

Walk-through tour

Chapter 2

Introduction to financial accounting

In the last chapter, we outlined the objectives and purpose of financial accounting in reporting the performance of a business over a set period of time. In this chapter we show how this is done, slowly building the basis of the subject from first principles. We will start with a simple intuitive exercise looking at how a small trader in this case a taxi driver, commenced business, and then reviewed his financial position at the end of his first month trading. From there we will show how accounts are built up using a few simple principles. These principles capture the essence of the subject and with them you will see how the accounts of a larger enterprise are constructed. These principles will also help you create a mental map of the financial accounting process so that by the end of this chapter you will be able to identify how particular business decisions impact upon the financial performance of a business.

Learning objectives

There are five outcomes we hope you can achieve in this chapter. Again we have split the chapter down into learning sections, which are:

The first principles of financial accounting

- That you understand the principles of identity, additivity and matching and their importance in transaction-based accounting.
- That you understand the principal ways of classifying assets and liabilities.
- That you know how assets, liabilities and debts are related through the extended trial balance.
- That you can relate your understanding of the structure of accounts to the balance sheet published by a public limited company.

How to produce a set of simple accounts

- That you can produce, for the first year of a business's operation, from simple transactions:
 - An income statement
 - A cash flow statement
 - A balance sheet

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Introduction Brief overview of chapter with contextual comments linking to previous learning and concepts.

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Review activity 2.2 Go online and find the accounts of Booking at www.booking.com. Navigate to the investor's website and download the latest set of financial accounts. Identify within the annual report first the statement of financial position (the US term for the balance sheet) and identify the sections of the statement which correspond to the headings: current assets; non-current assets; current liabilities; non-current liabilities and owners equity.

In the case exercise below we take a small business start-up and show intuitively how the financial accounting system works.

Creating the balance sheet and income statement – a case exercise

Financial realities Sid Buddle had been made redundant from his job and with the compensation payment he decided to establish a taxi business serving the main streets of Oxford. The town was poorly served by taxi companies and Sid believed there was an opportunity to be taken. His wife,eryl – a lecturer in finance at the local technical college – was not so sure. However, after taking a training course in the local knowledge and obtaining his taxi licence from Oxford City Council, Sid's wife helped him to get a business plan to the bank. Sid had £75,000 available and the bank agreed to lend him £25,000.

Sid paid £50,000 for a new taxi from the London International Taxi Company, carefully printed his Sid's Taxi on the side, filled it with diesel and started to haul the streets of Oxford looking for customers.

Exhibit 2.10 Sid's opening balance sheet

| Exhibit 2.10 Sid's opening balance sheet at the beginning of the first month of operation | | |
|---|--------|-------------------------|
| | £ | |
| Value of the taxi at cost | 50,000 | (Non-current asset) |
| Cash in hand | 5,000 | (Current asset) |
| | 35,000 | |
| Bank loan | 20,000 | (Non-current liability) |
| Sid's capital | 15,000 | (Owners' equity) |
| | 35,000 | |

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Financial realities These problems are fully explored in the text and provide a key component of the learning process.

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Learning objectives These are divided into sections and highlight the expected learning outcomes from each chapter. Success against these learning outcomes is assessed as the chapter proceeds.

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We then rule off and add each of the columns, and the totals form the values to be entered in the opening balance sheet.

- The first series of transactions were conducted during the first month of trading and again we list each transaction as it is undertaken.
- The purchase of diesel initially shows as an asset transaction on cash is spent and diesel received of £150 (decrease cash, increase assets).
- Some of the diesel is recognised as an expense attributable to the process of earning revenue during the month. This is an expense transaction showing the consumption of £150 of diesel (reduce assets, increase expenses). Note that all expenses are negative by definition.
- Rent of £60 is paid in advance, creating a receivable balance (reduce cash, increase receivables). One month's rent is recognised for the month in question (reduce receivables, increase expenses).
- Interest on the loan becomes due (increase current liability, increase expenses) for the month in question and the liability is discharged by a cash payment (decrease cash, decrease current liability).
- Finally, we recognise the revenue that Sid earned during the month with an £800 increase in cash and revenue respectively.

Closing the extended trial balance

Step 1: total the revenue and expense columns or debts and take the difference and transfer it to the owner's equity account. The details in the revenue and expenditure columns form the income statement.

Step 2: total each of the remaining columns, ensuring that the total of the balance on the left of the equal sign equals the values on the right. The columns total on the entry value into your balance sheet.

Step 3: the figures in the cash columns give the details of the cash receipt and expenditure which form the statement of cash flow.

