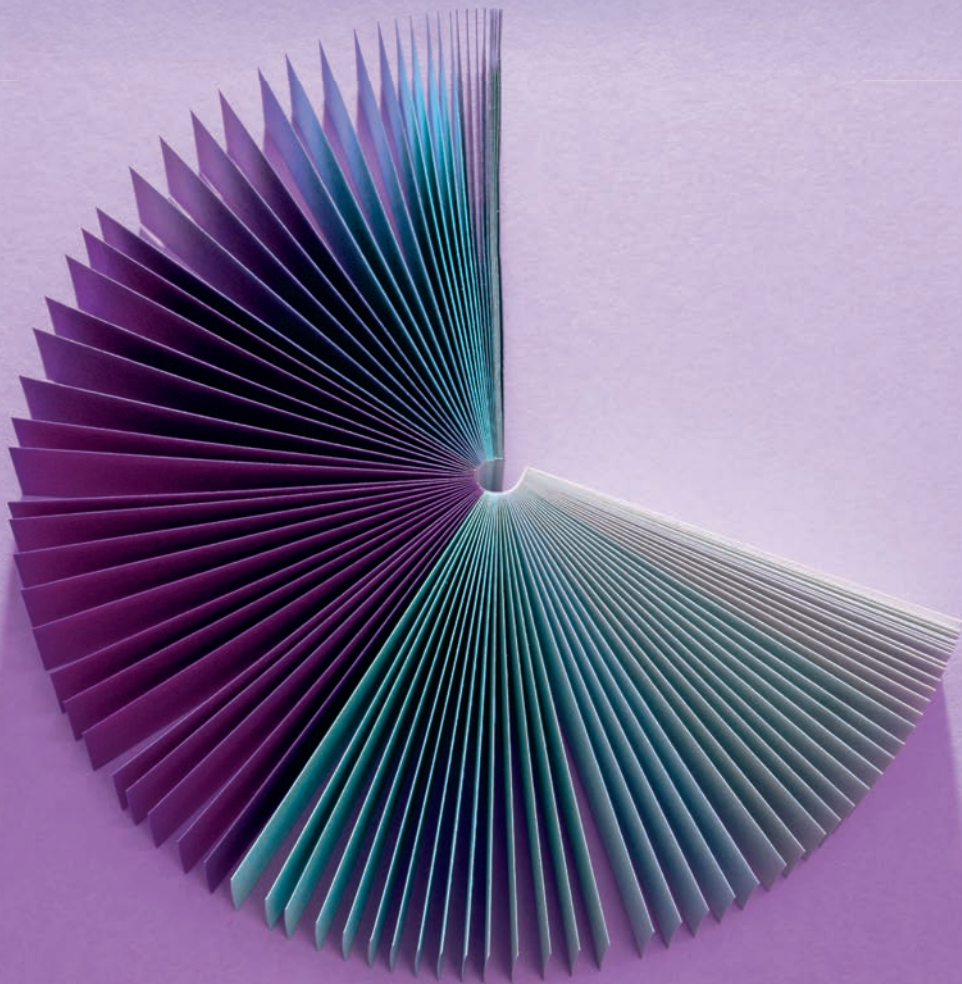


Financial Accounting

An introduction

Pauline Weetman



FINANCIAL ACCOUNTING

LEONA's comment: This is another expense account showing an item which has decreased the ownership interest through a decrease in the recorded amount of some assets. This is where accounting begins to look slightly complicated because no cash has changed hands. Recording depreciation is the accounting way of expressing caution as to the expected future benefits from an asset. These will be eroded as the asset is used up. Depreciation is a way of acknowledging that erosion.

L14 Expense of medical supplies

Date	Particulars	Page	Debit	Credit	Balance
			£	£	£
Oct. 31	Inventory (stock) of medical supplies	L8	350		350

LEONA's comment: This account continues the story from L8 where the inventory (stock) of medical supplies was found to have dwindled through use in examining patients. It is assumed that the difference between the amount purchased and the amount held at the end of the month represents the expense of using the asset during the month.

Checking the accuracy of double-entry records

At periodic intervals it may be considered necessary for a number of reasons to check the accuracy of the entries made in ledger accounts. For instance, the omission of an entry on the debit side of a customer's ledger account for goods sold on credit terms could result in a failure to issue reminders for payment of an amount owed to the business.

