SOLUTIONS TO END OF CHAPTER QUESTIONS CHAPTER 3

RECALL AND REVIEW

Question 3.1

(a) The difference between cash receipts and cash payments is not a precise measure of either the business's performance or its profit. This measure just summarises the net cash inflow or outflow of an entity and does not reflect all the business activity that has taken place within a given period. In order to measure the financial performance and profit of the company precisely, Forbes must apply the accruals basis of accounting.

(b) Under the accruals basis of accounting, the timing of cash receipts and cash payments is irrelevant. Transactions are matched to the periods in which they occur not to the periods in which cash is paid and in which cash is received. If the accruals basis of accounting did not exist, entities could time their cash receipts and payments to manipulate their results and to show the picture they wanted to show rather than the picture of income actually earned and expenses actually incurred in any given accounting period.

Question 3.2

(a)

	£
Add: prepayment at 1 January 2021	800
Add: payments made during 2021	3,200
Deduct: prepayment at 31 December 2021	1,400
Advertising expenditure for 2021	2,600

(b) £1,400 paid for advertisements to be published in 2022 will be reported as a prepayment, a current asset, on the statement of financial position of Johnson Limited at 31 December 2021.

DEVELOP YOUR UNDERSTANDING

Question 3.3

1. Abi's capital account balance at 1 September 2020

Remember that assets – liabilities = capital (equity)

	£
Assets	
Inventory	2,382
Cash and cash equivalents (= bank balance)	7,342
Total assets	9,724
Liabilities	
Trade payables	3,445
Assets – liabilities = capital	6,279

2. Abi's bank account for the year to 31 August 2021

	Cash in £	Cash out £
Bank balance at 1 September 2020	7,342	
Rent for the year		6,000
Sales for the year	157,689	
Refunds given to customers during the year		3,789
Trade payable at 1 September 2020 paid		3,445
Cash paid for purchases		116,328
Wages paid to part time assistant 50 weeks paid × £100		5,000
Display stands		600
Drawings 12 months × £1,500		18,000
Bank balance at 31 August 2021 (total receipts – total payments)		11,869
	165,031	165,031

3. Statement of profit or loss for the year ended 31 August 2021 and a statement of financial position at that date

Abi: statement of profit or loss for the year ended 31 August 2021

	£	£	Note
Revenue: £157, 689 – £3,789 + £650		154,550	1
Cost of sales			
Opening inventory	2,382		2
Purchases	120,465		3
Closing inventory	(4,638)		4
Cost of sales		118,209	5
Gross profit		36,341	6
Expenses			
Rent	6,000		7
Assistant £5,000 + £200	5,200		8
Depreciation of display stands	190		9
Total expenses		11,390	10
Net profit for the year		24,951	11

Abi: statement of financial position at 31 August 2021

	£	Note
Non-current assets		
Display stands (£600 cost – £190 accumulated depreciation)	410	9
Current assets		
Inventory	4,638	4
Bank balance at 31 August 2021	11,869	
Cash in hand at the year end = unbanked sales	650	1
	17,157	
Total assets (£410 non-current assets + £17,157 current assets)	17,567	
Current liabilities		
Trade payables (£120,465 total purchases – £116,328 cash paid)	4,137	3
Assistant's wages accrual (£5,200 charge for year – £5,000 paid)	200	8
Total liabilities	4,337	
Net assets (£17,567 total assets – £4,337 total liabilities)	13,230	
Equity (capital account)		
Capital account at 1 September 2020 calculated above in 1	6,279	
Add: net profit for the year from the statement of profit or loss	24,951	
Less: drawings (personal expenses) paid from bank	(18,000)	
Capital account at 31 August 2021	13,230	

Notes

1. Revenue is made up of the cash receipts from sales to customers of £157,689 less the refunds to customers for goods returned of £3,789 (= sales returns, the cancellation of a sale) + £650 cash at 31 August 2021 representing sales that had not yet been banked. This £650 cash is added on to sales and is recorded as a cash asset on the statement

of financial position at 31 August 2021. This cash represents sales that had taken place during the accounting year and a cash asset at the end of the financial year.

