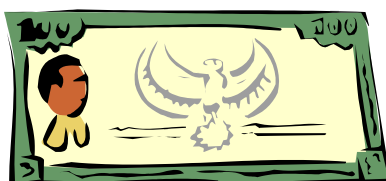
The **appropriation account** (similar to the concept explored in Partnership Accounts chapter) is the division of profits before tax. Basically, profits may be distributed by:

- Provision for taxation
- Dividends to shareholders
- Transfer of any profit to the company reserves (profits retained in the company)

The capital of limited companies:

There are a number of terms relating to a limited company's share capital that you need to become familiar with:

Issued capital – is the nominal capital issued to shareholders and cannot be in excess of authorised capital



Authorised capital – is the nominal capital of the company and is normally the maximum amount of capital it can issue. It is the company's registered capital

Paid up capital – refers to issued capital paid up by shareholders. If some shareholders have not yet paid for their shares, they are debtors to the company until they do pay. Continuing our example, if only £245,000 had been received from the called up capital, the £5,000 represents **unpaid capital**.

Called up capital – refers to shares which have been allotted to shareholders but have only called up part of the sum due on the shares. For example, a company could allot £500,000 £1 shares and only call up 50p a share. It will receive £250,000 as paid up capital, even though it has issued £500,000 of share capital. The balance due is **uncalled capital**.

Capital and revenue reserves:

Capital reserves are not retained profits as seen in the appropriation account because these are revenue reserves.

Capital reserves can include sums transferred to the share premium account (shares sold at a higher sum than the nominal value) or a revaluation reserve (an increase in the value of, say, a premises).

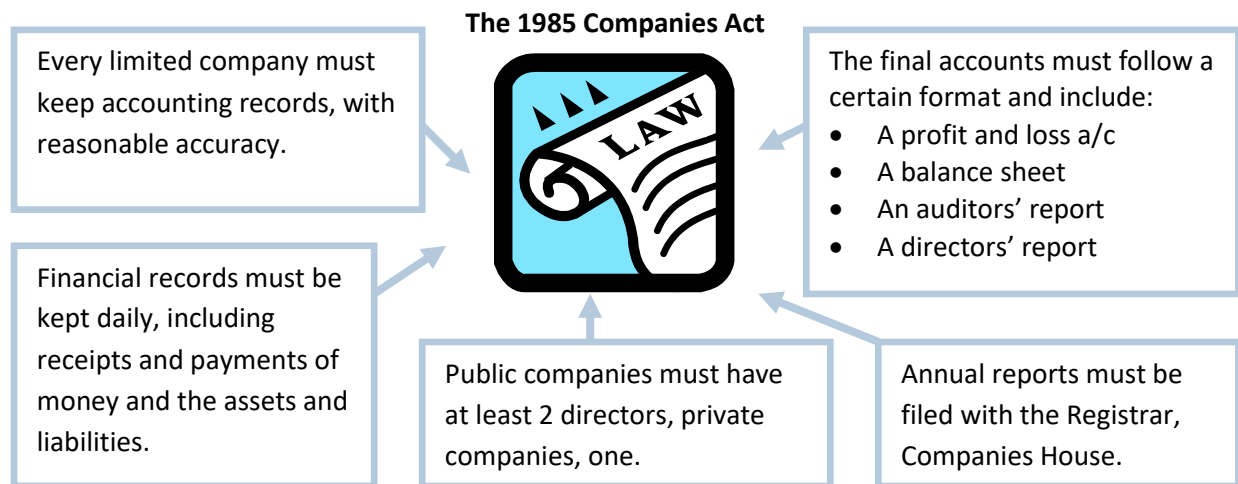
Shares and Debentures:

There are two classes of shares that may be issued to shareholders: ordinary shares and preference shares. (Please note: preference shares rarely feature in limited companies today.)

Ordinary share – the rate of dividend depends on how much profit is being made and how much is distributed. When shareholders vote on actions of the business, one share equals one vote.

Preference share – paid a fixed rate of dividend and holders entitled to be paid first before ordinary shares. These shares have no voting rights.

Debentures – represent loan capital and not share capital. They are paid a fixed rate of interest over the specific period of the loan. The interest paid to the debenture holder is an expense on the profit and loss account.



International terminology

The financial statements of limited companies are now being asked to be prepared using the international terminology rather than the present UK terms.

UK Term

Profit and loss account
 Turnover/sales
 Taxation
 Fixed assets
 Tangible fixed assets
 Stock
 Debtors
 Creditors
 Long-term liabilities
 Debentures
 Capital and reserves
 Profit and loss account
 Capital and reserves (consolidated a/c)

International Term

Income statement
 Revenue
 Tax expense
 Non-current assets
 Property, plant and equipment
 Inventory
 Receivables
 Payables
 Non-current liabilities
 Loan stock
 Equity
 Retained earnings
 Equity attributed to equity holders of parent





End of Chapter 27 Test Questions:

1. The following list of balances as at 28 February 2010 of ALZ Ltd has been taken from the books AFTER the trading account has been completed:

	£000	£000
	Dr	Cr
Gross profit for the year		410
Equipment at cost	300	
Equipment depreciation (01 03 09)		120
Ordinary share capital (£1)		200
Distribution costs	140	
Administration expenses	90	
Interim dividend paid	10	
Stock (inventories) at 28 02 10	210	
Trade debtors	250	
Trade creditors		70
Cash and bank	10	
5% Debentures (redeemable 2016)		100
Profit and loss account (01 03 09)		110
	1,010	1,010
	===	===

Notes:

- Equipment is to be depreciated at 25% on cost.
- Interest on debentures is still unpaid.
- Corporation tax of £15,000 is to be provided.
- The directors have declared a final dividend of 9 pence per share.

Required:

- Prepare the profit and loss account (income statement) for the year ended 28 February 2010. [8]
- Prepare the balance sheet (position statement) as at 28 February 2010. [8]
- Calculate the EPS. [2]
- Calculate the profit before tax as a percentage of shareholders' total capital. [2]

2. The following trial balance has been taken from the accounts of Simric Ltd as at 31 May 2010:

	£000	£000
Turnover		1,400
Purchases	930	
Stock (inventory) (01 06 09)	64	
Postage, telephone, fax expenses	25	
Rent rates and insurance	46	
Marketing expenses	42	
Energy costs	20	
Wages and salaries	261	
Debenture interest	2	
Debtors (accounts receivable)	95	
Creditors (accounts payable)		65
Cash and bank	10	
4% Debentures (repayable 2016)		100
Equipment at cost	350	
Depreciation of equip. (01 06 09)		100
Provision for doubtful debts (01 06 09)		4
£1 Ordinary share capital		200
Premises	250	
Depreciation of premises (01 06 09)		60
Profit and loss account (01 06 09)		166
	-----	-----
	2,095	2,095
	=====	=====

Notes at 31 May 2010:

	£000
• Stock (inventory) is valued at	67
• Energy costs owing amounted to	8
• Rates prepaid amounted to	2
• The provision for doubtful debts is to be increased to	7
	==
• The equipment is to be depreciated by 25% on cost.	
• The premises are to be depreciated by 2% on cost.	
• The outstanding debenture interest is due for payment on 3 June 2010.	
• The directors wish to provide 2 (£000) for taxation.	
• The directors have declared an ordinary dividend of 12p per share.	

Required:

- Prepare the profit and loss account (income statement) for the year ended 31 May 2010. [11]
- Prepare the balance sheet (position statement) as at 31 May 2010. [9]

Chapter 28: Cash Flow Statements



Introduction

In 1990 the newly formed Accounting Standard Board (ASB) was created to govern accounting practices. In recognition of the importance of a business's cash flow position, their first Financial Reporting Standard was: **The Cash Flow Statement**.

The purpose of the cash flow statement is to emphasise a business's inflow and outflow of cash during the financial year. It shows the **liquidity** position of the business. That is, the cash or near cash funds the business has to cover debts – in other words, the **working capital** of the business.

A cash flow statement is reported under eight standard headings.

There are three distinct stages to preparation:

1. Reconcile the company's operating profit for the year and the net cash flow from operating activities.
2. The figure calculated in step one is then the starting figure to the second stage, which is to draw up the actual cash flow using the eight headings.
3. The final stage is to prepare a **reconciliation of net cash flow** to the movement of debt.

What are the eight standard cash flow statement headings?

1. Operating activities:

- a) Net profit on normal trading activities (before tax)
- b) Non-cash flow expenses like depreciation
- c) Adjustments to the movements in working capital

2. Returns on investments and servicing finance:

- a) Interest or dividends received
- b) Interest paid

3. Taxation

4. Capital expenditure and financial investment:

- a) Purchase of fixed assets
- b) Disposal of fixed assets

5. Acquisitions and disposals:

- a) Cash flow from the acquisition of a business
- b) Cash flow from the disposal of a business

6. Equity dividends paid:

- a) Dividends paid to equity shareholders (but excluding advanced corporation tax)

7. Management of financial resources:

- a) Cash flow from the acquisition or disposal of short-term investments (current assets)

8. Financing:

- a) The issue of shares or debenture stocks
- b) Repayment of shares or debenture stocks
- c) Repayment of other loans



As usual, the best way to understand the cash flow statement is to follow a complete example.

