

Service Firms.

2007 Q.6

This topic is incredibly similar to Club Accounts and Farm Accounts, so normally once you've mastered any of these the others become very easy. In 2007 the Service Firms question related to Oak Health Centre Ltd. and you would have been expected to do the following...

First of all part (a) asks us to work out the 'reserves' on 1/1/2006. This basically means working out what the company was worth at the start of the year. Anything that relates to stuff that has happened during the year is therefore not relevant. We only need to know what the company **owned** and what they **owed** on January 1st. To do this we look at the figures given to us at the very start of the question and we split this list into assets (things we owned) and liabilities (things we owed). The assets are: Buildings, Equipment, Furniture, Stock of Health Food, Heating Oil, Investments, and Contract Cleaning Prepaid (because when we prepay an expense it means that someone now owes us something). The liabilities are: Creditors for supplies, Client's fees paid in advance (because we now owe them something in return for their prepaid fees) and Issued Share Capital. The 'Authorised Share Capital' is not relevant because it just means the amount of shares we are *allowed* sell – It's the 'Issued' Share Capital (the amount we *have actually sold*) that goes into our answer.

A couple of issues have to be dealt with before we can finish part (A). First of all you might notice that there's a sneaky line underneath the first paragraph in the question saying 'All fixed assets have 2 years accumulated depreciation by 1/1/2006'. What this means is that when we include Buildings for example in our list of assets we shouldn't record it as being worth €500,000 at the start of the year. This is because by the start of the year there had already been 2 years of depreciation on these Buildings and therefore they weren't worth €500,000 on January 1st. What they were worth was the €500,000 minus 2% depreciation for one year of depreciation and minus another 2% for a second year of depreciation (the rate of depreciation is given near the end of the question in note 9. So in our list of assets the value of buildings should be $€500,000 - €10,000 - €10,000 = €480,000$. Likewise the other fixed assets must have their 2 years of depreciation taken off them before we record them for our answer to part (A). So Equipment should be $€70,000 - €10,500 - €10,500 = €49,000$ (we're told in note 9 that equipment depreciation is 15%) and Furniture should be $€20,000 - €5,000 - €5,000 = €10,000$ (we're told in note 9 that furniture depreciation is 25%).

Finally, there are two figures that need to appear as either assets or liabilities that you won't find in the opening paragraph. If you look at the 'Receipts and Payments' T account in the middle of the question, you'll see a list of all the money spent and received by the firm during the year. Like I said earlier, things that happened *during* the year aren't relevant to us in part (A) (because if you remember we're just trying to work out what we owned and owed before the year even began), but the big T account gives us two bits of sneaky information. The first of these is the opening balance of €7,250. This is essentially showing us how much money was in our bank at the start of the year (you'll see that it clearly says: 'Balance at Bank 1/1/2006') and therefore should appear in our list of assets for part (A).

On the other side of the T account you'll see a mention of a loan that we repaid during the year. The crucial thing about this is that it says there was '18 months interest' on the loan. If you think about it that means that we must have had this loan out on January 1st (because if we have 18 months interest on a loan it must mean we took out the loan 18 months ago). So in our list of liabilities for January 1st we have to include the loan and *whatever amount of interest we would have owed on the loan on January 1st*. This involves a little bit of calculating unfortunately. We're told the loan was €50,000 and so that definitely goes in as a liability on January 1st but the bigger question is how much of the €7,200 interest should we put in to part (A)? The answer is simply however much of that we would have owed on January 1st. So if €7,200 is how much interest we owed after four months of the year (it says we paid the loan back on May 1st), then all we need to do is subtract four months of interest from this. Bearing in mind that €7,200 was the interest for 18 months, all we do is divide this by 18 to find one month of interest (€400) and multiply by 4 to get four months of interest (€1,600). This €1,600 wouldn't have been owed by us at the start of the year so the interest figure we put into our answer for part (A) is €7,200 minus €1,600 = €5,600.

Now that we have all of the assets and liabilities at the start of the year, we just list them and take one from the other:

Reserves 1/1/2006.

