

Chapter 8 Adjustments to the Profit and Loss Account and Balance Sheet: 1

Questions

1. Joey's recent business phone bills are as follows:

| Period covered | £ |
|-------------------|-----|
| 1.11.X4 – 31.1.X5 | 661 |
| 1.2.X5 – 30.4.X5 | 776 |
| 1.5.X5 – 31.7.X5 | 524 |
| 1.8.X5 – 31.10.X5 | 840 |

Joey's year end is 31 December. At 31 December 20X5 he estimates that the November and December phone charges (which will not be billed until the end of January 20X6) will amount to 2/12 of the previous 12 months' charges.

How much is the telephone expense in Joey's profit and loss account for the year ending 31 December 20X5? (work to the nearest £).

2. Jacinta's accrued expenses for the year ending 31 March 20X8 total £4820. In her balance sheet this amount:

- (1) Decreases net current assets
- (2) Increases net current assets
- (3) Is included under current liabilities
- (4) Is deducted from capital.

Which of these statements are correct?

- a) 2 & 3
- b) 1 & 4
- c) 1 & 3
- d) 2 & 4

3. Per prepares his accounts to 31 January each year. At 31 January 20X4 he has the following balances on electricity and telephone accounts:

| | £ |
|-------------|-------|
| Electricity | 6 464 |
| Telephone | 3118 |

Per is due to receive an electricity bill in respect of the three-month period to 31 January 20X4, but it has not yet arrived. By 15 February it has still not arrived and he rings up the electricity company. The customer services representative tells Per that they are having trouble with their computerised billing system, but that the amount of the bill to 31 January 20X4 will be £2350.

The most recent telephone bill received by Per covered the three-month period to 30 November 20X3. Usually Per would expect to spend about £300 per month on phone charges and that seems a reasonable estimate for January 20X4. However, he knows that an unusually large number of calls were made just before Christmas, and he estimates that call charges for December were probably in the region of £420.

- (a) What amount should be included in Per's profit and loss account for electricity and telephone expenses up to 31 January 20X4?
- (b) What is the total accrual for electricity and telephone at 31 January 20X4?
- (c) Where is this amount shown in the balance sheet?
4. Khalil runs a decorative tile shop. He imports an exclusive range of tiles from South America upon which import duties have to be paid. Most of Khalil's sales are for cash, but he supplies some trade customers on credit. In order to encourage his debtors to pay within 30 days he offers a discount of 1.5% for early payment.

Khalil is concerned because his volume of trade has declined and he thinks it's probable that his margins have worsened over the year. In the year to 31 December 20X3 his gross profit margin was 23.7% and net profit margin was 8.2%.

At Khalil's year end, 31 December 20X4, he has the following balances in his account books relating to sales and expenses items:

| | £ |
|-----------------------------------|---------|
| Sales returns | 1 897 |
| Opening stock at 1 January 20X4 | 98 761 |
| Premises rent and rates | 32 900 |
| Bank charges | 976 |
| Sundry expenses | 4 992 |
| Sales | 618 772 |
| Service charges on property | 5 252 |
| Telephone | 1 772 |
| Purchases | 473 405 |
| Administration and accountancy | 3 700 |
| Staff wages | 47 550 |
| Purchases returns | 2 950 |
| Discounts allowed | 477 |
| Electricity | 4 906 |
| Import duties | 5 547 |
| Closing stock at 31 December 20X4 | 103 471 |

Prepare Khalil's profit and loss account for the year ending 31 December 20X4. Calculate his gross and net profit margins. Have they worsened, as Khalil suspects, or have they improved?

5. Ling imports household furnishings and ornaments which she sells on at a profit to retailers. She runs her business from a small warehouse, with an office attached, and she employs a full-time manager to take care of the day to day running of the business while she is away on buying trips.

