

Financial Accounting

2nd Edition

A.R. Jennings



*"The
Complete
Course
Text"*

Financial Accounting

2nd Edition

A.R. Jennings

BA (Hons), FCCA

Principal Lecturer in Accounting,
Department of Accounting,
Trent University, Nottingham

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London W12 8AW

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Preface

AIM

This book has been designed to provide coverage, to the requisite depth, of the practical financial accounting content of ACCA Papers 10 and 13, CIMA Stage 2 Financial Accounting, CIMA Stage 3 Advanced Financial Accounting and AAT Paper 9 - Financial Accounting. Additionally it provides coverage of the financial accounting content of ICSA, RSA, LCC and BTEC HND/C courses.

SCOPE AND LAYOUT

The book is divided into seven sections, the first five of which deal with the various topics:

- | | | |
|---------|-----|--|
| Section | I | The accounts of unincorporated businesses |
| | II | Accounting practice for specialised transactions |
| | III | The accounts of companies (excluding groups) |
| | IV | Analysis of financial statements |
| | V | The accounts of groups of companies. |

Each section contains chapters on items within its subject area. Two further sections follow containing supportive material to support the first five sections:

- | | | |
|---------|-----|--|
| Section | VI | Questions without answers |
| | VII | Appendices giving statutory disclosure requirements and the Annual Report and Accounts of an actual company. |

USING THE BOOK EFFECTIVELY

The sections and chapters, which need not necessarily be studied in the sequence in which they have been presented, are fairly uniform in structure. Each chapter gives the general background of the topic so that it can be understood in context. The operating arrangements which underlie the financial procedures are then outlined and explained briefly. Thirdly, the basic accounting methods and procedures are stated and supported by examples. Finally, test exercises and questions of varying difficulty are set. Examination questions set by the ACCA and AAT appear at the end of the chapters. Answers to all of these exercises and questions are given in a separate Students Solutions Manual, together with full explanations of points of especial difficulty, where appropriate.

SPECIAL NOTE FOR LECTURERS

Section VI of this book contains a selection of test exercises and examination questions, some from the past papers of professional bodies, so that lecturers who adopt the book as a course text can use them for coursework or homework or assignment purposes. Outline answers to these are available, free of charge, to lecturers on application to the publishers

NOTE TO SECOND EDITION

This edition includes Financial Reporting Standards 1, 2 and 3.

A.R. Jennings
Nottingham
25 May 1993

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Section I

The Accounts of Unincorporated Businesses

Chapter

- 1 Incomplete records
- 2 Sole traders
- 3 Partnerships
- 4 Clubs and societies

1 Incomplete Records

GENERAL BACKGROUND

1.0 On occasions accountants are required to produce accounting statements from basic records in varying degrees of completeness.

1.1 Many sole proprietorships, for example, are operated by those who, though highly skilled and knowledgeable in their own specialisms, lack the ability and/or time to keep any but the simplest financial records.

1.2 Under other circumstances, proper records may have been maintained but subsequently lost or destroyed as the result of a catastrophe such as a fire, or an accident or a burglary.

1.3 The reconstruction of missing figures and accounting statements using incomplete records techniques are part of the core syllabus for foundation level papers.

1.4 This chapter assumes that students studying at professional level are fully conversant with and understand those techniques. For that reason they are not repeated here.

1.5 This topic can be examined in greater breadth and depth than at the earlier level, by the introduction, for example, of a greater volume of financial data and/or more complex situations.

STUDENT SELF TESTING

Test Exercises

1. After completing a training course at a technical college, Michael Faraday set up in business as a self-employed electrician on 1 January 19-5.

He was very competent at his job but had no idea how to maintain proper accounting records. Sometime during 19-5 one of his friends asked Michael how well his business was doing. He replied "All right...I think...but I'm not quite sure".

In the ensuing conversation his friend asked whether he had prepared accounts yet, covering his first quarter's trading, to which Michael replied that he had not. His friend then stressed that, for various reasons, it was vital for accounts of businesses to be prepared properly.

Shortly afterwards Michael came to see you to ask for your help in preparing accounts for his first quarter's trading. He brought with him, in a cardboard box, the only records he had, mainly scribbled on scraps of paper.

