ACCOUNTING PRINCIPLES AND PRACTICE

S. HALL
B.A. (comm.), F.C.A.

Lecturer in Accounting
Fourah Bay College
The University College of Sierra Leone

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Preface

My aim in this book has been to describe the principles and conventions which provide the structure of Accounting practice. At each stage I have tried to explain Accounting techniques in these terms, believing that the best way to master Accounting techniques is to grasp the principles and conventions on which they are based.

I have frequently introduced a consideration of the validity of the principles involved and of the limitations of the conventions. This is pure theory but of immense practical import. The whole book is based upon the conviction that the oft-quoted distinction between theory and practice is disastrously misleading. Good theory and good practice are inseparable.

Many of the questions have been taken from the past examinations of the Royal Society of Arts, the Association of Certified and Corporate Accountants, the Society of Incorporated Accountants and the Institute of Chartered Accountants, to whom grateful acknowledgment is made.

CHAPTER 1

The Double Entry System of Accounting

Introduction

Accounts. An account is merely an arrangement of certain financial information in a form convenient for necessary arithmetical calculations. Consider the following example.

On the 1st January, the balance of cash in hand was £40. The following payments were made:

Jan.	5	Rent	£12
	8	Salary	£14
	12	Goods	£28

Cash Sales were made on:

Jan.	7	£10
	10	£30

A record of these (very simple) transactions could be made in this way.

				£
Jan.	1	Balance		40
	5	Rent Paid		12
			Balance	28
	7	Cash Sales		10
			Balance	38
	8	Salary Paid		14
			Balance	24
	10	Cash Sales		30
			Balance	54
	12	Goods purchased		28
			Final Balance	26

But this is a tedious process even when only a few transactions are involved. It is quite impracticable for any business.

In the Cash Account, receipts and the balance in hand at the beginning are listed on one side and payments on the other. The two sides are headed DR (Debit) and CR (Credit).

Dr.			*Cash Account*			*Cr.*
Jan. 1	To Balance	40		Jan. 5	By Rent	12
7	Sales	10		8	Salary	14
10	,,	30		12	Purchases	28

The use of the terms "To" and "By" is merely conventional. If both sides are added, the totals are:

Debit	80
Credit	54
	£26

This is the balance we previously calculated. It is inserted in the account as follows:

Dr.			*Cash Account*			*Cr.*
Jan. 1	To Balance	40		Jan. 5	By Rent	12
7	Sales	10		8	Salary	14
10	,,	30		12	Purchases	28
				14	Balance carried down	26
		£80				£80
Jan. 15	To Balance brought down	26				

Entering the balance on the credit side means that we have two totals which agree and can be ruled off. The balance is then brought down on the debit side (i.e. as a debit balance) and it represents the cash with which we begin on the 15th January.

Subject Matter of Accounts. The above example was a record of cash. The particular example was chosen because of its simplicity and because we all know that it is necessary to keep a record of cash transactions. But they are a small part of business life and consequently business records must have a wider coverage.

1. It is obviously necessary to know how much money is owed to the business by various people and how much is owed by the business. Thus we need records of debtors and creditors.
2. The business will own various assets, e.g. machinery, motor vehicles and premises. Records showing how much has been expended on the acquisition of such assets are needed.
3. Periodically it will be necessary to calculate the profit made by the business. This is done by comparing the revenue received from sales with the expenditure involved in earning that revenue. Records giving this information must be kept. Note that a suitable analysis of this information is required. In our first example money was spent on Rent, Salaries and Goods. At the end of a trading period (a year or six months) the proprietor will have to consider the amounts spent in these separate categories and, of course, many others.
4. One account, differing from all the above, is nevertheless necessary for a complete picture. It is the "Capital Account". This represents, admittedly imperfectly, the value of the business to the proprietor.

The Ledger:

The ledger is the book or books (it is frequently sub-divided) in which the accounts of a business are kept.

Classification of Accounts:

Accounts are classified according to subject matter in the following way:

1. Real Accounts—Tangible assets and expenditure on their acquisition, e.g. machinery, motor cars, etc.

2. Nominal Accounts—Items of income and expenditure such as sales, purchases, wages, etc.
3. Personal Accounts—Financial relations with other persons, i.e. debtors or creditors.

Principles of Entry. The form of an account is a matter of convenience in arrangement. The mode of entry of business records is a matter of convention but a convention which is most valuable and based on important and consistent principles. The principles are easily grasped in a rough and ready way though it is not so easy to state them in precise terminology.
Roughly then:

(a) debit balances are either assets or expenses;
(b) credit balances are either liabilities or revenues.

Following this classification of balances we can classify entries:

DEBITS	CREDITS
Increases in Assets	Decreases in Assets
Decreases in Liabilities	Increases in Liabilities
Deduction from Revenues	Additions to Revenues
Additions to Expenses	Deductions from Expenses

The Capital account does not fall easily into any of these categories. It is almost invariably a credit balance and can be regarded, somewhat inaccurately, as the liability of the business to its proprietor.

Double Entry Methods

Exchange is of the essence of business life. Rarely do you get "something for nothing" and you do not normally give "something for nothing." Double Entry principles are based on the fact that in business transactions you normally both give and get "something for something!"

The following are examples of such exchange:

(1) The purchase of a motor car on credit. There are:
(a) the acquisition of an asset
and (b) the incurring of a liability.
(2) The sale of a motor car for cash:
(a) an increase in cash
and (b) the giving up of another asset, the car.
(3) The payment of a debt by cheque:
(a) the wiping out of the liability
and (b) a reduction in the asset, cash at bank.

Following the principles of entry the transactions will be recorded:

(1) (a) Debit Motor Car Account.
(b) Credit Account of Supplier.
(2) (a) Debit Cash Account.
(b) Credit Motor Car Account.
(3) (a) Debit Account for Liability.
(b) Credit Bank Account.

The "exchange" element in these transactions involves two equivalent entries on opposite sides of two ledger accounts.

This, of course, assumes that we exchange one asset for its exact equivalent. We have ignored the possibility of gain or loss, the very reason for the existence of the business. This can be illustrated simply by the sale of a motor car for more than it is valued in our books.

The entries are:

(a) A debit in Cash Account for the full amount received;
(b) A credit in Motor Car Account to wipe off the balance there;
(c) The difference, representing the gain, is credited to Capital Account.

It is an increase in proprietorship, the value of the business to the owner.

However, gains or losses are rarely isolated so simply. Business consists of a constant flow of expenses and a similar flow of sales revenue. Profit or Loss can only be calculated over periods of time. Meanwhile entries for a whole variety of transactions must be made day by day. These entries still conform to the Double Entry Principles.

(1) Expenses: The Nominal Accounts are debited, corresponding credits being made either in:
   (a) Asset Accounts to record the payment by cash or cheque.
   or (b) Personal Accounts to record the liability incurred.

(2) Revenues: The Nominal Account is credited, corresponding debits being made either in:
   (a) Cash Accounts to record the receipt of money
   or
   (b) Personal Accounts to record the debt owing to the business.

To illustrate further we can think of the transactions first studied. Obviously each one involved cash, either receiving or paying, and we can see that the entries were made in accordance with the principles subsequently outlined.

1. Cash Sales—increase in asset (cash)—debit in Cash Account.
2. Rent, Salary, Purchases —decrease in asset (cash)—credit in Cash Account.

But the entries in Cash Account are only one part of the story. Also needed are records of the revenue received and expenses paid. So we have:

1. Cash Sales—addition to Revenues—credit in Sales Account.
2. Rent / Salary / Purchases $\Big\}$—addition to Expenses—debits in Nominal Accounts.

The last item may cause difficulty. Is expenditure on Goods Purchased an addition to expenses or an increase in assets? We leave the question for a later explanation noting for the present that, whatever answer we give, the entry remains a debit in Purchases Account. Additions to expenses and increases in assets are both represented by debit entries.

The principle, from which is derived the phrase "Double Entry" is illustrated in these simple transactions. The records are:

(a) Cash Sales—Debit in Cash Account
Credit in Sales Account
(b) Rent —Credit in Cash Account
Debit in Rent Account and so on.

Each transaction leads to two entries, one on the debit and one on the credit side. Somewhat mechanically the rule is formulated:

"Every Debit has a corresponding Credit and *vice versa*."

The rule is the expression of a deeper principle. The Double Entry system of Bookkeeping is that whereby the two aspects of every business transaction are recorded on opposite sides of two ledger accounts.

EXAMPLE 1.

A. Jones commenced business on 1st January, 1962, with capital in the form of cash of £500. His transactions for the first two weeks of January were as follows:

Jan. 1 Purchased Goods on Credit from R. Smith, £200.
4 Paid Rent for Premises, £100.
7 Cash Sales for Week, £84.
Paid Salary of Shop Assistant, £8.

9 Sold Goods on credit to B. Barlow, £60.
14 Cash Sales £96. Shop Assistant's Salary £8.
Paid R. Smith £200.

Dr. *Cash Account* *Folio 1* *Cr.*

1962			£	1962			£
Jan. 1	To Capital	2	500	Jan. 4	By Rent	4	100
7	Sales	3	84	7	Salary	5	8
14	,,	,,	96	14	,,	,,	8
					R. Smith	7	200
					Balance carried down		364
			680				680
Jan. 15	To Balance brought down		364				

Dr. *Capital Account* *Folio 2* *Cr.*

				1962			£
				Jan. 1	By Cash	1	500

Dr. *Sales Account* *Folio 3* *Cr.*

				1962			£
				Jan. 7	By Cash	1	84
				9	,, B. Barlow	8	60
				14	,, Cash	1	96
							240

Dr. *Rent Account* *Folio 4* *Cr.*

1962			£
Jan. 4	To Cash	1	100

Dr. *Salaries Account* *Folio 5* *Cr.*

1962			£
Jan. 7	To Cash	1	8
14	,, ,,	,,	8
			16

Dr. *Purchases Account* *Folio 6* *Cr.*

1962			£
Jan. 1	To R. Smith	7	200

Dr.			*R. Smith*			*Folio 7*	*Cr.*
1962			£	1962			£
Jan. 14	To Cash	1	200	Jan. 1	By Purchases	6	200

Dr.			*B. Barlow*			*Folio 8*	*Cr.*
1962			£				
Jan. 9	To Sales	3	60				

(a) Small points to note are:

1. The dating of each item with the year at the top of each account. This is not important in theoretical exercises but the careless omission of such dates causes trouble in practice.
2. The use of the folio or reference column immediately before money columns. In this column is given the page or Account number where the corresponding "double entry" is to be found. Again this is most important in practice.

(b) A test of the arithmetical accuracy of our work is to hand. Every debit has a corresponding credit and *vice versa.* Consequently the total of debit entries equals the total of credit entries. Even more simply, the total of debit balances equals the total of credit balances.

Trial Balance	*Dr.*	*Cr.*
	£	£
Cash	364	
Capital		500
Sales		240
Rent	100	
Salaries	16	
Purchases	200	
B. Barlow	60	
	£740	£740

We shall give more attention to the Trial Balance later but, here, we note it as a valuable by-product of the application of Double Entry principles.

Some Particular Transactions in the Double Entry Pattern

Returns and Allowances:

Sometimes goods sold do not satisfy the purchaser. They may be below the quality promised or expected. In such circumstances the supplier may:

(1) receive back the whole or the offending part of the goods and cancel the charge made to the customer.
(2) allow the customer to keep the goods but reduce the charge by giving an allowance.

In the books of both the supplier and the customer, entries will be required to record the Returns or the Allowance.

(1) *The Supplier's Books.* The debt of the customer must be reduced (a decrease in an asset involves a credit entry) and the deduction from Revenues recorded (a debit entry). The entries are thus:

Debit Returns & Allowances on Sales.
Credit Customer's Personal Account.

These entries will have the effect of cancelling, in whole or in part, the original record of the sale which was: Debit Customer, Credit Sales.

(2) *The Customer's Books.* The liability to the supplier is reduced by a debit entry and the reduction of expenses by a credit.

Debit Supplier's Personal Account.
Credit Returns and Allowances on Purchases.

Similarly, these entries have the effect of a total or partial cancellation of the original records of the purchase: Debit Purchases, Credit Supplier.

Discounts. In business life, two kinds of discount are to be found.

(1) *Trade Discount.* This is strictly an adjustment to the quoted price of goods. An article priced at 25/- less 20% Trade Discount is actually sold at £1. Trade Discount does not appear in Accounting books at all as Sales are entered at the net figure.

(2) *Cash Discount.* This is an offer designed to encourage the quick settlement of accounts. For instance, customers may be entitled to deduct 5% from all amounts paid within 20 days. Such Discounts do appear in the financial books.

Obviously, there are two kinds of cash discounts—Discounts Allowed and Discounts Received. The former is an expense in running the business and the latter is a reduction in expenses. Thus the former involves a debit entry and the latter a credit.

EXAMPLE 2,

The following transactions take place in the business of B, Wright. Feb. 8. He settles the account of A. Jones, £300. receiving 5% Discount. Feb. 9. R. Green pays £290 in full settlement of his account. The balance on his account was £300.

Dr.		*A. Jones*			*Cr.*
		£			£
Feb. 8	To Cash	285	Feb. 1	By Balance b/f	300
	Discount	15			
		£300			£300

Dr.		*R. Green*			*Cr.*
		£			£
Feb. 1	To Balance b/f	300	Feb. 9	By Cash	290
				,, Discount	10
		£300			£300

Discounts Received

Dr.				*Cr.*
				£
		Feb. 8	By A. Jones	15

Discounts Allowed

Dr.				*Cr.*
		£		
Feb. 9	To R. Green	10		

Bad Debts. A business does not always receive the money that is due from its debtors. Occasionally one is unable to pay. Sometimes a debtor disappears and it is impossible to recover the money due from him. Such losses can be considered expenses of running the business.

The entry in Bad Debts Account recording the loss is on the Debit side. The corresponding credit is in the Debtor's Account where it serves to wipe off the balance which, though legally due, is actually worthless.

EXAMPLE 3.

A. Jones, who owes £120, is declared bankrupt. His Trustee is only able to pay 10/– in the £ on his debts. Show the relevant accounts.

A. Jones

Dr.			*Cr.*
To Balance b/f	120	By Cash	60
		Bad Debts Account	60
	£120		£120

Bad Debts Account

Dr.			*Cr.*
	£		
To A. Jones	60		

Depreciation. We have distinguished between expenditure incurred on expenses of a business (Nominal Account entries) and that incurred in the acquisition of assets (Real Account entries). In fact, the distinction is not quite so clear cut as it appears. Consider the purchase of a motor vehicle. We hope that it will give us useful service for 5 to 10 years but we know it will not last for ever. The expenditure on the purchase of the asset is also an expense of the business. The difference is that it is an expense properly spread over the years when the asset is expected to give service. Similarly, expenditure on buildings and on machinery is an expense of the business even though these assets have lives much longer than that of a motor vehicle.

EXAMPLE 4.

G. Green purchases a motor lorry for £1,000 on 1st January, 1960. He estimates that it will last six years and that he will then be able to sell it for £100. Show the Motor Lorry and Depreciation Accounts for the first three years.

Motor Lorry

Dr.					*Cr.*
1960		£	1960		£
Jan. 1	To Cash	1,000	Dec. 31	By Depreciation	150
				„ Balance c/d	850
		£1,000			£1,000
1961			1961		
Jan. 1	To Balance b/d	850	Dec. 31	By Depreciation	150
				„ Balance c/d	700
		£850			£850
1962			1962		
Jan. 1	To Balance b/d	700	Dec. 31	By Depreciation	150
				„ Balance c/d	550
		£700			£700
1963					
Jan. 1	To Balance b/d	550			

Depreciation

Dr.			*Cr.*
1960		£	
Dec. 31	To Motor Lorry	150	
1961			
Dec. 31	„ „ „	150	
1962			
Dec. 31	„ „ „	150	

The cost apportioned annually is $\frac{1,000 - 100}{6}$ which equals £150.

Another way of describing this is to say that the annual figure for depreciation reduces the balance on the Asset Account to the true value of the asset at the close of each year. This, however, is inaccurate. The Depreciation figure is only an estimate and it is quite possible that on, say 1st January, 1962, the lorry could have been sold only for a much lower figure. The balance on the Asset Account represents the original cost less the depreciation written off to the date concerned. To claim more for such balances is unwise.

The different methods of calculating depreciation will be considered later. The one used in Example 4 is known as the Straight line method. The total cost is apportioned in equal annual instalments. The most common alternative is the Reducing Balance method whereby a fixed percentage of the opening balance each year is written off as depreciation. For the data in Example 4 it would be necessary to write off depreciation at the rate of 30% of the reducing balance.

	£
Cost	1,000
Depreciation, Year 1	300
	700
,, ,, 2	210
	490
,, ,, 3	147
	343
,, ,, 4	103
	240
,, ,, 5	72
	168
,, ,, 6	50
	118

Thus the Asset Account is reduced to approximately the same balance but the annual charge for depreciation grows smaller year by year.

EXAMPLE 5.

B. Perry commenced business on 1st January, 1962, with a capital of £2,000 in cash. On 3rd January he occupied factory premises for which he agreed to pay a quarterly rent of £150. The rent was payable on 31st March, 30th June, and so on. On 6th January he purchased a Motor Van for cash, £1,300. The following transactions then took place:

Jan.	9	Purchased goods on credit from A. Booth, £350.
	16	Paid Wages £24.
	20	Purchased goods for cash, £180.
	24	Sold goods on credit to J. Rosewall, £210.
	30	Paid Wages £20.
Feb.	4	Sold goods on credit to B. Holt, £100.
	6	Paid A. Booth £350 less £15 cash discount.
	9	J. Rosewall paid £200 and was allowed £10 cash discount.
	13	Paid wages £25.
	18	Purchased goods on credit from G. Salt, £1,120.
	25	Sold goods for cash, £60.
	26	Received £70 from B. Holt.
	27	Paid Wages £25.
Mar.	1	Returned defective goods to G. Salt and was credited £40.
	4	Sold goods on credit to J. Rosewall £350.
	12	Paid Wages £30.
	14	Received payment on account from J. Rosewall, £200.
	15	Sold goods for cash £160.
	18	J. Rosewall paid £125 in full settlement of his account.
	20	Received a loan from a friend, A. Rose, £600.
		Sold good, on credit, to J. Rosewall, £680.
	26	Paid Wages £40. Paid G. Salt in full settlement, £1,030.
	28	Received information that B. Holt was unable to pay any further amount of his debt.
	31	Paid Rent £150.

Write up the Ledger Accounts for the three months providing for £40 Depreciation of the motor van.

Dr.				*Cash Account*			*Folio 1*		*Cr.*
1962				£	1962				£
Jan.	1	To Capital	2	2,000	Jan.	6	By Motor Van	3	1,300
Feb.	9	„ J. Rosewall	12	200		16	„ Wages	6	24
	25	„ Sales	7	60		20	„ Purchases	4	180
	26	„ B. Holt	13	70		30	„ Wages	6	20
Mar.	14	„ J. Rosewall	12	200	Feb.	6	„ A. Booth	14	335
	15	„ Sales	7	160		13	„ Wages	6	25
	18	„ J. Rosewall	12	125		27	„ „	„	25
	20	„ Loan,			Mar.	12	„ „	„	30
		A. Rose	16	600		26	„ „	„	40
							„ G. Salt	15	1,030
						31	„ Rent	8	150
							„ Balance c/d		256
				£3,415					£3,415
Apl.	1	To Balance b/d		256					

Dr.				*Capital Account*			*Folio 2*		*Cr.*
					1962				£
					Jan.	1	By Cash	1	2,000

Dr.				*Motor Van*			*Folio 3*		*Cr.*
1962				£	1962				£
Jan.	6	To Cash	1	1,300	Mar.	31	By Deprecia-tion	10	40
							Balance c/d		1,260
				£1,300					£1,300
Apl.	1	To Balance b/d		1,260					

Dr.				*Purchases*			*Folio 4*		*Cr.*
1962				£	1962				
Jan.	9	To A. Booth	14	350					
	20	„ Cash	1	180					
Feb.	18	„ G. Salt	15	1,120					
				£1,650					

Dr.				*Returns on Purchases*			*Folio 5*		*Cr.*
					1962				£
					Mar.	1	By G. Salt	15	40

Dr.				*Wages*			*Folio 6*	*Cr.*
1962			£					
Jan. 16	To Cash	1	24					
30	„ „	„	20					
Feb. 13	„ „	„	25					
27	„ „	„	25					
Mar. 12	„ „	„	30					
26	„ „	„	40					
			164					

Dr.				*Sales*			*Folio 7*	*Cr.*
				1962				£
				Jan. 24	By J. Rosewall	12		210
				Feb. 4	„ B. Holt	13		100
				25	„ Cash	1		60
				Mar. 4	„ J. Rosewall	12		350
				15	„ Cash	1		160
				20	„ J. Rosewall	12		680
								1,560

Dr.				*Rent*			*Folio 8*	*Cr.*
1962			£					
Mar. 31	To Cash	1	150					

Dr.				*Bad Debts*			*Folio 9*	*Cr.*
1962			£					
Mar. 28	To B. Holt	13	30					

Dr.				*Depreciation*			*Folio 10*	*Cr.*
1962			£					
Mar. 31	To Motor Van	3	40					

Dr.				*Discount*			*Folio 11*	*Cr.*
1962			£	1962				£
Feb. 9	To J. Rosewall	12	10	Feb. 6	By A. Booth	14		15
Mar. 18	„ „ „	„	25	Mar. 26	„ G. Salt	15		50
			35					65

J. Rosewall — *Folio 12*

Dr.									*Cr.*
1962				£	1962				£
Jan.	24	To Sales	7	210	Feb.	9	By Cash	1	200
Mar.	4	„ „	„	350			„ Discount	11	10
	20	„ „	„	680	Mar.	14	„ Cash	1	200
						18	„ „	„	125
							„ Discount	11	25
						31	„ Balance c/d		680
				£1,240					£1,240
Apl.	1	To Balance b/d		680					

B. Holt — *Folio 13*

Dr.									*Cr.*
1962				£	1962				£
Feb.	4	To Sales	7	100	Feb.	26	By Cash	1	70
					Mar.	28	„ Bad Debts	9	30
				£200					£100

A. Booth — *Folio 14*

Dr.									*Cr.*
1962				£	1962				£
Feb.	6	To Cash	1	335	Jan.	9	By Purchases	4	350
		„ Discount	11	15					
				£350					£350

G. Salt — *Folio 15*

Dr.									*Cr.*
1962				£	1962				£
Mar.	1	To Returns	5	40	Feb.	18	By Purchases	4	1,120
	26	„ Cash	1	1,030					
		„ Discount	11	50					
				£1,120					£1,120

Loan Account—A. Rose — *Folio 16*

				Cr.
1962				£
Mar.	20	By Cash	1	600

Trial Balance	*Dr.*	*Cr.*
	£	£
Cash	256	
Capital		2,000
Motor Van	1,260	
Purchases	1,650	
Returns on Purchases		40
Wages	164	
Sales		1,560
Rent	150	
Bad Debts	30	
Depreciation	40	
Discount	35	65
J. Rosewall	680	
Loan—A. Rose		600
	£4,265	£4,265

Questions 1

1. B. Pratt commenced business on 1st January, 1962, with a capital of £3,000 cash. The following transactions took place:

   Jan. 3 Paid £200 Rent for premises.
   6 Purchased good for cash, £160.
   7 Purchased goods on credit from W. Davies, £300.
   9 Paid Wages, £60.
   10 Cash Sales to date, £200.
   14 Purchased goods on credit from H. Penn, £600.
   15 Sold goods on credit to B. Cooper, £210.
   16 Paid Wages, £60.
   18 Paid W. Davies in full settlement, £293.

   Enter these transactions in the accounts of B. Pratt and take out a Trial Balance.

2. *Turner is in business as a manufacturer and the following are his transactions with Smith for the month of January, 1962:

   Jan. 1 Balance due to Smith £430.
   10 Bought from Smith 20 tons xyncalia at £45 per ton, less 15% trade discount.
   15 Paid amount due to Smith on 1st January less 5% cash discount.
   16 Returned to Smith 3 tons of xyncalia as supplied on 10th for credit in full.
   17 Bought from Smith 5 tons coranium at £22/10/– per ton.

*Re-printed by courtesy of the Royal Society of Arts (R.S.A.).

22 Sold to Smith 4 old Pressing machines as scrap, for £220 the lot.
28 Paid cheque to Railway £5 for carriage on goods returned on the 16th January, chargeable to Smith.
31 Bought from Smith a supply of chemical waste for £50.

You are asked to prepare from the above information Smith's account as it would appear in Turner's ledger, balancing it and bringing down the balance on the 31st January.

3. On 1st July, 1962, B. Hoad paid £2,000 into his business as capital. The following transactions took place:

July 3 Purchased Motor Van for £800.
6 Purchased goods on credit from Vale & Co., £700.
8 Paid Rent £40.
14 Purchased goods on credit from B. Archall, £300.
16 Sold goods for cash, £200.
18 Sold goods on credit to D. Fale, £400.
21 Paid for Petrol and Oil, £20.
23 Sold goods on credit to G. Jones, £600.
25 Paid Vale & Co. £680 in full settlement.
30 Received £350 from D. Fale but was informed that it would not be possible to collect any more of the debt.
31 Paid Salaries, £100.
Goods, invoice price £80, were returned by G. Jones.
Provide for Depreciation on the Motor Van, £20.

Make the requisite entries in the accounts of B. Hoad and take out a Trial Balance.

4. On 1st January, 1960, J. Milford purchases a machine costing £600 from Wheelers Ltd. He estimates that the machine will last nine years and its scrap value will then be £60. Prepare two accounts for the three years to 31st December, 1962, charging depreciation:

(a) on the Straight Line method,
and (b) at 25% per annum of the Reducing Balance.

CHAPTER 2

Final Accounts

The Calculation of Profit. In order to calculate the profit earned by a business, we deduct from the revenues received, the total costs incurred in earning those revenues. Normally the calculation is for a given period, e.g. a year. References to Gross or Net Profit almost invariably imply periodic profits. Most advanced studies in Accounting are concerned, in one way or another, with the task of their calculation. At this introductory stage we ignore the difficulties and the task consequently appears simple.

A Profit Statement of a Trading Concern could be prepared in this way:

A. Bee. Results of Trading for the Year to 31st December, 1962

	£	£
Sales		12,420
Less Cost of Goods Sold		6,940
GROSS PROFIT		5,480
Less Expenses:		
Rent and Rates	600	
Lighting and Heating	180	
Salaries of Assistants	1,200	
Discounts Allowed	120	
Sundries	80	2,180
NET PROFIT		£3,300

As can be seen, the Gross Profit is the excess of Sales over the Cost of Goods sold. The Gross Profit less Expenses is the Net Profit.

This statement is not in the form of an account but it can easily be changed into that form. Before we do so, one item merits special attention. There is an important difference between "Purchases" and the "Cost of Goods Sold." The difference arises because businesses almost invariably carry stocks. Of the goods that are sold in, say 1962, most will have been purchased during that year. Some, however, were purchased in earlier years and were in stock at the beginning of 1962. Again some of the goods purchased in 1962 will not be sold until the following year. They are in stock at the end of 1962. We can formulate the equation:

The Cost of Goods Sold = Stock at the Beginning of the Year + Purchases during the year − Stock at the End of the Year.

Note that this equation is only correct when the goods are consistently valued at the same (Cost) prices.

Two further points can be made before we pass on to the account.

1. The above equation applies only to a trading concern, buying and selling the same articles. The Cost of Goods Sold in a Manufacturing Business is a much more complex calculation.
2. In practice, a deviation from the above principles is commonly accepted. The Accounting profession prides itself on its conservatism. It is always unwilling to anticipate gains but ready to recognize losses. The accepted formula for the valuation of stock is "at cost or market price whichever is the lower." Where the market price has fallen below the cost, the former figure is used. The charge against Sales is then above the actual cost of the Goods sold.

The Trading and Profit & Loss Account. We are now ready to translate the Profit Statement into the form of an account. The rules already given still apply. Revenues are credit entries and Expenses are debits. The account is called the Trading and Profit & Loss Account.

Dr. *Trading and Profit & Loss Account for the Year ended 31st December, 1962* *Cr.*

	£	£		£
To Cost of Goods Sold:			By Sales	12,420
Stock, 1st January	2,100			
Purchases	6,430			
	8,530			
Less Stock, 31st Dec.	1,590	6,940		
,, Gross Profit carried down		5,480		
		£12,420		£12,420
To Rent & Rates		600	By Gross Profit brought down	5,480
,, Lighting & Heating		180		
,, Salaries of Assistants		1,200		
,, Discounts Allowed		120		
,, Sundries		80		
,, Net Profit		3,300		
		£5,480		£5,480

Is this a superior form of presenting the information? We may well have doubts. The previous statement was clear and adequate. We recast it into the form of an account because, as an account, it fits into the Double Entry System *from where we collected the data for its preparation.* We find the total of Sales and the totals of the various expenses in the Nominal Accounts. The entries in the Trading and Profit & Loss Account have corresponding entries in the Nominal Accounts. Indeed we can put it another way and say that we close the Nominal Accounts by transferring the balances to the Trading and Profit & Loss Account. Example 6 illustrates this by taking the Nominal Accounts in Example 5 (the closing stock is valued at £640).

EXAMPLE 6. B. Perry (*continued*)

Dr. *Purchases Account* *Cr.*

1962		£	1962		£
Jan. 9	To A. Booth	350	Mar. 31	By Trading Account	1,650
20	„ Cash	180			
Feb. 18	„ G. Salt	1,120			
		£1,650			£1,650

Dr. *Returns on Purchases Account* *Cr.*

1962		£	1962		£
Mar. 31	To Trading A/c	40	Mar. 1	By G. Salt	40

Dr. *Wages Account* *Cr.*

1962		£	1962		£
Jan. 16	To Cash	24	Mar. 31	By P. & L. A/c	164
30	„ „	20			
Feb. 13	„ „	25			
29	„ „	25			
Mar. 12	„ „	30			
26	„ „	40			
		£164			£164

Dr. *Sales Account* *Cr.*

1962		£	1962		£
Mar. 31	To Trading A/c	1,560	Jan. 24	By J. Rosewall	210
			Feb. 4	„ B. Holt	100
			25	„ Cash	60
			Mar. 4	„ J. Rosewall	350
			15	„ Cash	160
			20	„ J. Rosewall	680
		£1,560			£1,560

Dr. *Rent Account* *Cr.*

1962		£	1962		£
Mar. 31	To Cash	150	Mar. 31	By P. & L. A/c	150

Dr. *Bad Debts Account* *Cr.*

1962		£	1962		£
Mar. 28	To B. Holt	30	Mar. 31	By P. & L. A/c	30

Dr.		*Depreciation Account*			Cr.
1962		£	1962		£
Mar. 31	To Motor Van	40	Mar. 31	By P. & L. A/c	40

Dr.		*Discount Account*			Cr.
1962		£	1962		£
Feb. 9	To J. Rosewall	10	Feb. 6	By A. Booth	15
Mar. 18	„ „	25	Mar. 26	„ G. Salt	50
31	„ P. & L. A/c	30			
		£65			£65

Dr.		*Stock Account*	Cr.
1962		£	
Mar. 31	To Trading Account	640	

Dr. *Trading and Profit & Loss Account for the 3 months ending 31st March, 1962* Cr.

	£	£		£
To Purchases	1,650		By Sales	1,560
Less Returns	40	1,610		
„ Gross Profit carried down		590	„ Stock, 31st March, 1962	640
		£2,200		£2,200
To Rent		150	By Gross Profit brought down	590
„ Wages		164	„ Discount	30
„ Bad Debts		30		
„ Depreciation		40		
„ Net Profit		236		
		£620		£620

For every item except stock, the Double Entry is complete within the Nominal Accounts and the Trading and Profit & Loss Account. All the Nominal Accounts are closed and are thus ready for the accumulation of data for the following period.

The Stock Account is a Real Account. It represents a tangible asset and as an asset it is a Debit balance. No further entry will be made in this account until the end of the next trading period when the next profit calculation is made. The Stock Account will then appear like this:

Dr.		*Stock Account*			*Cr.*
1962		£	1962		£
Mar. 31	To Trading A/c	640	June 30	By Trading A/c	640
June 30	To Trading A/c (say)	800			

On 30th June, two entries are made in the Trading Account. On the debit is charged the value of the stock at the beginning of the period—£640. On the credit is entered the new stock on hand—£800. Only one figure for stock appeared in the Trading Account of Example 6 because this was a new business and there was no opening stock.

The Net Profit figure is transferred to the credit of Capital Account. The owner of the business is entitled to receive the profits of the business and consequently the value of the business to him is increased by the amount of Net Profit. If a loss is made, it reduces the balance of capital in the business. The Loss is debited to Capital Account after appearing on the credit side of the Profit & Loss Account.

The Balance Sheet

By transferring the balances of the Nominal Accounts to the Trading and Profit & Loss Account we derive a figure of Net Profit. The Trading and Profit & Loss Account gives us, in summary form, the history of the trading for the period concerned. This leads naturally to a consideration of the next financial statement. The Balance Sheet is the statement of the position of the business at the end of the trading period.

The "position of the business" means the assets it possesses compared with the liabilities. We can pursue the example of

B. Perry's business. From the Trial Balance on Page 17 we select the assets and liabilities, adding the Stock figure from Example 6.

	£
Assets:	
Cash	256
Motor Van	1,260
Debtor—Rosewall	680
Stock	640
	2,836
Liability:	
Loan—A. Rose	600
	2,236

The assets, less liability, amount to £2,236. This according to the books of account is the value of the business to the proprietor. It is the capital of B. Perry. We can approach the figure another way.

At the beginning, Perry introduced capital of	£2,000
In the first three months, the profit made was	236
Therefore the new capital is	£2,236

Thus at any one time we can write:

Capital = Assets − Liabilities

and we can also write:

Capital = Capital at beginning of Trading Period + Net Profit for Period or − the Net Loss.

The Double Entry System incorporates both principles.

EXAMPLE 7. B. Perry (*continued*)

After the preparation of the Trading and Profit & Loss Account the following accounts are still open (i.e. are not ruled off).

Dr. *Cash Account* *Cr.*

1962		£				
April 1	To Balance b/d	256				

Dr. *Motor Van* *Cr.*

1962		£	1962		£
Jan. 6	To Cash	1,300	Mar. 31	By Depreciation	40
				„ Balance c/d	1,260
		£1,300			£1,300
Apl. 1	To Balance b/d	1,260			

Dr. *Loan Account—A. Rose* *Cr.*

			1962		£
			Mar. 20	By Cash	600

Dr. *J. Rosewall* *Cr.*

1962		£			
Apl. 1	To Balance b/d	680			

Dr. *Stock Accouut* *Cr.*

1962		£			
Mar. 31	To Trading A/c	640			

Dr. *Capital Account* *Cr.*

			1962		£
			Jan. 1	By Cash	2,000
			Mar. 31	„ P. & L. A/c, Net Profit	236
					£2,236

These balances are summarised in the form of a Balance Sheet

Balance Sheet as at 31st March, 1962

	£	£		£
Capital:			Assets:	
Balance at 1st Jan. 1962	2,000		Motor Van	1,260
Add Net Profit for period	236	2,236	Stock	640
			Debtor	680
Liability				
Loan—A. Rose		600	Cash	256
		£2,836		£2,836

It is helpful to ask, Why does this (or any other) Balance Sheet balance? The answer has already been given in the two equations given earlier. The Balance Sheet is a particular form of the equation:

Capital = Assets − Liabilities.

The rearrangement is simply,

Capital + Liabilities = Assets.

But the figure for Capital is not derived from this equation. It comes from the account which gives:

Capital = Beginning Capital + Net Profit.

The Balance Sheet only balances because the Double Entry System incorporates both principles.

Note that no entry is made in the Real and Personal Accounts recording the transfers to the Balance Sheet. The balances on these accounts are summarised in the Balance Sheet; they are not transferred to it. The difference is vital. The balances remain in the respective accounts for the beginning of the following period. The Cash Balance at the close of one period is the balance at the beginning of the next. The value of assets (at least insofar as it is given by past expenditure adjusted for depreciation) is identical at the end of one, and at the beginning of the next, period. We have already seen how the closing stock of the current period becomes the opening stock for the next. Similarly, debts owed to or by the business are not wiped off at any particular date. If they are unpaid this period they must be paid the next. The accounts present these facts by balances that are carried forward on various Real and Personal accounts.

We can profitably close this introduction by stressing two fundamental points of difference between the Trading and Profit & Loss Account and the Balance Sheet.

The Trading and Profit & Loss Account IS an integral part of a Double Entry Accounting System.

The Balance Sheet IS NOT an account; it is merely a summary of balances.

The Trading and Profit & Loss Account is prepared for a given period, e.g. for the Year Ended 30th June, 19—. The Balance Sheet gives the situation at a given date, e.g. at 30th June, 19—.

The Preparation of Final Accounts

Considering Examples 5, 6 and 7, we realise that a great deal of work has gone into the preparation of the Trading and Profit & Loss Account and Balance Sheet of B. Perry. Yet these Final Accounts (a somewhat inaccurate term used to describe them) are very simple. As we proceed to lengthier and more complicated exercises it becomes impossible to record all the individual transactions. Fortunately it is unnecessary. We can prepare Final Accounts from a Trial Balance supplemented by a little further information, e.g. the value of the closing stock.

EXAMPLE 8

The following Trial Balance was extracted from the books of R. Woolley on 30th June, 1962.

Trial Balance

	£	£
Sales		6,100
Purchases	4,810	
Salary	600	
Heating and Lighting	80	
Stock	620	
Rent and Rates	62	
Sundry Expenses	40	
Capital		1,400
Shop Fixtures	120	
Creditor		62
Cash	720	
Debtors	510	
	£7,562	£7,562

The Stock on Hand on 30th June, 1962 was valued at £360. Prepare Trading and Profit & Loss Account and Balance Sheet.

Dr. *Trading and Profit & Loss Account for the Year ended 30th June, 1962* *Cr.*

	£		£
To Stock, 1st July 1961	620	By Sales	6,100
,, Purchases	4,810	,, Stock, 30th June 1962	360
,, Gross Profit carried down	1,030		
	£6,460		£6,460
To Salary	600	By Gross Profit brought down	1,030
,, Rent and Rates	62		
,, Heating and Lighting	80		
,, Sundry Expenses	40		
,, Net Profit	248		
	£1,030		£1,030

Balance Sheet as at 30th June, 1962

	£	£		£
Capital—R. Woolley			Assets:	
Balance at 1st July 1961	1,400		Shop Fixtures	120
Add Net Profit for Year	248	1,648	Stock on Hand	360
			Sundry Debtors	510
			Cash in Hand	720
Liability:				
Creditor		62		
		£1,710		£1,710

The first step in this process is to study the individual items in the Trial Balance. Each one is to be entered in:

1. the Trading Account
2. the Profit & Loss Account

or 3. the Balance Sheet.

The student may find it helpful to mark each item with a small 'T', 'P' or 'B' respectively. The preparation of the Final

Accounts is then merely a matter of collecting together the items appropriately marked for each stage of the work.

Some items appearing in Trial Balances require further consideration and explanation.

1. *Drawings.* So far we have assumed that the proprietor takes nothing from the business. It is a most unrealistic assumption. Normally he will withdraw money regularly or as he requires it. He may consider these withdrawals as his salary but they are not recorded as such in the accounts. All withdrawals of the proprietor are withdrawals of profit—or, if no profit is made, of his capital. Individual payments are entered:

   Debit Drawings Account   Credit Cash Account.

   But the Drawings Account is merely a sub-division of the Capital Account and, at the end of a Trading Period, the total is transferred to the debit of Capital Account. Details are given in a Balance Sheet in this form:

		£	£
Capital:	Balance at 1st January 19—	1,600	
	Add Net Profit for Year	864	
		2,464	
	Less Drawings	1,000	1,464

   Note that one of the fundamental equations on page 27 now requires amendment.

   Capital = Capital at beginning of trading period + Net profit − Drawings.

   The principle, however, is unchanged.

2. *Carriage.* The treatment depends upon the nature of the expense. Carriage Inwards (i.e. on goods purchased) is part of the cost of the goods we sell. Carriage Outwards (i.e. on goods sold) is part of the cost of selling the goods. The Cost of Goods sold, including carriage inwards, is charged in the Trading Account. Selling Expenses are debited to the Profit & Loss Account.

3. *Legal Expenses.* These may be incurred in connection with the purchase of an asset. If so, they are part of the cost of the asset and are debited to the Real Account. On the other hand, legal charges may be an expense of the business, e.g. in the collection of debts, and then they are debited to the Profit & Loss Account.

We aim to present the Final Accounts in the most meaningful and intelligible form. In large concerns, great skill is required in the manner of presentation. Even in elementary work, care and thought are rewarded. Three points may be mentioned here:

1. If the Trading Account can be arranged to show the Cost of Goods Sold, this ought to be done. Thus, the Trading Account of Example 8 would appear:

	£	£		£
To Cost of Goods Sold:				
Stock, 1st July 1961	620		By Sales	6,100
Purchases	4,810			
	5,430			
Less Stock, 30th June 1962	360	5,070		
,, Gross Profit		1,030		
		£6,100		£6,100

2. There is no one agreed order for expenses in the Profit & Loss Account. It is, however, customary to enter abnormal and unusual items after the others. Depreciation is conventionally the last item before the Net Profit.
3. Assets are listed in the Balance Sheet in order of permanence. Fixed Assets come first. They are held for use and not for immediate conversion into cash. The rest are Current Assets.

Stock is held for purposes of sale and conversion into cash. Debts are to be collected. Bank balances are as good as cash.

A typical order is:

Fixed Assets:

Premises
Plant and Machinery
Motor Vehicles

Current Assets:

Stock
Sundry Debtors
Cash at Bank
Cash in Hand

The order on the opposite side of the Balance Sheet is

Capital
Loans
Trade Creditors

Unexpired Charges and Accrued Expenses:

The principle of profit determination is that we deduct from the revenues received the total of expenses incurred in earning those revenues. In the light of that principle consider the following Rent Account.

Dr. *Rent Account* *Cr.*

1962			£	1962			£
Apl.	3	To Cash, Quarter to 31st March	300				
June	30	" " , Quarter to 30th June	300				
Oct.	4	" " , Quarter to 30th Sept.	300	Dec.	31	By P. & L. A/c	900
			£900				£900

This is in accordance with the practice previously explained but something is obviously wrong. The annual rent is £1,200 but the P. & L. A/c charge for the year is only £900. The remaining £300 has not been paid but must be paid presumably early in January, 1963. Two mistakes will affect the Final Accounts:

(1) The charge in the Profit & Loss Account is too little and consequently the Net Profit will be overstated.
(2) The Balance Sheet will not include the liability of £300 for Rent due at 31st December. No balance for that amount appears in the ledger.

The mistakes are corrected together by the insertion of a credit balance for the amount accrued.

Rent Account

Dr.				*Cr.*		
1962		£	1962			£
Apl. 3	To Cash	300				
June 30	„ „	300				
Oct. 4	„ „	300				
Dec. 31	Amount Accrued c/d	300	Dec. 31	By P. & L. A/c		1,200
		£1,200				£1,200
			1963			
			Jan. 1	By Amount Accrued b/d		300

The true annual rent is charged in the Profit & Loss Account and the credit balance must be included in the Balance Sheet as a liability.

Other expenses may be paid in advance and at the end of the Trading Period a proportion must be regarded as being "in Hand." A debit balance is carried forward as a prepayment.

Insurance Account

Dr.				*Cr.*	
1961		£	1961		£
Apl. 1	To Cash, Fire Insce. Year to 31st March 1962	60	Sept. 30	By Amount Prepaid c/d	30
				„ P. & L. A/c	30
		£60			£60
Oct. 1	To Amount Prepaid b/d	30			

The correct charge for the half year is made in the Profit & Loss Account and in the Balance Sheet there is entered an asset:
Prepayment £30.

EXAMPLE 9

Write up the Rent, Rates and Insurance Account for the year ended 31st December, 1962 from the following information:

On 1st January, 1962 the rent for the quarter to 31st December, 1961 was owing. The Rates for the year to 31st March, 1962 amounted to £88 and had been paid in October, 1961. Insurance is payable in advance on 1st July each year and the annual premium is £48.

The following payments were made:

Jan. 4	Rent for December Quarter	£60	
Apl. 16	Rent for March Quarter	£66	(increased as from 1st Jan. 1962)
June 29	Insurance, Year to 30th June, 1963	£48	
July 5	Rent for June Quarter	£66	
Sept. 16	Rates, Year to 31st March, 1963	£96	
Oct. 8	Rent for September Quarter	£66	

Dr. *Rent, Rates and Insurance Account* *Cr.*

1962		£	1962		£
Jan. 1	To Amounts Prepaid b/d		Jan. 1	By Rent Accrued b/d	60
	Rates	22			
	Insurance	24			
4	„ Cash—Rent	60			
Apl. 16	„ „ „	66	Dec. 31	„ Amounts Prepaid c/f	
June 29	„ „ Insurance	48			
July 5	„ „ Rent	66		Rates	24
Sept. 16	„ „ Rates (1962/63)	96		Insurance	24
Oct. 8	„ „ Rent	66			
Dec. 31	„ Rent Accrued c/f	66		„ P. & L. A/c	406
		£514			£514

1963		£	1963		£
Jan. 1	To Amounts prepaid b/f		Jan. 1	By Rent Accrued b/f	66
	Rates	24			
	Insurance	24			

Notes:

Rates. At 31st December the amount prepaid is one quarter of the annual sum:
31st December, 1961 ¼ of £88
31st December, 1962 ¼ of £96.

Insurance. At 31st December the amount prepaid is one half of the annual premium.

The charge to Profit & Loss Account is £406. Is this correct? We can check it by adding together the true annual expense for each of the items.

			£	£
Rates:	1st Jan.—31st March	3 months @ £88 p.a.	22	
	1st Apl.—31st Dec.	9 months @ £96 p.a.	72	94
Insurance:	Premium for one year.			48
Rent:	Annual charge as increased for 1962			264
	Expenditure actually incurred during 1962			£406

Rent, Rates and Insurance are expenses, the charge for which is based on the passage of time. Accruals are not limited to such items. For example, it is common for the wages for several days to be outstanding at the close of a trading period. Discount is a very different item but it is common for a business to anticipate the discounts that are either allowable or receivable at the end of a trading period. Discounts Allowable are a deduction in assessing the real value of debts owing to the business and will therefore be recorded as a credit balance. Conversely, Discounts Receivable are recorded as a debit balance, a deduction from liabilities.

EXAMPLE 10

During 1962, B. Rivers allowed discounts of £640 to various customers and received discounts of £220. At the end of the year he wishes to make provision for discounts on debtors (5% of £1,400) and on creditors (2½% of £960). Give the two Discount accounts.

Dr. *Discount Received Account* *Cr.*

1962		£	1962		£
Dec. 31	To P. & L. A/c	244	Various dates	By Sundry Creditors	220
			Dec. 31	,, Amount Receivable c/d	24
		£244			£244
1963					
Jan. 1	To Amount Receivable b/d	24			

Dr. *Discount Allowed Account* *Cr.*

1962		£	1962		£
Various dates	To Sundry Debtors	640	Dec. 31	By P. & L. A/c	710
Dec. 31	,, Amount Allowable c/d	70			
		£710			£710
			1963		
			Jan. 1	By Amount Allowable b/d	70

The principle involved is the same as that in the previous example but there is a difference in the presentation in the Balance Sheet. Discounts do not appear separately but as deductions.

		£	£
Under Liabilities:	Sundry Creditors	960	
	Less Discount Receivable	24	936
Under Assets:	Sundry Debtors	1,400	
	Less Discount Allowable	70	1,330

Finally, in this section, must be considered the provision for bad debts. Business conservatism and caution demand that we do not wait for the unwelcome events before providing for them. The provision may be of two kinds:

(1) Specific. A careful analysis of the list of debtors is made and a provision made for specific doubtful debts.

(2) General. A certain percentage of the total amount due is regarded as a satisfactory provision.

Alternatively, the provision may be a blend of the specific with the general.

EXAMPLE 11

During 1962, V. Race had to write off the debts of G. George and J. Joyce who owed £40 and £130 respectively. At 31st December the total of Sundry Debtors was £1,440. Race wishes to make provision for Bad Debts of 5% and for Discounts Allowable of 4%. Give the Bad Debts Account and show how the Provisions would appear on the Balance Sheet.

Dr. *Bad Debts Account* *Cr.*

1962		£	1962		£
Dec. 31	To G. George	40	Dec. 31	By P. & L. A/c	242
	„ J. Joyce	130			
	„ Provision c/d	72			
		£242			£242
			1963		
			Jan. 1	By Provision b/d	72

Balance Sheet—Assets Side	£	£	£
Sundry Debtors		1,440	
Less Provision for Bad debts	72		
Provision for Discounts	55	127	1,313

The provision for Discounts is calculated on the total of Debtors less the provision for Bad Debts. Discounts are not allowed on bad debts!

To make provision, even a specific provision, for a Bad Debt is very different from writing it off but it is easy for the student to confuse the two.

EXAMPLE 12

On 1st January, 1962, the Bad Debts Provision in the books of T. Case was £260. This was made up as follows:

	£
50% of the doubtful debt of A. Rose	105
5% of all other debts	155
	£260

On 15th March, A Rose paid £140 but this was to be regarded as a final instalment towards his debt. On 30th June it was decided to write off the amount of £30 due from G. Bloom. At this date, S. Flower owed £40 and, as he was known to be in financial difficulties, Case decided to make 100% provision against this debt. Other debts totalled £2,800 and a provision of 5% was to be made on this total. Give the Bad Debts Account.

Dr. *Bad Debts Account* *Cr.*

1962		£	1962		£
Mar. 15	To A. Rose	70	Jan. 1	By Provision b/f	260
June 30	„ G. Bloom	30	June 30	„ P. & L. A/c	20
	, Provision c/d	180			
		£280			£280
			July 1	„ Provisions b/d	180

Notes:

1. A. Rose owed £210. He paid £140 and consequently the amount written off was £70. This is not affected by the

provision brought forward, £105 of which related specifically to A. Rose.

2. Details of the calculations of the provisions are not included in the accounts where they would only serve to mislead. Once the provisions have been determined, the make-up of the figures does not affect the subsequent accounting.

Sometimes a separate Provision for Bad Debts Account is opened. This is a difference of arrangement rather than of principle. In the previous example T. Case would include these accounts in his ledger.

Dr. *Provision for Bad Debts Account* *Cr.*

1962		£	1962		£
June 30	To Bad Debts A/c	80	Jan. 1	By Balance b/d	260
	„ Balance c/d	180			
		£260			£260
			July 1	By Balance b/d	180

Dr. *Bad Debts Account* *Cr.*

1962		£	1962		£
Mar. 15	To A. Rose	70	June 30	Adjustment to Provision	80
June 30	„ G. Bloom	30		„ P. & L. A/c	20
		£100			£100

We are now in a position to consider the preparation of more complicated final accounts.

EXAMPLE 13

You are required to prepare the Trading and Profit & Loss Account for the year ended 30th September, 1962 and a Balance Sheet as at that date, for the business of W. Watson. The following balances were extracted from his ledger.

	£		£
Sales	24,200	Heating and Lighting	420
Purchases	16,180	Rent and Rates	380
Salaries and Wages	4,000	Shop Fixtures and Fittings	2,160
Discounts	300	Stock	2,400
Returns on Sales	1,100	Drawings	1,210
Debtors	1,410	Creditors	1,810
Bad Debts Provision	300	Bad Debts written off	190
Sundry Expenses	210	Capital	3,904
Cash	810	Returns on Purchases	816
Motor Van	640	Motor Expenses	220

(a) The Stock at 30th September, 1962 was £1,810.

(b) You are required to write off Depreciation on:

1. Motor Van at 20%.
2. Shop Fixtures and Fittings at 5%

(c) At 30th September, 1962, £40 was owing for Rent but the Rates for the year ending 31st March, 1963, amounting to £120, had been paid.

(d) The Provision for Bad Debts is to be reduced to £200.

One immediately notices that the list of balances is not in the form of a Trial Balance. It can be assumed that a Trial Balance would balance for we are not examining the examiner. However, we have to prepare a rough Trial Balance in order to know whether the balance for Discount is debit or credit. A shorter method is to ring the credit items (usually fewer in number). Then adding the ringed and unringed items separately we have the totals of a Trial Balance.

The Bad Debts and Rent & Rates Account perhaps need writing out for easier comprehension. Later, practice will make this unnecessary.

Dr. *Bad Debts Account* *Cr.*

1962		£	1961			£
Sept. 30	To Sundry Persons	190	Oct.	1	By Provision b/f	300
	„ Provision c/d	200	1962			
			Sept. 30		„ P. & L. A/c	90
		£390				£390
			Oct.	1	By Provision b/d	200

Dr. *Rent & Rates Account* *Cr.*

1962		£	1962			£
Sept. 30	To Balance	380	Sept. 30		By Prepayment—Rates c/d	60
	„ Rent Accrued c/d	40			„ P. & L. A/c	360
		£420				£420
Oct. 1	To Prepayment b/d	60	Oct.	1	By Rent Accrued b/d	40

More quickly the charges to Profit & Loss Account can be calculated:

Bad Debts — Amounts written off less decrease in Provision.
£190 − £100 = £90.

Rent & Rates. — Balance on Account plus accrual less prepayment
£380 + £40 − £60 = £360.

Dr. *Trading and Profit & Loss Account for the year ending 30th September, 1962* *Cr.*

	£	£		£	£
To Cost of Sales:			By Sales	24,200	
Stock, 1st Oct. 1961	2,400		Less Returns	1,100	23,100
Purchases, less Returns	15,364				
	17,764				
Less Stock, 30th Sept., 1962	1,810	15,954			
Gross Profit carried down		7,146			
		£23,100			£23,100

	£	£		£
To Salaries & Wages		4,000	By Gross Profit	
Rent & Rates		360	brought down	7,146
Bad Debts		90	Discount	300
Heating & Lighting		420		
Motor Expenses		220		
Sundry Expenses		210		
Depreciation:				
Motor Van	128			
Fixtures & Fittings	108	236		
Net Profit		1,910		
		£7,446		£7,446

Balance Sheet as at 30th September, 1962

Capital:	£	£	*Assets:*	£	£
Balance at 1st October 1961	3,904		Shop Fixtures & Fittings:		
Add Net Profit for Year	1,910		Balance at 1st Oct. 1961	2,160	
	5,814				
Less Drawings	1,210	4,604	Less Depreciation	108	2,052
			Motor Van:		
			Balance at 1st Oct. 1961	640	
			Less Depreciation	128	512
Liabilities:			Stock on Hand		1,810
Creditors		1,810	Sundry Debtors	1,410	
Accrued Expenses		40	Less Provision for Bad Debts	200	1,210
			Prepayment		60
			Cash		810
		£6,454			£6,454

The next example is that of a manufacturing concern. At this stage in our work it is very difficult to calculate a figure for Gross Profit that is at all meaningful. The problem is that the Cost of Goods Sold is different from the cost of materials used in making those goods. Wages of employees, machinery depreciation and other factory expenses are all part of the cost of making the goods that are to be sold. After this example a more satisfactory presentation is considered. But very frequently, the given data is inadequate for the preferred presentation and we have to do the best we can. It becomes a matter of compromise. Usually, we record factory wages in the Trading Account and leave other expenses in the Profit & Loss Account. We also avoid the use of the inappropriate term, "Cost of Goods Sold."

EXAMPLE 14

The following Trial Balance was extracted from the books of A. Sawyer at 31st December, 1962. You are required to prepare a Trading and Profit & Loss Account for the Year ended 31st December, 1962 and a Balance Sheet at that date, given the following additional information:

(1) The Stock on Hand at 31st December, 1961, was valued at £2,612.

(2) Factory Wages accrued amounted to £80 and Telephone Expenses accrued were estimated at £40.

(3) Insurance prepaid amounted to £45.

(4) Depreciation is to be written off:
   1. Buildings at 2% p.a.
   2. Plant and Machinery at 10% p.a.

(5) Early in the year a machine was sold for £220. This machine was valued in the books at £158.

(6) Make allowance for Discounts on Debtors at the rate of 6¼% and increase the provision for Bad Debts by £10.

(7) Interest on the Loan at 5% p.a. is due for the whole of 1962.

Trial Balance	£	£
Capital		6,481
Loan, B. Baker		5,000
Buildings	5,100	
Plant and Machinery	4,778	
Stock	2,109	
Purchases	5,614	
Factory Wages	4,060	
Sales		16,108
Rates	260	
Salaries and Wages	1,219	
Carriage Outwards	601	
Lighting and Hearing	80	
Telephone	20	
Insurance	180	
Discounts	931	
Bad Debts	94	
Bad Debts Provision		50
General Expenses	119	
Sale of Machinery		220
Creditors		1,016
Debtors	1,420	
Cash	190	
Drawings	2,100	
	£28,875	£28,875

Dr. *Trading and Profit & Loss Account for the Year ended 31st December, 1962* *Cr.*

	£		£
To Stock, 1st January 1962	2,109	By Sales	16,108
Purchases	5,614	Stock, 31st Dec. 1962	2,612
Wages—Factory	4,140		
Gross Profit carried down	6,857		
	£18,720		£18,720

	£		£
To Rates	260	By Gross Profit	
Salaries and Wages	1,219	brought down	6,857
Carriage Outwards	601	Gain on Sale of	
Lighting and Heating	80	Machine	62
Telephone	60		
Insurance	135		
Discounts	1,016		
Bad Debts	104		
General Expenses	119		
Loan Interest	250		
Depreciation:			
Buildings	102		
Machinery	462		
Net Profit	2,511		
	£6,919		£6,919

Balance Sheet as at 31st December, 1962

	£	£			£	£
Capital:			*Assets:*			
Balance at 1st Jan.	6,481		Buildings			
Add Net Profit	2,511		Balance at 1st Jan.		5,100	
	8,992		Less Depreciation		102	4,998
Less Drawings	2,100	6,892	Machinery			
			Balance at 1st Jan.		4,778	
			Less Sale at Book Value		158	
					4,620	
			Less Depreciation		462	4,158
Liabilities:			Stock			2,612
Loan and Accrued Interest		5,250	Debtors		1,420	
Creditors		1,016	Less Prov. for Bad Debts	£60		
Accrued Expenses		120	Less Prov. for Discount	£85	145	1,275
			Prepayments			45
			Cash			190
		£13,278				£13,278

When completed the Machinery Account would appear as follows:

Dr. *Machinery Account* *Cr.*

			£				£
1962			£	1962			£
Jan.	1	To Balance b/f	4,778	Jan.	9	By Cash—Sale	220
Dec.	31	P. & L. A/c— Gain on Sale	62	Dec.	31	Depreciation	462
						Balance c/d	4,158
			£4,840				£4,840
1963							
Jan.	1	To Balance b/d	4,158				

Manufacturing Accounts

A Trading Account of a manufacturing concern as given above is still unsatisfactory. It does not compare the Sales with the Cost of Goods Sold. For this comparison considerably more information must be forthcoming. In particular, the Stock figures must be analysed into three parts:

(a) Raw Materials,
(b) Partly Finished Goods or Work in Progress
and (c) Finished Goods.