At Ling's year end, 30 April 20X6, the balances in her accounting records relating to sales and expenses items are as follows:

| | £ |
|----------------------|---------|
| Manager's salary | 22 650 |
| Other staffing costs | 18 917 |
| Sales | 293 750 |
| Discounts received | 720 |
| Travelling expenses | 10 766 |

| | |
|--|---------|
| Sales returns | 1 222 |
| Import duties on purchases | 7 721 |
| Opening stock at 1 May 20X5 | 24 297 |
| Telephone | 2 892 |
| Interest received | 1 652 |
| Warehouse rental | 20 470 |
| Other premises costs | 10 200 |
| Purchases | 120 887 |
| Delivery charges (for delivery to customers) | 5 521 |
| Administrative expenses | 6 247 |
| Bank charges | 360 |
| Closing stock at 30 April 20X6 | 13 127 |
| Sundry expenses | 2 424 |

Notes:

1. Of the warehouse rental, £2173 should be accounted for as a prepayment.
2. Telephone charges have been invoiced up to the end of March 20X6. Ling estimates that an accrual of £385 will be required for April's charges.

Prepare Ling's profit and loss account for the year ending 30 April 20X6.

6. Linley has a retail business selling bedroom furniture. Two years ago he opened a branch of his business in a nearby town. The day to day management of the branch is delegated to Linley's trusted colleague, Olwen.

All the records for the business are kept at the head office. Linley keeps a record of sales made by the branch so that he can pay Olwen a sales-based commission. In the year ending 31 March 20X5 sales at the branch total £159 500. Linley has agreed to pay Olwen 1% of branch sales as commission, and this must be accrued for in the year end accounts.

At the year end, 31 March 20X5, the following amounts are recorded in Linley's books:

£

| | |
|--|---------|
| Purchases | 447 331 |
| Closing stock at 31 March 20X5 | 75 210 |
| Premises rental | 39 421 |
| Electricity | 7 662 |
| Insurance | 6 420 |
| Other staff costs | 41 448 |
| Debtors | 1 620 |
| Cash at bank | 12 471 |
| Drawings | 52 000 |
| Administrative costs | 12 246 |
| Sundry expenses | 5 521 |
| Fixed assets | 26 250 |
| Sales returns | 2 588 |
| Purchases returns | 3 667 |
| Haulage and carriage costs (for delivery of purchases to Linley) | 10 261 |
| Opening stock at 1 April 20X4 | 70 462 |
| Trade creditors | 40 211 |
| Capital at 1 April 20X4 | 48 014 |
| Creditors: Inland Revenue and VAT | 5 227 |
| Telephone | 3 860 |
| Sales | 642 442 |

Notes:

1. The insurance total of £6420 comprises:

Charges to 31 December 20X4 2 700

Paid on 1 January 20X5 3 720

The amount paid at the beginning of January covers the year to 31 December 20X5. An adjustment is required for a prepayment.

2. Commission for Olwen must be accrued in accordance with the arrangements explained earlier.
3. The telephone charges of £3860 are for the ten months to 31 January 20X5. An accrual is required for February and March 20X5. Linley's estimate of the total charges for the two months is £772.

7. Miles is the sole UK distributor for an extensive range of glassware imported from Ireland. The business was started by Miles' father, and is well-established and profitable. Its principal customers are retailers, although Miles sells a small proportion of 'seconds' stock direct to the public from a shop attached to the warehouse. Miles' relationships with his customers are generally good and most of them pay within 30 days. Miles offers a fairly generous settlement discount of 1.5% to those customers who settle promptly.

Recently, however, Miles has had some trouble extracting payment from Welbrand Furnishers plc, a listed company which has experienced some well-publicised trading difficulties. By 31 December 20X4, Miles' year end, the Welbrand debt has built up to £35 270. Three months ago, Miles refused to make any further supplies to the company. Some of outstanding invoices are now over 9 months old. These days, when Miles rings the accounts department of the company, he gets an answering machine. His calls are never returned.

