

ACCOUNTANCY ASPECTS OF LIABILITY CLAIMS

COSTING IN GENERAL

Every business needs to have some kind of costing system. - although many smaller businesses do not! Without one, management can have no idea of whether an individual product is making a profit or a loss. When dealing with claims we find wide variety of costing systems, however the basic principles are always there.

Accountants categorise costs incurred by a business in two ways:

Direct, or indirect
Variable, or fixed

Direct: Costs that are directly attributable to a unit of production.

Indirect: Costs that cannot be attributed to an individual unit of production.

Consider, as an example, the manufacture of motor vehicle sub assemblies which requires the raw materials which are machined by the workshop staff to form a manufactured part which is then assembled with a purchased part prior to incorporation into the vehicle. The machining process uses power and needs consumables such as lubricants. Workshop staff are paid for a 40-hour week irrespective of the number of parts produced.

Direct costs are those which are directly incorporated in the unit of production. In this example, raw materials, workshop labour, purchased parts and power and consumables associated with machining are all direct costs. The cost of workshop supervision, power for light and heat and general machine repairs are indirect costs - they are not directly incorporated into a production unit.

Example 1

Consider a Chinese takeaway restaurant and identify which of the following costs are direct or indirect:

<u>Costs</u>	<u>Direct or Indirect</u>
Meat and vegetables	Direct
Chef's wages	Direct
Packaging materials	Direct
Gas and electricity	Direct/Indirect
Counter staff wages	Indirect
Telephone	Indirect
Rent and rates	Indirect

Remember that direct costs are those which are incorporated into a production unit.

As a separate exercise, costs can be categorised as either variable or fixed. We will see later that direct costs can be either variable or fixed.

Variable: Cost varies directly with the number of units produced. If one more unit is manufactured, the cost increases proportionally.

Fixed: Cost remains the same irrespective of the number of units produced, assuming the business continues.

Going back to our example of the car manufacturer, variable costs are those which vary directly with the number of sub assemblies manufactured. In the example, raw materials, purchased parts, and power and consumables associated with machining are all variable costs - if the Insured manufactures one more sub-assembly, then the value of these costs will all increase. In this example, labour is not variable, it is fixed at least in the short term as the wages bill for the workshop will be the same whether 20 or 40 units are produced. We would, however, say that labour is semi-variable if overtime can be worked to meet production over 40 units, or variable in the long term if additional staff are recruited to meet demand. We would expect the cost of the workshop's supervision, power for light and heating, and general routine repairs to be fixed in the short term.

Example 2

Consider the Chinese takeaway restaurant again and identify which of the following costs are variable or fixed:

<u>Costs</u>	<u>Variable or Fixed</u>
Meat and vegetables	Variable
Chef's wages	Fixed
Packaging materials	Variable
Gas and electricity	Semi-variable
Counter staff wages	Fixed
Telephone	Fixed
Rent and rates	Fixed

You will notice in this example that in general, direct costs tend to be variable and indirect costs fixed, however this is not always the case and wages is often the exception which requires particular care.

Exercise 1

Consider a manufacturer of chocolate bars. The factory produces 23 hours a day throughout the year. Production lines are stopped for an hour a day for cleaning and maintenance. The cleaning procedure is to meet with hygiene standards and must be completed irrespective of the amount of chocolate produced. Staff in the packing department are paid on a piecework basis. The plant is depreciated on a straight line basis over time and the contribution to group overhead was agreed at the beginning of the year.

Identify which of the following costs are direct/indirect and variable/fixed.

<u>Costs</u>	<u>Direct/Indirect</u>	<u>Variable/Fixed</u>
Raw material ingredients	Direct	Variable
Production wages	Direct	Fixed
Shift supervisor's wages	Indirect	Fixed
Cleaning/Maintenance wages	Indirect	Fixed
Consumables/cleaning materials	Indirect	Fixed
Packaging materials	Direct	Variable
Packing department wages	Direct	Variable
Factory rates	Indirect	Fixed
Group overheads	Indirect	Fixed
Depreciation	Indirect	Fixed

Standard Cost: To allow a manufacturing business to budget for and control costs during the year, many businesses operate a standard costing system. This sets quantities, materials and labour that will be required to produce a single unit and costs them at the rate incurred at a particular point in time. Labour and variable costs can readily be allocated to each unit of production but the allocation of fixed costs is more difficult. It is usual to estimate the number of parts that will be produced in the year and allocate the total expected annual costs over these units. Obviously, the allocation per unit will be incorrect if the number of units produced differs from the expected level. If an extra unit is manufactured, then the total rent paid for the year will not increase! The allocation of fixed costs can be very detailed. For example, a company may allocate the fixed costs for each department separately over only those units which pass through that department.

