

ACCOUNTING

for Non-Accounting Students

Tenth Edition

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**Answer to
Example 6.2**

| Wren Manufacturing Company: manufacturing account for the year to 31 March 2021 | | | |
|--|---|---------------|----------------------|
| | £ | £ | £ |
| <i>Direct materials</i> | | | |
| Raw material inventory at 1 April 2020 | | | 4000 |
| Purchases | | 56000 | |
| Carriage inwards (1) | | <u>6000</u> | <u>62000</u> |
| | | | 66000 |
| Less: Raw material inventory at 31 March 2021 | | | <u>6000</u> |
| <i>Cost of materials consumed</i> | | | 60000 |
| <i>Direct wages</i> | | | 25000 |
| <i>Direct expenses</i> | | | <u>3000</u> |
| <i>Prime cost</i> | | | 88000 |
| <i>Other manufacturing costs (2)</i> | | | |
| Administration | | 6000 | |
| Heat and light | | 500 | |
| Power | | 1500 | |
| Rent and rates | | 2000 | |
| Supervisory | | <u>5000</u> | |
| <i>Total manufacturing overhead expenses</i> | | | <u>15000</u> |
| | | | 103000 |
| <i>Work-in-progress</i> | | | |
| Add: Work-in-progress at 1 April 2020 | | 5000 | |
| Less: Work-in-progress at 31 March 2021 | | <u>(8000)</u> | <u>(3000)</u> |
| <i>Manufacturing cost of goods produced</i> | | | 100000 |
| Manufacturing profit (50%) (3) | | | <u>50000</u> |
| <i>Market value of goods produced (4)</i> | | | <u><u>150000</u></u> |

Tutorial notes

- 1 Carriage inwards (i.e. the cost of transporting goods to the factory) is normally regarded as being part of the cost of purchases.
- 2 Other manufacturing costs include production overhead expenses. In practice, there would be a considerable number of other manufacturing costs.
- 3 A profit loading of 50 per cent has been added to the manufacturing cost (see question note 3). The manufacturing profit is a debit entry in the manufacturing account. The corresponding credit entry will eventually be made in the statement of profit or loss.
- 4 The market value of goods produced will be transferred to the finished goods inventory account.

Links with the other accounts

Example 6.2 deals with the manufacturing account in isolation. However, once the manufacturing account has been prepared, it will then be linked with the trading account (and hence also the statement of profit or loss) by transferring either the *manufacturing cost* of the goods produced or the *market value* of the goods produced to the trading account. The manufacturing cost or the market value of the goods produced is, therefore, the equivalent of 'purchases' in the trading account of a non-manufacturing entity. Apart from this minor amendment, the preparation of a trading account for a manufacturing entity is exactly the same as that for a trading entity. This relationship is shown in an outline in Figure 6.1.

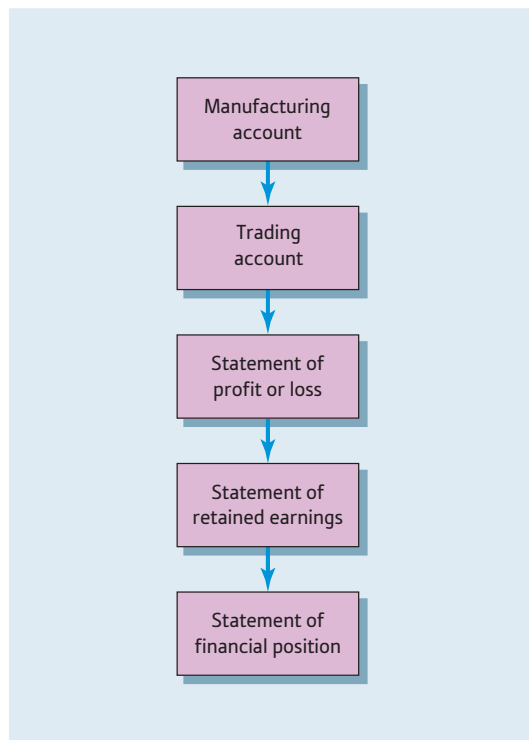


Figure 6.1 The relationship between the main accounts

Service entity accounts

The profit-making sector is made up of a great many other types of entities beside those that may be classified as manufacturing or trading. For convenience, we will describe them as *service entities*. Unlike manufacturing or trading entities, service entities do not normally deal in physical or tangible goods. Instead they offer advice and provide assistance to their customers, clients, patients or passengers. In recent years the manufacturing sector in the United Kingdom has declined and the service sector has become much more important.

The service sector is extremely diverse, but there are a number of recognisable categories. Some of the main ones are as follows.

