

Finance

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Finance

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Preface

The unit 'Finance' is common to all BTEC National Certificates and Diplomas in Business and Finance, Distribution Studies and Public Administration. It has to be covered in the first year of these courses. This book has been produced specifically to cover the unit.

Chapters 1 to 29 have been based on the book 'Business Accounting' written by Frank Wood, and also published by Pitman. This part of the book has been adapted in a suitable fashion to fit the BTEC unit. The remainder of the book has either been written specifically for this unit, or else it has been based on other books written by Frank Wood and Joe Townsley.

It is hoped that lecturers will fully integrate this unit with the other units in the course. Finance is all-pervasive throughout all spheres of business activity. It should therefore be possible to co-operate with lecturers on the other units to produce interesting assignments which are relevant in the eyes of their students.

Frank Wood
Joe Townsley
Cheshire · Spring 1986

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Introduction

Most of the readers of this book will be studying the unit 'Finance' in a BTEC National Awards course. What you are about to study includes both personal finance, the finance of businesses in the private sector from small shops to large concerns such as Marks and Spencer or of Imperial Chemical Industries (ICI), and also the finance of publicly owned organisations such as the National Coal Board or of your own local council.

In the first instance we will start by looking at the finance of business in the private sector, for it is from here that most of the basic ideas and methods of finance have begun and spread to other areas. Then we will have a look at finance in the public sector and then, finally, personal finance. Leaving the finances of the reader until the end may seem unusual, but in fact you will be applying some of the techniques you will have learned from business situations, and therefore it is more logical to deal with the items in this order.

The underlying financial information system of all types of organisations is called 'Accounting'. Decisions about finance are based in whole or in part upon the information which comes out of this system. This means that 'Accounting' is going to be the subject of the first part of this book. Before we start to examine this subject in any great detail we will first examine what it is, how it has developed, and also consider who will use the information.

What is accounting?

Accounting is concerned to give people information of an economic type about businesses or organisations. Economic information basically means that it is information capable of being measured in money terms. For example the amount a business spent last year on wages is economic information. Telling people that all the employees were very happy is not economic information because there is no precise way of measuring happiness in money units.

Because information of a non economic sort is often very useful, accounting reports are frequently issued with supplements containing more general material. This helps to overcome the limitation of accounting being expressed in purely economic data.

The information included in accounting statements is of two sorts. Firstly there is information about the resources used. For most

organisations the resources cover a very wide range of items. On the one hand there will be things with a very long life such as land and buildings and at the other extreme small items like elastic bands and ball point pens. It would be possible to list thousands of individual items that a large business includes in its resources. Accounting will also list the obligations an organisation incurs in obtaining its resources. For example if someone lends £5,000 cash to a business accounting is concerned to record both the new cash resource and quite separately the obligation to repay the lender.

The second type of information in accounting statements is concerned with the organisation's performance. This is basically a measurement of the changes that have taken place between two points in time. For accounting measurement one year is the normal time span. For commercial and industrial organisations the changes are expressed in a statement which shows whether the business has made a profit or loss. The profit or loss figure is a very important measure of success. Virtually everybody who has anything to do with a firm will want to know how profitable it is. Investors, employees and government are all concerned with this accounting index of performance.

Accounting is still useful for organisations which do not operate for profit. Organisations of this type such as the National Health Service still need to measure their resources and to assess performance over time.

ACCOUNTING COMMUNICATES INFORMATION OF AN ECONOMIC NATURE WITH PARTICULAR REFERENCE TO THE RESOURCES AND THE PERFORMANCE OF AN ORGANISATION.

How has accounting developed?

Accounting methods have changed over many hundreds of years to reflect the nature of the organisations being accounted for. A small farmer in the reign of Elizabeth I would have little need for accounts as he could probably remember all his resources because he lived amongst them. He could also assess his performance from year to year by inspection of his herd and crops and with reference to his memory. It is also likely that he could neither read, write, nor calculate with numbers. The steward who managed the estates of a large landowner was in a different position. The landowner would expect the steward to be able to account to him both for all the resources of the estate and the performance in managing resources over time. This type of situation demands a proper method of accounting because the estates could be large and the transactions many. Also the landlord might be absent over long periods. Proper accounts were essential then as now to provide a check on honest management. Stewardship is just as important for the manager of a large modern corporation who acts on behalf of absent owners.

Who is Accounting information for?

Traditionally we are accustomed to preserving information about our personal wealth and income as private rather than public knowledge. There is nothing to stop us telling anybody what we like about our own affairs but nothing in the UK requires private individuals to make public disclosure of their wealth or income. This is not true however in our dealings with the government. They are entitled to ask us for information they require about all out wealth and income in order to tax us. Many small businesses prepare accounts largely for the benefit of the tax authorities.