2. Opening inventory is the inventory of £2,382 that Abi held at 1 September 2020.
3. The cost of purchases is the total cost of goods purchased of £120,465, even though Abi has only paid out £116,328. Remember that, under the accruals basis of accounting, transactions are recorded in the accounting period in which they occurred, not in the accounting period in which cash is received or paid. Therefore, as the total cost of purchases for the year was £120,465, this is the amount recognised in the statement of profit or loss for the year to 31 August 2021. While the cost of purchases is £120,465, only £116,328 of this amount has been paid, so there is a liability at the year-end of £120,465 – £116,328 = £4,137. This figure represents the obligation to pay for goods purchased during the year so that a purchase of goods and a trade payable are both recognised for this amount at the end of the financial year.
4. Closing inventory is a deduction from cost of sales and an asset in the statement of financial position. The cost of closing inventory is carried forward to the next accounting period to match against the sales revenue generated from the sale of these goods in the year to 31 August 2021.
5. Cost of sales = opening inventory + purchases – closing inventory.
6. Gross profit = revenue – cost of sales.
7. Rent is the annual cost of the rent paid from the bank account. As Abi has paid all the rent due for the year there is no prepayment or accrual of rent to recognise at the accounting year end.
8. The assistant has been paid for 50 weeks of the year, so £5,000 has been paid out of the bank account. As the assistant has carried out her work for the last two weeks of August, Abi has an obligation at 31 August 2021 to pay for two more weeks of work, so an additional £200 is recognised as a cost incurred in the financial year in the statement of profit or loss and as an accrual in the statement of financial position.
9. Depreciation on the display stands is calculated by deducting the scrap value (= residual value) of the stands from the cost (£600 – £30 = £570) and then dividing £570 by the three years that the display stands are expected to last. £570 ÷ 3 = £190 depreciation for each of the three years that the display stands will be in use in Abi's business. As the display stands have been in use for a whole year in the business (from 1 September 2020 to 31 August 2021) a whole year's depreciation is recognised in the statement of profit or loss. The carrying amount of the display stands at the end of the financial year is £410: £600 cost – the accumulated depreciation at 31 August 2021 of £190 = £410.
10. Total expenses are given by adding £6,000 (rent) + £5,200 (assistant) + £190 (depreciation for the year) to give total expenses of £11,390.
11. Net profit for the year is given by deducting total expenses for the year of £11,390 from the gross profit of £36,341 to give a net profit figure of £24,951.

» Question 3.4

Alison: statement of profit or loss for the year ended 31 December 2021

	£	£	Note
Sales 437,990 (sales) – 17,682 (sales returns)		420,308	1
Opening inventory	27,647		2
Purchases 225,368 (goods purchased) – 5,724 (purchase returns) – 2,324 (discounts received)	217,320		3
Closing inventory	(22,600)		4
Cost of sales		222,367	5
Gross profit		197,941	6
Expenses			
Administration expenses	15,265		
Telephone expenses	5,622		
Rent on warehouse and office unit 15,000 – 3,000	12,000		7
Business rates 9,325 – 1,865	7,460		8
Delivery costs	36,970		
Electricity and gas	8,736		
Insurance	3,250		
Depreciation charge for the year on non-current assets	13,255		
Accountancy costs	1,250		9
Increase in allowance for receivables in the year 2,740 – 0	2,740		10
Total expenses		106,548	11
Net profit for the year		91,393	12

Alison: statement of financial position at 31 December 2021

	£	Note
Non-current assets		
Racks, shelving and office furniture £33,600 cost – £14,650 accumulated depreciation	18,950	13
Computer equipment £20,775 cost – £13,850 accumulated depreciation	6,925	14
	25,875	
Current assets		
Inventory	22,600	4
Trade receivables £27,400 – £2,740 (allowance for receivables)	24,660	10
Rent prepayment	3,000	7
Rates prepayment	1,865	8
Cash and cash equivalents	52,315	
	104,440	
Total assets (non-current assets £25,875 + current assets £104,440)	130,315	
Current liabilities		
Trade payables	24,962	
Accountancy accrual	1,250	9
Total liabilities	26,212	
Net assets (total assets £130,315 – total liabilities £26,212)	104,103	
Equity (capital account)		
Capital account at 1 January 2021	52,710	
Profit for the year	91,393	12
Drawings	(40,000)	
Capital account at 31 December 2021	104,103	

Notes

Figures that do not change from the list of balances in the question are not discussed further in these notes. Check that you classified these balances correctly as assets, expenses, income, liabilities or capital (equity) in the answer given above.

