

FRANK WOOD'S

# BUSINESS ACCOUNTING 2

THIRTEENTH EDITION



ALAN SANGSTER

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**BUSINESS ACCOUNTING 2**



Frank Wood  
1926–2000

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THIRTEENTH EDITION

# 2

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## Supporting resources

Visit [www.pearsoned.co.uk/Wood](http://www.pearsoned.co.uk/Wood) to find valuable online resources

### For instructors

- Complete Solutions Manual for answers within the book
- PowerPoint slides that can be downloaded and used for presentations



# Dedication

For Aparecida who thinks this is what it is not and not what it is.

# Notes for teachers and lecturers

This textbook has been written so that a very thorough introduction to accounting is covered in two volumes. The split into two volumes is made in recognition of the fact that many students new to accounting will find all that they require in *Frank Wood's Business Accounting 1*.

This second volume completes the coverage of the financial accounting and management accounting parts of many examinations in accounting and should be suitable for anyone studying intermediate and final level financial accounting or anyone studying management accounting at introductory and intermediate levels on courses at school, college, or university; or studying for qualifications from the LCCI, Association of Accounting Technicians, the Institute of Secretaries and Administrators; or for qualifications of any of the six UK and Irish Chartered Accountancy bodies.

As examination syllabuses are constantly being revised, it would not make sense to be too specific as to which chapters would be needed by students taking each of the various examinations. However, **Financial Accounting and Financial Reporting are covered in Chapters 1–39 and Management Accounting is covered in Chapters 40–51.**

While management accounting has evolved to a point where changes in practice are limited, and the double entry method of bookkeeping and the fundamentals of financial accounting have long been established, the same is not true of financial reporting. Far from being the never-changing subject many perceive it to be, it is in a constant state of change. The current major ongoing change, begun in 2005 and still ongoing, is the switch from domestic accounting rules to international rules. Specifically, the rules that had been developed in the UK since 1970, known as Statements of Standard Accounting Practice (SSAPs) and Financial Reporting Standards (FRSs), are being phased out. In their place most businesses are now using International GAAP, i.e. International Financial Reporting Standards (IFRSs) and International Accounting Standards (IASs).

Some small and medium-sized businesses continue to use UK standards. These were consolidated and revised in 2013 and 2014 and now have simpler requirements more in keeping (in terms of length and detail, but not in substance) with those issued under International GAAP. It now seems only a matter of time before all businesses will be using International GAAP.

A number of changes have been made in this new edition, some topics have moved within the book, some new ones have been added, and all the content has been updated. Major changes include:

- The term 'Income statement' has been replaced throughout with, 'Statement of profit or loss'. This is in line with the IFRS. The change was requested by a number of users of the book who felt it more appropriate, not simply because it was recommended by the IASB, but because it reflected more accurately the content of the statement.
- Chapter 2 has been retitled *Purchases by instalments* to better reflect its contents.
- Chapter 11 has been renamed *Accounting standards, related documents and accounting ethics*. It has been updated to incorporate international standards in issue in February 2015 and a new section, 11.49, *Professional ethics*, has been added in response to requests that students be made aware of this aspect of accountancy practice.
- Chapter 12, *The financial statements of limited companies: statements of profit or loss, related statements and notes*, now includes a new Section 12.2 which contains what was previously in Sections 19 and 21 of Chapter 29, *Accounting theory*.

- Chapter 26 has been extensively revised and retitled *Standards covering subsidiaries, associates and joint arrangements* following changes introduced by recent changes to IAS 27, *Separate financial statements*.
  - Chapter 27, *Interest, annuities, and leasing*, was previously Chapter 45.
  - Chapter 29 (was Chapter 28) has been retitled *Interpretation of financial information* and Section 29.8 has been added on **Earnings Management**. This was added in response to requests to provide students with some understanding of what is actually done by organisations to portray the financial performance and financial position they wish to show rather than the one that simply presents a true and fair view.
  - **Chapter 30, Theories of accounting-related choice, is new** and has been added at the request of some reviewers who wished to be able to take their students beyond the interpretation of financial information presented in Chapter 29. **This new chapter presents many of the theories typically included in courses on Accounting Theory.** These theories describe, explain, and predict accounting-related choices made by companies, managers, investors, groups of stakeholders, and regulators. In addition, social judgement theories are introduced that explain how some accounting-related decisions are taken.
  - Chapter 31 (previously Chapter 29) has been retitled *Theories of accounting practice* to better reflect its focus upon theories that underpin accounting practice. Two sections from Part III (Objectives of financial statements), Sections 19 and 21, have been moved to Chapter 12. The remaining section in Part III has been deleted as its topic is covered elsewhere.
  - Chapter 33 (previously Chapter 31) has been completely rewritten. It now also includes **integrated reporting** and has been retitled *Social and environmental reporting and integrated reporting*.
  - Chapter 34 (previously Chapter 32), *Corporate governance*, has been extensively rewritten to incorporate recent legislation and updates of the relevant Codes.
  - Part 10 has been moved to become Part 6 with Chapters 48 (*The supply chain and enterprise resource planning systems*), 49 (*E-commerce and accounting*), and 50 (*Forensic accounting*) becoming Chapters 37, 38, and 39, respectively.
  - Chapter 38 (previously 49), *E-commerce and accounting*, has been updated to reflect current trends.
  - Chapter 39 (previously 50), *Forensic accounting*, has been extensively revised.
  - The *Notes for Students* on the next page have been updated.
  - Over 120 new questions have been included in this edition.
- As previously:

