

INSTITUTE OF RISK MANAGEMENT

**Business Finance
for Risk Management**

by

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Section One Financial Accounts

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Author Profile

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Preface

Business Finance for Risk Management is intended to cover the broad areas of financial and management accounting. For this reason, the text considers the basic elements of book-keeping in order to give the reader an understanding of the principles underlying the accounting process. Later chapters incorporate such topics as the structuring of the accounts of the sole trader, the partnership and corporations. This is complemented by the management aspects of accounting wherein the reader is introduced to an analytical framework for the interpretation of accounts and the principles of budgeting, pricing and investment appraisal.

Readers must be clear in their minds that it is not possible in a book of this length to consider all the aspects of these subjects in detail and hence in some areas it is only possible to give a surface discussion. Nevertheless, this provides a base from which a 'fine-tuning' may take place; wider, more specific reading is essential if learning is to be effective.

Throughout the text, a number of examples have been provided, examples which set out to clarify some of the points that have been discussed. What is important is that readers must be able to show that they understand the underlying principles and the method and be able to prove that they can put both into practice with speed and efficiency.

There is no short-cut to success and for this reason the principle texts that are suggested as supportive include some that are methodological in their nature.

Practice produces proficiency!

Finally, there remains the pleasant task of acknowledging the generous help of colleagues and friends particularly Rodd Strutt for his critical comments and suggestions on various chapters.

Bill Hastings
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Section One
Financial Accounts

Chapter One

AN INTRODUCTION TO FINANCIAL ACCOUNTING

1.1 The Theoretical Framework

Let us first examine a number of definitions of Accounting. These, of course, are not exclusive of others and the reader is commended to seek his own. These definitions will provide a framework from which we can examine the nature of financial accounting.

"The central purpose of financial accounting is to make possible the periodic matching of costs (efforts) and revenues (accomplishments)."

"Accounting is the art of recording, classifying and summarising ... in terms of money ... events ... of a financial character."

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

Whatever the definition, implicit in them all is the exchange of value and the provision of information.

1.1.1 Information

In today's fast moving business climate, managers at all levels require information. Such information is needed, amongst other things, for planning and decision making. Whatever the nature of the business, whatever the environment within which it operates, the business' effectiveness can be frequently assessed by the quality of its information base. This is an aspect which we will deal with in more detail later.

1.1.2 Exchange of Value

The recording of business transactions has existed for a long time. Evidence is to be found in the crumbling clay tablets of the Pharaohs. Later, recordings were made on papyrus, the Greek word upon which our word "paper" is based. Many years later, the Romans recorded the written word on parchment vellum and in South East Asia, the Buddhist Monks engraved the daily accounts of the revenues and expenses of their monasteries.

The modern terminology for this systematic recording of transactions is called Book-keeping. In its correct form, it is known as Double-Entry, a process which has been generally attributed to 15th century Italians.

Book-keeping, which may be defined as the science of correctly recording business transactions that result in the transfer of cash or money's worth in the books of account is clearly a concept that is not new, and the principles of handling such a process in a small business are no different from those applied in the multi-national conglomerate. Indeed, in the light of modern hardware and software developments, sophisticated techniques are now available to the small businessman, thereby assisting

him to make effective decisions. Despite this, many accounting systems in the older more traditional business often remain cumbersome and unwieldy. Certainly, specialisation, decentralisation and internationalisation of many businesses have led to the mechanisation of accounting systems and today, the main-frame computer, the mini-computer and the micro have meant that the needs of the book-keeper and the accountant are more easily met. Indeed the latest equipment is no longer out of the reach and the purse of the small businessman.

It is clear that book-keeping, as a means of recording business transactions in terms of a monetary unit, is well practiced. Flexibility is a key to its success. Rigidity in any system is likely to be a recipe for failure but nevertheless it must be subject to certain fundamental principles, principles to which this text will soon turn.

Clearly, the volume of information which is required by a business depends much upon its size and its needs but one feature which must be closely watched is that of the benefits accruing to an organisation from system implementation. Costs must not be excessive in relation to the information obtained. Whatever the organisation, whatever the function, the clarity of the painting can only be observed if the artist applies the brush with some precision. If monetary movements are committed to paper then at any moment in time a businessman should be able to assess the value of that which he owes and the things that he owns.

The main purpose of being in business is to make a profit and it is essential that accounting systems are designed to ensure that this figure is easily determined. In addition, it is important to see how final profitability is established, in other words, evidence must be given concerning the component parts of profit and their cumulative effect upon an Organisation.

Records are important not only to the owners of a business but to others who may well have vested interests. Creditors should be happy with the risk they are taking; bankers with theirs. The Inland Revenue will base their evaluation of tax liabilities on the accounts and prospective purchasers of a business will require justification of the price that is being asked. In the instance of Limited Companies, records must be kept in accordance with statutory requirements. Other types of Organisations will do so to protect their internal interests (for example Partnerships and their partners, Social Clubs and their members). What is clear is that even though there may be no legal requirement, the prudent businessman will be well advised to maintain an adequate book-keeping system.

1.2 Personality and Status

Let us briefly examine the nature of legal personality. The law recognises 'personality' as moving beyond the behavioural considerations which most of us appreciate. The nature of these personalities will be more thoroughly examined elsewhere and for this reason only passing comment will be made here.

1.2.1 Incorporated Associations

Corporations take a variety of forms but, once established, acquire a 'personality' that is separate from those who have collectively formed it. Thus one would reasonably expect the law to recognise that the few (for example, the Board of Directors) who represent the many (say the Shareholders) will have a special responsibility. This is in fact the case. Statutory corporations derive their entire existence from some statutory authority which clearly delineates (or at least ought to) their terms of reference, their powers and the extent of their authority. There are a number of important statutes, particularly The Companies' Act 1985, which we will have to consider. At this stage, suffice it to say that record-keeping for these Organisations which fall within such statutory remits is, to a certain extent, predetermined.

1.2.2 Unincorporated Associations

These do not boast a legal personality of their own. They extend to include The Sole Trader, Partnerships, Trade Unions, Clubs and Societies and other similar Organisations which although not having the same legal obligations as their Corporate counterparts nevertheless have moral obligations to their members.

The importance of these aspects will become clear later, for though the basic book-keeping principles are much the same, the treatment of the financial accounts as between them is subject to some variation. Specifically, we will first consider financial accounting within the framework of the Sole Trader and later move to Partnerships and the accounts of Corporations. In the meantime, however, let us consider the nature of the accounting profession.

1.3 The Accounting Profession

The nature of business is such that the management of the accounting process is divided into two broad divisions. The reader should clearly differentiate between the financial accountant and the management accountant.

1.3.1 The Financial Accountant

Let us, for a moment, examine the book keeper. He is the person who makes the various entries to the 'note books' of the business as each business event occurs. These 'subsidiary' books are the base from which the ledger is created. This latter document is in fact the permanent record of the Organisation and it, in turn, serves as the basis for *structuring* the final accounts.

As will be seen, the final preparation of such final business accounts as the Manufacturing, Trading and Profit & Loss and Appropriation accounts, and the Balance Sheet depends upon these subsidiary books being accurately completed. The nature of these books vary from one Organisation to another, each choosing what it needs. The main types are:

- (a) Sales Book : Contains details of the credit sales of the business
- (b) Purchases Book : Contains details of the credit purchases of the business
- (c) Sales Returns : Contains details of goods that have been returned by customers to the business
- (d) Purchases Returns : Here, details of goods returned by the business to suppliers are recorded
- (e) Journal : A general purposes book in which each transaction is entered, with statements as to the accounts to which it is to be entered.
- (f) Cash Book : Contains details of cash transactions

In general it is the role of the book-keeper to keep these books.....but always under the watchful eye of the Accountant whose responsibilities may be summarised as:

- (a) The maintenance of adequate records
- (b) The maintenance of the daily business transactions
- (c) The maintenance of the accounts
- (d) The preparation of the final accounts
- (e) The necessary handling of money
- (f) Authorisation of necessary information
- (g) The provision of necessary information to assist management in their decision making
- (h) The maintenance of records according to statutory requirements

1.3.2 The Management Accountant

The management accountant is less concerned with the physical completion of the documents that aid formation of the final accounts of an Organisation than with such matters as:

- (a) Implementing the necessary controls to assist efficiency and prevent fraud
- (b) Providing the back-up for profit planning and budgetary planning.
- (c) The determination of marginal costs.

This dichotomy into Financial Accounting and Management Accounting serves to illustrate the manner of approach that this text will take. First, we will deal with the principles of financial accounting and then turn to a number of aspects which typify the role of the management accountant.

1.4 The Balance Sheet

Earlier in this chapter reference was made to the ledger as the basis of the final accounts and the balance sheet as one document that was derived from them. Let us then start with the end product namely the Balance Sheet. It has to be emphasised that this document is NOT an account, it

is but a financial snapshot at a point in time. It exhibits the financial health of the Organisation it represents and is one method available to the accountant by which significant facts about an Organisation are represented. Clearly, in understanding a balance sheet, the reader will be better able to see the financial position of a business and to assess the effect alterations will have.

One useful framework in which to introduce the idea of a balance sheet is to ask the reader to assume the role of a rich benefactor who meets a penniless pauper. Bearing in mind that the accountant measures wealth in financial terms then the pauper must be perceived as having none. The pauper is hungry and he seeks help. The 'kindly' benefactor provides the funds but his magnanimity is clouded by his demands that the money is later returned to him.

One effect is that the pauper has gained an asset. In addition to having gained an asset, the pauper has also gained a liability. He owes money to the rich benefactor. Let us differentiate between these two terms. In business terms, an asset may be more appropriately defined as the property or possessions belonging to the Organisation, including money owed to them by customers (in other words, debtors). These assets of a business are used to generate income. On the other hand the liabilities of a business comprise the obligations and debts owing for the goods supplied, or the services rendered.

It will be noticed that what the pauper owns and what he owes are financially the same. If we were to place these on either side of a set of scales they would be in equilibrium. This idea of equilibrium in the balance is important. What is owed by an Organisation must equate to what is owned. Try it for yourself. Equate what you own against what you owe. For example, you may, today, start by owning

	£
(a) A house (cost)	50,000
(b) Furniture (cost)	10,000
(c) A Car (cost)	4,000
(d) Cash	6,000
	70,000

and owing:	£
(a) Building Society	20,000
(b) The Furniture Firm	1,000
(c) Bank Loan	2,000
	23,000

Yet this does not balance. You own £70,000 but only owe £23,000. Why? the answer lies in the fact that the balance sheet will also show what you "owe" to yourself; namely £30,000 of the house, £9,000 of the furniture, £2,000 of the car and all of the cash. In other words, £47,000 is owed to yourself and £23,000 to others. This indebtedness to yourself is termed

Capital. From a business point of view it represents what has been invested in the business by the owner. Be sure to be clear in your mind that Capital is a liability, the money itself is, of course, an asset.

This is a most important feature and it must be seen that the business and the owners are considered to be separate entities.

In balance sheet format then this information would be as follows:

Balance Sheet, Myself as at -1-1-

	£		£
Capital	47,000	House	50,000
		Car	4,000
Building Society	20,000	Furniture	10,000
Bank Loan	2,000	Cash	6,000
Furniture Firm	<u>1,000</u>		
	<u>70,000</u>		<u>70,000</u>

Fig. 1.1.

Note the format. In this 'traditional' style of presentation the assets are shown on the right hand side and the liabilities on the left. That this is the case is simply tradition (a more modern approach will be considered later). Indeed, in the United States the habit is the reverse. Whatever the case, it does serve to show the nature of the equilibrium.

1.4.1 The Effects of Change

Let us now examine what happens if changes in circumstances take place. Let us assume the following transactions at the end of each day:

- Day 1: Transfer to Building Society £5,000
- Day 2: Sale of Car for £4000. Money to be paid Day 4.
- Day 3: Buy a boat for £2000. Pay on Day 5.
- Day 4: Car money is received
- Day 5: Pay for the boat.

Consider the effect upon the balance sheet outlined in Figure 1.1. In Day 1 the cash is reduced by £5,000 and the building society is increased by the same amount. Here an asset is reduced and another one is increased. Thus the balance sheet at the end of Day 1, would be as follows:

Balance Sheet, Myself as at Day 1

	£		£
Capital	47,000	House	50,000
		Car	4,000
Building Society	20,000	Furniture	10,000
Bank Loan	2,000	Cash	1,000
Furniture Firm	<u>1,000</u>	Building Society	<u>5,000</u>
	<u>70,000</u>		<u>70,000</u>

On Day 2 the car item is reduced by £4,000 and another asset (a debtor) is increased ... also by £4,000. Here is the balance sheet at the end of that day:

Balance Sheet, Myself as at Day 2

	£		£
Capital	47,000	House	50,000
		Debtor	4,000
Building Society	20,000	Furniture	10,000
Bank Loan	2,000	Cash	1,000
Furniture Firm	<u>1,000</u>	Building Society	<u>5,000</u>
	<u>70,000</u>		<u>70,000</u>

On the third day, a boat was bought thus an asset increases but no money has changed hands. Nevertheless there are two changes; first a new asset at valuation (in this instance its cost) and a new liability (a creditor) in the same amount.