We can then add an extra stage to the Profit Calculation. In the Manufacturing Account, we present:

1. The Cost of Materials Consumed,
2. All Factory Wages and Factory Expenses;

Added together, these give us,

3. The Factory Cost of Goods Produced.

But there is a complication. The cost of goods finished will include certain costs incurred on goods partly finished at the beginning of the accounting period, i.e. the "cost" value of the commencing Work in Progress. Just as this figure must be included in the "Factory Costs of Goods Produced," so we must exclude the "cost" value of the Work in Progress at the end of the accounting period.

With the Factory Cost of Goods Produced, the Trading Account is able to perform its true function and to give a meaningful Gross Profit figure. The Profit & Loss Account is affected by the preparation of the Manufacturing Account only in that Factory expenses (rent, machinery depreciation etc.) will not appear in it.

EXAMPLE 15

Prepare the Manufacturing, Trading and Profit & Loss Accounts for the Year ending 31st December, 1962 and a Balance Sheet as at that date from the following information:

Trial Balance	£	£
Capital		93,074
Plant & Machinery	84,100	
Motor Vehicles	6,600	
Creditors		16,216
Debtors	18,400	
Stock: Finished Goods	7,160	
Work in Progress	6,120	
Raw Materials	3,100	
Sales		131,210
Purchases	29,460	
Wages	41,400	
Salaries	16,200	
Drawings	10,400	
Rent and Rates	2,500	
Insurance: Factory	1,610	
Office	140	
General Factory Expenses	840	
Sundry Office Expenses	680	
Motor Expenses	2,194	
Salesmen's Commissions	2,400	
Provision for Bad Debts		700
Bad Debts	695	
Cash at Bank	7,130	
Cash in Hand	71	
	£241,200	£241,200

Notes:

1. Write off Depreciation, (a) 10% of Plant & Machinery,
   (b) 20% of Motor Vehicles.
2. Make the provision for Bad Debts equal to 5% of Sundry Debtors.
3. Of the Rent & Rates, one fifth relates to the Office and the rest to the factory.
4. The Stocks at 31st December, 1962 were:

	£
Finished Goods	8,190
Work in Progress	5,420
Raw Materials	1,980

Dr. *Manufacturing, Trading and Profit & Loss Accounts for the Year ended 31st December, 1962* *Cr.*

	£	£		£
To Cost of Materials Consumed:			By Factory Cost of	
Stock, 1st January, 1962	3,100		Goods Produced	85,540
Purchases	29,460			
	32,560			
Less Stock, 31st Dec., 1962	1,980	30,580		
,, Wages		41,400		
,, Factory Rent & Rates		2,000		
,, Factory Insurance		1,610		
,, General Factory Expenses		840		
,, Depreciation—Plant & Machinery		8,410		
		84,840		
Add Work in Progress 1st Jan., 1962		6,120		
		90,960		
Less Work in Progress 31st Dec., 1962		5,420		
		£85,540		£85,540

	£		£
To Cost of Goods Sold:		By Sales	131,210
Stock of Finished Goods 1st Jan., 1962	7,160		
Factory Cost of Goods Produced	85,540		
	92,700		
Less Stock of Finished Goods 31st Dec. 1962	8,190		
	84,510		
„ Gross Profit carried down	46,700		
	£131,210		£131,210
To Salaries	16,200	By Gross Profit brought down	46,700
„ Office Rent & Rates	500		
„ Office Insurance	140		
„ Sundry Expenses	680		
„ Motor Expenses	2,194		
„ Depreciation of Motor Vehicles	1,320		
„ Salesmen's Commissions	2,400		
„ Bad Debts	915		
„ Net Profit	22,351		
	£46,700		£46,700

Balance Sheet as at 31st December, 1962

	£	£		£	£
Capital:			*Assets:*		
Balance at 1st Jan., 1962	93,074		Plant & Machinery Balance at 1st Jan. 1962	84,100	
Add Net Profit	22,351		Less Depreciation	8,410	75,690
	115,425				
Less Drawings	10,400	105,025	Motor Vehicles:		
			Balance at 1st Jan., 1962	6,600	
			Less Depreciation	1,320	5,280
			Stock:		
Liabilities:			Finished Goods	8,190	
Sundry Creditors		16,216	Work in Progress	5,420	
			Raw Materials	1,980	15,590
			Sundry Debtors	18,400	
			Less Provision for Bad Debts	920	17,480
			Cash at Bank	7,130	
			Cash in Hand	71	7,201
		£121,241			£121,241

Sometimes the Manufacturing Account is credited (and the Trading Account debited), not with the Factory Cost of Goods Produced, but with an assumed market value of the production. This refinement reveals a profit or loss on the manufacturing with a consequent adjustment to the Trading Account Gross Profit.

Thus in the foregoing example, the assumed market value of production might be £100,000 which will give a Gain on Manufacturing of £14,460. The Trading Account will appear:

To Cost of Sales:	£		£
Stock of Finished Goods 1st Jan., 1962	7,160	By Sales	131,210
Market Value of Production	100,000		
	£107,160		
Less Stock of Finished Goods, 31st. Dec., 1962	8,190		
	98,970		
Gross Profit on Trading	32,240		
	£131,210		£131,210

The credit side of the Profit & Loss Account will be

By Gross Profit on Manufacturing	14,460
Gross Profit on Trading	32,240
	£46,700

This gives the same total for the account and therefore the same Net Profit.

Questions 2

1. *The following Trial Balance of a sole trader, although it adds up to the same total on both sides, is incorrect:

Trial Balance at 30th June, 1962	*Dr.*	*Cr.*
	£	£
Capital, 1st July, 1961	8,950	
Drawings		1,050
Stock, 1st July, 1961	3,725	
Purchases	23,100	
Sales		39,425
Wages and Salaries	6,205	
Lighting and Heating	310	
Equipment	3,600	
Carriage Outwards		230
Returns Inwards	105	
Returns Outwards		290
Provision for Bad Debts	350	
Discount Allowed	285	
Discount Received		315
Rent, Rates & Insurance	1,115	
Motor Vehicles	1,475	
Cash in Hand	110	
Sundry Creditors	4,925	
Sundry Debtors		13,920
Bank Overdraft	975	
	£55,230	£55,230

Draw up a corrected Trial Balance.

2. *On 1st January, 1962 the Provision for Bad Debts Account in the books of G. Gardham showed a credit balance of £230. During the following twelve months, debts amounting to £185 were written off as irrecoverable and £25 was received in respect of a debt previously written off in 1959. At 31st December, Gardham decided to carry forward a provision of £250. You are asked to record the above in Gardham's books.

3. *The books of Francis Macarthy, a wholesale dealer in toys, showed the following balances at the close of business on 30th June, 1962:

*Re-printed by courtesy of the Royal Society of Arts (R.S.A.)

	£	£
Capital, 1st July, 1961		7,163
Stock, 1st July, 1961	2,795	
Purchases	32,329	
Sales		43,237
Warehouse Wages	1,625	
Office Salaries	1,927	
Traveller's Salary and Commission	1,425	
Customs Duty on Imported Purchases	317	
Carriage Outwards	432	
Returns Inward	218	
Returns Outward		74
Rent, Rates and Insurance	2,170	
Fixtures and Fittings	900	
Discount Allowed	315	
Discount Received		284
Sundry Debtors	5,132	
Sundry Creditors		2,390
Drawings	1,200	
General Expenses	496	
Balance at Bank	1,321	
Cash in Hand	115	
Carriage and Freight Inwards	468	
Provision for Bad Debts		37
	£53,185	£53,185

You are required to draw up Macarthy's Trading and Profit & Loss Account for the year ended 30th June, 1962, and his Balance Sheet as at 30th June, 1962, taking into account the following:

(a) On 30th June, 1962, his unsold stock was valued at £4,385.

(b) During the year Bad Debts, as they occurred, had been debited to Provision for Bad Debts Account. Additional provision should be made to bring the balance of this account up to £100.

(c) Fixtures and Fittings should be depreciated by £50.

(d) The rent of the warehouse and offices is £1,400 a year and the quarterly instalment due on 24th June, 1962, has not been paid.

4. *A manufacturer, who prepares his accounts to 31st December each year, debits all his purchases of machinery to a single Plant and Machinery Account, and writes off depreciation by fixed annual instalments from each asset.

*Re-printed by courtesy of the Royal Society of Arts (R.S.A.).

From the following details, prepare the Plant and Machinery Account for the years ended 31st December, 1959 to 31st December, 1962 inclusive.

1959				
Jan. 1	Machine cost.	£500;	estimated life, 10 years;	scrap value £50.
1960				
Jan. 1	,, ,,	£48;	estimated life, 2 years;	,, ,, nil.
1961				
Jan. 1	,, ,,	£1,000;	estimated life, 10 years;	,, ,, £100.
1962				
Jan. 1	,, ,,	£350;	estimated life, 8 years;	,, ,, £30.

5. *The following Trial Balance was extracted from the books of Jackson trader, at 31st March, 1961.

Trial Balance 31st March, 1961	£	£
Capital Account		14,400
Purchases	41,400	
Sales		55,620
Trade Debtors	7,250	
Trade Creditors		3,860
Stock in Trade, 1st April, 1960	4,120	
Balance At Bank	3,920	
Drawings	4,600	
Motor Expenses (including Petrol)	510	
Motor Vans	1,250	
Rent and Rates	750	
Salaries	8,120	
Provision for Bad Debts, 1st April, 1960		210
Bad Debts	730	
General Expenses	1,120	
Discounts Allowed	1,050	
Discounts Received		930
Insurances	200	
	£75,020	£75,020

*Re-printed by courtesy of the Royal Society of Arts (R.S.A.).

The following matters are to be taken into account:

(a) The Stock in Trade at 31st March, 1961 was valued at £5,040.
(b) Salaries accrued at 31st March, 1961 amounted to £840 and Rent accrued, £250.
(c) Insurances paid in advance at 31st March, 1961 amounted to £30.
(d) The provision for doubtful debts is to be increased to £250.
(e) The stock of unused Petrol at 31st March, 1961 was valued at £25.
(f) The balance of £1,250 on Motor Vans Account was made up as follows:

1960		£	1960		£
Apl. 1	To Balance (Old Van) b/f	350	Apl. 1	By Cash on sale of old van	500
	Cost of New Van	1400	1961 Mar. 31	Balance	1250
		£1750			£1750

Provide for the depreciation on the new van at the rate of 20% per annum on cost.

You are required to prepare a Trading and Profit & Loss Account for the year to 31st March, 1961 and a Balance Sheet as at that date.

6. †At September 30th, 1961, the directors of XY Ltd. created a provision in their accounts against the following debts which they consider to be of doubtful nature:

	£.	s.	d.
Smith Ltd.	250.	7.	2.
S. Jones	5.	9.	4.
T. Robinson	26.	13.	3.
A. Brown	30.	14.	6.

During the year ended 30th September, 1962, no further business was done with any of these debtors, but a first and final dividend of £85 was received from the liquidator of Smith Ltd. and T. Robinson paid his debt in full. A further debt of £100. 16. 2. by King Ltd. proved to be bad.

On September 30th, 1962, the directors decided to maintain the provisions existing against the debts of S. Jones and A. Brown and to create provisions as follows:

	£.	s.	d.
A. K. James	21.	9.	4.
B. L. Stanley	16.	10.	5.

Show the entries that these facts will require in the Company's Nominal Ledger in the year ended September 30th, 1962.

†Re-printed by courtesy of the Society of Incorporated Accountants (S.A.A.).

7. *A trader dealing in a standard line of goods which he regularly sold at 25% above cost price, discovered on the morning of 17th March, 1962—a Monday—that during the week-end all his stock had been destroyed by fire. His stock was fully covered by insurance, but no records were immediately available from which he could calculate how much he should claim from the insurance company. His account books were, however, undamaged and from them he was able to obtain the following figures:

	£
Stock on Hand 1st January, 1962 at cost price	6,000
Purchases from 1st January to 14th March, 1962	14,000
Sales from 1st January to 14th March, 1962	18,000

State the value of the stock destroyed by fire, showing your calculations.

8. *Given below is the abridged Balance Sheet of G. Cantone:

Balance Sheet 1st March, 1962

	£		£
Creditors	1,890	Cash	20
G. Cantone		Debtors	625
Capital Account	2,355	Stock	2,100
		Machinery	1,500
	£4,245		£4,245

The following transactions took place on 2nd March, 1962:

(a) Cantone receives a loan of £500, which he used to pay £200 to a creditor and £300 for the purchase of new Machinery.
(b) A debtor pays £120 on account.
(c) Cantone purchases goods for resale (stock) costing £75. This was a credit Purchase.
(d) Old machinery is sold for £100 in cash; the book value was £250.
(e) It is decided to correct the valuation of stock on 1st March, 1962, reducing it by £320.
(f) Goods were sold on credit for £190 (cost price £145).

Show Cantone's Balance Sheet as it would appear on 2nd March, 1962, after the transactions, as noted, had been recorded.

9. *T. is proposing to set up in business as a retailer and is negotiating for a shop, the rent of which is £450 per annum and the Rates £375 per annum. He expects that he will need to employ an assistant at a wage of £8 per week and that the incidental expenses of the business will be £50

*Re-printed by courtesy of the Royal Society of Arts (R.S.A.).

per annum. The rate of gross profit he expects to make on Sales is 25 % (i.e. before deducting expenses or wages). Assuming that T. will make a Net Profit of £1,000 and that, at the end of the year he will have a stock of £500, draft a pro forma Trading and Profit & Loss Account for the first year.

10. Give the Rent, Rates and Insurance Account incorporating the following information:

		£
April 1	Rent Accrued	60
	Insurance prepaid	200
	Payments	£
May 16	Rent, 3 months to 30th April	300
Aug. 1	Insurance, Year to 31st July, 1963	216
24	Rates, Year to 31st March, 1963	156
Sept. 16	Rent, 4 months to 31st August	400

You are to make provision for the prepayments and accrual at 30th September, 1962 and to show the transfer to the Profit & Loss Account at that date.

11. From the following information relating to a manufacturing business, compile a statement from which to ascertain:

(a) The cost of materials used,
(b) The cost of goods produced,
(c) The cost of goods sold and the gross profit theron, and
(d) The net profit earned.

		£
Raw Materials:	Stock at Beginning	2,100
	Purchases	12,000
	Stock at End	3,100
Finished Goods:	Stock at Beginning	1,750
	Stock at End	980
Work in Progress:	At Beginning	1,870
	At End	2,090
Sales		34,646
Wages		7,960
Carriage:	Inwards	650
	Outwards	482
Fuel, Light and Power:	Factory	520
	Office	168
General Expenses:	Factory	142
	Administration	3,875
	Selling	1,490

12. *Curran pays all his car expenses by cheques drawn on his business bank account. In the books of the business all these payments are debited to an account for Motor Expenses.

To cover private use of the car he treats half of the expenses as private and transfers this proportion to his personal Drawings Account.

On 1st January, 1962, he owed £16 for Repairs and had paid Insurance in advance £12. During 1962 he drew cheques to the value of £193 and on 31st December, 1962, he owed £13 for Repairs and had paid Insurance in advance £14.

Show the account for Motor Expenses in Curran's ledger for 1962 after the accounts for the year had been closed.

13. From the following list of balances and additional information prepare Manufacturing, Trading and Profit & Loss Accounts for the year ended 31st December, 1962, and a Balance Sheet as at that date:

	Dr. £	*Cr.* £
Sales		250,000
Raw Materials Purchased	65,000	
Wages: Factory	71,000	
Showroom	3,800	
General Office	10,420	
Rent and Rates: Factory	3,000	
Showroom	1,800	
General Office	1,200	
Machine Repairs	5,810	
Advertising	13,000	
Fuel & Power: Factory	2,940	
Showroom	320	
General Office	560	
Showroom Equipment	17,000	
General Office Equipment	12,000	
Machinery and Plant	183,400	
Stocks at 1st January, 1962		
Raw Materials	11,400	
Work in Progress	8,090	
Finished Goods	20,160	
Capital		210,000
Drawings	6,200	
Creditors		21,094
Debtors	30,615	
Cash at Bank	13,379	
	£481,094	£481,094

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Notes:

1. Stocks at 31st December, 1962, were:

	£
Raw Materials	8,316
Work in Progress	9,410
Finished Goods	18,613

2. Provide Depreciation as follows:

Machinery and Plant	10%
Showroom Equipment	5%
General Office Equipment	5%

14. A manager is entitled to receive commission at the rate of 5% of net profits after charging such commission. How much is this commission if the net profit was £4,200 before charging the commission?

CHAPTER 3

Books of Original Entry

The Journal and Its Sub-divisions

The entry of various transactions in the ledger alone has not been found adequate for business purposes. Records of individual transactions are complete in themselves but there is no place where the detailed story of the business transactions is given in time sequence. Some transactions are in certain accounts and others in different accounts. No one account is a comprehensive record of the life of the business as a whole. The Journal was intended to be that comprehensive record in correct date order. It was the complete financial "diary" of the business.

The form of the Journal is a matter of convenience. It is a preliminary record, not an account and not part of the Double Entry system. On the other hand, as all transactions recorded in the Journal are later entered in the accounts, it is convenient to use a debit and credit presentation. The records must be informative but brief. The following entries show the pattern we adopt:

Date	Details		Ledger Folio	Dr. £	s.	d.	Cr. £	s.	d.
1962									
Jan. 3	J. Baron	Dr.	31	241	13	4			
	To Sales		20				241	13	4
	being credit sale, see Invoice No. 1613.								
14	Bad Debts	Dr.	84	60	1	6			
	To G. Hardtimes		39				60	1	6
	being amount written off.								
23	Machinery	Dr.	60	1000	0	0			
	To British Engineering Co.		28				1000	0	0
	being purchase of press								

Entries that are to be entered or posted on the credit side of ledger accounts are entered in the credit column of the Journal. In the debit column are entered items that are to be posted to the debit of ledger accounts.

Any kind of transaction can be entered in the Journal. In a normal business a large number will be routine sales, purchases and returns. A great saving of work is achieved if these routine items can be segregated into separate books. Compare the following arrangements (dates and folios are omitted merely for convenience).

Journal:			£	£
(1)	G. Hardware	Dr.	80	
	To Sales			80
	being sale invoiced no. 1312			
(2)	R. Jones	Dr.	130	
	To Sales			130
	being sale invoiced no. 1313			
(3)	M. Machin	Dr.	75	
	To Sales			75
	being sale invoiced no. 1314			

Sales Journal: (or Sales Day Book).		Invoice Number	£
(1)	G. Hardware	1312	80
(2)	R. Jones	1313	130
(3)	M. Machin	1314	75
			£285

The Double Entry is achieved by posting the individual amounts to the debit of personal accounts and the total to the credit of Sales Account. The economy is obvious for three items. It is inescapably necessary when sales number 3,000 or even 300 a month. The total is usually posted to the credit of Sales Account at the end of each month but it is not uncommon for this posting to be made quarterly, half-yearly or even annually. The ruling of the Sales Journal is along these lines:

Date 1962	Name	Invoice Number	Ledger Folio	Amount £	s.	d.
Jan. 4	G. Hardware	1312	31	80	0	0
5	R. Jones	1313	26	130	0	0
6	M. Machin	1314	16	75	0	0

and so on.

A Sales Returns Journal can be prepared in the same way, the only difference being that the numbers of Credit Notes replace those of Invoices. The rules for posting to the ledger are, as one would expect, the opposite of the rules for the Sales Book. Personal accounts are credited with individual amounts and the total is debited to the Sales Returns Account or, often, to the Sales Account.

The Purchases Journal, in its simplest form, is exactly like the Sales Day Book.

Date 1962	Name	Invoice Number	Ledger Folio	Amount £	s.	d.
Jan. 2	W. Hargreaves	321	62	41	17	6
3	A. Moses	322	56	138	2	8

and so on.

Individual items are credited to the personal accounts of suppliers and the total is debited to Purchases Account. Exactly opposite postings are made for Returns on Purchases. However, it is not often that we see a Purchase Book in such a simple form.

Numerous invoices are received from various suppliers. Most relate to the purchase of goods and materials. Other invoices are for expenses of one kind or another: repairs, petrol and other motor expenses, machinery, lighting and heating etc. If the simple kind of Purchases Journal is used, these have all to be passed through the Journal itself. It is much more convenient to have a Purchases Analysis Book, the principle of which is illustrated in this simplified example.

Date	Name	Inv. No.	Folio	Amount	Purchases	Repairs	Motor Exs.	Printing & Sty.	Sundries
				£	£	£	£	£	£
May 1	B. Booth	36	138	66	66				
2	A. Jones	37	162	136	136				
	A. Shepherd	38	51	17				17	
4	R. Rings	39	116	38		38			
8	S.Y. Garage	40	114	14			14		
10	B. Booth	41	138	195	195				
	Excel Clng.	42	72	3					3
13	R. Rings	43	116	19		19			
				£488	397	57	14	17	3

Obviously in practice the number of columns will be greater and the totals will only be ruled off at monthly or even less frequent intervals. But this serves to illustrate the maintenance of the Double Entry. Individual amounts (£66, £136 etc.) are credited to the appropriate personal accounts and the totals of the individual analysis columns (£397, £57 etc.) are debited to the nominal accounts. The total of the individual items must equal the total of the analysed totals so the double entry is correctly completed.

A similar ruling may be used for the Purchases Returns Book. Indeed where it is considered desirable to have an analysis of sales, e.g. into products or areas, the same kind of ruling is appropriate for the Sales Journal.

Having extracted sales, purchases and returns from the Journal "proper," we have taken away the bulk of transactions. We shall later note that cash, bank and discount items are not recorded in the Journal. The residue left is a mixture of special transactions which do not fit into the records of normal business routine. In a sense, this gives added importance to the Journal as the difficult parts of book-keeping and accounts pass through it. It also gives added importance to the narration, the brief explanation following each Journal entry. The entries given at the beginning of this chapter were, on the whole, self-explanatory. To debit Baron and credit Sales must mean the sale of goods on credit to the person named. Similarly, the other two entries had rather obvious meanings. But this is not true of every Journal entry and the narration is most important.

To illustrate further, the Journal entries are given below to:

(a) correct a misposting of a Sale of £160 to the account of J. Brown instead of to A. Brown,
(b) open the books of a new business, the capital of which is £10,000 in the form of,

	£
Buildings	3,000
Stock	4,000
Cash	3,000
	£10,000

				£	£
(a)	1962				
	Jan. 14	A. Brown	Dr.	160	
		To J. Brown			160
		being correction of misposting of Sales Invoice 1469 on 16th Dec.			
(b)	1962				
				£	£
	Jan. 1	Buildings	Dr.	3,000	
		Stock		4,000	
		Cash		3,000	
		To Capital			10,000
		being assets introduced into business.		£10,000	£10,000

The Journal, with all its subdivisions, is known as a Book of Original Entry. The Cash Book is the other so described. All transactions are entered into one of these books before being posted to the ledger. Conversely, no entries are made in the ledger without first having passed through one of the Journals or the Cash Book.

The Cash Book

The Cash Account is of sufficient importance to merit the use of a separate book even though as an account it remains part of the whole ledger. In modern businesses, however, the cash account is much less important than the Bank Account. For reasons of security and convenience, every responsible business makes full use of the banking system. The Cash and Bank Accounts are kept together in a book ruled as a normal ledger account except that:

(1) One page stretches across two sides of the book, giving more space for the figures and for written details.

(2) On each side, debit and credit, there are two columns. One is for cash and the other for bank.

EXAMPLE 16

Record the following transactions in the Cash Book of R. Riley.

1962

Jan. 1 Balances in hand: Cash £10, Bank £360.
2 Paid £210 to R. Wayside by cheque.
3 Cash Sales £20.
4 Received a cheque from D. Booth, £300.
5 Purchased postage stamps by cash, £2.
6 Cash Sales banked, £40.
7 Paid Salary by cash, £10.
8 Withdrew for private use a cheque for £20.

Dr. 1962		Fo.	Cash £	Bank £	1962		Fo.	Cash £	Cr. Bank £
Jan. 1	To Balances	b/f	10	360	Jan 2	By R. Wayside	39		210
3	Sales	16	20		5	Stamps	14	2	
4	D. Booth	54		300	7	Salary	9	10	
6	Sales	16		40	8	Drawings	2		20
						Balances c/d		18	470
			£30	£700				£30	£700
Jan. 9	To Balances	b/d	18	470					

There are thus two balances on two accounts. The Cash Balance must be a debit as you cannot pay out more than you have received. The Bank Balance is usually a debit but may be a credit, i.e. an overdraft.

In the previous example, there were no transactions between cash and bank. These are numerous; frequently a cheque is cashed and cash is often paid into the bank. The entries involved are known as contra entries, i.e. the double entry is within one book and normally on the same page. The entries required are:

(a) Paying cash into bank:

Increase in Asset, Cash at Bank.	Debit Bank account.
Decrease in Asset, Cash.	Credit Cash account.

(b) Cashing a cheque:

Debit Cash account.	Credit Bank account.

To debit the Bank account means simply an entry in the Bank column on the debit side of the Cash Book and similarly with the other entries.

Discount:

Discounts, allowed or received, are invariably linked to cash or bank transactions. It would be possible to pass all such discounts through the Journal but that would be a lengthy business. The work is considerably reduced by the addition of a Discount column on both sides of the Cash Book. The system works simply but it is important to realise that the Discount columns, unlike the Cash and Bank columns, do not constitute an account. They are a convenient collection of individual items, the totals of which are posted to the nominal account or accounts (sometimes a single Discount Account is used, sometimes Discounts Allowed and Received are kept separate).

Discounts Received are associated with payments, Discounts Allowed with receipts. Consequently the Discount column on the credit side of the Cash Book lists Discounts Received and that on the debit side lists Discounts Allowed. The Double Entry is achieved as follows:

Cash Book Debit —Discount is credited along with cash or bank amounts to the accounts of individual customers.
The total of the Discount column is debited to the Discount Account—this is an expense of the business.

Cash Book Credit—Discount is debited along with cash or bank amounts to the accounts of individual suppliers.
The total of the Discount column is credited to Discount Account—representing a reduction in expense.

EXAMPLE 17

Record the following transactions in the Cash Book of A. Perry.

1962
April 1 Balances: Cash £30 and Bank £510.
2 Purchased stamps for cash, £4.
3 Received £385 from J. Jones, allowing discount £15.
4 Cashed a cheque for £70 and paid salaries in cash, £50.
5 Paid Arthur Supplies Ltd. £216, receiving Discount £11.
11 Cashed a cheque for £30 and paid Salaries in cash £50.
12 Purchased stationery by cheque £15.
13 Cash Sales £70.
14 Received £520 from Drapers Ltd., allowing Discount £20.
15 Paid account of Bronkton Cottons Ltd., £600 net.
16 Paid Rent by cheque, £60.
17 Cash Sales £140. Paid Cash to Bank £100.
18 Paid Salaries £50.
20 Settled account of Sendquick Engineering Co., £60 receiving discount of £2.

Dr.

Date		Details	Folio	Discount	Cash	Bank
				£	£	£
April	1	To Balances	b/f		30	510
	3	J. Jones	26	15		385
	4	Bank	C.		70	
	11	,,	C.		30	
	13	Sales	5		70	
	14	Drapers Ltd.	27	20		520
	17	Sales	5		140	
		Cash	C.			100
				£35	£340	£1,515
April	21	To Balances	b/d		86	466

Cr.

Date		Details	Folio	Discount	Cash	Bank
1962				£	£	£
April	2	By Stamps	13		4	
	4	Cash	C.			
		Salaries	11		50	70
	5	Arthur Supplies	41	11		
		Ltd.				216
	11	Cash	C.			
		Salaries	11		50	30
	12	Stationery	13			
	15	Bronkton Cottons	40			15
		Ltd.				600
	16	Rent	16			
	17	Bank	C.		100	60
	18	Salaries	11		50	
	20	Sendquick Eng. Co.	44	2		
		Balances	c/d		86	58
						466
				£13	£340	
						£1,515

The totals of Discount, £35 and £13, are posted to the debit and credit of Discounts Allowed and Received respectively.

Bank Reconciliation Statements. One of the many advantages of using the banks is that their records are available to check the accuracy of our own. Each month or quarter we receive a Bank Statement which is a copy of our account in the books of the bank. The same items as are in our bank account appear, but on opposite sides. If we have money in the bank, this is our asset but also the bank's liability. The balance on the Bank Statement might be expected to equal the balance in our books but it rarely does. The reasons, excepting errors, are threefold:

1. Bank Charges will have been entered in the Bank Statement but not in our cash book. The Statement is the first notification of such charges and as there is an inevitable delay before statements are received, the entry in our cash book will always be some days after the end of the month to which the Statement refers.
2. Some cheques we have drawn will not have been paid into the bank by the recipients and the bank is thus unaware of their existence. The credits appear in our Bank Account but no entry appears on the Bank Statements.
3. The bank sometimes delays before crediting our accounts with cheques we have paid in. If this has happened, our account will naturally show a different balance from that of the Bank Statement.

A Reconciliation Statement is necessary to agree the two balances.

EXAMPLE 18

The Cash Book on 30th September, 1962, shows a balance in the bank of £684. 19. 4. The Bank Statement on that day gives a balance of £751. 5. 1. Bank Charges appear on the Statement as £14. 13. 7. but they have not been entered in the Cash Book. Examination of the two records show that unpresented cheques amount to £120. 19. 4. A cheque for £40 deposited in the bank on 30th September has not been credited in the Statement.

Bank Reconciliation:

	£	s.	d.
Balance as per Cash Book	684	19	4
Less Bank Charges	14	13	7
	£670	5	9
Balance as per Bank Statement	751	5	1
Less Unpresented Cheques	120	19	4
	630	5	9
Add cheque not yet credited	40	0	0
	£670	5	9

The Reconciliation Statement can be prepared as one continuous whole. Dividing it into two sections has the advantage of reaching a figure which represents the true balance after all outstanding transactions have been completed.

Petty Cash Book. Not all the incidental cash payments of an office are passed through the Cash Book. Usually, a person is given a small balance to meet such payments and he keeps the records in a Petty Cash Book. This is often analysed so that, at the end of a period, it is possible to know on what kind of expenditure the money has gone.

The control of Petty Cash expenditure is important and the Imprest system is the most satisfactory system of control. The Petty Cashier is given a round sum of suitable size, e.g. £10 or £20, he then makes various payments and when he needs more money he receives a cheque covering the actual amount he has used. This restores his balance to the original round sum. He thus has to account for the amount previously received before he receives any more and the responsibility given him is limited to an agreed figure, i.e. the original round sum.

There are three ways in which the Petty Cash transactions can be brought into the Double Entry framework.

1. The Petty Cash Book is actually an account, debited with all amounts received and credited with payments made. The only difference between this and other accounts is that the payments are debited to the Nominal Accounts in summary figures from the analysis, not as individual payments.
2. An Account for Petty Cash is opened in the ledger. This is debited with amounts received. The credits are transfers (through the Journal) of the analysed expenditure. The Petty Cash Book is a memorandum record outside the double entry system.
3. The Petty Cash Book is again a memorandum record but no account is opened for the summary of Petty Cash transactions. Instead, when a cheque is drawn to restore the Imprest balance, the amount is analysed in the Cash Book according to the expenditure incurred and the Nominal Accounts are debited from the Cash Book.

Questions 3

1. *D. Tigg is in business as a wholesaler, and on 1st February 1962, his assets and liabilities were:

		£
Stock		1,800
Office Furniture		490
Cash at Bank		197
Cash in Hand		5
Debtors:	A. Jonas	40
	M. Tapley	65
Creditors:	S. Gamp	78
	B. Harris	90

Entries in the respective Day Books during the period 1st to 15th February are summarised below:

	Purchases	£		Sales	£		Returns Inwards	£
Feb. 3	S. Gamp	150	Feb. 2	A. Jonas	232	Feb. 10	M. Tapley	25
8	B. Harris	96	8	J. Brick	195	15	J. Brick	5
14	M. Lupin	120						
		£366			£427			£30

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Other transactions during the period were:

		£
Feb. 1	Drew and cashed cheque for cash purposes	10
	Cash payments: Wages	6
	Sundry Trade Expenses	3
	Drawings (D. Tigg)	5
3	Sold to C. Dickins for cash, Office Furniture	15
4	Cash Sales	75
	Paid to Bank	50
5	Paid by cheque to S. Gamp the amount due to him on Feb. 1st less 5% cash discount.	
6	Cash Sales	80
	Received and banked a cheque from M. Tapley for	50
7	Received and banked a cheque from A. Jonas for the amount due from him on 1st Feb. less $2\frac{1}{2}$% cash discount.	
	Paid by cheque, Rent	25
8	Cash payments: Wages	6
	Sundry Trade Expenses	2
9	Cash Sales	99
	Paid to Bank	70
10	Paid to D. Tigg as Drawings a cheque for	25
14	Received and banked a cheque from T. Pinch as loan	100
15	Paid cheque to M. Lupin on account	50
	Banked all cash in hand except £5.	

You are to:

(a) Open the accounts of D. Tigg on 1st February by journal entry.
(b) Enter the cash and bank transactions in a three-column cash book.
(c) Post all entries, including the Day Books, to the appropriate ledger accounts.
(d) Balance the personal accounts and cash book on 15th February and take out a Trial Balance on that date.

2. Give the Journal entries for the following transactions:

(a) A. Fale owes £120 but as he is unable to pay we write off the debt as bad.
(b) An entry in the Sales Day Book for £140 has been incorrectly posted to the account of B. Udo instead of B. Udom. Make the correction.
(c) Goods costing £72 have been withdrawn for personal consumption. Charge to Drawings.
(d) The credit purchase of machinery costing £160 from Argus & Jones Ltd.
(e) A purchase of Office Stationery has been included in the Purchase Book as ordinary purchases. The amount involved is £15. Make the correction.

3. *State precisely the circumstances which could have given rise to the following Journal entries in the books of G. Gough, a manufacturer.

(a) Bad Debts Reserve	Dr.	£100	
To P. & L. A/c			£100
(b) A. Buyer	Dr.	10	
To Discount Allowed			10
(c) Machinery	Dr.	200	
To Wages			200
(d) Machinery	Dr.	50	
To Depreciation			50

4. *(a) Smith, a trader, received from his solicitor a cheque for £74 which represented the proceeds of collecting a debt due to him from Jones, a customer, less the solicitor's charges £6. Show the entry in Smith's Journal to record the matter.

   (b) By arrangement with Motor Sales Ltd., an old motor lorry, standing in Basset's books at a value of £650, is accepted in part exchange at a value of £600 against the purchase from them, on credit, of a new lorry costing £1,150. Give the necessary entries in the Journal proper of William Basset, a merchant, in respect of this transaction.

   (c) A cheque for £50, which had been received by a trader from his customer Paterson in settlement of an account due, was dishonoured and returned by the bank. The trader receives information that Paterson is bankrupt and unlikely to be able to pay any part of the amount due. Show the entries to record these matters in the Company's Journal.

   Note: in all cases cash is to be journalised.

5. *The system in force for the recording of the transactions of Jarrow & Jersey Ltd. is that all invoices, whether for goods or for services, are entered in the Purchases Journal, the entries in that Journal being analysed to furnish the totals for posting to the Nominal and Real Accounts. Rule a Purchases Journal which would give the details required, enter the following invoices and show the totals under each heading:

1961			£
Jan.	1	Leek & Co.—raw materials	176
	4	Postmaster General—telephone	22
	8	Leigh & Co. Ltd.—raw materials	283
	15	Elecricity Board—light & power	157
		Luton Bros.—raw materials	530
		Ashby S.S. Co.—freight	126

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19	Melton & Son—carriage	53
	J. Mowbray—raw materials	510
31	Morpeth Ltd.—rent	300
	Road Services—carriage	58
	A. Malvern—printing	27
	Leek & Co.—raw materials	520

6. *The Cash Book of J. Carlisle as at 30th June, 1961, showed a balance at the bank of £509. 16. 8. On checking the Bank Statements, the following differences were discovered:

   (a) A cheque for £127. 9. 6. sent to Akeswick & Co. had not been presented for payment.

   (b) Cash Sales £362. 10. 4. paid into the bank on 30th June, 1961, had not been credited by the bank until 1st July.

   (c) Bank Charges amounting to £8. 8. 0. shown in the bank statement had not been entered in the Cash Book.

   (d) A cheque for £52. 13. 4. issued to Whitehaven & Co. was paid by the Bank on 15th June, 1961, but had been omitted from the Cash Book.

   (e) On 20th June, 1961, a cheque for £10. 10. 0. was received from A. Debtor and duly banked. On 25th June the bank returned the cheque marked "Refer to Drawer", but no record of the dishonour had been made in the Cash Book.

   Show the Cash Book with such amendments as are necessary, and prepare a reconciliation of the balance with that shown by the Bank Statement as at 30th June, 1961.

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CHAPTER 4

The Correction and Detection of Errors

Limitation of the Trial Balance

The Trial Balance has been described as a check on the arithmetical accuracy of our work. As such, it is invaluable. But it is not an infallible guide and some errors may have been made even though the Trial Balance balances. These can be summarised under certain headings.

1. *Errors of Original Entry*

   The Trial Balance is unaffected by an error made in the first entry of a transaction in the books if the corresponding debit or credit is the same figure, e.g. an entry of a sale of £66 in the Day Book as £60 will not be disclosed by the Trial Balance if £60 has been posted to the customer's account.

2. *Errors of Omission and Duplication*

   If the transaction is wholly omitted from the books the Trial Balance will not reveal the fact. Similarly, a complete duplication of an entry will not be disclosed.

3. *Compensating Errors*

   If we have made an error in one account and an equal and opposite error elsewhere, the Trial Balance can still balance. Such unfortunate coincidences do occur.

4. *Postings to Wrong Accounts.*

The Trial Balance checks that every debit has a corresponding credit. It does not confirm that the corresponding credit (or debit, if we make the alternative approach) is in the right account; e.g. a sale may be debited to B. Brown's account instead of to the account of A. Brown. By far the most important of such mis-postings are those where items have been posted to the wrong class of account—real instead of nominal etc., e.g. repairs to a motor vehicle debited to Motor Vehicles Account instead of Motor Expenses. These are sometimes called "errors of principle."

Suspense Accounts

Nevertheless, the Trial Balance does reveal many errors. If the totals do not agree, we must find the error(s). We may be lucky. On the other hand, it may be a long job. Frequently the Final Accounts are in preparation before the "out of balance" has been found. In those circumstances it is necessary to open a Suspense Account and enter there the amount needed to balance.

This sounds questionable practice! It appears that, if the accounts do not balance, we just make them do so. Certainly the amount we enter in the Suspense Account has no corresponding debit or credit. If it had, it would not help us to balance. The justification is that this is a temporary measure pending the finding of the errors. The only errors that can be left undiscovered are those of negligible amounts and even these ought not to be left until a considerable search has been made. The normal procedure is to open the Suspense Account with the amount out of balance and to close it as the error or errors are found and rectified.

EXAMPLE 19

When he tried to balance his books, J. Jacobs found that in the Trial Balance the debits exceeded the credits by £114. 13. 2.

Later he discovered that the Sales Day Book had been under-cast by £100 and that a balance of £14. 13. 2. had been omitted from the list of creditors. Give the Suspense Account.

Dr.				*Suspense Account*			*Cr.*
	£	s.	d.		£	s.	d.
To Sales	100	0	0	By Out of Balance	114	13	2
„ J. Booth's Balance omitted from list of Creditors	14	13	2				
	£114	13	2		£114	13	2

In this example only two errors are made but they differ in an important way.

(a) Error in Day Book. This led to an error in the Sales Account and a correction must be made in that account. The correction made through the Journal would appear:

Suspense a/c	Dr.	£100 0 0	
To Sales a/c			£100 0 0
Being error in Day Book Addition.			

(b) Error in List of Creditors. There was no mistake in the ledger; it was only in the extraction of the balances that the error was made. Consequently, no correction is needed in the ledger after the amendment of the list of balances. The Journal record would be:

Suspense a/c	Dr.	£14 13 2	
....			....
being omitted balance from list of creditors.			

The different errors require different correction, the one by Double Entry and the other by a Single Entry.

EXAMPLE 20

In looking for errors disclosed by the Trial Balance, J. Careless found the following:

(a) An addition in the Purchases Book was £100 too little.
(b) An item of £32. 14. 6. had been posted from the Sales Day Book to the account of J. Rose instead of the account of M. Rose.
(c) A balance of £61. 16. 4. had been omitted from Sundry Debtors.
(d) The last month's total of Discounts Received had not been posted to the Nominal Account. The total was £106. 14. 11.

Show the Suspense Account after the corrections have been made.

We are not given the amount by which the Trial Balance totals disagreed and have to compute the figure. The effect of the errors will be:

(a) Debit total £100 too little.
(b) No effect in the Trial Balance.
(c) Debit total £61. 16. 4. too little.
(d) Credit total £106. 14. 11. too little.

By addition and subtraction we find that the credit total must have exceeded the debit by £55. 1. 5. This becomes the opening entry in the Suspense Account.

Dr. *Suspense Account* *Cr.*

	£	s.	d.		£	s.	d.
To Out of Balance	55	1	5	By Purchases a/c	100	0	0
„ Discounts Received a/c	106	14	11	„ Balance omitted from Debtors	61	16	4
	£161	16	4		£161	16	4

Error (b) would be corrected by Journal entry:

M. Rose	Dr.	£32	14	6			
To J. Rose					£32	14	6
to correct misposting of Invoice No. ——							

Sub-divisions of the Ledger

In principle, there is one ledger for each business and it comprises all the accounts including cash and bank. In practice it is necessary to have separate ledgers, the basic sub-divisions being:

1. Sales Ledger for the personal accounts of customers,
2. Purchases (or Bought) Ledger for suppliers' accounts,
3. Impersonal (or Nominal) Ledger for other accounts.

There is sometimes, in addition, a Private Ledger for accounts which the proprietor wishes to keep hidden from his staff. The Capital Account, Real Accounts and one or two nominal accounts may be considered confidential in this way.

The division is often carried further as many businesses have too many customers for one Sales Ledger and so it is divided, usually on an alphabetical or geographical basis. Thus we may have:

1.	Sales Ledger	A—B
2.	,, ,,	C—G

and so on.

Such divisions are, perhaps, less common than they used to be as accounts are frequently kept on cards instead of in books.

Control Accounts

When a Trial Balance discloses an error the search must cover every division of the ledger and also the books of original entry. It is a wide field and sometimes one is reminded of the proverbial needle in the haystack. The work involved can be considerably reduced if we can be certain that the error is not in particular sections, e.g. if we can prove that the Sales Ledger and Sales Journal are correct. Control Accounts are the tool we use to this end. An alternative name is "Total Accounts" and this is useful in describing their preparation.

Basically, there are two Control Accounts: the Sales Ledger and Bought Ledger Accounts. The principle is simple. Everything that is debited in individual accounts of the Sales Ledger is debited in total in the Sales Ledger Control Account. Similarly all individual credits in the Sales Ledger are included in totals credited in the Control Account. It follows that the balance on the Control Account must equal the total of balances in the Sales Ledger, e.g.

Sales Ledger Accounts

Dr.			*J. Booth*				*Cr.*
1962			£	1962			£
June	1	To Balances b/f	410	June	1	By Returns	62
	6	,, Sales	360		5	,, Bank	390
						,, Discount	20
					30	,, Balance c/d	298
			£770				£770
July	1	To Balance b/d	298				

Dr.			*R. Mace*				*Cr.*
1962			£	1962			£
June	1	To Balance b/f	84	June	6	To Bank	80
	20	,, Sales	326			,, Discount	4
	28	,, ,,	164		28	,, Bank	300
						,, Discount	26
					30	,, Returns	34
						,, Balance c/d	130
			£574				£574
July	1	To Balance b/d	130				

Dr.			*R. Weekes*				*Cr.*
1962			£	1962			£
June	16	To Sales	320	June	20	To Bank	260
					30	,, Bad Debt	60
			£320				£320

Dr. *Sales Ledger Control Account* *Cr.*

1962		£	1962		£
June 1	To Balance b/d	494	June 30	To Returns	96
30	„ Sales	1,170		„ Bank	1,030
				„ Discount	50
				„ Bad Debts	60
				„ Balance c/d	428
		£1,664			£1,664
July 1	To Balance b/d	428			

The closing balance on the Control Account equals the total of the closing balances on the accounts of J. Booth and R. Mace. This illustrates the principle of a Control Account but it is inadequate for two reasons:

1. The value of such accounts is derived from the large number of transactions. Short examples cannot convey the "point" and usefulness of Control Accounts.
2. The items in the Control Account were found by the addition of the individual items in the personal accounts. In practice this would be a hopeless task and would severely limit the value of the account. Instead we get:

    1. The Sales and Returns totals from the Sales and Returns Books,
    2. The Bank and Discount totals from the Cash Book,
    3. Bad debts and other non-routine items from the Journal.

This not only facilitates the preparation of the Control Accounts, it widens their value. Thus, if the total of Sales Ledger balances equals the balance on the Sales Ledger Control Account, the arithmetical accuracy (excepting compensating errors) of the work in the Sales Ledger, Sales Day Book, Returns Book and the "Received" Side of the Cash Book is proved.

This discussion of the Sales Ledger Control is, with the obvious modifications, applicable to the Bought Ledger. Totals from the Purchases and Returns Books and the Cash Books are entered in the Bought Ledger Control on the same side as they have been posted in the individual Bought Ledger Accounts.

Before considering a more complicated example, two further points must be noted:

(a) In the Sales Ledger we normally deal with cash received. Occasionally, however, we have an item of cash paid. After he has settled his account, a customer may find that the goods he has received are defective in some way. He returns them or is given an allowance. Although he is a customer he becomes a creditor and we may settle the balance by the payment of a cheque. Arising from similar reasons we may have a few (probably small) credit balances in the Sales Ledger. If, after settling an account, we return goods or receive an allowance, debit balances or items of cash received will appear in the Bought Ledger.

(b) Sometimes a customer is also a supplier and he then has an account in both the Sales and Bought Ledger. Frequently, there will be transfers between the two, e.g.

Bought Ledger Account

A. Moses

Dr.					*Cr.*
1961		£	1961		£
Mar. 31	To Transfer from S.L. A/c	500	Mar. 12	By Purchases	500

Sales Ledger Account

A. Moses

Dr.					*Cr.*
1961		£	1961		£
Mar. 20	To Sales	600	Mar. 31	By Cash	100
				,, Transfer from B.L. A/c	500
		£600			£600

As everything that is entered in individual accounts must be included in the Control Accounts, the total of such transfers will appear in both the Sales Ledger and Bought Ledger Control Accounts.

EXAMPLE 21

From the following information prepare the Sales Ledger Control Account for the month of September 1961.

	£
Debit Balances at 1st September, 1961	1,604
Credit Balance " " " "	46
Sales	2,406
Sales Returns	189
Cash Received	1,960
Discount Allowed	104
Cash Paid to Customers	62
Interest charged on Overdue Account	10
Bad Debt	89
Contra Account Transfers	210
Credit Balances at 30th September, 1961	24
Stock at 30th September	1,019

Dr. *Sales Ledger Control Account* *Cr.*

1961		£			£
Sept. 1	To Balances b/f	1,604	Sept. 1	By Balances b/f	46
30	" Sales	2,406	30	" Sales Returns	189
	" Cash paid	62		" Cash received	1,960
	" Interest	10		" Discount Allowed	104
	" Balances c/d	24		" Bad Debt	89
				" Contra A/c	210
				" Balances c/d	1,508
		£4,106			£4,106
Oct. 1	To Balances b/d	1,508	Oct. 1	By Balances b/d	24

Note: We ignore the Stock figure as this has no place in the Control Account.

There are three possible ways in which the Control Accounts can be related to the Double Entry framework:

1. The Control Account is a supplementary record outside the Double Entry system. This is probably the simplest, commonest and best arrangement.
2. The Control, or better, the Total Account is part of the Double Entry, the individual accounts being memorandum records outside the Double Entry system. In a school, for example, it may be preferable to have one account for Students in the Double Entry books and supplementary records of the accounts of individual students. The same method can be adopted in business for personal accounts.
3. Somewhat artificially, both the individual accounts and the Control Account are kept within one Double Entry framework. This is achieved by repetition of the Control Accounts as follows:

   (a) In the General Ledger are kept the Bought Ledger and Sales Ledger Control Accounts as already described.
   (b) In the Bought Ledger is kept a General Ledger Control Account which is identical to the Bought Ledger Control Account with debits and credits reversed.
   (c) In the Sales Ledger is kept another General Ledger Control Account identical to the Sales Ledger Control Account with debits and credits reversed.

Thus, the balances of the four accounts cancel each other out. It is from this system that the term 'Self Balancing Ledgers' is derived. Including the General Ledger Control Accounts, the balances in both the Sales Ledger and Bought Ledger amount to equal debit and credit totals. The system has already been described as artificial but it may have convenience in the arrangement of work between different clerks in an office.

On the same lines, Control Accounts may be prepared for subdivisions of the Sales or Bought Ledgers. For example we can have,

Sales Ledger (A—B) Control Account.

These are based on the same principles but more work is needed to collect the necessary data. Analysis columns must be used in the Sales, Returns and Cash Books. Thus the Cash Received will be ruled:

Date	Details	Folio	Discount	Cash	Bank	A–B	C–G	H–K	L–Q	R–Z

Control Accounts are a very useful tool in the location of errors but this does not exhaust their usefulness, Sectional Balancing makes fraud more difficult as the manipulation of the figures must be performed wholly within one section of the business. The possibility of innocent compensating errors is likewise reduced as the chance that they will occur within one section is obviously smaller than the chance that they will occur within the business as a whole.

More positively, if the accountant is preparing a Balance Sheet for internal use, speed of preparation is vital. To take out a list of individual debtors and creditors is a time consuming task and delay can be avoided by the use of the balances from the two Control Accounts. Such figures, will, of course, be subject to later verification by the extraction of the balances from the Sales and Bought Ledgers.

The Private Ledger Control Account. The purpose of this account is somewhat different from that of the other Control Accounts. The object of the use of a Private Ledger is privacy; certain accounts are kept away from the general office staff. But the staff need the balances from the Private Ledger in order to prepare a Trial Balance. The balance on the Private Ledger Control Account is always the net difference between the debit and credit balances in the Private Ledger and thus, with this balance, an abbreviated Trial Balance is possible.

In addition, items from the Cash Book or Journal are entered in the Private Ledger Control Account prior to their posting in the Private Ledger. At regular intervals, the proprietor or the accountant occupying a confidential post, will transfer these items to the proper accounts. In doing so he closes the Control Account re-opening it with the new balance as described above. The following illustration shows the link between the Control Account and the Private Ledger.

IN GENERAL LEDGER.

Dr.		*Private Ledger Control Account*			*Cr.*
1961		£	1961		£
Jan. 16	To Bank R. Booth	100	Jan. 1	By Balance	1,684
Mar. 31	„ „	300	June 30	„ Bank-Credit Total	9,326
June 30	„ „	500		„ Interest A/c	20
	„ „ R. Booth	20		„ Transfer to Private Ledger	286
	„ Bank-Debit Total	10,396			
		£11,316			£11,316
			July 1	By Balance	1,539

IN PRIVATE LEDGER.

Dr.		*Capital Account*			*Cr.*
1961		£	1961		£
Mar. 31	To Bank	300	Jan. 1	By Balance b/f	6,160
June 30	„ „	500	June 30	„ Net Profit	1,610
	„ Balance c/d	6,970			
		£7,770			£7,770
			July 1	By Balance b/d	6,970

Dr.		*Bank Account*			*Cr.*
1961		£	1961		£
Jan. 1	To Balance b/f	3,920	June 30	By Cash Book Total	9,326
June 30	„ Cash Book Total	10,396		„ Balance c/d	4,990
		£14,316			£14,316
July 1	To Balance b/d	4,990			

Stock Account

Dr.					Cr.
1961		£	1961		£
Jan. 1	To Balance b/f	1,456	June 30	By Trading A/c	1,456
June 30	To Trading A/c	1,241			

Loan Account—R. Booth

Dr.					Cr.
1961		£	1961		£
Jan. 16	To Bank	100	Jan. 1	By Balance b/f	900
June 30	„ Bank	20	June 30	„ Interest	20
	„ Balance c/d	800			
		£920			£920
			July 1	By Balance b/d	800

The new balance on the Control Account is made up as follows:

	£	£
Capital		6,970
Loan		800
		7,770
Less Stock	1,241	
Bank	4,990	6,231
		£1,539

The difficulty about the balance on the Private Ledger Control Account is that it is not "brought down" on the account. It seems to come from nowhere. In fact, at each ruling off, the balance is calculated anew from the Private Ledger itself.

In the above example, only four accounts are kept in the Private Ledger. In practice, the number and nature of such accounts varies greatly: Fixed Asset accounts are often kept in the Private Ledger. On the other hand, the Bank Account is often not considered private and balances are carried forward in the Cash Book in accordance with normal practice.

QUESTIONS 4

1. *The following totals are taken from the books of Dover and Dudley:

1962		£
Jan. 1	Credit Balances in Purchases Ledger	5,926
	,, ,, ,, Sales Ledger	134
	Debit Balances in Purchases Ledger	56
	,, ,, ,, Sales Ledger	10,268
Dec. 31	Sales	71,504
	Purchases	47,713
	Cash received from customers	69,872
	Cash paid to Creditors	47,028
	Sales Ledger Balances written off as bad	96
	Sales Returns and Allowances	358
	Purchases Returns and Allowances	202
	Discounts Allowed	1,435
	Discounts Received	867
	Purchase Ledger Credits transferred to Sales Ledger	75
	Legal Expenses charged to Customers	28
	Credit Balances in Sales Ledger	101
	Debit Balances in Purchases Ledger	67

Prepare separate Purchases Ledger and Sales Ledger Control Accounts as they would appear in the General Ledger of the firm, showing the balances carried forward to the following year.

2. *The following figures have been taken from the books of a trader for the year to 31st December, 1962.

	£
Sales Ledger debit balances 1 Jan., 1962	4,200
Sales	78,450
Cash Received from Debtors for Goods	75,780
Bad Debts written off	930
Provision for Bad Debts, 1 Jan., 1962	210
,, ,, ,, ,, 31 Dec., 1962	250
Discounts Allowed	1,430
Discounts Received	1,090
Returns Inwards	970
Returns Outward	840
A balance on a Sales Ledger Account set off against a balance on a Bought Ledger Account in the name of the same person	120
Cash paid in settlement of a credit balance on a Sales Ledger Account	80
Sales Ledger Credit Balances 31 Dec. 1962	130

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All sales were entered in Personal Accounts. Using the relevant figures prepare the Sales Ledger Control Account for the year to 31st December, 1962.

3. *In the books of Dundee & Co. is an account for J. Blythe in both the Bought and Sales Ledgers.

   On 28th February, 1962, the Bought Ledger Account showed a credit balance of £260 and the Sales Ledger Account was closed. During the month of March, 1962, the following transactions took place:

   March 4 Sold goods on credit to Blythe for £285.
   10 Purchased goods on credit from Blythe for £75.
   12 Paid Blythe the balance due to him on the 1st day of the month less $2\frac{1}{2}\%$ cash discount, by cheque.
   17 Blythe returned goods and Dundee & Co. issued a credit note for £15.
   20 Sold goods on credit to Blythe for £290.
   24 Purchased goods on credit from Blythe for £120, less a trade discount of 10%.
   26 One-half of the goods purchased on the 24th were returned to Blythe and an allowance of the cost of such goods was made by Blythe.

   Complete the accounts of J. Blythe in the books of Dundee & Co. showing on ONE account the net balance outstanding at the end of the month.

4. *When the Trial Balance of Oxford & Co. was prepared, it was found that the total of the credit side exceeded that of the debit side by £1,061 and a Suspense Account was opened with this amount.

   On checking the records, it was found that:

   (1) A debit balance of £520 on Rent Account had been entered on the credit side of the trial balance.
   (2) The Sales Account was over-cast by £10.
   (3) An invoice of £60 in respect of goods purchased from J. Williams had been credited to the account of J. Williamson.
   (4) The purchase of a motor truck for £647 had been correctly entered in the Cash Book but had been posted to the Motor Truck Account as £674.
   (5) A balance of £38 due from C. Cambridge had been omitted from the trial balance.
   (6) Goods to the value of £40 returned by D. Durham were not entered in the Returns Inwards Book but had been included in the stock on hand.

   Write up the Suspense Account showing how it would be affected, if at all, by these errors.

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5. Prepare a Trading and Profit & Loss Account for the year ending 31st December, 1960 and a Balance Sheet as at that date from the following Trial Balance and supplementary information:

	£	£
Sales		15,660
Purchases	6,900	
Stock	3,100	
Discounts	940	160
Wages	1,140	
Rent, Rates and Insurance	632	
Bad Debts	160	
Provision for Bad Debts		420
General Expenses	202	
Premises	2,000	
Motor Vehicle	1,620	
Debtors	3,600	
Creditors		920
Drawings — A. Johnson	600	
Cash	496	
Suspense Account	3,770	
Capital — A. Johnson		8,000
	£25,160	£25,160

(a) After a little further work, the errors necessitating the Suspense Account were found. They were:
   1. The balance of £800 for Fixtures and Fittings had been omitted from the Trial Balance.
   2. An addition in the Purchases Book was £3,000 too little.
   3. A mis-posting to General Expenses Account.

(b) Provide for Depreciation at the following rates:

Premises	2% p.a.
Fixtures & Fittings	5% p.a.
Motor Vehicle	20% p.a.

(c) The provision for Bad Debts is to be reduced to 5% of Sundry Debtors.

(d) Allow for the prepayments:

Rates	£30
Insurance	£62.

(e) No Motor Expenses appear in the Trial Balance. It appears that purchases of petrol have been included with general purchases. The total amount is £120. Other Motor Expenses have been paid by A. Johnson, who estimates the amount as £50.

(f) During the year Johnson has taken goods for personal consumption. The cost of those goods was £160.

(g) The closing stock was valued at £2,800.

