Limited Companies

Question:

Explain the meaning of the following terms so as to make clear the differences between them:

> ***Ordinary Shares*** are certificates of ownership to a company. They are issued to shareholders who are willing to take a "risk" in the company. In case of bankruptcy, these shareholders will either not get their investment back, or get a balance after every creditor and preference shareholder gets their dues. But if the company were to be successful in making good profits, they will be entitled to all balance profit after the preference shareholders take their "fixed" earnings. Ordinary shareholders also have a right of voting at general meetings. They generally have no special privileges over other shares. But they normally comprise the bulk of a company's capital.
>
> ***Preference Shares*** attract fixed dividends. They have no right to vote. In the event of bankruptcy of the company, they are entitled to be returned their investment in priority to ordinary shareholders. Preference shares consist of many types each holding different rights & privileges. They are cumulative (i.e. dividends, if unpaid, accumulate on the next year) or non-cumulative, participating or non-participating, redeemable or non-redeemable.
>
> A ***debenture*** is an acknowledgement of debt. It pays a fixed rate of interest to the holder, whether the company is making profits or not. A debenture holder has certain rights and privileges over both ordinary & preference shareholders. They will be repaid first in cases of bankruptcy.

Question:

State what you understand by the following terms used in connection with limited companies:

> ***Debentures*** are long term loans that earn fixed rates of interest. They may be redeemable or irredeemable. Debentures are held by the debenture holders, whose rights are set out in a trust deed. They have priority to repayment of principal upon liquidation of company over preference and ordinary shareholders.
>
> ***Preference Shares*** are held by members of the Company, who are entitled to receive fixed dividends every year and have priority in recovering their investment (during winding-up) over ordinary shareholders. Preference shares have no voting rights.
>
> ***Authorized Share Capital*** is the maximum share capital that a company can call up or issue. This amount is specified in the Memorandum of Association. The amount can only be changed upon registration with the Registrar of Companies.
>
> ***Called-up Share Capital*** is the amount of share capital actually issued by the company to its members or public investors to raise funds. The called-up share capital cannot be more than the Authorized Share Capital.

Question:

State briefly what you understand by the following terms used in connection with limited companies:

Authorized Share Capital The Share Capital in which the company is allowed by the Law to issue to the public. It is stated in the Memorandum of Association of the Company. The company cannot issue shares more than the Authorized Share Capital. If the company decides to issue more, it must inform the respective Law body and change its Memorandum of Association.

Issued Share Capital It is the Share Capital already issued and taken up by the public. It cannot be more than the Authorized Share Capital. Although taken up by the public, it is not necessarily fully paid.

Called-up Share Capital It's part of Issued Share Capital. Sometimes the company does not require the shares to be fully paid at one time. It may decide to set payment in installments and at specific dates; the shareholders will be called-up to pay the specified installment.

Preference Shares Those special shares, preferred over ordinary shares because they bear a fixed rate of dividend. In bankruptcy / liquidation cases, they will be given priority over ordinary shareholders for repayment. The fixed rate of dividend may be cumulative (i.e. if not paid in one year, it will accumulate in next year) or non-cumulative.

Debentures are loans to companies. They bear a fixed rate of interest which must be paid whether the company is making profits or not. They are first in line for repayment in terms of bankruptcy or liquidation. Unlike Preference Shares and Ordinary Shares, Debentures do not carry the right to participate in the running of the company. Debenture holders are basically outsiders, not owners.

Question:

Ordinary shares differ from debentures. Describe two features of each.

Two features of each are:

(i) Ordinary Shares are certificates of ownership to a company i.e. ordinary shareholder are owners of the company.

On the other hand, debentures are long term loans which means that the holders are not owners but long term creditors of the company.

(ii) Ordinary Shareholders are paid dividends as and when the directors recommend i.e. when the company is making profits. However, a fixed rate of interest must be paid on the debentures every year whether or not the company makes profits.

Question:

Describe three features of the following different types of capital.

Features of each of the following different types of capital are:

Ordinary Shares They are certificates of ownership to a company. Their features are:

(i) They carry no fixed rate of dividends, which means that if the company makes high profits they may get very high returns depending on the director's proposals. On the other hand, they may not get any returns at all if the company suffered losses or made low profits.