He explained that he started his business with a car worth £700, and £2,250 in cash of which £250 was his savings and £2,000 had been borrowed from a relative at an interest rate of 10% per annum. It was his practice to pay his suppliers and expenses in cash, to require his customers to settle their accounts in cash and to bank any surplus in a business bank account. He maintained lists of cash receipts and cash payments, of supplies obtained on credit and of work carried out for customers and of appliances sold, on credit.

The list of suppliers comprised:

<i>Date supplied</i>	<i>Supplier</i>	<i>Amount owed</i>	<i>Date paid</i>	<i>Amount paid</i>	<i>Remarks</i>
19-5		£	19-5	£	
<i>January</i>	Dee & Co.	337.74	March	330.00	Received discount £7.74
	AB Supplies	528.20	March	528.20	
<i>February</i>	Simpson	141.34	March	138.00	Received discount £3.34
	Cotton Ltd	427.40	March	130.00	Payment on account
			April	297.40	Remainder
	Dee & Co.	146.82	March	140.00	Received discount £6.82
<i>March</i>	AB Supplies	643.43	April	643.43	
	Simpson	95.60			Not yet paid

The purchase in January from Dee & Co. was of tools and equipment to enable him to carry out electrical repair work. All the remaining purchases were of repair materials, except for the purchase in February from Cotton Ltd. which consisted of electrical appliances for resale.

In addition to the above credit transactions, he had bought repair materials for cash, as follows:

1 : Incomplete Records

19-5	£
January	195.29
February	161.03
March	22.06

Other cash payments comprised:

19-5		£
<i>January</i>	Rent of premises for January to June 19-5	400.00
	Rates of premises for January to March 19- 5	150.00
	Stationery	32.70
	Car running expenses	92.26
<i>February</i>	Sundries	51.54
	Car running expenses	81.42
<i>March</i>	Sundries	24.61
	Car running expenses	104.52
	Transfer to bank	500.000

He had also withdrawn £160.00 in cash at the end of each month for living expenses.

The list of credit customers comprised:

<i>Date of Sale</i>	<i>Customer</i>	<i>Amount owed</i>	<i>Date received</i>	<i>Amount received</i>	<i>Remarks</i>
19-5		£	19-5	£	
<i>January</i>	D. Hopkins	362.80	February	357.00	Allowed discount £5.80
	P. Bolton	417.10	March	417.10	
<i>February</i>	G. Leivers	55.000	March	55.00	
	M. Whitehead	151.72	April	151.72	
	N. John Ltd	49.14	April	49.14	
	A. Linneker	12.53	March	12.53	
<i>March</i>	E. Horton	462.21	April	462.21	
	S. Ward	431.08	March	426.00	Allowed discount £5.08
	W. Scothern & Co.	319.12			Not yet received
	N. Annable	85.41			Not yet received

The above amounts relate to charges for repair work which he had carried out, except that the amounts shown in February for G. Leivers, N. John Ltd. and A. Linneker are for sales of electrical appliances.

In addition to the above credit transactions, he had cash takings, as follows:

19-5		£
<i>January</i>	Repair work	69.44
<i>February</i>	Repair work	256.86
<i>March</i>	Repair work	182.90
	Appliances	112.81

He estimated that, at the end of March 19-5, his stock of electrical repair materials was £691.02 and of electrical appliances for resale was £320.58, his tools and equipment were worth £300.00 and his car, £600.00.

Apart from loan interest, the only accrual was for heating and lighting, £265.00.

Required:

- a. Prepare
 - i. purchase daybook with analysis columns for type of purchase, and
 - ii. sales daybook with analysis columns for class of business undertaken.
- b. Open, post to 31 March 19-5 only, and balance a columnar cash book suitably analysed to facilitate ledger postings.
- c. Open, post to 31 March 19-5 only, and balance a creditors ledger control account and a debtors ledger control account. Use the closing balances in your answer to (g) below. [NB. Individual accounts for creditors and debtors are NOT required].
- d. Open, post and balance sales and cost of sales accounts, each with separate columns for "Repairs" and "Appliances".