Duran Ltd: Balance Sheet as at 31 December

	Year 1		Year 2	
	£	£	£	£
Fixed assets				
Cost	60,000		100,000	
Less cumulative depreciation	<u>20,000</u>		<u>34,000</u>	
		40,000		66,000
Investments at cost		<u>40,000</u>		<u>20,000</u>
		80,000		86,000
Current Assets				
Stock	40,000		120,000	
Debtors	44,000		96,000	
Bank	<u>2,000</u>		<u>6,000</u>	
	<u>86,000</u>		<u>222,000</u>	
Current Liabilities				
Tax owing	12,000		28,000	
Dividend owing	8,000		10,000	
Creditors	<u>14,000</u>		<u>20,000</u>	
	<u>34,000</u>	<u>52,000</u>	<u>58,000</u>	<u>164,000</u>
		132,000		250,000
Long term loans		<u>20,000</u>		<u>28,000</u>
		<u>112,000</u>		<u>222,000</u>
Financed by:				
Ordinary shares		80,000		100,000
Share premium account		-		20,000
Profit and loss account balance		<u>32,000</u>		<u>102,000</u>
		<u>112,000</u>		<u>222,000</u>

Duran Ltd Abbreviated profit and loss accounts for Year ended 31 December

	Year 2
	£
Sales	1,500,000
Cost of sales	(1,200,000)
Gross profit	300,000
Total expenses (inc depreciation)	(196,500)
Operating profit for year	103,500
Add profit on sale of investments	8,000
Less interest payable	<u>(3,500)</u>
	108,000
Less tax provision	<u>(28,000)</u>
	80,000
Add retained profits	<u>32,000</u>
	112,000
Less proposed ordinary dividend	<u>(10,000)</u>
Retained profits c/f	102,000

Note: No tangible fixed assets were disposed of during the year but £20,000 of investments had been sold for £28,000.

Required: Prepare a cash flow statement for the year ended 31 December (year 2)

Solution:

Duran Ltd Cash flow statement for the year ended 31 December (Year 2)

	£	£
1. Operating activities *		
Cash outflow		(8,500)
2. Returns on investments and servicing finance:		
Interest paid		(3,500)
3. Taxation		(12,000)
4. Capital expenditure and financial investment:		
Purchase of fixed assets	(40,000)	
Sales of fixed assets	<u>28,000</u>	(12,000)
5. Acquisitions and disposals		-
6. Equity dividends paid:		
Ordinary shares		(8,000)
7. Management of financial resources		<u>0</u>
		(44,000)
8. Financing:		
Issue of ordinary shares	20,000	
Share premium account	20,000	
Long term loan	<u>8,000</u>	<u>48,000</u>
Net cash inflow		4,000

*Calculation of operating activities: (working for Step 1)

	£
Operating profit	103,500
+ depreciation charges	<u>14,000</u>
	117,500
Working Capital:	
+ stock	(80,000)
+ debtors	<u>(52,000)</u>
	(14,500)
+ creditors	<u>6,000</u>
	(8,500)

Reconciliation of net cash flow to movement in net debt

	£	£
Increase in net cash flow		4,000
Cash from increase in debt (loan 20k to 28k)		<u>(8,000)</u>
Change in net debt		(4,000)
Net debt in year 1 - Bank	2,000	
- Loan	(20,000)	(18,000)
Net debt in Year 2 - Bank	6,000	
- Loan	(28,000)	<u>(22,000)</u>
Change in net debt		(4,000)



End of Chapter 28 Test Questions:

1. The summarised financial statements of Kandy Ltd for 2008 and 2009 were as follows:

Kandy Ltd balance sheets (position statements) as at 31 December:

	2008		2009	
	£000	£000	£000	£000
Fixed assets at cost	16,000		19,000	
Depreciation	(7,000)	9,000	(9,000)	10,000
Current assets				
Stock (inventory)	7,000		9,000	
Debtors (a/cs receivable)	9,000		8,000	
Bank	2,000		7,000	
	-----		-----	
	18,000		24,000	
	-----		-----	
Current liabilities				
Creditors (a/cs payable)	4,000		3,000	
Taxation	4,000		6,000	
Dividends	4,000		6,000	
	-----		-----	
	12,000		15,000	
	-----		-----	
Working capital		6,000		9,000
Long-term loans		(3,000)		(5,000)
		-----		-----
		12,000		14,000
		-----		-----
Capital and reserves:				
Ordinary shares (£1)		7,000		8,000
Profit and loss account		5,000		6,000
		-----		-----
		12,000		14,000
		-----		-----

Kandy Ltd profit and loss account (income statement) for the year ended 31 December 2009:

	£000
Operating profit	15,000
Interest paid	<u>(2,000)</u>
Profit before tax	13,000
Taxation	<u>(6,000)</u>
Profit after tax	7,000
Dividend	(6,000)
Retained profit	<u>1,000</u>

Required:

- a) Prepare a cash flow statement for Kandy Ltd for the year ended 31 December 2009. [10]

Chapter 29: Accounts of Clubs and Societies



Introduction

Most private sector businesses are profit motivated. However, there are non-profit organisations that are not set up to make money. These are often clubs and societies organised for specific purposes, for example, social, sporting and political ventures.



The money that comes in (member's subscriptions) and the money that goes out of a social organisation should be properly accounted for, in order to safeguard members' interests. It is therefore necessary to keep some basic records of the accounts.



A social organisation may elect honorary members: a chairman (the figure-head), the club secretary (responsible for paperwork) and a treasurer (responsible for the accounts).

The treasurer's accounting reports:

Formal accounting methods tend to be uncommon, but the principles of accounting remain the same. The following reports are usually prepared for the club or society's yearly activity.

- A receipts and payments account
- Any specialised accounts such as a bar account
- An income and expenditure account
- A balance sheet showing the organisation's state of affairs.



The receipts and payments account:

This is a summary of all cash receipts and payments of the organisation and is a simplified cash book, the purpose being to show where the cash has come from and where it has gone.

The income and expenditure account:

This is the equivalent of the business's trading, profit and loss account, where expenses are matched against income. Just like in company accounts, adjustments such as accruals, pre-payments and depreciation are also accounted for because they affect the profit and loss for the year.

Instead of the words profit and loss, a social organisation uses the terms 'surplus' or 'deficit'.

The balance sheet:

This statement is prepared in the same way as any other organisation. The net resources of the club or society are financed by the 'accumulated funds' - that is, the capital or net worth of the organisation.

Accumulated funds represent assets less liabilities in the same way as capital. Any surplus from the income and expenditure account is added to the funds. Any deficit is reduced.



End of Chapter 29 Test Questions:

1. The following are the details in respect of subscriptions for a sports club:

	£
1 June 2009 subscriptions in advance	145
1 June 2009 subscriptions in arrears	55
Total subscriptions received in year	13,200
31 May 2010 subscriptions in advance	165
31 May 2010 subscriptions in arrears	70
There were no bad debts in the year.	

Required: Write up the subscriptions account for the year ended 31 May 2010. [6]

2. Included in the assets and liabilities of the Nelson Cricket Club on 1 January 2010 was the following: Club premises £150,000; equipment £30,000; bar stock £4,200; long-term investments £35,000; bar wages owing £400; subscriptions in arrears £300; subscriptions paid in advance £700.

The following is a summary of the club's receipts & payments for the year ended 31 December 2010:

RECEIPTS		PAYMENTS	
	£		£
Cash in hand 1 January 2010	1,100	Bar purchases	57,400
Investment income	950	Wages (bar)	32,300
Subscriptions received	52,300	General expenses	15,800
Bar sales	125,600	Competition prizes	3,700
Cricket competition receipts	2,100	New equipment	45,000
		Postage/stationery	6,100
		Insurance and rates	7,900
		Investments	10,000
		Balance c/f	3,850
	-----		-----
	182,050		182,050
	=====		=====

NOTES at 31 December 2010:

- Bar stock was valued at £5,200.
- Insurance prepaid amounted to £300.
- Bar wages owing amounted to £600.
- All equipment is to be depreciated by 25%.
- Subscriptions in arrears amounted to £400.
- Subscriptions paid in advance amounted to £900.
- The club's accumulated fund on 1 January 2010 was £219,500

Required:

- a) Prepare the club's bar trading account for the year ended 31 December 2010. [5]
b) Prepare the club's income and expenditure account for the year ended 31 December 2010. [8]
c) Prepare the club's balance sheet as at 31 December 2010. [7]

Chapter 30: The Extended Trial Balance



Introduction

If you remember, the trial balance is test of arithmetical accuracy of the double entry system. The trial balance is extracted from the accounts of the nominal ledger in order to prepare the final accounts. All adjustments relating to the end of the period must also be taken into account to ensure correct matching of revenue with expenses.



The extended trial balance (ETB) has additional columns in order to accommodate any adjustments which may be required before the preparation of the final accounts.