Balance Sheet, Myself as at Day 3

	£		£
Capital	47,000	House	50,000
		Boat	2,000
Creditor	2,000	Debtor	4,000
Building Society	20,000	Furniture	10,000
Bank Loan	2,000	Cash	1,000
Furniture Firm	<u>1,000</u>	Building Society	<u>5,000</u>
	<u>72,000</u>		<u>72,000</u>

It's the fourth day now. The debtor is removed because he pays what is due to you and at the same time your cash increases by an equal amount. This dual effect is recognised in the balance sheet prepared at the end of that day:

Balance Sheet, Myself as at Day 4

	£		£
Capital	47,000	House	50,000
		Boat	2,000
Creditor	2,000	Furniture	10,000
Building Society	20,000	Cash	5,000
Bank Loan	2,000	Building Society	<u>5,000</u>
Furniture Firm	<u>1,000</u>		<u>72,000</u>
	<u>72,000</u>		<u>72,000</u>

On the last day, Day 5, you pay out some cash; the creditor item is no longer there and your cash item falls by the same amount

Balance Sheet, Myself as at Day 5

	£		£
Capital	47,000	House	50,000
		Boat	2,000
Building Society	20,000	Furniture	10,000
Bank Loan	2,000	Cash	3,000
Furniture Firm	<u>1,000</u>	Building Society	<u>5,000</u>
	<u>70,000</u>		<u>70,000</u>

This dual aspect of change in the Balance Sheet is fundamental and the reader must be sure to understand its basic principles.

The following table outlines the range of change possibilities and how they will affect the balance sheet.

Change 1	Change 2
1. Asset increases	Asset decreases
2. Asset decreases	Asset increases
3. Asset increases	Liability increases
4. Asset decreases	Liability decreases
5. Liability increases	Liability decreases
6. Liability decreases	Liability increases
7. Liability increases	Asset increases
8. Liability decreases	Asset decreases

It is important to understand that each change affects the balance sheet in two ways and the balance sheet always maintains equilibrium.

We have already introduced the nature of assets and liabilities. These can be further broken down as follows:

Assets:

The following is essentially a scale of permanency. In other words the first shown represents the least liquid assets. The last shown are more easily converted into cash.

1. Fixed Acquired for continuous use, (for example buildings)
2. Working Fixed in nature but gradually consumed (for example coal in a coal mine)
3. Current Cash and goods acquired for the purposes of sale (that is, assets in various stages of conversion to cash)

It should be noted that even within each asset type there exists a scale of permanency. For example, the fixed asset of land is clearly more permanent than the fixed asset of a motor car; the current asset of stock is more permanent than that of cash.

Liabilities:

These are not so easily broken down but traditionally they fall into:

1. Current That is, those of a short term nature (in other words are less than one year and which are usually met out of current assets)
2. Long Term those that exceed one year.

Yet again, there exists a scale of permanency. For example, a bank overdraft is clearly a short-term method of funding and hence is less permanent than its bank-loan counterpart. This in turn is less permanent than a mortgage.

The reader should clearly differentiate between these liabilities that are endogenous to the Organisation and those that are exogenous. What we have discussed so far are liabilities that lie "outside" the Organisation. The "inside liability we have already discussed and, of course, it takes the form of Capital.

Given this general outline, an interesting feature materialises namely,

$$\text{CAPITAL} + \text{EXTERNAL LIABILITIES} = \text{ASSETS.}$$

In other words, in the knowledge of any two, the third can be deduced.

Finally, the reader must realise that the layout of these elements in the traditional format of a balance sheet should be as follows. It will be seen both between and within the elements of the balance sheet, that the most permanent aspects are shown first with the least, last. This structure within elements remains even when the balance sheet is in a more modern form.

Balance Sheet of "Organisation" as at "Date"

Capital	XXX	Fixed Assets	
		Most Permanent	XXX
			XXX
Liabilities greater than one Year		Least permanent	<u>XXX</u>
Most Permanent	XXX		XXX
	XXX		
Least Permanent	<u>XXX</u>		
		XXX	
		Current Assets	
		Most Permanent	XXX
			XXX
Liabilities less than one Year		Least permanent	<u>XXX</u>
Most Permanent	XXX		XXX
	XXX		
Least Permanent	<u>XXX</u>		
		<u>XXX</u>	
		XXX	<u>XXX</u>

Using the information from the balance sheet of Day 5 (see page 10) we may restructure it in accordance with this format. Thus we have:

Balance Sheet, Myself as at Day 5				
	£	£	£	£
			Fixed Assets	
Capital	47,000		House	50,000
			Boat	2,000
Liabilities greater than one Year			Furniture	<u>10,000</u>
				62,000
Building Society	20,000			
Liabilities less than one year			Current Assets	
			Furniture Firm	1,000
			Bank Loan	<u>2,000</u>
				<u>3,000</u>
			Building Society	5,000
			Cash	<u>3,000</u>
				<u>8,000</u>
				<u>70,000</u>

There is an alternate, form of presentation which the reader will come across. In essence it shows how the business is financed. Thinking about the above balance sheet, we see that if the business were to be closed then the immediate liabilities could be paid off by realising the current assets. The longer-term liabilities would require disposal of some of the fixed assets. A picture of this may be obtained by equating what is known as the **net worth** of the business to its **capital**. Clearly, these too should balance. The balance sheet overleaf is a re-formatted version of that outlined above and it shows the nature of this relationship:

Balance Sheet, Myself as at Day 5				
	£	£	£	£
Fixed Assets				
House		50,000		
Boat		2,000		
Furniture		<u>10,000</u>		
				62,000
Add				
Current Assets				
Building Society		5,000		
Cash		<u>3,000</u>	8,000	
Less				
Liabilities less than one year				
Furniture Firm		1,000		
Bank Loan		<u>2,000</u>	<u>3,000</u>	
				<u>5,000</u>
Total Net Assets				67,000
Less				
Liabilities greater than one year				
Building Society				<u>20,000</u>
NET WORTH				<u>47,000</u>
Financed by:				
CAPITAL EMPLOYED				<u>47,000</u>

1.5

Conclusion

In this chapter we have introduced the reader to the nature and role of accountancy. Some of the basic language has been considered and before moving further the reader should be familiar with the basic tenets of balance sheet structure. This document is in some ways the end product of financial accounting but it must be realised that it is but a statement. Indeed by the time the accountant has presented the document it is already out of date. It changes with great regularity and the reader must realise the dual effect that these changes precipitate.

Chapter Two

DOUBLE ENTRY AND THE TRIAL BALANCE

2.1 Introduction

In the last chapter we considered, amongst other things, the basic structure of the balance sheet and we saw that every time a change took place there were two dimensions to the transaction. This, of course, simply reflects the reality of business where there is exchange of value. Whatever the case, the exchange of cash for goods, or services, indicates that one element of the balance sheet benefits and the other loses. This duality is fundamental in that it does NOT mean that in the ledger the same entry is made twice but rather that two independent entries result. In fact, the terminology is that one entry is a 'Debit' entry and the other a 'Credit' entry. As will be seen you cannot have one without the other.

The balance sheet as a snapshot in time does have its limitations. For example, it does not tell us who are the debtors or the creditors. Neither does it tell us the age of the assets. Certainly, we have examined the two-fold nature of change in the balance sheet and this has served to introduce the idea of debit and credit entries. However, the balance sheet itself is neither debited or credited though it has to be said that it will reflect the consequences of such entries. Where then are they made? The answer is in the Ledger, the document to which we referred earlier and from which the final accounts are created. It is the ledger that hosts the transactions and which provides:

1. The information that the balance sheet lacks.
- and
2. The place for debiting and crediting the financial consequences of a business transaction.

2.2 The Structure of the Ledger

Before turning to a small example it is appropriate now to consider how the ledger itself is divided. Clearly, in the small business where there are a minimal number of transactions, keeping track of the various accounts that the ledger houses is not too difficult a task. This cannot be said of the larger Organisation. In order to overcome this problem the ledger is traditionally sub-divided as follows.

1. *Personal*
This section of the ledger houses those accounts of a personal nature, namely the Debtors and Creditors of the business.
2. *Impersonal*
 - (a) *Real*
These accounts are concerned with those things of a business that are more tangible. They contain records of acquisition and disposal of objects of possession, namely, the Assets. They also contain details of the Liabilities.
 - (b) *Nominal (non-real)*
Here will be found the accounts that relate to the expenses or the income of the business.

Let us now assume that the creditor is paid. Yet again, two accounts have to be considered this time the creditor's personal account (which already has a credit entry of £7,000) and the cash account. The entries will now be.

(a)	(b)	(c)
Furniture a/c	Named person a/c	Cash a/c
7,000	7,000 7,000	7,000

A dashed arrow points from the 7,000 credit in (b) to the 7,000 debit in (c).

What has been said? The Furniture account has 'received value' of £7,000, that value having been obtained from a credit item elsewhere in the ledger; specifically a personal account. Notice the pattern. First, one account gives value then another receives. This principle was repeated in the second transaction whereby the cash account lost value and the creditor gained value. Again, the credit items and the debit items are co-equal.

In summary, we see that the various ledger accounts host the principles of double entry, one account is always debited, the other credited.

This simple example has served to show the fundamentals and the reader should try further to understand its basic tenets by endeavouring to structure some ledger accounts for himself, from the following series of transactions which commence, as seems natural, with a business capitalisation of £25,000 by the owner.

Day Transactions

- (a) £25,000 placed by the proprietor into a business bank account
(b) Paid £10,000 premium (by cheque) for premises.
(c) Paid £2,500 (by cheque) for plant and machinery.
(d) Transferred £250 from the bank to cash.
- Purchased, on credit, goods for resale:
(a) £300 steel bars from Bars plc.
(b) £500 metal goods from Metals plc.
(c) £400 other materials from Suppliers plc.
- Purchased, by cheque, £1,000 goods from Factors Co.
- Bought Office furniture for cash £150.

The first transaction would be as follows:

Capital Account	Bank Account
25,000	25,000

(The full, worked example, is to be found on page 32)

2.4 Capital and Revenue Expenditure

All businesses are not like our pauper. If they are to move forward they will require in the first instance to be capitalised. Consider for a moment a business entrepreneur who decides to set up a business selling craft toys.

He complies with the appropriate requirements and makes a capital contribution of £10,000. Our businessman keeps a simple cash record of his transactions, let us say it is as follows:

Starting Cash	£ 10,000
Less: Purchase of Wood 2,000	
Premises purchase 5,000	7,000
	3,000
Cash from Sales	5,000
Cash at the week end	8,000

Having started with £10,000, it appears to be the case that a loss has resulted. The business is £2,000 cash down on what it started with. The fault of this conclusion lies in the fact that no account has been taken of the difference between Capital expenditure and Revenue expenditure; two concepts which are of fundamental importance in the determination of profits. What then is the difference?

2.4.1 Capital Expenditure

This is expenditure by a business on those items which last longer than a year and which therefore have an enduring influence on the profit-making capacity of a business. In this example, the premises will continue to be used for a long time before they require to be replaced. Indeed, if the decision was taken not to trade any more then the premises could easily be sold. Remember, the purpose of an asset is to generate income and if there were no premises then there would be doubt as to the likelihood of trade. Examples of capital expenditure include expenditure on land and buildings, plant and machinery, fixtures and fittings, motor vehicles and so on. Such expenditure appears in the Balance Sheet as Fixed Assets.

2.4.2 Revenue Expenditure.

On the other hand, revenue expenditure is on those items that are consumable in their nature, be it goods or services. These are items which do not last a long time but are used quickly by the business for its benefit and are then lost for all time. Examples would include, for example, postage charges, telephone charges, wages, salaries, overdraft interest, stationery. This type of expenditure appears in the Profit and Loss Account.

Is then, our earlier view of a £2,000 loss true? In the light of what has been said regarding the nature of expenditure, the accountant would consider that the premises purchase should be spread over several years and would take this view:

Sales (Cash)	£ 5,000
Purchases	2,000
Cost of Goods Sold	2,000
PROFIT	3,000

This is a somewhat different picture. It is clear that the reason for this, in this example, is that the accountant ignored the capital expenditure. Clearly this should not be the case and ways of handling the consumption of these items will be considered later.

Two further aspects should be noted. First, the example serves to show that profit and cash are not necessarily the same thing. The second aspect concerns the revenue obtained from sales. It is clear that stocks have been depleted. If further income is to be derived then the cash benefits from sales will have to be spent on more wood.

2.5 The Problem of Stock

This question of stocks is important. The astute business person will not pass on stock at cost . . . it is usual to provide some form of mark-up! This presents a problem for the principles of double-entry. If we return to our earlier set of figures then the transactions for the purchase and disposal of stock might be represented in the ledger accounts as follows.

Stock a/c	Cash a/c
2,000 <div style="text-align: right; padding-right: 10px;">5,000</div>	<div style="text-align: left; padding-left: 10px;">5,000</div> 2,000

Notice, we have £3,000 (debit) left in the cash account but £3,000 (credit) in the stock account! The presence of the mark-up is the problem and maintaining a single stock account like this is fine only if the stock is sold at cost. In reality this is seldom the case and to overcome the problem the stock account is sub-divided to cater for all possible movements of stock that a business will have, namely:

1. The Purchases Account: To cater for the goods purchased by a business for the purposes of resale.
2. The Purchases Returns a/c: To cater for those goods that the business, for some reason, finds unacceptable and hence returns to the party from whom they bought.
3. The Sales Account: To cater for the goods which the business resales.
4. The Sales Returns a/c: To cater for those goods which are returned to the business by its customers.

Let us now assume that the accountant finds that certain stocks have indeed been returned. First, £500 by the business and second, £1000 to the business by customers. Our calculations of profit would now be:

Sales		£	
less returns			5,000
			1,000
			4,000
Purchases	2,000		
less returns	500		
Cost of goods sold			1,500
Profit			2,500

and the relevant entries in the ledger accounts would be:

Purchases	Purchase returns	Sales	Sales returns	Cash
2,000	500	5,000	1,000	500 2,000 5,000 1,000

Another point we must consider is the effect of existing stocks. The four stock accounts we have considered represent the effects of changes in the levels of stock during any one financial period. Very few businesses, however, commence and end one financial period with no stock. Thus, if an Organisation closes one night with 400 tins of beans on its shelves and next morning purchases another 300, then altogether it has the next day 700 tins of beans available for sale. Whether it does or not depends upon how many tins are left on the shelf at the end of the next day. If 700 are left then it has been a poor day for beans! If 100 remain then the purchase of 300 has been insufficient to meet demand and some of yesterday's remaining stock was sold.