1 : Incomplete Records

- e. Prepare M. Faraday's trading account for the quarter ended 31 March 19–5, distinguishing between gross profit on repairs and on appliance sales.
- f. Prepare M. Faraday's general profit and loss account for the quarter ended 31 March 19–5.
- g. Prepare M. Faraday's balance sheet as at 31 March 19–5.

2 Sole Traders

GENERAL BACKGROUND

1.0 The simplest of all business organisations is that of a sole proprietor or trader.

1.1 The feature of such a formation is that the same person is not only the owner but is often the manager and maybe the workforce as well. A freelance artist or author would fall into this category.

1.2 Where the business involves providing goods or services to members of the public, for example, a solely owned electrical repair business or veterinary surgery, the owner may need to engage employees as the workforce to operate for or with him.

1.3 Many sole traders record only the basic financial data which they then hand over periodically to their accountants for processing, reporting and appraisal.

1.4 The collection, recording and processing of this data for reporting purposes is part of the core syllabus for foundation level papers.

1.5 This chapter assumes that students studying at professional level are fully conversant with and understand these matters, together with the associated routine work, including, for example, the detection and correction of errors, suspense accounts, bank reconciliation statements, etc. For that reason they are not repeated here.

1.6 This topic can be examined in greater breadth and depth than at the earlier level, by the introduction, for example, of a greater volume of financial data and/or more complex situations.

STUDENT SELF TESTING

Test Exercises

1. a. I. Wright is a professional author whose income is derived mainly from royalties, that, is payments from his publisher based on the number of his books sold. He also receives fixed rate fees for articles and features which he writes for magazines and periodicals. Two of his books have been reproduced in instalments by a weekly newspaper which pays serialisation fees to his publisher who then pays Wright a proportion of these fees. Additionally, he derives a small part of his income from publicity activities and from lecturing. He carries out his writing activities in a purpose-equipped study room at his home. His accounting year ended on 31 May 19-2, for which the following information is available.

	£
Royalties Received (including Advance Royalties, £900) (<i>see note (8)</i>)	23,650
Fees received for articles and features published	8,000
Serialisation fees received	5,400
Fees received for publicity activities (<i>see note (9)</i>)	2,734
Fees received for lecturing on Writers' Residential Courses	250
<i>Expenses:</i>	
Rates (<i>see notes (1) and (2)</i>)	440
Heating and Lighting (<i>see notes (1) and (3)</i>)	916
Postages	414
Stationery <i>see note (4)</i>	659
Telephone charges (<i>see notes (1) and (5)</i>)	762
Secretarial expenses	6,866
Travelling expenses (<i>see note (9)</i>)	3,427
Photocopying expenses	640
Fees paid to artist (for providing illustrations for inclusion in his books)	715
Insurance (<i>see notes (1) and (6)</i>)	308
Subscriptions –to professional societies	70
– to writers' periodicals and magazines	226

Miscellaneous expenses <i>see note (9)</i>	691
<i>Other information:</i>	
Drawings by cheque during the year	21,547
Office equipment at 1 June 19-1 (cost £2,200)	1,700
Office furniture at 1 June 19-1 (cost £600)	510
Bank balance at 31 May 19-2	2,265
Cash balance at 31 May 19-2	28
Capital account at 1 June 19-1	2,150

The above items need to be adjusted, where appropriate, to reflect the following:

1. When invoices are received which include combined business and private expenses, it is Wright's practice to pay them out of business bank account and to make the necessary transfers at the end of the accounting year.
2. Rates of £480 for the six months 1 April to 30 September 19-2 have not yet been paid. One quarter of the total rates is attributable to his study room.
3. An electricity invoice for £60 in respect of the three months ended 31 May 19-2 has been received but not yet paid. One quarter of the total heating and lighting charge is attributable to his study room.
4. Items of stationery (typing and duplicating paper, typewriter ribbons and carbons, etc.) unused at 31 May 19-2 amount to £213.
5. A telephone invoice has been received, but not yet paid, as follows:

	£
Telephone rental (main installation and extensions) (three months 1 June to 31 August 19-2)	24
Telephone calls (for three months 1 February to 30 April 19-2)	<u>270</u>
	<u>£294</u>

An estimated one-third of all calls have been made for private purposes not connected with Wright's authorship.

