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Introduction to Finance
Topic 5:
Current Assets

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Current Assets Lecture 5 - 6.4

Current Asset

- Refresh your understanding of the definition of an asset from Unit 2.
- A current asset defined as:
 - expected to be realised in the entity's normal operating cycle
 - held primarily for the purpose of trading
 - expected to be realised within 12 months after the reporting period
 - cash and cash equivalents (unless restricted).
 - All other assets are non-current. [IAS 1.66]

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Learning Objectives for Unit 5

After completing this unit students will be able to:

- Define current assets and identify typical examples
- Explain the concept of receivables and the accounting processes for irrecoverable debts and allowances for receivables
- Explain how prepayments arise
- Define and discuss the nature of working capital
- Identify the categories of inventory and discuss the different approaches to cost issues to production

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Current Asset: Examples

- Inventories (stocks):
 - Materials for manufacture
 - Work in progress
 - Finished goods
- Trade receivables (debtors)
- Cash in hand and at bank

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Introduction to Lecture 5

In this lecture we will look at current assets. In particular we will consider:

- Working capital
 - Inventories (stocks)
 - Receivables (debtors)
 - Cash
 - Bank
 - Prepayments
- Accounting for cost of inventories

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Current or Non-Current Asset?

- It is partly the reason for holding an asset that dictates whether it is treated as non-current or current
- For example, The Vehicle Supply Company sells commercial delivery vehicles to local industry
- The vehicles they have for sale are their trading stock and thus current assets
- However, company vehicles such as sales-representative's car, the CEO's car and the recovery vehicle are not held for the purpose of being traded and are treated as non-current assets



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Receivables (Debtors)

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- Goods sold on credit are paid for at a later date; until that time the amount owing is recorded as receivables or debtors, a current asset
- The sale has been recorded as made and therefore the profit calculated in the income statement






Recording in the Financial Statement - examples

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A company has trade receivables of £13,000. Stage 1 - £1,000 is considered irrecoverable and Stage 2 - the allowance is increased from £700 to £1,200



Stage 1 - Irrecoverable debt		Stage 2 - Allowance for receivables	
<i>Income Statement</i>	£	<i>Income Statement</i>	£
Expenses		Expenses	
Irrecoverable debt	1,000	Irrecoverable debt	1,000
		Increase in allowance for receivables	500
<i>Statement of Financial Position</i>		<i>Statement of Financial Position</i>	
	£		£
Current Assets		Current Assets	
Trade receivables	12,000	Trade receivables	11,500

Irrecoverable Debts

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- If it is not possible to obtain payment from a customer the profit has not been made and the income statement requires adjustment
- This is done by writing-off the debt as an expense to the income statement thus also reducing ownership interest






Prepayments

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Example: Aung Yee pays insurance premiums annually at the end of June; half way through the financial year.

- Thus, every year half of the insurance premiums paid are to cover the first half of the next year
- Under the accruals concept, the unconsumed element of the expense is shown as a current asset and consumed in the next year

Allowance for Receivables

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- Managers may adopt a prudent approach in assuming that not all customers will pay outstanding debts, without necessarily knowing which ones
- These debts are not written-off but a 'provision' is made in the accounts of, say, 1% of debtors to allow for this possibility. The debt is still pursued
- This expense is charged to the income statement, serving to reduce profit and ownership interest
- In future years, it is only the change in the provision that appears on the income statement
- Also known as provision for doubtful debts








Illustration of Prepaid Insurance

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Assuming the insurance premium of £2,000 is paid on 30 June Year 1 covering the period from 1 July Year 1 to 30 June Year 2 and this is increased in the next year by 10%.

Statement of Financial Position at 31 December Year 1		Statement of Financial Position at 31 December Year 2	
Current Assets	£	Current Assets	£
Prepaid Insurance	1,000	Prepaid Insurance	1,100






Working Capital

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“The capital available for conducting the day-to-day operations of an organisation; normally the excess of current assets over current liabilities.”



(CIMA, 2005 p.82)

Inventories (Stocks)


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- Valued at the lower of cost or net realisable value (IAS 2.9)
- 'Cost' includes those incurred in bringing the stocks to their current condition and location such as taxes and transport
- The value of raw materials may fall. For example, the international price of copper may fall, affecting the value of copper tubing in store at a builder's merchant
- If the fall in price drops below cost, inventory is valued at net realisable value which is the estimated selling price less the costs of selling the inventory
- This is not necessarily a problem in-year but may require an end of year adjustment for the financial statements

Working Capital: Transaction Cycle

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Issue to Production

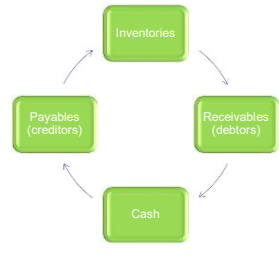
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- Inevitably suppliers prices change
- Inventories may be held that have been acquired at different times and prices
- They may be issued to production at
 - First-in-first-out (FIFO)
 - Average cost (AVCO)
 - This necessitates a detailed stock record of receipts and issues

Working Capital: Accounting (Value) Cycle

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Inventory Issue Cost

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Consider the stock record on the next slide.

- What would the issue cost be under
 - FIFO?
 - average cost (AVCO) methods?

Stock Record

Date	Received	Unit price	Price paid	Issued to production
	Units	£	£	Units
1 May	100	2.00	200	
5 May	200	2.10	420	
10 May	100	2.20	220	
15 May	150	2.30	345	
21 May				250

Perpetual inventory records

The calculations in the previous slide were made for the entire period. If more movements take place, a perpetual method, reflecting the changes of inventory values after each issue.

Issue Cost: FIFO

The first goods purchases are sold first.

- 100 at £2.00 each = £200
- 150 at £2.10 each = £315
- Total cost to production = £515

• The remaining inventory has a cost of:
 $50 \times £2.10 + 100 \times £2.20 + 150 \times £2.30 = £670$

Illustration of Average Cost (Perpetual)

Date	Receipt quantity	Price per unit £	Total £	Issue quantity	Cost per unit £	Total Cost £	Balance quantity	Total Value £
1 Jan	10	10	100				10	100.00
4 Jan	20	12	240				30	340.00
7 Jan				12	11.33	135.96	18	204.04
10 Jan	20	13	260				38	464.04

Issue Cost: Average Cost

Average cost calculation:

- Received 550 units; total cost £1,185
- Average cost therefore = £2.155 each

Total cost to production =

- 250 units at £2.155 each = £538.75
- Or, more accurately without rounding £538.64 ($1,185/550 \times 250$) but that is still not precise!

Words You Should Know



- Bad debts – a debt owed by a customer written-off as irrecoverable
- Provision for doubtful debts – a reduction in profit to allow for the likelihood that not all customers will pay due amounts
- Inventories – stocks of materials for manufacture, work in progress and finished goods
- Prepayments – a payment made in advance of consumption of the expense
- Receivables (debtors) – amounts owing to the business for goods or services provided
- Working capital – see earlier slide

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Summary

In this lecture we have looked at:



- Types of current asset
- Receivables (debtors)
 - Irrecoverable receivables and allowance for receivables
- Prepayments
- Working capital
- Inventories (stocks)
 - Issue cost to production FIFO and Average Cost

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References

- CIMA. (2005) *Management Accounting: Official Terminology*. London: Chartered Institute of Management Accountants.
- IAS 1 Presentation of Financial Statements. London: International Accounting Standards Board
- IAS 2 Inventories. London: International Accounting Standards Board

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Lecture 5

Any Questions?

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