There are methods in double-entry bookkeeping of discovering these and other errors. One such method is the use of the *trial balance*.

If a debit entry and a credit entry have been made in the appropriate ledger accounts for each business transaction, then the total money amount of all the debit entries will equal the total money amount of all the credit entries. If a debit entry has been made without a corresponding credit entry (or vice versa), then the totals will not agree.

In the ledger accounts shown in this example, the balances have been kept as running totals. It would be possible to add up all the debit and all the credit entries in each ledger account but the same arithmetic proof will be obtained by listing all the debit balances and all the credit balances. It was explained earlier in this supplement that brackets are used in the ledger accounts to show credit balances. The list of balances on all the ledger accounts for Dr Lee's medical practice is set out in Table 5.8.

Error detection using the trial balance

The calculation of the totals of each column of the trial balance is a useful precaution which will reveal some, but not all, of the errors it is possible to make in a debit and credit recording system. Think first about the errors you might make and then check against the following list:

Table 5.8 Trial balance at 31 October for Dr Lee's medical practice

<i>Ledger account title</i>	<i>Debit</i>	<i>Credit</i>
	£	£
L1 Cash	18,100	
L2 Ownership interest		49,000
L3 Medical equipment and office furniture	36,250	
L4 Office Supplies Company (trade payable)		6,500
L5 Rent	1,900	
L6 Wages	1,200	
L7 Patients' fees		5,500
L8 Inventory (stock) of medical supplies	850	
L9 P. Jones		nil
L10 Electricity	100	
L11 Mrs West	nil	
L12 Mr East (trade receivable)	2,000	
L13 Depreciation	250	
L14 Expense of medical supplies	350	
<i>Totals</i>	<u>61,000</u>	<u>61,000</u>

Errors which will be detected by unequal totals in the trial balance

- Omitting one aspect of a transaction (e.g. a debit entry but no credit entry).
- Writing incorrect amounts in one entry (e.g. debit £290 but credit £209).
- Writing both entries in one column (e.g. two debits, no credit).
- Incorrect calculation of ledger account balance.

Errors which will leave the trial balance totals equal

- Total omission of a transaction.
- Errors in both debit and credit entry of the same magnitude.
- Entering the correct amount in the wrong ledger account (e.g. debit for wages entered as debit for heat and light).

Preparing the financial statements

The main part of this chapter set out the statement of financial position (balance sheet) and income statement (profit and loss account) of Dr Lee's medical practice for the month of October. If you compare the amounts in the trial balance with the amounts in the financial statements you will see they are the same. The normal practice in accounting is to use the trial balance to prepare the statement of financial position (balance sheet) and income statement (profit and loss account).

Table 5.9 Rearranging the trial balance into statement of financial position (balance sheet) items and income statement (profit and loss account) items

Ledger account title	£	£
L3 Medical equipment and office furniture	36,250	
L8 Inventory (stock) of medical supplies	850	
L12 Mr East (trade receivable)	2,000	
L11 Mrs West	nil	
L1 Cash at bank	18,100	
L4 Office Supplies Company (trade payable)		6,500
L9 P. Jones		nil
L2 Ownership interest		49,000
Subtotal X	57,200	55,500
Difference: profit of the month (57,200 – 55,000)		1,700
L7 Patients' fees		5,500
L14 Expense of medical supplies	350	
L6 Wages	1,200	
L5 Rent	1,900	
L10 Electricity	100	
L13 Depreciation	250	
Subtotal Y	3,800	5,500
Difference: profit of the month (5,500 – 3,800)	1,700	
Total of ledger balances in each column X + Y	61,000	61,000

In this case it would be a little easier to use the trial balance for this purpose if it were arranged so that all the statement of financial position (balance sheet) items are together and all the income statement (profit and loss account) items are together. This is done in Table 5.9.

This form of trial balance will be used in later chapters as the starting point for the preparation of financial statements.