Review activity 2.2 Sid's business during the next month is even better than in the first. Sid purchased a further £200 of diesel and had just filled his taxi with £150 before heading on the last day of the month. He paid a service bill of £240 at the beginning of the month which he believed would keep his taxi in good shape for the next 3 months. He also purchased and installed a GPS navigation system for £150. During the month he collected £1,450 in fares. Prepare an income statement and balance sheet for his second month of business using the extended trial balance approach.

Check the answers to this Review activity at the back of the book (see page 403).

Review activities These short questions allow you to explore the learning you have just undertaken. They also include challenging issues which you may wish to use as the basis of discussion or further reading.

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This principle is specifically referred to in the UK Companies Act (1985) as the non-aggregative principle which views that in determining the aggregate amount of any item the amount for each individual asset or liability should be taken into account as if the determined separately (para 14 Companies Act 1985). However, this all pervasive principle can be challenged. Any business is more than the sum of its parts but rather a combination of resources and facilities put together in a way which creates value. Indeed, the whole process of adding value results from the successful combination of human personality, physical resources and capital to create additional wealth. The additivity principle is therefore a hindrance to undertake the value of the firm in the balance sheet as it ignores the way assets are linked together.

How to produce a set of simple accounts

In this section we will take the extended trial balance and use it to construct a simple set of accounts. Our first example will be to work Sid's accounts described in the previous section. We will then tackle a more substantial problem where we will produce the accounts for the first year of a new business.

Using the extended trial balance

We will now use the extended trial balance to work Sid's example. Our first step is to lay out the full extended trial balance across seven pages on a spreadsheet as in Exhibit 2.15.

The first three transactions are:

1. The introduction of Sid's capital of £15 000. This will be shown as both an increase in owner's equity and cash of £15 000.
2. The loan is shown as an increase in the new business's non-current liabilities and a corresponding increase in cash.
3. The purchase of the first house which differs as it impacts on the asset side only, with a reduction in cash of £20 000 and an increase in non-current assets of the same amount.

Exhibit 2.15 The extended trial balance for the first year of trading

| | NEA | Int | Rev | CL | C | CL | CL | CE | CE | R | E |
|------------------------------|--------|-----|-----|----|--------|----|----|----|----|--------|--------|
| (1) Introduction of capital | 15 000 | | | | | | | | | 15 000 | |
| (2) Loan from bank | | | | | 20 000 | | | | | | 20 000 |
| (3) Purchase of first house | | | | | 30 000 | | | | | | |
| Opening balance sheet | 30 000 | | | | 5 000 | | | | | 20 000 | 15 000 |
| (4) Purchase of second house | | | | | 150 | | | | | | |
| (5) Cash used in month | | | | | 100 | | | | | | 100 |
| (6) Rent for garage | | | | | 60 | | | | | | 60 |
| Rent charged to month | | | | | 10 | | | | | | 10 |
| (7) Interest on loan | | | | | 100 | | | | | | 100 |
| Interest paid | | | | | 100 | | | | | | 100 |
| (8) Cash from first house | | | | | 800 | | | | | | 800 |
| Profit for the period | | | | | | | | | | 585 | 585 |
| Closing balance sheet | 30 000 | | | | 5 400 | | | | | 20 585 | 15 585 |

Exhibits These give a visual representation of key concepts or data. Look for 'Post-its' to guide you through the more complex analysis on spreadsheet exhibits.

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Questions

The answers to the questions followed by 'C' can be found at the back of the book, the answers to the remaining questions can be found on the website accompanying this book: www.cengage.co.uk/walkthrough.

1. Mr Slippy has left you a list of balances with outcashes to prepare a balance sheet and income statement in standard UK format. He has left you with no further instructions.
- | | |
|--------------------------------|---------|
| Accumulated depreciation | 425 000 |
| Administrative expenses | 43 000 |
| Cash | 6 400 |
| Corporation tax | 16 800 |
| Cost of sales | 144 000 |
| Current liabilities | 20 000 |
| Debtors | 67 000 |
| Dividends paid | 11 500 |
| Fixed assets | 240 000 |
| Interest paid | 5 700 |
| Long-term liabilities | 73 500 |
| Owner's equity | 50 000 |
| Sales turnover | 395 500 |
| Selling and distribution costs | 26 700 |
| Stocks | 45 000 |

Using the balance sheet and income statements derived from the above figures and given the following information:

- the operating cash flow for the year was 805 000
- fixed assets were purchased for £35 000
- last year's tax was paid of £35 500

Produce a cash flow statement and explain why operating profit and cash flow might not be different.

2. On the basis of the information produced for the Far Eastern Company in Chapter 3, produce a cash flow statement for the year in question.