The position of limited companies and their shareholders has already been mentioned. The accounts of limited companies are required by law and are basically prepared for the shareholders in their capacity as owners but with specific provisions to safeguard the creditors of the business. However as time has passed more and more people have become involved in the need to obtain accounting information. Limited Companies have become the most popular form of organisation in commerce and industry. Some companies are very small family concerns; others have become huge organisations operating internationally. Increasingly there has been recognition that there may be greater need for special disclosure particularly from the very large firms, who wield considerable economic power and employ important resources both of labour and capital.

In addition to stewardship information therefore there is a general movement toward disclosure of information specifically for employees, government and the public at large. The sort of Accounting which is aimed at providing information to people outside management is called Financial Accounting.

So far all the emphasis has been given to describing accounts which a company is required by law to produce for those outside who do not have managements' access to inside information. In a large and complex modern business it poses quite a problem simply to provide management with enough of the right information to manage the business properly. As we said earlier a small farmer can probably remember most of what he needs to manage the operations of his farm. Very soon however if the business grows this becomes impossible and proper records need to be kept so that proper decisions can be taken. This type of accounting which is for use inside the business is called Management Accounting.

ACCOUNTING WHICH IS FOR THOSE OUTSIDE THE BUSINESS IS CALLED FINANCIAL ACCOUNTING. ACCOUNTING WHICH IS PREPARED TO HELP MANAGERS RUN THEIR BUSINESS EFFICIENTLY IS CALLED MANAGEMENT ACCOUNTING.

The other situation which gave rise to a need for proper accounts was trading ventures where more than one man was sharing in the profits or losses of the business. Indeed the basic framework of modern accounting started in fifteenth century Italy. The merchants of Venice and the other Italian states would charter a vessel between them which they would send to the East to buy spices and other scarce commodities. The risks of such ventures were high but the rewards were correspondingly great. Human nature then as now tends to be suspicious of fraud where large amounts of money are involved. Therefore a system of accounting which fairly recorded and reported the economic results of the business had to be devised. The system of recorded events known as 'Double entry' has stood the test of time for five hundred years although the ways in which it is applied have changed a great deal.

The Industrial Revolution and the changes it led to in the organisation of society gave rise to the next major development in accounting. It was the need to collect large amounts of capital to build large units such as railways in the 1830's which led to the development of the modern concept of the limited liability company. The main feature of this type of organisation is that many people can invest an amount of money in a company by buying 'shares'. Although some shareholders may be managers of the firm particularly in small firms, the majority will not, especially in large companies. Whilst a senior manager has access to whatever information is available, a shareholder does not. The reason for this is that it is considered likely to be harmful to a business if detailed information on its affairs were available to its competitors. If shareholders could obtain any information they wanted, then competitors would only have to buy a few shares to obtain what information they needed. The conflict of interest here is vital for accounting. On the one hand the owner of shares must have enough information to ensure that the management carry out their function honestly and efficiently; on the other hand the company will need to preserve some confidential information.

The company law enactments which have been passed by Parliament throughout a century or more have reflected changes in society's attitudes and the experience gained with time. Accounting requirements for companies have grown substantially both in quantity and in sophistication.

ACCOUNTING DEVELOPED AS A RECORD OF STEWARDSHIP FOR EXAMPLE WHERE AN OWNER EMPLOYED SOMEONE ELSE TO MANAGE HIS PROPERTY. WHERE A NUMBER OF PEOPLE COMBINE TOGETHER IN A BUSINESS VENTURE THE NEED FOR ACCOUNTING INFORMATION IS ESPECIALLY IMPORTANT. THIS NEED IS OF GREAT IMPORTANCE FOR MODERN COMPANIES.

1 The Accounting Equation and the Balance Sheet

The Accounting Equation

The whole of financial accounting in the private sector is based on the accounting equation. This can be stated to be that for a firm to operate it needs resources, and that these resources have had to be supplied to the firm by someone. The resources possessed by the firm are known as Assets, and obviously some of these resources will have been supplied by the owner of the business. The total amount supplied by him is known as Capital. If in fact he was the only one who had supplied the assets then the following equation would hold true:

$$\text{Assets} = \text{Capital}$$

On the other hand, some of the assets will normally have been provided by someone other than the owner. The indebtedness of the firm for these resources is known as Liabilities. The equation can now be expressed as:

$$\text{Assets} = \text{Capital} + \text{Liabilities}$$

It can be seen that the two sides of the equation will have the same totals. This is because we are dealing with the same thing from two different points of view. It is:

Resources: What they are =	Resources: Who supplied them
(Assets)	(Capital + Liabilities)

It is a fact that the totals of each side will always equal one another, and that this will always be true no matter how many transactions are entered into. The actual assets, capital and liabilities may change, but the equality of assets with that of the total of capital and liabilities will always hold true.

