**Lecture 3 notes**

**1. In lecture 3 the following were done:**

* Principles involved in preparing financial statements.
* Homework: Income Statement for A.
* Statement of financial position for A.

**2. Homework for Lecture 4** (*this is towards the of these notes*)

* Prepare the Statement of financial position (SOFP) for B. (for Groups A & B) and check with the answers provided below.
* Prepare financial statements (an ‘Income Statement’ and the SOFP) for sole trader C. This will be good practice. The answer for this is provided to check your work. This may NOT be done in lecture 4. We need to move on to company financial statements.
* Introduction to company accounts: please read notes on this below and attempt an example - D Ltd. This is the focus of lecture 4 [and for Q 1 in the end of term exam].

**3. Principles involved in preparing financial statements [a quick review].**

* A ***trial balance*** and ***year end additional information/notes*** affecting some of the accounts in the trial balance is required to prepare the 2 financial statements:

1. Income statement

2. Statement of financial position (SOFP)

* Recap: So, what is a trial balance? A Trial balance is a listing of the ledger accounts of a business entity with their respective account balances at the end of an accounting period (usually) for one year. There are 5 types of accounts [as well as contra accounts to these accounts] within the trial balance and these are:

Incomes

Expenses

Assets

Liabilities

Capital

* EXPENSES & ASSETS WILL HAVE DEBIT BALANCES
* INCOMES, LIABILITIES & CAPITAL WILL HAVE CREDIT BALANCES
* ALL OTHER CONTRA A/CS WILL HAVE BALANCES WHICH ARE THE OPPOSITIES OF THE ABOVE

**How is an Income Statement prepared?**

* All the income and expense accounts from the trial balance are closed off – i.e. their balances are transferred to the ‘Income statement’ to calculate or account for the net profit or net loss for the accounting period.
* The Income Statement is prepared to show the Gross Profit and the Net Profit or Net Loss for the accounting period.
* Gross profit (or GP) = Sales minus Cost of Sales

Net profit (NP) = Gross Profit minus Expenses

Note: Where expenses are greater than the gross profit this will result in a Net Loss (NL).

**How is the Statement of Financial Position (or SOFP) prepared?**

* With the Income Statement now completed to show the Net Profit/Loss, the SOFP can now be prepared.
* The remaining ledger accounts in the trial balance (after closing off the Income and Expense accounts) will be the various Assets, Liabilities and Capital account (as well as their contra accounts).
* These remaining ledger accounts (assets, liabilities, capital account as well as their contra accounts) and Net Profit/Loss (from the Income Statement) are the accounts that is used to prepare the SOFP.
* The first section of the SOFP lists the assets: starting with non-current assets followed by current assets) to make up ‘Total Assets.
* The current assets are listed in the SOFP in order of liquidity [ i.e. ‘Inventory, Receivables, Prepayments, Bank & finally Cash’].
* The next section starts with the ‘Capital’ section (Opening capital + NP – Drawings = Closing Capital) followed by Non-current Liabilities and Current Liabilities to make up ‘Capital and Liabilities’.
* The SOFP reflects the accounting equation:

Assets (total of non-current assets + current assets) = Capital + Liabilities (non-current liabilities + current liabilities). This is explained further below.

**The SOFP should now show:**

**Total Assets (first section)**

**Total for Capital and Liabilities (second section)**

Both of these sections should be equal. The reason: What the business entity owns (i.e. the assets) should always be equal to what the business entity owes (i.e. the capital and liabilities) at any point of the accounting period. This is reflected in the accounting equation (refer to Lecture 1 notes). In addition, it is also the result of the correct application of the double entry system in recording all business transactions for the entity).

**4. Financial statements for A (completed in lecture 3).**

**Question**

The following trial balance is for a sole trader, A, as at 30 June 2019.

|  |  |  |
| --- | --- | --- |
|  | **Dr** | **Cr** |
|  | £000 | £000 |
| Sales - **I** |  | 146 |
| Purchases-**E** | 60 |  |
| Inventory at 1 July 2018 - **CA** | 5 |  |
| Vehicle running expenses - E | 3 |  |
| Rent and business rates - E | 14 |  |
| Office expenses - E | 7 |  |
| Interest on bank loan - E | 1 |  |
| Wages and salaries- E | 43 |  |
| Shop fittings – cost - NCA | 40 |  |
| Shop fittings–accumulated depreciation- CONTRA NCA |  | 11 |
| Vehicles- cost - NCA | 30 |  |
| Vehicles-accumulated depreciation – CONTRA NCA |  | 12 |
| Trade receivables- CA | 6 |  |
| Trade payables - CL |  | 5 |
| Capital - C |  | 41 |
| Drawings – CONTRA C | 11 |  |
| Bank - CA | 2 |  |
| Cash- CA | 1 |  |
| Long term bank loan - NCL |  | 8 |
| **Totals** | **223** | **223** |

**Notes as at 30 June 2019**

• Inventory was valued at £9,000

• Wages accrued £2000

• Office expenses accrued £1000

• Business rates prepaid £4000

• Shop fittings to be depreciated at 25% pa on cost.