(ii) They carry voting rights.
(iii) Upon liquidation, they are the last to be repaid, which means they may get nothing at all.

Preference Shares These are special shares preferred over ordinary shares because:
(i)They carry a fixed rate of dividends which means that no matter whether the company makes high or low profits, the same rate of dividend is paid to the holders. Thus dividends do not fluctuate according to profits made.
(ii) They may be cumulative which means that if the dividends are not paid in one year, it is accumulated to the following year.
(iii) They are given priority over ordinary shareholders for repayment upon liquidation.

Debentures are long-term loans to companies, that is, the debenture holders are lenders or creditors of the company. Their features are:

(i)They carry a fixed rate of interest which must be paid yearly, whether the company makes profit or not.
(ii) Do not entitle the holders to participate in the running of the company as they are considered outsiders, not owners.
(iii) They have priority to repayment of principal upon liquidation of company over preference and ordinary shares.

Trial Balance

Question:

Give one reason why a Trial Balance is prepared.

A trial balance is an easy way to check for double entry errors, i.e. whether all transactions have been posted and recorded correctly.

Question:

(a) What do you consider to be the main object of preparing a Trial Balance?

The main object of preparing a trial balance is to ensure that the debits and credits have been entered correctly. It is also to check the accuracy of the transactions or amounts written in the ledger. Another reason is to list all the accounts that are in the ledger.

(b) State three different types of error which a Trial Balance will not reveal.

Three different types of error which will not be revealed by a Trial Balance are:

(1) Errors of omission: Complete failure to record a transaction in the books.

(2) Reversal of entries: Entries made on the wrong side of one account and vice versa.

(3) Errors of principle: Posting to a wrong type of account for e.g. Repairs expenses wrongly debited to a Machinery Asset Account.

(c) Name and explain three errors of book-keeping which could cause the Trial Balance to disagree.

Three errors of book-keeping which could lead the Trial Balance to disagree are:

(1) Errors of omission to post part of an entry: e.g. making a debit entry and omitting to make the corresponding credit.

(2) Errors of commission: Debiting an account with e.g. $29.80 and crediting the other account with $28.90.

(3) Errors in the additions of ledger accounts or any of the subsidiary journals.

Question:

Name or describe three types of errors which do not affect the balancing of the trial balance.

The three types of error which do not affect the balancing of the final balance are:

(1) Errors of omission i.e. total failure to record a transaction.

(2) Reversal of entries i.e. entries made on the wrong side of one account and vice versa.

(3) Errors of principle i.e. posting to a wrong type of account for e.g. Repairs expense wrongly debited to a Machinery Asset Account.

Question:

(a) State and explain the purposes of preparing a Trial Balance.

Accounts books are written up according to the double entry system of book-keeping. When a debit entry is made in one account, the corresponding credit entry of the same amount is made in another account. Thus it follows that the total debit entries must be equal to total credit entries. To check whether the two totals are equal, a trial Balance is drawn up.

The Trial Balance is extracted at a certain date, usually the last day of the trading period. On this day, a list of all the accounts in the Ledger is made and the debit and credit entries of these accounts totaled. If the double entry principles of recording have been strictly followed to the total of all the debit entries must be equal to the total of all credit entries.

Thus the Trial Balance is prepared for the purpose of checking the arithmetic accuracy of the entries made in the ledger.

(b) State three different types of error which a Trial Balance will not reveal.

Three different types of error which a Trial Balance will not reveal are:

— Complete Omission of a transaction so that there is no debit or credit entry.

— Entry of a transaction on both sides but in the wrong account or accounts.

— Errors in original entry — where the original figures was incorrectly entered although the correct double entry principle has been observed.

(c) Explain, with examples, three errors of bookkeeping which could cause the Trial Balance to disagree.

Three errors of book-keeping which could cause the Trial Balance to disagree:

• Wrong addition in any account in the General Ledger

— Sales account under added by £115.

This will result in the disagreement of Trial Balance. The credit side will be less than the debit side of the Trial Balance by £115.

