

## STUDENTS' WORKBOOK

### CHAPTER 1 WHAT IS ACCOUNTING? AND WHY STUDY IT ANYWAY?

#### 1.1 Introduction

The purposes of chapter one of the main text are two fold. First, it introduces the basic characteristics of accounting which, once understood, provide a basis on which to build bookkeeping and financial reporting practices. Second, and perhaps more importantly at this early stage, it challenges you to think about: why you are undertaking a course of study in accounting; and, how you feel about studying accounting.

#### 1.2 Discussion topics

These questions are simply to reinforce your familiarity with the language and concepts from Chapter 1 of the text.

##### *Question 1.1*

Obtain two sets of financial statements (sometimes called 'the annual report' or 'the financial accounts') - one of a company and one of some other type of organization with which you are familiar (for example: the college or university at which you are studying, the Students' Union, your old school, an organization in which you have worked or one that produce goods or services with which you are familiar - the local health trust, the local authority, a sports good manufacturer or a charity perhaps). These financial statements should give you a 'picture' of the organization.

Required:

- (i) Compare your perception of the main characteristics of the organization and what you see as its objectives, with the impression and information given by the financial statements.
- (ii) Discuss who you think might want information about these organizations and what information they might want. Is this information in the financial statements?
- (iii) Discuss what additional information you think might usefully be included by these organizations in their financial statements.
- (iv) How do the financial statements of the two organizations differ?

(We recommend that you also come back to this question and use it as a revision exercise after studying Chapters 2 and 3 and after the completion of your first course of study.)

### *Question 1.2*

Using one of the annual reports which you have obtained for Question 1.1 above – find the following information:

- (i) The main business of the organization
- (ii) How many people the organization employs
- (iii) The average age of the directors (or equivalent) of the organization
- (iv) The name of the auditors of the business
- (v) The financial year end of this organization
- (vi) How much money the organization has in the bank/owes the bank
- (vii) How much the organization owes its creditors
- (viii) The page number where you can find an auditors report

How easy was it to find this information? What other information did you see at the same time? Did you understand this other information? What function do you think annual reports serve?

### *Question 1.3*

State the four differentiating characteristics of the accounting activity and describe how they apply in the case of:

- (i) a corner shop;
- (ii) a hospital;
- (iii) your college;
- (iv) a firm of chartered accountants;
- (v) British Petroleum plc or another major multi-national corporation.

### **1.3 Class exercises**

Here are two exercises to do in class in groups.

#### *Question 1.4 - constructing a 'learning contract'*

The objective of this exercise is to establish the ground rules of the tutorial/seminar/workshop where you, in small group settings, will be working on problems from the Workbook.

On your own, prepare two lists: one entitled "the things I hope to get from this tutorial/seminar/workshop" the other entitled "my responsibilities within this tutorial/seminar/workshop". Under each heading try and list at least 8 items. How can your requirements be met by your tutor and fellow class members? How can you discharge your responsibilities? Think of how these lists impact on your tutor - remember he/she is also part of your class.

Working in pairs or threes discuss items you have on each list and draw up a common list. Share your lists with the class. This will culminate in two lists under each heading from all class members. Agree as a class what should be on these two lists from the variety of suggestions that have been obtained. The agreed list you have prepared is often called a 'learning contract'. A

learning contract comprises a list of the expectations and commitments that a group collectively make in a particular learning environment. It is a useful way to set the ground rules for group meetings and can be returned to in the future if the small group sessions are not operating the way you feel they should.

### *Question 1.5 - education experiences*

Everyone is involved in a wide array of education experiences over their whole lives and it is hoped that, on average, these experiences are positive ones for the individual. It is useful to reflect on past experiences in order to gain insights into what constitutes a positive learning experience. In this way we hope to increase the probability that your time at college or university will be exciting, stimulating and enjoyable. Indeed, this may be an appropriate time to consider if you expect your studies to excite you and if not, why not? We believe that learning should always be fun and suggest the following exercise to start you on the path to understanding **how** you learn and **why** you enjoy learning.

On your own, make up two lists: one entitled "positive learning experiences" the other entitled "negative learning experience". Briefly describe situations that you have encountered that fall into each category. Share one item from each list with the class. Taking each list in turn try to identify the common elements from the list of positive and negative learning experiences. In pairs or threes discuss each element identified and make a common and agreed list of elements which lead to positive and negative learning experiences. As a class make an overall list of these items.

- (a) How do the above factors relate to your present learning situation? What can you do to ensure the positive factors always remain a part of your learning experiences?
- (b) Can you describe your past learning experiences as being characterised as deep or shallow learning?
- (c) How do your past education experiences relate to Blooms's taxonomy of learning? (See figure 1.9 of the chapter).

Again be sure to include your tutor in this exercise, he/she is also involved in your current learning experience, has had past learning experiences and is likely to be having his/her own learning experience by teaching you.

## STUDENTS' WORKBOOK

### CHAPTER 2 CASH, CASH BOOKS, AND UNITS OF ACCOUNT

#### 2.1 Introduction

This chapter of the workbook consists of three sections. Section 2.2 contains three simple cashbook exercises to reinforce the basic message of the text. Section 2.3 contains a number of discussion questions and section 2.4 contains an answer to Question 2.1 to allow you to check your own answer. DO NOT consult this or any other answers in the Workbook until you have attempted the questions. Whilst your tutor may set one or more of these problems for homework or for class discussion, we recommend that you check through all of them for revision to make sure you followed the material in the chapter.

#### 2.2 Computational problems

The following question is an extension of the Mr Brain example in the text. It should cause you no problems at all if you follow the text carefully.

##### *Question 2.1 Mr Brain's second term at college*

The information in Table 2.1 relates to A. Brain's cash transactions during his second term at college. In addition, you find out that at the end of the term Mr Brain owes the bar £36 for March, and the landlord £15 for March plus a £5 retainer. He has no food or drink left.

REMEMBER Brain had £6 left at the end of last term and so we must start him off with £6 this term.

Required:

- (i) Draw up Mr Brain's columnar cash book for his second term. (Do not forget he has some cash left from last term.)
- (ii) Make a list of what he has 'left over' (his assets and liabilities) and their financial 'value'.
- (iii) What additional financial and non-financial record(s) do you think Mr Brain could usefully consider keeping? Why?

Table 2.1 - A. Brain's second term

Date	Description	Value	Receipt (+) Payment (-)
20 Jan.	Receives another cheque from parents	200	+
21 Jan.	Pay landlord arrears and rent for January	35	-
22 Jan.	Pay December bar bill	34	-
22 Jan.	Stock up on food	20	-
24 Jan.	Buy textbooks	15	-
2 Feb.	Pay rent for February	20	-
4 Feb.	Sell first textbook	4	+
5 Feb.	Sell dartboard	7	+
6 Feb.	Pay bar bill for January	25	-
10 Feb.	Jack repays part of loan	10	+
10 Feb.	Buy bicycle	45	-
15 Feb.	Repay Fred	2	-
20 Feb.	Loan from parents	100	+
20 Feb.	Withdraw last of savings	60	+
21 Feb.	Buy disco unit and records	140	-
21 Feb.	Buy trailer for bicycle	25	-
1 Mar.	Disco for Accounting Society	25	+
2 Mar.	Pay bar bill for February	40	-
3 Mar.	Buy some more food	5	-
15 Mar.	Disco for Student's Union	25	+
25 Mar.	Leave landlord towards rent	10	-
26 Mar.	Train ticket home	5	-

### Question 2.2

Draw up a columnar cash book for your first week or fortnight at college and then consider the following:

- (i) What use could be made of the cashbook?
- (ii) What additional financial and non-financial information might it be worth keeping?
- (iii) Why have you made the choices you have in part (ii)?

### Question 2.3

Wakanui Kayaks is a small business jointly owned by Melinda and Ross Chapman. Melinda and Ross have a shop in Perth where they sell kayaks, kayaking equipment and other outdoor gear. During the week the following events occurred which affect the cash position of the organization.

Monday:

Cash sales	1,840
Paid electricity bill	180
Sold old display stand	160
Paid for new stationery	90

Tuesday:

Cash sales	1,920
Paid wages for last week	840
Damaged goods returned by customer (refunded cash)	160

Wednesday:

Cash sales	1,880
Withdrew cash for own use	260
Paid for new stock	1,010
Made donation to local charity	100

Thursday:

Cash sales	2,010
Paid cleaning expenses for week	140
Paid rent for the month	900
Paid bill owed supplier	610

Friday:

Cash Sales	2,150
Received refund on faulty stock delivered	540
Purchased new display stand	720

Saturday:

Cash sales	1,400
Received money a customer owed	500

Required:

Draw up a cash book to reflect these events. On Monday Wakanui Kayaks had £8,090 of cash in the bank.

Hint: first decide if items represent a receipt or payment of cash and then record them in the cashbook.

### **2.3 Discussion topics**

These questions are simply to reinforce your familiarity with the language and concepts from Chapter 2 of the text.

#### *Question 2.4*

- (i) What accounting records would you expect your local grocer/general store to keep and why?
- (ii) Would they be any different from those kept by your local doctor?
- (ii) If so, why?
- (iii) In what ways would they differ?

#### *Question 2.5*

- (i) What can a cashbook tell you?
- (ii) What does a cashbook not tell you?
- (iii) In what way do the four distinguishing characteristics of accounting (i.e. accounting entities, economic events, financial description, and users) affect our treatment of Wakanui Kayaks in Question 2.3?

#### *Question 2.6*

- (i) State three reasons why an accounting entity (and the accountant) might give information to someone.
- (ii) Why are people presumed to want information about an accounting entity?
- (iii) Why might strictly financial information about (say) a charity be less than completely useful to people?

### **2.4 Selected answers to computational problems**

#### Question 2.1(i) Mr Brain's Cash Book

2.1 (i) Mr A. Brain: Cash book for term 2 Students' workbook – selected answers to computational questions – chapter two

2.1 (i) Mr A. Brain: Cash book for term 2

Date		Grant	Loans	Savings	Earnings	Sundry	Total	Date		Rent	Drink	Food	Capital Equipment	Sundry	Total
20/1	O.Bal					6	6	21/1	Landlord	35					35
20/1	Parents	200					200	22/1	Dec. bar		34				34
4/2	Text					4	4	22/1	Spar			20			20
5/2	Dartboard					7	7	24/1	Textbooks					15	15
10/2	Jack					10	10	2/2	Landlord	20					20
20/2	Parents		100				100	6/2	Jan. bar		25				25
20/2	TSB			60			60	10/2	Bicycle				45		45
1/3	Acc Soc				25		25	21/2	Disco unit				140		140
15/3	SU disco				25		25	15/2	Repay Fred					2	2
		<u>200</u>	<u>100</u>	<u>60</u>	<u>50</u>	<u>27</u>	437	21/2	Trailer				25		25
								2/3	Feb. bar		40				40
								3/3	Spar			5			5
								25/3	On account	10					10
								26/3	Train					5	5
										<u>65</u>	<u>99</u>	<u>25</u>	<u>210</u>	<u>22</u>	421
									Balance						<u>16</u>
	Balance						<u>437</u> 16								<u>437</u>

Question 2.1(ii) What Mr Brain has 'left over' (assets and liabilities)

A simple list is all that is required at this stage, but the approximate balance sheet lay out below may help you get used to the idea for later on.

Mr Brain's 'Left Over' Statement (Balance Sheet) for the end of Term 2

'Owned' (Assets)		
Disco		140
Trailer	25	
Bicycle	45	
Textbook		15
Debt (Jack)		10
Cash		<u>16</u>
Total Assets		<u><u>£251</u></u>
'Owed' (Liabilities)		
Landlord		20
Bar		36
Loan		100
Add Savings (50 + 60)	<u>110</u>	
		266
Net consumption - Term 2	39	
Net consumption - Term 1	<u>(54)</u>	<u>(15)</u>
		<u><u>£251</u></u>

Should your tutor suggest that you pursue the 'consumed'/^used up' theme at this stage, you may find Brian's 'consumed in the term statement' (a basic profit and loss account) useful:

Mr A. Brain Net consumption for Term 2

Income:		
- Parents		200
- Earnings		50
- Profit on textbook		<u>1</u>
		251
Expenditure:		
- Food		25
- Drink (see note 1)		111
- Rent (see note 2)		70
- Loss on dartboard		1
- Travel		<u>5</u>
		<u>(212)</u>
'Profit'		<u><u>£39</u></u>
Notes:		
(1) The drink figure is: Cash book		99
	Dec bar bill	(34)
	March bar bill	36

	Guinness	<u>10</u>
		<u>£111</u>
(2) The rent figure is:	Cash book	65
	Owing March	20
	Arrears paid	<u>(15)</u>
		<u>£ 70</u>

Question 2.1 (iii) Additional information for Mr Brain

This question really relies upon your imagination. The sort of records that you might consider are:

(1) Financial: record of debtors ('owed to Mr Brain') and creditors ('owing by Brain'), assets ('owned by Brain'), separate record of the disco and which bookings make money (noting that he does not pay for his time).

(2) Non-financial: attendance at lectures, essay marks, state of health, interesting ideas and/or discussions held, etc.

## STUDENTS' WORKBOOK

### CHAPTER 3 ORGANIZATIONS, ORGANIZATIONAL SUBSYSTEMS AND THE FLOWS OF DOUBLE ENTRY BOOKKEEPING

#### 3.1 Introduction

##### 3.1.1 Links with the text chapter

Chapter 3 suggested that the *raison d'être* of accounting is the information that the activity produces for the participants, both internal and external to the organization. The concept of organization is fundamental to accounting, it being the entity (or focal organisation) about which accounting collects information in order, *inter alia*, that it might be controlled by the participants.

We identified two broad groups of organizations: commercial (companies, banks, sole traders, partnerships, etc) and non-commercial (charities, local authorities, etc). This distinction principally lay in differences in terms of ownership.

The main text then introduced a general systems model of the organization. In this model there was the general environment, the substantial environment and the focal organization and its subsystems. The focal organization subsystems consisted of the decision and control subsystem, the funds subsystem and the operations subsystem. These, together with a simple indication of the associated flows, were shown in Figure 3.4 in the text.

##### 3.1.2 Design of this chapter of the Workbook

The computational problems and discussion topics in this chapter are interrelated and so the chapter consists of just one large section (3.2) broken down into subsections which mirror the text followed by a further section (3.3) which provides possible solution to questions 3.1 and 3.2.

*Section 3.2.1 Holy Smoke* - numerical and discussion questions with solutions provided.

*Section 3.2.2 Wakanui Kayaks* - an interrelated series of questions working through all the principles developed in the chapter. These questions are split into two parts. The first part of the question requires a fairly conventional approach to recording movements in cash and the other flows associated with organizational activities. If you have grasped the principle or organizational flows you can just complete the main part of this chapter. If, however, you are finding the idea of flows difficult then you may find that the appendix to this chapter helps you understand the flows idea more readily.

*Section 3.2.3* Two discussion questions asking you to apply what you have learnt about substantial environments and organizational flows to your own college and department, and then to place yourself in the position of an external participant considering lending money to various different organizations.

### 3.2 Computational problems and discussion topics

#### 3.2.1 Numerical and discussion questions (Holy Smoke)

In this section you are asked to analyze and discuss an organization called Holy Smoke - a rock band. First you have to construct a cashbook, then consider what sort of basic accounting records the band might need (Question 3.1). Once you have done this there are some discussion questions to consider (Question 3.2).

##### *Question 3.1*

Holy Smoke are an up and coming local rock band who have decided to try and put their finances on a more organized basis with effect from 1 April. They ask you to help and give you the following details for April.

Table 3.1 - Holy Smoke Information

Date	Description	£
1 Apr.	Cash balance brought down	48
1 Apr.	Hire of rehearsal room - 1 month in advance	(20)
3 Apr.	Purchase of microphone (second-hand)	(35)
4 Apr.	Performance for Women's Institute	40
4 Apr.	Equipment hire	(10)
4 Apr.	Petrol to get to Women's Institute	(5)
5 Apr.	Loan from guitarist to band	50
6 Apr.	Purchase of lights for stage performances	(27)
12 Apr.	Performance for Student's Union	50
12 Apr.	Hire of equipment	(15)
12 Apr.	Petrol	(4)
14 Apr.	Loan from drummer to band	65
16 Apr.	Publicity leaflets and posters	(10)
19 Apr.	Performance at local social club	25
19 Apr.	Petrol	(5)

19 Apr.	Equipment hire	(10)
22 Apr.	Purchase of public address system (second-hand)	(150)
23 Apr.	Payment of babysitting fees owing (the singer has a 4 year old daughter)	(15)
24 Apr.	Performance at local hotel	15
24 Apr.	Petrol	(4)
26 Apr.	Loan from bass guitarist to band	50
27 Apr.	Have equipment serviced	(32)

After some careful questioning you also learn the following:

- The rehearsal room was only used three times during the month so the band have £5 (or 1 night's rehearsal) in hand.
- The bank still owe £6 for babysitting, £5 for equipment hire, and £20 for the balance of the equipment they brought.
- The local radio station recorded one of their performances and owes them £10 as a fee for broadcasting two of the songs.

Required:

- Draw up a columnar cashbook showing inputs to and outputs from the funds subsystem for April.
- Describe any additional accounting records which you think the band might find useful.

### Question 3.2

- What are the inputs during April to the band's operations subsystem?
- What other inputs to the band's operations subsystem can you think of that are not recorded in the accounting records?
- What are the outputs to the band's operations subsystem? (Specify which are and are not recorded in the accounting records.)
- Discuss whether or not you think Holy Smoke is a commercial organization and relate this to what you would imagine the objectives of its decision and control subsystem might be.
- In what ways does the information you have collected in the accounting records help the band's decision and control subsystem control the organization?
- Which organizational systems in the band's substantial environment might find information (as an output from the decision and control subsystem) about the band useful? What information would they want? Would the band give it to them?

### 3.2.2 Numerical and discussion questions (Wakanui Kayaks)

In Chapter 2 of the Workbook we saw a week in the life of Wakanui Kayaks. Now we shall use the knowledge acquired in Chapter 3 to explore this organization in more detail, to identify the inflows and outflows through the organization's subsystems and start recording inflows and outflows in terms of double entry bookkeeping. To do this we are going to go back in time to when Wakanui Kayaks was created. Table 3.2 and 3.3 contain information required for question 3.3 and 3.4.

Table 3.2: Background to Wakanui Kayaks

Melinda and Ross Chapman are both keen kayakers who realised that a niche existed in the market for a specialist kayak and outdoor gear retail shop. They agreed to form a partnership<sup>1</sup> (Wakanui Kayaks) and to put their savings into the business. In addition, they received a loan from a small business development agency.

Wakanui Kayaks hires a retail shop in a large shopping complex in which to conduct its business. Both partners work in the business and are paid wages. In addition they hire two other employees on a part time basis. The partnership owns all the shop fittings and pays all the shop running costs as well as a share of the shopping complex costs. It buys in various outdoor and kayak items from suppliers which are then sold to customers. Most sales are for cash, however, some customers are allowed to buy now and pay later. The partners pay taxes on any profits they make.

Table 3.3: Setting up Wakanui Kayaks

You have the following information about the first month of operations.

Date	Description of transactions
1 Feb.	Melinda and Ross opened a bank account for Wakanui Kayaks and deposit £5,000 each from their own savings.
3 Feb.	The small business development agency loaned the business £10,000 to be repaid in 5 years time.
8 Feb.	Paid one months rent of £800 in advance for the shop.
10 Feb.	Paid £2,800 for shop fittings. Purchased a cash register for £1,200 and promised to pay for it in March.
14 Feb.	Paid £6,030 for stock.
16 Feb.	Paid £980 for the grand opening of the shop. Made £520 of cash sales.
18 Feb.	Had more stock delivered amounting to £2,010 which was to be paid for in March. Paid wages of £600.
25 Feb.	Made total cash sales for the week of £1,620. Paid share of shopping centre costs of £1,000. Paid wages of £960.
28 Feb.	Made cash sales of £850. Sold £210 worth of goods on credit. Paid next months rent of £800. Paid electricity bill for the month of £310.

### Question 3.3

(i) Describe what constitutes an organization that we might wish to account for.

<sup>1</sup> Partnerships are covered in more detail in Chapter 13 of the main text. However, at this stage of your studies you need not worry about the special issues that arise in the context of partnerships.

- (ii) How does the description in (i) above relate to Wakanui Kayaks ?
- (iii) What is the relationship between Melinda and Ross and the accounting entity?
- (iv) What type of organization is Wakanui Kayaks? Briefly outline the characteristics of such an organization. What other kinds of organisation could Melinda and Ross have formed ?

The funds subsystem governs the payment and receipt of cash. The inputs to and the outputs from this subsystem are recorded in the cash book.

#### *Question 3.4*

- (i) Prepare a columnar cash book from the information in Table 3.3 taking care to ensure that just the inflows and outflows of cash are identified.

Study the cash book you have prepared and answer the following questions.

- (ii) What are the main categories of funds subsystem inputs shown by the cash book?
- (iii) What are the main categories of funds subsystem outputs shown by the cash book?
- (iv) What additional categories of funds subsystem inputs and outputs would you expect to find in an organization of this type?

#### *Question 3.5*

In Question 3.4 you have prepared only the inputs and outputs associated with the funds subsystem. Using the principles from Figure 3.8 and 3.9 in the main text take the list of transactions in Table 3.3 of the Workbook and prepare an information account and a goods and services account for Wakanui Kayaks (you have already prepared the cash account in Question 3.4 above).

#### *Question 3.6*

Using the information prepared in Question 3.5, the background information you have about Wakanui Kayaks and your own imagination and experience answer the following questions:

- (i) From the accounts you have prepared for Wakanui Kayaks (3.5 above) identify the main categories of inputs to the operations subsystem.
- (ii) From the accounts you have prepared for Wakanui Kayaks (3.5 above) identify the main categories of outputs from the operations subsystem.
- (iii) Can you think of other likely inputs to or outputs from the operations subsystem that you would expect but which are not listed in the accounts?

#### *Question 3.7*

From what you know of Wakanui Kayaks, discuss the following questions:

- (i) Who operates the decision and control subsystem of the partnership?
- (ii) What are the objectives of the partnership?
- (iii) How would you assess the success of the partnership?

- (iv) What is the purpose of the cashbook?
- (v) What information does the cashbook contain that will help the decision and control subsystem control the organisation?
- (vi) What additional information does the decision and control subsystem need in order to control the other subsystems of the partnership?

*Question 3.8*

- (i) Who would like information about Wakanui Kayaks?
- (ii) If you were Melinda or Ross to whom would you give information?
- (iii) What information would it be? Why?

### **3.2.3 General discussion questions**

*Question 3.9*

- (i) List some of the major inputs to your university or college operations subsystem.
- (ii) List some of the major outputs from your university or college operations subsystem.
- (iii) The department in which you are studying is likely to be an accounting entity. Which inputs and outputs of its funds subsystem and operations subsystem would you think it could usefully record? What accounting records would you think the department might usefully keep?
- (iv) What would you imagine to be the objectives held by the decision and control subsystem of your department?
- (v) What are the major organizational systems in your department's substantial environment? How do they influence the department? How does the department influence them?
- (vi) How would you find out more accurately the answers to these questions? Would the department give you the answers? Why?
- (vii) In terms of inputs to and outputs from the decision and control subsystem, the funds subsystem and the operations subsystem, how does the department and the college differ from Wakanui Kayaks?

*Question 3.10*

- (i) An acquaintance asks you for a loan to help with an organization with which he/she is involved. Assuming you have the money, what information would you want from them (and why) if the organization was:
  - a charity intending to offer a mountain rescue service?
  - a rock band?
  - a shop selling second-hand CDs?
  - a small company designing computer software?
  - a medium sized company manufacturing caravans?
  - an accounting department in a university or college?
- (ii) Can you explain, from the point of view of each of these organizations, how the inputs and outputs of the subsystems might reflect:

- this request for a loan;
- the information they gave you; and
- your decision about the loan?

### 3.3 Selected answers to computational questions and discussion topics

(a) Holy Smoke: Cash book and subsystems flows

#### *Question 3.1*

- (i) See next page.
- (ii) At this level of activity it is doubtful whether any further records really need to be kept. The group's decision and control subsystem might wish for records on the loans; the actual cost of bookings and which make money; the capital equipment owned by the bank and they might also be interested to know whether it is cheaper to hire or buy equipment. See also Chapter 13 on partnerships.

#### *Question 3.2*

- (i) The "recorded" inputs are those listed as expenses in the cash book plus the outstanding items in the question.
- (ii) The groups' own time and effort, wear and tear on their own equipment and vehicles are the most obvious ones.
- (iii) "Recorded" outputs are the performances represented by the accounting records and the radio station broadcast. "Unrecorded" outputs might include unpaid recordings and performances, the suffering of neighbours whilst the band practice, the flowering of the individuals' talents which may not yield financial benefit (at least not in this accounting period or with this organisation).
- (iv) This particular question is one in which the taxation authorities are very interested but the solution is not simple. The question, at a basic level, is whether the group play to make money, or vice versa.
- (v) For example, maintain equity between members; assess which performances are 'profit-making'; control costs; etc.
- (vi) Members of the group as lenders; other potential lenders; potential members; organisations negotiating performance fees; the taxation authorities, etc might all find financial information useful to assess the financial viability of the band. The group would give the information if it was in their interest to do so, or, perhaps, if they believed there was a moral duty to supply it. Other organisational systems may be fans, family, other bands may also want information. We leave you to decide what it might be and whether the band will supply it.