- 1 Each chapter:
  - (a) starts with *Learning Objectives*;
  - (b) uses colour, especially blue, to enhance readability and bring out key points in the text;
  - (c) contains *Activities* designed to broaden and reinforce students' understanding of the concepts being covered and, in some cases, to introduce new concepts in such a way that they do not come as a surprise when introduced formally later in the book;
  - (d) ends with *Learning Outcomes* that can be mapped back to the Learning Objectives, so reinforcing the major topics and concepts covered in the chapter;
  - (e) contains answers to all the Activities immediately after the Learning Outcomes.
- 2 The book has an alphabetical Glossary (in Appendix 3) of all the significant terms introduced, including those added for the first time in this edition. Each entry is referenced back to the chapter in which it appeared.
- 3 A set of Notes for Students is presented on the next page. This covers how to use this book, how to tackle the end-of-chapter Review Questions, and how to study for and sit examinations. It should be read by students before they start working through the main text.

I hope that you find these changes helpful and appropriate and would welcome comments on these and on any other changes you feel ought to be made in future editions. You can contact me by email at [a.j.a.sangster@btinternet.com](mailto:a.j.a.sangster@btinternet.com) or by letter via the publishers.

Three chapters from the *eighth* edition (3, *Container accounts*; 17, *Value added statements*; and 18, *Investment accounts*) can be found on this book's website.

A *Solutions Manual* giving suggested solutions to those questions with the suffix A in the book (e.g. 5.8A) is available to teachers and lecturers adopting this book on their course. They can download them from the lecturers' section of the website for *Frank Wood's Business Accounting 1* and *Frank Wood's Business Accounting 2* at [www.pearsoned.co.uk/Wood](http://www.pearsoned.co.uk/Wood).

Finally, I would like to thank all those teachers and lecturers who contacted me offering advice as to the changes they would like to see incorporated in this edition. A special mention should go, in particular, to Christopher Foo for all his advice and contributions over the past decade.

*Alan Sangster*

# Notes for students

This textbook presents your topics in what has been found to be the most appropriate sequencing of topics as you build upon the foundations of accounting knowledge that you developed when you studied *Frank Wood's Business Accounting 1*. You will find that a number of features of the book, properly used, will enhance your understanding and extend your ability to cope with what will possibly appear, at first, to be a mystifying array of rules and procedures.

While much, but by no means all, of what follows was in *Frank Wood's Business Accounting 1*, all of the advice given to you in that book will apply to you throughout your studies of accounting, whatever the level. I therefore offer no apologies for repeating some of it here along with some new advice appropriate to the level of *Frank Wood's Business Accounting 2*.

In order to make best use of this resource, you should consider the following as being a proven path to success:

- At the start of each chapter, **read the Learning Objectives**. Then, while you work through the material, try to detect when you have achieved each of these objectives.
- At the end of each chapter **check what you have learnt against the Learning Outcomes** that follow the main text.
- If you find that you cannot say 'yes, I have achieved this' to any of the Learning Outcomes, look back through the chapter and reread the topic you have not yet learnt.
- **Learn the meaning of each new term as it appears**. Do not leave learning what terms mean until you are revising for an exam. Accounting is best learnt as a series of building blocks. If you don't remember what terms mean, your knowledge and ability to 'do' accounting will be very seriously undermined, in much the same way as a wall built without mortar is likely to collapse the first time someone leans against it.
- **Attempt each of the Activities in the book at the point at which they appear**. This is *very* important. They will reinforce your learning and help set in context some of the material that may otherwise appear very artificial and distant from the world you live in. The answers are at the end of each chapter. **Do not look at the answers before you attempt the questions; you'll just be cheating yourself**. Once you have answered one, check your answer against the one in the book and be sure you understand it before moving on.
- Above all, remember that accounting is a vehicle for providing financial information in a form that assists decision-making. Work hard at presenting your work as neatly as possible and remember that pictures (in this case, financial figures) only carry half the message. When you are asked for them, words of explanation and insight are essential in order to make an examiner appreciate what you know and that you actually understand what the figures mean.

There are two subjects we would like you to consider very carefully: making best use of the end-of-chapter Review Questions and your examination technique.

## Review questions: the best approach

As I did in *Business Accounting 1*, I have set Review Questions at the end of most chapters for you to gauge how well you understand and can apply what you have learnt. **If you simply read the chapters without attempting these questions, you will not pass your examinations**. You should

first of all attempt each question for which there is an answer at the back of the book. Then check it fully against the answer.

**Do not simply compare the question with the answer and tick off the bits of the answer against the relevant part of the question.** Doing so is no substitute for attempting to answer the question. No one ever learnt to do accounting properly that way. It is tempting to save time in so doing, but you will regret it eventually.