Assets consist of property of all kinds, such as buildings, machinery, stocks of goods and motor vehicles, also benefits such as debts owing by customers and the amount of money in the bank account.

Liabilities consist of money owing for goods supplied to the firm, and for expenses, also for loans made to the firm.

Capital is often called the owner's equity or net worth.

The Balance Sheet and the Effects of Business Transactions

The accounting equation is expressed in a financial position statement called the Balance Sheet. It is not the first accounting record to be made, but it is a convenient place to start to consider accounting.

The Introduction of Capital

On 1 May 19-7 B. Blake started in business and deposited £5,000 into a bank account opened specially for the business. The balance sheet would appear:

B. Blake
Balance Sheet as at 1 May 19-7

<i>Assets</i>	£		£
Cash at bank	5,000	Capital	5,000
	<u>5,000</u>		<u>5,000</u>

The Purchase of an Asset by Cheque

On 3 May 19-7 Blake buys a building for £3,000. The effect of this transaction is that the cash at bank is decreased and a new asset, buildings, appears.

B. Blake
Balance Sheet as at 3 May 19-7

<i>Assets</i>	£		£
Buildings	3,000	Capital	5,000
Cash at bank	2,000		
	<u>5,000</u>		<u>5,000</u>

The Purchase of an Asset and the Incurring of a Liability

On 6 May 19-7 Blake buys some goods for £500 from D. Smith, and agrees to pay for them some time within the next two weeks. The effect of this is that a new asset, stock of goods, is acquired, and a liability for the goods is created. A person to whom money is owed for goods is known in accounting language as a creditor.

B. Blake
Balance Sheet as at 6 May 19-7

<i>Assets</i>	£	<i>Capital and Liabilities</i>	£
Buildings	3,000	Capital	5,000
Stock of goods	500	Creditor	500
Cash at bank	2,000		
	<u>5,500</u>		<u>5,500</u>

Sale of an Asset on Credit

On 10 May 19-7 goods which had cost £100 were sold to J. Brown for the same amount, the money to be paid later. The effect is a reduction in the stock of goods and the creation of a new asset. A person who owes the firm money is known in accounting language as a debtor. The balance sheet now appears as:

B. Blake
Balance Sheet as at 10 May 19-7

<i>Assets</i>	£	<i>Capital and Liabilities</i>	£
Buildings	3,000	Capital	5,000
Stock of goods	400	Creditor	500
Debtor	100		
Cash at bank	2,000		
	<u>5,500</u>		<u>5,500</u>

Sale of an Asset for Immediate Payment

On 13 May 19-7 goods which had cost £50 were sold to D. Daley for the same amount, Daley paying for them immediately by cheque. Here one asset, stock of goods, is reduced, while another asset, bank, is increased. The balance sheet now appears:

B. Blake
Balance Sheet as at 13 May 19-7

<i>Assets</i>	£	<i>Capital and Liabilities</i>	£
Buildings	3,000	Capital	5,000
Stock of goods	350	Creditor	500
Debtor	100		
Cash at bank	2,050		
	<u>5,500</u>		<u>5,500</u>

The Payment of a Liability

On 15 May 19-7 Blake pays a cheque for £200 to D. Smith in part payment of the amount owing. The asset of bank is therefore reduced, and the liability of the creditor is also reduced. The balance sheet now appears:

B. Blake
Balance Sheet as at 15 May 19-7

<i>Assets</i>	£	<i>Capital and Liabilities</i>	£
Buildings	3,000	Capital	5,000
Stock of goods	350	Creditor	300
Debtor	100		
Cash at bank	1,850		
	<u>5,300</u>		<u>5,300</u>

Collection of an Asset

J. Brown, who owed Blake £100, makes a part payment of £75 by cheque on 31 May 19-7. The effect is to reduce one asset, debtor, and to increase another asset, bank. This results in a balance sheet as follows:

B. Blake
Balance Sheet as at 31 May 19-7

<i>Assets</i>	£	<i>Capital and Liabilities</i>	£
Buildings	3,000	Capital	5,000
Stock of goods	350	Creditor	300
Debtor	25		
Cash at bank	1,925		
	<u>5,300</u>		<u>5,300</u>

It can be seen that every transaction has affected two items. Sometimes it has changed two assets by reducing one and increasing the other. Other times it has reacted differently. A summary of the effect of transactions upon assets, liabilities and capital is shown below.