• Omission of either the debit or credit entry of a transaction.

— £75 cash received from T. Jones, a debtor was recorded in the Cash Book only. This error of omitting the posting of amount on the credit side of T. Jone's Account will result in a higher debit total of Trial Balance by £75.

• Entry into the wrong side of an account.

— Interest paid £50 was credited to the Cash Book but was wrongly credited to Interest Received Account. An expense paid £50 but posted wrongly to the credit side of an Income Account will make the credit side of Trial Balance to be more than the debit side by £100.

Capital & Revenue

Question:

Explain the difference between Capital Expenditure and Revenue Expenditure.

Capital Expenditure is the purchase of fixed assets of which the useful life is longer than one accounting year. For example the purchase of motor vehicles, furniture and equipment or even substantial expenses incurred to renovate a building. Capital Expenditure is entered in the Balance Sheet.

Revenue Expenditure is expenses incurred due to the day-to-day activities and transactions. It could be in the purchase of tangible goods such as packing materials, small terms of stationery. Or it could be in the purchase of services like PUB Services, Telephone, Rent of a place or repairs of equipment. Revenue Expenditure is entered in the Trading and Profit & Loss Account.

State which of the following are Capital Expenditure and which are Revenue Expenditure. Give your reason in each case.

i. ***Purchase of packing material from Cartons Ltd for dispatch of goods.***

Revenue Expenditure:
Because packing material is used for that accounting year.

ii. ***Payment by cheque for air freight costs of goods exported.***

Revenue Expenditure:
This Air Freight costs are incurred to sell the goods for that accounting year.

iii. ***Purchase of laser printer for use in own office from Alpha Business Equipment.***

Capital Expenditure:
This laser printer can be used for more than 1 accounting year. So keep it in Balance Sheet as Fixed Asset.

iv. ***Orzel, a partner in the firm, paid for motor vehicle parts for the firm out of her private bank account.***

Capital Expenditure:
If the parts is for the betterment of the Motor Vehicle.
If the purchase of the parts is just a repair and service expenses for Motor Vehicles, then it should be Revenue Expenditure. (Note: A. Orzel will be repaid by the firm).

Question:

Explain briefly the difference between capital expenditure and revenue expenditure

Capital Expenditure is expenses incurred to buy assets having a life duration extending over several accounting periods, e.g. vehicles, furniture and equipments. It also includes major expenditures to renovate or improve the usefulness of such assets. Capital Expenditure is added to the cost of the relevant fixed assets, thus carried forward to future years. On the other hand Revenue Expenditure is expenses incurred for assets or services which will be consumed within the current accounting period e.g. rent expense, wages, supplies of stationeries, etc.

This is matched off against the revenue earned for that period. It should not be brought forward to the next accounting year.

If capital expenditure is incorrectly treated as revenue expenditure, state the effect in the buyer's books on:

(i) net profit (ii) fixed assets

(i) Net Profit would be understated. For example, purchase of motor vehicles at $30,000 is incorrectly charged to Net Profit (as an expense) causing Net Profit to be understated by $30,000.

(ii) Fixed Assets would be understated. Referring to the example above, charging the $30,000 to Net Profit as an expense would mean no record in the Fixed Assets account, thus understating Fixed Assets by that amount.

Various business transactions of a department store are given below. State whether they result in capital expenditure or revenue expenditure. Give reasons in each case.

(i) Purchase of computer print-out stationery

Capital Expenditure. It's not for resale but for use in the store.

(ii) Purchase of goods for re-sale

Revenue Expenditure. Goods for re-sale are stocks, which are charged to Net Profit of the year.

(iii) Installation of new escalator in the store

Capital Expenditure. Its for betterment of facilities in the store.

(iv) Cost of painting the store

Revenue Expenditure. Its the cost of maintenance.

(v) Purchase of computers for staff use

Capital Expenditure. These are fixed assets for use in the store.

(vi) Cost of rebuilding a fire-damaged warehouse.

Capital Expenditure. It's a long-term, one-time cost of rebuilding the fire-damaged warehouse.