## Need for practice

Try to find the time to answer as many Review Questions as possible. This is why:

- 1 Even though you may think you understand the text, when you come to answer the questions you may find you don't. The true test of understanding is whether or not you can tackle the questions competently.
- 2 It is often said that practice makes perfect. If you don't practise doing accounting questions you will almost certainly not become good at accounting.
- 3 You need to be able to answer questions quickly: many fail accounting exams because they run out of time. A lot is expected from you in an accounting exam in a very short time because examining boards believe, and have always believed, that an adequately prepared student will be able to work quickly on the problems set. By an 'adequately prepared' student, they mean a student who not only has the knowledge, but has been trained to work quickly and at the same time maintain accuracy and neatness.
- 4 Speed itself is not enough; **you also have to be neat and tidy**, and follow all the proper practices and procedures while working at speed. Fast, correct, but really scruffy and unreadable work can cause you to fail the exam. Why is this so? At this level the accounting examiner is mainly concerned about your practical ability in the subject. Accounting is a practical subject, and your practical competence is about to be tested. The examiner will therefore expect the answers to be neat and well set out. Untidy work with figures spread over the page in a haphazard way, badly written figures, and columns of figures in which the vertical columns are not set down in straight lines will be penalised and can easily mean the difference between a pass and a fail.
- 5 Appropriate presentation of information is important. Learn how to present the various financial statements you may need to produce in an examination. Examiners expect to see the items in statements of profit or loss, statements of financial position and statements of cash flow in the correct order and will probably deduct marks if they aren't. Practise by writing down examples of these statements without any numbers until you always get the layout correct. One exam trick most students overlook is that the layout of a financial statement is often included in an examination paper as part of one question yet another question asks you to produce an answer using the format of that financial statement. **The one you need to produce will contain different numbers but the general layout should be very similar.**

## Need for headings

Your work should not only be neat, it should be well presented. **Headings should always be given, and any dates needed should be inserted.** The test you should apply is to imagine that you are a partner in a firm of professional accountants and have taken a holiday for a few weeks. During that time your assistants have completed all sorts of work including reports, drafting final accounts, various forms of other computations and so on. All of this work is waiting for you when you return. When you return you look at each item in the pile awaiting your attention.

Suppose the first one looks like a statement of financial position as at 31 December in respect of one of your clients. When you looked at it you could see that it was a statement of financial

position, but you didn't know for which client, neither did you know which year it was for. Would you be annoyed with your assistant who prepared it? Of course you would. So in an exam why should the examiner give you high marks if you prepare a statement of financial position answer without the date or the name of the business or the fact that it is a statement of financial position written clearly across the top? If proper headings are not given, you may lose a lot of marks. **Don't wait until your examination to do this.** You also need to take similar care with sub-totals and sub-headings that need to be shown, such as those for non-current assets or for current liabilities.

## The examiner

When answering an examination question, think about what you would say if you were employing an accounts assistant who gave you a sheet of paper with accounting entries written in the same style as your own efforts in answering the exam question.

Anyone who works in accounting knows well that untidy work leads to unnecessary errors. This is why examiners penalise unclear, untidy, poorly presented work. Examiners want to ensure that you are not going to mess up the work of an accounting department. Even today, accountants still write down many things on paper, so don't imagine that examiners will overlook such messy work just because most accounting is now done using a computer.

Imagine going to the savings bank and the manager says to you: 'We don't know whether you've got £5 in the account or £5,000. You see, the work of our clerks is so untidy that we can never sort out exactly how much is in anybody's account.' We would guess that you would not want to put a lot of money into an account at that bank. How would you feel if someone took you to court for not paying a debt of £100 when in fact you owed them nothing? This sort of thing would happen all the time if we simply allowed people to keep untidy accounts. The examiner is there to ensure that the person to whom they award a pass will be worthy of it, and will not continually mess up the work of any firm at which they may work in the future.

If you want to pass your accounting exam, and your work is untidy, what can you do about it? Well, the answer is simple enough: start right now to be neat and tidy in your work. I did. My writing was so bad that my accounting teacher at school told me to print everything in capital letters. I thought he was mad, but my marks improved immediately, and so did my handwriting and my overall neatness in preparing answers. **Start being neat now. You cannot suddenly become neat in an examination.**

## The structure of the questions

The review questions in each chapter generally start with the easiest and then get gradually more difficult. Some are very difficult and time-consuming. If all the questions were easy, the shock of meeting more complicated questions for the first time in an examination could lead you to fail it. By giving you a mixture of straightforward and complicated questions, you will learn how to deal with the complex issues before meeting them in an exam. It's in your best interests not to ignore review questions you find hard. Put in the effort, the practice will increase your knowledge and understanding, and your performance in the exam will improve as a result.

## The answers

At the back of the book, you will find answers to approximately half of the Review Questions. The answers to the other Review Questions (indicated by the letter 'A' after the question number) are only available to you from your teacher or lecturer. Don't worry if you are studying this subject on your own. There are still more than sufficient Review Questions with answers in this book to ensure you know and understand the material you are learning.

## Examination technique

If you were completely devoid of examination technique, you would probably not have advanced to this stage of your accounting studies. A lot of what follows was written in *Frank Wood's Business Accounting 1*. Don't avoid reading it just because you read it when you were studying the material in that book.

In your first accounting examination you were competing with people who had probably never sat an accounting examination before. A lot of them will not get past Stage 1. In Stage 2 you are competing against people who have already proved they have a certain degree of competence in the subject. You might have got away with a certain amount of poor examination technique at Stage 1, but that will not be as easy at Stage 2.

I'll concentrate here on the main deficiencies noted by examiners. These never change.

### Failing to read the question carefully

A large number of students do not answer the questions that they are asked by the examiner. This happens because they have not read the question properly. They answer what they think the examiner wants, not what the examiner is asking for.

Taking a simple example, suppose the examiner sets the following question: 'Describe the use of accounting ratios in assessing the performance of businesses.'

A lot of students will immediately start to describe how to calculate various accounting ratios. Marks which will be obtained – NIL. The question asked for the *use* of accounting ratios, not *how to calculate* them.

Many other students will have concentrated on the word *use*. They will then write their answer based on comparing this year's accounting ratios in a business with those of last year. They may well even mention trends in ratios and that will earn them some extra marks. If they, however, restrict their discussion to comparing ratios of a business for one year compared with other years, they cannot get top marks, no matter how well they have written their answers. They have failed to think carefully enough about what they are being asked: businesses, not a business.