1. Sales are reduced by the sales returns. These returns are treated as a deduction from sales, as the return of goods amounts to the cancellation of a sale.
2. Inventory on the first day of the accounting year, 1 January 2021, is opening inventory. The closing inventory at 31 December 2021 is given in the additional information.
3. Purchases are the purchase of goods for resale, the goods bought in that are sold on to customers. Purchase returns are deducted from this figure as these represent cancelled purchases. Likewise, the discounts received are also deducted from the purchases figure as these discounts received represent a reduction in the cost of purchases made.
4. Closing inventory in the statement of profit or loss is also a current asset in the statement of financial position as the cost of these unsold goods is carried forward to match against sales of these goods in the next accounting period.
5. Cost of sales is calculated as £27,647 (opening inventory) + £217,320 (purchases net of purchase returns and discounts received) – £22,600 (closing inventory) = £222,367.
6. Gross profit = £420,308 (sales) – £222,367 (cost of sales) = £197,941.
7. As £3,000 of the rent is prepaid, £3,000 is deducted from the rent expense for the year and recognised as a current asset in the statement of financial position.
8. Similarly, as £1,865 of rates have been paid in advance, this figure is deducted from the rates expense for the year and recognised as a current asset in the statement of financial position.
9. Accountancy costs have not been taken into account; as they have been incurred in the year, but not yet paid for, they must be recognised as both an expense in the statement of profit or loss and as an accrual, a current liability at the financial year end, in the statement of financial position.
10. The allowance for receivables is calculated as 10% of year end trade receivables. Year-end trade receivables stand at £27,400, so 10% of this figure is £2,740. £2,740 is deducted from trade receivables and charged as an expense in

the statement of profit or loss. As there was no allowance for receivables at the end of the previous accounting year, the change in the allowance for receivables is the allowance now of £2,740 – the allowance at the end of last year of £Nil = £2,740. Trade receivables in the statement of financial position are stated net of the allowance for receivables at a figure of £27,400 – £2,740 = £24,660.

11. £106,548 is the total of all the expenses from administration expenses down to the increase in the allowance for receivables.
12. Net profit for the year is calculated by deducting total expenses of £106,548 from the gross profit of £197,941. This net profit for the year belongs to Alison, so this figure is added to the capital account balance on the statement of financial position.
13. The carrying amount of the racks, shelving and office furniture is calculated by deducting the accumulated depreciation of £14,650 at the end of the current accounting period, 31 December 2021, from the cost of the racks, shelving and office furniture of £33,600.
14. Similarly, the carrying amount of the computer equipment is calculated by deducting the accumulated depreciation of £13,850 at the end of the current accounting period, 31 December 2021, from the cost of the computer equipment of £20,775.

Question 3.5

Volumes Limited: statement of profit or loss for the year ended 30 September 2021

	£000
Revenue (= sales)	4,750
Cost of sales (see working)	(3,550)
Gross profit	1,200
Distribution and selling costs	(200)
Administration expenses	(300)
Operating profit	700
Finance income	25
Finance expense	(100)
Profit before tax	625
Income tax	(250)
Profit for the year	375

Cost of sales working

	£000
Production costs	2,600
Opening inventory at 1 October 2020	100
Production wages	1,000
Closing inventory at 30 September 2021	(150)
Cost of sales	3,550

Cost of sales = opening inventory + production costs – closing inventory. Production wages are also added in to cost of sales in this example as these costs are directly incurred in the production of goods for sale. See the explanation of how cost of sales is made up in Chapter 3, Cost of sales.