Date		Gigs	Loans	Sundry	Total	Date		Gig costs	Equip.	Advert.	Sundry	Total
1/4	Opening balance			48	48	1/4	Rehearsal rooms				20	20
4/4	Women's Institute	40			40	3/4	Microphone		35			35
5/4	Guitarist		50		50	4/4	Petrol	5				5
12/4	Student Union	50			50	4/4	Equip hire	10				10
14/4	Drummer		65		65	6/4	Lights		27			27
19/4	Social Club	25			25	12/4	Equip hire	15				15
24/4	Hotel	15			15	12/4	Petrol	4				4
26/4	Bassist		50		50	16/4	Publicity			10		10
						19/4	Petrol	5				5
						19/4	Equip hire	10				10
						22/4	P A system		150			150
						23/4	Babysitting				15	15
						24/4	Petrol	4				4
						27/4	Equip service				32	32
								<u>53</u>	<u>212</u>	<u>10</u>	<u>67</u>	342
							Closing balance					<u>1</u>
		<u>130</u>	<u>165</u>	<u>48</u>	<u>343</u>							<u>343</u>

Question 3.1 (i) Holy Smoke: Cash book for April

## Appendix to chapter three

In this appendix we provide a more detailed consideration of the substantive environment of Wakanui Kayaks. If you have been able to complete the questions in chapter three of this workbook you may find this material a little repetitive. If, however, you wish to you can test your understanding of organisational flows by working through the questions below. Use Table 3.A.1 to answer Questions 3.A.1- 3.A.3.

### Question 3.A.1

From the cashbook it is possible to identify 12 organisational systems with which Wakanui Kayaks interacted in February. List them in Table 3.A.1.

Table 3.A.1: Wakanui Kayaks' interactions with its substantial environment

Organisation with which Wakanui Kayaks interacts	Provides an <b>input</b> to the ..... subsystem	In the form of .....	And receives an <b>output</b> from the ..... subsystem	In the form of .....
(1)				
(2)				
(3)				
(4)				
(5)				
(6)				
(7)				
(8)				
(9)				
(10)				
(11)				
(12)				

### Question 3.A.2

Can you think of any further organisational system which would interact with Wakanui Kayaks but which are not mentioned in the cashbook? List these as well on Table 3.A.1.

### Question 3.A.3

(i) Enter, in Table 3.A.1, the inputs to and the outputs from the subsystems of Wakanui Kayaks which arise from the interactions with those organisational systems which you have already identified.

(Note that for most of the interactions you will be able to identify both an input and an output. As you will discover from Chapter 4 this will always be the case, and is, selectively operated, the basis of accountants' double-entry bookkeeping.)

(ii) Enter, also in Table 3.A.1, a description of the flow or interaction. (This might be, for example, cash, or good, or services, or even information or a 'thank you'.)

## STUDENTS' WORKBOOK

### CHAPTER 4 ORGANISATIONAL FLOWS, A CATEGORISATION OF BASIC TRANSACTIONS, ACCOUNTING RECORDS AND DOUBLE ENTRY BOOKKEEPING

#### 4.1 Introduction

In Chapter 4 we introduced the eight different types of financial transactions which form the key concern of traditional financial accounting. In addition we indicated how these financial transactions are recorded in accounting. A highly summarized picture of the contents of Chapter 4 is contained in Figure 4.10 in the text. This figure is of particular importance and you will need to refer to it constantly when answering the following questions which are intended to reinforce your understanding about the nature of financial transactions and the accounting interpretations of them.

The contents of this chapter are divided into three sections. Section 4.2 contains a worked example typical of the computational problems contained in section 4.3. In section 4.4, a number of discussion topics are presented which ask you to reflect not only on the eight types of financial transaction and how to record them but also their limitations for accounting records in both commercial and non-commercial organisations. We have purposefully placed these discussion questions after the computational ones to ensure that you do know how to record financial transactions before questioning their nature! Finally in section 4.5 we provide an answer on how to record the transactions in Question 4.4.

#### 4.2 A worked example

It is suggested that for each of the transactions in the questions below you adopt the following approach which, to aid comprehension, we will illustrate by an example of a cash purchase of goods for £1,000.

Step 1: Take each of the transactions and decide which of the eight basic bookkeeping transactions it is according to Figure 4.10. In terms of our example we would describe this as a cash purchase (transaction 1).

Step 2: Clarify the important flows which arise with this type of transaction from an accounting viewpoint. These can be found in summary form in Figure 4.10. In terms of our example it would be an input of goods and services and an output of funds.

Step 3: Record the transaction in a 'T' Account format. For our example it would look thus:

Debit/inflow	Cash	Credit/outflow
	Purchases	1000

Debit/inflow	Purchases of stock	Credit/outflow
Cash	1000	

### 4.3 Computational problems

For each Questions 4.1 - 4.4 complete the steps outlined in section 4.2 above.

#### Question 4.1

Able Ltd, a small grocery store, had the following financial transactions during one week:

1. Cash purchases of perishable goods £200
2. Cash purchases of non-perishable goods £400
3. Rent for a month in advance paid in cash £100
4. Paid the three months' electricity bill in cash £220
5. Purchased a new display stand £180
6. Cash sales £1000

#### Question 4.2

Isis Ltd, a large family owned company, had the following transactions:

1. Purchases of materials for cash £10m
2. Purchases of materials on credit £30m
3. Cash payments to creditors £25m
4. Wages and salaries paid in cash £10m
5. Administrative, legal and professional expenses on credit £8m
6. Rent, rates, light heat etc paid in cash £12m
7. Taxes paid £5m
8. Grants to local and national charities £1m
9. Cash sales £200m

#### Question 4.3

Fred Ltd started business on 1 January. His transactions for the first year were as follows:

1. Capital supplied by Mr Fred: £100,000 in share capital and £100,000 in a loan which is expected to earn interest of 10% (on the £100,000)
2. Government grant for new businesses received in cash £10,000
3. Paid £10,000 loan interest and a 5% dividend of £5,000 both for cash
4. Purchases of materials, etc., for cash £90,000
5. Purchases of material, etc., on credit £120,000
6. Payments to creditors £95,000 in part settlement
7. Administrative and selling expenses for cash £75,000

8. Salaries and wages for cash £130,000
9. Tax payment made in cash £10,000
10. Donation to local charities paid in cash £1,000
11. Cash sales £300,000
12. Sales on credit £200,000
13. Cash receipts from debtors £140,000 in part settlement

#### *Question 4.4*

Oggle Ltd, a small company, had the following financial transactions during last year:

1. Purchases of materials etc., for cash £20m
2. Purchases of materials etc., on credit £40m
3. Payments to creditors £35m
4. Rent, rates, heat, light and power paid in cash £10m
5. Administrative and professional services paid in cash £3m
6. Grants made to charities paid in cash £1m
7. Tax paid in cash £6m
8. New shares issued leading to cash receipts of £5m
9. Dividends paid for cash on new and old shares £4m
10. Loans received in cash of £7m
11. Interest paid on new and old loans in cash £2m
12. Cash sales £45m
13. Sales made on credit £50m
14. Cash receipts from debtors £42m
15. Regional grants received from government in cash £2m

#### **4.4 Discussion topics**

#### *Question 4.5*

Company A and Hospital B each incurred annual costs of £5m in the pursuit of their different activities for 200X. Company A sells precision tools whereas Hospital B, situated in the inner city, offers a service primarily to the poor and homeless. Company A sold precision tools to the value of £8m in cash in 200X and Hospital B saved several hundreds of lives and improved the health of several thousand more. It received cash grants from the central government during 200X of £5m to cover the costs of its activities.

Required:

- (i) How would you record the financial transactions of Company A and Hospital B using the double-entry method?
- (ii) Is this basic data an adequate basis upon which to provide a judgement as to the contribution of either organisation? If not, what other basic data would you require? Can you record this other data in double-entry form?

#### *Question 4.6*

Critically examine the eight financial transactions summarised in Figure 4.10

- (i) What are their distinguishing characteristics?
- (ii) Can you think of any financial transactions which are not encompassed through these general types?
- (iii) Do you think the way that accounting records these transactions summarizes their nature?

*Question 4.7*

Traditional financial accounting has limited itself to using only the eight types of financial transactions of any focal organisation.

- (i) What limitations do you think this creates?
- (ii) Do you think other aspects of organisational life should be in the domain of interest for financial accounting? If so what other events or actions should be recorded and why?

**4.5 Selected answer to computational problem**

*Question 4.4*

If you are feeling confident about your ability to “post” transactions directly to ‘T’-accounts then you may skip working through transactions as indicated in the table directly below. If you are still finding it hard to decide what ‘T’-accounts to use then you may wish to follow transactions through the table and then into the ‘T’-accounts.

	Transaction type	Input system	Debit Account Title	Output system	Credit Account Title
1	Cash purchases	Goods and services	Purchases	Funds	Cash
2	Creditors	Goods and services	Purchases	Information	Creditors
3	Creditors (discharge)	Information	Creditors	Funds	Cash
4	Cash purchases	Goods and services	Rent, Rates, light and power	Funds	Cash
5	Cash purchases	Goods and services	Administrative and professional services	Funds	Cash
6	Grants paid by FO	Information	Donation	Funds	Cash
7	Taxed paid by FO	Information	Taxes	Funds	Cash
8	Capital for FO	Funds	Cash	Information	Capital
9	Capital for FO	Information	Dividend	Funds	Cash

	(discharge)				
10	Loans to FO	Funds	Cash	Information	Loan
11	Loans to FO (discharge)	Information	Interest	Funds	Cash
12	Cash sales	Funds	Cash	Goods and services	Sales
13	Debtors (set up)	Information	Debtors	Goods and services	Sales
14	Debtors (discharge)	Funds	Cash	Information	Debtors
15	Grants to the FO	Funds	Cash	Information	Grants received

'T' Accounts

Debit/inflow	Cash	Credit/outflow
8 Capital	5	1 Purchases 20
10 Loans	7	3 Creditors 35
12 Sales	45	4 Rent, rates etc 10
14 Debtors	42	5 Admin and prof 3
15 Grant	2	6 Donations 1
		7 Taxation 6
		9 Dividends 4
		11 Interest 2

Debit/inflow	Purchases	Credit/outflow
1 Cash	20	
2 Creditors	40	

Debit/inflow	Creditors	Credit/outflow
3 Cash	35	2 Purchases 40

Debit/inflow	Rent, rates, heat etc.	Credit/outflow
4 Cash	10	

Debit/inflow	Admin and professional services	Credit/outflow
5 Cash	3	

Debit/inflow	Donations	Credit/outflow
6 Cash	1	

Debit/inflow	Taxation	Credit/outflow
7 Cash	6	

Debit/inflow	Capital	Credit/outflow
	8 Cash	5

Debit/inflow	Dividends	Credit/outflow
9 Cash	4	

Debit/inflow	Loan	Credit/outflow
	10 Cash	7

Debit/inflow	Interest	Credit/outflow
11 Cash	2	

Debit/inflow	Sales	Credit/outflow
	12 Cash	45
	13 Debtors	50

Debit/inflow	Debtors	Credit/outflow
13 Sales	50	14 Cash
		42

Debit/inflow	Grant	Credit/outflow
	15 Cash	2

## STUDENTS' WORKBOOK

### CHAPTER 5 PUTTING THE EIGHT BASIC TRANSACTIONS TO WORK, PRODUCING THE ACCOUNTING RECORDS AND AN INITIAL TRIAL BALANCE

#### 5.1 Introduction

Chapter 5 brings some important refinements to the recording process. Chapter 4 introduced you to the recording of the eight different types of financial transactions at a rather general level. This has hopefully allowed you to gain some confidence in the accounting process without worrying too much about the specifics of this or that account. Chapter 5, on the other hand, gives much greater emphasis to the presentation of the accounting and develops the transactions listed in Figure 4.10. It provides a rather more meaningful (from an accounting viewpoint) format. The following is intended to reinforce this understanding.

The contents of this chapter of the Workbook are divided into four sections. Section 5.2 contains a number of computational problems; a case study is presented in section 5.3; section 5.4 contains a number of discussion topics and section 5.5 provides a model answer to one of the more typical computation problems (Question 5.4). Once again we have placed the discussion topics after the computational problems to allow you to reflect on the various issues raised in this Chapter and Chapter 4 once you are fully conversant with how accountants record these financial transactions.

We have purposefully not produced a worked example in this chapter for you to follow because the whole of Chapter 5 contains all that you need. Thus if you do have any problems in the following you are encouraged to work systematically through the example of Bird Industries Ltd (which dominated Chapter 5 of the text) which will supply you with all the information that you require. However, in section 5.5, we provide an answer to Question 5.3 (one of the central questions in the chapter) to allow you to self-correct your attempt.

#### 5.2 Computational problems

The four questions which follow are intended to reinforce both certain specific points raised in Chapter 5 of the text as well as to develop your more general understanding of the context of this chapter. Question 5.1 requires you to prepare a detailed set of accounts, while Questions 5.2 to 5.4 require you to construct a full set of accounting records including a trial balance and, in the process, reinforce your understanding of the central and dominant themes of Chapter 5.

Note: For all questions the cash and bank transactions can be recorded in one account.

### Question 5.1

The transactions of Acker Ltd for a typical year were as follows:

1. Cash purchases £30,000.
2. Credit purchases £50,000.
3. Bank payments to creditors £35,000.
4. Sales for cash £55,000.
5. Sales on credit £90,000.
6. Cheque for loans received from Mr Acker £100,000.
7. Loans paid by cheque to another company £130,000.
8. Interest paid by cheque £22,000.
9. Bank receipts for interest £15,000.
10. Taxes paid by cheque £25,000.
11. Regional grant cheque received from government £12,000.
12. Salaries paid in cash £27,000.
13. Rent, rates, administration, etc., paid by cheque £13,000.
14. Bank receipts for debtors £75,000.

Required:

- (i) Identify the flows and accounts associated with each of the above transactions.
- (ii) Draw up the detailed accounting records for Acker Ltd using 'T' accounts.

### Question 5.2

Wacsacks Ltd had the following transactions in the first quarter of 200X:

1. Fast food supplies brought from Soupa Ltd for cash £20,000.
2. Food and drink supplies purchased on credit from FF Ltd for £30,000.
3. Sales of food and drink through own shops for cash £35,000.
4. Credit sales of food and drink through Wacdist Ltd £50,000.
5. Salaries paid in cash £10,000.
6. Rent, rates, heat, light, etc., paid in cash £12,000.
7. Cheque for loans received to help expand the business £100,000.
8. Purchase of new retail outlet by cheque £40,000.
9. Interest on loans paid by cheque £7,000.
10. Bank payments to the creditor FF Ltd £25,000.
11. Bank receipts from the debtor Wacdist Ltd £38,000.
12. Interim tax payment paid by cheque £4,000.

Required:

- (i) Draw up the detailed accounting records for Wacsacks Ltd in a 'T' account format.
- (ii) Draw up an initial trial balance as at 31.3.200X.

### Question 5.3

Scoopa Ltd, a toy manufacturer, had the following transactions in 200X (the first year of its operations):

1. Cash purchases of materials £45,000.
2. Credit purchases of materials £85,000.
3. Cheque payments to creditors £65,000.
4. Cash sales £140,000.
5. Credit sales £100,000.
6. Bank receipts from debtors £75,000.
7. Bank receipts from issue of share capital £150,000.
8. Bank receipts from issue of loans £110,000.
9. Interest paid by cheque £11,000.
10. Dividends paid by cheque £15,000.
11. Interim tax payment by cheque £8,000.
12. Government grants received as a cheque £18,000.
13. Bank payments for salaries £35,000.
14. Bank payments for rent, rates etc. £10,000.
15. Light, heat, etc., paid by cheque £13,000.
16. Travel costs paid by cheque £9,000.
17. Stationery, postage, etc., paid by cheque £4,000.
18. Returns of goods which were previously included in credit sales £16,000.
19. Returns of good which were previously included in credit purchases £17,000.

Required:

- (i) Draw up the detailed accounting records for Scoopa Ltd in a 'T' account format.
- (ii) Draw up an initial trial balance as at 31.3.200X.

Note: for number 18. and 19. have a look at the explanatory note at the end of the 'T' accounts in section 5.4 if you need help (try and have a go for yourself first).

### Question 5.4

Fine Foods Ltd, a cake baker, had the following transactions during the month of November.

1. Received cash of £18,000 from issuing shares.
2. Purchased flour and sugar for £2,300 paying by cheque.
3. Purchased dried fruit for £1,800 on credit.
4. Paid wages of £1,300 for cash.
5. Paid rent of £800 by cheque.
6. Found some of the dried fruit (which cost £200) was off so returned it to the supplier.
7. Paid electricity of £700 by cheque.
8. Made cash sales of £4,100.
9. Sold cakes for £3,600 on credit.
10. Paid creditors £1,000.

11. Cakes (which were sold for £300, but not yet paid for) were returned as being unsatisfactory.
12. Received cash from debtors of £3,000.
13. Paid dividends of £900 by cheque.
14. Paid taxation of £700 by cheque.
15. Made donation to local authority of £200 cash.

Required:

- (i) Draw up the detailed accounting records for Fine Foods Ltd in a 'T' account format.
- (ii) Draw up an initial trial balance at the end of November.

### 5.3 Case Study

#### *Question 5.5*

Carefully read the following case study material on Oliver Optics Company and

- (i) List and number the financial transactions which have occurred in the first year of the company's operations.
- (ii) Classify these transactions according to their financial transaction types (i.e. one of the eight types discussed in Chapter 4 and summarized in Figure 4.10).
- (iii) Record these transactions into the appropriate 'T' accounts.
- (iv) Draw up a trial balance for the year to 31 December.

Notes:

1. The rather unusual form of financing the equipment should be seen as a special type of creditor transaction.
2. The total cost of the equipment should not include the interest charges.
3. The fifth payment for the equipment plus the £60 interest charge can be assumed to be paid on 1 January in the year following.
4. The 4 per cent interest on the loan can be assumed to be paid on 31 March in the following year.
5. The £310 worth of goods sold to the defaulting customer needs to be entered before it is written off. At present it does not appear in any of the figures given.
6. The cash on hand is the balance of the Cash account at 31 December.
7. The balancing figure on the Cash account will be the figure for cash sales.
8. At this stage concentrate only on the financial transactions which have occurred. A number of the figures (e.g. for inventory on hand) and concerns are irrelevant in this context and should be ignored. These will be picked up in Chapters 8-11 where we return to this case to construct Oliver Optics Company financial statements.

### **Oliver Optics Company**

When John Oliver graduated from technical school, he immediately started a small business making special lenses and certain high quality optical items for the scientific and military demand. At the time, there was keen demand for a high quality product, and Oliver thought he could build a substantial business by stressing this quality element. After a year of some very disturbing and revealing difficulties in meeting customers' high standards, Oliver thought he had things going well. By working hard and personally satisfying all complaints, he knew he had created much goodwill for his firm.

Oliver had started his business on 1 January with £5,000 of savings, including some money he had inherited. At the end of the third month he borrowed £2,000 on a one year loan at 4 per cent, from his uncle, who had intimated he would renew the loan every year as long as Oliver needed the money. He has had large bills for materials, but had been able to keep from falling too far behind in his payments. Except for the accounts indicated below as unpaid, all bills had been paid in cash.

Mr Oliver purchased some standard equipment at the beginning of the year to be paid for by instalments, agreeing to make a partial payment of £1,000 and to pay £250 every three months for four years. Since the payments were scheduled to start at once and since he had agreed to pay £60 interest every six months in advance, his initial payment was £1,310. A year having past, the fifth payment of £250 would now have to be met, plus £60 interest (see Note 3).

When the equipment was brought, the company insisted on Oliver's taking out four years' insurance, which cost a total of £200. The equipment presumably would be useful for at least 10 years, though Oliver contemplated that if all went according to his plans, he would have to get rid of the equipment in five years and buy some with a greater operating capacity.

By the end of the first year, Oliver had three people working for him. One took care of the office work and spent about one-third of her time packing the delicate products as they were completed in the shop. The other two workers, hired at about the third month, spend all their time in the shop. About 20 percent of Mr Oliver's time was spend in office work and on selling trips, but he rest of the time he was to be found in the shop working.

At the end of the year, Oliver's records included the following:

	£
Salaries paid (to December 31):	
Sally Schultz	1,200
John Bardell	3,200
Peter Nutchell	3,500
John Oliver	6,000
Rent	2,000
Unpaid bills from suppliers *	5,130
Paid bills from suppliers	12,120
Uncollected accounts:	
UK Government	5,150
Universities Scientific Supply Company	4,130
Payment due to Oliver for subcontract work, completed, and shipped, December 17 - Pegasus Aircraft Company	970
Spend on office supplies	250
Inventory on hand, at estimated cost:	
Raw materials and supplies	830
Goods in process	1,270
Finished goods	1,100
Office supplies	50
Various administrative and selling expenses (includes travel and advertising)	2,730
Electricity, etc.	430
Cash on hand **	730

\* Does not include the balance due for the equipment referred to in the third paragraph of the case.

\*\* See note 6 above.

Most of Oliver's sales were to two buyers, the UK Government and the Universities Scientific Supply Company. Oliver had sold some £310 worth of goods to one buyer earlier in the year when business was slow, and when the man became bankrupt with no assets whatsoever and without having paid his bill, Oliver promised himself, 'Never again'. Other firms, he was told, protected themselves against such losses by use of a charge of 1 per cent of year-end accounts receivable as an allowance for bad debts.

In October, the Pegasus Aircraft Company had asked Oliver to do some work for them, altering special equipment which they sent on to Oliver's shop. The first lot had been completed before the year's end, but the payment for the work, £970, had not been received. A second shipment, apparently value at £3,000, had just come in (afternoon of December 31) from the Pegasus plant, but the alteration work (which would come to about £1,000) had not yet been started. Mr Oliver ascertained that the value of this incoming material, £3,000, had not been included in the totals for inventory listed above.

Approximately £800 of the finished goods inventory consisted of 200 special items that had been made for a government order, but had not as yet been shipped. Frankly, Mr Oliver had wanted the situation to settle a little before making delivery, from a previous shipment of the same size (one-half the original order) had not met the specifications of the government inspectors, and Oliver had been notified that 20 per cent of the shipment was being returned as unsatisfactory. Fortunately, the items carried a 30 per cent markup over Oliver's costs, so he would not fare too badly. Still, Oliver was disturbed about the matter because he thought his inspection standards, when the first batch had been made, had been no different from those in force at any other time, a besides, he was advertising high quality products. He certainly had no idea as to why the 20 per cent had been rejected. He intended to file an appeal to try to collect the full amount that he had billed the government (included in the £5,150 in the year-end listing given above), particularly since the rejected items could not be reworked and were not worth much to any other possible buyer.

(Adapted from Harlan and Vancil (1961), pp.20-22)

Note: Not all the information will be relevant for this question (see also question 11.6 which is an extension of this question and which uses all the information given). You should be able to read about this organisation and identify transactions which should be recorded. It is more difficult to extract the information in this case study format – however, it is important that you learn how to do this because when you work as an accountant you will not be given lists of transactions. Take it slowly and keep thinking about the principles in the text and you should be fine!

## 5.4 Discussion topics

### *Question 5.6*

Refer back to the 25 events and transactions of Bird Industries (contained in Figure 5.1 in the main text) and list some of the other event which may have occurred during January 2007. After you have done this discuss the following questions:

(i) Do any of the item in your list involve movements in the organizational subsystems of Bird

Industries Ltd?

(ii) Why do you think the contents of your list and some of the 25 events and transactions are considered to be unimportant elements in the basic data set for traditional financial accounting statements?

*Question 5.7*

We would like to now consider the first few months in the life of a non-commercial organisation:

- (i) Imagine that a new charity (for the purpose of assisting students who have recently been treated for drug addiction to get back on their feet) is being established and outline the kind of events and transactions would be likely to take place during the first few months of the charity's existence.
- (ii) Which of these events and transactions would be recognized under financial accounting?
- (iii) Consider how the charity's 'T' accounts would differ from those of Bird Industries. In particular would the charity have a share capital or a sales account?
- (iv) What information do you think would be most important for the charity to record and for what purpose?

**5.5 Selected answer to computational problem**

*Question 5.3 - Scoopa Ltd*

- (i) Detailed 'T' accounts

Inflow/Debit	Cash	Outflow/Credit	
4. Sales	140000	1. Purchases	45000
6. Debtors	75000	3. Creditors	65000
7. Capital	150000	9. Interest	11000
8. Loan	110000	10. Dividend	15000
12. Grant	18000	11. Taxation	8000
		13. Salaries	35000
		14. Rents, rates	10000
		15. Light heat	13000
		16. Travel costs	9000
		17. Stationery etc	4000
		Bal c/d to T.Bal	<u>278000</u>
	<u>493.000</u>		<u>493.000</u>

Inflow/Debit	Purchases	Outflow/Credit	
1. Cash	45000	Bal c/d to T.Bal	130000
2. Creditors	<u>85000</u>		
	<u>130.000</u>		<u>130.000</u>

<b>Inflow/Debit</b>	<b>Creditors</b>	<b>Outflow/Credit</b>	
3. Cash	65000	2. Purchases	85000
19. Purchases returns	17000		
Bal c/d to T.Bal	<u>3000</u>		
	<u>85,000</u>		<u>85,000</u>

<b>Inflow/Debit</b>	<b>Sales</b>	<b>Outflow/Credit</b>	
Bal c/d to T.Bal	240000	4. Cash	140000
	<u>240,000</u>	5. Debtors	<u>100000</u>
			<u>240,000</u>

<b>Inflow/Debit</b>	<b>Debtors</b>	<b>Outflow/Credit</b>	
5. Sales	100000	6. Cash	75000
		18. Sales returns	16000
		Bal c/d to T.Bal	<u>9000</u>
	<u>100,000</u>		<u>100,000</u>

<b>Inflow/Debit</b>	<b>Share capital</b>	<b>Outflow/Credit</b>	
Bal c/d to T.Bal	<u>150000</u>	7. Cash	<u>150000</u>

<b>Inflow/Debit</b>	<b>Loan</b>	<b>Outflow/Credit</b>	
Bal c/d to T.Bal	<u>110000</u>	8. Cash	<u>110000</u>

<b>Inflow/Debit</b>	<b>Interest</b>	<b>Outflow/Credit</b>	
9. Cash	<u>11000</u>	Bal c/d to T.Bal	<u>11000</u>

<b>Inflow/Debit</b>	<b>Dividend</b>	<b>Outflow/Credit</b>
10. Cash	<u>15000</u>	Bal c/d to T.Bal <u>15000</u>

<b>Inflow/Debit</b>	<b>Taxation</b>	<b>Outflow/Credit</b>
11. Cash	<u>8000</u>	Bal c/d to T.Bal <u>8000</u>

<b>Inflow/Debit</b>	<b>Grants received</b>	<b>Outflow/Credit</b>
Bal c/d to T.Bal	<u>18000</u>	12. Cash <u>18000</u>

<b>Inflow/Debit</b>	<b>Salaries</b>	<b>Outflow/Credit</b>
13. Cash	<u>35000</u>	Bal c/d to T.Bal <u>35000</u>

<b>Inflow/Debit</b>	<b>Rent, rates etc.</b>	<b>Outflow/Credit</b>
14. Cash	<u>10000</u>	Bal c/d to T.Bal <u>10000</u>

<b>Inflow/Debit</b>	<b>Heat, light etc</b>	<b>Outflow/Credit</b>
15. Cash	<u>13000</u>	Bal c/d to T.Bal <u>13000</u>

<b>Inflow/Debit</b>	<b>Travel costs</b>	<b>Outflow/Credit</b>
16. Cash	<u>9000</u>	Bal c/d to T.Bal <u>9000</u>

<b>Inflow/Debit</b>	<b>Stationery, postage, etc.</b>	<b>Outflow/Credit</b>
17. Cash	<u>4000</u>	Bal c/d to T.Bal <u>4000</u>

<b>Inflow/Debit</b>	<b>Sales returns *</b>	<b>Outflow/Credit</b>
18. Debtors	<u>16000</u>	Bal c/d to T.Bal <u>16000</u>

<b>Inflow/Debit</b>	<b>Purchases returns **</b>	<b>Outflow/Credit</b>
Bal c/d to T.Bal	<u>17000</u>	19. Creditors <u>17000</u>

\* Applying the logic of organisational flows and double entry bookkeeping we can deduce the following. Where we have sales returns we must have an inflow of goods and services (DR Sales Returns Account) with the outflow account either being a refund of cash (CR Cash) or, as in this case, a reduction in the amount owed to the focal organisation (CR Debtors).

