Chapter 6

Other entity accounts

Getting better . . .

Unqualified sign-off for EU accounts

The National Audit Office has issued a report summarising the results of the European Court of Auditors' examination of the European Union's accounts for 2007 and progress on initiatives by the European Commission and member states. For the first time the court gave a positive statement of assurance, without qualification, on the reliability of the accounts in effect, confirming that they provide a true and fair view. But for the 14th successive year it did not provide a positive statement of assurance on whether the underlying transactions conformed to the applicable laws and regulations.

The most troublesome area is cohesion policy funds, which are designed to reduce disparities in the level of development between regions of the EU – for example, by supporting infrastructure projects. The court estimates that at least 11 per cent of expenditure on cohesion schemes should not have been reimbursed by the commission in 2007. This reflects weakness in controls at member state level as well as the difficulty of implementing such complex programmes. But the commission has increased the rate at which it recovers incorrect payments for cohesion schemes from member states: from €287m in 2007 to €843m to September 2008.

'Recent initiatives have started to improve the financial management of EU funds, but a positive statement of assurance on the legality and regularity of expenditure has yet to be achieved' said Tim Burr, head of the National Audit Office. 'The implementation of cohesion policy remains the chief source of error. The commission will soon start work with member states on the design of future programmes.'

Source: *Financial Management*, May 2009.

Source: Reproduced with permission from CIMA.

Questions relating to this news story can be found on page 142

About this chapter

In previous chapters we have shown you how to compile a set of financial statements and explained what they tell you by using examples from private sector sole trader businesses and limited liability companies. However, we would be presenting an unbalanced and unhelpful view of accounting if we did not also refer to the many other types of private and public entities.

In a book of this nature we cannot possibly deal with every conceivable type of entity that you may come across but fortunately we do not need to. In broad terms the accounting requirements are usually similar to those of sole traders and companies and all that is possibly required is some technical specialist advice, e.g. if the entity is an investment bank or an insurance company. The main difference is more in the way that their financial statements are presented rather than in their accounting methods.

By the time that you get to the end of this book you will find that you will have gained sufficient knowledge and confidence to be able to find your way around almost any type of financial statement no matter whether it is in the private or the public sector and irrespective of its organization, size and type.

This chapter is yet another step towards achieving that goal.

Learning objectives

By the end of this chapter you should be able to:

- **prepare a simple manufacturing account;**
- **describe the type of financial statements required by service sector entities;**
- **compare and contrast financial statements in the profit-making sector with those in the not-for-profit sector;**
- **state why accounting procedures in the public sector may be different from those in the private sector.**

Why this chapter is important

This chapter is important for non-accountants because it will give you a more balanced and a more well-rounded appreciation of accounting and the presentation of accounting information in different types of entities.

Most accounting textbooks concentrate on looking at accounting practices in the private profit-making sector, especially those relating to manufacturing and trading entities. However, the service sector now forms a significant element in the private sector, so it would be misleading to ignore the accounting procedures in that sector. Similarly, in the not-for-profit sector there are many types of entities (such as charities and voluntary bodies) that play an important part in the life of many people. The Government too has a major impact on economic life and so we must also have a brief look at its method of accounting.

The relatively few other types of entity that we cover in this chapter will give you an indication of how basic accounting practices are used (with some modification) in other kinds of entity. You will also find that if you are involved in such entities you can adapt your accounting knowledge to suit the requirements of different entity. Many non-accountants, for example, will be members of various social and sporting clubs so the accounting knowledge that you have gained by working your way through this book will enable you to assess the financial position and future prospects of such

entities with relative ease. Indeed, you may already have come across misleading statements prepared by club treasurers, such as calling a summary of cash received and cash paid a 'balance sheet'! Mistakes like this may not be very serious but they will certainly confuse the club members and give them a false impression of the club's assets and liabilities.

It is to be hoped that after reading this book in general, and this chapter in particular, you will not make such mistakes – or other, much more serious ones.

Manufacturing accounts

An organization that purchases or obtains raw materials and converts them to a finished goods state is known as a *manufacturing* entity. The finished goods are then sold to customers. Manufacturing entities are normally to be found in the private sector and they may operate as sole traders, partnerships or companies.

Unlike the examples we have used in previous chapters, manufacturing entities are not likely to use a *purchases* account. This is because they normally buy raw materials and then process them before they are sold as *finished goods*. So before the trading account can be compiled it is necessary to calculate the cost of converting the raw materials into finished goods. The conversion cost is called the *manufacturing cost* and it is the equivalent of a trading entity's purchases.