Volumes Limited: statement of financial position at 30 September 2021

ASSETS	**£000**
Non-current assets	
Property, plant and equipment £2,000 (cost) – £800 (depreciation)	1,200
Current assets	
Inventory (= closing inventory in the statement of profit or loss)	150
Trade receivables	430
Cash and cash equivalents	175
	755
Total assets £1,200 (non-current assets) + £755 (current assets)	1,955
LIABILITIES	
Current liabilities	
Trade payables	300
Taxation payable (= income tax charged in the statement of profit or loss)	250
	550
Non-current liabilities	
Borrowings	500
Total liabilities £550 (current liabilities) + £500 (non-current liabilities)	1,050
Net assets: total assets – total liabilities £1,955 – £1,050	905
EQUITY	
Called up share capital	250
Share premium	125
Retained earnings £155 (at 30 September 2020) + £375 (profit for the year)	530
	905

Question 3.6

Guimaraes Limited and Porto Limited: statements of profit or loss for the year ended 31 December 2021

	Guimaraes Limited		Porto Limited	
	£000	£000	£000	£000
Sales		14,500		99,400
Opening inventory	4,000		21,000	
Purchases	8,000		54,200	
Closing inventory	(5,000)		(31,000)	
Cost of sales		7,000		44,200
Gross profit		7,500		55,200
Other income		—		5,000
Expenses				
Selling and administration expenses	1,600		12,800	
Depreciation of non-current assets	1,000		6,500	
Wages and salaries	1,200		7,300	
Insurance	500		—	
Bank interest	400		3,600	
Tax	840		9,000	
Total expenses		5,540		39,200
Net profit for the year		1,960		21,000

Question 3.7

(a) (£160,000 – £10,000) ÷ 5 years = £30,000 annual depreciation charge for each year of the asset's useful life using the straight line depreciation basis.

(b) Annual depreciation charge for each year of the asset's useful life using the reducing balance basis.

Year	Depreciation Charge	Accumulated depreciation	Year-end carrying amount
	£	£	£
1	160,000 x 40% = 64,000	64,000	96,000
2	96,000 x 40% = 38,400	102,400	57,600
3	57,600 x 40% = 23,040	125,440	34,560
4	34,560 x 40% = 13,824	139,264	20,736
5	20,736 x 40% = 8,294	147,558	12,442

(c) The most appropriate method of depreciation for this asset depends on how the economic benefits of the asset are consumed. A piece of production machinery is likely to be more productive in the early years of its life. If this is the case then the reducing balance basis would be more appropriate. If the economic benefits of the piece of machinery are consumed evenly over the asset's life, then the straight line basis would be the most appropriate depreciation method to use.

TAKE IT FURTHER

Question 3.8

Aaron Limited: statement of profit or loss for the year ended 31 December 2021

	£000	£000
Sales		2,500
Opening inventory	400	
Purchases	1,300	
Closing inventory	(375)	
Cost of sales		1,325
Gross profit		1,175
Expenses:		
Selling and administrative expenses	330	
Insurance £500 – (£500 x 6/12)	250	
Power and heating £125 + £45 (unpaid bill)	170	
Depreciation (£2,400 – £400) ÷ 10	200	
Irrecoverable debt	50	
Total expenses		1,000
Profit for the year		175

Aaron Limited: Statement of financial position at 31 December 2021

ASSETS	£000
Non-current assets	
Equipment £2,400 (cost) – £200 (accumulated depreciation at 1 January 2021) – £200 (depreciation charge for the year to 31 December 2021)	2,000
Current assets	
Inventory	375
Trade receivable £250 – £50 (irrecoverable debt)	200
Insurance prepayment £500 ÷ 2	250
Bank	170
	995
Total assets	2,995
LIABILITIES	
Trade payables	175
Accruals (unpaid power and heating)	45
Total liabilities	220
Net assets (total assets – total liabilities)	2,775
EQUITY £2,600 + £175 (profit for the year)	2,775