* Vehicles to be depreciated at 20% pa on cost

**Required:**

(a) Income statement for the year ended 30 June 2019.

(b) Statement of financial position as at 30 June 2019.

**Answers**

(a)

A

Income statement for the year ended 30 June 2019 (in £000s)

|  |  |  |
| --- | --- | --- |
| Sales |  | 146 |
| Cost of sales |  |  |
| Opening inventory | 5 |  |
| Purchases | 60 |  |
| Closing inventory | (9) | (56) |
| GP |  | 90 |
| Expenses |  |  |
| Wages and salaries (43 + 2) | 45 |  |
| Office expenses (7 + 1) | 8 |  |
| Rent and business rates (14 – 4) | 10 |  |
| Depreciation of shop fittings (40 x 0.25) | 10 |  |
| Depreciation of vehicles (30 x 0.2) | 6 |  |
| Vehicle running expenses | 3 |  |
| Interest on bank loan | 1 | (83) |
| NP |  | 7 |

(b)

A

SOFP as at 30 June 2019 (£000s)

|  |  |  |  |
| --- | --- | --- | --- |
| Non-current assets | Cost | Accumulated  Depreciation | NBV |
| Shop fittings | 40 | 11 + 10 = 21 | 19 |
| Vehicles | 30 | 18 (12 + 6) | 12 |
|  | 70 | 39 | 31 |
| Current assets |  |  |  |
| Closing inventory | 9 |  |  |
| Receivables | 6 |  |  |
| Prepayment | 4 |  |  |
| Bank | 2 |  |  |
| Cash | 1 |  | 22 |
| Total assets |  |  | 53 |
|  |  |  |  |
| Capital - opening |  |  | 41 |
| NP |  |  | 7 |
| Drawings |  |  | (11) |
| Capital - closing |  |  | 37 |
| Non-current liabilities |  |  |  |
| Long term bank loan |  |  | 8 |
| Current liabilities |  |  |  |
| Accruals (2 +1) | 3 |  |  |
| Payables | 5 |  | 8 |
| Capital & liabilities |  |  | 53 |

**5. Financial statements for C (Please attempt this on your own and check with the answers below. Email me any questions on this on sa.palan@lsclondon.co.uk**

**Question**

The trial balance below is for C as at 31/12/2019 (in £000s)

|  |  |  |
| --- | --- | --- |
| Sales - I |  | 725 |
| Purchases - E | 378 |  |
| Opening inventory - CA | 90 |  |
| Receivables - CA | 151 |  |
| Payables - CL |  | 100 |
| Rent and rates - E | 50 |  |
| Insurance - E | 12 |  |
| Energy and telephone - E | 10 |  |
| Salaries and wages - E | 153 |  |
| Administration expenses - E | 23 |  |
| Drawings - Contra C | 35 |  |
| Discounts allowed - E | 13 |  |
| Long term bank loan - NCL |  | 100 |
| Interest on bank loan - E | 3 |  |
| Freehold premises at cost - NCA | 530 |  |
| Machinery at cost - NCA | 150 |  |
| Machinery - accumulated depreciation – Contra NCA |  | 50 |
| Capital - C |  | 620 |
| Cash - CA | 2 |  |
| Bank overdraft - CL |  | 5 |
| Totals | 1600 | 1600 |

**Additional information as at 31/12/2019:**

• Inventory was valued at £100,000.

• Administration expenses owed: £3000.

• Interest on long term bank loan accrued: £2000.

• Prepaid rates £2000; Salaries prepaid: £5000.

• The machinery is to be depreciated by 20% on

straight line

**Required:**

(a) Income Statement for the year ended 31/12/2019.

(b) Statement of Financial Position as at 31/12/2019.