In reality the number of columns can be large (including bank and cash transaction, accruals and prepayments) but for examination purposes it is often shortened to the following:

Details	Trial Balance		Adjustments		Profit and Loss		Balance Sheet	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Sales		95,100				95,100		
Purchases	52,150				52,150			
Telephone	1,325		50		1,375			
Light, heat	1,540		75		1,615			
Stationery	890			100	790			
Wages	14,745		100		14,845			
Motor van	2,450						2,450	
Depreciation of van		490		490				980
Equipment	1,500						1,500	
Depreciation of Equip		150		150				300
Accruals								225
Prepayments							100	
Depreciation of fixed assets			640		640			

Notes:

- The trial balance column lists all figures concerning the trial balance at the period end
- The adjustments column is used for making the balance day adjustments including accruals, prepaid expenses, writing off bad debts, making provisions for depreciation, bad debts or discounts and for adjusting figures for VAT.
- The final two columns are used to extend the figures across to either the profit and loss account or the balance sheet
- The difference between the columns in the profit and loss account will indicate either profit or loss that is then transferred to the balance sheet.

Now let us work through an example of this simplified extended trial balance.

Example:

The trial balance of Arthur Jones did not balance as on 30 June and a suspense account was entered in the ETB as £690 credit. Since then, the following errors were located:

- Equipment £500 had in error been posted to the purchases account
- A gas bill £85 had been paid but not put through the books
- Discount allowed £68 had not been posted to the ledger
- Sales had been under-cast by £800
- A cheque from a debtor £150 had been recorded as £105 in debtor's account but correctly recorded in the corresponding account
- The total from the returns inward account £87 had not been posted to the ledger
- Cash sales £900 into bank had in error been posted in reverse.

In addition to these entries, on 30 June the closing stock value was £2,150 and wages owing were £240. Depreciation of the van equipment is at 10% per annum and buildings valued £12,000, at 2% per annum.

The solution:

Firstly, we need to make the appropriate corrections in the journal and then directly in the ETB, entering the suspense account on the opposite side of the adjustment column. This is to offset errors that affect the suspense account.

Journal			
Date	Details	Debit	Credit
June 30	Equipment	500	
	Purchases		500
	Light and heat	85	
	Bank		85
	Discount allowed	68	
	Suspense		68
	Suspense	800	
	Sales		800
	Suspense	45	
	Debtors		45
	Returns inward	87	
	Suspense		87
	Bank	1,800	
	Sales		1,800

Now we can complete the extended trial balance:

The ETB of Arthur Jones								
Details	Trial Balance		Adjustments		Profit and Loss		Balance Sheet	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Premises	20,000						20,000	
Motor vehicle	500						500	
Equipment	2,100		500				2,600	
Opening stock	1,860				1,860			
Debtors	675			45			630	
Creditors		1,155						1,155
Capital		12,500						12,500
Bank		455	1,800	85			1,260	
Sales		35,750		800		38,350		
				1,800				
Purchases	20,195			500	19,685			
General expenses	1,250				1,250			
Wages	3,970		240		4,210			
Suspense		690	690					
Light and heat			85		85			
Discount allowed			68		68			
Returns in			87		87			
Closing stock			2,150	2,150		2,150	2,150	
Accrued expenses				240				240
Depreciation:								
Van			50	50				
Equipment			260	260				
Buildings			240	240	550			540
Net Profit					12,695			12,965
	<u>50,550</u>	<u>50,550</u>	<u>6,170</u>	<u>6,170</u>	<u>40,500</u>	<u>40,500</u>	<u>27,140</u>	<u>27,140</u>



End of Chapter 30 Test Questions:

1. The following figures relate to the financial data of Harry Smith. Prepare a draft extended trial balance for the client as well as a set of final accounts.

Trial balance as at 31 May	Debit £	Credit £
Premises	50,000	
Equipment	15,100	
Provision for depreciation of equipment		2,500
Motor vehicle	6,040	
Provision for depreciation of vehicle		3,480
Debtors	8,800	
Creditors		8,130
Opening stock	10,300	
Bank	7,451	
Mortgage on premises		30,130
Mortgage repayments (inc. interest)	2,460	
Capital		62,500
Purchases, sales	38,058	49,603
Stationery	672	
Light and heat	403	
VAT	885	
British Telecom*	423	
Motor expenses*	1,598	
Wages	10,960	
Maintenance & repairs	935	
General overheads	1,350	
Bank & interest charges	298	
Discounts	445	225
Bad debts	190	
Petty cash float	200	
	156,568	156,568

*VAT is inclusive of these figures and needs to be extracted in the ETB.

Further information provided as on 31 May:

- Stock: the closing value was £15,400
- The owner, Harry Smith, has taken £550 cash per month from sales takings for personal use and this has NOT been recorded in any of the books.
- Depreciation of fixed assets: Vehicle, 25% reducing balance; Equipment, 20% on cost.
- Gas and electricity bills in arrears: £190; wages by £420. Stationery unused was valued at £80.
- A provision of 5% for bad or doubtful debts is to be made against debtors.
- Of mortgage repayments, £1,020 was interest charged.
- Harry Smith has rented part of premises to a client for £900 p/a, starting in April. Payment will not be received until 30 June.

Required:

- a) Prepare an extended trial balance from the above information.
- b) Prepare a draft copy of the profit and loss account and balance sheet for period ended 31 May.



Using Accounting Information

Chapter 31: Accounting Ratios and Preparing Reports



Introduction

Ratios help to measure the performance of a business and provide important indicators of how well a business is doing. They show trends in current years and help make comparisons from one year to another and between different business organisations.

Ratios help owners and managers to improve their decision making. Although, one ratio in isolation may tell you very little, so it is important to compare to past performance or with businesses in the same category. It is also important to be consistent with the way ratios are calculated when comparing different periods.

Ratios can be analysed into various groups:

- Profitability
- Liquidity (short-term solvency)
- Efficiency
- Liquidity (long-term solvency)
- Investment

Profitability Ratios:

These ratios are used to measure the trading performance of a business in terms of profit to sales or profit to capital.

- The gross profit % = $\frac{\text{Gross profit} \times 100}{\text{Net sales}}$
- The net profit % = $\frac{\text{Net profit} \times 100}{\text{Net sales}}$
- Return on capital employed = $\frac{\text{Net profit} \times 100}{\text{Capital employed}}$
- Return on net worth = $\frac{\text{Net profit} \times 100}{\text{Net worth (owner's equity)}}$
- Return on total assets = $\frac{\text{Net profit} \times 100}{\text{Total assets}}$



Liquidity Ratios (short-term solvency):

These ratios indicate the business's ability to have sufficient cash to meet current debts.

Working capital ratio = $\frac{\text{Current assets}}{\text{Current liabilities}}$

Quick asset ratio = $\frac{\text{Current assets (less stock)}}{\text{Current liabilities}}$

Working capital needs to be adequate to enable the business to trade with reasonable 'comfort'. It should be enough to finance short-term debt, so if creditors demand payment the business is in a sound enough financial position to meet those demands.



Liquidity is just as important as profit earning. A business can be in an attractive profit earning position and yet still fail because it has disregarded its liquidity.

The quick asset ratio is an immediate test of liquidity because the value of stock is deducted from current assets. It answers the question: can a business, without relying on its stock, meet its immediate debts?

Efficiency Ratios (effective resource use):

These ratios are used to try and identify the strengths and weaknesses of a business using a variety of different ratios, including money incurred on expenses, stock turnover, debt collection, the investment of assets to turnover and productivity.

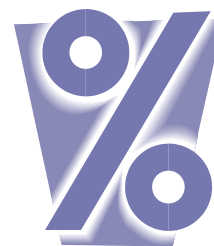
Expense percentages:

- Cost of sales % = $\frac{\text{Cost of sales} \times 100}{\text{Sales}}$
- Distribution expenses % = $\frac{\text{Distribution expenses} \times 100}{\text{Sales}}$
- Administration expenses % = $\frac{\text{Administration expenses} \times 100}{\text{Sales}}$
- Financial expenses %
(Interest payments) = $\frac{\text{Financial expenses} \times 100}{\text{Sales}}$

The rate of stock turnover:

This ratio refers to the number of time the stock is sold within an accounting period. It gives an indication of a business's selling efficiency.

- Rate of stock turnover = $\frac{\text{Cost of sales}}{\text{Average stock}}$



The speed of stock turnover depends on the nature of goods sold. A large supermarket, for example, will have a high turnover rate because it sells goods required everyday.

The collection of debt:

This ratio is an indication of how long it takes debtors to pay their debts. The ratio has a significant bearing on both the efficiency of credit control and the accuracy of liquidity.

- Av. credit taken by debtors = $\frac{\text{Debtors} \times 365}{\text{Credit sales}}$

Creditors' payment period:

This measurement links with the collection of debt from customers. If debtors pay promptly, it makes it easier to make payments to creditors (assuming they're in the same proportion).

- Av. Credit obtained from supplies = $\frac{\text{Creditors} \times 365}{\text{Credit Purchases}}$

The higher the number of days it takes to pay creditors in comparison to the time it takes debtors to settle debts the higher the liquidity advantage to the company. However, this liquidity advantage needs to be balanced with the financial advantages of prompt payment discounts.

Asset usage:

There are a number of ratios that can be used to identify the amount of investment in assets which will generate turnover (sales).

- Asset turnover = $\frac{\text{Sales}}{\text{Capital employed}}$
- Sales/Trading assets = $\frac{\text{Sales}}{\text{Current assets}}$

The trading assets ratio shows the amount of sales you are generating for every one pound invested.