3. Gravelly Builders Ltd has the following income statement balance sheet and notes for the year ended 31 December 2026.

| | |
|---|-----------|
| Income statement for the year ended 31 December | |
| Turnover | 6945 000 |
| Cost of sales | 2 500 000 |
| Gross profit | 6 844 600 |
| Other operating costs | 4 330 100 |
| Operating profit | 2 484 500 |
| Interest payable | 65 000 |
| Profit before tax | 2 420 500 |
| Tax | 1 203 275 |
| Distributable profit | 1 336 225 |
| Dividends payable | 240 000 |
| Profit retained | 1 096 225 |
| | 1 336 225 |

Questions The questions are designed to test your achievement of the learning objectives specified at the beginning of each chapter. Each question should take between 30 and 45 minutes to complete.

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Chapter summary

In this chapter we have explored the basic mechanics of financial accounting. The extended trial balance provides you with a single model of the financial structure of any business. Using this structure of a business you should be able to identify how transactions will impact upon the income statement and balance sheet. You should also have gained some familiarity with the component parts of a balance sheet in the next chapter we will develop your skills in financial reporting based upon what you have now accomplished.

Further reading

Arnold, J., Hope, A., Southworth, A. and Kilham, L. (1994) *Financial Accounting*, London: Prentice Hall. This is an excellent book with which to develop your understanding of the theory of accounting using an early version of the extended trial balance approach.

ARL, P. and Midway, E. (2002) *Financial Accounting for Non-specialists*, 2nd edn, Harlow: Financial Times, Prentice Hall. A very straightforward text which does not use the extended trial balance approach but focuses on adjustments to the final accounts. A useful secondary source to the present book.

Ellis, B. and Ellis, A. (2005) *Financial Accounting and Reporting*, Harlow: Financial Times, Prentice Hall. This is one of the best books on financial reporting and you will find that Chapters 1 and 2 give a good introduction to cash-based and accrual-based accounting. Note, however, that the conceptual approach to the subject is not as shown in this book.

Franks, A. and Schipper, K. (1988) Have financial statements lost their relevance? *Journal of Accounting Research* 26(2):310. A serious article in one of the top research journals to get you thinking.

Hopson, A. (2002) *Corporate Financial Reporting: Theory and Practice*, London: Sage. An excellent text to develop your skills and general knowledge of the problems of financial reporting. Try the first three chapters.

Jones, B. and Rees, S. (2000) *Financial Reporting Standard for smaller entities – a fundamental or cosmetic change*, ACCA Occasional Research Paper No 30, Certified Accountants Educational Trust London 2000. An interesting article if you are interested in the problems of accounting for small businesses with an excellent review of the relevant literature.

Progress check

These questions are designed to test your comprehension of the subject matter of this chapter. They are straightforward, so if you do not know the answer you should return to the page referenced and refresh your understanding.

1. The terms *real*, *intangible* and *monetary* all relate to a particular accounting concept. What is it? (p 35)
2. How are non-current assets classified from one another? (p 35)
3. List four different types of current asset. (p 35)
4. In the absence of any new capital introduced, or any withdrawal of capital by the owner, what will cause the balance on the owners equity account to change from year to year? (p 37)

Progress check At the end of each chapter there are a dozen or more brief questions which are designed to test your knowledge of the content of the chapter. These are very useful for bringing the subject together and preparing you to undertake the more substantial questions that follow.

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liabilities were £22 000. Whether his loan nor his situated capital changed during the year, how much profit did he make during the year?

4. The accounting year end was the 31 December. On 1 November Sid paid £5000 for a square year rent advance and £8000 on a twelve lease, in advance. How much would be shown in his income statement for the year to 31 December in each case and how much in the balance sheet?

Case exercises

1. Locate and print out the latest published financial report from www.cobham.co.uk.
 - (a) Compare the current and prior year figures in the balance sheet and income statement, noting the magnitude of changes and their significance to the company.
 - (b) Compare and contrast the figures in the current years income statement and balance sheet with the figures for 2005 shown in the text.
 - (c) Using an information service such as *Fincom* or *Reuters.com* search for the most recent financial news about the company and in particular any items commenting upon the financial performance of the company for the year you have downloaded.
2. Locate and print out the most recent accounts of Matala & Spencer plc from the www.investorcentre.co.uk website for comparison with the accounts of Cobham plc. Read the balance sheets of the two companies side by side and, using the notes to the accounts, compare them.
 - a. Are there entries in one balance sheet that we do not see in the other?
 - b. Where is the manufacturing aspect of Cobham's business revealed in its balance sheet?
 - c. Where is the merchant aspect of Matala & Spencer's business revealed in its balance sheet?
 - d. What percentage of the total assets fixed and current of both companies are fixed and what is the likely reason for the difference between them?
 - e. For both companies: what proportion of the cash inflow during the accounting year came from operating activities?

Case exercises These are much more substantial pieces of work which will allow you to explore, using current materials and data, the methods and concepts in the text.