What then is the effect on profit? If, for example, the business we are considering had £1500 stock left over from the previous day and £1000 left at the end of the day? Our accountant's calculation would now be as follows:

Sales		£
less returns		5,000
		1,000
		4,000
Opening Stock	1,500	
Add Purchases	2,000	
less returns	500	
	1,500	
Goods available for sale	3,000	
less Closing Stock	1,000	
Cost of Goods Sold		2,000
Profit		2,000

The profit we have just calculated is a special type of profit. It is called **Gross Profit**. It represents the extent to which the goods being sold, were sold at more than cost. Had, of course, stocks been sold at less than cost then the result would have been a **Gross Loss**.

2.6 Expenses and Revenue

No business can operate without "enjoying" some form of expenses in its operations. Wages, telephone bills, heating bills are invariably incurred and it would be a foolish businessman who would not mark-up his selling price to allow for these. Clearly, expenses are paid by the firm and in accordance with the principles of Double-entry the relevant expense

account would receive value and the cash account (or bank account, if the transaction involved settlement by cheque) would give value away. On the other hand, where there are revenue receipts by the Organisation, the entries would be the converse. Consider three examples. Suppose the firm pays £1500 for wages, £200 for rates and receives £2000 rent in respect of part of its building that it is letting. The first two are expenses, the last a revenue and the entries in the ledger accounts would be:

Cash		Wages	Rates	Rent received
2,000	1,500	1,500	200	2,000
	200			

Clearly, these transactions will affect ultimate profitability. In fact it would increase by £300 thus:

		£
Gross Profit		2,000
Rent received		<u>2,000</u>
		4,000
Wages	1,500	
Rates	<u>200</u>	
		1,700
Profit		<u>2,300</u>

What we have now deduced is the business' final profit after we have considered the expenses and revenues of the business. This profit too has a special name. It is **Net Profit** and is the Gross Profit adjusted positively for "non-sales" revenue and negatively for those other costs that have been incurred in running the business. This remaining profit has been generated by the business and is a liability of the business to the owner, hence it is an addition to Capital.

There is one particular expense that we must consider in a little depth. It is the expense of carriage. A business may well incur the cost of delivering the goods it has sold to its customers and clearly this is an expense that will be carried after net profit. On the other hand a separate charge may be incurred with respect to the goods that the business purchases. In other words it has to pay carriage on those goods it obtains prior to resale. These two types of carriage are distinguished in the ledger accounts as "Carriage Out" (when with respect to sales) and "Carriage In" (when with respect to purchases).

Let us briefly deal with the problem of "Carriage In". In order that a proper comparison may be made between purchases with carriage already included in the price of purchase and those where it is not, "Carriage In" is always added to Purchases; that is it appears before Net Profit is calculated.

A simple example will help to make this point clear. Imagine you have decided to purchase from two suppliers, two identical items. These are for resale. The first supplier will deliver the item to you and the entire

transaction will cost you £120. Carriage is included in the price. The second supplier charges you £100, but on the basis that you uplift the item from his premises. In other words getting the item to your premises is going to cost you something. Now imagine you were to sell each of these items at £200 each. Consider the first £200 less £120 would produce a net profit on that item of £80. Not bad! Now the second £200 less £100 makes the net profit on the second item £100. Better, but what if the cost of uplifting was £60? The reality is that the cost of goods from the second supplier was really £160 and hence the true net profit £40. Clearly, not such a good performance as the first.

Such matters should be properly reflected in the accounts.

For example, we might have a statement as follows from which the reader will note:

1. That a cost of "Carriage In" (£150) has been added to the purchases and an expense "Carriage Out" (£500) is carried after net profit.
2. That as a result of the first entry, the Cost of Goods Sold has risen and Gross Profit is thereby reduced by £150.

	£	£	£
Sales			5,000
less returns			<u>1,000</u>
			4,000
Opening Stock		1,500	
Add Purchases	2,000		
Add Carriage In	150		
	<u>2,150</u>		
less returns	500		
		<u>1,650</u>	
Goods available for sale		3,150	
less Closing Stock		<u>1,000</u>	
Cost of goods Sold			<u>2,150</u>
Gross Profit			1,850
Rent received			<u>2,000</u>
			3,850
Carriage out	500		
Wages	1,500		
Rates	<u>200</u>		
			<u>2,200</u>
Net Profit			<u>1,650</u>

At this stage it is as well to remind the reader that we are concerned with the costs incurred in running the business. Sometimes, the proprietor of a business will wish to draw money from the business for his own use. These are termed Personal Drawings and are accommodated in the ledger in an account entitled "Drawings", where the history can be easily seen. Because drawings are not part of the business they are not considered a revenue expense and hence must be treated as a reduction in the liability of the business to the owner (i.e. as a reduction in his Capital).

The net effect of Capital + Profit, less Drawings is sometimes known as the "Owner's Equity" and is the liability of the business to the proprietor(s) after all other liabilities of the business have been met.

2.7 Towards the Trading and Profit and Loss Account and the Balance Sheet

In effect, what we have done so far, is to derive in a "conversational" manner, the basic structure of two important revenue accounts namely:

1. The Trading Account: Which determines Gross Profit
2. The Profit & Loss Account Which determines Net Profit

What we must now consider is how these final two accounts and the balance sheet are derived from the various ledger accounts that lie behind them. In the knowledge of the principles of double entry and given the background to the final accounts which we have just considered let us now reconsider the matter but within a methodological framework.

We will start with the following series of business transactions during, say, the month of January for a hypothetical Organisation called R.M. Enterprises:

Day Details of transactions.

1. Started business with cash of £5,000.
2. Transferred £3,000 to the bank.
3. Bought goods for re-sale ... £200. Paid in cash.
4. Bought goods for re-sale, on credit from:
 - (a) Wallach ... £460.
 - (b) Kogan ... £520.
 - (c) Burt ... £200.
 - (d) Smith ... £420.
5. Bought stationery, on credit from:
 - (a) Bell ... £225.
6. Sold goods on credit to:
 - (a) Wigan ... £190
 - (b) Bashful ... £240.
 - (c) Happy ... £250.
 - (d) Peters ... £240.
8. Paid insurance charges, by cheque ... £160.
10. Bought Fixtures and Fittings, on credit from:
 - (a) Metheras ... £560.

11. Salaries paid, by cheque ... £160.
12. Returned goods to:
 - (a) Kogan ... £75.
 - (b) Burt ... £95.
15. Bought a motor van, by cheque ... £950.
16. Received a loan from Hawkes. Paid in a cheque ... £950.
18. Goods returned to us by:
 - (a) Wigan ... £40.
 - (b) Happy ... £60.
21. Cash Sales £120.
24. Credit Sales to:
 - (a) Bashful ... £150.
 - (b) Pearson ... £370.
 - (c) Singleton ... £115.
26. We paid the following, by cheque:
 - (a) Kogan ... £390.
 - (b) Burt ... £70.
27. We received cheques from:
 - (a) Singleton ... £115.
 - (b) Bashful ... £190.
28. Received a further loan from Hawkes, by cash, £300.
29. The proprietor effects a cash withdrawal of £400 for his own use.
30. Carriage is paid (cash):
 - (a) £200 on goods purchased by the business.
 - (b) £600 on goods sold by the business.

2.7.1 Structuring the ledger accounts

The first thing we will do is structure the ledger accounts but before doing so, let it be said that by design, a number of errors have been made in the given answers. (see figure 2.2) The reason for this will become clear soon but in the meantime readers are well advised to create for themselves each ledger account entry and to follow the given responses carefully and thereby locate where these errors lie. To do so will aid understanding.

If at close of business we wish to consider the financial state of the business then the ledger accounts may be balanced-off. The term "Balance" is an accounting term that means the difference between the two sides of an account and it is easily established by independently summing the two sides and adding to the lowest the amount required to make both sides equal. In keeping with the principles of double-entry, this amount is then carried down to the other side of the account that is being balanced and hence the closing balance today is the opening balance for tomorrow. It will be seen from the various examples that the accounts have been balanced-off on the assumption of close of business on the 30th day, the day on which we wish to obtain our "snapshot" of the business. The "carried down" figures represent the opening balances in the various ledger accounts for the 1st of February the day on which a new set of transactions will take place.

30 Bal c/d	5000	1 Cash	5000
	<u>5000</u>		<u>5000</u>
		30 Bal b/d	5000

1 Capital	5000	2 Bank	3000
21 Sales	120	3 Purch	200
28 Hawkes	300		
29 Drawings	400		
	<u>5820</u>	30 Bal c/d	2620
30 Bal b/d	2620		<u>5820</u>

30 Bal c/d	225	5 Stationery	225
	<u>225</u>		<u>225</u>
		30 Bal b/d	225

12 Purchases returns	75	4 Purchases	520
26 Bank	390		
30 Bal c/d	55		
	<u>520</u>	30 Bal b/d	55

2 Cash	3000	8 Insur.	155
16 Hawkes	950	11 Salaries	160
27 Singleton	115	15 Van	950
27 Bashful	190	26 Kogan	390
		26 Burt	70
		30 Bal c/d	2530
	<u>4255</u>		<u>4255</u>
30 Bal b/d	2530		

6 Wigan	190	6 Bashful	240
6 Happy	250	6 Peters	240
21 Cash	120	24 Bashful	150
24 Pearson	370	24 Singleton	115
30 Bal c/d	1675		
	<u>1675</u>	30 Bal b/d	1675

30 Bal c/d	560	10 fixtures & fits.	560
	<u>560</u>		<u>560</u>
		30 Bal b/d	560

6 Sales	190	18 Sales returns	40
		30 Bal c/d	150
	<u>190</u>		<u>190</u>
30 Bal b/d	150		

3 Cash	200		
4 Wallach	460		
4 Kogan	520		
4 Burt	200		
4 Smith	420		
		30 Bal c/d	1800
	<u>1800</u>		<u>1800</u>
30 Bal b/d	1800		

18 Wigan	40		
18 Happy	60		
		30 Bal c/d	100
	<u>100</u>		<u>100</u>
30 Bal b/d	100		

6 Sales	240	27 Bank	190
24 Sales	150	30 Bal c/d	200
	<u>390</u>		<u>390</u>
30 Bal b/d	200		

6 Sales	250	18 Sales returns	60
		30 Bal c/d	190
	<u>250</u>		<u>250</u>
30 Bal b/d	190		

	12 Kogan	75	
	12 Burt	95	
30 Bal c/d		<u>170</u>	
		<u>170</u>	
	30 Bal b/d	170	

30 Bal c/d	460	4 Purchases	460
	<u>460</u>		<u>460</u>
		30 Bal b/d	460

6 Sales	240	30 Bal c/d	240
	<u>240</u>		<u>240</u>
30 Bal c/d	240		

24 Sales	370	30 Bal c/d	370
	<u>370</u>		<u>370</u>
30 Bal b/d	370		

12 Purchase returns	95	4 Purchases	200
26 Bank	70		
30 Bal c/d	35		
	<u>200</u>		<u>200</u>
		30 Bal c/d	35

30 Bal c/d	420	4 Purchases	420
	<u>420</u>		<u>420</u>
		30 Bal b/d	420

24 Sales	115	27 Bank	115
	<u>115</u>		<u>115</u>

5 Bell	225	30 Bal c/d	225
	<u>225</u>		<u>225</u>
30 Bal b/d	225		

10 Matheras	560	30 Bal c/d	560
	<u>560</u>		<u>560</u>
30 Bal b/d	560		

8 Bank	155	30 Bal c/d	155
	<u>155</u>		<u>155</u>
30 Bal b/d	155		

15 Bank	950	30 Bal c/d	950
	<u>950</u>		<u>950</u>
30 Bal b/d	950		

11 Bank	160	30 Bal c/d	160
	<u>160</u>		<u>160</u>
30 Bal b/d	160		

30 Bal c/d	1250	16 Bank	950
	<u>1250</u>	28 Cash	300
			<u>1250</u>
		30 Bal b/d	1250

30 Bal c/d	400	29 Drawings	400
	<u>400</u>		<u>400</u>
		30 Bal b/d	400

Fig. 2.2

2.7.2 Structuring the trial balance

Because we have always adhered to the principles of double-entry it should be the case that the sum of the credits will be equal to the sum of the debits. Logically, then, the sum of the credit balances will also equal the sum of the debit balances. We can test this by using a mechanism known as the Trial Balance. This document is simply a listing of all the accounts showing what their balances are and is the first step towards completion of the final accounts. Using the various balances from the example we have just considered, its form would be as in Figure 2.3.

Trial Balance R.M. Enterprises 31st January 19--

Account	Debit	Credit
	£	£
Capital		5000
Cash	2620	
Bank	2530	
Purchases	1800	
Sales		1675
Sales Returns	100	
Purchases Returns		170
Wallach		460
Kogan		55
Burt		35
Smith		420
Bell		225
Matheras		560
Wigan	150	
Bashful	200	
Happy	190	
Peters	240	
Pearson	370	
Stationery	225	
Fixtures and Fittings	560	
Insurance Charges	155	
Motor Van	950	
Salaries	160	
Hawkes Loan		1250
Drawings		400
	10250	10250

Fig. 2.3

Notice that the document is in equilibrium thereby implying that our credit and debit entries are in order. However, the system is not perfect for it does not trace all errors, typical errors which will not affect the equilibrium of the trial balance are as follows:

Error Type	Nature of Error
1. Omission:	Where transactions are completely missed out
2. Commission:	Correct amounts but the wrong way round.
3. Principle:	Correct amounts but in the wrong accounts.
4. Compensation:	Two or more errors that cancel each other out.
5. Original entry:	Double-entry in order but original amounts are wrong.
6. Complete reversal:	Correct entries have been made but to the wrong sides of an account.