6. Insurance premiums have been prepaid by £72. One half of the total insurance charge has been incurred for private purposes.
7. Depreciation of fixed assets is to be provided on the original cost at the following rates:

	%
Office equipment	25
Office furniture	20

There were no additions to fixed assets during year ended 31 May 19-2.

8. Advance Royalties are a fixed fee paid by publishers to authors when the contract is signed and/or when the draft manuscript is delivered to him. If, for any reason, the author does not fulfil the terms of the contract, they must be repaid. The £900, therefore, remains repayable until publication takes place.
9. Publicity fees include a total amount of £456, being reimbursement of travelling expenses £370, and of miscellaneous expenses, £86, incurred by Wright in carrying out these activities.

Required:

Prepare the Profit and Loss account for Wright for the year ended 31 May 19-2 and his Balance Sheet at that date

(b) Wright is concerned about the efficiency with which he is operating his professional affairs and has consulted you for your opinion whether his net profit for the year expressed as a percentage of his net assets is a suitable indicator.

Required:

Advise Wright on a suitable 'operating' indicator in his particular circumstances.

2. In 19-3, Keith Maltby had bought a cafe which he re-opened under the name 'Keith's Kaff'. In February 19-5 he rented a grocery shop which he renamed 'Keith's Larder'.

Notes on the operations of the businesses:

1. The annual rental of the grocery shop is £3,200 payable quarterly in advance on the last day of March, June, September and December.
2. The shop buys food in bulk both for resale to the public and for supply to the cafe. Food is transferred to the cafe at cost.
3. Each establishment is under the control of a manageress who is paid a basic salary plus a commission of 10% (calculated to the nearest £1) of the net profit of her establishment *before* charging the commission (see note (9) but after crediting the Enterprise Grant instalment (see note (11)).
4. The office work for both establishments is carried out by the shop manageress who receives an annual payment of £600 for the extra responsibility. Two-thirds of this sum is charged to the cafe (see note (9)).
5. Maltby's accounting year runs from 1 April to 31 March and he accounts for the cafe and the shop as separate departments.
6. The shop manageress lives above the shop in self-contained accommodation for which she pays an inclusive rental of £60 per month, payable one month in arrears (see note (9)).
7. Depreciation of fixed assets is provided on the reducing balance method at the following rates:

	%
Premises	2
Fixtures, etc	10
Vehicles	20

8. Closing stocks at 31 March 19-7, at cost

	£
Food – cafe	3,513
– shop	1,774
Cleaning materials – cafe	30
– shop	24
Wrapping materials – cafe	10
– shop	12

9.

At 31 March 19-7	£
Electricity accrued – cafe	131
– shop	78
General expenses accrued – cafe	46
– shop	68
Shop manageress' office allowance due	600
Shop manageress' accommodation rent receivable	60
Commission – cafe manageress	to be calculated
– shop manageress	to be calculated
Rent payable prepaid – shop	800

10. On 31 March 19-6, Maltby obtained a Business Development Loan for the cafe, to be repaid in one lump sum in 19-1, at a concessionary rate of interest (10% per annum), payable half yearly on 30 August and 31 March.

11. Maltby has also been awarded an Enterprise Grant of £5,000 for the cafe, with effect from 1 April 19-6. He has decided to hold this sum in suspense and to credit it to the cafe profit and loss account in five equal instalments in the year ended 31 March 19-7 to 19-1 inclusive. However, at 31 March 19-7 the £5,000 had not yet been received.

12. The sales of both the shop and the cafe are for cash, except that the cafe has a contract to supply meals to a local factory which is then invoiced with the cost, for which seven days' credit is allowed.

13. The overdraft finances Maltby's operations in general but is accounted for as a liability of the shop.

At 31 March 19-7, the following balances were extracted from the ledger.

