Chapter 14
Company Accounts

10-15 questions

3. Financial Statements: Regulatory Framework

Companies Act 2006 (CA06)

- Balance sheet
- Income statement
- Director's report
- Auditor's report

Accounting standards

- IAS/IFRS – to achieve transparent and comparable financial statements to global accounting standards
- Cash flow statements (IAS 7)

UKLA listing rules

3. Financial Statements: Regulatory Framework

The auditor's report

The auditor reports to shareholders whether the accounts:

- Are properly prepared
- Give a true and fair view

If one of these conditions is not met the auditor will 'qualify' the report

- Limitation of scope
- Disagreement

These qualifications are then subdivided into:

- Fundamental
- Material

4. Balance Sheet

Balance sheet: purpose

The balance sheet shows the condition of the company as at the balance sheet date.

Company's accounting period

It is composed of two halves:

- Total assets = Capital and reserves + Liabilities

It is compiled in compliance with the accruals principle.

Hints

The Accounting Equation

The balance sheet leads to the accounting equation

Assets = Equity + Liabilities

Or

Non-current assets + Current assets = Capital + Reserves + Liabilities

4. Balance Sheet

Top half

XYZ plc

Balance Sheet as at 31 March 20X2

	20X2 £'000
ASSETS	
Non-current assets	
• Intangible	275
• Tangible (at NBV)	59,628
• Investments	726
Total non-current assets	**60,629**
Current assets	
• Inventories	41,121
• Trade receivables	9,235
• Other current assets	
◦ Prepayments	1,101
• Cash and cash equivalents	8,972
Total current assets	**60,429**
TOTAL ASSETS	**121,058**

4. Balance Sheet

Bottom half

EQUITY AND LIABILITIES	
Capital and reserves	
• Share capital	11,365
• Share premium	20,340
• Revaluation reserve	14,216
• Retained earnings	20,976
Total equity	**66,897**
Liabilities	
Non-current liabilities	
• Long-term borrowings	23,846
• Deferred tax	1,848
• Long-term provisions	3,230
Total non-current liabilities	28,924
Current liabilities	
• Trade and other payables	
• Trade payables	22,778
• Accruals	1,568
• Short-term borrowings	891
Total current liabilities	25,237
Total liabilities	54,161
TOTAL EQUITY AND LIABILITIES	**121,058**

4. Balance Sheet

- Non-current assets
  - Typically assets intended to be kept for greater than one year.
- Intangible non-current assets:
  - Expected to generate future revenue but have no physical substance
    - Goodwill
    - Brand name
    - Patents
- Tangible non-current assets:
  - Expected to generate future revenue and have physical substance
    - Land and property
    - Plant and machinery
    - Valued at net book value (NBV)
- Non-current asset investments:
  - Generally shares in other companies intended to be held for greater than one year

4. Balance Sheet

Current assets

- Assets held for conversion into cash
- Inventory
    - Raw materials
    - Work in progress
    - Finished goods
- Receivables
    - The amount the company is owed on the balance sheet date
        - Trade receivables
- Cash

Hints

Inventory is valued prudently at the lower of cost and net realisable value.

4. Balance Sheet

Share capital and share premium account

- Share capital
  - Nominal value of total shares in issue
- Share premium
  - Any excess above the nominal value raised on issue

Alterations in share capital

- Any adjustment to the issued shares affects these accounts, e.g.:
  - Issue of new shares
    - Share capital increases
    - Share premium increases
  - Bonus/scrip issue
    - Share capital increases
    - Share premium decreases
  - Stock splits/consolidations
    - No change to share capital or premium

4. Balance Sheet

Reserves

- The amount belonging to shareholders that is retained by the company.

- Revaluation reserve
  - Represents the cumulative amount by which non-current asset values have increased

- Profit and loss reserve
  - Running total of retained earnings

4. Balance Sheet

Liabilities

- Current liabilities
  - Amount owed by the company and due for payment within one year
    - Trade creditors
    - Accruals
      - Expenses not yet invoiced
- Long-term liabilities
  - Amount owed by the company and due for payment after one year
    - Long-term bank loans
    - Bonds issued by the company
- Provisions for liabilities
  - Amount recognised by the company that may become a liability or charge
    - Deferred tax
    - Doubtful debt
- Contingent liabilities
  - Uncertain liabilities
  - Disclosed in a note to accounts not on the balance sheet itself

5. Balance Sheet: Further Issues

Depreciation

- Tangible non-current assets recorded on balance sheet at net book value (NBV)

  NBV = Cost - Accumulated depreciation

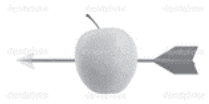
- Freehold land not depreciated
- Annual depreciation charge straight line method

$$\frac{\text{Cost of asset - Residual value of asset}}{\text{Useful life of asset}} = \text{Annual depreciation charge}$$

Keeping on target

A machine has been purchased for £150,000. It is expected to have a useful life of 5 years and a resale value of £15,000. What would be the net book value at the start of year 3 using the straight line depreciation method?