Productivity:

Two ratios may be used to identify productivity in terms of the number employed.

- Sales: Employees = $\frac{\text{Turnover}}{\text{Employee}}$
- Profit (before tax): Employees = $\frac{\text{Profit}}{\text{Employees}}$

Productivity has always been seen to be an important contributory factor to efficiency in business. The greater the productivity, the greater the profit and the more resources are available for distribution. If productivity increases, a business could afford to pay its workforce more. If productivity falls, employees are producing less in terms of units to man-hours – the business has become less efficient.

Structure Ratios (long-term solvency):

These measure the relationship between the members' capital and the extent of liabilities. The term structure refers to financial structure, not physical structure.

- The owner's stake = $\frac{\text{Capital (net worth)}}{\text{Assets (total assets)}}$

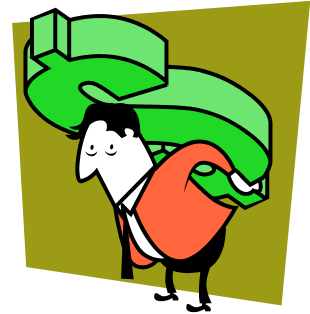
This first ratio shows how much the owners are worth in the business, compared with the creditors of the business.

- Interest cover = $\frac{\text{Net profit (before tax, interest)}}{\text{Interest payable}}$

The interest cover ration shows the number of times the interest liability can be paid from profits.

Capital Gearing:

This is a key ratio and is a measure of how heavily burdened the company is with long-term debt. A company which is high-g geared has a high proportion of borrowed capital relative to ordinary shares. If creditors hold the balance of financial power they can call in loans and accelerate the collapse of a company. A company is said to be low-g geared if the opposite is true.



$$\bullet \text{ Capital Gearing} = \frac{\text{Long-term debt}}{\text{Capital employed}}$$

Investment Ratios:

As you now know, the shares of public limited companies can be bought and sold on the Stock Exchange. It is these stocks and shares that are published daily in the newspapers.

The Financial Times Index (FTI) is the barometer of the Exchange, and its rise or fall each day indicates how the market responds to the demand for stocks and shares.

If the market believes there is confidence in the economy, demand for shares could increase and the market is said to be '**bullish**' and share prices are likely to rise.



On the other hand, if confidence falls, demand can dry up and investors may rush out to sell, causing share prices to fall. This is a '**bear**' market.

A good way to remember the difference between a bull market and a bear market is to think about the way these two animals attack.



A bear is standing on its back legs and sweeps a paw down on its target – representing a market going down.

A bull, on the other hand, starts with its head low down and raises its head rapidly to use its horns as a weapon – representing a market going up.



- Earnings per share =
$$\frac{\text{Net profit (after tax)} - \text{Preference dividend}}{\text{No. of ordinary shares}}$$
- Percentage dividend =
$$\frac{\text{Sum to ordinary share holders} \times 100}{\text{Issued \& paid up capital}}$$
- Yield percentage =
$$\frac{\text{Dividend per share} \times 100}{\text{Market value per share}}$$
- Cover =
$$\frac{\text{Net profit (after tax)} - \text{Preference dividend}}{\text{Dividend on ordinary shares}}$$
- Price/Earnings ratio =
$$\frac{\text{Market price per share}}{\text{EPS}}$$

The EPS is one of the most publicised ratios when companies report their half-yearly or yearly results. It indicates the earning potential of each ordinary share, and is therefore of great interest to investors.

The price earnings ratio indicates the market value in relation to the number of years' profits it represents – generally speaking, the higher the P/E ratio, the better. It indicates what the market is prepared to pay for them.

The Limitations of Accounting Ratios



There have been a number of cases where accounting ratios have indicated a sound financial position, but on closer inspection it was revealed the organisation was far from sound.

Not all organisations are the same - in the way they operate or are structured. Often more careful thought needs to go into inter-company comparisons.

Ratios that appear to show a healthy position can hide big problems. Over-reliance on them can be dangerous.

Bankers and creditors who lend money to the business will use the financial accounts and ratios but will usually refer to specialist organisations in assessing credit rating. A sign of how much value the lenders of money give basic ratio analysis.

On their own, they often provide little benefit. They must always be used in comparison with other figures.



End of Chapter 31 Test Questions:

Past Paper Question:

1. The following data relates to two different companies, which operate in the same business sector:

	A	B
	£000	£000
Sales in year (all on credit)	4,900	8,700
Cost of sales for the year	2,600	4,300
Total expenses for the year	1,100	1,900
	-----	-----
Opening inventory (stock) value	160	300
Closing inventory (stock) value	180	320
Closing debtors (accounts rec.)	350	510
Closing total current assets	560	880
Closing total current liabilities	290	550

Required:

- a) For each company calculate the following:
- i gross profit to sales percentage
 - ii net profit to sales percentage
 - iii expenses to sales percentage
 - iv stock turnover in days
 - v debtor collection period
 - vi current ratio
 - vii acid test ratio [2 each]
- b) Comment on the financial performance of the two companies. [6]

Past Paper Question:

2. The following details have been obtained from the final accounts of Rebluck plc for the last three years:

	2007	2008	2009
	£m	£m	£m
Sales all on credit	180	230	310
Cost of sales	85	100	110
Total expenses	75	90	100
Closing debtors (accounts receivable)	15	18	19
Average stock (inventory)	17	20	17
Total purchases (all on credit)	82	101	119
Closing creditors (accounts payable)	8	8	9

Required:

- a) Prepare the summarised profit and loss account for EACH of the three years. [2]
- b) Calculate for EACH of the three years:
- i the gross profit percentage
 - ii the net profit percentage
 - iii the expenses to sales percentage
 - iv the debtor collection period in days
 - v the stock turnover period in days
 - vi the creditor payment period in days [18]

Chapter 32: Accounting Standards



Statements of Standard Accounting Practice and Financial Reporting Standards

Introduction

Statements of Standard Accounting Practice and Financial Reporting Statements represent the profession's accounting standards. Their aim is to standardise the preparation of final accounts for the benefit of all stakeholders – looking for objectivity, reliability and consistency.

The Accounting Standards Board (ASB) was formed in 1990 and is the authority tasked with the issuing of new accounting standards, called FRSs.



GAAP:

This is a generally accepted accounting principle. These are governed by the rules of the accounting profession and company law, such as the Companies Act 1985. When these rules, mandatory or otherwise, become consistently adopted by businesses, they then become the accepted practice of the accounting profession.

The International Accounting Standards Committee (IASC):

The aim of this committee was to promote greater standardisation in the preparation of financial statements in many areas of the world, through the creation of International Accounting Standards (IAS). A balance sheet, for example, prepared in Europe, Australia or the USA should look like a balance sheet in the UK and follow the same principles.

The statement: **'true and fair'**

"Accounting standard are authoritative statements and compliance with accounting standards will normally be necessary for financial statements to give a **true and fair view**."

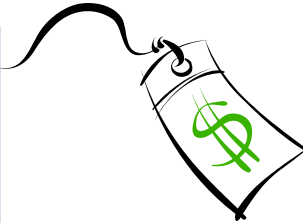
The concept of cost:

The recording of accounts is traditionally on a historical cost basis which means that the recording of transactions is in relation to what the business paid for them. But there are a number of ways to value an asset:

Cost price – to value an asset at historical cost price simplifies the recording process. The price paid for the asset is the price recorded in the accounts.

Current replacement cost – the current market cost of replacing an asset in order to acquire the same service from it.

Net realisable value – it estimates the current value of the asset i.e. what it would sell for less selling expenses (such as advertising).



Present value – applies to investment opportunities and compares the returns an asset could provide, in terms of future earnings potential discounted to present day interest rates.

Cost less depreciation – a fixed asset has a charge against it to account for the decreasing value of the asset during its useful life to the business. The difference between historical cost and depreciation becomes the net book value of the asset.

These methods of asset valuation link to the concept of 'capital maintenance'. This is about comparing the value of net assets in one period to the value in the following period, to see how well off a business is at the end of that period.

We will now look at some specific accounting standards and explore some of the key concepts that have come from them.

FRS 18: Disclosure of accounting policies

The four fundamental concepts that came from the standard are:

- Going concern
- Accruals concept
- Consistency concept
- Prudence concept

Going concern concept:

The value of an organisation's assets is based on the assumption that the firm will continue trading. If the business faces bankruptcy, this would affect the value of the assets on its balance sheet. There may also be other liabilities that need to be accounted for, such as redundancy payments.

Accruals concept:

This concept is about the matching of revenue and expenses with the period in which they were earned or incurred.

Realisation concept:

Only profits realised at the period end should be included as income. Uncertain income should not be included.

Prudence concept:

Accounts must be prepared with a degree of caution so as not to over value the company's assets. Prudence is especially required in areas of uncertainty about the value of assets, liabilities, gains or losses.

Objectives and constraints in the selection of accounting policies:

"Business entities should use those policies that are the most appropriate to their particular circumstances for the purpose of giving a true and fair view. These policies are determined against the objectives of relevance, reliability, comparability and understandability."