Bad Debts

Question:

Explain the reason for the annual calculation of a provision for the doubtful debts. What name is given to this concept?

The purpose for the annual calculation of a provision for doubtful debt is to allocate a bad debt cost which represents a loss, to the period in which it occurs. The debts due by our customers represent an asset. It is inevitable that from time to time certain debtors will fail to pay their accounts. However, the debts are usually found to be bad in an accounting period after that in which the sale and thus the revenue was brought to account. The effect of this is to distort the accounting profit of both the periods concerned, because there is no acceptable matching of expense with revenue for either period. Thus it is customary in the period in which the sales revenue is recognized, to estimate the amount of debts which is not expected to be collected, and charge it as an expense to the Profit and Loss account. This is in line with the matching concept.

Question:

Explain the reason for the annual calculation of a provision for doubtful debts.

In order to get as accurate a figure as possible for debtors who appear in the Balance Sheet as an Asset, it is essential to provide for doubtful debts. This is done by estimating the number of debtors who will never pay their accounts. By providing for doubtful debts — the profits automatically decreases — which is the correct accounting practice. It is recognized that the provision for bad and doubtful debts is a necessary expense to earn that periods profits.

Stock Valuation

Question:

If closing stock was undervalued by £1,000, what would be the effect on a firm's Gross Profit?

If closing stock had been undervalued by £1,000, cost of goods sold would be overstated by as much, thus understating Gross Profit by £1,000.

Question:

State the accounting principle on which stock is valued.

Stock is valued using the rule of lower of cost or net realizable value (market value) in accordance with the prudence concept, which does not recognize unrealized profits but provides for unrealized losses.

Question:

A firm's stock at the end of its financial year was shown incorrectly in the Trading Account as £16,400. It should have been £14,600. What was the effect of this error on the gross profit?

If closing stock is overvalued, Cost of Goods Sold would be undervalued. An undervaluation of Cost of Goods Sold would cause the Gross Profit to be over valued by the difference / error (£16,400 - £14,600) = £1,800.

Question:

What is the usual basis for the stock valuation that is included in the year-end Final Accounts? Explain the reason for choosing this basis.

The usual basis for the stock valuation that is included in the year-end Final Account is The Lower of Historical Cost or Market / Net Realizable Value.

The reason for choosing this basis is to observe the 'Doctrine of Conservatism'. This concept calls for to provide for all losses but anticipate no gains. The concept is to select the method of measurement that yields the 'gloomiest' immediate results. This is because erring in the direction of conservatism would usually have less-severe economic consequences than erring (making a mistake) in the direction of overstating assets and net income.

If we value ending inventory at NRV (market value) when NRV is higher than cost, then we would be recognizing unrealized profits. The higher ending inventory will give a lower cost of goods sold and thus a higher profit. This would be misleading to financial statement users.

Question:

State why stock is normally valued at the lower of cost or net realizable value when final accounts are prepared?

Stock is normally valued at the lower of cost or net realizable value when final accounts are prepared because of the adoption of the Doctrine of Conservatism which does not recognize unrealized profits but provide for unrealized losses. Unrealized profits will arise if we value ending inventory at NRV when NRV is higher than cost. This is because a higher closing stock will give a lower cost of sales and thus a higher profit, on the other hand, unrealized losses will be provided for if we value ending inventory at NRV when it is lower than cost.

Question:

Explain why stock is normally valued at cost price not at selling price.

Stock is normally valued at cost price and not its selling price is because of the adoption of the Doctrine of Conservatism which does not recognize unrealized profits but provide for unrealized losses. This concept is to select the method of measurement which would not show a higher profit, thus, misleading financial statements users. To value the stock at its selling price (which is higher than cost price) will cause Cost of goods sold to be lower, hence making profits higher. To err (to make a mistake) in the direction of conservatism (i.e. provide for unrealized losses) would usually have less-severe economic consequences than erring (making a mistake) in the direction of overstating assets (stock in balance sheet will be higher) and net income.

Question:

State and explain the accounting principle on which stock is valued.