In the ledger accounts that we completed earlier (see figure 2.2) there were a number of designed errors. Where were they?

- Two transactions were wrong (Drawings and Insurance)

Drawings : Here, the Drawings Account had been credited and the cash account debited. This of course should have been the other way round, namely the Drawings Account debited and the Cash Account credited.

Insurance : This transaction had the entries in the correct places but they were simply the wrong amounts; they should have been £160 and not £155!

- Two transactions were missed out (Carriage In and Carriage Out). In other words, no entries were made to any account.

The accounts, in corrected form, and the entries that require to be corrected in the trial balance are as shown in figure 2.4. (The Trial Balance totals should be £9850). The reader must be clear in his mind that despite these errors, the trial balance was still in equilibrium and that the picture given in figure 2.3 was in effect wrong.

Cash Account		Drawings Account	
	89 Drawings 400	29 Cash 100	30 Bal c/d 100
	30 Carriage out 600		
	30 Carriage in 200		
	30 Bal c/d 1020		
	<u>5420</u>		<u>100</u>
30 Bal b/d 1020		30 Bal c/d 100	
			<u>100</u>
Carriage Out Account		Carriage In Account	
30 Cash 600	30 Bal c/d 600	30 Cash 200	30 Bal c/d 200
	<u>600</u>		<u>200</u>
30 Bal b/d 600		30 Bal b/d 200	
			<u>200</u>
Insurance Account			
8 Bank 160	30 Bal c/d 160		
	<u>160</u>		
30 Bal b/d 160			<u>160</u>

The Corrected Balances of R.M. Enterprises 31 January 19--

Account	Debit	Credit
Cash	1020	
Drawings	400	
Carriage Out	600	
Carriage In	200	
Insurance	160	
Bank	2525	

Fig. 2.4

2.7.3 Structuring the Final Accounts and the Balance Sheet

One final point concerns adjustments that may arise. We have already discussed the adjustments for opening and closing stocks.... there are others and we will be discussing these soon but in the meantime let us assume that there is in this first period of business £750 of stock left on the shelves at the end of the period. Using this information and the trial balance we are now in a position to start constructing the Trading Account, The Profit and Loss Account and the Balance Sheet, but first, here are some hints on dealing with this type of problem:

1. Each item that appears in a trial balance sheet is used ONCE.
2. If the trial balance tells you that an item is a "debit" then it is entered in the final accounts. It will either be:
 - (a) An expense in the revenue accounts
 - OR
 - (b) An asset to be shown in the balance sheet.

If the trial balance tells you it is a "credit" then it is entered in the final accounts as:

- (a) An income in the revenue accounts.
 - OR
 - (b) A Liability in the balance sheet.
3. If there are any notes as to the adjustments that require to be made then these will be required to be used TWICE thereby meeting the requirements of double-entry.
 4. Decide where a particular item in the trial balance should go and mark it accordingly, say "T" for Trading Account, "P" for Profit and Loss Account and "B" for Balance Sheet.
 5. Prepare the accounts by picking out the relative items from the trial balance, be sure to tick the item as you use it.

Once you have done this you should end up with a set of final revenue accounts and a balance sheet as follows:

Trading and Profit and Loss Account R.M. Enterprises 31 January 19--

		£
Sales		1675
Less Sales Returns		<u>100</u>
		1575
Purchases	1800	
Plus Carriage In	<u>200</u>	
	2000	
Less Purchase Returns	<u>170</u>	
Goods Available for Sale	1830	
Less Closing Stock	<u>750</u>	
Cost of Goods Sold		<u>1080</u>
GROSS PROFIT		495
Selling Expenses		
Carriage Out	600	
Administration		
Salaries	160	
Insurance	160	
Stationery	<u>225</u>	
	<u>545</u>	
NET LOSS		<u><u>1145</u></u> <u>(650)</u>

Balance Sheet . . . R.M. Enterprises 31 January 19--

	£	Fixed Assets	£	£
Capital	5000	Fixtures	560	
Less Drawings	<u>400</u>	Motor Vans	<u>950</u>	
	4600			
Less Net Loss	<u>650</u>			1510
	3950			
Long Term Liabilities		Current Assets		
Hawkes Loan Account	1250	Stock	750	
		Debtors	1150	
Current Liabilities		Bank	2525	
Creditors	<u>1755</u>	Cash	<u>1020</u>	
	<u>6955</u>			<u>5445</u>
				<u>6955</u>

Completed answer for example on page 18

<table border="1" style="width: 100px; margin: auto;"> <tr><td style="text-align: center;">Capital Account</td></tr> <tr><td style="text-align: center;">25000</td></tr> </table>	Capital Account	25000	<table border="1" style="width: 100px; margin: auto;"> <tr><td style="text-align: center;">Bank Account</td></tr> <tr><td style="text-align: center;">25000</td></tr> <tr><td style="text-align: center;">10000</td></tr> <tr><td style="text-align: center;">2500</td></tr> <tr><td style="text-align: center;">250</td></tr> <tr><td style="text-align: center;">1000</td></tr> </table>	Bank Account	25000	10000	2500	250	1000
Capital Account									
25000									
Bank Account									
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<table border="1" style="width: 100px; margin: auto;"> <tr><td style="text-align: center;">Premises Account</td></tr> <tr><td style="text-align: center;">10000</td></tr> </table>	Premises Account	10000	<table border="1" style="width: 100px; margin: auto;"> <tr><td style="text-align: center;">Plant and Machinery Account</td></tr> <tr><td style="text-align: center;">2500</td></tr> </table>	Plant and Machinery Account	2500				
Premises Account									
10000									
Plant and Machinery Account									
2500									
<table border="1" style="width: 100px; margin: auto;"> <tr><td style="text-align: center;">Cash Account</td></tr> <tr><td style="text-align: center;">250</td></tr> <tr><td style="text-align: center;">150</td></tr> </table>	Cash Account	250	150	<table border="1" style="width: 100px; margin: auto;"> <tr><td style="text-align: center;">Goods Account</td></tr> <tr><td style="text-align: center;">300</td></tr> <tr><td style="text-align: center;">500</td></tr> <tr><td style="text-align: center;">400</td></tr> <tr><td style="text-align: center;">1000</td></tr> </table>	Goods Account	300	500	400	1000
Cash Account									
250									
150									
Goods Account									
300									
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400									
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Bars plc a/c									
300									
Metals plc a/c									
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Suppliers plc a/c									
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<table border="1" style="width: 100px; margin: auto;"> <tr><td style="text-align: center;">Office Furniture Account</td></tr> <tr><td style="text-align: center;">150</td></tr> </table>	Office Furniture Account	150							
Office Furniture Account									
150									

Chapter Three

STOCK AND CREDIT SALES

3.1 Stock Valuation

Probably, the largest item in the working capital group of most trading organisations is stock, an item, as we have seen, that is used to generate the Cost of Goods Sold. The fact that stocks are a real asset presents problems not only of physical control but also of financial control and one problem that faces the accountant is the determination of the value of remaining stock. Clearly an inappropriate assessment will result in the cost of goods sold (which invariably, is the largest deduction from sales) being either over, or understated with the inevitable results being an inaccurate picture of profitability.

Insofar as closing stock is concerned the effects of improper valuation will become self-evident.

An example will help to make this issue clear.

Let us first deal with the broad issue of the effect of valuation on profitability by returning to the data of R.M. Enterprises. The reader will recall being asked to assume that the closing stocks were valued at £750 (see Section 2.7.3) On the assumption that this was correctly valued, then the Gross Profit (and hence Net Profit) is realistic. But what if the closing balance was over-valued by £250? If this was so, then the relevant parts of the trading account would be as follows:

	£	£
Sales less returns		1575
Goods available for sale	1830	
Less Closing Stock	<u>1000</u>	
COST OF GOODS SOLD		<u>830</u>
Gross Profit		745

Notice gross profit has risen by £250

If it were the case that the closing stock had been under-valued by £250, then the Cost of Goods Sold item would be £1330 with the inevitable reduction in profitability.

	£	£
Sales less returns		1575
Goods available for sale	1830	
Less Closing Stock	<u>500</u>	
COST OF GOODS SOLD		<u>1330</u>
Gross Profit		245

The reader will, of course, realise that the closing stock valuation of today, is the opening valuation of tomorrow. Clearly, an erroneous valuation yesterday will have a 'knock-on' effect in later periods. Another example will help to make this clear; an example in which all elements used to calculate the cost of goods sold remain constant except for one. Across the three cases that follow purchases and closing stocks are all the same ... the only thing that varies are the opening stocks.

	Nature of Opening Stock Valuation		
	Over £	Correct £	Under £
Opening Stocks	1000	750	500
Add purchases	<u>1000</u>	<u>1000</u>	<u>1000</u>
Goods available for sale	2000	1750	1500
Less Closing Stocks	<u>200</u>	<u>200</u>	<u>200</u>
Cost of Goods Sold	1800	1550	1300

On the basis that sales are £1900 then the relative Gross Profits of £100, £350 and £600 can be deduced by subtracting from the sales figure, the various costs of goods sold. The 'knock-on' effect may be summarised as follows:

1. If the opening valuation is overstated Profit is understated.
2. If the opening valuation is understated Profit is overstated.

Clearly, accurate valuation of stock is essential if profitability is to be correctly recorded. At best, an accountant would value an item of stock in accordance with its particular cost but whilst this is reasonably easy with low volume, high cost items which may be specifically identified (for example motor cars) it is easy with items that are high volume low cost.

Imagine that an organisation has just completed its first monthly financial period and is about to value its stock. Its record of transactions might be as follows:

Purchases				Sales			
Week	Volume	Unit Price	Cost	Week	Volume	Unit Price	Cost
		£				£	£
1	100	3.00	300				
2	100	3.40	340				
				3	80	5.00	400
4	200	4.00	800				
				5	240	6.00	1400
	<u>400</u>		<u>1440</u>		<u>320</u>		<u>1800</u>

You will see that eighty items of stock remain. In other words (400 - 320). The problem that remains to be solved is just what eighty items of stock remain? In the absence of any logical approach it could be those purchased in the first week. On the other hand it could be those purchased last or

any combination of weeks 1, 2 and 4. In this instance alternative methods of valuing stock have to be considered among them the LIFO and FIFO methods; methods to which we will now turn

3.1.1 Last in First Out

By this method, as each item of stock is sold it is deemed to be from the last lot of goods received prior to that date. If the latest addition to stock is insufficient to meet demand then the balance, for the purposes of accounting, is considered to have come from the next previous lot which is still available.

Let us now consider the matter from the point of view of LIFO. The following figure outlines the nature of the calculations involved from which it will be seen that the closing stock valuation is £240.

Last in First Out (LIFO)					
Day	Received	Issued	Stock at the end of the Transaction		
			Summary of Value		Total Value
1	100 at £3.00		100 at £3.00	300	300
2	100 at £3.40		100 at £3.00	300	640
			100 at £3.40	340	
3		80 at £3.40	100 at £3.00	300	368
			20 at £3.40	68	
4	200 at £4.00		100 at £3.00	300	1168
			20 at £3.40	68	
			200 at £4.00	800	
5		200 at £4.00	80 at £3.00	240	240
			20 at £3.40		
			20 at £3.00		

Fig. 3.1

3.1.2 First in First Out

Then there is FIFO. As will be seen from the following figure, by this method, the first goods received are issued first and as the reader will see

First in First Out (FIFO)					
Day	Received	Issued	Stock at the end of the Transaction		
			Summary of Value		Total Value
1	100 at £3.00		100 at £3.00	300	300
2	100 at £3.40		100 at £3.00	300	640
			100 at £3.40	340	
3		80 at £3.40	20 at £3.00	60	400
			100 at £3.40	340	
4	200 at £4.00		20 at £3.00	60	1200
			100 at £3.40	340	
			200 at £4.00	800	
5		20 at £3.00	80 at £3.00	240	320
			100 at £3.40		
			120 at £4.00		

Fig. 3.2

a different valuation of the closing stock emerges ... indeed it is somewhat higher at £320.

Clearly the choice of method does have a bearing on the nature of the final valuation and both have their advantages and disadvantages. LIFO, for example, reflects a 'true' cost of goods sold and hence gives a good measure of revenue. On the other hand, it might not represent the best valuation for the purposes of the balance sheet, particularly where there have been long periods of price increases (or decreases), an aspect which LIFO overcomes.

3.2 Bad Debts and their Provision

We have seen how stock turnover is the usual basis of trading. A businessman, in order to encourage sales, invariably will give credit to selected customers; indeed, it is arguable that the majority of business transactions these days are on a credit basis. In other words, they are part of an understanding between the parties that payment for the goods which have been purchased will be made at a later date. Clearly, there is a risk associated with a policy of giving credit and management have to "trade-off" the profit advantages of increased sales with the disadvantages of some of these debts thereby incurred becoming uncollectable by the Organisation.

3.2.1 Known Bad Debts

It will be recalled that at the end of any one financial period, the total value of the balances on the various debtor accounts (sometimes known as accounts receivable) and which are yet to be paid, must be shown as an asset in the balance sheet. The question that remains open is whether or not the total of the balances of these various personal accounts reflect their total worth. It would not if, for example, the business knew that some of their debtors will fail to settle, be it due to bankruptcy, liquidation or even the inability to pay through cash-flow problems. Such a failing on the part of the clients, means that the business has to carry the cost.

Let us take an example. Assume that R.M. Enterprises (see section 2.7) have exerted poor control over their credit arrangements and that two of their remaining debtors' (Happy and Peters) balances will not be paid. It should be clear that the value of the assets shown in the balance sheet (£1150) is not representative of their true worth.