Relevance:

Financial information is only relevant if it has ability to influence the economic decisions of users. The choice of accounting policy should be most relevant to the business. For example, deciding whether to use the straight line method or reducing balance method of asset depreciation.

Reliability:

Financial information is reliable if it can be depended upon by its users to represent somewhat faithfully, what it is supposed to represent.

Comparability:

Information about an entity's financial statements gains more credibility when figures can be compared more readily with other similar organisations. This is achieved through a consistent approach and disclosure of financial information.

Understandability:

Information in financial statements needs to be understood by a variety of users of that information. The figures should have been calculated correctly and conform to basic principles of arriving at profit that are seen as true and fair.

Other concepts:

Substance over form:

A transaction should be accounted for with the view of representing its economic substance, not simply its legal form. Hire-purchase fixed assets, for example, should have their value recorded in the balance sheet even though there is no legal ownership until the last payment has been made to the hire-purchase company.

Materiality concept:

This is the view that small, insignificant items may be excluded from the normal accounting policy. The size of the business will dictate what is materially relevant. For example, a fixed asset under £500 is insignificant to a large organisation, so it could be treated as an expense item and written off in the same year, rather than being depreciated over a number of years.

SSAP 5: Accounting for Value Added Tax

We have covered VAT in previous chapters, so the key point to take from this accounting standard is:

Businesses that are registered with HMRC should exclude VAT on all taxable inputs and taxable outputs. In other words, sales, purchases, taxable expenses and fixed assets are recorded net (excluding VAT). The VAT charges are to be recorded in a separate VAT account. At the end of the

financial period, any VAT owing would be listed as a current liability (a credit balance), or a current asset (a debit balance) in the balance sheet.

With expenditure that is not VAT deductible or for expenses the VAT office will not allow recovery, the full amount will appear in the profit and loss account and balance sheet. The same applies for non-registered businesses which are exempt from VAT.

SSAP 13: Accounting for research and development:

The question is can research and development costs be classified as revenue expenditure or capital expenditure. Remember: revenue expenditure relates to expenses charged to the profit and loss account. Capital expenditure is a charge to the fixed assets in the balance sheet (to be written off in future accounting periods to the profit and loss account).

Research is seen as revenue expenditure to be written off in the profit and loss account in the period it was incurred.

Development relates to improving products from the research stage. If future benefits are to be gained, then some development costs can be capitalised and spread over a number of periods.

FRS 15: Accounting for depreciation

The standard defines depreciation as:

“Depreciation is the measure of the wearing out of a fixed asset through use, time, or obsolescence and that charges of depreciation should be spread fairly over the fixed asset’s life. It is the measure of the cost of the economic benefits of the fixed asset that have been consumed during that period.”

This basically says if the benefit gained from using a fixed asset is greater at the beginning of its life, the depreciation charge should reflect this (using the reducing balance method, for example). If the benefit gained is spread across the asset’s useful life, the straight line method would be more appropriate.



End of Chapter 32 Test Questions:

Past Paper Question:

1. Explain the importance of Financial Reporting Standards. [10]
2. Present value takes into consideration the future estimated returns. Explain what this actually means.
3. FRS 18 is seen to be of fundamental importance to the accounting profession. Why is this the case?
4. An historic cost basis is traditionally used in preparing final accounts. In times of inflation, it has been said that these final accounts may mislead users of financial information.
 - a) Explain the alternative approaches in the preparation of inflation-adjusted accounts.
 - b) The likely effect on the measurement of profits and fixed assets when these alternatives are adopted.
 - c) What may be considered as capital expenditure in SSAP 13?
5. In FRS 15 the term 'impairment' arises.
 - a) What does this imply as far as depreciation is concerned?
 - b) If an asset is to be re-valued what effect has this on the rate of depreciation?
6. Why is it important when preparing financial statements, to comply with accounting standards set by the Accounting Standards Board?

Chapter 33: Accounting for Stocks



Introduction

The purchase of stock is of great importance to many organisations, particularly in manufacturing. If a business over-spent on stock, it could tie up too much of its working capital on materials, which in a serious case could cause the collapse of the company.

Running out of stock when sales of your product are high can also be costly in terms of lost sales and reputation.

Being in control of stock means proper planning and proper documentation.

Purchase requisition	An internal request for stock items from the storekeeper or production manager to those responsible for ordering materials.
Purchase order	The buyer will make out the order to send to the appropriate supplier, considering: price, delivery dates and reliability of supplier.
Progress of deliveries	It is the responsibility of the buyer to ensure orders are chased up and arrive on time.
Delivery of materials	The delivery note is the document that accompanies the goods on arrival and is signed by the person receiving the goods as proof of delivery.
Goods received note	The document made once the goods have been checked in, inspected and signed for. A copy is sent to buying office to check against incoming invoice.
Issues to store	Materials issued from stores to production as and when required, the stores issue voucher is an authorisation to release stocks and record of usage.
Stock bin card	Details of goods received and issued for each stock item. Kept with physical stock and helps to control stock movements.

Stock Control Levels:

Each bin card should indicate the following levels of control:

- a) The minimum stock level
- b) The maximum stock level
- c) The re-order level

A business needs to estimate, for each stock item, the average usage and the anticipated delivery time (lead time), so that as stock levels fall to the re-order level, an order can then be placed to replenish the stock item.

Continuous Stocktaking

This is a system whereby a certain proportion of stock items are checked each day. Over the course of a year, all items are checked at least once.

Methods of Stock Taking:**ABC Inventory**

This system attempts to put the emphasis on the most significant items in stock, in terms of relative annual cost. Often, about 20% of stock items account for about 80% of stock purchasing – so it makes sense to focus the checks on the 20%.

Periodic Stocktaking

This is usually required on an annual basis, at the end of the accounting period, so the stock end figure can be used in final accounts. This can be a big task and can interrupt production times.

Perpetual Inventory

This stock recording system is where the balance is shown on the record for a stock item after every movement, either receipt or issue. The balances on the stock record cards represent the stock on hand and can be used for preparing the periodic accounts.

SSAP No. 9 (Stocks and Work-in-Progress):

This states that stock should be valued at its cost or, if lower than cost, at its net realisable value (i.e. its expected selling price).

Costing direct materials:

Stocks of materials are normally held in stores and issued to production as and when required. When costly parts (such as car engines) are valued, the cost price of each is clearly known and used for stock valuation purposes.

However, for low value stock items purchased frequently in large quantities (such as nuts, bolts, brackets etc) it may not be possible or desirable to itemise the value of each item – particularly when costs vary over time.

To cost these types of products, there are three distinct methods of valuation:

- FIFO – First-in, first-out (stock in first is the first stock out)
- LIFO – Last-in, first-out (stock in last is the first stock out)
- AVCO – Average cost of stock (takes the weighted average of units in stock)

Example:

Stock received: 300 @ £1 = £300 January

200 @ £1.20 = £240 March

Stock issued: 400 between January to March

Using the three methods of stock valuation, what is the value of stock still in hand for each method?

FIFO = 100 x £1.20 = £120

LIFO = 100 x £1.00 = £100

AVCO 100 x £1.08 = £108 (£540/500 = £1.08)

So for valuation purposes the FIFO method values stock the highest (when prices rise) and LIFO the lowest. Most organisations tend to use either the FIFO or AVCO. LIFO is rarely used because in times of rising prices it values stock the lowest and so under-states profit.



End of Chapter 33 Test Questions:

1. Make a list of all the significant documents used in the acquisition of materials.
2. Why is it important to have a system of stock control in a large manufacturing organisation?
3. You are given the following information regarding material stock code Q242:
 - The average demand for the material is 400 kilos per week, 50 weeks of the year.
 - The cost of ordering is £150 per order
 - Q242 costs £6.00 per kilo and carrying costs (holding costs) are 33 1/3% of this figure for each kilo held.
 - The maximum usage in any one week is 600 kilos, the minimum 400 kilos

On average, the orders take between 1 and 3 weeks to be delivered. Note that these figures are based on weeks rather than days of use.

Required:

- a) The optimum order quantity to be placed
 - b) The re-order level
 - c) The minimum stock level
 - d) The maximum stock level
4. Write short notes which will clearly differentiate between:
 - Continuous stocktaking
 - Periodic stocktaking
 - Perpetual stock level
 5. Calculate the normal stock control levels from the following information:

Economic order quantity	12,000 kilos
Lead time	10 – 14 working days
Average usage	600 kilos per day
Minimum usage	400 kilos per day
Maximum usage	800 kilos per day

Chapter 34: Accounting for Incomplete Records



Introduction

Many small businesses do not keep a full set of adequate accounting records. Sole traders, in particular, keep only partial records. It is the role of the accountant to use the financial information that is available (invoices, till rolls, bank statements etc.) to prepare a set of accounts.

The procedure:

Establish the owner's capital (net worth) at the beginning of the financial year by listing assets against liabilities.

Prepare a bank/cash summary (simplified cash book) identifying receipts and payments of money in and out of the business.

Establish sales and purchases for the year using invoices, credit notes etc. Possibly reconstruct debtors' and creditors' accounts.

Extract a trial balance and prepare an extended trial balance (if required).

Prepare the profit and loss account, (including items for adjustments) and a balance sheet.