In order to calculate an entity's manufacturing cost, we need to prepare a *manufacturing account*. A manufacturing account forms part of the double-entry system and it is included in the periodic financial statements. It normally contains only manufacturing *costs* since it is rare to have any manufacturing *incomes*.

Manufacturing costs are debited to the manufacturing account. They are usually classified into *direct* and *indirect* costs. Direct costs are those costs that can be easily and economically identified with a particular segment (economically means at the least possible cost). A segment may be a department, a section, a product or a unit. Indirect costs are those costs that cannot be easily and economically identified with a particular segment. Indirect costs are sometimes referred to as 'overhead' or 'overheads'.

The format of the manufacturing account is straightforward. Normally, it contains two main sections itemizing the direct and the indirect costs. Each section is then analysed into what are called the *elements of cost*. The elements of cost include materials, labour and other expenses.

Example 6.1 illustrates the format of a typical manufacturing account. A detailed explanation of its contents follows.

Construction of the account

In this section, we are going to explain how to construct a manufacturing account. We use Example 6.2 to do so.

Example 6.1

Format of a basic manufacturing account

	£000	£000
Direct costs (1)		
Direct materials (2)	20	
Direct labour (3)	70	
Other direct expenses (4)	5	
Prime cost (5)		95
Manufacturing overhead (6)		
Indirect material cost (7)	3	
Indirect labour cost (7)	7	
Other indirect expenses (7)	10	
Total manufacturing overhead incurred (8)		20
Total manufacturing costs incurred (9)		115
Work-in-progress (10)		
Opening work-in-progress	10	
Closing work-in-progress	(15)	(5)
Manufacturing cost of goods produced (11)		110
Manufacturing profit (12)		11
Market value of goods produced transferred to the trading account (13)		121

Notes:

(a) The number shown after each item refers to the tutorial notes. The values have been inserted purely for illustrative purposes.

(b) The term 'factory' or 'work' is sometimes substituted for the term manufacturing.

Tutorial notes to Example 6.1

1 *Direct costs*. The exhibit relates to a *company's* manufacturing account. It is assumed that the direct costs listed for materials, labour and other expenses relate to those expenses that have been easy to identify with the specific products manufactured by the company.

2 *Direct materials*. The charge for direct materials will be calculated as follows:

direct material cost = (opening stock of raw materials + purchases of raw materials) – closing stock of raw materials

The total of direct material cost is sometimes referred to as *materials consumed*. Direct materials will include all the raw material costs and component parts that have been easy to identify with particular products.

3 *Direct labour*. This will include all those employment costs that have been easy to identify with particular products.

4 *Other direct expenses*. Besides direct materials and direct labour costs, there are sometimes other direct expenses that are easy to identify with particular products, e.g. the cost of hiring a specific machine. Such expenses are relatively rare.

5 *Prime cost*. The total of direct material costs, direct labour costs and other direct expenses is known as prime cost.

6 *Manufacturing overhead*. Overhead refers to the total of all indirect costs and so any manufacturing costs that are not easy to identify with specific products will be classified separately under this heading.

Tutorial notes to Example 7.1 continued

7 *Indirect material cost, indirect labour cost and other indirect expenses*. Manufacturing overhead will probably be shown separately under these three headings.

8 *Total manufacturing overhead incurred*. This item represents the total of indirect material cost, indirect labour cost and other indirect expenses.

9 *Total manufacturing costs incurred*. The total of prime cost and total manufacturing overhead incurred equals the total manufacturing costs incurred.

10 *Work-in-progress*. This represents the estimated cost of incomplete work that is not yet ready to be transferred to finished stock. There will usually be some opening and closing work-in-progress.

11 *Manufacturing cost of goods produced*. This equals the total manufacturing costs incurred plus (or minus) the difference between the opening and closing work-in-progress.

12 *Manufacturing profit*. The manufacturing cost of goods produced may be transferred straight to the finished goods stock account. The finished goods stock account is the equivalent of the purchases account in a trading organization. Sometimes a manufacturing profit is added to the manufacturing cost of goods produced before it is transferred to the trading account. The main purpose of this adjustment is to enable management to compare more fairly the company's total manufacturing cost (inclusive of profit) with outside prices (since such prices will also normally include some profit). The profit added to the manufacturing cost of goods produced may simply be an appropriate percentage or it may represent the level of profit that the industry generally expects to earn. Any profit element added to the manufacturing cost (irrespective of how it is calculated) is an internal bookkeeping arrangement, because the profit has not been earned or *realized* outside the business. It is what accountants call a 'book entry'.