A. £140,000
B. £103,000
C. £96,000
D. £69,000



5. Balance Sheet: Further Issues

Depreciation

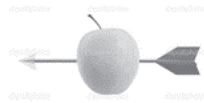
- Annual depreciation charge reducing balance method

$$\text{Depreciation charge} = 1 - \sqrt[n]{\left(\frac{\text{expected residual value}}{\text{Original cost}}\right)}$$

Keeping on target

A machine has been purchased for £150,000 which is expected to have a useful life of 5 years and a resale value of £15,000. What would be closest to the net book value at the end of year 3 using the reducing balance depreciation method?

A. £140,370
B. £69.000
C. £37,507
D. £7,598



Answer to the question on the previous slide:

C

$$\text{Annual Depreciation} = \frac{£150{,}000 - £15{,}000}{5 years} = £27{,}000$$

NBV after 2 years = £150,000 - (£27,000x2) = £96,000

Note : This is at the start of year 3(end of year 2).

5. Balance Sheet: Further Issues

Valuation of inventory

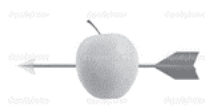
Actual cost not always possible, instead a cost flow assumption will be used:

- Weighted average
  - Inventory drawn proportionally
- First in first out (FIFO)
  - Old inventory assumed to be used first
- Last in first out (LIFO)
  - New inventory assumed to be used first

Keeping on target

A company buys the following stock: 18 October - 300 kg @ £4/kg, 20 November - 200 kg @ £5/kg. In December, 250 kgs were sold for £2,500. What is the value of the remaining stock using FIFO, LIFO and Weighted average?

A. £1200, £900, £1100
B. £1100, £800, £900
C. £1300, £9000, £1000
D. £1200, £1000, £1100



Further information

IAS 2 does not permit the use of LIFO since, in times of rising prices, as the balance sheet value of closing stock will be that of the stock first purchased and will, therefore, not resemble current prices. It also produces the lowest reported profit figure of the three bases.

Answer to the question on the previous slide:

C

$$\text{Annual rate of depreciation} = 1 - \sqrt[5]{\frac{£15{,}000}{£150{,}000}} = 0.37 \text{ (or } 37\%)$$

$$\text{Annual residual value} = 1 - 0.37 = 0.63 \text{ (or } 63\%)$$

NBV of asset at end of year 3

$$£150{,}000 \times 0.63^3 = £37{,}507.05$$

6. Income Statement

Income statement: Example

XYZ plc.

Income statement for the year ended

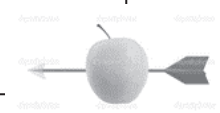
31 March 20X2

	Discontinued operations 20X2 £000	Continuing operations 20X2 £000	Total 20X2 £000
Turnover	988	60,403	61,391
Cost of sales	(896)	(40,691)	(41,587)
Gross profit	92	19,712	19,804
Distribution	(47)	(4,610)	(4,657)
Administration	(40)	(4,005)	(4,045)
Operating profit	5	11,097	11,102
Material items	(77)		(77)
Net interest payable			(300)
Profit before tax			10,725
Tax charge			(1,901)
Net Income			8,824

Keeping on target

A company has sales of £100m, pays dividends of £2m, has costs of £40m and a tax rate of 23%. The retained income would be:

A. £44m
B. £44.2m
C. £44.6m
D. £46.2m



Answer to the question on the previous slide:

D

$$FIFO = 50x£4 + 200x£5 = £1{,}200$$

$$LIFO = 250x£4 = £1{,}000$$

$$\text{Weighted average} = \left[\frac{(300x£4 + 200x£5)}{(200 + 300)}\right] x250 = £1{,}100$$

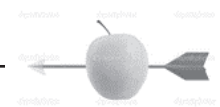
6. Income Statement

- Turnover
  - Income generated by a company from selling its goods and services
  - Recognised at point of sale
  - Recognition can be apportioned over several accounting periods for long-term contracts
- Cost of sales
  - Costs directly associated with the cost of producing a product or service
- Other operating costs
- More general costs of running a business
  - Selling and distribution
  - Administrative expenses
- Operating profits
  - Profit before interest and tax (PBIT)

Keeping on target

A company undertakes a three year project. The project will incur an upfront cost of £9,000 and will generate an income of £4,000 in the first year and in each of the two following years, generating a total revenue of £12,000 over the three years. What is the company likely to reflect on the income statement at the end of the first year?