While the Insured's accountants will spend a great deal of time working out these costs, standard costs can vary from actual for the following reasons:

Material costs:	More or less material actually used than the standard quantity Cost price of materials changes
Production labour:	More or less time actually taken to produce unit than the standard time allowed Hourly cost of labour different from standard
Fixed costs:	Variation in actual costs from initial annual estimate Variation in the number of units produced

Businesses will also often operate with a "standard selling price". This in effect is a budget price and which it is unlikely that many customers will actually pay. The difference may affect turnover or be shown separately as discounts.

At the end of the month or possibly quarter, the Management Accountants will produce what is known as a variance analysis which compare the actual costs incurred against the standard cost. If costs incurred are greater than the standard then the variance is described as **adverse**, whilst if the cost is less than standard then the variance is described as **favourable**.

When we are dealing with a manufacturing business and discussing their costing system, we must always check whether it is a standard costing system and, if it is, ask to review the variance analysis. If variances are substantial, then we will need to adjust the standard cost to allow for this when making a payment.

Budgets: Many businesses, even the smaller ones, will produce budgets or projections and will seek to base their claim on these. A budget or projection is no more than the businesses' best guess of what will happen in the forthcoming year. Just because something is in the budget it does not mean it will happen! Budgets would normally include projected sales levels together with costs expected to be incurred to produce that revenue. When presented with a budget, it is important to consider the following:

1. When was the budget prepared? - Before the loss?
2. Why was the budget prepared? - For the bank, or as the target for salesmen?
3. Review past actual performance against budget - Is it likely that this budget would have been achieved?

Marginal cost: This is the additional costs incurred in making one more unit of production. In normal circumstances, this will equate to the variable cost of production, but it may be that normal capacity is exceeded by the production of this next unit and that overtime has to be worked, or, taking it to the real extreme that another factory needs to be built to meet the order!

In summary, when discussing costs with the business, there are no hard and fast rules. We must make sure we understand the business and how the cost structure works. To recap, we need to consider:

1. Are costs direct or indirect?
2. Are costs variable or fixed?
3. Is there a standard costing system in operation?

STOCK LOSSES

The overall consideration is that we must identify the actual value of the stock to the Third Party at that time. This may be historic cost or replacement depending upon the circumstances. We are in effect interested in the marginal cost of replacing what has been lost.

Here we need to consider businesses which buy in stock items for resale and those which manufacture. In both cases, we must consider two scenarios - the first, where stock can be replaced/remanufactured, and the second, where it cannot.

1. Purchase Goods - Replaced

This is the simplest situation. The Third Party loses stock and can go out and buy identical replacements. The loss payable is the replacement cost of the stock items.

2. Purchase Goods - Not Replaced

It may be that the goods are not replaced because the order for which they were required has been lost or alternatively that they cannot be replaced because they are not available. In this scenario we should be looking at historic purchase price making adjustments for any downward movement in market prices and of course obsolescence.

3. Manufactured Goods - Remanufactured during Normal Working Hours

In this scenario, we can pay the Third Party the additional costs which he incurred in remanufacture. The direct variable cost such as materials and power will certainly be reincurred and can be paid. Turning now to the wages, no additional costs have been incurred as the items have been remanufactured during working hours. The wage bill has therefore not increased and we are justified in resisting any payment for wages.

4. Manufactured Goods - Remanufactured during Overtime Working

As above, the direct variable costs such as materials and power are certainly payable. In this scenario, there is no capacity during normal working hours and for example staff are brought in on a Saturday morning to remanufacture the lost stock. This is a true additional cost and can be included in the stock loss.

5. Manufactured Goods - Not Remanufactured

Here, we are looking at the situation where the business has been lost so the Third Party has no reason to remanufacture the goods, or they can not be remanufactured because there is no spare capacity even through overtime working.

In this scenario where business is lost, we would pay the variable costs but not the labour. Why not?