Stock is valued using the rule of lower of cost or Net Realizable Value in accordance with the Prudence Concept. This concept does not recognize unrealized profits but provides for unrealized losses. Choosing the lower of the two costs, would lead to a lower closing stock value. A lower closing stock value would lead to a higher Cost of Goods Sold which ultimately would lead to a lower gross profit (see the effects as indicated below).

Opening Stock	—
Add Purchases	—
Cost of Goods available for sales	—
Less Closing Stock (↓)	lower (↓)
Cost of Goods Sold (↑)	higher (↑)
Sales	—
Less Cost of Goods Sold (↑)	higher (↑)
Gross Profit (↓)	lower (↓)

The main aim is to select the cost which would show the gloomiest results (profit). This is better than showing a high profit value which could mislead financial statement users.

Depreciation

Question:

Why is it necessary to provide for depreciation in the accounts of a business?

Fixed assets help to generate revenue. Their values keep falling as a result of wear & tear during business operations. As these assets are capitalized when purchased, it is only rational to provide for depreciation every year to allocate part of the costs as depreciation expense to charge against the revenue earned during the same accounting period.

Question:

a. Suggest which of the balance sheet items should be depreciated.

(ii) State and explain two reasons why the depreciation of fixed assets should be provided for in business accounts.

b. (i) State and explain two different methods of depreciation.

c. State one advantage of each of the methods you

have described in (b).

(a) (i) The Balance Sheet items which should be depreciated are:

(1) Premises
(2) Plant
(3) Vehicles

(ii) (1) To provide for the wear and tear of the assets used during business operations.

(2) For a better allocation of costs against revenue, as depreciation is charged every year.

(b) (i) Two different methods of depreciation are:

(1) Straight-Line Method

This method allocates a constant amount of depreciation throughout the life of the asset.

(2) Reducing / Declining-balance Method

In this method, depreciation is provided by means of periodic charges calculated as a constant proportion of the balance of the asset after deducting the amount previously provided.

(c) Advantage of Straight-Line Method:

It is simple to apply and easy to calculate.

Advantage of the Reducing-Balance Method:

Useful for assets which are mostly efficient in the earlier years of their life. Provides a more truthful allocation of depreciation.

Question:

State two reasons why it is necessary to provide for the depreciation of fixed assets in drawing up a business profit & loss account.

(a) It is necessary to provide for the depreciation of fixed assets because :

(i) To provide for the wear and tear of the assets in the business. Assets go through wear & tear throughout their useful years. It is more logical to provide for the yearly wear and tear than writing off the whole amount in lump sum when they are disposed off.

(ii) To better allocate costs against revenue i.e. to charge to revenue, the wear & tear of the assets in the year they are used to generate the revenue.

Ratios Analysis

Question:

Why is it important that a business had adequate working capital?

Sufficient working capital is necessary in a business in order to carry out the day to day operations of the business; for instance buying goods, paying expenses, granting credit sales and so forth. If working capital is insufficient, the following situations may arise:

1. Loss of sales for there is insufficient stock to meet customers' demands.
2. Insufficient cash to pay for day-to-day expenses.
3. Difficulty to get credit as a consequence of not being able to pay creditors in time. Liquidity of business is an important criteria in granting credits by creditors.

As such, it is vital that a business maintains sufficient working capital so that the enterprise can be carried out profitably and efficiently.

Question:

State the formula for calculating working capital.

The formula for calculating Working Capital is:

Current Assets Less (-) Current Liabilities.

Question:

i. How is Working Capital calculated?

ii. Why may a business fail through insufficient Working Capital?

iii. Give two examples of how a sole trader can increase his Working Capital but still be a sole trader.

(i) Working Capital = Total Current Assets-Total Current Liabilities

(ii) Working Capital represents the funds available in the business to finance the day-to-day transactions the business. Thus, if there's insufficient Working Capital, the firm will not be able to finance the said activities, i.e. current operations such as repayment to creditors, purchases of stock, payment of bills etc.

(iii) Two examples how a sole trader could increase his Working Capital are:

(1) Sell off his Fixed Assets. Here cash will increase and thus, Current Assets will increase. Thereto Working Capital will also increase.

(2) Increasing Sales by either promoting discounts or reducing the sale price. With this, cash or debtors will increase and hence Working Capital will also increase.