Workings and notes

- The unpaid power and heating bill has not been taken into account, so this represents an accrual at the end of the year, adding an expense incurred during the year but not yet paid to both expenses and liabilities. The power and heating expense in the statement of profit or loss is increased by £45,000 and a current liability of £45,000 is recognised in the statement of financial position to reflect the obligation due at the year end.
- The insurance premium represents an expense for part of the year to 31 December 2021 and a prepaid expense for the financial year to 31 December 2022. Half the amount paid in 2021 is a prepayment for 2022, so £500,000 ÷ 2 = £250,000. £250,000 is deducted from the insurance expense in the statement of profit or loss and added to current assets in the statement of financial position as a prepayment.
- £50,000 represents a known irrecoverable debt that must be charged as an expense in the statement of profit or loss and deducted from trade receivables in the statement of financial position.
- Depreciation on equipment is calculated on the straight-line basis. This means that the depreciation charge for the year is based upon the cost of the assets. Plant and machinery cost is £2,400,000. Deducting the residual value of £400,000 leaves a depreciable amount of £2,000,000 (£2,400,000 cost – £400,000 residual value). Dividing £2,000,000 depreciable amount by 10 years of useful life gives a £200,000 depreciation charge for the year to be added to the statement of profit or loss as an expense and to be deducted from the cost of equipment in the statement of financial position. The carrying amount of equipment in the statement of financial position is now £2,000,000 (£2,400,000 – £200,000 (accumulated depreciation at the start of the financial year) – £200,000 (depreciation charge during the financial year)).

››› Question 3.9

Textiles Limited: statement of profit or loss for the year ended 30 June 2021

	£000
Revenue £7,550 (sales) – £150 (sales returns)	7,400
Cost of sales £4,550 (cost of sales) – £80 (purchase returns) – £125 (discounts received) + £600 (plant and machinery depreciation charge for the year)	(4,945)
Gross profit (revenue – cost of sales)	2,455
Distribution and selling costs £1,000 + £100 (motor vehicle depreciation charge for the year)	(1,100)
Administration expenses £700 + £10 (accountancy and audit fees for year) – £15 (prepaid insurance) + £50 (known irrecoverable debt) – £20 (reduction in allowance for receivables	(725)
Operating profit (gross profit – distribution and selling – administration)	630
Finance expense	(110)
Profit before tax	520
Income tax £520 (profit before tax) × 25%	(130)
Profit for the year	390

Textiles Limited: statement of financial position at 30 June 2021

ASSETS	**£000**
Non-current assets	
Plant and machinery £3,000 (cost) – £1,200 (depreciation to 30 June 2020) – £600 (depreciation charge for the year to 30 June 2021)	1,200
Motor vehicles £800 (cost) – £400 (depreciation to 30 June 2020) – £100 (depreciation charge for the year to 30 June 2021)	300
	1,500
Current assets	
Inventory	300
Trade receivables £1,050 – £60 (allowance for receivables at 30 June 2020) – £50 (known irrecoverable debt) + £20 (reduction in allowance for receivables in year)	960
Insurance prepayment	15
	1,275
Total assets £1,500 (non-current assets) + £1,275 (current assets)	2,775
LIABILITIES	
Current liabilities	
Bank overdraft	200
Trade payables	300
Accruals £10 (audit and accountancy fees for the year)	10
Taxation payable (from the statement of profit or loss: £520 (profit before tax x 25%)	130
	640
Non-current liabilities	
Borrowings	1,000
Total liabilities £640 (current liabilities) + £1,000 (non-current liabilities)	1,640
Total assets – total liabilities £2,775 – £1,640	1,135
EQUITY	
Called up share capital	200
Retained earnings £545 (at 30 June 2020) + £390 (profit for the year)	935
	1,135

Workings and notes

- The audit and accountancy fees for the year have not been taken into account, so these represent an accrual at the end of the year, adding an expense incurred during the year to costs and liabilities. Administration expenses are increased by £10,000 and a current liability of £10,000 is recognised to reflect the obligation due at the year end.
- The insurance premium represents an expense for part of the year to 30 June 2021 and a prepaid expense for the financial year to 30 June 2022. Six months have been prepaid (July to December 2021), so £30,000 × 6/12 = £15,000 is deducted from administration expenses and added to current assets as a prepayment.