13 *Market value of goods produced*. As explained in note 12 above, the market value of goods produced is the amount that will be transferred (i.e. debited) to the trading account.

Activity 6.1

Do you think that the structure of a manufacturing account makes it easy to follow? Check that you clear about the meaning of each individual item. What does the information tell you about the cost of manufacturing during the period in question?

Example 6.2

Constructing a manufacturing account

The following balances, *inter alia*, have been extracted from the Wren Manufacturing Company as at 31 March 2011:

	Dr
	£
Carriage inwards (on raw materials)	6 000
Direct expenses	3 000
Direct wages	25 000
Factory administration	6 000
Factory heat and light	500
Factory power	1 500
Factory rent and rates	2 000
Factory supervisory costs	5 000
Purchase of raw materials	56 000
Raw materials stock (at 1 April 2010)	4 000
Work-in-progress (at 1 April 2010)	5 000

Additional information:
1 The stock of raw materials at 31 March 2011 was valued at £6000.
2 The work-in-progress at 31 March 2011 was valued at £8000.
3 A profit loading of 50 per cent is added to the total cost of manufacture.

Required:
Prepare Wren's manufacturing account for the year to 31 March 2011.

Answer to Example 6.2

Wren Manufacturing Company
Manufacturing account for the year to 31 March 2011

	£	£	£
Direct materials			
Raw material stock at 1 April 2010		4 000	
Purchases	56 000		
Carriage inwards (1)	6 000	62 000	
		66 000	
Less: Raw material stock at 31 March 2011		6 000	
Cost of materials consumed			60 000
Direct wages			25 000
Direct expenses			3 000
Prime cost			88 000
Other manufacturing costs (2)			
Administration		6 000	
Heat and light		500	
Power		1 500	
Rent and rates		2 000	
Supervisory		5 000	
Total manufacturing overhead expenses			15 000
			103 000
Work-in-progress			
Add: Work-in-progress at 1 April 2010		5 000	
Less: Work-in-progress at 31 March 2011		(8 000)	(3 000)
Manufacturing cost of goods produced			100 000
Manufacturing profit (50%) (3)			50 000
Market value of goods produced (4)			150 000

Tutorial notes

1 Carriage inwards (i.e. the cost of transporting goods to the factory) is normally regarded as being part of the cost of purchases.
2 Other manufacturing costs include production overhead expenses. In practice there would be a considerable number of other manufacturing costs.
3 A profit loading of 50 per cent has been added to the manufacturing cost (see question note 3). The manufacturing profit is a debit entry in the manufacturing account. The corresponding credit entry will eventually be made in the profit and loss account.
4 The market value of goods produced will be transferred to the finished goods stock account.

Links with the other accounts

Example 6.2 deals with the manufacturing account in isolation. However, once the manufacturing account has been prepared it will then be linked with the trading account and the profit and loss account by transferring either the *manufacturing cost* of the goods produced or the *market value* of the goods produced to the trading account. The manufacturing cost or the market value of the goods produced is, therefore, the equivalent of 'purchases' in the trading account of a non-manufacturing entity. Apart from this minor amendment, the preparation of a trading account for a manufacturing entity is exactly the same as that for a trading entity. This relationship is shown in outline in Figure 6.1.