	€	€	€
<u>Assets.</u>			
Buildings		480000	
Equipment		49000	
Furniture		10000	
Health Food		1300	-
Heating Oil		640	
Investments		70000	
Cleaning Prepaid		250	
Balance at Bank		<u>7250</u>	618440
<u>Liabilities.</u>			
Creditors for Supplies		1250	-
Clients in Advance		4300	
Issued Capital		300000	
Loan		50000	
Loan Interest		<u>5600</u>	<u>361150</u>
			-
Reserves 1/1			257290

(B) In part (B) we're asked to calculate if the shop made a profit or loss for the year. This follows pretty much the normal layout for a 'Trading Account' with the couple of little twists that you might expect. First of all, hopefully you know that a 'Trading Account' looks like this:

	€	€	€
Sales			X
Opening Stock		X	
Purchases		X	
Closing Stock		<u>(X)</u>	
Cost of Sales		<u>X</u>	<u>X</u>
Gross Profit			X

So if we want to know the profit for the shop we just need to fill in:

- The shop sales of €65,000 (from the 'T' Account in the middle of the question);
- The opening stock (from the opening balances at the start of the question);
- The purchases (from the 'T' Account in the middle of the question); and
- The closing stock (from the closing balances at the end of the question).

Shop Trading Account 31/12/2006

	€	€	€
Sales			65000
Opening Stock		1300	
Purchases		42100	
Closing Stock		<u>1600</u>	
Cost of Sales		<u>41800</u>	<u>41800</u>
Gross Profit			20000

We need to be careful though because some expenses that relate directly to the shop are specifically mentioned in note 5 of the extra information at the bottom of the question. We need to subtract these to get the ultimate net profit for the shop.

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Shop Trading and Profit and Loss Account 31/12/2006.

	€	€	€
Sales			65000
Opening Stock		1300	
Purchases		42100	
Closing Stock		<u>-1600</u>	
Cost of Sales		<u>41800</u>	<u>41800</u>
Gross Profit			23200
Wages and Salaries *		8400	
Light and Heat		200	
Insurance		500	
Telephone		<u>340</u>	
		<u>9440</u>	<u>9440</u>
Net Profit			13760

* = 70% of €12,000

(C) The profit and loss account is asking us whether the company as a whole made or profit or a loss (as opposed to the shop on it's own like we worked out above). Before we do this, it's important to learn a few rules that will help us through this part of the question. These rules are used not only in service firms questions, but also in club accounts and farm accounts, so it's well worth learning them. Like everything else in accounting, you can either try to understand them or can just learn them off.

Important Rules:

Due.

1/1: Subtract

31/12: Add

Prepaid.

1/1: Add

31/12: Subtract

Stock.

Opening: Add

Closing: Subtract

Debtors or Creditors.

1/1: Subtract

31/12: Add

So what we need to do is have a look through the question and first of all identify any items that involve us either spending or receiving money this year. Then we need to see if there's any mention at the top or bottom of the question of anything connected to these items of income and expenditure that was due or prepaid at the start or end of the year. To make life easier for us, the items of income are almost all on the left hand side of the 'T' Account and the items of expenditure are almost all on the right.

If you look at the left hand side of the 'T' Account for example we see four entries:

Balance at Bank: This does not go in the profit and loss account because it's not money we received during the year (it's what we already had at the beginning of the year).

Clients Fees: This definitely goes in the profit and loss account. But before we put €252,600 into the answer, don't forget the rules mentioned above. If you look at the top and bottom of the question you'll see a mention of things that are due or prepaid. The figure we need to put into our answer is therefore €252,000 (from the 'T' Account) + €4,300 (clients fees prepaid on the 1/1) - €3,000 (clients fees prepaid on the 31/12) + €450 (clients fees due on the 31/12). There is a mention in note 4 of a dishonoured cheque from a client. Really this doesn't actually make a difference at this stage because technically what you should do is minus it from the €252,600 of clients fees we received (because now we know we haven't actually received it) and then add it to clients fees due on the 31/12. Since these two things cancel each other out, it's fine to do nothing at all and we'll still get the same answer. The figure for clients fees in the answer then is €254,350

Investment Income: This also goes into the profit and loss account because it represents money we have received this year. The important thing to remember is that the investments we have are 5% Investments of €70,000 (this is mentioned in the opening balances). We should get €3,500 this year in investment income. Although the 'T' Account tells us we've only received €3,000 of this, don't forget from the important rules that we're meant to add on anything that is still owed on the 31/12 – in this case, the remaining €500. So in the profit and loss account investment income should appear as €3,500.