How then, is this problem resolved? In this example, the two debtor accounts would be credited with the remaining balances and these then written off to a new account known as the "Bad Debts" account; an account which gradually accumulates these losses as they occur during the financial year and which in turn, at the year end, is written-off to the Profit and Loss Account, thus:

Happy a/c		Bad Debts a/c		
190	190	190		
190	190			
Peters a/c				
240	240	240	430	430
240	240	430	430	430
				P & L a/c

(NB For illustrative purposes, the P & L account has been treated rather like a 'T' a/c)

The reader should satisfy himself as to the effect of this upon the balance sheet. It is:

1. Total expenses (currently £1145) would rise to £1575 with the Net Loss now £1080 and the owner's equity in the business (formerly £3950) now standing at £3520.
2. The other change in the balance sheet, of course, is the debtors which would now be reduced by £430 to £720.

In addition, the reader should also note that it is possible for the account which was treated as bad to suddenly become recoverable. If this is the case then a "Bad Debts Recovered" account is opened and its balance at the year end is either transferred as a revenue to the Profit and Loss account or as a credit to the "Bad Debts" account.

3.2.2 Provision for Unknown Bad Debts

So far, we have centred upon the idea that a debt is **KNOWN** to be bad. There are, however, many instances where a business firm thinks that a debt **MIGHT** be bad. In the first instance there is certainty, in the second, uncertainty. In the former the problem is managed, as we have seen, via the bad debts account. But what of the latter? It certainly would be unwise of an organisation to ignore it!

Clearly, in dealing with potential bad debts, there is a long-tail effect in settlement and it is important that this is recognised in the accounts. Suppose, for example, a debt arose towards the end of year 1; at the end of that year, the business thinks the debt to be bad and initiates methods to recover. During the course of year 2, they are still trying to effect recovery and by year 3, the business ultimately fails in its endeavours. The debt becomes bad for certain and the accountant writes off the debt to the bad debts account. The failing of that method is that the Profit and Loss account for the third year of business is "penalised" for a debt that was incurred from sales in its first year of operation. It seems more equitable that the first year profits should have been adjusted to cater for this potential indebtedness to the firm. In other words, it is reasonable to suggest that if a bad debt arises as part of the process of generating sales, then the debt should be charged against the income that these sales create. To overcome this problem, the accountant provides, out of **CURRENT** profits an amount which satisfies his expectations. This amount is carried in a contra-account called the "Provision for Bad Debts" account.

Let us put this in perspective by reconsidering R.M. Enterprises' position. Assume now that there are no **KNOWN** bad debts but that some **MIGHT** become bad. In other words the status quo remains but now there is the addition of uncertainty as to the likelihood of some of the debtors paying their accounts. If the accountant were to expect £115 of

this period's accounts to become bad then he would provide £115 out of this year's profits, thus:

P&L a/c	Provision for Bad Debts a/c
115	115
----->	

The following points should be noted:

1. The balance of the provisions account appears in the trial balance.
2. The balance of the provisions account is shown in the balance sheet as a REDUCTION in the value of the debtors.

The relevant portion of R.M. Enterprises' balance sheet would now be as follows:

Current Assets	£	£
Stock		750
Debtors	1150	
Less Provision for Bad Debts	115	
		1035
Bank		2525
Cash		1020

This reduction in the value of the assets will, of course, be reflected by a similar reduction in Net Profit (and hence, the owner's equity in the business).

3.3 Determining Expectations

We have seen that the matter of providing for bad debts is one of expectations. How then does the accountant arrive at his figure? There are two methods that they tend to use, both of which we will now consider.

3.3.1 Percentage of Sum Method

One method available, is to provide for a pre-determined proportion of the year end sales; that proportion based upon past experience. If, for example, the sales and bad debts incurred in a business during the past five years were:

Year	Net Sales £	Bad Debts £
1	623100	7477
2	725250	10153
3	843475	14339
4	926432	21308
5	952423	28137
Total	4070680	81414

2.0 per cent

then it will be seen that at the end of the 6th year, if sales were £975432 that the provision should be 2 per cent of that value namely, £19509.

3.3.2 Ageing Method

This method considers the age of all outstanding accounts. The process involves listing each overdue debtor in accordance with the date of the account. Clearly, the more distant the due date, the less likely the outstanding account is to be paid.

Consider the following table:

Debtor	Total	Overdue period (in months)				
		Not yet due	> 3	3 > 6	6 > 9	9 >
A	1275		1120		155	
B	827			600		227
C	4004	1937	1342	725		
D	1464	522		942		
E	794				367	427
Other	18261	9372	4372	2763	1234	520
Total	26625	11831	6834	5030	1756	1174
%	100	44	26	19	7	4

Past experience has shown that the proportion of accounts that become bad varies according to how old they are. The following table expresses this experience and shows how the ultimate provision of £1569 is derived.

Overdue Period	Total £	% value	Amount £
Not yet due	11831	2	237
> 3 months	6834	4	273
3 > 6 months	5030	8	402
6 > 9 months	1756	16	281
9 months and over	1174	32	376
	26625		1569

It must be noted that an accountant's expectations of indebtedness change from year to year and hence his concern is with the increases and decreases in provisions that are required. This is inevitable as credit sales and expected losses are never static, hence the provision account is ADJUSTED to bring it into line with expectations. If, for example, the provision carried forward from the previous financial period was £975 and the required provision this period was estimated by the ageing method, then the various entries in the ledger accounts would be as follows with the inevitable effect on the balance sheet.

P & L a/c	Provision for Bad debts a/c
Increase in Provision 594	Bal b/d 975
	----->
	Bal c/d 1569
	1569
	Bal b/d 1569

Whatever method is used, if the balance carried down by way of a provision from previous periods was more than sufficient, then the account entries would comprise a debit entry to the provisions account (which would have the effect of reducing the year end balance) and a credit entry to the P & L a/c (which has the effect of adding to the owner's equity)

Chapter Four

ADJUSTMENT ACCOUNTING

4.1

Introduction

An important point to be considered is the effect of adjustment accounting upon an Organisation's profit (or loss). This form of accounting is an attempt to match the expenses and revenues of a business to a period in which they are earned, for basing transactions simply upon cash movements will often lead to an *inexact picture of profitability*

Its purpose is to ensure at the end of any one accounting period that those transactions which cross the boundaries of financial periods are equitably distributed and that the earning power of a business is correctly reflected in the final accounts.

In effect, such adjustments are managed by two processes. First, an ACCRUAL, which in effect is the current period's recognition of an expense or revenue that has not yet been recorded. For example, rates may be due to be paid but have not, or a service has been rendered and the commission earned has yet to be received. Second, the process of DEFERRAL in which an expense already paid (for example the advance payment of insurance), or a revenue which has been received (for example, advance commission in respect of a service to be provided in a later period) is accommodated in the financial accounts.

4.2

Accruals

Let us first deal with those cases where expenses are due to be paid but haven't been; or where revenues have been earned but for which there is no financial recording. In other words, accruals.

4.2.1

Accrued revenues

Consider, for example, a hypothetical Risk Management Consultancy firm. It is possible that commission is paid to the firm AFTER the service has been provided. The absence of a cash movement must not imply that the Organisation has no revenue to account for. Nor, for example, must the absence of the receipt of interest from the bank necessarily be interpreted as meaning that it has not been "earned".

Both these positions may be recognised in the accounts, for example:

(a)	(b)	(c)	(d)
Accrued commission Received a/c	Commission Earned a/c	Accrued Interest Received a/c	Interest Earned a/c
1000	1000	50	50

These debit entries in (a) and (c) are telling us that £1000 commission and £50 of interest is yet to be paid. In other words, both these are considered as assets of the Organisation. The credit entries in (b) and (d) identify the revenue which has been "earned" and hence the amount which should be carried to the Profit and Loss account as an addition to the owner's equity.

4.2.2 Accrued expenses

In addition to unrecorded revenues it is equally possible to have expenses that are not yet recorded. One typical example which is invariably paid "in arrears" is salaries. Let us return to R.M. Enterprises. We see that £160 salaries have been paid but now let us assume that £100 is still due to be paid. Clearly, these are not yet reflected in the accounts yet the business has benefited from the effort that they represent. This liability of the business to their employees may be represented in the financial accounts thus:

Salaries payable a/c	Salaries Expense a/c	Profit and Loss account
100	160 100 260	260

Notice that the salaries expense account has been increased by the amount due with the liability of the Organisation being recognised in the salaries payable account. When settlement is actually made the double entries will lie between the cash account and the salaries payable account.

4.3 Deferrals

What then of deferrals? Let us first deal with the concept of deferred revenues.

4.3.1 Deferred Revenues

Imagine that R.M. Enterprises, in addition to trading goods, is providing a consultancy service and that the contractual arrangements are such that the fees must be paid in advance. Let us say that the fee for one contract is £100 and is to be paid to R.M. Enterprises on the 31st January. This being the case, then the temptation would be to carry the revenue in the current profit and loss account. However, it has not yet been earned for the work has yet to be done. It has simply been paid in advance.

To overcome this problem, two accounts are used. First, an "Unearned Commission" account and second, an "Earned Commission" Account, thus:

Cash Account	Unearned Commission account	Earned Commission account
100	100	

Double Entry when "Earned" →

The "Unearned" commission is treated as a liability and appears as such in the balance sheet, after all, if R.M. Enterprises failed to carry out its contractual obligation then, at the least, the contracting party is entitled to its money back!

4.3.2 Deferred Expenses

The second type of deferral we will consider is the pre-payment of costs and expenses. The accounting systems used are designed to ensure that that proportion of the expenditure that has benefited the current financial

period is charged as an expense in that period with the remaining proportion considered as an asset of the Organisation; an asset available for consumption in the following period.

It will be recalled that R.M. Enterprises paid £160 insurance on the 8th January. Let us now assume that the policy falls due for renewal on the 1st January, annually. This being the case, it seems unreasonable that the entire amount paid should be carried to the Profit and Loss account, after all, 11/12ths of the premium that has been paid provides insurance cover from the 1st February until the next policy anniversary.

Let us now reconsider R.M. Enterprises position. The entries previously show that the balance carried to the profit and loss account was £160. With some retrospective wisdom it seems more reasonable to charge against profit, not £160 but £13 (i.e. 1/12th of £160). That being the case, then one way to cope with the problem would be to rename the insurance account as the "insurance pre-paid" account and to carry from that account the true amount of the expense for the period. Thus:

Insurance Prepaid a/c	Insurance Expense a/c	Profit and Loss account
160	13	13
147	147	
160	160	
147		

Notice the effect. At the end of the financial period, these accounts will be closed with only £13 being carried to the Profit and Loss account and £147 balance on the pre-paid account which will remain as an asset for consumption in later periods.

4.4 Depreciation

Let us finally deal with depreciation, a deferral that is arguably the most important. For this reason we will examine this matter in somewhat greater depth.

If you were to purchase a motor car in early January, would you expect to receive the price you paid for it at the end of the year should you decide to sell it? Whatever your expectations, it is unlikely that you would receive what you paid; undoubtedly, a financial cost would be incurred. It is clear that as the vehicle grows older, its value becomes less and less until some years hence it is almost worthless. This gradual loss is caused by a number of factors, principally wear-and-tear and obsolescence.

It is no different in a business. It purchases assets for the purposes of production and the initial costs are gradually "consumed" as the production process continues. For example, a printer may purchase a printing press for £100,000. This item is clearly a capital expenditure and as already discussed it would not appear in the revenue accounts. Indeed, if the total amount were to appear as an expense then this would mean that the current period's profits would be unduly penalised. Clearly, the

asset has been purchased with a view to retention over a long period. One problem the accountant has to face is how to apportion the initial cost of purchase over the expected life of the asset. Clearly, the asset will be used to create revenue for a number of years and it seems reasonable to suggest that this initial cost will be distributed over its years of expected service. In other words, an allocation should be made for that cost in each period during which the business benefits from using the asset. If this is done, then a number of important features arise:

- (1) The profit for each year is more equitable.
- (2) The value of the asset is not overstated in the balance sheet.
- (3) As the value lessens, the proprietors of the business are not giving a false picture of the financial state of the organisation.

This allocation is called depreciation.

It is worth emphasising that depreciation is an allocation of a cost that has already been incurred. It is NOT (as many believe it to be) the setting aside of funds to cater for re-purchase whenever that may be considered necessary. The accountant views the matter as the gradual conversion of a known cost into an expense. This allocation is not a matter of valuation, and though it is technically possible that in purchasing the asset that changes in the market place will result in an asset's value increasing, this increase has no bearing on the distribution of a cost that has already taken place.

There are three factors to depreciation:

1. The original (or historic) cost
2. The estimated useful life.
3. The estimated scrap value.

Let us reconsider the printer's purchase. The machine cost £100,000. Let us now assume its estimated useful life (to the printer) is 5 years and he expects to be able to sell it for £10,000. The net depreciable cost, then, is £90,000. The question that remains open is this.

"Given the net depreciable cost, how is it to be allocated over the periods of its use?"

There are a number of methods but the most popular are:

1. The Straight Line Method.
2. The Diminishing (or reducing) Balance method.

4.4.1 The Straight Line Method

In this system, a fixed proportion of the original capital expenditure is written-off annually in order to reduce the asset to zero, or its residual value. The formula is:

$$\text{Annual depreciation Charge} = \frac{\text{Cost} - \text{Scrap Value}}{\text{Estimated Life}}$$

Using the formula we establish that our yearly allocation is one fifth of £90,000, namely £18,000. The following table identifies for each period, the accumulated depreciation and the residual value

Period	Yearly Allocation £	Accumulated Depreciation £	Residual Value £
1	18000	18000	82000
2	18000	36000	64000
3	18000	54000	46000
4	18000	72000	28000
5	18000	90000	10000

Now consider figure 4.1 following in which the residual values are graphed.

The straight line nature of the graph serves to identify the reason behind the method's title. The constant nature of both the amount of the depreciation and the increase in the accumulation results in differing residual values in each period until at the end of the estimated period, the scrap value is reached.