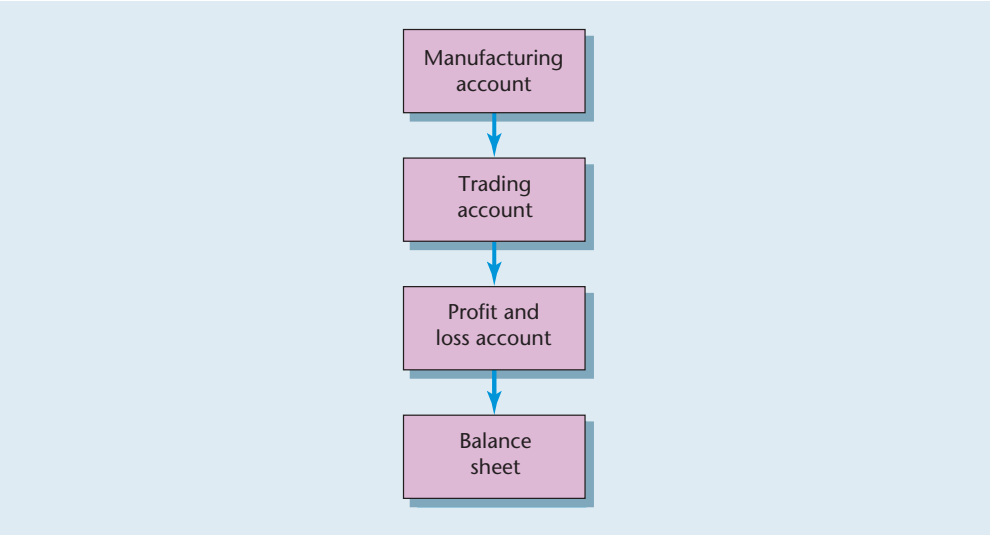

Figure 6.1 The relationship between the main accounts

Service entity accounts

The profit-making sector is made up of a great many other types of entity beside those that may be classified as manufacturing or trading. For convenience we will describe them as *service entities*. Unlike manufacturing or trading entities, service entities do not normally deal in physical or tangible goods. Instead they offer advice and provide assistance to their customers, clients, patients or passengers. In recent years the manufacturing sector in the United Kingdom has declined and the service sector has become much more important.

The service sector is extremely diverse, but there are a number of recognizable categories. Some of the main ones are as follows.

- *Hotels and catering.* Such entities are generally regarded as being part of the service sector although the service they offer includes a physical or tangible element, e.g. the supply of food and drink.
- *Leisure and recreational activities.* Services included in this category include cinema, concerts and theatre productions, leisure and sports centres, and travel agencies.

- *Personal.* Examples of personal services include beauticians, hairdressing and manicuring.
- *Professional.* The more common professional services include accounting, legal and medical (including chiropody and optical).
- *Transportation.* Transportation services include the movement of goods and passengers by air, land and sea.

Activity 6.2

Think of the main street in your own town or city. List six different types of service entitity.

It will be apparent from the above summary that there is an extremely wide variety of different types of service entities. This means that the accounts of different entities will also be somewhat different, e.g. the accounts of a beautician will not be identical to those of a railway company. Nevertheless, there are some basic features that are common to all service sector entities and that distinguish them from manufacturing and trading entities. These may be summarized as follows:

1 *No manufacturing and trading accounts.* These accounts are irrelevant in service entities because they do not normally manufacture products or trade in tangible goods.
2 *No gross profit.* As service entities do not prepare trading accounts the calculation of gross profit is irrelevant.
3 *Primacy of the profit and loss account.* Details of the income and expenditure for a particular accounting period are shown almost entirely in the profit and loss account.
4 *Format.* The format of a service-sector profit and loss account is very similar to that of a trading entity. However, sometimes specific groups of expenditure are deducted from specific groups of income, the net amount then being highlighted in the profit and loss account. For example, suppose an entity sells food for £1000 and its cost was £600. The £1000 income *could* be shown in the income section of the profit and loss account with the £600 being shown separately as an expenditure item. But as there is a close relationship between the income and the expenditure, it is helpful to users if it is grouped as in Example 6.3.

Example 6.3

Extract from the profit and loss account

	£	£
Income from sale of food	1 000	
Less: cost of provision	600	400

5 *Segmentation.* Similar categories of income or expenditure are usually grouped together in the same part of the profit and loss account with the subtotal of each category being shown separately.

We illustrate the presentation of a set of financial statements for a service entity in Example 6.4. As you will see, the presentation of the profit and loss account and the balance sheet is very similar to the examples used in previous chapters.

Example 6.4

A service entity account

Mei Loon: Educational training consultant
Profit and loss account for the year to 31 March 2012

	£	£
INCOME (1)		
Article fees	5 000	
Author's licensing and collecting payments	2 000	
Consultation fees	90 000	
Lecture fees	30 000	
Public lending right payment	1 000	
Royalties	20 000	148 000
EXPENDITURE (2)		
Computing	5 000	
Depreciation : equipment (3)	2 000	
: furniture (3)	500	
Heat and light	1 000	
Insurances	600	
Photocopying	200	
Postage	100	
Rates	1 500	
Secretarial	30 000	
Stationery (4)	700	
Subscriptions	400	
Travelling	6 000	48 000
Net profit for the year (5)		100 000