CHAPTER 5

Miscellaneous Accounts (1)

Bills of Exchange

A Bill of Exchange is a written order to pay a given sum of money at a stated time. The person preparing the Bill and making the order is called the DRAWER. The person to whom the Bill is addressed is the DRAWEE. The person to whom payment is to be made is the PAYEE. Naturally enough, the Drawee is not liable just because the Bill has been addressed to him. He assumes liability by signifying his acceptance on the face of the Bill; so doing, he becomes the ACCEPTOR.

The most common Bills of Exchange are cheques. A cheque is an order to a banker to pay money. The distinctive features of cheques are

(a) that they are drawn on a banker, and
(b) that they are payable on demand.

Formal acceptance is dispensed with. Other Bills may order payment "on demand" or payment at some specified time in the future. Opposite is a specimen form of a Bill ordering payment in the future:

S. Green is both drawer and payee, G. Smith drawee and acceptor. For S. Green, it is a Bill Receivable and for G. Smith it is a Bill payable.

The advantages to be derived from the use of Bills are:

1. The date for payment is specified. Failure to discharge a Bill on the due date is much more damaging to a person's reputation than postponing payment of a credit account.

Manchester
6th January 1962

2d Stamp

To G. Smith

Three months after date pay to me or my order the sum of six hundred pounds, value received

£600. 0. 0.

S. Green

(Note, for bills payable at specified future dates, three extra "days of grace" are allowed before payment is actually to be made. The Bill illustrated is payable on 9th April.)

2. The rights of the creditor may be passed to a third party. If the Bill is not payable to bearer, it requires endorsement on such a transfer. A person holding a Bill endorses it by signing on the back. A common practice is to endorse a Bill in favour of a Bank. The Bank pays the amount of the Bill less discount and collects the full sum payable when the Bill matures. The process is known as "discounting" the Bill.
3. Should legal action be required on the bill, the debtor is indeed "liable on the bill." The holder is not bound to provide evidence regarding any previous contract of sale or other indebtedness. The debtor must prove some defect in the bill itself to avoid his liability.

Bills have been found extremely useful in overseas trade. Frequently, documents of title to goods exported are attached to a bill and are to be handed over only "on acceptance" or even "on payment."

Another special type of Bill is the accommodation bill. A bill is accepted by a drawee even though he is not indebted to the drawer. The purpose is to allow the drawer to "discount" the bill and obtain liquid funds. The acceptor has not received value for the Bill but is liable to any holder. The drawer must, however, provide him with the funds required to meet the Bill at its due date. In effect, the acceptor "guarantees" a loan to the principal debtor.

Accounting for Bills Receivable

A person receiving a Bill in settlement of a debt owing to him exchanges one asset for another (the Debt for the Bill). Later, when he receives the due amount of the Bill, he again exchanges assets (the Bill for Cash). The following Journal entries record these exchanges:

				£	£
1962					
January	6	Bill Receivable	Dr.	600	
		To G. Smith			600
		being 3 months acceptance of this date.			
April	9	Bank	Dr.	600	
		To Bills Receivable			600
		being payment of Bill by G. Smith.			

The second exchange of assets may take place earlier if the Bill is discounted. The entry would be:

				£	£
1962					
January	9	Bank	Dr.	591	
		Discount		9	
		To Bills Receivable			600
		being Bill accepted by G. Smith discounted at 6% p.a. for 3 months.			

No further entry is required when Smith pays the bank.

If the Bill is dishonoured on maturity, the entries required are:

(a) if the Bill has not been discounted:

Debit Debtor, *Credit* Bills Receivable, with the amount of the bill.

This restores the accounting situation existing before the Bill was given; the legal situation, as explained, is different.

(b) if the Bill has been discounted:

Debit Debtor, *Credit* Bank with the amount of the Bill.

The holder of a Bill is involved in certain expenses when the Bill is dishonoured. These must be charged to the principal debtor. The new balance due may be settled by the issue of a new bill or by cash.

Accounting for Bills Payable

The acceptance of a Bill involves the exchange of one liability (a Creditor) for another (the Bill). Payment involves the elimination of the new liability by a reduction of an asset (Cash at bank). The entries are:

				£	£
1961					
January	6	S. Green	Dr.	600	
		To Bills Payable			600
		being acceptance of 3 months bill.			
April	9	Bills Payable	Dr.	600	
		To Bank			600
		being payment of Bill drawn by S. Green			

EXAMPLE 22

On 1st January, 1961, G. Goose owes the sum of £800 to D. Duck and is owed £1,200 by C. Chick. He accepts a 3 months draft in settlement of D. Duck's account. Duck immediately discounts the bill with his banker at 6% p.a. Chick accepts a two months bill for £600 and a six months bill for the same amount. Goose immediately discounts these bills with his banker at 6% p.a. The first is dishonoured and the bank debits Goose with the amount of the Bill plus £2 expenses. Chick agrees to substitute a four months bill for £620 and pays both outstanding bills at their due dates.

Record these transactions in the books of G. Goose.

Dr. *D. Duck* *Cr.*

1961			£	1961			£
Jan.	1	To Bill Payable	800	Jan.	1	By Balance b/f	800

Dr. *C. Chick* *Cr.*

1961			£	1961			£
Jan	1	To Balance b/f	1,200	Jan.	1	By Bill Receivable	600
						" " "	600
			£1,200				£1,200
Mar.	4	To Bank— Dishonoured Bill	600	Mar.	4	By Bill Receivable	620
		" Bank Expenses	2				
		" Interest	18				
			£620				£620

Dr. *Bills Payable* *Cr.*

1961			£	1961			£
Apl.	4	To Bank	800	Jan.	1	By D. Duck	800

Dr. *Bills Receivable* *Cr.*

1961			£	1961			£
Jan.	1	To V. Chick	600	Jan.	1	By Bank	600
		" "	600			" "	600
			£1,200				£1,200
1961			£				£
Mar.	4	To C. Chick	620	July	7	By Bank	620

Dr. *Bank Account (extracts)* *Cr.*

1961			£	1961			£
Jan.	1	To Bills Receivable	600	Jan.	1	By Discount on Bill	6
		" " "	600			" " "	18
July	7	" " "	620	Mar.	4	" C. Chick, Bill Dishonoured	600
						" C. Chick, Expenses	2
				Apr.	4	" Bill Payable	800

Dr.			Discount Account			Cr.
1961			£	1961		£
Jan.	1	To Bank	6	Dec.31	By P. & L. A/c	24
		,, ,,	18			
			£24			£24

Dr.		Interest Account			Cr.
1961		£	1961		£
Dec. 31	To P. & L. A/c	18	Mar. 4	By C. Chick	18

Notes:

1. No entry is required in the books of Goose when Duck discounts the bill with his bankers.
2. When Chick pays the six months bill, no entry is made in the books of Goose because he has already discounted the bill with his bankers.

If, in a particular business, the number of Bill transactions is large, it is possible to have specially ruled subsidiary books. These do not affect the double entry principles elaborated above.

The Bill Books:

1. Reduce the number of entries in the Bills Receivable and Bills Payable accounts. Periodic totals are posted.
2. Provide a convenient record of the details of Bills received or accepted.

Contingent Liabilities

Balance Sheets often contain statements of liabilities for which the business will become liable if certain contingencies occur. One of the commonest examples is "Bills Discounted not yet matured." The acceptors are primarily liable on the bills but, should they default, the endorser is liable to repay the bank. Having discounted a Bill with his banker, the man knows that he may become liable on the bill if the principal debtor fails to pay.

Consignment Accounts

These relate to the form of trading whereby a merchant sends goods to an agent abroad who is to sell them and remit the proceeds after deducting expenses and commission. Special accounting is required because the goods are not sold to the agent or consignee. They remain the property of the consignor until the agent succeeds in selling them.

We have to consider two sets of accounts; those of the merchant for Consignments Outwards and those of the agent for Consignments Inwards.

Consignments Outwards

In the consignor's books, the object is to determine the net profit or loss on each particular consignment. The Consignment Account serves as a Profit and Loss Account for the one consignment. It is debited with the cost of the goods and with all expenses incurred. It is credited with all the proceeds. The balance, profit or loss, is transferred to the general Profit & Loss Account.

The account for the agent is a personal account. No entry is made in it when the goods are consigned as the agent does not purchase them. When he has sold part or all of the goods, he renders an "Account Sales." This gives the proceeds of sale and details of expenses incurred. It forms the basis for the accounting entries. The agent is debited with the proceeds of sale and credited with the expenses incurred on behalf of the consignor. Corresponding entries are made in the Consignment Account. The agent is also credited with his commission or commissions (he may be entitled to an extra "del credere" commission if he guarantees the consignor against bad debts). The balance on the agent's account is, of course, a debt owing to the consignor. The account balances when the remittance is received.

A third special account is often opened. This is the "Goods on Consignment Account." The cost of the goods debited to the Consignment Account is credited here. However, its existence is only justified if there are several consignments. The cost of the goods consigned must be extracted from Purchases Account. As these goods are the subject of a separate profit calculation, they must not be charged in the general Trading Account. If such consignments are infrequent, the cost can be credited directly to Purchases Account. If they are frequent, the cost of the various consignments is collected together in a "Goods on Consignment Account" and the total transferred to the credit of Purchases Account.

Sometimes a consignment has not been completely sold at the date to which a general Profit & Loss Account is to be prepared. In those circumstances, a figure for stock must be carried down on the Consignment Account. The valuation of the stock includes not only the cost of the goods but also a proportion of the expenses incurred in connection with the whole consignment.

EXAMPLE 23

On 1st October, 1960, G. Adams & Co. consign 100 cases of goods costing £6,000 to their agent D. Atkins in New Zealand.

G. Adams & Co. pay the following expenses:

Freight, £140; Insurance, £70; In New Zealand, D. Atkins pays Customs Duty of £1,000 and Landing Charges of £40.

On 20th December, G. Adams & Co. receive an Account Sales reporting the sale of 40 cases at £95 each. The amount due after deduction of 5% commission and $1\frac{1}{2}$% "del credere" commission is remitted by a draft accompanying the Account Sales.

Give the accounts in the books of G. Adams & Co. as at 31st December, 1960.

Dr. *Consignment to D. Atkins* *Cr.*

1960			£	1960			£
Oct.	1	To Goods (100 cases)	6,000	Dec.	20	By Atkins—Sale (40 cases)	3,800
		„ Cash—Freight	140				
		„ „ Insurance	70		31	„ Stock c/d	4,350
Dec.	20	„ Atkins—Duty	1,000				
		„ „ Landing Charges	40				
		„ „ Commission	190				
		„ „ Del Credere Commission	57				
	31	„ Profit & Loss Account	653				
			£8,150				£8,150
1961							
Jan.	1	To Stock b/d	4,350				

Dr. *D. Atkins* *Cr.*

1960			£	1960			£
Dec.	20	To Consignment a/c Sale	3,800	Dec.	20	By Consignment a/c Duty	1,000
						Landing Charges	40
						Commission	190
						„ Del Credere	57
						„ Bank	2,513
			£3,800				£3,800

Dr. *Goods on Consignment Account* *Cr*

1960			£	1960			£
Dec.	31	To Purchases	6,000	Oct.	1	By Consignment to D. Atkins	6,000

The Stock is valued at 60% of the total costs incurred:

Goods	6,000
Freight & Insurance	210
Duty & Landing Charges	1,040
	7,250

60% of this total is £4,350.

The percentage is determined by the proportion of the total consignment still unsold.

Consignments Inwards

The agent's records are simpler. No entry is made in his ledger when the goods are received. Expenses incurred are debited to a Consignment Account. When the goods are sold the proceeds are credited to this account. Entries for commission and the remittance close the account. The credit on Commission Account represents income to be transferred to Profit & Loss Account.

EXAMPLE 24

Give the accounts of the Consignment from G. Adams & Co. in the books of D. Atkins (previous example).

Dr. *Consignment from G. Adams & Co.* *Cr.*

	£		£
To Cash—Duty	1,000	By A. Purchaser	3,800
,, ,, Landing Charges	40		
,, Commission Account	247		
,, Bank	2,513		
	£3,800		£3,800

Dr. *Commission Account* *Cr.*

To Profit & Loss A/c	£247	By Consignment from G. Adams & Co.	£247

Joint Ventures

Two parties may agree to join together in one particular business venture with no intention of a permanent arrangement of partnership. Typical ventures are the purchase, conversion and sale of property, the purchase and sale of a consignment of merchandise or dealings in stocks and shares. The parties may agree to share profits and losses in any particular ratio. In the absence of any contrary agreement, they will be shared equally.

If the Venture is sufficiently large to justify a special set of account books and a separate bank account, no problems arise. But the records are frequently kept in the accounts of the two parties, each party recording only the transactions in which he has been directly concerned. The complete history of the joint venture is thus not to be found in any one set of books. Both contain partial records. A Memorandum Account for the venture as a whole is necessary in order to determine the profit or loss.

A Joint Venture Account is opened in the ledgers of both parties. Each party records in this account his receipts and payments on behalf of the venture. He debits the account with a share of the profit (or credits it with a share of the loss). The balance then represents a debt owing to or from the other party.

EXAMPLE 25

Jervis and Read agree to share the profit or loss of a certain venture in the ratio 2:1. Jervis borrows £4,000 from his bank and purchases with that sum a building suitable for conversion into offices. Read supervises the conversion and meets the following expenses:

Architects Fees	£200
Labour	£730
Materials	£420

It is agreed that Bank Interest of £284 paid by Jervis is to be charged to the venture. For a time the property is let and Read receives rents of £560. Finally, the property is sold for £7,600, the money being paid to Jervis. He pays Read the amount due to him.

Give the memorandum Joint Venture Account and the accounts in the ledgers of Jervis and Read.

Memorandum Joint Venture Account

Dr.		£		*Cr.* £
To Purchase of Building		4,000	By Rent	560
,, Architect's Fees		200	,, Sale	7,600
,, Labour		730		
,, Materials		420		
,, Bank Interest		284		
Profit				
Jervis	1,684			
Read	842	2,526		
		£8,160		£8,160

IN LEDGER OF JERVIS

Dr. *Joint Venture with Read* *Cr.*

	£		£
To Bank—Purchase of Building	4,000	By Bank—Sale	7,600
„ Bank Interest	284		
„ Profit & Loss Account—Share of Profit	1,684		
„ Bank—Read	1,632		
	£7,600		£7,600

IN LEDGER OF READ

Dr. *Joint Venture with Jervis* *Cr.*

	£		£
To Bank—Architect's Fees	200	By Bank—Rent	560
„ Cash—Wages	730	„ „ —Jervis	1,632
„ Bank Materials	420		
„ Profit & Loss Account—Share of Profit	842		
	£2,192		£2,192

QUESTIONS 5

1.* On 1st July, 1962, Williams owes Dixon £1,200 and immediately accepts three bills of £400 each due respectively in one, two and four months. The first bill is retained by Dixon and is met in due course; the second is discounted (charges £4) and is met in due course; the third is also discounted (charges £2) and is dishonoured; the notarial charges are 10/-.

New arrangements are immediately made whereby Williams pays cash of £100 and accepts a bill due in two months for the balance of the account with interest at 6 per cent per annum. The bill is retained by Dixon until maturity. On being presented the bill is dishonoured; the notarial charges being 5/-. Williams is shortly afterwards made bankrupt, his trustee paying a first and final dividend of 5/- in the £.

Prepare the Ledger Accounts in Dixon's books.

2. On 1st January, 1961, Barlow and Ring enter into an agreement to provide liquid funds.
   (1) Barlow accepts a 3 months bill payable to Ring for £1,000.
   (2) Ring pays £300 to Barlow and accepts a 6 months Bill for £700 payable to Barlow.

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Both immediately discount the bills with their bankers. The discount charged to Barlow is £16 and to Ring £18.

Barlow pays his bill on the due date but Ring is unable to do so. He arranges for a friend, Wells, to pay the amount to the banker. He accepts a three months draft payable to Wells for £720, and Wells immediately discounts this bill. On the due date, Ring honours the bill.

Give the accounts in the books of Barlow and those of Ring.

3. †On 1st October, 1961, Marten consigned goods to the value of £10,000 to Stevens, incurring expenses for freight and insurance of £600. An Account Sales was received from Stevens, who is entitled to a commission of 5% on gross sales, made up to 31st December, 1961, the end of Marten's accounting year, which showed that:

   1. 60% of the goods had been sold for £8,000, but only £6,500 had so far been received.
   2. Expenses of £300 had been incurred in connection with the goods consigned and £200 in connection with the goods sold.

   On 15th January, 1962, Marten incurred bank charges of £10 in cashing the sight draft for the balance due, which accompanied the Account Sales from Stevens.

   A further Account Sales was received, made up to 31st March, 1962, which showed that:

   1. The balance of the goods had been sold for £5,500 and Selling Expenses of £150 had been incurred.
   2. All cash due had been received, except that a bad debt of £100 had been incurred.

   On 15th April, 1962, Marten incurred bank charges of £8 in cashing the sight draft for the balance due, which accompanied the Account Sales from Stevens.

   Write up the accounts in the books of Marten necessary to reflect the above transactions.

4. ‡Duke and Lord entered into a joint venture to buy and sell second-hand cars. Profits and losses were to be shared: Duke two-thirds and Lord one-third.

   On 16th August, 1962, Duke purchased two cars for £320 and £480 respectively. He incurred expenditure of £120 on repairs and on 1st September, sold one of the cars for £400 and on 10th September the other car for £620.

   On 12th September, 1962, he purchased a further car for £600 which was sold on 20th September for £800, which amount was paid to Lord who paid it into his own bank account.

†Re-printed by courtesy of the Society of Incorporated Accountants (S.A.A.).

‡Re-printed by courtesy of the Institute of Chartered Accountants (C.A.).

On 12th August, 1962, Lord purchased a car for £400 which he sold for £500 on 15th August, having incurred expenses of £40 on it. This car was returned by the customer on 20th August; he was allowed £480 for it. As this car was still unsold on 30th September, 1962, it was agreed it should be taken over by Duke at a valuation of £450.

On 30th September, 1962, the sum required in full settlement as between Duke and Lord was paid by the party accountable.

You are required to prepare:

(a) The Joint Venture Account as it would appear in the books of Duke recording his transactions with the joint venture, and

(b) A Memorandum Account for the Joint Venture, showing the net profit.

CHAPTER 6

Receipts & Payments and Income & Expenditure Accounts

So far, our attention has been given to the accounting for businesses carried on with the intention of making profit. Many organisations (clubs, societies, churches and schools) exist to achieve other objectives. Such organisations are classified as "non profit-making." That does not mean that they never make profits. The classification is one of intent: the primary purpose of such organisations is not the making of profit.

Accounts are still necessary. The treasurer must be able to give a report of his stewardship. It is necessary to know whether income has been adequate to meet expenditure. A Society that does not exist "to make profit" will cease to exist if it makes continual losses.

The Report of Stewardship is frequently given in the form of a Receipts and Payments Account. This is simply a summary of the Cash Book. It begins with the opening balances, and ends with the closing balances, of cash in hand and at the Bank. e.g.

Dr. Receipts and Payments Account for the year to 31st December, 1960 Cr.

		£			£
To Balances 1st January, 1960			By Secretarial Expenses		40
Cash in Hand	4		,, Cost of Issues of		
Cash at Bank	160	164	Newsletter		58
,, Subscriptions		342	,, Cost of Annual Dinner		140
,, Donations		100	,, Repayment of Loan		
,, Entrance Fees		15	,, from G. Brown		200
			Balances 31 Dec. 1960		
			Cash in Hand	6	
			Cash at Bank	177	183
		£621			£621

The Receipts and Payments Account has the virtue of simplicity. For a small society possessing little in the way of equipment or property, it is adequate. For other organisations, it is grossly inadequate and an Income and Expenditure Account is required.

The Receipts and Payments Account is inadequate for the following reasons:

1. No account is taken of prepayments and accruals. Payments made during a year may relate to debts actually incurred in a previous year or may relate to the future. How important this can be is seen by a consideration of the effect on the Receipts and Payments Account of the treasurer postponing payment of a heavy bill until after the end of the year. An unhealthy financial position can be hidden from members in that way.
2. The receipts for a particular year may include subscriptions owing in the past or prepaid for the future. The amount actually due from members for the current year is not given on the Receipts and Payments Account.
3. No distinction is made between capital and revenue items. Thus cash resources may be reduced considerably during a year not because of a deficiency of income but because of heavy expenditure on semi-permanent equipment or property. Conversely, the cash balances may have increased not because of the adequacy of income but because the organisation has negotiated a loan during the year.

The Income and Expenditure Account is, in fact, a Profit & Loss Account of a non-profit making concern. Perhaps it would be more accurate to use the term Revenue Account as the overall description. Thus, we have Revenue Accounts

(a) for Profit-making Businesses—Profit & Loss Accounts.
(b) for Non profit-making Concerns—Income & Expenditure Accounts.

As its name suggests, the latter is a comparison of income with expenditure. The income for a particular period is compared with the expenditure which can fairly be charged to that period. Capital expenditure as such is excluded. It is charged over the life of the assets as depreciation.

The Balance Sheet is complementary to the Income and Expenditure Account. In principle it is the same as the Balance Sheet of a trading concern. The one basic difference is the absence of a Capital Account. A club or society rarely commences with capital. Necessary funds may be borrowed but then the loan appears on the Balance Sheet as a liability. However, there is often an accumulation of a capital fund in the form of surpluses of annual income. The name given to this account varies. It may be the "Accumulated Fund" or simply "Surplus."

EXAMPLE 26

The following Receipts and Payments Account is for the Azaro Musical Society. At 1st January, 1959, subscriptions in arrears amounted to £140. The corresponding figure on 31st December, 1959 was £25. An invoice for costumes used in the latest production was received on 24th December but was unpaid at the end of the year. The amount was £104.

Receipts and Payments Account
Dr. *for the year to 31st December, 1959* *Cr.*

	£		£
To Bank Balance, 1st Jan.	136	By Rent of Concert Hall	216
,, Annual Subscriptions	610	,, Cost of Music	68
,, Entrance Fees	40	,, Production Expenses	274
,, Donations	120	,, Secretarial Expenses	106
,, Sales of Concert Tickets	572	,, Sundry Donations	120
		,, Balance at Bank, 31 Dec.	694
	£1,478		£1,478

Prepare an Income and Expenditure Account for the Year ended 31st December, 1959, and a Balance Sheet as at that date.

Azaro Musical Society:

Dr.	*Income & Expenditure Account for the Year ending 31st December, 1959*		*Cr.*
	£		£
To Rent of Concert Hall	216	By Annual Subscriptions	495
,, Cost of Music	68	,, Donations	120
,, Production Expenses	378	,, Sales of Concert Tickets	572
,, Secretarial Expenses	106		
,, Sundry Donations	120		
,, Surplus for Year	299		
	£1,187		£1,187

Balance Sheet as at 31st December, 1959

Liabilities:		£	*Assets:*	£
Creditor		104	Subscriptions due	25
Accumulated Fund:			Balance at Bank	694
Balance at 1st Jan.	276			
Add Surplus for Year	299			
,, Entrance Fees	40	615		
		£719		£719

Notes

1. Accumulated Fund—Balance brought forward. This figure is not given but can be derived from the net assets at 1st January.

Subscriptions due	140
Cash at Bank	136
	£276

As there are no liabilities, this is the balance on the Accumulated Fund at 1st January, 1959.

2. Entrance Fees: This source of income provides an accounting problem. Strictly, the income relates to the whole period the new member will belong to the society. But no one knows how long this will be. The alternative accounting procedures are:

   (a) To credit all entrance fees to the Income & Expenditure Account. Provided they are small in total compared with other income, this is acceptable. It is still inaccurate but the inaccuracy is of little import.
   (b) To credit all amounts received to a special Entrance Fees Account, transferring a proportion (say one-tenth) to succeeding Income and Expenditure Accounts.
   (c) To credit entrance fees directly to the Accumulated Fund. This avoids the distortion involved in (a) and the complexities involved in (b).

Note that Life Members' Subscriptions present a similar problem.

QUESTIONS 6

1. *The New Town Association commenced activities on 1st January, 1959, and the following is a summary of its transactions for the following year:

Receipts:		£
Subscriptions		350
Net income from dances and whist drives, etc.		120
Deposit interest		6
		476
Payments:	£	
Rent of premises	150	
Rates	40	
Lighting, heating, etc.	52	
Purchase of Savings Certificates	120	362
Balance in hand at 31st December, 1959 (including £86 in Post Office Savings Bank)		£114

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One quarter's rent, £50, is due at 31st December, 1959, and £10 for a coal bill is not paid. Subscriptions received include £25 in advance for 1960. Rates in advance at 31st December, 1959, were £15.

You are asked to prepare the Association's Income and Expenditure Account for the year and its Balance Sheet on 31st December, 1959.

2. *The following is a summary of the Cash Book of Benworth Social Club for the year to 31st December, 1962:

Cash Book

		£		£
Balance at bank, 1 Jan. 1962		360	Restaurant and Bar Supplies	6,000
Bar & Restaurant Sales		8,000	Wages	2,120
Members' Subscriptions:			Printing, Stationery and Postages	140
for 1962	£2,660			
for 1963	100	2,760	General Expenses	1,830
			Balance at bank, 31st Dec., 1962	1,030
		£11,120		£11,120

Additional information is obtained as follows:

	31st Dec. 1961	31st Dec. 1962
	£	£
Freehold Premises	5,000	5,000
Furniture	3,620	3,620
Stock of Restaurant and Bar Supplies	618	548
Creditors for Restaurant and Bar Supplies	450	490

You are required to prepare:

(a) A Trading Account for the Restaurant and Bar for 1962.
(b) An Income and Expenditure Account for the year 1962.
(c) A Balance Sheet on 31st December, 1962.
Note: Ignore depreciation.

3. †The books of the Brownstone Old Boys' Social Club at 31st December 1962, showed the following balances:

	£
Buildings Extension and Renovation Fund	2,500
Accumulated Fund	5,945

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Entrance Fees	180
Annual Subscriptions	1,072
Crockery, Glassware, Plate, etc.	765
Printing, Stationery, Postages and Telephone	250
Library Books	300
Furniture, Fixtures and Fittings	1,500
Hire of Hall (Credit)	451
Games Room Receipts	379
Rates and Insurance	225
Balances at Bank—Current Account	600
Deposit Account	500
Cash in Hand	45
Repairs and Replacements	455
Profit on Bar and Catering	1,265
Receipts—Annual Outing	450
Entertainments	290
Creditors	781
Honorarium, Secretary	200
Salaries and Wages	873
Heating, Lighting and Cleaning	305
Deposit, Exton Building Society	2,000
Audit Fee	52
Club Premises (Freehold)	4,000
Cost of Annual Outing	363
Interest on Investments—Building Society Deposit	50
Bank Deposit	11
Newspapers and Magazines	121
Stocks of Wines, Spirits, Tobacco, etc.	810
Cost of Entertainments	210
Donations to Building Extension Fund	200

Subscriptions amounting to £104 have been paid in advance, and there were arrears of £24. Insurances paid in advance amounted to £15. Depreciation is to be provided at the following rates per annum:

Library Books	25 per cent.
Furniture etc.	10 per cent.
Crockery etc.	10 per cent.
Club Premises	2 per cent.

A sum of £500 is to be transferred to Buildings Extension and Renovation Fund. The charge for Repairs and Replacements included cost of a Television Set, £120.

Prepare Income and Expenditure Account for the year ended 31st December, 1962 and Balance Sheet at that date.

CHAPTER 7

Single Entry Records

NOT ALL business proprietors are sufficiently concerned to enjoy the benefits of double-entry accounting. Many seek to keep a minimum of records and often they fail to keep the necessary minimum. Profit determination in these circumstances can be extremely difficult. In a book like this we discuss the principles applicable but we do not face what is often the chief problem, i.e. the digging out of the basic information. This is a practical task and the training for it is practical experience.

Businesses with inadequate financial records can be divided into two classes for Accounting purposes.

(a) Where sufficient information is (eventually) available to make the comparison of income and expenditure in a Trading and Profit & Loss Account. The information, though not in the form of double entry records, is obtainable by the examination of bank statements, suppliers' invoices and statements and odd books where the proprietor has kept some notes or records.

(b) Where information for a Trading and Profit & Loss Account is not available no matter how much searching one has done or is prepared to do. Here we rely on one of the fundamental equations given earlier:

Capital at Beginning + Net Profit − Drawings = Capital at End of Period.

Perhaps it is here better to use the term "Net Assets" instead of Capital. The equation must also be modified to include the opposite of Drawings, a further contribution of capital. Re-arranged it now becomes:

Net Profit = Net Assets at End − Net Assets at Beginning + Drawings − Further Capital Contributions

OR

Increase in Net Assets + Drawings − Further Capital Contributions.

This gives us a figure equal to that which would have been derived from double entry work provided the terms of the equation are known with sufficient accuracy. Usually, however, we have to estimate Drawings and, sometimes, the beginning assets.

EXAMPLE 27

On 1st January, 1961, B. Freen commenced business. At that date he purchased the shop premises for £1,400 and paid £200 for interior fittings. He also paid £400 into the business bank account. On 31st December, 1962 he realised the need of a profit figure for the two years he had been in business, but his records were completely inadequate. At this date the assets he possessed in addition to the Premises and Fittings were:

	£
Stock	600
Debtors	104
Motor Van—purchased on 30th June, 1962, for	800
Cash at Bank	250

He owed £140 to Trade Creditors and had borrowed £1,000 from a friend. Interest accrued but unpaid on the loan amounted to £20. Freen estimates that he has withdrawn £30 a month from the business. Prepare a statement of Net Profit for the two years valuing the fixed assets at cost less depreciation:

(a) On Premises @ 2% per annum,
(b) On Fittings @ 5% „ „
(c) On the Motor Van @ 20% per annum.

Statement of Net Assets:	1st Jan. 1961		31st Dec. 1962
	£		£
Premises	1,400		1,344
Shop Fittings	200		180
Motor Van			720
Stock			600
Debtors			104
Cash at Bank	400		250
	£2,000		£3,198
Trade Creditors		140	
Loan & Accrued Interest		1,020	1,160
	£2,000		£2,038

Statement of Net Profit for two years ending 31st Dec., 1962.

	£
Increase in Net Assets	38
Add Drawings @ £30 per month	720
Net Profit	£758

The next example belongs to the other class of single entry work, where a Trading and Profit & Loss Account is possible.

EXAMPLE 28

A. Jones has not kept double entry accounts but from his records it is possible to derive the following information for 1960.

	1st Jan., 1960	31st Dec., 1960
	£	£
Stock	400	600
Debtors	324	396
Creditors	417	612
Loan to G. Brook	600	—

An analysis is made of his bank account:

Dr. *Bank Account* *Cr.*

	£		£
To Balance, 1st Jan., 1960	216	By Creditors for Goods Purchased	2,102
„ Debtors for Goods Sold	2,720	„ Salary of Assistant	360
„ Cash Sales	1,016	„ Sundry Expenses	116
„ G. Brook— Loan & Interest from 1st Jan., 1960	615	„ Withdrawals	500
		„ Purchase of new Motor van	600
		„ Balance, 31st Dec., 1960	889
	£4,567		£4,567

The Motor Van was purchased on 30th September. You are required to write off depreciation at the rate of 20% per annum. A. Jones has taken goods to the value of £120 for personal consumption.

Before preparing the Final Accounts, some preliminary calculations must be made.

Sales for Year = Cash Sales + Amount Received from Debtors − Debtors at 1st Jan. + Debtors at 31st Dec.
= £1,016 + £2,720 − £324 + £396 = £3,808.

The Credit Sales are obviously the amount received from debtors plus the increase, or minus the decrease, in Total Debtors over the Trading Period. Similarly,

Purchases = Payments to Creditors − Creditors at 1st Jan. + Creditors at 31st Dec.
= £2,102 − £417 + £612 = £2,297.

Dr. *Trading and Profit & Loss Account for the Year ended 31st December, 1960* *Cr.*

	£	£		£
To Cost of Goods Sold:			By Sales	3,808
Stock, 1st Jan.	400			
Purchases	2,297			
	2,697			
Less Stock, 31 Dec.	600			
	2,097			
Less Withdrawals	120	1,977		
„ Gross Profit c/d		1,831		
		£3,808		£3,808
To Salary		360	By Gross Profit b/d	1,831
„ Sundry Expenses		116	„ Interest	15
„ Depreciation		30		
„ Net Profit		1,340		
		£1,846		£1,846

Balance Sheet as at 31st December, 1960

	£	£		£	£
Capital:			*Assets:*		
Balance at 1 Jan. 1960	1,123		Motor Van at cost	600	
Add Net Profit	1,340		Less Depreciation	30	570
	2,463				
Less Drawings	620	1,843	Stock		600
Liabilities:			Debtors		396
Sundry Creditors		612	Cash at Bank		889
		£2,455			£2,455

The Capital at 1st January 1960 is found:

	£
Stock	400
Debtors	324
Loan	600
Bank Balance	216
	1,540
Less Creditors	417
	£1,123

QUESTIONS 7

1.* A Trader commenced business on 1st January, 1960, his position then being:

	£
Assets	
Land and Buildings	7,500
Fixtures and Fittings	550
Balance at Bank	1,750
Liabilities	
Loan on Mortgage of Land and Buildings	5,000

He traded for a year, drawing nothing out of the business for his personal use and paying in no additional capital. His position on 31st Dec. 1960 was:

	£
Assets	
Land and Buildings	7,500
Fixtures and Fittings	550
Delivery Van	650
Sundry Debtors	445
Stock	970
Balance at Bank	1,445
Cash in Hand	115
Liabilities	
Loan on Mortage of Land and Buildings	5,000
Sundry Creditors	875

Prepare a statement of profit or loss for the year.

2.† Ben White, a retailer, adds 25% to the cost of goods purchased for resale to arrive at his selling prices.

His financial position at 30th June, 1961 was:

		£
Assets:	Plant & Machinery	5,000
	Stock	3,825
	Debtors	7,175
	Cash at Bank	2,200
Liabilities:	Creditors	3,000
	Loan from Z.	2,000

During the year ended 30th June, 1962 he:

(a) paid £11,675 for Goods for Resale.

(b) repaid £500 of the Loan from Z.

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(c) purchased a van for £700.
(d) withdrew from the bank £80 per month for personal expenses.
(e) paid into the Bank a legacy of £300.
(f) paid income tax £600 (treat as Drawings).

At 30th June, 1962, Stock at cost was £4,000, Debtors totalled £7,000 and creditors were £3,500; the balance at bank amounted to £1,950.

Ascertain Ben White's Gross and Net Profits or Losses for the year ended 30th June, 1962.

3. B. Letitslide is in business but does not keep proper books of account. In order to prepare his Trading and Profit & Loss Account for the Year ended 31st December, 1960 you are given the following information:

	1st Jan. 1960	31st Dec. 1960
	£	£
Stock on Hand	1,310	1,623
Debtors	268	412
Creditors for Goods	712	914
Creditors for Expenses	116	103

In addition, you are able to prepare the following summary accounts for the year:

Cash Account

Dr.	£		*Cr.* £
Balance, 1st Jan.	62	Payments into Bank	3,050
Shop Takings	4,317	Purchases	316
Cheques cashed	200	Expenses	584
		Drawings	600
		Balance, 31st Dec.	29
	£4,579		£4,579

Bank Account

Dr.	£		*Cr.* £
Balance, 1st Jan.	840	Cash withdrawn	200
Cheques from Customers	1,416	Purchases	2,715
Cash paid in	3,050	Expenses	519
		Drawings	400
		Delivery Van (purchased 1st Sept.)	900
		Balance, 31st Dec.	572
	£5,306		£5,306

In addition, Mr. Letitslide says that he has taken goods for personal consumption and estimates that those goods cost £100.

In considering the debtors, Mr. Letitslide suggests that there is no hope of receiving an amount of £30 from one customer. There are other doubtful debts and a provision is to be made of 5% of the debtors.

Allowing depreciation on the Delivery Van of 20% per annum, prepare the accounts as requested and a Balance Sheet as at 31st December, 1960.

4.¶ Eric Stupher was trading as a furniture manufacturer and he submits to you the following information relating to the year ended 30th September, 1961.

	1st Oct. 1960	30th Sept. 1961
	£	£
Capital Account	5,750	
Sundry Debtors	4,200	5,100
Trade Creditors	2,400	2,600
Stock	1,250	1,520
Plant and Machinery	2,400	
Fixtures and Fittings	600	
Motor Vehicle	400	

Summary of Cash Book

	£		£
Cash Balance, 1/10/60	27	Bank Balance, 1/10/60	727
Received from Debtors	14,000	Paid to Trade Creditors	9,400
Paid in by E.S.	1,000	General Expenses	1,240
		Wages and Salaries	1,970
		Drawings: E.S.	1,500
		Cash Balance, 30/9/61	20
		Bank Balance, 30/9/61	170
	£15,027		£15,027

Mr. Stupher pays his manager a commission of 5% of the trading profits after charging such commission. Depreciation is to be provided on assets as follows:

Plant and Machinery	10%
Fixtures and Fittings	5%
Motor Vehicles	20%

Included in the debtors is a debt for £175 which Mr. Stupher considers doubtful. During the year Mr. Stupher had personally purchased a new motor vehicle for use in the business for £1,200 and had received an allowance on this purchase for the old vehicle of £500.

From the foregoing information you are required to prepare a Balance Sheet as at 30th September, 1961 and Trading and Profit & Loss Accounts for the year ended on that date. Calculations may be made to the nearest £.

¶Re-printed by courtesy of the Association of Certified Accountants (A.C.C.A.).

CHAPTER 8

Goodwill and the Value of a Business

IMPORTANT as it is to know the information presented in a Balance Sheet, it is at least as important to note what the Balance Sheet does not tell us. It is difficult to think in terms of Balance Sheet values without thinking that the Balance Sheet gives the value of a business. This is a fallacy widely held.

Consider certain individual items. Stock, as we have seen, is normally valued at cost price and this is necessary if we are to charge the true Cost of Sales in the Trading Account. But we cannot regard cost as the only reasonable valuation of the stock. If, for example, a manufacturer holds stock which has cost him £1,500 to produce, it is highly improbable that he will consider that stock as worth only £1,500 when in the near future he will be selling it for £1,800. It is not wrong to value stock at cost price; it is required by our method of profit determination. But this means that the Balance Sheet figure is but one valuation amongst several that are possible. Other answers to the question, "What is this stock worth?" are reasonable.

Similarly, Fixed Assets do not appear on the Balance Sheet at current valuations. The formula used is "cost less depreciation." The rates of depreciation are governed by the expected life of the asset and its scrap value at the end. The balances of cost less depreciation in the interim years may or may not be close to realisable values. Quite obviously, the formula can take no note of increases in value and these are possible. For instance, the value of shop premises may rise considerably because of housing schemes in the immediate vicinity. Such increases are not shown on a Balance Sheet.

So far as a proprietor continuing in possession of a business is concerned, these qualifications are not of great importance. The profits of the business are calculated on consistent principles and the Balance Sheet is secondary to that calculation. But, should the ownership of a business change, the limitations of the Balance Sheet must be recognised. The parties to the transaction must agree on realistic valuations of the assets involved and the divergences from the Balance Sheet figures may be considerable.

There is an even more important qualification. The value of a business is not the sum of the values of its constituent parts. Intangible factors are involved; a business is far more than a building, some machines and stock. The connections of the business matter greatly. Such connections can be classified in three groups:

(a) Connections with customers. The links with satisfied customers are tremendously important and a new business is often involved in much effort and expense to build up its custom. The established business, with a regular supply of orders or with products that are widely known and respected, enjoys great advantages and these advantages are part of the value of the business.

(b) Connections within the business. The success of a business depends upon the teamwork of the employees, particularly those in administrative positions. Where you have the mutual confidence, understanding and co-operation that go to make up a team, the prospects of the business are so much the better. The better the prospects, the more valuable the business.

(c) Connections with Suppliers of Goods and Services. Except in times of shortages, one can assume that suppliers are grateful for extra custom. Nevertheless, established relations with such suppliers may go far to ease the progress of a business.

The term used to denote these connections and the value of these intangible factors is "Goodwill." In using this term, we must note that we are giving it wider implications than its past, traditional use. In 1810, the word was briefly defined by Lord Eldon as "the probability that customers will resort to the old place." Such brevity has usually been regarded as leading to inaccuracy but the emphasis on selling connections has traditionally been maintained. If we retain this narrow interpretation, we need another word to describe the other intangible factors. Provided we realise that we are giving it a wider meaning, it does seem sensible to describe all valuable "connections" as "Goodwill."

That Goodwill is a vital part of the value of a business is obvious. To place a value upon it in particular circumstances is very difficult. For this reason, many businessmen do not like to see Goodwill on the Balance Sheet. Where a payment is made for Goodwill on the acquisition of a business, the proprietor frequently chooses to write off the balance of the Goodwill Account as quickly as possible, i.e. to transfer the amount to the debit of Profit & Loss Account over the next few years. This desire is not logical for we do not use up Goodwill in making profit. Indeed good profits signify increasing Goodwill.

When businesses change hands, Goodwill must be valued. There are several formulæ we can use.

(a) A given number of years of the average annual profits for the past years, e.g.

		£
Profits 1957		200
,, 1958		1,300
,, 1959		5,000
,, 1960		4,600
,, 1961		3,200
Average for 5 years	$\frac{£14,300}{5}$ =	£2,860
Goodwill valued at 2 years purchase of the average profits for the past 5 years		£5,720

(b) A weakness of the above method is immediately apparent. For a valuation in 1962, the profits of 1961 are surely more relevant (i.e. should carry more weight) than those of 1957. This can be rectified by weighting the average:

		£	£
Profits	1957	200 × 1	200
,,	1958	1,300 × 2	2,600
,,	1959	5,000 × 3	15,000
,,	1960	4,600 × 4	18,400
,,	1961	3,200 × 5	16,000
		15	£52,200

Average for 5 years $\frac{£52,200}{15}$ = £3,480

Goodwill valued at 2 years purchase £6,960

(c) A refinement is to concentrate upon the super profits, i.e. the profits over and above what could be considered a reasonable return on the capital employed, having in mind the risk involved. Assuming the business of the previous example had a capital of £20,000 and that 10% is considered a reasonable return, Goodwill would be calculated as follows:

	Profits (£)	Normal Return (£)	Super Profits (£)	£
1952	200	2,000	−1,800 × 1	−1,800
1953	1,300	2,000	− 700 × 2	−1,400
1954	5,000	2,000	3,000 × 3	9,000
1955	4,600	2,000	2,600 × 4	10,400
1956	3,200	2,000	1,200 × 5	6,000
				£22,200

Average Annual Super Profits $\frac{£22,200}{15}$ = £1,480.

Goodwill valued at 5 years purchase of average super profits £7,400

Such calculations may not be difficult to follow but the reader may well feel troubled that, starting from the same basic data, we have found three radically different values for Goodwill. Obviously, the question must be asked:

Who or what determines the number of years purchase of either average or average super profits?

More specifically,

In the last example, Goodwill was valued at five years purchase of the average super profits. Why five? Why not four or six? The only answer seems to be an appeal to the custom of the particular trade or profession. This does provide some safeguard. To say that the number of years adopted is customary is not to say that it is correct but, at least, that it is hardly likely to be grossly incorrect.

Yet we may well doubt whether this is the right approach. It is simpler and probably more common to value the business as a whole. What are the prospects of the business and what are those prospects worth? Different people will give different valuations but, when a purchase or sale is involved, a figure is eventually agreed by parties with conflicting interests. Goodwill then appears as the residual value after the rest of the purchase price has been apportioned to the tangible assets.

EXAMPLE 29

A. Richards sells his business to R. Arthur as from 1st January, 1960. The total purchase price is £10,000. The Balance Sheet of the business on 31st December, 1959 was as under:

	£		£
Capital	8,000	Motor Vans	1,100
		Stock	3,750
Creditors	500	Debtors	2,600
		Cash at Bank	1,050
	£8,500		£8,500

R. Arthur takes over all the assets except cash at the bank but does not take over the liabilities. In agreeing the price, he values the Motor Vans at £1,000, the Stock at £4,500 and the Debtors at £2,400.

The purchase price is apportioned as follows:

	£	£
Total Purchase Price		10,000
Values given to Tangible Assets:		
Motor Vans	1,000	
Stock	4,500	
Debtors	2,400	7,900
Goodwill		2,100

The opening Balance Sheet of R. Arthur will be as follows:

	£			£
Capital	10,000	*Assets:*		
		Goodwill		2,100
		Motor Vans		1,000
		Stock		4,500
		Debtors	2,600	
		Less Provision for Bad Debts	200	2,400
	£10,000			£10,000

In closing this chapter, we must restate the principles underlying and prior to the problems of calculation.

(a) Balance Sheets are not in themselves adequate as guides to the value of a business or even of the values of particular assets.

(b) The "connections" of a business are vitally important. Goodwill, as we have decided to call them, may or may not appear on the Balance Sheet but it must be taken into consideration when a change of ownership is contemplated.

CHAPTER 9

Partnership Accounts

FREQUENTLY, a business is owned by two or more partners. It is then commonly known as a "firm." Partnership is defined by the Partnership Act of 1890 as "the relation which subsists between persons carrying on business in common with a view to profit." The law allows the partners wide powers of determining their relationships with each other. In the absence of agreements on certain matters, ordinary partnerships are governed by the Act of 1890. Not more than twenty persons may be associated in partnership.

Characteristics of a Partnership

(a) Normally partners are personally liable (jointly with the other partners) for debts incurred whilst they are associated in the partnership.

(b) For normal business purposes, each partner is an agent of the firm.

(c) Capital is provided by the partners in agreed proportions.

(d) The ultimate object of the partnership must be the making of profit to be shared amongst the partners.

In our Accounting, the distinctive characteristics that involve special consideration are:

1. The contribution of capital by several co-proprietors,
2. The division of the Net Profit amongst several partners.

Capital

Instead of one account for the sole proprietor, there is a separate capital account for each partner. Indeed, it is often found convenient to subdivide each partner's capital account into two, the Current and the Capital Accounts. This is an arrangement of convenience rather than of principle. The purpose is to avoid fluctuating balances on the Capital Accounts. Drawings and Appropriations of Profit are recorded in the Current Accounts. The Capital Account balances remain at the agreed contributions and are only changed by major additions or withdrawals. The following Balance Sheets record identical positions of the firm. The second illustrates the effect of subdividing the Capital Accounts.

Balance Sheet as at 31st December, 1960

Capital Accounts:	£	£	*Assets:*	£
Green	4,320		Machinery	5,000
Grey	3,690	8,010	Stock	3,000
			Debtors	1,600
			Cash	410
Liabilities:				
Creditors		2,000		
		£10,010		£10,010

Balance Sheet as at 31st December, 1960

Capital Accounts:	£	£	*Assets:*	£
Green	4,000		Machinery	5,000
Grey	3,500	7,500	Stock	3,000
			Debtors	1,600
Current Accounts:			Cash	410
Green	320			
Grey	190	510		
Liabilities:				
Creditors		2,000		
		£10,010		£10,010

One side shows the division of the Balance Sheet total amongst the various classes of assets. The other shows the various rights to those assets.

The creditors are entitled to £2,000. The balances on the Capital Accounts give the partners' rights to the remainder. Note that the agreement is only in total. Particular rights are not attached to particular assets. We can only say that the sum of the rights of the various parties equals the sum of the assets. For partnerships just as for the sole proprietor,

$$\text{Capital} = \text{Assets less Liabilities.}$$

Now, however, the capital is recorded in two or more accounts.

Profit Division

In the accounts of a sole proprietor, the Net Profit represents the total remuneration he receives from the business. Within that total we can differentiate in principle if not in amount:

(a) remuneration for services of management;
(b) interest on capital employed;
(c) pure profit, the reward of enterprise and risk-bearing.

It is unnecessary to give actual figures to these separate elements that make up the Net Profit figure and it is not easy to do so. The value of the proprietor's management services in particular must, in the nature of things, be a subjective estimate.

In a partnership, it may be considered desirable to "split up" the Net Profit into its component parts. In this way equity is achieved when capital contributions differ considerably or when one partner gives much more of his time to the business than the other(s). Provision is made in the Partnership Agreement for the appropriation of profit under these heads:

(a) Interest on Capital.
(b) Partnership Salaries.
(c) Residuary Net Profit.

The rate of interest, the amounts of salaries, and the ratio in which the remaining profit is distributed are all subjects for the Partnership Agreement. If no agreement is made on these matters, the Act of 1890 provides for an equal distribution of profit with no provision for interest on capital or partnership salaries. Interest at 5% is allowed on Partners' advances over and above their capital contributions.

EXAMPLE 30

Jacobs, Jones and Jonah enter into partnership on 1st January, 1959. No agreements are made regarding the distribution of profit which for the first year amounts to £1,500. At the beginning of 1960, it was agreed for the future that Interest on Capital is to be allowed at 5% per annum and that Jonah is to receive a salary of £500. The remaining profit is to be distributed in the proportions, Jacobs one-half, Jones one-third and Jonah one-sixth. For 1960 the Capital Balances of the partners were Jacobs £2,000, Jones £1,500 and Jonah £500. The profit for 1960 was again £1,500. Contrast the appropriation of profit for the two years.

1959 Equal Division according to Partnership Act 1890.

	£
Jacobs	500
Jones	500
Jonah	500
	£1,500

1960 Division according to the new Partnership Agreement.

	Jacobs	*Jones*	*Jonah*
	£	£	£
Interest on Capital	100	75	25
Partnership Salary			500
Division of remaining profit	400	267	133
	£500	£342	£658

making a total of £1,500.

The division of the profit is now sufficiently complex to require a separate section added to the Profit & Loss Account. From the Profit & Loss Account the Net Profit is credited to the Appropriation Account. The division is shown on the debit side. The Appropriation account for 1960 of the "Jacobs, Jones & Jonah" partnership will appear as follows:

Dr.		*Appropriation Account*		*Cr.*
	£	£		£
To Interest on Capital:			By Net Profit b/d	1,500
Jacobs	100			
Jones	75			
Jonah	25	200		
Salary—Jonah		500		
Profit Shares				
Jacobs	400			
Jones	267			
Jonah	133	800		
		£1,500		£1,500

Assuming figures for Drawings and Opening Balances, we can give the Partners' Current Accounts:

Dr.		*Current Account—Jacobs*			*Cr.*
1960		£	1960		£
Dec. 31	To Drawings	390	Jan. 1	By Balance	30
	„ Balance c/d	140	Dec. 31	„ Interest	100
				„ Share of Profit	400
		£530			£530
			1961		
			Jan. 1	By Balance b/d	140

Dr.		*Current Account—Jones*			*Cr.*
1960		£	1960		£
Dec. 31	To Drawings	350	Jan. 1	By Balance b/d	100
	„ Balance c/d	92	Dec. 31	„ Interest	75
				„ Share of Profit	267
		£442			£442
			1961		
			Jan. 1	By Balance b/d	92

Dr. *Current Account—Jonah* *Cr.*

1960		£	1960		£
Dec. 31	To Drawings	600	Jan. 1	By Balance b/d	14
	„ Balance c/d	72	Dec. 31	„ Interest	25
				„ Salary	500
				„ Share of Profit	133
		£672			£672
			1961		
			Jan. 1	By Balance b/d	72

For examinations and exercises an economy of presentation is possible.

Dr. *Current Accounts* *Cr.*

1960		*Jacobs*	*Jones*	*Jonah*	1960		*Jacobs*	*Jones*	*Jonah*
		£	£	£			£	£	£
Dec. 31					Jan. 1				
	To Drawings	390	350	600		By Balances b/d	30	100	14
	„ Balances c/d	140	92	72	Dec. 31				
						By Interest	100	75	25
						„ Salary			500
						„ Profit Shares	400	267	133
		530	442	672			530	442	672
					1961				
					Jan. 1	By Balances b/d	140	92	72

Admission of a New Partner

A new partner receives a share in the value of the business which value may or may not be adequately presented by the Balance Sheet. If the Balance Sheet does present an adequate valuation of the whole business, there are no problems on the admission of a new partner. He is credited with the capital he contributes. The asset or assets which he brings into the business are debited.

EXAMPLE 31

On 31st December, 1960, the Balance Sheet of the partnership of Green & Grey is as follows:

Capital Accounts	£	£	*Assets:*	£
Green	4,000		Goodwill	2,000
Grey	3,000		Machinery &	
		7,000	Equipment	1,800
			Stock	1,960
Liabilities:			Debtors	2,130
Creditors		980	Cash at Bank	90
		£7,980		£7,980

As from 1st January, 1961, Gold joins the partnership. He contributes £2,000 in cash as capital. The old partners and Gold agree to accept the Balance Sheet figures as adequate valuations of the business assets including Goodwill.

Give the Balance Sheet of the new firm at 1st January, 1961.

Balance Sheet as at 1st January, 1961

Capital Accounts	£	£	*Assets:*	£
Green	4,000		Goodwill	2,000
Grey	3,000		Machinery &	
Gold	2,000	9,000	Equipment	1,800
			Stock	1,960
Liabilities:			Debtors	2,130
Creditors		980	Cash at Bank	2,090
		£9,980		£9,980

For reasons already discussed it is unusual for a Balance Sheet to be so satisfactory as a valuation of the business. Sometimes the value of certain fixed assets has to be adjusted. More frequently, the figure for Goodwill is unacceptable. Indeed, it is often absent altogether. By far the simplest method of dealing with this situation is to adjust the Balance Sheet of the old partnership prior to recording the admission of the new partner. The old partners' Capital Accounts are credited with any net increase in valuation, and debited with a net decrease, in their profit-sharing ratio.

EXAMPLE 32

The following Balance Sheet was taken from the books of a firm on 30th June, 1960:

Capital Accounts	£	£	*Assets*	£
A. Pearce	4,000		Machinery	3,120
B. Pearce	3,000	7,000	Stock	2,400
			Debtors	1,680
Liabilities			Cash	324
Creditors		524		
				£7,524
		£7,524		

On 1st July, 1960, E. Pearce is admitted as a new partner. Goodwill is valued at £4,000 but it is agreed that Stock should be revalued at £2,000 and a Provision for Doubtful Debts of 5% of Sundry Debtors be created. The adjustments are to be made in the books. A. & B. Pearce shared profits in the ratio of 2:1.

E. Pearce, who is to receive a one-quarter share of the profits, contributes £3,000 in capital. He pays in cash £2,000 and brings into the business machinery worth £1,000.

The entries consequent upon the admission of E. Pearce and the Balance Sheet of the new firm will be as follows:

		£	£
Revaluation a/c	Dr.	484	
To Stock			400
„ Provision for Bad Debts			84
being adjustable to book value of stock and creation of Prov: of 5% of Sundry Debtors.			
Goodwill	Dr.	4,000	
To Revaluation a/c			4,000
being agreed value on admission of E. Pearce.			

		£	£
Revaluation a/c	Dr.	3,516	
To Capital a/c A. Pearce			2,344
„ „ „ B. Pearce			1,172
being gain on Revaluation transferred in Profit Sharing Ratio.			
Bank	Dr.	2,000	
Machinery	„	1,000	
To Capital a/c E. Pearce			3,000
being assets introduced by new partner.			

Balance Sheet as at 1st July, 1960

Capital Accounts	£	£	*Assets*	£	£
A. Pearce	6,344		Goodwill		4,000
B. Pearce	4,172		Machinery		4,120
E. Pearce	3,000	13,516	Stock		2,000
Liabilities			Debtors	1,680	
Creditors		524	Less Provision for Doubtful Debts	84	1,596
			Cash		2,324
		£14,040			£14,040

As the example shows, the treatment of any revaluation of Goodwill is not fundamentally different from that of the revaluation of other assets. It is, however, often discussed separately for two reasons:

1. The adjustment is more frequently needed.
2. The partners often do not want Goodwill to appear on the Balance Sheet. This leaves two alternatives:
   (a) an adjustment which does not involve a Goodwill account at all.
   (b) the writing-up of Goodwill to its agreed value and the writing off of the balance immediately afterwards.

The fact that no account is open for Goodwill does not imply the non-existence of the asset. For a healthy business, its value is real. When a new partner is admitted he receives a share of the Goodwill. He is entitled to share in profits made possible by the Goodwill and, if it is eventually sold, he will be credited with a share of the proceeds. The rights to the total assets as recorded on the Balance Sheet are determined by the balances of the partners' capital accounts. The rights to asset values above the Balance Sheet figures are governed by the Partners profit-sharing ratio. Gains on Revaluation or Sale of assets will be credited to the partners in this ratio.

Where Goodwill does not appear on the Balance Sheet at its agreed value, equity demands that a new partner should pay for the share he receives on admission. The amount paid is known as a premium and is shared by the other partners in the ratio in which they forgo profits.

e.g. Smith & Weaver admit Brown into partnership. Previously Smith & Weaver shared profits equally. The new profit sharing ratio is 2:2:1. Goodwill is not recorded in the books but the value is agreed at £5,000.

On admission, Brown receives a one-fifth share of Goodwill and ought to pay £1,000 for it. As Smith & Weaver forgo future profits equally, they are entitled to receive £500 each.

Smith & Weaver shared the premium in their profit sharing ratio, i.e. equally. The reader may wonder why the phrase "in the ratio in which they forgo profits" has been used. It is unfortunately necessary.

e.g. Angus & Mellor admit Jones into partnership. Previously, they shared profits equally. The new profit sharing ratio is 4:3:3. Goodwill is not recorded in the books but the value is agreed at £5,000.

Premium paid by Jones 3/10ths of £5,000 = £1,500.

	Angus	*Mellor*
Old Profit Shares	1/2	1/2
New Profit Shares	2/5	3/10
	1/10	2/10

Angus & Mellor share the premium in the ratio 1:2, i.e. Angus receives £500 and Mellor £1,000. This is not the same as either the old or the new profit sharing ratio. This more complex approach is required when, as between themselves, the old partners change the ratio of their profit-sharing.

The premium may be:

(a) paid to the old partners privately,

(b) paid into the business and credited to the capital accounts of the old partners.

(c) paid into the business and, then, immediately withdrawn by the old partners.

No accounting problems are created by this choice but the financial interests of the partners may be considerably affected. The actual effects will depend upon,

1. whether or not there is agreement for the payment of interest on capital and,
2. the additional return that can be earned by the use of extra capital.

Another method of adjusting the partner's equity is to open a Goodwill account, crediting the original partners in their old profit sharing ratio, and then to write off the amount by debiting the partners in the new profit sharing ratio. This gives a result similar to the payment of a premium which is left in the business.

Taking the facts of the previous example, the Journal entries would be:

		£	£
Goodwill	Dr.	5,000	
To Angus—Capital a/c			2,500
,, Mellor ,,			2,500
Being agreed valuation credited in old profit-sharing ratio.			
Capital a/c Angus	Dr.	2,000	
,, Mellor		1,500	
,, Jones		1,500	
To Goodwill			5,000
Being Goodwill written off in new profit-sharing ratio.			