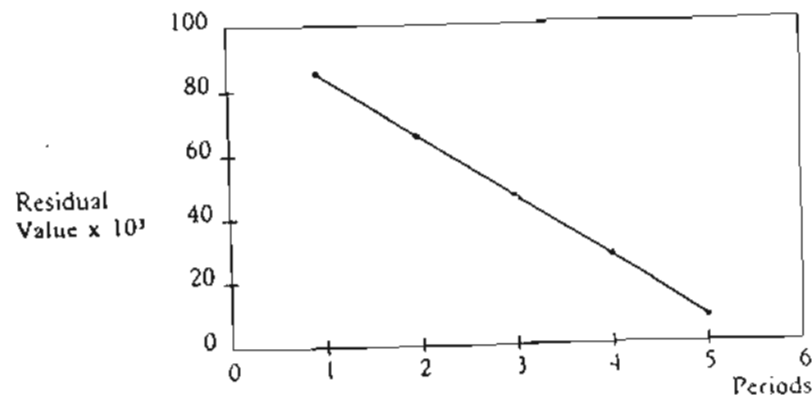


Fig. 4.1

4.4.2 The Diminishing Balance Method

By this method, a fixed rate per cent of the REDUCING balance is written off to the revenue accounts each period. There are techniques for establishing the required annual rate under this method but we will not discuss them here. For our purposes, it is sufficient to accept a given rate. Indeed, we will base our example upon a rate of 36.9 per cent per annum. The allocation for period 1 is 36.9% of £110,000, namely £36900. With this latter amount now "written-off", the residual value is clearly £63100. In period 2 the amount of depreciation is 36.9% of that value, namely £23284. The process is repeated for each period and the table following shows the results of the various calculations.

Period	Yearly Allocation £	Accumulated Depreciation £	Residual Value £
1	36900	36900	63100
2	23284	60184	39816
3	14692	74876	25124
4	9271	84147	15853
5	5853	90000	10000

Turning to figure 4.2, which graphs these residual values, we see the diminishing nature of the periodic balances.

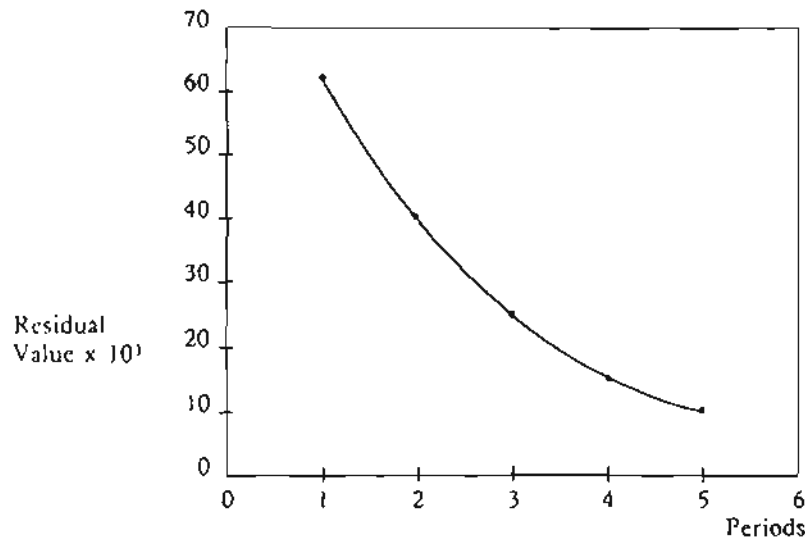


Fig. 4.2

The difference between the two methods should be clearly understood and the advantages of one over the other carefully considered. For example, the straight line method provides for an easily calculated distribution of cost whereas the diminishing balance method allows for a more equitable distribution in that as depreciation charges reduce, expected repair costs will increase, the net effect is reasonable stability.

What then of recording depreciation in the final accounts?

There are two basic styles of book-keeping. The first method which is frequently adopted uses the following double entries:

1. Debit the profit and loss account.
2. Credit the asset account.

The second and more popular style is:

1. Debit the profit and loss account
2. Credit a "Provision for Depreciation" account.

Let us return to the example in chapter two and embellish this data to help make this difference more clear.

Assume the R.M. Enterprises now buys a new machine for £10,000 on credit. Let's say its useful life was estimated by the accountant to be 8 years and its expected break-up value was calculated to be £2000. Let us also assume that the straight line method of depreciation was used and that the accountant recorded the transactions in accordance with the first method. Assuming there to be no other transactions, then in one year's time the relevant accounts in the ledger would be as follows:

Creditor a/c	Machine a/c	Profit and Loss a/c
10000	10000	1000
	1000	
	9000	
	10000	
	9000	

Notice that the closing balance in the asset account is £9000...an amount which would be shown in the balance sheet. As each period comes and goes so this balance would get smaller and smaller until eventually the break-up value is reached. This recording is much in keeping with the principles of the data in the earlier graphs.

Now let us use the second method.

Machine Account	Provision for Depreciation Account	Profit and Loss Account
10000	1000	1000
10000	1000	
10000	1000	

In this instance it will be seen that the amount of the annual charge for depreciation is the same, but it never appears in the asset account. For this reason, the asset account balance is always maintained at original cost. The annual charge certainly appears as a debit in the Profit and Loss Account but the credit entry is carried in the provision account where the amount gradually accumulates.

Notice at the end of the year when the accounts are balanced off that the historical cost of the asset is retained and this value would appear in the balance sheet. Indeed, it would remain in this state until the asset is disposed of. Notice also that there is a constantly increasing balance in the provisions account, which balance is shown in the balance sheet as a reduction to the value of the asset.

Assuming no further business transactions by R.M. Enterprises then the relevant part of the balance sheets from these two differing methods of presentation would now read:

Method 1		Method 2		
Fixed Assets	£	Fixed Assets	£	£
Machine	9000	Machine	10000	
		Less accumulated depreciation	<u>1000</u>	9000

What are the advantages of one style over the other? Consider the following extracts from balance sheets of two separate companies:

(a)		(b)	
Fixed Assets	£	Fixed Assets	£
Plant	1000	Plant	1000

Which is the oldest asset? You just can't tell. Indeed, you are not even sure as to the asset's original cost! This is one failing of the first method we have just considered. If these were represented in accordance with the second method then an entirely different picture might emerge. For example:

(c)		(d)	
Fixed Assets	£	Fixed Assets	£
Plant	10000	Plant	1100
Less accumulated depreciation	<u>9000</u>	Less accumulated depreciation	<u>100</u>
	1000		1000

Styles (c) and (d) now tell us something. Clearly, the latter method is to be preferred; in fact, for Companies falling within the statutory remit of The Companies Acts, it is essential that this method is adopted.

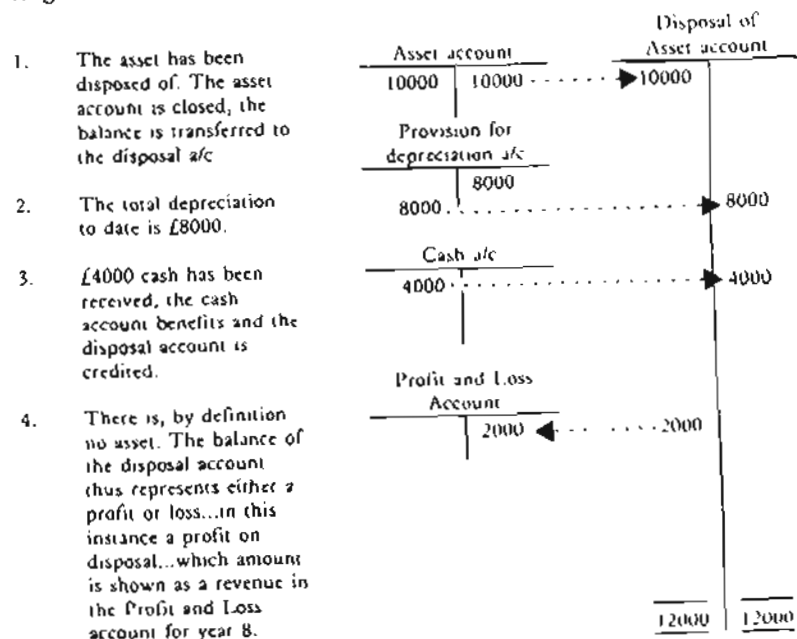
4.5 Disposal of Assets

Assets are clearly not retained in perpetuity. Sometime in their life cycle they are disposed of, and more frequently than not, at a profit or at a loss. That this is the case or not depends on whether the proceeds obtained on disposal exceed the book value of the asset (namely, the original cost less the accumulated depreciation provided for that particular asset since it was purchased).

Disposal is usually carried out via a "Disposal of Asset" account and the accounting is accomplished by:

1. Crediting the asset account and debiting the disposal account with the cost of the asset (in effect closing the original asset account and transferring the cost).
2. Debiting the "Provision for Depreciation" account with the amount of depreciation that has been charged to date and crediting the "Disposal of Asset" account.
3. Completing the double entry for any cash transaction that may take place as a consequence of disposal.
4. Passing to the Profit and Loss account, either the profit on disposal (as a revenue) or the loss on disposal (as an expense).

Let us now do a little "crystal ball" gazing and predict that at the end of 8 years, R.M. Enterprises sells its machine for more than its anticipated scrap value of £2000. A deal is struck at £4000. What is the effect on the ledger accounts?



It would be a worthwhile exercise for the reader to re-construct these accounts on the basis of a cash settlement of £1000 and to show clearly the loss on disposal that would be incurred in year 8. In addition, the reader should reconsider the entire matter of depreciation and disposal by now assuming that the depreciation has been calculated not by the straight line method but by the reducing balance method choosing for themselves an appropriate scrap value, time period and annual percentage.

Finally, the reader must always bear in mind, that disposal can take place at any time. An asset may well last longer than its expected life or it may be replaced earlier than anticipated. If still retained beyond its estimated life, no further depreciation should be charged against profits and the accumulated depreciation should be retained.

Whatever the case, neither should the asset be written off nor the accumulated depreciation transferred until the asset is actually disposed of.

Chapter Five

MANUFACTURING ACCOUNTS

5.1 Introduction

It seems a natural progression for an Organisation to move from simply purchasing goods for the purposes of re-sale to actually manufacturing a finished product for themselves. Having considered the effects of trading on the financial accounts now let us re-consider the matter within the framework of an Organisation which not only trades but now manufactures its own products.

5.2 The use of Production Resources

Before dealing with the matter, let us examine briefly the general manner in which resources are used in the production process. Figure 5.1 summarises this.

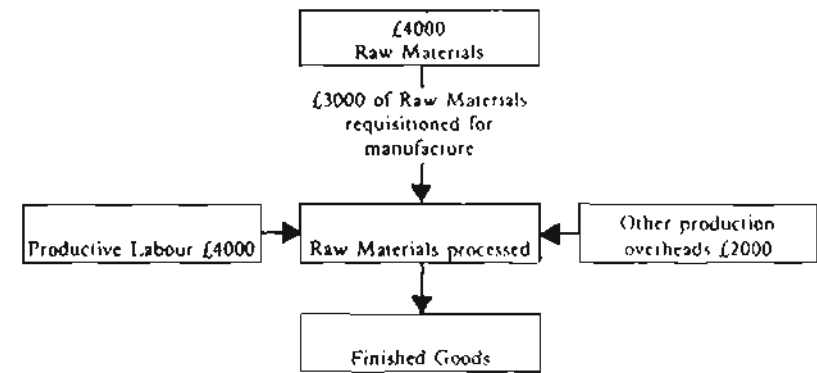


Fig. 5.1

It will be seen that in the first instance, raw materials are purchased. They are then subject to a process which converts them to a finished good. This process invariably involves the consumption of labour and other overheads, for example power. In effect, the initial cost of production which may be represented by the cost of the raw materials, increases as it passes through the production process. In the end, the good is in its manufactured form and in financial terms all necessary costs in its process of conversion have been incurred. The product is now saleable and it has to be sold at a price which is not only sufficient to cover manufacturing costs but those that will be incurred in the process of product disposal.

Consider figure 5.1. It will be observed that at the start of this hypothetical production process £4000 of raw material was purchased, of which £3000 was used in the production process. To this, £6000 additional resources were applied; £4000 wages (which were directly earned by productive labour) and £2000 of other overheads.

This example serves to illustrate the nature of costs in the production process and it acts as a base for demonstrating the production of the relevant final accounts.

5.3 Structuring the Manufacturing Accounts

First, let us consider the management of the raw materials. Some insight into how this is done may be obtained by considering the position vis-a-vis the trader. It will be recalled from chapter three, that the Cost of Goods Sold was assessed by considering the Goods Available for Sale (i.e. opening stock valuation to which was added the purchases made during the course of the financial period) and deducting from that the closing stock valuation. The matter, in essence, is no different when we consider the assessment of raw materials; it is opening valuation of raw materials plus that which has been purchased in the course of the financial period giving the cost of Raw Materials Available for Consumption. By adjusting for closing stock valuation, we obtain, in cost terms, the material that actually has been requisitioned by the production process.

We might, therefore, have:

	£	£
RAW MATERIALS		
Opening Stock Valuation		10000
Purchases of raw materials	7500	
Plus carriage in	<u>1000</u>	
	8500	
less returns	<u>1500</u>	
		<u>7000</u>
Raw Materials Available for use		17000
less Closing Stock		<u>7500</u>
Cost of Raw Materials Consumed		9500

What this tells us is that £9500 of raw materials were requisitioned by production during the financial period and that £9500 is currently at various stages in the process. Some may be one-half way through, some may be finished, indeed, some may have already been sold.