Question:

Give two examples of problems that a business may have if there is not enough working capital.

If there is not enough Working Capital, a business may have the problems of

(1) Meeting (paying off) short-term / Current Liabilities i.e. paying short-term debts and obligations.

(2) Running the daily day-to-day operations.

Question:

Describe two ways in which a sole trader can increase the working capital.

Two ways in which a sole trader can increase the Working Capital are:

(1) Delaying payments to long-term creditors (increase cash).

(2) Borrowing money from long-term creditors (long-term loans) (increase cash).

Question:
State what is meant by the following items. State the formula where appropriate.
(i) Working Capital

(ii) Owner's Capital

(iii) Capital Employed

(iv) Authorized Share Capital

(v) Loan Capital
Explain the importance of working capital to a business.

i. Working Capital represents the funds available in the business to finance day-to-day transactions such as payment of bills, purchases of stock.

   Working Capital = Total Current Assets - Total Current Liabilities.

ii. Owner's Capital is the amount of funds contributed by the owner to the business plus net profit less drawings. Owner's Capital = Total Assets - Total Liabilities.

iii. Capital Employed is represented by Total shareholder's funds + Long-term liabilities.

   Capital Employed = Share capital + Reserves + Long-term liabilities (Debentures + Long-term loan etc). Capital Employed can also be calculated as follows :
   Fixed assets + Current assets + Other assets - Current liabilities.

iv. Authorised Share Capital is the maximum share capital that a company can call up or issue. This amount is specified in the memorandum of Association of the company. The amount can only be changed upon registration with the Registrar of Companies.

v. Loan Capital also known as borrowed capital, it denotes funds raised by long-term loans for example debentures. The word capital is used mainly for accounting convenience and does not ordinarily intended to be included as capital of a company.

Question:
Explain how one could use information regarding his rate of stock turn.
Suppose the rate of stock turn is 20 times for that year which is considerably high. Although a high rate would normally indicate that the business is doing well, one should be cautious as it could mean something else. Whether the rate is considered good or not depends on the type of products he is selling. Goods with

low markups over cost such as food items should have rapid turnover while goods with high markups over cost such as jewellery, do not need to have rapid turnovers. A high rate could also mean that one is keeping his inventory too low. Although this may save costs of keeping the inventory (like warehouse costs, insurance etc ...), he may lose sales as customers cannot find what they want or do not wish to wait. It is better than one compares this rate with those of past years and with those of other traders in the same business.

Question:

Give two examples of problems that a business may have if there is not enough working capital.

Two examples of problems that a business may have if there isn't enough Working Capital:

(i) Business will not be able to take advantage of valuable cash discounts since creditors may not be paid on time.

(ii) There is always this likelihood of the business not being in a position to take advantage of profitable business opportunities during this period.

Question:

Describe and explain two ways in which a sole trader can increase the working capital.

Firstly the sole trader can bring in additional capital in the form of cash. On one hand this will increase the capital and on the other hand liquid cash will also increase resulting in the increase of working capital.

Secondly, a sole-trader can also increase the amount of his working capital by taking a long term loan from the bank, if it has some fixed asset which is acceptable by the bank as security. This will result in flow of cash into the business thus resulting in an increase in working capital.

True False

***Question*:**

Giving brief reasons for your answers, state whether each of the following statements is true or false:

(a) If a business makes a profit, the cash and bank balances in the year end Balance Sheet will show this increase.

(b) A payment made in one financial year can be an expense in the following financial year.

(c) A Provision for Depreciation Account shows the amount of cash the business has set aside to replace the Fixed Asset concerned.

(d) Fixed Assets are always shown in a Balance Sheet at the market value on that date.

(a) The statement is false for the following reasons:

(i) Profit is determined not on the basis of the inflow or outflow of cash but rather on an accrual basis. Thus, although the profit may be high, cash may be tied up with:

(1) Unsold stocks
(2) Debtors
(3) Prepayments

(ii) Profits may have also been invested in long-term investments such as shares and fixed assets.

(iii) The owners could have withdrawn cash from the business as in the case of sole trader and partnership, or in the form of dividends as in the case of companies.

