UNIT 10: FINANCIAL ACCOUNTING

LO2: PREPARE FINAL ACCOUNTS FOR SOLE TRADERS,PARTNERSHIPS AND LIMITED COMPANIES IN ACCORDANCE WITH APPROPRIATE PRINCIPLES,CONVENTIONS AND STANDARDS

UNIT 10: FINANCIAL ACCOUNTING

P3: PREPARE FINAL ACCOUNTS FROM GIVEN TRIAL BALANCE FIGURES ADJUSTING FOR ACCURALS,DEPRECIATION AND PREPAYMENTS

FINANCIAL REPORTS

- Financial reporting refers to the communication of financial information, like financial statements, to the financial statement users, like investors and creditors. Financial reporting is typically viewed as companies issuing financial statements.

FINANCIAL REPORTS

- A general purpose set of financial statements include a balance sheet, income statement, statement of owner's equity, and statement of cash flows, but financial reporting is much more broad than just as set of financial statements.

FINANCIAL REPORTS

- Financial reporting includes all financial communication from the business to outside users including press releases, shareholder minutes, management letters and analysis, auditor reports, and even the notes of the financial statements. Basically, anything that can convey financial information to the public is considered financial reporting of some kind.

FINANCIAL STATEMENTS

- Financial statements are prepared to ascertain the profits earned or losses incurred by a business concern during a specified period and also to ascertain its financial position at the end of that specified period.
- Financial statements are generally of two types (a) Income statement which comprises of Trading Account and Profit & Loss Account, and (b) Position Statement i.e., the Balance Sheet.

FINANCIAL STATEMENTS

- Statement of Financial Position: Also known as the Balance Sheet, presents the financial position of an entity at a given date. It is comprised of the following three elements:
- Assets: Something a business owns or controls (e.g. cash, inventory, plant and machinery, etc)
- Liabilities: Something a business owes to someone (e.g. creditors, bank loans, etc)
- Equity: What the business owes to its owners. This represents the amount of capital that remains in the business after its assets are used to pay off its outstanding liabilities. Equity therefore represents the difference between the assets and liabilities.

FINANCIAL STATEMENTS

- **Income Statement:** Also known as the Profit and Loss Statement, reports the company's financial performance in terms of net profit or loss over a specified period. Income Statement is composed of the following two elements:
- Income: What the business has earned over a period (e.g. sales revenue, dividend income, etc)
- Expense: The cost incurred by the business over a period (e.g. salaries and wages, depreciation, rental charges, etc)
- Net profit or loss is arrived by deducting expenses from income.