The examiner did not restrict them to only looking internally, so the best answer would be one that looks both internally *and* externally, by mentioning comparison of the ratios of the business with those of its competitors and with the rest of the industry in which it operates. The examiner will have set aside marks for mentioning these external comparisons. Failing to mention them will be guaranteed to lose marks.

**So, (a) read the question carefully, (b) underline the key words to get to the meaning of the question, (c) think carefully about how comprehensive your answer should be.**

Be careful also not to make the opposite mistake: *don't* go beyond what is asked in the question. In this example, the question is asking about the *use* of *accounting* ratios, *not* the use of *all types* of ratios. Besides accounting ratios there are marketing ratios – e.g. size of share of market, how long it takes to supply orders, ratios of defective goods, etc. The question does not ask for these. If you give them, you will not get any extra marks, no matter how well you do so.

### Poor time management

Using time well to gain the highest possible marks is essential. Examiners constantly report that students are very poor in this aspect of tackling an examination. How, then, can you avoid the usual pitfalls?

First of all, **read the rubric carefully**. This is the instructions at the top of the paper. For example, 'Attempt four questions only: the three questions in Section A and one from Section B. Begin each answer on a separate page.'



There are four instructions in this rubric, but some students won't notice. Some, for example, will try to answer more than one question from Section B. If you tackle two questions from Section B, you will get marks for only one of your answers. Few examiners will mark both and then give you the marks for your highest marked answer. Many will simply mark the first of the optional questions answered and ignore the next, unnecessary, answer. As a result, your best answer may not gain any marks.

Having been told to do so, if you don't **start each answer on a new page**, you'll only annoy the examiner, which is the last thing you should do. It is your job to make the examiner's work as easy as possible. Examiners are only human, and it would be surprising if their annoyance did not result in its influencing the marking of your paper.

Whatever the rubric, you really *must* attempt each and every question you are required to answer according to what is said in the rubric. If you have to answer five questions then you must avoid attempting only four questions. You won't get the extra marks for the question you did not attempt added to your total. They will be lost, permanently.

Students often feel that they would be better spending their time getting four good answers instead of five answers, some of which have not been finished. In accounting examinations this is not true:

- 1 Accounting examiners use positive marking. This means that if you have done 80 per cent of an answer worth 20 marks in total, and you have got it absolutely correct, then you get 80% of 20 = 16 marks.
- 2 **The first marks in a question are the easiest marks to obtain.** It is easier to get the first 10 marks out of 20 than it is to get the second 10 marks. By attempting all the questions you have to answer, you ensure that you get the easiest marks on every question. Any questions you finish will raise your mark even higher but **do not finish answering a question if it means you do not attempt to answer a question you were required to answer.**

To ensure that you tackle (not necessarily finish) each question you should **mark the number of minutes to be allowed by yourself for each question**. Thus, a 20-mark question in a 100-mark exam should be given 20 per cent of the time. Twenty per cent of 2 hours = 24 minutes. When 24 minutes have passed, *stop answering the question* unless it is the last question to be attempted, and go on to the next question.

If you don't know the answer, or part of an answer, you should guess. You don't lose marks for guessing and, if you guess correctly, you get the marks. Intuition will often give the correct answer. If you don't guess on part of a computational question you will often be unable to go on to the remainder of the question which you can answer.

## Workings

You may wonder why this is under a separate heading. I cannot emphasise enough how important it is that you should:

- (a) submit all your workings; and
- (b) ensure that your workings are set out in a way that the examiner can easily follow.

A very high percentage of candidates in an examination are near the pass mark, within either a few percentage points above it or below it. If you are one of them and, as we have said, there are a lot of you in the same position, handing in workings which can be understood by the examiner will often make the difference between a pass and a fail. Conversely, no workings, or completely messy and unclear workings, may result in your failing an examination you should have passed.

This last point is important. Some students think that putting down a set of random notes and calling them 'workings' will gain marks. It won't. **Examiners won't waste time searching through random notes for something relevant.** Treat your workings as if they, themselves, are part of your answer. **Insert titles and headings to indicate what each item in your workings is for.**

## Tackle the easiest questions first

**Never start your examination by tackling a difficult question.** You must be able to settle down properly and not let your nerves get out of control. Starting off on the easiest question is the best way to enable you to get off to a good start. Much more about this was written in *Frank Wood's Business Accounting 1*.

## State your assumptions

Sometimes a question is ambiguous. Examiners try to prevent this from happening, but it does happen despite all the care taken to prevent it. Questions also do, sometimes, contain errors.

In both of these cases, in your answer, you must point out the ambiguity/error. You should then make an assumption, based on what you thought the examiner meant, and carry on with your answer. **You must state what your assumption is.** Try to make your assumption as sensible as possible. The examiner will then mark your answer accordingly. If you make a ridiculous assumption, it is unlikely that you will be given any marks for that part of your answer. Don't be sarcastic in your comments or complain about inefficiency – there are other times and places for that.

## Answering easy questions

### The problem

Unlike computational answers, you will not know whether your written narrative answers are good enough until you receive your examination result. In addition, written questions lack the certainty and precision of accounting problems and it is often difficult to decide what the examiner requires of you. For this reason, having a sound exam technique is essential, along with precise knowledge of relevant laws and accounting regulations, such as IFRSs.