	Cafe £	Shop £
Premises (at cost)	25,000	–
Fixtures, fittings (at cost)	7,500	–
Vehicles (at cost)	–	6,000

Provisions for depreciation at 1 April 19-6:		
Premises	6,000	—
Fixtures, fittings	1,600	—
Vehicles	—	1,000
Rent paid (see note 1)	—	4,000
Manageresses' salaries and related charges (see notes 3 and 9)	4,200	3,900
Assistants' wages and related charges	2,100	900
Electricity charges	1,874	851
Telephone charges	209	411
Stationery (see note 4)	—	126
Turnover	36,791	27,430
Food transferred from shop to cafe (see note 2)	19,427	19,427
	(Debit)	(Credit)
Stocks at 1 April 19-6:		
Food	1,272	303
Cleaning materials	44	32
Wrapping materials	27	28
Purchases:		
Food (see note 2)	—	30,432
Cleaning materials	71	68
Wrapping materials	45	53
Loan interest paid (see note 10)	700	—
Business Development loan (see note 10)	7,000	—
Bank overdraft (see note 13)	—	2,209
Bank overdraft interest (see note 13)	—	37
Creditors:		
Food	—	4,582
Other items	15	6
Rates (general and water)	2,943	1,864
General expenses	605	756
Cash	109	155
Rent receivable (see note 6)	—	660
Debtors:		
Trade (see note 12)	1,312	—

The only other balances are the personal accounts of the proprietor and are not allocated to departments:

£

K. Maltby:		
Capital	9,000	
Current account	1,634	(credit)

Required:

Prepare a departmental trading and profit and loss account for the year ended 31 March 19-7 and a departmental balance sheet at that date, in each case using separate columns for the cafe, the shop and the total business.

ACCA EXAMINATION QUESTIONS

3. The following Balance Sheet has been prepared by B. Swift as at 30 November 1982.

<i>Capital Account</i>	£	£	<i>Fixed Assets</i>	£	£
Balance 1.12.81	76,132		Equipment, at cost	54,000	
Add: Net Profit for year	25,000		Depreciation	9,600	
	<hr/>			<hr/>	44,400
	101,132		Motor vehicle, at cost	25,200	
Less: Drawings	10,000		Depreciation	14,400	
	<hr/>			<hr/>	

	91,132		10,800
<i>Current Liabilities</i>		<i>Current Assets</i>	
Creditors	28,000	Stock	30,000
Accruals	2,070	Debtors	40,000
Bank overdraft	<u>3,664</u>	Provision	<u>2,400</u>
	33,734		37,600
		Suspense	67,600
			2,066
	<u>£124,866</u>		<u>£124,866</u>

The Debtors' total of £40,000 in the Balance Sheet is the balance appearing on the Sales Ledger Control Account in the General Ledger. Individual personal accounts for debtors are kept on a memorandum basis.

The accounting system used to record credit sales transactions was as follows:

Sales recording

- i. Copy sales invoices are batched in date order. Each batch is add listed by a clerk who enters the batch total in a batch total register. The register is then passed to the machine operator to post the Sales Ledger Control Account in the General Ledger.
- ii. Each batch of copy invoices is passed to a machine operator who makes the appropriate entry on the debtor's ledger card. A copy of the amount is accumulated and at the end of posting the individual accounts, the accumulated total is posted to the Sales Account in the Nominal ledger.

Remittance recording

- iii. The cheques received from debtors are listed in the cashier's office. A memorandum with details of the total is passed to a machine operator who posts the Sales Ledger Control Account and Cash Account in the General Ledger.
- iv. The detailed list is passed to a machine operator who makes the appropriate entries in the individual debtor's ledger card.

Reconciliation

- i. The control account is reconciled with the list of Sales Ledger balances monthly. At 30 November 1982 the list of ledger balances totalled £41,520.