- *Hotels and catering.* Such entities are generally regarded as being part of the service sector although the service they offer includes a physical or tangible element, e.g. the supply of food and drink.
- *Leisure and recreational activities.* Services included in this category include cinema, concerts and theatre productions, leisure and sports centres, and travel agencies.
- *Personal.* Examples of personal services include beauticians, hairdressing and manicures.
- *Professional.* The more common professional services include accounting, legal, architectural and medical (including chiropody and optical).
- *Transportation.* Transportation services include the movement of goods and passengers by air, land and sea.

Activity 6.2

Think of the main street in your own town or city. List six different types of service entities.

It will be apparent from the above summary that there is an extremely wide variety of different types of service entities. This means that the accounts of different entities will also be somewhat different, e.g. the accounts of a beautician will not be identical to those of a railway company. Nevertheless, there are some basic features that are

common to all service sector entities and that distinguish them from manufacturing and trading entities. These may be summarised as follows:

- 1 *No manufacturing and trading accounts.* These accounts are irrelevant in service entities because they do not normally manufacture products or trade in tangible goods.
- 2 *No gross profit.* As service entities do not prepare trading accounts, the calculation of gross profit is irrelevant.
- 3 *Primacy of the statement of profit or loss.* Details of the income and expenditure for a particular accounting period are shown almost entirely in the statement of profit or loss.
- 4 *Format.* The format of a service-sector statement of profit or loss is very similar to that of a trading entity. However, sometimes specific groups of expenditure are deducted from specific groups of income, the net amount then being highlighted in the statement of profit or loss. For example, suppose an entity sells food for £1000 and its cost was £600. The £1000 income *could* be shown in the income section of the statement of profit or loss with the £600 being shown separately as an expenditure item. But as there is a close relationship between the income and the expenditure, it is helpful to users if it is grouped as in Example 6.3.
- 5 *Segmentation.* Similar categories of income or expenditure are usually grouped together in the same part of the statement of profit or loss with the subtotal of each category being shown separately.

Example 6.3

Extract from the statement of profit or loss

| | £ | £ |
|--------------------------|--------------|-----|
| Income from sale of food | 1000 | |
| Less: cost of provision | <u>(600)</u> | |
| | | 400 |

We illustrate the presentation of a set of financial statements for a service entity in Example 6.4. As you will see, the presentation of the statement of profit or loss, statement of retained earnings and the statement of financial position is very similar to the examples used in previous chapters.

Example 6.4

A service entity account

Mei Loon: Educational training consultant Statement of profit or loss for the year to 31 March 2021

| | £ | £ |
|--|--------------|--------|
| INCOME (1) | | |
| Article fees | 5000 | |
| Author's licensing and collecting payments | 2000 | |
| Consultation fees | 90000 | |
| Lecture fees | 30000 | |
| Public lending right payment | 1000 | |
| Royalties | <u>20000</u> | 148000 |
| EXPENDITURE (2) | | |
| Computing | 5000 | |
| Depreciation : equipment (3) | 2000 | |
| : furniture (3) | 500 | |

| | £ | £ |
|-----------------------------|-------------|---------------|
| Heat and light | 1000 | |
| Insurances | 600 | |
| Photocopying | 200 | |
| Postage | 100 | |
| Rates | 1500 | |
| Secretarial | 30000 | |
| Stationery (4) | 700 | |
| Subscriptions | 400 | |
| Travelling | <u>6000</u> | (48000) |
| Net profit for the year (5) | | <u>100000</u> |

Statement of retained earnings for the year to 31 March 2021

| | £ |
|--------------------------------|----------------|
| Opening retained earnings (12) | 7000 |
| Net profit for the year (13) | 100000 |
| Less: drawings (14) | <u>(40000)</u> |
| Closing retained earnings | <u>67000</u> |

Statement of financial position at 31 March 2021

| | £ | |
|--------------------------------|---------------|--------------|
| NON-CURRENT ASSETS (6) | | |
| Office equipment | 10000 | |
| Less: accumulated depreciation | <u>(4000)</u> | 6000 |
| Office furniture | 5000 | |
| Less: accumulated depreciation | <u>(1500)</u> | <u>3500</u> |
| | | 9500 |
| CURRENT ASSETS | | |
| Inventory of stationery (7) | 200 | |
| Receivables (8) | 15000 | |
| Prepayments (9) | 3000 | |
| Cash at bank and in hand | <u>52300</u> | <u>70500</u> |
| | | <u>80000</u> |
| CAPITAL AND RESERVES (12) | | |
| Capital | 10000 | |
| Retained earnings | <u>67000</u> | 77000 |
| CURRENT LIABILITIES | | |
| Payables (10) | 2000 | |
| Accruals (11) | <u>1000</u> | <u>3000</u> |
| | | <u>80000</u> |

**Tutorial notes to
Example 6.4**

- 1 All six of the listed income items will have been compiled on an accruals and prepayments basis, i.e. the cash received during the period will have been adjusted for any opening and closing receivables.
- 2 Apart from depreciation, the expenditure items will have been adjusted for any opening or closing accruals and prepayments.
- 3 Mei Loon appears to be depreciating her office furniture by 10 per cent per annum on cost $[(£500 \div £5000) \times 100\%]$ and her office equipment by 20 per cent per annum on cost $[(£2000 \div £10,000) \times 100\%]$.