A. £5,000 loss
B. £3,000 loss
C. £1,000 profit
D. £3,000 profit



Answer to the question on the previous slide:

B

£100m - £40m = £60m earnings before tax
£60m x 0.23 = £13.8m tax
£60m - £13.8m = £46.2m net income
£46.2m - £2m = £44.2m retained income

6. Income Statement

Material items

- Within the ordinary activities of a company
- Require separate disclosure

For example:

- Redundancy
- Large bad debt
- Law suits

Answer to the question on the previous slide:

C

The cost of £9,000 can be apportioned over the life of the project, so £3,000 per year. If the income generated is £4,000, this makes a profit of £1,000 at the end of each year.

8. Cash Flow Statement

Cash flow: Example

XYZ plc.

Cash Flow Statement for the Year Ended 20X2

	20X2 £'000
Operating activities	
Cash receipts from customers	X
Cash paid to suppliers and employees	(X)
Income taxes paid	(X)
Net cash from operating activities	X
Investing activities	
Interest received	X
Dividends received	X
Proceeds on disposal of non-current assets	X
Purchases of non-current assets	(X)
Net cash used in investing activities	(X)
Financing activities	
Equity dividends paid	(X)
Repayment of debt	(X)
Proceeds on issue of bonds or equities	X
Bank loans raised	X
Increase/(decrease) in bank overdrafts	X
Net cash from financing activities	X
Net increase/(decrease) in cash and cash equivalents	X

9. Cash Flow Statement: Further Issues

Reconciling net cash flow from operating activities with operating profits:

- Depreciation charges: add to trading profit
- Increase to general provisions: add to trading profit
- Increase/decrease in stocks: deduct from/add to trading profit
- Increase/decrease in debtors: deduct from/add to trading profit
- Increase/decrease in creditors: add to/deduct from trading profit

Keeping on target

A company makes an operating loss of £13m. Their inventory decreased by £2m and their trade receivables and payables increased by £1m each.

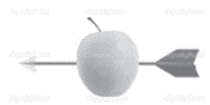
Based on this information alone, what is the net cash flow?

A. -£9m

B. -£11m

C. -£13m

D. -£15m



8. Cash Flow Statement

Free cash flow

- Surplus cash once all compulsory payments have been made.
- Enterprise cash flow (free cash flow to the firm)
  - Comparable cash flow irrespective of capital structure
- FCFF =
  - Net cash flow from operating activities
  - **Minus** essential capital expenditure
  - **Plus** net interest payments
- Equity cash flow (free cash flow to equity)
  - Excludes cash owed to lenders
- FCFE =
  - Net cash flow from operating activities
  - **Minus** essential capital expenditure
  - **Minus** preference dividends
  - **Minus** cash spent of debt and preference share redemption
  - **Plus** cash raised through borrowing and issuance of preference shares

Answer to the question on the previous slide:

B

The reduction in inventory would have been charged as a revenue expense to profits, but was not a cash outflow, so this can be added back to the -£13m giving -£11m.

The trade receivables and payables cancel each other out

Operating loss - £13m

+ Reduction in inventory + £2m

- Increase in trade rec. -£1m

+ Increase in trade payables + £1m

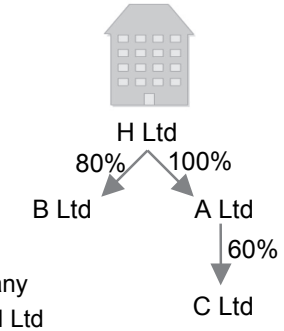
Net cash flow = -£11m

10. Group Accounts

Introduction

- Group = Parent company + Subsidiaries
- Accounts: one for each member of the group and one for the group itself

The group consists of:



- H Ltd – Holding company
- A Ltd – Subsidiary of H Ltd
- B Ltd – Subsidiary of H Ltd (20% minority interest)
- C Ltd – Indirect subsidiary of H Ltd (40% minority interest)

Further information

A subsidiary company is created when share ownership lies above 50%. The parent would need to create consolidated group accounts.

Non-current investments would include investment in an associate company. An associate company is created when share ownership lies between 20% to 50%.

10. Group Accounts

Minority interests

Consolidating the accounts if the subsidiary is not entirely owned:

- 100% of the assets, liabilities, revenues and expenses of the subsidiary added
- Minority interest in shareholders' funds on Balance Sheet
- Minority interest in Income Statement after tax

Goodwill

Goodwill is the difference between what was paid for a subsidiary and its net asset value at the time of purchase.