Shop Receipts: Although shop receipts definitely represent income, don't forget that we've already worked out a profit for the shop in part (B). What we do therefore is put the shop profit in as income in the profit and loss account (€13,760) and then we don't have to put any other shop gains or expenses into this part of the answer again.

So now we have half of the answer to part (C):

	€	€	€
<u>Profit.</u>			
Clients Fees		254350	
Investment Income		3500	
Shop Profit		<u>13760</u>	271610

Next we need to work through each of the expenses mentioned in the question and work out how much we should put down for each one. If we look at the right hand side of the 'T' Account, we see the following costs:

Laundry: This is an expense and since it isn't mentioned anywhere else in the question we don't need to change it at all. €800

Wages and Salaries: Before we put these in, we need to remember that some of the wages and salaries already appeared when we worked out the profit for the shop. Since the shop profit will already appear in this profit and loss account, it's vital not to put it in here again. The figure for wages and salaries then is €86,220 (from the 'T' Account) - €8,400 (that was put in the shop trading account). €77,820

Loan & Loan Interest: If you can cast your mind back to the very beginning of the question you might remember that we had to deal with this loan and loan interest in part (A). At that stage we were trying to work out how much of the interest we owed on 1/1 (so that we could include the answer in our liabilities at the start of the year). Now what we're trying to do is the opposite – we're trying to work out how much of the €7,200 interest relates to *this year* (i.e. not including anything we already owed before the year began). The good news is that we know the total (€7,200) and we know from our workings in part (A) that €5,600 of this was owed by us on the 1/1. So the amount of loan interest we have incurred this year is the total bill of €7,200 minus €5,600 we owed from last year. €1,600

Equipment: Equipment isn't an expense because it involves spending money on a fixed asset. Fixed assets never appear in the expenses.

New Extension: Exact same as equipment – it's a fixed asset so if you put it in our list of expenses you're wrong.

Cleaning: Cleaning is definitely an expense but there's a few things we need to do with it before we put it in the profit and loss account. It should be €2,600 (from the 'T' Account) + €250 (cleaning prepaid on the 1/1) - €300 (cleaning prepaid on the 31/12). €2,550

Light and Heat. Light and heat is €2,800 (from the 'T' Account) + €640 (opening stock of heating oil) - €250 (closing stock of heating oil) - €200 (light and heat for the shop) + €270 (electricity due 31/12). €3,260

Insurance. €6,200 (from the 'T' Account) - €500 (insurance for the shop). €5,700

Telephone. €1,660 (from the 'T' Account) - €340 (telephone for the shop). €1,320

Purchases for the Shop. We don't need to put this in because we already used it to work out the shop profit and the shop profit will be appearing in this answer as a gain. If we put the purchases in here again we'd basically be putting the same thing in twice which would be wrong.

Purchases of Supplies. These are an expense and should appear as €36,800 (from the 'T' Account) - €1,250 (creditors for supplies 1/1) + €1,400 (creditors for supplies 31/12). €36,950

Balance at Bank. This is not an expense. It's just how much we had at the end of the year and not an amount of money we spent or received.

Aside from the items on the right hand side of the 'T' Account, there's one other thing we must always remember to include in our expenses – Depreciation. In this case there are three fixed assets to be depreciated:

Buildings is 2% of €570,000 (that's the buildings we had at the start of the year plus the new extension we built during the year). €11,400

Equipment is 15% of €84,000 (that's the equipment we had at the start of the year plus the new equipment we bought during the year). €12,600

Furniture is 25% of €20,000. €5,000

So now we have our income and our expenditure and we can show the full answer to part (C):

Profit and Loss Account 31/12/2006.