There are several major aspects to success in written papers. *Plan* your answer, answer the question *as set*, pay attention to good *layout*, and explain in clear and simple terms what you are doing. Remember you can only be marked on what you write down. You have no opportunity to explain any ambiguity in your answers and if what you write is unclear you will *not* get the benefit of the doubt.

### Plan

First read the question and note down the key *verb* within it, i.e. your instructions; this may be to discuss, explain, advise, set out, list, draft an audit programme, write a letter, etc.

If the question requires a discussion or an explanation, it should be written in proper paragraph form. Each paragraph should be self-contained and explain the point it makes. Sentences should be short and to the point. **The ideal length for a paragraph is three short sentences, with four as a maximum.** Over four and you are probably making more than one point and should have gone into two paragraphs.

Plan how many points you are going to make and what the answer is. This is essential as otherwise your answer will 'drift' as you struggle to arrive at a conclusion. The plan should consist of arrows connecting points to each other so that the answer will flow and be logical. The plan need not be too extensive; it is silly to waste time on a 'mini-answer'. It should consist of the *headings* you are going to use. Putting these into a bullet point list can be useful in organising your answer.

### Layout

Whenever examiners meet to discuss results, or write down their commentary on students' performance, they all agree on the importance of good layout; yet students generally tend to take no notice. The range of marks between good papers and poor papers tends to be quite small. Anything you can do to put the examiner on your side will pay off in those few extra marks.

The main areas for good layout are:

- 1 *Tabulate* in numbered points, unless you are writing an essay-type question (as explained above).
- 2 Leave a blank line between each point or paragraph.
- 3 Use headings whenever possible to indicate what major point or series of points you are about to make. Make it easy for the examiner to read your work and follow what you are doing. A solid mass of material is difficult to read, provides no respite for the eye and shows a lack of discipline.
- 4 Take care with your *language*. Be objective and avoid the use of the words ‘I’ or ‘we’ at too frequent intervals. Be direct and concise, say what you mean, do not use pompous terminology, and make sure that any technical words are used with their correct meaning.

Short sentences are far more effective and punchy than long ones. An evaluation of an internal control system could well start with a series of *verbs*. Good ones are: test, examine, inspect, calculate, reconcile, compare, summarise, enquire, investigate. These key words will help you to construct answers to these types of questions that are much more direct and to the point. If you start with them you are bound to avoid falling into the trap of being long-winded, or of padding out your answer. You only have a limited time and everything you write down *must* earn you marks.

- 5 *Think* while you are writing out your answer to make sure you are answering the question *as set*. Keep on reading the instructions and make sure you are following them. Use the question to help you to get the answer and, while this should be tackled at the planning stage, it is always possible that inspiration will strike while you are writing out your answer. In this case, note down the point beside your plan, otherwise you might forget it and that can cause frustration. What you say should be relevant, but if you are in doubt about the relevance but sure about the accuracy – include it in your answer. You cannot lose and it may be one of the key points the examiner was looking for.

### Key points

**Do try to find a couple of key points to each question.** These are points which you feel are vital to answer the question. You may well be right, and anyway, noting them down after you have read the question carefully can help to give your answer much needed direction.

### Practice

You will need to practise these routines. Written answers need more practice than computational ones. Attempt a question. Write out the answer as you would in the examination. Compare it with the suggested answers.

**Write at the foot of your answer what you left out and what you got wrong.** Learn from the answers and from the work you do, so that when you see a similar question you will produce a better answer.

### Time pressure

If you experience a lot of time pressure as you write your answers, don’t worry: this is a good sign.

In the examination, spread your time sensibly. **Start with the questions you like the most** and, if you have to go slightly over the time you allotted for those, do so, but not by very much! End with the question you think you cannot answer or will be hardest to answer, **but give yourself time to have a reasonable go at it.**

If a narrative question is included in a computational paper, do not spend more than the allocated time on it but *do spend that time answering it*. **Examiners pay great attention to the written parts of computational papers – they often carry more marks than the computation part, so do not treat those parts as if they don't matter.**

All this sounds formidable. It is. Exams require skill, application and, above all, confidence. Practice makes perfect and once the skill is acquired then, like riding a bicycle, it will not be for-gotten. Take pride in your work and be critical of your own efforts, but do not imagine your answers have to be perfect to pass an exam. Suggested answers you may have seen that were provided by examiners tend to be quite long because examiners do not wish to reveal any signs of weakness or ignorance about the subjects of which they are considered to be experts.

Go for the main points and make them well. That is the secret of success.

## Summary

### Remember:

- 1 Read the rubric, i.e. the instructions.
- 2 Plan your time before you start.
- 3 Tackle the easiest questions first.
- 4 Finish off answering each question when your time allocation for the question is up.
- 5 Hand in and label all your workings.
- 6 Do remember to be neat, also include all proper headings, dates, sub-totals, etc. A lot of marks can be lost if you don't.
- 7 Only answer as many questions as you are asked to tackle by the examiner. Extra answers will not normally be marked.
- 8 Underline the key words in each question to ensure that you answer the question set, and not the question you wrongly take it to be.
- 9 Never write out the text of essay questions.

Good luck with your exam. I hope you get the rewards you deserve!