The profitability of a business cannot be used as a basis to determine the liquidity of the business. A business may obtain high profits during the year but find that it is unable to pay off debts to creditors as cash is tied up with non-liquid assets like stock or fixed assets.

(b) True. Not all expenses incurred are a result of activities that occur during the accounting year. Expenses may be paid in advance or remain unpaid until the next year. Businesses may prefer to pay bills / expenses in advance. However, at the end of the year, there is a need to separate those expenses which have expired / used up (e.g. telephone charges for the year) and those which have not expired (services / activities not yet used up). These unexpired costs will be brought forward to next year.

(c) False. A provision for depreciation is the accounting for the fall in value of the asset. This is merely an accounting adjustment and there is no movement of cash into or out of the business. The estimate is just to allocate cost to revenue for the job done by the fixed asset.

(d) False. The balance sheet is prepared on a historical cost basis which means that fixed assets are shown at actual cost paid less its accumulated depreciation amount.

Question:

State whether each of the following is TRUE or FALSE. Give brief reasons for each answer.

(a) A payment made in one financial year can be an expense in the following year.

(b) A Provision for Depreciation Account shows the amount of cash the business has available to replace the fixed asset concerned.

(c) Between the end of one year and the end of the next year, the cash and bank balances will always increase by the amount of the net profit made during the year.

(d) When a balance sheet is prepared, it is always the accounting practice to show the fixed assets at the market value on that date.

(a) TRUE

Not all expenses incurred are a result of current activities. Advance payment may be made and is called Prepayments or Prepaid Expenses. This payment should not be entered in the Profit & Loss Account as it is an expense for next year. Charge to the following year Profit & Loss. For this year (the year when the payment is made), charge it to an asset a/c in the Balance Sheet.

When Payment is made:

Dr. Prepaid Expenses A/c

Cr. Cash at Bank A/c

The following year, adjustments to be made:

Dr. Expense A/c (Profit & Loss)

Cr. Prepaid Expense A/c

(b) FALSE

Depreciation is merely an allocation of the depreciable amount of an asset over its estimated useful life. Depreciation indicates that the usefulness of an asset has declined.

This is merely an accounting adjustment and there is no movement of cash into or out of the business. Thus, depreciation does not show the amount of cash the business has available to replace the fixed asset concerned.

(c) FALSE

Profit is determined not on the basis of the inflow or outflow of cash but rather on accrual basis i.e. whatever expenses incurred, whether paid or unpaid, will appear in Profit & Loss A/c and likewise, whatever revenue is earned, whether cash received or not yet received, will appear in Profit & Loss A/c.

A business may obtain high profits for the year but has low cash balance as the cash may be tied with unsold stocks, debtors, prepayments.

(d) FALSE

The balance sheet is prepared on a Historical Cost Basis which means that fixed assets are shown at actual cost paid less its accumulated depreciation amount.

To show the assets at market value may result in the company having gains (if market value is higher than historical cost) or having tosses (if market value is lower than historical cost).

However, companies may carry out revaluation procedures to revalue the assets according to market price or its usefulness. The gains or losses from revaluation must be clearly shown in the Balance Sheet to distinguish it from the trading profit or loss.

Question:

The following sentences are incomplete. Give the word/words or figure/ figures to complete the sentences. Do not write out the whole sentences.

Example: A bank statement shows an overdraft as a ____ balance. Answer, debit

(a) The purchase of fixed assets is __________ expenditure.

(b) Debentures earn a fixed rate of __________

(c) Preference shares earn a fixed rate of ___________

(d) A debit balance on a sole trader's capital account means that the business is ______

(e) A fixed asset costing £21,000 has an estimated useful life of five years, after which it has a scrap value of £1 000. The annual depreciation on a straight line basis will be _______

(f) The issued capital of a company cannot exceed the ________ ________

(g) Subscriptions in advance from club members are shown as a ———— in the Balance Sheet.

(h) If closing stock is undervalued, net profit will be _________

(i) The value of the good reputation and profitability of a business is known as _______

(j) Working capital is found by deducting ________ ________ from current assets.