Balance sheet at 31 March 2012

	£	£
FIXED ASSETS (6)		
Office equipment	10 000	
Less: accumulated depreciation	4 000	6 000
Office furniture	5 000	
Less: accumulated depreciation	1 500	3 500
		9 500
CURRENT ASSETS		
Stock of stationery (7)	200	
Debtors (8)	15 000	
Prepayments (9)	3 000	
Cash at bank and in hand	52 300	
	70 500	
CURRENT LIABILITIES		
Creditors (10)	2 000	
Accruals (11)	1 000	
	3 000	67 500
		77 000

	£	£
CAPITAL		
At 1 April 2011 (12)		17 000
Net profit for the year (13)	100 000	
Less: drawings (14)	40 000	60 000
Balance at 31 March 2012		77 000

Tutorial notes to Example 6.4

1 All six of the listed income items will have been compiled on an accruals and prepayments basis, i.e. the cash received during the period will have been adjusted for any opening and closing debtors.

2 Apart from depreciation the expenditure items will have been adjusted for any opening or closing accruals and prepayments.

3 Mei Loon appears to be depreciating her office furniture by 10 per cent per annum on cost [(£500 ÷ £5000) × 100%], and her office equipment by 20 per cent per annum on cost [(£2000 ÷ £10,000) × 100%].

4 The stationery costs for the year have been reduced by the stock at 31 March 2012 (see note 7).

5 The net profit for the year has been added to Mei Loon's capital at 1 April 2011 (see note 12).

6 The fixed assets are shown at their gross book value less the accumulated depreciation. The difference is known as 'net book value'.

7 Mei Loon has valued the stock of stationery that she held at 31 March 2012 at £200.

8 The debtors entry probably represents what is owed to Mei Loon for various fees as at 31 March 2012.

9 The prepayments represent what she has paid in advance at the end of the year for various services, such as insurances or heat and light, from which she would expect to benefit in the year to 31 March 2013.

10 The creditors represent what she owes at the end of the year for various goods and services supplied during the year.

11 The accruals are similar to the creditors, but they probably relate to services such as insurances or heat and light (see note 9).

12 Mei Loon's opening capital balance is shown as £17,000. This would be composed of her original capital contribution plus previous years' profits that she had not drawn out of the business.

13 The net profit for the year is the balance on the profit and loss account.

14 Mei Loon has drawn £40,000 out of the business during the year for her own private use. Some of the £40,000 probably relates to previous years' profits that she has drawn out during the current year, along with various amounts drawn out in advance of this year's profits.

Activity 6.3

Referring to Example 6.4, examine Mei Loon's profit and loss account and balance sheet. What does the information tell you? How well has her consultancy done during the year to 31 March 2012? Is she likely to go bankrupt in the near future?

Not-for-profit entity accounts

News clip

Accounting for charities

In a recent review the Charity Commission has argued that accounting and reporting requirements are important tools for charities. The Commission believes that such requirements help them balance their books, plan for the future, and account for their income and spending. The report also highlighted a lack of proper controls which made existing problems harder to sort out.

Source: Adapted from www.accountancyage.com/articles/print/2225722, 10 September 2008.

As the term suggests, not-for-profit entities are in business solely to provide some sort of service without necessarily needing to or wanting to make a profit. Examples include charities such as 'Save the Children', bridge clubs, music societies and sports organizations. It is possible that such bodies might be engaged in some sort of trading (or even manufacturing) but the profit motivation would not be their main consideration.

If not-for-profit entities have some manufacturing or trading activities, they will prepare manufacturing and trading accounts. The balance on the manufacturing account would be transferred to the trading account and the balance on the trading account (i.e. the gross profit) to an *income and expenditure account*. An income and expenditure account is almost identical to a profit and loss account except that the title is different and the balance on the account is described as the *excess of income over expenditure* (or expenditure over income) instead of *profit* (or *loss*).

An example of an income and expenditure account and a balance sheet for a social club is shown in Example 6.5. The preparation of such accounts is very similar to that for trading entities.