- £50,000 represents a known irrecoverable debt that must be charged as an expense (to administration expenses, not as a deduction from sales) and deducted from trade receivables.
- Trade receivables at the year end now stand at £1,000,000 (£1,050,000 (trade receivables at 30 June 2021) – £50,000 (known irrecoverable debt)); 4% of £1,000,000 = £40,000. The allowance for receivables at 30 June 2020 was £60,000, so there is a reduction in this allowance of £20,000. This reduction in allowance is added to trade receivables to give a net allowance for receivables at 30 June 2021 of £40,000 (£60,000 at 30 June 2020 – £20,000 reduction in the allowance in the year). The reduction in the allowance of £20,000 is also deducted from administration expenses to reflect the reduction in the allowance for receivables during the year to 30 June 2021. Essentially, this reduction in the allowance for receivables is income that reduces expenditure in the current year.
- Depreciation on plant and machinery is to be calculated on the straight line basis. This means that the depreciation charge for the year is based upon the cost of the assets. Plant and machinery cost is £3,000,000, so 20% of this cost is £600,000; £600,000 is deducted from plant and machinery and added to cost of sales. The carrying amount of the plant and machinery is now:

	£000
Cost	3,000
Accumulated depreciation to 30 June 2020	(1,200)
Depreciation charge for the year ended 30 June 2021	(600)
Carrying amount at 30 June 2021	1,200

- Motor vehicle depreciation is to be charged on the reducing balance basis. As this is not the first year of ownership of the motor vehicles, depreciation cannot be based on cost but must be based on carrying amount, the cost – accumulated depreciation at the end of the preceding financial year. The carrying amount at the start of the year is £800,000 – £400,000 = £400,000; 25% of the carrying amount of £400,000 = £100,000. Thus, £100,000 is deducted from the carrying amount of the motor vehicles at 30 June 2021 and added to selling and distribution expenses. The carrying amount of motor vehicles is now:

	£000
Cost	800
Accumulated depreciation to 30 June 2020	(400)
Depreciation charge for the year ended 30 June 2021	(100)
Carrying amount at 30 June 2021	300

- The taxation charge is based upon the profit before tax for the year. Profit before tax totals up to £520,000; 25% of £520,000 = £130,000. Thus, £130,000 is deducted from profit before tax to give a profit for the year of £390,000. As the tax has not yet been paid, a current liability for taxation payable of £130,000 is also recognised on the statement of financial position as a liability due for payment. The profit for the year of £390,000 is now added to retained earnings in the statement of financial position.

Question 3.10

1. Laura's bank account

	Receipts £	Payments £
Cash paid in by Laura	50,000	
Receipts from cash sales	112,000	
Receipts from credit sales	36,000	
Payments for construction materials		38,000
Payment for van		6,000
Payment for construction equipment		5,000
Van running expenses		4,000
Wages paid to part time employees		9,600
Insurance		1,800
Bank charges		400
Bank interest paid		200
Interest received	250	
Drawings 12 months × £2,500		30,000
Drawings: mortgage repayment		90,000
Balance in bank at 31 August 2021		13,250
	198,250	198,250

Remember that the bank account just includes cash receipts and cash payments. If any of your figures are different from the above, check back to the information in Question 3.10 to make sure you have correctly identified the cash receipts and payments rather than cash that had not been received and payments that had not been made by 31 August 2021 The notes at the end of the statement of financial position below also provide further explanations of these figures.

2. Laura: statement of profit or loss for the year ended 31 August 2021

	£	£
Sales: £112,000 (cash sales) + £36,000 (credit sales cash received) + £12,000 (credit sales made but cash not yet received)		160,000
Opening inventory: nil as this is the first year of trading	—	
Purchases: £38,000 (cash paid) + £7,000 (payment still owed for construction materials) – £,000 (bulk discount received)	44,000	
Closing inventory	(4,500)	
Cost of sales		39,500
Gross profit		120,500
Expenses		
Irrecoverable debt	2,500	
Increase in allowance for receivables: (£12,000 – £2,500) × 10%	950	
Van depreciation: (£6,000 – £600) ÷ 3 years	1,800	
Van running expenses (all paid for in year)	4,000	
Equipment depreciation: (£5,000 – £60) ÷ 4 years	1,235	
Wages of part time employees: £9,600 (paid) + (£9,600 ÷ 12 weeks)	10,400	
Insurance: £1,800 (paid for 18 months) – (£1,800 × 6/18)	1,200	
Bank charges: £400 (paid) + £75 (accrual up to 31 August 2021)	475	
Bank interest paid	200	
Total expenses		22,760
Interest received: £250 (received) + £50 (due for August 2021)		(300)
Profit for the year		98,040

