



Introduction To Financial Accounting Notes - Lecture notes, lectures 1 - 10 - part 1, complete

Introduction to Financial Accounting (University of Sheffield)

Introduction to financial accounting

(132)

So what is it?

Businesses must maintain accounts not just by law, but to enable to see their income/expenditures in order to assess their businesses financial position. They may need to report these financial results to its owners. And also to act as a basis for computing tax.

The balance sheet is also known as “statement of financial position” (SFP) and can simply be explained as:

Assets	Liabilities
House	Mortgage
Bank	Loan
Cash	Overdraft
Clothes	Gas bill
Total	Total

Accounting equation is as follows:

Assets = liabilities + capital OR liabilities = assets – capital

At the end of the financial year

Total asset = total sources of finance

- A balance sheet lists what a business owns and owes
- It shows assets and how they are financed
- Assets are financed by owners, long term liabilities and short term liabilities
- Vertical format calculates owners equity as:

Fixed assets

+ current assets

-current liabilities

-non current liabilities

=net assets

Balance sheet layout

Fixed assets	XXX
+ current assets	XXX
= total assets	XXX
Capital	XXX
Less current liabilities	(XXX)
= total equity	XXX

These must balance

Leasing may also be a source of finance as it spreads the cost over a period of time

	Start	End	Change
Assets	2000	7150	5150
Less liabilities	0	3950	3950
= Capital	2000	3200	1200

If there is no transactions with owner then any profit/loss = change in capital

So the following formula would suffice:

Closing capital – opening capital = profit/loss

$$3200 - 2000 = 1200$$

If there are transactions with owner then we must allow for these when calculating profit:

Opening capital + capital introduced – drawings + profit/loss = closing capital

So suppose £1000 capital was introduced and £750 withdrawn

$$£2000 + 1000 - 750 = 2250 \text{ closing capital}$$

Deduct this from closing capital figure to work out profit/loss (if not given)

$$3200 - 2250 = 950$$

So...

Capital at start	2000
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+ capital introduced	1000
-Drawings	(750)
+ profit (worked out)	950
= closing capital	3200

Each transaction changes 2 things on the balance sheet in order for it to balance. The balance sheet only records cost of assets and not value.

Income statements

The layout for this financial statement would be as follows:

Sales		291,000
Less cost of sales		
Opening stock	5000	
+Purchases	207000	
-Closing Stock	(18000)	(194000)
Gross Profit		97000
Add discounts received		1000
Total Gross Profit		98000
Less expenses		
Selling and distribution	6000	
Administration	7500	
Wages and salaries	18000	
Rent and rates	12000	
Deprecation of fixtures	2500	
Bank loan interest	2000	(48000)
Net profit		50000

Recording transactions

These must be maintained for 6 years by law of HMRC. The transactions are classified according to type to be recorded 'accounts'. Recorded in ledgers such nominal, debtors, creditors.

Cash transactions are recorded in a cash book due to Corporate Government Companies Act 2006 and must be held for 6 years.

Using the double entry bookkeeping system

For every transaction you make, there must be two entries in the relevant accounts.

Example

A man opens his business putting £5000 into the business account.

He then purchases a van for £4000

He pays for 1 month of his rent costing £100

He then purchases goods for resale for £900

And receives £500 cash for the sale of goods

He then withdraws £110 for personal use

He buys goods on credit from AB Suppliers PLC costing £800

And sells goods on credit for CD Products LTD costing £900

He pays AB suppliers £600 in part payment

And CD Products LTD pays £850 in full payment

Produce all the relevant accounts for these transactions.

Trial balance to final accounts for sole traders

For this we will be making adjustments to the trial balance before moving onto the S.O.F.P. when doing this we must apply the accruals concept.

Errors which may not be visible in the trial balance

- Error of principle
- Error of duplication
- Error of omission
- Compensating errors
- Error of original entry

Suspense account – this is an account for when you are unsure which ledger a transaction goes into. It has to be cleared out every year end.