Two reasons:

1 The labour cost has not been incurred again

2..Overlap with payments for loss of gross profit

Cost structure for damaged items:

Selling price	100
Materials	(20)
Power	<u>(5)</u>
Gross profit	75
Wages	25
Overheads	<u>20</u>
Net profit	<u>30</u>

$$\text{Rate of gross profit} = \frac{75}{100} \times 100\% = 75\%$$

If the sale is lost then the Business Interruption loss is £100 (selling price) x 75% (rate of gross profit) = £75.

We would be happy to pay the materials and power elements as the stock loss as these are the direct variable costs. Together materials and power total £25.

It cannot be right that the Third Party receives more than the selling price in total, so we are justified in not paying the wages element.

What if the goods are not manufactured because they have enough stock anyway? We would pay the direct variable costs but would, of course, need to consider the question of obsolescence.

What is payable to a manufacturer as a stock loss may appear a little confusing. However, the differences can best be illustrated by way of an example.

Exercise 2

Consider a manufacturer of metal parts for washing machines. The standard cost structure for a particular part is as follows:

	<u>£/Unit</u>
Selling price	10.00
Materials	2.00
Consumables	0.50
Packing materials	0.50
Production wages	3.00
Foremen's wages	0.50
Factory overheads	2.00
Group overheads	<u>0.50</u>
Net profit	<u>1.00</u>

If overtime is worked it is paid at "time and a half".

What is the stock loss (per unit) in the following circumstances:

1. Remanufactured during normal working.
2. Remanufactured during overtime working.
3. Replaced by purchasing from a competitor at £11.00/unit.

Suggested Answer

1. Remanufactured during normal working

	Stock loss
	£
Materials	2.00
Consumables	0.50
Packing materials	<u>0.50</u>
	<u>3.00</u>

2. Remanufactured during overtime working

	Stock loss
	£
Materials	2.00
Consumables	0.50
Packing materials	0.50
Wages - overtime (x 1.5)	<u>4.50</u>
	<u>7.50</u>

3. Purchased from competitor

	Stock loss
	£
Purchase price	11.00
Savings in: materials	(2.00)
consumables	<u>(0.50)</u>
	<u>8.50</u>

In summary, we need to pay the Third Party the loss he has suffered calculated with reference to the particular circumstance. You will note we need to know a lot of detail concerning production capacity and labour before we can do the calculation.

BUSINESS INTERRUPTION

When we are dealing with the Business Interruption aspect of the liability claim, there is no policy formula to follow and we must calculate the Third Party's actual loss. While there is no formula the calculation does logically follow the same format as the standard Business Interruption policy calculation. This is not as difficult as it sounds if we consider it under the following 3 areas:

- A. Loss of gross profit
- B. Additional costs incurred
- C. Less savings in costs to the business

A Loss of Gross Profit

Reduction in Turnover

To suffer a loss of gross profit, the Third Party must have suffered an irretrievable loss of sales. The Third Party will often argue that the factory was unable to work for a couple of days and that his loss should be calculated upon this “down-time”. We are not interested in this - it may well be that there was some slack in the system or additional overtime was worked and that no sales have actually been lost.

Reduction in Turnover: The difference between the level of turnover expected but for the incident and the actual turnover achieved.

When calculating this reduction in turnover we will need to consider how long the business has been affected by the incident - for good or bad. For example, it is not unusual for some of the turnover lost to be recovered as soon as the business reopens. This is often referred to as “claw back”.

How do we calculate reduction in turnover?

For a small business where there has only been a short interruption period, for example a fish and chip shop closed for a weekend, I would ask to see their takings book and, by reference to the weekends before and after the incident (say four each side) would calculate the income taken on a typical weekend. Obviously, when doing this, we need to take into account any peculiarities such as Christmas, Easter, Bank Holidays or local events.

We need to satisfy ourselves that we have been given the genuine records of the business - make reference to VAT returns, tax returns and annual accounts.

In the example of a chip shop, it is unlikely that there would be any “claw back” once the shop reopened. However, if we were looking at a clothing shop, we would need to check back that sales in the period immediately after the closure were not more than expected.

It may, if the interruption period is a little longer, be useful to look at turnover generated in the corresponding period in the previous year.