Laura: statement of financial position at 31 August 2021

ASSETS	**£**
Non-current assets	
Van: £6,000 (cost) – £1,800 (accumulated depreciation charged up to the current year end)	4,200
Construction equipment: £5,000 (cost) – £1,235 (accumulated depreciation charged up to the current year end)	3,765
	7,965
Current assets	
Inventory: (from closing inventory in the statement of profit or loss)	4,500
Trade receivables: £12,000 (invoices not paid) – £2,500 (irrecoverable debt) – £950 allowance for receivables	8,550
Insurance prepayment: £1,800 × 6/18	600
Interest receivable: £50 due for August 2021	50
Cash at bank: (from bank account in part (1))	13,250
	26,950
Total assets: £7,965 + £26,950	34,915
LIABILITIES	
Current liabilities	
Trade payables: £7,000 (payment still owed for construction materials supplied) – £1,000 (bulk discount received)	6,000
Accruals: £800 (wages) + £75 (bank charges)	875
Total liabilities	6,875
Net assets: £34,915 – £6,875	28,040
Capital account	
Capital introduced by Laura	50,000
Profit for the year: from statement of profit or loss	98,040
Drawings: 12 × £2,500 = £30,000 + £90,000 (mortgage repayment)	(120,000)
Capital account at 31 August 2021	28,040

Notes

- Cash received and paid into the bank from cash sales is £112,000. The sales made on credit amount to £48,000. As these sales all occurred within the financial year to 31 August 2021 they, too, have to be recorded as sales, giving total sales of £112,000 (cash) + £48,000 (credit) = £160,000. Laura has only received cash of £36,000 from her credit customers, so only this amount can be recorded as a cash receipt into her bank. The remaining £12,000 of sales (£48,000 sales – £36,000 cash paid) owed by customers who have not yet paid is recorded as trade receivables in the statement of financial position. Remember that the accruals basis of accounting says that you must reflect the sales (and expenses) that have occurred in an accounting period regardless of when the cash for those sales was received (or when the cash was paid for expenses).
- Cash paid for construction materials amounts to £38,000. This is the total that is recorded as a payment out of the bank account for construction materials. However, £45,000 of purchases of construction materials took place during the year, so, under the accruals basis of accounting, the total purchases figure is £45,000. The £1,000 quantity discount is a discount received from Laura's supplier. This discount received is deducted from purchases to give a net purchases figure of £44,000 (£45,000 expenditure – £1,000 reduction in costs). The quantity discount relates to purchases within the financial year to 31 August 2021, so this discount is taken into account in this year rather than being taken into the accounting year in which it was received, the year ended 31 August 2022. The remaining £7,000 of amounts owed for construction materials (£45,000 total cost – £38,000 cash paid) is recorded as a trade payable less the £1,000 discount received, a net trade payable of £6,000.
- The known irrecoverable debt of £2,500 is deducted from trade receivables in the statement of financial position and recorded as an expense in the statement of profit or loss. This irrecoverable debt is not deducted from sales, but is recorded

as an expense. Net trade receivables now stand at £9,500 (£12,000 unpaid sales – £2,500 irrecoverable debt): 10% of these trade receivables is to be recorded as an allowance for receivables; 10% of £9,500 = £950. This amount is deducted from trade receivables and recorded as an expense in the statement of profit or loss (this is not a deduction from sales). There was no allowance at the start of the year as this is the first year of trading, so the statement of profit or loss charge for the movement in the allowance for receivables is the year end allowance of £950 – the allowance at the start of the year of £nil = £950.