Types of adjustments we are going to cover

- Correction of errors
- Closing stock
- Depreciation
- Fixed assets
- Bad and doubtful debts
- Prepaids
- Accruals

Fixed assets and depreciation

Fixed assets are held for long term use by the business. Typically they are used to assist production, administration, selling and rental purposes. To be recognised in the balance sheet they must be owned by the reporting entity as a result of past transactions or activities and be expected to give rise to future economic benefits.

Measuring fixed assets

They are recorded at cost in the SOFP, and would be subject to the adjustment for depreciation. Some are revalued (land and buildings and investments). They may also be subject to “impairment reviews” and may result in the value decreasing in the balance sheet, as for the implementation of the revaluation reserve which companies and directors dislike.

Depreciation

This applies to accruals concept and can be estimated by using: straight line method, reducing balance method and expected method.

Straight line = $\text{NBV} \times \% = \text{dep}$

Reducing balance = $\text{NBV} - \text{dep} \times \% = \text{dep}$

Expected = $\text{cost} - \text{residual value} / \text{years}$

We would **debit** the depreciation expense a/c and **credit** the accumulated depreciation a/c.

Reducing balance charges higher prices in the earlier years and is also not liked by directors and accountants.

As for the consistency concept you have to stick to the same method every year.

Clarabel

5. motor van (4 years with no residual value)

Cost - note 9 = NBV

$42000 - 6000 = 36000 \div 4 \text{ years} = 9000 \text{ dep}$

Office furniture and fittings (20% using straight line)

Cost x %

$18,000 \times 20\% = 3600 \text{ dep}$

6. computer equipment (40% using reducing balance)

Year 1 = $28000 \times 40\% = 11,200$

Year 2 = $28000 - 11,200 = 16,800 \times 40\% = 6720$ (but we don't use this one)

Disposal of a fixed asset (note 9)

Credit disposal a/c	debit bank	with sale proceeds
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Debit disposal a/c	credit fixed asset	with its costs
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Credit disposal a/c	debit acc dep a/c	with acc dep
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A disposal will always result in either a profit or a loss.

How are fixed assets shown in the balance sheet?

<u>Fixed assets</u>	<u>Cost£</u>	<u>Dep£</u>	<u>NBV£</u>
Office fixtures and fittings	18,000	3600	14,400
Motor van	36,000	9000	27,000
Computer equipment	<u>28,000</u>	<u>11,200</u>	<u>16,800</u>
	<u>82,000</u>	<u>23,800</u>	<u>58,200</u>

How would we calculate depreciation for year 2

This is purely just an example of how to calculate subsequent years. These would not be entered into this year's balance sheet; they would go in next years. For this we would assumed there were no additions or disposals during the year.

Office fixtures and fittings (straight line)	$18,000 \times 20\% = 3600$
Motor van (straight line)	$36,000 \times 25\% = 9000$
Computer equipment (reducing balance)	$(28,000 - 11,200) \times 40\% = 6720$
Total depreciation expenses = £19,320	

So the balance sheet at the end of year 2 would look as follows:

<u>Fixed assets</u>	<u>Cost£</u>	<u>Acc Dep£</u>	<u>NBV£</u>
Office fixtures and fittings	18,000	7200	10,800
Motor van	36,000	18,000	18,000
Computer equipment	<u>28,000</u>	<u>17,920</u>	<u>10,080</u>
	<u>82,000</u>	<u>43,120</u>	<u>38,880</u>

Bad debts and doubtful debts

Some debtors will not pay (BAD) and have to be written off (usually over 6 months) to record as a loss.

Others may not pay (DOUBTFUL) and we consider a provision for estimated loss.

We would use the prudence concept to record expected losses from these debtors who are expected to not pay.

If bad debts are already written off:

- Bad debt a/c in the income statement

- Debtors are adjusted

If bad debts are to be written off:

- Debit bad debt a/c expense in the income statement
- Credit debtor a/c reduce debtors in balance sheet

Prepayments

Some expenses are paid in advance: and we apply accruals concept and charged in the income statement.

Debit expense a/c in balance sheet under current assets

Credit expense a/c in income statement

Accruals

This is when you are owing an expense and will apply the accruals concept.