An examination of these entries shows that Goodwill appears in the books and promptly disappears again. Angus receives a net credit of £500 and Mellor of £1,000. Their capital balances are the same as they would have been had a premium been distributed between them. Jones is debited with £1,500 but now all the money he pays into the business is credited to his Capital Account.

Death or Retirement of a Partner

A Partnership is dissolved by the death or retirement of one of the partners. However, the business is frequently continued by the surviving partners or partner. In law, a new partnership (or sole proprietorship) replaces the old. There is no need for this clear break to be shown by a new set of accounts. Necessary adjustments can be passed through the Capital accounts.

The basic requirement is the closing of the departing partner's capital account and the transfer of the balance to a personal (Loan) account, until it is paid. If the partner has died, this account will be in the name of his executors. The Partnership Agreement often contains provisions regarding the repayment of this sum and the interest allowed on it prior to repayment.

Retirement can be arranged conveniently to coincide with the end of a business trading period. There will then be a Profit & Loss Account prepared up to the date of retirement and a Balance Sheet as on that date. The death of a partner cannot be so conveniently arranged! It usually occurs within a trading period. Consequently, the last Profit & Loss Account will be prepared to a date some weeks or months before the death.

Some means of calculating the profit due to the deceased partner for the period from the last Profit & Loss Account to the date of the death must be found. This involves the preparation of a Profit and Loss account for the period unless the partners have previously agreed otherwise. A common agreement is to the effect that, instead of a share of profit for the period to his death, a deceased partner's estate is entitled to interest on the balance of his capital account as at the date of the last Balance Sheet.

EXAMPLE 33

Edwards, who is a partner in the firm of Edwards, Green & Co., dies on 30th May, 1961. The Balance Sheet of the firm on 31st December, 1960, was as follows:

	£	£		£
Capital Accounts			Sundry Assets	16,410
Edwards	7,200			
Green	4,000			
Hughes	3,000			
		14,200		
Current Accounts				
Edwards	600			
Green	200			
Hughes	210			
		1,010		
Liabilities				
Creditors		1,200		
		£16,410		£16,410

The agreement between the partners states that, instead of a share in the profit, a deceased partner's estate is entitled to 10% interest to date of death on the balance of the partner's capital at the date of the last Balance Sheet.

Calculate the amount due to the executors of Edwards and give the Journal entries required on his death.

		£
Amount Due:	Capital Account	7,200
	Current Account	600
		7,800
	Interest on £7,800 @ 10% for 5 months	325
		£8,125

Journal Entries.		£	£
Capital a/c—Edwards	Dr.	7,200	
Current a/c ,,		600	
To Executors of Edwards dec'd being transfer of balances on death			7,800
Interest on Partner's Capital	Dr.	325	
To Executors of Edwards dec'd being interest in lieu of profit from last Balance Sheet to date of death.			325
Executors of Edwards dec'd	Dr.	8,125	
To Bank, being settlement of debt.			8,125

The debit on "Interest on Partner's Capital" will be debited to the next Appropriation Account. It is to be distinguished from any Interest allowed after the date of death to the time of settlement, which is strictly Interest on a loan and is to be debited to Profit & Loss Account.

A partner, on retirement or death, relinquishes not an account in a ledger, but a share in the business. The balance on his capital account is only a correct assessment of the value he gives up if the assets of the business are correctly valued on the Balance Sheet. This, we have seen, is rarely so. Thus, to determine the share of the partner, the assets must be revalued on some fair and equitable basis. In particular, Goodwill merits special attention.

On revaluation, adjustments can be made to the accounts and all the partners' capital accounts will be credited with shares of the "gain on revaluation" (or debited with shares of a loss). This is the simplest method but it is often the desire of the surviving partners not to disturb the existing Goodwill a/c. Adjustments will then be made within the Capital Accounts.

EXAMPLE 34

Balance Sheet as at 31st December, 1961

	£	£		£
Capital Accounts:			*Assets*	
Rat	8,000		Goodwill	2,000
Mouse	3,500		Machinery	6,000
Mole	3,300	14,800	Stock	3,100
			Debtors	4,200
			Cash	1,600
Liabilities				
Creditors		2,100		
		£16,900		£16,900

The above was the last Balance Sheet prepared before the death of Rat on the 30th June, 1962. Profits in the firm were shared in the proportions Rat one-half, Mouse and Mole one-quarter each. The Partnership Agreement provided that, on the death or retirement of a partner,

1. His estate is entitled to interest on the balance of his capital account at the time of the last Balance Sheet at $12\frac{1}{2}\%$ per annum to the date of death.
2. The assets of the business should be revalued in determining the payment due to the partner's estate.

On the death of Rat, Goodwill is valued at £4,000 and Plant and Machinery at £7,000. The remaining partners agree to adjust the Plant and Machinery Account but not to change the Goodwill Balance. No plant has been purchased since 31st December, 1961.

Give the adjusting entries.

			£	£
1. Plant & Machinery		Dr.	1,000	
To Capital A/cs	Rat			500
	Mouse			250
	Mole			250
being adjustment on revaluation.				

			£	£
2. Capital Account				
	Mouse	Dr.	500	
	Mole	,,	500	
To Capital A/c	Rat			1,000
being adjustment for Rat's share of excess value of Goodwill over Balance Sheet figure.				
3. Capital Account Rat		Dr.	9,500	
To Executors of Rat				9,500
being transfer of adjusted balance on death				
4. Interest on Partner's Capital.			500	
To Executors of Rat				500
being interest @ 12½% on £8,000 for 6 months.				

Survivorship Policies

Consideration of the last example will raise the question: How can the partnership pay the £10,000 owing to the executors of Rat? The money is just not there. Additional resources will be necessary and often a new partner will be sought.

The difficulty can be anticipated and overcome in advance by taking out an Insurance Policy on the lives of the partners. The capital sum payable by the Insurance Company on the death of a partner provides the liquid resources needed to settle the debt to his executors. Two kinds of policies are available:

1. Those in which the capital sum is payable on the death of any one of the partners.
2. Those related to one member only, i.e. a separate policy is taken out for each partner.

We are confronted with a variety of accounting problems and possibilities.

(a) The treatment of the premiums paid annually.
(b) The receipt of the capital money on the death of a partner.

(c) Adjustments required on dates before some of the policies have matured.

The annual premiums can be debited either to a Policy Account or to Profit & Loss Appropriation account. The latter choice means that no balance for the Insurance Policy appears on the Balance Sheet. To open a Policy Account raises the question: What is the balance that should appear on any Balance Sheet?

There are again alternative answers.

1. The accumulation of annual premiums paid to date, with or without interest.
2. The Surrender Value of the policy. This is the amount which the Insurance Company would pay if the policy was surrendered by the insured at any particular date. This represents the realisable value of the policy at the date of a Balance Sheet. But the insurance is not taken out with any intention of surrender and, on this basis, we are justified in avoiding the complications of maintaining the balance at Surrender Values.

On the death of a partner, the firm receives the capital sum from the Insurance Company. The requisite entries are:

1. If no Policy Account has been opened:

Debit Insurance Company with full amount receivable.	*Credit* Partners' Capital Accounts in Profit-sharing Ratio.

2. If premiums have been accumulated in a Policy Account:

Debit Insurance Company with full amount receivable.	*Credit* Policy Account.
Debit Policy Account with excess of amount receivable over balance of Account.	*Credit* Partner's Capital Accounts in Profit-sharing Ratio.

Where separate policies have been taken out for each partner, the death of one will not affect the policies of the others. But these policies are Partnership Assets and must be taken into account when determining the rights of the deceased partner. No new principles are involved. The situation is exactly parallel to that where there is Goodwill undisclosed or undervalued on the Balance Sheet.

The value of such policies will have to be agreed. Surrender Value is a possible basis.

EXAMPLE 35

Day, Dean and Davey are in partnership sharing profits in the ratio 2:2:1. Insurance Policies have been taken out on the lives of the three partners for the capital sum of £6,000 each. No accounts have been opened for the policies. Day dies. At the date of his death the Surrender Values of the other policies are:

1. on Dean, £2,400 and
2. on Davey, £3,000.

Goodwill is valued at £4,500 but does not appear in the books.

Give the entry relating to the capital sum on the death of Day and the adjustments to be made through the Capital Accounts for the other policies and Goodwill.

			£	£
Insurance Company		Dr.	6,000	
To Capital a/c	Day			2,400
" " "	Dean			2,400
" " "	Davey			1,200
being amount receivable on death of Day.				
Capital a/c	Dean	Dr.	1,200	
" "	Davey		600	
To Capital a/c	Day			1,800
being adjustment for Day's share of Goodwill. (2/5ths of £4,500).				

			£	£
Capital a/c	Dean	Dr.	1,440	
,, ,,	Davey		720	
To Capital a/c	Day			2,160

being adjustment for Day's share of policies on lives of other partners at Surrender Values (2/5ths of £5,400).

Revision of Partners' Profit Sharing Ratio

We have seen that revaluation of partnership assets is required whenever a partner joins or leaves the firm. It is not quite so obvious that the revaluation is also necessary when there is a change of the ratio in which existing partners share profits. The necessity follows from the principle that "the rights to assets not recorded on the Balance Sheet or to the excess over the Balance Sheet figures are governed by the Partners' profit-sharing ratio." Consequently a change in that ratio effects a change in the Partners' rights to some of the business assets. Such a change requires compensation.

e.g. Black and White are in partnership sharing profits in the ratio 2:1. A new arrangement whereby they share profits equally comes into force. Goodwill is valued at £6,000 but does not appear in the books. Give any adjusting entry required.

	Black	*White*
New Shares	1/2	1/2
Old Shares	2/3	1/3
	−1/6th	+1/6th

Adjustment

		£	£
Capital Account—White	Dr.	1,000	
To Capital Account—Black			1,000

being adjustment re transfer of 1/6th share of undisclosed Goodwill with change in Profit-sharing Ratio.

Dissolution

Here we consider the different story of disposal of the business either as a unit or by the sale of the assets separately. The Partnership Accounts are now to be closed completely.

The procedure is to open a Realisation Account which is debited with:

1. The partnership assets (except cash) at book values.
2. The expenses of realisation.

The credits in the account are the amounts realised on the sale of the assets or the collection of the debts. A Gain or Loss on Realisation will be transferred to the Capital Accounts in the partners' profit-sharing ratio,

Other accounts are closed as follows:

1. Creditors by payment.
2. Current Accounts of partners by transfer to the respective Capital Accounts.

We then reach the stage when the only balances are the Capitals and the Cash Account. A Trial Balance at this stage will still balance (subject to working errors) and might appear like this:

	Dr. £	Cr. £
Cash at Bank	6,460	
Capital Account. C.	320	
Capital Account. A.		5,000
Capital Account. B.		1,780
	£6,780	£6,780

The distribution of cash amongst the partners will now close all accounts. If a Partner has a debit balance (e.g. C above) he must contribute that sum into the business.

EXAMPLE 36

The following relates to a firm immediately prior to dissolution:

Balance Sheet as at 31st March, 1960

	£	£		£	£
Capital:			*Assets:*		
Club	4,000		Premises		2,000
Spade	400		Machinery		3,100
Heart	3,600	8,000	Stock		1,600
			Debtors	3,100	
Liabilities			Less Prov:	150	
					2,950
Creditors		1,810	Cash at Bank		160
		£9,810			£9,810

The assets realised:

	£
Premises	1,600
Machinery	3,000
Stock	1,800
Debtors	2,400

Expenses of Realisation amounted to £600. Discount of £100 was received from creditors. Record the dissolution in the accounts of the Partnership. The partners share profits and losses equally.

Dr. *Premises Account* *Cr.*

		£		£
To Balance	b/f	2,000	By Realisation a/c	2,000

Machinery Account

To Balance	b/f	3,100	By Realisation a/c	3,100

Stock Account

To Balance	b/f	1,600	By Realisation a/c	1,600

Sundry Debtors

To Balance	b/f	3,100	By Realisation a/c	3,100

Bad Debts Account

Dr.	£		Cr £
To Realisation a/c	150	By Provision b/f	150

Sundry Creditors

	£		£
To Bank	1,710	By Balance b/f	1,810
„ Discount—Realisation a/c	100		
	£1,810		£1,810

Realisation Account

Dr.	£		Cr. £
To Premises	2,000	By Provision for Bad Debts	150
„ Machinery	3,100	„ Bank—Premises	1,600
„ Stock	1,600	„ „ Machinery	3,000
„ Debtors	3,100	„ „ Stock	1,800
„ Bank—Expenses	600	„ „ Debtors	2,400
		„ Discount from Creditors	100
		„ Loss on Realisation	
		Club —£450	
		Spade —£450	
		Heart —£450	
1960			1,350
	£10,400		£10,400

Bank Account

Dr.	£		Cr. £
To Balance b/f	160	By Expenses of Realisation	600
„ Realisation a/c		„ Creditors	1,710
Premises	1,600	„ Capital A/c Club	3,550
Machinery	3,000	„ „ „ Heart	3,150
Stock	1,800		
Debtors	2,400		
„ Capital A/c Spade	50		
	£9,010		£9,010

Capital Accounts

Dr.	Club	Spade	Heart	Cr.	Club	Spade	Heart
Loss on Realisation	450	450	450	Balances	4,000	400	3,600
Bank	3,550		3,150	Bank		50	
	£4,000	£450	£3,600		£4,000	£450	£3,600

In attempting such a question in an examination, a student must note that the Cash, Realisation, and Capital Accounts make up an adequate answer in themselves.

Garner v Murray

A partner with a debit balance on his capital account, e.g. *Spade* in the last example, is liable to contribute cash to the firm. If he is bankrupt and unable to do so, the other partners must bear the loss. It was decided in the case Garner v Murray, 1904, that a loss arising from the insolvency of a partner must be borne by the others in the ratio of the last agreed Capital Account balances.

Thus, if in the previous example, *Spade* had been unable to contribute the amount of his deficiency the loss would have been shared by *Club* and *Heart* in the ratio 40 : 36, not equally as they shared trading profits and losses. The Capital Accounts would appear:

	Club	*Spade*	*Heart*		*Club*	*Spade*	*Heart*
	£	£	£		£	£	£
To Loss on Realisation	450	450	450	By Balances	4,000	400	3,600
,, *Spade's* deficiency	26		24	,, Deficiency		50	
,, Bank	3,524		3,126				
	£4,000	£450	£3,600		£4,000	£450	£3,600

Interim Distributions

The complete dissolution can obviously take several months with assets realised at varying intervals within these months. Naturally enough, the partners will not favour the idea of waiting till the completion of the dissolution before they receive any of the proceeds. It is possible to make interim distributions to partners after prior claims of creditors have been satisfied.

Care must be taken not to pay any partner money which he will have to repay later when the loss on realisation is determined.

The rule to apply is that payments should be made in such a way as to reduce the balances on the partners' capital accounts to the same ratio as that in which profits are shared. Further distributions are in that ratio.

EXAMPLE 37

When it was decided to dissolve the partnership, the balances on the capital accounts of the firm "Night & Day" were:

Night	£6,000
Day	£4,000
Dawn	£1,200

The partners shared profits in the ratio 2:1:1.
The assets realised the following amounts:

		£
	20th March	2,000
	16th May	2,300
	28th June	3,000
and finally	16th July	3,500

The creditors amounted to £1,400. Give the distributions that may safely be made following the realisation of the above amounts.

	Night	*Day*	*Dawn*
	£	£	£
Capital Balances	6,000	4,000	1,200
In Profit-Sharing Ratios	2,400	1,200	1,200
Surpluses	3,600	2,800	—
In Profit-Sharing Ratios	3,600	1,800	
Surplus	—	1,000	

In order to reduce the balances to the required ratio, Night must receive £3,600 and Day £2,800 before Dawn receives anything. So much is clear but there remains the question of the priority between Night & Day. Day must receive £1,000 before Night receives anything. That will bring their capital balances into the ratio of 2:1 which is, as between themselves, the ratio of profit-sharing.

Thus, the distribution is as follows:

1.	The first £1,000 (after payment of creditors)	All to Day
2.	The next £5,400	To Night and Day in the ratio 2:1.
3.	Any further amount	To the three partners in the ratio 2:1:1.

Statement of Distribution			*Night*	*Day*	*Dawn*
		£	£	£	£
Capital Balances			6,000	4,000	1,200
Mar. 20	Realised	2,000			
	Creditors	1,400			
	Distribution	600		600	
			6,000	3,400	1,200
May 16	Realised	2,300		400	
			1,267	633	
			4,733	2,367	1,200
June 28	Realised	3,000	2,000	1,000	
			2,733	1,367	1,200
July 16	Realised	3,500	333	167	
			1,500	750	750
Balance Unpaid (i.e. Loss on Realisation).			£900	£450	£450

Note that from 16th May, Night and Day are "in step," i.e. their balances are in the ratio 2:1. Dawn only comes into line on 16th July. The Loss on Realisation can be checked. We do not know the value of the individual assets but the total is given by the equation:

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \text{Capital} \\ &= £1{,}400 \quad + (£6{,}000 + £4{,}000 + £1{,}200) \\ &= £12{,}600 \end{aligned}$$

$$\begin{aligned} \text{Loss on Realisation} &= \text{Assets} \quad - \text{Amount Realised} \\ &= £12{,}600 - (£2{,}000 + £2{,}300 + £3{,}000 \\ &\qquad\qquad + £3{,}500) \\ &= \quad £1{,}800 \end{aligned}$$

The closed Capital Accounts will appear as follows:

	Night	*Day*	*Dawn*		*Night*	*Day*	*Dawn*
	£	£	£		£	£	£
Mar. 20 To Bank		600		Mar. 11			
May 16 „ „	1,267	1,033		By Bal.	6,000	4,000	1,200
June 28 „ „	2,000	1,000		b/f			
July 16 „ „	1,833	917	750				
Loss on Realisation	900	450	450				
	£6,000	£4,000	£1,200		£6,000	£4,000	£1,200

Note—The question asks for a statement of the distributions. The Capital Accounts are not required as part of the answer to the question, but are given for purposes of explanation and clarification.

Questions 9

1.* On 1st January, 1961, Black, White and Brown were in partnership and, at that date, their capital accounts showed credit balances of £5,000, £4,000 and £1,000 respectively.

The partnership agreement provided that interest at the rate of 5 per cent per annum should be allowed on capital but no interest charged on drawings; that White should be credited with a salary of £1,200 per annum and Brown with a salary of £840 per annum before division of profits; that of the first £2,000 of net divisible profit, Black should take 50 per cent, White should take 30 per cent and Brown 20 per cent, and that any profit in excess of £2,000 should be divided equally.

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Before making any adjustments required by the agreement, the profit for the year ending 31st December, 1961, amounted to £5,440 and, during the year, each partner had drawn £100 per month.

Prepare the Profit and Loss Appropriation Account and the partners' Current Accounts for the year ending 31st December, 1961.

2. *Two friends, Guppy and Jobling, are engaged in preliminary discussions with a view to setting up in business as retailers. It is agreed that Net Profits and Losses are to be shared between them in the ratio of two-thirds to Guppy and one-third to Jobling, and they further estimate that:

1. The net profit for the first year will be sufficient for Jobling to get £500 as his share of it.
2. Rent, assistant's wages, and other expenses will amount to £1,800 for the first year.
3. The rate of Gross Profit will be 20 per cent of the sales.
4. Stock at the end of the first year will be £1,500.

You are asked to show (giving your calculations)

(a) The value of sales necessary to produce the required net profit.
(b) The amount of purchases for the year.

3. *Peele and Mellis conduct a merchanting business in partnership on the following terms:

(a) Interest is to be allowed on partners' capital accounts at 6 per cent per annum.
(b) Peele is to be credited with a partnership salary of £750 per annum.
(c) The balance of profit in any year is to be shared equally by the partners.

After preparing their Trading and Profit & Loss Account for the year ended 31st March, 1960, but before making any provision for Interest on Capital or for Peele's partnership salary, the following balances remained on the books:

		Dr.	Cr.
		£	£
Capital Accounts:	Peele (as on 1st April, 1959)		1,000
	Mellis (as on 1st April, 1959)		2,000
Current Accounts:	Peele		220
	Mellis		100
Drawings Accounts:	Peele	890	
	Mellis	500	
Profit & Loss Account—Net Profit for Year			4,500
Stock—31st March, 1960		1,400	

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Goodwill Account	1,000	
Plant and Machinery, at cost	3,000	
,, ,, ,, Depreciation		600
Fixtures and Fittings, at cost	1,800	
,, ,, ,, Depreciation		950
Trade Debtors and Creditors	3,500	850
Loan from H. Oldcastle, and accrued interest		2,120
Rent accrued due at 31st March, 1960		150
Insurance unexpired at 31st March, 1960	95	
Cash at Bank: Current Account	305	
	£12,490	£12,490

It is agreed by the partners to reduce the book value of Goodwill by writing off £250 at 31st March, 1960 (to be charged to the Appropriation Section of the Profit and Loss Account).

You are asked to prepare the Appropriation Section of the firm's Profit & Loss Account and the partners' current accounts for the year ended 31st March, 1960, together with the Balance Sheet as on that date.

4. Green and Blue agree to admit Brown into partnership as from 1st January, 1961. Brown is to receive a one-fifth share of the profits, Green and Blue receiving equal shares as before. Goodwill does not appear in the books but is valued at £5,000. Brown introduces £7,000 into the business as capital and premium.

Give the Journal entries recording the admission of Brown.

5. In 1955, A set up in business as a sole trader. On 1st January, 1956, B. joined him as a partner taking one-third of the profits and paying £1,200 as a premium for Goodwill.

On 1st January, 1958, C was admitted as a new partner. It was decided to raise a Goodwill Account in the books of the firm and the value placed upon this asset was £6,000. The profit sharing ratio of the new firm was A: one-half, B: one-third and C: one-sixth.

From 1958 to 1961, the Goodwill balance was written down in the books of the firm and on 31st December 1961, it stood at £3,000. The business was then sold and the amount received for Goodwill was £3,600.

Prepare a statement showing the net amount gained or lost by each of the partners on account of Goodwill from the commencement of the business to the final date of sale.

6. †Two professional firms agree to amalgamate their practices. The first firm consists of three partners, A, B and C, who share profits in the

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ratio 5:4:3 with a total capital of £6,000 shared in the same proportions. The second firm has two partners, D and E, sharing profits and a total capital of £5,000 in the ratio 3 :2. In the combined practice, A, B and D are each to take one-quarter and C and E one-eighth of the profits after providing for a salary of £900 per annum to both C and E. The Capital of the new firm is to be £16,000, shared A, B and D £4,000 each and C and E £2,000 each.

For the purposes of adjustment between the partners it is agreed that the goodwill of each of the old practices shall be valued at four years purchase of the average profits of the firm for the previous five years. No Goodwill is to appear in the books of the new firm, and partners are to bring in or withdraw cash at the end of the first year to give effect to these arrangements. It is also agreed that partners shall be deemed to be interested in the Goodwill of the new firm in the ratio of their participation in the first year's profits, including salaries where applicable.

The first year's profits before charging partners' salaries amounted to £16,200. The profits of the five years preceding the amalgamation were: A, B and C, £9,070, £9,500, £10,850, £10,330 and £10,495. D and E, £4,120, £5,215, £6,125, £6,375 and £6,140.

Prepare the Capital Account of each partner as at the end of the first year, assuming that all adjustments on Capital Account were passed through the new firm's books.

7. ¶X, Y and Z were in partnership as retailers sharing profits as follows:

X	one-half
Y	one-third
Z	one-sixth

with a proviso that Z's share should be guaranteed by Y at a minimum rate of £1,500 per annum.

Interest was to be allowed on fixed capitals and allowed or charged on current account balances at the beginning of each year at the rate of 5 per cent per annum.

Particulars regarding the partners' accounts were:

	Fixed Capitals as at 1st April, 1959	Current Account balances as at 1st April, 1959	Drawings for the year to 31st March 1960
	£	£	£
X	10,000	Cr. 1,500	4,000
Y	5,000	Cr. 2,500	3,500
Z	3,000	Dr. 1,200	1,500

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The draft accounts for the year to 31st March, 1960 showed a net profit of £9,155 and on examination the following facts were revealed and decisions made:

(a) Partners during the year had been supplied with goods from stock and these were to be charged to them as follows:

	£
X	90
Y	155
Z	60

(b) A staff bonus of £1,200 was to be paid of which £130 was payable to X's son and was to be charged against X's share of the profit.

(c) W, the manager, was to receive a bonus of 2 per cent of the net profits, after charging the staff bonus, but before taking into account partners' interest.

(d) The sums credited and debited to partners for interest had been posted to an Interest Account, the balance on which had been written off to Profit & Loss Account in arriving at the profit of £9,155.

It was agreed to take W into partnership on 1st April, 1960 and that thereafter profits should be shared as follows:

X	one-third
Y	two-ninths
Z	two-ninths
W	two-ninths

W was to bring in £4,000 as his share of the firm's fixed capital, the total of which was to remain at £18,000, and to purchase his share of Goodwill, valued at £27,000 for the business as a whole, from the other partners in the proportion in which they previously shared profits. No account for Goodwill was to appear in the firm's books. W duly paid into the business his capital and the purchase price of his share of Goodwill; at the same time the other partners drew on capital accounts (or paid in) such sums as would leave their fixed capitals in proportion to their revised shares of profits.

You are required to prepare:

1. The Profit and Loss Appropriation Account for the Year ended 31st March, 1960 (adjusted to the correct net profit before allocation to partners); and
2. Partners' Current and Capital Accounts in columnar form, showing the entries necessary on W becoming a partner.

8. ¶X and Y are equal partners. On 1st July, 1962, they agree to admit Z as partner. Z is to pay £2,000 as a premium—the money to be left in the business—and to contribute £5,000 as capital. The Balance Sheet of the old firm as at 30th June, 1962, was as follows:

Balance Sheet 30th June, 1962

		£		£
Capital Accounts—			Freehold Property	8,500
X	£19,000		Plant and Machinery	6,500
Y	6,500		Debtors	11,500
		25,500	Stock	6,700
			Bank	800
Creditors		7,500		
Reserve Account		1,000		
		£34,000		£34,000

It was agreed, after negotiation between the parties, that the following adjustments in book values were to be made:

		£
(a)	Freehold Property to be valued at	11,000
(b)	Plant and Machinery to be reduced to	5,750
(c)	Bad Debts to be written off	850
(d)	Stock revalued at	5,750

Reserve Account to be transferred to Revaluation Account.

Prepare Revaluation Account and Balance Sheet of new firm as at 1st July, 1962.

9. *Up to 31st March, 1959, Henry, John and Kenneth had been trading in partnership and sharing profits in the respective proportions of 8, 7 and 5, and the firm's balance sheet drawn up as on that date was as follows:

		£		£
Capital Accounts—			Freehold Property	5,500
Henry	£17,000		Other Fixed Assets	4,100
John	14,000		Stock	26,600
Kenneth	12,000	43,000	Debtors	10,700
Creditors		3,200		
Bank Overdrawn		700		
		£46,900		£46,900

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*Re-printed by courtesy of the Royal Society of Arts (R.S.A.).

Henry having given notice that he wished to retire on the date mentioned, and it having been determined to admit Lambert as a new partner on the following day, the following terms were agreed:

(a) The balance sheet was to be revised, before the change, by writing up the book value of the freehold property to £7,500, and £200 was to be set aside as a provision against doubtful debts.

(b) Henry was to be credited with £3,000 for his share of Goodwill. He was to be paid £5,000 out of money to be brought in by Lambert, and agreed to leave the balance of the sum remaining due to him as a loan to the firm.

(c) Lambert was to bring in £7,000 in cash and to be entitled to one-fifth of the profits, the other partners, as between themselves, sharing the balance in the same proportion as before.

(d) Finally, adjustments were to be made between the partners' capital accounts to give effect to their agreement that Lambert should purchase one-fifth of the firm's Goodwill, which was to be valued for this purpose at £9,000. No Goodwill account was to appear in the books of the new firm.

Write up the partners' capital accounts, showing the entries recording the foregoing, and draw up an initial balance sheet for the new firm.

10. Scott and King, who occupied adjacent shops, became partners as from 1st January, 1962. Capital contributed was:

	Scott	King
	£	£
Shop property valued at	3,500	1,760
Fittings and fixtures	850	490
Stocks on hand	2,980	1,910
Cash in bank	387	980
	£7,717	£5,140
Less: Accrued expenses	184	98
	£7,533	£5,042

The partnership agreement provided that profits should be shared three-fifths to Scott and two-fifths to King, after provision for salaries at the annual rate of £630 to Scott and £420 to King and interest on the foregoing capitals introduced at 6% per annum. The cash account of the combined business for the year ending 31st December, 1962 was as follows:

	£			£
Trading Receipts	23,560	Goods purchased for resale		16,432
Bank drawn	14,963	Running Expenses		3,526
		Personal withdrawals:		
		Scott	£720	
		King	380	1,100
		Bank lodged		17,356
		Cash in hand 31st Dec. 1962		109
	£38,523			£38,523

King died on 31st August, 1962, and the balance found due to him as at the date of his death based on the accounts for year ending 31st December, 1962, had to carry interest at the rate of 5% per annum until paid over to his executors. The amount due on death had to include £1,000 for Goodwill payable by the remaining partner. Prepare accounts for the year ending 31st December, 1962, making provision for the following additional items:

Depreciation on shop property	5%
Depreciation on fittings	10%
Stocks on hand at 31st December, 1962	£4,360
Expenses outstanding	£244
Creditors for goods purchased for resale	£484

(Calculations to nearest £1 and month).

11. †A, B and C are in partnership at Exton and Wyeton sharing profits in the ratio 4:4:2. Their Balance Sheet at 31st December, 1962, was as follows:

	Exton	Wyeton	Total
	£	£	£
Furniture and Equipment	1,000	500	1,500
Motor Cars	1,700	800	2,500
Work in Progress	2,800	3,400	6,200
Debtors	2,268	2,422	4,690
	7,768	7,122	14,890
Balance at Bank			5,000
			£19,890

†Re-printed by courtesy of the Society of Incorporated Accountants (S.A.A.).

Creditors		Exton 755 Wyeton	398	1,153
Current Accounts	— A		1,465	
	— B		947	
	— C		325	2,737
Capital Accounts	— A		6,400	
	— B		6,400	
	— C		3,200	16,000
				£19,890

C retired from the partnership on 1st January, 1963, when it was agreed that:

(a) A should take over Exton assets with the exception of a motor car of a book value of £800 which C should have and that B take over the Wyeton assets; A and B are to assume the Exton and Wyeton liabilities respectively;

(b) C to have £1,500 as his share of the Goodwill of the firm and to forgo any share of profit on the work-in-progress.

Draw up statements to show amounts due to and by each partner in the final settlement.

12. *Hale, Neath and Redcar, who had been carrying on business in partnership, sharing profits and losses in the proportions of one-half, one-third and one-sixth respectively, decided to dissolve partnership on 30th June, 1962.

The balance sheet of the firm immediately before the dissolution was as follows:

	£		£
Hale—Capital Account	3,095	Goodwill	1,000
Neath ,, ,,	2,304	Furniture	250
Redcar ,, ,,	300	Debtors	2,795
Creditors	370	Stock	2,813
Loan Account—Hale	1,000	Bank	211
	£7,069		£7,069

In the realisation, the Debtors produced £2,492; the Furniture £149; the Stock £2,085; and the Goodwill £360. The expenses of the realisation amounted to £130. All the partners were solvent and any deficiency on capital account was made good.

Prepare the Realisation Account, Cash Book and the Partners' Capital Accounts to show the final distribution.

*Re-printed by courtesy of the Royal Society of Arts (R.S.A.).

13. ¶X, Y and Z are in partnership and their agreement provides:

(a) Each partner is to receive a salary of £500 per annum.

(b) X, Y and Z are to share profits and losses in the proportions of one-half, three-tenths and one-fifth respectively.

The partners agreed to dissolve the partnership on 30th June, 1959. As attempts to sell the business as a going concern had failed, the realisation of the assets was likely to be spread over some months and it was agreed that as cash was received it should be distributed. Z had no assets outside the partnership.

The balances in the books at 30th June, 1959, before making the necessary transfers to partners' capital accounts for the year ended on that date, were as follows:

	Dr.	Cr.
	£	£
Capital Accounts: X		4,550
Y		2,890
Z		1,060
Loan Account: X		1,000
Goodwill	2,600	
Plant and Machinery	3,100	
Motor Vehicles	650	
Furniture and Fittings	150	
Stock	2,700	
Sales Ledger Control Account	3,200	
Bought Ledger Control Account		4,200
Reserve for Bad Debts		200
Cash at Bank	2,700	
Profit & Loss Account (before charging partners' salaries)		1,200

Assurance Policies for £1,000 on the life of each partner had been entered into, and the premiums had been charged to Profit & Loss Account annually. The surrender values of the policies at 30th June, 1959, were:

X £400 Y £300 Z £300

It was agreed that X and Y should each take over the policies on their own lives, and that the policy on the life of Z should be surrendered.

Discounts of £100 were received on the payment of creditors. Cash was received on the realisation of assets as follows:

¶Re-printed by courtesy of the Association of Certified Accountants (A.C.C.A.).

			Amount Realised
1959			£
July	—	Sundry Debtors	1,400
		Life Policy Z	300
August	—	Sundry Debtors	1,500
		Motor Vehicles	700
September	—	Stock	2,200
October	—	Furniture and Fittings	100
November	—	Plant and Machinery	2,600

You are required to:

(a) Prepare the accounts showing the entries closing the books of the partnership.

(b) Prepare a statement showing the periodical distributions of cash, together with your computations of amounts distributed to partners.

14. †James, John and Williams are equal partners and dissolved partnership on 30th June, 1962, on which date their position is disclosed by the following:

Balance Sheet

		£		£
Creditors		5,000	Plant	3,000
Loan Account—James		1,000	Stock	5,000
Capital Accounts:			Debtors	4,000
James	4,000		Cash at Bank	100
John	3,000		Capital Account:	
		7,000	Williams	900
		£13,000		£13,000

The assets other than cash realised £8,000 and the costs of realisation were £230.

Write up the necessary accounts to show the final result of the dissolution and the division of the cash between the partners. Williams has no assets and cannot contribute anything towards his deficiency.

15. †Read, White and Blue are in partnership. The following is their Balance sheet as at 31st December, 1961, on which date they dissolve partnership. They share profits in the ratio 5 : 3 : 2.

†Re-printed by courtesy of the Society of Incorporated Accountants (S.A.A.).

Balance Sheet	£	£
Creditors		4,000
Loan Account—Read		1,000
Capital Accounts—		
Read	5,000	
White	1,500	
Blue	4,500	11,000
		£16,000

	£
Premises	4,000
Plant and Machinery	3,000
Stock	3,000
Debtors	6,000
	£16,000

It was agreed to repay the amounts due to the partners as and when the assets were realised, viz:

	£
1st February, 1962	3,000
1st April, 1962	7,300
1st June, 1962	4,700
	£15,000

Prepare a statement showing how the distribution should be made and write up the Cash Account and Partners' Capital accounts.

CHAPTER 10

Introduction to the Accounts of Limited Companies

THE DEVELOPMENT of the modern economic world has been made possible by the creation and development of limited liability companies. The scale of present day enterprise is inconceivable in a world restricted to partnerships and sole proprietorships. The origins of the modern company can be traced in the medieval chartered companies and those later formed by special Acts of Parliament. It is, however, brought into being by the much simpler process of registration with a public officer, the Registrar of Companies.

A company is a separate legal entity. It is in law treated as a person distinct from the persons who are its members. It can thus enter into contractual relations with members. The death of a member does not affect the continued life of the company.

Through the instrument of the limited liability company, the collection and concentration of vast sums of capital have been made possible. Two characteristics of the company have facilitated this.

1. Capital is in the form of transferable shares. A person is far more willing to invest his money in the purchase of shares which he can readily sell if he later finds it necessary to do so.
2. The concept of limited liability gives protection to the investor. The creditors of a partnership may, if necessary, proceed against the personal property of any of the partners. The liability of a shareholder to make good the debts of a

company is limited to any amount which remains to be paid on the shares he holds. There is thus a distinct limit to the risk involved in investing in shares. There are other kinds of companies but "companies limited by shares" constitute the vast majority and others will not be dealt with here.

Besides facilitating the mobilisation of capital, the limited company also gives the opportunity for using the available technical and managerial ability. There is a divorce of ownership from management which allows people with money but no ability to invest and allows people with ability but no money to control the capital contributed. The members of a company delegate the management to a Board of Directors. The Board controls the company's affairs and reports annually to the members. Thus the technical and managerial skill of the directors is linked to the finance of the members. It scarcely needs to be said that ability and capital are often found together. Directors are often also large shareholders.

Current company legislation is consolidated in the Companies Act, 1948. Many provisions of that act concern accounts and will have to be discussed later. The basic "constitution" of a particular company is laid down in two documents.

1. The Memorandum of Association. This defines the company's relationship with the outside world. The domicile, the objects and the capital are all stated in the Memorandum.
2. The Articles of Association. The Articles contain rules for the regulation of rights within the Company, e.g. the rights of various classes of shareholders, the powers and duties of directors and so on.

All companies must keep proper books of accounts and must have the annual accounts audited.

There are Private and Public Companies. Private companies are a device suitable for smaller businesses giving the benefit of limited liability without forfeiting the close relations the owners would enjoy as partners. A Private Company is relieved from certain requirements imposed on a public company, e.g. the minimum number of members is two not seven.

A Private company must, in its Articles:

(a) Restrict the right to transfer its shares.
(b) Limit the number of members to fifty (exclusive of employees and ex-employees).
(c) Prohibit any invitation to the public to subscribe for any shares or debentures of the company.

The Companies Act 1948, contained a provision making it necessary for all companies, public and private, to include in the Annual Return filed with the Registrar a copy of the last Balance Sheet and Profit & Loss Account. Previously, private companies had not been required to submit their accounts but this privilege is now given to a smaller group known as exempt private companies.

One of the advantages of company organisation is that capital can be collected by the issue of different kinds of shares appealing to different kinds of investors.

1. *Preference Shares* have a prior claim on profits available for distribution. The holders of other shares have a right to receive dividends only after a certain dividend has been paid on the Preference Shares. But no dividend is payable until the Company in General Meeting has passed a resolution to that effect. The priority of the preference shareholder is thus jeopardised by the possibility of withholding a preference dividend one year and using the money to pay an ordinary dividend in a later year. The issue of *Cumulative Preference Shares* makes this impossible. Arrears of preference dividends accumulate not as a liability but as a priority. Other dividends cannot be paid until the arrears of the preference dividend have been wiped off. All Preference Shares are

cumulative unless the Articles provide otherwise. *Participating Preference Shares* give the holders a right to a priority of dividend and then the right to participate in further distributions when the Ordinary Dividend is greater than a given rate. The Articles may confer a further right on holders of Preference Shares. In the winding-up of a company, they may enjoy a right to repayment of capital before other shareholders.

2. *Ordinary Shares* have no special rights. The risk of a small or no return on an investment in ordinary shares is greater, but there is the compensating possibility of large returns.
3. *Deferred Shares*. These receive no dividend until other classes have participated in the profits to an agreed level. They are sometimes called Founders Share, being taken by founders of a company or by vendors of a business taken over by the company.

The Capital of a company may be changed from shares to stock. Share Capital is usually in the form of identifiable numbered units. Stock is a "mass" of capital and can be transferred in "blocks" of any amount subject to provisions relating to administrative convenience, e.g. that transfers must be of multiples of £10.

Debentures are, like shares, a form of investment in companies. But they are not part of capital. The holder of a debenture is a creditor, not a member of a company. A debenture represents a loan to the company and debenture interest is an expense of a business not an appropriation of profits. In winding-up the claims of debenture holders are prior to those of shareholders. Thus debentures offer a greater security than any kind of shares and attract the most cautious type of investor, satisfied with a lower rate of return with greater security.

The Issue of Shares

The following steps are involved in a public issue of shares:

1. An invitation to subscribe for shares is issued to the public. The invitation will specify the amounts per share payable along with applications and also when the shares have been allotted.
2. The public send in applications for the shares and pay the amounts due with the applications.
3. The directors meet and allot the shares. If applications have been received for more shares than are to be allotted, the choice must be made either,
   (a) to refuse certain applicants altogether and to return their money,
   (b) to give applicants smaller numbers of shares than those for which they applied.
4. The applicants are notified of the shares they have been allotted. At this point, a further sum is payable to the company.
5. When they require additional capital, the directors pass a resolution making a "call" on the shareholders. The latter are normally liable to pay the full face value of the shares they have been allotted. The difference between this amount and the money already paid on application and allotment can be "called up" by the directors at any time subject to any specific provision in the original invitation to subscribe. There may be but one "first and final" call or there may be several.

The basic reality behind this process is the receipt of capital in the form of cash. The ultimate result of our entries will be an increase in cash at the bank and a corresponding credit in Share Capital Account. Other accounts are opened only to record the different stages in the issuing process.

EXAMPLE 38

On 1st March, 1960, The Arches Ltd. offered 50,000 Ordinary Shares of £1 each to the public. The amount was payable:

2/- on application, 8/- on allotment and 10/- on call. By 12th March, applications had been received for 60,000 shares. On 15th March, the directors allotted the shares. Applicants for 8,000 shares received no allotment at all. Allotment money was received in full by the 31st March. The call was made on 18th June. By the end of the month, all shareholders had paid the amounts due except one who had been allotted 4,000 shares. Give the entries in the books of The Arches Ltd.

JOURNAL			£	£
1960				
Mar. 12	Bank To Application a/c being application money @ 2/- per share for 60,000 shares.	Dr.	6,000	6,000
Mar. 15	Application a/c Allotment a/c To Ordinary Share Capital a/c being allotment of 50,000 shares: 2/- due on Application and 8/- on Allotment.	Dr. ,,	5,000 20,000	 25,000
Mar. 15	Application a/c To Bank being cash returned to unsuccessful applicants.	Dr.	800	 800
	Application a/c To Allotment a/c being application money on 2,000 Shares not allotted used as set-off against amounts now due.	Dr.	200	 200
Mar. 31	Bank To Allotment a/c being allotment moneys received.	Dr.	19,800	 19,800
June 18	Call a/c To Share Capital a/c being first and final call made by directors at this date.	Dr.	25,000	 25,000
June 30	Bank a/c To Call a/c being call moneys received on 46,000 shares.	Dr.	23,000	 23,000

Alternatively, the answer could have been given by presenting the ledger accounts:

Dr. *Bank Account—(extracts)* *Cr.*

1960		£			£
Mar. 12	To Application a/c	6,000	Mar. 15	By Application a/c	800
31	„ Allotment a/c	19,800			
June 30	„ Call a/c	23,000			

Dr. *Share Capital Account* *Cr.*

			1960		
			Mar. 15	By Application and Allotment a/c's	25,000
			June 18	„ Call a/c	25,000
					£50,000

Dr. *Application Account* *Cr.*

1960		£	1960		£
Mar. 15	To Share Capital a/c	5,000			
	„ Bank	800	Mar. 12	By Bank	£6,000
	„ Allotment a/c	200			
		£6,000			£6,000

Dr. *Allotment Account* *Cr.*

1960		£	1960		£
Mar. 15	To Share Capital a/c	20,000	Mar. 15	By Application a/c	200
			31	„ Bank	19,800
		£20,000			£20,000

Dr. *Call Account* *Cr.*

1960		£	1960		£
June 18	To Share Capital a/c	25,000	June 30	By Bank	23,000
				„ Calls in Arrears c/d	2,000
		£25,000			£25,000
July 1	To Calls in Arrear b/d	£2,000			

A simplification is to combine the Application and Allotment accounts:

Dr. *Application and Allotment Account* *Cr.*

1960		£			£
Mar. 15	To Share Capital a/c	25,000	Mar. 12	By Bank	6,000
	„ Bank	800	31	„ „	19,800
		£25,800			£25,800

This is a convenient place to illustrate the meaning of certain terms used in regard to Share Capital.

Nominal or Authorised Capital. This is the amount, divided into different classes of shares, stated in the Memorandum of Association. The Company may choose to issue only a part of the Nominal Capital at first, but the Memorandum gives the total capital which the Company is authorised to issue. Capital Duty is paid on this figure at the time of registration. The Nominal Capital does not appear in the ledger of the company but must be stated as a note on the Balance Sheet.

Issued Capital. This is the part of the Company's capital that has been issued to members. The Issued Capital of a Company exists from the time when the directors allot shares to applicants. Note that this is the time when the first entry is made in the Share Capital Account.

Called-up Capital. The amount payable by persons who have been allotted shares is, as we have seen, divided into amounts due on application, allotment and subsequent calls. The Called-up Capital is the amount that has actually become due at any particular time. It is represented by the balance on the Share Capital Account. Thus in Example 38 the Called-up Capital at the given dates is as follows:

March 15 — £25,000
June 18 — £50,000

Paid-up Capital. Calls made on shareholders are not always paid as quickly as one would like. As in the previous example we have Calls in Arrear. The Paid-up Capital is the amount of the Issued Capital called and paid-up. It is in fact the amount that appears on the Balance Sheet of the Company. The statement of capital for The Arches Ltd. would appear on its Balance Sheet at 30th June, 1960 as follows:

Issued Capital:	£	
50,000 Shares of £1 each fully called	50,000	
Less Calls in Arrear	2,000	£48,000

Share Premiums

The nominal value of a share is its face value. Dividends are usually stated as a percentage of the nominal value. But the real value of a share may bear little relationship to the face value. The real value of a share is governed by the public's expectation of future profits and dividends. If, for example, a dividend of 10% has been and is expected to be paid regularly on certain shares and, for that type of investment, the public regards a return of 5% as satisfactory, a share of £1 nominal value can be sold for £2.

This is often the kind of situation which faces a company wishing to raise extra capital. It may be able to offer its shares to the public at a price above the face value, e.g. issue £1 shares at a price of 25/-. The difference between the issue price and face value is the Share Premium. The amount must be credited to Share Premium Account. There it must remain as a balance until it is used for one of the few purposes allowed by the Companies Act.

Discount on Shares

When the real value of a class of shares is less than the nominal value, it is possible to gain permission for the shares to be issued as a discount, e.g. £1 Shares at 18/–. This leads to a debit balance on Share Discount Account. It is certainly not as asset and is regarded as a loss to be written off to Profit & Loss Account as soon as possible.

Forfeiture of Shares

When shareholders delay the payment of calls made by the company, the directors are usually empowered to forfeit the shares. The portion of capital involved is cancelled, the money received previously on account of the shares becomes a gain of the company at the expense of the defaulting shareholder. The balance of Calls in Arrear is also cancelled. The defaulting shareholder loses his shares but is released from the liability to pay the call (except when the company is liquidated soon afterwards).

EXAMPLE 39

In June 1962, Brown & Blue Ltd. offered 100,000 shares of 10/– each to the public at a premium of 2/6 per share.

The amount was payable:	on application	2/–
	on allotment	5/–
	(including the premium)	
	on call three months after allotment	5/6

By 14th June, applications were received for 110,000 shares. On 20th June the directors allotted the shares. Cash was returned to the unsuccessful applicants for 10,000 shares. All money due on allotment was paid. The call was duly made on 20th September and all members paid with the exception of B. Green who had been allotted 2,000 shares. On 14th October the directors forfeited these shares and on 20th October they were re-issued at a price of 8/– per share. Record these transactions in the books of Brown & Blue Ltd.

Dr. *Bank Account (extracts)* *Cr.*

1962		£	1962		£
June 14	To Application & A. a/c	11,000	June 20	By Application & A. a/c	1,000
30	„ A. & Allotment a/c	25,000			
Sept. 30	„ Call a/c	26,950			
Oct. 20	„ Forfeited Shares Re-issued a/c	800			

Dr. *Application and Allotment Account* *Cr.*

1962		£	1962		£
June 20	To Share Capital a/c	22,500	June 14	By Bank	11,000
	„ Share Premium a/c	12,500	June 30	„ „	25,000
	„ Bank	1,000			
		£36,000			£36,000

Dr. *Share Capital Account* *Cr.*

1962		£			£
Oct. 14	To Forfeited Shares	1,000	June 23	By Application & Allotment a/c	22,500
20	„ Balance c/d	50,000	Sept. 20	„ Call a/c	27,500
			Oct. 20	„ Forfeited Shares Re-issued a/c	1,000
		£51,000			£51,000
			Oct. 21	By Balance b/d	50,000

Dr. *Share Premium Account* *Cr.*

			1962		£
			June 20	By Application & Allotment a/c	12,500
			Oct. 20	„ Forfeited Shares	250
					£12,750

Dr. *Call Account* *Cr.*

1962		£	1962		£
Sept. 20	To Share Capital a/c	27,500	Sept. 30	By Bank	26,950
				„ Calls in Arrear c/d	550
		£27,500			£27,500
Oct. 1	To Calls in Arrear b/d	550	Oct. 14	By Forfeited Shares a/c	550

Dr. *Forfeited Shares Account* *Cr.*

1962		£	1962		£
Oct. 14	To Calls in Arrear	550	Oct. 14	By Share Capital a/c	1,000
20	„ Forfeited Shares Re-issued a/c	200			
	„ Share Premium a/c	250			
		£1,000			£1,000

Dr. *Forfeited Shares Re-issued Account* *Cr.*

1962		£	1962		£
Oct. 20	To Share Capital b/d	1,000	Oct. 20	By Bank	800
				„ Forfeited Shares a/c	200
		£1,000			£1,000

The entries regarding forfeiture and re-issue are now summarised:

1960			£	£
Oct. 14	Share Capital a/c	Dr.	1,000	
	To Forfeited Shares a/c			1,000
	being cancellation of 2,000 shares allotted to B. Green on non-payment of call.			

1960			£	£
Oct. 14	Forfeited Shares a/c	Dr.	550	
	To Call Account			550
	being amount due on forfeited shares of B. Green.			
Oct. 20	Forfeited Shares Re-issued a/c	Dr.	1,000	
	To Share Capital a/c			1,000
	being re-issue of 2,000 shares.			
	Forfeited Shares a/c	Dr.	200	
	To Forfeited Shares Re-issued a/c			200
	being discount on re-issue of shares.			
	Forfeited Shares a/c	Dr.	250	
	To Share Premium			250
	being transfer of gain on re-issue of shares.			

A credit balance on Forfeited Shares Account represents the amounts actually received on the shares before forfeiture less any discount given on the re-issue. Legally, it is possible to re-issue the shares at any discount which does not exceed the amounts previously received for the same shares. This ensures that, on shares forfeited and re-issued, the full nominal value is received. Often more is received and there is a credit balance on Forfeited Shares Account after the re-issue. This is a premium received on the shares and ought to be transferred to Share Premium Account. Note that until the shares are re-issued, a credit balance on Forfeited Shares Account does not represent a premium or gain. It is carried forward in the account until the shares are again issued.

The Conversion of a Partnership into a Limited Company

This is a common occurrence, usually based on the desire of the partners to enjoy limited liability. It involves two accounting processes, the closing of the Partnership Books and the opening of the books of the Company. It is essential to keep these separate. In particular:

1. In the Partnership Books, we are concerned with the book values of the assets, any excess of the price received for the business being a Gain on Realisation.
2. In the Company's Books, the assets are recorded at values considered true by the directors of the Company, any excess of the price given for the business being taken as Goodwill.

EXAMPLE 40

Grey & Black decide to convert their business into a limited company as from the date of the following Balance Sheet:

Dr.		*Balance Sheet*		*Cr.*
Capital Accounts		£	*Fixed Assets*	£
Grey	5,000		Plant & Machinery	3,614
Black	3,000	8,000	Motor Vehicles	1,280
			Current Assets	
Liabilities			Stock	1,462
Creditors		1,421	Debtors	2,119
			Cash in Bank	946
		£9,421		£9,421

Grey & Black share profits in the ratio 2:1. The Company, Grey & Black Ltd., takes over all the assets and liabilities with the exception of cash. The agreed price is £10,000 to be paid by the issue of 10,000 ordinary shares of £1 each. The company revalues the machinery at £4,000, the stock at £1,300 and decides to create a Reserve for Bad Debts of £200.

Close the books of the Partnership and give the entries in the Company's Journal to record the purchase of the business. Give the opening Balance Sheet of the Company.

PARTNERSHIP BOOKS

Dr. *Realisation Account* *Cr.*

		£		£
To Plant & Machinery		3,614	By Creditors	1,421
,, Motor Vehicles		1,280	,, Grey & Black Ltd.	
,, Stock		1,462	Consideration for	
,, Debtors		2,119	Business	10,000
,, Gain on Realisation				
Grey	1,964			
Black	982	2,946		
		£11,421		£11,421

Dr. *Grey & Black Ltd.* *Cr.*

	£		£
To Realisation a/c		By Capital a/cs—	
Purchase of Business	10,000	Shares Allotted	
		Grey	6,667
		Black	3,333
	£10,000		£10,000

Dr. *Capital Accounts* *Cr.*

	Grey £	*Black* £		*Grey* £	*Black* £
To Grey & Black Ltd.			By Balances	5,000	3,000
Shares Allotted	6,667	3,333	,, Gain on		
,, Cash	297	649	Realisation	1,964	982
	£6,964	£3,982		£6,964	£3,982

Dr. *Cash Account* *Cr.*

	£		£
To Balance	946	By Capital Accounts	
		Grey	297
		Black	649
	£946		£946

COMPANY'S JOURNAL

		£	£
Plant & Machinery	Dr.	4,000	
Motor Vehicles	,,	1,280	
Stock	,,	1,300	
Debtors	,,	2,119	
Goodwill	,,	2,922	
To Bad Debts Reserve			200
,, Creditors			1,421
,, Vendors—Grey & Black			10,000
being business purchased		£11,621	£11,621
Grey & Black	Dr.	10,000	
To Ordinary Share Capital a/c			10,000
being satisfaction of consideration for business by the issue of ordinary shares.			

Balance Sheet of Grey & Black Ltd.

Dr.	£	*Cr.*		£
Capital—Issued		*Fixed Assets*		
10,000 Ordinary Shares of £1 each	10,000	Goodwill		2,922
		Plant & Machinery		4,000
		Motor Vehicles		1,280
Liabilities		*Current Assets*		
Creditors	1,421	Stock		1,300
		Debtors	2,119	
		Less Reserve for Bad Debts	200	1,919
	£11,421			£11,421

Very often, the purchasing company does not take over the debts of the vendors but agrees to collect them as agent. Records must be kept separately for debtors of the vendors, receipts from them and any expenses of collection, e.g. discount. The agreement to pay the vendors' creditors out of the proceeds does not involve such complications and usually can be controlled by Memorandum records. The Accounting processes are illustrated in Example 41.

EXAMPLE 41

Avenues Ltd. takes over the business of Builder & Son on 30th June, 1960. It does not take over the debts or liabilities but agrees to collect the debts on behalf of the partnership and out of the proceeds to pay the creditors. The amounts involved are:

Debtors	£3,400
Creditors	£1,200

A commission of 1% is to be allowed on all amounts collected. On 31st July, the Company reported to the partners:

Debts collected	£2,000	less discount at 5%
Creditors Paid	£1,200	less discount of £25.

A cheque was enclosed for the net sum after deduction of the Company's commission.

The final position was reported on 30th September. All debts except £200 owing by a bankrupt had been collected. There was no hope of receiving this amount. No discount had been allowed on the other amounts. A cheque was sent to settle the account with the partners.

Give the entries in the Company's ledger and also the appropriate entries in the Partnership Journal.

Avenues Ltd.

Dr. *Sundry Debtors* (Builder & Son) *Cr.*

1960		£	1960		£
June 30	To Debtors Suspense a/c	3,400	July 31	By Cash	1,900
				„ Debtors Suspense a/c	100
				„ Balance c/d	1,400
		£3,400			£3,400
Aug. 1	To Balance b/d	1,400	Sept. 30	By Cash	1,200
				„ Debtors Suspense a/c	200
		£1,400			£1,400

Dr. *Debtors Suspense Account* *Cr.*

1960		£	1960		£
July 31	To Debtors— Discount	100	June 30	By Sundry Debtors	3,400
	„ Builder & Son	1,900			
	„ Balance c/d	1,400			
		£3,400			£3,400
Sept. 30	To Debtors— Bad Debts	200	Aug. 1	By Balance b/d	1,400
	„ Builder & Son	1,200			
		£1,400			£1,400

Dr. *Builder & Son* *Cr.*

1960		£	1960		£
July 31	To Bank—Creditors	1,175	July 31	By Debtors Suspense a/c	1,900
	„ Commission	19			
	„ Bank	706			
		£1,900			£1,900
Sept. 30	To Commission	12	Sept. 30	By Debtors Suspense a/c	1,200
	„ Bank	1,188			
		£1,200			£1,200

Dr. *Commission Account* *Cr.*

			1960		£
			July 31	By Builder & Son	19
			Sept. 30	„ „ „ „	12
					£31

Builder & Son *Journal*

			Dr.	*Cr.*
July 31	Avenues Ltd.	Dr.	1,900	
	To Realisation a/c			1,900
	being amounts collected from Sundry Debtors.			
	Sundry Creditors	Dr.	1,200	
	To Realisation a/c			25
	„ Avenues Ltd.			1,175
	being amount paid to creditors with discount of £25.			

July 31	Bank	Dr.	706	
	Realisation a/c		19	
	To Avenues Ltd.			725
	being remittance less commission.			
Sept. 30	Avenues Ltd.	Dr.	1,200	
	To Realisation a/c			1,200
	being final amount collected from debtors (Bad Debt £200)			
	Realisation a/c		12	
	Bank		1,188	
	To Avenues Ltd.			1,200
	being remittance less commission.			

The Final Accounts of a Company

The trading of a company is recorded in the same way as the trading of a private individual or partnership. The main accounting differences arise from the different form of capital and different ways of profit appropriation. The former has already been described.