\*\* Applying the logic of organisational flows and double entry bookkeeping we can deduce the following. Where we have purchases returns we must have an outflow of goods and services (CR Purchases Returns Account) with the inflow account either being a receipt of cash (DR Cash) or, as in this case, a reduction in the amount owed to creditors (DR Creditors).

While these points have not been explicitly covered in the text we hope that you were able to determine the appropriate entries from using the principles and logic developed with the preceding chapters. If you found you could not do this, then it is perhaps advisable that you return and work through the chapter again to ensure the concepts are well etched on your brain.

(ii) Initial Trial Balance

TRIAL BALANCE FOR SCOOPA LTD: 31 DECEMBER 200X		
Account	Debit	Credit
Cash	278000	
Purchases	130000	
Creditors		3000
Sales		240000
Debtors	9000	
Capital		150000
Loan		110000
Interest	11000	
Dividends	15000	
Taxation	8000	
Grant received		18000
Salaries	35000	
Rents, rates, etc.	10000	
Light, heat, etc.	13000	
Travel costs	9000	
Stationery, postage etc.	4000	
Sales returns	16000	
Purchases returns		17000
	<u>£538,000</u>	<u>£538,000</u>

**References:**

Harlan, N.E. and Vancil, R.F. (1961). *Cases in Accounting Policy*. Prentice Hall: Englewood Cliffs, NJ.

## STUDENTS' WORKBOOK

### CHAPTER 6 THE ACCOUNTING INFORMATION SYSTEM: ORGANISING AND CONTROLLING THE ACCOUNTING RECORDS

#### 6.1 Introduction

Chapter 6 focuses on introducing you to some of the detailed background systems that support and ensure the accuracy of the financial accounting records. For the most part we have assumed that the numbers we include in the accounts are accurate. However, as we have suggested there is a considerable amount of time and effort involved in practice to ensure that this is the case.

The Workbook focuses on accounting systems and it also provides practice at bank reconciliations. Often students get very involved with doing bank reconciliations when in fact it is only a small part of the operation of accounting information systems. It is also the part of the topic which you should already be familiar with via reconciling your own cheque book (or your understanding of what cash you have in the bank) to your bank statement! For this reason we do not dwell on it in the Workbook.

Of particular importance in our mind is the case study presented here. The situation described is a real one, however, it is relatively easy to visualise and we hope it becomes real to you as you tackle the questions. There are also a number of discussion questions for you to consider - all of which require you to use your imagination and your knowledge of accounting systems. This is perhaps the most important point to get across. You interact with accounting information systems whenever you interact with an organisation, whether it be as a customer, employee, owner, etc. You have inevitably come across most of the components covered in the text - even though you may not have realised it at the time. Therefore, it is useful if you can be alert when you interact with organisations so that you can identify what their accounting information systems are demanding of you.

The Chapter contains four sections. Section 6.2 has two questions which focus on the bank reconciliation. Section 6.3 presents the case study, while section 6.4 contains selected answers to computational questions.

#### 6.2 Computational problems

##### *Question 6.1*

Required:

Using Wakanui Kayaks' cash book (see page 40) and bank statement (see below), prepare a bank reconciliation. What is the partnerships **actual** cash position at 29/2/XX?

Grab and Snatch Bank Ltd: Wakanui Kayaks Bank Statement				
Date	Details	Debit	Credit	Balance
Feb.				
4	Lodged		10000	10000
7	Lodged		10000	20000
10	001	800		19200
16	003	6030		13170
16	Opening charge	25		13145
18	004	980		12165
19	Lodged		520	12685
19	005	600		12085
20	Direct debit		500	12585
26	006	1000		11585
27	007	960		10625
29	Lodged		1600	12225
29	008	800		11425

Further information

Wakanui Kayaks  
Cash book for February

Date		Ref	Sales	Loan	Sundry	Total	Date		Ref	Purchases	Rent	Wages	Other Costs	Assets	Total
1 Feb	Owners	R01			10000	10000	8 Feb	Rent	001		800				800
2 Feb	Loan	R02		10000		10000	10 Feb	Fittings	002					2800	2800
16 Feb	Sales	B01	520			520	14 Feb	Purchases	003	6030					6030
25 Feb	Sales	B02	1620			1620	16 Feb	Opening	004				980		980
28 Feb	Sales	B03	850			850	18 Feb	Wages	005			600			600
							25 Feb	Centre costs	006				1000		1000
								Wages	007			960			960
							28 Feb	Rent	008		800				800
								Electricity	009				310		310
			<u>2990</u>	<u>10000</u>	<u>10000</u>	<u>22990</u>				<u>6030</u>	<u>1600</u>	<u>1560</u>	<u>2290</u>	<u>2800</u>	14280
								Balance							<u>8710</u>
	Balance					<u>22990</u>									<u>22990</u>
						87100									

### Question 6.2

Using your bank statements and any records you keep (such as filling out the front of your cheque book) reconcile what you think you have in the bank and what balance is shown on your latest bank statement. Is this a useful exercise from your point of view? How does it help you control your cash position?

### 6.3 Case study

#### Question 6.3

Pacifica Garage Ltd is a small company which is jointly owned by a husband and wife team who operate a garage on a busy main road in a small town. The garage sells fuel, a variety of car care accessories, assorted spare parts and sweets and drinks. In addition, they offer a vehicle repair service which caters for the local farming community in which the business is situated. One of the owners is an authorised mechanic for a breakdown service organisation and is often called out to assist motorists who have broken down.

Pacifica Garage Ltd's sales come from a variety of sources, principally:

- (i) Cash sales of fuel from passing motorists (well not actually passing when they buy the fuel!);
- (ii) Cash sales for goods such as sweets, drinks, accessories, etc.,
- (iii) Cash sales for repair work in the workshop.
- (iv) Credit sales of fuel, goods and services, and repair work to local residents who have an account with the garage. All account holders are billed monthly.
- (v) AA repair work which is billed directly to the AA on the basis of the work done.
- (vi) Credit sales of fuel to two large designated trucking companies are made on the basis of retail price less 5 percent discount. Likewise a number of the local farmers belong to a farmers trading co-operative and their purchases are charged directly to the co-operative at retail prices less 5 percent.

Pacifica Garage Ltd's expenses consist of the following:

- (i) Fuel purchases which are all from one large fuel distributor;
- (ii) Purchases of goods sold in the shop which are from a variety of suppliers;
- (iii) Wages for four employees, three of which work in the repair workshop and one who sells petrol and looks after the shop;
- (iv) Vehicle parts etc., that are used in the workshop;
- (v) Drawings for the owners to cover their own private expenses; and
- (vi) Various overhead costs that are incurred such as electricity, rates, upkeep of the building, running a work van, cleaning, etc.

Pacifica Garage Ltd keeps the following records which form the basis for preparing the accounting records:

- (i) Till receipts from the garage (which are balanced on a daily basis with the banking made from the till).
- (ii) A book which records all the credit sales made for fuel and goods from the shop (these are all noted at retail prices and signed for by the person who is buying the fuel and goods. Where discounts are allowed they are calculated separately on the basis of the month's credit sales to each

customer).

(iii) A workshop book recording all the repair jobs in and out of the workshop. A record of how much time each mechanic has spent on each job is noted here as are all the spare parts that are used in each job and the cost of each spare part (which is written on the packages of spare parts in most instances, where the cost is not recorded it can be traced back to a purchase invoice from the appropriate supplier).

(iv) A time book in which all employees put their daily hours. This is checked each week and signed by one of the owners when they agree with the hours recorded.

(v) As bills come into the business they are put into a box and at the end of each month these are checked for accuracy by the owners (who know what has come and gone from the business as they both work there on a day to day basis) and paid.

Required:

(i) Identify the source documents within Pacifica Garage Ltd and outline how they will enable the bookkeeper (who is also one of the owners) to capture the information needed to record, say three, transactions in the accounts.

(ii) What controls do you think are necessary in order to ensure that the accounting records are accurate? Consider both internal controls and external control mechanisms.

(iii) What books of prime entry do you think will be required for Pacifica Garage Ltd? How do these relate to the purchases/sales day books and debtors/creditors ledgers that are described in the textbook?

(iv) On the basis of the information you have here, can you suggest any improvements to the information system as it presently operates?

## 6.4 Discussion topics

### *Question 6.4*

Required:

Outline the accounting information systems and systems of internal controls that would be necessary to reliably produce the following accounting events and transactions for any organisation.

1. Paid wages of £3,000.
2. Cash purchases of £280.
3. The cash account balance is £2,470.
4. I owe J.Britten £300.
5. Purchased a motor vehicle for £8,600.
6. Paid electricity bill of £560.
7. Crash Repairs Ltd owe me £420.
8. Made credit sales of £1,650.
9. Made cash sales of £760.
10. Paid insurance costs of £1880.

### Question 6.5

Required:

Assume that you wish to keep more accurate accounting records about your own finances. Construct a suitable chart of accounts for yourself as the focal organisation. Open a set of books of account and record one week's actual transactions in it. Using the experience gained from this exercise outline what accounting information systems you would now wish to develop in order to assist to keep accurate records of your activities.

### Question 6.6

Required:

Over a week keep all the source documents you receive in the course of your interactions with other organisations. For each source document you have, explain the role it has for the organisation which generated it and how it would fit into their accounting information systems. Can you reconstruct your accounting transactions for the week from your source documents? If not why not? What specific gaps in information do you have?

## 6.5 Selected answers to computational problem

### Question 6.1

Bank reconciliation for Wakanui Kayaks, February	
Description	Amount (£)
Balance brought down per cashbook	8,710
ADD Direct debit not recorded in cashbook	500
LESS Adjustment for error in cashbook (1,620 - 1,600)	(20)
LESS Bank charges not recorded in cashbook	(25)
Correct balance per cashbook	9,165
LESS Cashbook receipts not in the bank statement	(850)
	8,315
ADD Cashbook payments not yet recorded in the bank statement:	
Cheque 002	
Cheque 009	2,800
	310
<b>BALANCE PER BANK STATEMENT</b>	<b>11,425</b>

## STUDENTS' WORKBOOK

### CHAPTER 7

#### THE TRIAL BALANCE AND CATEGORIZATION: THE ACCOUNTING CONVENTIONS, ASSETS, LIABILITIES, REVENUES, EXPENSES, PROVISIONS AND RESERVES

##### 7.1 Introduction

In Chapter 7 of the main text we focused on the end-product of the financial accounting process - the financial statements - and examined some of the issues that will arise in translating an initial trial balance into a set of financial statements. The process largely consisted of classifying inputs to and outputs from the focal organisation as:

- (a) Revenues
- (b) Expenses
- (c) Assets
- (d) Liabilities and claims

Revenues and expenses are recorded in the profit and loss account, while assets and liabilities/claims are recorded in the balance sheet.

As we have seen, many of the decisions about how to represent a particular flow is seemingly arbitrary and frequently following a logic which is difficult to comprehend. Once we have the initial trial balance we enter the world of accounting judgement where the decisions are rarely uncontentious. The judgement will be the result of some combination of accounting conventions (which we discussed in some detail in Chapter 7), company law, views on best practice, predictions of the future and the desires and wishes of the participants in the judgement process. We will examine some of these issues in more detail in Chapter 14 but some of the more straightforward matters are dealt with in this chapter.

This chapter of the Workbook follows the pattern of earlier ones. The next section contains computation questions, section 7.3 discussion questions and section 7.4 has solution notes to Question 7.1.

##### 7.2 Computational problems

###### *Question 7.1*

Using the trial balance for Wacsnacks Ltd (see the solution to question 5.2 in the teachers' manual) classify the entries as to their financial statement category type and draw up a rudimentary set of financial statements.

###### *Question 7.2*

The following balances were derived from the accounting system of W. Wally Ltd for the year ended 31.12.200X, being the first year of business.

	£
Cash at bank	6,000
Buildings	60,000
Equipment	20,000
Motor vehicles	15,000
Purchases	45,000
Sales	84,000
Salaries	22,500
Heat, light and power	4,000
Selling expenses	5,000
Administrative and property expenses (including rates)	3,000
Discounts received	1,000
Discounts allowed	700
Creditors	17,700
Debtors	12,000
Interim taxes for 200X	4,000
Long-term loans	25,000
Share capital (shares issued to owners)	80,000
Interest paid	2,500
Interim dividend paid for 200X*	8,000

\* Interim dividend paid is treated in similar manner as to taxation paid in Question 7.1 for much the same reasons.

Required:

- (i) Draw up an initial trial balance.
- (ii) Classify the entries in terms of revenue, expense, asset or liability/claim.
- (iii) Construct a set of rudimentary financial statements based on your categorization in (ii).

### 7.3 Discussion Questions

#### *Question 7.3*

- (i) Based on your reading of Chapter 7 of the text, plus any additional literature which addresses the problem of defining financial statement elements (see, for example, Perks (1993) and Mathews and Perera (1990) which are referenced in the main text) outline the characteristics of expenses, revenues, assets, liabilities and claims?
- (ii) List and discuss some of the problems and difficulties involved in operationalizing these definitions with regard to particular receipts and payments?

#### *Question 7.4*

The following questions require you to reflect on the concepts of "profit" and "financial position" (or "income" and "wealth") for both commercial and non-commercial organizations.

- (i) What constituent elements are involved in arriving at profit and financial position (or income and wealth)?
- (ii) How does traditional financial accounting interpret the concepts of profit and financial position?
- (iii) Compare and contrast your interpretation in (i) above with that of traditional financial accounting

expanded in (ii) above (if you see these two differently).

(iv) How satisfactory is the traditional financial accounting model for measuring profit and financial position (or income and wealth) for commercial organisations? What problems do you see and how do you think they can be resolved?

(v) If you were asked to measure income and wealth for a non-commercial organisation how would you go about doing this?

(vi) What are the problems involved in using traditional financial accounting thinking for measuring income and wealth in non-commercial organisations?

### *Question 7.5*

Consider a professional football team, a hospital and your college. Are the 'stars' (top players, top consultants, top tutors, for example) assets of the organisation? Are they on the balance sheet? If not why not? Should they be?

### *Question 7.6*

For the following situations describe what accounting treatment you would adopt and which accounting conventions would assist you in determining that treatment.

For example in the case of a Theatre:

\* Theatre tickets worth £680 have been sold. The cash for these tickets has been received before balance day, however the tickets relate to performances after balance day. How should these tickets be treated in the accounts?

\* This money should not be treated as revenue as it relates to another accounting period. The matching convention and the periodicity convention cover this situation.

1. Melinda Chapman (one partner of Wakanui Kayaks – see earlier questions) has recently taken out a mortgage to buy herself a house in the country. What effect will this have on Wakanui Kayaks?

2. A liquor manufacturing company also has a classic car collection which contains, amongst other things, a rare special bodied Jowett Jupiter. The company paid £38,000 for the vehicle but has recently received an offer of £56,000 for it. Further, it is believed that at an auction the car could fetch £60,000. What figure should be shown in the accounts?

3. In the past all sales have been recorded when goods are delivered to the customer. Due to poor payment records it is being suggested that sales should be recognized on the receipt of cash from debtors. What conventions would support/inhibit this approach?

4. A mineral extraction company has recently started exploring for copper deposits in a remote part of Canada. To date \$490,000 has been spent but no reserves have yet been detected, however the company remains hopeful that deposits will be found. Should this amount be treated as an asset or an expense?

5. A company has assets of £54 million of which £20 million is land. During an environmental review they discover that 80 percent of the land is contaminated in such a manner that there is a legal requirement to clean it up immediately. It has been estimated that this will cost £44 million after which the contaminated land would be worth £8 million. What issues does this situation raise?

### *Question 7.7*

For this question you will need a set of published financial statements. We suggest that it is best treated as a group exercise, divided up amongst individuals. The discoveries of the individuals can

then be shared and discussed with the group.

Required:

Take one or more items in your chosen organisation's financial statements and:

- (i) Explain what the item is and whether it is an item of revenue, expense, asset or liability/claim.
- (ii) Outline how the figure involved is likely to have been arrived at.
- (iii) Specify what accounting conventions you think are likely to have been applied in determining this item.
- (iv) Compare this item with the same or a similar item in the published financial statements of another company in the same line of business. How and why are the two numbers different?

## 7.4 Selected Answers to Computational Questions

### Question 7.1

INITIAL TRIAL BALANCE FOR WACSNACKS LTD		
Account	Debit	Credit
Bank	55000	
Purchases	50000	
Creditors		5000
Sales		85000
Debtors	12000	
Salaries	10000	
Rent, rates, heat, etc.	12000	
Loan		100000
Retail outlet	40000	
Interest	7000	
Taxation	4000	
	<u>£190,000</u>	<u>£190,000</u>

Revenue: Sales.

Expense: Purchases, salaries, rent rates heat etc, interest, taxation\*.

Asset: Bank, debtors, retail outlet.

Liabilities/claim: Creditors, loan.

\* Taxation is an unusual kind of expense (actually we will go on to find that it is actually a distribution) in that rather than being consumed in order to generate sales it arises as a result of profit. This of course raises the interesting question of when a classified expense becomes a distribution. We always assume that salaries, for example, are an experience but it is not impossible to argue the case that this is also a distribution - for more on this point see Chapter 17. As such we keep it separate from the list of expenses in the simple profit and loss account we construct below.

<b>PROFIT AND LOSS ACCOUNT FOR WACSNACKS LTD</b>		
Sales		85,000
Less costs:		
Purchases	50,000	
Salaries	10,000	
Rent etc	12,000	
Interest	<u>7,000</u>	<u>79,000</u>
Profit		6,000
Less taxation		<u>4,000</u>
Profit after tax		<u><u>£2,000</u></u>

<b>BALANCE SHEET OF WACSNACKS LTD</b>	
<b>Assets:</b>	
Cash	55,000
Debtors	12,000
Retail outlet	<u>40,000</u>
	<u><u>£107,000</u></u>
<b>Liabilities/claims:</b>	
Creditors	5,000
Loan	100,000
Profit generated	<u>2,000</u>
	<u><u>£107,000</u></u>

Note: At this stage we are not too concerned with formats of accounts. The format here reflects that implicit within the accounting equations. As your studies advance you will be introduced to legally defined formats which are used in published financial statements.

## STUDENTS' WORKBOOK

### CHAPTER 8 ACCRUALS, PREPAYMENTS AND GENERAL PROVISIONS (and an introduction to the production and format of the profit and loss account and balance sheet)

#### 8.1 Introduction

This and subsequent Chapters focus on refining the accounting process so that the financial statements produced in compliance with the accounting conventions (especially those of periodicity and matching). The focus in this Chapter of the Workbook is on the timing problems which arise when various expenses are either unpaid at year end (in the case of accruals) or have been 'overpaid' for that year (in the case of prepayments). The matching or accrual convention dictates that these situations should be "tidied up" and only those expenses incurred during a year should appear in the profit and loss account. Expenses incurred during a period may not equal cash paid during the year and hence adjustments are required. At the same time any expenses owing need to be reflected as liabilities and overpayments need to be reflected as assets on the balance sheet.

A number of questions contain opening accrual and prepayment balances which can be dealt with using the same logic as that used in the Yothu Yindi Ltd example. You should be very familiar with this example before tackling the computational questions in section 8.2, which are designed to both reinforce your prior bookkeeping knowledge and explore the principles of accruals and prepayments. Section 8.3 contains discussion questions, while section 8.4 provides solutions to one of the computational questions.

#### 8.2 Computational problems

##### *Question 8.1*

We are going to return to Wakanui Kayaks, a small business which rents a shop in a retail complex and sells kayaks and other outdoor gear. Wakanui Kayaks has been operating successfully for a number of years and has now formed itself into a company. Their Balance Sheet as at 31.12.X6 is reproduced below.

BALANCE SHEET FOR WAKANUI KAYAKS LTD AS AT 31.12.X6		
Fixed Assets:		
Plant and Equipment	25,000	
Shop Fittings	<u>12,000</u>	37,000
Current Assets:		
Cash	5,600	
Debtors	2,000	
Prepayments - Insurance	120	
Prepayments - Rates	<u>80</u>	7,800
Current Liabilities:		
Creditors	1,200	
Accruals - Rent	110	
Accruals - Wages	195	
Accruals - Electricity	<u>85</u>	<u>(1,590)</u>
		<u>£43,210</u>
Represented by:		
Share Capital		40,000
Retained Earnings		<u>3,210</u>
		<u>£43,210</u>

During the year to 31.12.X7 the following transactions occurred.

1. Purchases stock for £60,000 of which £1,800 was still owing at year end. All this stock was sold during the year.
2. Made cash sales of £84,000 and credit sales of £3,000 during the year.
3. Opening debtors paid all the amounts outstanding and Wakanui Kayaks paid all their opening creditors.
4. Paid insurance of £720.
5. Paid rates of £480.
6. Paid rent during the year of £1,540.
7. Wages paid to employees totalled £2,400.
8. Electricity bills of £1,100 were paid.
9. Purchased additional shop fittings and paid cash of £12,600.

Required:

- (i) Open `T' Accounts from the Balance Sheet as at 31.12.X6.
- (ii) Enter the transactions described in note 1. to 9. into the `T' Accounts.
- (iii) Close off each `T' Account and prepare an initial trial balance.

In addition to the above transactions, at the end of the year the following adjustments need to be made.

10. Insurance paid relates to a 12 month period commencing from 1.3.X7.
11. Rates were paid on 1.3.X7 for one year in advance.
12. The amount paid for rent during the year includes that which was owed at 31.12.X6. The rent expenses increased to £130 per month for the whole of the year and one month remains unpaid at the end of the year.
13. Wages of £210 were owing at year end.
14. It is estimated that the total electricity expense for the year is £1,300.

Required:

- (iv) Enter these adjustments into an extended trial balance.
- (v) Prepare a pro-forma profit and loss account and balance sheet for the year ending 31.12.X7.

### Question 8.2

Debits & Credits is a sole trader owned by Don Entrie. The organisation provides courses for trainee accountants to assist them in passing their professional accountancy examinations (Debits & Credits has to pay an annual fee to the accountancy bodies to be an approved educator for this purpose). Debits & Credits is operated from rented premises. It started business with £5,000 of cash which Don put into the organisation.

During the first six months of operations the following transactions arose:

Received Fees	21,250
Paid:	
Rent	1,015
Electricity	610
Gas	990
Hire of equipment	660
Certification fee	3,800
Teaching salaries	7,400
Stationery and supplies	970

The following information is obtained:

- (a) The fees related to the first 6 months of operation only.
- (b) The rent paid includes a deposit of one months rent and rent is paid on the first day of each month.
- (c) An electricity bill for the sixth month of operation is due and is estimated to be £65.
- (d) One months gas bill, amounting to £180, remains unpaid at year end.
- (e) The certification fee covers a 12 month period.
- (f) Salaries of £1,100 was owing at the end of the six months.
- (g) All the stationery and supplies were used by the end of the first six months.

Required:

- (i) Record the initial transactions directly into the first two columns of an extended trial balance.  
(ii) Create an extended trial balance with the above information.

### Question 8.3

Welcome Ltd made the following payments for services during 20X7:

	\$/£/Y
Rates:	
Year to 31.3.20X8	1,200
Electricity:	
Quarter to 31.1.20X7	600
Quarter to 30.4.20X7	400
Quarter to 31.7.20X7	200
Quarter to 31.10.20X7	300
Gas:	
Quarter to 28.2.20X7	510
Quarter to 31.5.20X7	450
Quarter to 31.8.20X7	250
Quarter to 31.11.20X7	360
Telephone:	
Quarter to 31.12.20X6	190
Quarter to 31.3.20X7	210
Quarter to 30.6.20X7	230
Quarter to 30.9.20X7	250

It was noted from the 20X6 accounts that there were:

Payments in advance for rates	250
Accruals for electricity	400
Accruals for gas	170
Accruals for telephone	190

It was also noticed that the following payments were made in the first few months of 20X8:

For electricity quarter to 31.1.20X8	810
For gas quarter to 28.2.20X8	660
For telephone quarter to 31.12.20X7	280

Required:

- (i) Draw up the individual 'T' accounts for 20X7 to record these payment, accruals and prepayments.