Example: The valuation of stock, following loss through theft or fire:

During the night, the premises of Match Ltd were damaged by fire. It destroyed a quantity of stock and all the stock records. The destroyed stock was covered by insurance and so the company needs to work out how much to claim for. The following information is available:

	(On 1 January)	(On 17 June)
	£000	£000
Stock at cost	132	
Trade creditors	45	53
Trade debtors	39	47

The following transaction took place between 1 January and 17 June

	£000
Cash purchases	17
Payments to creditors	274
Cash received from debtors	314
Cash sales	80
Discounts received	10
Discounts allowed	8

A physical stock take carried out first thing in the morning on 18 June showed the remaining stock to have a cost of £91,000. Match Ltd earns a gross profit of 30% of selling price on all of its sales.

Required: Calculate the cost of the stock destroyed by the fire.

Solution:

Match: Finding sales and purchases

Debtors account

1/1 Balance	39,000	17/6 Bank	314,000
17/6 Sales	330,000	Discount	8,000
		Balance	<u>47,000</u>
	<u>369,000</u>		<u>369,000</u>
Balance b/d	47,000		

Creditors account

17/6 Bank	274,000	1/1 Balance	45,000
Discount	10,000	Purchases	292,000
Balance	<u>53,000</u>		
	<u>337,000</u>		<u>337,000</u>
		Balance b/d	53,000

Trading account as on 17 June

	£	£	£
Sales:			
Credit		330,000	
Cash		<u>80,000</u>	410,000
Cost of sales:			
Stock		132,000	
Purchases:			
Credit	292,000		
Cash	17,000	<u>309,000</u>	
		441,000	
Stock undamaged		<u>(91,000)</u>	
		350,000	
Stock loss		<u>(63,000)</u>	<u>287,000</u>
Gross profit			<u>123,000</u>



End of Chapter 34 Test Questions:

Past Paper Question:

1. The following are the records of a business which has not kept a full set of accounts:

Assets and liabilities	£	£
	01 09 09	30 08 10
Fixed assets (book value)	80,000	?
Debtors (accounts receivable)	17,000	22,000
Creditors (accounts payable)	8,000	9,000
Stock (inventory)	33,000	36,000
Wages owing	1,800	2,300
Prepaid insurance	800	1,200
Balance at bank	5,000	?

Summary of the bank transactions in the year:

	Payments	Receipts
	£	£
Purchase of new fixed assets	20,000	
Wages	69,000	
Insurance	19,000	
Rent and rates	18,000	
Communication exps.	15,000	
Payments to suppliers	152,000	
Misc. expenses	16,000	
Drawings	24,000	
Receipts from debtors		324,000

It has been decided to depreciate fixed assets by 20%.

Required:

- Calculate the opening capital. [2]
- Calculate the bank balance as at 30 August 2010. [3]
- Calculate the total amount of sales for the year. [2]
- Calculate the total amount of purchases for the year. [2]
- Prepare the profit and loss account (income statement) for the year ended 30 August 2010. [6]
- Prepare the balance sheet (position statement) as at 30 August 2010. [5]

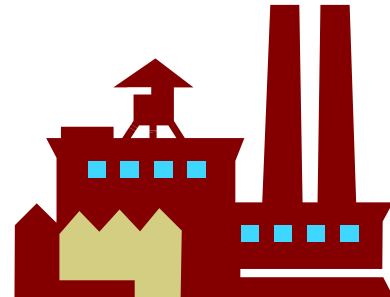
Chapter 35: Manufacturing Accounts



Introduction

A manufacturing organisation which makes its own products wants to know, among other things, how much it costs to produce its goods and how these costs are divided in terms of costs directly or indirectly related to production.

It needs to know this to set the correct selling price. The selling price is determined by adding a sum to the total cost, a **margin** considered to be what the market will pay.



A manufacturing account is a way to calculate the cost of production i.e. the factory cost as distinct from other costs in the profit and loss.

Direct Costs:

Costs directly involved in making the product.

1. Direct labour – factory wages of those workers actively involved in production
2. Direct materials – raw materials specifically used to make the product
3. Direct expenses – fewer of these because most tend to be indirect overheads. Direct expenses include direct power, leasing of specialist equipment or payment of royalties for patents used in production.

The total of **direct costs** = the **PRIME COST**

Indirect Costs:

These refer to the factory overheads.

1. Indirect labour – This relates to the factory employees but excludes direct wages. Factory store men, cleaners and engineers are examples.
2. Indirect materials – these may relate to lubricants, stationery, safety material, but excludes direct materials.
3. Indirect expenses – relate to factory rates, insurance, light and heat, power, rent, depreciation of factory equipment.

The total of **indirect costs** = the **FACTORY OVERHEAD COST**

Now we will work through an example, taking raw data and creating a manufacturing account and finally a profit and loss account:

Figures relating to the accounts of ABC Ltd (T.V manufacturers) for year ended 31 December

	£000s
Stocks of raw materials 1 January	3,186
Stocks of raw materials 31 December	4,479
Stocks of finished goods 1 January	4,264
Stocks of finished goods 31 December	9,651
Purchase of raw materials	23,766
Sales of finished goods net	79,695
Rent and rates	3,292
Manufacturing wages	23,463
Manufacturing power	765
Manufacturing heat and light	237
Manufacturing expenses and maintenance	819
Salaries and wages	13,870
Advertising	2,217
Office expenses	786
Depreciation of plant and machinery	745
Hiring of plant	504
One half of salaries and wages and three-quarters of the rent and rates are to be treated as a manufacturing charge.	
Work-in-progress (1 January)	1,156
Work-in-progress (31 December)	£1,066



Required: Manufacturing and profit loss accounts for the year.

ABC's Manufacturing account year ended 31 December

	£000s	£000s	£000s
Direct costs			
Stocks of raw materials (1/1)	3,186		
Purchases of raw materials	<u>23,766</u>		
	26,952		
Less stocks of raw materials (31/12)	<u>4,479</u>		
	22,473		
Direct wages	23,463		
Direct expenses	<u>504</u>		
			46,440
Indirect Costs			
Indirect wages and salaries		6,935	
Indirect expenses:			
Depreciation: plant		745	
Manufacturing heat and light		237	
Expenses and maintenance		819	
+ power		765	
+ rent		<u>2,469</u>	
			<u>11,970</u>
Add			58,410
Work-in-progress (1/1)			<u>1,156</u>
			59,566
Less			
Work-in-progress (31/12)			<u>1,066</u>
Factory Cost (transferred to profit and loss)			58,500

ABC's profit and loss account year ended 31 December

	£	£
Sales		76,695
- Cost of sales		
Stocks of finished goods (1/1)	4,264	
Factory cost	58,500	
	62,764	
- Stocks of finished goods (31/12)	<u>9,651</u>	<u>53,113</u>
Gross profit		26,582
- Other expenses		
Rent and rates		
Wages and salaries	823	
Advertising	6,935	
Office expenses	2,217	
	<u>786</u>	<u>10,761</u>
Net Profit		15,821

Note: the total cost of output is £58,500 + £10,761 = £69,261

Mark-up and margins of profit:

The '**mark-up**' is usually expressed as a percentage and is added to the cost price of goods in order to arrive at the selling price.

The '**margin**' is always based on the selling price. The margin price is a useful indicator of profit calculated on the value of sales.

There is a distinct relationship between these concepts of profit. For example, a 50% mark-up is always a 33.333% margin.

If a product cost £4 to manufacture and 50% mark up was added, the selling price would = £6. The margin therefore would = 33.333% (2/6). The following mark-up percentages will always equal their respective margin percentages:



Mark Up	Margin
100%	50%
50%	33.333%
33.33%	25%
25%	20%
20%	16.666%



End of Chapter 35 Test Questions:

Past Paper Question:

1. Jallow & Jagne (Manufacturing) Ltd presented a trial balance as at 31 December 2010 as follows:

	£	£
Stock of raw materials (01/01/2010)	14,000	
Finished goods stock (01/01/2010)	45,000	
WIP (01/01/2010)	26,000	
£1 Ordinary share capital		300,000
Profit and loss account balance (01/01/2010)		175,000
Land and buildings at cost	360,000	
Manufacturing equipment at cost	80,000	
Prov. for depreciation of equipment (01/01/2010)		35,000
Debtors/creditors	54,000	32,000
Bad debts written off in the year	2,000	
Bank balance	5,000	
Cash	1,000	
Direct wages	132,000	
Purchase of raw material	182,000	
Production overheads	101,000	
Insurance of buildings (see notes below)		30,000
Indirect factory wages	41,000	
Misc. office overheads	61,000	
Selling expenses	38,000	
Sales		630,000
	-----	-----
	1,172,000	1,172,000
	=====	=====

NOTES at 31 December 2010:

- Stock of raw material was £16,000; WIP was valued at £28,000; and the finished goods stock was valued at £49,000.
- The manufacturing/factory occupies 80% of the building.
- The manufacturing equipment is to be depreciated by 25% on cost.
- The directors propose:
 - i) A provision for taxation of £8,000
 - ii)

An ordinary share dividend of 3 pence per share

Required:

- Prepare the manufacturing account for the year ended 31 December 2010. [10]
- Prepare the profit and loss account for the year ended 31 December 2010. [10]

Chapter 36: Marginal Costing



Introduction

Marginal costing is related to those costs that can be directly traceable to a specific unit. For marginal costing to take place, it is necessary to divide costs into variable and fixed:

Variable costs:

Variable costs are those direct costs traceable to a unit such as direct materials and direct labour which are sensitive to output change. If output goes up, so do variable costs.