Example 6.5

A social club's accounts

Balli Social Club
Income and expenditure account for the year to 31 March 2011

	£	£
INCOME (1)		
Bar sales (2)	60 000	
Less: purchases	40 000	20 000
Building society interest		200
Dances (2)	1 600	
Less expenses	900	700
Food sales (2)	8 000	
Less: purchases	4 500	3 500
Members' subscriptions		36 200
	c/f	60 600

	b/f	60 600
EXPENDITURE (3)		
Accountants' fees	250	
Depreciation: furniture and fittings	3 900	
Insurances	600	
Electricity	1 400	
Office expenses	22 000	
Rates	2 000	
Salaries and wages	14 000	
Telephone	3 100	
Travelling expenses	13 000	60 250
Excess of income over expenditure for the year (4)		350

Balance sheet at 31 March 2011

	£ *Cost*	£ *Accumulated depreciation*	£
FIXED ASSETS (5)			
Club premises	18 000	–	18 000
Furniture and equipment	39 000	17 900	21 100
	57 000	17 900	39 100
CURRENT ASSETS (5)			
Stocks	1 500		
Prepayments	200		
Members' subscriptions (in arrears)	7 000		
Building society account	2 700		
Cash	5 500	16 900	
CURRENT LIABILITIES (5)			
Trade creditors	2 000		
Members' subscriptions (paid in advance)	800		
Accruals	1 250	4 050	12 850
			51 950
ACCUMULATED FUND (6)			
Balance at 1 April 2010 (7)			51 600
Excess of income over expenditure for the year (8)			350
Balance at 31 March 2011 (9)			51 950

Tutorial notes to Example 6.5

1 The income items will have been calculated on an accruals and prepayments basis.

2 Details relating to the bar, dances and food sales (and other similar activities) may require separate disclosure. If so, individual accounts would be prepared for these activities, the balance on such accounts then being transferred to the income and expenditure account.

3 Expenditure items would be calculated on an accruals and prepayments basis.

4 The balance on the account (the excess of income over expenditure for the year) is transferred to the Accumulated Fund account (see note 6).

5 Fixed assets, current assets and current liabilities are calculated and presented in exactly the same way that they are for profit-making entities.

Tutorial notes to Example 6.5 continued

6 The Accumulated Fund is the equivalent of the capital element in the accounting equation. The total amount of £51,950 represents what the members have invested in the club as at 31 March 2011, and what could have been paid back to them (in theory) if the club had been closed down at that date. In practice, of course, the various items on the balance sheet would not necessarily have been disposed of at their balance sheet values.

7 This was the balance in the Accumulated Fund at the beginning of the club's financial year.

8 This balance has been transferred from the income and expenditure account.

9 This is the balance in the Accumulated Fund as at the end of the club's financial year.

Activity 6.4

Referring to Example 6.5, how satisfactory do you think the Balli Social Club's financial performance has been during the year to 31 March 2011?

Government accounts

News clip

Whitehall needs accountants

It has been reported that there are only a small number of civil servants working in Whitehall who have an adequate financial qualification. Edward Leigh, Chairman of the House of Commons Public Accounts Committee, is quoted as saying, 'You would think that no department would contemplate implementing a policy without first estimating what it is going to cost. But only 20 per cent of departments based policy decisions on a thorough assessment of their financial implications.'

Source: Adapted from www.accountancyage.com/articles/print/2225631, 10 September 2009.

Another important set of entity accounts relate to the government sector of the economy. Such accounts may generally be regarded as part of the not-for-profit service sector. There are three broad categories: central government accounts, local government accounts, and quasi-governmental accounts.

Central government accounts incorporate the results of major departments such as defence, the environment, social security and trade and industry. Until a few years ago they were prepared on a cash basis, i.e. cash received for the year was matched with cash paid during that year but then the government switched to what it calls *resource* accounting. This is just another term for accounts prepared on an accruals and prepayments basis.

Resource accounting was introduced because government services needed to become more efficient, i.e. to offer a better service to the public for every pound spent. Cash accounting resulted in a lack of control of operations and projects. If a project was costing more than had been budgeted for it, for example, payments to suppliers would be delayed because this made the cash position look better.

Resource accounting has required government departments to adopt a different approach to the way that they manage their affairs. It involves setting objectives, laying down long-term and short-term plans, the tight management of funds and resources, and statutory reporting similar to that required in the private sector.

Resource accounting involves producing sets of accounts that include operating cost statements. These are similar to profit and loss accounts and balance sheets. It is claimed that they have the following advantages:

- costs are charged to departments when they are incurred and not when they are paid for;
- distortions are removed between when goods and services are received, when they are paid and when they are consumed;
- departmental budgets are more realistic;
- it is much more difficult to disguise the overall cost of departmental activities;
- there is greater control over the safeguarding of fixed and current assets, e.g. stocks, and the monitoring of current liabilities such as creditors.

These are substantial claims. Bearing in mind the difficulties that the commercial world has in dealing with 'accruals and prepayment' accounting, it is doubtful whether resource accounting is operating quite as smoothly as the government had expected.