(Note: Remember in your accounts to bring forward the accruals and prepayments balances for 20X6.)

### Question 8.4

Wishbone and Washer Ltd derived the following balances for their accounting system for 200X:

Cash at bank	48,000
Cash in hand	1,000
Buildings	100,000
Equipment	40,000
Motor vehicles	25,000
Purchases	150,000
Sales	240,000
Factory salaries	35,000
Administrative salaries	15,000
Factory light, heat and power	10,000
Administrative light and heat	5,000
Advertising, selling, etc.	9,000
Rates	1,000
Administration	3,000
Discounts received	2,000
Discounts allowed	2,500
Purchases returns	6,000
Sales returns	4,000
Creditors	74,000
Debtors	56,500
Other expenses	10,000
Government grants received	14,000
Long-term loans	40,000
Share Capital	120,000
Unappropriated profit from 200W	29,000
Interest paid	4,000
Dividend paid from 200W profits	6,000

(note 200W is the year prior to 200X)

Required:

- (i) Draw up an initial trial balance.
- (ii) Classify the entries in terms of revenue, expense, asset and liabilities/claims.

The following adjustments have been noted:

- (a) Factory salaries of £1,450 and admin salaries of £700 are owing at year end.
- (b) Factory light, heat and power figure does not include £3,000 which is owing at year end.
- (c) The advertising figure includes £2,000 relating to a campaign that is due to be launched in the next accounting period.
- (d) Rates are paid yearly in advance, with £200 of the above figure relating to the next accounting period.

Required:

- (iii) Record the above adjustments in the extended trial balance.  
 (iv) Construct a pro-forma profit and loss account and balance sheet from the above information.

### 8.3 Discussion topics

#### Question 8.5

Using a set of financial statements with which you are familiar examine the format and disclosure in the profit and loss account and the balance sheet. How is it similar to or different from the accounts you have prepared in the case of Wakanui Kayaks Ltd? Why are there some differences? What are the implications of these differences?

#### Question 8.6

Using your own financial position, identify what prepayments, accruals and general provisions exist at this point in time.

### 8.4 Selected answer to computational problem

#### 8.1 Wakanui Kayaks

- (i), (ii) and (iii)

Inflow/Debit	Plant and Equipment		Outflow/Credit
Opening balance	<u>25,000</u>	Bal c/d to T.Bal	<u>25,000</u>

Inflow/Debit	Shop Fittings		Outflow/Credit
Opening balance	12,000	Bal c/d to T.Bal	24,600
9. Cash	<u>12,600</u>		
	<u>£24,600</u>		<u>£24,600</u>

Inflow/Debit	Cash		Outflow/Credit
Opening balance	5,600	1. Purchases	58,200
2. Sales	84,000	3. Creditors	1,200
3. Debtors	2,000	4. Insurance	720
		5. Rates	480
		6. Rent	1,540
		7. Wages	2,400
		8. Electricity	1,100
		9. Shop Fittings	12,600
		Bal c/d to T.Bal	<u>13,360</u>
	<u>£91,600</u>		<u>£91,600</u>

<b>Inflow/Debit</b>	<b>Debtors</b>		<b>Outflow/Credit</b>
Opening balance	2,000	3. Cash	2,000
2. Sales	<u>3,000</u>	Bal c/d to T.Bal	<u>3,000</u>
	<u>£5,000</u>		<u>£5,000</u>

<b>Inflow/Debit</b>	<b>Insurance</b>		<b>Outflow/Credit</b>
Opening balance	120	Bal c/d to T.Bal	840
4. Cash	<u>720</u>		<u>840</u>
	<u>£840</u>		<u>£840</u>

<b>Inflow/Debit</b>	<b>Rates</b>		<b>Outflow/Credit</b>
Opening balance	80	Bal c/d to T.Bal	560
5. Cash	<u>480</u>		<u>560</u>
	<u>£560</u>		<u>£560</u>

<b>Inflow/Debit</b>	<b>Creditors</b>		<b>Outflow/Credit</b>
3. Cash	1,200	Opening balance	1,200
Bal c/d to T.Bal	<u>1,800</u>	1. Purchases	<u>1,800</u>
	<u>£3,000</u>		<u>£3,000</u>

<b>Inflow/Debit</b>	<b>Rent</b>		<b>Outflow/Credit</b>
6. Cash	1,540	Opening balance	110
	<u>1,540</u>	Bal c/d to T.Bal	<u>1,430</u>
	<u>£1,540</u>		<u>£1,540</u>

<b>Inflow/Debit</b>	<b>Wages</b>		<b>Outflow/Credit</b>
7. Cash	2,400	Opening balance	195
	<u>2,400</u>	Bal c/d to T.Bal	<u>2,205</u>
	<u>£2,400</u>		<u>£2,400</u>

<b>Inflow/Debit</b>	<b>Electricity</b>		<b>Outflow/Credit</b>
8. Cash	1,100	Opening balance	85
	<u>          </u>	Bal c/d to T.Bal	<u>1,015</u>
	<b><u>£1,100</u></b>		<b><u>£1,100</u></b>

<b>Inflow/Debit</b>	<b>Share Capital</b>		<b>Outflow/Credit</b>
Bal c/d to T.Bal	<u>40,000</u>	Opening balance	<u>40,000</u>

<b>Inflow/Debit</b>	<b>Retained Earnings</b>		<b>Outflow/Credit</b>
Bal c/d to T.Bal	<u>3,210</u>	Opening balance	<u>3,210</u>

<b>Inflow/Debit</b>	<b>Purchases</b>		<b>Outflow/Credit</b>
1. Cash	58,200	Bal c/d to T.Bal	60,000
1. Creditors	<u>1,800</u>		<u>          </u>
	<b><u>£60,000</u></b>		<b><u>£60,000</u></b>

<b>Inflow/Debit</b>	<b>Sales</b>		<b>Outflow/Credit</b>
Bal c/d to T.Bal	87,000	2. Cash	84,000
	<u>          </u>	2. Debtors	<u>3,000</u>
	<b><u>£87,000</u></b>		<b><u>£87,000</u></b>

TRIAL BALANCE FOR WAKANUI KAYAKS (31.12.X7)		
Account	Debit	Credit
Plant and equipment	25,000	
Shop fittings	24,600	
Cash	13,360	
Debtors	3,000	
Insurance	840	
Rates	560	
Creditors		1,800
Rent	1,430	
Wages	2,205	
Electricity	1,015	
Share Capital		40,000
Retained earnings		3,210
Purchases	60,000	
Sales		87,000
	<u>£132,010</u>	<u>£132,010</u>

(iv)

**EXTENDED TRIAL BALANCE at 31 DECEMBER  
FOR WAKANUI KAYAKS LTD (000's)**

Account	Trial Balance		Adjustments		Profit & Loss		Balance Sheet	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Plant & equipment	25,000						25,000	
Shop fittings	24,600						24,600	
Cash	13,360						13,360	
Debtors	3,000						3,000	
Insurance	840			(10) 120	720			
Rates	560			(11) 80	480			
Creditors		1,800						1,800
Rent	1,430		(12) 130		1,560			
Wages	2,205		(13) 210		2,415			
Electricity	1,015		(14) 285		1,300			
Share Capital		40,000						40,000
Retained earnings		3,210						3,210
Purchases	60,000				60,000			
Sales		87,000				87,000		
Prepay-insurance			(10) 120				120	
Prepay-rates			(11) 80				80	
Accrual-rent				(12) 130				130
Accrual-wages				(13) 210				210
Accrual-electricity				(14) 285				285
Profit					20,525			20,525
<b>TOTALS</b>	<b>132,010</b>	<b>132,010</b>	<b>825</b>	<b>825</b>	<b>87,000</b>	<b>87,000</b>	<b>66,160</b>	<b>66,160</b>

(v)

<b>PROFIT AND LOSS ACCOUNT OF WAKANUI KAYAKS LTD FOR YEAR ENDING 31.12.X7</b>		
Sales		87,000
Less Purchases		<u>(60,000)</u>
<b>GROSS PROFIT</b>		<b>27,000</b>
Less Expenses:		
Insurance	720	
Rates	480	
Rent	1560	
Wages	2415	
Electricity	<u>1300</u>	<u>(6,475)</u>
<b>NET PROFIT</b>		<b><u>£20,525</u></b>

<b>BALANCE SHEET OF WAKANUI KAYAKS LTD AS AT 31.12.X7</b>		
Fixed Assets:		
Plant and equipment	25,000	
Shop fittings	<u>24,600</u>	49,600
Current Assets:		
Cash	13,360	
Debtors	3,000	
Prepayments-insurance	120	
Prepayments-rates	<u>80</u>	16,560
Less Current Liabilities:		
Creditors	1,800	
Accruals-rent	130	
Accruals-wages	210	
Accruals-electricity	<u>285</u>	<u>(2,425)</u>
		<u>£63,373</u>
Represented by:		
Share capital		40,000
Retained Earnings		3,210
Plus profit		<u>20,525</u>
		<u>£63,735</u>

## STUDENTS' WORKBOOK

### CHAPTER 9 DEPRECIATION OF FIXED ASSETS AND PROFITS AND LOSSES ON DISPOSAL

#### 9.1 Introduction

There are a number of points to keep in mind in this chapter of the Workbook. First, the aim of depreciation is to attempt a proper matching of revenues and expenses. In this case the "using up" of an asset is being recorded by way of a depreciation charge to the profit and loss account. The asset is progressively recognized as an expense. Second, it is important to remember the following points: (i) depreciation is calculated in a relatively arbitrary manner and involves a number of estimates to be made (asset life, residual value etc), (ii) depreciation charged to the profit and loss account does not equate to cash being set aside for replacement of that asset (depreciation is a non-cash charge to the profit and loss account) and (iii) net book value (asset cost less accumulated depreciation to date) does not necessarily have any relationship to the value of that asset - as estimated by, for example, the amount the asset could be sold for. It is this final point (in conjunction with other estimates that are made in this process) which requires the recognition of a "profit or loss on the disposal" of a fixed asset.

The chapter is organised in the following manner. Section 9.2 contains a number of computational questions designed to increase your familiarity with calculating depreciation. Question 9.5 is different from the other questions in that it is a much larger question which requires you to apply your bookkeeping knowledge from previous chapters. Work through this question systematically, returning to previous chapters where you need to. Tackling such a cumulative question will pay great dividends in the future and will reinforce the material you have already covered. Following chapters of the Workbook also adopt this strategy. Three discussion questions are covered in section 9.3 and selected answers to computational questions are contained in section 9.4.

#### 9.2 Computational problems

##### *Question 9.1*

Hesket Ltd brought some new equipment on 1.1.2005 for £40,000. After much discussion and disagreement with the accountants it was agreed by the directors that the equipment will be replaced after 5 years at which time it is estimated that it will be worth £8,000 on the second-hand market.

Required:

- (i) Calculate the annual depreciation charge for each of the five years using the straight line and the reducing balance method.
- (ii) Draw up the relevant accounting records (in the form of 'T' Accounts) for the straight line method in the first year.

Question 9.2

Britten Enterprises had the following balances in its fixed asset accounts at 31.12.2007:

	Cost	Accumulated Depreciation	Net Book Value
Equipment	85,000	(32,000)	53,000
Motor Vehicles	35,000	(15,000)	20,000

The equipment was all purchased on 1.1.04 and at that time had an estimated scrap value of £5,000. The motor vehicles were all purchased on 1.1.05 and at that time no scrap value was anticipated. Full allowance is made for depreciation of fixed assets in the year of purchase and no depreciation is charged in the year of sale.

In January 2008 half the equipment by value was sold for £28,000 and new equipment worth £61,000 was purchased (it has an estimated scrap value of £5,000 and a useful life of 10 years). In addition, one motor vehicle was sold. While it had originally cost £7,000, only £3,500 was received from the sale.

Required:

- (i) What is the useful lives of the above assets, assuming depreciation is calculated on a straight line basis.
- (ii) Use the relevant 'T' accounts to record the sale and purchase of fixed assets during the year. Clearly identify any profit or loss on sale of fixed assets.
- (iii) Calculate the depreciation charge to the profit and loss account for the year to 31.12.08.

Question 9.3

The following records are extracted from the balance sheet of Upward and Onward Ltd, a retail outlet, as at 31.12.2001.

Description	Cost	Accumulated depreciation	Net book value
Fixed Assets:			
Buildings	280,000	(56,000)	224,000
Fixtures and fittings	82,000	(75,000)	7,000
Motor vehicles	<u>26,000</u>	<u>(10,000)</u>	<u>16,000</u>
	388,000	(141,000)	247,000

During the year ending 31.12.2002 the following movements in fixed assets arose:

- (a) During the year the whole shop was refitted. All the fixtures and fittings were removed and new

fixtures and fittings to the value of £186,000 were installed, of which £30,000 remains unpaid. The old fixtures and fittings yielded £8,600 in cash. The new fixtures and fittings are expected to last ten years and a nil scrap value is assumed.

(b) The motor vehicles account includes of a delivery van purchased on 1.1.2000 for £16,000, which had a useful life of 4 years. It is replaced during 2002 by a new van which cost £20,000 and was paid for during the year. It is estimated to have a 4 year useful life and a scrap value of £4,000. Sale of the old van yielded £9,500.

The remainder of the motor vehicles account relates to a car which was purchased on 1.1.2001.

In addition, you are given the following information:

- all fixed assets have been depreciated on a straight line basis.
- the buildings were purchased 5 years ago (on 1.1.1997) and nil scrap value is assumed.
- no depreciation is charged in the year of sale and a full years depreciation is charged in the year of purchase.

Required:

(i) Open the relevant 'T' accounts to record the above information. (*HINT: You have to work out the useful life of the Buildings for yourself.*)

(ii) Prepare an extract of the Fixed Assets section of the Balance Sheet of Upward and Onward Ltd as at 31.12.2002.

#### Question 9.4

The following information has been extracted from the accounts of Pacifica Garage Ltd as at 31.3.2009.

	Cost
Land	60,000
Buildings	50,000
Plant and equipment	35,000
Shop fittings	15,000
Motor vehicles	<u>15,000</u>
Total	<u>\$175,000</u>

You have the following information:

(i) The land and buildings were purchased on 1.4.2001. At that time the useful life of the buildings was assessed to be 25 years with nil scrap value.

(ii) The plant and equipment and shop fittings were purchased 18 months after the land and buildings. The plant and equipment was assessed to have a scrap value of \$3,000 and a useful life of 8 years. The shop fittings had an estimated scrap value of \$3,000 and a useful life of 6 years.

(iii) The motor vehicles account comprises of a car (cost \$8,000 on 1.4.2007) and a van (cost \$7,000 on 1.4.2008). No scrap values have been assumed on either and they are expected to have useful lives of 8 and 5 years respectively.

(iv) During the year to 31.3.2010 the following purchases and sales of fixed assets occurred:

- Sold all the shop fittings for \$2,500 cash.
- Sold half the plant and equipment by value for \$5,000 cash.
- Sold the van and made a \$600 loss.
- Purchased shop fittings for \$17,300 which had an estimated scrap value of \$500.
- Purchased \$41,600 of plant and equipment.
- Purchased a new van for \$8,500 which has an estimated scrap value of \$2,500 and a useful life of 6 years.

Use straight line depreciation and assume that asset purchases have the same total useful life as existing assets unless otherwise stated.

Required:

- (i) As at 31.3.2009 calculate the accumulated depreciation and net book values for Pacifica Garage Ltd's fixed assets.
- (ii) Accounting for the purchase and sale of fixed assets during the year to 31.3.2010 using 'T' account.
- (iii) Calculate the depreciation expense for the year to 31.3.2010.

#### *Question 9.5*

Bruce's Adventure School Ltd is an outdoor activity centre in a remote but beautiful area of Scotland. Each month outdoor courses are run by Bruce and his staff for a course fee. The following balance sheet relates to the year ended 31.12.2005.

Balance Sheet of Bruce's Adventure School Ltd as at 31.12.05			
	Cost	Acc. Depn	NBV
Fixed Assets:			
Land	180,000	-	180,000
Buildings	65,000	-	65,000
Motor vehicles	22,500	(11,600)	10,900
Launch	18,000	(2,300)	15,700
Sailing boats	<u>6,000</u>	<u>(2,000)</u>	<u>4,000</u>
Total fixed assets	291,500	(15,900)	275,600
Current Assets:			
Cash	16,820		
Prepayment-rates	1,680		
Prepayment-insurance	4,800		
Debtors	<u>5,470</u>	28,770	
Current Liabilities:			
Creditors	2,390		
Accruals-electricity	1,360		
Accruals-wages	<u>2,800</u>	<u>(6,550)</u>	
Net Current Assets			22,220
Less Long Term Liability			
Loan			<u>(95,000)</u>
			<u>£202,820</u>
Represented by:			
Share Capital			150,000
Retained Earnings			<u>52,820</u>
			<u>£202,820</u>

You have been given the following information for the year to 31.12.06.

(1) Fixed Assets

All fixed assets were purchased 1.1.02. At that time the following scrap values and useful lives had been estimated for each class of asset.

	Scrap value	Estimated life
Motor Vehicles	8,000	5
Launch	6,500	20
Sailing Boats	1,000	10

Straight line depreciation has been used.

During the year one of the motor vehicles was sold for £3,000 (cost £8,500, scrap value £2,400).

In its place a new vehicle was purchased for £12,800 (of which £2,000 is unpaid at year end). It is estimated that it will have a scrap value of £3,200 in 8 years time when it comes to the end of its useful life.

In addition, half of the sailing boats (by value) were sold for £2,400. They were replaced by new boats costing £4,920 which are expected to have a 12 year useful life and no scrap value. These boats were paid for during the year.

## (2) Fees and Debtors

The opening debtors balance comprises fees owing to the organisation. During the year all these fees were received. Fees totalling £284,700 were received in cash for course run over the year. At the end of the year £6,100 of fees were still owing. In addition £2,500 of the fee income received in cash relates to courses to be held after 31.12.06.

## (3) Expenses and Creditors

The following payments were made during the year:

Opening creditors	2,390
Rates	6,960
Insurance	12,000
Electricity	25,250
Wages	36,210
Food	56,900
Vehicle running costs	16,850
Launch running costs	4,900
Sailing boats repairs & maint.	5,000
Buildings repairs & maint.	6,790
Certification	25,000
Safety costs	8,440
Tree planting	26,800

*HINT: you need to make a decision as to the appropriate treatment of the tree planting expenditure. Is it an asset or an expense?*

In addition:

- Rates covers the period 1.4.06 to 31.3.07.
- Insurance is paid 31.6.06 and covers a 12 month period.
- Wages of £3,290 are outstanding at the end of the period.

#### (4) Long Term Loan

The long term loan carries an interest rate of 8% p.a. Interest is paid 6 monthly in advance on 1 April and 1 July each year. During the year £8,000 of the capital of the loan was repaid.

Required:

- (i) Record the opening balances and the transactions during the period into 'T' accounts and prepare an initial trial balance.
- (ii) In an extended trial balance make end of period adjustments for prepayments, accruals, income in advance and depreciation.
- (iii) Prepare a pro forma profit and loss account and balance sheet as at 31.12.06.

### 9.3 Discussion topics

#### *Question 9.6*

One of the owners of Pacifica Garage Ltd (question 9.4 above) suggests that the net book value of the fixed assets on the balance sheet indicates what cash would be generated if the assets were sold. Write a brief report explaining if this is the case.

#### *Question 9.7*

In Bruce's Adventure School Ltd (question 9.5 above) you had to make some decision about whether or not to capitalise tree planting expenditure. Write a brief justification for the approach you have taken.

#### *Question 9.8*

The manager of Bruce's Adventure School Ltd (question 9.5 above) is confused as to why the profit figure in the profit and loss account is different from the increase in the cash balance over the year. Explain why the two differ using examples drawn from the accounts you have prepared.

### 9.4 Selected answers to computational problems

#### *Question 9.1*

Hesket Ltd

- (i) Depreciation charges under straight line and reducing balances method.

	Straight line method	Reducing balances method
Cost	40,000	40,000
2005 depreciation	6,400	* 11,000
Net Book value	33,600	29,000
2006 depreciation	6,400	7,975
Net Book value	27,200	21,025
2007 depreciation	6,400	5,782
Net Book value	20,800	15,243
2008 depreciation	6,400	4,192
Net Book value	14,400	11,051
2009 depreciation (and rounding correction)	6,400	3,051
Estimated sales proceeds	8,000	8,000

\* 27.5% rounded.

(ii) 'T' accounts under straight line method.

Inflow/Debit	Equipment	Outflow/Credit
Opening balance	40,000	

Inflow/Debit	Accumulated depreciation of equipment	Outflow/Credit
	31.12.05 Depreciation	6,400

Inflow/Debit	Depreciation on equipment	Outflow/Credit
31.12.05 Acc Depn	6,400	

### Question 9.2

Britten Enterprises

(i) Useful lives

Equipment:

85,000 - 5,000 = 80,000 (depreciable cost)

Depreciated for 4 years ... total 32,000 therefore 8,000 p.a.

80,000/8,000 = 10 year life

Motor Vehicles:

35,000 (depreciable cost)

Depreciated for 3 years ... total 15,000 therefore 5,000 p.a.

35,000/5,000 = 7 year life

(ii) 'T' Accounts

Inflow/Debit	Equipment		Outflow/Credit
Opening balance	85,000	Sale	42,500
Purchase	<u>61,000</u>	Bal c/d to T.Bal	<u>103,500</u>
	<u>£146,000</u>		<u>£146,000</u>

Inflow/Debit	Acc. Depn. on equipment		Outflow/Credit
Sale	16,000	Opening balance	32,000
Bal c/d to T.Bal	<u>25,600</u>	Depreciation	<u>9,600</u>
	<u>£41,600</u>		<u>£41,600</u>

Inflow/Debit	Sale of equipment		Outflow/Credit
Cost	42,500	Acc. Depn	16,000
Gain - Bal c/d to T.Bal	<u>1,500</u>	Cash	<u>28,000</u>
	<u>£44,000</u>		<u>£44,000</u>

Inflow/Debit	Motor vehicles		Outflow/Credit
Opening balance	35,000	Sale	7,000
	<u>35,000</u>	Bal c/d to T.Bal	<u>28,000</u>
			<u>£35,000</u>

Inflow/Debit	Acc. Depn. on motor vehicles		Outflow/Credit
--------------	------------------------------	--	----------------

Sale	3,000	Opening balance	15,000
Bal c/d to T.Bal	<u>16,000</u>	Depreciation	<u>4,000</u>
	<u>£19,000</u>		<u>£19,000</u>

Inflow/Debit	Sale of motor vehicles	Outflow/Credit	
Cost	7,000	Acc. Depn	3,000
		Cash	3,500
		Loss - Bal c/d to T.Bal	<u>500</u>
	<u>£7,000</u>		<u>£7,000</u>

(iii) Depreciation charge

Equipment:

Old equipment ... depreciable cost  $(42,500 - 2,500) = 40,000/10$  years = £4,000

New equipment ...  $61,000 - 5,000 = 56,000/10$  years = £5,600

Total depreciation = £9,600

Motor Vehicles:

Balance of motor vehicles =  $£28,000/7$  years = £4,000

## STUDENTS' WORKBOOK

### CHAPTER 10 STOCK ALLOCATION, VALUATION AND THE COST OF SALES

#### 10.1 Introduction

Chapter 10 continues the introduction to the adjustments which are required to allow the construction of the profit and loss account and the balance sheet. This time we are seeking to (more) accurately allocate the cost of stocks between that which is still held by the entity at year end (in the form of inventory - an asset) and that which was sold during the year (the cost of sales figure). This is a very important element of the construction of financial statements in practice as this judgement has a direct, and often substantial, impact on profits. The ability to make this adjustment is further complicated by the fact that items of inventory are often purchased for different costs during the year.

The chapter is organised thus: section 10.2 contains a number of computational questions. The first three test your understanding of the stock allocation adjustment, while the remaining two (Question 10.4 and 10.5) require you to prepare a full set of books incorporating all the adjustments you have covered to date (in a similar fashion as Question 9.5). Once again we have included such questions to reinforce your understanding of previous topics - return to earlier chapters if you are having problems with these two questions. Section 10.3 contains two discussion questions. Finally section 10.4 provides selected answers to selected computational questions.

#### 10.2 Computational problems

##### *Question 10.1*

Wonderbug Ltd, which buys and sells cans of fly repellent, had the following transactions in January 200X:

- 1 January opening inventory 2,500 cans at \$1.50 per can
- 2 January 1,000 cans purchased at \$1.60 per can
- 9 January 1,100 cans purchased at \$1.70 per can
- 18 January 900 cans purchased at \$1.70 per can
- 22 January 1,200 cans purchased at \$1.80 per can
- 29 January 1,400 cans purchased at \$1.90 per can

Sales for January totalled 6,500 cans transferred from inventory on the following dates:

- 10 January 2,500 cans
- 23 January 4,000 cans

Required:

Using FIFO, LIFO and AVCO methods assess the cost of sales and inventory figures for the month of January using a:

- (i) Perpetual method of inventory valuation;
- (ii) Periodic method of inventory valuation.

*(Note: (1) A periodic method of inventory valuation assumes that the sales are made on the last day of the period and allocates stock units on that basis. In contrast, a perpetual method of inventory valuation takes the units which are in inventory at the time of the sale and allocates them on a FIFO, LIFO or AVCO basis as at that date. That is, it continuously updates the stock figures. Invariably the LIFO and AVCO figures are different under the two methods. In the example in chapter 10 the periodic method had been used. (2) It is useful to photocopy the tables (on the following pages) to calculate the various figures.)*

### Question 10.2

Makepiece Ltd started producing Part No. 23 for a range of products made by their sister company Comworks Ltd during January 200X. To produce 1 unit of Part No. 23 involves:

- 1 piece of pre-turned metal
- 2 hours of labour time in two separate processes of 1 hour each
- 4 units of electricity in two separate processes (aligned to labour input) of 2 units each (see section 10.3 of the main text - or any introductory management accounting text - for an introduction to the complexities of this area).