Exercise 3

Consider a pub which serves meals. On Saturday 1 September there was a flood which caused damage to kitchen equipment and water spread into the bar. The pub had to close for Saturday 1 and Sunday 2 September and reopened as normal on Monday 3 September. You have been given the following turnover figures (net of VAT):

<u>Sat / Sun</u>		<u>£</u>
4/5	August	320
11/12	August	280
18/19	August	310
25/26	August	505
1 /2	September	0
8/9	September	290
15/16	September	305
22/23	September	310
29/30	September	285

Calculate the reduction in turnover as a result of the incident on the basis of average of pre- and post- incident turnover achieved this year.

Suggested Answer

The figures for Saturday/Sunday 25/26 August are not representative - they have been affected by the summer Bank Holiday and should be excluded.

Calculate average turnover:

	<u>Saturday/Sunday</u>
	320
	280
	310
	290
	305
	310
	<u>285</u>
	<u>2100</u>
Average	300

The reduction in turnover is therefore:

	<u>Sat/Sun</u>
Expected	300
Less actual	<u>0</u>
Reduction	<u>300</u>

Exercise 4

Consider now a clothes shop which has a fire on 15 April 1998. The shop reopened part way through July, enjoys better than average sales in August due to renewed interest in the business, but sales are still down in September with turnover returning to normal in October. Based upon the turnover figures provided (net of VAT), calculate reduction in turnover as a result of the fire.

	1997	1998
	£	£
January	22,609	18,652
February	15,652	12,913
March	20,870	17,218
April	18,723	7,723
May	21,277	0
June	19,574	0
July	21,277	5,106
August	15,319	14,468
September	17,021	12,766
October	15,319	12,638
November	13,617	
December	17,872	

Suggested Answer

1. Consider year on year trend for each complete month of trading

	1997	1998	Trend
	£	£	
January	22,609	18,652	-17.5%
February	15,652	12,913	-17.5%
March	20,870	17,218	-17.5%
August	15,319	14,468	-5.6%
September	17,021	12,766	-25.0%
October	15,319	12,638	-17.5%

Expected Trend but for the fire = -17.5%

2. Apply trend to 1997 figures to estimate turnover that would have been achieved in 1998 but for the fire:

	1997	Trend	1998 Expected	1998 Actual	Reduction in Turnover
April (15-30)	9,361	-17.5%	7,723	0	7,723
May	21,277	-17.5%	17,554	0	17,554
June	19,574	-17.5%	16,149	0	16,149
July	21,277	-17.5%	17,554	5,106	12,448
August	15,319	-17.5%	12,638	14,468	(1,830)
September	17,021	-17.5%	14,042	12,766	<u>1,276</u>
					<u>53,320</u>

Rate of Gross Profit

We have now calculated the reduction in turnover and to this we need to apply a suitable rate of gross profit. Why?

Retailers - lost sales will result in a saving in goods purchased.

Manufacturers - lost sales results in a saving in materials which would have been used in the manufacturing process.

In broad terms, gross profit for our purposes can be defined as sales less direct variable costs as adjusted for movements in stock.

We need to consider which costs we are going to deduct and not simply take the Third Party's word for it.

This is best illustrated by way of example. Consider a manufacturing company. From discussion we establish that the only truly variable cost is the cost of materials and on this basis we could calculate the rate of gross profit to be 58% as follows:

	£	£
Sales		50,000
Opening stock	5,000	
Purchases	<u>20,000</u>	
	25,000	
Closing stock	<u>(4,000)</u>	
		<u>21,000</u>
Gross Profit		<u>29,000</u>

$$\text{Rate of gross profit} = \frac{29,000}{50,000} \times 100\% = 58\%$$

By calculating the rate of gross profit in this way, we are allowing that in the event that sales are lost wages continue to be paid. This is realistic in that unless staff are paid on a piecework basis, wages will continue to be paid.

However, if you were to ask the managing director what the company's rate of gross profit was then he may well tell you 32% as follows:

	£	£
Sales		50,000
Opening Stock	5,000	
Purchases	20,000	
Wages	7,000	
Maintenance	<u>6,000</u>	
	38,000	
Closing Stock	<u>(4,000)</u>	
		<u>(34,000)</u>
Gross Profit		<u>16,000</u>

$$\text{Rate of gross profit} = \frac{16,000}{50,000} \times 100\% = 32\%$$

This figure is lower and to a liability adjuster immediately seems more attractive! However we need to understand why there is a difference and the impact payment of the lower rate may have on any stock loss.