	€	€	€
<u>Profit.</u>			
Clients Fees		254350	
Investment Income		3500	
Shop Profit		<u>13760</u>	271610
<u>Loss.</u>			
Laundry		800	
Wages and Salaries		77820	
Loan Interest		1600	
Cleaning		2550	
Light and Heat		3260	
Insurance		5700	
Telephone		1320	
Purchase of Supplies		36950	
Buildings Depreciation		11400	
Equipment Depreciation		12600	
Furniture Depreciation		<u>5000</u>	<u>159000</u>
Net Profit			112610

(D) The Balance Sheet is the last thing we need to do and thankfully all the hard work is already done. Remember, what we're doing here is working out what we own and what we owe *at the end of the year*. The four sections can be explained as follows:

Fixed Assets.

Three out of the four figures here are easy:

The equipment figure is the total equipment we own (the €70,000 from the start of the year + the €14,000 we bought during the year) minus the total depreciation so far (the €21,000 we worked out for part (A) + the €12,600 we worked out for part (C)).

The furniture figure is the furniture we own (from the opening balances at the top of the question) minus the total depreciation so far (the €10,000 we worked out for part (A) + the €5,000 we worked out for part (C)).

The investments figure comes straight from the opening balances at the start of the year (we had €70,000 investments at the start of the year and there's been no mention of selling any of these or buying any more, so therefore we still have €70,000 at the end of the year).

The final figure in the fixed assets (buildings) is slightly more complicated. Basically, we think that our buildings are worth €538,600. This is the total buildings we own (€500,000 from the start of the year + the €70,000 extension we bought during the year) minus the total depreciation so far (the €20,000 we worked out for part (A) + the €11,400 we worked out for part (C)). The slight complication is that we're told in note 6 to revalue the buildings to €680,000. What we do therefore is just put €680,000 into the fixed assets as the value of buildings, and the difference between this new value and what we actually thought the buildings were worth (€680,000 - €538,600 = €141,400) is entered as a 'Revaluation Reserve' in the Financed By section.

Current Assets.

The current assets consist of the investment income due (€3,500 we're meant to get minus the €3,000 we have got), closing stock of both the shop and oil, cleaning prepaid (note 2 in the question), customers fees due (€450 from note 3, plus the €100 from note 4) and finally the closing figure from the bank (see the very bottom entry in the 'T' Account).

Current Liabilities.

The three current liabilities are the electricity due (note 7), the customers fees prepaid for next year (note 3) and the creditors for supplies (note 8).

Financed By.

In the financed by we list the share capital (always a safe option to list both the authorised and the issued – even though it's only the issued that we'll actually be using in our answer), the revaluation reserve we worked out when we did the fixed assets above, the reserves from the 1/1 (the answer to part (A)), and the profit and loss balance (the answer to part (C)).

With all of these figures we can then write out the full answer to part (D):

Balance Sheet As At 31/12/2006.

	€	€	€
<u>Fixed Assets.</u>			
Buildings			680000
Equipment	84000	33600	50400
Furniture	<u>20000</u>	<u>15000</u>	<u>5000</u>
	<u>104000</u>	<u>48600</u>	735400
Investments			<u>70000</u>
			805400
<u>Current Assets.</u>			
Investment Income Due		500	
Stock Shop		1600	
Stock Oil		250	
Cleaning Prepaid		300	
Customers Fees Due		550	
Bank		7370	
		10570	
<u>Current Liabilities.</u>			
Electricity Due	270		
Customers Fees Prepaid	3000		
Creditors	<u>1400</u>		
	<u>4670</u>	<u>4670</u>	
		<u>5900</u>	<u>5900</u>
			<u>811300</u>
<u>Financed By.</u>	<i>Authorised</i>	<i>Issued</i>	
Share Capital	<u>430000</u>	300000	
Revaluation Reserve		141400	
Reserves 1/1		257290	
Net Profit 31/12		<u>112610</u>	
		<u>811300</u>	