During 200X the following occurred:

- 25,000 pieces of metal were purchased at £2 per piece.
- 50,000 labour hours were expended at £3 per hour.
- 100,000 units of electricity were consumed at £0.50 per unit.
- 18,000 complete units were sold at £15 per unit.
- £23,000 of other factory overheads were incurred which, when applied to production, were to be charged out at £1 per unit as soon as production commences.

At the end of 200X it was ascertained that there were:

- 2,000 pieces of unprocessed metal in stock.
- 2,800 units of Part No. 23 finished up to the first stage (i.e. using 1 hour of labour time and 2 units of electricity).
- 2,200 units of finished goods.
- Indirect labour costs totalling £20,400 (6,800 hours consumed at £3 per hour) and indirect electricity cost £6,800 (13,600 units consumed at £0.50 per unit).

Required:

Draw up the basic accounts and the profit and loss account for 200X along with balance sheet abstracts under the following separate assumptions.

- (i) That factory overheads are charged to the units in production.
- (ii) That factory overheads feature as a total expense item in the profit and loss account.

*(Note: It is important to build up the inventory figures from the elements which constitute them, i.e. metal, salaries, heat etc.)*

### Question 10.3

At the end of 2005, the second year of operations for W. Wally Ltd (see Question 7.2 for the first year), the following balances were drawn from the accounting system of the company:

	£
Cash at bank	12,000
Buildings	60,000
Equipment	20,000
Accumulated Depreciation on Equipment	2,000
Motor vehicles	15,000
Accumulated Depreciation on Motor vehicles	3,000
Purchases	90,000
Sales	180,000
Salaries	50,000
Light, heat and power	12,000
Selling expenses	10,000
Administration and property costs (including rates)	4,900
Discounts received	1,700
Discounts allowed	1,100
Sales returns	3,000
Purchase returns	4,500
Creditors	28,000
Debtors	33,000
2004 interim taxation repaid	4,000
Share capital	80,000
Long term loans	25,000
Interest paid	2,500
Accruals (of heat and light from 2004)	1,000
Payments in advance (of rates from 2004)	500
Inventory (from 2004)	5,000
Loss for 2004	10,200

The following additional information is discovered:

1. light, heat and power incurred but not paid was £1,200.
2. There was a payment in advance for rates of £700.
3. Depreciation for the year needed to be provided on a straight line basis in the following amounts:

Equipment	£2,000
Motor vehicles	£3,000

4. Inventory at 31.12.2005 was £20,000.

Required:

- (i) Draw up an extended trial balance.
- (ii) Construct a more detailed and precise version of the financial statements.

Notes:

- (1) You need to adjust for both opening and closing accruals and prepayments accounts.
- (2) The tax repayment for 2004 received in 2005 is most obviously seen as an adjustment to the loss brought forward and should be linked with this on the balance sheet.

#### Question 10.4

Your friend Nicola Mansell, a sole trader, runs a small garage in Forfar and knows nothing about how to prepare financial accounts. Therefore, she has asked you to prepare a profit and loss account and balance sheet for the year ending 31.12.X2. You find a balance sheet prepared the previous year by another accountant and decide to use this as a starting point. After much discussion you ascertain the following information:

- (a) All the fixed assets were purchased on 1.1.W7 (that is, in the previous decade). Straight line depreciation has been used for all assets and nil residual values were assumed - the same depreciation policy applies to purchases in the current year. Depreciation is not charged in year of sale, a full year's depreciation is charged in year of purchase. During the year plant and equipment was sold for £14,000 (original cost £20,000) and motor vehicles costing £12,000 were sold for book profit of £2,000. (Hint: Look at the Balance Sheet ... the motor vehicles are currently wholly depreciated ... this means that any profit on disposal must equal the cash received from the disposal). Additions to plant and equipment cost £30,000 (of which £7,000 remains unpaid) and motor vehicles of £15,000 were purchased for cash.
- (b) During the year Nicola made sales totalling £485,000 of which £12,300 remained unpaid at year end. All the debtors from 20X1 were paid.
- (c) The 20X1 inventory relates to parts (£23,800) and consumables (£6,000). During the year a further £213,000 of parts and £143,000 of consumables were purchased. At year end a stocktake revealed that £25,000 of parts and £8,500 of consumables remained on hand. All 20X1 creditors were paid, but at the end of 20X2 £12,600 was owed to suppliers.
- (d) During the year the following cash payments were made:
  - Wages £18,600 (with a further £600 owing at year end)
  - Rates £920 (of which £120 relates to the next financial year)
  - Advertising £8,900
  - Travelling costs £ 6,300
  - Electricity £23,900 (the total amount of electricity used is estimated to be £24,100).
- (e) The loan incurred interest at 9% p.a. which was paid during the year. On the last day of the year Nicola repaid £5,000 of the principal.

BALANCE SHEET OF NICOLA MANSELL AS AT 31.12.X1			
	Cost	Acc. Depn.	NBV
Fixed Assets:			
Land	100,000		100,000
Buildings	80,000	(20,000)	60,000
Plant & Equipment	50,000	(25,000)	25,000
Motor Vehicles	<u>25,000</u>	<u>(25,000)</u>	-
	<u>255,000</u>	<u>(70,000)</u>	185,000
Intangible Assets:			
Goodwill		20,000	
Patent		<u>8,000</u>	28,000
Current Assets:			
Bank		14,850	
Inventory		29,800	
Debtors		<u>8,400</u>	
		<u>53,050</u>	
Less Current Liabilities:			
Creditors		<u>(9,400)</u>	43,650
Less Long Term Liabilities:			
Loan			<u>(20,000)</u>
			<u>£236,650</u>
Represented by:			
Capital			150,000
Accumulated profits			<u>86,650</u>
			<u>£236,650</u>

Required:

- (i) Open the appropriate accounts for Nicola Mansell's business and record the transactions for the year.
- (ii) Prepare a Profit & Loss Account for the year ending 31.12.X2.
- (iii) Prepare a Balance Sheet as at 31.12.X2.

### Question 10.5

You have just been appointed financial consultant for Temptations Ltd, who manufacture hand-crafted chocolates for immediate human consumption. During the past year (20X4) they have not had an accountant but present you with last year's Balance Sheet and information about the company and the year's transactions.

BALANCE SHEET OF TEMPTATIONS LTD AS AT 31.12.X3			
	Cost	Acc. Depn.	NBV
Fixed Assets:			
Land	580,000		580,000
Buildings	265,000	(33,125)	231,875
Machinery	186,000	(62,000)	124,000
Fixtures & Fittings	102,000	(51,000)	51,000
Motor Vehicles	<u>84,000</u>	<u>(60,000)</u>	<u>24,000</u>
	<u>1,217,000</u>	<u>(206,125)</u>	1,010,875
Intangible Assets:			
Goodwill		12,000	
Research and Development		<u>82,000</u>	94,000
Current Assets:			
Debtors		18,600	
Stock		36,200	
Prepayments		<u>1,600</u>	
		<u>56,400</u>	
Less Current Liabilities:			
Creditors		8,400	
Accruals		2,100	
Bank		<u>26,800</u>	
		<u>37,300</u>	19,100
Less Long Term Liabilities:			
Debentures			<u>(130,000)</u>
			<u>£993,975</u>
Represented by:			
Issued Share Capital			
Ordinary			400,000
Preference			250,000
General Reserve			60,000
Retained Earnings			<u>283,975</u>
			<u>£993,975</u>

Additional Information:

(1) Fixed Assets

All the fixed assets were purchased on 1.1.W9 (that is, during the previous decade) when the company set up operations. During the year one machine which cost £43,000 was sold for £25,000 and replaced at a cost of £52,000. Likewise motor vehicles which had cost £14,000 were sold for £5,000. New vehicles worth £20,000 were purchased. It is the company's policy not to depreciate assets in the year of sale and to provide a full year's worth of depreciation in the year of purchase. All depreciation is calculated on a straight line basis.

## (2) Intangibles

During the year £6,700 was spent on developing a new flavour chocolate centre. The company decided to capitalise this expenditure. At the moment there is no policy in place to write off intangible assets.

## (3) Debtors, Creditors, Prepayments and Accruals

All opening creditors were paid and all opening debtors paid. Debtors of £18,400 were owing at the end of the year. The opening prepayments related to rates while the opening accrual is made up of £1,800 owed in salaries with the remainder relating to electricity.

## (4) Purchases, Sales and Stock

Purchases of £727,800 were made during the year with £10,200 of these remaining unpaid at year end. Sales for the year totalled £1,892,200 of which £18,700 relates to goods to be delivered in the next financial year. Stock at year end cost Temptations £40,900, however, closer scrutiny indicated that some items which had cost £8,000 could now only be sold for £5,000.

## (5) Debentures

Interest on the debentures is set at 6% p.a. and is payable at six-monthly intervals. At the end of the year one interest payment is outstanding. No amount of the debentures were repaid during the year but £25,000 is due to be repaid in the next financial year.

## (6) Expenses

The following information concerns sundry expenses paid:

Rental	26,400
Rates (for the year to 31.3.X5)	31,800
Electricity	137,200
Salaries	286,000
Repairs and maintenance	43,800
Sundry purchases	12,700

At the end of the year it was noted that £26,200 of salaries remained unpaid and that the total electricity expense incurred was £137,800.

## (7) Other

On the last day of the year Temptations invested £500,000 on short term deposit with the bank. The preference shares carry a 10% dividend, which was unpaid at year end. No dividends were declared on the ordinary shares.

Required:

Prepare the books of account for the year ended 31.12.X4 and present the profit and loss account and balance sheet from that information.

### 10.3 Discussion topics

#### Question 10.6

(a) When would the following stock valuation methods be appropriate:

- (i) LIFO
- (ii) FIFO
- (iii) AVCO

(b) In times of rising inventory prices how will the method of inventory valuation affect:

- (i) an entity's profit?
- (ii) an entity's stock valuation?

#### Question 10.7

Using the financial statements of a organisation with which you are familiar:

- (i) identify the stock valuation method used.
- (ii) make a note of any other factors affecting stock valuation which the annual report and accounts mention.

### 10.4 Selected answers to computational problems

#### Question 10.1

Perpetual Method - Inventory valuation method <b>FIFO</b>									
Opening stock and purchases				Sales			Inventory		
Date	Quantity	Unit	Total	Quantity	Unit	Total	Quantity	Unit	Total
200X		Cost	Cost		Cost	Cost		Cost	Cost
1 Jan	2,500	1.50	3,750				2,500	1.50	3,750
2 Jan	1,000	1.60	1,600				1,000	1.60	1,600
9 Jan	1,100	1.70	1,870				1,100	1.70	1,870
10 Jan				2,500	1.50	3,750	1,000	1.60	1,600
							1,100	1.70	1,870
18 Jan	900	1.70	1,530				900	1.70	1,530
22 Jan	1,200	1.80	2,160				1,200	1.80	2,160
23 Jan				1,000	1.60	1,600			
				1,100	1.70	1,870			
				900	1.70	1,530			
29 Jan	1,400	1.90	2,660	1,000	1.80	1,800	200	1.80	360
Totals	8,100		13,570	6,500		10,550	1,600	1.90	2,660

Periodic Method - Inventory valuation method <b>FIFO</b>									
Opening stock and purchases				Sales			Inventory		
Date 200X	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost
1 Jan	2,500	1.50	3,750	2,500	1.50	3,750			
2 Jan	1,000	1.60	1,600	1,000	1.60	1,600			
9 Jan	1,100	1.70	1,870	1,100	1.70	1,870			
18 Jan	900	1.70	1,530	900	1.70	1,530			
22 Jan	1,200	1.80	2,160	1,000	1.80	1,800	200	1.80	360
29 Jan	<u>1,400</u>	1.90	<u>2,660</u>	-----		-----	<u>1,400</u>	1.90	<u>2,660</u>
Totals	8,100		13,570	6,500		10,550	1,600		3,020

Perpetual Method - Inventory valuation method <b>LIFO</b>									
Opening stock and purchases				Sales			Inventory		
Date 200X	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost
1 Jan	2,500	1.50	3,750				2,500	1.50	3,750
2 Jan	1,000	1.60	1,600				1,000	1.60	1,600
9 Jan	1,100	1.70	1,870				1,100	1.70	1,870
10 Jan				1,100	1.70	1,870			
				1,000	1.60	1,600			
				400	1.50	600	2,100	1.50	3,150
18 Jan	900	1.70	1,530				900	1.70	1,530
22 Jan	1,200	1.80	2,160				1,200	1.80	2,160
23 Jan				1,200	1.80	2,160			
				900	1.70	1,530			
				1,900	1.50	2,850			
							200	1.50	300
29 Jan	<u>1,400</u>	1.90	<u>2,660</u>	-----		-----	<u>1,400</u>	1.90	<u>2,660</u>
Totals	8,100		13,570	6,500		10,610	1,600		2,960

Periodic Method - Inventory valuation method <b>LIFO</b>									
Opening stock and purchases				Sales			Inventory		
Date 200X	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost
1 Jan	2,500	1.50	3,750	900	1.50	1,350	1,600	1.50	2,400
2 Jan	1,000	1.60	1,600	1,000	1.60	1,600			
9 Jan	1,100	1.70	1,870	1,100	1.70	1,870			
18 Jan	900	1.70	1,530	900	1.70	1,530			
22 Jan	1,200	1.80	2,160	1,200	1.80	2,160			
29 Jan	<u>1,400</u>	1.90	<u>2,660</u>	<u>1,400</u>	1.90	<u>2,660</u>	-----		-----
Totals	8,100		13,570	6,500		11,710	1,600		2,400

Perpetual Method - Inventory valuation method AVCO									
Opening stock and purchases				Sales			Inventory		
Date 200X	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost
1 Jan	2,500	1.50	3,750				2,500	1.50	3,750
2 Jan	1,000	1.70	1,600				1,000	1.60	1,600
9 Jan	1,100		1,870				1,100	1.70	1,870
10 Jan		1.70		2,500	1.57	3,924	2,100	1.57	3,296
18 Jan	900	1.80	1,530				900	1.70	1,530
22 Jan	1,200		2,160				1,200	1.80	2,160
23 Jan		1.90		4,000	1.66	6,653	200	1.66	333
29 Jan	<u>1,400</u>		<u>2,660</u>	-----		-----	<u>1,400</u>	1.90	<u>2,660</u>
Totals	8,100		13,570	6,500		10,577	1,600		2,993

Periodic Method - Inventory valuation method AVCO									
Opening stock and purchases				Sales			Inventory		
Date 200X	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost
1 Jan	2,500	1.50	3,750						
2 Jan	1,000	1.60	1,600						
9 Jan	1,100	1.70	1,870						
18 Jan	900	1.70	1,530						
22 Jan	1,200	1.80	2,160						
29 Jan	<u>1,400</u>	1.90	<u>2,660</u>	-----		-----	-----		-----
Totals	8,100		13,570	6,500	1.68	10,890	1,600	1.68	2,680

Question 10.2

INPUTS, OUTPUTS AND INVENTORY FOR 200X  
(All figures in 000's)

INPUTS			INVENTORY						OUTPUTS			
			Unprocess		WIP		Finished Goods		Sales		Indirect Costs	
	Units	£	Unit	£	Unit	£	Unit	£	Unit	£	Unit	£
Metal	25	50	2	4	2.8	5.6	2.2	4.4	18	36		
Salaries	50	150			2.8	8.4	4.4	13.2	36	108	6.8	20.4
Elect.	100	50			5.6	2.8	8.8	4.4	72	36	13.6	6.8
O/Head		23				2.8		2.2		18		
Total	25	273	2	4	2.8	19.6	2.2	24.2	18	198		27.2

Inflow/Debit	Purchases	Outflow/Credit	
Bank	50,000	Inventory:	
		Unprocessed	4,000
		WIP	5,600
		Finished goods	4,400
		Bal. to trading account	<u>36,000</u>
	<u>£50,000</u>		<u>£50,000</u>

Inflow/Debit	Salaries	Outflow/Credit	
Bank	150,000	Inventory:	
		WIP	8,400
		Finished goods	13,200
		Bal. to trading account	108,000
		Bal. to profit and loss	<u>20,400</u>
	<u>£150,000</u>		<u>£150,000</u>

Inflow/Debit	Electricity	Outflow/Credit	
Bank	50,000	Inventory:	
		WIP	2,800
		Finished goods	4,400
		Bal. to trading account	36,000
		Bal. to profit and loss	<u>6,800</u>
	<u>£50,000</u>		<u>£50,000</u>

Inflow/Debit	Sales	Outflow/Credit	
Bal. to trading account	<u>270,000</u>	Bank	<u>270,000</u>

Overhead account when charged to production (assumption (i)).

Inflow/Debit	Overheads	Outflow/Credit	
Bank	23,000	Inventory:	
		WIP	2,800
		Finished goods	2,200
		Bal. to trading account	<u>18,000</u>
	<u>£23,000</u>		<u>£23,000</u>

Overhead account when not charged to production (assumption (ii)).

Inflow/Debit	Overheads		Outflow/Credit
Bank	<u>23,000</u>	Bal. to profit and loss	<u>23,000</u>

Trading account and profit and loss account for the year ended 31 December 200X

	Assumption (i) Overheads charged to production		Assumption (ii) Overheads not charged to production	
Sales		270,000		270,000
Less cost of sales				
Purchases	36,000		36,000	
Salaries	108,000		108,000	
Electricity	36,000		36,000	
Overheads	<u>18,000</u>	<u>(198,000)</u>	<u>0</u>	<u>(180,000)</u>
<b>GROSS PROFIT</b>		<b>72,000</b>		<b>90,000</b>
Less indirect expenses				
Salaries	20,400		0	
Electricity	6,800		6,800	
Overheads	<u>0</u>	<u>(27,200)</u>	<u>23,000</u>	<u>(50,200)</u>
<b>NET PROFIT</b>		<b><u>£44,800</u></b>		<b><u>£39,800</u></b>
<b>BALANCE SHEET</b>				
Inventory:				
Unprocessed mats		4,000		4,000
Work in Progress		19,600		16,800
Finished Goods		<u>24,200</u>		<u>22,000</u>
		<b><u>£47,800</u></b>		<b><u>£42,800</u></b>

## STUDENTS' WORKBOOK

### CHAPTER 11 BAD AND DOUBTFUL DEBTS (And another look at Provisions)

#### 11.1 Introduction

Chapter 11 deals with the last of the basic adjustments - those relating to debtors - as well as revisiting the issue of provisions briefly. Our concern is again to increase the accuracy with which costs and revenues are matched, and in particular, the matching of the sales during the period with an expense to reflect those sales that are not expected to realise cash in the longer term (via the doubtful debts provision). At the same time the convention of prudence or conservatism dictates that we are careful about the valuation of the debtors on the balance sheet. This requires that the debtors balances be carefully examined to include only those debts which we can be reasonably sure will be paid - this is the essence of the bad debts adjustment.

The chapter is organised thus: section 11.2 contains a number of computational questions which test your ability to make adjustments for bad and doubtful debts. In addition, there are two questions which test your knowledge of all the bookkeeping covered to this point in the text. Section 11.3 contains a case study, Oliver Optics, which builds on a question first encountered in Chapter 5. Finally, section 11.4 provides selected answers to computational questions.

#### 11.2 Computational problems

##### *Question 11.1*

Lamplight Ltd had made £12,000 profit for 20X8 before charging any bad debts or making provisions for doubtful debts. At the end of 20X7 the following balances appeared on the balance sheet:

Profit and Loss account (credit balance)	20,000
Provision for Doubtful Debts	1,500

At the end of 20X8 the debtors balance stood at £23,000, but of this total £1,000 was considered to be a bad debt and of the remainder it was considered prudent to make a general provision of 10 percent for doubtful debts.

Required:

Draw up the key accounts involved to show the entries relating to the circumstances of Lamplight Ltd and present an abbreviated set of financial statements before as well as after the adjustment.

*Note: You can enter any figures you wish for the 'other assets' and 'other claims' on the balance sheet.*

### Question 11.2

Technical Books Ltd is a small bookshop in a University town who sells books for cash and on credit. They provide you with the following information about their credit sales and cash sales over the last four years:

	20X2	20X3	20X4	20X5
Credit sales	243,800	256,000	241,300	254,100
Receipt of cash:				
- opening debtors	16,530	18,000	22,000	16,900
- credit sales	220,000	234,000	224,000	230,500
Bad Debts written off	3,800	2,000	0	400

Further:

1. The opening debtors balance in 20X2 was £16,530.
2. In 20X2 it was decided to adopt a policy of making a provision for doubtful debts of 5 percent of closing debtors.
3. During 20X4 £540 was unexpectedly received from a debtor that had been written off in 20X2.
4. At the end of 20X5 it was decided to adjust the provision for doubtful debts so that it increased to 8 percent of closing debtors.

Required:

Prepare the appropriate accounts to record the above information for 20X2 to 20X5.

### Question 11.3

The following information relates to 16 March 20X7, the first day of the existence of Tank Engines Ltd, which previously traded as 'Thomas' - a sole trader business owned and run by the Fat Controller.

1. The Fat Controller opened a bank account for Tank Engines Ltd with £2,000 - a loan he was making to the company. The Fat Controller then transferred all the cash from Thomas' bank account - an amount of £350 - to the new account.
2. The Fat Controller transferred all the assets and liabilities of Thomas to Tank Engines. These consisted of:

Another loan of £1,500 from the Fat Controller's mother  
Creditors of £900  
Debtors of £600  
Stock of £1,000  
Leasehold building valued at £2,000

3. The Fat Controller has negotiated a large order for £7,500 worth of goods to be supplied to James Ltd. The goods are for delivery in April and payment is upon delivery.

4. Gordon, a good friend of the Fat Controller, joined the board of Tank Engines Ltd and introduced £700 and his car, valued at £2,500, to the business. Gordon was given share capital in exchange.
5. The authorized share capital of the company consists of 10,000 £1 shares. the Fat Controller's wife and mother each buy £1,000 worth of shares in the new company for cash.

Required:

- (i) Write up the accounting records and produce a balance sheet for Tank Engines Ltd for the end of the first day. (Hint: You must work out the Fat Controller's initial injection of capital to the company before you begin).
- (ii) If the Fat Controller's mother is dissatisfied with the way the company is being run, what options has she?

#### *Question 11.4*

(Note: This question follows on from Question 11.3)

The following balances are extracted from Tank Engines Ltd for the year to 15 March 20X8.

Sales	48,000
Cost of sales	15,000
Other expenses (before adjustment - see below)	7,500
Debtors	2,200
Creditors	3,000
Stock	4,400
Cash and bank	650

All other figures have remained the same except for the following:

1. The company paid cash of £27,000 for a freehold warehouse during the year.
2. Taxation (unpaid) is estimated at £750.
3. Interest (at 10 %) on the loans has not yet been paid.
4. The directors estimate that some of the stock will sell for less than cost and propose a stock write off provision of £700.
5. The company intends to depreciate its vehicles over three years and its leasehold over five years - both on the straight line method (assume no terminal value).
6. The bank has authorized an overdraft limit of £6,000.
7. The company spent £1,000 on research and development during the year. This has not yet been paid for (it was performed by contractors) and has yet to be entered in the books.
8. The directors are proposing a dividend of 10p per share.
9. The directors are agreed that Tank Engines Ltd paid (by way of share capital) too little for Thomas' and agree a goodwill figure of £2,250.

Required:

Produce a profit and loss account and balance sheet for Tank Engines Ltd for the year ended 15 March 20X8. Note, in detail, the treatment of any items that you consider might be contentious.

*Question 11.5*

Canterbury Management Ltd is a company that exists to manage the operations of the football team 'Canterbury Tigers', the football stadium and grounds at Christchurch and the operations of the successful football clothing manufacturer 'Christchurch Gear'.

As their financial accountant you find the balance sheet for their last financial year (to 31.12.X2).

BALANCE SHEET OF CANTERBURY MANAGEMENT LTD AS AT 31.12.X2 (All figures in \$000's)			
	Cost	Acc. Depn.	NBV
Fixed Assets:			
Land	850.0		850.0
Buildings	280.0	(41.5)	238.5
Fixtures and Fittings	60.0	(24.0)	36.0
Machinery	82.0	(24.6)	57.4
Motor Vehicles	<u>49.0</u>	<u>(21.0)</u>	<u>28.0</u>
	1,321.0	(111.1)	1,209.9
Current Assets:			
Cash at Bank		67.9	
Investments		762.0	
Debtors	82.0		
less Provision for Doubtful Debts	<u>(4.1)</u>	77.9	
Inventory		<u>62.7</u>	
		<u>970.5</u>	
Less Current Liabilities:			
Creditors		83.7	
Accruals		<u>14.2</u>	
		<u>97.9</u>	872.6
Less Long Term Liabilities:			
Loan			<u>(218.0)</u>
			<u>\$1,864.5</u>
Represented by:			
Issued and Paid up Share Capital			1,000.0
General Reserve			350.0
Asset Replacement Reserve			200.0
Retained Earnings			<u>314.5</u>
			<u>\$1,864.5</u>

You find out the following information:

The land comprises the football stadium in Christchurch (purchased for \$660,000) and the clothing factory site (purchased for \$190,000). Likewise the buildings include the stadium itself (purchased for \$195,000 on 1.1.20W2 and estimated to have a useful life of 45 years and a scrap value of \$60,000) and the factory premises (purchased for \$85,000 on 1.1.20W7 and estimated to have a useful life of 60 years and no scrap value). All the fixtures and fittings and machinery were purchased with the factory premises and had useful lives of 15 and 20 years respectively. The motor vehicles were all purchased in 20X0. The loan carries an interest rate of 7% p.a. and is due to start being repaid in six equal yearly instalments as from 1.1.20X4. The investments comprise shares and fixed term bank deposits. Inventory consists of finished 'Christchurch Gear'. The accrual is comprised of \$6,570 of electricity and \$7,630 interest on loan.