*Alan Sangster*

## The Last Lecture

*Our course is run, our harvest garnered in,  
And taking stock of what we have, we note how life,  
This strange, mysterious life which now we hold and now  
eludes our grasp,  
Is governed still by natural law, and its events  
Tread on each other's heels, each one compelled to follow  
where the first has led.  
Noting all this, and judging by the past,  
We form our plans, until we know at last  
The treasure in the future's lap.*

*The man, the plant, the beast, must all obey this law,  
Since in the early dawn of this old world  
The law was given, and the stuff was made  
Which still alone can hold the breath of life:  
Whereby we know that grass and man are kin,  
The bond a common substance which within  
Controls their growth.*

*Can we know all? Nay, but the major part  
Of all that is must still elude our grasp,  
For life transcends itself, and slowly noting what it is,  
Gathers but fragments from the stream of time.  
Thus what we teach is only partly true.  
Not knowing all, we act as if we knew,  
Compelled to act or die.*

*Yet as we grow in wisdom and in skill  
The upward path is steeper and each step  
Comes higher unto heaven, piercing the clouds  
Which heretofore have hid the stars from view.  
The new-gained knowledge seems to fill the air,  
It seems to us the soul of truth is there.  
Our quest is won.*

*Bold climber, all that thou hast won  
Lies still in shadow of the peaks above;  
Yet in the morning hours the sun  
Rewards thy work of love,  
Resting a moment on thy lesser height,  
Piercing the vault with rays too bright to face,  
Strengthens thy soul and gives thee ample might  
To serve thy human race.*

Theodore Dru Allison Cockerell (1866–1948)  
*Zoology: A Textbook for Colleges and Universities*, Yonkers-on-Hudson, NY:  
World Book Company, 1920, pp. 538–539

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## Text

Exhibit 11.1 adapted from *Accounting Standards Board Statement of Principles 1999*, Accounting Standards Board Ltd (1991, 1999), © Accounting Standards Board (ASB). Adapted and reproduced with the kind permission of the Financial Reporting Council. All rights reserved. For further information please visit [www.frc.org.uk/asb](http://www.frc.org.uk/asb) or call +44 (0)20 7492 2300.

Exhibit 33.1 The PwC Integrated reporting model; Exhibit 33.2 Information areas and their interdependencies in an *Integrated Report*: PricewaterhouseCoopers.

## Photos

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# SPECIAL ACCOUNTS



## Introduction

The first two chapters of this part are concerned with two items that are treated in a similar way, irrespective of the form of business involved. The third deals with something the treatment of which may vary.

1	Accounting for branches	3
2	Purchases by instalments	29
3	Contract accounts	47





# Accounting for branches

## Learning objectives

After you have studied this chapter, you should be able to:

- explain two methods of recording the entries relating to branches
- describe how double column statements of profit or loss can be used in order to monitor any unexpected losses
- explain the difference between using a memoranda columns approach and an integrated inventory monitoring system for inventory control
- explain the issues relating to maintaining branch accounts for foreign branches

## Introduction

In this chapter, you'll learn about two methods of recording branch transactions and of the issues that arise when items are in transit between branches. You'll also learn about how to record the entries in the books when branches are located in different countries.

### 1.1 Background

Branch accounting was the genesis for accounting as we know it today. Merchants in thirteenth-century Europe were able to move along the trade routes established in the Crusades, and their knowledge of what lay where had developed well beyond knowing simply what existed within a few days' walk of their homes. The more adventurous merchants started travelling further afield, some to fairs in other towns, districts, and even countries. There they would sell their own products and buy or barter the products of others to take home and sell to their fellow townsfolk.

In time, this grew to the point where a merchant had simply too many opportunities and too much to do. Agencies were formed in other towns and countries, and employees were engaged to do the travelling while the merchants stayed home. Some of those merchants were so successful that they became 'merchant princes' with power, wealth and authority to rival the aristocracy. Nowhere was this more so than in what is now the northern part of Italy. From Naples to Milan and Genoa in the west, and Perugia to Venice in the east, merchants' businesses became increasingly large.

A method had to be found for merchants to record and monitor the activities of their salesmen and their branches. The result is what we now know as 'joint venture accounting' (see *Frank Wood's Business Accounting 1*) and 'branch accounting', the topic of this chapter.

## 1.2 Accounting records and branches

There are two commonly used methods for recording transactions for branches of an organisation:

- (a) the headquarters (or 'head office') keeps all the accounting records; or
- (b) each branch has its own full accounting system.

It is easier to understand accounting for branches if these two methods are dealt with separately. The first is shown in Sections 1.3–1.8; and the second in Sections 1.9–1.13. Sections 1.12 and 1.13 may also apply to the first method.

## 1.3 If headquarters maintains all the accounting records

The ledgers are used for three main purposes:

- (a) to record transactions showing changes in assets, liabilities and capital;
- (b) to ascertain the profitability of each branch; and
- (c) to enable checks to be made that might indicate whether anyone at the branches is stealing goods or cash.

**This third purpose is very important for businesses that have many branches.** The people who manage or work in these branches may be receiving and paying out large sums of money. In addition, they may be handling large amounts of goods. The branches may be a considerable distance away from the head office, the headquarters of the business. Being at a distance from control can be tempting to some people for whom distance equates to freedom to do what they wish. Some may think that this includes being able to steal things without being caught.

## 1.4 Methods for checking inventory and cash

If a business with just a few branches sells only very expensive cars, it would be easy to check on purchases and sales of the cars. The number of cars sold would be relatively small. Checking that cars or money have not been stolen would be easy. However, a business with branches selling many thousands of cheap items could not be checked so easily. To maintain a check on each carton of salt or bag of flour sold would be almost impossible. Even if it could be done, such checks would cost much more than they could possibly save.