Miles' accountant suggests that 100% provision should be made against the debt. She does not think it should be completely written off at present because there is some talk in the financial press of a takeover bid for Welbrand. This could put the company on a secure footing and may mean that Miles' debt will eventually be paid.

Miles' accounting records at 31 December 20X4 show the following balances:

| | £ |
|---|---------|
| Opening stock at 1 January 20X4 | 71 445 |
| Closing stock at 31 December 20X4 | 73 622 |
| Business rates | 10 791 |
| Trade creditors | 84 420 |
| Capital at 1 January 20X4 | 447 729 |
| Water rates & plumbing repairs | 8 800 |
| Secretarial and administrative salaries | 32 869 |
| Discounts allowed | 8 640 |
| Bank interest received | 1 202 |
| Sales | 898 720 |
| Telephone | 8 370 |
| Electricity | 11 621 |

| | |
|---|---------|
| Warehouse supervisor's salary | 20 408 |
| Other warehouse salaries | 38 696 |
| Accountancy charges | 2 400 |
| Debtors (including £35 270 owed by Welbrand) | 109 172 |
| Sundry expenses | 2 590 |
| Legal costs | 1 800 |
| Purchase returns | 1 850 |
| Cash at bank | 26 259 |
| Selling costs | 22 440 |
| Drawings | 45 000 |
| Fixed assets: warehouse & equipment | 282 460 |
| Delivery expenses (for deliveries to customers) | 16 260 |
| Fixed assets: delivery vans | 32 600 |
| Sales returns | 8 620 |
| Purchases | 672 680 |

Notes:

1. An adjustment must be made to the business rates total: £2178 relates to the 20X5 accounting year and should be treated as a prepayment.
 2. An accrual of £1497 for electricity charges is required.
- Prepare Miles' profit and loss account and balance sheet at 31 December 20X4.
8. Sharon

Sharon runs a business selling cards and novelty items from a busy shop in a large shopping centre. She has the following list of account balances at 31 August 20X1:

| | £ |
|--|---------|
| Administration expenses | 8 219 |
| Purchases | 224 069 |
| Fixed assets | 27 662 |
| Sundry expenses | 1 007 |
| Bank charges | 1 830 |
| Premises rental (including business and water rates) | 68 000 |
| Opening stock at 1 September 20X0 | 45 517 |

| | |
|-------------------------------------|---------|
| Sales | 464 714 |
| Subscriptions to trade association | 818 |
| Electricity | 5 337 |
| Property services charge | 17 004 |
| Cash at bank | 18 712 |
| Interest received | 460 |
| Assistants' wages | 38 830 |
| Mobile phone | 766 |
| Travelling expenses | 3 600 |
| Phone – shop | 3 234 |
| Drawings | 61 300 |
| Insurance | 5 237 |
| Creditors | 24 165 |
| Opening capital at 1 September 20X0 | 42 065 |
| Accountant's and solicitor's fees | 2 070 |
| Discounts received | 1 808 |
| Closing stock at 31 August 20X1 | 46 522 |

Note the following additional information:

1. In a normal year Sharon expects to make a gross profit on sales of 50% and a net profit of 16.3%.
2. An accrual of £1307 for property services charges is required at 31 August 20X1.
3. Not all of the £5237 for insurance relates to the year to 31 August 20X1. Sharon estimates that £465 of the charges relate to the next accounting period.
4. Sharon is still waiting for an electricity bill up to 31 August 20X1. She reads the electricity meter at 31 August and on the basis of the reading estimates that further charges of £1107 will have to be accrued for the year.
5. Some phone charges have not been billed by the year-end. An accrual of £200 should be made.

Prepare a profit and loss account for Sharon for the year ending 31 August 20X1 and a balance sheet at that date. Calculate gross and net profit margins and compare them with the expected performance of the business.

