**Lecture notes 2**

**1. In lecture 2 the following were done:**

* Principles involved in preparing financial statements.
* Income Statement for B. [this is in **(7)** below.]

**2. Homework for the next lecture**

* Prepare an Income Statements for **A and C** and check with the answers provided below.
* See below for both questions A and C (*this is in (5) and (6) below*)

**3.** In the **next lecture** both financial statements (an ‘Income Statement’ and the ‘SOFP’) for sole trader C will be the focus. So, it will be good practice to prepare the Income Statement for C before the next lecture.

**4. 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’.
* The Income Statement will 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 a Statement of Financial Position (or SOFP) prepared?**

* With the Income Statement now completed to show the Net Profit/Loss, the SOFP can now be completed.
* 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 the end [or at any point] of the accounting period. This is in accordance to business entity concept as reflected by 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).

**5. Homework**

**Income statement for A (to be completed before 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.

[Homework]

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

[to be done in the next lecture]

**Answer**

(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 |

**6. Income statement for C (Please attempt this on your own and check with the answer 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 |  | 725 |
| Purchases | 378 |  |
| Opening inventory | 90 |  |
| Receivables | 151 |  |
| Payables |  | 100 |
| Rent and rates | 50 |  |
| Insurance | 12 |  |
| Energy and telephone | 10 |  |
| Salaries and wages | 153 |  |
| Administration expenses | 23 |  |
| Drawings | 35 |  |
| Discounts allowed | 13 |  |
| Long term bank loan |  | 100 |
| Interest on bank loan | 3 |  |
| Freehold premises at cost | 530 |  |
| Machinery at cost | 150 |  |
| Machinery - accumulated depreciation |  | 50 |
| Capital |  | 620 |
| Cash | 2 |  |
| Bank overdraft |  | 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.

[Homework]

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

[to be done in the next lecture]

**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 |

**7. Income statement for B: This was done in the last lecture. Repeat 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.

[Completed in the last lecture]

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

[to be done in the next lecture]

**Answer**

**(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 |

**END OF LECTURE 2 NOTES & HOMEWORK QUESTIONS [Please get your reading and homework done before the next lecture; it will be good for both a healthy lifestyle and education.** Do remember making mistakes is part of learning.]