The following information relates to the year ending 31.12.X3:

(1) During the year additional machinery was purchased for \$21,000 with \$8,000 still unpaid. Half the motor vehicles by value were sold during the year for \$11,800. They were replaced by new motor vehicles costing \$30,000 and these were paid for in full during the year. The same depreciation policies apply to current year purchases as to present fixed assets. No depreciation is charged in year of sale; a full year's depreciation is charged in the year of purchase.

(2) The football stadium took \$846,000 of cash gate takings during the year. In addition the company sold \$46,900 worth of season tickets for the next financial year. During the year the following expenses arose:

Groundkeeping expenses	109,400
Cleaning expenses (which include \$10,600 not yet paid)	39,500
Stadium maintenance	200,100
General expenses (including prepayments of \$6,400)	298,200

(3) The clothing manufacturing operations resulted in credit sales of \$268,400 and cash sales of \$322,700. The following expenses arose:

Manufacturing costs paid	201,400
Wages and salaries	168,100
Electricity paid (in addition electricity of \$11,400 was owed)	43,900
Rates (including a pre-payment of \$2,500)	14,500
Advertising	33,300

All debtors and creditors also relate to this part of the business. All creditors were paid during the year. An additional amount of \$66,200 of manufacturing costs were outstanding at year end. All opening debtors paid their accounts except \$2,800 which were judged to be a bad debt. Total debtors at 31.12.X3 were \$74,000. The same Doubtful Debts policy is to apply this year. All the inventory relates to this part of the business. A stocktake at year end found \$68,400 of goods on hand. Of this inventory which cost \$8,700 is going to be hard to sell. The store manager estimates it will sell for between \$7,700 and \$7,100.

(4) The football team incurred a variety of costs during the period totalling \$228,400, all paid in cash. In addition, two players were signed to the team for three years, incurring total transfer fee costs of \$590,000. Part of the investments were liquidated to pay these transfer fees, there were no profits or losses on the sale of the investments. You decide to capitalise the transfer fees paid without any subsequent write-down.

(5) All interest on the loan for the current financial year has been paid, as has the interest accrued last year. The directors of the company have recommended a dividend of \$25,000 be declared but unpaid. \$50,000 of profit is to be transferred to General Reserves.

Required:

Prepare the books of account for Canterbury Management Ltd. and present the Profit and Loss Account and Balance Sheet of the company for the year ending 31.12.X3.

### 11.3 Case study

#### *Question 11.6*

Trial balance figures for Oliver Optics Company (see Question 5.5) for the first year of operations were as follows:

Sales	38,040
Supplies	17,250
Salaries	13,900
Rent	2,000
Electricity	430
Office Supplies	250
Administrative and selling	2,730
Insurance	200
Bad Debts	310
Interest	120
Creditors	8,130
Debtors	10,250
Bank	730
Equipment	5,000
Share Capital	5,000
Loan	2,000

Required:

Using these figures and the other information contained in the case draw up a basic set of financial statements using the extended trial balance format.

Notes:

(1) There is little information given in the case with regard to the cost elements involved in deciding

inventory valuation. A reasonable assumption would be that the supplies and salaries (of those working in the shop rather than in office, selling or despatch work) are the most obvious elements involved.

(2) The possible sales returns/bad debt on the government order is one of the events in the 'grey area' of accounting where it is difficult to decide as to whether it should appear in the accounting records. It can be recorded as a bad debt, as a sales return or ignored altogether. Many accountants would opt for the latter strategy on the grounds that whatever is to happen has not really happened yet and thus can be ignored until it does occur - especially as the outcome is very uncertain. Maybe you would be advised to adopt this way of thinking!

(3) Adopt a straight line method for the depreciation of the equipment.

### 11.4 Selected answers to computational problems

#### Question 11.1

Lamplight Ltd

Inflow/Debit	Debtors		Outflow/Credit
Opening Balance	23,000	Bad Debt	1,000
		Bal c/d to B.Sheet	<u>22,000</u>
	<u>£23,000</u>		<u>£23,000</u>

Inflow/Debit	Bad and Doubtful Debts		Outflow/Credit
Bad and Doubtful Debts	<u>1,700</u>	Bal c/d to P&L	<u>1,700</u>

Inflow/Debit	Provision for Doubtful Debts		Outflow/Credit
Debtors Written Off*	1,000	Opening Balance	1,500
Bal c/d to B.Sheet	<u>2,200</u>	Bad and Doubtful Debts	<u>1,700</u>
	<u>£3,200</u>		<u>£3,200</u>

- Alternatively the £1,000 bad debt could be posted direct to the debit of the bad and doubtful debts account making the balancing figure from the provision account £700 rather than £1,700. Either way you do the bookkeeping the end result is the same.

ABBREVIATED PROFIT AND LOSS ACCOUNT AFTER PROVISIONS	
Net Profit	12,000
Less Bad and Doubtful Debts	<u>(1,700)</u>
Net Profit to Claimants	<u>£10,300</u>

ABBREVIATED BALANCE SHEET BEFORE PROVISIONS		
Assets:		
Debtors	23,000	
Less Provision	<u>(1,500)</u>	21,500
Other Assets		<u>80,000</u>
		<u>£101,500</u>
Represented by:		
Accumulated Profit		20,000
Profit for Year		12,000
Other Claims		<u>69,500</u>
		<u>£101,500</u>

ABBREVIATED BALANCE SHEET AFTER PROVISIONS		
Assets:		
Debtors	23,000	
Less Provision	<u>(2,200)</u>	19,800
Other Assets		<u>80,000</u>
		<u>£99,800</u>
Represented by:		
Accumulated Profit		20,000
Profit for Year		10,300
Other Claims		<u>69,500</u>
		<u>£99,800</u>

*Question 11.2*

Relevant Accounts for Technical Books Ltd.

Inflow/Debit	Debtors		Outflow/Credit
Opening Balance (20X2)	16,530	Cash	16,530
Credit Sales	243,800	Cash	220,000
		Bad Debt	3,800
		Bal c/d to B.Sheet	<u>20,000</u>
	<u>£260,330</u>		<u>£260,330</u>
Opening Balance (20X3)	20,000	Cash	18,000
Credit Sales	256,000	Cash	234,000
		Bad Debt	2,000
		Bal c/d to B.Sheet	<u>22,000</u>
	<u>£276,000</u>		<u>£276,000</u>
Opening Balance (20X4)	22,000	Cash	22,000
Credit Sales	241,300	Cash	224,000
		Bal c/d to B.Sheet	<u>17,300</u>
	<u>£263,300</u>		<u>£263,300</u>
Opening Balance (20X5)	17,300	Cash	16,900
Credit Sales	254,100	Bad Debt	400
		Cash	230,500
		Bal c/d to B.Sheet	<u>23,600</u>
	<u>£271,400</u>		<u>£271,400</u>

Inflow/Debit	Provision for Doubtful Debts		Outflow/Credit
Bal c/d to B.Sheet	<u>1,000</u>	Doubtful Debts (20X2)	<u>1,000</u>
Bal c/d to B.Sheet	1,100	Opening Balance (20X3)	1,000
		Doubtful Debts (20X3)	<u>100</u>
	<u>£1,100</u>		<u>£1,100</u>
Doubtful Debts	235	Opening Balance (20X4)	1,100
Bal c/d to B.Sheet	<u>865</u>		
	<u>£1,100</u>		<u>£1,100</u>
Bal c/d to B.Sheet	1,888	Opening Balance (20X5)	865
		Doubtful Debts (20X5)	<u>1,023</u>
	<u>£1,888</u>		<u>£1,888</u>

Inflow/Debit	Bad and Doubtful Debts		Outflow/Credit
Debtors (20X2)	3,800	Bal c/d to profit and loss	4,800
Provision (20X2)	<u>1,000</u>		
	<u>£4,800</u>		<u>£4,800</u>
Debtors (20X3)	2,000	Bal c/d to profit and loss	2,100
Provision (20X3)	<u>100</u>		

Bal c/d to profit and loss	<u>£2,100</u>	Provision (20X4) **	<u>£2,100</u>
Provision (20X5)	<u>235</u>	Bal c/d to profit and loss	<u>235</u>
	<u>1,023</u>		<u>1,023</u>

Inflow/Debit	Bad Debts Recovered *	Outflow/Credit
Bal c/d to profit and loss	<u>540</u>	Cash
		<u>540</u>

\* This is not specifically covered in the text however the treatment of bad debts recovered can be developed from the preceding material.

\*\* It may seem counter intuitive to have an expense account with a credit balance, however, it follows from the provision account being reduced during the year. If there are bad debts incurred during the same year, the two can be netted off.

### Question 11.3

The first thing is to produce Thomas' closing balance sheet.

BALANCE SHEET OF THOMAS' AS AT 15 MARCH 20X7		
Fixed Assets:		2,000
Current Assets:		
Stock	1,000	
Debtors	600	
Cash	<u>350</u>	
	1,950	
Less Current Liabilities:		
Creditors	<u>(900)</u>	1,050
Less Loan		<u>(1,500)</u>
NET ASSETS		<u>£1,550</u>

The amount of net assets must be the Fat Controller's introductory capital.

The opening balance sheet of Tank Engines will therefore be:

BALANCE SHEET OF TANK ENGINES LTD AS AT 16 MARCH 20X7		
Fixed Assets:		
Buildings	2,000	
Motor Vehicles	<u>2,500</u>	4,500
Current Assets:		
Stock	1,000	
Debtors	600	
Cash & Bank *	<u>5,050</u>	
	6,650	
Less Current Liabilities:		
Creditors	<u>(900)</u>	5,750
Less Loan		<u>(3,500)</u>
		<u>£6,750</u>
Represented by:		
Issued Share Capital **		<u>6,750</u>
		<u>£6,750</u>

\*  $350+700+2,000+2,000 = \text{£}5,050$

\*\*  $1,550+2,500+700+2,000 = \text{£}6,750$

## STUDENTS' WORKBOOK

### CHAPTER 12 FROM THE TRIAL BALANCE TO THE FINANCIAL STATEMENTS: Ownership claims, profit, appropriations and social reality

#### 12.1 Introduction

This chapter draws together the themes which were introduced in Chapter 7 (with the conventions) and expanded on in Chapters 8-11 (on adjustments). It also expands on some of the issues which arise in the context of ownership claims (but see also Chapter 13 which examines partnerships in more detail). The computational questions in this chapter of the workbook concentrate on your ability to manipulate accounts once you have prepared them. In this manner your understanding of how accounts are constructed and the pictures the accounts paint are being tested. In addition, your understanding of how accountants "socially construct reality" is developed.

The workbook is structured thus: section 12.2 contains two computational questions which require you to apply the ideas developed in the text to date. Section 12.3 then presents some discussion questions, while section 12.4 contains selected answers to computational questions.

#### 12.2 Computational problems

##### Question 12.1

Heartbreakers Ltd is a small new company with three equal shareholders: Mr Tom, Mr Petty and Ms Rickenbacker. At the end of the first year of the company's activities (31 March 2003), Mr Tom wishes to sell his share of the company to either of the other two shareholders and asks for their bids. Mr Rickenbacker thinks that one-third share is worth approximately \$11,000 whilst Mr Petty thinks it is worth approximately \$2,000. They produce the following financial statements in support of their figures.

Heartbreakers Ltd				
Profit and loss Accounts for the year to 31.3.03				
	Ms Rickenbacker		Mr Petty	
	\$	\$	\$	\$
Sales		24,000		17,800
Cost of sales		<u>(10,000)</u>		<u>(13,000)</u>
		14,000		4,800
Interest	100		-	
Bad debts	200		-	
Depreciation	2,000		6,250	
Wages	2,000		6,000	
Other exp's provision	-		2,000	
Purchase provision	-	<u>(4,300)</u>	<u>4,000</u>	<u>(18,250)</u>

Net profit (loss)		9,700		(13,450)
Proposed dividends		<u>(2,000)</u>		<u>-</u>
Profit c.fwd		<u>\$7,700</u>		<u>\$(13,450)</u>

Balance Sheets for year ended 31.3.03				
	Ms Rickenbacker		Mr Petty	
	\$	\$	\$	\$
Fixed assets:				
Buildings		24,000		18,300
Machines		4,000		1,000
Vehicles		<u>3,000</u>		<u>1,750</u>
		31,000		21,050
Current assets:				
Stock	3,000		-	
Debtors	6,000		-	
Cash	<u>1,500</u>	<u>10,500</u>	<u>1,500</u>	<u>1,500</u>
		41,500		22,550
Current liabilities:				
Trade creditors	3,000		9,000	
Wages owed	2,000		6,000	
Interest	100		-	
Dividends	<u>2,000</u>	(7,100)	<u>-</u>	(15,000)
Long-term liabilities:				
Loan		<u>(1,000)</u>		<u>(1,000)</u>
Net assets		<u>\$33,400</u>		<u>\$6,550</u>
Represented by:				
Share capital		20,000		20,000
Revaluation reserve		5,700		-
Profit and loss		<u>7,700</u>		<u>(13,450)</u>
Ownership claim		<u>\$33,400</u>		<u>\$6,550</u>

You discover that Ms Rickenbacker has adopted the following in her calculation:

1. Sales (and the debtors of course) include \$4,000 made in the first week of April.
2. The buildings are entered at a figure based upon the revaluation of a certified valuer.
3. The machines and the vehicles were sold to Heartbreakers Ltd on the understanding that they had useful lives of 5 years and 4 years respectively.
4. The shareholders have not yet agreed the dividend.

On the other hand, Mr Petty has made the following calculations:

1. He has valued the buildings at cost and the machines and the vehicles at what he knows he could

sell them for.

2. He dislikes counting chickens before they hatch and has therefore removed the outstanding trade debtors from the sales figure. He has also taken the bad debts figure out of the debtors.
3. On the grounds that the stock may be worthless he has included the year end inventory within the cost of sales.
4. He thinks it preposterous that there are no other expenses for the year and has included \$2,000 for this which he believes has been overlooked and will be due in April.
5. Heartbreakers received a delivery of \$4,000 worth of materials just after the warehouse closed down for the night on the 31.3.03. This was not invoiced or paid until well into May 2003, but Mr Petty has included the figure.
6. He thinks it improper to pay dividends when the organization is making a loss. He also thinks it improper to pay any loan interest (the loan is held by Ms Rickenbacker) in the circumstances.
7. He thinks the financial statements do not show the full position if all wages are not charged. (The \$2,000 in Ms Rickenbacker's accounts is for the foremen of the business. Mr Petty wishes to include wages for himself and Ms Rickenbacker - \$1,000 each - an \$2,000 for his wife who currently looks after all the finances for nothing at all.)

Required:

Explain to Mr Tom:

- (i) How the two very different figure have been arrived at;
- (ii) how each of the accounting conventions has influenced the results; and
- (iii) what a more realistic price might have been if the accounting conventions had been applied in a more usual way.
- (iv) Discuss what you think are the highest and the lowest figures for profit and net assets that you would feel confident in trying to justify to the company auditor.

### *Question 12.2*

Nerds Ltd is a company which manufactures computer software products as well as developing software for children's computer games. Recently a large software company has expressed interest in buying all the shares of the organisation. Nerds Ltd is presently owned equally by four friends. The latest Profit and Loss Account and Balance Sheet of Nerds Ltd is presented below:

Profit & Loss Account of Nerds Ltd for year ending 31/12/X5 (all figures are £000's)		
Sales		49,090
Cost of Sales		<u>(27,065)</u>
		22,025
Less Expenses:		
Wages & Salaries	1,970	
Utilities	482	
Research Costs	3,040	
Depreciation	69	
Other Expenses	1,668	
Interest	<u>30</u>	<u>( 7,259)</u>
Net Profit		14,766
Less Taxation		<u>(2,490)</u>
Profit after Tax		12,276
Less Dividends		<u>( 400)</u>
Profit to Carry Forward		11,276
Plus Opening Retained Earnings		<u>(6,991)</u>
Closing Retained Earnings		<u>£ 4,885</u>

Balance Sheet of Nerds Ltd as at 31/12/X5 (all figures are £000's)			
	Cost	Acc Dep	N.B.V
Fixed Assets:			
Land	4,110	-	4,110
Buildings	2,000	-	2,000
Fixtures & Fittings	650	( 491)	159
Motor Vehicles	<u>320</u>	<u>( 300)</u>	<u>20</u>
	7,080	( 791)	6,289
Intangible Assets:			
Goodwill		938	
Software Development Costs		<u>9,000</u>	9,938
Current Assets:			
Cash	580		
Debtors	200		
Inventory - Computers	670		
Inventory - Software	710		
Prepayments	<u>85</u>	2,245	
Current Liabilities:			
Trade Creditors	109		
Non-Trade Creditors	180		

Accruals	48		
Dividends owing	<u>200</u>	<u>( 537)</u>	1,708
Less Long Term Liabilities:			
Loan			<u>( 250)</u>
			<u>£17,685</u>
Represented by:			
Share Capital			12,000
Asset Replacement Reserve			600
General Reserve			200
Retained Earnings			<u>4,885</u>
			<u>£17,685</u>

The following assumptions and judgement have been made in the preparation of the above accounts.

(1) Fixed Assets & Depreciation

The fixed assets were all purchased on 1/1/X0 when the following information was obtained.

Asset	Useful Life (range)	Residual Values (estimates)
Fixtures & Fittings	8-12	50,000-60,000
Motor Vehicles	5-7	20,000-25,000

Depreciation has been calculated on a sum of digits basis in the accounts.

The land and buildings are included in the accounts at what they cost the company. Most recent valuations of the property indicate that the land may be worth £6,000,000 and the Buildings £1,800,000.

(2) Intangible Assets

The goodwill on the balance sheet arose when a business was acquired 4 years ago. At that time the goodwill figure stood at £1,173,000 but since then some goodwill has been amortized. The software development costs have not been amortized and represent costs incurred over the last 6 years.

(3) Current Assets

At present, the company has no doubtful debts provision. However, they are concerned that some

8 percent of their debtors balances are more than 6 months overdue (credit terms are 30 days). The industry average for doubtful debts provisions is 12 percent.

A leaking roof in the computers warehouse has been discovered and 2 percent of the stock (by value) has been damaged. This is not reflected in the accounts as the company believes that these items can still be sold.

The software inventory includes £25,000 worth of games that are now regarded as "old hat". Despite this the company believes that the games could be sold for 70 percent of their cost so they have not adjusted the figures.

#### (4) Liabilities

There are two potential liabilities that have yet to appear in the accounts. The first concerns a lawsuit against the company for a restraint of trade which is due to be decided in the next month. All the indications are that the company will lose the case which will cost them anything between £300,000 and £180,000 in damages and costs.

In addition, site surveys have identified contamination of part of the land the company owns. At some stage in the future this land will need to be cleaned up (at an estimated total cost of £680,000) but there are no immediate plans to do so. In the meantime the contaminated area has been fenced off.

#### (5) Profit and Loss Account

The sales figure includes a shipment of £980,000 which has subsequently been rejected. It is believed that this shipment can be reworked to bring it up to standard for a mere £28,000. This has not been adjusted for in the accounts.

The other expenses includes a number of estimates and the actual expense figure could range from £2,000,000 to £1,500,000.

The dividends of £400,000 have not yet been approved at the Annual General Meeting. This figure includes £200,000 of interim dividend which has been paid. Given the interest in the company half the shareholders have indicated a willingness to forgo the final dividend if it would help them get a better price for their shares.

Required:

- (i) Prepare your own version of Nerds Ltd Profit & Loss Account and Balance Sheet bearing in mind that this new set of accounts is going to be given to the possible purchaser of the business. Use the accounting conventions and any knowledge you have about standard accounting practice and company law to inform your choices.
- (ii) Explain how you came by your figures and, where necessary, provide reasons why you have made the choices you have.

### 12.3 Discussion topics

#### Question 12.3

In the light of your answers in question 12.2 and 12.3 explain why Hines (1988) would say that in preparing these accounts you have just "constructed social reality". Do you agree with her? Why/why not?

#### Question 12.4

Using a set of accounts from an organisation with which you are familiar, look through its Balance Sheet and determine the extent to which you believe the numbers are objective. Identify factors which may make the numbers in the accounts greater or less than what they are at present.

(Hint: look at the notes to the accounts for each item - they may give you more of an idea of how these amounts could change).

### 12.4 Selected answers to computational problems

#### Question 12.1

There can be no model answer to this question but the following guidelines might be useful.

(i) The first part of the question is really already answered. You have to explain how the two sets of statement differ, and this information is given in the question. Such difficulty as there is lies in following the double entry through and working out things like the original cost of the machines and vehicles. (If we assume a straight line method of depreciation and we know these assets are one year old then the original costs were respectively \$5,000 and \$4,000).

(ii) In the second part of the question you should be able to say something about each of the 'conventions':

\* *entity* - wages, interest and dividends are examples of payments from one entity (organizational system) to another;

\* *money measurement* - the input to the operations subsystem represented by Mrs Petty's efforts does not show in the financial statements unless she is actually paid wages;

\* *going concern* - Mr Petty, in his valuation of the machines, is assuming either that the business will not continue or that there is no synergistic value attached to these assets;

\* *accrual* - the purchases and sales should relate to the periods in which (1) the legal liability arose and (2) they generated revenues/costs;

\* *periodicity* - this convention produces a 'cut-off' which would normally exclude the April sales;

\* *consistency* - are the parties being internally consistent and consistent through time in their treatment of (for example) wages, interest and dividends?

(iii) The third part of the question requires you to try to draw up some 'sensible' financial statements. The following is a guide based upon the Rickenbacker accounts - it is still fairly optimistic, perhaps:

Heartbreakers Ltd			
Profit and loss for year to 31.3.03			
	\$	\$	
Sales		20,000	eliminate April sales
Cost of sales		<u>(10,000)</u>	OK
		10,000	
Interest	100		OK?
Bad debts	200		OK
Depreciation	2,000		Further depn provn?
Wages	2,000		Debatable, but no wife's wage
Other exp's prov'n	1,000		Reasonable to have some
Purchases prov'n	<u>-</u>	<u>(5,300)</u>	Unusual
Net profit/(loss)		4,700	
Proposed dividends		<u>(2,000)</u>	As long as not out of capital
P&L c.fwd		<u>\$2,700</u>	

Heartbreakers Ltd			
Balance Sheet as at 31.3.03			
	\$	\$	
Fixed Assets:			Revaluation is common practice
Buildings		24,000	OK as above
Machines		4,000	OK as above
Vehicles		<u>3,000</u>	
		31,000	
Current Assets:			OK
Stock	3,000		No April sales
Debtors	2,000		
Cash	<u>1,500</u>	<u>6,500</u>	
		37,500	
Current Liabilities:			Include the expenses prov'n
Trade creditors	4,000		Debatable as above
Wages owed	2,000		OK
Interest	100		OK
Dividends	<u>2,000</u>	(8,100)	
Long Term Liability:			OK
Loan		<u>(1,000)</u>	
Net Assets		<u>\$28,400</u>	
Represented by:			
Share capital		20,000	
Revaluation reserve		5,700	
Profit & loss account		<u>2,700</u>	

Ownership Claim		<u>\$28,400</u>	
-----------------	--	-----------------	--

A price for the business would be a matter of negotiation and many of the above would be issues.  
Start at \$9,000?

## STUDENTS' WORKBOOK

### CHAPTER 13 PARTNERSHIPS

#### 13.1 Introduction

This chapter highlights the accounting issues which arise when accounting for partnerships. On the whole, partnerships are accounted for in the same manner as other entities, however they differ in the following ways. First, transactions between the entity (the partnership) and its owners (the partners) are accounted for via capital and current accounts which form the "represented by" part of the balance sheet. Second, the profit and loss account does not have a residual figure which is carried forward to the balance sheet in its own right, rather any profits or losses are transferred into the partners' current accounts thus creating a zero balance at the end of the profit and loss account.

The chapter is organised in the following manner. Section 13.2 contains computational questions. Question 13.1 builds on the Jeopardy partnership question which is introduced in the text in section 13.2.4, while Question 13.2 examines the area of accounting for goodwill. The discussion questions contained in Section 13.3 cast the net wider and draws on material from this chapter as well as chapter 12. In addition, Question 13.4 requires you to find material from a variety of sources including newspapers, journals and CD-ROM searches.

#### 13.2 Computational problems

##### *Question 13.1*

You are continuing as accountant for the Jeopardy Partnership. The partnership has been in existence since 1 January 2009 and the balance sheet for the year ended 31.12.09 is provided below. You have been called in to help them with their accounts for the six months ended 30 June 2010 as one of the founder members is leaving.

<b>Balance Sheet of Jeopardy Partnership as at 31.12.09</b>		
<b>Fixed Assets:</b>		
Equipment	8,600	
Less Acc. Depreciation	<u>(860)</u>	7,740
<b>Current Assets:</b>		
Cash	671	
<b>Current liabilities:</b>		
Creditors	114	
<b>Net Current Assets</b>		<u>557</u>
		<u>£8,297</u>
<b>Represented by:</b>		
Capital a/c - DH	1,600	
PM	3,400	
JY	2,000	

RG	<u>1,600</u>	8,600
Current a/c - DH	(41)	
PM	(20)	
JY	(115)	
RG	9	
Lyn	<u>(136)</u>	<u>(303)</u>
		<u><u>£8,297</u></u>

From last year, the following accounting policies continue:

(a) The partners put up their own equipment as capital and agree to take responsibility for repairs and maintenance. Additions to capital are to be added to the capital accounts. Repairs and maintenance are to be treated as operating expenditure.

(b) All income (except otherwise agreed below) is to be retained to fund the recording of an album. Each founder member (DH, PM, JY, RG) would contribute equally to the costs of hiring rehearsal rooms and they would bear their own transport and incidental costs (see below).

(c) The equipment is depreciated on a straight line basis over ten years with an assumption of no scrap value. To keep matters simple, only the balance at the end of the year is depreciated.