In a partnership, the full Net Profit is credited to the accounts of the partners and Drawings are debited to those accounts. In a company, profit distribution takes the form of dividends on shares and these are debited to the Appropriation Account. Profits retained in the business may be transferred to a Reserve Account, or, alternatively, may be carried forward as a balance on the Profit & Loss Appropriation Account. The Appropriation Account and Balance Sheet can be illustrated as follows:

Dr. *Profit & Loss Appropriation Account for the year ended 31st December, 1960* *Cr.*

	£		£
To Transfer to General Reserve	5,000	By Balance brought forward 1st January, 1960	3,210
,, Preference Dividend	3,000	,, Net Profit for Year	16,815
,, Ordinary Dividend	10,000		
,, Balance carried forward	2,025		
	£20,025		£20,025

Balance Sheet as at 31st December, 1960

	£		£
Share Capital—Authorised		*Fixed Assets*	
100,000 6% Preference Shares of £1	100,000	Land at cost	15,000
100,000 Ordinary Shares of £1	100,000	Buildings at cost less depreciation	29,000
		Machinery at cost less depreciation	64,000
	£200,000		
			108,000
Share Capital—Issued			
50,000 6% Preference Shares of £1 fully paid	50,000	*Current Assets*	
100,000 Ordinary Shares of £1 fully paid	100,000	Stock	44,300
		Debtors	29,840
	150,000	Cash at Bank	9,840
General Reserve	25,000		
Profit & Loss Account Balance carried forward	2,025		
Liabilities			
Sundry Creditors	14,136		
Accrued Expenses	819		
	£191,980		£191,980

This illustration does not give all the information which the Companies Act requires of a published set of final accounts. It is not intended to do so, as those requirements are to be studied later. It does illustrate the two basic features peculiar to the final accounts of a company:

1. The Profit & Loss Appropriation Account shows balances of unallocated profits brought forward from the previous year and carried forward to the following year.
2. On the Balance Sheet, the capital of the business is reported in other accounts besides the Share Capital Accounts. Thus the capital of the above firm is made up of:

	£
Amounts contributed by Preference Shareholders	50,000
Amounts contributed by Ordinary Shareholders	100,000
Retained profits accumulated as General Reserve	25,000
Retained profits carried forward in the Profit & Loss Appropriation Account	2,025
	£177,025

This capital figure can be confirmed by the deduction of liabilities from the total assets:

		£
Assets		191,980
Less Creditors	14,136	
Accrued Expenses	819	14,955
		£177,025

Questions 10

1. †Audrey Limited invited applications for 200,000 of its £1 Ordinary Shares on the following terms:

Payable on application on 31st January	10/- per share
Payable on allotment on 28th February (including the premium of 1/- per share)	6/- per share
Payable on first and final call on 30th June	5/- per share

Applications for 250,000 shares were received. It was decided:

(a) to refuse allotment to the applicants for 10,000 shares;
(b) to allot in full to the applicants for 40,000 shares;
(c) to allot the balance of the available shares pro rata among the other applicants;
(d) to utilise excess application money in part payment of allotment money.

One applicant to whom shares had been allotted in full did not pay the amount due on call and his 200 shares were forfeited. The shares were re-issued on 31st October, at 18s.

Show the Journal and Cash Book entries necessary to record the foregoing.

†Re-printed by courtesy of the Society of Incorporated Accountants (S.A.A.).

2. On 1st January, 1960, Cabinet Construction Ltd. offered 100,000 £1 Ordinary Shares to the public at a price of 25/–. The amount per share was payable:

On application	5/–
On allotment	7/6 (including 2/6 of the Premium)
On first call	5/– (including 2/6 of the Premium)
On second call	7/6

The closing date for applications was on 25th January and, by that date, applications had been received for 120,000 Shares.

On 31st January, the directors allotted the shares.

Applicants for 5,000 shares had their money returned as they received no allotment. Applicants for 20,000 shares were allotted only 5,000 and the balance of their application money was used for Allotment and the first call. The rest of the applications were allotted in full.

The allotment money was received in full by 15th January. The First Call was made on 31st March and all the money due was received by 16th April except that from T. Bad who had been allotted 4,000 shares, (the number for which he had applied).

The shares were forfeited on 20th April and re-issued as fully paid on 15th May for a price of 20/– per share.

Record these transactions in the books of the company.

3. *The Rotar Company Limited was formed to purchase the business of Roberts and Taring, who share profits, two-thirds and one-third respectively, and whose Balance Sheet was as follows:

Balance Sheet—Roberts and Taring.

	£	£			£
Capitals					
Roberts	12,000		Goodwill		2,000
Taring	7,000		Freehold Property		8,000
		19,000	Plant and Machinery		5,000
Creditors		5,700	Stock		4,000
Bills Payable		1,900	Debtors	£3,100	
Loan Account		400	Less Provision	200	2,900
			Bills Receivable		1,800
			Investments		2,000
			Cash		1,300
		£27,000			£27,000

*Re-printed by courtesy of the Royal Society of Arts (R.S.A.).

The Company takes over the assets at book values with the exception of freehold property, which is taken over at £10,000. The cash and investments are retained by the firm, and the investments are sold by them for £1,600. They also discharge the loan of £400; but the Company takes over the remaining liabilities.

The purchase consideration for the net assets taken over is fixed at £22,500 payable as follows: 22,000 fully paid ordinary shares of £1 each and the balance in cash. Roberts and Taring agree to divide the shares in the proportion of the balances of their respective Capital Accounts.

Show the Ledger Accounts closing the firm's books, and the Journal entries opening the Company's books.

4. †Enterprise Ltd. agreed to purchase as at 30th June, 1959, the business of Day and Night whose Balance Sheet at that date was summarised as follows:

	£	£
Goodwill		10,000
Land and Buildings		65,000
Plant and Machinery		28,000
Stocks		24,000
Debtors		67,000
		194,000
Less:		
Creditors	28,000	
Overdraft at Bank	9,000	37,000
Partners' Capitals		£157,000

The purchase consideration was agreed at £150,000 and the company took over all the assets and the liability to the creditors, but the bank overdraft was discharged by Day and Night. In arriving at the purchase price, stocks were revalued at £21,000, a reserve of £5,000 was considered necessary in respect of a doubtful debt, and plant and machinery was revalued at £30,000.

To provide funds for the purchase of the business and further working capital Enterprise Ltd. decided to issue 200,000 new Ordinary Shares of £1 each, at 22/6 per share. Of these new shares Day and Night agreed to accept 50,000 shares in part satisfaction of the purchase consideration for their business and these were allotted as fully paid on 15th July, 1959, the balance of the consideration being payable in cash on 1st September, 1959.

†Re-printed by courtesy of the Society of Incorporated Accountants (S.A.A.).

Enterprise Ltd. offered the remaining 150,000 new Ordinary Shares to the public on 1st July, 1959, payment thereof being due as follows: 5/- on application, 7/6 on allotment on 15th July (including the premium of 2/6) and 10/- first and final call on 15th August, 1959. The public applied for 200,000 shares and applications were scaled down pro rata; all balances due on allotment, and all call moneys were received with the exception of the call on 5,000 shares. On 31st October, 1959, these 5,000 shares were forfeited and were re-issued fully paid up on 10th November, 1959 for a consideration of 20/- per share which was paid on that day.

You are required to show the journal entries (including cash items) to record, in the books of Enterprise Ltd., the purchase of the business and the issue of the new Ordinary Shares.

5. †Nether and Wallop were equal partners and their Balance Sheet at 31st December, 1961, was as follows:

	£	£		£	£
Creditors		28,000	Balance at Bank	12,000	
Current Accounts			Debtors	36,800	
Nether	6,500		Stock	14,400	63,200
Wallop	4,500	11,000			
			Furniture & Fixtures	2,000	
Capital Accounts			Plant	41,600	
Nether	50,000		Leasehold Factory	32,200	
Wallop	50,000	100,000			75,800
		£139,000			£139,000

On 1st January, 1962, they formed a company with an authorised capital of £200,000, half in 6 per cent. Cumulative Preference Shares and half in Ordinary Shares of £1 each, to take over the business. It was agreed that:

(a) the purchase consideration should be £150,000, payable by allotment at par of 50,000 Preference Shares and 80,000 Ordinary Shares, and the balance in cash;

(b) the assets to be revalued as follows:

Furniture and Fittings	at £3,000
Plant	at £40,000
Premises	at £35,000;

(c) the vendors should retain the balance at bank and discharge creditors;

(d) the Company should collect debts on behalf of the vendors.

†Re-printed by courtesy of the Society of Incorporated Accountants (S.A.A.).

Shares were allotted to the vendors on 1st January, 1962, and the balance of the purchase consideration was paid to them on 1st March, 1962. The Company completed the collection of debts, with the exception of bad debts amounting to £750, by April 15th, 1962, and paid the net proceeds on that date. Partnership creditors were paid off by 15th March, discounts of £400 being received. The vendors paid the costs incidental to formation of the Company and the amount, £2,000, was refunded by the Company on 1st March.

Close the books of the partnership and also draft the Balance Sheet of the Company as at 1st January, 1962.

6. *Conway and Bangor Ltd. has an authorised capital of £30,000 divided into 20,000 ordinary shares of £1 each and 10,000 6 per cent preference shares of £1 each.

The following were the balances on the books as at 31st March, 1962:

	£	£
Amounts received on:		
20,000 Ordinary shares fully called		20,000
10,000 Preference shares fully called		9,500
Profit & Loss Account, 31.3.61		2,987
Plant and Machinery (cost, £15,000)	12,000	
Stock at 1st April, 1961	9,625	
General Expenses	2,974	
Discounts allowed	357	
Purchases	79,735	
Provision for Bad Debts		498
Bad Debts	502	
Salaries	4,766	
Balance at Bank	4,939	
Preference Dividend paid to 31.3.62	570	
Sales		97,012
Rates	366	
Discounts received		1,989
5 per cent Debentures		10,000
Sales Returns	802	
Debenture Interest to 30.9.61	250	
Creditors		6,003
Directors' Salaries	5,200	
Freehold Land and Building (cost)	16,000	
Debtors	9,653	
Insurance	250	
	£147,989	£147,989

*Re-printed by courtesy of the Royal Society of Arts (R.S.A.).

The following matters are to be taken into account:

(a) The stock on hand at 31st March, 1962, was valued at £9,898.
(b) Salaries accrued at 31st March, 1962 amounted to £260.
(c) Insurance paid in advance at 31st March, 1962 amounted to £49.
(d) The provision for bad debts is to be made up to £404.
(e) The plant and machinery is to be depreciated at the rate of 10 per cent.
(f) The necessary provision for interest on the debentures is to be made.

Prepare the Trading and Profit and Loss Account of the company for the year ending 31st March, 1962, and the Balance Sheet at that date.

7. A. Juby Ltd. is a company with an authorised capital of £20,000 divided into:

10,000 6% Preference Shares of £1 each.
20,000 Ordinary Shares of 10/- each.

All the shares have been issued and are fully paid with the exception of 1,000 Preference Shares on which the final call of 7/6 per share is in arrears.

The Net Trading Profit for the Year to 30th June, 1961, is £6,000 and the Balance on Profit & Loss Account brought forward from the previous year is £1,200. It is proposed to pay the following dividends:

6% on the fully paid Preference Shares
and 20% on the Ordinary Shares.

£2,000 is to be transferred to General Reserve.

In addition to the balances mentioned above, the following appear in the Company's Ledgers:

	£		£
Sundry Debtors	6,000	Cash at Bank	1,810
Sundry Creditors	2,160	Share Premium Account	1,000
Stock	7,410	Goodwill at cost	4,000
Plant at cost less depreciation	9,200	Accrued Expenses	135
		Motor Vehicles at cost less depreciation	1,700

Prepare the Appropriation Account and the Balance Sheet as at 30th June, 1961.

CHAPTER 11

Departmental and Branch Accounts

Departmental Accounts

Many businesses may conveniently be divided into separate departments. For management purposes it is then desirable, indeed almost essential, for the financial report to describe not only the total picture but also the performance of different departments. A large garage for instance, may perform the following services:

(a) Sale of Petrol and Oil.
(b) Sale of Vehicles.
(c) Sale of Components.
(d) Repair Work.

The accounts will be more valuable if they give some indication of the profitability of each aspect of the business. Similarly, many retail stores must be considered departmentally.

Some costs can be traced directly to particular departments. The cost of goods sold and the wages of employees wholly employed by a department are examples. The revenues of departments are easily separated. But then we reach the snag. Many expenses of the business relate to the whole business and cannot be directly charged to any particular department. The rent of the whole building and the salaries of higher management are examples. In order to determine a profit or loss figure for each department, these costs must be arbitrarily apportioned. Apportionment is along these lines:

(a) Rent & Rates according to floor space occupied by different departments. Sometimes allowance is made for differing values of particular

	areas, e.g. the situation near a door on the ground floor is considered much more valuable than the remote counter on a third floor.
(b) Staff Welfare Services	according to number of employees in, or the wage bill of, each department.
(c) Other Expenses	according to the turnover of each department. This may be measured in money or in number of articles sold.

The next example illustrates the common approach to departmental accounts.

EXAMPLE 42

The Archways Company have three main departments in their store.

1. Confectionery
2. Pharmacy
3. Café.

The following figures relate to the year 1960.

	Confectionery	*Pharmacy*	*Café*
	£	£	£
Stock 1st January	1,600	3,100	1,100
Purchases	10,400	16,920	24,300
Stock 31st December	2,090	2,930	1,050
Wages	2,510	3,460	23,100
Sales	18,000	36,000	54,000

and for the business as a whole:

	£
Rent & Rates	3,800
Motor Expenses	2,810
Management Expenses	8,000
Heating and Lighting	620
Sundry Expenses	360

Prepare a Departmental Profit & Loss Account for the year 1960 allowing Depreciation on Motor Vehicles of £1,400 and on the Café Equipment of £300.

Rent and Rates are to be charged according to occupied space: Confectionery 2 parts, Pharmacy 3 parts and the Café 5 parts.

All other indirect expenses are to be charged in the ratio of turnovers.

Dr. *Trading & Profit & Loss Accounts for the Year ended 31st December, 1960* *Cr.*

	Confectionery	*Pharmacy*	*Café*		*Confectionery*	*Pharmacy*	*Café*
	£	£	£		£	£	£
To Stock 1 Jan.	1,600	3,100	1,100	By Sales	18,000	36,000	54,000
„ Purchases	10,400	16,920	24,300	„ Stock 31 Dec.	2,090	2,930	1,050
„ Gross Profit	8,090	18,910	29,650				
	£20,090	£38,930	£55,050		£20,090	£38,930	£55,050
To Wages	2,510	3,460	23,100	By Gross Profit	8,090	18,910	29,650
„ Rent & Rates	760	1,140	1,900	„ Net Loss			2,245
„ Management Exs.	1,333	2,667	4,000				
„ Heating & Lighting	103	207	310				
„ Sundry Exs.	60	120	180				
„ Motor Exs.	468	937	1,405				
„ Depreciation Motor Vehicles	233	467	700				
Café Equipment			300				
„ Net Profit	2,623	9,912					
	£8,090	£18,910	£31,895		£8,090	£18,910	£31,895

The total Net Profit is thus:

	£
Confectionery	2,623
Pharmacy	9,912
	12,535
Less Loss in Café	2,245
	£10,290

The calculations involve plenty of work but that is said to be justified by the extra information provided by such accounts. A simple figure of £10,290 as profit would hide the loss made by the café. Management would find the extra information regarding departmental results invaluable, at least it would if that information were reliable. Unfortunately, it is most misleading. The practice of preparing Departmental Accounts in this way, though common, is not to be commended.

A superficial reading of the accounts of The Archways Company would suggest that the closing of the café would increase the net profit of the business. In fact, this is most unlikely. The portion of the indirect expenses or overheads charged to the café would not necessarily be saved by closing the café. Management Expenses, Heating and Lighting Charges etc. would scarcely be halved. The floor space occupied by the café might be sublet but the rent received could be more or less than £1,900. The café has made a loss on the assumption of an arbitrary apportionment of certain expenses. That arbitrary apportionment is unlikely to portray the economic reality and the results can thus mislead. The following presentation appears to give less information. In fact, it will be much more useful:

Dr. *Trading & Profit & Loss Account for the Year ended 31st December*, 1960 *Cr.*

	Confectionery £	*Pharmacy* £	*Café* £		*Confectionery* £	*Pharmacy* £	*Café* £
To Cost of Goods Sold				By Sales	18,000	36,000	54,000
Stock 1 Jan.	1,600	3,100	1,100				
Purchases	10,400	16,920	24,300				
	12,000	20,020	25,400				
Less Stock 31 Dec.	2,090	2,930	1,050				
	9,910	17,090	24,350				
,, Wages	2,510	3,460	23,100				
,, Depreciation of Equipment			300				
,, Surplus	5,580	15,450	6,250				
	£18,000	£36,000	£54,000		£18,000	£36,000	£54,000

Dr.	£		*Cr.* £
To Rent & Rates	3,800	By Surpluses over Direct Costs	
,, Motor Expenses	2,810	Confectionery Dept.	5,580
,, Management Expenses	8,000	Pharmacy Dept.	15,450
,, Heating & Lighting	620	Café	6,250
,, Sundry Expenses	360		
,, Depreciation— Motor Vehicles	1,400		
,, Net Profit	10,290		
	£27,280		£27,280

No attempt has been made to show the "profit" of each department. The contribution to overheads and profit made by each department is a more definite figure and is of much more value. If the future working of the café is to be considered the straightforward question must be answered.

Will the closing of the café lead to a saving of expense and alternative income (e.g. through the subletting of the floor space) greater than £6,250?

If so, it can be considered. Note that even then, the best policy is not self-evident. Consideration must be given to the way in which the café attracts customers to the other two departments. This is and must remain a matter of opinion, for it would be almost impossible to provide any relevant and reliable figures.

Branch Accounts

For accounting purposes, businesses which operate through branches fall into two main categories:

1. Those where the Head Office keeps all the accounting records, only supplementary and memorandum books being kept at the branch:
2. Those where each branch keeps its own set of accounts.

1. *All Accounting Records at Head Office*

Although the records form one unit, the transactions of the branch are in separate accounts. The following extra accounts are kept:

(a) *Branch Stock Account* (or Branch Trading Account)

Whatever name used, this does serve as a Trading Account for the Branch. It is debited with the Stock on hand at the beginning of the Year and with Goods received from the Head Office during the Year. It is credited with Sales and the closing Stock, the latter being carried down as a balance on the account.

The difference between the two sides of the account is either the Gross Profit or Loss.

(b) *Branch Expenses Account*

Separate accounts are kept for the branch selling and administrative expenses. In theoretical exercises, these expenses are often entered in one account merely for convenience.

(c) *Branch Cash Account*

This is a record in summary form of the Branch Cash transactions. Sometimes it is unnecessary for the Branch remits all takings to the Head Office as they are received and all expenses are paid from Head Office.

(d) *Branch Debtors Account*

This is a "Total Account" kept when the branch sells goods on credit.

(e) *Goods Sent to Branch(es) Account*

This relates to the Head Office side of the Branch's existence. Goods sent to the branch for sale have been purchased by the Head Office and are included in the Head Office Purchases Account. When sent to the branch, they must be extracted from the charge for Head Office Purchases. This is done in total at the end of the year, the amounts first passing through a separate Goods sent to Branch Account. This is best described as an intermediate station between the Branch Stock Account and the Head Office Purchases Account, similar in function to the "Goods on Consignment Account" previously described.

EXAMPLE 43

A business in London has a branch at Brighton. At 1st January, 1962, the accounts showed:

(a)	Stock on hand at the branch (Cost Price)	£1,200
(b)	Cash in hand " " "	£360
(c)	Sundry Debtors of branch	£820

The following figures summarise the 1962 transactions of the branch:

	£
Sales—Cash	4,620
Credit	10,960
Goods sent from Head Office (at cost)	10,200
Cash received from Debtors	10,100
Discounts allowed to Debtors	460
Returns from Customers	220
Returns to Head Office (at cost)	394
Cash remitted to Head Office	13,000
Sundry Expenses paid at branch	210
Wages of Branch Assistants paid from Head Office	2,400
Rent and Rates of branch paid from Head Office	420

The Branch Stock at 31st December, 1962, was valued at £2,350.

Record the above transactions in the Head Office Books.

Dr. *Branch Stock Account* *Cr.*

1962		£	1962		£
Jan. 1	To Stock b/d	1,200	Dec. 31	By Sales—Cash	4,620
Dec. 31	,, Goods from HO	10,200		Credit	10,960
	,, Returns—Customers	220		,, Returns to Head Office	394
	,, Gross Profit to P. & L. A/c	6,704		,, Stock c/d	2,350
		£18,324			£18,324
1963					
Jan. 1	To Stock b/d	2,350			

Dr. *Branch Cash Account* *Cr.*

1962		£	1962		£
Jan. 1	To Balance b/d	360	Dec. 31	By Remittance	13,000
Dec. 31	,, Debtors	10,100		,, Sundry Expenses	210
	,, Cash Sales	4,620		,, Balance c/d	1,870
		£15,080			£15,080
1963					
Jan. 1	To Balance b/d	1,870			

Dr. *Branch Debtors Account* *Cr.*

1962		£	1962		£
Jan. 1	To Balance b/d	820	Dec. 31	By Discount	460
Dec. 31	,, Sales	10,960		,, Cash	10,100
				,, Returns	220
				,, Balance c/d	1,000
		£11,780			£11,780
1963					
Jan. 1	To Balance b/d	1,000			

Dr. *Branch Expenses Account* *Cr.*

1962		£	1962		£
Dec. 31	To Discount	460	Dec. 31	By P. & L. A/c	3,490
	,, Branch Cash—Sundries	210			
	,, H.O. Cash—Wages	2,400			
	,, Rent & Rates	420			
		£3,490			£3,490

Dr. *Branch Profit & Loss Account for the Year to 31st December, 1962* *Cr.*

	£		£
To Wages	2,400	By Gross Profit	6,704
,, Rent and Rates	420		
,, Discount	460		
,, Sundries	210		
,, Net Profit to Head Office P. & L. A/c	3,214		
	£6,704		£6,704

Dr. *Goods sent to Branch Account* *Cr.*

1962		£	1962		£
Dec. 31	To Branch Stock a/c —Returns	394	Dec. 31	By Branch Stock a/c	10,200
	,, H.O. Purchases a/c	9,806			
		£10,200			£10,200

The Assets of the Branch will also be recorded in separate accounts. For example, there may be two Shop Fittings Accounts, one for the Head Office and one for the Branch. These Accounts present no problems, and we are content just to mention them in passing.

The above example assumed that Goods sent to the Branch by the Head Office were charged out at cost price. It is often found preferable to charge out such goods at selling price or at cost plus an expected profit. Two advantages are claimed for this practice.

1. The Branch Manager is not aware of the actual profits made by the Branch.
2. A check on the honesty and efficiency of the Branch staff is automatically provided.

The degree to which this check is available will depend upon the nature of the business, e.g. the consistency of the rate of gross profit on all the articles sold, seasonal price variations etc. Many will feel that the hiding of actual profits from the Branch Manager is not good policy. It does not encourage the Manager in his work. Both advantages of this method of charging out goods at selling price can thus be questioned. If so, we are still left with one benefit. The method provides some delightfully intricate examination problems!

There are two accounting methods available:

1. The Double Entry Accounts are as in the previous example but a special memorandum column is included in the Branch Stock Account. In this column, entries are made at selling price.
2. All figures are incorporated in the Double Entry system. An additional account, the Branch Adjustment Account is opened. In this account is recorded the Profit Loading (the difference between Cost and assumed Selling Price). The Branch Stock Account is then kept at Selling Price. There is a profit loading on:

   (a) Opening and Closing Stocks

   (b) Goods sent to Branch and Returns from the Branch.

   The Stock in the Branch Stock Account is at assumed selling price. But it would be wrong to record this as a balance in the Balance Sheet where all Stock appears at cost. There is a credit balance on Branch Adjustment Account which serves as a set-off against the debit for Stock at Selling Price. As this credit is the Profit Loading, the net difference is the Stock at Cost Price.

   Goods received from the Head Office are debited in the Branch Stock Account at selling price. But the corresponding credit in Goods sent to Branch Account (to be transferred to Head Office Purchases Account) must be at cost. The difference is the Profit Loading which is credited to the Branch Adjustment Account.

   The Branch Adjustment Account is thus in this form:

Debit	*Credit*
To Profit Loading on Returns from Branch	By Profit Loading on Opening Stock b/f
„ Profit Loading on Closing Stock c/f	„ Profit Loading on Goods sent to Branch.

The balance can be stated,

Profit Loading on (Opening Stock + Goods sent to Branch during Year less Returns − Closing Stock).

A moment's thought will simplify this statement. It is obviously the Profit Loading on Goods sold by the Branch, i.e. the Branch Gross Profit. Frequently, slight adjustments are necessary for Allowances or for Shortage of Stock.

EXAMPLE 44

Record the following in the appropriate accounts:

	£
Branch Stock, 1st January 1962 at Selling Price	1,640
Goods sent to Branch at Selling Price	18,420
Goods returned by Branch at Selling Price	388
Sales during Year	17,252
Branch Stock, 31st December 1962 at Selling Price	2,376

Goods are sold at $33\frac{1}{3}\%$ on Cost Price. All sales are for cash which is immediately remitted to the Head Office.

METHOD 1

Branch Stock Account

Dr.		*Memorandum S.P. Column*	*Double Entry Column*			*Memorandum S.P. Column*	*Cr.* *Double Entry Column*
1962		£	£	1962		£	£
Jan. 1	To Stock b/d	1,640	1,230	Dec. 31	By Returns to H.O.	388	291
Dec. 31	„ Goods sent to Branch a/c	18,420	13,815		„ Sales	17,252	17,252
					„ Stock c/d	2,376	1,782
	„ Gross Profit		4,280		„ Stock Deficiency	44	
		£20,060	£19,325			£20,060	£19,325
1963							
Jan. 1	To Stock b/d	2,376	1,782				

METHOD 2

Branch Stock Account

Dr.		£		Cr.	£
1962			1962		
Jan. 1	To Stock b/d	1,640	Dec. 31	By Returns to H.O.	388
Dec. 31	„ Goods sent to Branch a/c	18,420		„ Sales	17,252
				„ Stock c/d	2,376
				„ Adjustment a/c Loss of Stock	44
		£20,060			£20,060
1963					
Jan. 1	To Stock b/d	2,376			

Branch Adjustment Account

Dr.		£		Cr.	£
1962			1962		
Dec. 31	To Profit Loading on Returns to H.O.	97	Jan. 1	By Profit Loading on Stock b/d	410
	„ Profit Loading on Stock c/d	594	Dec. 31	„ Profit Loading on Goods sent to Branch	4,605
	„ Loss of Stock	44			
	„ Gross Profit	4,280			
		£5,015			£5,015
			1963		
			Jan. 1	By Profit Loading on Stock b/d	594

Goods sent to Branch Account

Dr.		£		Cr.	£
1962			1962		
Dec. 31	To Branch Stock a/c Returns	291	Dec. 31	By Branch Stock a/c	13,815
	„ Purchases a/c	13,524			
		£13,815			£13,815

The Balance Sheet figure for Stock will be £2,376 less £594, i.e. £1,782.

The Journal entries for the Goods sent to the Branch and the Returns are as follows:

			£	£
1962				
Dec. 31	Branch Stock a/c	Dr.	18,420	
	To Branch Adjustment a/c			4,605
	,, Goods sent to Branch a/c			13,815
	being goods sent from H.O. invoiced at cost + 33⅓%			
	Branch Adjustment a/c	Dr.	97	
	Goods sent to Branch a/c		291	
	To Branch Stock a/c			388
	being goods returned from Branch at cost + 33⅓%.			

Finally, the Profit figure can be confirmed.

Profit on Sales at 25% (33⅓% of Cost = 25% of Sales)	4,313
Less Stock Deficiency at Cost 75% of £44	33
	£4,280

2. *Branches keeping Independent Records*

A full set of accounts are kept at each branch. There is only one important difference between these accounts and those of a separate business; there is no Capital Account so-called. Other differences are minor. Goods received from the Head Office are merely a special class of Purchases. Frequently such branches also purchase from outside suppliers as well. Goods from Head Office and Purchases from other suppliers may or may not be recorded in separate accounts but both are charged in the Branch Trading Account. The preparation of the Branch Trading and Profit & Loss Accounts involve no new principles.

The Head Office Account in the Branch Books is the one that merits special attention. It is the Capital Account of the Branch but differs from normal Capital Accounts. Many items are passed through it during the trading periods. Drawings are non-existent but are paralleled by remittances to the Head Office. The parallel is only partial for some of the remittances could be regarded as payment for goods supplied or services rendered by the Head Office.

The Head Office Account thus records:

On the Debit Side:

Remittances from Branch
Returns of Goods to Head Office
The closing balance to be carried forward.

On the Credit Side:

The opening balance brought forward
The Goods supplied by the Head Office
Any administrative charge made by the Head Office
The Net Profit of the Branch.

There is an account for the Branch in the Head Office books which should correspond. The Branch Account in the Head Office books is the exact reverse of the Head Office Account in the Branch books. However, it often happens that the balances at a particular date do not agree. This may be due to:

(1) Cash in Transit. A sum sent by the Branch to the Head Office has not arrived. It has been debited in the Branch books but there is no corresponding credit in the Head Office books

(2) Goods in Transit. Stock sent by the Head Office to the Branch may not have arrived. The debit has been made in the Head Office books but no entry has been made in the Branch books.

The reconciliation is illustrated simply.

The balance of the XY Branch in the Head Office books on 30th September 1960 is £12,160. The balance of the Head Office Account in the Branch Books is £10,400. The difference arises because the branch remitted £1,500 to the Head Office on 29th September and this remittance had not arrived at the time the Head Office balanced its books. There was also a consignment of goods in transit from the Head Office. These goods had been invoiced at £260. The Branch Account in the Head Office books will be adjusted in this way.

Dr.		*Branch Account*			*Cr.*
1960		£	1960		£
Sept. 30	To Balance b/d	12,160	Sept. 30	By Goods in Transit c/d	260
				„ Cash in Transit c/d	1,500
				„ Balance c/d	10,400
		£12,160			£12,160
1960					
Oct. 1	To Goods in Transit b/d	260			
	„ Cash in Transit b/d	1,500			
	„ Balance b/d	10,400			

Goods and Cash in Transit will appear as separate balances in the Balance Sheet. Early in the following year, the Cash in Transit will be cancelled by the credit entry on receipt of the money. Goods in Transit remains on the account as a charge to the Branch in the following year.

The Final Accounts of the Branch and Head Office are prepared from separate books but as they apply to the same business they must be brought together. In the actual accounting records, the link is the Net Profit of the branch. This is found in the Branch Profit & Loss Account but it is incorporated in the Head Office Profit & Loss Account as part of the total business profit. The entries are:

BRANCH BOOKS.

Debit Profit & Loss Account   Credit Head Office Account.

HEAD OFFICE BOOKS.

Debit Branch Account   Credit Profit & Loss Account or Appropriation Account.

Although this is the only real link between the two Revenue Accounts, it is obviously desirable to present them together in columnar form.

Trading & Profit & Loss Account for the Year ended 30th September, 1960

	H.O.	Branch	Total		H.O.	Branch	Total
	£	£	£		£	£	£
To Stock 1 Oct. 1959	2,100	1,646	3,746	By Sales	16,416	12,312	28,728
,, Purchases	11,360	8,439	19,799	,, Stock 30 Sept. 1960	3,040	1,937	4,977
,, Gross Profit c/d	5,996	4,164	10,160				
	£19,456	£14,249	£33,705		£19,456	£14,249	£33,705
To Wages & Salaries	3,000	1,500	4,500	By Gross Profit b/d	5,996	4,164	10,160
,, Rent & Rates	300	400	700	Administrative Charge to Branch	500		
,, Sundry Expenses	860	310	1,170				
,, Head Office Charge		500					
,, Net Profit	2,336	1,454	3,790				
	£6,496	£4,164	£10,160		£6,496	£4,164	£10,160

The amount of £3,790 is credited to the Profit & Loss Appropriation Account or to the Proprietors Capital Account.

The Balance Sheet of the whole business is a collection of balances from two sets of accounts. We can regard it as being prepared from the Head Office Trial Balance with the individual assets and liabilities of the Branch substituted for the one balance of the Branch Account. The principle is illustrated from these simplified Trial Balances taken out after the Profit & Loss Accounts have been prepared.

	H.O.		Branch	
	Dr.	Cr.	Dr.	Cr.
	£	£	£	£
Capital Account		20,000		
Branch Account	7,000			
Head Office Account				6,000
Liabilities		2,000		1,500
Sundry Assets	15,000		7,500	
	£22,000	£22,000	£7,500	£7,500

The difference between the Branch and Head Office Accounts arises because of £600 Cash in Transit and £400 Goods in Transit.

Balance Sheet as at................

		£		
Capital		20,000	*Assets*	
Liabilities			Sundries Head Office	15,000
Head Office	2,000		Branch	7,500
Branch	1,500			
		3,500		22,500
			Stock in Transit	400
			Cash in Transit	600
		£23,500		£23,500

EXAMPLE 45

The Head Office of the Boothby Trading Co. is at Liverpool. The firm opened a Branch in Chester some years ago. The Branch keeps a full set of double-entry accounts and, indeed, makes many purchases from outside suppliers. You are required to prepare a Trading and Profit & Loss Account for the Year ended 30th September, 1962 and a Balance Sheet as at that date.

On 30th September, 1962, the Stocks on hand were valued:

Liverpool	£14,200
Chester	£7,430

A consignment of goods had left Liverpool for Chester but had not arrived. The value was £810. The Branch had remitted £2,000 to the Head Office but it reached Liverpool on 2nd October.

Trial Balances

The partners share profits equally. Depreciation is to be written off at the rates:

Motor Vehicles	20%
Fixtures and Fittings	5%
Premises	2%

The Branch is to bear 25% of the Advertising Costs and £1,500 of the Head Office Salaries.

	Head Office		*Branch*	
	Dr.	*Cr.*	*Dr.*	*Cr.*
	£	£	£	£
Capital A. Boothby		43,170		
Y. Boothby		25,416		
Drawings A. Boothby	2,400			
Y. Boothby	2,000			
Shop Premises	10,600		8,000	
Stock	13,134		6,216	
Debtors	2,100		1,413	
Creditors		6,032		1,412
Fixtures and Fittings	2,320		2,020	
Motor Vehicles	3,010			
Motor Expenses	239			
Sales		104,178		44,612
Purchases	107,230		18,172	
Goods from Head Office to Branch (at cost)		20,620	19,810	
Salaries and Wages	10,300		3,960	
Lighting and Heating	1,106		920	
Rates and Insurance	613		418	
Advertising	2,000			
Printing and Stationery	417		196	
Interest on Investments		750		
Investments at cost	15,000			
Cash at Bank	8,181		1,605	
Head Office Account				16,706
Branch Account	19,516			
	£200,166	£200,166	£62,730	£62,730

The Boothby Trading Co.

Dr. *Trading & Profit & Loss Account for the Year ended 30th September, 1962* *Cr.*

		Liverpool £	Chester £	Total £		Liverpool £	Chester £	Total £
To Stock, 1st Oct. 1961		13,134	6,216	19,350	By Sales	104,178	44,612	148,790
,, Purchases	107,230		18,172		,, Stock	14,200	7,430	21,630
Less Goods sent to Branch	20,620	86,610		124,592				
Goods from Head Office			19,810					
,, Gross Profit c/d		18,634	7,844	26,478				
		£118,378	£52,042	£170,420		£118,378	£52,042	£170,420
To Salaries & Wages		8,800	5,460	14,260	By Gross Profit b/d	18,634	7,844	26,478
,, Lighting & Heating		1,106	920	2,026	,, Interest on Investments	750		750
,, Rates & Insurance		613	418	1,031				
,, Advertising		1,500	500	2,000				
,, Printing & Stationery		417	196	613				
,, Motor Expenses (including depreciation)		841		841				
,, Depreciation—Premises		212	160	372				
Fixtures & Fittings		116	101	217				
,, Net Profit c/d		5,779	89	5,868				
		£19,384	£7,844	£27,228		£19,384	£7,844	£27,228
To A. Boothby				2,934	By Net Profit b/d			5,868
Y. Boothby				2,934				
				£5,868				£5,868

Balance Sheet as at 30th September, 1962

Capital		£	£	*Fixed Assets at Cost less depreciation*		£	£
A. Boothby —	Balance b/f	43,170		Premises	Liverpool	10,388	
	Add Net Profit	2,934			Chester	7,840	18,228
		46,104		Fixtures &			
	Less Drawings	2,400	43,704	Fittings	Liverpool	2,204	
					Chester	1,919	4,123
Y. Boothby —	Balance b/f	25,416					
	Add Net Profit	2,934		Motor Vehicles			2,408
		28,350					24,759
	Less Drawings	2,000	26,350	*Investments* at Cost			15,000
			£70,054	*Current Assets*			
				Stock	Liverpool	14,200	
Liabilities					Chester	7,430	
Creditors	Liverpool	6,032			In Transit	810	22,440
	Chester	1,412	7,444	Debtors	Liverpool	2,100	
					Chester	1,413	3,513
				Cash at Bank	Liverpool	8,181	
					Chester	1,605	
					In Transit	2,000	11,786
			£77,498				£77,498

The Branch Account in the Head Office books will appear as follows:

Dr.		Branch Account			Cr.
1962		£	1962		£
Sept. 30	To Balance b/d	19,516	Sept. 30	By Cash in Transit c/d	2,000
	„ Advertising	500		„ Goods in Transit c/d	810
	„ Salaries & Wages	1,500		„ Balance c/d	18,795
	„ P. & L. A/c Branch Net Profit	89			
		£21,605			£21,605
Oct. 1	To Cash in Transit b/d	2,000			
	„ Goods „ „ „	810			
	„ Balance b/d	18,795			

So far, the discussion and examples have concerned businesses with only one branch. The accounting for several branches follows the same pattern. However, a business sometimes has several branches without any one being clearly and definitely the Head Office. A partnership may operate in several centres with a partner in charge of each. It is then convenient for the capital and current accounts of the partner to be in the books of the branch where he is in charge. This does introduce a vital difference of principle. The "Capital" of a Branch is not represented by a balance on Head Office account. In each branch, there will be separate accounts for the other branches. The way in which these operate as "clearing accounts" is illustrated in the next example as is also the preparation of the Balance Sheet. It cannot now be considered as prepared from a list of Head Office Balances with details subsituted for the balance of the Branch Account. It is prepared from the full list of all the Balances of the separate branches, the Branch Current Account Balances eliminating each other.

EXAMPLE 46

The partnership of Dixie, Dean & Lawton has shops in Oxford, Birmingham and Luton. Dixie is manager at Oxford, Dean at

Birmingham and Lawton at Luton. Each partner receives 50% of the net profit of the branch he manages and 25% of the net profit of the other branches. The following Trial Balances were taken from the Branch Books after the preparation of the Profit & Loss Accounts.

	Oxford		*Birmingham*		*Luton*	
	Dr. £	*Cr.* £	*Dr.* £	*Cr.* £	*Dr.* £	*Cr.* £
Capital —Dixie		8,510				
,, —Dean				9,620		
,, —Lawton						6,920
Drawings—Dixie	1,250					
,, —Dean			1,150			
,, —Lawton					1,000	
Net Profit for Year		1,176		3,080		1,896
Sundry Fixed Assets	5,610		3,686		1,870	
Stock	3,817		3,439		3,714	
Debtors	1,816		3,174		962	
Liabilities		2,142		2,500		2,160
Cash at Bank	1,385		2,915		2,216	
Current Accounts:						
Birmingham		1,340			504	
Luton		710		504		
Oxford			1,340		710	
	£13,878	£13,878	£15,704	£15,704	£10,976	£10,976

Give the completed Branch Current Accounts, the Partners' Capital Accounts and a Balance Sheet of the business at the given date, 31st October, 1962.

OXFORD BOOKS

Dr.	*Birmingham Branch Account*		*Cr.*
	£		£
To Capital—Dixie Share of Birmingham Profit	770	By Balance b/d	1,340
,, Balance c/d	864	,, P. & L. A/c—Dean's Share of Profit	294
	£1,634		£1,634
		By Balance b/d	864

Dr.	*Luton Branch Account*		Cr.
	£		£
To Capital—Dixie		By Balance b/d	710
Share of Luton Profit	474	,, P. & L. A/c	
,, Balance c/d	530	Lawton's Share of	
		Profit	294
	£1,004		£1,004
		By Balance b/d	530

Dr.	*Capital Account—Dixie*		Cr.
	£		£
To Drawings	1,250	By Balance b/d	8,510
Balance c/d	9,092	,, Birmingham Account—	
		Share of Profit	770
		,, Luton Account	
		Share of Profit	474
		,, P. & L. A/c	
		Share of Profit	588
	£10,342		£10,342
		By Balance b/d	9,092

BIRMINGHAM BOOKS

Dr.	*Oxford Branch Account*		Cr.
To Balance b/d	1,340	By P. & L. A/c—Dixie's	
,, Capital—Dean		Share of Profit	770
Share of Oxford Profit	294	,, Balance c/d	864
	£1,634		£1,634
To Balance b/d	864		

Dr.	*Luton Branch Account*		Cr.
	£		£
To Capital—Dean		By Balance b/d	504
Share of Luton Profit	474	,, P. & L. A/c—Lawton's	
,, Balance c/d	800	Share of Profit	770
	£1,274		£1,274
		By Balance b/d	800

Capital Account—Dean

Dr.	£		*Cr.* £
To Drawings	1,150	By Balance b/d	9,620
„ Balance c/d	10,778	„ Oxford a/c Share of Profit	294
		„ Luton a/c „ „ „	474
		„ P. & L. A/c „ „ „	1,540
	£11,928		£11,928
		By Balance b/d	10,778

LUTON BOOKS

Oxford Branch Account

Dr.	£		*Cr.* £
To Balance b/d	710	By P. & L. A/c—Dixie's Share of Profit	474
„ Capital—Lawton Share of Oxford Profit	294	„ Balance c/d	530
	£1,004		£1,004
To Balance b/d	530		

Birmingham Branch Account

Dr.	£		*Cr.* £
To Balance b/d	504	By P. & L. A/c—Dean's Share of Profit	474
„ Capital—Lawton's Share of Birmingham Profit	770	„ Balance c/d	800
	£1,274		£1,274
To Balance b/d	800		

Capital Account—Lawton

Dr.	£		*Cr.* £
To Drawings	1,000	By Balance b/d	6,920
„ Balance c/d	7,932	„ Oxford a/c—Share of Profit	294
		„ Birmingham a/c—Share of Profit	770
		„ P. & L. A/c—Share of Profit	948
	£8,932		£8,932
		By Balance b/d	7,932

Balance Sheet as at 31st October, 1962

	£	£		£	£
Capital Accounts			*Fixed Assets*		
Dixie:			Oxford	5,610	
Brought Forward	8,510		Birmingham	3,686	
Add Share of Profit	1,832		Luton	1,870	11,166
	10,342				
Less Drawings	1,250	9,092	*Current Assets*		
Dean:			Stock:		
Brought Forward	9,620		Oxford	3,817	
Add Share of Profit	2,308		Birmingham	3,439	
	11,928		Luton	3,714	10,970
Less Drawings	1,150	10,778			
Lawton:			*Debtors:*		
Brought Forward	6,920		Oxford	1,816	
Add Share of Profit	2,012		Birmingham	3,174	
	8,932		Luton	962	5,952
Less Drawings	1,000	7,932	*Cash at Bank:*		
		27,802	Oxford	1,385	
Liabilities			Birmingham	2,915	
Creditors:			Luton	2,216	6,516
Oxford	2,142				
Birmingham	2,500				
Luton	2,160	6,802			
		£34,604			£34,604

3. *Foreign Branches*

Branches in foreign countries require special consideration because of the exchange transactions involved and because of the related task of the conversion of one currency into another. The accounts of the branch are naturally kept in the currency of the country where it is situated. The results of the branch have, somehow or other, to be incorporated into the Head Office Books in the "home" currency. Two extreme cases can be quickly disposed of:

1. Where the currency exchange rates are stable and have been stable for a considerable time. The Branch results are translated into the "home" currency at the given rates. Any slight deviations involved in remittances to and from the branch will appear as gains or losses on exchange.

2. Where the currency exchange rates fluctuate violently. The task of accounting rationally in this kind of irrational situation is a separate task for each set of circumstances. It may indeed be necessary to keep a set of books for the Branch in the Head Office Books and to keep them in the home currency.

Between these extremes, there are the branches which involve moderately fluctuating rates of exchange. The accounting procedure is to convert the Trial Balance of the branch into the home currency (here assumed to be sterling) according to the nature of the particular item.

1. Fixed Assets and Depreciation thereof—at the rate ruling at the time of purchase.

2. Fixed and Long Term Liabilities—at the rates ruling at the time they were incurred. Where, however, there has been a substantial adverse change in the rates over the period involved, it is prudent to make provision for the additional sterling that will be required for payment.

3. Current Assets and Liabilities—at the rates ruling at the date of the Balance Sheet.

4. Revenue items—at the average rate ruling within the Trading period concerned.

Remittances to and from the Branch do not need conversion as the actual amounts paid in one currency and received in the other are known. Similarly, the balances carried forward on the Branch and Head Office Accounts have a direct relationship.

EXAMPLE 47

The following Trial Balances were extracted from the Head Office and the Loretonia Branch of a London firm at 31st December, 1960.

	Loretonia		London	
	Dr.	*Cr.*	*Dr.*	*Cr.*
	$	$	£	£
Capital				40,000
Fixtures and Fittings	152,000		16,400	
Loretonia Branch			15,600	
Loretonia Remittances				4,200
Head Office		360,000		
Head Office Remittances	100,000			
Stock 1st January	40,000		15,060	
Purchases	716,120		102,130	
Sales		1,088,304		152,180
Expenses	90,000		25,680	
Creditors		21,150		8,146
Debtors	70,206		12,164	
Cash at Bank	301,128		17,492	
	$1,469,454	$1,469,454	£204,526	£204,526

The Rates of Exchange were:

1st January, 1960	22 Loretonia $ to the £
Average during 1960	24 ,, ,, ,, ,, ,,
31st December, 1960	25 ,, ,, ,, ,, ,,
At the time of the purchase of the Fixtures	20 ,, ,, ,, ,, ,,

The Stocks at the 31st December, 1960 were:
Loretonia $ 52,400 and London £12,416.

Allow depreciation at 5% p.a. on Fixtures and Fittings.
Prepare Trading & Profit & Loss Account and Balance Sheet.

Conversion of Loretonia Trial Balance

	Dr.	*Cr.*	*Rate*	*Dr.*	*Cr.*
	$	$		£	£
Fixtures, etc.	152,000		20	7,600	
Head Office		360,000	Actual		15,600
Remittances	100,000		,,	4,200	
Stock 1st Jan. 1960	40,000		22	1,818	
Purchases	716,120		24	29,838	
Sales		1,088,304	24		45,346
Expenses	90,000		24	3,750	
Creditors		21,150	25		846
Debtors	70,206		25	2,808	
Cash at Bank	301,128		25	12,045	
	$1,469,454	1,469,454		£62,059	£61,792
Gain on Exchange					267
				£62,059	£62,059

Stock 31st December, 1960 $52,400 @ 25 = £2,096.

Trading & Profit & Loss Account for the Year ending 31st December, 1960

	Loretonia	*London*		*Loretonia*	*London*
	£	£		£	£
Stock 1 Jan. 1960	1,818	15,060	Sales	45,346	152,180
Purchases	29,838	102,130	Stock 31 Dec. 1960	2,096	12,416
Gross Profit c/d	15,786	47,406			
	£47,442	£164,596		£47,442	£164,596
Expenses	3,750	25,680	Gross Profit b/d	15,786	47,406
Depreciation	380	820	Branch Net Profit		11,656
Net Profit of Branch to H.O. P. & L. Account	11,656				
Net Profit		32,562			
	£15,786	£59,062		£15,786	£59,062

Balance Sheet as at 31st December, 1960

	£	£		£	£
Capital			*Fixed Assets*		
Brought Forward	40,000		Fixtures &		
Add Net Profit	32,562	72,562	Fittings less		
			depreciation		
			H.O.	15,580	
			Branch	7,220	22,800
Liabilities etc.			*Current Assets*		
Exchange Reserve		267	Stock H.O.	12,416	
Creditors:			„ Branch	2,096	14,512
H.O.	8,146		Debtors H.O.	12,164	
Branch	846	8,992	„ Branch	2,808	14,972
			Cash H.O.	17,492	
			„ Branch	12,045	29,537
		£81,821			£81,821

Note : A Gain on Exchange is prudently carried forward as a reserve. Losses are written off to Profit & Loss Account. The Loretonia Branch Account at 31st December will appear :

Branch Account

		£		£
To Balance b/f		15,600	By Remittances	4,200
„ P. & L. A/c			„ Balance c/d	23,323
Branch Gain		11,656		
„ Exchange Reserve		267		
		£27,523		£27,523
To Balance b/d				
Fixtures	7,220			
Stock	2,096			
Debtors	2,808			
Cash	12,045			
	£24,169			
Less				
Creditors	846	£23,323		

QUESTIONS 11

1. From the following information prepare Departmental Revenue Accounts in the form you consider most helpful:

	Books		Stationery	Office Equipment
	£		£	£
Stocks 1 Jan. 1961	6,417		2,812	3,650
Purchases	40,113		21,161	24,060
Sales	60,200		28,010	38,080
Departmental Salaries	3,800		2,750	6,116
Stocks 31 Dec. 1961	5,216		2,932	4,218
General Expenses		£		
Rent and Rates		2,818		
Cleaning Expenses		584		
Repairs		1,261		
Lighting and Heating		3,418		
Administrative Salaries		4,520		
Depreciation		860		
Sundry Expenses		430		

The areas of the building occupied by the departments are:

Books	$\frac{1}{2}$
Stationery	$\frac{1}{3}$
Office Equipment	$\frac{1}{6}$

2. S. Eller carries on a retail business in Birmingham. On 1st March, 1962, he opened a branch shop in Coventry from which all sales were made on credit terms. All goods for the branch were supplied from Birmingham and were charged out at cost plus 25 per cent.

The following were the transactions during the first three months:

	March	April	May
	£	£	£
Goods sent to branch (at cost of purchase)	4,400	5,600	7,200
Returns by branch (at price charged to branch)	150	180	120
Sales as per monthly return from branch	4,200	4,800	6,300
Cash received and remitted to Birmingham	2,600	5,800	4,500

The value of the stock at the branch on 31st May, 1962, at the price it was invoiced to the branch, was £6,300.

Record these transactions as they should appear in the books at Birmingham bringing down balances as on 31st May, 1962, and show the gross profit of the branch for the period ended on that date.

3. †Hard and Fast carry on a business having a Head Office and two branches.

All purchases are made by Head Office which invoices goods to the branches at cost plus 25%.

All sales are made by the branches.

Cash received by the branches is remitted to Head Office.

Branch expenses are paid direct from Head Office.

The following are the details of transactions for the year to 30th June, 1962.

	Branch X Street	*Branch Y Street*
	£	£
Goods from Head Office at Invoiced prices	30,000	25,000
Returns to Head Office	500	375
Cash Sales	18,500	17,000
Credit Sales	13,000	8,750
Returns from Customers at selling price	450	325
Carriage	100	90
Rent and Rates	800	740
Sundry Expenses	100	70
Salaries and Wages	950	900
Discounts Allowed	200	150
Cash received in respect of credit accounts	12,250	9,250
Bad Debts written off	300	100
Debtors, 1st July, 1961	5,250	4,500
Stock, 1st July, 1961 — Invoice prices	5,500	6,000
Stock, 30th June, 1962— Invoice prices	4,875	6,375

Record the above transactions in the Head Office Books and close off the Accounts concerned at 30th June, 1962.

4. Duck and Swan are equal partners carrying on a retail business at Poole and a branch at Pond. The balances on the books at 31st March, 1962, were:

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Head Office	*Dr.*	*Cr.*	*Branch*	*Dr.*	*Cr.*
	£	£		£	£
Partners Capital			Debtors	700	
Duck		10,000	Sales		14,500
Swan		10,000	Goods from Head Office	14,000	
Premises	9,000		Premises	4,000	
Fixtures and Fittings	2,000		Fixtures and Fittings	1,000	
Debtors and Creditors	12,300	13,400	General Expenses	1,900	
Stock 1 Apl. 1961	10,800		Cash in Hand	400	
Purchases & Sales	75,300	81,000	Head Office Account		7,500
Balance at Bank	3,850				
Cash	200				
General Expenses	7,250				
Goods to Branch		14,500			
Branch Account	8,200				
	£128,900	£128,900		£22,000	£22,000

The Stocks at 31st March, 1962, are:

Head Office	£9,950
Branch	£1,910

The difference on Current Accounts is due to Goods and Cash in Transit.

Prepare a Trading and Profit & Loss Account and Balance Sheet (Depreciation—Premises 2%: Fixtures and Fittings 5%).

5. †A and B are in partnership, sharing profits in the proportions 60% and 40% respectively and conduct a retail department store in London. The Goodwill of the business is valued at £20,000. On 1st January, 1962, C, who has a similar business in Bristol, joins them as a partner and aquires equally from A and B a 20% share of their Goodwill; in payment for the Goodwill and as his contribution to the capital of the firm, C introduces the assets, less liabilities, of his Bristol business which were:

Stock	£1,200
Debtors	£2,600
Lease of store	£6,000
Fixtures	£2,500
Creditors	£2,300.

The new firm decided that no account for Goodwill shall appear in the books; that C will continue to manage the Bristol store for which he will receive, out of the profits of that store, a partner's salary of £1,000

†Re-printed by courtesy of the Society of Incorporated Accountants (S.A.A.).

per annum, and 5% of the profits after charging the salary and percentage of profits; and that the balance of profits on the Bristol store shall be included with the London profits and the total divided among the partners as follows:

A	50%
B	30%
C	20%

All purchases are made by the London store which delivers goods to Bristol at cost plus 20%. A Head Office charge of £500 per annum is to be made by London to Bristol but this has not yet been recorded in the books.

The Trial Balance at 31st December, 1962 was:

	London	*Bristol*
	£	£
Stock	21,000	1,200
Fixtures at Cost	4,000	2,500
Leases at Cost	15,000	6,000
Purchases	72,000	
Goods supplied from London		33,000
Debtors	2,750	1,900
Salaries and Wages of Staff	7,800	2,050
Rent, 9 months to 30th September	1,500	600
Rates	1,200	500
Stationery and Postages	700	200
Packing Materials	2,300	1,200
General Expenses	1,700	800
Heating and Lighting	900	300
Drawings:		
A	3,000	
B	2,000	
C	1,800	
Cash at Bank	4,600	950
Bristol Account	3,750	
	£146,000	£51,200
Assets less liabilities introduced by C		10,000
Capital Accounts		
A	10,000	
B	8,000	
Goods supplied to Bristol	33,000	
Sales	80,000	37,000
Creditors	15,000	450
London Account		3,750
	£146,000	£51,200

Fixtures are to be depreciated at 10% per annum and leases by 5% per annum.

Three months rent is outstanding for both London and Bristol; rates include £200 (London) and £150 (Bristol) in respect of the three months ended 31st March, 1963.

Stocks at 31st December, 1962, were:

London (at cost)	£14,050
Bristol (all at issue price)	£10,200

From the above information, prepare a Trading and Profit & Loss Account (in columnar form) for the year ended 31st December, 1962 and a Balance Sheet at that date. Submit the partners' Accounts (in columnar form).

6. ¶A. & B. Bryson are partners in the firm of ACARA, Wholesale Exporters, sharing profits and losses equally, after interest of 8 per cent has been allowed on fixed capital, and salaries of £2,400 and £2,000 have been credited respectively.

The following is the Trial Balance of the General Ledger at 31st December, 1960:

		£	£
Bank		10,384	
Cost of goods sent to Kara Branch			52,560
Cost price of goods sold or transferred		56,400	
Current Capital—A. B.			1,064
,, ,, B. B.			1,370
Debtors and Creditors		2,500	14,160
Fixed Capital—A. B.			24,000
,, ,, B. B.			16,000
Freight and Insurance		1,320	
Home Sales			8,000
Furnishings		1,750	
Kara Branch Account		71,680	
Office Charges		560	
Partners' Withdrawals—A. B.	£2,000		
,, ,, B. B.	£2,000	4,000	
Premises—Store		4,300	
,, Office		7,000	
Remittances from Branch			50,000
Rates		240	
Sundry Charges		260	
Wages		2,080	
Stock at 31st December, 1960		4,680	
		£167,154	£167,154

¶Re-printed by courtesy of the Association of Certified Accountants (A.C.C.A.).

Rates of Exchange: Aras to £—

1st January, 1958	50
1st January 1960	60
31st December, 1960	40
Average for 1960	45

Trial Balance of Kara Branch

	Aras	*Aras*
Premises at cost at 1 Jan. 1958	50,000	
Motor Vans at cost at 1 Jan. 1958	8,000	
Furnishings at cost at 1 Jan. 1958	5,000	
Local Creditors		72,000
Local Purchases	540,000	
Goods from Head Office	2,160,000	
Remittances to Head Office	2,722,000	
Wages	220,000	
Administration Expenses	190,000	
Sales		3,673,000
Sundry Debtors	306,000	
Stock at 1st Jan. 1960	240,000	
Bank	177,640	
Head Office Account		2,873,640
	6,618,640	6,618,640

Stock at 31st Dec. 1960	180,000 Aras
In Home Books create a Depreciation Reserve of	£1,000
Remittances in transit at 31st Dec. 1960	£10,000
Goods in transit at 31st Dec. 1960	£4,600

Convert the Branch Trial Balance to Sterling, obtain gross profit for branch and head office, and prepare consolidated Profit & Loss Account for the year and Balance Sheet as at 31st December, 1960.

7. Some years ago, John and George combined their separate businesses in Oxtown and Camley into a partnership. The following abbreviated Trial Balances were extracted from the books of the two branches at 31st October, 1961:

	Oxtown		*Camley*	
	Dr.	*Cr.*	*Dr.*	*Cr.*
	£	£	£	£
Capital —John		16,418		
,, George				14,719
Drawings—John	1,960			
,, George			1,500	
Premises	5,710		4,672	
Debtors	2,315		3,116	
Sales		48,394		46,218
Cost of Sales	34,318		30,927	
Expenses	6,053		7,194	
Stock	4,816		5,320	
Branch Current Accounts	13,600			8,600
Sundry Creditors		4,197		1,324
Cash at Bank	237		18,132	
	£69,009	£69,009	£70,861	£70,861

Prepare Trading and Profit & Loss Accounts for the Year ended 31st October, 1961, and a Balance Sheet of the partnership at that date. The difference on Branch Current Accounts arises because of a remittance from Camley which had not arrived at Oxtown on 31st October, 1961.

The partners are entitled to 20% of the Net Profit (calculations to nearest £) of the branch they manage and then to equal shares in the rest.

Also give the Camley Branch Account in the Oxtown books after the year's closing entries have been made.

CHAPTER 12

Hire Purchase Accounts

WITHIN this sphere of ever growing importance, the accounting can be classified into three divisions:

1. The purchase of high-cost assets.
2. The sale of vehicles or machinery.
3. The common retail selling on Hire Purchase terms.

The Acquisition of Assets on Hire Purchase

The Hire Purchase Price is larger than that for immediate cash payment as it includes interest. The interest is the cost of financing the purchase in this way: it is not part of the cost of the asset. The accountancy problem is to separate the interest portion of the expenditure from the true cost of the asset and to debit it as "Interest" to Profit & Loss Account. This can be done in three ways.