Activity 6.5

Consider the benefits listed above that the switch to resource accounting was supposed to bring to government activities. How far do you think that they are being met? Is the absence of the profit motive in the not-for-profit sector a major difficulty?

An important part of the government sector is *local government*. Local government accounts include income and expenditure details relating to major services such as education, housing, police and social services. The annual budget (running from 1 April to 31 March) determines the amount of cash that the local authority needs to raise from its council tax payers in order to finance its projected expenditure for the forthcoming year. This is a highly political consideration and councillors are usually more concerned about the impact that a forthcoming budget may have on the electorate than about expenditure that has already been incurred.

News clip

Outsourcing local government

According to *The Economist* one way that local councils could cut their costs is 'to do less by getting others to do more'. This policy requires councils to contract private sector and not-for-profit organizations to manage facilities and provide necessary services for them. If this policy is done right, it is argued, the facilities and the local budget are improved although it is admitted that if it is done wrong, 'services vanish'.

Source: Adapted from *The Economist*, 11 April 2009, p. 30.

Another part of the government sector includes *quasi-government* bodies. They include those entities that are owned by the government but operated at arm's length (i.e. indirectly) through specially appointed authorities and councils. Examples include the British Broadcasting Corporation (BBC), secondary and tertiary education colleges, the Royal Mail and universities. Such entities are often heavily dependent on the Government for providing a great deal of their operational income.

News clip

London Olympics in a hole

Apparently the finances of the London Olympics are in a hole because it has been discovered that the Directorate failed to make a provision for between £60m and £100m to cover a compensation claim for local businesses forced to relocate from the Olympic site.

Source: Adapted from www.accountancyage.com/articles/print/2244697, 27 June 2009.

Overall, government accounting generally is a highly specialist activity, although the basics are similar to the procedures used in the private sector. As it is so specialized, we will not consider it any further in this book.

Questions you should ask

This chapter covers a number of different types of entity so the following questions may not be relevant in all instances.

- How do you distinguish between 'direct costs' and 'indirect costs'?
- Why bother with manufacturing profit?
- How has the amount added for manufacturing profit been calculated?
- Are there any problems in deciding what income to take to the income and expenditure account?
- How have the depreciation rates for the fixed assets been arrived at?
- Should we allow for any bad debts or any doubtful ones? [A very important question in the case of social clubs.]
- What method has been used to estimate them?
- How have any accruals and prepayments been taken into account?

Conclusion

We began this chapter by describing the nature and purpose of manufacturing accounts and demonstrating how they may be compiled. We then moved the focus away from manufacturing and trading accounts toward other types of accounts used in the service sector and the non-for-profit sector.

You will have noticed that there is a great deal of similarity between manufacturing and trading accounts and the accounts of service sector entities. Manufacturing, trading and service sector entities all usually adopt an accruals and prepayments basis for preparing their financial statements and they are presented in the form of a profit and loss account (or equivalent) and a balance sheet.

The main difference is in the detail. Non-manufacturing and trading entities have few (if any) raw material stocks, work-in-progress or finished goods, and product costing is largely irrelevant. There are also a few differences in the way that information is presented in the profit and loss account (or the income and expenditure account) and the balance sheet. So if you can work your way through a manufacturing entity's accounts, you should not have too much difficulty with non-manufacturing, non-trading and service sector accounts. Government accounts are, however, a different matter!

Key points

1. Entities that convert raw materials and component parts into finished goods may need to prepare a manufacturing account.
2. A manufacturing account is part of the double-entry system. Normally it will be prepared annually along with the other main financial accounts. It usually comes before the trading account.
3. The main elements of a manufacturing account include direct materials, direct labour, direct expenses and various indirect manufacturing costs.
4. A direct cost is a cost that can be easily and economically identified with a particular department, section, product, process or unit. An indirect cost is a cost that cannot be so easily and economically identified.
5. The type of manufacturing account described in this chapter would not be required if an entity had a management accounting system.
6. Service sector entities do not normally deal in physical or tangible goods or services. So they do not need to prepare a manufacturing or a trading account, their basic accounts consisting of a profit and loss account and a balance sheet. The preparation of such financial statements is similar to that required for compiling manufacturing and trading entity accounts.
7. The accounts of not-for-profit entities are very similar to those of service entities, except that the profit and loss account is referred to as an income and expenditure account.
8. Government accounts are highly specialized although their basic structure is now similar to that adopted in the private sector.