The accountant discovered the following items.

a. *Relating to the debtors*

- i. On one of the add-lists of copy sales invoices, the clerk omitted to include an invoice for £2,100. It appeared to her to be an unusually large item and she intended to query it. In the event, it was omitted from the add-list but passed through with the rest of the batch for ledger posting. The accountant verified that the sale had been correctly authorised.
- ii. An invoice for £250 was correctly add-listed but removed by the clerk who noticed an error in the address. The invoice was still in her pending tray at 30 November 1982 and consequently had not been passed to the machine operator.
- iii. One invoice for £799 was posted to the debtor's ledger card as £979.
- iv. A credit entry of £150 was made in R. Black's ledger account although no cheque had been received and no credit authorised.
- v. One of the lists of cheques was correctly totalled at £4,400 but posted in the General Ledger Control Account as £4,040 and in the General Ledger Cash Account as £4,004.

b. *Other errors*

- i. On 1 October 1982 Swift had paid rent of £1,200 to cover the period 1 October 1982 to 31 March 1983. In the accounts to 30 November 1982 an accrual of £400 has been raised for the rent thought to be outstanding for the period 1 October 1982 to 30 November 1982.
- ii. A bank reconciliation revealed that a standing order payment of £150 for Swift's subscription to a video film club had passed through the bank statement on 25 November

1982 and bank interest of £200 had been debited on 30 November 1982 but no entries had been made in the Cash Account.

- iii. Stock included a video recorder (cost £500) that had been purchased by Swift for his personal use with his own funds. The evaluation of stock items was correct but the stock sheets were overcast by £1,000.
- iv. The Fixed Assets of £54,000 included an office copying machine that was being purchased on hire purchase. The agreement was dated 1 December 1981. The terms were:

	£	
Cost	20,000	
Deposit	<u>4,000</u>	
	16,000	
Interest	<u>3,200</u>	
Balance	<u>£19,200</u>	payable in 24 monthly instalments of £800

The Fixed Asset Account was debited with £23,200 and depreciation has been charged on this at 10% per annum.

The creditors (£28,000) include the hire purchase suppliers balance of £9,600 (being £19,200 less 12 instalments of £800).

Required:

- a. Show the amended balance on the Sales Ledger Control Account and reconcile with Sales Ledger balances.
 - b. Show the effect of the necessary corrections to the profit for the year to 30 November 1982.
 - c. Draw up the amended Balance Sheet as at 30 November 1982.
 - d. Journalise the clearance of the Suspense.
- (ACCA)

3 Partnerships

GENERAL BACKGROUND

1.0 This section is concerned with certain problem areas of partnership accounting. Legal requirements governing the conduct of partnerships together with the preparation of final accounts, including appropriation and final accounts, are assumed to have been learned at an earlier stage of study and are not repeated in this section.

1.1 Specific problems considered are those which arise on:

- a. formation of partnerships
- b. changes in the constitution of partnerships
- c. dissolution of partnerships.

FORMATION OF PARTNERSHIPS

2.0 A partnership may be formed in one of several ways, for example.

- a. as a partnership at the outset of the business
- b. by the amalgamation of two or more sole proprietorships, and, more rarely,
- c. by conversion from a limited company.

2.1 The formation of a partnership as such at the outset presents no particular accounting problems. The values of the assets contributed to the firm by each of the partners constitute their respective capitals.

2.2 Problems may arise when sole proprietors amalgamate to form a partnership.

EXAMPLE

2.3 Two professional men, G and H, decided to amalgamate their practices and to form a partnership with effect from 1st May 19-0.

Their respective balance sheets on 30th April 19-0, disclosed the following figures.

	G	H		G	H
	£	£		£	£
Capital	15,300	23,300	Premises	7,000	12,000
Creditors	200	400	Office etc equipment	2,600	10,000
Loan from business associate	—	9,000	Stock of stationery etc	500	900
			Debtors for fees	3,200	5,700
			Bank and Cash	2,200	4,100
	<u>15,500</u>	<u>32,700</u>		<u>15,500</u>	<u>32,700</u>

For the purposes of the amalgamation:

G's premises were revalued at £10,000 and were to be used as a branch office and office equipment, valued at £800, was written off as obsolete; the fee debtors included an amount of £600 which was to be regarded as irrecoverable; the creditors were paid out of the bank balance; otherwise assets were brought in at book value.

H had agreed to acquire out of his private resources additional equipment costing £3,000, to pay his creditors from his bank balance, to repay the loan from his private resources, and to bring his other assets in at book value.

Prepare the balance sheet for the partnership of GH & Co on 1st May 19-0.