Answers

(a)

C

Income Statement for the y/e 31/12/2019 (£000s).

|  |  |  |
| --- | --- | --- |
| Sales |  | 725 |
| Cost of sales |  |  |
| Opening inventory | 90 |  |
| Purchases | 378 |  |
| Closing inventory | (100) | (368) |
| GP |  | 357 |
| Expenses |  |  |
| Administration expenses (23 + 3) | 26 |  |
| Interest on bank loan (3 +2) | 5 |  |
| Rent & rates (50 - 2) | 48 |  |
| Salaries and wages (153 – 5) | 148 |  |
| Depreciation of machinery (150 x 0.2) | 30 |  |
| Insurance | 12 |  |
| Energy and telephone | 10 |  |
| Discounts allowed | 13 | (292) |
| NP |  | 65 |

(b)

C

SOFP as at 31/12/2019 (IN £000s)

|  |  |  |  |
| --- | --- | --- | --- |
| Non-current assets | Cost | Accumulated Depreciation | NBV |
| Freehold premises | 530 | - | 530 |
| Machinery | 150 | 50 + 30 = 80 | 70 |
|  | 680 | 80 | 600 |
| Current assets |  |  |  |
| Inventory | 100 |  |  |
| Receivables | 151 |  |  |
| Prepayment (5 + 2) | 7 |  |  |
| Cash | 2 |  | 260 |
| Total assets |  |  | 860 |
|  |  |  |  |
| Capital - opening |  |  | 620 |
| NP |  |  | 65 |
| Drawings |  |  | (35) |
| Capital - closing |  |  | 650 |
| Non-current liabilities |  |  |  |
| Long term bank loan |  |  | 100 |
| Current liabilities |  |  |  |
| Accruals (3 + 2) | 5 |  |  |
| Payables | 100 |  |  |
| Bank | 5 |  | 110 |
| Capital & Liabilities |  |  | 860 |

**5. Financial statements for B: Do this by yourself and check with the answers provided below.**

The following account balances were extracted as at 31/12/2019 from the books of B, who owns a retail business.

|  |  |  |
| --- | --- | --- |
|  | £000 | £000 |
| Sales - I |  | 1860 |
| Purchases - E | 1120 |  |
| Inventory at 1/1/2019 - CA | 60 |  |
| Trade receivables - CA | 64 |  |
| Trade payables - CL |  | 176 |
| Business rates - E | 41 |  |
| Insurances - E | 40 |  |
| Heating and lighting - E | 55 |  |
| Motor running expenses - E | 27 |  |
| Selling expenses - E | 172 |  |
| Long term bank loan - NCL |  | 200 |
| Interest on bank loan - E | 4 |  |
| Land and buildings at cost - NCA | 850 |  |
| Motor vehicles at cost - NCA | 70 |  |
| Motor vehicles – accumulated depreciation – CONTRA NCA |  | 20 |
| Wages and salaries - E | 295 |  |
| Bank – CA | 3 |  |
| Cash - CA | 1 |  |
| Capital - C |  | 600 |
| Drawings – CONTRA C | 54 |  |
| Totals | 2856 | 2856 |

**Notes as at 31 December 2019**

• Inventory was valued at £65,000

• Wages accrued £5000

• Heating and lighting accrued £2000

• Business rates prepaid £3000

• Motor vehicles depreciated at 20% pa on cost

**Required:**

(a) Income statement for the year ended 31 December 2019.

(b) Statement of financial position as at 31 December 2019.

**(a)**

**B**

**Income statement for the year ended 31 December 2019 (in**

**£000)**

|  |  |  |
| --- | --- | --- |
| Sales |  | 1860 |
| Cost of sales |  |  |
| Opening inventory | 60 |  |
| Purchases | 1120 |  |
| Closing inventory | (65) | (1115) |
| Gross profit |  | 745 |
| Expenses |  |  |
| Wages and salaries (295 + 5) | 300 |  |
| Heating and lighting (55 +2) | 57 |  |
| Business rates (41 – 3) | 38 |  |
| Depreciation of MV (70 x 0.2) | 14 |  |
| Insurances | 40 |  |
| Motor running expenses | 27 |  |
| Selling expenses | 172 |  |
| Interest on bank loan | 4 | (652) |
| Net profit |  | 93 |

**(b)**

**B**

**SOFP as at 31 December 2019 (in £000)**

**Non-current assets** **Cost Accumulated NBV**

**Depreciation**

Land and buildings 850 - 850

Motor vehicles 70 20 + 14 = 34 36

920 34 886

**Current assets**

Closing inventory 65

Receivables 64

Prepayment 3

Bank 3

Cash 1 136

**Total assets** 1022

**Capital** – opening balance 600

Net profit 93

Drawings (54)