How does this all fit in with the Accounts?

A simple example best illustrates this:

Turnover	£100
Purchases	<u>(£40)</u>
Gross profit	£60
Wages	(£30)
Overheads	<u>(£20)</u>
Net profit	<u>£10</u>

$$\text{Rate of gross profit} \quad \frac{60}{100} \times 100\% = 60\%$$

If the reduction in Turnover is £100 then the loss of Gross Profit will be:

$$£100 \times 60\% = £60$$

In effect by paying the loss of gross profit of £60, the Third Party is being reimbursed for the ongoing costs of running the business (payable out of gross profit) and net profit which would have been earned, i.e.:

Wages	£30
Overheads	£20
Net Profit	<u>£10</u>
	<u>£60</u>

It is important to remember that if wages, or indeed any other cost, are not deducted from sales in the gross profit calculation, then these costs will be paid by the Third Party out of the loss of gross profit paid to them by Insurers.

Exercise 5

Calculate the rate of gross profit for a manufacturing company whose accounts show the following:

	£	£
Turnover		1,500,000
Opening stock	50,000	
Raw materials	500,000	
Packaging materials	50,000	
Bad debts	10,000	
Production wages	300,000	
Salaries	200,000	
Consumables	40,000	
Depreciation	<u>80,000</u>	
	1,230,000	
Closing stock	<u>(55,000)</u>	
		<u>(1,175,000)</u>
		<u>325,000</u>

Remember, we need to deduct from turnover only those direct costs which are truly variable.

Suggested answer:

	£	£
Turnover		1,500,000
Opening stock	50,000	
Raw materials	500,000	
Packaging materials	50,000	
Bad debts	10,000	
Consumables	<u>40,000</u>	
	650,000	
Closing stock	<u>(55,000)</u>	<u>(595,000)</u>
		<u>905,000</u>

$$\text{Rate of gross profit} = \frac{905,000}{1,500,000} \times 100\% = 60\%$$

B Additional Costs Incurred

We can recommend that Insurers pay any additional costs that have been incurred to mitigate the Third Party's loss of gross profit. I cannot stress enough that we are looking at **additional** costs, that is costs that would not have been incurred but for the incident.

Consider the following example and identify what would be payable as additional expenditure:

1. To ensure that a sales order was met, the Third Party air freights finished goods to the customer rather than sending them by sea. Air freight costs £500 while normal sea freight would have been £50.

The additional cost was incurred to mitigate any loss of gross profit and therefore the additional cost of air freight of £450 would be payable.

2. A printing press breaks down and the operatives are unable to work for 2 days. The Third Party claims their wages which amount to £1,000 for this period of downtime.

If This is not a true additional cost, the operatives would have been paid in any event. sales had been lost then wages would be paid out of any payment made for loss of gross profit.

3. Similar scenario as 2 above, but in order to meet customer orders, the operatives worked overtime at the weekend to catch up. They are paid at time and a half and the overtime cost amounts to £1,500. Under normal circumstances, the company does not work overtime.

The additional costs incurred to mitigate loss of gross profit is the whole of the overtime cost of £1,500.

4. A machine is down for 5 hours and Third Party explain that running the machine makes a contribution to the factory overheads of £200 per hour. He therefore claims £1,000.

No additional cost is being incurred. He would have incurred the factory overheads in any event. The only way anything is payable is as loss of gross profit if the sales order has been lost.

C Savings

We need to deduct from our Business Interruption calculation any savings in costs that the Third Party would have incurred had the incident not happened. The easiest way to do this is to obtain a copy of the detailed profit and loss account and run your eye down the list of costs included there. Depending upon the circumstances, savings are commonly achieved in the following:

- Wages - Overtime working
- Packing and freight
- Consumable power
- Maintenance costs
- Rent and rates

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**ACCOUNTANCY ASPECTS OF LIABILITY CLAIMS
EXAMPLES WORKSHEET**

COSTING IN GENERAL

- Direct: Costs that can be directly attributed to a unit of production.
- Indirect: Costs that cannot be attributed to an individual unit of production.
- Variable: Cost varies directly with the number of units produced. If one more unit is manufactured, the cost increases proportionally.
- Fixed: Cost remains the same irrespective of the number of units produced, assuming the business continues.