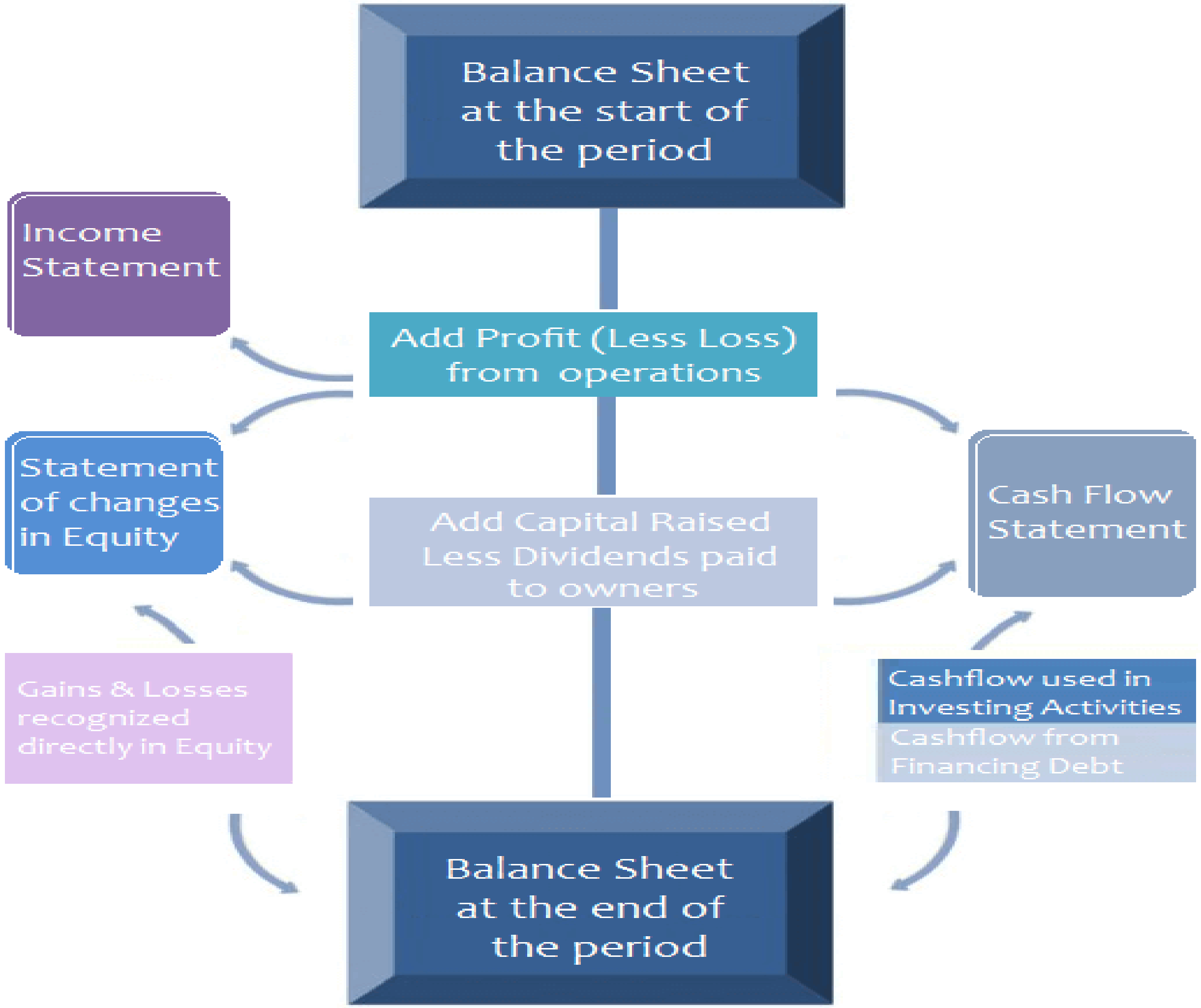
FINANCIAL STATEMENTS

- **Cash Flow Statement,** presents the movement in cash and bank balances over a period. The movement in cash flows is classified into the following segments:
- Operating Activities: Represents the cash flow from primary activities of a business.
- Investing Activities: Represents cash flow from the purchase and sale of assets other than inventories (e.g. purchase of a factory plant)
- Financing Activities: Represents cash flow generated or spent on raising and repaying share capital and debt together with the payments of interest and dividends.

FINANCIAL STATEMENTS

- Statement of Changes in Equity, also known as the Statement of Retained Earnings, details the movement in owners' equity over a period.
- The movement in owners' equity is derived from the following components:
- Net Profit or loss during the period as reported in the income statement
- Share capital issued or repaid during the period
- Dividend payments
- Gains or losses recognized directly in equity (e.g. revaluation surpluses)
- Effects of a change in accounting policy or correction of accounting error.

FINANCIAL STATEMENTS



ADJUSTMENTS ACCURALS

- Accrued expenses are expenses that have been incurred, but not yet paid for. To put it another way, an accrued expense is paid after being recorded on the books. Every adjusting entry for accrued expenses debits an expense account, increasing expenses on the income statement and reducing net income, and credits a payable account, increasing liabilities on the balance sheet.