(d) The members of the group are allowed a notional £5 for travel expenses for each rehearsal and gig. This only applies to DH, PM, JY and RG.

The group has prepared, under your guidance, the following information:

### 1. Membership

(a) The membership of the band stayed as it was on 31.12.09 (i.e. DH, PM, JY, RG and Lyn) except that a keyboard player (DB) joined at the beginning of February 2010 and introduced capital of £600. RG left on 28.6.2010.

(b) All partners continue to have equal rights to profits and losses regardless of their capital in the business or the incidental costs they bear. Profits and losses are calculated at the balance sheet dates only.

### 2. Gig Receipts and Application of the cash

Date	£ received	To Lyn	To DB	To studio	Stage Gear
7/1	55				
18/1	70				
11/2	50			50	
17/2	80	10			
21/2	60				

23/2	80	10	10		
24/2	70	10	10		
8/3	70				
17/3	70	10		60	
21/3	60		10	50	
23/3	70	10		60	
7/4	80	10		70	
15/4	10		10		
26/4	80	10		70	
3/5	60			60	
18/5	70	10	5	10	45
27/5	50			50	
28/5	charity				
9/6	70	10		60	
16/6	80	10		70	
21/6	<u>60</u>	<u>10</u>		<u>50</u>	
	<u>1,295</u>	<u>110</u>	<u>45</u>	<u>660</u>	<u>45</u>

### 3. Other Payments

#### (a) Studio

The band were recording an album for distribution and perhaps for sale. In addition to the above cash payments the band may two payments by cheque of £200 each and one payment by cheque of £574. They also made a payment to the studio of £90 cash from the proceeds from T-shirt sales (see below). The studio payments cover studio time, recording tape, photographs, inlay card and 200 copies of the recorded cassettes. The cassettes were received on 20.6.2010.

#### (b) T-shirts

The band made one payment for a consignment of 100 specially printed Jeopardy T-shirts by cheque for £217. At 30 June 2010 they had sold 30 at £5 each (£60 from these sales was paid into the building society on 26 February, the rest was paid direct to the studio). Forty T-shirts had been given away as promotional material and there was a remaining stock of 30.

(c) DH, PM, JY and RG each paid £2 from their own pockets for a newspaper advert for a keyboard player in January.

(d) There were 24 practices in the period ended 30.6.2010. Twelve of these cost £15 per night for the hire of the hall; the others cost nothing.

(e) Incidental expenses incurred by the group are:

DH    Strings £30  
PM    Strings £20  
      Repairs £40  
JY    Sticks £20  
RG    Strings £50

(f) New equipment purchased by the band members from their own pockets:

DH £350: PM £500: JY £200: RG £120

(g) The periodic payments of (usually) £10 detailed above to Lyn and DB are for babysitting and pocket money respectively. These have been agreed by the band and (as in 2009) should be adjusted through the partners' current accounts.

(h) Creditors brought forward from 31.12.09.

It is agreed (with Steph, a former partner of the band) that her debt of £85 be written off except that the band will still owe her a T-shirt and a recorded cassette. The other creditor (advert £29) was paid by PM from his own pocket.

#### 4. Other Information

(a) The studio has been fully paid for its work and has actually allowed the bank a rebate of 10 hours (at £10 per hour) free recording time. The studio is seeking radio time for the bank's tape. The studio has also taken two of the band's songs for use with other performers (with the band's permission!). Royalties may be forthcoming.

(b) The band has been offered a short record contract under which one of their songs will appear on a compilation album. The contract was signed on 15 July 2010.

(c) RH will take all his equipment with him when he leaves, although he will allow the band to continue to borrow some of his PA and stage equipment (value £200). He expects to receive 30 copies of the cassette as complete settlement of his dealings as partner. The band have a right to continue unconstrained use of RG's songs but they do not have the right to sell them and he would expect to feature in any future royalties from the songs or the cassette. A deposit of £25 that RG paid for rehearsal rooms has been paid back to him by the manager of the rehearsal rooms. (The amount had previously been credited to his current account).

(d) From performing a bank reconciliation it becomes apparent that the bank account has been credited with £25 of interest.

Required:

- (i) Prepare the cash book for the partnership for the six months ending 30 June 2010.
- (ii) Prepare the partners' capital and current accounts for that 6 months and such other accounts as you find helpful.
- (iii) Prepare a profit and loss account and balance sheet for the partnership as at 30 June 2010.

#### *Question 13.2*

Paddlers Holidays is a partnership of three keen canoeists who organise and guide adventure holidays in remote and beautiful lakes in New Zealand. The three partners are Ms Wanaka, Mr Tekapo and Ms Ohau. Wanaka and Tekapo put \$2,000 each into the partnership, while Ohau

injected \$4,000 of cash at the start of the partnership some 10 years ago. The partnership has operated successfully but Mr Tekapo wants to travel the world and is therefore looking to sell his share of the partnership. A valuation of the business was conducted and it was estimated that it is now worth \$200,000 as a going concern. A Mr Manipouri has expressed a desire to buy into the partnership in Mr Tekapo's place and is willing to pay 25 percent of the value of the business (as determined by an independent valuation). This has been accepted by the existing partners.

Required:

Prepare the relevant accounts required to record the change of partner for the Paddlers Holidays partnership.

### 13.3 Discussion topics

#### *Question 13.3*

Paddlers Holidays partnership continued to operate successfully with Manipouri as the new partner. However, the opportunity arose to expand their operations considerably which would require a large injection of capital. The partners were reluctant to bring more partners into the organisation so they started considering the possibility of forming a company.

Required:

- (a) Advise the partners of the advantages and disadvantages of forming a company as opposed to continuing on in a partnership structure.
- (b) Outline how the financial statements would change if a company structure were adopted.
- (c) Suggest possible ways they could raise finance within a company structure (if this is the course of action they decide to take).
- (d) Outline the advantages and disadvantages of raising the above finance from the perspective of both the focal organisation and the finance providing organisation.

#### *Question 13.4*

From your reading of the newspapers, journals and from a search of relevant data sources (via CD-ROM of relevant materials) provide examples of how organisations which have not traditionally placed financial performance at the head of their corporate objectives have been influenced by an imposed (or chosen) increase in the importance of "market emphasis", "competition" and financial performance and other traditional manifestations of commercial organisations?

*(Hints: (i) look back at Section 13.4 of the main text which considers this kind of question in the context of the Jeopardy partnership; (ii) using a CD ROM may be a very effective way of obtaining this information - ask your tutor for likely keywords on which to search; and (iii) the types of organisations you may like to focus your search around are those which have in recent years changed to a more financial focus - examples may include those involved in healthcare, education and utilities.)*

## STUDENTS' WORKBOOK

### CHAPTER 14 ACCOUNTING REGULATION AND COMPANY ACCOUNTS

#### 14.1 Introduction

Chapter 14 dealt primarily with the regulations governing the construction of financial statements categorized under three headings:

- (a) law;
- (b) professional pronouncement;
- (c) other regulations.

The accounting conventions also form part of this set of rules and they have been dealt with in chapter 7 (you should look back to this chapter to refresh yourself on the conventions as they are also relevant to this area). The inter-relationships between the elements that make up the rules of financial reporting are summarized by Figure 14.1 in the main text.

*Note: It is important for you to look at your collection of annual reports as these are prepared in accordance with the laws, pronouncements and regulations which are in force in your country.*

A company's financial statements are the responsibility of the directors of the organization and are the major mechanism by which the directors discharge their accountability to shareholders.

The various categories of rules govern two issues:

- (a) how particular items must be treated (for example, when an item of expenditure is treated as an asset or an expense);
- (b) which items and what level detail must be disclosed in the financial statements.

The contents of this Workbook chapter contains one section which consists of discussion questions. Question 14.1, 14.2 and 14.3 are exercises based on a set of published financial statements - as has been emphasised repeatedly in the text you should by now have a small collection of annual reports of companies and these can be used to answer these questions. Finally, question 14.4 requires you to search for topical issues that are facing the standards setting body in your country of study and to debate the issues which arise in this context.

#### 14.2 Discussion topics

##### *Question 14.1*

For this question you will need a set of published financial statements. (We suggest that it is best treated as a group exercise, divided up amongst individuals, and then the discoveries of the individuals shared and discussed with the group.)

Required:

For six items in your chosen organization's financial statements:

- (i) Explain what the item is and what it and any related terminology means.
- (ii) Explain how you think the figure(s) involved were arrived at (use your knowledge of bookkeeping and accounting information systems to determine this).
- (iii) Specify in detail the company law, accounting conventions, standards and other regulations which apply to this item.
- (iv) Compare this item with the same or similar item in the published financial statements of another company in the same line of business. Is your organization's figure high or low? Is this good or bad? Why?

#### *Question 14.2*

Using a set of financial statements you are familiar with:

- (i) examine the directors report in some detail and match the requirements in Figure 14.6 with those items disclosed/discussed in the directors report (where the contents of Figure 14.6 are inappropriate for the country you are studying in replace them with a list of requirements from your country's companies legislation), and
- (ii) outline why you believe these items have been identified by company law as being required and why are these items important to the discharge of the accountability relationship between directors and shareholders.

#### *Question 14.3*

Using a set of financial statements you are familiar with:

- (i) examine in detail the specific accounting policies adopted by that organisation. Identify the professional pronouncements that inform the specific accounting policies and distinguish as to whether they related to issues of treatment or disclosure.
- (ii) compare these specific accounting policies to those of another organisation in the same line of business. Do their specific accounting policies differ? If so, how and why do they differ?

#### *Question 14.4*

From your reading of newspapers and the professional press identify financial reporting related issues that have exercised the accounting profession over the last 2/3 years. (Hint: an effective way to conduct this search may be to conduct a CD-ROM search using key words. Ask your tutor to help you by providing some key words to search on).

Required:

- (i) Make a list of the issues you have identified. Why are these issues important?
- (ii) Take an issue and debate the pros and cons of how the Accounting Standards Board (or its equivalent in your country) should respond.
- (iii) Debate the following statement:

"Government should regulate financial reporting practice rather than the accounting profession."

(iv) Debate the following statement:

"An accountants job is to serve the client not the public interest. Therefore, accounting regulation is not appropriate and should be left to the market place."

## STUDENTS' WORKBOOK

### CHAPTER 15 READING THE FINANCIAL STATEMENTS AND THE ANNUAL REPORT: Cash flow analysis and interpreting financial numbers

#### 15.1 Introduction

The central concern of Chapter 15 is with extracting additional information about commercial organizations from (primarily) their financial statements. We have looked both at the cash flow statement and ratio analysis as a means of extracting this information. Most introductory texts on financial accounting look at these two additional sets of information separately. We have purposefully combined them in both the text and the Workbook since they have a common concern with extracting additional information, and are complementary in the insights they portray (although being clearly different in actual contents).

This chapter also sees the last of the traditional financial accounting model which has dominated our attention so far in this book. Of all the elements involved in our journey, this last port of call contains the most complexity as well as the most dangers. Cash flows statements are complex and students often struggle with them. Equally ratio analysis is often seen by students as comparatively easy but one where inappropriate reliance is placed in the information forthcoming. It cannot be stressed enough that ratio analysis is not an unbiased and all encompassing keyhole into the life of any commercial organization. It is reliant on the financial statements for its data which in turn are built up from accountants' interpretation of the eight types of financial transactions discussed in Chapter 4. It is limited therefore in the insights it can provide.

Given these provisos the following is addressed to enabling you to both construct cash flow statements and ratio analysis as well as to reflect on the information forthcoming.

The chapter is organized in the following manner: Section 15.2 provides an extensive array of computational questions, while section 15.3 contains some discussion questions. Finally, section 15.4 provides selected solutions for the computational questions.

#### 15.2 Computational problems

##### *Question 15.1*

Wallace Peter Ltd has the following transactions during 200X (its first year of operations):

1. Cash purchases \$45,000.
2. Credit purchases \$56,000.
3. Cash sales \$90,000.
4. Credit sales \$82,000.
5. Bank payments to creditors \$43,000.
6. Bank receipts from debtors \$60,000.
7. Bank receipts from share capital \$250,000.
8. Bank receipts from long-term loans \$120,000.
9. Bank payment for building \$150,000.

10. Bank payment for motor vehicles \$60,000.
11. Bank payment for equipment \$90,000.
12. Bank payment for administration \$15,000 (which includes the interest payments).
13. Bank payment for light, heat and power \$20,000.
14. Bank payment for salaries \$26,500.
15. Discounts received £3,000 on cash purchases.
16. Discounts allowed \$4,000 on cash sales.
17. Bad debts \$2,000.

Additional information is as follows:

- (a) Depreciation is to be provided on: motor vehicles \$2,000 and equipment \$9,000.
- (b) Inventory at 31.12.200X was \$15,000 (on the purchase figures only).
- (c) Accrual for light, heat and power was \$2,200.
- (d) Payment in advance for rates (in the administration account) was \$700.

Required:

- (i) Draw up the accounting records using 'T' accounts.
- (ii) Draw up and extended trial balance.
- (iii) Construct a cash flow statement by analyzing the pertinent accounting records (see section 15.3 of the main text if you are unsure of what to do).

### Question 15.2

The balances from the balance sheet at 31.12.2005 for W. Wally Ltd (see Question 10.3) were as follows:

Buildings	60,000
Equipment (written down value)	16,000
Motor vehicles (written down value)	9,000
Share capital	80,000
Accumulated profit	15,500
Long-term loans	25,000
Inventory	20,000
Payments in advance (for rates)	700
Debtors	32,000
Cash at bank	12,000
Trade creditors	28,000
Accruals (for light, heat, etc.)	1,200

During 2006 W. Wally Ltd had the following transactions:

1. Cash purchases £85,000.
2. Credit purchases £75,000.
3. Cash sales £110,000.
4. Credit sales £140,000.
5. Bank payments to creditors £68,000.
6. Bank receipts from debtors £135,000.

7. Bank payment for administration £6,500 (includes rates).
8. Bank payment for light, heat and power £15,000.
9. Bank payment for salaries £70,000.
10. Bank payment for selling expense £12,000.
11. Discounts received on cash purchases £2,000.
12. Discounts allowed on cash sales £1,700.
13. Bad debts £2,000.
14. Interest paid by cheque £2,500.
15. Bank receipts from disposal of equipment £5,000.
16. Bank payments for new equipment £12,000.

Additional information made available is as follows:

- (a) Depreciation is to be provided on: motor vehicles £3,000 and equipment £3,500.
- (b) Inventory at 31.12.06 was £52,000 (on the purchases only as with the inventory at 31.12.05).
- (c) Accrual for light, heat and power was £1,400.
- (d) Payment in advance for rates (in the administration figure) was £1,000.
- (e) Written down value of equipment disposed of was £4,000.

Required:

- (i) Draw up the basic accounting records using 'T' accounts.
- (ii) Draw up and extended trial balance.
- (iii) Construct a cash flow statement by analyzing the pertinent accounting records.

*Question 15.3*

A.R. Manwaring plc produced the following balance sheets for the year ended 20X8 and 20X9:

Balance Sheet of A.R. Manwaring plc						
	20X8 (£000s)			20X9 (£000s)		
	cost	depn	NBV	cost	depn	NBV
Fixed Assets:						
Freehold property	-	-	-	180		180
Plant and equipment	240	(56)	184	300	(70)	230
Motor vehicles	<u>70</u>	<u>(34)</u>	<u>36</u>	<u>70</u>	<u>(40)</u>	<u>30</u>
	<u>310</u>	<u>(90)</u>	220	<u>550</u>	<u>(110)</u>	440
Current Assets:						
Inventory	90			164		
Debtors	130			188		
Bank	<u>136</u>	356		<u>4</u>	356	
Less Current Liabilities:						
Creditors	70			142		
Dividend proposed	<u>16</u>	<u>(86)</u>		<u>20</u>	<u>(162)</u>	
Net Current Assets			<u>270</u>			<u>194</u>
			<u>£490</u>			<u>£634</u>
Represented by:						
12% debentures			60			90

Share capital (£1 shares)			150			200
Share premium			-			20
Accumulated profits			<u>280</u>			<u>324</u>
			<u>£490</u>			<u>£634</u>

In addition,

During the year to 31.12.X9 some plant and equipment was disposed of which originally cost £140,000. The loss on sale (charged to the profit and loss account) was £48,000.

Also charged to the 20X9 profit and loss account were the following amounts for depreciation: motor vehicles £6,000 and plant and equipment £44,000.

Required:

Prepare a cash flow statement for 20X9.

#### Question 15.4

Ferm Industries plc produced the following balance sheets for the years ended 20X7, 20X8 and 20X9:

Balance Sheet of Ferm Industries plc						
	20X7 (\$000s)		20X8 (\$000s)		20X9 (\$000s)	
<b>Fixed Assets:</b>						
Land and buildings (cost)		100.0		67.0		67.0
Plant and equipment (net)		<u>188.0</u>		<u>204.6</u>		<u>260.2</u>
		288.0		271.6		327.2
<b>Investments</b>		48.0		-		-
Patents		-		70.0		90.0
<b>Current Assets:</b>						
Inventory	26.0		58.0		72.6	
Debtors	<u>57.2</u>		<u>100.4</u>		<u>104.2</u>	
	83.2		158.4		176.8	
<b>Less Current Liabilities:</b>						
Creditors	52.0		56.8		72.0	
Dividend	14.0		15.0		15.0	
Bank	<u>4.0</u>		<u>12.0</u>		<u>6.0</u>	
	(70.0)		(83.8)		(93.0)	
<b>Net Current Assets</b>		<u>13.2</u>		<u>74.6</u>		<u>83.8</u>
		<u>\$349.2</u>		<u>\$416.2</u>		<u>\$501.0</u>
<b>Represented by:</b>						
10% Debentures		80.0		60.0		40.0
Share capital (\$1)		200.0		230.0		300.0
Capital reserve		-		27.6		27.6
Undistributed profits		<u>69.2</u>		<u>98.6</u>		<u>133.4</u>
		<u>\$349.2</u>		<u>\$416.2</u>		<u>\$501.0</u>

Additional information is as follows:

(a) Extracts (in \$000s) from the profit and loss account for the year ended:

	20X8	20X9
Loss on sale of investments	4.8	-
Profit on disposal of plant and equipment	8.4	16.0
Depn on plant and equipment	56.0	72.0
Interim dividend paid (in 20X7 as well)	6.0	6.0
Final dividend proposed	15.0	15.0

(b) The capital reserve was created out of the profit from the sale of land and buildings.

(c) Plant originally costing \$36,000 was disposed of in the year to 31.12.X8 for \$14,400 and plant costing \$40,000 was disposed of for \$20,000 in 20X9.

(d) The detailed plant and equipment accounts (all in \$000s) were as follows:

	20X7	20X8	20X9
Cost value	344.0	386.6	478.2
Accumulated Depreciation	<u>156.0</u>	<u>182.0</u>	<u>218.0</u>
Net value on balance sheet	<u>\$188.0</u>	<u>\$204.6</u>	<u>\$260.2</u>

Required:

Construct a cash flow statement for 20X8 and 20X9 for Ferm Industries plc.

### Question 15.5

The following additional information concerning A.R. Manwaring plc (see Question 15.3) is available (note you will have to work out cost of sales for yourself):

	20X8 £	20X9 £
Sales (all credit)	1,270,000	1,480,000
Opening inventory	74,000	90,000
Closing inventory	90,000	164,000
Gross profit	644,000	760,000
Interest payments	24,000	36,000
Net profit (before interest and tax)	92,000	80,000
Market value of £1 shares at 31.12	3	2

Average industry ratios were as follows:		
Gross margin	53.1%	55.2%
Net profit	8.6%	10.3%
Return on capital employed	18.9%	23.1%
Inventory turnover	9.5 times	10.2 times
Debtors collection period	34.0 days	30.0 days
Sales value to capital employed	3.8	4.1
Current	3.2	3.3
Acid test	1.8	1.7
Basic gearing	1:8	1:9
Debt to equity	1:7	1:8
Percentage claims against the business	21.6%	22.3%
Times interest earned	4.1 times	4.5 times
Dividend yield	7.6%	8.3%
Dividend coverage	4.1	4.0
Earnings per share	55.16p	63.22p
Earnings yield	16.3%	18.1%
Price earnings	11.5	12.6
Company value	£1.2m	£1.5m

Required:

- (i) Calculate the above ratios for 20X8 and 20X9 for A.R. Manwaring plc.
- (ii) Write a short report discussing what the ratios indicate using the cash flow statement (prepared in Question 15.3) and the average industry ratios to illustrate the points being made.

### Question 15.6

The following additional information concerning Ferm Industries plc (see Question 15.4 above) has been made available (note you will have to work out cost of sales for yourself)

	20X7	20X8	20X9
	\$	\$	\$
Sales (all credit)	202,200	253,300	297,900
Opening inventory	13,000	26,000	58,000
Closing inventory	26,000	58,000	72,600
Gross profit	53,400	70,200	83,600
Interest payments	5,600	4,200	2,800
Net profit (before interest and tax)	34,400	46,200	53,000
Market value of \$1 shares at 31 December	3.10	3.20	3.30
Average industry ratios were as follows:			
Gross margin	23.4%	26.6%	29.7%
Net profit	16.2%	18.3%	19.2%
Return on capital employed	11.1%	12.2%	12.8%
Inventory turnover	8.1	9.2	10.1
Debtors collection period	68.0	56.0	49.0
Sales value to capital employed	1.1	1.4	1.7
Current ratio	2.6	2.9	3.2

Acid test	1.4	1.3	1.2
Basic gearing	1:9	1:10	1:12
Debt to equity	1:8	1:9	1:11
Percentage claims against the business			
Times interest earned (times)	21.6%	19.8%	18.6%
Dividend yield	7.6	13.3	20.1
Dividend coverage	6.3%	7.2%	8.3%
Earnings per share	2.8	3.2	3.5
Earnings yield	25.11c	27.23c	29.26c
Price earnings	7.9%	10.6%	15.2%
Company value	23.6	25.2	27.3
	\$1.1m	\$1.2m	\$1.3m

Required:

- (i) Calculate the above ratios for 20X7, 20X8 and 20X9 for Ferm Industries plc.
- (ii) Write a short report discussing what the ratios indicate using the cash flow statements (prepared in Question 15.4) and the average industry ratios to illustrate the points being made.

### 15.3 Discussion topics

#### Question 15.7

The following groups typically interact with a commercial organisation:

- shareholders,
- creditors,
- employees,
- customers, and
- local community

Required:

- (i) Form groups and assign the role of one of the above groups to each individual within the group.
- (ii) Individually, for the group you represent, make a list of the information you would require and for what purpose you would require that information.
- (iii) As a group, discuss whether you think that the information supplied in the financial statements, the cash flow statement and through ratio analysis could satisfy, in some overall sense, the information needs of all these actual as well as potential users, drawing on the list you have compiled in (ii) above.

#### Question 15.8

- (i) Why do you think ratio analysis is often used for prediction purposes?
- (ii) What are the deficiencies of ratio analysis for these purposes?

#### Question 15.9

Explain why an organisation who makes profits may still have a cash flow problem (the selected answer to Question 15.3 may assist you greatly in answering this question).