Exercise 1

Consider a manufacturer of chocolate bars. The factory produces 23 hours a day throughout the year. Production lines are stopped for an hour a day for cleaning and maintenance. The cleaning procedure is to meet with hygiene standards and must be completed irrespective of the amount of chocolate produced. Staff in the packing department are paid on a piecework basis. The plant is depreciated on a straight line basis over time and the contribution to group overhead was agreed at the beginning of the year.

Identify which of the following costs are direct/indirect and variable/fixed.

<u>Costs</u>	<u>Direct/Indirect</u>	<u>Variable/Fixed</u>
Raw material ingredients		
Production wages		
Shift supervisor's wages		
Cleaning/Maintenance wages		
Consumables and cleaning materials		
Packaging materials		
Packing department		
Factory rates		
Group overheads		
Depreciation of machinery		

STOCK LOSSES

Exercise 2

Consider a manufacturer of metal parts for washing machines. The standard cost structure for a particular part is as follows:

	<u>£/Unit</u>
Selling price	10.00
Materials	2.00
Consumables	0.50
Packing materials	0.50
Production wages	3.00
Foremen's wages	0.50
Factory overheads	2.00
Group overheads	<u>0.50</u>
Net profit	<u>1.00</u>

If overtime is worked it is paid at "time and a half".

What is the stock loss (per unit) in the following circumstances:

1. Remanufactured during normal working.
2. Remanufactured during overtime working.
3. Replaced by purchasing from a competitor at £11.00/unit.

REDUCTION IN TURNOVER

Reduction in Turnover: The difference between the level of turnover expected but for the incident and the actual turnover achieved.

Exercise 3

Consider a pub which serves meals. On Saturday 1 September there was a flood which caused damage to kitchen equipment and water spread into the bar. The pub had to close for Saturday 1 and Sunday 2 September and reopened as normal on Monday 3 September. You have been given the following turnover figures (net of VAT)

<u>Sat / Sun</u>		<u>£</u>
4/5	August	320
11/12	August	280
18/19	August	310
25/26	August	505
1 /2	September	0
8/9	September	290
15/16	September	305
22/23	September	310
29/30	September	285

Calculate the reduction in turnover as a result of the incident on the basis of average of pre- and post- incident turnover achieved this year.

Calculate average turnover excluding any abnormal weeks::

	<u>Sat/Sun</u>
Expected	
Less actual	-----
Reduction	-----

Exercise 4

Consider how a clothes shop which has a fire on 15 April 1998. The shop reopened part way through July, enjoys better than average sales in August due to renewed interest in the business, but sales are still down in September with turnover returning to normal in October. Based upon the turnover figures provided (net of VAT), calculate reduction in turnover as a result of the fire.

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	£	£
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December	17,872	

Consider year on year trend for each complete month of trading

	1997	1998	Trend
	£	£	
January			
February			
March			
August			
September			
October			

Expected Trend but for the fire =

Apply trend to 1997 figures to estimate turnover that would have been achieved in 1998

	1997	Trend	1998	1998	Reduction in
	Actual		Expected	Actual	Turnover
April (15 to 30)					
May					
June					
July					
August					
September					

RATE OF GROSS PROFIT

Gross profit for our purposes can be defined as sales less direct variable costs as adjusted for movements in stock.

We need to consider which costs we are going to deduct and put them into the following formula:

	£	£
Sales		xxx
Opening Stock	xx	
Direct Variable Costs	<u>xx</u>	
	.xx	
Closing Stock	<u>(xx)</u>	
		<u>(xx)</u>
Gross Profit		<u>xx</u>

$$\text{Rate of gross profit} = \frac{\text{Gross Profit} \times 100\%}{\text{Turnover}}$$

Exercise 5

Calculate the rate of gross profit for a manufacturing company whose accounts show the following:

	£	£
Turnover		1,500,000
Opening stock	50,000	
Raw materials	500,000	
Packaging materials	50,000	
Bad debts	10,000	
Production wages	300,000	
Salaries	200,000	
Consumables	40,000	
Depreciation	<u>80,000</u>	
	1,230,000	
Closing stock	<u>(55,000)</u>	
		<u>(1,175,000)</u>
		<u>325,000</u>