Capital – closing balance 639

**Non-current liabilities**

Long term bank loan 200

Current liabilities

Accruals (5 + 2) 7

Payables 176 183

**Capital and liabilities**  1022

**6.** **Introduction to company accounts**. This is the focus of the next lecture [lecture 4] and the end of term exam.

**Company financial statements**

* The technique and principles of preparing company financial statements are **similar** to that of a sole trader. However, there are **additional items** to account for in both statements.
* **Additional items** for company financial statements:

In the **Income statement** these are:

* Profit before taxation (PBT)
* Corporation tax (CT)
* Profit after taxation (PAT)
* Dividends
* Transfers to reserves
* Retained profits

In the **SOFP** these are:

* Share capital
* Reserves
* Shareholders’ funds
* Debentures (Non-current liabilities)
* Dividends proposed (Current liabilities)
* Taxation/Corporation tax (Current liabilities)
* In an Income Statement - accounting for incomes and expenses remain the same. This will account for Gross Profit (GP) and **Profit before Tax** (PBT)

* Within the SOFP – accounting for the Non-Current Assets, Current Assets and Total Assets are exactly the same as that of sole traders. Accounting for shareholders funds and liabilities – are the new areas to enjoy discovering in the next lecture.
* Below is an example (D Ltd) to learn about company financial statements.

D Ltd is a previous exam question – it is the standard expected for the compulsory question (Q 1).

**Question**

The following trial balance is as at 31/12/2019 for D Ltd:

|  |
| --- |
| £ £ |
| £1 Ordinary share capital 400,000 |
| 5% Debentures 120,000 |
| Purchases & sales 1,000,000 1,700,000 |
| Returns 3,000 2,000 |
| Opening inventory 65,000 |
| Receivables & payables 100,000. 64,000 |
| Rent, rates & insurance 67,000 |
| Heating & lighting 25,000 |
| Communication expenses 6,000 |
| Miscellaneous expenses 3,000 |
| Audit fee 9,000 |
| Bad debt 3,000 |
| Salaries and Wages 180,000 |
| Directors’ remuneration 107,000 |
| Debenture interest 5,000 |
| Land & buildings at cost 700,000 |
| Machinery |
| - at cost 200,000 |
| - provision for depreciation 50,000 |
| Fittings |
| - at cost 100,000 |
| - provision for depreciation 20,000 |
| Cash 1,000 |
| Bank 3,000 |
| Retained profit 50,000 |
| Share premium 100,000 |
| General reserve 120,000 |
| Ordinary dividend paid 55,000 |
| ------------ ------------ |
| 2,629,000 2,629,000 |
| ======= ======= |

**Additional information as at 31/12/2016**:

* Inventory was valued at £70,000.
* Prepayments for: Rates - £5,000; Miscellaneous expenses - £1000
* Accruals for: Salaries £5,000; Audit fee £1000; Rent £2000
* Machinery to be depreciated by 20% on reducing balance basis.
* Fittings to be depreciated by 10% on straight line.
* Provide £70,000 for taxation.
* The directors propose a final ordinary dividend of 25p per share

**Required:**

**a) Income Statement for the y/e 31/12/2019. [20 marks]**

**b) SOFP as at 31/12/2019. [20 marks]**

**Answer**

**a)**

**D Ltd**

**Income Statement for the y/e 31/12/2019. [in £000s)**

|  |  |  |
| --- | --- | --- |
| Sales | 1700 |  |
| Sales returns | (3) | 1697 |
| Cost of sales |  |  |
| Opening inventory | 65 |  |
| Purchases | 1000 |  |
| Purchase returns | (2) |  |
| Closing inventory | (70) | (993) |
| GP |  | 704 |
| Expenses |  |  |
| Rent, rates & insurance (67 – 5 + 2) | 64 |  |
| Miscellaneous expenses (3 – 1) | 2 |  |
| Salaries & Wages (180 + 5) | 185 |  |
| Audit fee (9 + 1) | 10 |  |
| Depreciation of fittings (100 x 0.1) | 10 |  |
| Depreciation of machinery (200 – 50) x 0.2 | 30 |  |
| Heating & lighting | 25 |  |
| Communication expenses | 6 |  |
| Bad debt | 3 |  |
| Directors’ remuneration | 107 |  |
| Debenture interest (5 +1) | 6 | (448) |
| Profit before taxation / PBT |  | 256 |
| Corporation tax / CT |  | (70) |
| Profit after taxation / PAT |  | 186 |
| Dividends - Interim paid | 55 |  |
| - Final proposed (400 x 0.25) | 100 | (155) |
| Retained profit for the year |  | 31 |
| Retained profit b/f |  | 50 |
| Retained profit c/f |  | 81 |

END OF LECTURE NOTES