It will be recalled that as expenses were incurred in the trading process, these were registered in the Profit and Loss account. It might be thought that this would also be the case with respect to manufacturing expenses. It is not. What then happens to these expenses? Here, we are interested in obtaining an indication as to what is the total cost of producing the goods which we want to sell and to carry any of the components of manufacturing costs in the profit and loss account will result in an inaccurate assessment. As a consequence, the costs specific to the production process are carried in the manufacturing account and in such a fashion that certain elements of cost may be easily identified. One of these costs is known as **Prime Cost**. This element of Total Cost is represented by the Cost of Raw Materials Consumed and any costs that are **DIRECTLY** associated with the production process. Customarily, this includes productive labour but not other, indirect costs, an aspect to which we will turn next. In the meantime, if we were to assume that £5000 of labour had been paid to date, then the Prime Cost of production would be:

	£	£
RAW MATERIALS		
Opening Stock Valuation		10000
Purchases of raw materials	7500	
plus carriage in	<u>1000</u>	
	8500	
less returns	<u>1500</u>	
		<u>7000</u>
Raw Materials available for use		17000
Less Closing Stock		<u>7500</u>
Cost of Raw Materials consumed		9500
DIRECT COSTS		
Productive labour		<u>5000</u>
PRIME COST		14500

Let us now turn to the other costs of production, namely the indirect costs. In other words, those costs that cannot directly be measured against the unit of production. Again, these are accounted for in the Manufacturing Account and they follow Prime Cost. The consequence may be the following statement:

PRIME COST		14500
FACTORY OVERHEADS		
Salaries	2500	
Rent and rates	3450	
Heat	<u>1250</u>	
		<u>7200</u>
TOTAL COST OF MANUFACTURE		21700

It will be recalled that the purpose is to establish what the ultimate cost is of the goods that have been manufactured. In the process of production there exist goods that are partially complete. Adjustments must be made to cater for such stocks. In other words, account must be taken for the opening and closing valuations of stock which remain unfinished and the Total Costs of Manufacture as above would be adjusted for any increase (or decrease) in Work-in-Progress that may have materialised over the financial period under consideration. If Work-in-Progress has increased by, say £2700 then the Total Cost of Manufacture must be reduced by this amount in order that the correct valuation of finished goods is derived. Clearly, if Work-in-Progress has decreased then the Finished Goods Valuation will be represented by the Total Costs of Manufacture plus the decrease. The following two examples will help to make the effects clear. Example A shows what happens when the opening stock of Work-in-Progress is higher than the closing valuation and example B the converse.

Example A		Example B	
Total Cost of Manufacture	£ 21700	Total Cost of Manufacture	2170
Less increase in Work-in-Progress	<u>2700</u>	Add decrease in Work-in-Progress	<u>130</u>
Cost of Production	19000	Cost of Production	2300

In previous chapters, the reader will have seen how there always lay behind the items that appeared in the trading account, the ledger accounts. It is the same for the manufacturing account. Ledger accounts are retained for the purposes of handling the purchase of raw material their returns etc. Accounts exist to accommodate the direct and indirect expenses. The principles by which these various accounts are handled remain the same and for this reason unnecessary repetition is avoided here.

5.4

The relationship between what we have considered and the process of trading should now be more clear, for instead of purchasing finished goods, the business is now manufacturing its own. After accounting for the various on-costs in the production process, the balance of the manufacturing account is passed to the trading account where the selling process is noted. By continuing with our simple example this will become clear. For a moment, however, let us consider this matter within the framework of a 'ledger account' format for the manufacturing account:

Manufacturing Account	
Raw Material consumed	Cost of Production t/f to Trading a/c
Direct costs	
Prime costs	
Indirect costs	
Less increase in Work-in-Progress	
Cost of Production	

Trading Account	
Opening valuation of finished goods	←
Cost of Production t/f from Manufacturing	
Goods available for sale	
Less Closing valuation of finished goods	
Cost of Goods Sold	

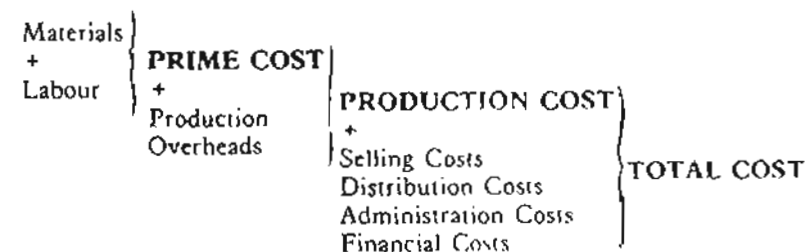
5.5

It will be seen that the concept of double entry has been maintained with the balance in the Manufacturing Account (sometimes with a margin added for gross profit on manufacture) being transferred to the Trading Account, this latter account, of course, being adjusted, as in earlier chapters, for any increases (or decreases) in the finished goods inventory, thereby obtaining the Cost of Goods Available for Sale and the Cost of Goods Sold. Thereafter, the data is handled as outlined in Chapters 1 to 4, namely Gross Profit on Trading is established and eventually, Net Profit.

The reader will have noted that the format of the layout has varied. In this later example it is more in keeping with the traditional lines of presentation whereas in the earlier part of this chapter, that data seemed simply a series of statements. Nevertheless, they were in keeping with the more modern form of presentation which is to set accounting data in vertical form.

The Elements of Cost

Another feature worth commenting upon is the relationship between this process and costing, an aspect to which we will return later in this text. Note that:



and hence:

$$\text{TOTAL COST} + \text{PROFIT} = \text{SELLING PRICE}$$

The Concepts and Conventions

Clearly, we are now at the stage of being able to carry out some basic interpretation of accounts. For example, we can comment upon the unit costs if we know the volume produced; we can comment upon the proportions of expenses one to the other; we can calculate a number of important ratios. Indeed, this is a matter to which we will return in a later chapter.

For a moment consider the following extract from the final reported accounts of a well known organisation. Your attention is directed to the fact that the auditors comment upon the accounts giving a "true and fair view of the profits".

We have audited the accounts on pages 34 to 45 in accordance with approved accounting standards.

In our opinion, the balance sheet of the Company gives a true and fair view of the state of the Company's affairs at 31 December, 1985 and complies with the Companies Act 1985, and the consolidated accounts comply with the provisions of the Companies Act 1985 applicable to insurance companies.

Deloitte Haskins & Sells

Chartered Accountants
London 16 April 1986

As potential users of the information that accounts give, the reader, like the auditor, must feel "safe" in what it is that they have to say, particularly where there exist large complex organisations with equally complex accounting systems. For these, and other reasons, the accounting profession has adopted a number of accounting concepts and conventions which are of importance in bringing meaningfulness to financial statements and other accounting reports. As we move towards considering the information that accounts give it is perhaps appropriate, at this stage to consider these principles, principles whose purpose is to try and bring some objectivity to the science of book-keeping.

5.5.1 The Money Measurement Concept

There are certain aspects of a business which are not possible to record in the books of a business but which nevertheless may be important in decision-making. The books are therefore unable to tell the whole story of an organisation. In order to obtain a complete over-view the reader must look beyond the ledger entries, entries which can only give an assessment in money terms.

5.5.2 The Double Entry Concept

As we have seen, all business transactions are based upon the exchange of value. Every outgoing obtains a benefit, an aspect that is recorded in the books.

5.5.3 The Business Entity Concept

We know that we consider the business to be a separate entity from the owner(s). This is easily seen within the framework of the Corporate Body, but less so in the instance of a Sole Trader. Whatever the case, only the transactions of the business are recorded; income and expenditure that is private must be ignored in the books.

5.5.4 The Cost Concept

We have considered the problems associated with the valuation of stock. What is the cost of its replacement? Is it market value? Is it selling price? For the purposes of the accounts they are recorded at cost paid on the value received by the business.

5.5.5 The Going Concern Concept

The value of certain assets may vary according to the circumstances. The value taken, is the value to the business based on it having an infinite life. Intrinsic value is not considered.

It is worth stressing the fact that assets under a forced sale may be of much less value than either their book value or their market price under conditions where a sale is not forced.

That value, of course, may be subject to adjustment (for example, following depreciation)

5.5.6 The Accrual Concept

Cash which has been received or paid out by an organisation may not necessarily represent the true income or expenditure for a particular financial period. Hence, adjustments must be made for receipts or payments that have been made either in advance or in arrears.

5.5.7 The Consistency Convention

It is appropriate for a business to maintain consistency in its methods. For example, it would be inappropriate to jump to and from one method to another in depreciating an asset. It is important that users be able to assume that consecutive statements are based upon similar principles.

5.5.8 The Materiality Convention

The advantages of systems implementation should always exceed the costs. Installation should always be justified and the charge should not be made if it is of little significance.

5.5.9 The Conservatism Convention

It is always best to favour a method or procedure that yields the lesser net income or asset value. For this reason:

- (a) Never anticipate profits
- (b) Always enter stock at the lowest of two values:
 - (i) Cost
 - or
 - (ii) Replacement
- (c) Anticipate possible losses (e.g. Bad Debts).

NEVER at selling price.

5.6 Revision

What we have now considered is the creation of the final accounts of an organisation that is involved in both a Manufacturing and a Trading Function. The ultimate aim, as before, is the evaluation of profitability. Let us therefore encapsulate what we have done so far within the framework of two examples. The first deals with what has been covered up to and including Chapter 4. In this instance, however, only the Trial Balance and the Trading and Profit and Loss account and Balance Sheets are given by way of answer. The second deals, in principle, with the elements of this chapter and the production of the final accounts of a Manufacturing Organisation. In this example, however, it is only the final accounts that are presented. The reader's attention is drawn to the more modern format of these presentations.

EXAMPLE 1

John Smith started business as a sole trader on 1 January 1987 with cash in the bank of £50,000.

the following transactions took place:

		£
Jan. 1	Obtained from Mrs Smith a 10 year interest free, cash loan	5,000.00
Jan. 1	Purchased premises by Cash	40,000.00
Jan. 1	Bought Goods on credit from W. Martin	2,500.00
Jan. 1	Bought Motor Van by Cash	5,000.00
Jan. 2	Bought Warehouse fixtures and fittings by cash	400.00
Jan. 11	Sold Goods to T. Crown on credit	800.00
Jan. 21	Paid W. Martin by cheque	1,500.00
Feb. 1	Sold Goods to W. Wilson on credit	1,000.00
Feb. 5	Received cheque from T.Crown	700.00
Feb. 5	Allowed T. Crown a discount	20.00
Feb. 6	Paid wages by cheque	700.00
Mar. 18	Bought goods for cash	300.00
Apr.9	Sold Goods to L. Robinson on credit	1,700.00
Apr. 9	T. Crown returns goods	80.00
May 10	Purchased Goods from F. Pearson on credit	1,300.00
May 11	Paid W. Martin in settlement by cheque	950.00
May 11	Discount allowed by W. Martin	50.00
June 12	Paid carriage by cash on goods sold	20.00
June 13	Cheque drawn for wages	700.00
July 14	Bought goods from W. Martin on credit	150.00
July 15	Bought goods for cash	40.00
Aug. 16	Sold goods to W. Wilson on credit	1,800.00
Sep. 17	W. Wilson paid by cheque	2,000.00
Sep. 18	Purchased goods from H. Wood on credit	850.00
Sep. 19	Sold goods for cash	920.00
Sep. 19	Goods returned to H. Wood	100.00
Sep. 20	Cheque drawn to pay wages	700.00

Sep. 21	Sent cheque to H. Wood	720.00
Sep. 21	Discount allowed by H. Wood	30.00
Oct 22	Sold goods to T. Crown on credit	1,300.00
Oct. 23	Bought goods from W. Martin on credit	2,400.00
Oct 24	Bought goods for cash	730.00
Oct 25	Bought £500 goods by cash from F. Pimms and paid £50 carriage charges by cash	550.00
Oct 25	Sent cheque to W. Martin	2,000.00
Oct 26	Received cheque from T. Crown	1,000.00
Nov. 27	Cheque drawn for wages payment purposes	700.00
Dec. 28	Paid Electricity Account by cheque	50.00
Dec. 29	Paid Rates by cheque	80.00
Dec. 30	John Smith draw by cheque for personal use	150.00
(a)	Prepare the appropriate ledger accounts	
(b)	Extract a Trial Balance as at 31st December, 1987	
(c)	Prepare appropriate Trading and Profit and Loss accounts and Balance Sheet as at 31st December, 1987, subject to the following adjustments:	

- (i) Wages for the year are overpaid £350.00
- (ii) Rent due amounts to £40.00
- (iii) Electricity due amounts to £15.00

(d)

For information:

- (i) Stock on hand was valued at the year end as £3250.00.

Trial Balance J. Smith 31 12 1987

Account	Ledger Account Balances	
	Dr	Cr
	£	£
Cash	8730	
Bank		4400
Drawings	150	
Capital		50000
Mrs Smith Loan a/c		5000
Premises	40000	
Purchases	8700	
Sales		7520
Returns Out		100
Returns In	80	
Carriage in	50	
Motor Van	5000	
Fixtures and Fittings	400	
Creditors	M 550	
	P <u>1300</u>	1850
Debtors	R 1700	
	W 800	
	C <u>300</u>	2800
Discounts Allowed	20	
Discounts received		80
Wages	2800	
Carriage Out	20	
Rates	80	
Electricity	50	
	<u>68950</u>	<u>68950</u>

Trading and Profit and Loss Account J. Smith 31 12 1987

Sales		7520
Less Returns In		<u>80</u>
		7440
Purchases	8770	
Less Returns Out	<u>100</u>	
	8670	
Plus Carriage in	<u>50</u>	
Goods Available for Sale	8720	
Less Closing Stock	<u>3250</u>	
Cost of Goods Sold		5470
Gross Profit		1970
Discounts Received		<u>80</u>
		2050
Wages	2800	
Less Prepaid	<u>350</u>	2450
Electricity	50	
Plus due	<u>15</u>	65
Carriage out		20
Rates		80
Rent Due		40
Discounts allowed		<u>20</u>
Total expenses		2675
NET LOSS		625

Balance Sheet J. Smith as at 31 December 1987

	£	£	£
Fixed Assets			
Premises			40000
Motor Van			5000
Fixtures and Fittings			<u>400</u>
			45400
Current Assets			
Stock (1/1)		3250	
Debtors		2800	
Cash		8730	
Prepayments		<u>350</u>	
		15130	
Less Liabilities			
less than 1 Year			
Creditors	1850		
Bank Overdraft	4400		
Accruals	<u>55</u>		
		<u>6305</u>	
Working Capital			<u>8825</u>
Total Net Assets			54225
Less Liabilities			
greater than 1 Year			
Loan from Mrs Smith			<u>5000</u>
Net Worth			<u>49225</u>
Financed by:			
Capital employed			
Opening Balance		50000	
Less Net Loss		<u>625</u>	
		49375	
Less Drawings		<u>150</u>	
		<u>49225</u>	

EXAMPLE 2

A. Stewart carries on business as a manufacturer. The following trial balance was extracted from his ledger on 30th June 1987.