Fixed costs

Fixed costs are far less sensitive to output changes and are the indirect costs such as rent, rates, insurance etc. If output increased the factory rent, for example, would not increase.

It is important to make this distinction because the level of activity will have a direct bearing on the amount of profit or loss on a given output of production.

When more units are produced, the fixed cost per unit will decrease, increasing potential profits. If output levels fall, then the fixed costs per unit will increase, reducing the profit level.

The importance of contribution:

Contribution is an easy figure to calculate, but important as it is used in a number of formulae (calculating break-even, for example).

$$\text{Contribution} = \text{selling price} - \text{variable cost}$$

Example: A product is sold for £15 a unit. The variable cost is £10 per unit. Fixed costs are estimated to be £12,000. Calculate the estimated profit on an output of 4,000 units and the break-even point.

$$\begin{array}{rcl} \text{Contribution} & = & \text{selling price} - \text{variable cost} \\ \text{£5} & & \text{£15} \quad \quad \text{£10} \end{array}$$

$$\begin{array}{rcl} \text{Estimated profit} & = & (\text{output} \times \text{contribution}) - \text{fixed costs} \\ & & (4,000 \times \text{£5}) \quad \quad \text{£12,000} \\ & = & \text{£8,000} \end{array}$$

$$\begin{array}{rcl} \text{Break-even point} & = & \frac{\text{fixed costs}}{\text{Contribution per unit}} \\ & = & \frac{\text{£12,000}}{\text{£5}} \\ & = & \text{2,400 units} \end{array}$$



The contribution to sales ratio:

This can be used to estimate profit on a known sales revenue figure. If that year there were £76,800 sales to date, what profit is estimated on this revenue? Assume fixed costs of £25,000.

Profit = Revenue x Contribution/Sale ratio (C/S ration) less fixed costs

$$\text{Contribution/Sales ratio} = \frac{\text{Contribution}}{\text{Sales}} = \frac{5}{15}$$

$$\text{Therefore, contribution on estimated revenue} = £76,800 \times \frac{1}{3} = £25,600$$

$$\text{Less fixed costs} = £25,000$$

$$\text{Estimated profit} = £600$$

A summary of costing formula

$$\text{Contribution} = \text{selling price} - \text{variable cost}$$

$$\text{Profit or Los: } (\text{output} \times \text{contribution/unit}) - \text{Fixed costs}$$

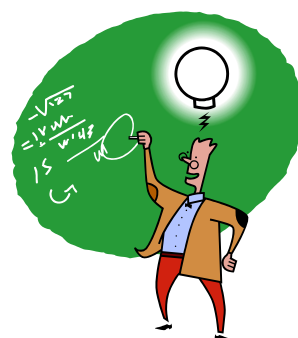
$$\text{Break-even point} = \frac{\text{Fixed costs}}{\text{Contribution/Unit}}$$

$$\% \text{ Margin of safety: } \frac{(\text{Planned output} - \text{Break-even point})}{\text{Planned output}}$$

$$\text{Contribution/Sales Ratio: (C/S)} = \frac{\text{Contribution per unit}}{\text{Sales per unit}}$$

$$\text{Break-even Revenue} = \frac{\text{Fixed costs}}{\text{Contribution/Sales Ratio}}$$

$$\text{Estimated Profit from Sales Value} = (\text{Sales} \times \text{Contribution/Sales Ratio}) - \text{Fixed costs}$$



The break-even point taken from a profit and loss account:

Estimating the break-even point from, say, the monthly forecast of the profit and loss account, can be a useful indicator of the minimum sales required to break-even.

Gross profit must be sufficient to cover all overhead costs – break-even has then been achieved.

For example, if overheads were £25,000, then gross profit would need to be at least the same figure. If the gross per cent margin was known, then the estimated sales to break-even could be calculated by dividing the margin into the overhead expenses.

Example: estimated sales for March

	£
Sales	80,000
Cost of sales	<u>48,000</u>
Gross profit (40%)	32,000
Less	
Operating expenses	<u>25,000</u>
New profit (8.75%)	7,000

Estimate the sales required to break-even:

$$\begin{aligned} &= \frac{\text{Operating expenses}}{\text{Gross margin \%}} \\ &= \frac{25,000}{0.40} \\ &= \textbf{£62,500 sales to break-even} \end{aligned}$$

Note:

The amount of contribution per unit a business makes is essential to profit. The greater the contribution, the greater the potential to make profits.

If a company made two or more products and there was some constraint of some sort in the production or demand for the products, it may have to make a choice on the products that will achieve the greater contribution.

A final note on marginal costing:

The use of marginal costing assists management by providing further information with which to improve decision making, in particular when output levels differ from those planned, or special prices for special orders need to be calculated.

In the real world, however, you must remember that solutions are not always based on figures alone.

You may decide through marginal costing, for example, that one customer's order is more profitable to the business to fulfil. However, the customer that is less profitable may be your most valued customer and the likelihood of additional orders from this customer would mean you may choose the less profitable short-term decision, for the more profitable long-term gain.



End of Chapter 36 Test Questions:

1.

- a) Explain the benefits of including an element of 'payment by results' in a factory wages system. [6]
- b) Virinda Ltd expects to be able to sell 75,000 items of a product at £120 per unit. The cost data is as follows:

	£
Direct material per unit	25
Direct labour per unit	40
Variable cost per unit	30
Fixed costs allocated to the product	950,000
Maximum possible production without incurring extra fixed costs is 105,000 units.	

Required:

- i) Calculate the budgeted profit. [3]
- ii) Calculate the breakeven point in units. [2]

2. You are arranging a 'gig' at a medium-sized live music venue. You have carried out some research, and have established the following cost data:

	£
Cost of hiring the band	800
Cost of hiring the venue	500
Insurance costs	300
Casual wages	400
Cost of leaflets and advertising	400

The maximum possible capacity is 500 customers.

The owners of the venue will sell the tickets for you at a cost of £2 per ticket sold. It is a condition of the agreement that they are the sole agent for ticket sales.

The owners of the venue will run the bar etc., and take any associated profits.

The budgeted number of tickets sold is 400.

Required:

- a) Calculate the cost per ticket (excluding the £2 commission). [3]
- b) Calculate the total cost per ticket. [2]
- c) On the basis that you decide to sell tickets to customers at a price of £15 each:
- i) Calculate the breakeven number of tickets to be sold
 - ii) Calculate the profit if 400 tickets were sold
 - iii) Calculate the profit if 500 tickets were sold
 - iv) Calculate the profit/loss if 300 tickets were sold
 - v) Calculate the profit/loss if 150 tickets were sold [2 each]

Chapter 37: Budgeting



Introduction

The budget is a key financial plan of a business. It attempts to forecast a number of months ahead, in order to make best use of its resources.

In a well-structured organisation the budget is at the centre of the financial control system. The basic purpose of a budget is to control the organisation's expenditure and to plan ahead for the future. Expenditure can be planned, profits estimated and targets set.

Actual results are then compared with the budget and any variances are analysed and acted on.

The main types of budget are:

The personnel budget

Does the business have the right manpower and the financial support to meet recruitment and training needs.

The production budget

Production must be able to meet the demands set by the sales budget. It must be in control of stocks and ensure the necessary materials, labour, machinery, etc. are there to meet sales budgets.

The sales budget

The sales budget must start with the expected level of sales. Sales are the lifeblood of business, so accurate estimation of sales are important.



The operating budget

This represents a forecast of the profit and loss account. It is about planning objectives to ensure a satisfactory return on capital employed.

The cash budget

Otherwise known as cash flow forecast, it is the key budget. It involves all the other budgets in its forecast as it must include all sources of revenue and expenditure.

The administration budget

Considers the overheads of the business and involves costs such as rent, rates, stationery, heating, etc.

The capital expenditure budget

This takes into account capital costs and involves the purchase of fixed assets like equipment and premises. The budget needs to plan for their replacement or expansion purposes.

If a budget needs adjustment because circumstances have changed, then forecasts need to be amended to reflect changes. In this way, a budget becomes a very significant management tool to help them make better decisions and improve forward planning.

Example: The cash budget

A new company has gathered the following information for six months from 1 January to 30 June.

- Sales (in units) £40 per unit:
 - Jan 200; Feb 300; Mar 200; Apr 400; May 300; June 400 (units)
- Production is 300 units per month for the whole 6 months
- Fixed overhead costs will be £3,000 per month, payable in the month after production.
- Variable overhead costs will be £15 per unit payable in the month of production.
- Direct wages will be £5 per unit payable in the month of production.
- Equipment costing £10,000 will be purchased in February and paid for in March. Once installed, it will allow production to increase to 500 units per month.
- Materials will cost £8 per unit and suppliers will be paid in the month following purchases.
- All sales of units are on credit. Debtors are expected to pay in the month following their purchases.
- Cash at bank on 1 January = £10,000

Required:

A separate schedule of payments and a cash budget for the six month period, January to June.