One solution to this problem is to record all transactions at the branch in terms of selling prices. For each accounting period, it should then be possible to check whether the closing inventory is as it should be. For a small branch, you may be given the following figures:

	£
Inventory at 1 January – at selling price	5,000
January – Goods sent to the branch by the head office – at selling price	20,000
January – Sales by the branch – obviously at selling price	18,000

The calculation of the closing inventory is:

	£
Opening inventory (selling price)	5,000
Add Goods sent to the branch (selling price)	<u>20,000</u>
Goods which the branch had available for sale (selling price)	25,000
Less Goods sold (selling price)	<u>(18,000)</u>
Closing inventory should be (selling price)	<u>7,000</u>

## 1.5 Allowances for deficiencies

In every business there will be:

- (a) wastage of goods for some reason – goods may be damaged or broken, or they may be kept too long and become unsaleable;
- (b) stealing by customers, especially in a retail business;
- (c) thefts by employees.

No one can be certain how much inventory is wasted or stolen during a period. Only experience will enable a good estimate to be made of these losses.

## 1.6 The double column system

At regular intervals, at least once a year but usually more frequently now that accounting for branches is virtually always computerised, headquarters prepares a special type of trading account for each branch. The trading account can be shown in a form similar to a 'T-account' but with two columns on each side, as shown in Exhibit 1.1.

The right-hand column on the left side shows goods sent to the branch or held in inventory at cost price, i.e. the normal basis for any business. The other columns show all trading account items at selling price. This allows deficiencies in trading to be compared with the normal allowance for wastages, etc. of the business.

When such a system is in place, it is easy for head office to tell if the branch is operating as expected; and, of course, easy for the branch itself to assess its own operations against the norms for the business.

### Exhibit 1.1

Branch Trading Account for the year ending 31.12.2015					
	At selling price			At selling price	
	£	£		£	£
Inventory 1 Jan 2015	1,600	1,200	Sales	7,428	7,428
Goods from head office	8,000	6,000	Deficiency (difference)	172	
	9,600	7,200			
Less Inventory 31 Dec 2015	2,000	1,500			
	7,600	5,700			
Gross profit c/d		1,728			
	7,600	7,428		7,600	7,428
			Gross profit b/d		1,728

Exhibit 1.1 is drafted from the following details for a business which sells goods at a uniform mark-up of  $33\frac{1}{3}\%$  on cost price:

	£
Inventory 1 Jan 2015 (at cost)	1,200
Goods sent to the branch during the year (at cost)	6,000
Sales (selling price)	7,428
Inventory 31 Dec 2015 (at cost)	1,500

Allowances for wastage, etc., 1% of sales.

As the actual deficiency of £172 exceeds the amount expected, i.e. 1% of £7,428 = £74, an investigation will be made.

This method is suitable where all the sales are for cash, there being no sales on credit, or when debtors make their payments to the branch where the sale took place.

**Activity 1.1**

Why should it make any difference if debtors make payment to a branch other than the one where the sale took place?

## 1.7 The inventory and accounts receivable system

Further adjustments are needed when there are credit sales as well as cash sales. There are two ways of making the entries. These are:

- (a) using memoranda columns *only* to keep a check on inventory;
- (b) integrating inventory control into the double entry system. This is often called an ‘integrated method’.

Under both these approaches, information is kept relating to inventory and debtors.

Using the following data, Exhibit 1.2 shows the records in the head office books when (a), the memoranda method, is used. Exhibit 1.3 shows (b) the records when the integrated method is used.

*Data:* A branch sells all its goods at a uniform mark-up of 50% on cost price. Credit customers are to pay their accounts directly to the head office.

	£
First day of the period:	
Inventory (at cost)	(A) 2,000
Accounts receivable	(B) 400
During the period:	
Goods sent to the branch (at cost)	(C) 7,000
Sales – cash	(D) 6,000
Sales – credit	(E) 4,800
Cash remitted by debtors to head office	(F) 4,500
At the close of the last day of the period:	
Inventory (at cost)	(G) 1,800
Accounts receivable	(H) 700

**Note:** The letters A to H beside the figures have been inserted to identify the entries in Exhibits 1.2 and 1.3.

### (a) Memoranda columns method

#### Exhibit 1.2

		Branch Inventory					
		Selling price (memo only)			Selling price (memo only)		
		£	£				
Inventory b/d	(A)	3,000	2,000	Sales: Cash	(D)	6,000	6,000
Goods sent	(C)	10,500	7,000	Credit	(E)	4,800	4,800
Gross profit to profit and loss			3,600	Inventory c/d	(G)	2,700	1,800
		13,500	12,600			13,500	12,600
Inventory b/d	(G)	2,700	1,800				

Branch Accounts Receivable							
Balances b/d	(B)	£	400	Cash	(F)	£	4,500
Branch inventory	(E)		<u>4,800</u>	Balance c/d	(H)		<u>700</u>
			<u>5,200</u>				<u>5,200</u>
Balance b/d			700				
Goods Sent to Branches							
Headquarters trading		£	<u>7,000</u>	Branch inventory	(C)	£	<u>7,000</u>
Cash Book							
Branch inventory – cash		£					
sales	(D)		6,000				
Branch accounts receivable	(E)		4,500				

The branch inventory account is similar to the branch trading account you saw in Exhibit 1.1. However, in addition a branch accounts receivable account is in use.

The balance of the goods sent to the branch account is shown as being transferred to the headquarters trading account at cost. This figure is deducted from the purchases in the headquarters trading account, so that goods bought for the branch can be disregarded when the gross profit earned by the business is calculated.