By way of providing further help in preparing the income statement (profit and loss account) and statement of financial position (balance sheet), subtotals are calculated for each part of the trial balance in Table 5.9. The difference between the subtotals in each section gives the profit amount. That is because the exhibit has been subdivided according to two equations, each of which leads to profit:

Assets	minus	Liabilities	minus	Capital contributed/withdrawn	equals	Profit
Revenue	minus	Expenses			equals	Profit

S Test your understanding

- S5.1** Prepare ledger accounts for the transactions of Jane Gate's dental practice, listed in self-test question A5.5.
- S5.2** Which of the following errors would be detected at the point of listing a trial balance?
- (a) The bookkeeper enters a cash sale as a debit of £49 in the cash book and as a credit of £94 in the sales account.
 - (b) The bookkeeper omits a cash sale of £23 from the cash book and from the sales accounts.
 - (c) The bookkeeper enters cash received of £50 from Peter Jones as a debit in the cashbook but enters the credit of £50 in the ledger account of Roger Jones.
 - (d) The bookkeeper enters a cash sale as a credit of £40 in the cash book and as a debit of £40 in the sales account.

CHAPTER 6

Accounting information for trading businesses

Real World Case

Mulberry plc: trading strategy and performance

Extracts from Annual Report 2017

Business model

Mulberry is a vertically integrated luxury brand which was founded in 1971 in Somerset. The Group designs, develops, manufactures, markets and sells products under the Mulberry brand name. The Group has over 1,400 employees (full-time equivalents), the majority of whom are based in the UK. The design studio for leather goods is based in London, where the seasonal collections are conceived. The two Somerset factories, which are owned by the Group, employ nearly 700 people and manufacture approximately 50% of the brand's handbags. The remainder of production is outsourced to specialist third parties, mainly outside the UK, with whom the Group has long-standing relationships.



Education & Exploration 4/Alamy Stock Photo

Highlights

Financial highlights

- Total revenue up 8% to £168.1 million (2016: £155.9 million).
- Profit before tax up 21% to £7.5 million (2016: £6.2 million).
- Cash of £21.1 million at the end of the period (2016: £14.0 million).
- Inventory reduced to £42.8 million (2016: £44.4 million).

Operating highlights

- Retail sales (including Digital) up 8% to £128.3 million (2016: £118.7 million) with like-for-like up 5%.
- Revenue from Digital channels increased by 19% to represent 15% of Group revenue (2016: 14%) with localised mulberry.com sites introduced in China and Korea.
- Establishment of Mulberry (Asia) Limited ("Mulberry Asia"), a majority-owned entity, to develop the brand in China, Hong Kong and Taiwan.
- New products introduced under the creative direction of Johnny Coca, including the new Zipped Bayswater, continue to gain momentum.

Business review

Mulberry continues to make progress with increased sales and profit. Total revenue grew by 8% to £168.1 million (2016: £155.9 million), and profit before tax by 21% to £7.5 million (2016: £6.2 million) driven by growth in sales. The Group has generated cash of £7.3 million (before the effect of foreign exchange rate changes) during the year and maintained strong control over the balance sheet.

During the year the Group acquired the Mulberry store in Australia from its long-standing distribution partner and in March 2017 signed an agreement with Challice Limited ("Challice"), its ultimate controlling party, to directly operate its business in China, Hong Kong and Taiwan. These transactions will further develop the Group's international strategy.

The Group has invested in creative and product development and a large number of new products were launched in the year that continue to gain traction. Looking forward, the Group will continue to invest in product and international development.

Strategy

The Board's long term objective is to grow Mulberry as a global luxury brand, offering unique and desirable products at the best value for price, and thereby create shareholder value. The Group considers that revenue growth is the key performance indicator with which this goal can be measured.

Product

Leather goods remain the core commercial focus of the Group. Following the acceleration of new product launches during the financial year ended 31 March 2017, there will continue to be a focus on novelty in coming seasons. This will include the extension of existing bag families into new sizes, as well as the introduction of new bag designs to cover all functions and lifestyles.

Over the longer term, the objective is to reinforce Mulberry as a lifestyle brand by strengthening complementary categories to its core leather goods ranges. The key focus categories are footwear, ready-to-wear, soft accessories and jewellery. As part of the initiative to further develop these relatively new categories, the Group will continue to invest in targeted product development and marketing.

Source: Mulberry plc, Annual Report, pp. 1, 3, 5 and 6. http://www.mulberry.com/plugins/investor_relations/pdf/annual_report_2017.pdf

Discussion points

- 1 How does the company describe its trading activity in words?
- 2 What are the accounting measures that the company uses to highlight its trading performance?

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