ADJUSTMENTS ACCURALS

Balance Sheet as at 28 February 20X7

Fixed assets			
Office furniture		2,900	
Less Depreciation		380	2,520
Delivery van		3,750	
Less Depreciation		1,250	2,500
Current assets			5,020
Stock		2,400	
Debtors	12,316		
Less Provision for doubtful debts	496	11,820	
Prepaid expenses		230	
Cash at bank		4,100	
Cash in hand		324	
Less Current liabilities		18,874	
Creditors	5,245		
Expenses owing (340 + 72)	412	5,657	
Net current assets			13,217
			18,237
Financed by:			
Capital			
Balance at 1.3.20X6			11,400
Add Net profit			23,937
			35,337
Less Drawings			17,100
			18,237

ADJUSTMENTS PREPAYMENTS

- Prepaid expenses (a.k.a. prepayments) represent payments made for expenses which have not yet been incurred.
- In other words, these are "advanced payments" by a company for supplies, rent, utilities and others that are still to be consumed. Hence, they are included in the company's assets.
- Because prepayments they are not yet incurred, they are not recorded as expenses. Rather, they are classified as current assets since they are readily available for use.

ADJUSTMENTS PREPAYMENTS

Balance Sheet as at 28 February 20X7

Fixed assets			
Office furniture		2,900	
Less Depreciation		380	2,520
Delivery van		3,750	
Less Depreciation		1,250	2,500
			5,020
Current assets			
Stock		2,400	
Debtors	12,316		
Less Provision for doubtful debts	496	11,820	
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ADJUSTMENTS BAD DEBTS

- With many businesses a large proportion, if not all, of the sales are on credit. The business is therefore taking the risk that some of the customers may never pay for the goods sold to them on credit. This is a normal business risk and such bad debts are a normal business expense. They must be charged to profit and loss as an expense when calculating the profit or loss for the period. The other thing that needs to be done is to remove the bad debt from the asset account.

- Usually, this will mean closing the debtor's account, but not always.
- When a debt is found to be 'bad', the asset as shown by the debt in the debtor's account is worthless. It must be eliminated from the account.
- This is done by crediting the debtor's account to cancel the asset and increasing the expense account of bad debts by debiting it there.

ADJUSTMENTS BAD DEBTS

At 31 December 20X3, the debtors figure after deducting bad debts was £10,000. It is estimated that 2 per cent of debts (i.e. £200) will eventually prove to be bad debts, and it is decided to make a provision for these. The accounts will appear as follows:

Profit and Loss Account (extract) for the year ended 31 December 20X3

	£
Gross profit	xxx
Less Expenses:	
Provision for doubtful debts	(200)

Provision for Doubtful Debts

				£
	20X3			
	Dec	31	Profit and loss	200

In the balance sheet, the balance on the provision for doubtful debts will be deducted from the total of debtors:

Balance Sheet (extract) as at 31 December 20X3

	£	£
Current assets		
Debtors	10,000	
Less Provision for doubtful debts	(200)	
		9,800

ADJUSTMENTS - DEPRECIATION

- Depreciation policies
- Some businesses adopt a policy of charging a full year's depreciation in the year the asset was purchased, and none in the year of its sale. Others take proportionate depreciation for the number of months of ownership of the asset in the year. The first requirement, therefore, is to read the question carefully to find out what has to be done for each non-current asset.

ADJUSTMENTS - DEPRECIATION

- Methods of depreciation
- There are two main methods of depreciation which are tested in the Foundation level exams:
- straight line method – a percentage of cost (or cost less residual value) is charged each year
- reducing balance method – a percentage is charged on the carrying amount (cost less accumulated depreciation to date).

ADJUSTMENTS - DEPRECIATION

A business has just bought a machine for £8,000. It will be kept in use for four years, when it will be disposed of for an estimated amount of £500. The accountant has asked you to prepare a comparison of the amounts charged as depreciation using both methods.

For the straight line method, a figure of (£8,000 − £500) ÷ 4 = £7,500 ÷ 4 = £1,875 per annum is to be used. For the reducing balance method, a percentage figure of 50 per cent will be used.

	Method 1 *Straight Line* £		*Method 2* *Reducing Balance* £
Cost	8,000		8,000
Depreciation: year 1	(1,875)	(50% of £8,000)	(4,000)
	6,125		4,000
Depreciation: year 2	(1,875)	(50% of £4,000)	(2,000)
	4,250		2,000
Depreciation: year 3	(1,875)	(50% of £2,000)	(1,000)
	2,375		1,000
Depreciation: year 4	(1,875)	(50% of £1,000)	(500)
Disposal value	500		500

ADJUSTMENTS - DEPRECIATION

- Statement of profit or loss
- The current year's depreciation charge is calculated and appears as an expense. Do not include the accumulated depreciation. The accumulated depreciation is the total depreciation charged during an asset's life (assuming no revaluation) and as such previous depreciation will have been charged against profits in earlier periods.