(a) At the time of the purchase the asset is debited and the supplier credited with the cash price. Interest is credited to the supplier at the time of payment of each instalment.

(b) At the time of the purchase, the asset account is debited with the cash price but the supplier is credited with the full Hire Purchase price. The difference is debited to an account called Interest Suspense Account. The amount is transferred over the relevant Trading periods to Profit & Loss Account.

(c) No entries are made at the time of purchase unless a deposit is then paid. Each instalment subsequently paid is apportioned between the Asset and Interest accounts.

These methods are now illustrated. It is important to recognise that the differences are only in method. The Interest charge in each Profit & Loss Account must be the same as also must be the entries for the Asset on the Balance Sheets. From the time of the acquisition of the *asset*, whatever method used, the charge for depreciation must be based on the full cash price.

EXAMPLE 48

The Eastamshire Smelting Co. purchased 10 wagons on 1st January, 1957, from the Wagon Supply Agency Ltd. The cash price was £180 for each wagon. A deposit of £200 was immediately paid and the rest was payable in three instalments at the end of the years 1957, 1958 and 1959. Interest at the rate of 6% was charged and the instalments payable were £600 each. Give the relevant accounts of the purchasing company for the three years. Allow for depreciation at 20% per annum.

Method (a)

Dr. *Wagon Supply Agency Ltd.* *Cr*

1957		£	1957			£
Jan.	1	To Bank	200	Jan. 1	By Wagons	1,800
Dec.	31	,, ,,	600	Dec. 31	,, H.P. Interest	
		,, Balance c/d	1,096		6% of £1,600	96
			£1,896			£1,896
1958				1958		
Dec.	31	To Bank	600	Jan. 1	By Balance b/d	1,096
		,, Balance c/d	562	Dec. 31	,, H.P. Interest	
					6% of £1,096	66
			£1,162			£1,162
1959				1959		
Dec.	31	To Bank	600	Jan. 1	By Balance b/d	562
				Dec. 31	,, Interest	38
			£600			£600

(Due to approximation, the final interest is slightly more than 6% of £562).

Dr. *Wagons Account* *Cr.*

			£				£
1957							
Jan.	1	To Wagon Supply Agency Ltd.	1,800	Dec. 31		By Depreciation	360
						,, Balance c/d	1,440
			£1,800				£1,800
1958				1958			
Jan.	1	To Balance c/d	1,440	Dec. 31		By Depreciation	288
						,, Balance c/d	1,152
			£1,440				£1,440
1959				1959			
Jan.	1	To Balance b/d	1,152	Dec. 31		By Depreciation	230
						,, Balance c/d	922
			£1,152				£1,152
1960							
Jan.	1	To Balance b/d	922				

Dr. *Hire Purchase Interest Account* *Cr.*

			£			£
1957				1957		
Dec. 31	To Wagon Supply Agency Ltd.		96	Dec. 31	By Profit & Loss Account	96
1958			—	1958		—
Dec. 31	To Wagon Supply Agency Ltd.		66	Dec. 31	By Profit & Loss Account	66
1959			—	1959		—
Dec. 31	To Wagon Supply Agency Ltd.		38	Dec. 31	By Profit & Loss Account	38

Method (*b*)

The account for the *Asset*, Wagons Account, is omitted as it is no different from that in the previous method.

Dr. *Wagon Supply Agency Limited* *Cr.*

			£				£
1957				1957			
Jan.	1	To Bank	200	Jan.	1	By Wagons & H.P. Interest	2,000
Dec.	31	,, ,,	600				
		,, Balance c/f	1,200				
			£2,000				£2,000

1958				1958			
Dec.	31	To Bank	600	Jan.	1	By Balance b/f	1,200
		,, Balance c/d	600				
			£1,200				£1,200
1959				1959			
Dec.	31	To Bank	600	Jan.	1	By Balance b/d	600

Dr. *H.P. Interest Suspense Account* *Cr.*

1957				1957			
Jan.	1	To Wagon Supply Agency Ltd.	200	Dec.	31	By P. & L. Account	96
						,, Balance c/d	104
			£200				£200
1958				1958			
Jan.	1	To Balance b/d	104	Dec.	31	By P. & L. Account	66
						,, Balance c/d	38
			£104				£104
1959			£	1959			£
Jan.	1	To Balance b/d	38	Dec.	31	By P. & L. Account	38

Note that the amounts are transferred to the successive Profit & Loss Accounts on the basis of the actual interest accruing each year.

Method (*c*)

Dr. *H.P. Interest Account* *Cr.*

1957			£	1957			£
Dec.	31	To Bank-Wagon Supply Agency Ltd.	96	Dec.	31	By P. & L. Account	96
1958				1958			
Dec.	31	To Bank-Wagon Supply Agency Ltd.	66	Dec.	31	By P. & L. Account	66
1959				1959			
Dec.	31	To Bank-Wagon Supply Agency Ltd.	38	Dec.	31	By P. & L. Account	38

Wagons Account

Dr.			*Cr.*		
1957		£	1957		£
Jan. 1	To Bank-Wagon Supply Agency Ltd.	200	Dec. 31	By Depreciation (20% of £1,800)	360
Dec. 31	„ „ „ „ „	504		By Balance c/d	344
		£704			£704
1958			1958		
Jan. 1	To Balance b/d	344	Dec. 31	By Depreciation (20% of £1440)	288
Dec. 31	„ Bank-Wagon Supply Agency Limited	534		„ Balance c/d	590
		£878			£878
1959			1959		
Jan. 1	To Balance b/d	590	Dec. 31	By Depreciation (20% of £1,152)	230
Dec. 31	„ Bank-Wagon Supply Agency Ltd.	562		„ Balance c/d	922
		£1,152			£1,152
1960					
Jan. 1	To Balance b/d	922			

As is evident, there is no personal account for the supplier when this method is used.

The Balance Sheet entries at 31st December, 1958 would be

Method (*a*)

		£	£
Wagons on Hire Purchase (Cash Price)		1,800	
Less Depreciation written off to date		648	
		1,152	
Less Amount due to Supplier		562	590

Method (*b*)

		£	£
Wagons on Hire Purchase (Cash Price)		1,800	
Less Depreciation written off to date		648	
		1,152	
Less: Amount due to Supplier	600		
Interest not yet accrued	38	562	590

Method (*c*)	£	£
Wagons on Hire Purchase (Capital Portion of Payments made)	1,238	
Less Depreciation written off to date	648	590

The Sale by Hire Purchase of Vehicles and Machinery

The transactions involved are of the same type as those already discussed. The supplier will also seek to differentiate between the sale of the goods and the interest earned by the Hire Purchase facilities. The accounting is usually on the lines of the second method described above. The customer is debited with the full Hire Purchase price, sales being credited with the cash price and the balance credited to Interest Suspense Account.

EXAMPLE 49

Record the transactions detailed in Example 48 as in the books of the Wagon Supply Agency Limited.

Dr. *Sales Account (extract)* *Cr.*

				1957			
				Jan.	1	By Eastamshire Smelting Co.	1,800

Dr. *Eastamshire Smelting Co.* *Cr.*

1957			£	1957			£
Jan.	1	To Sales & H.P. Interest	2,000	Jan.	1	By Bank	200
				Dec.	31	„ „	600
						„ Balance c/d	1,200
			£2,000				£2,000
1958			£	1958			£
Jan.	1	To Balance b/d	1,200	Dec.	31	By Bank	600
						„ Balance c/d	600
			£1,200				£1,200
1959				1959			
Jan.	1	To Balance b/d	600	Dec.	31	By Bank	600

Dr. *Hire Purchase Interest Account* *Cr.*

1957		£	1957			£
Dec. 31	To P. & L. Account	96	Jan.	1	By Eastamshire Smelting Co.	200
	„ Balance c/d	104				
		£200				£200
1958			1958			
Dec. 31	To P. & L, Account	66	Jan.	1	By Balance b/d	104
	„ Balance c/d	38				
		£104				£104
1959			1959			
Dec. 31	To P. & L. Account	38	Jan.	1	By Balance b/d	38

Retail Hire Purchase Transactions

We are not concerned with the records of the purchaser. Probably there are no such records in the household concerned. The sales can lead to complicated calculations and accounts, and these are our concern.

The Hire Vendor can keep accounts along the lines of those presented above. The major differences will arise because of the smaller value and greater number of transactions. It is not difficult to keep a Day Book in which the Hire Purchase Price is separated into the Cash Price and the Interest charged. Periodically the totals will be credited respectively to Sales Account and to Hire Purchase Interest Account. The difficulty arises in the transfer of Hire Purchase Interest to successive Profit & Loss Accounts. It is impracticable to calculate the actual interest accruing for each transaction in each trading year. The work involved would be out of all proportion to the value of the accuracy achieved. The quantity of work is excessive not only because of the number of transactions but also because most of those transactions involve monthly or weekly instalments.

One solution, based on approximation, is to collect the interest charged into separate accounts for each year. The amount is then credited to successive Profit & Loss Accounts in specified proportions. Thus, if the sales on Hire Purchase provide for instalments spread over two years, the interest involved will be allocated between three trading years. e.g.

A Hire Purchase Sale on
30th June, 1957, involves interest for 1957 (½ year)
1958
1959 (½ year)

It may conveniently be assumed that the 30th June is the average date of the year's sales in which case it may be decided to allocate the total interest charged in these proportions:

1st year	30%
2nd year	55%
3rd year	15%

In the Profit & Loss Account for the Year 1959 will be credited:

(1) 15% of the H.P. Interest charged in 1957.
(2) 55% „ „ „ „ „ „ 1958.
(3) 30% „ „ „ „ „ „ 1959.

If all transactions are of this nature, at any one time there will be three live accounts for Hire Purchase Interest Suspense. But if there are transactions involving instalments over varying periods, the complications become intolerable.

Preferable is the *Stock System* of Records. Interest as such is not segregated but for each transaction we credit Profit & Loss Account only with a proportion of the profit: the same proportion as the amounts paid bear to the total Hire Purchase price.

e.g. In October, 1959, a piano costing £72 is sold for £120, payable by a deposit of £40 and 16 monthly instalments of £5.

At the end of the year the amounts received are:

Deposit	40
November Instalment	5
December Instalment	5
	£50

Total Profit on Transaction = £120 − 72 = £48.
Proportion of H.P. Selling Price paid in 1959 = 50/120
Profit taken into 1959 P. & L. Account

$$= \frac{£50}{£120} \times 48 = \underline{£20}$$

Details of each transaction are first recorded in the Hire Purchase Sales Day Book. The ruling is as follows:

Date	Particulars of Customer	No. of Instalments	Period of Instalments	Cost Price	Folio	H.P. Selling Price
				£		£
1959						
May 6	R. Bell	26	Weekly	108	31	144

In a Memorandum Hire Purchase Ledger are kept accounts for each customer. The full H.P. Selling Price is debited to the account: instalments received are credited. At any date the total balances in this ledger represent the amount outstanding from customers re Hire Purchase transactions. They do not represent amounts due at that date.

A separate Trading Account is written up for Hire Purchase transactions. It is debited with the cost of goods sold this way. The corresponding credit is in the General Purchases Account. The reason behind these entries is simple. If at the time of purchase, goods were directed into one channel, either the Hire Purchase or the Cash Trading, we could build up two Purchases Accounts accordingly. But this is not so. The same goods may be sold outright or on Hire Purchase. So we have one Purchases Account and at the end of the trading period extract the amount relating to Hire Purchase transactions.

The credits on the Hire Purchase Trading Account are:

1. The deposits and instalments received.
2. A valuation of the stock out on Hire Purchase.

This is a proportion of the Cost Price determined by the amount of instalments not yet due in relation to the total Hire Purchase Price of the goods involved in outstanding transactions.

The effect of this calculation is to give a profit figure determined by the principle enunciated earlier.

EXAMPLE 50

The Tate Furnishing Co. introduced Hire Purchase trading as from 1st January, 1960. Their terms called for payment in ten equal monthly instalments, the first being payable as a deposit. The following table gives a summary of the transactions for the first six months.

	C.P. of Goods Sold	H.P. Price of Goods Sold	Instalments Received
	£	£	£
January	60	90	9
February	140	210	30
March	300	420	72
April	300	450	117
May	430	630	180
June	380	540	234

Give the Hire Purchase Trading Account for the six months ending 30th June, 1960.

It is necessary to prepare a Stock Schedule.

Hire Purchase Stock Schedule

Sales for:	No. of Instalments	Instalments Paid	Instalments Unpaid	Cost Price	Stock Fraction	Stock Valuation
				£		£
January	10	6	4	60	4/10	24
February	10	5	5	140	5/10	70
March	10	4	6	300	6/10	180
April	10	3	7	300	7/10	210
May	10	2	8	430	8/10	344
June	10	1	9	380	9/10	342
				£1,610		£1,170

Hire Purchase Trading Account

	£		£
To Purchases	1,610	By Instalments Received	642
„ Gross Profit to P. & L. A/c	202	„ Stock with Customers c/d	1,170
	£1,812		£1,812
To Stock b/d	1,170		

The profit can be confirmed by taking the relevant proportion of the total profit expected on each transaction:

	£
6/10 of (90 − 60)	18
5/10 of 70	35
4/10 of 120	48
3/10 of 150	45
2/10 of 200	40
1/10 of 160	16
	£202

When goods are returned, their condition will not allow them to be resold as new. They may have been used for many months. The accounting entries involved are as follows:

Debit Hire Purchase Returns a/c Credit Hire Purchase Trading a/c	with the value of the goods returned. (The valuation is on the same basis as that for stock).
Debit Hire Purchase Returns a/c Credit Cash or Wages a/c	with expenses in repairing or renovating the goods.
Debit Purchases a/c Credit Hire Purchase Returns a/c	with the goods taken into ordinary stock at an agreed valuation.

There may then be a slight gain or loss on Hire Purchase Returns Account. This will be transferred to Profit & Loss Account.

QUESTIONS 12

1. On 1st January, 1961, A. James obtained two motor vehicles, the total cash price of which was £2,400. Payment was to be made as follows:

   (1) A deposit of £400.

   (2) Four half-yearly instalments of £538, the first being payable on 30th June, 1961. Interest at the rate of 6% per annum is included in the instalments.

   In the accounts for the Trading Year to 31st December, 1961, depreciation at the rate of 20% per annum is to be written off the Motor Vehicles.

   Show the above transactions in the ledger of A. James and the Balance Sheet entry at 31st December, 1961.

2. A. Jones bought a motor car on Hire Purchase terms from M.B.J. Ltd. on the 1st January, 1959. The H.P. Price was £2,075 payable by an immediate deposit of £500 and three equal instalments of £525 on 30th June and 31st December, 1959, and the 30th June, 1960. The H.P. Price includes interest at the rate of 10% per annum. The Cash Price was £1,930.

   On 31st December, 1959, the only balance on the books relating to the transaction is a debit on Motor Car Account of £1,550. Make any adjusting entries you think desirable and provide for depreciation at 20% per annum. Show how the balance will appear in the Balance Sheet of Jones at 31st December, 1959.

3. The Cash Price of a machine was £1,200. D. George acquired it on 1st January, 1959, and paid a deposit of £400 on that day. The balance including interest at 8% per annum was to be settled by seven quarterly instalments of £123 5s. 0d. over the years 1959 and 1960. No account is opened for the supplier.

   Give the Machine Account for the two years, providing depreciation at 10% per annum.

4. On 14th June, 1960, the Easy Terms Company sold an electric washer to Mrs. Ready for the Hire Purchase price of £140. The price was payable by a deposit of £60 and 16 monthly instalments of £5, the first instalment being paid one month after the sale. The Company prepares its accounts to 31st January each year. What is the "stock" value of the washer on 31st January, 1961? How much profit from this transaction is included in the accounts for the year to this date? The cost of the washer was £90.

5. Attractive Purchases Ltd. started to sell goods on H.P. terms in 1961 and made the following sales:

Date	Sale No.	Cost of Goods	Hire Purchase Price	Deposit	Monthly Instalments	No. of Instalments
1961		£	£	£	£	
17 Aug.	1	120	240	24	12	18
20 Sept.	2	90	180	24	13	12
12 Dec.	3	160	320	32	24	12
1962						
3 Feb.	4	252	504	56	28	16
18 July	5	184	368	68	25	12
24 Oct.	6	72	144	12	22	6

The first instalment was due one month after the date of the contract: all instalments were paid when due

Prepare the Hire Purchase Trading Account for the two years.

6. †J. Smith and Co. are retailers of electrical applicances. As from 1st July, 1953, they have sold goods on hire-purchase terms as well as for cash. The cash selling price of all their goods shows a gross profit of $33\frac{1}{3}\%$ on the cost price and 10% is added to the cash price to arrive at the hire-purchase price with payments spread over three years. In the Trading Account for the year to 30th June, 1954, set out below, the full profit including the additional 10% has been taken to credit on all hire-purchase sales during the year:

	£		£
Stock, 1st July, 1953	2,155	Sales (Cash)	19,160
Purchases	23,140	„ (Hire Purchase)	10,560
Returns (Hire-Purchase)	770	Stock, 30 June, 1954	4,225
Gross Profit for year	7,880		
	£33,945		£33,945

The firm has asked you to re-draw the account taking credit only for such proportion of the profit and additional 10% as the instalments actually received bear to the total payable under the agreements, excluding agreements cancelled during the year which are separately considered.

Instalments actually received during the year amount to £2,046. The returns £770 represent unpaid instalments on goods returned, which have been included in the closing stock at a valuation of £500 compared with their original cost of £600.

Prepare the revised Trading Account, and show by Journal entries how the adjustments in respect of the hire-purchase transactions for the year should be made in the books of the firm.

†Re-printed by courtesy of the Association of Incorporated Accountants (S.A.A.).

CHAPTER 13

Miscellaneous Accounts (2)

Investment Accounts

Investment Accounts fit into the normal Double Entry pattern but it is found convenient to introduce extra columns. There are three columns on both sides of the account. In them we record:

(a) The Nominal Amounts of Stock or Shares bought and sold.
(b) The Income (Interest and Dividends) received from the Investment.
(c) The Capital Amounts involved in the purchase or sale of the Investment.

The information regarding the Nominal Value of the stock is not part of the Double Entry accounting but is certainly a useful supplement. The other two columns are genuine accounts.

Stamp Duty, Brokerage and other expenses are involved in investment dealings. To the purchaser these are part of the capital cost. For the vendor, the proceeds of sale must be calculated as the total contract price less these expenses of sale.

Cum Div. and Ex Div. Quotations: Interest is usually paid for periods of six months or a year. During those periods the stock may have been bought and sold several times. But the paying body does not apportion the interest between successive holders of the stock. The whole interest is paid to the person registered as holder on a particular day, usually a few weeks before the interest payment date. This time lag is administratively necessary. A similar practice is adopted for the payment of company dividends.

Transactions "cum div." give to the purchaser the right to the next payment of interest. The interest accumulated to the date of the transaction is bought along with the stock itself. In "ex div." transactions the right to the next dividend or interest payment remains with the vendor.

Examples:

(1) On 1st June, A.B. purchases £2,000 6% Queenland Stock at 110. Expenses are £20. Interest is payable on 1st March and 1st September each year.

	£
Cost of Purchase:	
£2,000 @ 110	2,200
Expenses	20
	£2,220

	£
Interest accumulated to date of purchase 6% of £2,000 for 3 months (1st March to 1st June)	30
Therefore the capital cost of the stock itself is	2,190
	£2,220

(2) On 31st August, A.B. sells the stock @ 105 ex div. Expenses are £15.

	£
Proceeds of Sale	
£2,000 @ 105	2,100
Less Expenses	15
	£2,085

No adjustment is needed for interest as A.B. will receive the payment to date on the following day.

Our accounts aim at a segregation of Interest and Dividends from capital transactions. The heading, "Income" Column is perhaps a little inaccurate. Our income from investment dealing may be either,

(a) interest or dividends received
or (b) gain on sale of investments.

As will be seen the first appears in the "Income" column and the second in the "Capital" Column.

In preparing an Investment Account, one must analyse each purchase and sale on the lines of the above example. Though the analysis need not be written out so fully as in the illustration below, it is essential to understand the nature of the calculations involved.

EXAMPLE 51

Prepare the Investment Account to 31st December, 1960 to record the following:

1960		
March	1	Purchased £6,000 Eastamshire 5% Stock at 90. Interest payable 1st January and 1st July.
June	1	Purchased a further £4,800 of the Stock at 85 ex div.
Nov.	1	Sold £3,000 of the Stock at 90.
Dec.	1	Sold £3,600 of the Stock at 88 ex div.

Ignore Brokerage and other expenses and Taxation.

Notes:

1. March	1	Expenditure, 6,000 @ 90	5,400
		Accumulated Interest for 2 months	50
		Capital cost of Stock	£5,350
2. June	1	Expenditure, 4,800 @ 85	4,080
		Allowance for June interest to be received by vendor	20
		Capital cost of Stock	£4,100

3. Nov.	1	Received 3,000 @ 90	2,700
		Accumulated Interest for 4 months	50
		Capital proceeds of Sale	£2,650

4. Dec.	1	Received 3,600 @ 88	3,168
		Allowance for December interest not to be received by purchaser	15
		Capital Proceeds of Sale	£3,183

Two other calculations are necessary:

1. Capital Value of Stock still held on 31st December, 1960
   Nominal Value still held £4,200

   Cost $\dfrac{4{,}200}{4{,}800} \times £4{,}100 = £3{,}587.\ 10.\ 0.$

2. Interest Accrued at 31st December, 1960

   5% of £7,800 for 6 months £195.

It is possible to prove the transfer to Profit & Loss Account for the Interest received. It should be the interest on the actual amounts held for specific periods.

	Months	Holding	Interest		
		£	£		
Mar. 1st to June 1st	3	6,000	75	0	0
June 1st to Nov. 1st	5	10,800	225	0	0
Nov. 1st to Dec. 1st	1	7,800	32	10	0
Dec. 1st to Dec. 31st	1	4,200	17	10	0
Profit & Loss Account			£350	0	0

INVESTMENT ACCOUNT—EASTAMSHIRE 5% STOCK

		Nominal	*Income*			*Capital*		
		£	£	s.	d.	£	s.	d.
1960								
Mar. 1	To Bank–Purchase cum div.	6,000						
	Accumulated Interest		50	0	0			
	Capital Cost					5,350	0	0
June 1	To Bank—Purchase ex div.	4,800				4,080	0	0
	To Transfer to Income—Interest for June on Stock purchased					20	0	0
Dec. 1	To Transfer to Capital re December interest		15	0	0			
31	To P. & L. A/c—Interest		350	0	0			
		£10,800	£415	0	0	£9,450	0	0
1961								
Jan. 1	To Balances b/d Interest		195	0	0			
	Stock	4,200				3,587	10	0

		Nominal	*Income*			*Capital*		
		£	£	s.	d.	£	s.	d.
1960								
June 1	By Transfer of June Interest from Capital		20	0	0			
July 1	,, Bank—Interest 5% of £6,000 for six months		150	0	0			
Nov. 1	,, Bank—Sale cum div.	3,000						
	Accumulated Interest		50	0	0			
	Capital Proceeds					2,650	0	0
Dec. 1	,, Bank—Sale ex div.	3,600				3,168	0	0
	,, Transfer from Income—Interest for December on Stock sold					15	0	0
31	,, Balances c/d Interest Receivable		195	0	0			
	Stock	4,200				3,587	10	0
	,, P. & L. A/c—Loss on Sales					29	10	0
		£10,800	£415	0	0	£9,450	0	0

Royalty Accounts

Royalties may be payable:

(a) on the extraction of minerals from the ground,
(b) for the use of a patented process in manufacturing a particular product, or
(c) for the printing of a manuscript by someone not owning the copyright.

They are an expense of a business and must be charged in Profit & Loss Account.

Entries at the time of payment are:

Debit Royalties Account	Credit Cash

and at the end of the trading period,

Debit Profit & Loss Account	Credit Royalties Account.

So much is straightforward.

A Royalty agreement may contain provisions for a Minimum Rent. Normally, the royalty is based on the units of production, e.g. 6d per ton. If the production falls below a given level, the amount payable to the owner of the land (patent or copyright) may be fixed as a Minimum Rent. For example, the agreement may specify a royalty of 6d per ton of ore extracted with a provision for a Minimum Rent of £800 per annum. The following amounts are then payable:

Production	40,000 tons	Royalty @ 6d per ton = £1,000
„	30,000 tons	Royalty @ 6d per ton = £750 and consequently the Minimum Rent of £800 is payable.

The difference between the Minimum Rent paid and the Royalty calculated on the production is known as Short Workings. In the above example this was £50 at a production of 30,000.

In the early years of a particular venture, it is not always possible to avoid the payment of the Minimum Rent. It takes time to develop the production and marketing of the output.

This is often allowed for in the Royalty Agreement. The Agreement may specify that any accumulated short workings are to be recouped by deduction from later royalties paid. There may or may not be a time limit for such deductions.

Short Workings that are thus recoverable are in the nature of an asset. If they are not recovered within the time limit, they are known as "Dead Rent" and are written off to Profit & Loss Account.

EXAMPLE 52

The Elsodion Mining Company enters into an agreement whereby it pays 1/- per ton of ore raised. A Minimum Rent of £1,750 per annum is payable but the company is allowed to recoup Short Workings from Royalties payable in the first six years of production. The production in tons was as follows:

1953	4,000
1954	10,000
1955	28,000
1956	48,000
1957	60,000
1958	56,000
1959	65,000

Show the amounts payable to the landlord and record them in the accounts of the Elsodion Mining Company.

Preliminary Working

	Production	Royalty	Minimum Rent	Short Workings	Amount Payable	Short Workings Recouped
	(tons)	£	£	£	£	£
1953	4,000	200	1,750	1,550	1,750	
1954	10,000	500	1,750	1,250	1,750	
1955	28,000	1,400	1,750	350	1,750	
1956	48,000	2,400			1,750	650
1957	60,000	3,000			1,750	1,250
1958	56,000	2,800			1,750	1,050
1959	65,000	3,250			3,250	

Landlord's Account

Dr.					*Cr.*
1953		£	1953		£
Dec. 31	To Cash	1,750	Dec. 31	By Royalty	200
				„ Short Workings	1,550
		£1,750			£1,750
1954			1954		
Dec. 31	To Cash	1,750	Dec. 31	By Royalty	500
				„ Short Workings	1,250
		£1,750			£1,750
1955			1955		
Dec. 31	To Cash	1,750	Dec. 31	By Royalty	1,400
				„ Short Workings	350
		£1,750			£1,750
1956			1956		
Dec. 31	To Short Workings	650	Dec. 31	By Royalty	2,400
	„ Cash	1,750			
		£2,400			£2,400
1957			1957		
Dec. 31	To Short Workings	1,250	Dec. 31	By Royalty	3,000
	„ Cash	1,750			
		£3,000			£3,000
1958			1958		
Dec. 31	To Short Workings	1,050	Dec. 31	By Royalty	2,800
	„ Cash	1,750			
		£2,800			£2,800
1959			1959		
Dec. 31	To Cash	3,250	Dec. 31	By Royalty	3,250

Dr. *Royalties Account* *Cr.*

		£			£
1953			1953		
Dec. 31	To Landlord	200	Dec. 31	By P. & L. A/c	200
1954			1954		
Dec. 31	,,	500	Dec. 31	,, ,, ,,	500
1955			1955		
Dec. 31	,,	1,400	Dec. 31	,, ,, ,,	1,400
1956			1956		
Dec. 31	,, ,,	2,400	Dec. 31	,, ,, ,,	2,400
1957			1947		
Dec. 31	,, ,,	3,000	Dec. 31	,, ,, ,,	3,000
1958			1958		
Dec. 31	,, ,,	2,800	Dec. 31	,, ,, ,,	2,800
1959			1959		
Dec. 31	,, ,,	3,250	Dec. 31	,, ,, ,,	3,250

Dr. *Short Workings Accouut* *Cr.*

		£			£
1953					
Dec. 31	To Landlord	1,550			
1954					
Dec. 31	To Landlord	1,250			
		£2,800			
1955					
Dec. 31	To Landlord	350			
		£3,150			
			1956		
			Dec. 31	By Landlord	650
				,, Balance c/d	2,500
		£3,150			£3,150
1957			1957		
Jan. 1	To Balance b/d	2 500	Dec. 31	By Landlord	1,250
				,, Balance c/d	1,250
		£2,500			£2,500

1958				1958			
Jan.	1	To Balance b/d	1,250	Dec.	31	By Landlord	1,050
						„ P. & L. A/c Dead Rent	200
			£1,250				£1,250

Packages

The packing required by different products varies considerably. Our concern here is with the packages sent out to customers with the intention that they should be returned and used again. The usual practice is to charge the customer with the packages sent to him and to credit him if they are returned within a given period. Our records must thus cover:

(a) The purchase of the cases or packages.

(b) Any loss through breakages or wear and tear.

(c) The charging of the packages to customers.

(d) The crediting of packages returned.

The charge made to customers is usually at more than cost price. The credit may be at the figure charged or at a lower figure. The latter practice involves a charge for use or hire.

At any one date, and therefore at the end of an accounting period, there will be a number of packages in the hands of customers. Those customers have been debited for those packages and consequently, within the total of Sundry Debtors, there are many amounts representing returnable packages. It is incorrect to regard these as normal debts. They can be cancelled by the return of packages of much lower value (i.e. cost price). In our accounts we:

(a) Treat as an asset the returnable packages held by customers and value them at cost price.

(b) Bring down a credit balance equal to the number of returnable packages held by customers at the charged-out price. This credit serves as a set-off against the amounts relating to packages in the Sales Ledger Balances. It can perhaps be termed "Provision for Returns."

EXAMPLE 33

A business consigns its products in cartons which cost 6/– each but are charged to customers at 10/–. They are returnable within three months. On 1st January, 1960, the number of cartons in the warehouse was 1,480 and 2,300 were in the hands of customers and still returnable. During the year a further 2,000 were purchased at 6/–, 10,400 were sent out to customers and 10,600 were returned. Of the rest 600 had been held for more than three months but the others were returnable. 40 cases were scrapped during the year. Record these facts in the ledger accounts.

Dr. *Cartons Stock Account* *Cr.*

1961		No.	£	1961		No.	£
Jan. 1	To Balances b/d			Dec. 31	By Trading a/c Cartons Retained	600	180
	In Hand	1,480	444		By Trading a/c Cartons Destroyed	40	12
	With Customers	2,300	690		By Balance c/d	5,140	1,542
Dec. 31	„ Purchases	2,000	600				
		5,780	£1,734			5,780	£1,734
1962							
Jan. 1	To Balances b/d						
	In Hand	3,640	1,092				
	With Customers	1,500	450				

Dr. *Cartons Trading Account* *Cr.*

1961		No.	£	1961		No.	£
Dec. 31	To Customers Cartons returned	10,600	5,300	Jan. 1	By Provision for returnable Cartons b/d	2,300	1,150
	„ Stock a/c Cartons retained	600	180		„ Customers Cartons charged	10,400	5,200
	„ Stock a/c Loss on Cartons destroyed		12				
	„ Provision for returnable Cartons c/d.	1,500	750				
	„ P. & L. a/c Gain		108				
		12,700	£6,350			12,700	£6,350
				1962			
				Jan. 1	By Provision for returnable Cartons b/d	1500	750

An alternative presentation could be made within one account and this seems preferable in that certain complications are avoided.

Dr. *Cartons Account* *Cr.*

1961		No.	£	1961		No.	£
Jan. 1	To Stock b/d In Warehouse	1,480	444	Jan. 1	By Reserve re Returnable Cartons b/d	2,300	1,150
	With Customers	2,300	690	Dec. 31	By Debtors	10,400	5,200
Dec. 31	„ Purchases	2,000	600		„ Scrap	40	
	„ Debtors—returns	10,600	5,300		„ Stock c/f In Warehouse	3,640	1,092
	„ Provision re returnable Cartons c/f	1,500	750		With Customers	1,500	450
	„ P. & L. a/c Gain		108				
		17,880	£7,892			17,880	£7,892

1962			No.	£	1962			No.	£
Jan.	1	To Stock b/f In Warehouse	3,640	1,092	Jan.	1	By Provision re Returnable Cartons b/f	1,500	750
		With Customers	1,500	450					

The Gain is derived from the cartons retained by customers:

600 @ 4/– each	£120
Less Cost Price of Scrapped Cartons	12
	£108

The credit balance of £750 on 31st December, 1960, will be deducted from Sundry Debtors. This illustrates the comment that it would be wrong to regard as assets those portions of Sales Ledger Balances which refer to returnable packages. Scattered among these balances are amounts totalling £750 but these debits will probably be cancelled by the return of cases worth only £450.

Example 54

Record the following data in the Cases Account:

Stocks 1st April, 1962	In Warehouse	2,480
	With customers	1,800

Cases purchased during year 1,000 @ 12/– each.

Cases charged to customers during year 16,480 @ £1 each.

Cases returned by customers during year 17,040 credited @ 15/– per case.

Cost of Labour and Materials in repairing cases £120.

100 cases in the hands of customers were not returnable at 31st March, 1963.

Cases in stock are valued @ 10/– per case.

Dr. *Cases Account* *Cr.*

1962		No.	£	1962		No.	£
Apl. 1	To Stock b/f			April. 1	By Provision re		
	In Warehouse	2,480	1,240		Returnable		
	With Customers	1,800	900		Cases b/f	1,800	1,350
1963				1963			
Mar. 31	To Purchases	1,000	600	Mar. 31	By Debtors—		
	,, Debtors—				Issues	16,480	16,480
	Returns	17,040	12,780		,, Stock c/d		
	,, Repairs		120		In Ware-		
	,, Provision re				house	4,040	2,020
	returnable				With		
	Cases c/d	1,140	855		Customers	1,140	570
	,, P. & L. A/c						
	—Gain		3,925				
		23,460	£20,420			23,460	£20,420
Apl. 1	To Stock b/d			Apl. 1	By Provision re		
	In Warehouse	4,040	2,020		Returnable		
	With				Cases b/d	1,140	855
	Customers	1,140	570				

The Gain can be verified

			£
Profit on Cases retained by Customers	100 @ 10/-		50
Profit on Hire of Cases issued (less those retained)	16,380 @ 5/-		4,095
			4,145
Less Depreciation on new cases purchased	1,000 @ 2/-	100	
Less Cost of Repairs		120	220
			£3,925

Questions 13

1. ¶A company purchases £10,000 3½% War Loan at 88 cum interest on 1st April, 1958. Brokerage and Stamp Duties amounted to £4. On 1st May, 1958, it purchased £6,000 3½% War Loan at 87½ ex interest. Brokerage and Stamp Duty amounted to £3.

   It made the following sales of its holding:

   1958
   Oct. 1 £9,000 @ 87 — Brokerage £2.
   1959
   Mar. 1 £7,000 @ 90 — Brokerage £2.

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Both the sales were cum interest.

Interest is payable on 1st June and 1st December, without deduction of tax.

Record the above transactions in the Company's ledger. The close of the Company's trading year is 31st March.

2. A. James whose accounting period ends on 31st March each year has the following transactions in Government Stocks.

(1) "A" Government 6% Stock (Interest payable 1st March and 1st September).

Purchases		*Sales*	
1960		1960	
April 1	£2,000 @ 98	Oct. 1	£3,000 @ 94
July 1	£1,800 @ 96	Dec. 1	£3,800 @ 98
Aug. 1	£3,000 @ 90 ex div.		
1961		1961	
Jan. 1	£6,000 @ 95	Feb. 1	£4,000 @ 94 ex div.

(2) "B" Government 4% Stock (Interest payable 1st May and 1st November).

Purchases		*Sales*	
1960			
Oct. 1	£10,000 @ 72 ex. div.		
1961		1961	
Feb. 1	£2,000 @ 80	Jan. 1	£6,000 @ 80

All transactions are cum div. except where otherwise stated. Write up the two Investment Accounts.

3. A sand and gravel company are engaged in working a sand pit. On 1st January, 1956, it entered into an agreement with the owner of the land in which the sand pit was situated providing for:

(1) A royalty of £2 per ton of sand removed.
(2) A minimum rent of £500 per annum.
(3) The recovery of short workings within a period of five years from the end of the year in which they occurred.

The amounts of sand removed during the first three years were:

1956	200 tons
1957	225 tons
1958	300 tons

The amounts due to the landlord in respect of each year were paid on 31st January in the year following.

You are required to write up in the company's books the necessary ledger accounts to record its relations with the landlord during the three years to 31st December, 1958.

4. *Automatics Ltd. granted a licence to P. Reynolds to manufacture and sell an automatic device on the following terms:

   (a) the licence to commence on 1st January, 1958, and to operate for four years.

   (b) Reynolds to pay a minimum sum of £1,500 per annum, merging into a royalty of 5/- per device sold; the sum to be paid on 31st December in each year.

   (c) In any year in which the minimum sum was in excess of the royalty, Reynolds to have the right to recoup such sums out of the royalties due in excess of the minimum in any subsequent year.

The numbers of devices sold were:

1958	3,600
1959	5,800
1960	8,500
1961	5,200

Assuming that all payments were duly made, and excesses of minimum payments over royalties were considered recoverable, show the ledger accounts recording the transactions in the books of P. Reynolds The books were closed on 31st December each year.

5. †A company makes a charge to its customers for cases in which its product is delivered; if they are returned in good condition within three months a refund is made.

During the year 1962, 50,800 cases were sent to customers and 46,400 returned by them; the company scrapped 4,200 damaged cases and sold the proceeds for £20. A physical check of cases in stock at 31st December, 1962, revealed an unaccounted deficit of 640 cases.

At the commencement of the year there were 10,500 cases in stock at the company's warehouse and 4,900 in the hands of customers supplied within the previous three months; the company purchased 15,000 new cases during the year and, following a dispute with a supplier, returned 3,000 new cases for which a credit note for £2,840 was received. At 31st December, 1962, there were still in the hands of customers 3,200 cases supplied within the previous three months.

New cases cost 20/- each; they are charged out to customers at 24/- each and credited on return at 18/- each. They are valued for stock-taking at 15/- each.

Show the accounts in the books of the company for the year 1962 to record the above transactions, and the balances of cases, in quantities and value, at 31st December, 1962. Give a statement reconciling the profit or loss on the cases "service" for the year.

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6. †Goods are sold by a firm in crates, purchased at 7/6d each. Customers of the firm are charged 10/- and allowed 6/- for each crate returned within a specific period.

At Balance Sheet dates, stocks are valued at 5/- each.

Write up the Ledger Accounts for the year ended 30th June, 1962, from the following information:

	No. of Crates
Purchases	3,000
Sent to Customers	7,000
Returned by Customers	5,200
In hands of Customers—return period unexpired	
at 1st July, 1961	4,300
at 30th June, 1962	3,900
Stock in Warehouse at 1st July, 1961	2,000
at 30th June, 1962	3,100
Scrapped	100

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CHAPTER 14

Depreciation

SO FAR we have devoted but one small section to this subject. The charge for depreciation was explained as the method of charging the cost of an asset over the whole time span when that asset gives service or is expected to give service. We also mentioned the fallacy that depreciation is the charge to bring the balance on the asset account down to the "true" value of the asset.

The question now before us is: what is the best or most accurate way of apportioning the cost of an asset? The two most common methods have already been described briefly.

1. *The Straight Line Method.* A fixed percentage of the cost of the *asset* is written off each year. The annual charge thus remains constant until the asset has been wholly depreciated.

2. *The Reducing Balance Method.* A fixed percentage of the balance brought forward on the asset account is written off each year. The charge for a particular asset falls year by year, i.e. it is a fixed percentage of a reducing balance. To write off the asset in the same number of years, this method entails a higher percentage than that used in the Straight Line Method.

Compare the two methods for a motor vehicle costing £600 and expected to be worth £100 after eight years:

	(1) Depreciation for Year	Balance	(2) Depreciation for Year	Balance
	£	£	£	£
Cost		600		600
Year 1	62·5	537·5	120	480
2	62·5	475	96	384
3	62·5	412·5	77	307
4	62·5	350	61	246
5	62·5	287·5	49	197
6	62·5	225	39	158
7	62·5	162·5	32	126
8	62·5	100	25	101

The accounting for depreciation takes the form already shown. Thus you will have:

Dr. *Motor Vehicle* *Cr.*

		£	s.	d.		£	s.	d.
Year 1	To Bank—				By Depreciation	62	10	0
	Purchase	600	0	0	,, Balance c/d	537	10	0
		£600	0	0		£600	0	0
Year 2	To Balance b/d	537	10	0	By Depreciation	62	10	0
					,, Balance c/d	475	0	0
		£537	10	0		£537	10	0
Year 3	To Balance b/d	475	0	0	etc. etc.			

or

Dr. *Motor Vehicle* *Cr.*

		£	s.	d.		£	s.	d.
Year 1	To Bank—				By Depreciation	120	0	0
	Purchase	600	0	0	,, Balance c/d	480	0	0
		£600	0	0		£600	0	0
Year 2	To Balance b/d	480	0	0	By Depreciation	96	0	0
					,, Balance c/d	384	0	0
		£480	0	0		£480	0	0
Year 3	To Balance b/d	384	0	0	etc. etc.			

The data given by this type of account is presented on the Balance Sheet as :

		£	s.	d.	£	s.	d.
Motor Vehicle	Balance at 1st January	480	0	0			
	Less Depreciation for Year	96	0	0	384	0	0

A more informative presentation is possible and, indeed, is now required by Company legislation.

Motor Vehicle at cost	600	0	0			
Less Depreciation written off	216	0	0	384	0	0

The data for such a presentation is not easily obtainable from the above form of account, especially when constant additions and retirements are involved. For this reason, the practice of retaining the Asset account at cost and building up a Contra account for accumulated depreciation is to be commended. The accounts will then appear:

Dr.		*Motor Vehicle*	*Cr.*
Year 1	To Bank	£600	

Dr.	*Depreciation Account—Motor Vehicles*				*Cr.*
	Year 1	By P. & L. A/c	62	10	0
	2	,, ,, ,,	62	10	0
			125	0	0
	3	,, ,,	62	10	0
			£187	10	0

and so on.

This leads to rather complex entries on the sale or other retirement of an item of equipment, e.g. for the sale of the vehicle for £400 at the end of year 3, the entry is:

		£	s.	d.	£	s.	d.
Cash	Dr.	400	0	0			
Depreciation Account—Motor Vehicle		187	10	0			
P. & L. Account—Loss on Sale		12	10	0			
To Motor Vehicle Account					600	0	0
		£600	0	0	£600	0	0

The percentage used in the Straight Line Method is always less than that of the corresponding Reducing Balance calculation. The example illustrates something much more important. With a comparatively small item of capital expenditure there are substantial differences in the Depreciation charge to Profit & Loss Account.

e.g. Year 1 The difference is £57·5— 92% of the smaller charge.
„ 8 The difference is £37·5—150% of the smaller charge.

Accounting is obviously not an exact science! The differences will be very important in a business with assets costing thousands and, indeed, millions of pounds. This is so even though there is less relative difference when the assets have longer lives.

In the business world both methods are used. It is not possible to say that one is correct and the other incorrect. We can only be dogmatic in defining the criterion of judgement between the two. This must be:

> Which gives the most equitable apportionment of the cost of an asset over its years of service?

Unfortunately this is not one of the questions that are answered as soon as they are asked! To say that the most equitable apportionment is that with the closest relation to the annual economic contributions of the asset is correct but merely raises other problems. Is the relation to the planned and intended economic contributions or to the actual? How do we measure them?

The Straight Line Method is generally in use in America and is accepted by a growing body of opinion in Great Britain. It involves more work. A register of all Plant and Equipment is necessary to ensure the correct calculations of depreciation. But the truest and fairest methods of charging depreciation are not necessarily the ones involving least work. For the Reducing Balance Method it can be maintained that allocation of cost ought to take account of the "net" economic contribution of the asset.

If passing years bring increased running and repair costs, more delays for breakdowns and so on, a diminishing charge for depreciation is justified. But none would claim that the Reducing Balance Method accurately caters for this refinement.

A more consistent attempt to do this is to have a combined Repairs, Maintenance and Depreciation Fund Account. All expenses of repairs and maintenance and the annual provision for depreciation are debited. Each year, a fixed sum is transferred to Profit & Loss Account. Usually, a small balance, debit or credit, will then be carried forward. In principle, this has much to commend it. The practical difficulty is the estimation of the Profit & Loss Account charge so that it closely approximates to the average of all expenditure to be included in the account.

3. *The Annuity Method.* One factor which has not been considered in the discussion so far is the influence of interest. In fact, it is not possible to take account of interest in apportioning the costs of assets like Plant, Machinery and Motor Vehicles. The work involved would be too great. But this is a practical limitation. In the depreciation or amortisation of a long lease, there is a method which does take account of interest and the reasoning behind it is important for our theory as a whole.

The occupier of a building may have entered into an agreement involving the payment of annual rent or he may have purchased the lease for a stated number of years. The occupation rights are purchased by the payment of rent in both arrangements: the rent is paid annually or is paid by a lump sum in advance. There is obviously a relationship between the annual rent and the lump sum when both are offered as alternatives for the same property. But the lease for, say, 20 years will not cost twenty times the annual rent (with the same security of tenure) for no one would then choose to pay in advance. The 20-year lease will cost less than the sum of annual rents and the difference is rightly interpreted as the return on the money outlay involved. The purchase of a lease is thus:

1. A payment of an expense (rent) in advance.
2. A mode of investing the money used in the purchase.

The consequences to be recognised in our accounting in the following years are:

1. The cost or expense—annual rent.
2. The income from the investment of the bulk payment in advance.

The true rent charge will be a constant figure but the interest will decrease year by year. As the years pass by, the amount invested as "rent paid in advance" will obviously grow less and so will the interest arising from it.

Annuity Tables are used to identify the element of annual rent involved in a lease payment.

Table (extracts)

Showing the Annuity, payable yearly, which £1 will purchase, for any number of years from 1–50.

Years	3%	3½%	4%	4½%	5%
1	1·0300000	1·0350000	1·0400000	1·0450000	1·0500000
2	0·5226108	0·5264005			0·5378049
3	0·3535304	0·3569342			0·3672086
4	0·2690270	0·2722511			0·2820118
5	0·2183546	0·2214814			0·2309748
10	0·1172305	0·1202414			0·1295046
15	0·0837666	0·0868250			0·0963423
20	0·0672157	0·0703611			0·0802426

Thus a lump sum payment of £1,000 for 20 years is equivalent to varying annual rents determined by what is regarded the relevant rate of interest, i.e. the interest regarded as satisfactory for the investment. The annual rent equivalents are:

(a) at 3% £67·2157
(b) at 3½% £70·3611
(c) at 5% £80·2426

The application of these principles is adequately illustrated in the following example. The commoner longer leases involve only an extension of the same method.

EXAMPLE 55

Give the Lease Account for a five year Lease costing £10,000, allowing interest at the rate of 5%.

From the Annuity Tables, we can read off the equivalent annual rent—£2309·748.

Lease Account

	£	s.	d.		£	s.	d.
Year 1				Year 1			
To Cash	10,000	0	0	By Depreciation	2,309	15	0
„ Interest at 5% p.a.	500	0	0	„ Balance c/d	8,190	5	0
	£10,500	0	0		£10,500	0	0
Year 2				Year 2			
To Balance b/d	8,190	5	0	By Depreciation	2,309	15	0
„ Interest	409	10	3	„ Balance c/d	6,290	0	3
	£8,599	15	3		£8,599	15	3
Year 3				Year 3			
To Balance b/d	6,290	0	3	By Depreciation	2,309	15	0
„ Interest	314	10	0	„ Balance c/d	4,294	15	3
	£6,604	10	3		£6,604	10	3
Year 4				Year 4			
To Balance b/d	4,294	15	3	By Depreciation	2,309	15	0
„ Interest	214	14	9	„ Balance c/d	2,199	15	0
	£4,509	10	0		£4,509	10	0
Year 5				Year 5			
To Balance b/d	2,199	15	0	By Depreciation	2,309	14	9
„ Interest	109	19	9				
	£2,309	14	9		£2,309	14	9

In each year's Profit & Loss Account, the charge for depreciation will be debited and the interest credited. The interest is of course not received from any outside source. It arises in the method of apportioning the cost of the lease.

	Depreciation £	s.	d.	Interest £	s.	d.	Net Charge to P. & L. Account £	s.	d.
Year 1	2,309	15	0	500	0	0	1,809	15	0
2	2,309	15	0	409	10	3	1,900	4	9
3	2,309	15	0	314	10	0	1,995	5	0
4	2,309	15	0	214	14	9	2,095	0	3
5	2,309	14	9	109	19	9	2,199	15	0
							£10,000	0	0

The cost is apportioned in increasing annual instalments, the very opposite of the reducing balance method.

The Annuity Method cannot be applied to most classes of assets. For instance, items of plant and machinery are constantly being purchased and replaced. To make separate "annuity" calculations for each purchase would be a clerical impossibility. But the reasoning behind the annuity method is applicable to the depreciation of other assets. When a machine is purchased, we are actually acquiring a stream of future services from the machine. Interest on the money invested is part of the cost of those services. If it is a practical impossibility to introduce this refinement into our books, it need not be overlooked in our discussions. We apportion the cost in increasing annual instalments when incorporating interest. If this is an "ideal standard," the straight line comes nearer to it than the reducing balance method. But this assumes equal economic contributions from the asset in each year of its life, and that as we know, is a questionable assumption.

There are two other methods in use for limited spheres—

4. *The Depletion Method.* This is used to charge the cost of a Mine, the charge being based on output not on the passage of time. It is well to remember that the apparent precision of this method is based upon an estimate (sometimes very rough) of the accessible product.

e.g. A Mine costs £20,000 and the estimated tonnage of accessible ore is 100,000. Depreciation will be charged annually on the basis of 4/– per ton of ore raised during the year.

5. *The Revaluation Method.* This is suitable for minor items of equipment often classified together as Loose Tools. Expenditure is debited to the asset account and the balance carried down at the year end is based on physical stocktaking and valuation. The difference is written off as depreciation.

It is not very difficult to understand the various methods of providing for depreciation. It is much more difficult, indeed it is as yet not possible to demonstrate a clear and overwhelming superiority of one method over the others. When considering or submitting a figure of net profit for a business it is well to remember that different but acceptable methods of charging depreciation could result in a very different calculation of net profit. Our concern to learn "methods" must not be allowed to divert our attention from the tremendous implications of this disconcerting fact. The profit figure is calculated by comparing a period's revenues with the related costs. Some of those costs are straightforward, e.g. materials and wages. But just as real are the costs of assets that must be spread over many years and in some way charged against the revenues of those years. Because there are different ways of spreading these costs in the depreciation charge, there are different figures for net profit which are still in accord with acceptable accounting principles.

Obsolescence:

The above discussion has been based on the assumption that assets purchased do give service for the time anticipated. A fairly wide margin of error is inevitable and some assets will last longer and some will be retired sooner than was expected. Depreciation rates are normally fixed at a level which ensures that the assets will be "written off" in their life time.

The life of an asset, in so far as it is only influenced by wear and tear, can be estimated with reasonable accuracy. But it is not only wear and tear that is relevant. The period during which a machine gives service may be terminated abruptly by the invention of a more efficient machine. A whole group of machines in a particular process may become of little value when a different process is substituted. Even more catastrophically, the whole plant designed for the production of a particular product may become obsolescent if the market for that product disappears.

Depreciation is the allocation of the cost of an asset over the years it is expected to give service. Is it possible to anticipate the ending of the usefulness of an asset through obsolescence? The traditional answer is "No" and is probably justified in many areas of industrial life. Where it occurs, the loss involved is written off to Profit & Loss Account as obsolescence. But in industries where technical progress is greatest, this traditional answer may not be good enough. It is true of many industries that machines are more frequently replaced because of obsolescence than because they are physically worn out. The challenge to the accountant and to the engineer is to incorporate these facts and expectations into the calculation of depreciation rates.

QUESTIONS 14

1. *On 1st January, 1959, a firm bought Machinery at a cost of £2,000 and on 1st July, 1960, additional Machinery costing £500. On 1st January, 1961, Machinery which cost £300 on 1st January, 1959, was sold for £160. Additional Machinery was purchased on 1st April, 1961, at a cost of £400. Part of the Machinery, purchased on 1st July, 1960, for £150, was scrapped and sold for £70 on 1st October, 1962.

   The Machinery had been depreciated annually at 31st December, at the rate of 5 per cent per annum calculated on the original cost over the period of its use.

   Show the accounts recording these transactions for the four years ended 31st December, 1959, 1960, 1961 and 1962.

2. *A company was incorporated on 1st January, 1960, and on that date purchased two machines, each costing £1,000.

   Depreciation is provided at the rate of 20 per cent per annum by the straight line method. Each year the amount so provided is credited to an account called "Provision for Depreciation" and the balance on this account is deducted in the Balance Sheet from the original cost of the asset.

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On 31st December, 1962, one machine was sold for £420 and on the same day was replaced by a new machine which cost £1,200.

You are asked to give all the accounts necessary to record these matters, including transfers to Profit & Loss Account, for each of the years 1960, 1961 and 1962 and to show the balance carried down on 1st January, 1963.

3. ¶Smith and Thompson are partners in a Manufacturing Business sharing profits and losses in the following proportions:

Smith: three-fifths. Thompson: two-fifths.

A draft Profit & Loss Account for the year ended 31st March, 1962, and a Balance Sheet at that date have been prepared. The Balance Sheet was as follows:

Capital Accounts	£	£	*Fixed Assets*		£	£
Smith—			Freehold Land at cost			6,000
As at 31st March, 1961	9,510		Freehold Buildings		8,000	
Add share of Profit	2,550	12,060	Less depreciation to date		800	7,200
Thompson—			Plant and Machinery at cost		4,500	
As at 31st March, 1961	6,200		Less depreciation to date		2,000	2,500
Add share of Profit	1,700	7,900	Motor cars at cost		5,000	
Sundry Creditors		5,875	Less depreciation to date		3,800	1,200
						16,900
			Current Assets			
			Stock		3,100	
			Sundry Debtors	5,350		
			Less Provision for Bad Debts	200	5,150	
			Cash at Bank and in hand		685	8,935
		£25,835				£25,835

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On each of the fixed asset accounts in the books of the firm the "cost" is brought down at the end of the year as a debit balance, and the "total depreciation to date" is brought down as a credit balance.

Depreciation is charged "Straight Line" as follows:

Freehold Buildings	2%
Plant	10%
Motor Cars	20%

Depreciation is charged in the year of purchase, but not on assets sold or scrapped during the year.

In the course of your examination of the books and accounts of the firm for the year ended 31st March, 1962, you discover the following:

(a) A small building costing £50 erected in the year to 31st March, 1954, has been demolished. No adjustment has been made to the Asset Account except that depreciation has not been charged on the £50 in the year to 31st March, 1962.

(b) A machine costing £420 in December, 1954, had been sold in December, 1961, and the proceeds of sale £275 have been credited to Sales Account.

(c) The Motor Car Account has been debited during the year with 9 monthly instalments of £60 each in respect of a new motor van, which has been purchased under a hire-purchase agreement. An examination of the agreement revealed that the cash price was £960, and the hire-purchase price was £1,080, payable in eighteen equal monthly instalments of £60, the first instalment being paid 1st July, 1961. (Hire-Purchase Interest to 31st March, 1962—£80).

(d) Weekly drawings of £25 by each partner had been debited to Wages Account.

(e) As a result of an examination of the Sales Ledger balances it was decided that a debit of £73 should be specifically reserved in addition to the general reserve for bad debits of £200.

After making the necessary adjustments arising from the above, you are required to show:

1. The Fixed Asset Accounts for the year ended 31st March, 1962, as they would appear in the books of the firm, and
2. The revised Balance Sheet as at 31st March, 1962.

4. On 1st January, 1958, the Argos Co. purchased a lease for £10,000. The lease was for 20 years. It was decided to use the Annuity method of amortisation taking interest at 3%. Give the Lease Account for the first four years.

5. Having purchased a 10-year lease of his premises for £5,000, Mr. A. Ross asks advice regarding the amortisation of the lease. You are asked to give the annual Amortisation charge under the Annuity method taking interest at 5% and to prepare a table contrasting the net charge to Profit & Loss Account with the charge under the Straight Line method. Briefly answer Mr. Ross's further query:

   "But why should the net charge increase?"

CHAPTER 15

Sinking Funds

SINKING Funds are created to set aside money needed for two objects:

1. The replacement of an asset in the future.
2. The settlement of a liability or the redemption of redeemable preference shares.

The rather pedestrian phrase, "To set aside money", will serve to remind us that this is not the only way of preparing for future payments. The Sinking Fund is just one particular method.

Sinking Fund to Replace an Asset

An annual amount is invested each year so that when the asset requires replacement, sufficient liquid funds are made available by the sale of the investment. Tables are available to help with requisite calculations.

Sinking Fund Table (Extracts)

of Annual Sinking Fund Instalments to Provide £1.

Year	3%	3½%	4%	4½%	5%
3	0·323530	0·321934			0·317209
4	0·239027	0·237251			0·232012
5	0·188356	0·186481			0·180975
.					
.					
10	0·087231	0·085241			0·079505
.					
.					
20	0·037216	0·035361			0·030243

(It is important when consulting tables to read the heading carefully. There are other tables giving the data in different form).

The investment does not of itself constitute a Sinking Fund, neither does it fulfil the function of a depreciation charge. The annual sum involved is also debited to Profit & Loss Account and credited to Depreciation Sinking Fund. Thus the building of a Sinking Fund to replace an asset has two facets:

(1) Depreciation.	Debit P. & L. A/c	Credit Sinking Fund a/c.
(2) Investment.	Debit Sinking Fund Investment a/c.	Credit Bank.

The amounts involved are the same except that the investment in years after the first includes the interest received during the year. However, when received, this interest is credited to the Sinking Fund Account and so the balances of this account and of the Investment Account will normally be equal.

In Balance Sheets the asset is shown as follows:

Lease at cost	xx	
Less Depreciation Sinking Fund	xx	xx

The balance of the asset account remains at cost until the time for replacement. Then the entries are:

1. Dr. Sinking Fund a/c Cr. Asset a/c
   with the accumulated provision for depreciation. This has been so calculated that it is just sufficient to reduce the Asset account balance to nil.
2. Dr. Bank Cr. Sinking Fund Investment a/c
   with the proceeds of sale. Any gain or loss will be transferred to Profit & Loss Account.

3. Dr. Asset Cr. Bank
with the cost of the asset replacement.

This may be less than, equal to or more than the funds made available by the sale of the Sinking Fund Investment. Business affairs are not governed by pleasing mathematical precision! However, the bulk of the money required will have been provided by the sale of the investment.