Solution:

	Schedule of payments					
	Jan	Feb	Mar	Apr	May	June
	£	£	£	£	£	£
Fixed assets		3,000	3,000	3,000	3,000	3,000
Var. overheads (300 x 15)	4,500	4,500	4,500	4,500	4,500	4,500
Direct wages (300 x £5)	1,500	1,500	1,500	1,500	1,500	1,500
Equipment			10,000			
Materials (300 x £8)		2,400	2,400	2,400	2,400	2,400
	<u>6,000</u>	<u>11,400</u>	<u>21,400</u>	<u>11,400</u>	<u>11,400</u>	<u>11,400</u>

	Cash Budget					
	Jan	Feb	Mar	Apr	May	June
	£	£	£	£	£	£
Bank balance b/f	10,000	4,000	600	(8,800)	(12,200)	(7,600)
+ receipts*	-	8,000	12,000	8,000	16,000	12,000
	<u>10,000</u>	<u>12,000</u>	<u>12,600</u>	<u>(8,000)</u>	<u>3,800</u>	<u>4,400</u>
- payments	<u>6,000</u>	<u>11,400</u>	<u>21,400</u>	<u>11,400</u>	<u>11,400</u>	<u>11,400</u>
Bank balance c/f	<u>4,000</u>	<u>600</u>	<u>(8,800)</u>	<u>(12,200)</u>	<u>(7,600)</u>	<u>(7,000)</u>

* Receipts calculated at £40 unit sales, allowing one month credit.

Analysis:

It is important for the exams to be able to analyse the cash budget you will be asked to prepare. As you can see in this example, the company does have sufficient cash resources to finance the above plan. It would have to either lease the equipment or raise more capital in March. Without this cash budget, this company may not have been prepared for a deficit in cash like this.



End of Chapter 37 Test Questions:

1. Justine is to open a gift shop in a large tourist venue. On 1 April 2011 Justine will deposit £90,000 in a business bank account. Her plans are as follows:
 - On 1 April to pay rent of £24,000.
 - On 1 April to buy equipment etc. costing £90,000. Half of the £90,000 is to be paid in April, and there will be two further payments (£22,500 each) in May & June.
 - Goods for resale will be purchased according to the following schedule:

April and May	£7,000
June and July	£9,000
August and September	£10,000
 - Suppliers will give one month's credit.
 - Sales are expected to be £16,000 in each of the first three months, and will rise to £21,000 a month in July. All sales are on a cash basis.
 - Monthly wages of £2,200 are payable in each month.
 - Justine will take £1,000 per month in drawings.
 - Justine will spend £1,000 per month on marketing. Half of the £1,000 is payable in the same month, and the other half is payable in the following month.
 - Other expenses of £2,900 per month are expected – payable in the same month.
 - Justine will depreciate the equipment at 25% pa on cost.

Required:

- a) Prepare a cash budget for the period 1 April to 30 September 2011. [10]
 - b) Comment on the potential performance of the business. [5]
 - c) Explain the benefits of cash budgeting. [5]
-
2. Explain the importance of budgetary control. [10]

Chapter 38: Capital Investment Appraisal



Introduction

Often management needs to make financial decisions about investment proposals or opportunities. Capital investment appraisal is a way of ensuring a business invests its money in the best long-term capital projects.

There are three major methods of capital investment appraisal:

Discounted Cash Flow

This is about looking at the future earnings of an investment and seeing those values in terms of what they are worth today against the interest that could have been earned doing nothing. There is no point investing resources for a project that returns less than simply holding the money in a bank account and receiving interest.

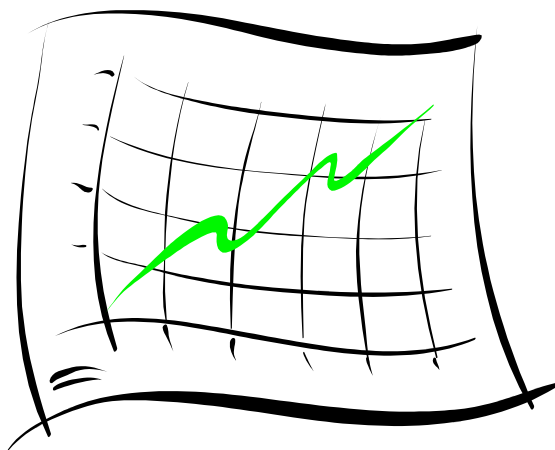
The **Net Present Value (NPV)** converts the future cash flow into present values after deducting the original investment from the total. The project which reveals the most favourable net cash flow at present values would be seen as the most profitable.



The Pay-Back Method

This method approaches capital appraisal with the question, how long will it take to pay back the original cash sum invested. Cash flow refers to the actual movement of cash. Cash flow in is the cash received, the cash flow out is the cash paid. Net cash flow is the difference between these two flows.

When using this method of capital appraisal, the project with the fastest pay-back time in terms of net cash flow will be taken as the best.



The Return on Investment Method

The ROI is the average profit for the project expressed as a percentage of the capital invested. This method is also referred to as the 'accounting rate of return' (ARR).

$$\text{ROI} = \frac{\text{Average profit} \times 100}{\text{Average investment}}$$

We will now look at a couple of examples:

Example: The Pay-back method:

A business has £70,000 to invest and the estimated net cash returns (NCR) from each project over a given time of six years are as follows:

Year	Project A £	Project B £	Project C £
1	25,000	16,000	15,000
2	23,000	18,000	17,000
3	18,000	18,000	17,000
4	14,000	16,000	16,000
5	10,000	16,000	15,000
6	8,000	12,000	10,000
Total returns:	98,000	96,000	90,000

Which of these projects pays back its original £70,000 the fastest?

Project A = 3 years 4.8 months - (25,000+23,000+18,000+4/10,000 of 1 year)

Project B = 4 years 1.5 months - (16,000+18,000+18,000+16,000+2/16,000 of 1 year)

Project C = 4 years 4 months - (15,000+17,000+17,000+16,000+5/15 of 1 year)

Example: ROI

From the above figures, and taking into account depreciation of 50% for each of the three projects, calculate the average ROI.

	Project A £	Project B £	Project C £
Total returns: (over 6 years)	98,000	96,000	90,000
Less 50% depreciation	49,000	48,000	45,000
Net profit	8,167	8,000	7,500
Average profit: (divide by 6 years)	11.67%	11.43%	10.71%

ROI is calculated for Project A as: $\frac{\text{Average profit} \times 100}{\text{Average investment}}$

$$= \frac{8,167 \times 100}{70,000}$$

$$= 11.67\%$$

Alternatively the average investment could take into account its residual value (if any) at the end of the appraisal period.



End of Chapter 38 Test Questions:

1. Vijay Ltd is considering investing in a project which has the following cash flows:

	£000
Initial investment	2,900
Cash flows:	
Year 1	900
Year 2	1,000
Year 3	1,100
Year 4	600
Year 5	200

The cost of capital is 8%

Extracts from NPV (DCF) tables:

Rate of discount	8%	9%	10%
Year 0	1.000	1.000	1.000
Year 1	.926	.917	.909
Year 2	.857	.842	.826
Year 3	.794	.772	.751
Year 4	.735	.708	.683
Year 5	.681	.650	.621
Year 6	.630	.596	.564

Required:

- Calculate the payback period (in years and months). [2]
- Calculate the ARR (accounting rate of return). [2]
- Calculate the NPV (net present value). [4]
- Explain briefly if you think that the project is viable. [4]
- Explain the benefits of using investment appraisal techniques in the allocation of large capital sums. [8]

Chapter 39: Exams and Examination



Introduction

The most important thing is to be prepared. That means learning the material in depth and most importantly going through past exam papers.

Thoughts on Revision:

Make a list of all the major topic areas of the examination. Revise each topic carefully and ensure you understand its basic underlying principles.

You will need to organise and manage your time carefully, to ensure you are fully prepared for the exams you wish to take.

If you are attempting a number of exam papers, try to organise certain days of the week so that you spend an adequate time on each subject.

Ensure you have sufficient exam questions to practise on and always try to obtain the recommended answers so that you can check your progress.



Wherever possible, nearer the exam time, try to set up your own 'mock exam' at a week-end and attempt to do four or five different questions within the time limits. Many examinations are of a 3-hour duration, so set yourself the requisite number of questions and a time to complete them. It is of essential importance to know how long you have to complete each question.

The exam:

- Always arrive to the exam in plenty of time
- Relax and have confidence that you know the material
- Read the paper briefly before starting any questions (ensuring you select the best ones)
- Attempt the easier question first to get your pen flowing and your confidence up
- Write quickly, but ensure your handwriting is neat and legible
- Use a ruler to draw lines rather than do it freehand. Major totals should always be underscored. It improves presentation and makes your work look more organised.
- If you have any time left at the end, always go over the questions again, checking for any obvious errors.
- Ensure that you have your name and candidate number on the examination booklet and also on any extra pages that you may have used.

Preparation is key. Put the work in and it WILL pay off in the exams. Revise in advance and make sure that last evening is free for you to relax. It can only help you to achieve great success. Good luck.