Answers

1. Joey

Telephone expenses for the year ending 31 December 20X5 are calculated as follows:

| | £ |
|---------------------------------------|-------------|
| January 20X5 – $1/3 \times £661$ | 220 |
| February – April 20X5 | 776 |
| May – July 20X5 | 524 |
| August – October 20X5 | 840 |
| $(661 + 776 + 524 + 840) \times 2/12$ | 467 |
| Total | <hr/> 2 827 |

2. Jacinta

Accruals decrease net current assets (statement 1) and are included under current liabilities (statement 3). The correct answer is (c).

3. Per

- (a) Electricity: $£6464 + £2350 = £8814$. Telephone: $£3118 + 420 + 300 = £3838$.
- (b) Total accrual = $£2350 + 420 + 300 = £3070$.
- (c) The accrual will be shown as part of current liabilities, generally immediately following trade creditors.

4. Khalil

Profit and loss account for the year ending 31 December 20X4

| | £ | £ | £ |
|---------------|---------|--------|---------------|
| Sales | | | 618 772 |
| Less: returns | | | (1 897) |
| | | | <hr/> 616 875 |
| Cost of sales | | | |
| Opening stock | | 98 761 | |
| Purchases | 473 405 | | |

| | | |
|----------------------------|---------|-----------|
| Add: import duties | 5 547 | |
| Less: Purchases returns | (2 950) | |
| | <hr/> | 476 002 |
| | | <hr/> |
| | | 574 763 |
| Closing stock | | (103 471) |
| | | <hr/> |
| | | 471 292 |
| Gross profit | | <hr/> |
| | | 145 583 |

| | | |
|-----------------------------------|--|---------|
| Expenses | | |
| Premises rent and rates | | 32 900 |
| Service charges on property | | 5 252 |
| Staff wages | | 47 550 |
| Electricity | | 4 906 |
| Telephone | | 1 772 |
| Discounts allowed | | 477 |
| Bank charges | | 976 |
| Administration and accountancy | | 3 700 |
| Sundry expenses | | 4 992 |
| | | <hr/> |
| | | 102 525 |
| Net profit | | <hr/> |
| | | 43 058 |
| | | <hr/> |

Gross profit margin

$$\frac{145\,583}{616\,875} \times 100 = 23.6\%$$

Net profit margin

$$\frac{43\,058}{616\,875} \times 100 = 7.0\%$$

Both gross and net profit margins are lower than in the previous year.

5. Ling

Profit and loss account for the year ending 30 April 20X6

| | £ | £ | £ |
|------------------------------------|---------|---------------|---------------|
| Sales | | | 293 750 |
| Less: returns | | | (1 222) |
| | | | <hr/> 292 528 |
| Cost of sales | | | |
| Opening stock | | 24 297 | |
| Purchases | 120 887 | | |
| Add: import duties | 7 721 | | |
| | <hr/> | 128 608 | |
| | | <hr/> 152 905 | |
| Closing stock | | (13 127) | |
| | | <hr/> | 139 778 |
| | | | <hr/> 152 750 |
| Interest received | | | 1 652 |
| Discounts received | | | 720 |
| | | | <hr/> 155 122 |
| Expenses | | | |
| Warehouse rental | 20 470 | | |
| Less: prepayment | (2 173) | | |
| | <hr/> | 18 297 | |
| Other premises costs | | 10 200 | |
| Manager's salary | | 22 650 | |
| Other staff costs | | 18 917 | |
| Travelling expenses | | 10 766 | |
| Telephone | 2 892 | | |
| Add: accrual for telephone charges | 385 | | |
| | <hr/> | 3 277 | |
| Delivery charges | | 5 521 | |
| Administrative expenses | | 6 247 | |
| Bank charges | | 360 | |
| Sundry expenses | | 2 424 | |
| | | <hr/> | |

| | |
|------------|--------|
| | 98 659 |
| Net profit | 56 463 |

6 Linley

Working 1: insurance

| | |
|--|---------|
| Insurance to 31 December 20X4 | 2 700 |
| Paid on 1 January 20X5 (for one year) | 3 720 |
| Less: prepaid – $9/12 \times £3\,720$ | (2 790) |
| Insurance charge for year to 31 March 20X5 | 3 630 |