EXAMPLE 56

A 5-year lease was purchased for £10,000 on 1st January, 1956. It was decided to build up a Sinking Fund to provide for its replacement. The investment yields 5% interest. Give the relevant accounts for the next five years. The instalment for 1960 is not invested. On 29th December, 1960, the investments are sold for £8,000. The Lease was renewed for £11,000.

From the tables, the annual instalment is seen to be £1,809·75

Depreciation Sinking Fund a/c (or Lease Redemption Fund a/c)

							£	s.	d.
					1956				
					Dec. 31	By P. & L. A/c	1,809	15	0
					1957				
					Dec. 31	„ Interest (5% of £1,809 15 0)	90	9	9
						„ P. & L. A/c	1,809	15	0
					1958		3,709	19	9
					Dec. 31	„ Interest (5% of £3,709 19 9)	185	10	0
						„ P. & L. A/c	1,809	15	0
					1959		5,705	4	9
					Dec. 31	„ Interest (5% of £5,705 4 9)	285	5	3
						„ P. & L. A/c	1,809	15	0
1960					1960		7,800	5	0
Dec. 31	To Lease A/c	10,000	0	0	Dec. 31	„ Interest (5% of „ £7,800 5 0)	390	0	0
						„ P. & L. A/c	1,809	15	0
		£10,000	0	0			£10,000	0	0

Sinking Fund Investment Account

		£	s.	d.			£	s.	d.
1956									
Dec. 31	To Bank	1,809	15	0					
1957									
Dec. 31	,, ,,	1,900	4	9					
1958		3,709	19	9					
Dec. 31	,, ,,	1,995	5	0					
1959		5,705	4	9					
Dec. 31	,, ,,	2,095	0	3					
1960		7,800	5	0	1960				
Dec. 31	,, P. & L. A/c Gain	199	15	0	Dec. 31	By Bank	8,000	0	0
		£8,000	0	0			£8,000	0	0

Lease Account

		£	s.	d.			£	s.	d
1956					1960				
Jan. 1	To Bank	10,000	0	0	Dec. 31	By Sinking Fund Account	10,000	0	0
1961									
Jan. 1	To Bank	11,000	0	0					

Insurance Policy Method. This can be regarded as a particular way of building a Sinking Fund. Instead of investing the annual instalment outside the business, the Company pays an annual premium to an Insurance Company. The capital sum insured is payable at the end of a given period. The premium is in effect an alternative way of investing the annual instalment. The advantage is that there is no danger of loss on realisation of the investment—the insurance company will pay the agreed sum. The price to be paid for avoiding the risk is a lower interest than could be expected from ordinary investments.

The accounts kept may be on the same lines as shown in the previous example. The Policy Account will be the Investment Account. There will be two other minor differences:

(1) No interest will be received in cash and the entry for the annual interest will be:

Debit Policy A/c Credit Sinking Fund a/c.

There will be no question of re-investing the interest: it is automatically added to the value of the policy.

(2) The premium will be paid at the beginning of each year and so interest will be earned within the first year.

Sometimes no policy account is opened and the premiums are charged to Profit & Loss Account. There is then no account for Depreciation Provision whilst the Asset remains in the books at cost. It is therefore necessary to include a note on the Balance Sheet to the effect that "Provision for the replacement of the asset is made by an insurance policy." When the capital sum is received, the entry is

Debit Cash Credit Asset Account,

and the balance on the Asset Account is cancelled.

Sinking Fund to Redeem a Liability

Here, the objective is to have sufficient liquid funds available at a future date when payment of a liability, e.g. debentures, is required.

As before, an amount is invested annually outside the business and the interest is re-invested. The annual instalment is debited to Revenue Account and credited to the Sinking Fund Account. But the apparent similarity conceals a basic difference. The debit in Profit & Loss Account for the Depreciation Sinking Fund instalment represents a real expense—depreciation. No parallel expense is involved in providing for the settlement of a liability. When a creditor is paid the Double Entry is:

Dr. Creditor Cr. Bank
(reduction in an asset) (removal of a liability)

and the principle is the same whether the creditor is a supplier or a debenture holder. No expense is involved.

What then is the purpose of the Revenue Account debit for the Sinking Fund instalment? It is the safeguarding of the funds which are being accumulated from profits for the payment of the liability. By debiting Revenue Account with the annual instalment (as an appropriation of profit not as an expense), we reduce the balance of profits available for distribution and achieve our purpose. We build up a Reserve of Undistributed Profits which is directly represented by the amounts invested outside the business.

The entries at the close of the period when the investment is realised and the liability settled are as follows:

(1) Dr. Bank Cr. Investment a/c with the proceeds of sale.
(2) Dr. Liability Cr. Bank with the amount paid to settle the liability.

Now the nature of the Sinking Fund Account is evident: there is no transfer required which will close the account and utilise the balance. It is, as described, an accumulation of profit and can be transferred to General Reserve.

EXAMPLE 57

£10,000 is borrowed on 1st January, 1955, repayable on 1st January, 1960. A Sinking Fund is created for the repayment, investments being made at 3%. The final instalment is not invested. The proceeds of sale on 31st December, 1959, are £7,800. Give the accounts for the five years (usually a much longer period is involved but the accounts are governed by the same principles).

Note: From the tables, the Sinking Fund instalment is calculated at £1,883·56.

Dr. *Loan Account* *Cr.*

		£	s.	d.			£	s.	d.
1960					1955				
Jan. 1	To Bank	10,000	0	0	Jan. 1	By Bank	10,000	0	0

Dr. *Sinking Fund Investment Account* *Cr.*

		£	s.	d.			£	s.	d.
1955									
Dec. 31	To Bank	1,883	11	2					
1956									
Dec. 31	,, ,,	1,940	1	4					
1957		3,823	12	6					
Dec. 31	,, ,,	1,998	5	4					
1958		5,821	17	10					
Dec. 31	,, ,,	2,058	4	4					
		7,880	2	2	1959				
					Dec. 31	By Sale	7,800	0	0
						,, Sinking Fund a/c Loss on Sale	80	2	2
		£7,880	2	2			£7,880	2	2

Dr. *Loan Redemption Sinking Fund Account* *Cr.*

£	s.	d.			£	s.	d.
			1955				
			Dec. 31	By Appropriation a/c	1,883	11	2
			1956				
			Dec. 31	,, Cash—Interest	56	10	2
				,, Appropriation a/c	1,883	11	2
			1957		3,823	12	6
			Dec. 31	,, Cash—Interest	114	14	2
				,, Appropriation a/c	1,883	11	2
			1958		5,821	17	10
			Dec. 31	,, Cash—Interest	174	13	2
				,, Appropriation a/c	1,883	11	2
				c/f	7,880	2	2

Dr.		£	s.	d.			£	s.	d. *Cr.*
1959					1959				
						b/f	7,880	2	2
Dec. 31	To Loss on Sale of Invest-ment	80	2	6	Dec. 31	By Cash—Interest	236	8	1
	„ General Reserve	9,919	17	6		„ Appropria-tion a/c	1,883	9	9
		£10,000	0	0			£10,000	0	0

The loss on sale of the investment reduces the transfer to reserve. In this and the previous example, the final instalment is not invested for the obvious reason that no one buys an investment one day to sell it the next—at least, not in normal business life.

Sometimes debentures are issued with the provision that they must be redeemed by a certain date but that, in the interim, the Company has the right to purchase its own debentures in the open market. Such purchases usually, but not invariably, lead to the cancellation of the debentures. No new principle is involved, but the transfer of accumulated profits to General Reserve is partially implemented when, on the redemption, an amount equal to the nominal value of the debentures redeemed is transferred from the Sinking Fund Account.

Gains or Losses on Redemption of the Debentures arise when they are purchased below or above par and these are transferred to the Sinking Fund Account.

EXAMPLE 58

Years ago, the Swift Co. Ltd. issued 5% debentures to the value of £150,000. A Sinking Fund has been created and on 1st January, 1960, the balance stood at £73,500. The amount had been invested in 3% War Loan at an average price of 84. On 30th June, 1960, War Loan of nominal value £35,000 was sold for £30,000. This amount was used to purchase debentures at 96. On 31st December, 1960, the sinking fund instalment of £8,000 was debited to Appropriation Account. Interest received during the year amounted £1,850. Further War Loan was purchased on 31st December at 88. Give the Debentures, Sinking Fund and Investment Accounts. (Ignore Debenture Interest).

Dr. *5% Debentures* *Cr.*

1960		£	1960			£
June 30	To Bank	30,000	Jan.	1	By Balance b/d	150,000
	,, Sinking Fund a/c, Gain on Redemption	1,250				
Dec. 31	,, Balance c/d	118,750				
		£150,000				£150,000
			1961			
			Jan.	1	By Balance b/d	118,750

Dr. *Debenture Redemption Sinking Fund Account* *Cr.*

1960		£	1960		£
June 30	To General Reserve	31,250	Jan. 1	By Balance b/d	73,500
			June 30	,, Gain on Realisation of Investment	600
Dec. 31	,, Balance c/d	53,950		,, Gain on Redemption of Debentures	1,250
			Dec. 31	,, Cash—Interest	1,850
				,, P. & L. Appropriation Account	8,000
		£85,200			£85,200
			1961		
			Jan. 1	By Balance b/d	53,950

Dr.		*Sinking Fund Investment Account—3½% War Loan*					*Cr.*
1960		*Nominal*		1960		*Nominal*	
		£	£			£	£
Jan. 1	To Balance b/f	87,500	73,500	June 30	By Bank	35,000	30,000
June 30	„ Sinking Fund a/c Gain on Realisation		600	Dec. 31	„ Balance c/d	63,700	53,950
Dec. 31	„ Bank	11,200	9,850				
		£98,700	£83,950			£98,700	£83,950
1961							
Jan. 1	To Balance b/d	63,700	53,950				

A further refinement can be considered in the light of the bracketed instruction "Ignore debenture interest." The debentures were purchased on 30th June and if the interest was payable half-yearly no problem arises. The purchase would be "ex div" and the full interest would be paid for the first six months. But if the interest was only payable annually, the cancellation of the debentures in June would mean the cancellation of responsibility to pay six months interest. The price of the debentures would then include six months interest accrued. The correct entries for the purchase and cancellation would be:

		£	s.	d.	£	s.	d.
Debenture Interest	Dr.	1,562	10	0			
5% Debentures		28,437	10	0			
To Bank					30,000	0	0
being purchase of Debentures of Nominal Value £31,250 at 96 and cancellation of debentures and accrued interest.							
5% Debentures		2,812	10	0			
To Debenture Redemption Sinking Fund Account					2,812	10	0
being gain on redemption.							

Redemption of Preference Shares. Since 1929, it has been possible for companies to issue preference shares which are at the option of the Company, capable of being redeemed. This must be authorised by the Articles of Association. Special provisions are made to protect the interests of creditors for whom the irredeemable capital fund forms a security only jeopardised by losses. The redemption of preference shares must be effected either:

1. Out of profits available for distribution but no longer so available after the redemption.
2. Out of the proceeds of a fresh issue of shares made for the purposes of the redemption.

Where the redemption is effected out of profits available for distribution, a sum equivalent to the nominal value of the shares redeemed must be transferred to the credit of a Capital Redemption Reserve Fund. This fund can only be used for the issuing to members of fully paid bonus shares. As Share Capital or as the Capital Redemption Reserve Fund, the amount serves to preserve the security of the creditors enjoyed before the redemption of the preference shares.

Any premium on the redemption of preference shares must be provided out of profits or out of Share Premium Account.

EXAMPLE 59

On 30th June, 1961, the Wellsborough Co. Ltd. exercised the right to redeem 100,000 £1 Redeemable Preference Shares at a premium of 5/–. The funds required were to be provided in part out of profits and in part from the issue of 60,000 £1 Ordinary Shares at par. Show the Journal entries for the transactions.

1960			£	£
June 30	Bank	Dr.	60,000	
	To Ordinary Share Capital Account			60,000
	being issue of 60,000 shares at par.			

		£	£
Redeemable Preference Shares	Dr.	100,000	
Premium on Preference Share Redemption		25,000	
To Bank			125,000
being redemption of Preference Shares at a premium of 5/–.			
P. & L. Appropriation a/c	Dr.	25,000	
To Premium on Preference Share Redemption			25,000
being provision of premium out of profits.			
P. & L. Appropriation a/c	Dr.	40,000	
To Capital Redemption Reserve Account			40,000
being the funds needed for redemption of the Preference Shares over the amount available from the issue of Ordinary Shares.			

A Sinking Fund can be created for the redemption of preference shares. The pattern of entries is similar to that used in the redemption of debentures. The vital difference is that the accumulation of profits in the Sinking Fund Account is finally transferred not to General Reserve but to the Capital Redemption Reserve Account.

QUESTIONS 15

1. On 1st January, 1956, the XY Trading Company Limited issued debentures to the value of £50,000 repayable in twenty years. It was decided to create a Sinking Fund to prepare for the repayment. The rate of interest estimated as receivable was 3%. Give the entries in the books of account of the company for the first three years.

2. A company's Debenture Redemption Account shows a balance of £19,000 represented by £20,000 (nominal) invested in securities. The balance on the Debentures Account is £25,000 and the company sells £15,000 (nominal) securities at par to redeem £12,500 (nominal) debentures at 101. Show the relevant accounts ignoring brokerage and interest.

3. ¶Karnatic Ltd. has issued £500,000 of Debentures at par on the condition that it opens up and invests a Sinking Fund. During the life of the fund the annual contributions have amounted to £485,000 and interest and dividends on the investments have totalled £9,975. Under the terms of the issue £50,000 of Debentures have been purchased on the open market for £47,860, which was raised by selling investments (costing £37,556) for that amount.

The company is now exercising its option to redeem the rest of the Debentures at 102 and the remaining investments are sold for £488,419.

Set out and close off the ledger accounts in which these transactions should be recorded.

4. The following was the Balance Sheet of A. Ltd. at 31st March, 1962:

Share Capital Authorised and Issued		£		£	£
			Fixed Assets		
10,000 Ordinary Shares of £1 each		10,000	Plant etc. at Cost	11,000	
10,000 6% Redeemable Preference Shares of £1 each		10,000	Less: Depreciation	5,000	6,000
		20,000	*Current Assets*		
Revenue Reserves			Cash at Bank	10,000	
Profit & Loss A/c	£4,500		Debtors	14,000	
General Reserve	8,000		Stocks	14,000	38,000
Future Taxation	3,000	15,500			
Current Liabilities		8,500			
		£44,000			£44,000

It was decided to issue a further 3,000 Ordinary Shares at a premium of 10/- per share for cash and to redeem at par the Redeemable Preference Shares.

You are required to show the necessary Journal entries and to prepare a Balance Sheet after the completion of the transactions which took place on 1st April, 1962.

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†Re-printed by courtesy of the Society of Incorporated Accountants (S.A.A.).

CHAPTER 16

The Presentation of Company Accounts

THE Annual Report of a Company is receiving considerable attention today. For some companies, it is very much more than a Statement of Accounts. Information of a non-financial nature is given in the hope of stimulating the interest of members in the life of the company. Products are described and commended: the Annual Report thus becomes a valuable advertising medium.

In addition to this supplementary information, often of considerable interest to members and non-members, the actual financial data is presented with increasing care and thought. The law prescribes rules which lay down the details that must be presented. For many the prescribed minimum becomes the maximum; the bare legal essentials are published. However, a growing number of companies are recognising that more information and careful presentation of financial statements are helpful to both members and potential investors and that to give this help is in the best interests of the company. We can, therefore, sub-divide our present subject into three sections:

1. The Requirements of the Companies Act 1948.
2. The Technique of Presentation.
3. Additional Financial Data given by some companies.

The Requirements of the Companies Act 1948

The general provision is that a Company must lay before members in general meeting, a Profit & Loss Account and

Balance Sheet. The former must give a true and fair view of the profit or loss for the financial year and the Balance Sheet, a true and fair view of the state of affairs of the Company at the end of that financial year. The term, Profit & Loss Account, is misleading. A detailed Profit & Loss Account might be helpful to competitors and, therefore, the presentation is basically that of the Appropriation Account, supplemented by prescribed additional data.

Detailed requirements are set out in Part 1 of the Eighth Schedule of the Act. Thus, the Profit & Loss Account or appended notes must disclose:

1. The charge for depreciation.
2. Debenture interest or interest on other fixed loans.
3. Amounts provided for the redemption of share capital or loans.
4. Material changes in reserves or provisions. These may be additions or withdrawals, but a withdrawal from a provision, made for the original purpose of the provision, need not be stated.
5. Income from investments, distinguishing between trade and other investments.
6. The charge for United Kingdom Income Tax and for other United Kingdom taxation—the basis of the charge for United Kingdom Income Tax must be explained.
7. Dividends paid and proposed.
8. The remuneration of auditors, unless it is fixed by the company in general meeting.
9. The effects, where material, of:
    (a) exceptional or unusual transactions or circumstances;
    (b) changes in the basis of accounting.

An earlier provision in the Act requires the disclosure of details of directors' remuneration, distinguishing between that for services as directors and any other emoluments, e.g. for management services. Also to be shown are amounts paid:

1 for past or present directors' pensions;
2 to past or present directors as compensation for loss of office.

It will be noted that some of these requirements relate to items normally entered in the Profit & Loss Account and others to items normally in the Appropriation Account. This has led some companies to present an account which is a mixture of the two. The preferable presentation, involving the use of appended notes, will be given later. The requirements do prevent the withholding of certain desirable information from members and avoid possible ambiguities which would make interpretation difficult.

In the same Schedule are given the requirements concerning the Balance Sheet. The following information must be given:

1. Authorised and Issued Share Capital. Any part of the issued capital which consists of Redeemable Preference Shares must be stated along with the earliest date on which they can be redeemed.
2. Share Premium Account.
3. Liabilities for which security has been given. It is not necessary to state the asset on which the liability is secured. Also, particulars of redeemed debentures which may be re-issued must be presented.
4. Capital Reserves, Revenue Reserves and Provisions, the source of any increase thereof and the application of any reduction in the reserves, unless the information is given in the Profit & Loss Account or in notes.
5. The basis on which the amount set aside for United Kingdom Income Tax is computed.

6. Liabilities, divided into appropriate classifications specifying separately Bank Loans and Overdrafts and Proposed Dividends.

7. Goodwill, Patents and Trade Marks so far as not written off.

8. Fixed Assets and the basis of their valuation.
   The normal presentation must be:

   (a) Cost, less
   (b) Aggregate Provision for Depreciation.

   (That this could lead to considerable expense on its introduction in 1948 was recognised; in the circumstances the balance at 1st July, 1948, was permitted instead of cost and accrued depreciation to that date). An alternative presentation is:

   (a) Valuation plus Additions since at cost less (b) Aggregate Provision for Depreciation since date of revaluation.

9. Investments classified as:

   (a) Investments in Subsidiaries.
   (b) Trade Investments—investments not solely for direct financial returns but leading to business association and co-operation.
   (c) Quoted Investments other than trade.
   (d) Unquoted Investments other than trade.

   Usually investments are stated at cost although permanent falls in value may be recognised. The market value of (c) must be stated as a note to or with the Balance Sheet.

10. Loans made to Officers of the Company during the financial year and outstanding balances of such loans made before the commencement of the financial year. Loans made within the normal business or, if under £2,000, within the established practice of the company are excepted.

11. Current Assets under appropriate headings.

12. So far as not written off:
    (a) Preliminary Expenses.
    (b) Share or Debenture Issue Expenses.
    (c) Commission paid in respect of shares or debentures.
    (d) Debenture discount.
    (e) Discount on Shares.

The above is an extensive summary of the provisions of the Act. It does indicate the major requirements but is no substitute for the wording of the Act itself.

Other data must be given in attached notes or reports and these include:

1. Arrears of fixed cumulative dividends.
2. Contingent Liabilities.
3. Amounts (or estimates) involved in contracts for capital expenditure.
4. If depreciation is not provided by the normal charge to Profit & Loss Account, the method by which it is provided or a statement that no provision is made.

Both the Profit & Loss Account and Balance Sheet must give the corresponding figures for the previous year.

The distinction between Capital Reserves, Revenue Reserves and Provisions was an important feature of the 1948 Act.

Capital Reserves:

Credit balances arising from gains or surpluses which cannot be distributed to shareholders are capital reserves. Examples are:

1. Share Premium Account.
2. Capital Redemption Reserve Fund.

The amounts in such accounts form part of the capital fund of a company—a fund that cannot be reduced by distributions to members. They can, however, be distributed by the issue of bonus shares as fully paid. The amounts cannot be used in settlement of the uncalled balance on shares already issued.

This would effectively reduce the capital fund to which creditors can look for security.

The Share Premium Account can also be used:

1. To write off Preliminary Expenses.
2. To write off Share or Debenture Issue Expenses.
3. To provide the premium on the redemption of Preference Shares or Debentures.

Other forms of capital reserves include Pre-incorporation Profits and the Surplus on Revaluation of Fixed Assets.

Revenue Reserves. These are also part of the equity of the company but the amounts are not consolidated in a permanent capital fund. In fact, though they may be called by different names, the balances of these accounts are retained profits—profits which, for one reason or another, have been withheld from distribution but which can still be distributed if the directors and general meeting so decide. Examples are:

1. Dividend Equalisation Reserve.
2. General Reserve.
3. Profit & Loss Account Credit Balance.

A Debenture Redemption Sinking Fund Account also comes in this category.

Provisions. Before the 1948 Act, this term was used for accrued expenses but, now, these amounts must be treated simply as liabilities. Provisions are:

1. Amounts provided for depreciation or the diminution in value of an asset.
2. Amounts provided for liabilities, the amounts of which can only be estimated, i.e. where the amount of the liability is not known with reasonable accuracy.

Strangely enough, the most common provision does not fit the definition exactly. The Provision for Bad Debts is provided for a loss not a liability. It does however, illustrate the fact that the amount is not known with substantial accuracy.

Additional Notes:

1. *Pre-incorporation Profits.* A Company cannot make profits before it comes into existence, i.e. before incorporation. However, the business which a company is formed to take over can make profits before that date. Sometimes, the arrangement is made for the company to take over a business prior to its actual date of incorporation. The profits made between the two dates belong to the company but are not available for distribution to members.

EXAMPLE 60

R. Jones and P. White decide to convert their partnership business into a limited company as from 30th June, 1960. The date of incorporation of the company is 1st August, 1960. The following is the summary of the trading for the year to 30th June, 1961.

	£	£
Gross Profit		14,000
Less Expenses:		
Rent, Rates etc.	1,360	
General Expenses	4,712	
Directors' Fees	2,500	
Depreciation	4,100	12,672
Net Profit		£1,328

The turnover for July 1960 was one-fourteenth of that for the year. Give the Profit & Loss Account and Appropriation Account.

The first task is to apportion the gross profit and expenses between the pre- and post-incorporation periods. Gross Profit is divided according to the respective turnovers and, for most expenses, the equitable division is according to time. However, this rule must not be applied incritically. Directors' Fees in this example relate to the post-incorporation period alone.

	July 1960	Aug. 1960 to June 1961
	£	£
Gross Profit	1,000	13,000
Expenses, Rent, Rates etc.	113	1,247
General Expenses	393	4,319
Directors' Fees	—	2,500
Depreciation	342	3,758
	842	11,824
Net Profit	£152	£1,176

Dr. *Profit & Loss Account* *Cr.*

	£		£
To Rent, Rates etc.	1,360	By Gross Profit	14,000
,, General Expenses	4,712		
,, Directors' Fees	2,500		
,, Depreciation	4,100		
,, Net Profit c/d	1,328		
	£14,000		£14,000
To Capital Reserve:		By Net Profit b/d	1,328
Pre-acquisition Profits	152		
,, Balance carried forward	1,176		
	£1,328		£1,328

2. *Bonus Shares.* The Reserves may be used to distribute Bonus Shares to members. The effect of such a distribution is illustrated in the following Balance Sheets:

	Before Distribution	*After Distribution*		
	£	£		£
Share Capital			Assets	24,000
—Issued	10,000	20,000		
Capital Reserve	6,000	—		
Revenue Reserves	5,000	1,000		
	21,000	21,000		
Liabilities	3,000	3,000		
	£24.000	£24,000		£24,000

The accounting entries for this issue would be:

		£	£
Capital Reserve	Dr.	6,000	
Revenue Reserves	Dr.	4,000	
To Bonus Account			10,000
being amounts used for bonus issue.			
Bonus Account	Dr.	10,000	
To Share Capital Account			10,000
being issue of bonus shares on "one for one" basis.			

There is no change in the total equity of the company, nor in the share of any particular member. The effect of the bonus issue is that the capital employed is more adequately represented by the amount of share capital. Before the issue the capital employed was more than twice the nominal value of the issued shares.

Both Capital Reserves and Share Capital are part of the permanent capital fund of a company. A Bonus Share issue from Capital Reserve effects a change of name not of substance. An issue from Revenue Reserve is different: an amount previously distributable is capitalised. No such issue should be made unless the company requires the increase in its permanent capital fund.

3. *Income Tax Accounts.* The United Kingdom Income Tax (or Fiscal) Year ends on 5th April. It thus covers parts of two calendar years and we refer, for example, to the 1962/3 Fiscal Year. All Income Tax Levied on companies is payable on 1st January within the tax year, e.g. the 1962/3 tax is payable on 1st January, 1963.

The normal basis of the computation of the tax on profits (described as Schedule D tax) is the "adjusted profit" earned in the trading period ending within the previous year, e.g.

A trading year ends on 31st December. The 1962/3 tax is based on the profit to 31st December, 1961. If the trading year ends on 31st March, the 1962/3 tax is based on the profit to 31st March, 1962.

For taxation, certain prescribed adjustments are made to the P. & L. Account figure for Net Profit, hence the term "adjusted profit."

Consider a company having a trading period ending on 31st March and achieving the following results:

	£
Year to 31st March, 1960	6,000 profit (adjusted)
Year to 31st March, 1961	2,000 ,, ,,
Year to 31st March, 1962	5,000 ,, ,,

The rules of assessment mean that the 1960/61 Assessment is based on the adjusted profit of the year to March 1960, i.e. tax based on an adjusted profit of £6,000 is charged in a year when the adjusted profit is only £2,000. The following year, tax based on an adjusted profit of £2,000 is charged in a year when the adjusted profit is £5,000. It is not surprising that most business men prefer a system whereby the tax charged in a Profit and Loss Appropriation Account is the tax based on the profits for the current year. In this way provision is made for tax which will only become payable in the future.

e.g.	*Trading Year*	*Tax Charged in Accounts*	*Date the Amount is Payable*
(a)	To 31 March, 1962	1962/3	1st Jan., 1963
(b)	To 30th June, 1962	1963/4	1st Jan., 1964
(c)	To 31st Dec., 1962	1963/4	1st Jan., 1964

Taking the second example: at the Balance Sheet date 30th June, 1962, the balance on Taxation Account will include the 1962/3 tax payable six months later and the 1963/4 tax estimate. Strictly speaking, only one quarter of the 1961/2 tax has accrued by 30th June, 1961. However, a convention is now commonly accepted whereby the tax for the fiscal year containing the Balance Sheet date is regarded as a current liability. The credit for the following year's tax is regarded as a Reserve for Future Taxation and, in the Balance Sheet, appears separately. The figure is, of course, only an estimate.

EXAMPLE 61

The ZY Trading Company Ltd. makes full provision in its accounts on all profits to date. At 1st January, 1962, the balance brought forward was £16,500 representing:

1961/2	Schedule D	£9,400
1962/3	Schedule D	£7,100.

The 1961/2 liability was settled on 5th January and the 1962/3 liability was finally agreed at £7,410. The estimate for 1963/4 was £6,800.

Required: The Taxation Account for 1962 and the relevant entries in the Profit & Loss Account and Balance Sheet at 31st December, 1962.

Dr. *Taxation Account* *Cr.*

1962		£	1962			£
Jan. 5	To Bank	9,400	Jan. 1	By Balances b/f		
Dec. 31	„ Balances c/d			1961/2 Schedule D		9,400
	1962/3 Schedule D	7,410		1962/3 Schedule D		7,100
	1963/4 „ „	6,800	Dec. 31	„ P. & L. Account		7,110
		£23,610				£23,610
			1963			
			Jan. 1	By Balances b/d		
				1962/3 Schedule D		7,410
				1963/4 Schedule D		6,800

Profit and Loss Appropriation Account—Debit.

To Taxation on Profit for Year	6,800	
Add Under-Provision for 1962/3 Assessment	310	7,110

Balance Sheet.

Reserve for Future Income Tax	6,800
Current Liabilities:	
Income Tax	7,410

It is not difficult to see why the Companies Act requires published accounts to state the basis on which the amounts set aside for United Kingdom Income Tax is computed. A company chooses from three alternatives and may provide for:

(a) Taxation to the Balance Sheet date, taking only the appropriate fraction of the liability of the current fiscal year.
(b) Taxation including the estimated assessment for the whole of the current fiscal year.
(c) Taxation on all profits to the Balance Sheet date.

e.g. A company at 31st December, 1962 makes provision:

Under (a) for three-quarters of the 1962/63 Schedule D Assessment.
,, (b) for the whole of the 1962/3 Schedule D assessment.
,, (c) for the whole of the 1963/4 Schedule D assessment.

Plausible arguments can be advanced for each procedure although (c) has been described above as the most common. In examining the published accounts of a company, it is vital to know which has been adopted.

The additional tax on company income, the Profits Tax, does not cause similar difficulty. The assessment is directly related to the company's trading year.

One further facet of United Kingdom Taxation is involved in the preparation of company accounts. The principle of tax collection by "deduction at source" applies to the payment of debenture interest and dividends. Also, most investment income received by a company is received after deduction of tax. The payment of dividends is entered "net" in the Appropriation Account. For the payment of debenture interest and for investment income we adopt the procedure of "*grossing up.*"

When a company deducts tax from the payment of debenture interest, the net figure will be entered in the Bank Account and debited in the account for Debenture Interest. But this net figure is the result of two transactions:

(a) the payment of interest.
(b) the deduction of tax.

In our accounts we seek to show the full amount of interest paid (i.e. the gross figure) and the tax deduction. This is done by a transfer from Debenture Interest Account to Taxation Account.

e.g. Annual Interest paid £8,000 gross. Tax deducted at 7/9 in the £, = £3,100.

Journal Entry for Grossing up:

		£	£
Debenture Interest Account	Dr.	3,100	
To Taxation			3,100
being tax deducted from annual interest.			

A similar procedure is adopted for the tax deducted from Investment Income. The money received is usually the net figure and this is credited to the Nominal Account. A transfer to Taxation brings the figure up to the gross amount.

EXAMPLE 62

On 1st January, 1962, the A.B. Company Limited issued £40,000 5% Debentures. Interest is payable half yearly on 1st July and 1st January.

The Company's Trading Period ends on 30th September. During the year to 30th September, 1962, the Company received interest (net) of £735.

Give the accounts for Debenture Interest and Interest Received and the relevant extracts from Taxation Account. Taxation is at the rate of 7/9 in the £.

Dr. *Debenture Interest* *Cr.*

1962		£	s.	d.	1962		£	s.	d.
July 1	To Bank	612	10	0	Sept. 30	By P. & L. A/c	1,500	0	0
Sept. 30	„ Amount Accrued c/d	306	5	0					
	„ Taxation A/c	581	5	0					
		£1,500	0	0			£1,500	0	0
					1962				
					Oct. 1	By Amount Accrued b/d	306	5	0

Dr.		*Interest Received*							*Cr.*	
1962		£	s.	d.	1962		£		s.	d.
Sept. 30	To P. & L. A/c	1,200	0	0	Sept. 30	By Sundry Amounts	735		0	0
						,, Taxation A/c	465		0	0
		£1,200	0	0			£1,200		0	0

Dr.		*Taxation Account*						*Cr.*	
1962		£	s.	d.	1962		£	s.	d.
Sept. 30	To Interest received	465	0	0	Sept. 30	By Debenture Interest	581	5	0

The Technique of Presentation

In most of the examples in this book, shillings and pence have been omitted. The principles could be illustrated adequately with figures for pounds only. There is a similar omission in published accounts: shillings and pence only confuse the presentation and, of course, have no significance in the light of the large sums involved. The presentation of important data satisfactorily involves the omission of figures which are insignificant. This principle is accepted in the Act and the disclosures specified in the last section are only required when the amounts involved are material.

The requisite disclosures must be made in the Profit & Loss Account or Balance Sheet or in notes appended thereto. There must be discretion in determining how much information should be given by way of note. A study of published accounts will show how much use is made of notes—it is not difficult from such a study to realise how necessary this is. To incorporate all the required detail in the "body" of the Accounts would make them very difficult to read and to follow. Inevitably, theoretical exercises are less complex than the affairs of real companies and, consequently, the use of notes is less important. Another prominent feature of published accounts is the intelligent use of type and colour. Comparative figures from the previous year are "segregated" by different type and/or use of background colour.

The traditional design of the "two-sided" Profit & Loss Account and Balance Sheet is giving way to the vertical form. The change has not been so definite for both statements. Most companies now produce a vertical Profit & Loss Account but many retain the two-sided Balance Sheet. The following illustration uses the vertical form throughout.

EXAMPLE 63

Veracity Ltd.

Profit & Loss Account for the year ended 31st December, 1961

1960			1961		1960
			£		£
	Net Trading Profit after charging the expenses listed below		13,060		16,228
£		£			
4,000	Directors Emoluments—Fees	4,000			
5,000	,, ,, —for Management Services	6,000			
600	Audit Fee	600			
280	Debenture Interest	280			
4,756	Provision for Depreciation	5,538			
	Add Income from Trade Investments		432		432
	Income from other Quoted Investments		124		98
			13,616		16,758
	Less United Kingdom Income Tax on Profits for Year	£ 5,924		£ 6,860	
	Less Over-provision of Previous Year	200		534	
		5,724		6,326	
	Profits Tax	1,210	6,934	1,418	7,744
			6,682		9,014
	Balance brought forward 1st January		9,027		4,613
	Balance Disposable		£15,709		£13,627

	£	£
Proposed Dividends less tax.		
Ordinary	4,250	4,000
Preference	600	600
Transfer to General Reserve	5,000	—
Balance carried forward	5,859	9,027
	£15,709	£13,627

Veracity Limited

Balance Sheet as at 31st December, 1961

		1961		1960
		£		£
Fixed Assets (see Note 1)		69,546		70,708
Investments at cost (see Note 2)		9,516		8,908
		79,062		79,616
Current Assets	£		£	
Stock at cost or under	32,312		31,816	
Debtors less Provision	19,246		16,497	
Cash at Bank	2,334		1,580	
	53,892		49,893	
Current Liabilities				
Current Taxation	7,550		5,440	
Proposed Dividends	4,850		4,600	
Trade Creditors and Accrued Expenses	15,090		15,118	
	27,490		25,158	
Current Assets less Current Liabilities		26,402		24,735
		£105,464		£104,351
Capital Employed				
Issued Share Capital (see Note 3)		60,000		60,000
Share Premium Account		10,000		10,000
Revenue Reserves	£		£	
General Reserve	20,000		15,000	
Profit & Loss Account	5,859	25,859	9,027	24,027
Reserve for Future Income Tax		5,605		6,324
		101,464		100,351
7% Mortgage Debentures (secured)		4,000		4,000
		£105,464		£104,351

Notes on Balance Sheets

1. *Fixed Assets*

	1961			1960		
	Cost	*Deprn.*	*Balance*	*Cost*	*Deprn.*	*Balance*
	£	£	£	£	£	£
Freehold Land and Buildings	15,300	1,300	14,000	15,300	750	14,550
Plant and Machinery	71,546	23,416	48,130	68,390	19,683	48,707
Motor Vehicles	10,680	3,264	7,416	9,460	2,009	7,451
	£97,526	£27,980	£69,546	£93,150	£22,442	£70,708

2. *Investments*

	1961	1960
	£	£
Trade Investments	7,060	7,060
Other Quoted Investments (Market Value–£2,872; 1960–£2,014)	2,456	1,848
	£9,516	£8,908

3. *Share Capital* (1960 as 1961)

Authorised		£
20,000	6% Preferences Shares of £1	20,000
80,000	Ordinary Shares of £1	80,000
		£100,000
Issued		£
10,000	6% Preference Shares of £1 each fully paid	10,000
50,000	Ordinary Shares of £1 each fully paid	50,000
		£60,000

Such a presentation used technical language which is not readily comprehensible to many readers. The efforts to avoid this difficulty fall into two categories:

(a) The actual accounts are presented with as little technical language as possible. Where necessary, longer descriptions are given.

(b) A supplementary set of accounts is presented in simplified form. The following is an example of a simplified Profit & Loss Account.

Veracity Limited

Income and Expenditure for the Year ended 31st December, 1961

	1961	1960
	£	£
The excess of Sales over Cost of Sales and Selling and Administrative Expenses was	13,060	16,228
To which we add Income from Investments held by the Company	556	530
	13,616	16,758
We have to provide for Taxation on these profits	6,934	7,744
	6,682	9,014
From last year, we brought forward undistributed profits	9,027	4,613
Giving us a balance for disposal	£15,709	£13,627
Your directors recommend:		
A transfer to General Reserve to strengthen the finances of the Company	5,000	—
Preference Dividend	600	600
Ordinary Dividend	4,250	4,000
	£9,850	£4,600
Leaving a Balance to be carried forward of	£5,859	£9,027

Simplified Balance Sheets are also prepared in non-technical language.

Additional Information in the Annual Report

Fortunately, the prescribed minimum of presented facts does not become the maximum for many companies. Much more is published and welcomed by the investing public.

The turnover is not required by the Act but is most valuable in assessing the progress and prospects of a company. Some regard it as too valuable to publicise, i.e. too valuable for competitors.

Almost certainly, this fear is grossly exaggerated and the growing practice of publishing the annual turnover and, sometimes, a division of the global sum between geographical areas or between different product groups is to be welcomed.

Later, in considering the interpretation of accounts, we shall have to face the severe limitations of one set of accounts, even when the figures for the previous year are also given. To study the all-important trends requires far more than the results of two years. Leading companies oblige by printing statistical tables of vital figures for five or ten years. These figures will be derived from successive Profit & Loss Accounts and Balance Sheets. Some of the ratios to be described in Chapter 18 may also be presented in the tables.

An important supplement is the "Source and Application of Funds Statement." This summarises the resources which have become available to the business and the expenditure of those resources.

Additional resources arise from:

(a) The Surplus of Current Receipts over Current Outlays. This is not only the Net Profit. The Provision for Depreciation reduces the Net Profit but does not involve any current outlay.
(b) Additional Capital.
(c) Long-term Loans received.

The resources are disposed of in:

(a) The Distribution of Profit—Drawings, Dividends and Taxation.
(b) The purchase of Fixed Assets.
(c) The Repayment of Long-term Loans.

The "balancing item" is the adjustment (increase or decrease) in Working Capital. A statement of Changes in Working Capital is an important supplement to the Funds Statement.

EXAMPLE 64

From the following information, prepare a statement showing the additional funds that became available in 1961, the use of those funds and the changes in Working Capital position.

Balance Sheets

	1960	1961		1960	1961
	£	£		£	£
Share Capital	40,000	50,000	Fixed Assets	40,406	47,759
Share Premium	8,000	10,000	Stock	27,200	30,918
General Reserve	6,000	10,000	Debtors	15,132	18,363
P. & L. Account	3,416	1,548	Bank	4,016	2,124
Future Income Tax	5,200	6,000			
Debentures	10,000	—			
Current Liabilities					
Creditors	3,621	8,416			
Taxation	4,117	5,200			
Proposed Dividend	6,400	8,000			
	£86,754	£99,164		£86,754	£99,164

Profit & Loss Account 1961

	£		£
Dividends Proposed	8,000	Net Trading Profit	15,713
Taxation on Profits for year	6,000	Gain on Sale of Machine	419
Transfer to General Reserve	4,000	Balance brought forward	3,416
Balance carried forward	1,548		
	£19,548		£19,548

Fixed Assets Account

	£		£
Balance b/f	40,406	Sale of Machine	1,614
Gain on Sale	419	Depreciation	2,363
Purchases	10,911	Balance c/f	47,759
	£51,736		£51,736

Statement of Working Capital

	1960	1961	Change
	£	£	£
Debtors	15,132	18,363	+3,231
Bank	4,016	2,124	−1,892
Liquid Assets	19,148	20,487	+1,339
Current Liabilities			
Creditors	3,621	8,416	+4,795
Taxation	4,117	5,200	+1,083
Proposed Dividend	6,400	8,000	+1,600
	14,138	21,616	+7,478
Surplus (or Deficiency) of Liquid Assets	5,010	(1,129)	−6,139
Stock	27,200	30,918	+3,718
Working Capital	£32,210	£29,789	−2,421

Statement of Funds

Source	£	*Application*	£
Issue of Shares (at Premium)	12,000	Purchase of Fixed Assets	10,911
Net Trading Profit	15,713	Repayment of Debentures	10,000
Sale of Machine	1,614	Taxation	5,200
Provision for Depreciation	2,363	Proposed Dividend	8,000
	31,690		
Decrease in Working Capital	2,421		
	£34,111		£34,111

Note:

The amount for Taxation in the Funds Statement is £5,200, the Current Liability assumed during the Year. In the Profit & Loss Account the charge is £6,000 but this is a transfer to Reserve. The resources of a company are not affected by transfers to Reserve Accounts, i.e. no funds are expended.

The skilled analyst welcomes all such additional data in a Company Report. Others may not be so happy with "masses of figures." For them, skilful diagrammatic presentation of salient features of the Report is to be commended. But diagrams must supplement, not replace, figures.

QUESTIONS 16

1. *On 31st December, 1961, a limited company owned machinery which appeared in its balance sheet drawn up as on that date as "at cost £97,300 less aggregate depreciation £51,770."

   During 1962 the company bought new machinery at a cost of £12,400 and sold old machinery which had originally cost £5,800 and in respect of which it had provided £4,900 (part of the £51,770 above) depreciation. The additional depreciation provided in respect of the year ended 31st December, 1962, in respect of all the machinery in use at that date was £9,780.

   Show how the machinery should appear in the company's Balance Sheet as on 31st December, 1962, supposing that:

   (a) the company wishes to disclose to its members information regarding additions to and disposals of machinery, and
   (b) no more than the minimum statutory information is to be given.

2. *The authorised share capital of the Excelsior Machine Co. Ltd. is £250,000 divided into 60,000 5 per cent preference shares of £1 each and 190,000 ordinary shares of £1 each: 40,000 preference shares and 60,000 ordinary shares have been issued and fully paid.

   The balances on the books on 31st December, 1961, before the appropriation of the balance on the Profit & Loss Account, are as follows:

	£	£
Preference Share Capital		40,000
Ordinary Share Capital		60,000
Freehold Land and Buildings	40,050	
Machinery and Plant	112,176	
Furniture, Fixtures and Fittings	4,832	
Premium on Shares Account		14,000
General Reserve		26,000
Profit prior to incorporation		10,356
5 per cent Debentures (repayable after 1964)		60,000
Quoted investments, at cost	9,784	
Sundry Debtors and prepayments	28,551	
Creditors and accrued expenses		11,203
Stock on hand, at cost	46,259	
Cash at bank	10,327	
Cash in hand	1,052	
Trade investments, at cost	5,000	
Provision for deferred repairs		2,786
Debentures Redemption Reserve		4,000
Profit & Loss Account		29,686
	£258,031	£258,031

*Re-printed by courtesy of the Royal Society of Arts (R.S.A.).

The balances shown for Freehold Land and Buildings, Machinery and Plant, and Furniture, Fixtures and Fittings are the net amounts after providing depreciation on the diminishing value up to 31st December, 1961. From the accounts for these items it is ascertained that the cost of the assets now in existence was:

Freehold Land and Buildings	£47,840
Machinery and Plant	£232,980
Furniture, Fixtures and Fittings	£10,570

No disposal of any of these assets has been made during the year.

The directors are of the opinion that the market value of the Stock on hand and of the Trade Investments is in excess of cost. The market value of the Quoted Investments is £10,800.

Out of the Profit & Loss Account balance it has been decided to:

(a) appropriate £8,000 by way of future tax reserve;
(b) increase the debenture redemption reserve to £5,000;
(c) set aside £5,000 against a possible increase in the prices of raw materials;
(d) pay a half-years dividend on the preference shares and propose a dividend of 12 per cent on the ordinary shares (both dividends less income tax at 7/9 in the £):
(e) carry forward the balance.

Prepare for publication the Balance Sheet of the company as on 31st December, 1961.

3. ‡Brisk Limited has an authorised share capital of £150,000 in shares of £1 each of which 100,000 shares have been issued on which 15/- per share has been called up.

After making some of the closing entries, the following is the Trial Balance as on 31st December, 1962:

	£	£
Share Capital	—	75,000
Calls in arrear	1,200	—
Freehold Buildings, at cost	52,000	—
Plant and Machinery, at cost	126,000	—
6% Notes, 1960/63	—	20,000
Future Income Tax, 1962/3	—	22,000
Capital Reserve	—	8,560
Creditors and accrued expenses	—	10,100
Stock-in-trade, at or under cost	39,276	—
Share Premium Account	—	4,000
General Reserve	—	10,000
Interest on 6% Notes (net)	368	—
White Bank Limited, overdraft	—	5,400

‡Re-printed by courtesy of the Institute of Chartered Accountants (C.A.).

	£	£
Trade Investments, at cost	10,000	—
Debtors	25,030	—
Marketable Investments, at cost	9,260	—
Depreciation, 31st December, 1961:		
On Freehold Buildings	—	9,140
On Plant and Machinery	—	37,580
Interest on Trade Investments (net)	—	1,225
Interest on Marketable Investments (net)	—	490
Balance at Green's Bank Ltd.	15,260	—
Cash in hand	1,202	—
Profit & Loss Balance, 1st January 1962	—	13,260
Profit for the year 1962	—	62,841
	£279,596	£279,596

The profit for the year 1962 is after charging £3,000 salary of the factory manager, who is also a director, and writing off £1,800 to reduce the stock-in-trade to market value. Owing to a rise in raw material prices, the directors decide to set aside to set aside £4,000 as a replacement reserve.

Provision is to be made for: depreciation on buildings at 5% on cost and on plant and machinery at 8% on cost, directors' fees £1,000, auditors' remuneration, fixed by the directors, £630, doubtful debts £380, six months interest on the 6% notes (which were repaid on 1st January, 1963) and £5,000 for the cost of repairing damage caused by fire not covered by insurance.

The liability for income tax 1962/3, Case 1, Schedule D, has been finally agreed at £18,526; on the profit of the year 1962, it is estimated to be £20,500. Profits tax for the year 1961 has been agreed and paid and an overprovision of £474 has been included in the profit of the year 1962; for the year 1962, it is estimated to be £4,800.

Marketable Investments have a market value of £8,540. There is no market quotation for the Trade Investments but they are considered to be at least worth their cost.

The Directors decide to appropriate £5,000 to General Reserve and to recommend a dividend of 20%, less income tax, on the paid up share capital, the calls in arrear having since been received.

You are required to prepare in a form suitable for publication the Balance Sheet of Brisk Ltd. as on 31st December, 1962, and the Profit & Loss Account for the year ended on that date. (Income Tax is 7/9 in the £).

4. On 30th September, 1960, the Arconia Co. Ltd. issued £30,000 4% debentures, interest being payable on 31st March and 30th September. Give the Debenture Interest Account including the entry for income tax for the period ending 31st March, 1961. Prepare another account on the assumption that the trading year ends on 30th June, 1961. Take income tax at 7/9 in the £.

5. Give the Journal entries for the "grossing up" of the following payments:
   (a) Interest paid net on £50,000 6% Debentures for the year 1961.
   (b) Net income from investments during 1961–£690. (Tax is 7/9 in the £).

6. For some years, the Adjo Trading Company Ltd. has made provision in its books for taxation based on all profits earned to the Balance Sheet date. On the 1st October, 1959, the following balances appeared on the Income Tax account:

   Schedule D 1959–60 £6,100
   Schedule D 1960–61 £9,000.

   The 1959–60 assessment was paid on the due date. The 1960–61 assessment was finally agreed at £8,100. Give the Income Tax Account for the year to 30th September, 1960 and the relevant entries in the Profit & Loss Account and Balance Sheet at that date. The 1961–2 assessment was estimated at £7,500.

7. ¶Megas Ltd. has an issued share capital of £50,000 ordinary shares and 10,000 7½ per cent preference shares of £1 each. In addition, it has issued 10 per cent unsecured loan stock of £15,000 and £8,000 in 6 per cent debentures. The interest on these latter two items is payable in equal instalments on 1st January and 1st July.

   The company owns £6,000 3½ per cent Treasury Bonds, 1977/80 (interest payable 15th June and 15th December).

   The preference share dividends are payable in equal instalments on 1st April and 1st October and a final dividend on the ordinary shares of 8 per cent was paid on 15th April, 1962, in respect of the previous year, with an interim dividend of 7 per cent paid on 19th October, 1962.

   The company's year-end is on 31st December, and on 1st January, 1962, the provision for taxation amounted to £46,424 and the reserve for future taxation was £37,600. On 31st January profits tax of £5,418 was paid by cash and also Schedule D tax 1961/2 of £41,233.

   By 31st December the income tax 1962/3 was agreed at £38,129. The profits tax for the accounting period to 31st December, 1962, was estimated at £2,917 and the income tax 1963/4 was estimated at £27,648.

   You are required to set out the Taxation Account in the company's books for 1962 and to show the charge for taxation as it should appear in the published accounts of the company. (Income Tax is 7/9 in the £).

¶Re-printed by courtesy of the Association of Certified Accountants (A.C.C.A.).

8. The Balance Sheets of R. Williams for 31st December, 1960 and 1961 are summarised below:

	1960	1961		1960	1961
	£	£		£	£
Capital	3,416	3,834	Fixed Assets (cost)	3,418	4,810
			Less Depreciation	1,204	1,612
				2,214	3,198
Current Liabilities	2,132	3,261	Current Assets:		
			Stock	1,411	2,095
			Debtors	1,349	1,524
			Bank	574	278
	£5,548	£7,095		£5,548	£7,095

The Capital Account was as follows:

	£
Balance brought forward, 1st January, 1961	3,416
Add Net Profit for Year	2,418
	5,834
Less Drawings	2,000
	£3,834

Prepare a Funds Statement and also a Statement of Working Capital Changes.

9. From the following accounts, prepare a Statement of Working Capital and a Source and Application of Funds Statement:

	1961	1962
	£	£
Share Capital	50,000	60,000
Share Premium	10,000	10,000
General Reserve	4,000	—
Profit & Loss Account	11,010	4,016
Future Income Tax	3,620	5,710
Current Liabilities:		
Creditors	2,019	4,416
Proposed Dividend	4,000	4,800
	£84,649	£88,942

	£	£
Fixed Assets at cost less depreciation	48,000	50,400
Stock	21,019	24,136
Debtors	10,962	14,119
Cash at Bank	4,668	287
	£84,649	£88,942

The Profit & Loss Account for 1962 was:

	£		£
Taxation	5,710	Net Trading Profit	9,116
Transfer to Reserve	6,000	Balance brought forward	11,010
Proposed Dividend	4,800	Over-provision of tax at	
Balance carried forward	4,016	31 Dec. 1961	400
	£20,526		£20,526

At 31st December, 1962, the Reserve was used to issue Bonus Shares on the basis of one for every five held.

The depreciation of Fixed Assets was £3,022 in 1962.

CHAPTER 17

Company Reconstructions and Amalgamations Group Accounts

Reconstructions

A company which has made heavy losses over a period of years will have accumulated a debit balance on its Profit & Loss Account. On the Balance Sheet, this may appear on the Assets side, but, of course, the figure represents no asset. It is an example of that contradiction in terms, a "fictitious asset." The better presentation is as a deduction from the Capital Fund for the debit is a loss of capital. Sometimes such a situation becomes intolerable and hopeless; the company must be liquidated. At other times, it is possible, or appears possible, to save the company provided a drastic reconstruction takes place. Such reconstructions involve:

1. The recognition of the loss of capital and the apportionment of that loss between the different classes of shareholders. This leads to a new start with a realistic figure for capital and reasonable prospects of a fair return.
2. Possible arrangements with debenture holders and other creditors whereby they forgo part of their rights against the company. No one gains from a reconstructed company being doomed from the start by the burdern of past debts.

Delicate questions of equity and fairness are raised by a scheme for the reconstruction of a company. The shareholders, and particularly the Ordinary Shareholders, are the risk-bearers; why then should others share the burden of loss? There is neither a legal nor a moral obligation for them to do so. Arrangements with creditors are made because it is sometimes beneficial to their interests. The forced sale of all assets on liquidation may offer to creditors worse prospects than a partial cancellation of their debts in a reconstruction of the company. If their security is adequate, debenture holders may not face any loss; but if the debentures are unsecured or inadequately secured, the holders may cut their losses by agreeing to some sacrifice in the reconstruction.

There is also a clash of interests as between the different classes of shareholders. The main burden of loss must be borne by the Ordinary Shareholders; they have had no limit on prospective dividends and have knowingly accepted the greater risk. But the Preference Shareholders may share some of the loss because it is in their interests that the company carries on. They may, therefore, forgo all or part of their rights to cumulative dividends and accept a reduction in the "nominal" or "par" value of their shares.

Creditors sacrifice by accepting the writing-off of part of their debt. Preference Shareholders may sacrifice by the reduction of the par value of their shares. The reduction in the nominal value of ordinary shares in itself involves *no* sacrifice to the Ordinary Shareholders of a continuing business. Their rights are residuary rights. The value of ordinary shares is determined by the residue of profits available for ordinary dividends and "par value" is a misleading and irrelevant factor.

An identical distribution can be described as 5% of the original Ordinary Share Capital or 10% of the reconstructed capital (if the nominal value is halved in the reconstruction).

Ordinary Shareholders lose not by a change in the nominal value of their shares but by:

(a) An increase in the amount of interest-carrying debt or preferred capital, or an increase in the interest or dividend rates involved.

(b) The issuing to other parties of additional ordinary shares.

The first involves a reduction in the amount of future profits available for ordinary dividends, the second means there are more people to share in such distributions. Common elements in schemes of reconstruction are the issuing of debentures in satisfaction of past debts and of additional share capital to creditors or Preference Shareholders as full or part consideration for the sacrifices they have made.

The accounting for the reconstruction of a company is illustrated in the next example. All adjustments are passed through a Reconstruction Account.

EXAMPLE 65

The following is the Balance Sheet of Hard Times Ltd. on 30th June, 1961, when a Reconstruction Scheme is approved.

	£		£
Capital Nominal & Issued		*Assets*	
20,000 4% Preference Shares of £1	20,000	Buildings	10,400
40,000 Ordinary Shares of £1	40,000	Machinery	36,960
		Motor Vehicles	3,120
	60,000	Stock	20,890
Less Profit & Loss Account Debit Balance	12,316	Debtors	15,414
	47,684	Cash at Bank	2,012
Liabilities			
6% Debentures	25,000		
Debenture Interest Accrued	1,500		
Trade Creditors	14,612		
	£88,796		£88,796

The Preference Dividends were in arrears for two years. A Scheme of Reconstruction was agreed as follows:

(a) The Preference Shares were to be reduced to a par value of 15/- and the Ordinary Shares to one of 10/-.
(b) The Preference Shareholders were to receive Ordinary Shares in settlement of the dividend arrears and two Ordinary Shares for every five Preference Shares held, as compensation for the reduction of the value of their holdings.
(c) The Debenture holders agreed to accept Ordinary Shares in settlement of the accrued interest.
(d) Amongst the creditors was R. Wallace to whom was owed £5,000. He agreed to accept debentures for this amount.
(e) The Profit & Loss Account balance was to be written off.
(f) Stock was valued at £17,000 and the balance on Machinery Account was reduced by £3,000. The remaining balance on Capital Reconstruction Account was to be used in the creation of a Provision for Bad Debts.

Give the Journal entries to record the implementation of the scheme and the Balance Sheet on its completion.

1961			£	£
June 30	Ordinary Share Capital A/c	Dr.	20,000	
	To Capital Reconstruction A/c			20,000
	being reduction of 40,000 Ordinary Shares to a par value of 10/-.			
	Preference Share Capital A/c (Old)	Dr.	20,000	
	To Preference Shareholders			20,000
	being transfer of balance on old account.			
	Preference Shareholders	Dr.	20,000	
	To Preference Share Capital A/c (New)			15,000
	„ Ordinary Share Capital A/c			4,000
	„ Capital Reconstruction A/c			1,000
	being arrangement with Preference Shareholders, reduction of par value to 15/- and issuing of two new Ordinary Shares for every five Preference Shares held.			

		£	£
Debenture Interest	Dr.	1,500	
To Ordinary Share Capital A/c			1,500
being issue of 3,000 Ordinary Shares in satisfaction of Interest accrued.			

Capital Reconstruction A/c	Dr.	1,600	
To Ordinary Share Capital A/c			1,600
being issue of 3,200 Ordinary Shares in satisfaction of arrears of Preference Dividends.			

Capital Reconstruction A/c	Dr.	12,316	
To P. & L. A/c			12,316
being elimination of P. & L. A/c balance.			

Sundry Creditors	Dr.	5,000	
To Debentures			5,000
being issuing of Debentures to R. Wallace in satisfaction of debt.			

Capital Reconstruction A/c	Dr.	6,890	
To Machinery A/c			3,000
„ Stock A/c			3,890
being adjustment of book values.			

Capital Reconstruction A/c	Dr.	194	
To Provision for Bad Debts			194
being creation of Provision.			

The key account is as follows:

Dr. *Capital Reconstruction Account* *Cr.*

1961		£	1961		£
June 30	To Arrears of Preference Dividends	1,600	June 30	By Ordinary Share Capital	20,000
	„ P. & L. A/c	12,316		„ Preference Shareholders	1,000
	„ Machinery & Stock	6,890			
	„ Provision for Bad Debts	194			
		£21,000			£21,000

Balance Sheet as at 30th June, 1961

	£			£
Issued Capital		*Assets*		
20,000 4% Preference Shares of 15/-	15,000	Buildings		10,400
54,200 Ordinary Shares of 10/-	27,100	Machinery		33,960
		Motor Vehicles		3,120
	42,100	Stock		17,000
Liabilities		Debtors	15,414	
6% Debentures	30,000	Less Provision for Bad Debts	194	15,220
Trade Creditors	9,612	Cash at Bank		2,012
	£81,712			£81,712

A scheme that involves the reduction in capital in this way must receive the sanction of the court. Approval is given because the scheme does not effect, so much as recognise, the reduction in the capital fund. The accumulated losses in the Profit & Loss Account balance represent a loss of capital.