	£	£
	Dr.	Cr.
Advertising	900	
Bank		11560
Capital		19900
Cash	700	
Creditors		7500
Delivery Van.		
1. Cost	2000	
2. Depreciation		400
Drawings	2500	
Debtors	8500	
General Expenses	1000	
Heat and Light	1600	
Manufacturing Wages	10000	
Office Salaries	2500	
Stock (Raw Materials: 30.6.86)	7000	
Office Furniture		
1. Cost	800	
2. Depreciation		240
Plant		
1. Cost	10000	
2. Depreciation		3000
Power	1800	
Property cost	4000	
Purchases		
1. Raw materials	50000	
2. Goods for resale	2000	
Rates and Insurance	300	
Sales		72000
Work in progress (30.6.86)	3000	
Stock (Finished Goods 30.6.86)	6000	

The following information is also available:

- Stocks at 30.6.87 were valued

Raw Materials	£8000
Finished Goods	£6300
- Work in progress at 30.6.87 was valued at £4200
- Depreciation is to be provided by the straight line method as follows.

Plant	10%
Office Furniture	5%
Delivery Van	20%

4. Expenses are to be allocated thus:
- | | Factory | Office |
|---------------------|---------|--------|
| Heat and Light | 80% | 20% |
| General Expenses | 75% | 25% |
| Rates and Insurance | 80% | 20% |
5. The purchase of £2000 goods for resale was a special transaction to enable an order to a customer to be completed at a time when the manufacturer's plant broke down.
6. Finished Goods are transferred at cost of production plus 10%.

**Manufacturing Trading and Profit and Loss Account
for A. Stewart, 30.6.87**

	£	£	£	£
Sales				72000
Raw Materials				
Opening Stock		7000		
Purchases		<u>50000</u>		
Raw materials available		57000		
Less Closing Stock		<u>8000</u>		
Raw Materials Consumed		49000		
Direct Costs				
Direct Wages		<u>10000</u>		
PRIME COST		59000		
Factory Overheads				
General Expenses	750			
Rates and Insurance	240			
Heat and Light	1280			
Increase in Depreciation (plant)	1000			
Power	<u>1800</u>		<u>5070</u>	
			64070	
Work in Progress				
Add Opening Stock		<u>3000</u>		
		67070		
Less Closing Stock		<u>4200</u>		
		62870		
Add Gross Margin on Manufacture		<u>6287</u>		
Cost of Production				69157

Cost of Production			69157
Finished Goods			
Opening stock	6000		
Goods purchased for resale	<u>2000</u>		<u>8000</u>
Goods available for sale			77157
Closing Stock of finished goods			<u>6300</u>
Cost of goods sold			<u>70857</u>
Gross Profit on Trading			1143
Gross Profit on Manufacture			<u>6287</u>
			7430
Selling and Distribution Expenses:			
Heat and Light	320		
Rates	60		
Advertising	900		
Depreciation on Van	<u>400</u>		<u>1680</u>
Administration Expenses:			
General	250		
Depreciation on Office Furniture	40		
Office Salaries	<u>2500</u>		<u>2790</u>
Total Expenses			<u>4470</u>
Net Profit			<u>2960</u>

Balance Sheet A. Stewart as at 30.6.87

	£	£	£
Fixed Assets	Cost	Depreciation	Net Value
Property	4000	nil	4000
Plant	10000	4000	6000
Furniture	800	280	520
Van	<u>2000</u>	<u>800</u>	<u>1200</u>
	<u>16800</u>	<u>5080</u>	<u>11720</u>
Current Assets			
Stock:			
Raw Materials	8000		
Finished Goods	6300		
Work in Progress	<u>4200</u>	18500	
Debtors		8500	
Cash		<u>700</u>	
		27700	
Less Liabilities			
Less Than 1 Year			
Creditors	7500		
Bank overdraft	<u>11560</u>	<u>19060</u>	
Working Capital			<u>8640</u>
Net Worth			<u>20360</u>
Financed By:			
Capital			19900
add Net Profit			<u>2460</u>
			22860
less drawings			<u>2500</u>
			<u>20360</u>

Chapter Six

PARTNERSHIP ACCOUNTS

6.1 Introduction to Partnerships

In the process of building a business, there frequently arises the need for further expansion. The sole trader, for example, may reach the point where he simply has no further access to capital. Perhaps he has even reached the limit of his management skill and time has become a severe constraint. A variety of techniques are available whereby such problems may be overcome, not least the formation of a partnership. This technique introduces others into the business who are prepared to bring additional capital (either in terms of cash or other asset). More frequently than not, partners take specific roles when they join the organisation but it is not necessarily a pre-requisite.

6.2 The Partnership Acts

What is a partnership? According to The Partnership Act (1890), it is a relationship with a common view to profits. In accordance with the statute, any relationship which is subject to the Companies Act or subject of a Royal Charter is NOT a Partnership within the meaning of the Act.

Clearly, a partnership cannot comprise less than two persons and the Companies Act, with some exceptions, places an upper ceiling, namely twenty. Any formation in excess of this number cannot be constituted as a Partnership. The exceptions to the rule are:

1. Solicitors.
2. Accountants
3. Members of the Stock Exchange.

In general, those who agree to form a Partnership may make what arrangements they please but the rules and regulations are more usually set out in a document known as "The Deed of Partnership". This document is an important means of expressing the relationship between partners and it should deal with such specifics as:

1. The duration of the partnership (for example, for 10 years or until death).
2. The extent of partners' Capital commitment.
3. The apportionment of profits (usually on a 'proportion of capital' basis but this is not always the case for some may bring the brawn, others the brains and others the money!)
4. The extent of interest to be charged, for example:
 - (a) On drawings (in a hope to keep these to a minimum)
 - (b) On Capital (therefore reflecting the different risks taken).
5. How Goodwill is to be determined.
6. The amount to be paid on death or retirement.
7. The duties and responsibilities of partners.
8. The salaries, if any, to be paid.

In the event of there being no Deed of Partnership, then, in the event of a dispute, the relationship between the partners will be determined by Section 24 of the 1890 Act, which amongst other things, says:

1. There will be an equal share in capital and profits (and loss!).
2. That five per cent interest is to be paid by the Partnership on that portion of the capital advance which exceeds the amount which the partners agreed to contribute.
3. That there is no entitlement to interest on capital before profits have been ascertained.
4. That partners are NOT entitled to a salary in return for services to the partnership

These, are the principal provisions of the Act but there are others which concern themselves, for example, with the introduction of new partners, access to the books of accounts and the nature of their policy-making. It has to be said, however, that this act is a codifying act and the precise nature of the relationship may still have to "fall-back" to common law.

Clearly, the partnership relationship is not perfect, it does have some disadvantages. First, Partners may find legal action being taken against their private possessions in order that creditors may recover from a failing by the partnership to settle their debts. Second, each partner is liable for action(s) of his colleagues.

One means of overcoming these shortcomings is to form the partnership under the Limited Partnership Act of 1907. The effect, briefly, is that "General" partners are fully liable with those who are "Limited" not being liable beyond the capital they invest.

6.3 The Structure of Partnership Accounts

We have seen from our earlier discussions, that the manufacturing, trading and profit and loss accounts were used to show the profitability of the operation. It will be recalled that the profitability of the Sole Trader resulted in an addition to his capital. In the case of the partnership, however, there is a multiplicity of ownership and clearly there must be some special features in their accounts. Essentially, the structure of the accounts is no different from what we have considered so far with the odd exceptions. These are as follows:

1. Capital Accounts : With the sole trader, a single capital account was shown. With a partnership, each partner has his own.
2. Current Accounts : These accounts replace the "drawings" account of the sole trader. There is, for each partner, a "current" account which shows the change in the financial relationship between the partners and the partnership that has taken place during the current financial period.

3. Appropriation : This account is an extension of the profit and loss account. The net trading profit of the partnership is carried down as a credit to this account, appropriate adjustments are made (such as interest on capital, drawings, partners' salaries) and the balance is the final profit available for distribution to the partners in accordance with the agreement. The double entry is to the current accounts.

A simple example will make this clear. Consider example 2 in the last chapter. There, the business concluded with a profit of £2960; an amount which raised the owner's equity in the business to £20,360. What, however, if this business were a partnership comprising, say three partners, no longer would there have been a single capital account showing a balance of £19900. There would have been three perhaps as follows:

Partner A	Partner B	Partner C
6000	6000	7900

Notice the effect: three separate accounts, therefore three separate balances in the trial balance and, of course, three separate entries in the balance sheet. Whatever the case, if any direct capital injections (or capital reductions) are made by the partners, then these will appear in the capital accounts. Beyond that, no other entries are made to them.

We have said that the Current Accounts replace the drawings accounts. In the trial balance of that example, total drawings were shown as £2500 but this was for the sole proprietor of that business. Continuing with our assumption concerning the presence of three partners if these drawings had been made by one partner alone the entry in the ledger accounts would not have been:

Drawings Account		Current Account (Partner A)
2500	but, say	2500

Let us, now continue with our assumption of three partners and that each made independent drawings totalling £2500 thus:

Current Account (Partner A)	Current Account (Partner B)	Current Account (Partner C)
1000	1000	500

These accounts are used to establish the nature of any change in the partner's equity in the business during the financial period. They identify the rise and fall in commitment and hence they are adjusted for such matters as we have already considered above.

Let us now make some further assumptions. Let us say that:

1. Five per cent interest is to be paid by the Partnership on capital in excess £5000.
2. Ten per cent interest is to be paid on cash drawings.
3. A salary of £500 is to be paid to each partner.

These are clearly not the expenses of running the Partnership. For this reason they are considered as an appropriation by the partners of profits that the business has earned. In effect the profit is distributed via the appropriation account to the current accounts, the balances of which are either an addition or reduction in partners' equity.

As a partnership, the balances of The Profit and Loss Account will now be carried to the Appropriation Account, with the various second entries of adjustments appearing in the partner's current accounts thus:

Partnership XYZ Appropriation Account			
		Net profit c/d	2960
<i>Interest on capital</i>		<i>Interest on Drawings</i>	
Partner A	50	Partner A	100
Partner B	50	Partner B	100
Partner C	145	Partner C	50
	245		250
<i>Salaries</i>			
Partner A	500		
Partner B	500		
Partner C	500		1500
<i>Balances of profits</i>			
Partner A	488		
Partner B	488		
Partner C	489		1465
	<u>£3210</u>		<u>£3210</u>

For the sake of convenience, only one current account has been fully completed to show the double entries. The reader is left to complete the rest.

Current Account (Partner A)			
Drawings	1000	Interest on Capital	50
Interest on Drawings	100	Salaries	500
		Profit appropriation	488
		Balances c/d	62
	<u>£1100</u>		<u>£1100</u>
Balance b/d	62		

All but two of the second entries for these accounts have been shown above. The second entries which are missing from this example are:

1. That of net profit (which is in the P & L account).
- and 2. That of the drawings (which is in the cash account).

Notice the effect, the balance in the current accounts now show the collective effect of adjustments made during the financial period. They are not closed off by transferring the balances to partners' relative capital accounts. The balance is carried forward into the following period.

6.4 The Balance Sheet

No statutory requirement is laid down with respect to the presentation of either the final accounts or the balance sheet of a partnership but in general they are the same as we have already considered within the framework of the sole trader. There are one or two exceptions. For the balance sheet, the exception is that the capital of each partner should be clearly identified as should the balance in their current accounts. The balances on these two accounts should not be consolidated into a single, representative amount for each partner. Indeed, the practice is sometimes to summarise the content of the current accounts. For example, the relevant capital section of a balance sheet for a partnership might look like:

Balance Sheet of Partnership XYZ as at --/--/--

<i>Capital Accounts</i>		
Partner A	1000	
Partner B	1000	
Partner C	<u>1000</u>	3000
<i>Current Accounts</i>		
Partner A	500	
Partner B	500	
Partner C	<u>500</u>	1500

As an alternative presentation, the net equity of each partner may be identified in the balance sheet by presenting, for each partner their capital with that amount either increased or decreased by the balance in their current account. It is simply a matter of convenience.

6.5 Changes in the Partnership

Clearly a partnership is an ongoing organisation. It is created, new partners join, others leave the business either through retirement or death. The effects of such changes are that the old partnership ceases and a new one is created. To ensure equity, certain adjustments have to be made to ensure that those forming a new partnership or new partners entering an existing business do not obtain an unfair advantage and that existing partners who are leaving the partnership do remove from the business that which is rightfully theirs.

6.5.1 The Creation of a Partnership

Let us first consider the case where two sole traders decide to form a new partnership. Clearly, there is a need to prior agreement as to what elements of each independent business are to be included in the new venture. Here is a list of hypothetical assets and liabilities which represent the independent balances of the two businesses:

	Business A	Business B	Sum
	£	£	£
Cash in Bank	2400	—	2400
Cash in hand	240	160	400
Debtors	4600	6200	10800