Profit and loss account for the year ending 31 March 20X5

| | £ | £ | £ |
|---------------------------------|---------|----------|---------|
| Sales | | | 642 442 |
| Less: returns | | | (2 588) |
| | | | 639 854 |
| Cost of sales | | | |
| Opening stock | | 70 462 | |
| Purchases | 447 331 | | |
| Add: haulage and carriage costs | 10 261 | | |
| Less: Purchases returns | (3 667) | | |
| | | 453 925 | |
| | | 524 387 | |
| Closing stock | | (75 210) | |
| | | | 449 177 |
| Gross profit | | | 190 677 |
| Expenses | | | |
| Premises rental | | 39 421 | |
| Electricity | | 7 662 | |
| Telephone charges | 3 860 | | |
| Add: accrual | 772 | | |
| | | 4 632 | |
| Insurance (working 1) | | 3 630 | |
| Staff costs | | 41 448 | |

| | | |
|-------------------------------|--------|---------------|
| Administrative costs | 12 246 | |
| Sundry expenses | 5 521 | |
| Accrued commission – Olwen | | |
| $£159\,500 \times 1\%$ | 1 595 | |
| | | 116 155 |
| Net profit | | <u>74 522</u> |

Balance sheet at 31 March 20X5

| | | |
|--|---------------|---------------|
| | £ | £ |
| Fixed assets | | 26 250 |
| Current assets | | |
| Stock | 75 210 | |
| Debtors | 1 620 | |
| Prepayment | 2 790 | |
| Cash at bank | 12 471 | |
| | <u>92 091</u> | |
| Current liabilities | | |
| Trade creditors | 40 211 | |
| Creditors: Inland Revenue and VAT | 5 227 | |
| Accruals (£772 + £1595) | 2 367 | |
| | <u>47 805</u> | |
| Net current assets (£92 091 – £47 805) | | 44 286 |
| | | <u>70 536</u> |
| Capital at 1 April 20X4 | | 48 014 |
| Add: profit for the year | | 74 522 |
| Less: drawings | | (52 000) |
| | | <u>70 536</u> |

7. Miles

Profit and loss account for the year ending 31 December 20X4

£ £ £

| | | |
|---|---------|---------------|
| Sales | | 898 720 |
| Less: returns | | (8 620) |
| | | <hr/> 890 100 |
| Cost of sales | | |
| Opening stock | | 71 445 |
| Purchases | 672 680 | |
| Less: Purchases returns | (1 850) | |
| | <hr/> | 670 830 |
| | | <hr/> 742 275 |
| Closing stock | | (73 622) |
| | | <hr/> 668 653 |
| Gross profit | | <hr/> 221 447 |
| Bank interest received | | 1 202 |
| | | <hr/> 222 649 |
| Expenses | | |
| Business rates | 10 791 | |
| Less: prepayment | (2 178) | |
| | <hr/> | 8 613 |
| Telephone | | 8 370 |
| Electricity | 11 621 | |
| Add: accrual | 1 497 | |
| | <hr/> | 13 118 |
| Delivery expenses | | 16 260 |
| Water rates & plumbing repairs | | 8 800 |
| Secretarial and administrative salaries | | 32 869 |
| Warehouse supervisor's salary | | 20 408 |
| Other warehouse salaries | | 38 696 |
| Accountancy charges | | 2 400 |
| Legal costs | | 1 800 |
| Discounts allowed | | 8 640 |
| Selling costs | | 22 440 |
| Sundry expenses | | 2 590 |

| | | |
|-----------------------------|--------|---------|
| Provision for doubtful debt | 35 270 | |
| | | <hr/> |
| | | 220 274 |
| Net profit | | <hr/> |
| | | 2 375 |
| | | <hr/> |