## 15.4 Selected answers to computational problems

### Question 15.1

Wallace Peter Ltd (i) 'T' accounts

Inflow/Debit	Bank		Outflow/Credit
(3)	90,000	(1)	45,000
(6)	60,000	(5)	43,000
(7)	250,000	(9)	150,000
(8)	120,000	(10)	60,000
		(11)	90,000
		(12)	15,000
		(13)	20,000
		(14)	26,500
		Balance	<u>70,500</u>
	<u>\$520,000</u>		<u>\$520,000</u>
Balance	70,500		

Inflow/Debit	Creditors		Outflow/Credit
(5)	43,000	(2)	56,000
Balance	<u>13,000</u>		
	<u>\$56,000</u>		<u>\$56,000</u>
		Balance	13,000

Inflow/Debit	Debtors		Outflow/Credit
(4)	82,000	(6)	60,000
		(17)	2,000
		Balance	<u>20,000</u>
	<u>\$82,000</u>		<u>\$82,000</u>
Balance	20,000		

Inflow/Debit	Purchases		Outflow/Credit
(1)	45,000	Balance	104,000
(2)	56,000		
(15)	<u>3,000</u>		
	<u>\$104,000</u>		<u>\$104,000</u>
Balance	104,000		

<b>Inflow/Debit</b>	<b>Building</b>	<b>Outflow/Credit</b>
(9)	150,000	

<b>Inflow/Debit</b>	<b>Motor vehicle</b>	<b>Outflow/Credit</b>
(10)	60,000	

<b>Inflow/Debit</b>	<b>Equipment</b>	<b>Outflow/Credit</b>
(11)	90,000	

<b>Inflow/Debit</b>	<b>Administration</b>	<b>Outflow/Credit</b>
(12)	15,000	

<b>Inflow/Debit</b>	<b>Light, heat and power</b>	<b>Outflow/Credit</b>
(13)	20,000	

<b>Inflow/Debit</b>	<b>Salaries</b>	<b>Outflow/Credit</b>
(14)	26,500	

<b>Inflow/Debit</b>	<b>Sales</b>	<b>Outflow/Credit</b>
Balance	176,000	(3) 90,000
		(4) 82,000
		(16) <u>4,000</u>
	<u>\$176,000</u>	<u>\$176,000</u>
		Balance 176,000

Inflow/Debit	Share capital	Outflow/Credit
	(7)	250,000

Inflow/Debit	Long term loan	Outflow/Credit
	(8)	120,000

Inflow/Debit	Discounts allowed	Outflow/Credit
(16)	4,000	

Inflow/Debit	Discounts received	Outflow/Credit
	(15)	3,000

Inflow/Debit	Bad debts	Outflow/Credit
(17)	2,000	

(ii) Extended trial balance

EXTENDED TRIAL BALANCE of Wallace Peter Ltd for year ending 20X8								
Account	Trial Balance		Adjustments		Profit & Loss		Balance Sheet	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
Cash at bank	70500						70500	
Trade creditors		13000						13000
Debtors	20000						20000	
Purchases	104000			15000	89000			
Building	150000						150000	
Motor vehicles	60000			12000			48000	
Equipment	90000			9000			81000	
Administration	15000			700	14300			
Light, heat etc	20000		2200		22200			
Salaries	26500				26500			
Discounts allowed	4000				4000			
Bad debts	2000				2000			
Sales		176000				176000		
Share capital		250000						250000

Long term loans		120000						120000
Discounts received		3000				3000		
Depreciation			12000					
			9000		21000			
Inventory			15000				15000	
Accrual				2200				2200
Payment in advance			700				700	
Profit/loss					0	0	0	0
TOTALS	562000	562000	38900	38900	179000	179000	385200	385200

(iii) Cash flow statement

Cash flow statement of Wallace Peter for year ended 20X8		
<b>Operating Activities:</b>		
Cash received from customers	150,000	
Cash payments to suppliers	(88,000)	
Cash payments to employees	(26,500)	
Cash paid for admin	(15,000)	
Cash paid for light etc	<u>(20,000)</u>	500
<b>Investing Activities:</b>		
Purchase of buildings	(150,000)	
Purchase of motor vehicles	(60,000)	
Purchase of equipment	<u>(90,000)</u>	(300,000)
<b>Financing Activities:</b>		
Increase in share capital	250,000	
Increase in long term loans	<u>120,000</u>	<u>370,000</u>
Increase in cash		<u>£70,500</u>
Cash at year end		£70,500

Question 15.3

A.R. Manwaring plc

Cash flow statement of A.R. Manwaring plc for year ended 20X9		
<b>Operating Activities:</b>		
Profit before dividends	64,000	
Depreciation charged	50,000	
Loss on sale	48,000	
Increase in inventory	(74,000)	
Increase in debtors	(58,000)	

Increase in creditors	<u>72,000</u>	102,000
Investing Activities:		
Purchase of freehold property	(180,000)	
Sale of plant & equipment	62,000	
Purchase of plant & equipment	<u>(200,000)</u>	(318,000)
Financing Activities:		
Issue of debentures	30,000	
Increase in share capital	50,000	
Increase in share premium	20,000	
Payment of dividends	<u>(16,000)</u>	<u>84,000</u>
Change in cash		(132,000)
Plus opening cash balance		<u>136,000</u>
Equals closing cash balance		<u>£4,000</u>

Notes on cash movements:

Purchase and sale of plant and equipment

Inflow/Debit	Plant and equipment	Outflow/Credit	
Balance	240,000	Sale	140,000
Purchases (cash)	<u>200,000</u>	Balance	<u>300,000</u>
	<u>£440,000</u>		<u>£440,000</u>
Balance	330,000		

Inflow/Debit	Acc depn on plant and equipment	Outflow/Credit	
Sale	30,000	Balance	56,000
Balance	<u>70,000</u>	Depreciation (P&L)	<u>44,000</u>
	<u>£100,000</u>		<u>£100,000</u>
		Balance	70,000

Inflow/Debit	Disposal of plant and equipment	Outflow/Credit	
Cost	140,000	Accumulated depreciation	30,000
		<b>CASH</b>	62,000
		Loss on disposal	<u>48,000</u>
	<u>£140,000</u>		<u>£140,000</u>
Loss (P&L)	48,000		

Question 15.6

Ferm Industries plc

Ratios	20X7	20X8	20X9
<b>PROFITABILITY:</b>			
Gross Margin	26.4%	27.7%	28.1%
Net Profit	17.5%	18.2%	17.8%
Return on Capital Employed	10.1%	11.1%	10.6%
<b>ACTIVITY:</b>			
Inventory turnover	7.6	4.6	3.3
Debtors collection period	103 days	145 days	128 days
Sales value to capital employed	0.6	0.6	0.6

Ratios	20X7	20X8	20X9
<b>LIQUIDITY:</b>			
Current	1.2	1.9	1.9
Acid test	0.8	1.2	1.1
<b>GEARING:</b>			
Basic gearing	1:4	1:7	1:13
Debt to equity	1:3	1:6	1:12
Percentage claims against the business	35.8%	28.8%	22.4%
Times interest earned	6.3 times	11 times	18.9 times
<b>STOCK MARKET:</b>			
Dividend yield	3.2 %	2.9%	2.1%

Dividend coverage	1.5	2	2.4
Earnings per share (EPS)	14.9c	18.26c	16.73c
Earning yield	4.8%	5.7%	5.1%
Price earnings (PE)	20.8	17.5	19.7
Value of company	\$619,840	\$735,000	\$988,94
	\$620,000	\$736,000	0
			\$990,00
			0

Some of the more important points to draw out from the ratio analysis in conjunction with the cash flow statements and the industry ratios are as follows:

1. The company generally is stable unlike the rest of the industry which is expanding. In terms of efficiency, however, which is not unrelated to the stabilizing of performance, there has been a marked decline over the three-year period which suggests that unless things change and the alteration in the asset base improves the situation we may see future decline.
2. Profitability ratios indicate a stable situation while the industry averages indicate a steady growth. There has been a major revamping of the asset base as the cash flow statements indicate, but whether this will lead to growth in profitability depends on many factors, not least an improvement in the activity ratios.
3. The activity ratios indicate a major problem for the company - stock turnover and debtors collection are worsening which is not happening in the industry as a whole.
4. Liquidity ratios indicate a tight but improving situation, but with the stock turnover and debtors collection ratios giving cause for concern it is uncertain how realistic such improvements really are.
5. Gearing is reduced and thus coming more into line with the industry, even though these ratios indicate that the company still is above the (declining) industry norms.
6. Poor earnings per share, dividend and earnings yield are apparent in comparison with the industry. The price earning ratio likewise is wavering a little even though reasonably stable as distinct from the industry norms which are increasing. However, the value of the company is increasing on the assumption that the new assets will make a significant contribution to the future profitability of the company.

## STUDENTS' WORKBOOK

### CHAPTER 16 ACCOUNTING FOR CHANGING PRICES AN INTRODUCTION

#### 16.1 Introduction

This chapter begins the process of examining alternative ways of accounting for organisational activity. Although we remain within the 4 characteristics of accounting (see chapter 1 of the main text), and thus within "conventional accounting", the issue in the chapter concerns if we can offer alternatives to HCA as a basis for financial accounting.

There are a number of key points to remember from the corresponding chapter of the text:

- (a) Price changes may be general or specific.
- (b) We have concentrated on the central issues of asset valuation and capital maintenance and some of the simpler interpretations of these.
- (c) The CCA approach we have emphasized takes an entity approach to capital maintenance. The CPP approach we have talked about adopts a proprietary concept of capital maintenance and is basically an adjustment of the HCA financial statements.
- (d) Finally, we have argued that you are not searching for truth but trying to provide additional financial information and examine alternative presentations of entities economic behaviour.

This chapter is organized as follows: section 16.2 contains some computational problems, and section 16.3 provides a series of discussion topics. Finally, section 16.4 we provide solutions to selected computational questions.

#### 16.2 Computational problems

##### *Question 16.1*

- (i) If you have a fixed asset which cost you £160 on 1 January 20X8 and the RPI rose by 5% during the year to 31 December 20X8, at which time it would cost you £190 to replace the asset, calculate the HCA, CPP and RCA asset values and associated depreciation which would appear in your financial statements at the end of 20X8. (Assume a five year life and straight line depreciation.)
- (ii) Have you any holding gains? Of what do they consist? What would you do with them?

##### *Question 16.2*

Calculate the annual and accumulated depreciation for the following asset figures using the HCA, CPP and RCA conventions. Assume an estimated asset life of 5 years and treat the 'revalued' figures as referring to both CPP and RCA. Calculate and show the backlog depreciation as appropriate.

	Purchase price	Revalued figure
Start year 1	£150	-
End year 1	-	£200
End year 2	-	£230
End year 3	-	£250

### 16.3 Discussion topics

#### Question 16.3

- (i) How did Hicks (1946) define 'income'?
- (ii) State which figure in the 'traditional' (HCA) financial statements is equivalent, under the HCA convention, to this Hicksian definition on income.
- (iii) Why is the income figure for an organization important? Can you think of who might use this figure and what they might use it for?
- (iv) In what ways might the 'traditional' income figure be inadequate in a period of changing prices/inflation? Give examples of the problems that, for example, the proprietor of a small general grocery shop trading as a sole trader might face if he/she relied upon 'traditional' financial statements.

#### Question 16.4

- (i) What happens to the financial description of an organization's assets in a period of changing prices/inflation? What happens to the underlying assets themselves in such a period?
- (ii) Consider the example of a textbook owned by your college library. Bearing in mind that this is just one of thousands of assets owned by the organization, take the case of a textbook with which you are familiar (this one perhaps) and consider all the different ways you could value it (a minimum of six). How would you set about determining these values? What additional factors would influence these values and what would their influence be?

*(Hint: When considering replacement cost, for example, you might consider whether the replacement would be the same book, a different edition, a new or second hand copy, a paperback or hardback edition, or even a completely different book altogether.)*

#### Question 16.5

List 10 items that might typically appear in a profit and loss account and 10 items that might typically appear in a balance sheet. Briefly discuss which of these will be affected by a period of changing prices/inflation and describe in detail the nature of any affect.

## 16.4 Selected answers to computational problems

### Question 16.1

Assuming five years life and straight line depreciation

	HCA	CPP	RCA
Asset value 20X8	160	168	190
Depreciation for the year	<u>32</u>	<u>33.6</u>	<u>38</u>
NET BOOK VALUE	<u>128</u>	<u>134.4</u>	<u>152</u>

There will be an UGH on the RCA machine and how it is treated will depend upon the capital maintenance concept we are employing.

### Question 16.2

Year	Cost	HCA depn	HCA acc	CPP depn	CPP acc	RCA depn	RC A acc	Backlog depn
Start 1	150	-	-	-	-	-	-	-
End 1	200	30	30	40	40	40	40	-
End 2	230	30	60	46	92	46	86	6
End 3	250	30	90	50	150	50	136	14

## STUDENTS' WORKBOOK

### CHAPTER 17 EXPANDING THE REPORTING FUNCTION: SOCIAL AND ENVIRONMENTAL ACCOUNTING AND REPORTING

#### 17.1 Introduction

Chapter 17 has three broad themes:

- (a) the development of newer types of (often non-financial) information for shareholders;
- (b) the development of information for other groups of participants; and
- (c) the impacts of the accounting activity on the economy and on society.

The common element of these themes is a questioning of what has been conventionally seen as the traditional concern of accountants. That is, is the discipline of accounting and the accounting activity to be restricted to the recording, description and communication of the immediate, purely financial effects of the focal organization's activities, as they affect only the focal organization and the focal organization's owners? Chapter 17 has argued that this should not be the case: shareholders do (or perhaps should) have more than a simply financial interest in their organization, there are groups other than shareholders with a legitimate interest in the organization, and the accounting activity **does** affect the economy and society.

Whilst these views used to be contentious, they are becoming accepted. The extent of one's agreement with these ideas is largely dependent upon opinion and predisposition, while developments in law and in corporate reporting practices demonstrate that the reporting function is expanding and social and environmental accounting and reporting is increasingly recognized as being necessary for the discharge of corporate accountability.

This chapter is structured thus: section 17.2 contains a computational question requiring a plant closure decision to be made using financial and non-financial information. Section 17.3 develops a series of discussion questions focused around material that can be gleaned from published financial reports, CD-ROM searches and the Internet. These questions are designed to yield an array of actual examples of corporate social reporting from which debates about this type of reporting can be developed. Finally, section 17.3 provides a suggested solution to question 17.1

#### 17.2 Computational problem

Accounting numbers can have significant effects upon investment and disinvestment decisions by organizations. For example, the issue became widely public in the mid 1980's in the UK during the lengthy miners' strike. *Inter alia*, it was obvious that one major issue of the strike was the (then) National Coal Board's decision to close 'uneconomic' pits. The problem was, how does one decide which pits are 'uneconomic'? As Berry et al., (1985) showed, the extent to which a pit is uneconomic depended almost entirely on how one chose to do one's accounting. Have a look at this article and Harte and Owen (1987) and then consider the following question.

### Question 17.1

#### The plant closure decision

Bad Company plc is an international conglomerate which has decided to close down one of its wholly-owned subsidiary companies, Free Ltd. Mr Kossof, the MD of Free Ltd and Mrs Fraser, the union representative in the company, have come to you for help in persuading Bad Company plc not to liquidate the company. Bad Company's decision is based upon the last three years' financial statements, a summary of which are shown below.

	20X5 \$000	20X6 \$000	20X7 \$000
NBV of fixed assets	450	250	50
Share capital	(50)	(50)	(50)
Revenue reserves (incl. P&L)	<u>(400)</u>	<u>(200)</u>	<u>0</u>
Net profit (before charging):	500	560	600
R&D in the year	(50)	(60)	(60)
Debt charges	(100)	(100)	(100)
Depreciation	(200)	(200)	(200)
Management charges	(300)	(310)	(340)
Allocation of audit fee	(10)	(10)	(10)
Redundancy costs	-	<u>(30)</u>	<u>(40)</u>
Net loss	(160)	(150)	(150)
Dividends	<u>(50)</u>	<u>(50)</u>	<u>(50)</u>
Transfer from revenue reserves	<u>(210)</u>	<u>(200)</u>	<u>(200)</u>

You also learn the following:

1. Free Ltd is located in an economically depressed area of the country, and is housed in government-sponsored industrial units on one of the new industrial estates. The buildings are let at a nominal rent as part of the government's policy of attracting industry to areas of high unemployment. The company is a major employer in the area.
2. The company is engaged in the design, development and manufacture of musical amplification systems and stage lighting systems. The company has only been in existence for eight years but is already established as a leader in its field and orders exceed current production.
3. The fixed assets consist of a specially designed and manufactured series of machines. These machines have a minimum of ten years estimated useful life. Ten machines were bought when the company started and these machines are still in full-time use and show no signs of faltering. A further five machines were brought in 20X4 for \$800,000. It is Bad Company's policy to depreciate everything over a maximum of four years.
4. Bad Company adopts a policy of immediate write-off of all intangible assets. The R&D shown above relates to the development of a new musical amplification system which was put into full

production during 20X7, and for which advance orders are streaming in. It appears that Free Ltd has developed a potential market leader with the product.

5. Bad Company insists that any additional finance needed by its subsidiaries must be taken in the form of a loan with Bad Company itself. Its reason is that it does not wish its companies to undertake risky projects over which it has no control and Bad Company also wishes to prevent any nervous bank from foreclosing on a loan to one of its subsidiaries. All Free's debt charges are paid to Bad Company and relate to a loan for the purchase of the machines in 20X4.

6. The management charges are also paid to Bad Company. These cover central legal, computing and financial management services. Free believe that it could acquire the same services at less than half the cost. Bad Company does not disagree but refuses to change its policy on this.

7. Bad Company is proud of its cash flow profile and makes quite a feature of this in its Annual Report and Accounts. It insists on a positive cash flow from each of its subsidiaries.

8. The redundancy costs have arisen because Free simply does not have the cash flow to support the work-force it believes it needs. The redundancies are almost entirely amongst the design, quality control and after-sales support teams. All those made redundant were previously untrained local people whom Free engaged under the government-supported training schemes and believes that its training is both of a very high standard and too specific to be of very much value to another employer.

9. Free Ltd does not see its individual audit charge and simply receives an allocation from the total audit fee for the group. In 20X7 the audit report contained a 'going concern' qualification. This also apparently influenced Bad Company in its decision about liquidation and closure.

Required:

- (i) Is Bad Company 'right' to liquidate the company?
- (ii) Why do you think it is considering liquidation?
- (iii) What other options are available to Bad Company?
- (iv) Help Mr Kossof and Mrs Fraser prepare a case against closure.
- (v) What options are available to Mr Kossof and Mrs Fraser?
- (vi) What would be the general effect on the local and national economy and on the local society if Free Ltd is liquidated? Do you think that local or central government may wish to intervene in this issue?

### **17.3 Discussion topics**

The following questions require you to search for examples of corporate social reporting from a variety of sources including: published annual reports, published social and environmental reports, the professional press, other professional publications, CD-ROM databases and the internet. We are asking you to search widely for examples for three reasons. First, we wish to eliminate any particular country bias in these questions so it seems sensible for you to discover what is happening in your own country. Second, the area of social and environmental accounting is evolving and developing rapidly and as a result any examples we could provide here will rapidly become out of date. A search by you should identify cutting edge, recently released material. Finally, in keeping with the educational theme permeating this book we believe that you will enjoy this material and understand it better if you have been actively involved with seeking out examples.

### *Question 17.2*

- (i) Using an annual report with which you are familiar (from your small but growing library of annual reports!) examine it in some detail to identify examples of non-financial information disclosure. Write a brief description of this additional information and indicate where it is located in the annual report.
- (ii) Using the above annual report, extract all the information which you consider to be social and environmental accounting/reporting.
- (iii) Using the web and CD-ROM searches locate as much additional information as you can about the organization you have chosen to examine.
- (iv) How do the two above sets of information differ from each other? Is there some overlap? What is this overlap?
- (v) Put all this information together and create a “silent social account”.

### Class exercise building on 17.2

In class exchange your silent social account with someone else. Read the silent social account you have been given and note what information you found most interesting. Discuss your perceptions of the organization with the person who collated that information. Do you believe that silent social accounts may change people's perceptions of organizations?

### *Question 17.3*

Conduct a CD-ROM search of a well known business paper and identify articles which consider the area of social and environmental accounting. The types of key words that could be useful include: social accounting, environmental accounting, employee accounting, social audit, value added statement, environmental disclosures, environmental liabilities. Bring a sample of these articles to class and summarise the articles for the rest of the class. How do the ideas in the article relate to those in the chapter?

### *Question 17.4*

Browse through the journal published by a professional accounting body with which you are familiar. Identify articles that focus on elements of social and environmental accounting.

Required:

- (i) Bring a sample of these articles to class and summarise the articles for the rest of the class.
- (ii) How do the ideas in the article relate to those in the chapter?
- (iii) Can you identify any other professional material on social and environmental accounting (for example, research reports or monographs, profession sponsored books or accounting standard related materials)?

### *Question 17.5*

Obtain some examples of 'stand alone' corporate social reporting. These may be environmental reports, social reports or sustainable development reports. There are two ways in which this information can be obtained:

- (i) Using your own library of annual reports, write to the companies whose accounts you have and

obtain any stand alone reports they produce.

*(Hint: it may be appropriate to check with your tutor first to see if s/he can suggest particular organizations to write to and if the companies you are considering produce any stand alone information).*

(ii) A number of organizations produce social and environmental information on the internet. Accessing this material required you to know the address at which the information is stored. One way to access this kind of information is to access it from a related page such as the home page of the Centre for Social and Environmental Accounting Research (CSEAR). The address for CSEAR's home page is: **http://www.gla.ac.uk/departments/accounting/csear**. From this page you will be able to access all sorts of interesting material. In particular, CSEAR has a student resources section which includes links to on-line reporting directories - happy surfing.

Required:

Bring your examples of the stand alone reports to class *(Note: check about the practicality of printing pages from the internet. Depending on the facilities available this may be a very time consuming task).*

- (i) Who do you think these reports are aimed at?
- (ii) How could the information contained in the reports be used by:
  - (a) shareholders,
  - (b) employees,
  - (c) members of a local community and
  - (d) society at large?
- (iii) What do you see the strengths and weaknesses of these reports to be?
- (iv) Why do you think these reports are produced?

## **17.4 Selected answers to computational problems**

### *Question 17.1*

The numerical question contained here is really very straightforward in principle, but with opportunities for you develop the 'answer' in as much detail as suits yourself. A few pointers are worth highlighting:

(i) Given the heavy-handedness of the example, Bad Company's decision looks fairly ridiculous unless they do have an actual policy of bleeding companies before disposal. (This need not be an explicit or even conscious policy of course). The immediate accounting issues are the depreciation rate of machines and the R&D policy. The redundancy, audit fee, management charge and debt charge are matters of the accounting/finance/organizational policy of Bad Company. These should form the basis of discussion for much of the question. That is, for example, under what circumstances would these policies seem to be economically sensible?

(ii), (iii), (iv) and (v) would all be based around the points mentioned in (i) above. If Free Ltd is a sound company, might Mr Kossof and Mrs Fraser consider, for example, some arrangement for the workforce to buy the company (a 'management buyout')?

(vi) For this part of the question, you should consider the public versus private cost questions. That is, for example, Bad Company's decision is a private decision which is imposing public costs on the region. To what extent can the public effects of private decisions (and vice versa) be realistically separated? Might the Government be interested in intervening in this issue? Why? To what extent might such intervention (or non-intervention) be economic rather than strictly a matter of political philosophy?

**References:**

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## STUDENTS' WORKBOOK

### CHAPTER 18 THINKING ABOUT ACCOUNTING: THEORETICAL PERSPECTIVES ON FINANCIAL ACCOUNTING AND REPORTING

#### 18.1 Introduction

The central concern of Chapter 18 is to highlight that there is more than one way to look at financial accounting information. The alternatives discussed in Chapter 18 are, to a large extent, mutually exclusive and thus require some choice as to which one is most appropriate. In this chapter of the Workbook we look at these alternatives in a little more depth, as well as introducing you to the problem of evaluation and choice.

The contents of the chapter are organized thus: Section 18.2 contains an extended exercise, which can be done individually or within groups in class, which is designed to develop your thinking about the nature of the financial reporting function. A number of discussion questions are presented in section 18.3 which are designed to develop your understanding of the alternative approaches to accounting theory and how these approaches may be evaluated. Finally, section 18.4 contains a suggested answer for the discussion questions contained in section 18.3.

#### 18.2 Class (or individual) exercise

##### *Question 18.1*

##### (i) Nature of current accounting

(a) Critically examine the following quotes from the American Accounting Association describing accounting and suggesting a purpose for accounting. Add or subtract elements from the definitions as you think appropriate. For example, you may not think that the description of accounting is full enough or you may believe accounting does not operate the way it is described.

AAA quotes concerning the nature of financial accounting	Additions/Subtractions
Description of accounting: "... the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by the users of that information"	
Purpose of accounting: "... to provide information which is potentially useful for making economic decisions and which, if provided, will enhance social welfare"	

(b) Rewrite the above two definitions in a way you think students at secondary school would understand.

## (ii) Stakeholder analysis

Here is a list of potential stakeholders in an organisation. This list forms the basis for the following questions.

**STAKEHOLDERS:** Individual shareholder, institutional shareholder, management of entity, unsecured creditors, secured creditors, employees, trade unions, customers, pressure groups, local community, society in general and government.

(a) For the above list of potential stakeholders indicate:

(i) the type of information they are likely to want (specify why you believe the stakeholders want this),

(ii) what purpose they are likely to use that information for, and

(iii) whether they presently receive that information from the financial accounting process (focus on the audited financial statements themselves, rather than on the annual reporting package).

Be as imaginative as you can and try not to restrict your categories to that information these stakeholders may currently receive.

(b) How have you assessed what information stakeholders are likely to want? How could you find out what their wants are? If you could find no evidence that stakeholders **used** a piece of information provided would you still provide it? Why or why not?

(c) Do you think stakeholders are always going to want the same thing from all entities?

## 18.3 Discussion topics

### *Question 18.2*

Think creatively about the contents of Figure 18.1 in the main text which presents, in diagrammatical form, the nature of the financial accounting problem:

(i) Assume yourself to be the owner of a focal organization which is concerned with the supply of utilities (water, gas, etc). Who would be your information receiving stakeholders?

(ii) What possible type of information would you need to supply to these recipient organizations in your substantive environment?

(iii) Based on your list from (ii) above think through the possible organizational actions and activities which you would need to record do that this information can be supplied.

(iv) How many of your alternatives can be satisfied though the information generated form the traditional financial accounting model discussed in the first 15 chapters of this book?

### *Question 18.3*

Drawing from section 18.2 of the text, consider the strengths and weaknesses of adopting an 'accountability' perspective to the data orientated approach in comparison with the other variants which express this overarching philosophy.

#### *Question 18.4*

Adopting an 'accountability' perspective, how would you answer the questions: (a) accountable to whom? and (b) accountable for what? if you were the chief executive of:

- (i) a hospital;
- (ii) a company selling furniture;
- (iii) a nuclear power station;
- (iv) a steel works.

#### *Question 18.5*

Read section 18.3 of the text and then answer the following:

- (i) Highlight the distinctions between the decision-makers and decision models expressions of the decision usefulness approach.
- (ii) What objections exist to the decision-makers variant?
- (iii) What claimed advantages exist for the decision models variant?
- (iv) Despite (ii) above why do you think that the decision makers emphasis has proponents both with information receiving organizations and academics?

#### *Question 18.6*

Re-read pages 312 and 313 from Davis, Menon and Morgan (1982), pages 74-80 of Laughlin and Puxty (1981), and section 18.4 of the text and then answer the following:

- (i) List the characteristics of the agent/principal and organization control variants of the organizational resource approach.
- (ii) What is the relationship between these two alternatives?
- (iii) Why do you think the organizational resource approach, as a totality, would appeal to the management of focal organizations?
- (iv) Why do you think the organizational resource approach, as a whole, is treated with some suspicion by most academics and standard setters?

### **18.4 Solution notes to discussion topic**

#### *Question 18.2*

This question builds on the class exercise in Question 18.1. Try to be as imaginative as possible in your answers to this set of questions. Make sure the list of recipient organizations that you highlight are not just those which are most directly involved with any service industry (e.g. suppliers, customers etc.) but also those social and environmental organizations who have an interest in the actions and inactions of these corporations (see also Chapter 17). Try hard to think realistically what these different types of organizations might want to know about the activities of your chosen service organization. At this stage you might also want to clarify the purpose you are assuming for the information you are suggesting. Given a fair degree of imagination it is anticipated that you will find few alternatives that you suggest being satisfied through the traditional accounting model which has dominated the first 15 chapters of the book.