(k) Cash discount is an allowance for __________ __________

(I) If a customer has been undercharged, he may be sent a __________ ________ for the additional amount instead of an amended invoice.

(a)	Capital	(b)	Interest	(c)	Dividend
(d)	Insolvent	(e)	£4 000	(f)	Authorized Capital
(g)	Liability	(h)	Undervalued	(i)	Goodwill
(j)	Current Liabilities	(k)	Prompt Payment	(I)	Debit Note

General Questions

Question:

Why is the balance of the Capital Account normally shown as a liability in the balance sheet? If it appeared as an asset, what would it indicate?

It is normally shown as a liability in the Balance Sheet because it represents a loan; money owed by the business to the owner of the business. The owner has put in his own money into the business, in other words he lends his money to the business. The business has to repay the owner when business is liquidated.

If it appeared as an asset, it indicates that the capital belongs to the business and the Owner has no right to the money he contributed, in time of liquidation.

Question:

Explain briefly three differences between a Receipt & Payments account and an Income & Expenditure account.

The three differences between a Receipts and Payments Account (R & P) and an Income and Expenditure Account (I & E) are as follows:

i. a R & P A/c shows the actual movement of cash into and out of the club / society. It shows the cash inflows and outflows. The I & E A/c shows the income received and expenses incurred during the year. But it does not denote actual movement of money.

ii. R & P A/c shows an opening balance which is the balance of cash in the bank. The I & E A/c has no opening balance.

iii. R & P A/c will show a closing balance which is actually the balance of cash in the bank at the end of the year. The I & E A/c will give a surplus if income is more than expenditure or a deficiency if expenditure is more than income.

Question:

Explain briefly three differences between fixed assets and current assets.

Three differences between fixed assets and current assets are:

(1) Fixed Assets are durable in nature and are relatively long life (i.e. can last more than 1 accounting year) whereas currents assets are items of a short-term in nature.

(2) Fixed Assets are used in the operation of the business and not intended for sale whereas Current Assets are acquired for use in operations or for resale.

(3) Fixed Assets are normally subjected to depreciation while Current Assets are not.

Question:

Briefly explain the meanings of Goodwill.

Goodwill can generally be defined as the benefits derived from a favorable reputation among customers. It is composed of a variety of elements such as location of the business premises, manufacturing efficiency, and nature of firm's products or reputation of its services. It is sometimes viewed as that portion which provides momentum to future profits. A firm possessing greater goodwill is more likely to perform well.

Question:

Owners need to check the progress of their businesses from year to year. Such as you have prepared Statements of Profit & Loss do not give all the information needed for this purpose.

State three ways in which a trading and profit and loss account drawn up from full double entry records gives the information about a business which the owner needs.

A Trading and Profit and Loss Account drawn up from double entry records shows, among others (i) Sales (iii) Expenses (ii) Gross Profit. These data cannot be found in the statement of profit & loss.

Sales data are important so that owners can see how much sales are made for that year and hence can compare to other years. The future of a business depends on its sales volume. So this data is important if an owner wants to check the progress of their businesses.

Expenses represent the cost of the goods and services used up in the process of obtaining revenue. Owners can see where their money goes to and whether any effort is made to control costs and expenses. High sales may be offsetted by high expenses, hence resulting in low net profit. Low expenses must be ensured to secure maximum profits.

Gross Profit is used to help determine whether the products sold are profitable. It also helps owners in deciding whether to increase or decrease price and whether costs could be reduced further.

Question:

A person often has to pay for goodwill when admitted as a partner or when taking over a business. State what factors are taken into account when goodwill is determined?

When an established business admits a new partner, the question of goodwill has to be considered. An established business which has built up a reputation among its customers is able to earn more profits than a new business starting in the same trade for the first time. When a new partner is admitted into an existing business he will have a share of the future profits of the business and also a share of the goodwill. Goodwill arises from a combination of various factors. It may arise from:

1. the favorable location of the business.
2. the personality of the proprietor.
3. the reputation for service and quality of goods.

It is therefore essential that the incoming partner should pay for his share of the goodwill which has been created by the old partners.