Balance sheet at 31 December 20X4

| | | | |
|---|----------|---------|----------|
| | | £ | £ |
| Fixed assets: warehouse & equipment | | | 282 460 |
| Fixed assets: delivery vans | | | 32 600 |
| | | | <hr/> |
| | | | 315 060 |
| Current assets | | | |
| Stock | | 73 622 | |
| Debtors | 109 172 | | |
| Less: provision for doubtful debt | (35 270) | | |
| | <hr/> | 73 902 | |
| Prepayment | | 2 178 | |
| Cash at bank | | 26 259 | |
| | | <hr/> | |
| | | 175 961 | |
| Current liabilities | | | |
| Trade creditors | | 84 420 | |
| Accrual | | 1 497 | |
| | | <hr/> | |
| | | 85 917 | |
| Net current assets (£175 961 - £85 917) | | | 90 044 |
| | | | <hr/> |
| | | | 405 104 |
| | | | <hr/> |
| Capital at 1 January 20X4 | | | 447 729 |
| Add: profit for the year | | | 2 375 |
| Less: drawings | | | (45 000) |
| | | | <hr/> |
| | | | 405 104 |
| | | | <hr/> |

8. Sharon

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

| | £ | £ | £ |
|----------------------|---|----------|-----------|
| Sales | | | 464 714 |
| Cost of sales | | | |
| Opening stock | | 45 517 | |
| Add: purchases | | 224 069 | |
| | | <hr/> | |
| | | 269 586 | |
| Less: closing stock | | (46 522) | |
| | | <hr/> | |
| | | | (223 064) |
| Gross profit | | | 241 650 |
| Discounts received | | | 1 808 |
| Interest received | | | 460 |
| | | | <hr/> |
| | | | 243 918 |

Expenses

| | | |
|--|--------|--------|
| Premises rental (including business and water rates) | | 68 000 |
| Property services charge | 17 004 | |
| Add: accrual | 1 307 | |
| | <hr/> | |
| | | 18 311 |
| Electricity | 5 337 | |
| Add: accrual | 1 107 | |
| | <hr/> | |
| | | 6 444 |
| Assistants' wages | | 38 830 |
| Phone – shop | 3 234 | |
| Add: accrual | 200 | |
| | <hr/> | |
| | | 3 434 |
| Mobile phone | | 766 |
| Insurance | 5 237 | |
| Less: prepayment | (465) | |
| | <hr/> | |
| | | 4 772 |
| Administration expenses | | 8 219 |

| | | |
|------------------------------------|-------|---------------|
| Sundry expenses | 1 007 | |
| Subscriptions to trade association | 818 | |
| Bank charges | 1 830 | |
| Accountant's and solicitor's fees | 2 070 | |
| Travelling expenses | 3 600 | |
| | | (158 101) |
| Net profit | | 85 817 |

Balance sheet at 31 August 20X1

| | | |
|--|----------|--------|
| | £ | £ |
| Fixed assets | | 27 662 |
| Current assets | | |
| Stock | 46 522 | |
| Prepayment | 465 | |
| Cash at bank | 18 712 | |
| | 65 699 | |
| Current liabilities | | |
| Creditors | 24 165 | |
| Accruals (£1307 + £1107 + £200) | 2 614 | |
| | 26 779 | |
| Net current assets (£65 699 - £26 779) | | 38 920 |
| Net assets | | 66 582 |
| Capital | | |
| Opening capital balance 1 September 20X0 | 42 065 | |
| Add: net profit for the year | 85 817 | |
| | 127 882 | |
| Less: drawings | (61 300) | |
| Closing capital balance 31 August 20X1 | | 66 582 |

Sharon's gross profit margin is:

$$\frac{241\,650}{464\,714} \times 100 = 52\%$$

Her net profit margin is:

$$\frac{85\,817}{464\,714} \times 100 = 18.5\%$$

Business performance has been better than usual in the year to 31 August 20X1.

Gross profit margin is generally expected to be 50% but this year it has improved to 52%. Net profit margin is expected to be 16.3% but this year has improved to 18.5%.