Debit expense a/c and increase expense in income statement

Credit bal b/d in expense a/c and under current liabilities in the balance sheet

Income statement (using the information from the t-bars and trial balance)

Sales		345,000
Opening Stock	-----	
+ Purchases	132,000	
Less closing stock	(14,000)	
Cost of goods sold		(118,000)
Gross profit		227,000
Add discount received		900
Gross profit		227,900
Expenses		
Wages and salaries		76,000
Rent and rates		24,000
Administration		15,000
Heat, light and power		13,000
Discount allowed		1200
Selling and distribution		10,000
Loan interest		3000
Repairs and maintenance		17,000
Bad debts	2000	
Provision for doubtful debts	600	2600
Depreciation:		
Office fixtures and fittings	3600	
Motor van	9000	
Computer equipment	11,200	23,800
Loss on disposal		3700
		(189,300)
NET PROFIT		38,600

Incomplete records

This when we are not provided with a trial balance, income statement or statement of financial position. These generally occur with early start up sole traders or partnerships.

Denston example

Here we have to work through this example step by step so we can work out all the relevant figures needed to complete the income statement and statement of financial position. We will need to calculate the following:

- Capital

- Bank
- Sales
- Purchases
- Expenses
- Fixed asset
- Drawings

Once we have calculated all these we are then able to compile the required accounts.

Step 1 – calculating the capital (capital = assets – liabilities)

Fixed assets	2200
Current Assets	
Stock	2141
Debtors	3219
Prepays	100
Bank	<u>821</u>
	8481
Current liabilities	
Creditors	1842
Accruals	<u>31</u>
	<u>(1873)</u>
Opening capital	<u>6608</u>

Step 2 – calculating how much there is in the bank at the end of the year. This is given in the question and shows as £1030 bank overdraft.

Step 3 – calculating purchases from creditor figures

Creditors a/c			
Bank	18,624	Bal b/d	1842
Bal c/d	<u>8,191</u>	Purchases	<u>18,673</u>
	20,515		20,515

Step 4 – calculating sales from debtor figures

Debtors a/c			
Bal b/d	3219	Bank	24,264
Sales	<u>24,433</u>	Bal c/d	<u>3388</u>

27,652	27,652
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Step 5 – calculating all the expense accounts

Heating and Lighting expense a/c			
Bank	168	Bal b/d	31
Bal c/d	<u>42</u>	I.S	<u>179</u>
	210		210

Rent and rate expense a/c			
Bal b/d	100	I.S	804
Bank	<u>824</u>	Bal c/d	<u>120</u>
	924		924

General Expenses a/c			
Bank	1581	Drawings	2469
Bank	<u>2669</u>	I.S	<u>1781</u>
	4250		4250

Salaries expenses a/c			
Bank	2249	I.S	2249

This had a note attached to it

Step 6 – calculate the fixed assets to be entered into the SOFP

Fixed Asset a/c	
	Bal c/d 2200

Fixed Asset depreciation a/c			
Provision	220	I.S	220

Provision for depreciation a/c	
	Dep a/c 220

We can now compile the income statement and the statement of financial position:

Income statement for the year ending 31st December 2011

Sales	24,433
Opening Stock	2141
+ Purchases	18,673
Less closing stock	<u>(2648)</u>
Cost of goods sold	<u>(18,166)</u>
Gross profit	6267
Less Expenses	

Heating and lighting	179	
Rent and rates	804	
General expenses	1781	
Salaries	2249	
Provision for depreciation	<u>220</u>	<u>(5233)</u>
Net profit		1034

Statement of financial position as at 31st December 2011

	Cost	Dep	NBV
Fixed Asset	2200	220	1980
<u>Current Assets</u>			
Stock	2648		
Debtors	3388		
Prepays	<u>120</u>		
	6156		
Total Assets			<u>8136</u>
<u>Current Liabilities</u>			
Creditors	1891		
Accruals	42		
Bank overdraft	<u>1030</u>		
	2963		
<u>Equity</u>			
Capital	6608		
Less drawings	(2469)		
Add net profit	<u>1034</u>		
	5173		
Total Capital and liabilities			<u>8136</u>