ADJUSTMENTS - DEPRECIATION

A business has a financial year end of 31 December. A computer is bought for £2,000 on 1 January 20X5. It is to be depreciated at the rate of 20 per cent using the reducing balance method. The records for the first three years are:

Computer

20X5		£			
Jan 1	Cash	2,000			

Accumulated Provision for Depreciation – Computer

20X5		£	20X5		£
Dec 31	Balance c/d	400	Dec 31	Profit and loss	400
20X6			20X6		
Dec 31	Balance c/d	720	Jan 1	Balance b/d	400
			Dec 31	Profit and loss	320
		720			720
20X7			20X7		
Dec 31	Balance c/d	976	Jan 1	Balance b/d	720
			Dec 31	Profit and loss	256
		976			976
			20X8		
			Jan 1	Balance b/d	976

Profit and Loss Account (extracts) for the year ended 31 December

		£
20X5	Depreciation	400
20X6	Depreciation	320
20X7	Depreciation	256

ADJUSTMENTS - DEPRECIATION

- Statement of financial position
- The statement of financial position shows the cost, accumulated depreciation (the figure in the trial balance brought forward from the end of the previous accounting period, plus the current year's charge from the statement of profit or loss), and the carrying amount. The easiest way to present this is as a table, as follows (figures invented):

ADJUSTMENTS - DEPRECIATION

	Cost $	Accumulated depreciation $	Carrying amount $
Buildings	800,000	80,000	720,000
Plant and equipment	390,000	260,000	130,000
Motor vehicles	210,000	100,000	111,000
	1,400,000	440,000	960,000

π

28.8 The following trial balance was extracted from the books of R Giggs at the close of business on 28 February 20X7.

	Dr £	*Cr* £
Purchases and sales	92,800	157,165
Cash at bank	4,100	
Cash in hand	324	
Capital account 1 March 20X6		11,400
Drawings	17,100	
Office furniture	2,900	
Rent	3,400	
Wages and salaries	31,400	
Discounts	820	160
Debtors and creditors	12,316	5,245
Stock 1 March 20X6	4,120	
Provision for doubtful debts 1 March 20X6		405
Delivery van	3,750	
Van running costs	615	
Bad debts written off	730	
	174,375	174,375

Notes:

(*a*) Stock 28 February 20X7 £2,400.
(*b*) Wages and salaries accrued at 28 February 20X7 £340.
(*c*) Rent prepaid at 28 February 20X7 £230.
(*d*) Van running costs owing at 28 February 20X7 £72.
(*e*) Increase the provision for doubtful debts by £91.
(*f*) Provide for depreciation as follows: Office furniture £380; Delivery van £1,250.

Required:
Draw up the trading and profit and loss account for the year ending 28 February 20X7 together with a balance sheet as on 28 February 20X7.

› Sources: Business Accounting Volume 1

28.8 R Giggs

Trading and Profit and Loss Account for the year ended 28 February 20X7

Sales			157,165
Less Cost of goods sold:			
Opening stock		4,120	
Add Purchases		92,800	
		96,920	
Less Closing stock		2,400	94,520
Gross profit			62,645
Add Discounts received			160
			62,805
Less Expenses:			
Wages and salaries (31,400 + 340)		31,740	
Rent (3,400 – 230)		3,170	
Discounts allowed		820	
Van running costs (615 + 72)		687	
Bad debts		730	
Doubtful debt provision		91	
Depreciation:			
Office furniture	380		
Delivery van	1,250	1,630	38,868
Net profit			23,937

› Sources: Business Accounting Volume 1

Balance Sheet as at 28 February 20X7

Fixed assets			
Office furniture		2,900	
Less Depreciation		380	2,520
Delivery van		3,750	
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Current assets			
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- Sources: Business Accounting Volume 1

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