Example of Transaction

1. Buy goods on credit.	Increase Asset (Stock of Goods)	Increase Liability (Creditors)
2. Buy goods by cheque.	Increase Asset (Stock of Goods)	Decrease Asset (Bank)
3. Pay creditor by cheque.	Decrease Asset (Bank)	Decrease Liability (Creditors)
4. Owner pays more capital into the bank.	Increase Asset (Bank)	Increase Capital
5. Owner takes money out of the business bank for his own use.	Decrease Asset (Bank)	Decrease Capital
6. Owner pays creditor from private money outside the firm.	Decrease Liability (Creditors)	Increase Capital

Note: Generally, the figures used for exhibits and for exercises have been kept down to relatively small amounts. This has been done deliberately to make the work of the user of this book that much easier. Constantly handling large figures does not add anything to the study of the principles of accounting, instead it simply wastes a lot of the student's time, and he/she will probably make far more errors if larger figures are used.

It could lead to the authors being accused of not being 'realistic' with the figures given, but we believe that it is far more important to make learning easier for the student.

Assignment Exercises

Note: Assignments with the letter A shown after the assignment number do NOT have answers shown at the back of the book. Answers to the others are shown on pages 392 onwards.

1.1 You are to complete the gaps in the following table:

<i>Assets</i>	<i>Liabilities</i>	<i>Capital</i>
£	£	£
(a) 12,500	1,800	?
(b) 28,000	4,900	?
(c) 16,800	?	12,500
(d) 19,600	?	16,450
(e) ?	6,300	19,200
(f) ?	11,650	39,750

1.2A You are to complete the gaps in the following table:

<i>Assets</i>	<i>Liabilities</i>	<i>Capital</i>
£	£	£
(a) 55,000	16,900	?
(b) ?	17,200	34,400
(c) 36,100	?	28,500
(d) 119,500	15,400	?
(e) 88,000	?	62,000
(f) ?	49,000	110,000

1.3 Distinguish from the following list the items that are liabilities from those that are assets:

- (a) Office machinery
- (b) Loan from C. Shirley
- (c) Fixtures and fittings
- (d) Motor vehicles
- (e) We owe for goods
- (f) Bank balance.

1.4A Classify the following items into liabilities and assets:

Motor vehicles
 Premises
 Creditors for goods
 Stock of goods
 Debtors
 Owing to bank
 Cash in hand
 Loan from D. Jones
 Machinery.

1.5 A. Smart sets up a new business. Before he actually sells anything he has bought Motor Vehicles £2,000, Premises £5,000, Stock of goods £1,000. He did not pay in full for his stock of goods and still owes £400 in respect of them. He had borrowed £3,000 from D. Bevan. After the events just described, and before trading starts, he has £100 cash in hand and £700 cash at bank. You are required to calculate the amount of his capital.

1.6A T. Charles starts a business. Before he actually starts to sell anything he has bought, Fixtures £2,000, Motor Vehicles £5,000 and a stock of goods £3,500. Although he has paid in full for the fixtures and the motor vehicle, he still owes £1,400 for some of the goods. J. Preston had lent him £3,000. Charles, after the above, has £2,800 in the business bank account and £100 cash in hand. You are required to calculate his capital.

1.7 Draw up A. Foster's balance sheet from the following as at 31 December 19-4:

	£
Capital	23,750
Debtors	4,950
Motor vehicles	5,700
Creditors	2,450
Fixtures	5,500
Stock of goods	8,800
Cash at bank	1,250

1.8A Draw up Kelly's balance sheet as at 30 June 19-2 from the following items:

	£
Capital	13,000
Office machinery	9,000
Creditors	900
Stock of goods	1,550
Debtors	275
Cash at bank	5,075
Loan from C. Smith	2,000

1.9 Complete the columns to show the effects of the following transactions:

Effect upon
Assets Liabilities Capital

- (a) We pay a creditor £70 in cash
- (b) Bought fixtures £200 paying by cheque
- (c) Bought goods on credit £275
- (d) The proprietor introduces another £500 cash into the firm
- (e) J. Walker lends the firm £200 in cash
- (f) A debtor pays us £50 by cheque
- (g) We return goods costing £60 to a supplier whose bill we had not paid
- (h) Bought additional shop premises paying £5,000 by cheque.

1.10A Complete the columns to show the effects of the following transactions:

Effect upon
Assets Liabilities Capital

- (a) Bought a motor van on credit £500
- (b) Repaid by cash a loan owed to P. Smith £1,000
- (c) Bought goods for £150 paying by cheque
- (d) The owner puts a further £5,000 cash into the business
- (e) A debtor returns to us £80 goods. We agree to make an allowance for them.
- (f) Bought goods on credit £220
- (g) The owner takes out £100 cash for his personal use
- (h) We pay a creditor £190 by cheque.