- The £6,000 cost of the van is a payment out of the business bank account; £6,000 is recognised as a non-current asset on the statement of financial position. This amount now has to be depreciated. As the van is expected to travel 5,000 miles each year on business journeys, this indicates an even pattern for the consumption of the van's economic benefits, so straight line depreciation will be the most appropriate depreciation method to use. The annual depreciation will be (£6,000 (cost) – £600 (residual value)) ÷ 3 years = £1,800 per annum. This depreciation is deducted from the cost of the van and added as an expense to the statement of profit or loss. The van now has a carrying amount of £6,000 (cost) – £1,800 (depreciation charged in the first year of the business) = £4,200.
- Van running expenses have all been paid from the bank account during the year, so these are recorded as a payment of cash out of the bank and an expense in the statement of profit or loss. There are no adjustments to make to this cost as there are no prepaid or outstanding amounts in relation to these expenses in the question.
- The second-hand construction equipment is a payment out of the business bank account and a non-current asset. As Laura expects to make the same use of these assets in each of the four years, this equipment should be depreciated on the straight line basis. Cost of £5,000 less residual value of £60 gives a depreciable amount of £4,940. As these assets will last for four years, the annual depreciation will be £4,940 ÷ 4 years = £1,235. Thus, £1,235 is deducted from the cost of the construction equipment and added to the statement of profit or loss as an expense. The carrying amount of the construction equipment is now £5,000 (cost) – £1,235 (depreciation charged in the first year of the business) = £3,765.
- £9,600 has been paid out of the business bank account in respect of part time wages. However, £9,600 is not the total part time wages expense. The part time workers were employed for 13 weeks during the summer, but have only been paid for 12. The weekly part time wages were £9,600 ÷ 12 weeks = £800. Therefore, a further £800 expense needs to be recognised in the year to 31 August 2021. The additional £800 cost was incurred during this period, so it must be recognised in the financial statements for this year regardless of whether it was paid or not. The part time wages expense is thus the £9,600 paid during the year + the £800 incurred but not yet paid = £10,400. The £800 not yet paid is then recognised as an accrual, an obligation to make a payment for services received by the year end, on the statement of financial position.
- The amount paid out of the bank account in respect of insurance was £1,800. This payment covers 18 months of insurance expense. The financial year to 31 August 2021 is only 12 months long, so 6 out of the 18 months paid for has been prepaid. The prepaid element = £1,800 × 6/18 = £600. This prepayment is deducted from the £1,800 paid to leave statement of profit or loss charge for insurance of £1,200 (£1,800 paid – £600 prepayment). The prepayment is then recognised as a current asset in the statement of financial position.
- Closing inventory is a deduction in the statement of profit or loss and an asset in the statement of financial position. There is no cash element in respect of this inventory, so no entry is made in the bank account.
- The payment out of the bank for bank charges is £400. This is cash paid and an expense incurred. £75 additional bank charges up to 31 August 2021 have been incurred but not yet paid. Therefore, this additional £75 has to be recognised as an expense in the year to 31 August 2021 as it was incurred in that financial year but paid in the next accounting period. An additional £75 is added to the bank charges expense in the statement of profit or loss and £75 added as an accrual to the statement of financial position as an obligation validly incurred but not yet paid.
- £200 bank interest on the overdraft is the payment out of the bank. No additional bank interest is due, so there are no additional or prepaid expenses relating to bank interest. The £200 is recorded as a payment out of the bank and an expense in the statement of profit or loss.
- £250 interest received from the bank is recorded as a receipt in the bank account and income in the statement of profit or loss. An additional £50 interest has been earned up to 31 August 2021, so, as this income was earned in the accounting period, a further £50 is added to interest received in the statement of profit or loss and a receivable of £50 recorded as a current asset, money due but not yet received from the bank.
- Laura has taken money out of the business each month for her own personal expenses as well as making a large payment off her personal mortgage at the end of the financial year. Total cash withdrawn for personal expenses was £2,500 per month × 12 months = £30,000. This is a payment out of the bank and a deduction from the capital account in the statement of financial position. Money withdrawn by the owner of a business is not a business expense, but a repayment of capital to the owner, so this £30,000 does not appear in the statement of profit or loss. Similarly, the £90,000 mortgage payment is a payment out of the bank account and a deduction from the capital account, a repayment of capital to the owner of the business not a business expense or the repayment of a business liability.
- £198,250 has been paid into the bank and £185,000 paid out. Therefore £13,250 is left in the bank account. This is recorded on the statement of financial position as a current asset of the business.