- 4 The stationery costs for the year have been reduced by the inventory at 31 March 2021 (see note 7).
- 5 The net profit for the year has been added to Mei Loon's capital at 1 April 2021 (see note 12).
- 6 The non-current assets are shown at their gross book value less the accumulated depreciation. The difference is known as 'net book value'.
- 7 Mei Loon has valued the inventory of stationery that she held at 31 March 2021 at £200.
- 8 The receivables entry probably represents what is owed to Mei Loon for various fees as at 31 March 2021.
- 9 The prepayments represent what she has paid in advance at the end of the year for various services, such as insurances or heat and light, from which she would expect to benefit in the year to 31 March 2022.
- 10 The payables represent what she owes at the end of the year for various goods and services supplied during the year.
- 11 The accruals are similar to the payables, but they probably relate to services such as insurances or heat and light (see note 9).
- 12 Mei Loon's capital balance is shown as £10,000. This is her original capital contribution. Previous years' profits of £7,000 that she had not drawn out of the business are reserves which are used in the retained earnings calculation. That should effect what addition investment (through reinvesting profits) has Mei Loon made since the inception of the business.
- 13 The net profit for the year is the balance on the statement of profit or loss.
- 14 Mei Loon has drawn £40,000 out of the business during the year for her own private use. Some of the £40,000 probably relates to previous years' profits that she has drawn out during the current year, along with various amounts drawn out in advance of this year's profits.

Activity 6.3

Refer to Example 6.4, examine Mei Loon's statement of profit or loss, statement of retained earnings and statement of financial position. What does the information tell you? How well has her consultancy done during the year to 31 March 2021? Is she likely to go bankrupt in the near future?

Not-for-profit entity accounts

News clip 6.1

Kids Company – the charity that hit the news

By Sarah Gordon

Business bosses who enjoy too long a tenure lose self-awareness. They become reluctant to promote people around them who will challenge their point of view. Meanwhile, questioning a boss who enjoys such stature becomes all but impossible, encouraging hubris, and leading to bad business decisions.

Depressingly, efforts to address this and, in general, improve corporate governance in the US and elsewhere since the financial

crisis have been lukewarm. Boards continue to fail in their duties. Look at Kids Company. This worthy British charity, with its establishment cast of supporters including prime minister David Cameron, collapsed in 2015. Its trustees included Alan Yentob, the former boss of the BBC, who, along with his co-trustees, appeared too in thrall to its charismatic founder, Camila Batmanghelidjh, to question its financial health.

As the term suggests, not-for-profit entities are in business solely to provide some sort of service without necessarily needing to or wanting to make a profit. Examples include charities such as 'Save the Children', bridge clubs, music societies and sports organisations. It is possible that such bodies might be engaged in some sort of trading (or even manufacturing) but the profit motivation would not be their main consideration.

If not-for-profit entities have some manufacturing or trading activities, they will prepare manufacturing and trading accounts. The balance on the manufacturing account would be transferred to the trading account and the balance on the trading account (i.e. the gross profit) to a *statement of financial activities* (a sort of *income and expenditure account*). A statement of financial activities is in principle the same as a statement of profit or loss except that the balance on the account is described as the *excess of income* (or net expenditure) instead of *profit* (or *loss*) and (in the case of charities) it splits the incomes and expenses among *unrestricted funds*, *restricted funds* and *endowment funds*.

An example of a statement of financial activities and a statement of financial position for a social club is shown in Example 6.5. The preparation of such accounts is very similar to that for trading entities.

Example 6.5

A social club's accounts

| Balli Social Club | | |
|---|---------|--------------|
| Statement of financial activities for the year to 31 March 2021 | | |
| | £ | £ |
| INCOME (1) | | |
| Bar sales (2) | 60000 | |
| Less: purchases | (40000) | 20000 |
| Building society interest | | 200 |
| Dances (2) | 1600 | |
| Less expenses | (900) | 700 |
| Food sales (2) | 8000 | |
| Less: purchases | (4500) | 3500 |
| Members' subscriptions | | 36200 |
| | | <u>60600</u> |
| EXPENDITURE (3) | | |
| Accountants' fees | 250 | |
| Depreciation: furniture and fittings | 3900 | |
| Insurances | 600 | |
| Electricity | 1400 | |
| Office expenses | 22000 | |
| Rates | 2000 | |
| Salaries and wages | 14000 | |
| Telephone | 3100 | |
| Travelling expenses | 13000 | (60250) |
| Net income for the year (4) | | <u>350</u> |