### (b) The integrated method

The integrated method introduces the idea that gross profit can be calculated by reference to profit margins. It relies upon all selling prices being set strictly on the basis of the profit margins adopted by the business. For example, assume that a travelling salesman sells all his goods at cost price plus 25%. At the start of a week he has £80 of goods at cost, he buys goods costing £800, he sells goods for £900 (selling price) and he has goods at the end of the week which have cost him £160. A trading account based on this data is shown below.

Trading					
Inventory b/d	£	80	Sales	£	900
Purchases		800	Inventory c/d		160
Gross profit c/d		<u>180</u>			<u>1,060</u>
		<u>1,060</u>	Gross profit b/d		180

This could be shown as an extract from the statement of profit or loss or could be presented as:

Profit made when opening inventory is sold	£	20
Profit made when purchases are sold		<u>200</u>
Profit made when all goods are sold		<u>220</u>
But he still has left unsold goods (cost £160) on which the profit still has to be realised		<u>(40)</u>
Therefore profit realised		<u>180</u>

This could be expressed in account form as:

Salesman's Profit Adjustment			
	£		£
Gross profit realised	180	Unrealised profit b/d	20
Unrealised profit c/d	<u>40</u>	Unrealised profit when goods were bought	<u>200</u>
	<u>220</u>		<u>220</u>

The integrated system uses an adjustment account because goods sent to the branch are shown at cost price in a 'goods sent to branch account'. (This is the same as under the memoranda column method.) In the branch inventory account, these goods are shown at selling price. Obviously, if one entry is made at cost price and the other at selling price, the accounts would not balance. As the integrated method does not use memoranda columns, to correct this an extra account called a 'branch adjustment account' is opened. As with the salesman's profit adjustment account shown above, the entries in this account are in respect of the profit content *only* of goods.

The branch inventory account acts as a check upon inventory deficiencies. The branch adjustment account shows the amount of gross profit realised (i.e. earned) and unrealised during the period.

Exhibit 1.3 shows the ledger accounts needed for the integrated system from the same information given on p. 6 that was used to complete Exhibit 1.2. (For simplicity, there is no deficiency in the inventory in this example.)

### Exhibit 1.3

Branch Inventory (Selling Price)			
		£	
Balance b/d	(A)	3,000	Sales: Cash
Goods sent to branch	(C)	10,500	(D) 6,000
		<u>13,500</u>	Credit
			(E) 4,800
			Balance c/d
			(G) <u>2,700</u>
			<u>13,500</u>
Balance b/d	(G)	2,700	

  

Branch Accounts Receivable (Selling Price)			
		£	
Balances b/d	(B)	400	Cash
Branch inventory	(E)	4,800	(F) 4,500
		<u>5,200</u>	Balances c/d
			(H) <u>700</u>
			<u>5,200</u>
Balances b/d	(H)	700	

  

Goods Sent to Branch (Cost Price)			
		£	
Headquarters trading		<u>7,000</u>	Branch inventory
			(C) <u>7,000</u>

  

Branch Adjustment (Profit Content)			
		£	
Gross profit to profit and loss		3,600	Unrealised profit b/d
Unrealised profit c/d	(G)	900	(A) 1,000
		<u>4,500</u>	Branch inventory – goods sent
			(C) 3,500
			<u>4,500</u>
			Unrealised profit b/d
			(G) 900

The opening and closing inventories are shown in the branch inventory account at selling price. However, the statement of financial position should show the inventory at cost price. The previous

statement of financial position should therefore have shown inventory at a cost of £2,000. This is achieved by having a compensating £1,000 credit balance brought forward in the branch adjustment account so that the debit balance of £3,000 in the branch inventory account is offset by that £1,000, leaving a balance of £2,000 to be shown in the statement of financial position. Similarly, at the close of the period the statement of financial position will show inventory at £1,800 (branch inventory debit balance £2,700 less branch adjustment credit balance £900).

Compare the entries in the branch adjustment account to the differences between the memoranda and 'real' column figure in the branch account shown in Exhibit 1.2. You should be able to see how both methods show the same information, one (the *memoranda columns method*) using gross amounts as the basis for presentation while the other (the *integrated method*) presents the gross profits as separate amounts.

## 1.8 The inventory and accounts receivable integrated method – further points

### Returns

Goods may be returned:

- (a) from the branch inventory to the head office;
- (b) from customers of the branch to the branch inventory;
- (c) from customers of the branch to the headquarters of the business.

Exhibit 1.4 shows the entries when all the returns were by debtors (i.e. the original sales were credit sales).

### Exhibit 1.4

To examine the entries needed, suppose a business sells goods at cost plus 25% profit, and goods sold at the following prices were returned: (a) £90, (b) £150, (c) £30. The entries needed are:

Branch Inventory (Selling Price)			
		£	
Returns from debtors	(b)	150	Returns to headquarters
			(a)      £
			90
Branch Adjustment (Profit)			
		£	
Returns from branch	(a)	18	
Returns from debtors	(c)	6	
Goods Sent to Branch (Cost Price)			
		£	
Returns from branch	(a)	72	
Returns from debtors	(c)	24	
Branch Accounts Receivable (Selling Price)			
			£
		Returns to branch	(b)      150
		Returns to headquarters	(c)      30

Entries (b), both being in accounts shown at selling price, were two in number, i.e. £150 *Dr* and £150 *Cr*; entries (a) and (c) each needed entries in three accounts, (a) being £90 *Cr* and £18 *Dr* and £72 *Dr*, (c) being £30 *Cr* and £24 *Dr* and £6 *Dr*.