Amalgamations

This is a general term which covers many different forms of association between two or more companies. An amalgamation between companies A and B may take any of the following forms:

1. Company A acquires the shares of Company B or *vice versa.*
2. Company A acquires the assets of Company B or *vice versa.*

   (The consideration in both these transactions may be in the form of cash or of shares in the purchasing company).
3. A Share Exchange whereby both companies become substantial shareholders in the other. Very often the Boards include several directors of both companies. This arrangement involves few accounting problems.

When a company disposes of its assets, it may continue in existence as an investment company or it may distribute shares and cash to the members and cease to exist. In the latter process, the entries in the financial books resemble the entries consequent on partnership dissolution. The actual administration, of course, differs considerably. The records for the purchase of assets are not affected by the nature of the purchaser (firm or company) except when the consideration is in the form of shares. This exception presents no difficult problem of accounting entries. There is a possible difficulty in valuing the company's shares in such a transaction—are they issued at par or at a premium? Once the valuation is fairly and reasonably made, the entries are straightforward.

EXAMPLE 66

The Tiger Company Ltd. acquired the business of Lynx & Co. Ltd. when the latter's Balance Sheet was as follows:

	£		£
Issued Capital		Fixed Assets	17,400
25,000 Ordinary Shares		Stock on hand	6,160
of £1	25,000	Debtors	4,920
Profit & Loss Account—			
Balance	2,080	Cash in Bank	692
Liabilities			
Trade Creditors	2,092		
	£29,172		£29,172

All the assets and liabilities are taken over with the exception of the Bank balance. The agreement provides that the "Lynx" shareholders are to receive 4 Ordinary £1 Shares in the Tiger Company Ltd. for every 5 shares held. Also £2,000 in cash is to be paid by the purchasers. The shares of "Tiger" are valued at 30/–. Costs of liquidation of Lynx & Co. Ltd. amount to £192.

The directors of "Tiger" revalue the assets taken over as follows:

Fixed Assets	£20,000
Stock	6,000
Debtors	— subject to a Provision for Bad Debts of 5%.

Give the entries in the books of both companies.

The first step is to value the consideration given :

	£
20,000 Ordinary Shares @ 30/-	30,000
Cash	2,000
	£32,000

1. *The Ledger of Lynx & Co. Ltd.*

Dr. *Ordinary Share Capital Account* *Cr.*

	£		£
To Sundry Shareholders	25,000	By Balance b/f	25,000

Dr. *Profit and Loss Account* *Cr.*

	£		£
To Sundry Shareholders	2,080	By Balance b/f	2,080

Dr. *Sundry Shareholders Account* *Cr.*

	£		£
To Shares in Tiger Co. Ltd.	30,000	By Ordinary Share Capital	25,000
,, Cash	2,500	,, Profit & Loss A/c	2,080
		,, Gain on Realisaton	5,420
	£32,500		£32,500

Dr. *Realisation Account* *Cr.*

	£		£
To Fixed Assets	17,400	By Trade Creditors taken over	2,092
,, Stock	6,160	,, Tiger Co. Ltd. Purchase Consideration	32,000
,, Debtors	4,920		
,, Bank—Costs of Liquidation	192		
,, Gain on Realisation	5,420		
	£34,092		£34,092

Dr.	*Bank Account*		*Cr.*
	£		£
To Balance b/f	692	By Costs of Liquidation	192
„ Tiger Co. Ltd.	2,000	„ Sundry Shareholders	2,500
	£2,692		£2,692

Dr.	*Tiger Co. Ltd.*		*Cr.*
	£		£
To Realisation Account	32,000	By Cash	2,000
		„ Sundry Shareholders Issue of Shares	30,000
	£32,000		£32,000

2. *The Journal of the Tiger Co. Ltd.*

		£	£
Fixed Assets	Dr.	20,000	
Stock		6,000	
Debtors		4,920	
Goodwill		3,418	
To Provision for Bad Debts			246
„ Creditors			2,092
„ Lynx & Co. Ltd.—Vendors			32,000
being assets & liabilities taken over			
		£34,338	£34,338
Lynx & Co. Ltd.	Dr.	2,000	
To Bank			2,000
being payment of part of consideration.			
Lynx & Co. Ltd.	Dr.	30,000	
To Ordinary Share Capital			20,000
„ Share Premium			10,000
being issue of 4 Ordinary Shares valued @ 30/- each for every 5 Shares of Lynx & Co. Ltd., held by members.			

The "Goodwill" figure is simply the residue of the purchase consideration after its allocation to the tangible assets. The use of the term in this context has been questioned and it may well be true that this amount has no reference to any such asset possessed by Lynx & Co. Ltd. The extra consideration may have been paid because of the particular value of the two businesses in association with each other. Earlier, we suggested a wider meaning for Goodwill to cover all valuable connections within and without the business. With that wider connotation the term is acceptable here.

The following illustration is designed to underline the difference between the taking over of shares in a company and the purchase of the business assets. The example is concerned with the purchaser.

EXAMPLE 67

The following are Balance Sheets of three companies on a date when amalgamation took place:

	A. Ltd.	*B.Ltd.*	*C.Ltd.*		*A.Ltd.*	*B.Ltd.*	*C.Ld.*
	£	£	£		£	£	£
Share Capital £1 Shares	120,000	100,000	100,000	Fixed Assets	106,411	72,816	62,094
Share Premium A/c	30,000			Stock	31,160	29,280	26,710
				Debtors	13,219	14,604	12,006
Profit & Loss A/c	15,116	12,020	1,016	Bank	16,000	4,090	9,060
Liabilities	1,674	8,770	8,854				
	£166,790	120,790	109,870		£166,790	120,790	109,870

A. Ltd. took over all the assets and liabilities of B. Ltd. for a consideration of £120,000 and purchased all the shares of C. Ltd. for 22/– per share. In both transactions, the consideration was newly issued shares in A. Ltd., valued at 25/– per share.

Give the Balance Sheet of A. Ltd. after these transactions have taken place.

The Preliminary working in the answer to such a question is conveniently done in the form of abbreviated Journal entries.

	£	£
Fixed Assets	72,816	
Stock	29,280	
Debtors	14,604	
Bank	4,090	
Goodwill	7,980	
To Liabilities		8,770
„ Share Capital A/c		96,000
„ Share Premium A/c		24,000
being B's assets and liabilities taken over in exchange for shares		
	£128,770	£128,770
Shares in C. Ltd.	110,000	
To Share Capital A/c		88,000
„ Share Premium A/c		22,000
purchase of shares of C. Ltd.		

Balance Sheet — A. Ltd.

	£		£
Share Capital		Goodwill	7,980
£1 Shares	304,000	Fixed Assets	179,227
Share Premium Account	76,000	Shares in C. Ltd.—at cost	110,000
Profit & Loss Account	15,116	Stock	60,440
Liabilities	10,444	Debtors	27,823
		Cash at Bank	20,090
	£405,560		£405,560

Consolidated (or Group) Balance Sheets

The amalgamation of the previous example leads to the situation where the fortunes of C. Ltd. are the direct interest of, and only of, the company A. Ltd. The latter company owns the former. Conversely, it is impossible to assess the progress and position of A. Ltd. without knowing how C Ltd. is faring. On the Balance Sheet, the investment in C. Ltd. is shown at cost but, as the years go by, the value of the investment will be governed by the profits of C. Ltd: it will probably deviate greatly from the original cost. This is a very simple illustration of a common situation; most big companies nowadays are "families" or "groups" of companies. Great attention was given to this fact in the Companies Act, 1948.

Quite clearly there are degrees of ownership. A Ltd. purchased all the shares of C. Ltd. but it could have acquired 80%, 50%, 40% and so on. Any considerable holding involves the fortunes of the "A" Co. shareholders in the progress of C. Ltd. Somewhere, the line has to be drawn which determines whether C. is the *Subsidiary* of A. and A. the *Holding Company* of C. It is therefore provided that a company is a subsidiary of another company if the latter:

(a) owns 50% or more of the equity share capital, or
(b) is a member and controls the composition of the Board of Directors of the former company.

In addition, a company is a subsidiary of another if it is a subsidiary of the other's subsidiary.

Consolidated or Group Accounts are designed to give a picture of the state of affairs of the whole family or group. The basic process is an aggregation of the figures appearing separately in the statements of the individual companies. Certain adjustments are necessary and the most important ones are progressively introduced in the following examples. Nevertheless, this section is only an introduction to a vast, and at times, complicated subject. We begin at the simplest level.

A. *Balance Sheets*

	Bats Ltd.	*Owls Ltd.*		*Bats Ltd.*	*Owls Ltd.*
	£	£		£	£
Share Capital	50,000	20,000	Fixed Assets	26,000	17,000
Profit & Loss Account	15,000	—	Shares in Owls Ltd.	20,000	
Liabilities	6,000	4,000	Stock	8,000	5,000
			Debtors	6,000	1,000
			Bank	11,000	1,000
	£71,000	£24,000		£71,000	£24,000

At the date of these Balance Sheets, Bats Ltd. had acquired all the shares in the other company and these shares are stated in its Balance Sheet at cost. The consolidation of the two Balance Sheets is a matter of simple aggregation, with but one exception. The share capital of Owls Ltd. and the investment of Bats Ltd. are allowed to cancel each other out. In a Consolidated Balance Sheet the share capital is always, and only, that of the Holding Company.

Consolidated Balance Sheet—Bats Ltd.

	£		£
Share Capital	50,000	Fixed Assets	43,000
Profit & Loss Account	15,000	Stock	13,000
Liabilities	10,000	Debtors	7,000
		Bank	12,000
	£75,000		£75,000

Another way of describing this procedure is to say that we substitute in the Holding Company's Balance Sheet, the individual assets and liabilities of the subsidiary in place of the item, "Investment in Subsidiary." The above illustration was so simple because the cost of this investment was exactly equal to the net assets of the subsidiary, i.e.

1. the shares of the subsidiary were acquired at par, and
2. the share capital of the subsidiary represented the total equity: there were no accumulated profits brought forward.

B. *Balance Sheets*

	Bats Ltd.	*Owls Ltd.*		*Bats Ltd.*	*Owls Ltd.*
	£	£		£	£
Share Capital	50,000	20,000	Fixed Assets	26,000	17,000
Profit & Loss Account	15,000	—	Shares in Owls Ltd.	30,000	—
Liabilities	6,000	4,000	Stock	8,000	5,000
			Debtors	6,000	1,000
			Bank	1,000	1,000
	£71,000	£24,000		£71,000	£24,000

The one difference from the previous example is that the investment in the shares of Owls Ltd. cost £10,000 more and the Bank balance is thus reduced by that amount. But the difference is fundamental in the process of consolidation. The net assets or equity of Owls Ltd. still total £20,000 but the investment in its shares cost £30,000. If we ignore the difference, the Consolidated Balance Sheet simply will not balance. We must insert the figure as an asset, "Goodwill" or "Cost of Control."

Consolidated Balance Sheet—Bats Ltd.

	£		£
Share Capital	50,000	Fixed Assets	43,000
Profit & Loss Account	15,000	Cost of Control in Owls Ltd.	10,000
Liabilities	10,000	Stock	13,000
		Debtors	7,000
		Bank	2,000
	£75,000		£75,000

We must mention the possibility that the cost of the shares in the subsidiary may be less than the value of the net assets of the subsidiary. To protest that this is impossible (e.g. that it must imply the incorrect valuation of some of the assets) is to assert that "good bargains" are not made in this sphere, an obvious fallacy. The aggregation of the assets in these circumstances means that we are substituting for the cost of investment in the Holding Company's Balance Sheet, figures for net assets of the subsidiary totalling a larger amount. The difference is entered as "Capital Reserve." Thus you may have "Cost of Control" on the Assets side or "Capital Reserve" on the opposite, Equities, side of a Consolidated Balance Sheet.

We now have to remove the other convenient simplification of our illustration, i.e. that the share capital of the subsidiary represents the true equity of the company. This is done by introducing a balance on Profit & Loss Account, reducing the figure for liabilities to compensate.

C. *Balance Sheets*

	Bats Ltd.	*Owls Ltd.*		*Bats Ltd.*	*Owls Ltd.*
	£	£		£	£
Share Capital	50,000	20,000	Fixed Assets	26,000	17,000
Profit & Loss Account	15,000	3,000	Shares in Owls Ltd. at cost	30,000	
Liabilities	6,000	1,000	Stock	8,000	5,000
			Debtors	6,000	1,000
			Bank	1,000	1,000
	£71,000	£24,000		£71,000	£24,000

The shares cost £30,000: the equity of the subsidiary is now £23,000. Consequently, the Cost of Control is now £7,000.

The equity can be derived in two ways:

1. Assets – Liabilities or 2. Share Capital + Accumulated Profits.

Consolidated Balance Sheet—Bats Ltd.

	£		£
Share Capital	50,000	Fixed Assets	43,000
Profit & Loss Account	15,000	Cost of Control in Owls Ltd.	7,000
Liabilities	7,000	Stock	13,000
		Debtors	7,000
		Bank	2,000
	£72,000		£72,000

The balances on the Profit & Loss and other Revenue Reserve Accounts of the subsidiary at the date when the Holding Company acquires its shares are known as *Pre-acquisition Profits.* Their character and treatment are of vital importance. The normal profits of a subsidiary belong to the Holding Company, can be distributed as dividends to the Holding Company and, eventually, as dividends of the Holding Company to its members. But pre-acquisition profits are not revenue profits that can be so treated; as already illustrated, they are part of the equity of the subsidiary purchased through the investment. Pre-acquisition profits can be distributed to the Holding Company but, as they do not form part of the revenue profit earned within the life of the Group as a Group, they cannot be passed on to the members of the Holding Company as a dividend. Indeed when such profits are distributed to the Holding Company, it is best to regard them as a return of part of the purchase price of the interest in the subsidiary. The correct entry in the books of the Holding Company is:

Debit Bank : Credit Investment in Subsidiary A/c.

A corollary to all this is that pre-acquisition profits are never included in the Revenue Account balances in the Consolidated Balance Sheet. Thus in the previous example, £15,000 represents only the Profit & Loss Account Balance of Bats Ltd. The corresponding balance of Owls Ltd. is dealt with in the "Cost of Control" calculation which can be stated thus:

	£
Cost of Shares in Owls Ltd.	30,000
Less Pre-acquisition Profits	3,000
	27,000
Less Par Value of Shares	20,000
Cost of Control	£7,000

Adjustments of this nature are not only needed at the time of acquisition of the shares. To illustrate this, we shall follow the fortunes of Bats Ltd. for the following two years.

D. *Balance Sheets—Year 2*

	Bats Ltd. £	*Owls Ltd.* £		*Bats Ltd.* £	*Owls Ltd.* £
Share Capital	50,000	20,000	Fixed Assets	28,000	17,000
Profit & Loss Account	14,000	6,000	Shares in Owls Ltd. at cost	30,000	—
Liabilities	9,000	2,000	Stock	6,000	6,000
			Debtors	5,000	3,000
			Bank	4,000	2,000
	£73,000	£28,000		£73,000	£28,000

The Cost of Control calculation is exactly the same as before. In the Consolidated Balance Sheet the Profit & Loss Account figure will be:

	£	£
Bats Ltd.		14,000
Owls Ltd.	6,000	
Less Pre-acquisition Balance	3,000	3,000
		£17,000

Consolidated Balance Sheet—Bats Ltd. (Year 2)

	£		£
Share Capital	50,000	Fixed Assets	45,000
Profit & Loss Account	17,000	Cost of Control in	
Liabilities	11,000	Owls Ltd.	7,000
		Stock	12,000
		Debtors	8,000
		Bank	6,000
	£78,000		£78,000

Within the next twelve months, a dividend was paid to the Holding Company. Of this dividend, £2,000 was regarded as being paid from pre-acquisition profits and consequently was credited to the Investment Account.

E. *Balance Sheets—Year 3*

	Bats Ltd.	*Owls Ltd.*		*Bats Ltd.*	*Owls Ltd.*
	£	£		£	£
Share Capital	50,000	20,000	Fixed Assets	28,000	17,000
Profit & Loss			Shares in Owls Ltd.		
Account	16,000	7,000	at cost less		
Liabilities	8,000	3,000	dividend credited	28,000	—
			Stock	5,000	4,000
			Debtors	7,000	5,000
			Bank	6,000	4,000
	£74,000	£30,000		£74,000	£30,000

If this was our first meeting with the problem, we would have to calculate the Cost of Control from the above Balance Sheets (supplemented by data of pre-acquisition profits). The resulting figure will, of course, be the same as previously calculated.

Cost of Control:		£
Shares in Owls Ltd.—Balance of Investment A/c		28,000
Less Undistributed Pre-acquisition Profits		1,000
		27,000
Par Value		20,000
	Cost of Control	£7,000

Profit & Loss Account Balance:		£
Bats Ltd.		16,000
Owls Ltd.	7,000	
Less undistributed Pre-acquisition Profits	1,000	6,000
		£22,000

Consolidated Balance Sheet—Bats Ltd. (Year 3)

	£		£
Share Capital	50,000	Fixed Assets	45,000
Profit & Loss Account	22,000	Cost of Control	
Liabilities	11,000	in Owls Ltd.	7,000
		Stock	9,000
		Debtors	12,000
		Bank	10,000
	£83,000		£83,000

EXAMPLE 68

The following are the Balance Sheets of Grass Ltd. and its wholly owned subsidiary, Hay Ltd., on 30th June, 1962.

	Grass Ltd.	*Hay Ltd.*		*Grass Ltd.*	*Hay Ltd.*
	£	£		£	£
Share Capital	100,000	60,000	Plant & Machinery	46,000	31,000
Revenue Reserve	50,000	10,000	Motor Vehicles	5,000	3,000
Profit & Loss Account	36,000	8,000	Investment in Hay Ltd. at cost less Dividend credited	92,000	
Liabilities:					
Trade Creditors	13,000	5,000	Stock	21,000	15,000
Proposed Dividend	10,000	—	Debtors	19,000	26,000
			Cash at Bank	26,000	8,000
	£209,000	£83,000		£209,000	£83,000

When Grass Ltd. purchased its investment, the balances in the accounts of Hay Ltd. included:

Revenue Reserve	£8,000
Profit & Loss Account	£7,000
The dividend paid out of pre-acquisition profits was	£2,000

Prepare the Group Balance Sheet as at 30th June, 1962.

Preliminary Calculations:

		£	£
1. Cost of Control—	Balance of Investment A/c		92,000
	Less Pre-acquisition Profits,		
	Revenue Reserve	8,000	
	Profit & Loss Account	7,000	
		15,000	
	Less Dividend paid	2,000	13,000
			79,000
	Par Value of Shares		60,000
	Cost of Control		£19,000
2. Revenue Reserve—	Grass Ltd.		50,000
	Hay Ltd.	10,000	
	Less Pre-acquisition Balance	8,000	2,000
			£52,000

		£	£
3. Profit & Loss Account	—Grass Ltd.		36,000
	Hay Ltd.	8,000	
	Less Pre-acquisition Balance (net of distribution)	5,000	3,000
			£39,000

Grass Ltd.

Group Balance Sheet as at 30th June, 1962.

	£		£
Share Capital	100,000	Plant & Machinery	77,000
Revenue Reserve	52,000	Motor Vehicles	8,000
Profit & Loss Account	39,000	Cost of Control in Hay Ltd.	19,000
Liabilities:		Stock	36,000
Trade Credtiors	18,000	Debtors	45,000
Proposed Dividend	10,000	Cash at Bank	34,000
	£219,000		£219,000

The work is more complex when the Holding Company owns less than 100% of the shares of the subsidiary. It is arguable that, in those circumstances, only the relevant percentage of the value of the subsidiary's assets and liabilities should be included in the Group Balance Sheet figures. However, it is simpler and more satisfactory to bring in the actual values of those assets and liabilities with a separate entry on the Equities side of the Balance Sheet for the interests of outside shareholders, often termed Minority Interests. The procedure is first illustrated in a very simple example.

Balance Sheets

	Alpha Ltd. £	*Beta Ltd.* £		*Alpha Ltd.* £	*Beta Ltd.* £
Share Capital			Sundry Assets	46,000	21,600
(£1 shares)	60,000	20,000	Shares in Beta		
Liabilities	4,000	1.600	Ltd. (15,000 shares)	18,000	
	£64,000	£21,600		£64,000	£21,600

Consolidated Balance Sheet—Alpha Ltd.

	£		£
Share Capital	60,000	Sundry Assets	67,600
Minority Interest in Beta Ltd.	5,000	Cost of Control in Beta Ltd.	3,000
Liabilities	5,600		
	£70,600		£70,600

The amount for Minority Interests is, here, merely the par value of the shares held by outside shareholders. Normally to this figure must be added the relevant proportion of Revenue Reserves and, if any, Capital Reserves. The Cost of Control is now calculated with reference to the equity of the subsidiary taken over, i.e. in the above example, 75% of the share capital.

EXAMPLE 69

On 30th September, 1961, Wood Ltd. purchased 60% of the share capital of Stone Ltd. The Balance Sheets of the two companies, a year later, were as follows:

	Wood Ltd.	*Stone Ltd.*		*Wood Ltd.*	*Stone Ltd.*
	£	£		£	£
Share Capital	100,000	40,000	Fixed Assets	77,000	34,000
Revenue Reserve	16,000	5,000	Investment in		
Profit & Loss			Stone Ltd.		
Account	18,000	12,000	at cost	30,000	—
Liabilities	21,000	6,000	Stock	19,000	13,000
			Debtors	26,000	15,000
			Bank	3,000	1,000
	£155,000	£63,000		£155,000	£63,000

On 30th September, 1961, the Revenue Account balances of Stone Ltd. were:

Revenue Reserve	£5,000
Profit & Loss Account	£8,000

Prepare a Group Balance Sheet as at 30th September, 1962.

Wood Ltd.

Consolidated Balance Sheet as at 30th September, 1962

	£		£
Share Capital	100,000	Fixed Assets	111,000
Capital Reserve— on acquisition of shares in Stone Ltd.	1,800	Stock	32,000
		Debtors	41,000
		Bank	4,000
Revenue Reserve	16,000		
Profit & Loss Account	20,400		
Total Group Equity	£138,200		
Minority Interests in Stone Ltd.	22,800		
Liabilities	27,000		
	£188,000		£188,000

Notes:

(1) Pre-acquisition Profits

	Total	*Group Share (60%)*
	£	£
Revenue Reserve	5,000	3,000
Profit & Loss Account	8,000	4,800

(2) Cost of Control (actually Capital Reserve)

	£
Cost of Investment in Stone Ltd.	30,000
Less Group Share of Pre-acquisition Profits	7,800
	22,200
Par Value of Shares held	24,000
Capital Reserve	£1,800

(3) Revenue Account Balances:	*P. & L. A/c*	*Revenue Reserve*
	£	£
Stone Ltd.	12,000	5,000
Less Minority Interests (40%)	4,800	2,000
	7,200	3,000
Less Pre-acquisition Profits	4,800	3,000
	2,400	—
Wood Ltd.	18,000	16,000
	£20,400	£16,000

(4) Minority Interests in Stone Ltd.	£
Share Capital	16,000
Revenue Reserve	2,000
Profit & Loss Account	4,800
	£22,800

Consolidated (or Group) Profit & Loss Accounts

Recognition of the primacy of the Profit & Loss Account has extended to the field of Group Accounts. Group Profit & Loss Accounts used to be comparatively rare but are now obligatory under the Companies Act 1948—with exceptions equally applicable to Group Balance Sheets.

The principle of aggregation applies equally to the Profit & Loss Accounts. The adjustments required are:

(a) The elimination of the Group Share of pre-acquisition profits.

(b) The extraction of amounts due to Minority Shareholders.

(c) Proposed dividends of the subsidiary must be set off against the item "Dividends Receivable" in the Holding Company's account. If no entry has been made in the Holding Company's account, the adjustment must be made on consolidation.

Prepared in tabular form, the Consolidated Profit & Loss Account, can be seen as a flow, thus:

Net Trading Profit
less Taxation
equals Net Profit after taxation
less Shares of Minority Interests
equals Group Share of Profit after Taxation.
Add Group Share of Balances brought forward.
Less Dividends paid or payable on Holding Company Shares.
„ Group Share of Appropriations to Reserve
equals Group Profit & Loss Account Balance carried forward.

Note that the Group Share of Balances Brought Forward must exclude any pre-acquisition balance of the subsidiary.

EXAMPLE 70

The following Profit & Loss Accounts are for the year ended 31st December, 1961. Twelve months before, Rope Ltd. acquired 80% of the shares of String & Co. Ltd.

	Rope Ltd.	*Sting & Co. Ltd.*
	£	£
Net Trading Profit	80,000	30,000
Taxation	32,000	11,000
Net Profit after Taxation	48,000	19,000
Balances b/f 1st January, 1961	16,000	8,000
	£64,000	£27,000
Appropriations:		
Transfer to General Reserve	20,000	10,000
Dividends proposed	34,000	16,000
Balances carried forward	10,000	1,000
	£64,000	£27,000

Rope Ltd.

Group Profit & Loss Account for the year ended 31st December, 1961

		£
Net Trading Profit		110,000
Taxation		43,000
Net Profit after Taxation		67,000
Less Share attributable to Minority Interests in String & Co. Ltd.		3,800 (a)
Group Share of Net Profit after Taxation		63,200
Add Balance brought forward 1st January, 1961		16,000 (b)
		79,200
	£	
Less Transfers to General Reserve	28,000	
Dividend Proposed	34,000	62,000 (c)
Balance carried forward 31st December, 1961		£17,200 (d)

In the normal debit and credit form, it would appear like this:

Dr. *Profit & Loss Account for the year ended 31st December, 1961* *Cr.*

	£		£
To Taxation	43,000	By Net Trading Profit b/d	110,000
„ Net Profit after Taxation c/d	67,000		
	£110,000		£110,000
To Share of Minority Interests in String & Co. Ltd.	3,800	By Net Profit after Taxation b/d	67,000
„ Group Share c/d	63,200		
	£67,000		£67,000

Dr.			*Cr.*
	£		£
To Transfer to General Reserve	28,000	By Group Share of Net Profit after Taxation	63,200
„ Proposed Dividend	34,000	„ Balance brought forward 1st Jan. 1961	16,000
„ Balance carried forward 31st Dec. 1961	17,200		
	£79,200		£79,200

Notes:

(a) 20% of £19,000.

(b) The balance of £8,000 on String's Profit & Loss Account is omitted. 20% of it relates to the interests of Minority Shareholders and 80% is Group Pre-acquisition Profits.

(c) Only 80% of the transfer to Revenue Reserve of String & Co. is included and the whole of the proposed dividend of the subsidiary is excluded. 20% of this dividend is payable from the amount extracted for Minority Interests and the remainder is receivable by the Holding Company.

(d) It is desirable to reconcile this figure with that we would have calculated directly for the Group Balance Sheet.

		£
Profit & Loss A/c Balances	Rope Ltd.	10,000
„ „ „	String & Co. Ltd.	1,000
		11,000
Less Share of Minority Interests		200
		10,800
Less Pre-acquisition Profit of String & Co. Ltd.		6,400
		4,400
Add Dividend receivable by Rope Ltd.		12,800
		£17,200

Legal Provisions re the Accounts of Holding Companies

The general provision of the Companies Act, 1948, is that Holding Companies must present Group Accounts to members along with their own Profit & Loss Account and Balance Sheet. There are permitted exceptions:

1. where the Holding Company is itself a wholly owned subsidiary of another Company incorporated in Great Britain.
2. where the directors are of the opinion that—
   (a) it is impracticable, or would be of no value to members in view of insignificant amounts involved, or would involve expense or delay out of proportion to the value to members, or
   (b) the result would be misleading or harmful to the business of the Company or any of its subsidiaries.
   (c) the business of the Holding Company and that of the Subsidiary are so different that they cannot reasonably be treated as a single undertaking.

The Board of Trade must sanction the latter reason and the contention that the results would be harmful.

Group Accounts consist of a Consolidated Balance Sheet and Profit & Loss Account. The information, however, can be presented in other forms.

Exceptions are not so important as the central practice, adopted by most Holding Companies, of publishing Group Accounts. Normally printed are:

1. The Balance Sheet of the Parent Company.
2. The Balance Sheet of the Group.
3. The Profit & Loss Account of the Group incorporating that of the parent company.

Section 145 (a) of the Act allows the non-presentation of the Profit & Loss Account of the Holding Company provided the Group Profit & Loss Account complies with the requirements of the Act and, also, shows how much of the Group Profit has been dealt with in the accounts of the Company.

In addition to the normal requirements, the Balance Sheet of a Holding Company must show separately:

(a) the aggregate of shares in subsidiaries,
(b) the aggregate of indebtedness of subsidiaries to the company and of the company to subsidiaries.

QUESTIONS 17

1. *A, B and C were three companies engaged in the same trade and all preparing accounts annually to 31st March; the following statement summarises their respective balance sheets as on 31st March, 1960:

	A	B	C
	£	£	£
Capital and Liabilities			
Issued Capital (all in shares of £1):			
Preference	—	10,000	—
Ordinary	200,000	50,000	30,000
Capital Reserves	—	8,000	—
Revenue Reserves	50,000	27,000	11,000
Current Liabilities	30,000	7,000	6,000
	£280,000	£102,000	£47,000
Assets			
Goodwill	—	—	5,000
Fixed Assets	111,000	57,000	7,000
Investment:			
1,000 B Ltd. Ordinary Shares at cost	12,000	—	—
Bank	25,000	6,000	—
Other Current Assets	132,000	39,000	35,000
	£280,000	£102,000	£47,000

It was agreed between the directors that it would be in the common interests of all that the three undertakings should come under common control and that this should be done as follows:

As regards B, A should make an offer to buy the whole of its shares from the existing members. As regards C, the company should be wound up and A should buy all its assets from the Liquidator.

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These proposals were duly approved and put into effect. A offered to the ordinary shareholders of B ten of its own shares taken as valued at 22/6d each and £4 in cash for each ten shares of B, and this offer was accepted in respect of all except 5,000 shares of B. The liquidator of C sold all that company's assets to A, all at book values except for the goodwill, for £51,000, which was settled as to £6,000 in cash (out of which the liquidator paid the company's creditors) and as to the balance by the issue of 40,000 new shares of A valued at 22/6d per share.

Record the foregoing transactions in the form of journal entries in the books of A and draw up a balance sheet showing the position of A (only) after completion.

2. *The following is the Balance Sheet at 31st March, 1962, of the Irish Manufacturing Co. Ltd.:

	£		£
Nominal Capital	100,000	Buildings	44,500
		Plant and Machinery	31,400
Issued Capital—		Stock in Trade	24,370
100,800 6% Pref. Shares		Debtors	18,210
of 10/- each	50,400	Cash in Bank	1,420
117,600 Ordy. Shares of		Profit & Loss	
5/- each	29,400	Appropriation A/c	16,730
5% Debentures	36,000		
Creditors	20,830		
	£136,630		£136,630

The company has, until recently, made trading losses. Debenture Interest is a year in arrears. Buildings and Plant are old, and fresh capital is required to set the business on a sound footing.

A scheme of reduction is agreed as follows:

(a) The Ordinary Shares to be consolidated into 23,520 Shares of 10/- each.

(b) The rate of interest on the Preference Shares is to be reduced to 5% and the 100,800 Preference Shares will then be consolidated into 33,600 shares of £1 each.

(c) The Debenture holders, in view of interest due, will accept 3,600 of the new Ordinary Shares.

(d) A further 52,880 Ordinary Shares will be issued for cash to the directors and their friends.

(e) Buildings and Plant are to be reduced to £35,000 and £25,000 respectively.

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(f) The Share Capital is to be reduced by cancelling as unrepresented by assets 3/4d per share of the Preference Shares and 3/- per share of the Ordinary Shares. The Profit & Loss Account Balance is to be wiped out.

The scheme is carried out and the issue for cash is all subscribed.

Show Journal entries for the translation and the Balance Sheet on completion.

3. The Balance Sheets of A. Ltd. and its subsidiaries B. Ltd. and C. Ltd. at 31st December, 1961, are summarised as follows:

	A. Ltd.	*B. Ltd.*	*C. Ltd.*
	£	£	£
Capital—£1 shares fully paid	100,000	50,000	25,000
Profit & Loss Accounts:			
A. Ltd. (profit for year £30,000)	40,000		
B. Ltd. (profit for year £4,500)		5,580	
C. Ltd. (profit for year £2,000)			2,600
	£140,000	£55,580	£27,600
Investment at cost			
In B. Ltd. (50,000 Shares)	62,000		
In C. Ltd. (20,000 Shares)	23,000		
Other Assets less liabilities	55,000	55,580	27,600
	£140,000	£55,580	£27,600

Both investments were acquired on 1st January, 1961.

Prepare the Group Balance Sheet.

4. ¶A, B and C are three companies with issued share capitals of £200,000, £150,000 and £60,000 respectively. A holds 75% of the shares of B and 80% of the shares in C at a cost of £120,000 and £48,000 respectively. A has a balance at the bank of £10,000.

The following information is extracted from the books of B and C.

	B	*C*
Assets	£	£
Goodwill	20,000	5,000
Plant and Machinery	60,000	30,000
Stock	80,000	50,000
Debtors	95,000	29,000
Cash at Bank	10,000	15,000

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	B	*C*
Liabilities	£	£
Debentures	50,000	15,000
Loan from A	10,000	25,000
Sundry Creditors	30,000	20,000

For all companies, the Profit & Loss Account Balance is the only figure omitted in the above information.

When the shares in the subsidiaries were acquired the balances on the Profit & Loss Accounts were:

B. £16,000 *C.* £4,000

Draw up in columnar form the Balance Sheets of the three companies and prepare a Group Balance Sheet.

5. Alpha Ltd. owns 75% of the shares of Beta Ltd. The Profit & Loss Accounts of the two companies for the year ended 31st October, 1961, were as follows:

	Alpha Ltd.	*Beta Ltd.*
	£	£
Net Profit from Trading	16,500	6,960
Add Investment Income	4,216	
	20,716	6,960
Less Income Tax	7,110	3,010
	13,606	3,950
Add Balances brought forward	14,312	2,162
	27,918	6,112
Less Interim Dividend paid	8,000	
Balance Disposable	£19,918	£6,112
Proposed Transfers to Reserve	10,000	3,000
Recommended Final Dividend	8,000	2,000
Balance carried forward	1,918	1,112
	£19,918	£6,112

The balance on Profit & Loss Account of Beta Ltd. when Alpha Ltd. acquired its shares was £960.

Prepare a Group Profit & Loss Account.

6. Some years ago, Parent Ltd. acquired 60% of the shares of Child Ltd. On 31st December, 1962, the Balance Sheets of the two companies were as follows:

	Parent	Child		Parent	Child
	£	£		£	£
Share Capital	200,000	80,000	Fixed Assets	180,000	64,000
Revenue Reserves	41,000	5,000	Investment in		
Profit & Loss A/c	24,000	9,000	C. Ltd.	61,000	
Future Income Tax	12,000	9,000	Stock	44,000	27,000
5% Debentures	50,000		Debtors	31,000	19,000
Proposed Dividend	20,000	10,000	„ C. Ltd.	6,000	
Creditors	17,000	4,000	Cash and Bank	42,000	13,000
„ P. Ltd.		6,000			
	£364,000	£123,000		£364,000	£123,000

For 1962, the Profit & Loss Accounts were:

	Parent	Child		Parent	Child
	£	£		£	£
Income Tax	12,000	9,000	Balances 1st January	33,000	10,000
Proposed Dividends	20,000	10,000	Net Trading		
Balances carried forward	24,000	9,000	Profits for Year	23,000	18,000
	£56,000	£28,000		£56,000	£28,000

When the shares were acquired, the Revenue Reserve of Child Ltd. was £5,000 and the balance on Profit & Loss Account, £6,000. No dividends have been credited to the Investment Account in the books of Parent Ltd.

Prepare a Group Balance Sheet at 31st December, 1962, and a Group Profit and Loss Account for the year.

CHAPTER 18

The Interpretation of Accounts

THE interpretation of accounting data is the concern of many different parties. Managers must make the fullest use of the accounts presented to them: it is part of the technique of management. But management accounting is a subject in itself and covers much more than the interpretation of figures in the published accounts of companies. These accounts are the basic data given to other interested parties who include:

1. Trade Creditors who wish to ensure that they can grant credit safely.
2. Lenders or prospective lenders who wish to be assured of the safety of their funds and of the return receivable from the loan.
3. Prospective purchasers of small or medium-sized businesses.
4. The members of the company and prospective investors.

The different approaches of these people will involve different emphases in interpretation.

A creditor is concerned with the Liquidity position; if it is sound and not jeopardised by trading losses, he will be satisfied. Loans are often adequately secured on property. If a loan is unsecured or inadequately secured, the lender will be concerned over the general soundness of the business and its prospects. He will not be interested in any excessive profit-making potential. Purchasers and investors have wider interest in the possibilities of the business, its past progress and present position.

A broad classification of approach suggests itself:

1. A consideration of the present situation of the business with the Balance Sheet being the basic data.
2. A study of the record of the business in the past few years. The Profit & Loss Accounts will be central in this study.

But the classification is not entirely satisfactory. The situation at the date of a particular Balance Sheet is only fully appreciated in the light of the trend of Balance Sheet figures over several years. Trends and changes are of fundamental importance in the interpretation of financial statements generally.

The Situation at a Given Time

(A) *Available Funds.* Funds used by a company are contributed by:

1. Members, either for shares or as undistributed profits and
2. Creditors in the form of loans or short term credit.

Quite obviously, the total of such funds is one measure of the size and growth of a company. The proportions contributed by the different classes is also of some interest. Thus you may have two companies:

Company Y	£		*Company Z*	£	
Share Capital	60,000	50%	Share Capital	70,000	59%
Reserves	20,000		Reserves	25,000	
Debentures	30,000	19%	Debentures	40,000	25%
Creditors	50,000	31%	Creditors	25,000	16%

There is no right proportion whereby we can say one arrangement is better than another. Nevertheless, the uncertainty of trade conditions does render a large or a growing dependence on trade credit suspect; for stability, a substantial "pure capital" proportion is desirable. It is also well to note that even long term loans are not permanent. The question of repayment arises some day and it may bring a change in the fortunes of a company, e.g.

it may be impossible to raise another loan at the time or it may be necessary to increase the interest offered.

For the investor, and consequently for the promoters of companies who must attract the investor, the capital structure of a company is important. Consider two possible ways of raising £100,000.

A		B	
Ordinary Shares	100,000	Ordinary Shares	£30,000
		6% Preference Shares	£40,000
		5% Debentures	£30,000

(Debenture or Loan Capital is considered within this context.) The dividend payable to Ordinary Shareholders in the two examples varies considerably.

Distributable Profits	£4,000	£8,000	£10,000
A. Ordinary Dividend	4%	8%	10%
B. Preference Dividend	£2,400	£2,400	£2,400
Debenture Interest	£1,500	£1,500	£1,500
Amount available for Ordinary Dividend	£100	£4,100	£6,100
Ordinary Dividend	Nil	13%	20%

Within the same range of profit the Dividend in "A" varies by 6% and that in "B" by 20%. Preferred and Loan Capital accentuate the variations in the Ordinary Dividend, i.e. they increase the possibilities of high returns and the risk of low returns. This build-up of capital is known as capital gearing: the lower the proportion of Ordinary Share Capital, the higher the capital gearing.

A consideration of the Balance Sheets of an expanding company for five or ten years will give the answer to another important question: "To what extent have the funds for expansion been provided internally out of retained profits?" A five- or ten-years Source and Application of Funds Statement will give the full picture regarding self-financing and the raising of extra capital.

(B) *The Use of Funds.* In considering the other side of the Balance Sheet we must remember that, for most companies, the entries for Fixed Assets are not valuations but the residue of cost after depreciation charges. A purchaser of a business would have to satisfy himself as to the condition and value of these assets. This is not a possibility for the normal student of an Annual Report. (Take-over bidders are not normal readers of the Reports; their position is akin to that of a prospective purchaser.)

The Balance Sheet does give figures for total cost and total depreciation of fixed assets. At least, most Balance Sheets do. From this information, it may be possible to gain some idea of the age of the capital equipment. The extremes of "very new" or "very old" equipment are indicated. For most companies, however, the equipment will be a mixture of old and new.

The Working Capital situation is important for all businesses, large and small. The definition, Current Assets less Current Liabilities, does not bring out the true significance of Working Capital. A business needs resources to cover current outlays, purchases, wages, etc., which are incurred some time before the related receipts. This inevitable time lag can ruin a business if adequate financial provision (i.e. Working Capital) is not made for it. There may be several months between the purchase of raw materials and the final receipt of cash from the sale of the manufactured product, the beginning and the end of a production cycle. Especially in relation to an expanding business, we forget this truth at our peril. Expanding business requires additional Working Capital.

An excess of Current Assets over Current Liabilities is not, in itself, enough. You cannot settle debts with stock. The Liquidity position is a more exacting test of the business health. Is the cash (in hand or at bank) adequate to meet the current liabilities? A moderation of this test allows the inclusion of amounts owing to the business—on the reasonable assumption that as we pay our debts so our debtors will be settling theirs.

A Working Capital Statement will indicate the strength or weakness of a given position. However, the trend of the position is of great interest—a satisfactory position may be a stage in a development that is a strengthening or a weakening of the position. The assessment of the situation will be materially affected by that development. There are many ratios that can be calculated to reveal the movement in the Working Capital or Liquidity situations. The ratios to be illustrated are:

(a) Liquid Assets: Current Liabilities.

(b) Current Assets: Total Assets.

Balance Sheets (in thousands of £)

Years	1.	2.	3.	Years	1.	2.	3.
Capital and Reserves	30	32	35	Fixed Assets	17	18	24
Debentures	5	5	10	Current Assets			
Current Liabilities	11	13	16	Stock	15	17	20
				Debtors	9	10	14
				Bank	5	5	3
	46	50	61		46	50	61

Liquid Assets : Current Liabilities

Year 1	14	:	11	—1·27
„ 2	15	:	13	—1·15
„ 3	17	:	16	—1·06

Current Assets : Total Assets

Year 1	29	:	46	— ·63
„ 2	32	:	50	— ·64
„ 3	37	:	61	— ·61

Three years is not a long time for trends to be noted but the first ratio obviously discloses a very dangerous development; the other ratio reveals why. The increased capital resources have been largely channelled into the purchase of fixed assets. Even with increased stock, current assets form a smaller proportion of the whole. Meanwhile there has been a growth in the dependence on short term credit—from 23·9% to 26·2% of total funds.

The Past Record of the Business

If disclosed, the turnover is a natural starting point for this study. The total Sales is one measure of the size of a business and the progress of turnover a measure of its growth. That progress must be considered in the light of general market conditions: to maintain the same turnover in a falling market is good, merely to maintain it in an expanding market is not good. Thus big concerns ask themselves: "Are we maintaining our share of the market?" Although the same question may sound unrealistic for a small company, it is in principle still applicable. Turnover must be considered in the light of market conditions.

The rate of stock turnover is calculated:

$$\frac{\text{Sales (at cost price)}}{\text{Average Stock}}$$

The higher this rate, the more work a given quantity of capital is financing. The effect on Net Profit is both obvious and important.

If turnover is a natural starting point, the figures for Net Profit (before and after taxation) are the centre of most attention. If progress had to be measured by but one figure, that figure would have to be Net Profit. Such interpretation would be inadequate, however. The Net Profit must be considered in the light of capital employed. Most companies have, over the years, ploughed back considerable profits into the business. Many have raised additional funds with share or debenture issues. In these circumstances, an increasing Net Profit is not necessarily commendable. It is to be expected and a stable Net Profit would represent failure. An additional return on additional capital must be expected. Thus the trend of Net Profit must be considered in the light of the increasing capital employed.

The following record of Net Profit shows a consistent rise from £21,000 to £36,000 over the years. This appears excellent but the ratio of Net Profit to Capital Employed gives a much less exciting picture. There is an improvement over the years but it is much more modest than the trend of Net Profit suggests.

Resources at Beginning of Year (in thousands of £)	1	2	3	4	5	6
Share Capital	100	100	100	150	150	150
Reserves	42	49	51	50	48	54
Debentures	40	40	40	40	60	60
	182	189	191	240	258	264
Net Profit (in thousands of £)	21	24	25	28	32	36
Net Profit: Capital Employed	11·5%	12·7%	13·1%	11·7%	12·4%	13·6%

The ratio of Net Profit to Turnover is also a vital pulse of business activity. An increase in Net Profit may be the result of increased margins on a stable turnover or a greater turnover at the same or even reduced margins. This ratio will show up the effect of increasing costs and the flexibility of price in relation to them. These, in turn, indicate the toughness (or otherwise) of the competition in the market for the company's products.

Years	1	2	3	4	5	6	7	8
Turnover (thousands of £)	200	240	360	400	420	430	410	420
Net Profit (thousands of £)	25·0	29·5	41·4	45·6	47·0	47·3	45·1	45·4
% Net Profit on Turnover	12·5	12·3	11·5	11·4	11·2	11·0	11·0	10·8

The record seems to demand interpretation along these lines: "From Year 1 to 4, the company sought to expand its market and, as part of its policy, reduced its profit margin to do so. The policy was successful: the turnover increased by a far greater proportion than the cut in margins and the Net Profit increased. In the following years, however, conditions were tougher. Further expansion was slight and margins were not maintained. Either competition demanded further cuts in prices or else costs rose and it was not possible to pass on the increases to the customer. Consequently, the Net Profits of Years 7 and 8 were slightly less than that of Year 4."

Finally, the record of dividends paid is of obvious importance. Equity or Ordinary Dividends, being of a varying nature, give some indication of the prosperity of a company. Preference Dividends become relevant when in arrears. An investor, however, is not merely interested in the dividends paid, he is interested in the security or cover for those dividends. Will they be maintained? This is a rather obvious question, for an investor is only interested in past dividends so far as they indicate future prospects. Debenture holders and Preference Shareholders have a similar interest in "cover." A Company has a capital structure:

Ordinary Shares	£50,000
7% Preference Shares	£40,000
5% Debentures	£24,000

The following Net Profits were made in successive years

	£
Year 1	13,200
„ 2	11,400
„ 3	9,600
„ 4	10,300

The Ordinary Dividend was 8% for Years 1–3 but was raised to 10% in Year 4.

The cover for the interest and dividends will be calculated as follows:

Calculations are approximate.

Years	1	2	3	4
Profits before Charge for Debenture Interest (£1,200)	£14,400	12,600	10,800	11,500
Debenture Interest cover	12 times	$10\frac{1}{2}$ times	$9\frac{1}{2}$ times	9 times

Years	1	2	3	4
Profits after Debenture Interest is charged	£13,200	11,400	9,600	10,300
Preference Dividend (£2,800) cover	$4\frac{1}{2}$ times	4 times	$3\frac{1}{2}$ times	$3\frac{3}{4}$ times
Profits available for Ordinary Dividend	£10,400	8,600	6,800	7,500
Ordinary Dividend Cover	2·6 times	2·15 times	1·7 times	1·5 times

The increased Ordinary Dividend may be justified in the circumstances. The company may be able to afford the greater distribution. On the other hand, an investor will certainly note the precarious cover for the dividend. A slight set-back in profits will lead to a reduced dividend. The Debenture holders must feel secure with a cover of over nine times the interest; the Preference Shareholders, whilst they have no immediate worries, are probably hoping for greater cover for their dividend. The improvement in Year 5 is only a slight recovery viewed in the light of the situation in Year 1.

Inter-Firm Comparisons of Net Profit : Capital Employed

Ideally, this ratio is the best measure of the profitability of economic activity. The investor wishes to place his resources where they are productive of the highest return and it is generally in the community's interest that he should do so. Unfortunately, the difficulties of making this comparison are too great.

There is the preliminary problem of defining "Capital Employed." There are three possibilities:

1. Shareholders Equity—this has been used above.
2. Shareholders Equity plus Loan Capital. For this interpretation, it can be argued that the total capital employed cannot depend on the capital structure, e.g. whether all funds are raised by shares or some by debentures. Whichever way they are raised, the funds become capital employed.

3. Shareholders Equity plus Loan Capital and the average amount of trade credit. This is a more comprehensive conception more relevant to an economic survey of the community.

To any of these a further adjustment might be made. If a company has invested surplus funds outside the business, these funds are regarded as not employed in the business. Needless to say, the income from those investments is likewise excluded from the business Net Profit.

The greatest problem is to put a true value to the equity of a company in this context. The Balance Sheet figures of Reserves etc. only reflect the Asset figures and, as has been stressed, these are not valuations. A simple illustration will show the difficulty. Suppose a company acquired freehold land and buildings ten years ago for £18,000. Because of development in the area, the property is now worth £40,000 but it stands in the books at a depreciated figure of £16,200. The latter figure determines the Balance Sheet presentation of capital employed: the former represents economic reality. Nor is this distortion limited to property. Inflation has affected all prices and machines purchased ten years ago for £4,000 may be replaceable at a figure nearer £8,000. The Balance Sheet ignores any such change. These distortions will not affect different companies in the same way and, consequently, they undermine any reliability we would like to discover in the ratio of Net Profit to Capital Employed.

QUESTIONS 18

1.* A business friend of yours who does not know much about accountancy has a holding of 1,000 ordinary shares in a public company and asks you to explain certain points in connection with the company's last balance sheet, a copy of which he has just received. The following is a summarised copy of the balance sheet in question.

	1,000s of £s		1,000s of £s
Capital issued and fully paid:		Fixed Assets	1,090
200,000 7% Cum. Pref.		Less Depreciation	420
Shares of £1	200		670
2,000,000 Ordinary			
Shares of 5/-	500	Current Assets	1,580
Debentures	250		
Capital Reserves	300		
Revenue Reserves	650		
Provisions	60		
Current Liabilities	290		
	£2,250		£2,250

The questions your friend wants answered are the following:

1. On the assumption that the ordinary shares of a well-managed company of this size, engaged in the industry in question, should have a market quotation such that the ratio of the balance of the company's annual earnings, after paying the preference dividend, to the total market value of the ordinary shares should be 12½ per cent, what ought the company's profit (before tax) to be in order to justify a quotation of 18/–?
2. Assuming that the company's profit for the last year did in fact amount to the figure you calculate, what is the ratio of net profit to total capital employed in earning that profit as disclosed by the balance sheet?

2.* The balance sheet of a limited company as on 31st December, 1958, was as follows:

	£		£
Issued Capital	100,000	Fixed Assets	72,300
Reserves	20,000	Stock	72,500
Debentures	50,000	Debtors and Prepayments	22,400
Current Liabilities	5,500	Bank	8,300
	£175,500		£175,500

*Re-printed by courtesy of the Royal Society of Arts (R.S.A.).

(a) What was the amount of the company's working capital at that date?

(b) During the year ended 31st December, 1959, the company earned a net profit of £19,700 after charging £4,800 for depreciation of the fixed assets, new fixed assets were brought at a cost of £18,600 and old ones sold for £1,300. Calculate the amount of working capital at the end of the year.

(c) The following appropriations are proposed out of the profit for 1959: the transfer of £5,000 to General Reserve and the declaration of dividends amounting to £7,500. What effect will each of these have on the working capital, and why?

3. Comment upon the following results:

(Figures in thousands of £).

Years	1957	1958	1959	1960	1961	1962
Sales	4,000	5,000	5,300	5,400	5,320	5,250
Gross Profit	860	890	910	900	890	875
Average Stock	950	1,050	1,080	1,100	1,180	1,210
Net Profit (before tax)	170	180	200	190	180	160
Capital Employed:						
6% Preference Shares	200	200	200	200	200	200
Ordinary Shares	1,200	1,200	1,200	1,200	1,200	1,200
5% Debentures	60	60	60	60	60	60
Reserves	40	60	90	100	120	130
Ordinary Dividend	10%	10%	14%	11%	11%	10%

CHAPTER 19

Final Qualifications

A WARNING of the limitations of the subject so far covered is always desirable at the close of an intermediate survey. With Accounting, it is perhaps more important to close with a warning as to the limitations of the subject itself.

It is so easy to give or to obtain an impression of precision and accuracy that is most misleading. The Trial Balance and Balance Sheet balance to the nearest penny. The whole accounting system is based on accepted principles and conventions. It is not easy to see with this background, that an accounting statement such as a Profit & Loss Account or Balance Sheet may be described as "true and fair" without implying that a different statement for the same business must be untrue or unreasonable.

That this is so has already been made evident by the discussion of Depreciation. Different methods produce very different figures of Net Profit without one method being right and the others wrong. A provision for Bad Debts is merely an estimate and may be considered reasonable within fairly wide limits. There are different methods of providing for Income Tax.

The Stock on hand is valued at "cost or lower market price:" at least, that is the conventional phrase. The ambiguities of the phrase have lately received considerable attention. In a trading firm, does "lower market price" relate to the purchasing market or selling market? For example, articles purchased for £10 each were formerly sold for £14. There is a fall in both prices, the new cost price being £8 and the new selling price £12. Are the articles in stock valued at £8—the lower purchasing price, or £10, the cost price which is still lower than the selling price? Another query can be raised: is cost or lower market price a formula applied to individual items of stock or to the stock as a whole? The alternative valuations can be very different.

But the ambiguities and inadequacies of the phrase are more marked for a manufacturer. The cost of manufactured produce is usually considered as

1. The cost of raw materials.

plus 2. The cost of labour and any other expenses directly related to the particular product or batch of products.

plus 3. A fair share of the Factory or Administration expenses of the business—expenses which cannot be directly related to any specific part of production.

Certainly, the total of these costs is the total cost of production and it seems reasonable to value stocks of finished goods on this basis. Work in progress will then consist of proportional parts of the three classes of expenditure.

However, the function of stock figures in the Trading or Manufacturing Account raises a doubt over this method of valuation. Why are the stock figures entered? The answer given early in this book is in order to compare the Sales with the Cost of Goods Sold, and for a Manufacturing Concern that includes the cost of manufacture. The closing stock figure represents costs incurred which are not related to the sales of the current trading period. The opening stock figure represents costs incurred in the previous period which relate to the current period's sales.

Broadly speaking, the costs of manufacture can be classified into

1. Those which vary with the production achieved.
2. Those which do not vary directly with production but accrue with the passage of time—periodic costs.

Some maintain that the costs carried forward in the stock valuation should be limited to the first group. The full burden of periodic costs should fall on the trading of the period concerned. The costs then carried forward in the stock valuation are the costs which would not have been incurred if the goods in stock had not been processed, i.e. the variable cost of the stock. The force of this argument is gaining ground considerably and the practice of limiting the stock figure to variable costs is already acceptable. But this method gives a very different valuation than the traditional one which includes shares of fixed costs.

Income and Profit

It is natural to consider the Net Profit figure a statement of the income derived from a business by the proprietors. But the link between profit and income is not at all clear and definite.

Income is a difficult concept in economics and a very distinguished economist offers a very pedestrian but still useful conception—income is the amount a person can consume in a year and be as well off at the end as he was at the beginning. It seems difficult to quarrel with that. It is vague but perhaps greater precision is not possible.

Transferring the idea to the world of commerce and industry, we can say—the income from a business is that which can be distributed leaving the business as valuable at the end as it was at the beginning of the given period. The Balance Sheet is not satisfactory as a valuation of the business. How therefore can we avoid subjective estimates of the value of a business? The answer is that we cannot avoid them. The value of a business (proprietorship, partnership or company) is the present value of the stream of net receipts that can be expected in the future by the owners. Such a valuation, based on future expectations with all the uncertainty involved, must be based on subjective estimates and anticipations. It follows that income as defined above is also determined by subjective estimates.

The Net Profit of a business Profit & Loss Account is not the "income" in this sense. The whole profit can be distributed and the business may be much more (or much less) valuable at the end. Considerable appreciations in the value of property will not be included in the Net Profit figure. The prospects of the business will be determined by the state of the order book and the future market for the firm's products. Increasing competition will effectively reduce the value of the business. None of these matters are necessarily reflected in the current accounting statement. The Investment market illustrates these factors. Many investors do not look to dividends as the main source of income—they hope for appreciation in the value of the shares, i.e. a share in the increasing value of the company.

The severe criticism that accounting Net Profit is the result of conventional calculations and has no link with reality at all is an unfair extension of the above reasoning. To acknowledge the limitations of accounting Net Profit is not to admit that it has no link with reality. The "conventional calculations" are designed to produce a result which has as much meaning and as clear a meaning as possible. The excess of revenues received over the expenditure incurred in earning those revenues is not adequate as an expression of "income." But it is a sufficiently definite concept to have served as a basis for:

1. Taxation. 2. Dividend distribution.

In addition, if income is to be a subjective valuation, the accounting net profit is amongst the most important data upon which such a valuation is based.

Price Level Changes

The most difficult problem the accounting profession faces is the production of meaningful financial statements in a world where the value of the monetary unit changes. Accounting practice has assumed the "stability" of different currency units as "measures of value" and that assumption is sadly removed from reality. The effects of this situation are illustrated in the following example.

A business is started on 1st January, 1961. Machinery is purchased from the U.S.A. at a cost of $100,000. The summarised Profit & Loss Account at the close of 1961 is as follows:

Expenses (except Depreciation)	£12,000	Gross Profit	£35,000
Depreciation	$20,000		
Net Profit	£3,000		
	£35,000		£35,000

Obviously the statement is ridiculous. It was meant to be. You cannot mix up dollars and pounds in one statement. But depreciation in many Profit & Loss Accounts relates to expenditure of the past when the purchasing power of a £ was as different from that of the present £ as is the dollar. Our accounts do not mix up currency units of different countries, but they do mix up currency units of widely different purchasing powers. The chief impact is through the depreciation charge but another distortion can be caused by the effect of inflation on stock figures. It is possible to imagine a situation where the opening and closing stocks are physically identical but, because of a general price inflation, have different "cost" valuations. The cost of goods sold will then be undervalued and the resulting profit figure inflated.

A more advanced work would explain efforts to counteract the distortions of a changing price level. Here, we are content to point out the problem and the severe defects of conventional Profit & Loss Accounts. The defects are not remedied by the appropriation of profits to special Reserve Accounts, e.g. Fixed Asset Replacement Reserve Accounts, to deal with problems of replacement at inflated prices. Such appropriations may be necessary expedients but you cannot correct a defect in the *calculation* of Net Profit by taking account of it in the *appropriation* of that Profit. The intensely difficult problem of adjusting accounts for changes in the value of the currency unit remains.

Similarly the Balance Sheet is a collection of items expressed in the same currency unit, but representing receipts and payments at different periods, when the unit had widely different values. Its value is severely limited by this fact.

The whole structure of financial statements involves the use of the currency unit. When the unit has dramatically lost its value in runaway inflations, the continuity of financial statements is made impossible. New starts have to be made. When the unit changes its value less dramatically, our Revenue Accounts and Balance Sheets are prepared without reference to the change. The distortion is real but difficult to correct. These facts present a challenge which has yet to be answered effectively.

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