Check your learning

The answers to these questions can be found within the text.

1 What is a manufacturing account?

2 What is (a) a direct cost, (b) an indirect cost?

3 What is meant by the term 'prime cost'?

4 How does an allowance for profit in the manufacturing account affect the cash position of the entity?

5 To which account is the 'market value of goods produced' transferred?

6 What is meant by the 'service sector'?

7 List five different groups of service sector entities.

8 Name four different types of businesses operating in the service sector.

9 What is meant by a 'not-for-profit' entity?

10 What terms are applied to its main financial statement?

11 Can a not-for-profit entity make profits?

12 What is the balance called that is transferred to the accumulated fund at the end of a financial period?

13 What is meant by an 'accumulated fund'?

14 What term does the government use to describe its method of accounting?

15 Name two types of local government activities.

16 Name two quasi-governmental entities.

News story quiz

Remember the news story at the beginning of this chapter? Go back to that story and reread it before answering the following question.

This article reflects a worrying state of affairs in the management of the European Union. You would expect that an organization as big and as important as the EU could manage its finances effectively and efficiently. Unfortunately this has not been the case although this article indicates that recently there has been some improvement. The issues raised in this article are highly complex but we suggest that you have a go at answering the following questions by using a combination of your accounting knowledge and a certain amount of common sense.

Questions

1 How do you think a supposedly sophisticated organization could present accounts over a number of years that are not 'reliable', i.e. they do not represent a true and fair view?

2 What would the consequences be if a *company* presented accounts that were unreliable?

3 What steps would you suggest could be taken to ensure that there is greater control in releasing funds to cover expenditure on infrastructure projects?

Tutorial questions

The answers to questions marked with an asterisk can be found in Appendix 4.

6.1 A direct cost has been defined as 'a cost that that can be easily and economically identified with a particular department, section product or unit'. Critically examine this definition from a non-accounting manager's perspective.

6.2 Although a manufacturing account may contain a great deal of information, how far do you think that it helps managers who are in charge of production cost centres?

6.3 It has been asserted that the main objective of a profit-making entity is to make a profit, while that of not-for-profit entity is to provide a service. Discuss this assertion in the context of the accounting requirements of different types of entities.

6.4* The following information relates to Megg for the year to 31 January 2010:

	£000
Stocks at 1 February 2009:	
Raw material	10
Work-in-progress	17
Direct wages	65
Factory: Administration	27
Heat and light	9
Indirect wages	13
Purchases of raw materials	34
Stocks at 31 January 2010:	
Raw material	12
Work-in-progress	14

Required:
Prepare Megg's manufacturing account for the year to 31 January 2010.

6.5* The following balances have been extracted from the books of account of Moor for the year to 28 February 2011:

	£
Direct wages	50 000
Factory indirect wages	27 700
Purchases of raw materials	127 500
Stocks at 1 March 2010:	
Raw material	13 000
Work-in-progress	8 400
Stocks at 28 February 2011:	
Raw material	15 500
Work-in-progress	6 300

Required:
Prepare Moor's manufacturing account for the year to 28 February 2011.

6.6 The following balances have been extracted from the books of Stuart for the year to 31 March 2012:

	£000
Administration: Factory	230
Direct wages	330
Purchases of raw materials	1 123
Stocks at 1 April 2011:	
Raw material	38
Work-in-progress	29
Additional information:	
Stocks at 31 March 2012:	
Raw material	44
Work-in-progress	42

Required:
Prepare Stuart's manufacturing account for the year to 31 March 2012.

6.7 The following balances have been extracted from the books of the David and Peter Manufacturing Company as at 30 April 2011:

	£000
Direct wages	70
Factory equipment: at cost	360
General factory expenses	13
Heat and light (factory $\frac{3}{4}$; general $\frac{1}{4}$)	52
Purchases of raw materials	100
Stocks at 1 May 2010:	
Raw material	12
Work-in-progress	18
Rent and rates (factory $\frac{2}{3}$; general $\frac{1}{3}$)	42

Additional information:

1 Stocks at 30 April 2011:

	£000
Raw material	14
Work-in-progress	16

2 The factory equipment is to be depreciated at a rate of 15 per cent per annum on cost.

Required:
Prepare the David and Peter Manufacturing Company's manufacturing account for the year to 30 April 2011.

Further practice questions, study material and links to relevant sites on the World Wide Web can be found on the website that accompanies this book. The site can be found at **www.pearsoned.co.uk/dyson**