Accounting principles, concepts and stock valuation

Principles

Accounting convention- concerns the whole accounting process

- Entity: business is separate and distinct identity separate from the owner
- Price measurement : items measured in financial terms
- Historical cost : use of original amount paid for goods, there are exceptions

- Periodicity : accounts are prepared for a set period

Concepts

- Going concern – assume the business will continue trading
- Accruals – recognition of revenues and expenses in set period
- Consistency – items treated similarly from year to year
- Prudence – introduces caution but treats potential income differently to potential liabilities

Policies

Business must describe the accounting policies used to prepare their financial statements. They have a choice of policy such as fixed assets, goodwill, sales and stock valuations.

Inventories

Inventories are owned assets of the company and will fall under the current assets in the balance sheet. They are a result of past transactions of activities and are expected to provide future economic benefits.

Measurement of stock

This can be done by cost or NRV. NRV is selling price less the cost of getting the item ready for sale.

Going concern – the valuation of stock will be done by cost or NRV. It doesn't assume that there will be an enforced sale

Accruals (matching) – by carrying stock forward it ensures the cost or NRV will be matched against income

Costing inventories

- Purchase price includes carriage in
- Direct cost of manufacture together with production overheads

Disclosure of policies

Lower of cost and NRV. But why?

- Specific requirements of accounting standards (SSAP 9) or (ISA 2)
- Long adopted approach
- Cost relatively objective
- Inventory is often a significant item

Implications

If cost is lower than NRV then- stock is valued at cost price to avoid unrealised profits being recorded in the accounts. = profit

If NRV is lower than cost then – stock is valued at NRV so that the expected loss on sale is recorded in current year and stock is not overvalued = loss

For example:

	Cost	Exp SP	Cost to sell	NRV	Lower	Expected
A	100	150	0	150	100	Profit
B	150	160	20	140	140	Loss
C	200	170	50	120	120	Loss
Total	450				360	

Methods of stock valuation

FIFO – this assumes that the purchased items are used first, so closing stock is valued at the latest price

LIFO – this assumes that the latest items are purchased first, so closing stock is valued at the earliest and incurred

AVCO – this is based on the weighted average cost calculated each time stock is recorded

RC (replacement cost) – cost of goods sold is based on cost of replacing stock.

The matching of current revenues with current costs.

Manto example

Jan buys 6 units at £15

Feb sells 4 units at £19

April buys 10 units at £16

June buys 7 units at £17

Nov sells 15 units at £22

Calculate using **FIFO**, **LIFO** and **AVCO**.

FIFO – 23 bought – 19 sold = 4 remaining

4 units x latest price of £17 = £68

Date	Purchases	Sales	FIFO	LIFO	AVCO***
Jan	6 at £15 = £90	----	6 at £15 = £90	6 at £15 = £90	6 at £15 = £90
Feb	----	4 at £19 = £76	6-4 = 2 2 at £15 = £30	2 at £15 = £30	2 at £15 = £30
Apr	10 at £16 = £160	----	2 at £15 = £30 +10 at £16 = £160 = £190	2 at £15 = £30 +10 at £16 = £160 = £190	12 at £15.83 = £190

June	7 at £17 = £119	----	12 = £190 + 7 at £17 = £119 = £309	12 = £190 + 7 at £17 = £119 = £309	19 at £16.26 = £309
Nov	----	15 at £22 = £330	19-15 = 4 4 at £17 = £68	2 at £15 = £30 + 2 at £16 = £32 = £62	4 at £16.26 = £65
Total	£369 for 23 units	£409 for 19 units	4 units left	4 units left	4 units left

AVCO calculations:

$$\text{April} = \frac{2 \text{ at } £15 + 10 \text{ at } £16}{12 \text{ units}} = £15.83 \text{ per unit}$$

$$\text{June} = \frac{12 \text{ at } £15.83 + 7 \text{ at } £17}{37 \text{ units}} = £16.26 \text{ per unit}$$

All of the different methods will give a different effect on profits.